Regulatory Environment in Financial System in Bosnia and Herzegovina and how to improve it

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After 2011 started in recovery mode, the near-term economic outlook for Bosnia and Herzegovina has weakened. The recovery is at a risk of being derailed, as the region becomes caught in the downward trend of the euro area. IMF revised real GDP growth at 1.7 percent in 2011 and 0.7 percent in 2012 from 2.2 percent and 3 percent respectively.[1]

With private consumer confidence at very low level, growth of GDP was possible due to soaring investment activity. In the first half of 2011 construction work value increased about 15%, imports of capital goods 15.7%, what made investments most important contributor to the overall economic growth in Bosnia and Herzegovina in 2011.[2]

With unsettled international financial markets and complete drain of FDI along with tight borrowing regulations, largest share of investment is financed by companies' own funds. However, data reveals that banking sector partly supported private investment. Loans in non-financial enterprises increased 7.3% in the first half of 2011 [3]. On the other hand, financing of public investment has been significantly hampered due to delay in Government budget adoption.

As statistic from the Ministry of Finance and Treasury of Bosnia and Herzegovina shows, multilateral financial institutions have approved loans for 2.3 billion KM (8% GDP) towards infrastructure projects in Bosnia and Herzegovina and close to 1 billion KM (3% GDP) are waiting to be approved.

(Most significant for the country's economic boom certainly is Corridor 5c project, a part of Pan-European network of highways stretching from Budapest (Hungary) through Bosnia and Herzegovina to port Ploce at the Adriatic Sea. The European Bank for Reconstruction and Development (EBRD) allocated 180 million Euros and European Investment Bank (EIB) 300 million Euros towards the project in signed contracts with BiH authorities to finance portion of the 5c corridor. Only about 45 miles of the highway has been constructed so far due to internal political and inter-ethnic disputes over some segments of corridor 5c (Blagaj – Pocitelj, very complex administrational mechanisms in BiH, questions on role for the entities versus state level government in the project implementation, and other similar known problems in almost very segment of country's life that clearly requires certain Constitutional reforms of the Dayton Peace Accord structure to unable country to move faster towards the EU and NATO institutions without petty obstructions).

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[1] Statement by the IMF Staff Mission to Bosnia and Herzegovina, Press Release No.11/426
November 22, 2011

[2] Bosnia and Herzegovina: Economic Trends January-Juny 2011, DIRECTORATE FOR ECONOMIC PLANNING

[3] Financial Statistics, Central Bank of Bosnia and Herzegovina

Commercial banks are the dominant financial firms in the financial system of the Bosnia and Herzegovina, with overhemlming majority of total credit provided through them. This institutional feature is likely to persist indefinitely, so significant increase of their activity is indispensible for return to growth rates before crisis.

Banking landing activities slow down significantly in 2009 only to witness slight increase of 3% in 2010. Much stronger banking dynamics started beginning of 2011. At the end of first half of 2011 total amount for outstanding loans stood at 15.1 billion KM or just above 50% of GDP, an increase of 6.0% compared y/y. Biggest loans share belongs to non-financial enterprises in amount of 8 billion KM with recorded growth of 7.2% y /y. Loans for household sector continued to register much more modest growth rate. Household loans at the end of second quarter of 2011 amounted to 6.4 billion KM, representing an increase of 1.9% comparing to same period in 2010. Loans to non-financial companies comprise 53.3% of total loans disbursed, with household loans shares at 42.4%. State institutions received negligible amount of loans from local banks, with public debt in long maturity structure and low-level interest rates[4].

Active interest rates recorded a further decline, as the weighted average of active interest rates in March 2011 was 7.84 per cent, 38 basis points lower relative to the end of 2010. They are still above competitive level especially for manufacturing companies in tradable sector. The spread between lending and deposit interest rates of commercial banks in Bosnia and Herzegovina was 7.45 percentage points in March 2011, 42 basis points lower, relative to December 2010 level[5]. Decrease of sovereign credit rating of Bosnia and Herzegovina from Standard & Poor's in November 2011 from B+ to B with negative outlook could make debt expenses unsustainable for already illiquid real sector[6].

