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FINANCIAL SECTOR ASSESSMENT

BOSNIA AND HERZEGOVINA

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A joint World Bank and International Monetary Fund team visited Bosnia and Herzegovina during October 29–November 18, 2014 to conduct an assessment under the Financial Sector Assessment Program (FSAP)[1]. The mission assessed financial sector risks and vulnerabilities, assessed the quality of financial sector supervision, evaluated financial safety net arrangements, financial inclusion, the insolvency and creditor rights regime, deposit insurance, corporate financial reporting, capital markets and public bank governance.

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GLOSSARY

AMC	Asset Management Company
AML/CFT	Anti-money laundering/combating terrorism financing
BARS	Banking Agency of the Republika Srpska
BCBS	Basel Committee for Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BiH	Bosnia and Herzegovina
BLSE	Banja Luka Stock Exchange
BU	Bottom-up
CAR	Capital Adequacy Ratio
CBBH	Central Bank of Bosnia Herzegovina
DBFBiH	Development Bank of FBiH
DIA	Deposit Insurance Agency
DIF	Deposit Insurance Fund
EBIT	Earnings before Interest and Taxes
ELA	Emergency Liquidity Assistance
FBA	Banking Agency of the Federation of BiH
FBiH	Federation of Bosnia and Herzegovina
FedSC	Securities Commission of Federation BiH
FMI	Financial Market Infrastructure
FSA	Financial Sector Assessment
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Fund
FSSA	Financial System Stability Assessment
FSC	Financial Supervision Committee
GDP	Gross Domestic Product
GFAP	General Framework Agreement for Peace
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance supervisors
ICP	Insurance Core Principles
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IRBRS	Investment Development Bank of RS
ISA	Insurance Supervision Agency
ITA	Indirect Taxation Authority
KPI	Key Performance Indicators
LCR	Liquidity Coverage Ratio
LOLR	Lender of Last Resort
MaPP	Macroprudential Policies
MCC	Microcredit Companies
MCF	Microcredit Foundations

MCO	Microcredit Organizations
MoF	Ministry of Finance
MoJ	Ministry of Justice
MoU	Memorandum of Understanding
MTPL	Motor Third Party Liability
NIIP	Net International Investment Position
NPL	Nonperforming Loan
NSFR	Net Stable Funding Ratio
P&L	Profit and Loss Statement
P&A	Purchase and assumption
PIF	Private Investment Fund
QIS	Quantitative Impact Study
ROE	Return on Equity
ROSC	Report on the Observance of Standards and Codes
RS	Republika Srpska
RSSC	Securities Commission of Republika Srpska
RTGS	Real-Time Gross Settlement System
SASE	Sarajevo Stock Exchange
SBA	Stand-By Arrangement
SCFS	Standing Committee on Financial Stability
SME	Small- and Medium-sized Enterprise
SPV	Special Purpose Vehicle
SOE	State Owned Enterprises
TD	Top-down
VI	Vienna Initiative

INTRODUCTION AND KEY RECOMMENDATIONS

Bosnia and Herzegovina (BiH) is still dealing with the aftershocks of the global financial crisis that have weakened financial sector asset quality and profitability. In the wake of the global financial crisis, real growth has remained sluggish and domestic demand is held back by stagnant wages, high unemployment, and uncertain economic and political environment. System-wide NPL ratios stood at 15.5 percent (ranging from 6 to 58 percent) at end-June 2014, reflecting not only the impact the crisis had on the region but also lax credit lending policy. Bank governance problems, related party loans and inadequate corporate resolution and insolvency frameworks are obstacles to addressing asset quality problems and re-establishing bank profitability. As a result of the slowdown in foreign funding, banks have become more reliant on domestic funding sources. The institutional fragmentation is delaying some of the needed financial sector reforms.

System-wide solvency and liquidity indicators appear broadly sound, but significant pockets of vulnerability exist among domestically-owned banks. The financial system is dominated by banks with a large presence of foreign subsidiaries. While declining, notable cross-border exposures exist. A number of domestically-owned banks are struggling to meet capital requirements, while some others rely on quasi-fiscal support. The authorities have used public sector institutions to provide liquidity and capital support to the weak institutions. Stress tests indicate that those banks have large concentration risks and low liquidity ratios.

Banking and insurance oversight have improved since the 2006 FSAP, but a number of important shortcomings in some segments remain. Cooperation among the various oversight institutions is complex, having potential repercussions in times of stress. Lack of adequate governance and risk management has contributed to the current number of problem banks. The administrative powers of the agencies to sanction and fine supervisory board members and significant owners are inadequate. Moreover, the identification of ultimate beneficiaries of banks is problematic and related party lending and group exposures cannot be fully identified. The insurance sector is small and a number of insurance companies have thin solvency margins. The prudential framework for the insurance sector follows Solvency I, which is not risk sensitive. Consumer protection and financial literacy in the insurance industry are weak.

Decisive and immediate actions to deal with weak banks are critical for preserving financial stability. The authorities are advised to develop, as a matter of high priority, a comprehensive strategy to either facilitate the recovery of these banks (if practicable) or implement a cost-effective resolution consistent with maintaining the stability of the financial system and protection of insured depositors. The timetable for the diagnostic and strategy to address the potential implications needs to be spelled out clearly and effectively communicated. A credible and transparent public backstop may be needed to deal with systemic cases.

Going forward, the financial safety net needs to be strengthened. The creation of resolution authorities with comprehensive powers, appropriate resolution tools, and temporary and limited emergency liquidity—within the currency board arrangement—will be the key pillars to support the resolution of troubled banks and provide liquidity to solvent but illiquid banks. The deposit insurance system is largely compliant with international standards. Shortening the payout period by bringing

the pay-out date in line with the EU relevant directive, will further support financial stability. Well coordinated contingency planning—both domestic and cross-border—are also essential to building an effective financial safety net. A macroprudential framework should be established, underpinned by broader and more focused cooperation among the relevant agencies.

Financial sector development in microfinance and leasing is constrained. Increased transparency and disclosure of information could help foster responsible access to finance, especially for underserved segments such as women and bottom 40 percent of income earners. To enhance leasing operations as an alternative for firms with limited collateral or credit history, taxation disincentives should be removed, collateral requirements revisited, and repossession of assets made more effective. Easing corporatization requirements for microcredit foundations, with better market discipline through strengthened supervisory and enforcement tools, will improve the environment.

The legal framework governing creditor/debtor relationships is comprehensive, however neither debt resolution, businesses reorganization or bankruptcy liquidation work effectively. There is a need to streamline execution procedures, introduce tools and incentives to facilitate corporate debt restructurings and resolution, and adopt out-of-court restructuring guidelines. The institutional framework could be further improved through hiring more commercial court judges with appropriate experience and improving the regulation of the insolvency profession.

Capital markets are small but with significant potential. The legal and regulatory framework is sound and the securities market infrastructure well developed. However, closer cooperation between the entities is essential. Introducing an EU style 'passporting' framework, an electronic link between the two exchanges, and formation of an association to enhance coordination on regulatory matters is important. To restore investor trust, legislation for transformation of legacy closed-end PIFs to open-ended funds should be introduced.

The financial reporting framework has improved recently and is substantially aligned with the *acquis communautaire* and harmonized between the two entities. The implementation of IFRS for SMEs has proven successful in the RS and should be expanded to all SMEs. Current monitoring and enforcement arrangements do not ensure the quality of financial statements. Further concerns stem from downward pressures on statutory auditor fees, rapid rotation of auditors and their late appointment.

Governance processes of state-owned banks reveal a number of concerns. There is a need to further strengthen the supervisory board selection process and internal audit functions of state banks. The Development Bank of the FBiH is only partially supervised by the FBA. Specific strategies and exit plans for the RS government's support of the financial sector are undefined.

Table 1. Bosnia and Herzegovina: FSAP Key Recommendations	
Recommendations and Authority Responsible for Implementation	**Time[1]**
Banking Oversight	
Develop a remedial action program focusing on new tools and earlier step-up enforcement and heavier fines to expedite corrective action (FBA, BARS, relevant Ministries of Finance and Justice).	NT
Strengthen provisioning under IAS by issuing standards to encourage conservative assumptions by banks on impairment (FBA, BARS).	MT
Enact new Laws on Banks and amend other relevant legislation that addresses deficiencies in supervisory powers, consolidated supervision, and identification of ultimate beneficiary owners (FBA, BARS, CBBH, relevant Ministries).	I
Conduct additional AQRs in other banks with weak solvency and liquidity indicators (FBA, BARS).	I
Assure that banks continue implementing IFRS and external auditor implement IAS (FBA, BARS).	MT
Insurance Oversight	
The appointment of the FBiH-ISA director should be based on the relevant law (Government).	MT
The new insurance law in the FBiH should be approved if it shows improved convergence towards the EU insurance directives (FBiH-ISA).	I
Introduce a formal channel of information sharing with banking agencies (FBiH-ISA).	I
Update solvency regime by a gradual incorporation of risk elements, develop an early warning system, including prompt corrective actions. Capacity building in this area will be required (ISAs).	I
Introduce and implement consumer protection regulation aligned with IAIS Core principles (ISAs).	I
Develop a comprehensive strategy to increase the insurance literacy of the public (Governments).	MT
Financial Safety Net, Resolution of NPLs, and Systemic Liquidity Management	
Revise the reserve requirements, maturity mismatch, and the liquidity ratio (FBA, BARS, CBBH).	NT
Design and implement the LCR, adapted to BiH (FBA, BARS).	NT
Revise the consequences to the bank for not complying with the reserve requirement (CBBH).	MT
Enable prompt depositor pay-out (DIA).	I
Provide resolution powers to the FBA and BARS for banks in their respective jurisdictions on the new Laws on Banks, following FSB Key Attributes and EU BRRD (FBA, BARS, DIA, relevant Ministries)	I
Broaden the scope to draw on the existing DIF to use it for funding bank resolution, such as P&A, using least-cost solution (DIA)	I
Establish a Financial Stability Fund (FSF)—under the DIA—to provide for open bank resolution and limited and temporary liquidity support in systemic crisis, where non-public funding is available (DIA, CBBH, FBA, BARS, Governments).	MT
Strengthen and test bank contingency plans of SCFS members and review them regularly (SCFS).	I
Strengthen the coordination and cooperation between DIA and financial safety net players by: (i) revising the MoU with the Banking Agencies to ensure the automatic exchange of information and (ii) broaden the discussion of the SCFS to cover small banks in circumstances where their distress could have implications for financial stability (DIA, CBBH, FBA, BARS).	I
Assess the availability of suitable back-up facilitates given DIA's potential expanded role and the fact that its existing back-up line expires at end-2017 (DIA).	NT
Add macroprudential analysis and policy to the coordination MoU. Define and collect additional information for the assessment of vulnerabilities and macroprudential tools (CBBH, FBA and BARS).	NT
Insolvency and Creditor/Debtor Regime	
Streamline collateral execution procedures by allowing a final auction at no reserve price if previous rounds of auctions failed to attract bidders, and specifying realistic criteria for asset market values at current conditions. (RS/FBiH MoJ).	I
Consider tools and incentives to facilitate restructurings and debt resolution as well as adoption of out-of-court restructuring guidelines. (RS/FBiH/BiH MoF, FBA, BARS).	I

Revise the insolvency framework by introducing incentives to initiate proceedings early and expand the insolvency framework to cover businesses run by individuals. (RS/FBiH MoJ).	NT
Improve institutional framework through creation of new judicial positions and implement a more comprehensive regime for regulating the insolvency profession. (RS/FBiH MoJ).	MT
Financial Inclusion and Consumer Protection	
Strengthen the supervisory powers of the Federation Banking Agency by giving it a broader range of enforcement tools to allow for intermediate corrective measures and improve the framework for appeals against FBA's supervisory actions. (FBiH MoF, FBA) .	I
Facilitate corporatization of interested MCFs to MCCs by amending Article 15 of the Law on MCOs on activities of microcredit organizations and resolve issues on donated capital. (FBiH MoF, FBA).	NT
Exempt the VAT on interest for financial leases to create a level playing field in the context of a comprehensive and detailed set of recommendations of other elements of the VAT law. (Government, BiH ITA).	NT
Enhance the by-laws of the pledge registry and the regulatory framework for enforcement to enable more effective repossession of movable collateral. (BiH MoJ, industry associations)	NT
Improve transparency and disclosure of information in the banking and MCO sectors. (FBA, BARS).	I
Capital Markets	
Enhance coordination and cooperation through (i) introduction of an EU compatible 'passporting' framework, (ii) creation of an electronic link between the two Entity-level exchanges, and (iii) formation of an association between Entities to help spur market development. (FedSC, FBiH MoF, SASE, RSSC, RSMoF, BLSE).	NT
Support development of government debt markets by developing a framework to enable REPOs and OTC trading. (FedSC, FBiH MoF, SASE, RSSC, RSMoF, BLSE, FBA, BARS, and Insurance regulators)	I
Develop legislation for reform of the closed-end investment funds sector and implement transformation of legacy PIFs to open-ended funds. (FedSC, RSSC).	I
Corporate Financial Reporting	
Expand implementation of simplified accounting frameworks using the IFRS for SMEs to reduce their burden and improve the quality of SMEs financial statements. (FBiH MoF, RS MoF).	I
Change regulation on external auditors appointment to ensure appointment before the closing date for financial statements and for a multi-year period of at least three years. (FBiH MoF, RS MoF).	I
Public Bank Governance – State-owned commercial and development banks	
Modify the selection criteria for supervisory board members at public commercial and development banks to enable accountability of bank management. (FBiH MoF, RS MoF, IRBRS).	I
Assign specific responsibility to the supervisory board to strengthen its internal audit function. (FBiH MoF, RS MoF, IRBRS).	I
Strengthen the ownership role conducted by the IRBRS by dedicating institutional resources to focus specifically on monitoring financial sector exposures, evaluating institutional performance, mitigating risks and defining an exit strategy for each equity or debt exposure. (RS MoF, IRBRS)	I

[1] I-Immediate" is within one year; "NT-near-term" is 1–3 years; "MT-medium-term" is 3–5 years.

