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Trends behind Implementation of Basel Core Principles in Banking Sector of Bosnia and Herzegovina - A Look Back and a Look Forward

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Abstract

The aim of this paper is to analyze banking regulation in Bosnia and Herzegovina (B&H), as well as the reflection of implementation of Basel Core Principles on business of banks and certain trends in domestic banking. Questionnaire survey is used to investigate on possible concrete progress that is achieved in developing of the banking sector in B&H over the past decade. This paper represents the results of a research carried out on 19 out of 28 planned banks in B&H that were surveyed during summer of 2012. In addition, this paper analyzes the qualitative research whose main goal is to gain the respondents' opinions about the past experiences and possible concrete progress that has been made in developing of the banking sector in B&H. Summarized results of the questionnaire, also, show that the consolidation of domestic banking market, although slow, is not yet fully completed and that the regulation in the field of banking supervision has a positive impact on improvement of the banks' soundness, discipline and strengthening of their competitiveness. Additionally, our findings indicate that it can be expected to reduce the number of banks over the next several years. The banks are aware of the importance of the capital and its role in the stability of the banking sector in connection with the required minimum amount of capital supporting their needs to maintain capital requirements.

Keywords: Central Registry of Credit, Financial Safety Net, Deposit Insurance System Banking Regulation, Minimum Capital Requirements, The Basel Capital Accord, Banking Sector

Introduction

The banking sector is characterized by a strong influence of the globalization process and increased competition. The struggle to increase market share and profit sets itself as a priority task, in which the risks are very often ignored. The financial sector of B&H is traditionally based on the dominant role of banks. Over the last decade foreign banks have been substantially increasing their presence in B&H, firstly by forming new banks (affiliates), and then by acquiring of local banks in the public (state) and private ownership.

Entry of foreign banks into the country is supported by the adoption of new regulations, in line with international practices and standards. The path to this regulation of the banking

sector in B&H was long, but marked by a series of changes and reorganizations. Banking sector of B&H is enhanced by the structural reforms, as well as the development of a strategy for the privatization of domestic banks, mostly by sale to foreign strategic investors. A number of these transformations have the formal organizational nature, which is particularly indicative of the period transforming its socialist patterns of organization into a market oriented one. However, the most significant changes occurred after the year 2000 (e.g. measures that have been taken by with the support of IMF program) when a government created a favorable investment environment to attract foreign investors. In coming years, after adoption of internationally accepted standards in banking industry, included compliance with Basel Core Principles on Banking Supervision and the framework for banking business has significantly improved. Building of institutional framework and introduced banking standards that function in developed economies has been a long process. In fact, a large number of those banks are regional and local oriented and are faced with many problems in imposing the general prudential requirements (Mehl and Winkler, 2003). Early years of transition are characterized by a scarcity of liquidity, high and rising levels of non-performing loans, high ratios of nonperforming loans to total loans, poor quality of management, lack of savings, deposits etc. In general, the banking sector is not able to cover greater losses, preserving the required solvency and liquidity, with weak prospects for a stable and long term growth. In recent time, thanks to the patient reform efforts supported by the international community the concept of international banking standards and prudential requirements is gradually introduced in the banking industry of B&H.

The system of banking supervision is organized according to the principles of effective supervision of banks set by the Basel Committee on Banking Supervision. Gradual achievements in the system of regulation foster the development and strengthening of the banking sector, as well as the strengthening of capital bases of domestic banks and their growth. Among other things, the total capital of the banking sector in B&H, for example, has increased from 684 million KM in 2000 to 2.83 billion KM at the end of 2011 (Central Bank of Bosnia and Herzegovina, Annual Report, 2012). An excessive number of banks are reduced from 56 to 28, respectively. These positive developments are accompanied by improvements in the overall general trends, which were almost impossible to find until 2002. These trends are the following: a more comprehensive approach to capital adequacy and risk assessment methods, standardization and efficiency in banking operations, better and more sensible way of managing risks, etc.

According to the Constitution of B&H, the jurisdiction over the issue of financial services is mainly at the entity level. Each entity in B&H has its own banking agency. The supervision and examination process of banks performing Entities' Banking Agencies is coordinated by the Central Bank of B&H. Function and control of the financial condition and stability of banks is overseen by the Banking Agency of the Federation of Bosnia and Herzegovina and Banking Agency of the Republic of Srpska. Both entities in B&H (Republic of Srpska and Federation of B&H) have adopted rules regarding the implementation of regulations and enhancement of the policies managing: credit, operational and market risks, and the new chart of accounts for financial institutions. Banking legislation on the country-basis is still in accordance with Basel 1 and in preparatory phase of implementation of Basel 2.

