Credibility of Serbian banking sector from the aspect of foreign direct investments

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ABSTRACT

Foreign direct investments (FDIs) have extraordinary importance for the development of the country, contributing to the higher level of its competitiveness. Some transition economies were focused on FDIs attraction, selecting banking sector as one to the most propulsive targets. Using empirical evidence on FDIs in Serbian banking sector during XXI century through granular analysis by differentiation between greenfield and brownfield investments, this paper pinpoints on major movements and perspectives of development. Also, beside the FDIs aspect, which is the central point of the paper, this paper summarize the major regulatory changes in accordance with Basel III standards aimed to increase the credibility of Serbian banking sector.

KEY WORDS: foreign direct investments, Serbian banking sector, Basel III standards

JEL classification code(s): G21, F21, P33

POVZETEK

Neposredne tuje investicije (NTI) imajo izjemen pomen za razvoj države in prispevajo k višji stopnji njene konkurenčnosti. Nekatera gospodarstva v tranziciji so se osredotočila na izbiro bančnega sektorja kot enega do najbolj propulzivnih ciljev za pritegnitev neposrednih tujih naložb. Z empiričnimi dokazi o neposrednih naložbah v bančnem sektorju v Srbiji v 21. stoletju s pomočjo granularne analize z diferenciacijo med grinfild in brownfield naložbami so v tem dokumentu poudarjena glavna gibanja in perspektive razvoja. Poleg vidika NTI, ki je osrednja točka članka, avtoji povzemajo tudi glavne regulativne spremembe v skladu s standardi Basel III, katerih cilj je povečati verodostojnost bančnega sektorja v Srbiji.

KLJUČNE BESEDE: neposredne tuje investicije, bančni sektor v Srbiji, standardi Basel III

1 Introduction

Foreign direct investments (hereinafter: FDIs) are generally treated as very important source of economic growth and development as well as the factor of increasing GDP, increasing

employment rate and factor of creation confidence in institutions of certain country. As the credibility of the country leads to increased engagement into international flows and better competitiveness level, it is necessary to emphasize the significance of FDIs in transition economies, such as Serbia. According to „Global Competitiveness Report for 2017-2018“among 137 countries, Serbia is ranked on 78th place with average score of 4.1 (scores are in range between 1 and 7), which is for 12 places better than in previous report (World Economic Forum, 2018). More precisely, in the FDI segment: Serbia is 80th ranked when we consider business impact of rules on FDI (average score: 4.3, with positive trend) and 101th ranked in the area of FDI and technology transfer within 9th pillar (Technological readiness) with average score 3.9, followed by steady trend.

2 Literature overview

According to Lipsey (2001) there are differences between FDIs on macro and micro level. FDIs on macro level are related to capital shifts within national borders from host country to end-user country, whilst FDIs on micro level are linked with motivation issue of certain investors which are focused on investments in foreign country. In IMF (2004) is proposed the definiton of FDI enterprise as “an enterprise (institutional unit) in the financial or non-financial corporate sectors of the economy in which a non-resident investor owns 10 per cent or more of the voting power of an incorporated enterprise or has the equivalent ownership in an enterprise operating under another legal structure“. The definition emphasizes long-term connection between direct investor from one side and enterprise-resident from the other side and existence of significant impact of investors on management decisions in foreign enterprise.

Close interconnection between privatization and FDIs are in the center of paper by Kalotay and Hunya (2000). They stressed inequality in relationship between privatization and FDIs in the manner that privatization is the dominant form of FDIs in transition economies, while FDIs are not the dominant form of the privatization. Also, they distinguished greenfield (as the most acceptable type of FDIs) from brownfield investments (as the consequence of privatization process) in foreign country. Based on regression analysis of 10 countries in Central and Eastern Europe, Hunya and Geishecker (2005) pointed out on positive impact of FDIs on economic growth and vice versa: economic growth of host country has positive influence on FDIs inflow, private sector strengthening and industry restructuring.

