Financial Systems in the Western Balkans – Present and Future

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Abbreviations

ALB	Albania
AQR	Asset Quality Review
BiH	Bosnia and Herzegovina
BIS	Bank of International Settlement
BoA	Bank of Albania
BRICS	Brazil, Russia, India, China and South Africa
CBM	Central Bank of Montenegro
CBK	Central Bank of Kosovo
CDS	Credit Default Swap
CEE	Central and Eastern Europe
CESEE	Central, Eastern and Southeastern Europe
CRD	Capital Requirement Directive
DIA	Deposit Insurance Agency
EBA	European Banking Authority
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
EU	European Union
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
FSC	Financial Stability Committee
FSI	Financial Stability Indicators
GDP	Gross Domestic Product
IFS	International Financial Statistics
KSV/KOS	Kosovo
LIBOR	London Interbank Offered Rate
FYR MKE/MKD	Former Yugoslav Republic of Macedonia
MNE	Montenegro
MREL	Minimum Requirement for Eligible Liabilities
NBFI	Non-Bank Financial Institutions
NBS	National Bank of Serbia
NBRM	National Bank of the Republic of FYR Macedonia
NMS	New Member States
NPL	Non-performing loan
OECD	Organization for Economic Co-operation and Development
PTA	Preferential Trade Agreements
RA	Resolution Authority
RoA	Return on Assets
RoE	Return on Equity
SAP	Stabilization and Association Process
SDG	Sustainable Development Goals
SEE6	South Eastern Europe Countries (Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, Serbia)
SIFI	Systemically Important Financial Institution
SLR	Strength of Legal Rights
SME	Small and Medium-sized Enterprise
SOE	State owned enterprises
SRB	Serbia
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
WBS	Western Balkans
WDI	World Development Indicators
WEO	World Economic Outlook

Executive Summary

Financial systems in the Western Balkans continue to face a number of challenges to financial sector development and stability in both the short- and medium term. The size and structure of the financial sector varies considerably across Western Balkan countries and is primarily bank-based with different degrees of concentration. While banking sectors have developed rapidly, nonbank financial services have remained relatively shallow. Financial intermediation in the Western Balkans remains low when compared to other countries in Central, Eastern and Southeastern Europe (CESEE). The depth of the financial sector measured by private sector credit to GDP stands at an average of 45 percent with particularly low levels in Kosovo and Albania. Foreign bank dominance contributed to more efficient and deepened financial systems but also increased exposure to external risks.

A new set of global rules, weakened asset quality and profitability, a new perspective on exchange rate risk exposures, and a shift in funding structures towards domestic deposit mobilization are among the key features of the post-crisis reality. The impact of these challenges is compounded by the lower growth scenarios under which financial systems in the region are operating. Following stagnant or declining credit conditions in recent years, lending recovered slightly during 2015 in most Western Balkans countries. The banking sector is still dealing with the aftershocks of the global financial crisis that have weakened financial sector asset quality and profitability. At the end of 2015 non-performing loans (NPLs) stood at an average of 13.9 percent and return on assets (RoA) at 1 percent with considerable variations across the region. Although the banking systems - dominated by foreign banks - appear broadly sound, significant pockets of vulnerability exist among domestically-owned banks. Protracted risks stem from the large stocks of foreign exchange lending to unhedged borrower and foreign bank deleveraging. Against this backdrop, post-crisis trends towards domestic resource mobilization are encouraging but need further improvement in an environment where uncertainty related to external funding sources prevails.

Over the longer term, prospects for the financial systems in the Western Balkans are significantly dependent on external events. Reflecting that the outcome of a number of external critical uncertainties will shape the future of Western Balkan financial systems – notably in the global economy and financial markets, the European Union (EU), as well as technology-based innovation – a fundamental question emerges as policy makers and regulators consider their options: *What could the world around the financial systems of the Western Balkans look like in 2025?* Acknowledging existing uncertainties, three scenarios were developed to facilitate a conversation at the regional and national level on possible policy responses.

The dynamism of the global economy in the *Shifting Orange* scenario presents many opportunities for countries in the region but might also require much rethinking of conventional assumptions. With the center of gravity no longer in the advanced countries the *Shifting Orange* scenario is characterized by growth of multidimensional capital flows and major new players in the banking foreign direct investment (FDI) scene. Balancing tensions between regulation and innovation while helping regional financial systems leapfrog in terms of depth and inclusion is key in this scenario. Moreover, managing risks and opportunities arising from the relaxation of the global regulatory environment, as well as ensuring that the 'new' financial system has become a positive force for growth and stability in 2025, should be of particular focus in this world. Finally, international partnership 'diversification' beyond the EU merit consideration in the context of this scenario.

The turmoil in the global economy reflected in the *Unsettling Grey* scenario raises problems for the financial system, stemming from a low growth environment and assumed political fragility, including in the EU. Building oversight capacity, improving bank resolution regimes and strengthening coordination structures at the regional and European level are crucial in such an adverse environment. Swift reaction to funding risks stemming from parent bank deleveraging and retrenchment

will be important. There is a need for strengthened corporate governance regimes in a world with increasing state involvement in the banking sector. Public banks or domestic development banks could play an increasing role to facilitate long-term finance and counterbalance cyclical effects, however distortions in their institutional and governance setup need to be avoided. Moreover, in a scenario where core EU countries revert to national currencies, the question of currency ‘affiliation’ becomes key. Balancing the financial stability challenges presented by this world with the aim of increasing financial depth and inclusion poses a substantial challenge. Finally, considering measures to avoid contagion as risk perceptions about emerging market countries become heightened will be important for the region in *Unsettling Grey*.

The positive evolution of the EU economy and integration in the *Orderly Blue* scenario would offer countries in the region many opportunities for banking and capital markets integration.

Advantages from tailoring relevant EU directives and regulations to country specific contexts versus full transposition requirements at accession stage will need to be balanced carefully. In this world the Basel-driven regulatory environment brings benefits in terms of a safer and sounder financial system. At the same time its potential unintended effects imply higher compliance costs and capital requirements which could have a detrimental effect on bank FDI and credit lines, on which the region is quite dependent. Tightened global liquidity conditions require further emphasis on domestic resource mobilization. In this scenario, further steps would be required by policymakers and regulators to ensure that credit growth is supportive of private sector activity—even in the context of restrained foreign bank activity. Limited innovation in financial services and payment systems in this scenario should be considered an opportunity for small countries to become pioneers, rather than seen as a constraint.

The scenarios are intended to facilitate a conversation at the regional and national level on possible policy responses to each of the scenarios.

While the regional level discussion provided a useful validation of the scenarios and a starting point for analyzing implications for actions, the greatest value to be derived from the scenarios will be at a national level aimed at informing financial sector strategies and action plans. Each scenario spotlights different challenges and opportunities that would be useful for financial policymakers and regulators to consider. The illustrative examples in Table 6 of Chapter V are meant as a starting point for exploration of scenario

implications and ‘strategic action’ at the national level. The issues and questions are highlighted in the ‘world’ where they are most critical - which does not preclude their relevance for other scenarios - and revolve around the following policy areas: (i) bank regulation, supervision and coordination, (ii) financial intermediation, (iii) regulation and supervision of new entrants/players, (iv) financial sector stability and security, and (v) financial infrastructure. Comparing the appropriate responses across scenarios will provide insights on key policy areas that need to be addressed no matter what the future looks like and can shed light on policy areas paid insufficient attention to in the current policy dialogue. The scenarios can also serve to test policy options under consideration and inform the development of financial sector strategies that contribute to the country’s overall success in sustainable and inclusive growth.

I. Snapshot of the Western Balkans (WBS) Financial Systems

An abstract graphic consisting of numerous thin, light blue wavy lines that overlap and flow across the lower half of the page, creating a sense of movement and depth.

A. Macroeconomic Situation and Prospects in the WBS

Following a decade of conflicts, Western Balkan countries accomplished robust economic growth in the 2000s. With the materialization of the peace dividend, Western Balkan countries experienced rapid structural transformations towards market-based economies, became more open to the world, and prioritized macroeconomic stability including sharp inflation reduction. As a result, the average GDP growth exceeded 4 percent annually between 2002 and 2008, per capita income in the region almost tripled, and poverty declined considerably notwithstanding the rise in income inequality.

This growth pattern was domestic demand driven and externally financed, hence was hampered significantly by the global financial crisis and subsequent euro area debt crisis. Accompanied by abundant global liquidity conditions and low interest rates, capital account liberalization bolstered external inflows to the region while increased integration with the EU strengthened trade and financial linkages. Accordingly, the region started to incur large current account deficits and became heavily dependent on capital inflows and remittances to finance domestic demand driven economic growth. Reversal of capital flows and weak external demand, stemming from the global financial crisis and subsequent euro

area debt crisis, deteriorated the growth dynamics significantly and caused a double-dip recession in the region. Overall, the recession lasted longer than in other emerging markets and new member states, and stalled the poverty reduction trend through increases in already high unemployment.

Despite modest post-crisis recovery, the region continues to struggle with structural problems that undermine economic growth. Western Balkan economies continue their post crisis recovery with an average growth rate of 2.1 percent in 2015. While lagging behind the rest of the region, Serbia and Bosnia and Herzegovina (BiH), heavily hit by the floods in 2014, are recovering faster than expected (see Figure 1). Western Balkan economies experienced a considerable rebalancing following the recession. Current account imbalances narrowed somewhat in most countries, but remain high at an average of 6.3 percent of GDP in 2015. While average fiscal deficit remain almost unchanged compared to 2014 at 3.8 percent, developments have been heterogeneous across the region. Continued fiscal consolidation efforts in 2015 narrowed deficits considerably in most countries. The exception was Montenegro, where the deficit widened sharply (from 3.1 to 7 percent of GDP) following a spike in capital expenditures, repayment

Figure 1: Real GDP growth (annual %)

Source: Country authorities, World Bank estimates and projections.

Figure 2: Current account balances, percent of

Source: World Bank calculations based on data from central banks and national statistical offices.

Figure 3: Fiscal deficit to GDP

Source: Ministries of Finance.

of public arrears, and revenue underperformance. High unemployment, especially among youth, and low productivity of capital are among the factors that constrain income growth in the medium-term.¹

Prospects for the region remain significantly dependent on external developments—but also progress on structural reform agendas. Continued dependency on external inflows, trade and remittances as well as limited fiscal buffers threaten the sustainability of economic growth given regional and global uncertainties. On a country-level, high debt and large current account deficits will continue to dampen economic prospects in the region unless there is marked progress on structural reforms. Moreover, the Western Balkans remain vulnerable to political cycles, which may threaten current reform momentum in consolidating public finances, addressing rigidities in capital and labor markets, refining the legal system, progressing on institutional quality, improving the business environment, and restructuring remaining state-owned enterprises (SOEs). Aside from the 'slow but steady' emigration of domestic populations to third countries, the attention of policymakers in the region, and in the EU, has also turned to the challenge of rising transit migration through the region to the EU.

Against this backdrop, further financial deepening and improved financial stability are essential to boosting sustainable growth. The growth potential in the region is hampered by weaknesses in financial sector development and stability, with high costs of intermediation and high levels of NPLs. Further challenges are posed by growing risks in domestic banks in select countries, shallow non-bank financial sectors, and weaknesses in bank regulation and oversight. External factors that have an impact on financial systems in the region include the global market outlook, external borrowing risks and constraints, EU regulatory and supervisory reforms and parent bank capital constraints. Addressing existing financial stability challenges while identifying opportunities for further financial sector development will help ensure that the Western Balkan economies have the financial sectors they need, and will allow entrepreneurs to better invest in productive (and tradable) sectors, creating more jobs to support export-led growth.

¹ South East Europe Regular Economic Report No. 9: Rebalancing for Stronger Growth, World Bank, Spring 2016.

B. Structure of the WBS Financial Systems

Figure 4: Assets as a share of GDP (2014)

Source: IFS, National authorities and World Bank staff calculations

The size and structure of the financial sector varies considerably across the Western Balkan countries and is primarily bank-based. In terms of size, on average, the region's financial sector assets are equal to 93 percent of GDP. Levels of financial sector depth vary across the region ranging from 81 percent of GDP in Kosovo to 103 percent in Albania and Serbia

(see Figure 4). Financial sectors in the Western Balkans are bank-centric, with relatively minor levels of capital market activity, negligible penetration of insurance products, and generally insignificant non-bank financial institutions. Banking sector assets represent between 70 and 92 percent of financial sector assets. The importance of the banking sector is the lowest in Kosovo, with around 70 percent of financial system assets, due to the significant role that pension funds play in complementing the pay-as-you-go government funded system (see Table 1).

Banking sectors in the region are dominated by foreign banks. Foreign banks from euro area countries dominate.² In terms of total banking assets, in five of the Western Balkans countries between 80 and 90 percent are controlled by foreign banks. Serbia is the exception, where state-owned commercial banks control about 20 percent of the banking sector and the level of foreign bank ownership is lower at 75 percent. Concentrations differ across the region, with around two thirds of total assets in the hands of the three largest banks in FYR Macedonia, Kosovo and Albania; and moderate concentration in Serbia, Montenegro and BiH at around 45 percent of total assets owned by the largest three banks.

Table 1: The Structure of Financial Systems in the WBS (2014)

	ALB		BiH		MKD		KOS		MNE		SRB	
	No.	% of total assets	No.	% of total assets	No.	% of total assets	No.	% of total assets	No.	% of total assets	No.	% of total assets
Commercial banks	16	90.3	26	86.3	15	86.8	10	70.3	12	87.6	29	91.8
Private	16	90.3	24	83.9	14	83.6	10	70.3	12	87.6	23	74.1
Domestic	2	11.7	8	5.9	2	3.4	2	6.7	5	18.0	2	5.8
Foreign	14	78.7	16	78.0	12	80.2	8	63.6	7	69.7	21	68.3
State-Owned*	-	-	2	2.4	1	3.3	-	-	-	-	6	17.6
Other depository institutions (savings and loan associations)	126	0.7	-	-	4	0.6	-	-	-	-	-	-

² Austrian banks are most prevalent. Italian banks (Unicredit and Banca Intesa) have large market shares in Serbia and BiH and, to a lesser degree, in Albania. Greek banks hold significant market shares in Albania, Macedonia, and Serbia. NLB Bank from Slovenia has a significant presence across the region except in Albania. French banks hold important market shares everywhere except BiH. Germany's ProCredit bank dominates the market in Kosovo, while Hungary's OTP bank has a large market share in Montenegro. In addition to European banks, banks from Turkey hold smaller but significant market shares in Albania and Kosovo and have started operations in BiH and Montenegro. The state-owned Russian Sberbank is also present in BiH and Serbia.

