Evaluating the banking reforms in Serbia using survey results

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Abstract

Purpose – The main objective of this paper is to critically examine the effects of the ongoing reform process on the overall functioning of Serbia's banking system. It is essential that this reform process bears fruit by developing a sound, efficient and reliable banking system.

Design/methodology/approach – The research results were obtained through exploratory field research. The interviews were aimed at capturing the attitudes of bank managers regarding the country's banking reform process and examining the context of the managers' feelings, thoughts, and actions.

Findings – Based on questionnaire results collected from Serbia bank managers in 2004, the findings suggest that the reform process, although characterized as slow and sluggish due to a lack of customer's confidence in banks, has indeed improved the overall functioning of Serbia's banking sector.

Research limitations/implications – This study's weakness is the fact that it was for the most part exploratory research. Conclusions can be drawn from the research, but not at the desired level of cause-and-effect.

Practical implications – The Serbian banking reform process can offer lessons for both more and less advanced economies, as it exposes critical problems and mistakes that could be avoided and managed appropriately.

Originality/value – This paper contributes to the research and literature on transition, as Serbia is an area of research in the transition literature, especially regarding the banking sector, which appears to be inadequate and limited.

Keywords Serbia, Banks, Banking, Economic reform

Paper type Research paper

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1. Introduction

To the best of our knowledge, the Serbian banking system represents a unique case study, which is not previously presented and analyzed in the literature. Therefore, it is essential to closely examine and to highlight the most decisive factors that led to banking reform. Herein, we examine the Serbian banking system prior to reform and analyze whether the ongoing reform process has improved the country's overall banking system. We also point out the factors that led to the implementation of the reform process, in order to:

(1) identify the problems that banks faced during the reform;

(2) highlight the major changes in the banking sector brought on by the reform process;

(3) discuss whether changes in banking regulations and supervision improved the overall performance of the banking system; and

(4) present the future prospects of Serbia's banking sector.

2. Reform of the banking system during transition

After over a decade of dramatic economic decline (1989–2000), sanctions, severe regional instability, mismanagement and corruption, Serbia finally embarked on a path to radical economic reform with ambitious goals, all the while, facing both transition and post-transition conflict problems. After leading the transition process in the region at the beginning of the 1980 s, as Yugoslavia, nowadays Serbia lags behind the most advanced transition economies. Since, late 2000, the Serbian Government officials have initiated a comprehensive banking reform process aimed at establishing a sound and efficient banking system.

In this context, it is important at this point to mention that different approaches have been taken by the economies in transition in order to create a market-oriented banking system. Both gradual and rapid approaches have been used. For example, Hungary adopted a gradual method which has proven to be successful as Hungary is one of the most rapidly growing nations in Central Europe. Meanwhile, Poland's use of a shock therapy reform has also provided positive results. Rapid privatization and private companies built from scratch have made Poland's reform method extremely successful. Banking reform has also been substantially different across countries even though transition economies had a similar institutional, legal and regulatory framework to those of developed and developing countries during the central planning era. Most Central and Eastern European (CEE) countries have chosen a rehabilitation approach. Such an approach, as shown in Figure 1, consists of three stages of reform:

(1) decentralization, or the division of the mono-bank system into a number of state-owned commercial banks;

(2) recapitalization of state banks; and eventually

(3) the privatization of state banks (Claessens, 1996).

Alternatively, the former Soviet Union (FSU) Republics launched the new entry approach. This approach, as shown in Figure 2, also consists of three stages of reform:

(1) decentralization, or the division of the mono-bank system into a number of state specialized banks;

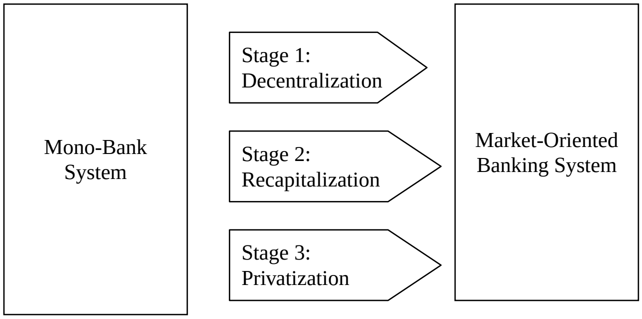

Figure 1.
Rehabilitation approach to banking reform

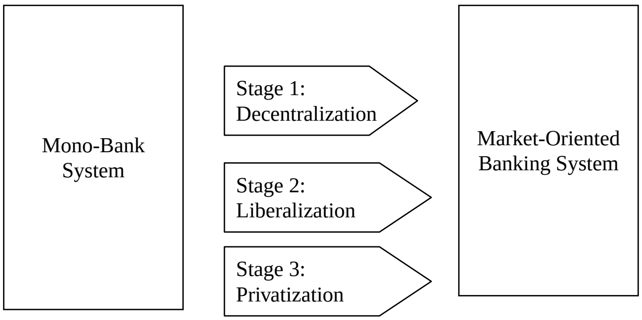

Figure 2.
The new entry approach to banking reform

(2) liberalization, or the liberal entry of new banks; and
(3) the privatization of state banks (Vysokov, 2001)

These two divergent approaches to banking reform can be attributed to differences in the initial economic and banking conditions between CEE and FSU countries.

While the FSU countries, Russia in particular, were deeply affected by the South-East Asian financial crisis and suffered a set-back during the transition process, other more advanced CEE countries did show resistance and were able to retain macroeconomic stability (Aleksashenko, 2000). CEE banks had access to the know-how of the banking world, as they had knowledge of commercial banking skills and therefore were able to handle competition from foreign banks, in contrast to banks in the FSU countries. This was reflected in the relatively lower amounts of non-performing loans and inflation rates in the CEE countries contrary to the opposite conditions in the FSU republics in the early stages of the transition (Riess, 2002). Thus, hyperinflation eliminated non-performing loans through negative real interest rates and along with a shortage of funds, it was unnecessary to recapitalize banks in the FSU Republics due to decreased fiscal revenues, and due to the fact that the scale of banking in these countries was substantially lower than that of the CEE countries in the early stages of transition (Alexander *et al.*, 2000). As a result, authorities in the FSU countries had no other choice than to follow the new entry approach.

