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Financial Crisis Response Bosnia and Herzegovina

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Berina Selimovic-Mehmedbasic, Chief of Party

Partnership for Advancing Reforms in the Economy (PARE)



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Outline

- Background:
 - USAID PARE
 - Structure and characteristics of BiH Government and Financial Sector
 - BiH Banking Industry
- BiH economy before economic/financial crisis
- Impact of the crisis 2008 and 2009
- Government/financial sector response
 - Immediate response/short term measures
 - Mid to long-term reforms
- PARE assistance complements authorities' efforts
 - Assistance to address immediate needs
 - Assisting mid to long-term reforms
- BiH Financial/Banking Sector coped well with crisis



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Background: USAID PARE

- Project timing
 - A four-year activity started in March 2008
- Mandate
 - PARE partners with BiH private and public counterparts to design, sequence and implement reforms
 - Demand driven to establish partnerships for reforms in the BiH financial sector including: banking supervision, central banking, deposit insurance, capital markets, and insurance supervision
- Key objectives
 - Advance reforms in the financial sector
 - Build institutional capacity and assist BiH in:
 - (i) meeting requirements on its path towards joining the EU, and (ii) implementing Basel II, EU directives and other international standards
 - Contribute to creation of a single economic space in BiH through convergence of the financial sector regulators
 - Enable effective financial intermediation to support private sector growth



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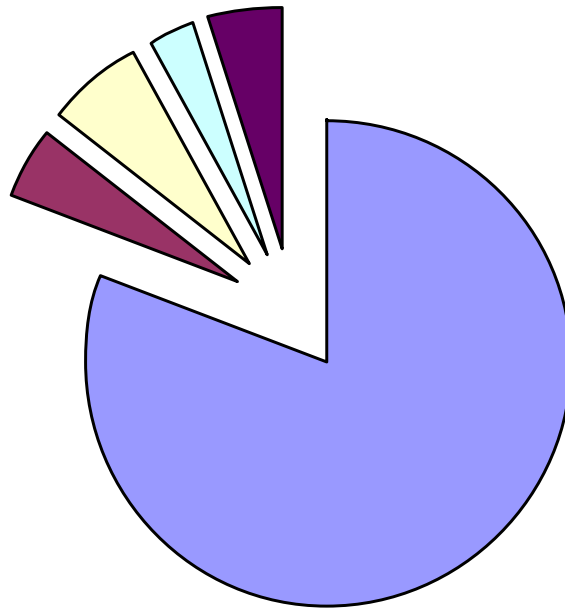
Background: Structure and characteristics of BiH Government and Financial Sector

- BiH is unique in having to both transition to a market economy and recover from a war.
 - Progress was being made.
 - But neither process was complete.
- Government
 - BiH general government is large (46% relative to GDP) with many layers - State, entity, cantons, municipalities, extra-budgetary funds
 - Authority for regulating financial/banking sector weak at the BiH level
- Financial sector
 - Financial sector institutions are fragmented (state- and entity-level regulators)
 - Financial sector has been built in the last 15 years from nil
 - Conservative financial sector regulation (helped combat the crisis)
 - Further reforms to comply with international standards needed
 - Experience with frozen citizen savings - a legacy to consider



Background: Structure of Financial Sector in BiH

Total Assets ~ EUR 13 bn



- Banks (80.9%)
- Investment funds (4.8%)
- Leasing companies (6.2%)
- Insurance/reinsurance companies (3.5%)
- Microcredit organizations (4.7%)



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Background: BiH Banking Industry

- 30 registered banks
 - Federation of BiH 20 banks
 - Republika Srpska 10 banks
- 28 banks privately owned and 2 state owned
- 93 % privately owned
 - 84 % are foreign owned banks
- Well capitalized
 - Capital Adequacy Ratio (CAR) 16 %
 - Minimal CAR 12 % (as currently regulated)



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BiH Economy Before Economic/Financial Crisis

1. Positive developments and optimistic outlook
 - GDP growth averaged at 6 percent per year during 2003–08
 - Favorable external environment
 - Currency board arrangement is an anchor of stability
 - Inflation remained low
 - Large capital inflows
 - FDI and long-term borrowing by foreign bank subsidiaries driving a domestic demand
 - Introduction of the VAT, income tax reforms
 - Fiscal coordination improved through the BiH Fiscal Council
 - Strengthened coordination of public finance
 - Stabilization and Association Agreement signed in June 2008



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BiH Economy Before Economic/Financial Crisis

