BSCEE

Review

2004

Group of Banking Supervisors from Central and Eastern Europe

Published by the Secretariat of BSCEE
Address: H-1013 Budapest, Krisztina krt. 39.

Edited by Andrea Deák
Designed by Tibor Rencsényi

INTRODUCTION

The Group of Banking Supervisors from Central and Eastern Europe (the BSCEE Group) was established in 1990. The Agreement of the BSCEE Group was signed during the Stockholm International Conference of Banking Supervisors (ICBS) in 1996. The BSCEE Group is operating according to its Agreement that determines its organizational structure and the rules governing its operations. As of today the Agreement is signed by nineteen member countries: Albania, Republic of Belarus, Federation of Bosnia and Herzegovina (2002), Bulgaria, Croatia (1996), Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Serbia and Montenegro (Central Bank of Montenegro – 2004), Slovakia, Slovenia and Ukraine. The Chairmanship of the BSCEE Group rotates on annual basis. In 2003 Mr. Andres Trink, Chairman of the Management Board of the Estonian Financial Supervision Authority chaired the Group.

The function of the Secretariat of the BSCEE Group also rotated on an annual basis until 1996. In 1996 the BSCEE Group entered into an agreement setting out a framework for cooperation and coordination in organizing common events. The primary role of the Secretariat is to provide technical assistance in organizing conferences, leaders' meetings, workshops, and training seminars. The Secretariat also facilitates cooperation among the member countries as well as provides documents for their work. The permanent Secretariat of the Group is located in Budapest, at the Hungarian Financial Supervisory Authority (HFSA).

According to the previous years practice the Annual Review of the BSCEE Group summarizes the developments of the member countries in 2003. This publication gives an overview of the macroeconomic circumstances in the 19 member states, and it describes the banking sector as well as the supervisory activities. It was prepared on the basis of the information given by the member countries. The Annual Review also summarizes the main events of the BSCEE Group, including two regional workshops co-organized by the Bank of International Settlement (BIS) and the Financial Stability Institute (FSI) and by the BSCEE Group. The 16th Annual Conference was organized by the Estonian Financial Supervision Authority in Tallin, Estonia on the 29-30th of May 2003.

This Annual Report intends to provide in-depth information reflecting the mission of the BSCEE Group in a detailed and accurate manner regarding the banking sector of the member countries.

I hope that you will consider this publication informative and useful. I am sure that this will help you to become acquainted with our supervisory job in the Central and Eastern European region, the cooperation among the supervisory authorities of the member countries and with the Basle Committee.

Deák Andrea

Senior Coordinator
of the Secretariat

CONTENTS

2003 DEVELOPMENTS IN THE BANKING SYSTEM
OF THE MEMBER COUNTRIES

2003 DEVELOPMENTS IN THE BANKING SYSTEM OF THE MEMBER COUNTRIES

2003 DEVELOPMENTS IN THE ALBANIAN BANKING SYSTEM

MACROECONOMIC ENVIROMENT

The compliance with the main macroeconomic objectives settled by the mid-term poverty reduction and economic growth program enabled the sustainability of the domestic macroeconomic equilibrium during 2003.

The year 2003 left the impression that the Albanian economy experienced a recovered pulse of economic growth. Preliminary economic evaluations revealed a 6 per cent growth of Gross Domestic Product during 2003, compared to 4.7 per cent marked in 2002. The pick up in the economic activity was proved by all sectors of economy, but it was particularly evidenced in the construction, transport and service sector. The economic progress was additionally amplified by the investment growth, which amounted to 22.3 per cent of GDP, reflecting a 0.3 per cent growth compared to 2002. Investments in the private sector, which counted for 75 per cent of total investments, were highly backed up financially by the banking system. The outstanding credit extended during 2003 grew by ALL[1] 11.9 billions, equivalently to 30.7 per cent.

The labor market activity evidenced a slight upturn, highlighting an increase in the number of employed persons. Nevertheless, the transition phenomena: emigration and informal economy contracted the employment potential as well as shadowed the effect of employment and economic development strategies. The unemployment rate registered in 2003 was 15 per cent, 0.8 per cent lower then in 2002.

The inflation rate remained within the monetary policy objective, marking 3.3 per cent in December 2003, while the consumer price experienced a 2.37 per cent growth on average.

The general control of demand pressures through effective monetary and fiscal policies contributed to maintain a low inflation rate throughout the year.

Developments in public finances during 2003 were characterized by a rational distribution of fiscal expenditures. The government demand to raise funds was dispersed more uniformly throughout the year, condensing the concentration of deficit financing at year-end. Moreover, the local elections of October and the irritated political climate during the second half of the year were not accompanied by any expenditure concentration or any other infringement of the fiscal discipline. These specifics, along with the limitation of government domestic borrowing to 2.7 per cent of GDP, enhanced the fiscal policy contribution to macroeconomic stability and particularly to price stability. Nevertheless, the

[1] *ALL: Albanian Lek

Achilles' heel remained the revenue collection, which reckoned 93 per cent of the forecasted incomes, and especially the capital expenditures which resulted only in 62 per cent of the projected amount.

Year 2003 saw favorable developments in the foreign sector of economy, underscoring the substantial increase in the current incomes and expenditures. The current account deficit was evaluated to count 6.7 per cent of GDP, revealing a decrease of 2 per cent vis-à-vis the deficit in 2002. Yet to be mentioned, the trade deficit keeps increasing in absolute terms. It reflects the augmented domestic consumption, which urges the need to expand the production capacity and competition of the Albanian economy. Nevertheless, the positive developments in the balance of payments brought about a continuous increase of foreign exchange reserves. The level of foreign exchange reserves recorded USD1 billion for the first time in December 2003, ending up to USD 1.026 billion at the end of December 2003.

BANKING SYSTEM DEVELOPMENTS

The banking market presented significant developments during 2003, well-supported by a good macroeconomic environment. The entry of two new banks and the Savings Bank's privatization from a strong investor headquartered in an EU member country, set the ground for a higher productivity and competition in the system.

Banking system assets, their structure and quality

Total assets of the banking system totaled up to lek 34.3 billion or 10.1 per cent compared to the end of 2002. This growth is attributed not only to the "treasury and interbank transactions" but also to the "lending activity", as well as to "investments in securities". "Treasury and interbank transactions" increased by lek 12.3 billion. "Lending activity" increased by lek 11.9 billion, whereas "investments in securities" increased by lek 3.4 billion. The higher contribution of the last two items shows that banking transactions are expanding towards more effective activities.

Total assets, its trend in years

Indicator in billion Lek	December '99	December '00	December '01	December '02	December '03
Total assets	249.5	270.8	318.5	339.3	373.6
In % of the GDP	49.2	50.2	53.5	51.6	50.2[2]

[2] The lower weight is explained through the application of the new calculating method of the estimated GDP.

In the analysis as to the bank groups of the system[3], compared to the end of 2002, the state-owned capital banks group (G1) marked a rise of about lek 10.4 billion of total assets; the group of banks of joint capital (G2) had a rise of lek 0.86 billion and the group of banks of private capital (G3) had a rise of lek 23.1 billion. The satisfactory growth of the private banks group, the growth of which surpasses twice as much that of the two other groups, shows the private management efficiency even in the banking industry.

Lending activity

Compared to 2002, the new extended credit during 2003 mounted to lek 92.7 billion, or about 1.5 times higher, while the credit balance rose by lek 11.9 billion (or 30.5 per cent).

The weight of short-term loans has been going down since mid-term and long-term loans increased; however, extension rate of short-term loans remains still high.

The credit balance in lek has a lower weight versus the total credit, a performance that differs from that of 2002.

Assets quality

The indicator "bad loans/credit balance (gross), considered as the main indicator of the quality of this portfolio, was in a downward trend during 2003. The decline of this indicator is due to a lower growth rate of bad loans versus credit balance. Thus, credit balance increased by 30.5 per cent by the end of 2002; bad loans increased only by 8.2 per cent compared to the same period.

The credit classification performance as presented in the following table, shows an enhanced portfolio quality by the end of 2003.

Credit classification

Credit classification (in % versus credit balance)	First quarter'03	Second quarter'03	Third quarter'03	Fourth quarter'03
Standard credits	90.3	91.8	91.6	92.3
Special mention credits	3.6	3.0	3.2	3.1
Sub-standard credits	2.5	2.3	2.4	1.9
Doubtful credits	0.2	0.2	0.3	0.5
Lost credits	3.4	2.6	2.5	2.1

[3] While the privatization of the Savings Bank is now *de facto*, its capital is still state-owned and *de jure* under transfer process.

Efficiency

The financial result of the banking system was positive and satisfactory by the end of 2003. Net incomes were about lek 4.45 billion or 0.6 per cent of GDP. Compared to the end of 2002, net incomes are lek 0.6 billion or 14.4 per cent higher (in real terms, this rise is estimated to be 11.4 per cent). Net incomes from the main activity of the banking system were lek 13.3 billion. Compared to the end of 2002, net incomes increased by lek 2.1 billion or 18.8 per cent. From these, 84 per cent belong to net incomes from interests, which still are the main contributors in net incomes. The rest comes mainly from commissions and foreign exchange.

The outcome of policies and bank management decisions is reflected in profitability indicators. The positive value of ROA of about 1.24 per cent shows the banking system ability to operate generally with profit; the high level of ROE of about 19.5 per cent shows the possibility of investments to rise.

Capital adequacy

By the end of 2003, the system's shareholder capital was lek 22 billion, or lek 0.4 billion more than in 2002. Paid-up capital, which constitutes the main element of the shareholder's capital, had a considerable growth of 27.5 per cent or about lek 4 billion[4]. This element is most influential in the shareholder's capital apart from earnings over the year. However, the revaluation differences due to USD depreciation versus lek had significant negative impact[5]. Capital adequacy ratio was 28.5 per cent by the end of 2003, from 31.6 per cent it was in 2002. The level of regulatory capital and that of risk-classified assets rose respectively by 1.2 per cent (lek 207 billion) and 12.2 per cent (lek 6.8 billion). Precisely, the higher growth rates of risk classified assets explain the fall of capital adequacy ratio.

Liquidity

Liquidity analysis is based on the analysis of its main indicators[6]: liquidity, maturity gaps and credit/deposit ratio. By the end of 2003, liquid assets ratio17 in total assets of the banking system resulted at a satisfactory level, over 30 per cent.

The above-mentioned indicator is backed up also by the "short-term assets/ short-term liabilities" ratio, which in the banking system resulted 107.1 per cent, or 25.8 percentage points lower than the end of 2002. This is considered a satisfactory indicator in the banking system, however in decline because of the high growth rates of short-term liabilities (26.4 per cent or lek 29.5 billion) compared to short-term assets (1.9 per cent or lek 2.8 billion).

---

4 The augmentation of paid-in capital is due to the entrance of two new banks in the system, and the rise of the capital of some other banks.

5 Debit differences of capital re-assessment in 2003 had negative impacts on some of the banks, the core capital level of which was lower than the minimum required capital.

6 These ratios are liquid assets versus total assets and short-term assets versus short-term liabilities.

STATISTICAL TABLES

**Number of financial institutions
(at year-ends)**

Type of financial institutions	2001	2002	2003
Bank	13	13	15
Non-banking financial institution	4	5	7
Savings and credit association	N.A	127	136
Financial institution, total	**17**	**145**	**158**

**Ownership structure of financial institutions (banks)
on the basis of registered capital (%)
(at year-ends)**

Item	2001	2002	2003
Public sector ownership	13.9	13.5	10.0
Other domestic ownership			4.0
Domestic ownership total	*13.9*	*13.5*	*14.0*
Foreign ownership (private banks)	72.7	73.6	76.0
Other foreign ownership (joint-venture)	13.4	12.9	10.0
Foreign ownership total	*86.1*	*86.5*	*86.0*
Banks, total	**100.0**	**100.0**	**100.0**

**Ownership structure of financial institutions (banks)
on the basis of total assets (%)
(at year-ends)**

Item	2001	2002	2003
Public sector ownership (100%)	59.0	54.0	52.0
Other domestic ownership			1.0
Domestic ownership total	*59.0*	*54.0*	*53.0*
Foreign ownership (private banks) 100%	35.0	40.0	42.0
Other foreign ownership (joint-venture)	6.0	6.0	5.0
Foreign ownership total	*41.0*	*46.0*	*47.0*
Banks, total	**100.0**	**100.0**	**100.0**

Concentration of assets by the type of financial institutions (%)

Type of financial institutions	The first 3 largest	The first 5 largest
Bank	70	85

Return on assets (ROA) by type of financial institutions

Type of financial institutions	2001	2002	2003
Bank	1.50	1.20	1.24

Return on equity (ROE) by type of financial institutions

Type of financial institutions	2001	2002	2003
Bank	21.60	19.20	19.50

Distribution of market shares in balance sheet total (%)

Type of banks	2001	2002	2003
G1 (< 2 % of total banks assets)	3.0	3.8	4.6
G2 (2 % – 7% of total banks assets)	28.2	10.4	10.6
G3 (> 7% of total banks assets)	68.8	85.8	84.8
Banks, total	**100.0**	**100.0**	**100.0**

**based on assets*

The structure of assets and liabilities of the banking system (%) (at year-ends)

Assets	2001	2002	2003
1. Treasury operations and interbank	85.7	80.6	76.5
2. Operations with customers (net)*	8.6	11.4	13.5
3. Securities transactions (net)	3.3	4.9	5.4
4. Other assets	0.4	0.9	0.8
5. Fixed assets	1.8	1.8	1.5
Total accrued interest	0.3	0.5	2.6
Liabilities and shareholders' equity	**2001**	**2002**	**2003**
1. Treasury operations and interbank transactions	3.6	5.3	4.4
2. Operations with customers	86.2	84.0	87.5
3. Securities transactions	0.0	0.0	0.0
4. Other liabilities	3.0	2.9	0.7
5. Permanent resources	6.2	6.7	6.2
Total accrued interest	1.1	1.2	1.2

** Since 2002 this class on the balance sheet has been expressed on the gross basis (without deduction of the provisions)*

Development of off-balance sheet activities (%) (off balance sheet items / balance sheet total)

Type of financial institutions	2001	2002	2003
Bank	3.5	13.8	7.4

Solvency ratio of banks

Type of financial institutions	2001	2002	2003
Bank	35.3	31.6	28.5

Asset portfolio quality of the banking system (%)

Asset classification	2001	2002	2003
Standard	88.3	89.9	92.3
Special mentioned	4.6	4.6	3.1
Substandard	4.0	3.0	1.9
Doubtful	1.7	0.7	0.5
Loss	1.3	1.8	2.1
Overdue loans/total of loans	6.9	5.6	4.6
Classified total	**100.0**	**100.0**	**100.0**
Provisions	**4.4**	**4.2**	**4.3**

The structure of deposits and loans (at year-end)

Type of deposits	as a % of total deposits	Loans	as a % of total loans
Current accounts	12.3	Short term loans	40.3
Demand deposits	3.4	Medium term loans	29.6
Time deposits	81.6	Long term loans	9.2
Other deposits	2.5	Real estate loans	15.6
Certificates of deposits	0.2	Leasing contracts	0.0
		Other loans	5.3
Classified total	**100.0**		**100.0**
Public sector deposits	5.8	Public sector loans	0.3
Private sector deposits	8.3	Private sector loans	75.2
Households and others	85.9	Households and others	24.5
Classified total	**100.0**		**100.0**
Deposits in leks	69.7	Loans extended in leks	17.9
Deposits in foreign currency	30.3	Loans extended in foreign currency	82.1
Classified total	**100.0**		**100.0**

The structure of deposits by final maturity (%) (at year-end)

Maturity of deposits	as a % of total deposits
At sight	37.0
Within one year	62.5
Over one year	0.5
Total	**100.0**

Proportion of foreign exchange assets and liabilities (at year ends)

	FOREX assets/Total assets			FOREX liabilities/Total liab&equity capital		
Type of financial institutions	2001	2002	2003	2001	2002	2003
Bank	37.6	37.5	36.3	37.2	36.9	35.9

Structure of incomes and expenses of banks

(in million of Lek)

Items	2001	2002	2003
I. Total interest income	**22,410.8**	**23,538.1**	**27,838.0**
Treasury and interbank transactions	3,490.9	2,581.5	2,203.5
Interest received from customers	2,223.1	2,981.6	3,885.1
Interest received from securities	16,683.9	17,957.4	20,980.7
Other interest received	13.0	17.6	768.7
II. Total interest expenses	**13,472.3**	**14,690.8**	**16,687.8**
Interest expenses on treasury and interbank transactions	289.9	508.8	173.8
Interest paid to customers	13,111.8	13,915.4	16,150.8
Interest expenses on securities	8.5	126.0	230.7
Other interest expenses	62.1	140.5	132.5
Net interest income (I-II)	**8,938.5**	**8,847.3**	**11,150.2**
Noninterest income	3,679.5	3,361.7	3,277.1
Noninterest expenses	1,568.8	971.3	1,078.9
Net noninterest income	**2,110.7**	**2,390.5**	**2,198.1**
Provisioning expenses	681.3	1,062.9	907.9
Gross operating income	**10,367.9**	**10,174.9**	**12,440.5**
Overhead expenses	4,796.8	5,562.0	6,066.5
of which: personnel expenses	1,964.2	2,328.9	2,423.2
Net operating income	**5,571.1**	**4,612.8**	**6,373.9**
Net extraordinary income (loss)	59.4	423.4	(116.5)
Taxes other than income taxes	49.8	47.6	41.1
Net income (loss) before tax	**5,580.7**	**4,988.6**	**6,216.3**
Income tax	1,299.3	1,094.7	1,761.3
Net income (loss) after tax	**4,281.4**	**3,894.0**	**4,454.9**

Structure of registered capital and own funds of banks in 2003

(in mio of EUR)

Type of financial institutions	Registered capital	/Total assets	Own funds	/Total liabilities
	in mio of EUR	%	in mio of EUR	%
Bank	137.8	5.0	163.7	5.9

Note: Rate of exchange EUR/Lek =134.32

2003 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF BELARUS

MACROECONOMIC ENVIRONMENT

Compared with 2002, the economic situation in 2003, on the whole, was characterized by deceleration of inflationary and devaluation processes, higher rates of GDP growth, production of goods and services in most industries, investment in fixed capital, and foreign trade. Based on the results of performance in 2003, the Republic of Belarus joined the group of countries with a high pace of economic growth.

GDP in 2003 in current prices amounted to BYR35.9 trillion, a 6.8% increase in comparable prices relative to 2002, the target for the year being 6-6.5% (in 2002 GDP grew by 5%).

Industrial output grew in comparable prices by 6.8% and consumer goods production by 7.3%. Agricultural produce in 2003 increased by 6.8% compared with 2002 . Major contributors to production growth were rather favorable, on the whole, foreign economic conditions which promoted exports as well as an increase in domestic demand (higher expenditure for final consumption and gross savings).

Production of goods and services was increasing with simultaneous reduction in the number of employed which indicates that intensive factors of growth were effective. Productivity (relative to GDP) in 2003 grew by an estimated 8.5%.

Investment in fixed capital increased in comparable prices by 17.7% relative to 2002.

In the budgetary sector, efforts continued to cut and streamline overall public expenses while the budget was still socially-oriented.

Preliminary data from the Ministry of Finance of the Republic of Belarus suggest that the republican budget in 2003 ran a BYR579.5 billion deficit (1.6% of GDP), the target being BYR974.2 billion.

Households' real monetary income grew by 3.4% compared with 2002. Higher incomes facilitated the expansion of consumer demand which boosted retail trade and paid services to the general public. Retail trade turnover increased by 9.9% and services by 11.1%.

In 2003, the tendency to higher propensity to save by households persisted. The share of households' income used for purchasing goods and paying for services in the monetary income employment pattern was 71.7% versus 74% in 2002. Households' savings in deposits and securities in the monetary income employment pattern grew by 0.9 percentage point compared with 2002, amounting to 4%.

Financial condition of enterprises in 2003 was somewhat better than in 2002. Balance sheet profit in the economy at large grew in real terms by 11.4% and proceeds from sale of goods by 13.4%.

There was a certain positive shift in the dynamics of product profitability – it grew by 0.6 percentage point with respect to 2002, amounting to 9.1%. The share of loss making enterprises dropped from 32 to 27.2%.

Trends towards reducing the real amount of accounts receivable and accounts payable persisted.

As at December 31, 2003, there were 136.1 thousand registered unemployed in the country (or 3.1% of economically active population) compared with 130.5 thousand a year ago.

Consumer price index grew in December 2003 by 25.4% versus December 2002 (or by 1.9% on average for a month compared with 2.5% in 2002), inflation rate in 2003 being the lowest in the past 12 months.

DEVELOPMENT OF THE BANKING SYSTEM

As of January 1, 2004, the banking system of the Republic of Belarus included 30 banks operating under normal conditions. In 2003, three new banks were registered, i.e. Open Joint-Stock Company «Mezhdunarodny Bank Economicheskogo Sotrudnichestva» («International Bank for Economic Cooperation»), Closed Joint-Stock Company «Joint-Stock Commercial Bank «Belrosbank»» and Open Joint-Stock Company «Joint-Stock Commercial Bank «Raton»» (located in the free economic zone «Gomel»). Open Joint-Stock Company «Torgovo-Promyshlenny Bank» was liquidated by affiliation with Open Joint-Stock Company «Tekhnobank». As a result, in the previous year the number of operating banks increased by two (in 2002, by three). The number of banks' affiliates reduced during the previous year by three affiliates (in 2002, by 29 affiliates) amounting by the end of 2003 to 473.

11 foreign banks have their representative offices in the Republic of Belarus (4 Latvian, 3 Russian, 1 German, 1 Polish, 1 Lithuanian and 1 established by the CIS Interstate Bank). There were no changes in the number of representative offices in the previous year.

In 2003, the gross assets of the banking system increased by BYR5,906.3 billion in nominal terms, or by 53.8% (in 2002, by 66.0%) and as of January 1, 2004, amounted to BYR16,882.2 billion, or the equivalent of USD7.83 billion. The growth of the gross assets in real terms in 2003 amounted to 22.6% (in 2002, to 23.1%). In the dollar equivalent the increase in the gross assets during the year amounted to 2.11 billion.

«Gross assets/GDP ratio» macroeconomic indicator increased during the year from 42.0% to 47.0% evidencing a quicker growth of the banking sector in relation to the rate of growth of the national economy as a whole.

In 2003, the net assets increased by BYR3,876.0 billion, or by 57.8%, and amounted to BYR10,585.5 billion, including a BYR3,286.1 billion (64.1%) increase in the income bearing-assets which amounted to BYR8,410.8 billion.

The share of the income-bearing assets in the net assets amounted to 79.5% in the system on average. This indicator has been growing steadily in recent years evidencing a qualitative improvement in the banking system's assets. By the end of 2003, the net assets of the national banking system amounted to the equivalent of USD4.9 billion.

In 2003, «net assets/GDP ratio» macroeconomic indicator increased from 25.7% to 29.5%, or by 3.8% (in 2002, this indicator decreased by 0.6%).

As mentioned above, in 2003 the banks' aggregate authorized capital increased in nominal terms by 77.3% (in 2002, by 2.6 times). The increase in real terms (adjusted for inflation) amounted to 41.4%. As of January 1, 2004, aggregate authorized capital of the banking system amounted to BYR1,446.6 billion, or the equivalent of USD670.9 million.

In the previous year, the volume of the banking system's own capital increased in real terms (adjusted for inflation) by 41.2%, the increase in nominal terms being 77.0% (in 2002, by 2 times) and as of January 1, 2004, amounted to BYR2,147.2 billion (or the equivalent of USD995.9 million, or EUR796.7 million).

Investments in the banks' authorized capital were the main source of capital build-up in the banking system as a whole.

The resource base increased in nominal terms by 59.4% and in real terms by 27.1% in the banking system as a whole.

Authorized capital of 25 banks was formed with participation of foreign investments. In 2003, their total share in the aggregate authorized capital ranged from 8% to13%, but by the end of the year it reduced slightly (up to 7.52%) due to major state investments in the banking system.

The banks' profits in 2003 amounted to BYR131.5 billion (in 2002, to BYR53.7 billion). All banks except one enjoyed profit at the end of the year.

The following indicators of the banking system's profitability grew in 2003: «profit/authorized capital ratio» – by 3.49 percentage points; «profit/assets ratio» - by 0.55 percentage point and «profit/own capital ratio» - by 1.69 percentage points.

As of January 1, 2004, problem credits (including inter-bank credits) amounted to 3.66% of the total amount of credits. Problem debts of all Belarusian banks except one are less than 5.0%. Eight banks had no problem debts at all.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS

In accordance with the IMF recommendations and based on the Core Principles of Effective Banking Supervision, established by the Basel Committee on Banking Supervision, the Instructions on the procedures for market risks evaluation and calculation and reworded Instructions on the procedures for open currency position maintenance were developed. Amendments and modifications have also been made to other regulatory legal acts that govern the activities of banks and non-bank credit and financial institutions of the Republic of Belarus. As a result of these, banks, in carrying out their activities, will be able to reflect more accurately the risks related to banking operations, evaluate the probability of and reasons for emergence of critical situations in their activity and develop mechanisms that minimize their negative consequences.

Work related to the establishment of unified requirements to the regulation of banking activities within the framework of the Belarusian and Russian legislation was carried on.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2003

Self-evaluation of the compliance of the Belarusian banking supervision with the international standards was carried out and its shortcomings and weaknesses were revealed, as well as strategic documents regarding its improvement in the medium term – the Concept of Republic of Belarus Banking Supervision Development and Improvement and the Plan of Actions to Introduce International Banking Supervision Standards - were devised.

Banking supervision procedures are being streamlined. Best practices of performing qualitative risk-oriented supervision based on switching from the formal control over the attainment of numerical values specified in prudential norms to the qualitative assessment of financial condition and prospects of banks' development have been implemented. In doing so, the criteria which could not be formalized and mathematically estimated and which characterize the quality of a bank's management, the condition of internal control systems and the extent to which a bank's assessment of risks correspond to their actual state have been used.

New methods regarding evaluation of the banks' financial condition on the basis of their reports and accounting of inspections findings, which are based on the international experience, were developed and implemented.

In 2003, specialists of the National Bank of the Republic of Belarus carried out 12 comprehensive inspections of Belarusian banks.

In 2003, the National Bank of the Republic of Belarus examined to what extent and how effectively all Belarusian banks that had problem debts used their legal rights to recover such debts. Out of 29 banks registered at the time in the Republic of Belarus 22 banks (including 478 affiliates thereof) were examined.

During the year, for breach of banking legislation banks were fined in the amount of BYR203.1 million.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

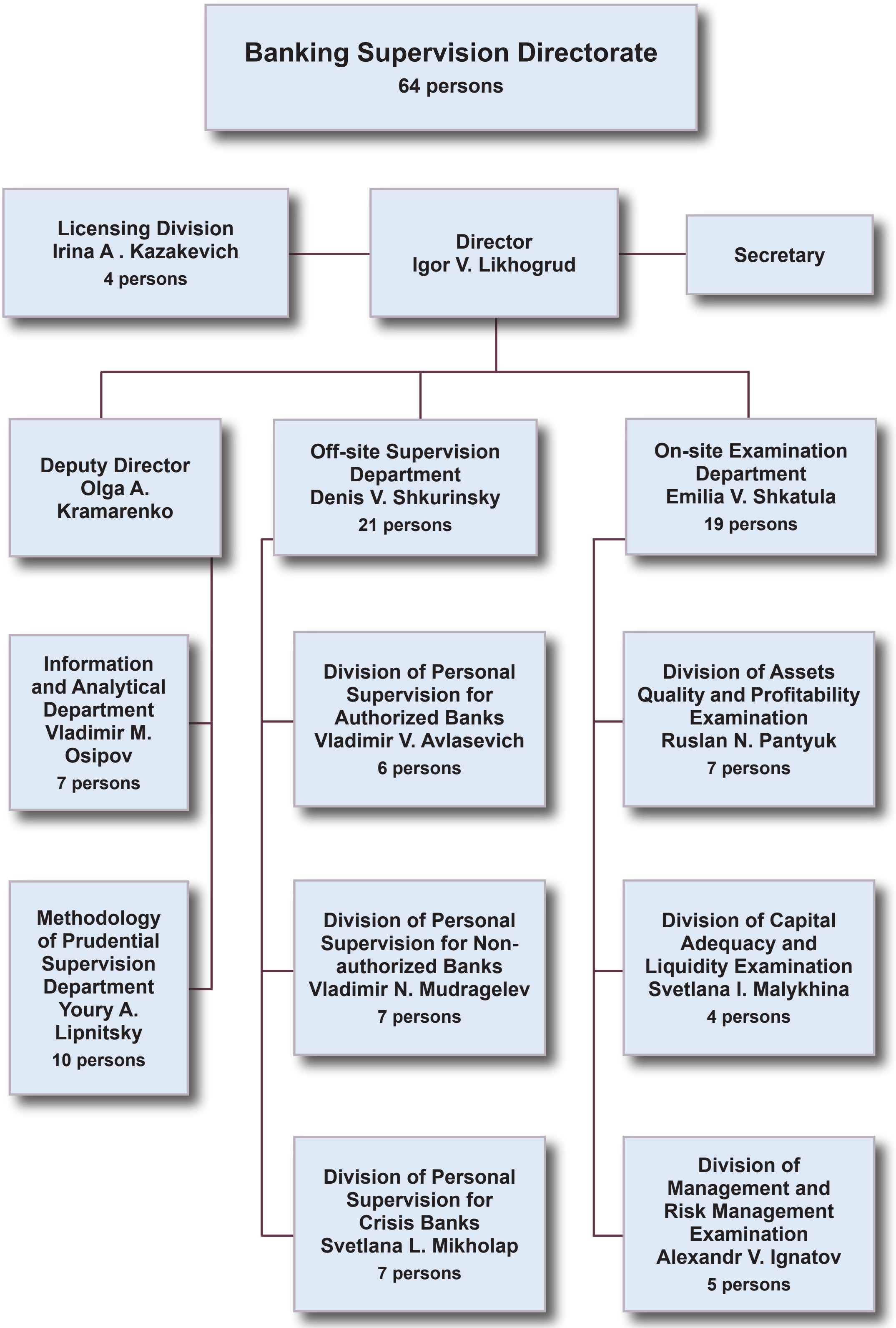
In the Republic of Belarus the function of supervision is assigned to the central bank of the country – the National Bank, which incorporates a division specializing in said issues, i.e.the Banking Supervision Directorate.

In carrying out banking supervision in the Republic of Belarus, the National Bank carries out the following functions:

- State registration of banks, licensing of banking activity,
- Development of prescribed economic standards for maintaining stability and soundness of the banking system,
- Development of rules and procedures for banking operations,
- Identification of infringements of banking legislation and application of sanctions therefor,
- Establishment and exercise of currency control,
- Determination of publication rules and contents of information being published used for assessing the degree of reliability of banks and non-bank financial institutions,
- Review of bank reports,
- Regulation of foreign capital admission to the banking system of the country,
- Regulation of banks' reorganization and liquidation, and
- Involvement in ensuring the return of funds attracted by banks to natural persons.

The majority of the above functions is carried out by the Banking Supervision Directorate, whose new structure was approved in April 2001.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISION DIRECTORATE



INTERNATIONAL COOPERATION OF THE SUPERVISORY AUTHORITY

In 2003, the specialists of the Banking Supervision Directorate of the National Bank of the Republic of Belarus attended 17 international workshops, conferences and meetings on supervisory issues in eight countries (Russia, Austria, Poland, Czech Republic, France, Germany, Estonia and the USA).

Unification of principles, instruments and mechanisms of performing banking supervision in the Republic of Belarus and Russian Federation was carried on. In particular, the regulatory base of executing mutual control over investments in the authorized capital of the Belarusian and Russian banks was modified.

In December 2003, the IMF mission visited the National Bank of the Republic of Belarus to provide technical assistance in banking supervision. Following the mission, the report «Belarus. Health of the Banking System, Bank Supervision and Bank Restructuring» was prepared.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

In carrying out its functions of banking supervision, the National Bank cooperates on a regular basis with the Ministry of Internal Affairs, the Office of Public Prosecutor, the Committee of State Control, financial investigation bodies, and tax authorities.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2003

In 2003, the main strategic objectives of the Banking Supervision Directorate were the maintenance of stability of the banking system of the Republic of Belarus and protection of the banks' depositors and creditors.

The above-mentioned objectives were achieved through:

- ensuring that only conscientious and financially stable investors with good reputation had access to the banking system;
- ensuring that the banks' top managers had adequate professional skills and reputation;
- setting up prudential restrictions regarding banking risks and capital and reserves adequacy requirements which comply with the international practice and take into account economic situation in the country;
- execution of the effective day-to-day supervision of banks' activities by analyzing official reports and carrying out inspections in banks;
- timely application of corrective measures which ensure solvency, liquidity and reliability of banks; and

- timely removal of banks whose condition cannot be improved from the market, as well as minimization of consequences related to the banks' bankruptcies for the banking system and creditors.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF THE LAST YEAR

Macroprudential indicators of banks' activity in 2003 were as follows:

- as of January 1, 2004, own capital/risk weighted assets ratio amounted to 27.3% for the banking system as a whole, the standard for one bank being not less than 10%;
- by the end of 2003, liquid assets/total assets ratio amounted to 29.1%, the standard being not less than 20%;
- actual liquidity/required (current) liquidity ratio amounted to 1.2%, the standard being not less than 1%; and
- demand assets/demand liabilities (instant liquidity) ratio amounted to 55.5%, the standard being not less than 20%.

Most indicators of stable and liquid banks' operation at the banking system level were met and enjoyed positive development.

Considerable credit discipline improvement and major decrease of problem debts on banks' balance sheets were the main positive qualitative results. The income-bearing assets share continued to grow. The confidence of population in the Belarusian banks increased.

STATISTICAL TABLES

Number of financial institutions *
(at year-ends)

Type of financial institution	2000	2001	2002	2003
Commercial banks	31	25	28	30

**) Number of acting financial institutions*

Ownership structure of financial institutions in 2003
on the basis of registered capital (%)
(at year-ends)

Item	Commercial banks
State ownership	85.04
Other domestic ownership	7.44
Domestic ownership total	*92.48*
Foreign ownership	7.52
Financial institution, total	**100.00**

Ownership structure of financial institutions on the basis of assets total (%)
(at year-ends)

Item	2001	2002	2003
Public sector ownership	58.52	58.91	56.96
Other domestic ownership	35.70	35.59	23.75
Domestic ownership total	*94.22*	*94.50*	*80.71*
Foreign ownership	5.78	5.50	19.29
Financial institution, total	**100.00**	**100.00**	**100.00**

Distribution of market shares in balance sheet total (%)
(groupage of acting banks according to equity)

Type of financial institution	2001		2002		2003	
	Quantity of banks	market share (%)	Quantity of banks	market share (%)	Quantity of banks	market share (%)
Bank's equity capital	**25**	**100.00**	**28**	**100.00**	**30**	**100.00**
incl.						
negativ equity capital	0	0.00	1	3.57	1	3.33
to 1 bln. roubles	2	0.25	2	7.14	0	0.00
from 1 to 10 bln. roubles	11	10.65	7	25.00	7	23.33
from 10 to 40 bln. roubles	8	24.90	13	46.43	16	53.33
more than 40 bln. roubles	4	64.20	5	17.86	6	20.00

The structure of assets and liabilities of the banking system (%)
(at year-ends)

	Assets	2000	2001	2002	2003
1	Cash assets, gold, precious metals	1.0	2.2	2.3	2.5
2	Assets in the National Bank of the Republic of Belarus	2.6	1.3	1.4	2.1
3	Correspondent accounts in other banks	9.4	13.3	11.5	11.4
4	Required reserves	0.0	5.7	4.6	4.4
5	Securities	4.6	8.2	9.1	8.5
6	Credit to individuals and enterprises	29.2	60.5	63.0	63.9
7	Permanent assets and intangibles	2.3	7.1	6.3	5.5
8	Other assets	50.9	1.7	1.8	1.7
	Total	**100.0**	**100.0**	**100.0**	**100.0**
	Liabilities				
1	Settlement and current accounts	43.5	36.4	20.0	22.3
2	Correspondent accounts of other banks	2.0	2.7	2.1	2.0
3	Deposits of other banks	1.9	2.2	1.0	1.8
4	Deposits of individuals and enterprises	20.9	37.3	51.2	50.9
5	Interbank credits	10.1	21.4	18.0	15.5
6	Other liabilities	21.6	0.0	7.7	7.5
	Total	**100.0**	**100.0**	**100.0**	**100.0**

Development of off-balance sheet activities (%)
(off balance sheet liabilities / balance sheet total)

Type of financial institution	2000	2001	2002	2003
Commercial banks	131.63	193.10	197.71	175.74

Solvency ratio of financial institutions (%)

Type of financial institution	2000	2001	2002	2003
Commercial banks	24.43	20.70	24.20	27.29

Asset portfolio quality of the banking system

mln.roubles

Asset classification	2000	2001	2002	2003
Loans, total	**1,701,805.3**	**2,726,594.8**	**4,286,479.8**	**6,959,087.8**
Extended loans	72,207.0	75,675.4	64,518.7	30,394.2
Past due loans	36,037.7	78,163.9	76,672.9	58,182.6
Doubtful loans	150,129.1	2,388,441.9	214,643.3	165,927.5
Past due interest				
up to 30 days	13,415.9	15,642.1	8,552.5	7,286.0
more than 30 days	75,936.3	116,725.8	167,565.5	180,738.9
Special reserves	122,294.3	137,937.5	66,208.5	109,201.9

The structure of deposits and loans (%) (at year-end)

	Deposits	Loans
Commercial organizations	17.5	31.8
Households	46.9	18.1
Noncommercial organizations	34.0	49.7
Nonbank financial institutions	1.6	0.4
Total	**100.0**	**100.0**

Time structure of deposits and loans (%) (at year-end)

Types of deposits		Types of loans	
Demand deposits	49.30	Long-term lending	47.60
Time deposits	50.70	Short-term lending	52.40
Total	**100.00**	**Total**	**100.00**

Proportion of foreign exchange assets and liabilities (%) (at year-ends)

Type of financial institutions	Forex assets/ Total assets				Forex liabilities /Total liabilities			
	2000	2001	2002	2003	2000	2001	2002	2003
Commercial banks	55.75	49.02	45.57	42.87	54.16	47.62	44.59	42.08

Structure of revenues and expenditures of financial institutes (at year-end)

bln.roubles

	Revenues	2000	2001	2002	2003
1	Interest revenues	551.1	604.2	903.4	1,120.1
2	Commission	65.5	147.1	250.0	354.9
3	Other revenues	96.3	356.5	498.4	189.0
4	Other operational revenues	3.2	5.4	8.1	41.3
5	Reserve settlement	6.2	15.1	20.7	29.3
6	Unanticipated revenues	0.2	0.0	0.2	0.5
	Total revenues	**722.5**	**1,128.3**	**1,680.8**	**1,735.1**
	Expenses				
1	Interest expenses	387.1	370.6	525.4	617.0
2	Commission	6.4	17.8	25.4	31.9
3	Other expenses	54.6	307.0	437.2	607.9
4	Other operational expenses	215.5	365.1	579.3	231.6
5	Allocation to reserve	40.4	39.1	59.7	115.2
6	Unanticipated expenses	0.0	0.0	0.0	0.0
	Total expenses	**704.0**	**1,099.6**	**1,627.0**	**1,603.6**
	Economic revenue	**18.5**	**28.7**	**53.8**	**131.5**

Excluding banks under liquidation

Structure of registered capital and own funds of financial institutes

Type of the financial institutions	Registered capital /Total assets		Own funds / Total liab.	
	EUR	%	EUR	%
Commercial banks	536.7	8.6	796.7	12.72

Concentration of asset by the type of financial institutions in 2003

Type of institutions	The first three largest	The first five largest
Bank	69.12	83.87

Return on asset (ROA) by type of financial institutions (%)

Type of institutions	2001	2002	2003
Bank	0.78	0.96	1.53

Return on equity (ROE) by type of financial institutions (%)

Type of institutions	2001	2002	2003
Bank	4.85	4.43	6.12

2003 DEVELOPMENTS IN THE BANKING SYSTEM OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

INTRODUCTION

Banking sector in the Federation of BiH has arrived to the end of the consolidation and stabilization process at the end of 2003, meaning, this is a completion of the first phase in the reform changes. The reliability of the system, constant and modest growth during the past three years, adoption of new organizational forms, improved governing, strengthening of competition, introduction of new products, adoption and implementation of the international standards and regulations in banking and supervision resulted in more efficient operations and increased profitability, as final demonstration of success in the system. Actually, the banking sector is in the process of development of the banking "industry", which is especially important in our conditions where financial sector can be characterized as "centralization of banks period".

The most significant characteristics reflecting the improvement of banking sector could be, in brief, presented as follows:

Stability: During the last two years there were no significant disturbances in the system, therefore, there was no need for FBA to undertake any radical actions in banks. In 2002, the FBA did not initiate single provisional administration, and only one liquidation procedure was started upon the request of the owner (ICB Bank). During the last year, two provisional administrations were initiated in banks (in Ljubljanska and Poštanska Bank) requested by the Government, that is, Ministry of Finance of the F BiH due to slow implementation of privatization process, that is, due to inherited positions, not because of current abrupt problems in current operations.

Transparency: The trust in banks has reached a satisfying level. The best proof for that is growth of citizens' savings. Aside from inception and operations of Deposit Insurance Agency and continuing activities of FBA, high transparency of banks' operations helped in the process of recovering the trust in banks. By previous legislative and FBA's decisions, bank's duty was to publish brief audit reports containing year-end financial results in public media. Starting from 2003, banks have to publish unaudited reports as of June 30th. All banks complied with these regulations. That provided shareholders (especially small shareholders) ongoing insight to financial positions in banks, also potential clients and public had chance to make comparisons of banks before they make decision to whom they would trust their money. This disclosure of information is not that common all over the world, especially in neighboring countries.

Profitability: Profit, as leading motive for investment and business, achieved significant size in banks in the F BiH. After several years of negative results, during the last two years, measured by income to capital or assets ratio, we have noticed an increase in the area that is in the same level or close to common earnings of international banks. Hence, the system figure of return on assets (income to assets in percentages) was 1.09% during the last year, which is compatible to the international standard of 1%. Return on equity (income to equity in percentages) was 10.08% which is close to the international standard of minimum 12% and maximum 18%. Obviously foreign investors timely and prudently estimated opportunity of local banking market. They made positions timely and today they own 68.3% of total equity in banks in the Federation of BiH. Only four largest banks owned by foreign investors earned 67% of total gross income for the system, which was KM 68 million in 2003.

General opinion made by many local and foreign experts is that banking industry in the F BiH, including regulatory and supervisory institutions, in terms of transition, other reform changes and implementation of the international standards made step ahead in comparison to other sectors. That can be taken as reason for satisfaction, but should not be understood as justification for slowing down any further activities or postponement of logically expected development process. Firstly, privatization of remaining state owned banks should be completed in the shortest possible period. Any further maintaining of current status quo would represent serious obstacle for new developments. Acceleration of the reform in other sectors will increase activities of the economy in whole, and that will be reflected in increased loan services for industries and growth of operations in other industries. Having ambition to come closer and become part of the European Union includes development and improvement legislative and other regulations in accordance to the European banking directives. Regulations passed by FBA partially include certain directives. But, unlike the Basle Principles, the European banking directives are obligatory for member states and in many forms include more details than the Basle Principles. FBA has prepared action plan for compliance with regulations to the EU directives, and this long-term process could be completed by 2008.

Finally, consolidation of the existing entity banking agencies under Central Bank BiH “umbrella” should be performed during 2004. The Agency on state level would provide pertinent response for functioning, regulating and supervising of united economy and financial system in the state.

Results achieved are solid foundation for further development of banking sector. Comparison to other countries in transition and developed countries indicated that there is more to achieve. For example, penetration level, measured by ratio between total banking assets and GDP are commonly used as indicator of size and development of financial institutions in a country. Penetration of banking sector was approximately 60% in 2003 in the Federation of BiH, in comparison to 2000, when it was 33%, is almost double sized in short period of time. In other transition countries, this ratio ranges between 50 and 90%, except for Czech Republic (130%) and Croatia (100%). Banking systems in the EU member states operate with assets twice larger then GDP, and in some countries it is almost 260%. Obviously, our banks have more battles to fight in order to grow. Similar conclusion raises from observation of other common indicator - ratio between loans and GDP. Total loan portfolios in banks in the Federation of BiH were between 35 and 40% of GDP in 2003. By this ratio, the Federation is among many transition countries. But, in the EU, average ratio is 110%. Therefore, there is significant unemployed potential. Of course, we have to have in mind conditions in which our banks operate - maturity adjustments and prices of funding or integrity of creditors, for example.

Nevertheless, banking system of the FBiH achieved good financial results in 2003. Balance sheet increased by 26% in comparison to the last year and at the end of reporting period it was KM 5.8 billion. We should emphasize that in the structure, observed in percentages, we had no significant changes in comparison to 2002. The major participation is still with loans (56.1%) and money assets (35.6%). The growth of larger banks and closing of small ones granted concentration of major assets in small number of banks. Consequently, three largest banks with assets of KM 500 million each have controlled 49.8% of total banking assets in the Federation of BiH. In the next group of banks are those with assets between KM 300 and 500 million there were two banks with 16.4% of total assets in the system, and eight banks which are in the group of banks with KM 100 and 300 million of assets had 22.4% of total assets in the system. Remaining 13 banks did not achieve KM 100 million of total balance sheet assets.

Important changes were recorded in the currency structure of money assets held by banks. 60.6% (70.4% in 2002) were in foreign currencies, and 39.4% in Convertible Marks (29.6% in 2002). This is mainly due to changed regulations on accrual of regulatory reserves deposited by banks at the Central Bank of BiH and limits for adjustment of foreign currency positions as regulated by FBA.

On the liabilities side, the major participation is still with deposits - 74.2% or KM 4.3 billion. Loans were KM 589 million or 10.2% out of total liabilities.

Continued improvement of maturity adjustment structure was evident. Long-term deposits increased faster then short-term and they were 30.9% of total deposits at the end of year (they were 24% in 2002). This is significant indicator of positive changes. Citizens' savings increased by 16% and at the end of reporting period they were KM 1.7 billion. Interestingly, growth ratio of 7 points was higher then in 2002. In addition to that, short-term deposits increased by 8% and long-term by 47% which is very indicative information. Out of total savings, 75.7% were in foreign currencies and 24.3% in domestic.

In 2003, loans achieved growth ratio of 28% or KM 758 million hence total loans were KM 3.5 billion. Analysis displayed that loans approved to citizens increased by 30% and to privately owned enterprises by 36%. Therefore, participation of privately owned enterprises in total loans was 42.7% (last year it was 40.1%) and citizens 47.6% (last year 46.9%). The abrupt growth of loans in 2002 attained moderate ratio in 2003, mainly due to maturity adjustments of funding and placements to which FBA has paid special attention since there was actual danger of system risk.

In 2003, capital in banks increased by 15%, that is, by KM 108 million and at the year-end it was KM 845 million. Due to increased growth of assets to capital, capital ratio was 14.1% and it is 1.3% less than at the end of 2002. But, declining of capital adequacy ratio ended and it remained almost at the same level (19.6%) as it was last year (19.7%). These indicators suggest that further strengthening of capital in banks is necessary, especially in those that experienced fast assets growth.

Income of KM 68.4 million was earned by 22 banks in 2003, and four banks reported loss of total KM 11.5 million. Therefore, based on unaudited reports, income for the whole system was KM 57 million. This is four times higher than income earned in 2002 (KM 14.7 million).

BANKING SYSTEM REFORM

Dominant position in the financial sector of the Federation of BiH is still with the banking system, therefore its condition has a special meaning to the economic development in whole. At the end of eight-year period after the war, we can make conclusion that consolidation process of the banking system has reached the end:

- majority of problems inherited from previous system and induced by the war were eliminated;
- three quarters out of total number of banks are privately owned now;
- we are expecting finalization of privatization process in remaining banks owned by the state;
- foreign investors own 68.2% of share capital in the system;
- arrival of foreign investors introduced more competition, contemporary know-how, new banking products;
- capital base in banks was strengthened, efficiency and profitability of banking operations was improved and getting closer to the international standards;
- international supervision formats were accepted and implemented, management of risks was improved etc.

Unfortunately, successful transformation of banking industry was not followed by changes in other sectors, especially in the core economy sector, which is still stagnating. If the reform of other sectors continues to be slow, it could be obstacle for further development of banking. Slow recovery process of economy brings danger of multiple consequences, which will, if trends remain the same, affect banking as well.

It is important to emphasize that reform process, transformation, recovery and consolidation of banking sector in the Federation of BiH was accomplished without any public investments. Based on some estimation, other transition countries approved large assets for above-mentioned purposes: in Croatia 27, in Czech Republic 25, Hungary 13 and in Poland 8 percent of GDP.

The weakest point is privatization process of state owned banks. There are still seven banks owned by the state. Those banks stagnated last two or three years because they were unable to catch up with changes in the market. It is the last minute to finalize the process, by privatization, liquidation or bankruptcy of those banks.

Reconstruction

Number of banks in the Federation of BiH will for sure continue to decrease, although that process will slow down in comparison to the previous period. Merging of Zagrebačka Bank BH and Universal Bank and Central Profit Bank and HVB Bank are already contracted, and there are indications that more merging will occur.

If we observe size of assets, there were radical changes in the system. The list of banks, listed by size of assets, displayed large variety. The largest banks own fifty times more assets than the smallest bank in the system! To be more precise, the largest bank in the system owns over one billion of KM, and on the other hand, there are five banks in the Federation of BiH with assets under KM 50 million.

Benefit of the system with less larger banks is nicely illustrated by the information that 89% or KM 1.1 billion out of total growth of balance sheet was earned in five largest privately owned banks in the system. At the same time, five banks owned by the state reported decrease of assets.

Banking Agency (FBA)

Banking Agency of the F BiH extensively contributed to the reform of the banking system, although, often actions initiated by the Agency were misunderstood. FBA, as independent institution for supervision and licensing of banks was founded at the end of 1996. From the very beginning the activities of the Agency were designed to create strong and stable banking system, market oriented and complied with the international performance and supervision standards in banks. The Law on Banking Agency established main duties of the Agency which, in short, are bank licensing for inception and operations, passing regulations, supervising banks and undertaking actions as regulated by the Law (this includes provisional administration and liquidation in banks or initiation of bankruptcy process in banks).

Since the leading objective of the Agency is to protect money and interests of depositors, the FBiH Banking Agency initiated provisional administration in 21 bank in period between foundation of the Agency until end of 2003. High representative initiated provisional administration in one bank. There are still 5 banks with provisional administration currently and those procedures should be completed soon. Provisional administration was successfully resolved in three cases by merging of those banks, liquidation procedures were implemented in 8 banks, out of that number, three liquidations were completed without negative outcome for depositors and shareholders, and one resulted in merging. The Agency filed requests for bankruptcy procedure in sex banks, and legal procedure is currently going on. Liquidation procedure is currently going on in four banks. In 2003, the FBA initiated provisional administration in two banks upon request of the Government, that is, Ministry of Finance of the Federation of BiH.

International experience and rule saying that banks are the most often destroyed “from inside” has been confirmed by examples in the Federation of BiH. Analysis performed during and after provisional administration and liquidation procedures displayed that main sources of problems in those banks were operations with related entities, disregarding regulations and laws passed by the Agency and crime. Responsibility for that was on managers and governing bodies in banks.

Payment system

Banks have successfully taken over whole internal payment system, which was one of the most complex and significant elements of the reform changes.

Upon information of Central Bank BiH, in 2003 banks in the Federation of BiH have performed almost 35 million of the internal payment system transactions with total value of KM 49 billion. Out of that, 23.1 million were intra-bank transactions with total value of KM 30.1 billion, and they also have performed 11.7 billion of inter-bank transactions with total value of KM 18.8 billion. Therefore, out of total number, 66.5% were intra-bank transactions, and 38.5% were inter-bank transactions.

For the whole Bosnia and Herzegovina, banks in the Federation of BiH have performed 75% of total intra-bank transactions and 65.8% of inter-bank transactions. By value, banks in the Federation of Biz: have executed 64.2% of intra-bank transfers and 72.6% of inter-bank transfers.

Individual participation of banks in the payment system transactions in the Federation of BiH ranges between 0.2 and 14.53 by number and between 0.05 and 11.39 by value of transactions.

The fact that there is no unified registry of transaction accounts in Central Bank of BiH proved to be weakness, especially for the execution of court orders. Preparations for implementation of the registry are currently going on.

Combat against money laundering and terrorism financing

Taking over the whole payment system exposed banks to increased risk of being used for money laundering and terrorism financing. Thanks to the measures undertaken and other activities by banks, FBA and other institutions we can make estimation that quantity of risk of money laundering and terrorism financing in the banking system is moderate now. Also, quality of managing this risk is satisfactory.

All banks adopted minimum standards for prevention of money laundering and terrorism financing and passed policies as regulated by FBA's Decision on Minimum Standards for Prevention of Money Laundering and Terrorism Financing in Banks, which is complied with international standards. As it is regulated by the Decision, banks appointed coordinator (KUPIT) for compliance with requirements for activities against money laundering and terrorism financing, and in order to improve capability and efficiency of staff, and prepared comprehensive manuals containing laws and regulations related to prevention of money laundering and terrorism financing.

Banks started implementation of polices in 2003, but the level of implementation and the policy itself were different in each bank. In general, implementation of the adopted policies was as follows:

- **Policy on customer's acceptance:** Criteria for customer's acceptance have been defined.
- **Policy on customer's identification:** Banks have adopted customer's identification as basic element of the standard "know your customer". The policy on customer's identification is implemented at the occasion of establishment of business relation with the customer. But, for the business relations previously established (accounts opened before the Decision was passed) this policy was not satisfactory implemented.
- **Policy on continuous monitoring of accounts and transactions:** In order to protect themselves and eliminate all risks that may arise from omissions made in prevention of money laundering, banks implemented formal reporting on connected transactions of their customers, aside from reporting regulated by the law.
- **Policy on management of risk from money laundering and terrorism financing:** Elements of the outlined policy are defined in banks' programs. Reporting lines of Management and Supervisory Boards are also defined.

Aside from above mentioned, examinations showed following weaknesses: banks did not implement special registries of customers' acceptance; reporting on connected transactions is mainly simple adding, rather than standard "know your customer"; training of staff is not on going process, as it is regulated by the Decision.

FBA initiated prescribed measures in banks where deficiencies and irregularities were found during the examination. The measures ranged from passing orders for elimination of deficiencies and irregularities determined to filing civil code charges against banks that made those violations. FBA revoked banking license to organizational units of Nova Bank a.d. Bijeljina in Mostar and Ljubuški due to unresponsive attitude towards the FBA's orders. Authorized institutions cooperated somewhat with the Agency related to issues of money laundering and terrorism financing, but the cooperation should be improved.

Banking supervision

In order to promote and secure whole macroeconomic and financial stability, the Basle Committee has adopted twenty-five core principles in 1997, which should be respected in order to have effective supervisory system.

The core principles are minimum actions to be implemented and in many cases it is necessary to supplement them with other actions in order to comply with specific conditions and regulate risks of financial systems in particular countries. The principles regulate conditions for effective supervision of banks, licensing, prudential regulations and requirements, methods for continuous supervision of banks, necessary information, official authorization of supervisors and cross-border banking.

Legal and regulatory framework for banking performance in the Federation of BiH is complied with the international standards. The Law on Changes and

Additions to the Law on Banks from August 2002 provides in Article 69 that "The regulations passed by the Agency... are based on the core principles for supervision of banks as regulated by the Basle Committee for supervision of banks." While preparing and adopting regulations implemented from the beginning of 2003, FBA complied with those standards. The regulations also include some of the standards from the European banking directives.