The principal differences between these two banking reform approaches appear in Stage 2. The problem of non-performing loans was resolved in the CEE countries through the comprehensive financial and operational restructuring of banks and enterprises, while the FSU Republics simply ignored this issue (Lavrov, 1999). Moreover, the CEE countries launched a restrictive policy toward the entry of new banks which had somewhat limited competition among banks. Conversely, the FSU countries have been more liberal toward the entry of new banks, which has led to a large number of smaller and undercapitalized banks (Boyd and Frank, 2002). CEE and FSU countries also followed different strategies related to privatization at Stage 3. While state banks in CEE countries were slowly privatized due to the restructuring of bad loans and the recapitalization of state banks, the FSU Republics launched a rapid approach (Begg and Portes, 1993). The slow privatization of state banks may lead to the recurrence of non-performing loan problems and limit the expansion of efficient banks, while rapid privatization, in the absence of good prudential regulation and supervision, may distort the process of competition.

Although Claessens (1996) argues that the institutional development of banking systems can be faster under the new entry approach than under the rehabilitation approach, the FSU Republics still display banking systems with a lower level of financial intermediation than the CEE countries (European Bank for Reconstruction and Development (EBRD, 1998)). This could be due to weaker initial conditions, macroeconomic instability and inconsistent reform measures in the FSU Republics. The wide spreads between loan and deposit rates, especially in the FSU Republics, and the big difference in low deposit rates and high demand for loans and many non-repaid loans show that the activity of banks in these countries is extremely inefficient compared to banks in the CEE countries (EBRD, 1998). This confirms that it is better to restructure and recapitalize the banks rather than try to recover losses on non-performing loans by increasing their margins (Alston and Gallo, 1999). Although the rehabilitation approach is costly (which could be avoided through fast privatization and strict financial discipline of banks), the banking crises in the FSU Republics suggests that resolving these issues does not require less fiscal costs than the recapitalization of banks (Caprio and Levine, 1994).

One of the reasons for implementing the reform process in the Serbian banking system was the lack of a sufficient regulatory and supervisory framework in the country that eventually caused the failure of many banks. The financial services industry has always been politically sensitive and heavily regulated. The banking sector relies on public confidence. The fractional reserve banking system greatly increases the potential profitability of banks but also leaves them at risk from the loss of public confidence, which may cause a run on their deposits (Begg and Portes, 1993). The risk of collapse increases by the contrast between the liquid nature of bank liabilities (deposits) and the liquid nature of their assets (loans).

There are a number of concerns regarding the collapse of banks. The first area of concern is the prospect of contagion (infection). As the collapse of one financial institution leads to a loss of confidence in other financial institutions, causing their possible collapse (Largan, 2000). This is what happened in Serbia, as the collapse and closure of the Dafiment Bank and the Invest Bank which offered high-interest rates on savings as many people in Serbia deposited their funds in these banks. After some time the owners of those two banks (Dafina and Jezda) left the country with all the savings. This caused a loss of confidence in the whole banking system. The second concern relates to consumer protection, given that a collapse of financial institutions within a sophisticated financial system is bound to affect a large number of people. The safest response for policy makers is to attempt to regulate the market with the hope of preventing such situations and to provide insurance when and where they do arise (Goacher, 1999). Bank regulation aims to guarantee the integrity of the transaction medium and to prevent the process of financial intermediation from failing; therefore, the third concern with the collapse of banks is that their liabilities form the means of payment (Howells and Bain, 2000). In addition, there is asymmetric information in financial markets because the users of funds almost invariably have greater knowledge than their potential lenders or borrowers and investors. Also, competition and fairness in financial markets must be promoted in order to prevent fraud and reduce risk (Mishkin, 2004).

Taking into consideration the previous arguments and given that modern financial systems are complex and vital to a nation's economic well-being, it is generally agreed that regulation in the banking sector is required. An important component of the supervision of banking institutions concerns their liquidity position (Goacher, 1999). All banks should be able to meet their obligations when they are due. In order to achieve this, banks must hold cash or other liquid assets and be aware that their value may vary due to fluctuations in market prices. Another approach would be to attempt to match the maturity characteristics of assets with the maturity characteristics of the deposit base, so that there is an appropriate cash flow from maturing assets (Howells and Bain, 1999). Furthermore, banks may seek to maintain a diversified deposit base and an appropriately high standing in the money markets, which would be able to attract deposits when and where they are required without having to pay excessive interest rates. A bank's capital is an important consideration since it is a measure of the bank's ability to absorb losses that arise from bad debts or trading losses on investments (Largan, 2000). It is also a source of finance for investments in technology and potential acquisitions of other financial institutions. An adequate level of capital in relation to a bank's lending coupled with an adequate level of liquidity is therefore an essential requirement of a sound banking system and confidence in that system.

3. Research methodology

In order to study the ongoing reform process in the Serbian banking sector, our research was based on qualitative and quantitative data obtained through exploratory field research. A survey was carried out in July through September of 2004 using a combination of semi-structured interviews and questionnaires (the term "survey" can refer to one or a combination of two procedures, questionnaires, and/or interviews (Breakwell, 1995)). First, we conducted face-to-face interviews, which allowed us to examine various issues in depth with our respondents and then follow-up questionnaires were distributed to the same respondents to cross-reference data collected during the initial interviews. From the 46 banks operating in Serbia in 2004, we were able to interview 17 bank managers from 17 different banks ranging in size and ownership structure. Our sample size largely depended on the availability of the respondents and consisted of employees in the managing section of the branch due to our belief that they, in particular, were in a position to offer us a more accurate view of the Serbian banking sector reform.

The interviews were aimed at capturing the attitudes of bank managers regarding the country's banking reform process and examining the context of these managers' feelings, thoughts, and actions. Generally, interviews provide a means of examining the relationships between different aspects of a situation (Arksey and Knight, 1999). Interviews allow for greater flexibility and encourage people to speak their minds (Mason, 1996). Furthermore, interviews produce richer data and captured a better image of the complexity of human nature (Robson, 1993). Semi-structured interviews were suitable for this study because the objective was to obtain a clear picture of the bank managers' views, opinions, ideas, experiences, and perceptions of the banking reforms.

