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ORIGINAL PAPER

The Role and Financial Performance of Banks in the Western Balkans

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Abstract:
The bank's performance is its ability to generate sustainable profitability. Although banking institutions have become increasingly complex, the key factors in their performance remain earnings, risk-taking efficiency and financial leverage. The countries of the Western Balkans have some common features: the history of socio-economic development, the transformations that have taken place, the reforms undertaken, liberalization, restructuring and the path to development. Their financial sector is primarily bank-based, so the soundness of the banking sector is significantly important for the stability and progress of their economies in the long term. Using a qualitative and quantitative analysis, the main objective of this paper is to generate and explain the main features about the role and financial performance of banks in the Western Balkans. The research methodology is based in explaining through a descriptive and graphical analysis, the particularities of the main banking systems in Albania, Bosnia and Herzegovina, North Macedonia and Serbia, presenting the four main performance measurement indicators: return on assets (ROA), return on equity (ROE), cost-to-income ratio and net interest margin. Analyzing the data for the period 2000-2019, it was assessed that the region is quite consistent in terms of the performance of the banking sector, the latter being almost equally dynamic for all four countries. The regional economic environment does not favor the stability of the financial system, but prevents the increase of the efficiency and productivity of the banking sector.

Keywords: *Cost-to-Income Ratio; Net Interest Margin; Return on Assets; Return on Equity; Western Balkans.*

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Introduction

The bank's performance is its ability to generate sustainable profitability. Although banking institutions became more and more advanced, the main determinants of their performance stay earnings, the efficiency of taking risks, and money leverage. Though it's understandable that a bank should be ready to generate earnings, it's additionally vital to require under consideration the composition and volatility of these earnings. Efficiency is related to the bank's ability to come up with financial gain from a particular quantity of assets and to exploit a particular supply of financial profit. The efficiency of taking risks is mirrored within the necessary changes to earnings for the risks taken to come up with them, as it can be mentioned the value of credit risk during a specific period of time. The financial leverage however, on the one hand might improve the outcome in the means that it works as a multiplier, and on the other hand, it might make bank even more possible to fail thanks to rare, surprising losses.

According to the objectives of each stakeholder, there can be identified several measures used to estimate the bank's performance, where the most used are the return on assets (ROA), the return on equity (ROE), and the cost-to-income ratio. Likewise, the determinant of the net interest margin is also evaluated, taking into consideration the important role of banks in the intermediation process.

The cost-to-income ratio shows the institution's ability to generate profits from a certain revenue stream. ROE is an internal measure of shareholder performance and is by far the most popular measure of performance, as it: (i) proposes a direct assessment of the return on investment of a shareholder; (ii) is readily available to analysts based solely on public information; and (iii) allows comparison between different companies or different sectors of the economy. Finally, the net interest margin is a proxy for the ability to generate income from the intermediary function of banks.

Part of the analysis of banks' performance as financial intermediaries should be the collection of information and data from formal or non-formal sources, to help both depositors and investors achieve their desired objectives. Measuring the performance indicators of the banking activity was considered a difficult process due to the nature of both the services and the products it offers, being immaterial.

Banking crises in developing markets have been associated with major macroeconomic disruptions: gross interest rate rises, high currency depreciations, collapses in production and sustained declines in credit supply. Bank loans have since recovered in a number of countries and there have been significant changes in banking structure, performance and risk management capacity. European banks continued to build a solid capital position and strengthen their balance sheets. The recapitalization effort created by European banks in the wake of the 2008 financial crisis is making the European banking sector more resilient and robust.

The countries of the Western Balkans have some common features: the history of socio-economic development, the transformations that have taken place, the reforms undertaken, liberalization, restructuring and the path to development. Their financial sector is primarily bank-based, so the soundness of the banking sector is significantly important for the stability and progress of their economies in the long term.

Using a qualitative and quantitative analysis, the main objective of this paper is to generate and explain the main features about the role and financial performance of banks in the Western Balkans. The research methodology is based in explaining through a descriptive and graphical analysis, the particularities of the main banking systems in

Albania, Bosnia and Herzegovina, North Macedonia and Serbia, presenting the four main performance measurement indicators: return on assets (ROA), return on equity (ROE), cost-to-income ratio and net interest margin.

