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From:	General Secretariat of the Council
To:	Delegations
Subject:	Report on Financial Stability Challenges in EU candidate and potential candidate countries

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In view of the ministerial dialogue lunch between the economic and finance ministers of the EU and the Candidate Countries of 6 May 2014, delegations will find attached

" Report on Financial Stability Challenges in EU candidate and potential candidate countries"

endorsed by the members of the EFC and representatives of the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey on 24 April 2014 as a background document.

ECB-RESTRICTED  
20 March 2014

*Report on financial stability challenges in EU  
candidate and potential candidate countries<sup>1</sup>*

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<sup>1</sup> This report has been prepared by a group of experts from central banks established under the auspices of the ESCB International Relations Committee, chaired by the ECB and comprising staff from both the European System of Central Banks (ESCB) and from EU candidate and potential candidate countries. The authors are grateful to staff at the Central Bank of Iceland, the National Bank of the Republic of Macedonia, the Central Bank of Montenegro, the National Bank of Serbia, the Central Bank of the Republic of Turkey, the Bank of Albania, the Central Bank of Bosnia and Herzegovina and the Central Bank of Kosovo for their forthcoming responses to several data and information requests that have been instrumental to the production of this report. The views expressed in this report are those of the expert group and do not necessarily reflect those of the central banks contributing to this report.

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**List of abbreviations**

*Countries*

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

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

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

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

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## Executive summary

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

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

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

to afford greater degrees of policy freedom to monetary authorities. As regards funding risk, the extent to which ‘forced’ deleveraging may materialise in the period ahead remains open. This could either imply outright divestments of locally systemic entities if these are sold or less supportive parent bank finance to domestic economies in the event that local resources are insufficient to meet credit demand once this picks up in a durable manner.

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

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

## 1. Introduction

In cooperation with financial stability experts from national central banks of the European System of Central Banks (ESCB) and under the auspices of the International Relations Committee, ECB staff has provided in recent years reports on financial stability challenges in countries preparing for membership of the European Union (EU). These reports, which have focused on countries with a 'candidate' status, have been produced with biennial frequency since 2003.

In light of the continued high interest in financial stability issues in countries with close real and financial links to both the euro area and the EU, an interim update (to the 2012 report) was prepared in 2013, with coverage extended for the first time to EU potential candidates. This wider coverage is kept in this report given the common features and challenges to financial stability across countries.

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

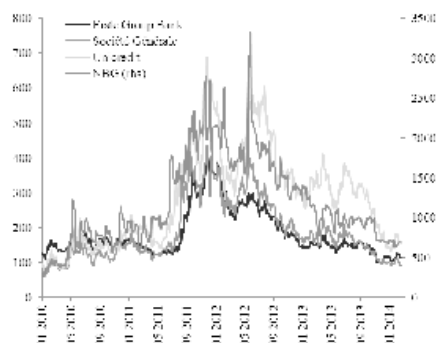


## 2. Key financial stability challenges in EU candidate and potential candidate countries

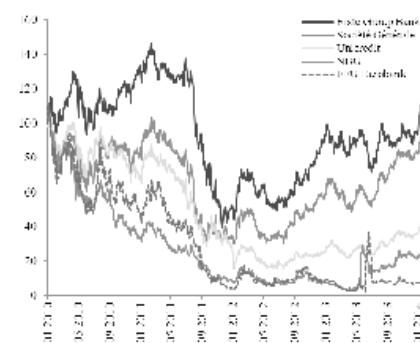
### 2.1 Funding conditions for parent banks have eased in recent months

Funding conditions for parent entities whose subsidiaries have a strong presence in EU candidate and potential candidate countries have eased significantly in the review period.<sup>2</sup> The compression in five-year CDS spreads for key banking groups has been broad-based, with the relative decline for banking groups originating in (now less) financially stressed euro area countries being comparatively larger (see chart 2.1). Equity valuations for key cross-border banking groups have also trended up over recent months (see chart 2.2), consistent with both the reduction in financial tensions related to the euro area sovereign debt crisis in general and the improved outlook for the banking sector in particular, including as a result of plans to establish a ‘banking union’ in Europe (see also Chapter 4).

**Chart 2.1: CDS spreads of selected banks**  
(basis points)



**Chart 2.2: Equity prices of selected banks**  
(4 Jan 2010 = 100)



Sources: Bloomberg, Datastream and ECB staff calculations.

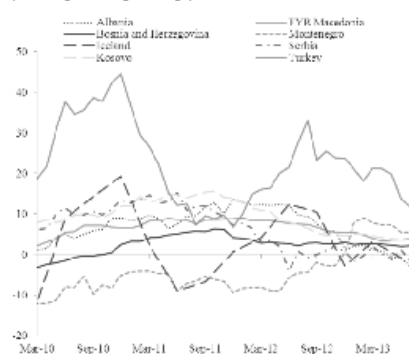
Overall, while bank funding costs still differ (at times significantly) depending on the nationality of the parent group and CDS spreads have not converged to pre-crisis levels in all cases, the closer clustering of bank spreads in recent months around the level which prevailed back in 2010 has been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

<sup>2</sup> The main data cut-off date for this report is 2013Q2, consistent with the data templates kindly submitted by participating central banks of EU candidate and potential candidate countries as input to this report. Market data are reported until end-January 2014. The data cut-off date for the 2013 interim update report on financial stability challenges in EU candidate and potential candidate countries was 2012Q3, again with the exception of high-frequency market data. Therefore, the main review period of this report is 2012Q3 to 2013Q2.

## 2.2 Credit dynamics in host banking systems have weakened further

The improvement in parent bank funding conditions contrasts sharply with developments in credit dynamics in host banking systems during the period under review, where a significant weakening in the pace of credit extension to the private sector has generally taken place. The downtrend has been particularly acute in Albania and Iceland, which together with Serbia have occasionally posted negative rates of credit growth to the private sector in nominal terms (on an fx-adjusted basis). In other EU candidate and potential candidate countries – such as the former Yugoslav Republic of Macedonia, Kosovo, and to a lesser extent Bosnia and Herzegovina – the slowdown in credit growth has been more moderate but is still noticeable (see chart 2.3). In Turkey, the pace of credit extension has lost some momentum but still remained vigorous overall. Montenegro is a partial exception to this broad trend insofar as the turnaround of credit dynamics over the equivalent period has been notable, but this is largely seen to reflect changes in accounting standards rather than actual developments on the ground.<sup>3</sup>

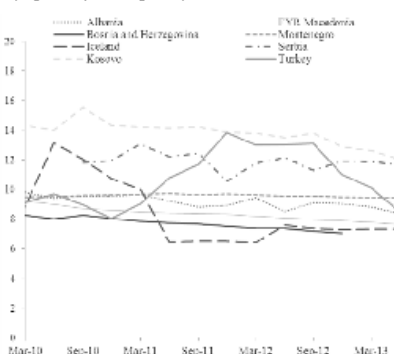
**Chart 2.3: Credit to the private sector**  
(annual percentage change)



Sources: National central banks and ECB staff calculations.

