Abstract:
The financial sector in the Western Balkans is bank-dominated, with banks accounting for over 90 percent of financial assets. Capital markets and the insurance sub-sector play a lesser role. Nonetheless, total banking assets in the Western Balkans are only equivalent to those of one mid-sized European bank. The benefits of regional integration derived from economies of scale, knowledge spillovers and increased liquidity would thus be substantial. Across the Western Balkans, financial sector restructuring and bank privatization is well advanced and has brought the market share of EU banks to levels between 50-80 percent. Similar developments are now underway in the insurance sector. In the longer term, a deeply integrated regional market for financial services could emerge, driven by linkages between stock exchanges, an adoption of the financial sector acquis, participation in the Euro Payment Area and cooperation between financial regulators.
Introduction

This paper reviews the process of financial sector restructuring in the countries of the Western Balkans as well as the interdependencies between financial sector reforms and deeper regional integration. It starts out with a brief introduction on the importance of financial sector reform in economic transition and a summary of the main regional integration issues that arise in the sector. The main section outlines past reform trends and future reform needs in the region. The annex contains country fact-sheets with additional information on the financial sector in each of the countries. The geographical focus of the analysis is on Albania and the countries of former Yugoslavia (i.e. Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia). Since the patterns of regional integration often go beyond that narrow region, however, neighboring countries will be referred to, where appropriate.

Financial Markets and Economic Transition

The financial sector can be divided into three sub-sectors: banking, insurance and capital markets. In most Western Balkan countries, banks account for over 90 percent of financial sector assets. Banks act as intermediaries between savers and investors. They provide a range of financial instruments and manage risks arising in the process. The more developed the banking sector, the more sophisticated the financial products on offer. In advanced economies, savers and investors also interact directly through capital markets via tradable securities like bonds and stocks. Institutions such as bourses, clearing houses and investment banks are needed to enable these interactions. Key determinants for the efficiency of capital market are their depth (market capitalization), liquidity (turnover) and diversity (range of financial instruments). Institutional investors such as pension funds, mutual funds or asset managers are needed for the development of more sophisticated capital markets. The third sub-sector is the insurance industry, which includes life and non-life insurance companies, insurance brokers and reinsurance firms. The insurance market allocates risk and provides long-term savings instruments.

Even at its current level of development, banking accounts for about 60,000 employees in the Western Balkans. But financial markets are not only an important sector in their own right. They encourage higher savings and investments throughout the economy, they help allocate scarce resources to the most promising ventures and they ensure smooth financial transactions across borders. Efficient mechanisms for delivering microfinance to small entrepreneurs, rural-finance to farmers and housing finance to the general population make an important contribution to poverty reduction. A stable banking sector and an extended branch network help to mobilize savings. Markets for leasing, bonds and equity provide private companies with the financial resources needed for growth and investment. More generally, financial markets help facilitate the reallocation of resources that lies at the heart of the transition process. If financial markets do not function properly, high lending premiums impose excess costs on savers and investors. Bad loans can lead to bank insolvencies and costly bail outs. Systemic banking crises, low capitalization rates or the crowding out by government debt may starve the private sector of funding. Poorly managed banks and weak regulation can aggravate macroeconomic shocks by triggering inflation, exchange rate volatility or capital flight.

A stable and transparent policy framework is a precondition for efficient financial markets. This not only includes the prudential regulation of banks and other financial institutions, but also adequate bankruptcy and accounting laws, a separation between financial and non-financial institutions and a judicial system that permits the enforcement of creditors’ rights. Important flanking measures for financial market development include privatization programs (to enhance stock market capitalization and liquidity), fiscal policies (streamlined tax regimes, moderate budget deficits) and, in more advanced
countries, pension reforms (to increase savings rates and foster the emergence of institutional investors). Better corporate governance in financial services spills over into the rest of the economy for a number of reasons: banks and capital markets demand high levels of transparency from their clients in order to minimize risk, increased financial intermediation helps reduce the share of the gray economy and banks are instrumental in enforcing rules against money laundering.\(^1\)

**Financial Markets and Regional Integration**

The relationship between regional integration in financial markets and in the broader economy runs in both directions. On the one hand, financial services are required for a range of cross-border transactions, including trade finance, foreign investment or the transfer of workers’ remittances. Hence, more efficient and better integrated financial markets facilitate deeper regional integration. On the other hand, the integration of financial markets mirrors the patterns of broader economic integration. In the early years of transition, for instance, many EU banks set up small representative offices in the Western Balkans in order to serve their home clients who were entering the region. As cross-border linkages became more diverse and as foreign banks became more familiar with local conditions, they gradually expanded their presence. Now several of them have established branch networks throughout the Western Balkans and act as ‘universal banks’ that offer a broad range of services.

Given the importance of scale economies in financial markets, cross-border integration is particularly beneficial for small countries like those in the Western Balkans.\(^2\) Total banking assets in the five countries together amounted to € 57 billion and are equivalent to that of one mid-sized EU bank. 60 percent of the total is accounted for by Croatia alone and the sector in most other countries is miniscule by international standards. Hence, regional integration would permit banks and insurance companies to gain critical size, the market to increase liquidity and competition and investors to hold more diversified portfolios. Among the benefits of regional integration are a better match between supply and demand, risk diversification, reduced spreads and enhanced customer choice. The process of regional integration in the financial sector of the Western Balkans has primarily been driven by foreign direct investments of EU banks. These strategic investors are bringing technical know-how, such as modern risk-management and marketing techniques. They tend to raise governance standards and introduce new financial products. And they come with the resources to re-capitalize local banks and modernize branch networks. FDI also helps the region to ‘import’ modern prudential regulation, since local subsidiaries are normally supervised by the home regulator of the parent institution and

\(^1\) Reducing the share of the gray economy is a key priority for all countries in the region. In BiH, for instance, the informal sector is estimated to be equivalent to 55 percent of the observed economy.

\(^2\) Economies of scale in this sector are significant both at the level of individual institutions and at the market level. Financial sector companies therefore have a natural tendency to establish cross-border operations in regions with small national markets and a high degree of cultural proximity. Examples are the Scandinavian countries in Northern Europe, the Spanish speaking countries of Latin America or the Slavic countries of Central and Eastern Europe.

Daniel Müller-Jentsch

EC-WB Office for South East Europe
because EU banks are familiar with the EU acquis. Another set of policies that facilitate regional integration of financial markets concern the removal of restrictions to cross-border capital flows and foreign exchange transactions. Capital account liberalization in the region is generally well advanced.

Box 1: Erste Bank’s entry into the Serbian market

As part of the privatization process in Serbia’s banking sector, Austria’s Erste Bank purchased an 83 percent stake in Novosadska Banka for € 73 million in 2004. Novosadska is the second largest bank in the northern Vojvodina region, but with 71 branches it only ranks number 13 in the country as a whole. However, it is in direct proximity to Erste’s existing branch networks in neighboring Hungary and Croatia and the bank intends to use it as a launching pad for expansion across Serbia. As one of the first measures, Novosadska was renamed Erste Bank Serbia. An ambitious restructuring program was launched soon after the takeover. It focuses on organizational reform and the replacement of key managers as well as the upgrading of risk management and accounting procedures to meet the standards of the parent institution. Erste is also redesigning existing financial products and introducing a host of new ones. Two specific initiatives are geared at developing the mortgage business and financing programs for SMEs. Investments into staff training, branch refurbishing and the modernization of the IT infrastructure are being made. As restructuring of the existing operation progresses, Erste has ambitions to increase its Serbian market share from 2 to 10 percent. After opening 15 new branches in 2006, it plans to add a further 20 in each of the two following years.

In many respects, Erste Bank’s entry into the Serbian market is typical for the activities of foreign banks in the Western Balkans: It treats the region as one common market by building a border-spanning branch network and consumer brand. It transfers extensive know-how through the secondment of experts, the development of local staff and the implementation of its standard business practices. At the same time, it brings considerable amounts of FDI to the country as it recapitalizes its new subsidiary, modernizes the physical infrastructure and expands the branch network. This comes on top of the privatization receipts and taxes that go to the government budget. Other beneficial effects that foreign investors like Erste Bank bring are new financial products, an impetus to banking competition, a deepening of financial markets and increased confidence in the banking sector. In the longer term, FDI by international banks also generates positive spillovers, such as the movement of trained employees to other firms, backward linkages with local suppliers and demonstration effect of using new technology and management techniques. Last but not least, many foreign banks are also active in the insurance sector and key players in the emerging capital markets of the Western Balkans.

In the EU, where financial services account for more than seven percent of GDP, the reform and integration of financial markets is well-advanced. The cross-border flow of capital was one of the ‘four freedoms’ of the 1992 Single Market program and thus many barriers between capital markets were already removed a decade ago. The euro, launched in 1999, further facilitated integration by eliminating currency risk and reducing transaction costs. The Financial Services Action Plan (FSAP) spelled out a strategy to further integrate financial markets between member states and was implemented between 1999 and 2005. Potential benefits of those reforms have been estimated to be 0.5 percent of EU GDP, or € 43 billion per year. The FSAP contained proposals for 42 pieces of legislation for the wholesale market, the retail market, prudential regulation and the harmonization of taxes on pensions and financial products. Three high-level committees of national regulators were established on securities, banking and insurance. In the longer term they might become the nucleus for pan-European regulatory institutions. After reviewing progress under the FSAP, the Commission published its White Paper on “Financial Services Policy 2005-2010”. It lays out a set of initiatives to streamline and complete the regulatory framework, to ensure effective implementation by member

---


states and to enhance supervisory cooperation. A number of reviews will assess the effectiveness of existing and the need for new legislation. Annual progress reports on financial services will be published.

The *acquis communautaire* for the financial sector relates to the licensing, operation and supervision of financial services providers, such as banks, insurance companies, securities markets or mutual funds. Full acquis compliance is a condition for EU accession and should be the ultimate objective for all Western Balkan countries. For a number of reasons, however, regulatory convergence in the financial sector ought to be pursued gradually. First, regulatory priorities for less developed financial markets, such as those in the Western Balkans, differ from those in more mature economies. Whereas many EU rules are complex pieces of legislation targeted at sophisticated capital markets, the current priority in South-Eastern Europe are more basic banking and insurance reforms. Second, the main challenge for acquis compliance will not be legislative approximation, but effective supervision and enforcement. This, however, requires further capacity building at central banks and the establishment of functioning regulators for non-banking financial services. Third, adopting the acquis will become much easier once EU banks and insurance companies have consolidated their presence in the region. Finally, the Commission has just launched a review process for parts of the financial sector acquis that should be completed by 2010. By then, financial markets and regulatory institutions in the Western Balkans should have evolved far enough to accelerate acquis convergence.