MACRO-FINANCIAL SETTING AND FINANCIAL SYSTEM STRUCTURE

A. Recent Crisis Experience and Initial Response

1. The banking sector weathered the global financial crisis relatively well. Fueled by a benign global environment and ample lending supported by foreign parent banks' funding and capital in subsidiaries, bank credit to the private sector in Bosnia and Herzegovina (BiH) grew at an average annual rate of around 25 percent over 2003-07 (see Appendix Figure 1). While the level of credit-to-GDP rose from around 35 to 45 percent over this period, this represented the smallest expansion in the region. However, the associated vulnerabilities became clear during the 2009 crisis when capital inflows came to a halt. A traditional banking sector model and the absence of riskier mortgage and foreign exchange-related instruments in the currency board arrangement (CBA)[2] helped to mitigate the impact of the global financial crisis on the banking sector.

2. The authorities' response to the crisis shored-up depositors' confidence and helped to safeguard financial stability. The Central Bank of Bosnia and Herzegovina (CBBH) swiftly responded to the crisis by lowering bank high reserve requirements in several steps to free-up liquidity. The negotiation of the 2009 SBA with the IMF, participation in the European Bank Coordination Initiative (EBCI) or "Vienna Initiative" and the two-step increase of deposit insurance coverage to KM 35,000 (€17,000) to all banks,[3] helped to preserve market and depositors' confidence. Moreover, a formalized coordination framework across the agencies through the Standing Committee for Financial Stability (SCFS) was established.[4]

3. The economy appears to recover from the natural disaster that hit the country in May 2014. On the back of strong exports and a broad-based industrial recovery, real GDP expanded by over 2 percent in 2013. However, the flooding and landslides in early-2014 caused damages estimated at nearly 15 percent of GDP and economic activity fell sharply after the disaster. On balance, growth is expected to reach close to 1 percent this year, and to pick up gradually in the coming years. The rate of deflation has started to slow, although consumer prices fell by 1.2 percent in the twelve months through September 2014. The increase in economic activity has yet to result in a decline in the unemployment rate, which stands at 27.5 percent.

[2] The CBA, introduced in 1997, is seen as a fundamental pillar for economic policies. The CBA fixes the convertible marka to Euro and introduces constraints on monetary policy and limits the options for systemic liquidity management. The CBBH sets required reserves for the commercial banks, which were as high as 18 percent at the outset of the global financial crisis. The CBBH foreign reserve cover stands at 107 percent of CBBH monetary liabilities as of 2014Q3.

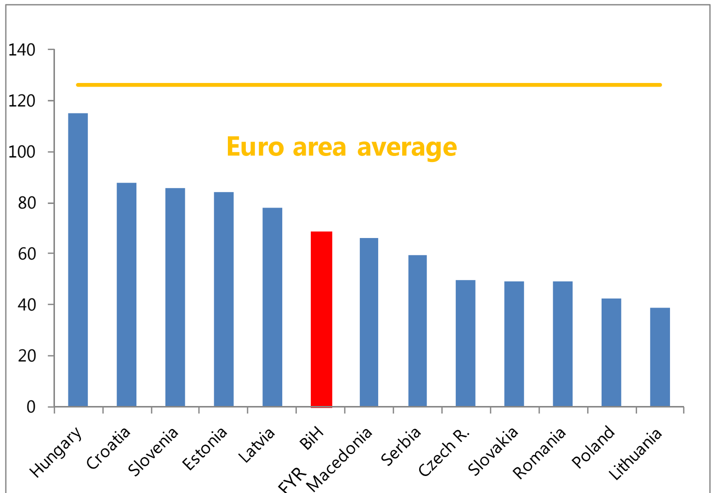
[3] The most recent increase in the level of deposit insurance was on January 1, 2014 to KM50,000.

[4] The Standing Committee on Financial Stability (SCFS) was created in December 2009 through a Memorandum of Understanding (MoU) among the CBBH, the two Banking Agencies, the Deposit Insurance Agency and the Fiscal Council to ensure cooperation at all time for sharing information and assessments of each member to facilitate the achievement of their policy function and financial stability.

4. **Credit to the private sector seems to have turned the corner albeit from low levels**. In the wake of the global financial crisis, private sector credit growth has remained subdued—averaging around 3 percent yearly since 2010—reflecting tighter credit standards and the weak economy. Nonetheless, credit growth has started to pick up in recent months reaching an annual rate of 4 percent in September; largely driven by household lending (increase of 6 percent). However, these numbers mask a substantial variation across banks, with a few banks attempting to gain market share growing at substantially higher rates than more established banks.

5. **Although corporate and household debt levels seem manageable, signs of credit constraints are emerging.** BiH's corporate sector consists primarily of small and medium-size enterprises. Corporates rely heavily on bank credit for financing, with limited alternative sources of funding available. At end-2013, corporate sector debt stood at around 69 percent of GDP, of which around 45 percent was of a short-term nature (see Figure 1). These debt levels are comparable to those in other emerging European economies. However, growing levels of intercompany debt suggest that corporates may be circumventing the banking sector to secure financing, which could ultimately lead to liquidity problems and lack of investment capital. Household debt to GDP has remained steady at around 30 percent of disposable income in the aftermath of the global financial crisis. However, increased reliance on short-term debt in the form of credit card or general consumption loans suggests that households are turning to debt accumulation to finance current expenditures against a backdrop of stretched incomes and increasing debt service liabilities.

Figure 1. Corporate Sector Debt



Source: European Central Bank, National Bank of the Republic of Macedonia, National Bank of Serbia, APIF, AFIP, and CBBH.

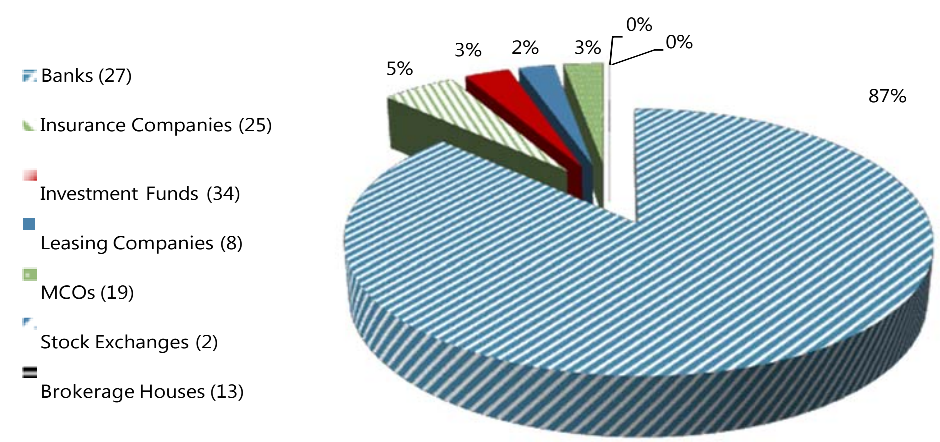
[5] Data were obtained from financial statements submitted by over 25,000 legal entities to APIF and AFIP, the registries in RS and FBiH respectively, where legal entities are required to submit their annual financial statements. Sole proprietorship businesses are not required to submit their statements. Therefore, the figures above are likely to underestimate the true amount of debt in BiH.

B. Financial Sector Structure

6. The financial system in Bosnia and Herzegovina is dominated by a moderately concentrated banking sector. The banking sector accounts for 87 percent of financial system assets, which are equivalent to 84 percent of GDP as of end-2013. There are twenty seven banks operating in the country (17 in FBiH and 10 in RS, respectively (see Appendix Table 1). The five largest banks (three in FBiH and two in RS) represent over half of banking sector assets[6]. The banking system comprises mostly foreign subsidiaries—82 percent of the banking sector assets, while domestically-owned and public banks account for 16 and 2 percent. Banks' financial performance varied widely; aggregate data is provided in Appendix Table 2.

7. As elsewhere in the region, the largest foreign banks operating in BiH are from Austria and Italy. Together with Slovenia another important player in BiH, these banks make up ¾ of banking sector assets in FBiH, and half in RS (see Appendix Table 3). In terms of direct exposure, BiH banking sector is mostly exposed to Austria and Germany, accounting for nearly 50 percent of banks' total foreign claims and comprising ⅓ of banking sector regulatory capital. Most of these foreign exposures are domestic banks' deposits at their correspondent accounts.

Figure 2. Financial System Structure



Source: CBBH.

8. The rest of the non-banking financial system is small. It is distributed among insurance companies (5 percent of financial system assets), leasing companies (2 percent), investment funds, and MCOs (3 percent each) as of end-2013 (see Figure 2). The share of nonlife insurance is about 1.4 percent of GDP, while life insurance accounts for only 0.7 percent of GDP. The nonlife segment collects over 80 percent of insurance premiums whereas two-thirds of it is related to the mandatory motor third party liability insurance (MTPL). There is one stock exchange in each entity, but capital

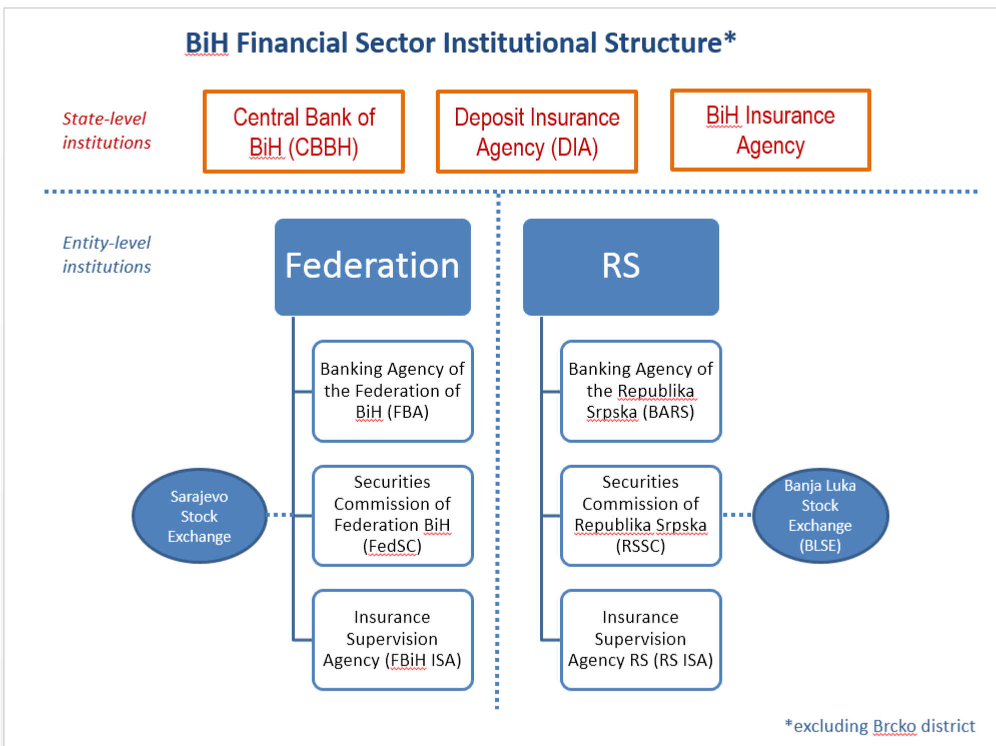
[6] However, the first five largest banks present about 70 and 80 percent of FBiH and RS banking assets in each entity respectively.

markets remain underdeveloped despite advanced infrastructure. The real-time gross settlement (RTGS) system settles high-value credit funds transfers and net balances submitted by the GIRO clearing system (GCS) and card switching network.

C. Fragmented Financial Sector Regulatory and Supervisory Structure

9. BiH is divided into two semi-autonomous political entities—the Federation of Bosnia and Herzegovina (FBiH) and the Republica Srpska (RS).[7] Both entities have their own parliament, government, judicial system and stock exchange. Similarly, regulatory and supervisory responsibilities for banking, insurance, and capital markets lie at the entity level. Banks and insurance companies in each entity often have branches in the other. In addition, there is a central ("state") level administration but with few enumerated powers. In this context, the Central Bank of Bosnia and Herzegovina (CBBH) and Deposit Insurance Authority (DIA) reside at the state level (see Figure 3 below).

Figure 3. Financial Sector Institutional Structure



10. Banks in RS and in the FBiH are supervised by their respective banking supervisory agencies and funded by supervised entities. The agencies follow the same supervisory approach based on a blend of onsite and offsite activities. The agencies coordinate closely the drafting and issuance of their respective decisions, keeping in mind the need to harmonize the regulatory framework in both entities and with the respective EU directives as much as possible. Further

[7] The Brcko District, a third distinct entity, has been self-governing since 2000.

cooperation takes place through the deposit insurance board meetings, the SCFS, and through frequent bilateral contacts.