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

**Chart 2.4: Reference lending rates**  
(in percent, end of period)



Sources: National central banks and ECB staff calculations.

Notes: Reference lending rates refer to weighted averages of short- and long-term lending rates to households and non-financial corporations, in domestic and foreign currency.

The available evidence continues to point to a mix of demand and supply factors behind the generally weak pace of credit extension to the private sector in most EU candidate and

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

**potential candidate countries.** The findings of a special survey to help disentangle the driving forces in this regard across corporates and households in EU candidate and potential candidate countries as seen from the point of view of their central banks – which was undertaken for the purposes of this report – are presented in more detail in Chapter 3. Credit standards for corporates have been tightened to different degrees in most countries against generally weaker demand for loans. The patterns for credit demand by and lending standards applied to households in EU candidate and potential candidate countries are much more diverse in comparison, suggesting some discrepancy in households' willingness to take on new loans and banks' desire to fund these.

**Taken together, the trends emerging from the lending survey could help explain why reference lending interest rates applied by banks in EU candidate and potential candidate countries have remained broadly stable** with the exception of Turkey and to a lesser extent Kosovo (see chart 2.4). Reference lending rates have remained broadly stable in spite of a number of measures taken by monetary policy authorities in EU candidate and potential candidate countries to enhance credit extension by banks both through reductions in key policy rates and other measures designed to reduce the cost of bank funding (e.g. changes in reserve requirements or risk weights for certain loan categories).

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

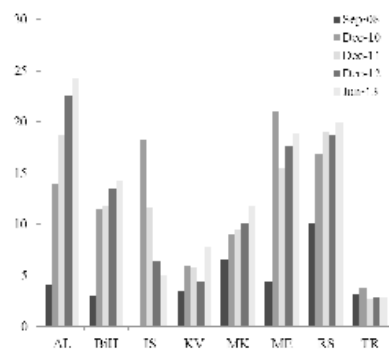
**The bank lending channel in most EU candidate and potential candidate countries continues to be impaired by lingering challenges to asset quality, reflected in a sizeable non-performing loan (NPL) burden.** NPL ratios remained broadly unchanged over the period under review in most countries, with the situation of banks in Albania, Montenegro and Serbia (where non-performing loans to total loans are at around 20% or above) still giving most cause for concern. Problems are concentrated in the corporate loan segment (see country annexes). Although the level of non-performing loans is lower in comparison, the recent increase of NPLs in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia should also be noted (see chart 2.5 and table 2.1).

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

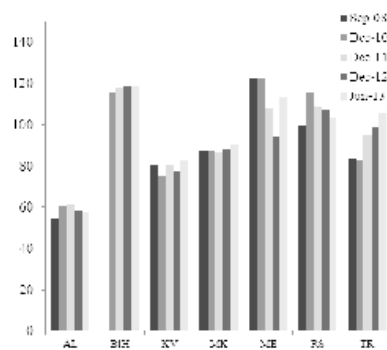
## 2.4 Bank capitalisation and liquidity remain at healthy levels

Banking systems in most EU candidate and potential candidate countries appear well-positioned to weather continued challenges as regards credit risk stemming from a high NPL burden amid weak credit dynamics on account of robust capital and liquidity buffers. The ratio of regulatory tier-1 capital to risk-weighted assets has remained broadly unchanged at double-digit levels in all banking systems during the period under review, with only Kosovo<sup>4</sup> and to a lesser extent Montenegro and Turkey experiencing a moderate decline. The rise in capital adequacy ratios in Serbia during the equivalent period has been notable.

**Chart 2.5: Non-performing loans to total loans**  
(in percent of total gross loans)



**Chart 2.6: Loan-to-deposit ratio**  
(in percent)



Sources: National central banks.

Notes: The loan-to-deposit-ratio for Bosnia and Herzegovina is calculated using total loans net of interbank loans and customer's deposit (excl. deposits from financial institutions). In Montenegro, due to the implementation of IAS 39 in 2013, the definition of loans has changed. Since data for loan-to-deposit ratios prior to 2013 have not been revised according to the new methodology, the ratio for 2013 is not comparable with data for previous periods. See individual country annexes (table 3) for country-specific definitions of non-performing loans. Iceland is excluded due to lack of data for the loan-to-deposit ratio.

Moreover, liquidity cushions available to banks (as proxied by both liquid assets to total assets or liquid assets to short-term liabilities) also appear comfortable, suggesting that banks should also be able to cope with unexpected challenges associated with potential fund withdrawals (see table 2.1). However, it should be noted that the NPLs net of provisions to capital remain very high in both Albania and Montenegro, and to a lesser extent also in Bosnia and Herzegovina, Serbia and the former Yugoslav Republic of Macedonia, (although *total* loan provisioning is very comfortable in the latter two cases). This suggests that the potential ability of banks in some of these countries to absorb losses would be limited in the event of further (unexpected) shocks.

<sup>4</sup> In Kosovo, the decline in capital adequacy ratios was largely attributable to regulatory changes in the classification of regulatory capital.

**Box 1: NPL resolution in Albania, Montenegro, Bosnia and Herzegovina and Serbia**

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

**Albania:**

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

**Montenegro:**

A technical assistance project with the World Bank ('Podgorica approach') was set-up in July 2012. The 'Podgorica approach' is based on the following principles/items: (i) mandatory cooperation and disclosure requirements; (ii) a mediation center which should enhance the resolution in case of a dispute and avoid court solutions; (iii) improved access to finance for borrowers; (iv) tax exemptions that are singularly available during the NPL restructuring process for creditors and debtors; (v) agreement on the restructuring plans by the debtor and the creditor; and (vi) 'safe-harbor provisions' to protect participants, respectively. The aim of this project is to: (i) adopt restructuring solutions to convert unsuccessful NPL workouts into restructured loans; (ii) stabilise distressed but viable companies and avoid unwarranted liquidation; (iii) promote renewed lending and access to credit to restricted companies; and (iv) stabilise the banking system (e.g. adequate capitalization, provisions, effective risk management) and mitigate losses (effective restructuring, swift maximal recovery). In order to achieve such goals, a screening of the status quo was done which set the following priorities for further action: protection of creditor rights, tax treatment, financial consumer protection, prudential regulation and supervision, and NPL management skills. The NPL resolution framework will start as soon as at least one bank wishes to participate. The legal framework is also scheduled to be improved as part of the implementation of this process over 2014, including a draft law on voluntary financial restructuring and amendments to the central banks' regulation of minimum conditions for the credit risk management (CRM Decision) to accommodate regulatory incentives for the banks. Guidelines underpinning strategies for banks' NPL reduction will also be prepared by domestic monetary authorities.