**Box 2: Home-Host Regulatory Cooperation**

As cross-border investments by financial institutions lead to the emergence of regional markets at the company level, regulators have to follow suit. Especially the exchange of information and other forms of cooperation between the regulators in the ‘home’ countries of international financial groups and those in the ‘host’ countries of their subsidiaries are needed to counter regulatory arbitrage or contagion in the case of market turbulences. In October 2006, a meeting of central bankers from the region, hosted by the Bank of Albania, discussed how cooperation between them could be improved. Around the same time Austria’s Financial Market Authority announced that it was scaling up its capacity to supervise foreign operations of domestic financial institutions. Further such efforts will be needed to ensure that regional markets are properly supervised.

Key reform priorities in the Western Balkan countries over the coming years include the following (i) Modernize regulatory frameworks and strengthen regulatory capacity in line with the Basle Core Principles for Effective Banking Supervision. (ii) Ensure compliance with EU rules on ‘home-host’ supervisory issues. (iii) Facilitate market entry by and consolidation through EU financial services companies. (iv) Address specific regulatory issues arising in the transition process, especially rapid expansion of consumer credit and high exposure to currency risk. (v) Reinforce the fight against money laundering and financial sector crime. In recent years, donor assistance in the Western Balkans has largely focused on sector stabilization, regulatory reform and bank privatization. Increasingly, more advanced reform issues such as the development of modern capital markets are gaining importance. Especially in the accession candidates Croatia and FYR Macedonia, the question of acquis compliance and the transfer of experience from EU countries through instruments such as twinning arrangements are increasingly moving to the forefront.

---

6 Information about the single market for financial services, including the various elements of the financial acquis can be found under: ([http://europa.eu.int/comm/internal_market/finances/index_en.htm](http://europa.eu.int/comm/internal_market/finances/index_en.htm)). A guidebook on the internal market acquis, including for financial services is available under: ([http://ec.europa.eu/internal_market/extent-dimension/docs/enlargement/guidebook_en.pdf](http://ec.europa.eu/internal_market/extent-dimension/docs/enlargement/guidebook_en.pdf)).

7 For information on the Basle Core Principles and the associated assessment methodology see website of the Bank for International Settlements: ([www.bis.org/dcms/fl.jsp?aid=7&pmdid=3&smdid=14&tmdid=0&findid=0&tid=25](http://www.bis.org/dcms/fl.jsp?aid=7&pmdid=3&smdid=14&tmdid=0&findid=0&tid=25)).
Reform Trends in the Western Balkans

The financial markets of the Western Balkans are at different stages of development, but they share many commonalities and are converging towards similar market structures. Whereas the annex reviews country-specific developments, this section analyses regional reform trends and benchmarks the sector performance of individual countries.

Financial markets have overcome the turbulences of the 1990s: Fifteen years ago, financial markets in former Yugoslavia and even more so in Albania were poorly developed. The break-up of Yugoslavia led to the fragmentation of financial services companies, the establishment of new regulatory institutions and a freezing of foreign currency deposits. During the 1990s, pyramid saving schemes in Albania and Macedonia, hyperinflation in Serbia and Montenegro, the wars in Bosnia and Kosovo as well as banking crises in several countries of the region took their toll on the sector. Macro-economic disturbances, a weak rule of law, a large stock of bad debt and low capitalization rates further undermined the stability of financial markets. As a consequence, the policy agenda during the late 1990s and early 2000s was dominated by efforts to clean up and stabilize the banking industry. Balance-sheet restructuring reduced the amount of non-performing loans, undercapitalized banks received new funds or were closed down, inflation was brought under control, and frozen foreign currency deposits were gradually being redeemed. These often painful measures lay the basis for future growth.

Diagram 2: Quality of Banking Legislation by Country (2005)

Source: EBRD Transition Indicators. Values for the quality of legislation range from 0 (the lowest) to 100 (the highest). The categories in diagram 2 are: (1) Competence of banking supervisory authority. (2) Discharge of banking supervisory authority’s powers. (3) Definition of bank and banking activities. (4) Licensing authority and requirements. (5) Supervision of operations by domestic banks overseas and foreign banks locally. (6) Transfer of ownership and major acquisitions. (7) Prudential regulations. (8) Extension of credits and investment activities. (9) Risk management. (10) Governance and auditing.

8 In Croatia and in Albania, for instance, the clean-up of the banking crises in the 1990s imposed costs the government budgets that were equivalent to 8 and 12 percent of a year’s worth of GDP.
**Regulatory frameworks are being modernized:** A central element in the rehabilitation of the sector has been regulatory reform. In all countries, the initial concern was to tighten prudential regulation of banks and to strengthen institutional capacity of central banks as the banking regulators. Other early priorities were the establishment of credit registers (to facilitate risk management and encourage lending) and deposit insurance systems (to increase confidence in the banking sector and transform cash-holdings into deposits). As financial markets mature, the regulatory framework has to evolve accordingly. An increasing number of countries have put in place specific legislation for new financial products, such as leasing or mortgages. At the same time, central banks have tried to encourage balanced growth. For instance, they have tightened reserve requirements and rules for foreign currency exposure in response to the credit boom that most countries experienced in the wake of sector restructuring. Broader regulatory reforms are also being tackled with regard to accounting and auditing, the fight against money laundering, collateral (e.g. land titles, collateral registries) and the enforcement of creditors’ rights (e.g. bankruptcy procedures). In addition, governments have to modernize the legal framework and build regulatory capacity for the insurance and capital market sub-sectors. The EBRD cobweb diagrams on the quality of banking legislation show that the process of regulatory reform in Western Balkan countries still has some way to go (see diagram 2).

**Bank privatization will soon be completed:** Across the region, privatization has reduced state and collective ownership in banking assets from close to a hundred percent in the early 1990s to below 10 percent in Bosnia and Herzegovina (BiH), Croatia and Albania. The sale of state-owned banks in Serbia and Montenegro started later, but has gathered momentum in 2005 and was down to 21 percent in by June 2006. In Macedonia, the government’s stake in total banking assets was reduced to 2 percent, but in contrast to neighboring countries, several banks were sold to managers, employees and local investors. This form of privatization has induced less comprehensive restructuring and resulted in lower rates of sector efficiency than the sale to foreign strategic investors. Across the region, the disposal of banking assets generated privatization receipts for governments, injected fresh capital into the sector, reduced directed and related-party lending and triggered bank restructuring. The privatization of formerly state-owned insurance companies is also advancing, but given the size of the sector, the economic repercussions have been less pronounced than in banking. Since capital markets only emerged in the process of transition, they have been largely privately-owned from the beginning.

**Foreign participation has increased dramatically:** Western Balkan countries have successfully attracted foreign banks through a removal of nationality restrictions, the liberalization of market access, and the sale of state-owned banks. In 2005, the market share of foreign banks stood at around 90 percent in Croatia and Albania and 66 percent in BiH. In Serbia it increased from 37 percent in 2005 to 72 percent in 2006 due to privatization and organic growth of the subsidiaries of EU banks. With around 50 percent Macedonia has one of the lowest shares. Increased foreign ownership is having important knock-on effects. The new entrants are investing heavily in the modernization and expansion of their branch networks, they are introducing a host of new financial products and they are increasing...
the rate of financial intermediation (see text-box 1). Intense competition between them is accelerating market restructuring, triggering credit growth and reducing interest rate spreads to the benefit of the host economies. Last but not least, they establish border-spanning consumer brands that make regional integration tangible for the general population. This cascade of secondary effects has created a transformative momentum that is likely to continue for several years.

A small number of EU banks are driving regional consolidation: Austrian and Italian banks in particular operate across the Western Balkans. Italy’s largest bank Unicredito and its subsidiary Bank Austria-Creditanstalt (BA-CA) hold around 25 percent of banking assets in Croatia and Bosnia and 6 percent in Serbia. Raiffeisen International has 55 percent market share in Albania and substantial operations in Bosnia, Croatia, Serbia, and Slovenia. Erste Bank has subsidiaries in Croatia and Serbia and Volksbank International (VBI) in Serbia, Croatia, BiH and Slovenia. Hypo Alpe-Adria Bank, another Austrian player, has a network extending to BiH, Serbia, Croatia and Slovenia. Italy’s second largest bank, Banca Intesa owns banks in Croatia, Slovenia, Serbia, Montenegro, and BiH. It aims for at least 8 percent market share in each of these countries. Greek banks have also entered the region. By mid 2005, they had invested around € 750 million in the Western Balkans, half of which in Serbia alone. The main players are Greece’s two largest banks National Bank of Greece and Alpha Bank, with 230 and 176 branches across the region respectively. A notable feature of the banking market are also intra-regional FDI flows. Slovenia’s Nova Ljubljanska Banka (NLB) has subsidiaries in Montenegro, FYR Macedonia and Bosnia. Unicredito has used its Croatian subsidiary Zagrebacka Banka to buy Bosnia’s second largest bank. In 2006 Hungary’s OTP, already active in Croatia and Albania, bought stakes in three Serbian and the leading Montenegrin bank.

![Diagram 4: Foreign Ownership (%)](source: Bank Austria-Creditanstalt. (as % of banking assets))

### Table 1: Market Share of Major EU Banks by Country (as % of banking assets)

<table>
<thead>
<tr>
<th></th>
<th>Unicredito/BA-CA</th>
<th>Intesa</th>
<th>Raiffeisen</th>
<th>Erste</th>
<th>Hypo Alpe</th>
<th>NLB</th>
<th>NBG</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>55</td>
</tr>
<tr>
<td>BiH</td>
<td>25</td>
<td>5</td>
<td>26</td>
<td>14</td>
<td>4</td>
<td></td>
<td></td>
<td>74</td>
</tr>
<tr>
<td>Croatia</td>
<td>24</td>
<td>18</td>
<td>11</td>
<td>11</td>
<td>7</td>
<td></td>
<td></td>
<td>71</td>
</tr>
<tr>
<td>Macedonia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>25</td>
<td>25</td>
<td>50</td>
</tr>
<tr>
<td>Montenegro</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>25</td>
<td></td>
<td>41</td>
</tr>
<tr>
<td>Serbia</td>
<td>6</td>
<td>11</td>
<td>14</td>
<td>2</td>
<td>6</td>
<td>2</td>
<td></td>
<td>41</td>
</tr>
<tr>
<td>Slovenia</td>
<td>6</td>
<td>3</td>
<td>2</td>
<td>33</td>
<td></td>
<td></td>
<td></td>
<td>44</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>21</td>
<td>8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>9</td>
<td>38</td>
</tr>
</tbody>
</table>

Various Sources. Notes: Unicredito and BA-CA merged, NLB=Nova Ljubljanska Banka, NBG=National Bank of Greece

