VIII. Supervision of Banks and Saving Houses

8.1. Supervision of Banks

8.1.1. Regulatory Framework

In 2000, the reforms of banking sector in Macedonia continued in direction of establishing sound, stable and effective banking system, as a precondition for stable and sustainable development of the Macedonian economy. In this context, of special importance is the enforcement of Banking Law, which represent further approximation of regulatory framework with the European Directives on banking and the so-called 25 Core Principles for Effective Supervision of Banks. The following is expected by implementing this Law and the respective by-laws:

- higher attractiveness of the banking system of Macedonia for foreign investors, especially foreign banking institutions;
- reinforcing the prudent standards and practices in bank activities;
- reinforcing the corporate governance in banks and increase of the efficiency of bank activities;
- reinforcing the supervision of banks, especially in the area of corrective actions conducted for banks with identified irregularities on their operating processes that endanger their stability and safety.

Changes consisted in the Banking Law can be summarized in the following main points:

- precise definition of the Bank and Banking activities, with the bank becoming the only institution regulated by this Law;
- establishing new licensing procedures for new entrants in the banking system of the Republic of Macedonia i.e. establishing two stage licensing procedure, reducing the amount of capital required for conducting foreign payment operation and credit and guarantee operations abroad from DEM 21 million to EURO 9 million denominated in Denars, as well as increasing the right of participation of one shareholder in the ownership structure of the bank from 20% to 1/3;
- reinforcing the supervisory standards that regulates banking operations in order to provide solvent, sound, stable and effective banking system;
- reinforcing corporate governance in banks, by institutionalizing new bodies in the bank and precise definition of relationships among the Assembly, Governing Board, Management Body, Risk Management Board and Auditory Board;
- establishing wide range of corrective actions for auditing and sanctioning the banks where certain operating irregularities are identified, and increasing the effectiveness of 'exit' of bankrupted bank from the banking system of the Republic of Macedonia.

With regard to the Banking Law enactment, in the second half of 2000 intensive activities were undertaken for revision of the supervisory by-laws in order to approximate them with the Basle supervisory standards.

With respect to the banking and financing system regulatory framework, there is an importance of enforcement of some laws, such as: Securities Law, Deposit Insurance Fund Law, Law on Consensual Mortgage and Law on Amendments to the Law on Executive Procedure.

The new Banking Law together with the other legislative solutions in this domain, creates a solid base for improving the banking and financial system in the Republic of Macedonia and hence, increasing the confidence of economic agents in the banking system. Effective use of household saving through the intermediary function of the banking system gives strong growth impulse for the national economy. Henceforth, successful reforms in the banking system are essential for the reforms in the Macedonian economy, as a whole.

8.1.2. Supervisory Function of the National Bank of the Republic of Macedonia

The National Bank of the Republic of Macedonia as a supervisory authority performs its supervisory function in the following levels:

- Licensing function, i.e. processing of requests for issuing licenses and approvals, in accordance with the regulatory framework;
- Examination and off-site surveillance of banks and saving houses operations; and
- Undertaking corrective actions against banks and saving houses in which irregularities have been identified.

In 2000, the National Bank of the Republic of Macedonia, in the frame of its licensing function issued licenses for the saving houses "Moznosti" d.o.o. Skopje and "Zegin Viktorija i drugi" d.o.o. Skopje. Also, a license was issued for opening a representative office of the International Commercial Bank of the Republic of China – Taiwan.

According to the Law on the National Bank of the Republic of Macedonia and the Banks, and Saving Houses Act, and the respective by-laws and supervisory procedures, the National Bank of the Republic of Macedonia conducts on-going surveillance of the banks and saving houses operations through:

- direct (full-scope or limited) supervisory examination of banks and saving houses operations; and
- permanent off-site (regular or reinforced) monitoring of the banks and saving houses operations.

In the frame of the activities for direct examination, in 2000, in total 55 on-site supervisory examinations were carried out, out of which, 23 examinations referred to whole banking institutions operations and 32 examinations were limited. Thus, the on-site supervisory examinations included all operations of 14 banks and 9 saving houses, while limited controls were performed in all banks and 8 saving houses. Limited supervisory examinations of banks and saving houses operations are aimed at checking and verifying the findings they got from off-site monitoring, also they verify the corrective actions undertaken by the National Bank of the Republic of Macedonia.

