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SERBIAN BANKING SECTOR AND ITS FINANCING THROUGH FDI

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Abstract**—**Serbian economy experienced significant deterioration in macroeconomic sphere observing last two decades. In a period of global financial crisis, some structured problems that occupied Serbian economy in previous period were emphasized to broader extent. Banking sector in Serbia also passed through significant structural changes in the last decade. Although there are many improvements in banking operations and their regulations, there are also unsolved problems accompanied with non-performing loans, uncertainty on global financial markets and high exposure to operational risks, which are the subject of the analysis in the first part of the paper. Besides, important feature of Serbian banking industry is its financing through foreign direct investments. Together with the rise of foreign direct investments into the country, during the first decade of this century, there was upward trend of FDIs in the financial sector. With the liberalization of investment flows and opening the country to foreign capital inflows and also with the significant reforms in the banking sector of Serbia, there was a growing inflow of foreign direct investments in the banking industry of the country. Local banking sector has become increasingly financed by investments of foreign banks. This fact and its accompanied issues regarding a predominant role of foreign-owned banks in the banking sector of Serbia are the subject of the analysis in the second part of the paper.

Keywords**—**banks, financing, foreign direct investments, non-performing loans (NPLs), operational risk.

I. SERBIA: MACROECONOMIC WRAP UP

SERBIAN economy, among the other emerging countries, experienced significant deterioration in macroeconomic sphere observing last two decades. Simultaneously, crisis in economy was transferred to crisis of whole society, involving the core standards of each civilization impersonated in respecting of ethic standards. Direspect of ethic standards and crisis of whole society has a direct consequence on losing of confidence in institutional measures and currently accepted economic policy. Abovementioned circumstances create an atmosphere of unbelief and consequently slow down the recovery of already weak Serbian economy. As economic and financial collapse could not be analyzed separately, it is imperatively needed to conduct complementary analysis in terms of their inter-condicionality and interdependency.

Certainly, the reasons for Serbian crises partially lie on the ground of 2008 global financial crisis, but subscribing the blame for internally generated problems and cumulated negative effects solely to crisis is too biased approach. In a period of global financial crisis some structured problems that occupied Serbian economy in previous period were emphasized to broader extent. Inefficency in their resolution has a negativne influence on the level of competitiveness of Serbian economy. Thus, as per World Economic Forum "The Global Competitiveness Report for 2012-2013" (World Economic Forum, 2012), Serbia is ranked at 95th place among 144 countries with total competitiveness index of 3.87.

Even worse situation is if we observe subindexes in different pillars defined by World Economic Forum. In the area of macroeconomic environment Serbia is 115th ranked, whilst it is 100th ranked in the field of financial market development. Inflation stood as one of the major problems as Serbia is ranked on 129th place with annual inflation rate of 11.2%, whilst in the area of government debt, Serbia is 92nd ranked. In the financial area, Serbia is ranked on poor 119th place regarding soundness of banks criterion. Massive changes in economic policy are needed in order to make progress in the level of competitiveness of Serbian economy. Also, the level of competitiveness is closely related to country's credit rating: according to Standard and Poor's and Fitch rating agencies, Serbia has BB- country rating with negative outlook, which could not be assessed a good starting point for recovery of distressed economy.

At the end of 2012, Serbian government introduced a set of fiscal consolidation measures, for the main purpose of discouraging further increase of budget deficit. Major changes were following:

- value added tax (VAT) is increased from previous 18% to 20%,
- tax on capital gains is revised from 10% to 15%,
- corporate income tax rose from 10% to 12%.

Introduced measures have to take effect in 2013 and following years regarding narrowing budget deficit in relation to GDP. According to latest information, after finished talks with IMF Mission which started on May 8, 2013, saving measures need to be taken immediately and they should include at least freezing state controlled salaries and pensions. Also, IMF states that if nothing is done on the fiscal consolidation, by the end of 2013 the budget deficit will reach 8% of the GDP and public debt will be at more than 65% of the GDP. IMF also said that monetary easing can only be contemplated after the fiscal situation is stabilized. State owned banks should be restructured or shut down and pension and labour reforms should be initiated. According to IMF officials' assessment, the financial system in Serbia is stable.

