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The Trieste Eastern Europe Investment Forum

The role of banking, insurance and finance

DRAFT FOR DISCUSSION

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INTRODUCTION

Paolo Garonna, Franco Delneri, Federica Seganti[1]

This is the third Report on "Investment in South Eastern Europe (SEE)" that we issue based on the contributions provided at the Trieste Eastern Europe Investment Forum. The first Report of 2017 came out when post-crisis Europe was still struggling with a weak uneven and uncertain recovery, while the Brexit process at its early stages and the fledgling regional cooperation program signaled heavy clouds coming to pose a threat to the stability and the sustainability of the economic outlook. (The zero report was made in 2015, but with focus only on the insurance sector). The second Report showed an environment marked by deeper and sharper contrasts and contradictions along the many and interacting coordinates of EU SEE integration: geopolitical, social, institutional, regulatory and economic.

In Part I of this Report we will shortly present the basic performances of the main segments of the financial service sector in the countries of South-Eastern Europe, including Turkey, *plus* Ukraine. After short macroeconomic introduction, financing potential of banks, insurers and other relevant financial institutions will be presented as well as their contribution to financing small and medium business. The data for this publication were collected from the official reports and via the survey of banking and insurance associations, central banks, national statistics offices and financial supervisory authorities in the SEE countries. Database for the previous years, back in 2002, provide the trends, in other words, long-term dynamics of the economy of the SEE region and its particular countries.

The entire Report, Part I and Part II, with Individual Country Reports of *Slovenia, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Greece, Kosovo, Montenegro, North Macedonia, Romania, Serbia, Slovenia, Turkey and Ukraine,* will be available at our web page http://www.febaf.it/trieste-eastern-europe-investment-forum-2019/

The economic outlook in SEE has improved substantially in Europe. The euro area grew in 2018 at the fastest pace in years. There are downside and upside risks, but this momentum is long-lasting. Growth is spreading to all Member States and labor market conditions are improving. One essential growth component is stability in Europe and in the neighboring countries, with a credible enlargement perspective.

On 10 July 2018 the UK hosted the Western Balkans Summit in London to build on the achievements of previous Summits – Berlin (August 2014), Vienna (August 2015), Paris (July 2016), Trieste (2017) – and to progress further in several areas of cooperation. The summit brought together the leaders of the Western Balkans countries and like-minded European partners to increase economic stability, strengthening regional security co-operation to help tackle common threats, encourage political co-operation, to help the region resolve bilateral disputes and overcome legacy issues stemming from the conflicts of the 1990s and strengthen democracy.

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The inclusion of Western Balkans, with a view to consolidate and unite the continent, is a strategic investment in peace, democracy, prosperity, security and stability of Europe as a whole.

History teaches us that a secure and stable Western Balkans means a secure and stable Europe. By contrast, fragility in the Western Balkans holds risks not only for the people of the region but for everyone who calls Europe home. So it is in our shared interest to work together to increase stability and cooperation.

In order for enlargement to remain credible as a policy and EU as a policy actor in the WB region, the way enlargement is run needs to change. We are at the crossroads: process of enlargement will either accelerate until the final goal of new members joining the EU in a foreseeable future or it will lose its purpose.

Basic assumption necessary for the success of the enlargement process is that the EU sincerely wants to accept new members and that the WB sincerely wants to join the EU and fulfil membership criteria. Proposals are mostly directed to the EU institutions and EU member states since they are defining the policy, setting the dynamic and methodology of the process. WB (potential) candidates should fulfil their obligations regarding membership criteria that are already defined and well known, and not to attempt mimicking their fulfilment.

The Belgrade Security Forum, which takes place from 17 to 19 October 2018, focused on these mean topics:

- The EU should boldly implement and reform its enlargement strategy, should demonstrate the political readiness to make enlargement functional, putting it in the center of its policy by devoting resources and funds, as it was the case in the 2004/2007 enlargement. The EC must insist on three crucial conditions that are linked to WB progress towards accession: the respect of the rule of law, further economic and social development and the advancement of regional cooperation.
- Current methodology of accession negotiations became an end in itself and it is questionable whether it could lead to closing the negotiations and membership.
- The EU should, in particular, devote more funds to enlargement to the Western Balkans. This increase would start with the new MFF 2021-2027, with the goal of reaching 2% of individual WB countries' GDP in the year of their accession to the EU. The EU should extend the benefits of its internal market to the region prior to accession as much as possible.
- The EU should guide the WB to gradually redirect public funds from perpetuating economic inefficiencies to supporting investments compatible with the internal market.

A credible enlargement perspective requires sustained efforts and irreversible reforms. European Commission President Jean-Claude Juncker has announced a Western Balkan accession perspective with target of accession in 2025 (although this date may only be indicative).

Banks, Insurances and financial services can play an important role in the process of integration of SEE countries in EU.

Modern developed and sophisticated banking and insurance sectors are required for encouraging domestic production, innovation, investments and trade. Banks, moreover, channeling funds and their other typical financial intermediary activities, in the initial years of transition in these countries, relied on relatively low expertise and made up a tiny share of economic activity. To the other side, insurance companies reduced the investment risk faced by

private sector companies, and the state. Insurance thereby facilitates access and reduces costs of raising the capital needed by firms, particularly small and medium-sized ones. This is especially important in emerging markets, as a shortage of capital is common there and represents one of the major disincentives to investment and economic growth. By reducing the investment risk, insurance can also encourage companies to think more long-term and increase their risk absorption capacity.

The Western Balkans lack infrastructure capacity and investment – particularly in non-traditional sectors such as water, sewerage, waste, health, social affairs and education. Two important regional infrastructure investment initiatives are active in the Western Balkans: the European Western Balkans Investment Framework - WBIF and the Chinese Belt and Road Initiative - BRI. Both are focusing on traditional infrastructure such as energy and transport and both come with a volume of about EUR 8 billion in loans. The European initiative has in addition provided for some EUR 800 million in grants and has an emphasis on Green Economy projects.

Overall infrastructure investment needs in the region are huge. The financial conditions in the area are underdeveloped but improving. Nevertheless, external debt levels have increased substantially since the outbreak of the global financial crisis and thus pose a serious threat to economic stability in a situation when the global interest rates are again on the rise.

The region is quite diverse in terms of the banking sector performance. In some countries is growing rather slowly, lagging behind their peers in Central Europe and even many countries in the euro area, while in others it is much more dynamic.

In addition to the banking and insurance sector, the Forum will discuss the current situation and the challenges and growth opportunities of institutional investors in the region, drawing on skills and prospects of leading local pension funds, private equity experts and capital markets, as well as international asset managers.

The region's financial markets in general and the retail household loan market segment are expected to grow in the long run consistent with the macroeconomic fundamentals of the countries.

This Trieste – FeBAF's Forum aims is to stimulate a debate among all participants and stakeholders and to contribute to change the perspective for a Europe that is often depicted divided and fragmented.

PART I – THE FINANCIAL SERVICE SECTOR IN SOUTH-EASTERN EUROPE ECONOMIES

Safet Kozarevic, Selena Begovic[2]

In Part I we will shortly present the basic performances of the main segments of the financial service sector in the countries of South-Eastern Europe, i.e. Slovenia, Croatia, Bosnia and Herzegovina, Serbia, Montenegro, Kosovo, Albania, North Macedonia, Greece, Romania, Bulgaria, Turkey, *plus* Ukraine. After short macroeconomic introduction, financing potential of banks, insurers and other relevant financial institutions will be presented as well as their contribution to financing small and medium business. The data for this publication were collected from the official reports and via the survey of banking and insurance associations, central banks, national statistics offices and financial supervisory authorities in the SEE countries. Database for the previous years, back in 2002, provide the trends, in other words, long-term dynamics of the economy of the SEE region and its particular countries.

POSITIVE TRENDS IN THE ECONOMIC OUTLOOK OF SOUTH-EASTERN EUROPE IN 2017

At the beginning we are going to briefly overview the basic macroeconomic parameters of the SEE in order to create the context for the research issue, i.e. the financial structures of the SEE region countries. Although the subsequent comparative analysis provides an overview of the basic macroeconomic indicators for the SEE countries over the period 2002-2017, we will put the emphasis on significant changes in the macroeconomic environment in 2017. In that regard, the total GDP for the SEE countries was EUR 1.438,7 billion in 2017 and continued to increase. It needs to be emphasized that Turkey's share in the SEE GDP in 2017 was slightly more than a half (precisely, 52,4% or, in absolute term, EUR 754,0 billion). When we compare the SEE GDP of EUR 1.438,7 billion, to the EU GDP in 2017 of EUR 15.382,6 billion, we can conclude that the SEE countries generate only 9,4% of the EU GDP. The data regarding the total GDP of the particular SEE countries from 2002 to 2017 are presented in Figure 1.

What is most important, all SEE countries registered economic growth in 2017 (see Figure 2). The highest rate of real GDP growth was recorded in Turkey (7,4%), followed by Romania (6,9%), Slovenia (5,0%), and Montenegro (4,4), while other countries had the rate of real GDP growth less than 4%. More specifically, Bosnia and Herzegovina (BiH) had the same rate of growth as in the previous year (3,1%), while in the case of Croatia, Kosovo, North Macedonia and Serbia the rate of growth was lower than in the previous year (by 0,6; 0,4; 1,3 and 0,9%, respectively). By comparison, an average real GDP growth in the EU in 2017 was 2,4%.

[2] The author of PART I is Safet Kozarevic, PhD, Professor at Faculty of Economics, University of Tuzla, except for the analysis related to the banking market (Banks as the main players in the financial service sector) written by Selena Begovic, PhD, Assistant Professor at School of Economics and Business, University of Sarajevo.

Figure 1. Total GDP of the SEE countries over the period 2002-2017 (EUR millions)

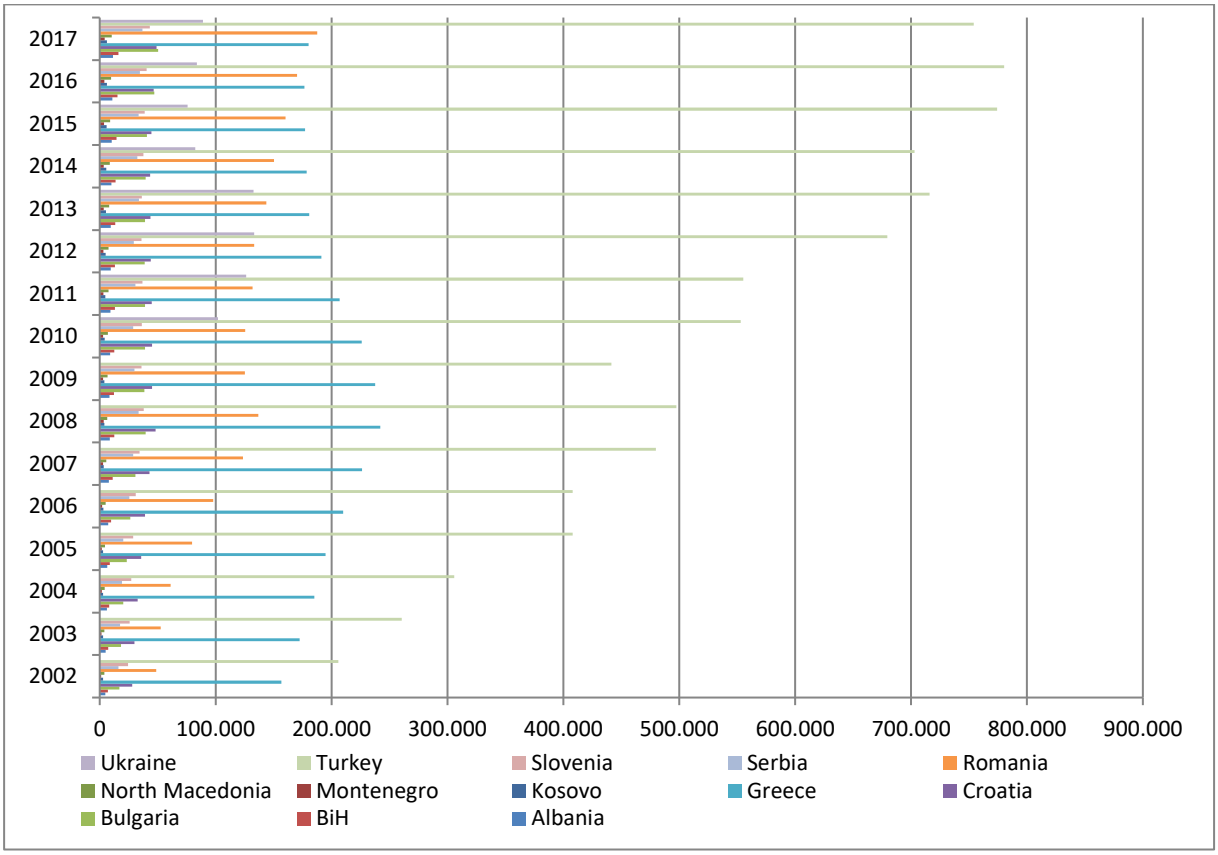
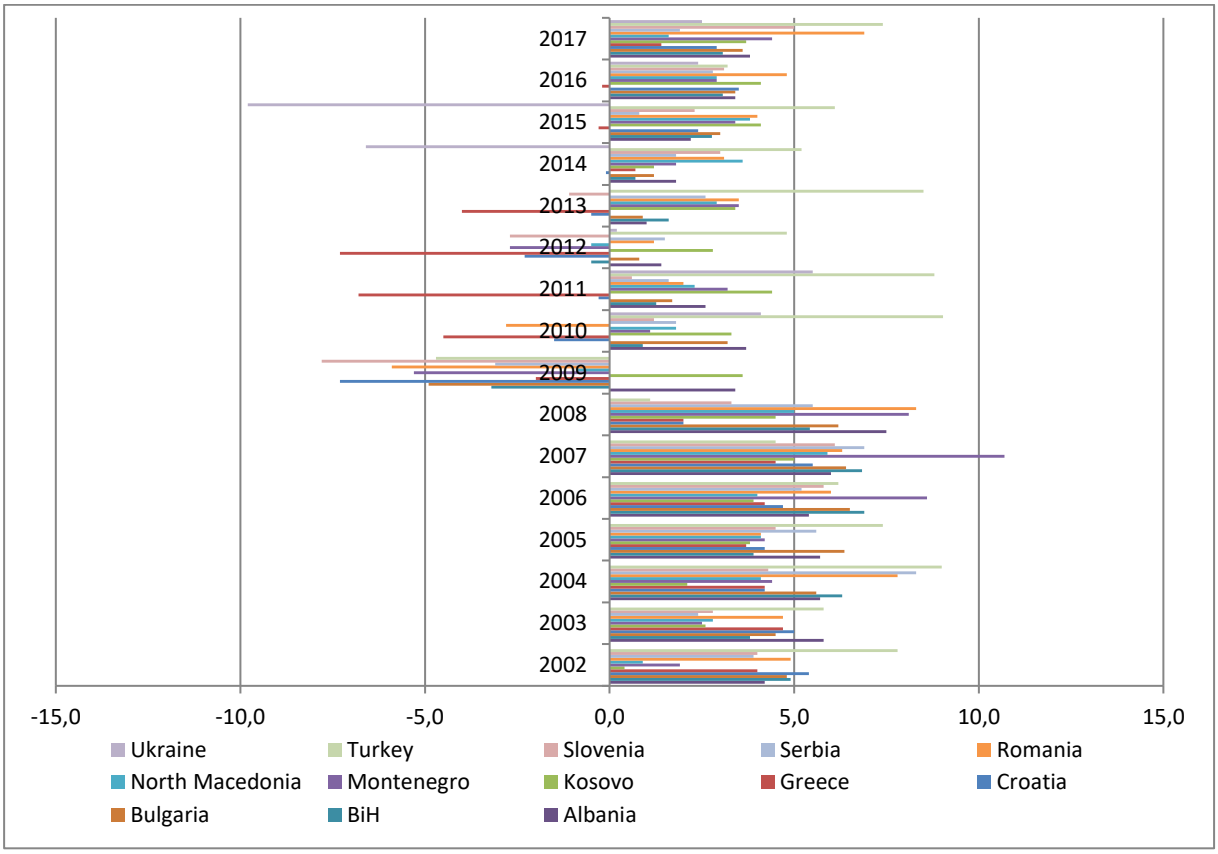


Figure 2. Real GDP growth of the SEE countries over the period 2002-2017 (%)



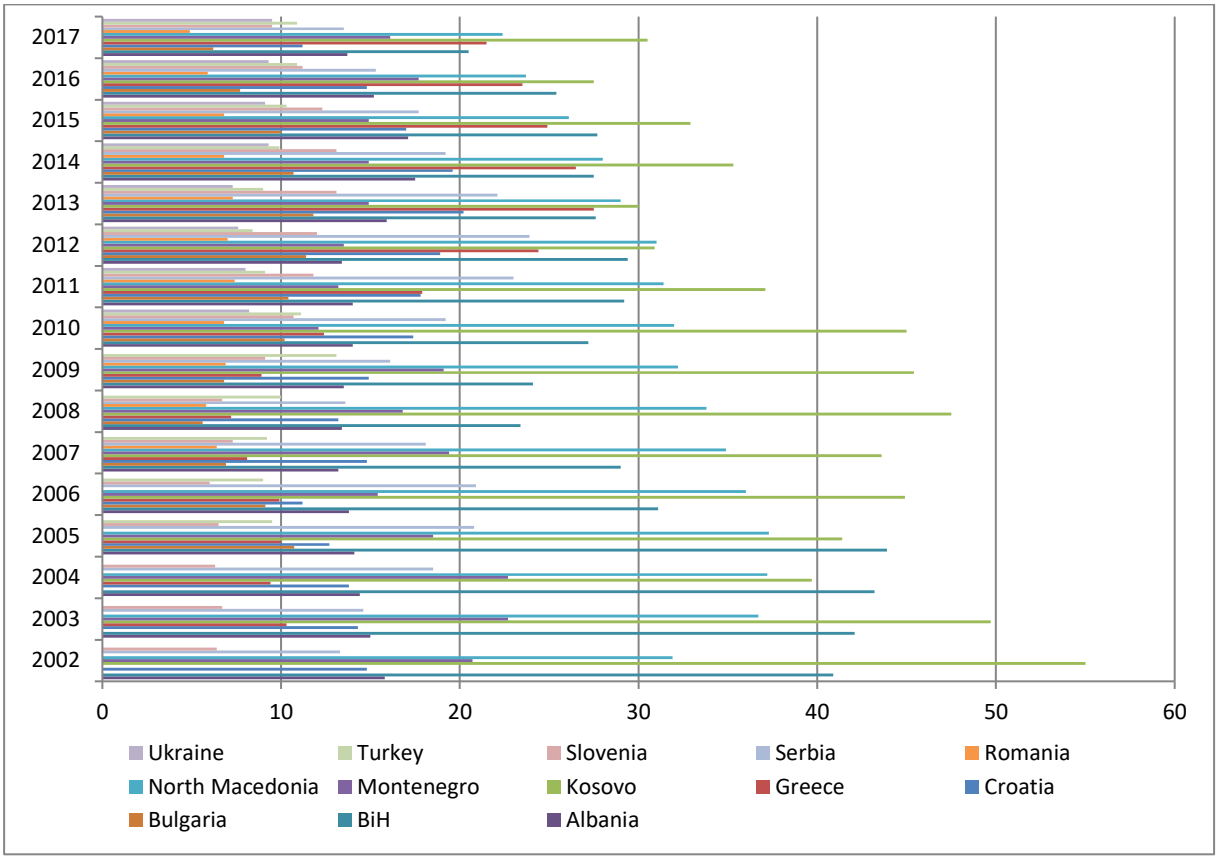
The EU member states of this region, Greece (since 1981), Slovenia (2004-), Romania (2007-), Bulgaria (2007-), and Croatia (2013-), are trying to be more competitive members, while other countries are at different stages in the EU integration process. To be more precise, Turkey, Serbia, Montenegro, Albania, and North Macedonia have the candidate status (Turkey as of 1999), while BiH and Kosovo are the potential candidate countries. Ukraine has still not applied for the EU membership. As we can assume, the progress in the EU integration process depends much more on political than economic issues. Nevertheless, there are still many economic reforms that need to be implemented, such as pension reform, reduction of grey (informal) economy, rule of law, elimination of corrupt practices, consolidation and reduction of the number and costs of parafiscal charges and burdens, etc.

Thanks to the trend of economic growth, foreign direct investments (FDI) inflows to most of the SEE countries boosted in 2017, especially for those countries making efforts to join the EU (for example, the Western Balkans achieved an increase of 18,0%). Most of the FDI is a result of interregional cooperation, while other investors come from the EU, China, the Middle East, and the Russian Federation. From the interregional perspective, the largest investor in the region is Turkey. The investors are mainly interested in energetic and financial sectors, but there is also an increasing interest in the manufacturing industry, such as automobile plants and organic food production as well as tourism, infrastructure investments, etc.

As a result of these mostly underdeveloped economies, which are substantially behind EU member states, probably the biggest economic problem for most of the SEE countries is a high unemployment rate (Figure 3), in particular of the youth. For example, while the general unemployment rate in some SEE countries was above 20% in 2017, the youth employment rate was above 50%. For the purpose of comparison, in Germany, as one of the leading EU economies, the general unemployment rate in the same year was only 3,7% and for the youth around 7,0%. Therefore, the migration trend of the young, unemployed, and well-educated population to the EU is becoming more evident and, consequently, a major threat for the SEE countries in the future, as the EU labour market opens. Moreover, working-age population is decreasing as the result of unfavourable demographics and in some SEE countries there is almost only one employee per each retired person. This creates additional difficulties to their social pension and health insurance systems.

Regarding the (general) unemployment rate in the SEE countries in 2017, the lowest unemployment rate was noticed in Romania (4,9%), less than in 2016 (5,9%). In order to make comparison to the EU countries, in the same year an average unemployment rate in the EU was 7,6%. Kosovo had the highest unemployment rate (30,5%), even higher than in 2016 (27,5%). Besides Kosovo, three countries had the unemployment rate above 20% (North Macedonia 22,4%, Greece 21,5% and BiH 20,5%), which means that around a fifth of their labour force was out of a job in 2017. On the contrary, because of intensified migrations and grey economy, we should have doubt in official statistics about unemployment in some countries.

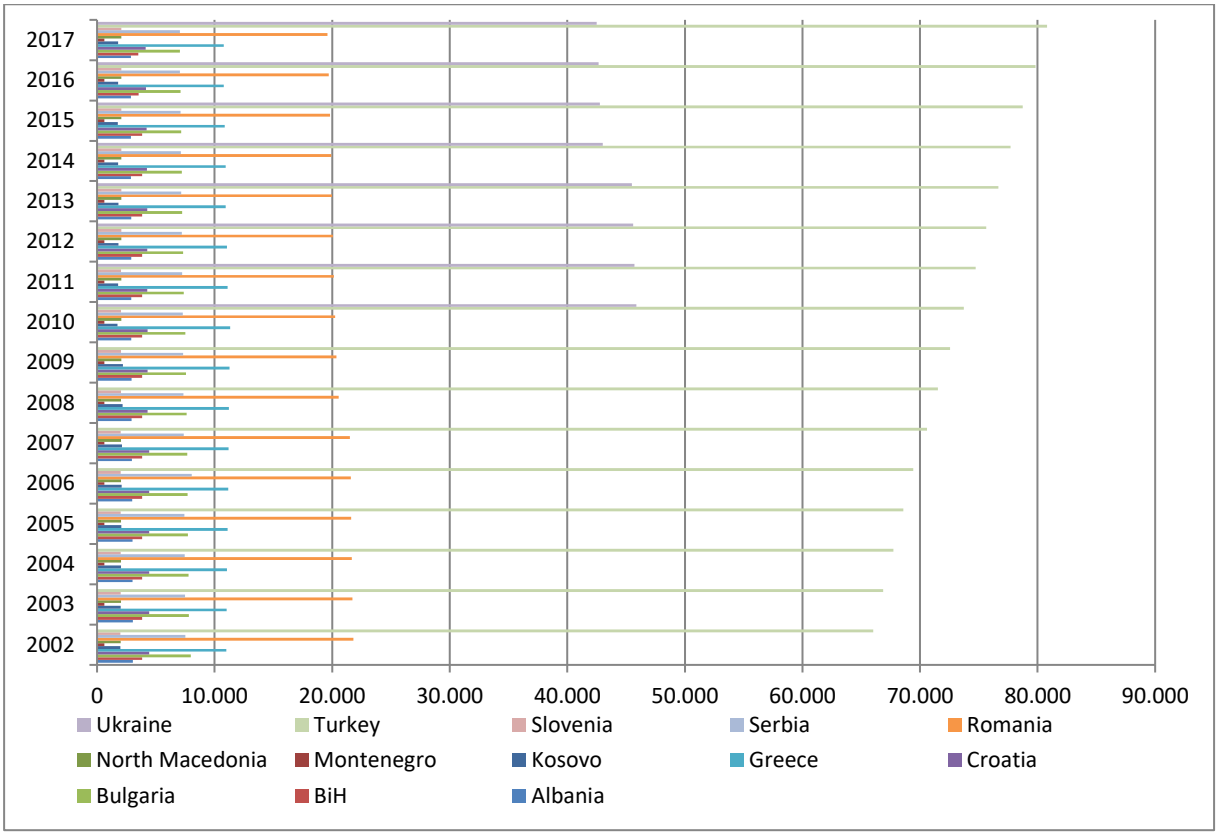
Figure 3. Unemployment rate in the SEE countries over the period 2002-2017 (%)



Furthermore, Figure 4 illustrates the trends of the population changes, where we can notice stagnation or even a decline of the population in almost all the countries, except Turkey. Turkey had the continuity of the slight population growth over the period, exceeding 80 million in 2017 (precisely 80,8 million). The total population of the SEE region was 184,8 million and it was 36,1% of the EU population (512,2 million).[3] Greece, Slovenia, Bulgaria and Romania are included in both groups. Hence, Turkey's contribution to the SEE population was 43,7% in 2017. Also, owing to the increase of the Turkish population, the total population of the SEE region increased by 7,6% since 2002 or by 4,4% in the last ten years (the data for Ukraine dating back to 2010). Compared to the previous year, the total population in the SEE region grew by only 0,3% slowly decreasing in most of the countries.