Other aspect of examination function of the National Bank of the Republic of Macedonia is the permanent off-site monitoring of the banking institutions operations. The auditing of these institutions is carried out through monitoring and regular analysis of the reports submitted by banks and saving houses, and also on the basis of the findings got from the full-scope and limited supervisory examinations. The regular off-site audit represents a fundament for establishing a system of early warning signals, which should alarm for potential problems in banks and saving houses operations since their initial stage. The monthly and quarterly analysis of particular banking institutions operations are the base for measuring the performance of the whole banking system.

When in the banking system of a country several problem banks are identified, the experience shows that most efficient method of dealing with these banks, in organizational aspect, is to locate these banks in a special department. Establishing the Unit for Conservation, Monitoring and Enforcement Actions make it possible for other units of the Supervision Department to continue with their ordinary operations, which cannot response to the needs for reinforced control against institutions that requires a special audit. Simultaneously, the Unit performs reinforced supervisory examination of these banks and suggests corrective measures and actions for quantitative and qualitative improvement of their performances, as well as measures for faster exit from this unit.

With regard to previous experience and Regulatory Instructions for operating of the Unit for Conservation, Monitoring and Enforcement Actions, the following criteria are identified by which a bank might become a subject of a special, reinforced supervisory examination, that is:

- composite rating 4 or 5, confirmed by the last direct examination,
- capital adequacy ratio below 12%,
- identified serious violation of the regulations, and
- liquidity problems of the institution, manifested as sustainable non-liquidity.

At the end of 2000, 8 banks were under examination of this Unit, which showed high risk concentration in their operations, thus from the criteria above where they were considered as a subject of reinforced examination. In the second half of 2000, full-scope on-site examinations were performed in all banks under reinforced supervisory examination, where 3 of them showed improved operating performance, hence their composite rating improved from 4 to 3. If this trend continues in 2001 and these banks confirmed that operate in accordance with principles of safety, stability and supervisory standards, they will be transferred to the On-site Supervision Unit, i.e. the special examination will be replaced with ordinary one. Reinforced permanent monitoring of these banks is carried out through analysis of the ordinary and extra-ordinary reports submitted by these banks, as well as direct supervisory examination, in order to have more effective monitoring of all changes in operating of these institutions and undertaking corrective actions at real time.

At the end of 2000, banks and saving houses in the Republic of Macedonia had the following composite ratings: 1 bank and 2 saving houses had the worst rating "5"; 7 banks and 1 saving house had the composite rating "4"; while 7 banks and 1 saving house had composite rating "3". The composite rating "2" was given to 5 banks and 3 saving houses, but no banking institution got rating "1".

Regarding the supervision of banks and saving houses, the National Bank of the Republic of Macedonia performs inspection of the implementation of the regulations in the field of foreign exchange operations. Hence, in 2000, 130 inspections in total were carried out. Out of them, 14 examinations were for the overall foreign exchange operation, 10 examinations were in separate domains of foreign exchange operations, 14 examinations in foreign currency saving deposits, and the remaining 90 examinations were made in the authorized exchange offices. Often, the partial examinations were focused on monitoring of the implementation of the measures imposed by the National Bank of the Republic of Macedonia, fulfillment of conditions for foreign exchange operations, control of operations with payment cards, foreign exchange market, non-resident accounts, transformation of old to new foreign currency savings, control of the deposited foreign currency savings, control of foreign currency deposits etc.

On-site supervisory examinations and permanent off-site monitoring of banks and saving houses in the Republic of Macedonia in 2000, as well, confirmed the almost identified problem segments of their operations. Namely, yet the most significant are the problems related to the weak quality assets, as a result of weak loan procedures and bank policies, and external implications as well. Problems with the quality of the loan portfolio may have negative impact on the liquidity banking institutions that causes the need for secondary sources of funds. The low quality of loan portfolio has negative impact on bank profitability, in compliance with the inadequate amount of revenues generated from the loan activities of the bank compared to the high level of expenses related to bad loans due to the regulations for holding special reserves for potential losses.

8.2. Structure of the Banking System in the Republic of Macedonia

At the end of 2000, the banking system of the Republic of Macedonia was consisted of 22 banks and 19 saving houses. 17 banks had the so-called full license for conducting foreign payment operations, credit and guarantee operations abroad, while the other 5 banks have only a domestic operations license.

The analysis of the structural shares of the two main segments of the banking system of the Republic of Macedonia in 2000, confirms the domination of banks with a share of 98.6% in total financial potential that represents almost the entire banking system of the Republic of Macedonia. This is as a result of quite limited domain of saving houses operations, which according to the legislation are oriented mostly in operations with households.