There are also opposite findings regarding FDIs impact on economic growth. In the paper by De Mello (1999) there are observed 32 developed and emerging economies and pinpointed on insufficient elements for close relationship conclusion between FDIs and economic growth. Similar, Carkovic and Levine (2002) analyzed 72 developed and emerging countries and proved that FDI inflows do not perform strong and independent impact on economic growth. In his paper Stančik (2007) does not deny positive effect of FDIs on productivity and employment rate increase, but he criticized the influence of horizontal and vertical spillover effects on competitiveness level of domestic companies in Czech Republic. According to Hausmann and Fernández-Arias (2000) there should be focus on investment climate creation for FDIs attraction and making prerequisites for efficient market functioning. Very similar conclusion gave also Albuquerque (2002), which noticed that most of FDIs are going toward emerging countries i.e. countries which have not developed enough in term of financial market. In order to improve efficiency, there is a necessity for active role of banks and other financial institutions for speeding up the privatization process and foreign capital attractiveness.

3 Methodology: FDIs in Serbian banking sector

Required, but not sufficient, condition for FDIs attractiveness is existence of adequate internal and external institutional framework. Internal conditions for institutional framework are meant for creation of open market economy and competitiveness growth on that basis, especially taking into account property transformation in emerging economies into private ownership. External conditions are related to establishment of sound and long-term relationship with international financial institutions (IMF, EBRD, IFC etc.) in order to achieve credibility among various bases. Positive outlook given by credit rating agencies and removing of barriers and risks in large extent for potential investors is the final result of reached credibility).

As of June 15, 2017, long-term sovereign credit rating of Republic of Serbia is affirmed to BB and stable outlook, according to credit rating agencies Standard and Poor's and Fitch, confirming better investment climate in Serbia (see Table 1).

Table 1: Republic of Serbia's long-term credit rating

Rating agency	***Standard and Poor's***	***Fitch Ratings***	***Moody's Investors Service***
Rating	BB / stable outlook	BB / stable outlook	Ba3 / stable outlook
Date	15 June 2018	15 June 2018	17 March 2017
Action	Rating affirmed	Rating affirmed	Rating upgraded

Source: National bank of Serbia, 2018a

Additionally, Serbia's risk premium, measured by EMBI, continued down in Q4 2017 reaching its new lowest point in December of 96 basis points (National bank of Serbia, 2018b). Improvement in Serbia's risk premium was recorded owing to two-fold factors: domestic (and regional) factors on one side and global factors on the other side. Within the segment of domestic and regional factors the most important are: successful completion of the eighth review of the arrangement with the IMF, raised Serbia's credit rating to BB by Standard & Poor's and Fitch in the mid-December 2017 and improved outlook for growth of countries in the region, thanks to faster than expected economic growth in the euro area and better outlook for the period ahead. Moreover, the acceleration of global economic growth, particularly in the euro area, had a positive impact, as did the continued implementation of the ECB's monetary stimulus measures. In addition, optimism regarding economic growth and the rise in inflation in the US drove up yields on US ten-year Treasury bonds, which rose from 2.3% to 2.7% in Q4 and January 2018. This narrowed the spread between them and yields on Serbia's Eurobonds (National bank of Serbia, 2018b).

Banking sector is the dominant force in Serbian financial system, with portion of more than 90%. As end of December 2017, Serbian banking sector consists of 29 banks with following ownership structure: 21 of them in majority ownership of foreign entities, 6 of them are state-owned banks, while 2 of them are domestic privately-owned banks. Banks in Serbia continuously reach satisfactory and above average liquidity levels presented in more than doubled average monthly liquidity ratios in comparison with minimum regulatory proscribed level. The banking sector is well-capitalized with the capital adequacy ratio (hereinafter: CAR) of 22.7% as end of March 2018 (last available data). The results of the quarterly macro

prudential stress tests confirm the high level of CAR above the regulatory minimum of 8%, while the stress tests confirm that the liquidity ratio stays also well above the regulatory minimum of 1.0 even in the worst-case scenario.

Efforts toward banking stability strengthening are realized through adoption of regulations introducing Basel III standards and introduction of measures such as: leverage ratio (last available data: 11.1% as of March 31, 2018) and liquidity coverage ratio - LCR (last available data: 228% as end of March 2018) which are currently on more than satisfactory levels. Beside the satisfactory market liquidity, driven by high portion of liquid assets in total assets (36.8% at the end of April 2018), and taking into account that gross lending activity is fully covered with stable domestic corporate and retail deposits (loan to deposit ratio stood at 93.8% at the end of April 2018), banking sector of Republic of Serbia is characterized with more than stable funding structure (National bank of Serbia, 2018c).