The COVID-19 pandemic has pushed the Western Balkans region into a deep recession, accompanied by a decline in the domestic and external demand and disruptions in supply chains, pushing all six countries in the region into a negative territory of economic growth for 2020. The main risk for the Western Balkans is that a protracted pandemic, as well as a deeper recession within the European Union, could make it difficult to resolve the ensuing economic crisis. As a result, the banking system of these countries has experienced difficulties in general, and in terms of performance in particular. Repaying loans has become very difficult given the rising unemployment. The region is endangered by the growth of non-performing loans.

Literature Review

Rengasamy (2012) defines banking performance as "a mirrored image of how the bank has used its resources to achieve its objectives". The bank's performance is its ability to generate sustainable profitability. An institution that persistently records a loss will eventually deplete its capital base, which in turn jeopardizes holders of equity and debt (ECB, 2015).

The soundness of the banking sector in a country is very important for the health of the country's economy (Sufian and Chong, 2008). Also, in agreement with this statement, Katrodia (2012) argues that a country's banking sector and economy are closely linked. On the other hand, it is important to note that the soundness of commercial banks depends largely on their financial performance, which was normally used to indicate the strengths and weaknesses of such a commercial bank (Makkar and Singh, 2013). The financial performance of any bank is normally assessed by determining their profitability.

Yousef et.al. (2016) argues more broadly the need to measure the efficiency of the banking sector and says that it is directly related to the productivity of the economy. The efficiency of a bank is its ability to transform labor, capital, technology into financial services and banking products to better serve its customers. Another important conclusion comes from the study of Chortares et.al. (2012). They observed a direct relationship between the development of the financial systems and the banks' efficiency, with larger banks operating in less concentrated economies being more efficient. Hence, a key point for assessing the stability of the entire financial system is measuring the efficiency and productivity indicators (Gabeshi, 2020).

Hawkins and Mihaljek (2001) studied the consolidation and systemic stability of the banking industry in the emerging markets, by comparing it with the developed economies. They found out that the new technologies have an effect on the structure and performance of the banking sector both in developing and developed markets, mainly through their impact on costs and in the establishment of an optimal level. This advantage related to costs seems to favor smaller institutions more than the larger ones, because the investments needed to attract deposits or provide internet banking services are, in general, lower than the costs of founding a traditional branch network. Simultaneously, the cost advantages for larger institutions are created by the huge investments required to expand back office services and risk assessment systems.

It is clear from the literature that the stability of the banking sector is an integral part of the growth and sustainability of emerging and developing markets. Based on

Monnin and Jokipii (2013) results, the periods of stability are particulary followed by an increase in the real output growth while the periods of instability are associated with a decrease in the real output growth. Therefore, it is undeniable that the instability in the banking system affects economic growth due to financial constraints for the government, companies and individuals with direct long-term consequences for the country. In addition, Pradhan et.al. (2019) revealed that the bank's stability is linked to the development of the stock market, indicating that the banking system is linked to other aspects of the economy. Ntarmah (2019) concluded that the stability of the banking system plays a role in the economic sustainability of developing economies.

Even in 2021, it is clear that the financial services industry has not yet embraced the full capabilities of the new technology and there is still a relative friction between fintech (financial technology) organizations and established banks and credit unions. This can be explained, partly by the nature of the industry, where several new and great fintech companies work hard to push more traditional banks into more dynamic services, because of the innovation advantage they have and also by the fact that they were not related to the 2008 financial crisis. According to Talukder (2019) the solution for banks is fintech. By actively investing in the right technology, banks can adapt to the latest technological developments in the financial industry and begin to raise their profiles with modern consumers and innovative businesses.