Since 2008, Entities' Banking Agencies have been working on preparation for adoption and implementation of Basel 2 in B&H, in line with the international best practices. In late 2008, in Federation of B&H and in early 2009 in RS, a strategy for introducing the Basel 2 standards has been adopted by the relevant Entities' Banking Agencies. Their primary aim is

to prepare the banks in B&H to apply and implement a new regulatory framework and to develop capacities of relevant institutions to apply and utilize the supervisory procedures as defined by Basel 2. Today, the banking agencies are redrafting the strategy for the introduction of "International Convergence on Capital Measurement and Capital Standards". As goals and timelines set in this document have not been yet achieved, this document is in the drafting legislation phase.

Literature Review

The enforcement and implementation of the prudential rules in the financial sector play a significant role in limiting moral hazard, as well as in providing incentives to intermediaries to efficiently allocate resources. During the 1980s and 1990s, many developing countries begin the process of transition of its system of supervision, in accordance with the new, proposed Basel standards. Process of transition is not going quite smoothly. Recent decades have seen rapid liberalization, which contributed to the emergence of a large number of financial crises. In response to these crises, there is a detailed regulation of the banking sector (and other parts of the financial sector), in order to improve the regulatory environment and emphasize its importance, especially in emerging market economies (World Bank, 2001).

The process of geographic expansion and consolidation of banking and other financial institutions has largely overcome national borders and takes global character. It may be said that what happened in the field of finance in the last couple of decades represents the most significant progress of our era, which is also very abundant in transformations, crises in the economic area, and all aspects of social reality. Some of these developments are not and should not go unnoticed. On the contrary, they set up and produce new challenges and tasks on monetary authorities to address them in order to successfully adapt to new circumstances. The establishment of the modern banking system, present in virtually all developed financial systems, has as its goal not just the overall objective of meeting the needs of the economy, but also the requests of international financial institutions. The reason is very simple. The safety and soundness of banking system in one country creates the preconditions for the expansion of banks in other countries whose banking system is also based on sound foundations.

The first draft of the Basel Capital Accord (also known as Basel 1) was published in December of 1987, in order to complete a set of rules, which came into effect in January of 1993. In accordance with the original proposal of Basel 1, it is focused primarily at the minimum capital requirements to limit credit risk (the risk of other types are left to the jurisdiction of national regulators), in order to define the required amount of capital a bank must hold in relation to the risk of its balance sheet and off balance sheet items. In addition, the Basel 1 requires for banks, which are actively engaged in international transactions to hold capital equal to at least eight percent of their risk weighted assets (Tarullo, 2008). However, the supervision of banks, as well as the developments in financial markets, since the beginning of implementation of Basel 1 shows a few shortcomings, particularly with regard to the credit, market and operational risks. These deficiencies cause that Basel 1 framework the need for a more flexible and more risk-sensitive capital standards. The revised Basel Accord came into effect in 1996 by introducing short term subordinated debt (tier 3 capital) to cover market risk exposures. This amendment also 'allowed banks to use their own internal models to determine the required capital charge for market risk. There is no doubt that this amendment represented a revolutionary change in regulatory thinking in the former, and certainly the original decision of The Basel Capital Accord. No matter in what direction

we may look, one should have in mind that Basel 1 sets formal regulatory capital requirements for banks that have become acceptable to regulatory agencies. Thus, Basel 1 firstly succeeds to identify primary, secondary and additional capital; secondly, it introduces the first formal standard for the bank exposure to risks from off-balance sheet transactions. Likewise, the Basel 1 sets conditions for determining the required level of capital for each bank individually using the same set of at-risk: Tier 1 capital must be at least 4% of total risk-weighted assets, and total capital must be at least 8% of total risk-weighted assets (Hal, 2005).