	ALB		BiH		MKD		KOS		MNE		SRB	
	No.	% of total assets	No.	% of total assets	No.	% of total assets	No.	% of total assets	No.	% of total assets	No.	% of total assets
Non-bank financial institutions	827	8.9	583	13.7	106	12.5	75	29.7	51	12.4	2,853	8.2
Insurance companies	10	1.7	25	5.1	15	3.6	13	3.1	11	4.7	25	5.2
Pension funds	3	0.0	1	1.0	4	7.3	2	24.1	2	0.0	6	0.7
Leasing companies**	-	-	7	1.9	8	0.9	-	-	5	2.1	16	2.0
Securities industry	-	-	24	0.1	7	0.0	-	-	11	0.1	28	n/a
MFIs (non deposit-taking)**	-	-	19	2.5	-	-	18	2.5	5	1.1	2	0.0
Financial auxiliaries	784	n/a	449	n/a	41	n/a	42	n/a	-	-	2,757	n/a
Investment funds	2	4.5	34	3.1	13	0.4	-	-	10	3.8	13	0.3
Fund management companies	1	n/a	24	n/a	12	0.1	-	-	7	0.6	5	0.0
Other**	27	2.7	-	-	6	0.0	-	-	-	-	-	-
Total financial system	969	100	609	100	125	100	85	100	63	100	2,882	100

Source: World Bank calculations based on data from central banks and national statistical offices

*FYR Macedonian development bank is included as it falls under supervision of the central bank.

**Since 2005, the Serbian microcredit organizations have conducted their activities via licensed banks as lending activities are restricted to banks. Albanian MFIs and leasing companies are reported under category 'Other'.

*** There is no trading at the Tirana Stock Exchange (the only licensed stock exchange in Albania).

C. Banking Sector Performance

Figure 5: Credit and deposit as a share of GDP

Source: IFS, WEO, national authorities

Financial intermediation in the Western Balkans remains low when compared to other countries in CESEE. The depth of the financial sector measured by private sector credit to GDP stands at an average of 45 percent, with particularly low levels in Kosovo and Albania (compared to around 93 percent in the euro area). The trend over the past six years has shown slight improvement in financial sector deepening overall, with the exception of Montenegro where credit to the private sector has contracted by around 35 percent of GDP since 2008 (see Figure 5).

Lending remains banks' main activity accounting for almost two thirds of total banking sector assets in the region. Albanian banks have the most diversified portfolio with loans making up 44 percent of banking sector assets at end-2015.

Post-crisis trends suggest a shift in the funding structures of Western Balkan banks towards domestic deposit mobilization. Between 2008 and 2015, Bank of International Settlement (BIS)-reporting banks reduced their cross-border exposure in the Western Balkans by an average of almost 6 percent of GDP. Cross-border deleveraging impacted all countries across the region, its effects were most pronounced in new EU member states. In the same period, domestic deposits grew to an average of 10 percent of GDP (see Figures 6 and 7). Deposits remain the largest funding source for banks, accounting for between 55 percent (Serbia) and almost 80 percent (Kosovo and Albania) of total liabilities (see Figure 9). This shift is also reflected in the average loan-to-deposit ratio continuing its generally moderate downward movement towards average levels of around 89 percent. Besides continuous growth of domestic deposits, the downward trend is due to more cautious new loan extension and sluggish credit demand (see Figure 8).

Figure 6: Banks' external and internal funding (% of GDP)

Source: IFS, BIS locational statistics, WB staff calculations

Figure 7: External Positions of BIS-reporting Banks, 2014:Q1-2015:Q2

Source: IFS, BIS locational statistics, WB staff calculations

Figure 8: Loan to deposit ratio (%)³

Source: IFS, national authorities and World Bank staff calculations

Figure 9: Funding structure of banks, Q2 2015

Source: IFS, national authorities and World Bank staff calculations

There is a need to further improve banks' funding bases through domestic resource mobilization, in an environment where uncertainty related to external funding sources prevails. The reorientation of funding towards domestic sources is encouraging. However, domestic savings are likely not to be sufficient to offset the reduction of foreign funding as credit growth picks up again. Moreover, domestic deposits are predominantly short term in maturity. On average, the share of long-term deposits makes up only 23.4 percent of total deposits, while long-term loans represent around 75 percent of total loans. Resource mobilization is a particular challenge for local banks, with higher funding and operating costs and weaker client base. Solutions to mitigate potential shortcomings to this effect may include developing

local capital markets as well as adopting policies to foster greater domestic savings by households.

Capital markets can play a key role in complementing bank-centric financing. Compared to other parts of the world, Western Balkan businesses – similar to most countries in Europe – remain heavily reliant on banks for funding and relatively less on capital markets. Stronger capital markets would complement banks as a source of financing, and would (i) unlock more investment for all companies, especially SMEs, and for infrastructure projects; (ii) attract more investment into the region from the rest of the world; and (iii) make the financial system more stable by opening up a wider range of funding sources.⁵

³ Total deposits are computed as the sum of demand deposits (IFS line 24), other deposits (IFS line 25), and liabilities to non-residents (IFS line 26). Total credit equals claims on other sectors (IFS line 22s).

⁴ In this context, long-term deposits and loans are defined as deposits and loans with a maturity larger than one year.

⁵ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=COM:2015:63:FIN&from=EN> (EU Green Paper on capital markets).

Given that the countries in the region are relatively small in terms of economic size and population base, there is a compelling case for regional integration of capital markets. Stock markets exist in all of the Western Balkan countries, except Albania and Kosovo, but the value traded is minimal. Equity markets remain underdeveloped with only a limited number of companies listed, and there is no liquidity of the secondary markets. On the debt side, in general, government bond markets exhibit more development, with corporate bond markets still being negligible in size. As to the demand side, the investor base across countries is still narrow. In general, direct retail investor participation is very limited and institutional investors (mutual funds, pension funds and insurance companies) while growing, have not reached significant size, neither in terms of assets under management nor relative to the economy. Consideration could be given to an EU-style model, where 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.

Following stagnant or declining credit conditions in recent years, lending recovered slightly during 2015 in most Western Balkans countries. Post-crisis tightening of credit standards and the deterioration in parent funding conditions have reduced the supply of credit across the region. With economic growth firming up in 2015, credit growth has been strong in FYR Macedonia and Kosovo. In the rest of the region (except Albania) lending has recently shown signs of growth, although at a slow pace (see Figure 10). Findings of a recent survey⁶ among banks suggest that developments in the region are heterogeneous. In Kosovo, supply conditions have eased amid a strong revival in retail credit growth and falling NPLs. In Serbia, growing optimism on the demand side continues to be constrained by a much slower improvement of lending conditions on the supply side. At the same time in Albania, conditions on both the demand and the supply side remain tepid.

Figure 10: Private Sector Credit growth, y-o-y, percent

Source: IMF International Financial Statistics and WB staff calculations

⁶ EIB CESEE Bank Lending Survey, H2 2015.

While banks in the Western Balkans remain overall well-capitalized and liquid, risks to financial stability in the region persist, including weaknesses in some domestic banks. Commercial banks in the region remain reasonably liquid and well-capitalized, though high NPLs and the resulting provisioning may erode some banks' earnings and capital buffers. Capital adequacy of the system reached an average of 16.9 percent as of end-2015, which should be sufficient to absorb identified risks in the system. Questions about the health of some domestically owned banks in the region – in particular in BiH and Montenegro – need to be addressed. This has been confirmed by two recent failures of domestic banks in BiH/Republika Srpska. In Serbia, failure of three state-owned banks in 2012 and 2013 have raised concerns about the oversight and governance of the remaining state-owned banking sector.

Strong competition, low post crisis profitability, new regulatory pressures and difficulties in obtaining funding – in particular for local banks – may require further consolidation of the banking sectors in the region. In BiH and Montenegro especially, the number of banks operating remains remarkably high at 26 and 15 banks respectively while profitability remains subdued raising the question of bank consolidation going forward. The Central Bank of Montenegro (CBM) has issued four new banking licenses in the past 1.5 years. Against this backdrop, a more conservative approach to evaluation of business plans and issuance of new licenses would appear warranted.

Protracted risks stem from large stocks of foreign exchange lending to unhedged borrowers, foreign bank deleveraging as well as downsizing.

In Albania, FYR Macedonia and Serbia foreign currency lending remains high, at 40 to 70 percent of total lending, posing risks to unhedged borrowers in the event of nominal exchange rate depreciations/devaluations. Local savings patterns mirror the high levels of foreign currency lending accounting for between 42 percent (FYR Macedonia) and as much as 67 percent (Serbia). Most countries in the region continued to see reductions in foreign bank funding, albeit at a slower pace. Regulatory reforms and strengthened supervisory mechanisms under the European Banking Union have created pressures on some of the parent banks to shrink their balance sheets, reduce the amount of capital held in subsidiaries, or even to go as far as to sell their subsidiaries. Rising uncertainty about the soundness of leading banks in Europe active in the Western Balkans poses a significant threat. The prolonged uncertainty surrounding the Greek macroeconomic adjustment program and its impact on Greek banks are still present in affected countries.

High but slowly declining NPL levels continue to pose serious threats to the banking sector and continue to burden bank balance sheets, undermine profits and capital, and suppress new lending—and more generally, impede banks' ability to boost economic activity and growth. NPLs remain high at a regional average of 14 percent with particular high levels in Albania and

Table 2: The Performance of Financial Systems in the WBS (2015)

	ALB	BiH	KOS	MKD	MNE	SRB
Regulatory capital to risk-weighted assets	15.7	15.0	19.0	15.5	15.5	20.9
Liquid assets to total assets	32.3	26.4	44.9	28.2	24.8	34.3
Bank nonperforming loans to total loans	18.2	13.7	6.2	10.3	13.4	21.6
Bank provisions to nonperforming loans	70.8	71.2	115.1	108.4	48.4	114.2
Return on assets – ROA	1.2	0.3	2.9	1.1	-0.1	0.32
Return on equity – ROE	13.2	2.4	26.4	10.4	-0.7	1.58

Source: IMF FSI, national authorities

Serbia at 18 and 22 percent respectively (see Figure 11). NPLs are concentrated in the corporate sector. On average, NPLs across the region declined by about 1 percentage point in 2015 year-on-year, with the sharpest decline registered in Montenegro and Albania. NPLs in Albania have decreased primarily due to a Bank of Albania regulation requiring banks to write-off NPLs older than 3 years, while in Montenegro large NPL portfolios were off-loaded to dedicated special purpose vehicles belonging to parent banks. In Serbia, NPLs increased by 1 percentage point to around 22 percent due to re-classifications following the recently completed asset quality reviews of 14 banks. In Kosovo, NPLs remain significantly lower than in neighboring countries at 6.2 percent end 2015. Weaknesses in corporate and personal insolvency and creditors' rights regimes, legal ambiguity/barriers regarding the sale of NPLs, weaknesses in regulatory NPL classification and provisioning standards, and the absence of legal frameworks sufficient for corporate out-of-court debt restructuring, need urgent policy attention across the region. This is not only essential for healthy credit growth in the banking system, but also necessary to bring a lot of idle assets back into the productive economic sphere.

All countries have taken steps in improving their NPL resolution frameworks, either through own initiatives or through regional cooperation such

as the Vienna Initiative. In Serbia and Albania comprehensive strategies were adopted to address the large share of distressed assets within the banking system. A recent asset quality review (AQR) of 14 banks revealed further re-classification and adjustment needs. In FYR Macedonia and Albania, regulators have taken measures requiring banks to write-off fully provisioned NPLs older than two and three years respectively. In Kosovo, a newly introduced private bailiff system has been supporting enforcement of collateral recovery attributing to a decrease of NPL levels. In BiH, the authorities in RS took measures to strengthen the corporate bankruptcy and out of court restructuring proceedings. The newly adopted Insolvency Law in RS foresees more efficient and cost-effective procedures related to sale of assets of a debtor and collection of proceeds as well as clearly defined, shorter deadlines in the newly introduced restructuring process (pre-bankruptcy proceedings). In Montenegro, a law on voluntary financial restructuring known as the 'Podgorica approach' was adopted in 2015 providing a framework for out-of-court restructuring of economically viable companies, including through purchases of debtors' claims supported by tax and supervisory incentives. In 2013, CBM introduced a requirement for banks to prepare a multi-year NPL resolution strategy including annual operational targets and quarterly reporting against those targets.

Figure 11: Non-performing loans (% of total loans)

Source: National authorities, World Development Indicators (WDI)

The June-July 2015 events of the Greek crisis tested the stability of the financial sectors in the Western Balkans.

There are three Greek bank subsidiaries in Albania, two in FYR Macedonia, and four in Serbia. The Greek bank subsidiaries are independent legal entities (i.e. they are not branches of the parent bank), and are thus separately capitalized. Although currently stable and not in need of external funding, recent events highlighted that the persistence of uncertainties regarding the Greek crisis may still trigger an adverse fallout. During the recent events, there were many instances of slight impairment of confidence (despite the authorities' pro-active measures), resulting in limited depositor outflows from these institutions. The deposit withdrawals remained, nevertheless, within the banking systems as they were transferred from the Greek bank subsidiaries to other banks.

The authorities took a number of ring-fencing measures to mitigate possible contagion.

All countries increased their monitoring efforts and deployed pro-active communication strategies. In Albania, the regulator imposed higher capital requirements and limited the dividends that subsidiaries could pay to their parent banks. The Bank of Albania issued an order prohibiting commercial banks from transferring money to banks in Greece. In FYR Macedonia, the Central Bank adopted temporary precautionary measures to restrict capital outflows from the country to Greek entities affecting not only banks but also corporates. These have since been lifted. National Bank of Serbia (NBS) has also taken measures to limit spillovers potentially materializing through Greek-owned subsidiaries operating in the country.

