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ABSTRACT

This study reviews and evaluates a particular aspect of the institution building process in the transition countries of Southeast Europe. The focus is the development of the banking sector. It is argued that banking sector development plays an integral and pivotal role in the successful completion of the transition process. It functions as a very strong integrating force contributing to the broader institution building process and as a pillar of future growth and development in the new market environment of the Balkan economies. This study concentrates on three main issues. First, it undertakes a brief literature review of regional integration approaches in the Balkans. Second, it provides an overview of the most significant changes that have taken place in the banking sector. Third, it reviews some structural characteristics and performance indicators, all of which point to considerable advancements made in this sector in recent years. Empirical evidence is provided showing that a substantial harmonisation of ownership structures and performance indicators has been achieved in the banking sectors of these countries initiating a convergence process toward EU banking structures and functions. In this regard, this study complements the findings of other studies focusing on various sectors of economic activity, which clearly show that a *de facto* regional and, even more so, continental integration of the Southeast European countries is under way.

Keywords: Balkan banking; foreign banks; regional integration; transition policies
JEL classification: R10; P30; G21

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1. Introduction

This paper intends to argue that foreign banking institutions have played a key, and in some cases, dominant role in the restructuring, reorganisation and reform of the banking sector in all Balkan economies. Their role, which continues unabated, has contributed to the much-needed institution building process as a necessary advancement leading to the completion of the transition project.

In developing this argument, this paper concentrates on the following three main issues. First, it undertakes a brief literature review of the theoretical understanding of regional economic integration as it applies to the Balkan countries[1]; second, it provides an overview of the most significant changes that have taken place in the banking sector since 1989; and, third, it reviews the main ownership and structural characteristics as well as some selective performance indicators which point to the most recent advancements in this sector.

2. Balkan Integration: Selected Theoretical Contributions

Since 1989, concurrently with a substantial number of regional economic integration initiatives launched various theoretical arguments for and against Balkan integration have been proposed and debated[2]. The relevant literature focuses on three main issues: the reasons why integration needs to be promoted, the obstacles hindering integration efforts and a critical assessment of the regional integration initiatives already implemented.

Uvalic (2001) identifies four reasons for promoting regional economic integration in the Balkans. First, the need to increase mutual trade through the elimination of tariff and non-tariff barriers. Lower prices would encourage greater regional trade flows and compensate for the weak export performance of Balkan states to the West. Even a transitory impulse to trade flows, Uvalic argues, may create static and dynamic gains and provide strong incentives for regional development.

[1] Albania, Bosnia-Herzegovina, Bulgaria, FYR Macedonia, Romania and Serbia and Montenegro.
[2] The initiatives towards regional co-operation in Central and South Eastern Europe arose as a reaction to two main events. First, the dissolution of the Eastern Block and the Council of Mutual Economic Assistance resulted in an institutional vacuum; in response, the Central European Initiative (1989), the Black Sea Economic Co-operation (1992) and the Central European Free Trade Area (1992) were launched. Second, the disintegration of the former Yugoslavia and the Bosnia-Herzegovina conflict led to a second wave of economic integration efforts with the Conference of Southeast European Countries (1996), the Southeast European Co-operative Initiative (1997), the Stability Pact (1999) and the Stabilisation and Association Process.

Second, integration can contribute to the resolution of issues that need to be addressed at a regional level, such as migration, infrastructure, energy, ecological damage, environmental issues, illegal trafficking etc. Due to the nature of these issues, which affect the Balkans as a whole, an attempt to resolve them unilaterally can be only partially successful. Third, integration can encourage investment through greater political and economic stability in the region. A high savings deficiency, due to poverty, underdevelopment and loss of confidence in the banking system, renders the attraction of capital from abroad especially important. Regional co-operation can reduce political risk, promote economic stability and increase the size of local markets, contributing, therefore, to investment activity. Fourth, regional integration is a means through which convergence and eventual integration into the European and the Euro-Atlantic economic and security structures can be accelerated.

Anastasakis and Bojicic-Dzelilovic (2002) elaborate on five reasons why the international community and, in particular, the EU advocate a central role for regional co-operation. First, the 'prescriptive' argument emphasizes the positive effects of regional interdependence and co-operation, referring to the EU as the most successful example of integration efforts. Second, the 'new regionalist' argument considers the transformation of the Balkans as part of a wider global effort to promote democracy and market economy through multilateral co-operation. Third, the 'strategic' argument considers regional co-operation as the main contributing factor to security and confidence-building among neighbouring states. Fourth, the 'EU internal' argument advocates the development of sub-regional co-operation (Central Europe, Baltic countries, Western Balkans) as a way of facilitating the broader and long-term EU integration process. Fifth, the 'Southeast regional' argument emphasizes the need for joint resolution of common problems and maintains that SEE countries should prove their ability to cooperate with their neighbours before building stronger ties with the EU.

A common underlying theme in the views expressed above is the political motive for the implementation of integration policies. The authors acknowledge the fact that there are strong political reasons for promoting closer economic integration in the Balkans, in the hope of enhancing regional stability, secure peace, reduce ethnic tensions and prepare these countries for their eventual incorporation into the EU.

On the issue of economic obstacles that hinder the efforts towards regionalism, Kyrkilis and Nikolaidis (2001) argue that certain limitations derive from both the demand and the supply sides of the economies of the region. In particular, demand-side limitations arise from the small population size of the Balkan countries and the low levels of development and per capita GDP, which undermine their ability to exploit economies of scale. Further limitations are brought about by the constrained local demand and the shift of exports to the EU market rather than the regional one. On the supply side, Balkan production is structured in such a way as to take advantage of its relatively cheap but adequately trained labour force and, thus, specialises in low-to-medium technology sectors. Lack of complementarity, overlapping structures of production and similarities in the comparative advantages of Balkan states reduce the potential for significant gains from inter-industry trade.

Anastasakis and Bojicic-Dzelilovic (2002:11-13) emphasize the political aspect of the obstacles to economic integration. In particular, they argue that geographic proximity, the existence of many borders and the massive displacement of population have all combined to facilitate regional co-operation in informal and, to a considerable extent, criminalised economic activities. The informal sector has hindered the normalisation of relations among countries in the region, undermined economic and political institutions and obstructed the process of regional integration.

Lopandic (2001a) also describes a number of other obstacles to economic integration efforts in the Balkans noting, in particular, the lack of tradition in multilateral co-operation and their peripheral position with respect to Europe. Furthermore, the divergences of Balkans states in terms of their national, political and economic development hinder their foreign investment prospects and diminish their regional integration potential (Stubos 1993).