But in recent years, it has become all too apparent that Basel 1 has become inadequate to oversee the international financial groups. Basel 1 has been criticized for a variety of dimensions. The most important criticisms of Basel 1 are that it had gaps in its coverage and that the opportunities it created for regulatory arbitrage became progressively more serious as the mix of bank activities shifted toward securitization, writing derivatives, and other financial products that had comprised much smaller segments of major bank activity during the period in which Basel 1 was drafted. These criticisms formed much of the motivation for the launch of Basel 2. In order to give a significant contribution to realizing the conditions required to solve the problem mentioned above, the Basel Committee has published a new revised framework: International Convergence of Capital a (also known as Basel 2), which has acquired all the requirements to replace the one from 1988. In another section of this chapter we will give a more detailed overview on the Basel 2 Capital Accord. The New Capital Accord consists of three mutually reinforcing pillars. First, the components of bank capital are described. Pillar 1 defines the minimum capital requirements for credit, market and operational risk. Pillar 2 describes the supervisory review process to verify whether the bank holds sufficient capital to cover all its risks. Pillar 3 defines the market disclosure to catalyze prudential risk management and sufficient capitalization.

The Basel 2 involves an important revision of the rules for credit risk towards higher risk sensitivity, as well as greater reliance on the banks' internal expertise, internal historical databases, risk methodologies, models and risk-parameter estimates. Complementary improvements are the recognition of credit risk mitigation techniques like collateral, guarantees, netting and credit derivatives, and the recognition of the importance of diversification across regions and industries (Van Gestel and Baesens, 2009).

Rules adopted by the Basel 2 allow banks to rely more on their internal capacity credit of expertise and at the same time stimulating them to improve the quantitative risk management techniques. In principle, these developments have proven to be useful for banks and other stakeholders, to finally perform more precise allocation of capital, in line with the banks' risk profile. This is certainly evident improvement compared to Basel 1, which cannot be disputed. The relative importance of support for the need for regulation of banks has increased dramatically in recent years. In one study done by Podpiera (2006) he argues that there is a link between banking sector's performance and the quality of regulation and supervision as measured by the compliance with the Basel Core Principles. The aim of his study was to examine whether BCP compliance creates a regulatory and supervisory environment that helps to improve banking sector performance. As explained by Podpiera, being Basel compliant creates a regulatory environment that helps improve banking sector performance. In his analyses he concludes that higher compliance is associated with lower non-performing loans and a narrower net interest margin (Podpiera, 2006). The most general and perhaps theoretically significant form of relation between banking sector performance and the quality of regulation and supervision can be found in the research of (Demirguc-Kunt *et al.*, 2008). They examined in their extensive empirical analysis the relationship of regulation

of the banking industry. According to their research work they found that compliance with the BCP improves bank soundness. Also, they examined relationship between compliance with information provision and bank soundness and concluded that there is a significant and positive link between them. Their results suggest that countries aiming to upgrade banking regulation and supervision should consider giving priority to information provision over other elements of the core principles.

Research Methodology and Objectives

The research was carried out by applying the questionnaire survey methods. The research process was conducted in B&H. Questionnaire is based on the concept of close questions by examining the impact of the proposed rules to implementation of Basel Core Principles on certain trends in banking of B&H. Each question represents the objective of this research. The survey was carried out in the spring of 2012. The data for this research has been collected from the primary source. Out of the total of 28 questionnaires, 19 banks were used for further analysis. To obtain the necessary information and data it was used the method of exploration, through questionnaires or responses of the respondents. The empirical data were then processed calculating descriptive statistics, which helped to establish measures of central tendency: mean frequencies and percentages of responses and standard deviation. The data for the sample was collected by the method of survey in the beginning of 2012, which makes 67.85% of the total sample. Our research focused on the reflection of the implementation of the Basel Core Principles on business of banks and certain trends in banking of B&H. In this sense, the research work was carried out by examining the past experiences and possible concrete progress that has been made in developing of the banking sector in Bosnia and Herzegovina in recent years. Also, the qualitative research methods used in this paper are in-depth interviews, in some selected banks in B&H, focus group discussions and participant observations.

Research Results

Although the process of implementation of Basel 2 in B&H is still at the beginning, the results of the survey research will be visible (i.e. through the impact of capital requirements on risk-taking). The impact of banking regulation to improve the stability and soundness of the banking sector in B&H, the expected competition in the banking sector of B&H in the horizon of the next two years, the general review of the banks' future business strategies, the impact of competition on the recent trends in the banking sector of B&H and past experiences and possible concrete progress that has been made in developing of the banking sector in B&H.