The objective of the questionnaire was to provide information on issues related to the length of the specific bank been in operation, the number of employees, the branches and sub-branches and the length of time the respondents had been employed. Moreover, the questionnaire was used to identify the main factors that led to the implementation of the reform process, key problems the bank faced during reform, and to gather the general opinion of respondents regarding the success, or lack thereof, of Serbia's banking reform. Questionnaires are appropriate to check on the interpretation of interview data, as well as a way to analyze how views, feelings, and understandings are shared (Breakwell, 1995). A complete list of the topics which served both as the interview guide and as questionnaire items is presented below:

- Description of the situation prior to reform process initiation.
- Factors that led to reform process implementation.
- Evaluation of the reform process up to now.
- Problems/issues for banks because of the reform process.
- Employee satisfaction from the realization of the reform process.
- Customer satisfaction from the new environment in banks as perceived by the bank managers.
- The role of private and foreign banks in realizing a market-oriented banking system.
- The effect of increased competition on the banking sector functioning.
- Evaluation of the best method for bank sector restructuring.
- The effect of bank privatization, and revised regulation on banking sector efficiency.
- Evaluation of banks' scale of activity.
- Expectations of the Serbian banking sector level of development compared to EU countries.
- Expectations for the overall banking sector in Serbia when the reform process is completed.
- The future of the banking sector in Serbia.

As the research process progressed, new topics arose from previous interviews and were added to the list. The next section presents the research findings related to the above-mentioned areas of discussion.

4. Research findings: general descriptive analysis

As previously indicated, the respondents were positioned in the higher levels of the bank's hierarchy since our purpose was to interview those who have more experience and therefore presumably to provide more reliable information. Table I indicates that of the 17 respondents only six had worked in the specific bank more than four years, indicating that only 35.3 percent of respondents continued to work in the same bank after the reform process was implemented. At the same time, 11 respondents had worked in the specific bank less than four years, which demonstrates that these respondents had started working in a specific bank after the reform was implemented. In addition, ten respondents had not worked in any other bank except in the one they were currently working. Finally, seven respondents had work experience in other banks. Only four banks (i.e. three foreign and one domestic) out of 17 have been operating in Serbia for less than four years. Most of the foreign banks opened branches in the country after the initiation of the reform process, after 2000, because they considered the Serbian market a safe investment with many opportunities and business potential.

As shown in Table II, six respondents have worked in the same bank for more than four years and seven respondents had working experience in other banks. In total, 13 respondents had adequate knowledge and experience in banking affairs and thus, they were certainly aware with the past and current situation as a result of reform in the Serbian banking sector. It is also worth mentioning that six respondents have worked in the same bank for more than four years, actually most of them worked in the same bank for more than 20 years, and did not have any work experience in other banks. Only four respondents have a total banking experience of less than four years, which means that they started working in the banking sector after the reform was

	Frequency	Percent
Position in the bank		
Branch manager	17	100.0
Other	0	0.0
Total	17	100.0
Existence of the bank		
Less than four years	4	23.5
More than four years	13	76.5
Total	17	100.0
Years of employment in the bank		
Less than four years	11	64.7
More than four years	6	35.3
Total	17	100.0
Employment in other banks		
Yes	7	41.2
No	10	58.8
Total	17	100.0

Table I.
Respondents' profile

	Employment in other banks		
Number of years of employment in the bank	Yes	No	Total
Less than four years	7	4	11
More than four years		6	6
Total	7	10	17

Table II.
Years of employment in the bank industry

implemented, and therefore, their views and opinions about the banking sector in the period prior to reform are less significant. Hence, we concluded that the participants were suitable for this research project.

Figure 3 shows the banking ownership structure of our sample. It was our intent to gather views and opinions from bank managers with divergent ownership structures in an effort to account for potentially different experiences and perceptions concerning the banking reform process. The majority of banks included in this research were private banks (35.3 percent). State-owned, mixed private and foreign-owned, and foreign banks were also incorporated into our study (17.6 percent). The minority of banks included in the project had a mixed state-owned and private-owned structure (11.8 percent). Five of the largest banks (i.e. banks with the highest amount of assets) in the country were included in the project. In addition to these five, four banks belonged to the 15 largest banks in the country. An additional six banks were among the medium-sized banks and just two belong to the small size banks.

Table III details the size of the banks in our study. Three banks had more than 100 branches in Serbia and an additional three banks have between 50 and 100 branches and sub-branches in the country. As expected, the largest banks in the country had the highest number of employees and a well-developed branch network. Furthermore, 11 banks had less than 50 branches and sub-branches. Nine banks had less than

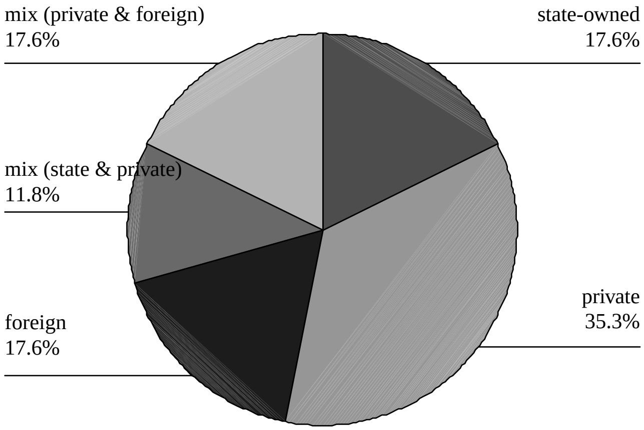

Figure 3.
Banks' ownership structure

	Frequency	Percent
Number of branches and sub branches		
Less than 50	11	64.7
Between 51 and 100	3	17.6
More than 101	3	17.6
Total	17	100.0
Number of employees		
Less than 500	9	52.9
Between 501 and 1,000	4	23.5
More than 1,001	4	23.5
Total	17	100.0

Table III.
Bank size

500 employees. These banks belong to the medium- and small-sized banks. In addition, four banks had more than 1,000 employees and four more banks have between 500 and 1,000 employees.

It should be pointed out that the number of employees in state-owned banks was much higher than in the foreign, private, and mixed ownership banks as demonstrated in Table IV.

Table V provides the list of active banks in Serbia as of June 21, 2006.Owing to a confidentiality clause in our research project we cannot reveal the specific banks that participated in our survey.