An important part of the literature engages in a critique of regional economic integration initiatives since the dissolution of the Eastern Block (CEI, BSEC, CEFTA, SECI, SP, SAP)[3]. The underlying view of this approach is that economic integration initiatives in the Balkans, with the possible exception of the Stability Pact and the SAPs, have been progressing at a slow pace failing to produce concrete results in

[3] CEI: Central European Initiative; BSEC: Organisation of the Black Sea Economic Co-operation; CEFTA: Central European Free Trade Agreement; SECI: Southeast European Co-operation Initiative; SP: Stability Pact; SAP: Stabilisation and Association Process.

promoting economic development, modernising institutions and stabilising the region politically. A distinction is typically made between the micro and the macro levels of their effectiveness. Although it can be argued that, at the micro level, regional initiatives have had a positive effect, it is widely accepted that these initiatives and forms of multilateral co-operation have not, to date, helped Balkan countries to further integration with the EU or to critically change the political, economic or social environment in the region. Lopandic (2001b:8) writes that 'a major shortcoming of economic initiatives has been the lack of coherence, with each regional co-operation arrangement [having] its own autonomous development and agenda, thus often resulting in activities overlapping each other'.

3. **Institution Building and the European Trajectory**

The European Commission has consistently made clear its objective to assist the Balkans to reach first candidate status and, eventually, full EU membership. The European Council in Feira, in June 2000, confirmed this objective in the clearest terms possible. The Copenhagen Council, in December 2002, reaffirmed this perspective. In 2003, the Commission inaugurated the Stabilisation and Association Process (SAP) outlining specifically the required changes leading to pre-accession status. At the Thessaloniki Summit of the EU, in June 2003, the leaders of the Balkan countries were invited for a joint session during which it was confirmed that the SAP will be the last contractual agreement between association and membership. Together with this kind of political commitment, a set of new instruments have been established over the last a few years aiming, primarily, to enhance the institution building capacity of the Balkan countries. The CARDS, TAIO and EP[4] are all programmes conceived, activated and implemented for this purpose.

The six Balkan countries seem to have fully adopted the view that the nature and character of their economic restructuring and economic integration will be determined by an economic rationality and logic imposed upon them by their EU trajectory (Stubos 1997). Toward this common objective, they advance at different speeds. Bulgaria and Romania have already signed agreements with the EU and are working on an expected date of accession in 2007. For the other countries, the process for gaining candidate status leading eventually to full membership to EU needs to go

[4] CARDS: Community Assistance for Reconstruction, Development and Stabilisation, TAIEO: Technical Assistance Information Exchange Office, EP: European Partnership.

through the Stabilisation and Association Agreements (SAA) which are negotiated with each country separately. Croatia and FYR Macedonia signed such agreements in 2001. Albania is currently negotiating its SAA, Bosnia and Herzegovina have been given a conditional go-ahead to start SAA negotiations, while Serbia and Montenegro have not yet started negotiating due to outstanding issues regarding their Constitutional Charter.

Gligorov (2003:375) argues that a defining characteristic for a country aspiring to be European is not only its geographic location, but even more importantly, the sharing with EU countries of some fundamental values and institutions. He points out (2004:11) that the European integration of the Balkan countries needs to go through both a *de facto* and a *de jure* process. The *de jure* side may have to wait a while longer but the *de facto* side is already proceeding in many sectors of economic activity. The available data on trade clearly show that for the Balkan transition economies bilateral relations with the EU are more important than relations among them. Regional trade, which has been praised as a desirable option and even as a prerequisite for sustainable growth and development, has shown to be persistently weak with small yearly fluctuations (Christie 2004).

Tables 1 and 2 record inter-regional trade between the SEE countries and between themselves and the EU. With the exception of Bosnia and Herzegovina, all other countries depend for at least half of their imports and exports on the EU. In the case of Albania these figures are over 70% and 90%, respectively. In the case of Albania Bulgaria and Romania, inter-regional trade volume is particularly small. At times, it does not exceed 2 or 3 percent of total trade, which is atypical and highly unusual for countries in such geographic proximity. What these tables do not show is the size of illegal regional trade[5] and the fact that Italy, Greece and Germany are the main trading partners of the Balkan countries.

[5] Empirical evidence suggests that there are very significant illegal trade flows in the Balkans. High tariffs and taxes combined with lax implementation practices tend to aggravate this problem. It has been estimated that, in some cases, illegal trade may exceed 30% of GDP annually (Gligorov and Holzner 2004).

Table 1: Imports of SEE Countries from EU-15 and other SEE countries (% of total)												
Year	ALB		BiH		BUL		ROM		FYROM		SEM	
	SEE	EU	SEE	EU	SEE	EU	SEE	EU	SEE	EU	SEE	EU
1998	6.3	79.0	43.4	33.4	2.8	46.1	1.1	57.9	20.4	52.8	14.1	45.1
1999	7.0	77.6	32.8	37.6	2.2	50.9	0.9	62.7	20.7	50.7	14.6	38.3
2000	6.1	75.6	21.4	33.2	4.4	44.0	0.7	63.0	19.8	49.4	20.9	40.9
2001	5.7	77.4	27.9	37.2	3.0	49.0	1.4	63.0	18.2	46.1	21.8	49.1
2002	6.1	77.6	22.8	39.0	2.5	50.5	1.1	63.9	11.1	53.0	15.3	52.0
2003	6.5	70.8	n/a	37.3	2.9	49.5	n/a	57.7	19.7	43.7	n/a	42.6
Source: IMF Direction of Trade Database, National Central Banks, WTO database												

Table 2: Exports of SEE Countries from EU-15 and other SEE countries (% of total)												
Year	ALB		BiH		BUL		ROM		FYROM		SEM	
	SEE	EU	SEE	EU	SEE	EU	SEE	EU	SEE	EU	SEE	EU
1998	2.3	88.8	54.1	33.8	7.0	51.5	2.9	64.6	19.2	51.8	33.0	38.0
1999	2.1	89.9	42.9	42.3	8.6	53.3	2.9	66.0	20.4	50.9	33.8	34.3
2000	2.1	93.4	30.5	47.6	12.6	51.2	2.3	60.6	30.9	46.1	28.2	37.7
2001	2.8	91.8	31.2	46.3	9.8	55.2	3.1	65.1	38.3	41.4	28.7	47.0
2002	2.2	90.0	37.2	51.1	9.3	56.1	2.9	66.3	20.0	40.0	31.1	54.0
2003	3.1	93.3	n/a	40.9	8.4	56.6	n/a	67.9	32.2	54.6	n/a	43.6
Source: IMF Direction of Trade Database, National Central Banks, WTO database												

The increasing role of the EU in the Balkan economies is critical not only in relation to trade but also in terms of bringing about changes in institutions and policies. The peculiarity in this regard lies in the fact that, under EU guidance and financial assistance, institutions and policies in certain sectors are becoming homogenised in terms of their function, regulation and efficiency. One would assume that the establishment of a modern and viable banking system fulfils this criterion and, in turn, brings the aspiring Balkan countries a step closer to their western neighbours.