D. Efficiency of Banking Sectors

After a sharp decline following the onset of the financial crisis, bank profitability has shown improving tendencies across the region (except Montenegro). Bank profitability had declined sharply over the past several years, and continued to weaken throughout 2012 and 2013 in some countries due to weakened asset quality and subdued economic environment. This pattern reversed in 2014 and

2015 as a result of a modest economic recovery and provisioning catching up with NPL levels. Profitability indicators increased compared to the previous period, as RoA in the region improved to 1.3 percent in 2015 (0.9 percent in 2014), while RoE improved to 8.4 percent in 2015 (7.1 percent in 2014). Kosovo stands out with its RoE reaching 26.4 percent in December 2015 while its RoA improved to 2.9 percent. Montenegro's banking system, on the other hand, has been more significantly impacted by the crisis, suffering large and ongoing losses between 2009 and 2012, and continued low profitability levels turning negative again at the end of 2015 due to a persistently high backlog in NPLs, increasing competition in the banking sector, and slow economic recovery. While the profitability of banks in the region prior to the crisis was unsustainable and "inflated" by the lending and economic boom, today's profit levels are weak in comparison to normal expectations for banks in emerging/middle income countries.

Although high compared to other countries in CESEE, interest rate spreads have followed a gradual declining path in most countries.

Interest rate spreads, calculated as the difference between lending and deposit rates, have declined in most countries in the region compared to 2012, with the exception of Albania and Montenegro. On average the interest rate spread in the Western Balkans accounted for 5.6 percent in 2015 (down from 6.2 percent in 2014). Spreads in 2015 were lowest in BiH and Serbia, at 4.3 and 4.4 percent respectively. The highest spread of 6.9 percent was registered in Montenegro followed by Kosovo and Albania. Lowest spreads were registered in Serbia and FYR Macedonia, at around 4.2 percent (Figure 12). Spreads in Kosovo significantly exceeded the regional average reaching over 8 percent in 2012 but have recently shrunk considerably to around 6.5 percent, reaching an average rate closer to other peers in the region.

An interest rate spread decomposition⁷ is a useful exercise to gain insights into underlying bank trends – including efficiency and profitability.

The spread can be decomposed (from a straightforward accounting identity) into profits, provisions, overheads, and reserves. A regional exercise, conducted based on 2014 data, points

⁷ The decomposition approach draws on Randall, 1998 (IMF WP/98/59). The simplified approach applied for decomposing interest rate spreads is the following: $IL-id=il*RR + Prof/Dep + Overheads/Dep + Provisions/Dep - Non-Intr.Income/Dep$, where: 'IL' is the derived lending rate; 'id' is the derived deposit rate; 'Prof' is before tax profit; 'Overheads' are operational costs of the banks; 'Provisions' are loan loss provisions from the income statement; 'Non-Intr.Income' is non-interest income; 'Dep' are deposits averaged over two year period due to discrepancy between stock and flow approach with the rest of the variables.

Figure 12: Interest rate spread (weighted average lending rate minus deposit rate,%)⁸

Source: National authorities

to the negative effect of high NPLs on the spread composition (see Figure 13). The interest rate spread decomposition shows that in most countries, spreads are not in principle driven by profits, but by operating costs and provisions associated with the deterioration in banks' asset quality in the wake of the global financial crisis. By contrast, in Kosovo and Albania, the profit margin plays a significant role, accounting for around a third of the total spread.

The contribution of operational costs has increased in almost all countries with the exception of Kosovo, implying that the operational efficiency of banks has declined. Across the region, banks continue to derive a large percentage of their income from non-interest income, highlighting the importance of fees and commissions for banks' profitability on the one hand, and the charges that are imposed on the consumer on the other.

Figure 13: Spread decomposition, 2014

Source: World Bank staff calculations based on BankScope data.

⁸ Defined as spread between weighted average interest rate on new loans minus weighted average interest rate on new deposits.

Figure 14: Spread decomposition by bank ownership, 2014

Source: World Bank staff calculations based on BankScope data.

In almost all countries in the region, foreign owned banks have lower interest rate spreads.

Spread decomposition shows that in Albania, Serbia and FYR Macedonia foreign owned banks have lower spreads compared to domestic banks due to lower contribution of loan loss provisions. In Montenegro, foreign owned banks appear to have higher operational efficiency which enables them to set lower spreads (see Figure 14). No linkages appear to exist between the size of banks and the spread among the region. However, larger banks appear to have higher operational efficiency - using economies of scale and having lower operational costs - compared to smaller banks in the region.⁹ This can be noticed by the lower contribution of the operational costs to the interest rate spread in the larger banks.

countries compared to the (developing) ECA average of 51 percent, according to the Global Findex Survey 2014. Account penetration ratios in all countries in the region (except Albania) are higher relative to their income levels. Despite this positive picture, most of the countries in the region significantly lag behind new EU member countries and other advanced countries in financial inclusion (see Figure 15).

Since the last Findex survey in 2011, account penetration increased on average by 6 percent in the region. With the exception of BiH and FYR Macedonia, all countries have seen improvements in financial inclusion. In particular, the account penetration ratio in Serbia increased by more than 20 percentage points, while Albania had the second largest increase after Serbia mostly due to the base effect. Thanks to these performances, the region's account penetration increased by 6 percentage points on average between 2011 and 2014 (see Figure 16).

E. Access to Finance

Households

The Western Balkans financial inclusion level is relatively higher than the region's income level suggests, but lags behind new EU member countries.¹⁰ On average 59 percent of the adult population has an account in Western Balkan

There is considerable disparity in account penetration with respect to gender, while differences stemming from income levels and living areas are relatively small. On average, about 54 percent of women have an account at a formal financial institution in the Western Balkans, compared to the ECA average of 47 percent. Yet, crucially, the gap between female and male access is high, at 11

⁹ The size of banks is determined according to their nominal value of assets. Banks are divided in large and small sized groups depending whether their asset value is below or above the median bank asset value of each country, respectively.

¹⁰ Bulgaria, Croatia, Romania.

Figure 15: Account (% age 15+, 2014) vs GDP per Capita (Constant 2011 PPP,

Source: Global Index Database, WDI

Figure 16: Account ownership (% 15+)

Source: Global Index Database

percent points, with the female population being highly constrained especially in Kosovo, BiH, and FYR Macedonia (see Figure 17). Usage statistics show that this gap arises mostly from the fact that women use their accounts much less for receiving wages than men, in line with relatively low female labor force participation in these countries. Meanwhile, the overall state of financial inclusion (better than developing ECA, but lagging behind the new EU member states) does not alter much with income level and living area in the region, with Albania and

Montenegro being exceptions on former and latter respectively (see Figure 18).

Western Balkan countries use bank branches for financial transactions significantly more than their comparators do. ATMs and bank tellers are the main modes of withdrawal in the Western Balkans with 47 and 44 percent of account holders using them on average respectively according to the Global Index 2014 (see Figure 19). While the ratio of ATM users is lower than both ECA and new EU member state

Figure 17: Gender gap, account at a formal institution (percentage points)

Source: Global Findex Database

Figure 18: Account penetration (% ages 15+, 2014)

Source: Global Findex Database

averages, the picture is exactly opposite for the usage of bank branches (see Figure 20). The average number of ATMs per 100,000 adults in the region in 2013 is 44¹¹, compared to 67 for ECA and 83 for new member states. The number of bank branches per 100,000 adults is 41, significantly higher than ECA and new EU member states averages of 22 and 12 respectively. On an individual country basis, the pattern is rather mixed with FYR Macedonia and Kosovo favoring ATMs and Montenegro and Serbia

choosing bank tellers as the main mode of financial transactions, partly due to both cultural and security-related considerations.

Overall, lending activity is high while savings remain limited. The lending performance of Western Balkan countries is somewhat comparable with new EU member states, with more than 13 percent of the population on average borrowing from a financial institution in 2014. In contrast, only an average of

¹¹ World Development Indicators 2013.

Figure 19: Modes of withdrawal

Source: Global Findex Database

Figure 20: ATMs and bank branches

Source: World Development Indicators

9 percent of the population saved at a financial institution in the region, almost 18 percentage points lower than the average of new EU member states (see Figure 21). These numbers are unsurprising as Western Balkan countries have very low savings rates and high current account deficits. Considering that 30 percent of the population saved in 2014, and 9 percent used financial institutions, there is potential for gains from financial inclusion improvements to strengthen financial intermediation. The Global Findex Survey 2014 highlighted an interesting pattern in the savings behaviors of Western Balkan countries.

According to the Survey, countries in the region have different motivations for saving. For instance, while most Serbians save for old age, Albanians save more for education, highlighting the need for tailor-made policies for each country to increase domestic savings (see Figure 22). The growth of the financial sector since the 2000s has contributed to greater access to finance, but also exposed vulnerabilities and risks. Rising levels of household indebtedness raise questions on their debt service capacity and stress the importance of robust monitoring and consumer protection arrangements.

Figure 21: Saving vs Lending

Source: Global Findex Database

Figure 22: Motivations for saving

Source: Global Findex Database

Firms

The credit crunch has made it extremely difficult for new firms to emerge and grow. Demand side data shows that access to financial services remains a key obstacle in the Western Balkans. Enterprises identify it as the third largest business environment constraint shortly after tax rates and the impact of the

informal sector. Access to finance appears particularly constrained in Kosovo, where 45 percent of firms identified access to finance as a major constraint, but less so in Albania and Montenegro (see Figure 23) where there is greater reliance on internal funds to finance their investments (68 percent). The most

Figure 23: Percent of firms identifying access to finance as a major constraint

Source: Enterprise Surveys (2013)

Figure 24: Sources of financing of new investments

Source: Enterprise Surveys (2013)

important source of external financing are banks. At the same time, the proportion of new investments financed via banks remains low at an average of 15 percent. Small and medium sized enterprises (SMEs) – the backbone of the Western Balkan economies – continue to have limited access to credit, which is associated with high cost and stringent conditions. SMEs suffer from structural capacity constraints and higher levels of informal transactions, reducing the quality of financial information. Most banks have not yet introduced delivery models, which are appropriate to the characteristics and risks of this market segment. Alternative financing sources are limited. Improvements in credit reporting and financial reporting would help reduce information asymmetries. Financial institutions should be encouraged to develop delivery models tailored to the characteristics of SMEs. Public support instruments could be improved to ensure the effectiveness and efficiency of their interventions.

High collateral requirements hinder firms' access to credit. On average 85 percent of corporate loans in Western Balkan countries require collateral, and its

value is high, at 235 percent of the loan amount on average. This is mostly a result of higher perceived firm risk (both due to corporate governance problems and low profit prospects) but challenges in collateral enforcement and liquidation processes are also among contributing factors.

The region saw some progress in the reform agenda in recent years, but more remains to be done, especially on legal rights. Deteriorated financial intermediation channels show that economic and institutional challenges remain to be addressed in the short term. All Western Balkan countries showed an improvement in the credit depth of information index¹² in the last three years (see Figure 27). However, the region was unsuccessful in increasing the strength of legal rights (SLR) index, which measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders, and thus facilitate lending. The SLR index amounted to only 7.5 out of 12 in 2014, showing that urgent reform is necessary in this area. This would also facilitate NPL resolution, and address the issue of high collateral requirements.

Figure 25: Value of collateral needed for a loan (% of the loan amount)

Source: Enterprise Surveys (2013)

Figure 26: Proportion of loans requiring collateral (%)

Source: Enterprise Surveys (2013)

¹² The credit depth of information index measures rules affecting the scope, accessibility, and quality of credit information.

Figure 27: Credit depth of information index (0=low to 8=high)

Source: World Bank Doing Business Survey

Figure 28: Strength of legal rights index (0=weak to 12=strong)

Source: World Bank Doing Business Survey

F. Banking Sector Regulation and Oversight

Financial sector authorities across the region are making progress in strengthening banking sector regulation and oversight. All supervisory agencies in the Western Balkans are moving toward risk-based supervisory regimes, as well as implementation of Basel II and Basel III requirements. Moreover, all have implemented International Financial Reporting Standards (IFRS) for banks. However, countries are at different stages of implementation. Further progress is needed in implementation of risk-based regulatory and supervisory practices as well as linking regulatory capital requirement to commercial banks' market and credit risk. Additional focus should be directed to the implementation of new standards, such as enhanced supervision of systemically important banks, and recovery and resolution planning. Regulation in the areas of corporate governance and identification of ultimate beneficiary owners and related-party lending should also be strengthened.

The main challenge for regulators across the Western Balkans is balancing the need for a stringent approach to supervising banks burdened with high levels of NPLs, while promoting debt restructuring for viable businesses. With the level of NPLs rising and economic growth feeble, supervisors need to find a balanced approach to incentivize banks

to restructure viable borrowers, eliminate NPLs, and recapitalize if necessary. Supervisors need to enforce loan classification, realistic collateral valuation, and provisioning requirements more stringently. Rigorous enforcement, coupled with implementation of recapitalization plans where necessary, will encourage banks to resolve or write off problem loans more efficiently. However, until recently, regulators in most countries have offered some form of forbearance (for instance, on provisioning) in case of loan restructuring. This treatment may encourage banks to sustain viable borrowers, but could delay much needed balance sheet adjustment of troubled banks, while at the same time preventing lending to new borrowers.