11. The insurance sector in BiH has independent insurance supervisory agencies in each entity and one state-level insurance agency, the BiH-IA. The state-level agency has the mandate to act as a coordinating body, responsible for harmonizing the regulation in both entities towards compliance with the EU directives. It also consolidates relevant statistics, resolves possible conflicts of jurisdiction arising between the two ISAs when supervising branches of the insurers domiciled in the other entity, and is the representing body for international matters. The corresponding insurance laws allow the information exchange among the entity ISAs and in the case of branches operating cross entity, close coordination and detailed information exchange occurs, including for sharing onsite inspection reports.

12. FMI oversight responsibilities fall under the CBBH and securities commissions. The CBBH has direct oversight responsibilities over the payment system and governs it through operational rules, instructions, and decisions. The two banking agencies in the respective entities support the CBBH as they are empowered to ensure the financial soundness of banks to participate in the payment system. The banking agencies can issue and revoke banking licenses, authorizing them to perform operations in internal payment transactions. The MoU on "Coordination of Banking Supervision and Cooperation and Exchange of Information" establishes the basis for cooperation between the CBBH and banking agencies in the entities, which includes cross-cutting issues on payment systems. The securities commissions in each entity regulate separately the central securities depositories and securities settlement systems in their jurisdictions. See the companion financial stability FSSA by the IMF for more details on insurance and FMI.

13. Interconnectedness among banks is limited, but linkages between banks and the insurance sector, as well as the RS development bank (IRBRS), are more significant. Interlinkages between banks and insurance companies are mainly through insurance companies' deposits in the banking sector, amounting to about 40 percent of the insurance sector's total assets and 3 percent of the total deposits of banks. The IRBRS plays a major role in providing credit lines for on-lending mainly to RS banks and capital to RS domestically-owned banks—through certain of its development funds. It also holds sizeable deposits in some domestically-owned banks in RS.[8] The exposures between banks and microcredit organizations (MCOs) are fairly small.[9]

FINANCIAL SECTOR OVERSIGHT

[8] The two development banks are non-deposit taking institutions supporting investments and export-oriented activities in the respective Entities.

[9] Banks' claims and liabilities on all MCOs account for only KM 48 million and 37million (about 0.2 percent of banks' assets), respectively. One of the largest MCOs is currently in the process of liquidation, but the overall impact on banks' balance sheets is very limited.

Banking supervision has significantly improved since 2006, but shortcomings remain.

14. As laid out in Appendix II, both supervisory authorities have made progress in enhancing the regulatory framework and supervisory processes since the 2006 FSAP.[10] The banking agencies are in the process of preparing a new Law on Banks more in line with current EU requirements that should address, *inter alia*, some deficiencies in the supervisory powers, recovery and resolution, and consolidated supervision. These reforms will likely impact the respective laws on the Banking Agency, such as adding more supervisory powers. The regulatory framework has been broadened by the issuance of regulations on corporate governance, credit risk management and capital. Harmonization in regulation between the entities has been largely achieved and joint planning continues for the implementation of additional regulations and operational improvements (see Box 1 for further information on EU legislation approximation progress).

Box 1. EU legislation approximation

EU legislation in the field of financial services includes rules for the authorization, operation and supervision of financial institutions in the areas of banking, insurance, supplementary pensions, investment services and securities markets. The authorities in BiH have been taking gradual steps to approximate their legislation and policies with the acquis:

On financial services, both Entities' banking agencies are in the process of drafting new laws on banks. In addition, numerous decisions related to minimum standards for banks' capital management, fees for members of supervisory and steering boards, reporting standards and conditions for conducting payment transactions abroad were passed.

On capital markets, the respective regulators have begun the process of adopting various EU directives and protocols into their own legislation, with the result being a fairly sound and improving legal framework, though a lot of further work still lies ahead. In both the Federation and the RS, for example, recent revisions to the Securities Act and other related regulations have sought to enshrine various key elements of the EU Prospectus Directive.

The scope of coverage and definition of insured deposits in the Law on Deposit Insurance follows the scope of the EC Directive of Deposit Insurance 94/19. Going forward, shortening of the payout period in line with the EU relevant directive, will further support financial stability.
In the field of insurance services, the Insurance Agency of BiH has strengthened its coordinating role in the preparation of draft legislation by the Entities with the aim of harmonizing and aligning all new enacted regulation with the EU insurance directives.

15. Cooperation and coordination among the various institutions involved in banking oversight is very complex, having potential repercussions in times of financial sector stress. For instance, the SCFS at the state level and the Committee for Coordination of Supervision of the Financial Sector at the level of the RS seem to have overlapping mandates. This could become problematic in a crisis. In addition, the key players tend to exchange information guided by specific arrangements and laws, but crucial information on the risk profile of banks (i.e. the CAMEL rating) is not always shared with relevant stakeholders, such as FBA, CBBH, and the DIA, creating information

[10] The 2006 BCP assessment was based on the standards as of 1999. The BCP principles have since been revised in 2006 and 2012.

asymmetries. It is therefore important to strengthen the coordination and in exchange of information. The development of an integral contingency plan is encouraging in this respect.

16. The supervisory agencies do not have a full picture at several banks regarding the identification of the ultimate beneficiary owner and its holdings. As a result, related party lending and group exposures are not fully identified. Root cause of this problem lies at the licensing and approval process, which should be more substantive. The review of an application must provide sufficient information not only on direct owners but also parent companies and related parties of parent companies.

17. A lack of adequate governance and risk management at some banks has contributed to the current challenges at a number of banks. The banking agencies have recently issued regulations on corporate governance and are in the process of developing bank-wide risk management guidance. In conjunction with strengthened corrective action powers, compliance with the regulations would improve the resiliency of banks and the ability of the agencies to impose early corrective measures.

18. Currently, most banks have implemented IFRS 2009 since this is the latest version translated into local language. Further, several auditors refer in their audit opinion to the Law on Accounting and Auditing instead of IFRS. This makes it difficult to compare different financial statements in the banking sector and brings uncertainty to the quality of the external audit. In addition, development of the quality assurance of the financial audit seems to be blocked by the Chamber of Auditors consisting of 102 local auditors, outnumbering the larger international auditors. Also, the external auditors are appointed only for a year (with a maximum duration of five years) which may have an adverse effect on the continuity of the auditor and the quality of the audit. The agencies do not have the power to rescind external auditors, but only to reject their report and ask for a new one. Appointing an external auditor for minimal three years, together with the power to rescind, will give a different incentive to an external auditor and could have a positive effect on the continuity of the auditor and audit quality.

19. Loan loss provisioning is based on International Accounting Standards (IAS) and prudential requirements, but provisioning levels may not be adequate as reflected by the adjustments required by inspectors during onsite reviews. While the current system may be appropriate for a transitional period; the focus going forward should be on developing supervisory standards to encourage the conservative implementation by banks of factors to be considered in determining incurred losses under IAS and moving away from the current prudential standard. This move must be accompanied by appropriate training of inspectors. The need to adjust provisioning levels during onsite inspections raises the probability that banks do not properly estimate losses and make provisions.

20. Under the legal framework the banking agencies possess operational independence, but government actions may impact future independence. Currently the agencies experience difficulties identifying the ultimate beneficiary owners of some banks and their related entities. In RS there is increasing support of domestically-owned banks by the development bank, which may

place BARS in a difficult position when addressing non-viable banks.

FINANCIAL SYSTEM RESILIENCE

The Banking Sector has Pockets of Vulnerability

21. The global financial crisis weakened asset quality and profitability of the banking system.[11] System-wide NPLs ratios stood at 15.5 percent (ranging from 6 to 58 percent) at end-June 2014, compared to just 3 percent at the onset of the crisis, reflecting the impact the crisis had on the region and lax credit lending policy (Figure 4). Banking sector profitability has deteriorated, partly due to weak economic environment in BiH and the region in general, partly due to regulatory provisioning requirements (the provisions to NPL ratio is at 68 percent). Owing to ineffective corporate resolution and insolvency frameworks, asset quality is becoming an important obstacle for re-establishing bank profitability. The sector-wide regulatory capital adequacy ratio is at over 17 percent as of end-June 2014, although with wide dispersion. The recent natural disaster prompted regulatory forbearance measures for loan classification, but so far has had a relatively mild impact on asset quality. According to the authorities, only about 1 percent of total loans have been restructured so far, even though more loans could be restructured (see Appendix Table 2).

22. Liquidity in the system is high, although with high dispersion. Liquid assets stood at 24.7 and 43.6 percent of total assets and short term liabilities, respectively, as of 2014Q1, partly reflecting the importance that banks place on liquidity buffers under the CBA. Notwithstanding the relatively high required reserves ratios with the CBBH, the banking system has a total excess of 150 percent central bank deposits over the ten days average required reserves.[12] The funding profile of commercial banks has improved, although the loan-to-deposit ratio stands still at a relatively high 120 percent, underscoring the dependence on parent funding. Banks present relevant differences in terms of their liquidity indicator. The relatively higher level of liquidity in FBiH compared to RS is partly explained by different interpretation and enforcement of the regulation on maturity mismatch**.**

23. A number of domestically-owned banks rely heavily on public sector support. In the RS, the IRBRS, utilizing the six development funds under its management, hold a sizeable amount of shares and subordinated debt issued by some of the domestically-owned banks that otherwise would be undercapitalized. It also has large credit lines for on-lending to all commercial banks in RS, and places deposits in four domestically-owned banks. In the FBiH, some public sector entities have stakes in some domestically-owned banks. Furthermore, some small banks hold each other's shares, although only up to limited amount.

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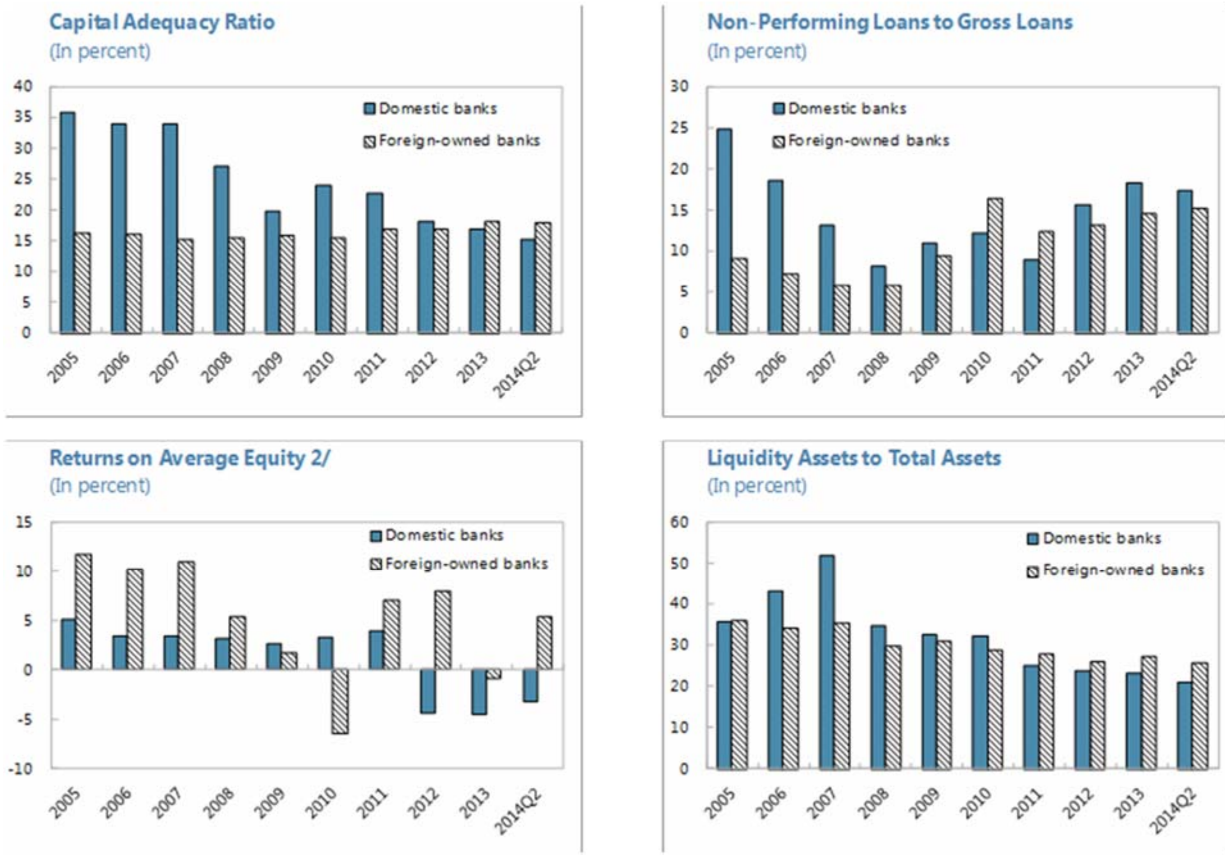
[11] Three small banks were nationalized or liquidated following the crisis. In addition, Hypo Alpe Adria Bank was nationalized by the Government of Austria in 2009. In December 2014, Austria agreed to sell the Balkans network to private equity firm Advent and the European Bank for Reconstruction and Development (EBRD) as co-investor.

[12] The reserve requirements are currently set at 10 percent for liabilities with a contractual maturity of up to one year, and at 7 percent for other liabilities.