**Bosnia and Herzegovina:**

Authorities have conducted a review of the NPL resolution framework in the context of the IMF programme and identified a number of areas for future improvement in the overall legal and regulatory environment. These include (i) clarification of the

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

#### **Serbia:**

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

## **2.5 Deleveraging by parent banks appears to be moderating**

**Deleveraging by parent banks whose subsidiaries are systemically important for EU candidate and potential candidate countries appears to have moderated during the period under review, consistent with the relative easing of financial tensions for euro area-headquartered entities.** From a cross-border (locational) point of view, the change in external positions from BIS-reporting banks to some countries was 'net positive' over recent quarters (in the year to 2013Q3), for example in Montenegro and Albania (see chart 2.7). In other countries changes in external positions from BIS-reporting banks have been more erratic, but the recent trend suggests that net funding withdrawals were less significant relative to GDP than before. This is also the case when compared to the second half of 2011, a time when broad-based regulatory pressures to increase capitalisation in euro-area headquartered banks amid severe

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**Table 2.1: Key financial stability indicators in EU candidate and potential candidate countries**  
(in percent)

	Regulatory Tier-1 capital to RWA	Return on assets	Return on equity	Liquid assets to total assets	Liquid assets to short-term liabilities	Interest margin to gross income	Loan to deposit	NPL net of provisions to capital	NPL to total gross loans	... of which in FX	FX loans to total loans	Net open position in FX to capital
<b>Albania</b>												
2012 Q3	14.5	0.4	4.2	29.0	35.8	130.6	38.0	39.5	22.7	24.4	66.5	4.1
2012 Q4	14.6	0.3	3.8	29.4	36.7	130.4	38.3	55.6	22.5	24.7	64.5	4.0
2013 Q1	15.2	0.4	5.2	29.1	36.1	123.6	38.2	57.0	23.7	26.0	64.8	1.7
2013 Q2	15.4	0.3	2.9	27.4	33.8	131.2	37.5	56.4	24.2	26.5	64.5	4.0
<b>Bosnia and Herzegovina</b>												
2012 Q3	14.1	0.8	6.4	24.8	43.5	63.6	121.1	28.6	12.7	n.a.	63.7	6.4
2012 Q4	14.1	0.6	5.0	25.4	44.1	63.7	118.5	30.0	13.5	n.a.	63.1	5.4
2013 Q1	14.6	0.3	2.0	24.1	42.2	64.3	118.1	30.2	13.8	n.a.	63.2	6.5
2013 Q2	14.9	0.5	4.2	24.2	42.4	63.3	118.7	31.6	14.3	n.a.	63.7	11.1
<b>Iceland</b>												
2012 Q3	21.0	2.1	12.7	23.3	199.9	192.1	n.a.	3.4	7.9	n.a.	25.3	18.4
2012 Q4	22.3	2.3	13.7	23.4	180.1	128.1	n.a.	-2.8	6.4	n.a.	24.6	7.7
2013 Q1	22.9	2.0	11.5	23.3	192.4	488.1	n.a.	-2.6	5.8	n.a.	22.8	3.7
2013 Q2	23.3	2.3	13.0	22.9	178.0	164.2	n.a.	-7.5	5.1	n.a.	22.4	3.6
<b>Kosovo</b>												
2012 Q3	14.8	1.0	10.7	30.3	37.9	74.7	79.7	5.6	7.0	n.a.	0.4	3.1
2012 Q4	15.2	1.5	15.0	37.3	47.0	74.7	77.4	2.9	4.3	n.a.	0.4	12.4
2013 Q1	12.5	1.0	10.0	31.1	39.2	73.8	78.6	6.7	7.6	n.a.	0.4	0.3
2013 Q2	13.4	1.2	12.3	29.3	37.3	74.0	82.9	7.3	7.8	n.a.	0.4	0.3
<b>Former Yugoslav Republic of Macedonia</b>												
2012 Q3	14.4	0.3	2.3	30.2	49.3	64.3	89.4	12.9	10.6	10.2	53.0	12.3
2012 Q4	14.5	0.4	3.8	32.4	53.0	60.7	88.1	10.7	10.1	9.7	52.4	11.4
2013 Q1	14.7	-0.1	-0.4	33.1	54.9	62.5	87.5	14.1	11.4	10.8	51.9	7.3
2013 Q2	14.7	0.2	1.8	32.0	54.6	62.9	90.3	15.4	11.8	11.4	51.7	12.1
<b>Montenegro</b>												
2012 Q3	14.7	-2.3	-21.7	25.2	41.8	69.7	94.5	82.2	18.5	n.a.	2.1	-0.6
2012 Q4	15.8	-2.0	-18.3	24.0	40.1	73.1	94.0	68.0	17.6	n.a.	1.9	-0.8
2013 Q1	13.2	1.4	10.0	12.5	20.2	69.5	114.8	75.7	19.4	0.5	4.0	-0.6
2013 Q2	13.8	1.3	9.2	14.5	23.5	71.0	113.4	72.7	18.8	0.8	3.8	0.4
<b>Serbia</b>												
2012 Q3	15.6	0.6	2.8	22.7	55.1	65.1	112.2	36.4	19.9	18.3	75.5	1.9
2012 Q4	19.0	0.4	2.0	23.9	57.2	65.6	107.3	31.0	18.6	17.9	74.1	2.7
2013 Q1	19.2	1.5	7.2	25.1	39.5	67.0	105.3	32.2	19.9	19.4	72.3	1.9
2013 Q2	19.1	1.1	5.3	24.0	38.0	66.8	103.6	33.4	19.9	19.4	72.8	1.1
<b>Turkey</b>												
2012 Q3	14.5	1.8	14.5	17.4	27.7	65.6	98.4	3.7	3.0	n.a.	25.3	1.7
2012 Q4	15.1	1.8	14.5	17.5	28.2	64.4	99.0	3.5	2.9	n.a.	24.9	1.6
2013 Q1	14.7	1.8	14.3	16.0	26.3	63.4	101.6	3.7	3.0	n.a.	24.7	2.3
2013 Q2	14.0	1.9	14.3	13.9	22.8	60.4	105.7	3.9	2.8	n.a.	25.7	-0.7

Sources: National central banks.

Notes: The ratio NPL in FX for Albania refers to NPL in foreign currency to total loans in foreign currency. Loan to deposit in the case of Bosnia and Herzegovina is calculated using total loans net of interbank loans and customer's deposit (excluding deposits from financial institutions).