[3] The data for the EU is taken from Eurostat database (www.ec.europa.eu/eurostat/data/database, accessed 18 May, 2018).

Figure 4. Total population of the SEE countries over the period 2002-2017 (in thousands)



Average GDP per capita for the region was EUR 7.785 in 2017 and it increased by 0,6% compared to 2016. However, it was still far below the EU average of EUR 30.000, almost four times smaller. Besides, while GDP per capita in the SEE region increased by only 0,6%, the EU GDP increased by 2,7% in 2017 compared to the previous year.

More analytically, Slovenia was the SEE country with the highest GDP per capita in 2017, of EUR 20.951. Ukraine was the poorest among the observed countries, with GDP per capita EUR 2.097 (the second lowest in Europe in 2017, after Moldova). Further, Croatia, Greece and Slovenia were the countries with GDP per capita above EUR 10.000, while Albania, BiH, Kosovo, North Macedonia and Ukraine had the amounts below EUR 5.000. Bulgaria, Montenegro, Romania, Serbia and Turkey were in the middle, with GDP per capita between EUR 5.000 and 10.000 (see Figure 5).

In 2017 the inflation rate was between 1,1 and 3,0%, excluding Turkey and Ukraine with the inflation rates as high as 11,9% and 14,4%, respectively. As Figure 6 shows, the lowest inflation rate, of 1,1%, was recorded in Greece, as the Economic and Monetary Union (EMU) member since 2001, and Croatia, that has led flexible but managed monetary arrangement. Hence, unlike 2016, the case of deflation was not registered in 2017. For the purpose of comparison to the EU countries, an average inflation rate in the EU was 1,7% in the same year.

Figure 5. GDP per capita of the SEE countries over the period 2002-2017 (EUR)

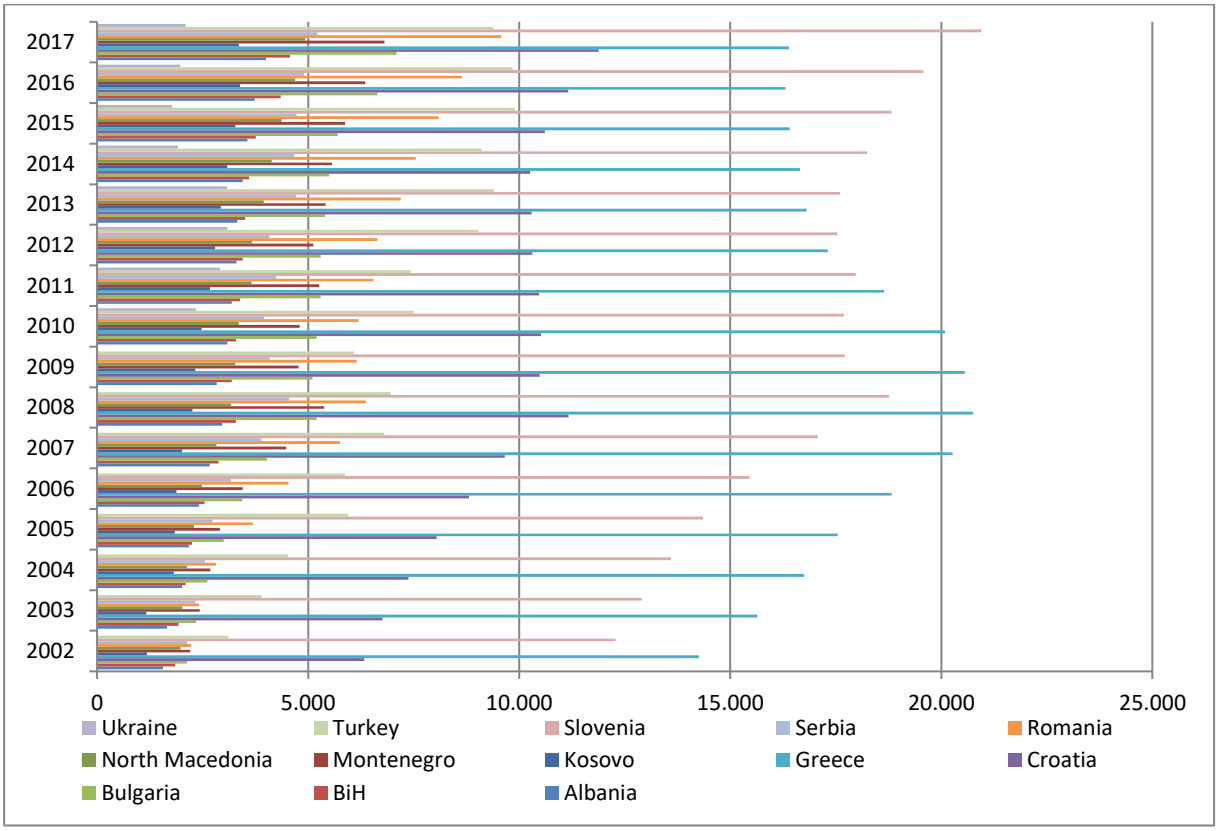
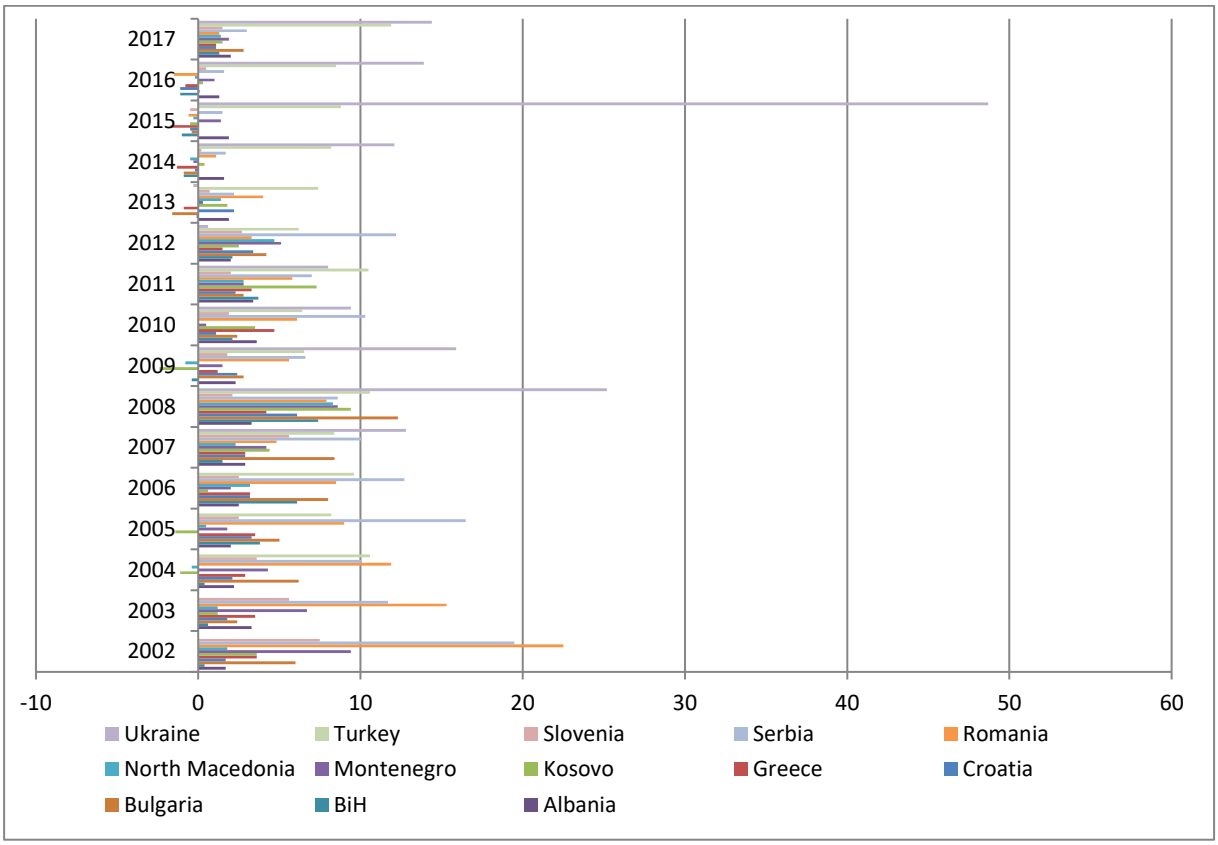


Figure 6. Average annual inflation rate of the SEE countries over the period 2002-2017 (%)



BANKS AS THE MAIN PLAYERS IN THE FINANCIAL SERVICE SECTOR

Since the markets of the countries included in the analysis are bank-centric, after a short introduction related to the legal institutional framework, we will focus on the comparative analysis of banking sector indicators among these countries as well as their comparison to developed European countries. We collected banking sector data for the SEE countries from the official reports of their relevant national supervisory institutions and with support of central banks and banking associations of some countries.

LEGAL AND INSTITUTIONAL FRAMEWORK

The observed countries differ in the monetary regime implemented, although the main goal of central banks in each country is price and monetary stability. The supervision is assigned to central banks with an exception of BiH, where the entities' agencies supervise the banks and Turkey, where the Banking Regulation and Supervision Agency is responsible for supervising the banking sector.

Most of the countries are in the process of adopting Basel III standards. In Greece, as it is a member of the Eurozone, the regulatory framework is based on and incorporates Basel III framework and related provisions. In Croatia, the Government and the Croatian National Bank have started the activities for Euro adoption process. Croatia also initiated the implementation of Basel III in Croatian legislation in 2013 with the adoption of the new Credit Institutions Act transposing CRD IV, following its accession to the EU. Consequently, there have been some changes in the regulatory framework regarding the coverage of risky assets in capital and capital buffers. Banks across the region have also overtaken fraud prevention and cyber security activities in recent years.

In the observed period in Croatia, bankruptcy proceedings were opened against two banks with the total market share of 0,4%. In Serbia the banks with 2,3%, 2,1% and 1,0% share in the total banking assets failed in 2011, 2012 and 2013, respectively. In Greece, 16 banks were resolved with the total share 13,0% of the total assets as of the end of 2012. Since the Greek banking sector was heavily hit by the financial and debt crises and confronted serious problems, the key challenge is the resolution of non-performing exposures and the improvement of liquidity position.

COMPARATIVE ANALYSIS OF THE BANKING SECTOR INDICATORS[4]

Figure 7 shows that the size of the banking sector differed among the countries of the region in 2017, with the largest share of banks' assets in GDP in Greece (166,9%) and the lowest in Ukraine (41,4%). The average banking assets as a percentage of GDP for the observed countries in 2017 was 85,8%.

In the period analysed in this report (2012-2017), the size of the banking sector increased in Albania and BiH, while it decreased in Croatia, Greece, Romania and Slovenia. In other countries of the region there was no clear trend in the banking sector size over this period (Figure 8).

[4] An asterisk (*) in the graphs means that the data for 2017 were not available and the data for the previous year was used.

Figure 7. Banks' total assets as % of GDP in 2017

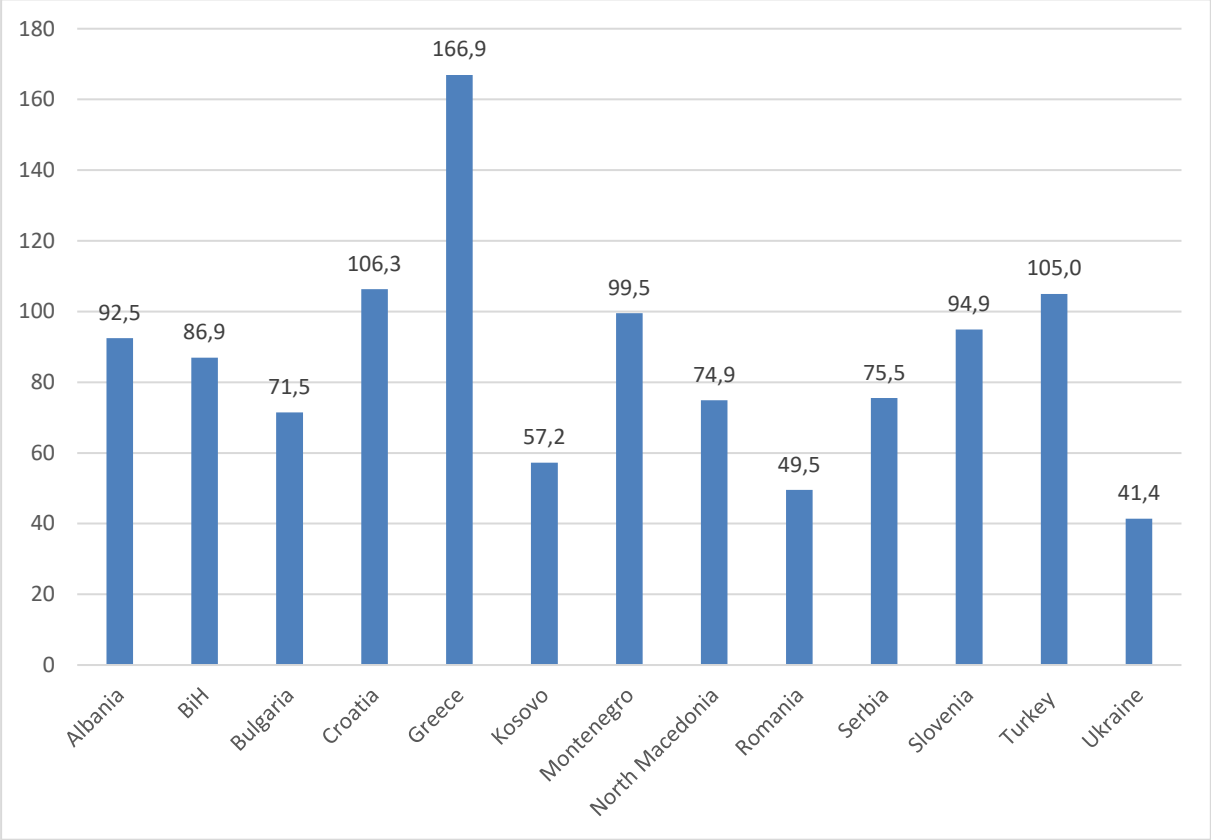
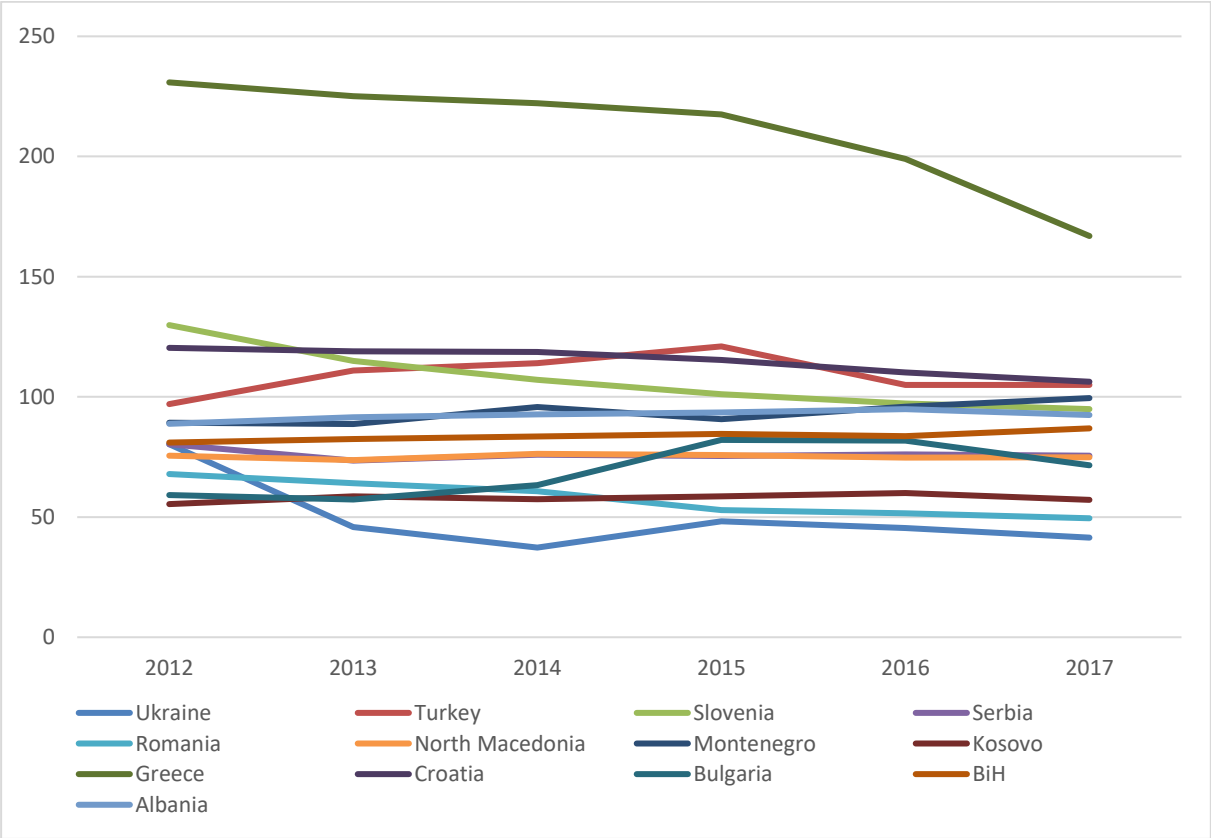


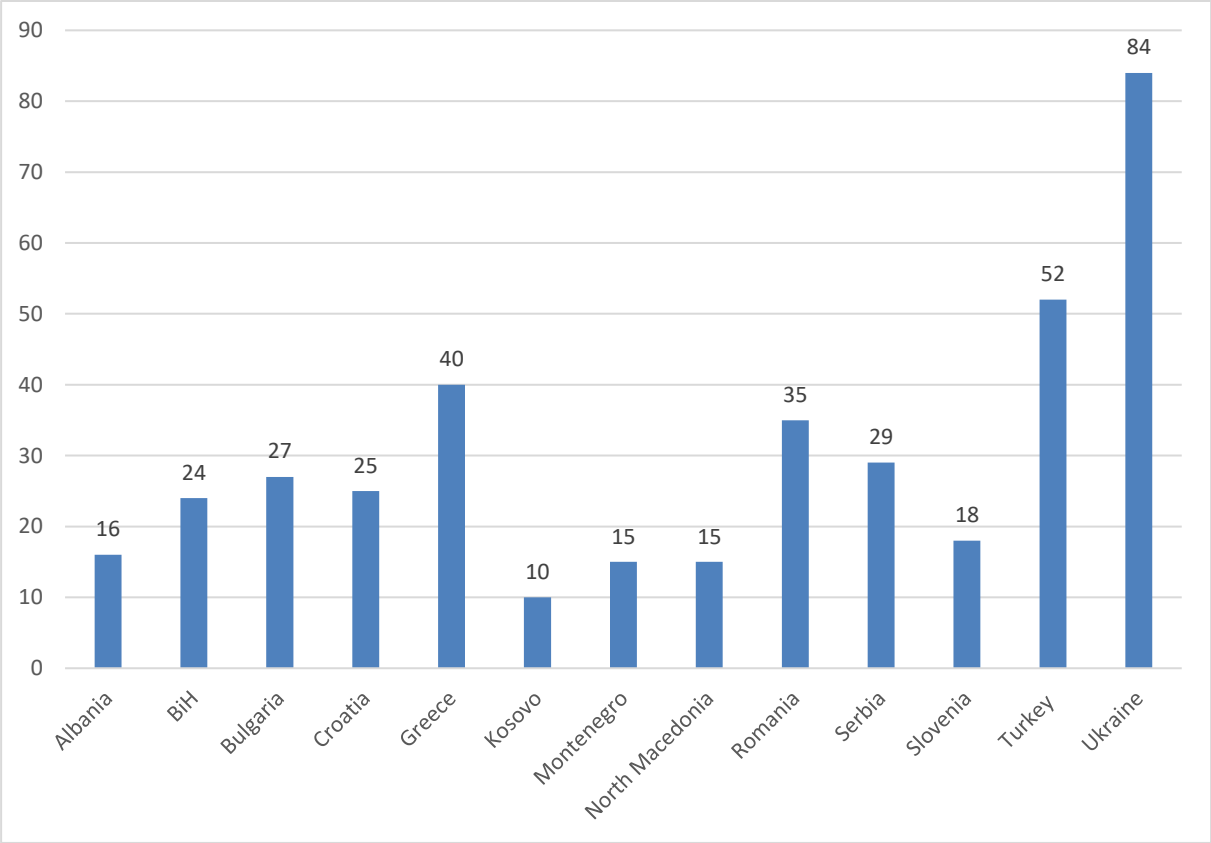
Figure 8. Total banks' assets as % of GDP in the period 2012-2017



Total assets of domestic banking groups and foreign-controlled subsidiaries and branches in relation to GDP in Eurozone in 2016 was approximately 250%[5], which was significantly higher compared to region's average. However, this indicator differed significantly among the Eurozone member countries (from less than 100% in Lithuania to 1.500% in Luxemburg).

The number of banks varied from 10 in Kosovo to 84 in Ukraine in 2017 (Figure 9) and did not change significantly since 2012 (except in Ukraine where it dropped from 176 to 84 and Greece where it dropped from 52 to 40).

Figure 9. Number of banks in 2017



On a consolidated basis, the total number of credit institutions in the Eurozone amounted to 2.290 (domestic banking groups and stand-alone banks) at the end of 2016, down from 2.904 in 2008 and 2.379 at the end of 2015. The number of foreign branches declined slightly, from 706 in 2008 to 688 in 2016.[6] If we divide this number with the number of Eurozone member states we get 157 banks per country, while the average for the countries analysed in this report was 30. However, the number differed significantly among the countries in both Eurozone and the SEE region.

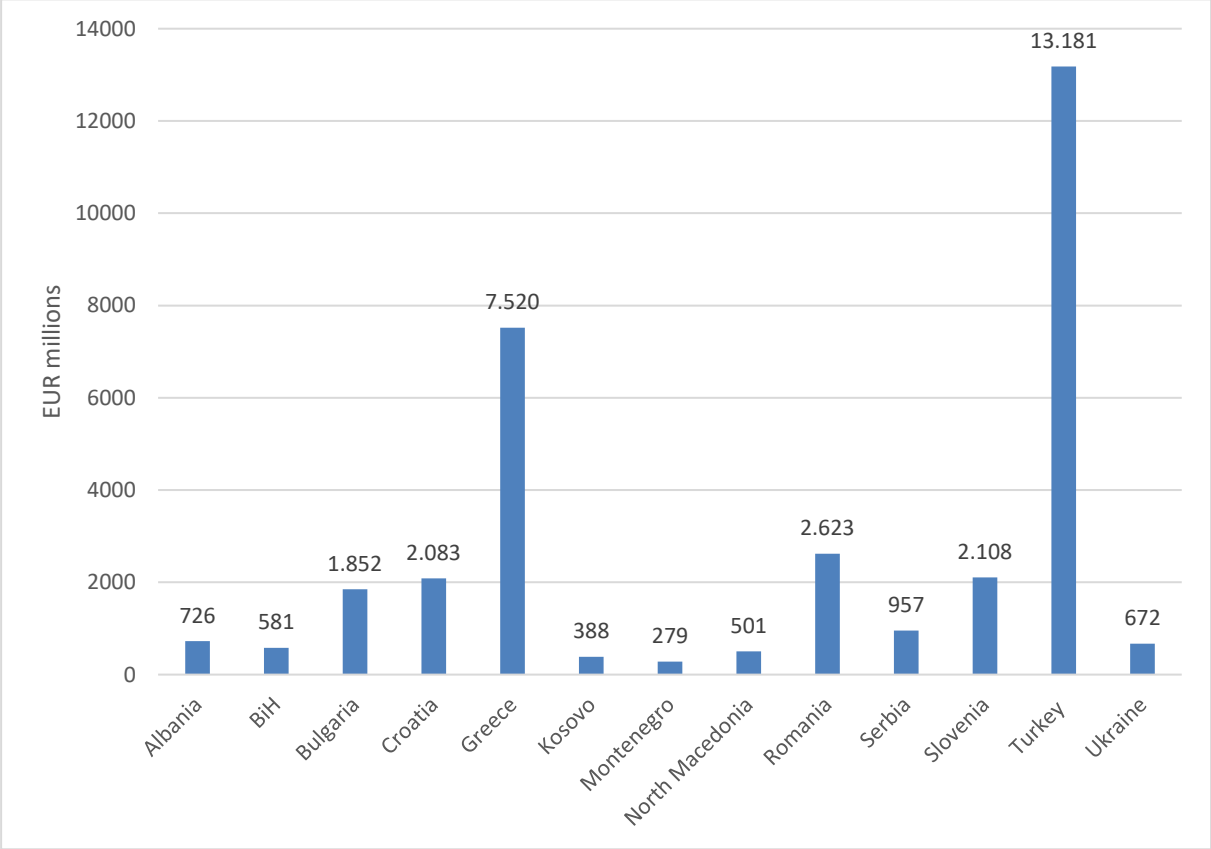
[5] European Central Bank (2017), Report on Financial Structures. Available at: https://www.ecb.europa.eu/pub/pdf/other/reportonfinancialstructures201710.en.pdf

[6] *Ibidem*.

