The Impact of the Global Financial Crisis on the Banking Sector of Western Balkans: Cross-country Comparison Analysis

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Abstract: *The aim of this paper is to examine the extent and impact of the global financial crises on position of the banking sector of Western Balkans covering both pre-crisis and crisis period as well as to provide an explanation for these trends.This paper deals with cross-country comparison analysis of banking in Western Balkans before and during crises. Altough, depth of the crisis in the banking sector of Western Balkans is not yet fully evident, selected indicators in this paper point to its direction. The research alone has determined the paper's structure which consist an analysis of the impact of the global financial crisis on recent occurrences in the banking of the region.*

Impact of global financial crises has been transmitted on the position banking sector selected countries through several sources, especially through: impact profitability, credit growth has dropped significantly and asset quality has deteriorated markedly.
Altough the economies of Western Balkan countries in crisis period performed differently the results of the comparison show that theglobal financial crisis has a substantial impact on the banking sector of the region.

KEYWORDS:
financial crisis, profitability, credit growth, asset quality, liquidity

ARTICLE HISTORY
Submitted: 20 March 2012
Resubmitted: 21 May 2012
Resubmitted: 05 December 2012
Accepted: 24 December 2012

JEL code: *G 21*

Introduction

In the last 15 years, banking of Western Balkans has come a long way from stumbling, radical reforms to healing. Among other things, a high degree of vitality and ability was demonstrated to strengthen the deposit potential of banks and restore lost public confidence. Overall, the continued growth rates in the Western Balkans over last ten years were converged mostly due to similar policies of economic stabilisation and a period of relative political stability.No matter what are the ways of institutional and administrative changes for each country, they are visible almost identical areas in which they made the necessary structural reforms, as in the case of banking markets. This position of the banking sector in Western Balkansis the result of the process of structural reforms implemented in most banks of these countries in 1990s signaling the begining of transformation from socialist ownership to private ownership and market economy. Significant progress has been made in the area of the privatisation of banking sector which is almost completed in most of the selected countries in during 1990s.With its comprehensiveness reforms have changed the whole structure of the banks in terms of the ownership, organizational and business. They emphasized creation of favorable conditions for entry of private capital and eliminating barriers to entry foreign (western) banks. In addition, the low credibility of the Western Balkans, the absence of additional credit ratings was greater complexity for the situation by forcing banks to borrow abroad at much less favorable conditions.

The adoption of new laws created a framework dealing with the instruments and institutions of the banking market. Changes that were later made to existing laws by their character were editing market-oriented concept of development and functioning of the banking market in order to strengthen the financial system of Western Balkans with the appropriate parties and different offerings of banking products and services.
More or less in all transition countries facing the reality of market economy and risks were something new and they all had to adapt to it quickly. Price paid for getting used to the new reality was not small, given the loss of public confidence.

The issue of major reforms in the field of banking imposed an imperative. The implementation of these measures led to significant changes and improvements in almost all transition economies.

The reforms introduced have not only put the countries of the Western Balkanson the path to growth but also made its economy strong to sustain positive trends in coming years. After the credit boom years between 2003 and 2007, which were characterised by strong credit growth the economy of Western Balkans saw a downward trend in economic growth in the period between 2008-2010 on the back of the unfolding global financial turmoil.A recent survey, conducted by Jiménez and Saurina (2006) was pointed out that there is positive, although quite lagged, relationship between rapid credit growth and future nonperforming loans of banks. In according their finding during lending booms riskier borrowers obtain funds, and collateral requirements are significantly decreased. The same turned out to be time for the Western Balkans.

The spill overs from the global crisis fully hit the economies of Western Balkan and led in 2009 to the deepest recession since early transition.The countries of the Western Balkans have faced significant challenges since the latest financial crises began in 2008. However, 2009 has proved to be a difficult year for all economies of the Western Balkan countries. The credit expansion of Western banks caused instability in many transition economies where these banks had operations. Especially if we know that many transition economies are dependent on remittances or on revenues from natural resources, all of which sharply decreased with the downturn. The paper begins by giving an overview of the banking sector in Western Balkans in pre - crisis by describing the development structure of the banking sector. Then, the consequences of the global crisis will be explained and its implications will be highlighted.

Objective and Methodology

The main objective of the study is to analyze the certain banking variables in order to have a bigger picture about effects of the latest financial crisis on stability and efficiency of banking sector of Western Balkan.This study uses a cross-country comparison methodology and examines the following aspects: Capital adequacy, liquidity position and efficiency of the banking sector of the Western Balkan in pre crisis and crisis period.