LEGAL FRAMEWORK FOR BANKING AGENCY OF THE FEDERATION OF BIH AND BANKS IN THE FEDERATION OF BIH

1. Law on Banking Agency of the Federation of BiH ("Official Gazette of the F BiH", 9/96, 27/98, 20/U0, 45/00, 58/02, 13/03 ánd 19/03),
2. Law on Central Bank of BiH ("Official Gazette of the F BiH", 1/97, 29/02 and 13/03),
3. Law on Banks ("Official Gazette of the F BiI-I", 39/98, 32/00, 48/01, 27/02, 41/02, 58/02, 13!03, 19/03 and 28/03),
4. Law on Financial Performance ("Offcial Gazette of the F BiH", 2/95, 13/00 and 29/00),
5. Law on Internal Payment System ("Official Gazette of the F BiH", 15/00-cleared version, 54/01),
6. Law on Foreign Exchange ("Official Gazette of the F BiH", 35/98),
7. Law on Securities ("Offcial Gazette of the F BiH", 39/98 and 36/99),
8. Law on Securities Registry ("Official Gazette of the F BiH", 39/98 and 36/99),
9. Law on Securities Commission ("Of~cial Gazette of the F.BiH", 39/98 and 36/99),
10. Law on Prevention of Money Laundering ("Official Gazette of the F BiH", 8/00),
11. Law on Notes ("Official Gazette of the F BiH", 32/00 and 28/03),
12. Law on Cheques ("Official Gazette of the F BiH", 32/00),
13. Law on Payment Transactions ("OfPicial Gazette of the F BiH", 32/00),
14. Law on Obligations ("Official Gazette of the F BiH", 2/92, 13/93 and 13/94 and Official Gazette of the F BiH, 29/03),
15. Law on Commercial Enterprises ("Official Gazette of the F BiH", 23/99, 45/00, 2/02, 6/02 - correction and 29/03),
16. Law on Bankruptcy ("Official Gazette of the F BiH", 29/03),
17. Law on Liquidation ("Official Gazette of the F BiH", 29/03),
18. Labor Law ("Official Gazette of the F BiH", 43/99, 32/00 and 29/03),
19. Law on Executive Procedure ("Official Gazette of the F BiH", 32/03),
20. Law on Procedure of Registration of Legal Entities into the Court Registry ("Official Gazette of the F BiH", 4/00, 19/00, 49/00, 32/02, 58/01, 13/03, 19/03 and 50/03),

21. Law on Administrative Procedure ("Official Gazette of the F BiH", 2/98 and 48/99),
22. Law on Violations Representing a Breach of Federal Regulations ("Official Gazette of the F BiH", 9/96 and 29/00),
23. Law on Treasury of BiH Institutions ("Official Gazette of the F BiH", 19/03),
24. Law on Bank Privatization ("Of~icial Gazette of the F BiH", 12/98, 29/00 and 37/01),
26. Law on Accounting ("Official Gazette of the F BiH", 2/95, 14/97 and 12/98).

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2001	2002	2003
Banks	33	29	27

Ownership structure of the financial institutions(%)
on the basis of registered capital
(at year-ends)
/banks/

Item	2001	2002	2003
Public sector ownership	14.4	12.8	12.6
Other domestic ownership	22.4	20.5	19.1
Domestic ownership total	36.8	33.3	31.7
Foreign ownership	63.2	66.7	68.3
Financial institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of the financial institutions on the basis of assets total
/banks/

Item	2001	2002	2003
Public sector ownership	10.0	7.9	6.4
Other domestic ownership	16.9	16.4	14.7
Domestic ownership total	26.9	24.3	21.3
Foreign ownership	73.1	75.8	78.9
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of institutions	The first three largest (%)	The first five largest (%)
Bank	49.8	66.2

Return on asset (ROA) by type of financial institutions

Type of institution	2001	2002	2003
Bank	-1.18	0.36	1.09

Return on equity (ROE) by type of financial institutions

Type of institution	2001	2002	2003
Bank	-6.15	3.00	10.08

The structure of assets and liabilities of the banking system (%) (at year-end)

Assets	2001	2002	2003
Cash and securities	48.7	36.4	40.0
Placements to other banks	0.7	0.4	0.6
Loans-net value	41.7	54.6	56.1
Premises and other fixed assets	7.2	6.4	5.4
Other assets	1.7	2.2	1.9
Liabilities	**2001**	**2002**	**2003**
Deposits	77.0	76.8	74.2
Borrowings from banks	0.2	0.1	0.1
Loans payables	6.7	6.8	10.2
Other liabilities	2.7	2.7	3.0
Capital	13.4	13.6	12.5

Development of off-balance sheet activities (%) (off balance sheet items / balance sheet total)

Type of financial institution	2001	2002	2003
Banks	13.69	15.11	12.96

Solvency ratio of financial institutions (liabilities/assets) (%)

Type of the financial institution	2001	2002	2003
Banks	86.6	86.3	87.5

Asset portfolio quality of the banking system

Asset classification	2001	2002	2003
A	85.5	85.9	87.3
B	8.3	8.8	8.3
C	2.5	2.7	2.3
D	3.3	2.5	2.0
E	0.1	0.1	0.1
Classified total	**100.0**	**100.0**	**100.0**
Specific reserves	**23.1**	**21.8**	**20.3**

The structure of deposits and loans in 2003 (%)
(at year-end)

	Deposits	Loans
Households	40.5	47.6
Government sector	11.6	0.7
Corporate	30.8	49.1
Foreign	-	-
Other	17.1	2.6
Total	**100.0**	**100.0**

The structure of deposits and loans in 2003 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	51.6	Long term loans	72.4
Within one year	17.5	Medium-term loans	-
Over one year	30.9	Short-term loans	27.6
Total	**100.0**	**Total**	**100.0**

Proportion of foreign exchange assets and liabilities
(at year-ends)

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2001	2002	2003	2001	2002	2003
Banks	42.0	32.8	61.5	66.9	59.7	61.8

Structure of registered capital and own funds of financial institutions in 2003

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	000 EUR	%	000 EUR	%
Banks	305,931	10.3	64,803	2.5

2003 DEVELOPMENTS IN THE BULGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In an adverse world environment in 2003, Bulgaria's economy managed 4.3% growth. The past year was the sixth in a row to see Bulgaria attaining relatively high growth. The greatest contribution to *Gross domestic product* came from households' consumption and investment in fixed capital. Growth in goods and service imports outstripped that of exports, with the balance of payments contributing negatively to GDP growth. *Final household expenditure* grew by 5.1% in real terms. A trend towards more favourable consumer expenditure patterns has emerged over the past few years, indicating gradual lifestyle improvements. *Consumer demand* growth boosted *retail trade*, which grew by 4.2% in real terms year on year. Dynamic trade boosted *budget revenues* from *indirect taxes*, as well as the demand for cash. *Fixed capital investment* grew by 14.8% in real terms. The increase in non-government sector lending (by a nominal 80.7% to households and 37.6% to non-financial corporations) provided additional money for consumer spending and investment.

Exports were an important driver for the high rates of industrial growth in 2003. The rate of export growth increased in 2003. Goods and service exports in euro grew by 10.7% over the previous year. Exports to EU countries continued growing.. The contribution of exports to GDP growth matched that of household consumption. Increased domestic was the main driver of imports growth. Balance of payments data shows *goods and service imports* in euro growing by 14.1%.

Increasing employment was an important factor in household income growth and hence consumption. This was due both to economic expansion and to the government's labour market policy. The registered *unemployment rate* fell to 13.5% or 2.8 percentage points lower than in late 2002.

Average annual inflation in 2003 was 2.3%. The fall in unit labour cost of industrial production helped keep *CPI inflation* down. Major inflationary moves in 2003 included the raising of electricity and central heating prices as part of aligning them with production costs, and the raising of alcohol and fuel excise duty. At the year's close, inflation rose due to the Bulgarian and European poor grain harvest, with the price of bread rising rapidly. Fluctuations in the price of crude oil impacted monthly inflation figures but did not contribute to overall annual inflation.

Increased demand for transaction cash, increased banking system deposits, and a continuing credit expansion boosted the nominal rate of increase in monetary aggregates. The 11.7% growth of monetary aggregate M3 at the year's start rose to 18.4% in June, coming to rest at some 20%. *Quasi-money*, including deposits with maturities of up to two years and deposits redeemable at notice of up to three months, grew by 17.8%. Despite low interest rates, *deposits* continued growing steadily in line with rising incomes and increasing confidence in *the banking system*. Financial services took deeper root, with ratios of domestic credit to nongovernment sector and of broad money to GDP reaching 27.6 % and 48.1 %. The average annual interest for borrowers fell by 40 basis points to 10.3 %.

DEVELOPMENT IN THE BANKING SYSTEM

In 2003 the Bulgarian banking sector was made up of 35 banks, incl. 29 local banks or subsidiaries of foreign banks and 6 foreign bank branches. Banking *privatisation already finished* with the deal for Bank DSK, the second largest bank and former retail banking specialised institution in Bulgaria. Furthermore, the new owner, the Hungarian OTP Bank is aimed to expand its business in corporate and commercial banking. Only the so called Nasarchitelna Banka (Encouraging Bank) remains in state ownership. The share of bank assets controlled by foreign banks and other foreign investors increased to 83%. Recently, most of the large Bulgarian banks belong to international banks and financial groups (i.e. Bulbank owned by UniCredito Italiano, the United Bulgarian Bank owned by the National Bank of Greece, Biochim Commercial Bank owned by BankAustria Creditanstalt, Expressbank owned by Société Générale, Hebrosbank owned by Regent Pacific Group, Post Bank owned by EFG Eurobank Ergasias, and BNB-Paribas (Bulgaria) and Raiffeisenbank (Bulgaria) owned by BNP-Paribas and Raiffeisenbank, respectively).

Increased volatility and risks on international markets as well as *growing demand on transaction cash* in the Bulgarian economy were the main drivers for local banks to considerably shift their foreign banks placements on to domestic lending. The trend to growth in the volume of banking operations sustained over several years continued during the last year. Total banking system assets indicated a growth of 18.4% over the close of 2002. Lending increased by 44.4 %, showing the most dynamic development. Deposits grew by 20.6 % and the capital base, by 24.2 %.

Commercial bank *revenue* was good. Net core operation revenue was steady, with high net interest income and a minimal income from extra operations. Given the good asset quality, there was no need for significant provisioning against impairment losses. Only noninterest expenditure diverged from trends in other points of income and cost. This reflects increases in operating and innovation expenditure. As a result, *return on average assets* (ROA) reached 2.1 % and *return on equity* (ROE) was 18.7 %. The trend toward sustainable revenue growth from core operations (core ROA) continued in most banks and the system in general. Based on revenue from core transactions, return on assets was 2.8 %.

Market concentration and dispersion in the Bulgarian banking system were relatively low. In 2003 owing to the high activity of almost all banks in terms of lending and deposits attraction, the *Loans, Deposits from Clients* in the nonfinancial sector and *Total Assets* aggregates, measured by the Herfindahl-Hirschman Index[7], indicated a lack of market concentrations.

Credit risk played a key role in banking system **risk profile**. Despite accelerated credit growth in 2003 the quality of credit was maintained. Though both consumer and corporate customers were sought, corporate lending was particularly aggressive, featuring a trend to project financing and risk sharing among banks.

Currency risk was very low and EUR-denominated positions prevailed. The position is long in euro and short in US dollars, with the value of the net open position to own funds accounting for -4.65 per cent: far below the regulatory maximum.

Sensitivity to changes in securities' prices and interest rates was relatively low. Investment was mainly in low-risk Bulgarian government securities and securities from issuers in countries listed in Appendices 1 and 2 of BNB Regulation No. 8 on the Capital Adequacy of Banks. This predetermined a lack of dramatic fluctuations in portfolio prices. Interest rate sensitivity was low to moderate, with lengthening asset maturity and fewer interest-sensitive assets. Liquid assets matched the makeup and maturity of borrowed funds, cutting liquidity risk.

The assets' quality in 2003 remained good. Classified assets slightly grew over the year: far below the general asset growth. This is an indication of adequate credit solutions which largely remove the typical lag between a credit expansion and the appearance of signs of claims depreciation. 'A zone of heightened credit risk' emerged in 2003 at several banks with credit risk levels exceeding the system average. This reflects weaknesses in lending management, ineffective control over market risk, and lending to economically related persons. The market share of these banks is insignificant but there are supervisory strategies in place to improve their behavior in line with the best banking practices.

Banks' **capital position** was sound and adequate for the level of asset risk. Most banks' capital adequacy exceeds regulatory levels significantly (12%). Higher capital risk affects a small number of banks with prerequisites for capital erosion, and banks whose capital adequacy is close to regulatory values. Overall, there is a surplus of risk-weighted capital in the system. While this might arguably fund a further rise in the total risk component of assets, this applies to the well capitalised large and medium-sized banks. Thus, any further risk assumption by the rest of banks has to be approached most prudently.

Banking system *liquidity* was high irrespective of the reduced share of high-liquid assets through expanded lending. In 2003 banks had no serious liquidity shortfalls. The share of tradable assets in gross assets remained high and was adequate to banks' balance sheet risk. The credits to deposits ratio continued rising to reach 69 %. This may be considered a limiting level. Any higher would require wholesale change in liquidity management and operations financing. Such a change would be associated with strengthening the role of long-term borrowed funds and attaining a more acceptable maturity imbalance between banks' assets and liabilities.

[7] The Herfindahl-Hirschman Index (HHI) accepts values of up to 10,000. A value of below 1000 indicates a lack of concentration; values between 1000 and 1800 indicate acceptable concentration, and values of over 1800 are regarded as high concentration.

LEGAL AND INSTITUTIONAL FRAMEWORK FOR OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS

In addition to the macroeconomic stabilisation, the contemporary bank legislation and adequately efficient supervision contributed for strengthening the banking sector. The Law on Banks is the primary law on banking. Together with other laws such as the Commercial Law, the Law on Securities, Stock Exchanges and Investment Companies, the Law on Accounting and the Law on Measures against Money Laundering, it creates the legal base for banking in Bulgaria.

The 1997 adopted Law on the BNB significantly changed the functions of the Bulgarian National Bank. Its Bank Supervision Department (BSD) is the only supervisory authority for banks. The Law on the BNB defines its supervisory task as regulation and supervision over activities of other banks in the country for the purpose of ensuring the stability of the banking system and protecting depositors' interests. The laws and a number of prescribed, in forms of detailed Regulations, issued by the Management Board of BNB, provide minimum prudential standards that banks must meet.

New developments

The launch of the new Basle Capital Accord II was accompanied by an international test and survey of 365 banks to determine what effect this new methodology for calculating risk-weighted assets and operational risk had on bank capital adequacy. The Banking Supervision Department brought eight Bulgarian banks (with 64 per cent of Bulgarian banks' assets) into the survey. The major conclusion was that provided current own funds levels are maintained under Basle II, most large Bulgarian banks will fulfill capital adequacy requirements. Due to the stricter rules for assessing risk-weighted assets when applying the standard approach, the results show a rise in risk weights, largely in exposures to sovereigns and banks. The inclusion of operational risk will commit an additional part of banks' capital bases.

Jointly with the French and Dutch central banks, the BNB held training sessions for Banking Supervision Department specialists in supervisory treatment of market risk, applying the EU capital adequacy directive, the use of bank internal VaR models, reporting financial instruments exposures in the trading portfolio, and supervisory assessments of trading in financial instruments.

New packages of forms for reporting finances and basic banking risks introduced in early 2003 were incrementally improved with experience.

A new regulation on internal control in banks was adopted. It is compliant with the principles of the Basle Committee on Banking Supervision on internal control systems in credit institutions. The scope of this regulation broadened with requirements on management oversight, risk controls, information systems, and specialist internal auditing offices.

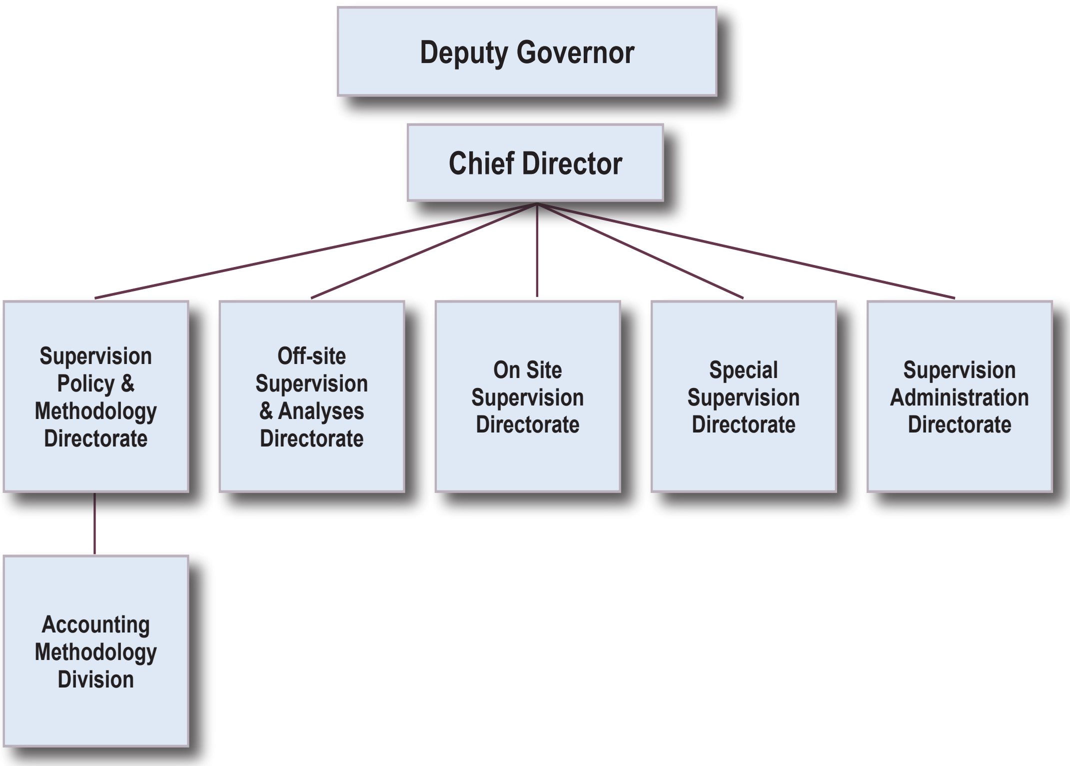
In December 2003 European regulatory institution and European Commission specialists conducted a second review of financial sector supervisory adequacy and the degree to which regulations follow European requirements. Their main conclusion was that Bulgarian banking sector and banking supervision have attained great progress and a high degree of harmony with European banking regulations and practices.

Major recommendations included the comprehensive application of capital requirements on market risk and setting the preparation for Basle II as a main priority.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN BULGARIA

According to the laws, the Governor of the central bank is empowered to grant or revoke a bank license, taken on a motion by the Deputy Governor in charge of banking supervision. The head of BNB has also a central role in the orderly resolution of a problem bank case, as powers independent to appoint a conservator, to approve a merger or take-over, to sell a liquidated bank, and to petition the court to institute bankruptcy proceedings. Finally, to draw all levels of competence, the Deputy Governor of BNB in charge of Bank Supervision carries out the tasks of running supervisory enforcement and measures. In this relation, he may require any accountings and other records, as well as any information on banks' activities, be submitted, and may appoint on-site inspections fulfilled by officers and other persons that authorised by him.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISION DEPARTMENT



In parallel with the work on the regulative framework, the Banking Supervision Department has been working on its institutional set-up. Banking supervision performs its functions with a staff of 65 persons, divided into five directorates. The overall structure of Banking Supervision is developed according to the internationally accepted norms and practices.

ACTIVITY OF THE BANKING SUPERVISION DEPARTMENT (BSD)

The BSD monitors the current finances of banks, analyzes banking system trends, identifies and researches major risks and the dynamics of the risk profile of individual banks and the banking system. ***Off-site*** supervisors regularly assign running three-month CAEL ratings.

In 2003 the methodology of risk-based off-site supervision continued to improve. Efforts aimed at early identification of risks in the system and at individual banks as a basis for timely and effective remedial strategies. An upgraded *Early Warning System* was developed and implemented. Its basic element is the banks' uniform accounting form. The form allows monitoring of the major threats to the banking system: credit, liquidity and market (price, interest and forex) risk.

Emerging *risk modeling* improved in 2003 by changing the parameters and scenarios of the stress test model in use. Apart from the opportunities inherent in the accumulated longer time series for individual balance sheet aggregates, the different scenarios of worsening bank finances also changed. Modeling aims to establish the maximum extent of capital risk at any given moment, both for each basis risk and for an accumulation of more than one risk. This allows financial stability to be forecast when one or more symptoms of localized or systemic risk appear.

The year also saw the development of a model for *monitoring* local *branches and subsidiaries of foreign entities*. The aim was to get a set of indicators for assigning internal supervisory ratings of the parent company's financial stability and the ability of the parent banks to support local structures. This was most important in view of the large number of foreign banks and their branches in Bulgaria.

The timing and scope of ***on-site inspections*** depended on each bank's risk rating, and on an annual schedule. Since banks' current states (reflected in quarterly reports and other regular reports) did not call for changes in supervisory strategy, the schedule remained unaltered. Supervisory principle remains that the longest period between full supervisory inspections does not exceed two years for reasonably managed banks with good finances, while problem banks and those requiring greater supervisory attention get annual inspections.

On-site *inspections* were entirely *concerned* with testing and assessing the efficiency, adequacy and robustness of systems to identify, measure, monitor, and manage risks inherent at each bank. Supervisory inspections comprised a review of capital and capital adequacy, assessments of the quality of assets and of provisioning for risk exposures, analyses of liquidity and the quality and quantity of revenue, assessments of sensitivity to market risk, management and internal control, and off-balance sheet commitments. A priority alongside regularly monitored items concerned the quality of credit risk management with a view to establish whether principles of prudent and reasonable banking practice applied amid a credit expansion and the widening range of bank products. Other major accents in supervisory inspections concerned the Regulation No. 9 requirement to apply mechanisms to classify risk exposures and allocate provisions to cover impairment losses, and the manner of completing new supervisory reports after the launch of International Accounting Standards for financial institutions in early 2003.

Supervisory strategy papers setting out mandatory measures and recommendations, as well as indications of the time of future inspections and the number of supervisory officers assigned to them, were prepared after each inspection. The trend to fewer infringements of the regulatory base and of recommended supervisory measures appears stable. This is a result of the robust development of most banks. Because of stricter loan application assessment, and of improved lending procedures, credit risk management and control remain effective and reliable amid a credit expansion. Internal systems for rating loan applications using qualitative and quantitative financial analyses are being set up or have already been applied. Internal lending rules have improved and been amplified with procedures and requirements for keeping up with the rapid expansion of credit portfolios and variety of banking products.

INTERNATIONAL ACTIVITIES

In 2003 BSD was involved in the work with the missions of the IMF and the World Bank in line with the agreements and close cooperation of the Bulgarian Government with the international financial institutions in recent years. Globalisation of financial activities, enhanced level of supervisory functions and privatisation of Bulgarian banks by foreign investors call for close cooperation with foreign supervisory authorities. In view of the need to exchange supervisory expertise and information on business and state of Bulgarian bank branches abroad and foreign bank subsidiaries and branches in Bulgaria, there were seven agreements (Memorandums of Understanding) concluded in previous years with the OCC of the United States, and with the respective supervisory authorities of Austria, Albania, Netherlands, Cyprus, Greece, Italy and the Netherlands,. In 2003 three new memorandums were undersigned with the supervisors of Hungary, Macedonia and Slovenia. All nine memorandums prescribe ways of information exchange and cooperation in the field of bank supervision, particularly in the consolidated supervision of bank groups.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BULGARIA

After the Memorandum for Cooperation between BSD and the Deposit Insurance Fund concluded in 1999 cooperation already started between BSD and the other financial sector supervisors. This became reality after the newly adopted Law on the Commission on Financial Supervision (CFS). The law on the Commission also constitutes the so-called Financial Stability Council (FSC, in Bulgarian Savet za Finansova Stabilnost), which enlist the heads of the Commission, the Bank Supervision and the Secretary of Finance of Bulgaria. The Council activity covers several areas: financial stability tasks and strategic development issues, regulation rules and methodology harmonisation, sharing and exchange of information and supervisory expertise, joint examinations and actions, etc.

MAIN STRATEGIC OBJECTIVES

The major efforts of the Bulgarian banking supervision continued to be focused on the full compliance of the domestic supervisory rules and practice with the European Banking Directives. The EU Financial Services Action Plan (a package of some 40 measures intended for implementation by 2005 in a single European financial services market), the rapid appearance of new products and structures in the financial market, and the continuing globalisation of banking, as well as technological advance, are hastening change in the EU regulatory framework. Bulgarian banking supervision reflects these circumstances and its major priority is to concentrate on challenges created by these conditions as Bulgaria converges with the EU. Its advances raise further demands on supervisory capacity as regards capital adequacy requirements concerning market risk, the new Basle Capital Accord (Basle II), and keeping abreast of developments in corporate management and transparency. As regards regulation, the Banking Supervision Department puts the emphasis on prudence by updating the regulatory base in line with financial market development and the degree of bank risk.

Preparation activity of bank supervisors is in action for the implementation of the new European capital directive for banks and financial institutions that will legally incorporate Basel II. Its significance and complexity called for designing a BSD action plan, which envisages a package of some 20 measures and actions intended to bring into step supervisory comprehension on new approaches proposed with expectations of the commercial banks. A joint task group of BSD and banking experts will be formed in order to reflect new circumstances for the Bulgarian market and institutional framework and achieve a higher degree of cooperation and unity of action in the preparation process for the new Basel Capital Accord.

STATISTICAL TABLES

Number of financial institutions (operating at year -ends)

Type of financial institution	2001	2002	2003
Commercial Banks	35	34	35
of which:			
Large banks	3	3	3
Small and medium-sized banks	25	25	26
Foreign bank branches	7	6	6
Nonbanking financial institutions	66	72	83
Leasing companies	32	39	45
Fianancial institutions, total	**101**	**106**	**118**

Ownership structure of the banks on the basis of registered capital (%)

Item	2001	2002	2003
Public sector ownership	15.1	13.0	3.4
Other domestic ownership	18.2	20.4	20.3
Domestic ownership total	*33.3*	*33.4*	*23.7*
Foreign ownership	66.7	66.6	76.3
Banks, total	**100.0**	**100.0**	**100.0**

Ownership structure of the banks on the basis of assets total (%)

Item	2001	2002	2003
Public sector ownership	19.90	14.23	0.42
Other domestic ownership	8.12	12.25	16.91
Domestic ownership total	*28.02*	*26.48*	*17.33*
Foreign ownership	71.98	73.52	82.67
Banks, total	**100.00**	**100.00**	**100.00**

Concentration of assets by the type of financial institutions (%)

Type of institutions	The first 3 largest	The first 5 largest
Commercial Banks	40.59	54.21
Nonbanking financial institutions	53.03	75.1

Return on Assets (ROA) by the type of financial institutions (%)

Type of institutions	2001	2002	2003
Commercial Banks	2.93	2.05	2.04
Nonbanking financial institutions	-1.00	1.37	0.69

Return on Equity (ROE) by the type of financial institutions (%)

Type of institutions	2001	2002	2003
Commercial Banks	21.85	16.20	18.73
Nonbanking financial institutions	-2.22	5.82	4.79

Distribution of market shares in balance sheet total (%)

Type of institutions	2001	2002	2003
Commercial Banks	99.34	99.15	98.85
Nonbanking financial institutions	0.66	0.85	1.15

Structure of assets and liabilities of the banking system (%)
(at year-end)

Assets	2001	2002	2003
Cash in vault & funds in current account with BNB	10.5	8.6	9.4
Due from banks & other financial institutions	33.3	24.2	14.9
Securities in trading portfolio	12.5	11.8	8.6
Loans extended to non-financial institutions and other clients	33.9	41.2	52.0
Securities in investment portfolio	4.2	7.6	10.0
Fixed assets	3.8	4.6	4.6
Other assets	1.8	2.1	0.6
Total assets	**100.0**	**100.0**	**100.0**
Liabilities and capital			
Deposits by banks and other fin. Institutions	7.5	8.4	8.6
Deposits by NFIs and other clients	70.9	68.6	70.0
Total deposits	*78.3*	*77.0*	*78.5*
Other liabilities	8.3	9.4	8.0
Subordinated debt	0.0	0.0	0.4
Capital	7.1	6.4	5.4
Reserves	6.3	7.2	7.8
Total liabilities & own funds	**100.0**	**100.0**	**100.0**

Development of off-balance sheet activities (%)
(off-balance sheet items / balance sheet total)

Type of bank	2001	2002	2003
Large banks	5.7	5.0	8.8
Small and medium-sized banks	17.1	20.6	19.6
Banks, total	**11.8**	**13.8**	**14.6**

Solvency ratio of banks

Type of banks	2001	2002	2003
Large banks	37.0	28.7	27.7
Small and medium-sized banks	27.3	23.3	18.8
Banks, average	**31.1**	**25.2**	**22.2**

Asset portfolio quality of the banking system

Assets classification		2001	2002	2003
Amount in BGN Millions		**8,722,129**	**10,067,439**	**11,568,572**
Standard	%	92.3	93.5	93.5
Watch	%	3.2	2.9	3.1
Substandard	%	1.1	1.0	0.8
Doubtful	%	0.9	0.5	0.6
Loss	%	2.5	2.1	2.0
Classified total	**%**	**100.0**	**100.0**	**100.0**
Specific reserves	%	4.9	3.6	3.7

The structure of deposits and claims on sectors (%)
(at year -ends)

Item	2001		2002		2003	
	Deposits	Claims	Deposits	Claims	Deposits	Claims
Households	51.9	7.7	47.7	9.2	47.3	19.1
Government sector	4.8	12.4	3.5	13.8	6.6	0.2
Corporate	31	31.6	38.8	44.8	35.8	56.9
Foreign	10.1	41.4	8.7	26.4	10.3	16.1
Other	2.2	6.9	1.3	5.8	0.0	7.7
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

The structure of deposits and loans by maturity (%)
(at year-ends)

Deposits	2001	2002	2003	Claims	2001	2002	2003
At sight	46.3	47.1	47.0	Short term	71.4	65.7	52.0
Within one year	49.9	48.5	44.0	Medium term	20.5	30.3	35.7
Over one year	3.8	4.4	8.9	Long term	7.7	3.8	12.2
				Other	0.4	0.2	0.1
Total	**100.0**	**100.0**	**100.0**	**Total**	**100.0**	**100.0**	**100.0**

**Proportion of foreign exchange assets and liabilities of banks (%)
(at year-ends)**

Type of banks	FOREX assets/total assets			FOREX liabilities/total liab.		
	2001	2002	2003	2001	2002	2003
Large banks	60.5	51.5	45.8	55.9	53.4	47.8
Small and medium-sized banks	56.9	56.5	51.7	59.3	57.8	56.1
Foreign bank branches	64.0	65.6	53.9	64.9	67.2	36.8
Banks, average	**59.2**	**54.9**	**49.4**	**58.2**	**56.6**	**51.7**

**Structure of revenues and expenditure of banks
(at year-ends)**

BGN millions

Revenues	2001	2002	2003
Interest earned	686	740	1,015
Net income from fees and commissions	199	238	264
Securities income/loss (net)	126	148	60
Forex operations income/loss (net)	49	41	34
Other banking operations revenues	13	0	60
Extraordinary revenues/expenses (net)	32	11	8
Total revenues	**1,105**	**1,178**	**1,441**
Expenses			
Interest paid	212	218	261
General operating costs	552	602	721
Reserve and provisions creation/reintegration (net)	-75	12	43
Other operating costs			
Total expenses	**764**	**820**	**982**
Pre-tax profit	**416**	**346**	**416**
Taxes	117	84	97
Net profit	**299**	**262**	**319**

Structure of registered capital and own funds of banks in 2003

Type of banks	Registered capital / Total assets		Own funds / Total liab.	
	EUR in thous.	%	EUR in thous.	%
Large banks	171,957	4.8	587,633	19.5
Small and medium-sized banks	305,235	5.8	576,403	12.3
Banks, average	**477,192**	**5.4**	**1,164,036**	**15.1**

2003 DEVELOPMENTS IN THE CROATIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2003, the Croatian economy recorded solid economic growth and low inflation. Real GDP grew 4.3% in 2003, down from the 5.2% rate in 2002. The driving forces behind the growth in 2003 were investment, above all in public infrastructure, and personal consumption. Investment grew some 16.8% in real terms, even faster than the 10.1% growth of 2002. Personal consumption growth slowed from 6.6% in 2002 to 4.1%. Government consumption stagnated during 2003, as it did during the preceding two years. Foreign demand once again made a negative contribution to GDP growth, with merchandise imports again growing strongly. Both imports of capital goods and imports of consumer durables grew rapidly as a result of a fast growth in investment and personal consumption respectively. The growth rate of merchandise exports increased in 2003 relative to the low rate seen in 2002, and the growth rate of services increased very sharply. Tourism revenues were up some 47%. As a result of the solid economic growth, employment grew by 2.5% in 2003, while registered unemployment fell by some 19.3%

Core inflation, which excludes both administrative prices and prices of agricultural products, rose by a mere 0.7% in 2003. In keeping with the central bank's policy of maintaining a broadly stable exchange rate, the average daily exchange rate of the kuna against the euro depreciated by 2.1% in 2003. The kuna appreciated strongly against the US dollar, with the average daily exchange rate of the kuna strengthening some 14.8% compared with 2002. This led to an appreciation of the real effective exchange rate of the kuna (deflated by retail prices) of 2.5%.

Croatia's current account improved in 2003, but the trade balance did not. The current account deficit decreased from some 8.5% of GDP in 2002 to 7.2% in 2003. However, large current account and fiscal deficits, and a sharp rise in the country's external debt, posed important challenges to policy makers. In January 2003, the central bank introduced measures to penalise a rapid credit growth and to ensure that banks hold adequate foreign exchange liquidity, and reinforced these measures with tightened reserve requirements (increases in the percentage of the reserve requirement on foreign exchange obligations that must be held in kuna from 25% to 35% in September and from 40% in November to 42% in December).

BANKING SYSTEM

At the end of 2003, the banking system of the Republic of Croatia comprised 45 banking institutions: 41 commercial bank and 4 housing savings banks, which is 5 less than at the end of 2002. In the course of the year, four banks merged with other banks and one bank initiated liquidation proceedings. The share of bank assets in full or majority foreign ownership in total bank assets increased mildly, from 90.2% in 2002 to 91% at end-2003. Croatia's banking system is dominated by six banks/banking groups, accounting for 84.1% of the total banking sector assets, all of them being majority foreign-owned. Competition among banks and banking groups has been rising, as is clearly visible from the continued reduction in interest rates, continued adjustment of loan approval conditions aimed at outperforming the competition and increasing the supply of innovative products specially tailored to fit the needs of different market segments.

Balance Sheet Structure of Banks

Total bank assets amounted to HRK 204.1bn at the end of 2003, which is a 17.2% increase, compared with end-2002. This was mostly the result of a rise in net loans to other clients (non-financial sector), which rose by 18.8% compared with the end of 2002. To finance this rise banks used the funds obtained from deposit growth and loans received. The share of loans to other clients in the structure of bank assets increased from 51.8% at end-2002 to 52.4% at end-2003. Cash in banks increased substantially, while deposits with the CNB continued the previously started trend of a strong growth (compared with 2002 they grew 30.7%, while their share went up from 11% to 12.3%).

Deposits predominated in the bank liability structure. At end-2003, they accounted for 70.4% of total liabilities, which is less than at end-2002 when they amounted to 71.5%. Like in the previous years, the majority of deposits were denominated in foreign currency (67.6%).). Loans received (loans from financial institutions and other loans) rose from 13.5% at end-2002 to 15.8% at end-2003. The central bank's above-mentioned measures seem to have led to an increase in foreign borrowing by some banks.

Bank Capital

At end-2003, banks' regulatory capital amounted to HRK 19.3bn, which is a 14.6% increase compared with end-2002 when it stood at HRK 16.8bn. Banks' capital adequacy ratio totalled 16.2% at end-2003, which is less than at end-2002 when it stood at 17.2%. All but one bank reported capital adequacy above the minimum prescribed ratio of 10%. The downward trend in the capital adequacy ratio, which was recorded over the last three years, resulted from a faster growth of risk-weighted assets than regulatory capital.

Asset Quality

At the end of 2003, fully recoverable placements (groups A and B) grew by 16.2% compared with 2002 and accounted for 94.9% of total risk assets. Partly recoverable placements (groups C and D) went up in nominal terms and accounted for 3.5% of the total risk assets, while placements whose present value equals zero (group E) went down in nominal terms and accounted for 1.6% of total risk assets. The downward trend in total provisions, both in absolute terms and as a share in total placements, resulted from an increase in the share of group B, but also a decline in average provisioning percentage for groups C and D, as well as a reduction in group E placements.

Earnings Quality

In 2003, banks reported a profit of HRK 2,506.7m. Net interest income generated in 2003 went up 19.8% compared with 2002, as a result of a larger growth of interest income than interest expense. Earned profit grew by 20.8% over the previous year, which triggered an upward trend in the return on average assets (ROAA), which rose from 1.58% in 2002 to 1.59% and return on average equity, which went up from 13.74 % in 2002 to 14.46% in 2003.

Bank Liquidity

The ratio of total loans to total deposits grew mildly from 74.2% at the end of 2002 to 76.7% at the end of 2003, while the gross-liquid-assets-to-total-assets ratio continued to decrease from 14.3% in 2001 to 13.6% in 2002 and 11.6% at end-2003.

THE LEGAL AND INSTITUTIONAL FRAMEWORKS OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS – NEW DEVELOPMENTS

The financial sector of the Republic of Croatia consists of banks, housing savings banks, insurance companies, leasing companies, pension funds, investment funds and savings and loan co-operatives. Deposit money banks, with a share of 85% in the total financial sector assets, account for the largest part of the Croatian financial market.

The Croatian National Bank is responsible for the operation and supervision of banks and housing savings banks. The Croatian Securities Commission is responsible for the operation and supervision of investment funds, the Directorate for Supervision of Insurance Companies is responsible for the operation and management of insurance companies, the Agency for Supervision of Pension Funds and Insurance supervises pension funds, while the Ministry of Finance supervises savings and loan co-operatives.

The Croatian National Bank exercises supervision over banks and savings banks in accordance with the powers granted to it pursuant to the Law on the Croatian National Bank and the Banking Act.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2003

Apart from an ongoing supervision of banks' operations, preparation of analyses and indicators of the banking system performance, as well as regular and extra on-site examinations of banks, the Prudential Regulation and Bank supervision Area employees were engaged in many other important activities during 2003. The preparation of new banking regulations and their interpretation was completed and the regulations were published in the official gazette of the Republic of Croatia. In 2003, consolidated bank supervision was introduced together with the settlement of matters related to market competition within the banking sector. In 2003, the Bank Supervision Area continued to organise interactive workshops for deposit money banks aimed at improving the prudential regulations. The program of banks' information technology supervision also continued.

During the last quarter of 2003 and in early 2004, intensive preparations were going on in the Croatian National Bank for the reorganisation and development of a new organisational scheme. The process was completed in March 2004. The preparation activities also included the reorganisation of the Bank Supervision Area.

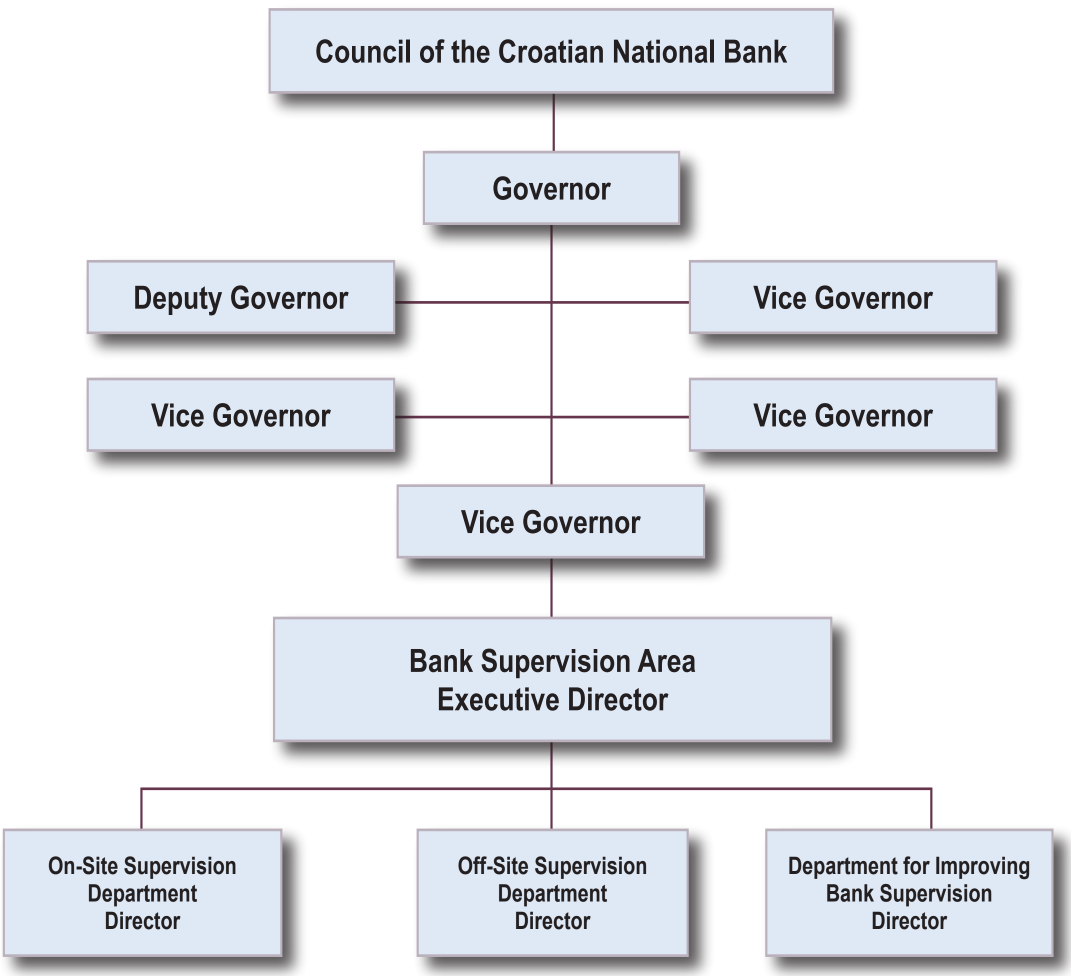
The main reasons for the reorganisation were the need for specialisation as a result of the banking technology development, which introduces new risks into bank operations, as well as the necessity to monitor the implementation of the new prudential regulations. The management boards of Croatian banks have been given an opportunity to design their internal risk management models subject to obtaining a license from the CNB supervision authorities. Apart from the credit, interest rate and market risks, which have been considered as typical bank operation risks, other risks are becoming increasingly important. These various risks can be subsumed under the concept "operational risk".

Besides the above mentioned, the reasons for the reorganisation of the supervisory activity were the following: a need for international co-operation between supervisors, due to the ownership structure of Croatian banks; a need for a more profound analysis of the banking system as a basis for a successful performance of the main supervisory tasks.; the expansion of powers and responsibilities of the supervision on new areas like the protection of market competition, supervision over the IT systems of banks, consolidated bank supervision etc. In order to meet these requirements, a reorganisation process was initiated and a new Prudential Regulation and Bank Supervision Area was established, which included five departments as shown in the new organisational chart.

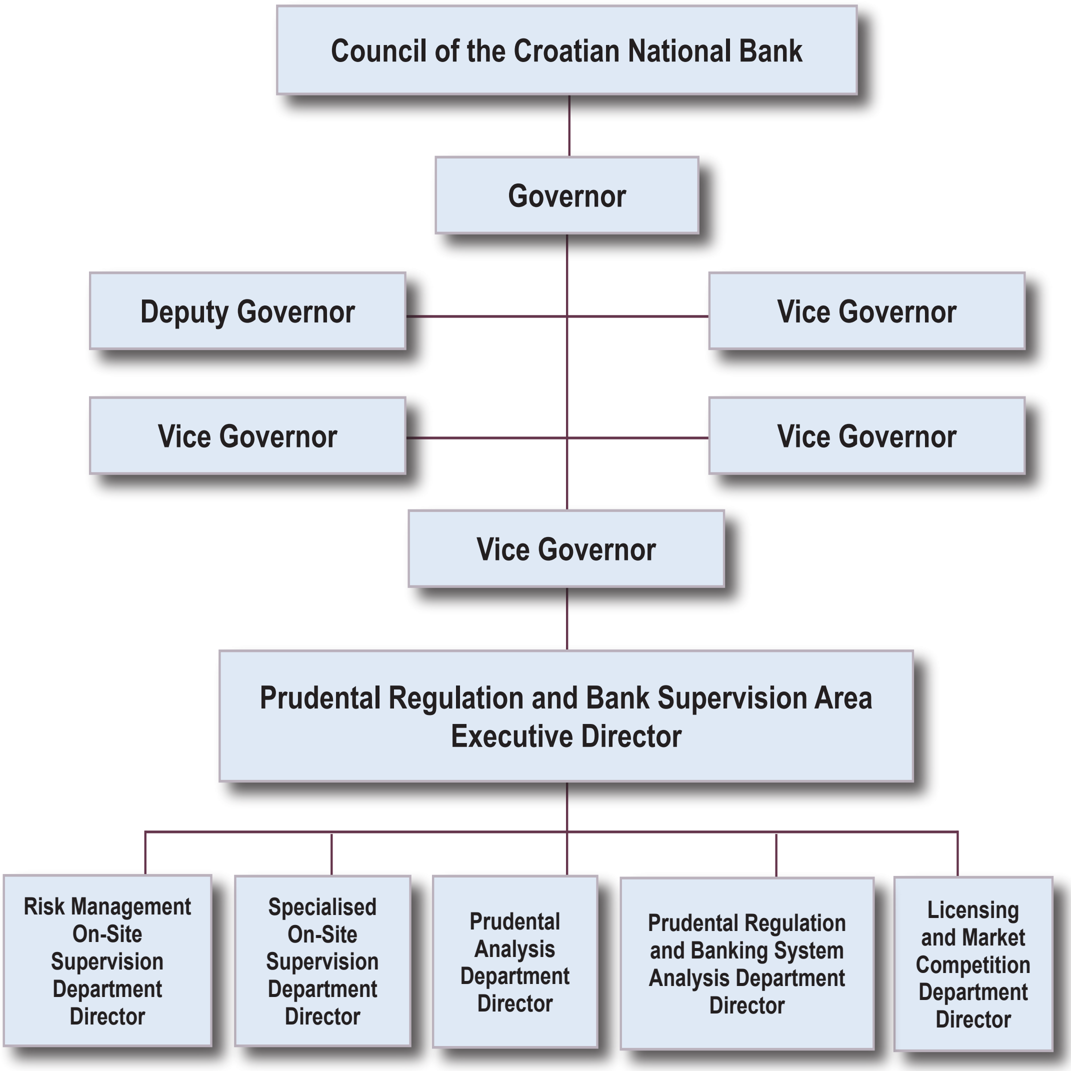
LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

As previously mentioned, the Banking Act is the fundamental law governing banking operations. The Banking Act, which came into force in July 2002, is in conformity with the EU regulations in all its essential elements. Pursuant to this Act, 2003 saw the enforcement of prudential decisions regulating the method of classifying placements and contingent liabilities, as well as capital adequacy and currency risk management. These decisions were followed by decisions related to the organisation and method of carrying out bank examination, which stipulate in detail the method of bank operations supervision, consolidated supervision of banking groups and the scope and content of the audit of financial reports. In addition, a decision was adopted defining in detail the methods and procedures for protecting market competition, and a new decision regulating the operations of foreign bank representative offices. Due to the complexity of these issues, especially in the part relating to the market risk management, the transitional and final provisions of these prudential decisions stipulate that most of their provisions should be applied as of 1 January 2004. Hence, the effects of the new prudential regulations will not be fully visible until that year.

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



The new organisational scheme of the supervisory functions that became effective on 1 April 2004 is as follows:



INTERNATIONAL ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY AND CO-OPERATION WITH OTHER SUPERVISORY BODIES

Several foreign banks from the EU member states have taken ownership in some Croatian banks. One bank domiciled in the Republic of Croatia owns subsidiaries outside Croatia. Maintaining contacts and co-operation with the bank supervisory authorities of EU member states and other countries are particularly important for the development of the bank supervision in the Republic of Croatia.

In 2003, the CNB undertook different steps to establish co-operation with the supervisory authorities of banks owning Croatian banks as well as banks owned by Croatian banks. As a result, the 2003 saw the signing of the Memorandum of Understanding and Co-operation in Banking Supervision with the agency responsible for bank supervision in Bosnia and Herzegovina, while similar agreements are under way with the responsible authorities in Austria and Italy. In addition, in 2003, co-operation was developed with other institutions in the Republic of Croatia.

THE MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISORY AUTHORITY

The main strategic objectives of the supervisory authority in 2003 were: to ensure successful implementation of the new subordinate legislation under the Banking Act, which have been harmonised with the EU regulations. In this connection, the subordinate legislation, which is in full conformity with the Basle I, became effective on 1 January 2004; to establish co-operation with foreign supervisors responsible for parent banks and subsidiaries of banks operating in the Republic of Croatia; to introduce supervision on the consolidated basis; to continue the implementation of the human resources improvement and professional improvement schemes; to enhance the information transparency through the CNB publications and Website; and to strengthen the organisational structure of the bank supervision.

STATISTICAL TABLES

Type of financial institution

Type of financial institution	2001	2002	2003
Banks	43	46	41
Saving banks	19	4	4
Financial institutions, total	**62**	**50**	**45**

Ownership structure of financial institutions in 2003 on the basis of registered capital (%) (at year end)

Item	Type of financial institution		Total
	Banks	Savings banks	
State ownership	7.9	0.0	7.8
Other domestic ownership	13.7	0.0	13.4
Domestic ownership total	*21.7*	*0.0*	*21.2*
Foreign ownership	78.3	100.0	78.8
Financial institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of financial institutions on the basis of registered capital (%) (at year end)

Item	2001	2002	2003	2003/2001 (indeks)
State ownership	10.5	8.0	7.8	74.0
Other domestic ownership	14.7	13.7	13.4	91.2
Domestic ownership total	*25.2*	*21.7*	*21.2*	*84.1*
Foreign ownership	74.8	78.3	78.8	105.3
Financial institutions, total	**100.0**	**100.0**	**100.0**	

Distribution of market shares in balance sheet total (%)

Type of financial institution	2001	2002	2003
Banks	98.4	98.7	98.3
Savings banks	1.6	1.3	1.7
Financial institutions, total	**100.0**	**100.0**	**100.0**

Development of off-balance sheet activities (%) (off balance sheet items/ balance sheet total)

Type of financial institution	2002	2003
Banks	14.5	12.8
Savings banks	0.2	0.3
Financial institutions, total	**14.3**	**12.6**

Solvency ratio of financial institutions

Type of the financial institution	2001	2002	2003
Banks	18.5	17.2	16.2
Savings banks	37.4	34.2	31.0
Financial institutions, average	**18.7**	**17.2**	**16.3**

** Capital adequacy ratio*

The structure of assets and liabilities of the banking system (%) (at year-end)

Assets	2001	2002	2003
Money assets	5.3	1.3	1.4
Deposits with CNB	9.7	11.0	12.3
Deposits with banking institutions	16.1	11.6	15.3
Treasury bills and CNB bills	6.5	5.8	3.8
Trading portfolio of securities	3.2	4.8	3.6
Loans to financial institutions	1.0	1.2	1.5
Loans to other clients	43.3	51.8	52.4
Investment portfolio of securities	8.6	7.3	5.4
Investment in subsidiries and affiliated companies	1.5	1.4	1.2
Foreclosed and repossessed assets	0.3	0.2	0.2
Tangible assets and software	2.4	2.2	2.0
Interests, fees and other assets	2.9	2.3	1.8
General provisions	-0.8	-0.9	-0.9
Liabilities	**2001**	**2002**	**2003**
Borrowings from financial institutions	2.4	2.3	3.5
Giro and current account deposits	11.1	13.4	12.4
Savings deposits	17.8	13.8	12.1
Time deposits	41.6	44.3	45.9
Other loans	10.8	11.2	12.3
Subordinated debt instruments	0.2	0.4	0.4
Hybrid instruments	1.6	1.3	1.1
Interests, fees and other liabilities	5.3	3.8	3.4
Equity capital	6.0	5.6	4.9
Current year profit or loss	0.4	1.1	1.2
Retained profit (loss)	0.1	0.5	0.6
Reserves	2.7	2.3	2.2

Asset portfolio quality of the banking system

in million HRK

Asset Classification	2001	2002	2003
A	137,195.6	168,693	193,767
B	3,391.0	3,558	6,399
C	3,193.4	3,718	4,813
D	3,526.2	2,756	2,663
E	4,287.3	4,245	3,371
Classified total	**151,593.3**	**182,970**	**211,014**
Specific reserves	**7,912.1**	**7,303**	**6,574**

The structure of deposits and loans in 2003 (%)
(at year-end)

	Deposits	Loans
Households	55.3	47.8
Government sector	2.6	7.8
Corporate	21.6	41.0
Foreign	15.9	0.4
Other*	4.7	3.1
Total	**100.0**	**100.0**

** Financial sector is included*

The structure of deposits and loans in 2003 (%)
(at year-end)

Maturity of Deposits		Loans	
At sight	19.6	Long term loans	30.6
Within one year	46.1	Medium-term loans (1 to 3 years)	19.4
Over one year	34.3	Short-term loans	50.0
Total	**100.0**	**Total**	**100.0**

Proportion of foreign exchange assets and liabilities
(at year-ends)

Type of the financial institutions	FOREX assets/ Total assets			FOREX liabilities/ Total liabilities		
	2001	2002	2003	2001	2002	2003
Banks	35.0	28.8	30.4	67.6	64.8	61.8
Savings banks	1.0	1.6	4.5	3.0	6.5	0.0
Financial institutions, average	**34.7**	**28.5**	**30.0**	**67.0**	**64.1**	**60.7**

Structure of revenues and expenditures of financial institutions
(at year-ends)

in million HRK

Revenues	2001	2002	2003
Interest income	8,973.6	9,940.4	11,121.7
Non-interest income	3,230.8	4,107.2	4,415.7
Expenditures			
Interest expense	4,315.5	4,655.0	4,784.2
Non-interest expense	1,974.1	1,931.9	2,316.5
General and administrative expenses	3,878.1	4,427.2	4,831.8
Provisions for identified and unidentified losses	807.9	488.8	594.3
Income taxes	334.6	470.0	504.0

Structure of registered capital and own funds of financial institutions in 2003

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	000 USD	%	000 USD	%
Banks	1,625,495	4.9	3,149,788	9.4
Savings banks	31,602	5.5	27,927	4.9
Financial Institutions, average	**1,657,098**	**4.9**	**3,177,716**	**9.4**

DEVELOPMENTS IN THE CZECH BANKING SECTOR IN 2003

MACROECONOMIC ENVIRONMENT IN THE CZECH REPUBLIC

The year 2003 saw continuing economic growth. The rate of growth of gross domestic product was 2.9% in 2003, an increase of 0.9 percentage point on a year earlier. As at December 2003 gross domestic product totalled CZK 1,587.2 billion at constant 1995 prices. The continuing GDP growth trend is due to steadily growing domestic demand, based primarily on rising household consumption.