G. Cross-border Collaboration and Supervision

The establishment of the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM), two of the three building blocks of the EU Banking Union, is set to have a number of implications for banking systems in the Western

Balkans. The SSM and SRM has resulted in four different supervisory and resolution arrangements impacting banks operating in the Balkans: (i) systemic euro area headquartered entities (around 60 percent of total banking assets in the Western Balkans) for whom the European Central Bank (ECB) is indirectly the 'home supervisor' and the Single Resolution Board the "home resolution authority", (ii) subsidiaries of euro area headquartered entities deemed as 'less significant', and therefore not falling under direct supervision of the SSM and as a rule not under the resolution scheme of the SRB, (iii) subsidiaries from non-SSM jurisdictions (including Russia and Turkey), and (iv) domestic banks. Benefits are seen in positive spill-overs to the extent that the Banking Union leads to sounder banking system and stronger supervision as well as creation of a level playing field across borders and simplified 'home-host' interactions. Potential challenges stem from ensuring an adequate level playing field given the new four-tier approach as well as ensuring adequate cooperation and communication.¹³

Good progress has been made regarding supervisory cooperation in the context of the SSM but further efforts are needed to strengthen and improve cross-border supervisory cooperation and planning. There are a number of provisions in the Capital Requirements Directives (CRD) and Regulation (EU) No 575/2013 (CRR) which set out requirements for cooperation with third countries including college participation, information exchange, and equivalence of third countries. Five countries in the region successfully passed the European Banking Authority (EBA) assessment on the equivalence of confidentiality regimes in 2015, hence paving the way for its supervisory agencies' formal participation in supervisory colleges on cross-border banking groups. Further assessments are foreseen on equivalence of prudential requirements applicable to institutions established in third countries, and the equivalence of consolidated supervision regimes applicable in third countries, allowing third countries among others to benefit from the same, often more favorable, treatment applied to EU exposures, meaning lower risk weights would be applicable.¹⁴

In October 2015, the EBA signed a memorandum of cooperation with five Western Balkans supervisory authorities (except Kosovo), establishing a framework for cooperation and information sharing designed to strengthen banking regulation and supervision of banks operating in the EU and in the Western Balkans countries. On the national level, cross-border supervisory cooperation, which is critical given the dominance of foreign banks, is improving. The Western Balkans supervisory authorities have signed a number of MoUs with other supervisory authorities in Europe and are participating in some supervisory colleges. However, gaps remain. As confidentiality rules are now assessed to meet EU standards it is expected that participation in respective colleges will improve. There is also a need to expand bilateral information sharing efforts with EU and non-EU supervisory agencies. In particular cooperation with Austrian authorities needs to be enhanced. BiH is so far the only country in the region that has signed a MoU with the Austrian Financial Market Authority (FMA).

Following the 2008-2009 crisis, the Vienna Initiative as a public-private platform has served an important role in safeguarding the region from disorderly deleveraging. The Initiative was launched at the height of the first wave of the global financial crisis in January 2009. It brought together all the relevant public and private sector stakeholders of EU-based cross-border banks active in emerging Europe, which own much of the banking sectors in that region and also hold a significant part of government securities. Key objectives of the Vienna Initiative are: i) avoiding disorderly deleveraging, ii) ensuring that potential cross-border financial stability issues are resolved, and iii) achieving policy actions, notably in the supervisory area, that are taken in the best joint interest of home and host countries. For these purposes, regular meetings are held with the participation of the World Bank, the EBRD, the EIB, the IMF, the European Commission, other relevant EU institutions (e.g. the ECB), main cross-border banking groups, and home and host country authorities, setting up platforms where private and public sector decision makers meet to exchange experience and discuss appropriate actions on relevant areas.

¹³ Occasional Paper Series No 164, Financial stability challenges in EU candidate and potential candidate countries, ECB, 2015.

¹⁴ <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-19+%28Opinion+on+cooperation+with+third+countries+-+Art+161+%287%29%20CRD%29.pdf>

H. Financial Stability Frameworks

All Western Balkan countries have made progress in improving their financial stability frameworks.

Steady progress is measured in terms of strengthening crisis planning and information sharing (typically through Financial Stability Committees), macro-prudential supervision frameworks, and emergency liquidity assistance facilities.

Financial Stability Committees should be further strengthened and include all relevant financial safety stakeholders as members.

Each country has formed a Financial Stability Committee (FSC) to facilitate communication and information sharing amongst the domestic financial sector authorities. One weakness is that in Kosovo, FYR Macedonia, and Montenegro, the FSC does not include the deposit insurance agency. These bodies should be members of FSCs and planning mechanisms, because crisis preparedness and facilitation of decision-making in a crisis can have a significant impact on deposit insurance funding. In some countries, the effectiveness of FSCs could be improved through the sharing of more detailed, institution-specific information and open discussions of key emerging macro and micro risks.

An emergency lending facility is needed in BiH and the arrangements require further strengthening in other countries.

FYR Macedonia, Serbia and Albania all have adequate Emergency Liquidity Assistance (ELA) frameworks in place. ELA arrangements are lacking in BiH due to mandate limitations in the currency board arrangement. Kosovo and Montenegro have limited official capacity to lend to banks due to the lack of national currencies. In Montenegro, ELA is currently prescribed under the CBM Law and the special draft resolution law (*lex specialis*), it should instead be brought under a single framework and follow best international practice. In Kosovo, the authorities have made efforts to strengthen the ELA framework. Further steps will be needed in both countries to ensure adequate resources for ELA as well as the development of operational procedures.

The authorities should set up more comprehensive macroprudential frameworks.

In terms of crisis prevention efforts, macro-prudential supervision needs to be strengthened across the region. This is particularly relevant as Montenegro, Kosovo and BiH have no control over monetary policy. The only instrument used by the respective central banks in the period of strong build-up of systemic

imbalances that preceded the recent crisis was the reserve requirement. NBS published a consultation document on the framework for macro-prudential policy in March 2015, outlining the main objectives, instruments, and decision-making process. In Albania and FYR Macedonia, the legal and institutional framework for macroprudential policy is generally strong. Both have used macroprudential tools in the past to manage the credit cycle.

Decisive and immediate actions are required to deal with weak banks.

An AQR of 14 banks recently concluded in Serbia revealed a decrease of the capital adequacy ratio of all participating banks of 1.76 percent when taking into account the offsetting between impairment reinforcements and banks' prudential loan-loss reserves. Similar to the case of Serbia, recent Financial Sector Assessment Programs (FSAPs) conducted in BiH and Montenegro recommended AQRs to be conducted for weak banks posing a risk to financial stability. Based on the results, the respective supervisors should develop time-bound supervisory action plans, requiring capital increases by shareholders where necessary. In parallel, resolution plans for vulnerable banks should be prepared aiming to minimize the use of public resources.

I. Financial Safety Nets

To improve crisis readiness and conform to international standards, authorities should ensure that deposit insurance systems are adequately funded and the legal system is able to resolve failing banks.

Deposit insurance systems are not designed to cope with systemic banks or a systemic crisis. For these cases, a bank resolution framework in line with international best practices is needed and deposit insurers need a credible line of emergency funding to cover shortfalls of the fund.

Deposit insurance systems are in place in all six countries and are relatively well developed

(see Table 3). All operate under the narrow mandate of a pay-box, except for Serbia. The use of a flat rate deposit insurance premium (as opposed to risk-based premiums) in most countries is prudent given the Deposit Insurance Agencies' (DIAs') relatively recent establishment and the need to build up deposit insurance funds. All countries upgraded their deposit insurance frameworks since the crisis

through an increase in coverage for the purpose of restoring public confidence in the banking system and adjusting the national regulations with the EU *acquis communautaire*. They are financed by annual premiums from member banks, and in some cases supported by a standby credit line with the EBRD and a statutory provision for back-up funding from the government.

Further improvements are recommended in a number of areas. In some cases, direct or backup (government) funding of the deposit insurance systems still needs to be strengthened, especially in BiH and Kosovo where the agencies have no statutory power to access funds from the government. The current timeframes for payout are too long compared to good practice; the procedures for insured deposit calculations, mechanism for automated payout, and auditing requirement, all need further strengthening

to improve this. It is important that coordination with other financial safety net participants is enhanced, including by DIAs' becoming members of Financial Stability Committees. In addition, most DIAs in the region are missing an official target ratio. The absence of coverage for legal entities in Albania and FYR Macedonia is a material weakness in the safety net for depositors, as it contravenes a primary objective of deposit insurance—to protect small, financially unsophisticated depositors including SMEs—as well as European Union guidance on coverage.

Across the region, there remain significant gaps in the frameworks for resolving failing banks. Resolution, as opposed to liquidation, allows a bank's critical functions to continue and lowers the ultimate cost of bank failures (for taxpayers) through, for instance, transferring and selling assets and liabilities of a failed bank, establishing a temporary

Table 3: Overview of deposit guarantee schemes in the Western Balkans

	Mandate	Coverage ratio	Target Level	Type of deposits	Premium
Albania (ADIA)	Paybox	2.5 million lek (approx. EUR 17,800)	n/a	Individuals	Flat rate
BiH (DIA)	Paybox	KM 50,000 (approx. EUR 28,500)	Set semi-annually via financing assessment but no official target level exists	Individuals/-legal entities	Flat rate (0.26% of eligible deposits annually)
Kosovo (DIFK)	Paybox	3,000 EUR	The target size of the DIF is set in the law at a minimum of five per cent of the total of insured deposits. However, the current policy on target size is 8 – 9 percent which equals to the total amount of insured deposits for two small banks	Individuals/-legal entities	Risk-based premium (between 0.3 and 1.5 % of insured deposits, starting 1. January 2016 between 0.45 and 1.5% of insured deposits)
Montenegro (FZDCG)	Paybox	50,000 EUR	10% of guaranteed deposits	Individuals/-legal entities	Flat rate (initial premium EUR 50,000; 0.5% of total deposits annually)
FYR Macedonia (FODSK)	Paybox	30,000 EUR in Macedonian Denar equivalent	n/a	Individuals	Flat rate (0.5% of eligible deposits annually)
Serbia (AOD)	Paybox+ loss minimizer	50,000 EUR in Serbian Dinar equivalent	5% of total insured deposits	Individuals/-legal entities	Flat rate (initial: 0.3% of the cash portion of minimum initial capital of the bank); • regular: payable on a quarterly basis at the level of 0.2% of the total insured deposits held by the bank, and • extraordinary: maximum 0.4% of total insured deposits held by the bank over one year

bridge institution, forcing debt write-downs or debt-equity conversions on bank creditors, and overriding the rights of shareholders. The ultimate objective of the bank resolution framework is to maintain the value of borrower-lender relationships and the trust of depositors, as well as to safeguard interbank markets and payment systems, while imposing market discipline to avoid excessive risk taking by banks. BiH and FYR Macedonia do not have sufficient frameworks for dealing with failing banks, other than open bank “administration” and bankruptcy/liquidation. Reforms of the banking laws in BiH are currently underway, including strengthening the bank resolution framework. In Kosovo, available tools as well as the timeframe and requirements for least-cost resolution need to be clarified. The bank resolution framework in Serbia was substantially strengthened in 2015 to make bank resolution more effective and aligned with the EU Bank Recovery and Resolution Directive (BRRD), however without providing for special resolution funding. The new Bank Resolution Department is operational and resolution plans for systemically important banks are currently being prepared. Albania has a special bank resolution regime largely based on modern principles, but significant gaps remain in the area of resolution planning, funding and powers to ensure fast, decisive implementation of resolution action. In Montenegro, the CBM functions as the de facto

resolution authority for banks but lacks a formal mandate.

In the wake of the financial crisis, international principles for the resolution of systemic banks were created. The “Key Attributes of Effective Resolution Regimes for Financial Institutions (KA)” issued by the Financial Stability Board in 2011 provide the international standard for resolution regimes for financial institutions and are key to addressing the moral hazard and systemic risks associated with institutions that are too big and/or too complex and interconnected to fail. What holds true for complex systemically important financial institutions (SIFIs) at the international level may also apply to national big players, albeit under different terms. In the EU, the BRRD provides the new legal basis for bank recovery and resolution.

The eventual transposition of the BRRD into national legislation can address many of the shortcomings of bank resolution frameworks. The BRRD was adopted in the EU in June 2014, and had to be transposed by Member States into national law by January 2015 (bail-in provisions by 2016). The BRRD broadly regulates the following four key elements: i) the preparation and prevention of resolution via recovery and resolution planning; ii) enhanced early intervention measures by the

Table 4: Overview of resolution systems in the Balkans

	Bank Resolution Authority	Resolution tools	Funding Source	Resolution framework governed by
Albania	BoA	Purchase and Assumption, Bridge Bank, Liquidation and Depositor Reimbursement	Use of DIF, government	Special Bank Resolution Regime
BiH	X	Liquidation and Depositor Reimbursement	DIF (for insured depositors in liquidation)	Bankruptcy and Insolvency Laws
Kosovo	CBK	Purchase and Assumption, Bridge Bank, Liquidation and Depositor Reimbursement	DIF (for insured depositors in liquidation)	Special resolution scheme (Banking Law)
Montenegro	X	Liquidation and Depositor Reimbursement	DIF (for insured depositors in liquidation)	Bankruptcy/insolvency laws
FYR Macedonia	X	Liquidation and Depositor Reimbursement	DIF (for insured depositors in liquidation)	Bankruptcy/insolvency laws
Serbia	NBS	Purchase and Assumption, outside liquidation bail-in, Asset separation, Bridge Bank, Liquidation and Depositor Reimbursement	Use of DIF, government	Special Bank resolution regime in Law on Banks

supervisor; iii) the application of special resolution tools and powers in the case of an actual bank failure instead or in addition to liquidating (part of) the bank; and last but not least iv) cooperation and coordination between national authorities.

Countries implementing the BRRD will still have to make decisions on certain aspects where the Directive leaves room for discretion. The BRRD foresees the establishment of a resolution authority (RA) to be operationally and functionally separated from the supervisory functions. It sets out three main conditions to determine whether resolution authorities should take resolution actions. First, the determination has to be made that the institution is failing or likely to fail. Second, there must be no reasonable prospect that alternative private sector measures would prevent the failure. Third, resolution action must be in the public interest. A resolution action is especially problematic if the Resolution Fund, or taxpayers' money, is misused due to a wide definition and "creative interpretation" of "public interest test", "resolution objectives" and "systemic stability". In order to achieve the objectives of resolution, the RA is given four "resolution tools": the bail-in tool and three transfer tools, including the sale of business to a private acquirer, the bridge bank, and the asset separation tools. The BRRD requires banks to hold a minimum requirement of eligible liabilities (MREL) to ensure banks actually have sufficient bail-inable instruments. It does not, however, regulate the type of instruments for which bail-in would be technically feasible, or when and for which instruments bail-in would severely damage financial stability.

