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BOSNE I HERCEGOVINE

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Maršala Tita 25, 71000 Sarajevo
tel. (387 33) 278 100
faks (387 33) 278 299
Internet: www.cbbh.ba
e-mail: publications@cbbh.ba

For all information concerning this publication please contact:
Financial Stability

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Aleksandar Sikiraš

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Acronyms

AECI	Spanish International Cooperation Agency
BAM	convertible mark
BARS	Banking Agency of RS
BH	Bosnia and Herzegovina
BHAS	BH Agency for Statistics
CBBH	Central Bank of Bosnia and Herzegovina
CEA	Classification of Economic Activities
CEFTA	Central European Free Trade Agreement
CET1	Core Equity Tier 1
CHF	Swiss franc
CPU	Currency Pool Unit
CRC	Central Registry of Credits
CRD IV	IV Capital Requirements Directive
CRR	Capital requirements regulations
DIA	Deposit Insurance Agency of BH
EBA	European Banking Agency
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EFSE	European Fund for Southeast Europe
EIB	European Investment Bank
EU	European Union
EUR	Euro
FATF	Financial Action Task Force
FBA	Banking Agency of FBH
FBH	Federation of BH
FED	Federal Reserve System
FIA	Financial Information Agency
FSAP	Financial Sector Assessment Program
FSR	Financial Stability Report
GBP	Great Britain pound
GDP	Gross domestic product
GRECO	Group of States against Corruption
HHI	Herfindahl-Hirschman's Index
IBRD	International Bank for Reconstruction and Development
ICO	Instituto de Credito Oficial
ILO	International Labor Organization
IMF	International Monetary Fund
KWD	Kuwaiti dinar
LCR	Liquidity Coverage Ratio
MCC	micro-credit company
MCF	micro-credit fund
MCO	micro-credit organization
MFT	Ministry of Finance and Treasury
MONEYVAL	Council of Europe Committee assessing the combat against money laundering and terrorist financing
NPL	non- performing loans
NSFR	Net Stable Funding Ratio
OPEC	Organization of the Petroleum Exporting Countries
RS	Republika Srpska
RSIDB	RS Investment Development Bank
RTGS	Real Time Gross Settlement
SCFS	Standing Committee for Financial Stability
SDR	special drawing rights
SNB	Swiss National Bank
SSM	single supervisory mechanism
S&P	Standard and Poor's
USA	United States of America
USD	American dollar

Countries

AT	Austria
BE	Belgium
BG	Bulgaria
CY	Cyprus
DE	Germany
ES	Spain
FR	France
GB	Great Britain
GR	Greece
HR	Croatia
IE	Ireland
IT	Italy
ME	Montenegro
PT	Portugal
SI	Slovenia
SK	Slovakia
RS	Serbia

INTRODUCTION

The Central Bank of Bosnia and Herzegovina (CBBH) considers a financial stability as the condition in which a financial system can absorb shocks without significant disruptions in its current and future operations and whose functioning has no negative effects on the economy.

CBBH's mandate to monitor the financial system stability indirectly arises from the Law on CBBH. CBBH plays an active role in the development and implementation of Bosnia and Herzegovina's (BH) policy on stability and sustainable economic growth, by ensuring stability of the domestic currency and of overall financial and economic stability in the country. One of CBBH's basic tasks is to establish and maintain adequate payment and settlement systems as a part of the financial infrastructure. CBBH contributes to preservation of financial stability through its legally defined competency for coordination of Entity Banking Agencies' activities. Based on a Decision of the Governing Board, CBBH participates in the work of international organisations that work on strengthening of financial and economic stability through the international monetary cooperation. CBBH activities in the field of monitoring financial system's stability also include specialised communication with relevant international and domestic institutions that ensures continuity in the process of monitoring system risks. CBBH contributes to the preservation of financial stability through its membership at the BH Standing Committee for Financial Stability.

By publicising the Financial Stability Report (FSR), CBBH tries to contribute to the financial stability in BH through:

- Improvement of understanding and encouraging dialogue on risks for financial intermediaries in the macroeconomic environment;
- Warning financial institutions and other market participants about potential collective influence of their individual actions;
- Establishing consensus on financial stability and improvement of the financial infrastructure.

Although the FSR focuses on events from 2014, its scope was expanded to the most important developments in the first half of 2015, in line with data available at the time of its development. FSR for 2014 is organised in chapters, as follows. The first chapter includes the FSR's executive summary. It points out the most important risks for the financial system stability. The second chapter introduces the main trends and risks from the international environment. This chapter particularly singles out the main risks from the EU and euro zone and describes effects of these risks on the banking sector and real economy of this geographical area and indirectly the effects on BH banking sector and real economy. The third chapter provides an overview of trends and potential risks from the domestic environment that were identified as threats for the financial system stability. Distinguishing risks from foreign countries in 2014 were as follows: weak and uneven recovery of euro zone, low inflation rate, high level of public debt and high unemployment rates in a large number of EU countries, while the banking sector did not record any significant credit growth or improvement in the credit portfolio quality. As for BH, distinguishing risks were as follows: slow real sector recovery and weak domestic demand, fiscal weaknesses in the country and high current account deficit. The fourth chapter illustrates effects of the risks identified in the previous chapters on claims on households. The fifth chapter focuses on effects of the identified risks on the companies sector. The sixth chapter evaluates risk effects on the financial system stability, focusing on the banking sector. Stress tests are a consisting part of the sixth chapter of FSR and serve to establish the banking sector's ability to absorb extreme but still possible shocks from the macroeconomic environment. The seventh chapter illustrates the main trends in the financial infrastructure: payment systems and regulatory framework.

FSR for 2014 also includes four text boxes that analyse current topics discussed in the main part of the text in greater details. The second chapter, which describes risk effects on the banking sector of the EU and euro zone, includes a text box dedicated to results of the Assets Quality Review process and stress tests in the euro zone's banking sector. Chapter Financial Intermediaries contains two text boxes. Text box 2 provides an overview of main findings of the Financial Sector Assessment Program in BH (FSAP) implemented in 2014, while the Text Box 3 describes potential effects of the EU Regulation 575/2013 implementation on exposures of banks majority-owned by European banking groups toward governments and central banks. Text box 4 in the Financial Infrastructure chapter briefly describes changes in the regulatory framework of the BH banking sector pertaining to capital management.

Finally, it should be emphasised that the FSR exclusively deals with issues of importance for the systemic risk, because competent financial sector supervisors are in charge of supervising operations of financial intermediaries, according to the existing laws in BH. Its main goal is to point to risks arising from the financial system and the macroeconomic environment, and to evaluate the system's ability to absorb those shocks.

1. EXECUTIVE SUMMARY

Different recovery levels of the US and EU economies and uneven recovery of the strongest economies of the euro zone and its peripheral countries, along with strengthening of geopolitical risks and deflationary pressures due to trends in food and oil prices on world markets were some of the main characteristics of the global economy in 2014. Consequently, there was a turn in FED's monetary policy, as it ended the program of quantitative easings and announced an increase in interest rates by the end of 2015. At the same time, the ECB continued implementing expansive monetary policy, thus creating preconditions for continued financing under favourable terms in 2015.

Some of the most important euro zone risks are: uneven and slow economic recovery of euro zone member states, deflationary pressures and alarmingly high public debt level and high unemployment rates in many EU member states. ECB measures enabled banks to approve loans under extremely favourable conditions, but due to lack of significant credit growth, banks were not able to substantially improve the credit portfolio quality and generate expected income. During 2014, substantial progress was achieved in strengthening banking sector's regulations, by establishing a single framework regulating operations of EU financial institutions, which includes a single mechanism for banks supervision and harmonisation of deposit insurance systems. Establishment of this framework was preceded by ECB activities aiming at capital enhancement and cleaning portfolios of the largest banks in euro zone, which eventually returned confidence in the banking sector, reduced risks related to financing of banks, but also created preconditions for stronger banks' support for euro zone's economic recovery.

The debt crisis in Greece was intensified due to failure of the Greek Government in negotiations with the rest of the EU and other international creditors on necessary fiscal consolidation measures and continuation of financial assistance to the extent that Greece's stay in the euro zone was put in question, and thus the euro zone's sustainability as well. Final escalation of these problems in 2015 was manifested in the form of systemic banking crisis caused by uncontrolled deposit outflow from Greek banks.

Main risks for financial stability in the domestic macroeconomic environment still include fiscal weaknesses in the country, reflected in the budget deficit and rising public debt, complex public sector, increasing current account deficit in 2014, slow economic recovery and weak domestic demand determined by, among other things, consequences of disastrous floods in 2014. Budget deficit from previous periods and slowness in the implementation of required structural reforms resulted in increased BH debt with international financial institutions, due to absence of previously agreed tranches based on the Stand-By Arrangement, through increase in the government sector's debt with commercial banks and on the domestic capital market. According to rating agencies, BH sovereign rating is still in the area of speculative creditworthiness with high credit risk.

Unfavourable payment balance trends caused by the current account balance continued in 2014. Significant import rise and slight export increase eventually caused deepening of the trade deficit. Inflows based on secondary income and inflows recorded within the financial and capital account managed to mitigate the pressure on foreign currency reserves caused by the increase of current account deficit, and the upward trend in foreign currency reserves continued in 2014. Continuation of deleverage process of commercial banks lead to a decrease in foreign liabilities in 2014 as well.

Weak domestic demand still stands out as a dominant risk in the household sector. Although labour market trends pointed to a slight recovery in 2014, achieved positive trends were not sufficient for noticeable strengthening of domestic spending, and no significant increase in overall household debt was recorded either. Although this sector recorded credit growth, more intense household orientation to saving than to spending is still noticeable.

Stagnating lending activity and high credit risk level were the main features of companies sector in 2014. Weak demand of corporate sector for loans was caused by several factors, such as long standing stagnation of economic activity in the country, weak domestic demand, low personal spending level, absence of a significant investment cycle, and overall macroeconomic and political environment in the country. Moreover, deflation occurrence in BH and euro zone countries could partially affect lending activity in the companies sector as well, in view of the fact that price drop in the country can postpone planned investments for a future period, expecting further price drop, while deflation in euro zone countries is negatively reflected on income and profitability levels of export oriented companies, as well as their credit standing. High credit risk level in the companies sector and more restrictive loan approval conditions additionally limited credit growth in this sector. On the other hand, interest rate drop implies that banks are ready to finance projects that are economically justified.

BH banking sector maintained stability in 2014 and successfully amortized risks it was exposed to from the country and abroad. Capitalisation and liquidity of the banking sector are on a satisfying level, and record profitability was also achieved. Credit risk stands out as the most important risk in the banking sector. Apart from the credit risk, a number of banks, mostly with majority domestic ownership have prominent concentration and liquidity risks. The most significant risk from the international environment, deleveraging process of BH banks with majority foreign ownership toward parent banks from the EU, influenced by EU regulators' requests for strengthening their capital positions, but also due to weak demand of domestic sectors for loans, was also evident in 2014. Results of stress tests conducted by the CBBH showed that the banking sector is able to absorb assumed macroeconomic shocks, but the capitalisation level would drop significantly in case the extreme scenario materialised. As for significant events in the BH banking sector in 2014, transfer of non-performing receivables of Hypo banks should be noted, as a part of the final re-privatisation stage of Hypo Alpe Adria Bank International AG, as well as the liquidation of Bobar bank a.d. Bijeljina and changes in the regulatory framework pertaining to capital requests and capital positions in BH banks' balances.

In 2014, the CBBH continued successfully supporting the payment system functions through up-to-date accounting systems and payment systems for performance of interbank payment transactions, in line with its legal obligation. By keeping the Central Registry of Credits (CRC) with daily updated data, CBBH enabled financial institutions to better manage credit risks by monitoring credit exposure and credit history of clients. Also, by maintaining the Single Registry of Transaction Accounts (SRTA) and single database of all blocked accounts of business entities in BH, business entities were enabled to review the status of their existing or potential business partners.

2. TRENDS AND RISKS FROM MACROECONOMIC ENVIRONMENT

The aim of this Chapter is to point to the most important risks in the international macroeconomic environment. Risks from the macroeconomic environment are observed, both in terms of effects on the banking sector in euro zone countries (Subchapter 2.2.1) and effects on the real sector (Subchapter 2.2.2), primarily in euro zone countries, and their influence on the real economy (Chapters 4 and 5) and the banking sector in BH (Chapter 6) are examined.

2.1 Trends in International Environment

Different recovery levels of the USA and EU economies and uneven recovery of the strongest economies of the euro zone and its peripheral countries, along with strengthening of geopolitical risks and deflationary pressures due to trends in food and oil prices on world markets constitute some of the main characteristics of the global economy in 2014. The USA economy recorded substantial recovery reflected in general economic growth level and unemployment rate reduction, while euro zone's economic recovery on the other hand is uneven and economic growth is lower than expected, even in the strongest euro zone economies. Consequently, there was a turn in FED's monetary policy, as it ended the program of quantitative easings, and there are realistic expectations for an increase in interest rates by the end of 2015, while the ECB continued implementing the expansive monetary policy and, by taking a range of measures combined with positive effects of the conducted banking sector analysis, it created preconditions for continued financing under favourable terms in 2015.

The trend of slower and uneven growth of the global economy continued throughout 2014, and global economy growth rate amounted to 3.4%. Apart from different levels of recovery between the USA and EU economies and uneven recovery levels between the strongest economies of the EU and its peripheral countries, geopolitical tensions between Russia and Ukraine also affected the global economic activity. International economic sanctions against Russia caused substantial drop in Russia's economic activity and weakening of its national currency. The first half of 2015 recorded gradual increase in the exchange rate of rouble against euro and dollar and stabilisation on Russia's financial markets that resulted from measures implemented by the Russian Central Bank. However, recovery of Russian economy is still uncertain. According to IMF's projections, downturn of Russia's economic activity by 3.8% is expected in 2015, which is a decrease by 4.3 percentage points compared to the previous projection.

At the end of 2014, euro zone recorded GDP growth by 0.9%, which is lower than expected at the beginning of 2014. Investments in the private sector were on a low level, except in Germany, Ireland and Spain. The investment decline was caused by poor macroeconomic conditions, more stringent financing terms, lowered expectations when it comes to the economic growth and inflation, and geopolitical risks. Nevertheless, economic activities in the last quarter of 2014 and the first quarter of 2015 show signs of increase.

During 2014, the USA achieved significant recovery, and real GDP growth amounted to 2.4%, which is by far more than expected. Growth of the USA economy resulted from increased domestic demand due to substantial drop in prices of oil and other goods, decline of the unemployment rate that amounted to only 5.6% in December 2014, the lowest since June 2008, and increase of available income.

Moderate strengthening of global economic activity is expected in the coming period and, according to IMF's projections, real growth of global GDP may reach 3.5% in 2015 and 3.8% in 2016. Observed by groups of countries, more intense economic growth is expected in developed countries in the coming period and, on the other hand, economic activity downturn is expected in developing countries compared to 2014, which mostly results from lower expectations when it comes to growth of several large developing economies and oil exporting countries. Table 2.1 provides an overview of annual growth rates of real GDP, real GDP projections and changes of projected 2015 growth rates compared to projections from October 2014.

Table 2.1: Real GDP, Annual Growth Rate

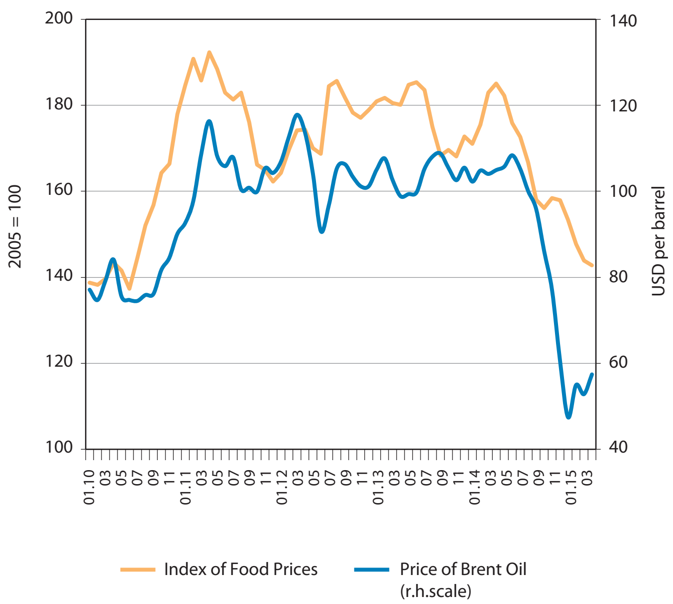
	Real GDP, Annual Growth Rate				Change Compared to Projection from October 2014	
	2013	**2014**	**2015**	**2016**	**2014**	**2015**
World	**3.4**	**3.4**	**3.5**	**3.8**	**-0.2**	**-0.4**
Developed Economies	1.4	1.8	2.4	2.4	-0.4	0.1
EU	0.1	1.4	1.8	1.9	-0.2	0.0
Euro Zone	-0.5	0.9	1.5	1.6	-0.3	0.0
USA	2.2	2.4	3.1	3.1	-0.4	0.1
Japan	1.6	-0.1	1.0	1.2	-1.5	0.0
Great Britain	1.7	2.6	2.7	2.3	-0.3	0.2
Russia	1.3	0.6	-3.8	-1.1	0.4	-4.3
Developing Countries	5.0	4.6	4.3	4.7	-0.3	-1.0
Central and Eastern Europe	2.9	2.8	2.9	3.2	0.4	0.0
BH	2.5	0.8	2.3	3.1	-1.2	-0.9
Main Foreign Trade Partners						
Germany	0.2	1.6	1.6	1.7	0.2	0.1
Croatia	-0.9	-0.4	0.5	1.0	0.2	0.1
Serbia	2.6	-1.8	-0.5	1.5	-2.8	-2.0
Italy	-2.9	-0.6	0.7	0.8	-1.2	-0.4
Slovenia	-1.0	2.6	2.1	1.9	1.4	0.5
Austria	0.2	0.3	0.9	1.6	-1.4	-0.8
Montenegro	3.3	1.1	4.7	3.5	-1.7	1.8

Source: World Economic Outlook, IMF, Apr 2015

Drop of food and oil prices on the global market in the second half of 2014 (Graph 2.1) influenced deflationary trends in euro zone. Prominent oil price drop on global markets started in August 2014 and continued until the end of the year, reaching the minimum price of crude oil of USD 60.55 per barrel. Such oil price trend was caused by the activity of economic factors, i.e. offer and demand, and global political trends. On the one hand, oil demand went down due to slower economic activity both in developed countries and in countries with emerging markets while, on the other hand, increased oil offer on the market was recorded. Libya and Iraq maintained the existing oil production levels despite the current political situation, while the USA significantly increased their production level, thus becoming the largest oil producer in the world. Despite the rising oil offer on the global market, OPEC member states, primarily Saudi Arabia, did not reduce their production, which contributed to further offer expansion of this energy source. Despite a short-term increase of oil prices at the beginning of 2015, further offer expansion is expected on the global market, without accompanying demand increase, which may lead to continued downward trend in oil prices in 2015. The second half of 2014 recorded significant drop of food prices, primarily grain prices. Owing to favourable climate conditions, global increase in food production and supplies was recorded.

In order to encourage economic growth and achieve target inflation level in the euro zone, ECB took several stimulating actions in the monetary policy during 2014. In June 2014, ECB introduced negative interest rate on commercial banks' deposits for the first time. Reference interest rate was reduced by additional 10 basis points in September 2014, to 0.05%, while the EBB interest rate on loans to commercial banks went down to 0.30%, and the interest rate on banks' deposits with this institution were reduced to -0.20%. Package of ECB stimulating actions also includes the Targeted Longer Term Refinancing Operation, which matures by September 2018, with fixed annual

Graph 2.1: Food and Oil Prices



Source: IMF

interest rate of 0.15%. These actions aim at providing banks with additional liquidity in order to relax lending terms to the real sector. In the first two offers, banks borrowed EUR 212 billion of the total of 400 billion that were available to them from the ECB. Banks mostly used these funds to repay loans from the previous long-term lending program. In October 2014, the ECB started buying private sector's securities i.e. backed bonds, and then also asset backed securities in November. Despite the aforementioned actions, the ECB failed to significantly encourage the economic activity and reach the target inflation of 2% (in December 2014, inflation in the euro zone amounted to -0.2%, and -0.1% in March 2015), given that the second half of 2014 and the beginning of 2015 were dominated by deflationary pressures caused by oil price drop on the global market. Therefore, in March 2015, the ECB started implementing a quantitative easings program, which implies purchase of government bonds and continued purchase of private sector's bonds worth EUR 60 billion in total per month, which will last at least until September 2016. Bonds are purchased on the secondary market, including bonds with negative yield up to the level of negative interest rates on banks' deposits with the ECB. Also, long-term refinancing programme continued in March 2015.

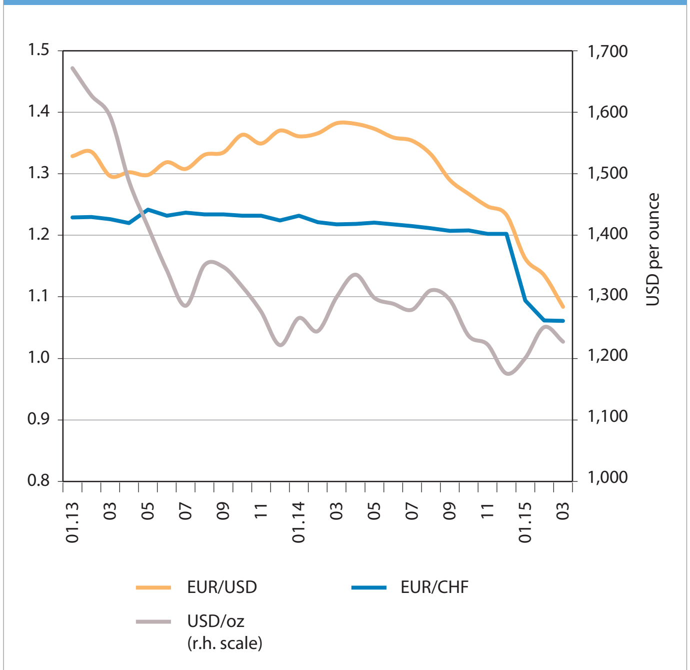
Unlike the ECB, FED tightened its monetary policy by ending the quantitative easings programme in October 2014. Reference interest rates remained unchanged in order to further encourage maximum employment level and price stability, whereas a reference interest rate increase is expected during 2015.

The beginning of 2015 also recorded a turn in the monetary policy of the Swiss National Bank (SNB), which decided to abandon the policy of fixed exchange rate of Swiss franc against euro. Such decision was made due to a substantial drop in the exchange rate of euro against dollar, which caused weakening of the Swiss franc against dollar. The anticipation of the ECB's quantitative easings programme, political tensions and the debt crisis in Greece and economic crisis in Russia influenced further decrease in the value of euro, which made the SNB decide that maintaining of the minimum exchange rate of franc against euro was no longer justified. As the result of this decision, the Swiss franc suddenly appreciated against euro and dollar. At the same time, in order to stop the franc appreciation, SNB increased negative interest rate on commercial banks' deposits by half of the percentage point, to -0.75%. The target level of three-month CHF LIBOR was also changed from -0.75% and -0.25% to a level between -1.25% and -0.25%.

Introduction of ECB quantitative easing measures that had been announced for a long time and tightening of FED's monetary policy on the other side by gradual abolishment of the quantitative easing programme determined exchange rate trends between euro and dollar and the price of gold on the global market. In the period from the second quarter of 2013 to the second quarter of 2014, EUR/USD exchange rate displayed tendency of slight increase and reached the level of around 1.38 EUR/USD, in accordance with the indications and announcements of gradual recovery of the euro zone economy. In the second half of 2014 and in early 2015, euro exchange rate against dollar and other world currencies weakened substantially, due to deflation in the euro zone and ECB announcement of additional monetary policy loosening. The gold price drop in

2014 was influenced by good economic indicators in the USA, strengthening of dollar and rising yield on ten-year USA bonds. Gold prices on the global commodity markets thus ended 2014 at the level of USD 1,185 per ounce due to lower investors' demand, which was by 1.4% compared to the previous year. Still, the beginning of 2015 recorded a temporary increase in gold prices, as a result of ECB announcements of the introduction of quantitative easings programme, geopolitical uncertainties in Ukraine and developments in Greece. However, stronger increase of gold prices was stopped by FED's announcement of potential increase of reference interest rates, and continued decrease of gold prices is expected in 2015 (Graph 2.2).

Graph 2.2: The Price of Gold and EUR Exchange Rate against USD and CHF



Source: ECB, World Bank

2.2 Overview of Main Risks in the EU and Euro Area

Some of the most important euro zone risks are: uneven and slow economic recovery of euro zone member states, inflation rate significantly below the target level and alarmingly high public debt level in many EU member states. High unemployment rate is still evident in many euro zone countries, which particularly applies to youth unemployment. ECB measures enabled banks to approve loans under extremely favourable conditions, but due to lack of significant credit growth, the credit portfolio quality was not substantially improved and banks failed to generate the expected income. The debt crisis in Greece was intensified due to failure of the Greek Government in negotiations with the European Commission, ECB and the IMF on the implementation necessary fiscal consolidation measures that constitute the precondition for further financial support. However, Greece's stay in euro zone is not only a political issue, in view of recent developments in the Greece's banking sector, primarily the uncontrolled deposit run in April and June 2015. Uncertainty of crisis resolution and of reaching an agreement about terms of necessary new assistance programmes for Greece will be among the main risks in the EU in the coming period, but not as serious as in the previous periods, given that mechanisms were built within the euro zone to isolate Greece's influence on the remainder of the euro area.

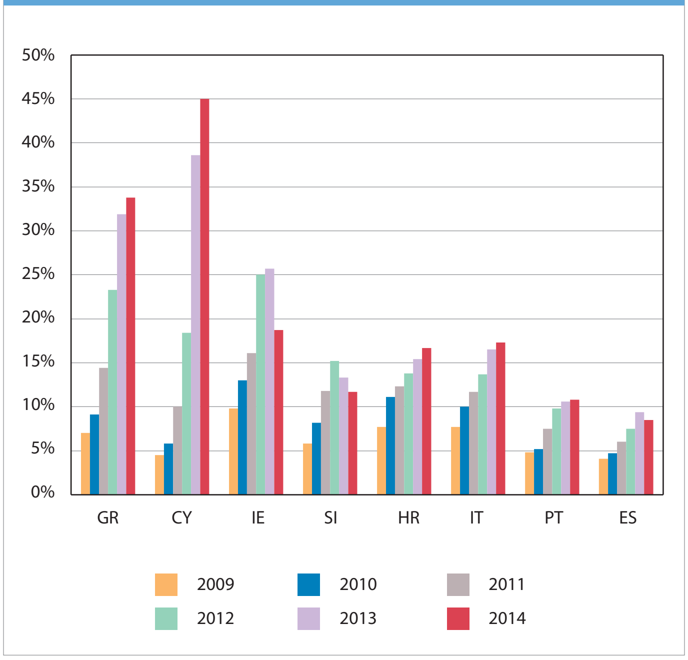
2.2.1 Effects on Banking Sector

Due to uneven and slower euro zone recovery during 2014, the banking sector is still characterised by weak lending activity, high level of non-performing loans and low profitability. Low lending activity in 2014 resulted from restrictions both on the side of loan demand and of loan offer. In their efforts to reduce further risk exposure and strengthen their capital positions, banks in the euro zone made balance sheet sum contraction while, on the other hand, demand for loans was weakened due to high indebtedness of households and companies in the conditions of low economic activity.

In the course of 2014, banks strengthened their balance sheet positions by adjusting to capital requirements defined in Basel III, implementing the directive and regulation CRDIV-CRR2 (more details provided in chapter 6 Financial Intermediaries). Banks that underwent ECB comprehensive asset quality review compensated for the found capital shortfalls during the year, while other banks that did not meet capital requirements announced plans for recapitalisation and coverage of missing capital. These activities contributed to the increase of EU banks' capitalisation ratios that were at the highest level since 2009, while the core tier 1 capital (CET 1) went up by 50 basis points compared to 2013 and amounted to 12.1%.

Asset quality is still the main challenge of the EU banking system. Although the trend of deteriorating asset quality was stopped in 2014, and the share of non-performing loans in total loans at the EU level dropped by 20 basis points compared to the end of the previous year and amounted to 6.6%, levels of non-performing loans are still extremely high in some EU member states EU (Graph 2.3). Growth in the share of non-performing loans in overall loans partly resulted from the asset quality review in the banking sector, given that it was fund that banks failed to qualify non-performing receivables adequately.

Graph 2.3: The Share of Non-performing in the Total Loans in the Selected EU Countries



Source: IMF
Note: The latest available data for Ireland - Q3 2014, for Italy - Q2 2014

Interest rates in the euro zone are at a record low level. Low interest rates contributed to asset quality maintenance and improvement of banks' lending opportunities, but they also negatively affected profitability. Banks in the euro zone are faced with serious profitability problems due to increased provision costs for non-performing assets and decrease of the already low net interest rate margin in the conditions of weak lending activities. Despite favourable financing terms, high private sector indebtedness and risks related to poor macroeconomic indicators contributed to low credit activity in 2014. ECB stimulating actions started to bring positive results with regard to lending activity in the first quarter of 2015. ECB provided banks with additional liquidity and enabled access to cheap financing sources, which influenced additional improvement of financing terms. Record low interest rates combined with positive expectations regarding the economic growth in 2015 resulted in rising demand for household loans, and to a small extent for company loans as well.

During 2014, substantial progress was achieved in strengthening banking sector's regulations by establishing a single framework regulating operations of euro zone's financial institutions, which includes the Single Supervisory Mechanism for banks and Single Resolution Mechanism for problem banks, as well as harmonisation of deposit insurance systems. The Single Supervisory Mechanism became operational as of November 2014, and the Single Resolution Mechanism for problem banks as of January 2015. The process of establishment of a single banking union was preceded by ECB's comprehensive analysis of the banking sector, and its results were published in October 2014 (explained in greater details in Text box 1). Publication of the analysis results returned confidence in the banking sector and reduced risks related to financing of banks i.e. of risk premium on their bonds. Banks that underwent capital enhancement are expected to provide stronger support to the euro zone's economic recovery.