The rate of inflation in December 2003 dropped to the very low level of 0.1%. One year earlier the rate had been 1.8%.

In addition to the external influence of unfavourable foreign demand due to the weak economic growth of the Czech Republic's major trading partners, the Czech economy was faced by appreciation of the koruna's exchange rate against the US dollar. From an annual average of CZK 32.74 to the dollar in 2002, the koruna strengthened to CZK 28.23 in 2003. The opposite trend was seen against the euro. The koruna's annual average exchange rate against the euro weakened from CZK 30.81 to CZK 31.84 in the same period.

In December 2003 the unemployment rate exceeded the 10% level for the first time ever. By the end of the year it had reached 10.3%, which was 0.5 percentage points higher than in 2002. The average nominal wage increased by 7% in 2003 and the average real wage by 6.2% in the same period due to the very low inflation rate.

DEVELOPMENTS IN THE BANKING SYSTEM

As of 31 December 2003, the Czech banking sector consisted of 35 banks and branches of foreign banks. The number of banks fell by two in 2003 because of the revocation of the licences of Union Banka and Plzeňská banka. Due to the exit of these two banks, whose capital was held mainly by Czech entities, the share of foreign owners in the equity capital of the Czech banking sector continued to grow. As of 31 December 2003, foreign entities held a 84.9% share in the total equity capital of the sector, an increase of 3 points on a year earlier, and controlled 95.9% of the total assets of the sector. In only four banks, two of which are state-owned banks supporting government policies, do Czech owners have a majority share in the equity capital now.

Throughout 2003, there was a continuing decline in the number of bank employees and bank outlets. At the end of 2003, there were 39,004 people working in the Czech banking sector, 4.0% less than a year earlier. The number of banking units was 1,670, a 3.0% decline compared with a year earlier.

As of 31 December 2003, banking assets stood at CZK 2,557.7 billion, a 1.9% annual increase. The ratio of total assets/GDP at current prices was 1.1 at the year end. Commercial banks dominated the financial sector, with 74.2% of total assets as at December 2003. The group of large banks accounted for 62.1% of the banking sector's assets. Providing credit products, which increased by 9.9% to CZK 1024.8 billion, was the major activity of the Czech banking sector on the asset side of its balance sheet. The increase in credit was mainly due to 34.6% growth in credit to households, which reached CZK 210.8 billion at the end of 2003. Households became the second largest recipient of credit at the end of 2003, behind non-financial corporations with their figure of CZK 427.5 billion.

The asset quality of the banking sector continued to improve. Non-performing loans were CZK 49.6 billion at the end 2003, which means that the ratio of non-performing loans to total loans fell from 8.1% at the beginning of 2003 to 4.9% at the end of 2003. The capital adequacy of the Czech banking sector was 14.5% at the end of 2003. The profitability of the Czech banking sector in 2003 was similar to that in the preceding year. The net income of Czech banks in 2003 was CZK 30.2 billion, which resulted in a 1.21% return on assets and a 23.8% return on Tier 1 capital.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN THE CZECH REPUBLIC

There are four regulatory bodies in the Czech Republic. The Czech National Bank's banking supervisory authority (CNB Banking Supervision) is responsible for the stability of the banking sector, including building societies. The Czech Securities Commission supervises investment companies and investment funds. The Ministry of Finance of the Czech Republic is the surveillance body for insurance companies and pension funds. The Credit Union Supervisory Authority regulates credit unions.

The two fundamental laws governing banking regulation are the Act on Banks and the Act on the Czech National Bank. In 2003 the following changes to the legislation affecting banks and their supervision were adopted:

- the Act on Payment Systems, which regulates transfers of funds in the Czech currency within the Czech Republic, cross-border transfers, the issuing and use of electronic payment instruments, and the establishment and operation of payment systems. The amendment took effect on 1 January 2003. The part concerning cross-border transfers took effect on 1 May 2004 (when the Czech Republic became a member of the EU);

- an amendment of the Act on Building Savings and State Support for Building Savings, which decreases the state subsidy for this type of saving, extends the minimum saving period required for granting a subsidy, and changes the licensing terms for building societies. As a result, there was a massive inflow of deposits into saving accounts in building societies before the beginning of 2004.

In addition to the above changes the Czech National Bank issued the following new provisions (N) and amended some existing provisions (A):

- on the internal control system of a bank, which specifies requirements for the management of credit risk, market risk, operational risk and liquidity risk; most of the requirements were transferred from previous provisions, but requirements for internal audit, management of operational risk and information systems are new (A);
- stipulating the minimum information requirements of a bank (not for foreign branches) (A);
- on the internal control system of a bank for the area of money laundering prevention – adopted to minimise the risk of abuse of banks in respect of money laundering (N);
- stipulating rules for assessment of financial receivables and creation of provisions and reserves, and rules for the acquisition of certain types of assets (A);
- stipulating the prudential rules of parent undertakings on a consolidated basis, as amended under the Banking Act, effective as from 1 January 2003 (A);
- on capital adequacy of banks and other prudential rules on a solo basis – to harmonise the calculation of capital adequacy, credit exposure and other macroprudential indicators on a consolidated and solo basis (N).

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2003

In 2003, the CNB continued implementing its medium-term banking supervision plan for the period 2002–2004. This is based on the principles set by the Basel Committee on Banking Supervision and the recommendations ensuing from the assessment programs of international institutions (e.g. the Financial Sector Assessment Program of the IMF and WB and the missions of the European Commission). The main tasks of this plan for 2003 were as follows:

- to establish a supervisory division to develop a comprehensive methodology for banking risk assessment,
- to intensify supervision on a consolidated basis,

- to intensify on-site inspections and to concentrate on the risks generated by new banking products,
- to enhance the knowledge of supervisory staff in order to supervise individual banks and consolidated groups more effectively according to their risk profiles,
- to enhance the transparency of supervisory activities,
- to ensure a fast and efficient supervisory response to the deficiencies identified,
- to enhance cooperation with domestic regulators and to eliminate duplication of effort in banking supervision,
- to introduce regulatory provisions stipulating the requirements for the management of banking risks,
- to determine regulatory requirements for anti-money-laundering and anti-terrorism-financing procedures in banks,
- to enhance cooperation with foreign supervisory authorities.

Besides the realisation of these strategic objectives, many of which are long term in nature, measures were undertaken relating to accession to the EU, such as implementation of the single licence concept and the New Basel Capital Accord.

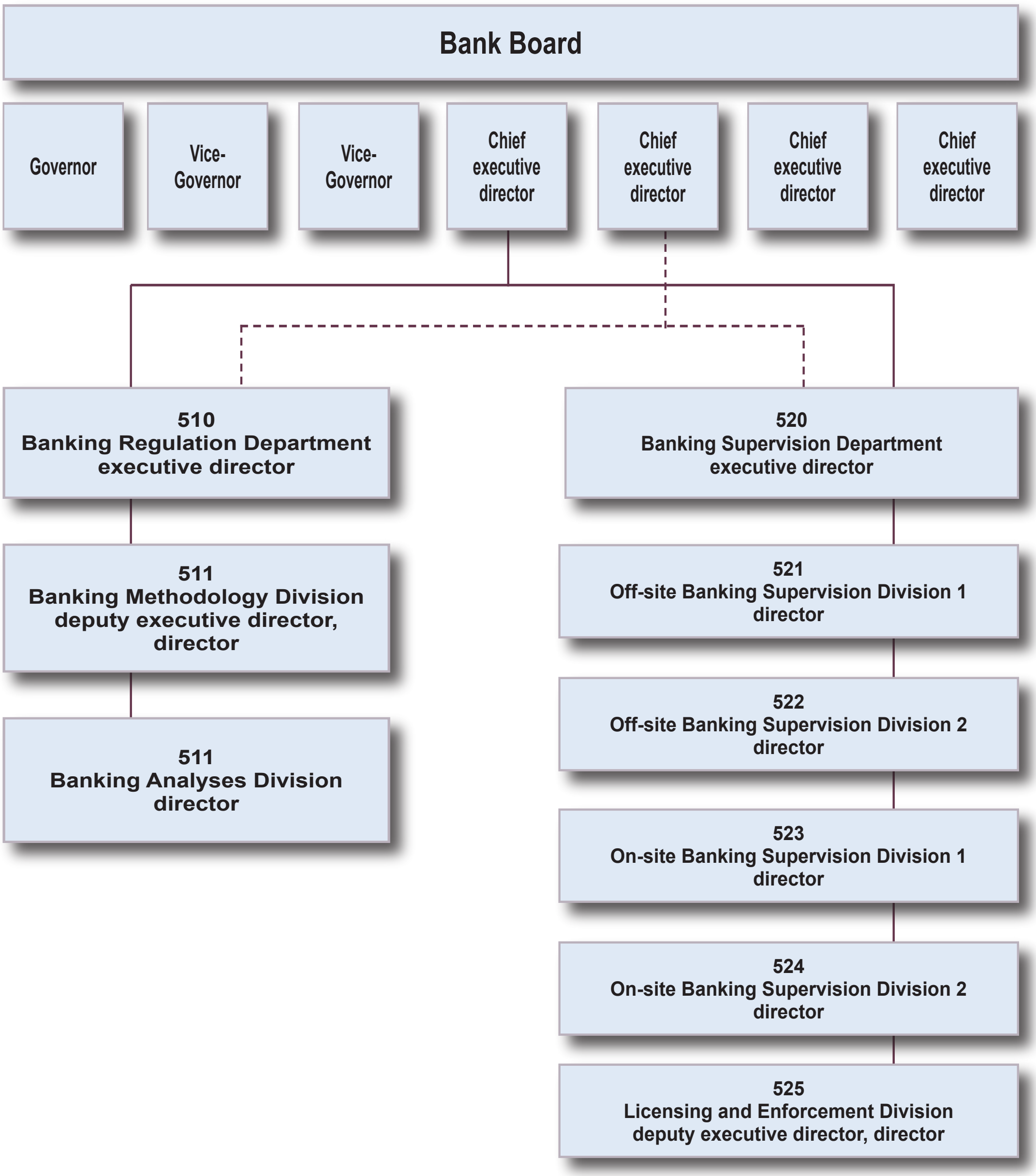
THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2003

In preparation for the implementation of the accession-related single licence principle, the CNB drew up an analysis of the possible effects of the single licence principle on the structure of the Czech banking sector and the CNB's supervisory activities. For the first time, the CNB in 2003 employed auditors' reports assessing management and control systems in selected banks as an information source for its supervisory activities. The CNB assigned auditors the task of assessing 12 specific areas in eight banks. The results of the reports were subsequently evaluated during discussions with all parties involved.

In 2003, the CNB intensified supervision on a consolidated basis. The supervised banks started to submit their consolidated statements on a quarterly basis, the CNB's cooperation with foreign regulators was extended, and the CNB focused on the specific of individual financial groups. Finally, the CNB began the process of re-licensing banks and foreign bank branches in order to harmonise their licences with the banking law.

In 2003, CNB Banking Supervision undertook 18 inspections in 15 banks and foreign bank branches, two of them complex and 16 partial monitoring selected types of risks. The supervisors focused primarily on the systems used for credit risk and market risk management, the functionality and effectiveness of internal management and control systems and the area of risks connected with information systems and technology.

ORGANIZATIONAL CHART OF THE CNB BANKING SUPERVISION
as of 31 December 2003



INTERNATIONAL ACTIVITIES OF THE CZECH NATIONAL BANK IN THE FIELD OF BANKING SUPERVISION

CNB Banking Supervision is involved in international co-operation in different ways, ranging from bilateral co-operation based on Memoranda of Understanding with foreign regulators through to active participation in the work of international organisations. In collaboration with the working groups of the Bank for International Settlements and the committees and working groups of the European Union, including the European Central Bank and the European System of Central Banks, CNB Banking Supervision elaborates methodological approaches to, and regulatory measures of, banking supervision.

Co-operation with regulators from six countries based on MoUs (with Austria, Germany, France, Belgium, Slovakia and the USA) continues successfully. MoUs with Italy and Netherlands are being prepared. The stepping-up of bilateral co-operation is closely linked with supervision on a consolidated basis, the Czech Republic's accession to the EU, and the single banking licence regime.

Czech National Bank representatives are members of the Banking Advisory Committee, the Committee of European Banking Supervisors, the European Banking Committee, the Groupe de Contact (a working group of Central European Banking Supervisors – CEBS), the Working Group on the Capital Requirements for Banks and Investment Firms, and the Banking Supervision Committee within the ECB, having support in the Working Group on Macro-Prudential Analyses and the Working Group on Developments in Banking.

The Czech Republic was involved in the preparation and implementation of the New Basel Capital Accord by the Core Principles Liaison Group and Working Group on Capital. This enabled us to share information and express our opinion on the process.

CO-OPERATION WITH OTHER SUPERVISORY BODIES IN THE CZECH REPUBLIC

The three main supervisory bodies of the Czech financial sector, i.e. the Czech National Bank, the Ministry of Finance of the Czech Republic and the Czech Securities Commission, signed a tripartite co-operation agreement in 1998. An amendment to this first Memorandum of Understanding for the Performance of Banking Supervision and State Supervision of the Financial Market was signed at the beginning of 2003 with a view to promoting the smooth development of supervision on a consolidated basis.

The purpose of the Memorandum is to provide for a more detailed specification, harmonisation and greater efficiency with regard to the procedures in the field of banking supervision and state supervision of the financial market so as to fulfil the statutory aims and duties in this field. The fundamental aim of this Memorandum is to ensure the implementation of analogous criteria and procedures for supervision of the financial market, including licensing procedures etc.

The parties to the Memorandum co-operate in carrying out supervision on a solo and consolidated basis, particularly in the areas of licensing and granting approvals, inspections, imposing remedial measures and sanctions, exchange of information, regulation of the Czech financial market and procedures vis-à-vis foreign entities supervising the financial market and international institutions.

Based on the aforementioned MoU, a committee was set up to enhance mutual co-operation. In the second half of 2003 this committee discussed the issue of integration of supervisory institutions.

Co-operation also continues with professional organisations active in the domestic banking sector. At present the Czech National Bank co-operates with the Czech Banking Association and the Czech Chamber of Auditors. At the moment, close attention is being paid to the New Basle Capital Accord, which is expected to be introduced in 2006.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

On 1 January 2003, Act No. 229/2002 Coll., on the Financial Arbiter, came into legal force. Under this Act the authority of the Financial Arbiter of the Czech Republic was established with effect from 1 January 2003. This is a special body for out-of-court settlement of disputes arising between payment services providers and their clients or between issuers and users of electronic payment instruments. Its establishment meant that the relevant provisions of Act No. 124/2002 Coll., on Transfers of Funds, Electronic Payment Instruments and Payment Systems, were satisfied. The Financial Arbiter was established as part of the process of harmonising Czech law with that in the European Union, as European Community Directive No. 97/5/EU, on cross-border transfers, requires the possibility for consumers to settle disputes in an efficient and appropriate manner with transfer institutions through out-of-court procedures. Openness towards the public is an important feature of the Financial Arbiter's activities. This institution has a preventive function as well, as it can either directly advise the relevant institutions of insufficiencies in their functioning or notify the supervisory body of prevailing shortcomings. The Financial Arbiter may impose fines of up to CZK 1 million, and may do so repeatedly if necessary.

The Arbiter performs his duties independently and impartially and refrains from doing anything that might raise doubts about his impartiality. Although the CNB has provided all the resources required for the Financial Arbiter's operations, the Arbiter is not dependent on the CNB and is not a part of the CNB's regulatory and supervisory body. The Arbiter may authorise an employee of the Czech National Bank or another individual to conduct an inquiry into a particular matter. For this purpose, institutions are obliged to appear before the Arbiter and submit the required documents, enable the Arbiter to review their files and so on.

STATISTICAL TABLES

Number of financial institutions
(at year-ends, banks carrying on activities
as of 31 December of the given year, excl. central bank)

Type of financial institution	2001	2002	2003
Large banks	3	4	4
Medium-sized banks	10	9	10
Small banks	8	9	6
Foreign bank branches	10	9	9
Building societies	6	6	6
Banks under conservatorship	1	0	0
Financial institutions, total	**38**	**37**	**35**

Ownership structure of financial institutions on the basis of registered capital (%)
(at year-ends, banks with licences as of 31 December of the given year)

Item	2001	2002	2003
State ownership	4.3	4.1	4.4
Other domestic ownership	25.7	14.0	10.7
Domestic ownership total	*30.0*	*18.1*	*15.1*
Foreign ownership	70.0	81.9	84.9
Financial institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of financial institutions on the basis of total assets (%)
(at year-ends, banks with licences as of 31 December of the given year)

Item	2001	2002	2003
State ownership	3.8	4.6	3.1
Other domestic ownership	2.0	2.1	1.0
Domestic ownership total	*5.8*	*6.7*	*4.1*
Foreign ownership	94.2	93.3	95.9
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions (at year-ends, banks with licences as of 31 December 2003, %)

Type of financial institution	The first three largest	The first five largest
Large banks	-	-
Medium-sized banks	47.4	72.4
Small banks	53.5	-
Foreign bank branches	72.0	93.1
Building societies	74.4	-
Financial institutions, total	**56.9**	**65.8**

Note: Information on less than three banks cannot be released. This applies when the remaining number of banks not being included into calculation is less than three, too.

Return on asset (ROA) by type of financial institutions (banks with licences as of 31 December 2003, %)

Type of financial institution	2001	2002	2003
Large banks	0.75	1.44	1.37
Medium-sized banks	0.87	0.79	1.14
Small banks	0.35	0.16	1.32
Foreign bank branches	0.41	1.00	0.86
Building societies	0.90	0.92	0.50
Financial institutions, total	**0.73**	**1.24**	**1.21**

Return on equity (ROE) by type of financial institutions (banks with licences as of 31 December 2003, %)

Type of financial institution	2001	2002	2003
Large banks	16.11	30.99	25.80
Medium-sized banks	14.88	12.86	16.78
Small banks	3.65	1.49	11.50
Foreign bank branches	-	-	-
Building societies	16.10	20.31	13.38
Financial institutions, total	**16.64**	**27.4**	**23.8**

Note: For equity Tier 1 is used.

Distribution of market shares in balance sheet total (at year-ends, banks with licences as of 31 December 2003, %)

Type of financial institution	2001	2002	2003
Large banks	65.3	62.7	62.1
Medium-sized banks	15.1	17.3	15.8
Small banks	1.2	1.9	2.0
Foreign bank branches	12.2	9.7	9.6
Building societies	6.3	8.3	10.5

Financial institutions, total	**100.0**	**100.0**	**100.0**

Development of off-balance sheet activities (%)
(off balance sheet items-receivables / balance sheet total)
(at year-ends, banks with licences as of 31 December 2003)

Type of financial institution	2001	2002	2003
Large banks	106.8	127.7	146.7
Medium-sized banks	199.8	195.0	207.8
Small banks	18.8	16.4	39.7
Foreign bank branches	461.9	326.9	306.2
Building societies	2.7	4.4	3.4
Financial institutions, total	**156.4**	**146.4**	**154.4**

The structure of assets and liabilities of the banking system
(at year-ends, banks with licences as of 31 December 2003, %)

Assets	2001	2002	2003
Deposits with CNB	12.8	20.0	19.2
Deposits with banks	22.6	15.9	11.8
Credits	36.7	35.9	39.4
Securities	19.2	18.5	21.2
Fixed assets	2.3	2.2	2.2
Other assets	6.5	7.4	6.2
Liabilities			
Clients´ deposits	60.4	64.8	65.9
Banks´ deposits	14.8	12.2	11.3
Sources from central bank	0.2	0.1	0.0
Bond issues	8.4	6.5	7.8
Equity capital	5.4	6.4	7.0
Other liabilities	10.8	10.0	8.1

Solvency ratio
(at year-ends, banks with licences as of 31 December 2003, %)

Type of financial institution	2001	2002	2003
large banks	14.82	13.41	13.56
medium-sized banks	16.28	15.98	16.29
small banks	29.18	37.19	29.02
building societies	16.20	13.59	13.28
Financial institutions, total	**15.40**	**14.34**	**14.48**

Asset portfolio quality of the banking system
(banks with licences as of 31 December 2003)

CZK in mil.

Asset classification	2001	2002	2003
Standard	759,225	785,348	908,074
Watch	71,091	71,332	64,404
Substandard	31,859	27,515	19,299
Doubtful	29,447	11,689	6,913
Loss	66,889	36,566	23,398
Non-performing total	**128,194**	**75,770**	**49,610**
Classified total	**199,285**	**147,102**	**114,014**
Reserves and provisions	**77,283**	**58,689**	**38,265**

The structure of deposits and loans in 2003
(at year-end, banks with licences as of 31 December 2003, %)

	Deposits	Loans
Non-financial	22.7	45.0
Financial	5.9	8.7
Government sector	7.4	16.7
Small business	3.8	2.6
Households	56.2	22.2
Other	4.1	4.8
Total	**100.0**	**100.0**

The structure of deposits and loans by time in 2003
(at year-end, banks with licences as of 31 December 2003, %)

Maturity of deposits		Loans	
At sight	48.9	Short term loans	26.4
Within one year	34.5	Medium term loans	30.1
Over one year	16.6	Long term loans	43.5
Total	**100.0**	**Total**	**100.0**

Proportion of foreign exchange assets and liabilities
(at year-ends, banks with licences as of 31 December 2003, %)

Type of the financial institution	FOREX assets/total assets			FOREX liabilities/total liabilities		
	2001	2002	2003	2001	2002	2003
Large banks	19.2	15.8	16.5	15.0	13.4	13.3
Medium-sized banks	28.2	20.1	21.2	26.4	22.7	24.9
Small banks	26.1	13.7	17.3	24.2	13.1	19.4
Foreign bank branches	45.8	36.5	24.7	43.5	40.3	49.7

Financial institutions, aver.	**22.6**	**17.2**	**16.3**	**19.3**	**16.5**	**17.4**

Structure of registered capital and own funds of financial institutes in 2003 (at year-end, banks with licences as of 31 December 2003)

Type of the financial institution	Registered capital/total assets		Own funds/total liab.	
	EUR in mil.*	%	EUR in mil.*	%
Large banks	1,352.2	2.8	3,768.7	7.8
Medium-sized banks	455.1	3.7	1,096.4	8.9
Small banks	149.7	9.6	189.5	12.1
Foreign bank branches	12.5	0.2	84.9	1.1
Building societies	137.3	1.7	322.2	3.9
Financial institutions, aver.	**2,106.8**	**2.7**	**5,461.7**	**7.0**

** Rate of exchange CZK/EUR= 32.405*

Structure of revenues and expenditures of financial institutions (banks with licences as of 31 December 2002)

CZK in mil.

Revenues	2000	2001	2002
Interest earned	141,360	121,162	99,773
Fees and commissions earned	25,488	29,647	35,657
Profit from shares and units	907	1,122	824
Profit from foreign exchange activities	7,059	5,441	6,347
Profit from other financial operations (incl.derivatives)	3,477	6,088	2,436
Expenditures			
Interest paid	85,234	65,962	45,470
Fees and commissions paid	4,755	6,133	9,314
Administrative costs	47,115	46,975	47,513
Net creation of reserves and provisions, write-offs and receivables-transfer expenses	20,169	8,537	744
Taxes	5,172	11,223	11,074

2003 DEVELOPMENTS IN THE ESTONIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN ESTONIA

In view of the global economic environment, Estonian economy displayed fast growth of about 5.1% and record low inflation of 1.3% in 2003. Although export revenues increased in the second half of 2003, it was private consumption and investments, which sustained economic growth.

In 2003, external demand was relatively unfavorable for Estonia: this was explicit not so much in slowly growing exports but rather in major differences in markets of various goods. For the second consecutive year, domestic demand exceeded external demand in growth. Although private consumption shrank from 9–10% in 2002 to 5–6% in 2003, investments boomed for the second successive year. Historic low interest rate level contributed to debt burden, which exceeded 70% of GDP in 2003. Primarily new business projects, including housing, large investments in transport, and continued reconstruction of power plants sustained the rapid growth. Most of the undertakings which have been operating in the market for a long time, preferred to invest modestly. Housing boom derived from better access to retail loan facilities and housing loans sustained rapid growth.

The unemployment level continued to decline slowly (9,3%). The rapid growth in wages was sustained throughout 2003. Real wages grew on the average by 8.2% over the year (7.1% in 2002) and still outpaced the economic growth. The annual growth in labour costs exceeded the growth in productivity.

The current account deficit (% of GDP) was 12.7%. Foreign direct investments covered about a half of the financing gap, and similar to previous years, loans from Estonian and foreign banks were used to finance new businesses. The government savings reached 2.6% of the annual GDP, the best indicator ever, and contributed considerably to balancing Estonia's economy. The trend of recent years - central government budget surplus offset by local government deficit - was sustained.

In 2003, Fitch and Standard & Poor's raised Estonia's credit outlook from stable to positive whereas the level of credit rating was not changed. S&P assigned a rating of A- to long-term foreign currency liabilities and A-2 to short-term foreign currency liabilities, Fitch assigned A- and F, respectively. Since autumn 2002 when Moody's raised ratings it has not introduced any changes, and the ratings have remained at A1 and P-1, respectively.

Estonia's positive rating outlook reflects, first and foremost, growth potential in the country's creditworthiness vis-à-vis upcoming entry to the Economic and Monetary Union. According to the agencies, the euro-area member status would reduce significantly risks arising from balance of payments and external shocks. Estonia's conservative fiscal policy, which is also important for meeting the EMU criteria, and relatively rapid economic growth were considered as factors contributing to the rating. The main factor undermining the rating according to the rating agencies was large current account deficit in 2003.

DEVELOPMENT IN THE BANKING SECTOR

Six credit institutions, one branch of a foreign credit institution and seven representative offices of foreign banks operated in Estonia at the end of 2003. By the end of 2003, 85,7% of share capital in the banking sector belonged to foreign owners and 14,3% to the residents. The majority of non-resident investors were as before foreign credit institutions whose ownership rose with a year from 78,9% to 80,1%.

The competition between the banks is tight, although there were no major changes in market distribution in 2003. Market share of the two largest banks formed 81,7% by the end of year, indicating a decrease compared to the end of 2002. Nordea bank Finland Plc branch in Estonia increased actively its market share by loan growth.

The stable growth of the Estonian financial sector was facilitated by the domestic economic growth. Despite the weakness of the external environment, Estonian economic growth was 4.8%. Regardless of active lending, the banking sector's growth was stable, profitability, capitalization and liquidity on a high level. Banks focused on traditional banking, mainly on financing private customers. Housing loans and leasing are the main loan products for private customers. Likewise, the banks continue their activities in further development of electronic services.

The annual growth of banks' total assets was 20,7% i.e. 16,9 billion kroons, forming 98,6 billion kroons by the end of the year. Similar to the 2002, banking sector was characterized by relatively rapid growth in loans in 2003. By the end of 2003, gross loan portfolio reached 69,2 billion kroons, annual growth being 38,4%. Banks' loan portfolio constituted 70,2% of total assets.

The main reasons for the rapid growth in loans were low interest rate offered by banks, as well as the continuing economic optimism of individuals and companies. As the growth rate of customer's deposits decreased, foreign borrowing increased in the second half of 2003. Because 85,7% of the banking sector share capital belongs to the foreign banks, the borrowing from parent companies was particularly common. Fast loan growth has not yet affected loan and leasing portfolio quality, but increased risks of the economic environment may pose a hazard (economic growth based on domestic demand).

Loan portfolio was composed almost equally as one third by loans to financial institutions (mainly financing leasing subsidiaries), other business loans and household loans. The portion of household loans increased during 2003 to 27,6%. Compared to 2002, the balance of household loans accelerated even more, the annual growth being 48,2% i.e. 6,2 billion kroons. The annual growth of business loans was more modest, constituting by the end of year 20,7% i.e. 3,9 billion kroons. Financing went primarily towards real estate, leasing and business service. At the same time the volume of loans to the industrial sector, important in aspect of economic growth, decreased.

The loan portfolio quality has not deteriorated despite the rapid growth in loan volumes and the quality of the loan portfolio of banking sector is characterized by declining share of overdue loans. The share of overdue loans in loan portfolio formed 2,3% by the end of 2003, compared to 3,9% in 2002. The volume of overdue loans more than 60 days indicates also a significant decline. The quality of the loan portfolio of the banking sector as whole may be assessed as satisfactory. 90,6% of total loan portfolio was classified as “in order” loans, compared to 89,2% in 2002.

Under conditions of rapid loan growth the maintenance of the loan portfolio quality and effective risk management is very important for banks. In October 2002 and in December of 2003 the Bank of Estonia and the FSA warned the banks of the risks accompanying rapid loan growth and offered additional recommendations on the financing of housing loans.

By the end of 2003 banks’ securities portfolio formed 9,1 billion kroons, decreasing 5,0 billion kroons within a year. The major change in securities portfolio resulted from reorganization of the financing model for leasing subsidiaries.

Banks’ level of liquidity in the conditions of fast loan portfolio growth may be assessed as adequate in 2003, though the share of liquid assets indicated a downward trend. The share of liquid assets in total assets has fallen from 21,4% to 20,9% within the year. Banks met the reserve requirement in the course of the entire year.

On the liabilities side of credit institutions the growth of deposits could not keep up with the growth of loans and rapid loan growth forced banks to use external financing. During 2003, customers’ deposits grew 9,7% i.e. 4,7 billion kroons that is about 14 billion kroons less than the growth of loan portfolio. Banks’ resource base reached 84,9 billion kroons by the end of 2003 and has increased within a year by 15,9 billion kroons i.e. 23,0%. Customer deposits constituted 63% of total resources. The resources from credit institutions accrued volume was 4,7 billion kroons and the annual increase was 40,0%. In 2003, considerably more resources, 6,5 billion kroons, were involved by issued bonds that exceeds the growth of 2002 by six times.

The banking sector earned on solo basis unaudited profit of 1,3 billion kroons in 2003, exceeding 2002 profit by 0,2 billion kroons.

Capital adequacy fell from 15,3% to 14,5% in 2003 (minimum requirement 10%). Despite the rapid loan growth, banks’ capitalization remains on high level. The capital adequacy was mainly affected by credit risk, the share of trading portfolio risks has remained relatively modest since in the current market conditions the volumes of trading with securities, currency or derivative instruments are not very significant. The capital adequacy indicator may rise since unaudited profit is not included in the calculation of capital adequacy.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISION AUTHORITY IN ESTONIA

The Estonian legal environment, including the financial sector regulations in recent years, has been characterized by rapid and dynamic development. According to the Financial Supervision Authority Act, the FSA must for meeting supervisory goals for implementing and amending acts and other regulations concerning the financial sector and supervision thereof and participate in the preparation of relevant drafts. Additionally to the collaboration in analyzing and preparing legal acts affecting the financial sector and supervision thereof, the FSA also regularly monitors legislation in other areas. The FSA analyzes drafts forwarded for approval from other ministries, discussed in the government and proceedings in the Riigikogu and also court decisions affecting the financial sector. In connection with EU accession, the FSA also observes development of legal acts prepared in the EU and decisions of the European Court of Justice in implementation of directives concerning financial law.

The regulatory environment of the banking sector has been generally stable in recent years. The legal framework of the Estonian banking system is established by Credit Institutions Act which regulates the principles of credit institutions' activities, founding conditions and requirements, fit and proper requirements, internal audit, prudential ratios, reporting, merger issues, moratorium, liquidation, supervision and liability. On the basis of law and for its implementation, regulations are issued. The President of the Bank of Estonia issues regulations based on the Credit Institutions Act governing banking whereas the Minister of Finance imposes regulations based on other acts (i.e. Securities Market Act etc.). For more defined regulation of supervised entities, several Minister o Finance and Bank of Estonia regulations were drafted and consulted by the FSA.

According to the Financial Supervision Authority Act, the FSA is entitled to issue guidelines to explain the legal acts regulating the activities of the financial sector or guide supervised entities. New guidelines that were issued in the area of banking sector:

- Principles for including positions to the composition of trading portfolio;
- Additional measures for Money Laundering Prevention in Credit and Financing Institutions.

The FSA continues the preparations for the implementation of the new capital adequacy (Basel II) in Estonia.

Banking supervision covers supervision of Estonian credit institutions and their subsidiaries, branches and representative offices located abroad unless otherwise agreed upon with the supervision authority abroad, also over subsidiaries, branches and representative offices of foreign credit institutions in Estonia unless otherwise agreed upon with the host country supervision authority. In addition, supervision also covers undertakings belonging to credit institutions' consolidated group.

The activities of FSA are directed by the management board, which has the authority to make all the decisions concerning financial supervision. Among issues concerning banking supervision, the management board has the authority to issue and cancel activity licenses and other matters related to activity licenses, to give consent, approval or permission, to issue precepts, to apply administrative coercive measures, to impose administrative penalties, to order special audits or expert assessments, to establish moratorium or special regime, to file a bankruptcy petition and to carry out related activities.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2003

The main objective of the financial supervision is to enhance the stability, reliability, transparency and efficiency of the financial sector, to reduce systemic risks and to promote prevention of the abuse of the financial sector for criminal purposes, with a view of protecting the interests of clients and investors by safeguarding their financial resources, and thereby supporting the stability of the Estonian monetary system.

In 2003, the FSA focused primarily for upcoming integration with the EU, improving the quality of supervision, especially in preventing abuse in the securities market and enhancing transparency of financial services as well as credit risk monitoring in banking.

The goals of the FSA in the area of banking supervision for 2003 were:

- to strengthen the role of FSA as the establisher of uniform operational standards in the financial sector, improve communication with market participants and increase the level of standardization and transparency of supervisory activities;
- to continue the preparations to apply new capital regulation (Basel II);
- to apply international financial reporting standards to public issuers and certain supervised entities from 2005;
- due to the current rapid growth in lending, especially in private loans, credit risk monitoring in banking became one of the priorities;
- to increase partnership in supervision and communication with Nordic and Baltic countries;
- to be prepared for the implementation of the Financial Services Action Plan;
- to create the creating preparedness for the supervision of cross-border financial services;
- to prevent money laundering and terrorist financing under continuous surveillance;

- to expand and develop communication with market participants by initiating seminars to explain FSA guidelines and supervisory views.

THE ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY LAST YEAR

To carry out the objectives of financial supervision, FSA regularly monitors the financial sector and the supervised entities. Monitoring as a supervisory process implies constant observation and analysis of the operations and the status of supervised entities, identification of the main risk areas and supervision of compliance with the law.

The organizational side of the banking supervision process has developed constantly since 2002. Supervision is no longer clearly divided into off-site and on-site supervision, but based on the specificity of the risks inherent to banking. Supervisory responsibilities are divided into two main areas: assessment of the more quantitative or measurable risks of banking activities (e.g. credit risk, market risk, liquidity risk) and assessment of the more qualitative risks (e.g. operational risk, internal control systems).

To improve the assessment of the supervised entities' business operation and resulting risks, the FSA has designed regular, monthly and quarterly monitoring cycles to determine that main risk areas accompanying business operation. The main information sources for the FSA are regularly submitted reports, but also public sources, on-site inspections and other supervisory activities. A throughout overview of the main developmental trends of bank and their consolidation groups, the main risk areas and problems are prepared every quarter to help plan further supervisory activities and to identify the areas that require greater attention.

In 2003, there was rapid increase in the volume of loans granted by banks and the FSA highlighted credit risk issue, but also operational risks related to the banks' lending activities and assessment of internal control mechanisms operational in the credit area.

In addition to monitoring, the FSA uses on-site inspections as on of its supervisory methods. The FSA dose not limit on-site inspections with the control of compliance with legal acts, but also assesses the general risk strategy employed by the supervised entity.

To ensure higher quality of on-site inspections, the FSA prepares last year an internal methodology that provides and unifies as much as possible the requirements for preparing and conducting on-site inspections in all supervised areas.

There were 9 on-site inspections of the credit institutions in 2003, including on-site inspections of one institution as a depository. The greatest attention were paid to:

- credit risk and operational risks related to lending activities and assessment of internal control mechanisms employed in the credit area;

- risk areas accompanying e-banking and assessment of measures banks implement to reduce the risks;
- protection of customers' interests and assessment of internal control systems for provision of investment services;
- assessment of internal audit function and its effectiveness in different areas and internal control systems;
- assessment of risk management systems in different areas;
- assessment of measures to prevent money laundering.

With the Swedish financial supervision authority, the FSA also conducted joint inspection of the Estonian subsidiaries of Swedish credit institutions.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISION AUTHORITY

Andres Trink
Chairman of the Management Board

- Strategies and policies
- Institutional development and collaboration
- Organizational development
- Executive tasks
- Foreign and public relations
- Internal audit

Units:
- Internal Audit – Raivo Linnas
- Public Relations – Livia Kulm

Kaido Tropp
Member of the Management Board

- Insurance sector supervision
- Legal environment of insurance sector and services
- Budgeting
- Internal services

Units:
- Auditing Department – Leiu Einberg
- Analysis and Reporting – Priit Kask
- Internal Services

Kilvar Kessler
Member of the Management Board

- Securities market supervision
- Code of Conduct
- Information disclosure and market transparency
- Legal environment of the financial sector
- Licensing
- Quality and development of FSA legal authority

Units:
- General Supervision – Margus Normak
- Market Supervision – Kristjan-Erik Suurväli

Andres Kurgpõld
Member of the Management Board

- Supervision of credit and investment companies and other financial institutions belonging to their holding group
- Capital regulation of supervised entities
- External risks
- Financial sector's IT risks, e-services supervision
- Reporting to FSA

Units:
- Institutional Supervision – Priit Kiilmaa
- Risk Monitoring and Analysis – Eve Sirts
- Methodology and Reporting – Helene Trušina

Angelika Koha
Member of the Management Board

- Supervision and legal environment of investment funds, management companies, and depositories
- Internal communications
- Training

Units:
- Investment and Pension Funds Supervision – Andre Nõmm

INTERNATIONAL ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY

International co-operation is an important part of the FSA due to several subsidiaries, branches and representative offices of foreign credit institutions operate in the Estonian banking market. Also the Financial Supervision Authority Act specifies co-operation with international financial supervisory agencies and other competent agencies or individuals of foreign countries as one of the functions of FSA and provides legal basis for signing co-operation agreements. In April of 2003 the FSA signed authority the Memorandum of Understanding in banking supervision with the Swedish financial supervision. The FSA has the Memorandums of Understanding in banking supervision with 6 countries now – Finland, Latvia, Lithuania, Germany, Denmark and Sweden.

Collaboration with international organizations the FSA prioritized matters related to the EU in 2003. Estonia as a candidate state was involved in the European Commission working groups formed of representatives of the EU member states since the end of 2002. In 2003 employees of the FSA were engaged in the Banking Advisory Committee and its subgroup, Contact Committee on Money Laundering, committee dedicated to electronic money issues, also committees on investment funds and securities market issues.

The FSA participates in the activities of BSCEE. The Estonian FSA was elected the presiding member of the organization for 2003, due to this the FSA held an international conference on banking supervision on May 29 and 30 in Tallinn.

COOPERATION WITH OTHER SUPERVISORY BODIES IN ESTONIA

Being an integrated supervision authority, already in 2002 the FSA has signed the trilateral agreement with the Bank of Estonia and Ministry of Finance. On the basis of this collaboration agreement, joint efforts were geared towards preparation of legal acts and exchange of information necessary for the work. On January of 2003 the FSA and Bank of Estonia signed a protocol on cooperation in exchanging, processing and maintaining data. On February of 2003 the FSA signed a data exchange agreement also with the Estonian Central Register of Securities and on September of 2003 the FSA and AS Tallinna Börs signed a cooperation agreement. The FSA also continued its active cooperation with external auditors of supervised entities and with several domestic government agencies in 2003.

STATISTICAL TABLES

Number of financial institutions

Type of financial institution	2001	2002	2003
Banks	6	6	6
Foreign bank's branch	1	1	1
Financial institutions, total	**7**	**7**	**7**

Ownership structure of financial institutions on the basis of registered capital (%)

Item	2001	2002	2003
Public sector ownership	0.0	0.0	0.0
Other domestic ownership	14.3	13.3	14.3
Domestic ownership total	*14.3*	*13.3*	*14.3*
Foreign ownership	85.7	86.7	85.7
Financial institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of financial institutions on the basis of assets total

Item	2001	2002	2003
Public sector ownership	0.0	0.0	0.0
Other domestic ownership	68.3	66.1	60.5
Domestic ownership total	*68.3*	*66.1*	*60.5*
Foreign ownership	31.7	33.9	39.5
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of assets by the type of financial institutions (%)

Type of institution	The first three largest	The first five largest
Bank	90.26	99.18

Return on asset (ROA) by type of financial institutions

Type of financial institution	2001	2002	2003
Bank	2.7	1.6	1.7

Return on equity (ROE) by type of financial institutions

Type of financial institution	2001	2002	2003
Bank	20.7	12.2	14.4

Distribution of market shares in balance sheet total (%)

Type of financial institution	2001	2002	2003
Bank	100.0	100.0	100.0

The structure of assets and liabilities of the banking system (%)

Assets	2001	2002	2003
Cash	2.33	1.71	1.44
Claims on central bank	5.53	4.36	5.12
Claims on credit institutions	13.22	12.38	11.68
Claims on customers	59.52	61.18	70.02
Allowance for uncollectible claims	-0.88	-0.64	-0.56
Securities	15.83	17.27	9.71
Intangible assets	0.92	0.59	0.44
Tangible assets	1.56	1.27	0.82
Other assets	1.97	1.89	1.33
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2001**	**2002**	**2003**
Amounts owed to credit institutions and central bank	9.43	14.54	16.83
Amounts owed to customers	62.41	59.74	54.17
Government lending funds and counterpart funds	0.45	0.29	0.21
Issued debt securities	8.57	8.47	13.90
Other liabilities	3.87	3.19	2.32
Subordinated liabilities	1.93	1.54	1.19
Provisions	0.07	0.08	0.08
Equity capital	13.27	12.14	11.30
Total	**100.00**	**100.00**	**100.00**

Development of off-balance sheet activities (%)
(off-balance sheet items/balance sheet total)

Type of financial institution	2001	2002	2003
Banks	23.92	23.99	28.25

Solvency ratio of financial institutions

Type of financial institution	2001	2002	2003
Banks	14.39	15.26	14.51

Asset portfolio quality of the banking system

Asset classification	2001	2002	2002
Standard	83.14	89.19	90.58
Special mention	10.62	6.86	6.75
Substandard	2.89	1.77	1.50
Soubtful	2.52	1.43	0.65
Loss	0.83	0.75	0.52
Classified total	**100.00**	**100.00**	**100.00**
Specific reserves (mio of EEK)	**515**	**364**	**398**

The structure of deposits and loans in 2003 (%)

	Deposits	Loans
Households	41.95	27.55
Government sector	6.77	3.91
Corporate	41.27	33.41
Foreign*	11.64	1.40
Other	10.01	35.13
Total	**100.00**	**100.00**

**deposits and loans from total amounts*

The structure of deposits and loans in 2003 (%)

Maturity of deposits		Loans	
At sight	67.2	Long term loans	62.4
Within one year	28.9	Medium-term loans	30.5
Over one year	3.9	Short-term loans	7.1
Total	**100.0**		**100.0**

Proportion of foreign exchange assets and liabilities

Type of financial institution	FOREX assets/total assets			FOREX liabilities/total assets		
	2001	2002	2003	2001	2002	2003
Banks (only balance sheet items)	39.6	41.3	45.6	39.6	41.3	45.6

Structure of revenues and expenditures of financial institutions

th of EUR

Revenues	2001	2002	2003
Interest income	275,275	271,792	268,361
Net interest profit/loss (+/–)	139,452	151,469	145,766
Income from financial investments	45,227	4,650	15,750
Commission income	67,897	76,845	85,707
Profit on financial operations	44,137	65,904	62,408
Value adjustments of claims and off-balance sheet commitments (income)	15,919	15,761	8,594
Value adjustments of financial fixed assets (income)	7,579	398	254
Other operating income	4,230	3,432	4,733
Extraordinary income	0	0	0
Expenditures	**2001**	**2002**	**2003**
Interest expense	135,823	120,323	122,594
Commission expense	18,074	21,305	22,659
Loss on financial operations	15,818	42,936	36,214
Administrative expenses	101,205	112,317	122,788
Value adjustments of tangible and intangible fixed assets (expenses)	34,414	26,569	16,070
Value adjustments of claims and off-balance sheet commitments (+/–)	21,314	24,482	15,108
Value adjustments of financial fixed assets (expenses)	12,327	717	429
Other operating expenses	12,418	12,510	12,043
Extraordinary expenses	0	0	0
Profit/loss of the reporting period	107,565	73,690	96,674

Structure of registered capital and own funds of financial institutions in 2003

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	th of EUR	%	th of EUR	%
Banks	132,415	2.1	713,730	12.7

2003 DEVELOPMENTS IN THE HUNGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

External conditions

In 2003 the world's economy considerably expanded at an increasing pace compared to the preceding two years without any major rip, or crisis. The approximately three-year old slowdown resulting from the saturation of the global stock market, in particular the technology sector, is nearing the end according several signs once the stock market has been through the large-scale correction that was necessary. The various players of the economy adapted relatively quickly to the consequences of the said correction on profits and capital. In addition, the alarmist scenarios emphasizing the geo-political risks of the conflict in the Middle East in the beginning of the year, which had negative influence on the securities markets as well as on global demand until the middle of March, were not confirmed. Developed economies did not fall victim to general deflation that seemed be threatening before, partly because total demand changed positively eventually and partly because the corporate sector underwent a significant structural reformation. This way major waves of bankruptcies were avoided and the positive correction of stock prices and global financial assets started at an unexpected speed. The excellent growth performance of developing countries in Asia and the considerable loosening of North American macroeconomic policy were key contributors to that.

Following an annual rate of 3 percent in 2002 the GDP growth of the world economy increased to almost 3.5 percent during 2003. The main engine of the development was, surprisingly, the outstanding performance of the two biggest Asian economies, China and India. These two economies together account for one-fifth of the world' economy, when measured by internationally comparable prices. Last year their consolidated economic growth reached 8.5 to 9 percent (6.8 percent in 2002) as a result of large-scale foreign investment based on rather inexpensive local labour. The Chinese and Indian import demand took with it the other economies of the region, indeed, to a certain extent even other regions of the world economy. For example the performance of the Japanese economy increased by 2.7 percent after several years of stagnation (in 2002 the growth was hardly 0.1 percent). It is apparent that the foremost targets of corporations in developed economies seeking cheap production sites in order to improve profitability are the dynamically liberalized and human resource rich developing economies of Asia. Along this line fast economic growth in the region that narrows the gap between the region and the developed world seems certain even over the long run. The flow of capital on ever increasing scale for productive investments in Asia is perhaps the greatest reserve of economic growth in the world economy.

The upswing of the North American economy that accounts for more than the fifth of the world economy was another driver of global growth in 2003. The growth of gross domestic product of the United States increased to 3.1 percent (it was 2.2 percent in 2002). The regeneration was primarily attributable to the three-year long simultaneous and considerable loosening of the monetary and fiscal policies, which was primarily successful in the revitalization of domestic demand (mostly consumer demand and demand for credit). During this process the interest rate of FED reserve funds fell from its 6.5 percent peak in 2000 to 1 percent by the middle of 2003, while the federal budget swung from a former surplus into a deficit exceeding 4 percent of the GDP. However, this outlined demand side policy did not go together with increased inflationary pressure, indeed, by the end of the 2003 core inflation fell to about 1 percent. While there remained a huge amount of available free resources, this happened because the productivity of labour increased at an unusual rate as a consequence of corporate restructuring programs. The latter phenomenon had a crucial influence on the considerable improvement of profit expectations, in light of which the demand for consumer and capital assets significantly increased.

In spite of the upswing of the world economy the growth of the European economy continued its moderate slow down in 2003. The gross domestic product of the European Union, representing another fifth of the world economy, grew by merely 0.7 percent (by 1.1 percent in 2002) with a very slight growth (0.4 percent) within the Euro-zone and somewhat better performance in countries with their own national currencies (primarily in the United Kingdom). The relatively poor growth may be explained by the fact that even though the key motives of the North American recovery, corporate restructuring, higher budget deficit and central bank interest reduction, were present in the European economy as well, they appeared on a much smaller scale than in the United States. This is primarily true of the macroeconomic policy, where the big member states right away started with government deficits, the growth of which is highly limited by the European Union's stability pact. Additionally the size of ECB interest reduction also lagged behind the North American example: refinancing interest rate decreased from its 4.75 percent in 2001 to 2 percent by the middle of 2003. Of these the increasingly widely recognized adverse influence of the stability pact was dominant. This stems from the fact that because the budget deficit limit (3 percent of the GDP) does not take economic trends into account, business cycles are rather reinforced, than mitigate. However, the case of interest policy is somewhat different, because the rate of consumer inflation was typically around 2 percent in the Euro-zone with strong inflationary pressure in the service sector all along, mostly because of price convergence within the Euro-zone. In view of that ECB has not yet undertaken to reduce the rate of interest.

It is important to emphasize that eventually monetary conditions were loosened much less in the Euro-zone, than it could be suspected on the basis of the ECB's interest measures. This was so because the due to the balance of payments surplus, the higher yield on euro deposits and the favourable bond market expectations the common European currency significantly strengthened: the EURUSD exchange rate increased by a total of 43 percent in 2002 and 2003. Considering that many of the Asian and South American countries have a dollar based exchange rate system, the aforementioned appreciation of the currency obviously restricted the export potentials of the Euro-zone, while domestic (consumer and investment) demand was ailing already. The strong euro only increased the pressure on the corporations' profit margin in the European Union, the consequence of which was additional cost saving and reduction of domestic demand. In other words the dynamically appreciating euro basically hindered the European economy in embarking on path to vigorous recovery on the wave of upswing in the world's economy. However, this unfavourable situation was ameliorated by the positive effects of strengthening stock markets and low lending rates on demand.

In 2003 the price of crude oil had a peculiar influence on the prospects of the world economy. The fear that in case of a prolonged crisis in the Middle East the global oil supply would be threatened and that the potentially skyrocketing energy prices a classical stagflationary environment would characterize world economy was a crucial motive behind the gloomy projections in the beginning of the year emphasizing geopolitical risks. As it is known the above threat vanished as a consequence of which the price of crude oil dropped by 20 to 30 percent in March. However, subsequently analysts were taken by extreme optimism. For a long time the dominant opinion was that in 2004, following the upturn of Iraq's oil production the price of Brent oil could permanently fall below 25 dollars per barrel. However, this did not happen, indeed, prices climbed again into the range of 30 dollars. This may be partially attributed to the fact that the Iraqi production increased at a much slower rate than expected and partly to the significant demand pressure generated by the upswing in the world's economy.

In light of the above the 2004 outlook of the world economy can be more or less charted. There is general agreement among official and market analysts, governments and international organizations that the pace of the world economy's growth will further increase in the short run, in 2004 it will reach, or exceed 4 percent. Within that the exceptionally fast expansion of developing countries in Asia is very likely to continue in spite of the fact that the considerable production cost advantage in these countries is expected to gradually erode over the medium run. During this election year the fast growth of the North American economy is expected to continue. However, in USA a fiscal tightening is expected in 2005 because of the level of budget deficit, which is generally believed to be unsustainable. The next FED interest rate measure is likely be tightening in light of the current macroeconomic trend. This, however, does not necessarily occur already in 2004, or it will be small scale, because due to the fast increase of the productivity of labour there are still substantial reserves for inflation-free growth. In recent months the European economy also gave signs of a slow recovery, which was mainly attributable to rapidly expanding export demand. According to the most likely script this trend will continue, but the upswing of the European economy must necessarily be slow, since the factors markedly strengthening the euro are still present and the provisions of the stability pact continue to enchain the fiscal policies of the biggest member states. Nevertheless, ECB may soon decide to further decrease the interest rate considering that the consumer inflationary rate in the Euro-zone is expected to sink significantly below the targeted 2 percent expectations. The outflow of working capital from developed economies is likely to continue, the main targets of which are the politically and financially stabile, rapidly liberalized developing countries with cheap labour and satisfactory infrastructure. In 2004 still certain Asian countries will be the biggest beneficiaries of this capital influx, or the new member states of the EU.

In contrast to the optimistic scenario outlined above any risk factor like the general and multi-faceted concern about the Middle-East conflict a year ago does not seem to prevail in the beginning of 2004. However, the international environment is not free from risks this time either. Recent events (Madrid, March 2004) proved that international terrorism is still a concern. The resulting threat may considerably hold back the activities of certain branches of the economy (transportation, or tourism, etc.), cause ruptures in, or disturb different infrastructures and the operation of financial markets. Similarly to the event in the past few years potential strengthening of the threat of terrorist attacks would reduce the value of assets invested in securities and substantially reduce demand in certain regions, perhaps in the world economy, by diminishing consumer and corporate confidence. Global climate change, which caused increasing damages both in Europe and in other parts of the world during the past couple of years, appears to be a risk of almost identical weight. In the field of economy potential further sizeable strengthening of the euro against the dollar, which cannot at all be excluded in light of the European and North American balance of payments, poses a significant risk for Europe. Such a change would seriously threaten the export of the Euro-zone further reducing corporate profitability and the already fragile chances for a European economic boom. Finally, the relentlessly fast growth of the world economy and the political instability in certain oil producing countries (Iraq, or Venezuela) makes a significant drop in crude oil prices unlikely in 2004, indeed, event further increases can be expected. Such a scenario is not likely to fundamentally alter the favourable price stability forecasts now typical everywhere in the world, but would make it difficult for certain monetary authorities (first of all for ECB) to support recovery from the period of slow growth by looser interest policy.

Economic growth

In the second quarter of 2003 the growth of the Hungarian economy reached its through and subsequently started to markedly accelerate following the trend in the world economy. Following a 2.4 percent annual growth of gross domestic product from April to June the expansion was 2.9 percent in the third quarter and 3.5 percent in the period from October to December. The acceleration was mainly attributable to increased performance in the processing industry, while on the demand side it could be associated with the growth of export and a marked expansion of investment into the processing industry.

From the middle of the year a definite revival started in the industry, which could clearly be traced back to a spectacular increase in export demand. In the second half of the year total industrial production expanded by 8.5 percent in annual comparison, within which export sales increased by 15 percent. The growth of export was particularly noticeable in engineering industry (primarily in the manufacturing of telecommunication equipment and in the automotive industry), the branch of domestic industry that can by now regarded as a traditional success industry. In contrast to that domestic sales increased by merely 1 percent in the second half of 2003. In view of constantly strong retail trade with an annual expansion exceeding 8 percent the conclusion could only be that most of the increase in consumer demand was typically import oriented. Considering the small size and openness of the Hungarian economy this is understandable, nevertheless, in terms of external balance and the way it is handled it may be considered as a sign of warning.

The 2003 boom of Hungarian industrial export is not a unique phenomenon it was noticeable in the majority of the countries joining the European Union. The phenomenon doubtlessly coincided with a certain increase in demand in the economies of the European Union however, its scale and pace were greater than could have been justified by the trend in EU economies during this period. The phenomenon could mostly be explained by the strategy of corporations within the EU outlined above, according to which, in order to widen narrow profit margins following the rise of confidence indices in the middle of last year, they expanded their activities in the inexpensive production sites of the accession countries. In case of Hungary this led primarily to a boom in the processing industry (mainly in engineering). These industries grew by 13 percent in 2003, while, for example, the size of government investment into the infrastructure decreased. The results of the expansion of capacities soon became manifest, for the volume of the domestic economy's total product export grew by 13 percent in the third quarter and by 18 percent in the fourth quarter in annual terms.