4. Financial Integration: A Theoretical Comment

The completion of reforms and restructuring in the banking sector is considered to be a critical and integral element of the transition process (Doukas *et al*. 1998; Mullineux 1998; Walter 1998). A well developed and properly functioning and supervised banking system is a prerequisite for the development of the real economy, because it affects some of its key functions ranging from capital accumulation to the channelling of funds to households and enterprises (Allen and Gale 2000; Mishkin 2001).

As noted by Stepic (2004:84), 'financial intermediation and structural changes are strongly interconnected'. A well-developed banking system can be the initiator of many other restructuring projects. It provides the confidence needed for local and foreign capital to invest in new or existing companies; it brings in know-how, technology and modern management skills; it provides the much needed start-up capital, especially to small- and medium-sized companies. All in all, a viable banking system is considered an important precondition for dynamic and sustainable growth.

The development of a banking sector seems to be also a part of a longer and broader process. Many recent studies have concluded that during the past few decades banking systems have become more globally integrated. The main contributing factors are the removal of regulatory barriers, advances in technology allowing for better management of financial institution and assets globally or regionally and the growth of the activities of multinational corporations (Berger and Smith 2003).

The entry of foreign banks, particularly in a less developed banking market, brings with it significant benefits (Konopielko 2003; De Haas and Lelyveld 2002; Mero and Valentinyi 2003). These benefits can be seen from the perspective of the economy as a whole or from the perspective of the banking sector itself. In the first case, the establishment and functioning of foreign banks allow a country to engage in 'consumption smoothing' and safeguard economic stability. It attracts more financial resources from the international community and induces national governments to follow more disciplined macroeconomic policies (Agenor 2001). In the second case, as Kraft (2004) points out, the presence of foreign banks improves the sector itself by introducing new products and services and by consolidating the banking sector through mergers and acquisitions.

Empirical evidence, however, suggests that the entry of foreign banks may simultaneously have some other diverse effects. While, on the one hand, they render national banking markets more competitive with positive welfare implications for banking customers, on the other hand, they reduce the profitability of domestic banks and, in a lot of cases, force them out of the market. Obviously, this kind a collateral damage is part and parcel of the consolidation process, with its own negative consequences on some depositors and also on employment (Claessens, Demirguc-Kunt, Huizinga 1998).

Turning our attention to the Balkans, the banking sector in the late 1990s found itself in its worst state since 1989. After a series of consecutive crises in previous years, the sector remained underdeveloped and of doubtful reputation, while services were of poor quality and strictly limited. The level of non-performing loans was very high, privatisation efforts had failed and supervisory institutions were unable to perform their tasks. These prevailing conditions necessitated the introduction of radical and bold reforms for the sector to move forward again. At that time, the expectation and the perception prevailed in policy making circles and among the public at large that liberalisation and openness of the banking system could remedy its weaknesses and deficiencies (Bossone, Honohan, Long 2001). Under these conditions, the large, competitive and advanced EU banking institutions, given their geographic proximity to the region, made cross-border expansion and take-overs a rational investment choice. In the late 1990s the foreign invasion of the Balkan banking sector started in earnest.

In the following section, this study reviews and evaluates developments in the banking sector since 1989. Changes of the initial, particularly turbulent period are given in a summary form, while developments since 1998 are described in more detail. Various qualitative aspects of the banking sector are illuminated as it emerged after the second round of privatisation spearheaded by foreign institutions. These developments signal a major shift in the transition process from economic reform and reconstruction to institution building. In this regard, banking sector changes contribute to the broader transition project at the national level and as a means through which Balkan economies integrate themselves both regionally and continentally.

5. Banking Reform

All Balkan countries, except former Yugoslavia, emerged from the communist era with the legacy of a single-bank system that performed both central bank functions and commercial transactions. A first step in banking reform was the creation of a two-level banking system, separating commercial from central banking functions. The Balkan countries, like all other transition economies, introduced a legal and regulatory framework that followed the broad guidelines, standards and procedures of the BIS. This development was in line with the so-called Washington consensus for banking reform advocated by the International Financial Institutions (IFIs) (Calvo and Frenkel 1991, Caprio and Levine 1994).

Reform of the financial sector in its initial phase advanced more in terms of quantity rather than quality. The number of financial institutions quickly multiplied through the privatisation of state banks and the establishment of new private institutions. In some countries the sector was immediately opened up to foreign interests as well. At the beginning, the nascent banking system faced serious problems. First, financial institutions found themselves functioning within an insufficiently regulated environment and, therefore, were improperly supervised. Expansion was frequently associated with improprieties, scandals and fraudulent schemes. Second, the dubious reputation and unreliability of the new financial institutions limited their ability to attract deposits and prevented the growth of their loan portfolios. It was difficult, therefore, to develop extensive client networks. Third, state banks were compelled to carry a high number of non-performing loans accumulated as a result of the past practice of government subsidisation programmes to state-run enterprises.

The initial phase of reforms resulted in numerous bank failures, scandals and transactional irregularities which questioned the very basis and viability of the emerging system. This deterioration coincided with and, in some cases, was caused by the deep economic crises that most Balkan economies experienced between 1996 and 1998. Under these conditions, reform of the banking system 'could not be put off any more' as all major International Financial Institutions were very plainly pointing out (Köhler 2002:125; Lemierre 2002:18; Tumpel-Gugerell 2002:3). Governments had to re-think and redesign their banking reform strategy, which quickly led to new policies aiming to liberalise and consolidate the system in an effort to guarantee its viability and sustainability. It was this new policy that ushered in the penetration of the Balkan market by foreign banks.

Some countries have gone further than others in liberalising and modernising their banking and financial systems, more often in concert with their corresponding transition pace. The following section provides a synoptic review of the most significant changes in the banking sector covering the whole transition period from 1989 to the present.