The economies of the Western Balkan countries are among the most affected by the effects of recent recessions strongly influenced by the evolution of the region's economies. The slow recovery of euro area economies poses a risk to world economies. The almost unmistakable rate of economic growth leads to a decrease in demand, followed by inflation to deflation. The risks carried out by the world economy that can be transmitted to the economies of the region are: market fluctuations, geographical and political tensions, low rates of economic growth in developed countries and decline in emerging countries. European countries will suffer a decrease in investments due to shrinking activity and market development, weakening the economy and increasing investor uncertainty. In such an economic environment, the analysis of the financial stability of the region is of particular importance. The countries of the Western Balkans have some common features, like the history of socio-economic development, the transformations that have taken place, the reforms undertaken, liberalization, restructuring and the path to development. The structure of their financial system is mainly based on the banking sector, and capital markets are underdeveloped or inactive as in the case of Albania. Another common feature that makes them even more exposed to financial instability is that the majority of banks are owned by the largest ones operating in European countries. Meanwhile, the economies and banking sectors of their "parental" countries are facing problems and their economies are shrinking. According to ECB (2015), the most exposed of the Western Balkan countries to foreign capital are Montenegro, Albania and Macedonia. All these savings have been directly or indirectly affected by the crisis of recent years. The economies of these countries are small, but all aim to join the European Union, despite the different levels of development.

The banking sector protifability indicators in the Western Balkans, based on the the study of Varesi (2015), follow the same negative trend with the economic growth rates and the recovery rates are lower than the forecasted ones. The efficiency of the banking sector in the countries of the Western Balkans decreased for the observed period by the author, as well the profitability and overall banking performance showed a decreasing trend. The financial depth of the results of the countries studied has worsened compared to the pre-crisis period. Non-performing loans remained the main risk as they tended to increase.

From the analysis of the banking system profitability in Western Balkan countries of Tmava et.al. (2019), it can be concluded that both performance indicators (ROA and ROE) in the Western Balkan countries, for the comparative period (2008-2015), showed on average better performance in the period before the global financial crisis than in the following one and that some of these countries need to fully recover from the crisis in question. Based on the performance indicators (ROA and ROE), the Kosovo banking system presented the best results.

Research Methodology and Discussion

As mentioned in the introduction part, the research methodology is based in explaining through a descriptive and graphical analysis, the particularities of the main banking systems in Albania, Bosnia and Herzegovina, North Macedonia and Serbia, presenting the four main performance measurement indicators: return on assets (ROA), return on equity (ROE), cost-to-income ratio and net interest margin. The data are analyzed for the period 2000-2019.

In Figure 1. below is represented the evolution of the return on assets (ROA), during the years 2000-2019, for Albania, Bosnia and Herzegovina, North Macedonia and Serbia. The average ROA value for Albania during this period was 1.26%, with a minimum of 0.22% in 2015 and a maximum of 2.28% in 2000. The most recent value in 2019 is 1.39%. The average ROA value for Bosnia and Herzegovina during this period was 0.66%, with a minimum of -1.8% in 2001 and a maximum of 1.5% in 2018. The most recent value in 2019 is 1.3%. The average ROA value for North Macedonia during this period was 1.21%, with a minimum of -0.92% in 2001 and a maximum of 2.43% in 2007. The most recent value in 2019 is 1.3%. The average ROA value for Serbia during this period was 0.6%, with a minimum of -4.68% in 2002 and a maximum of 2.46% in 2017. The most recent value in 2019 is 1.8%.

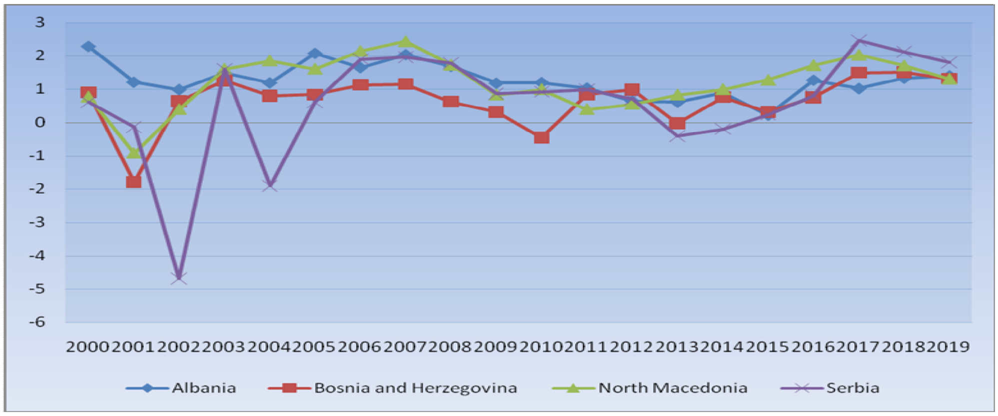

Figure.1. Evolution of ROA: Albania, Bosnia and Herzegovina, North Macedonia and Serbia, Source: processing according to the data from https://www.theglobaleconomy.com/ and the data taken from the reports of the Central Banks of the 4 countries

