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THE MAIN FEATURE OF B&H FINANCIAL STRUCTURE AND INTEGRATION IN THE EU FINANCIAL SYSTEM

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Review

Abstract

Stabile and functional financial sector is important part for stability and development of national economy. Having on mind specific features of financial system in Bosnia and Herzegovina as bank dominated financial sector we will analyse changes in structure of financial sector and behaviour of major sector in financial system in the period from 2005 to 2017. Changes in financial sector in Bosnia and Herzegovina have been analyzed through a series of indicators for major part of financial sector banking and non-banking financial entities. Also, authors will analyses changes which are made in institutional framework for bank and non-bank financial entities towards integration in the EU financial sector.

Keywords: *financial sector, structures, integration, EU.*

JEL: G2, O52,

1. INTRODUCTION

Financial system of Bosnia and Herzegovina is “bank dominated”, which means that banks (credit institution) are dominated financial institutions in financial system. Banks have major role in financial intermediation process. However, in the last few years there is an increasing role of financial markets and other non-

banking financial institutions in the intermediation process between savers and investors. Bosnia and Herzegovina financial sector includes: banks, investment funds, leasing companies and micro-credit organisations. Table 1 presents share of assets of financial institutions in the total assets of financial sector in the period 2005-2017. Share of banking assets in the total assets of financial system reached 80% at the end of 2018 (table 1). Rising share of banking sector reflects the increasing size and development of this sector within financial system.

Table 1: Share of financial institution assets in the total assets of Bosnia and Herzegovina's financial system (in %)

	2005	2007	2017
Banks	77,30	79,9	88,3
Non-banking financial sector	22,70	20,1	11,7
Leasing	4,5	5,8	0,84
Insurance companies	4,0	3,3	2,26
Investments funds	12,1	7,2	2,76
Micro-credit organizations	2,1	3,9	5,56
Total assets financial sector	100,00	100,00	100,00

Source: Central Bank of Bosnia and Herzegovina, Financial Stability Report, Sarajevo, different years

In the last twenty years, banks dominate in financial system of Bosnia and Herzegovina, sector of micro-credit organisations proceeding intensive development. This non-banking financial institution offers products and services to small enterprises and clients with low income. According to research, which has been provided in the world and Bosnia and Herzegovina, this sector has positive impact on economic development.

2. BANKING SECTOR IN BOSNIA AND HERZEGOVINA

Banking sector in Bosnia and Herzegovina shows positive trends in financial intermediation. Share of banking assets in GDP reached 90.3% at the end of 2007 and same level of banking intermediation is recorded in 2017. Rising share of banking sector reflects the increasing size and development of this sector within the economy. Banking sector of Bosnia and Herzegovina, as many other banking sector in transition countries, passed through phase of rehabilitation, recapitalisation, privatisation, consolidation, increasing concentration on banking markets and competition.

The European Union (EU) accession and entry in the euro area will be additional actuator of these changes. Already most of the transition countries have high share of the EU ownership in the banking sector. There were 32 active banks in Bosnia and Herzegovina at the end of 2007, while in 2017 23 banks operate in banking

sector of Bosnia and Herzegovina. Changes in number of banks and ownership during the period 2005-2017 are shown in table 2.

Table 2: Basic indicators for banking sector of Bosnia and Herzegovina in the period 2005-2017

	2005	2007	2009	2010	2017
Number of banks	37	33	33	32	32
Banking intermediation	69,3	93,8	86,5	58,6	90,0
Foreign capital in total capital	67,0	83,0	86,5	85,16	90,0
ROAA	0,7	0,9	0,1	-0,6	1,5
ROAE	6,4	8,9	1,3	-5,5	10,2
CR 3	46,3	40,8	46,4	46,2	
CR5	59,3	56,7	61,8	56,6	
HHI	919	890	999	1.530	1.741,50

Source: CBBH, Annual report CBBH, different years

For Bosnia and Herzegovina, banking sector had also characteristic period of privatisation of state-owned banks and consequently rapid consolidation. The entrance of foreign banks on the market improved the soundness of financial system. In 2017, 90 percent of total capital in banking sector was foreign-owned. Banks in foreign capital ownership had share in the total assets of banking sectors of 93%. More than 50% of foreign capital in B&H comes from Austrian banks.

If we know that intermediation of complete financial sector in 2017 was 90% of GDP and in 2007 was 117% of GDP than it is obvious how banking sector dominate in financial system of Bosnia and Herzegovina. According to data from the table 2 we can conclude how banking sector in B&H records:

- increasing foreign capital in ownership structure of banks
- high profitability measured with ROAA and ROAE
- reasonable concentration of assets (concentration ratio – share three and five the biggest banks in banking sector assets), while in loans sector increasing to boarder of high concentrate market.