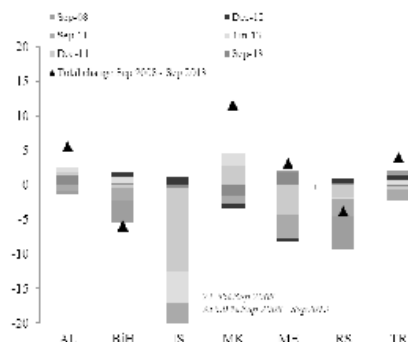
As of 1 January 2013, funds and deposits with banks in Montenegro are part of loans and other receivables, which influences the decline in the liquid assets to total assets ratio and the increase in the loan-to-deposit ratio. In addition, the methodological changes in January 2013 also had an impact on the rise in NPLs since loans and receivables classified under category E (written off) have been transferred from off-balance sheet records into the balance sheet.

NPL net of provisions to capital in Serbia are based on IFRS provisions only. NPLs net of total provisions (statutory and IFRS provisions) to capital however are 0%, i.e. NPLs are fully provisioned for according to national authorities.

For FYR Macedonia, NPLs net of provision to capital refer to NPLs (and corresponding provisions) to the nonfinancial sector, which includes domestic and foreign households, enterprises, non-profit institutions serving households, and government (state). It does not include any type of financial institution or company.

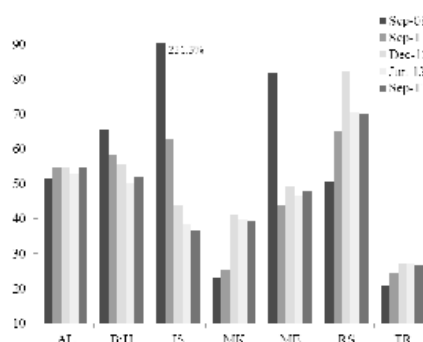
financial tensions in some euro area sovereigns were associated with a sharp increase in cross-border funding withdrawals by banks.<sup>5</sup>

**Chart 2.7: Change in cross-border positions by BIS-reporting banks**  
(in percent of full-year nominal GDP)



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

**Chart 2.8: Consolidated claims by BIS-reporting banks**  
(in percent of full-year nominal GDP)



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

However, it would be premature to ascertain the durability of this trend going forward. In the short-term, capitalisation pressures for some entities following the results of the ECB's comprehensive assessment/asset quality review cannot be ruled out. Nevertheless, this exercise is seen as a key contributor to restore confidence in the euro area banking system as a whole from a medium-term perspective, home to key cross-border banking groups with a strong presence in most EU candidate and potential candidate countries. More broadly, the heterogeneity in deleveraging trends across countries from a longer-term point of view (as well as their relative dependency on parent funding, if applicable) should also be kept in mind.

**From a consolidated point of view, the trend towards an increased reliance on domestic sources of funding, in particular through local deposits (see section 2.6 below), has been associated with a broad-based stabilisation of (parent) bank exposures to EU candidate and potential candidate countries.** Only Bosnia and Herzegovina and Iceland constitute exceptions to this trend, and exposures of BIS-reporting banks on other countries as a whole (relative to GDP) remained constant or increased over the equivalent period (see chart 2.8).

<sup>5</sup> Deleveraging trends are also monitored by the European bank co-ordination initiative (Vienna II initiative) in which the ECB also participates as an observer. The latest 'CESEE deleveraging and credit monitor' can be found here: [http://vienna-initiative.com/wp-content/uploads/2014/02/Deleveraging\\_Credit\\_Monitor\\_Feb\\_2014.pdf](http://vienna-initiative.com/wp-content/uploads/2014/02/Deleveraging_Credit_Monitor_Feb_2014.pdf).



Taken together, these trends imply that the discrepancy between cumulated changes in consolidated and cross-border (locational) BIS-reporting banking exposures to EU candidate and potential candidate countries in the Western Balkans has widened in the recent period, albeit ‘for the better’. Whereas consolidated exposures in 2013Q2 were 10 percentage points above those prevailing at the start of the crisis (as proxied by the Lehmann bankruptcy in 2008Q3), cross-border exposures over the same time frame are 5 percentage points below (see chart 2.9). The evolution of these variables provides indirect evidence of the degree to which banking systems in the respective countries have successfully bridged potential funding gaps in the aftermath of the crisis, since consolidated exposures include claims of local subsidiaries (in all currencies) to the real sector.<sup>6</sup>

## 2.6 The reorientation of funding towards domestic sources remains underway

**The shift towards a growing reliance on domestic funding sources for banks in EU candidate and potential candidate countries has been reinforced.** On an fx-adjusted basis, deposit growth has outpaced loan growth during the period under review in most EU candidate and potential candidate countries except Turkey and Iceland, at times by a significant margin (see chart 2.10). This development is significant insofar as it applied not only to countries where credit dynamics has been negative at times in nominal terms (such as Albania and Serbia), but also to those where the pace of credit extension has remained moderately positive and the reliance on local funding was already high (such as the former Yugoslav Republic of Macedonia). It also applied to those countries that have been traditionally more dependent on parent funding regardless of underlying credit trends (such as Serbia).<sup>7</sup> In contrast, Turkey stands out as a case where loan growth by far outpaced deposit growth over the period under review, which can be partly attributed to growing reliance on external (short-term) funding. Notwithstanding the robustness of the overall trend, the degree to which deposit growth may be partly a by-product of sluggish economic activity in some countries (e.g. precautionary motives by households, lack of investment opportunities by corporates) remains in doubt.

**Coupled with the moderation of parent bank deleveraging, increased reliance on local funding would suggest that near-term risks to the bank funding base have decreased, but cross-country evidence remains heterogeneous.** Loan-to-deposit ratios in those banking

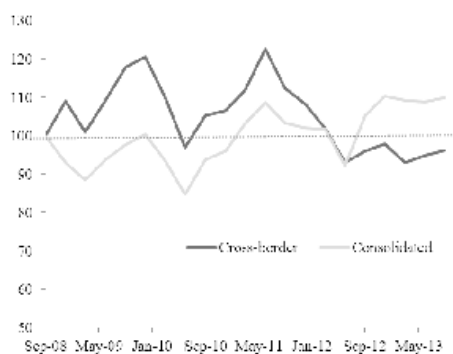
<sup>6</sup> The *BIS Consolidated Banking Statistics* capture the worldwide claims of banks headquartered in the BIS reporting countries, including claims of their foreign affiliates, but exclude positions between related offices. The Consolidated Foreign claims cover cross-border claims in all currencies of BIS reporting countries and local claims in foreign currency of their foreign affiliates, as well as the local claims in local currency of their foreign affiliates.

*BIS Locational Banking Statistics* provide information about the geographical composition of banks’ balance sheets since they provide the outstanding claims of banking offices located in BIS reporting countries (including positions between related offices).