As seen from Figure 1. Albania is the only country that for the years 2000-2019 did not recorded negative values of ROA and Serbia is the one that recorded the lowest value in 2002. A higher ROA indicates a higher profitability, because a bank is earning more money on less investment. Before the financial crisis of 2008, the evolution of ROA for the four countries was varied, and after the crisis it registers almost the same trend.

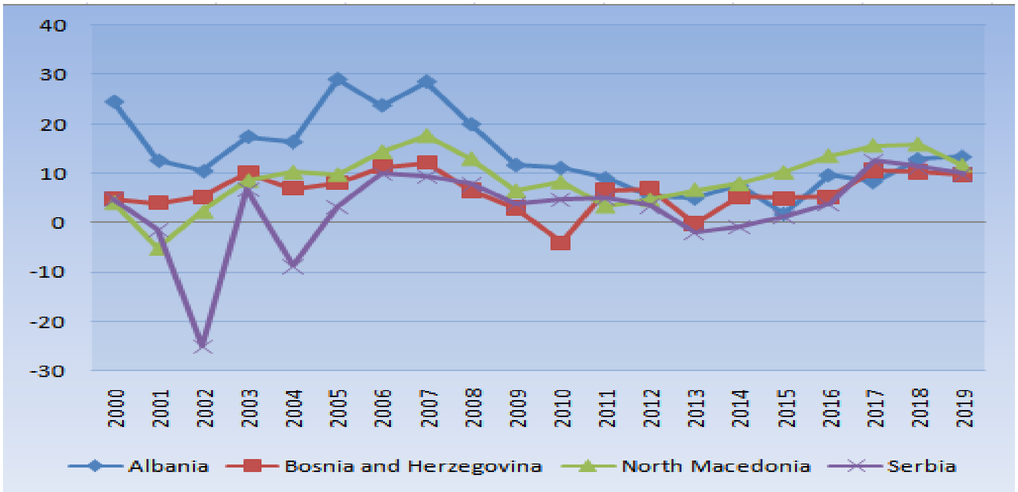

Figure.2. Evolution of ROE: Albania, Bosnia and Herzegovina, North Macedonia and Serbia, Source: processing according to the data from https://www.theglobaleconomy.com/ and the data taken from the reports of the Central Banks of the 4 countries

In Figure 2 above is represented the evolution of the return on equity (ROE), during the years 2000-2019, for Albania, Bosnia and Herzegovina, North Macedonia and Serbia. The average ROE value for Albania during this period was 13.94%, with a minimum of 1.76% in 2015 and a maximum of 29.02% in 2005. The most recent value in 2019 is 13.45%. The average ROE value for Bosnia and Herzegovina during this period was 6.33%, with a minimum of -4.02% in 2010 and a maximum of 12.05% in 2007. The most recent value in 2019 is 9.6%. The average ROE value for North Macedonia during this period was 9.01%, with a minimum of -5.21% in 2001 and a maximum of 17.77% in 2007. The most recent value in 2019 is 11.7%. The average ROE value for Serbia during this period was 2.97%, with a minimum of -25.09% in 2002 and a maximum of 12.57% in 2017. The most recent value in 2019 is 9.8%. As seen from Figure 2., the evolution of ROE is in the same trend as the evolution of ROA, Albania being the only country that for the years 2000-2019 did not recorded negative values of ROE and Serbia being the one that recorded the lowest value in 2002. A higher ROE is usually better in terms of profitability, because suggests that a bank is increasing its profit generation without needing as much capital. Also, the same as per ROA, the biggest differences in the ROE trend between the four countries are seen before the financial crisis of 2008.

