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Financial stability challenges in EU candidate and potential candidate countries

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Contents

Abstract

This paper reviews financial stability challenges in countries preparing for EU membership, i.e. Albania, Bosnia and Herzegovina, Kosovo*, Iceland, the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey. The paper has been prepared by an expert group of staff from the European System of Central Banks (ESCB) in which experts from EU candidate and potential candidate country central banks also participated. The paper finds that near-term challenges to financial stability primarily relate to credit risks from the generally weak economic dynamics in combination with already high non-performing loan burdens in many banking systems, especially in the Western Balkans. In the medium-term, challenges to financial stability stem from indirect market risks to banks related to foreign currency lending as well as lingering exposures to funding risks, with Western Balkan economies again appearing as relatively more vulnerable. Looking further ahead, the paper highlights that the magnitude of the challenge to reach a 'new banking normal' for banking systems in these countries appears to remain sizeable, while noting that the establishment of adequate home-host cooperation channels would be important to help maximise the potential benefits to third parties stemming from centralised banking supervision under the Single Supervisory Mechanism (SSM).

JEL code: F31, F34, F36, F41, G21, G28.

Keywords: Europe, banking sector, emerging markets, deleveraging, foreign exchange lending, banking union, cross-border flows.

* This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence.

Executive summary

Banking systems in EU candidate and potential candidate countries continue to face a number of challenges to financial stability in both the short-term and medium-term. The near-term challenges primarily relate to credit risks stemming from the generally weak economic dynamics in combination with already high non-performing loan burdens in many banking systems, especially in the Western Balkans. Notwithstanding sizeable cross-country heterogeneity, Albania, Serbia and Montenegro appear as particularly vulnerable in this regard. Although still showing positive credit trends, the continued increase of non-performing loans in both Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia also gives cause for concern. If the projected recovery in economic activity turned out to be more protracted than currently anticipated as a result of domestic factors or renewed external headwinds, this would exacerbate such vulnerabilities. Bottlenecks to the bank lending channel resulting from weak asset quality are not only of concern from a financial stability point of view, but also from the perspective of monetary policy and ultimately economic growth. Taken together, this implies that removing impairments to bank balance sheets which may be standing in the way of enhanced credit extension should remain a key near-term policy priority for authorities in most Western Balkan economies.

While short-term credit risks have tilted to the downside during the period under review, the continued trend towards increased reliance on local sources of finance (notably domestic deposits) coupled with the moderation of parent bank deleveraging has dampened bank funding vulnerabilities. However, loan-to-deposit ratios remain very high in the cases of Bosnia and Herzegovina and Montenegro, implying lingering funding risks. Iceland and Turkey are outliers to the trends depicted above characterising much of the Western Balkans, each exhibiting their own country-specific traits. In Iceland, the main risks to financial stability continue to stem from the legacy of the 2008 crisis and the potential implications of the lifting of capital controls. In Turkey, the key challenge going forward is to achieve a ‘soft landing’ as regards the pace of credit extension, while containing risks stemming from increased reliance on external funding amid a changing international environment.

In the medium-term, the key challenges to financial stability in EU candidate and potential candidate countries relate to indirect market and funding risks, especially in Western Balkan economies. With regard to market risk, indirect vulnerabilities posed by widespread foreign exchange-denominated or -indexed lending remain a structural weakness in many cases which may materialise through unhedged borrowers in the event of nominal exchange rate depreciations/devaluations. This is especially an issue for Serbia, Albania, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia, albeit to varying degrees and notwithstanding considerable differences in underlying monetary and exchange rate policy frameworks. This suggests that active policies to increase the use of local currencies should be pursued both to reduce financial stability risks and to afford greater degrees of policy freedom to monetary authorities. As regards funding risk, the extent to which ‘forced’ deleveraging may materialise in the period ahead remains open.

This could either imply outright divestments of locally systemic entities if these are sold, or less supportive parent bank finance to domestic economies in the event that local resources are insufficient to meet credit demand once this picks up in a durable manner.

More broadly, the magnitude of the challenge to reach a 'new banking normal' – a new status quo – for banking systems in EU candidate and potential candidate countries appears to remain sizeable. On the lending side, the above-mentioned challenges to asset quality in some cases hamper increased financial intermediation. Concerning funding, the trend substitution of external for domestic sources of finance has been encouraging, but the potential of domestic deposits to fully offset the reduction in foreign funding when credit demand picks up remains an open issue. Furthermore, while the increased reliance on local deposits should be ex ante associated with greater stability in bank funding patterns, this could also accentuate maturity mismatches in bank balance sheets. The development of domestic capital markets to provide stable and longer-term funding alternatives is thus key to mitigating potential shortcomings in this context. As regards profitability, pressure has generally remained high in the period under review, with provisioning for bad loans denting banks' net income. Banks in several countries have tried to make-up for this shortfall by increasing their exposure to the public sector, which has had a limited impact on bank profitability. The growing exposures in this regard do not appear to constitute a near-term financial stability risk as their initial level is very low in most cases. However, holdings of national and foreign government bonds account for a significant share of total bank assets in Turkey and Albania, implying that local banking systems are exposed to potential sovereign shocks.

EU candidate and potential candidate countries will also be affected by the establishment of the main pillars of the European Banking Union, a key element of which will be centralised supervision under the Single Supervisory Mechanism (SSM). This will be a significant change in the supervisory landscape of EU candidate and potential candidate countries in the Western Balkans, as nearly 60% of total bank assets in these countries are expected to fall under direct ECB home supervision from a consolidated point of view. The establishment of the SSM could bring a number of benefits for EU candidate and potential candidate countries. These include increasing financial stability in those countries which are home to key parent banking groups, a simplification of home-host supervisory relationships and possibly a reduction in 'home bias' by home country authorities and the achievement of a more level playing field for banks. At the same time, host authorities in EU candidate and potential candidate countries have expressed some concerns which mainly stem from an asymmetry between the relevance of subsidiaries of euro area-headquartered banks for host countries on the one hand and for the parent banking group on the other. These concerns could be addressed by establishing adequate channels for communication and cooperation between home and host authorities under the new system.

1 Introduction

In cooperation with financial stability experts from national central banks of the European System of Central Banks (ESCB) and under the auspices of the International Relations Committee, the ECB staff have in recent years provided reports on financial stability challenges in countries preparing for membership of the European Union (EU). These reports, which have focused on countries with a ‘candidate’ status, have been produced biennially since 2003 and published since 2006 in the ECB Occasional Paper Series[1].

In light of the continued high interest in financial stability issues in countries with close real and financial links to both the euro area and the EU, the coverage has been extended to EU potential candidates, given the common features and challenges to financial stability across countries.

The remainder of this paper is structured as follows. Chapter 2 provides an overview of the key financial stability challenges in EU candidate and potential candidate countries, structured around horizontal topics. Chapter 3 discusses recent changes to bank lending, funding and profitability in EU candidate and potential candidate countries in order to help gauge the extent to which the move towards ‘a new banking normal’ to substitute the pre-crisis model has progressed. Chapter 4 analyses the potential implications of the Single Supervisory Mechanism (entailing centralised supervision of European banking groups) on EU candidate and potential candidate countries, focusing on conceptual and practical aspects. Country-specific assessments detailing the salient challenges to financial stability are provided in an annex.

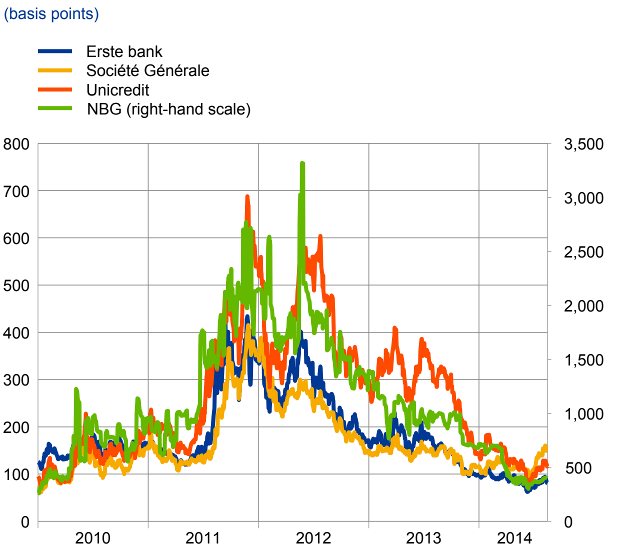
[1] See ESCB International Relations Committee Expert Group (2006), “Macroeconomic and financial stability challenges for acceding and candidate countries”, ECB Occasional Paper, No. 48, available at http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp48.pdf ESCB International Relations Committee Expert Group (2008), “Financial stability challenges in candidate countries: managing the transition to deeper and more market-oriented financial systems”, ECB Occasional Paper, No. 95, available at http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp95.pdf ESCB International Relations Committee Expert Group (2010), “Financial stability challenges in EU candidate countries: financial systems in the aftermath of the global crisis”, ECB Occasional Paper, No. 115, available at http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp115.pdf ESCB International Relations Committee Expert Group (2012), “Financial stability challenges for EU acceding and candidate countries: making financial systems more resilient in a challenging environment”, ECB Occasional Paper, No. 136, https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp136.pdf

2 Key financial stability challenges in EU candidate and potential candidate countries

2.1 Funding conditions for parent banks have eased in recent months

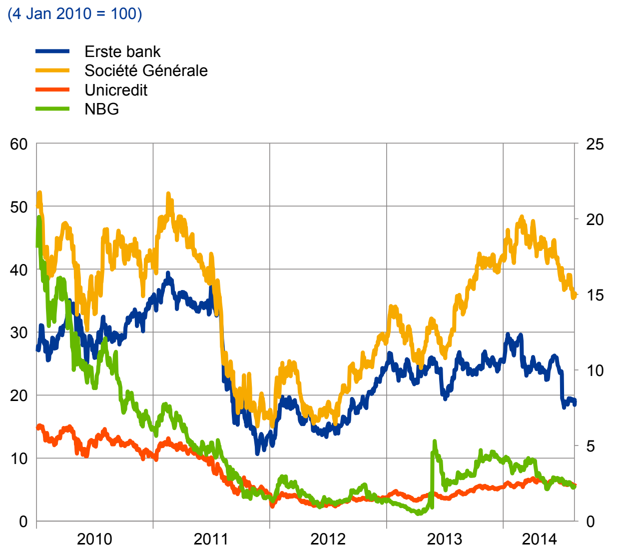
Funding conditions for parent banks whose subsidiaries have a strong presence in EU candidate and potential candidate countries have eased significantly in the review period.[2] The compression in five-year spreads of corporate default swaps (CDS) for key banking groups has been broad-based, with the relative decline for banking groups originating in (now less) financially stressed euro area countries being comparatively larger (see Chart 1). Equity valuations for key cross-border banking groups have also trended up over recent months (see Chart 2), consistent with both the reduction in financial tensions related to the euro area sovereign debt crisis in general and the improved outlook for the banking sector in particular, including as a result of plans to establish a 'banking union' in Europe (see also Chapter 4).

Chart 1
CDS spreads of selected banks



Sources: Bloomberg, Datastream and ECB staff calculations.

Chart 2
Equity prices of selected banks



Sources: Bloomberg, Datastream and ECB staff calculations.

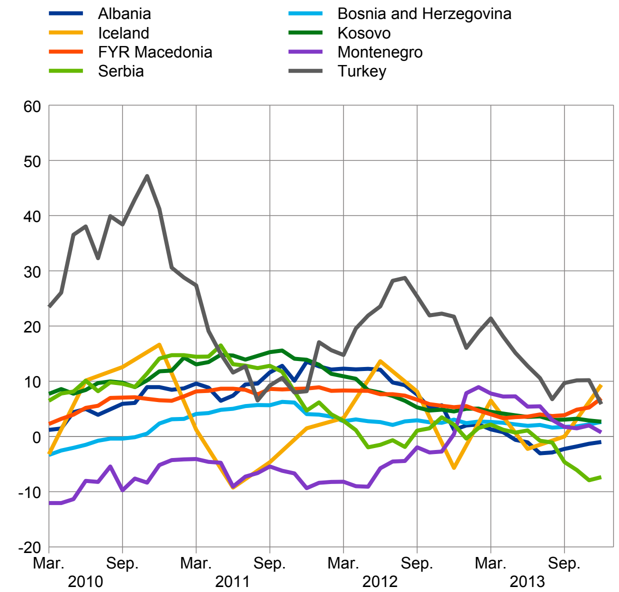
2 The main data cut-off date for this report is 2013Q4, consistent with the data templates kindly submitted by participating central banks of EU candidate and potential candidate countries as input to this report. Market data are reported until mid-August 2014. The data cut-off date for the 2013 interim update report on financial stability challenges in EU candidate and potential candidate countries was 2012Q3, again with the exception of high-frequency market data. Therefore, the main review period of this report is 2012Q3 to 2013Q4.

Overall, while bank funding costs still differ (at times significantly) depending on the nationality of the parent group and CDS spreads have not converged to pre-crisis levels in all cases, the closer clustering of bank spreads in recent months around the level which prevailed back in 2010 has been notable.

2.2 Credit dynamics in host banking systems have weakened further

Chart 3
Credit to the private sector

(annual percentage change)



Sources: National central banks and ECB staff calculations.
Notes: The time series are converted into euro and foreign exchange-adjusted with the difference in the exchange rate compared to the same month of the previous year. Private sector here comprises households, non-financial corporations and private sector banks.

The improvement in parent bank funding conditions contrasts sharply with developments in credit dynamics in host banking systems during the period under review, where a significant weakening in the pace of credit extension to the private sector has generally taken place. The downtrend has been particularly acute in Albania and Iceland, which together with Serbia have occasionally posted negative rates of credit growth to the private sector in nominal terms (on an foreign exchange-adjusted basis). In other EU candidate and potential candidate countries – such as the former Yugoslav Republic of Macedonia, Kosovo, and to a lesser extent Bosnia and Herzegovina – the slowdown in credit growth has been more moderate but is still noticeable (see Chart 3).

In Turkey, the pace of credit extension has lost some momentum but still remained vigorous overall. Montenegro is a partial exception to this broad trend insofar as the turnaround of credit dynamics over the equivalent period has been notable, but this is largely seen to reflect changes in accounting standards rather than actual developments on the ground.[3]

The available evidence continues to point to a mix of demand and supply factors behind the generally weak pace of credit extension to the private sector in most EU candidate and potential candidate countries. The findings of a special survey to help disentangle the driving forces in this regard across corporates and households in EU candidate and potential candidate countries as seen from the point of view of their central banks – which was undertaken for the purposes of this report – are presented in more detail in Chapter 3. Credit standards for corporates have been tightened to different degrees in most countries against generally weaker demand for loans. The patterns for credit demand by and lending standards applied to households in EU candidate and potential candidate countries are much more

[3] According to the Central Bank of Montenegro, the growth in loans (and other receivables) as of January 2013 primarily resulted from the implementation of International Accounting Standards (IAS 39), with banks transferring a portion of written-off items onto their balance sheet that were previously held off balance. Although the credit growth series has been revised back to 2009, the pre- and post-2013 figures are not exactly comparable because the loans and receivables classified in category E (written off) have been transferred from off-balance sheet records into the balance sheet in January 2013.

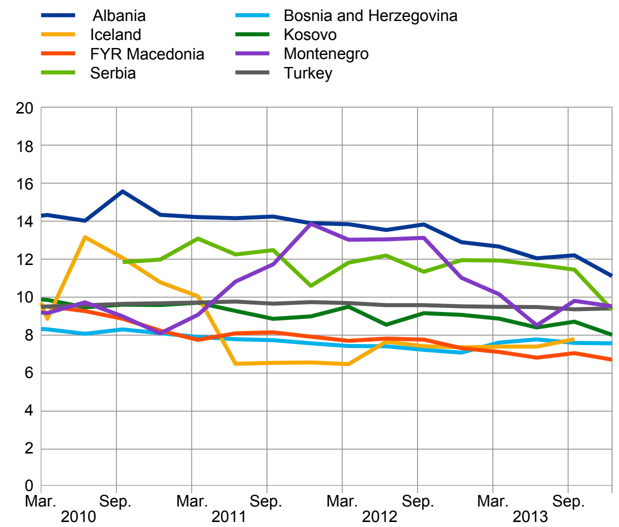
diverse in comparison, suggesting some discrepancy in households' willingness to take on new loans and banks' desire to fund these.

Taken together, the trends emerging from the lending survey could help explain why reference lending interest rates applied by banks in EU candidate and potential candidate countries have remained broadly stable, with the exception of Turkey and to a lesser extent Kosovo (see Chart 4). Reference lending rates have remained broadly stable despite a number of measures taken by monetary policy authorities in EU candidate and potential candidate countries to enhance credit extension by banks, both through reductions in key policy rates and other measures designed to reduce the cost of bank funding (e.g. changes in reserve requirements or risk weights for certain loan categories).

Chart 4

Reference lending rates

(in percent; end of period)



Sources: National central banks and ECB staff calculations.
Notes: Reference lending rates refer to weighted averages of short-term and long-term interest rates on loans to households and non-financial corporations, in domestic and foreign currency. Rates on new loans for all countries except Montenegro, where weighted rates on outstanding amounts (due to lack of data).

2.3 Impairments to bank lending are being exacerbated by worsening asset quality

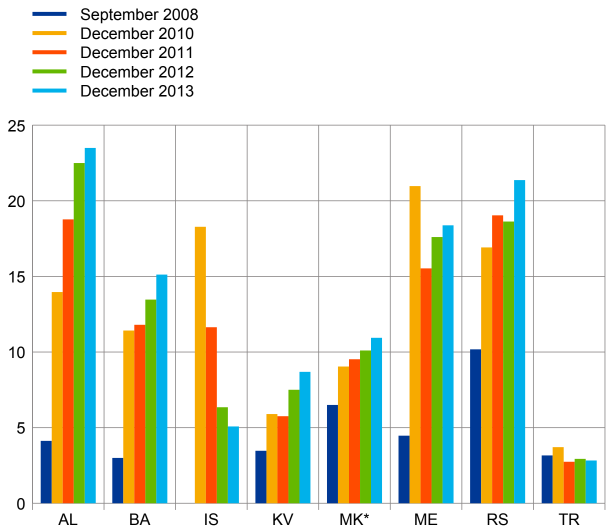
The bank lending channel in most EU candidate and potential candidate countries continues to be impaired by lingering challenges to asset quality, reflected in a sizeable non-performing loan (NPL) burden. NPL ratios remained broadly unchanged over the period under review in most countries, with the situation of banks in Albania, Montenegro and Serbia (where non-performing loans to total loans are at around 20% or above) still giving most cause for concern.[4] Problems are concentrated in the corporate loan segment (see country annexes). Although the level of non-performing loans is lower in comparison, the recent increase of NPLs in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia should also be noted (see Chart 5 and Table 1).

In contrast, progress in NPL reduction in Iceland has continued. The stock of NPLs remained broadly contained in Kosovo, notwithstanding a mild increase, while that of Turkey remained low and stable. Overall, dealing with the continued challenge posed by the sizeable stock of non-performing loans in a comprehensive manner appears key to both reducing financial stability risks in the near-term and to helping unlock the bank lending channel (thereby providing critical support to economic activity) in a medium-term context. The various steps undertaken (or planned) to foster NPL clean-up by authorities in some Western Balkan economies are detailed in Box 1.

[4] However, in the case of Serbia, NPLs are fully provisioned. See also Section 2.4.

Chart 5
Non-performing loans to total loans

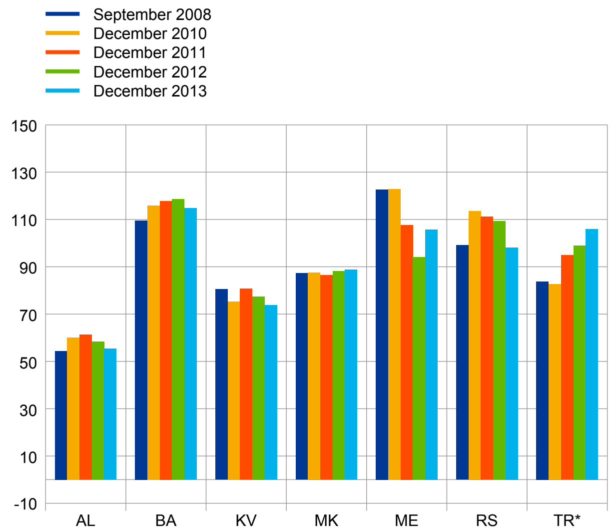
(in percent of total gross loans)



Source: National central banks.
Notes: In the case of Iceland, first quarter is Q1 2009 and figures for 2013 are as of June 2013. In Montenegro, due to the implementation of IAS 39 in 2013, the definition of loans has changed. See individual country annexes (Table 3) for country-specific definitions of non-performing loans.
* Loans to the financial and non-financial sector.

Chart 6
Loan-to-deposit ratio

(in percent)



Sources: National central banks.
Notes: The loan-to-deposit-ratio for Bosnia and Herzegovina is calculated using total loans net of interbank loans and customers' deposit (excl. deposits from financial institutions). In Montenegro, due to the implementation of IAS 39 in 2013, the definition of loans has changed. Since data for loan-to-deposit ratios prior to 2013 have not been revised according to the new methodology, the ratio for 2013 is not comparable with data for previous periods. Iceland is excluded due to lack of data.
* Excluding development and investment banks

2.4 Bank capitalisation and liquidity remain at healthy levels

Banking systems in most EU candidate and potential candidate countries appear well-positioned to weather continued challenges as regards credit risk stemming from a high NPL burden amid weak credit dynamics on account of robust capital and liquidity buffers. The ratio of regulatory Tier-1 capital to risk-weighted assets has remained broadly unchanged at double-digit levels in all banking systems during the period under review, with only Kosovo[5] and to a lesser extent Montenegro and Turkey experiencing a moderate decline. The rise in capital adequacy ratios in Serbia during the equivalent period has been notable.

Moreover, liquidity cushions available to banks (as proxied by both liquid assets to total assets or liquid assets to short-term liabilities) also appear comfortable, suggesting that banks should also be able to cope with unexpected challenges associated with potential fund withdrawals (see Table 1). However, it should be noted that the NPLs net of provisions to capital remain very high in both Albania and Montenegro, and to a lesser extent also in Bosnia and Herzegovina, Serbia and the former Yugoslav Republic of Macedonia, (although *total* loan provisioning is very comfortable in the latter two cases). This suggests that the potential ability of banks in some of these countries to absorb losses would be limited in the event of further (unexpected) shocks.

[5] In Kosovo, the decline in capital adequacy ratios was largely attributable to regulatory changes in the classification of regulatory capital.