<sup>7</sup> This was also the case in Montenegro although the influence of methodological (IAS) changes in loan data as of 2013 makes the interpretation of credit versus deposit growth trends difficult.

systems which already in the past were comparatively less reliant on parent funding – i.e. those of Albania, Kosovo, and the former Yugoslav Republic of Macedonia – have remained broadly stable during the period under review at levels ranging from about 60% to 90%. Serbia, Montenegro and Bosnia and Herzegovina continue to exhibit ratios of above 100%, although the respective underlying dynamics have been different (with loan-to-deposit ratios trending down in Serbia, remaining high in Bosnia and Herzegovina, and showing an erratic pattern in Montenegro, also due to methodological (IAS) changes in loan definitions as of 2013). The trend-up in loan to deposit ratios in Turkey – which exceeded 100% at the end of the period under review and has thus joined the group of EU candidate and potential countries deemed to be most vulnerable on this count – should also be noted (see chart 2.6).

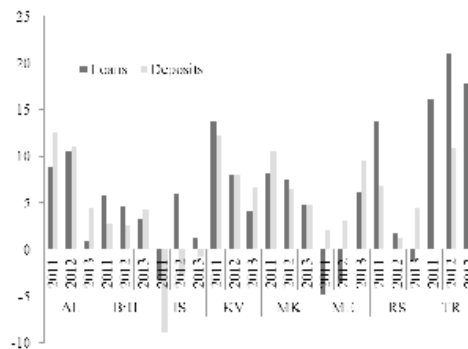
**Chart 2.9: Change in cross-border and consolidated positions by BIS-reporting banks on the Western Balkans**  
(Index September 2008=100)



Sources: BIS consolidated foreign and locational banking statistics and ECB staff calculations.

Notes: Western Balkans here consist of Albania, Bosnia and Herzegovina, FYR Macedonia, Montenegro and Serbia. Figures are not fit-adjusted.

**Chart 2.10: Loan and deposit growth**  
(average of annual percentage changes)



Sources: National central banks and ECB staff calculations.

Notes: Data in national currency converted into euro and fit-adjusted with exchange rate of the same month the previous year. Total loans here consist of households, non-financial corporations, private sector banks and public sector. Total deposits include households, non-financial corporations, private sector banks and government deposits. Figures for each year are an annual average of the year on year growth rate for each month (January to July for 2013).

In Montenegro, growth in loans and other receivables primarily resulted from the implementation of the International Accounting Standards, whereby the banks transferred a portion of written-off loans and other receivables from the off-balance sheet records into their balance sheets starting in January 2013.

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

Although the increased reliance on local deposits in EU candidate and potential candidate countries' banking systems should ex ante reduce funding risk, the extent to which host

**countries could be affected by ‘forced deleveraging’ remains open.** As documented in Chapter 4, the relative importance of subsidiaries from euro area-headquartered banks operating in (most) EU candidate and potential candidate countries is very asymmetric for ‘home’ and ‘host’ authorities. While a bank subsidiary may be locally systemic for host authorities, the relative weight of that same bank in the activities of the larger cross-border group as a whole (and hence the concern which it may elicit on the part of home supervisors) would likely be minor. This raises two potential issues.

**First, cross-border banking groups may be ‘forced’ by home authorities to dispose of subsidiaries that are seen as ‘non-core’ for the activities of the group as a whole.** This could apply to those cross-border banking groups with an important presence in EU candidate and potential candidate countries which have had or may have in the future ‘state aid’ cases addressed by the European Commission (EC). The recent cases in this regard<sup>8</sup> point to the possibility of forced divestment which could arise regardless of the underlying profitability of the bank subsidiaries in question or their relative dependency on parent funding. In principle, profitable entities should find buyers, while market exit by banks without viable business models is ultimately unavoidable and a contribution to banking sector consolidation, which in some countries seems warranted. At the same time, it should be recognised that short-term disruptions to domestic financial systems resulting from potential ‘orphan banks’ (i.e. those for which no buyers can be found) may still ensue, even in those cases where a host country’s long-term interest would be best served by disposing of unhealthy banks that provide little de facto funding to the real economy.

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

<sup>8</sup> There have been three main cases in this regard so far: (i) Hypo Alpe-Adria Group (HAAG) from Austria; (ii) National Bank of Greece / EFG Eurobank/Piraeus Bank; and (iii) the Slovenian NLB. In the case of HAAG, the EC decision of September 2013 forces the group to sell its entire network in South-Eastern Europe by end-June 2015 at the latest. The EC decision on the Greek-owned entities is still pending, while that for NLB states that the bank should focus on core activities but otherwise remains silent on the future of its cross-border subsidiaries. The importance of the NLB subsidiaries for the group as a whole is much larger relative to those of HAAG, accounting for 23% as compared to 10% of group assets, respectively. For more information, see “State aid: Commission approves plan to orderly wind down Hypo Group Alpe Adria”, EC press release, 3 September 2013; “State aid: Commission temporarily approves aid to Alpha Bank, EFG Eurobank, Piraeus Bank and National Bank of Greece; opens in-depth investigations”, EC press release, July 2012 and “State aid: Commission approves rescue or restructuring aid for five Slovenian banks”, EC press release, 18 December 2013.

## 2.8 Foreign currency lending still poses indirect vulnerabilities to banks

**Widespread lending in foreign currency in many EU candidate and potential candidate countries (outright or indexed to fx) continues to constitute a risk to financial stability.** The share of fx loans to total loans has remained broadly unchanged across most EU candidate and potential candidate countries during the period under review, ranging from around a quarter in Turkey and Iceland, over a half in the former Yugoslav Republic of Macedonia, to two-thirds to three quarters in Albania, Bosnia and Herzegovina and Serbia (see table 2.1).<sup>9</sup> Accordingly, foreign currency lending continues to be a 'structural' feature of many banking systems. The banking system's exposure to unhedged borrowers in the event of currency depreciation thus remains a key source of vulnerability in many countries, notwithstanding the fact that the underlying monetary and exchange rate policy frameworks across countries are often very different. There are signs that fx lending is tilting away from the household sector to the corporate sector (with hedging being presumably more common in the latter case), which suggests that risks in this regard may be on a downward path while remaining sizeable at present.

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

## 2.9 Conclusions

**Taken together, near-term challenges primarily relate to credit risk stemming from the generally weak economic dynamics in combination with already high non-performing loan burdens in many banking systems, especially in Western Balkan economies.** Notwithstanding sizeable cross-country heterogeneity, Albania, Serbia and Montenegro appear as particularly vulnerable. Although showing still positive credit trends, the continued increase of non-performing loans in both Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia also gives cause for concern. The risk that the projected recovery in economic activity

<sup>9</sup> Montenegro and Kosovo are unilaterally euroised countries and the share of fx lending in total lending is low or negligible.

turns out to be more protracted than currently anticipated, through domestic factors or renewed external headwinds, would exacerbate such vulnerabilities. Bottlenecks to the bank lending channel resulting from weak asset quality are not only of concern from a financial stability point of view, but also from the perspective of monetary policy and ultimately economic growth. Taken together, this implies that removing impairments to bank balance sheets which may be standing in the way of enhanced credit extension should remain a key near-term policy priority for authorities in most Western Balkan economies.