Thus, on the basis of the developments outlined it appears that there is a sort of real convergence taking place between the economies of the accession countries and the economy of the European Union, in the course of which the accession countries increase their shares in the EU markets of goods and services based on their low production costs. Specifically, in Hungary the domestic price level of goods and services is approximately 50 to 60 percent of the EU average, while domestic labour costs even less. In 2003 the Hungarian economy's per capita GDP at comparative prices was 54 percent of the EU average with a smaller number of people employed in comparison to the total population as in the average European economy. Consequently, average Hungarian productivity (GDP per number of people employed) is approximately 60 percent of the EU average, whereas domestic wages do not reach 25 percent of the European average. Consequently the Hungarian cost of labour on industrial production amounts to merely 35 to 40 percent of the average level in the European Union.

DEVELOPMENT IN THE BANKING SYSTEM
(including the assets total / GDP)

The consolidated size of the financial sector increased by 15 percent in 2003, just like a year before, when measured by the total year-end amount of capital traded, while the fraction of capital traded and the GDP increased from 123 percent at the end of 2002 to 128 percent. Therefore the financial 'penetration rate' continued to increase, i.e. the intensity of financial intermediation elevated further in comparison to the size (aggregate income) of the economy. Here it is useful to remark that an additional significant increase of financial penetration can be expected along the expansion of national income and financial wealth and as the domestic system of financial intermediation matures, considering that the penetration rate defined as the fraction of traded capital and the GDP is rather small in case of Hungary at the moment: according to year-end 2002 figures it amounted to one-fourth of the EU average in terms of both the balance-sheet of banks and the invested reserves of insurance companies.

The low level of domestic financial penetration and the resulting extensive long-term growth potential is well exemplified by the households' indebtedness to banks. In this respect there was a substantial lending expansion in 2003, which had a major part in increasing the proportion of the total assets of the domestic banking sector from 65 percent to 69 percent to the GDP in a year. This may be contrasted with the 257 percent level measured in the banking system of the Euro-zone at the end of 2002, which, by the way, suggested a slightly rising trend. The fast growth started from a characteristically low basis level, which could be most clearly demonstrated in case of retail lending, which grew at the fastest rate (in 12 months by 63 percent). The total bank debts of households amounted to 21 percent of the available income estimated at the end of 2003, while in the Euro-zone the similar measured rate was not less than 80 percent. In this comparison the indebtedness of the domestic households may still be regarded patently low and on the long run a quite significant credit increase potential is foreseeable. The 2003 truly fast increase in household debts, therefore, seems to be a macroeconomic (budgetary) problem, rather than a prudential problem for banks.

Concerning the structure of the financial sector it can be concluded that about three-fourth of the traded capital are concentrated at banks, for the most part (more than half of the total traded capital) in the banks' balance sheets, while a small part is held in client assets managed in the framework of investment services. Subsequent to the liberalization opening the road for universal banking investment services are being gradually taken over by banks and the importance of independent investment firms is declining. In 2003 the expansion of areas exceeding the sector's overall growth rate (banks, financial undertakings, funds and credit cooperatives) could primarily be attributed to the dynamic increase of demand for retail loans (property and vehicle). In case of the funds the statutory changes reinforcing and extending the mandatory private pension fund system played a positive role. The size of businesses increased at an average pace, but in excess of the growth of the GDP in the insurance sector. Home building and vehicle purchasing boosted damage insurance, while the performance of the life insurance business was hold back by the diminishing propensity of households to save. At the same time the size and weight of capital deposited into investment funds decreased for the reasons detailed below. Following these organizational changes at the end of 2003 63 percent of all domestic financial intermediation was realized in deposits, or loans, 20 percent in trust investment, 13 percent in various asset management services and 4 percent in insurance policies.

Banks ended an outstandingly profitable year in 2003. The activities of the banks were incentivized by foreign owners, mother banks and investors together with the business opportunities offered by domestic economic policy. In addition to long-term business strategy decision, such as the intensification of lending and retail activities, they also tried to grab occasional opportunities.

The wealth of available inexpensive foreign resources created favourable conditions for the development of the banking sector, so corporate credit demand could expand, while the government assisted the expansion of home lending by subsidizing interest payments.

The banks successfully adapted to the external conditions, further expanded businesses that bore more risks, but were also more profitable and increased the weight of lending and off-balance sheet activities. In terms of lending especially home lending, backed by government support, flourished, however, bank financing gained importance in the corporate sector too. The role of foreign exchange transactions and foreign exchange swaps increased within off-balance sheet activities. Lending was expanded partly by regrouping some of the liquid assets and partly by drawing on foreign sources. The weight of foreign liabilities increased throughout the year. Additionally there was a large-scale inflow/borrowing of short-term foreign funds as well. In January the inflow of foreign speculatory capital counting on the strengthening of the forint temporarily, but substantially increased the banking sector's total assets and liquidity. As a result of the extraordinary measures taken by the central bank the total assets of the sector returned again to a level similar to the one in September 2002 by the end of March, with the difference that the proportion of foreign liabilities continued to be high. There was a unique short-term business opportunity behind the July external borrowing. In November disinvestment by foreigners created a problem that was successfully resolved by a 3-percentage point increase of the central bank base rate.

The expansion of activity resulted in improved profitability, which was favourable even in international comparison. Reinvested earnings increased the banks' capital strength, therefore the capital required for hedging risks was available.

Market players

In 2003 the number of market players in the banking sector fell altogether by one, thus, at the end of the year there were a total of 36 credit institutions operating as stock corporations. From January 2003 MFB and EXIM bank have not belonged to the banking sector, as these are not commercial banks, rather they fulfil special tasks for the state.

From 1 January 2003, with the elimination of the specialized credit institution status1, of the credit institutions that used to operate as such three (Cetelem, Merkantil and Porsche) were converted into commercial banks and one (GMAC) into a financial enterprise. Obviously the financial enterprise, GMAC, was removed from the banking sector. PK Bank was also converted into a financial enterprise and removed from the sector. During the year two foreign-owned credit institutions (Bank of China Rt. and EB und Hypo Bank Burgerland Sopron

Rt.) entered the market. At the same time Fundamenta and Lakáskassza home savings and loan associations merged. In 2003 the regional expansion efforts of Hungarian banks strengthened. In addition to a Slovakian subsidiary bank OTP Bank also acquired a Bulgarian bank and entertained further bank acquisition plans in the region.

At the end of 2003 ten big banks were in business with at least 3 percent share of the banking sector's total assets each. The number of big banks was not yet reduced by the privatization of Postabank, because the merger of Postabank into Erste Bank was not yet completed at the end of the year. The number of mid-size banks with at least a 0.9 percent share of the banking sector's total assets each decreased by one compared to the preceding year to eight. The number of mid-size banks was not yet changed by the privatization of Konzumbank, since, similarly to Postabank, the process was not yet completed at the end of the year. Because of the changes mentioned above the number of small banks increased by six compared to the end of the previous year to thirteen, while the number of specialized credit institutions fell by eight, leaving altogether five operating specialized credit institutions at the end of 2003.

Concentration remained strong in the banking sector, at the end of the year the assets of the ten big banks accounted for almost three-fourth of the sector's total assets. Seemingly concentration is smaller in lending that in deposit collection, however, in reality the difference is hardly significant. The apparent relaxation of concentration in lending is attributable to the fact that certain mother banks sell their home loans to their mortgage banks, consequently specialized credit institutions' share of the credit portfolio significantly increased. Mortgage banks finance home loans by issuing mortgage bonds, most of which are purchased by the mother banks.

The number of employees in the last quarter of 2003 exceeded the average of the last quarter of the previous year by 2.1 percent reaching 27,163. The altogether almost 550-person staff increase was not a result of the development that characterized the sector in general, because headcounts increased, or remained unchanged at about two-thirds of the banks that also operated during the preceding year, however at a third of these banks the number of employees fell. The development of the retail business justified the staff increase in case of three big banks and one mid-size bank. However, it is to be noted that in addition to effective staff increases one bank's significant staff increase was attributable to the employment of persons who had been contracted for work as external entrepreneurs. This did not represent real staff development.

The dominant role of foreign owners did not change in the ownership structure of the banking sector. At the end of the year the registered capital directly owned by foreign investors reached 81.9 percent of the sector's total registered capital. The almost HUF 39 billion direct foreign registered capital increase resulted from the privatization of Postabank and FHB, furthermore, from the total capital increase of HUF 15.4 billion by the foreign owners of five banks.

---

[8] Pursuant to Act CXII of 1996 on credit institutions and financial enterprises (hereinafter 'Credit Institutions Act') financial institutions specialized under Article 5(2) and Article 35 of the Financial Institution Act passed in 1991 had to be converted into banks, specialized credit institutions, or financial enterprises.

The foundation of Bank of China and Sopron represented a foreign capital increase of altogether HUF 4.7 billion. The increase of direct domestic ownership was mainly attributable to the capital increase of OTP Jelzálogbank. The decrease of government ownership was caused by the privatization of Postabank and FHB.

Assets

The total assets of the banking sector reached HUF 12,860 billion at the end of 2003, exceeding the 2002 year-end portfolio by 26.1 percent. The total assets of the banking sector increased temporarily at an extraordinary degree on two occasions in January and June, however, it returned to the preceding levels in subsequent periods. The significant increase in January was prompted by the influx of speculatory capital counting on the strengthening of the forint, which was channelled by the banks mainly into central bank and interbank deposits. In order to squeeze out speculatory foreign liabilities the central bank reduced the deposit interest rate from 8.5 percent to 6.5 percent, limited the banks' deposit portfolio with the central bank and sold a good part of the foreign exchange portfolio accumulated at the central bank. As a result of these measures the sector's total assets fell back to a level close to the September 2002 level by the end of March. The July increase in total assets was caused by an individual short-term foreign placement and the corresponding borrowing.

The central bank stopped the withdrawal of foreign capital that started in November by a 3-percentage point increase of the base rate.

The approximately HUF 2029.3 billion increase in total assets characterizing the year was almost entirely attributable to the expansion of lending, because the majority of the increase in the securities portfolio was attributable to the mortgage bond trade related to home lending. A scheme emerged according to which a bank closely related to the mortgage bank purchased a good part of the mortgage bonds issued by the mortgage bank and these increased the sector's securities portfolio.

As a result of the expansion of lending the proportion of higher risk, but more profitable loans increased within the portfolio, while the proportion of low-risk and less profitable liquid assets fell, therefore, the sector's overall liquidity diminished.

The bank sector's role increased in financial intermediation. The consolidated total assets of the sector increased faster than the gross domestic product (GDP) and the penetration ratio calculated as a fraction of the two figures (balance sheet total of the banking sector/GDP) increased from 60.9 percent in 2002 to 69.2 percent. The weight of financial intermediation, calculated on the basis of the credit portfolio, which had been growing for years, speeded up in 2003. The debt/GDP indicator increased from 25.8 percent at the end of 1998 to 36.4 percent by the end of 2002 and to 43.7 percent by the end of 2003.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

Supervisory control

Development of consolidated supervision

Development of consolidated supervision involved in part regulatory and in part methodological tasks. During the first half of the year legislators accepted without substantial modification the statutory amendments proposed by HFSA that the Supervision prepared in order to improve the efficiency of consolidated supervision simultaneously for the Credit Institutions Act, the Capital Market Act and the Insurance Act. As part of the methodological development program the HFSA recorded the monitoring methods created for groups in the Group Inspection Manual, pertaining to group structure, group level compliance with prudential requirements, group management and control and the monitoring of transactions inside the groups. The organizational and methodological solutions designed to ensure coordination between supervised industries were fine-tuned.

Last year the Supervision continued to develop the tools of consolidated supervision, thereby contributing to the strengthening of supervision on a consolidated basis. During the inspections the supervisors carefully examined the regularity, registration and risk management of transactions within the group. Degree of risk-transfer within financial groups and their effect on the total risk of the group and of individual institutions was assessed as well. For that reason members of the staff inspecting different institutions within the same group maintained continuous consultation. When the summary of the closing conclusions of the inspections at the group was produced, all experiences with the group members were taken into account. Whenever necessary, the HFSA calls the attention of the institution leading the group by way of a supervisory resolution, or in an executive letter to the need for group level risk management and to the importance of the prudent exercise of ownership rights.

Supervisors work together with the relationship managers responsible for the other group members, ensuring the flow of information that is inevitable for consolidated supervision. The supervisors of institutions within the group maintain continuous day-to-day contact, which also plays an important role in defining the focal points of inspections.

Risk-based supervision

Satisfying a precondition of the conversion to risk-based supervision a coordinated system of risk-assessment, inspection manuals, inspection programs and procedures for planning and executing supervisory inspections was developed. As an important part of this system the HFSA has launched a new, high quality method for institutional risk assessment based on objective indicators and supervisors' assessment and raised the relationship between risk assessment and supervisory control on system level. In connection with the system of risk-based assessment the standard internal measures prompted by individual risk levels were defined. Supervisory manuals complete with methodological vademecums (handouts) for financial institutions, investment service providers, insurers, pension funds, investment fund managers and clearing houses were prepared and finalized.

Supervisory procedures

The legislative changes as of 1 January 2003 opened the possibility for the HFSA to conduct comprehensive reviews according to its own inspection plan taking the typical risks associated with the activities of the financial organization into account. The frequency of mandatory comprehensive inspections did not change; it remained two years. The obligation to conduct comprehensive on-site inspection was removed from the act.

These changes required a new methodological approach from the Supervision. Several steps led to the development of the new methodology, the final aim of which was the establishment of risk-based supervision and control. The HFSA developed a system that definitely strengthens the risk-based preventive characteristics of supervision.

In order to put the new regulations into effect the Supervisory Control Procedure Project (SCPP) reviewed the processes of planning and executing supervisory inspections. As a result of that review supervision (continuous monitoring of the institution) and the complementary system of on-site inspections produce a much more operative system, with faster response capabilities than before. In line with the new development strategy the Supervision revised the procedures for planning and executing on-site inspections. All that helped to prepare for inspection duties more efficiently, more sensitively to risks and at the same time using fewer resources.

A consequence of the statutory amendments is that the compulsory comprehensive reviews repeated in every two years do not necessarily have to be fully conducted on-site, as the results of two years of ongoing control may be also taken into account. There are some areas, like the inspection of reliability of reporting, efficiency of the management, the keeping of records up-to-date and compliance with anti-money laundering requirements, which cannot be covered without on-site inspection in the future either.

Institution-specific inspection programs are based on the risk map prepared during the two-year period of continuous monitoring and analysis, which determine the depth and scope of the inspection. Based on identified risks in the course of continuous assessment the Supervision also conduct targeted inspections and compliance control with the provisions of the previous resolutions of the HFSA is mandatory.

The conclusions and results of the quarterly institutional risk assessment, which is based on the utilization of a wide scope and substantial quantity of information and on continuous monitoring, may also provide basis for the inspection of institutions and for the bi-annual (annual) comprehensive review.

From autumn 2003 onwards comprehensive reviews were conducted in accord with the new approach: the HFSA slightly shortened the on-site segments of inspections and simultaneously expanded the resources that may be used to perform off-site inspection tasks. Inspected areas and risk factors were weighted according to risk levels, determining the depth and scope of the inspection and the necessary resources. Off-site inspections are conducted as part of ongoing monitoring on the basis of documents sent to the Supervision pursuant to legal requirements, or documents requested by the HFSA.

In connection with the above requirements the Supervision continued to develop the criteria of quarterly risk assessment in 2003. Standard internal measures (like requesting information, initiating discussions, or starting a targeted, or thematic inspection) were rendered to the new risk assessment system based on objective indicators and supervisory assessment and to the individual risk levels.

The requirement vis-à-vis the assessment procedure supporting control system is to make the risks recognizable and appraisable based on the factors investigated during the assessment and to make the identification of the type and depth of the supervisory inspection and the range of necessary measures possible.

Risk factors are summarized in three key blocks (personnel, operational and business) in each and every sector. Business risks include risks connecting to capital and liquidity positions, market risk, profitability, market position and asset quality. The HFSA has developed a system of indicators corresponding to certain risk factors that cover the most important risks to a necessary and sufficient degree based on accumulated experience.

The scope of documents to be inspected on and off-site was clearly separated. The relationship managers in conformity with applicable procedures notify inspected institutions. Worksheet and report templates were standardized and their use extended to all supervised areas. Consistence between comprehensive on-site inspection programs and risk assessment criteria was created as well.

Legal consultants are participating in each and every inspection, by preparing questions with legal relevance for resolution-making, if necessary even on-site.

Supervisory control in 2003

Execution of the duties stemming from supervisory control responsibilities, in particular institution-monitoring and on-site inspections, formed the most important parts of the activities of the HFSA in 2003 as well. The HFSA used its own staff for the majority of on-site inspections last year, external experts were only called in for credit cooperatives (51) by involving 6 audit companies selected by way of public tender.

In the previous years the report was exclusively about the results of on-site inspections. From 2003, as it has already been mentioned, there is a mix of on-site and off-site work in inspections changing in proportions from case to case. Previously the beginning of the inspection was identical with the beginning of the on-site work, while the beginning of the inspection according to the new regulation is a legal act not necessarily connected to any actual on-site inspection. For that reason the table also give the number of inspections completed in a legal sense in the columns marked by an asterisk, although it also has a comparative figure for previous years' data.

Compared to the preceding years the Supervision could decrease the number of on-site inspections because, on the one hand the number of supervised institutions has diminished somewhat and, on the other hand, the performance of the financial sector improved and risks were reduced. Starting from these facts the HFSA strove to conduct inspections relying on internal resources and to make resource management more efficient.

All inspections required by law were completed, however, as a consequence of the new inspection methodology introduced, in several cases/occasions the HFSA conducted off-site inspections already in 2003. It is a clear intention in the future to avoid investigating things on-site that could also be analysed off-site. By that the Supervision satisfy the market's expectation that the on-site inspections should put the least possible burden on the supervised institutions. The HFSA's organization and experience enables it to conduct further comprehensive, targeted, or follow-up on-site inspections at the needed depth by using its own staff or delegating this to external experts if it is necessary.

Experiences of inspections

Banks - General experiences

Banks ended an outstandingly profitable year in 2003. The year-end profit is expected to be around HUF 210 billion. The return on equity (ROE) exceeded 20 percent, i.e. twice the EU average. The banks' total assets grew by 26 percent, their credit portfolio increased by 33 percent, however, deposits expanded by merely 9.3 percent over the previous year. The growth of private borrowing substantially exceeded the increase in household deposits (savings) in 2003.

The activities of the banks and the further improved efficiency of their business management were motivated by the interests of owners and investors together with the business opportunities offered by domestic economic policy. The abundance of available foreign resources created favourable conditions for the development of the banking sector, so retail and corporate credit could be expanded in proportion to these resources.

The banks successfully adapted their activities to the external conditions and they were also successful at meeting the threefold, at times contradictory requirements of continuous solvency, adequate return and safe operation. They increased the role of riskier, but also more profitable business lines, the role of lending and off-balance sheet activities, at the same time the quality of their assets and their collateral also improved, therefore the overall risk exposure did not increase. Lending, especially mortgage lending with government backed interest rates, flourished, but corporate finance gained importance too.

Inspections in 2003 did not discover any grave problems, or major risks that would have threatened the banking system. In spite of the rapid expansion of lending the system-wide portfolio quality remained practically unchanged.

The overwhelming majority of the banks put great emphasis on eliminating deficiencies and the recurrence of a negative supervisory remark in a subsequent inspection was rare. Some banks took serious measures after the inspections, they implemented organizational and staff changes when that was necessary, as a result of which the 2003 inspections revealed considerable progress in these banks' operations.

Risk management systems operated by banks can in general be considered adequate. Inspections did not identify any major risk in the area of banks' liquidity management, although occasionally the inspections revealed a need for strengthening the liquidity position, or for the further development of liquidity management. Management of market risks all in all can be judged as adequate, apart from one case the inspections did not reveal any shortcoming. The banks' overall capital position and profitability were stable with low, or moderate exposure, although the solvency ratio of a few banks approached 8 percent (from above), while the banks' average solvency ratio was around 13 percent.

Key deficiencies

The owners of certain foreign owned banks did not leave enough independence for their subsidiary institutions. As a result, these credit institutions' executive bodies could not exercise the rights granted to them by law. Some subsidiaries operated almost as branches.

On several occasions the Supervision criticized the way accounting was internally regulated, bookkeeping could be controlled or identified lack of full legal compliance. Accounting problems are generally in connection with the applied information technology system and, accordingly, the Supervision ordered several banks to update their IT systems.

The HFSA discovered deficiencies in the field of investment services at several banks, which were related to reporting, regulated ness and full compliance with physical safety and personnel conditions prescribed by law. In case of certain banks additional steps are required in order to ensure that provisions pertaining to custody activities are more carefully complied with.

Supervisory measures

On-site inspections were concluded in case of each bank by the HFSA's resolution (18 resolutions), which prescribed several measures to be taken. Inspection was concluded without requesting any measures to be taken in case of one bank, while fines were put on six occasions. The HFSA sanctioned severe deficiencies by imposing fines in case the instructions prescribed in the resolution concluding the previous inspection were not completely adhered to, failure to fully meet consumer protection provisions, violating the statutory requirement pertaining to showing the total cost indicator of loan, furthermore, accounting, record keeping and reporting deficiencies, or non-compliance with provisions pertaining to investment services. Over and above the instructions attached to the resolutions, for the sake of improving prudential banking behaviour the HFSA called on the managements of banks in a so called 'executive letter' to correct the minor deficiencies discovered and voiced its expectations and recommendations.

Enforcement

The HFSA provides supervised institutions with a broad range of information and makes the consequences of statutory violations clear prior to sanctioning through obvious and transparent operation. The legal practice of the supervised institutions is shaped by statements issued for information, or upon request and especially by the resolutions concluding the inspections, the objective of which is to promote legal compliance.

In 2003 the HFSA issued 625 statements and made 5258 resolutions. In the resolutions including sanctions the HFSA provides for individual measures and sanctions following the principle of gradualism, the primary aims of which are prevention and the elimination of deficiencies. The use of the sanctioning powers of the HFSA under the legislation covering the supervised industries is only the ultimate means for the enforcement. The Supervision meets the objectives of both general and individual prevention through its consistent and transparent activities. Due to the sanctioning policy formulated over the past few years and to the clear stance taken by the HFSA this year the willingness of supervised institutions to abide by the rules increased further. This development is well demonstrated by the fact that severe sanctions were imposed less and less frequently and simultaneously the number and amount of fines were also diminishing. The publication of the resolutions (without violating secrecy legislation) makes supervisory intervention accessible to all market participants, therefore, the Suepervision's enforcement activity becomes calculable and predictable. There is no administrative appeal against the resolutions of the Supervision, but appeals may be lodged with a court. The soundness of HFSA's enforcement policy is demonstrated by the fact that the contested resolutions withstand the trial of legality almost without exception.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2003
THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY LAST YEAR

Summary and priority tasks

2003 was a very difficult, although rather productive year for the Hungarian Financial Supervisory Authority ('HFSA', or 'Supervision'). It has arrived to a contradicting situation: while the Supervision was treated as an equal professional partner by supervisory authorities of European countries in terms of its activities, organization and management, they relied on the Supervision's opinion and various international organizations acknowledged its efforts and methodological developments, domestically the Supervision was the target of a number of attacks, although not by the representatives of the industry. This report, built upon a wealth of factual data, proves that last year HFSA fully met its supervisory responsibilities required by law as well, furthermore, it achieved significant results in methodological development, international cooperation and integration.

In its 2003 Work Plan HFSA defined six strategic tasks for core activities development and three for the development of support activities.

The targets for core activities:

- full conversion to risk-based inspection and supervision;
- further development of supervision on consolidated basis;
- preparation for the introduction of the Basel II Capital Accord in 2006;
- preparation for accession to the European Union;
- fight against money laundering;
- finalizing the consumer protection program and starting this activity.

The targets for supporting activities:

- completion of the comprehensive information technology project;
- revision of the certification acquired last year during the quality control project and raising the project to a higher level;
- introducing the staff incentive system already tested in the second half of 2002.

A precondition of conversion to effective risk-based supervision was the development of a coordinated system of risk-assessment procedures, inspection manuals, inspection programs and the establishment of procedures for planning and executing supervisory inspections. This process has been concluded. In the course of this process the Supervision developed a new risk assessment method, based on calculated indicators derived from the processed and analyzed data reported by the supervised institutions' that replaced former supervisory ratings. The steps for the risks identification and assessment were defined together with the interconnections between risk assessment and supervisory control. In connection with the system of risk-based assessment a set of standard internal measures prompted by specific risk levels were defined. All HFSA supervisory manuals have been completed with specific methodology for financial institutions, investment service providers, insurers, pension funds, investment fund managers and clearing houses.

These tasks were supplemented by the Supervisory Control Procedure Project (SCPP) that reviewed the process of programming and executing supervisory inspections. As a result the former concept of supervision was redefined as a complimentary system of ongoing institutional controland inspections. The system of comprehensive inspections with a compulsory on-site phase every two years has been replaced by a more sophisticated and managable system. In this framework information received from supervised institutions is constantly analysed by the supervisors and when necessary, the reasons of specific risks are investigated in way of targeted inspections, supervisory actions are recommended and the conclusions are summarized during the comprehensive inspections once in every two years.

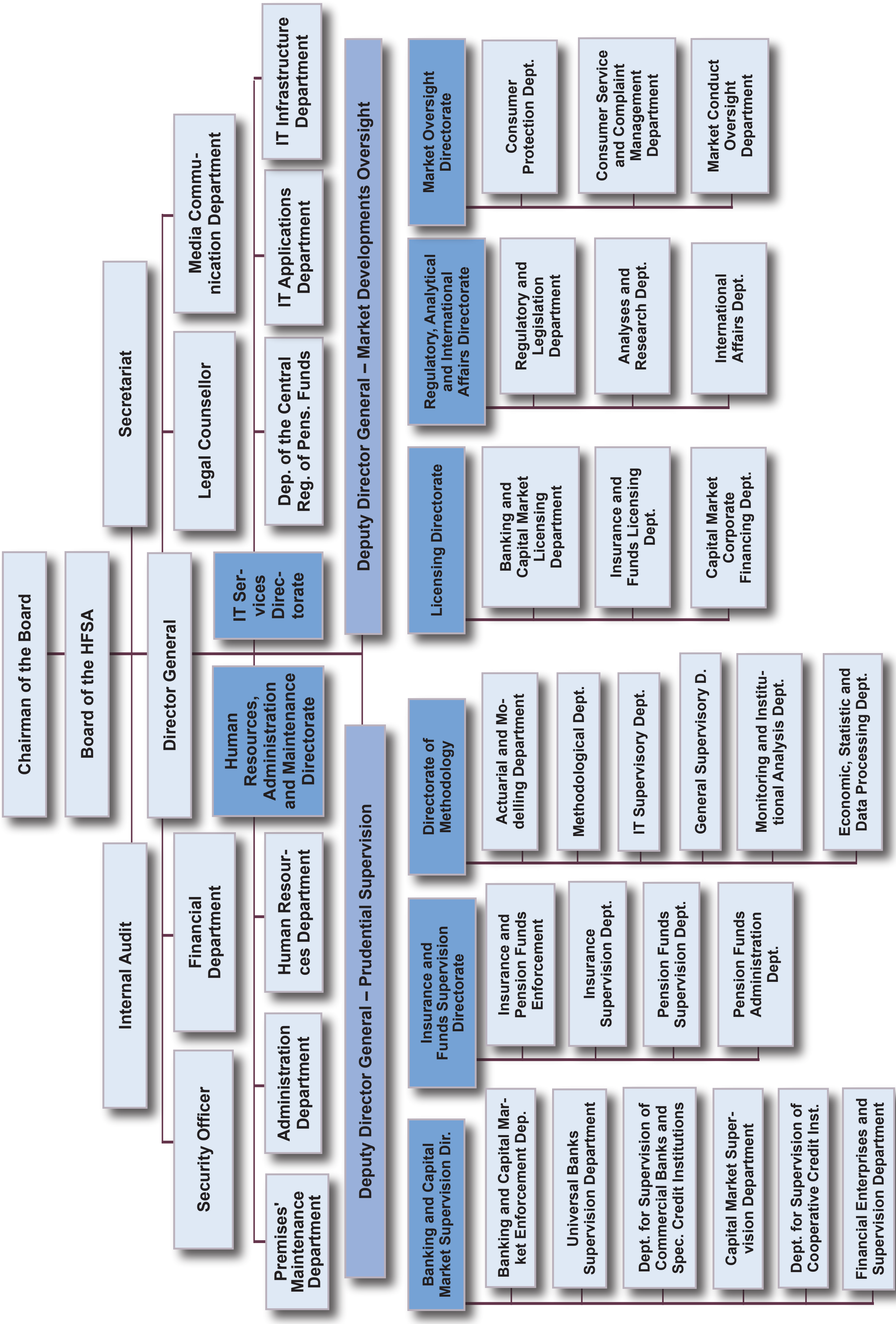
The procedures for programming and executing supervisory control, replacing former procedures for programming and executing on-site inspections, were defined. All that suggests that in terms of tools the HFSA is prepared to perform its supervisory duties using its resources significantly more efficiently and in a more targeted manner.

Further improvement of group level consolidated supervision involves on the one hand regulatory and on the other hand methodological tasks. During the first half of the year legislators accepted practically without change prpos-als for statutory amendments for the Credit Institution, Capital Market and Insurance Acts, respectively, prepared by HFSA, in order to improve the effi-ciency of consolidated supervision . Already in 2002 and 2003 the Supervision ordered the provison of data in line with the needs of consolidated supervision, in particular for the calculation of the consolidated capital adequacy ratio,. As part of the methodological development the HFSA incorporated in the group inspection manual the suprevisory methods created for group inspection, in particular those relating to the group structure, group level compliance with prudential requirements, group management and control of transactions within the group.

In January 2003 a preparatory timetable was prepared for the implementation of supervisory tasks related to the New Basel Capital Accord (Basel II.), setting new capital adequacy standards for credit institutions,., coordinated and mediated by the HFSA , with 42 other countries, , the Hungarian banking system took part in a global survey, on the basis of which a quantitative impact study (QIS3) outlined the foreseeable consequences of the introduction of the proposed new regulation. The summary of conclusions was published on the HFSA website. In addition to that, , approximately 200 pages of Hungarian documents were also made available on the HFSA website concerning the Basel II recommendations and subsequently, on the draft EU directive. The HFSA organized six consultations for supervised credit institutions and investment firms on this topic. As a closure of these series of events renowned foreign experts were invited to an international Basel II conference orga-nized by HFSA on 20 November 2003 for supervised institutions to offer first hand information about the requirements and preparations in other countries. The staff has been involved in internal training in the framework of an educational program since September and a separate chapter has been opened for them on the Intranet. In September, the steps taken and the measures envisaged were presented to the Supervisory Council as well, that commented positively and supported the HFSA's efforts. The Council agreed both with the key strategic decisions and with the super-visory policy for the preparatory process.

In 2003 the HFSA played an important role in the delisting of Hungary also from the FATF monitoring list (the list of countries to be specially moni-tored). FATF is an international task force operating in close co-operation with OECD, the key international entity in the global fight against money laundering.,. The most important factor in this success was the exemplary co-operation between the supervised institutions, the Ministry of Finance, the Ministry of Justice, the National Police, the National Bank of Hungary and the HFSA. That was largely promoted by the Government Commissioner chairing the competent Interdepartmental Commission and coordinating the fight against money laundering. He has belonged to the HFSA's staff and was in office until January 2004 in his capacity as Commissioner due to the the Government's decision.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF YOUR AUTHORITY

International affairs

Preparation for the accession to the EU and the integration into EU processes

In the course of 2003, the preparation for the accession to the EU was a primary strategic objective of the Supervision. This task was completed with the participation of its international (British and German) EU-experts highly experienced supervisory and regulatory activities.

In order to integrate into the EU's internal workflow and to represent Hungary's interests, it was an important strategic task to secure the right to be present and rise to speak at the most important EU working committees (banking, insurance, pension funds, solvency, capital market, money laundering). As of April 16, 2003, the HFSA was given an observer's status in all the working groups and expert groups related to its activities. Currently the HFSA is represented in 31 committees, including 12 working groups. As a result, it has the opportunity to prepare materials and opinions, make proposals, and at the same time, gather information on the most important regulatory efforts at the European level, while also having the option to participate in the work. By applying extremely cost-effective solutions, the personal and material prerequisites required to participate in the EU's relevant working groups have been ensured.

It is an important factor that there is now an internal procedure in place on the acceptance and representation of the HFSA's stance as a supervisory body, which is to be applied in the work of EU working committees and other organizations, as well as during the finalization of the EU's legal publications.

The HFSA has processed the financial rules („EU regulations") coming into force directly without any further legal action in the accession countriesat the time of accession. It has been established that no substantial measures have to be taken, but a few issues (e.g. cross-border payments) need further attention.

In 2003, further legal harmonization tasks surfaces in the following areas: financial conglomerates, financial covers, collective investment undertakings. The legal harmonization initiative on behalf of the HFSA took place in 2003 or in January 2004. The adoption of the directive regarding collective investment undertakings (UCITS) took place by amending the Capital Market Act.

Impact studies were prepared by the HFSA on the expected effects of the accession to the EU on the Hungarian financial sector, and alternative scenarios have been prepared. These documents are available on the HFSA's website.

By examining the harmonization of the regulations containing the supervisory tasks, new functions of the HFSA as a result of the EU membership, and requiring confirmation, have been identified. Consequently, the following tasks have been identified and completed:

The internal procedures to supervise the operations of branches within the EU (including branches of foreign companies in Hungary, and branches of Hungarian companies in the EU), as well as the supervision of cross border services have been prepared.

The concept of the "general good" as it pertains to the financial markets, including statutory provisions, requirements, expectations have been defined.

As a result, an information package has been prepared to foreigners who intend to provide services to clients in Hungary.

A proposal has been prepared on the supervisory fees to be paid by branches, was sent to the Ministry of Finance in January 2004.

Capital market consultative group

The Consultative Group has become the form of cooperation among the securities supervisory bodies of the accession countries and countries that intend to join the EU later. The Group was formed in June 2001 in order to synchronize the activities of the different countries and to share experiences. The Group held its March 2003 meeting in Budapest. At the meeting, the President of the HFSA was elected President of the Group.

Other tasks of international relevance

The questionnaires sent by the World Bank and the IMF, which focus increasingly on the issues of financial supervision, have been answered by the Supervision on a regular basis. It should be emphasized that the study by the World Bank on integrated supervisory bodies published in 2003, the HFSA is prominently featured, and at the conference in Washington last December the "Hungarian model" became part of the consciousness in the international financial community.

OECD's latest country report was accepted in December 2003. The requested information on the financial sector and the Supervision was prepared. The report voiced no concerns over the state of the financial sector, but stressed the importance of the Supervision's independence and accountability.

OECD has several expert committees, of which the Money Market Committee, the Insurance Committee and the Working Party on Pension Funds stand out from a supervisory perspective. The HFSA regularly and actively participated in their meetings and in the preparatory efforts. The HFSA's representative holds a leading position in INPRS, the international organization that supervises pension funds. This organization currently works jointly with OECD, in tight cooperation, but is expected to become independent in 2004.

The international organization of the insurance supervisors, the IAIS, its general assembly and its working committees also request regular, personal and written contribution from the HFSA. As to IOSCO, the international organization of securities supervisory bodies, personal participation is limited to attending the annual general meeting, although the Supervision always participates in large scale questionnaires. In 2003, the HFSA joined IOSCO's multilateral cooperation agreement, a first such move in our region.

The HFSA fulfils the secretarial position of the Group of Banking Supervisors from Central and Eastern Europe, which substantially raises the prestige of the Hungarian supervision both in the group involving 18 countries and in international organizations. The group's annual report is regularly prepared by the HFSA and in 2003 the Supervision cooperated in organizing the annual general meeting and two seminars as well.

COOPERATION WITH OTHER SUPERVISORY BODIES IN YOUR COUNTRY

International supervisory cooperation, exchange of experiences

Last year, bilateral cooperation with foreign supervisory bodies was strengthened with respect to several banks. Exchange of information became regular between the National Bank of Slovakia and the HFSA as a result of the activities of OTP Bank and its affiliate bank in Slovakia. With respect to OTP Bank's acquisitions abroad, the relevant Bulgarian authorities contacted the HFSA and the Supervision supplied the requested information. As part of the acquisition of a majority holding of Postabank by Erste Bank AG, information was exchanged between the Supervision and the relevant supervisory body of Austria, regarding the effected banks. As to the severe shortcomings found at K&H Equities and K&H Bank, and the steps taken in their wake, there has been continuous cooperation and tight supervisory consultation with the Belgian and Dutch supervisory authorities. Based on the MoU, personal consultations took place with the German supervisory authority, as part of which information was exchanged regarding German-owned banks in Hungary and their parent banks in Germany.

Apart from the exchange of data, the cooperation also involved, based on the Memoranda of Understanding, on-site investigations of certain banks. Experts of the National Bank of Austria held a risk-based, on-site investigation at Erste Bank Hungary and HVB Bank, while the representatives of the US-based New York State Banking Department, a supervisory body, conducted investigations at the Hungarian subsidiary of GE Capital, Budapest Bank. Prior to and after the investigation, personal consultations took place where the parties mutually informed each other of their respective findings at the parent bank and subsidiary, as well as current issues. The report of the findings, as per the MoU, was sent to the HFSA by the foreign authorities.

There was ongoing exchange of information with British, Slovak, US and Belgian supervisory bodies regarding certain cross-border issues.

The HFSA also regards as one of its tasks to provide information regarding its experiences to foreign supervisory bodies, thus promoting an efficient supervisory system in other countries. Among others, high-ranking officials from supervisory bodies of Bulgaria, the Ukraine, China, Vietnam paid visits to Budapest. Some of those countries requested several visits.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

In 2003 the international activities of HFSA were determined by the strategic targets set for the year. Intensive international cooperation and communication were essential during the implementation of these tasks. Continuation of the preparation for the 1 May 2004 accession to the EU in several areas, the completion of the connecting preparatory process, was a significant task.

In regard of integrating into the internal EU processes it should be highlighted that the Supervision was screened once again in 2003 by the experts of the European Commission (in the framework of a Peer Review), which was a follow up tothe 2001 review. It assessed the fulfillment of the relative action plan including the commitments undertaken by the Hungarian authorities. The Peer Review experts acknowledged the Supervision's achievements (such as consolidated supervision, sanctioning policy, the various steps made to strengthen supervisory independence as provided by law and the wide spread introduction of supervisory recommendations) and called on to further continue the process. In the summer of 2003 the only shortcoming discovered during the assessment of supervisory independence has been the lack of regulatory power. The HFSA's achievements mentioned in the Peer Review report were also confirmed by the EU's country report published in last November (Monitoring Report) in the chapter dealing with financial services and the Supervision. While the the HFSA was qualified as an independent and efficient organization the Review urged the granting of regulatory power to the HFSA as soon as possible.

As part of the preparation for accession to the EU, already at the beginning of the year, the HFSA identified the relevant EU committees and working groups requiring regular supervisory presence and participation. An internal procedure has been developed and, along its lines the Supervision's position is formulated and represented in the course of preparing EU legal materials. Since the signing of the Accession Treaty experts of the Supervision have been officially invited to take part in the activities of various committees and working parties as observers. National supervisoryauthorities were given a particularly huge task in the new structure created by the Lámfalussy process, which first started to operate in the field of capitalmarkets and was later extended to the fields of banking and insurance. The Lámfalussy process substantially upgraded the role and responsibilities of supervisory authorities in the European regulatory process and in the harmonized application of EU rules. The HFSA made all preparations required for fully assuming that new responsibility.

As part of the preparations for the European internal market for financial services the internal procedure for the operation and supervision of branches and the supervision of cross-border services was elaborated. A 'general good', document mainly focusing on consumer protection was prepared. That will serve to inform EEA service providers opening branches or providing cross-border services about the conditions of operation in Hungary. The HFSA contributed to the preparations of supervised institutions for the accession to the EU with analytic, forecasting and impact studies concerning the entire financial sector, which were available on our website and were also presented in press conferences. (Three such studies were prepared: on the credit institution sector, on insurers and on pension funds.) A separate study focused on the capital requirements of the insurance sector and that of individual insurers, in light of the requirements of the new Insurance Act aligned with the more stringent capital requirements adopted by the European Union in June 2003. Insurance companies and associations analyzed in the impact study were informed (and were asked how they were preparing for meeting the increased capital requirements prescribed by the new insurance act in perspective).

Last year with the intention to get closer to EU practices the HFSA set up its Consumer Protection Service and its Consumer Protection Department in order to strengthen consumer protection policy. By the beginning of this year the Department prepared its action plan for client and customer protection, which reflects the previously neglected idea that instead of individual complaints shifted to supervisors, this Department should focus on strategic cases that affect a wide circle of clients and customers. Complaints must be treated primarily by the supervised institutions themselves in a manner satisfactory to customers. The costumer complaints regulation template prepared by the Supervision could provide a significant contribution in that process. Dissemination of information and education received much attention in the HFSA's consumer protection activities in accord with its action plan. Comparative tables of most important retail products in all sectors are available on the Supervision's website for public information. New information brochures were prepared on unit-linked life insurance policies, consumer loans and settling consumer disputes, furthermore, a series of popular financial articles were published in Köznevelés *(Public Education)*, a journal accessible to all teachers and schools nationwide. In order to more directly involve the consumer side of the market in the Supervision's consumer protection efforts, customer service started to use a software to recordall calls which are then used to prepare consumer analyses . In 2003 the HFSA invited public research tenders in various topics, including on customer friendly product information and on the opportunities of non-governemental organizations in the field of consumer protection.

The HFSA both in 2001 and in 2002 had reported on the project aiming at the development of a Comprehensive Information Technology System (CITS) wthin the institution.. Last fall the more than two-year long information technology project was successfully completed.. This new system replaced the former segregated IT systems used by the predecessor organizations. The new comprehensive system is much more developed in terms of sectoral neutrality, quality of information and data management, qualityof regulation, data security, well-defined access rights and the ability to keep pace with regulatory changes. Previously missing areas have also become part of the system. The new information technology system provides major support for the function of integrated supervision. The project's original objectives were completely fulfilled; eventual regulatory changes related to data supply requirements may be fully introduced in the system without additional software development or intervention by IT specialists. The sub-systems are fundamentally sector neutral, they have a standard user surface, and therefore, it is easier to use and to maintain them. CITS is able to export the results of all queries into well known developer environments, therefore data can be quickly and efficiently customized and used for analyses beyond risk assessment. All types of sector specific data required to be registered by law can be found in the Central Master Data Warehouse (CMDW) and includes continuously updated information involving the most important set of data. The procedures regulating in a comprehensive manner the use of CMDW were completed and put into operation. During the introduction of the system a training was organized for the staff,. Individual learning is aided by a training software on the Intranet. The interrelated system of data and applications available for HFSA constitute outstanding IT value and is an essential tool for efficient and continuous preventive supervision i At the same time the confidential and safe handling of individual business and personal data provided to the HFSA by supervised institutions are essential elements and strict legal preconditions of the operation of the IT system.

The 2003 HFSA strategic objectives contained the development and implementation of the ISO 9001:2000 quality control system within the institution. The HFSA was first among public administrative entities in Hungary in satisfyingintegrated quality control requirements already in 2002. This was achieved by having completed the CAF self-assessment widely used in the EU and obtaining the relative certificate. The HFSA, since the establishment of integrated supervision, have relied on external opinion surveys assessing partners' image and satisfaction and also on employees' satisfaction surveys in determining the Supervision's quality management tasks. During the 2003 revision the HFSA met again ISO requirements and produced outstanding results both in terms of the internationally updated CAF self-assessment and in terms of the employees' satisfaction survey. Indeed, the Supervision was the first in Europe and the first among public administration entities worldwide to be reviewed against the excellence system called QM 9004 as well. These modern strategic management tools guarantee that processes are always well regulated, controllable and transparent, while the institution can perform its job efficiently, organized in the best possible way. Regular review and necessary update of the quality management system is an essential part of this compliance. The quality management system does not merely improve internal operational efficiency, but it is already an inherent part of the Supervision's balanced and unbiased operation.

As a subsequent milestone of HFSA's human resource strategy, from 1 January 2003, a new incentive system was introduced, developed in 2002.The advantage of the introduced bonus unit is that it compensates for the anomalies deriving from the compulsory application of the rigid carrier development scheme fixed in the Law on Civil Servants,. Accordingly, remuneration of staff members employed in identical positions and performing similar jobs, but rewarded differently on the basis of the career development scheme, will be tied to their effective performance. This way the new regulations bridge the differences in the remuneration system and makes possible the transfer of experts between the Supervision and the supervised sectors for. The management of the Supervision sets strict performance and moral requirements on the staff. At the same time the HFSA's policy on personal care and social sensibility are proven by the fact that it was awarded by the Family Friendly Workplace title last year.

Last year's major events to be highlighted from the HFSA's perspective included **Pannonplast, the K&H Equities** case and the bankruptcies of investment and real estate co-operatives. The latter, according to the law, does not fall within the competence of the Supervision. To make judgements on these complex cases, thatprovoked high emotions and harsh public debates, it has to be recognized, that financial supervisory institutions anywhere in the world themselves cannot reduce risks to zero, or to the level expected by the public.

Financial supervision is part of a multilevel screening system, that includes the efficient operation of internal audit, management and owners' control within the financial institution. The supervision is not the only 'external filter' since external auditors play an outstanding role.Indeed, their responsibility precedes that of the financial supervision. Although it is true that the Supervision is one of the strongest among the monitoring institutions as it also has official powers, if the first four screens fail, or the supervisory authority ise deliberately misled, then it may be unable to fulfill its duties. This apparently hardly acceptable conclusion is confirmed by international experience and the K&H case in Hungary as well. The Supervision attributes great importance to prevention, but it has no investigative powers, therefore, when distorted or falsified figures are used it cannot immediately substantiate suspicions suggesting deliberate illegal activities. Criminal activities may come within the Supervision's sight often only when they already manifest in operational problems. Nevertheless, the HFSA was the first to discover and report to the competent judicial authorities the series of very complex criminal acts behind Pannonplast share transactions, in which K&H Equities and other institutions were involved.

The Supervision is only able and entitled to supervise the operation of organizations falling within its competence under the law and may only sanction illegal behaviour in that scope. Investment co-operatives may pursue their activities in accord with the provisions of the Act on Co-operatives especially the provisions relative toloan provision by members of the co-operative. Licensing, control and sanctioning the operation of these organizations do not fall within the powers of the HFSA. Considering, however, that on the basis of their publicities and activities the suspect of illegall deposit collecting emerged, therefore, the HFSA inspected these cooperatives on several occasions. Whenever it was necessary, the HFSA reported its findings and suspect to the judicial authorities In addition to that, the HFSA took various steps in order to protect consumer interests, including issuing warning communications and paid advertisements to the public about risks in highlighting that these activities are neither covered by government guarantee schemes, nor are they supervised by the state. The HFSA initiated on several occasions with the relevant ministers and with the prime minister the establishment of a legislation that would guarantee improved protection to retail savings.

The fact that a draft law was prepared to modify the statutory law on the HFSA cannot be omitted from a comprehensive annual review of 2003. In the absence of professional consultations and coordination with the interested parties, contrary to the requirements of the law, the Draft Bill, failed to satisfy basic professional requirements. The draft completely disregarded the prevailing international standards relating to effective supervision, especially core principles requiring the supervisions' operative independence. The draft bill prepared during the fall of 2003, which substantially reduced the level of supervisory independence already achieved in several respects, provoked strong reactions within the professional comminity worldwide and with international organizations, including the EU Commission. The European Commission, the OECD Secretariat and the President of the European Central Bank took firm stance about the case. Several affected special committees of the European Union dealt with the issue. It was also on the agenda of the International Monetary Fund and the World Bank.

Following the submission of the draft bill to the Parliament the HFSA (and the National Bank of Hungary) in the absence of opportunity to comment the draft, submitted its position expressing its seriousprofessional concerns to the legislators. The HFSA and the Central Bank askedfor the revocation of the draft bill and for consultation with international experts. The Supervision's professional concerns almost fully coincided with the observations of the above mentioned international organizations and supervisory authorities. As a result of this criticism the wording of the original draft was modified in several points in the course of the legislative process, yet it did not substantially change in terms of reducing the independence of the HFSA. Eventually, the President of the Republic of Hungary submitted the act voted on 15 December to the Constitutional Court for preceding review, to check the voted law's compliance with the Constitution's certain stipulations. It must be highlighted that European and other international critiques related to the violation of international standards of effective supervision are far from being identical with the constitutional concerns expressed by the President of Hungary [9].

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2002	2003
Banks and specialized credit institutions	37	36
Saving and Credit Cooperatives	189	182
Financial Institutions	**226**	**218**

Ownership structure of the banking system on the basis of registered capital (at year-ends)

Item	2003	
	HUF billion	%
Public sector ownership	3,6	0,9
Other domestic ownership	49,2	13,1
Domestic ownership total	*52,8*	*14,0*
Foreign ownership	308,0	81,9
Preferential and repurchased stocks	15,1	4,0
Banking system, total	**375,9**	**100.0**

[9] The Constitutional Court in its Decision taken on the 23 March, 2004 declared the voted law as unconstitutional in one respect and asked for the rectification of the section in question. The law, in its modified form, was voted on April 5th, 2004.

Ownership structure of saving and credit cooperatives on the basis of registered capital (at year-ends)

Item	2003	
	HUF billion	%
Public sector ownership	1,3	9.0
Other domestic ownership	13,4	90.9
Domestic ownership total	*14,8*	*99.8*
Foreign ownership	0,0	0.2
Preferential and repurchased stocks	0,0	0.0
Saving and credit cooperatives, total	**14,8**	**100.0**

Concentration of asset by the type of financial institutions 2003

HUF billion

Type of institutions	The first three largest	The first five largest	Total
Bank and Specialized Credit Institutions	5,291.8	7,182.6	12,860
Saving and Credit Cooperatives	70.1	106	922.5
Financial Institutions	**5,361.9**	**7,288.6**	**13,782.5**

Return on asset (ROA) by type of financial institutions

Type of institution	Pre-tax profit (HUF billion)	Average assets (HUF billion)	ROA (%)
Bank and specialized credit institutions	215.9	11,657.4	1.85
Savings and credit cooperatives	11.2	816.8	1.37
Financial institutions	**227.1**	**12,474.2**	**1.82**

Return on equity (ROE) by type of financial institutions

Type of institution	Pre-tax profit (HUF billion)	Average own equities (HUF billion)	ROE (%)
Bank and specialized credit institutions	215.9	1,021.9	21.13
Savings and credit cooperatives	11.2	54.1	20.7
Financial institutions	**227.1**	**1,076.0**	**21.11**

Balance sheet total (at year-end)

HUF billion

Type of financial institution	2002	2003
Bank and specialized credit institutions	10,195.6	12,860.0
Savings and credit cooperatives	779.1	922.5
Financial institutions	**10,974.7**	**13,782.5**

The structure of assets and liabilities of the banking system (%)
(at year-end)

Assets	2002	2003
Cash and settlement accounts	4.8	3.6
Securities for trading purposes	4.5	5.3
Securities for investment purposes	10.4	11.5
Central bank and inter-bank deposits	14.2	10.0
Credits	59.8	63.2
Proprietary interests	1.9	2.0
Own assets	1.9	1.8
Other assets		
Balance sheet total	**100.0**	**100.0**
Liabilities	**2002**	**2003**
Deposits	65.3	56.6
Inter-bank deposits	7.1	8.2
Borrowing	7.8	12.3
Dept securities	4.5	8.5
Subordinated liabilities	1.3	1.3
Special provisions	1.1	1.0
Own capital	8.7	8.5
Other liabilities		
Balance sheet total	**100.0**	**100.0**

The structure of assets and liabilities of savings and credit cooperatives (%)
(at year-end)

Assets	2002	2003
Cash and settlement accounts	5.9	5.9
Securities for trading purposes	29.0	26.6
Securities for investment purposes	6.1	5.7
Central bank and inter-bank deposits	12.7	11.9
Credits	40.5	44.2
Proprietary interests	0.3	0.3
Own assets	3.3	3.3
Other assets	2.2	2.2
Balance sheet total	**100.0**	**100.0**
Liabilities		
Deposits	90.1	89.8
Inter-bank deposits	0.5	0.5
Borrowing	0.2	0.4
Dept securities	0.0	0.0
Subordinated liabilities	0.4	0.4
Special provisions	0.4	0.4
Own capital	6.4	6.6
Other liabilities	2.1	2.0
Balance sheet total	**100.0**	**100.0**

Development of off-balance sheet activities

Type of financial institution	2002	2003
Balance sheet total (HUF billion)		
Banks and specialized credit institutions	10,196	12,860
Savings and credit cooperatives	779	922
Financial institutions	**10,975**	**13,782**
Off balance sheet total (HUF billion)		
Banks and specialized credit institutions	7,320	9,693
Savings and credit cooperatives	26	37
Financial institutions	**7,346**	**9,730**
Off balance sheet / balance sheet (%)		
Banks and specialized credit institutions	71.8	75.4
Savings and credit cooperatives	3.4	4.0
Financial institutions	**66.9**	**70.6**

Solvency ratio of financial institutions

Type of the financial institution	Guaranteed capital (HUF billion)	Weighted assets (HUF billion)	Solvency ratio (%)
Bank and specialized credit institutions	914.9	8,249.4	11.09
Savings and credit cooperatives	54.3	398.5	13.63
Financial institutions, average	**969.2**	**8,647.9**	**11.21**

Portfolio quality of the banking system

Asset classification	2002		2003	
	HUF billion	%	HUF billion	%
Problem free	13,516	92.8	18,863	94.6
Special mention	743	5.1	739	3.7
Non-performing	300	2.1	339	1.7
- substandard	142	1.0	166	0.8
- doubtful	78	0.5	82	0.4
- bad	80	0.6	92	0.5
Classified total	**14,559**	**100.0**	**19,941**	**100.0**
Specific reserves (HUF billion)	**156**		**170,0**	

The structure of deposits and loans of banking system in 2003 (%) (at year-end)

	Deposits		Loans	
	HUF billion	%	HUF billion	%
Households	3,867.8	53.1	2,001.6	24.6
Government sector	232.8	3.2	267.6	3.3
Corporate	2,289.7	31.5	4,030.9	49.6
Foreign	548.0	7.5	533.4	6.6
Other	339.0	4.7	1,292.5	15.9
Total	**7,277.3**	**100.0**	**8,126.0**	**100.0**

Proportion of foreign exchange assets and liabilities (at year-ends)

Type of the financial institutions	2002			2003.		
	FOREX assets HUF bn	Total assets HUF bn	FOREX assets / Total assets %	FOREX liabilities HUF bn	Total liab. HUF bn	FOREX liabilities / Total liab. %
Bank and specialized credit institutions	4,140.2	12,860.0	32.2	3,596.6	12,860.0	28.0
Savings and credit cooperatives	0.4	779.1	0.1	0.4	922.5	0.0
Financial institutions	**4,140.6**	**13,639.1**	**30.4**	**3,597.0**	**13,782.5**	**26.1**

Structure of revenues and expenditures of the banking system (at year-ends)

HUF bn

Revenues	2002	2003
1. Interest income	846.4	1,045.4
2. Net non interest income	107.8	150.1
Of which: Net income from commissions	128.8	167.2
Dividends	8.3	12.8
3. Extraordinary income	8.6	12.6
Revenues total (1.+2.+3.)	**1,099.9**	**1,388.1**
Expenditures	**2002**	**2003**
1. Interest expenditures	459.8	595.3
2. Overheads	341.9	387.9
3. Extraordinary expenditures	5.6	9.0
Expenditures total (1.+2.+3.)	**807.3**	**992.2**

Structure of revenues and expenditures of savings and credit cooperatives (at year-ends)

HUF bn

Revenues	2002	2003
1. Interest income	84.6	93.4
2. Net non interest income	4.0	4.2
Of which: Net income from commissions	10.1	12.3
Dividends	0.0	0.0
3. Extraordinary income	0.2	0.7
Revenues total (1.+2.+3.)	**88.8**	**98.2**
Expenditures	**2002**	**2003**
1. Interest expenditures	41.4	41.7
2. Overheads	38.7	45.3
3. Extraordinary expenditures	0.1	0.1
Expenditures total (1.+2.+3.)	**80.2**	**87.0**

2003 DEVELOPMENTS IN THE LATVIAN BANKING SYSTEM

MACROECONOMIC ENVIROMENT

In 2003, Latvia continued to enjoy significant economic growth. In 2003, Latvia retained a high gross domestic product (GDP) growth rate, the increase of which constituted 7.5%. The growth rate of the financial sector and money supply accelerated.