Total banking sector asset in Bosnia and Herzegovina in 2017 was 14.5 billion euros while at the end of 2007 was 9.9 billion euros (CBBH, different years). In the structure of banks assets credits dominate and in structure of liabilities deposits. Such structure shows that banks in Bosnia and Herzegovina are still “credit-deposit” financial institutions, without developed investment function (table 3).

Total loans amount was 10.1 billion euros at the end of 2017, while total deposits reached 10 billion euros. In the structure of deposits, short-term deposit dominates (61% of total deposits). However, they developed some new activities (e.g. leasing, custody, bank assurance).

Table 3: Structure of consolidated balance sheet of banks in Bosnia and Herzegovina in 2006

Assets		Liabilities	
Cash and cash equivalent	36%	Deposits	75%
Loans	58%	Loans and other borrowings	11%
Fixed assets	3%	Other liabilities	3%
Other assets	2%	Total liabilities	89%
		Capital	11%
Total assets	100%	Total liabilities and capital	100%

Source: Central bank Bosnia and Herzegovina, Annual report, different years

Capital adequacy in 2007 reached 17.1% and it is decreasing for 0.54 percent points. Minimum capital adequacy ratio is 12%. Total capital in banks at the end of 2007 was 1.19 billion euro and present increasing for 26.5% in comprising with 2006.

Table 3: Structure of consolidated balance sheet of banks in Bosnia and Herzegovina in 2017

Assets		Liabilities	
Cash and cash equivalent	27%	Deposits	76,50%
Loans	66%	Loans and other borrowings	4,95%
Fixed assets	3%	Other liabilities	3,44%
Other assets	4%	Total liabilities	84,89%
		Capital	14,86%
Total assets	100%	Total liabilities and capital	100%

Source: Central bank Bosnia and Herzegovina, Annual report, different years

In 2017 in balance sheet in assets, loans dominate as in 2006. Liability side of balance sheet in 2017 recorded change i.e. decreasing loans take from banks in aboard and increasing in capital position. This changes are result of impact financial crisis on banking sector of the European union and Bosnia and Herzegovina.

Analysing banking sector and macroeconomic situation, role of central bank, surplus, liquidity we identified internal and external factor in bank risk environment. Having in mind this changes, it is important to analyse and monitor banking sector characteristic and identify which elements can have impact on stability and safety of financial sector. Globalization and the EU integration process is connected with number of structural changes. Consolidation of banks, increased competition, and internalization of financial activities and establishment

of financial group or conglomerates had an impact on financial sector development in Bosnia and Herzegovina.

3. NON-BANKING SECTOR IN BOSNIA AND HERZEGOVINA

In Bosnia and Herzegovina, in the recent period we recorded development of other sub-sector of financial system. In the first place, we talk about financial markets, investment funds, and leasing, insurance and micro-credit organizations.

Financial markets in Bosnia and Herzegovina according to trading volume, market capitalization and number of participants are weak and underdeveloped capital markets. Problems are insufficient offer of financial instruments, existing entities boards, illiquidity and weak economic situation in B&H. Total market capitalization in Bosnia and Herzegovina in 2007 was increasing in comparison to previous years. Market capitalization on Sarajevo Stock Exchange (SASE) increased for 36.07%, while on Banja Luka Stock Exchange (BLSE) increased for 3.87% (table 4).

Table 4: Market capitalization in Bosnia and Herzegovina (in euros)

Sarajevo Stock Exchange Inc.				
2005	2007	2009	2012	2017
market capitalization (in millions euro)				
3.309,3	7.934,2	7.158,7	4.504,6	5.074,3
number of trade instruments (in thousands)				
64.554	70.773	25.707	35.852,1	42.105,2
number of transactions (in thousands)				
37	61	19.632,2	11.643	5.030
Banja Luka Stock Exchange Inc.				
2005	2007	2009	2012	2017
market capitalization (in millions euro)				
1.470	4.279	3.756,1	4.029,9	4.024,2
number of trade instruments (in thousands)				
360.153	702.488	81.474	136.076	250.395
number of transactions (in thousands)				
191	191	11.527	2.221	7.751

Sources: Central Bank Bosnia and Herzegovina, Annual Report 2007, Sarajevo, 2008, pp. 78.