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

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

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

balance sheets, thereby underlining the need to develop domestic capital markets to provide stable longer-term funding alternatives.

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

**Financial sectors in EU candidate and potential candidate countries remain heavily bank-based, with most entities participating in the system following a ‘traditional’ business model devoted to intermediating retail and corporate deposits to loans.** While the focus of bank business models across the region was not necessarily in question in the wake of the crisis, developments since the bursting of the financial and credit bubble in 2009 have shown that the underlying funding dynamics prevailing in many cases (namely the dependency on parent funding) were unsustainable. In this regard, there is some evidence to suggest that credit dynamics between parent banking groups and their subsidiaries were pro-cyclical in both the run-up to the crisis and during its aftermath. At the same time banking systems across the region are still grappling with the challenge of resolving legacy issues associated to the turning of the credit cycle.<sup>10</sup>

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

#### **3.1 Recent lending developments**

**Asset growth of banking systems in most EU candidate and potential candidate countries has slowed down significantly, but there are no signs of disorderly balance sheet adjustments.** In the context of subdued economic activity in most of the countries concerned, the median asset growth of private sector banks in candidate and potential candidate countries came down from 6.3% in 2012 as a whole to 1.3% in the first half of 2013.

<sup>10</sup> See “Financing Future Growth: the Evolving Role of Banking Systems in CESEE”, IMF, April 2013.

Notwithstanding this overall trend, the developments on the asset side of banks' balance sheets have remained very heterogeneous among countries. In Turkey, balance sheets strongly expanded with an increase of 11.5% in the first half of 2013 compared with end-2012, whereas in Bosnia and Herzegovina and Serbia, banks' assets remained broadly stagnant (see table 3.1). Looking at the decomposition of items on the asset side, loans to the private sector remain the most important item ranging from 60% to 78% of total private sector banks assets in all countries except in Albania, Serbia and Turkey (see table 3.2).

**Table 3.1: Total banking sector asset growth**  
(percentage change)

	2011	2012	2013
Albania	13.1	6.1	1.4
Bosnia and Herzegovina	2.8	0.9	0.2
Iceland	6.2	0.8	1.6
Kosovo	7.9	6.8	1.1
FYR Macedonia	8.5	6.6	1.2
Montenegro	-4.5	-0.1	3.8
Serbia	4.6	8.7	0.1
Turkey	21.0	12.6	11.5

Sources: National central banks.

Notes: Annual percentage change except between 2012 and 2013 where the difference is calculated between end-2012 and June/July 2013.

**Table 3.2: Private sector loans to banking sector assets**  
(in percent)

	2011	2012	2013
Albania	47.8	46.1	45.6
% private sector banks' assets	47.8	46.1	45.6
Bosnia and Herzegovina	65.1	66.4	66.8
% private sector banks' assets	n.a.	n.a.	n.a.
Iceland	61.7	61.7	60.5
% private sector banks' assets	n.a.	n.a.	n.a.
Kosovo	61.8	60.5	62.2
% private sector banks' assets	61.8	60.5	62.2
FYR Macedonia	61.2	60.5	61.4
% private sector banks' assets	63.1	62.6	n.a.
Montenegro	77.2	77.6	77.7
% private sector banks' assets	77.2	77.6	77.7
Serbia	54.1	55.3	54.1
% private sector banks' assets	65.8	67.5	66.2
Turkey	39.3	41.1	42.5
% private sector banks' assets	56.4	58.8	60.4

Sources: National central banks.

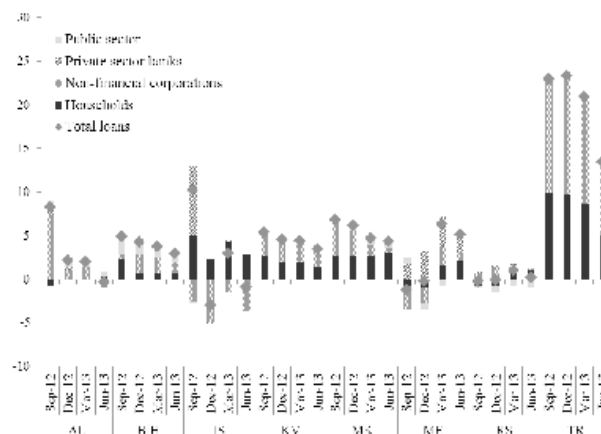
Notes: Private sector loans cover loans to households, non-financial corporations and private sector banks, and outstanding amounts as of December in each year (June/July for 2013).

**Banks' core business – retail and corporate lending – has remained weak.** Credit growth has been lackluster in most cases, with a noticeable slowdown in credit growth rates in all CC and PCC banking systems over the period under review notwithstanding different underlying credit dynamics, and Turkey being the exception with still relatively strong growth rates (see section 2.2). The decline in overall rates of credit growth appears to have been broad-based across relative components, with the more dynamic contribution of credit to households in some cases not being sufficient to compensate for the drop in corporate lending over the equivalent period (see chart 3.1).

**The lackluster pace of credit extension in most EU candidate and potential candidate countries appears to reflect a combination of demand and supply factors, especially as regards corporate lending.** A special survey among the central banks of EU candidate and potential candidate countries conducted for the purposes of this report suggests that, from the

point of view of the central banks in the countries concerned, both tighter supply and weaker demand help to explain the recent downtrend in corporate lending in most cases. In this regard, anticipated investment activities by corporates, which would require long-term bank financing, remained low in most candidate and potential candidate countries except Turkey.

**Chart 3.1: Contributions to overall lending growth**  
(annual percentage change, adjusted for fx changes)



Sources: National central banks, Haver Analytics and ECB staff calculations.

Notes: Time series are converted into euro and fx-adjusted with the difference in the exchange rate compared to the same month the previous year. Total loans cover the sum of the four sectors.

The demand for short-term financing (e.g. working capital), but also for corporate debt roll-over, for working capital as well as for mergers/acquisitions increased slightly (e.g. Bosnia and Herzegovina, Turkey and the former Yugoslav Republic of Macedonia). Looking at the supply side for corporate credit, lending standards for corporates tightened in most cases, which could to a certain extent also be a result of the lowered creditworthiness of corporates and adjustments of banks' internal risk-weighting schemes. In contrast, the picture as regards lending to households appears more diverse in comparison to corporate lending, with signs of a partial mismatch between relative supply and demand factors in some cases, such as Kosovo and Albania (see table 3.3).