The size of banks in 2017, measured as average assets per bank, differed significantly among the observed countries, from EUR 13.181 million in Turkey, 7.520 million in Greece to 388 million in Kosovo (Figure 10). If we compare this to 2012, the average assets per banks increased significantly in BiH (55,9%), North Macedonia (39,6%), Albania (36,5%) and Bulgaria (36,3%), while in other countries it increased by less than 30% and in Greece it decreased by 11,4% (Figure 11).

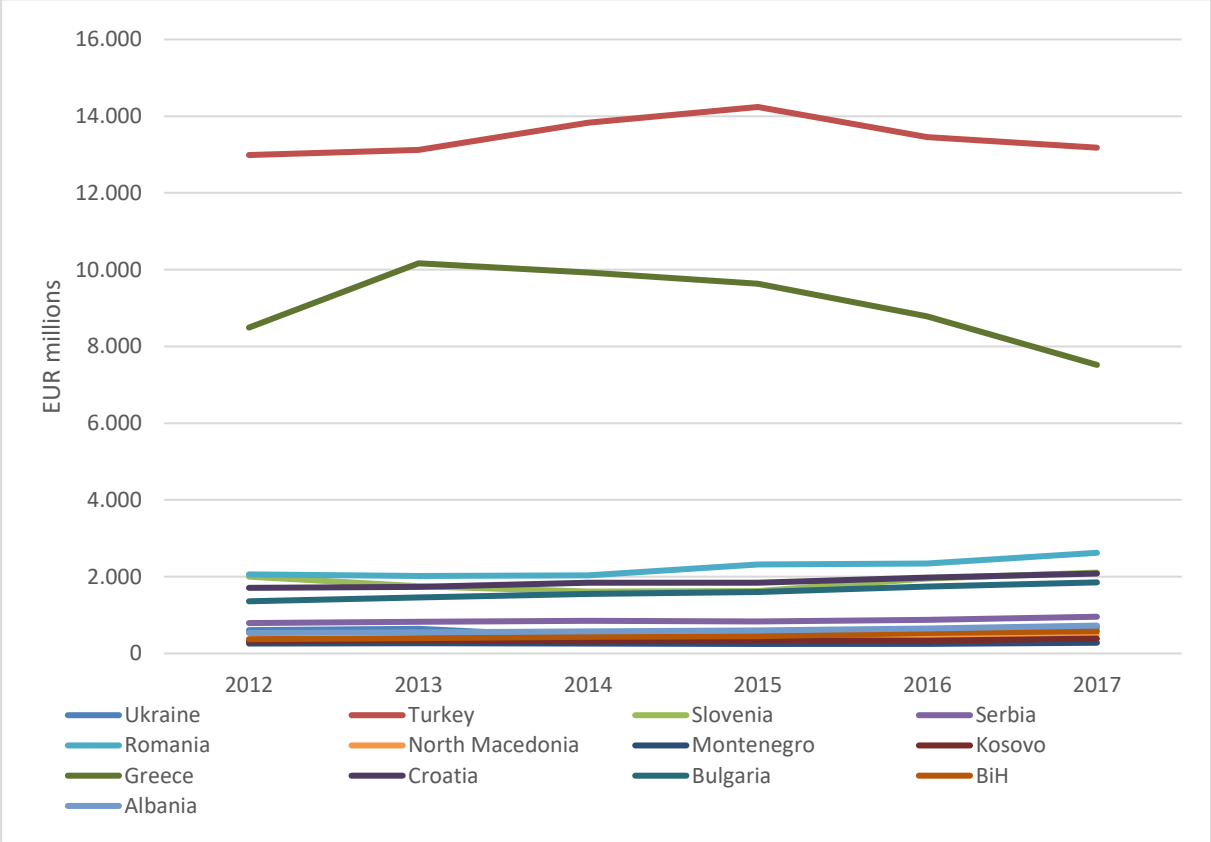
As the total assets of the Eurozone, domestic banks stood at EUR 24.183 billion on a consolidated basis at the end of 2016 and the number of domestic banks was 2.290. The average assets per bank in the Eurozone in 2016 was EUR 10.560 million, which is much higher than the region average (EUR 2.602,4 million in 2016).[7]

Figure 10. Average assets per bank in 2017



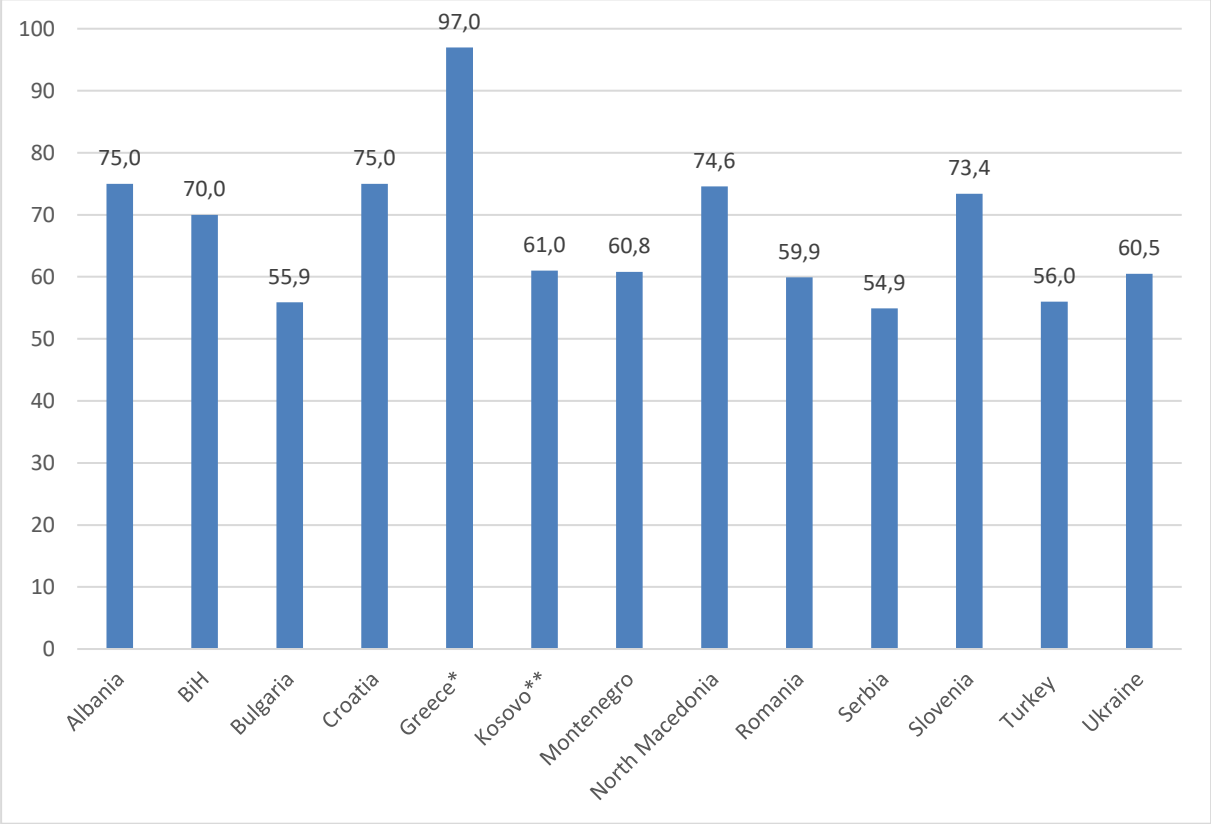
[7] *Ibidem*.

Figure 11. Average assets per bank (2012-2017)



The market concentration in 2016, measured as the share of five largest banks in the total banking assets, was the highest in Greece (97,0%), although it was lower in 2012 (79%) and then increased significantly as a consequence of failed banks in 2012 (Figure 12). The lowest market concentration in 2017 was reported in Serbia (54,9%). Figure 13 shows that, if we observe the share of the largest bank, it was again the highest in Greece (37,0%) and the lowest in Turkey (14,3%).

Figure 12. Market share of five largest banks in 2017 (%)



**three largest

Figure 13. Market share of the largest bank in 2017 (%)

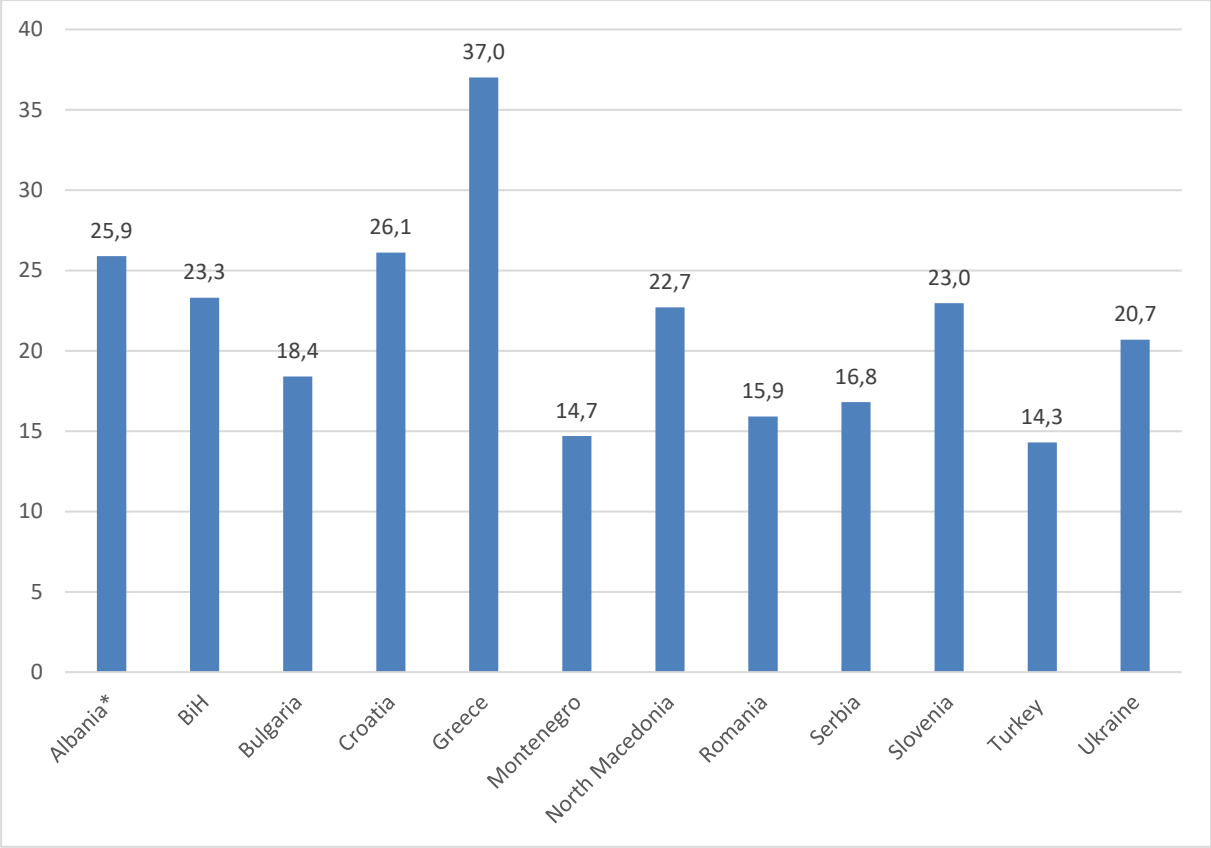


Figure 14 shows that in all countries, except Slovenia, Turkey and Ukraine, there was a high share of foreign ownership in the total banking assets (from 68,0% in Greece to 90,1% in Croatia). In Slovenia, Turkey and Ukraine, the banking sector was dominated by domestic banks (85,0%, 69,2% and 70,8% of the total assets were held by domestic banks, respectively).

In the observed countries, net loans had the highest share in banks' assets (Figure 15), while households and corporation deposits had the highest share in total banks' liabilities (Figure 16).

Figure 14. Share of banks with majority foreign ownership in the total assets in 2017 (%)

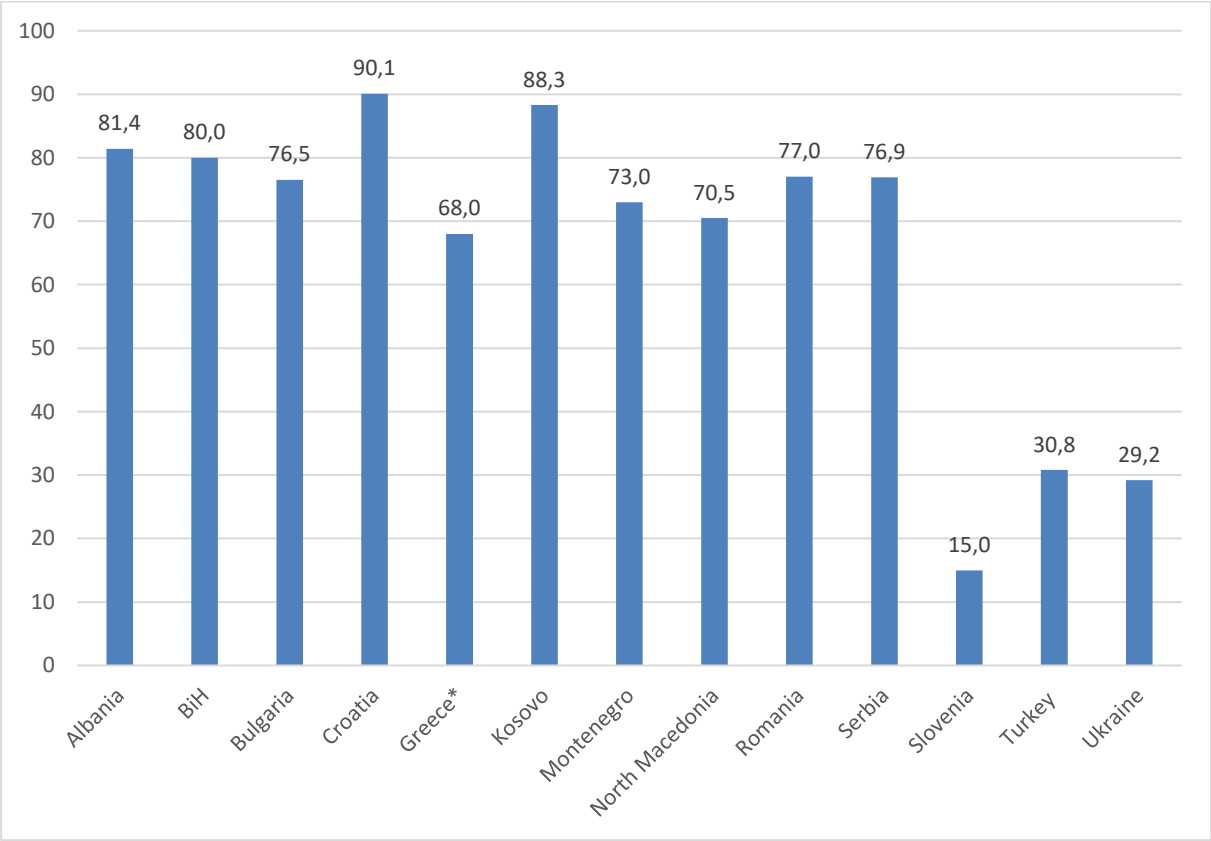


Figure 15. Composition of banks' assets in 2017 (%)

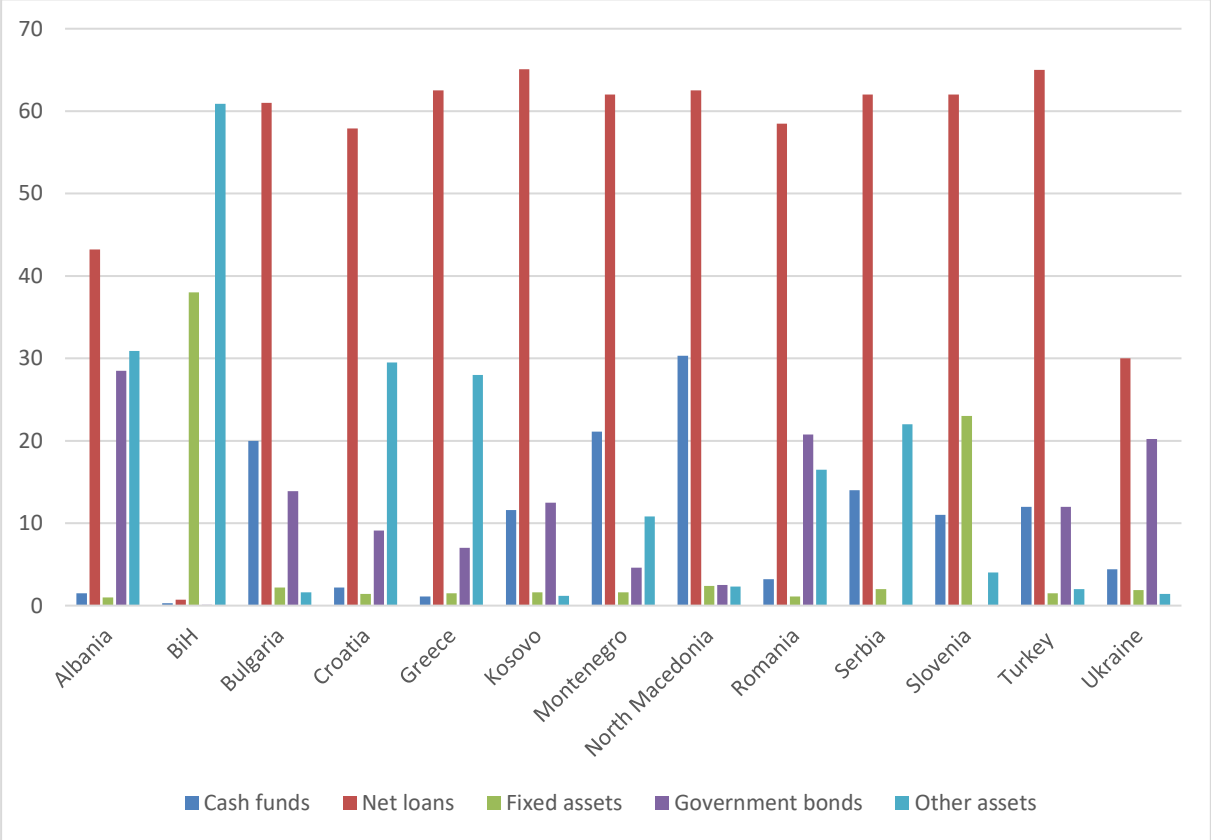
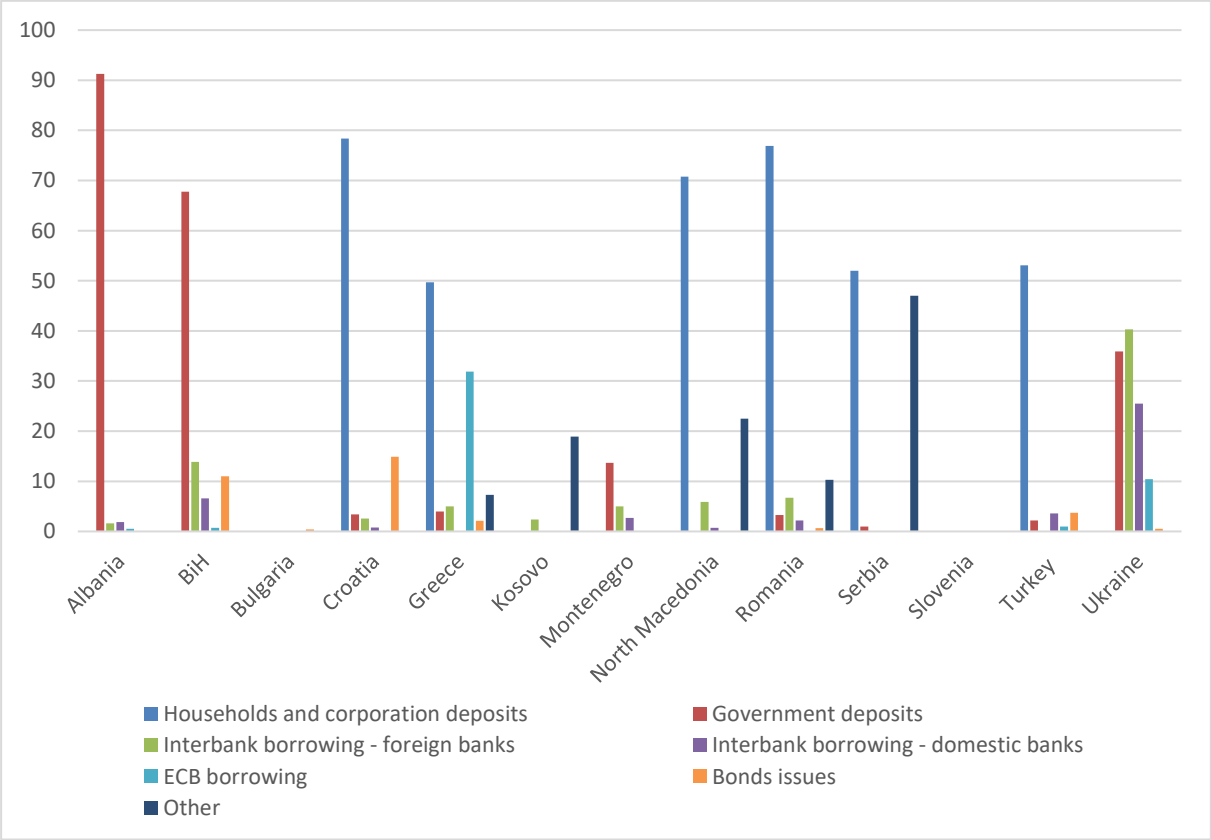


Figure 16. Composition of banks' liabilities in 2017 (%)



Regarding the maturity of deposits in 2017, there was a significant mismatch among the countries as we can see in Figure 17. While Albania and BiH had almost the same share of short-term and long-term deposits, the share of short-term deposits in other countries was much higher than long-term, except in Turkey where the share of short-term deposits was significantly lower than long-term (26,0%). The highest share of short-term deposits in total deposits was in Romania (92,8%). The share of long-term loans was significantly higher than short-term loans in all countries, except Romania, Turkey and Ukraine. In Romania and Turkey, the share of short-term loans was much higher than long-term (84,0% and 78,5%, respectively), while in the case of Ukraine the share of short-term and long-term loans was almost equal (46,1% and 53,9%, respectively). All the other countries had a much higher share of long-term loans and Croatia, with 85,8%, had the highest share of long-term loans (Figure 18).