9Other SEE countries where BA-CA has a strong presence are Slovenia, Bulgaria, Romania and Hungary. In 2000 BA-CA was bought by Germany’s Hypo-Vereinsbank (HVB) and HVB was overtaken by Unicredit in 2005. Eastern European operations of Unicredito and HVB are now being run from Vienna (FTD, 15 March 06).
Bank competition is working well but needs to be safeguarded: The banking sector in the Western Balkans is much more consolidated than in most EU countries, with the top five banks accounting for 47 percent (Serbia) to 77 percent (Albania) of total assets. Despite high concentration in the top end of the market, competition remains dynamic, as well-capitalized foreign banks vie for stakes in rapidly expanding markets. As the sector matures, however, it will be important to prevent the emergence of dominant positions that stifle competition. In that context, the application of competition rules will gain in importance, as the case of Croatia demonstrates. After Unicredito took over HBV in 2005 the central bank obliged the combined group to shed one of its two subsidiaries, as their combined market share exceeded 35 percent.10 Another country, where a high degree of market concentration could hamper competition is Albania. The Savings Bank, sold to Raiffeisen in 2004, enjoys more than 50 percent market share. In FYR Macedonia, the dominance of the largest bank was reduced though the spin-off of its five largest branches prior to privatization.11 Across the region, the overall number of banks has been reduced in recent years through bank mergers and closures. It currently varies between 10 in Montenegro and 40 in Serbia, but given the small size of domestic markets, most of these countries can still be considered overbanked in terms of bank numbers. In Serbia, for instance, half the banks have less than one percent market share. The best way to achieve market consolidation in the low end of the market is regulatory pressure such as minimal capital requirements, effective competition and the entry of foreign investors (which act as consolidators and increase competitive pressure).

Table 2: Market Concentration in Banking

<table>
<thead>
<tr>
<th></th>
<th>Number of Banks</th>
<th>Market Share of top-5 banks (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>13</td>
<td>17</td>
</tr>
<tr>
<td>BiH</td>
<td>61</td>
<td>33</td>
</tr>
<tr>
<td>Croatia</td>
<td>53</td>
<td>34</td>
</tr>
<tr>
<td>Macedonia</td>
<td>23</td>
<td>20</td>
</tr>
<tr>
<td>Serbia</td>
<td>75</td>
<td>40</td>
</tr>
<tr>
<td>Montenegro</td>
<td>n.a</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Bank Austria-Creditanstalt.

The banking sector is maturing rapidly: As a range of indicators illustrate, the financial sector in the region is gradually maturing, but remains underdeveloped in absolute terms. The expansion of branch networks is increasing the geographic access to financial services, but many rural areas remain poorly served. Thanks to effective restructuring and deposit insurance schemes, the population is regaining confidence in the sector and puts savings previously held in cash back into the banking system. Between 2000 and 2004, total deposits increased between 13 in Albania and 31 percent in Bosnia. In countries like Serbia, however, this process still has some way to go. Increased deposits together with the recapitalization by foreign owners are increasing the level of financial intermediation across the Western Balkans. Total banking assets as a share of GDP ranged from 42 percent in Montenegro to 114 percent in Croatia. Despite recent growth rates,

10 At the same time, it precluded the sale to one of the other six leading banks in the country (FT, 4 January 06).
11 Another example on how problems of market dominance can be addressed comes from Poland, where the merger between Unicredito and HVB will lead to the merger of two large Polish subsidiaries: in April, Unicredito agreed to sell 200 of the 466 branches of one of its two subsidiaries to reduce its dominant position (FT, 6 April 2006).
most of the region remains underbanked in terms of financial intermediation and has significant potential for further growth. Total loans as a percentage of GDP ranged from 10 percent in Albania to 67 percent in Croatia, compared to 102 percent in the euro area. The gap in the ratio of deposits to GDP was lower, but remains significant (between 20 and 60 percent, compared to 73 percent in the euro area). As confidence in the banking sector has increased, the maturity profile of deposits is also improving (fewer demand deposits and more time and savings deposits). This facilitates lending and reduces the risk of a maturity mismatch between loan and deposit portfolios of banks. Another indicator for the increased maturity of the banking sector in the region is the gradual reduction in interest rate spreads. In Bosnia, they have come down from 16 percent in 2000 to 4 percent in 2004 and in Serbia from 72 percent (the aftermath of an economic crisis) to 10 percent.

**The range of financial instruments for consumers is broadening:** As markets in the region mature, the range of financial instruments on offer becomes more diverse. Whereas normal savings accounts have long existed, the use of ATM machines and debit cards is now spreading rapidly. Credit cards and consumer credit, until recently niche products are also becoming prevalent. As cadastres are being established and land titles become available as collateral, mortgages and housing finance are being offered. More sophisticated savings instruments such as mutual funds, life insurances or private pension schemes tend to gain prominence at later stages of development. In diagram 6, Albania would probably be somewhere on wave 1, Serbia and Macedonia between waves 2 and 3 and Croatia on wave 4. Similar waves for product launch and market penetration can be observed for insurances. The basic product that serves as the basis for development of this sub-sector is mandatory vehicle insurance. Real estate, life, health and other insurance types follow later.

![Diagram 6: Stylized Development Path of Banking Markets](image)

Even though the spread of these products is largely a function of per capita income, the status of financial sector development and complementary reforms (e.g. pension reforms) are also determining factors. As most financial products require some specific regulatory and institutional arrangements, continuous adjustments in the policy framework have to be made as the sector matures.

**The insurance sector is at an early stage of its development:** The low share of total premium income in GDP is testimony to the underdeveloped state of the insurance sub-sector in the region. The figure ranges from 0.5 percent in Albania to 3.5 percent in Croatia, compared to 9 percent in the EU. From this low base, however, several countries are experiencing growth rates of around 10 percent annually. The product mix is still dominated by vehicle insurance and other products are slow to emerge. Privatization of insurance companies is progressing, but remains less advanced than that of banks. Most countries have between 10 and 30 insurance companies and the challenge will be to encourage consolidation among smaller players while preventing a degree of market concentration that would stifle competition. EU insurance companies like Wiener Staedtische, Allianz or Genereli have started to move into the region and several EU banks are offering insurance products. For
instance, Austria’s Uniqua cooperates with Raiffeisen Bank to sell insurance products in Croatia and Bosnia, Erste Bank’s subsidiary “s Versicherung” sells life insurance through bank branches in markets like Serbia. There are also cases of intra-regional FDI. Croatia Osiguranje wants to buy the main insurance company in the Bosnian Federation, Albania’s market leader has expanded into Macedonia and Kosovo while Slovenia’s largest insurance Zavarovalnica Triglav is active in most countries of former Yugoslavia. Reflecting the small size of national markets, insurance regulators tend to be tiny and institutionally weak. To address that problem, several countries are establishing multi-sector regulators: Croatia has recently merged all non-banking financial regulators into one, Albania is contemplating to do the same and Serbia has expanded the central bank’s mandate to include supervision of the insurance market. In fact, Serbia’s recent efforts to build regulatory capacity and to significantly tighten regulation in the insurance sub-sector – which resulted in the closure of 18 insurance companies – could provide some useful lessons for countries like BiH and Albania.

Capital markets remain small, fragmented and underdeveloped: The market capitalization of all Western Balkan countries together amounts to just over € 50 billion (equity only). Even though this figure has increased considerably in recent years, the total is only equivalent to about a third of the already small Vienna Stock Exchange. To make matters worse, this tiny volume is fragmented between half a dozen exchanges. Total turnover of the region, an indicator for trading dynamics and liquidity, is just 6 percent of that in Vienna. The number of listed companies is very high, but only a tiny fraction is actively traded. Miniscule exchanges like those in Macedonia, Montenegro, Bosnia (which has two of them) and Albania (where no securities are listed) do not seem viable as stand-alone operations. A number of issues will have to be tackled to if proper capital markets are to develop. First, the various exchanges will need to team up if they are to reap scale economies and gain visibility in the international marketplace (see text-box 3). Second, capital market regulators in all countries, with the possible exception of Croatia, need to be strengthened and the legal framework has to be modernized. Third, flanking measures that can help stimulate market development include reforms of corporate governance, accounting and auditing or privatization programs with stock market listings. Another important segment of capital markets where more ought to be done are bond markets. The obvious starting point would be efforts by national ministries of finance, central banks and securities regulators to render the trade in government bonds more efficient. This includes the issuing of additional

Table 3: Selected Insurance Indicators

<table>
<thead>
<tr>
<th></th>
<th>number of insurance companies</th>
<th>premium income as % of GDP</th>
<th>growth rate in 2005/06</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>10</td>
<td>0.5</td>
<td>6</td>
</tr>
<tr>
<td>BiH</td>
<td>27</td>
<td>2.7</td>
<td>n.a.</td>
</tr>
<tr>
<td>Croatia</td>
<td>25</td>
<td>3.2</td>
<td>10</td>
</tr>
<tr>
<td>Macedonia</td>
<td>10</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Serbia</td>
<td>19</td>
<td>3</td>
<td>12</td>
</tr>
</tbody>
</table>

Various Sources.

Table 4: Stock Market Indicators (2006)

<table>
<thead>
<tr>
<th></th>
<th>market cap. (bn €)</th>
<th>turnover (bn €)</th>
<th>companies listed*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>Tirana</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>BiH</td>
<td>Sarajevo</td>
<td>6.1</td>
<td>0.7</td>
</tr>
<tr>
<td></td>
<td>Banja Luka</td>
<td>4.2</td>
<td>0.4</td>
</tr>
<tr>
<td>Croatia</td>
<td>Zagreb</td>
<td>23.0</td>
<td>2.9</td>
</tr>
<tr>
<td></td>
<td>Varazdin</td>
<td>7.4</td>
<td>0.3</td>
</tr>
<tr>
<td>Macedonia</td>
<td>Skopje</td>
<td>0.9</td>
<td>0.6</td>
</tr>
<tr>
<td>Montenegro</td>
<td>Podgorica</td>
<td>1.9</td>
<td>0.5</td>
</tr>
<tr>
<td></td>
<td>NEX</td>
<td>1.9</td>
<td>0.2</td>
</tr>
<tr>
<td>Serbia</td>
<td>Belgrade</td>
<td>8.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Total</td>
<td>54.1</td>
<td>8.1</td>
<td>3206</td>
</tr>
</tbody>
</table>

Source: Vienna Stock Exchange. * official and unofficial market segments

Table 4: Stock Market Indicators (2006)
maturities, a better organization of the issuing calendar, improved settlement procedures and measures to increase the liquidity and transparency of secondary markets. A more efficient market for government bonds would also facilitate the development of corporate bond markets. Foreign-owned banks are already key players in the region’s emerging capital markets (e.g., they own brokers and sell securities to retail clients) and will continue to play an important role.