**The findings of the IRC expert group's survey are broadly consistent with those of the EIB bank lending survey among parent bank groups, their subsidiaries as well as domestic banks in CESEE.<sup>11</sup>** The survey of the EIB also covers lending developments to households and

<sup>11</sup> EIB (2013), CESEE Bank lending survey 2013 H2. Among candidate and potential candidate countries this survey covers Albania, Bosnia and Herzegovina and Serbia.



corporates in some EU candidate and potential candidate countries. From the point of view of private sector agents corporate loan demand is curbed by the weak macroeconomic environment in most countries as well as by a sluggish global economic outlook. The EIB survey further suggests that access to finance was per se not a constraining factor for lending in the first half of 2013, because domestic funding currently compensates for declining cross-border funding. In this context, the results show that lending standards have been negatively influenced by the high level of NPLs in bank balance sheets as well as by regulatory uncertainties.

**Table 3.3: Survey of lending developments in the first half of 2013**

	DEMAND						LENDING STANDARDS					
	Lending to corporate			Lending to households			Lending to corporate			Lending to households		
	Overall	Short-term	Long-term	Overall	Loans to public sector	Consumer credit and other	Overall	Short-term	Long-term	Overall	Loans to public sector	Consumer credit and other
Albania												
Bosnia and Herzegovina												
Iceland		n/a	n/a					n/a	n/a			
Kosovo												
FYR Macedonia												
Montenegro												
Serbia				n/a						n/a		
Turkey				n/a						n/a		

Dark grey: Significant credit growth  
 Medium grey: Credit growth moderate  
 Light grey: Credit growth unchanged  
 White: Credit growth decreased  
 Dark grey: Significant credit growth

Sources: National central banks.

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

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

The rates of credit growth to the public sector by banking systems in EU candidate and potential candidate countries has tended to be very dynamic over the review period, also given that the starting level was very low in all cases under consideration. Loans to the public sector still count for a very small share of total banking sector assets, mostly around 1%, and the share of loans to the public sector in total bank loans also remains low (typically 5% or less, see table 3.4). The contribution of lending to the public sector to overall credit growth is limited in most countries except Bosnia and Herzegovina and to a lesser extent Albania. However, the increase in lending to the public sector has been steady in recent years, and the contrast with the

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pre-crisis situation remains striking. The weight of direct lending to the public sector in total bank lending has doubled, tripled or more within a relatively short period of time in some EU candidate and potential candidate countries in the Western Balkans.

**Table 3.4: Loans to the public sector**  
(in percent)

		2008	2009	2010	2011	2012	2013*
Albania	...of total loans	2.9	4.4	2.7	3.6	4.4	4.4
	...of total banking sector assets	1.4	2.2	1.3	1.8	2.1	2.1
Bosnia and Herzegovina	...of total loans	6.1	7.0	8.1	9.0	10.1	10.4
	...of total banking sector assets	4.2	4.7	5.7	6.4	7.4	7.8
Iceland	...of total loans	0.7	0.8	1.3	1.0	1.0	0.9
	...of total banking sector assets	0.4	0.5	0.8	0.6	0.6	0.5
Kosovo	...of total loans	0.0	0.0	0.4	0.1	0.1	0.0
	...of total banking sector assets	0.0	0.0	0.3	0.1	0.1	0.0
FYR Macedonia	...of total loans	n.a.	0.1	0.1	0.2	0.9	0.9
	...of total banking sector assets	n.a.	0.1	0.0	0.1	0.5	0.5
Montenegro	...of total loans	1.4	4.0	4.3	7.4	6.7	7.4
	...of total banking sector assets	1.1	3.5	3.7	6.1	5.6	6.3
Serbia	...of total loans	1.1	2.0	4.0	4.2	3.4	3.0
	...of total banking sector assets	0.6	1.1	2.3	2.4	2.0	1.7
Turkey	...of total loans	2.2	2.1	1.5	1.4	1.1	0.9
	...of total banking sector assets	0.8	0.7	0.6	0.6	0.5	0.4

Sources: National central banks and ECB staff calculations.

Notes: \* As of June 2013 (July in the case of Kosovo and Serbia). Total loans cover loans to households, non-financial corporations, private sector banks and public sector, and outstanding amounts of the respective period.

The analysis of exposures of banking systems in EU candidate and potential candidate countries to their respective public sectors via banks' holdings of government securities tends to reveal a similar pattern of moderate to fast growth against a low starting base. Over the period under review, banks in Albania, the former Yugoslav Republic of Macedonia, Montenegro and Serbia have increased their holdings of government securities, with only banks in Turkey showing a pronounced trend in the opposite direction. From a longer term perspective, the growing weight of government securities in total bank assets is notable in all cases except for Albania and Turkey. The fact that holdings of government securities have crept up to amount to just under 10% of total bank assets in cases such as Kosovo, Serbia or the former Yugoslav Republic of Macedonia within only a few years is particularly noteworthy (see table 3.5).

Overall, the exposure of banks in EU candidate and potential candidate countries to the public sector remains limited in most cases and does not constitute a near-term financial stability risk. However, the growing nexus between banking systems and their respective sovereigns should continue to be monitored in a medium-term context as a potentially emerging

risk, particularly in view of rising public debt in most countries concerned. Furthermore, banks in Albania and Turkey are currently vulnerable to potential sovereign shocks through their sizeable holdings of government securities, even though from a longer term perspective the share of government securities in total bank assets appears to have been trending down in both countries since 2008.

**Table 3.5: Banks' holding of government securities**  
(in percent of total banking sector assets)

	2008	2009	2010	2011	2012	2013*
Albania	31.2	30.2	28.0	26.7	24.7	25.5
Bosnia and Herzegovina	0.0	0.0	0.1	1.3	1.9	1.9
Iceland	1.1	8.5	8.5	7.5	7.2	7.0
Kosovo	n.a.	n.a.	6.7	7.6	9.1	8.7
FYR Macedonia	3.7	4.8	5.9	5.0	8.5	9.2
Montenegro	n.a.	n.a.	n.a.	n.a.	1.5	3.4
Serbia	0.1	4.1	5.8	5.8	8.7	9.1
Turkey	25.8	30.7	27.7	22.6	19.1	17.3

Sources: National central banks and ECB staff calculations.

Notes: \* Figures for 2013 are as of June/July 2013 (August in the case of Iceland).

### 3.2 Recent funding developments

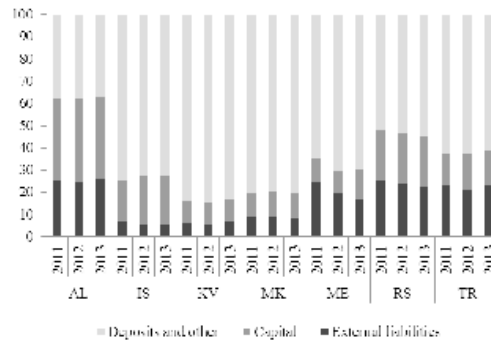
The longer term reorientation of bank funding bases towards increased local deposits at the expense of external sources of finance has continued in the period under review (see also Section 2.6). A decomposition of bank liabilities into their main components shows that this development has been moderate in Montenegro and Serbia within a relatively short period of time. In other cases, the relative growth of deposits among banks liabilities ('deposit capture') has been more difficult to attain as the reliance on local funding was already very high (e.g. in Kosovo and the former Yugoslav Republic of Macedonia, see chart 3.2). With the exception of Albania, "deposits and other" are the most important funding source for banks in candidate and potential candidate countries, counting for 54.7% in Serbia on the lower end to 83.4% in Kosovo on the upper end.