Prices of euro zone banks' shares continued following the upward trend in the first quarter of 2014 under the influence of ECB expansive monetary policy i.e. decrease of reference interest rates. Weak economic growth of the euro zone, geopolitical tensions between Russia and Ukraine and anticipation of results of the comprehensive assessment of the banking sector caused instability on financial markets and a decline in prices of banks' shares in the remainder of the year. The pressure on price drop of shares was mitigated with publication of the banking sector comprehensive analysis results.

In 2014, the Credit Rating Agency Standard & Poor's (S&P) reduced credit rating of some banking groups that operate in BH. Due to low expectations regarding Italy's economic growth, credit rating of two banking groups operating in BH, Intesa Sanpaolo S.p.A. and UniCredit S.p.A, was lowered from BBB to BBB- with stable outlook. Credit rating of three systemically important Austrian banks was also reduced due to a law passed by the Austrian Government that puts into question activation of guarantees provided by its public bodies. These banks include Raiffeisen Bank International AG and UniCredit Bank Austria AG. After their credit rating hand been decreased in 2014 (from A/A-1 to A-/A-2 for Raiffeisen and from A- to BBB+ for UniCredit), their long-term credit rating was lowered again at the beginning of June 2015: for Raiffeisen Bank International AG to BBB+ with negative outlook, and for UniCredit Bank Austria AG to BBB with negative outlook. According to the rating agency's evaluation, despite recapitalisation conducted in the previous year, NLB bank is still exposed to high credit risk, which is why it was assigned long-term rating BB-, with negative outlook.

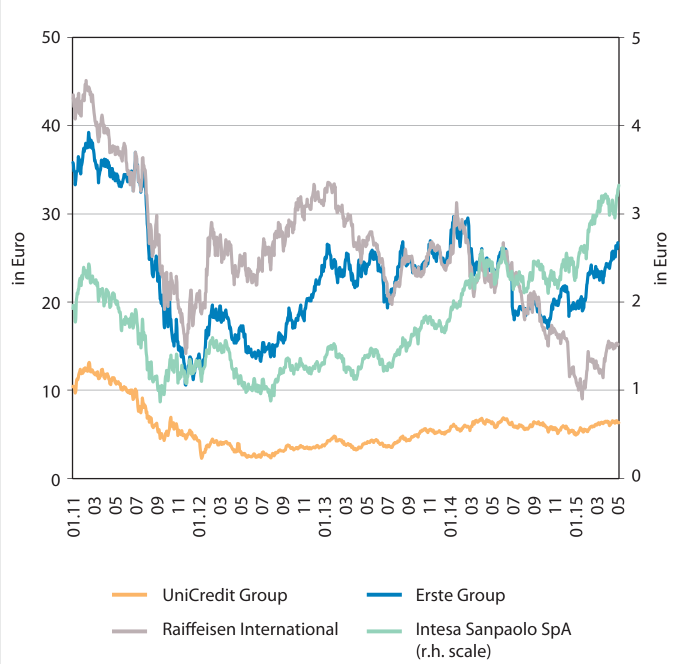
Text Box 1: Results of the Assets Quality Review and Stress Tests in Euro Area Countries

Within the process of establishment of the single banking union and taking over a supervisory role over euro zone's credit institutions, the ECB conducted a comprehensive analysis of euro zone's banking sector in 2014, in cooperation with national supervisors. The analysis included 130 largest banks that account for 82% of total assets of euro zone banks, and it used data as of the end of 2013. The comprehensive analysis of the banking sector included Asset Quality Review and stress tests. The aim of the Asset Quality Review was to determine whether the value of assets was properly stated in banks' balances as of 31 December 2013 and, if not, to make necessary corrections and assess their influence on capital adequacy. The Asset Quality Review by harmonised criteria was required for the implementation of stress tests, given that differences were spotted in the existing asset classification and valuation between individual banks. The stress test was conducted with the assistance of the European Banking Agency (EBA) and the European Systemic Risk Board (ESRB). The stress test was used to check banks' resilience to assumed macroeconomic shocks. Two scenarios were developed for the needs of stress tests, and testing was performed for 2014-2016 period. In the basic scenario, banks were obliged to maintain minimum core capital Tier 1 (CET 1) adequacy ratio of 8%, while the crisis scenario in the stress test required minimum CET 1 of 5.5%. According to comprehensive analysis results published in October 2014, 25 banks stated capital deficit in the amount of EUR 25 billion. Value of banks' assets should be corrected by EUR 48 billion, of which EUR 37 billion does not generate capital deficit. The defined asset value correction is mostly related to additional loan value corrections (EUR 43 billion), while the balance of non-performing receivables went up by additional EUR 136 billion. 12 banks already made the required corrections in 2014 and provided the missing capital, thus reducing the amount of missing capital to 9.5 billion.

According to the comprehensive analysis results, euro zone's credit institutions operating at the territory of BH stated appropriate capital adequacy rate that protects them from potential unforeseen losses and provides them with the required resilience to stress in both presumed scenarios. Nova Ljubljanska bank is an exception, as it stated a need for additional capital of EUR 34.25 million in the crisis stress test scenario for 2016. As the bank underwent a detailed balance restructuring process in 2014 and recorded positive financial result at the end of the year, its year-end profit will be sufficient to entirely cover the capital gap found in the comprehensive review.

Trends in prices of shares of BH banks' parent banking groups are shown in Graph 2.4.

Graph 2.4: Price Movements of Parent Banks Stocks



Source: Bloomberg

2.2.2 Effects on Real Economy

Some of the most important euro zone risks are still: uneven and slow economic recovery of euro zone member states with poor prospects for economic growth in 2015 (Table 2.1), deflationary pressures and alarmingly high public debt level in many EU member states. Throughout 2014, inflation in the euro zone was significantly below the target level, influenced by decreasing prices of raw materials, especially oil, while the annual inflation rate crossed to the negative zone in December, for the first time in five years, and amounted to -0.2%. High unemployment rate still raises concern in many euro zone countries, which particularly applies to youth unemployment.

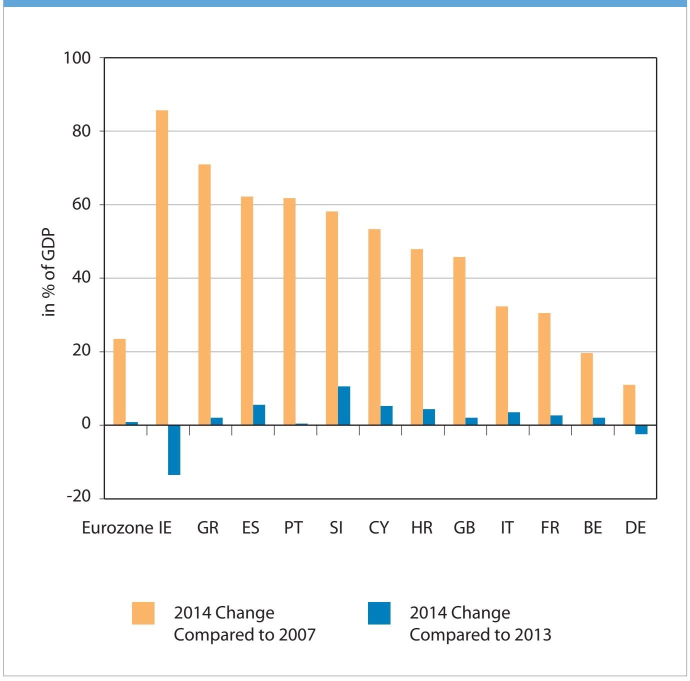
Public debt of euro zone member states, stated in percentages of gross domestic product (GDP) is still alarmingly high and records an increase by 1.1 percentage points compared to 2013, while an increase by 1.5 percentage points was recorded at the EU level. The strongest public debt increase among the observed countries, measured by GDP percentages, was recorded in Slovenia, Croatia, Spain and Cyprus, while Ireland and Germany were the only countries to record a public debt decrease in GDP percentages (Graph 2.5). Public debts in Belgium, Ireland, Spain, France, Italy and Portugal are still above 90% of GDP, while Croatia and Slovenia recorded much higher levels compared to the period before the economic crisis.

Debt crisis in Greece continued in 2014, and Greece has the highest public debt in euro zone, which amounts to 177.1% of GDP. Coming into power of the centre-left opposition party, which opposes drastic saving measures, caused turbulence on the European public debt market due to investors' concerns that Greece would not reach a reform agreement with international creditors, which is a precondition for the approval of a new credit line required for financing of state operations and the public debt. Due to failure to reach an agreement by mid-2015, Greece faced potential state bankruptcy and exit from the euro zone.

Fiscal consolidation of euro zone member states continued in 2014, but with slower dynamics due to significant progress in the past years. Budget deficit in the EU stated in GDP percentages went down by 40, and in euro zone by 50 basis points compared to the previous year and amounted to 2.9% and 2.4% of GDP respectively at the end of 2014. Although a significant progress has been achieved in terms of fiscal consolidation, further structural reforms are required in order to ensure long-term public debt sustainability of euro zone member states.

During 2014 and in the first half of 2015, S&P Agency raised credit ratings of Ireland, Portugal, Spain and Cyprus due to the progress they achieved in the recovery from crisis, as well as the improvement of these countries' economic indicators. However, euro zone countries were characterised by uneven recovery levels in 2014 and the first half of 2015, which led to a decrease of Greece's and Italy's credit ratings in this period. Greece's credit rating was downgraded on two occasions since the beginning of 2015, with an explanation that the country's debt was not sustainable without adequate economic reforms and additional financial support of international creditors. As for countries in the region, Slovenia's credit rating was raised, while the one of Montenegro was downgraded due to increased level of debt. The three leading rating agencies placed Slovenia among low investment risk countries due to its fiscal reform progress, privatisation and the expected stabilisation in the banking sector. Table A1 of the Statistical Appendix provides an overview of credit rating changes from 2009 to April 2014 for countries that were the most severely affected by crisis in the previous period.

Graph 2.5: Public Debt Changes in Percents of GDP



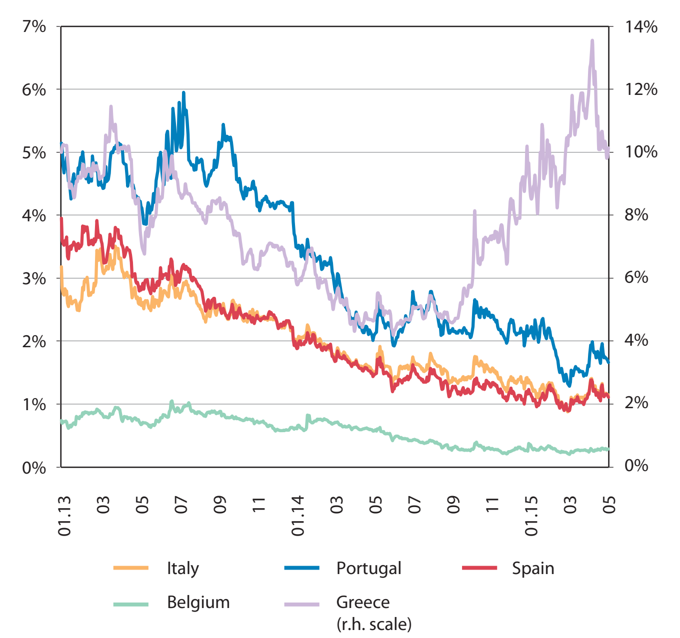
Source: Eurostat

The second half of 2014 also recorded continued decline of yield on ten-year state bonds of euro zone countries (Graph 2.6), due to anticipation of the introduction of ECB quantitative easings programme. After the ECB started buying state bonds in March 2015, yields of euro zone countries dropped to record low levels. However, it is possible that the ECB introduction of the programme for purchase of state bonds prevents securities markets from sending the right risk signals in individual euro zone countries. High unemployment rates, the amount of debt, low growth rates and other indicators indicate that yields on bonds of some euro zone countries should not be decreased to such low levels, given that risk perceptions in euro zone countries remained relatively unchanged. Yields on Greece's ten-year bonds followed the opposite trend, pointing to the country's idiosyncratic risk, resulting from the anticipation of presidential elections at the beginning of 2015.

Slight unemployment rate drop was noticeable in 2014 in almost all EU member states, including countries with very high unemployment rates, such as Greece, Spain and Portugal. Unemployment rate is still high, which particularly applies to youth unemployment under the age of 25 (Graph 2.7). Unemployment rate trends differ significantly between individual EU member states, and thus the lowest unemployment rate was recorded in Germany (5.0%), and the highest one, despite a decrease compared to the previous year, was recorded in Greece (26.5%), while average unemployment rate in EU member states amounts to 10.2%.

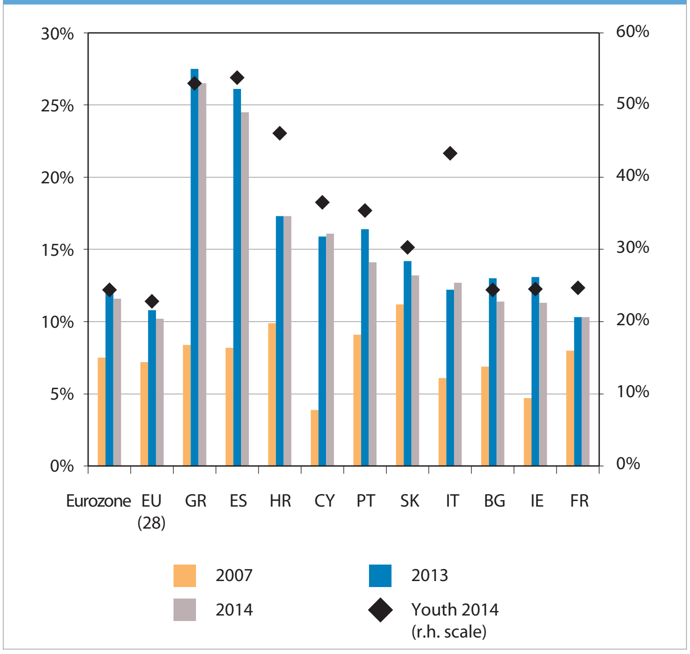
Weak economic activity was recorded in the majority of countries - BH main foreign trade partners. Germany, as BH most important trading partner still drives euro zone's economic growth, and it recorded real economic activity growth in 2014 due to increase of domestic demand, employment growth and wage increase.

Graph 2.6: Spread Compared to Ten Year German Government Bonds



Source: Bloomberg

Graph 2.7: Unemployment Rate in EU

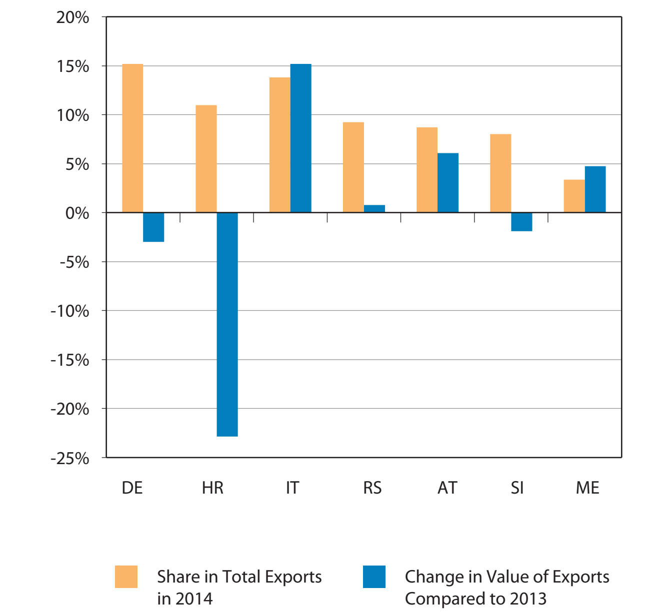


Source: Eurostat

Unlike Germany, Croatia, Serbia and Italy as BH major foreign trade partners recorded economic activity downturn in 2014. In 2014, Serbia recorded economic activity downturn of -1.8%, partly due to floods and decline in exports. Also, an increase in Serbia's public debt was recorded, and a high budget deficit of the country. According to IMF's assessments, planned investments and fiscal consolidation measures will influence mitigation of GDP drop to -0.5% in 2015. Croatia recorded continued recession trends due to low domestic demand and additional investment drop in 2014, although much less severe than in the previous years. Slight economic activity increase is expected in 2015, driven by strengthening of foreign demand and investments due to substantial withdrawals from EU funds. Italy has also recorded economic activity downturn for three years in a row, but the economic recovery is expected in 2015 due to favourable macroeconomic conditions, ECB expansive policy, Government's structural reforms and rising exports.

IMF's projections from April 2015 show that the majority of BH main foreign trade partners may see moderate economic growth, which should positively impact the demand for BH export products. According to the projections, economic activity downturn can only be expected in Serbia, which may contribute to an increase in exports to this country (Table 2.1). Graph 2.8 shows the share of exports to BH most important foreign trade partners in 2014 in total exports and a change in the value of exports as compared to 2013. Exports to Croatia recorded the strongest decrease in 2014, caused by Croatia's EU accession and leaving the CEFTA agreement. However, the significant decline in exports to Croatia did not influence the total value of exported goods, given that BH exporters successfully redirected a portion of previous exports to Croatia to other CEFTA markets, and other markets outside of the region. In 2014, Italy contributed the most to overall export growth with a share of 13.79% in total exports.

Graph 2.8: BH Exports to Main Trading Partners



Source: BHAS

3. TRENDS AND POTENTIAL RISKS IN BH

Fiscal weaknesses in the country, reflected in the budget deficit and rising public debt, complex public sector, which spends a large portion of public resources on non-productive items of current spending, increasing current account deficit in 2014, slow economic recovery and weak domestic demand are the main financial stability risks coming from domestic macroeconomic environment. Budget deficit from previous periods and slowness in the implementation of required structural reforms resulted in increased BH debt with international financial institutions, due to absence of previously agreed tranches based on the Stand-By Arrangement, through increase in the government sector's debt with commercial banks and on the domestic capital market. Fiscal sustainability risk was increased due to continued rise of the public debt under the conditions of weak economic growth. According to rating agencies, due to the aforementioned fiscal weaknesses and political situation in the country, BH sovereign rating is still in the area of speculative creditworthiness with high credit risk. Unfavourable payment balance trends caused by the current account balance continued in 2014. Significant rise of imports and slight increase of exports eventually caused deepening of the trade deficit. Inflows based on secondary income and inflows recorded within the financial and capital account managed to mitigate the pressure on foreign currency reserves caused by the increase of current account deficit, and the upward trend in foreign currency reserves continued in 2014. Continuation of deleverage process of commercial banks lead to a decrease in foreign liabilities in 2014 as well.

3.1 Country's Fiscal Position

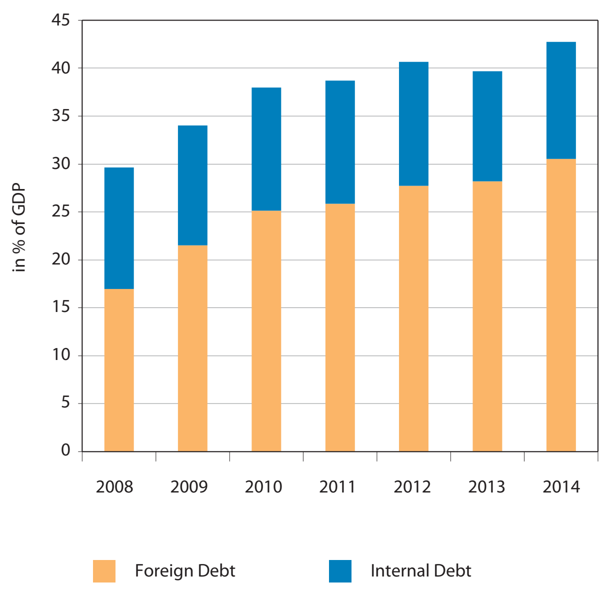
Measures taken to restrict budget spending and positive indirect tax collection trends resulted in lower budget deficit in 2014 compared to the previous year. Budget deficit in 2014 amounted to BAM 555.3 million (2.1% of GDP[1]), and public infrastructure investments and needs for recovery from flood consequences made a significant impact on the level of generated fiscal deficit. In 2014, there were no difficulties in foreign debt servicing, and both international rating agencies that were selected to develop and monitor BH sovereign credit rating confirmed its credit rating.

Factors that are considered when evaluating the credit rating did not change compared to previous periods, which is why sovereign credit rating remained at the same level. S&P International Agency conducted two assessments of BH sovereign credit rating in 2014 and confirmed "B" credit rating with positive outlook both times. Also, Moody's Agency confirmed "B3" rating with stable outlook for BH. The fact that BH economy proved to be more resilient to impacts of natural disasters than expected influenced the confirmation of the country's credit rating. Also, when the rating was determined, it was assumed that BH would continue implementing the required reforms and that the international financing sources would still be available.

According to data from the Ministry of Finance and Treasury of BH (MFT), BH [2] public debt amounted to BAM 11,516.3 million at the end of 2014, which makes 42.8% of GDP (Graph 3.1). Although the public debt still ranges within the defined limits of debt sustainability, dynamics of public debt trends indicates the need for a systemic control of new debts, due to difficulties of Entity Governments in financing short-term liabilities and servicing the accumulated debt at the same time.

As compared to 2013, public debt went up by BAM 1,089 million or 10.4%. Of the total public debt amount, BAM 8,218.3 million or 71.4% accounts for the foreign debt. Foreign debt of the country (government sector) compared to the end of the previous year is by BAM 809.5 million higher (10.9%), which resulted from combined effects of loan withdrawal from foreign creditors, servicing of due liabilities based on the existing debt and depreciation of the domestic currency against some currencies in which the foreign debt was agreed. Of the total external debt, 19.65% accounts for the "old" debt[3]. The largest percentage of the "new" debt accounts for debts to international financial institutions[4]. External debt increase in 2014 was mostly caused by withdrawal of tranches based on the Stand-by Arrangement[5] and engagement of previously approved loans with international financial institutions.

Graph 3.1: BH Public Debt, in Percents of GDP



Source: BH Ministry of Finance and Treasury

1 GDP for 2014 is based on CBBH projection.

2 BH public debt comprises overall external and internal debts of all Government levels (debt of BH Institutions, Entity and Brčko District debts, debts of cantons, municipalities and cities).

3 The "old" debt consists of inherited commercial debts, originating from the period before 2 April 1992 that, according to MFT data as of 31 December 2014, account for a debt to Paris Creditor Club (BAM 815.8 million), the World Bank – EBRD (BAM 444.6 million) and London Creditor Club (BAM 354.2 million).

4 The World Bank – IDA and EBRD, European Investment Bank – EIB, IMF, EBRD and the European Commission.

5 In 2014, BAM 468.6 million was engaged based on the Stand-By Arrangement (BAM 93.8 million in January and BAM 374.8 million in July).

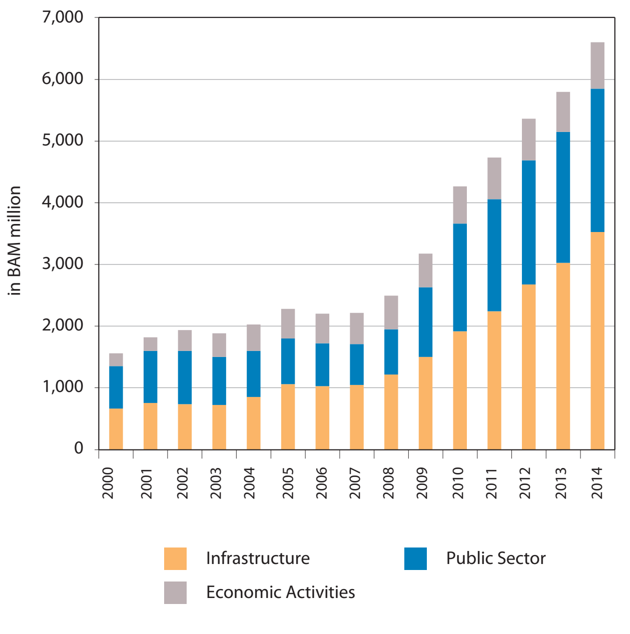
The majority of these funds were used for the implementation of infrastructure projects that have continuously increased in the new debt structure since 2009 (Graph 3.2). External debt increase is mostly related to the implementation of infrastructure projects, while governments redirected over time a portion of own resources from financing of public institutions to financing of current spending[6]. In the overall foreign debt balance based on new loans, 53.4% accounts for loans intended for the implementation of infrastructure projects, 35.2% for loans for the public sector, and 11.4% was intended for economic activities. Loans intended for the public sector are used for macro-financial assistance and different development projects, support to healthcare and social sectors, for debt servicing based on the Stand-By Arrangement, and to support budgets. A large part of the Stand-By Arrangement funds was used to consolidate the budget and finance current spending, and the additional tranche approved in July 2014 was intended for mitigating flood consequences.

Despite relatively favourable terms[7] under which the external debt was approved, market risk is not irrelevant, because 50.8% of total external debt accounted for loans with variable interest rates at the end of 2014. Nevertheless, due to low-interest-rate policies applied by the leading central banks in order to stimulate economic activity in their countries, the variable interest rate clause currently has no substantial effect on the level of BH public debt.

The share of foreign debt in EUR was slightly decreased compared to the previous year. At the end of 2014, 51.9% of external debt was denominated in EUR, 33.9% in SDR, 7.1% in USD, 2.5% in CPU[8], and 4.5% in other currencies. Market risk mostly arises from foreign currency risk exposure, particularly because the debt to IMF, as one of the large creditors, is denominated in SDR[9].
In 2014, the total of BAM 760.9 million of foreign debt was repaid, which means that all assumed debt servicing liabilities were fulfilled. Of this amount, principal accounts for BAM 659.8 million, and interest, servicing and other costs and banking commissions account for BAM 101.1 million. Observed per creditor, the largest portion of the total serviced amount (49.4%) was paid to the IMF. BAM 469.4 million of foreign debt matures in 2015, of which BAM 104.1 million is based on the Stand-by Arrangement with the IMF. Table 3.1 provides a detailed overview of liabilities to the IMF as of 30 April 2015.

According to MFT data, BH internal debt[10] at the end of 2014 amounted to BAM 3,298.1 million[11]. In the total amount of internal debt, the Federation of Bosnia and Herzegovina (FBH) accounts for 33.63%, Republika Srpska (RS) for 65.74%, and Brčko District with 0.63%. The amount of internal debt increased by BAM 279.6 million at the end of 2014. The increase compared to the previous year is mostly caused by rising banks' claims on the government sector, due to the absence of previously contracted tranches based

Graph 3.2: Sectoral Structure of Loan Purpose Based on "New" Debt



Source: BH Ministry of Finance and Treasury

Table 3.1: Repayment Plan of the Stand-by Arrangement with the IMF

(on 30.04.2015)		in SDR	in BAM
Year	**Description**	**Repayment Amount**	**Repayment Amount**
2015	SBA Principal	14,796,250	36,926,394
	Charges / Interest	3,462,926	8,642,282
	TOTAL	**18,259,176**	**45,568,677**
2016	SBA Principal	67,640,000	168,806,375
	Charges / Interest	4,307,868	10,750,970
	TOTAL	**71,947,868**	**179,557,344**
2017	SBA Principal	136,336,875	340,250,349
	Charges / Interest	3,367,539	8,404,229
	TOTAL	**139,704,414**	**348,654,578**
2018	SBA Principal	143,735,000	358,713,546
	Charges / Interest	1,655,671	4,131,990
	TOTAL	**145,390,671**	**362,845,537**
2019	SBA Principal	68,696,875	171,443,974
	Charges / Interest	372,867	930,549
	TOTAL	**69,069,742**	**172,374,523**

Source: IMF
Note: Amounts in BAM have been calculated according to the CBBH exchange rate on 28.04.2015
1 SDR = 2.495659 BAM
For 2015, the remaining amount for repayment is only shown.

6 According to IMF's assessments, the share of capital spending in BH decreased with time, from around 8% of GDP on average in the pre-crisis period to less than 7% of GDP after the crisis.
7 According to MET data, total BH foreign debt as of 31 December 2014 was contracted with the average interest rate of 1.67%.
8 Currency basket used by the World Bank and other regional development banks to calculate liabilities on loans that are usually disbursed in dollars.
9 SDR structure: USD 41.9%, EUR 37.4%, GBP 11.3% and JPY 9.4%.
10 BH internal debt is comprised of Entities and Brčko District debts, and it includes liabilities based on pre-war foreign currency savings, war-time claims, general liabilities, liabilities based on issued securities, liabilities based on loans in the country and liabilities based on tax refund and activated guarantees.
11 BH internal debt does not include liabilities based on restitution, because this issue is still not regulated by the law.

on the Stand-By Arrangement. According to data from the CBBH, the government sector's debt based on issuing securities that were bought by commercial banks in BH increased by 50.6%, while the government sector's debt based on loans with commercial banks went up by 17.8% as compared to the previous year (Table 3.2). Commercial banks' exposure to the government sector was additionally expanded during the initial three months of 2015.

In 2014, FBH and RS Governments issued securities in the total amount of BAM 739.5 million. The FBH Government organized twelve auctions of treasury bills in the total nominal value of BAM 240 million, with the accepted average weighted interest rate ranging from 0.59% to 1.78%. The RS Government organized ten auctions of treasury bills in 2014 worth BAM 174.5 million in total, and average yield rates for issued treasury bills ranged between 1.82% and 4.0%. Balance of liabilities based on issued treasury bills amounted to BAM 194.5 million at the end of 2014. Apart from short-term debts incurred to finance mismatch between budget revenues and expenditures and increase social benefits after the May floods, Entity Governments also issued long-term securities in the amount of BAM 325 million. FBH Government issued bonds maturing in three and five years, in the nominal amount of BAM 140 million, and the debt balance on this basis amounted to BAM 290 million in FBH at the end of 2014. In 2014, the RS Government issued long-term bonds with repayment deadlines of four and five years in order to finance budget expenditures amounting to BAM 185 million, and total balance of liabilities based on the issued long-term bonds in the RS amounted to BAM 335 million at the end of 2014.

2014 recorded an increase in the debt resulting from the issue of Entity bonds based on pre-war foreign currency savings and war-time claims. Until the end of 2014, Entities and Brčko District issued bonds based on pre-war foreign currency savings accounts in the amount of BAM 1,338.8 million, and liabilities were repaid in the amount of BAM 906.3 million based on principal (67.69%) and BAM 77.8 million based on interest (83.04%).