4.1 Research findings: factors behind the Serbian banking reform

Respondents described the situation in the banking sector prior to 2000 as a period of social ownership of banks, with a low level of investments and credit analysis, politically influenced decision-making and a high level of contaminated (bad) assets. It was a period with low profitability, underestimation of loan loss provisions, frozen foreign loans and savings, undercapitalization, hidden insolvency of the largest banks and illiquidity. Furthermore, the internal control system was not operational, the willingness to take risk management was inadequate, long-term interest rates were negative and the supervision by the National Bank of Yugoslavia was weak as there were no internal control, bank supervision and risk management. Frauds, self-dealing and other misuses were common practices. As expected, economic sanctions and bad economic conditions in the country had a negative impact on the Serbian banking system and therefore banks were faced with a high level of debt. Moreover, the banking system prior to 2000 was characterized as a system with increased government intervention and unethical banking operations. In addition, there were some big state-owned banks that did not follow the changes in the market. These banks received loans from the National Bank of Yugoslavia and under government pressure would grant credit to specific state-owned enterprises without applying any credit analysis. In most cases, credit was never repaid and therefore bad loans or contaminated assets were created. To make matters worse, banks faced high inflation, spontaneous privatization, and low-real values of assets on the one hand, and high-real values of liabilities on the other. Prior to 2000, most banks were state-owned, few banks were privately owned, and there was only one foreign bank in the country. Monetary policy was inadequate, the domestic currency depreciated, and exchange rates were unstable. The number of services banks offered was limited. Overall, people had lost confidence in the banking system and they therefore kept their money outside of banks. Thus, it was crucial for the Serbian banking sector to emerge from this vicious situation.

	Number of employees			
Banks' ownership structure	Less than 500	Between 500 and 1,000	More than 1,000	Total
State-owned	1		2	3
Private	4	1	1	6
Foreign	1	2		3
Mixed (state and private)		1	1	2
Mixed (private and foreign)	3			3
Total	9	4	4	17

Table IV. Ownership structure of banks and number of employees

Table V.
Active banks in Serbia as of June 21, 2006

No.	Name of Bank	Ownership	Country of origin	Web site
1	"A BANKA" A.D. Beograd	Local		www.alcobanka.co.yu
2	AGROBANKA A.D. Beograd (POLJOPRIVREDNA BANKA)	Local		www.agrobanka.co.yu
3	AIK BANKA A.D. Niš (AGROINDUSTRIJSKO KOMERCIJALNA BANKA AIK BANKA AD NIŠ)	Local		www.aikbanka.co.yu
4	ALPHA BANK A.E. Beogradska Afilijacija Beograd + JUBANKA A.D. Beograd	Foreign	Greece (Alpha Bank)	www.jubanka.co.yu
5	PIRAEUS ATLAS BANKA A.D. Beograd	Foreign	Greece (Piraeus Group)	www.piraeusbank.co.yu
6	ČAČANSKA BANKA A.D. Čačak	Local		www.cacanskabanka.co.yu
7	(LAIKI BANK AD BEOGRAD)	Foreign	Cyprus	www.centrobanka.co.yu
8	CONTINENTAL (NLB) BANKA A.D. Novi Sad	Foreign	Slovenian	www.cont.co.yu
9	CREDY BANKA A.D. Kragujevac	Local		www.credybanka.com
10	DDOR BANKA A.D. Novi Sad	Local		Sold to Erste Bank
11	DELTA BANKA A.D. Beograd	Local		Sold to Intesa Bank
12	EFG Eurobank A.D. Beograd	Foreign	Greece (EFG Eurobank – Ergasias)	www.efgeurobank.co.yu
13	EKSPORT-IMPORT BANKA – "EKSIM BANKA" A.D. Beograd	Local		Sold to HVB Bank
14	HVB BANKA SRBIJA I CRNA GORA A.D. Beograd	Foreign	Germany	www.hvb.co.yu
15	HYPO ALPE-ADRIA-BANK A.D. Beograd	Foreign	Austria	www.hypo-alpe-adria.co.yu
16	BANCA INTESA AD BEOGRAD	Foreign	Italy	www.bancaintesabeograd.com
17	JUGOSLOVENSKA BANKA ZA MEÅUNARODNU EKONOMSKU SARADNJU A.D. Beograd	Local		www.jubmes.co.yu
18	KOMERCIJALNA BANKA A.D. Beograd	Local		www.kombank.com
19	KOSOVSKO-METOHIJSKA BANKA A.D. Zvečan	Local		www.kosmet-banka.com
20	KULSKA BANKA A.D. Novi Sad	Local		www.kulbank.co.yu
21	LHB BANKA A.D. Beograd	Foreign	LHB Bank Frankfurt (Germany)	www.ppbank.com
22	MB BANKA A.D. Niš	Local		Bankrupt
23	MERIDIAN BANK A.D. Novi Sad – CRÉDIT AGRICOLE GROUP AD NOVI SAD	Local	France	www.bankmeridian.com

(continued)

Table V.

No.	Name of Bank	Ownership	Country of origin	Web site
24	METALS BANK A.D. Novi Sad	Local		www.metals-banka.co.yu
25	NACIONALNA ŠTEDIONICA – BANKA A.D. Beograd (National Savings Bank AD)	Local		www.nsb.co.yu
26	NATIONAL BANK OF GREECE S.A. Beograd	Foreign	Greece (NBG – National Bank of Greece)	www.nbgbanka.co.yu
27	NIŠKA BANKA A.D. Niš	Local		www.niskabanka.co.yu
28	NOVA BANKA BEOGRAD A.D. Beograd (FINDOMESTIC BANKA AD BEOGRAD)	Local	Italy	www.novabanka.co.yu
29	ERSTE BANK AD NOVI SAD	Local	Hungary	www.erstebank.co.yu
30	PANONSKA BANKA A.D. Novi Sad	Local		www.panban.co.yu
31	POŠTANSKA ŠTEDIONICA A.D. Beograd	Local		www.posted.co.yu
32	PRIVREDNA BANKA BEOGRAD A.D. Beograd	Local		www.pbbad.com
33	PRIVREDNA BANKA BEOGRAD A.D. Pančevo	Local		www.pbp.co.yu
34	ProCredit Bank A.D. Beograd	Foreign	Joint venture (KfW (Kreditanstalt f?r Wiederaufbau – German Bank), EBRD, IFC (World Bank), FMO (fund from Netherlands), ProCredit Holding and Commerzbank AG)	www.procreditbank.co.yu
35	RAIFFEISEN BANK YUGOSLAVIA A.D. Beograd	Foreign	Austria	www.raiffeisenbank.co.yu
36	SOCIETE GENERALE YUGOSLAV BANK	Foreign	France	www.socgenyu.com
37	SRPSKA BANKA A.D. Beograd	Local		www.srpskabanka.co.yu
38	UNIVERZAL BANKA A.D. Beograd	Local		www.ubbad.co.yu
39	VOJVOÅANSKA BANKA A.D. Novi Sad	Local		www.voban.co.yu
40	VOLKSBANK A.D. Beograd	Foreign	Joint Venture (VOLKSBANK Group from Austria + EBRD)	www.volksbank.co.yu
41[a]	ZEPTER BANKA A.D. Beograd	Local		www.banka.zepter.co.yu

Note: In mid 2005 there were 41 banks present in Serbia, by the mid-2006 they were 36
Source: www.nbs.yu/english/banks/

Respondents identified in Table VI the main factors that led to the implementation of the Serbian banking reform process.