With extremely high net interest margin, banking sector low profitability results in Bosnia and Herzegovina looks somewhat strange. At the end of first two quarters in 2011, banks net profit in Bosnia and Herzegovina was below 3% of net equity.

There are two major culprits for such a poor results:

* High loan loss provisions
* Over liquid banking sector

The ratio of nonperforming loans to total loans was 3.1% in Q4 2008. With slowdown of economic activity accompanied by lending reductions and increase of interest rates in 2009 logical consequence was spoiling of bank assets. Nonperforming loans stood at 5.9% and 11.4% respectively at the end of 2009 and 2010.
Reduction of interest rates and 2011 increase of economic activity helped reversed spoiling bank asset quality that made possible for non-performing loans to raise to 11.8% mid 2011.

[4] Total public debt is 33.8% of GDP, foreign debt is 22.3% of GDP, mainly from multilateral agancies. Average maturity is 24.4 years, grace period 6.8 years with average interest rate of 1.45%. Domestic debt is 11.5% of GDP and constitues bonds issued for war destructions and deposits lost, with interest rate bwtween 2-3%. Public debt at 31.10.2010, Ministry of Finance and Treasury, BiH

[5] Central Bank, Bulletin 1, 2011

[6] Deposits of corporate sector are at the lowest level since 2007, CB BiH statistics

However, in 3rd quarter the financial sector continued to face pressures, with nonperforming loans on the rise to 12.6% of total banking sector loans.
Ever since 2000, banking sector has kept around 30% of assets in highly liquid form. Banks could tolerate this unusual balance sheet structure paying close-to-nothing for retail demand deposits and receiving in average above 2.5% for such assets. These very liquid assets demanded deposition either in the banks abroad or at the Central Bank of Bosnia and Herzegovina. When earnings from such liquid assets fell below 0.5% in 2009 and 2010, banks were in problem how to compensate for lost revenue. They responded by increasing an active interest rates and halted lending's. By the end of 2010, liquid assets were at minimal level since 2000 but still at astonishing 29% of banking sector total assets.

On the other side real sector is illiquid and requires urgent long term and working capital financing. This raises question: Why banks don't decrease interest rates and pour this money in the real sector instead of receiving small 0.5% from liquid assets? Answer is - they are not allowed. In 2003, Banking Agencies in both Entities in Bosnia and Herzegovina (Federation of Bosnia and Herzegovina and Republika Srpska) enacted decision concerning liquidity requirements for banks:

* Decision on minimal standards for managing bank's liquidity risk *(«Official Newsletter of the Federation of BiH», No: 3/03, No. 88/07)*
*Decision on minimal standars for managing bank's liquidity risk *("Official Newsletter, Republika Srpska, No. 12/03, 31/04, 111/07")*

In both cases, most interesting is article 6, paragraph 3, first reading:

*Minimum of 85 % funds (until 2008, 100%) with maturity up to 30 days, must be engaged in assets with maturity of maximum 30 days
*Minimum of 80% funds (until 2008, 100%) with maturity up to 90 days, must be engaged in assets with maturity of maximum 90 days
*Minimum of 75% funds (until 2008, 95%) with maturity up to 180 days, must be engaged in assets with maturity of maximum 180 days

In 2003, regulators imposed extremely rigid regulation requiring perfect nominal maturity matching of assets and liabilities. This means that retail demand deposits were effectively of no use for banks, leaving banks no other option but to store funds at the Central Bank or deposit them abroad.
In 2008 regulators changed the nominal maturity matching to 85%, where 15% of retail demand deposits could be transformed in maturity assets longer then 1 month. At the end of second quarter of 2011, demand deposits constituted 29,7% of total banks liabilities so basic mathematics tells us that minimal required liquidity for banks in Bosnia and Herzegovina in that moment was 25.24%. Real liquidity of banking sector at 26.2% of total assets was barely above required minimum. This rigid regulation is far from international standards in liquidity risk management and leads directly to logical chain: very high banking sector liquidity, very high interest rates on available loans in order to compensate lost revenue on liquid funds, high loan loss provisions due to high interest rates.

