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2024 SUPERVISORY EXPECTATIONS ON BANKS' PRACTICES

Sarajevo, February 2024

Introduction

1. The Banking Agency of the Federation of Bosnia and Herzegovina (hereinafter: Agency) is disclosing these supervisory expectations with the aim of steering banks towards sustainable business, as well as for the purpose of mitigating the risks and consequences of external disturbances that may have a negative impact on the economy and the banking system. The planned supervisory activities described below in this document can steer banks' preparatory activities and result in more efficient supervision. The order in which the expectations are set out in this document does not indicate the level of priority or the distinct importance of individual expectations.

2. Geopolitical uncertainties are still present and adversely affect economic expectations in Bosnia and Herzegovina. In addition to external risks, internal factors that have an adverse impact on the outlooks for significant economic growth stem from the current political situation, sluggish pace of the EU accession process, and adverse demographic trends. The Agency's estimate is that the harmonisation of development policies and the acceleration of the EU accession process could spur the growth of investments and significantly contribute to strengthening the stability of the financial sector.

3. Risks for companies in some sectors of the economy are still pronounced. The business models and performance of export-oriented companies depend on the level of economic recovery of the main trading partners. Risks for companies can also arise as a result of slow adaptation to a dynamic business environment, loss of markets and labour shortages. Banks are expected to have an in-depth understanding of the business models of their major debtors, and to structure the financing of these customers in accordance with their realistic needs and capabilities.

4. Although the banking sector of the Federation of BiH is exceptionally capitalised and liquid, the question of its resilience can be raised in case of adverse development of external factors and disturbances that can intensify the effect of unexpected shocks on the country's economy and financial system. Preventive and planning actions of all relevant participants is essential to mitigate the risks to which banks are exposed or could be exposed and to preserve stability. The practices during the COVID-19 pandemic and the shock of rising interest rates in the EU are examples of appropriate responses by the banking sector and the Agency.

Supervisory Expectations on Banks' Practices

5. The level of investments in the private and public sectors is unfavourable with the weak outlooks for the next medium-term period. Although improving the climate for investors and quality public investment programs are important factors that should support investment growth, the role of banks in this process cannot be neglected. Banks are expected to support the financing of sustainable capital projects that will contribute to the economic development of the country. In this context, it is necessary to analyse possible sustainable financing models, with the participation of a larger number of banks or with the support from international investors and partners.

6. Banks should support business digitalisation with extra attention, which is essential in order to ensure the transformation of business models in the medium term, to maintain and

strengthen the market position of banks. In addition to creating opportunities and managing the modern needs of users, digitalisation must aim for financial inclusion, risk management and more affordable services. A pricing policy that favours responsible and inclusive products in combination with efficient risk management is a prerequisite for wider social acceptance of digitalisation. In addition to their own systems and processes, banks are expected to support digitalisation initiatives that may be required or promoted by relevant institutions. Considering the importance, social impact and role, and the data infrastructure at their disposal, banks have a significant role in the process of digitalisation of society and economy. In this context, the role of banks must be more intensively promoted.

7. Banks should approach with particular attention the analysis of any revision or adjustment of the fee levels, which includes, among other things, checking the way in which the fee was agreed, its revisability and the way in which the customers are to be notified, as well as checking whether the proposed revision of the fee level is appropriate and in accordance with actual costs. It is necessary to highlight more clearly the characteristics, risks and costs of the product, the eligibility of which may be subject to different considerations. For example, customers and the wider community have to recognise the cost and price advantages of products that reduce the need to use cash, paper documents, physical presence in the bank, etc. An adequate approach includes clarifications of the risks associated with traditional approaches to transactions and banking, the role of which will surely diminish in the future.

8. The Agency strongly supports initiatives related to financial inclusion. A dynamic process of developing new products and technologies that facilitate a higher degree of financial inclusion is expected from banks as socially responsible companies. New and innovative technologies can facilitate accessibility, affordability and the provision of banking services to socially vulnerable categories of the population, however, financial inclusion has also a wider significance and is not limited to products that are only affordable. Banks are expected to create products that clearly indicate the attitudes and business transformation in the direction of managing future risks and adapting to the needs of the transition towards a sustainable economy.