In **Albania**[6]**,** banking reform started at a slow pace. In the early 1990s, the country was characterised by very low levels of financial intermediation, an inadequate legal framework for banking operations and an extensive money-laundering problem. The system allowed for the proliferation of unsound, speculative investment schemes promising excessive returns on deposits. These investment practices became very widespread between 1994 and 1996 leading to an acute crisis which manifested itself at the end of this period. The shock waves caused by the collapse of the so-called 'pyramid schemes', in 1997, led to a gradual and more methodical restructuring of the banking sector. Successive pieces of legislation, which were introduced following the crisis, significantly strengthened the banking regulation and supervision frameworks. Capital adequacy ratios reached very high levels, 31.5% in 2002, compared to the required 12%. In October 2002, a deposit insurance policy was introduced, guaranteeing deposits of up to USD 5000, which covered about 60% of all deposits. With these and other relevant measures, confidence in the banking sector was gradually restored.

In terms of structure and ownership, at the end of 2002, the Albanian banking system consisted of 13 banks of which only one, the Saving Bank (SB) was entirely state-owned. This depiction, however, is misleading if one considers that the SB, in 2001, accounted for 59% of the total banking assets, while its share of deposits was 64%. Two attempts to privatise it, in 2001 and 2002, failed. A third attempt, however, succeeded. At the end of 2003, the Austrian Raiffeisen ZentralBank acquired 100% of the SB. The privatisation process in Albania was, therefore, completed, creating appropriate conditions for improving competition and the quality of products and services offered. Though the privatisation of the Savings Bank is not expected to impact significantly on the level of its deposits, it is expected to increase its lending considerably. In 2003, two more foreign private banks began their operations in Albania. At the end of 2003, 16 banks were operating in the country of which 14 were foreign-owned.

In **Bosnia and Herzegovina**[7] (BH), at the end of the civil war in 1995, the banking sector was marked by a large number of institutions, most of which were very small and under-capitalised. These conditions prevailed in both entities, the

[6] Source: Bank of Albania *Annual Report* 1995, 1997, 2000, 2002, 2003.
[7] Source: Central Bank of Bosnia Herzegovina *Annual Report* 2000, 2003.

Federation of Bosnia and Herzegovina (FBH) and the Republica Srpska (RS). The much needed reform and restructuring of the banking sector accelerated after the Central Bank of Bosnia and Herzegovina (CBBH), functioning as Currency Board, was established in June 1997. One of its key mandates was to harmonise the legal framework and to take measures to improve the co-ordination and co-operation between the two Entity Banking Agencies. The Law on Banks enacted in 1998 laid the foundation for a more uniform, properly supervised and functioning banking system.

Two increases in the minimum reserve capital requirement introduced in August 1999 and in June 2001 (reaching 7.6 million euros) profoundly affected the structure and ownership of the banking sector. They initiated two rounds of consolidation and facilitated the entry of foreign strategic investors. By 2003, the number of banks had been reduced to 37 from 55 in 2000. Privatisation has been essentially completed with all banks in the RS being privately owned while only a few in the FBH, performing specialised functions, are still majority state owned. In both Entities over 65% of banking assets are in foreign ownership. During 2002-3, the legal framework was strengthened further through the adoption of significant amendments to the Law on Banks regarding the management of banking institutions, the introduction of mandatory audit committees, the protection of government deposits and the implementation of measures against so-called 'financial terrorism'. A deposit insurance programme was initiated in 2001 but was effectively enforced in October 2002. A year later, only 13 banks had fulfilled the conditions for membership; the rest were ordered to urgently introduce action plans for fulfilling the prudential ratios necessary for membership. The Currency Board is also actively trying to improve the anti-laundering policy with a single registration of commercial bank accounts.

In recent years, the banking sector in BH has been growing rapidly. Total assets grew from 32% of GDP in 2000 to 58% at the end of 2003. Credit from commercial banks towards both households and enterprises has been expanding rapidly, exceeding 30% per annum in 2002 and in 2003. This is occurring in spite of a historically bad credit culture and the lack of reliable accounting and auditing standards. This rate of credit expansion, incidentally, was one of the reasons why the Currency Board raised reserve requirement in 2001 in order to slow the rate of expansion. Deposits are also increasing as people show confidence in the banking system and repatriate their funds from foreign banks.

In **Bulgaria**[8], new legislation introduced in January 1991, permitted the creation of new financial institutions with private domestic or foreign capital. Within two years of the liberalisation of the banking sector, 80 commercial banks were established and organised as self-managed joint-stock companies. The activities and lending practices of these new institutions, however, quickly became identified with serious irregularities and illicit financing. The lack of effective regulatory scrutiny made the problem endemic. During the same period state-owned banks continued, under government pressure, to extend loan facilities to money-losing enterprises. It is estimated that in 1995 alone total loses amounted to 15% of GDP. By the end of that year the system was insolvent. Many banks faced liquidity problems, temporarily alleviated through massive central bank refinancing. This consequent money creation affected the foreign exchange market, undermining confidence in the national currency and led to the devaluation of the lev/USD exchange rate from 10 in December 1995 to 3200 in February 1996. The annual inflation rate climbed to over 1000%. By January 1997, one in every four banks was in receivership.

Following the advice of the IMF, the Bulgarian government introduced a Currency Board accompanied by a package of structural reforms. This package included strict control and financial supervision of money losing state enterprises, the liberalisation of trade and a more rigorous privatisation policy. In July 1997, the Currency Board pegged the lev to the DM, took measures to restrict government expenditure and the activities of the Central Bank, which was permitted to provide only three-month loans to commercial banks. The Board's policy was very effective in containing inflation, which was reduced to 1% monthly by the end of the year. The policy of the Board, however, did not come without cost. Bulgaria experienced a severe depression and GDP contracted by 7.4% in 1997, though it bounced back with a 4.5% increase in 1998.

After six years of systematic restructuring, the banking sector in Bulgaria is considered well regulated and well supervised. The credibility of its institutions has been restored and their viability has been improved through a series of mergers and acquisitions. In 2003, new regulations on internal control in line with the principles of

[8] Source: Bulgarian National Bank *Annual Report*, 1996-2003.

the Basel Committee on Banking Supervision were adopted. At the end of that year, most of the 35 banks operating in the country were privately owned, while 27 were foreign owned. Foreign investors controlled about 84% of the total banking assets. Overall, the banking sector is fairly liquid, quite profitable and adequately capitalised. In 2003, the capital adequacy ratio was 22.2%, way over the required minimum (12%). Banking intermediation, however, still remains low in comparison not only to the western European countries but also to other Central European transition countries.