Figure 17. Maturity structure of deposits in 2017 (%)

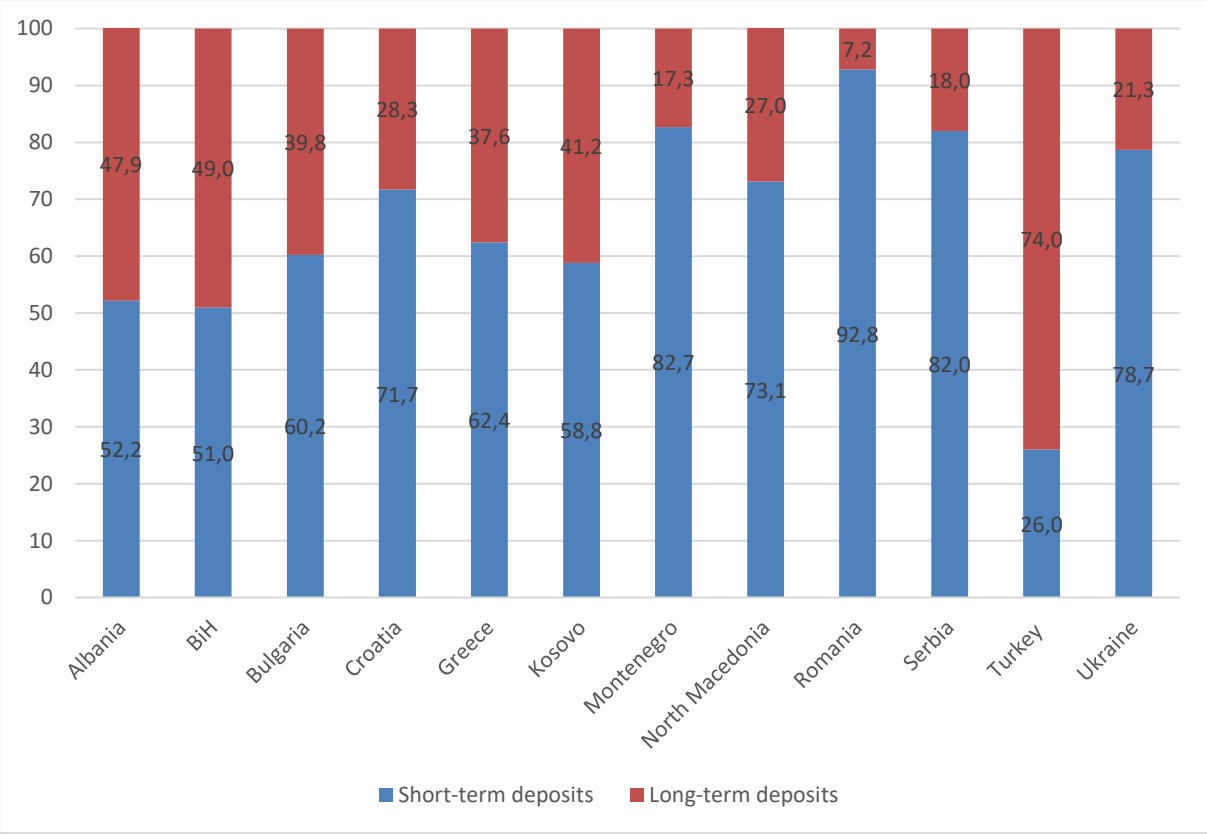
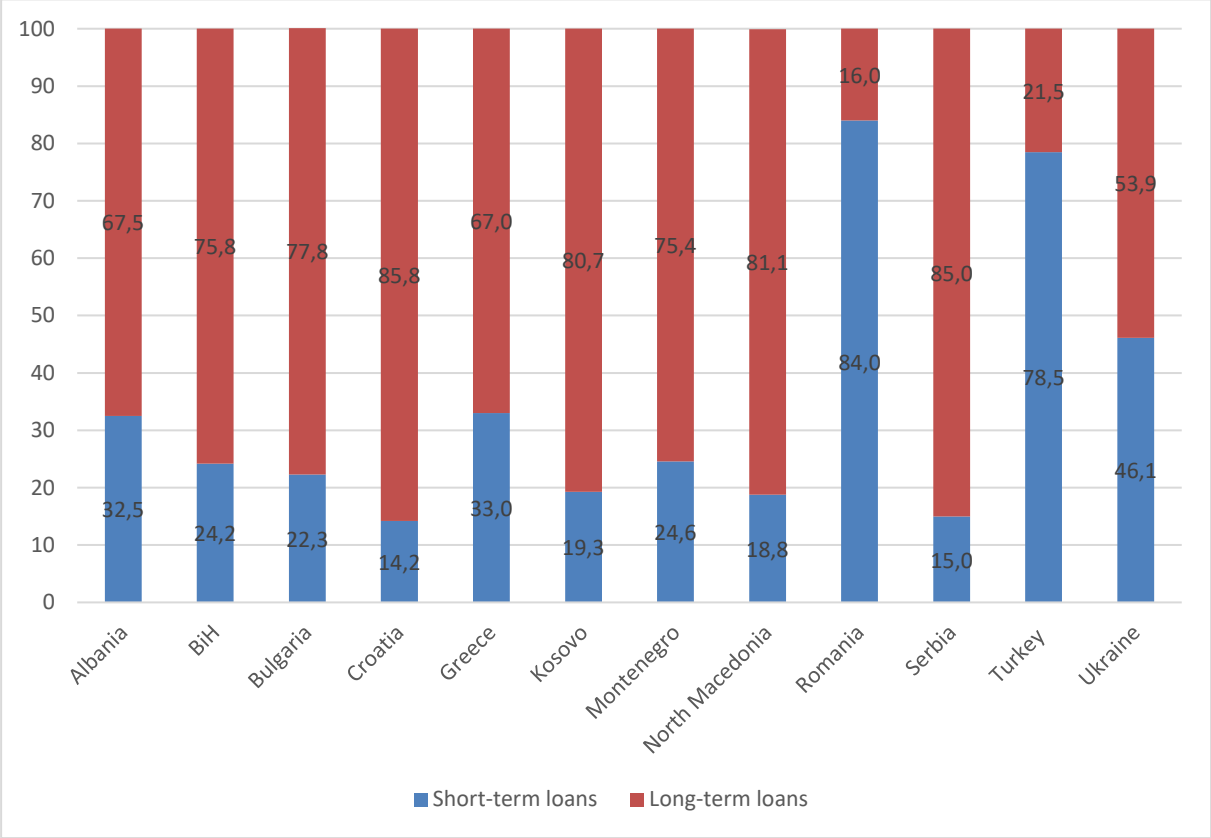


Figure 18. Maturity structure of loans in 2017 (%)



Currency structure of deposits in 2017 in Figure 19 shows domination of deposits in the local currency, especially in the countries where Euro is local currency (in Greece 95,2%, Kosovo 95,2% and Montenegro 92,9%). In Croatia and Serbia, there was a high share of deposits in EUR (53,3% and 61,0% respectively). Other countries had more than 50% deposits in their local currency, while Turkey and Ukraine had large share of deposits in other currencies (39,% and 37,4%, respectively). From Figure 20 we can see that loans in the local currency were dominating in the currency structure of loans in 2017 in Kosovo (99,9%), BiH (99,3%), Greece (91,9%) and Montenegro (93,3%). The highest share of loans in EUR, where EUR is not local currency, was in Croatia (60,0%). Like for deposits, Turkey and Ukraine had a large share of loans in other currencies (24,3% and 40,4%, respectively).[8]

[8] Official data about currency structure of deposits and loans for Greece and Slovenia were not available.

Figure 19. Currency structure of deposits in 2017 (%)

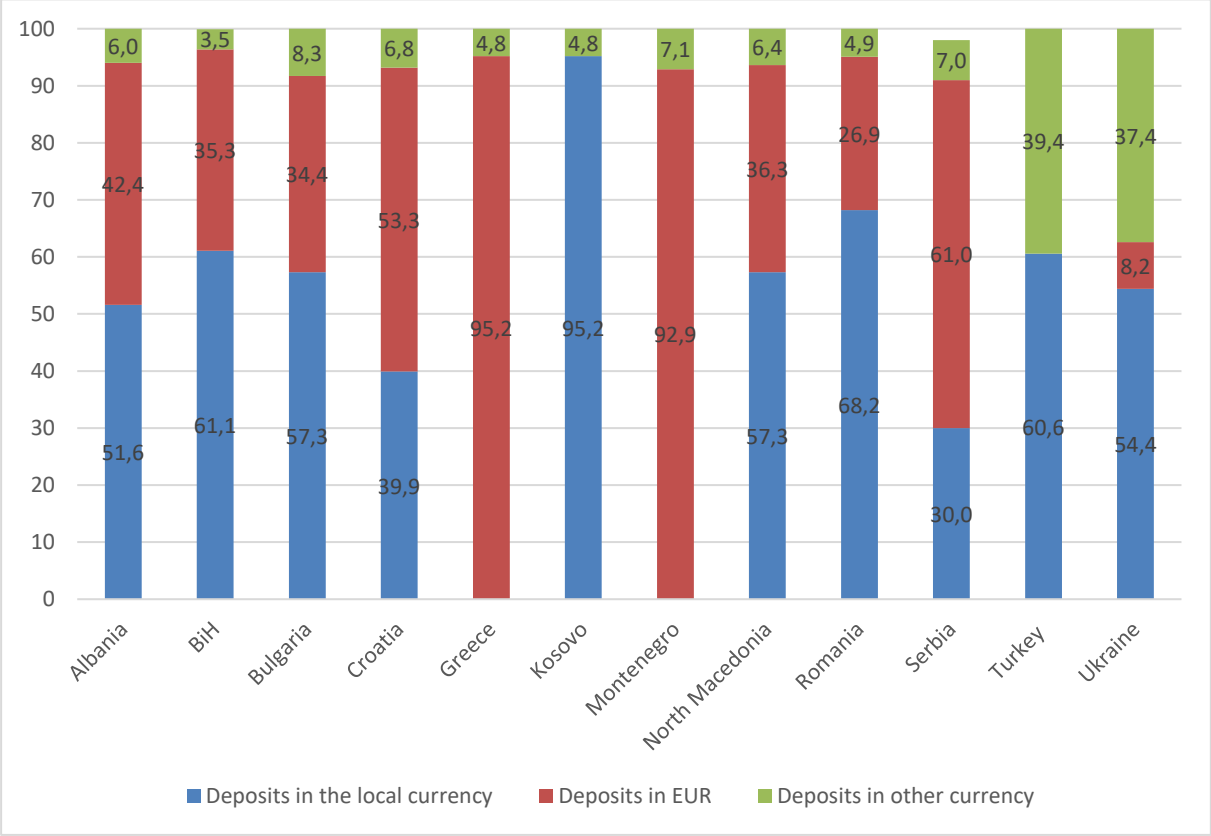
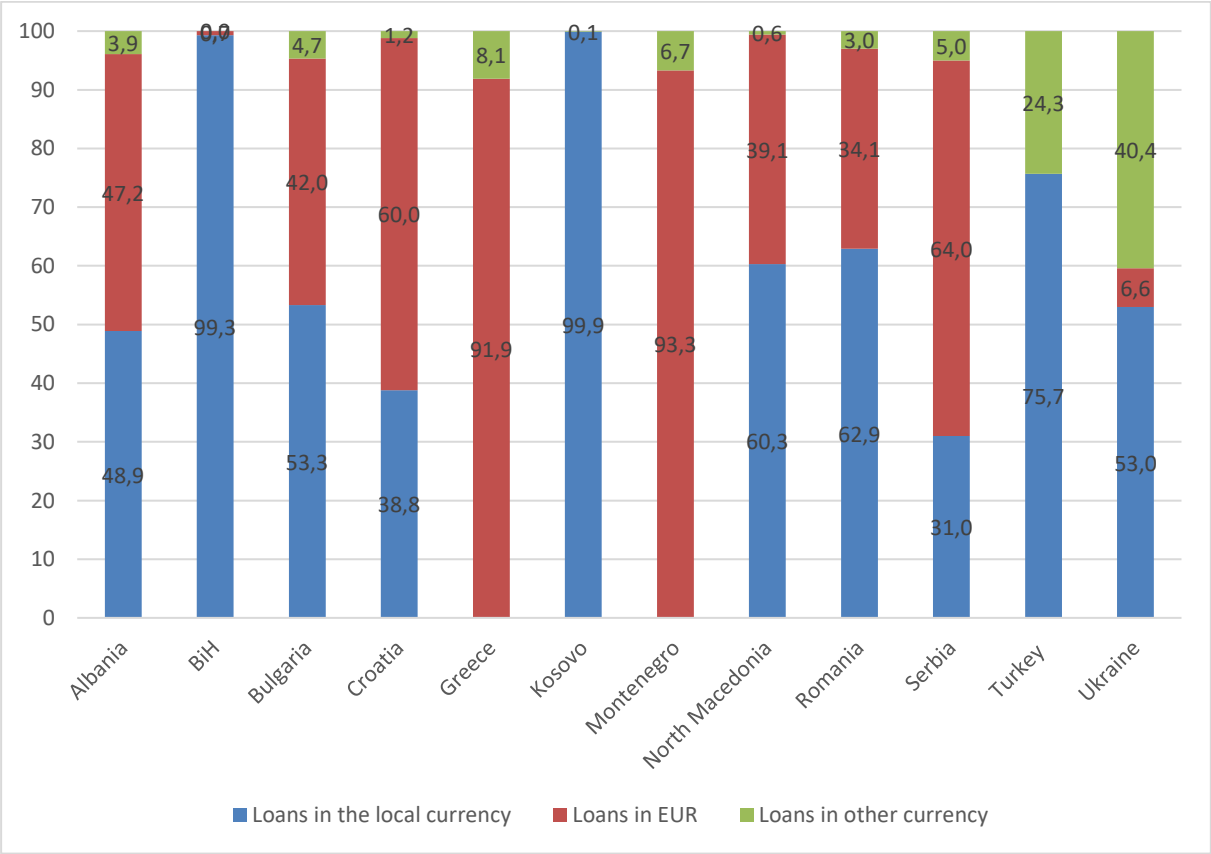


Figure 20. Currency structure of loans in 2017 (%)



Regarding the basic features of the banking sector in 2017, in Figure 21 we can notice that the capital adequacy ratio in the countries varied between 15,7% (BiH and North Macedonia) and 23,8% (Croatia). The ratio was relatively stagnant over the period 2012-2017, with an exception of Greece, where it had a positive trend (from 9,7% in 2012 to 17,0% in 2017) and Romania (14,9% in 2012 to 20,0% in 2017) and a decreasing trend in BiH (17,0% in 2012 and 15,7% in 2017). For comparison to the developed European countries, all capital ratios for the group of significant institutions in the Eurozone, i.e. the banks supervised by the ECB, slightly increased in the third quarter of 2018 compared to the previous quarter. The Common Equity Tier 1 (CET1) ratio stood at 14,2%, the Tier 1 ratio at 15,4% and the total capital ratio at 17,8%. Average CET1 capital ratios at participating Member State level ranged from 11,8% in Spain to 25,3% in Luxembourg.

The highest ratio of non-performing loans (NPLs) was recorded in Ukraine. It increased from from 8,9% in 2012 to 35,0% in 2017. In Greece, the ratio of NPLs in total loans increased significantly from 29,9% in 2012 to 43,9% in 2015, and fell in 2017 to 33,3%. In Romania the ratio of non-performing loans decreased from 18,2% in 2012 to 6,4% in 2017. In other countries, this ratio was relatively stable, and the lowest 3,0% was recorded in Turkey (Figure 22). Figure 23 shows that return on equity (ROE) was negative in Greece (-0,5% in 2016) and Ukraine (-15,3% in 2017). The highest ROE in 2017 was recorded in Kosovo (21,3%) and Albania (15,7% in 2017).

Figure 21. Capital adequacy rate in 2017 (%)

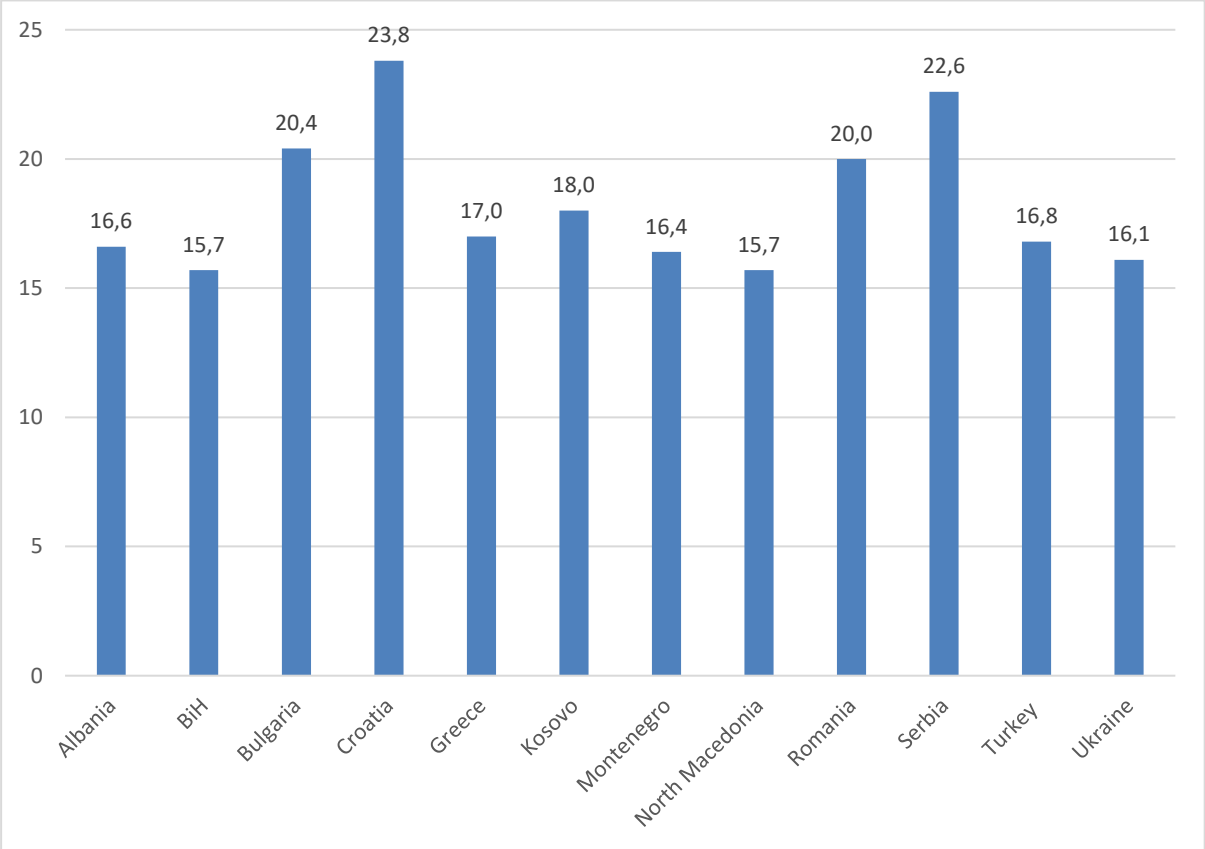


Figure 22. Ratio of non-performing to total loans in 2017 (%)

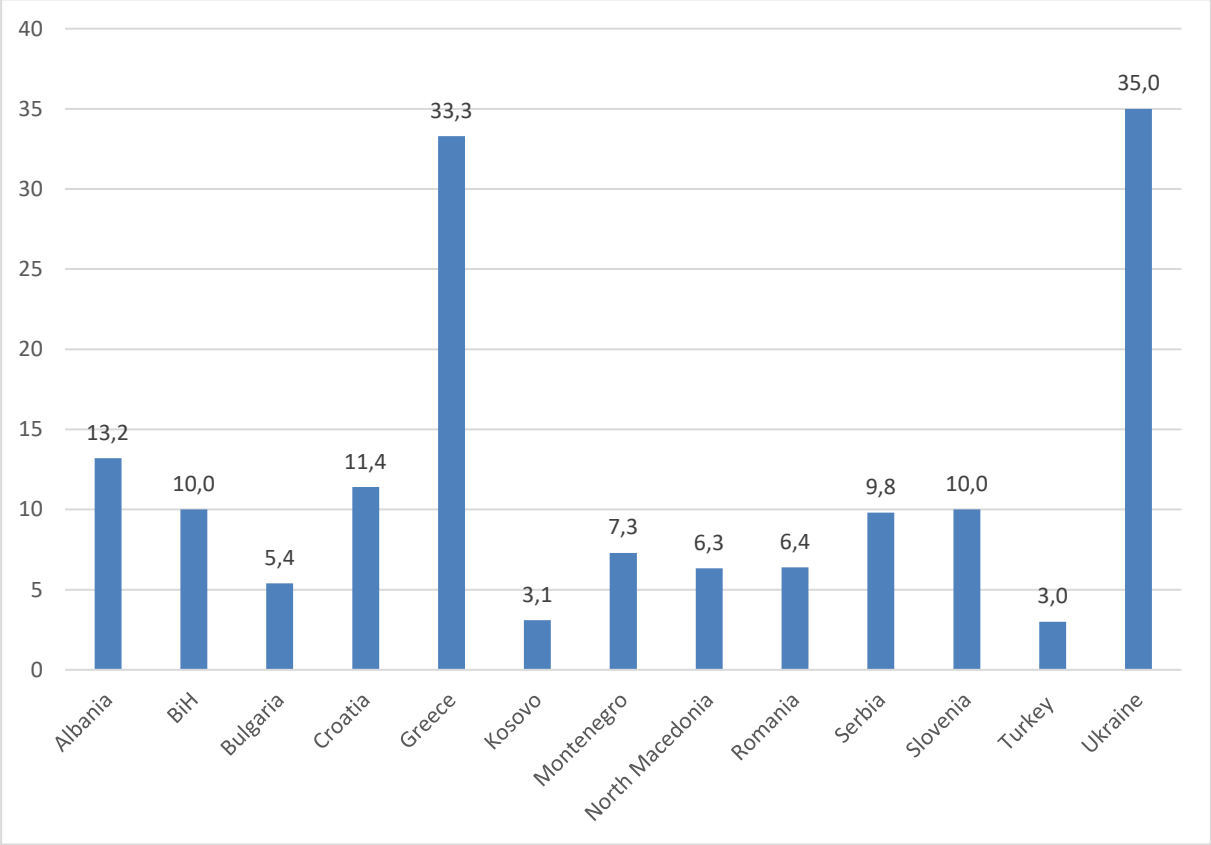
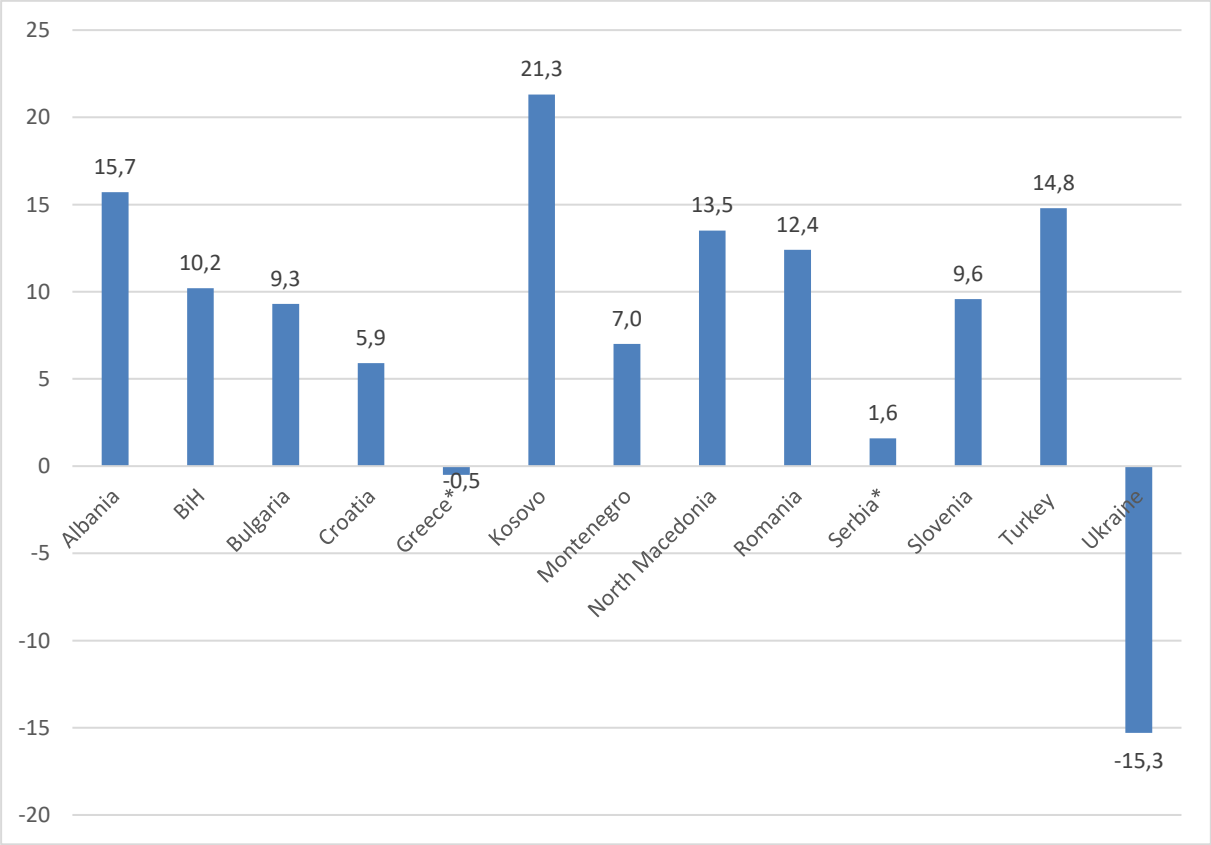


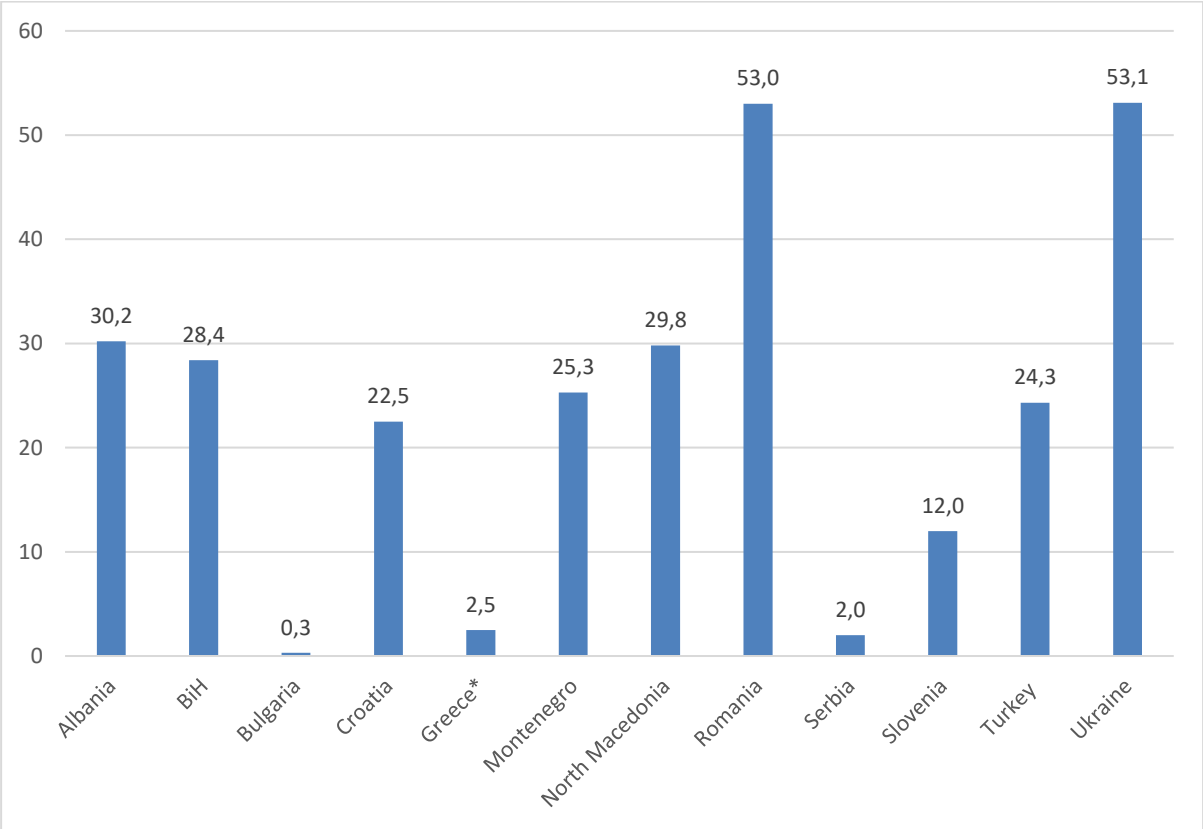
Figure 23. Return on equity in 2017 (%)