Box 3: Towards a Regional Stock Exchange

Even large international bourses are merging to compete on the global stage. For instance, Euronext – itself an alliance between the exchanges of France, Belgium, the Netherlands and Portugal – is merging with the New York Stock Exchange. The OMX Nordic Exchange provides an integrated securities marketplace between the bourses of Sweden, Finland and Denmark on the one hand and those of the new EU member states Estonia, Latvia and Lithuania on the other. It supplies IT systems to 60 exchanges world-wide and acquired a stake in the Oslo exchange in late 2006. These developments are in stark contrast to those in the Western Balkans, where governments still tend to see the existence of a stock exchange as a question of national pride. As one of the first cooperation initiatives in the region, the Ljubljana Stock Exchange organized a joint information platform for eight exchanges in countries of former Yugoslavia: the Stock Exchange Monitor (SEM). It was launched in 2003 and provides access to 2,200 securities and 170 brokers.

A more ambitious attempt to join forces is the current effort of Vienna Stock Exchange to forge an alliance between bourses in Central and Eastern Europe, including those of the Balkans. In 2004, the Viennese exchange and a consortium of its main shareholders bought 69 percent of Budapest Stock Exchange in the first major tie-up of the region. Both bourses plan to jointly distribute market data, to link their trading platforms and to conduct common road shows for investors. Joint working groups were established to harmonize trading and listing procedures, listing segments and corporate governance rules. Both sides would like to extend their partnership to other exchanges in the region, but plans for a joint holding company with Warsaw were shelved after the Polish government cancelled the privatization of its bourse. In the meantime, the Vienna Stock Exchange is developing partnership activities with South-East European counterparts. It has signed MoUs with bourses in Bosnia, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia. A first joint activity will be the publication of a South Eastern European Trade Index for the 15 largest quoted companies in the region. Vienna also publishes national indices for some partner bourses. A gradual deepening of joint activities is foreseen.

Cooperation on data distribution, connectivity between trading platforms and a harmonization of listing rules will make the regional market more attractive for international investors. Common indices permit mutual funds and banks to offer index-tracking investment products and thus help to channel investment funds to the region. Deeper forms of integration, however, would be desirable. Equity participation and common management structures would facilitate the transfer of know-how from more developed exchanges to their less developed peers. The ultimate goal, however, should be the establishment of a tightly integrated regional network of stock exchanges. One option would be the holding structure advocated by the Vienna Stock Exchange, in which a holding company builds the common infrastructure and international business lines, while national exchanges cater to the local market and develop local expertise. At the policy level, the gradual convergence towards the capital market acquis will harmonize the regulatory frameworks in which bourses and their clients operate. Whatever the exact modalities of cooperation, the Western Balkan stock exchanges will need to establish regional structures if they want to plug into global capital markets.

Limited access to finance for private companies remains a major concern: Throughout the Western Balkans, limited access to finance has long been a key impediment to private sector development (especially for SEMs) and one of the main deficiencies of the financial sector. According to the

---


13 Another example comes from Africa, where the dominant player Johannesburg has established alliances with many of the continent’s smaller bourses.
World Bank-EBRD Business Environment and Enterprise Performance Survey (BEEPS) 2005, about 45 percent of companies in South East Europe stated that access to finance was a problem for doing business (down from 50 percent in 2002) while 57 percent complained that the cost of finance was a problem.\(^\text{14}\) Regarding sources of funding, an average 70 percent of new investments are financed through retained earnings and only 20 percent through formal borrowing or trade credit. These figures vary significantly between countries, but they indicate significant financial sector deficiencies. While interest rate spreads have come down in most countries, the ratio of corporate loans to GDP remains much lower than in the new EU member states (see table 5). The situation, however, is gradually improving as competition between recapitalized banks intensifies and as foreign owners introduce modern loan evaluation techniques. Special SME credit lines, which the EBRD and the IFC are extending to local banks also help develop that market segment. While all this has led to rising lending volumes, a number of complementary measures should further improve access to finance. These include accounting and auditing reforms, better corporate governance, more effective enforcement of creditors’ rights (i.e. modern bankruptcy laws, competent commercial courts) and improved collateral regimes (i.e. collateral registries, land cadastres). More directly within the realm of financial sector policies are regulations that foster the development of leasing markets (an important source of capital for SMEs) and measures that help develop corporate bond and equity markets.

### Remittance flows have important implications for financial markets:

Around five million people from the Western Balkans reportedly live abroad, many of them in the EU. The remittances they send home amount to over $5 billion each year – which is equivalent to 5 percent of GDP in intermediate migration countries like Croatia and Macedonia and around 20 percent in high migration countries like Albania or Bosnia (see table 6).\(^\text{15}\) Even though reliable data is hard to come by, only a share of these remittances are sent home through official channels. This share should rise as people’s confidence in local banks increases, cross-border payment systems are becoming more efficient and as transfer fees are being reduced. Another way to channel more of these remittances into the financial sector would be for banks to develop specific services and financial products that are targeted to the needs of migrants and their families at home. In Mexico, for instance, banks already offer products such as bi-national credit cards, cross-border mortgages and mutual funds tailored to migrants. There might be potential for Western Balkan banks to do the same – especially since many of their parent banks come from the main host countries of the migrants (e.g. Germany, Italy, Greece).

<table>
<thead>
<tr>
<th>Remittances</th>
<th>Albania</th>
<th>BiH</th>
<th>Croatia</th>
<th>Macedonia</th>
<th>Serbia &amp; Mont.</th>
</tr>
</thead>
<tbody>
<tr>
<td>mio. $</td>
<td>889</td>
<td>1,824</td>
<td>1,222</td>
<td>171</td>
<td>1,397</td>
</tr>
<tr>
<td>% of GDP</td>
<td>16</td>
<td>23</td>
<td>5</td>
<td>4</td>
<td>8</td>
</tr>
</tbody>
</table>

**Source:** World Bank.


---

**Table 5: Availability of Credit to the Private Sector**

<table>
<thead>
<tr>
<th></th>
<th>Interest Rate Spread</th>
<th>Corporate Loans/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2004</td>
</tr>
<tr>
<td>Albania</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Bosnia &amp; Herzegovina</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>Croatia</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Macedonia</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Serbia</td>
<td>17</td>
<td>11</td>
</tr>
</tbody>
</table>

**Source:** Bank Austria-Creditanstalt.
Box 4: The Single Euro Payment Area

A vast number of payments between individuals and companies are transacted via inter-bank payment systems. Increasing the cost, speed, convenience and security of these payments is important for retail customers and corporate clients alike. Technical and regulatory incompatibilities between the systems of individual banks and countries considerably reduce the efficiency of such transactions. In order to minimize the cost and complexity of cross-border transfers, the EU is establishing common technical and institutional structures:

- **The TARGET system** as the inter-bank settlement system for cross-border payments in euros. It connects the national settlement systems of the 27 EU member states with that of the European Central Bank and constitutes an EU-wide payment platform. In addition, the Euro Banking Association (EBA) operates the **STEP 2 system**, which permits automatic processing of mass low-value payments throughout the EU.

- The **Regulation on Cross-Border Payments in Euro (2560/2001/EC)**, which came into effect in mid-2003, stipulates that fees for low-value payments between EU countries must be equal to fees for domestic transfers. This applies to payments below € 50,000. This entails complex technical changes to the payment infrastructure within and between banks. One requirement is that all EU banks introduce International Bank Account Numbers (IBANs) and Bank Identifier Codes (BICs).

- The EU plans to establish a **Single Euro Payment Area (SEPA)** by 2010. The European Commission will create the regulatory framework through a Payment Services Directive, but the actual infrastructure for SEPA will be put in place by the European Payment Council (EPC). EPC members include large banks as well as banking and payments associations from 29 countries. The EPC defines a set of technical standards, processes and universal rules that will govern those transactions. The long-term goal should be the integration of the Western Balkans into the European Payment Area. This, however, will require the overhaul of internal payment systems by individual banks, the overhaul of national payment systems in line with European standards, changes to domestic regulations and supervisory capacity related to payment systems and the introduction of the IBAN system. (Bulgaria introduced IBANs in 2006 and Croatia is in the process of doing so.) The dominance of EU banks in Western Balkan markets should facilitate that process, but the speed and sequencing of reforms should be guided by cost-benefit considerations.

The degree of euroization in financial markets of the region is high: The euro has both positive and negative implications for financial markets in the region. First, the introduction of euro coins and notes in 2001 brought significant amounts of cash holdings from ‘under the mattress’ into the banking sector and considerably increased the rate of financial intermediation. This one-off effect has now petered out. Second, most regional currencies are pegged against the euro and Montenegro and Kosovo have even adopted the euro as their official currency. In 2007, Slovenia became the first country of former Yugoslavia to officially accede to the euro zone. Third, most Western Balkan economies are characterized by a high degree of euroization. For instance, 80 percent of loans in Albania and 70 percent of deposits in Croatia are denominated or indexed in foreign currency (mainly euro). Such a high exposure of domestic financial systems to currency risk increases exposure to external shocks and makes it difficult for monetary authorities to make adjustments to the exchange rate. Therefore, several central banks in the region have adopted regulatory measures to reduce the currency exposure of banks (e.g. by requiring higher capital adequacy ratios for foreign currency loans). Even though the foreign exchange exposure is thus gradually being reduced, it remains at uncomfortably high levels in several countries of the region.

Fighting money laundering remains a significant challenge: Money laundering and other forms of financial crime remain wide-spread across the Western Balkans. Several countries in the region have

---

16 The 29 SEPA countries include the 25 EU member states plus Switzerland, Norway, Iceland and Liechtenstein (European Payment Council. March 2006. How to make the ‘Single Euro Payment Area’ a reality.)
adopted national strategies against money laundering and the European Commission gives this issue great prominence in its bilateral relations. In fact, all annual progress reports contain sections on money laundering. The main problem, however, is not the inadequacy of legislation but the poor track-record of enforcement. Even though money laundering often takes place outside the financial system, banks play an important role in detecting, reporting and countering this illegal practice. The increased presence of EU banks, with their higher levels of transparency and their familiarity with international rules on money laundering, should facilitate enforcement. Stricter banking supervision, which has pushed many poorly managed banks out of the market, also helps. Money laundering and illicit transactions outside the banking system, however, tend to be more difficult to detect. Since financial crime is often a cross-border phenomenon, collaboration between financial regulators and law enforcement agencies will also be needed – both within the region and vis-à-vis the EU.