Impact of Capital Requirements on Risk-taking

The first issue (Figure 1) of research relating to Basel Core Principles was focused on detecting whether introduction of fixed minimum capital requirements lead banks to hold higher capital ratios. Respondents were interviewed to express their attitudes on the issue of impact of capital requirements on risk-taking. The purpose of this question is to determine whether in the respondent's opinion, the implementation of minimum capital requirements by the Law on banks reflects their needs for additional capital requirements.

This finding reveals that majority of the respondents (76.09% of total banking assets in B&H or 85% of the sample) agree with the statement that the minimum capital requirements, in terms of the sum of the risk weighted assets meets riskiness of their business, while one

respondent (2.62% of total banking assets in B&H or 5.26% of the sample) was against the statement. Second group of respondents share opinion that minimum capital requirements, as set by the Law on banks in Federation of B&H Law on banks in Republika Srpska are forcing banks to hold higher capital requirements than banks need, in order to meet riskiness of their business. For the option; "to hold less capital in order to meet riskiness of their business", opted one surveyed respondent (e.g. 1.74% of total banking assets in B&H).

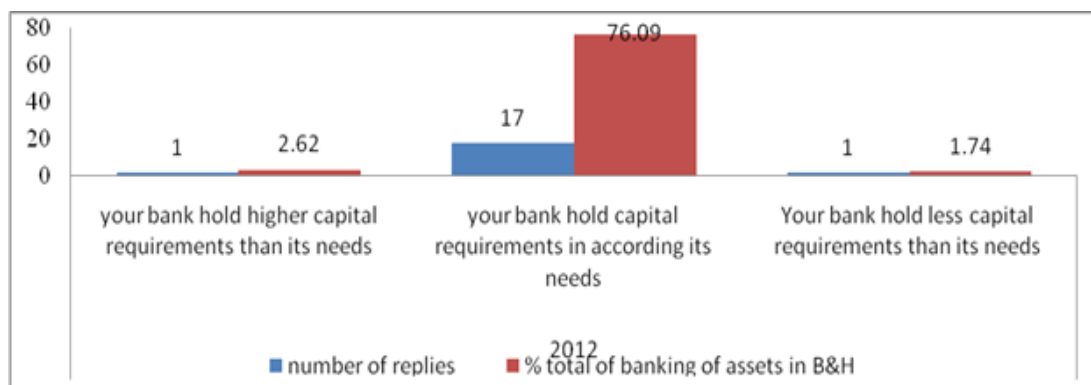


Figure 1. Impact of capital requirements on risk-taking

Source: Own work based on quantitative research

The Impact of Banking Regulation to Improve the Stability and Soundness of the Banking Sector in B&H

The second question relating to the Basel Accord focuses on the impact of banking regulation to improve the stability and soundness of the banking sector in B&H. To this question, the majority of banks indicated that „the impact of banking regulations to improve the stability and soundness of the banking sector in 2002 was positive“ (17 responses or 89.5% of the sample). As it can be seen from the Table 1, with only two banks in the sample (10.5% of the sample) that influence is negative. This period corresponds to the entry of foreign banks and the extensive application of decisions on minimum standards for bank operations.

Table 1

The impact of banking regulation to improve the stability and soundness of the banking sector

The impact of banking regulation to improve the stability and soundness of the banking sector in B&H	2012		2002	
	Number of replies	% of the sample	Number of replies	% of the sample
Positive	19	100	17	90
Negative	0	0	2	10

Source: Own work based on quantitative research

After ten years since the introduction of the Basel standards respondents share opinion that the introduction of new banking regulations in B&H have been successful in improving the stability and soundness of the banking sector in B&H.

The Expected Competition in the Banking Sector of B&H in the Horizon of the next two Years

Specifically, we examine the respondents' views on their current positions and plans for their future, in the horizon of next two years.