2. Factors of concern

- Unsustainable economic expansion and macroeconomic imbalances
- Lack of a BiH single economic space
- Fragmented financial/banking sector supervisors/regulators
- Non-compliant with EU directives and international standards
 - Advanced financial/banking sector reforms required
- Incomplete structural reforms
- Political complexities
 - Lags behind the EU accession agenda
 - Lack of clear vision for economic development



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Impact of Crisis in 2008 and 2009

Crisis started in the financial sector in last quarter of 2008, but deepened in 2009

- Transferred and expanded in the real economy
- GDP declined but smaller than regional average
 - Contraction by 3½ percent in 2009
- Fiscal position of the general government deteriorated sharply
 - Fiscal outlook has worsened and general government deficit has reached 5.3% of GDP
 - Significant public spending cuts needed
- Current account deficit narrowed faster than anticipated
 - Decline in domestic consumption and imports relative to GDP
 - Rapid credit growth trend ended



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Impact of Crisis in 2008 and 2009

- Financial sector came under pressure
 - In October 2008, depositors made a rush on banks in order to withdraw deposits, however, authorities reacted effectively and confidence was maintained
 - Total deposit decreased by EUR 400 million in October
 - included cca EUR 340 million of citizens' deposits
 - By end of 2008 some EUR 150 million was recovered