The other two performance measurement indicators that will be represented are the bank cost-to-income ratio and net interest margin. In Figure 3. below is represented the evolution of the bank cost-to-income ratio, during the years 2000-2019, for Albania, Bosnia and Herzegovina, North Macedonia and Serbia.

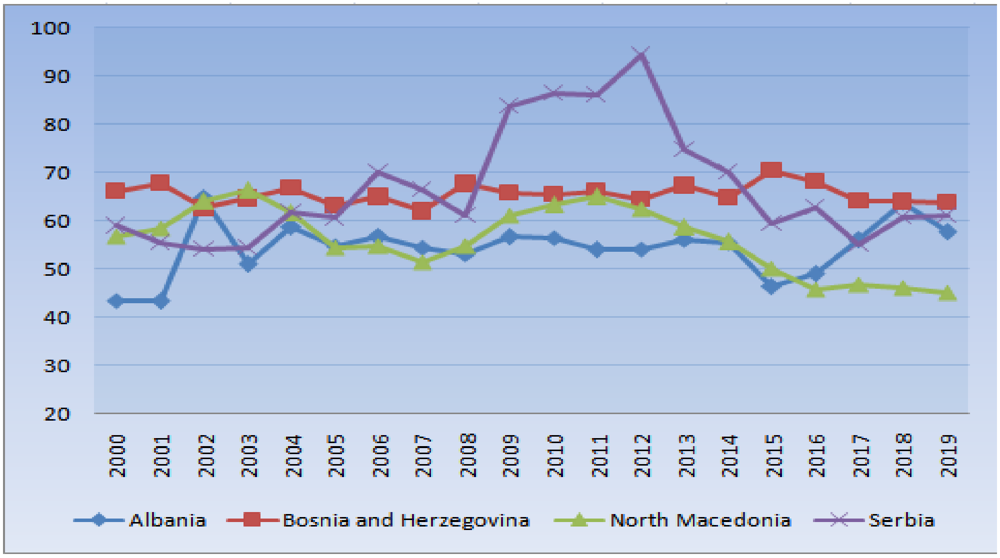

Figure.3. Evolution of the bank cost-to-income ratio: Albania, Bosnia and Herzegovina, North Macedonia and Serbia, Source: processing according to the data from https://www.theglobaleconomy.com/ and the data taken from the reports of the Central Banks of the 4 countries

The average cost-to-income ratio value for Albania during this period was 54.30%, with a minimum of 43.28% in 2001 and a maximum of 64.71% in 2002. The most recent value in 2019 is 57.61%. The average cost-to-income ratio value for Bosnia and Herzegovina during this period was 65.54%, with a minimum of 62.04% in 2007 and a maximum of 70.51% in 2015. The most recent value in 2019 is 63.86%. The average cost-to-income ratio value for North Macedonia during this period was 56.18%, with a minimum of 45.1% in 2019 and a maximum of 66.34% in 2003. The average cost-to-income ratio value for Serbia during this period was 66.91%, with a minimum of 54.1% in 2002 and a maximum of 94.32% in 2012. The most recent value in 2019 is 61.2%. The bank cost-to-income ratio is calculated as the share of the operating expenses of a bank and the sum of net-interest revenue and other operating income. As seen in Figure.3, the highest value is recorded by Serbia in the year 2012 and the lowest value is recorded by Albania in the year 2001. This ratio gives a clear view of how efficiently a bank is being run, so the lower the value, the more profitable the bank is. Albania also recorded the lowest maximum value between the four countries, so according to cost-to-income ratio indicator, the Albanian banks are more profitable.

The last indicator, net interest margin, is represented in Figure 4. below, for Albania, Bosnia and Herzegovina, North Macedonia and Serbia, during the years 2000-2019. The average net interest margin value for Albania during this period was 4.14%, with a minimum of 3.28% in 2002 and a maximum of 5.65% in 2007. The most recent value in 2019 is 3.4%. The average net interest margin value for Bosnia and Herzegovina during this period was 4.82%, with a minimum of 3.79% in 2016 and a maximum of 6.49% in 2002. The most recent value in 2019 is 3.87%. The average net interest margin value for North Macedonia during this period was 4.83%, with a minimum of 4.16% in 2016 and a maximum of 5.9% in 2007. The most recent value in 2019 is 4.2%. The average net interest margin value for Serbia during this period was 5.51%, with a minimum of 0.58% in 2000 and a maximum of 8.39% in 2006. The most recent value in 2019 is 3.6%.