The majority of respondents 5/17 (29.4 percent) recognized the bad conditions in the country's economy and in the banking sector along with the absence of a financial market as the most vital factors behind the need for a banking reform. For instance, they suggested that banks had to clean up bad loans and recover their liquidity, solvency, stability, efficiency, and establish consumer confidence. The insolvency of banks and the absence of financial markets had negative consequences for the economy (the so-called "grey economy"), which led to lower fiscal revenues, saturation of foreign currency, illiquidity, high-interest rates, a significantly lower GDP, and inefficient allocation of money and capital. State-owned banks operating in a centrally planned economy, such as the Serbian case prior to reform, adapted easily to the prevalent weak economic conditions. Changes in enterprises' ownership structure led to changes in ownership structure of the banks and therefore to the implementation of reform. Three (i.e. 17.6 percent) of the respondents identified changes in ownership structure and privatization as crucial factors in realizing the banking reform process (for a discussion regarding privatization and the transition reform process see Bitzenis, 2003). Two respondents mentioned that since Serbia is a country in transition, the banking reform process was unavoidable. Thus, these two respondents (11.8 percent) considered the transition process as the most decisive factor that led to the banking reform. Moreover, two (11.8 percent) of the respondents highlighted the need to reach the level of development of the EU banking system, as a motive for reform. Two (11.8 percent) respondents argued that in order to achieve a stable monetary policy and a stable domestic currency, banking reform was necessary. Only one (5.9 percent) respondent identified the end of economic sanctions and political changes as prime factors leading to banking reform. Other factors considered to be crucial for the implementation of banking reform were the need for:

(1) changes in banking sector regulation and supervision;
(2) cheaper sources for the financing of enterprises (low entry cost of foreign banks); and finally
(3) lower intervention of authorities in credit allocation.

As Figure 4 shows that 52.9 percent of the respondents consider that the banking reform produced positive results and believed that the results will be even better in the future. For example, one of the respondents stated:

Factors that led to the implementation of the banking reform process	Frequency	Percent
Bad conditions in the country's economy and in the banking sector	5	29.4
Changes in the ownership structure and privatization	3	17.6
The need to reach the level of development of the EU banking	2	11.8
Transition process	2	11.8
The achievement of a stable monetary policy and a stable domestic currency	2	11.8
Others	2	11.8
End of economic sanctions and political changes	1	5.9
Total	17	100.0

Table VI.
Factors leading to banking reform

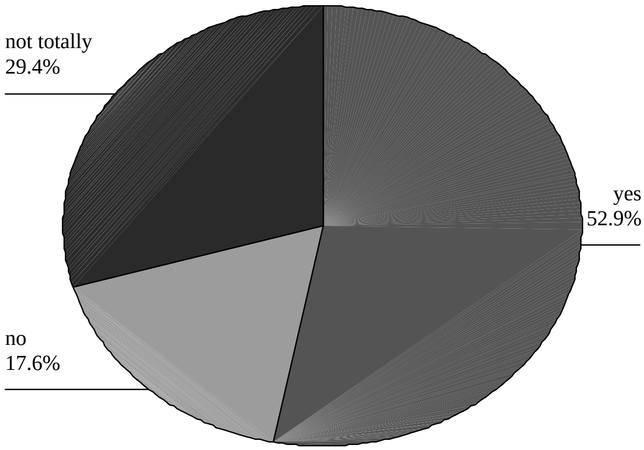

Figure 4.
Banking reform success

Reform in the banking sector is still an on going process. It was needed; it was necessary and had to be radical. Comprehensive reform is fundamental for the development of a sound and market-oriented banking sector (Interview 12: Lines 157–60).

Respondents identified the liquidation of the four largest Serbian banks at the beginning of 2002 as one of the major changes since the reform began. As one respondent explained:

With the closure of the four major banks, a base for the reform of the banking system was created. Instead of four big banks, today there are smaller and more flexible banks that are able to meet the demanding needs of the enterprises (Interview 8: Lines 420–23).

Respondents also acknowledged the shift of the payment transactions system from the old clearing system ZOP (i.e. the Clearing and Settlement Bureau) to commercial banks along with the launching of the new clearing system of the National Bank of Serbia as significant changes that occurred during the reform process. They claimed that these changes bore fruit to both banks and customers, and with the transfer of the payment system to commercial banks, Serbian banking was more in line with western banking. Also with the entrance of foreign banks in Serbia as a result of reform, competition increased, and there was an increase in quantity and quality of services offered by foreign banks.

On the other hand, Figure 4 also shows that five (29.4 percent) of the respondents considered that the banking reform process was only partially successful. They pointed out the sluggishness of the reform process due to the lack of customers' confidence in banks. Much more needs to be done and therefore, additional time is required. Besides, this, they added that compared to reforms in other sectors of the economy, the banking reform process has been more successful. However, they further mentioned that due to the very slow reform process in the overall country's economy, the banking sector has yet to reach its full potential. Finally, three (17.6 percent) of the respondents stated that banking reform has not produced good results due to the fact that domestic banks "have lost their importance compared to foreign banks" (Interview 1: Line 299).

Table VII summarizes the problems that banks encountered. Six respondents stated that banks have not faced any serious problems that they could not deal with since the banking sector embarked on the reform process. Two respondents pointed out that although banks had technical problems, such as inexperience to use new operating systems and their inability to set up connections with the National Bank of Serbia, these problems has been overcome by introducing employee-training programs. Two other respondents stated that the banks had problems in applying new regulations since some of the new regulations were unclear. However, banks dealt with this problem in cooperation with the National Bank of Serbia. Other respondents mentioned liquidity problems from the past were overcome by receiving credit with favorable conditions from the EBRD. Nonetheless, changing customer behavior and the introduction of a new payment system and new services are some of the persistent problems that continue to hinder reform. Furthermore, the lack of clients' credit tracking history was a problem that one respondent pointed out. Most of the respondents from domestic banks agreed that another crucial problem is the "unethical competition of foreign banks" (Interview 2: Line 554). For instance, a respondent claimed, "Since, foreign banks have cheaper sources of financing, they offer very low interest rates for their services and therefore, domestic banks cannot compete with them" (Interview 14: Lines 678–80). Respondents argued that the National Bank of Serbia should apply strict rules and regulations for foreign banks and therefore, "provide a base for healthy competition" (Interview 11: Lines 302–4).