A number of issues need to be considered in tailoring the BRRD to the country specific circumstances of the Western Balkans as well as other small countries in the region. The creation of a separate legal resolution entity might not be feasible for small countries due to institutional and staffing constraints. Hence, the creation of a resolution unit, e.g. within the supervisory authority, could be considered. Even if synergies between resolution and supervision exist when they are part of the same authority, a clear functional and organizational separation should be implemented. The trigger for resolution ('public interest') should be clearly specified and defined, e.g. by including a reference to 'critical function and financial stability'. While least cost in terms of 'less costly than liquidation' is safeguarded under the 'no creditor worse off principle' in the BRRD framework, introduction of a least-cost-test from the perspective of state support (deposit insurance fund, potential

resolution fund and ultimately public backstop) could be beneficial. Financial markets in the region will need more flexibility and time to establish instruments that qualify for Minimum Requirement for Eligible Liabilities (MREL). External bail-inable instruments created on the local market, and also "internal bail-in" from parent for subsidiaries, should be considered. Adjusting the liability structure of the system is complex and costly, though unavoidable if reliance on the use of taxpayer's money is to be overcome.

J. Conclusions

Financial systems in the region are primarily bank-based with differing degrees of concentration.

Financial sectors in the Western Balkans are bank-centric, with relatively minor levels of capital market activity, negligible penetration of insurance products, and generally insignificant non-bank financial institutions. Banking sectors in the region are dominated by foreign banks. Serbia is the exception, where state-owned commercial banks control about 20 percent of the banking sector and the level of foreign bank ownership is lower at 75 percent. Concentration differs across the region with around two thirds of total assets in the hand of the three largest banks in FYR Macedonia, Kosovo and Albania and moderate concentration in Serbia, Montenegro and BiH at around 45 percent. Financial intermediation in the Western Balkans remains low when compared to other countries in CESEE. The depth of the financial sector measured by private sector credit to GDP stands at an average of 45 percent with particularly low levels in Kosovo and Albania. The banking sector is still dealing with the aftershocks of the global financial crisis that have weakened financial sector asset quality and profitability. At the end of 2015 NPLs stood at an average of 13.9 percent and RoA at 1 percent with considerable variations across the region. Although the banking systems - dominated by foreign banks - appear broadly sound, significant pockets of vulnerability exist among domestically-owned banks. Following stagnant or declining credit conditions in recent years, lending recovered slightly during 2015 in most Western Balkans countries. Post-crisis trends suggest a shift in the funding structures of Western Balkan banks towards domestic deposit mobilization.

In the near term, policymakers and regulators in the region face a number of challenges with regard to supporting economic growth, expanding

financial inclusion, and maintaining financial stability. Across the region, high levels of NPLs need further urgent policy attention by strengthening the corporate and personal insolvency and creditors' rights regimes as well as regulatory classification and provisioning standards. Deleveraging remains a risk as some parent banks plan to further scale back their presence in the region as a result of continued market and regulatory pressures. Shifts in banks' funding models, increased competition as well as low bank profitability levels in some countries in the region, may require further bank consolidation to adjust to the new circumstances. Given the high dependency on foreign currency lending and borrowing, active policies to increase the use of local currencies should be pursued both to reduce financial stability risks and to afford greater degrees of policy freedom to monetary authorities. Moreover, it is essential that the financial safety net is further strengthened by building up financial and institutional capacity of the deposit insurance systems and developing a comprehensive resolution regime to deal with the weakest banks. In terms of crisis prevention efforts, macro-prudential supervision needs to be strengthened across the region. This is particularly relevant as Montenegro, Kosovo and BiH have no control over monetary policy. An emergency lending facility is needed in BiH, while in other countries, the arrangements require further strengthening.

Banking regulation and oversight have improved over the last decade, but a number of important shortcomings in some segments remain. Further progress is needed in implementation of risk-based regulatory and supervisory practices as well as linking regulatory capital requirement to commercial banks' market and credit risk. Regulation in the areas of corporate governance and identification of ultimate beneficiary owners and related-party lending should also be strengthened. While the EU Banking Union will lead to sounder banking system and stronger supervision as well as creation of a level playing field across borders and simplified 'home-host' interactions, potential challenges stem from ensuring an adequate level playing field between supervised entities as well as ensuring adequate cooperation and communication.

Financial inclusion levels of households in the Western Balkans is relatively higher than the region's income level suggests, but significant gender gaps exist in some countries. As to enterprise finance, the credit crunch has made it extremely difficult for new firms to emerge and grow. In particular SMEs – the backbone of Western Balkan economies – continue to have limited access to credit,

which is associated with high cost and stringent conditions. SMEs suffer from structural capacity constraints and higher levels of informal transactions, reducing the quality of financial information. Most banks have not yet introduced delivery models which are appropriate to the characteristics and risks of this market segment. Alternative financing sources are limited. As the shift in banks' funding models towards increased deposit mobilization is mainly short term in nature, diversification of funding sources will be key when it comes to the provision of term financing aimed at fostering investments and ultimately economic growth. In this context, capital market development is key to mitigating potential shortcomings in the context of required funding diversification. Improvements in credit reporting and financial reporting would help reduce information asymmetries. Finally, public support instruments could be improved to ensure the effectiveness and efficiency of their interventions.

While the snapshot in Chapter 1 focuses on near term challenges and policy responses with regard to financial sector development and stability, the following chapters look more broadly at the external context and take a longer term view on challenges and opportunities that could present themselves over the next decade. It does so not by proposing a single forecast, or view of the future, but by exploring key uncertainties and applying the tool of scenario thinking to create three different visions for the world around the Western Balkans financial systems in 2025 aimed at informing the development of financial sector strategies that contribute to the country's overall success in sustainable and inclusive growth.

II. A Glimpse into the Future: Using Scenarios to Explore Challenges and Opportunities in a Changing World

A. Why Scenarios?

Scenario analysis is a powerful tool that can help policymakers prepare for a range of possible alternative futures. Scenarios represent a coherent set of intersections of how the different uncertainties could play out. They are plausible yet challenging stories about the future which address core issues (or “central questions”) of importance to a particular set of stakeholders. By giving diverse stakeholders a shared basis for discussion, scenarios enable creative thinking about how to shape future responses proactively. They also encourage discussion of ‘stretch’ outcomes, unintended effects from combinations of factors, and second- and third-order consequences that may flow from them. By making uncertainty explicit, they tease out preconceptions and help decision-makers consider how they and others might react to the different ways in which future events could unfold. Once described, scenarios can be used to initiate dynamic conversations about opportunity, risk management, contingency planning, strategy testing and collaborative action. More details on the scenario analysis methodology and its use are presented in Annex 1.

B. Scenario Development Process

The scenarios were developed based on a rigorous consultation process. The complete scenario-building process is summarized in Figure 29. The scenarios were prepared by the World Bank Group through consultations with a number of external stakeholders including development partners as well as technical experts from relevant authorities in the region (in particular central banks and ministries of finance) at each stage of the process. Following the identification of 14 key areas of uncertainty that could prove to be major drivers of change in the region and the ‘stretch’ continuum of outcomes, scenario plots were developed and tested (see Chapter III for further detail). Finally, the completed scenarios were presented at a regional workshop in Vienna, which gathered senior policymakers and financial regulators. The aim of the workshop was not for the participants to review or endorse the scenarios but for the group to discuss possible implications for financial systems at the regional level. Because of the limited scope for policy at the regional level, however, the ultimate goal of the scenario-building exercise is to provide a basis for exploring country-specific policy options and regulatory strategies.

Figure 29: Key steps in scenario analysis

III. Uncertainties as Elements of Change

A key step in any process of thinking about the future is to identify the most decisive elements of change and their degree of uncertainty over the next ten years. This chapter briefly reviews the continuum of uncertainty for each of the 14 different elements of change that were identified as most relevant to the scenario development exercise (see Table 5). This list of elements of change was designed

to represent the key areas of uncertainties affecting the region's financial systems. It was focused on the broad context (economic, political and market) and derived from extensive consultations with regional stakeholders, international organization partners and experts—both inside and outside the World Bank (see Figure 30).

Table 5: Key uncertainties in detail

GEO-POL-ECONOMICS	GLOBAL FINANCIAL MARKETS	FINTECH ADOPTION	EU AND EURO AREA
Geo-political development	Global banking landscape and FDI	Payment systems evolution	EU enlargement appetite
Economic growth path	Capital markets	Financial service innovation	EU and euro area consolidation (incl. banking union)
Centers of gravity for the global economy	Banking regulation		
Trade patterns	Monetary dynamics		
Energy commodity markets/prices	Sovereign debt markets		

Figure 30: Stakeholder and Expert Consultations

EXPERTS

WORLD BANK GROUP

The scenario analysis benefited from inputs and insights of a number of experts in the World Bank Group with relevant expertise (including experts from GFMDR, GMFDR, DECPG, GTCID, ECACE, ECCU4 and GFADR)

REGIONAL STAKEHOLDERS

Albania

Bosnia and Herzegovina

Kosovo

Republic of Macedonia

Montenegro

Serbia

EXTERNAL STAKEHOLDERS

INSTITUTE OF
INTERNATIONAL
FINANCE

OECD

Center
for Global
Development

European Bank
for Reconstruction and Development

EUROPEAN CENTRAL BANK
EUROSYSTEM

BCG

THE BOSTON CONSULTING GROUP

The elements of change are grouped into three sets of global change and one set of uncertainties more specifically related to the EU. Detailed descriptions of each uncertainty and its impact on the Western Balkans region were prepared to serve as underlying building blocks for the scenario development process. The following pages contain an excerpt of the underlying analysis including a series of facts, thoughts, and questions designed not as a comprehensive review of the issues but rather as a guide to exploring uncertainty around key elements of change.

Figure 31: Key areas of uncertainty

Following the identification of the 14 elements of change, end-points for each uncertainty were determined to define the different possible extremes for each of the ranges in the 2025 scenarios. The identified continuums of uncertainty then serve two related purposes: first they provide a dashboard for thinking about change drivers in the relevant context for the region's financial systems; second they become the building blocks to construct a set of internally coherent and plausible stories of the future. It is worth noting that the left or right position of the end points does not have any meaning of its own. This section presents them very briefly and Annex 2 shows how they play out in each of the scenarios.

A. Geo-Pol-Economic Uncertainties

Economic Growth

From the early 2000s onwards - when global growth started to be driven by the strong performance of a few large emerging countries - a growth differential of several percentage points appeared between emerging and advanced countries. This came to be seen as the “new normal”. But recent developments have put that notion in question and highlight the high level of uncertainty around global economic growth dynamics. Reflecting the fact that prospects for the financial systems in the Western Balkans are significantly dependent on external economic dynamics this uncertainty is highly relevant. It focuses on the pace of growth and complements the next uncertainty (that considers the composition of the world economy). The range of economic growth outcomes can be simply viewed from strong to weak. On the one side of the spectrum economic growth is strong with resumption of strong growth in China and increased US productivity while on the other end the 2015-2025 decade is counted as a lost decade for the global economy.

Center of Gravity in the World Economy

Until recently, high-income countries dominated the global economy. But the composition of the global economy has been changing fast in favor of emerging and developing economies. This geo-economic shift has already had visible effects in international negotiations and the emergence of new “trade influence” zones. It is also worth noting that the reshaping of the global economy is not just a story of nation states. It is also a corporate story—with major enterprises (private, quasi-private and state-owned) from emerging economies becoming major players in their industries. This uncertainty

is important because economic dynamics will be a major factor determining the global structure of ‘soft powers’ by 2025. It complements the economic growth uncertainty (which looks at the size of the world economy). At one end of this uncertainty continuum the center of gravity of the global economy moves back towards advanced countries and at the other it continues to shift towards developing and emerging countries.

Geopolitical Dynamics

In line with shifts in the world economy, geopolitical clout has shifted east in the last decade. India and particularly China have been increasing their voice and weight in international politics as they grow richer, and continue to forge new relationships with countries around the world. How this evolves and how the United States and other powers respond will be a driver of change with many ripple effects. Given the regional focus of this report, Russia’s geo-political interests and strategy is of particular importance. This uncertainty is important as the geography of the Western Balkan countries exposes them to the political and economic repercussions of geopolitical tensions. The opposite end points for this uncertainty continuum are viewed as convergent and divergent geopolitical dynamics.

Trade Patterns

For decades, global trade in goods and services expanded more than twice as fast as global GDP due to dramatic decreases in transport and communication costs as well as lower trade

barriers (the combination of these factors is usually seen as an integral part of globalization). In the recent crisis, the volume of global trade shrank by almost 20 percent and it remains to be seen how the trade/GDP ratio evolves and if trade flows become more regionally fragmented or globalization resumes. While the volume and value of trade flows will also depend on many other factors, it is greatly affected by trade policy and tax decisions (by individual countries and through bilateral and multilateral agreements). How this uncertainty plays out in the continuum from increased protectionism to further liberalization is important because it will determine market access and competitiveness of the Western Balkans, and therefore their export opportunities.

Commodity Markets (Energy)¹⁵

Commodity markets have shown great volatility in recent years. While the magnitude of the impact of commodity price changes on these variables differs across countries, the impact of price changes is significant in virtually all countries. In addition, the asymmetry of the effects of oil price swings and the concentration of gains from high oil prices in a few countries impact the distribution of savings and reserves around the world. The uncertainty affects both demand and supply. Countries in the Western Balkan region rely heavily on imported hydrocarbons. Therefore, trends and fluctuations in energy prices will have direct impacts on the countries' macroeconomic stability and development prospects. Endpoints of the uncertainty continuum range from low energy prices due to significant improvements in energy efficiency and increased supply from renewable sources on the one hand to a rise in prices due to strong growth and related energy demand in many large emerging economies without improvements in energy efficiency.

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¹⁵ The uncertainty focuses on energy because that market has shown particular volatility and wide-ranging implications.

B. Financial Market Uncertainties

Global Monetary Dynamics

In response to the 2008 global financial crisis, countries have mainly relied on monetary policy to stimulate the economy. Central banks, especially in developed countries, reduced interest rates significantly, followed by quantitative easing programs when conventional policies did not prove effective enough. Interest rates have now been close to zero for several years in many countries, with wide-ranging implications for security markets, pension funds, and investors in general who, in search of higher returns, have created new financial flow patterns. Abundant liquidity on the back of monetary easing supported developing countries' growth performance as it resulted in the availability of low-cost but short-term finance--and created vulnerabilities often associated with credit booms. This uncertainty is important because the small size of financial markets in the Western Balkan countries as well as their monetary policy regimes makes their evolution dependent on broader monetary and exchange rate dynamics. The uncertainty continuum ranges from contractionary to expansionary monetary policies. Plausible 2025 outcomes for this area of uncertainty lie anywhere between the following end-points: (i) interest rates have remained low in major developed markets with negative real rates in a number of major economies, leading to an unprecedented one and a half decades of low rates ('world of negative return'); and (ii) interest rates increased in developed countries leading to large quantities of capital being repatriated.