In **Romania**[9], privatisation and reform in the banking sector has proceeded more slowly than in the rest of the region. For almost ten years (1990-1999), the level of intermediation was very low, the degree of concentration high (the largest four banks controlled more than 65% of total banking assets) and the problem of non-performing loans to state banks unresolved. Reform measures were taken after 1999 with the closure of a large state bank, Bancorex, the restructuring, recapitalisation and eventual privatisation of the Banka Agricola and the clearance of a substantial part of the non-performing loans. At the end of 2002, thirty-nine banking institutions were in operation, of which twenty-four had a majority foreign ownership. In November 2003, the government announced the partial privatisation of Banca Commerciala Romana (BCR) through the sale of 12.5% to the International Finance Corporation (IFC) and another 12.5% to the EBRD. This bank alone holds almost 30% of the total banking assets. The Romanian government plans to reduce further its stake in BCR by selling to a strategic investor by 2006.

Banking supervision and the legal and regulatory framework have also been strengthened in recent years. At the beginning of 2002, new regulations were introduced governing the operations of saving co-operatives and the administration of the secondary Treasury bills and money markets. At the end of 2003, 38 banks were operating in the country, after the removal of the problem Columna Bank by final decision of the Bucharest Court. In general, after a decade of delays the banking sector in Romania is quickly catching up with the progress made in the other Balkan countries.

[9] Source: National Bank of Romania *Annual Report*, 1994,1997, 1999,2000-2003.

In **F.Y.R. Macedonia**[10], initial banking sector reform was based on a policy of rehabilitation and privatisation of existing entities. Banking institutions came under the supervision and guidance of a government agency, which became responsible for clearing their balance sheets and securing adequate capitalisation. Concurrently the National Bank made a consistent effort to create a regulatory and supervisory framework for the establishment of a viable banking sector. Strict capitalisation requirements were introduced, money laundering was checked and measures for expanding credit to small- and medium-sized enterprises were implemented. Legislation, introduced in 2000 and 2001, created the legal framework for modernising and consolidating the banking sector along the lines of the European Union banking directives and international standards. A temporary set back caused by a severe economic downturn in 2001 was quickly overcome. At the end of 2002, the banking system of the country consisted of 20 commercial banks, of which 7 were foreign owned and 17 classified as saving houses.

Presently, the banking sector is predominantly privately owned, while the share of foreign ownership has increased to over 40%. Consistent efforts have continued for the regulation and supervision of the system, while liquidity and capitalisation conditions are improving. However, financial intermediation is still low and there are clear signs of high concentration with two banks controlling 50% of the total banking assets.

In **Serbia and Montenegro**[11]**,** the banking sector had to wait until 2001 before reforms getting under way. It suffered, like all other sectors of the economy, from the reluctance of the Milosevic regime in the 1990s to proceed with privatisation and restructuring. Banking institutions remained effectively under state control and operated under soft budget constraints, mostly supporting money-losing enterprises. With an artificially maintained fixed exchange rate and official reserves estimated at very low levels, banking and financial conditions in former Yugoslavia remained difficult until the democratic transformation in 2000.

The banking sector emerged from the Milosevic era was insolvent with its liabilities well above the value of its assets. At the same time, it faced a severe liquidity crisis. The National Bank of Yugoslavia (NBY), in collaboration with the

[10] Source: National Bank of the Republic of Macedonia *Annual Report*, 1998-2003.
[11] Source: National Bank of Serbia, *Annual Report*, 2003.

World Bank and the IMF, embarked on an ambitious restructuring policy in May 2001. The proposed objective of this policy was to complete all necessary liquidation procedures for insolvent institutions and privatise the remaining banks, most of which were severely undercapitalised. The implementation of this policy is still under way. Initially, all banking institutions were categorised into three groups: healthy, solvent but undercapitalised and insolvent. By 2002, 28 banks (including four of the largest) were declared insolvent and closed. Another 50 banks (including 12 foreign owned) were characterised as healthy, some of which, however, were still facing serious capitalisation problems. Concurrently, emphasis was placed on bank privatisation, the strengthening of banking supervision and the enforcement of prudential rules and regulations. At the end of 2003, 47 banks were operating in the country, of which 16 were foreign owned. In 2004, the Serbian government offered three large state banks for sale, while the largest bank of Montenegro (the Montenegro Banca) was sold to the Slovenian Nova Ljublianska Banca in July 2003. The intention of the NBY is to increase the minimum capital requirement, introduce new asset classification, improve internal auditing procedures, control and credit policies. Recently, a new accounting law was introduced, requiring all banks to implement International Accounting Standards (IAS). Overall, steps have been taken to improve the banking sector in Serbia and Montenegro, but much remains to be done, especially in the areas of strengthening the regulatory framework and privatising the remaining state owned banks.

6. Banking System Reform Index

The general review of banking developments provided above shows that reforms have proceeded at different speed in the various Balkan countries. It is also fair to say that the banking sector has transformed itself substantially in the past few years and this improvement was the result of changes in:

- the privatisation of state owned banks and the closure of insolvent institutions;
- the writing-off of non-performing loans;
- the entry of foreign banks either by establishing an autonomous presence or by taking over local banks;
- the adoption of regulations according to international standards and practices; and,

- the implementation of tighter and more effective supervision exercised by the central banks and currency boards.

Many challenges lie ahead for the banking sector in the SEE countries which, overall, remains less developed relative to the Central Eastern European transition countries. Table 3 depicts improvements in the SEE countries' banking sector over the past 6 years, according to the EBRD Index of Banking System Reform. According to this index, the banking system reform in all SEE countries ranges between 2.3 and 3.3[12].

Table 3: SEE Countries' Banking System Reform Index

	Year	EBRD Index of Banking System Reform
Albania	1998	2.0
	2003	2.3
Bosnia-Herzsegovina	1998	2.3
	2003	2.3
Bulgaria	1998	2.7
	2003	3.3
FRY (Serbia and Montenegro)	1998	1.0
	2003	2.3
FYR Macedonia	1998	3.0
	2003	3.0
Romania	1998	2.3
	2003	2.7

Source: EBRD Transition Report 2003

Bulgaria has recorded by far the largest improvement since the 1997-8 crisis, while FYR Macedonia and Romania have recorded very significant progress. Reforms in Albania and in Bosnia-Herzegovina have been implemented at a slower pace, while in Serbia and Montenegro reforms were first introduced after 2001 and since then changes are proceeding quite rapidly.