Table 1

Key financial stability indicators in EU candidate and potential candidate countries

(in per cent)

	Regulatory Tier-1 capital to RWA	Return on assets	Return on equity	Liquid assets to total assets	Liquid assets to short-term liabilities	Interest margins to gross income	Loan to deposit	NPL net of provisions to capital	NPL to total gross loans	… of which in FX	FX loans to total loans	Net open position in FX to capital
Albania												
2012 Q3	14.5	0.4	4.2	29.0	35.8	130.6	58.0	59.5	22.7	24.4	66.5	4.1
2012 Q4	14.6	0.3	3.8	29.4	36.7	130.4	58.3	55.6	22.5	24.7	64.5	4.0
2013 Q1	15.2	0.4	5.2	29.1	36.1	123.6	58.2	57.0	23.7	26.0	64.8	1.7
2013 Q2	15.4	0.3	2.9	27.4	33.8	131.2	57.5	56.4	24.2	26.5	64.5	4.0
2013 Q3	14.8	-0.1	-1.7	29.2	36.5	148.3	55.3	45.4	24.2	26.2	63.7	4.3
2013 Q4	14.9	0.5	6.4	27.6	34.7	112.6	55.3	40.2	23.5	25.7	63.0	4.1
Bosnia and Herzegovina												
2012 Q3	14.1	0.8	6.4	24.8	43.5	63.6	121.1	28.6	12.7	n.a.	63.7	6.4
2012 Q4	14.1	0.6	4.9	25.4	44.1	63.7	118.5	30.0	13.5	n.a.	63.1	5.3
2013 Q1	14.6	0.3	2.0	24.1	42.2	64.2	118.1	30.6	13.8	n.a.	63.2	6.6
2013 Q2	14.9	0.5	4.2	24.2	42.4	63.3	118.7	31.7	14.3	n.a.	63.7	11.1
2013 Q3	14.6	0.5	3.9	25.3	44.0	63.0	115.4	33.3	14.9	n.a.	64.1	10.5
2013 Q4	15.2	-0.2	-1.4	26.4	46.2	62.3	114.7	31.0	15.1	n.a.	62.9	6.7
Iceland												
2012 Q3	21.0	2.1	12.7	23.3	199.9	192.1	n.a.	3.4	7.9	n.a.	25.3	18.4
2012 Q4	22.3	2.3	13.7	23.4	180.1	128.1	n.a.	-2.8	6.4	n.a.	24.6	7.7
2013 Q1	22.9	2.0	11.5	23.3	192.4	488.1	n.a.	-2.6	5.8	n.a.	22.8	3.7
2013 Q2	23.3	2.3	13.0	22.9	178.0	164.2	n.a.	-7.5	5.1	n.a.	22.4	3.6
2013 Q3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	21.6	6.4
2013 Q4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6.5
Kosovo												
2012 Q3	14.8	1.0	10.7	30.3	37.9	74.7	79.7	5.6	7.0	n.a.	0.4	3.1
2012 Q4	11.6	0.8	8.6	32.6	40.8	74.7	77.4	7.4	7.5	n.a.	0.4	0.7
2013 Q1	12.5	1.0	10.0	31.1	39.2	73.8	78.6	6.7	7.6	n.a.	0.4	0.3
2013 Q2	12.2	1.2	12.3	29.3	37.3	74.0	82.9	7.3	7.8	n.a.	0.4	0.3
2013 Q3	12.5	1.2	12.0	32.1	41.2	72.7*	76.7	8.7	8.5	n.a.	0.4	4.4
2013 Q4	12.8	1.0	10.6	36.6	47.1	72.6	73.7	7.8	8.7	n.a.	0.3	2.3
Former Yugoslav Republic of Macedonia												
2012 Q3	14.4	0.3	2.3	30.2	49.3	64.3	89.4	12.9	10.6	10.2	53.0	12.3
2012 Q4	14.5	0.4	3.8	32.4	53.0	60.7	88.1	10.7	10.1	9.7	52.4	11.4
2013 Q1	14.7	-0.1	-0.4	33.1	54.9	62.5	87.5	14.1	11.4	10.8	51.9	7.3
2013 Q2	14.7	0.2	1.8	32.0	54.6	62.9	90.3	15.4	11.8	11.4	51.7	12.1
2013 Q3	14.6	0.4	3.9	32.2	55.9	63.3	88.3	13.1	11.2	11.7	50.7	16.1
2013 Q4	14.4	0.6	5.7	31.2	54.5	62.2	88.8	11.6	10.9	12.1	49.7	15.6
Montenegro												
2012 Q3	14.7	-2.3	-21.7	25.2	41.8	69.7	94.5	82.2	18.5	n.a.	2.1	-0.6
2012 Q4	15.8	-2.0	-18.3	24.0	40.1	73.1	94.0	68.0	17.6	n.a.	1.9	-0.8
2013 Q1	13.2	1.4	10.0	13.2	21.3	69.5	114.8	71.7	19.4	0.5	4.0	-0.6
2013 Q2	13.8	1.3	9.2	14.5	23.5	71.0	113.4	68.6	18.8	0.8	3.8	0.4
2013 Q3	13.7	1.3	9.2	21.2	34.1	70.3	108.8	66.9	18.4	n.a.	3.4	1.5
2013 Q4	13.0	0.1	0.5	20.0	32.2	68.2	105.8	62.4	18.4	n.a.	3.9	0.6
Serbia												
2012 Q3	15.6	0.6	2.8	22.7	55.1	65.1	112.0	36.4	19.9	18.3	75.8	1.9
2012 Q4	19.0	0.4	2.0	23.9	57.2	65.6	109.3	31.0	18.6	17.9	74.7	2.7
2013 Q1	19.2	1.5	7.2	25.1	59.5	67.0	106.2	32.2	19.9	19.4	72.6	1.9
2013 Q2	19.1	1.1	5.3	24.0	58.0	66.8	103.8	33.4	19.9	19.4	72.3	1.1
2013 Q3	18.9	0.8	3.8	25.5	62.1	69.3	102.0	35.4	21.1	20.7	72.0	1.6
2013 Q4	19.3	-0.1	-0.4	26.1	63.2	69.2	98.1	32.7	21.4	20.9	71.5	1.9
Turkey												
2012 Q3	14.5	1.8	14.5	17.4	27.7	64.8	98.4	3.7	3.0	n.a.	25.3	1.6
2012 Q4	15.1	1.8	14.5	17.5	28.2	64.7	99.0	3.5	2.9	n.a.	24.9	1.5
2013 Q1	14.7	1.8	14.3	16.0	26.3	64.5	101.6	3.7	3.0	n.a.	24.7	2.1
2013 Q2	14.0	1.9	14.3	13.9	22.8	63.3	105.7	3.9	2.8	n.a.	25.7	-0.6
2013 Q3	13.4	1.8	14.2	13.5	22.1	62.4	105.2	4.0	2.8	n.a.	25.5	0.5
2013 Q4	13.0	1.6	13.1	13.1	21.8	62.6	105.9	3.9	2.8	n.a.	26.2	-0.3

Sources: National central banks.
*Methodological change.
Notes: The ratio NPL in foreign exchange for Albania refers to NPL in foreign currency to total loans in foreign currency. Loan to deposit in the case of Bosnia and Herzegovina is calculated using total loans net of interbank loans and customers' deposit (excluding deposits from financial institutions). As of 1 January 2013, funds and deposits with banks in Montenegro are part of loans and other receivables, which influences the decline in the liquid assets to total assets ratio and the increase in the loan-to-deposit ratio. In addition, the methodological changes in January 2013 also had an impact on the rise in NPLs since loans and receivables classified under category E (written off) have been transferred from off-balance sheet records into the balance sheet. NPL net of provisions to capital in Serbia are based on IFRS provisions only. NPLs net of total provisions (statutory and IFRS provisions) to capital however are 0%, i.e. NPLs are fully provisioned for according to national authorities. For FYR Macedonia, NPLs net of provision to capital refer to NPLs (and corresponding provisions) net of provision for NPLs of the non-financial sector.

Box 1

Non-performing loan resolution in Albania, Montenegro, Bosnia and Herzegovina and Serbia

The clean-up of non-performing loans (NPL) is a multifaceted problem involving a number of different foreign and domestic stakeholders which thus requires a multi-pronged approach that is tailored to country-specific circumstances. In recognition of this, authorities in several Western Balkan economies have taken a number of measures to alleviate the sizeable burden of non-performing loans on bank portfolios.

Albania

Following several on-site examinations in banks to effectively assess the magnitude of the NPL issue, the authorities have decided to take some measures and address both the 'stock' and 'flow' of NPLs. In order to deal with the former, the Bank of Albania acted as lead in the establishment of two working groups designed to tackle different problems related to NPL clean-up. A first working group was set up in August 2011 focusing on (difficulties in) collateral execution, together with the Albanian Association of Banks and the Ministry of Justice. The outcome of the reflections by this working group led to the revision of the Civil Procedure Code that entered into force at the end of September 2013. A second working group, together with the banking industry, the General Directorate of Taxes and the Ministry of Finance, was set up in July 2012, with the aim of dealing with the issue of considering write-offs as a deductible item when calculating the net income for tax purposes. The outcome of this working group was reflected in a ministerial order (by the Minister of Finance) in May 2013, which is expected to be reinforced in law in Q1 2014. The Bank of Albania also introduced a number of regulatory changes in May 2013 that aimed to both encourage lending in the economy and discourage the passive 'parking' of liquidity in foreign assets. Furthermore, banks were also encouraged to apply early restructuring of loans before they became non-performing. In order to support the restructuring process for loans already categorised as NPLs, the time that a loan was allowed to remain as 'non-performing' following restructuring was shortened. In addition, the central bank has also worked closely with the World Bank on an NPL enhancement framework, which was launched in October 2013. The first phase of the new platform, which has already been accomplished, has aimed to ensure more financial data on banks' borrowers. In the second phase, it will comprise selecting a meaningful sample of the banks' classified loans portfolio in terms of size and composition, for which the banks must prepare potential scenarios for the resolution of specific problems, following the principal of "least costly solution" for the stakeholders and under the monitoring of the Bank of Albania. In addition, the Bank of Albania plans to provide more guidance to banks regarding the process of NPL sale to non-bank financial institutions.

Montenegro

A technical assistance project with the World Bank ('Podgorica approach') was set-up in July 2012. The 'Podgorica approach' is based on the following principles/items: (i) mandatory cooperation and disclosure requirements; (ii) a mediation centre which should enhance the resolution in case of a dispute and avoid court solutions; (iii) improved access to finance for borrowers; (iv) tax exemptions that are singularly available during the NPL restructuring process for creditors and debtors; (v) agreement on the restructuring plans by the debtor and the creditor; and

(vi) ‘safe-harbour provisions’ to protect participants. The aim of this project is to: (i) adopt restructuring solutions to convert unsuccessful NPL workouts into restructured loans; (ii) stabilise distressed but viable companies and avoid unwarranted liquidation; (iii) promote renewed lending and access to credit to restricted companies; and (iv) stabilise the banking system (e.g. adequate capitalisation, provisions, effective risk management) and mitigate losses (effective restructuring, swift maximal recovery). In order to achieve such goals, a screening of the status quo was done that set the following priorities for further action: protection of creditor rights, tax treatment, financial consumer protection, prudential regulation and supervision, and NPL management skills. The NPL resolution framework will start as soon as at least one bank wishes to participate. The legal framework is also scheduled to be improved as part of the implementation of this process over 2014, including a draft law on voluntary financial restructuring and amendments to the central banks’ regulation of minimum conditions for credit risk management (CRM Decision) to accommodate regulatory incentives for banks. Guidelines underpinning strategies for banks’ NPL reduction will also be prepared by domestic monetary authorities.

Bosnia and Herzegovina

Authorities have conducted a review of the NPL resolution framework in the context of the IMF programme and identified a number of areas for future improvement in the overall legal and regulatory environment. These include: (i) clarification of the tax treatment of loan-loss provisioning by banks in corporate income taxes applicable in both the Federation and the Republika Srpska (so as to encourage provisioning); (ii) plans to submit legislation to regulate the establishment and supervision of asset management companies, thereby facilitating the operation of a secondary loan market, including items related to loan sales, accounting, taxation and provisioning rules; (iii) a review of corporate insolvency laws to strengthen restructuring provisions, reduce barriers to entry into bankruptcy, and speed up bankruptcy proceedings; and (iv) an assessment of the feasibility of establishing an out-of-court restructuring mechanism so that viable companies have a better chance of remaining productive as well as to promote the return of operationally viable companies to sustainable debt servicing. In this context, the World Bank is expected to conduct an assessment of banks’ NPLs to provide an estimate of the loans that could return to sustainable performance status through restructuring actions.

Serbia

In March 2013 the National Bank of Serbia and IMF together organised the ´Belgrade Initiative´ meeting, where the issue of NPL resolution was the main topic. The National Bank of Serbia subsequently prepared a proposal for the framework of NPL resolution in Serbia, with the regulatory recommendations that should govern this process in the future being published in its annual Financial Stability Report (for 2012, published in June 2013). The key recommendations in this regard were that: (i) banks should draft plans to reduce the share of NPLs, including a precisely defined goal expressed as a percentage share of NPLs in total loans, an expected time frame for the achievement of this goal, and an outline of ways of decreasing the NPL share to be applied (e.g. through sale, write-off or restructuring of receivables, or enforced collection) as well as of the sources of financing for the implementation of such plans, respectively; (ii) concerning the regulation of mandatory write-offs, banks should be obliged to write off the receivable in those cases where it is an unsecured receivable and the debtor’s delay in payment exceeds three years, the receivable is secured by a mortgage and the debtor's delay in payment exceeds five years, it is an unsecured receivable from a debtor who has been in bankruptcy for more than a year, or it is a receivable for which a write-off has been agreed in an a compulsory enforced settlement procedure, respectively; (iii) the process of out-of-court collection of receivables from the value foreclosure of mortgaged property should be enhanced to improve the process of mortgage activation enforcement; (iv) a regulatory framework for personal bankruptcy should be established, such that the resolution of NPLs is extended to natural persons; and (v) concerning consensual financial restructuring, there is a need to continue with the implementation of the Law on Consensual Financial Restructuring of Companies, which is generally based on the London Approach principles.

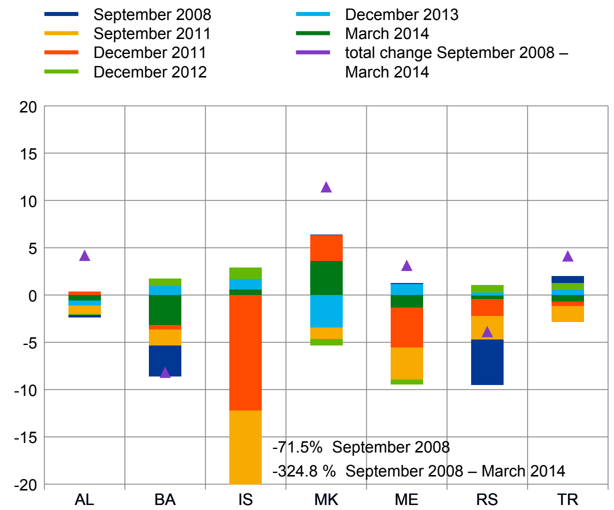
2.5 Deleveraging by parent banks appears to be moderating

Deleveraging by parent banks whose subsidiaries are systemically important for EU candidate and potential candidate countries appears to have moderated during the period under review, consistent with the relative easing of financial tensions for euro area-headquartered entities. From a cross-border (locational) point of view, the change in external positions from BIS-reporting banks to some countries was 'net positive' over recent quarters (in 2013 up to 2014Q1), for example in Montenegro and Albania (see Chart 7). In other countries changes in external positions from BIS-reporting banks have been more erratic, but the recent trend suggests that net funding withdrawals were less significant relative to GDP than before. This is also the case when compared to the second half of 2011, a time when broad-based regulatory pressures to increase capitalisation in euro area-headquartered banks amid severe financial tensions in some euro area sovereigns were associated with a sharp increase in cross-border funding withdrawals by banks.[6]

Chart 7

Change in cross-border positions by BIS-reporting banks

(in percent of full-year nominal GDP)



Sources: BIS locational banking statistics, IMF/WEO and ECB staff calculations.
Notes: Quarter on quarter change in outstanding amounts for claims on all sectors. Data are not foreign exchange-adjusted.

However, it would be premature to ascertain the durability of this trend going forward. In the short-term, capitalisation pressures for some entities following the results of the ECB's comprehensive assessment/ asset quality review cannot be ruled out. Nevertheless, this exercise is seen as a key contributor to restore confidence in the euro area banking system as a whole from a medium-term perspective, home to key cross-border banking groups with a strong presence in most EU candidate and potential candidate countries. More

[6] Deleveraging trends are also monitored by the European bank co-ordination initiative (Vienna II initiative) in which the ECB also participates as an observer. The November 2014 'CESEE deleveraging and credit monitor can be found on the Vienna Initiative's website: http://www.ebrd.com/downloads/news/DCM_note_October_Final.pdf

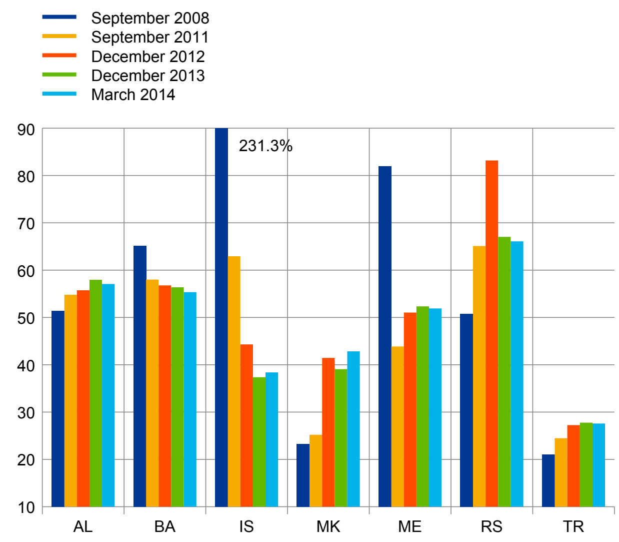
broadly, the heterogeneity in deleveraging trends across countries from a longer-term point of view (as well as their relative dependency on parent funding, if applicable) should also be kept in mind.

From a consolidated point of view, the trend towards an increased reliance on domestic sources of funding, in particular through local deposits (see Section 2.6 below), has been associated with a broad-based stabilisation of (parent) bank exposures to EU candidate and potential candidate countries. Only Bosnia and Herzegovina and Iceland constitute exceptions to this trend, and exposures of BIS-reporting banks to other countries as a whole (relative to GDP) remained constant or increased over the equivalent period (see Chart 8).

Taken together, these trends imply that the discrepancy between cumulated changes in consolidated and cross-border (locational) BIS-reporting banking exposures to EU candidate and potential candidate countries in the Western Balkans has widened in the recent period, albeit 'for the better'. Whereas consolidated exposures in the second half of 2013 were almost 7 percentage points above those prevailing at the start of the crisis (as proxied by the Lehmann bankruptcy in 2008Q3), cross-border exposures over the same time frame are about 4 percentage points below (see Chart 9).

Chart 8
Consolidated claims by BIS-reporting banks

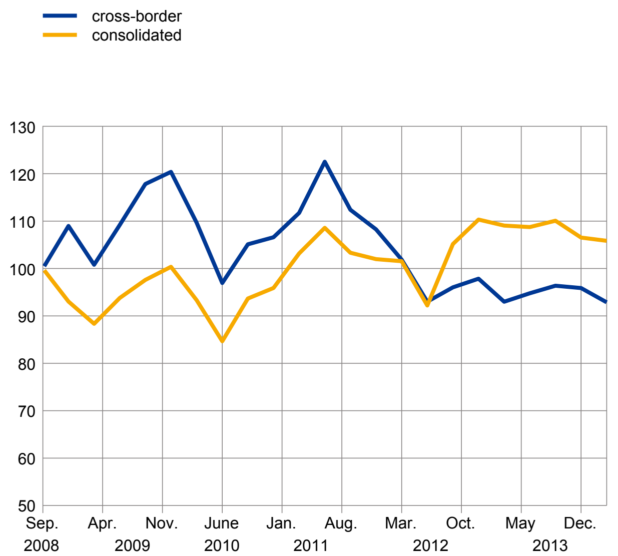
(in percent of full-year nominal GDP)



Sources: BIS consolidated foreign banking statistics, IMF/WEO and ECB staff calculations.
Notes: Outstanding amounts, claims on all sectors. Data are not foreign exchange-adjusted.

Chart 9
Change in cross-border and consolidated positions by BIS-reporting banks on the Western Balkans

(Index September 2008=100)



Sources: BIS consolidated foreign and locational banking statistics and ECB staff calculations.
Notes: As used here, Western Balkans covers Albania, Bosnia and Herzegovina, FYR Macedonia, Montenegro and Serbia. Figures are not foreign exchange-adjusted.

The evolution of these variables provides indirect evidence of the degree to which banking systems in the respective countries have successfully bridged potential funding gaps in the aftermath of the crisis, since consolidated exposures include claims of local subsidiaries (in all currencies) to the real sector.[7]

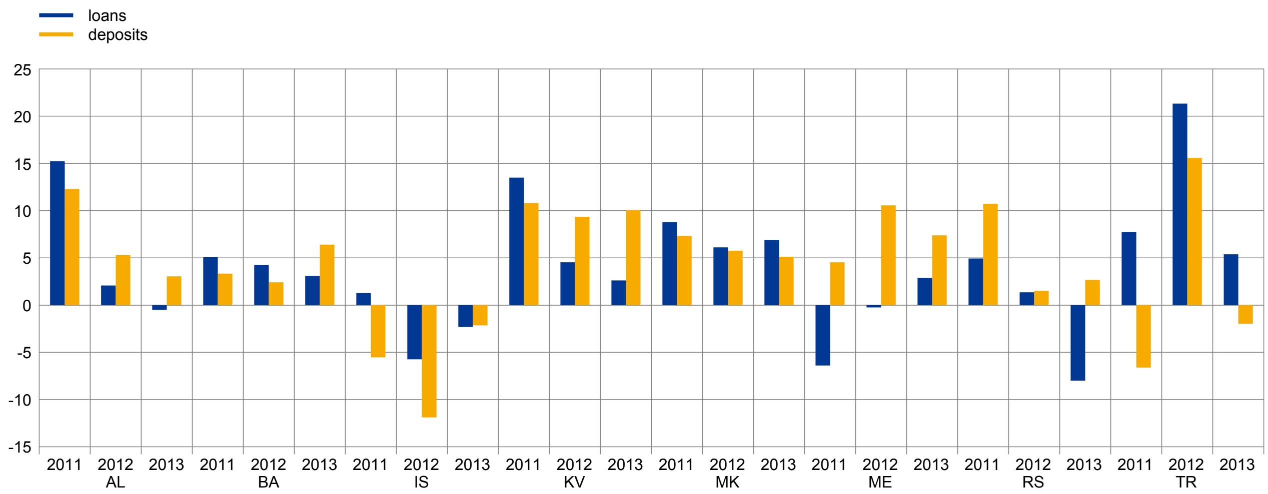
2.6 The reorientation of funding towards domestic sources remains underway

The shift towards a growing reliance on domestic funding sources for banks in EU candidate and potential candidate countries has been reinforced. On a foreign exchange-adjusted basis, deposit growth has outpaced loan growth during the period under review in most EU candidate and potential candidate countries except Turkey and Iceland, at times by a significant margin (see Chart 10). This development is significant insofar as it applied not only to countries where credit dynamics has been negative at times in nominal terms (such as Albania and Serbia), but also to those where the pace of credit extension has remained moderately positive and the reliance on local funding was already high (such as the former Yugoslav Republic of Macedonia). It also applied to those countries that have been

Chart 10

Loan and deposit growth

(annual percentage changes)



Sources: National central banks and ECB staff calculations.
Notes: Data in national currency converted into euro and foreign exchange-adjusted with exchange rate of the same month of the previous year. Total loans here comprise households, non-financial corporations, private sector banks and public sector. Total deposits include households, non-financial corporations, private sector banks and government deposits. Figures are as of December in each year (June 2013 in the case of Iceland). For Montenegro, growth in loans and other receivables primarily resulted from the implementation of the International Accounting Standards, see footnote 3.

[7] The *BIS consolidated banking statistics* capture the worldwide claims of banks headquartered in the BIS reporting countries, including the claims of their foreign affiliates, but exclude positions between related offices. The consolidated foreign claims cover cross-border claims in all currencies of BIS reporting countries and local claims in foreign currency of their foreign affiliates, as well as the local claims in local currency of their foreign affiliates. *BIS locational banking statistics* provide information about the geographical composition of banks' balance sheets since they provide the outstanding claims of banking offices located in BIS reporting countries (including positions between related offices).

traditionally more dependent on parent funding regardless of underlying credit trends (such as Serbia).[8] In contrast, Turkey stands out as a case where loan growth by far outpaced deposit growth over the period under review, which can be partly attributed to growing reliance on external (short-term) funding. Notwithstanding the robustness of the overall trend, the degree to which deposit growth may be partly a by-product of sluggish economic activity in some countries (e.g. precautionary motives by households, lack of investment opportunities by corporates) remains in doubt.

Coupled with the moderation of parent bank deleveraging, increased reliance on local funding would suggest that near-term risks to the bank funding base have decreased, but cross-country evidence remains heterogeneous. Loan-to-deposit ratios in those banking systems which already in the past were comparatively less reliant on parent funding – i.e. those of Albania, Kosovo, and the former Yugoslav Republic of Macedonia – have remained broadly stable during the period under review at levels ranging from about 60% to 90%. Serbia, Montenegro and Bosnia and Herzegovina continue to exhibit ratios of above 100%, although the respective underlying dynamics have been different (with loan-to-deposit ratios trending down in Serbia, remaining high in Bosnia and Herzegovina, and showing an erratic pattern in Montenegro, also due to methodological (IAS) changes in loan definitions as of 2013). The trend-up in loan to deposit ratios in Turkey – which exceeded 100% at the end of the period under review and has thus joined the group of EU candidate and potential countries deemed to be most vulnerable on this count – should also be noted (see Chart 6).

2.7 Will 'forced deleveraging' be a matter of concern in the medium-term?

Although the increased reliance on local deposits in EU candidate and potential candidate countries' banking systems should ex ante reduce funding risk, the extent to which host countries could be affected by 'forced deleveraging' remains open. As documented in Chapter 4, the relative importance of subsidiaries from euro area-headquartered banks operating in (most) EU candidate and potential candidate countries is very asymmetric for 'home' and 'host' authorities. While a bank subsidiary may be locally systemic for host authorities, the relative weight of that same bank in the activities of the larger cross-border group as a whole (and hence the concern which it may elicit on the part of home supervisors) would likely be minor. This raises two potential issues.