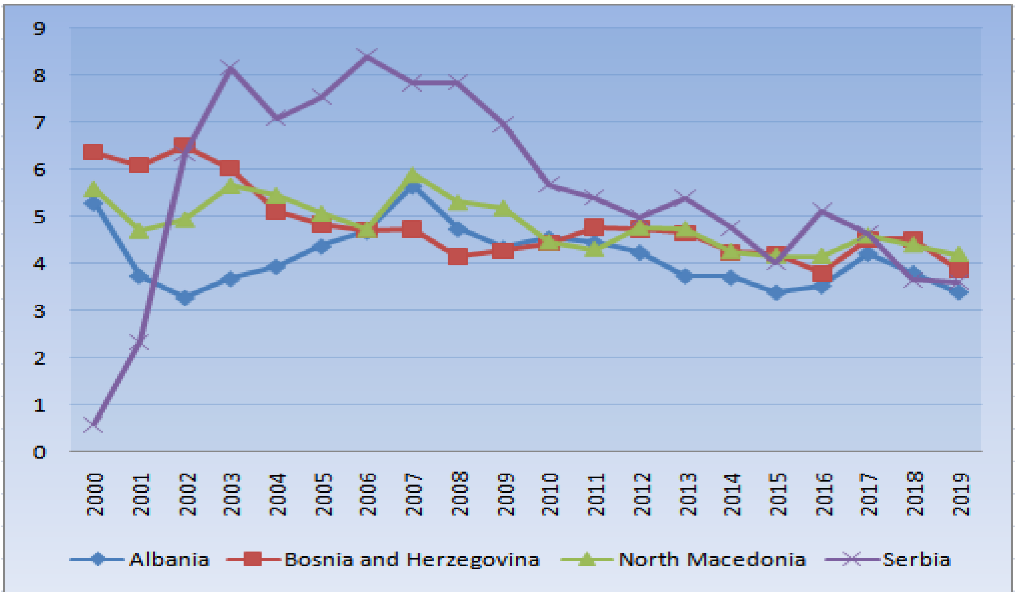

Figure.4. Evolution of the net interest margin ratio: Albania, Bosnia and Herzegovina, North Macedonia and Serbia, Source: processing according to the data from https://www.theglobaleconomy.com/ and the data taken from the reports of the Central Banks of the 4 countries

Net interest margin (NIM) is calculated as the share of bank's net interest revenue and total earnings assets. Net interest margin measures the effectiveness of a bank's investment decisions. A higher NIM would represent an increase of bank's profitability. So the country with the largest NIM value, theoretically has more profitable banks. As seen from Figure 4., Serbia is the country that has recorded the highest NIM value in 2006, but it is also the country with the lowest value registered in the year 2000. The other countries continued almost the same trend of NIM ratio after the financial crisis of 2008.

The values for the four indicators are processed according to the data from The Global Economy, the Financial Stability Reports (2019) of the Bank of Albania and Central Bank of Bosnia and Herzegovina, the Financial Stability Report (2018) of the National Bank of the Republic of North Macedonia and the Annual Financial Stability Report of the National Bank of Serbia.

Another common feature that makes the countries of the Western Balkans even more exposed to financial instability is that the majority of banks are owned by the largest banks operating in European countries. Banks' profitability, measured through two key indicators (ROA and ROE), displayed a heterogeneity in the four WB countries in the period before global financial crisis that conducted in an extremely difficult business environment and in the period after it their evolution tend to evolve in the same trend. The dominant component of the Albanian financial system is the banking sector, whose activity is transparent and leads to an efficient market economy. The Albanian banking system underwent further consolidation in 2019, a process initiated in previous years of the decade. The financial soundness indicators of the Albanian banking system have generally improved. The ROA profitability indicator in 2019 was 1.39%, slightly higher than the previous year. Serbia's banking sector, making up over 90% of financial sector assets, was stable in 2019 owing to adequate capitalisation, high liquidity and profitability. As in the previous years, in 2019, the North Macedonian banking system maintained its stability. The banks with their prudent policies and the National Bank, through the constant improvement of the standards in accordance with the European regulations, enabled the maintenance of high and stable liquidity and solvency. In 2019, the Bosnian banking sector continued to grow as well as being a generator of business for the economy.