9. It is estimated that demographic risks and labour shortages could represent key risks for a more significant economic growth of Bosnia and Herzegovina in the medium term. Banks should be able to timely identify and avoid credit risk concentrations by individual exposures and particularly exposed activities, i.e., sectors of the economy, in order to mitigate the aforementioned risks in a timely manner. The negative consequences of demographic risks for a bank's business can be mitigated by actualising the initiatives to plan for management of these risks, in cooperation with the wider business community and institutions.

10. Banks are expected to actively participate in initiatives that support the transition of the BiH economy towards „carbon neutrality“. Banks should be able to take advantage of the opportunities arising from the transition to a carbon-neutral and circular economy to diversify investments and sources of funding, i.e., to strengthen their own business models. The development of harmonised financial products and pricing strategies can encourage companies and individuals to initiate investments in „green“ technologies earlier. Banks should use the significant resources available internationally to finance the transition to a „green“ economy or to share investment risks.

11. Unadjusted structuring of credit products by amounts and terms can produce negative consequences for the market and cause an increase in the share of non-performing loans. Inadequately structured financing of systemically important debtors can cause wider negative consequences for the country's economy. If significant exposures represent a systemic risk, and the business model of the company shows weaknesses, banks are expected to participate actively and in a coordinated manner at the level of the banking sector in activities to create adequate financing modalities, including timely restructures. In this context, enhanced monitoring and analysis of the sustainability of major debtors' business models is crucial for the timely creation of adequate collection strategies and systemic risk mitigation.

12. The implemented credit risk measurement systems cannot cover all uncertainty factors that affect the potential materialisation of credit losses. The political risks, disinflation slowdown, and still elevated interest rate levels in the region are risk factors that are generally not included in the consideration when calculating expected credit losses on a collective basis. Banks are expected to make adjustments to the expected credit loss models to include all relevant factors that may affect the credit risk level. Adjustments can be made within the models themselves (in-model adjustment) or after application of the models (post-model adjustment), where the assumptions used must be justified and adequately documented. Where possible, effects should be assessed based on data and quantitative analyses.

13. Banks should review and improve methods for identifying increased credit risk level (SICR). Identification systems should be automated to the greatest extent in order to avoid incomplete solutions that cannot adequately cover in terms of pace and volume the bank's entire portfolio, including portfolios with a large number of small exposures and revolving exposures. Banks that mostly finance companies with short-term credit products (revolving) should assess their actual duration and adequately form expected credit losses for stage 2 exposures.

14. Banks are required to give particular focus to the comprehensive and efficient management of risks arising from the negotiation of retail long-term general-purpose and replacement loans. The growing exposure of banks to general-purpose and replacement consumer loans with or without collateral leads to the concentration of credit risk, which could cause an increase in non-performing loans and systemic risk in a situation of worsening macroeconomic trends. When approving retail general-purpose or replacement loans, banks are obliged to comprehensively and adequately assess the debtor's creditworthiness, taking into account the Agency's internally prescribed criteria and regulations. The development of a loan portfolio of general-purpose and replacement loans that is not aligned with the improvement of the macroeconomic parameters of BiH or is not connected with the improved payment capacity of customers will result in additional supervisory concerns, possible restrictions and additional requirements from the Agency. Banks must have a full understanding of the long-term macroeconomic and other effects of potentially expansionary credit policies aimed at a rapid growth of parts of the loan portfolio.

15. Banks are expected to allocate resources for the development of methodologies and tools used to measure financial risks, primarily credit risk, funding risk and interest rate risk in the banking book. As a support to these systems, it is necessary to consider the

establishment of a data management function proportional to the size and complexity of the bank. The data management function ensures the reliability and efficiency of the system for sorting, organising and grouping a large amount of data that are the basis for measuring and managing risks in the bank. This expectation is of particular importance in the context of the new regulatory framework in the segment of interest rate risk in the banking book management, which has brought significant changes and requires banks to commit resources in order to establish an adequate system for managing this risk.