The global financial crisis has seen a strong uptake in NPLs in banks' balance sheets, leaving policymakers worldwide concerned by this challenge. This trend has been exacerbated for some countries by the Eurozone crisis, particularly in the SEE region, resulting in an EU-wide peak NPL ratio of 7,5% in 2012. However, NPL ratio trajectories point to a significant decline across the EU which can be attributed to enhanced loan selling activities of banks in recent years. In fact, as of 2017, the ratio for the EU has stood just below the World average of 3,74%, at 3,7%, which suggests that NPLs are no longer a specific European problem. With the ECB maintaining its ultra-low interest rates, profitability remains a key challenge facing European banks. The ROE, a key indicator to assess the bank sector's attractiveness for investors has been slowly recovering. The ROE of European banks was 5,6% in 2017 for EU28, practically half of the 10,6% registered in the burst of the financial crisis, but the highest since 2007. The ROE across EU countries diverged after 2007 signalling growing fragmentation particularly across the Eurozone. After reaching a peak in 2013 (25,8%), the dispersion around the average ROE substantially decreased falling to 8,3% in 2014, 7,4% in 2015, 5,7% in 2016 and further into 2017 to 5,1%, the closest so far to the 4,5% seen in 2007 before deviation started.[9]

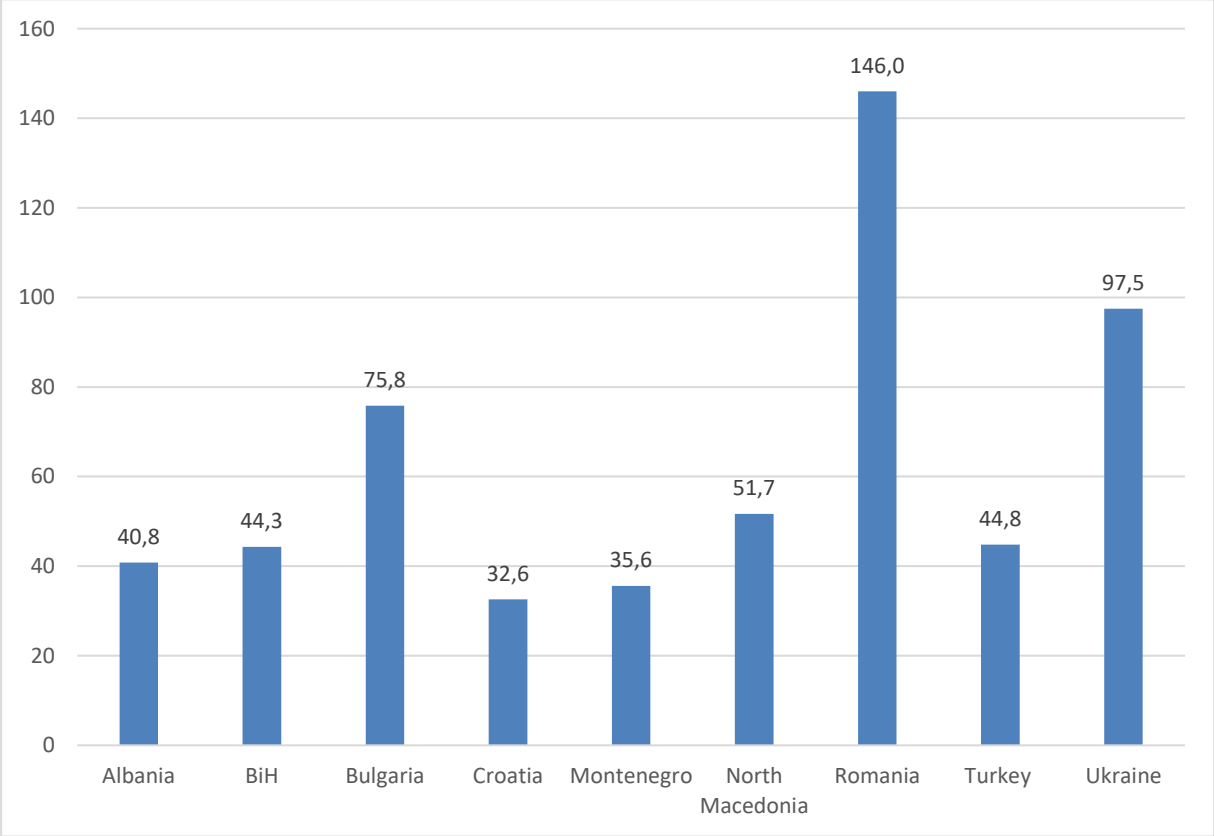
Figures 24 and 25 show that Ukraine and Romania recorded the highest ratio of liquid assets to total assets (53,1% and 53,0%, respectively) and Romania largest liquid assets to short-term financial liabilities ratio (146,0%), which are far above the observed group's average. Liquid to total assets were the lowest in Bulgaria and Serbia (0,3% and 2,0%, respectively), while the lowest liquid assets to short-term financial liabilities in 2017 (for nine observed countries with available data) were in Croatia and Montenegro (32,6% and 35,6%, respectively).

Figure 24. Liquid to total assets in 2017 (%)



[9] https://www.ebf.eu/facts-and-figures/banking-sector-performance/

Figure 25. Liquid assets to short-term financial liabilities in 2017 (%)



FEATURES OF INSURANCE MARKETS

As far as the functioning of the SEE region insurance markets in 2017 is concerned, we can state that most markets continued to grow as in the previous years. At the beginning, it is very important to emphasize that a comprehensive picture of the region insurance markets would be still less remarkable without Turkey's contribution.

We collected insurance market data for the SEE countries from the official reports of their relevant national supervisory institutions and with support of insurance associations of some countries. Consequently, we could do a comparative insurance market analysis among the observed thirteen countries using different parameters and, which is also very important, comparison to the parameters for the Insurance Europe (IE), the European (re)insurance federation that represents the developed part of the European insurance market.

In order to gain knowledge of the trends, we used the data from the reports since 2002, but comparative analysis was focused on 2017 and a deep market review will be presented. Besides, in PART II of this publication, a detailed report of particular country insurance market indicators is provided for all countries. We collected the basic market indicators for all countries as well as the other relevant data necessary for comparative analysis for 2017 from their annual reports published by the relevant national institutions, as mentioned before.

A YEAR AFTER NEW REGULATORY REGIME

The previous year will be remembered as the starting year of implementation of the new regulatory framework for insurance and reinsurance undertakings in the EU, Solvency II. Considering a period of several years for the preparation (six years or more), it did not cause much difficulties for most of the EU member states.

However, the SEE countries that are non-EU member states will not remember 2016 as the year of a huge change in the legal and institutional framework. These countries are still implementing the Solvency I rules and their insurance markets are still making initial steps in the preparation for new prudential and supervisory regime. Some of them are focusing on further liberalisation of motor third party liability (MTPL) insurance, a prevalent line of insurance business, while others are struggling with plenty of burdens, trying to provide a better supervision process and improve market discipline.

In the observed year, 2017, the SEE countries that are the EU members continued to focus on meeting Solvency II requirements and establishing the related reporting process. The other countries continued to improve the regulation regarding MTPL insurance as well as popularize risk management practices in the insurance undertakings. Additionally, throughout the process of joining the EU, SEE countries that are non-EU member states will have the opportunity to use the technical support and projects to establish the EU's Solvency II regime.

Generally, even during 2017 most SEE countries did not make serious preparations for a new legal and institutional framework in their insurance sectors. Unlike in the developed part of Europe, insurance is still not perceived as an important factor of financial stability as well as economic development in these countries. In the following chapter we will see why.

THE INSURANCE MARKETS OVERVIEW

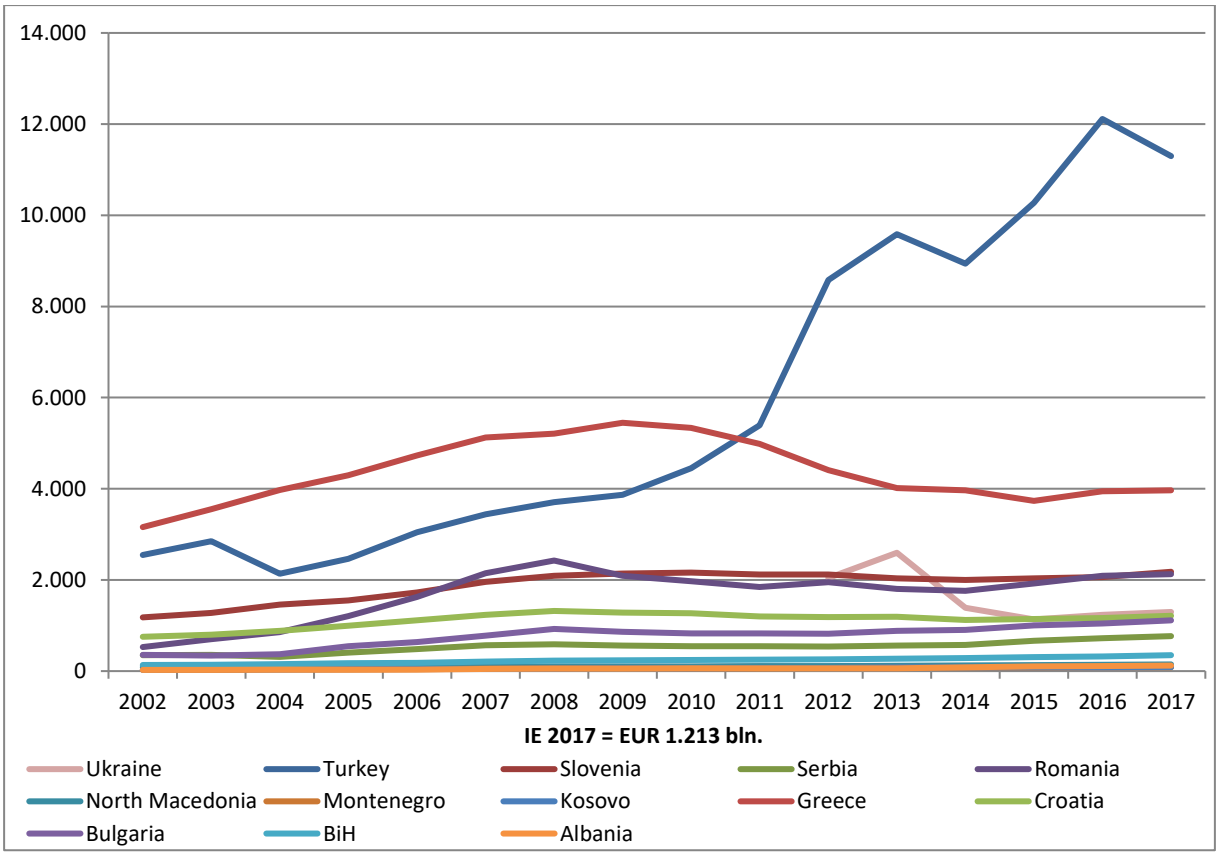
The following comparative insurance market analysis among SEE countries as well as their comparison to the Insurance Europe members reveals their diversity concerning various criteria.

A year after the largest growth of the SEE insurance market since 2012 (at a rate of 11,1%), in 2017 the total premium of the SEE region countries was EUR 24.744 million and it decreased by 1,5% compared to 2016. This was mostly caused by similar trends of Turkish market in the last two years. On the other hand, the total insurance premium of the Insurance Europe members was EUR 1.213 billion and it increased by 2,0% compared to 2016, while the comparability of the Insurance Europe members data with those of the previous years is not relevant because of the changes in the methodology of data collection in 2016.

In order to better illustrate the market potential, the total insurance premium of the Insurance Europe members in 2017 was as many as 49 times higher than the premium of the SEE countries. Due to the recent movements in the insurance premium volume, the spread was even bigger compared to the previous year (47,3). More clearly, as far as the insurance premium is concerned, SEE insurance markets stayed at the level of only 2% of the share in the Insurance Europe members' premium, or at a primordial stage in the insurance culture development.

From Figure 26 we can easily notice that the total insurance premium of the SEE region in 2017 decreased because one country registered decline in the premium (the country with the largest contribution to the region insurance landscape – Turkey). The total premium volume of Turkey was EUR 11.299 million, 45,7% of the SEE insurance premium, and fell by 6,7% compared to 2016 (since 2002, Turkey's insurance premium declined in 2004 by 25%, as well as in 2014, by 6,8%). The region country with the lowest insurance premium in 2017 was Montenegro as the smallest country, with the premium of EUR 82 million (but only for EUR five million less than Kosovo). Apart from Turkey, Greece, Ukraine and Kosovo did not record a three-year continuity of premium increase.

Figure 26. Total premium of the SEE insurance markets in the period 2002-2017 (EUR millions)



Figures 27 and 28 illustrate the trends in insurance penetration and insurance density in the region, i.e. the trends in the share of insurance premium in GDP and the insurance premium per capita, respectively. The insurance penetration and insurance density of the SEE region in 2017 followed the trend of the total insurance premium. An average insurance penetration for the region was 1,7% and it was slightly less than in 2016 (1,8%). Insurance density for the region in 2017 was EUR 133,9, also less than in 2016, EUR 136,4, by 1,5%. In the Insurance Europe members in 2017, insurance penetration was 7,5% (4,4 times higher than in the SEE region) and insurance density was EUR 2.030 (as much as 15,2 times higher than in the SEE region). As we can assume, both parameters increased in the case of the Insurance Europe members in 2017 compared to the previous year (from 7,2% and EUR 1.981, respectively).

Figure 27. Insurance penetration of the SEE insurance markets in the period 2002-2017 (%)

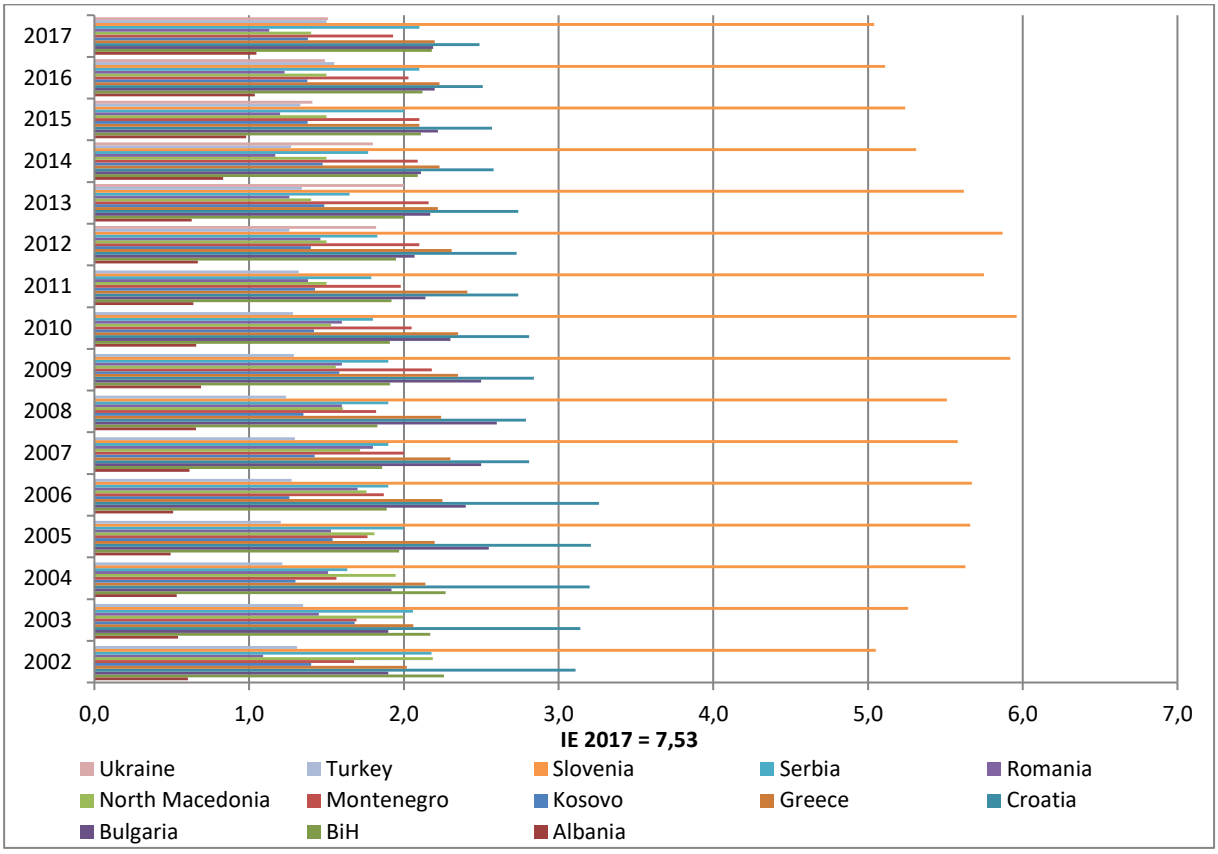
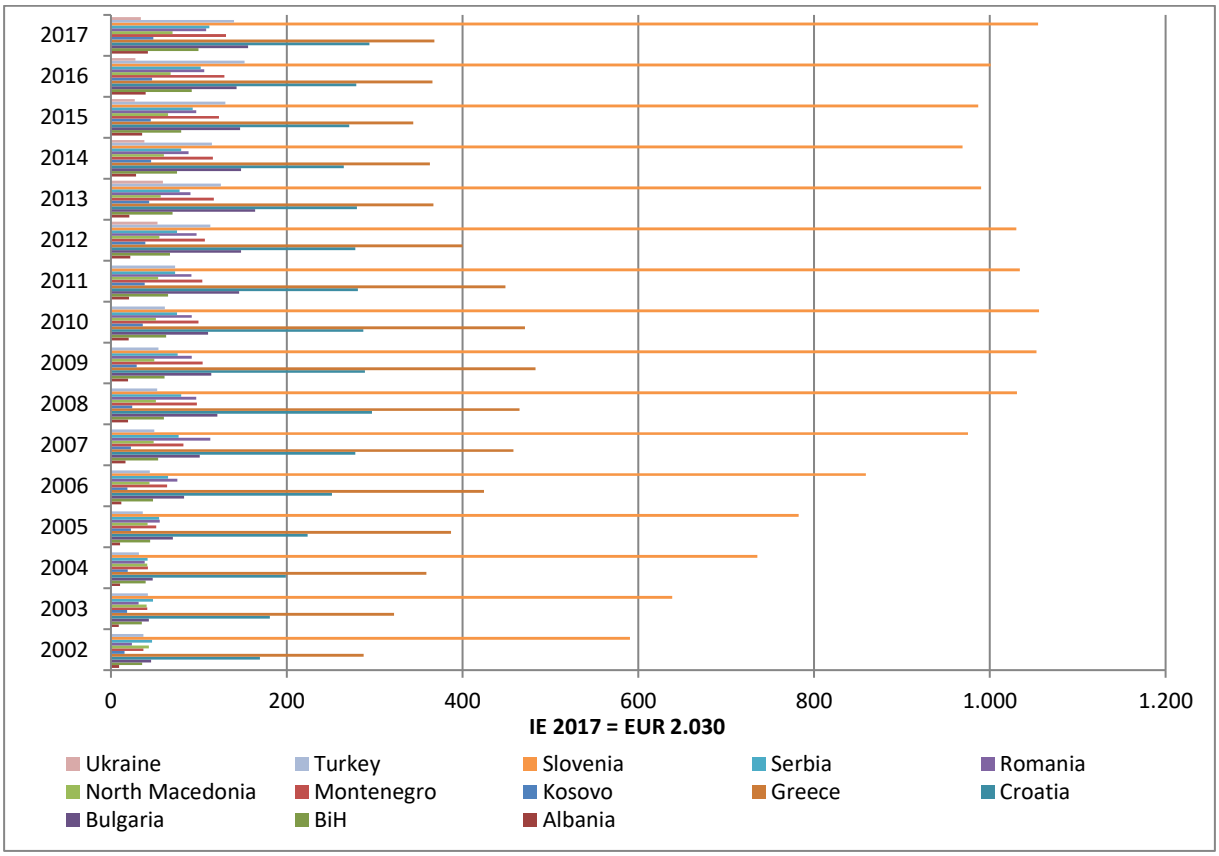


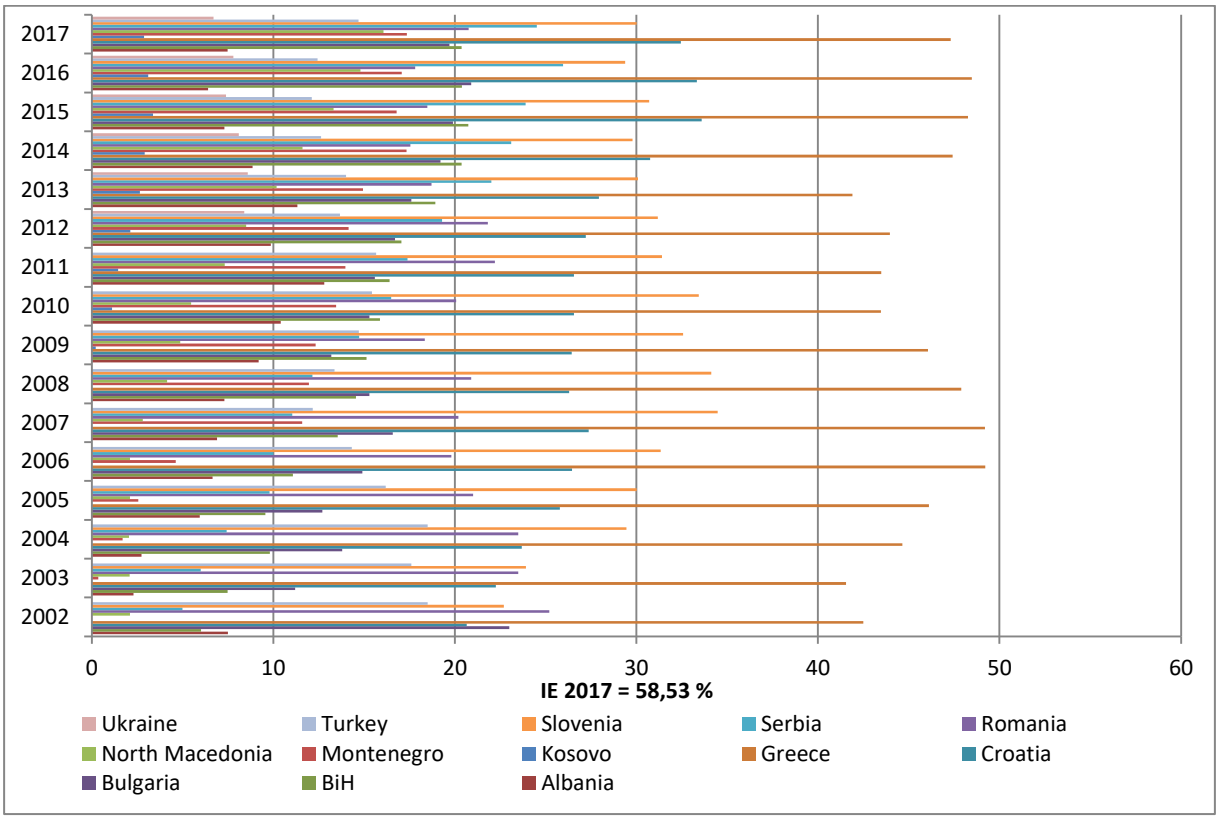
Figure 28. Insurance density of the SEE insurance markets in the period 2002-2017 (EUR)



More analytically, the largest level of insurance penetration was traditionally recorded in Slovenia (5,0%) and that is the closest to the Insurance Europe average. Slovenia also had the best indicator of insurance density (EUR 1.055). All the other countries of the region, except Greece (EUR 368) and Croatia (EUR 294), continued to have features of poor insurance markets with insurance density around EUR 150 or less (for example, EUR 156 in Bulgaria, fourth largest penetration, and the lowest in Ukraine, EUR 34).

Considering the structure of insurance premium of the SEE insurers, a positive change regarding life insurance was noticed. Namely, the average share of life insurance in total premium of the SEE region in 2017 was 22,8%, by 1,3% higher compared to 2016. Simultaneously, in the Insurance Europe members, the average share of life insurance in the total premium stayed unchanged, at the level of 58,5%. Figure 29 shows that the largest share of life insurance in 2017 was traditionally registered in Greece (47,3%). Moreover, Croatia (32,5%), Slovenia (30,0%), Serbia (24,5%), Romania (20,8%) and BiH (20,4%) were the only countries among the remaining ones that had the share of life insurance above 20%, a fifth of the premium. Kosovo had the smallest share of the life insurance in the total premium in 2017 (2,9%).