7. Ownership Structure

The privatisation of state owned banks was a critical element in the banking reform process. In all SEE countries there have been serious delays mainly due to

[12] EBRD *Transition Report 2003*, p.17. The classification 3 means '*there has been progress in establishment of bank solvency and of a framework for prudential supervision and regulation, while there is significant lending to private enterprises and significant presence of private banks'*.

government reluctance, unfavourable political circumstances and general economic uncertainty.

Table 4 presents the asset shares of state owned banks. While in the 1990s the privatisation process proceeded rather slowly, over the last six years it has increased dramatically. In Bosnia-Herzegovina, FYR Macedonia and Bulgaria, the asset share of state-owned banks dropped below 15%. In Albania, the privatisation of the Albanian Savings Bank in 2003 lowered the percentage share of state owned banks below 10%, while in Romania the government plans to reduce further its stake in Banca Commerciala Romana (BCR) and significantly lower the percentage share of state owned banks in total bank assets. The privatisation process has been delayed in Serbia and Montenegro since the transition process started only after 2001.

Table 4: SEE Countries' Bank Ownership Structure

	Year	Asset share of state-owned Banks
Albania	1998	85.6%
	2002	54.1%
Bosnia-Herzsegovina	1999	75.9%
	2002	6.2%
Bulgaria	1998	56.4%
	2002	14.1%
FRY (Serbia and Montenegro)	1998	90.0%
	2002	35.6%
	2003	37.5%
FYR Macedonia	1998	1.4%
	2002	2.0%
	2003	1.8%
Romania	1998	75.3%
	2002	43.6%
	2003	41.5%
Greece	2003	49.0%

Source: EBRD Transition Reports 2003; Annual Reports 2003 from the Central Banks of Greece, Romania, Serbia/Montenegro

Table 5 below presents the extent of foreign ownership of banking institutions in the SEE countries. With the exception of Serbia and Montenegro, privatisation and the liberalisation of the banking sector were characterised by the entry of foreign banks in the market. Typically, entry occurred by either acquisition of local banks (state owned or private) or establishment of their own subsidiaries or branches. Their presence must be considered important, since they introduce modern organisational and management techniques and much needed financial market know-how. Foreign ownership is dominant in almost all SEE countries. For instance, in Albania, almost all the banking sector is foreign-owned.

Table 5: SEE Countries' Bank Ownership Structure II

	Year	Total number of Banks	Foreign Owned Banks
Albania	1998	10	8
	2002	13	12
	2003	16	14
Bosnia-Herzegovina	2000	55	n/a
	2002	40	n/a
	2003	37	n/a
Bulgaria	1998	34	17
	2002	34	26
	2003	35	27
FRY (Serbia and Montenegro)	1998	104	3
	2002	50	12
	2003	47	16
FYR Macedonia	1998	24	6
	2002	20	7
Romania	1998	36	16
	2002	39	24
	2003	38	21
Greece	2003	59	20

Source: EBRD Transition Report 2003; Central Banks Annual Report 2003 of the respective countries

8. Capitalisation

During the initial phase of transition, many banks became insolvent under the weight of non-performing loans, while others were kept operating with Capital Adequacy Ratios (CARs) much below 8%, the regulatory minimum according to the Basle Capital Adequacy Agreement rules. The restructuring of state owned banks and the capital injections received from their respective governments improved bank capitalisation significantly. As table 6 shows the private banks that entered the market in the following years were on average well-capitalised and maintained high CAR.

During the last six years, all operating banks - both private and public - have improved their CAR. In all countries, banks are now on average well capitalised, recording ratios well above the regulatory minimum (8%). In Albania, Bulgaria and Romania, the regulatory minimum CAR is 12%, following the severe financial crises during the 90's. The regulatory authorities in these countries are expected to reduce the minimum CAR to 8% in the near future, after the banking system has been stabilised and considered sufficiently capitalised. It is more than likely that in the near future, the CAR will fall to lower levels (albeit above the regulatory minimum) given the intention of banks to increase their lending.

Table 6: SEE Countries' Banks Capitalisation

	Year	Capital Adequacy Ratio	Regulatory Capital Adequacy Ratio
Albania	1998		12.0%
	2002	31.5%	
	2003	28.5%	
Bosnia-Herzsegovina	2000	28.4%	8.0%
	2002	20.6%	
	2003	19.8%	
Bulgaria	1998	37.0%	12.0%
	2002	25.2%	
	2003	22.2%	
FRY (Serbia and Montenegro)	1998	n/a	8.0%
	2002	30.4%	
	2003	31.3%	
FYR Macedonia	1998	25.2%	8.0%
	2002	28.1%	
	2003	25.8%	
Romania	1998	10.3%	12.0%
	2002	24.6%	
	2003	20.0%	
Greece	2003	12.8%	8.0%
EU Large Banks	2003S	11.4%	8.0%

Source: Central Banks Annual Reports 1998, 2002, 2003 of the respective countries; Bloomberg Consolidated Fiscal Statements 2003.

9. Profitability

The profitability of the banking sector, has improved steadily over the past six years. This was the result of reform implementation regarding the adjustment of non-performing loans, the introduction of modern banking techniques and the increasing pace of credit expansion. The table below presents two indexes of bank profitability, the Return on Assets (ROA) and the Return on Equity (ROE).

Table 7: SEE Countries' Bank Profitability

	Year	ROA	ROE
Albania	1998	-1.8%	-82.3%
	2002	1.2%	19.1%
	2003	1.2%	19.5%
Bosnia-Herzsegovina	2000	-1.5%	-5.8%
	2002	0.4%	3.2%
	2003	0.7%	6.4%
Bulgaria	1998	1.7%	15.8%
	2002	2.7%	19.2%
	2003	2.0%	18.4%
FRY (Serbia and Montenegro)	1998	n/a	n/a
	2002	-0.7%	-3.2%
FYR Macedonia	1998	2.0%	8.2%
	2002	1.5%	6.9%
	2003	1.7%	8.8%
Romania	1998	0.1%	1.0%
	2002	2.7%	19.7%
Greece	2003	0.9%	12.8%
EU Large Banks	2003S	0.4%	11.4%

Source: Central Banks Annual Reports 1998,2002, 2003 of the respective countries; Bloomberg Consolidated Fiscal Statements 2003.