Sovereign Debt

Sovereign debt levels around the world have increased significantly in recent years. The financial crisis resulted in a general "flight to safety", causing interest rate spreads of developing countries to rise sharply. As markets calmed, spreads declined but remained at levels high enough to lead to large inflows of funds into emerging markets, generally providing higher yields. While this has resulted in relatively easy financing conditions in developing countries, the reaction to the Federal Reserve System's announcement that it would start tapering its quantitative easing program in 2013 shows that emerging markets, including Western Balkan countries, remain exposed to risks emanating from high-income countries. The uncertainty continuum ranges from sovereign debt being shunned to being sought after in global markets.

Banking Regulation

After the 2008 financial crisis, governments across the world initiated financial reforms designed to provide greater transparency of transactions and reduce risk in order to make financial systems more stable and better regulated. The Basel III Accord strengthens bank capital requirements and increases bank liquidity reserves, and has been implemented in a number of countries. In the EU, the relevant Capital Requirements Regulation and Capital Requirements Directive include a large

number of options allowing for national discretion. The financial crisis underscored the potential value of strengthened, coordinated regulation but there is also growing fatigue with large, rigid bureaucratic solutions and concerns that regulatory reforms do not reflect specific country situations and are crowding out the space for innovation related to instruments and intermediation mechanisms. The uncertainty continuum ranges from tightened Basel-type regulations becoming widely adopted and implemented across countries—including through the EU Banking Union—providing a basis for expanded regulatory coordination to regulatory loosening and fragmentation generating wide-ranging perceptions of risk across countries and room for regulatory arbitrage.

which pushed the corporate sector to shift towards bond financing. Especially in emerging markets, the outstanding debt of non-financial companies has increased markedly. The greater dependence on bank lending makes the European economy, especially SMEs, more vulnerable when bank lending tightens, as happened in the financial crisis. This uncertainty is important because the small size of capital markets in the Western Balkans countries implies that their evolution will have considerable dependence on broader capital market dynamics. The uncertainty continuum ranges from unevolved to further deepened capital markets.

Global Banking Landscape

Global financial integration has increased substantially over the last two decades—including an increasing role of foreign banks across the world. While foreign bank penetration may have led to more efficient intermediation and risk sharing, and the development of domestic financial sectors through increased competition, it has also increased exposure to external crises. Hence, the 2008 financial crisis and its aftermath had significant effects on the global banking landscape. Large reductions in cross-border bank flows (mainly due to the retrenchment of European banks) took place as banks sought to restore balance sheets. Retrenchment to home markets also reflected weakened demand, increased sovereign/country risks, and an adjustment to regulatory reforms. Countries in the Western Balkans have significant reliance on foreign banks and their capital inflows—both through FDI and credit lines. The dynamics of banking FDI and cross-border credit is an important uncertainty. The continuum ranges from further retrenchment – in particular of Western European parent banks - towards home markets to expanded banking cross-border flows and FDI.

Capital Markets Development

Capital markets have expanded around the world in recent decades and while the 2008 crisis represented a set-back, there has been a strong recovery since, particularly in stock markets. Stricter regulations and market pressures caused bank deleveraging in the aftermath of the crisis

C. Fintech Uncertainties

Innovation in Financial Services

Modern information technologies have allowed financial services providers to serve previously underserved segments of the population, while improved technologies for credit reporting and borrower identification have dramatically reduced the cost of financial intermediation. Digital channels within banks have grown continuously and significantly – outpacing all other channels and changing the traditional sources of competitive advantage for banks. Besides the traditional banking business, nontraditional providers of financial services such as money transfers, savings, and lending have surfaced as a result of increased digitization. Some of these are new companies such as peer-to-peer lending firms like Kickstarter or Lending Tree. Others are nonfinancial institutions (or “nonbanks”) setting up a finance arm, such as e-commerce sites like eBay (owner of PayPal) or Alibaba, internet intermediaries like Google, electronics and software developers like Apple, and telecom operators like Safaricom. How fast and widely the range of financial services provided by banks and alternative providers will expand is a key factor affecting the evolution of the financial systems in the region. This uncertainty is also important because it could radically challenge regulatory mandates. The uncertainty continuum ranges from inhibited to lively tech-based adoption of innovations in financial services.

This uncertainty is important because consumer trends spread rapidly across countries and financial services in any country will find either strong pressure or resistance emerging from behaviors elsewhere. Potential benefits, including for financial inclusion, are huge but the fast development of whole new segments of finance raises challenges for regulatory architecture, financial stability, and security. The uncertainty continuum ranges from traditional payment systems continuing to prevail to cutting edge ones spreading widely.

Payment Systems

The use of non-cash payments has grown rapidly with the introduction of plastic cards. More recent technological advances in the way information is stored, the physical form of the payment mechanism, and biometric account access and authentication are creating efficiencies, reducing transaction costs and times at the point of sale. Mobile money transfer services have already transformed the landscape for domestic remittances in several African countries.

D. EU and Euro Area Uncertainties

LEFT END-POINT

RIGHT END-POINT

EU Financial and Monetary Consolidation

To address institutional shortcomings revealed by the 2008 financial crisis the EU has embarked on a process leading to Banking and Capital Markets Unions. Euro area stability and how much, if any, progress will have been made on an EU-wide financial architecture is an important uncertainty as the financial market development strategies of both new EU members and non-EU countries in the region, including the Western Balkans, will be greatly influenced by the evolution of EU financial and monetary policy. The uncertainty continuum ranges from EU financial and monetary integration proceeding forward or being forced by events to retreat backwards.

EU Enlargement

The European Union enlargement agenda presently includes the Western Balkans, with each country at a different stage of the process. This uncertainty is of significant relevance to Western Balkan countries as EU membership is a major determinant of the future options of the region. In 1999, the EU established the Stabilization and Association Process (SAP), with the goal of facilitating the accession process of Western Balkan countries. The SAP is governed by the Stabilization and Association Agreements, which tailored to each country's needs, identify common political and economic goals and foster regional cooperation. The uncertainty however is broader and it affects the broader appetite for EU enlargement. The continuum of uncertainty ranges from stalled to accelerated EU enlargement.

Besides these key uncertainties, it is worth noting that demographic characteristics are a fundamental factor to be considered—both because of its more certain and uncertain aspects. They were not treated as a contextual uncertainty for

the region as a whole but should be used to draw specific implications for individual countries. The root cause of the less certain aspects of demographics (notably migration) are covered in broader uncertainties including economic growth dynamics and EU enlargement. But recent development with the influx of refugees into the EU and its periphery clearly complicate this picture and will have an effect on migration prospects and options for Western Balkan citizens (see Box 1).

Finally, in order to validate the choice of key elements of change as context for the Western Balkans financial systems, regional stakeholders completed an anonymous online survey in July 2015. This exercise also served to inform the scenario-building process, and encouraged stakeholders to think about which specific relevant aspects of the future are more susceptible to change. Eighteen respondents from financial regulators and policymakers across the region completed the survey. Uncertainties were rated on a scale from one to six with respect to their relevance and uncertainty. The results are summarized in Figure 32. Although all uncertainties were rated medium- to highly-relevant and medium- to highly uncertain, sovereign debt features more prominently as a highly relevant and uncertain issue. This may be due to the fact that the Greek sovereign debt crisis was at its peak when the survey was conducted. Other prominent uncertainties that emerged from the survey were EU consolidation process and trends in commodity markets. It is interesting to note that financial innovation was perceived as relatively less uncertain and relevant than the majority of other uncertainties indicating that regional stakeholders might not pay sufficient attention to the opportunities but also threats such as cybercrime arising from new technologies. The dominant uncertainty identified in the 'other' category was political instability in individual countries of the Western Balkans.

Box 1: Demographics in the Western Balkans

Age dependency ratio of Western Balkan Countries

Source: World Bank, World Development Indicators

The size of the population in 2025 is reasonably predictable and even more so the size of the working-age population.

Urbanization rates are also relatively certain over the next decade. Differences across countries are significant and gradual trends towards greater urbanization in countries with larger rural shares would seem to be subject to minor variations.

Migration rates (gross and net) are an area of greater uncertainty—and recent developments and considerations around migration policy options set in motion by the influx of refugees underscore that. Plausible outcomes range from significant numbers of migrants returning to their home countries to fresh emigration. Remittances implications include 'guest workers' retirement and the question of where they settle.

The scenarios are intended to facilitate a conversation at the regional and national level on possible policy responses to each of the scenarios. As a first step, a high-level seminar was held in Vienna on November 13, 2015 with regional stakeholders and international partners.

The authors are very grateful to the participants of the seminar for their thoughtful contributions and insights. Seminar participants were not asked to vet or endorse the scenarios - which are just a device for exploring future possibilities, not for predictions - but to take them as a given and use them to explore

Figure 32: Results from regional stakeholder survey

Source: World Bank staff calculations based on survey results. Chart scaled from 1-6 to 1-3 for visualization purposes.

potential implications. Discussions revolved around topics including regional integration, management capabilities and corporate governance, technology, and the building of a robust economic and financial sector structure. EU integration and harmonization was recognized as an important anchor of reform in the region. However, regardless of the fate of the EU in different scenarios, cross-country harmonization will keep playing an important role in attracting and facilitating investments, as well as transferring knowledge. Finally, as was the case with the survey, there was surprisingly little emphasis placed by participants on the role of technology and how it might affect financial systems and regulatory mandates. Keeping this initial discussion at a regional level provided a valuable perspective that enriches the thinking that could be done at the level of individual countries. It also gave a strong sense of the importance at both levels of action now to ensure that all countries in the region arrive at 2025 with financial systems that are ready to make the best possible contribution to economic growth and prosperity. But the greatest value to be derived from the scenarios is at a national level—where most policies and regulations are set.

IV. 2025 Scenarios on the World around the Western Balkans Financial Systems

A. Overview

The three scenarios differ both in terms of the overall pace of economic growth and of the location of the global expansion of GDP—summarized simply by looking at the growth paths over the next decade of the countries that today we call “advanced” or “emerging/developing”.

Comparing the scenarios from this perspective suggests a greater potential variability of growth rates (from the current, 2015 level) for emerging economies than for advanced economies. Both groups of countries see growth set-backs in one of the scenarios while in each of the others the relative performance of advanced and emerging differs.

A broad look at the world is provided by singling out the two largest global economies (China and the USA), then the European Union and then considering the rest of the advanced and emerging worlds. Using that lens for 2025, in two of the scenarios the USA remains the largest economy, in one of them with the EU close in terms of aggregate GDP size, while in the third scenario China is the largest single-country economy and the “rest of emerging” block has also significantly increased its share of the world economy. The scenarios differ both in terms of the incremental value added generated over the next decade and the relative contribution to that growth by different countries/blocks. In one of the scenarios the center

of gravity of the world economy has definitely shifted to China and, notably, all other emerging countries.

Commodities in general and oil prices in particular also show marked differences in the three scenarios. One of them has oil prices rising steadily while in another one we see them crawling around the recent bottom—with obvious implications in terms of resource transfers between oil importers and exporters; and financial stocks in the hands of the latter.

The scenarios have a particular focus on the financial and monetary dimensions of the global economy. From that perspective there are two indicators that illustrate important differences across scenarios. First, interest rates (illustrated in Figure by 3-month LIBOR rates): two of the scenarios present very different money worlds—one of persistently low and another one of rapidly rising interest rates—while the third scenario shows interest rates evolving modestly upwards. Second, sovereign debt spread averages—as an indication of the global market appetite for debt issued by emerging countries—and, hence, the price they must pay to mobilize funding: in one of the scenarios the spreads narrow to historical lows while in another they climb to historical highs (Figure 35). In the third scenario they increase steadily but stay within a moderate range.

Figure 33: Crude oil, USD/barrel

Source: WEO Database and World Bank staff calculations

Figure 34: Quarterly average 3M LIBOR

Source: ICE Benchmark Administration Limited (IBA)
World Bank staff calculations

Figure 35: Developing Countries' Sovereign Debt Spreads against US treasuries

Source: World DataBank and World Bank staff calculations

There are other major differences across scenarios but they do not lend themselves to quantification: the EU's internal evolution (progress towards consolidation—including a banking union—characterizes one of the scenarios while a stalled enlargement process features in another scenario); strengthening of banking regulation (its unintended consequences a significant feature of one scenario), the global landscape for banking FDI (two scenarios see further retrenching and one envisages expansion), deepening of capital markets (in one scenario), and innovation in payment systems and financial services more generally (rapid technology adoption is a salient characteristic of one of the scenarios).

Figure 36: GDP Growth - Advanced Economies

Source: World Bank staff calculations

Figure 37: GDP Growth - Emerging Economies

Source: World Bank staff calculations

Figure 38: 2025 Nominal GDP

Source: World Bank staff calculations

Figure 39: Shares of GDP growth 2015-2025

Source: World Bank staff calculations

Shifting Orange

The global economy is on a roll—and the center of gravity is no longer in the old advanced countries. 2015 did not mark the end of the “emerging golden age” but a pause in their growth march. By 2025 though, the term “emerging countries” made no sense any longer as quite a lot of those formerly called emerging were now well-established upper-middle income countries. Trade is again a major driver of economic activity and supply chains keep getting more global.

China is an important part of the story but far from the only one—Poland and Turkey, alongside Colombia and Indonesia, are among non-BRICs¹⁶ performing strongly. In China, the growth slowdown of 2015/2016 turned out to be a process of adjustment and a strong, steady growth

resumed thereafter—as the economy finally shifted towards a better balance between investment and consumption. Just as important, the quality of investment improved steadily. This changed its import demand pattern and had many implications for its evolving landscape of trading partners.