In our analysis we use annually data series which are sourced from the following IMF databases: International Financial Statistics (IFS), and Global Financial Stability Report (GFSR), The United States Agency for International Development (USAID) Partners for Financial Stability Program (PFS), from the national central banks, their annual reports. The data covers the period between 2003 - 2010 and included 6 countries of Western Balkan: Albania, Bosnia and Herzegovina, Croatia, Macedonia FYR, Montenegro and Serbia.

How the crisis started?

Improving the institutional framework of the banking sector in the Western Balkans shows that it should be helpful for banks to reduce the credit risk there. The momentum of banking reform began in the 1990s in all transition economies was fully focused on strengthening the safety and soundness of the banking system, improving efficiency and eliminating all distortions expressed in non profit activities of banks in the area where they are concentrated and accumulated losses and outstanding debts from other sectors of the economy. In addition, income growth and growth in production is assumed to be largely stimulated by continued increase in demand for loans. Further, positive results in the economy especially after 2003 reinforced the positive expectations about future incomes and profits, which led to a further increase in demand for loans.

Equally important is that in the pre crisis period (2003-2007) the economies of the Western Balkan had enjoyed solid economic growth mainly fuelled by large inflows of bank credits, enabling increased domestic borrowing. In some cases, notably Montenegro, average annual rates of credit growth exceeded 90percent. Over this period, in Bosnia and Herzegovina, Macedonia, Serbia, and Albania, average annual rates of credit growth were between 20percentand 30percent. On the other hand, Croatia managed to keep the rate of credit growth within reasonable bounds, averaging 15percentover the period.

The latest financial crisis was transmitted to the region of Western Balkans with a delay, so that the first adverse effects are felt at the middle of 2008. Adverse effects of the global financial crisis were hit first by banksand mostly economies of this region began to face a crisis of confidence in the banking sector and a large reduction in inflows from abroad.The consequences of the global crisis were expressed primarily through the rationalization of credit, falling export demand and commodity prices, cut in foreign credit lines and low remittances.

Table 1. Selected Macroeconomic indicators

	Bosnia and Herzegovina			Albania			Croatia			Macedonia FYR			Montenegro			Serbia		
	2007	2009	2010	2007	2009	2010	2007	2009	2010	2007	2009	2010	2007	2009	2010	2007	2009	2010
GDP Growth Rate	6.14	-3	0.01	5.9	3.3	3.5	5.1	-6	-1.2	6.1	-0.9	1.8	10.7	-5.7	1.04	6.9	-3.1	1.76
CPI (period average)	1.5	-0.4	2.37	2.94	2.22	3.4	2.9	2.4	1	2.28	-0.8	1.86	4.2	3.4	0.5	6.5	8.11	4.65
Unemployment rate (as % of total labor force)	29	24.1	27.2	13.5	13.1	12.5	9.6	9.1	11.8	34.7	33	32	11.9	11.2	12.2	18.8	17.4	18.21
External Debt (as % of GDP)	42.5	46.6	58.3	14.4	23.4	25.6	77.7	99.1	101	52.5	58.8	59.4	75.8	96.9	98.9	64.9	65.5	80.7
Fiscal Balance (as % of GDP)	0.34	-5.82	-5	-3.55	-7.4	-4.1	-1.3	-1	-3.6	0.59	-2.6	-2.5	7.8	-4.4	-2.8	-1.92	-4.1	-4.76
Gross Reserves (as % of GDP)	28.7	19	14.2	19.7	19.1	20.7	21.5	22.7	23.2	26.3	22.2	22.4	18.8	14	13.9	35.3	35.5	31.48

Source:International Financial Statistics (IFS), and Global Financial Stability Report (GFSR), The United States Agency for International Development (USAID) Partners for Financial Stability Program (PFS)

Regardless of the consequences of financial crisis it should be noted that theeconomy of the region suffers from serious macroeconomic imbalances. This is the reason why they are reflected primarily in higher budget deficit that generally increase domestic demand for foreign goods causing foreign trade deficitto rise. In particularly, to make matters worse, this crisis has significantly reduced the flow of cash flows to finance these deficits. Another sharp contrast between pre -crisis and crisis period relates to output dynamics and due to lower growth in GDP and export revenues. In the period of crisis the average GDP growth rate of Western Balkan countries has fallen while external debt to GDP in Albania is almost doubled. A detailed breakdown is presented in table 1 to show the results for the change in output and demand growth are presented in Table 1.