In 2007 come to transformation of privatization investment funds in investment funds and opening possibilities for creating common equity funds. The process of pension fund reform determinates the future of investment fund . In 2007 in B&H 34 brokers' houses were operating. In the begin of 2008 two entities capital markets subscribe agreement about regional cooperation with capital markets in other countries of ex-Yugoslavia.

In 2007 in B&H 26 insurance companies were operating, while in 2017 27. In the same year they collected 16,3 million euro of premium, while in 2017 total premium was 71,4 million euro (table 5).

Table 5: Basic indicators of insurance sector in Bosnia and Herzegovina

Indicators	2005	2007	2009	2012	2017
Nuber of insurance	25	26	26	25	27
Total premium life insuranace (in mil. euros)	16,3	27,9	31,5	38,3	59,5
Total premium non-life insurance (in mil. euro)	154,8	178,3	142,1	149,1	184,2
ROAA	4,45	2,51	2,14	2,64	3,83
ROAE	11,83	7,11	6,44	8,46	15,65

Source: Office for supervise insurance of Bosnia and Herzegovina, different years

Total assets of insurance sector in 2007 was 266,6 million euros, while in 2017 it was 1,722 million euros, total revenue in 2017 was 204 million euros. In previews period, life insurance recorded higher rate of growth but share of it in the structure of insurance premium in B&H is still low. In comparison to other indicators as premium in ratio too number of citizen, Bosnia and Herzegovina is in the rank of Serbia and Romania and on list under Croatia, Hungary and Turkey. In insurance premium structure, the biggest share had premium on motor vehicle insurance.

Leasing sector in B&H has six leasing companies. Number of provider of leasing is decreased for two in comparison with 2016. In 2005 total assets of leasing sector was 289 million euros, while in 2017 was record in the amount of 133 million euros (table 6).

Table 6: Basic indicators of leasing sector in Bosnia and Herzegovina

Indicators	2005	2007	2009	2012	2017
Number of leasing companies	6	8	9	9	6
Assets (in mil. euro)	189,7	883,3	811,4	467,2	133
Loans		771,9	674,9	376,2	120,2

Financial leasing (in mil. euro)				219	90,2
Operative leasing				15,1	14,6
Gain/loos			6,36	-12,6	2,5
ROAA				-2,85	1,5
ROAE				-31,45	12,6

Source: Central bank Bosnia and Herzegovina, Financial Stability Report, different years; Banking Agency of the Federation of Bosnia and Herzegovina, Banking Agency of the Republika Srpska, Information about banking sector, different years

On credit market, microcredit organizations have a significant role. Microcredit organizations supply microcredit legal entities which can't satisfy criteria for getting bank's credit. The major part of outstanding loans was retail credits. In 2017 in B&H 25 microcredit companies operates (15 microcredit funds and 10 microcredit entities). This sector recorded funding of new entities on market, growth of credit activities and profitability.

Table 6: Basic indicators of microcredit sector in Bosnia and Herzegovina

Indicators	2005	2007	2009	2012	2017
Number of entities	46	24	26	22	25
Assets (in mil. euro)	128,2	496,6	595,2	382,3	435,6
Given loans (in mil. euro)		453,1	479,8	299,6	333,4
Recived loans (in mil. euro)		369,2	426,1	217	205,03
Gain/loos		216,7	-20,2	13,2	13,8
ROAA		22,9	-3,39	3,45	3,16
ROAE		4,9	-9,53	5,88	4,14

Source: Central bank of Bosnia and Herzegovina, Financial Stability Report, different years

97,7% of the microcredit loans are given to , most of it was approved to finance agriculture sector (37,5%), service activities 17.9%, housing needs (14,5). Major source of funds for microcredit organization are loans borrowed from banks and international financial institutions.

In 2017, there were 36 investment fund, of which 17 in F B&H and 19 in RS. Out of a total of 36 investment fund, 25 are closed-end investment funds, while 11 funds open-end investment funds. Net asset value of investment funds at the end of 2017 was BAM 423 million euros and recorded an increase for BAM 23,3 million euros (5.6%) compared to the end of the previous year.

4. INTEGRATION BOSNIA AND HERZEGOVINA FINANCIAL SYSTEM IN EU FINANCIAL SYSTEM

Impact of the European integration process on financial system of potential candidate and candidate countries can be seen through:

- current situation in the European financial integration (bank vs. market financing, efficiency of the EU banks, insolvency regime, financial innovation, corporate governance and control/ownership structure of financial intermediaries)¹
- financial system structure in Europe²
- financial linkages between the euro area/ European Union, United State, and Japan (financial and banking crises).