The analysis of the structure of banking system in the Republic of Macedonia according to the size of banks' own assets, confirms the conclusions from the previous years about financial potential concentration in some banks. Namely, the five largest banks in the Republic of Macedonia account for 72.4% of total net assets, which compared to December 31, 1999 represents an increase of 1 percentage point. The overall balance and off-balance operations, used as a criteria for the banks' size, also confirm the domination of the five largest banks, whose structural share in the banking system of the Republic of Macedonia, according to this criteria account for 73.7%. At the end of 2000, the five largest banks' portion in the total capital of banking system in the Republic of Macedonia accounts for 51.8%. Comparing to the end of 1999, an increase of 2.9 percentage points of this structural share is registered, or an increase of 9 percentage points if compared to June 30, 2000. Mainly, this is a result of the final capitalization through investments made by foreign investors in two of five largest banks in the second half of 2000.

The process of bank privatization in the Republic of Macedonia, as a component of banking sector reforms, continued in 2000, as well. Thus, at the end of 2000, the level of privatization of banking capital accounts for 83.5%, and compared to December 31, 1999, it is 6.7 percentage points higher. If the state-owned banking institution (Macedonian Bank for Development Promotion) is excluded from the analysis, the level of privatization of the remaining banking capital in the Republic of Macedonia accounts for 87.8%, or 5.5 percentage points higher compared to December 31, 1999. Analyzing banks separately, the level of privatization ranges from 61.5% to 100%. At the end of 2000, 6 banks were 100% private.

In 2000, the entrance of foreign strategic investors in some Macedonian banks is important to be mentioned. The total amount of the foreign capital invested in 2000, is DEM 216.7 million, of which DEM 97.3 million are investments in bank capitalization, while the remaining part was aimed at purchasing shares from the existing shareholders. Thus, the year 2000 is noted as the year with highest foreign investments since the independence of the Republic of Macedonia. Hence, the portion of foreign capital in the total banking capital increased from 19,3% (December 31, 1999) to 40,8% (December 31, 2000). According to the bank-by-bank analysis, the results indicates that the foreign capital is present in 16 banks, ranging from 0.3% to 100%.

From the regional aspect, the structure of the banking system in the Republic of Macedonia confirms its asymmetry and concentration of financial services in the capital city. Namely, out of total number of financial institutions, only 6 banks and 5 saving houses are located out of Skopje, and out of them, only 3 have license to perform foreign payment operations and credit operations abroad. The financial potential of these 11 banking institutions is 11.6% of the total financial potential of the banking system in the Republic of Macedonia and compared to the end of 1999 it remained unchanged.

The existing regional structure is alleviated by the relatively extended network of branches, subsidiaries, counters, operational units and representative offices. At the end of 2000, banks in the Republic of Macedonia had: 20 branches, 89 subsidiaries, 8 operational units, 96 counters and 4 representative offices. The counters of the “Macedonian Post Offices” Public Enterprise should also be mentioned (total of 600 throughout the whole territory of the Republic of Macedonia) that are operated through the “Postenska Stedilnica” saving house.

8.3. Performance and Risk Exposure of the Banking System of the Republic of Macedonia

8.3.1. Credit Risk

The credit risk represents the main risk that the banks of the Republic of Macedonia are facing with. Namely, in the conditions of underdevelopment of the remaining financial instruments, the classical intermediary functions of the banking operations are prevailing. As a result of yet underdeveloped credit policies, procedures and practices, the circumstances of the Macedonian economy, as well as external shocks, the high level of credit risk is present in the banking operations.

The trend of improving the asset quality and reducing the credit risk the banks are exposed to, has stopped in 1999 because of the war in the neighborhood. Thus, in 1999 the share of high risky placements in the bank credit portfolio came back to the level of the end of the first quarter of 1997. However, in 2000 the main ratios for the bank asset quality were improved, so at the end of 2000 they reached the level close to that before the Kosovo crisis.

In December 31, 2000, the total amount of claims and off-balance sheet items classified in risk categories C, D and E was Denar 17,615 million, which represented 34.8% of the total credit exposure, or 94.2% of the total guarantee capital of banks in the Republic of Macedonia. For comparison purposes, this ratio in 1999 amounted to 41.3%, that is 6.5 percentage points higher. The trend of lowering the share of credit exposure classified in the risk categories C, D and E in the guarantee capital of the banking system is more significant, as a result capitalization of Macedonian banks foreign capital inflow in 2000. Namely, in December 31, 2000 this indicator amounted 94.2%, which compared to the end of 1999 (145.3%) if for 51.1 percentage points lower. Such movements in 2000 contributed in lowering the level of the credit risk exposure of banks in the Republic of Macedonia and reaching the level close to that before the Kosovo crisis. It is important to mention that the level of the bad placements in 2000 decreased in line with the trend of increasing total placements that requires improvement of credit procedures and practices of banks. However, the conclusion remains that there is high credit risk of banks in the Republic of Macedonia measured though high level of claims classified in the risk categories C, D and E, which represent an indicator for inefficient allocation of resources in the Macedonian economy.