First, cross-border banking groups may be 'forced' by home authorities to dispose of subsidiaries that are seen as 'non-core' for the activities of the group as a whole. This could apply to those cross-border banking groups with an important presence in EU candidate and potential candidate countries which have had or may have in the future 'state aid' cases addressed by the European

[8] This was also the case in Montenegro although the influence of methodological (IAS) changes in loan data as of 2013 makes the interpretation of credit versus deposit growth trends difficult.

Commission (EC). The recent cases in this regard[9] point to the possibility of forced divestment which could arise regardless of the underlying profitability of the bank subsidiaries in question or their relative dependency on parent funding. In principle, profitable entities should find buyers, while market exit by banks without viable business models is ultimately unavoidable and a contribution to banking sector consolidation, which in some countries seems warranted. At the same time, it should be recognised that short-term disruptions to domestic financial systems resulting from potential 'orphan banks' (i.e. those for which no buyers can be found) may still ensue, even in those cases where a host country's long-term interest would be best served by disposing of unhealthy banks that provide little de facto funding to the real economy.

Second, even in non-state aid cases, parent banks might still seek to keep exposures of their (smaller) subsidiaries in third countries relatively contained, reflecting strategic risk-return considerations for the group as a whole. While such business decisions are legitimate from a home point of view, for host countries this may imply that their banking systems become less supportive to economic activity. This could in particular be the case if local deposits are insufficient to meet credit demand and domestic capital markets do not offer viable alternatives to make up for the shortfall.

2.8 Foreign currency lending still poses indirect vulnerabilities to banks

Widespread lending in foreign currency in many EU candidate and potential candidate countries (outright or indexed to foreign exchange) continues to constitute a risk to financial stability. The share of foreign exchange loans to total loans has remained broadly unchanged across most EU candidate and potential candidate countries during the period under review, ranging from around a quarter in Turkey and Iceland, over a half in the former Yugoslav Republic of Macedonia, to two-thirds to three quarters in Albania, Bosnia and Herzegovina and Serbia (see Table 1).[10] Accordingly, foreign currency lending continues to be a 'structural'

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9 There have been three main cases in this regard so far: (i) Hypo Alpe-Adria Group (HAAG) from Austria; (ii) National Bank of Greece /EFG Eurobank/Piraeus Bank; and (iii) the Slovenian NLB. In the case of HAAG, the European Commission (EC) decision of September 2013 forces the group to sell its entire network in South-Eastern Europe by end-June 2015 at the latest. The EC decision on the Greek-owned entities is still pending, while that for NLB states that the bank should focus on core activities but otherwise remains silent on the future of its cross-border subsidiaries. The importance of the NLB subsidiaries for the group as a whole is much larger relative to those of HAAG, accounting for 23% as compared to 10% of group assets, respectively. For more information, see: European Commission (2012), "State aid: Commission temporarily approves aid to Alpha Bank, EFG Eurobank, Piraeus Bank and National Bank of Greece; opens in-depth investigations", press release, Brussels, 27 July. European Commission (2013a), "State aid: Commission approves plan to orderly wind down Hypo Group Alpe Adria", press release, Brussels, 3 September, European Commission (2013b), "State aid: Commission approves rescue or restructuring aid for five Slovenian banks", press release, Brussels, 18 December. European Commission (2014a), "State aid: Commission approves restructuring aid for Greek bank Alpha Bank", press release, Brussels, 9 July. European Commission (2014b), "State aid: Commission approves restructuring aid for National Bank of Greece", press release, Brussels, 23 July. European Commission (2014c), "State aid: Commission approves restructuring aid for Greek Piraeus Bank", press release, Brussels, 23 July.

10 Montenegro and Kosovo are unilaterally euroised countries and the share of foreign exchange lending in total lending is low or negligible.

feature of many banking systems. The banking system's exposure to unhedged borrowers in the event of currency depreciation thus remains a key source of vulnerability in many countries, notwithstanding the fact that the underlying monetary and exchange rate policy frameworks across countries are often very different. There are signs that foreign exchange lending is tilting away from the household sector to the corporate sector (with hedging being presumably more common in the latter case), which suggests that risks in this regard may be on a downward path while remaining sizeable at present.

Moreover, widespread foreign exchange lending poses a challenge not only to financial stability but also to the conduct of monetary policy in many countries. It is one factor pushing authorities to opt for de jure or de facto pegs to the euro in some cases and constraining the degree of policy freedom also in those countries where authorities allow for some nominal exchange rate flexibility. This calls for the maintenance or intensification of active strategies by host authorities to foster the use of local currencies. The banking system's exposure to direct market risks (as proxied by the net open position in foreign exchange to capital) remains generally low in most countries, with the exception of Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia, although in both cases the ratios for the banking system as a whole are below the respective regulatory limits set by domestic authorities.

2.9 Conclusions

Taken together, near-term challenges primarily relate to credit risk stemming from the generally weak economic dynamics in combination with already high non-performing loan burdens in many banking systems, especially in Western Balkan economies. Notwithstanding sizeable cross-country heterogeneity, Albania, Serbia and Montenegro appear as particularly vulnerable. Although showing still positive credit trends, the continued increase of non-performing loans in both Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia also gives cause for concern. The risk that the projected recovery in economic activity turns out to be more protracted than currently anticipated, through domestic factors or renewed external headwinds, would exacerbate such vulnerabilities. Bottlenecks to the bank lending channel resulting from weak asset quality are not only of concern from a financial stability point of view, but also from the perspective of monetary policy and ultimately economic growth. Taken together, this implies that removing impairments to bank balance sheets which may be standing in the way of enhanced credit extension should remain a key near-term policy priority for authorities in most Western Balkan economies.

While short-term credit risks have tilted to the downside during the period under review, the continued trend towards increased reliance on local sources of finance (notably domestic deposits) coupled with the moderation of parent bank deleveraging has dampened bank funding vulnerabilities. However, loan-to-deposit ratios remain high in the cases of Bosnia and Herzegovina, Serbia and Montenegro implying lingering funding risks.

Iceland and Turkey are outliers to the trends depicted above characterising much of the Western Balkans, each exhibiting their own country-specific traits. In Iceland, the main risks to financial stability continue to stem from the legacy of the 2008 crisis and the potential implications of the lifting of capital controls. In Turkey, the key challenge going forward is to achieve a 'soft landing' as regards the pace of credit extension, while safeguarding risks stemming from increased reliance on external funding amid a changing international environment.

In the medium-term, the key challenges to financial stability in EU candidate and potential candidate countries relate to indirect market and funding risks, especially in Western Balkan economies. Concerning market risk, indirect vulnerabilities posed by widespread foreign exchange-denominated or indexed lending remain a structural weakness in many cases which may materialise through unhedged borrowers in the event of nominal exchange rate depreciations/ devaluations. This is especially an issue for Serbia, Albania, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia, albeit to varying degrees and notwithstanding considerable differences in underlying monetary and exchange rate policy frameworks. This suggests that active policies to increase the use of local currencies should be pursued both to reduce financial stability risks and to afford greater degrees of policy freedom to monetary authorities. As regards funding risk, the extent to which 'forced' deleveraging may materialise in the period ahead remains open. This could either imply outright divestments of locally systemic entities if these are sold (resulting in high business uncertainty even if the sale is ultimately successful), or less supportive parent bank finance to domestic economies in the event that local resources are insufficient to meet credit demand once this picks up in a durable manner. More broadly, while the increased reliance on local deposits should be ex ante associated with greater stability in bank funding patterns, this would also accentuate maturity mismatches in bank balance sheets, thereby underlining the need to develop domestic capital markets to provide stable longer-term funding alternatives.

3 Recent developments in bank lending, funding and profitability in EU candidate and potential candidate countries

The financial sectors in EU candidate and potential candidate countries remain heavily bank-based, with most entities participating in the system following a 'traditional' business model devoted to intermediating retail and corporate deposits to loans. While the focus of bank business models across the region was not necessarily in question in the wake of the crisis, developments since the bursting of the financial and credit bubble in 2009 have shown that the underlying funding dynamics prevailing in many cases (namely the dependency on parent funding) were unsustainable. In this regard, there is some evidence to suggest that credit dynamics between parent banking groups and their subsidiaries were pro-cyclical in both the run-up to the crisis and during its aftermath. At the same time, banking systems across the region are still grappling with the challenge of resolving legacy issues associated with the turning of the credit cycle.[11]

There is thus an emerging consensus in the region that a 'new normal' as regards bank business models should be found, with local resources playing a greater role in bank funding than before. However, the extent to which this should be the case in a non-crisis 'steady state' remains an open issue, since it is not evident that autonomous (local) resources would suffice to meet credit demand once this picks up in a sustained manner. In turn, this implies that questions on bank profitability and viability in a less dynamic credit environment going forward remain unanswered. Against this background, the remainder of this chapter investigates recent changes in bank lending, funding and profitability of banks so as to help gauge the extent to which the move to a 'new banking normal' is ongoing.

3.1 Recent lending developments

Asset growth of banking systems in most EU candidate and potential candidate countries has slowed down significantly, but there are no signs of disorderly balance sheet adjustments. In the context of subdued economic activity in most of the countries concerned, the median asset growth of private sector banks in candidate and potential candidate countries came down from 6.3% in 2012 as a whole to 4.3% end 2013.

Notwithstanding this overall trend, the developments on the asset side of banks' balance sheets have remained very heterogeneous among countries. In Turkey, balance sheets strongly expanded, with an increase of 26% end 2013 compared with a year earlier, whereas in Iceland and Serbia, banks' assets remained

[11] See International Monetary Fund (2013a), "Financing future growth: the evolving role of banking systems in CESEE", *IMF CESEE Regional Economic Issues*, April, Washington DC.

Table 2
Total banking sector asset growth

(percentage change)

	2011	2012	2013
Albania	13.1	6.1	3.9
Bosnia and Herzegovina	2.8	0.9	4.0
Iceland	6.2	0.8	1.6
Kosovo	7.9	6.8	8.1
FYR Macedonia	8.5	6.6	4.7
Montenegro	-4.5	-0.1	5.4
Serbia	4.6	8.7	-1.2
Turkey	21.0	12.6	26.4

Source: National central banks.
Note: Annual percentage change (except in the case of Iceland where the change between 2012 and 2013 is calculated using end-2012 and June 2013 figures, due to lack of data).

Table 3
Private sector loans to banking sector assets

(in percent)

	2011	2012	2013
Albania	47.8	46.1	44.1
% private sector banks' assets	*47.8*	*46.1*	*44.1*
Bosnia and Herzegovina	65.1	66.4	65.6
% private sector banks' assets	*n.a.*	*n.a.*	*n.a.*
Iceland	61.7	61.7	61.9
% private sector banks' assets	*61.7*	*61.7*	*61.9*
Kosovo	61.8	60.5	57.5
% private sector banks' assets	*61.8*	*60.5*	*57.5*
FYR Macedonia	61.2	60.5	61.7
% private sector banks' assets	63.1	62.6	64.2
Montenegro	*77.2*	*77.6*	*74.2*
% private sector banks' assets	77.2	77.6	74.2
Serbia	54.1	55.3	52.2
% private sector banks' assets	*65.8*	*67.5*	*64.3*
Turkey	56.1	58.0	60.5
% private sector banks' assets	*80.4*	*82.9*	*87.3*

Sources: National central banks.
Notes: Private sector loans cover loans to households, non-financial corporations and private sector banks, and are outstanding amounts as of December in each year (June 2013 in the case of Iceland).

broadly stagnant during the same period (or even slightly negative) (see Table 2). Looking at the decomposition of items on the asset side, loans to the private sector remain the most important item, ranging from 60% to 74% of total private sector banks assets in all countries except in Albania (see Table 3).

Banks' core business – retail and corporate lending – has remained weak. Credit growth has been lacklustre in most cases, with a noticeable slowdown in credit growth rates in all CC and PCC banking systems over the period under review, notwithstanding different underlying credit dynamics, and Turkey being the exception with still relatively strong growth rates (see Section 2.2). The decline in overall rates of credit growth appears to have been broad-based across relative components, with the more dynamic contribution of credit to households in some cases not being sufficient to compensate for the drop in corporate lending over the equivalent period (see Chart 11).

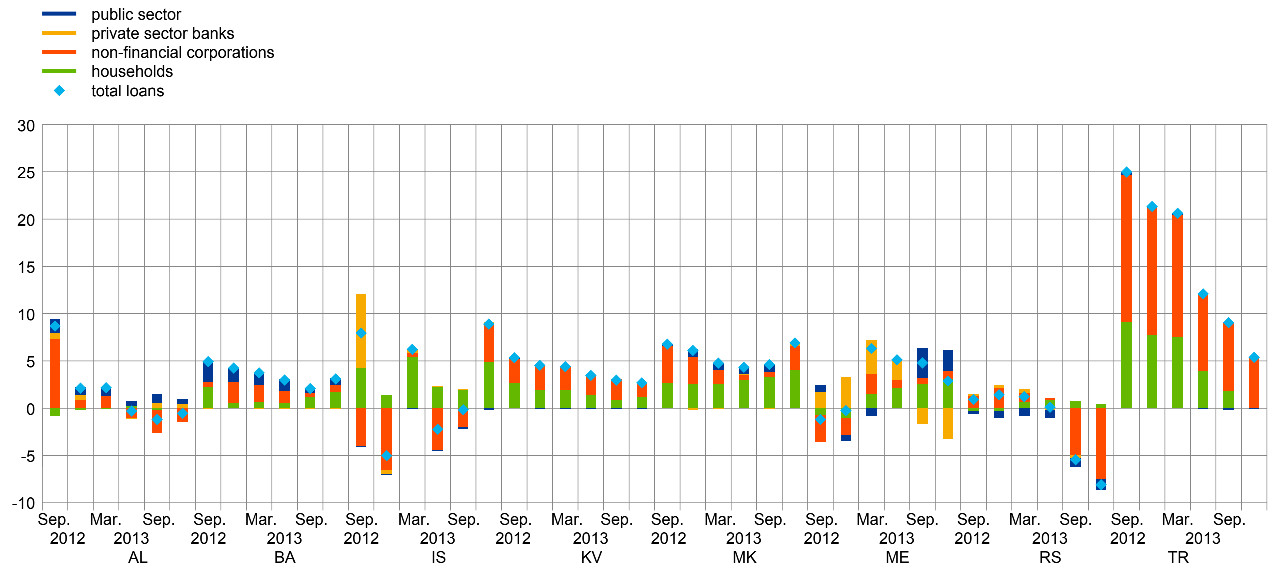
The lacklustre pace of credit extension in most EU candidate and potential candidate countries appears to reflect a combination of demand and supply factors, especially as regards corporate lending. A special survey among the central banks of EU candidate and potential candidate countries conducted for the purposes of this report suggests that, from the point of view of the central banks in the countries concerned, both tighter supply and weaker demand help to explain the recent downtrend in corporate lending in most cases. In this regard, anticipated investment activities by corporates, which would require long-term bank financing, remained low in most candidate and potential candidate countries except Turkey.

The demand for short-term financing (e.g. working capital), but also for corporate debt roll-over, for working capital as well as for mergers/acquisitions increased slightly (e.g. Bosnia and Herzegovina, Turkey and the former Yugoslav Republic of Macedonia). Looking at the supply side for corporate credit, lending standards for corporates tightened in most cases, which could to a certain extent also be a result of the lowered creditworthiness of corporates and adjustments of banks' internal risk-weighting schemes. In contrast, the picture as regards lending to households appears more diverse, with signs of a partial mismatch between relative supply and demand factors in some cases, such as Kosovo and Albania (see Table 4).

The findings of the IRC expert group's survey are broadly consistent with those of the European Investment Bank's (EIB) bank lending survey among parent bank groups, their subsidiaries as well as domestic banks in central-eastern

Chart 11
Contributions to overall lending growth

(annual percentage change; adjusted for foreign exchange changes)



Sources: National central banks, Haver Analytics and ECB staff calculations.
Notes: Time series are converted into euro and foreign exchange-adjusted with the difference in the exchange rate compared to the same month of the previous year. Total loans cover the sum of the four sectors.

Table 4
Survey of lending developments in the first half of 2013

	DEMAND						LENDING STANDARDS					
	Lending to corporates			Lending to households			Lending to corporates			Lending to households		
	Overall	Short-term	Long-term	Overall	Loans house purchases	Consumer credit and other	Overall	Short-term	Long-term	Overall	Loans house purchases	Consumer credit and other
Albania	Decreased/tightened considerably	Decreased/tightened somewhat	Decreased/tightened considerably	Increased/eased somewhat	Increased/eased somewhat	Increased/eased somewhat	Decreased/tightened somewhat	Remained basically unchanged	Decreased/tightened somewhat	Increased/eased somewhat	Remained basically unchanged	Increased/eased somewhat
Bosnia and Herzegovina	Decreased/tightened somewhat	Decreased/tightened somewhat	Remained basically unchanged	Decreased/tightened somewhat	Remained basically unchanged	Decreased/tightened somewhat	Decreased/tightened somewhat	Decreased/tightened somewhat	Decreased/tightened somewhat	Decreased/tightened somewhat	Decreased/tightened somewhat	Decreased/tightened somewhat
Iceland	Decreased/tightened somewhat	n/a	n/a	Remained basically unchanged	Remained basically unchanged	Decreased/tightened somewhat	Remained basically unchanged	n/a	n/a	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged
Kosovo	Decreased/tightened somewhat	Remained basically unchanged	Decreased/tightened somewhat	Increased/eased somewhat	Increased/eased somewhat	Remained basically unchanged	Decreased/tightened somewhat	Remained basically unchanged	Decreased/tightened somewhat	Increased/eased somewhat	Remained basically unchanged	Increased/eased somewhat
FYR Macedonia	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged	Remained basically unchanged
Montenegro	Decreased/tightened somewhat	Decreased/tightened somewhat	Decreased/tightened somewhat	Increased/eased somewhat	Increased/eased somewhat	Increased/eased somewhat	Decreased/tightened considerably	Decreased/tightened somewhat	Decreased/tightened considerably	Remained basically unchanged	Decreased/tightened somewhat	Remained basically unchanged
Serbia	Decreased/tightened somewhat	Remained basically unchanged	Decreased/tightened somewhat	n/a	Decreased/tightened somewhat	Remained basically unchanged	Decreased/tightened somewhat	Decreased/tightened somewhat	Decreased/tightened somewhat	n/a	Remained basically unchanged	Remained basically unchanged
Turkey	Increased/eased somewhat	Increased/eased somewhat	Increased/eased somewhat	n/a	Increased/eased somewhat	Increased/eased somewhat	Increased/eased somewhat	Increased/eased somewhat	Increased/eased somewhat	n/a	Remained basically unchanged	Decreased/tightened somewhat

Decreased/tightened considerably
Decreased/tightened somewhat
Remained basically unchanged
Increased/eased somewhat
Increased/eased considerably

Sources: National central banks.
Notes: In the case of Kosovo and Turkey, changes are with respect to 2013 Q2. The survey is of a qualitative nature and was filled in by the national central banks according to their own assessment of the lending developments in their country. The colours in the table reflect each national central bank's assessment.

and south-east Europe (CESEE).[12] The survey of the EIB also covers lending developments to households and corporates in some EU candidate and potential candidate countries. From the point of view of private sector agents, corporate loan demand is curbed by the weak macroeconomic environment in most countries, as well as by a sluggish global economic outlook. The EIB survey further suggests that access to finance was per se not a constraining factor for lending in the first half of 2013, because domestic funding currently compensates for declining cross-border funding. In this context, the results show that lending standards have been negatively influenced by the high level of NPLs in bank balance sheets as well as by regulatory uncertainties in the run-up to the establishment of the Single Supervisory Mechanism in the euro area (see Chapter 4).

Banks in most EU candidate and potential candidate countries appear to be increasing their exposure to their respective public sectors in an attempt to compensate for the sluggish environment for private sector credit prevailing in most cases and thereby positively affect their profitability. Banks in some countries (such as Albania, Bosnia and Herzegovina, and Montenegro) have stepped-up lending to central and local governments, with loans to the public sector accounting for a growing share of total loans extended by banks. This is also the case in the former Yugoslav Republic of Macedonia, although in this case a single bank is largely responsible for the trend.

The rates of credit growth to the public sector by banking systems in EU candidate and potential candidate countries has tended to be very dynamic over the review period, also given that the starting level was very low in all cases under consideration. Loans to the public sector still count for a very small share of total banking sector assets, mostly around 1%, and the share of loans to the public sector in total bank loans also remains low (typically 5% or less, see Table 5).

Table 5
Loans to the public sector

(in percent)

		2008	2009	2010	2011	2012	2013
Albania	*… of total loans*	3.2	2.7	2.0	3.4	4.2	4.7
	… of total banking sector assets	1.5	1.4	1.0	1.7	2.0	2.2
Bosnia and Herzegovina	*… of total loans*	6.1	7.0	8.1	9.0	10.1	10.5
	… of total banking sector assets	4.2	4.7	5.7	6.4	7.4	7.7
Iceland	*… of total loans*	0.7	0.8	1.3	1.0	1.0	0.7
	… of total banking sector assets	0.4	0.5	0.8	0.6	0.6	0.5
Kosovo	*… of total loans*	0.0	0.0	0.4	0.1	0.1	0.0
	… of total banking sector assets	0.0	0.0	0.3	0.1	0.1	0.0
FYR Macedonia	*… of total loans*	n.a.	0.1	0.1	0.2	0.9	0.9
	… of total banking sector assets	n.a.	0.1	0.0	0.1	0.5	0.6
Montenegro	*… of total loans*	1.4	4.0	4.3	7.4	6.7	8.7
	… of total banking sector assets	1.1	3.5	3.7	6.1	5.6	7.0
Serbia	*… of total loans*	1.1	2.0	4.0	4.2	3.4	2.8
	… of total banking sector assets	0.6	1.1	2.3	2.4	2.0	1.5
Turkey	*… of total loans*	4.2	3.8	3.0	2.6	2.3	2.1
	… of total banking sector assets	2.2	1.9	1.6	1.5	1.4	1.3

Sources: National central banks and ECB staff calculations.
Notes: Total loans cover loans to households, non-financial corporations, private sector banks and public sector, and are outstanding amounts in December each year. In the case of Iceland, figures for 2013 are as of June.

[12] European Investment Bank (2013), *CESEE Bank lending survey – H2-2013*. Among candidate and potential candidate countries, this survey covers Albania, Bosnia and Herzegovina and Serbia.

The contribution of lending to the public sector to overall credit growth is limited in most countries except Bosnia and Herzegovina and to a lesser extent Albania. However, the increase in lending to the public sector has been steady in recent years, and the contrast with the pre-crisis situation remains striking. The weight of direct lending to the public sector in total bank lending has doubled, tripled or more within a relatively short period of time in some EU candidate and potential candidate countries in the Western Balkans.

The analysis of exposures of banking systems in EU candidate and potential candidate countries to their respective public sectors via banks' holdings of government securities tends to reveal a similar pattern of moderate to fast growth against a low starting base. Over the period under review, banks in Albania, the former Yugoslav Republic of Macedonia, Montenegro and Serbia have increased their holdings of government securities, with only banks in Turkey showing a pronounced trend in the opposite direction. From a longer term perspective, the growing weight of government securities in total bank assets is notable in all cases except Albania and Turkey. The fact that holdings of government securities have crept up to amount to just under 12% of total bank assets in cases such as Kosovo, Serbia or the former Yugoslav Republic of Macedonia within only a few years is particularly noteworthy (see Table 6).

Table 6

Banks' holding of government securities

(in per cent of total banking sector assets)

	2008	2009	2010	2011	2012	2013
Albania	30.9	28.7	27.1	25.5	25.2	25.0
Bosnia and Herzegovina	0.0	0.0	0.1	1.3	1.9	2.1
Iceland	1.1	8.5	8.5	7.5	7.2	7.0
Kosovo	n.a.	n.a.	6.7	7.6	9.1	11.6
FYR Macedonia	3.7	4.8	5.9	5.0	8.5	10.0
Montenegro	n.a.	n.a.	n.a.	n.a.	1.5	3.4
Serbia	n.a.	4.1	5.8	5.8	8.7	10.8
Turkey	25.8	30.7	27.7	22.6	19.1	15.2

Sources: National central banks and ECB staff calculations.
Note: In the case of Turkey and Iceland, figures for 2013 are as of June/August respectively.