Furthermore, Serbia may discuss a possible new precautionary loan agreement with the IMF after the EU begins membership talks with Serbia. In Serbia is expected that a sudden inflow of foreign direct investments after the date of accession talks is granted (decision date June 28th) would reverse the negative trends throughout Serbia's ailing economy. Deep recession in eurozone with its impact on emerging countries represents additional ballast for Serbia. In that sense, it is crucial for Serbia to successfully finish talks with IMF Mission. It would make better reputation and return confidence in the "eyes" of foreign investors. It is also a matter of credibility on macro level followed by adequate credit rating. Inversely, if talks with IMF Mission do not bring desired effect, it would have negative reputation and bring more concerns about future developments. Consequently, it would be an uthopia to consider Serbia as a country attractive for foreign direct investment and with credible rating in international framework.

II. MAIN ISSUES IN SERBIAN BANKING INDUSTRY

Traditionally, in Serbia banking sector has above-average performances in comparison with global country's economy. In the last decade, banking sector in Serbia pass through significant structural changes out of which the most important are: decreased number of banks on the market (from 43 in 2004, to 32 at the end 2012); decreased share of banks with majority state ownership, i.e. increased share of banks with majority capital from eurozone countries; mergers and acquisitions between several banks (state-owned and private foreign banks) as well as banckruptcy and liquidation of some banks due to irregularity in business. Period of high expansion in banking industry (from 2005 to 2008) were followed by the growth of activities (more than 30% annualy) which was accompanied with larger risk exposure. After 2008, banks adjusted their business operations to changed macroeconomic environment, which have lead to modest growth rates in comparison to pre-crisis period. The focus from high growth rates were redirected on improvement of internal efficiency and reorganizations which resulted in decreasing number of employees and organizational units.

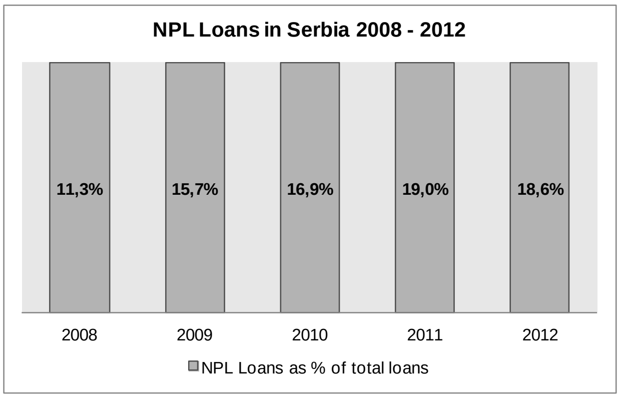
According to main performance indicators, Serbian banking sector is stable in comparison with other markets from the region. It is very liquid, considering both liquid indicators, which are defined at threshold of 1 (monthly liquidity ratio) and 0.7 (narrow liquidity ratio). Namely, average monthly liquidity ratio in last quarter of 2012 reached 2.08, while average narrow liquidity ratio stood at 1.58. No bank had liquidity problems which is primarily the result of restrictive monetary policy conducted by National bank of Serbia. The sector is well capitalized, with capital adequacy ratio of 19.9% while minimum being 12%.

Capital adequacy ratio determines the bank's capacity to meet the time liabilities and absorb risks such as: credit risk, operational risk, market risk etc. Defining and monitoring of capital adequacy ratios is important because of maintaining confidence in banking system. In a whole period between 2008 and 2012, capital adequacy ratio is significantly above the proscribed level and at the end of 2012 amounted 19.9%. With achieved average RoE of 4.65%, banking sector is still far from pre-crisis values results. Still, it should be emphasized visible difference between banks "losers" and banks "gainers". In 2012, total loss of banks made more than 30% of achieved result of profitable banks indicating that successful banks absorb the losses of bad banks, in order to maintain the stability of the whole sector.

However, almost idyllic picture of healthy banking sector is undermined with high exposure to credit and operational risks. The most prominent indicator of credit risk exposure is high level of non-performing loans (NPLs). At the end of 2012 they reached 18.6% of total granted loans, with significant effects on realized financial result. NPLs have continuously increasing trend in observing period 2008-2012, excluding period 2012 vs. 2011. Explanation for decline in that period lies in a different statistical treatment of NPLs mainly related to two banks (Agrobanka and Razvojna banka Vojvodine) which were in the center of media due to losing license because of operational irregularities. Analyzing available data, it could be pointed the NPLs were at the level of 20% or even more, meaning that each fifth loan was delinquent. Furthermore, quality of credit portfolio is worsened, indicating not so "healthy" banking sector.