The inflation rate was only one percentage point higher than in 2002 and was still low (2.9%). In 2003, the average monthly gross wage for the employed rose by 11.4%[10] as compared to the year before.

An increasing demand for some of Latvia's export markets pushed up the growth rate of exports, which slightly exceeded that of imports year-on-year (17.8% and 15.8%, respectively).

Though the budgetary expenditure went up markedly in the 4th quarter of 2003 and the fiscal deficit of the general government consolidated budget was 103.2 million lats in 2003, it was still considerably lower than the planned one and amounted only to 1.8% of GDP (131.1 million lats or 2.5% in 2002).

Unemployment in the age group of 15-64 years has decreased considerably (from 20.5% in 1996 to 12.1 % in 2002 and 10,7% at the end of 2003).

The economic growth potential is best described in terms of investment growth. In 2003 the increase of gross fixed capital formation according to the estimation of the Ministry of Economics was 10%.

DEVELOPMENTS IN THE BANKING SYSTEM

At the end of 2003, the banking sector of Latvia comprised 22 banks and one branch of a foreign bank (Latvian Branch of Nordea Bank Finland Plc (Finland)).

The total paid-up share capital of banks grew by 8.5%, reaching 307.9 million lats by the end of the year. In 2003, there were no substantial changes in the structure of shareholders of banks. Foreign shareholders owned more than 50% of the share capital of nine banks, whose market share accounted for 45% of total banking assets.

In 2003, the privatisation of the JSC *Latvijas Krājbanka* was completed. On 17 May 2003, the Latvian Government-owned share in the JSC *Latvijas Krājbanka* in the amount of 25.01% was sold. As a result, the Government-owned

[10] Source: Internet home page of the Central Statistics Board of the Republic of Latvia. www.csb.lv

share in the JSC *Latvijas Krājbanka* decreased from 32.1% at the beginning of 2003 to 0.7% at the end of the year. The Latvian Government was still the only shareholder of the State JSC *Latvijas Hipotēku un zemes banka*, whose assets made up 4.1% of Latvia's total banking assets at the end of 2003.

During the reporting year, the market share of Latvia's five largest banks did not substantially change and amounted to 63.1% of total banking assets, 73.4% of loans and 66.6% of deposits at the end of the year (compared to 65.3%, 73.7% and 68.4%, respectively, a year earlier).

In 2003, Latvian bank assets grew by 29%, reaching 5.71 billion lats by the end of the year. The rapid growth in lending continued. As the former rate of increase in the bank loan portfolios (41%) was maintained, the banking asset structure changed and the share of loans in total banking assets rose from 48.1% to 52.5%

A major indicator characterising the relative significance of the banking sector for the national economy is the ratio of the banking sector assets to the gross domestic product (hereinafter – GDP). In 2003 in Latvia this ratio was 97%[11].

In 2003, mortgage lending developed rapidly and grew by 96%. Consequently, the share of mortgage loans in Latvia's bank loan portfolios increased to 28%, totalling 806 million lats at the end of the year.

In 2003, the term structure of loans changed. The volume of long-term loans (5 years or more) rose by 59%, and their share in bank loan portfolios increased from 37% at the beginning of the year to 42% by the end of the year.

It is significant that with the increase in the volume of lending, the loan quality did not deteriorate during the reporting year. The share of non-performing loans (substandard, doubtful, or lost) in the total of loans granted to non-banks dropped from 2% to 1.4%. At the end of 2003, the ratio of specific provisions for exposures to non-banks to the total of loans granted to non-banks was 1.2%. At the end of the reporting year, specific provisions for loans to non-banks covered 89.4% of the amount of non-performing loans.

In 2003, the profits of the banking sector reached 71.5 million lats[12], i.e. 27% more than in 2002, when total profits were 56.3 million lats. In 2003, the main sources of profit in the banking sector were income from interest on loans issued to non-banks (39% of total bank income), fee and commission income (26%), and interest on debt securities (10%).

At the end of 2003, there were 28 cooperative credit unions in Latvia. On 31 December 2003, the market share of the two largest credit unions comprised 78% of credit union assets, 76% of loans, and 83% of deposits (compared to 79%, 77%, and 84%, respectively, a year earlier).

The total assets of Latvia's credit unions rose by 44%, and reached 3.9 million lats (0.07% of all financial sector assets). This increase resulted largely from an influx of credit union member deposits, which grew by 47% in 2003 and amounted to 2.63 million lats.

On 31 December 2003, the return on equity (ROE) of credit unions was 7.3% (compared to 10.6% a year earlier), while the return on assets (ROA) was 1.7% (compared to 3.3% on 31 December 2002).

[11] Source: Internet home page of the Central Statistics Board of the Republic of Latvia. www.csb.lv

[12] Non-audited profits.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF OPERATIONS AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS

The legislative framework for the banking sector complies with the requirements of the EU directives in all material aspects. The strategy of the Financial and Capital Market Commission (hereinafter – the Commission) provides for further enhancement of the regulatory framework to keep it in line with the new *acquis*, international standards and best practices and developments in the financial sector.

The Commission shall enjoy full rights of an independent/autonomous public institution and, in compliance with its goals and objectives, shall regulate and monitor the functioning of the financial and capital market and its participants.

The Commission shall make independent decisions within the limits of its authority, execute functions assigned to it by law, and be responsible for their execution.

In 2003, several new regulations as well as some amendments to previously approved regulations of the Commission were approved.

The Financial Instruments Market Law (adopted by the Parliament on 20 November 2003), which replaced the Law on Securities, introduced several requirements of EU directives into the Latvian financial market.

Credit institutions will not be required to obtain a separate licence issued by the Financial and Capital Market Commission to provide investment services.

Under the latest amendments of **the Credit Institution Law** (adopted by the Parliament on 20 November 2003), the original maturity for subordinated loans eligible for Tier 2 capital is reduced from seven to five years.

MAIN STRATEGIC OBJECTIVES OF THE FCMC IN 2003

1. The supervision of the Latvian financial and capital market by analysing financial statements and other information and by conducting on-site examinations of market participants.

2. Improvements to Latvian legislative enactments and their harmonization with EU requirements, with the recommendations of international financial supervisory authorities and with the best international practices in this field, so as to continue the preparation of the Latvian financial and capital market for smooth integration into the EU market.

3. Consistent maintenance of the Commission's Quality Management System and certification in conformity with the ISO 9001:2000 international quality standard.

On 7 May 2003, the Commission received an ISO 9001:2000 certificate issued by the Bureau Veritas Quality International, which testifies to the full conformity of the Commission's Quality Management System with this standard.

The Commission's Action Plan for 2003 is available on the Commission's Internet home page at www. fktk.lv.

THE ACTIVITIES OF THE FCMC IN THE FIELD OF BANKING SUPERVISION IN 2003

In 2003, the supervision of operations of market participants carried out by the Commission was comprised of on-site examinations, submitted reports and an analysis of the most substantial risks.

The primary task of on-site examinations is to assess the financial standing and capital adequacy for supervised market participants, as well as whether the internal control system ensures aggregate risk evaluation and management. Duly detection of causes of potential problems and finding of preventative solutions during examinations reduce a possibility for individual market participants to default on their obligations as well as the effects of potential problems on the entire financial and capital market.

The analysis of financial statements of market participants, in turn, allows the evaluation of the financial standing, operational risks and their tendencies, as well as of the conformity of operations with regulatory enactments. Conclusions from these analyses were regularly submitted to the Commission's Board, at which priorities of supervisory activities were discussed with a view to reduce risks inherent in operations of market participants.

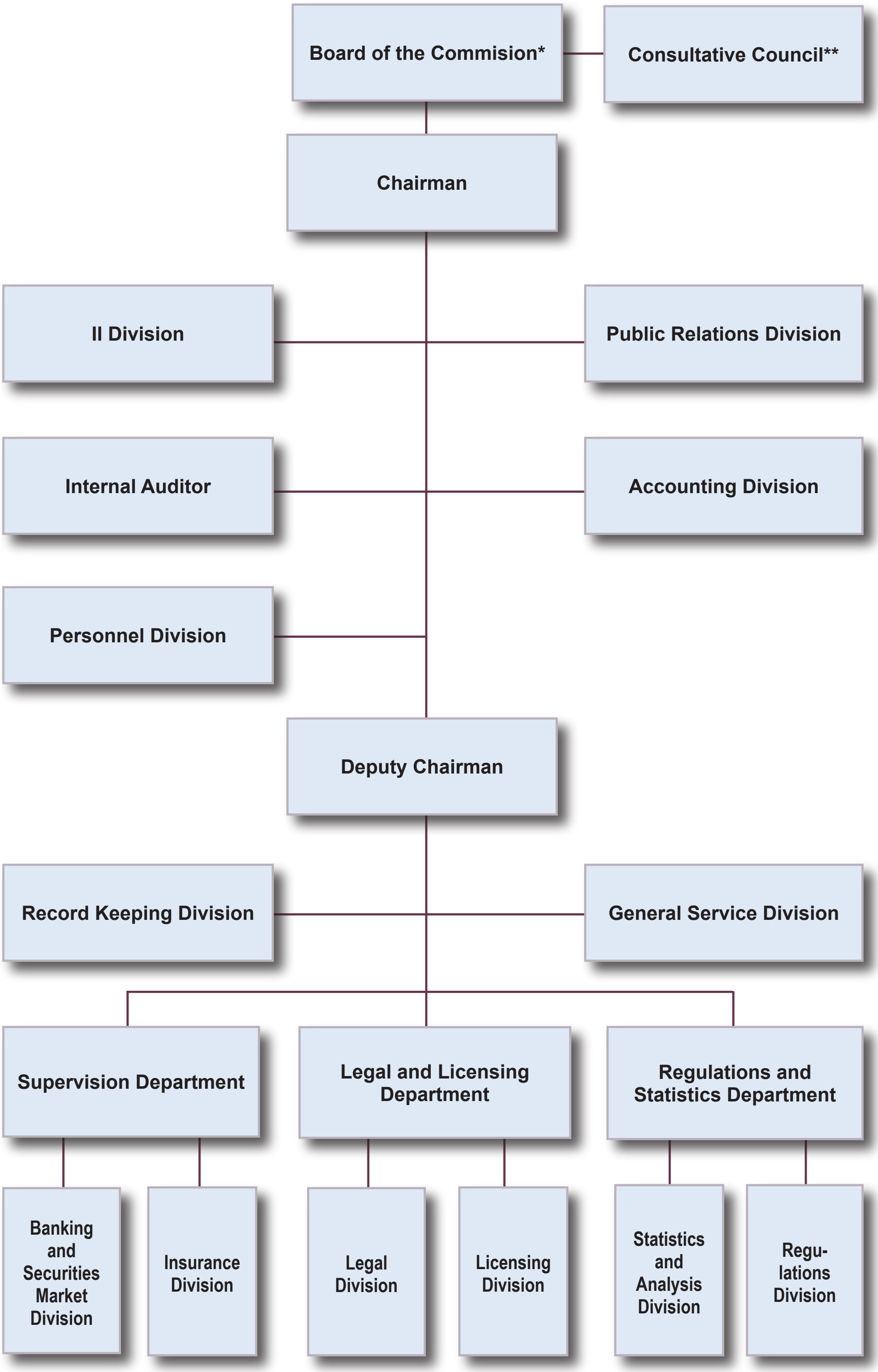
In 2003, the supervision of the financial sector was ensured by adhering to the following priorities:

- evaluation of the capital adequacy for market participants and assessment of operational risks and management controls thereof;
- the compliance of market participant operations with laws, other regulatory enactments, principles of the best practice and standards of professional ethics;
- particular attention to important market participants;
- protection of interests of investors, ascertaining whether market participants provide customers with accurate and true information concerning the legislative requirements for financial services, and assisting customers in understanding the procedure for reviewing complaints and disputes as well as their rights and obligations in general;
- a continuous dialogue with individual market participants and professional associations;
- unambiguous and reasoned decisions and actions, paying constant attention to each market participant's opinion.

In 2003, by taking account of principles for supervising the EU financial market and following recommendations of the International Monetary Fund, the Commission launched its work on developing a system that would ensure a continuous and systematic evaluation of risks incurred by individual market participants. This system, which is designed to assess risks, will also be required for the implementation of the new Basel Capital Accord. This work will be completed during 2004.

For the purpose of ensuring efficient and qualitative supervision, providing for equal treatment of all market participants, the Commission has formulated a Supervision Manual, which establishes guidelines and procedures for conducting examinations. In 2003, based on changes in the financial market, some parts of the manual, i.e. those pertaining to the review of separate risk (credit risk and market risk) management and control adequacy, were amended.

6. ORGANIZATIONAL CHART OF THE FCMC



* The Board consists of five Board members Chairman of the Commission, Deputy Chairman of the Commission and three Board members, who are simultaneously directors of the departments of the Commission

** The Consultative Council of the Financial and Capital Market is formed on a parity basis from representatives of the Commission and heads of professional organisations of financial and capital market participants.

INTERNATIONAL ACTIVITIES OF THE FCMC

Cooperation with Institutions of the European Union

In the reporting year, representatives of the Commission participated as observers in meetings of several committees of the European Commission, including the Banking Advisory Committee and the Banking Supervision Committee of the European Central Bank, as well as in working groups set up by these committees.

Upon accession to the EU, Latvia will participate in these committees already as a full member, which will enable Latvia not only to follow first-hand the latest developments in regulatory requirements for financial market activities and in supervisory practice but also to take part in the decision-making process.

Peer Review of Financial Service Supervision in Latvia

On 5 and 6 May 2003, a group of experts from the European Commission visited Latvia with the follow-up mission to assess the progress made after the first peer review, which took place in 2002. During this visit, the group of experts held meetings with both the Commission staff and financial and capital market participants, discussing matters related to the implementation of proposals expressed during the first peer review. After this visit, the Commission received a report providing a positive evaluation of the Latvian financial sector supervision.

International Organisations and Foreign Financial Supervisory Authorities

During the reporting year, the Commission was engaged in active cooperation with major international organisations operating in the financial and capital market: the BSCEE, the World Bank, the International Monetary Fund and the International Commercial Crime Bureau. Likewise, active cooperation was effected with the European Committee on Crime Problems in order to jointly combat the involvement of financial and capital market participants in money laundering.

The Commission increased its number of cooperation partners among foreign financial supervisory authorities. Memoranda of Understanding (MoUs) on the mutual exchange of information were signed with the Central Bank of Cyprus and the National Bank of Ukraine in the field of banking supervision. The Commission has concluded a total of 18 MoUs with financial supervisory authorities of various countries. In addition, the Commission has reached agreement with the US Office of the Comptroller of the Currency on the exchange of information between both organisations in the field of banking supervision.

COOPERATION WITH OTHER SUPERVISORY BODIES

The FCMC is a unified supervisory authority for the financial sector in Latvia.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2001	2002	2003
Banks	22	22	22
Credit unions	22	26	28
Foreign bank branches	1	1	1
Financial institutions, total	**45**	**49**	**51**

Ownership structure of banks on the basis of registered capital (%) (at year-ends)

Item	2001	2002	2003
Public sector ownership	4.5	7.3	6.3
Other domestic ownership	27.7	38.3	39.8
Domestic ownership total	*32.2*	*45.6*	*46.1*
Foreign ownership	67.8	54.4	53.9
Banks, total	**100.0**	**100.0**	**100.0**

Ownership structure of banks on the basis of assets total (%)

Item	2001	2002	2003
Public sector ownership	3.2	4.0	4.1
Other domestic ownership	47.7	49.2	46.3
Domestic ownership total	*50.9*	*53.2*	*50.4*
Foreign ownership*	49.1	46.8	49.6
Banks, total	**100.0**	**100.0**	**100.0**

**Banks with foreign ownership >50% and foreign bank branch*

Concentration of assets (%)

	The first three largest	The first five largest
Banks	50.4	63.1

Return on assets (ROA) (%)

	2001	2002	2003
Banks	1.5	1.5	1.4

Return on equity (ROE) (%)

	2001	2002	2003
Banks	19.0	16.4	16.7

Distribution of market shares in balance sheet total (%)

Type of financial institution	2001	2002	2003
Banks	96.7	96.0	95.4
Foreign bank branches	3.3	4.0	4.6
Financial institutions, total	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

Assets	2001	2002	2003
Cash and balances with the Bank of Latvia	5.9	5.7	4.5
Claims on credit institutions	24.2	25.2	23.2
Loans	47.3	48.1	52.5
Bonds and other fixed interest securities	16.3	15.6	15.3
Shares and other variable yield securities	0.9	0.7	0.3
Participating interest and other financial investments	0.5	0.6	0.6
Other assets	4.9	4.1	3.6
Liabilities	**2001**	**2002**	**2003**
Amounts owed to the Bank of Latvia	0.6	0.7	1.0
Amounts owed to credit institutions	15.0	14.4	18.9
Deposits	67.4	69.4	65.3
Other liabilities	6.5	5.5	5.2
Provisions	1.6	1.3	1.2
Total equity	8.9	8.7	8.4

Development of off-balance sheet activities (%)
(off balance sheet items / balance sheet total)

	2001	2002*	2003
Banks (incl. foreign bank branch)	42.3	9.6	12.4

** As of 1 January 2002, currency and interest rate futures and forwards are shown in a balance sheet*

Capital adequacy of banks (%)

	2001	2002	2003
Banks	14.2	13.1	11.7

Asset portfolio quality of the banking system (%)

Asset classification	2001	2002	2003
Standard	95.8	97.1	97.6
Watch	1.4	0.9	1.0
Substandard	1.7	0.9	0.6
Doubtful	0.7	0.7	0.5
Lost	0.4	0.4	0.3
Classified total	**100.0**	**100.0**	**100.0**
Specific provisions	**1.7**	**1.5**	**1.2**

The structure of deposits and loans in 2003 (%)
(at year-end)

	Deposits	Loans
Households	24.4	24.8
Government sector	2.0	3.7
Corporate	19.0	59.1
Other	1.0	0.7
Foreign	53.6	11.7
Total	**100.0**	**100.0**

The structure of deposits and loans in 2003 (%)
(at year-end)

Maturity of deposits		Maturity of loans	
At sight	73.2	Long term loans	41.6
Within one year	20.1	Medium-term loans	38.1
Over one year	6.7	Short-term loans	20.3
Total	**100.0**	**Total**	**100.0**

Proportion of foreign exchange assets and liabilities
(at year-ends) (%)

	FOREX assets / Total assets			FOREX liabilities / Total liabilities		
	2001	2002	2003	2001	2002	2003
Banks (incl. foreign bank branch)	64.3	64.2	65.2	65.8	65.6	65.0

Structure of revenues and expenditures of the banking system (%)
(at year-ends)

Revenues	2001	2002	2003
Interest income, incl.:	58.8	57.2	54.3
interest on loans	38.3	40.4	39.4
interest on deposits with credit institutions	8.2	5.5	4.4
interest on bonds and other fixed income securities	10.9	9.6	9.5
interest income on futures and forwards	1.2	-	-
Dividends	0.1	0.1	0.04
Commission received	23.1	24.6	25.6
Profit/loss from securities and currencies trading	8.9	10.4	11.2
Other	9.1	7.7	8.8
Expenditures	**2001**	**2002**	**2003**
Interest expense	32.7	29.1	25.8
Commission paid	5.1	5.6	6.4
Operating expenses	38.9	42.8	43.6
Depreciation	7.8	8.4	7.7
Loan loss provision expense	11.1	8.5	8.9
Other	4.4	5.6	7.6

Structure of registered capital and own funds of banks in 2003

in thousand of EUR

	Registered capital	/Total assets	Own funds	/Total liabilities
	EUR	%	EUR	%
Banks	456,791	5.6	641,739	7.9

2003 DEVELOPMENTS IN THE LITHUANIAN BANKING SYSTEM

MACROECONOMIC ENVIROMENT

The growth of the Lithuanian economy that started in 2000 continued and was reflected by 9.0 per cent growth of the Gross Domestic Product (GDP) in 2003. Further progress of the Lithuanian finance system and economy growth were positively evaluated by the largest international rating agencies that in 2003 issued higher borrowing ratings for the country. Rating agency "Moody's" issued Lithuanian credit rating A3 for long term loans in foreign currency. At the beginning of 2004 rating agency Fitch increased their rating from BBB to BBB+. "Standard&Poor's" also reviewed their rating and issued Lithuania long term borrowing in foreign currency rating A- instead of the previous BBB+.

Rating agency experts in their conclusions have mentioned that the country economy growth sustained by investments and increasing private consumption is the highest among ten new EU member countries from the Middle and East Europe region. Economy develops under the conditions of low inflation, unemployment level has notable reduced, and labour productivity is increasing. Moreover, Lithuania has made progress in implementing structural reform, modernising economy and integrating it into the EU economic environment. Strict fiscal policy exercised by the Government, consistent reforms of tax and pension system shows strengthening administrative capabilities in the Lithuanian public finance sector that are necessary in trying to successfully master EU structural funds after the accession to EU.

Changes in the foreign trade balance of 2003 show that Lithuanian companies can successfully penetrate into the foreign country markets despite the drop of US dollar exchange rate and reduced economic development in EU countries that form the main export market for goods. Last year exports increased by approximately 9 per cent, and imports by 6 per cent.

Exports to EU countries in 2003 comprised about 42 per cent of the domestically produced output and services (in 2002 this market received 48.4 per cent of total export of goods). Reduced export to EU countries was compensated by the larger trading possibilities in the growing markets of the new EU members. Last year Lithuanian exports to the candidate countries increased by 8.6 per cent and amounted to 19.3 of the total export of the country. Trade with CIS countries occupies a rather significant place, however, several years in turn exports to these countries were reducing (in 2002 exports made 19.2 per cent, 2003 – 17 per cent of the production), partially due to unfavourable duty policy of these countries. The largest part of exports was made of mineral products, re-exported transport goods, and textile products.

The main trade partners included Switzerland with 11.7 per cent share in the total exports, Russia (10.1 %) and Germany (9.9 %). As to imports, most goods, again, were imported from EU countries (44.5 % of total imports of goods); CIS countries were second by significance with a 25.3 per cent share in the total import value.

Last year the GDP increase was largely determined by the development of economy branches that were oriented towards the growing internal demand. Construction, retail trade and finance sectors developed especially quickly, economy growth was also supported by further growth of foreign direct investment. In 2003, there were several large energy, transport and alcohol production companies privatised. Improvement of the legal basis regulating work relations and taxes, bankruptcy procedures, modernisation of manufacturing and creating of new work places contributed to the successful economy development. Average unemployment ratio reduced from 11.3 to 10.3 per cent, real wage increased by 7.8 per cent. Increase of purchasing power was determined by the price index that did not change considerably during a few years. In 2003, 1.3 per cent deflation was recorded that was in part determined by comparative increase of national currency litas (that was repeged from USD to euro in 2002) value if compared to some other currencies in which settlements are made for imported production. In state finance management area in 2003, balanced borrowing policy was continued. Taken into consideration the increased economy activity, current account deficit growth last year was moderate and amounted to 6.6 per cent of GDP (in 2002 – 5,3 per cent of GDP).

In 2003, financial sector preserved the tendencies of stability and growth. Banking assets increased by 28 per cent, and asset and real GDP ratio in 2003 grew from 34 to 39.5 per cent. Banks implemented modern information technologies, improved quality of services provided and developed subsidiary company activities. Although borrowing needs increased with the growing consumer activity, interest for loans remained record-breaking low (for example, average yearly interest rate for long term loans in national currency for residents at the end of 2002 was 6.06 per cent, and at the end of 2003, 5.07 per cent), and improving private business and population expectations prompted further demand for borrowing.

In 2003, pension system reform was started in Lithuania that provided a possibility to transfer part of compulsory social insurance contribution to private pension funds. During the first year of the reforms (2004) there will be 2.5 per cent of contributions paid to the compulsory social insurance fund transferred to accumulative insurance. It is anticipated to slightly increase this tariff every year by 1 percentage point until it will reach 5.5 per cent in 2007.

DEVELOPMENT OF THE BANKING SYSTEM

In late 2003, the Lithuanian banking system comprised:

- 10 commercial banks with 117 branches in different regions throughout the country;

- 3 branches of foreign banks;
- 3 representative offices of foreign banks.

Major changes in the banking system during the last few years were related to the sale of the 2nd and 3rd according to the assets state owned banks' shares. In 2002, having concluded the last privatisation transaction state participation in bank management reduced to the minimum – Lithuanian Government and state enterprises own 0.1 per cent of commercial bank share capital. By the end of 2003, foreign investor-owned capital (mostly Scandinavian and German) prevailed in the domestic banking sector, the share of which comprised 88.7 per cent.

Investments of financially strong strategic foreign partners contributed to the strengthening of the Lithuanian banking system. In 2003, share capital of the banking system increased by 11 per cent and reached EUR 347,5 million. Larger capital enabled banks to devote considerable attention to the modernisation of infrastructure and created preconditions for taking additional assets risk in financing significant projects. In 2003, banks continued organisational structure reforms in order to more effectively use the resources and increase activity efficiency under the growing competition conditions and at the same time hold the present position on the market and ensure further business development.

The result of banks' performance in 2003 is the profit of EUR 67.7 million that is the best during the banking activity history since the reestablishment of independence. This shows that consistent increase of banks' work effectiveness, application of progressive information technologies, improvement of loan portfolio and development of new financial services gives positive results, banks successfully adjust to the increasing market competition conditions and increase performance profitability, although real interest margin in 2003 was constantly reducing as well as during a few previous years.

In 2003 profit partly was determined by banks' lower expenses for special provisions as well as recovery of written –off loans, and increasing income from services and commissions. The growth of this income is partially related to further increase of the number of payment cards and more and more popular Internet bank services. At the end of 2003 banks had issued 2.2 million payment cards, i.e. compared with the beginning of the year the number of cards in circulation increased by 1.5 times, the same increase was in the value of settlements made by payment cards. Deposits kept with banks (deposits of financial sector institutions kept with banks) increased by 16.2 per cent in 2003, individual deposits among them by 14.7 per cent.

Rapid economy development gave an impulse for the growth of loan portfolio. Total loan portfolio in 2003 increased more than 1.5 times and reached EUR 3.5 billion. 2003 witnessed further increase of long-term loans that was strengthened by favourable borrowing conditions, positive evaluation of business development perspectives after accession to the EU, increase of individuals purchasing power and state policy encouraging housing lending by applying respective individual income tax relieves. Amount of long-term loans issued for private companies if compared to 2002 increased by more than 1.6 times and for individuals even 2 times. Loan issuance for individuals in 2003 was the most quickly developing bank activity area, because retail banking market in previous years was comparatively slowly developing.

In 2003, concentration in banking sector slightly reduced and the most important place was occupied by three largest banks. These banks managed 71 per cent of the banking system assets and had 79 per cent of individual deposits; they issued 73 per cent of the banking sector loans to private enterprises.

LEGAL AND INSTITUTIONAL FRAMEWORK FOR SUPERVISION OF FINANCIAL INSTITUTIONS

The role of the Bank of Lithuania and its responsibilities in supervising credit institutions are defined in the Law on the Bank of Lithuania, the new edition of which was adopted in 2001. These functions are directly performed by one of the structural units of the Bank of Lithuania, i.e. Credit Institutions Supervision Department.

The Department implements ongoing supervision of credit institutions using internationally recognized methods and taking into consideration recommendations of Basle Committee on Banking Supervision and provisions contained in the directives of the European Union.

The supervision of the activities of credit institutions, which hold a license, or permission of the Bank of Lithuania involves:

- the collection and analysis of information obtained for the purposes of supervision in the form of reports;
- assessments of activities of credit institutions and their financial situation on the basis of the said information, taking into account prudential and other requirements of the activities of credit institutions, established by legal acts;
- inspection of the activities of credit institutions, such as verification of the correctness of the compilation of financial reports presented to the Bank of Lithuania and assessments of the activities and financial situation (capital, the quality of assets, profitability) of credit institutions, as well as assessments of the efficiency of the management of assets and liabilities, and of the management of a credit institution;
- application of economic and other enforcement measures prescribed by legal acts against credit institutions failing to comply with the requirements concerning sound and reliable activities provided for in legal acts.

In carrying out the functions of the licensing and supervision of credit institutions, the Bank of Lithuania has the right to exchange information with the institutions of other states performing the supervision of credit institutions on the activities of any credit institution, and it has to ensure the confidentiality of such information.

MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISORY AUTHORITY IN 2003

In 2003, the Bank of Lithuania further improved and strengthened credit institution supervision by encouraging the development of safe, sound and competitive banking system in the country. Constantly continuing work that was started in previous years, the main attention was paid to the following areas of activity:

- preparation for implementation of the New Basel Capital Accord provisions in Lithuania;
- improvement of thorough risk management in banks and respective preparation for ensuring activity continuation under extraordinary conditions,
- shift to risk-focused on-site inspection together with traditional bank activity areas starting analysing and assessing new risk factors, such as reliability of informational systems and e-banking processes;
- improvement of bank financial accounting and reporting order, keeping close contacts with international audit companies that audit banks;
- expanding and strengthening co-operation with respective foreign countries' financial sector supervisory authorities by exchanging the information necessary to ensure effective banking supervision.

KEY ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2003

In performing the function of the supervision of credit institutions, in 2003 the Bank of Lithuania focused on the regulation of risk management processes in banks and improvement of internal control systems, encouraging banks to adequately assess, control and manage traditional risks and to identify in due time the problems arising in the provision of banking services, as well as be prepared to operate in emergency situations.

As part of the preparation to apply the provisions of the New Basel Capital Accord in Lithuanian banks in the future, the Bank of Lithuania has decided to perform a detailed analysis of the current situation and undertake certain preparatory work. In 2003, the Bank of Lithuania prepared a summary of the New Basel Capital Accord and familiarised commercial banks with it. During the subsequent meetings with representatives of banks, the core principles of the New Basel Capital Accord were discussed, sharing the experience of how strategic foreign partners of the banks intended to implement the Accord, and further aspects of work co-ordination were addressed.

To be able to forecast more accurately the likely future development of the banking sector, the Bank of Lithuania analysed the information submitted by banks about the complex stress testing of key risks (credit, market, liquidity, operating, etc.). Banks were recommended to periodically perform testing at least once a year and to assess the assumed risk on a consolidated basis, i.e. to take into account the influence on the whole parent bank group of not only the bank itself but also of other companies within the group. This stress testing is aimed at establishing the risks that would have the strongest negative impact on the performance of banks, finding out to what extent unfavourable market conditions could dampen the ability of banks to meet their liabilities, and at ensuring compliance with the minimum capital adequacy ratio.

The recent significant increase of the bank loan portfolio has shown that this business area should remain in the focus of attention. The Bank of Lithuania has initiated the implementation of a new concept of the centrally managed Loan Risk Database in order to improve credit risk management and to provide possibilities for banks for gradually introducing internal borrower rating systems, as recommended in the New Basel Capital Accord. More information will be available on each borrower, including some of the borrower's financial performance indicators. A more comprehensive database will provide wider possibilities for the qualitative and quantitative analysis of credit risk.

Taking into consideration the increased level of market discipline, in 2003 the Bank of Lithuania approved new General Regulations on the Assessment and Classification of Doubtful Assets and Formation of Specific Provisions to enter into force as from the latter half of 2004. This legal act has provided for a much more flexible and liberal procedure for classifying doubtful assets than was previously the case, providing possibilities to assess the risk on these assets more accurately. Last year, each bank began working out and co-ordinating its own rules of assessment and classification of doubtful assets in observance of the Bank of Lithuania's established minimum requirements. During the meetings held at the Bank of Lithuania, the shortcomings of these rules were discussed, comments on, and suggestions for, their further improvement were provided.

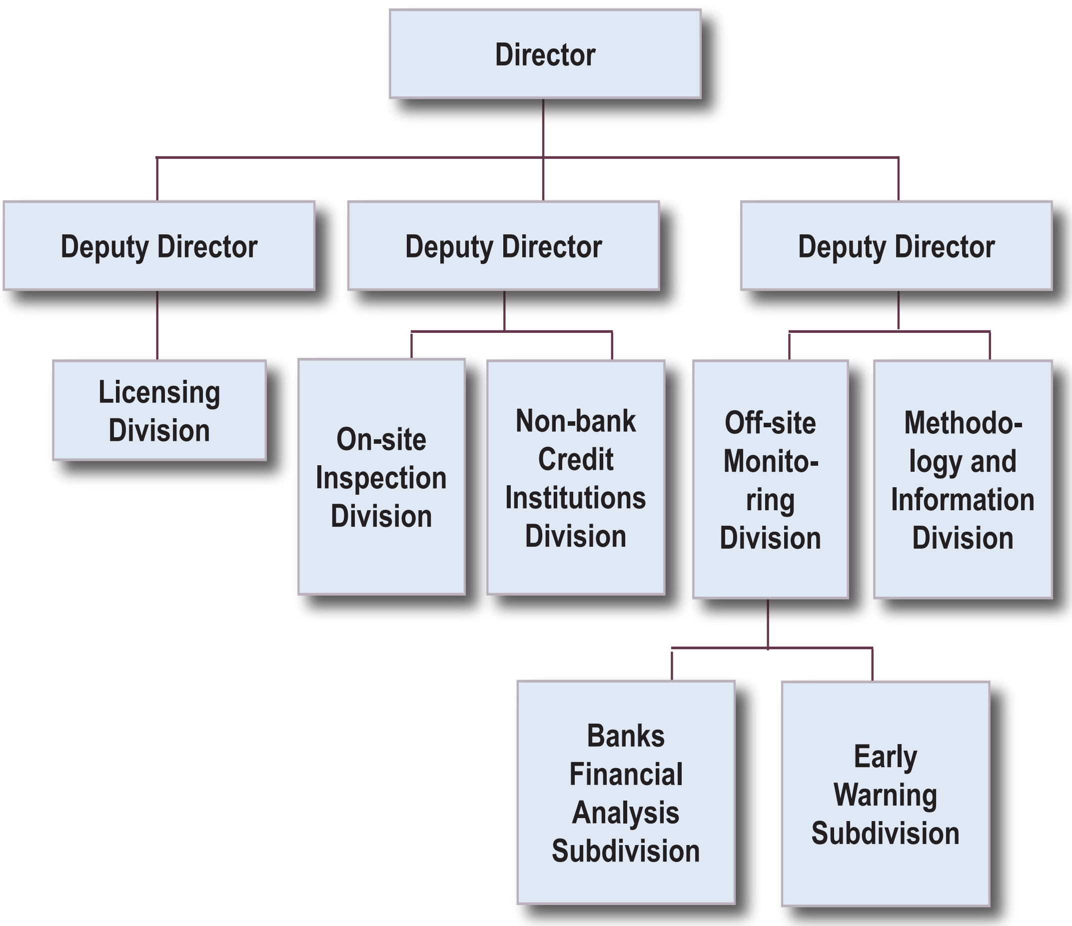
In developing their business, beside regular risks, banks inevitably face new ones; one of these is operational risk. Operational risk, most often occurring as a result of the failure of technical systems and employee errors and inaccuracies, is particularly closely connected with the ever-increasing use of IT in providing banking services. The Bank of Lithuania approved General Provisions of Operational Risk Management in 2003 seeking to encourage banks to devote more attention to the management of this risk and to take in due time appropriate actions to reduce their losses on potential failures in operation. The Provisions defined the operational risk identification, assessment, monitoring and control procedures.

In 2003, saw a further increase in the scope of Internet banking services provided by banks and in the number of their users. In view of the increasing importance of this process, the Bank of Lithuania included a new area of inspection into its inspection programme – IT and electronic banking. During the examination of this area, inspection focuses on the bank's operations in terms of management of the risks inherent in IT and electronic banking, including the assessment of the organisation of system design, application, maintenance and operating continuity, analysis of IT security risk factors and their impact on the confidentiality, integrity and accessibility of information and data, the assessment of the organisational, physical and logical internal control measures and procedures applied in the bank, etc.

Another important area which the Bank of Lithuania devoted quite significant attention to was the ongoing adjustment of accounting and reporting requirements according to the requirements of EU directives and the international accounting standards in order to ensure that the statements submitted for supervisory purposes and for the public were sufficiently informative and objective. In 2003, the forms of the balance sheet and profit (loss) statements submitted for supervisory purposes and the forms of publicly announced annual financial statements and minimum requirements for the explanatory notes, the Rules for Accounting and Reporting of Operations in Foreign Currency in Banks as well as the Rules of Consolidation of Financial Statements and Consolidated Supervision were revised.

In continuation of the main activities of 2003, the Bank of Lithuania intends to proceed with pursuing a purposeful policy for credit institution supervision to ensure a safe and competitive domestic system of credit institutions and to provide conditions for the sound development of the domestic financial market.

THE STRUCTURE OF CREDIT INSTITUTIONS SUPERVISION DEPARTMENT OF THE BANK OF LITHUANIA AT THE END OF 2003



INTERNATIONAL ACTIVITIES

In 2003, the Bank of Lithuania participated in the assessment of how the recommendations of the Lithuanian Financial Sector Assessment Programme conducted by the World Bank and the IMF and the proposals on the banking sector submitted by the European Commission during the appraisal of the Lithuanian financial sector supervisory authorities were implemented. The EU experts who carried out the said assessment were furnished with information about the developments in the banking sector and the tasks accomplished during the implementation of the action plan drawn in accordance with the Commission's recommendations. The Commission had already recognised earlier the compliance of the domestic credit institution supervisory system with international practices and EU requirements, and its capability to ensure prevention of the occurrence of problems in banks.

The Bank of Lithuania enhanced co-operation with the ECB, joined the activities of the advisory committees and working groups of other EU institutions, in which the issues related with credit institution supervision were widely discussed, such as unification of the requirements under the New Basel Capital Accord and EU directives, cross-border supervision of financial groups, crisis management policy, harmonisation of the international accounting and audit standards with EU law, etc.

CO-OPERATION WITH OTHER SUPERVISORY BODIES

Last year, the Bank of Lithuania further strengthened co-operation with foreign financial sector supervisory authorities and continued the implementation of EU legal acts in order to prepare properly for EU membership.

With strengthening globalisation processes in the banking sector, co-operation of the supervisory authorities on the international level is becoming increasingly important. An agreement of co-operation with the Swedish Financial Supervisory Authority was prepared in 2003 and signed in early 2004, a renewed agreement of co-operation with the Bank of Russia was co-ordinated. Such co-operation agreements were signed earlier with the respective supervisory authorities of Poland, Finland, Latvia, Estonia, Germany, and Belarus. These agreements provide for co-operation principles in performing joint bank supervision on the international level, including licensing requirements and capital ownership control, on-site inspections, subsidiaries' control, application of prudential requirements, principals for mutual exchange of information, and general actions in supervising banks or bank branches established in either country.

In view of the strengthening relations between the financial sector and the insurance sector and their influence on the business of credit institutions, in 2003 the Bank of Lithuania began co-operating more closely with other financial and insurance undertaking supervisory authorities of Lithuania. This co-operation was also encouraged by the fact that last year the Commission for the Regulation of the Business of Financial Institutions and for the Coordination of Supervision was set up, including representatives of all the three financial and insurance undertaking supervisory authorities of Lithuania. The Commission, in consultation with the representatives of banks, other financial institutions and insurance undertakings, will seek a more efficient coordination and improvement of the supervisory processes in individual sectors of the Lithuanian financial market, development of a supervisory strategy and identification of its priorities; it will submit proposals to the Seimas on the amendments to the laws and other legal acts regulating the provision of financial and insurance services, the business and the supervision of financial institutions and insurance undertakings.

STATISTICAL TABLES

**Number of financial institutions
(at year-end)**

Type of financial institution	2001	2002	2003
Commercial banks	9	10	10
Foreign bank branches	4	4	3
Credit unions	41	54*	58*

** including Central Credit Union*

**Ownership structure of financial institutions on the basis
of registered capital* (%)
(at year-end)**

Item	2001	2002	2003
Public sector ownership	7.6	0.5	0.3
Other domestic ownership	10.1	11.5	11.7
Domestic ownership total	*17.7*	*12.0*	*12.0*
Foreign ownership	82.3	88.0	88.0
Financial institutions, total	**100.0**	**100.0**	**100.0**

** registered capital of a foreign bank branch is funds of this branch received from the headquarter with the purpose to commence the branch operations*

**Ownership structure of financial institutions on the basis of assets total (%)
(at year-end)**

Item	2001	2002	2003
Public sector ownership	N/a	N/a	N/a
Other domestic ownership	N/a	N/a	N/a
Domestic ownership total	*81.7*	*87.0*	*89.1*
Foreign ownership	18.3	13.0	10.9
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of assets by the type of financial institutions (%)
(at year-end)

Type of institutions	The first three largest	The first five largest
Banks	71.1	81.6
Credit unions	35.2	43.8
Financial institutions	-	-
Savings cooperatives	-	-
Specialized credit institutions	-	-

Return on assets (ROA) by the type of financial institutions
(at year-end)

Type of institutions	2001	2002	2003
Banks	-0.17	0.93	1.26
Credit unions *	1.16	0.65	0.71
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

** Without Central Credit Union*

Return on equity (ROE) by the type of financial institutions
(at year-end)

Type of institutions	2001	2002	2003
Banks	-1.2	9.8	13.37
Credit unions*	7.95	4.9	5.5
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

** Without Central Credit Union*

Distribution of market shares in balance sheet total (%)
(at year-end)

Type of financial institution	2001	2002	2003
Commercial banks	93.0	92.2	90.7
Foreign bank branches	6.8	7.4	8.6
Credit unions	0.2	0.4	0.7
Financial institutions, total	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%) (at year-end)

Assets	2001	2002	2003
Cash in hand	3.8	3.8	3.1
Claims on banks and other financial institutions	24.2	18.7	21.1
Securities	20.1	22.5	15.8
Loans granted*	41.3	45.6	54.4
Other assets	10.6	9.4	5.6
Liabilities	**2001**	**2002**	**2003**
Liabilities to banks and other financial institutions	14.7	14.8	22.6
Deposits and L/C	67.9	67.8	61.6
Other liabilities	7.5	7.4	5.3
Bank capital	9.9	10.0	10.5

** Net values*

Development of off-balance sheet activities (off-balance sheet items/balance sheet total) (%) (at year-end)

Type of financial institution	2001	2002	2003
Commercial banks	12.9	16.8	23.6
Foreign bank branches	18.7	10.6	22.9
Credit unions	-	-	-
Financial institutions, total	**13.3**	**16.3**	**23.4**

Solvency ratio of financial institutions (%) (at year-end)

Type of financial institution	2001	2002	2003
Commercial banks	15.6	14.8	13.2
Foreign bank branches*	-	-	-
Credit unions	18.6	16.5	16.6
Financial institutions, average	15.6	14.8	13.3

**:solvency ratios of foreign bank branches is not calculated*

Loan portfolio quality of the banking system (%) (at year-end)

Asset classification	2001	2002	2003
Standard loans	70.4	76.2	79.6
Watch loans	22.2	18.0	17.7
Substandard loans	3.1	4.1	1.7
Doubtful loans	2.6	1.5	0.9
Bad loans	1.7	0.2	0.1
Non-performing loans/ Total loan portfolio	**7.4**	**5.8**	**2.6**

The structure of deposits and loans of the banking system in 2003 (%)
(at year-end)

	Deposits	Loans
Households	55.7	20.2
Government sector	8.8	5.8
Corporate	29.3	71.7
Foreign	4.5	2.0
Other	1.7	0.3
Total	**100.0**	**100.0**

The structure of deposits and loans of the banking system in 2003 (%)
(at year-end)

Maturity of deposits		Loans*	
At sight	57.2	Long-term loans**	33.6
Within one year	40.1	Medium-term loans***	27.2
Over one year	2.7	Short-term loans****	39.2
Total	**100.0**	**Total**	**100.0**

** net value*
*** over 3 years*
**** 1-3 year*
****** 1 year and less*

Proportion of foreign exchange assets and liabilities (%)
(at year-end)

Type of financial institution	FOREX assets/Total assets			FOREX liabilities/Total liabilities		
	2001	2002	2003	2001	2002	2003
Commercial banks	49.8	32.1	46.4	50.1	41.2	42.0
Foreign bank branches	71.1	75.7	77.4	81.0	83.5	82.2
Financial institutions, average	**51.3**	**45.3**	**49.1**	**52.3**	**44.5**	**45.9**

Structure of income and expenses of financial institutions (%)
(at year-end)

Income	2001	2002	2003
Interest income	66.2	58.8	59.0
Profit from operations in foreign exchange	4.8	6.6	12.9
Income from services and commissions	22.3	23.3	27.5
Other bank income	6.7	11.3	0.6
Total income	**100.0**	**100.0**	**100.0**
Expenses	**2001**	**2002**	**2003**
Interest expenses	30.1	23.7	23.4
Operational expenses	37.5	45.6	53.6
Expenses for specific provisions	9.4	7.3	-4.0
Other expenses	23.0	23.4	27.0
Total expenses	**100.0**	**100.0**	**100.0**

Structure of registered capital and own funds of financial institutions in 2003 (at year-end)

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liabilities
	EUR million	%	EUR million	%
Commercial banks	356.8	6.1	609.9	11.7
Foreign bank branches*	17,7	3.2	17.6	3.3
Credit unions	5.4	12.1	6.0	15.4
Financial institutions, average**	41.6	5.9	48.3	10.9
Financial institutions, average* **	**5.4**	**5.9**	**9.0**	**10.9**

** registered capital of a foreign bank branch is funds of this branch received from the headquarter with the purpose to commence the branch operations*
*** without Credit Unions*
**** Including Credit Unions*

2003 DEVELOPMENTS IN THE MACEDONIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN THE REPUBLIC OF MACEDONIA

The performances of the Macedonian economy in 2003 clearly indicate the capacity of the country for successful mitigation of the unfavorable effects of the security crisis in 2001 and resuming the positions of normal and stable economic functioning. Thus, after the moderate increase in 2002, 2003 registered an economic growth rate of 3.2%, thus exceeding the projected acceleration of 2.8%. One of the major generators of the real GDP increase in 2003 is the industry sector, the 4.5% growth rate of which is an encouraging indicator for the possibilities for more intensive growth. Moreover, the indicators of the foreign trade show gradual return of the Macedonian exporters to the international markets and normalization of the relations with the foreign partners, which is an additional signal for successful consolidation of the economy. In 2003, the economic activity was properly supported by the successful price stability maintenance, which contributes towards reducing the uncertainty and stabilizing the expectations of the economic entities.

The perceptions of the international community for gradual and successful recovery of the economy, the clear determination for conducting consistent macroeconomic policy and the consistent determination for implementing the commenced reforms were confirmed by the conclusion of the Stand-By Arrangement with the IMF on April 30, 2004. The arrangements meant establishing a consistent macroeconomic program, focused on proper fiscal consolidation, low and stable inflation rate and maintenance of a capacity for persistent implementation of the current monetary strategy.

In 2003, the FSAP Mission (joint IMF and World Bank Mission within Financial Sector Assessment Program) visited Macedonia for the first time, and reached positive conclusions for the resistance of the Macedonian banking system to various types of shocks, for the institutional layout of the National Bank of the Republic of Macedonia (NBRM) and the transparency in its operations, as well as for the payment system effectiveness and security. Thus the international financial institutions confirmed the successful convergence of the Macedonian financial system towards the internationally accepted operating standards and principles.

The Republic of Macedonia orientation towards integration into the global trade courses, its readiness to accept the commitments which are inevitably imposed by the integration, as well as the willingness of the international factor to include the country in its structures were confirmed with the official membership of the Republic of Macedonia in the World Trade Organization (WTO) on April 4, 2003. The membership in the WTO also means a clear determination for promoting competitive environment, which should contribute to larger effectiveness, higher quality and better standard of living.

In 2003, the NBRM continued with successful implementation of the strategy of targeting the exchange rate of the Denar against the Euro. The maintenance of the exchange rate stability as a nominal anchor essentially contributed towards preserving low and stable inflation rate, which means successful achievement of the ultimate goal of the monetary policy. Thus 2003 ended with an average inflation rate of 1.2%, which is below the projected inflation of 1.8%. The successful “inflation file” is a factor which contributes towards approximating of the Republic of Macedonia to the European Union and its further successful integration.

In 2003, compared to the previous two years, the monetary policy was conducted in a considerably changed environment. The successful fiscal consolidation, the substantially lower risk and the stabilized expectations of the economic agents called for gradual modification of the monetary policy design. Thus in 2003, the NBRM dynamics of the interest rates indicates gradual relaxation of the monetary policy.

The maintenance of the exchange rate at a stable level, as an intermediary monetary goal, still imposes the need of an active role of the NBRM on the foreign exchange market. With the set of amendments to the regulations in the area of foreign exchange operations (aimed at larger liberalization) the foreign exchange market started operating in a new manner at the end of January 2003. This means equal participation of the NBRM, which is to be aimed at larger effectiveness of the operations on the foreign exchange market and optimal allocation of the foreign assets.

The gross foreign exchange reserves went up on annual basis and remained at an adequate level of 4.7-month import coverage, with the liabilities to the external creditors being regularly serviced. Notwithstanding the increase in the external indebtedness (the total debt reached US Dollar 1,813 million), the Republic of Macedonia still remains within the group of low, i.e. moderately indebted countries. In 2003, the current account deficit was substantially reduced (and equaled 6% of the GDP), thus approximating to the sustainable deficit of 5%, set as a rule of thumb.

The further strengthening of the confidence in the banking system and the stronger preferences for saving within the official banking channels were illustrated with the continuous growth in the deposit potential. Thus the total deposits of the private sector in the banks registered considerable annual increase of 26.8% in 2003. The additional funds were allocated through the banks to both the households and the enterprises, generating positive impulses for stimulation of the economic growth.

In 2003, a positive trend was also registered in the area of banks’ interest rate policy, where the lending and the deposit interest rates indicated downward trend. The changes in the banks’ interest rates largely corresponded with the modified monetary policy design (particularly since April 2003), signalizing larger responsiveness of the banks to the monetary signals. Such movements resulted in narrowing of the average interest rate margin by 0.8 percentage points, which indicates positive developments in the efficiency of the banks' operations and the level of competitiveness in the banking system.

The process of harmonization of the regulation in the country with the internationally accepted standards continued in 2003. Thus amendments to the Law on the NBRM, Banking Law and Law on Foreign Exchange Operations were made. The amendments made to the regulations are aimed at further convergence to the internationally accepted standards, and the established European directives, thus ensuring prompter and more efficient integration of the Republic of Macedonia into the global developments.

Also, in 2003, the NBRM also showed its clear determination to conduct monetary policy directed towards maintaining low and stable inflation rate. Furthermore, the continuing promotion of the banking supervision contributes towards successful maintenance of the financial stability. The focus on the price and financial stability is a successful convergence of the NBRM to the positioning of the modern central banks in the developed market economies. Through the successful achievement of these goals, the NBRM further contributes to the creation of a favorable environment for sustainable economic growth on a long run.

DEVELOPMENT OF THE BANKING SYSTEM

Structure of the banking system

As of December 31, 2003, the Macedonian banking system was consisted of 21 banks and 15 savings houses[14]. The savings houses did not have any significant influence in the performance of the banking system, since they accounted for only 1.2 % of the total banking assets. The future perspectives and status of this segment of the banking system is an open question that needs to be resolved in the near future.

For the purpose of better quality of the analysis of banks' performances, the banks in the Republic of Macedonia were divided in three groups according the total assets criterion:

- Large banks (with assets higher then Denar 15 billion);
- Medium-size banks (with assets from Denar 2 to 15 billion); and
- Small-size banks (with assets lower the Denar 2 billion).

According this criterion, as of December 31, 2003, the group of large banks was consisted of 2 banks, the group of medium-size banks contained 6 banks, while the group of small-size banks was biggest and was consisted of 13 banks.

[14] At the beginning of 2003, a receivership procedure was initiated in one bank. In order to get more real indicators for the structure, the activities and the performances of the banking system of the Republic of Macedonia, this bank was exempted from the further analysis of the banking system.

The most significant group of banks according the size of total assets was the group of large banks, with 55,5% share of total assets, as of December 31, 2003. The remaining 44,5% belongs to the other two groups, whereas 28,1% refer to medium-size banks and 16,4% refer to small-size banks. The concentration of the banking system according to the capital strength as of December 31, 2003, analyzed by banking groups was moving in the interval from 31,3% to 35,4%. Contrary of the total assets criterion, where the large banks dominate the banking system of the Republic of Macedonia, according the total capital criterion, the concentration of medium-size banks was higher and accounted for 35,4% of the total banking system. Nevertheless, the concentration according to the capital as criterion shows almost equal concentration by the three banking groups.

The concentration of the assets of the banks in the Republic of Macedonia, expressed through the Herfindahl Index[15] for 2003, indicated certain concentration[16], which analyzed on annual basis registers an upward trend. Thus, as of December 31, 2003, the concentration in the banking system of the Republic of Macedonia amounts to 1,842 units, which is by 175 units higher compared to December 31, 2002. The value of the Herfindahl index for the large banks equals 1,618 units, which is by 153 units more compared to the same period of the preceding year.

The dominant position of the group of large banks in all banking areas structure is confirmed by their market share of 55,5% from the total volume of the on-balance sheet and off-balance sheet activities of the banks of the Republic of Macedonia. If the banks' credit activity is taken into consideration[17], the share of the group of large banks in the credit activity of all banks equals 48,3%, as of December 31, 2003. The most evident concentration by the group of large banks was ascertained in the analysis of the banks' deposit activity[18]. As of December 31, 2003 the group of large banks mobilized 66.8% of the total deposits.

As of December 31, 2003, 48,6% of the engaged capital in the banks in the Republic of Macedonia was owned by foreign shareholders, or the 8 banks owned by foreign shareholders cover 46,9% of the total assets at the level of all banks. From the remaining 13 banks, 12 banks were owned by domestic private shareholders and cover 51,3% of the total assets at the level of all banks, or 50,5% of the total banking capital and 1 bank was 100% state owned and covers 1,8% of the total banking assets.

As of December 31, 2003, the share of the foreign capital in the total banking capital in the Republic of Macedonia equals 47,2%. The bank-by-bank analysis indicates presence of foreign capital in 15 banks, with percentage share ranging from 0.2% to 100%.

Out of the total capital of the group of large banks, 51.9% is controlled by foreign shareholders. This percentage accounts 44,6% within the group of medium-size banks and 45% within the group of small-size banks.

[15] X =i (assets of each bank/ total assets of all banks *100)^2

[16] According to the Herfindahl if the Index ranges between 1,000 and 1,800 units, the concentration of the assets is considered acceptable, while up to 1,800 units, the concentration is considered as significant.