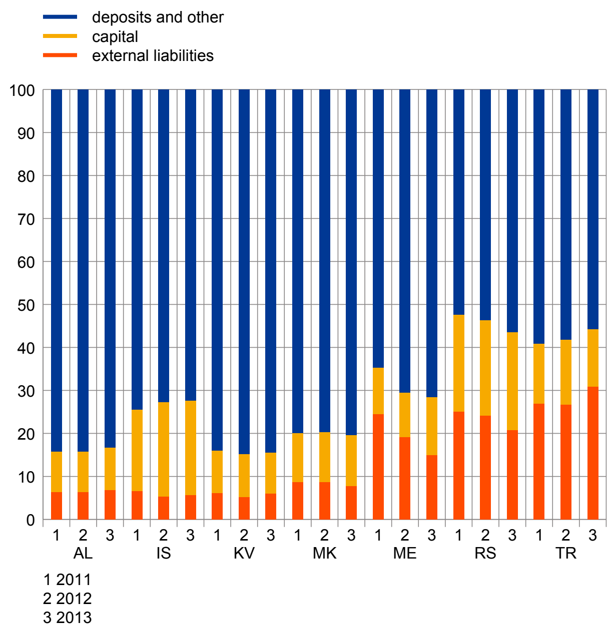
Overall, the exposure of banks in EU candidate and potential candidate countries to the public sector remains limited in most cases and does not constitute a near-term financial stability risk. However, the growing nexus between banking systems and their respective sovereigns should continue to be monitored in a medium-term context as a potentially emerging risk, particularly in view of rising public debt in most of the countries concerned. Furthermore, banks in Albania and Turkey are currently vulnerable to potential sovereign shocks through their sizeable holdings of government securities, even though from a longer term perspective, the share of government securities in total bank assets appears to have been trending down in both countries since 2008.

3.2 Recent funding developments

The longer term reorientation of bank funding bases towards increased local deposits at the expense of external sources of finance has continued in the period under review (see also Section 2.6). A decomposition of bank liabilities into their main components shows that this development has been moderate in Montenegro and Serbia within a relatively short period of time. In other cases, the relative growth of deposits among banks liabilities ('deposit capture') has been more difficult to attain as the reliance on local funding was already very high (e.g. in Kosovo and the former Yugoslav Republic of Macedonia, see Chart 12).

Chart 12
Liability structure of banks

(in percent of total liabilities)



Sources: National central banks and ECB staff calculations.
Notes: In this chart, total liabilities cover the sum of the three components (deposits and other, capital and external liabilities). In the case of Montenegro, wholesale funding and not external liabilities due to data unavailability. For Iceland, figures for 2013 are from June 2013. Due to lack of data, Bosnia vand Herzegovina was excluded from the chart.

With the exception of Albania, "deposits and other" are the most important funding source for banks in candidate and potential candidate countries, accounting for close to 55% in Serbia at the lower end of the spectrum to 85% in Kosovo at the upper end.

In countries like Albania, Kosovo and Turkey asset growth in 2013 was also funded by a slight increase in external liabilities, which counted for close to 9, 6% and 30%, of banks' balance sheets in 2013Q4, respectively (when looking at the three components used in Chart 12). The liability structure of the Turkish (and to a lesser extent the Icelandic) banking sector represents an exception among candidate and potential candidate countries insofar as external funding consists of short-term wholesale funding rather than parent funding. The banking sector in Serbia continued to adjust its funding model, hence external liabilities shrank to 20.7%.

Table 7
Committed credit lines by banks

(in percent of total liabilities, incl. equity)

	2006	2008	2010	2011	2012
Albania	1.2	2.5	2.7	2.4	3.1
Bosnia and Herzegovina	5.2	8.4	6.8	7.1	5.9
Iceland	n.a.	3.4	2.1	2.0	2.8
Kosovo	5.8	5.0	4.6	4.0	6.0
FYR Macedonia	n.a.	2.8	3.4	2.8	2.8
Montenegro	1.4	3.3	2.3	2.6	2.8
Serbia	2.2	4.8	3.4	6.7	4.4
Turkey	6.7	4.5	5.8	8.0	15.6

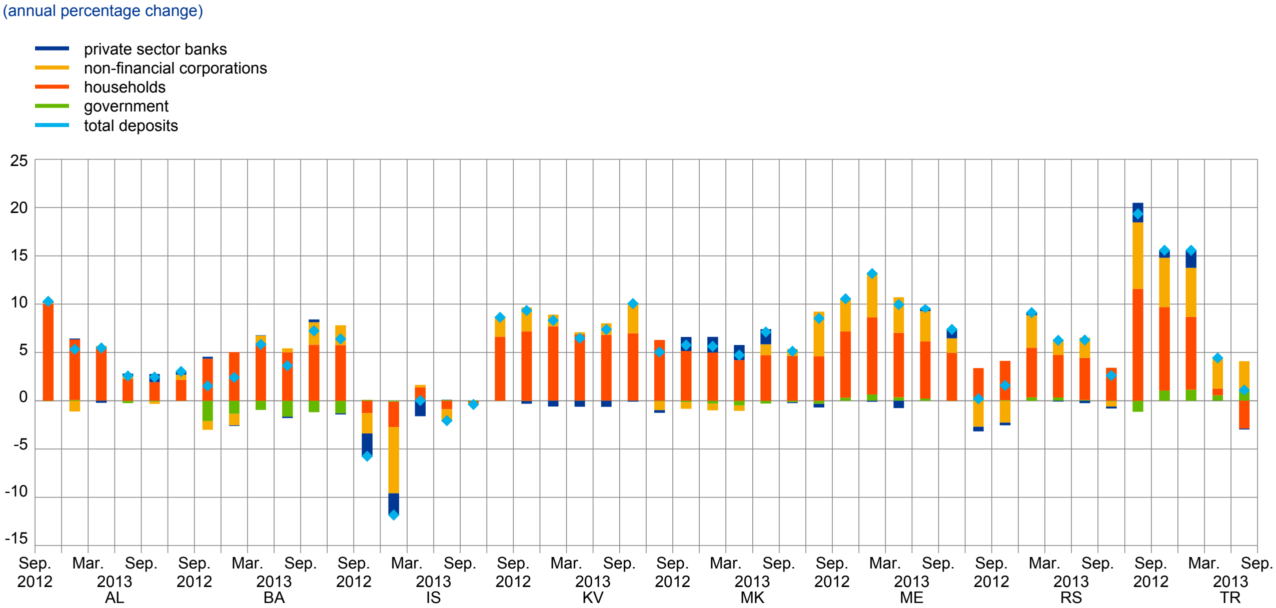
Sources: Bureau van Dijk, Bankscope (commercial banks active as of 2012) and ECB staff calculations.

The changing composition of bank funding sources is only partly reflected in the share of committed credit lines (typically from parent entities) in total liabilities. They have dropped only in Bosnia and Herzegovina and Serbia over the period 2011-2012. In contrast, those countries that have shown a comparatively more dynamic pace of credit extension compared to the pre-crisis period (i.e. Turkey, and to a lesser extent, Kosovo), recorded a noticeable increase in committed credit lines (see Table 7). Box 2 contrasts the experience as regards the substitution of bank funding sources in EU candidate and potential candidate countries with that of recent EU member states.

Household savings continue to account for the bulk of overall deposit trends, although the relative importance of deposits by non-financial corporations is growing in some cases. The evolution in household deposits continued to

Chart 13

Contributions to overall deposit growth



Sources: National central banks, Haver Analytics and ECB staff calculations.
Notes: Time series are converted into euro and foreign exchange-adjusted with the difference in the exchange rate compared to the same month of the previous year.

drive developments in overall deposit growth (see Chart 13), although the relative contribution of deposits by non-financial corporations remains significant in Turkey and Montenegro and has also been on the rise in Serbia. Among EU candidate and potential candidate countries, only Iceland's banking system has continuously posted negative rates of overall deposit growth in the period under review. This trend is partly due to the migration of non-resident deposits into other types of investment options amid the central bank's efforts to reduce the volume of 'offshore krónur' and thereby foster the smooth relaxation of capital account restrictions.[13]

Box 2

Re-composition of funding sources in Central, Eastern and South-Eastern European economies

Western European banks have a significant presence in both EU candidate and potential candidate countries in South-Eastern Europe (SEE EU candidate and potential candidate countries) and in EU member states of Central and Eastern Europe (EU-2004 and EU-post 2007).[14] This box investigates whether SEE candidate and potential candidate countries experienced the same re-composition of funding sources as occurred in EU-2004 and EU-post 2007 countries between 2008 and 2012 by comparing the development of the 'non-core liability ratio' (as a measure of more volatile funds) and the 'foreign liability ratio'.[15] In 2008, the non-core liability ratios in Bosnia and Herzegovina, Montenegro and Serbia were similar to

[13] Central Bank of Iceland (2013), *Financial Stability Report 2013-1*.

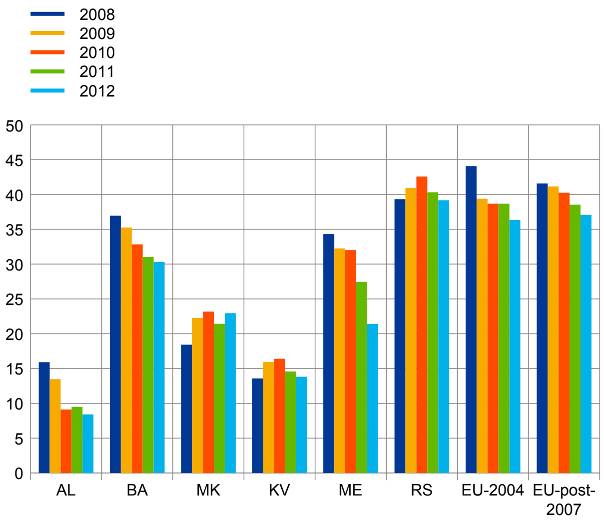
[14] For the purpose of this analysis, EU-2004 consists of the Czech Republic, Hungary and Poland, and EU-post 2007 includes Bulgaria, Romania and Croatia.

[15] The non-core liability ratio is defined as total liabilities minus capital and domestic deposits over total liabilities minus capital. The foreign liability ratio is defined as foreign liabilities over total liabilities minus capital. The term foreign in this context refers to non-residents.

Chart A

Non-core liabilities ratio

(2008-2012, non-core liabilities in percentage of total liabilities minus capital)

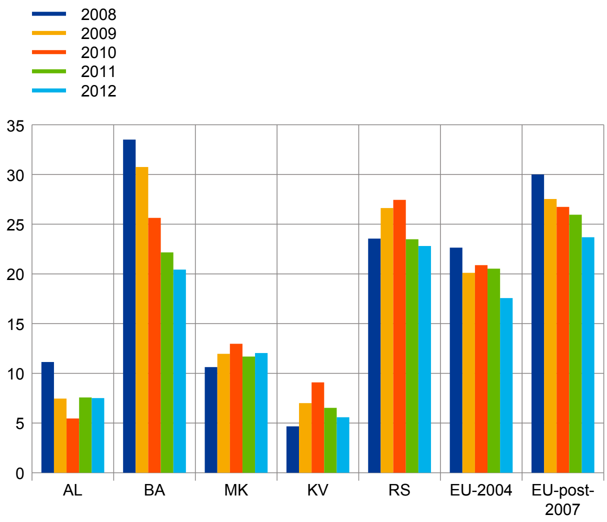


Source: Banca d'Italia based on data from national authorities.
Note: Weighted averages based on total liabilities excluding capital.

Chart B

Foreign ratio

(2008-2012, foreign liabilities in percentage of total liabilities minus capital)



Source: Banca d'Italia based on data from national authorities.
Note: Weighted averages based on total liabilities excluding capital.

that in EU-2004 and EU-post 2007 countries, while the ratios in Albania, the former Yugoslav Republic of Macedonia and Kosovo were much lower (see Chart A). Such differences likely reflected the composition of the banking systems' funding sources.[16] Between 2008 and 2012, non-core liabilities have been decreasing, especially in EU-2004, in EU-post-2007, and in Albania, Bosnia and Herzegovina and Montenegro, signalling that domestic deposits have gained more prominence among funding sources in the latter countries. At the same time, due to the strong presence of Western European parent banks in the region and thus easier access to foreign funding from parent groups, foreign liabilities, which are shown in Chart B2, have in many cases represented a significant source of financing. In the case of Serbia, a significant part of foreign liabilities is subordinated debt, which also tends to have longer maturity. Additionally, foreign liabilities appear to have driven the dynamics of non-core liabilities in many countries, as one can notice by comparing Chart A and Chart B. Between 2008 and 2012, foreign liabilities in EU-2004 and EU-post 2007 countries declined, reflecting parent bank groups' deleveraging. Nonetheless, the speed of the reduction is diverse among the two groups. Deleveraging was also implemented in SEE EU candidate and potential candidate countries between 2008 and 2012, although at different times and pace with respect to EU-2004 and EU-post 2007 countries. In general, there seems to be a broad-based re-orientation towards domestic funding at the expense of foreign liabilities in all countries. The pace and timing of deleveraging differs, which is likely related to domestic factors, including varying lending opportunities in the region.

Reference deposit rates in EU candidate and potential candidate country banking systems have remained broadly stable or declined in a context of some monetary policy easing by central banks both 'at home' and 'abroad'. Notwithstanding this overall trend, reference deposit rates vary widely among EU candidate and potential candidate country banking systems, reflecting both

[16] Gregorio, I., Heinz, R., and Ruggerone, L. (2013), "Bank Funding in Central and South Eastern Europe Post Lehman: a New Normal", *IMF Working Paper*, 13/148, Washington DC.

Table 8

Reference deposit rates

(as applied in the relevant quarter)

	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
Albania	3.5	3.4	3.4	2.8	2.3	1.9
Bosnia and Herzegovina	0.2	0.2	0.4	0.4	0.4	0.3
Iceland	0.9	1.0	1.1	1.1	1.1	n.a.
Kosovo	3.7	3.7	3.5	3.5	3.4	2.4
FYR Macedonia	1.3	1.5	1.2	1.2	1.2	1.2
Montenegro	3.2	3.2	3.1	3.0	2.7	2.5
Serbia	6.7	6.3	6.9	5.9	5.6	5.0
Turkey	6.5	5.9	5.2	5.3	6.2	6.1

Sources: National central banks and ECB staff calculations.
Notes: Reference deposit rates refer to weighted averages of short-term and long-term deposit rates to households and non-financial corporations, in domestic or foreign currency (as applied in the relevant quarter).

diverging monetary and exchange rate policy regimes as well as different underlying perceptions of 'country risk' (see Table 8).

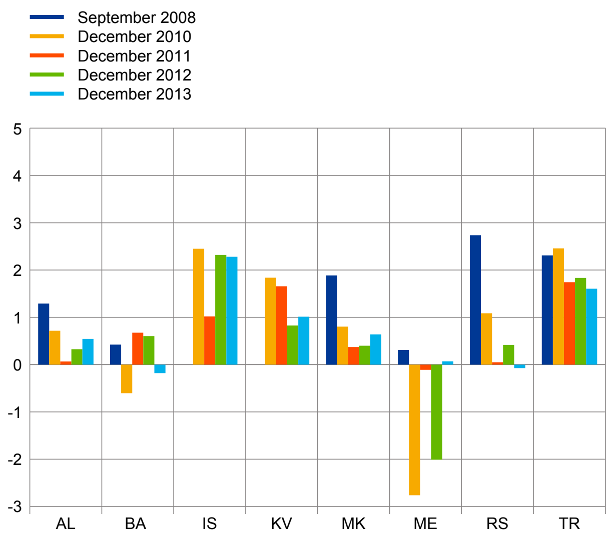
Relative reliance on interbank funding has remained broadly stable and thus of limited importance for most banking systems concerned. The share of interbank funding (both domestic and foreign banks) in total liabilities of banking systems in the Western Balkan EU candidate and potential candidate countries ranged from 5.2% (Serbia) to 16.4% (Montenegro) in Q2 2013.

In a longer term perspective, the share of interbank funding has decreased in Montenegro and Serbia, remained broadly unchanged in Albania and Kosovo and increased slightly in the former Yugoslav Republic of Macedonia since 2011 (although it remains marginal in banks' overall funding). In the first half of 2013, it was the second most important funding source in Turkey. Overall, these figures indicate that there is room to improve the functioning of the interbank market to channel funding from banks with a funding surplus to those with a funding deficit.

Chart 14

Return on assets

(in percent)



Sources: National central banks.
Note: In the case of Iceland, figures for 2013 are as of June.

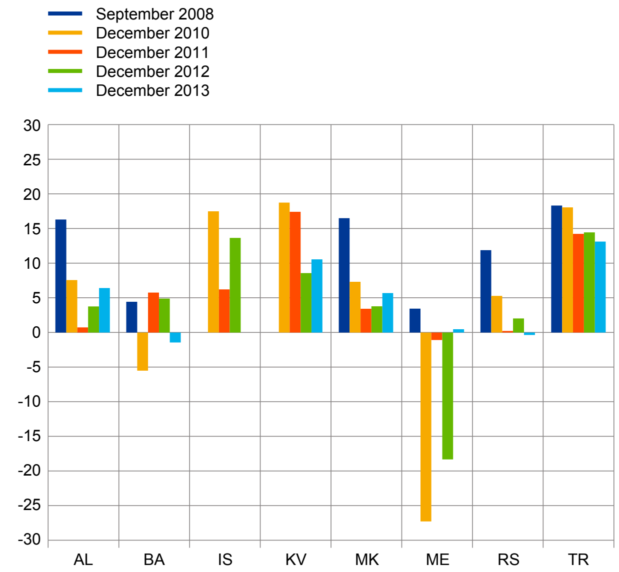
3.3 Dynamics in underlying profitability

Pressure on bank profitability has continued amid an often difficult business environment. Banks' return on assets (RoA) have remained subdued in all EU candidate and potential candidate countries except for Iceland, Turkey, and to a lesser extent Kosovo (see Chart 14). There seem to be tentative signs of improvement of such indicators in Serbia and Montenegro. In Q4 2013, RoA of the banks in EU candidate and potential candidate countries ranged from -0.2% in Bosnia and Herzegovina,1.0% in Kosovo and 1.6% in Turkey. Compared to the pre-crisis period, the returns generated from banks' assets decreased in all countries.

In the case of Montenegro, profitability turned around at the beginning of 2013 due to some sell-offs of NPLs.

Chart 15
Return on equity

(in percent)



Sources: National central banks.
Note: In the case of Iceland, figures for 2013 are as of June.

The ongoing adjustment in bank balance sheets has generally brought down the leverage ratio of banks, ranging from 11.9% in Albania to 4.8% in Serbia in Q4 2013 (see country annexes). Lower leverage has in turn often been associated with a downtrend in returns on equity in some cases, (see Chart 15). Overall, returns on equity ratios have remained consistently robust in the cases of Turkey, Kosovo and Iceland. In case of Iceland, this is mainly related to reductions in expenses costs and a net increase in loan values in the corporate sector.

Banks' net income has generally been dampened by increased provisioning for rising NPLs. Provisions rose in most EU candidate and potential candidate countries, primarily reflecting stubborn challenges to asset quality but also regulatory changes in some cases. The latter was the case in Turkey, where the Basel II.5 framework became operative. However, net income increased in 2012 compared to 2011 in all countries except Kosovo, while it remained negative in Montenegro (see also Table 9).

Interest-related income remains the most important source of revenue for banks in EU candidate and potential candidate countries. Although the low interest rates currently prevailing at a global level reduce banks' funding costs, they also put pressure on margins and thus ultimately on profitability as well. Revenues generated from lending are the most important income source in EU candidate and potential candidate countries. Gains from trading with securities and derivatives have a minor importance in overall net income except in the case of Turkey. Operating costs seem to dent significantly into profits. Non-interest expenses as a share of

Table 9
Net income in 2012

	Albania		Bosnia and Herzegovina		Iceland		Kosovo		FYR Macedonia		Montenegro		Serbia		Turkey	
as of 2012	million EUR	y-o-y change (%)	million EUR	y-o-y change (%)	million EUR	y-o-y change (%)	million EUR	y-o-y change (%)	million EUR	y-o-y change (%)	million EUR	y-o-y change (%)	million EUR	y-o-y change (%)	million EUR	y-o-y change (%)
Gross interest income	551.9	5.6	591.6	-2.9	1,089.3	14.6	200.5	2.7	326.9	3.0	189.5	-3.3	1,764.7	-8.2	46,730.4	30.4
– Total interest expenses	265.8	10.7	202.9	-5.0	525.8	21.2	63.1	8.0	142.0	-4.2	83.5	-7.0	735.2	-6.8	24,510.8	23.4
Net Interest income	286.0	1.3	388.7	-1.8	563.5	9.1	137.4	0.5	184.9	9.3	106.0	-0.2	1,029.5	-9.2	22,219.6	38.9
– Provisions for loan losses	133.7	-0.6	121.3	3.2	145.7	-31.1	n.a.	0.0	81.3	25.4	120.5	3.6	401.4	-31.9	1,754.6	4.6
+ Non-interest income	403.6	-16.8	221.9	-0.9	503.4	-31.7	46.6	3.5	101.7	8.0	96.7	-27.4	8,776.4	-3.4	12,147.2	13.7
– Non-interest expenses	345.5	-19.2	411.8	-1.7	632.6	-40.3	161.5	15.0	181.9	1.1	139.9	8.5	9,307.3	-3.2	18,213.8	23.6
+ Gain (losses) on securities	9.0	4.4	n.a.	n.a.	153.8	1.7	-0.6	57.8	1.2	-10.2	2.2	-47.1	5.3	60.0	-999.9	-257.0
Pre-tax earnings	37.1	130.2	77.4	-7.3	442.3	232.2	21.8	-45.7	24.5	23.5	-55.6	-2,997.5	102.5	756.2	13,398.4	22.9
Net income	27.1	438.5	64.4	-9.7	390.0	125.0	18.5	-48.7	23.8	23.5	-56.5	-1,655.5	74.3	511.5	10,002.3	24.0

Sources: National central banks, Haver Analytics and ECB staff calculations.
Notes: For Albania, provisions for loan losses cover provisions for loans and other assets. In the case of FYR Macedonia, impairment losses of non-financial assets are also included in provisions for loan losses, and gains (losses) on securities refer to net-income from assets and liabilities held for trading.

gross income range from 55% in Turkey to 100% in Bosnia and Herzegovina in Q4 2013. However, in order to improve their income, some banks are cutting operational costs (mostly staff-related through lay-offs and re-adjusting the remuneration structures) as well as utilising economies of scale and innovations.

The scope to increase interest rate margins appears limited to the extent that the credit environment remains sluggish and global interest rates remain low, especially in the foreign exchange lending segment which is dominant in many cases. Interest rate spreads between reference lending and deposit rates have remained broadly stable in the period under review, ranging from 4.6pp in the former Yugoslav Republic of Macedonia to 8.7pp in Kosovo in 2013 Q4. Looking into the currency denomination, the spread between lending and deposit rates in domestic currency ranged from 3.9pp to 9.2pp in 2013Q4 and thus remained above that for loans and deposits in foreign exchange, which ranged between 4.8pp and 6.2pp. The narrower dispersion of foreign exchange-denominated interest rate margins relative to domestic ones appears to provide limited room for significant increases in the former segment, especially to the extent that the global credit and interest-rate environment remains sluggish.

3.4 Conclusion

Overall, the magnitude of the challenge to reach a ‘new banking normal’ for banking systems in EU candidate and potential candidate countries appears to remain sizeable. On the lending side, challenges to asset quality through high NPL burdens in some cases hamper effective balance sheet repair and increased financial intermediation. Survey-based indicators show that demand for credit also remains weak in many cases, especially in the corporate sector. Concerning funding, the substitution of external for domestic sources of finance has been encouraging, with banks successfully capturing household deposits, although the evidence on loan-to-deposits provided in chapter 2 illustrates that the stability of domestic bank funding bases has yet to be cemented in many cases. Moreover, the potential of domestic deposits to fully offset the reduction in foreign funding when credit demand picks up again remains questionable, suggesting that the development of alternative sources of funding in local capital markets would be key. Concerning profitability, pressure has generally remained high in the period under review, with provisioning for NPLs denting banks’ net income. Banks in several countries have tried to make up for this shortfall by increasing their exposure to the public sector, but the impact on bank profitability (as well as on overall credit growth more generally) has been limited.

4 Potential implications of the Single Supervisory Mechanism for banking systems in EU candidate and potential candidate countries

The establishment of a 'banking union' in the European Union is set to have a number of implications for banking systems in EU candidate and potential candidate countries. The regulatory and supervisory environment of most euro area-headquartered banks with a strong presence in EU candidate and potential candidate countries will fundamentally change, as a key element of the banking union – the Single Supervisory Mechanism (SSM) – became fully operational in November 2014. This implies that the relationship between 'home' (euro area) and 'host' (EU candidate/potential candidate) supervisory and regulatory authorities will be altered going forward.

The environment in which euro area-headquartered banks operate will continue to evolve as further progress is made towards the completion of the banking union project. This will include the establishment of a Single Resolution Mechanism (SRM) as well as a system of harmonised Deposit Guarantee Schemes (DGS). EU candidate and potential candidate countries will also be impacted by these changes as the legal and regulatory environment which they must comply with as prospective EU members will be modified. Changes in the business strategies of parent banks operating in non-SSM countries resulting from banking union in the euro area appear more uncertain, but cannot be ruled out.