Table VIII details the degree of manager, employee, and customer satisfaction regarding the banking reform process. Totally 12 out of 17 respondents agreed that the

Table VII.
Problems encountered by banks during the banking reform

	Frequency	Percent
Banks did not face any problems	6	35.3
Technical problems	2	11.8
Application of new regulations	2	11.8
Liquidity problems	1	5.9
Changes in customer behaviour	1	5.9
Tracking credit history of the customers	1	5.9
Unethical competition with foreign banks	2	11.8
Other problems	2	11.8
Total	17	100.0

Table VIII.
Manager, employee and customer satisfaction

	Frequency	Percent
Manager and employee satisfaction		
More satisfied	12	70.6
Unchanged	3	17.6
Not satisfied	2	11.8
Total	17	100.0
Customer satisfaction		
More satisfied	13	76.5
Unchanged	1	5.9
Not satisfied	3	17.6
Total	17	100.0

banks' managers and employees have been generally more satisfied with banking affairs since reform was implemented. The reform process changed the banking environment and managers and employees use new operating systems. They were able to prove their working skills and qualities and to advance their careers. The employee selection process has become more careful and young well-educated people had the opportunity to work in the sector. On the other hand, three respondents indicated that there has been no change in manager and employee satisfaction. Two of them pointed out that the dissatisfaction was due to the persistent intervention of the state in bank operations.

Regarding customer satisfaction, 13 of the 17 respondents stated that customer satisfaction has increased as a result of the implementation of reforms. Banking in Serbia has become customer-oriented, and customers have the option to choose among many banks. Owing to higher competition, banks have started to offer new and improved services under conditions that are acceptable for customers. Most of the respondents mentioned that customers were particularly satisfied with the transfer of the payment system to commercial banks, since now this process has become cheaper, faster, and more convenient. Moreover, customers have the option to open and retain accounts in more than one bank, which was not the case prior to banking reform. Only one respondent considers customer satisfaction as unchanged. Finally, three of the respondents agreed that customers are not satisfied in general since the reform started. Before the initiation of reform, bank customers received credit easier and with fewer procedures, which is not the case nowadays.

When asked whether the entry of new private and foreign banks would create a more sound and market-oriented banking system in Serbia, 12 out of 17 respondents provided positive answers including: "With the entry of new private and foreign banks, banking operations will improve and become safer" (Interview 5: Line 314); "Moreover, better conditions will be offered to customers, savings will increase and confidence in banks will be recovered" (Interview 9: Lines 652–55); "With the entrance of foreign banks, new capital will enter the country" (Interview 10: Line 701).

Although most of the respondents agreed that the entry of foreign banks would contribute to the creation of a sound and market-oriented banking system, all of them felt that the state should control their entrance in order to avoid unethical competition. This argument was also supported by two respondents who suggested that the entry of new private and foreign banks cannot create a totally sound and market-oriented banking system. They claimed, for instance, "Too many small private banks with a lower number of depositors have less potential and they cannot be as effective as one big bank with many depositors" (Interview 15: Lines 802–3). Similar arguments were also made by three respondents, who noted that entry of foreign and private banks cannot create a sound banking sector. One of the respondents claimed, "Interventions of the state is common in domestic banks – this limits the performance of domestic banks. However, in the foreign banks, the state does not have any influence" (Interview 17: Lines 634–5).

Table IX shows that all 17 respondents agreed that increased competition would improve the overall banking sector in Serbia. As one respondent remarked:

If the competition is healthy, interest rates for bank services will decrease and credit will be cheaper, the quality and quantity of services will increase, new technologies for

	Frequency	Percent
Will entry of new private and foreign banks improve the banking sector?		
Yes	12	70.6
No	3	17.6
Not totally	2	11.8
Total	17	100.0
Will increased competition improve the banking sector?		
Yes	17	100.0
No	0	0.0
Not totally	0	0.0
Total	17	100.0

Table IX.
Competition

banking will be developed and more attention will be given to the education and training of employees (Interview 12: Lines 916–9).

As shown in Figure 5, 64.7 percent of respondents agreed that recapitalization is the best and safest method for bank restructuring in Serbia, if the banks inherited non-performing loans and are insolvent. Most of respondents felt that if the value of the bank, economically and politically, is greater than its liquidation value, the bank has to be recapitalized. They pointed out that shareholders, new private investors, authorities and especially foreign investors should carry out bank recapitalization. On the other hand, 23.5 percent of the respondents concluded that liquidation is a better method for bank restructuring, compared to rehabilitation and forbearance. Bank forbearance is simply the reluctance to face difficult decisions, hoping that a more favourable set of economic conditions will arrive, which will hopefully change the conditions of state enterprises and result in their ability to meet banks interests and principal payments, and thus the banks will grow out of their problems (Bonin and Watchtel, 1999). The downside of this approach is the possibility that things will not improve and indeed will get worse. Bank non-performing loan problems will continue to grow and the net worth positions of these banks will become even more negative and insolvent. All the respondents "approved" the liquidation of the four largest Serbian banks and noted that the closure of large insolvent banks has less negative impact on the real economy because the banking system in transition economies is still characterized by low depth and breadth. Finally, only 11.8 percent of the respondents argued that forbearance is

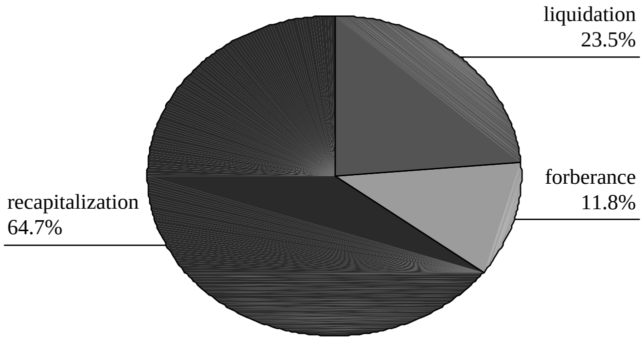

Figure 5.
Bank restructuring methods

the best method for bank restructuring, arguing that it is more moderate compared to liquidation and recapitalization as shown in Figure 5.