**Box 5: Regional Initiatives for Accounting and Auditing Reform**

Reliable and transparent financial information is vital for financial markets. It minimizes risk and information costs, while permitting for an efficient allocation of capital throughout the economy. The harmonization of accounting rules has also been a cornerstone of the EU Single Market and since the beginning of 2005 all listed companies in the EU have to use international financial reporting standards (IFRS). Accounting and auditing reforms are also critical for the Western Balkans and two complementary assistance initiatives are underway:

- The **REPARIS program** is a regional multi-donor initiative to upgrade the policy and institutional framework for corporate reporting in South East Europe. It is designed around the introduction, implementation, and effective enforcement of relevant portions of the EU acquis communautaire and international standards. A core element is a training program for about 1,000 senior officials and key market participants. There are plans to establish a REPARIS secretariat in Vienna in order to carry the work forward.

- The analytical underpinning for that work is the international **ROSC assessments** carried out by the World Bank. It helps client governments to review national reform needs and develop Country Action Plans in close cooperation with concerned stakeholders. ROSC assessments have been conducted in Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Serbia and Kosovo (UN UNMIK).

While these regional initiatives are important catalysts for the reform process, the implementation of ROSC Country Action Plans entails complex capacity building at the national level. Sector regulators, corporate accounting departments, financial market analysts, the domestic auditing profession and commercial courts all have to acquire the expertise needed to properly apply and enforce IFRS.

**Vienna has developed into a regional financial hub:** Financial institutions have a tendency to cluster in major cities. Such financial hubs emerge at the global level (e.g. London, New York), at the regional level (e.g. Frankfurt, Paris) and at the national level (usually in the capital). During the past decade, Vienna has emerged as the leading financial center for Central and Eastern Europe, including the Western Balkans. Important regional financial institutions have their headquarters in the Austrian capital, such as Bank Austria-Creditanstalt, Raiffeisen International, Erste Bank and the Vienna Stock Exchange. Other international players run their regional operations from Vienna. For instance, both Germany’s Allianz and Italy’s Generali recently established Vienna-based holding companies for their Eastern European insurance operations. A network of specialized service providers has sprung up around those anchor institutions to provide region-specific services – including accountants, lawyers and consultants. Such cluster structures are important for the development of region-specific expertise (e.g. equity analysts, project finance experts, bond traders),

economies of scale than do not exist at the national level and the spread of best practice between countries. All these benefits are particularly relevant for a region with many small economies, such as the Western Balkans. As financial markets develop regional structures, supervisors are doing the same. In October 2006, Austria’s financial sector regulator announced that it would upgrade its capacity to supervise foreign subsidiaries and strengthen cooperation with its counterparts in the region.

Reform Needs and Donor Assistance

Donors and International Financial Institutions (IFIs) play a key role in the transformation of the sector and they closely coordinate their interventions. One can roughly distinguish four overlapping phases of the reform process, in which different institutions bring to bear specific assistance instruments:

- The main interlocutors for governments during the first phase (sector clean-up and stabilization) have tended to be the IMF and the World Bank. They helped resolve the bad debt problem, restructure balance sheets and put in place the basic supervisory framework. One of their joint instruments has been national regulatory reviews under the Financial Sector Assessment Program (FSAP). The Commission has made important contributions through macroeconomic assistance and its assessment reports that include financial sector stability as part of the Copenhagen criteria.

- During the second phase of reforms (regulatory capacity building and privatization), the IMF and the World Bank continue to help with regulatory capacity building and the development of the sector infrastructure, such as deposit insurance systems and credit registrars. In addition, the EBRD and the International Finance Corporation (IFC) can contribute with a range of assistance instruments to help restructure and privatize state-owned banks.

- During the third phase (introduction of new financial products and development of capital markets), the World Bank and the European Commission tend to remain a player in such areas as the establishment of land cadastres (needed for collateral) or pension reforms (for capital market development). The role of the EBRD increasingly shifts to assisting private banks in the roll-out of new products through TA and the provision of specific credit lines (e.g. for SMEs or mortgages).

- The fourth phase, which is now starting in several Western Balkan countries, focuses on the adoption of the EU acquis, the capital market development and measures to increase availability of finance to the corporate sector (especially SMEs). The European Commission is best placed to assist with acquis compliance (e.g. through twinning arrangements, screening, and acquis-related technical assistance), while the EBRD and IFC are well suited to work with financial services providers in developing capital markets and providing finance to the private sector.

The policy framework provided by the Stabilization and Accession Process has been critical in keeping the reform process on track (see text-box 6). Equally important has been the fact that the main donors and IFIs have continued to speak with one voice and closely coordinated their interventions.

The status of sector reforms varies considerably between the countries of the Western Balkans. The country fact-sheets in the annex summarize past efforts and future reform needs at the national level.

---

18 FSAP reviews are conducted following the assessment methodology for the Basle Core Principles, developed by the BIS in Basle. For general information and individual country reports, see: (www.imf.org/external/np/fsap/fsap.asp).
## Box 6: Financial Services Provisions in the European Partnerships and Accession Partnerships

The short term (ST) and medium term (MT) provisions related to financial sector reform that are included in the 2006 European Partnerships and Accession Partnerships with the countries of the Western Balkans are listed below. In addition to these provisions regarding financial markets in the narrow sense, the European and Accession Partnerships also include provisions on money laundering, capital movements and related issues.

**Albania:** (i) ST: Strengthen the legal and supervisory framework for the banking and insurance sectors, including the establishment of independent and properly-staffed supervisory authorities. (ii) MT: Continue privatization, in particular in the financial and energy sectors.

**Bosnia and Herzegovina:** (i) ST: Set up the Insurance Agency of Bosnia and Herzegovina and ensure that it becomes fully operational. (ii) ST: Bring banking supervision to the State level and ensure effective functioning of the supervisory authority.

**Croatia:** (i) ST: Strengthen the regulatory and administrative framework for the supervision of financial services and in particular prepare for the transition towards the planned integrated supervisory authority for non-bank financial services. (ii) ST: Prepare the introduction of the new capital requirements framework for credit institutions and investment firms. (iii) MT: Complete the alignment with EU prudential requirements and continue strengthening supervisory practices. (iv) MT: Complete implementation of the new capital requirements framework for credit institutions and investment firms.

**FYR Macedonia:** (i) ST: Strengthen prudential and supervisory standards in the banking and insurance sectors. (ii) ST: Continue with the alignment of the legal framework for the financial sector and ensure swift implementation in order to ensure, in particular, a rapid catch-up with international standards and practices. (iii) ST: Reinforce the legislation and the supervisory framework, including enforcement, for the financial sector, in particular regarding the insurance sector and securities markets. (iv) Establish an independent and properly staffed supervisory authority for the insurance sector.

**Serbia and Montenegro:** (i) ST for **Serbia:** Complete the banking sector reform, in particular the privatization of State-owned banks. Continue with the restructuring and privatization of the insurance sector. (ii) ST for **Montenegro:** Adopt and implement the law on insurance supervision. (iii) MT for **Kosovo:** Develop the capacity of the banking sector to provide competitive banking services and long-term competitive financing. Ensure reliable and effective supervision of banking, insurance and pension institutions.
Annex: Country Factsheets

Albania: The privatized banking sector is highly concentrated and less developed than in neighboring countries. Capital markets barely exist and regulatory capacity remains weak. 19

- Decades of Communist rule and economic autarky left Albania with the least developed financial sector in the region. The collapse of the pyramid savings schemes in 1996-7 pushed the country into a deep recession and left financial markets in disarray. In 1998, 55 percent of all loans were non-performing. The Albanian economy is still largely cash-based and, as part of a campaign to increase financial intermediation, the government now pays all public-sector employees through bank accounts. Nonetheless, the financial sector is still much less mature than in neighboring countries and characterized by a number of distortions. It is almost completely dominated by the banking sub-sector, with insurance services and capital markets playing a negligible role.

- The government’s stake in total banking assets has been reduced to less than 5 percent. 14 of the 17 licensed banks are fully or partly foreign-owned. National Commercial Bank, the second largest in terms of assets, was sold to Turkey’s Kent Bank in 2000. Both the IFC and the EBRD took equity stakes to assist in this first bank privatization. Savings Bank, with over 40 percent market share, was acquired by Austria’s Raiffeisen International in early 2004. Other key players are American Bank of Albania (owned by US investors), Tirana Bank (owned by Greece’s Piraeus Bank) and ProCredit Bank Albania (partly owned by KfW and the IFC). In December 2005 the government also sold its stake in the much smaller Italian-Albanian Bank to Sanpaolo IMI of Italy. The planned disposal of a 40 percent stake in United Bank of Albania would complete the transfer of banking assets to the private sector. A source of concern remains the dominant position of Savings Bank. It is hoped that the competition of smaller banks for market share will gradually lead to a more balanced situation.

- With banking assets equivalent to only 60 percent of GDP at the end of 2005, the Albanian market remains at an early stage of its development. After the lending ban on Savings Bank was lifted in the course of its privatization, the country has experienced a credit boom. The stock of loans to the private sector increased by 74 percent in 2005. This growth however, has been from a very low base: In late 2005, the stock of outstanding loans to the private sector was still a mere 10 percent of GDP. Credit is constrained by difficulties to assess credit-worthiness (a credit registry does not yet exist), the lack of collateral (especially land titles) and limited institutional capacity of banks.20 Deposits are equivalent to 47 percent of GDP, but the majority of savings is still channeled into treasury bills. The spectrum of financial services is only broadening slowly. Even debit and credit cards, ATM machines and household loans are still relatively uncommon, not to mention mortgages or leasing. The ambitious expansion of foreign-owned banking operations, however, is expected to accelerate sector development.

- Insurance: Albania has ten insurance companies, three of which provide life insurance. With a total premium income of less than one percent of GDP the sector is even less developed than in neighboring countries. Growth has been volatile in recent years and amounted to about 6 percent in 2006. Mandatory vehicle insurance accounts for two thirds of the market and other types of insurance are still rare. Due to weak supervision, the sector’s record on claim payouts and compliance with reserve requirements remains patchy. This is also distorting competition. The


20 A collateral registry has been established and seems to be functioning relatively well.
state-owned insurance company INSIG enjoyed a monopoly until the late 1990s, but competition has reduced its market share to 20 percent. It is currently the number three in the market, after market leaders SIGAL and SIGMA. In 2003, the IFC and EBRD each acquired stakes of 19.5 percent in INSIG and have since helped restructure the company. In May 2006, the government launched the privatization of its majority stake and hopes to sell to a foreign strategic investor in the course of 2007. INSIG is also active in neighboring Macedonia and Kosovo.