The remainder of this chapter provides an overview of the prospective role of the SSM as the home supervisor of banks where parent-subsidiary relations are most prominent (i.e. EU candidate and potential candidate countries in the Western Balkans, Section 4.1). It then takes a closer look at the potential benefits and challenges for EU candidate and potential candidate countries associated with the establishment of the SSM (and the introduction of macro-prudential competencies at the euro area level, Sections 4.2 and 4.3)

4.1 The SSM as home supervisor of locally-systemic banks in EU candidate and potential candidate countries

The SSM will 'inherit' a banking structure in which subsidiaries of EU- and in particular euro area-headquartered banks in EU candidate and potential candidate countries are dominant and hence systemically-important from a 'host' point of view. At the end of 2012, almost 70% of bank assets in the six Western Balkan economies which are EU candidates and potential candidates (i.e. Albania, Bosnia and Herzegovina, Kosovo, the former Yugoslav Republic of

Table 10
Euro area head quartered banking groups in the Western Balkans

(in percent, as of December 2013)

		Share of Western Balkan subsidiaries in group's assets	Share in total banking assets Western Balkans
Raiffeisen Bank International	(AT)	5.0	11.3
Intesa Sanpaolo	(IT)	0.9	9.6
UniCredit Bank	(IT)	0.5	8.1
NLB	(SI)	26.5	5.8
Société Générale	(FR)	0.3	5.7
NBG	(GR)	2.3	4.5
Erste Group Bank (incl. Sparkasse Bank)	(AT)	1.0	3.4
Eurobank	(GR)	1.8	2.4
Alpha Bank	(GR)	1.9	2.5
Piraeus Bank	(GR)	1.3	2.2
Crédit Agricole	(FR)	0.0	1.3
BNP Paribas	(FR)	0.0	0.2
Veneto Bank	(IT)	0.4	0.3
Hypo Alpe-Adria Bank International	(AT)	9.8	4.5
ProCredit Bank	(DE)	36.5	3.7
Nova KBM	(SI)	2.3	0.2
Cyprus Popular Bank	(CY)	6.5	0.4
Total			66.1

Sources: Bankscope, national central banks and ECB staff calculations.
Note: The red box denotes those banks that are part of the ECB comprehensive assessment (June 2014). Western Balkans includes Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro and Serbia.

Macedonia, Montenegro and Serbia) were owned by euro area-headquartered banking groups, with Austrian, Greek, Italian, French and Slovenian subsidiaries dominating the market (see Table 10).

Consolidated claims by such parent banking groups typically amount to around 50% of host country GDP. Most of these cross-border banking groups are expected to be deemed 'significant'[17] entities and would thus fall under the direct supervision of the ECB once the SSM will assume its responsibilities in November 2014. Using the list of banks that has been released as part of the 'comprehensive assessment'[18] underway as a broad approximation to this end, the ECB would be the 'home' supervisor for about 60% of total banking assets in EU candidate and potential candidate countries in the Western Balkans (see Chart 16).

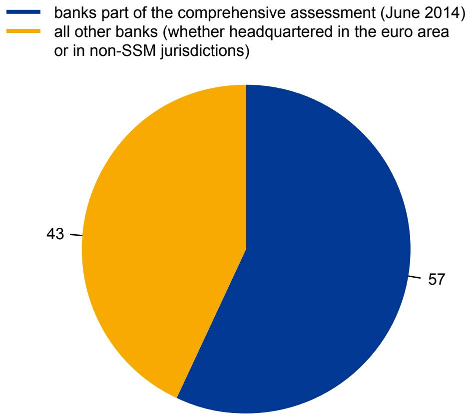
The key practical implication arising from the establishment of the SSM for EU candidate and potential candidate countries in the Western Balkans is that the ECB will become the 'home supervisor' for a large part of local banking

[17] The 'significance' of banking entities to fall under the direct auspices of the ECB from a consolidated supervision point of view will be established according to a number of different metrics. Banks will be deemed as significant if total asset size exceeds €30 billion, or if they account for more than 20% of a participating members' GDP (except if total assets amount to less than €5 billion). Banks which have received ESM/EFSF financial assistance as well as the three most significant banks in participating Member States will also be directly supervised by the ECB. In addition, entities can be deemed as significant if there is agreement between national supervisors ('National Competent Authorities') and the ECB that this is the case; if the activities of the bank in question are important for the EU economy and/or the Member State concerned; or if cross-border activities are sizeable. In addition, the SSM regulation confers on the ECB the power to take up the direct supervision of any individual entity which is deemed as 'less significant'. See European Central Bank (2014a) with an overview of the structure of the SSM on the ECB website "banking supervision", available at https://www.bankingsupervision.europa.eu/home/html/index.en.html

[18] See European Central Bank (2014b), "The list of significant supervised entities and the list of less significant institutions", *ECB publication*, September, available at http://www.ecb.europa.eu/pub/pdf/other/ssm-listofsupervisedentities1409en.pdf

Chart 16
Share of (presumably) directly ECB-supervised banks in the Western Balkans

(in per cent of total banking sector assets)



Sources: National central banks and ECB staff calculations.
Note: Western Balkans includes Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro and Serbia.

systems. At the same time, a still significant part of individual banking systems will remain outside the supervisory realm of the SSM, on account of (i) subsidiaries of euro area-headquartered entities expected to be deemed 'less significant', (ii) subsidiaries from non-SSM jurisdictions (notably Turkey), and (iii) the remaining parts of the system that are domestically-owned. For EU candidate and potential candidate countries in the Western Balkans, this implies that of the top three banks operating in any given country (as measured by total asset size), one will still fall outside the supervisory remit of the SSM from a consolidated viewpoint.

Most euro area-headquartered banks operating in EU candidate and potential candidate countries in the Western Balkans are expected to be deemed as 'significant' by the SSM. However, the activities of local subsidiaries within any given country are unlikely to elicit much concern from the point of

Table 11
Presence of selected euro area-headquartered banks in individual Western Balkan banking systems

(in percent, as of December 2013)

	Subsidiary's share in group assets	Market share of total assets in host country
Albania		
Raiffeisen Bank	1.6	22.7
Intesa Sanp aolo Bank	0.2	11.7
Tirana Bank (Piraeus Bank)	0.8	7.9
Alpha Bank	0.8	6.4
Bosnia and Herzegovina		
Unicredit Group	0.3	21.3
Raiffeisen Bank	1.5	17.3
Hypo Alpe-Adria Group	4.7	10.9
NLB Group	8.2	9.1
Kosovo		
ProCredit Bank	13.3	27.3
Raiffeisen Bank	0.5	23.4
NLB Bank	3.7	16.3
FYR Macedonia		
Stopanska Banka (NBG)	1.2	21.4
NLB Bank	7.8	16.2
Ohridska Banka (Société Générale)	0.0	7.6
Sparkasse (ErsteBank)	0.1	4.1
Montenegro		
NLB Bank	4.1	17.3
Erste Bank	0.2	11.9
Société Générale	0.0	11.8
Hypo Alpe-Adria Bank	0.9	8.1
Serbia		
Intesa Sanpaolo Bank	0.6	15.0
Unicredit Bank	0.3	8.9
Société Générale	0.2	7.8
Raiffeisen Bank	1.4	7.2

Sources: Bankscope, national central banks and ECB staff calculations.

view of consolidated supervision as they tend to account for a very minor share of total group assets. The individual weight of the four largest subsidiaries of euro area-headquartered entities in any given country rarely exceeds 1% of total group assets (see Table 11). Even from an aggregate perspective, the total share of subsidiaries of euro area-headquartered entities operating in the Western Balkans within any given banking group does not exceed 5% of total group assets, with the exception of NLB, Procredit and Hypo Alpe-Adria. However, the latter two banking groups are not expected to be deemed 'significant' by the SSM.

The relatively limited importance of local subsidiaries of euro area-headquartered banks for the group as a whole stands in contrast to the systemic nature of their activities for 'host' banking systems. Individual subsidiaries which typically only account for 1% or less of the respective total group assets tend to have a significant market share of banking activity in EU candidate and potential candidate countries in the Western Balkans, amounting for up to a quarter of total banking assets per country (see Table 11). As a result, there is an asymmetry between the relevance of subsidiaries of euro area-headquartered banks for host countries in the Western Balkans (and their respective supervisory authorities) on the one hand and for the parent banking group (and therefore the home supervisor) on the other.

4.2 Potential benefits of the SSM for EU candidate and potential candidate countries

The establishment of the SSM could bring a number of benefits to prospective EU members, especially to those countries in the Western Balkans whose banking systems are largely owned by euro area-headquartered parents.

First, EU candidate and potential candidate countries host to SSM-supervised banks should benefit from 'positive spillovers' stemming from increased financial stability at the core ('home' of parent banks) to the extent that the SSM leads to a sounder banking system and stronger supervision. The SSM is widely expected to be an important step to help reduce financial fragmentation and increase confidence in the banking sector, and thereby contribute to increased financial stability and better governance in the euro area. This is to materialise in particular through the centralisation of supervision under the aegis of the ECB, coupled with the adoption of a high-quality common supervisory approach, underpinned by a single rulebook and supervisory manual. Furthermore, the centralisation of supervision will address long-standing home-host coordination problems in a credible manner. Coupled with the SSM's supranational mandate, this should be associated with a reduction of both 'home bias' in the activities of cross-border banking groups and 'inaction bias' by national supervisors. The latter could be especially important where subsidiaries of SSM-supervised banks are significant local market players.

The adoption of a high-quality common supervisory approach/model should also be conducive to both the earlier detection and handling of problems in individual parent entities and a reduced risk of supervisory ring-fencing in crisis situations. So far as banking systems in prospective EU members are concerned, this coordinated approach could possibly also entail more consideration relative to the current status quo of (i) potential spillover effects of supervisory and macro-prudential measures to be taken at the level of the SSM on third parties; and (ii) possible cross-border circumvention by parent banking groups of supervisory and macro-prudential measures taken in prospective EU members, respectively.

As a result, provided that the SSM can deliver on the expectations which have been placed on it, countries whose banking systems have strong links to those of SSM member states are set to gain from more effective supervision at the core regardless of whether they participate in the system or not. However, it should be noted that the full benefits of the SSM in terms of enhanced financial stability can only be expected to unfold if the architecture of the banking union is completed. In particular an effective SRM complementing the SSM is necessary to break the sovereign/bank nexus in the euro area.

Second, EU candidate and potential candidate countries will benefit from simplified 'home-host' interactions following the establishment of the SSM, both bilaterally and through supervisory colleges, akin to the simplified interactions which countries that are party to the SSM may expect.[19] In bilateral terms, the SSM will lead to a streamlining of communication within existing cooperation agreements on consolidated supervision. For most euro area-headquartered banks operating in EU candidate and potential candidate countries (those to be deemed 'significant' entities by the SSM), host supervisors will interact with only one (the ECB) instead of multiple euro area home supervisors as is currently the case. As regards the supervisory colleges, the ECB will act as the 'home' supervisor for 'significant' banks from a consolidated point of view. Simplified communication will also be a benefit in this domain, since the ECB will become the counterparty to national supervisors, replacing several euro area supervisors. This will certainly be the case for non-SSM EU countries, but potentially also for non-EU countries which exhibit significant banking interconnections with SSM participating countries to the extent that host authorities are able to participate in such colleges.[20]

Third, EU candidate and potential candidate countries should also benefit from the establishment of a more level playing field for parent banks in home (SSM) countries as well as in an EU accession context. For parent entities the level playing field will consist of (i) a 'single rulebook' aiming at the consistent implementation of harmonised rules, on the basis of which the ECB (and national competent authorities for less significant entities) will supervise banks and which should be developed by the European Banking Authority (EBA) for the EU as a whole; (ii) a common supervisory manual laying down items such as the procedures for on-site inspections to be conducted in joint supervisory teams and the risk assessment systems to be used, which will apply to both 'significant' and 'less

[19] The SSM will bring simplification, efficiency and clarity by avoiding altogether the complicated arrangements between home and host supervisors currently in place as regards the consolidated supervision of cross-border banking groups operating in the euro-area.

[20] National supervisors ('National Competent Authorities') will continue to lead supervisory colleges for less significant SSM-headquartered entities as home supervisors, with the ECB retaining the option to participate in such arrangements.

significant' entities; and (iii) the establishment of uniform data reporting templates. Once established, these common rules and procedures could be associated with a lower cost of doing business (regulatory compliance) for cross-border banking groups that are present in both EU and non-EU countries, thereby indirectly benefiting the latter as well. Moreover, to the extent that such rules and practices become the standard at an EU-wide level beyond that of SSM participants, EU candidate and potential candidate countries will have strong incentives to align themselves at an early stage to the legal and regulatory environment which will become binding upon EU accession.

Finally, to the extent that the banking union will help to reduce the sovereign/bank nexus and thus financial fragmentation in the euro area, it should also lead to more homogenous funding costs for euro area-headquartered parent banks that are active in EU candidate and potential candidate countries. This levelling of the playing field across borders would be an important development, since the crisis in the euro area has been associated with significant differences in funding costs, depending on the nationality of the parent banks.

4.3 Potential challenges of the SSM for EU candidate / potential candidate countries

The establishment of the SSM might also bring about a number of challenges for prospective EU members. As is the case with its potential benefits, countries whose banking systems have strong interconnections to those in SSM jurisdictions would appear to be potentially more affected than others. In this context, some concerns as detailed below have been expressed by policy makers from EU candidate and potential candidate countries[21] as well as in the context of the European Bank Coordination 'Vienna II' Initiative.[22]

First, prospective EU members appear to be concerned about voice and representation, as their banking systems are 'too small to matter' when discussing implications from SSM/ECB decisions for third parties. This follows from the asymmetric importance of individual subsidiaries of euro area-headquartered banks for 'home' and 'host' authorities outlined in Section 4.1. In conceptual terms, the main concern is that the small significance of local entities in cross-border parent groups as a whole may not be conducive to the full internalisation of potential spillovers for third parties of micro-prudential decisions taken by the SSM from a consolidated point of view. In practical terms, the perception of this risk is also due to the fact that the channels of communication to voice such concerns ex ante vis-à-vis the ECB/SSM are not yet in place (see Section 4.4). Furthermore, the voicing of such concerns ex ante by EU candidate and potential

[21] See for example the speech by Ardian Fullani, Governor of the Bank of Albania, at the technical meeting to promote regional cooperation in the framework of Vienna II Initiative, Tirana, 3 October 2013; or the address of Maja Kadievska-Vojnovik, Vice-Governor of the National Bank of the Republic of Macedonia, at the regional summit of Governors, Belgrade, 8 November 2013.

[22] See in particular Vienna II Initiative, (2013a), *Working Group on the European Banking Union and Emerging Europe*, 30 April and Vienna II Initiative (2013b), *Observations on the proposed directive for bank recovery and resolution and the single resolution mechanism*, 12 November.

candidate country authorities vis-à-vis the ECB/SSM is also seen as at risk of being 'diluted' in a supranational context, compared to bilateral communication with national (euro area) supervisors. In a related concern, authorities in some prospective EU member states apparently believe that the adjusted future composition of the supervisory colleges for significant cross-border banking groups (which will be chaired by the ECB) will be associated with a loss of influence on their part, stemming from the need to establish working relationships with new officials and the reduced relevance of established relationships with key national supervisors in the euro area.

They also voice concerns about the adequate internationalisation of spillovers for non-SSM parties as regards macro-prudential policies, with EU candidate and potential candidate countries being possibly affected by decisions taken in a complex system by the ECB or national authorities.[23] Moreover, until such time as they are members of the banking union, EU candidate and potential candidate countries implement their own macro- and microprudential instruments, which could induce supervisory distortions. While the duty of consultation between the ECB and national authorities would reduce the risk of potentially contradictory decisions affecting local banking systems in EU candidate and potential candidate countries, authorities remain concerned about the possibility that their banking systems will be affected by 'coordinated' decisions from the core which may not be adequate for local circumstances, thus forcing host supervisors to act.

Second, there is a concern that centralised supervision from a consolidated point of view for only part but not the entire banking sector in EU candidate and potential candidate countries will lead to the emergence of a 'two-tiered' system, placing some entities at a competitive disadvantage. In this regard, the concern is that banks which are supervised by the SSM from a consolidated point of view could be perceived to be 'safer' on account of presumably more onerous oversight and the importing of credibility ex ante as well as the availability of financial backstops ex post. In this context, troubled banking parents which are party to the SSM would have the Single Resolution Mechanism/Single Resolution Fund as a prospective backstop as well as implicit access under certain conditions to direct recapitalisation through ESM resources, with neither option being available to banks headquartered in other jurisdictions, in particular domestically-owned banks.

The resulting competitive distortions introduced in domestic banking sectors would be primarily manifest though lower borrowing costs for some banks compared to others. According to this view, the fact that some banks would have implicit access to liquidity in euro provided by the ECB (through their parents) while others have not

[23] Given the different credit cycles in member states, the SSM regulation allows participating member states either to act on their own initiative when applying macro-prudential tools or to request the ECB to act. In addition, the ECB will have the power to apply higher (but not lower) requirements for capital buffers and other prudential measures set out in Union Law (CRD IV/CRR) to address systemic or macro-prudential risks. The macro-prudential toolkit defined in the regulation contains a number of instruments such as higher levels of own funds, liquidity, large exposure and public disclosure requirements, risk weights for mortgage exposures and intra-financial sector exposures. However, macro-prudential instruments which are not regulated by EU law, such as loan-to-income and loan-to-value ratios, will remain the sole responsibility of national supervisors. The national authorities and the ECB must inform each other of their respective intentions before proceeding with any policy action and the ECB will not have the possibility to 'block' national measures. For a detailed description see Angeloni, I. (2014), "European macroprudential policy from gestation to infancy", in Banque de France, *Financial Stability Review*, No. 18)

would further reinforce the competitive distortions in host banking systems. Such concerns on 'level playing field issues' are seen to be particularly relevant in the Western Balkans, where at least one of the top three banks per country would fall outside both the supervisory remit of the SSM and the liquidity-providing operations of the ECB (see Section 4.1).

The concerns mentioned above on the potential downsides to the establishment of the SSM need to be put into perspective and should also be assessed relative to the prevailing status quo. For example, the asymmetric importance of subsidiaries of euro area-headquartered banks for home and host authorities is a long-standing feature of banking systems in EU candidate and potential candidate countries and will not materially change as a result of the SSM. It does not necessarily follow that a perceived 'home bias' in supervision will increase (rather than decrease) on account of a broader pan-European supervisory mandate relative to a narrower 'national' one previously. Similar arguments apply as regards the new composition of the supervisory colleges. It is also not evident that the concerns of host authorities as regards macro-prudential spillovers would be more readily dismissed in a supranational context relative to the current set-up in which they must put forward arguments bilaterally vis-à-vis home authorities.

Moreover, while the granting of macro-prudential powers to the ECB as well as to national competent authorities may add to complexity for EU candidate and potential candidate countries, the implicit need for coordination among home authorities may also be seen as an improvement compared to the current status quo in which hosts are exposed to uncoordinated, overlapping and potentially conflicting decisions from various (euro area) supervisors. Lastly, it is questionable whether as a result of the establishment of the SSM competitive distortions in domestic banking systems would increase relative to the current state of affairs in which (i) bank funding costs already differ significantly according to the nationality of the parent in question; and (ii) significant parts of the system have indirect access to ECB liquidity-providing operations through parent entities while non-euro area-headquartered banks do not have recourse to this option.

Adequate cooperation and communication between 'home' and 'host' authorities would help to address the concerns on the establishment of the SSM (and the wider project of European Banking Union) as expressed by EU candidate and potential candidate countries, especially in the Western Balkans on account of strong banking interlinkages. This would appear all the more relevant since, as non-EU members, they do not have the possibility to 'opt in' into the SSM and are neither part of the ESRB nor EBA, and can only participate in supervisory colleges subject to the consent of the college itself. Further convergence to the EU legal and regulatory standards by prospective EU members should be fostered in this context. For example, gaps with EU standards as regards data confidentiality in some EU candidate and potential candidate countries have been seen as a major obstacle to both participation in the supervisory colleges and to the completion of Memoranda of Understandings (MoUs) in the supervisory domain.

5 Conclusions

Banking systems in EU candidate and potential candidate countries continue to face a number of challenges to financial stability in both the short-term and medium-term. The near-term challenges primarily relate to credit risks stemming from the generally weak economic dynamics in combination with already high non-performing loan burdens in many banking systems, especially in the Western Balkans. Notwithstanding sizeable cross-country heterogeneity, Albania, Serbia and Montenegro appear as particularly vulnerable in this regard. Although still showing positive credit trends, the continued increase of non-performing loans in both Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia also gives cause for concern. This implies that removing impairments to bank balance sheets which may be standing in the way of enhanced credit extension should remain a key near-term policy priority for authorities in most Western Balkan economies. The continued trend towards increased reliance on local sources of finance (notably domestic deposits) coupled with the moderation of parent bank deleveraging has dampened bank funding vulnerabilities. However, loan-to-deposit ratios remain very high in the cases of Bosnia and Herzegovina and Montenegro, implying lingering funding risks.

Iceland and Turkey are outliers to the trends depicted above characterising much of the Western Balkans, each exhibiting their own country-specific traits. In Iceland, the main risks to financial stability continue to stem from the legacy of the 2008 crisis and the potential implications of the lifting of capital controls. In Turkey, the key challenge going forward is to achieve a ‘soft landing’ as regards the pace of credit extension, while containing risks stemming from increased reliance on external funding amid a changing international environment.

In the medium-term, the key challenges to financial stability in EU candidate and potential candidate countries relate to indirect market and funding risks, especially in Western Balkan economies. Concerning market risk, indirect vulnerabilities posed by widespread foreign exchange-denominated or indexed lending remain a structural weakness in many cases, which may materialise through unhedged borrowers in the event of nominal exchange rate depreciations/devaluations. This is especially an issue for Serbia, Albania, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia, albeit to varying degrees and notwithstanding considerable differences in underlying monetary and exchange rate policy frameworks. This suggests that active policies to increase the use of local currencies should be pursued both to reduce financial stability risks and to afford greater degrees of policy freedom to monetary authorities. As regards funding risk, the extent to which ‘forced’ deleveraging may materialise in the period ahead remains open. This could either imply outright divestments of locally systemic entities if these are sold or less supportive parent bank finance to domestic economies in the event that local resources are insufficient to meet credit demand once this picks up in a durable manner.

Looking further ahead, the magnitude of the challenge to reach a ‘new banking normal’ – a new status quo – for banking systems in prospective EU member countries appears to remain sizeable. Challenges to asset quality in some cases hamper increased financial intermediation. Concerning funding, the trend substitution of external for domestic sources of finance has been encouraging, but the potential of domestic deposits to fully offset the reduction in foreign funding when credit demand picks up remains an open issue. The development of domestic capital markets to provide stable and longer-term funding alternatives is thus key to mitigate potential shortcomings in this context. Pressure on profitability has generally remained high, with provisioning for bad loans denting banks' net income and banks in several countries attempting to make-up for this shortfall by increasing their exposure to the public sector. The latter does not appear to constitute a near-term financial stability risk as exposures (while growing) remain very low in most cases except in Turkey and Albania, implying that those banking systems remain exposed to potential sovereign shocks.

The establishment of the Single Supervisory Mechanism (SSM) will be a significant change in the supervisory landscape of EU candidate and potential candidate countries in the Western Balkans, as nearly 60% of total bank assets in these countries are expected to fall under direct ECB home supervision from a consolidated point of view. The establishment of the SSM could bring a number of benefits to such parties, including increasing financial stability in those countries which are home to key parent banking groups, a simplification of home-host supervisory relationships and possibly a reduction in 'home bias' by home country authorities and the achievement of a more level playing field for banks. At the same time, host authorities in EU candidate and potential candidate countries have expressed some concerns which mainly stem from an asymmetry between the relevance of subsidiaries of euro area-headquartered banks for host countries on the one hand and for the parent banking group on the other. These concerns could be addressed by establishing adequate channels for communication and cooperation between home and host authorities under the new system.

Country-specific annexes

A.1 Albania

The banking sector, which is predominantly foreign-owned, has continued to grow in recent years, in contrast to developments in some peer countries (see Table A.1). Although there are 16 banks operating in the country, the system is relatively concentrated, with over half of total banking assets in the hands of the three largest players and around a quarter of total assets controlled by a single entity (Raiffeisen). While some progress has been achieved in the restructuring of Greek subsidiaries – which account for just under a fifth of total banking assets – the Bank of Albania has applied more stringent capital and liquidity requirements to such entities and intensified coordination with Greek authorities in order to prevent undue spillovers.[24]

Table A.1
Structure of the banking sector

	Description	2008	2009	2010	2011	2012	2013
Number of banks		16	16	16	16	16	16
… of which foreign-owned		14	14	14	14	14	14
Total assets of banking sector	Percent of nominal GDP	76.6	77.2	81.0	87.4	89.6	90.9
Total assets of private banks	Million euro	6,792	6,712	7,190	7,982	8,544	8,800
… of which assets of foreign-owned banks	Percent of total assets	93.6	92.4	90.6	90.3	89.8	88.6
Total liabilities of private banks	Million euro	6,792	6,712	7,190	7,982	8,544	8,800
… of which external liabilities	Percent of total liabilities	10.1	6.7	4.9	6.8	6.7	7.4
…… of which external liabilities to other private banks	Percent of total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Bank of Albania and IMF/WEO.