Figure 4. Key Financial Soundness Indicators: Domestic and Foreign Owned-Banks



Sources: Banking Agency of FBiH; and Banking Agency of RS; and IMF staff calculations.
1/ The classification of domestic and foreign-owned banks is listed in Appendix Table 3.
2/ Net income as percent of average equity capital

Dealing with Weak Banks

24. Urgent action is needed to deal with weak banks. A number of banks do not meet the prudential requirements[13] and others only do so as a result of public sector capital support. Since this capital support has been provided in the form of subordinated debt and preferred shares, existing equity holders have not been diluted. This contributes to moral hazard, lacks transparency, and is not conducive to a level playing field. Moreover, most of the weak banks still face significantly higher funding costs and suffer from legacy of loans to sub-par borrowers and related parties. Unless owners are willing to provide significant capital support, phase-out related party loans, and address asset quality issues, these banks need to be restructured/resolved.

[13]Subsequent to the FSAP mission, liquidation and pay-out of deposits was initiated at Bobar Bank on 22 December 2014.

25. The development and full implementation of a comprehensive bank restructuring strategy, including effective communications, is critical to preserve financial stability. Without immediate and decisive actions banks' financial positions will continue to deteriorate, leading to an increase of potential resolution costs. Therefore, the authorities are advised to develop, as a matter of high priority, a thorough plan to either facilitate the recovery of these banks (if practicable) or implement a cost-effective resolution consistent with maintaining the stability of the financial system and protection of insured depositors. This will require additional time-bound AQRs of domestically- owned banks and a strategy to address the potential implications. The strategy should explore all options for early action and ensure the technical readiness of the DIA to pay-out depositors promptly. A credible and transparent public backstop is essential to deal with systemic cases.

CONSTRAINED FINANCIAL SAFETY NET

26. A number of key elements in the financial safety arrangements are either not present or adequately developed. The main areas of deficiency are the inadequacy of resolution powers and the ability to provide emergency liquidity support to soundly capitalized, well managed banks.

A. Crisis Management Framework

Creating a Bank Resolution Regime

27. Building on recent initiatives, further progress is required to strengthen the financial safety net. Although improvements have been made to some of the legal powers for resolution in recent years and the authorities have developed financial crisis contingency plans, significant deficiencies remain in the financial safety net, including in respect of resolution powers, institutional responsibility for resolution, and recovery and resolution planning. As a consequence, the authorities are currently not well placed to implement bank resolution in form of P&A, bridge bank, or bail-in, in a manner consistent with maintaining financial stability, avoiding public funding and minimizing moral hazard. It is imperative that the deficiencies in the financial safety net framework are addressed as a matter of high priority. The high level of NPLs in the banking system and the number of banks in various levels of stress make it all the more urgent that the authorities move quickly to implement the changes needed to establish a robust resolution framework.

28. There is a need to establish a bank resolution authority. At present, the FBA and BARS have some of these powers, but are not formally designated -- nor equipped -- to be resolution authorities. The proposed new banking laws need to establish clear responsibility for bank resolution with appropriate accountability and transparency. One solution[14] would be to vest the resolution powers in FBA and BARS and designate them as the bank resolution authorities for the banks in their respective jurisdictions. This option would benefit from the inter-connection between the role of a supervisor in early intervention and supervision of recovery planning, and the role of

[14] Given the institutional constraints, the mission did not recommend its preferred option of vesting the resolution powers in the DIA and establishing it as the resolution authority.

the resolution authority in undertaking resolution planning and implementing resolution. However, if this model is adopted, there will be a need to have a degree of separation between the supervision and resolution divisions to avoid potential conflicts of interest, with robust accountability arrangements. Moreover, should the resolution authority powers be vested in the respective banking authorities, it is recommended the DIA management board be broadened to include the representatives of the two banking agencies.

29. The scope to draw on the existing deposit insurance fund (DIF) should be broadened for funding bank resolution. Currently, there are no funds available for bank resolution purposes in BiH as the deposit insurance fund currently can only pay out insured deposits. DIF should be allowed to participate in bank resolution subject to it being a least cost solution—up to the amount that would have been expended for insured depositor reimbursement in a liquidation—including for example purchase and assumption transaction (P&A). DIF resources should not be used to provide open bank assistance.

30. The financial sector safety net can be broadened over time by establishing a Financial Stability Fund (FSF) under the DIA. Open bank assistance in a systemic crisis should be provided only if absolutely necessary to preserve financial stability and where there is no new capital forthcoming from private creditors. To protect the taxpayer, the FSF backstop option should be subject to a set of clearly defined criteria. Most importantly, all losses in failed banks should be absorbed up-front by existing shareholders, but also by other creditors according to the hierarchy of claims in liquidation and subject to financial stability considerations. This option should be used under strict conditions that minimize the risk of moral hazard and allow for ex-post recovery from the banking industry.[15]

Correction Action Arrangements

31. Enforcement powers are limited when addressing individual supervisory board members and controlling owners. Regulations establish requirements on internal controls and governance and the responsibilities of the supervisory board. Although regulations addressing risk management and corporate governance assign responsibilities to the supervisory boards for implementing the proper systems and policies to achieve sound banking, the agencies' authority to fine individual supervisory board members and to levy fines is limited to small amounts and the ability to permanently suspend board members and controlling owners is limited, except under provisional administration. The misdemeanor channel for fines is dependent on court proceedings that may delay effecting corrective action. Moreover, the authority for replacing or restricting the powers of controlling owners outside of provisional administration is also limited.

Limited and Temporary Emergency Liquidity Assistance

[15] The FSF could be based on the principles of the EU Bank recovery and Resolution Directive (BRRD) with added limited and temporary liquidity support functions (see below).

32. In a number of CBAs the central banks have legal authority to perform LOLR functions, but usually within the very limited scope given the currency board constraints. However, there are limitations to this in the BiH legal framework underpinning the CBA, since the CBBH Law does not allow the CBBH to grant any credit and engage in money market operations "involving securities of any type." Moreover, the net excess reserves under the currency board arrangements are usually very limited to provide any meaningful basis for LOLR functions.

33. The FSF could be designed to provide very limited liquidity support to solvent banks in the case of acute liquidity stress. The limited and temporary liquidity support—as an early prompt corrective action tool—should be triggered only after the bank has used all the available liquidity management options, including the interbank market, parent bank funding if available, and its reserve requirements—the framework of which should amended along the line recommendations above. Such support should only apply to systemic banks which are solvent and comply with the supervisory capital requirements, are under sound management, and have sufficient collateral or guarantees to cover credit risks for the liquidity provider.

34. Emergency liquidity support should be accompanied by enhanced monitoring and supervision to minimize moral hazard. The compliance with the terms and conditions of the use of the limited and temporary liquidity support would be monitored by the applicable banking agency, which would take enforcement actions as required. An un-remedied breach of the FSF terms and conditions would be grounds for the relevant banking agency to exercise resolution powers.

35. The FSF could be financed through *ex-ante* levies on banks, with the capacity for *ex-post* levies on banks to cover costs and any losses sustained by the Fund. The FSF could be also supported by possible seed financing from an IFI. As well, there could be scope to further support the FSF by switching a portion of potential increases in RR into the FSF. The FSF would be administered by the DIA and separated from the DIF. The FSF should be protected with various safeguards. These would include the objectives of the fund, the purposes for which it may be used, the preconditions for invoking it and the governance arrangements.

B. Crisis Preparedness Framework

Deposit Insurance Fund

36. The deposit insurance framework in BiH has a relatively well developed paybox scheme. The DIA was established in 2002 at state level and is funded by member banks with reserves of about KM 285 million (€ 145 million) representing approximately 4.6 percent of insured deposits in the banking sector. It is supported by a €50 million standby facility with the EBRD. Since its establishment, the DIA has made good progress in developing much of the infrastructure required for an effective deposit insurance framework, including MOUs signed in 2003 to support coordination with the FBA and BARS, regular testing of depositor data and procedures for making deposit pay-outs. The current level of funding is sufficient to cover all insured deposits in the small domestically-owned banks.

37. However, further enhancement to the deposit insurance arrangements is needed as part of strengthening the overall bank resolution framework. In particular, there is a need for the DIA to establish the capacity for making prompt pay-outs to insured depositors once a bank has been closed. Under existing law, the DIA has up to 90 days to make pay-outs (and longer in some situations). This needs to be substantially reduced if deposit insurance is to achieve the objective of maintaining depositor confidence and providing insured depositors with quick access to their deposits. Ultimately, the payout period should be shortened to bring it in line with the EU relevant directive. To further enhance the effectiveness of deposit insurance, legislation should be amended to establish the means for the prompt pay out of depositors and a P&A transaction under the least cost solution (as mentioned above). DIA should be also involved very early in the problem bank resolution process with both bank supervision agencies. Moreover, the DIA should assess the availability of suitable back-up facilitates given its potential expanded role and the fact that its existing back-up line expires at end-2017.

38. It is essential the DIA, in close liaison with the FBA and BARS, undertake testing of the procedures to be followed for bank closures and pay-outs. This should be a major priority in readiness for activating deposit insurance arrangements if the need arises. In conjunction with this, all relevant authorities in the SCFS should ensure that their inter-agency contingency plan includes guidance on the actions required by all relevant members if a bank is closed and depositors are paid out, including public communications to minimize the risk of contagion.

Coordinating Arrangements and Contingency Planning

39. Coordination by the authorities is essential. The authorities have made good progress in this regard, with the establishment of the SCFS in December 2009 including CBBH, the two banking agencies, the DIA and the state and entity Ministry of Finance. The MoU establishing the SCFS sets out the objectives and principles for bank resolution (among other matters), the responsibilities of the respective authorities and procedures for information exchange and coordination. It will require refinement once the formalization of resolution objectives, powers and responsibility has been established by the new laws.

40. We would recommend to broaden the focus of the discussion of the SCFS's remit to cover small banks in circumstances where their distress could have implications for financial stability. Moreover, the current DIA MoUs with the banking agencies are more than 10 years old and information is not exchanged automatically. Enhancements are needed to facilitate cooperation and coordination between the DIA and the respective banking agencies in order to facilitate prompt depositor pay-out or deposit account transfers.

41. The authorities have recently established contingency plans covering their respective responsibilities and a coordinated cross-agency plan was prepared in November 2014. These represent a major advance in crisis resolution preparation. Further refinement of the individual agency plans and the cross-agency SCFS plan will be required, in conjunction with implementation of the new resolution laws. In particular, it is important for the plans to include more comprehensive guidance on the resolution options, the criteria for the selection of resolution options and the

procedures for implementing each option. The plans need to incorporate comprehensive guidance on policies, procedures and processes to manage each stage of a crisis, including systemic impact assessment, financial institution diagnostics, assessment of resolution options, determination and implementation of the appropriate resolution, cross-border coordination and communications with relevant stakeholders. Regular crisis simulation testing is also required as part of the contingency planning and capacity-building process.

42. **Cross-border cooperation and coordination requires particular attention.** Currently, the banking agencies, CBBH, DIA and other relevant authorities have no specific crisis resolution related arrangements in place with their respective foreign counterparts. Given the systemic importance of several foreign banks to the BiH financial system, this creates a significant risk of inadequate coordination with the home authorities to achieve a satisfactory whole-of-group resolution.

MACROPRUDENTIAL FRAMEWORK IN ITS INFANCY

43. **The macroprudential toolkit is underdeveloped and relies mostly on the CBBH's required reserve management.** The required reserves levels were used to mitigate the credit boom as well as the following liquidity crunch before and after the global financial crisis. The CBBH is also conducting top-down stress tests on the main financial risks and, jointly with the banking agencies, has developed a methodology to identify systemic domestic banks. The annual Financial Stability Report, prepared by the CBBH contains a broad range of information on the macroeconomic environment, household and legal entities, financial intermediaries, including the aggregate results of stress test, FSIs, and on financial infrastructure.

44. **The authorities should set up a more comprehensive macroprudential framework taking into account the BiH institutional set-up**. While there are number of forums for discussing overarching financial stability issues, there is currently no institution directly responsible for macroprudential policy and for the design and implementation of macroprudential toolkit. The CBBH is responsible, *inter alia*, to maintain the stability of the domestic currency, payment systems as well as to coordinate the work between the banking agencies. To this effect, an MoU *on "Coordination of Banking Supervision and Cooperation and Exchange of Information,"* was signed between the three institutions in 2008. While the SCFS is tasked with upholding financial stability, and as such is informed about stress tests, financial soundness indicators, financial supervisory matters and other reports, its main focus to date is on crisis management.

45. **Macroprudential policies should be underpinned by broader and more focused cooperation among the CBBH, FBA and BARS.** The above referenced MoU could be a good platform to enhance macroprudential work. The MoU could include (i) settings and process for the assessment of systemic risks and vulnerabilities; (ii) selection and calibration of macroprudential tools to enhance financial stability; and (iii) the timing for using macroprudential tools. The content of the updated MoU should be disclosed on the website of the respective parties.

46. **The CBBH Governor and the heads of the FBA and BARS should undertake consultations on systemic risks and macroprudential tools at least quarterly**. The conclusions

should be considered by the three institutions for action based on the statutory responsibilities of each institution. The SCFS will be regularly informed about the consultations, as well as on systemic risks and vulnerabilities that are be better mitigated by fiscal policies. The FSR, prepared by the CBBH, should include a separate write-up, endorsed by the CBBH, FBA and BARS, describing the activities and macroprudential tools used by the respective institutions.