Figure 40: Shifting Orange Growth: Advanced

Source: WEO Database and World Bank staff calculations

Figure 41: Shifting Orange: Nominal GDP

Source: WEO Database and World Bank staff calculations

¹⁶ BRIC is a grouping acronym that refers to the countries of Brazil, Russia, India and China.

Productivity growth, consumer confidence in the US, and a steady decline of debt levels in Southern Europe (after a debt workout for Greece was finalized in 2016) have meant that the 2020-2025 period has been one of economic stability and growth. By 2025 China has the world's largest GDP (it had headlined as #1 in 2014 ... but only in now-discredited purchasing power parity (PPP) terms), the US has surpassed the whole of the EU's GDP, and the three of them together represent 60% of the global economy. India has been growing fast and is in the midst of a momentous transformation, but still as a much-smaller economy—albeit larger than Germany and Japan.

The G8 never met again and the G7 had its last meeting in 2019 after these summits seemed to be increasingly powerless gatherings. The EU managed to stay together but had to face the reality of different visions, scale down integration ambitions

aims—defusing Western influence, but in a more cosmopolitan way than had been represented by the BRICS—a grouping it allowed to fade by neglect.

Growth outside the high-income countries has not been significantly more energy efficient than in the past, so energy demand was strong after 2017. The increase of supplies from the Middle East (reflecting subsiding tensions in the region) was not enough to keep prices down; the oil price increased steadily from 2016 on; in 2025 it is above \$100/barrel and seems poised to continue increasing. This gave Russia fiscal breathing room and led the new Kremlin leadership to focus more on economic reforms than foreign policy.

High energy prices have also meant that financial surpluses are again concentrated, and underpin another source of international expansion of Russian and other non-Western banks, supported

Figure 42: Shifting Orange Commodities (2005 = 100)

Source: WEO Database and World Bank staff calculations

and agree to special arrangements—notably starting with the UK (where the narrow outcome of the 'Brexit' referendum did not manage to settle the issue) which complicate further enlargement.

China launched its new international leadership strategy with the occasion of the G20 presidency in 2016—when it proposed the Hangzhou Initiative—a major reform of the group to make it more legitimately inclusive. Its strategy, besides the expanded role for the G20, involved the launch of a "new G5" dialogue (rumors had it that this and the demise of the G7 were not coincidental) with the US and EU, plus Japan and India. The inclusion of the latter two reflected one of China's other

Figure 43: Shifting Orange Financial Landscape

Source: World Bank staff calculations

by Sovereign Wealth Funds. Interest rates finally started to increase in earnest—in both nominal and real terms—after 2017. The "search for yield" dynamic of institutional investors is less of a feature of global markets, but growth and relative stability around the world make sovereign debt from many countries attractive.

In terms of financial markets, the growth of multidimensional capital flows, major new players in the banking FDI scene and the wish by newly prosperous countries (and, of course, China) to diminish the role of the New York/London financial axis meant supporting the growth of Dubai and Costa Rica alongside Hong Kong and Singapore

as alternatives. It also quietly undermined the Basel process by ignoring much of the guidance emerging from there, pushing for more flexible global financial regulation and the adoption of a more diverse set of rules reflecting country—and regional—differences. While it was not an intended consequence, regulatory arbitrage has been rampant since the early 2020s.

Aggressive digital and online banking strategies (including “hosting” of small “community payment unions”) by a few banks proved successful and a major strategic differentiator. Many banks hung on to what proved a perishable notion of customers wanting ‘brick and mortar’ bank branches and failed to adapt quickly enough. The late 2010s saw the emergence of many financial service innovators responding to a willing-to-experiment attitude by some regulators in major countries and regulatory loopholes (often in-between regulatory silos) in others. Many new options emerged reflecting local circumstances—and paved the way for international “umbrella” systems that use Blockchain-based platforms and/or distributed ledger approaches. Access to credit was changed forever by new players: Lending Club had paved the way in the US when it had \$2billion turnover in 2016 with Alibaba rumored to have done even more lending business, by 2020 a few sophisticated crowd funding/lending platforms were quickly becoming major international players and/or franchises.

Reality had swept away doubts on crowd-funding by 2020 (just as a decade earlier Wikipedia had done with knowledge). Non-bank mobile payment mechanisms have spread widely. Credit cards are going the way of the music CD—replaced by crypto transfers and the financial version of the Internet of Things. Social media platforms have added financial options that have been eagerly embraced by young users—a glimpse of that could be gained back in 2015 by looking at the wildfire-speed popularity of Venmo (that taps into networks like Facebook) among college students in the US.

Unsettling Grey

The world economy has had a 'lost decade' featuring: a divergent but generally bleak set of economic performances by countries in Europe; a major set-back in China (the 'hard-landing' included a banking crisis, a wealth management product bubble burst and local government fiscal and debt chaos); and secular near-stagnation in US (the ability to take hard, far-sighted decisions severely handicapped by partisanship in Congress). India could not find a way to decouple itself from all of that and experienced growth well below the high expectations of the start of the Modi period while Brazil hosted the Olympics and is still stuck in a crisis from which it has had two false recoveries, and which seems to have no end in sight.

Both commodity exporters and manufacture exporters among emerging economies have suffered from ripple effects from weakness in the Chinese economy and the lack of demand from Europe. Most countries with significant population growth have seen their per capita incomes stagnate—or even decline. Public expenditure in many countries

has been under severe constraints for so long that austerity is no longer a term under discussion—more lavish alternatives are not at all viable. Corporations with significant cash reserves wield great power and have extracted juicy concessions from cash-strapped governments by offering upfront payments.

Figure 44: Unsettling Grey Growth: Advanced and Emerging

Source: WEO Database and World Bank staff calculations

Figure 45: Unsettling Grey: Nominal GDP

Source: WEO Database and World Bank staff calculations

In 2025 the US continues to be the largest economy in the world—20% larger than the EU and more than 50% larger than China. Unfortunately, this is not due to a strong performance of the US economy but of even weaker situations elsewhere. Trade has continued to grow slightly faster than the anemic GDP pace but there has been creeping protectionism (including through local content regulations) and a greater share of trade exchanges has taken place within preferential trade agreements (PTAs)—eroding part of the benefits of globalization but at the same time it has created some new opportunities for enterprises focusing on regional markets.

stronger fundamentals have allowed it to muddle through the decade with slow but steady growth.

Many countries around the world with fragile political situations have seen instability and even turmoil. And the world has no functioning global engagement platform: the G20 has proven ill-suited and is just going through summit motions without impact; the UN is paralyzed by rhetoric (the beautifully convoluted sustainable development goals (SDGs) that were agreed in 2015 have not been pursued in any practical way) and by paralyzing Security Council vetoes. China 'stuck to its knitting' as economic,

Figure 46: Unsettling Grey: Commodities (2005=100)

Source: WEO Database and World Bank staff calculations

Figure 47: Unsettling Grey: Financial Landscape

Source: World Bank staff calculations

It is a world in which most countries forgo environmental protection to avoid any further dampening of economic growth and investment in renewable energy sources has suffered from low energy prices, fiscal constraints and corporate balance sheet pressures. The Middle East has remained mired in intractable tensions which have kept their oil supply from increasing in any reliable way—this combined with weak demand has left 2025 oil prices above their 2015 lows but volatile (prices dropped below \$30/barrel in 2020) and still well below the budget break-even point of oil-dependent countries. The financial reserves of Gulf countries have been largely depleted and weak oil/gas prices have severely undermined the Russian economy. In this context, the Kremlin exhibited further populist belligerence (in Georgia and Moldova ... besides Ukraine) which strained relationships even further. Moreover, Turkey's balance of payments problems have proven to be a major constraint requiring a painful adjustment in the late 2010s while Poland's

social and inter-regional problems require the leadership's full attention and do not create a favorable environment for global assertiveness.

In Europe, worsening economic performance in Italy and in some of the most recent entrants to the euro area, together with a lack of final resolution of the debt situation in Greece (where the economy showed no signs of recovery by end-2016) forced consideration of an alternative to the euro and generated much capital flight from the weaker euro nations. A two-euro approach was introduced in 2017 but by 2019 it had proven not viable and Germany led the way back to the old national currencies—goodbye ECB! The 2016 Brexit referendum did not really manage to settle the issue which remains a source of uncertainty and budget cuts in Brussels killing any appetite for further enlargement or deeper integration, and by 2025 the EU has evolved into a multi-tier agglomeration (no longer a community) of nations.

Persistently low interest rates have put great pressure on pension funds and insurance companies—which have become a major new area of consumer protection concern. In that uncertain and volatile financial market environment, relaxation of regulatory pressure on banks has been required—Basel had to address the trade-off between safeguarding risk and producing banking paralysis and BIS prescriptions have proven very divisive. Many countries (in part influenced by the situation in Europe) have introduced capital controls and measures to ring-fence their financial systems. Together with the generalized market view that sovereign debt (except for the few countries considered ‘safe heaven’) is “junk”, this environment makes it difficult and expensive for countries to obtain external finance, unless their financial and fiscal discipline earns them stand-out credibility.

Risk levels have been high throughout the decade and many large banks continue retreating towards their core markets—closing down or selling subsidiaries. HSBC’s exit from Brazil in 2015 was just the first step in a broader retrenchment and, in Europe, by 2020 the previously adventurous Austrian banks had already cut in half the number of countries where they have a presence. With their banking landscape looking bleaker, many countries resorted to state-owned banking initiatives—which only exceptionally appear to provide more than a poor patch-up solution.

Impetus for innovation in financial services and payment systems has been dampened by economic weakness and by major waves of cyber-crime and terrorist hacking. Only piecemeal innovation is taking place on capital markets, financial services and payment systems and it revolves around low-end products of the m-Pesa type and reducing transaction costs for remittances

Orderly Blue

This is a world that favors incumbents—including both the old advanced countries and well-established international banks. The G7 remains predominant politically and economically—reflecting the strength of the US economy (not least through a new productivity impetus) and, finally, a graduation from recovery to steady growth in Europe. Growth has moderated overall for emerging and developing countries that in the early 2000s had been growing fast—with averages masking periods of significant set-backs for a number of major countries (including Brazil and Russia which took longer than was expected in 2015—the latter especially hampered by persistently low oil prices). Low oil prices have been a major help to India—which has been the decade’s world fastest growing country.

The net global effect has been modest growth over the decade and the annihilation of what in 2015 seemed like the “new normal” growth differential between advanced and emerging countries. In 2025 the “two-speed economy” notion has become

a distant memory—as the growth path divergence is among individual countries not categories. Poland, for instance, has grown steadily at rates even higher than the EU average while Turkey has had more of a stop-and-go performance.

Figure 48: Real Growth: Advanced and Emerging

Source: WEO Database and World Bank staff calculations

Figure 49: Orderly Blue: Nominal GDP

Source: WEO Database and World Bank staff calculations

The resumption of solid growth in Europe, and continued, steady growth in the US underpin the resurgence of the G7 and associated institutions—while China made little progress during the decade in terms of its GDP catching up with that of the US. Not unrelated, the Annual Meetings of the World Bank and IMF have regained their prominence as a global point of encounter, and the leadership succession in both institutions did not offer a break with the past—by 2025 C. Lagarde has been twice re-elected as MD of the IMF and L. Summers is in his

countries in MENA. The end result has been that oil prices have remained in a narrow range around \$35/barrel—not having recovered from the 2015-2016 troughs as much as other commodities have.

Modest increases in interest rates in advanced countries have lessened the “search for yield” pressure and made markets more selective in their perceptions of sovereign debt risks—as evidenced by the widened range of credit default swap (CDS) levels.

Figure 50: Orderly Blue: Commodities (2005=100)

Source: WEO Database; World Bank staff calculations

second term at the helm of the World Bank. Trade volumes have grown at a slower pace than global GDP, as the ‘re-shoring’ of manufacturing to the US and Europe has been facilitated by rapidly expanding adoption of robotics and new technologies (notably the rapid spread of additive manufacturing—which in its infancy used to be called 3-D printing). There has been some narrowing of wage differentials and a reversal of the trend in labor unit costs to the advantage of advanced countries and higher-income emerging countries.

In the absence of the pressures from economic crisis, environmental concern has again moved to the front of policy and public opinion concerns in many countries, and new efforts to improve energy efficiency and foster development of renewable energy sources in high-income countries have proven fruitful. Together with growth hiccups among emerging countries, this has kept demand for energy commodities in check. Supply has benefited from a more stable situation in a number of oil-producing

Figure 51: Orderly Blue: Financial Landscape

Source: World Bank staff calculations

2017 was an important year for Europe. It started with the Greek debt workout being finally digested by all concerned (after Greece implemented reforms, regained credibility and managed to reactivate its economy in 2016). In the middle of the year the G8 process was reactivated—with Russia participating in a high-spirited summit in Italy in recognition of the EU-Russia rapprochement and invited to host the 2019 summit. This helped create a stable environment in Europe and open the door for efficiency-inducing pan-European infrastructure projects. Elsewhere the alliance between India and the US has become closer. China has been focused on solving internal challenges (including those resulting from an economic set-back in 2016-2018) and it is less visible in the international arena—focused on economic diplomacy in pursuit of specific interests rather than global prominence. And tensions in the Middle East have lessened.

Three more countries were granted EU accession before 2025 and several more are close to that milestone.

Renewed faith in the euro area has made possible progress towards banking and capital market unions in the EU, moving ahead of the 2015 road map pace. Addressing the need for critical mass for capital market operations in smaller EU members and members-to-be, the Vienna Financial Center was fully operational by 2020 and has proven a successful platform for corporate listings and public and private debt issues—with security pricing and CDS levels rewarding good governance and transparency.

The resumption of economic growth in advanced countries has dampened the anti-growth criticism of strict banking regulations that was emerging when major economies seemed to be gravitating towards secular stagnation.

The Basel approach has taken strong roots and implementation has proceeded apace. Together with renewed anti-money laundering efforts combating the financing of terrorism, regulatory dynamics have had the effect of accelerating concentration and consolidation of the banking industry in the EU and elsewhere—as compliance costs become prohibitive for small banks.

International banks are further curtailing activities outside their home bases; but retrenching by major Western banks from emerging markets stopped well short of the worst 2015 fears in CESEE.