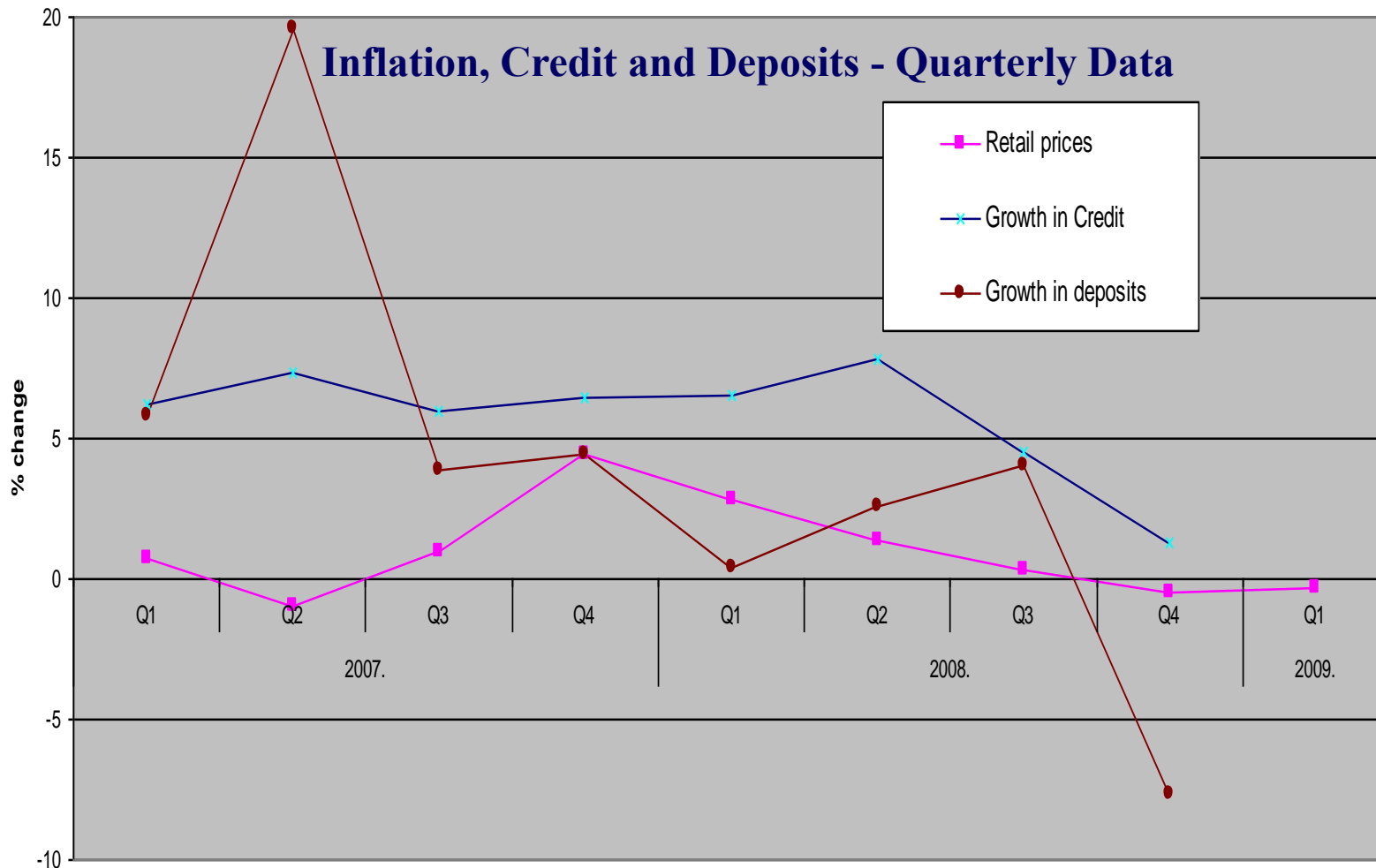


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Impact of Crisis in 2008 and 2009





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Impact of the Crisis in 2008 and 2009

- Credit activity contraction
 - Stricter lending standards almost halted private sector credit growth
- Increase of NPL
- Worsening the banks' profitability
 - Lower interest rates based income
 - Larger allocations for reserves



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Impact of the Crisis - Overview

Financial Sector Soundness Indicators 2008-2009

Description	Dec 2008	Dec 2009
Tier 1 capital to risk-weighted assets	12.0	12.4
Nonperforming loans to total loans	3.1	5.8
Return on equity	4.3	1.1
Liquid assets to short- term financial liabilities	51.8	52.9

Source: CBBH



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Government/Financial Sector Response

1. Immediate response/short term measures

- Authorities responded strongly and timely:
 - CBBH decreased level of required reserves from 18% to 14%
 - 10% and 7% for long term liabilities
 - Liquidity of the system secured
 - Currency Board mitigated exposures to FX related risks
 - Banking agencies issued
 - Decrees on rescheduling of loans to households and legal entities to extend maturity and lower installments
 - Provisions on directing commercial banks' profits to strengthen their capital
 - Regulation to strengthen liquidity and market risks



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Government/Financial Sector Response

1. Immediate response/short term measures

– Authorities ensured that:

- (Citizens') deposits payouts requests were serviced with no delays
- Insured deposit threshold was raised from EUR 3,700 to EUR 10,000
- Confidence in the banking system maintained through regular communication with public by the CBBH Governor, Deposit Insurance Agency Director and the banking agencies directors



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Government/Financial Sector Response

1. Immediate response/short term measures
 - Banks have maintained liquidity buffers
 - Due to non-government deposits flowing back, and
 - Weak credit demands
 - Commercial banks acted in responsible and conservative manner
 - Consumer protection issue emerged and addressed
- Standing Committee for Financial Stability formed as demanded under the IMF Stand-by Program
- NOTE: There were no direct transfers by the Government to support the financial sector in BiH during the crisis



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Government/Financial Sector Response

2. Mid to long term measures/reforms

- Despite the crisis, BiH authorities have sustained implementation of the following reforms with technical assistance from PARE:
 - Banking Supervision Reforms (Basel II, EU Directives, other international standards)
 - Strengthening Deposit Insurance Scheme in BiH
 - Strengthening Policy Coordination and Oversight in the BiH Financial Services Sector



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PARE assistance complements authorities efforts

1. Assistance to address immediate needs

- Emergency Response Group (ERG) formed to help authorities understand the crises and its impact on BiH economy and financial sector
- DIA investment policies revised and improved
- Insured deposits payout procedures updated
- Coordination gaps and weaknesses of the banking supervision identified
- Regular selected data/information sharing processes established
- Improved oversight/financial administration of public spending at the government and public institutions



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PARE assistance complements authorities efforts

2. Assisting the mid to long-term reforms:

- Banking supervision compliance with Basel II, EU directives and other international financial standards
- Mandatory policy coordination among key institutions - Banking Supervision Council proposed
- Public-private sector partnership: inclusion of private sector, via professional associations, in the banking supervision/financial sector reforms
- Insurance supervision compliance with the IAIS and other international standards
- Strengthening banking and appraisers professional associations



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PARE assistance complements authorities efforts

2. Assisting the mid to long-term reforms:

- Ultimate Objective: Modern, prosperous and stable financial sector
- Public education about the financial services and products via the CBBH website
- Increased donor's synergies in the financial sector reforms