When asked if the privatization of state-owned banks would improve overall bank efficiency and productivity, as well as limit intervention of authorities in credit allocation, 16 of the 17 respondents provided positive answers as revealed in Table X. All of them agreed that bank privatization is the final and most important stage for the banking system in transition economies, and that it would offer incentives to managers to minimize risks, and therefore credit will be granted according to bank rules and regulations without intervention from authorities. It was their belief that privatization would improve the productivity, performance, and operations of banks. Only a single respondent claimed that privatization could not totally improve overall bank efficiency, productivity and limit intervention of authorities in credit allocation. This respondent mentioned that success of the privatized bank largely depends on the buyer. Moreover, this respondent added that not all the banks should be privatized, and that there should be a few state-owned banks within the new system. Some of the respondents who agreed that privatization in banking system will bring benefits, also supported the latter argument.

As presented in Table X, eight respondents claimed that changes in regulation and supervision of the banking sector brought on by the reform process have improved the banking sector's functioning. One of the respondents mentioned, "What was changed in the banking regulations, since reform started, brought many more benefits to the Serbian banking sector compared to improvements brought on by changes in regulations in the last 20 years" (Interview 8: Lines 870–3). Conversely, two respondents pointed out that no improvements have resulted from the changes that occurred in regulation and supervision. They argued that more changes have to be made to regulations, and that stronger supervision is necessary. Moreover, they stated that regulations and supervision should be applied to foreign banks as well. Finally, seven respondents considered the changes in regulation and supervision to have little effect on the overall functioning of the banking sector, and they agreed that the ongoing changes are positive, but insufficient. With more time, as the reform process is progressing, regulations and supervision will even improve further.

Bonin and Watchtel (1999) suggest that a basic measure of the development of banks is the scale of their activity. The level and growth of lending and deposits are useful indicators of banking development because deposits and loans represent the payment and intermediation services provided by banks. When asked if the level of

	Frequency	Percent
Will privatization of state-owned banks improve the banking sector?		
Yes	16	94.1
No	0	0.0
Not totally	1	5.9
Changes in regulation and supervision		
Great improvement	8	47.1
Little improvement	7	41.2
No improvement	2	11.8

Table X.
Privatization, regulations and supervision of the banking sector

lending, savings, deposits and number of customers increased after the implementation of the reform process, most respondents (41.2 percent) claimed that there was only a slight increase, while 35.3 percent of the respondents stated that there was a huge increase, especially in the level of lending and deposits, as shown in Figure 6. The level of savings is increasing very slowly because customers still have not increased their trust in the banking sector. From the respondents 23.5 percent pointed out that there is no change in the level of lending, deposits, savings and the number of customers, due to the fact that nowadays competition is high and there is an abundance of smaller banks.

Although there has not been a huge increase in the level of lending, savings, deposits and the number of customers, results indicate that there is a tendency and potential for those levels to increase in the future after the reform. The majority of respondents (15 out of 17, or 88.2 percent) believe that the Serbian banking system will reach the level of development of the banking sector of other EU countries as demonstrated in Table XI.

Some respondents mentioned that many similarities already exist between the Serbian and the EU banking sector. However, they added that in order to reach the level of development of the EU banking sector, the Serbian economy has to grow further. More importantly, customers have to regain their confidence in the banking sector.

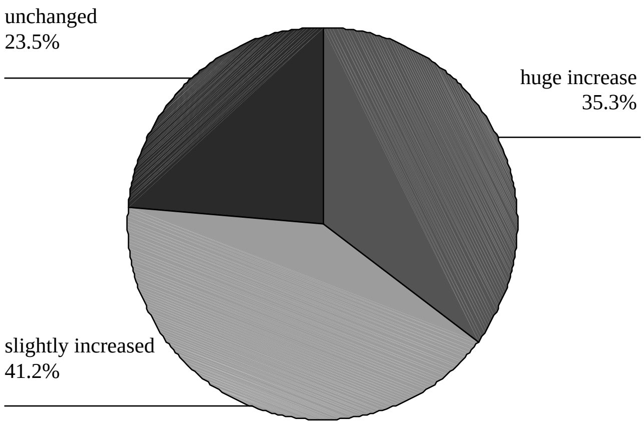

Figure 6.
Lending, deposits, savings and number of customers

	Frequency	Percent
EU level of banking development		
Yes	15	88.2
No	0	0.0
Not totally	2	11.8
Total	17	100.0
Time horizon		
Less than five years	5	29.4
Between five and 15 years	9	52.9
More than 15 years	3	17.6
Total	17	100.0

Table XI.
Serbian banking reaching level of EU development and time horizon

Only two out of 17 respondents, or 11.8 percent, claimed that Serbian banking sector cannot totally reach the level of development of the EU banking sector. For instance, one of them said.

The previous banking system was rapidly destroyed. ZOP, which performed the payment system functions in the past, had high credibility and its functioning was examined (studied as a phenomenon) by other countries for many years. It was possible to do things differently (Interview 6: Lines 1023–4).

According to nine of 17 respondents (52.9 percent) a period of 5–15 years is required in order for the banking reform process to be completed, while five of the 17 total respondents (29.4 percent) assume that less than five years are needed. Finally, three respondents (17.6 percent) support the belief that a longer time horizon (more than 15 years) is necessary.

All of the respondents agreed that the overall functioning of the banking sector in Serbia will eventually improve, once the reform process is fully carried out, and certain goals are met as demonstrated in Table XII. These goals include:

(1) the provision of financial services to the real sector based on market principles in order to improve old companies, and facilitate the establishment of new ones;

(2) the restructuring and creation of sustainable profitable banks, along with the strong involvement of the foreign financial institutions;

(3) the privatization of banks; and

(4) the restoration of customer confidence in the banking sector.