Based on war-time claims, FBH issued three bond issues in the amount of BAM 194.4 million, with maturity in 14 years, 9-year grace period and 2.5% interest rate. On the same basis, the RS issued nine bond issues in the amount of BAM 351 million, with maturity in 13 to 15 years, 3-5-year grace period and 1.5% interest rate.

Although a smaller amount of foreign debt matures for payment in 2015 than in 2014, in view of the effects of floods from May last year and the internal debt increase, concern about long-term sustainability of public debt is still present. In the following years, efforts should be put in directing new debts to development projects, and in redirecting Government spending from non-productive items of current spending to the increase of capital expenditures share, in order to strengthen the economic growth in BH.

Table 3.2: Banks' Claims on the Government Sector — in mil BAM

Claims	2008	2009	2010	2011	2012	2013	2014	March 2015
Central Government	**1.7**	**4.6**	**0.2**	**0.0**	**0.3**	**0.3**	**0.2**	**0.2**
Loans	1.7	4.6	0.2	0.0	0.0	0.0	0.0	0.0
Securities	0.0	0.0	0.0	0.0	0.3	0.3	0.2	0.2
Government at the Entity Level	**116.1**	**155.8**	**193.1**	**582.5**	**845.3**	**952.4**	**1,273.1**	**1,330.6**
Loans	115.8	151.7	179.6	310.5	445.7	484.9	565.6	578.1
Securities	0.3	4.2	13.5	272.1	399.6	467.5	707.5	752.6
Cantonal Government	**3.2**	**4.3**	**33.8**	**33.3**	**52.6**	**66.2**	**142.0**	**175.4**
Loans	3.2	4.3	33.8	33.3	52.6	66.2	142.0	175.4
Securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Municipal Government	**142.3**	**188.2**	**225.6**	**273.9**	**314.0**	**341.8**	**342.4**	**335.4**
Loans	141.5	186.0	222.5	269.8	309.4	337.7	339.2	332.3
Securities	0.9	2.2	3.1	4.1	4.6	4.1	3.2	3.0
TOTAL	**263.4**	**352.9**	**452.6**	**889.8**	**1,212.2**	**1,360.6**	**1,757.6**	**1,841.6**
Loans	262.2	346.6	436.0	613.6	807.7	888.8	1,046.7	1,085.7
Securities	1.2	6.4	16.6	276.1	404.5	471.9	710.9	755.9

Source: CBBH

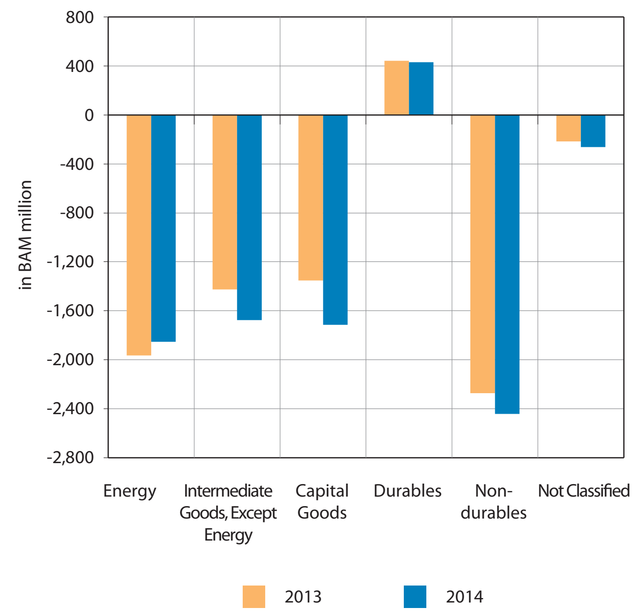
3.2 Financing of Current Account Deficit

Unfavourable payment balance trends primarily caused by changes in current account marked 2014. After it recorded decrease in the previous two years, current account deficit was increased by BAM 555.8 million in 2014 and amounted to BAM 2.07 billion or 7.69% of GDP. The main cause behind this increase lies in trends on the goods account, which recorded higher deficit than in the previous year by BAM 784.6 million. On the other hand, balance on the services account and primary and secondary income accounts mitigated this goods exchange imbalance. Slight surplus increase on the services account was caused by surplus increase on travel and transportation sub-account, and an increase in net exports of goods that are processed in BH. Although somewhat lower than in 2013, surplus on the primary income account was recorded in 2014 as well. Positive primary income account balance was recorded mostly owing to inflows based on compensations to employees. Debit items on the primary income account (income from direct investments, other investments and other primary income) negatively affected its balance, which was mostly due to payment of dividends of companies with foreign ownership. Dynamics of goods account trends that eventually led to worsening of the trade deficit was partially caused by higher import demand due to the need to repair flood damages. Increase of imports, at least for major import products (Table 5.1 in chapter 5) can be explained with flood consequences and significant infrastructure projects, as the strongest increase was recorded in groups of products that were used for this purpose. At the same time, some product groups recorded an increase in imported quantities, regardless of price increase, which additionally confirms the above conclusion about the cause of higher imports.

Analysing the trade deficit structure by economic purpose, capital products group recorded the most significant change as compared to the previous year, with increase in imports by 19.8%, which increased the trade deficit by BAM 360.5 million. Industry group *Energy* still has the highest trade deficit, although it declined compared to the previous year. The recorded deficit in this group is a combination of effects of lower oil prices on the global market and lower values of electricity exports in 2014. All other product groups recorded deficit increase, and surplus is still present only in the group of durable consumables, albeit without any significant changes compared to the previous period (Graph 3.3).

Constant surplus on the secondary income account substantially alleviates pressure from the current account deficit, i.e. its deepening. With slight decrease in 2013, surplus on the secondary income account has continuously grown over the past few years and it was by BAM 229.7 million higher in 2014 than in the previous year. Under the secondary income account, earnings based on personal transfers are particularly important, although other current transfers and government sector's transfers also went up. In view of the gradual economic recovery, continued trend of recording surplus on the secondary income account, primarily caused by earnings based on personal transfers can be expected. In addition, due to measures implemented by the ECB, increase in export demand can also be expected, as well as lower pressure on foreign currency reserves on this basis.

Graph 3.3: Trade Balance by Industrial Groups

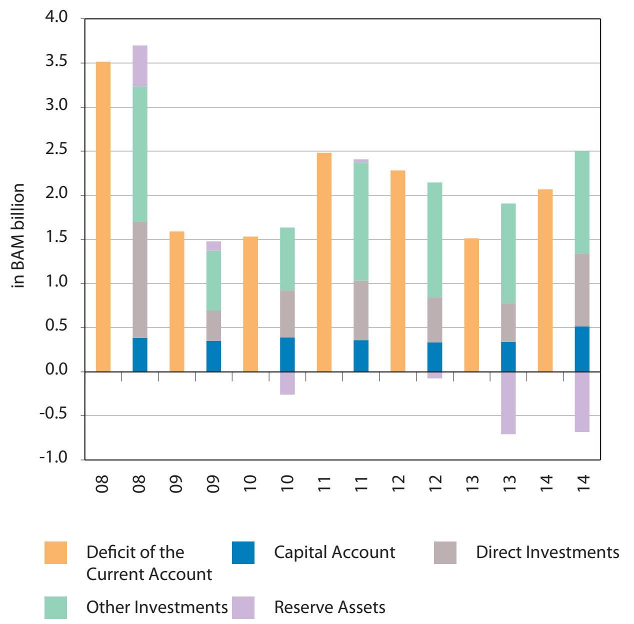


Source: BHAS

Financing of the current account deficit is significantly contributed by inflows to the financial account, where direct foreign investments play the most prominent role. After three years of consecutive dropping, increase in inflows on this ground was recorded in 2014. Direct foreign investments in 2014 were almost twice as high compared to the previous year, which may point to gradual regaining of foreign investors' confidence in BH economy. A significant portion of direct foreign investments still accounts for investments in the banking sector through recapitalisation of banks or reinvestment of retained earnings. Apart from direct foreign investments, inflows based on other investments also played an important role in financing of the current account deficit, as well as capital account inflows that went up by more than 50% due to unilateral transfers intended for recovery after the floods (Graph 3.4).

The current account deficit increase did not significantly affect foreign currency reserve balance at the end of the year. In 2014, gross foreign currency reserves recorded constant growth and amounted to BAM 7.83 billion at the end of the year, which is the highest value ever recorded at the end of a calendar year. Strong foreign currency reserve growth occurred in the second half of 2014, more specifically in the third quarter, when two tranches were withdrawn based on the *Stand-By Arrangement* with the IMF. The upward trend in foreign currency reserves continued in first few months of 2015. The level of foreign currency reserves in 2014 and in the previous years was largely determined by the rising external debt of the government sector. In 2014, rise of the government sector's external debt was caused by withdrawal of several tranches based on the Stand-By Arrangement, as well as the increase of debt stemming from activation of previously agreed or newly approved credit lines. During 2014, SDR 211.4 million was withdrawn in three tranches based on a credit arrangement with the IMF, which made a positive impact on foreign currency reserve balance. Table 3.3 shows the time schedule and amounts of withdrawn tranches based on the two most recent Stand-by Arrangements.

Graph 3.4: Financing of Current Account Deficit



Source CBBH

Table 3.3: Engaged Funds Based on III and IV Stand-by Arrangement

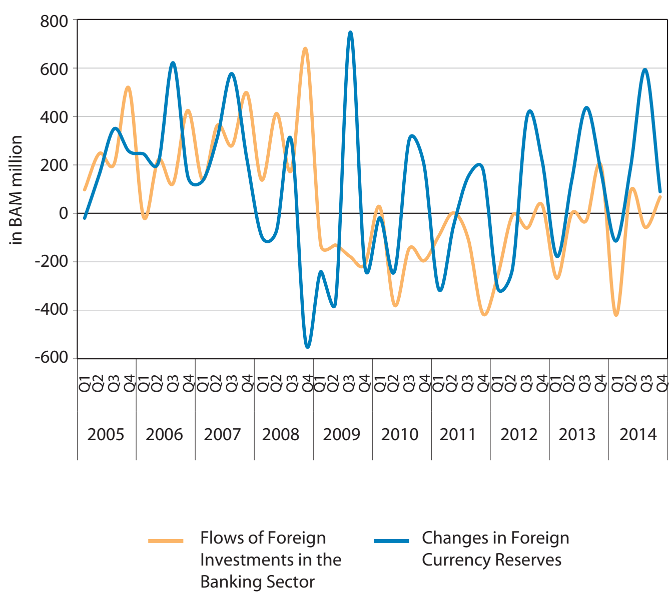
(on 31.05.2015) in SDR

	Tranche	Date of Withdrawal	Amount Drawn	Amount Repaid	Debt Balance
III SBA	I tranche	10/07/2009	182,630,000	182,630,000	0
	II + III tranche	26/03/2010	121,750,000	121,750,000	0
	IV tranche	19 /10/2010	33,820,000	25,365,000	8,455,000
	TOTAL		**338,200,000**	**329,745,000**	**8,455,000**
IV SBA	I tranche	26/09/2012	50,730,000	0	50,730,000
	II tranche	21/12/2012	50,730,000	0	50,730,000
	III tranche	08/05/2013	33,820,000	0	33,820,000
	IV tranche	28/06/2013	33,820,000	0	33,820,000
	V tranche	28/10/2013	42,275,000	0	42,275,000
	VI tranche	31/01/2014	42,275,000	0	42,275,000
	VII + VIII tranche + increase	2/07/2014	169,100,000	0	169,100,000
	TOTAL		**422,750,000**	**0**	**422,750,000**

Source: CBBH

Due to withdrawal of Stand-By Arrangement tranches and generally due to rising external debt of the government sector, the increase in foreign currency reserves is only temporary, given that repayment of the existing debts will reduce the level of foreign currency reserves. For the purpose of debt servicing to the IMF, repayment in the amount of BAM 104.1 million has been planned in 2015, which will impact the foreign currency reserve decrease, if the planned payments are not compensated by other inflows. Apart from payment balance and external debt influences, foreign currency reserve trends are significantly influenced by activities of commercial banks related to the fulfilment of regulatory requirements regarding maturity match, and currency and capital matching. In this regard, one should keep in mind certain changes in local and EU regulations that may influence foreign currency reserve balance. At the beginning of 2015, the implementation of Regulation 575/2013 of the European Council (more details about the Regulation are provided in Chapter 6) started, which introduced more stringent standards regarding the level of risk attached to funds kept by commercial banks at reserve accounts with central banks. This Regulation stipulates that all claims of banks from the EU on central banks and governments of other countries should be deemed risky and assigned with certain risk weight, which amounts to 100% in case of BH. Such treatment of claims on the central bank may contribute to decrease of excess reserve requirement funds kept by commercial banks on accounts with CBBH, which may reflect on foreign currency reserve balance under certain circumstances. During 2014, changes were introduced in local regulations pertaining to the regulatory capital structure and treatment of subordinated debt in the regulatory capital. These changes restricted the share of subordinated debt in the regulatory capital, compared to earlier periods. As the subordinated debt is of non-resident origin in the majority of cases, the decision of banks to repay a portion of the subordinated debt prematurely may also have a negative impact on the foreign currency reserve balance. The deleverage process of banks with majority foreign ownership also influences the level of foreign currency reserves (Graph 3.5).

Graph.3.5: Foreign Currency Reserves and Flows of Foreign Investment in the Banking Sector



Source: CBBH

Although not as prominent as in the previous periods, the deleverage trend was present in 2014 as well and made a negative effect on foreign currency reserves. Compared to the end of 2013, foreign liabilities of the banking sector decreased by BAM 334.8 million. The decline in foreign liabilities of the banking sector was also influenced by re-privatisation of a European banking group, which took place at the end of the year, involving two of its subsidiaries from BH. On this ground, foreign liabilities went down by BAM 101 million. Initial months of 2015 also recorded the trend of declining foreign liabilities, noting that the additional BAM 264.3 million of liabilities based on loans and other borrowings mature in the second half of the year, and the largest portion accounts for liabilities to non-residents. Also, it can be expected that a portion of non-resident deposits maturing in 2015 will not be renewed, which will additionally increase the pressure on foreign currency reserves.

3.3 Slow Recovery of Real Sector

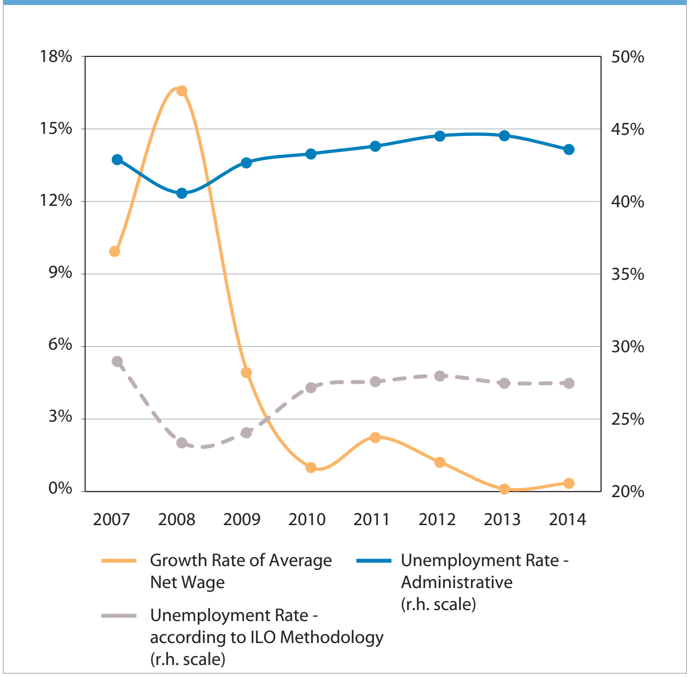
Although real sector trends in 2014 illustrate a slight recovery of BH economy, the positive progress can still be described as insufficient and very slow. Negative trends in economy in the past years and slow economic recovery in BH are reasons why weak domestic demand constituted one of the main risks from domestic macroeconomic environment in 2014 as well. Household prosperity indicators, actual individual consumption per capita and GDP per capita remained at very low levels in 2014. The competitiveness level of BH economy in foreign trade and investments as important factors for improvement of the living standard is still very low. Compared to other countries, business environment is still substantially less favourable, which is one of the main reasons behind low level of investments in BH[12]. Due to noticeable drop in the volume of production output in the main industrial group *Energy* in 2014 and extremely high growth rates in the past year, a modest industrial production increase (0.2%) was recorded. On the other hand, positive trend from the previous year continued in the construction sector. Despite positive trends in these sectors, economic activity in the country is still low, and improvement of labour market indicators still cannot be characterised as significant.

Extensive floods that inflicted enormous damage on the large part of the country, both on public infrastructure and on private facilities and other property of a large number of households and business entities caused pressure on economy growth in BH. As a consequence of floods, decrease of aggregate spending, with expenditures for final consumption of households as the most significant item, was reflected in lower growth of real GDP than originally projected for 2014, and it is expected that flood effects on BH economy will be felt in the coming period as well. Natural disasters also had short-term negative effects on exports of some products from BH and increase of demand for import goods, and monthly data on foreign trade exchange show that the lowest rate of the coverage of imports by exports was recorded at the time of the natural disasters, in May and August 2014. Imports growth was mostly encouraged by an increase in government sector spending, primarily investment spending for reconstruction of the infrastructure that was destroyed by the natural disaster. Damage recovery on private property put additional pressure on the already low available household income.

Household prosperity indicators, actual individual consumption per capita and GDP per capita did not record any significant changes compared to 2013 and remained at very low levels in 2014 as well. Preliminary results of the European Comparison Programme for prices and GDP [13]illustrate that GDP per capita in 2014, stated in the Purchasing Power Standard, amounted to 28% of the average in EU member states, where BH ranks last among 37 countries covered by the research[14]. Also, according to this research, actual individual consumption per capita expressed in the purchasing power standard amounted to 37% of the EU member states' average, and Albania was the only country with lower rank by this indicator. In addition, the largest portion of individual consumption in the structure of purchasing power standard is used for basic existential needs, primarily food and non-alcoholic beverages and costs of housing and utilities, which does not create preconditions for prosperity in the near future.

Low wages and their long-term stagnation, along with high unemployment rate (Graph 3.6) influenced weakening of purchase power and weak domestic demand in the previous years. For the first time after 2008, decrease of the administrative unemployment rate was recorded in 2014 compared to the

Graph 3.6: Growth Rates of Average Net Wage and Unemployment, 2007-2014



Source: BHAS

12 According to the World Bank's Annual Report Doing Business 2015, BH occupies 107th place out of 189 ranked world countries. Of special note, BH ranked 182nd on the above list when it comes to obtaining construction permits, 163rd by availability of electricity and 147th by business start-ups.

13 Eurostat, News release 107/2015, 16.06.2015

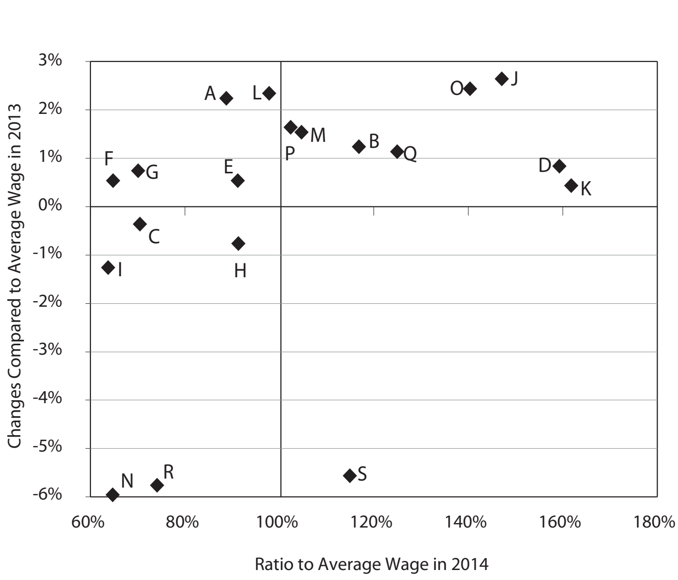
14 EU 28 countries, EFTA member states (Norway, Switzerland, Island), EU membership candidate countries (Turkey, Serbia, Montenegro and Former Yugoslav Republic of Macedonia) and potential candidates (BH and Albania).

previous year, but these are still very small positive changes to be able to talk about labour market recovery. According to the Labour Force Survey, conducted in line with the methodology of the International Labour Organization, unemployment rate in BH in April 2014 did not change compared to the end of 2013. A very small increase in the average net wage in 2014 and labour market trends in the first three months of 2015 that can be rather described as stagnation than as significant improvement of indicators also support the conclusion about poor labour market recovery.

Average net wage per employee amounted to BAM 830 in 2014, which is only by 0.36% higher than in the previous year, while average real net wage, despite deflationary trends, did not record any significant increase compared to 2013 (1.45%). Somewhat larger changes in wage level compared to the previous year were recorded in individual activities. Although 13 activities recorded an increase in average net wage levels, the biggest changes occurred in activities with lower average wage compared to 2013. *Administrative and Support Service Activities (*N), *Art, Entertainment and Recreation* (R) and *Other Service Activities* (S) thus recorded decrease in average net wage by 5.9%, 5.7% and 5.5% respectively. However, one should keep in mind that changes in average net wage levels in this activities did not make any serious impact on average net wage per capita in BH, because these activities have small number of employees, only 4.4% of the total number of employed population. *Manufacturing Industry* (C) activity, which employs almost one-fifth of overall employed population and has significantly lower average wage than the average wage in BH, recorded average new wage decrease by 0.3% in 2014. On the other hand, the strongest average net wage growth in percentages compared to 2013 (2.7%) was recorded in *Information and Communications* (J) activity, but given the large concentration of employed population, average wage increase was mostly influenced by activities *Public Administration and Defense; Compulsory Social Insurance* (O) and *Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles* (G). Slight positive progress is visible in some activities that recorded discontinuation of multiannual trend of deteriorating labour market indicators in 2014. Owing to the recorded increase of industrial output volume, *Construction* (F) thus recorded higher number of employees, as well as a slight increase in average net wage (0.6%). Also, after they recorded net wage decline in the past two years due to the implementation of budget expenditure rationalisation policy, activities *Public Administration and Defense; Compulsory Social Insurance* and *Education* recorded average net wage increase by 2.5% and 1.7% respectively (Graph 3.7).

According to the Labour Force Survey from April 2014, unemployment rate amounted to 27.5%. According to administrative data of the BH Agency for Statistics, unemployment rate amounted to 43.6% at the end of 2014, which is by 95 basis points lower compared to the previous year. Lower unemployment rate resulted from decrease in the number of unemployed persons by 1.2% and increase in the number of employed persons by 2.7% compared to 2013. Analysing employment data by individual activities (Graph 3.8), employment increase was recorded in all activities except for *Financial and Insurance Activities* (K).

Graph 3.7: Changes in Average Wage, by Activities



Source: BHAS

Graph 3.8: Changes in Number of Employees per Activities

Source: BHAS

Legend for graphs 3.7 and 3.8

A - *Agriculture, Forestry, Hunting,* **B** - *Mining and Quarrying,* **C** - *Manufacturing Industry,* **D** - *Electricity, Gas, Steam Production and Supply and Air Conditioning,* **E** - *Water Supply; Sewerage, Waste Management and Remediation Activities,* **F** - *Construction,* **G** - *Wholesale and Retail Trade; Repair of Motor Vehicles and Motorcycles,* **H** - *Transportation and Storage,* **I** - *Accommodation and Food Service Activities (Hotels and Catering),* **J** - *Information and Communication,* **K** - *Financial and Insurance Activities,* **L** - *Real Estate Activities,* **M** - *Professional, Scientific and Technical Activities,* **N** - *Administrative and Support Service Activities,* **O** - *Public Administration and Defence; Compulsory Social Security,* **P** - *Education,* **Q** - *Human Health and Social Work Activities,* **R** - *Arts, Entertainment and Recreation,* **S** - *Other Service Activities*

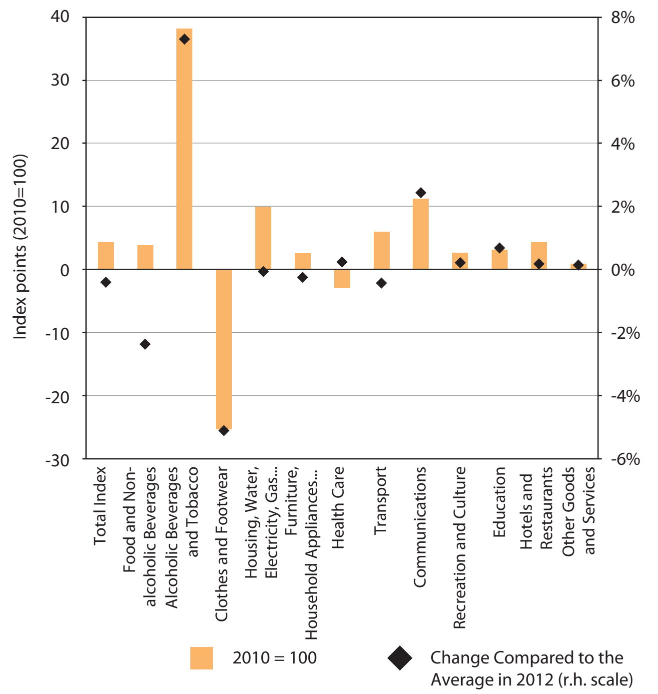
The strongest rise of the number of employed persons in the absolute amount was achieved in the *Manufacturing Industry*[15], which recorded 19.6% of total employed labour-active population. Also, the increase in number of employees in this activity gave the biggest contribution to overall employment growth in 2014 In percentages, the strongest increase of the number of employed persons was recorded in activities *Art, Entertainment and Recreation* (20.2%), *Other Service Activities* (13.2%), *Administrative and Support Service Activities* (9.7%), and in the aforementioned *Manufacturing Industry* (7.6%).

Labour market indicators at the end of the first quarter of 2015 did not record any significant changes compared to 2014. Unemployment rate maintained the level from the end of 2014, while average net wage in the first quarter of 2015 was by 0.24% lower compared to average net wage in the first quarter of the previous year.

Although deflationary pressures started weakening during 2014, general consumer prices, measured by consumer price index (CPI), were lower in 2014 than in the previous year. Annual deflation of 0.4% was recorded in December 2014, and average consumer prices in 2014 were by 0.9% lower as compared to the previous year. Deflationary trends at the end of the year were mostly caused by price drop in the category *Clothes and Footwear* and *Food and Non-Alcoholic Beverages*, and lower price level was also recorded in categories *Transport, Furniture, Household Appliances and General Household Maintenance* and *Housing, Water, Electricity, Gas and Other Energy Sources* (Graph 3.9).

Given the high trade deficit in *Food and Food Products* section, food price drop on world markets in 2014 strongly influenced price trends in the category *Food and Non-Alcoholic Beverages*, and thereby on the overall level of consumer prices in BH. Oil prices on the global market determined price trends in the category of *Transport*. Also, due to significant volume of imports of raw and production materials to BH, trends in prices of these products on international markets substantially influenced price trends of goods and services manufactured in BH. Increase in prices of alcoholic beverages and tobacco was caused by higher

Graph 3.9: Changes in Consumer Price Index



excise tax on these products, and therefore the inflation rate would have been even lower without these fiscal measures. Deflationary trends continued during the initial five months of 2015 as well. Prices measured in CPI were by 0.5% lower than in the same period of the previous year, while May 2015 recorded annual deflation rate of 0.4%.

Although real sector indicators point to slight recovery, economic activity in the country is still low, and weak domestic demand can be expected to act as a restricting factor in the coming period as well in terms of more substantial growth of economic activity in the country. Influence of weak domestic demand on household and legal entities sectors and on operations of financial intermediaries is explained in Report's Chapters below.

15 In 2014, Manufacturing Industry recorded 9,741 employees more than in 2013.

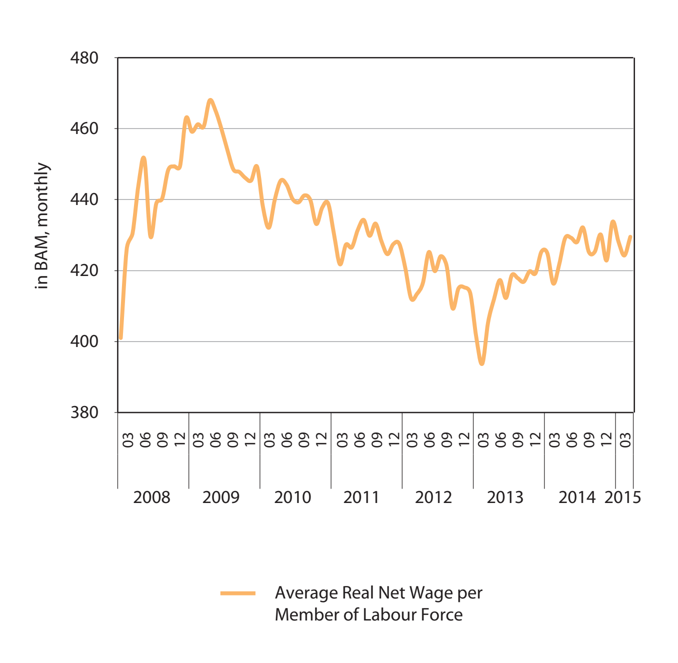
4. HOUSEHOLDS

Among financial stability risks identified in the previous Chapters, weak domestic demand still stands out as a dominant risk in the household sector. Although labour market trends pointed to a slight recovery in 2014, achieved positive trends were not sufficient for noticeable strengthening of domestic spending, and no significant increase in overall household debt was recorded either. Although household loans recorded an increase, more intense household orientation to saving than to spending is still noticeable. Prices of residential real estate maintained a slight downward trend in 2014, and an increase in real estate turnover was recorded, measured by the number of sold square meters of residential space.

Although labour market indicators point to a gradual recovery in 2014, living standard of the population is still at a low level. Average net wage did not record any significant growth, and unemployment is slightly lower compared to the previous year (see Sub-chapter 3.3). Average real net wage per labour active citizen[16] recorded growth by only 2% in December 2014 compared to the same period of the previous year, and the growth mostly resulted from deflationary trends in 2014 (Graph 4.1.) Although slight upward trend in average real net wage was evident from the beginning of 2013, its level in 2014 was still much below the level in 2009.