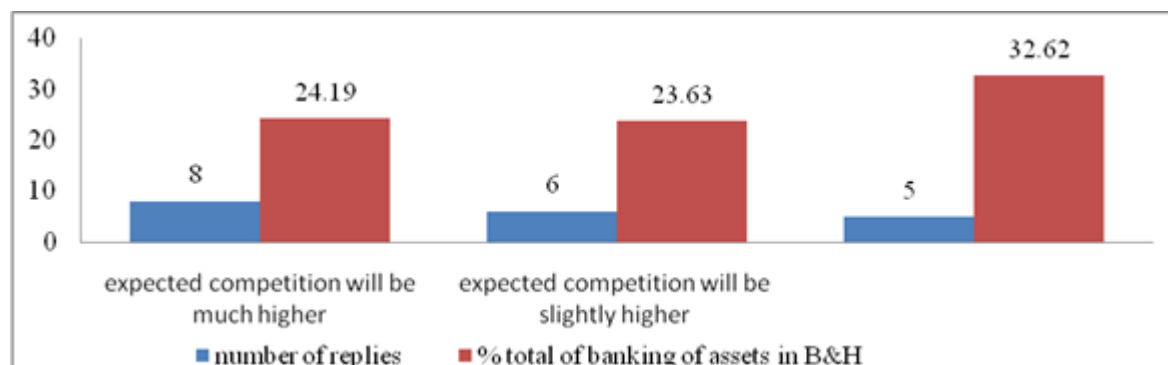


Figure 2. The expected competition in the banking sector of B&H in the horizon of next two years

Source: Own work based on quantitative research

The results of the questionnaire, in terms of the competition suggests that there are different respondents' opinions about the views of banking sector in B&H in the future, as illustrated in Figure 2.

Based on the response of surveyed banks it may be concluded that there are three groups of banks. The first group is represented by 8 surveyed banks (which account for 24.19% of total assets of the banking sector in B&H, or 42.1% of the sample). The banks in this group declared that expected competition between banks is going to be much higher in the horizon of the next two years.

Second group consisted of 6 surveyed banks (which account for 23.63% of total assets of the banking sector in B&H, or 31.5% of the sample). They declared that the process of consolidation will be much slower, due to circumstances of a global economic slowdown, and accordingly the expected competition will be slightly higher.

The remaining third group, consisted of 5 surveyed banks (32.62% of total banking assets in B&H or 26.31% of the sample) does not expect that the competition will be at the same level in the horizon of the next two years. The average estimation of responses obtained from samples is 1.84, with indicated value of standard deviation of 0.83421. According to the results of this question, it can be concluded that the consolidation of the domestic banking market, although slow, is not yet fully completed, and over the next several years, the trend of decline in number of banks in B&H can be expected.

General Review of the Banks' Future Business Strategy

This question was aimed at providing an overview of the banks' future business strategy, which will be followed by their managers (Fig. 3). The strategy of individual survival in the banking market was seen by 9 respondents (i.e. 55.3% of total banking assets in B&H or 47.36% of the sample). Out of the total number of respondents on this issue, 7 respondents (i.e. 16.08% of total banking assets in B&H or 36.84% of the sample) expressed the opinion to "merge with other banks".

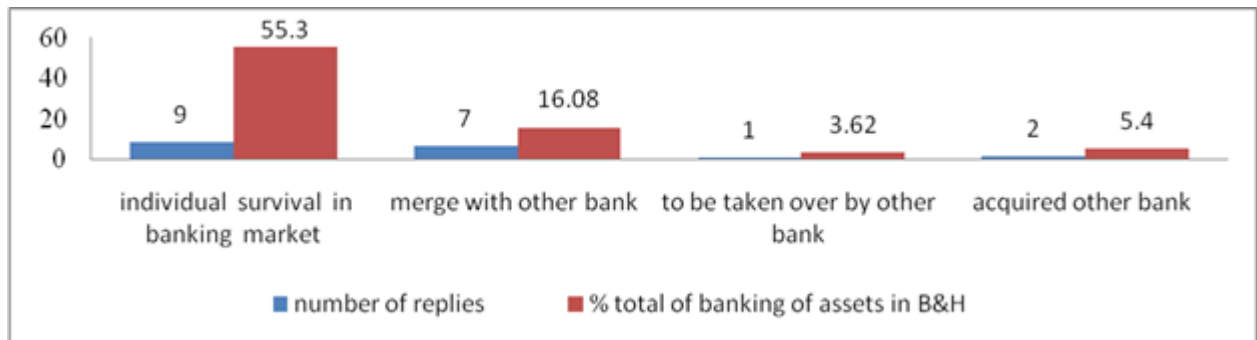


Figure 3. Strategic Review of the bank's future business strategy

Source: Own work based on quantitative research

This last group of banks expected the creation of need for a rigorous capital requirements, investments in information systems and compliance with Basel 2, all of which will likely require additional resources. Therefore, the respondents from these banks, see the option to "merge with other banks", at least in the near future as the only solution. Only one respondent, which accounts for 3.62% of the total banking assets in B&H (i.e. or 5.26% of the sample) expects to be taken over by other banks to solve their long-term standing in the market. As "acquired by other banks" was identified only by 2 respondents (i.e. 5.4% of total banking assets in B&H or 10.52% of the sample). The average obtained number of 1.789 means that respondents see in the future the strategic development of banks, whereas their bank features either "the individual surviving in banking market" or "the merger with other banks". The reliability of obtained responses from the sample indicate value of standard deviation of 0.976328.