The economy's development in selected countries was particularly successful in the period between 2003-2007 when was dynamic growth in all basic sectors. The summary statistics on selected macroeconomic indicators in selected economies suggestus that consequences of the global crises demonstrated the growing unemployment, raise the cost of financing external debt, as well as fall of gross foreign exchange reserves (with the exception ofAlbania). Despite several years of enviable economic performance with annual growth rates averaging 5.5 percent in pre-crisis period difficulties began to emerge in 2009 culminating in recession. In comparison to theperiod of pre crisis (2003-2007) lower growth ratesare mainly recordedin crisis period, rising food prices and energy as well as decline in growth rate of real GDP. The inflation remained low in single digits despite current account imbalance and fiscal deficit increased(the exception was Serbia where inflation in 2008 accountedover 12percent). Except for Albania,all selected countries are surprisingly below their pre-crisis growth path.

In addition, the external position of these countries remains weak due to the large foreign trade deficit.Also, in 2009 with the exception of theAlbania all the rest countries of Western Balkan were facing with the recession and itsadverse effects.Althoughmany economieshave demonstrated moderate positive economic recovery and out of the crisis in 2010, something like that cannot be said for theeconomies of the Western Balkan countries.The weakening of economic activity is confirmedby foreign trade activities, reduction of foreign exchange reserves, rising unemployment and increasing fiscal deficit. In 2010, external debt in Croatia has risen since 2007 and exceeded 100percent of GDP.

Cross-country Comparison Analysis of Banking Systems

Establishing a stable and healthy financial system in Western Balkans had fundamental importance for the transition to market-oriented economies. However, time has shown that such a transition was difficult and arduous with many challenges that region has faced.

A sound macroeconomic environment is generally seen as a prerequisite for the dynamic development of a banking system in abovementioned region. In that sense, for many years the development of the banking sector in Western Balkans reflected the uncertain and fragile macroeconomic environment.

Significant changes in the economic environment on a global scale have been observed in early 2008, particularly during 2009. The latest financial crises considerably altered external economic environment for all six countries. The implications of the global financial crisis have demonstrated specific effects on the economy of the Western Balkans. Due to the reduction of external capital inflows and low accumulative capacity of the domestic economy, there was a shortage of resources for lending by commercial banks. In the foreground are banksbecause they occupying the largest share of the financial system. Commercial banks' share of total financial assets is at over 80%, measured by total assets. In other words, this means that banks are the dominant channel of trade finance and the economy. This indicates the huge importance that banksmaintain a prevailing position in the financial sector's structure in compared to other financial intermediaries that have on the overall economy of the region. The remaining market share was divided among the other financial intermediaries (investment fund, leasing companies, insurance companies, and pension funds) which market share is almost neglected. In other words, it confirms a fact that financial systems of the Western Balkan countries are bank-centric while the other financial markets in the Western Balkans, are still shallow, narrow and thin. This means that unless of banks there are only a few institutions that are able to adequately fulfill the role of financial intermediaries. The arguments that most important with aspect of this paper of course concerned banking efficiency in crisis period. The impact of the latest financial crises on banking of Western Balkan can be examined in the context of three key aspects: capital adequacy, asset quality and position of liquidity.