16. It is necessary for banks to monitor the ratios of collateral coverage of portfolios with commercial and residential real estate, and to review credit policies with particular attention regarding the used loan-to-value (LTV) ratios. In order to take timely risk mitigation measures, it is necessary to review the longest housing and mortgage loan repayment terms, especially when a fixed interest rate is agreed for these exposures. Conservatively set LTV limits can increase the value of the bank's assets and mitigate credit risk in the event of an adjustment of mortgage prices. Limiting the longest contractual term of housing and mortgage loans can mitigate the level of credit and interest risks to which the bank is exposed. Banks' practices in this regard will be subject to enhanced monitoring by the Agency.

17. Using the financing cost reference rate as a variable component of the interest rate in new contracts can mitigate the interest-induced credit risk to which the bank is exposed, increase the level of protection of financial customers and investors, and, if sufficient representation is ensured, mitigate systemic risk. In this context, banks are expected to take account of the use of financing cost reference rate in the coming period, which will ensure a higher level of protection of financial customers and investors against arbitrary changes in the interest rate levels that are not connected with the actual financing costs in the market in BiH.

18. Banks should strengthen their capacities for consistent application of accounting standards. Options embedded in standardised banking contracts, such as the early loan repayment option, early term deposit withdrawal option or interest rate fluctuation limits, need to be valued separately from the underlying contracts, and when valuing investments in instruments measured at fair value, it is necessary to take into account all available market information. The method of discounting cash flows using the effective interest rate, without using relevant market information, is not suitable for determining the fair value of tangible investment portfolios.

19. Uncertainty regarding future macroeconomic trends can result in an insufficient level of formed expected credit losses, internal capital and internal liquidity. When assessing expected credit losses, banks are expected to consider assigning higher probability weights to adverse outcomes, and when carrying out stress tests for the purposes of ICAAP and ILAAP, they are expected to develop particularly severe stress scenarios in order to include as much as possible the effects of the potential materialisation of extraordinary events which occur with a very low probability, but with a large impact on the market and the banking sector.

20. With regard to anti-money laundering standards, banks are expected to consistently apply regulations, adopted national AML/CFT risk assessments in BiH, and guidelines and decisions issued by competent authorities. Activities are underway to adopt a new Law on the Prevention of Money Laundering and Financing of Terrorist Activities, the text of

which is harmonised with the EU Directives and Regulations in the aforementioned field. Considering the possession of expert knowledge in the implementation of measures for the detection of suspicious transactions, where applicable, banks are expected to support, within the framework of available resources, potential initiatives for building the capacities of other reporting entities for the purposes of the implementation of measures for the detection and prevention of money laundering and financing of terrorist activities, in particular the capacities of the parties who perform outsourced professional activities.

21. Due to the growing trend of representation of digitalisation and automation of business processes that rely on the application of information technologies, banks are expected to pay special attention to the identification of information system security risks, including potential attacks from inside and outside the bank's network, and to implement preventive, detective and corrective measures to reduce the risks identified. These measures should at least include an adequate information system risk analysis, the application of controls to protect against „cyber“ risks, and the implementation and testing of the availability of information systems for different scenarios. Taking into account that the aforementioned threats can also be materialised through outsourced activities, we expect banks to regularly verify the adequacy of the service provider's control environments, according to the assessed risk of the outsourced activity, and in accordance with the applicable regulations in the field of outsourcing management.

22. In order to follow the financial customer protection standards, banks should focus particular attention and promote responsible business practices that will contribute to a better understanding of the rights and obligations of financial customers. Appropriate discussions and trainings on the financial customer protection issues need to be updated regularly, regardless of the established practices in applying the existing legislative solutions. Banks must demonstrate that there are ongoing improvement and training processes for staff working on the provision of financial services. Banks are required to ensure the right of complaint and redress to financial customers, and to pay special attention to organising activities of dealing with complaints as well as the timely delivery of adequate responses to the complainants.