The analysis of the quality and structure of the credit portfolio, taking into considerations the reserves for credit exposure classified in risk categories C, D and E, shows that the uncovered share of this segment of risk exposure of banks amount to Denar 8,152 million, which represents 16.1% of the total credit portfolio, or 43.6% of the guarantee capital of Macedonian banks in December 31, 2000. If the worst scenario is assumed, meaning no collection of the banks' placements classified in risk categories C, D and E, then 43.6% of the bank guarantee capital should be used for losses coverage.

The average rate of risk of the credit portfolio of banks in the Republic of Macedonia, expressed as a ratio between the observed amount of potential losses and the total credit exposure, equaled 21.4% in December 31, 2000. For comparison, this indicator at the end of 1999 and 1998 was 22.6% and 17.5%, respectively.

8.3.2. Capital Adequacy / Insolvency Risk

The base of banks' stability and safety is the appropriate capitalization, from the aspect of the opportunity to absorb potential losses in case of eventual materialization of risks of operation. This is very important from the aspect of debtors protection, or the depositors in banks and increasing the public confidence in baking system. Only safe and stable banking system, which has the confidence of economic agents, can intermediate efficiently in allocation of resources of the national economy in the way of intensifying the economic development.

The upward trend of the total capital in 2000 results in increase in the level of capitalization and capital adequacy ratio of banking institutions in the Republic of Macedonia. Namely, the bank capitalization ratio in December 31, 2000 amounted 23.3%, which is by 2.6 percentage points higher compared to December 31, 1999.

Similar to the capitalization ratio, in 2000, the indicator that represents the relation between banks' own funds and total amount of banks balance and off-balance sheet activities had positive movements. Hence, at the end of 2000, this indicator amounted 19.9%, which is by 2.6 percentage points higher compared to December 31, 1999.

According to Basle Standards, the ratio of capital adequacy is the most relevant indicator for the level of capitalization of banking institutions. This indicator reflects the capital position of the bank in the best manner, taking into consideration the level of risk undertaken in operations. International standard is established at minimum 8%, which is implemented in the legislative of the Republic of Macedonia.

During 2000, the methodology for calculation of the guarantee capital was supplemented with new capital instruments, as hybrid capital forms and subordinate deposits. In this context, complete compliance was achieved with the structure of guarantee capital by the Basle Agreement for capital and 25 Core Principles for Effective Banking Supervision.

On December 31, 2000 the relation between the total guarantee capital and total risk-weighted assets of Macedonian banks gives a capital adequacy average ratio of 36.7%. On December 31, 2000 the capital adequacy ratio of the five largest banks amounts 26.9% and compared to the capital adequacy average ratio of banking system is 9.8 percentage points lower. The capital adequacy ratio of the two largest banks, which amounts 23.4% is excluded from them, which is 13.3 and 3.5 percentage points lower compared to the average capital adequacy ratio of the banking system and the five largest banks, respectively. The rest of the banks, have the average capital adequacy ratio of 60%, which is by 23.3 percentage points higher compared to the average ratio of the banking system.

Unlike previous years, when the capital adequacy ratio had a smooth downward trend, since the last quarter of 1999, it shows a steady upward trend until the end of 2000. Namely, the capital adequacy ratio on December 31, 2000 compared to December 31, 1999 (when it was at the lowest level) is by 16.5 percentage points higher. Compared to December 1999, this ratio increased by 7.9 percentage points in 2000.

All banks fulfill the required minimum of 8% capitalization in the Republic of Macedonia. Analyzing separately by banks, the lowest level of capital adequacy amounts to 23%. Compared to the average level of capital adequacy, which amounts 36.7%, 6 banks have the capital adequacy ratio under the average, while the rest 16 banks reflect higher average capital adequacy ratio.

8.3.3. Liquidity Risk

The increase in the deposit potential of banks and their capital position in 2000 increased the liquidity of the banking system. The share of liquid assets[25] in the total assets at the end of 2000 amounts to 45.4%, or 6.5 percentage points higher than the previous year. In the structure of the liquid assets accounts in foreign banks have the highest portion (64.8%), of which the largest share are available foreign currency funds or short-term time deposits in foreign banks.