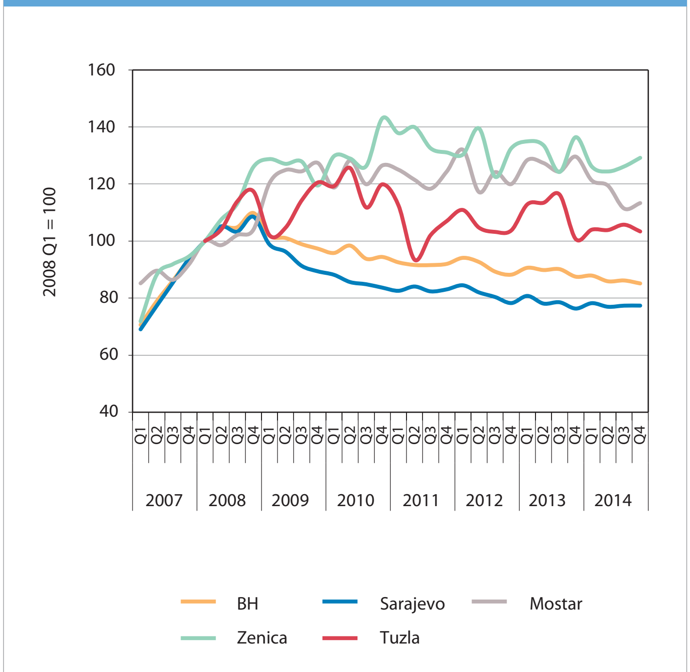
Recovery in the household sector, as shown by the labour market indicators, is still not sufficiently strong for its influence to be significantly reflected on the real estate market. Nevertheless, according to indicators on the real estate market, positive trends can be seen in this segment as well, but one cannot talk about significant recovery yet, especially considering the fact that comparisons are made to the period that recorded decline in sale of residential real estate, as well as very modest results in the construction sector. According to the Real Estate Price Index for BH[17], a slight decrease in real estate prices intended for housing was recorded in 2014[18], and a different trend in real estate prices was observed in Sarajevo compared to other regional centres in BH (Graph 4.2). While real estate prices in Sarajevo mostly stagnate, in other cities that were included in the calculation of real estate price index strongly oscillated, which can be explained with lower volume of trading with residential real estate than in the capital. Real estate prices in other BH regional centres recorded somewhat more noticeable drop compared to previous periods, but less square metres of residential space were sold nevertheless, which is mostly prominent in the City of Mostar (-12.2%). Somewhat lower demand for residential real estate despite lower prices illustrates the still poor living standard of population in these cities. On the other hand, Sarajevo municipalities recorded higher demand and increase in real estate sales[19], which was particularly prominent in the category of flats covering over 60 square meters, but again it is still too early to talk about significant recovery of this market.

Graph 4.1: Average Real Net Wage per Member of Labour Force



Source: BHAS, CBBH

Graph 4.2: Index of Real Property Prices



Source: CBBH

16 The analysis used the BHAS data on average net wage by economic activity, employment and unemployment levels and the consumer price index. The average net wage was adjusted to real amounts relative to January 2008 through application of the Consumer Price Index (2010= 100). Therefore, all values in Graph 4.1 are directly comparable to January 2008. Then, the real net wage was multiplied by the number of employed persons. Real wage costs for each month were calculated this way. This amount is then divided by the total number of working-age population.

17 The methodology for calculation of this index is defined in 2007 FSR. The Real Estate Price Index for the City of Sarajevo excludes the Old Town Municipality, which had not responded to the invitation to submit data since 2008. The Municipality of Tuzla, included since 2010, submitted the data from 2008. The RS Tax Authority was unable to submit the data for the City of Banja Luka in the required format. According to the annual data received, the changes in the residential real estate prices in Banja Luka followed a trend similar to other regional centers in BH.

18 In forming the Real Estate Price Index, data about prices of real estates that belong to newly built residential buildings were not used.

19 Sales stated in square meters of residential area in three Sarajevo municipalities together was by 17.1% higher than in 2013.

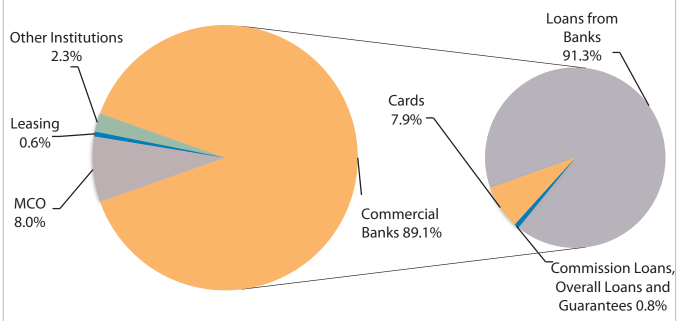
Rising number of finished, newly-built flats compared to 2013 illustrates slight recovery of the real estate market[20], whereas this indicator is still significantly below the average construction of residential units in the previous years. Although a part of residential area purchases is financed with general purpose loans, the data that household debt based on housing loans in the banking sector went down compared to 2013 also confirms the claim that the situation on the real estate market can still be described as stagnating. Further developments on the real estate market will depend on the recovery speed and labour market trends that the population's living standard depends on, and eventually the demand for residential real estate as well.

According to the data from the Central Registry of Credits (CRC), the claims on households at the end of 2014 amounted to BAM 8.18 billion and compared to the end of 2013, they recorded a growth of 4.1%. The exposure of financial institutions to households, in the per cents of GDP, was higher by 0.5% and at the end of 2014 it amounted to 30.4% of GDP. The growth of the total claims on households was caused by the growth of loans with commercial banks, by 4.2%, while, out of other kinds of claims on households, the growth of debt was recorded only in the category of debit cards (1.3%) and guarantees and overall loans whose shares in the total claims on households was negligible. Other kinds of claims compared to the previous year recorded a decline, and the largest decline was recorded in the category of commission loans (38.2%) and leasing (38.1%), and also deferred payment cards (28.6%). The household debt on the basis of credit cards, and also the household debt in microcredit sector also decreased compared to the previous year by 4.4%, i.e. 1%.

Compared with the loans extended to companies, the loans to households in the sector structure of loans from banks increased their share by 3.5 percentage points and at the end of 2014, their share in the total loans from banks amounted to 49.2%. The structure of the total claims on households did not significantly change compared to the previous years. A slight growth was recorded in the share of loans from banks, compared to the other types of claims on households. In the total claims on households, the biggest part was related to the claims of commercial banks (89.1%), in which loans were dominating with the share of 91.3%. Loans of commercial banks accounted for 81.3% of the total claims on households (Graph 4.3).

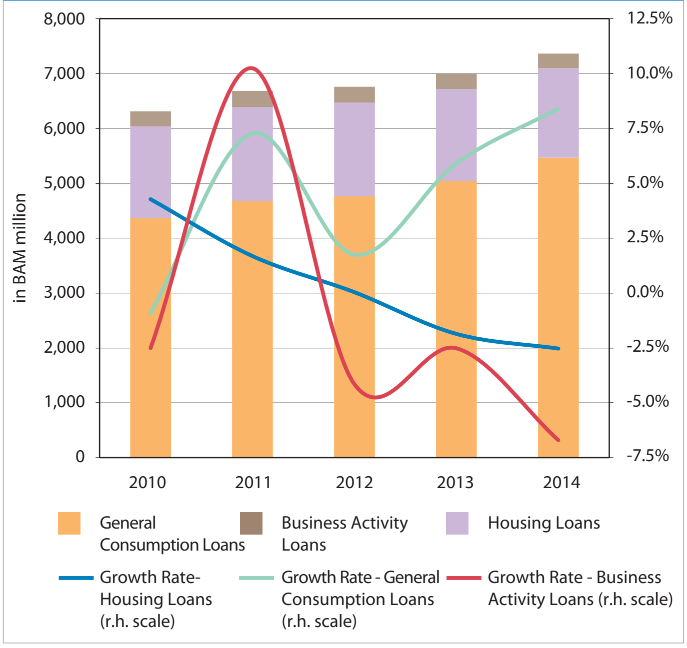
In the structure of the claims on households by purpose, general consumption loans were dominating (Graph 4.4). According to the data of the Banking Agencies, in the end of 2014, 74.3% of the loans to households was related to the loans intended for general consumption, including the claims on all types of cards, whereas the share of the housing loans

Graph 4.3: Claims on Households according to the Type of Debt at the 2014 End



Source: CRC

Graph 4.4: Loans to Households by Purpose and Credit Growth



Source: FBA and BARS

20 In 2014, 17.8% more housing units were finished than in 2013, while the size of finished flats was by 22.2% higher.

was 22.2%. Unlike the housing and loans for business activities, which in 2014 recorded a decline of 2.5% and 6.7% respectively, the loans intended for general consumption kept the growth trend and in the end of 2014 they recorded an increase of 8.4% compared to the end of the previous year, so their share in the total loans to households increased by 2.1 percentage points.

The continuous decline of housing loans, despite the downward trend of the interest rates on housing loans, with the growth of general consumption loans, is one of the indicators of the low standard of living of households, and the households in the previous years were decreasingly inclined to borrow in order to solve their housing issues, due to the uncertainty in respect of the possibilities of debt servicing, but also the expectations regarding further decrease of real estate prices. As the banks in the several previous years made the terms for extending housing loans more strict, it did not happen rarely that housing needs were solved though lowers amounts borrowed by several members of the household on the basis of the general consumption loans. Also, the growth of the general consumption loans was mainly caused by low available income, which caused the increased need of households to borrow in order to meet the basic needs of living, and not by the growth of private spending due to the economic recovery.

The number of the recorded payment cards in CRC in 2014 was lower by 5.4% compared to the previous year, which was mainly the consequence of the decrease of the number of debit cards with the approved overdraft[21]. The amount of the used part of the overdraft on the basis of payment cards was decreased compared to the previous year by 3.5%, and the biggest decline of the used overdraft amount was recorded with the deferred payment cards. The decrease of the amount of the used part of overdraft, both with the deferred payment cards and credit cards, could be the indicator of lower borrowing of households on the basis of cards due to the higher costs associated with this way of borrowing[22].

The increase of the used part of the overdraft amount per card (1.3%) was recorded only with debit cards. Also, with this type of cards, there was the increase of the amount of overdraft exceeding the approved overdraft amount, which points out a decline or revoke of the overdraft with more customers than in the previous year. As in the category of debit cards, there was an evident growth of the used part of the overdraft amount with the simultaneous decrease of the number of cards with approved overdrafts, the average debt per debit card compared to the previous year was higher by 10.4%. Unlike debit cards, the average debt per credit cards and deferred payment cards declined by 6.8% and 27.8% respectively (Table 4.1).

As the debit card overdraft is mainly determined by the amount of the average monthly income, the used part of the overdraft amount per card can be used as the indicator of the household spending compared to the amount of their income. The average debt per debit cards in the end of 2014 was BAM 509, which is 61.3% of the average net wage in 2014.

Table 4.1: Claims on Households, Cards, December 2014 — in BAM

	Number of Issued Cards	Approved Amount	Used Amount	Debt per Card
Debit Cards	674,916	736,157,101	343,393,060	509
Credit Cards	202,577	347,853,188	191,457,617	945
Deferred Payment Cards	118,721	146,421,326	41,268,380	348
TOTAL	**996,214**	**1,230,431,615**	**576,117,814**	**578**

Source: CRC

Observing the debit cards by the approved overdraft spread (Table 4.2), we can notice that the used part of the overdraft on the basis of debit cards decreased in all the categories, except in the category of the households with the lowest monthly income (the approved overdraft amount up to BAM 400). As even 31.6% of the total number of the debit cards recorded in CRC was in the category with the approved overdraft amount up to BAM 400, the debit cards from this segment affected the increase of the average debt per the total debit cards.

The category of households with the lowest monthly income still significantly uses the approved overdrafts on debit cards, which is a consequence of more strict conditions for extending loans in the several previous years and the absence of possibilities for this group of households to provide the needed financial resources in any other way.

Table 4.2: The Used Debit Card Overdraft — in BAM

		The Approved Overdraft Spread				
		up to 400	401-800	801-1200	1201-1600	over 1600
The Used Part of the Card Overdraft	December 2013	116	319	524	738	1,112
	December 2014	173	307	507	713	1,091
	Change, %	49.6	-3.8	-3.3	-3.4	-1.9

Source: CRC

21 A lower number of debit cards in CRC compared to 2013 resulted from the revoke of the approved overdraft amount for this type of cards, and the corrections made by one bank in the CRC base.

22 The average interest rate on the household debts based on cards in December 2014 was higher than the average interest rate on loans approved in December 2014 by 4 percentage points.

As this category of households in the previous period was mainly affected by deteriorated economic circumstances in the country and extensively used debit card overdrafts, in this category, there was still a higher ratio of non-performing to the total claims compared to the categories of customers with higher monthly income. Even 87.1% of the total number of debit cards which are classified in non-performing claims is in the group of debit cards with the approved overdraft amount up to BAM 400.

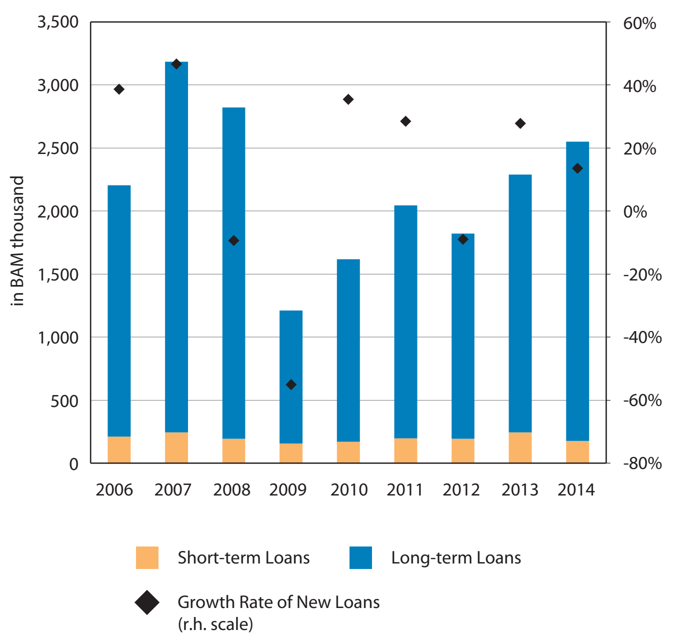
According to the data of the CBBH, during 2014, BAM 176.5 million of short-term loans and BAM 2.37 billion of long-term loans were extended to the household sector. The amount of new extended loans to households was higher by 11.5% compared to the loans extended in 2013 and it reached the highest level since 2008 (Graph 4.5). Although these data indicate a considerable increase of lending activities in the household sector, it should be taken into account that the new approved loans for 2014 include the rescheduled loans approved in the previous periods. So, the data that 16.1% more long-term loans were extended in 2014 than in the previous year, and that the credit growth in the segment of long-term loans was 6.1%, indicate that in 2014, beside a part of due and repaid loans, a part of new long-term loans is related to rescheduled claims on the households sector, which are recorded in the category of new placements.

After a significant growth of the level of non-performing loans in the period between 2009 and 2011, caused by a sudden deterioration of the credit portfolio quality due to the economic crisis, and also the including of E category in the balance sheet records of commercial banks, after 2011, no large changes were recorded in the level of non-performing loans in the household sector, either in the absolute amount or in the ratio of non-performing to the total loans of households (Graph 4.6). A more significant decline of the share of non-performing to the total loans was recorded in the end of 2014. According to the data of the Banking Agencies, non-performing loans to households in the end of 2014 amounted to BAM 750.8 million and they decreased by 0.5% compared to the end of 2013, and in addition to the decline of non-performing loans in the absolute amount, the share of non-performing loans in the total loans of households was decreased by 58 basis points, so in the end of 2014 it amounted to 10.2%.

The decrease of the share of non-performing in the total loans to households was caused by a decrease of the level of non-performing loans, and at the same time, slightly more significant growth of new placements to households in 2014. The decrease of the level of non-performing loans in the household sector was mainly the result of the undertaken activities by banks with the aim of the credit risk decrease and more efficient collection. Also, the rescheduling of loans for the customers for whom difficulties in debt repayment appeared, prevented the deterioration of the quality of the part of the loan portfolio where no delays in repayment occurred.

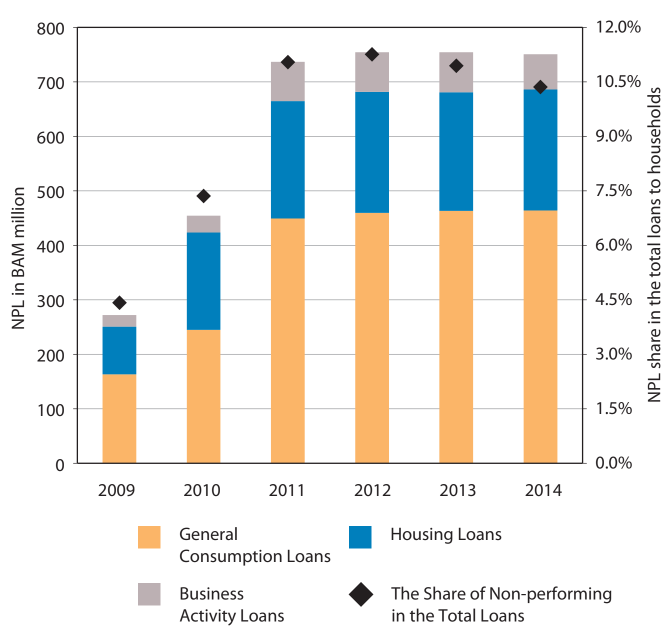
By the loan rescheduling, banks offer a possibility to the customers which are still not in the category of the non-performing ones to finance their existing obligations in an easier way and they avoid the growth of provisions due to the deterioration of the credit portfolio quality. Although the rescheduling of claims has a positive effect both for customers and for commercial banks, the slow recovery of real economy, identified in Chapter 3, indicates that the loan rescheduling will not permanently solve the expected problems with the collection of a part of claims, but they could only be postponed for future periods.

Graph 4.5: New Approved Loans and Growth Rate of New Loans



Source: CBBH

Graph 4.6: The Trend of Non-performing Loans in the Household Sector by Purpose



Source: FBA and BARS

Also, a slight impact on the decrease of the share of non-performing in the total loans at the system level came also from the revoke of the licence of the bank which had a very poor quality of the loan portfolio[23], after which the data for this bank were excluded from the data for the banking sector.

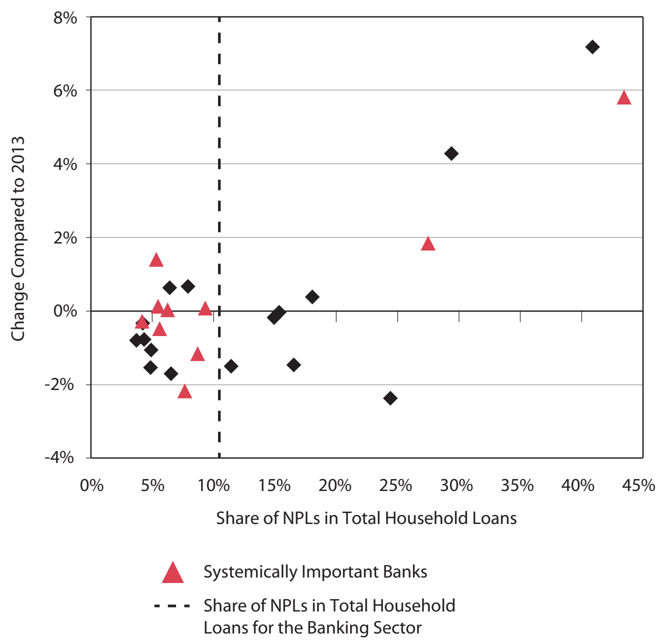
The consequences of the economic crisis, and also negative effects of the natural disasters which affected BH in the first half of 2014 and made the debt servicing for households more difficult, were partly mitigated by the measures taken by the Banking Agencies. The Banking Agencies adopted several subordinate enactments[24] with purpose of facilitating the meeting of liabilities of customers and preventing a negative influence on the quality of the loan portfolio of financial institutions, but these facilities were used more in the sector of non-financial companies than in the household sector. According to the data of the Banking Agencies in 2014, with the purpose of mitigating the impacts of the global economic crisis, BAM 21.8 million of loan liabilities was rescheduled in the household sector. Although, according to these data, according to both the number and the amount of rescheduled loan liabilities, a modest effect was realized, it should be mentioned that the data of the Banking Agencies on the rescheduling of loan liabilities do not include the data on the take-over of liabilities between the banks, but only the rescheduling within one bank. Also, during the second half of 2014, after the adoption of subordinate enactments facilitating the settlement of loan liabilities for customers which suffered damages due to the natural disasters, the moratorium was approved for the loan liabilities in the amount of BAM 8.6 million, and out of the total amount of the rescheduled loan liabilities, BAM 3.4 million was related to households.

The rescheduling has an important impact on the decrease of the activation of the loan collection instruments, primarily guarantors. According to the data of the Banking Agencies, the number of guarantors who repaid the loans decreased compared to the previous year. During 2014, 3103 guarantors /co-debtors repaid the loan liabilities on the basis of 2721 loan sub-accounts. Although, according to the official data of the Banking Agencies, for the fourth successive year, the number of guarantors and loan sub-accounts for which liabilities were settled by guarantors instead of main debtors, decreased, so these are not systemically important indicators, the problem of the repayment of loans by guarantors will remain to be a problem for a certain period to a certain number of households, which are quite often also burdened by their own debts with banks or other financial institutions.

The share of non-performing in the total loans to households by individual banks in the end of 2014 points out a low quality of the loan portfolio in the several banks in the sector (Graph 4.7). The problem of the high level of non-performing loans was particularly concerning in the case of four banks in the system, in which non-performing loans continued their growth in 2014. These banks include two systemically important banks, which have a high influence on the quality of the loan portfolio of the entire banking system and increased the share of non-performing in the total loans of the banking sector by 3.2 percentage points.

Observing the quality of the loan portfolio in the household sector, according to the purpose of loans, the loan portfolio quality compared to the end of 2013 deteriorated only in the case of housing loans. The amount of non-performing loans in 2014 in this category increased by 1.7%, while the share of non-performing in the total housing loans in the end of the year amounted to 13.6% and it was higher by 57 basis points compared to the end of the previous year, which was also influenced by the decrease of the portfolio of housing loans for the second successive year. The level of non-performing loans for general consumption was slightly higher, but taking into account the faster growth of the total portfolio of these loans, the share of non-performing in the total loans for this purpose was lower by 69 basis points compared to the previous year. Although the share of non-performing loans in the total loans for general consumption was 8.5% which is below the average value of the non-performing in the total loans to households, the risk in case of some banks in the system is not negligible, which can be seen in Graph 4.8.

Graph 4.7: NPL to Total Households Loans

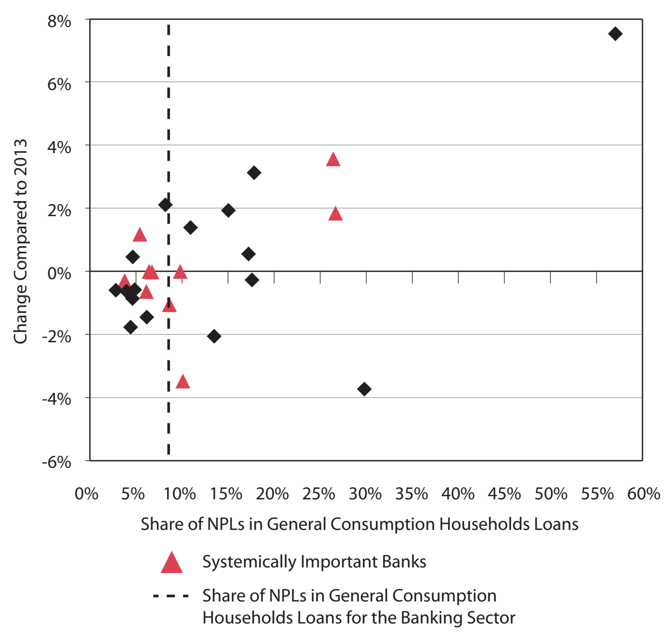


Source: FBA and BARS

23 On 23 December 2014, RS Banking Agency revoked the operating licence of Bobar banka a.d. Banja Luka. More details on the liquidation of Bobar banka are included in Chapter on Financial Intermediaries.

24 Decision on Provisional Measures for Treating Loan Liabilities of the Bank Customers Affected by Natural Disasters, dated 30 June 2014 ("Official Gazette of FBH", No 55/14 and „Official Gazette of RS" 57/14); Decision on Provisional Measures for Rescheduling of Loan Liabilities of Physical and Legal Entities ("Official Gazette of FBH", No.2/10, 1/12, 111/12 and 1/14 and „Official Gazette of RS" 9/10, 126/10, 127/11, 123/12, 01/14,01/15); Decision on Provisional Measures for Treating Liabilities on the Basis of Leasing Contracts of Leasing Companies Customers Affected by Natural Disasters, dated 21 October 2014 ("Official Gazette of the Federation of BH", No: 88/14).

Graph 4.8: Change in Performance of General Consumption Households Loans Compared to December, 2013



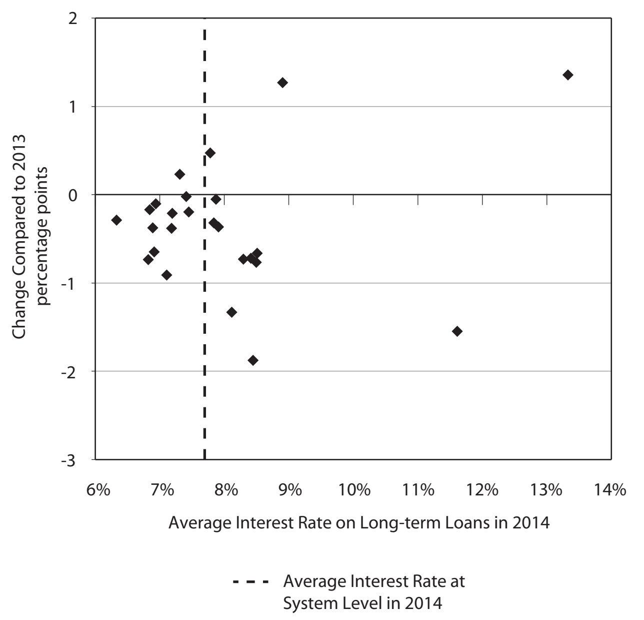
Source: FBA and BARS

Compared to the end of 2013, the downward trend in the quality of the loan portfolio for this type of claims was present in case of ten banks, and it was particularly emphasised in case of one small bank where 57% of general consumption loans was classified as non-performing. It is important to stress that among these banks, there are two already mentioned banks from the group of systemically important banks.

Although the share of the loans to households intended for business activity in the total loans to households was only 3.5%, it needs to be stressed that in this category of loans to households there is still the lowest quality of the loan portfolio, despite the decrease of non-performing loans in 2014. During the year, non-performing loans to households intended for business activity recorded a decline of 11.8% in the absolute amount, while the ratio of non-performing and the total loans for business activity was lower by 1.42 percentage points compared to the end of 2013. Yet, the share of non-performing in the total loans to households intended for performing the business activity at the end of 2014 amounted to even 24.7%. The poor quality of the loan portfolio, taking into account a small share of these loans in the total loans to households, was not concerning in respect of systemic risk, but it was emphasised in case of several individual banks, particularly with the bank where this type of loan accounted for 65.5% of the total loans to households, and 32.9% of the loans of this type was classified in non-performing claims.

The downward trend of lending interest rates from the previous years was continued in 2014 and more favourable conditions for the household borrowing contributed to the growth of demand for loans. Graph 4.9 shows the amount of the weighted average interest rates on newly approved long-term loans to households by banks during 2014 and the change compared to the average interest rate in 2013. The average interest rate on long-term loans to households in 2014 by banks was in the range from 6.33% to 13.33%, while at the level of the banking sector, the average interest rate was 7.73% and it was lower by 60 basis points compared to the average interest rate in 2013.

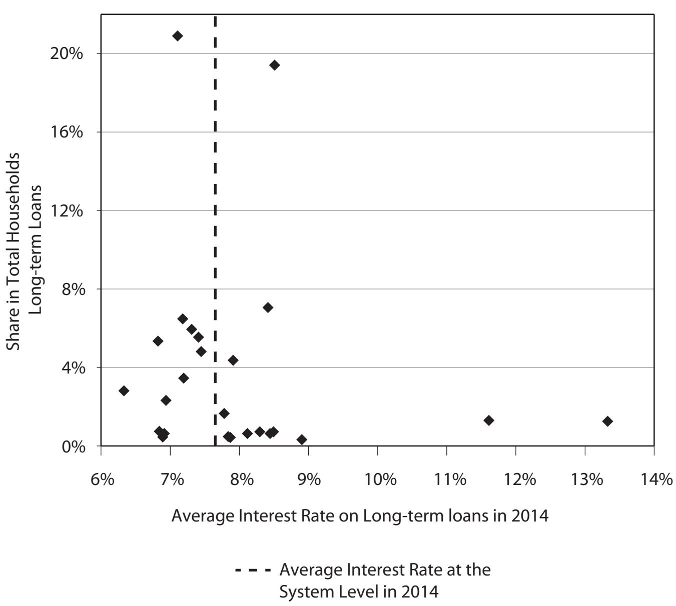
Graph 4.9: Average Interest Rates on Long-Term Loans to Households Approved in 2014



Source: CBBH, calculation by the author

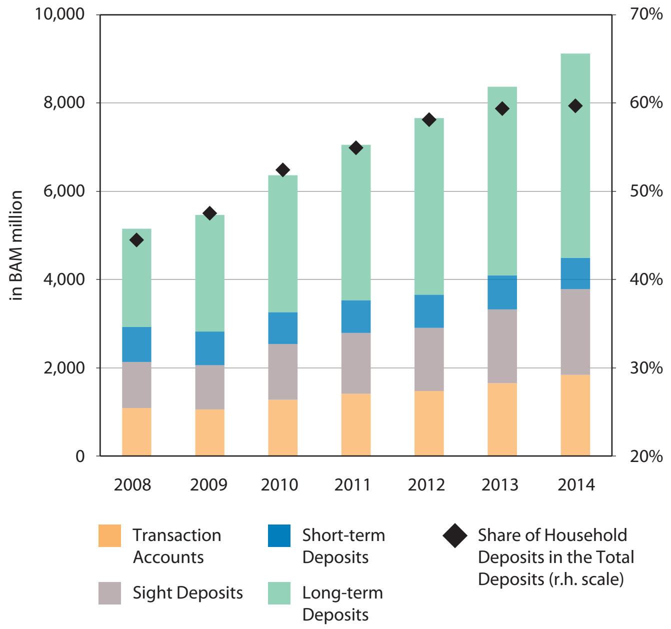
Average interest rates on long-term loans in most banks in the system were decreased compared to the previous year, which was mainly the consequence of the strong competition on the banking market and the weak demand of households for loans in the previous periods, therefore a large number of banks decided to implement the lower interest rate policy. The growth of the average interest rate in 2014 was recorded only in cases of four banks. Average interest rates on long-term loans by banks were mainly in the spread +/- one percentage point compared to the average interest rate at the banking sector level, and larger deviations were recorded only in the cases of four banks (Graph 4.10). The decrease of the average interest rate on long-term loans to households, with a significant growth of new long-term placements, and compared to that, a lower growth of long-term loans positions, leads to the conclusion that a part of the existing loans was rescheduled in a way that their repayment period was prolonged and the interest rate decreased.