Best way forward is to look at the International Supervisors proposition. In 2008, Basel Committee published *Principles for Sound Liquidity Risk Management and Supervision ("Sound Principles")* with detailed guidance on risk management and supervision of funding liquidity risk to help promote better risk management in this critical area.

To complement these principles, Committee has further strengthened its liquidity framework by developing two *minimum* standards for funding liquidity. These standards have been developed to achieve two separate but complementary objectives. First objective is to promote short-term resilience of a bank's liquidity risk profile by ensuring it has sufficient high-quality liquid assets to survive a significant one month long stress scenario. Committee developed Liquidity Coverage Ratio (LCR) to achieve this objective. Second objective is to promote resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis. Net Stable Funding Ratio (NSFR) has a one-year time horizon, and has been developed to provide a sustainable maturity structure of assets and liabilities[7]. Net Stable Funding Ratio is a measure International Supervisors propose for maturity matching and what is in highly rigid form implemented in Bosnia and Herzegovina with decisions for liquidity.

The NSFR is defined as sum of available amount of stable funding to the sum of required stable funding. This ratio must be greater than 100%. "*Stable funding*" is defined as sum's portion of the amounts for equity and liability financing. It is expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress.

It is clearly noted that available stable funding includes:
"portion of non-maturity deposits and/or term deposits with maturities (of less than one year) expected to stay with the institution for an extended period, in an idiosyncratic stress event[8]."

Basel Committee suggests "Stable" non-maturity (demand) deposits and/or term deposits with residual maturities (of less than one year) to be given a stable funding factor of 90% and "Less stable" 80%. They were meant for retail and small business. This Basel Committee important suggestion is contrary to existing regulation in Bosnia and Herzegovina where this crucial factor for retail demand deposits is effectively 15% (100%-85%).

Decision on Liquidity by the Entities Banking Agencies actually meant taking away required reserved instrument, as important tool for the Central Bank to run healthy monetary policy. In these circumstances, Central Bank of Bosnia and Herzegovina has lead an excellent monetary policy by designating benchmarks for short and medium terms financial sources, in respect to required reserves. Entities Banking Agencies requested far bigger liquidity then what Central Bank would desire. Even with latest Central Bank decision to reduce one-year deposits required reserves from 14% to 10%, unfortunately BiH economy did not benefit from such reduction due to Entities Banking Agencies right to control required reserves that is 75-85% for one-year deposits.

Instead of criticizing banks, regulators should change rigid regulation that doesn't allow banks to lend more at better terms. Illiquidity is a big problem for financial industry, but too much

[7] Basel III: International framework for liquidity risk measurement, standards and monitoring, Bank for International Settlements, December 2010

[8] Basel III: International framework for liquidity risk measurement, standards and monitoring, Bank for International Settlements, December 2010

liquidity in financial sector means illiquidity in real sector, leading to insolvency of real and eventually of financial sector. Liquidity right balance is indispensible for long-term stability of financial sector.

While gradually moving to Basel II/III standard, intermediate solution for liquidity provision should be abolishment of decision by banking agencies imposing 85% nominal maturity matching. Central Bank of Bosnia and Herzegovina should appoint rate for required reserves as benchmark for liquidity requirement. Currently benchmark rates stands for 10% of short and 7% of long-term liabilities.

Such policy, with almost no cost to implement, would enable banks to start new investment cycle lending at much lower interest rates with chance to reprogram existing loans injecting highly needed working capital in all solvent but illiquid companies. This measure would allow banks to return completely all funds borrowed from abroad from their mother companies, significantly reduce borrowing expenses and still stay very liquid according to international regulation[9].

Lower interest rates and increased lending capabilities would also lead to reduction of nonperforming loans and to improvement of stability in financial sector.

With strong reforms, new laws and regulations, Bosnia and Herzegovina is significantly improving its business environment creating better terms for both domestic and foreign investments. Changing this regulatory policy would further liberate robust economic growth expected in coming years for Bosnia and Herzegovina.

[9] Banking sector had foreign assets plus reserves held at central bank of Bosnia and Herzegovina in the amount 6.27 billion KM and foreign liablitities in the amount 4,65billion KM at the ned of 3rd quarter of 2011