On the side of the sources of funds, the sight deposits and short-term deposits up to three months, at the end of 2000 amounted to 94.2% of total deposits, or 80.7% of total liabilities of banking system, which compared to previous year represent an increase of 11,2 and 15,3 percentage points, respectively. Dynamically, during the whole year the financial potential of the banking system had a steady increase, especially the sight deposits and short-term deposits, that reflects the stability of this sources of funds.

The high level of liquidity of banks in the Republic of Macedonia in 2000 resulted in an excess compulsory reserves hold by banks. At the same time, the banks showed higher interest for Central Bank bills. At the Money market the supply of funds was higher than the demand, which resulted in with a decline of the average interest rate. In the conditions of high liquidity of banking system, the instruments of intervention defined as a last resort were used only from few banks in order to overcome the short-run liquidity problems. However, their influence on the regulation of liquidity of banking system was insignificant.

8.3.4. Analysis of the Profitability of the Banks in the Republic of Macedonia and Evaluation of their Efficiency

According to the 2000 final financial statement, the banks in the Republic of Macedonia reflected a net profit of Denar 645 million, which compared to 1999 represents an increase of Denar 142 million, or by 28.3%.

Also, we have to take into consideration that in 2000 the analysis of the structural components of the aggregate income statement of Macedonian banks, based on provisions, show negative net interest income of Denar 328 million. Regardless of the fact that the financial result achieved through the basic bank function (intermediate between financial-surplus and financial-deficit economic agents) with calculated expenses for potential losses from credit risk is negative, though in 2000, there was a downward trend of the expressed negative net interest income based on provision. Thus, the aggregate income statement of Macedonian banks on December 31, 2000 showed negative net interest income based on provisions of Denar 1,268 million. If the analysis the non-allocated reserves for potential loan

[25] Money funds and balances at the National Bank of the Republic of Macedonia, securities with the National Bank of Republic of Macedonia rediscount, checks and deposits at the accounts of domestic and foreign banks with three months maturity.

losses (including and the additionally calculated non-functional interest) identified during the on-site supervisory examinations in amount of Denar 313 million are taken into account, and are not reflected in the income statement, then the net interest income reaches a negative amount of Denar 641 million.

Out of total 22 banks in the banking system of the Republic of Macedonia as of December 31, 2000, 18 banks achieved positive financial result, while the other 4 banks reflects loss in their income statement. Compared to December 31, 2000 the financial results has improved in half of the banks in the Republic of Macedonia, and deteriorated in the other half.

The rate of Return on Assets (ROA), is quantified as a relation between the net profit of banks for 2000 and their average assets for the same period, amounts to 0.8%, which compared to December 31, 1999 represent an unchanged profitability of the Macedonian banks. In accordance with the international standards, the rate of Return on Assets should be above 1%.

The rate of Return on Equity (ROE), quantified as a relation between the net profit of banks for 2000 and their average capital for the same period, amounts to 3.8%. Even though there is evident increase of 0.3 percentage points, compared to December 31, 1999, the conclusion for low performance of Macedonian banks profitability holds yet. The international standards for this indicator ranges from 5% to 10%.

Another indicator that reflects the profitability potential and the efficiency of banks is the relation between the operating expenses and the total revenue. As of December 31, 2000 this ratio was 0.83 meaning that Denar 0.83 of operating expenses generated an income of Denar 1. In addition, in the same period, Denar 0.39 of expenses for wages generated income of Denar 1.

The ratio between the expenditures made for provisions for potential losses and the net interest income is 1,13 and shows negative margin of accomplishing net interest income, i.e. for producing Denar 1 interest income in 2000, Macedonian banks made Denar 1,13 expenditures based on provisions for covering credit risk on the placements made.

Improved liquidity of the banikg system in the Republic of Macedonia in 2000 resulted in a decline in banks' interest rates. Namely, the average nominal lending interest rates amounted to 18.9% (1.6 percentage points lower compared to 1999), while the nominal deposit interest rates on average amounted to 11.2% on annual basis (0.3 percentage points lower compared to 1999). Such movements of interest rates cause a reduction of the interest margin by 1.3 percentage points, which in 2000 amounted to 7.7 percentage points, on average. Even though the downward trend is present, the interest margins are still high compared to the other economies in transition and represents an indicator for low efficiency of banks in the Republic of Macedonia.

The reforms performed and the presence of foreign strategic investors in the banking system of the Republic of Macedonia, are real preconditions for improving the performance of the banking system. This should provide further reduction of interest rates and larger credit support for the Macedonian economy.