[17] Credit placements to the non-financial entities (corporate and households sector)

[18] Deposits to the non-financial legal entities (corporate and households sector)

The balance sheet structure

The increased deposit potential of the banks in the Republic of Macedonia as a major determinant of the credit activity in function of support of the total economic activity simultaneously reflects the strengthening of their function of financial intermediation in the Macedonian economy. The degree of financial intermediation of the banks in the Republic of Macedonia, measured through the ratio of the total assets, the gross credits extended to clients and the total deposits to the gross domestic product, registers continuous moderate upward trend. As of December 31, 2003, this indicator calculated as a ratio of the banks' total assets, the gross credits extended to clients and the total deposits to the gross domestic product, equals 41.4%, 17.8% and 27.7%, respectively. Even though that this indicator registers continuous moderate upward trend, still there is a room for expanding the activities of the banks and increasing the level of financial intermediation aimed at economic development of the country.

The trend of total assets of the banks in the Republic of Macedonia, in the last five years registers continuous upward trend, with exception to December 31, 2002. The total assets dynamics was primarily supported by continuous upward trend of total deposits, as major source of banks' funds. Analyzed by banking groups (large, medium-size and small-size banks), this upward trend of the total assets was caused by the upward trend of the total assets registered by the group of large banks', due to their continuous dominant share of above 54% in the net assets of the banks in the Republic of Macedonia. The comparison December 31, 2003 to December 31, 1999, shows that the increase of 52,2% of the total assets is a result of the increase of the group of large banks' assets and 42,9% of the increase of the group of medium-size banks' assets.

The total assets of the banking system as of December 31, 2003 amounted to Denar 104,875 million, which represents an increase of Denar 11,662 million or 12,5%, compared to December 31, 2002. The increase of the total assets was reflected by the increase of their dominant segments - credits extended to clients and banks, and also by the increase of the National Bank of the Republic of Macedonia bills. Compared to December 31, 2002, the assets structure remained almost unchanged. The placements to banks had retained their dominant share of 35,6% of the net assets, which were followed by placement to clients, accounting for 35.4% of the net assets.

Further continuous increase of the deposit potential registered from previous years, had followed during 2003. As of December 31, 2003, the level of the total deposits had overcome the achieved highest level of the total deposits during the Euro conversion. This trend of deposit potential refers to further strengthening of Macedonian banking system credibility and confidence. On December 31, 2003 as in the previous years, the total deposits of the non-financial legal entities and households remained to be the main source of funds, with their largest share of 66,9% of the total sources of funds. As of December 31, 2003, the total deposits of the non-financial legal entities and households amounted to Denar 70.188 million, which is increase of Denar 12.283 million or 21,2% compared to December 31, 2002. Analyzed by banking groups (large, medium-size and small-size banks), 68,7% of the increase of total deposits on annual basis was primarily determined by the increase of group of large banks total deposits, due to their dominant share of 66,8% of the total deposits.

Capital adequacy ratio

As of December 31, 2003, the total capital of the Macedonian banks accounts for 19.1% of the total sources of funds. The average capital adequacy ratio of the banks in the Republic of Macedonia equaled 25.8% at the end of 2003, which represents a decrease of 2.3 percentage points, compared to December 31, 2002. Analyzed by groups of banks, the capital adequacy ratio of large banks is lower by 9,4 percentage points then the average capital adequacy ratio of Macedonian banks. Contrary to this, the capital adequacy ratio of medium-size banks was higher by 2.3 percentage points compared to the average capital adequacy ratio. The discrepancy is larger within the group of small-size banks, whose capital adequacy ratio was by 23-percentage points higher then the average capital adequacy ratio of Macedonian banks, as of December 31, 2003. The reason for such high level of capital adequacy ratio within small-size banks group is due to the simpler structure of the sources of financing, whereas the own sources of funds have significant share, contrary to the small volume of activities, especially the credit activity, which indicates the lower efficiency in performing the financial inter-mediation.

As of December 31, 2003 all banks in the Republic of Macedonia had fulfilled the prescribed minimum of 8%. Analyzing by individual bank, as of the end of 2002, also as of the end of 2003, banks with capital adequacy ratio in the rank between 30-50% and banks with capital adequacy ratio in the rank between 50-100% are dominant.

The analysis of the movement of the capital adequacy ratio, starting from December 31, 2002 when the ratio equaled 25.9%, till December 31, 2003, when the ratio equaled 25,8%, indicates relatively stable trend. Also, relatively high capital adequacy ratio is an indicator for the stable solvent position of the banks in the Republic of Macedonia.

Credit Risk

Credit Risk has the main role in defining the risk profile of banks in Republic of Macedonia. The main indicators for the quality of the credit portfolio show that during 2003 there was further trend of moderate improvement of credit portfolio quality. The share of the total exposure classified in the risk categories C, D and E in the total portfolio of banks as of December 31, 2003 equaled 15.1%, which is a decrease of 0.8 percentage points compared to December 31, 2002. This improvement confirms the continuous process of strengthening of the prudent credit policies and practices by Macedonian banks. The aggregate credit risk level of the credit portfolio of the Macedonian banks, calculated as a relation between the total potential losses and the total credit exposure equaled 10.3%, as of December 31, 2003. Analyzed by groups of banks, this indicator is highest within small-size banks and equals 12,3%, then follows the group of large banks with rate of 10,8% and small-size banks with 8,3%.

The income statement structure and ratios

In 2003, the banks in the Republic of Macedonia showed positive financial result in the amount of Denar 448 million on aggregate level. Out of 21 banks in Republic of Macedonia, 17 banks, representing 93.7% of the total financial potential of all banks, showed positive financial result in the total amount of Denar 1.420 million, while 4 banks showed negative financial result in the total amount of Denar 972 million. Analyzed by banking groups, the main reason for the registered positive financial result on aggregate level is the financial result generated from the large banks, which represent 51,4% of the total financial result of all banks in Republic of Macedonia.

The positive financial result of the banks in 2003 was mainly based on registered extraordinary income. Namely, the banks' income generated from performing their main function (net interest income after provisions and net fees and commission income) was insufficient to cover all operating expenses. So, without the registered extraordinary income, on aggregate level, the financial result would be negative. But, despite this general conclusion, it is important to mention that in the Republic of Macedonia there are banks whose profitability is completely generated from performing their main function; i.e. they have stable profitability positions. The achieved positive financial result in 2003 reflects positive values of the indicators, rate of return on assets (ROAA) and rate of return on equity (ROAE). As of December 31, 2003, the ROAA and ROAE indicators were set at the level of 0.5%, i.e. 2.3%, respectively.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN MACEDONIA

National Bank of the Republic of Macedonia is a sole banking supervisory body in the Republic of Macedonia. The National Bank is an independent institution in conducting its functions, including the supervisory function. Within the National Bank of the Republic of Macedonia, a special department – Banking Supervision Department, conducts the supervisory function. According to the organizational chart of the National Bank of the Republic of Macedonia, the Supervision Department is directly liable for its operations to the Governor of the National Bank of the Republic of Macedonia.

The competence of the National Bank of the Republic of Macedonia is regulated by the Law on the National Bank of the Republic of Macedonia and the Banking Law, as well as other laws and prudential regulation that govern the operation of the banks. During 2003, this legal prudential framework has undergone several changes, the objective of which was to implement the FSAP recommendations and achieve higher level of compliance of the Macedonian banking supervision with the Basle Core Principles for effective Banking

Supervision, as well as to achieve higher consistence and compatibility with the EU Directives.

The Law on the National Bank of the Republic of Macedonia provides functional, institutional and financial sovereignty and independence of the National Bank of the Republic of Macedonia and provides adequate base for strong performance of its supervisory role. Having in mind that the existing Law provided a legal base for a cooperation only with foreign banking supervisory authorities, the amendments to the Law on the National Bank of the Republic of Macedonia, made during 2003, enabled the National Bank to cooperate and exchange information with other domestic supervisory authorities.

The Banking Law provides detailed rules related to the licensing, structure and governance of banks, efficient problem bank and bank failure resolution mechanism, etc. Based on the FSAP recommendations and the practical experience gained during its enforcement, several amendments were incorporated into this Law to further strengthen the legal foundation for regulation and supervision of banks. The most important amendments of this Law in 2003, were made for the purpose of improving the licensing process of banks and saving houses performed by the National Bank of the Republic of Macedonia, by strengthening the licensing criteria and preventing a capital with “suspicious” origin to enter the Macedonian banking system. Other amendments to the Banking Law pertain to the following: precise definition of banks’ capital, setting standards for consolidated supervision of banking groups, etc.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2003

In 2003, the main activities of the National Bank were focused on the implementation of the FSAP recommendation. Namely, in the period of May-June, 2003, the joint IMF and World Bank mission performed a Financial Sector Assessment Program (FSAP). The main aims of the mission were to evaluate the soundness, efficiency and development of the Macedonian financial system, as well as to identify its main weaknesses. The FSAP included an assessment of the compliance of the Macedonian banking supervision and regulation with the Basle Core Principles for effective Banking Supervision.

The general conclusion of the mission is that, as a result of the permanent improvement of the legal framework and the strengthened capacity of the banking supervision in the recent years, the stability and soundness of the banking system in the recent years, has increased. The Core Principle (CPs) review found that Macedonia is in compliance with those principles related to the regulatory and legal basis of supervision. With regard to the CPs, the assessment was as follows: 6 CPs are compliant; 17 CPs are largely compliant, 3 CPs are materially non-compliant; 1 CP is non-compliant, and 3 CPs are non-applicable.

Based on the findings, the mission has formulated several recommendations, such as: strengthening of the licensing criteria, development of regulation for consolidated supervision, setting standards for managing market risk, strengthening of the corrective measures undertaken by the National Bank, higher involvement of the National Bank in the anti-money laundering process, enhanced transparency of banks' operation through implementation of international standards for financial reporting and improvement of the banking supervision methods through gradual transfer from compliance focused supervision to risk-based supervision. Most of these recommendations were accepted and implemented through the changes of the legal framework and the internal supervisory procedures, made in the second half of 2003. The recommendations that were not implemented in 2003, mainly in the area of inclusion of the market risk in the capital adequacy framework, will be a priority for the National Bank in the upcoming period. From that point of view, the New Basle Capital Accord will be an enormous challenge for the supervision in the Republic of Macedonia, as an emerging country that will have to follow the international financial trends.

THE ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY LAST YEAR

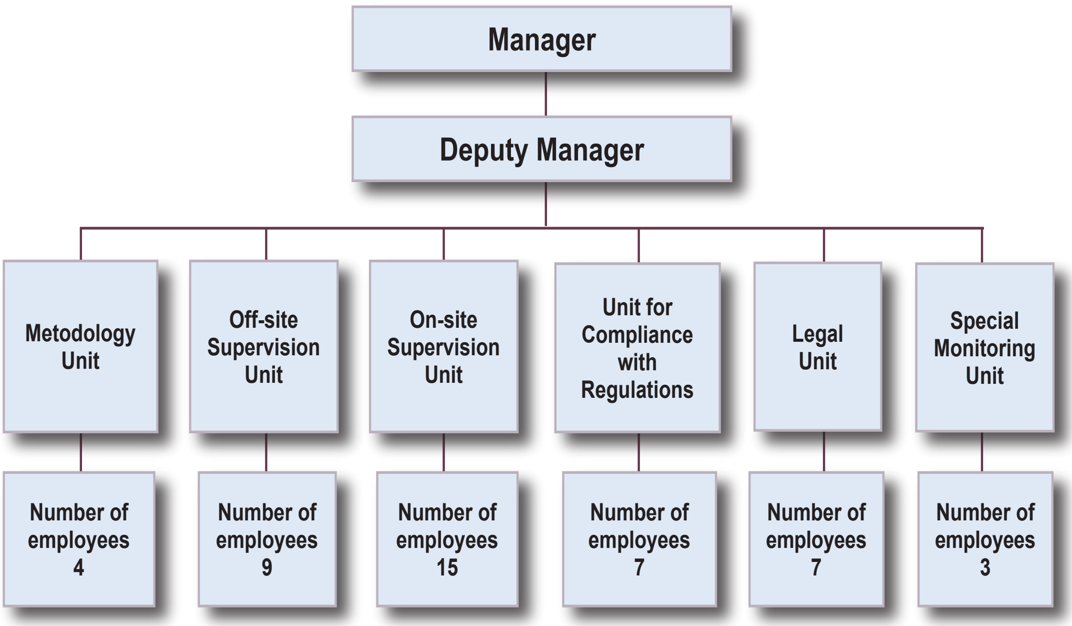
The supervisory function of the National Bank of the Republic of Macedonia, regarding the 3 main activities (licensing, on-site and off-site supervision and undertaking corrective measures) was performed as follows:

- Within the licensing framework, during 2003 the main activities of the National Bank of the Republic of Macedonia were in the area of issuing approvals on various bases, in accordance with the provisions of the Banking Law: issuing approval for founding a microfinance bank, issuing approvals for appointing an executive body of the banks; issuing approvals for changes in the ownership structure of the voting shares; issuing approvals for changes in the Statute of the banks; issuing approval for establishing a representative office of a foreign bank; issuing approval for capital investments of a bank (buying shares in other bank), etc.
- The basis of the supervision lies on the assessment of the risk level of the overall operations of the banks and the savings houses and assessment of the compliance of their operations with the supervisory standards and regulations. In 2003, the full-scope on-site examinations were supplemented with the assessment of the safety of IT systems i.e. IT supervision. In line with this activity the National Bank of the Republic of Macedonia had undertaken the following: questionnaire regarding the level of development and safety of the IT systems was send to the banks and legal framework regarding standards for the security of the IT systems based on the elements of ISO/IEC international standard was enacted. In 2003, the National Bank of the Republic of Macedonia carried out 36 on-site supervisory examinations, 19 of which were full-scope supervisory examinations and 17 were targeted examinations. The full-scope on-site examination was carried out in 12 banks and 7 savings houses. Moreover, 17 targeted examinations were carried out in 10 banks. The full-scope on-site examination is carried out on the basis of the CAMELS rating system;

- Within its legal authorizations, the National Bank of the Republic of Macedonia undertakes corrective actions against banks and savings houses in which violations and irregularities were identified in order to preserve the stability and the safety of the banks and the savings houses and the stability and the safety of the overall banking system. During 2003, the most common corrective measures and actions undertaken against banks and saving houses were the following: ban on performing certain banking operations within a certain period of time; measure for reducing the credit exposure within the prudential limits; ban on lending to clients classified in risk categories C, D and E; further bank capitalization; ban on capital investments; allocation of additional provisions for loan losses; prohibition on dividend payments; permanent oversight over the implementation of the imposed measures. Also the National Bank of the Republic of Macedonia appointed receiver in one bank at the beginning of 2003.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

Supervision Department Organizational Chart



INTERNATIONAL ACTIVITIES OF THE SUPERVISION AUTHORITY

The globalization of the financial system and the privatization of several Macedonian banks by foreign investors imposed the need for regulating the cooperation with the supervisory bodies of the home countries of parent banks. According to the regulation, the National Bank of the Republic of Macedonia may exchange information with foreign supervisory agencies with relation to supervision of internationally active banks. Furthermore, the National Bank may approve an on-site examination of a foreign bank and foreign bank subsidiary in the Republic of Macedonia conducted by supervisory bodies of the home country. In order to assert this right, the National Bank requires from the supervisory bodies of other countries to provide legal and operational capability to ensure confidentiality of the data.

At the same time, all issues regarding the mutual rights and obligations of supervisory agencies are resolved by concluding bilateral agreements (Memorandum of Understanding), which define the principal areas of co-operation, exchange of information and common procedures for supervision of subsidiaries of foreign banks. For that purpose, bilateral agreements have been concluded with the Bank of Slovenia and the Central Bank of the Russian Federation and Bulgarian National Bank and conclusion of such agreement with the Bank of Greece and the Banking Regulation and Supervision Agency of Turkey, is in process. This examination proved to be an excellent example of successful cross-border supervision.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE REPUBLIC OF MACEDONIA

The preparations for introducing consolidated supervision, which will focus on monitoring and controlling the risks in the banking group as a whole, will draw a necessary attention to the systemic co-operation between the domestic regulators and supervision bodies. Currently, in the Republic of Macedonia there are three domestic supervisory agencies: National Bank of the Republic of Macedonia, as an authorized body for banking supervision, Agency for supervision of the insurance companies and Securities and Exchange Commission, as an authorized body for supervision of capital market, brokerage houses and investment funds. The enactment of the Law on compulsory capital-financed pension insurance regulates the establishment of an Agency for supervision of pension funds, which will be the fourth-supervisory agency in the Republic of Macedonia. A significant intensification of the cooperation among these agencies is expected in the near future, and the first steps are already undertaken between the National Bank of the Republic of Macedonia and the Securities and Exchange Commission. The National Bank of the Republic of Macedonia and the Securities and Exchange Commission drafted a Memorandum of Understanding that should be signed during 2004. The undertaken activities should result with the signing of bilateral agreement, which should define more clearly the co-operation, exchange of information and forms of joint activities.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

During 2003 the National Bank of the Republic of Macedonia participated in the Technical Assistance for Banking Sector Reform - an EU-funded project managed by the European Agency for Reconstruction that covers several areas important for improvement of the banking system. The National Bank was included in the following 3 areas of the assistance: implementation of the International Accounting Standards in banking, determination of the level of compliance of the Macedonian banking regulation with the EU Directives, development of improved and sophisticated management information system of the Banking Supervision Department, through the creation of so called Bank File.

The conclusion of this ongoing technical assistance will provide a base for even higher qualitative improvement of the supervision within the National Bank of the Republic of Macedonia.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2001	2002	2003
Banks	21	21	21
Savings houses	17	17	15
Brokerage firms	10	9	8
Deposit insurance funds	1	1	1
Insurance companies	4	6	7
Stock exchange	1	1	1
Money market	1	1	1
Financial institutions, total	**55**	**56**	**54**

Ownership structure of financial institutions on the basis of registered capital (%)
(at year-end)

Item	2001	2002	2003
State ownership	4.90	4.90	4.80
Other domestic ownership	51.60	50.50	46.60
Domestic ownership total	*56.50*	*55.40*	*51.40*
Foreign ownership*	43.50	44.60	48.60
Financial institutions, total	**100.00**	**100.00**	**100.00**

Note: Savings Houses are not included due to their marginal participation in the total registered capital.
Note: Foreign owned banks are considered banks with foreign capital exceeding 50% of their capital structure.

Ownership structure of financial institutions on the basis of assets total (%)
(at year-ends)

Item	2001	2002	2003
State ownership	1.30	2.00	1.80
Other domestic ownership	47.60	54.00	51.30
Domestic ownership total	*48.90*	*56.00*	*53.10*
Foreign ownership	51.10	44.00	46.90
Financial institutions, total	**100.00**	**100.00**	**100.00**

** The table includes data for the ownership structure of the banks. The data for the other financial institutions are N/A*

Concentration of assets by the type of financial institutions (%)

Type of financial institution	The first three largest	The first five largest
Banks	66.90	76.10

Note: Savings Houses are not included due to their marginal participation in the total assets

Return on asset (ROAA) by type of financial institutions (%)

Type of financial institution	2001	2002	2003
Banks	-0.66	0.40	0.45

Return on equity (ROAE) by type of financial institutions (%)

Type of financial institution	2001	2002	2003
Banks	-3.24	2.06	2.28

Distribution of market shares in balance sheet total (%)

Type of financial institution	2001	2002	2003
Banks	99.40	99.03	98.80
Savings houses	0.60	0.97	1.20
Financial institutions, total	**100.00**	**100.00**	**100.00**

The structure of assets and liabilities of the banking system (%)
(at year-end)

Assets	2001	2002	2003
Cash and balance with NBRM	25.10	6.50	5.40
NBRM bills	1.80	2.10	3.80
Debt securities	7.20	0.90	0.90
Placements to other banks	28.00	36.30	35.60
Placements to clients	28.90	34.40	35.40
Accrued interest and other assets	2.40	4.80	5.80
Securities investments	1.20	8.30	7.00
Fixed assets	5.40	6.70	6.10
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2001**	**2002**	**2003**
Deposits of banks	2.30	3.10	2.10
Sight deposits	43.40	39.00	41.00
Short-term deposits up to one year	18.70	19.40	22.70
Short-term borrowings up to one year	4.50	3.10	1.80
Other liabilities	2.80	2.50	2.90
Long-term deposits over one year	4.10	3.70	3.20
Long-term borrowings over one year	5.30	7.90	6.60
Provisions for off-balance sheet liabilities	0.80	0.50	0.50
Owned funds	18.10	20.70	19.10
Total liabilities	**100.00**	**100.00**	**100.00**

Development of the off-balance sheet activities
(off balance sheet items/balance sheet total) (%)

Type of financial institution	2001	2002	2003
Banks	14.62	13.54	11.46
Financial institutions, total	**14.62**	**13.54**	**11.46**

Solvency ratio of financial institutions

Type of financial institution	2001	2002	2003
Banks	34.30	28.10	25.80
Savings houses	N/A	N/A	N/A
Financial institutions, average	**34.30**	**28.10**	**28.10**

Asset portfolio quality of the banking system

in million denars

Asset classification	2001	%	2002	%	2003	%
A	23,303	43.94	67,337	72.24	77,686	74.48
B	11,844	22.33	11,018	11.82	10,871	10.42
C	7,891	14.88	6,269	6.73	4,602	4.41
D	7,740	14.59	6,497	6.97	5,735	5.50
E	2,260	4.26	2,094	2.25	5,413	5.19
Classified total	**53,038**	**100.00**	**93,215**	**100.00**	**104,307**	**100.00**
Provisions	**9,609**		**8,166**		**10,719**	

The structure of deposits and loans (%)
(at year-end)

	Deposits	Loans
Households	56.08	19.50
Public sector	3.06	0.10
Corporate	34.44	73.43
Domestic banks	2.64	3.46
Foreign banks	0.40	2.63
Other	3.38	0.89
Total	**100.00**	**100.00**

The structure of deposits and loans (%)
(at year-end)

Maturity of deposits		Maturity of loans	
At sight	60.17	Long term loans*	60.46
Within one year	34.94	Medium term loans	
Over one year	4.89	Short term loans**	39.54
Total	**100.00**	**Total**	**100.00**

** In the amount of long term loans, the amount of non-performing loans is included*
*** In the amount of short term loans, the amount of past-due loans is included, but still performing loans*

Proportion of foreign exchange assets and liabilities (%)
(at year-end)

Type of the financial institution	FOREX assets/total assets			FOREX liabilities/total liability		
	2001	2002	2003	2001	2002	2003
Banks	63.77	55.43	56.22	53.07	43.90	45.78
Fin. institution, average	**63.77**	**55.43**	**56.22**	**53.07**	**43.90**	**45.78**

Structure of revenues and expenditures of financial institutes (at the year-end)

in million denars

Revenues	2001	2002	2003
Interest income	4,483	5,428	5,161
Other income	4,808	4,945	5,188
Expenditures	**2001**	**2002**	**2003**
Interest expenses	2,625	2,999	2,625
Provisions for potential loan losses	2,542	1,798	2,334
Other expenses	4,638	5,107	4,858
Income tax	107	74	83

Structure of registered capital and own funds of financial institutions in 2003

Type of financial institutions	Registered capital	/ Total assets	Own funds	/ Total liabilities
	EUR (million)*	%	EUR (million)*	%
Banks	301	17.59	328	19.14
Fin. institutions, average	**301**	**17,59**	**328**	**19,14**

** Calculated by the exchange rate of NBRM on December 31, 2003*

2003 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MOLDOVA

MACROECONOMIC ENVIRONMENT

Consumer prices raised over the year by 15.7%, especially due to the 20.0%-increase in foodstuff prices. Prices of services rendered to the public and of non-food articles rose by 12.6% and 11.5%, respectively.

Industrial output prices went up by 9.2% as compared to end of December 2002.

Gross Domestic Product (GDP) amounted to 27296.9 million lei, denoting a 6.3%-increase in real terms.

The industrial output of entities of all property types in 2003 totalled 16151.6 million lei in current prices, increasing by 13.6% in real terms from the previous year. The larger output was mainly determined by the share of processing industry, which raised by 15.1%.

Agricultural output (as in accordance with preliminary estimates for 2003) by all farm categories amounted to 10300.0 million lei in current prices, reducing by 14.1% in real terms as compared to the previous year.

The average monthly wage[19] of an employee in the national economy in 2003 totalled 892.0 lei, increasing by 15.5% in real terms as compared to 2002.

The minimum consumer budget computed for 2003 amounted to 1261.4 million lei, which is by 10.9% more than in 2002 (1137.4 lei). The coverage of the minimum consumer budget with the nominal average wage raised to 70.7% in 2003 from 60.8% in 2002.

The current account of the balance of payments closed with a deficit of US$ 142.09 million (7.3% of GDP). The trade deficit with goods and services amounted to US$ 661.77 million. The growth rate of imports of goods and services (33.8%) exceeded the one of exports (20.9%). Imports were covered by exports by 61.5% in 2003 (68.1% in 2002). Moldovan residents' remittances from abroad increased, as in accordance with estimates, by 52.4%, totalling US$ 317.0 million.

Moldova's total external debt as of December 31, 2003 amounted to US$ 1440.1 million. External public debt amounted to US$ 1008.5 million; private debt – to US$ 431.6 million.

According to estimates, consolidated budget revenues amounted to 6620.5 million lei; consolidated budget expenditures – to 6183.4 million. Consolidated budget excess totalled 437.1 million lei, or 1.6% of GDP.

[19] Entities with 20 employees and more.

Domestic public debt amounted as of December 31, 2003 to 2920.4 million. Out of this amount, loans extended by the National Bank of Moldova totalled 1744.0 million lei and state securities in circulation – 1176.4 million lei (inclusive 400.0 million lei in the NBM portfolio).

BANKING SYSTEM DEVELOPMENT

As of December 31, 2003 there were 16 commercial banks, including 2 branches of foreign banks authorised by the National Bank of Moldova on the territory of the Republic of Moldova.

The total number of banking offices included 719 units, out of which: 16 head offices of banks (placed in the city of Chişinău), 165 branches, 92 representative offices and 446 agencies.

The development of the banking sector of the Republic of Moldova over the reported year denoted positive trends. Total assets of the banking sector raised by 2369.8 million lei (29.9%) and amounted to 10289.9 million lei as of December 31, 2003.[20]

The larger value of assets was mainly due to increases in the balances of banking liabilities (by 2021.3 million lei or 33.1%) and equity capital (by 348.5 million lei or 19.1%).

Components of assets' structure displayed a pronounced upward evolution, except securities, which reduced by 67.1 million lei (8.5%). Net credits increased by 1788.3 million lei (44.7%); cash – by 156.5 million lei (40.0%); money means owed by banks and the NBM – by 358.0 million lei (19.4%); and other assets – by 134.1 million lei (14.9%).

Net credits accounted for the largest share of 56.2% in total assets, raising by 5.7 p.p. from the beginning of the year. Credits have been mainly extended to industry/trade – 45.6% and agriculture/food industry – 28.8% of total credits.

With regard to qualitative parameters of the credit portfolio, observed positive trends were furtheron noted in the reported year. Unfavourable credits (substandard, doubtful and compromised) reduced from 7.6% down to 6.2% of total credits and determined the reduction of the weight of credit loss provisions in total credits by 0.8 p.p. (5.5% as of December 31, 2003).

Liquid assets increased over the year by 450.2 million lei (15.8%). Liquidity ratios displayed high levels and generated the significant reduction of the payment risk in due time of clients' requests. Thus, long-term liquidity (assets with a term over 2 years / financial resources with a term over 2 years ≤ 1) constituted 0.5. The level of this indicator denotes reserves with regard to provision by banks of long-term credits.

Current liquidity (liquid assets (expressed in cash, deposits with the NBM, state securities, net interbank credits with a term up to 1 month) / total assets ≥ 20%) accounted for 32.1% as at year-end.

[20] US$ 1 = 13.2200 lei as of December 31, 2003.

Tier-1 Capital increased by 346.0 million lei (20.4%) and amounted to 2041.0 million lei as of December 31, 2003 mainly due to the larger value of net income gained by banks (by 411.1 million lei).

The average risk weighted capital adequacy (total regulated capital to risk weighted assets) within the banking sector accounted for a high value of 31.8% as at year-end (as against 12% set as minimum level in the Republic of Moldova). However, this indicator displayed over the year a slight downward trend due to the increase in the credit portfolio (which is included, to a large extent, in the 100%-risk category).

The significant share of 60.2% at year-end accounted for by foreign investments in the banking capital of the Republic of Moldova illustrates the attractiveness of the internal banking system for external bankers.

Within banking liabilities deposits hold the largest share of 84.6% or 6866.0 million lei, increasing by 34.2% from the beginning of 2003. Out of total deposits: deposits by individuals accounted for 49.0%; deposits by legal entities – for 48.8%; and deposits by banks – for 2.2%.

Assets profitability (net income to average assets) accounted for 4.5% in 2003. Equity capital profitability (net income to average equity capital) accounted for 20.3%.

LEGAL AND INSTITUTIONAL FRAMEWORK OF BANKING OPERATION AND SUPERVISION, NEW MODIFICATIONS. LEGAL COMPETENCE OF THE BANKING SUPERVISION AUTHORITY

The Republic of Moldova has a 2-tier banking sector: the National Bank of Moldova and 16 authorised commercial banks, which operate based on market mechanisms and principles. The activity of the National Bank of Moldova in the filed of banking regulation and supervision of commercial banks placed in the Republic of Moldova in stipulated in the Law on the National Bank of Moldova and the Law on Financial Institutions.

The Law on the National Bank of Moldova stipulates the competence, main objective and basic attributions of the National Bank and its relationship with financial institutions.

As in accordance with the above-mentioned Law, the National Bank is the sole institution to conduct the authorisation, regulation and supervision of the banking activity. Within this context, the NBM is empowered:

- to issue necessary normative acts and to take actions in order to execute its powers and duties under the Law, through proper licensing of financial institutions and elaboration of banking supervision standards and to establish the procedure of application of mentioned regulations and actions;
- to cause an inspection to be made, at its discretion, by any of its officers or by any other qualified person appointed to that affect, of any financial

institution and to examine its books, documents and accounts, the conditions of its affairs and whether it is in compliance with the Law and regulations;

- to require any officer or employee of the financial institution to furnish to the National Bank such information as requested for the purpose of enabling the National Bank to supervise and regulate financial institutions;
- to cause any financial institution to take remedial actions or to enforce penalties provided in the Law on Financial Institutions if the financial institution or its employees: have violated the provisions of the Law or any normative act of the National Bank; have violated a fiduciary obligation; have been engaged in risky or doubtful operations of a financial institution or any of its branch.

The Law on Financial Institutions is the basic Law that regulates the activity of financial institutions, including banks. Thus, the Law stipulates: main objectives of the Law; bank licensing; organisation and administration of banks; performance of banking operations; reporting by banks; illegal actions; remedy measures and sanctions; licence withdrawal.

Based on provisions of the current legislation (the Law on the National Bank of Moldova, the Law on Financial Institutions), the National Bank established and permanently improves the mechanism of banking supervision and regulation of risks faced by commercial banks in their daily activity.

Thus, following issued regulations, the National Bank of Moldova imposes a series of prudential requirements of mandatory character for banks. These requirements are worked out in accordance with BASEL Committee provisions.

MAIN STRATEGIC OBJECTIVES OF THE BANKING AUTHORITY IN 2003

With the view to maintaining banking system stability and consolidation, the National Bank of Moldova promoted over the year a policy aimed at stimulating banking sector prudential development by means of:

- further development of prudential regulations and banking supervision methods in line with best banking standards and principles;
- promotion of data disclosure with regard to banking sector activity in accordance with best accounting standards;
- improvement of internal control systems of commercial banks with the view to mitigating commercial banks' risks;
- further support of banking capitalisation and consolidation.

ACTIVITY OF THE BANKING SUPERVISION AUTHORITY IN 2003

The banking supervision function exercised by the National Bank of Moldova over 2003 was aimed at ensuring a relevant operation of Moldova's financial sector based on a strong and competitive market-oriented system, as well as preventing system-dependent risks.

Within this context and in accordance with powers and duties stipulated in the Law on the National Bank of Moldova, the National Bank conducts the examination of banks both on-site and off-site.

The target of off-site controls is to monitor and analyse the banks' financial condition in the time-period between on-site controls with the view to preventively identify risks and eventual problems in the bank's activity and to take relevant measures in due time. The off-site monitoring of commercial banks is conducted based on: financial statements submitted by banks on a monthly and/or quarterly basis as in accordance with the NBM requirements, including the balance sheet, the statement on financial results, reports reflecting bank's fulfilment of prudential indicators (especially capital sufficiency, liquidity, assets' quality, credit risks, foreign exchange position, etc.); data following complex controls; and external audit information.

The target of on-site controls is to identify the bank risk level and to evaluate the capacity of bank's administrators to efficiently control and manage this risk. Each bank is subject to such control annually. The on-site control determines the general condition of the bank and the reasons and factors that affect the bank's standing. Liquidity and solvability issues are considered following the evaluation of the bank's management, assets' quality and portfolio performance that determine the bank's need for liquidity and capital. On-site controls contribute to the close cooperation between the supervision authority and bank's management within the framework of discussions on existent problems and further plans.

On-site and off-site supervision is interdependent. Data received during off-site controls is always used to establish aims and targets of banking on-site controls.

The National Bank conducted over the year a series of actions aimed at maintaining the stability of the banking sector, as well as its further development. Under this scope, the NBM revised issued prudential regulations paying due consideration to the current normative framework and the general standards of banking supervision.

The bank's capital is the cornerstone of the banking activity, representing the source of possible loss coverage and confidence establishment. Considering that, the NBM has further put forth effort to consolidate the stability of Moldovan banks by increasing requirements towards minimum capital. The new required capital was raised as to make commercial banks conducting international operations be competitive in the world market and hold a capital in line with requirements applied in the majority of European states. Thus, minimum required capital rose from 32.0 million lei to 50.0 million lei (depending on the held license: A-category – from 32 to 50 million lei; B-category – from 64 to

100 million lei; and C-category – from 96 to 150 million lei). Banks operating in the market as of the date of the new requirement enforcement shall increase their capital gradually over the period of 30.06.2004 to 31.12.2005 from 40.0 million lei up to 50.0 million lei, depending on held license.

Special attention in the context of banking sector efficient functioning was paid to internal control systems within banks. Under this scope, the NBM conducted a series of actions related to the improvement of internal control systems of commercial banks. The National Bank established requirements on responsibilities to be assumed by bank's management and executive body. Thus, the board of the bank shall bear responsibility for the approval and revision, at least once per year, of an adequate internal control system, as well as for the approval of new internal regulations covering all aspects of the bank's activity. The executive board shall be responsible for the implementation of a relevant internal control system approved by the bank's board. With the view to mitigating risks related to common activity of shareholders, the NBM provided the bank's obligation to accumulate and update relevant information on shareholders.

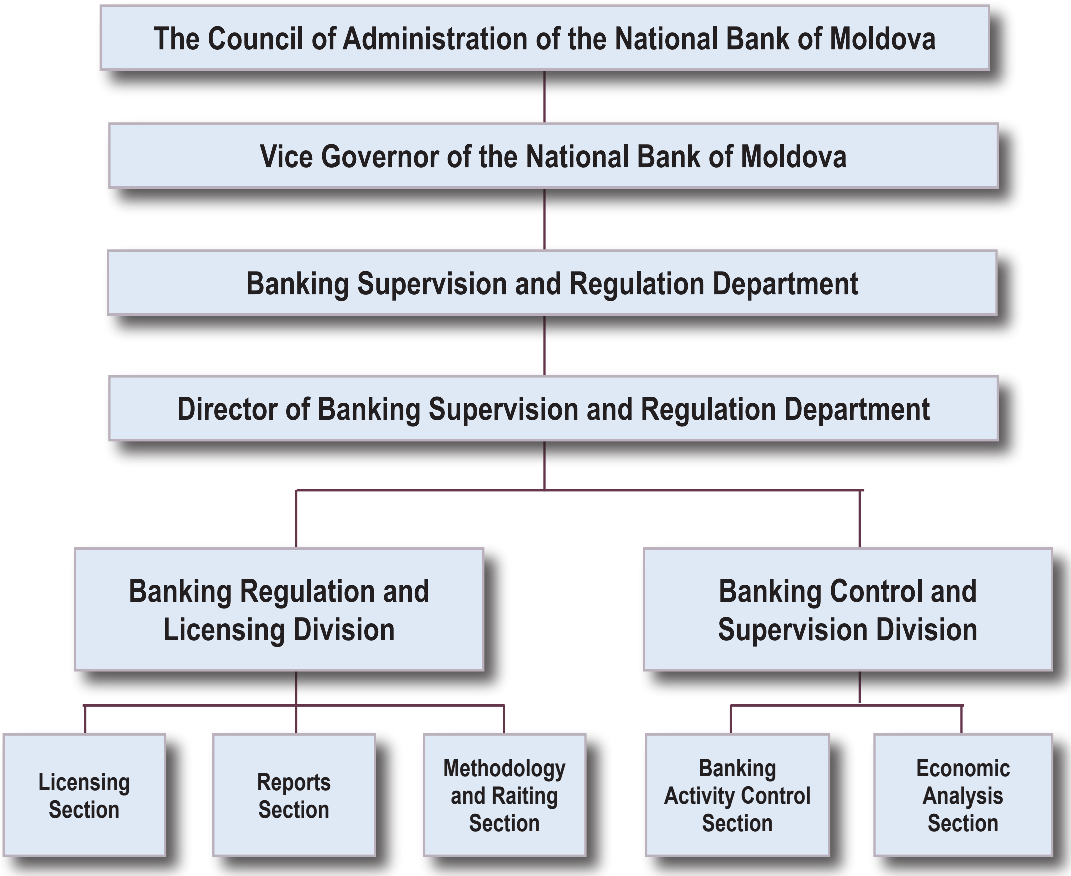
The increased transparency level in the banking sector shall contribute to the consolidation of individuals' and economic agents' capacity to fairly determine banks acting under due prudential condition, thus channeling financial sources towards banks capable to prudently manage their activity. With the view to ensuring banking transparency and to increasing confidence in the banking sector, the National Bank of Moldova has further promoted the consolidation of banking discipline. During on-site controls, the NBM verified at all commercial banks the level of public disclosure of information on bank's activity, as well as of prudential indicators.

Paying due consideration to the importance of adequate evaluation by the National Bank of Moldova of credit risks, the NBM has further revised the relevant prudential regulations. Thus, the normative acts, stipulating limits of exposure to one debtor or to a group of debtors (the relevant exposure covering all debts and transactions, balance and off-balance sheet values), have been subject to modification, being completed with provisions that allow the exclusion of risk implications assumed by bank's creditors from the bank's total debt upon calculation of net credit debt.

The NBM has also modified the Recommendations on Elaboration by Banks of the Republic of Moldova of Programs on Anti Money Laundering with the view to bringing these programs in line with the modifications of the Law on Anti Money Laundering.

Financial statements represent the information source, based on which the situation and condition of commercial banks could be computed and evaluated. Considering that, the National Bank of Moldova improved the above mentioned reports, as to provide further adequate monitoring of commercial banking activity.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISION AUTHORITY



INTERNATIONAL COOPERATION OF THE BANKING SUPERVISION AUTHORITY

With the view to establishing and developing bilateral relations in the filed of banking supervision, the National Bank of Moldova concluded cooperation agreements in the filed of banking supervision with supervision authorities from central banks of Romania, Russia, Belarus and Kazakhstan. All the agreements have been concluded based on provisions of the Basle Committee on banking supervision.

The National Bank of Moldova negotiated also over the year with the Central Bank of Ukraine with the view to concluding a bilateral agreement in the field of banking supervision, which is currently in the final stage.

Following the request of foreign authorities, as well as on its own initiative, the National Bank informed over the year the relevant authorities on the activity of a number of administrators of Moldovan banks and on certain doubtful transactions conducted through one Moldovan bank.

COOPERATION WITH OTHER SUPERVISION AUTHORITIES OF MOLDOVA

According to the current legislation and concluded bilateral agreements, the National Bank of Moldova co-operates with other supervision authorities of Moldova. Thus, the NBM analyses the impact of savings and credit associations upon the general banking system based on the information received quarterly from the State Supervision Service of savings and credit associations of individuals.

With the view to efficiently ensure the activity of the securities market, the National Bank of Moldova and the National Commission of Securities co-ordinate the elaboration of normative acts with regard to the issuance by banks of different types of financial instruments.

At the same time, the National Commission of Securities in common with the National Bank of Moldova established the form, elaboration procedure, submission and publication of specialised statements of professional participants of the securities market.

The National Bank of Moldova collaborates with relevant state establishments with the view to obtaining due information upon confirmation of bank administrators and information on certain shareholders.

To prevent the implication of banks in money laundering operations, the National Bank co-operates with state authorities in the field of anti-money laundering through informing and delivering relevant files to law bodies (General Prosecutor's Office, Centre for Corruption and Economic Crime Fight, etc.)

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2001	2002	2003
Banks including:	19	16	16
Subsidiaries of foreign banks	3	2	2

Ownership structure of financial institutions on the basis of registered capital (%) (at year-ends)

Item	2001	2002	2003
Public sector ownership	3.57	2.18	2.06
Other domestic ownership	35.57	38.03	37.74
Domestic ownership total	*39.14*	*40.21*	*39.8*
Foreign ownership	60.86	59.79	60.20
Financial institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of the financial institutions on the basis of assets total (%)

Item	2001	2002	2003
Public sector ownership	5.58	7.52	8.68
Other domestic ownership	55.35	54.63	54.59
Domestic ownership total	*60.93*	*62.15*	*63.27*
Foreign ownership	39.07	37.85	36.73
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of assets by the type of financial institutions (%)

Type of institution	The first three largest	The first five largest
Commercial Banks	50.78	70.81

Return on assets (ROA) by type of institutions

Type of institution	2001	2002	2003
Commercial Banks	4.27	4.27	4.5

Return on equity (ROE) by type of financial institutions

Type of institution	2001	2002	2003
Commercial Banks	14.26	16.74	20.28

Distribution of market shares in balance sheet total (%)

Type of financial institution	2001	2002	2003
Commercial banks	97.1	95.37	95.11
Subsudiaries of foreign banks	2.9	4.63	4.89
Total banks	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-ends)

Assets	2001	2002	2003
Cash	4.63	4.94	5.32
Due from banks and NBM	22.59	23.29	21.41
Loans and net financial lease	48.63	50.46	56.22
Total securities	9.86	9.94	7.00
Other	14.29	11.37	10.05
Total assets	**100.00**	**100.00**	**100.00**
Liabilities			
Deposits to individuals	28.13	30.25	32.69
Deposits to legal entities	29.52	34.37	34.04
Other	14.86	12.39	12.19
Share capital	27.49	22.99	21.08
Total liabilities and share capital	**100.00**	**100.00**	**100.00**

Development of off-balance sheet activities (%)
(off balance sheet items /balance sheet total)

Type of financial institution	2001	2002	2003
Total banks	8.21	10.47	11.62

Solvency ratio of financial institutions

Type of financial institution	2001	2002	2003
Average of risk-weighted capital sufficiency for the banking system ($\geq$ 12%)	43.11	36.39	31.82

Asset portfolio quality of the banking system (%)

Assets classification	2001	2002	2003
Standard	58.76	57.36	58.44
Under supervision	30.82	34.99	35.37
Substandard	6.16	5.23	4.67
Doubtful	3.84	2.29	1.32
Loss	0.43	0.13	0.2
Total	**100.00**	**100.00**	**100.00**
Specific reserves to total loans	**7.87**	**6.31**	**5.54**

Structure of deposits and loans in 2003 (%)
(at year-ends)

	Deposits		Loans
Individuals	48.99	Industrial / commercial loans	45.62
Legal entities	37.32	Agricultural/food industry loans	28.76
State budgets and local budgets	11.52	Real estate / construction and development loans	6.55
Deposits to banks	2.17	Energy resources and fuel loans	6.49
		Other loans	5.94
		Consumer loans	2.69
		Road construction and transportation loans	1.61
		Loans to banks	1.18
		Government loans	1.16
Total	**100.00**	**Total**	**100.00**

Structure of deposits and loans in 2003 (%)
(for year-ends)

Maturity of deposits		Loans	
At sight	43.1	Short-term loans	45.0
Time deposits	56.9	Medium and long-term loans	55.0
Total	**100.0**	**Total**	**100.0**

Foreign exchange assets and liabilities
(at year-ends)

Type of institution	FOREX assets / Total assets			FOREX liabilities / Total liabilities		
	2001	2002	2003	2001	2002	2003
Banks	39.16	39.62	41.89	45.71	47.14	48.64

Structure of revenues and expenditures of financial institutions (at the year-ends)

Revenues	2001	2002	2003
Total interest income including:	684.10	774.32	982.03
Interest income for loans and financial leasing	551.95	655.91	831.35
Interest income for securities	74.01	44.18	85.42
Interest income for other assets	58.15	44.24	65.26
Total non-interest income	376.23	498.32	593.17
Expenditures			
Total interest expences	254.7	281.86	334.99
Total non-interest expences	376.23	498.32	669.46
Allowances for loan losses	36.30	62.52	97.22
Total net income	222.11	289.63	411.13

Structure of registered capital and own funds of financial institutions in 2003

Type of financial institutions	Registered capital	/Total assets	Own funds	/Total liabilities
	EUR (thousand)	%	EUR (thousand)	%
Commercial banks	48,263.88	7.75	131,269.06	26.71

As of 31.12.2003 1 EURO – 16.5256 lei

Structure of off-balance (%) (at year end)

Conditional assets	/Total assets	Conditional liabilities	/Total liabilities
Acquisitions to current operations	0.34	Sales to current operations	0.76
Acquisitions to time operations	2.82	Sales to time operations	5.57
Acquisition of loans and securities	0	Sale of loans and securities	0.18
Total conditional assets	**3.16**	**Total conditional liabilities**	**6.51**

** Regulation position is not included (accounts “Placements in bank’s central office and subsidiaries”, “Subsidiaries’ “Nostro ” accounts”) and off-balance sheet accounts.*

2003 DEVELOPMENTS IN THE MONTENEGRIN BANKING SYSTEM

CBCG

MACROECONOMIC ENVIRONMENT

Macroeconomic indicators	2002	2003
GDP(EUR million)	1,221	1,375
GDP increase rate (%)	0.84	2.53
Population		672,556(616,258)*
GDP per capita	1,981	2,231
Inflation (%)	9.4	6.7
Balance of payments current account (EUR million)	-154	-114
Forein direct investments (EUR million)	86.9	43.8
Forein assistance (EUR million)	37.2	21.8
Savings (EUR million)**	22	44
Approved loans (EUR million)	125	201
M1 (EUR million)	402	377

** According to the population census from 2003 the number of inhabitants is 672.556, but 616.258 represents the number of inhabitants in the Republic*
*** Excluding the forein assistance received through the nongovernmental and humanitarian organiyations.*

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

During 2003, the following changes occurred in the composition of the Montenegrin banking system:

- Komercijalna Bank AD Budva, an affiliation of Komercijalna Bank AD Beograd, was licensed in the first quarter of 2003;
- Seven branches of Serbian banks that have not applied for setting up an affiliation were closed;
- Liquidation proceedings were initiated against Ekos Bank AD Podgorica at the end of the first quarter of 2003;
- Previously successfully reorganized, Montenegrobank AD Podgorica was privatized by a strategic partner during the second quarter of 2003.
- The banking network was expanded during 2003 for 44 new organizational units.

The total capital of banks in Montenegro grew up compared to the previous year (by about EUR 11 mil.).

At the end of 2003, Montenegrin banks employed 1,237 employees, which is by 268 or 30% more than in the previous year.

The banks expanded their operations, especially in the area of lending. Total assets of Montenegrin banks as of 12/31/03, amount to EUR 349,8 million, of which the three largest banks represent 59% of total assets. Compared to 12/31/02, banks' assets show nominal increase of EUR 9,3 million, or at the growth rate of 2.73%. By excluding frozen foreign exchange savings at the end of 2002, total assets of the banks have nominally increased by EUR 40 million or at growth rate of 12.89%.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The level of activities conducted in the previous two years determined the activities towards further upbuilding of normative and legislative infrastructure of the overall financial system. During the last year seven enabling regulations have been issued, most important of which are the Decision on Supervision on Consolidated Basis and Amended Decision on Chart of Accounts for Banks and Other Financial Organizations. By adopting new subsidiary legislation, normative infrastructure for the comprehensive and efficient supervision has been supplemented. New decisions ensured compliance of subsidiary legislation with amended Law on Banks. The most important quality of the adopted regulations is related to: creating basis for better and more extensive reporting by banks, creating conditions for expanding financial intermediation by regulating the manner of establishment, operation and supervision of credit unions and micro-financial institutions, establishing the chart of account that is more appropriate to the risk analysis in banks' operations and diversification of banking services and providing foundation for bank supervision on consolidated basis.

A significant progress in developing the legal basis for strengthening the banking system was the adoption of the Law on Deposit Protection. The adoption in 2003 and implementation during 2004 is supposed to contribute, to a large extent, to the return of trust of depositors and general public in the banking system. This law provides for the establishment of the Deposit Protection Fund that will be managed by the Central Bank via the Central bank's representatives on its Management Board.

The Law on Servicing Foreign Debt and Frozen Foreign Exchange Deposits, in the preparation of which the Central Bank was actively involved, was adopted with the same goal in mind.

MAIN STRATEGIC OBJECTIVES OF SUPERVISORY AUTHORITY IN 2003

The activity plan of the Bank Supervision Department (hereinafter: the Plan) is focused on the concrete goals defined in the Policy of the Central Bank of Montenegro aimed at increasing the efficiency of the banking industry, strengthening the financial market and regaining public trust in the banking system.

1. Development of norms and standards in the banking operations, in compliance with international standards.
2. Improvement of direct (on–site) and indirect (off-site) banking examination and monitoring of the bank compliance with established standards.
3. Efficient policy of measures against non-complying banks, including interim administration, bankruptcy and liquidation, to protect the creditors and depositors and prevent negative effects on the overall banking industry.
4. Conservative licensing policy for new banks and other financial institutions.
5. Upgrading of the presentation and structure of the bank balance sheets, with special stress on removing from books of the items that re historical heritage of inefficient regulations and banking operations.
6. Initiation of privatization of banks directly or through interim administration.
7. Finalization of started bank bankruptcy and liquidation processes.
8. Intensification of cooperation with other regulators for the purpose of exchanging information and experience, and with international financial institutions and organization aimed at presentation of reforms in the banking industry and cross border supervision.
9. Prevention of work of banks and financial institutions that are not licensed by the CBM .
10. Intensification of training of bank examiners at all levels

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY LAST YEAR

During the last year, 33 on-site examinations were performed. Of that, 11 were regular full-scope and 22 target examinations. Also, efficiency has been raised, which is reflected primarily in shorter duration of examinations, with the same number of examiners.

The full-scope examinations included risk evaluation by CAMELS methodology, examination of information technologies and compliance with other banking laws (Law on Accounting, Law on Prevention of Money Laundering). Special attention was devoted to classification of asset positions by banks, i.e. provisioning.

Change in strategy of commercial banks and diversification of their activities dominantly in retail banking operations provoked additional examination activities. It implies, mostly, the continued monitoring of procedures and practices of consumer loan approval and level of risk provisions related to these loans.

The condition of the overall banking industry was analyzed through macro analytical off-site reports prepared on the basis of statements and reports submitted by banks. Also, individual banks were quarterly analyzed by applying software packages for the review of bank operational indicators.

INTERNATIONAL ACTIVITIES OF YOUR AUTHORITY

In order to strengthen its supervisory function through the establishment and development of international relationships, the Central Bank signed cooperation agreements with the national banks of Serbia and Slovenia regulating the exchange of information obtained through supervision. The objective of the agreements is to facilitate cooperation in the supervision of consolidated basis of banks active in the signing countries and provide conditions for establishing a safe and sound position of banks in these jurisdictions.

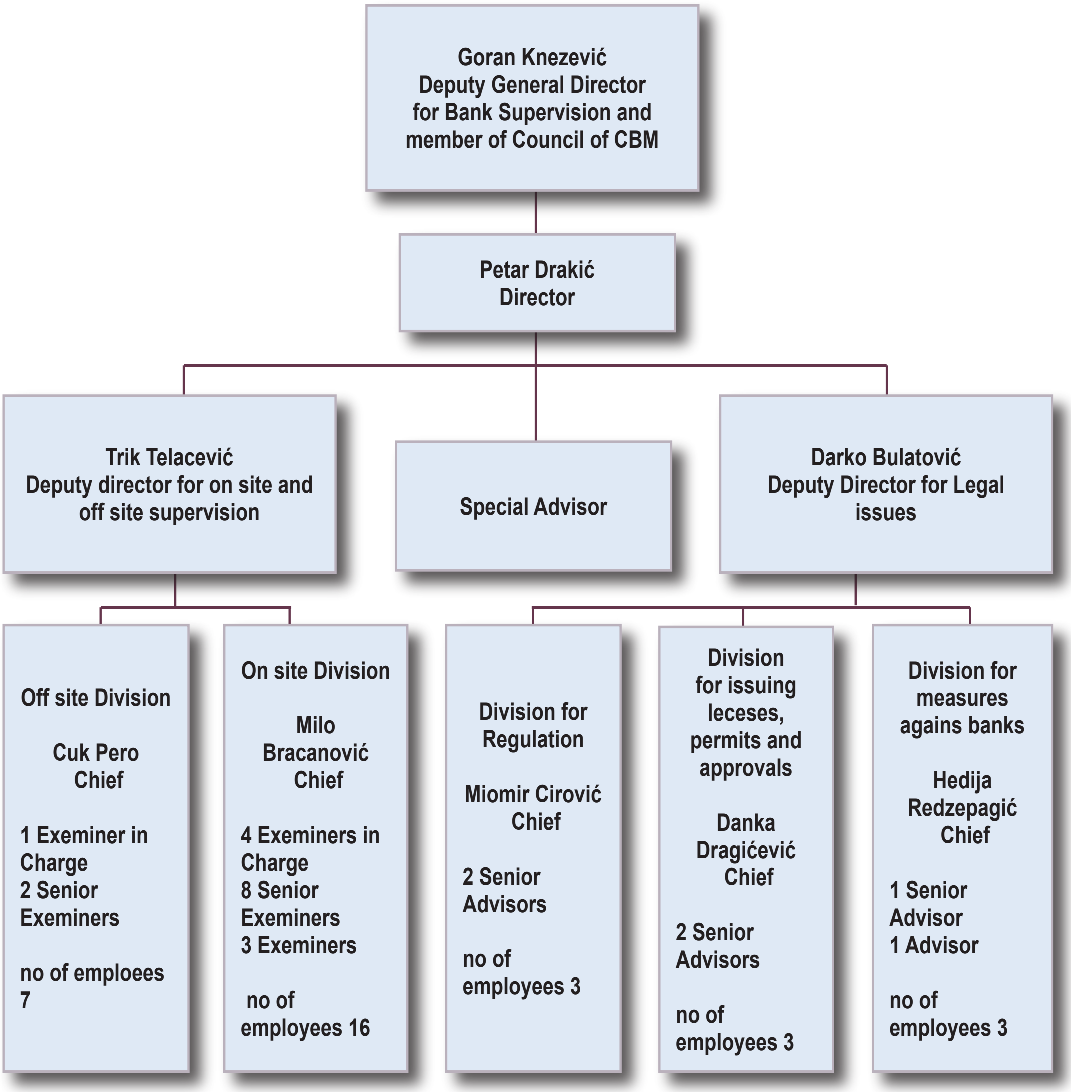
The supervision department has issued guidelines for implementation of these agreements.

Unfortunately, the cooperation agreement with the National Bank of Serbia has not been implemented in practice although the Central Bank of Montenegro invested significant efforts to make it working and meet all the obligations specified in the agreement. On the other side, the cooperation with the Bank of Slovenia is going on in accordance with the signed agreement, with very frequent communication on all matters of mutual benefit.