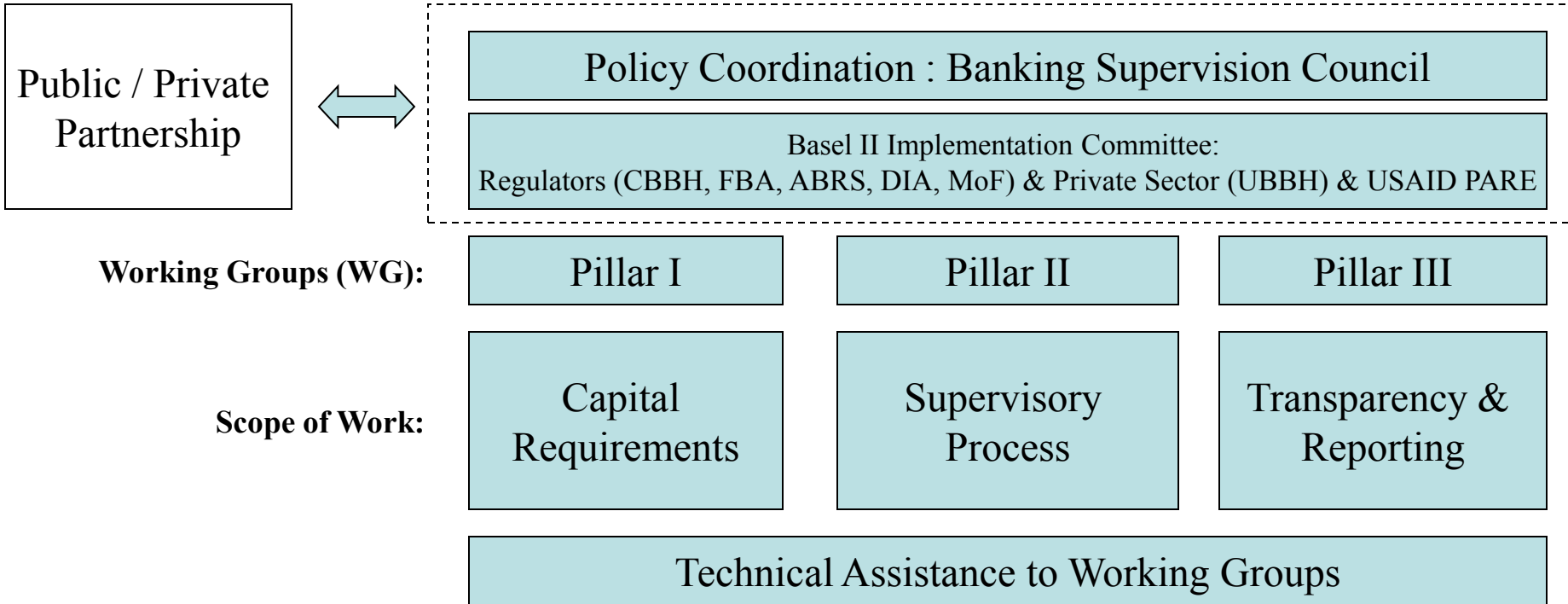


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USAID PARE Partnerships for Basel II reforms



- Legend:**
- FBA** – Banking Supervision Agency of FBiH
 - ABRS** – Banking Supervision Agency of RS
 - CBBH** – Central Bank of BiH
 - DIA** – Deposit Insurance Agency of BiH
 - MoF** – Ministry of Finance of BiH
 - UBBH** – Banking Association of BiH



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BiH Financial Sector Coped Well with Crisis

- Banking sector remained stable, liquid and adequately funded
 - Stability of financial system was maintained
 - Confidence of customers in banks was preserved
 - Currency Board served as a key macroeconomic stability anchor (FX shocks related to public and private debt service mitigated)
 - Effective joint response the key financial institutions (CBBH, Entity Banking Agencies, State Deposit Insurance Agency) to public
 - Government made no financial transfers to the financial sector



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BiH Financial Sector Coped Well with Crisis

- Effective short term measures introduced
- Ongoing mid to long term banking sector reforms assisted by PARE are helpful
- Macroeconomic program with IMF agreed and implementation started
- Vienna Agreement
 - Commitment of foreign banks to keep subsidiaries well capitalized and maintain exposure in BiH at before crises level
 - Includes 9 parent banks. The 13 subsidiaries of these banks account for 87 percent of banking sector assets.



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Financial Sector Coped Well With Crisis

Challenges ahead

- Facilitate real sector efforts to re-start economic activity
- Assist households to mitigate adverse effects of the crisis
- Implement sound policies to preserve the financial sector soundness and stability



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References:

- Presentation is based on the following:
 - PARE's technical assistance reports
 - PARE's counterparts information/reports
 - IMF reports
 - EBRD country report