Graph 4.10: Interest Rates on Newly Approved Long-term Loans by Volume of Lending to Households



Source: CBBH

Graph 4.11: Deposits of Households

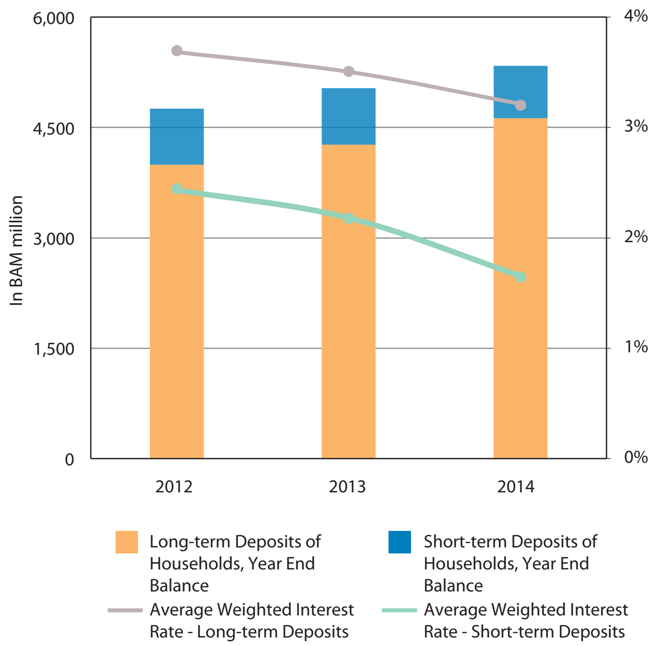


Source: CBBH

Despite the high unemployment level and the negligible growth of the average wage in BH and the downward trend of deposit interest rates in BH, in 2014, the household deposit growth trend continued (Graph 4.11). According to the CBBH data, the household deposits in the end of 2014 amounted to BAM 9.1 billion, with the recorded growth of 9% compared to the end of the previous year. The household deposit growth of BAM 756.9 million gave the biggest contribution to the growth of the total deposits (even 62.6% of the total deposit increase in the nominal amount was related to the growth of household deposits), so the trend of growth of the share of household deposits in the total deposits in the banking sector continued.

The growth of household deposits cannot be interpreted as the indicator of a better standard of living, but it is mainly a consequence of the uncertainty in respect of the future economic circumstances in the country, and the advantage is given to saving instead of spending. At the same time, the growth of the deposits of households is the indicator of trust in the banking sector and the decision of households to choose a safer kind of saving compared to investments in securities, despite the continued downward trend of deposit interest rates. Graph 4.12 shows the trend of short-term and long-term deposits with agreed maturities, and also the trend of the average weighted interest rates on short-term and long-term deposits in the period from 2012 to 2014.

Graph 4.12: Interest Rates on Short-term and Long-term Deposits



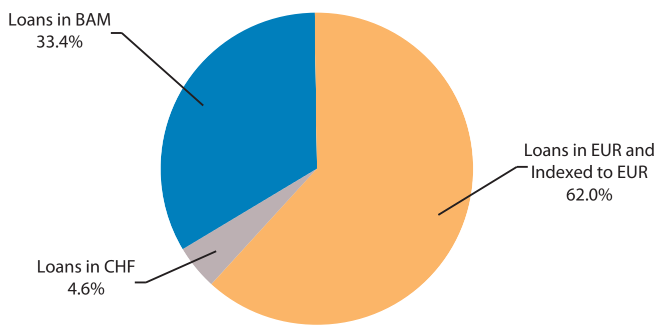
Source: CBBH

According to the data from CRC, at the end of 2014, the loans to households in foreign currencies and indexed to foreign currencies accounted for 66.6% of the total loans to households, out of it, the biggest part was related to the loans indexed to or extended in euro (Graph 4.13). As all the banks still did not harmonize their ways of reporting on the loans indexed in foreign currencies in CRC, it was not possible to define precisely the amount of the loans extended and the loans indexed in a foreign currency[25]. The loans indexed in CHF accounted for 4.6% of the total loans to households and their share in the total loans decreased by 90 basis points compared to the end of the previous year [26]. The downward trend of the loans to households indexed in CHF is a consequence of repayment, rescheduling or converting the loans into another currency and also the termination of extending new loans in CHF. It is important to mention that almost the entire amount of the existing claims in CHF currency was related to the loans extended by two banks.

Although, according to the data from CRC, in the end of 2014, the number of the approved loan sub-accounts to households in CHF was only 0.9% of the total approved loan sub-accounts to households, the repayment of the loans in CHF was still a large burden for the households with the debts in this currency. In the end of 2014, further deterioration of the loan portfolio in CHF currency was evident, and the ratio of the non-performing to the total claims reached 50.4%. The problem of the repayment of loans in CHF again became a current issue in mid - January 2015, after the decision of the SNB to abandon the policy of the maintaining of the CHF fixed exchange rate and the consequential appreciation of CHF in relation to EUR. Taking into account the appreciation of CHF, further deterioration of the quality of this part of the loan portfolio can be expected.

Compared to December 2013, the debt of households based on the loans extended in BAM increased by 13.2%, while the debt based on the loans extended in EUR and indexed to EUR recorded a lower growth (1.4%). In the maturity structure of the loans to households, the largest part of the claims was related to the loans with agreed maturities over 10 years, followed by the loans with the maturities between 5 and 10 years. In these very categories of loans to households, the largest credit growth was recorded, 5.5% compared to the previous year. Unlike the loans with agreed maturities over 5 years, the loans with the maturities up to 3 years, in BAM and foreign currencies, recorded decreases compared to 2013. The changes within the maturity structure of loans were to some extent the result of the rescheduling of the loan liabilities the repayments periods of which were prolonged.

Graph 4.13: Currency Structure of Loans to Households at 2014 End



Source: CRC

Table 4.3: Loans to Households, Maturity and Currency Structure, December 2014

in BAM thousand

Maturity	Debt Balance and Due Uncollected Principal			
		Loans in Foreign Currency and Loans with Currency Clause		
	BAM	EUR	CHF	TOTAL
Up to 1 Year	73,024	4,717	0	77,740
1 - 3 Years	160,304	163,681	9,710	333,695
3 - 5 Years	271,325	456,920	16,534	744,779
5 - 10 Years	827,478	1,643,190	39,112	2,509,780
Over 10 Years	889,023	1,854,882	241,229	2,985,134
TOTAL	**2,221,154**	**4,123,389**	**306,586**	**6,651,128**

Source: CRC

25 Within the project of the upgrade of CRC, it was made possible for financial institutions to report, beside the currency of placement, also the currency of indexation per individual placement as special data, which will, after all the banks harmonize their ways of reporting, provide insight into the positions of the loans extended in foreign currencies and the positions of the loans extended in BAM, and indexed in foreign currencies. According to the data of the CBBH, only 0.14% of the total loans to households was related to the loans extended in a foreign currency.

26 It should be taken into account that, due to CHF appreciation since mid January 2015, the value of the remaining debt of households in CHF, expressed in BAM, as well as the share of loans in CHF in the total loans of households, was higher compared to the 2014 end.

5. COMPANIES

The stagnating lending activity and a high level of credit risk were the main features of the corporate sector in 2014. A low demand of corporate sector for loans was a consequence of several factors, such as the long-lasting stagnation of economic activities in the country, weak domestic demand, low level of personal spending, absence of a significant investment cycle, and the overall macroeconomic and political circumstances in the country. Besides, the appearance of deflation in BH and the euro zone countries could partly influence the lending activities in the corporate sector. The decline of the prices in the country can postpone the planned investments for a future period in the expectations of lower prices, while the deflation in the euro zone countries had negative effects on the level of income and profitability of export oriented companies and their credit abilities. The high level of credit risk in the corporate sector and more restrictive conditions for extending loans additionally restricted the credit growth in this sector. On the other hand, the decline of interest rates implies that the banks are prepared to finance the projects with economic justification. The expected absence of a stronger economic recovery in 2015 leads to the conclusion that a considerable momentum in lending to companies cannot be expected in the period ahead either. On the other hand, the quantitative easing measures conducted by the ECB could, through the strengthened export demand, have a positive effect on the stimulation of lending activities, primarily in the export oriented activities.

The volume of foreign trade in 2014 recorded a significant increase, and, compared to 2013, there were increases in the recorded values of both imports and exports. The export growth rate in 2014 was slightly lower compared to the previous year which was partly a consequence of the floods in May and August and their negative effects on the volume of the production of traded goods. On the other hand, the gradual recovery of economic activities in the countries which are the main trading partners of BH and the strengthening of export demand influenced the fact that the value of the realized exports increased for the second successive year. The value of the recorded exports in 2014 was higher by BAM 303.5 million compared to the previous year. In most main groups of export products, the increase of the value of exports was a result of the increase of exported quantities, not the change in the prices of the main export products. Table 5.1 shows the most significant groups of export and import products, i.e. the groups with the largest shares in foreign trade, and the estimated price effects and the effects of the change in the volume of exported and imported goods on the values of exports and imports in the most significant groups of goods compared to 2013.

The most significant difference in exports in 2014 compared to 2013 is that in group *Mineral Fuels, Mineral Oils and Products of their Distillation, Electric Energy, Bituminous Substances, Mineral Waxes*, the decrease of the nominal value of exports of 14.3% was recorded. The decline of the value of exports in this group of products resulted from the decreased value of exports of electric energy, which in 2013 was the main determinant of the export growth. The negative growth was only the consequence of unfavourable price trend, firstly the decrease of the prices of electric energy on the markets of our neighbours, while the effect of the quantity of exported goods had a positive impact on the realized value of the exports.

The most significant export product remained to be *Base Metals, i.e. Iron, Steel, Aluminium and their Products*. In this group of products, there was a slight decrease of the value of exports compared to the previous year which was mainly caused by the decrease of the exported quantity of aluminium, and the products of aluminium, iron and steel. Although the price effect had a positive impact on the recorded value of exports, particularly in the second half of the year when there was a growth of the aluminium price on the world markets, it was not sufficient to compensate for a lower quantity demand for these metals. Besides, base metals lost the status of the category with the highest recorded surplus in the export structure. The surplus of this product group in 2014 amounted to BAM 248.1 million, which was lower by 200 million compared to the category *Wood and Wood Products*.

In the category *Wood and Wood Products*, there was a significant increase of the nominal value of exports. The strong expansion of exports in the previous several years in this group of products was a result of favourable price effects, but also the constant increase of the exported quantities. The companies from the field of the wood industry have significant comparative advantages which started this trend of production and exports. However, in most cases, it is the production of products in early stages of processing, which implies a modest contribution to the creation of added value, so there is a need to strengthen the competitive and exporting capacities with the direction towards the production of finished products. Therefore, the encouraging fact is that in the group *Miscellaneous Products*, which includes furniture, there was an increase of exports in the nominal value of 5.5%, where the increase of the exports was only the consequence of the increase of the exported quantity.

The increase of the nominal value of exports was recorded in the following product groups: *Shoes, Overshoes and Similar Products, their Parts*, followed by *Machinery, Appliances, Mechanical Equipment, Boilers and Parts thereof* and *Electric Machinery, Equipment and Parts thereof, Sound Recorders or Reproducers, Television Image and Sound Recorders or Reproducers and Parts and Equipment for such Products*. The increase of the value of the exports in the first two groups of products was influenced by the price and quantity effects, where in both cases the volume effect was more emphasised. In the third group of products, the increase of the value of exports was mainly the result of the increased quantity of exported goods while the price effect had a negative impact on the recorded value of exports. The same as in the industry of wood processing, the footwear industry in the previous years recorded a constant growth of exports, but the effect on the added value was quite low.

Most of the production was carried out in the so-called „lohn" jobs, where mainly the service of labour is charged. It is related to the import dependent industrial branch (in respect of importing intermediate goods) with quite a low share of the production of own products, where the production is labour intensive, and the level of earnings achieved by BH companies is low. Although the average wages in this branch of the economy are lower compared to the other manufacturing branches of industry, the increase of the production and exports in the footwear industry contributes to the mitigation of the unemployment problems. The increase of the production and exports in groups of products *Machinery, Appliances, Mechanical Equipment, Boilers and Parts thereof* and *Electric Machinery, Equipment and Parts thereof, Sound Recorders or Reproducers, Television Image and Sound Recorders or Reproducers and Parts and Equipment for such Products* is mainly the result of the recovery of car industry at the global level. The production of these products is characterized by a bigger share of the added value, and production and exports mainly depend on the trends on the world markets, as they rely on the demand and the needs of the biggest world car producers.

The recorded value of imports in 2014 was higher by BAM 1.03 billion, which at the annual level is the growth of imports by 6.8%. Such increase of imports was partly a consequence of the increased spending and demand for imported goods due to the need to repair the damages caused by the floods. The floods which affected our country destroyed a large part of industrial plants, so the increase of imports in *Machinery, Appliances, Mechanical and Electrical Equipment* can be explained by the need of repair and reconstruction of the destroyed plants. The increase of the value of imports in the category *Chemical Industry Products* was partly caused by the need to remove and repair the damages caused by the floods. In two groups of the main import products, a lower nominal value of imports was recorded in 2014, due to the deflationary trends on the global level. So, the decline of the imports of the mineral origin products and the food products was the result of the decreases of oil and food prices on the world market. The annual decline of the value of imports of the mineral origin products (which is mainly related to oil and oil derivatives) amounted to 7.6%, despite a slight increase of the imported quantity. A similar situation was recorded with food products, but the decline of the prices had a weaker effect on the decline of the values of imports compared to the mineral origin products.

Table 5.1: Main Positions in Foreign Trade of Goods

Main Export Product Groups

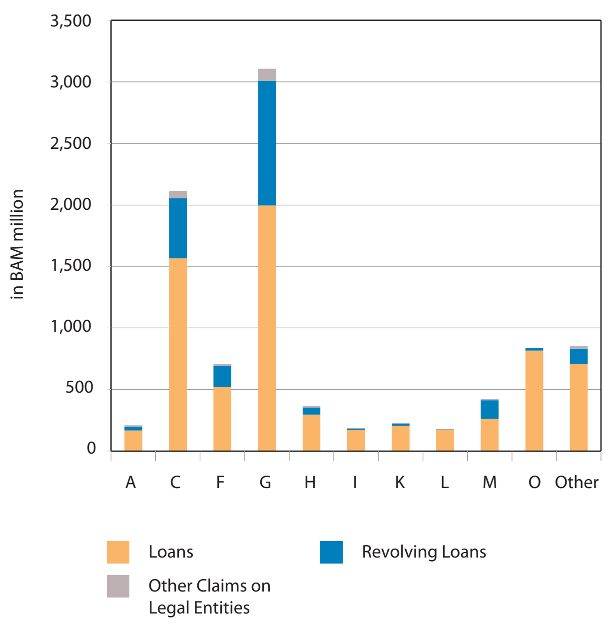
Name	Value of Exports, in BAM Million		Export Price Index	Nominal Export Growth, in %	Change of Export Values, (in Percentage Points)	
	2013	2014	I - XII 2014/ I - XII 2013		Price Effect	Exports Volume Effect
	1	2	3	4 = 2/1	5	6
Base Metals and Base Metal Products	**1,753.9**	**1,749.1**				
Out of it: Iron and Steel	591.5	625.9	96.4	5.8	-4.0	9.8
Aluminium and Aluminium Products	593.3	573.2	104.3	-3.4	4.0	-7.4
Iron and Steel Products	388.5	373.9	109.9	-3.8	8.7	-12.5
Mineral Origin Products	**1,091.9**	**949.2**				
Of which: Mineral Fuels, Mineral Oils and Products of their Distillation, Electric Energy, Bituminous Substances and Mineral Waxes	978.6	838.5	71.1	-14.3	-34.8	20.5
Miscellaneous Products	**898.5**	**944.4**				
Of which: Furniture; Mattress Supports, Bedding and Similar Products; Lamps and Lighting Fittings, not elsewhere Specified or Included; Lighting Signs, Lighting Name-plates ; Prefabricated Buildings	866.5	914.1	97.9	5.5	-2.2	7.7
Machinery, Appliances, Mechanical and Electrical Equipment	**859.6**	**939.5**				
Machinery, Appliances, Mechanical Equipment, Boilers and Parts thereof	554.5	591.5	100.9	6.7	1.0	5.7
Electrical Machinery, Equipment and Parts thereof, Sound Recorders or Reproducers, Television Image and Sound Recorders or Reproducers and Parts and Equipment for such Products	305.1	348.0	96.8	14.1	-3.8	17.9
Footwear, Hats, Caps and Similar Products	**557.2**	**666.2**				
Shoes, Overshoes and Similar Products, their Parts	546.7	653.6	107.4	19.6	8.2	11.3
Wood and Wood Products	**579.5**	**645.0**				
Wood and Wood Products; Charcoal	574.6	640.3	107.1	11.4	7.4	4.0

Main Import Product Groups	Value of Imports, in BAM Million		Import Price Index	Nominal Import Growth, in %	Change of Import Values, (in Percentage Points)	
	2013	2014	I - XII 2014/ I - XII 2013		Price Effect	Imports Volume Effect
	1	2	3	4 = 2/1	5	6
Mineral Origin Products	**3,045.2**	**2,813.2**				
Of which: Mineral Fuels, Mineral Oils and Products of their Distillation, Electric Energy, Bituminous Substances and Mineral Waxes	2,949.1	2,705.1	85.7	-8.3	-15.4	7.1
Machinery, Appliances, Mechanical and Electrical Equipment	**1,866.6**	**2,337.9**				
Machinery, Appliances, Mechanical Equipment, Boilers and Parts thereof	1,091.7	1,386.6	104.2	27.0	5.1	21.9
Electric Machinery, Equipment and Parts thereof, Sound Recorders or Reproducers, Television Image and Sound Recorders or Reproducers and Parts and Equipment for such Products	775.0	951.3	102.5	22.7	3.0	19.7
Chemical Industry or Related Industry Products	**1,475.4**	**1,565.6**		6.1		
Of which: Pharmaceutical Products	474.0	553.8	113.2	16.8	13.6	3.2
Essential Oils and Resins, Perfumery, Cosmetic or Toilet Products	184.2	196.4	99.9	6.6	-0.1	6.7
Inorganic Chemical Products, Organic and Inorganic Compounds of Precious Metals, Rare Metals, Radioactive Elements and Isotopes	190.8	168.2	98.7	-11.9	-1.2	-10.7
Miscellaneous Chemical Industry Products	154.5	163.4	107.1	5.8	7.0	-1.3
Base Metals and Base Metal Products	**1,399.8**	**1,500.4**				
Out of which: Iron and Steel Products	413.3	513.4	101.7	24.2	2.1	22.2
Iron and Steel	402.6	375.9	103.8	-6.6	3.4	-10.1
Aluminium and Aluminium Products	220.0	236.9	109.9	7.7	9.7	-2.0
Food Products	**1,482.8**	**1,434.2**				
Beverages, Alcohols and Vinegar	315.3	324.0	98.8	2.8	-1.3	4.1
Miscellaneous Food Products	209.9	220.2	100.7	4.9	0.8	4.1
Food Industry Waste and Scraps; Prepared Animal Food	193.6	194.0	91.0	0.3	-9.9	10.1
Cereal, Flour, Starch or Milk Products; Pastries	170.5	175.9	99.1	3.2	-1.0	4.1

Source: BHAS, calculation by the CBBH

Bank loans represent the main source of financing in the corporate sector in BH. Alternative sources of financing, such as financing by debt or equity instruments are poorly developed and almost do not exist. As the corporative sector in BH mainly includes small and medium size enterprises, the access to international sources of financing is unavailable. Only a limited number of large companies have access to this kind of financing in the form of trade loans. Therefore, the level of the debt in the corporate sector can be observed almost only as the debt to the banking sector.
In the structure of the bank claims on companies, the claims based on standard and revolving loans still make the most significant part of the total claims, while the claims based on guarantees, letters of credit and factoring account for a negligible part of the total claims and do not have any systemic importance. Graph 5.1 shows the claims of the banking sector on companies by the type of the claim.

Graph 5.1: Claims on Legal Entities per Type and Activity



Source: CRC

Legend:

A - Agriculture, Forestry, Hunting
C - Manufacturing Industry
F - Construction
G - Wholesale and Retail Trade; Repair of Motor Vehicles and Motorcycles
H - Transportation and Storage
I - Accommodation and Food Service Activities (Hotels and Catering)
K - Financial and Insurance Activities
L - Real Estate Activities
M - Professional, Scientific and Technical Activities
O - Public Administration and Defence; Compulsory Social Security
Other:
B - Mining and Quarrying
D - Electricity, Gas, Steam Production and Supply and Air Conditioning
E - Water Supply; Sewerage, Waste Management and Remediation Activities
J - Information and Communication
N - Administrative and Support Service Activities
P - Education
Q - Human Health and Social Work Activities
R - Arts, Entertainment and Recreation
S - Other Service Activities

The positions of the total bank claims on companies in the end of 2014 were mainly influenced by the activities of some banks related to mitigating credit risk and cleaning of balance sheets. As a continuation of the process of restructuring (see Chapter 6), two banks transferred a part of their claims to a separate legal entity. The value of the transferred portfolio amounted to around BAM 260 million, and almost the entire amount was related to the claims on companies. In addition, one of the systemically important banks, in the end of the year, carried out a permanent write-off and removal from the balance sheet of a part of E category in the amount of BAM 37 million. Also, the liquidation of Bobar banka a.d. Bijeljina additionally influenced the balance of the total claims on companies, as the claims of this bank were excluded from the debt balances of the companies in the end of 2014, so the total amount of the debt on this basis was lower by around BAM 200 million. The mentioned extraordinary events which took place during 2014 made more difficult a direct comparison of the positions of the claims in the end of the year with the earlier periods.

Graph 5.1 shows the sector structure of the claims on companies, which did not significantly change compared to the previous years. Taking into account the structure of BH economy and the share in the creation of gross added value, in the total claims of the banking sector on companies, still, the claims on manufacturing industry kept the largest shares (activity C) and also those on trade (activity G). The claims of the banking sector on these two activities accounted for more than 56% of the total claims. Although in 2014 the downward trend of the share of the claims on the companies from these two activities in the total claims continued, such high concentration indicates the increased vulnerability of the banking sector. In addition to these two activities, in 2014, the downward trend of the shares of these activities mainly depending on the domestic demand also continued. The positions of the claims in some activities, such as activity A (Agriculture, Forestry and Fishing) or activity H (Transport and Warehousing) were partly a consequence of the damages caused by the last year's floods.

A mild recovery in the sector of construction and accelerated activities on the realization of infrastructure projects caused the increase of the share of this activity in the structure of the total claims. It is important to stress that the upward trend of non-performing claims in this activity was stopped. A constant progress in the area of tourism resulted in the increase of the share of the activity I (Accommodation and Food Service Activities) in the structure of the total claims. The biggest increase in this activity was recorded with revolving loans, implying that such growth was caused more by the need of financing the turnover funds, and not the increase of accommodation capacities. The significant increase of the share in the structure of the total claims was recorded in activity O (Public Administration and Defence, Compulsory Social Insurance) resulting from the mismatch between revenues and expenditures at almost all the levels of the authorities and the increasingly prominent problems related to the budget liquidity. The survey of the total claims per all debt instruments and economic activities is provided in Table A4 in the Statistical Appendix.

The changes in the positions of the total claims of the banking sector in BH were mainly the reflections of the trend of the debt of companies on the basis of the standard loans. Therefore, the sector allocation of the total claims mainly reflects the sector structure of the standard loans. In Table 3 in Statistical Appendix, there is a survey of all the claims on the basis of the standard loans in the end of 2014 by all economic activities.

The upward trend of the approved and used overdraft amount based on revolving loans can indicate a conclusion that the companies start facing the liquidity problems and therefore they search for additional sources of financing for the adequate liquidity maintenance. The most significant change in respect of the debt based on revolving loans was recorded in activity B (Mining and Quarrying) where the debt on this basis increased by 113.3%. Such increase of the debt on the basis of a revolving loan can point out the difficulties in the liquidity maintenance and the servicing of the current liabilities in the activity of mining. The decline of industrial production volume in activity D (Production and Supply of Electric Energy, Gas, Steam and Air Conditioning) in 2014 did not impact the decreased level of financing, so the debt based on revolving and standard loans increased compared to the previous year. The reason is that in this activity, with the low level of non-performing loans, there are mainly big companies which generally have satisfactory performance indicators and they can offer adequate collaterals, which influences the trust of the banking sector and readiness to provide the credit support to them regardless of occasional oscillations in the level of business activities. In 2014, a higher level of the agreed overall loans was recorded with the simultaneous growth of the used amount based on this type of debt. The debt balance on the basis of guarantees, letters of credit and factoring continued to decrease indicating the fact that the requests of corporate sector for these banking products are decreasing.

The amount of newly approved long-term loans to companies compared to the previous year increased by BAM 87.6 million. The biggest contribution to the growth came from newly approved loans over EUR 1 million. This might suggest that within the corporate sector, commercial banks in respect of long-term financing perceive the large companies segment to be less risky than small and medium size companies, i.e. in the projects which large companies seek the financing for they have recognized bigger potentials compared to the projects offered by small and medium size companies. The amount of newly approved standard short-term loans in 2014 was lower by BAM 280.4 million compared to the previous year, therefore the share of the standard loans with the agreed maturities up to 1 year in the total standard loans decreased by 2 percentage points compared to the previous year. In the maturity structure of the standard loans, the biggest share was still taken by the loans with the agreed maturities of more than one year. In the structure of the long-term-loans, the biggest share was taken by the loans with agreed maturities of 5-10 years and their share in the total standard loans amounted to 40% and it was higher by 3 percentage points compared to the previous year. In other categories of long-term loan maturities, no significant changes were recorded in their share in the total conventional loans.

A high degree of euroisation, i.e. a high level of the liabilities denominated in euro or indexed to euro, is a feature of BH corporate sector. In the currency structure of claims on companies, still the largest share was taken by the loans extended in or indexed to euro. In the categories of maturities up to one year, loans in domestic currency were dominating, while in the other categories of agreed maturities, the largest shares were taken by the loans extended in, i.e indexed to euro. This is the consequence of the banking practice that, mainly, short-term loans are extended in the domestic currency, and long-term ones are indexed to euro, with purpose of a better management of maturity and currency match of banks' assets and liabilities. Yet, taking into account the currency board arrangement and the fixed exchange rate of convertible mark to euro, the currency risk in the corporate sector is not so prominent as in some surrounding countries where the exchange rate destabilisation could have considerable negative consequences for the financial stability and the level of debt of companies.

Also, compared to the household sector, which has a restricted possibility of protection against the currency risk, the realized export revenues and/or claims in the corporate sector can partly mitigate the negative effects of a potential exchange rate destabilization and act as "natural protection" in case of the appearance of the currency risk. Although it is not a systemic problem in the corporate sector, having in mind a negligible amount of the debt balance, the appreciation of Swiss franc in the beginning of 2015 did not have any impact on the increase of the currency risk in the corporate sector. Out of the total amount of debt balance based on standard loans, loans in CHF accounted for 0.5% (Table 5.2), while the total amount of loan sub-accounts at the end of 2014 amounted to 33, so this problem was not so prominent as in case of households. Loans indexed to CHF were mainly extended by only two banks in the system.

The stressed credit risk in the corporate sector was the characteristic of 2014. A longer period of economic stagnation in the country has influenced the absence of the recovery of the quality of loan portfolio in the corporate sector. Although, according to the data of the Entity Banking Agencies in 2014, there was a decrease of non-performing loans in the nominal amount, and also the decline of the share of non-performing loans to 17.3% (in the end of 2013, the share of NPLs in the loan portfolio of non-financial companies amounted to 18.6%),the reasons should not be searched in the improvement of economic fundamentals affecting their development. The basic reasons of the decline of the non-performing loans should be sought first of all in the extraordinary events that took place in 2014, which were described in the beginning of the Chapter.

Table 5.2 : Loans to Companies, Maturity and Currency Structure of the Remaining Debt

in BAM thousand

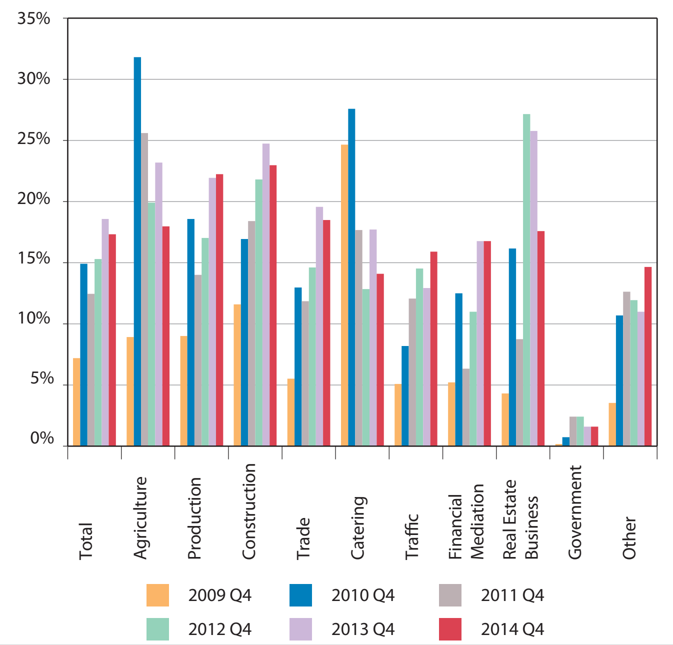
Maturity	The Remaining Debt and Due Uncollected Principal					
		Loans in Foreign Currency and Loans with Currency Clause				
	BAM	EUR	CHF	USD	KWD	**TOTAL**
Up 1 Year	510,531	165,766	0	9,536	0	**685,833**
1 to 3 Years	428,687	417,244	0	505	2,261	**848,697**
3 to 5 Years	399,309	765,455	749	0	456	**1,165,968**
5 to 10 Years	833,896	1,893,583	710	3,943	2,631	**2,734,762**
Over 10 Years	468,206	934,537	31,749	1,641	85	**1,436,218**
TOTAL	**2,640,629**	**4,176,585**	**33,208**	**15,625**	**5,432**	**6,871,479**

Source: CRC

The combination of the mentioned events resulted in lower shares of non-performing loans in the corporate sector. However, it should be mentioned that it is only a decreased perception of risk in the sector of non-financial companies and we cannot speak about the lower level of credit risk. The basic reasons affecting the positions and the trend of non-performing claims such as the low level of economic activities and weak domestic demand are still present. Also, it should be taken into account that the negative effects of the floods are still not fully realized in respect of the credit risk. The earlier mentioned events which brought about the decrease of NPLs, impacted the decrease of a share of non-performing loans in almost all the activities (Graph 5.2). Regardless of these corrections, the percentage of non-performing loans was above 15% in almost all the activities[27].