47. The relevant authorities should broaden the use of datasets to better assess emerging financial sector vulnerabilities and deploy macroprudential tools. For example, the CBBH, FBA and BARS should collect and analyze data, *inter alia*, such as LTV and DTI ratios, level of household and corporate indebtedness, currency mismatch in the debtor´s balances.

THE RESOLUTION OF NON-PERFORMING LOANS

48. Domestically-owned banks have experienced the largest increase in NPLs since the financial crisis, while the rate of NPLs in the foreign banks have remained relatively stable in the last couple of years. Within the corporate sector, business activities more dependent on domestic demand are experiencing the highest levels of NPLs, (with NPL levels of around 30 percent). The household NPLs have remained remarkably steady despite high levels of unemployment. The high share of special mention loans—that could become NPLs—exhibits weaknesses that could pose further risks to the system (see Table 2).

Table 2. Distribution of Non-Performing Loans

	2012Q4					2014Q2				
	TOTAL	FBiH	RS	Foreign	Domestic	TOTAL	FBiH	RS	Foreign	Domestic
NPL to total Loans	13.5	13.2	14.1	13.2	16.5	15.5	15.2	16.0	14.4	25.6
of which: corporates	8.5	8.2	9.3	8.1	13.7	10.7	10.5	11.3	9.5	22.0
of which: households	5.0	5.0	4.8	5.1	2.8	4.8	4.8	4.7	4.9	3.6
Memo item:										
Special mention loans (share of total loans)	9.8	9.0	11.6	9.2	17.5	8.7	7.6	11.3	7.8	18.0

Source: FBiH and RS agencies.

49. Weaknesses in the legal and judicial frameworks impede the resolution of NPLs. One of these is the inconsistent interpretation of some provisions of the Law on Obligations and Laws on Banking as well as legal impediments on the Law on Protection of Users of Financial Services for loans to natural persons, which impedes banks from transferring non-cancelled NPLs to an entity other than a bank. These legal ambiguities have been a significant obstacle in the ability of banks to resolve NPLs, given that one of the preferred mechanisms for doing so is the sale of NPLs to either a company formed for the purpose within the bank's group or to an external party which specializes in impaired debt collection.

50. Legal impediment need to be addressed by amending the relevant laws in each entity to enable NPLs to be transferred to private non-bank entities, subject to appropriate safeguards. These safeguards would include the ability of the banking agencies to continue to

monitor NPLs located in an asset management company within a banking group through consolidated group supervision. In addition, relevant regulations should be amended so that NPLs are maintained on a credit register to enable credit providers to identify the status of applicants for credit and to maintain incentives for borrowers to service their loans.

51. Another difficulty impeding the resolution of NPLs is the absence of an alternative to bankruptcy. Under BiH laws, there is no satisfactory streamlined process by which a company and its creditors can negotiate a restructuring of debt or the company itself to facilitate a least-cost solution to loan impairment. This results in a more piecemeal liquidation of assets than would otherwise be the case, with a consequential loss in recovery on the impaired loans and potentially greater costs to the economy in terms of loss of economic activity and jobs. It is therefore imperative that a new law be created to provide an efficient mechanism for companies and creditors to negotiate a debt restructuring to avoid bankruptcy, overseen by the courts.

52. The insolvency and judicial framework also contributes to the NPL situation. As discussed in the section on Insolvency and Creditor Rights Regime, litigation, execution, and bankruptcy cases take too long to be completed. This has contributed to a backlog in NPL cases, thereby lengthening the period for their resolution and making it more difficult to maximize recoveries. A strengthening of resources and training in the courts would assist in resolving this.

53. There are tax impediments to the resolution of NPLs which should be addressed. The authorities should commission a dedicated review of relevant tax laws in both entities and at state level, such as the Law on Corporate Income Tax,[16] to ensure that specific issues related to debt-restructuring processes, NPLs, and loan loss provisions encourage creditors and debtors to restructure debts and to sell NPLs to third parties. The authorities should review the application of VAT to the transfer of NPLs and associated collateral, with a view of exempting such transactions from VAT. Doing so will help to strengthen the incentives for the development for a secondary market of NPLs.

54. Measures should be taken to facilitate and regulate the operation of a secondary loan market where banks can trade or sell to third parties standard, as well as substandard, loans. Experience in other countries suggests that the sale of NPLs to third parties is an effective method of cleaning banks' balance sheets and improving liquidity management in banks, particularly at times of distress. In BiH, some banks are trying to sell their NPLs to collection agencies or factoring companies, although there is no clarity as to the procedures for and taxation of these transactions due to the lack of applicable legislation.

INSOLVENCY AND CREDITORS' RIGHTS REGIME

55. The legal framework governing creditor/debtor relationships in Bosnia and Herzegovina is comprehensive, however neither debt resolution, businesses reorganization or bankruptcy liquidation work effectively. Creation of security rights over both immovable and

[16] A new Corporate Tax Law has been drafted in FBiH.

moveable assets is not problematic. Corporate lending is usually secured, with real estate as favored form of collateral and mortgage as the security mechanism preferred by banks: approximately 90 percent of the corporate loan portfolio is secured with mortgages. As regards pledges over movable assets, the legal framework is modern and largely sound. However, non-possessory pledges are not extensively used because banks do not consider such security as secure. Recovery rates of loans secured with pledges are very low. Several legal issues affect loan recovery rates—in particular, the ineffectiveness of execution procedures.

56. As non-judicial enforcement procedures are not available, both secured and unsecured claims are enforced using a judicial procedure called 'execution', provided that the obligation is established in an executive title. Creditors who do not hold such a title must previously obtain a final judicial decision recognizing the obligation, issued in a 'lawsuit' which is a long and protracted procedure. Banks, however, always hold executive titles so they can typically enforce their claims filing an execution procedure directly. At the creditor's request and on the basis of a valid executive title, the court shall issue an executive order in a non-contradictory procedure which in theory should be expeditious (8 days) -- but in practice takes longer. The executive order shall be executed by a bailiff, who will seize the collateral and sell it in a public auction.

57. Execution delays are a result of some flaws in the legislation and ineffective implementation of execution procedures. Debtors are allowed to raise numerous objections and appeals that, in some cases, could convert the 'execution' into a protracted 'lawsuit'. Most judges do not typically exercise their powers to immediately stop abuses of the process. High numbers of loan execution procedures before the courts and, likely, inefficient case management also contribute to aggravate the slow resolution of such cases. On average, an execution procedure takes over 4 years according to most players. Depreciation of collateral value is significant, affecting in particular movable assets.

58. Both the valuation of the asset that will be sold at auction and the reserve prices are problematic.[17] Before a public auction is conducted, the court appoints an expert (typically, a civil engineer or an architect) to appraise the asset(s) to be sold. According to a long established practice, the valuation is done on the basis of construction costs. This practice leads to establishing inflated (or fictitious) values, which are significantly higher than the potential market value of the asset. Although the laws on execution contemplate somewhat different solutions in RS and FBiH, the auction systems currently practiced create similar problems to loan collection in both Entities, namely:

- In RS, the reserve price is 50 percent at the first auction. If there are no interested buyers, a second auction may be conducted with a reserve price of 1/3 (of the appraised value). If no one is bidding, the law does not allow a third auction at a further reduced reserve price or at no minimum price whatsoever. Thus, the execution procedure must start over again—which

[17] Reserve price = minimum price at which an asset will be sold at an auction.

is clearly an ineffective solution for collecting the loan. Alternatively, the creditor can accept title to the asset as payment in full, but this alternative is in most cases unattractive and costly, as the creditor must deposit the difference between the amount of its claim and the reserve price of the second auction[18].

- In FBiH, the reserve price at the first auction is also 50 per cent of the valuation price; and 1/3 of this valuation at the second auction. If the latter is not successful, the law permits a third auction with a lower reserve price. However, ever since the RS law eliminated the possibility of a third auction (see above), in practice many courts in FBiH are not allowing a third auction at low reserve price.

59. The levels of non-performing loans in the system are still high. Banks are engaged in negotiations with clients to resolve financial distress, however multi-creditor negotiations are few. A culture of seeking agreement among creditors on stand-still and restructuring is underdeveloped. Tax creditors lack the tools to participate effectively in debt resolution. Banks typically do not lend to businesses in financial distress.

60. The insolvency framework is biased towards piecemeal asset liquidation, in terms of both the law and practice, as the bankruptcy process is protracted and lengthy. Reorganizations or going concern sales are very rare. Indeed, insolvency proceedings often start too late, when the business is no longer viable. The system lacks sufficient incentives to file early, by either debtors or creditors, or to engage in other forms of restructurings. Critically, the reorganization regime does not include a mechanism to bind dissenting creditors to a pre-negotiated plan through a quick process of court approval.

61. Another critical anomaly in the system is the lack of insolvency regime for individual debtors. The insolvency law applies only to legal entities and partners in partnerships. Sole traders, craftsmen or entrepreneurs - who make up the vast majority of enterprises in BiH - cannot benefit from the insolvency framework.

62. The institutional framework for insolvency and creditor/debtor regimes is affected by several weaknesses. Litigation, execution and bankruptcy cases take too long to be completed. Some courts are dealing with excessive number of cases. Commercial Courts in RS and specialized commercial and bankruptcy departments in FBiH courts, while still in need of strengthening, would appear to provide better judicial service than courts of general jurisdiction. However, the rules for allocation of competence among judges, courts internal organization, case management and continued training in commercial law and bankruptcy are still in need of improvement.

63. The law does not establish an effective system for regulating and supervising the insolvency administrators. Insolvency administrators are not subject to the control and supervision of a specialized and independent regulatory body. There are no specific behavior standards

[18] Then, after all other claims and expenses (if any) are paid in the procedure, the remaining balance can be collected by the debtor / former owner of the sold asset.

developed to ensure the impartiality, transparency and liability of administrators. Nor does the law contemplate a remuneration system for administrators that could create proper incentives for prompt and effective resolution of insolvency proceedings. Many insolvency administrators should still improve their knowledge and abilities.

KEY RELATED FINANCIAL SECTOR DEVELOPMENT ISSUES

64. Underpinning each credit or investment related decision are a number of key determinants regarding insolvency, inclusion, capital markets, financial reporting and bank governance. Singularly each of these areas can contribute to legal certainty, access, transparency and overall confidence by market participants. Together, when properly organized these mutually reinforcing areas can both stimulate financial market development and mitigate risks. Alternatively, asymmetries occur when the development of one or more of these areas lag or do not function correctly, giving rise to new or heightened risks, including possible market distortions. The following sections describe issues and challenges in four key financial sector development areas.

A. Financial Inclusion

65. Financial inclusion in BiH performs relatively well compared to peers, but gaps remain for selected market segments. A total of 56.2 percent of adults in BiH have an account at a formal financial institution and 31.9 percent of these account holders use it with high frequency[19], compared to the regional average of 44.9 percent and 22.5 percent respectively. Lending services have a high outreach compared to regional peers, while the usage of saving services are low with only 13.5 percent of adults reporting saving any money in the past year compared to the regional average of 20.4 percent. In particular, for the bottom 40 percent, the ratio of adults reporting saving any money in the past year is even lower at 9.8 percent.[20] Moreover, BiH is facing one of the largest gender gaps in the region when it comes to female account holders at a formal financial institution, amounting to 19.5 percent.[21]

66. Financial sector development and access to finance for firms is constrained by weak domestic demand, high collateral requirements and inadequate credit enforcement mechanisms. Credit to the non-financial private sector expanded by only 0.9 percent year-on-year in the first nine months of 2014, and by 1.1 percent in 2013. A significant portion of the loans were used to finance working capital rather than investments, mostly due to unfavorable growth prospects. Reducing the stock and flow of NPLs remains a challenge, as financial institutions and borrowers alike have been deeply affected by the economic slowdown following the global financial crisis. The banking sector faces high NPL ratios of around 15.5 percent at Q2 2014, with higher

[19] Measured by withdrawals of three or more times in a typical month.

[20] Findex, latest available data is 2011.

[21] Usage statistics show that this gap arises mostly from the fact that women are using their accounts much less than men for receiving wages and government payments. This is an expected result, as according to the International Labor Organization (ILO) statistics, the female labor force participation is very low at 34.1 percent in BiH in 2012.

default rates in corporate loans. Weaknesses in the corporate insolvency and creditors' rights regimes also pose important obstacles to debt resolution. Moreover, collateral requirements are high, with collateral-to-loan values at 216 percent for small firms in BiH.[22] Overall, firms in BiH identify access to finance as the second major constraint in the Enterprise Survey 2013 (after political instability).

67. Banks are generally liquid, but are tightening lending standards and segmenting clients more distinctly. In general, there is a situation of over-liquidity in banks as they are cautious in extending credit. The large foreign banks tend to find SME lending too risky, viewing this segment as lacking stable repayment capacity. This perception of financial vulnerability has been aggravated by the financial crisis. Nevertheless, some of the locally-owned banks have aggressively expanded their SME portfolio, in part by taking over some of the clients of foreign banks. Banks report a segmentation of their SME clients, and smaller enterprises with less complete or formal documentation and lacking collateral tend to be excluded from the market. Regarding micro loans, banks are not interested to serve this segment of the market as the opportunities for cross-selling of products and services are limited.