In countries like Albania, Kosovo and Turkey asset growth in 2013 was also funded by a slight increase in external liabilities, which counted for 26.0%, 6.6% and 23.5% of banks' balance sheets in 2013Q2, respectively. The liability structure of the Turkish (and to a lesser extent the Icelandic) banking sector represents insofar an exception among candidate and potential candidate countries as external funding consists of short-term wholesale funding rather than parent funding. The banking sector in Serbia and in Montenegro continued to adjust their funding model, hence external liabilities shrank to 22.1% and 16.4% of total liabilities.

**Table 3.6: Committed credit lines by banks**  
(in percent of total liabilities, incl. equity)

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

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

**Chart 3.2: Liability structure of banks**  
(in percent of total liabilities)

Sources: National central banks and ECB staff calculations.

Notes: In this chart, total liabilities cover the sum of the three components (deposits and other, capital and external liabilities). In the case of Montenegro, wholesale funding and not external liabilities due to data unavailability. Figures for 2013 are from June/July 2013. Due to lack of data, Bosnia and Herzegovina was excluded from the chart.

The changing composition of bank funding sources is only partly reflected in the share of committed credit lines (typically from parent entities) in total liabilities. They have dropped only in Bosnia and Herzegovina as well as in Serbia over the period 2011-2012. In contrast, those countries that have shown a comparatively more dynamic pace of credit extension compared to the pre-crisis period (i.e. Turkey, and to a lesser extent, Kosovo), recorded a noticeable increase in committed credit lines (see table 3.6). Box 2 contrasts the experience as regards the substitution of bank funding sources in EU candidate and potential candidate countries with that of recent EU member states.

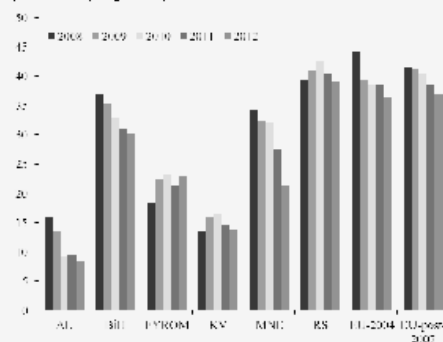
Household savings continue to account for the bulk of overall deposit trends, although the relative importance of deposits by non-financial corporations is growing in some cases. The evolution in household deposits continued to drive developments in overall deposit growth (see chart 3.3), although the relative contribution of deposits by non-financial corporations remains significant in Turkey and Montenegro and has also been on the rise in Serbia. Among EU candidate and potential candidate countries, only Iceland's banking system has continuously posted negative rates of overall deposit growth in the period under review. This trend is partly due to the migration of non-resident deposits into other types of investment options amid the central bank's efforts to reduce the volume of 'offshore króna' and thereby foster the smooth relaxation of capital account restrictions.<sup>12</sup>

<sup>12</sup> Central Bank of Iceland's Financial Stability Report 2013-1.

**Box 2: Re-composition of funding sources in Central, Eastern and South-Eastern European economies**

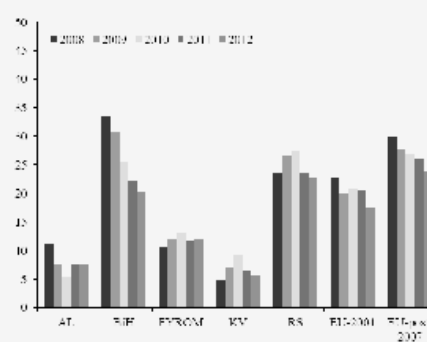
Western European banks have a significant presence in both EU candidate and potential candidate countries in South-Eastern Europe (SEE EU candidate and potential candidate countries) and in EU member states of Central and Eastern Europe (EU-2004 and EU-post 2007).<sup>(i)</sup> This box investigates whether between 2008 and 2012 SEE candidate and potential candidate countries experienced the same re-composition of funding sources as occurred in EU-2004 and EU-post 2007 by comparing the development of the 'non-core liability ratio' (as a measure of more volatile funds) and the 'foreign liability ratio'.<sup>(ii)</sup> In 2008, the non-core liability ratios in Bosnia and Herzegovina, Montenegro and Serbia were similar to that in EU-2004 and EU-post 2007, while the ratio in Albania, the former Yugoslav Republic of Macedonia and Kosovo were much lower (see chart B1). Such differences likely reflected the composition of the banking systems' funding sources.<sup>(iii)</sup> Between 2008 and 2012, non-core liabilities have been decreasing, especially in EU-2004, in EU-post-2007, and in Albania, Bosnia-Herzegovina and Montenegro, signalling that domestic deposits have gained more prominence among funding sources in the latter countries. At the same time, due to the strong presence of Western European parent banks in the region and thus easier access to foreign funding from parent groups, foreign liabilities, which are shown in chart B2, have been representing in many cases a significant source of financing. Additionally, foreign liabilities appear to have driven the dynamics of non-core liabilities in many countries, as one can notice by comparing chart B1 and chart B2. Between 2008 and 2012, foreign liabilities in EU-2004 and EU-post 2007 declined, reflecting parent bank groups' deleveraging. Nonetheless, the speed of the reduction is diverse among the two groups. Deleveraging was also implemented in SEE EU candidate and potential candidate countries between 2008 and 2012, although at different times and pace with respect to EU-2004 and EU-post 2007. In general, there seems to be a broad-based re-orientation towards domestic funding at the expense of foreign liabilities in all countries. The pace and timing of deleveraging differs which is likely related to domestic factors, including varying lending opportunities in the region.

**Chart B.1: Non-core liabilities as a share of total liabilities (2008-2012, in percent)**



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

**Chart B.2: Foreign liabilities as a share of total liabilities (2008-2012, in percent)**



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

<sup>(i)</sup> For the purpose of this analysis, EU-2004 consists of the Czech Republic, Hungary and Poland, and EU-post 2007 includes Bulgaria, Romania and Croatia.

<sup>(ii)</sup> The non-core liability ratio is defined as total liabilities minus capital and domestic deposits over total liabilities minus capital. The foreign liability ratio is defined as foreign liabilities over total liabilities minus capital. The term foreign in this context refers to non-residents.

<sup>(iii)</sup> Impavido Gregorio, Rudolph Heinz and Luigi Ruggerone, (2013), Bank Funding in Central and South Eastern Europe Post Lehman: a "New Normal", IMF Working Paper, 13/148.