Local capital markets serve mainly government funding needs. Local bond markets consist only of government bonds, amounting to 37% of GDP, and thus being by far the largest among EU candidate and potential candidate countries in the Western Balkans relative to GDP (see Table A.2).

Table A.2
Local capital markets

	Unit	2008	2009	2010	2011	2012	2013
Size of local bond market (amount outstanding, at market value)	Percent of GDP (eop)	34	33	34	32	33	37
... share of corporate bonds	in percent of t ot al local bond market	0	0	0	0	0	0
... share of governement bonds	in percent of t ot al local bond market	100	100	100	100	100	100
Size of local stock market (amount outstanding)	Percent of GDP (eop)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Banks’ outstanding corporate bonds	Million euro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Banks’ holding of government securities	Million euro	2,097	1,926	1,946	2,036	2,155	2,200
Debt securities issued by corporations[1)]	Percent of GDP (eop)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Banks’ credit to non-government residents[2)]	Percent of GDP (eop)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Bank of Albania.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) MFI (excluding NCB) credit to domestic non-MFI residents other than government. Credit includes outstanding amounts of loans and debt securities.

24 See IMF (2013b), Albania – Article IV consultation, country report 13/7.

Table A.3
Financial stability indicators

(percentages)

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Regulatory capital to risk-weighted assets	15.4	14.8	14.6	15.1	15.6	15.9	15.7	15.9	16.2	16.8	17.0	17.8	18.0
Regulatory Tier-1 capital to risk-weighted	14.5	13.9	13.5	13.9	14.3	14.7	14.5	14.5	14.6	15.2	15.4	14.8	14.9
Non-performing loans													
… net of provisions t o capital	35.9	38.1	47.4	51.2	52.0	54.2	55.8	59.5	55.6	57.0	56.4	45.4	40.2
… to total gross loans	14.0	14.7	17.0	18.4	18.8	20.1	21.1	22.7	22.5	23.7	24.2	24.2	23.5
Households: NPLs to total gross loans	11.8	13.1	13.9	15.4	15.8	16.4	16.8	17.4	17.2	17.8	17.2	17.1	16.7
Non-financial corporations: NPLs to total gross loans	15.5	16.0	19.1	20.5	20.8	22.5	23.8	26.0	25.9	27.4	28.4	28.6	27.7
… of which in FX	13.8	14.7	17.1	18.8	19.6	21.3	22.6	24.4	24.7	26.0	26.5	26.2	25.7
…… of which in Euro	14.3	15.0	17.5	19.9	20.8	21.6	22.8	23.9	24.2	25.5	25.8	25.4	25.3
…… of which in USD	10.0	13.1	12.7	11.2	12.0	20.0	21.8	27.8	28.0	29.6	31.6	33.5	29.5
…… of which in CHF	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Return on assets	0.7	0.3	0.2	0.2	0.1	0.7	0.4	0.4	0.3	0.4	0.3	-0.1	0.5
Return on equity	7.6	2.9	2.4	1.9	0.8	8.0	4.8	4.2	3.8	5.2	2.9	-1.7	6.4
Liquid assets to total assets	25.9	26.6	25.5	26.3	26.5	29.0	29.0	29.0	29.4	29.1	27.4	29.2	27.6
Liquid assets to short -term liabilities	30.6	31.4	30.2	31.3	33.1	36.1	36.0	35.8	36.7	36.1	33.8	36.5	34.7
Net open position in foreign exchange to capital	5.0	2.8	3.7	-3.0	3.9	4.0	6.0	4.1	4.0	1.7	4.0	4.3	4.1
Capital to assets	9.4	9.1	8.6	8.7	8.7	8.7	8.6	8.5	8.6	8.6	8.5	8.3	8.4
Large exposures to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Gross asset position in financial derivatives to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Gross liabilit y position in financial derivat ives to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Trading income to total income	1.2	0.9	1.6	1.6	1.5	1.4	1.3	1.4	1.5	2.4	2.2	1.7	2.2
Interest margins to gross income	118.9	129.6	146.6	147.6	147.7	119.7	129.5	130.6	130.4	123.6	131.2	148.3	112.6
Non-interest expenses to gross income	75.5	85.1	88.4	89.4	91.3	71.7	80.4	82.2	85.0	78.7	87.5	98.3	74.7
Foreign-currency-denominat ed loans to foreign-currency denominated deposits	86.0	88.1	87.4	82.9	83.3	83.5	79.7	74.2	74.1	75.4	75.9	70.7	69.8
Foreign-currency-denominated loans to total loans	69.8	69.4	68.7	68.8	67.9	68.2	67.1	66.5	64.5	64.8	64.5	63.7	63.0
Foreign-currency-denominat ed liabilit ies to total liabilities	51.0	50.2	50.2	50.3	51.9	52.1	52.3	53.7	52.6	52.4	51.8	52.9	52.8
Net open position in equities to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household loans to gross domestic product	12.1	11.5	11.8	11.9	11.4	11.2	11.1	11.3	11.2	11.1	11.2	11.1	11.0
Household debt service and principal payments to income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Residential real estate prices (Percentage change/last 12 months)	5.0	0.9	-1.3	5.6	-6.2	2.5	4.8	-10.9	-5.7	1.3	4.8	3.2	0.1
Loan-to-deposit ratio	60.1	60.7	61.1	60.1	61.3	61.0	59.5	58.0	58.3	58.2	57.5	55.3	55.3
Loan-to-value rat ios for housing loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Ratio of external liabilities to total liabilit ies of banks	4.9	5.1	6.3	6.3	6.8	7.2	6.9	6.6	6.7	7.0	7.1	7.6	7.4

Source: Bank of Albania.
Notes: NPL in foreign exchange refers to NPL in foreign currency to total loans in foreign currency. Due to lack of data, household debt to GDP refers to household loans to GDP. Non-performing loans cover those loans that are classified in the last three categories of credits classification: sub-standard, doubtful and loss. Their gross amount (principal + interest) is the total of non-performing loans. Non-interest expenses to gross income covers administrative expenses to net interest and non-interest income.

Credit risk and impairments to the bank lending channel are the largest financial stability challenges for the Albanian banking sector, with indirect market risks still latent. The quality of the loan portfolio deteriorated further during the period under review, with the ratio of NPLs to total gross loans edging up to 24.2% in mid-2013 (see Table A.3). This was mainly driven by developments in the corporate loan segment, which in turn suffers from a sluggish pace of liquidation of state arrears to businesses. Although provisions for impaired loans were stepped up, NPLs net of provisions to capital still came down to 40.2% in Q4 2013, but further efforts to foster workouts (particularly as regards collateral execution) thus appear necessary.[25]

Nevertheless, the Albanian banking sector remains well capitalised, with a ratio of regulatory capital to risk-weighted assets of 18.0% in Q4 2013. The liquidity position of the banking system remained strong, despite a slight decline in the main liquidity

[25] See IMF (2013c) Albania: Concluding Statement of the Staff Visit Tirana, September 27.

indicators, with liquid assets amounting to 28% of total assets and 35% of short-term liabilities in Q4 2013.

The banking sector appears to be well-hedged against direct risk from adverse exchange rate and interest rate movements, but remains indirectly sensitive to potential changes on these variables. In this context, the exposure to indirect market risk from unhedged borrowing in foreign exchange remains relatively high, with foreign exchange loans accounting for 63.0% of total loans. Exposure to adverse developments in interest rates stemming from potential sovereign shocks is also relevant through still-sizeable holdings of government debt securities (see also Table 6 in Chapter 3). Looking forward, capital adequacy needs to be monitored closely in light of the rapid deterioration of loan quality against a sluggish macroeconomic environment.

A.2 Bosnia and Herzegovina

The number of banks operating in Bosnia and Herzegovina remains remarkably high relative to peer countries.[26] Although the number of players active in the country as a whole fell to 27 in the period under review[27] (see Table A.4), there still appears to be room for further consolidation. Nevertheless the banking sector remains relatively concentrated, with the top three players in the system (i.e. Unicredit, Raiffeisen, and Hypo Alpe-Adria) holding a combined market share of just over half of total banking assets. The fact that the third and fourth-largest banks (Hypo Alpe-Adria and NLB) are being restructured creates some uncertainty to the medium-term banking sector outlook in Bosnia and Herzegovina.

Table A.4
Structure of the banking sector

	Description	2008	2009	2010	2011	2012	2013
Number of banks		30	30	29	29	28	27
… of which foreign-owned		21	21	19	19	19	17
Total assets of banking sector	Percent of nominal GDP	83.3	84.8	82.1	81.5	82.3	83.9
Total assets of banking sector	Million euro	10,643	10,537	10,439	10,735	10,833	11,261
… of which assets of foreign-owned private banks	Percent of total assets	95.0	94.5	92.8	92.1	91.9	90.5
Total liabilities of banking sector	Million euro	10,643	10,537	10,439	10,735	10,833	11,261
… of which external liabilities	Percent of total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which external liabilities to other private banks	Percent of total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Central Bank of Bosnia and Herzegovina and IMF/WEO.

Local capital markets need to be further developed in order to reduce the dependency on external financing. The local stock market has contracted in recent years on the back of sluggish economic growth (see Table A.5). The bond market is dominated by government bonds which are mainly held by the banking sector, whose exposure to entity government bonds (i.e. those of the Republika Srpska and the Federation of Bosnia and Herzegovina) has increased.

[26] This might be related to the complex structure of the country, in which each entity has its own banking supervision.

[27] One small domestic bank, Hercegovacka Bank d.d. Mostar, got its license revoked in July 2012. Another small domestic bank (PostBank BH d.d. Sarajevo) was delicensed in late June 2013, bringing the total number of banks to 27 in end-2013.

Table A.5

Local capital markets

	Unit	2008	2009	2010	2011	2012	2013
Size of local bond market (amount outstanding, at market value)	Percent of GDP (eop)	0.8	1.1	2.1	2.7	3.0	3.8
... share of corporate bonds	Percent of total local bond market	8.5	8.2	2.2	1.0	1.1	0.7
... share of governement bonds	Percent of total local bond market	91.5	91.8	97.8	99.0	98.9	99.3
Size of local stock market (amount outstanding)	Percent of GDP (eop)	46.6	45.2	43.9	29.4	29.3	29.5
Banks' outstanding corporate bonds	Million euro	5.0	4.7	12.5	12.9	7.8	2.7
Banks' holding of government securities	Million euro	0.0	3.3	8.5	139.1	206.8	241.3
Debt securities issued by corporations[1)]	Percent of GDP (eop)	0.1	0.1	0.0	0.0	0.0	0.0
Banks' credit to non-government residents[2)]	Percent of GDP (eop)	56.6	55.9	56.2	56.4	57.6	58.4

Source: Central Bank of Bosnia and Herzegovina.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) MFI (excluding NCB) credit to domestic non-MFI residents other than government. Credit includes outstanding amounts of loans and debt securities.

The main challenges to financial stability are rising credit and market risks, and improving the bank funding base, in an environment where the uncertainty related to the ongoing restructuring of key parent entities is expected to prevail.

The ratio of NPLs to gross loans rose to 15.1% in the period under review, suggesting that there is a need to undertake a further clean-up of lending portfolios in the banking system as a whole. The banking system appears to be adequately capitalised at the aggregate level, with a ratio of regulatory capital to risk-weighted assets ratio of 17.8% in Q4 2013, but NPLs net of provisions to capital amounted to 31% in Q4 2013, suggesting that the system's ability to cope with unexpected shocks may be compromised (see Table A.6). The banking system as a whole remained profitable until Q3 2013. The negative end-year performance can be attributed to five banks, while the majority of banks remained profitable. Despite this, the sluggish economic environment means that the anticipated modest improvement in credit growth will continue to put pressure on standard indicators in this regard.

The exposure to direct market risk – as measured by banks' net open position in foreign exchange to capital – increased to 11.1% in Q2 2013, while exposures to indirect market risks (in the form of foreign exchange loans to total loans, which amounted to 64% in Q2 2013) remained high but stable. Looking forward, securing stability in the bank funding base will remain critical on account of the high level of the loan-to-deposit ratio (almost 115% in Q4 2013). Closer coordination and cooperation with home country supervisors will also remain important given the ownership structure of the domestic banking system and the fact that key players (HAAG and NLB) are subject to restructuring plans.[28]

[28] Authorities in Bosnia and Herzegovina have recently amended the respective legal frameworks related to the treatment of confidential information so as to align them with EU requirements. This had previously been seen as an important hurdle preventing the conclusion of MoUs with key home supervisors in the euro area.

Table A.6
Financial stability indicators

(percentages)

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Regulat ory capital to risk-weighted assets	16.2	15.8	15.5	15.3	17.1	17.4	16.7	16.7	17.0	17.2	17.2	17.0	17.8
Regulatory Tier-1 capital to risk-weighted assets	12.6	12.8	12.5	12.4	13.6	14.2	14.1	14.1	14.1	14.6	14.9	14.6	15.2
Non-performing loans													
… net of provisions to capital	42.0	42.5	43.1	46.9	25.9	25.8	28.5	28.6	30.0	30.6	31.7	33.3	31.0
… to total gross loans	11.4	11.7	11.8	12.6	11.8	12.1	12.7	12.7	13.5	13.8	14.3	14.9	15.1
Households: NPLs to total gross loans	7.2	7.1	7.3	8.0	11.0	11.2	11.0	10.9	11.2	11.1	10.9	10.8	10.8
Non-financial corporations: NPLs to total gross loans	14.9	15.3	15.3	16.3	12.5	12.9	14.0	14.1	15.3	15.9	16.9	18.1	18.6
… of which in FX	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in Euro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in USD	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in CHF	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Return on assets	-0.6	0.2	0.4	0.4	0.7	0.2	0.5	0.8	0.6	0.3	0.5	0.5	-0.2
Return on equity	-5.5	1.4	3.5	3.4	5.8	1.8	4.2	6.4	4.9	2.0	4.2	3.9	-1.4
Liquid assets to total assets	29.0	27.9	26.2	27.2	27.2	24.7	24.7	24.8	25.4	24.1	24.2	25.3	26.4
Liquid assets to short -term liabilities	49.7	48.5	46.2	47.5	46.7	42.3	43.0	43.5	44.1	42.2	42.4	44.0	46.2
Net open position in foreign exchange to capital	4.4	11.6	11.2	11.8	16.0	6.4	8.2	6.4	5.3	6.6	11.1	10.5	6.7
Capital to assets	11.8	11.9	12.1	12.0	13.6	14.2	14.2	14.4	14.2	14.6	14.9	14.5	14.4
Large exposures to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Gross asset position in financial derivatives to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Gross liability position in financial derivatives to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Trading income to total income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest margin to gross income	60.1	61.3	60.5	61.0	63.9	65.5	64.2	63.6	63.7	64.2	63.3	63.0	62.3
Non-interest expenses to gross income	109.0	88.2	86.1	90.7	86.5	83.1	81.0	81.1	87.4	80.4	79.5	87.5	101.2
Foreign-currency-denominated loans to foreign-currency denominated deposits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign-currency-denominated loans to total loans	70.0	68.5	68.1	67.8	66.9	63.4	64.0	63.7	63.1	63.2	63.7	64.1	62.9
Foreign-currency-denominated liabilities to total liabilities	67.0	66.7	66.4	66.5	66.2	65.5	67.4	66.5	65.2	65.1	65.1	64.1	63.8
Net open position in equities to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt to gross domestic product	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt service and principal payments to income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Residential real estate prices (Percentage change/last 12 months)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Loan-to-deposit ratio	115.9	118.0	119.5	118.0	117.8	121.5	120.9	121.1	118.5	118.1	118.7	115.4	114.7
Loan-to-value ratios for housing loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Ratio of external liabilities to total liabilities of banks	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Central Bank of Bosnia and Herzegovina.
Notes: Loan-to-deposit-ratio is calculated using total loans net of interbank loans and customers' deposit (excl. deposits from financial institutions). Non-performing loans cover the three last categories of the credit classification, i.e. sub-standard (principal or interest is between 90 and 180 days overdue), doubtful (principal or interest is between 180 and 270 days overdue) and loss (principal or interest is 270 days or more overdue).

A.3 Iceland

The Icelandic banking sector has stabilised in recent years but remains highly concentrated and in public hands. The number of banks remained unchanged in 2013 (see Table A.7). The banking sector remains fully domestically owned, with

Table A.7
Structure of the banking sector

	Description	2008	2009	2010	2011	2012	2013*
Number of banks [1]		22	16	16	14	13	13
… of which foreign-owned [1]		0	0	0	0	0	0
Total assets of banking sector	Percent of nominal GDP	282.7	197.3	179.9	180.3	174.3	167.9
Total assets of banking sector	Million euro	24,617	16,434	17,968	18,483	17,431	18,669
… of which assets of foreign-owned banks	Percent of total assets	0.0	0.0	0.0	0.0	0.0	0.0
Total liabilities of banking sector	Million euro	24,617	16,434	17,968	18,483	17,431	18,669
… of which external liabilities	Percent of total liabilities	17.5	10.5	7.6	5.3	4.2	4.5
…… of which external liabilities to other private banks	Percent of total liabilities	4.9	6.1	5.8	3.7	2.1	2.1

Sources: Bank of Albania and IMF/WEO.
Notes: *As of June 2013.
1) Deposit Money Bank.

the three biggest commercial banks owning 96% of total banking assets. After a protracted period of contraction in order to correct for past excesses, the total asset size of the banking system has risen moderately since 2011, edging up to 168% of GDP in Q2 2013.

With capital controls in place, the relative importance of the domestic bond market for bank funding has increased (see Table A.8). Domestic sight deposits have also become a key funding source for this reason.

Table A.8

Local capital markets

	Unit	2008	2009	2010	2011	2012	2013*
Size of local bond market (amount outstanding, at market value)	Percent of GDP (eop)	114.2	90.9	110.2	112.2	109.9	110.4
... share of corporat e bonds	in percent of total local bond market	19.7	15.0	8.5	7.8	7.1	7.2
... share of governement bonds	in percent of t ot al local bond market	13.2	28.8	43.3	43.1	45.8	44.3
Size of local stock market (amount outstanding)	Percent of GDP (eop)	15.7	12.9	14.6	15.6	21.5	26.0
Banks' out standing corporate bonds	Million euro	74.0	75.5	38.4	153.3	116.7	222.7
Banks' holding of government securities	Million euro	262.7	1,403.4	1,526.5	1,381.4	1,261.1	1,326.7
Debt securities issued by corporations [1]	Percent of GDP (eop)	22.5	13.7	9.3	8.8	7.8	7.9
Banks' credit to non-government residents [2]	Percent of GDP (eop)	154.5	128.9	124.9	117.1	113.9	109.3

Source: Central Bank of Iceland.
* Market Cap information as of September 2013, GDP estimates for 2013. All other figures are as of August 2013.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) MFI (excluding NCB) credit to domestic non-MFI residents other than government. Credit includes outstanding amounts of loans and debt securities.

Iceland's new banks are well capitalised and profitable, but risks to financial stability stemming from the legacy of the 2008 financial bust remain. The three largest commercial banks have further strengthened their capital base so that the sector's total capital adequacy ratio rose to 25.2% in Q2 2013, from 20.9% in end-2011 (see Table A.9). Bank profitability is also high compared to other peer Nordic countries, reaching a return on equity of 13% in Q2 2013. Moreover, considerable progress has been made as regards corporate NPL reduction, with the sector-wide ratio to gross loans edging down to 5.1% in Q2 2013. Banks' exposure to direct market risk has also continued to contract from its post-crisis peak, with the net open position in foreign exchange dropping to 3.6% at the end of the period under review. However, despite these improvements, a number of legacy issues from the sharp financial bust of 2008 will continue to challenge financial stability going forward.

First, household indebtedness remains high, at 108% of GDP in Q2 2013. Authorities have recently presented a plan to reduce mortgage indebtedness, largely financed by an increase in the levy on financial institutions including from failed estates. However, this could aggravate negotiations over the final settlement of the estates of failed banks and thereby lead to a more protracted lifting of capital controls than would otherwise be the case. This is because the foreseen bank levy will reduce the value of the assets that will ultimately accrue to the (mostly foreign) creditors of the estates. Second, while banks' liquidity buffers are very high (with liquid assets to total assets and short-term liabilities at 23% and 178% respectively), these partly depend on a degree of domestic financial repression, including captive funds locked in by capital controls. Third, the lifting of capital controls could lead to capital outflows and heightened exchange rate volatility given the still substantial stock of liquid offshore krónur.

Table A.9
Financial stability indicators

(percentages)

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2
Regulatory capital to risk-weighted assets	19.7	21.2	22.1	22.7	20.9	20.9	22.4	22.7	24.3	24.8	25.2
Regulatory Tier-1 capital to risk-weighted assets	18.0	19.5	20.2	20.9	19.3	19.1	20.7	21.0	22.3	22.9	23.3
Non-performing loans											
… net of provisions to capital	40.2	n.a.	25.2	27.2	22.6	22.9	9.8	3.4	-2.8	-2.6	-7.5
… to total gross loans	18.3	n.a.	13.9	14.2	11.6	11.6	9.5	7.9	6.4	5.8	5.1
Households: NPLs to total gross loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-financial corporations: NPLs to total gross loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
… of which in FX	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in Euro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in USD	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in CHF	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Return on assets	2.5	2.9	3.0	2.5	1.0	2.5	2.5	2.1	2.3	2.0	2.3
Return on equity	17.5	18.8	18.9	15.1	6.2	16.4	15.4	12.7	13.7	11.5	13.0
Liquid assets to total assets	22.2	21.5	20.1	23.6	20.5	20.8	20.6	23.3	23.4	23.3	22.9
Liquid assets to short -term liabilities	159.3	196.2	201.6	231.9	205.8	205.4	225.9	199.9	180.1	192.4	178.0
Net open position in foreign exchange to capital	102.4	68.1	61.1	29.1	22.6	25.9	18.2	18.4	7.7	3.7	3.6
Capital to assets	14.0	16.3	16.5	16.7	16.4	15.8	16.4	16.7	17.0	18.1	18.0
Large exposures to capital	39.8	39.3	54.5	52.5	47.3	47.5	44.8	38.0	34.8	33.9	28.0
Gross asset position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross liability position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trading income to total income	1.0	3.1	-3.5	-0.7	11.6	5.5	5.8	6.3	5.7	4.9	4.3
Interest margins to gross income	102.1	388.2	219.2	148.6	257.1	454.8	245.2	192.1	128.1	488.1	164.2
Non-interest expenses to gross income	64.3	63.6	63.8	69.9	171.0	81.1	83.9	101.0	93.3	111.8	89.4
Foreign-currency-denominated loans to foreign-currency denominated deposits	563.0	519.0	455.0	269.0	227.0	224.0	228.0	212.0	200.0	185.0	176.0
Foreign-currency-denominated loans to total loans	47.9	45.5	40.3	34.3	28.1	28.7	26.2	25.3	24.6	22.8	22.4
Foreign-currency-denominated liabilities to total liabilities	6.1	6.1	5.9	8.9	9.0	8.8	8.4	8.7	8.8	9.2	9.3
Net open posit ion in equities to capital	9.9	n.a.	13.8	n.a.	14.0	n.a.	11.6	n.a.	7.7	n.a.	7.7
Household debt to gross domestic product	123.3	119.2	115.5	112.9	113.6	110.6	113.7	110.5	110.5	108.9	108.3
Household debt service and principal payments to income	30.6	22.0	20.2	20.3	20.3	18.6	18.4	19.6	19.8	18.6	18.8
Residential real estate prices (Percentage change/last 12 months)	0.2	1.9	4.7	7.3	9.9	8.7	6.3	6.0	5.8	4.6	6.9
Loan-to-deposit ratio	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Loan-to-value ratios for housing loans	51.0	n.a.	n.a.	n.a.	46.0	n.a.	n.a.	n.a.	43.0	n.a.	n.a.
Ratio of external liabilities to total liabilities of banks	9.0	8.3	7.8	7.1	6.3	6.3	5.7	5.8	5.1	5.3	5.5

Source: Central Bank of Iceland.
Note: Non-performing loans in the table are calculated as DMB's loan portfolios by the three largest commercial banks, parent companies. Past due items (COREP exposure).