- **Capital markets**: Albania’s capital markets remain embryonic. The Tirana Stock Exchange was established in 1997, but no companies have yet been listed. In contrast to some neighboring countries, privatization was carried out purely via vouchers and sales to strategic investors, with no direct floats on the stock exchange. A natural first step would be the establishment of a secondary market for government bonds (and at a later stage for corporate bonds). However, the high ownership concentration of government bonds, which are mainly held by the Savings Bank, is an impediment. Since 2005, Albania has two private pension funds, but as the pension system lacks a compulsory private pillar, this segment of the capital market is also slow to evolve.

- **Supervision**: The Bank of Albania (BoA) used to be the book-keeper for the central plan but is now in charge of monetary policy and banking supervision. A new banking sector law was approved in 2006. According to the 2005 FSAP report of the WB and IMF, a basic regulatory framework is in place but supervisory authorities should be strengthened. Albanian banks currently have a capital adequacy ratio of 19 percent (compared to a 12 percent legal requirement) and bad loans have been reduced to 3 percent of the total. One problem remains the large exposure to currency risk, with 77 percent of loans denominated in foreign currency.\(^{21}\) Institutional capacity of the Insurance Supervisory Authority, established in 2004, is very limited and the IMF has recommended a merger of all non-banking financial sector regulators.

- **Donor assistance**: The World Bank has provided assisted for bank privatization, regulatory reform and a development of bankruptcy and collateral regimes through its Financial Sector Adjustment Credit and the Financial Sector Institution Building loans. It plans further support to financial sector reform through its Business Environment Enhancement and Institutional Reform Project, focusing on regulatory capacity building for banking and insurance, a further strengthening of the collateral regime (including establishment of a cadastre) and the introduction of EU-compatible accounting and auditing standards. A World Bank/IMF FSAP report, published in August 2005, reviewed the regulatory framework. The IFC plans to help banks to introduce new products such as leasing, housing finance, SME financing and micro-credit. Together with EBRD it has taken an equity stake in Albania’s leading insurance company and helps to prepare it for privatization. Strengthening banking and insurance regulation is listed as a short-term priority in the European Partnership, but the Commission does not provide direct technical assistance to the sector.

- **Outstanding reforms**: Short to medium-term priorities include a privatization of the remaining state-owned bank and insurance companies, regulatory measures to reduce foreign currency exposure of banks, efforts to reduce the role of cash in the economy, a completion of the regulatory framework for the insurance and capital markets, a merger of non-bank financial regulators, regulatory capacity building for the central bank and the non-banking financial regulator, the fight against money laundering and a decision on whether to close or further develop the stock exchange. Longer term priorities include measures to reduce market concentration in banking and insurance, the development of a functioning market for government securities, a completion of land registration, measures to strengthen capital markets (e.g. through pension reforms and privatization) and initiatives to increase availability of finance to private companies.

---

\(^{21}\) This is due to low the confidence in lek-denominated instruments, existing interest rate differentials and the importance of remittances as a source of deposits.
**Bosnia and Herzegovina:** The banking sector has been largely restructured and privatization is well advanced, but capital markets remain underdeveloped and the fragmentation of financial markets between the two entities is a major problem.  

- Following independence and civil war, BiH was left with a fragmented and largely state-owned banking sector plagued by non-performing loans, frozen foreign exchange deposits and low client confidence. After the Dayton agreement, two largely independent financial markets emerged in the entities Republika Srpska (RS) and the Federation. In financial markets – where market size is critical for liquidity, depth and product diversity – the sub-division of an already small market imposes significant economic costs. In recent years, BiH’s banking sector was thoroughly restructured, privatized and recapitalized. It is now one of the most developed sectors of the economy. The rate of financial intermediation has increased from 44 percent of GDP in 2000 to 75 percent in 2005. As in the rest of the region, however, capital markets remain underdeveloped.

- Following mergers and the liquidation of insolvent banks, the number of licensed banks was reduced by half from 76 in 1997 to 33 in 2005. The top-five account for 60 percent of all banking assets. The privatization process in the Federation has been completed but a number of smaller banks in RS remain government-owned. A large share of all FDI-inflows into the country went into banking. In the Federation, the market leader with 26 percent of total assets is Raiffeisen Banka, followed by Unicredito’s Zagrebacka Banka BiH (17 percent) and Hypo Alpe-Adria Bank (14 percent). Bank Austria owns HVB Central Profit Banka, BiH’s number four with 37 branches and 160,000 clients. In February 2006, Banca Intesa completed the takeover of the fifth largest bank UPI Banka. Most banks in RS are relatively small. The market leader, with 34 percent of all assets, is Hypo Alpe-Adria Bank. Policy priorities in the banking sector are the completion of privatization and a full integration of regulatory frameworks between both entities.

- The entry of foreign banks in conjunction with a more stable political environment and the introduction of the euro (which brought former cash-holdings into the banking system) led to an expansion of financial intermediation. Private sector deposits have grown from 16 percent of GDP in 2000 to 35 percent in 2004. In the same period, loans to the private sector increased from 31 to 45 percent. The entire increase, however, went to households, as consumer credit grew rapidly from a low base. In the meanwhile, corporate loans stagnated at around 25 percent of GDP, reflecting a period of painful restructuring in the enterprise sector and difficulties by banks to assess credit risk. As in other countries of the region, the central bank put a lid on credit expansion by tightening reserve requirements and rules for foreign currency exposure. In fact, the share of foreign currency denominated loans and deposits has gradually decreased in recent years to 15 and 48 percent respectively (i.e. a mismatch between the two remains).

- **Insurance:** Bosnia’s insurance sector is poorly developed. According to a review commissioned by USAID in late 2003, the fragmentation of the regulatory framework between the two entities is a major handicap. Institutional capacity of the regulators and private insurance companies is very weak. A transfer of responsibility for insurance supervision to the central bank (as in Serbia) might be an option. Sector legislation has improved thanks to EU assistance, but there is a lack of enforcement. Available data show a premium income of 2.7 percent of GDP, almost two thirds of which is accounted for by compulsory vehicle insurance. At the end of 2003, there were 18 insurance companies in the Federation and 9 in the RS. Most are privately owned, but foreign

---

participation remains limited. The privatization of the country’s largest insurance company, Sarajevo Osiguranje, to Croatia Osiguranje is pending as long as the latter itself remains state-owned.

- **Capital markets**: The administrations of both entities have established separate capital market frameworks. Separate stock exchanges in Sarajevo and Banja Luka became operational in 2002. With a total market capitalization of € 10 billion and an annual turnover of € 1 billion between them, the two bourses are too small to be viable on their own. BiH also lacks a liquid government bond market, which currently induces banks to channel liquidity into foreign assets. As part of the voucher privatization program, investment funds were established but it is not quite clear how much they have contributed to capital market development. Given this state of affairs, the establishment of a common stock exchange with a national regulatory framework and the development of a functioning market for government securities would be a prerequisite for the development of more sophisticated capital markets in Bosnia and Herzegovina.

- **Supervision**: Bosnia’s system of banking regulation has two layers: entity-level banking agencies were established in 1997, while the Central Bank of BiH (CBBH) took on an oversight function in 2004 to harmonize and streamline regulations bank supervision. The creation of a fully integrated regulatory framework is an important priority. A Deposit Insurance Agency was established in 2002 and is funded by insurance premiums of the 21 member banks. So far, however, BiH does not yet have a credit agency or fully-fledged credit registry. The capital adequacy ratio of BiH banks stands at 18 percent, compared to a 12 percent legal requirement. This reflects the difficulties of banks to identify good risks in a country with a poorly developed private sector. As one of the few countries of the region, BiH still has a fair amount of related-party lending, especially in RS. Money laundering remains a serious issue and is a key concern for the European Commission. The government seeks to address this problem through an action plan against money laundering.

- **Donor assistance**: The World Bank, the IMF and USAID helped to clean up the banking system in the wake of the civil war, to strengthen the regulatory framework for banking supervision and to privatize banks. The World Bank and the IMF prepared a Financial Sector Assessment Program (FSAP) report on Bosnia in early 2006. The IFC has channeled housing and SME credit lines through private banks and assisted Bank Austria to take over Central Profit Bank (it still holds a stake in the merged bank). The EBRD helped establish Micro Enterprise Bank Sarajevo (together with the IFC), invested in UPI Banka and has extended a number of SME credit lines to private banks. The World Bank’s planned assistance to improving the business environment and accelerating privatization should help develop a credit-worthy private sector (a main constraint for expanded lending). The EC provides assistance for SME support, micro and rural credit.

- **Outstanding reforms**: The overriding reform priority should be the establishment of fully integrated financial markets between the two entities, with a common regulatory framework, joint regulatory agencies and a single stock exchange. Foreign financial institutions, such as Hypo Alpe-Adria Bank, have already started to establish country-wide operations that span both entities, but seamless integration will require a removal of regulatory barriers. Other short to medium term priorities include the completion of bank privatization in RS, the establishment of a fully-fledged credit registry, measures that facilitate corporate lending, regulations to reduce the currency exposure of deposits, the establishment of a functioning secondary market for government securities and tangible progress in the fight against money laundering. Other reforms that would contribute to financial sector development include pension reform and privatization.
**Croatia:** The largest and most developed financial market of the region is gearing up for acquis compliance and for full integration into the European Single Market.²³

- Croatia is the most advanced economy of the Western Balkans (with the exception of Slovenia) and also has the most developed financial sector. In 2005, the country had 1.100 bank branches and total banking assets equivalent to 110 percent of GDP – about twice the rate of most other countries in the region. The five largest banks account for three quarters of all assets. While the number of banks decreased from 60 in 1998 to 34 in 2005, a strengthening of some second tier banks slightly eroded the market share of the top-five. After the 1998 banking crisis and years of restructuring, the sector is now growing rapidly. Between 2000 and 2005, loans to the private sector increased from 36 to 65 percent of GDP while deposits more than doubled. Growth in consumer credit considerably outpaced growth in corporate lending, which stood at 26 percent of GDP in 2004. In fact, consumer credit expanded so rapidly, that the central bank had to introduce some regulatory restrictions to dampen growth. Interest rates spreads remain relatively high but are on a downward path. A range of new services are being introduced (e.g. mortgages, leasing) and there are now more charge cards than Croatian citizens.

- Foreign banks hold 94 percent of all banking assets in Croatia. The market leader Zagrebacka Banka, majority-owned by Unicredito, has total assets of € 9 billion, 1.200 million customers and 24 percent market share. The number two in the market, Privredna Banka Zagreb (PBZ), is a subsidiary of Banka Intesa. Erste Bank Croatia is the number three with ten percent market share and plans for further expansion.²⁴ Other big EU players are the subsidiaries of Austria’s Raiffeisen International (number 4) and Hypo Alpe-Adria Bank (numbers 6 and 9). Bank Austria owns Croatia’s fifth largest bank, HVB Splitska Banka. After Unicredito took over Bank Austria, however, the central bank obliged the new group to sell one of its Croatian subsidiaries to prevent emergence of a dominant position. Unicredito thus sold the smaller Splitska Banka to Société Générale. Only two small banks with a total market share of 3 percent remain state-owned.