The Western Balkan countries (WB) have only recently managed to recover from the diffuse effects of the eurozone crisis by recording strong economic growth in recent years. This is partly attributed to new inflows of foreign direct investment, especially in Serbia and Northern Macedonia, into sectors such as manufacturing, creating thousands of new jobs. The global COVID-19 pandemic and measures taken by governments around the world constitute a major disruption to the "work as usual" approach, including in the Western Balkans. The pandemic is overshadowing other developments, while also accelerating existing trends, and will continue to do so.

It is clear that one of the main challenges of the Western Balkans region today is the need to accelerate credit growth. But it is difficult in the current situation to push the banking sector to ease credit restrictions and provide more credit to the economy. In these circumstances, non-EU banks, non-bank entities and technological innovations, including Fintech and Bigtech have the potential to help. Given the risks associated with new market participants and actors in general, it is essential to increase awareness and cooperation between countries to minimize risks and vulnerabilities. In addition to higher awareness and collaboration, it is essential to gather as much information and data as possible about the new financial technologies that are reshaping the world financial markets. This data has not been available, but is essential not only to better understand but also to adapt oversight laws, regulations and practices to the new future. Finally, improving financial education would help both individuals and banks to establish financial sustainability and reduce financial risks.

Conclusions

The financial systems of the Western Balkan countries are dominated by banks mostly with foreign capital. The assets of banks held by foreing owened banks in these countries vary between 70-90% of the total assets of the banking sector in these countries. The profitability of banks in the Western Balkan countries, which operate in a difficult environment, is addressed through two key indicators (ROA and ROE). Based on the literature review as well as the data analyzed in the Western Balkan countries for the period 2000-2019 that was taken into consideration, using the comparative method, it can be concluded that these indicators differ and are reliable from the variations of a number of internal and external variables. Therefore, for a certain period of time, some variables for a certain group of banks in a country may have a high statistical significance on ROA and ROE, while for the other period it may not be significant at all.

The region is quite consistent in terms of the performance of the banking sector, the latter being almost equally dynamic for all four countries. The regional economic environment does not favor the stability of the financial system, but prevents the increase of the efficiency and productivity of the banking sector.

All these economies have been directly or indirectly affected by the crisis of recent years. The economies of these countries are small, but all have the objective of joining the European Union, despite the different levels of development. Therefore, according to the data generated during the research and the literature review, the profitability of banks measured by the ROA and ROE indicators, regarding the analyzed countries, turns out to be extremely low, especially compared to EU countries where they strive.

According to the cost-to-income ratio indicator, the Albanian banks are more profitable, compared to the other three countries during the observed period of 2000-2019 and Serbia was the country that has recorded the highest NIM value in 2006, but it was also the country with the lowest value registered in the year 2000.

Therefore, as a conclusion, the results of the evolution of the four indicators analyzed, ROA, ROE, cost-to-income ratio and net interest margin, indicated that the banking systems of the Western Balkan countries for the 2000-2019 period have been characterized by many fluctuations in terms of performance, business risk management and problems related to non-performing loans.

The COVID-19 pandemic hit the six Western Balkans amidst a reacceleration of economic activity and promising economic outlook for 2020. The main risk for the Western Balkans is that a protracted pandemic, as well as a deeper recession within the European Union, could make it difficult to resolve the ensuing economic crisis. As a result, the banking system of these countries has experienced difficulties in general, and in terms of performance in particular. Repaying loans has become very difficult given the rising unemployment. The region is endangered by the growth of non-performing loans. The central banks across the region reacted by cutting their key policy rates and providing liquidity to banks and non-bank financial institutions, which in turn, ease the burden on companies and individuals affected by sharp disruptions.

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