68. The microcredit organizations (MCO) sector in BiH is less than 3 percent of financial system assets in 2013. The size of sector has been declining since the microcredit crisis hit in late 2008. The crisis had followed a period of rapid expansion between 2006 and 2008, which was accompanied by weak MCO governance, imprudent lending and inadequate monitoring. The weakening of the loan portfolio and over-indebtedness of borrowers was aggravated by the global crisis in 2008. Although the Law on Microcredit Organizations (MCO Law) was passed in 2006, it came into effect only in mid-2008, when supervision was also introduced. The industry used the gap in between the adoption and full enforcement of the law to continue their imprudent practices in advance of supervision controls.

69. The separate laws governing microcredit organizations (MCOs) in the two entities are not aligned, which creates an uneven playing field in the sector. The market structure is different in the two entities: in the FBiH there are 12 MCFs and one small MCC; in the RS the market is dominated by one large MCC, with five smaller players.[23] As MCOs licensed in one entity can operate in the other, differences in the legal and regulatory frameworks are creating grounds for unfair competition. In the FBiH, it is recommended that two actions be taken in parallel: i) strengthen the supervisory powers of the Banking Agency by providing the FBA with explicit intermediate powers and improving the framework of appeals against supervisory actions, and ii) ease the corporatization process for MCFs.

70. The FBA lacks a sufficient range of enforcement tools for the MCO sector and it is recommended that this be strengthened. Currently, the FBA's enforcement mechanism is limited

[22] Enterprise Survey 2013.

[23] The microcredit sector in BiH is composed of non-profit organizations (microcredit foundations, MCFs) and for-profit companies (microcredit companies, MCCs). Minimum capital requirement for MCFs and MCCs are 50,000 KM and 500,000 KM respectively, while credit limits are 10,000 KM for MCFs and 50,000 KM for MCCs.

to issuing orders, or the severe action of revoking licenses, with no intermediate tools available. Providing the FBA with a broader menu of corrective actions will give it the authority to impose the necessary sanctions on MCOs that commit offences, while providing the rest of the market with a more conducive operating environment. It is recommended that the Law on MCOs in FBiH be amended to include, among others, explicit powers to appoint advisors, impose temporary administration, and remove or replace management and board members.[24] An improved framework for appeals against FBA's supervisory actions should also be considered.

71. In parallel, a greater ease of corporatization is recommended. Easing the transition from MCFs to MCCs in the FBiH would help to strengthen corporate governance. Companies are subject to the application of the Company Law, which provides better internal checks and balances. Corporatization can also bring about other benefits: i) fairer competition by leveling the playing field between the entities, ii) higher lending limits to be better able to meet the needs of clients, iii) clearer liquidation processes, and iv) allows for the sustainable growth of MCOs through a broader range of funding. It is recommended to i) amend Article 15 of the Law on MCOs, to ease the establishment of MCCs; and ii) to resolve the issue of donated capital.

72. The leasing sector is facing significant challenges and its viability is at stake. Leasing sector assets have continuously declined from 6.2 percent of financial system assets in 2008 to 2.4 percent in 2013. This trend is likely to persist unless the following challenges are addressed: i) VAT is applied on the interest of financial leases, which disadvantages leasing compared to banking products; ii) repossession of assets in the event of default is cumbersome and lengthy, and can lead to further depreciation of the value of the asset; iii) supervision of operating leasing within leasing companies puts them at a disadvantage compared to companies providing similar services outside the scope of Banking Agency supervision. Thus, it is recommended to:

i) exempt the VAT on interest for financial leases to make leasing on the same level playing field as other types of credit in the context of a comprehensive and detailed set of recommendations of other elements of the VAT law;[25]

ii) update the by-laws of the pledge registry and the regulatory framework for enforcement to enable more effective repossession of assets;

iii) revise the legal framework to clarify the business activities of operating leasing.

73. The financial sector consumer protection framework was significantly enhanced in recent years in BiH, but improvement is needed on the transparency and disclosure regimes. Reforms in the consumer protection area includes: i) placing the responsibility for the regulation and supervision of consumer protection in the banking, MCO and leasing sectors to the respective Banking Agencies; ii) establishing the Ombudsman offices, and iii) introducing consumer disclosure

[24] The Banking Agency of the RS has more nuanced powers, through amendments to the Law on MCOs in 2011.

[25] From a fiscal sustainability point of view, it is not recommended to open the VAT law for changes without having a comprehensive and detailed set of recommendations of other elements of the VAT law.

requirements in line with the EU Credit Directives. Going forward, it is recommended that transparency and disclosure of information in the banking and MCO sector should be improved to foster competition and increase the comparability of financial products and services.

B. Capital Markets

74. Bosnia's capital markets are currently small, but they have the potential to play a more important role in the country's future. At present, the capital market in Bosnia represents a small part of the financial system. And while many companies appear to be listed on the two entity-level stock exchanges resulting from the mass privatization program undertaken in the late-90s, in reality very few companies or institutions have actually used the securities markets to raise capital to finance growth and expansion. However, the two entity-level governments have just recently begun to issue treasury bonds and T-bills to finance their own budgetary needs. Going forward, the government debt market will hopefully continue to expand and deepen so that it can become a more meaningful source of funding for the governments' own needs in both entities.

75. The capital market played a key early role in BiH's transition through facilitating voucher privatization and enhancing transparency. However, the subsequent losses caused by failed privatization investment funds (PIFs) have damaged investor trust and market development. Having established the two entity-level stock exchanges in the late-90s to support the first stage of the mass privatization program, the governments of both entities seem committed to using their respective exchanges to create more transparency within the economy, a feature which distinguishes Bosnia from other, less-transparent emerging markets. However, another key element in the governments' privatization strategy has proven less successful, namely, the decision to establish so-called privatization funds as a means of providing investors with another way of investing their vouchers, while encouraging the post-privatization restructuring of numerous formerly public sector enterprises.

76. Although a number of other transition countries also used privatization funds as part of their voucher programs, in Bosnia's case, most of these funds have failed to achieve any meaningful restructurings of the firms in their portfolios. As these PIFs were set-up as closed-end vehicles, investors today are unable to realize the little value that still remains in these funds. This negative experience has been suffered by a very large number of PIF investors and has caused severe damage to investor trust and confidence in the capital market generally and the fund management sector in particular. Considerable thought has already been given to this issue in both Entities, but so far no substantive progress has been made.

77. Importantly, the legal and regulatory framework for the capital market is basically sound, but the regulators lack the resources necessary for effective implementation. The two capital markets in Bosnia are regulated at the entity-level by two separate securities commissions, each with its own set of broadly similar laws and regulations. The respective regulators have begun the process of adopting various EU directives and protocols into their own legislation, with the result being a fairly sound and improving legal framework, though a lot of further work still lies ahead. Both regulators have only a small number of staff and thus lack the resources necessary to supervise

the very large number of firms whose shares are presently listed on the two exchanges or to effectively implement many of the rules and regulations that are already in place. Currently there are no formal organizations in place for this kind of cooperation, but going forward, it will be important for the regulators to work more closely together to share the burden of developing new legislation and new instruments, etc.

78. Although the government could use the stock market to privatize and recapitalize some remaining large public sector companies, the privatization process in both entities is currently stalled. In many advanced and emerging countries around the world, governments have used the domestic capital markets to facilitate the privatization of large public sector firms and to raise substantial amounts of capital in so these firms can continue to expand and prosper. Although to date, both Entity-level governments still have a number of large and profitable SOEs, significant sums could be raised on the domestic stock markets, positively impacting capital market development. It would be advisable for both entity governments to consider engaging qualified financial and legal advisors to develop a strategy for privatizing and recapitalizing some of these large, strategic SOEs using either the domestic and/or global capital markets.

79. For the capital market to develop in the medium term, much closer cooperation between the entity-level regulators and the two stock exchanges will be essential. Given Bosnia's small population and the rather small size of its capital markets, there is a compelling case for combining the two markets into a single, unified marketplace, but Bosnia's current constitutional framework would not allow this. As an alternative, Bosnia could follow a model similar to what has been done in the EU - and is currently working well. In the EU, efforts were made to link-up national exchanges and harmonize legislation and regulation across the entire region, but without requiring any country to give up their national stock exchanges or their rights to regulate their home markets. Instead, a so-called 'passporting' framework has been put in place that allows for issuers, investors and market intermediaries to operate in each other's national market, thereby creating a vastly larger 'common' market, without sacrificing any institutions or independence.

80. As the two entities already share the same currency and are adopting the same EU Directives, it should be fairly straightforward to create an electronic link between the two entity-level exchanges. However, for more complex regulatory matters that affect both entities, it would be preferable to consider forming an association, similar to what Canada has done in establishing the Canadian Securities Administrators, which brings together the provincial and territorial securities regulators from all 14 of Canada's provinces and territories.

C. Corporate Financial Reporting

81. The Second Accounting and Auditing Report on the Observance of Standards and Codes (ROSC) for Bosnia and Herzegovina (BiH) was published in July 2011. The supporting

Technical Note (TN) should be read in conjunction with the ROSC as it, reviews the implementation of its recommendations[26] and provide the reader with information on current developments in BiH.

82. BIH has substantially aligned its accounting and auditing laws with the EU *acquis communautaire* and will need to implement the new Directives on Accounting and Auditing from 2016. BiH has agreed to implement the European Union (EU) corpus of laws (also known as the acquis communautaire) after signing a Stabilization and Association Agreement with the European Union (SAA) in 2008. The 2014 EU progress report for BiH, published in October, found that corporate accounting and auditing laws were substantially aligned with *the acquis communautaire* and harmonized between the two entities. BiH will need to further align its laws with the new provisions of the EU acquis. New Directives on Accounting (2013) and Auditing (2014) will become effective in 2016.

83. Since the 2010 ROSC was agreed, secondary laws were issued by the MoFs in FBiH and in RS to implement IFRS for SMEs and to address some of the recommendations of the ROSC. In FBiH, the MoF issued secondary legislation in 2013 for the implementation of IFRS for SMEs, allowing the standard to be used for the preparation of non-public interest SMEs' financial statements from 2013. In RS secondary legislation was issued in 2011 giving the option of using IFRS for SMEs when preparing financial statements of non-public interest entities from 2012. Other dispositions in RS included further harmonization to meet the same deadlines as in FBiH for the preparation and submission of consolidated financial statements, and publication of transparency reports for audit firms that audit Public Interest Entities (PIEs - listed companies, banks, insurances companies, pensions funds, etc).

84. The implementation of IFRS for SMEs has proven successful in the RS. More than 50 percent of companies file their financial statements prepared using this standard. This represents a great reduction in the burden on companies when preparing financial statements, as it requires far fewer disclosures than full IFRS. Implementation of the standard in FBiH is currently very low, as the corresponding secondary legislation was issued only in 2013. The requirement for IFRS for SMEs should be expanded to all SMEs in both Entities.

85. BiH will need further efforts to implement the lowering of requirements for small companies envisaged in the EU accounting framework. The new Accounting Directive opens an option for a micro regime. This process could be informed by the guidance published by the IFRS Foundation[27] on implementing IFRS for SMEs in micro-entities.

86. The RS Association of Accountants and Auditors and the FBiH Association of Accountants, Auditors and Financial Workers are respectively full member and associate member of International Federation of Accountants (IFAC). Both professional bodies have made

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[26] http://imagebank.worldbank.org/servlet/WDSContentServer/IW3P/IB/2012/06/22/000333038_20120622024152/Rendered/PDF/703650ROSC0P110osniaherzegovina0eng.pdf

[27] http://www.ifrs.org/IFRS-for-SMEs/Pages/Guidancemicrosizedentities.aspx

substantial efforts to comply with the statements of membership obligations of IFAC. More recently the RS association initiated preliminary work on audit quality assurance with the assistance of the French profession. The FBiH Association of Accountants, Auditors and Financial Workers has strengthened its initial and continuing education processes, and published a translation of IFRS for SMEs in local language using the Latin alphabet. The RS Association of Accountants and Auditors has published a version of IFRS for SMEs using the Cyrillic alphabet. The two versions are otherwise substantially alike.

87. Both professional bodies, however, fail to provide a continuous mechanism for the translation of International Financial Reporting Standards and International Standard on Auditing. Even if this is not currently causing substantial departure from the English version of the standards, a continuous mechanism for translation is to be put in place in cooperation with Entities governments. The respective Ministries of Finance, as the licensing bodies, should monitor that the translation processes are continuous.

88. Current monitoring and enforcement arrangements do not ensure that the quality of financial statements meet the standard of IFRS. The audit public oversight systems are nascent, and audit quality assurance systems have only performed preliminary work. It will take at least three to five years of constant effort to implement these systems effectively. In addition, provisions of the new EU audit regulation relating to the monitoring of audits of PIEs will necessitate that the institutions responsible for audit public oversight directly monitor audit firms responsible for PIEs statutory audits and are completely independent from the audit profession. These requirements will imply additional constraints on the capacity of the Entities to implement these systems. Financial sector regulatory agencies have increased their monitoring of financial statements compliance with IFRS and need to continue these efforts by hiring specialized staff or training existing staff in IFRS and at a minimum ISA 700, the standard that governs the audit report.

89. Preliminary results in implementing statutory audit quality assurance systems in both Entities point to a decrease in audit quality and numerous instances of non-compliance with ISA and IFRS. Some of the roots for low audit quality are the constant downward pressure on audit fees, rapid rotation, and late appointment of statutory auditors.