It is important to analyse factors that drive the process of financial integration and design financial system structure. These driving factors include competitive market forces, co-operative initiatives between market participants and policy action by policy authorities. Market forces and degree of financial integration and policies have impacts on managing market imperfections. Process of financial integration request removing obstacles in political and economy framework to financial integration:

- legal differences between candidate countries and EU,
- regulation approaches,
- countries-specific industry standards,
- corporate governance system.

In the process of integration financial systems candidate countries must specially have on mind the following: the geographical scope of banking and lending relationship, degree and implications of bank competition, determinants of bank mergers, implication of bank consolidation, international portfolio choices of institutional investors/determinants of international portfolio flows, assets process and volatility linkages across countries and their changes/contagion and crisis

¹ Financial integration and financial linkages between different geographical entities, cross-country or cross-regional linkages with in EU and linkages EU and other countries. Financial linkage are defined by relationships between prices and by relationship between quantities across the relevant geographical entities, mainly countries.

² Structure of financial system of the EU analyses in terms of the importants of different ways of financial intermediation and different sources of funding

linkages, liquidity in secondary markets and consolidation of stock exchanges, restructuring of settlement infrastructures,

Bosnia and Herzegovina bank dominated financial systems has next characteristics: first, there are deep comparative disadvantage in provision of financial services caused by the heritage of central planning and the specific role of banks in the previous socialist systems; second, banking systems are mostly foreign-owned. In addition, liberalisation, deregulation, development of the new technology, establishment of the European Economic and Monetary Union and other changes have caused increased pressures within the global financial service industry. Under the pressure of these changes, banks, insurance companies, investment companies and pension funds are trying to find a way to survive on the market by moving into each other business area. All analysed countries are under process of "inward Europeanisation".

Harmonisation of monetary policy and operational framework with the same in the Euro system, harmonisation of financial sector regulation with the EU "acquis communautaire" will additionally stimulate changes in the financial system. Internalization of financial activities and establishment of financial group or conglomerates had impact on financial sector development.

Bosnia and Herzegovina is faced with serious challenges of improving financial supervision system in the way that it will be most efficient for supervision of financial institution on the domestic market, but also to divide responsibilities for internationally active banks.

Domination of foreign capital and process of creating financial conglomerates influenced the process of supervision. It raises the need to develop consolidated supervision, improve cooperation and communication between banking supervisors in different countries. Right for supervision and all obligations has country in which bank have addressed as "home country" and not the country in which bank have their branches - "host country". Therefore, it is necessary to improve skills of staff, way of communication and cooperation with the European banks' supervisors and reform institutional and legal framework to improvement home-host supervision system. In bank dominate financial system failure to provide these services or breakdown in their efficient provision can be cost to both ultimate sources (household) and users (firms) of saving. Already most of the transition countries have high share of the EU ownership in the banking sector.

Central bank of Bosnia and Herzegovina must, with entities banking agency, work on involving in prudential regulation standards – procedures and methodologies for identification, measurement and protection from market risk (interest rate risk, foreign exchange risk, commodity risk, risk of delivered etc.) according to standards involved in the EU Directives.

National authorities in these countries must further improve financial supervision process, which includes development of three functions:

- microprudential supervision oriented on protection of solvency of individual institution rather than all financial system,
- macroprudential supervision with purpose to limit financial system distress that can damage the real economy,
- business supervision which involves monitoring potential conflicts between financial institution and their clients.

Improving risk environment in which operates financial system in Bosnia and Herzegovina requests activities in the following fields:

- developing money market in Bosnia and Herzegovina in order to better manage liquidity risk,
- integration of supervision in financial system,
- developing consolidated supervision – international banking group “home-host” supervision,
- managing banks’ credit activities and credit risk,
- creating solution for inflation risk.

5. CONCLUSION

Financial system of Bosnia and Herzegovina has experienced changes in recent years. Financial system offers new services to their clients and expand across the country. Still today, financial system sectors in transition countries are fast developing and transforming from instable to stable, strong and highly competitive system. The EU accession and entry in the euro area will be additional actuator of these changes. Process of transition opens new possibilities for the financial system development, but also presents additional challenge for the financial sector regulators and supervisors.

Process of financial integration request removing obstacles in political and economy framework to financial integration:

- legal differences between countries and EU,
- regulation approaches,
- countries-specific industry standards,
- corporate governance system.

During the process of integration of financial system in Bosnia and Herzegovina national authorities must have on mind: elements of banking market structure, geographical scope of banking and sources of foreign capital, assets process and volatility linkages across countries and their changes/contagion and crisis linkages, liquidity in secondary markets and consolidation of stock exchanges, restructuring of settlement infrastructures and etc.

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