Overall, the lifting of capital controls thus remains a major challenge both for the banking sector and for the wider economy as a whole, given the inherent costs for allocative efficiency associated with the maintenance of such restrictions in a small open economy such as the Icelandic one.

A.4 Kosovo

The banking sector in Kosovo has remained broadly stable in the period under review, with asset growth of 8.1% in end-2013 with respect to end-2012, as compared with a 6.8% increase in 2012 (see Table A.10). The entry of Türkiye İş Bankası into the system brought the total number of players up to nine in 2013, of which seven are foreign-owned entities. As is the case in many peer economies in the Western Balkans, the banking sector is relatively concentrated, with close to two-thirds of total banking assets in the hands of the top three entities operating in the country (all of them euro area-headquartered, i.e. ProCredit, Raiffeisen and NLB). The presence of Turkish-owned banks in the system is also notable, with a combined market share of

Table A.10
Structure of the banking sector

	Description	2008	2009	2010	2011	2012	2013
Number of banks		8	8	8	8	8	9
… of which foreign-owned		6	6	6	6	6	7
Total assets of banking sector	Percent of nominal GDP	45.9	55.0	57.2	55.6	57.6	59.4
Total assets of private banks	Million euro	1,808	2,205	2,455	2,650	2,829	3,059
… of which assets of foreign-owned banks	Percent of total assets	91.7	91.4	90.4	89.2	89.5	90.0
Total liabilities of private banks	Million euro	1,808	2,205	2,455	2,650	2,829	3,059
… of which external liabilities	Percent of total liabilities	4.2	6.4	8.2	5.9	5.0	5.7
…… of which external liabilities to other private banks	Percent of total liabilities	2.0	3.4	3.8	2.3	1.1	2.3

Sources: Central Bank of the Republic of Kosovo and IMF/WEO.

around 13% of total banking assets. Kosovo is defined as one of the strategic markets for the NLB group in its restructuring plan, but uncertainties related to this process going forward cannot be ruled out.

As is also the case in other peer economies, local capital markets in Kosovo are in an early stage of development, so that the availability of longer-term funding for credit institutions to help avoid maturity mismatches remains limited. In 2012, the government started issuing T-bills via the central bank, which serves as its fiscal agent. Domestic banks are the main investors in government debt securities, which together with foreign debt obligations amounted to 12% of total bank assets in 2013 (see Table A.11).

Table A.11
Local capital markets

	Unit	2008	2009	2010	2011	2012	2013
Size of local bond market (amount outstanding, at market value)	Percent of GDP (eop)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
... share of corporate bonds	in percent of total local bond market	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
... share of governement bonds	in percent of total local bond market	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Size of local stock market (amount outstanding)	Percent of GDP (eop)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Banks' outstanding corporate bonds	Million euro	n.a.	n.a.	7.8	0.5	0.0	0.0
Banks' holding of government securities [1)]	Million euro	n.a.	n.a.	165.6	201.5	256.5	354.5
Debt securities issued by corporations [2)]	Percent of GDP (eop)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Banks' credit to non-government residents [3)]	Percent of GDP (eop)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Central Bank of the Republic of Kosovo.
1) Government securities include securities invested in both domestic government securities and in securities of governments abroad.
2) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than government. Credit includes outstanding amounts of loans and debt securities.

Near-term challenges to financial stability stemming from the banking system appear contained, with a sector characterised by high capitalisation and liquidity buffers and low exposure to credit and market risks, although vulnerability to external spillovers remains. The ratio of regulatory capital to risk-weighted assets was 16.7% in Q4 2013, down by 2 percentage points since 2010 but still well above the minimum required ratio of 12% set by domestic supervisory authorities (see Table A.12).[29]

[29] The drop in capital adequacy ratios is mainly attributable to changes in the Regulation on Bank Capital Adequacy, effective as of December 2013, which enforced more conservative measures on regulatory capital calculation. For more information, see the Central Bank of the Republic of Kosovo Board decisions from 29 November 2012 and 26 April 2013 respectively, available at www.bqk-kos.org/?cid=2,53,527 and www.bqk-kos.org/?cid=2,53,576.

Table A.12
Financial stability indicators

(percentages)

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Regulatory capital to risk-weighted assets	18.8	18.1	17.2	17.1	17.6	18.0	17.2	17.7	14.2	15.1	15.0	16.4	16.7
Regulatory Tier-1 capital to risk-weighted assets	15.8	15.1	14.4	14.3	14.8	15.2	14.4	14.8	11.6	12.5	12.2	12.5	12.8
Non-performing loans													
… net of provisions to capital	5.4	5.7	5.7	5.2	4.4	4.4	5.2	5.6	7.4	6.7	7.3	8.7	7.8
… to total gross loans	5.9	6.2	5.9	6.0	5.8	6.0	6.5	7.0	7.5	7.6	7.8	8.5	8.7
Households: NPLs to total gross loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-financial corporations: NPLs to total gross loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
… of which in FX	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
… of which in Euro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
… of which in USD	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
… of which in CHF	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Return on assets	1.8	1.0	1.4	1.5	1.7	1.3	1.0	1.0	0.8	1.0	1.2	1.2	1.0
Return on equity	18.8	10.2	14.2	15.8	17.4	13.6	9.7	10.7	8.6	10.0	12.3	12.0	10.6
Liquid assets to total assets	36.8	33.9	29.8	32.1	31.3	30.4	28.9	30.3	32.6	31.1	29.3	32.1	36.6
Liquid assets to short-term liabilities	46.2	43.2	38.1	40.5	39.6	38.6	36.2	37.9	40.8	39.2	37.3	41.2	47.1
Net open position in foreign exchange to capital	-0.1	1.1	1.3	-1.3	2.5	-0.3	-2.4	3.1	0.7	0.3	0.3	4.4	2.3
Capital to assets	10.1	10.1	10.2	9.8	10.2	10.6	10.3	10.1	10.0	10.5	10.5	10.0	9.7
Large exposures to capital	72.4	73.3	82.7	77.3	77.8	76.7	80.9	88.0	80.4	69.2	79.0	106.1	107.4
Gross asset position in financial derivatives to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Gross liability position in financial derivatives to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Trading income to total income	-0.3	-0.5	-0.1	-0.5	-0.2	-1.1	-0.5	-0.7	-0.4	0.3	0.9	0.8	0.7
Interest margins to gross income	74.5	76.1	75.9	75.6	75.2	75.4	75.4	74.7	74.7	73.8	74.0	72.7*	72.6
Non-interest expenses to gross income	74.3	84.8	79.9	78.7	76.8	80.9	86.6	85.0	87.8	84.6	82.0	82.7	84.8
Foreign currency-denominated loans to foreign currency-denominated deposits	2.2	2.0	1.9	5.3	5.5	5.3	6.3	6.3	5.7	5.3	5.5	4.9	4.4
Foreign currency-denominated loans to total loans	0.2	0.2	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.3
Foreign currency-denominated liabilities to total liabilities	4.6	5.0	5.2	5.1	5.0	5.0	4.7	4.5	4.3	4.6	4.6	4.6	4.6
Net open position in equities to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household loans to gross domestic product	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt service and principal payments to income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Residential real estate prices (Percentage change/ last 12 months)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Loan-to-deposit ratio	75.3	78.8	83.0	78.9	80.7	82.3	84.2	79.7	77.4	78.6	82.9	76.7	73.7
Loan-to-value ratios for housing loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Ratio of external liabilities to total liabilities of banks	8.2	8.3	8.5	7.2	5.9	6.0	5.5	5.5	5.0	5.4	5.4	5.9	5.7

Source: Central Bank of the Republic of Kosovo.
Note: Non-performing loans cover loans categorised as doubtful (90-180 days late) or as loss (over 180 days late).
* Methodological change.

Moreover, banks seem to be rather well provisioned given that the share of NPL net of provisions to capital (7.8% in 2013 Q4) remains low, despite the up-tick in this ratio during the period under review. Banks' liquid assets amounted to 36.6% of total assets or 47.1% of short-term liabilities in 2013 Q4. As almost half of liquid assets are mainly sovereign bonds from euro area countries or placements in euro area banks, the banking sector remains exposed to negative spillovers from abroad, including through interest rate risk. The fact that banking sector development remains constrained by the limited absorption capacity of the domestic economy, resulting in a perceived shortage of fundable projects[30], would exacerbate this vulnerability to external factors in the event of adverse developments abroad.

[30] See IMF (2013d) Republic of Kosovo, Financial Stability Assessment.

A.5 The former Yugoslav Republic of Macedonia

The banking sector in the former Yugoslav Republic of Macedonia has continued to grow over the period under review, albeit at a more moderate pace than before. As is also the case in peer economies in the region, the banking sector remains relatively concentrated, with the three largest entities (Komercijalna Banka, Stopanska Banka / NBG and NLB) accounting for over 60% of total assets, notwithstanding the fact that there is a total of 16 players operating in the system (see Table A.13). As the parent groups controlling two of the three largest entities are in the midst of restructuring (following state-aid cases pursued by the European Commission), the domestic banking system is more exposed to uncertainty relative to peers.

Table A.13
Structure of the banking sector

	Description	2008	2009	2010	2011	2012	2013
Number of banks		18	18	18	17	16	16
… of which foreign-owned		14	14	14	13	12	11
Total assets of banking sector	Percent of nominal GDP	60.9	65.4	70.3	72.0	76.9	77.9
Total assets of private banks	Million euro	4,034	4,330	4,850	5,219	5,538	5,776
… of which assets of foreign-owned banks	Percent of total assets	94.3	94.6	95.1	95.4	95.5	71.0
Total liabilities of private banks	Million euro	4,034	4,330	4,850	5,219	5,538	5,776
… of which external liabilities	Percent of total liabilities	9.1	10.1	10.2	8.2	8.2	7.3
...… of which external liabilities to other private banks	Percent of total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: National Bank of the Republic of Macedonia and IMF/WEO.

Local capital markets are underdeveloped, although the relative exposure of the banking sector to its sovereign has grown. The size of the local bond market, which consists exclusively of government bonds, has declined further to 1.4% of GDP in 2013, from 4.4% in 2008 (see Table A.14). However, bank holdings of government bonds have almost tripled from 2011 to 2013, which could partly reflect attempts by banks to improve profitability and maintain liquidity buffers against the backdrop of limited bankable projects in a sluggish macroeconomic environment.

Table A.14
Local capital markets

	Unit	2008	2009	2010	2011	2012	2013
Size of local bond market (amount outstanding, at market value)	Percent of GDP (eop)	4.4	3.6	2.9	1.9	1.6	1.4
...share of corporate bonds	in percent of total local bond market	0.0	0.0	0.0	0.0	0.0	0.0
...share of governement bonds	in percent of total local bond market	100.0	100.0	100.0	100.0	100.0	100.0
Size of local stock market (amount outstanding)	Percent of GDP (eop)	25.8	29.7	28.2	25.9	24.6	21.7
Banks' outstanding corporate bonds	Million euro	0.0	0.0	0.0	0.0	0.0	0.0
Banks' holding of government securities	Million euro	149.2	209.7	290.4	267.5	487.1	600.9
Debt securities issued by corporations 1)	Percent of GDP (eop)	0.0	0.0	0.0	0.0	0.0	0.0
Banks' credit to non-government residents 2)	Percent of GDP (eop)	40.7	42.3	42.9	44.0	46.5	48.1

Source: National Bank of the Republic of Macedonia.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) MFI (excluding NCB) credit to domestic non-MFI residents other than government. Credit includes outstanding amounts of loans and debt securities.

The banking sector exhibits robust capital and liquidity buffers and is largely reliant on a domestic funding base, but risks to financial stability remain through indirect exposures to currency risk and bank uncertainty stemming from the restructuring of key parent entities. Notwithstanding the change in the

Table A.15
Financial stability indicators

(percentages)

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Regulatory capital to risk-weighted assets	16.1	16.8	16.5	16.7	16.8	17.5	17.4	17.1	17.1	17.3	17.3	17.3	16.8
Regulatory Tier-1 capital to risk-weighted assets	13.4	14.1	14.0	14.0	14.1	14.7	14.7	14.4	14.5	14.7	14.7	14.6	14.4
Non-performing loans													
… net of provisions to capital	11.9	10.9	11.0	11.6	10.8	10.7	11.5	12.9	10.7	14.1	15.4	13.1	11.6
… to total gross loans*	9.0	9.1	8.9	9.5	9.5	9.9	9.7	10.6	10.1	11.4	11.8	11.2	10.9
Households: NPLs to total gross loans	8.1	8.1	7.8	7.9	7.5	7.6	7.7	7.5	7.1	7.0	7.0	6.9	6.4
Non-financial corporations: NPLs to total gross loans	10.0	10.1	10.1	11.1	11.4	11.8	11.5	13.1	12.9	15.2	16.0	15.3	15.2
… of which in FX**	7.2	7.5	7.6	8.5	8.4	9.1	8.7	10.2	9.7	10.8	11.4	11.7	12.1
…… of which in Euro**	7.2	7.5	8.2	8.5	9.2	9.1	8.7	10.3	10.0	11.1	11.7	11.9	12.5
…… of which in USD**	13.2	10.8	10.9	9.3	6.4	6.3	6.6	4.9	3.9	3.3	3.4	4.6	4.1
…… of which in CHF**	2.7	3.6	3.9	4.6	4.6	9.2	10.1	17.9	17.3	17.1	18.1	20.4	25.5
Return on assets	0.8	-0.1	0.2	0.1	0.4	-0.3	0.4	0.3	0.4	-0.1	0.2	0.4	0.6
Return on equity	7.3	-1.0	2.1	1.0	3.4	-2.5	3.2	2.3	3.8	-0.4	1.8	3.9	5.7
Liquid assets to total assets	30.9	30.2	29.7	29.9	31.2	31.5	30.2	30.2	32.4	33.1	32.0	32.2	31.2
Liquid assets to short-term liabilities	46.9	46.7	46.1	46.6	48.9	50.2	48.6	49.3	53.0	54.9	54.6	55.9	54.5
Net open position in foreign exchange to capital	18.9	11.9	10.0	17.9	21.3	12.5	8.7	12.3	11.4	7.3	12.1	16.1	15.6
Capital to assets	10.6	11.0	11.0	11.1	11.0	11.4	11.6	11.5	11.2	11.1	11.2	11.3	11.3
Large exposures to capital	200.4	182.1	199.6	186.1	189.6	183.8	188.7	181.3	205.1	208.0	195.4	195.0	188.5
Gross asset position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross liability position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trading income to total income	0.5	0.5	0.5	0.5	0.5	1.1	0.7	0.5	0.4	0.2	0.4	0.3	0.5
Interest margin to gross income	61.8	63.5	62.7	62.5	60.0	64.2	64.0	64.3	60.7	62.5	62.9	63.3	62.2
Non-interest expenses to gross income	68.2	73.7	70.8	70.7	69.7	67.7	70.6	68.6	65.3	62.9	62.2	62.1	62.8
Foreign currency-denominated loans to foreign currency-denominated deposits	92.7	92.0	95.8	95.4	97.2	99.2	103.4	102.1	101.0	99.9	106.7	102.2	102.8
Foreign currency-denominated loans to total loans*	56.6	55.9	55.4	56.5	56.2	55.3	54.0	53.0	52.4	51.9	51.7	50.7	49.7
Foreign currency-denominated liabilities to total liabilities***	59.4	59.2	58.7	58.7	56.6	55.0	53.4	52.8	52.8	52.5	51.5	50.9	50.2
Net open position in equities to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt to gross domestic product	18.2	n.a.	n.a.	n.a.	18.4	n.a.	n.a.	n.a.	19.5	n.a.	n.a.	n.a.	20.8
Household debt service and principal payments to income	10.8	n.a.	n.a.	n.a.	11.2	n.a.	n.a.	n.a.	11.1	n.a.	n.a.	n.a.	12.4
Residential real estate prices (Percentage change/last 12 months)	0.9	n.a.	n.a.	n.a.	-3.8	n.a.	n.a.	n.a.	-0.4	n.a.	n.a.	n.a.	-6.2
Loan-to-deposit ratio	87.5	88.2	89.3	88.2	86.4	87.0	89.4	89.4	88.1	87.5	90.3	88.3	88.8
Loan-to-value ratios for housing loans	53.1	64.2	52.8	56.7	56.9	57.4	58.4	65.3	66.6	68.6	68.6	70.5	70.7
Ratio of external liabilities to total liabilities of banks****	13.1	12.8	13.5	12.3	11.8	11.7	11.8	11.6	12.2	12.2	13.1	12.3	11.6

Source: National Bank of the Republic of Macedonia.
Notes: For the ratio foreign currency-denominated liabilities to total liabilities, foreign currencydenominated liabilities refer to liabilities with contractual maturity while total liabilities refer to all liabilities excluding equity and reserves and current profit. Total gross loans cover loans to the financial and non-financial sector. Non-performing loans are loans classified in D and E risk category (doubtful and loss) or loans that are past due for more than 90 days. NPLs net of provision to capital refer to NPLs (and corresponding provisions) net of provision to NPLs to capital of the non-financial sector.
* Gross loans to the financial and non-financial sector; ** gross loans to non-financial sector; *** foreign currency-denominated liabilities refer to liabilities with contractual maturity while total liabilities refer to all liabilities excluding equity and reserves and current profit; **** total liabilities refer to all liabilities excluding equity and reserves and current profit.

methodology for determining capital adequacy in Q3 2012, regulatory (Tier-1) capital to risk-weighted assets has remained stable over the period under review, standing at 14.4% in Q4 2013 (see Table A.15) and thereby well above the 8% regulatory minimum set by the domestic supervisory authorities. Bank liquidity also remains comfortable in the system as a whole, with liquid assets amounting to 31% of total assets and 55% of short-term liabilities in Q4 2013.

The ratio of NPLs to gross loans rose to 10.9% in the period under review, partly reflecting worsened corporate sector performance. NPLs net of provisions to capital also rose to 15.4% in Q2 2013, but provisioning appears ample. The banking sector remains exposed to currency risks of both direct and indirect nature. This pertains to the net open position in foreign exchange to capital, which rose to 15.6% in Q4 2013 (though still well below the 30% ceiling set by domestic regulatory authorities), but especially to the share of foreign exchange-denominated and foreign exchange-indexed loans to total loans, amounting to 49.7% in Q4 2013. The share of foreign exchange loans in total loans has been steadily declining in recent years, in part due to efforts pursued by the central bank, and is the lowest among those regional peers which have a domestic currency. Latent tail risks to the banking system in this regard remain through unhedged borrowers in the event of an unexpected devaluation of the currency, as well as through currency mismatches since foreign exchange loans exceed (by a small margin) foreign exchange-denominated deposits. Uncertainty related to the impact of restructuring plans in key parent banking groups whose subsidiaries are locally systemic constitutes a further downside risk to the system in the medium-term.

A.6 Montenegro

The Montenegrin banking system is showing signs of incipient recovery after a protracted period of correction from the excesses in the run-up to the 2008 financial crisis. Total banking assets increased by 5% in 2013, after remaining virtually unchanged from 2011 to 2012 and contracting by 15% from their pre-crisis peak (2008) to their post-crisis trough (2012, see Table A.16). The number of banks operating in the country (11) may be seen as high relative to the size of the domestic economy. Although just over half of total banking assets remain in the hands of the three largest entities (i.e. OTP [Hungary], NLB [Slovenia], and Erste Bank [Austria]), the system comprises a number of other banks with non-negligible market shares. Besides domestic risks, the banking sector remains vulnerable to externally-induced uncertainty stemming from the ongoing restructuring of Hypo Alpe-Adria and NLB (which together hold just over a quarter of total banking assets), as is also the case in some other peer economies.

Table A.16
Structure of the banking sector

	Description	2008	2009	2010	2011	2012	2013
Number of banks		11	11	11	11	11	11
… of which foreign-owned		9	9	9	9	9	9
Total assets of banking sector	Percent of nominal GDP	107.3	101.5	94.8	86.9	89.2	89.8
Total assets of private banks	Million euro	3,309.7	3,025.2	2,943.7	2,809.7	2,808.3	2,959.0
… of which assets of foreign-owned banks	Percent of total assets	84.6	87.1	88.4	89.7	90.0	89.4
Total liabilities of private banks	Million euro	3,309.7	3,025.2	2,943.7	2,809.7	2,808.3	2,959.0
… of which external liabilities	Percent of total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which external liabilities to other private banks	Percent of total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Central Bank of Montenegro and IMF/WEO.

Local capital markets play a minor role in the funding of the economy and the banking sector, although the latter's exposure to its sovereign is rising rapidly from a low base. Local bond markets – amounting to close to 8% of GDP in 2013 – are dominated by government securities (94% of the total). However, banks' total holdings of government securities (foreign as well as domestic) has more than doubled in the period under review (see Table A.17), although these still comprise a modest share of bank assets.

Table A.17

Local capital markets

	Unit	2008	2009	2010	2011	2012	2013
Size of local bond market (amount outstanding, at market value)	Percent of GDP (eop)	6.7	6.1	4.6	3.6	7.4	7.6
... share of corporate bonds	in percent of total local bond market	0.0	0.0	4.9	17.1	8.1	5.9
... share of governement bonds	in percent of total local bond market	100.0	100.0	95.1	83.0	91.9	94.1
Size of local stock market (amount outstanding)	Percent of GDP (eop)	155.7	159.3	160.8	151.9	148.4	148.2
Banks' outstanding corporate bonds	Million euro	n.a.	n.a.	7.0	19.0	19.0	15.0
Banks' holding of government securities	Million euro	n.a.	n.a.	n.a.	n.a.	42.8	99.3
Debt securities issued by corporations [1)]	Percent of GDP (eop)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Banks' credit to non-government residents [2)]	Percent of GDP (eop)	n.a.	77.4	68.1	55.8	51.6	53.2

Source: Central Bank of Montenegro.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) MFI (excluding NCB) credit to domestic non-MFI residents other than government. Credit includes outstanding amounts of loans and debt securities.

Credit risk remains the main near-term challenge to financial stability, while uncertainty as regards the domestic impact of parent bank restructuring remains a concern in the medium-term. The ratio of non-performing to gross loans edged down significantly in 2011H2, at a time when some subsidiaries sold off troubled loans to parent banks, including to factoring companies set up by the latter. However, the upward trend in NPLs resumed in 2012 and the ratio to gross loans has since remained at a level which, though lower than before, still gives cause for concern (18.4% in Q4 2013). Further progress in NPL treatment by banks appears to depend in part on the improvement of the legal and regulatory environment underpinning this process, including the enforcement of procedures for collateral execution.[31]

Looking forward, the banking sector appears to exhibit adequate capital buffers to deal with the continued challenge to asset quality expected in the near term, with the regulatory capital to risk-weighted assets ratio standing at 14.4% in Q4 2013 (see Table A.18). However, NPLs net of provisions to capital amounted to almost 63%, implying that the system's ability to withstand further unexpected losses remains compromised. Should this negative scenario materialise, it would be reminiscent of the situation in 2012 when three banks in the system needed to be recapitalised following stress-tests conducted by the central bank.

Banks' liquidity buffers remain high, but have dropped significantly during the period under review (as measured by total assets to both liquid assets and short-term liabilities), although methodological changes undertaken by the central bank in the calculation of liquid assets mean that pre and post-2013 figures are not directly comparable. The banking system's incipient recovery in profitability (as measured by return on equity) is encouraging, but still needs to be durably ascertained in the period ahead. In the medium-term, uncertainty on the potential domestic impact of the ongoing restructuring of parent banking groups whose subsidiaries are locally systemic (i.e. HAAG and NLB) remains a matter of concern.

31 See IMF (2013e), Montenegro: concluding statement of the 2013 Article IV Consultation Mission Podgorica, May 20, 2013.