Alignment of views between major Western country regulators and large banks has resulted in financial service and payment innovations being rolled out cautiously—and they are reaching the consumer mainly through incumbent financial institutions. Large banks that developed a sophisticated hybrid of in-person and on-line banking are doing particularly well. However, in countries adopting Basel-type regulations often the unintended effect has been a proliferation of regular financial services being offered by non-banking institutions and “shadow banking institutions”. Meanwhile, consumer interest in more novel approaches to payments and crowd-lending was dampened by a series of high-visibility Ponzi schemes and other cyber-fraud.

V. Conclusions and Next Steps

Financial systems in the Western Balkans continue to face a number of challenges to financial sector development and stability in both the short- and medium-term. Tackling these challenges is urgent and will determine each country's ability to make the most of whatever shape the world takes by 2025. Across the region, high levels of NPLs need urgent policy attention by strengthening the corporate and personal insolvency and creditors' rights regimes as well as regulatory classification and provisioning standards. Further deleveraging remains a risk as some parent banks plan to further scale back their presence in the region as a result of continued market and regulatory pressures. Shifts in banks' funding models, increased competition, as well low bank profitability levels in some countries in the region, may require further bank consolidation to adjust to the new circumstances. The development of regional capital markets to provide stable and longer-term funding alternatives is key to mitigating potential shortcomings in this context. Given the high dependency on foreign currency lending and borrowing, active policies to increase the use of local currencies should be pursued both to reduce financial stability risks and to afford greater degrees of policy freedom to monetary authorities.

Over the longer term, the outcome of a number of critical uncertainties in the external context will shape the future of the Western Balkans financial systems – creating new opportunities and challenges. The uncertainties explored in this report focus on dynamics outside the region with particular relevance for the Western Balkans financial systems. They cover both global factors—such as economic dynamics, geopolitics, financial markets and technology-based innovation—and dynamics more specifically related to the EU. Acknowledging existing uncertainties and thinking through how they could shape the future options for policy makers and regulators to manage national financial systems is a valuable preparation for the eventualities of change.

This report presents three scenarios that were developed to explore different possible ways in which these uncertainties could play out and drive change. Each of the scenarios sketches out the characteristics of a different shape the world could take in 2025. The dynamism of the global economy in the *Shifting Orange* scenario presents many opportunities for countries in the region but might also require much rethinking of conventional assumptions. Conversely, the turmoil in the global economy in the *Unsettling Grey* scenario presents many challenges for the region given the low growth environment and fragile political situation

—including in the EU. Finally, *Orderly Blue* provides many opportunities for the region with its positive evolution of the EU economy and integration processes.

The initial discussion at the regional level provided a strong sense of the importance at both levels of action (regional and national) to ensure that the region arrives at 2025 with financial systems that are ready to make the best possible contribution to economic growth and prosperity. It also provided a valuable perspective and insights on the importance of coordination and cooperation within the region. In exploring possible implications of the scenarios for the financial systems in the region a number of key questions and issues were identified in discussions with internal and external stakeholders - including as part of the discussions held with regional policymakers and financial regulators during the regional high-level seminar in Vienna in November 2015. The key issues are:

- **GLOBAL FINANCIAL MARKET DYNAMICS:**

Developments in the global financial markets have a significant impact on the region because of the small size of their financial markets as well as monetary policy regimes being dependent on broader monetary and exchange rate dynamics. The question of currency 'affiliation' becomes key in the *Unsettling Grey* scenario, where core EU countries revert to national currencies. *Orderly Blue* highlights managing risks and opportunities arising from further tightened Basel-type regulations becoming widely adopted and implemented across countries—including through the EU Banking Union. While *Shifting Orange* raises important strategic questions in a world where regulatory loosening and fragmentation generates wide-ranging perceptions of risk across countries and room for regulatory arbitrage. As countries in the Western Balkans have significant reliance on foreign banks and their capital inflows, the dynamics of banking FDI and cross-border credit poses an important uncertainty. In *Unsettling Grey* (and to some extent in *Orderly Blue*), swift reaction to funding risks stemming from parent bank deleveraging and retrenchment would be important. There is a need for strengthened corporate governance and resolution regimes as well as diversification of funding sources including via regional capital market development and domestic resource mobilization. Public banks or domestic development banks could also play an increasing role to facilitate long-term finance and counterbalance cyclical effects, however distortive

effects in their institutional and governance setup would need to be avoided.

- **FINANCIAL INNOVATION:** For policymakers and regulators financial innovation can raise issues of mandate adequacy as well as the need to balance tensions between regulation and innovation while helping the regional financial systems leapfrog in terms of depth and inclusion. This is of particular importance in the case of the *Shifting Orange* scenario. There needs to be further emphasis placed on dealing with large-scale cyber threats.

- **EU INTEGRATION AND REGIONAL COORDINATION:** While EU integration and harmonization is recognized as an important anchor of reform in the region, cross-country harmonization can play an important role in attracting and facilitating investments, as well as transferring knowledge—independent of the fate of the EU in each scenario. Providing a regional platform for regulators and policy makers to facilitate a joint discussion would be of significant value. In all scenarios such a forum would help the region coordinate and cooperate to the mutual advantage of all countries. There would be additional value in using cooperation to create a positive regional "brand" that would help overcome the otherwise limited visibility of individual countries.

- **NATIONAL POLICIES:** Although the scenarios intentionally differ from each other in terms of the mix and nature of challenges and opportunities, the discussion during the regional seminar pointed strongly to the differential effect that national policies and decisions could have. By 2025 the progress on structural reforms made by each country, including in the financial sector, will determine how they fare—in absolute and relative terms. Countries that have progressed with structural reforms will be better equipped to address challenges and benefit from opportunities in any of the scenarios.

World Bank therefore aims to organize scenario analysis workshops at the national level with the aim of supporting financial sector policymakers and regulators in using the scenarios and thinking around the uncertainties and change that underpin them.

In particular, the scenarios can serve in testing policy options under consideration and inform the development of financial sector strategies that contribute to the country's overall success in sustainable and inclusive growth. Each scenario spotlights different challenges and opportunities that would be useful for financial policymakers and regulators to consider. In exploring policy responses to the implied challenges and exploiting the opportunities, the illustrative questions in Table 6 are meant as a starting point for exploration of scenario implications and 'strategic action' at the national level. The issues and questions are highlighted in the 'world' where they are most critical, this does not preclude their relevance for other scenarios. They revolve around the following policy areas: (i) bank regulation, supervision and coordination, (ii) financial intermediation, (iii) regulation and supervision of new entrants/players, (iv) financial sector stability and security, and (v) financial infrastructure. Comparing appropriate responses across scenarios will provide insights on key policy areas that need to be addressed no matter what the future looks like, and shed light on policy areas that are not given sufficient attention in the current policy dialogue. Moreover, the scenarios can help test policy options under consideration and inform the development of financial sector strategies that contribute to the country's overall success in sustainable and inclusive growth.

While the regional level discussion provides a useful validation of the scenarios and a starting point for analyzing implications for actions, the greatest value to be derived from the scenarios will be at a national level to inform financial sector strategies and action plans. It is the country level where most policies and regulations are set and, therefore it is in that context that exploring key uncertainties highlighted in this report and drawing the implications emerging from each scenario will offer most value. Going forward, the

Table 6: What if? Select Issues Requiring Particular Attention of Financial Sector Policymakers and Regulators in Each Scenario

POLICY AREAS	SHIFTING ORANGE	UNSETTING GREY	ORDERLY BLUE
Bank Regulation, Oversight and Coordination	• How to manage risks and opportunities arising from the loosed and fragmented global regulatory environment in this world? • How to balance the tension between regulation and innovation to help regional financial systems leapfrog in terms of depth and inclusion? • How to approach new dynamics in home-host interactions? What will be required to ensure cooperation and exchange of information between regulatory and supervisory agencies within and across jurisdictions? • How best to approach international partnership 'diversification' beyond the EU?	• How to address weaknesses in the local banking sector and high backlog of non-performing loans stemming from this 'lost decade'- world? • How to deal with FX lending risks in the wake of a severe exchange-rate depreciation and consequent losses for banks? • What does it take to strengthen corporate governance of banks? • How to enhance coordination of home and host authorities related to decisions on the disposal of foreign subsidiaries as disinvestment occurs?	• What steps does it take to ensure institutional capacity/resource adequacy of financial regulators/supervisors in light of accelerated EU integration towards banking and capital markets union? • How to deal with the risks of disorderly deleveraging of western parents and banking sector consolidation? • How to ensure coordination related to capital markets development among key regional stakeholders? • What new and differentiated positions vis-a-vis EU/EMU membership (full membership vs giving up national policies, which facilitate absorption of losses, too early) should be considered?
Platform facilitating regional integration and harmonization?			
Financial sector intermediation (credit growth/intermediation and non-bank financial sector development)	• How to leverage financial inclusion and efficiency improvements stemming from financial innovation? • What macro prudential tools are required to manage boom cycles? • How to create a level-playing field between similar financial services? • How to leverage recurrent payment streams, such as Government to Person (G2P) and remittances? • How to gain visibility in the new investor landscape?	• With the retreat of foreign banks at the start of the 2015-2025 decade not having been reversed, what are the options to avoid a slump in the availability of credit? • What macro prudential policy tools are needed to manage bust cycles? • Do public banks or domestic development banks have a role in filling the gap in lacking credit intermediation? How to avoid distortive effects with regards to their setup? • How to best balance the major stability challenge this world provides with the aim of increasing financial depth and inclusion?	• How to deal with negative effects of banking sector consolidation/concentration on competition/cost of credit? • What steps could be taken to ensure that credit growth is supportive of private sector activity—even in the context of restrained foreign bank activity? • Could microfinance and leasing sectors play a role in filling the gap of smaller banks? • How to advance the legal and regulatory framework for capital market development? • How to build up the institutional investor base? • How to foster transparency and integrity of capital market data?

POLICY AREAS	SHIFTING ORANGE	UNSETTING GREY	ORDERLY BLUE
Regulation and supervision of new entrants/players	• How to regulate new (digital) financial service providers commensurate with their risks and activities? • How to address data protection, sharing and ownership as well as digital financial consumer protection issues? • What needs to be considered when designing regulatory mandates and strengthening supervisory capacity to match the new financial player landscape and associated risks?	• How to set up institutional, supervisory and governance frameworks of public banks/domestic development banks? • How to design government support programs and instruments aimed at addressing market failures? • What does it take to strengthen financial consumer protection regimes?	• Proportionality & risk-based approach: How to design regulation and supervision of nonbank service providers commensurate with their risks and activities? • How to set up institutional arrangements for non-bank financial institutions (NBFIs) regulation and oversight in a world of expanding NBFIs and 'shadow banks'?
Financial sector stability and security	• What Anti-Money Laundering/Combating the Financing of Terrorism policies need to be introduced in relation to digital financial services and new players and products? • What will it take to address regulatory arbitrage arising from loosened bank regulation?	• What measures are needed to address the increased sovereign-bank nexus? • What does it take to strengthen the existing financial safety net? • What currency 'affiliation' and other options are there as core EU countries revert to national currencies? • How to avoid contagion including bank runs as risk perceptions about emerging market countries become heightened?	• What measures are needed in supervising and regulating the shadow banking system? • How much of a priority should being ready for large-scale cyber threats be?
Financial Infrastructure (secured transactions framework, credit reporting system, insolvency regime and payments systems)	• How to strengthen infrastructure to support responsible digital lending? • What will it take to ensure interoperability among digital services providers, and between them and traditional financial service providers?	• What steps are needed in financial infrastructure development underpinning safe and efficient transactions and lowering the costs and risks to financial service providers?	• What steps are needed in financial infrastructure development in light of increasing regional and EU integration? • How can small countries become pioneers in a world of limited innovation in financial services and payment systems?

ANNEX 1: Scenario Analysis Methodology

What is scenario analysis?

As a methodology, scenario analysis does not attempt to predict the future; rather, it aims to stretch the boundaries of the plausible. Scenarios explore a few diverse eventualities of how the world might look if the most uncertain and important drivers unfold in different ways.

The basic process of scenario analysis includes the following steps:

- Identifying predetermined factors, namely future developments that are predetermined, that is, will take place in any scenario. As an example, population growth is a variable that tends not to change quickly.
- Identifying critical uncertainties. These are areas in which the future is uncertain and can easily flip-flop. An example of a highly critical uncertainty in many countries is the type of government: right or left wing.
- Developing scenario plots. A scenario is defined by combining a small number of sets of critical uncertainties. A comprehensive description of how the future would look under this scenario is then developed. These futures must be plausible.
- Consultation. A rigorous consultation process will be carried out to clarify the scenarios and to make them representative. This process involves presenting the scenarios to a large number of people who have expertise relevant to the scenario exercise, collecting their comments, and subsequent incorporating the comments in the framework and scenario stories. Part of the consultation phase is further research in areas in which new or more knowledge will improve the quality of understanding.
- Assessing the implications of different scenarios. An assessment is made of the best possible

responses of the organization(s) concerned to each of the plausible future scenarios.

- Comparing possible responses. Finally, the responses to the different scenarios are compared. Two elements in the comparison require special attention. First are the actions that can be found in all responses and tend to be associated with low risk. Second are the responses that differ among scenarios. Responses in these fields may require further assessment to understand how the impact of change on these variables can be managed.

Why scenario analysis?

Scenario analysis is used as a complement to forecasting. It helps explore a longer term horizon and recognizes the uncertainties faced by financial policymakers and regulators in the region. Trend analysis is based on the assumption that the factors that drove change in the past will continue to drive it in the future. Scenarios, on the other hand, are not predictions, but hypothesis of different futures specifically designed to highlight the risks.

Who uses scenario analysis?

Scenario thinking was originally used by the US military in World War II. Subsequently, corporations began using this methodology to guide their strategic directions in the medium and long term; Royal Dutch/Shell is probably the most well-known. The World Bank Group uses elements of scenario thinking in crisis simulation exercises. More recently the Organization for Economic Co-operation and Development (OECD) used scenarios as a basis for a policy discussion at its 2015 Ministerial Meeting.

ANNEX 2: Scenario Configuration on the Uncertainty Continuum

Shifting Orange

Unsettling Grey

Orderly Blue

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