4 Results: empirical evidence of FDIs in Republic of Serbia

Noticeable and increasing presence of FDIs in banking sector crucially influenced on consolidation process and significant reduction in number of banks from 89 banks in 2000 to 49 banks in 2001. The peak of greenfield and brownfield activities was during period 2004 – 2006, simultaneously ending privatization process of banks in state and social ownership. The largest foreign direct investment in banking was realized when Italian banking entity Banca Intesa acquired domestic Delta banka in transaction worth 508 million EUR (SIEPA, 2013). In order to take insight into the magnitude of greenfield and brownfield investments, we are emphasizing several, the most valuable, transactions that are realized in Serbian banking sector, such as:

• acquisition of domestic Banka Nacionalna Štedionica for 500 million EUR by Greek bank Eurobank;
• market entrance of Austrian Raiffeisenbank in investment evaluated for 500 million EUR;
• merger between domestic Vojvodjanska banka and Greek entity National bank of Greece worth 425 million EUR;
• acquisition of domestic Meridijan bank from French banking entity Credit Agricole in transaction worth 264 million EUR etc. (SIEPA, 2013).

Greenfield investments, new investors' entrance, disinvestments of Greek banks, banking sector consolidation and privatization and restructuring of state-owned banks are the major characteristics of recent developments in Serbian banking sector. After National Bank of Serbia issued license to Moskovska banka in 2008, there was not any new greenfield investments in terms of new licenses until December 2014, when operating license was issued to Mirabank from United Arab Emirates and December 2016 when Bank of China from Republic of China entered on the market (see Table 2).

Table 2: Foreign banks in Serbia as end of December 2017

Bank's name	*Year of entrance*	*Country of origin*	*Type of entrance*
Addiko bank	2016	USA	Purchase of Hypo-Alpe-Adria bank
Banca Intesa	2005	Italy	Purchase of Delta banka
Bank of China	2016	China	Greenfield investment
Credit Agricole banka	2005	France	Purchase of Meridijan banka
Expobank	2017	Russia	Purchase of Marfin banka, Cyprus
Erste Bank	2005	Austria	Purchase of Novosadska banka
Eurobank	2003	Greece	Purhase of Postbanka; in 2006 merger with Nacionalna štedionica
Halkbank	2015	Turkey	Purchase of Čačanska banka
Mirabank	2014	UAE	Greenfield
NLB Banka	2005	Slovenia	Purchase of Continental banka; in 2008 acquisition of LHB Bank
Opportunity banka	2007	USA	Transformation of Opportunity štedionica
OTP Banka	2006	Hungary	Purchase of Niška, Kulska and Zepter bank
Piraeus Bank	2005	Greece	Purchase of Atlas banka
Procredit Bank	2001	Germany	Greenfield
Raiffeisen banka	2001	Austria	Greenfield
Sberbank	2012	Russia	Purchase of Volksbank globally
Societe Generale	1978	France	Greenfield
Telenor	2014	Norway	Purchase of KBC Banka
Unicredit bank	2006	Italy	Merger with HVB Bank globally
Vojvodjanska banka	2006	Hungary	Acquired from National bank of Greece; in 2017 bought by OTP Bank
VTB Banka	2013	Russia	Purchase of Moskovska banka

Source: National bank of Serbia, 2018d.

In 2015, the state-owned Čačanska banka was sold to Halk Bank from Turkey. Defaulted Slovenian KBM banking group subsidiary (KBM banka Kragujevac) and French BNP Paribas subsidiary (Findomestic Bank) was taken over by domestic businessmen (Direktna banka Kragujevac) in 2016 and 2017, respectively, diminishing the number of existing banks on Serbian market. Also, Marfin bank was acquired by Expobank from Czech Republic (parent bank from Russian Federation) in February 2017. During 2017, three out of four Greek banks changed the ownership structure: only Eurobank continues to operate in Serbian banking sector. The Alpha Bank was merged with the AIK Bank Beograd (after a brief transition period in which Alpha Bank operated under the name Jubanka); Piraeus Bank was purchased

by domestic private bank Direktna banka Kragujevac and Vojvodjanska banka Novi Sad (formerly owned by National bank of Greece) was bought by Hungarian OTP bank Beograd. With regard to state-owned banks, Banka Poštanska štedionica is in process of significant changes in line with the implementation of strategic guidelines. Furthermore, some of state-owned banks are in the process of restructuring and refocus on former customer base (Srpska banka Beograd), while some in the process of fundamental changes of business model (mts banka Beograd) and implementing their revised business strategy (Jubmes banka Beograd). Additionally, in December 2017, Government of the Republic of Serbia made conclusions regarding resolution of the status of Jugobanka Jugbanka Kosovska Mitrovica, implying transfer of their part of assets and liabilities to the Banka Poštanska štedionica Beograd. At the beginning of April 2018, Executive Board of National bank of Serbia passed the decision to revoke the license for Jugobanka Jugbanka a.d. Kosovska Mitrovica. All necessary measures have been taken to ensure that the bank's payment operations continue smoothly and that depositors have unimpeded access to their funds at the acquiring bank, i.e. Banka Poštanska štedionica a.d. Beograd (National bank of Serbia, 2018e).