By 2002, both ratios had increased to the point of exceeding the corresponding figures for the average EU large banks. This was the result of selective lending practices banks and the wide interest-rate spread. In the future, banks will likely have to find new sources of profits as market conditions change. Intermediation is expected to increase together with competition between banks, leading to a narrowing of interest-rate spreads. Financial institutions should seek new sources of revenue in retail banking and in asset management, while they will try to increase market share. Some of the key factors determining the SEE bank performance in the future are:

- controlling of operating expenses and minimising losses;
- implementation of a clear strategy to optimise capital allocation;
- introduction of new banking products and services;
- optimisation of human resources capabilities;
- introduction of modern and effective risk management techniques;
- a clearly defined segmentation of their target client base; and,
- increasing market share.

These factors are identical to those that affect the performance of banking institutions in the more advanced economies as well, and this is a clear sign as to how far the banking sector in SEE countries has come during the past few years.

10. Loan Portfolio Quality

During the 1990s, the banking system of the SEE countries experienced serious problems stemming mainly from the poor quality of their loan portfolios. Most of these problems were inherited from the 'old regime', where credit risk evaluation was irrelevant, the regulatory framework was inefficient and a bank's credit policy was just a government instrument used according to the needs of the centrally planned economy (Bonin 2001:1).

During the transition period and especially during the last six years, banking institutions took measures to improve their asset quality and loan portfolio performance. Concurrent with the privatisation and restructuring policies carried out by specially created agencies, the central banks adopted new methods, rules and regulations according to BIS standards in order to create a new and effective framework to deal with lingering functional and supervision problems. Table 8 below presents the loan portfolio quality of commercial banks in SEE countries.

With the exception of Serbia and Montenegro and FYR Macedonia, loan portfolio quality has improved substantially in all the SEE countries. In FYR Macedonia, the banking sector crisis and the economic downturn of 2001 were the main causes of a further delay in dealing with the non-performing loan adjustment. In Serbia and Montenegro, the economy is only now recovering from the war and most of the banks still have a large number of non-performing loans in their portfolios inherited from the past.

Table 8: SEE Countries' Bank Loan Portfolio Quality		
	Year	**Non-Performing Loans/ Total Loans (%)**
Albania	1998	35.4%
	2002	5.6%
Bosnia-Herzsegovina	1999	58.7%
	2002	11.5%
Bulgaria	1998	11.8%
	2002	10.4%
FRY (Serbia and Montenegro)	1998	13.1%
	2002	28.5%
FYR Macedonia	1998	50.3%
	2002	35.7%
Romania	1998	58.5%
	2002	2.3%
Greece	2003	5.4%
EU Large Banks	2002	2.7%

Source: EBRD Transition Reports 2000, 2003; Bloomberg Consolidated Fiscal Statements 2003

Overall, the share of non-performing loans to the total loan portfolio is still high compared to large EU banks. The introduction of modern and more sophisticated risk management techniques and the introduction and implementation of the new Basel II Accord are two of the measures expected to improve loan portfolio quality and accelerate convergence toward the EU average.

11. Financial Intermediation

Financial intermediation remained low during the first decade of transition, mainly due to weak depositor confidence caused by the protracted and, in some cases, severe financial crises experienced by most SEE economies. During the same period, legal protection for depositors and deposit insurance schemes were absent. In addition, personal income was barely sufficient to cover basic needs. All these conditions combined to result in a low household savings potential and affected negatively credit expansion by banks. Additionally, during this period, lending policy was to move only slowly and carefully in the market given that corporate performance was weak, balance sheets unreliable and clients' credit history non-existent. The banks' preferred option was to invest their funds in government bonds.

Table 9 presents data on the evolution of domestic credit to the private sector as a percentage of the GDP. Apart from Bulgaria, where the ratio is near 20%, in all the other countries the recorded ratio is indicative of the low level of financial intermediation.

Table 9: SEE Countries' Banking System Intermediation

	Year	Domestic Credit to Private Sector (% of GDP)
Albania	1998	0.6%
	2002	4.7%
Bosnia-Herzsegovina	1999	8.9%
	2002	12.0%
Bulgaria	1998	12.2%
	2002	18.0%
FRY (Serbia and Montenegro)	1998	11.2%
	2001	5.6%
FYR Macedonia	1998	17.7%
	2002	14.4%
Romania	1998	11.6%
	2002	8.4%
Greece	2003	26.3%
EU	2002	48.5%

Source: EBRD Transition Reports 2000, 2003; Bank of Greece Annual Report 2003.

Over the last six years through 2004, the level of financial intermediation has increased significantly. The deposit base has increased together with depositor confidence while adequate legal protection of the lenders, the introduction of modern credit risk management techniques and the good and more transparent performance of the business sector has led to significant credit expansion. However, financial intermediation in all the SEE countries is still low relative to the EU average. According to a recent research conducted by PriceWaterhouseCoopers (2003:20), the level of financial intermediation in SEE countries is also well below that of the Central and Eastern European countries. In the near future, however, as overall conditions improve, Balkan banks are expected to expand their lending activities in the retail, business and production sectors.

12. EU Countries' Ownership in the SEE Countries' Banking Sector

Some of the largest European banking institutions as well as the five largest Greek banks[13] have ownership of SEE banks, taking advantage of their geographic and cultural proximity. Additionally, Greek banks following the expansion and operation of many national firms in the area expanded their own operations, hesitantly at the beginning and more aggressively during the second half of the 1990s and thereafter. Tables 10-15 present the market share of banks from selected European countries in the Balkan countries at the end of 2003.

Table 10: BULGARIA

COUNTRY OF ORIGIN	PARENT BANK	SUBSIDIARIES/ BRANCH	MARKET SHARE (% of assets)
GREECE	EFG EUROBANK	BULGARIAN POST BANK	5.22%
	EMPORIKI BANK	EMPORIKI BANK BULGARIA	0.48%
	ALPHA BANK	BRANCH	0.69%
	PIRAEUS BANK	BRANCH	1.35%
	National Bank of Greece	UBB	10.42%
AUSTRIA	Bank Austria Creditanstalt	HVB Bank Biochim	7.30%
	Raiffesen Bank	Raiffesen Bank	5.30%
FRANCE	SOCIETE GENERAL	Express Bank	3.90%
ITALY	UNICREDITO	Bulbank	17.50%

Source: Central and Eastern European (CEE) Central Banking Sector Report, RZB, Oct 2004; On Greek banks: Published Results by the respective institutions.