- **Insurance:** The insurance sub-sector accounts for 6 percent of total financial assets, the highest in the region. With premium income equivalent to 3.2 percent of GDP, the Croatian insurance market is at a level of development similar to that in the new EU member states. The sector recorded average growth rates of 10 percent in recent years. Half of the 25 companies are majority foreign-owned and they account for a third of premium income. With 10 of the insurance firms having less than one percent market share, further consolidation can be expected. The market leader Croatia Osiguranje (38 percent market share) is state-owned but slated for privatization in 2006. It is followed by Euroherc Osiguranje (12 percent market share) and Allianz Osiguranje (10 percent market share). After a merger of two of its three Croatian subsidiaries, Austria’s Wiener Staedtische is the fifth largest player (6 percent market share). A life-insurance share in premium income of 24 percent is testimony to the relative maturity of Croatia’s insurance sector. Increasingly, specialized insurance companies are entering the market. In 2005, for instance, German’s Signal Iduna bought health insurance provider Addenda and Austria’s Sparkassen Versicherung set up a life insurance subsidiary that will operate through Erste Bank branches.

- **Capital markets** in Croatia are much more developed than in the other countries of the Western Balkans. Zagreb Stock Exchange accounts for almost half the stock market capitalization in the region and the number of listed companies increased from 66 in 2002 to 182 in 2006, partly due to the 2002 Securities Market Act that requires companies above certain capital and shareholder-

---
A new pension system with compulsory and voluntary private pillars was introduced in 2002. Two years later, pension funds already managed half a billion euro of investments for a total of 1.1 million policy holders. This contributes to the development of capital markets, whose share in total financial assets increased to 21 percent in 2005. A shift of government borrowing from foreign to domestic sources has given a boost to bond markets. Another category of institutional investors emerged from the voucher privatization in the late 1990s, when most vouchers were entrusted to privatization investment funds.

- **Supervision:** The Croatian National Bank (HNB) oversees the banking sector and its supervision department has 75 staff. Enforcement capacity seems to be adequate for the current state of development, but institutional strengthening will be needed as the market matures. The capital adequacy ratio of Croatian banks stands at 15 percent, compared to the 10 percent required by national law. HNB has introduced measures to limit the foreign exchange exposure of banks. A deposit insurance scheme (established 1997) and a credit register (launched in 2006) enhance the stability of the banking system. The latter started with credit records of natural persons and will eventually be expanded to legal entities. The government merged three small regulators for the insurance, securities and pension fund sub-markets into a new Financial Services Authority (FSA), which started operations in early 2006. The regulatory framework for the banking sector is quite advanced, but further legislative and institutional reforms will be needed for full compliance with the EU acquis, especially in insurance and capital markets.

- **Capital movements:** Croatia largely liberalized its capital account in early 2005 and the CNB keeps the kuna-euro exchange rate within a narrow band. The high degree of euroization in the financial sector makes it more difficult for the central bank to adjust the exchange rate, if needed. As an accession candidate, Croatia has to remove a number of barriers to the free movement of capital, such as remaining restrictions on short-term capital movements, domestic investment requirements for some institutional investors and constraints to the acquisition of real estate by EU citizens. Moreover, it has to comply with EU standards on payment systems, strengthen capacity to fight money laundering and gradually transpose the full financial acquis.

- **Donor assistance:** The EBRD has played a central role in developing Croatia’s financial markets. It helped to privatize banks and invested in a new insurance company as well as a new pension fund. It has extended more than half a dozen credit facilities to private banks for loans to SMEs, tourism investments, small municipalities and housing finance. The IMF and the World Bank provided financial sector assistance in the earlier stages of the reform process and jointly carried out an FSAP assessment in 2002. The IFC has assistance in the privatization of Bjelovarska Banka (now merged with Erste Bank), is providing credit lines for housing and SME finance through a local bank and contributes to a venture capital fund. Future assistance in developing the government security and capital markets as well as in SME finance are being considered.

- **Outstanding reforms:** A key challenge will be to make the new Financial Services Authority fully operational and to develop its independence, credibility and enforcement track-record. Other priorities will be the completion of bank and insurance privatization, measures to encourage the expansion of corporate lending, full compliance with EU rules on banking and insurance, a harmonization of payment systems with EU standards, progress in the fight against money laundering and a removal of remaining restrictions to cross-border capital movements. Within the next five years, full compliance with the financial sector acquis and integration of Croatia in the EU single market for financial services seems feasible.

---

25 70 percent of funds were held by just two funds, AZ and Raiffeisen.
26 Its intervention in currency markets is partly geared at smoothing seasonal currency fluctuations, resulting from high foreign currency inflows through tourism during the summer months.
FYR Macedonia: While the regulatory framework is well developed, advances in foreign ownership and sector consolidation will be needed for the banking sector to mature. Efforts to develop capital markets are progressing, but the insurance sector remains weak. 27

- The break-up of the Yugoslavian banking system left Macedonia with large frozen foreign currency deposits and a share of bad debt amounting to 85 percent of the loan portfolio. A series of political and economic shocks further destabilized the sector, such as the trade embargo by Greece, an inflow of refugees from Kosovo and internal civil strife. In response, the government comprehensively restructured the banking sector with the help of the IMF and the World Bank. By 1999, the cumulated costs of those measures amounted to 46 percent of one year’s GDP. Since then, however, the sector has been on the up. Non-performing loans has been reduced to 11 percent. The introduction of euro coins and notes brought an estimated € 300 million of deposits into the banking system. Privatization has been completed and foreign participation increased notably. Frozen foreign currency deposits are gradually being redeemed though privatization vouchers and government bonds. 28 Nonetheless, financial intermediation (i.e. banking assets as a share of GDP) is still relatively low at around 50 percent and some structural weaknesses persist.

- At the end of 2005, FYR Macedonia had 20 licensed banks. This was down from 24 a few years earlier, but with total assets of less than € 3 billion, the market can is still overbanked. At the same time, it is highly concentrated, with the three largest banks Stopanska Banka, Komercijalna Banka and Tutunska Banka accounting for two thirds of the market. Most remaining banks are very small and consolidation between them should be encouraged. With 51 percent foreign ownership, the role of EU banks is less pronounced than in the rest of the region. This is partly a legacy of insider privatizations. Seven banks are majority foreign owned. For example, Stopanska Banka is a subsidiary of the National Bank of Greece and Tutunska Banka of Slovenia’s Nova Ljubljanska Banka. The largest bank of the country, Komercijalna Banka, has dispersed private ownership and could be a takeover target for foreign banks that want to enter the market. In May 2006, the government sold its minority stakes in four banks on the Macedonian stock exchange. State-ownership in the banking sector is now down to 2 percent of total assets and the Macedonian Bank for Development and Promotion (MBDP) is the last publicly-owned bank.

- The share of deposits to GDP has tripled since 1997, but at 34 percent it remains rather low. Over 90 percent of deposits with a short-term maturity indicate low levels of confidence in the banking sector. The ratio of private sector loans to GDP is only 25 percent and a high capital adequacy ratio of 21 percent is a sign of excess liquidity. 29 Even though retail lending increased by two-thirds in 2004 alone, it stands at below 10 percent of GDP. At 11 percent the share of bad loans is still relatively high and according to the IMF might pose a risk to the financial system. With 54 percent of deposits and 40 percent of loans either denominated or indexed in foreign exchange, the currency exposure of the sector remains high. Another deficiency of the banking system is the limited geographical coverage of services, with only four banks operating outside the capital Skopje. In summary, banking in FYR Macedonia displays a lower degree of development than most other countries in the region. An increased share of foreign ownership and further market consolidation could help the sector mature.


28 In 2000 frozen forex accounts of 200.000 savers amounted to a sum of € 600 million. The government intends to resolve the issue by 2010.

29 This is almost triple the 8 percent legal requirement. The low level of lending is the result of banks’ weak capacity for risk assessment, an unfavorable maturity profile of deposits and a weak corporate sector (as potential clients).
• **Insurance:** Macedonia’s small insurance market is highly concentrated, with the largest of the ten insurance companies controlling 90 percent of the market. The sector saw virtually no growth in 2006 and the range of products on offer is rather limited. There is only one reinsurance company and one company offering life-insurance. The regulatory framework for the insurance sub-sector is poorly developed and will require considerable strengthening prior to EU accession.

• **Capital markets:** The Macedonian Stock Exchange (MSE) was established in 1994 and currently has 14 members (eight brokerages and six banks). Its turnover of € 632 million in 2006 was barely more than a third of the already small Ljubljana Stock Exchange. Market turnover is about equally divided between government bonds and stocks. For shares, the exchange operates an official market with strict reporting and disclosure requirements as well as an ‘unofficial’ market for smaller shares with a lower degree of scrutiny. Regulatory changes requiring all companies meeting the listing requirements to actually list on the MSE significantly increased the number of traded companies. The Ministry of Finance and the central bank have elaborated a strategy for the development of the government securities market, which previously did not exist. The ongoing pension reforms, with a newly established private pillar and two private pension funds, are also expected to contribute to the development of Macedonia’s capital markets.

• **Supervision:** A series of legislative amendments since 2000 has largely aligned bank supervision with EU and international (Basle) requirements. As in other countries of the Western Balkans, the central bank (National Bank of the Republic of Macedonia, NBRM) is in charge of bank supervision. A Deposit Insurance Fund was established in 1997 and the creation of a credit register for both natural persons and legal entities is being prepared. A National Strategy against Money Laundering has been adopted and stricter rules on money laundering were approved in mid-2004. The exchange rate of the Macedonian denar is pegged against the euro. Capital markets are being supervised by the Securities and Exchange Commission and a new Pension Supervision Agency has been established. A regulator for the insurance sub-sector still needs to be established and in fact, this is identified as a priority measure in the European Partnership.

• **Donor assistance:** The World Bank has provided comprehensive help to sector restructuring through its Financial and Enterprise Adjustment Loan II (FESAL II), which is dovetailed by a Financial Sector Development Project. Assistance has been and will be provided to bank privatization and restructuring, regulatory reforms, institutional capacity building for supervisory authorities and the roll-out of new financial services. The IFC helped to privatize Stopanska Banka, holds an equity stake in the microfinance institution ProCredit Bank and wants to help develop leasing, insurance and capital markets. The EBRD also plays a key role in financial sector restructuring. It still holds stakes in Komercijalna Banka (6 percent), Stopanska Banka (10 percent) and the eighth largest bank Izoyna i Kreditna Banka (32 percent). It has also extended a number of SME credit lines to local banks. The IMF and the WB jointly published an FSAP report for FYR Macedonia in late 2003. An EC-funded project helped establish an independent Banking Association to foster market development.