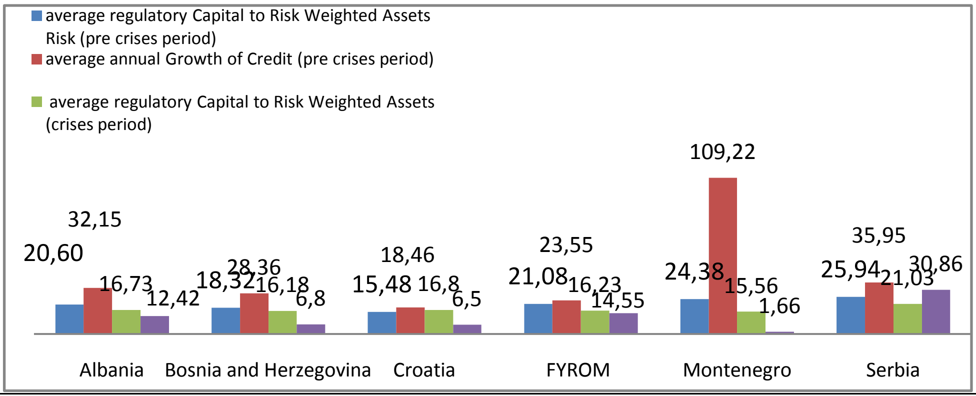
Capital adequacy

Despite the turbulence in financial markets the average capital adequacy ratio in the banking sectorof Western Balkans showed satisfactory results (figure 1). These relate primarily to the fact that the Capital to Risk Weighted Assets ratio during the entire reference period is higher than set by capital requirements. A cross-country comparison of some major capital adequacy indicators (Capital to Risk Weighted Assetsand Regulatory Tier 1 Capital to Risk-Weighted Assets) are presented in figure 1 and figure 2.As can be seem from figure 1 we can distinguish two groups of countries in terms of movement of capital adequacy indicators. Among group of analyzed countries Croatiais the only country showing progress in achieving increase the value of this indicator in the crisis period (2008 - 2010) than it was in late 2007. In the second group it can be included all the other Western Balkan countries that had relatively sharp declines in crises period relate to pre crisisperiod. Conservative prudential policy by the central bank and monetary authority ensured a well-capitalized, resilient banking system displaying high capital adequacy ratios. It is worth noting that, banks in the Western Balkan countriesheld at the end of 2010 average ratio of capital to risk weighted assets(CAR) at almost 15.6percent (Figure 1), that is significantly higher than set by capital requirements.[1]This capital adequacy indicator provided adequate protection against shocks originating in the domestic economy and the banking system.

Equally notable, however, it was the fact that recent years have witnessed speed of credit growth was not accompanied by additional appropriations adequate capital from banks and strengthening their capital base.One explanation is that poor asset quality implies the need for a greater degree creation of reserves against potential losses. Nevertheless, poor asset quality has a direct impact on the management of capital and the need for connection of additional funds to cover potential lossesor actual losses.Indicators of capital adequacy continue to gain importancein today's time, since it seeks to improve the banking sector's ability to maintain enough capital in order to absorb sudden loss.At the same time,banks operating in the market of Western Balkan have been stimulated to increase capital, due to the increase in the size of their balance sheet. As a result, the average capital adequacy ratio of the banking sector stood at19.05 percent in pre crises period, and 16.25 percent in crises period (see figure 1).

[1]Minimum capital requirements: Albania (12%), Bosnia and Herzegovina (12%), Croatia (10%), Macedonia (8%), Montenegro (10%), Serbia (8%).

Figure 1. Annual change of regulatory Capital to Risk Weighted Assets, 2003-2010



Source: The authors' elaborations on data: Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

In the pre-crisis period, annual average growth rate of credit of Western Balkan countries expanded at 41.28 percent while their post-crisis credit growth slowed down to 12.3 percent. In the period of crisis creditgrowth slowed down sharply in Bosnia & Herzegovina, Croatia, and Montenegro.By contrast, Serbiais managed to maintain extremely high rates of credit growth in the crisis period (average rate of credit growth was 30.86percent).

As shown in Figure 1, the ratio of average growth rate of creditand Regulatory Capital to Risk-Weighted Assets indicates that, in pre crisis period of high credit growth rates have not been adequately followed by increasing of capital ratios. Higher rates of credit growth should be followed and higher capital adequacy ratio, which was not the case in the Western Balkan.In particular, it was indicative at the end of the pre crisis period (2007), where average annual growth of credit was 52.24 percent. It was accompanied by a decrease of capital adequacy ratio (18.72 percent). The same explanation can be used to analyze trends in 2008, when the average growth rate was 23.74 percent (capital adequacy ratio of 17.1 percent), which ultimately increased the vulnerability of the banking sector.

Asset quality in the pre- crisis and crisis period

One of the most important problems of developing banks in the Western Balkans, which dates from the late 1990's, is the poor quality of bank assets, (i.e. high credit risk). Due to lack the rapid *development*of new *financial instruments,* banks are *relying* more on the traditional banking activities. At the same time, the quality of assets as a whole depended on the degree of credit risk involved in their business. The latest financial global crisis has left an indelible mark on the banking of Western Balkans.

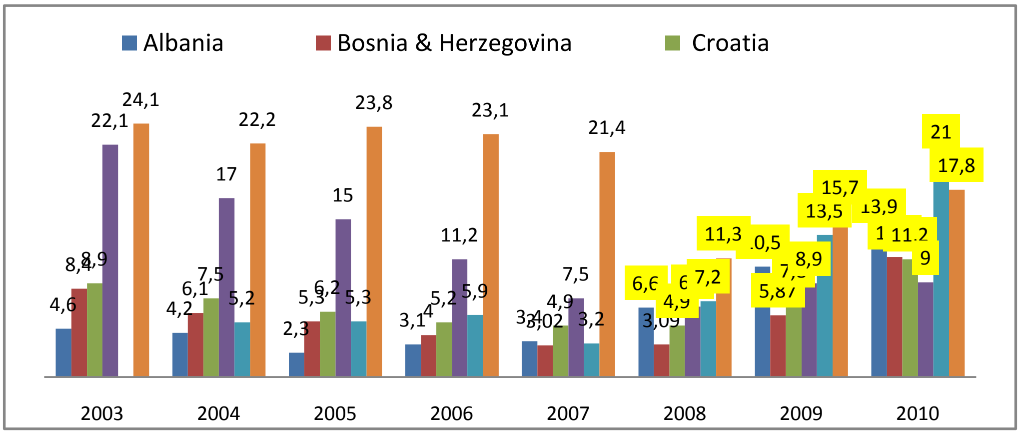
*As shown in Figure 3, the average ratio of NPL (non-performing loans) to totalloans for the 6 countries of Western Balkan increased from 7.23*percent *in 2007 to 14.5*percent *in 2010. This is the first significant increase in NPL ratio after more than ten years and period of banking reform began in the 1990s. In the pre-crisis period, the average rate of NPL in region of Western Balkan was significantly lower to 2001 with exception of the Serbia, which in over the period between 2003 to 2007 had NPL ratio of 22.92 percent. This means that in Serbia nearly of one fifth approved loans was uncollectible.These very high levels of NPLs have shown significant deterioration of loan quality.*