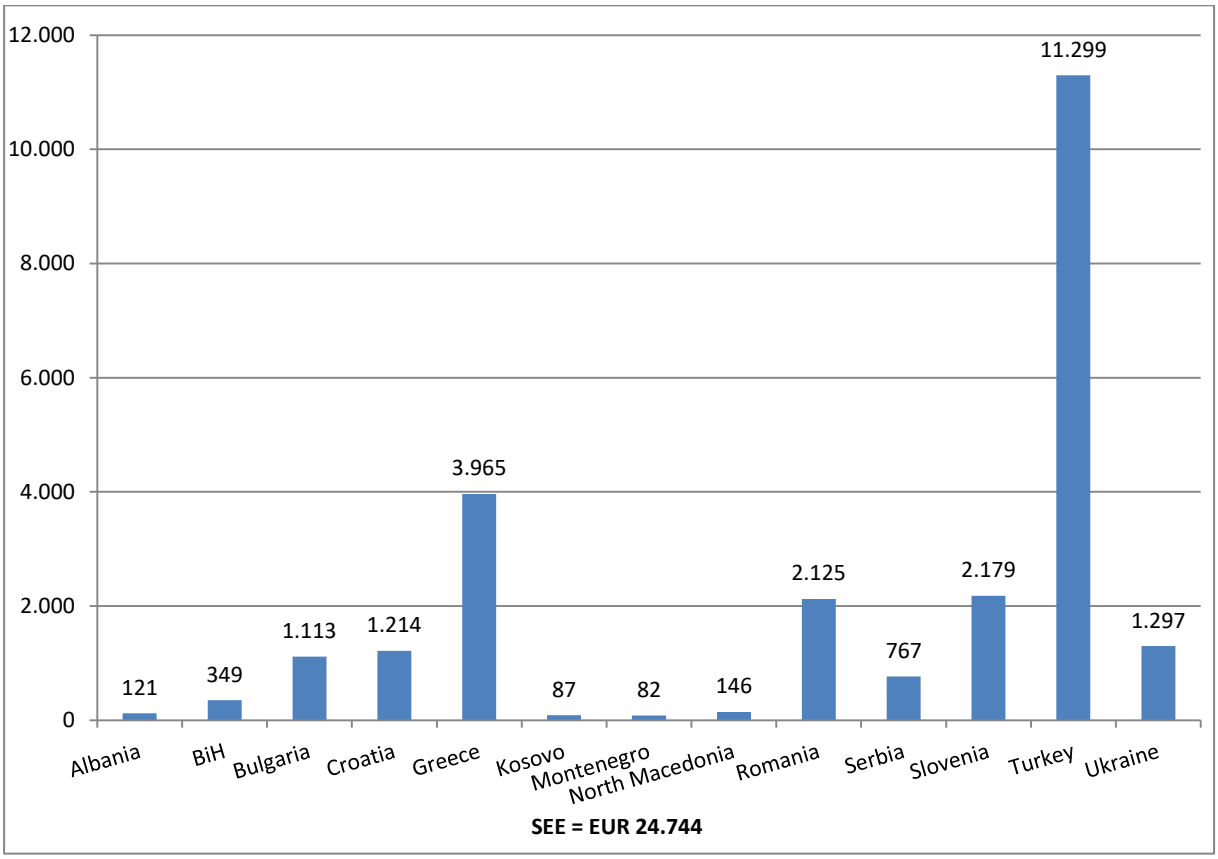
Figure 29. Share of life insurance in the total premium of the SEE insurance markets in the period 2002-2017 (%)



The further data about insurance markets of the SEE region in 2017 confirmed diversity among the countries regarding different criteria. In the following figures we will present specific market indicators, starting with the market size data shown in Figure 30. The total premium of EUR 24.744 million in 2017, where Turkey's contribution was EUR 11.299 million or, in relative terms, 45,7%, made the SEE region as one of the least developed parts of Europe when it comes to insurance. Like in the previous year, apart from Turkey, Greece (EUR 3.965 million), Slovenia

(EUR 2.179 million) and Romania (EUR 2.125 million) were the countries with the amount of the insurance premium above EUR 2.000 million in 2017. Nevertheless, considering the volume of the SEE economies (banking sectors, as their inherent parts, for example), one of their mutual characteristics refers to a high potential for insurance market growth.

Figure 30. Total premium of the SEE insurance markets in 2017 (EUR millions)



As Figure 31 illustrates, the total number of companies operating in 2017 was 324 and the data were collected for twelve markets (Ukraine was not involved). This indicates that most countries of the region had a disproportionately large number of companies in relation to market's premium. As it is shown in Figure 32, this is most evident in Kosovo, Montenegro, North Macedonia as well as Albania and BiH, where an average premium per company was between EUR 6 and 13 million, far less than in Turkey (EUR 185 million) and, especially, the Insurance Europe members (EUR 357 million).

To be more precise, although Kosovo, Montenegro, North Macedonia, Albania and BiH generated less than 3,2% of the total insurance premium in the SEE region, with overall 80 insurance companies they participated with 24,7% in the total number of companies operating on the selected thirteen markets. The average premium per company for the selected markets in 2017 was EUR 76 million, that is 4,7 times less than the average premium of the Insurance Europe. Only Turkey (EUR 185 million) and Slovenia (EUR 121 million) had an average premium per company above EUR 100 million. These indicators show that further mergers and acquisitions of the insurance undertakings can be expected, especially because of the new or upcoming regulatory requirements (Solvency II).

Figure 31. Number of companies on the SEE insurance markets in 2017

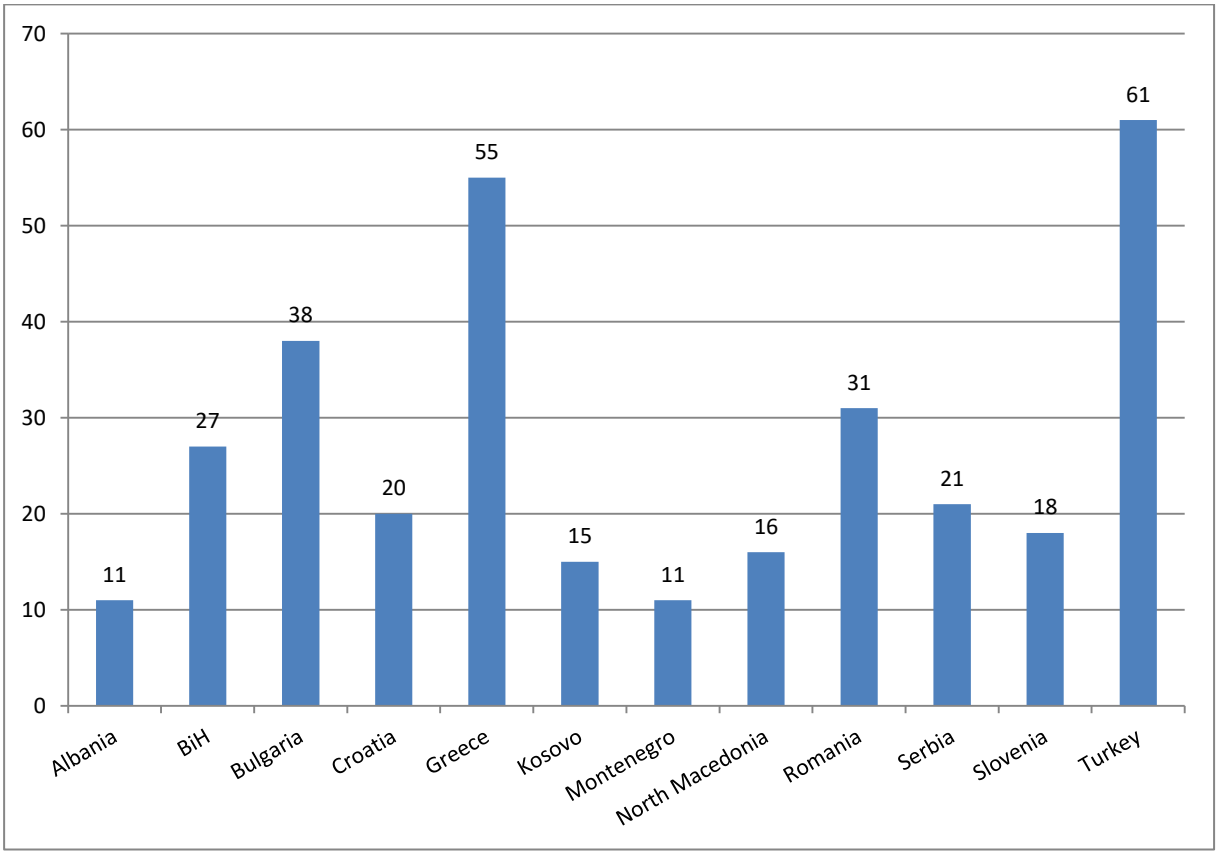
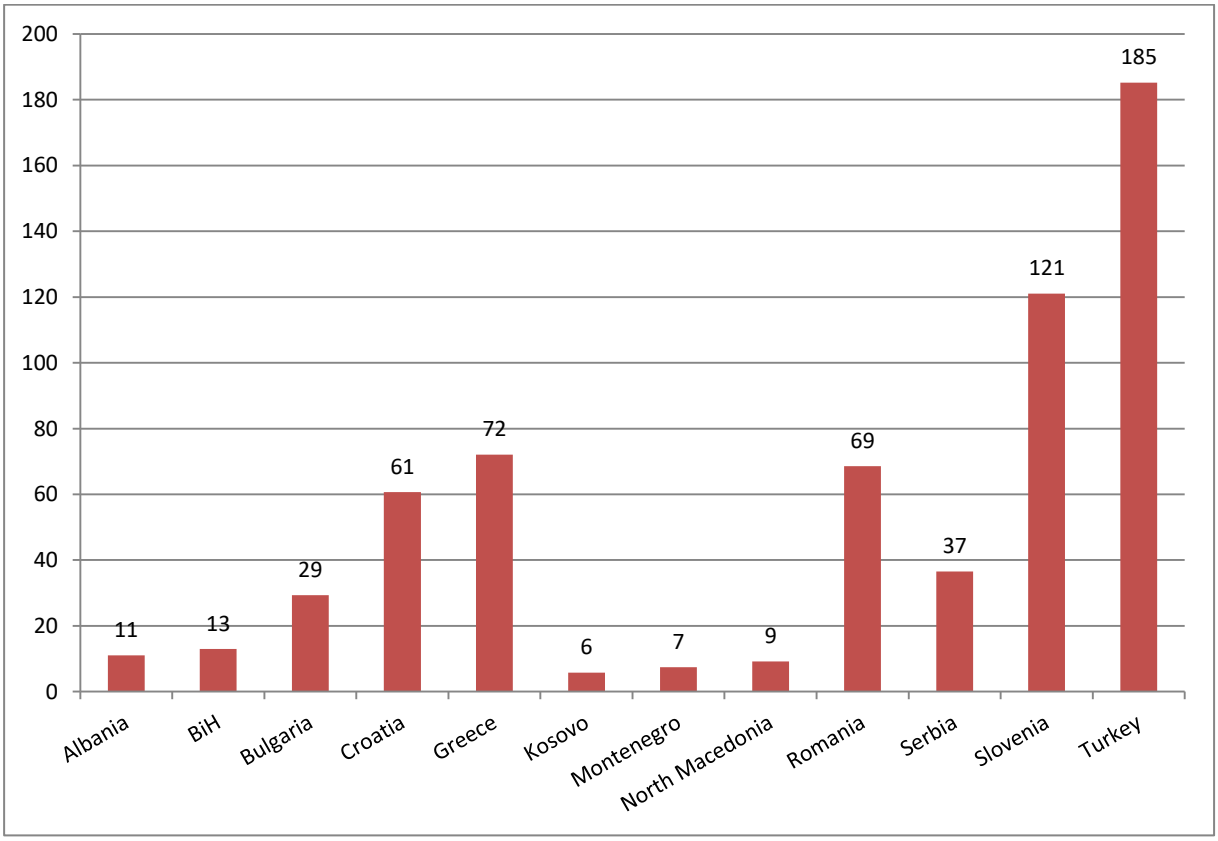


Figure 32. Average premium per company on the SEE insurance markets in 2017 (EUR millions)



Several indicators of the market concentration are shown in figures 33 to 36. Figure 33 illustrates that Montenegro continued to have the highest market share of the largest company in 2017 (36,6%), which was the successor of the monopolistic state company that existed in the earlier economic and political system. Regarding this criterion, Montenegro was followed by Croatia (28,9%), Slovenia (27,7%), Serbia (26,8%) and Albania (24,3%), while in other countries the largest insurance company covered below 20% of the market.

Figures 34 and 35 present market shares of three and five largest companies, respectively, where we can see that in all the analysed countries three largest companies covered more than 25% and five largest companies covered more than 40% of the total markets (except Turkey with 27,3% and 38,7%, and BiH with 24,9 and 39,2%, respectively).

Participation of small companies in the markets was best indicated by the number of companies with market share less than 3% and it is shown in Figure 36. The total number of companies with the market share less than 3% in the observed countries was 189. Turkey and Greece continued to have the largest number of these companies (50 and 39, respectively, or 47,1% both of them). The number of these companies declined over the last years as a consequence of not only mergers and acquisitions, but also bankruptcies. The average share of the largest company for all eleven observed markets (the data for Ukraine and Kosovo were not available) was 13,9%, while the average share of the largest three was 32,8% and the largest five 45,7%.

In order to make comparison, the share of the largest company in the Europe Insurance member states was 7,6%. The parameters regarding the largest three and five companies were 19,6% and 27,2%, respectively.

Figure 33. Market share of the largest company on the SEE insurance markets in 2017 (%)

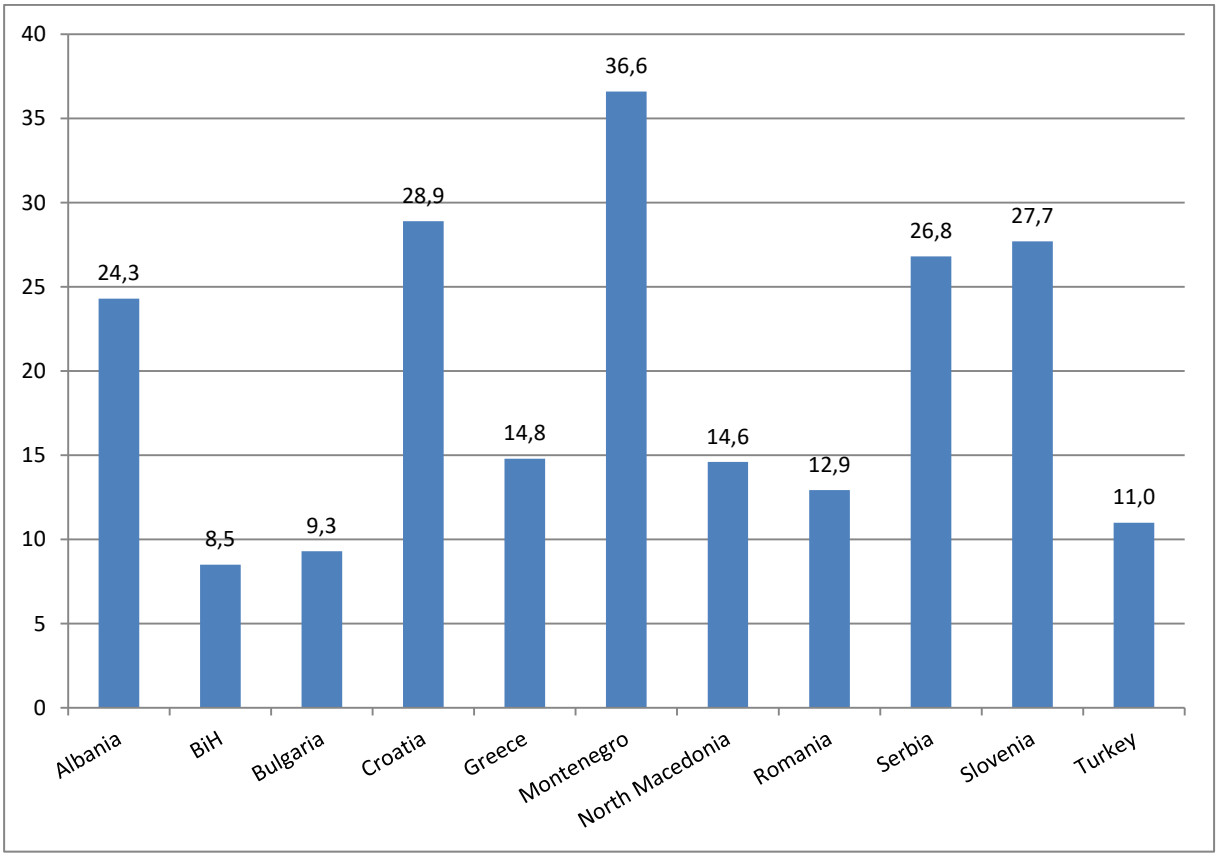


Figure 34. Market share of three largest companies on the SEE insurance markets in 2017 (%)

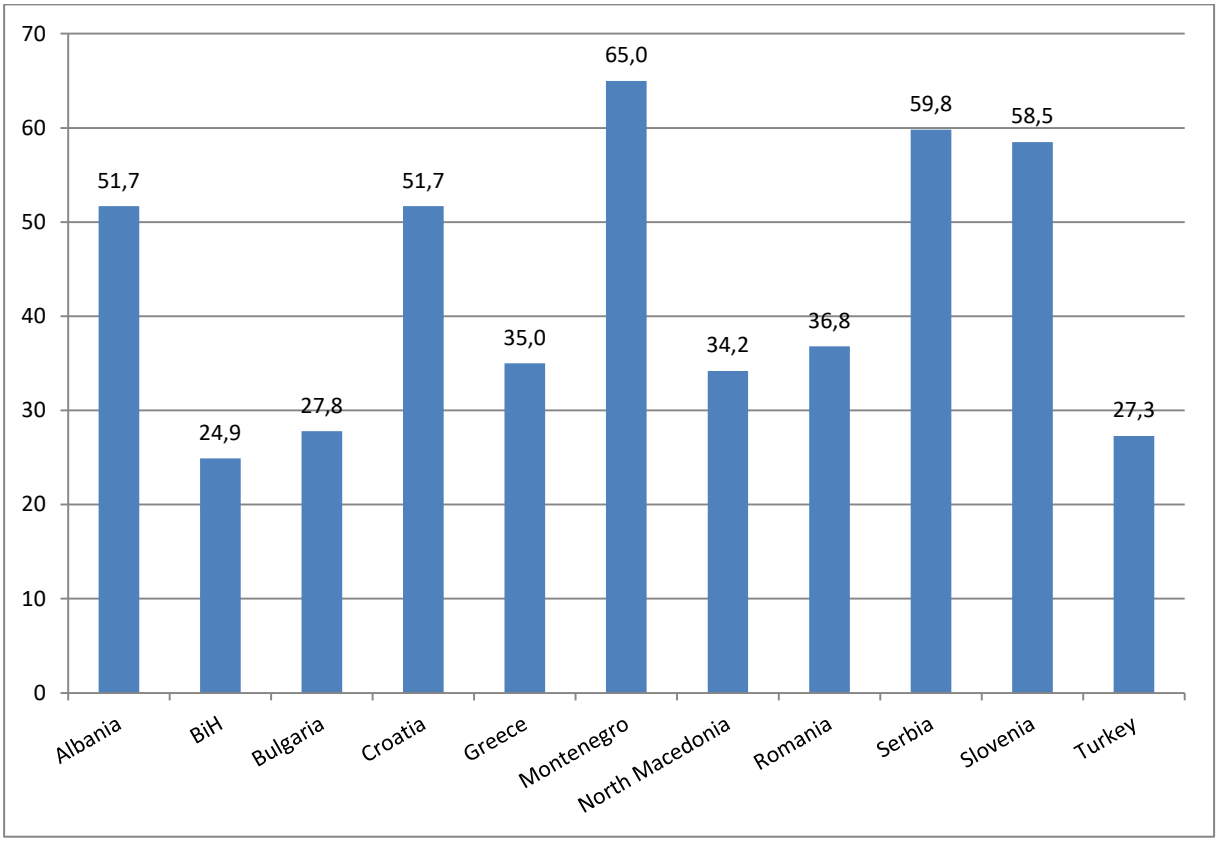


Figure 35. Market share of five largest companies on the SEE insurance markets in 2017 (%)

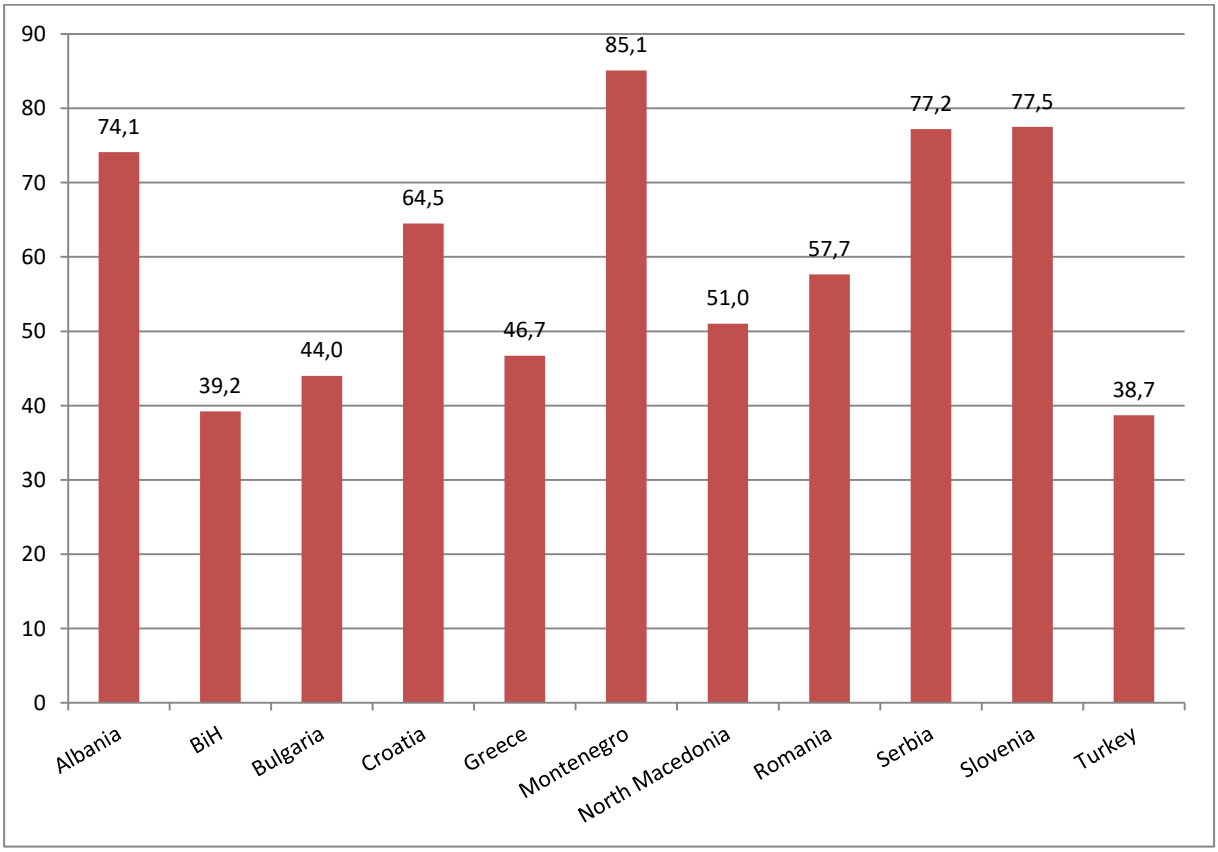
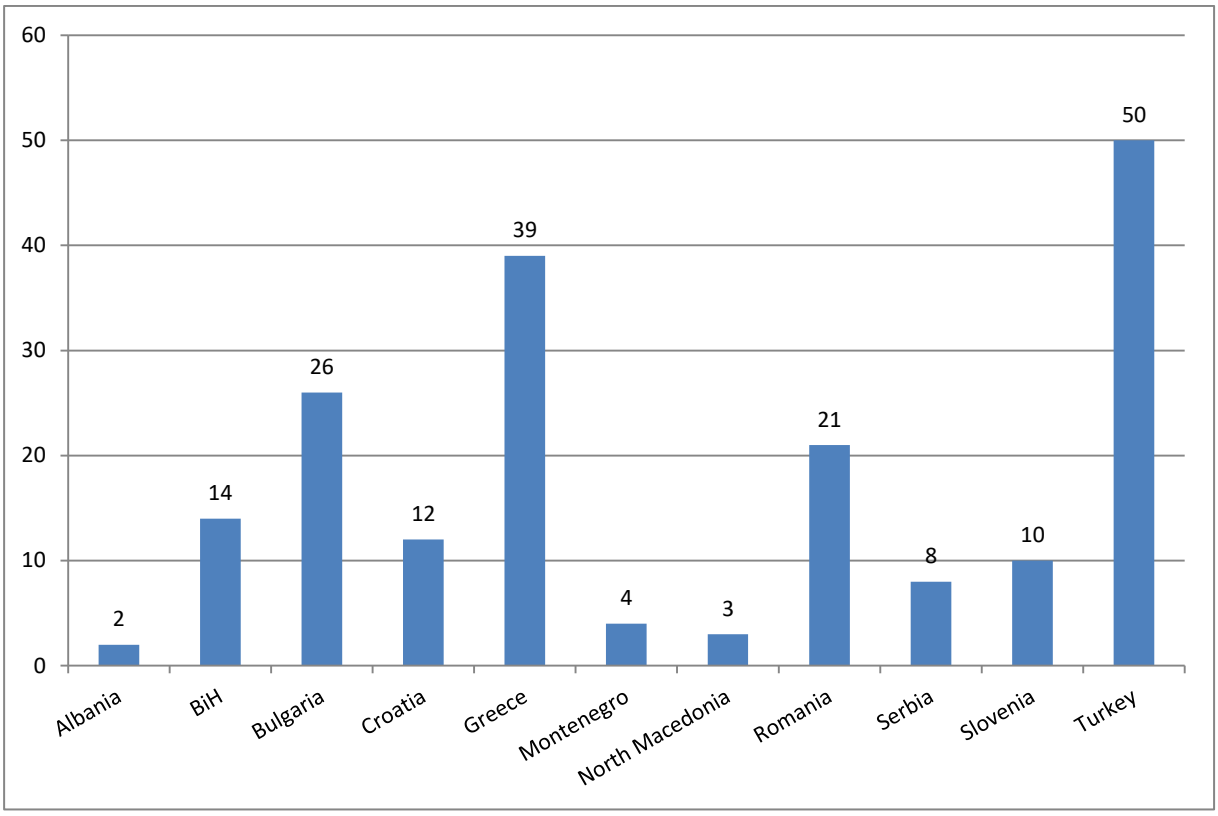


Figure 36. Number of companies with market share less than 3% on the SEE insurance markets in 2017



Figures 37 shows the structure of the insurers according to the type of insurance they were focused on. We can notice well-known dominance of nonlife insurers. Namely, it is easier for small domestic and/or local insurers to conduct their activities in the nonlife than life business lines, while life business is mostly in the hands of the insurers that come from the EU. A composite type of insurers is prohibited in some countries, in other words, life and nonlife insurance have to be separated.