COOPERATION WITH OTHER SUPERVISORY BODIES

In order to strengthen its supervisory function, the Central Bank maintain relations with other supervisory bodies and Government agencies in our country. The most intensive relation Central Bank has with Agencie for money–loandary preventio, Commision for Securities, Ministry of Finance.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



Total number of emploees: 36

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

In the field of bank supervision, the year was marked by several events and activities of special significance. These include, primarily: privatization of Montenegrobank, assessment of efficiency of banking supervision, liquidation of Ekos Bank, enactment of Deposit Protection Law, removal of historic positions from balance sheets of all banks and actions for prevention of operation of former offshore banks in Montenegro. Any of these offered the grounds for advancement of banking industry in Montenegro.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2001	2002	2003
Banks	10	10	10
Micro-financial institutions			2
Financial institutions, total	**10**	**10**	**12**

Ownership structure of the financial institutions
on the basis of registered capital (%)
(at year-ends)

Item	2001	2002	2003
Public sector ownership	43.0	31.13	24.94
Other domestic ownership	41.0	43.55	38.85
Domestic ownership total	*84.0*	*74.68*	*63.79*
Foreign ownership	16.0	25.32	36.21
Financial institutions, total	**100.0**	**100.00**	**100.00**

Concentration of asset by the type of financial institutions (%)

Type of institutions	The first three largest	The first five largest
Bank	72.47	85.8

Return on asset (ROA) by type of financial institutions

Type of institution	2001	2002	2003
Bank	-0.68	3.97	1.60

Return on equity (ROE) by type of financial institutions

Type of institution	2001	2002	2003
Bank	-4.44	15.69	6.50

The structure of assets and liabilities of the banking system (%) (at year-end)

Assets	2001	2002	2003
Loans and lease operations	33.76	40.30	57.36
Cash funds and deposit accounts with depositary institutions	31.80	45.24	27.45
Business premise and other fixed assets	2.18	7.10	6.91
Securities held to maturity	0.25	1.63	4.58
Other assets	31.69	3.61	2.98
Liabilities	**2001**	**2002**	**2003**
Deposits	40.36	66.34	60.33
Total capital	14.82	25.17	25.50
Borrowings taken from other banks	0.41	1.59	5.50
Liabilities on taken borrowings and loans	14.76	2.99	4.97
Other obligations	29.26	3.02	2.22

Development of off-balance sheet activities (%) (Off balance sheet items / balance sheet total)

Type of financial institution	2001	2002	2003
Banks	12.15	13.71	12.98

Solvency ratio of financial institutions

Type of the financial institution	2001	2002	2003
Banks	39	42	39

Asset portfolio quality of the banking system

Asset classification	2001	2002	2003
A	130,615	120,154	148,412
B	17,462	9,336	27,448
C	5,344	4,867	8,541
D	2,595	13,995	5,503
E	3,228	39	16
Classified total	**159,244**	**148,391**	**189,920**
Specific reserves		**19,283**	**34,043**

Loans, lease receivables and matured receivables

	Description	Short Term < 1 year			Long Term > 1 year			Matured receivables and paid-called for payment OBL			Total		
		2001	2002	2003	2001	2002	2003	2001	2002	2003	2001	2002	2003
1	Loans and receivables from GoM	9,791	16,302	16,257	3,741	181	239	517	0	0	14,049	16,483	16,496
2	Government agencies and org.	1,691	2,008	3,042	0	0	1,597	0	0	0	1,691	2,008	4,639
3	Municipalities	0	2,595	2,451	0	174	144	0	130	0	0	2,899	2,595
4	State owned companies	2,156	9,234	9,596	7,088	1,952	2,465	0	77	253	9,244	11,263	12,314
5	Privately owned companies	37,373	51,768	75,855	11,528	12,741	26,040	15	1,328	2,715	48,916	65,837	104,610
6	Entrepreneurs	0	937	6,228	0	890	1,745	0	44	125	0	1,871	8,098
7	Banks	0	688	1,570	0	0	0	0	0	0	0	688	1,570
8	Financial institutions	57	570	130	0	0	0	0	0	0	57	570	130
9	Non-profit organizations	0	37	70	0	0	5	0	0	0	0	37	75
10	Individuals	4,793	12,725	32,292	1,500	9,303	16,939	24	166	637	6,317	22,194	49,868
11	Credit cards	0	0	0	0	0	0	0	0	0	0	0	0
12	Other	2,225	204	78	1,725	791	153	0	27	0	3,950	1,022	231
Total		**58,086**	**97,068**	**147,569**	**25,582**	**26,032**	**49,327**	**556**	**1,772**	**3,730**	**84,224**	**124,872**	**200,626**

Deposits' structure by depositors

Depositors	2001	%	2002	%	2003	%
Government of RoM	23,263	15.70	50,442	24.54	22,732	10.77
Government institutions	0	0.00	18,161	8.84	16,541	7.84
Municipalities	0	0.00	6,546	3.18	9,127	4.33
Majority state owned companies	12,186	8.22	20,983	10.21	6,374	3.02
Privately owned companies	80,776	54.51	63,536	30.91	84,897	40.23
Entrepreneurs	0	0.00	380	0.18	1,241	0.59
Banks	9,633	6.50	9,212	4.48	3,408	1.62
Financial Institutions	2,242	1.51	1,907	0.93	2,658	1.26
Non-profit organization	2,111	1.42	9,521	4.63	4,794	2.27
Individuals	8,022	5.41	16,682	8.12	44,554	21.12
Other	9,952	6.72	8,166	3.97	14,678	6.96
Total	**148,185**	**100.00**	**205,536**	**100.00**	**211,004**	**100.00**

The structure of deposits and loans in 2003 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	56.0	Long term loans	-
Within one year	42.0	Medium-term loans	24.59
Over one year	2.0	Short-term loans	74.41
Total	**100.0**	**Total**	**100.0**

Structure of revenues and expenditures of financial institutions
(at year-ends)

Revenues	2001	2002	2003
Interest income	11,599	16,216	25,694
Fee income	7,826	12,551	18,413
Other operating income	3,247	2,324	2,413
Extraordinary income	3,385	36,023	1,396
Expenditures	**2001**	**2002**	**2003**
Interest expenses	4,341	3,893	6,199
Fee expenses	1,804	2,750	3,155
Operating expenses	11,823	17,141	25,492
Extraordinary expenses	556	14,412	727

MACROECONOMIC ENVIRONMENT IN 2003

The conditions and performance of the banking sector is directly influenced by the economic environment in which banks operate. According to the estimates of the Central Office of Statistics, the **GDP** grew by 3.7% in 2003. The growth was markedly faster than during the previous year (1.4%).

The accelerated growth was caused both by an increase in domestic demand (year-on-year rise by 2.3%) and good **export** results. In 2003, both export receipts (208.9 bn zloty at current prices) and import payments (265.1 bn zloty)[21] were higher (by 24.9% and 17.9%, respectively) than in the previous year and the trade deficit amounted to 56.2 bn zloty and was lower than in 2002 (57.5 bn zloty).

Industrial output[22] was up by 8.7% year-on-year, compared to an increase by 1.5% in the previous year. The increase (by 12.1%) of industrial production in the fourth quarter was much larger than in previous quarters. Labour efficiency (as measured by output per employee) rose by some 12%, while the average employment shrank (down by 2.9%).

Total consumption grew by 2.5% year-on-year, of which individual consumption grew by 3.1% (against 2.8% and 3.3% in 2002, respectively).

The average employment in the corporate sector (4,724 thousand) was by 3.8% lower than in the previous year. In 2003 registered unemployment declined, while during the previous 3 years year-on-year growth had been registered in this respect. At the end of December 2003, the registered jobless total came up to 3,175 thousand and the unemployment rate stood at 18%, just as in 2002 (20% after adjustment, i.e. taking the results of the 2002 national census into account).

The increase in **consumer prices** in 2003 was higher than in the previous year (1.7% compared to 0.8%) but the average annual inflation rate was lower than in 2002 (0.8% against 1.9%).

After six cuts in NBP **interest rates** in the first half of 2003, the Monetary Policy Council (MPC) did not change monetary policy parameters during the second half, which was the result of a visible economic recovery. At the end of the year, NBP interest rates were as follows: the reference rate stood at 5.25% (6.75% in 2002), the rediscount rate at 5.75% (7.50%), the lombard rate at 6.75% (8.75%) and the deposit rate at 3.75% (4.75%).

[21] In dollar terms, exports totalled $53.6 billion and imports came up to $68.0 billion.

[22] This refers to companies employing a staff of over nine.

The banks reacted to a slip in central bank rates by lowering interest rates on loans and deposits. At the end of 2003 weighted average rates on overall PLN deposits (from both households and corporates) were by 1.3 percentage points lower than in December 2002 (and amounted to 2.9%) and PLN lending rates sank 2.0 points to 9.6%.

THE POLISH BANKING SECTOR IN 2003

The banking sector remains the largest segment of the Polish financial market despite the dynamic growth of non-bank financial institutions (insurance companies as well as investment and pension funds) since the middle of the 1990s. At the end of 2003 the share of banks in the assets of the Polish financial system amounted to almost 78% (against 94.5% in 1996).

In 2003, the **number of commercial banks** decreased to 60 (from 62 at the end of 2002) and the number of banks **conducting operating activity fell to 58** (from 59).

Foreign investors controlled 46 commercial banks (one more than at the end of 2002). Their capital and assets accounted for 76.7% of total banking sector capital (as against 77.8% at year end 2002) and 67.8% of the sector's total assets (as against 67.4% at year end 2002).

The Treasury controlled **6 banks**, exercising direct control in 3 cases. These banks held 24.4% of assets, had extended 21.7% of all loans (less provisions) to the non-financial sector, had taken 29.5% of those customers' deposits, and held 15.7% of total core and supplementary capital (at year end 2002, the respective figures had been 25.1%, 21.5%, 30.5% and 15.3%).

The number of **private banks with majority Polish equity** dropped by one to **6**. These banks held 2.5% of assets.

The number of co-operative banks dropped from 605 at year-end 2002 to **600.** Their share in the total assets of the banking sector rose by 0.3 points to 5.3%.

Compared to the end of 2002, the number of **domestic offices of commercial banks** fell by **802**. Co-operative banks opened another 105 offices in the period under review. Most large banks and an increasing number of smaller ones, including cooperative banks, now offer their customers Internet-based services. BRE Bank SA, PKO Bank Polski SA and Volkswagen Bank Polska SA run their own virtual banks (these trade as, respectively, mBank, Inteligo, and Volkswagen Bank Direct).

The year 2003 has been the fourth in succession to witness a decline in staffing within the Polish banking sector. At the end of 2003, the number of persons in the commercial banks had dropped by 7,782 year-on-year. This reduction in employment can largely be traced to consolidations, the introduction of modern integrated IT systems, the expansion of electronic banking, and the banks' pursuit of cost-cutting. On the other hand, personnel numbers at cooperative banks have grown during the last two years (by 416 in 2002 and by 342 in 2003).

2003 was a better year for the banking sector than 2002. The economic and financial standing of banks improved and the assets of the sector grew by 4.8%.

The growth in assets was financed by **deposits from the non-financial sector**, which — for the first time since 2001 — expanded (by 8.8 billion zloty, i.e. 3.4%).

A **downward trend in household deposits** persisted (a drop of 4.7 billion zloty, i.e. by 2.3%), which was caused by falling deposits from persons (95% of household deposits). This was a result of several factors: a decrease in the savings rate as well as the growing interest in investment funds (by 48.3%) and insurance policies (by 21.3%).

In the coming years, the share of deposits in household savings will probably continue to shrink as alternative financial market instruments develop. In most EU countries the proportion of deposits in financing the banks' operations (from 25% to 50%) is much lower than in Poland.

The quality of loan claims on the non-financial sector improved. The slowdown in **irregular claims** growth and the accelerated rise in gross claims caused the **irregular loan ratio** at the end of the year (21.8%) to fall below the last year's level (by 0.2 percentage points) for the first time since 1997. These data are, however, subject to change as a result of audits.

The **gross earnings** increased by 27.5% (by 19.3% following adjustments due to the share in the earnings of subsidiaries included in the balance of provisions and adjustments last year) to 4.2 bn zloty, whist net earnings grew by 12.5% (up to 2.2 bn zloty).

The interest margin decreased (by 0.3 percentage points), since the reduction of the average ROA (by 2.3 percentage points) was greater than the decrease in the average cost of liabilities with interest (by 2.2 percentage points).

The **yield of interest assets** was adversely affected mainly by reductions in interest rates (for PLN loans — by 2 percentage points on average), and by the increased share of relatively cheap housing loans in assets (by 1.9 percentage points).

The balance of interest from operations with non-financial entities increased (by 2 billion zloty, i.e. by 36.0%) mainly due to the increased (by 2.1 percentage points to 75%) ratio of loans to liabilities towards the non-financial sector (due to deposits and issuance of bonds).

The decreasing share of deposits from the non-financial sector in financing the banks' operations and a low level of interest rate on a`vista funds (that dominate) means that the possibility to maintain the interest margin in the case of any further decrease in interest rates is limited.

The main cause of decreased **FX earnings** was the decreased turnover on the FX swap market. Changed conditions on the money and foreign currency markets adversely affected the financial situation of 9 out of top 10 banks. Earnings decreased due to the same reason also in the group of subsidiaries of foreign banks, whose activities focused on those operations.

The negative influence of the market conditions on the banks' earnings was partially offset by a fast growth of **commission earnings** (by 15.1% as compared to 6.9% in the previous year). Their share in the earnings from banking activity increased by 5.6 percentage points (to 28.1%), which is positive considering the stability of banks' earnings.

The banks' earnings also improved thanks to the reduction of **operating costs** (by 275 m zloty, i.e. by 1.9%), which was mainly due to lower costs of maintenance and rental of facilities (by 136.5 m zloty) and other material costs (by 144.5 m zloty).

A halt of growth in the operating costs did not prevent **cost effectiveness** from deterioration, which was indicated by an increase (by 5.1 percentage points) of the Cost/Income (C/I) ratio.

Following the increase in earnings, **ROE** increased by 0.7 percentage points and **ROA** remained on the same level.

THE NEW DEVELOPMENTS IN THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTION IN POLAND IN 2003

In the year, 2003 there were changes in two main acts that regulate Polish banking sector. The most important amendments in the Banking Act refer to:

a) Determination of the competence of the institutions, established by banks together with bank economic chambers for gathering, proceed and transfer information on matters concerning the bank operations. Banks may disclose data to such offices on the obligations arising under contracts related to bank operations, if such contracts include provisions on the possibility to transfer data to those offices.

b) The new competence of the Commission of the Banking Supervision that may, upon a motion from a State bank exclude a part of this bank activity or its entire activity related to the servicing of the funds established, entrusted with or transferred to that bank under separate Acts, from the duty to meet certain requirements and standards referred to in the Act, provided that this activity is financially separated, and in particular, the bank does not participate in financing this activity; the risk related to this activity does not burden the bank in any way and, in particular, the bank is not liable for the losses resulting from this activity.

c) The regulation, which indicates that banks are obliged to execute transfer orders referring to the tax dues apply to within 5 working days from the day when the bank account of the holder was debited. In case of failure to observe the time limit banks should pay the State Treasury or territorial self-government units the interest in the amount determined for default interest accrued on tax arrears.

In the Act on National Bank of Poland, other important amendments were made:

a) The scope of activities of the Commission of Banking Supervision was extended by the obligation to cooperation with the Head of the National Bureau of the Criminal Information. This authority was created mainly to gather, proceed and transfer of the criminal information.

b) Banks decrease the reserve ratio by the equivalent of 500.000 euro calculated in zlotys, according to the exchange rate announced by the National Bank of Poland.

Very important amendment in the Polish law relating to the Commission for Banking Supervision came into force with the Bankruptcy and Rehabilitation Act of 28 February 2003. This act includes a separate title, which refers to the bankruptcy proceedings in respect of banks. First section of this title regulates the general provisions of the legal action that concerns all types of banks, the second section rules bankruptcy proceedings in respect of mortgage banks and the third one rules the bankruptcy proceedings in respect of foreign banks, credit institutions and their branches. Before this act came into force, the fragmented regulation of bankruptcy proceeding was included in the Banking Act. Since then, the provisions concerning this matter are all placed in one place. This act includes also determines the role of the Commission of Banking Supervision, which is the only competent authority that can initiate the legal action in the bankruptcy proceeding concerning banks, mortgage banks, foreign banks, credit institutions and their branches.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2003

In 2003, the works of the Commission were performed in the face of progressing changes of the Polish banking sector. Consolidation processes, growing competition and worsened situation of borrowers, along with such internal factors as weak management and insufficient capital, made the activities and decisions undertaken by the Commission focus also on the restructuring processes. Credible investors were gained for some banks in a critical situation, which enlarged their capital, commenced recovery actions, or entailed takeovers by other banks. Complex operations were carried out to avert the decreasing confidence in the banking sector.

Harmonisation of prudential regulation with EU Directives was one of the crucial targets of the Polish banking supervision. In the year 2003 the full implementation of EU requirements in the area of own funds, capital adequacy (credit and market risk) and large exposures was achieved. Development of the assets classification and provisioning systems in order of compliance with standards used by EU countries was also primary task of the Commission.

THE ACTIVITIES OF THE COMMISSION FOR BANKING SUPERVISION IN 2003

The activities of the banking supervisory authority were undertaken in five basic areas:

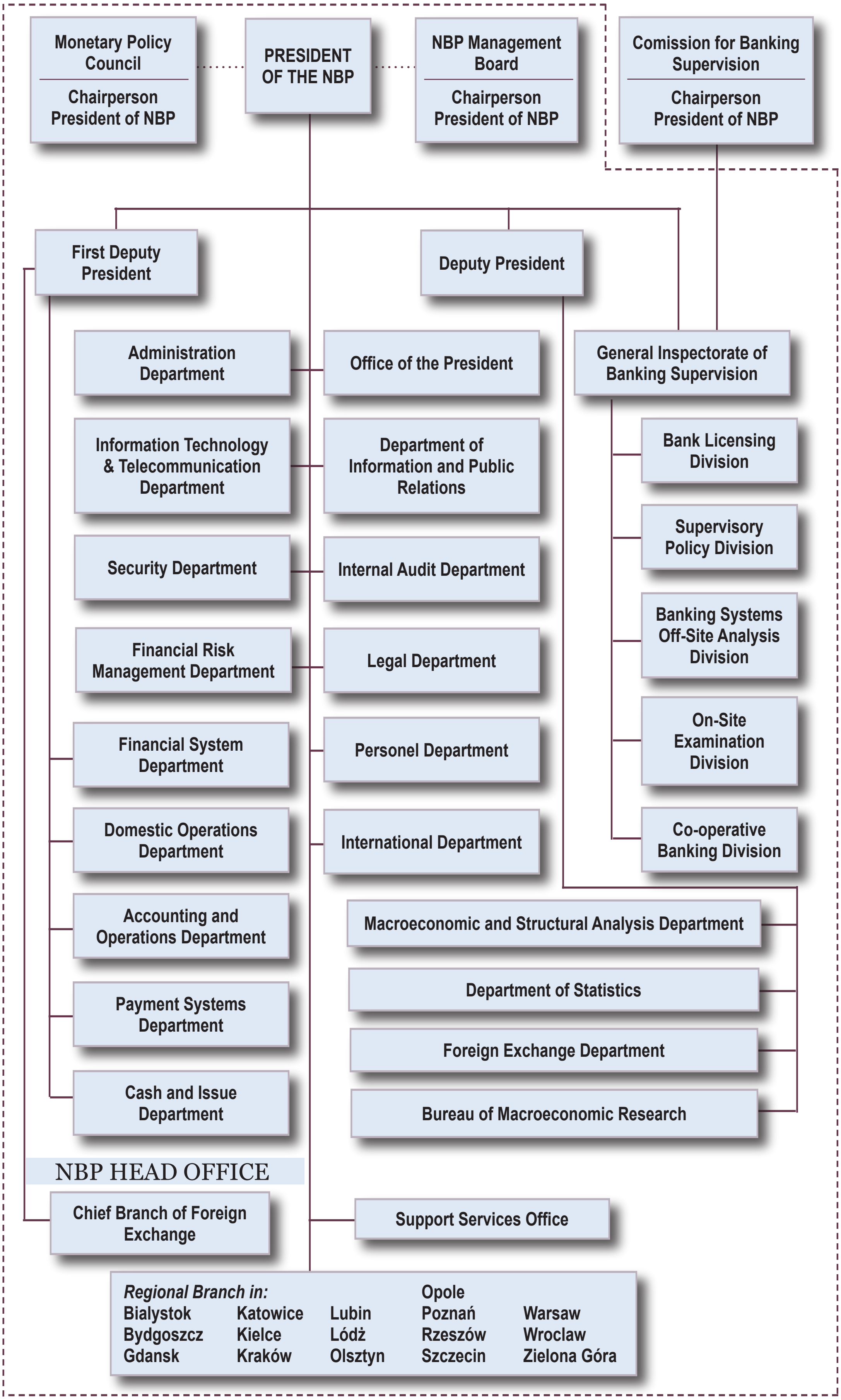
- licensing responsibilities,
- analytical responsibilities,
- on-site examination responsibilities,
- regulatory and legislative responsibilities,
- international contacts and training.

Very important for the whole banking sector were the legislative activities on the subsequent amendment of the Banking act. This amendment includes new rules for the supervision of branches of credit institutions from the Member States operating in Poland. Apart from these matter, the amendment to the Banking Act includes:

- regulations for new areas of banking operations, related to:
  - principles governing the outsourcing of banking activities,
  - securitization of banks' receivables, in particular in relation to the reduction of bank's risk in the securitization process,
- changes that contribute more detailed definitions to regulations already in force:
  - prudential regulations related to receivables concentration, equity account and capital adequacy standards,
  - principles governing the transfer of information falling under banking secrecy clauses,
  - consolidated supervision over banks,
  - control of shares flow in banks organized as joint-stock companies,
  - recovery and liquidation procedures for banks,
- provision of conditions necessary for supervisory activities in the Internal Market, and development of foundation for more effective cooperation between the banking supervision and supervisors in other countries.

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

NBP



INTERNATIONAL ACTIVITIES OF THE COMMISSION FOR BANKING SUPERVISION IN 2003

Poland's accession to the European Union on May 1, 2004 imposes specific requirements on the banking supervision. These responsibilities include establishing continued, working expert relationships between the General Inspectorate of Banking Supervision and the EU supervisory bodies and institutions. In this respect, starting from 2003, representatives of the Polish banking supervision have been invited to participate as observers (without voting capacity) in the activities of the following bodies:

1. **the EU Banking Advisory Committee** (BAC). The Committee plays a key role in developing European Union's banking directives. Polish supervision representatives participate in the work of four working groups of the Committee:

- **the EU Banking Advisory Committee Mixed Technical Group (MTG) for Prudential Supervision over Financial Conglomerates**. The group develops prudential regulations for financial conglomerates.
- the **EU Banking Advisory Committee Technical SubGroup (TSG) for Capital Adequacy Regulations** which develops a draft for European Union's directive on banking capital adequacy — CAD 3,
- **the EU Banking Advisory Committee Group for Interpretation and Application of the Banking Directives (GTIAD)** which currently works on introducing Directive 2000/46 on the use of electronic money.
- **the EU Banking Advisory Committee Sub-committee on Accounting and Auditing** which deals with the impact of the International Accounting Standards on banking sectors in the Member States.

2. **The European Central Bank's Banking Supervisory Committee (BSC)**. The Committee deals with issues of financial stability and supervision in countries participating in the European System of Central Banks (ESCB). Polish supervisors participate in the works of two standing working groups included in the Supervisory Committee:

- **the ECB Banking Supervisory Committee Working Group on Macro-Prudential Analysis (WGMA)**. The group focuses on macro-prudential analysis of the stability of ESCB countries' banking sectors, taking into account economic factors and the situation on financial markets.
- **the ECB Banking Supervisory Committee Working Group on Developments in Banking (WGDB)**. The objective of the group is to study the levels of banking sector development in the EU Member States and accessing countries.

3. Groupe de Contact (GdC) — the working group consisting of banking supervisors from the EU Member States. The group deals with the exchange of confidential information on individual institutions (at the moment, Poland does not participate in this part of the Group's meetings), information on supervisory practice, and on phenomena occurring in banking systems that are important for supervisors. The group also organizes ad hoc working teams that deal with issues related to supervisory practices and regulations. The teams provide opinions and develop reports.

As Polish supervisors participated in the works of the above-mentioned bodies in 2003 and have established direct working relationships with the EU institutions at multiple levels, they will be able to seamlessly engage in full cooperation after our country accesses the European Union in 2004.

As a part of cooperation with the Chinese supervisor, the representatives of the **China Banking Regulatory Commission** visited Poland on October 27-29. The representatives were led by Mr Tang Shuangning, Vice-President of CBRC. During the visit, the Chinese representatives learned about the achievement of the Polish supervision authorities in ensuring the stability of the banking sector, and about supervision methods in Poland.

In October 2003, **Mr Jaime Caruana**, Chairman of the Basel Committee on Banking Supervision, presented Professor Leszek Balcerowicz, Chairman of the Commission for Banking Supervision, with an official invitation for a representative of the Polish supervision to participate in the **Core Principle Liaison Group**. The Chairman of the Commission for Banking Supervision entrusted **Mr Wojciech Kwaśniak**, General Inspector of Banking Supervision, with the task of representing the Polish supervision in the works of the Group.

COOPERATION WITH OTHER SUPERVISORY BODIES IN YOUR COUNTRY

In the year 2003 Polish Commission for Banking Supervision concluded two domestic Memoranda of Understanding in order to perform consolidated supervision on financial market:

- with Commission for Securities and Stock Exchange on February the 4th, and
- with Commission for Insurance and Pension Funds on June the 10th.

Both of them are to facilitate information exchange between parties to those Memoranda and to perform joint on – site inspections in the premises of supervised entities as it is allowed by appropriate acts of law.

TRAINING INITIATIVE FOR BANKING SUPERVISION ACTIVITIES IN 2003

In 2003 the Polish banking supervision continued the technical and educational support program for supervisors from Central and Eastern Europe. Ever since its inception, the NBP Training Initiative for Banking Supervision (TIBS) was aimed at fostering best supervisory practices in countries within our region, sharing experiences on bank restructuring, developing and enforcing prudential regulations and methods for supervising banks. As a part of TIBS, the General Inspectorate of Banking Supervision held two international seminars in 2003:

- "Market Risk Regulation and Supervision" - June 2-6, 2003
- "Best Practices in Bank Regulation and Examination: Regional Experiences and Challenges" - November 17-21, 2003. The seminar was translated into Russian.

In total, 59 supervisors from 22 countries attended TIBS seminars in 2003. Participants represented both the regional group of supervisors from the Central and Eastern European countries, and the countries of the former USSR. The Countries that have taken TIBS training so far include: Armenia, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Serbia and Montenegro, Slovakia, Slovenia, Ukraine.

Additionally, at the request of the renowned **Toronto Centre - International Leadership Centre for Financial Sector Supervision**, an additional seminar was held on March 24-28, 2003 in Kraków for top-level executives from our region's supervisory institutions. The training was attended by representatives from 13 countries: Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Germany, Hungary, Kazakhstan, Latvia, Macedonia, Poland, Slovakia, Tajikistan.

All TIBS seminars enjoyed appreciation and renown both from central banks and supervisory isntitutions that participated in the program, and from international financial institutions that watched TIBS activities. Due to its cooperation with partners from G-10 countries, such as the Toronto Centre, with some banking supervisory authorities, and with the Professional Risk Managers International Association (PRMIA), Western supervisory authorities begin to perceive TIBS as a reliable partner that provides the highest quality training and acts pro publico bono in the region.

Three more NBP TIBS seminars are planned for 2004, including a special outgoing session for the National Bank of Ukraine, held in Lvov, and one additional training organized in cooperation with the **Financial Stability Institute** of Basel.

In addition to its organized training facilities, the General Inspectorate of Banking Supervision also hosted a number of study visits requested by central banks from other countries. In 2003, this facility was used by the National Bank of Kyrgyzstan, the National Bank of Azerbaijan, the National Bank of Ukraine (twice), and the National Bank of Vietnam.

STATISTICAL TABLES

NBP

Number of financial institutions (at year-ends)

Type of financial institution	2001	2002	2003
Commercial banks	69	59	58
Cooperative banks	642	605	600
Banking sector	**711**	**664**	**658**

Ownership structure of the financial institutions the basis of registered capital (%) (at year-ends)

Item	2001	2002	2003
Public sector ownership	15.3	17.3	16.9
Other domestic ownership	10.3	9.5	9.6
Domestic ownership total	*25.6*	*26.8*	*26.5*
Foreign ownership	61.3	63.2	63.3
Dispersed holdings	11.1	13.1	10.2
Total commercial banks	**100.0**	**100.0**	**100.0**

Ownership structure of the financial institutions on the basis of assets total

Item	2001	2002	2003
Public sector ownership	24.4	26.4	25.8
Other domestic ownership	3.1	2.7	2.7
Domestic ownership total	*27.5*	*29.1*	*28.5*
Foreign ownership	72.5	70.9	71.5
Total commercial banks	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions (%)

Type of institutions	The first three largest	The first five largest
Commercial banks	39.7	52.3

Return on asset (ROA) by type of financial institutions

Type of institution	2001	2002	2003
Commercial banks	1.0	0.5	0.5
Co-operative banks	1.6	1.6	1.2
Banking sector	1.0	0.5	0.5

NBP

Return on equity (ROE) by type of financial institutions

Type of institution	2001	2002	2003
Commercial banks	12.8	5.2	5.9
Co-operative banks	19.4	18.2	12.2
Banking sector	**12.1**	**5.8**	**6.3**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2001	2002	2003
Commercial banks	95.5	95.7	94.8
Co-operative banks	4.5	4.3	5.2
Banking sector	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%) (at year-end)

Assets	2001	2002	2003
Cash and balance with Central bank	6.2	4.6	3.9
Interbank deposits	19.5	16.7	15.7
Due from non-financial and government entities	44.5	46.2	44.4
Secuirties	20.4	22.6	23.2
Other assets	9.4	9.9	12.8
Liabilities	**2001**	**2002**	**2003**
Borrowing from Central Bank	0.9	0.6	0.5
Interbank deposits	14.1	13.4	14.9
Deposits from non-financial and government entities	66.0	61.1	64.6
Bonds	0.6	0.8	1.1
Other liabilities	9.2	14.0	8.8
Capital and reserves	9.2	10.1	10.1

Development of off-balance sheet activities (%) (off balance sheet items / balance sheet total)

Type of financial institution	2001	2002	2003
Commercial banks	244.6	266.7	361.4
Co-operative banks	0.4	0.4	0.7
Banking sector	244.9	267.1	362.0

NBP

Solvency ratio of financial institutions

Type of the financial institution	2001	2002	2003
Commercial banks	15.1	13.8	13.6
Co-operative banks	13.9	13.4	14.2
Banking sector	**15.0**	**13.8**	**13.7**

Asset portfolio quality of the banking system

Asset classification*	2001	2002	2003
Consumer loans classified satisfactory	17.3	16.8	16.1
Special mention claims	6.2	6.8	6.2
Irregular claims. of which:			
- substandard	4.6	4.8	4.4
- doubtful	5.1	5.6	5.6
- loss	8.2	10.7	11.0
Classified total	**17.9**	**21.1**	**21.0**
Specific reserves	**15,914.9**	**18,341.4**	**20,001.3**

**: From non-financial institutions*

The structure of deposits and loans in 2003 (%)
(at year-end)

	Deposits	Loans
Households	68.7	40.8
Government sector	6.2	8.2
Corporate	22.2	50.7
Foreign*	1.4	0.9
Other	2.9	0.3
Total	**100.0**	**100.0**

**: Deposits and loans are included in others items*

The structure of deposits and loans in 2003 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	33.9	Long term loans	59.2
Within one year	57.6	Medium-term loans	27.8
Over one year	8.5	Short-term loans	13.0
Total	**100.0**	**Total**	**100.0**

NBP

Proportion of foreign exchange assets and liabilities (at year-ends)

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2001	2002	2003	2001	2002	2003
Commercial banks	25.7	23.9	25.2	17.9	18.8	19.1
Co-operative banks	0.0	0.2	0.2	0.0	0.0	0.2
Banking sector	**24.7**	**22.7**	**23.9**	**18.0**	**17.1**	**18.2**

Structure of revenues and expenditures of financial institutions (at year-ends)

million zloty

Revenues	2001	2002	2003
Commercial banks	84,350.8	86,215.4	75,276.3
Co-operative banks	4,127.7	3,657.8	3,232.2
Banking sector	**88,478.5**	**89,873.2**	**78,508.5**
Expenditures	**2001**	**2002**	**2003**
Commercial banks	79,050.4	82,884.5	71,049.2
Co-operative banks	3,637.9	3,161.9	2,827.7
Banking sector	**82,688.3**	**86,046.3**	**73,877.0**

Structure of registered capital and own funds of financial institutions in 2003

Type of the financial institutions	Registered capital	/Total sector assets	Own funds	/Total liab.
	EUR	%	EUR	%
Commercial banks	2,451.0	2.4	9,805.1	9.5
Co-operative banks	92.5	0.1	557.2	0.5
Banking sector	**2,543.5**	**2.5**	**10,362.3**	**10.0**

2003 DEVELOPMENTS IN THE ROMANIAN BANKING SYSTEM

The Romanian banking system appeared stable and solid, part of a generally stable macro environment, with banks focused on consolidating their position on the internal market.

MACROECONOMIC ENVIRONMENT

Maintaining the same level as of the previous year, the dynamics of the GDP in 2003 (4.9 percent in real terms) was one of the most important indicators of the economic growth in 2003. The nominal value amounting 1,890,778.3 billion ROL was the support for the increase of the GDP per capita, up to 2,316 euro per capita (+4.3 percent against the level registered during 2002).

The dynamics of the gross value added (+4.9 percent), similar to that registered during the previous year, also has supported (with 4.4 percentage points) the increase of the GDP. In addition, the contribution of net taxes related to the product (calculated as the difference between the planed level of taxes and the value of the subventions relative to the product) has decreased (with 0.2 percentage points as compared to 2002), while their weight over the GDP has maintained almost constant (10.5 percent).

The positive dynamics of the gross value added in the agriculture has influenced the increase of the contribution of this sector to the GDP with 1.4 percentage points, while the decrease of the growth rhythm in industry, constructions and services was reflected by the same contribution to the GDP or even a lower one (in the case of the services sector).

Compared with 2002, the gross value added in industry has increased with 4.6 percent, based on the increasing in the case of the processing industry (+3.7 percent), the energy industry (+1.6 percent), while in the case of the extraction sub-sector the production volume decreased with 0.4 percent.

During 2003, the most important contribution in the GDP was that of the services sector (44.6 percent), which also has registered the increase of 5.2 percent of the gross value added, supported by the retail selling (+5.7 percent excepting the selling of cars and motorcycles which has increased with 14 percent) and the market services performed for the population (+4.9 percent).

The increase (3.0 percent) of the gross value added, made the agriculture, sylviculture and pisciculture sector to improve (with 0.3 percentage points) the contribution to the dynamics of the GDP. The high dependence of the Romanian agriculture of the climacteric conditions, has affected also during 2003 the vegetal sector (the extremely cold winter, the thermic fluctuations during the spring and the droughty summer led to decreasing in crops (between 8 and 66.5 percent). This imposed restrictions in exporting wheat and measures for stimulating such imports necessary for panification and animals feeding. These negative results were balanced by the significant growths, up to 151.8 percent in the case of the autumn crops (sun-flower, corn, soya-bean, vegetables and fruits). The live-stock sector had also a major contribution to the general development of the agriculture and both to internal consumption and to export.

During 2003, the most important increase of gross value added (7.0 percent in real terms) was recorded by constructions sector, based on the increase (6.5 percent) of the value of works performed in this field. The increase was mainly due to the majority private sector (90.6 percent of the total value of the works).

The real growth of final consumption (6.9 percent) has represented 83.3 percent of the total GDP. This high dynamics was the result both of the expansion of the private consumption and the government consumption.

BANKING SECTOR DEVELOPMENTS

The weight of the bank assets in the GDP increased from 29.6 percent in 2001 to 31.1 percent in 2002, and to 32.0 percent at end 2003 and those of nongovernmental loans from 9.9 percent to 11.7 percent and 15.8 percent respectively, reducing the distance which separates Romania from the other countries of the region.

For the third year consecutively, the banking activity has continued the boom based on the improvement of the macro-economic climate, as a result of the measures for restructuring the banking sector, applied by the NBR during 1999-2000.

The dynamics of the Romanian banking market was mainly sustained by the non-government loan, whose growth index in 2003 of +71 percent in nominal terms and +50 percent in real terms, was larger than that of 2002 of +51 percent, respectively +30 percent.

This expansion mainly expressed the accelerated rhythm of growth of loans to individuals of +259 percent in nominal terms and +215 percent in real terms. In such conditions, the weight of this segment over non-government loan doubled, from 12 percent as of the end of 2002, up to 25 percent as of December 2003, exceeding the corporate loan growth of 42 percent in nominal terms and 24 percent in real terms, due to the increased interest in the more diversified offers of the banks, as well as the larger demand of population for consumption and real estate loans.

Due to the measures imposed by the NBR in order to limit the risk for consumption loans (Norm 15/2003) and mortgage loans (Norm 16/2003), non-government loans and loans to individuals have recorded moderate rhythms of growth during the first quarter of the current year, of +6 percent in nominal terms and +4 percent in real terms, respectively +8 percent and +6 percent.

The loans to individuals showed small values of the past due amounts of 0.5 percent of total, even if they contributed decisively to the expansion of the nongovernmental credit. Otherwise, past due and doubtful loans have recorded sub-unit weights (0.6 percent) over the total non-government loans portfolio at net value.

The aggregated financial result illustrated the increasing granting loans activity. Thus, during 2003, the aggregated profit has increased from 12,498.1 billion ROL (December 2002) to 13,290.1 billion ROL (December 2003), the main resource being the net interest revenues. The 2003 smaller growth of the net aggregated profit of 6.3 percent, as compared with the 18.7 percent of 2002, was due to the contracted interest margins at operations with non-bank customers from 17.6 percent to 14.7 percent, in the context of the increased competition on the loan market, increased provisions expenses with 50.6 percent compared with the previous year, due to the new methodology for provisioning loans, enforced on the 1-st of January 2003 and the investments in infrastructure done by the majority of banks.

Subsequently to the enforcement of the new regulations for loans classification and provisioning, the two profitability ratios recorded by the Romanian banks have increased from 1.2 percent in January to 2.2 percent in December (ROA) and from 8.4 to 15.8 percent (ROE). At the end of 2003, the two ratios have mostly reached the levels registered at the end of the previous year (2.6 and 18.3 percent respectively).

The main source of the net aggregated profit of 4,626.7 billion ROL for the first three months of the current year, continued to be the net interest incomes, also increasing the profitability indicators (ROA recorded 2.8 percent and ROE 20.1 percent).

The favorable trends of the main ratios assessing the stability of the banking system is one of the conclusions of the Financial System Stability Assessment (FSAP)[23] done by the experts of the World Bank and the International Monetary Fund, as well as of the Peer review of the European Commission. Both these reviews concluded that the banking system is well capitalized, with a high liquidity and properly supervised (the supervision authority has a good administrative capacity, well trained staff and quality management). The banking system had been submitted to a stress testing within the FSAP, the results showing that it remains flexible to potential market and credit risks, with a low exposure to foreign currency and interest risks, while the banks succeeded to balance their net foreign exchange position and the interest rate to loans is variable. The main prudential ratios remained solid, showing a high resistance to shocks, with a high solvency (20 percent) and liquidity (3), a manageable level of non-performing loans of under 1 percent of the loans portfolio of banks, even if the loan granting activity increased.

The boom of consumption and mortgage loans, under safe terms, was possible because the insurance companies took over of a significant part of the banks' risks, which accepted as collateral insurance policies.

The monitoring of the measures' plan established after the Peer review mission showed their accomplishment, i.e. the harmonization in large extent of the bank regulations with the Basle principles, the focus of the supervision activity on banking risks and on the management of the banks, respectively on the setting up and the functioning of their internal controls.

[23] Intended to support countries in identifying and solving the weaknesses of the financial sector as a whole, increasing its resilience to macro-economic shocks.

The Phare-funded acquisition of new software to develop the actual off-site monitoring of bank risks and the introduction of a new assessment component - the sensitivity at market risk – as well as the improvement of the early warning systems of the potential bankruptcies will also improve the supervision activity.

THE LEGAL FRAMEWORK OF THE SUPERVISION

During 2003, the National Bank of Romania tried to include in the national legislation the aquis communitaire afferent to the banking sector.

As a consequence, the most important laws, norms and regulations issued during 2003, are the following:

- Law no. 485/2003 which modifies and completes the Banking Law no. 58/1998.
- Norms no. 11/2003 regarding the supervision, on individual and consolidate basis, of own funds;
- Norms no. 4/2003 regarding the licensing of real estate saving banks;
- Norms no. 5/2003 regarding the specific conditions imposed to real estate saving banks;
- Norms no 12/2003 regarding liquidity and large exposures supervision in the case of credit institutions;
- Norms no. 14/2003 regarding the investments permitted for the institutions able to issue e-money;
- Norms no. 17/2003 regarding the organization and the internal control of the activities performed by credit institutions, the management of the main risks and the performance of the internal audit of the credit institutions;
- The Order of the Minister of Finance and the Governor of the National Bank of Romania no. 188/2003 which modified and completed the Accounting Plan applicable to credit institutions and the Methodological Norms for the enforcement of this Order;
- The Order of the Minister of Finance and the Governor of the National Bank of Romania no. 999/3/2003 for the approval of the semiannual Accounting Report System for the credit institutions;
- The Order of the Governor of the National Bank of Romania no.2/2003 regarding the approval of the financial statements Models and of the Methodological Norms regarding their use by credit institutions applying the IAS;
- The Circulars no. 5/2003 and no. 31/2003, which modifies and completes the Foreign Exchange Regulations no.3/1997;
- The Circular no. 39/2003 which modifies and completes the Circular no. 26/2001 also modifying the Regulations no. 3/1997.

THE LEGAL COMPETENCE OF THE NATIONAL BANK OF ROMANIA IN THE AREA OF BANKING REGULATION AND SUPERVISION

The NBR has the exclusive competence to issue licenses and is responsible for prudential supervision of the banks, according to the banking law. It issues regulations, takes measures for their observance and applies sanctions for their infringement. In addition to the off site inspections performed based on the periodic reports submitted by the banks, on site inspections are conducted by the NBR at least once a year and more frequently when irregularities are detected. In case of any violation of the regulations, the NBR can impose penalties.

MAIN STRATEGIC OBJECTIVES IN 2003

The privatization of Banca Comerciala Romana (BCR) takes place according to the strategy approved by the Government Decision No. 772/07.03.2003.

On April 23, 2004, the General Meeting of the bank's shareholders has approved the modification of the BCR's Statute, the supervision, the management and the coordination of the bank's activity being delegated by the shareholders to a Supervisory Board of 7 members, 5 of them proposed by the Authority for the Privatization and Administration of the State Participation (APAPS) and 2 by the representatives of the 5 Financial Investment Agencies (SIFs). The directors' mandate covers 3 years, with the possibility to be re-elected for additional terms. A president and a vice-president lead the Supervisory Board.

The Supervisory Board shall:

- Monitor the implementation of the institution's restructuring plan, of financial targets and of environment procedures;
- Approve the lending, liquidity, treasury and risk management policies;
- Approve capital investments between 5 and 15 percent of the bank's own funds in commercial, financial and banking institutions and also their selling;
- Approve the plans and programs of incomes/expenses of the budget;
- Approve the acquisition or the selling of fixed assets of more than 10 percent of the bank's own funds;
- Approve the collective working contract;
- Approve the offers of real estates acquisition, including the concession and rental of buildings for the bank's premises;
- Approve the setting up in Romania and abroad of branches, affiliates and representative offices.

The shareholders have decided to set up an Executive Committee of 6 persons: the Executive President of the bank and 5 executive vice-presidents.

After the EBRD and the IFC take over 25 percent of Banca Comerciala Romana's share capital, the following step is to sell 8 percent of the total to the bank's employees, the APAPS still remaining the main shareholder with 36.88 percent of the total, the other being SIF Oltenia with 6.12 percent and the other SIFs, with 6 percent each.

In order to privatize Casa de Economii si Consemnatiuni (CEC), the Romanian Government have approved the Emergency Ordinance (EO) No. 19/04.07.2004[24] regarding the measures before starting the privatization, including the setting up of the Commission for the privatization of CEC, of the technical secretariat, as well as the amount and the source for their payment. This EO also mentions the need to withdraw the state guarantee on the deposits of the individuals and their related interests with CEC, until the privatization. The way to transfer this guarantee to the Bank Deposit Guarantee Fund will be approved at the same time with the privatization strategy.

The Government Program for 2001-2004 and the PSAL II mentioned the restructuring of Banca de Import-Export a Romaniei (EXIMBANK). This bank will monitor and implement the objectives of its 2003-2004 strategy to strengthen its main goal of better supporting both the production for the export and the export activity, and to improve its performances.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The Romanian banking market required the improvement of the activity of the supervision authority, which concentrated more on the analysis of risks directly and indirectly related to the banking activity, checking not only the financial performance, but also the correlation between the risk profile of banks with their capacity to monitor them.

Quarterly stress test reviews of the banking system to potential credit, foreign currencies and interest rate risks had been added to the monthly analysis[25] of its stability.

The existing regulatory framework, according to the prudent and sound bank practices, encouraged the new approach of the supervision authority.

Even if the Romanian banking system did not record structural changes during 2003 and the first months of the current year, the banks with majority private capital reached 63.5 percent of the aggregated balance sheet assets as of end-March 2004, influenced by the asset increase, while on the liabilities side the attracted deposits from non-bank customers grew with +28.5 percent and own capital with +27.4 percent.

One can estimate an increase of the weight of these banks with more than 28 percent once the largest state owned Romanian bank, Banca Comerciala Romana will be privatized. The signing on November 4, 2003 of the selling-buying contracts with EBRD and IFC was one of the events of that year.

[24] Published in the Official Gazette No. 322/04.14.2004
[25] Based on a set of economic, financial and prudential data

The foreign capital continued to hold the majority in the private sector, reaching 59.2 percent of the aggregated balance sheet as of end March 2004.

The withdrawal of Banca Columna from the CAAMPL monitoring, based on the final decision of the Bucharest Court to open the bankruptcy procedure, did not reduce the market share of foreign capital, because this bank was not operational from 1998. This opening of the procedure of bankruptcy ended the cleaning stage of the liquidation of the insolvent banks.

The new owners, Romanian legal persons, for Banca Daewoo and Libra Bank, which acquired the majority stake of shares, of 56.2 percent and of 64.8 percent respectively, from the previous foreign owners, increased the market share of the domestic private capital from 3.2 percent to 4.3 percent.

The weight of the private sector arrived at 74.3 percent of the aggregated capital as of December 2003, respectively at 75.6 percent on March 31, 2004, due to the increase of the share capital of foreign owned credit institutions and of minimum share capital and own funds enforced by the NBR up to 370 billion ROL (Norm 16/2002).

Austria, with 23 percent of total capital, Greece, with 10.5 percent and Italy with 6.5 percent, had the largest foreign direct investment from the 40 countries with participations in the Romanian banking system, as of the end of March-2004.

The structural changes of the last years modified the total number of banks and their specific weight. From the 38 banks registered as of end-March 2004, three were with majority state capital, 15 affiliates of foreign banks, six with Romanian private capital, six with private foreign capital and eight branches of foreign banks. The first credit co-ops network is also under the supervision of the NBR and inside the deposits guarantee system.

COOPERATION WITH OTHER SUPERVISORY BODIES IN ROMANIA

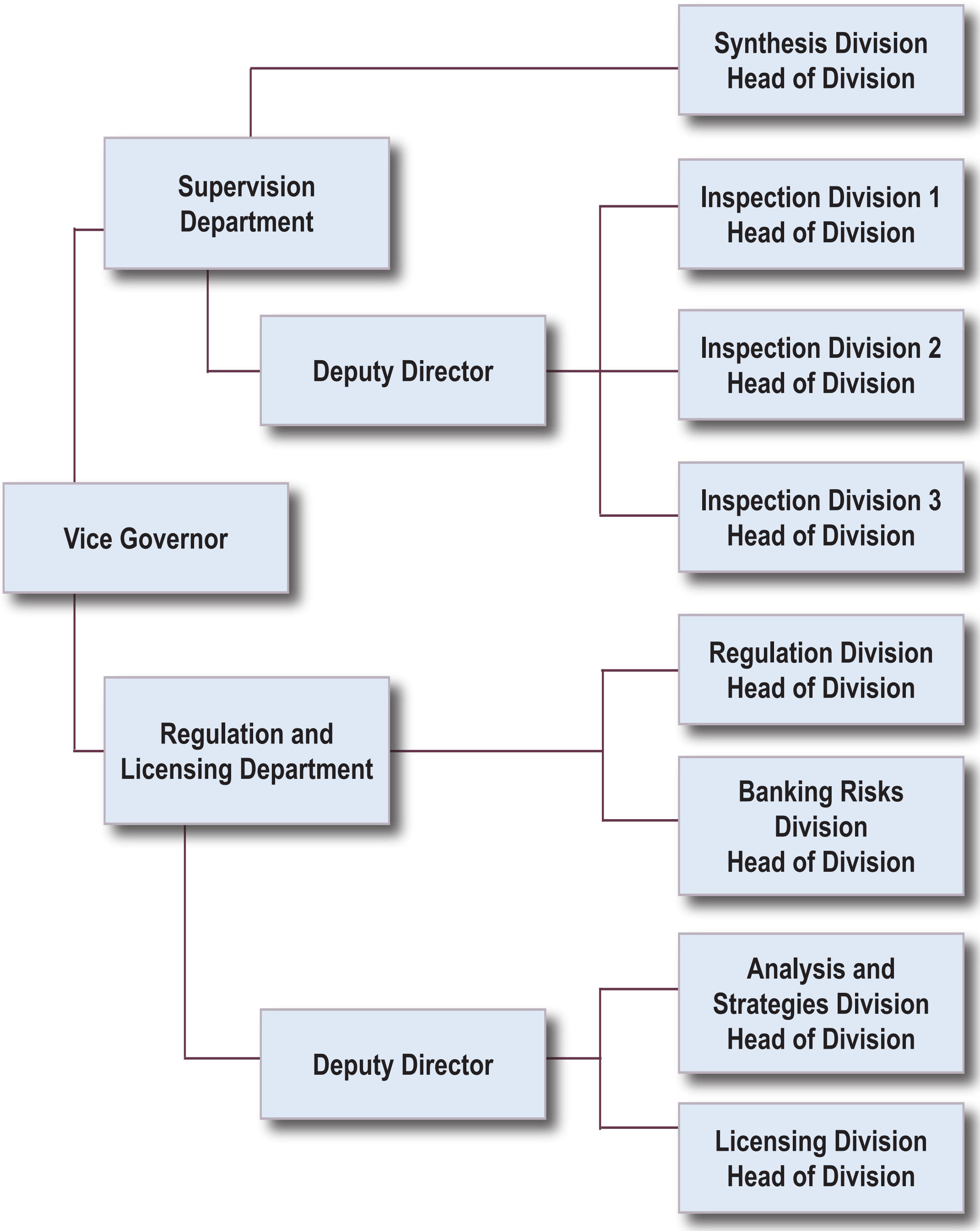
The results of the efforts to improve the cooperation between the Romanian supervision authorities were the protocols signed between the National Bank of Romania, the National Commission for Securities and the Insurance Supervision Commission, on April 3, 2002.

INTERNATIONAL ACTIVITIES OF THE SUPERVISION AUTHORITY

As a result of the negotiations for concluding memoranda in the field of banking supervision with competent bodies from the home countries of the banks which have set up in Romania affiliated, branches or representative offices, the National Bank of Romania have signed memoranda of understanding with six foreign supervision authorities (National Bank of Moldova, Turkish Regulation and Supervision Agency; Central Bank of Cyprus, Bank of Italy; Bank of Greece and Federal Office for Banking Supervision in Germany). Negotiations with Bank of Netherlands, Austrian National Bank and French Banking Commission are in progress.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS DURING 2003

During 2003, the number of credit cooperatives affiliated to the only authorized cooperatives net existing in Romania was supplemented with 17 more units, up to a total of 565. From the date of the licensing, the cooperative units are been supervised by the National Bank of Romania. As of the present, the provisions regarding the Deposits Guarantee Scheme in Romania are also applied to the cooperative units.



STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institutions	2001	2002	2003
Commercial banks	33	31	30
Branches of foreign banks	8	8	8
Total banking system	**41**	**39**	**38**

Ownership structure of financial institutions on the basis of the registered capital (%) (at year-ends)

Item	2001	2002	2003
State ownership	34.6	29.9	25.7
Other domestic ownership	4.8	5.2	8.0
Domestic ownership, total	*39.4*	*35.1*	*33.7*
Foreign ownership	60.6	64.9	66.3
Total banking system	**100.0**	**100.0**	**100.0**

Ownership structure of the financial institutions on the basis of assets total

Item	2001	2002	2003
Public sector ownership	41.8	40.4	37.5
Other domestic ownership	3.0	3.2	4.3
Domestic ownership, total	*44.8*	*43.6*	*41.8*
Foreign ownership	55.2	56.4	58.2
Total banking system	**100.0**	**100.0**	**100.0**

Concentration of assets by type of financial institutions (%) (at year end)

Type of institution	The first three largest	The first five largest
Banks	49.9	61.7
Credit cooperatives	-	-
Financial institutions	-	-
Savings cooperatives	-	-
Specialized credit institutions	-	-

Return on asset (ROA) by type of financial institutions (%)

Type of institution	2001	2002	2003
Banks	3.10	2.64	2.21
Credit cooperatives	-	-	2.2
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

Return on equity (ROE) by type of financial institutions (%)

Type of institution	2001	2002	2003
Banks	21.79	18.27	15.6
Credit cooperatives	-	-	9.9
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

Distribution of market shares in balance sheet total (%)

Type of financial institutions	2001	2002	2003
Commercial banks	92.1	92.6	92.3
Branches of foreign banks	7.9	7.4	7.7
Total banking system	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%) (at year-ends)

Assets	2001	2002	2003
Cash and claims on banks	43.0	41.9	36.0
Net loans	34.0	38.1	49.4
Securities	14.5	12.5	7.1
Fixed assets and other assets	8.5	7.5	7.5
Total assets	**100.0**	**100.0**	**100.0**
Liabilities	**2001**	**2002**	**2003**
Due to other banks and financial institutions	10.5	10.5	14.1
Due to clients	72.0	73.7	70.2
Other liabilities	3.5	1.6	1.8
Own capital	14.0	14.2	13.9
Total liabilities and capital	**100.0**	**100.0**	**100.0**

Development of off-balance sheet activities (%)
(off-balance sheet items*/balance sheet total)

Type of financial institutions	2001	2002	2003
Commercial banks	16.4	18.2	19.6
Branches of foreign banks	27.9	23.8	21.1
Total banking system	**17.3**	**18.6**	**20.0**

** commitments in favor of banking and non-banking customers*

Solvency ratio of financial institutions

Type of financial institutions	2001	2002	2003
Commercial banks	28.8	25.0	21.1
Branches of foreign banks	-	-	-
Total banking system	**28.8**	**25.0**	**21.1**

Asset portfolio quality of the banking system

Mill EUR

Asset classification	2001	2002	2003
Standard	7,030	7,792	4,589
Watch	26	21	1.701
Substandard	30	62	342
Doubtful	15	11	78
Loss	123	45	153
Classified total	**7,224**	**7,931**	**6,862**
Specific reserves	**130**	**58**	**118.6**

According to the classification statement of Commercial Banks

The structure of deposits and loans in 2003 (%)
(at year-end)

	Deposits	Loans
Households	28.8	16.0
Government sector	3.8	7.9
Corporate	23.8	24.0
Foreign	40.9	51.3
Other	2.7	0.8
Total	**100.0**	**100.0**

The structure of deposits and loans and commitments in 2003 (%)
(at year-end)

Maturity of deposits		Loans and commitments	
At sight	27.7	Short-term	50.1
Within one year	66.7	Medium-term	36.8
Over one year	5.6	Long-term	13.1
Total	**100.0**	**Total**	**100.0**

Proportion of foreign exchange assets and liabilities
(at year-ends)

Type of financial institutions	FOREX assets/Total assets			FOREX liabilities/Total liabilities		
	2001	2002	2003	2001	2002	2003
Commercial banks	45.7	40.9	45.0	38.5	37.6	43.2
Branches of foreign banks	77.7	70.6	71.4	73.1	65.1	63.3
Total banking system	**48.2**	**43.1**	**47.0**	**41.2**	**39.6**	**44.8**

Structure of revenues and expenditures of financial institutions
(at year-end)

Revenues	2001	2002	2003
Interest income	28.1	25.6	23.5
Income from securities transactions	11.3	8.7	3.4
Recoveries from provisions	8.4	6.8	7.6
Income not derived from interest	52.0	58.8	65.4
Extraordinary income	0.2	0.1	0.1
Expenditures	**2001**	**2002**	**2003**
Interest expenses	24.5	19.1	12.6
Expenses for securities transactions	0.3	2.0	0.5
Provisions expenses	10.4	7.8	9.7
Expenses, other than interest	61.7	68.9	75.5
Extraordinary expenses	1.0	0.4	0.0
Profit tax	2.1	1.8	1.7

Structure of registered capital and own funds of financial institutions in 2003

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liabilities
	Mill. EUR	%	Mill. EUR	%
Commercial banks	896.4	6.6	1,726.1	12.7
Credit cooperatives	9.3	11.9	18.1	23.1
Total banking system	984.3	6.6	1,744.2	11.8

2003 DEVELOPMENTS IN THE RUSSIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The dynamics of major macroeconomic indicators remained positive in 2003: the stable development of the Russian economy continued. Real GDP expanded by 7.3% in 2003 against 4.7% in 2002 and household real money income increased 13.6% year on year.