Figure 1 clearly shows periods in which NPLs level declined (i.e. the end of 2012), but the decrease was not conseqence of systemic resolution of NPLs, it is rather the outcome of write-offs and „cleaning"consolidated bank's financial statements after affairs with state-owned banks: Agrobanka and Razvojna banka Vojvodine. Outstanding high level of NPLs (often, very close to 20%) for small economies like Serbian, represent large threat for future survival of the country.

Fig. 1. NPLs in Serbian banking sector from 2008 – 2012 [3-7]



On the long-run outstanding level of NPLs is not sustainable due to their direct connection and impact on bank's capital. Each NPL could be treated as a „picture in the mirror"of real sector stability. The process of economic recovery implies „cleaning" in bank's financial statements with simultaneous decreasing amount of NPLs. Maintaining NPLs on current level and applying deffered measures for their resolution lead to unproductive pooling of capital in non-profit sectors, neutralizing further economic growth and lowering level of economic efficiency. NPLs increase bank's loan loss provisions in the future, directly diminishing financial result and decreasing available funds for granted of new loans.

In a process of "creation" NPLs banks have large responsibility. In order to save large and important clients, banks caused detorioration in credit portfolio quality. Applied restructuring plans solved liquidity problems of clients on short-run but it is not a sollution of structured problems for companies and whole economy. Basic problems which are major cause of company's insolvency and illiquidity are not solved and economic activity was not recovered. It was created mechanism in which banks were not capable to collect their claims, while clients faced with liquidity problems were not willing and capable to fulfill their obligations toward banks, tightening maneuver space for all market participants. (Mirkovic & Knezevic, 2013)

Solving the NPLs problems is accopmained with several drawbacks in legal, regulatory and tax issues. Banks recognized the importance of updated reporting regarding NPLs balance, so they are disciplined in the area of changing internal procedures and policies in order to indentify NPLs in earlier stage. Simultaneously, top management of the bank and risk management sector closely cooperate in order to maintain (or, if it is possible, improve) the quality of credit portfolio. Top management is responsible for appointment of independent "work-out" units, which are specialized in NPLs treatment and resolution. It is very challenging to create "work-out" unit with qualified human resources with enough experience, due to fact that those units are relatively new in emerging countries.

Considering inherent uncertainty on global financial markets, banks should carefully plan resolution of NPL issue. In that process, banks usually try "friendly" approach, in order to provide at least partially collection of debt, after negotiation with debtors and debt restructuring. Cooperation with debtors is important starting from the moment of first overdue installment, when it is not late to make a little change in amortization repayment plan, and the loan could be classified as a part of regular bank's credit portfolio, not as NPL. The key element is normalization of debt repayment by client.

National bank of Serbia, as the central monetary body, at the end of 2012 made amendments to the Decision on Risk Management by Banks and the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items. Changes were done in order to create prerequisites for more efficient resolution of NPLs. According to proscribed measures, claims could be resigned to entities that do not have headquarter in Serbia, to enities which are not prevailingly in financial sector and to related parties of the bank. Also, bank could start with debt restructuring for those clients which have a chance for survival; bank could use mortgages as a collateral when the client is overdue more than 720 days and according to internal procedures, banks could assess creditworthiness of client, respecting specifics of each client.

The second undermining factor of stability in Serbian banking industry is high exposure to operational riks. Main drivers of operational risk are coming from external factor and risk events inherent to weaknesses of internal processes and procedures. This confirms case of scandal and collapse of state-owned Agrobanka in 2011, with total loss of 300 million EUR and of Razvojna banka Vojvodine in 2012! High level of NPLs and weak collaterals caused undercapitalization of the bank which leads to catastrophic loss for the market such as Serbian. Investigations confirmed that majority of problem loans were approved to related parites based on false or forged documentation usually indicating that the loss and later on bancrutcy of the bank was caused by high exposure to operational risk that was transferred to credit risk.