Completion of privatization process in the largest state-owned bank - Komercijalna banka is extended until June 30, 2018. Operating licenses in four banks from 2012 to the beginning of 2014 (three state-owned banks: Nova Agrobanka, Razvojna banka Vojvodine and Privredna banka Beograd and one privately-owned bank: Univerzal banka) were revoked leading to establishment of financial system stability in terms of adequate capitalization and liquidity. State-owned banks that collapsed are the typical example of bailout scheme in Serbian banking sector as a consequence of inherent moral hazard element in their operation (Knežević and Mirković, 2015).

From its side, National bank of Serbia supports entrance of respectable and worthiness investors in Serbian banking sector, which fulfilled proscribed conditions, apart from the type of acquirer and country of origin. Conditions for entrance of new banks are clear and transparent, while neither one entity could obtain (direct or indirect) ownership in the bank which allow more than 5% of voting rights without previous consent of National bank of Serbia. Aware of potential massive negative movements in banking sector on global level, National bank of Serbia carefully and continuously monitors information which could affect stability, in order to protect deponents and strengthen the credibility level in Serbian banking system at whole (National bank of Serbia, 2018f).

5 Other aspects of Serbian banking sector's credibility

Ensuring that banks hold enough capital to withstand shocks has been a major focus of post-crisis regulation, particularly via Basel III package of reforms. One of the most widely accepted measures of bank resilience to shocks is a simple leverage ratio: the ratio of a bank's capital (or equity) to total assets. Simple leverage ratios tend to perform better than complex risk-weighted capital ratios as a predictor of bank failure, while research has also shown that high leverage is associated with financial instability.

The financial system should have sufficient buffers to be able to absorb even unexpected events, which can become mutually reinforcing in the system. Generally, resilience with regard to such systemic events should be measured with regard to the mechanisms that are in place to deal with losses. At the system level, the credibility of regimes for the recovery and resolution of financial institutions is a crucial element of resilience. For euro area countries, the Single Resolution Mechanism was established in 2016 with the Single Resolution Board

as a common resolution authority. The new rules were applied for the first time in 2017. These first applications highlight shortcomings that need to be addressed. Moreover, the first applications of the Bank Recovery and Resolution Directive (BRRD) revealed discrepancies in bail in rules according to the European resolution framework, state aid rules and national insolvency laws (Deutsche Bundesbank Eurosystem, 2018).

In order to improve the level of resilience in Serbian banking sector, regulatory reforms took very significant role in previous period, mainly in the segment of compliance with Basel standards at all. In December 2013 the National Bank of Serbia adopted the Strategy for Implementation of Basel III standards in Republic of Serbia that envisages their implementation in three phases. In the third phase, draft regulations were prepared implementing Basel III standards in Republic of Serbia, transposing the requirements of Regulation (EU) No 575/2013 (Capital Requirement Regulation - CRR) into the domestic regulatory framework.

On 15 December 2016, the Executive Board of the NBS adopted a set of regulations implementing Basel III standards on individual level containing:
• Decision on Capital Adequacy of Banks
• Decision on Disclosure of Data and Information by Banks
• Decision on Reporting on Capital Adequacy of Banks
• Decision Amending the Decision on Reporting Requirements for banks
• Decision on Liquidity Risk Management by Banks
• Decision Amending the Decision on Risk Management by Banks (National bank of Serbia, 2018g).

Decisions entered into the force since June 30, 2017 and the main goals of adopting these regulations are to increase the resilience of the banking sector by enhancing the quality of capital and introducing capital buffers, to increase the efficiency of monitoring and controlling banks' exposure to liquidity risk, further strengthening of the market discipline and transparency of banks' operation in the Republic of Serbia by publishing all relevant information on bank operation, as well as to bring the reporting system in line with the new regulatory arrangements.