What is Optimal Structure in Terms of Number of the Banks in B&H?

Managers have been asked for their present opinions about optimal structure, in terms of number of the banks in B&H. The purpose of this question is to determine whether in the bankers' opinion, the current number of banks meets the economic needs of national economy.

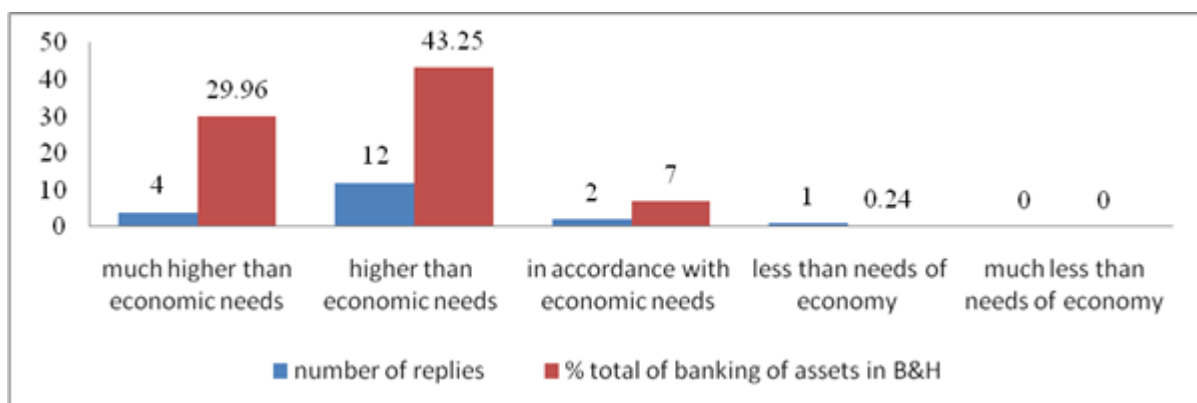


Figure 4. Optimal structure in terms of number of the banks in B&H

Source: Own work based on quantitative research

Analysis of data contained in Fig. 4. shows that in most cases, (12) respondents (e.g. 43.25% of total banking assets in B&H or 63.15% of the sample) identified that number of banks in B&H as "higher from economic needs". For the option "much higher from economic

needs" opted 4 surveyed respondents (e.g. 29.96% of total banking assets in B&H or 21% of the sample). "In accordance with economic needs" were given only 2 respondents, representing 7 % of total banking assets in B&H or 10.52% of the sample). From the data presented in Fig. 4, it can be noted that significant percent of the respondents stated that the current number of banks exceeding the needs of the economy B&H. This may be due to the fact that they can't see in the near future their bank isolated from potential acquisitions and mergers with other banks. No designated respondent answered "much less from the needs of economy" in the questionnaire. According to the obtained responses from sample the calculated average value was 2, while the standard deviation was 0.745356. Based on these values it can be determined that the bankers believe that the need for the banks in the economy of B&H is generally between options; "much higher from economic needs" and "higher from economic needs".

Impact of Competition on the Recent Trends in the Banking Sector of B&H

Finally, we are interested in the bankers' opinion about the potential impact of competition on the certain trends in B&H banking, or whether the introduction of competition harms certain trends in B&H banking. When asked about it, the majority of respondents claimed that it is positive. Responses reflect the degree of agreement or disagreement with the arguments given in the tables below. The comparison of the research results of the respondents' viewpoints regarding the impact of competition on the recent trends in the banking sector of B&H is presented in Table 2. Findings indicate the following:

- with 17 banks (77.7% of total banking assets in B&H or 89.47% of the sample) competition have had a positive effect on decline of active interest rate, while for only one bank (1.6% of total banking assets in B&H or 5.26% of the sample) it was negative.
- more than two thirds of respondents (15 banks, - which account for 64.71% of the total banking assets in B&H or 78.94% of the sample) competition have had a positive effect on reducing the banking fees in conducting transactions, while one bank (which accounts for 3.2% of total banking assets in B&H or 5.26% of the sample) stated that „the competition have had a neutral impact“, concluding with 2 banks (which account for 11.2% of total banking assets in B&H or 10.52% of the sample) stated that the competition have had a negativel effect;
- The analysis of the obtained answers also reveals that the respondents (13 banks which account for 62.71% of the total banking assets in B&H or 68.42% of the sample) consider that competition has the positive effect on the reduction of the interest margin, while for 2 respodents (11.67% of total banking assets in B&H, or 10.52% of the sample) it meant that it had a neutral impact. The 4 respodents (6.05% of total banking assets in B&H or 21.05% of the sample) considered that „a competition have had a negative effect on the reduction of the interest margin“.

The comparative research data analysis makes it apparent that respondents consider that the most positive impact of competition have the effect on the following features: improving the quality of services, decline of active interest rate, improving efficiency of banks, better risk assessments and risk analysis. Most of the respodents considered about the impact of competition on certain trends in the banking sector has received an average range of 1 to 1.5.

Table 2

Impact of Competition on the Recent Trends in the Banking Sector of B&H

	1) Positive		2) Neutral		3) Negative		4) I don't know		Mean	Standard deviation
	Number of replies	% of total banking assets in B&H	Number of replies	% of total banking assets in B&H	Number of replies	% of total banking assets in B&H	Number of replies	% of total banking assets in B&H		
Decline of active interest rate	17	77.7	1	1.15	1	1.6	0	0	1.157	0.5014
Reduce banking fees in conducting transactions	15	64.7	1	3.2	2	11.2	1	0.8	1.421	0.90159
The reduction of the interest margin	13	62.7	2	11.6	4	6.05	0		1.526	0.84119
Improving efficiency of banks	14	55.7	4	6.35	1	18.3	0	0	1.315	0.58239
Improvement of banking regulation	13	52.2	4	25.7	2	2.55	0	0	1.421	0.69248
The introduction of new banking products	19	80.4	0	0	0	0	0	0	1	0
Improve the quality of services provided by banks	17	77.3	2	3.12	0	0	0	0	1.105	0.31530
Better risk assessments and risk analysis	15	59.6	1	2.33	3	15.8	0	0	1.368	0.76088
The development of new methodologies for managing risk	16	58.9	2	4.65	1	17.2	0	0	1.210	0.53530
More stable and competitive banking sector	13	50.4	3	7.92	2	22.1	1	0	1.526	0.9048
Detailed and accurate credit policy	12	49.3	7	31.5	0	0	0	0	1.368	0.49559

Source: Own work based on quantitative research

Among other things, it should be noted that the increasing of the competition have had a more positive impact, with an average range of 1.15 or lower for the following features: the introduction of new banking products, improve the quality of services and decline of active

interest rates while impact of competition have had a less important on more stable and competitive banking sector and the reduction of the interest margin.

Conclusion and Discussion

Creating the institutional basis of the formation of the entity banking agencies in B&H, the introduction of the Currency board arrangement (CBA), a lot has been done to maintain the stability of the domestic banking sector and strengthening public confidence. The continuity of progress, since 2002 to date, has opened a new dimension and perspective of the financial position of the banking sector and strengthening its potential. The result is a healthier balance sheet structure of banks, liquidity operations, intensive credit activity and growth of nominal and real capital value. Unlike other sectors of economy B&H, the banking sector made significant progress in terms of increasing the minimum capital requirements of banks and the application of international standards in the banking sector with strengthening the capital banks base.

Also, the improvement of the institutional framework there was a reduction in banks' credit risk, which encouraged the growth of credit supply. Surveyed banks, as well as banking in B&H in general has shown significant progress in all areas of business. Most banks are now stable and profitable institutions that have gone a long way of adapting international prudential standards to the introduction of modern tools and techniques of risk management. In recent years the visible changes in the banking sector of B&H have took place, in this regard the contribution of Basel Accord is quite significant.

Basel standards are inevitable reality of the banking sector, both worldwide and in B&H. They were developed with aim of helping banks preserve stability and financial health, resist economic uncertainty and unfair conditions. Entities' Banking Agencies in B&H as well as the commercial banks are aware of the standards and they have shown willingness to adopt Basel Core Principles, but full compliance is still far away.

