

## RS citizens have more trust in banks than the other way around

People's deposits in RS banks had continuous growth since the great fall from October, 2008. On the other hand, the amount of credits granted to the population remained the same.

### Though liquid, the banking sector still in a state of hibernation

Crediting activity of the banking sector did not show signs of recovery in 2010. The growth of total credit payments of banks in RS at the end of the first half of 2010 was humble 3.8% in comparison with the same period previous year, while compared to the end of the last year it was 2%. Obviously, banks still reason that the continuation of the expansion of crediting activities in RS is a highly risky job, so they have continued with the policy of not increasing the existing exposure to private sector. Thus, one might conclude that the banking sector still does not believe that economic crisis is a past thing and that it is still difficult to estimate the existing level

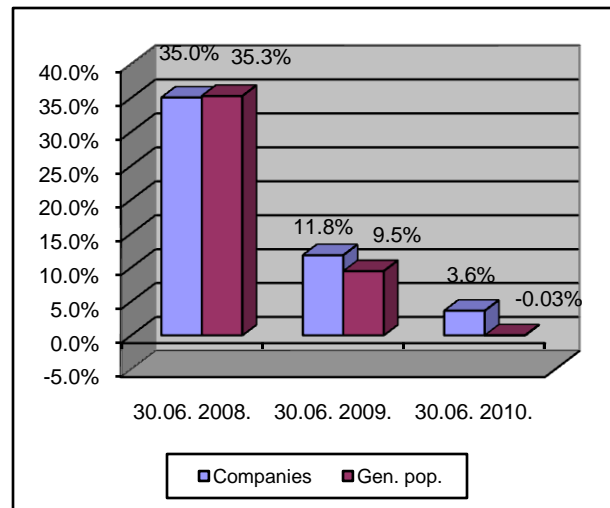
of systematic risk. Therefore, banks prefer keeping big amounts of money at their disposal (1.35 billion

BAM), as a means of protection against potential greater deposit outflows. Significant increase of credit payments is still present only in the sector of Government and its institutions, confirming the current high aversion of banks towards exposing to new risks, which returns the danger of preventing private sector to obtain capital and points to difficult fiscal position of public sector. Having in mind that consumption has historically been the initiator of GDP growth, it is apparent that a more stable economic recovery will not be achieved without more serious revitalization of banking activities. However, when this does come, one surely should not expect the continuation of astronomical growth rates of credit payments as it was before the crisis, which was above all the reflection of global enormously high economic optimism and tolerance for risk.

### Citizens have more trust in banks than banks in them?

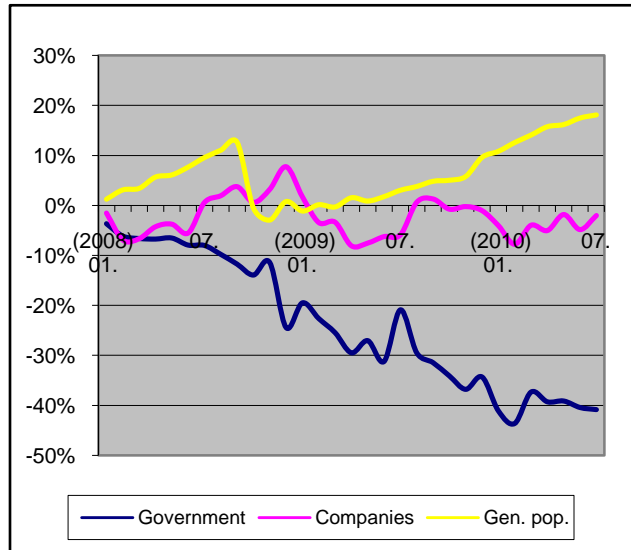
People's deposits continued with growth lasting since the last quarter of 2008 and in RS they increased by 6% during the first half of 2010. Such trend, at least at first, suggests that citizens did not have trust issues with the safety of the banking system. However, the same could be viewed from another angle. One should not disregard the fact that citizens, under the influence of economic crisis, have postponed a significant portion of their consumption and investment plans, thereby increasing the portion of their