Moreover, in fraudental activities management of the bank was involved which was additionally awarded by bonus system for achieved performances in previous period. That confirms high correlation between bonus system and moral hazard problem as a source of operational risk. Management greed for profit and personal gains exposed bank to higher risk and in a final instance caused the liquidation of the bank. This example clearly emphasizes inadequate risk management process, which is in line with definition, typical cause of operational risk. Example of Razvojna banka Vojvodine is very similar to case of Agrobanka, with risk generator impersonated in moral hazard. Resolution of two major obstacles in a process of stabilization in banking sector: NPLs and operational irregularities, with additional effort of central bank in order to meet regulatory requirements in process of harmonization with European Union (Basel II, Basel III) represents the most important challenges in future development.

III. THE ROLE OF FDI IN SERBIAN BANKING SECTOR FINANCING

One important feature of Serbian banking industry is also its increased financing through foreign direct investment (FDI). The role of foreign direct investment as a form of financing of Serbian economy has grown significantly since the beginning of the century. Growing since 2001, FDI inflow in Serbia reached its record level of 4.2 billion USD in the 2006, when Serbia became a country of Central and Eastern Europe with the highest foreign direct investments. After this year, FDI inflows in Serbia recorded a four-year decline by 2010, to a level of 1.1 billion USD. It was the result of both macroeconomic and institutional circumstances and also slowing of privatization process (which was the main reason for attracting FDI inflows in Serbia) and the negative impact of the global financial crisis (Stojadinović Jovanović, S., 2012, p. 172). There was a recovery in the 2011 to 2.5 billion USD, but followed by a drastic decline to 0.3 billion USD in the 2012. The average value of FDI inflows in the period 2010-2012 is significantly bellow the average value of the previous three-year period 2007-2009 and especially below recorded level in 2006.

Table 1. FDI inflows in Serbia [3-7,8]

Years	FDI Inflows (in million USD)
2000	50
2001	165
2002	475
2003	1.360
2004	966
2005	1.550
2006	4.264
2007	2.523
2008	2.718
2009	1.865
2010	1.157
2011	2.562
2012	302

Together with the corresponding rise of foreign direct investments into the country, during the first decade of this century, there was upward trend of FDIs in the financial sector. With the significant foreign direct investments increase since 2004, the sector which was largely being financed by foreign direct investments in period 2005-2008, became a financial intermediation. This was particularly pronounced in the 2006, when the financial intermediation accounted for more then 1/3 of the total FDI inflows into the country (Central bank of Serbia, 2013). In this way, a trend that has characterized the global foreign direct investments flows, meaning their orientation in the service sector and within it, in the financial services, is also present in the Serbian economy (Stojadinović Jovanovic, S., 2013). In recent years, despite the decline of FDI inflows in 2011 and especially in 2012, financial and insurance activities have also been among the leading sectors (third sector in order) financed by foreign direct investment, after manufacturing and trade (Central bank of Serbia, 2013).

The major sources of funding in Serbian banking sector have been investments of financial institutions and banks from neighboring countries. Thus, on the Serbian banking market, the National Bank of Greece has privatized the Vojvodjanska bank, Hungary's OTP Bank Zepter Bank, Greece's Alpha Bank Serbian Jubanka, while Italian bank Intesa Sanpaolo has done acquisition of local private Delta bank. These four banks, i.e. their investment in the Serbian banking sector have been among the 20 largest investments undertaken in Serbia in the previous period. It can be observed that foreign banks have applied mainly acquisitions i.e. takeovers of domestic banks as a method of entering the Serbian banking market.

With the liberalization of investment flows and opening the country to foreign capital inflows and also with the significant reforms in the banking sector of

Serbia, especially in the period 2001-2003, there was a growing inflow of foreign direct investments in the banking industry of the country. Local banking industry has become increasingly financed by investments of foreign banks.

Gradually it has come to a predominant role of foreign-owned banks in the banking sector of Serbia. Number of majority-owned foreign banks, in the period 2004-2012, increased from 11 to 21 (Central Bank of Serbia, 2013). In the same period, the share of foreign banks in total banking capital of Serbia has increased from 19,7% to 75,3% (Central bank of Serbia, 2011) and consequently the national banking sector is becoming flooded with foreign banks.