D. State Bank Governance

90. The FBiH and the RS have equity or debt in their respective domestically-owned banking sectors. The FBiH owns the Development Bank of the Federation of Bosnia and Herzegovina (DBFBiH) and one commercial bank, Union Bank. The government of the Republic of Srpska (RS) owns a majority stake in Banka Srpska and preferred, convertible shares in two other commercial banks, Pavlovic Banka and Bobar Banka. Additionally, the RS also holds subordinated debt in Nova Banka. The RS holdings are managed by the IRBRS.

Governance processes reveal a number of common practices and concerns

91. Banks' supervisory boards are not performing their intended leadership role. Supervisory boards provide little strategic direction (in terms of business approach and risk appetite), seemingly focused on conducting high level compliance activities rather than holding bank management accountable for executing its strategy, the prudent operation of the bank or establishing strong systems and controls. As a result, the management board is *de facto* placed in a stronger leadership and decision making position, resulting in an important blurring of lines of accountability and operational management.

92. Despite the existence of a structured recruitment process for banks' supervisory board members, overall the boards lack the experience, skills and independence to effectively guide their institutions. Selection criteria are rather basic (university degree and five years of professional experience). As a result, many board members do not have important sector specific skills needed to direct and oversee a bank. The government recruitment committee does not communicate with existing board members to determine the skills needed to construct a board with relevant experiences and qualifications. The laws are silent regarding independence requirements of supervisory board members and do not limit the number of civil servants in the supervisory boards of state banks.

93. The internal audit functions of state banks are not fulfilling their mandates in practice nor does the audit board structure promote effective monitoring of the banks' control environment. The audit board operates as a separate corporate body rather than as subcommittee of the board. This arrangement has the effect of diffusing responsibility and accountability for internal audit oversight and effectiveness.[28] As a result, the supervisory board is not fully apprised of the quality of performance of the internal audit function. Moreover, banks' internal audit departments suffer from understaffing and cannot comprehensively cover bank operations with a high level of quality.

94. The risk management function in the state banking sector is a nascent. Banks report that the functions typically support the credit approval process (which involves them in the business line), determine credit classification according to regulation, and periodically perform portfolio monitoring. However, the head of the functions are accountable to senior management and are currently not independent.

Development Bank of the Federation of Bosnia and Herzegovina (DBFBiH)

95. The DBFBiH is charged with promoting social and economic development in the FBiH. However, the DBFBiH lends directly to the market, but has not set targeted strategies or policies to

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[28] The supervisory board is responsible for both appointing and remunerating the internal auditor. However, the audit board reviews the audit plan, monitors the audit process, and receives the audit results. While the audit board may report periodically to the supervisory board, in some cases the reports are only written. It is not a common practice for the internal auditor to interact with the supervisory board. This makes it difficult, if not impossible, for the supervisory board to be apprised of the control environment and for it to assess the performance and adequacy of the internal audit function. This also can allow the supervisory board to relegate its responsibility for the bank's control environment and control oversight.

support specific sectors of the economy (e.g. SMEs, agriculture, etc.). Moreover, the DBFBiH faces important long term financing shortcomings, as according to Article 3 of the Law on the DBFBiH, it should have operating capital of 400 mn KM. However, its capital has not exceeded 180 mn KM since the creation of the bank.

96. The DBFBiH is only partially supervised by the Banking Agency of the FBiH (FBA). The DBFBiH is incorporated under a separate legislation, the Law on the DBFBiH, which restricts the FBA's supervisory reach. As a result, the FBA is not allowed to sanction the bank for violations of regulation or vet the fitness and propriety of its supervisory or management board members.

Investment and Development Bank of Republic of Srpska (IRBRS)

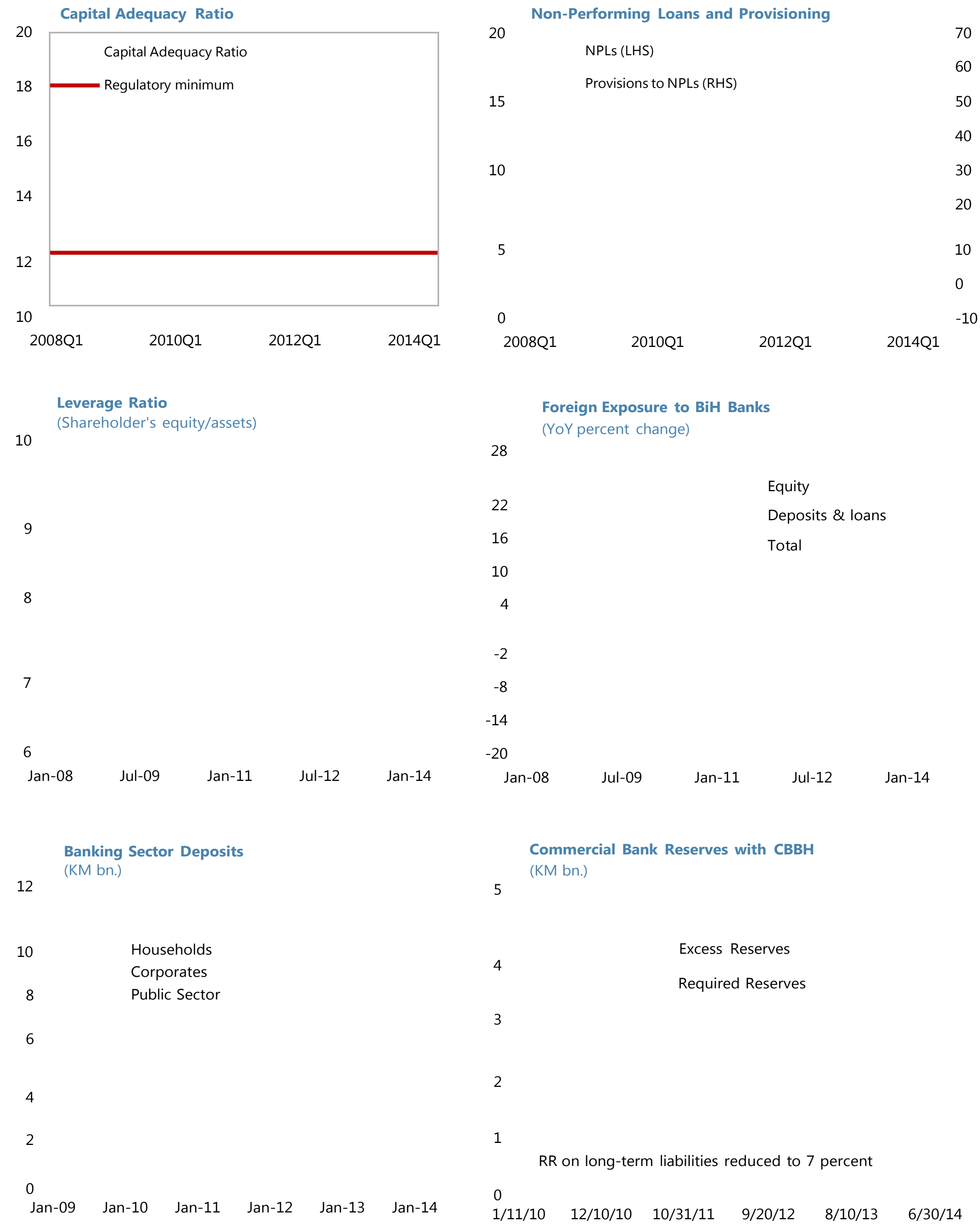
97. In addition to its development activities (e.g. housing finance, SME finance), the IRBRS is charged with oversight responsibility for the state's investments. The IRBRS oversees and carries out certain governance responsibilities in the state's investments in the real and financial sectors and manages the portfolio of existing state-owned enterprises. The IRBRS is set up as a joint stock company under the Law on the IRBRS and manages six funds through which the activities are conducted. The funds are individual joint stock companies; each formed under its own law.

98. Specific objectives, business strategies and exit plans for the government's participation in and support of the financial sector have not been defined. During the last two years, the government of the RS, through the IRBRS, has sharply increased its participation in the domestically-owned financial sector through equity stakes, subordinated debt and deposit placements. In order to support the government's role in the financial sector and to assure both clear objectives and an exit strategy, each IRBRS related bank investment should be supported by a specific financial institution mandate or comprehensive time-bound management plan.

99. During this period of financial sector intervention, the rigorous oversight by the IRBRS as shareholder for the government's bank related investments is warranted. While the IRBRS has a long established investment monitoring process for its historic holdings, specific bank level performance parameters have not been developed to provide feedback on the financial and qualitative performance of these financial institution investments. Given the specific types of credit, operational and other risks potentially emanating from the financial sector and the extensive nature of the government's involvement in the sector, a performance evaluation methodology that includes key performance indicators (KPIs) and linked management performance contracts should be developed and mutually agreed by the IRBRS and the respective banks' supervisory board and management. Once adopted, these should be regularly monitored to hold accountable the banks' supervisory boards, audit boards and management.

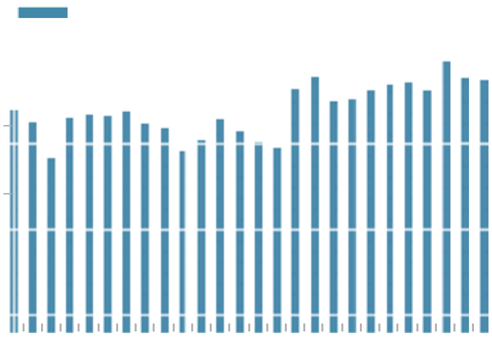
Appendix I. Figures and Tables

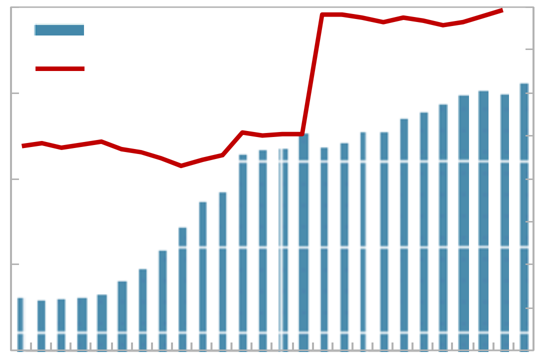
Appendix Figure 1. Banking Sector Developments

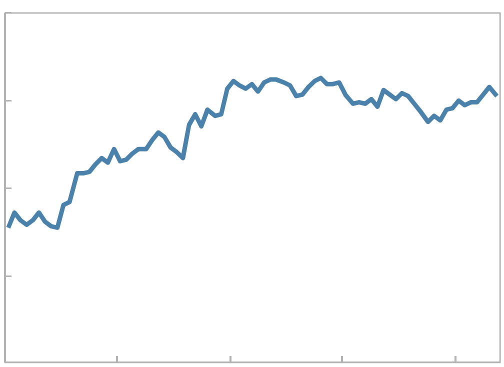


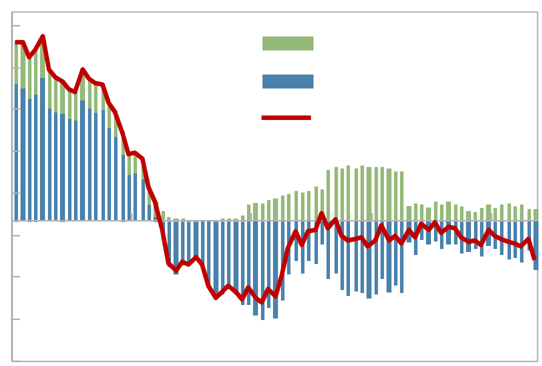
Source: CBBH, and FBIH and RS Banking Agencies.

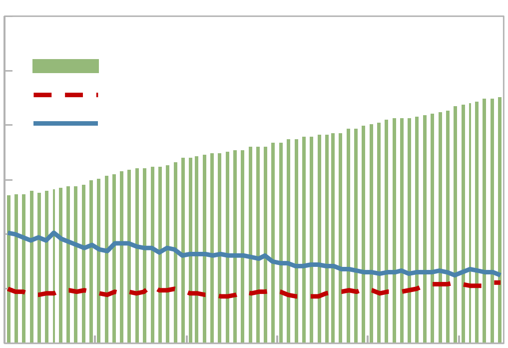
Note: Prior to 2010, assets classified as loss, alongside the provisions made against them, were held off-balance sheets by banks in BiH. This lowered the reported NPL ratios and coverage of nonperforming loans by provisions. Starting with the December 2010 date in the RS, and the December 2011 date in the Federation, banks recorded on-balance sheet the "loss" loans and related accrued interest and provisions, resulting in a structural break in the series.