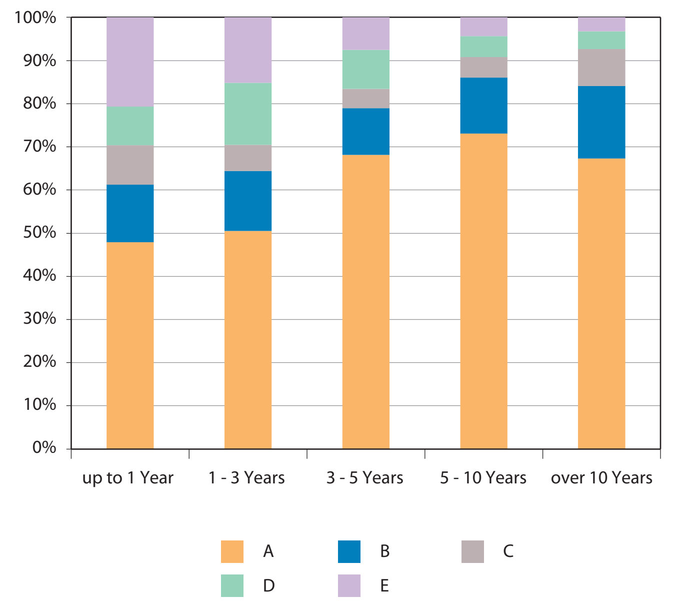
The biggest contribution to the level of non-performing loans came from the loans extended to the activities depending on domestic demand, such as trade and construction, as well as the loans approved to the activities mainly affected by the last year's floods such as manufacturing industry and agriculture. The problem of non-performing loans in the corporate sector has been present for a longer period of time and it is systemic. Due to the stagnation of the economic activities in the country, the deterioration in the quality of the loan portfolio took place in all the banks in the system regardless of the size of the portfolio. Besides systemic risk, there is also idiosyncratic risk, mostly in cases of smaller banks which in the periods of the loan expansion had inadequate lending policies in assessment of credit abilities of their customers. Such approach resulted in high losses based on the non-performing claims with a several small banks, and in one case, among other, a licence was revoked by the RS Banking Agency.

Graph 5.2: Share of NPLs in Total Loans to Legal Entities, per Economic Activity



Source: FBA and BARS

Graph 5.3: Classification and Maturity of Loans to Legal Entities in 2014



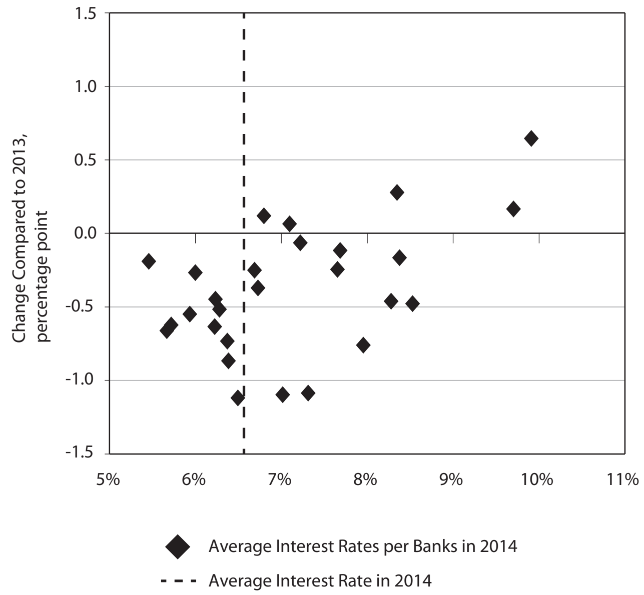
Suurce: CRC

27 *Agriculture* includes the activities of agriculture, forestry and fishing; *Production* includes the activities of mining and quarrying; manufacturing industry and the production and supply of electric energy, gas, steam and air conditioning; *Trade* includes wholesale trade and retail trade; repair of motor vehicles and motorcycles; *Catering* includes accommodation and food service activities (hotels and catering); *Financial Mediation* includes financial activities and insurance activities; *Government* includes activities of public administration and defence, compulsory social insurance.

The decline of interest rates in international financial markets impacted the slight decline of the interest rates at which the banks extend the loans to this sector. In the search for a larger market share in the corporate segment and in the conditions of stagnating lending activities, commercial banks continued to lower the interest rates on the loans to companies. According to the CBBH data, the average weighted interest rate on newly approved loans in the corporate sector in 2014 amounted to 6.63% and it was lower by 38 basis points compared to 2013. With most banks in the system, there was a decline of the average interest rate at which loans were extended to companies. The average interest rate in the corporate sector was in the range from 5.46% to 9.91%. The growth of interest rates was recorded with five banks and those were domestic owned banks, and the most probable cause was the impossibility to access international sources of financing and reliance on the local sources, which are, as a rule, more expensive.

In one case, it was a bank with very high share of non-performing loans in the corporate sector. With most systemically important banks, there were no significant changes in the amount of the average interest rate. Having in mind the data on the balance of non-performing loans in the corporate sector, the decline of the interest rates was not a reflection of a lower credit risk, but the stronger competition among banks and their need to try to stimulate the lending activities in this sector. The fact that a higher decline of the interest rates was recorded with the banks which in the period before the crisis were more focused on the market of legal entities than households confirms this.

Graph 5.4: Interest Rates on Legal Entities Loans, per Banks



Source: CBBH, the calculation of the author

In addition, a considerable decrease of the interest rates was recorded with several small banks which are trying to improve their competitive positions in the market and the banks pretending to enter the group of the market leaders in the corporate segment.

6. FINANCIAL INTERMEDIARIES

BH financial system has, despite the risks identified in the previous Chapters, managed to preserve the stability. The banking sector is still a dominating sector in the financial system, while the remaining part of the financial system is rather underdeveloped. BH banking sector recorded a slight increase of the balance sheet amount, so the share of banks assets in the total assets of financial intermediaries increased by 20 basis points. Unlike the banking sector, a considerable growth of the balance sheet amount during 2014 was recorded by insurance and reinsurance companies (10.2%), therefore this sector recorded the increase of the share in the total value of the financial intermediaries assets. On the other hand, as a result of the risks accumulated earlier, the contraction of the balance sheet amount is still present in the part of non-banking sector related to microcredit organizations and leasing companies. The absence of large domestic institutional investors, lack of willingness to invest in the securities by households and corporate sector are still the limiting factors for the growth of domestic investment funds. Domestic capital markets, due to their segmentation, are not sufficiently attractive to foreign investors. The most active segment of the capital market is still trading in domestic debt securities. Table 6.1 shows the trends and the structure of assets of BH financial intermediaries in the last three years.

Table 6.1: The Financial Intermediaries Asset Value

	2012		2013		2014	
	Value, BAM million	Share, %	Value, BAM million	Share,%	Value, BAM million	Share,%
Banks [1]	21,186	86.3	22,026	87.1	22,781	87.3
Leasing Companies [1]	716	2.9	597	2.4	512	2.0
Microcredit Organizations [1]	676	2.8	670	2.6	647	2.5
Investment Funds [2]	796	3.2	761	3.0	786	3.0
Insurance and Reinsurance Companies [3]	1,174	4.8	1,231	4.9	1,357	5.2
Total	**24,548**		**25,285**		**26,082**	

Source:
1 - FBA and BARS
2 - FBH Commission for Securities and Investment Funds
3 - Entity Agencies for Supervision of Insurance Companies

BH financial sector during 2014 was the subject of the comprehensive assessment by the team of the IMF and the World Bank experts, in cooperation with the domestic relevant institutions. Within the Financial Sector Assessment Programme (FSAP), the examination of the situation and assessment of the financial sector of BH were carried out. As the banking sector is a dominating part of the BH financial system, in this part of the Report a special attention is devoted to the basic findings of the FSAP mission related to the banking sector.

6.1 Banking Sector

Banking sector of BH in 2014 kept its stability and successfully mitigated the risks from the country and abroad which it was exposed to. Capitalization and liquidity of the banking sector were at the satisfactory level, and the record profitability was achieved. Credit risk is stressed as the most significant risk in the banking sector. A high level of non-performing loans with several banks led to a high share of non-performing in the total loans at the level of the entire banking system. Beside credit risk, in a part of the banking sector there is a stressed concentration risk and liquidity risk. Several smaller banks, mainly in domestic ownership, have high exposure to one or several related persons, which indicates a high concentration risk in the operations of these banks. Due to a significant exposure to risks, and restricted access to the sources of financing, these banks face the problems in fulfilling capital requirements. Although those are idiosyncratic risks, if they are realized in more banks at the same time, they could have significant negative systemic consequences.

The most important risk from the international surrounding, the process of deleverage of BH banks in majority foreign ownership towards their parent banks in the EU, under the influence of the requirements of the EU regulators for the strengthening of their capital positions and due to the low credit demand of domestic sectors, was evident also in 2014. The results of the stress tests conducted by the CBBH have shown that the banking sector is capable of absorbing the assumed macroeconomic shocks, but in the case of the realization of the extreme scenario, the level of capitalization would be significantly decreased. Stress tests and risk assessment in the banking sector were also performed within the FSAP mission. Out of the important events in BH banking sector, in 2014, it is necessary to stress the transfer of non-performing claims of Hypo banks within the final stage of the reprivatisation of Hypo Alpe Adria Bank International AG, the liquidation of Bobar banka a.d Bijeljina and also the changes in the regulatory framework related to capital requirements and capital positions in BH banks' balance sheets.

The risk analysis in the banking sector in 2014 was to a significant extent complementary with the analyses conducted within the FSAP mission. In the Text Box 2 there is a short survey of the findings and recommendations related to the banking sector.

Text Box 2: The Basic Findings of the Financial Sector Assessment Programme in BH (FSAP) in 2014

With purpose of the financial stability assessment, within the FSAP mission, there was a testing of the resistance of the banking sector to the assumed macroeconomic shocks. The shocks were quantified through three scenarios: the basic one and two alternative scenarios including significant deterioration of macroeconomic conditions in the country. So, with top-down stress tests of solvency for the banking system, bottom-up stress tests were conducted for the first time in BH, which were performed by all the banks individually. Additionally, all the banks in the system went through the stress tests of liquidity and financial contagion risk analysis, with the accompanying sensitivity analysis, which included concentration risk.

On the basis of the conducted analysis, the main risks and vulnerabilities in BH banking sector were identified. The main risk dominating the banking sector is the credit risk which was reflected in the deterioration of the asset quality as a result of the slowing down of economic activities in the country from the beginning of the crisis, but also inadequate lending policies in the past. The level of capitalization and liquidity in the banking sector was satisfactory, however, in a certain number of banks in majority domestic ownership, the risks of concentration and liquidity were more prominent. Several smaller banks did not meet prudential capital requirements, while some of them managed to do it only with the capital support of the public sector in the form of subordinated debt and preferred shares. In addition, most of these banks continued to face the problems of significantly higher financing costs and significant shares of non-performing in the total loans. If capital support and the strategy of solving non-performing loans in these banks does not take place in the near future, there might appear the need to restructure/resolve some banks in the system.

The results of the top-down stress tests suggest that the total potential losses in the banking sector, which would occur as a result of the growth of provisions to cover credit risks are not negligible, but are still manageable. The estimated potential loan losses within the first alternative scenario amount to around 1.9% of GDP, and around 7% of GDP within the second alternative scenario. The results of the top-down and bottom-up stress tests are generally harmonized, except in the second alternative scenario, where the bottom-up stress tests do not reflect a sufficiently strong reaction of banks in respect of the expected potential loan losses if the assumed extreme decline of economic activities in the country takes place.

After a detailed examination of the situation in the banking sector, the FSAP team presented the recommendations for improvements in the area of supervision of banking sector, improvements of management of the system liquidity and the mechanism of protection of the financial sector and also recommendations for establishing adequate macro-prudential framework according to the best international practice and respecting the specific institutional arrangement of BH.

- The recommendations from the area of the supervision of banking sector are related to the adoption of new laws on banks and other relevant laws and regulations which should strengthen supervisors in implementing correction measures and their existing authorities. Within the law on banks, the issue of solving problem banks should be regulated, which will ensure the necessary authorities for solving problem banks for the Banking Agencies. Also, in respect of strengthening the supervision of banking sector, the preparation of supervisory standards should be ensured in order to encourage conservative implementation of the factors in loan loss provisions according to the International Accounting Standards.

- Within the recommendations related to the strengthening of financial safety net, it is necessary to create bodies with comprehensive authorities, adequate tools and the function of providing temporary and restricted liquidity –according to the currency board arrangement – which will be the key pillars of support in the resolution of problem banks and providing liquidity to solvent but non-liquid banks. In respect of the existing infrastructure, it is necessary to expand the range of using the deposit insurance fund (DIF) in a way to make it possible to the fund to participate in banks resolution up to the amount which would be spent for the compensation to insured depositors in the liquidation, including e.g. transactions of purchase and acquisition (P&A). Further, financial safety net can be expanded in time by establishing the Financial Stability Fund (FSF) which should be in the function of resolving systemically important banks with the aim of protecting financial stability. The funds of the fund could be also used as a support to the liquidity of systemically important banks as early correction measure in case the solvent banks need liquidity.

- Within the financial safety net, the framework for readiness in case of crisis should be strengthened, through the expanding of plans for acting in crises. The plans should include comprehensive guidelines on policies, procedures and processes for managing each stage of the crisis, including the assessments of systemic influence, diagnosis of financial institutions, the assessment of the possibility of solving problems, determination and implementation of an appropriate solution, cross-border coordination and communication with the relevant participants. It is also necessary to regularly conduct the simulation testing of a crisis situation, as a part of planning for contingencies and processes of capacity building.

- Despite a rather high level of the liquidity in the banking sector, further improvements are needed within systemic liquidity management framework. The existing restrictions of the currency board in which the central bank does not have a function of "last resort" require conservative management of liquidity and high liquidity buffers of banks. For this very reason, it is necessary to adjust the required reserve instrument so that it can be used in prudential purposes, but also with the aim of rebuilding financial reserves. Also, it is necessary to define the minimum liquidity coefficient and to expand the macro-prudential framework and instruments by introducing Loan-to Value (LTV) and Debt to-Income (DTI) ratios.

- With purpose of establishing a mechanism for solving non-performing loans, besides the needed upgrade of the legal framework, it is necessary to upgrade the legal framework which will improve the efficiency in managing the relations between creditors and debtors. In that respect, it is necessary to rationalize the process of execution/collection of debts, introduce incentives in order to facilitate restructuring and solving corporate debt and adopt the guidelines for out-of-court restructuring.

By the realization of the recommended activities, the keeping of the financial stability in the country would be ensured, primarily through the strengthening of the protection of financial sector, which is a key support to BH economic growth.

2014 was characterized by several events, which were reflected in the balance sheet amounts and financial soundness indicators in the year end, and influenced the change of risk perception in BH banking sector. As the most significant events, we can stress: the final stage of reprivatisation of Hypo Alpe Adria Bank International AG[28], the liquidation of Bobar banka a.d. Bijeljina, and the changes in the regulatory framework related to capital requirements and capital positions in BH banks' balance sheets.
A part of non-performing loans of Hypo Alpe Adria Bank International AG, which included the non-performing loans from Hypo banks in BH, in the total value of EUR 168 million was sold in October 2014. The transfer and sale of the non-performing loans of Hypo banks from BH in the amount of around BAM 260 million to a separate legal entity were significantly reflected in the improvement of the asset quality indicators of BH banking sector in the fourth quarter of 2014. The additional pressure which these banks were exposed to in the beginning of 2015 was related to the appreciation of Swiss franc. As almost the entire amount of the claims based on loans indexed in CHF in BH is related to two Hypo banks, besides the pressure of the public for finding a solution for the users of the loans in CHF, the real increase of foreign exchange and indirectly credit risks in these banks was evident. The final agreement on the sale of the Hypo banks network in South Eastern Europe was concluded in the end of December 2014 and it is expected to be finalized in June 2015, after that, the ownership of the bank should be taken over by the consortium consisting of US Fund Advent and the EBRD. The completion of this process can be expected to bring a stabilization in the operations of Hypo banks and the decrease of the financial stability risks, as these are systemically important banks.

Due to a rather small share in BH banking sector, the liquidation of Bobar banka a.d. Bijeljina did not have any significant negative effects on the banking sector. For the first time since the establishment, BH Deposit Insurance Agency, on the basis of the legal obligation which occurred, carried out the payment of the insured deposits to the bank depositors. According to the data of the DIA, the total value of the insured deposits was BAM 86.6 million, and the payment started in mid-January 2015, so in the first months more than 90% of the insured deposit amount was paid. The largest part of the paid deposits did not go out of the banking sector, which shows that the confidence of depositors in BH banks was preserved.

The changes in the regulatory framework were primarily reflected in the BH banking sector capitalization indicators. The decisions on the minimal standards for managing bank capital and capital buffers, adopted in mid-2014, changed the regulatory capital structure, which created the perception of lower capitalization. The items *retained/unallocated profit from the previous years* and *profit of the current year* were transferred from Tier 2 to Tier 1 capital and they can be included in the Tier 1 capital if they are not burdened by any future liabilities and if there is a decision of shareholders on the allocation into Tier 1 capital. The biggest impact on the decrease of the Tier 1 capital value came from the excluding of the retained/unallocated profit from the previous years from Tier 1 capital in case of two banks in the amount of BAM 85.5 million. Also, new deduction items from Tier 1 capital (negative revaluation reserves on the basis of the effects of change of fair value of assets and the value of the delayed tax funds) decreased the amount of Tier 1 capital by BAM 9.3 million, while the value of positive revaluation reserves on the basis of the effects of the change of fair value of assets transferred from Tier 1 to Tier 2 capital had a positive impact on the value of Tier 2 capital. Also, the minimal standards in capital management were supplemented by additional measures for strengthening and preserving capital, but the regulations related to capital buffers will be applied from the end of 2015/2016, therefore the decrease of regulatory capital[29] can be expected.

In the conditions of weak economic activities in the country and the earlier mentioned events, there was no considerable growth of the balance sheet amount in 2014. The balance sheet amount recorded a growth of 3.48% compared to the end of the previous year. The biggest impact on the increase of the balance sheet amount came from the increase of deposits with banks and securities in assets, and the deposits of the domestic resident sectors and capital in liabilities. The inflow of funds from the domestic resident sectors, was mainly determined by the growth of transferable deposits of households and the inflow of funds collected for the repairs after the floods in BH. Having in mid the maturity of these deposits, banks placed the funds into liquid forms of assets, so the amounts of deposits in reserve accounts with the CBBH increased, deposits with foreign banks and also the amounts of the investments in Entity securities.

Item *Securities* in 2014 increased by BAM 276.6 million, due to the increase of the purchase of securities of the Entity governments. Balance sheet position *Loans, Claims Based on Leasing and Due Claims* increased by only 1.1%, which resulted from the weak lending activities in 2014 and the restructuring in two Hypo banks, the liquidation of Bobar banka and the permanent write-off of a part of non-performing loans in some banks. Consequently, loan loss provisions decreased, which was reflected in the decrease of item *Impairments*. Other asset components did not record any considerable changes. The trends in the change of the financing structure in favour of domestic sources continued in 2014.

Deposits and loans from non-residents decreased by 8.6%, while the deposits of resident sectors increased by 6.9% compared to the end of the previous year. The increase of the deposits of domestic resident sectors was constantly present since the beginning of 2010 when the process of deleverage of BH banks started. Since the beginning of 2010, the sources coming from residents increased by BAM 3.16 billion, while the liabilities of non-residents decreased by BAM 2.6 billion, which clearly points out the conclusion that the financing sources from non-resident sectors were substituted by the resident ones. The growth of resident deposits mitigated the effects of the deleverage of the banks in the ownership of foreign bank groups and contributed to the maintaining of financial stability in BH. Although foreign sources of financing in BH were adequately substituted by domestic sources, if there is a significant economic recovery and a growth of demand of domestic sectors for the financing of

28 The process of the reprivatisation of Hypo Alpe-Adria-Bank International AG started in November 2012, and it is related to the sale of subsidiaries of Hypo banks in 5 countries of South East Europe, including both Hypo banks from BH.

29 More details in Text box 4.

investment projects, the possibilities of banks for financing from domestic sources will be limited having in mind that the maturity of domestic deposits is inadequate for the financing of long-term projects. The capital of banks in BH compared to the previous year was increased by 3.85%, which mainly resulted from the achieved profit in the current period and recapitalization of several banks (Table 6.2).

Although the capital of the banking sector in 2014 recorded a growth, due to the earlier mentioned regulatory changes, regulatory capital and capital adequacy rate were decreased (Table 6.3). The reduction of regulatory capital was considerably influenced by the increase of missing provisions according to regulatory requirement, representing a deduction item from the regulatory capital of banks. The increase of missing provisions according to regulatory requirement with a certain number of banks leads to a conclusion that some banks still do not allocate a sufficient amount of provisions for loan losses. Although the adequacy rate was slightly lower in the end of 2014 compared to the previous year, the banking system capitalization remained satisfactory. Yet, it is crucial to control the risks in several smaller banks with difficulties in meeting capital requirements and recording high losses in operations.

Table 6.2: Simplified Balance Sheet of Commercial Banks in BAM million

Assets	2013	2014
Funds and Deposits with Banks	5,712	6,041
of which:		
Reserve Accounts with the CBBH	3,437	3,716
Securities	914	1,191
Loans, Claims Based on Leasing and Due Claims	15,728	15,903
Other Assets	1,393	1,331
Impairments	-1,721	-1,685
TOTAL	22,026	22,781
Liabilities	**2013**	**2014**
Residents' Deposits	14,233	15,212
Non-residents' Deposits	1,928	1,682
Liabilities Based on Loans	1,934	1,824
of which:		
Loans from Non-residents	1,262	1,234
Other Liabilities	764	775
Capital	3,167	3,289
TOTAL	22,026	22,781

Source: FBA and BARS

BH banking sector in the end of 2014 operated with positive results and achieved a record financial result. The profit of the banking sector amounted to BAM 159 million and it was mainly concentrated in systemically important banks where the profit in two systemically important banks was even 59% of the total profit recorded in 2014. Unlike systemically important banks, smaller banks due to lower quality of the loan portfolio and insufficient competitiveness, recorded a very low profitability. The negative financial results were recorded by three banks. The structure of the banking sector income in 2014 was stable compared to the previous periods. Non-interest expenditures of the banking sector compared to 2013 decreased by 15.7% due to a decrease of costs of impairments, which mainly affected a very good financial performance of the sector.

The liquidity of BH banking sector was at the satisfactory level. The basic indicators of liquidity, liquid assets to the total assets and liquid assets to short-term financial liabilities recorded a slight increase of the values compared to 2013. In the end of 2014, liquid assets accounted for 26.8% of the banking sector assets, while 46.1% of short-term liabilities was covered by liquid assets. Yet, some banks in majority domestic ownership had considerably lower liquidity coefficients that the system average, which indicates the existence of idiosyncratic risks in these banks.

Within the FSAP mission, liquidity stress tests were implemented, on the basis of the methodology prescribed by the Basel Committee for Banking Supervision (BCBS). Two regulatory minimum values defined by the International Framework for the Liquidity Risk Measuring and Monitoring represent separate but complementary standards. The first standard was developed in order to test the short-term resistance of banks to liquidity risks and requires that banks ensure sufficient High Quality Liquid Assets (HQLA) which would enable them to „survive", in stress circumstances, a much bigger outflow of funds compared to the inflows which they can generate in the duration of 30 days. The Basel Committee developed for this purpose a Liquidity Coverage Ratio (LCR) the implementation of which started on 01 January 2015, and the minimum LCR requirement was set at the level of 60% and each year it will be increased by 10% until the full amount of 100% in 2019 is reached. The other standard called Net Stable Funding Ratio (NSFR) should ensure in a time period of one year the sustainable structure of assets and liabilities for banks taking care of the maturity adjustment and it should take effect on 01 January 2018. The results of the conducted liquidity stress tests have shown that LCR for BH banking sector exceeds 250%, implying that there is sufficient liquidity in the banking sector of BH.

Table 6.3 shows the basic indicators related to capitalization, assets quality, profitability and liquidity.

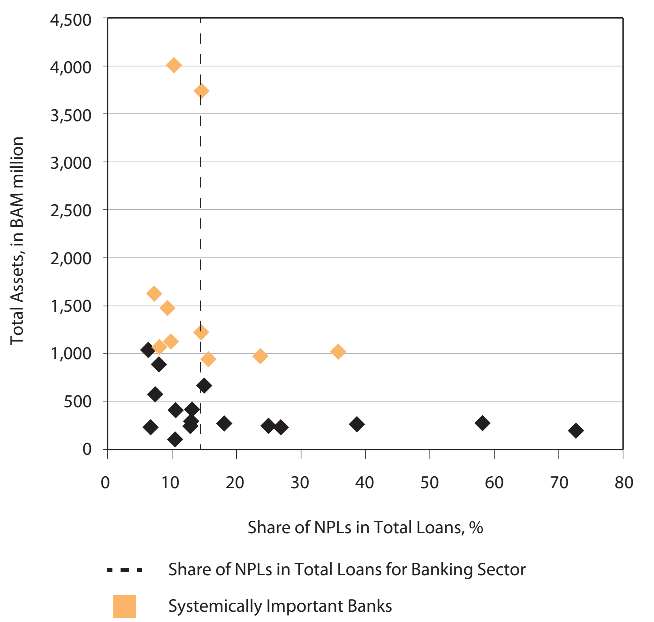
Table 6.3: The Basic Features of the Banking Sector

		2013	2014
Stable Capital-ization	Regulatory Capital, BAM Million	2,995	2,777
	Total Weighted Risk, BAM Million	16,784	17,030
	Capital Adequacy Rate	17.8%	16.3%
Lower Quality of Loan Portfolio	Total Loans, BAM Million	15,728	15,903
	Non-performing Loans, BAM Million	2,378	2,232
	Ratio of Non-performing to Total Loans	15.1%	14.0%
Positive Financial Perfor-mance	Net Profit/Loss, BAM Million	-38.6	159.1
	Return on Equity	-1.4%	5.7%
Satisfactory Liquidity	Liquid to Total Assets	26.4%	26.8%
	Likvid Assets to Short-term Financial Liabilities	46.2%	46.1%

Source: CBBH

Asset quality indicators in BH banking sector were improved in the end of 2014. Despite a slight improvement in the quality of the loan portfolio, non-performing loans remained the biggest source of the risk for BH banking sector. In the end of 2014, non-performing loans accounted for 14.03% of all the loans in the balance sheets of commercial banks in BH. In Graph 6.1, the survey of the quality of the loan portfolio was shown by banks.

Graph 6.1 : Loan Portfolio Performance, Q4 2014



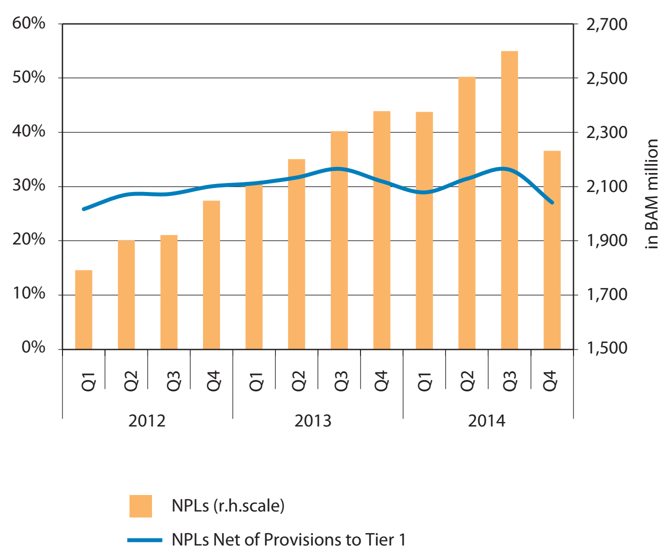
Source: FBA and BARS

Systemically important banks are marked by red colour. Except for two banks, the encouraging fact is that most of systemically important banks are below the average or at the average of the banking sector (the average for the banking sector is marked by the vertical line at the level of 14.03%).

Several small banks in majority domestic ownership recorded a significant deterioration in the portfolio quality since mid-2012, which resulted in prominent idiosyncratic risks and concentration of credit risk in the mentioned banks. Also, in some of these banks, a high concentration risk was prominent due to considerable individual exposures. The sensitivity analysis conducted within the FSAP mission has shown that in case of several banks, the combined amount of the two largest exposures exceeds the total regulatory capital of the bank. Although the average share of large exposures at the system level was still moderate, so at the system level, potential losses still can be adequately managed, several banks could become insolvent in case the customers towards whom there were large exposures failed to meet their liabilities.

The quality of the loan portfolio of the banking sector should be observed through the ratio of non-performing loans decreased by provisions to Tier 1 capital which indicates the ability of the banking sector to "cover" by Tier 1 capital the part of the non-performing loans not covered by provisions, i.e. it denotes the percentage of Tier 1 capital which will be lost for the banking sector if the non-performing loans become fully uncollectible. The increase of the value of indicator was particularly prominent in the second and third quarter of 2014, due to a prominent increase of non-performing loans which was not followed by adequate growth of provisions in banks with high credit risks (Graph 6.2) In the end of 2014, the value of the indicator was again decreased as a result of the earlier mentioned events.