National bank of Serbia took further steps on harmonization of domestic legal framework with Basel III standards. On this regard in June 2017 National bank of Serbia adopted the Decision Amending the Decision on Consolidated Supervision of a Banking Group introducing Basel III standards in Republic of Serbia at the level of the banking group supervised on consolidated basis (also applicable as of 30 June 2017). The minimum prescribed level of capital adequacy ratio of the banking group is reduced from 12% to 8%, which is equal to the requirement for individual banks. Capital requirement for other risks has been introduced (capital requirement for credit value adjustment - CVA risk and a capital requirement for large exposures for each member of the banking group). For calculating the capital requirement for operational risk at the level of the banking group the application of an alternative standardized approach is enabled. Obligations for the ultimate parent company to establish a system for liquidity risk management at the level of the banking group is stipulated, as well as the obligation to calculate the liquidity coverage ratio and accordingly apply the appropriate restrictions relating to a bank's exposure to liquidity risk.

In order to create additional regulatory requirements for achieving one of the basic goals of Basel III standards - increasing the resilience of the banking sector through increasing the

quality of regulatory capital of banks in September 2017, National bank of Serbia adopted Guidelines for Implementation of the Provisions of the Decision on Capital Adequacy of Banks Related to the Capital of the Bank. Guidelines introduced more detailed conditions for inclusion of certain items of capital in the calculation and closer regulation of the method of calculating deductibles, including the calculation of certain regulatory adjustments. Regulatory activities on creating more resilient banking system were continued through the Decision Amending the Decision on Risk Management by Banks (Republic of Serbia Official Gazette, 2017), which was adopted in December 2017 in order to improve the process of internal capital adequacy assessment (ICAAP), as well as the supervision of that process. Stress testing is systematically regulated, and reverse stress testing is introduced. New regulatory requirements are contributing to additional caution regarding the management of the risks arising from the introduction of new products, as well as on the basis of outsourced activities. Also, National bank of Serbia is committed to continuous improvement of legislation in the field of banking in line with international standards. In that regard banks are enabled to apply international accounting standard IFRS 9 starting from 1st of January 2018 (National bank of Serbia, 2018h). In accordance with domestic regulations, when compiling annual financial statements, a bank shall apply the international financial reporting standards as of the date which the competent authority has designated as the date of the application of these standards.

In addition, bearing in mind the changes in banks' operations and financial reporting due to the beginning of application of the new standard, in 2017 the National bank of Serbia monitored the process of banks' preparation for the onset of application of IFRS 9, in line with its jurisdiction. Questionnaires on banks' activities concerning the implementation of IFRS 9 were aimed at analyzing the capacity, in terms of quality, of individual banks and the banking sector as a whole for the application of IFRS 9, the models that banks intend to use for the calculation of impairment in line with the new standard and the estimate of expected effects of the commenced application of IFRS 9 to the amount of impairment of financial instruments and bank's capital. Based on submitted documents from the banks regarding the first-time application of IFRS 9, it can be noted that the total net increase in loan loss provision at the level of the entire banking sector amounts to 86.9 million EUR (increase of loan loss provisions by 4.7% as end of 2017), with three banks having a decreasing amounts of loan loss provisions. The aforementioned increase in loan loss provisions has a negligible impact on regulatory capital ratios due to application of prudential reserves, as well as on other indicators that are monitored in banks' operations.

6 Conclusion

FDIs have a great importance for the development and prosperity of countries, supporting improvement of their competitiveness level. Serbia had a significant FDIs inflow during XXI century, especially in banking sector, which was marked among the most interesting targets for potential investors. Simultaneously with consolidation process in Serbian banking sector are conducted process of entrance in form of greenfield investments, making Serbian banking market more competitive. Currently, foreign banks are dominant players in Serbian banking sector with portion of more than 75% in total assets (mostly from EU countries), but also investors are coming from: USA, United Arab of Emirates etc.

It shouldn’t be neglected the role of National bank of Serbia, central bank which provides an equal and transparent opportunities for all potential investors which are motivated to invest on Serbian banking market. Also, efforts of National bank of Serbia in the direction of making

regulated and competitive banking market in accordance with EU standards, obviously give positive results. Interest of foreign investors for Serbian banks and their presence on Serbian market are the indicator of "healthy" banking system and existence of equal opportunity for all competitors which could benefit from the business operation on regulated market under favorable conditions. However, further interest of foreign investors in Serbian, growing competitive banking market, will depend upon consolidation of banking groups within EU and their strategic objectives on the long-run.

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