23. In cases where, in addition to their own services, banks also offer third-party services to customers in accordance with the Banking Law and other laws, the offer of such services for customers must be clearly, consistently and unambiguously demarcated from the bank's services. The functions that create the bank's internal controls system, as well as the control functions, must pay special attention to proper communication. Risks that may arise due to an inadequate approach to promoting and selling third-party services will be considered a heightened or unacceptable operational risk for the bank. Cases in which financial customers cannot distinguish between the products and services of the bank and the products and services of other parties will be considered gross failures in the internal controls system.

24. Banks should review and improve the process of regulatory and statistical reporting to the Agency. Verification of the internal controls system within this process must be carried out at least quarterly. The development of the regulatory and reporting framework for banks is determined by the strategy for maintaining the equivalence with the EU regulatory framework, resulting in the requirement to submit reports on a larger scale compared to the previous periods. In this context, banks should abandon the practice of individually uploading reports to the Agency's database and implement solutions for automatic data

entry by reporting modules that can contain a large set of individual reports. The Agency has made it possible to enter and verify the correctness of data at the level of the reporting module, and solutions for signing reports with an electronic signature will be implemented in the coming period at the level of the reporting module.

Supervisory Priorities and Activities

25. The Agency analyses risks and priorities in the supervision as a basis for defining supervisory activities in the short and medium term. Priorities serve as guidelines for supervisory teams and promote the effectiveness and consistency of the supervisory planning process. Supervisory priorities are the basis of the supervisory review and evaluation of banks (SREP), taking into account the specific circumstances and risk profile of each individual bank. Based on the analysis of existing and potential risks in the banking sector, the Agency has defined key priorities for 2024:
    a) supervision of funding risk management and reporting on the net stable funding ratio,
    b) supervision of credit risk management,
    c) supervision of internal governance in banks,
    d) supervision of the practices of banks in the financial customer protection segment,
    e) supervision of the degree of execution of measures from previously performed on-site supervisions of credit risk management, liquidity risk management and supervision of the application of the Decision on Temporary Measures to Mitigate the Risk of an Interest Rate Increase,
    f) strengthening the capacities for the exercise of supervision of interest rate risk in the banking book and supervision of the implementation of environmental risk management standards in banks,
    g) supervision of the practices of banks when revising the fee levels in the segment of payment services and basic account negotiating,
    h) supervision of banks' compliance with the provisions of regulations in the segment of anti-money laundering and countering the financing of terrorism standards, and
    i) targeted supervisions of the availability and security of information systems in the event of a „cyber“ attack.

    Targeted supervision will mainly continue with a focus on credit exposures and portfolios that are more sensitive to macroeconomic factors, such as portfolios secured by residential and commercial real estate, and portfolios of small and medium-sized enterprises. The Agency will actively supervise banks' provisioning practices under the IFRS 9 framework. Banks in which significant deficiencies or non-compliances have been identified will be subject to enhanced supervision.

26. A full supervisory review and evaluation process (SREP) will be conducted for eight banks in accordance with the proportionality principle, unless otherwise determined based on significant changes in the business model or risk profile of a bank. Special attention during the conduct of the SREP will be focused on the business model analysis, internal governance and controls, credit risk and interest rate risk in the banking book. The final result of the SREP will be updated scores and capital requirements for banks. For banks that are not covered by the SREP process, an evaluation of the established internal capital and liquidity assessment frameworks, an evaluation of recovery capacity for all banks, and an evaluation of strategies and operational plans for the collection of non-performing exposures for banks whose share of non-performing loans is above 5% of the total loan portfolio will be carried out.