Graph 6.2: NPAs Net of Provisions to Tier1 and NPLs



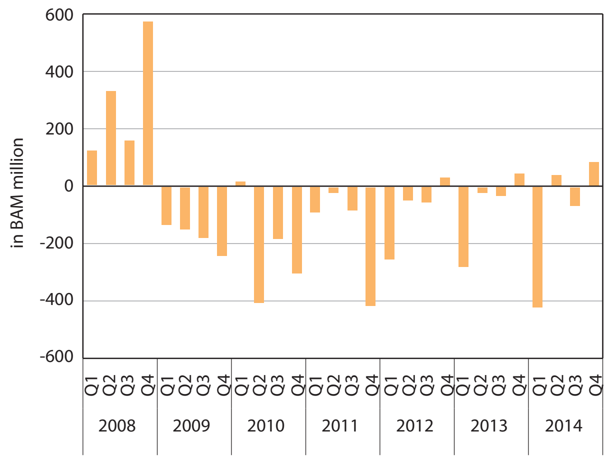
Source: FBA and BARS

The level of credit risk in BH banking sector would be mostly determined by the risk mitigation policies, as in the forthcoming periods no significant credit growth is expected which might contribute to the decrease of the share of the non-performing in the total loans. The non-performing loans are particularly prominent in the sector of non-financial private companies, particularly in the industries depending largely on domestic demand (more details in Chapter 5). In addition, we can expect the growth of non-performing loans in the activities which were mainly affected by the natural disasters in 2014. Taking into account all that is mentioned, the key role for the decrease of systemic risk level, in the periods ahead, will be that of the pace of the establishing and the efficiency of the framework for solving non-performing loans. The relevant institutions in BH have started the activities on the establishing of the framework for solving non-performing loans, and only after these processes finish, we can expect the decrease of the level of the non-performing loans in BH banking sector.

The BH banks deleverage process was continued in 2014. The deleverage process was under the influence of the continuation of the strengthening of the capital positions of banks in the euro zone, due to the process of assessment of asset quality and stress tests done by the ECB for the large European bank groups. Also, the transfer of non-performing claims within the process of reprivatisation of Hypo bank in the fourth quarter of 2014 influenced the decline of foreign liabilities of BH banking sector in the last two months of 2014 (Graph 6.3).

The beginning of the implementation of new European regulatory framework could influence the strengthening of the process of banking sector deleverage in the periods ahead.

Graph 6.3 : Flows of Foreign Liabilities



Source: CBBH

New regulations mean the implementation of the international standards for the management of capital and liquidity risks[30]. The text box 3 includes the analysis of potential impact of the regulatory changes (Regulation no. 575/2013) on bank exposure to governments and central banks.

Text Box 3: Potential Influence of Regulation (EU) no. 575/2013 on BH Banks' Balance Sheet Structure

In June 2013, legislative framework was established at the European Union level for the implementation of prudential policy, which was transposed to national frameworks of member states through acts of the European Parliament and Council: Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment companies (The Capital Requirements Directive IV – CRD IV) and Regulation 575/2013 on prudential requirements for credit institutions and investment companies (Capital Requirements Regulations - CRR). Implementation of the new European regulations regulating operations and supervision of banks, and prudential rules that come into force as of the beginning of 2015 may have substantial implications on the balance structure of BH banks - subsidiaries of European banking groups. Prudential rules related to risky assets classification account for more stringent criteria for distribution of credit institutions' exposures to different risk categories. Banks i.e. credit institutions that apply a standardised approach in classification of exposures to different risk categories are to assign 100% risk weight to exposures by central states and central banks, except in special cases[1]. If there is a credit assessment made by an external credit risk assessment institution for central states and central banks, risk weight for such exposures is assigned based on credit quality degree, in accordance with the credit assessment made by the external credit risk assessment institution. However, if banks apply the IRB approach[2] in categorizing exposures to different risk categories, which is the case in most parent banks with subsidiaries operating in BH, they are allowed to apply the standardised approach when classifying exposures by central states and central banks, if there is a limited number of other significant contracting parties, and introduction of a rating system for the other contracting parties would pose an excessive burden on the institution. As the BH's current credit rating[3] corresponds to the fifth degree of credit quality, exposure of parent banks from the EU territory to the BH Central Government and Central Bank is treated as risky and assigned 100% risk weight. Implementation of new prudential rules implies that, for the purposes of calculating consolidated risk weighted assets, mother banks will have to allocate capital reserves for all funds that their subsidiaries operating in BH keep at the account with CBBH. New regulations at the EU level aimed to strengthen banks' capital position together with the asset quality assessment process may result in changes of banks' business policies pertaining to risk mitigation. Under such circumstances, BH banks majority-owned by European banking groups can be expected to decrease funds they keep on accounts with CBBH and apply excess liquidity to investments that generate higher yield instead[4]. If strengthening of credit activity in BH fails to occur, the deleverage process will likely continue, to the extent in which banks are able to comply with domestic regulations on liquidity, maturity match and foreign currency position. Substantial funds withdrawal from the reserve account with CBBH would eventually affect the level of foreign currency reserves with the CBBH.

1 Cases where risk weight for exposures to central states and central governments is different from 100% are defined by Article 114, Paragraphs (2) through (7) of the Regulation (EU) no. 575/2013 of the European Parliament and Council.

2 Under Basel II, the Internal Ratings-Based Approach (IRB) implies internal methods and processes that banks use in credit risk assessment to classify exposures to rating categories or groups of exposures, for the purpose of capital adequacy calculation.

3 BH long-term credit rating is B according to S&P from March 2012 and B3 according to Moody's from July 2012.

4 As the compensation paid by CBBH to commercial banks on the funds kept at the reserve account in the observed period was tied to interest rate generated by CBBH on invested deposits in European central banks, since the introduction of ECB negative interest rate on banks' deposits in June 2014, the CBBH has not paid any compensation on funds kept at reserve accounts.

30 International regulatory framework for banks (Basel III), available on: http://www.bis.org/bcbs/basel3.htm

The deleverage process of the domestic banking sector is still under the influence of weak domestic demand that constitutes a restriction of a kind on domestic lending activity and the country's economic recovery. Credit growth only amounted to 1.1% in 2014. Positive expectations in terms of recovery of economic activities from the beginning of the year resulted in slight credit growth in the sector of private non-financial companies in the first part of 2014. Floods that affected BH in May 2014 influenced another credit activity slowdown in the companies sector in the second part of the year, and this sector recorded negative credit growth at the end of 2014 (-2.15%). On the other hand, credit activity in the household sector is mostly attributable to substitute loans and rescheduling, and to a lesser extent to moratoria on loans to individuals from flooded areas that were extended by banks in 2014. Thus the household sector, which includes household business loans, recorded credit growth of 5.18%. In view of the purpose of these loans, one can conclude that households tend to accumulate debts to finance current expenses, given the low and stagnating incomes. Data from the end of the first quarter of 2015 show that trends from the previous year continued. Slight credit growth is evident (annual growth rate in the first quarter amounted to 0.86%), where the annual credit growth rate in the household sector amounted to 5.46% in the same period.

Stress Tests

To identify vulnerabilities in the banking system, CBBH conducts quarterly macroeconomic top-down stress tests for the entire banking sector in the country for the next two years. Tests are conducted applying two scenarios, baseline and extreme one. The baseline scenario includes assumptions based on macroeconomic projections and projections of trends in the banking sector, in an attempt to define probable position of the banking sector at the end of two coming calendar years. The extreme scenario assumes highly unlikely events that will, if materialised, have significant negative effects on the banking sector. Brief description of shocks, basic macroeconomic assumptions and results of stress tests conducted with data as of the end of 2014 is given below.

The stress test is based on two assumed shocks: economic downturn and interest rate growth. In view of the fact that credit risk is the most important risk in BH's banking sector, stress tests are focused on testing the banking sector's resilience to deterioration of credit portfolio quality, and both shocks are thus reflected in the increase of non-performing loans, which eventually has negative effects on profitability and capitalisation of the banking sector.

Extreme scenario envisages a significant decline of domestic demand, which appears as a consequence of decrease of the available income of households, as well as decrease of external demand for domestic products. Thus, both periods of the extreme scenario assume slowdown of economic activities by five percentage points compared to the projections from the baseline scenario, which causes drop in banking sector's assets and credit activity downturn. And while the baseline scenario foresees growth of Entity securities on the banks' balance sheet, the extreme scenario, due to over-indebtedness and high exposure of the government sector does not foresee increase of investments in Entity securities. The extreme scenario assumes an increase of inflationary pressures by 100 basis points compared to the projections from the baseline scenario. Table 6.4 provides a survey of basic assumptions based on which stress tests were conducted, with data as of the end of 2014.

Basic findings of stress tests are expressed in terms of the banking sector's capitalisation over the coming two years. Findings of stress tests conducted based on data as of the end of 2014 indicate stability of the banking sector and its resilience to assumed shocks. Stress test results showed that capital adequacy rate of BH banking sector would have remained above the regulatory minimum (Table 6.5) if the assumed shocks materialised. However, despite the satisfying capitalisation at the banking sector level, stress tests showed that there was a significant number of banks that would need additional capital if the assumed shocks materialised. Although the risks are idiosyncratic, undercapitalisation of a large number of banks or of systemically important banks would become a threat to the stability of the entire banking sector.

Observing results by individual banks, four banks needed recapitalisation in the baseline scenario in 2015, and five banks in 2016. Of note, in terms of additional capital requirements, stress test results were also influenced by undercapitalisation of two small banks according to actual data as of the end of 2014. Other banks that stated recapitalisation needs in the baseline scenario for the first period belong to a group of banks that recorded evident substantial credit portfolio quality deterioration in recent periods, as well as difficult access to sources of funding, and that, according to actual data, have capital adequacy rates close to the regulatory minimum. In case the presumed shocks from the extreme scenario materialised, nine banks would require additional capital in 2015, and twelve banks would need recapitalisation in 2016.

Table 6.4: The Basic Macroeconomic Assumptions in %

	Basic Scenario		Extreme Scenario	
	2015	2016	2015	2016
Growth of Real GDP [1)]	2.3	3.1	-2.7	-1.9
Assets Growth	1.5	2.0	-3.5	-2.5
Nominal Credit Growth	4.1	4.3	-2.5	-2.0
Growth of Securities	15.0	10.0	0.0	0.0
Inflation [1)]	0.6	1.1	1.6	2.1

Source: IMF and CBBH
1) Growth of Real GDP and Inflation for the Basic Scenario is a projection of the IMF.

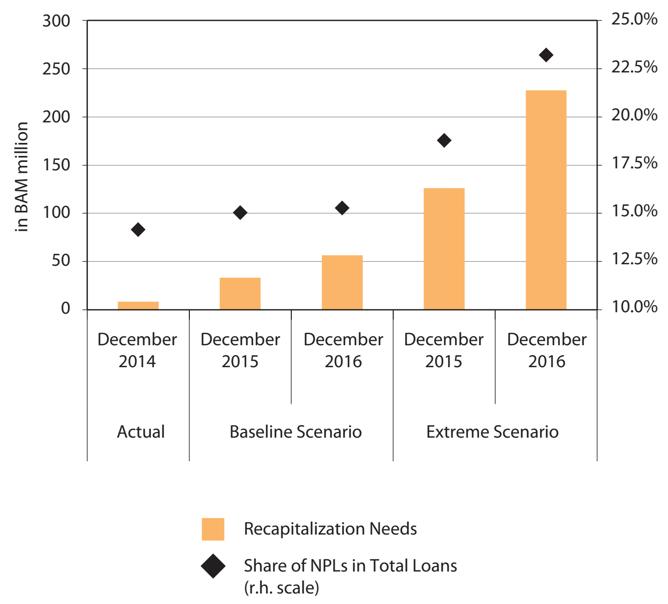
Table 6.5: Results of Stress Tests

	Basic Scenario		**Extreme Scenario**	
	2015	2016	2015	2016
Capital Adequacy Rate, %	16.7	17.4	14.6	14.1
Number of Banks that Need Recapitalization	4	5	9	12

Source: CBBH

Results of stress tests in the extreme scenario showed that bank capitalisation is primarily sensitive to the loan portfolio quality, which records significant aggravation due to the presumed shocks. Thus, due to materialisation of shocks, the share of non-performing loans at the end of 2015 would rise by additional 4.6 percentage points, and additionally by 4.2 percentage points by the end of 2016. Substantial increase of provisioning costs, due to deteriorated credit portfolio quality and financing costs of banks showed negative financial result in the extreme scenario in a large number of banks in the system, which influenced worsening of their capitalisation. It is important to note that stress tests do not assume that banks that stated recapitalisation needs in the first period replenished the missing capital, but recapitalisation needs are accumulated in both stress test periods. For this reason, the results in the second period of both scenarios are worse than in the first period. Graph 6.4 presents the level of recapitalisation needs and the share of non-performing loans in total loans according to the actual balance at the end of 2014 and stress test results in both scenarios.

Graph 6.4: Total Recapitalization Needs and Share of NPLs in Total Loans



Source: CBBH

6.2 Non-Banking Financial Sector

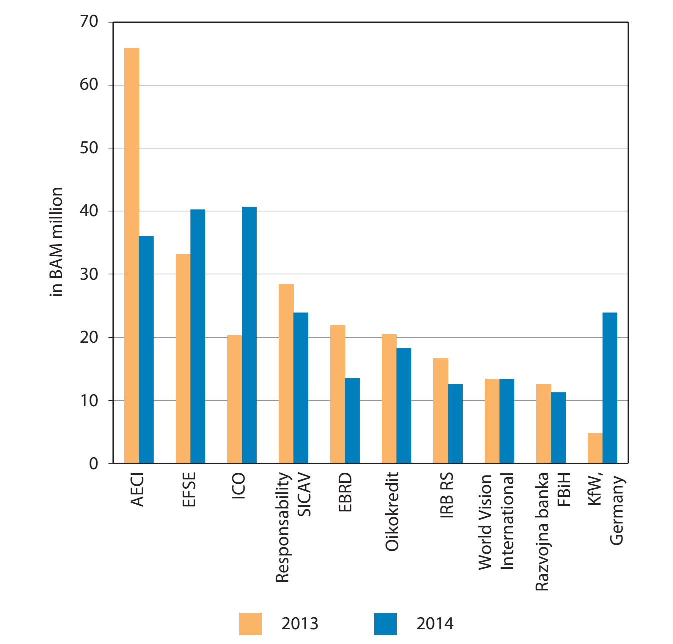
Low level of economic activities and weak domestic demand also determined trends in non-banking financial sector in 2014. Assets of the non-banking financial sector went up by BAM 51.7 million compared to 2013, mostly resulting from an increase in assets of insurance and reinsurance companies, and to a smaller extent of investment funds, while other financial intermediaries recorded balance sheet sum contraction (Table 6.1). The share of non-banking financial intermediaries in overall assets of the financial sector amounted to 12.7%, which is by 0.2 percentage points less compared to the previous year.

At the end of 2014, 19 micro-credit organizations (MCO) operated in BH, of which 15 micro-credit foundations (MCF) and four micro-credit companies (MCC). During 2014, two MCOs lost their operating licences, while one new MCO started its operations. Overall assets of the micro-credit sector are by 3.4% lower compared to 2013, primarily due to cessation of two MCOs and a significant shrinking of operations volume of a large MCO. MCO credit portfolio is by 2.6% lower than in the previous year, mostly due to reduction of an MCO's credit portfolio. Also, several small MCOs still recorded credit portfolio decline. Liquidity risk becomes increasingly prominent for small MCOs that were denied creditors' trust, especially in view of the fact that a significant amount of loans in these MCOs' liabilities matures by the end of 2015.

Loan loss provisions almost tripled compared to the previous year (from BAM 8 million at the end of 2013 to BAM 21 million at the end of 2014), whereas drastic quality deterioration of an MCO's assets exerted key influence on worsening of asset quality indicators. Other MCOs did not record any substantial asset quality deterioration in 2014. Off-balance records, mostly comprised of written-off claims were by 6.7% higher than in the previous year and currently account for 40.9% of the credit portfolio and their share is continuously growing.

The trend of decreasing MCO liabilities continued through 2014, and thus loan liabilities dropped by 2.2 %, with decrease of long-term loan liabilities by 2.0% compared to the previous year. The continued trend of decreasing investments in MCO sector indicates that investors display high degree of hesitation and prudence in lending to this sector. Graph 6.5 illustrates the trend in investments of major creditors in the MCO sector in 2013 and 2014.

Graph 6.5: Main Creditors to MCO Sector



Source: FBA and BARS

Downward trend in investments compared to last year is noticeable in most major creditors. Due to lower investments, many small MCOs are faced with lack of funds for financing of credit activity and are unable to generate sufficient income from regular operations.

In 2014, MCO sector achieved negative financial result of BAM 26.9 million, caused by substantial business losses stated by an MCO. With the exception of another small MCO, which stated minor loss, other microcredit institutions recorded positive financial result. Interest income recorded 16.9% decrease, primarily due to a decline in the level of approved loans, but partly also due to reduction of interest rates on long-term and short-term loans. Small MCOs that are facing credit portfolio decrease and thus decrease of interest income as well recorded positive financial result, due to rise in extraordinary revenues based on collection of write-offs, which they used to compensate for the lack of income from regular operations. MCOs continued decreasing effective interest rates on micro loans, but they are still very high due to high operating costs and high prices of capital used to finance the credit portfolio (average weighted effective interest rate on total loans in the fourth quarter of 2014 in FBH amounted to 24.1%, and 20.4% in the RS). In order to protect clients of microcredit organizations, in the coming periods, supervisors will focus, among other things, on control and justification of operating costs of MCOs that exert significant influence on interest rate forming in the MCO sector.

Operating expenses of the sector, mostly comprised of costs of wages and contributions are by 6% lower than in 2013, but they are still very high, although the number of employees in the MCO sector dropped by 5.1%.

Overall capital of the sector recorded a 6.3% decrease compared to the previous year, due to substantial operating loss of an MCO. Most other MCOs recorded capital increase, mostly caused by higher profit than in the previous year.

Of the total amount of micro loans, 98.1% was approved to physical persons, the largest portion (36.8%) of which was approved for financing the agriculture sector. In view of the sectorial structure of extended loans, after the natural disasters that affected a large area of BH in May 2014, deterioration in the quality of MCO credit portfolio can be expected in the period ahead.

Constant decline of balance sheet sum, decrease in demand for loans and limited availability of financing sources for some MCOs indicate the need for consolidation of this sector, which would lead to establishment of a small number of stronger and sounder MCOs. Main consolidation goal is strengthening the capital base, stability and quality of the institutions' portfolios, in order to ensure better accessibility of funding, regain investors' trust and enable provision of more favourable and better-quality services to clients.

Due to significant drop in the number and value of concluded leasing agreements, write off of a portion of the existing claims and withdrawal of a leasing company's operating licence, leasing companies recorded balance sheet sum decrease by 14.3% compared to the previous year (Table 6.1). At the end of 2014, 7 leasing companies had operating licences. In the structure of total assets, financial facilities constitute the most significant item in the balance sheet of leasing companies. Financial leasing accounts for 88.8% of the value of newly approved leasing agreements, and operative leasing for the remaining 11.2%. Total receivables based on financial leasing, which account for 65.5% of overall assets, were decreased by 13% compared to the previous year.

Leasing sector achieved negative financial result in 2014 as well. The recorded loss in the amount of BAM 14.2 million mostly resulted from inadequate business practices in the previous periods that led to deterioration in the quality of leasing claims, and the negative financial result influenced the drop in assets and decrease of overall capital of leasing companies. Leasing companies are still faced with difficulties in collection of due receivables, and consequences of slow recovery of the real sector will continue affecting operations of leasing companies in the coming period as well.

Insurance market is the best developed segment of the non-banking sector. Still, compared to surrounding countries, and especially the developed ones, the structure of this market is still underdeveloped, which is also illustrated by low premium share in overall BH's GDP of only 2%. Low level of available income of the majority of population, citizens unaccustomed to use other available types of insurance, apart from mandatory insurance, and insufficiently developed awareness and knowledge among population and in the economy about the necessity of obtaining other types of voluntary insurance largely influence the under-development of the insurance industry.

Although the insurance sector continued recording premium growth in 2014, compared to other countries in the region, BH has the lowest premium per capita of BAM 137[31]. Total premium at the end of 2014 amounted to BAM 562.1 million, which is an increase by 6.6% compared to the same period last year. Of the total calculated premium, 79.6%, or BAM 447.6 million was related to non-life insurance, and the largest share in total insurance premium accounts for car liability insurance (47.7%). The calculated premium for life insurance amounted to BAM 114.5 million, thus continuing the upward trend of the share in the total premium, which reached 20.4% from the previous 18.9%. Although 2014 also recorded an increase of the life insurance premium (7.3%) and of its share in total insurance premium, poor representation of voluntary insurance types is another indicator

31 Source: BH Insurance Agency

of under-development of the insurance market in BH and one of the main risks in this sector. The total gross paid damages amounted to BAM 249.6 million and accounted for 44.4% of the total calculated premium.

According to CBBH data, insurance companies held 39.5% of total assets on accounts with commercial banks in different deposit forms at the end of 2014. This is primarily caused by conservative investment policy of insurance companies, but also by limited investment opportunities on domestic capital markets. Also, laws and regulations stipulate that insurance companies must hold a part of the guarantee fund on accounts with commercial banks in the form of deposits. Also, analyses conducted within the FSAP mission identified significant exposure of the insurance sector to commercial banks in BH. In case the risks identified in the banking sector materialised, high concentration of exposure could result in significant losses in the insurance sector as well.

In 2014, 34 investment funds had operating licences, of which 18 in FBH and 16 in the RS. Value of investment funds' assets in 2014 recorded growth by 4.4% compared to the end of last year and amounted to BAM 810 million.

Investment potential of domestic capital markets is very limited, and the development level is fairly low. There are several problems that influence functioning of the capital market, such as illiquidity and limited trading instruments, insignificant number of investors, market fragmentation, incompatible regulations, insufficient public securities offers and alike. All of the above causes inefficiency in performing its basic function i.e. matching of capital-deficient and capital adequate entities. These problems also existed in the past, but they were further accentuated upon breakout of the financial crisis. Efficient capital markets offer an alternative when it comes to sources of financing and investments and belong to the most important indicators of general state of affairs in economy. However, capital market in BH never became an alternative to the banking market, which is why the financial system is still very bank-centric. Issues of new securities are not on a satisfying level, especially issues of shares for the purpose of financing new projects and development of business entities' operations. Interest of business entities in obtaining additional capital by issuing shares is insufficient, while the investment demand is very limited at the same time. Debt instruments have no significant role in financing either, due to under-development of real economy sector and business entities themselves that practically have no knowledge about this form of financing. Business entities primarily rely on financing through loans with commercial banks and insufficiently use capital market as the source of financing and business development. In the past few years, domestic capital market recorded issues of Entity bonds, first based on wartime debt and pre-war foreign currency savings, and then due to the need for budget deficit financing, as well as issues of FBH and RS treasury bills and bonds. These very debt instruments maintain to large extent liquidity on Sarajevo and Banja Luka Stock Exchanges and account for a substantial part of generated turnover. When it comes to turnover on the securities market, 2014 was characterised by increase of total turnover, including the value of debt securities issues. Sarajevo Stock Exchange generated total turnover of BAM 618.9 million and 16 primary issues in the total amount of BAM 379.2 million were completed. Total turnover on the Banja Luka Stock Exchange in 2014 amounted to BAM 586.6 million with 14 primary issues.

7. FINANCIAL INFRASTRUCTURE

7.1 Payment Systems

In 2014, the CBBH continued successfully supporting the payment system functions through up-to-date calculation systems and payment systems for performance of interbank payment transactions, in line with its legal obligation. In 2014, CBBH's payment systems recorded increase in number and value of transactions. The total number of transactions in interbank payment system went up by 5.9%, whereas the total value of transactions rose by 14.9% compared to the previous year (Table 7.1). Increase in the value of transactions mostly accounts for an increase through the real time gross settlement system, RTGS. The increase in the value of transactions in 2014 resulted in faster circulation of money in economy, and thus the number of days required to perform transactions in the value of annual nominal GDP also went down. Although the number of interbank transactions continuously rises, the majority of payments are still performed within the banks (61% of the total number of transactions).

Concentration of the total number and value of interbank transactions in payment transactions is illustrated by Herfindahl-Hirschman Index (HHI)[32]. Table 7.2 shows values of the index calculated on the basis of data about total number and amount of interbank transactions for all participants, in both payment systems (RTGS and gyro clearing). When the calculation includes all banks in the system, concentration of transactions measured by the HHI index does not point to existence of systemic risks in payment systems. Given that a large number of small banks operate on the BH market, the same analysis was also conducted for ten banks with the highest share in total value of interbank transactions. Values of HHI index are much higher and indicate moderate concentration of interbank payment transactions i.e. the fact that the majority of interbank payments take place between a small number of large banks.

Table 7.1: Payment System

Year	Total Number of Transactions, in Millions	Total Turnover, BAM Million	Average Daily Turnover, BAM Million	GDP/ Average Daily Turnover
2005	22.9	36,195	140.3	122
2006	24.9	47,728	185.0	104
2007	28.4	60,193	234.2	93
2008	29.6	70,345	272.7	91
2009	29.0	64,458	251.8	95
2010	31.8	67,779	263.7	94
2011	32.5	76,653	298.3	87
2012	33.8	81,533	318.5	81
2013	35.8	76,605	298.1	88
2014	37.9	87,859	341.9	79

Source: CBBH

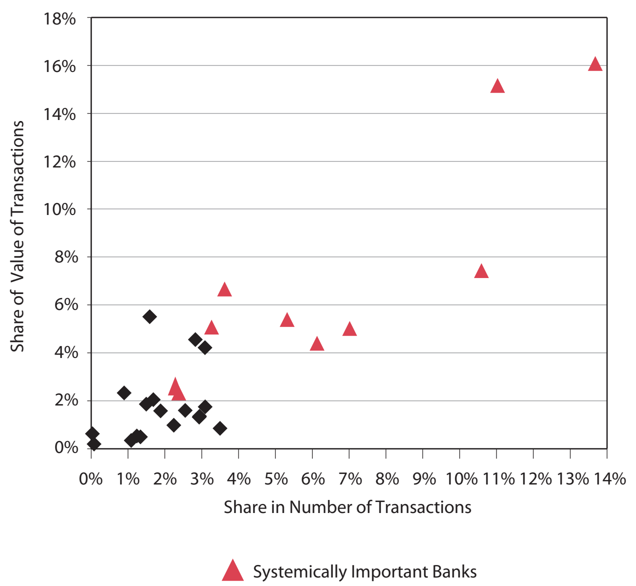
Table 7.2 Concentration of Transactions in Interbank Payment System (HHI)

Period	All Banks		10 Banks with the Largest Shares	
	Number of Transactions	Value of Transactions	Number of Transactions	Value of Transactions
December 2008	693	908	1,271	1,381
December 2009	651	989	1,233	1,413
December 2010	651	903	1,256	1,346
December 2011	626	836	1,230	1,287
December 2012	638	844	1,278	1,295
December 2013	654	810	1,337	1,378
December 2014	660	778	1,350	1,310

Source: CBBH

Graph 7.1 illustrates banks' share in the total number and value of interbank transactions for December 2014. Systemically important banks have dominant shares in the total value and the number of interbank transactions (69.3% and 65.5% respectively). The top five banks with the highest share account for 50.4% of the total value of payment transactions in 2014.

Graph 7.1 : Share of Banks in International Payments System in 2014



Source: CBBH

32 HHI is a concentration measure. It is calculated by summing the squared individual shares in the observed segment. Index below 1,000 points indicates non-concentration, 1,000 – 1,800 points indicate moderate concentration, and index above 1,800 points indicates high concentration.

In 2014, CBBH continued maintaining the Central Registry of Credits (CRC) and the Single Registry of Transaction Accounts (SRTA). By maintaining the Central Registry of Credits and providing its users with the opportunity to access the data updated on a daily basis, the CBBH contributes to the country's financial stability. Data on placements in CRC were updated by commercial banks, microcredit organizations, leasing companies and other institutions during 2014. The data updated on a daily basis contribute to the quality of loan application processing and enable adequate tracking of clients' credit history and, by providing insight in the client's actual exposure at the time of loan approval, reduce risks from approving non-performing loans. In 2014, the CBBH continued the process of continuous improvement of CRC database quality. Also, the CBBH continued maintaining the single registry of transaction accounts and the single database of all blocked accounts of business entities in BH. The list of blocked accounts of business entities is posted and updated on a monthly basis on the CBBH website. By announcing the list of blocked accounts, the CBBH enables all business entities to gain insight in the status of their current or potential business partners.

7.2 Regulatory Framework

Development of the regulatory framework for operations of the financial sector in BH continued during 2014 and the first half of 2015. What follows is an overview of the most important activities of relevant institutions on harmonisation of BH regulations with the best European practices, aiming at improvement of the environment for operations of financial intermediaries and directly preserving financial stability.

In support to the preservation of integrity and stability of financial markets, the Law on the Prevention of Money Laundering and Financing of Terrorism was adopted in June 2014. Only with the adoption of amendments to the BH Criminal Code in May 2015, criminal legislation in BH was harmonised with the international law and recommendations of GRECO, MONEYVAL Committee and FATF, the international body tasked with monitoring of measures for the prevention of money laundering and terrorism financing. The amendments, among other things, defined the obligation to seize property gain obtained through a criminal offence, not only from the offence perpetrator but also from persons to whom the property was transferred, and the law regulates in details all actions and omissions that occur while an authorised official performs their duty.

In 2014, Entity Banking Agencies continued upgrading the regulatory framework, in order to harmonise it with the Global Regulatory Framework for More Resilient Banks and Banking Systems[33] which, together with the International Framework for Liquidity Risk Measurement, Standards and Monitoring[34] constitutes reforms within Basel III related to strengthening of global capital and liquidity. Both Banking Agencies thus adopted new Decisions on Minimum Standards for Capital Management and Capital Protection of Banks mid - 2014, introducing an innovated concept of regulatory capital against the existing legal and regulatory framework, provisions of which are described in greater details in Text Box 4.