When we compare the results from figure 1 with the ones from figure 3 we see that in the years preceding the latest financial crisis were characterized by strong credit growth. In pre crisis period, NPLs ratios kept on falling substantially in all countries of Western Balkan. Recorded data on the movement of NPLs show that the banking system in the crisis period is facing major challenges in the process of preserving the stability of their banking system as a wholeand the stability of the entire economic system. Figure 2has shown how the ratio of NPLs in banks of region changed over time in comparison to pre crisis period.

The important point to take away from Figure 2 is that at the end of2010average ratio of NPLs for all six countries reached 10.45 percent of total loans.How uncollectible loans typically with a delay indicates problems in the banking system, it is evident that there was a decline of capital adequacy and increase credit risk.

In addition, strong growth in bank loans is limited by the ability of banks and banking supervisors to adequately assess the risks. This is particularly true for Serbia and Montenegro, and no less that there was no problem in Bosnia and Herzegovina Croatia and Albania.

Figure 2. Non-Performing Loans to Total Loans (in %) of banks in Western Balkan Countries, 2003-2010



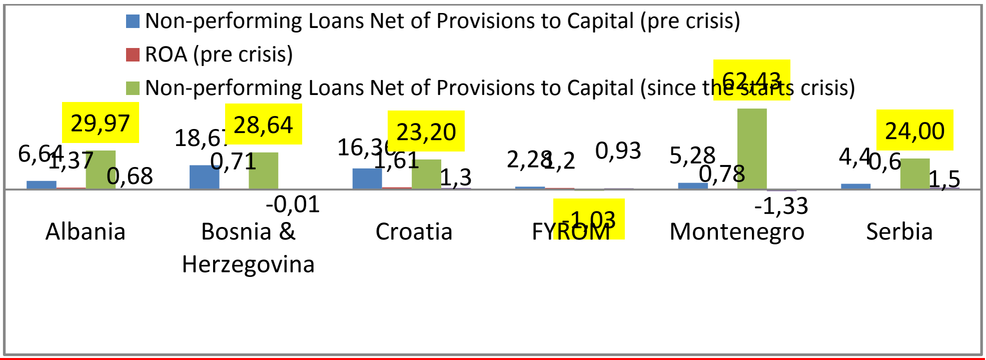
Source:the authors' elaborations on data:Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

There are several reasons that may explain these unfavorable trends. First, since the crisis began until the present lenders offered more loans to higher-risk borrowers, or customers with poor credit history.Secondly with a financial crisis there was a negative selection relation between asset allocation ability and selectivity of customers with poor credit history.Instead of quality projects, the funds are then channeled to the illiquid and even insolvent companies, making the economic crisis deepens and ultimately prevents the reduction of risks to financial stability.

Since provisions are a deduction from profits, increases in loan-loss provisions appeared to have a substantial impact on banks' profitability indicators (ROA and ROE). The increasing level of provisions reflects also the declining asset quality. Thanks to the increasing participation of NPLs and there was a significant increase in allocation of reserves to cover potential loan losses that had significant effect on earnings and regulatory capital.

Also from illustrateddata it can be noticed that pre crises period was mainly characterized by strong credit growth and low level of NPLs and specific provisions.However, with the change in general economic conditions ratio of Non-performing Loans Net of Provisions to Capitalalso deteriorated over the crisis period, from increased very rapidly (figure 3). Namely, the average ratio of non-performing loans (net of provisions) to capital for all selected countries increased to 8.93 percent in pre crisis period to a level around 27.87percent in crisis period indicating that banking sector recognizes poor asset quality.