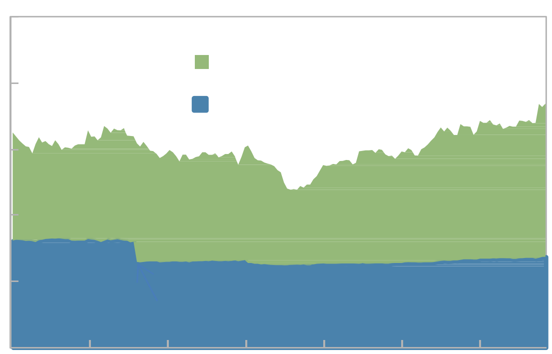












Appendix Table 1 Financial System Structure, 2005-2014

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014Q1
Number										
Banks 1/	33	32	32	30	30	29	29	28	27	27
of which: Foreign-majority owned banks 2/3/	20	22	21	21	21	19	19	19	17	15
Domestic private banks 3/	7	5	8	7	7	9	9	8	8	10
Domestic state-owned banks	6	5	3	2	2	1	1	1	2	2
Insurance and reinsurance companies	24	24	26	26	27	26	26	25	25	...
Investment funds (asset management companies)	24	24	28	32	33	32	32	33	34	...
Leasing companies	6	6	8	9	9	9	9	9	8	...
Microcredit organizations	50	...	24	27	26	25	25	22	19	...
Stock exchanges	2	2	2	2	2	2	2	2	2	...
Brokerage houses	17	18	27	26	23	20	17	15	13	...
Financial system assets (millions of KM)										
Banks 1/	11,726	14,683	19,570	20,813	20,608	20,416	20,995	21,186	22,023	21,862
of which: Foreign-majority owned banks (percent of total bank assets) 3/	90.8	94.0	93.8	95.0	94.5	92.8	92.1	91.9	90.5	82.4
Domestic private banks (percent of total bank assets) 3/	5.6	2.8	4.3	4.1	4.7	6.4	7.0	7.1	7.4	15.6
Domestic state-owned banks (percent of total bank assets)	3.6	3.2	1.9	0.9	0.8	0.8	0.9	1.0	2.1	2.1
Insurance and reinsurance companies	676	708	853	889	933	936	1,080	1,174	1,232	...
Investment funds (asset management companies)	1,793	1,553	1,762	1,225	871	888	810	796	762	...
Leasing companies	660	1,025	1,378	1,607	1,416	744	767	716	597	...
Microcredit organizations	314	488	946	1,213	1,087	853	742	676	667	...
Stock exchanges	3	5	7	7	7	7	8	7	8	...
Brokerage houses	1	5	7	4	4	7	6	4	4	...
Financial system assets (percent of total assets)										
Banks 1/	77.3	79.5	79.8	80.8	82.7	85.6	86.0	86.3	87.1	...
Insurance and reinsurance companies	4.5	3.8	3.5	3.5	3.7	3.9	4.4	4.8	4.9	...
Investment funds (asset management companies)	11.8	8.4	7.2	4.8	3.5	3.7	3.3	3.2	3.0	...
Leasing companies	4.4	5.5	5.6	6.2	5.7	3.1	3.1	2.9	2.4	...
Microcredit organizations	2.1	2.6	3.9	4.7	4.4	3.6	3.0	2.8	2.6	...
Stock exchanges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Brokerage houses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Nominal GDP (mln KM)	17,148	19,567	22,065	24,984	24,307	24,879	25,772	25,734	26,297	6,091
Exchange rate (KM/USD, eop)	1.66	1.49	1.33	1.39	1.36	1.47	1.51	1.48	1.42	1.42

Sources: Central Bank of Bosnia and Herzegovina (CBBH); Banking Agency of FBiH; Banking Agency of RS; and Agency for Statistics of Bosnia and Herzegovina.

1/ Data of banks are from the supervisory data, and data of non-banking insitutions are from the statistical MFS data.

2/ The foreign-owned banks are subsidiaries of large foreign banks.

3/ One bank's ownership changed from foreign to domestic in Q3 2014. Another foreign bank (according to CBBH) is classified as a domestic private bank here because it is a "round-trip" investment.

Appendix Table 2. Financial Soundness Indicators of the Banking System

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014Q1
	(In percent, unless otherwise specified)									
Capital adequacy										
Regulatory capital (mln KMs)	1,488	1,861	2,345	2,637	2,642	2,739	2,860	2,821	2,995	2,939
Regulatory capital to risk-weighted assets (RWAs)	17.8	17.7	17.1	16.2	16.1	16.2	17.1	17.0	17.8	17.3
Asset quality										
Non-performing loans (NPLs) to gross loans	5.3	4.0	3.0	3.1	5.9	11.4	11.8	13.5	15.1	14.9
Provisions to NPLs	...	...	...	...	34.5	43.7	66.3	65.9	66.7	68.0
NPLs net of provisions to Tier 1 capital	...	...	...	...	25.5	42.0	25.9	30.0	31.0	28.9
Earnings and profitability										
Return on average assets (ROAA) 1/	0.7	0.9	0.8	0.4	0.1	-0.6	0.7	0.6	-0.2	0.3
Return on average equity (ROAE) 2/	6.2	8.4	8.6	4.2	0.8	-5.5	5.8	4.9	-1.4	2.3
Gross income to average assets	7.6	7.0	6.4	5.8	5.6	5.8	5.9	5.7	5.6	1.4
Net interest income to gross income	54.1	54.3	59.7	60.6	61.5	60.1	63.9	63.7	62.3	62.5
Non-interest expenses to gross income	90.1	86.5	85.1	90.6	97.4	109.0	86.5	87.4	101.2	78.1
Liquidity										
Liquid assets to total assets	36.1	35.9	37.7	30.0	30.9	29.0	27.2	25.4	26.4	24.7
Liquid assets to short-term liabilities	61.9	60.8	61.3	51.8	53.0	49.7	46.7	44.1	46.2	43.6
Deposits to assets (excluding interbank deposits)	58.0	58.9	60.9	55.1	56.0	58.8	59.1	60.5	62.2	63.5
Loans to deposits	103.8	102.5	97.2	122.3	116.9	116.0	117.9	118.6	114.8	115.0
Sensitivity to market risk										
Net long position in foreign exchange to Tier 1 capital	8.3	9.1	5.9	6.2	1.7	4.4	16.0	5.3	6.7	4.7
Foreign-currency-denominated loans to total loans	68.7	71.0	74.1	73.3	73.9	70.0	66.9	63.1	62.9	61.8
Foreign-currency-denominated liabilities to total liabilities	64.4	62.8	65.1	69.5	69.2	67.0	66.2	65.2	63.8	63.2

Sources: CBBH; Banking Agency of FBiH; and Banking Agency of RS.

1/ Net income as percent of average assets.

2/ Net income as percent of average equity capital.

Appendix Table 3. Banking System Assets, end-March 2014

Bank Name	**Total Assets** *(Percent of total banking assets in BiH)*	**Total Assets** *(Percent of total banking assets in the Entity)*	**Ownership**
	Federation of Bosnia and Herzegovina (FBiH)		
Raiffeisen bank d.d. Bosna i Hercegovina	17.4	24.9	Foreign bank (Austria)
UniCredit bank d.d.	16.7	24.0	Mostly foreign bank (Italy)
Intesa Sanpaolo banka d.d. Sarajevo	6.1	8.8	Mostly foreign bank (Italy)
Hypo Alpe-Adria bank d.d. Mostar	5.0	7.2	Foreign bank (Austria)
Sparkasse bank d.d.	4.6	6.5	Mostly foreign bank (Austria)
Sberbank BH d.d.	4.0	5.7	Foreign bank (Russia)
NLB banka d.d.	3.8	5.5	Mostly foreign bank (Slovenia)
Bosnia bank international d.d. Sarajevo	2.5	3.6	Foreign bank (UA Emirates and Dubai, 54.5%; and Saudi Arabia, 45.5%)
Ziraatbank BH d.d.	1.8	2.6	Foreign bank (Turkey)
ProCredit bank d.d.	1.6	2.4	Foreign bank (Germany)
Vakufska banka d.d. Sarajevo	1.3	1.9	Mostly domestic private bank
BOR banka d.d.	1.1	1.5	Mostly domestic private bank
UNION banka d.d.	1.0	1.5	State-owned bank
Investiciono Komercijalna banka d.d.	0.9	1.3	Mostly domestic private bank
Moja banka d.d.	0.8	1.2	Mostly domestic private bank
Privredna banka d.d	0.7	1.0	Mostly domestic private bank
Komercijalno Investiciona banka d.d.	0.3	0.5	Mostly domestic private bank
	Republika Srpske (RS)		
Nova banka a.d.	6.9	22.8	Mostly domestic private bank 1/
NLB Razvojna banka a.d.	5.5	18.2	Mostly foreign bank (Slovenia)
Hypo Alpe-Adria bank a.d.	5.2	17.3	Mostly foreign bank (Austria)
UniCredit bank a.d.	4.1	13.5	Mostly foreign bank (Austria)
Sberbank a.d.	2.8	9.2	Mostly foreign bank (Russia)
Bobar banka a.d.	1.6	5.2	Mostly domestic private bank
Komercijalna banka a.d.	1.2	3.8	Foreign bank (Serbia)
Pavlovic international bank a.d.	1.2	3.8	Mostly domestic private bank 2/
Banka Srpske a.d.	1.1	3.5	State-owned bank
MF banka a.d.	0.8	2.6	Domestic private bank

Sources: Banking Agency of FBiH; Banking Agency of RS, and staff calculations..
1/ The ownership of this bank changed in Q3 2014 from a mostly foreign bank to a mostly domestic private bank.
2/ This bank is classified as a mostly domestic private bank because the majority owners of this bank have dual citizenship (BiH and the U.S.) and the other shareholders are mostly domestic.

Appendix II. Bosnia and Herzegovina: Progress on 2006 FSA Recommendations

2006 Main Recommendations	Implementing Agency	Status of Implementation
Improve bank capital adequacy, provisioning and loan classification and strengthen the capacity of supervisors to monitor and enforce these rules.	FBA, BARS	**Partially Implemented**. IAS has been introduced and the capital standard strengthened. However prudential provisioning standard has not been revised and capacity to enforce under IAS requires additional training.
Adjust prudential tools to foster a shift in financing of credit from foreign parent bank funding towards local deposits.	FBA, BARS, CBBH	**Not implemented**. However, market and economic changes have reduced the dependency.
Strengthen banks' risk measurement systems by improving the quality of data on credit, including by extending the CBBH credit registry to cover households.	FBA, BARS, CBBH	**Implemented**.
Strengthen the independence, powers and capacity of banking supervisors.	FBA, BARS	**Partially implemented.** The capacity of the supervisors is strengthened.
Enhance consolidated supervision and cooperation with the home country supervisors of the major foreign-owned banks in BiH, and work together to strengthen application of parent banks' risk management systems in BiH.	FBA, BARS	**Not implemented**. Although there has been a lot of progress in realizing MOU's with some key home supervisors, this is not yet finalized. Consolidated supervision is still to be implemented.
Unify two banking agencies within the CBBH with appropriate safeguards to ensure adequate protection for supervisors from political interference.	FBA, BARS	**Not implemented**. Legal protection in both entities should be enhanced.
Implement a new State level Banking Law upgrading the regulatory framework.	FBA, BARS	**Not implemented.** The authorities argue that financial sector regulation falls under the competency of the entities.
Improve the mechanisms to enforce antitrust rules in the banking sector.		**Not implemented.** Formal cooperation mechanisms between the Competition Council and the banking agencies remain to be developed.

Clarify inter-agency mandates, especially in mergers and acquisitions		**Not implemented.** The respective mandates of the Competition Council and the banking agencies, especially in bank mergers and acquisitions, are yet to be clarified.
Develop specific contingent arrangements for borrowing by the Deposit Insurance Agency in case of possible shortfalls in the Deposit Insurance Fund.	DGS	**Implemented.** A standby facility of €50 million was established with the EBRD. It is due to expire in 2017 unless renewed.
Issue the necessary technical regulations as soon as possible.	Insurance agencies	**Implemented**. The bylaws on solvency, technical provisions and the guarantee fund have been issued, Both entities have implemented Solvency I regimes
Set up a mechanism to enforce and to supervise the tariff for compulsory Motor Third Party Liability insurance.	Insurance agencies	**Not implemented**. A project to liberalized the tariffs is in advanced stage.
Upgrade the institutional structure and enforcement capacity of insurance supervision in both entities.	Insurance agencies	**Implemented**. The budget and the staff have been increased. Operational infrastructure has been established. The powers of the ISAs have been regulated in bylaws and used.
Strengthen disclosure of beneficial owners, quality of financial reporting, accountability of corporate bodies and effectiveness of regulatory agencies.	FBA, BARS	**Partially implemented.** Despite commendable efforts towards better transparency since 2006, further improvements are warranted to enhance the overall quality of disclosures beyond the simple appearance of compliance. Supervisory agencies need to enforce more effectively IFRS for companies under their supervision.
Approve an investment funds law allowing PIFs to be converted into either funds or closed joint stock holding companies.	FBiH: Fed SC RS: RSSC	**Not implemented.** The RS Securities Commission developed and the RS government approved a draft Law on Changes to the Investment Funds in June 2013 which would have enabled this transformation. However, this proposed legislation was withdrawn. Consideration is currently being given to re-introducing this legislation. In the FBiH, no such

		tangible efforts to has yet been undertaken.
Approve microfinance and leasing legislation, strengthening oversight of MCIs.	FBA, BARS	**Implemented.** Legislation was passed and implemented with the Law on Microcredit Organizations and Law on Leasing. Oversight is undertaken by the entity banking agencies
Upgrade and restructure the infrastructure of the court system in both entities.	RS MoJ, FBiH MoJ	**Partially implemented.** In the RS a Commercial Court has been established, and in the FBiH certain judges have developed specialization in commercial cases. Nonetheless, there is still a large backlog of commercial cases. Mediation and arbitration have not been taken up and have not reduced the workload. Enforcement of both secured and unsecured debt is a very lengthy and cumbersome process. Bankruptcy proceedings too are inefficient and do not in practice support the reorganization of viable businesses.