When asked about the future of banking in Serbia, respondents provided diverse answers. While five respondents (29.4 percent) indicated that some banks will close and the number of small banks will decrease, three other respondents (17.6 percent) believed that in the future the number of small banks will increase as revealed in Table XIII. Four respondents (23.5 percent) agreed that many banks will merge or

	Frequency	Percent
Improvement in the overall banking in Serbia		
Yes	17	100.0
No	0	0.0
Not totally	0	0.0
Total	17	100.0

Table XII. Improvement in the overall banking in Serbia

	Frequency	Percent
Future of banking		
Decrease in the number of small banks	5	29.4
Increase in the number of small banks	3	17.6
Mergers and acquisitions among banks	4	23.5
Privatization of state owned banks	1	5.9
Entry of new foreign banks	2	11.8
Creation of specialized banks (credit, investment...)	2	11.8
Total	17	100.0

Table XIII. Future of banking in Serbia larger banks will acquire the smaller ones. Again, opinions varied. Some argued that mergers and acquisitions in the banking sector will be only between domestic banks, while others said that foreign banks will also have an important role. Moreover, two respondents (11.8 percent) think that many new foreign banks will enter the market. Two other respondents noted that some banks will become specialized by offering specific services, such as credit banks, investment banks, etc. Still another respondent said that eventually all state-owned banks will be privatized. Overall, there was confidence that healthy competition in banking will increase, the quantity and quality of services offered will improve, while the price for these services will decrease, and savings and credit offerings will increase.

5. Policy recommendations

One of our main concerns is to discuss the impact of the ongoing reform process in the Serbian banking sector. Although, a positive impact has been recognized, it has also been suggested that the process has been prolonged. This is mainly attributed to two intervening conditions:

(1) the overall slow process in restructuring other sectors of the Serbian economy; and

(2) a lack of customer confidence in banks.

To evaluate the impact of the reform process, we first investigated issues/problems that banks encountered after the initiation of the reform process, which included:

(1) technical problems;

(2) problems with applying new regulations;

(3) liquidity problems;

(4) problems with changing customer behaviour;

(5) lack of clients' credit tracking history; and

(6) "unethical" competition from foreign banks.

Next, we examined the impact of the reform process on the banks' scale of activity. A positive impact was confirmed. For example, for a majority of the banks, the level of lending, savings, deposits, and number of customers slightly increased, and for some of the banks the increase was considerably large. We also found a preference for recapitalization as the best method for bank restructuring in Serbia because banks have inherited non-performing loans (this condition is the most common case in Serbia). In addition, our investigation revealed that the majority of bank managers, employees, and customers were more satisfied with the banking conditions since initiating the reform.

From the above research procedure, we can soundly claim that the following are the most significant changes that have occurred during the reform process:

(1) liquidation of the four largest Serbian banks at the beginning of 2002;

(2) transfer of the payment system from ZOP to banks;

(3) entrance of foreign banks into the Serbia banking sector;

(4) increased competition; and

(5) an increase in quantity and quality of services offered by banks.

Throughout the research project, the respondents recognised that the role of private and foreign banks, and the effect of bank privatization coupled with revised regulations of the banking sector were the two crucial conditions accounting for the positive impact of the reform process on the overall functioning of the country's banking sector, mainly through the resulting increase in competition. Most respondents agreed that the entry of new private banks, as well as foreign, encouraged a sound and market-oriented banking system in Serbia. However, all respondents suggested that the increased competition slightly improved the functioning of the overall banking sector. The argument that privatization of state-owned banks increased, although slightly, the overall bank efficiency, on the other hand, increased productivity and limited intervention of authorities in credit allocation, was supported by all respondents. Last, but not least, the changes in bank supervision and regulation was recognised as a positive step.

During the research process, we added three prospective items in order to validate the relationships identified in the previous stages of the research. Indeed, all respondents considered that the reform process, when completed, will definitely improve the overall banking sector's performance. Most of the respondents believe that the Serbian banking system will eventually reach the level of development of the banking sector in the EU countries, predicting a 5-15 years period for the reform process to be completed. They also suggested that overall quantity and quality of services offered by banks will increase, prices of services will decrease, and savings and credit offerings will increase, and most importantly healthy competition in banking will be established. Finally, it has been suggested that in the future a further consolidation of the sector will occur together with a tendency for more specialized institutions. Respondents anticipate bank mergers the acquisition of smaller banks by larger, along with new foreign banks entering the Serbian market, the specialization of banks, and also the privatization of an increasing number of state-owned banks.

6. Conclusion

As banks are the fundamental financial intermediaries in the financial system of a country and they perform vital roles through financial intermediation, it is essential that the banking reform process in Serbia develops a regulated, supervised, sound, and efficient banking system. This research project revealed that the reform process has brought positive results to Serbia. Additionally, an analysis of the joint banks' financial reports for the period following the implementation of reform suggests an improvement in the overall performance of the country's banking sector. The poor conditions in Serbia's economy and in the country's banking sector in particular, the changes in the ownership structure and privatization, the need of the Serbian banking to reach the level of development of the EU banking, the idiosyncratic transition process, the desire for Serbia to achieve a stable monetary policy and a stable domestic currency, and the end of economic sanctions and political changes in Serbia were identified as the major factors that led Serbia to embark on the banking reform. The most crucial issues encountered by the majority of banks, after the reform process was established, include: technical problems, liquidity problems, problems applying new regulations, problems associated with regaining customer confidence, unethical competition by foreign banks, and the lack of clients' credit tracking history. The liquidation of the four biggest Serbian banks at the beginning of 2002, the transfer of the payment system from ZOP to commercial banks, the entrance of foreign banks in Serbia, the increased competition and increased quantity and quality of services offered by foreign banks were identified as the most significant changes that occurred as a result of the banking reform process. Changes in the regulation and supervision of the banking sector had little effect on the improvement of the overall banking sector's performance, suggesting that changes were positive, but still insufficient. A decrease in the number of small banks, the mergers and acquisitions among banks, the entry of foreign banks, the increased number of specialized banks, and privatization of state-owned banks provide a positive environment to the banking sector in Serbia. It was envisaged that the reform process will provide the basis for healthy competition in banking and therefore, prices of services will decrease, and the quantity and quality of services offered by banks, as well as savings and credit offerings will rise. Indeed, the Serbian banking sector is firmly geared to resolving its problems.

Although survey research can be a cost-effective, it suffers from inherent weaknesses. This study's greatest weakness is the fact that it was in most parts an exploratory research. Conclusions can be drawn from the research, but not at the desired level of cause-and-effect. The sampling frame is also a weakness of this study. It is difficult to access the proper number and type of people who are required for a representative sample. The respondents were chosen according to their availability and accessibility, what sociologists refer to a convenience sample. Overall, leaving the weakness of the survey aside, we believe that the research project provides a decisive indication in evaluating the banking reforms in Serbia.

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