Figure 3. Average value of Non-performing Loans Net of Provisions to Capital of banks in Western Balkan Countries, 2003-2010

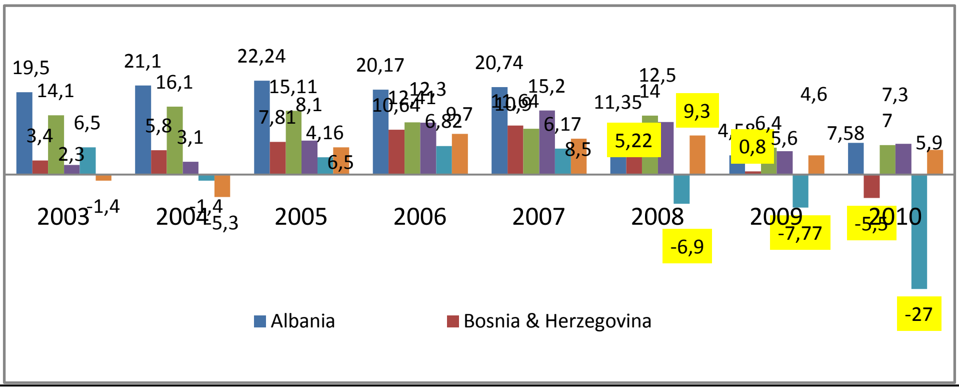


Source: the authors' elaborations on data: Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

Efficiency of the banking sector of the Western Balkan

Profitability of the bank is a key indicator of its business practices and efficiency. On the basis of profitability indicators it can be evaluated a significant improvement or deterioration in the efficiency of the banking sector. Larger share of net interest income in gross income of banks is an important indicator when evaluating the quality improvement and earnings stability. In the pre-crisis period, the rate of return on assets (ROA) and return on equity (ROE) in the Western Balkan countries recorded positive growth. As a confirmation it can be concluded in the pre-crisis period, the average rate of ROA was 1 percent and the rate of ROE of 9.67 percent.Figure 4 and 5 show that in Western Balkan countries earning indicators continue to weaken, as ROA and ROE worsened since the start crises. Thus, in the crisis period the average rate of ROA in the banking sector of the Western Balkans was 0.51 percent and the average rate of ROE of 3.05 percent.

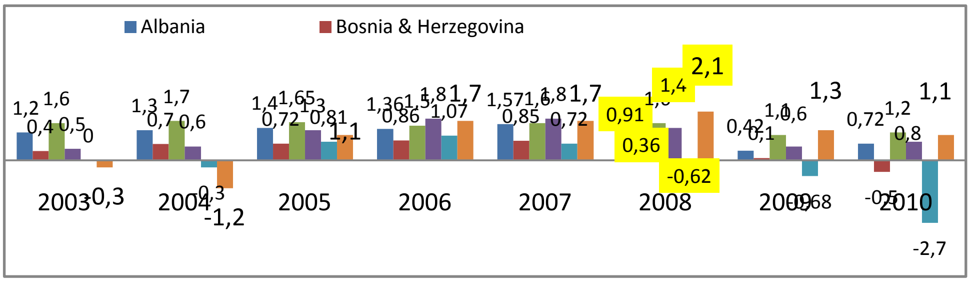
Figure 4. Return on equity - of banks in Western Balkan Countries, 2003-2010



Source: the authors' elaborations on data: Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

Decline in the profitability of the banking sector in the Western Balkan countries could be explained first with worsening of asset quality and increased banks' exposure to credit risk as well as increasing the allocation of provisions for credit losses. A significant deterioration in the quality of assets and directly affect the profitability of the banking sector, because there has been a reduction in bearing assets to total assets.

Figure 5. Return on assets of banks in Western Balkan Countries, 2003-2010



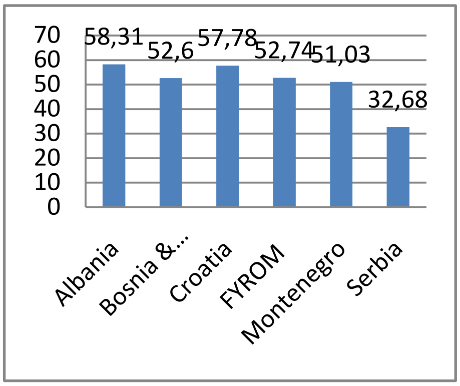
Source: the authors' elaborations on data: Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

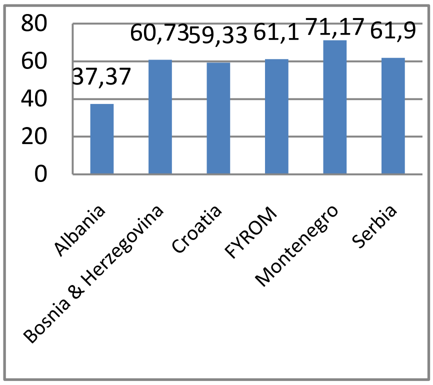
Excluding the banking sector of Bosnia and Herzegovina and Montenegro which in time of crisis remain unprofitable for other countries in the region a slight recovery had occurred in 2010 where indicators of profitability has been rising since the beginning of the global financial crisis.This conclusion can be drawn observing the movement of profitability indicators in Figure 4 and 5.