27. The Agency will continue its activities on participation in the implementation of initiatives aimed at the improvement and development of payment systems, and one of such initiatives is the implementation of the fulfilment of the conditions for BiH's admission to the Single Euro Payments Area (SEPA). Taking into account the required maintenance of the equivalence with the EU regulatory framework, activities will continue to further harmonise the regulations in the field of information systems management with the Digital Operational Resilience Act (DORA).

28. In order to limit and mitigate long-term systemic risks arising from the structure and setup of the financial system, which can have serious negative consequences for the banking sector and the economy, the Agency has started activities to strengthen the macroprudential framework for banks. The Agency will review the set thresholds and indicators for setting the structural systemic risk (SyRB) buffer at least annually, and will continue to develop regulatory requirements in the segment of the macroprudential framework and debtor-oriented measures (debt service-to-income ratio - DSTI and loan-to-value ratio - LTV).

Conclusion

29. In the past few years, banks have performed successfully, even in the face of increasing macroeconomic and geopolitical risks. A sound capital and liquidity position and a reduced share of non-performing loans helped banks to face the challenges that arose as a result of the COVID-19 pandemic, disruptions in supply chains, the war in Ukraine and elevated inflation. The resiliency of the banking sector to withstand significant economic shocks was also corroborated by the supervisory stress test that was conducted during 2023. In the medium term, a low growth of economic activity is expected due to the slower recovery of the economies of the EU countries and the slowdown of disinflation, while geopolitical risks may have a further impact on the prices of energy and other dependent raw materials. Estimates of macroeconomic variables are subject to a high degree of uncertainty, which must be taken into account in risk management processes. Any approach to risk planning and management must include the issues of sustainable business and operating in the conditions of significant external changes or disruptions.

30. Digital transformation, as a risk management principle, has become necessary in order to confirm the sustainability of banks' business models in the medium term. Banks are expected to allocate the necessary resources for digital transformation, while protecting themselves from „cyber“ risks and risks arising from outsourced activities, including the risk of concentration of critical services with significant service providers at the level of the banking sector. Banks’ bodies are expected to strengthen the corporate and risk culture within the institutions in order to create preconditions for active management and mitigation of material risks. Systems for managing credit risk, interest rate risk in the banking book and funding risk must be adjusted to cover all potential sources of the these risks, and deficiencies in the systems of internal governance, aggregation and risk reporting need to be remedied without delay. Modern risk management cannot be just a routine or a required activity, and risk management issues must be raised by different management levels in banks. This includes broader discussions on the risks that were not previously identified as material to the operations of a bank.

31. Banks are expected to be transparent in their operations, support the process of financial inclusion and actively participate in initiatives that support the transition of the BiH economy towards carbon neutrality, for which the Agency will provide its full contribution and support. Financial inclusion does not only refer to the price and other approximation of services to socially vulnerable categories of users, but also has a wider significance. Digital financial inclusion includes the development of new business principles that have effects on society, economy, risks and sustainability of banking business.

32. Banks should be able to identify significant exposures to physical and transition risks arising from climate change, and to assess the impact of these risks on the level of credit risk, operational risk and liquidity risk. Banks have been particularly focusing on supporting companies and capital projects of importance for economic development, with sustainable and justified profitability, and broader economic benefits for the economy and citizens.

33. In accordance with the prescribed competences for the supervision of the operations of banks in the Federation of BiH and in cooperation with domestic institutions and international partners, the Agency will continue taking measures and undertaking activities to preserve and strengthen the stability of the banking sector and the protection of depositors, as well as to improve safe, high-quality and legitimate operations of banks in the Federation of BiH. The effective implementation of these measures and activities will depend on the support from the banking sector, which is expected to adapt its visions and long-term planning, and to have regard for the need for corporate social responsibility in the BiH market.

34. The Agency expects that the highlighted risks, attitudes and expectations presented in this document will be covered in the work and considerations of the governance bodies and functions of banks. In accordance with the specific requirements and where relevant, the Agency expects the appropriate practices from banks in relation to these expectations.

THE BANKING AGENCY OF THE FEDERATION OF BIH