Table A.18

Financial stability indicators

(percentages)

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Regulatory capital to risk-weighted assets	15.9	15.4	15.3	15.1	17.3	15.9	14.5	13.6	14.7	14.4	15.5	15.0	14.4
Regulatory Tier-1 capital to risk-weighted assets	15.5	15.6	15.8	15.9	15.1	16.9	15.2	14.7	15.8	13.2	13.8	13.7	13.0
Non-performing loans													
… net of provisions to capital	102.8	122.3	129.1	92.4	66.9	67.1	77.8	82.2	68.0	71.7	68.6	66.9	62.4
… to total gross loans	21.0	23.2	25.3	19.7	15.5	15.5	17.1	18.5	17.6	19.4	18.8	18.4	18.4
Households: NPLs to total gross loans*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	28.4	22.6	19.4	22.3	23.8	23.2	23.4
Non-financial corporations: NPLs to total gross loans*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	67.5	74.5	73.8	74.4	73.0	76.8	76.6
… of which in FX	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.5	0.8	n.a.	n.a.
…… of which in Euro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in USD	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.0	0.0	0.0	0.0
…… of which in CHF	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.5	0.8	0.0	0.0
Return on assets	-2.8	-2.4	-0.6	-1.0	-0.1	-0.9	-1.3	-2.3	-2.0	1.4	1.3	1.3	0.1
Return on equity	-27.3	-23.4	-6.3	-10.1	-1.1	-8.8	-11.9	-21.7	-18.3	10.0	9.2	9.2	0.5
Liquid assets to total assets	19.1	19.4	19.9	23.0	19.9	18.2	19.5	25.2	24.0	13.2**	14.5	21.2	20.0
Liquid assets to short-term liabilities	32.9	33.5	33.9	39.2	32.8	30.0	31.1	41.8	40.1	21.3**	23.5	34.1	32.2
Net open position in foreign exchange to capital	0.8	-2.0	0.6	0.8	1.0	-0.3	-0.5	-0.6	-0.8	-0.6	0.4	1.5	0.6
Capital to assets	9.6	10.4	10.6	10.1	10.9	11.0	10.5	9.3	10.3	13.7	13.9	13.9	13.4
Large exposures to capital	112.1	106.5	107.0	99.9	100.8	95.5	123.3	162.8	125.9	87.4	60.2	59.7	110.6
Gross asset position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross liability position in financial derivatives to capital	0.2	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Trading income to total income	1.1	0.5	3.6	1.9	2.6	1.9	1.2	1.3	1.7	1.3	1.6	1.9	1.8
Net interest income to gross income	71.6	75.7	71.8	74.3	70.5	75.3	71.3	69.7	73.1	69.5	71.0	70.3	68.2
Non-interest expenses to gross income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign currency-denominated loans to foreign currency-denominated deposits	150.3	179.7	92.3	88.1	72.5	65.9	52.9	48.7	44.3	101.2	102.7	99.3	113.5
Foreign currency-denominated loans to total loans	4.1	3.7	2.8	2.8	2.3	2.2	2.2	2.1	1.9	4.0	3.8	3.4	3.9
Foreign currency-denominated liabilities to total liabilities	6.4	5.2	5.1	4.9	4.3	4.1	4.5	4.8	4.7	5.2	4.9	4.2	4.3
Net open position in equities to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt to gross domestic product	27.8	25.9	26.5	26.1	25.8	26.3	26.4	26.2	25.7	25.9	26.4	26.6	26.4
Household debt service and principal payments to income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Residential real estate prices (Percentage change/last 12 months)	-30.2	-31.0	-31.5	-30.8	-32.2	-31.0	-30.5	-30.9	-31.0	-31.1	-36.9	n.a.	n.a.
Loan-to-deposit ratio	122.9	117.3	111.3	104.2	107.6	109.6	106.2	94.5	94.0	114.8	113.4	108.8	105.8
Loan-to-value ratios for housing loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Ratio of external liabilities to total liabilities of banks	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Central Bank of Montenegro.
* Share of total gross loans.
** Methodological change.
Notes: Non-performing loans cover loans and matured receivables classified in C, D and E category (sub-standard, doubtful and loss respectively). As of 1 January 2013, loans and receivables classified under category E (written off) have been transferred from off-balance sheet records into the balance sheet, which is also reflected in the rise of NPL on an aggregated level.

A.7 Serbia

The banking sector has experienced some adjustments in the period under review. Total banking assets of private banks (which are dominant in the system) have dropped by 2% in 2013. However, total assets of the banking system as a whole relative to GDP have dropped moderately, in part due to the de-licensing of several (mostly public) entities by the central bank in recent years.[32] Despite the latter, the system continues to exhibit a high number of banks in operation (30, see Table A.19). In the case of Serbia, contrary to most peer economies, the large number of players in the system amounts

[32] Nova Agrobanka was delicenced in 2012 and Razvojna banka Vojvodine in April 2013. Privredna banka and Univerzal banka a.d had their licences revoked after the period under review (October 2013 and January 2014 respectively), bringing the total number of banks operating in the economy to 29.

Table A.19
Structure of the banking sector

	Description	2008	2009	2010	2011	2012	2013
Number of banks		34	34	33	33	32	30
… of which foreign-owned		20	20	21	21	21	21
Total assets of banking sector	Percent of nominal GDP	66.8	79.4	87.9	82.6	86.0	78.6
Total assets of private banks	Million euro	16,846.5	18,590.3	19,713.2	20,812.0	20,733.9	20,171.3
… of which assets of foreign-owned banks	Percent of total assets	89.7	90.0	89.6	90.2	91.8	91.5
Total liabilities of private banks	Million euro	16,846.5	18,590.3	19,713.2	20,812.0	20,733.9	20,171.3
… of which external liabilities	Percent of total liabilities	23.0	27.3	28.4	23.9	23.1	19.8
…… of which external liabilities to other private banks	Percent of total liabilities	12.9	14.4	16.2	11.9	10.8	8.8

Sources: National Bank of Serbia and IMF/WEO.

to a relatively low degree of concentration, with the combined market share of the three largest entities amounting to just over 35% of total assets. Relative to peer economies in the region, the Serbian banking system also appears to be relatively less exposed to uncertainty resulting from the ongoing restructuring of troubled parent banking groups, with the combined market share of the respective Hypo Alpe-Adria and NBG subsidiaries amounting to close to 6% of total banking assets.[33]

Local bond markets have grown significantly in size in recent years backed inter alia by increased government funding needs. Both dinar-denominated and euro-denominated bond issuance have been stepped-up, with domestic currency-denominated bonds accounting for more than 75% of the total bond market. The share of corporate bonds remains negligible. Banks' holdings of government securities have been on an upward trend over the last few years, edging up to 11% of total bank assets in 2013 (see Table A.20 and also Chapter 3).

Table A.20
Local capital markets

	Unit	2008	2009	2010	2011	2012	2013
Size of local bond market (amount outstanding, at market value)	Per cent of GDP (eop)	9.3	8.9	9.7	14.0	17.4	18.2
... share of corporate bonds	in per cent of total local bond market	1.3	0.3	0.4	0.3	0.7	0.5
... share of government bonds	in per cent of total local bond market	98.7	99.7	99.6	99.7	99.3	99.5
Size of local stock market (amount outstanding)	Per cent of GDP (eop)	28.8	28.3	26.7	21.3	19.0	18.3
Banks' outstanding corporate bonds	Million euro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Banks' holding of government securities	Million euro	n.a.	931.2	1,397.4	1,461.8	2,210.1	2,684.8
Debt securities issued by corporations 1)	Per cent of GDP (eop)	0.0	0.0	0.0	0.0	n.a.	n.a.
Banks' credit to non-government residents 2)	Per cent of GDP (eop)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: National Bank of Serbia.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) MFI (excluding NCB) credit to domestic non-MFI residents other than government. Credit includes outstanding amounts of loans and debt securities. Banks' holdings of government securities do not include banks' holdings of frozen foreign currency savings bonds.

The main challenges to financial stability continue to stem from persistent credit and indirect market risks, though capital and liquidity buffers appear sufficient and the funding base is showing signs of stabilisation. The ratio of non-performing to gross loans edged up to 21% in end-2013. While several measures to foster NPL clean-up have been taken, further efforts are needed in the restructuring of corporate debt in particular, including as regards collateral execution or out-of-court

33 See National Bank of Serbia (2013a), Banking Sector in Serbia – Fourth Quarter Report 2012.

Table A.21

Financial stability indicators

(percentages)

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Regulatory capital to risk-weighted assets	19.9	20.4	19.7	19.7	19.1	17.3	17.2	16.4	19.9	20.4	20.2	19.9	20.9
Regulatory Tier-1 capital to risk-weighted assets	15.9	16.5	16.1	16.1	18.1	16.3	16.3	15.6	19.0	19.2	19.1	18.9	19.3
Non-performing loans													
…net of provisions to capital	29.0	29.4	33.2	33.2	30.8	35.5	35.5	36.4	31.0	32.2	33.4	35.4	32.7
…to total gross loans	16.9	17.1	18.6	18.8	19.0	20.4	19.5	19.9	18.6	19.9	19.9	21.1	21.4
Households: NPLs to total gross loans	8.8	9.1	9.2	9.5	9.1	9.9	9.9	10.1	10.1	10.3	10.7	10.8	10.8
Non-financial corporations: NPLs to total gross loans	20.7	20.5	22.0	22.4	22.3	22.6	21.3	21.7	19.2	20.8	21.3	23.5	24.5
… of which in FX	n.a.	n.a.	n.a.	n.a.	n.a.	17.6	17.7	18.3	17.9	19.4	19.4	20.7	20.9
……of which in Euro	n.a.	n.a.	n.a.	n.a.	n.a.	17.8	17.9	18.7	17.8	19.3	19.4	21.0	21.1
……of which in USD	n.a.	n.a.	n.a.	n.a.	n.a.	15.3	11.0	8.3	9.5	15.1	9.8	6.0	6.3
……of which in CHF	n.a.	n.a.	n.a.	n.a.	n.a.	17.9	17.6	18.0	20.8	20.9	21.3	23.4	22.1
Return on assets	1.1	1.6	1.4	1.4	0.0	1.4	0.7	0.6	0.4	1.5	1.1	0.8	-0.1
Return on equity	5.3	7.6	7.0	6.5	0.2	6.9	3.6	2.8	2.0	7.2	5.3	3.8	-0.4
Liquid assets to total assets	27.2	25.7	26.9	25.5	25.4	24.3	22.9	22.7	23.9	25.1	24.0	25.5	26.1
Liquid assets to short-term liabilities	58.4	56.5	60.8	57.3	60.4	57.8	54.8	55.1	57.2	59.5	58.0	62.1	63.2
Net open position in foreign exchange to capital	1.3	0.7	0.9	0.9	2.5	0.9	1.3	1.9	2.7	1.9	1.1	1.6	1.9
Capital to assets	19.7	20.9	21.0	21.1	20.6	20.6	20.2	20.2	20.5	21.2	21.0	20.8	20.9
Large exposures to capital	39.6	45.0	42.7	40.8	65.0	74.4	79.3	72.0	61.9	50.7	53.2	52.2	52.8
Gross asset position in financial derivatives to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Gross liability position in financial derivatives to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Trading income to total income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest margin to gross income	65.7	71.4	69.5	68.8	69.0	65.8	65.3	65.1	65.6	67.0	66.8	69.3	69.2
Non-interest expenses to gross income	67.1	64.9	63.0	63.7	65.9	63.2	71.8	69.6	69.8	68.8	65.7	67.8	69.4
Foreign currency-denominated loans to foreign currency-denominated deposits	98.1	96.6	99.4	100.1	99.8	102.6	100.5	103.6	98.2	97.1	97.5	97.0	95.0
Foreign currency-denominated loans to total loans	77.1	70.3	68.6	69.6	69.9	70.5	74.1	75.8	74.7	72.6	72.3	72.0	71.5
Foreign currency-denominated liabilities to total liabilities	81.0	81.4	79.9	80.0	79.3	79.9	80.9	80.3	80.2	79.9	79.1	78.7	77.2
Net open position in equities to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt to gross domestic product	19.8	19.0	19.0	18.7	18.8	19.5	20.1	19.9	19.3	18.7	18.8	19.1	18.6
Household debt service and principal payments to income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Residential real estate prices (Percentage change/last 12 months)	-1.2	-4.7	-5.5	2.1	6.0	1.9	5.5	-0.7	-5.2	-0.5	1.1	-2.1	-1.4
Loan-to-deposit ratio	113.4	116.5	117.8	113.6	111.2	112.2	111.9	112.0	109.3	106.2	103.8	102.0	98.1
Loan-to-value ratios for housing loans	65.4	66.9	67.7	64.7	64.3	62.7	65.8	65.0	65.5	66.3	67.1	65.8	65.9
Ratio of external liabilities to total liabilities of banks	30.0	27.8	26.9	25.8	26.0	27.1	25.3	24.8	25.4	23.6	23.6	22.5	21.9

Source: National Bank of Serbia.

Notes: Non-performing loans cover the total outstanding debt under an individual loan (including the amount of arrears) under the following conditions: (i) where the payment of principal or interest is past due (within the meaning of the decision on classification of balance sheet assets and off-balance sheet items) over 90 days, (ii) where at least 90 days of interest payments have been added to the loan balance, capitalised, refinanced or delayed by agreement, (iii) where payments are less than 90 days overdue, but the bank has assessed that the borrower's repayment ability has deteriorated and doubts that the payments will be made in full. In Table A.21, NPL net of provisions to capital are based on IFRS provisions only. NPLs net of total provisions (statutory and IFRS provisions) to capital are 0%.

procedures.[34] However, the system appears relatively well-positioned to deal with the continued challenges to asset quality in the period ahead, with the ratio of regulatory capital to risk-weighted assets at 21% in Q4 2013. NPLs net of provisions to capital remain high at 33% in Q4 2013 (see Table A.21), but provisioning for total loans (including both IFRS and regulatory provisions) remains ample. The liquidity of the banking sector also remains high even by regional standards.

However, notwithstanding this aggregate picture for the system as a whole, stress tests conducted by the central bank in 2012 revealed that on an individual level some

[34] See IMF (2013f) 2013 Article IV Consultation – Serbia.

banks might need additional capital in an adverse scenario.[35] Concerning market risks, the indirect exposure of the banking system to adverse developments related to nominal exchange rate depreciation for unhedged borrowers remains high, with the ratio of foreign exchange loans to total loans at 72% in Q4 2013. Risks in this regard appear to be compounded by the high volatility of the domestic currency (the dinar) relative to the euro, which has, however, stabilised since June 2013. The moderate downtrend of the loan-to-deposit ratio (to 104% in Q2 2013) and the further reduction in the share of banks' external liabilities in total liabilities (20% in Q4 2013) indicate some improvement in the funding base, though both figures remain high and the durability of these trends amid a more dynamic credit environment still needs to be ascertained.

A.8 Turkey

The Turkish banking system has continued to grow at a brisk pace over the period under review, with total banking assets increasing by 11.5% in 2013 Q2 and about 26% between end-2012 and end-2013. Banks play an important role in the financial system, accounting for almost 90% of total financial system assets, despite the relatively large number of non-bank financial entities. A key difference with banking systems in EU candidate and potential candidate countries in the Western Balkans is that parent-subsidiary dynamics are very limited, with domestic banks controlling around three-quarters of total assets and foreign-owned banks making up less than half of the total number of entities operating in the country (see Table A.22). Bank concentration in Turkey is also lower than the Western Balkan average but remains comparable to some countries (such as Serbia), with the three largest market players in the system accounting for just over 33% of total assets.

Table A.22
Structure of the banking sector

	Description	2008	2009	2010	2011	2012	2013
Number of banks		49	49	49	48	49	49
… of which foreign-owned		24	24	24	23	24	23
Total assets of banking sector	Percent of nominal GDP	77.1	87.6	91.6	93.8	96.7	110.9
Total assets of private banks	Million euro	236,670.2	261,631.3	335,831.3	345,255.0	407,551.1	408,473.2
… of which assets of foreign-owned banks	Percent of total assets	24.4	23.3	24.2	23.6	24.1	26.8
Total liabilities of private banks	Million euro	236,670.2	261,631.3	335,831.3	345,255.0	407,551.1	408,473.2
… of which external liabilities	Percent of total liabilities	21.0	19.6	19.9	25.2	25.2	29.8
…… of which external liabilities to other private banks	Percent of total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Central Bank of the Republic of Turkey and IMF/WEO.
Note: Private banks here cover deposit money banks and investment banks.

While the total size of local capital markets has remained stable, their relative importance in bank funding has grown. The size of local bond markets has remained stable at around 29% of GDP, with over 90% of this accounted for by government bonds. Banks remain dependent on domestic deposits as their main funding source, but the relative importance of securities' issuances has grown, as

35 One bank had been recapitalised in Q1 2013 (see National Bank of Serbia (2013b), Banking Sector in Serbia – First Quarter Report 2013). Four other banks were recapitalised later in 2013H1.

can be seen from the pick-up in banks' outstanding corporate bonds in the period under review (see Table A.23). Banks' holdings of government debt securities have dropped, though this largely reflects valuation effects in holdings of foreign debt obligations.

Table A.23

Local capital markets

	Unit	2008	2009	2010	2011	2012	2013
Size of local bond market (amount outstanding. at market value)	Percent of GDP (eop)	29.0	34.7	32.4	29.5	29.4	28.6
... share of corporate bonds	in percent of total local bond market	0.2	0.2	0.8	3.8	7.1	8.2
... share of government bonds	in percent of total local bond market	99.8	99.8	99.2	96.2	92.9	91.8
Size of local stock market (amount outstanding) 1)	Per cent of GDP (eop)	6.7	7.4	7.4	6.9	6.9	6.7
Banks' outstanding corporate bonds	Million euro	2,188.7	2,197.6	3,495.7	3,249.0	3,020.0	2,820.9
Banks' holding of government securities	Million euro	87,673.4	118,503.9	135,851.6	111,800.0	111,057.5	89,909.1
Debt securities issued by corporations 2)	Percent of GDP (eop)	0.1	0.1	0.3	1.1	2.0	2.1
Banks' credit to non-government residents 3)	Percent of GDP (eop)	34.7	36.7	43.1	47.6	50.9	56.6

Source: Central Bank of the Republic of Turkey.
Notes: Figures for 2013 are as of June for all indicators except for the first four rows.
1) Figures do not indicate market capitalisation amounts but nominal outstanding securities.
2) Outstanding amount of debt securities issued by resident non-financial corporations. MFIs and other financial corporations.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than government. Credit includes outstanding amounts of loans and debt securities.

With risks to financial stability in Turkey remaining largely contained on account of strong fundamentals for the banking system as a whole, the main challenge going forward is to achieve a 'soft landing' as regards the pace of credit extension while containing funding risks. The Turkish banking system exhibits few of the vulnerabilities which afflict peer EU candidate and potential candidate countries in the Western Balkan region. Credit risks appear broadly in check, with the ratio of NPLs to gross loans at only 2.8% in Q4 2013. At the same time, developments in this regard have also been influenced by a pace of credit extension which, though exhibiting a somewhat volatile pattern, has remained brisk. Exposure to indirect market risks also remains low in comparison to Western Balkan peers, with foreign exchange loans amounting to just over 25% of total loans. Potential vulnerabilities resulting from foreign exchange lending to those parties deemed to be most at risk of being unhedged (i.e. households) have been safeguarded by law. However, holdings of government bonds account for a significant share of total bank assets, including relative to peer countries, implying that the banking system remains indirectly exposed to potential sovereign shocks.

The system's relative ability to withstand negative shocks appears high on account of both banks' considerable capital buffers, notwithstanding their mild decline in the period under review (with regulatory capital to risk-weighted assets at 15.3% in Q4 2013, see Table A.24) and the results of central bank stress tests.[36] Bank profitability also remains high, with return on equity at 13.1% in Q4 2013. The main challenge going forward will be to achieve a 'soft landing' as regards the pace of credit extension, both as regards the headline rate as well as in the specific segment of foreign exchange lending to the corporate sector (with an average annual increase of 15% in to July 2013). This is important, since some Turkish corporates tend to have sizeable open positions in foreign exchange, albeit mostly at longer-dated

36 See Central Bank of Turkey (2013), Financial Stability Report, May 2013.

Table A.24

Financial stability indicators

(percentages)

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4
Regulatory capital to risk-weighted assets	19.0	18.0	17.2	16.4	16.6	16.6	16.5	16.5	17.9	17.4	16.3	15.7	15.3
Regulatory Tier-1 capital to risk-weighted assets	17.0	16.4	15.6	14.9	14.9	14.9	14.7	14.5	15.1	14.7	14.0	13.4	13.0
Non-performing loans													
… net of provisions to capital	2.6	2.4	2.3	2.6	3.0	2.9	2.9	3.7	3.5	3.7	3.9	4.0	3.9
… to total gross loans	3.7	3.3	3.0	2.7	2.7	2.8	2.7	3.0	2.9	3.0	2.8	2.8	2.8
Households: NPLs to total gross loans	4.1	3.7	3.3	3.1	2.9	3.0	2.9	3.1	2.9	3.0	2.7	2.9	2.9
Non-financial corporations: NPLs to total gross loans	3.5	3.1	2.8	2.6	2.7	2.7	2.6	3.0	2.9	3.0	2.9	2.7	2.7
… of which in FX	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in Euro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in USD	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
…… of which in CHF	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Return on assets	2.5	2.2	2.0	1.8	1.7	1.7	1.7	1.8	1.8	1.8	1.9	1.8	1.6
Return on equity	18.1	16.7	15.4	14.6	14.3	14.2	14.2	14.5	14.5	14.3	14.3	14.2	13.1
Liquid assets to total assets (*)	28.7	26.6	22.6	21.3	19.8	19.2	18.5	17.4	17.5	16.0	13.9	13.5	13.1
Liquid assets to short-term liabilities (*)	42.7	41.3	36.6	34.3	31.7	30.5	29.1	27.7	28.2	26.3	22.8	22.1	21.8
Net open position in foreign exchange to capital	0.1	1.1	1.1	-0.6	0.4	0.5	0.1	1.6	1.5	2.1	-0.6	0.5	-0.3
Capital to assets	13.7	13.4	12.7	12.4	13.0	13.4	13.4	13.7	14.3	14.2	13.6	13.1	12.9
Large exposures to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Gross asset position in financial derivatives to capital (*)	155.7	179.6	195.7	215.2	199.1	209.7	213.0	199.2	196.4	243.5	250.4	281.7	291.4
Gross liability position in financial derivatives to capital (*)	155.7	180.9	196.5	215.2	197.9	209.3	212.5	199.0	196.9	243.5	250.4	280.8	291.0
Trading income to total income	0.5	1.1	0.5	-0.8	-0.3	-1.4	-1.2	0.5	2.0	2.9	4.2	3.0	0.9
Interest margin to gross income	61.5	59.5	58.6	59.1	59.9	62.1	63.8	64.8	64.7	64.5	63.3	62.4	62.6
Non-interest expenses to gross income	48.0	50.0	52.6	54.3	55.2	55.2	55.2	53.8	53.0	52.8	52.2	52.6	54.4
Foreign currency-denominated loans to foreign currency-denominated deposits (*)	86.9	91.8	96.3	94.7	92.6	88.9	86.9	88.7	89.8	91.1	99.2	91.2	89.4
Foreign currency-denominated loans to total loans	26.7	27.2	27.2	28.9	28.4	27.0	25.9	25.3	24.9	24.7	25.7	25.5	26.2
Foreign currency-denominated liabilities to total liabilities	30.4	31.2	31.7	34.5	35.9	35.4	36.2	35.5	35.1	35.6	36.8	39.0	40.8
Net open position in equities to capital	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt to gross domestic product	17.8	17.8	18.8	18.9	19.4	19.3	19.9	20.4	21.2	21.8	22.8	23.6	23.9
Household debt service and principal payments to income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Residential real estate prices (Percentage change/last 12 months)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Loan-to-deposit ratio (*)	82.6	86.9	91.3	93.7	94.9	96.7	98.7	98.4	99.0	101.6	105.7	105.2	105.9
Loan-to-value ratios for housing loans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Ratio of external liabilities to total liabilities of banks	15.8	17.3	18.0	19.3	20.0	19.4	20.8	20.5	20.4	21.5	22.2	22.5	23.3

Source: Central Bank of the Republic of Turkey.
Note: Non-performing loans are all loans and other receivables classified as with limited recovery means, suspicious recovery or having the nature of loss, according to the *regulation on procedures and principles for determination of qualifications of loans and other receivables by banks and provisions to be set aside*.
(*) Development and investment banks are excluded.

maturities.[37] It will be key to limit the vulnerabilities associated with potential shifts in market sentiment and the related shifts in external funding, whose share in total liabilities has increased to just over a fifth in the period under review for private banks. This is also warranted by the rising loan-to-deposit ratio, which has trended up to a high of 106% in the period under review.

[37] It should be noted that corporates which do not have fx income can also borrow in fx but only if the loan amount is higher than USD 5 million and the maturity is longer than one year. This implies that fx borrowing is de facto restricted to larger firms, which presumably have a greater ability to manage their fx exposures relative to smaller peers.

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Abbreviations

Countries

AL	Albania
BA	Bosnia and Herzegovina
IS	Iceland
KV	Kosovo*
MK	Former Yugoslav Republic (FYR) of Macedonia
ME	Montenegro
RS	Serbia
TR	Turkey
AT	Austria
BE	Belgium
CY	Cyprus
FR	France
DE	Germany
GR	Greece
IE	Ireland
IT	Italy
LU	Luxembourg
NL	Netherlands
PT	Portugal
SI	Slovenia
ES	Spain

Euro area-12: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain

*This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence.

Other

CCs/PCCs	EU candidate and potential candidate countries
DGS	Deposit Guarantee Scheme
MoU	Memorandum of Understanding
NPLs	Non-performing loans
RoA	Return on assets
RoE	Return on equity
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism

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