A low competition level of domestic companies in life business forced them to focus on less profitable, nonlife business. On the other hand, efficiency of foreign insurers was reduced by the lack of insurance culture and predominant interest of the insurers in auto insurance, especially in mandatory MTPL insurance. Figure 38 indicates that the share of life insurance on the selected markets in 2017 was 22,8%, while MTPL covered 25,8% and other nonlife 51,45%.

A high share of MTPL insurance on the market was evident in Albania (61,9%), BiH (50,1%), North Macedonia (45,3%), Montenegro (42,5%) and Romania (39,4%), where it contributed to the total premium around 40% or more (see Figure 39). For comparison, an average share of the MTPL insurance in the total premium of the Insurance Europe members was 5,1% and the share of the other nonlife insurance was 36,4% in 2017. The share of life insurance in the total premium of the Insurance Europe was mentioned before (58,5%).

Figure 37. Number of life, nonlife and composite insurers on the SEE insurance markets in 2017

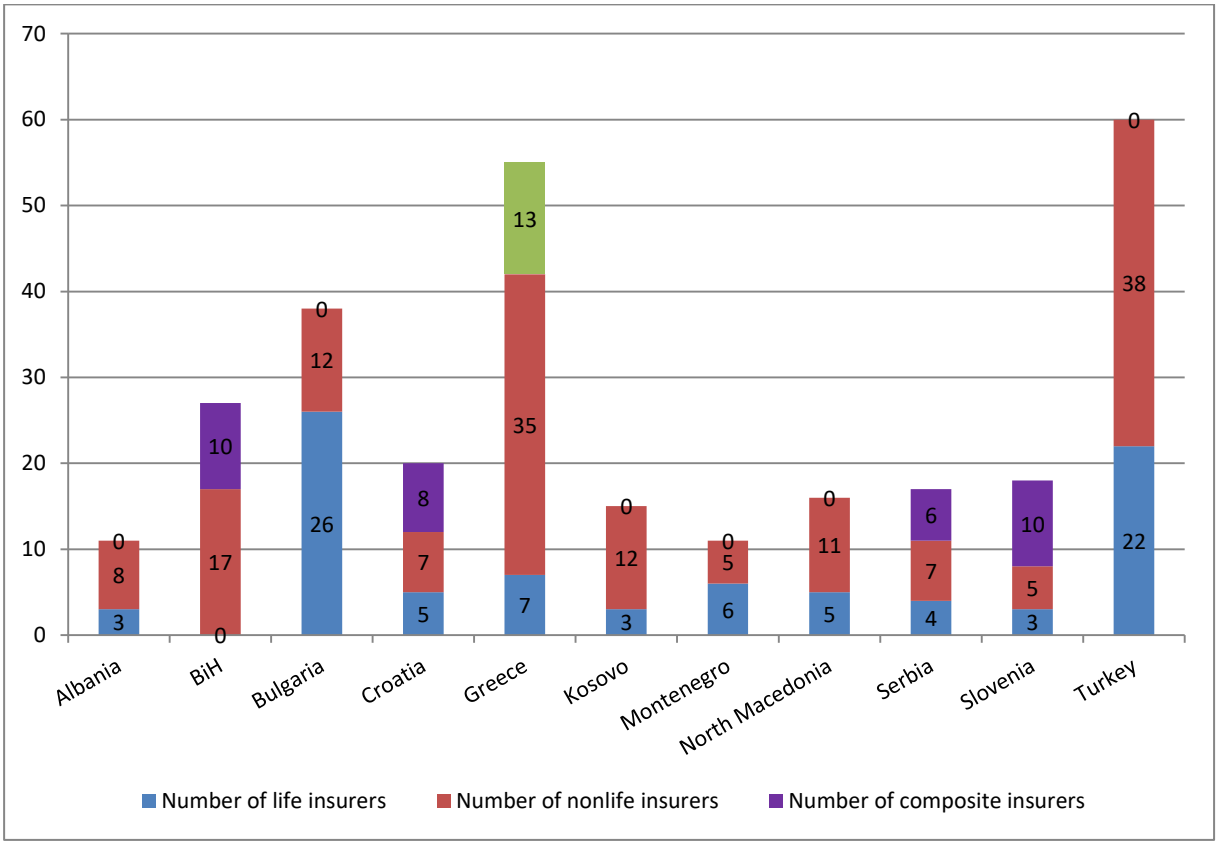


Figure 38. Share of life, MTPL and other types of nonlife insurance premium on the SEE insurance markets in 2017

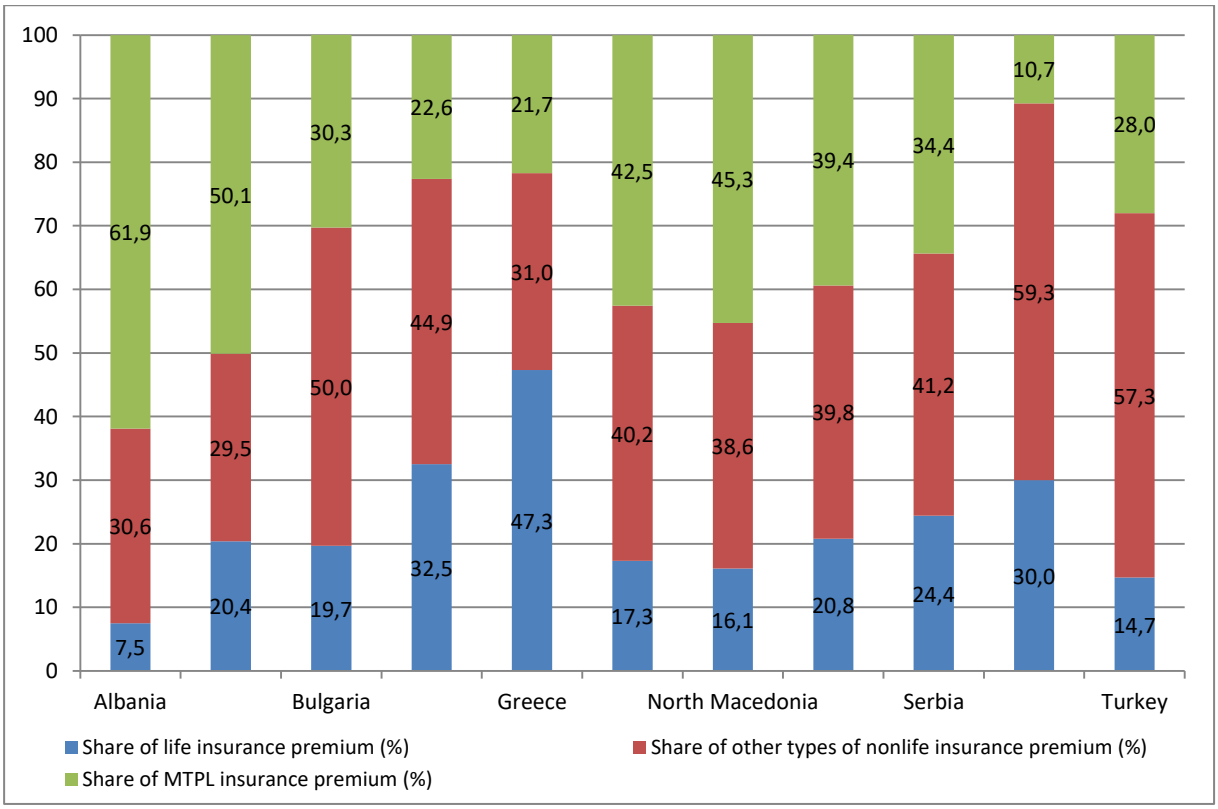
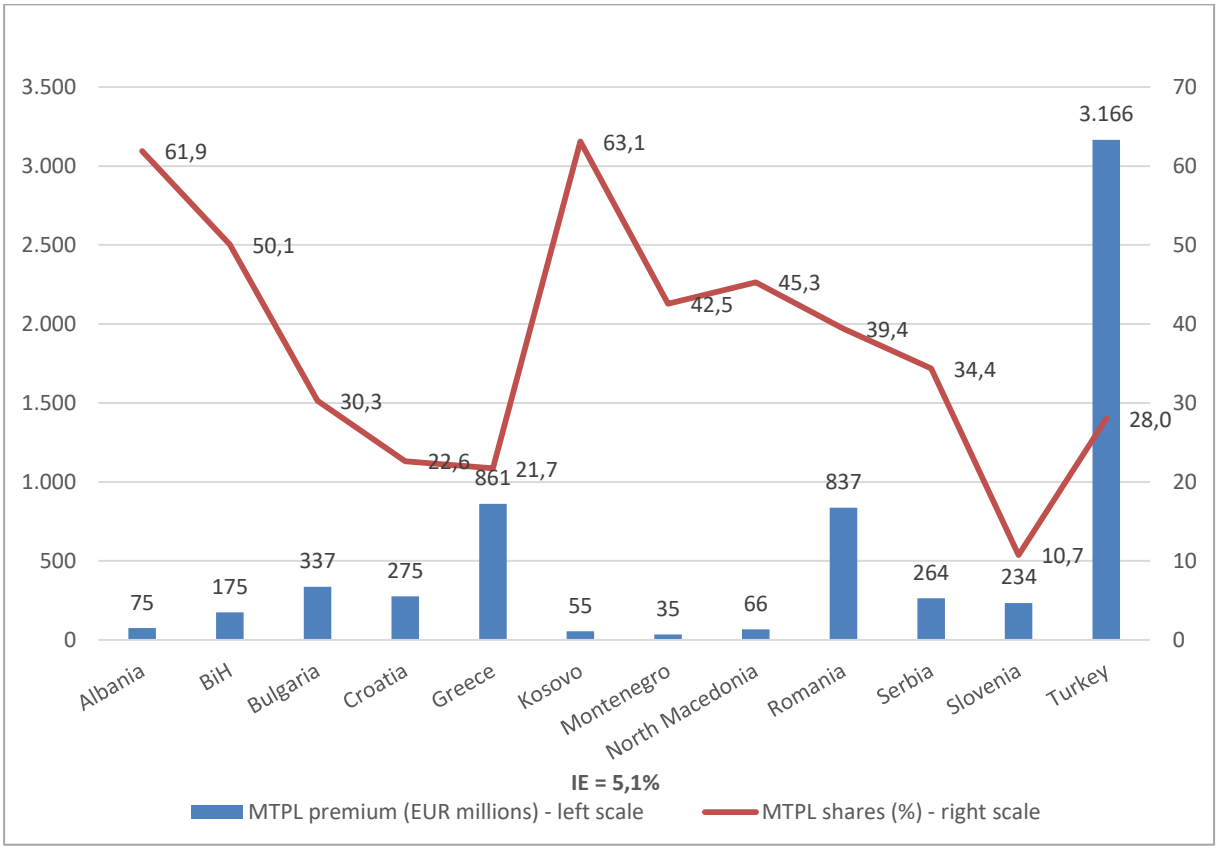


Figure 39. MTPL shares on the SEE insurance markets in 2017



Figures 40 and 41 show the numbers and market share of companies with the majority of domestic and foreign ownership for the countries with available data. Foreign insurers were prevalent in almost all observed markets, covering a half or more of the total premium, but there were many examples of insurers from one SEE country (such as Slovenia and Croatia) operating on the markets of other countries of the region. The largest market share of foreign insurers was registered in North Macedonia, where foreign insurers covered more than 90% of the market.

Figure 40. Number of companies with majority of domestic and foreign ownership on the SEE insurance markets in 2017

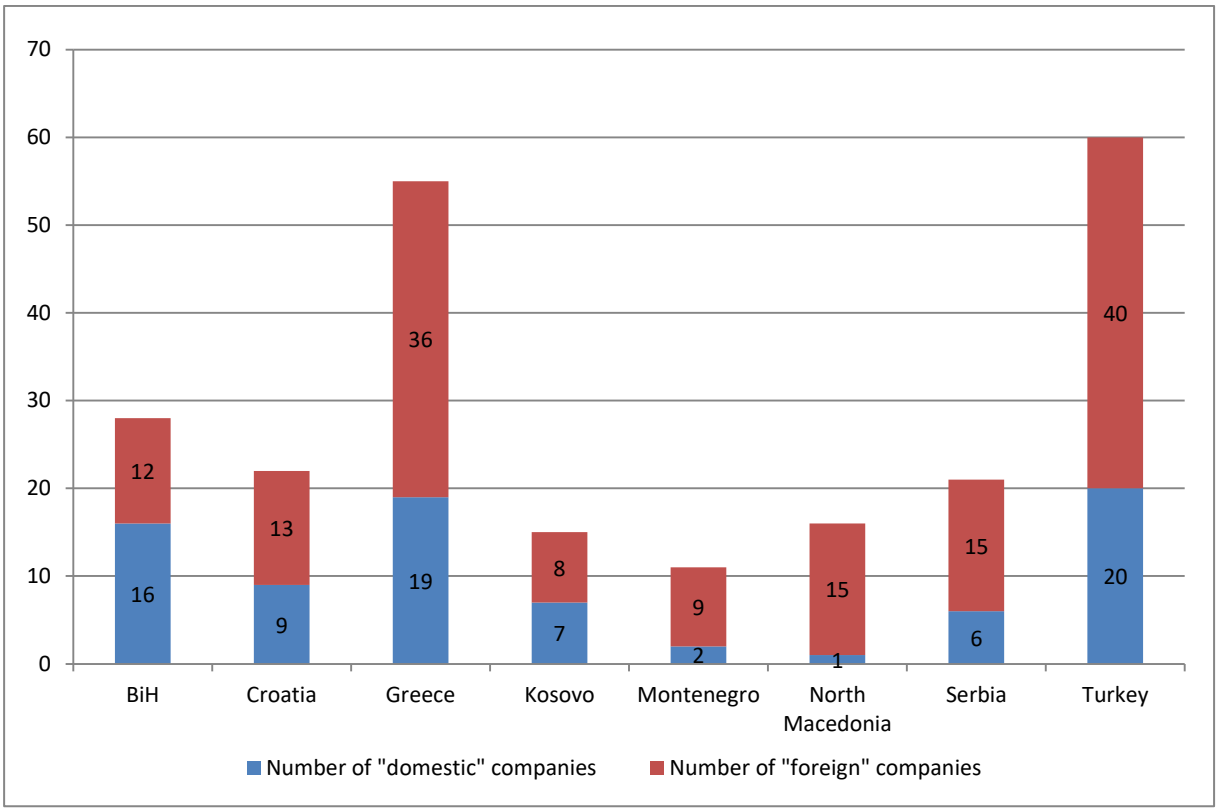
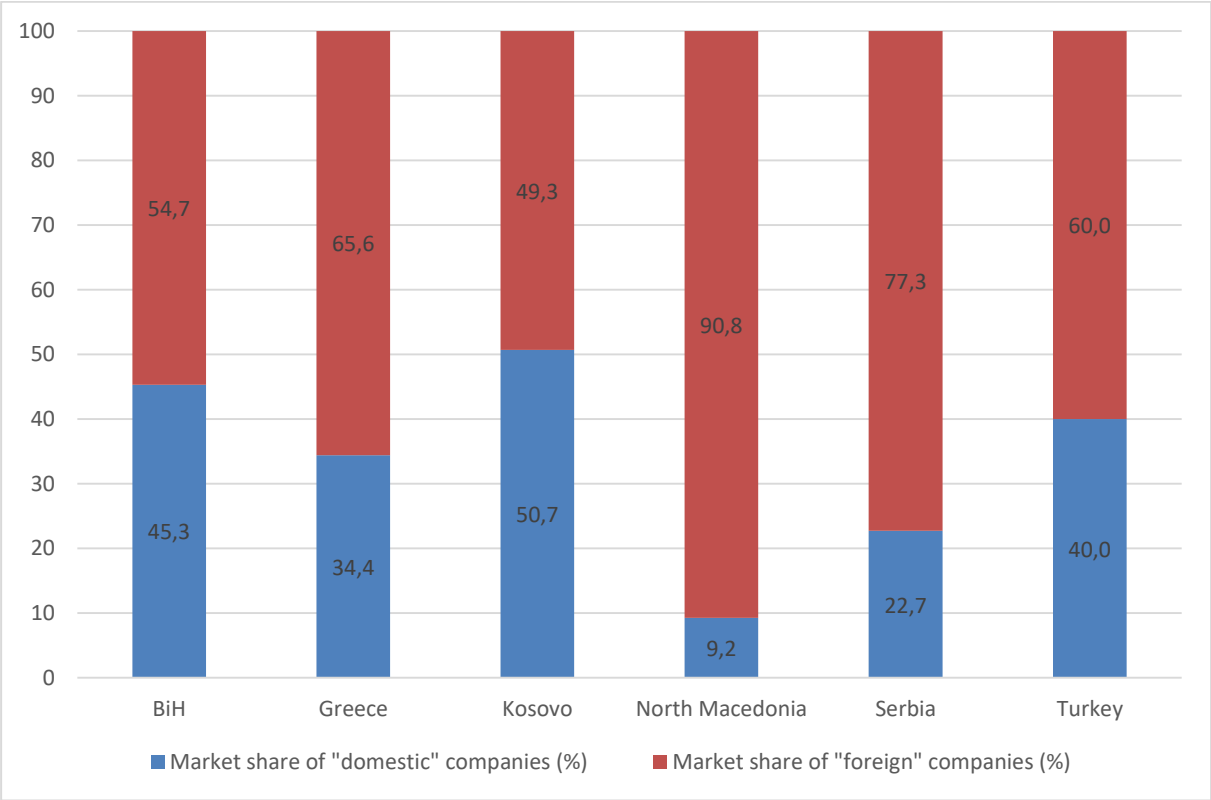


Figure 41. Market share of companies with majority of domestic and foreign ownership on the SEE insurance markets in 2017



OTHER RELEVANT FINANCIAL INSTITUTIONS IN SOUTH-EASTERN EUROPEAN FINANCIAL STRUCTURES IN 2017

Apart from banks and (re)insurance companies, when we analyse other financial institutions in the SEE financial structures, we can notice a wide range of different types of financial intermediaries such as investment funds and voluntary pension funds, micro-credit organizations (or microfinance institutions), leasing companies, saving and loans associations etc., but regarding their investment potential they are far below the banks. Banks still play a decisive role in all these financial markets. Individual reports for each country based on official reports published by their relevant national institutions include the part related to other relevant financial institutions. Therefore, we shall give an overview of the countries in order to shed some lights on the basics of their other relevant financial institutions.

As far as Albania is concerned, the share of other relevant financial institutions in the overall assets circulated in the financial system was 8,1% in 2017. There were three pension funds and they invested mostly in government bonds. Also, three investments funds operated on the market. According to the official data, in 2017 they invested 61,3% of their assets in government bonds, 17,7% in treasury bills, 9,7% in cash and cash equivalents, 5,3% in corporate bonds, 5,0% in other investments and 1,0% in other assets. In 2016 through the mergers, by absorption, the process of the reorganization of 98 existing saving and loans associations finished. At the end of 2017 there were 13 saving and loans associations and one union savings and loan associations. Micro-credit organizations (or microfinance institutions) as well as leasing companies operated on Albanian financial market. When it comes the object of leasing, in 2017 the leasing portfolio was dominated by financing for personal transport vehicles (55,1%) and working transport vehicles (26,1%).

The share of other relevant financial institutions in BiH financial system was 6,1% in 2017. The pension insurance reform is still not over, it is in some kind of transition. But in 2017 the first voluntary pension fund management company was founded and the first voluntary pension fund (European Voluntary Pension Fund) started to work. Investments funds are mostly closed-end, as a result of legaly permitted transformation from privatization funds in the 2000s. Regarding the investment structure of BiH investment funds, they invested the main part of the assets in cash and cash equivalents in 2017 (63,7% the investment funds located in the Federation BiH and 69,9% the investment funds in Republic of Srpska). The micro-credit sector of BiH has played a significant role in reducing poverty and supporting the development of entrepreneurship among the socially vulnerable parts of the population, which have no access to financial resources at traditional banks. The results achieved for the period since the establishment of the micro-credit sector rank BiH among the countries of the world that have gone further in the development of this area of financial offer. In 2017 on the BiH market 29 micro-credit organizations were functioning, out of which 15 operated as micro-credit foundations and 14 as micro-credit companies. They invested mostly in the net loans (in Federation BiH 77,0% of their assets and 80,0% in Republic of Srpska). When we consider the portfolio of leasing companies, 88,0% of all arrangements were financial and 12 operational leasing. The object of the leasing were mainly vehicles for business purposes and, expectedly, the users were mainly legal entities.

Compared to Albania and BiH, the share of other relevant financial institutions in the financial structure of Bulgaria was much greater in 2017, at the value of 17,3%. Currently, supplementary

pension insurance is implemented by participation in mandatory universal and/or professional pension funds, supplementary voluntary pension funds and/or supplementary voluntary pension funds with occupational schemes, which are established and managed by pension insurance companies licensed by the Financial Supervision Commission. At the end of 2017, the structure of the pension insurance market remained unchanged compared to the previous year in terms of the number of licensed pension companies (9) and the number of pension funds (28). They invested predominantly in debt securities issued or guaranteed by the EU member states, other states or by their central banks (63,0%). Investment funds in Bulgaria can be classified into two broad groups – resident and non-resident. As far as their portfolio structure is concerned, it is interesting that the funds mainly invested in shares and other equity (35,9%), then deposits (26,7%) and securities other than shares (25,1%). Moreover, in the portfolio of Bulgarian leasing companies the highest share had loans (85,4%). Much more leasing was financial (95,0%) than operational (5,0%), on the observed two-year continuity. The object of both leasing contracts were usually cars, transport and commercial vehicles as well as machinery and industrial equipment.

In 2017, slightly more than a quarter (25,6%) of the financial structure of Croatia referred to other relevant financial institutions, such as pension and investment funds, credit unions and leasing companies. There were voluntary pension funds, which may be of an open-end or closed-end type, and mandatory pension fund, which may belong to the one of the three categories (A, B or C). Mandatory pension funds invested 97,5% of their assets in securities and deposits, out of which the most in domestic government bonds (71,6%). Similarly, while voluntary open-end investment funds had 93,8% of the investment structure in securities and deposits (out of which 58,2% in domestic government bonds), voluntary closed-end funds had 92,8% in the same items (out of which 56,7% in domestic government bonds). There were two types of investment funds in Croatia – open-ended investment funds with public offering (UCITS) and alternative investment funds in 2017. UCITS funds predominantly invested in government bonds (41,0%), then money market instruments (24,6%), deposits (17,9%), shares (12,2%), other UCITS funds (3,0%) and corporate bonds (1,4%). Regarding the country of the origin of issuers, these funds invested the most in domestic securities (for example, 90,8% in 2016 and 84,3% in 2017). There was the special investment fund governed by the Act on the Fund of Croatian Homeland War Veterans and Members of their Families, but this fund stopped to operate on December 28, 2017. Beside this, credit unions nowadays play the role of micro-credit organisations in Croatia. As a result of the initiative of nine credit unions, the Croatian credit unions association was established on July 1, 2011, with its residence located in Zagreb, in order to achieve mutual interests. Furthermore, the majority of leasing companies in Croatia belong to the group of financial institutions and they traditionally offer financial as well as operational leasing services/products. In 2017, the most of the leasing contracts referred to passenger cars, commercial vehicles, plants, machinery, transport machines and equipment. The most frequent users were non-financial institutions (i.e. companies).