Table 11: ROMANIA

COUNTRY OF ORIGIN	PARENT BANK	SUBSIDIARIES /BRANCH	MARKET SHARE (% of assets)
GREECE	EFG EUROBANK	BANC POST	4.22%
	EMPORIKI BANK	EMPORIKI BANK ROMANIA	0.37%
	ALPHA BANK	ALPHA BANK ROMANIA	3.67%
	National Bank of Greece	BANCA ROMANEASCA	1.07%
	PIRAEUS BANK	PIRAEUS BANK ROMANIA	1.20%
	EGNANTIA BANK	EGNANTIA BANK ROMANIA	0.19%
AUSTRIA	Bank Austria Creditanstalt	HVB Bank Romania	3.40%
	Raiffesen Bank	Raiffesen Bank	6.90%
FRANCE	SOCIETE GENERAL	BRD	13.20%

Source: Central and Eastern European (CEE) Central Banking Sector Report, RZB, Oct 2004; On Greek banks: Published Results by the respective institutions.

[13] There is a strong connection between the size of banks and cross-border expansion since the business risk in the young markets of the Balkan countries can only be tolerated by large, viable and credible banking institutions.

Table 12: SERBIA&MONTENEGRO			
COUNTRY OF ORIGIN	**PARENT BANK**	**SUBSIDIARIES /BRANCH**	**MARKET SHARE (% of assets)**
GREECE	EFG EUROBANK	EUROBANK BEOGRAD	0.25%
	ALPHA BANK	BRANCH	1.19%
AUSTRIA	Bank Austria Creditanstalt	HVB Bank Serbia&Montenegro	0.20%
	Raiffesen Bank	Raiffesen Bank	8.50%
FRANCE	SOCIETE GENERAL	SOCIETE GENERAL	3.20%
Source: Central and Eastern European (CEE) Central Banking Sector Report, RZB, Oct 2004; On Greek banks: Published Results by the respective institutions.			

Table 13: (F.Y.R) Macedonia			
COUNTRY OF ORIGIN	**PARENT BANK**	**SUBSIDIARIES /BRANCH**	**MARKET SHARE (% of assets)**
GREECE	ALPHA BANK	ALPHA BANK SKOPIE	2.80%
	National Bank of Greece	STOPANSKA BANKA	26.40%
SOLVENIA*	NLB	TUTUNSKA	11.30%
FYROM	-	KOMERCIJALNA BANKA	28.50%
Source: Central and Eastern European (CEE) Central Banking Sector Report, RZB, Oct 2004; On Greek banks: Published Results by the respective institutions.			
*the Belgian KBC participates with 34% in NLB and EBR with 5%			

Table 14: ALBANIA			
COUNTRY OF ORIGIN	**PARENT BANK**	**SUBSIDIARIES /BRANCH**	**MARKET SHARE (% of assets)**
GREECE	EMPORIKI BANK	EMPORIKI BANK ALBANIA	1.18%
	ALPHA BANK	BRANCH	7.36%
	PIRAEUS BANK	TIRANA BANK	7.05%
	National Bank of Greece	BRANCH	2.23%
AUSTRIA	Raiffesen Bank	Savings Bank	49.10%
ITALY	Banca Di Roma	Banka ItaloAlbanese	4.40%
Source: Central and Eastern European (CEE) Central Banking Sector Report, RZB, Oct 2004; On Greek banks: Published Results by the respective institutions.			

Table 15: Bosnia-Herzegovina			
COUNTRY OF ORIGIN	**PARENT BANK**	**SUBSIDIARIES /BRANCH**	**MARKET SHARE (% of assets)**
AUSTRIA	Raiffesen Bank	Raiffesen Bank	19.90%
	Hypo Alpe-Adria	Hypo Alpe-Adria	16.20%
	Bank Austria Creditanstalt	HVB Bank BACA	7.90%
ITALY	Unicredito	Zagrebacka Banca	16.80%
Source: Central and Eastern European (CEE) Central Banking Sector Report, RZB, Oct 2004; On Greek banks: Published Results by the respective institutions.			

Tables 10-15 above indicate that a number of European banks have become prominent players in the Balkan market. In Bulgaria, their market share in 2003, in terms of total banking assets, was about 52%, in Romania about 34%, while in Albania and FYR Macedonia they dominated the market, controlling over 65% of total assets. The presence of European banks in Serbia and Montenegro is rather small (about 15%), but numerous commercial banks have already declared their intention and their plans to expand into that country.

The strong economic growth recorded in all the Balkan countries, the increasing financial stability, the improved corporate results, the increasing disposable income and the expansion of consumer credit provide a dynamic banking environment with favourable conditions for the operation of European banks. All of them, according to their most recent annual reports expect to increase their market share and lending activity in the foreseeable future.

13. Conclusion

The data and information presented in this study provide strong evidence that there have been rigorous and accelerated improvements in the banking sector of the Balkan countries, particularly after the acute crises that affected them between 1996 and 2000. Our review suggests that government reforms in recent years radically changed the ownership structure of the banking system and improved performance indicators. Moreover, a very significant harmonisation of ownership structure and performance indicators has been emerging in all the Balkan countries. This manifests a common convergence pattern despite the fact that the transformation drive in each country proceeded at different speed and by different method (Buch 1996). Overall, with the exception of a low level of intermediation, in all other respects the banking sectors in the Balkan countries resemble those of EU countries. To a great extent, this progress has been achieved because of the efforts of foreign investors. The Balkan experience shows that foreign investments, if concentrated collectively, timely and in a synchronised manner on a particular economic sector, can effectively redefine its structure and function.

Despite these significant developments in the past few years, the banking sector in the Balkans still faces many challenges. A new wave of reforms concentrating on sector consolidation through mergers and acquisitions is needed and, in some countries, is already under way. Deposit insurance schemes and loan collateral policies recently introduced are welcoming measures protecting both banks and their clients. The full implementation of the new Basel II Accord and the strengthening of the regulatory framework are also challenges requiring further action. It should also be noted in this context that the sustainability of banking sector reform in SEE countries will be determined, to a considerable extent, by the commitment of governments to implement market-oriented reforms in other sectors of the economy. Many weaknesses and problems, past and present, faced by the banking system are caused by the lack of transparency and accountability in public and private transactions, the negative consequences of the underground economy, the legacy of weak corporate governance and the lack of public confidence in public institutions.

Last but not least, there are clear signs that banking reform is already contributing to the broader objective of the Balkan countries to integrate in the EU. Ownership structure alone reveals a *de facto* strong continental integration pattern. This momentum should be seized as an opportunity by the EU to intensify the Stabilisation and Association Process of the Balkan countries instead of treating these advancements as a test ground and as a criterion for deciding their accession prospects in the distant future.

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