Text Box 4: Upgrading of the Regulatory Framework in the Capital Management Segment

The main characteristics of the new regulatory capital concept are reflected in the harmonisation with the international regulatory capital concept (Basel III); substantial improvement of the regulatory capital quantity and quality; introduction of a specific type of protective capital layers; introduction of additional and simple capital protection by prescribing requirements in terms of maintaining the financial leverage rate; restricting the distribution of bank's earnings if the protective capital layers are below the prescribed levels and appreciating the need to supervise banks in terms of recognizing core capital and Tier II capital items, in order to include in the core capital calculation items that are unconditionally, completely and without limitation available to cover loss at any time, and to define more precisely requirements for recognition of Tier II capital items.

According to the aforementioned decisions, banks are to allocate from the core capital that exceeds 6% of the amount of total risk weighted assets and for sufficient loss coverage the following:

a) preventive protection from increased losses that may occur during a crisis, i.e. at times of financial and economic stress, in the amount of 2.5% of the total asset risk (protective layer for capital preservation);

b) counter-cyclical protection (counter-cyclical protective capital layer), which can be prescribed by the Agencies by a separate decision, if needed; and

c) protection against systemic risk (protective capital layer for systemic risk), which can be prescribed by the Agencies by a separate decision.

Banks should meet the requirements pertaining to protective capital layers by the end of 2016 at the latest (protective layer for capital preservation), i.e. in a timeframe that can be prescribed by the Agencies by a separate decision (counter-cyclical or protective capital layer for systemic risk).

Apart from the protective capital layers, as the additional safety and simple capital protection, banks are also to maintain the financial leverage rate from the end of 2015, which, for a calendar quarter, is equal to simple arithmetic average ratio of the core capital amount and total risk exposure amount[1] of a bank on the last calendar day of a month, in the minimum amount of 6%.

1 Total risk exposure of a bank is a sum of the following amounts:

a) total balance sheet assets (gross book value) deducted by the amount of formed value corrections of balance sheet assets value and the amount of core capital debit items (book value amount of own (treasury) shares in the bank's possession; the amount of intangible assets in accordance with the applicable accounting framework and the amount of deferred tax assets); and

b) total off-balance sheet items that are classified, deducted by loss provisions on off-balance items and increased by 10% of the amount of potential liabilities on approved and unused loans that include the agreed bank's clause on unconditional cancellation at any time, without previous notice.

33 Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010

34 Basel III: International framework for liquidity risk measurement, standards and monitoring, December 2010

Also, calculation of net capital and capital adequacy should be harmonised with new provisions pertaining to general characteristics of acceptable core capital and Tier II capital items, as well as restrictions on the amount and conditions for recognition of Tier II capital items.

In accordance with new decisions, core capital calculation may only include items that are unconditionally, completely and without limitation available at any time to absorb losses, and are subject to all bank's liabilities reduced by regulatory adjustments. The Tier II capital amount may include the amount of general loan loss provisions for assets classified in category A, up to 1.625% maximum of overall asset risk, starting from the end of 2015, and maximum up to 1.25% of overall asset risk from the end of 2016. The subordinated debt amount that is included in the bank's Tier II capital in the last five years before the expiry of the agreed maturity period shall be reduced by 20% cumulative annual deduction from its value as of the date of Tier II capital calculation, whereas the subordinated debt shall not be included in Tier II capital in the final year before expiry of the agreed maturity period. Banks are to start implementing this provision from the end of 2015. Calculation of Tier II capital also includes the amount of positive revalorisation reserves based on effects of changes in the fair value of assets, deducted by tax liability effects, whereas banks are to decrease on a quarterly basis the found revalorisation reserve amount stated based on the fair value effects of tangible assets before the entry into force of the decisions, until the final harmonisation date at the end of 2016.

For the purpose of capital adequacy calculation as of the end of 2015/2016, maximum Tier II capital amount shall be up to the amount of one half/one third of the core capital, whereas the minimum core capital rate is set at 8% and 9% respectively against overall assets risk. According to the existing regulations, in calculating capital adequacy, banks are allowed to include in the net capital amount the amount of Tier II capital up to the core capital amount.

In 2014, activities were continued on drafting of new laws on banks that will be harmonised with the EU directives, recognising the specificities of BH legal framework. For the purposes of drafting the laws, IMF provided technical assistance, and an inter-institutional working group was established, which includes representatives of the Banking Agencies, Entity Ministries of Finance, Deposit Insurance Agency and the CBBH.

During 2014, the RS Banking Agency prolonged once again the validity of provisional measures for rescheduling of loan liabilities of physical and legal entities in banks until the end of 2015, in order to make it easier for debtors to repay their liabilities under the conditions of weak economic recovery.[35]

In June 2015, the FBH Law on Internal Payment Transactions was adopted[36] with the main purpose of improving and harmonising the legal framework regulating the payments system with the international standards. The new Law will also regulate and improve the forced collection process by determining the main account of a business entity that shall be used for all forced collection orders. In case the debtor lacks funds to repay its debts, the bank that maintains the main account shall submit a request for blocking of all debtor's accounts with authorised institutions until final settlement of the debt. During the process of improving the payment transaction system by the end of June 2015, establishment of the Financial and IT Agency (FIA) by the Law on the Financial and IT Agency has been planned, which will be in charge of maintaining the public registry of financial statements. With the establishment of FIA, the Agency for Financial, IT and Intermediary Services d.d. Sarajevo (AFIP) and the Agency for the Provision of IT and Intermediary Services from Mostar (FIP) shall cease their operations.

The FBH draft insurance law was sent for a public debate in mid-2014. The draft law regulates more clearly operations of insurance companies and introduces more efficient supervision of the insurance sector by defining the roles, powers and responsibilities of the FBIH FBH Insurance Supervisory Agency, which is a necessary precondition for proper functioning and further development of the insurance market. Additional legal norms were introduced for supervision of groups and related financial market entities that influence the financial position of insurance companies, as well as the financial reporting rules. Also, the RS Government developed the draft Law on Compulsory Insurance in Traffic at the beginning of 2015, in order to deregulate and liberalise prices of compulsory car liability insurance.

The FBH draft Law on Factoring was also adopted in 2014, in order to provide adequate legislation for regulation and further development of factoring deals in FBH. This is the first law in BH that regulates this field, and with the enactment of the Law on Companies, conditions will be created for more efficient collection of claims, which is especially important for small and medium enterprises faced with liquidity problems.

The RS National Assembly adopted the Law on Single System for Multilateral Compensation and Cession in 2014. Aimed to increase liquidity and reduce the internal debt, the Law prescribes compulsory multilateral compensation and the possibility to implement bilateral and multilateral cessions and sell claims through a single system maintained by the Banja Luka Stock Exchange. All participants in the system, including companies, Government units and financial institutions are to report all due and uncontested cash liabilities they have toward other participants.

At the beginning of 2015, the Law on Amendments to the Law on Direct Foreign Investment Policy in BH was passed, in order to provide better legal certainty and improve and simplify the process of direct foreign investment inflows. With the above Amendments, key areas of the Law on Direct Foreign Investment Policy were harmonised with the best international practices, which will contribute to stronger competitiveness of the country by improving the business environment and investment climate and thus attracting new investments in the country.

35 The Decision on provisional measures for rescheduling of loan liabilities of physical and legal entities in FBH was not prolonged, and it was in force until 31 December 2014.

36 The RS Law on Internal Payment Transactions was passed mid - 2012.

Although the Standing Committee for Financial Stability (SCFS) is not an institutional body[37], and is unable to pose a legal requirement on behalf of any member or third parties, by implementing the assessment of financial stability threats and providing several recommendations, it contributes to the preservation of BH financial system.

In 2014 and in the first half of 2015, SCFS held regular meetings, discussing extraordinary topics related to current state of affairs in the financial sector, in addition to standard information about the situation in the financial sector. Following the floods in BH in May 2014, SCFS issued a proposal for potential measures in the financial sector that may help clients in the areas affected by the natural disaster, based on which the Entity Banking Agencies made adequate decisions in a timely manner. In December 2014, the Comprehensive Action Plan for Crisis Situations was adopted, which includes a set of measures and actions that are to be taken by relevant institutions, SCFS members, in order to act preventively and avoid crisis situations, and to manage and act in crisis situations. In January 2015, the problem of debt servicing by clients with CHF loans was also discussed, due to significant and unforeseen CHF exchange rate increase. In view of the fact that CHF loans in BH were mostly approved by banks from Hypo Alpe Adria Group, SCFS recommended Hypo Alpe Adria banks in both BH Entities to offer solutions that would be acceptable to clients with these loans.

37 SCFS was established in 2009 based on the Memorandum of Understanding between the MFT, Entity Ministries of Finance, Entity Banking Agencies, DIA and the CBBH, in order to assess financial stability threats and act in the event of a systemic crisis.

Statistical Appendix

Table A1: Changes of Sovereign Rating

Country	Date of Change	Standard & Poor's Rating		
		Long-term	Outlook	Short-term
Greece	until 2009	A	Stable	A-1
	09.01.2009	A	Negative, Watch	A-1
	14.01.2009	A	Stable	A-2
	07.12.2009	A	Negative, Watch	A-2
	16.12.2009	BBB+	Negative, Watch	A-2
	16.03.2010	BBB+	Negative	A-2
	27.04.2010	BB+	Negative	B
	02.12.2010	BB+	Negative, Watch	BB+
	29.03.2011	BB-	Negative, Watch	B
	09.05.2011	B	Negative, Watch	C
	13.06.2011	CCC	Negative	C
	27.07.2011	CC	Negative	C
	05.02.2012	CCC	Stable	C
	27.02.2012	SD	NM	SD
	02.05.2012	CCC	Stable	C
	07.08.2012	CCC	Negative	C
	05.12.2012	SD	-	SD
	18.12.2012	B-	Stable	B
	28.01.2015	B-	Negative, Watch	B
	15.04.2015	CCC+	Negative	C
Ireland	until 2009	AAA	Stable	A-1+
	09.01.2009	AAA	Negative	A-1+
	30.03.2009	AA+	Negative	A-1+
	08.06.2009	AA	Negative	A-1+
	24.08.2010	AA-	Negative	A-1+
	23.11.2010	A	Negative, Watch	A-1
	02.02.2011	A-	Negative, Watch	A-2
	01.04.2011	BBB+	Stable	A-2
	05.12.2011	BBB+	Negative, Watch	A-2
	13.01.2012	BBB+	Negative	A-2
	11.02.2013	BBB+	Stabilan	A-2
	12.07.2013	BBB+	Positive	A-2
	06.06.2014	A-	Positive	A-2
	05.12.2014	A	Stable	A-1
Portugal	until 2009	AA-	Stable	A-1+
	13.01.2009	AA-	Negative, Watch	A-1+
	21.01.2009	A+	Stable	A-1
	07.10.2009	A+	Negative	A-1
	27.04.2010	A-	Negative	A-2
	30.11.2010	A-	Negative, Watch	A-2
	24.03.2011	BBB	Negative, Watch	A-2
	29.03.2011	BBB-	Negative	A-3
	05.12.2011	BBB-	Negative, Watch	A-3
	13.01.2012	BB	Negative	B
	06.03.2013	BB	Stable	B
	05.07.2013	BB	Negative	B
	09.05.2014	BB	Stable	B
	20.03.2015	BB	Positive	B

Spain	until 2009	AAA	Stable	A-1+
	12.01.2009	AAA	Negative, Watch	A-1+
	19.01.2009	AA+	Stable	A-1+
	09.12.2009	AA+	Negative	A-1+
	28.04.2010	AA	Negative	A-1+
	05.12.2011	AA-	Negative, Watch	A-1+
	13.01.2012	A	Negative	A-1
	26.04.2012	BBB+	Negative	A-2
	10.10.2012	BBB-	Negative	A-3
	23.05.2014	BBB	Stable	A-2
Italy	until 2009	A+	Stable	A-1+
	20.05.2011	A+	Negative	A-1+
	20.09.2011	A	Negative	A-1
	05.12.2011	A	Negative, Watch	A-1
	13.01.2012	BBB+	Negative	A-2
	09.07.2013	BBB	Negative	A-2
	05.12.2014	BBB-	Stable	A-3
Cyprus	until 2009	A+	Stable	A-1
	21.07.2010	A+	Negative, Watch	A-1
	16.11.2010	A	Negative	A-1
	30.03.2011	A-	Negative	A-2
	29.07.2011	BBB	Negative, Watch	A-2
	12.08.2011	BBB+	Negative, Watch	A-2
	27.10.2011	BBB	Negative, Watch	A-3
	13.01.2012	BB+	Negative	B
	01.08.2012	BB	Negative, Watch	B
	17.10.2012	B	Negative, Watch	B
	20.12.2012	CCC+	Negative	C
	21.03.2013	CCC	Negative	C
	10.04.2013	CCC	Stable	C
	28.06.2013	SD	-	SD
	03.07.2013	CCC+	Stable	C
	29.11.2013	CCC+	Stable	B
	25.04.2014	B	Positive	B
	24.10.2014	B+	Stable	B
	27.03.2015	B+	Positive	B

Source: Standard & Poor’s

Table A2: Real Estate Price Index

		Sarajevo	Mostar	Zenica	Tuzla	**TOTAL**
2004	Q1	47	84	60		**52**
	Q2	47	81	59		**51**
	Q3	47	82	60		**51**
	Q4	48	80	59		**52**
2005	Q1	49	79	61		**53**
	Q2	49	81	60		**52**
	Q3	50	79	60		**53**
	Q4	52	82	64		**56**
2006	Q1	54	84	67		**59**
	Q2	59	84	63		**62**
	Q3	58	82	66		**62**
	Q4	63	71	71		**65**
2007	Q1	69	85	72		**71**
	Q2	77	90	88		**79**
	Q3	85	86	92		**86**
	Q4	94	92	95		**94**
2008	Q1	100	100	100	100	**100**
	Q2	105	99	107	104	**105**
	Q3	103	102	113	114	**105**
	Q4	109	104	126	117	**110**
2009	Q1	99	120	129	102	**102**
	Q2	96	125	127	105	**101**
	Q3	91	124	128	114	**99**
	Q4	89	127	119	121	**97**
2010	Q1	88	119	130	119	**96**
	Q2	86	128	129	126	**98**
	Q3	85	120	126	112	**94**
	Q4	84	126	143	120	**94**
2011	Q1	83	125	138	113	**93**
	Q2	84	121	140	93	**92**
	Q3	82	118	132	102	**92**
	Q4	83	124	131	107	**92**
2012	Q1	84	132	130	111	**94**
	Q2	82	117	139	105	**93**
	Q3	80	124	122	103	**89**
	Q4	78	120	133	104	**88**
2013	Q1	81	128	135	113	**91**
	Q2	78	127	134	113	**90**
	Q3	79	124	124	116	**90**
	Q4	76	130	136	101	**88**
2014	Q1	78	121	126	104	**88**
	Q2	77	119	124	104	**86**
	Q3	77	111	126	106	**86**
	Q4	77	113	129	103	**85**

Source: CBBH

Table 3: Largest Debtors per Conventional Loans BAM thousand

Sector	Loans, Outstanding Balance	Share in the Sector	Share in the Total Claims
A: Agriculture, Forestry and Fishing	**167,119**		**2.4%**
Forestry and Logging			
Silviculture and other Forestry Activities	20,720	12.4%	0.3%
Plant and Cattle Production, Hunting and Related Service Activities, of which:			
Poultry Farming	20,664	12.4%	0.3%
B: Mining and Quarrying	**151,205**		**2.2%**
Mining of Coal and Lignite, of which:			
Mining of Lignite	35,331	23.4%	0.5%
C: Manufacturing Industry	**1,564,576**		**22.8%**
Production of Beverages, of which:			
Beer Production	63,317	4.0%	0.9%
Production of Food, of which:			
Production of Bread; Fresh Rolls and Cakes	62,956	4.0%	0.9%
Production of Milk, Milk Products and Cheese	45,847	2.9%	0.7%
Other Manufacturing and Preservation of Fruits and Vegetables	34,716	2.2%	
Manufacture of Wood and Products of Wood and Cork, except for Furniture; Production of Items of Straw and Wicker, of which:			
Sawing and Planing of Wood (Manufacture of Sawn Timber); Wood Impregnation	81,874	5.2%	1.2%
Production of Finished Metal Products, except for Machines and Equipment, of which:			
Production of Metal Structures and their Parts	55,690	3.6%	0.8%
D: Production and Supply of Electricity, Gas, Steam and Air Conditioning	**162,926**		**2.4%**
Production and Supply of Electricity, Gas, Steam and Air Conditioning, of which:			
Production and Supply of Steam and Air Conditioning	58,096	35.7%	0.8%
E: Water Supply, Sewerage, Waste Management and Environment Remedial Activities	**59,515**		**0.9%**
Water Collection, Treatment and Supply, of which:			
Water Collection, Treatment and Supply	16,863	28.3%	0.2%
F: Construction	**518,127**		**7.5%**
Civil Engineering Construction, of which:			
Construction of Roads and Highways	195,260	37.7%	2.8%
G: Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles	**1,994,383**		**29.0%**
Wholesale, except for Trade in Motor Vehicles and Motorcycles, of which:			
Non-specialized Wholesale	322,620	16.2%	4.7%
Wholesale of Solid, Liquid and Gas Fuels and Similar Products	48,548	2.4%	0.7%
Wholesale of Pharmaceutical Products	77,761	3.9%	1.1%
Wholesale of Wood, Construction Materials and Sanitary Equipment	58,183	2.9%	0.8%
Wholesale of other Household Goods	37,510	1.9%	0.5%
Non-specialized Wholesale of Food, Beverages and Tobacco Products	68,002	3.4%	1.0%
Wholesale Trade of Metal Products, Installation Materials, Devices and Equipment for Water Supply System and Heating	47,304	2.4%	0.7%
Retail Trade, except for Trade in Motor Vehicles and Motorcycles, of which:			
Retail Trade in Non-specialized Stores Mainly in Food, Beverages and Tobacco Products	154,182	7.7%	2.2%
Other Retail Trade in Non-specialized Stores	87,162	4.4%	1.3%
Retail Trade in Motor Fuels in Specialized Stores	47,075	2.4%	0.7%
H: Transportation and Warehousing	**295,155**		**4.3%**
Land Transport and Transport via Pipelines			
Freight Transport by Road	86,668	29.4%	1.3%
Passenger and Freight Rail Transport	62,810	21.3%	0.9%

I: Accommodation and Food Service Activities (Hotels and Catering)	**169,546**		**2.5%**
Accommodation, of which:			
Hotels and Similar	93,238	55.0%	1.4%
J: Information and Communications	**125,881**		**1.8%**
Broadcasting, of which:			
Television Broadcasting	37,658	29.9%	0.5%
K: Financial and Insurance Activities	**205,092**		**3.0%**
Other Financial Service Activities, except for Insurance and Pension Funds, of which:			
Other Lending Mediation	22,707	11.1%	0.3%
Financial Intermediation, of which:			
Other Financial Intermediation	44,701	21.8%	0.7%
L: Real Estate Business	**172,359**		**2.5%**
Real Estate Business, of which:			
Renting and Management of own or Leased Real Estate	87,721	50.9%	1.3%
Real Estate Management on a Fee or Contract Basis	41,523	24.1%	0.6%
Agency for Real Estate Business	19,152	11.1%	0.3%
M: Professional, Scientific and Technical Activities	**262,441**		**3.8%**
Veterinary Activities			
Veterinary Activities	53,220	20.3%	0.8%
Architecture and Engineering Activities; Technical Testing and Analysis, of which:			
Architecture Activities	44,579	17.0%	0.6%
Scientific Research and Development			
Other Research and Experimental Development in Natural, Technical and Technological Sciences	23,518	9.0%	0.3%
N: Administrative and Support Service Acitivities	**36,716**		**0.5%**
Travel Agencies,Travel Organizers, Tour Operators and other Booking Services and Related Activities, of which:			
Activities of Travel Agencies	7,674	20.9%	0.1%
Security and Investigation Activities			
Private Security Activities	7,319	19.9%	0.1%
O: Public Administration and Defence; Compulsory Social Insurance	**816,649**		**11.9%**
Public Administration, and Economic and Social Policy of Community, of which:			
General Activities of Public Administration	476,990	58.4%	6.9%
Activities of Compulsory Social Insurance, of which:			
Activities of Compulsory Social Insurance	71,657	8.8%	1.0%
P: Education	**33,133**		**0.5%**
Higher Education			
Higher Education	19,546	59.0%	0.3%
Q: Activities of Health Care and Social Care	**87,139**		**1.3%**
Health Care Activities			
Hospital Activities	42,675	49.0%	0.6%
R: Art, Entertainment and Recreation	**17,861**		**0.3%**
Gambling and Betting			
Gambling and Betting	9,797	54.9%	0.1%
S: Other Service Activities	**26,761**		**0.4%**
Other Personal Service Activities			
Other Personal Service Activities, not classified elsewhere	3,881	14.5%	0.1%
T: Activities of Households as Employers; Activities of Households Producing Various Goods and Performing Various Services for Own Needs	**141**		**0.0%**
Activities of Households Producing Various Goods for their own Needs			
Activities of Households Producing Various Goods for their own Needs	126	92.3%	0.0%
U: Activities of Extraterritorial Organizations and Bodies	**4,754**		**0.1%**
Activities of Extraterritorial Organizations and Bodies			
Activities of Extraterritorial Organizations and Bodies	4,571	96.2%	0.1%

Source: CRC

Table A4: Claims on Companies by Type and Activities — in BAM thousand

	Loans							Potential Debt		
		out of wich Commitment Loans	Commission Loans	Revolving Loans	Letters of Credit	Factoring	Guarantees	Guarantees	Revolving Loans	Overall Loans
A	167,119	46,747	6,955	33,520	0	0	723	3,473	15,250	7,140
B	151,205	24,174	7,501	31,177	0	0	169	9,086	7,370	7,363
C	1,564,576	861,208	38,697	489,565	8,705	1	14,283	199,102	153,617	208,768
D	162,926	12,737	0	16,939	1,994	0	7	11,935	4,423	4,562
E	59,515	23,823	84	19,737	0	0	379	8,698	4,558	8,010
F	518,127	364,094	3,384	173,282	1,312	0	9,806	282,156	69,790	125,303
G	1,994,383	1,628,051	10,456	1,015,110	37,089	14	50,219	545,971	379,671	325,171
H	295,155	190,589	5,366	60,316	83	0	8,312	190,559	29,323	39,650
I	169,546	35,643	1,317	14,397	0	0	413	2,497	5,268	30,819
J	125,881	54,787	1,310	28,296	279	0	4,044	34,998	17,587	15,856
K	205,092	27,525	1,745	16,905	0	0	5,851	78,702	14,562	11,571
L	172,359	37,341	1,361	1,333	2,316	987	0	525	921	1,488
M	262,441	186,149	4,831	149,850	0	0	5,680	169,958	43,452	42,372
N	36,716	14,456	50	12,162	0	0	639	7,062	3,165	6,067
O	816,649	0	0	19,719	0	0	0	17,539	34,410	0
P	33,133	2,989	40	1,456	0	0	268	2,414	1,498	333
Q	87,139	14,671	55	5,806	0	0	11	367	3,619	2,421
R	17,861	2,206	181	2,891	0	0	0	5,760	1,263	397
S	26,761	20,954	318	7,783	0	0	58	3,220	3,250	8,312
T	141	20	0	0	0	0	0	0	13	20
U	4,754	1,246	3,211	1,522	0	0	0	275	18	71
TOTAL	**6,871,479**	**3,549,412**	**86,862**	**2,101,766**	**51,778**	**1,002**	**100,861**	**1,574,299**	**793,030**	**845,695**
Actual Debt:	**9,213,748**									
Potential Debt:	**3,213,024**									

Source: CRC
Note: Amount of claims on the basis of Loans and Commission Loans includes the outstanding debt and the due Overdue Principal.

Table A5: Status Changes in Banks

Ref	Bank	Type of Change	Date of Change
1	Sparkasse Bank d.d. Bosnia and Herzegovina Sarajevo	Sparkasse Bank d.d. Sarajevo changed the name	Q3 2014
	Sparkasse Bank d.d. Sarajevo	ABS banka d.d. Sarajevo changed its name	Q3 2009
	ABS banka d.d. Sarajevo	Merged to Steiermaerkische Bank und Sparkassen AG, Erste group	Q4 2006
	Šehin banka dd Zenica	Merged to ABS bank	Q2 2002
2	BBI d.d. Sarajevo		
3	BOR banka d.d. Sarajevo		
4	UniCredit bank d.d. Mostar		
	UniCredit Zagrebačka banka BiH d.d. Mostar	UniCredit Zagrebačka banka BiH changed its name into UniCredit Bank d.d. Mostar	Q1 2008
	Univerzal banka d.d. Sarajevo	Merged to Zagrebačka banka	Q3 2004
	HVB Central profit banka d.d. Sarajevo	HVB Central profit banka Sarajevo merged to UniCredit Zagrebačka banka BiH	Q1 2008
	HVB banka d.d. Sarajevo	HVB banka d.d. Sarajevo changed its name into HVB Central profit banka d.d. Sarajevo	Q4 2004
	Central profit banka d.d. Sarajevo	Merged to HVB banka d.d. Sarajevo	Q4 2004
	Travnička banka d.d. Travnik	Merged to Central profit banka	Q4 2002
5	UniCredit banka a.d. Banja Luka	Nova Banjalučka banka a.d. Banja Luka changed its name	Q2 2008
	Nova Banjalučka banka a.d. Banja Luka	Merged to HVB Central Profit banka, continued its operations as a separate legal entity	Q4 2005
6	Hypo Alpe Adria Bank d.d. Mostar		
7	Hypo Alpe Adria Bank a.d. Banja Luka	Kristal banka Banja Luka changed its name	Q3 2003
8	IKB d.d. Zenica		
9	KIB banka d.d. Velika Kladuša		
10	NLB banka d.d. Tuzla	NLB Tuzlanska banka d.d. Tuzla changed its name	Q1 2012
	NLB Tuzlanska banka d.d. Tuzla	Tuzlanska banka d.d. Tuzla changed its name	Q2 2006
	Comercebank bančna skupina NLB d.d. Sarajevo	Merged to NLB Tuzlanska banka d.d. Tuzla	Q3 2006
11	NLB Razvojna banka a.d. Banja Luka	LHB banka a.d. Banja Luka changed its name	Q2 2006
	Razvojna banka jugoistočne Evrope	Merged to LHB banka	Q2 2006
12	Raiffeisen Bank d.d. BiH, Sarajevo		
	Raiffeisen Bank HPV d.d. Mostar	Merged to Raiffeisen banka d.d. Sarajevo	Q4 2002
13	ProCredit Bank d.d. Sarajevo	Microenterprise bank d.d. Sarajevo changed its name	Q4 2003
14	Privredna banka d.d. Sarajevo	Provisional administration revoked	Q3 2008
15	ZiraatBank BH d.d. Sarajevo	Turkish Ziraat Bank Bosnia d.d. Sarajevo changed its name	Q1 2013
16	Union banka d.d. Sarajevo		
17	Sberbank d.d. Sarajevo	Volksbank d.d. Sarajevo changed its name	Q1 2013
	Volksbank d.d. Sarajevo	Sberbank acquired Volksbank d.d. Sarajevo	Q1 2012
18	Sberbank a.d. Banja Luka	Volksbank a.d. Banja Luka changed its name	Q1 2013
	Volksbank a.d. Banja Luka	Sberbank acquired Volksbank a.d. Banja Luka	Q1 2012
	Zepter banka a.d. Banja Luka	Merged to Volksbank International AG, changed its name to Volksbank a.d. Banja Luka	Q3 2007
19	Intesa Sanpaolo banka d.d. BiH, Sarajevo		
	UPI banka d.d. Sarajevo	UPI banka d.d. Sarajevo changed its name	Q3 2008
	LT Gospodarska banka d.d. Sarajevo	Merged to UPI banka d.d. Sarajevo	Q3 2007
		Merged to Privredna banka Zagreb (PBZ)	Q4 2006
		Gospodarska banka d.d. Sarajevo changed its name to LT Gospodarska banka	Q1 2003
	LT Komercijalna banka d.d. Livno	Merged to Gospodarska banka d.d. Sarajevo	Q1 2003

20	Vakufska banka d.d. Sarajevo		
	Depozitna banka d.d. Sarajevo	Merged to Vakufska banka d.d. Sarajevo	Q2 2002
21	Nova banka a.d. Banja Luka	Nova Banka ad Bijeljina changed its seat	
	Agroprom banka Banja Luka	Merged to Nova banka a.d. Bijeljina	Q1 2003
22	Banka Srpske a.d. Banja Luka	Balkan Investment Bank a.d. Banja Luka changed its name	Q4 2013
	Balkan Investment Bank a.d. Banja Luka	Nationalized	Q2 2013
	Una banka d.d. Bihać	Merged to Balkan Investment Bank Banja Luka	Q4 2010
23	Pavlović banka International Slobomir Bijeljina		
	Privredna banka Brčko	Merged to Pavlović banka	Q4 2002
	Privredna banka Doboj	Merged to Pavlović banka	Q2 2003
24	MOJA banka d.d. Sarajevo	FIMA banka d.d. Sarajevo changed its name	Q4 2010
		VABA banka d.d. Sarajevo changed its name	Q3 2007
25	Komercijalna banka a.d. Banja Luka	Established	Q3 2006
26	MF banka a.d. Banja Luka	IEFK banka changed its name to MF banka a.d. Banja Luka	Q3 2010

	Banks whose licences were revoked:	Date of Change
1	Camelia banka d.d. Bihać	Q1 2002
2	Privredna banka Gradiška	Q2 2002
3	Ekvator banka Banja Luka	Q2 2002
4	International Commercial Bank Bosnia d.d. Sarajevo	Q3 2002
5	Privredna banka Brčko	Q4 2002
6	Banka za jugoistočnu Evropu Banja Luka	Q4 2002
7	Privredna banka S. Sarajevo	Q4 2004
8	Gospodarska banka d.d. Mostar	Q4 2004
9	Ljubljanska banka d.d. Sarajevo	Q3 2006
10	Hercegovačka banka d.d. Mostar	Q3 2012
11	Poštanska banka BiH d.d. Sarajevo	Q2 2013
12	Bobar banka a.d. Bijeljina	Q4 2014

Source: CBBH