*Growth of credit payments of banks in RS (June/July, last year)*



*Source: Banking Agency of RS*

**Movement of deposits in banks in B&H (changes in relation to December, 2007).**



Source: Central Bank of B&H

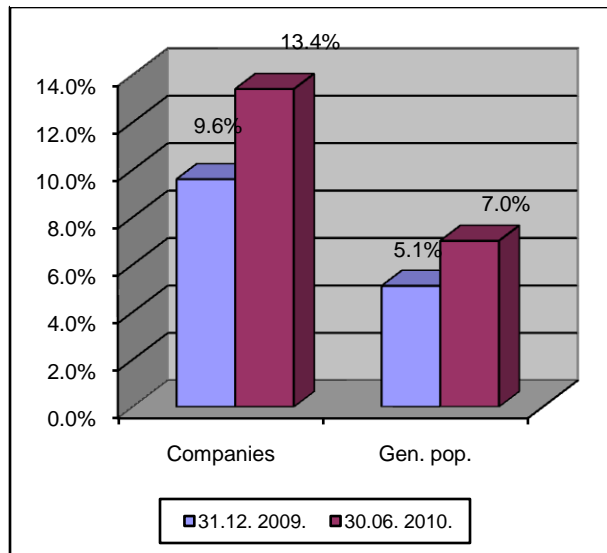
income going on savings. Then they would put this surplus on their current and savings accounts, so therefore, the consequential growth of deposits largely reflected the lack of choice and the fact that citizens felt more financially insecure during the crisis. Another proof that a portion of people's income going on savings increased was the information that the total value of people's deposits surpassed its pre-crisis amount, even though people's wages were not increased over the same period (cease of growth of wages, employment rate fall, fall of transfer of money from abroad).

If we were to measure the degree of trust of banks towards the people by the rate of growth of credits in this segment (-0.3%), then it can be said that banks did not return this "forced love". Banks did not grant new credits to the people even beside the fact that the people made a safer segment, having in mind the share of bad action capital in relation to legal entities (7% in relation to 13.4%). The halt alone of credit payments to the people can partially be blamed on the change in consumption habits and less secure financial situation of RS citizens, but surely the main reason for this lied in the new, much more rigid banks' crediting policy. Very high monthly changes in levels of deposits by companies pointed to problems of liquidity of the economy, while the constantly negative trend in deposits by the Government and its institutions mostly came as a result of withdrawing the privatization funds.

**Clients struggle in making monthly payments**

The quality of credit portfolio of RS banks deteriorated in the first six months of 2010. The share of bad credits (credits categorized in the highest risk categories – C, D and E) in total credit payments in the first six months of 2010 increased from 7.8% to 10.8%, representing the continuation of the negative trend from 2009. The economic crisis in RS, therefore, is not in any way a past thing, since private sector is facing with ever increasing difficulties in settling their obligations on time. The leading position here belongs to the sector of companies, where the share of bad credits reached 13.4%. A good share of responsibility for such situation goes to a certain number of banks which made business operation difficult even for the good clients. A recent statement by the governor of the Central Bank of B&H confirmed this. He stated that "banks did not adequately respond to the crisis in the aspect of understanding clients, because it was obvious that some clients, not by their own guilt, found themselves in a situation in which they could not settle their obligations."

**Percentage of bad credits in granted credit payments of RS banks**



Source: Banking Agency of RS

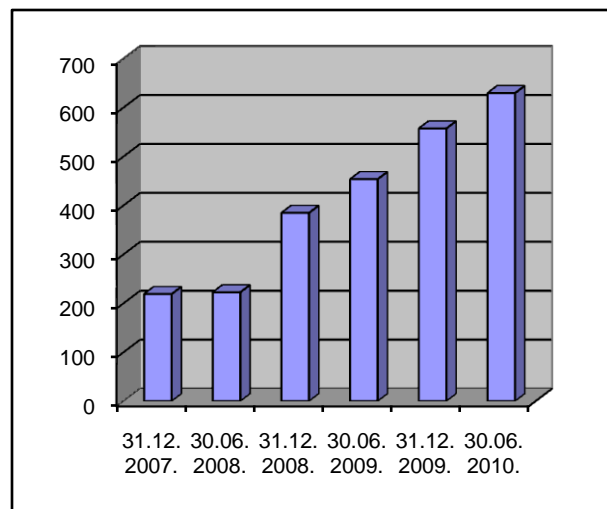
**RS banks depend more on credit financing and parent banks**