In spite of the fact that there are three pillars of the pension system, the first pillar on the social security accounts for more than 99 percent of the whole system in Greece. Voluntary occupational and private pension plans existed in 2017, but they still were of minor importance. Greek UCITS included two basic types of collective investment undertakings – mutual funds and variable capital investment companies. Both fund types were open-end or mutual. According to type, in 2017 out of 286 mutual funds in Greece, 74 were equity, 33 balanced, 75 funds of funds

and 14 specialized. The existing Banking Law requires a minimum capital of EUR 18 million to carry out financial or credit activities. A partnership with a licensed bank is required by all legal entities such as NGOs (including associations, foundations etc.) that are interested in serving the micro-credit market. Moreover, we noticed that 22,6% of the liabilities of leasing companies represented liabilities due to credit institutions, compared to 8,3% for factoring companies in 2016.

Pension funds, micro-credit organizations and leasing companies as other relevant financial institutions in Kosovo participated with 31,3% in the financial structure in 2017. Kosovo Pension Fund („Trusti") was established in August 2002 to administer and manage mandatory and voluntary pension contributions of Kosovo's employers and is supervised by the Central Bank of Kosovo. Since 2008, there were two voluntary pension fund management companies. The vast majority of microfinance institutions in Kosovo has non-governmental organization (NGO) status. They are supervised by the Central Bank. The leasing sector in Kosovo is at early stage of development and the Raiffeisen Leasing Kosovo was the only financial institution that offered this kind of financial services in the country in 2017. The main activity of this leasing company was to provide financial leasing for vehicles, equipment or machinery as well as real estate.

We can say that the financial system of Montenegro has still not recognized the role of the third part – other financial institution because of their contribution of only 2,4% in 2017 (relatively stable or in decreasing since 2012). There were two voluntary pension funds, out of which one invested 58,0% of its assets in money deposits and the other one 65,0% in the investment funds. Five closed-end and four open-end funds operated in the industry of the investment funds. They invested 88,0% of the assets in securities. Micro-credit organizations invested 96,2% of the assets in loans to citizens. Moreover, in 2017 four leasing companies conducted businesses, while 78,0% of the leasing activities referred to financial leasing and 22,0% to operational. The main object of the activities were passenger cars (89,0%).

In North Macedonia 13,4% of financial assets in the system referred to other relevant financial institutions in 2017. The fully funded pension insurance included two pension companies. Both companies managed one mandatory pension fund and one voluntary pension fund. They predominantly invested in bonds issued by domestic issuers. Investment funds had small contribution among institutional investors. In 2017 there were 15 open-end funds and not a single closed-end fund. The existing funds invested 52,9% of the assets in deposits. In 2017, the number of leasing companies remained seven, unchanged compared to the previous year. Unlike the previous four years, when the scope of activities of this sector was continuously decreasing, in 2017, the total assets of the leasing companies increased by 19,9%. All companies were with 100,0% foreign capital but the leasing market was still underdeveloped. Also, there were two saving houses and four financial companies on the market, relatively small according to the volume of their activities.

In Romania 18,4% of the financial assets were possessed by other relevant financial institutions in 2017. There were 17 pension funds, out of which 10 voluntary and seven mandatory, which functioned on the markets. They invested 61,3% of the assets in government bonds. Apart from pension funds, investment societies operated in Romania as well as open-end and close-end investment funds. The number of the non-bank financial institutions in the General Register

increased from 177 in 2016 to 183 in 2017. Their primary activities were multiple lending activities (81,4% in 2017, by 1,4% more compared to the previous year).

Slightly more than for Montenegro, 3,0%, was the share of other institutions in the financial structure of Serbia. The pension reform finished in 2006, since when only voluntary pension funds were operating. Four companies managed seven voluntary pension funds, one custody bank and five agent banks in 2017. As far as the investment structure of the pension funds is concerned, they invested 83,6% of their assets in the government debt securities. Besides, there were two types of investment funds on the market – open-end investment funds with public offering and alternative investment funds. In total, 17 investment funds on the market in 2017 mostly invested in short-term cash deposits (68,7%), more in EUR (54,0%) than domestic currency (36,0%). Micro-credits in Serbian financial system are approved exclusively by banks, and money control is carried out by UNHCR donors and tax authorities. Moreover, 16 leasing companies operated on the market and at the end of 2017 their financing of freight vehicles, minibuses, and buses (43,1%) continued to account for the largest share of financial lease as well as passenger vehicles (33,2%).

Regarding the financial system in Slovenia, 12,1% of the financial structures referred to other financial institutions in 2017. The First Pension Fund is a special type of a pension fund designed to cover for payments of pension annuities from insurance policies under supplementary pension insurance and is managed by Modra Zavarovalnica. At the end of 2017, seven management companies operated, which managed six umbrella funds with 96 sub-funds and four mutual funds. The Leasing Committee, established as a leasing office within the Bank Association, represents the leasing industry in Slovenia. Related to the leasing activities, there were relevant trends in 2017 such as the sale of the portfolios of the leasing companies, the sale of certain leasing companies, the specialisation of the member institutions, the changes in business models, etc.

From 2012 to 2017, the contribution of other relevant financial institutions in Turkey was around 8,9%. The number of active pension investment funds as of the end of 2017 was 299, which were managed by 18 pension companies. Standard Pension Investment Funds and Variable Pension Investment Funds were put up for sale on 01 January, 2018. Also, 456 investments funds on the market operated. The funds invested dominantly in private sector debt securities.

Other relevant financial institutions in Ukraine involve pension funds, investment funds, credit unions as well as leasing companies. Pension reform was introduced in October 2017. This reform has been one of the IMF's key demands for Ukraine in order to release an USD 8,4 billion tranche of finance, part of its USD 17,5 billion loan program. However, 49,0% of Ukrainians do not support the pension reform. In 2017, 1.160 investment funds operated on the market and 50,4% of their assets was invested in equities. Microfinance is not developed in Ukraine and the microfinance segment is mostly served by banks or credit unions, though NGOs are present on the market. Credit unions are the main non-bank financial institutions serving the financial needs of small and medium enterprises. The overall size of the credit union segment is very small, relative to the financial system. Similarly, the leasing market has been developing slowly. In 2000, the overall contribution of the leasing assets was registered at the level of 1,0% (the lowest in Europe). Vehicles (cars, trucks, LCV) were still the main subject of leasing in Ukraine,

comprising more than 70,0% of all items leased during 2017. Lessors were most interested in the leasing of equipment that is highly liquid and can be easily repossessed and resold.

THE ROLE OF FINANCIAL INSTITUTIONS IN FINANCING SMALL AND MID-SIZE ENTERPRISES: RECOMMENDATIONS FOR SOUTH-EASTERN EUROPE

Financing is one of the most important problems that small and mid-size enterprises (SMEs) face. The level of economy development and the development of financial system in particular, largely affect the sources of finance available to SMEs.

POSSIBLE SOURCE OF FINANCE FOR SMES

As a term, financing includes the process of provision of financial resources. The sources of finance for enterprises, including SMEs, can be defined as all financial resources owned by the enterprises regardless of their origin (own and/or borrowed, internal and/or external, etc.). Awareness of the existence of various sources and their appropriate usage are the main factors for maintaining continuity and success in enterprise's business operations.

The sources of enterprise's financing may be divided with regard to different criteria:

- by origin – internal and external,
- by ownership – own, borrowed and hybrid,
- by availability term – short-term, medium-term, and long-term.[10]

Own resources, as the source of finance, include the resources of the founder (owner), partnership shares, issued regular or preferential stocks, etc. This source can further be divided into internal own resources (amortization and retained earnings) and external own resources (stock capital paid in and the issuance of stocks or shares). Unlike own resources, borrowed resources are the sources that an enterprise is obliged to return to lenders (creditors, bondholders) while paying a certain fee (interest). Short-term sources of finance are those with maturity date up to one year. Most often they include: liabilities to suppliers (trade credits), issued short-term securities, short-term loans, etc. Long-term sources of finance have maturity date longer than a year. They are particularly important as they affect long-term stability of enterprise's financing.

In developed market economies, the range of sources of finance (financial instruments) available to enterprises is much wider when compared to the countries with emerging markets. However, regardless of the level of economy's development, certain sources of finance, particularly the borrowed ones, are less available to SMEs than large enterprises due to the fact that creditors and lenders perceive SMEs as a group of risky clients.

FINANCING MODEL DEPENDENCE ON MACROECONOMIC ENVIRONMENT

The size distribution of enterprises in emerging markets is rather different from that in developed economies. In the least developed countries on average almost two thirds of workers

[10] Kozarevic, E., Kokorovic Jukan, M. (2018) *Specifičnosti finansiranja malih i srednjih preduzeća – primjer Bosne i Hercegovine [Specificity of small and medium-size enterprises financing – The case of Bosnia and Herzegovina]*. Tuzla: Harfograf, p. 22.

are employed in very small (micro) enterprises – that is, enterprises with less than five employees – and most of the rest work for large enterprises that have more than 100 employees. SMEs are underrepresented in these economies. In total, they employ less than 10,0% of the total workforce. By contrast, in the most developed countries, more than two thirds of all employees work for large enterprises, the majority of the remaining work for SMEs while only a fraction for micro enterprises[11]. Although large enterprises have the largest share of aggregate economic activity in the most developed countries, SMEs play a much more important role than their proportion of total employment might indicate. They not only make up the majority of enterprises (they are most numerous) but they also dominate many sectors of economic activity and are the generators of new products and technological innovations more generally.

A common explanation for the comparative absence of SMEs in underdeveloped countries when compared to developed countries nowadays is that SMEs cannot obtain access to capital. According to a World Bank survey,[12] large enterprises in any country generally have better access to bank credit, in both local and foreign banks when compared to small enterprises that mainly rely on internal funds and retained earnings. In addition, the survey also showed that there is significant heterogeneity across countries when it comes to the sources of finance for SMEs, with the share of small enterprises without external finance ranging from 19,2% in Croatia to 72,9% in Armenia. In approximately a quarter of the countries, small enterprises obtain more than 10,0% of their funds from trade credits (liabilities to suppliers), while some 40,0% of them get the equivalent share of finance from local commercial banks. In general, moreover, the countries in which SMEs have access to such types of external sources are precisely the countries with more advanced financial systems, which indicates a potential causal relationship between financial development and the viability of SMEs.

Many economies of northern and western Europe as well as of North America have developed a wide spectrum of modern financial institutions quite early in their history and then successfully underwent industrialization over a period from the late 18th to the early 20th centuries. There is no doubt that modern financial institutions were of crucial importance for the overall registered growth of these economies. However, it does not necessarily mean that these institutions played an important role in the finance of SMEs. Indeed, the evidence suggests quite the opposite. SMEs in these regions rarely raised their capital on the equity markets or obtained credits from large banks in financial centres. Although SMEs used external sources for the provision of working capital, withstanding unfavourable business conditions and using the benefits of new technologies, they received assistance from a significant number of local financial intermediaries. Furthermore, it seems that these intermediaries emerged endogenously in order to satisfy their own needs wherever sufficient demand existed. Governments of these countries did little to prevent their formation but they also played little role in their creation by providing the environment which included reliable property rights and the establishment of national financial institutions such as central banks, which helped in mitigating local shocks. Governments were generally not able to initiate economic growth by promoting local financial institutions in regions where there was insufficient demand for their

[11] Snodgrass, D. R., Biggs, T. (1996) *Industrialization and the Small Firm: Patterns and Policies*. San Francisco: ICS Press.

[12] The survey into the sources of finance for enterprises was conducted under the World Bank investment climate program in 2002-2003 (Investment Climate Surveys - ICS) in 38 developing countries in Europe, Asia, Africa, and Latin America. For more details see http://research.worldbank.org/ics/jsp/index.jsp.

services. Admittedly, the specialized intermediaries that emerged to satisfy the needs of SMEs had significant weaknesses but they were able to get through local information networks and consequently extend credit to enterprises that were too "young" or small to secure funds from large regional or national institutions. Moreover, by raising the return to savings for households in their vicinity, they helped to mobilize significant resources for economic development.

SMEs in developing countries nowadays use various sources of finance just as those in the North Atlantic Core during the 19th century. Also, as enterprises grow, reliance on banks and other similar types of formal intermediaries increases, while dependence on informal sources of funding decreases.

Table 1. Main external sources depending on enterprise's size[13]

Enterprise size (1)	N (2)	Family, friends, informal sources as main external sources (% enterprises) (3)	Banks as main external sources (% enterprises) (4)	Equity capital, sale of stock (% enterprises) (5)	Leasing, trade credit, credit cards, development funds as main sources (% enterprises) (6)	% enterprises with no external finance (7)
Micro	1.756	14,4	9,5	3,2	8,9	64,0
Small	2.988	9,4	17,6	3,0	15,4	54,6
Medium	1.036	4,6	25,2	2,8	16,6	50,8
Large	1.036	3,6	29,5	4,1	17,0	45,9
Very large	1.317	2,7	31,5	2,9	14,7	48,1

Notes: (a) The survey included the enterprises in 38 countries – Albania, Armenia, Azerbaijan, Bangladesh, Belarus, BiH, Brazil, Bulgaria, Croatia, Czech Republic, Ecuador, Estonia, Ethiopia, Macedonia, Georgia, Honduras, Hungary, Kazakhstan, Kenya, Kirgizstan, Latvia, Lithuania, Moldova, Nicaragua, Nigeria, Philippines, Poland, Romania, Russia, Slovakia, Slovenia, Tajikistan, Tanzania, Turkey, Uganda, Ukraine, Uzbekistan, and Yugoslavia. (b) *N* is the number of enterprises included in the survey. Only enterprises with complete data for all four forms of external finance were included. Enterprises for which the category "other" was the leading source of external finance were also excluded. Micro enterprises have less than 10 full time workers; small enterprises have more than 10 but less than 50; medium have more than 50 but less than 100; large have more than 100 but less than 250; and very large enterprises have more than 250.

As was the case in the 19th century, only few enterprises of different size raised their capital for new investment by issuing stocks. Even today, SMEs simply do not raise capital in this way but provide their external finance by some form of credit. However, there is still a problem of relative absence of financial support to SMEs – the problem which is most acute in the poorest countries with the least developed financial systems. Historical analysis of the North Atlantic Core points to the one possible explanation of the evident absence of financial support to SMEs – these countries are like the Massif Central, financial "deserts" due to little demand for this type of finance. It is also simply possible that SMEs in developing economies, unlike their historical

[13] Cull, R., Davis, L. E., Lamoreaux, N. R., Rosenthal, J. L. (2006) Historical financing of small- and medium-size enterprises. *Journal of Banking & Finance*, 30, pp. 3019-3035.

counterparts in the most of the North Atlantic Core, operate without the position their counterparts had in world economy, too far away from productivity line to be competitive. However, it is also possible that there are regulatory and other institutional barriers that block the formation of local financial intermediaries or that "supress" demand for such financial services.[14]

FINANCING MODELS AT VARIOUS STAGE OF SME LIFE CYCLE: RECOMMENDATIONS FOR SOUTH-EASTERN EUROPE

The characteristic of undeveloped financial systems is the so-called shallow market with few financial intermediaries (financial institutions) where the most important intermediaries are deposit-credit institutions or commercial banks. On the other hand, developed financial systems are characterised by a large number of financial institutions that are able to satisfy any form of demand for financial services and a "decline" of the relative importance of banks with an increase in the importance of some other financial institutions, primarily investment and pension funds. In other words, more developed systems have the developed mechanisms of the so-called indirect finance as a result of more financial institutions and intermediaries.

There is a set of specificities in SME financing. Concrete differences between corporate (business) finance and finance for entrepreneurs and small and medium-sized business are evident in the following:

- inability to separate investment from financial decisions,
- less capacity for diversifying risks in SMEs,
- ability to include outside investors in the management,
- information problems in the realization of investment projects, and
- different perception of the top target function of the enterprise – creating (maximizing) owner value.[15]

Regarding two main groups of sources of finance for the SME sector (own and borrowed), there are certain specificities, explained as follows:

- Finance by own sources is based on self-financing by entrepreneurs, using the funds owned by family members and close friends. Very often, employees are included in financing, as at the beginning they receive lower salaries. Apart from these, there are also other sources, primarily franchising, factoring, property as collateral, etc. The dominant role in personal sources of finance is given to internal sources, which means that, particularly at the initial stages of business development, all the profit made is reinvested. External personal sources are, however, extremely limited and cannot be obtained without the change in the legal form, either by including new partners in the form of limited liability enterprise, by modifying the registration of the enterprise from limited liability enterprise to shareholding enterprise, which would enable the issuance of securities (stocks).
- Finance by borrowed sources is characterised by the creation of debt relations and takeover of the obligation to return the borrowed funds to the creditor. The lender, that

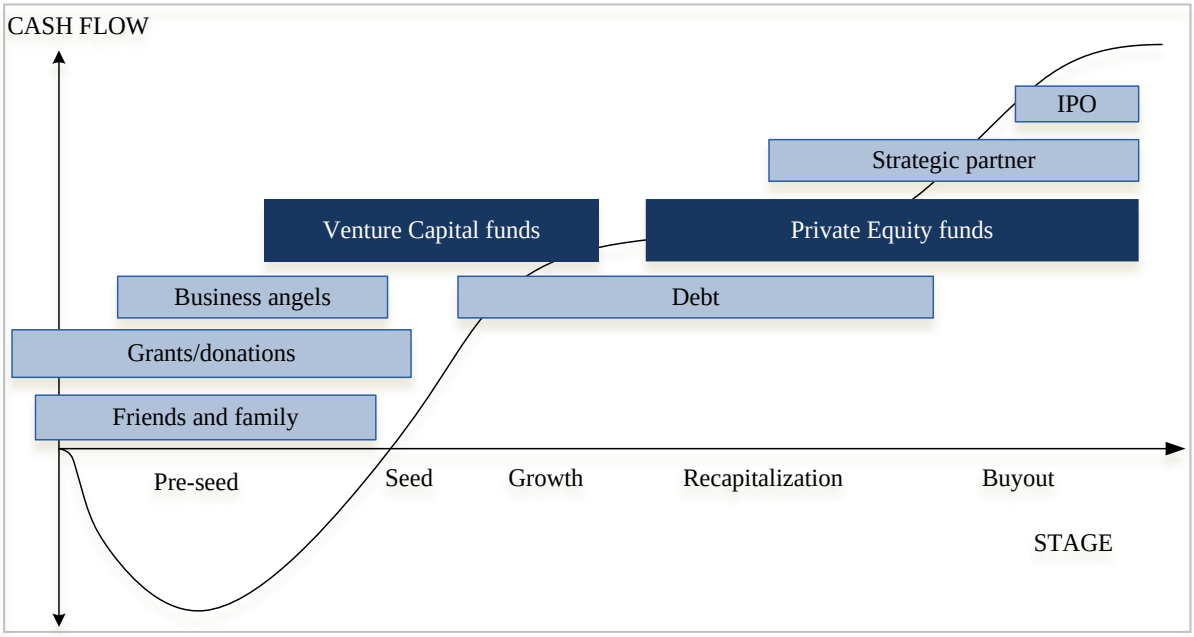
[14] *Ibidem*, pp. 3017-3036.

[15] Erić, D., Beraha, I. A., Đuričin, S. O., Kecman, N. Đ., Jakišić, B. (2012) *Finansiranje malih i srednjih preduzeća u Srbiji [Financing of small and mid-size enterprises in Serbia]*. Beograd: Institut ekonomskih nauka & Privredna komora Srbije, pp. 58-61.

is entrepreneur, is usually required to obey repayment plan which includes not only the payment of the principal but also of interest fees. Finance by borrowed funds is rather limited due to little capital and small value of the enterprise. At initial stages there are not financial reports for previous years, which is why the focus is limited to microfinance, bank loans,[16] state development programs, leasing, debt securities, etc.[17]

As SMEs are the result of an entrepreneurial venture, it is necessary to understand financial needs of SMEs through their life cycle. Enterprise's life cycle can be presented through the following stages: experimental or seed stage, start-up, expansion, recapitalization, and buyout. Figure 42 shows the sources of finance in enterprise's life cycle.

Figure 42. Financing enterprise's development[18]



During the seed phase enterprise's cash flow is negative due to cost of product development, legal and tax counselling, business plan preparation, etc., and non-existent sales income. As this is an extremely risky stage, which many enterprises never pass, external sources of finance are mostly friends, family and grants or subventions. Besides them, angel investors may show up as well as funds of risky capital, providing that the idea is rather promising and that investors are willing to take such a large risk. When the product is introduced to the market, during enterprise's start-up stage, angel investors and funds of risky capital come to the top of the list of investors, although family, friends and other investors may appear by means of grants. During the expansion stage cash flow is finally positive with the potential of rapid growth, which makes enterprises able to use credits and other debt instruments under favourable conditions. Funds of risky capital have an important role during this stage, through financial and non-financial support. The recapitalization stage, in which enterprise's capital structure changes, includes the use of credits and other debt instruments as well as the emergence of funds of private equity

[16] There is evidence that banks restrict lending for firms that are less than two years old and then slowly build up lending as they develop a relationship (Leitner, S. M. (2016) Financing constraints and firm growth in emerging Europe. *South East European Journal of Economics and Business*, 11(1), p. 33).
[17] Eric, D. et al., *op. cit.,* p. 61.
[18] http://www.cvca.hr/zasto-pe-i-venture-capital/rjecnik-termina

capital. The buyout stage refers to the sale of a controlling share or takeover of the entire enterprise, where strategic partners, managerial teams of funds of private equity capital emerge as buyers. In some cases, buyout is made through the initial public offering. Funds of risky capital, along with funds of private equity capital, are the institutions providing support to enterprises at all development stages, whereby support is most evident during the start-up and expansion stages while somewhat less evident during other stages. On the other hand, the funds invested by friends and family during the experimental stage are extremely important at this stage while finance through financial market and commercial banks is available at the stages when the enterprise rapidly grows or has stable operations. Angel investors need to be mentioned as well, as together with family and friends they provide support at the riskiest stages of enterprise's development. Hence, any type of investors can contribute to enterprise's development and it is up to entrepreneur to decide which of these options is the most appropriate at a certain stage of development.[19]

Since financial structures in the countries of the SEE are bank-centric, the existence of diverse non-banking institutions such as microfinancial institutions, investment funds such as funds of risky capital, leasing companies, etc., aimed at financing various needs/stages in SME life cycle, points to the imperative of strengthening or improving the segments of other relevant financial institutions, primarily the ones that operate locally. For example, in 2018, Culkin and Simmons conducted a survey[20] of SMEs in the Western Balkan countries and found that the access to funding is a significant obstacle. They noted that aspiring entrepreneurs in the Western Balkans are generally not in sectors with access to venture capital, and even if they are, may find it difficult to connect. Therefore, they depend on lending from banks.

More broadly, small firms financial constraints in the area of the Western Balkans may be illustrated as shown in Table 2.

Table 2. Small firm financing constraints (firm data)[21]

	Firms facing finance constraint	Share in %					
		Loan rejected	Too complex	Interest rate	Collateral needs	Poor loan terms	Expect "no" for an answer
Albania	60	2,0	11,8	80,4	3,9	2,0	0,0
BiH	35	14,0	20,7	55,2	5,2	1,7	3,4
Kosovo	45	5,0	16,4	58,2	13,4	4,5	3,0
North Macedonia	45	4,0	0,0	95,7	0,0	0,0	0,0
Montenegro	60	7,0	2,3	84,1	2,3	4,5	0,0
Serbia	35	5,0	8,6	74,1	2,5	2,5	7,4

[19] Caselli, S. (2010) *Private equity and venture capital in Europe – markets, techniques and deals*. Amsterdam: Elsevier Academic Press, p. 12.

[20] Culkin, N, Simmons, R. (2018) *Study of the challenges that hinder SME development in the Western Balkans*, Report for the British Council and Swedish Institute, p. 33. Available at https://www.britishcouncil.me/sites/default/files/report_western_balkans.pdf.

[21] Moder, I., Bonifai, N. (2017) *Access to finance in the Western Balkans*, Occasional Paper #197 Sept 2017, European Central Bank, Frankfurt, p. 17. Available at: https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op197.en.pdf?24296e890f7f5c039848046670a9769a.

In some SEE countries, such as Serbia and Ukraine, microfinancing is almost non-existent while in other countries such as BiH and Montenegro, it is an extremely expensive source of finance for SMEs. The possibility for opening micro-credit organizations in Serbia or certain business transformation of micro-credit organizations in BiH and Montenegro (which might include the possibility for dispersion and cheaper sources of finance for the very micro-credit organizations) would mean accessibility or better accessibility of micro-credits for SMEs. Micro-credits with mutual accountability might serve as a special type of micro-credits.

Furthermore, the efforts aimed at the improvement of credit finance for SMEs in SEE countries might head towards the reduction of costs of credit by means of credit-guarantee funds as well as funds for crediting small businesses. The appropriate Internet platform, the so-called peer-to-peer (P2P) lending, might reduce SMEs' dependence on bank loans and facilitate direct access to institutional investors and retail investors. Such positive example comes from the USA and it refers to the JOBS Act that came into effect in 2016. The JOBS Act legalized the so-called crowdfunding or financing by a large number of people. Investment crowdfunding provides SMEs with the possibility to sale equity shares to non-accredited investors via online platforms and social media. In other words, start-up enterprises and small entrepreneurs in the USA do no longer need to depend on large investors. Their equity shares are available to all citizens, whereby American start-up scene and small entrepreneurs are given access to significantly larger financial resources.