Net interest margin remains the main source of banks' profits, and has been almost stable with respect to total loans. The share of interest margin to gross income in the period before the crisis was of over 50percent except Serbia where the value of this ratio was 32.68 percent (figure 6 and figure 7).

The below trends also may indicate that thebanks are mainly engaged in credit transactions, as part of the off-balance sheet operations, while business from other services have becomeless profitable.

Figure 6. Average Interest margin to gross income, 2003-2007Figure 7. Average Interest margin to gross income, 2008-2010





Source: The authors' elaborations on data: Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

Adecline of growth in interest-earning assets was mainly caused by absence of high-quality resources of the banks. The adverse movement in interest rates in financial market contributed to the decline in profitability of the banking sector in the crisis period, while another reason lies in the fact of continued deterioration in the indicators of cost efficiency. In addition, a positive trend in profitability in the pre-crisis period and the movement of general business performance of the banking sector led to the reduction of risk and the attracting new capital into the banking sector.The sharp decline in key indicators of the profitability of the banking sector in the Western Balkan began since 2008 is the result of adverse recent trends: (i) a slowdown in credit growth, (ii) deterioration in the quality of loans and (iii) increase the risk premium. As a result, banks found it difficult to raise funds in the interbank market at higher interest rate than in past.

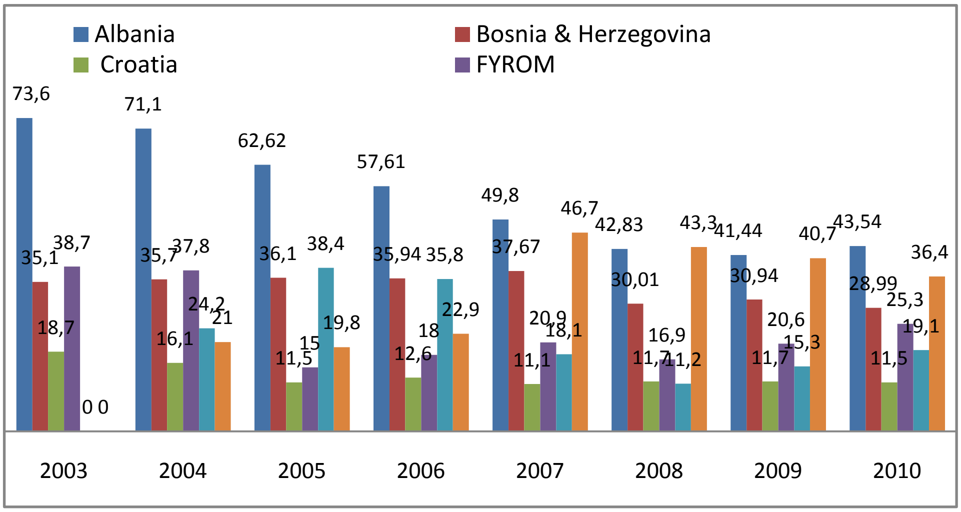
Position of Liquidity

Position of liquidity is one of the most obvious signals in terms of possible financial disorder and (in) stability of the banking sector. Bank's liquidity policy is the direct result of the overall policy formation in the balance of the financial resources of the bank. As the transmission of signals from the global crisis on local financial markets first manifested through a crisis of liquidity, an important impression on the stability of the banking sector is its liquidity position.

As it can be seen from Figure 8 the average share of liquid assets in total assets of banking sector in the Western Balkans in pre-crisis period was 32.64percent and in crisis period was 26.74percent. Although the banking sector experienced a drop in liquidity in crisis period things should not be generated. Thus, for example, the banking sector in Albania and Serbia is managed to maintain banking sector liquidity (average share of liquid assets to total assets is over 40percent), while banking sector in Croatia and Montenegro had very little participation share of liquid assets in total assets, 11.63percent and respectable 15.2percent (average).

Under the influence of withdrawal deposits from banks and adverse effects from the financial markets, economy has become increasingly vulnerablein these two countries.