Faced with the fall of deposits as the main source of financing, banks were forced to rely more on other sources. Thereby, credits taken by banks in RS grew by 13% in the first six months of 2010, having reached the amount of 629 million BAM. It is important to mention that in the structure of these credits a share of 76% was made of credits by the Republic of Srpska Investment-Development Bank (IRB RS), withdrawn by domestic banks with an obligation of granting them to entrepreneurs and companies for the purchase of basic and working capital, for refinancing of their financial obligations,

and to general population for the purchase of or expansion of housing units. Thereby, the IRB RS became the most significant source of credit financing of banks seated in RS. Banks' determination for this source of financing does not surprise at all, having in mind that interest rates on IRB RS funds are the lowest.

The participation of deposits by banking institutions of 20% in total deposits points to high dependence of RS banks on their parent banks, so potential withdrawal of these deposits could jeopardize their

**Obligations of RS banks per credits taken (in millions BAM)**



Source: Central Bank of B&H

liquidity. In line with that, business policy towards Western Balkan countries and financial status of parent banks will still have a strong influence on the business of domestic banks. The official stand of EU banks present in B&H has been formulated through IMFs “Wien Initiative”, in which parent banks stated their adherence to the decision to maintain the existing level of financial exposure at the market of B&H.

### **Microcredit organizations at the most challenging exam so far**

Microcredit organizations (MCO) represent a significant kind of financial mediators in RS. This is best confirmed by the value of total active capital of MCO in RS of 308 million BAM, with the major share falling to credit payments. MCO are a special kind of financial institutions that are characterized by low value of individual credits (limit by law of up to 50 000 BAM) intended to clients with lower income, often from informal sources, who have difficult approach to usual banking products. MCO fill in the emptied niche market and in developmental policy their operation is considered favorable for increasing income of economically most jeopardized residential groups. The biggest share of granted MCO credits was related to agriculture (33%). MCO credits are characterized by great promptness and simplicity in the process of granting. On the other hand, interest rates on these credits are much higher than in the banking sector, so an average effective interest rate on MCO credits in RS in the first six months of 2010 was 20.9%. Granted MCO credits lost their value by 8% in the first half of the year, illustrating a significant deterioration of business operation in this area.

<b>Business sector</b>	<b>Millions of BAM</b>	<b>Percentage</b>
<i>Services</i>	47,175	19,1%
<i>Trade</i>	33,026	13,4%
<i>Agriculture</i>	82,709	33,5%
<i>Production</i>	21,246	8,6%
<i>Household needs</i>	1,397	0,6%
<i>Other</i>	61,554	24,9%
<b>TOTAL</b>	<b>247,107</b>	<b>100,0%</b>

The contraction of microcredit activities aggravated the approach even to this, maybe the only, source of financing for the most vulnerable social categories of society in amidst the economic crisis. The increase of the share of credits with delayed payment from 10% to 16.2% at the end of the first half of this year and growth of realized loss to 2.5 million BAM point to a very serious problem of the current position of MCO. It appears that the economic crisis emphasized the limited possibility of MCO to manage their input costs within the existing laws. Since MCO do not collect deposits, they primarily rely on financing their operations through withdrawing credit funds from international and domestic sources. It is interesting that the share of the IRB RS in credit financing of MCO was incomparably less than the one of RS banks, indicating the existence of problems in providing financial support to MCO. Reasons for this should be searched in the lack of suitability of the existing financial products of the IRB



RS to specific conditions of MCO market that cannot be compared in any aspect to the market of standard banks. Therefore, alternative options for public policy in this area could be the development of special financial instruments by the IRB RS for MCO, change of regulations in RS limiting the kinds of services provided by MCO or possible transformation of MCO into other forms of financial institutions.