Summing up the results of the survey, it can be stated that the regulation in the field of banking supervision had a positive impact on the stability of the banking sector in B&H, disciplining banks and strengthen their competitiveness. The intention of the new prudential regulations was to support and maintain the financial health and put away bad practice by which the owners and founders of the banks were the biggest borrowers. Prudential regulations have imposed strict limits on lending to clients and related entities. It has been shown that without stricter prudential regulations the management of banks was not a function of the stability of the banking sector.

Analysis of the responses from interviews points to some key aspects of the understanding of past experiences and possible concrete progress that has been made in developing of the banking sector in B&H. Having analyzed the progress has been made in implementation of Basel standards, some achievements areas have exposed.

1. First, the key success issues regarding implementation of Basel standards together with an identification of its important effects for the banking of B&H. There are a few reasons why implementation of Basel standards is beneficial for the banks in B&H. On issues related to the effects of the implementation of banking regulations to the business and the stability of banks in B&H, most responses can be classified into four categories of parent:

- Banks were aimed at strengthening of their capital basis and they have adequate capital to support all the risks in their business.
- Banks widely used techniques for credit risk mitigation while collateral and guarantees continue to be the most commonly used risk mitigation techniques.

- The application of the new rules has affected banks to hold higher capital adequacy in relation to the existing regulations.

- Banks' exposure to credit risk is reduced in comparison overall credit limits at the level of individual borrowers and counterparties.

2. The second group of questions was aimed to see what is necessary to be done in order to improve business environment for banking sector in B&H. From the view of respondents, business's future landscape has to be change rapidly. When asked about particular indicators in business environment that are not changed after implementing Basel standards, respondents most often mentioned problems in:

- Legal system that created in debtor's favor against creditor.
- Financial indiscipline and the expansion of the underground economy.
- Slowness of executive actions, particularly those of the actual acquisition of property that allows payment of collateral.

- Critically low quality of financial reporting and external audit of the financial statements.

3. Third, the interviews managers have been asked about their experiences with system of managing risks. On the basis of the conducted interview it can be concluded that significant progress has been achieved in managing risks (credit risk, liquidity risk, operational risk).

Credit risk is the primary and most important risk for most of the respondents, while liquidity risk is on the second place. Also, in addition to using the services of a credit registry, banks have established their own-internal systems, other than methodologies and regulations to protect themselves against the credit risk. How exposure to liquidity risk depends on the specific position of the bank in the financial market, the interview revealed that most banks use more tools for managing liquidity risk, which can be considered very positive. Thus, regardless of the importance of liquidity risk banks are turning to prescribed procedures rather than creative solutions within the bank. However, there are also problems.

According to the responses of the interviews managers, it can be concluded that the management of operational risk is unknown for many banks and that their responses are primarily a matter of perception and reliance on laws and decisions of the entity banking agencies, and not the internally established systems of protection within the bank or creative solutions of the bank management. In respondent's opinion another problem that for many banks in B&H is the lack of enough people with the skills they are looking for that could complement these shortcomings in order to achieve better results of operational risk management.

Gradually changing the structure of the financial system of B&H among other issues is caused by structural changes in the banking sector. Our research has shown that banking sector of B&H has made the significant progress by introducing the Basel Core Principles, but there are gaps in the information base for the implementation of sophisticated approaches to the management of risks. Furthermore, there is still significant space for improving and accelerating the process of harmonization of domestic banking system with international prudential standards. Our findings have shown that the consolidation of the domestic banking market, although slow, is not yet fully completed. Over the next several years it can be expected to reduce the number of commercial banks in B&H. Furthermore, the study results suggest that banks are aware of the importance of capital and its role in the stability of the banking sector. It became evident that some trends began to appear after implementation of the Basel Core Principles as a significant increase in: development of banking products and services, the introduction of new technology, expanding knowledge, etc. In all of these, the

important role is played by foreign banks, through the entry into the ownership structure of domestic banks, as well as the deepening of the financial market spectrum. Thus, the increased competition among banks has resulted in a new products and expansion of banking business, thanks to which their products and services become available to most categories of clients. Also, the increased competition has also delivered benefits to households via the significant reduction in interest margins. That was made possible by improving efficiency of banks, because they are in the competition for market shares and to compete better these banks had to reduce their lending rates. Competition has led to a stronger marketing and introduction of a new banking products and services with aim to improve the quality of existing products and services.

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