Figure 8. Liquid Assets to Total Assets of banks in Western Balkan Countries, 2003-2010

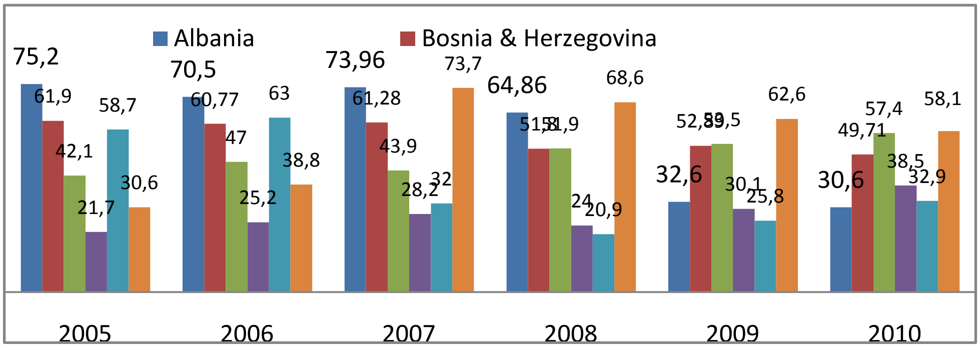


Source: the authors' elaborations on data: Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

Similar to the previous indicator, in the same reference period, a positive trend was recorded with coverage of short-term liabilities by liquid assets. The liquidity of the banking sectors of countries of the region remains good, with sufficient coverage of short-term liabilities by liquid assets (figure 9).Although, generally speaking, the average value of this indicator for selected countries in the region declined in the crisis period to 44.96 percent (in pre crisis period ratio of Liquid Assets to short term Liabilities was 50.6 percent) it could be concluded that banks are not excessively exposed to liquidity risk.

The exception of this is Montenegro where is value of this indicatorin the crisis period almost halved compared to the end of 2007. Another notable exception is Albania, where is the ratio decreased in the same period, with 73.96 percent to 42.68 percent.

Figure 9. Liquid Assets to short term Liabilities of banks in Western Balkan Countries, 2003-2010



Source: the authors' elaborations on data: Global Financial Stability Report (GFSR), Partners for Financial Stability Program (PFS), Central bank annual reports.

It may be concluded from these results and developments of this ratio that in spite of a challenging environment prevailing during crisis period, the banking sector cannot be considered endangered.

Conclusion

At the end of this comparative analysis the question is: what such an analysis can provide? That was done several years ago it would show that the banking sector of the Western Balkans is stable and resistant to sudden disturbances. But done today it shows how the banking sector in the region is vulnerable. It also showed that the rate of credit growth accelerated wear a serious threat to macroeconomic and financial stability. The latest financial crisis although not in the same measure has affected all banking sectors in Western Balkans. This is proven by the fact that excluding the banking sector of Bosnia and Herzegovina and Montenegro which in time of crisis remain unprofitable for other countries in the region a slight recovery had occurred in 2010.

If we consider the trends manifested in times of crisis it may be noted the following:

- It is noted the deterioration in asset quality of banks and rising NPLs as a result of an extremely high rate of credit expansion inpre-crisis period. Analyses made for 2010 show that average ratio of NPLs for all six countries reached 10.45 percent of total loans.
- Despite the turbulence in financial markets the average capital adequacy ratio in the banking sector of Western Balkanis higher than set by capital requirements. Although speed of credit growth in previous years has not been accompanied by additional appropriations adequate capital from banks and strengthening their capital base where it is ultimately increased the vulnerability the banking sector of Western Balkan.

Current changes in the transition process lay the foundation for the acceleration of reforms as well as in implementing key structural and governance reforms in the medium term. Significant presence and accumulation of bad loans in the bank's balance-sheets was the most striking example of the adverse effects of the global financial crisis. In recent years, the quality of loan portfolios has deteriorated significantly due to weak management's ability to control credit risk and collection of loans. It has also resulted in a deterioration of financial discipline and accountability to shareholders and the public.Since that implementation of Basel 2 has been already in the initial stage in these countries it should begin immediately with its implementation inthe near future. Looking at the conditions and operation of the banking sector in the Western Balkans it can be concluded that banks must continue to adapt stronger capital and other prudential standards, while it is expected from the government to create a better market environment. The most important features of such market environment that is necessary in the near future are: maintaining macroeconomic and financial stability, consistent with the protection of depositors, need for strengthen the capital base of banks in terms of capital adequacy requirements and establishing an effective system of supervision of management.

In order to get a clear picture of the resistance of the banking of Western Balkans and asses its exposure to credit risk it would be useful in the future studies to make a simulation of profits and losses of selected banks in selected countries under stressful conditions.Regards to that I would recommend anyone who is interested in researching to prepare studies that included stressful conditions and adverse macroeconomic scenarios to indicate which particular bank can pose potential threats to the stability of the banking sector of Western Balkan

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