The ownership structure of the Serbian banking sector is dominated by foreign banks. Their share in the balance sheet sum of the banking industry of Serbia in 2006 reached even 80% (Central bank of Serbia, 2008), while in the next period it has been at a level of 73%, and in 2011 it reached 74,1%. The share of locally owned banks is much lover, and among them the share of those that are state owned are 17,8% while those that are privately owned only 8,1% (Central bank of Serbia, 2011). So that nowadays the foreign-owned banks prevail and govern the banking sector of Serbia.

Selected features of banking sector of Serbia (Table 2) shows that nowadays in banking industry of Serbia there are 32 banks currently operating, of which 21 are foreign-owned, that is almost 2/3. It can be observed the predominant role of foreign banks in the banking sector of Serbia, accounting for 74% of total banking sector assets and also 74% of total banking capital. There are also a great number of employees (more than 20.000) in the foreign-owned banks, accounting for 72% of all employees in the banking sector of Serbia.

Table 2. Selected features of Serbian banking sector [3-7]

Serbian banks	Number of banks	Assets		Equity		Employees	
		in RSD billions	%	in RSD billions	%	in RSD billions	%
Domestic-owned banks	11	716	25	154	26	8.002	28
State	8	522	18	93	16	6.930	24
Private	3	194	7	61	10	1.072	4
Foreign-owned banks	21	2.164	75	437	74	20.392	72
Italy	2	657	23	136	23	4.142	14
Austria	3	449	15	102	17	3.656	13
Greece	4	426	15	88	15	5.267	20
France	3	287	10	46	8	2.698	9
Other	9	345	12	65	11	4.629	16
Total:	32	2.880	100	591	100	28.394	100

Serbian banking sector financing through direct investments is made most by the investors from the neighbour countries, EU countries and countries of the Central and Eastern European region, but also from some distant countries. Among them, the most important foreign-owned banks, regarding a share of total assets and capital in Serbian banking sector, originate from Austria (where it comes from Erste Bank, Hypo Alpe-Adria-Bank and Raiffeisen bank), Italy (where it comes from Banca Intesa and Unicredit Bank), Greece (where it comes from Alpha Bank, Eurobank, Piraeus Bank and National Bank of Greece) and France (where it comes from Credit Agricole Bank, Findomestic Bank and Societe Generale Bank). (Central Bank of Serbia, 2013)

In this way financing of domestic banks through investments undertaken by large foreign banks has led to a rise in foreign-owned banks in the banking sector of Serbia. Thither to foreign-owned banks, with a number nearly twice as much as locally owned banks, account for overwhelming part of total assets, total equity and total number of employees of the banking sector in Serbia and have the prevailing role on the Serbian banking market.

IV. Conclusion

Banking industry in Serbia is one of the most propulsive industries in both periods: pre-crisis and post crisis period. Certainly, global financial crisis and internally generated crisis in Serbia influenced on all segments of the economy, as well in banking industry. Those impacts did not jeopardize stability of the banking system, taking into account liquidity and capital adequacy. Major issues that are considered as a threat for banking system stability are: large presence of non-performing loans in bank’s portfolio and negative reputation for banks which mostly take origin from arisen operational risk inherent for banks. Main efforts banks should focus on resolution of those two issues simultaneously with harmonization of policies and procedures in banking sector in accordance with generally accepted principles within European Union impersonated in Basel Accords. Central bank of Serbia, as a key regulatory body, is responsible for stability of banking sector and implementation of Basel requirements in banks. Completing this process in effective way will make possible maintaining the stability of whole banking system and bringing Serbian banking sector close to European Union standards.

It can be also observed that the financial sector of Serbian economy is characterized with important role of foreign direct investments as a source of financing. Especially banking industry appears as an important receiver of foreign direct investments. During the whole former period this sector was among the leading recipients of foreign direct investments and in some years it has been the top receiver of foreign direct investment inflows in the economy. Financing of local banks through direct investments undertaken by large foreign financial institutions has led to a rise in foreign-owned banks in the banking sector of Serbia, whose number has almost doubled. Their number is nearly twice as much as locally owned banks, and they nowadays account for almost 2/3 of the total number of banks in the banking sector of Serbia. Foreign-owned banks account for overwhelming part of total assets, total equity and total number of employees of the banking sector in Serbia, which lead into the prevailing, dominant role of foreign-owned banks on the Serbian banking market.

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