• **Outstanding reforms:** Short and medium term priorities in FYR Macedonia include: a further reduction of non-performing loans, the establishment of the credit register and regulatory structures for non-banking financial services as well as tangible progress on implementing the national strategy against money laundering. The EBRD and the IFC, which still hold stakes in half a dozen banks, could help to accelerate banking sector consolidation and increase the relatively low level of foreign ownership. This, together with ongoing donor activity, should help to redress a number of structural problems in the sector, including low levels of confidence, a large stock of bad loans, low levels of lending and the unfavorable maturity profile of deposits.
Montenegro: The newly independent country has a tiny financial sector that is in the midst of a restructuring process and stands to benefit from regional integration.30

- With 10 banks and total assets of half a billion euros, the sector is extremely small. Financial intermediation is growing rapidly, but still stands at only 42 percent of GDP. In late 2006, Hungary’s OTP bought Crnogorska Komercijalna Banka (CKB) for €105 million from a consortium of non-banking institutions. With 150,000 customers, 30 branches and a 44 percent market share, CKB is the market leader in Montenegro. In April 2005, the government sold a 10 percent stake of Podgoricka Bank to the IFC and subsequently a majority share to Société Générale. Nickscika Banka also remains to be privatized.

- Montenegro’s banking sector needs both domestic consolidation and regional integration to gain critical mass and foreign banks are driving that process. Slovenia’s Nova Ljubljanska Banka bought Montenegrobank in 2003 (the number two) and Euromarket Banka in early 2005 (the number four). Around the same time, it also acquired Serbia’s Continental Banka. Montenegro’s three largest banks now account for two thirds of the market. Both Société Générale and OTP also have subsidiaries in neighboring Serbia and are likely to exploit scale economies between their operations in the two neighboring countries.

- Montenegro has unilaterally adopted the euro as its official currency. The Central Bank of Montenegro is in charge of bank supervision and the government seeks to strengthen its capacity. A credit register became operational in early 2005. A specific problem of Montenegro’s financial sector has been a large number of offshore banks that were characterized by low levels of transparency. As part of its fight against money laundering, however, the government has revoked all offshore licenses.

- A new law on insurance was adopted in 2006, but the Agency for Insurance Surveillance still needs to be established. The largest insurer Lovcen Osiguranje, majority owned by Slovenia’s market leader Zavarovalnica Triglav, has more than 70 percent market share. Perhaps somewhat surprisingly for a country its size, Montenegro has two stock exchanges (Montenegroberya und NEX). The volume of trade on these exchanges has increased recently but in terms of absolute numbers it remains very small, while active trading is confined to a handful of companies.

Serbia (incl. Kosovo under UNSCR 1244): Banking reforms lagged behind those of neighboring countries but are now progressing rapidly thanks to strict regulations, privatization and foreign entry.31

- Like other countries in the region, Serbia had its share of economic shocks that severely damaged the financial sector. These included the break-up of Yugoslavia, hyperinflation and a UN embargo in the early 1990s as well as the Kosovo war and NATO air strikes in 1999. A legacy of related-party lending, political interference in banking operations, lax supervision, bad debt and frozen foreign currency deposits had to be addressed. The government launched the painful restructuring process in 2000 with an overhaul of the regulatory framework and measures for balance sheet restructuring. The authorities closed two dozen insolvent banks (accounting for half the market) and recapitalized sixteen banks through debt-equity swaps that considerably increased the share

---


of public ownership in the sector. The number of banks was reduced from 87 (2001) to 38 (2006). Bank privatization was largely completed in 2006, but the overall transformation of Serbia’s financial markets still lags that of most neighboring countries by two to three years.

- The market leader with 14 percent of total assets is Raiffeisen Bank. In mid 2005, Italy’s Intesa bought the number two, Delta Banka from its private owners. EU banks also control the numbers three (Hypo Alpe-Austria Bank), five (Bank Austria), six (Société Générale) and eight (Greece’s Alpha Bank). In September 2006, the government sold Vojvodjanska Banka, the number seven and its last major stake in the sector, to National Bank of Greece for € 360 million. While this was the last major privatization in the sector, it also sold 25 percent stakes in Komercijalna Bank and Cacanska Banka to the EBRD, which will help restructure these smaller banks in view of eventual privatization. Two thirds of Serbia’s banks are now foreign-owned and other EU players in the country include Greece’s Piraeus Bank, Austria’s Erste Bank and France’s Crédit Agricole.

- In the course of the privatization process, the share of foreign ownership has increased to around 80 percent, a level comparable to that in neighboring countries. The five largest banks hold about half of total assets, a degree of concentration that should permit for healthy competition. With more than a dozen banks having a market share of less than one percent, however, further consolidation would be desirable among smaller banks. In fact, stringent capital requirements, restrictive licensing for new banks and the acquisitions of foreign players are the most likely drivers of further consolidation. In 2005, for instance, Bank Austria’s acquired Eksimbanka and merged it with its existing subsidiary HVB Bank Serbia and Montenegro.

- With total assets of € 6.5 billion and 43 percent of GDP, the size of Serbia’s banking sector is less than a quarter of Croatia’s (which has half the population). The large stock of non-performing loans (23 percent of the total) and the large interest rate spread (10 percent) illustrate that sector restructuring still has some way to go. Deposits have increased from 15 to 23 percent of GDP between 2002 and 2005, but their absolute level remains low, even by regional standards. It has been estimated that around $ 4 billion of foreign currency is still kept in cash-holdings. As confidence in the banking sector recovers, however, part of these funds are likely to be transformed into interest-earning deposits. At 22 percent, loans to the private sector also remain low, but the current credit boom (particularly to households) is starting to change this. As in neighboring countries, the central bank actually tightened regulatory requirements to slow the expansion and to reduce foreign currency exposure of loan and deposit portfolios.

- **Insurance:** Since the central bank took over insurance supervision from the Ministry of Finance in 2004, the sector has seen much greater scrutiny and significant restructuring. The number of insurance companies operating in Serbia fell from 36 in 2004 to 19 in 2006 due to a revocation of licenses and voluntary liquidation. Insurances accounts for 7 percent of all financial assets and the premium income was equivalent to 3 percent of GDP in 2006. Serbia’s association of insurance companies expects growth of at least 10 percent in the next few years. The two leading insurance companies, Dunav and DDOR, remain state-owned. The restructuring of Dunav is underway and a privatization tender for DDOR has been launched. This is an opportunity to attract further FDI into the sector. Austria’s Wiener Staedtische and Grawe already established greenfield operations a number of years ago, Generali Holding Vienna took over privately owned Delta (the number three in the market) in early 2006 and Austria’s Unia bought Zepter Osiguranje (the number five) around the same time. Zavarovalnica Triglav, Slovenia’s largest insurance, is also looking for takeover targets in Serbia and aims at 10 percent market share.

- **Capital markets:** With a market capitalization of € 8.7 and a turnover of € 2.5 billion in 2006, the Belgrade stock exchange remains small, but is growing substantially. Only about a dozen leading companies are actively traded. The market infrastructure and available instruments are at an early
stage of development. There are also deficiencies in the regulatory framework but reforms are currently underway. A new law on investment funds was adopted in May 2006, while the law on security markets and other financial instruments was modified. As part of the ongoing pension reforms, a law on voluntary pension funds was passed in late 2005. One way to foster capital market development would be through the floating of company shares as part of the ongoing privatization program. For instance, the government plans to sell Komercijalna Banka through a public offering on the stock exchange, as a means to strengthen capital markets.

- **Supervision:** The National Bank of Serbia (NBS) is in charge of supervising banks and since mid 2004 also of insurance companies. Capital markets are regulated by the Serbian Securities Commission (SCC). The regulatory framework was repeatedly strengthened and brought closer in line with EU standards. A deposit insurance scheme, funded by bank contributions, has been in place for over a decade and is currently being restructured. A Central Credit Registry has been established, but does not yet cover smaller loans. The high capital ratio of 28 percent at the end of 2004, compared to a legal requirement of 10 percent, reflects the successful re-capitalization of banks and the lagging build-up of credit portfolios. The IMF has recommended the adoption of a flexible exchange rate regime. However, the high degree of euroization will make this rather difficult – two thirds of deposits and a quarter of loans are denominated in foreign currency.

- **Donor assistance:** The World Bank, together with the IMF, has provided comprehensive support to sector restructuring through a series of three financial sector-related loans (PFSAC I, PFSAC II and PPFDDPC I). In September 2004, the World Bank published a Financial Sector Note for Serbia to identify priorities for future assistance and feed into the Country Assistance Strategy for 2005-7. In that context, the Bank also approved a pension reform project in mid 2005, which will contribute to the development of capital markets. The IFC helped establish a micro-credit bank, participated in the restructuring and privatization of Serbia’s largest bank and plans future assistance to the development of non-banking financial services (e.g. insurance, housing finance, leasing). The EBRD has contributed to the privatization process through equity participation in several banks, it has helped to establish micro-credit institutions in Serbia and Kosovo and it has extended SMEs and mortgages credit lines to commercial banks.

- **Outstanding reforms:** The short to medium term priorities in Serbia include the completion of the privatization process for banks and insurance companies, a further reduction of bad loans, implementation of the central bank’s Supervisory Development Plan and the establishment of a collateral registry to encourage corporate lending. Bank privatization and the entry of foreign banks should in turn trigger similar structural changes as in neighboring countries. Severed ties between state-owned banks and enterprises will eliminate directed lending, renewed confidence will bring savings back into the banking system and increase financial intermediation, while new management and greater competition should lead to credit growth and the introduction of new financial products. Longer term challenges include further pension reforms, the development of non-banking financial services and greater availability of finance for the private sector.

- **Kosovo:** The Banking and Payments Authority (BPA) established by UNMIK, acts as the central bank of the province and is in charge of financial market supervision. The regulatory framework is largely in line with international standards and Kosovo adopted the euro as legal tender in 2002. After BPA revoked the license of Credit Bank of Pristina in March 2006, six banks and eighteen microfinance institutions are active in the province. The market leaders are ProCredit Bank (43 percent of assets, owned by Commerzbank and several donors) and Raiffeisen Kosovo (19 percent of assets). The high degree of concentration restrains competition. More than half of all banking assets are foreign-owned. The number of branches and the degree of intermediation has increased considerably, with banking assets now equivalent to about 55 percent of GDP.