Price dynamics in the Russian economy were impacted by the balanced monetary policy pursued by the Bank of Russia and stable exchange rate dynamics of the ruble. Consumer price growth slowed down significantly due to the concerted actions of the Bank of Russia and the Russian government. In 2003, consumer prices rose 12.0% against 15.1% in 2002.

BANKING SECTOR DEVELOPMENT

Banking sector assets grew 1.6 times faster than GDP in 2003, loans extended to the non-financial sector almost twice faster and household deposit accounts more than twice faster than GDP. As a result, the ratio between major banking sector indicators and GDP continued to increase. The ratio of assets to GDP expanded from 38.3% to 42.1% in 2003, loans to resident non-financial enterprises from 14.7% to 17.0% and funds attracted from the enterprise and household sectors from 19.6% to 21.8%. The number of operating credit institutions remained unchanged in 2003 and stood at 1,329 (for dynamics see Table 1).

LEGAL AND INSTITUTIONAL FRAMEWORK OF BANKING AND BANKING SUPERVISION. THE POWERS OF THE BANK OF RUSSIA

The adoption of Federal Law No. 177-FZ, dated December 23, 2003, "On the Insurance of Personal Deposits in Russian Federation Banks" was of great importance for the upgrading of the legal framework of credit institutions' activities. The principal objective of this law is to protect the rights and legitimate interests of depositors of Russian banks, strengthen confidence in the banking system and encourage the public to entrust their savings to the banking sector. The law set out the legal, financial and organisational principles of the compulsory individual deposit insurance system and determined the power and procedure for the setting-up and functioning of an institution implementing compulsory deposit insurance as well as the procedure for paying compensation for deposits.

Federal Law No. 173-FZ, dated December 10, 2003, "On Foreign Exchange Regulation and Foreign Exchange Control", which is to come into force this year, has brought Russian legislation into compliance with international requirements for free capital movement. It is designed to further liberalise the Russian economy and improve the investment climate in Russia and its implementation will facilitate the development of the national economy and encourage international economic co-operation.

In 2003, Russia also passed the Federal Law on Mortgage-Backed Securities, which regulates the relations that arise in the issuance, delivery and circulation of mortgage securities, except mortgages themselves, and in the fulfilment of obligations on mortgage-backed securities. It grants to the Bank of Russia the right to establish for credit institutions that issue mortgage-backed bonds special capital adequacy calculation procedures and ratios, liquidity ratios, interest and currency risk profiles and information disclosure requirements in addition to the requirements established by other federal laws.

The powers of the Bank of Russia are set out in Federal Law No. 86-FZ, dated July 10, 2002, "On the Central Bank of the Russian Federation (Bank of Russia)". Seeking to upgrade and strengthen the Russian banking system, the Bank of Russia is the banking regulator and supervisor, which constantly monitors the compliance by credit institutions and banking groups with banking legislation, the laws against money laundering and terrorist financing as well as Bank of Russia's rules and regulations.

BANK OF RUSSIA'S KEY OBJECTIVES IN THE FIELD OF BANKING SUPERVISION IN 2003

The Federal Law No. 86-FZ, dated July 10, 2002, "On the Central Bank of the Russian Federation (Bank of Russia)" stipulates that the principal objectives of banking regulation and supervision are to maintain stability of the Russian banking system and protect the interests of creditors and depositors. The Bank of Russia consistently implements the tasks set by this law and specified in a new version of the Russian Banking Sector Development Strategy, which is being drafted now. In the medium term, supervisors of the Bank of Russia should accomplish the tasks that will help enhance the stability of the banking sector and its credibility in the eyes of creditors and depositors, reduce to a minimum the risk of a systemic banking crisis, prevent the use of credit institutions for dishonest commercial purposes and make banking more transparent.

BANKING REGULATION AND SUPERVISION MEASURES IMPLEMENTED BY BANK OF RUSSIA IN 2003

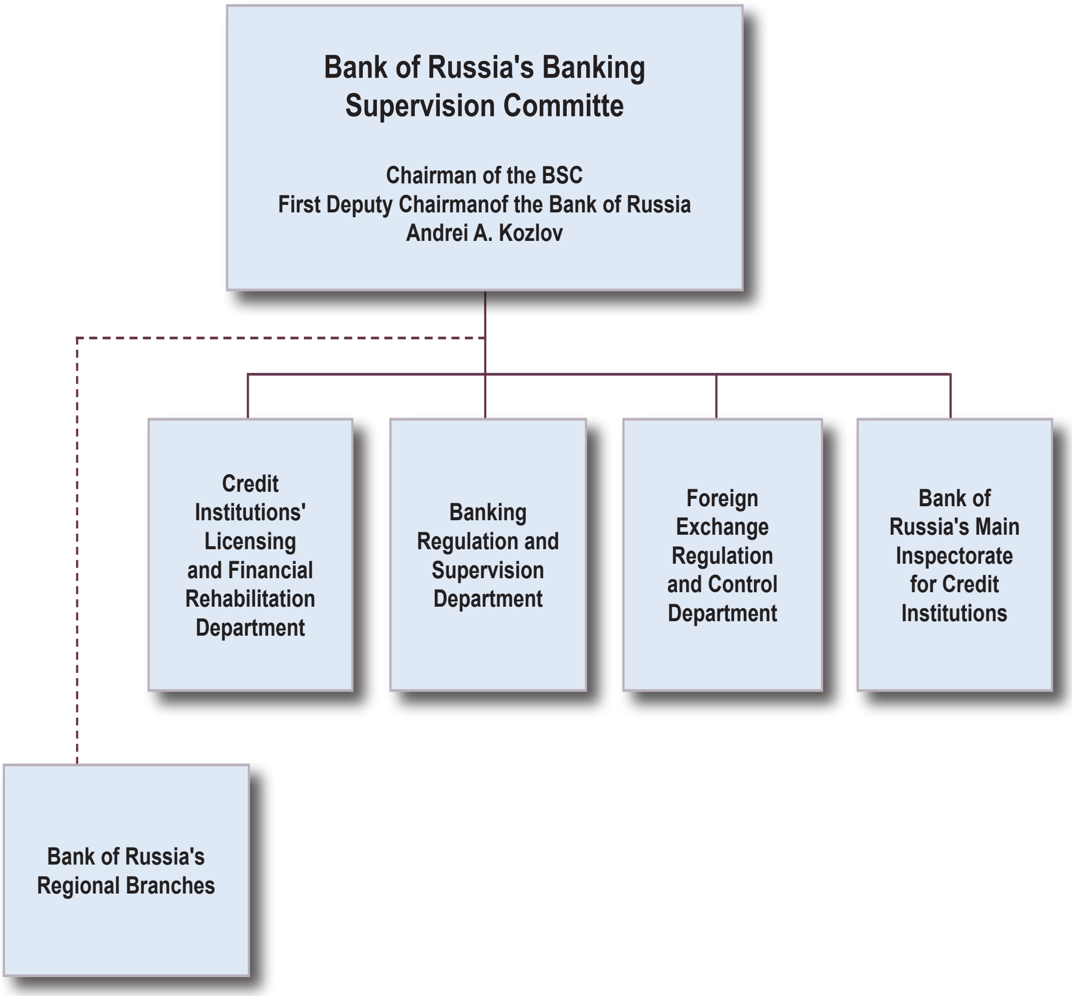
One of the most important decisions taken by the Bank of Russia in the field of banking regulation and supervision in 2003 was issuing regulations designed to improve the quality of credit institutions' capital. Should it be found out that a credit institution has used improper assets as a source of fixed or additional capital or a part thereof, the Bank of Russia shall require the credit institution to exclude the above sources of own funds or the corresponding part thereof from the capital calculation. The Bank of Russia has also ruled that the amount of own funds (capital) used in the calculation of the credit institution's required ratios is the value determined on the basis of the Bank of Russia assessment and that credit institutions and banking groups indicate this specific value of own funds in their reporting.

To implement the deposit insurance law, the Bank of Russia issued in 2003 the Ordinance "On the Assessment of the Financial Soundness of a Bank for the Purposes of Recognising it Sufficient for the Participation in the Deposit Insurance System", which established a set of indicators and methodology to calculate them and determine the overall result with due account of these indicators for the purpose of recognising the financial stability of a bank sufficient for its participation in the deposit insurance system.

In 2003, the Bank of Russia took steps to introduce in its regulatory framework the provisioning principles for possible losses that accord with international practices. Its Regulation No. 232-P, dated July 9, 2003, "On the Procedure for Making Provisions for Possible Losses by Credit Institutions", which came into effect on March 1, 2004, provides for the further use of informed judgement in evaluating the quality of assets and high liquidity collateral and introduces the principle of materiality, allowing a credit institution to make provisions for the portfolio of similar claims (obligations), immaterial from the viewpoint of the volume of activity, without making a professional judgement on each item.

In 2003, the Bank of Russia made efforts to improve regulations on its decision-making related to the state registration of credit institutions, licensing of banking activities, insolvency (bankruptcy) prevention, revocation of banking licence and liquidation of credit institutions as well as to bring the regulations into compliance with the Basle Committee's Core Principles of Effective Banking Supervision and Supervisory Guidance on Dealing with Weak Banks.

ORGANISATIONAL STRUCTURE OF BANK OF RUSSIA SUPERVISORY BODIES



INTERNATIONAL CO-OPERATION IN THE FIELD OF BANKING SUPERVISION

In 2003, the Bank of Russia expanded co-operation with international financial institutions, such as the IMF and World Bank, on a wide range of issues, including upgrading the banking supervision system, organising internal control systems in banks, developing early warning systems to detect problems in credit institutions at early stages and establishing credit bureaus.

The Bank of Russia participated in compiling information for the World Bank Survey on Prudential Regulation and Supervision of Commercial Banks and IMF Global Financial Stability Report, which are available on the websites of these organisations.

Bank of Russia representatives took part in the work of the Global Bank Insolvency Initiative, a joint project of the IMF, World Bank and Financial Stability Institute. A draft of the Main Report on Legal, Institutional and

Regulatory Aspects of Dealing with Problem Banks has been completed and its final version is expected to be released in March 2005.

The Bank of Russia exchanged information and participated in meetings held within the framework of the World Bank Programme "Corporate Governance in the Russian Banking Sector" and took part in the presentation of the project implementation report. It also participated in the EuroForum-organised conference "Securitisation in Russia and Kazakhstan".

Bank of Russia representatives participated in the activities and meetings of the Basel Committee's Core Principles Liaison Group and its Working Group on Capital (February, April, August and December) and also in the May 2003 meeting of chief supervisors on corporate governance, supervision and credit risk. The Bank of Russia provided for organisation of the Liaison Committee's meeting held in St. Petersburg in August 26 to 28, 2003.

The above meetings were focused on the New Basel Capital Accord (Basel-II) and practical aspects of independence, accountability and legal protection of banking supervisors; the accountability, transparency and stability in conformity with the principles of the New Basel Capital Accord; the observance of the Basel Committee's Core Principles for Effective Banking Supervision, systemic banking crises, credit and operational risk supervision, corporate governance, IAS 32 and IAS 39, co-ordination of actions (co-operation) between the Basel Committee and its regional groups, etc.

To inform the international banking community, the Bank of Russia took part in the International Conference "The Challenges of the Basel II Accords for Europe and its Neighbours", organised by the Russian Chamber of Commerce and Industry and Belgian Bankers' Academy with the support of the Basel Committee on Banking Supervision and the European Commission and held in St. Petersburg in April.

As part of the programme to evaluate the potential effect of the New Basel Capital Accord on bank performance indicators, the Bank of Russia took part in the Basel Committee's Quantitative Impact Study 3 (QIS3). At the request of the Bank of Russia, six Russian banks participated in the study, which involved 365 banks from 43 countries.

Bank of Russia representatives took part in a new project, FSI Connect, launched by the Financial Stability Institute and Bank for International Settlements. The aim of this two-year project is to develop and support teaching Internet programmes and information web resources for supervisors with a view to co-ordinating the efforts of supervisory authorities at global level and helping them to work out future strategies for various financial markets.

STATISTICAL TABLES

Number of credit institutions (at year-ends)

Type of credit institution	2001	2002	2003
Banks	1,276	1,282	1,277
Non-banking credit institutions	43	47	52
Banking sector, total	**1,319**	**1,329**	**1,329**

Ownership structure of the banking sector on the basis of registered capital (%) (at year-ends)

Type of ownership	2001	2002	2003
Russian credit institutions	95.1	95.1	95.3
Foreign-controlled banks (banks with non-resident interest in excess of 50%)	4.9	4.9	4.7
Banking sector, total	**100.0**	**100.0**	**100.0**

Ownership structure of the banking sector on the basis of assets total (%) (at year-ends)

Type of ownership	2001	2002	2003
Russian credit institutions	90.5	91.9	92.6
Foreign-controlled banks (banks with non-resident interest in excess of 50%)	9.5	8.1	7.4
Banking sector, total	**100.0**	**100.0**	**100.0**

Concentration of assets by the type of credit institutions (as % of aggregate assets of credit institutions)

Type of credit institution	The first three largest institutions			The first five largest institutions		
	2001	2002	2003	2001	2002	2003
Banks	35.9	37.5	37.0	42.9	44.3	43.0
Non-banking credit institutions	70.1	67.6	78.7	79.1	76.6	84.5
Banking sector, total	**35.8**	**37.4**	**36.8**	**42.8**	**44.2**	**42.9**

Return on equity* by type of financial institutions (%) (at year-ends)

Type of credit institution	2001	2002	2003
Banks	19.4	18.0	17.9
Non-banking credit institutions	49.7	53.7	45.2
Banking sector, total	**19.4**	**18.0**	**17.8**

* *Calculated as the ratio of the annual balance-sheet profit to the chronological average own funds (capital) in the period under review.*

**Distribution of market shares in balance sheet total (%)
(at year-ends)**

Type of credit institution	2001	2002	2003
Banks	99.76	99.76	99.56
Non-banking credit institutions	0.24	0.24	0.44
Banking sector, total	**100.00**	**100.00**	**100.00**

**Structure of assets of the banking sector (%)
(at year-ends)**

Assets	2001	2002	2003
Money, precious metals and gemstones	2.2	2.2	2.5
Accounts with the Central Bank of the Russian Federation	9.6	10.1	11.8
Correspondent accounts with other banks	10.0	7.3	5.5
Securities acquired by banks	17.8	18.8	17.9
of which:			
Russian government debt obligations	10.7	10.0	8.0
Loans	49.4	51.8	54.4
Other assets	11.0	9.8	8.0
Total assets	**100.0**	**100.0**	**100.0**

**Structure of liabilities of the banking sector (%)
(at year-ends)**

Liabilities	2001	2002	2003
Banks' funds and profits	16.2	15.7	14.9
Loans received from the Central Bank of Russian Federation	1.5	0.1	0.0
Accounts of other banks	5.2	4.3	3.6
Loans, deposits and other borrowings from other banks, total	6.4	7.6	9.4
Customers' funds	52.1	52.9	53.6
of which:			
Funds attracted from enterprises and organisations	28.6	26.3	24.7
Deposits and other funds attracted from private individuals	21.5	24.8	27.0
Debt obligations issued by banks	8.6	10.9	11.3
Other liabilities	10.0	8.4	7.2
Total liabilities	**100.0**	**100.0**	**100.0**

Development of off-balance sheet activities (%)
(off-balance sheet items/balance sheet total)
(at year-ends)

Type of credit institution	2001	2002	2003
Banks	11.71	12.46	18.15
Non-banking credit institutions	0.64	0.03	0.00
Banking sector, total	**11.68**	**12.43**	**18.07**

Solvency ratio of financial institutions (%)
(at year-ends)

Type of credit institution	2001	2002	2003
Banks	20.2	19.1	19.1
Non-banking credit institutions	52.9	43.1	47.9
Banking sector, total	**20.3**	**19.1**	**19.1**

Loan portfolio quality of the banking sector
(at year-ends, as % of total value of loans extended)

Loan quality	2001	2002	2003
Standard	89.4	90.1	90.7
Substandard	4.3	4.3	4.3
Doubtful	2.1	1.8	1.5
Hopeless	4.2	3.8	3.4
Provisions	6.7	6.3	5.9

The structure of deposits and loans in 2003 (%)
(at year-ends)

	Loans, deposits and other borrowings	Loans, deposits and other placements
Households	62.5	10.4
Government monetary authorities and extra-budgetary funds*	0.3	1.8
Corporate	12.2	71.7
Non-residents**	18.8	9.5
Banks	6.2	6.6
Total	**100.0**	**100.0**

* *Including the Central Bank of the Russian Federation.*
** *Including corporate entities (among them banks) and households*

Structure of deposits and loans in 2003* (%)
(at year-ends)

Maturity of loans, deposits and other borrowings		Maturity of loans, deposits and other placements	
At sight	11.7	Long-term (over 3 years)	13.0
Up to one year	46.7	Medium-term (1-3 years)	24.4
Over one year	41.5	Short-term (less than 1 year)	62.6
Total	**100.0**	**Total**	**100.0**

** Net of overdue debt.*

Structure of revenues and expenditures of financial institutions
(at year-ends, %)

	2001	2002	2003
Revenues, total	**100.0**	**100.0**	**100.0**
of which:			
interest received on loans, deposits and other placements	13.05	18.03	12.84
income received from operations with securities	6.52	10.13	11.54
income received from operations with foreign exchange and other foreign currency values	32.71	27.76	39.20
fines and penalties	0.55	0.56	0.11
other income	47.17	43.49	36.30
of which:			
amounts of recovered funds and provisions	41.15	35.31	28.52
commission received	3.00	3.77	3.14
Expenditures, total	**100.0**	**100.0**	**100.0**
of which:			
interest paid for loans taken	0.98	1.14	0.71
interest paid on borrowings from corporates	2.44	2.49	1.52
interest paid to individuals on deposits	3.46	5.04	3.98
expenses on operations with securities	3.15	5.42	7.14
expenses on operations with foreign exchange and other foreign currency values	32.73	28.03	41.00
administrative expenses	4.35	6.47	4.81
fines and penalties	0.31	0.05	0.03
other expenses	52.57	51.35	40.81
of which:			
charges to funds and provisions	45.30	41.20	32.43
commission paid	0.32	0.48	0.40

Structure of registered capital and own funds of credit institutions in 2003

Type of credit institution	Registered capital		Own funds (capital)	
	million euro	as % of total assets	million euro	as % of total liabilities
Banks	9,543.9	6.3	22,107.2	14.6
Non-banking credit institutions	286.9	43.4	23.6	3.6
Banking sector, total	**9,830.8**	**6.5**	**22,130.8**	**14.6**

Proportion of foreign exchange assets and liabilities (at year-ends)

Type of credit institution	FOREX assets / total assets			FOREX liabilities /total liabilities		
	2001	2002	2003	2001	2002	2003
Banks	37.9	36.2	30.0	32.2	31.8	28.2
Non-banking credit institutions	8.6	7.5	3.1	6.9	6.6	3.0
Banking sector, total	**37.8**	**36.2**	**29.9**	**32.1**	**31.7**	**28.1**

2003 DEVELOPMENTS IN THE SLOVAKIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2003, gross domestic product increased year-on-year by 4,2% at constant prices, where GDP growth was stimulated exclusively by foreign demand, the level of which was reduced by a fall in domestic demand (by 2,3%).

Development of domestic demand was negatively affected by a fall in gross capital formation and in final consumption of households whereas final consumption of general government increased.

The dynamic growth in the exports of goods and services, accompanied by weaker increase in imports, led to improvement in the balance of trade, where a positive balance at constant prices was registered.

Prices developments in 2003 and in the first two months in 2004 were determined mostly by domestic factors. Price levels were affected by administrative measures, increase in regulated prices and indirect taxes (excise duties and VAT rates), which accounted for more than 75% of the overall price increase. These measures (especially the increase in energy prices) appeared as a secondary effect after the marked increase in the prices of market services. External factors had a dampening effect on the rate of price increase. The appreciation of the Slovak koruna vis-à-vis the euro and the US dollar was reflected in fuel prices. The exchange rate of the koruna also had an impact on price levels in the form of low imported inflation.

Unemployment rate fell to an average 17,4% (ILO-definition) in 2003 from 18,5% in the last year, mainly due to amendment to labour legislation (new Act on Employment since January 2003) and to the application of an active labour market policy, designed for the creation for long-term job.

DEVELOPMENT IN THE BANKING SYSTEM

As of 31 December 2003, there were **eighteen banks** operating in the Slovak banking sector along with three branch offices of foreign banks. The number of branch offices increased to three as a result of the granting of a banking license to COMMERZBANK Aktiengesellschaft, whose branch office only disclosed its results of operations for a period ending 31 December 2003 for the first time.

The volume of subscribed share **capital** of the eighteen banking entities stood at SKK 40.4 billion, whilst the funding provided by foreign banks to their branch offices amounted to SKK 2.8 billion. After the entry of a foreign investor into Banka Slovakia, almost 90 percent of the subscribed share capital is now in the hands of foreign investors. In the year under review, there was an increase in the number of banks holding a license to transact mortgage business.

In this period, the **assets** of banks within the Slovak banking sector were worth SKK 985.4 billion, of which more than one half was held by three major financial institutions. These three generated 70 percent of the banking sector's financial results, which as of 31 December 2003 totalled SKK 11.3 billion, SKK 0.5 billion down from a year ago. This decrease can be ascribed to 10 banks, which as of 31 December 2003 reported financial results lower than in a corresponding period of the previous year.

Return on equity and return on assets – the banking sector's results of operations for the period subject to review (ending 31 December 2003) and its year-on-year development are characterised by profitability indicators calculated based on the offsetting of profit and losses, the average value of assets and share capital.

Return on equity (ROE) expressed in %	31. 12. 2002	31. 12. 2003
for the banking sector as a whole	29.43	27.15
Return on assets (ROA) expressed in %	**31. 12. 2002**	**31. 12. 2003**
for the banking sector as a whole	1.17	1.17

Yield on assets – an indicator depicting the performance of assets, i.e. net income from the banking sector's overall operations less interest on classified assets over average assets less classified claims. As of 31 December 2003, 1 SKK of assets in the banking sector yielded 3.95 haliers.

Ratio (haliers)	31. 12. 2002	31. 12. 2003
Yield on assets for the banking sector as a whole	3.96	3.95

The year-on-year development of the yield-on-assets indicator as of 31 December 2003 was influenced in particular by a decrease of 4.93 % in the net income from banking operations and a concurrent increase of 4.74% in the average volume of assets.

Net interest margin expresses net interest income (interest earned – interest paid) less the impact of interest on classified claims, charges and commissions over the average total assets less classified loans and legal reserves.

Ratio (%)	31.12.2002	31.12.2003
Net interest margin for the banking sector as a whole	2.69	2.91

The year-on-year development of net interest margin on interbank operations, operations with clients and securities operations and its slight increase from the end of 2002 was influenced by an increase in the net interest income by 2.90% at a concurrent decrease in the average volume of assets by 4.74%. In particular, the development of net interest income was favourably influenced by a distinct year-on-year increase in the net revenue from operations with clients by 218.49% at a concurrent decrease in the balance of securities operations by 16.55% and also the balance of interbank operations by 2.50%.

Assets total/GDP

Ratio (%)	31. 12. 2002	31. 12. 2003
Assets total/GDP	94.45	82.40

The ratio assets total to GDP decreased from 94.45% to 82.40% due to the GDP growth (11.3%) and the total assets decrease (2.82%).

THE LEGAL AND INSTITUTIONAL FRAMEWORK

Legislation addressing the institutional arrangement of supervision

Central Bank is responsible for banking supervision and its competences are defined in The National Bank of Slovakia Act.

Financial Market Authority FMA is responsible for capital and insurance market supervision, pension funds (retirement system reform) and its competences are defined in The Financial Market Authority Act.

According to the Government decision as of August 2003 integrated financial market supervision will be exercised by the Central bank from 1 st January 2006.

Substantive law

Laws and other legislation covering areas such as banking, stock exchanges, securities and investment services.

On 1 July 2003, Act No. 165/2003 Z.z., which is to amend Act No. 310/1992 Zb. on Home Savings, as amended by subsequent regulations (hereinafter the „Home Savings Act“) and Banking Act No. 483/2001 Z. z. and on the Amendment of Certain Laws, as amended by subsequent regulations (hereinafter the „Banking Act“) became effective.

By virtue of the amendment to the Home Savings Act, there was deleted the provision of § 3, which charged a home savings bank with an obligation to set interest rates on deposits and loans so that the difference between them is no more than 3%. Moreover, the Home Savings Act was extended for a new provision on the terms and conditions of home savings.

This amendment to the Home Savings Act also covers a decrease in the government bonus from 20 % to 15 % of the per annum deposit, with effect from 1 January 2004.

The amendment to the Banking Act was to coordinate the terminology used in its certain provisions with Act No. 566/2001 Z. z. on Securities and Investment Services and on the Amendment of Certain Laws, as amended by subsequent legislation. A change has occurred in the provision of § 84(2) of the Banking Act relating to the percentage level of a government contribution, which is no longer guaranteed for the entire maturity period of a mortgage loan, but is to be determined for individual calendar years through the Act on State Budget for the respective year, during which it will apply to all mortgage loan agreements.

On 1 January 2004, Act No. 603/2003 came into effect, which is to amend the Banking Act No. 483/2001 Z. z. This amendment aimed to incorporate those suggestions of the World Bank presented during the preparation of the second and third tranches of an EFSAL loan, which relate to requirements in respect of business done by banks and branch offices of foreign banks (including the related enhancement of promptness and flexibility as well as of effectiveness of the banking supervision) and which are compatible with directives applicable to the banking area in the European Union. There were several revisions of the Banking Act that aimed to harmonise this Act with other new statutes, which were only passed into law on the adoption of the Banking Act and which were to ensure the approximation of the system of law of the Slovak Republic to the law in force in the European Union in certain areas of financial services (such as capital market and insurance industry).

Also with effect from 1 January 2004, there was passed Act No. 602/2003, which is to amend the Foreign Exchange Act (Act of the NC SR No. 202/1995 Z. z., as amended) and Act No. 566/1992 Zb. on the National Bank of Slovakia, as amended (hereinafter the „Act on the National Bank of Slovakia“). Key provisions of the amendment of the Act on the National Bank of Slovakia are directly and immediately related to the amendment of the Foreign Exchange Act, chiefly to the provisions on foreign exchange reporting obligation and foreign exchange control. The most essential provisions in the amendment to the Act on the National Bank of Slovakia are the provisions governing an authorisation of the National Bank of Slovakia to acquire (request) and further process personal data and other data with a view to performing the authority of a statutory foreign exchange body and another statutory authority, activities and tasks of the National Bank of Slovakia in its capacity of an independent central bank in the Slovak Republic (such as authority, activities and tasks in the area of monetary policy, statistics, banking operations and supervision conducted by the National Bank of Slovakia).

The purpose of this amendment to the Foreign Exchange Act is to codify the rules for performing and intermediation of the remaining foreign exchange business activities subject to regulation (that concern dealing in foreign exchange assets and foreign exchange financial services), which are related to funds in the Slovak currency or in a foreign currency either in a cash or cashless form (buying, selling, exchanging of funds and cross-border cash transfers of funds in the Slovak currency or a foreign currency), as well as to regulate the performance of foreign exchange operations in a financial market that shows signs of riskiness and is not covered by the new Act on Securities and Investment Services (certain financial derivatives). The amendment to the Foreign Exchange Act also defines anew the concepts of a foreign exchange assets operation and the provision of foreign exchange financial services, as well as sets requirements on the grant of foreign exchange licenses for the transaction of business involving foreign currencies and the provision of foreign exchange financial services.

Likewise, beginning with 1 January 2004, Act No. 594/2003 Z. z. on Collective Investment and on the Amendment of Certain Laws (hereinafter the „Collective Investment Act“) became effective, which at the same time was to amend Act No. 530/1990 Zb. on Bonds, as amended, Act No. 566/2001 Z. z. on Securities and Investment Services and on the Amendment of Certain Laws, as amended and Act No. 429/2002 Z. z. on the Stock Exchange.

The purpose of the Collective Investment Act was to achieve a full harmonisation with the EU law, which will make it possible to extend the line of business of asset management companies for the management of portfolio of investments for individual clients and certain ancillary investment services, and will introduce other rules for prudential business for asset management companies, including the capital adequacy rules.

Another law, amended with effect from 1 January 2004, is represented by Act No. 604/2003 Z. z., which is to amend Act No. 510/2002 Z. z. on Payments and on the Amendment of Certain Laws. This amendment concerned newly proposed provisions of the Payments Act laying down basic rules and conditions for granting an authorisation in respect of electronic money operations to an electronic money institution. The Act sets the required minimum amount of a monetary deposit for an electronic money institution at EUR 1 000 000 or its equivalent in another currency converted to the Slovak currency by an exchange rate of the National Bank of Slovakia ruling as of the date of monetary deposit in the share capital.

Furthermore, this amendment stipulates basic conditions and requirements on the business done by an electronic money institution. The legal basis for these conditions can be found in the relevant Articles of Directive 2000/46/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions. Issuance of alternative forms of money implies several risks (among other things, the creation of electronic cash without a corresponding counter value, the alteration of valid amounts on an electronic payment instrument, and the like). The nature and degree of certain risks may adversely impact the stability of a financial system and smooth operation of payment systems.

Banking supervision is also performed pursuant to lower-level standards, namely through licensing and prudential banking decrees.

The Banking Supervision Division re-evaluated all the issued decrees still in force and developed a plan for their modification or amendment. This mainly concerns decrees relating to prudential banking; licensing decrees would only be amended pursuant to the amendment of the Banking Act.

In addition, new prudential banking decrees on risk management systems are under preparation and scheduled to take effect in the years 2004 to 2005.

MAIN STRATEGIC OBJECTIVES AND THE ACTIVITIES OF THE SUPERVISORY AUTHORITY IN 2003

In 2003, the situation in the banking sector stabilized as a result of achievements made by banks in 2002, when, inter alia, the yield on assets improved, competition in the market for banking products increased and the fulfilment of prudential banking indicators made a positive trend. As regards this last area, a qualitative shift occurred in the period under review in terms of the calculation of capital adequacy, where with the Decree on capital adequacy coming into force on 1 January 2003, both credit risk and market risks began to be taken into account.

Several other decrees, amendments to acts, as well as laws and statutes of lower legal power also became effective in this period, which will definitely contribute to improved work of the entire banking supervision. Some other law amendments came into force on 1 January 2004.

Performance of inspections

Inspections	I. Q		II. Q		III. Q		IV. Q		2003	
	started	comp-leted	started	comp-leted	started	comp-leted	started	comp-leted	plan	actual
comprehensive	3		3	3	3	3	1	4	10	10
follow-up	1	1			2	2	1	1	4	4
targeted					1	1			0	1
total	**4**	**1**	**3**	**3**	**6**	**6**	**2**	**5**	**14**	**15**

INTERNATIONAL ACTIVITIES

Bilateral agreements on co-operation in the performance of banking supervision

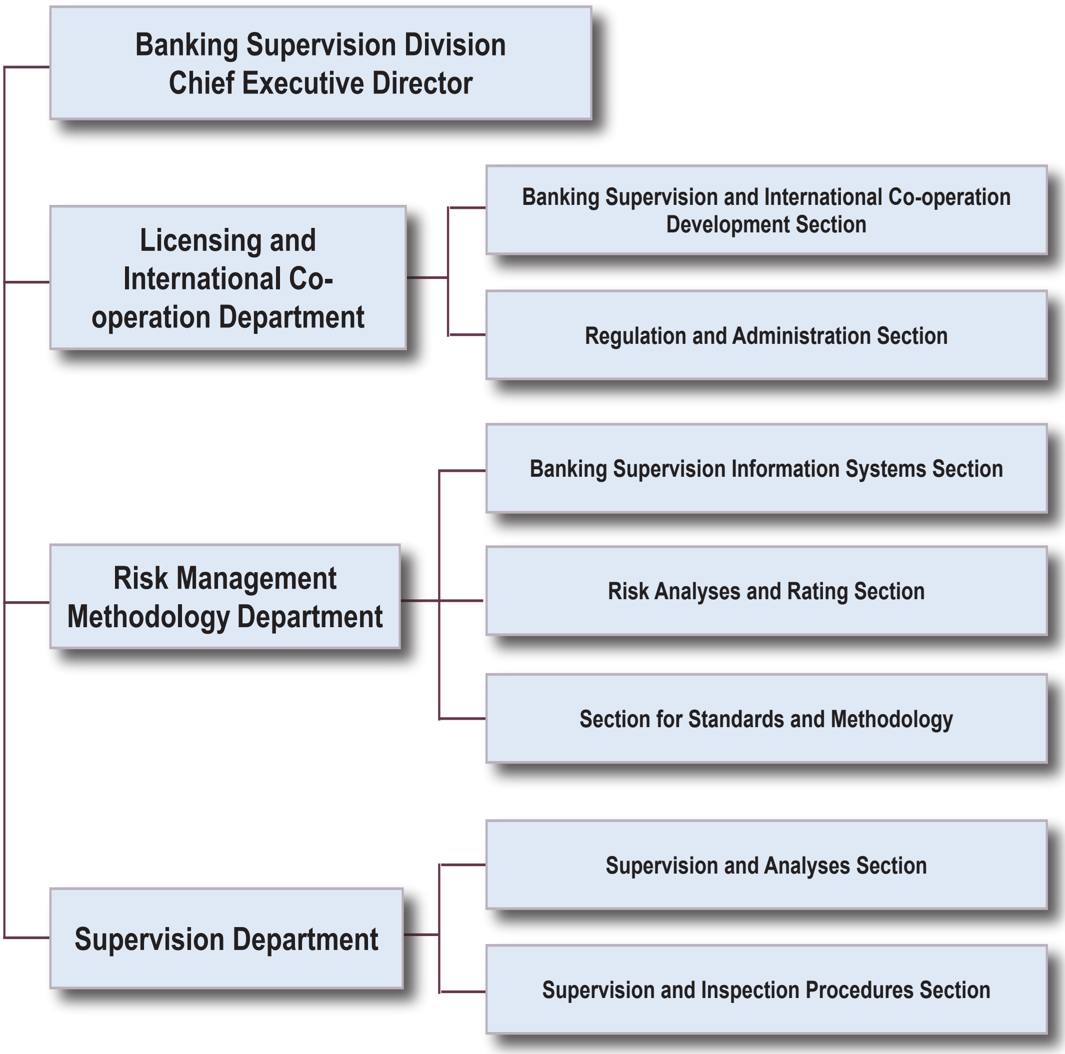
In 2003, there were Memoranda of Understanding concluded and signed between the National Bank of Slovakia and the following foreign supervisory institutions:

- De Nederlandsche Bank, the Netherlands signed on 17 February 2003
- Central Bank of Cyprus signed on 12 June 2003
- Austrian Federal Ministry of Finance and the Financial Market Authority signed on 1 December 2003

Memorandum with the Malta Financial Services Authority was signed on 12 February 2004.

Negotiations are currently underway in respect of the conclusion of Memoranda of Understanding with supervisory authorities of the following countries: Poland, Belgium, Latvia and Estonia.

ORGANISATIONAL CHART



STATISTICAL TABLES

Distribution of market shares in balance sheet total (%)

Type of the financial institutions	2000	2001	2002	2003
Joint stock companies	81.54	82.09	82.88	81.46
State financial institutions	2.37	1.78	0.00	0.00
Building savings banks	6.45	5.99	5.69	5.77
Branches	9.64	10.15	11.42	12.77
Financial institutions, total	**100.00**	**100.01**	**100.00**	**100.00**

The structure of assets and liabilities of the banking system (%) (at year-end)

Assets	2000	2001	2002	2003
Deposits and credits with banks	29.16	25.60	24.43	30.01
Granted credits	40.00	29.84	31.08	37.15
Securities	19.89	28.95	30.95	29.60
Tangible and intangible assets	10.95	15.61	13.55	3.24
Total assets	**100.00**	**100.00**	**100.00**	**100.00**
Liabilities	**2000**	**2001**	**2002**	**2003**
Deposits and credits from banks	18.44	17.59	19.93	14.10
Received deposits	70.72	71.54	69.97	75.51
Reserves	3.51	2.84	2.57	1.37
Initial capital	7.33	8.03	7.53	9.02
Total liabilities	**100.00**	**100.00**	**100.00**	**100.00**

Development of off - balance sheet activities (off-balance sheet liabilities / balance sheet total)

Type of the financial institutions	2000	2001	2002	2003
Joint stock companies	56.71	42.98	92.09	133.28
State financial institutions	3.56	2.57	0.00	0.00
Building savings banks	3.75	4.80	4.52	5.32
Branches	3.88	5.13	18.32	53.49
Financial institutions, total	**67.89**	**55.48**	**114.94**	**192.09**

Solvency ratio of financial institutions (%)

Type of the financial institutions	2000	2001	2002	2003
Joint stock companies	12.12	20.07	21.68	20.71
State financial institutions	34.80	11.58	0.00	0.00
Building savings banks	13.56	19.91	17.75	30.92
Branches	0.00	0.00	0.00	0.00
Financial institutions, average	**12.48**	**19.75**	**21.30**	**21.59**

Asset portfolio quality of the banking system

in mil. SKK

Asset classification	2000	2001	2002	2003
Substandard	6,880	6,260	7,335	6,812
Doubtfull	9,015	6,170	3,257	4,541
Loss	72,725	62,083	27,637	25,302
Classified total	**88,620**	**74,513**	**38,229**	**36,655**
Specific reserves	**70,968**	**62,268**	**29,609**	**28,974**

The structure of deposits and loans (%)
(at year-end)

	Deposits	Loans
Households	49.85	29.13
Government sector	20.10	5.11
Business sphere	29.38	64.99
Foreign	0.60	0.77
Other	0.07	0.01
Total	**100.00**	**100.00**

The structure of deposits and loans (%)
(at year-end)

Maturity of deposits		Maturity of loans	
At sight	36.22	Long term loans	40.89
Within one year	53.73	Medium-term loans	27.85
Over one year	10.05	Short-term loans	31.26
Total	**100.00**	**Total**	**100.00**

Concentration of assets by type of financial institutions
(at year-end)

Type of institutions	The first three largest (%)	The first five largest (%)
Bank	53.88	67.47
Credit cooperatives	x	x
Financial institutions	x	x
Savings cooperatives	x	x
Specialized credit institutions	x	x

Return on assets (ROA) by type of financial institutions

Type of institutions	2001	2002	2003
Bank	1.01	1.16	1.17
Credit cooperatives	x	x	x
Financial institutions	x	x	x
Savings cooperatives	x	x	x
Specialized credit institutions	x	x	x

Return on equity (ROE) by type of financial institutions

Type of institutions	2001	2002	2003
Bank	22.67	29.43	27.98
Credit cooperatives	x	x	x
Financial institutions	x	x	x
Savings cooperatives	x	x	x
Specialized credit institutions	x	x	x

Proportion of foreign exchange assets and liabilities (%)
(at year ends)

Type of the financial institutions	Foreign exchange assets / Total assets			
	2000	2001	2002	2003
Joint stock companies	18.00	19.13	13.89	16.42
State financial institutions	3.17	5.26	0.00	0.00
Building savings banks	0.35	0.35	0.35	0.37
Branches	36.74	26.49	13.05	11.15
Financial institutions, average	**18.32**	**18.51**	**13.02**	**14.82**

Type of the financial institutions	Foreign exchange liabilities / Total liabilities			
	2000	2001	2002	2003
Joint stock companies	16.02	17.50	14.66	15.34
State financial institutions	6.03	7.84	0.00	0.00
Building savings banks	0.03	0.03	0.05	0.05
Branches	32.12	27.82	26.04	47.36
Financial institutions, average	**16.30**	**17.31**	**15.64**	**19.04**

Structure of revenues and expenditures of banks
(at year-ends)

in th. USD(EUR)

Expenditures	2001	2002	2003
Expenses from banking operations	2,456,881	3,720,905	5,483,065
Operational expenses	451,688	584,341	620,742
Provisions and reserves	774,778	625,970	726,817
Other operational expenses	318,760	280,010	322,173
Extraordinary expenses	13,974	14,485	455
Income taxes	4,900	8,387	889
Revenues	**2001**	**2002**	**2003**
Income from banking operations	3,143,972	4,729,538	6,443,615
Provisions and reserves	1,004,087	725,020	847,123
Other operational income	32,873	30,820	137,956
Extraordinary income	27,209	32,570	377
USD	48,467	x	x
EUR	x	41,722	41,161

Structure of registered capital and own funds of financial institutions
(at year-end)

Type of the financial institutions	Registered capital	/Total assets	Own funds
	in mil. EUR	%	in mil. EUR
Joint stock companies	1,621.31	8.31	7,827.54
State financial institutions	0.00	0.00	0.00
Building savings banks	228.54	16.54	739.06
Branches	0.00	0.00	0.00
Financial institutions, total	**1,849.84**	**7.73**	**8,566.60**

SKK/EUR = 41.161

2003 DEVELOPMENTS IN THE SLOVENIAN BANKING SECTOR

MACROECONOMIC ENVIRONMENT

For the third year in a row economic growth in Slovenia was lower than the estimated potential growth, reaching just 2.3% in 2003. Value added grew most strongly in financial intermediation (5.7%), public administration (5.2%) and mining (5.1%), while it fell by 6.2% in agriculture and by 3.2% in the electricity, gas and water supply sector. This structure of growth shows the economy to have been under the influence of major changes on financial markets and relatively high employment growth in the public sector. Manufacturing exporters thus did not fully succeed in compensating for declining demand from traditional trading partners. In previous years they had plugged this gap with sales to former Yugoslav and Soviet republics and to other markets outside the EU. Given the economic downturn, wages grew relatively slowly, thanks primarily to low wage growth in the public sector. Average year-on-year growth in gross wages was 7.6%, or 1.9% in real terms. The employment trend in 2003 was rather slow-moving, or in line with the trend in economic activities. The number of unemployed in 2003 was down 4.8% from 2002, with the unemployment rate reaching 11.0% in December, somewhat lower than in December 2002 (11.3%). For the third year in succession employment grew fastest in real estate (5.4%), while employment growth was slightly slower in public administration (4.5%).

Inflation dropped significantly in 2003. Consumer prices rose by 4.6% measured from December 2002 to December 2003, or by 5.6% if measured on the basis of the average for each year. The reduction in inflation results from appropriate economic policies and a decline in inflationary pressures as a consequence of unfavourable economic conditions. The improvement in economic policy coordination has played an important role in bringing inflation down. The Bank of Slovenia maintained a relatively restrictive monetary policy enabling inflationary pressures of a monetary nature to be avoided, while the Slovenian Government kept administrative price growth within the inflation target and restricted pressure on inflation through fiscal adjustments. At the same time it also prevented volatility stemming from the international environment being passed on to domestic prices. The slowdown in economic growth, difficult labour market conditions and the absence of inflationary pressures from abroad also contributed to the reduction in inflation. Expectations of increased competition in the market for goods and services after Slovenia joins the European Union and ERM II have also resulted in a lowering of inflationary expectations and consequently of inflation.

In 2003 Slovenia had a current account surplus for the third year in a row, the surplus reaching EUR 17 million, or 0.1% of estimated GDP. The main factors influencing the reduction in the current account surplus compared with 2002, when it was EUR 330 million, were unfavourable trends in foreign goods trade in the context of higher domestic spending, and a fall in the surplus in trade in services. The surplus in current transfers decreased, while the fall of more than a third in net outward investment flows had a positive impact on the current account.

Preliminary figures put the general government deficit, which covers operations of the state budget, the municipal budgets and the treasuries of the Pension and Disability Insurance Institute and the Health Insurance Institute (compulsory insurance alone), at SIT 80 billion or 1.4% of estimated GDP. The state budget, the municipal budgets and the Health Insurance Institute all showed a deficit, but the Pension and Disability Insurance Institute showed a surplus.

Monetary policy conduct was oriented towards lowering inflation and achieving the earliest possible entry into the exchange rate mechanism (ERM II) and adoption of the euro. In November 2003 the Bank of Slovenia and the Slovenian Government adopted a joint programme for ERM II entry and adoption of the euro, in which they advocate entry into ERM II by the end of 2004 and creation of the conditions enabling the period within ERM II to be kept to a minimum and the euro to be adopted at the earliest opportunity. The Government and the Bank of Slovenia believe adoption of the euro will be possible at the beginning of 2007.

Modest domestic consumption, favourable balance of payments trends, lower inflationary expectations and the harmonisation of domestic economic policies allowed the Bank of Slovenia to lower the interest rates on its financial instruments several times, while maintaining real interest rates at a level that did not trigger an acceleration of domestic demand and consequently inflationary pressures. At the same time as lowering nominal interest rates the Bank of Slovenia also reduced the rate of growth in the tolar exchange rate. The exchange rate of the euro rose by 2.8% in 2003, while the exchange rate of the US dollar fell by 14.3%.

STRUCTURE AND OWNERSHIP OF THE BANKING SECTOR

The banking sector in Slovenia is the most important segment of Slovenia's financial system. Slovenia's banking sector is dominated by banks. At the end of 2003 banks formed 98.7% of the market as measured by total assets (up from 98.6% at the end of 2002), with savings banks and savings and loan undertakings making up the remainder. Savings banks formed 0.4% of the market (0.3% at the end of 2002), and savings and loan undertakings 0.9% (1.1% at the end of 2002).

In 2003 there were 20 banks operating in Slovenia, the same as on 31 December 2002. Of the 20, five were subsidiaries of foreign banks and one was a branch office of a foreign bank. In addition to the six banks under majority foreign ownership, there were seven wholly domestically owned and seven more under majority domestic ownership (of the seven under majority domestic ownership, three had less than 1% foreign equity capital).

Neither were there any changes to the savings banks in 2003. At the end of the year, as in 2002, there were two savings banks in operation. The number of savings and loan undertakings continued to fall, the reason being the need to bring their operations into line with the Banking Act. There were 25 savings and loan undertakings in operation at the end of 2002, but just eight at the end of 2003. During the last two years a large number of savings and loan undertakings amalgamated with the Association of Savings and Loan Undertakings, and to a lesser degree savings and loan undertakings were taken over by banks or underwent voluntary liquidation and bankruptcy.

There were only minor changes in ownership structure in 2003. The share of foreign equity did not change from end-2002 and amounted to 32.5%. Foreign shareholders are mostly from Austria, France, Italy and Belgium. Although most of foreign subsidiaries and a branch have Austrian owners, the equity capital of the Belgium bank KBC is dominant.

With the partial privatisation of Nova Ljubljanska banka, the share of state ownership in that bank and in the overall banking system decreased. The sale of 39 per cent of the government share in Nova Ljubljanska banka in summer 2002 turned the government from the majority owner to a minority one. The target ownership structure of Nova Ljubljanska banka (1/3 state, 1/3 strategic investor and 1/3 portfolio investors) was achieved. In case of Nova Kreditna banka Maribor (NKBM), the Government's privatisation programme approved in May 2001 envisaged the sale of a 65% shareholding to a foreign strategic partner. After carefully assessing three offers and holding talks with the bidders, the committee set up to direct and oversee the NKBM sale process came to the conclusion that none of the bids met all of the objectives established for the privatisation. In April 2002 the Government endorsed the committee's decision to suspend the sale of the 65% stake. The NKBM Management Board drew up a programme for the implementation of the bank's strategy, a central element of which is a linkage with Poštna Banka Slovenije, in which the Slovenian state owns 55% directly and the rest indirectly through the Slovenian Post Office. The Ministry of Finance is simultaneously studying the possibility of creating a broad financial pillar based around NKBM. The country's second-largest bank NKBM, and the 11th-largest bank, Poštna banka Slovenije d.d., remain under majority state ownership.

Total assets of banks, savings banks and savings and loan undertakings are rising annually as a proportion of GDP. The aggregate total assets of all credit institutions (banks, savings banks and savings and loan undertakings) accounted for almost 81 per cent of GDP at the end of 2003.

The Slovenian banking sector is characterised by a high concentration of banks. The largest bank in Slovenia, Nova Ljubljanska banka, represented 34 per cent market share at end-2003. Together with the banks, which belong to the Nova Ljubljanska banka banking group, the market share amounted to around 38 per cent. The second largest bank (NKBM) accounted for almost 11 per cent, and the third largest bank, Abanka Vipa amounted to 8.6 per cent. The market share of the five largest banks, measured by total assets, amounted to more than 67 per cent at the end of 2003. The market share of the seven largest banks accounted for more than 78 per cent at end-2003. The market share of majority foreign-owned banks has been increasing (At end-2002: 16.9 per cent, at end-2003: 18.9 per cent).

BANK PERFORMANCE IN 2003

Since savings banks and savings and loan undertakings have only a 1.3% combined market share in terms of total assets, this section on the bank performance focuses exclusively on banks.

The **total assets** of the banking system grew by 11 per cent in nominal terms as at 31 December 2003 in comparison to 31 December 2002. The total assets stood at SIT 5,057.5 billion (EUR 21.4 bn at the exchange rate of 31 December 2003). Nominal total asset growth of individual banks ranged from - 40.5%[26] to 52.8%. There was notably high growth in the total assets of the banks under majority foreign ownership, which with one exception had nominal growth in excess of 30%, and low growth in the total assets of the largest banks.

Bank credit activity was lively in 2003, with banks lending more to non-financial companies and other financial institutions, and significantly less to the state. The faster fall in lending rates brought about a squeeze in interest margins and as a consequence lower earnings for banks from net interest.

Banks ended the 2003 financial year with pre-tax profits of SIT 47.8 billion and after-tax profits of SIT 31.3 billion. Two banks ended 2003 with a loss. The **return on average assets** was 1.0% in 2003, slightly lower than in 2002 (1.1%). After rising in 2002 (because of slower equity growth as a result of the absence of a general capital revaluation in 2002), **the return on equity** was somewhat lower in 2003 at 12.5% (in 2002: 13.3%). The **net interest margin** (expressed as the ratio of net interest income to average gross interest-bearing assets) was 3.2% in 2003, and is continuing to fall because of the real decline in net interest. It was 0.5 percentage points lower than in 2002. The ratio of operating expenses to average assets has been decreasing steadily. Operating expenses grew by 6.9% in nominal terms in 2003, average total assets in 2003 were up 15.2% in nominal terms on the previous year. At end-2003 the ratio operating expenses to average assets amounted to 3%.

Banks' capital at the end of 2003, calculated in accordance with the Regulation on Capital Adequacy of Banks and Savings Banks, stood at SIT 364.6 billion, representing a **capital adequacy ratio** of 11.6% on risk-weighted assets of SIT 3,146.5. The capital adequacy ratio decreased as at 31 December 2003 in comparison with 31 December 2002 by 0.3 percentage points. The reason for the falling capital adequacy ratio is faster growth of risk-adjusted assets than of regulatory capital. At the end of 2003 three banks had a capital adequacy ratio lower than 10 per cent, of which one failed to meet the prescribed ratio of 8 per cent. An order of the Bank of Slovenia was issued to the bank, in line with which the bank had to attain the required capital adequacy ratio by the end of April 2004.

[26] The bank with a decrease in total assets went into liquidation on 29 December 2003.

The **quality of loan portfolio** has not changed much over the past few years. The share of performing on- and off-balance sheet items (claims classified in categories A and B) has ranged between 93 and 96 per cent (the share of non-performing assets has ranged between 4 and 7 per cent).

The new Slovenian Accounting Standards, which entered into force as at 1 January 2002, indirectly affected the concept underlying the classification of assets, provisioning and the exclusion of income. The principal change is that under Slovenian Accounting Standards investments in securities and investments in capital are valued at fair value and are thus not classified, while all other claims are classified into groups A, B, C, D and E.

LEGAL AND INSTITUTIONAL FRAMEWORK FOR SUPERVISION OF FINANCIAL INSTITUTIONS

In Slovenia several supervisory authorities are responsible for supervision and surveillance of individual segments of the financial system. The history of three supervisory authorities in Slovenia is not very long. The oldest and most developed domestic supervisor of financial sector is the Bank of Slovenia i.e. Banking Supervision Department which was created 12 years ago.

Slovenia's central bank, the Bank of Slovenia, is an independent institution that carries out the tasks conferred upon it by the Bank of Slovenia Act. Supervision of banks, savings banks and savings and loan undertakings is one of the tasks of the Bank of Slovenia. The responsibility for the implementation and enforcement of the Bank of Slovenia's supervisory function is conferred upon the Banking Supervision Department.

The Securities Market Agency is a self-governing and independent legal entity with full power to supervise stock-broking companies, investment funds (authorised investment companies, investment companies and mutual funds), mutual pension funds, investment fund management companies and mutual pension fund operators, as well as some other institutions (the Central Securities Clearing Corporation, Ljubljana Stock Exchange, etc.). 38 people are responsible for supervision of 27 stock-broking companies[27], 18 authorised investment companies, 8 investment companies, 20 mutual funds, 5 mutual pension funds, 19 investment fund management companies and 5 mutual pension fund operators.

The Insurance Supervision Agency became operational on 1 June 2000 as a self-governing and independent legal entity whose responsibility is the supervision of insurance companies, reinsurance companies, companies and agents who engage in insurance-related activities, as well as some other institutions (the Slovenian Nuclear Insurance and Reinsurance Pool, the Slovenian Insurance Association – guarantee fund, the Slovene Export Corporation - insurance operations, Kapitalska družba pokojninskega in invalidskega zavarovanja - Pension Fund Management - voluntary pension insurance).

[27] Including 11 banks authorised to engage in securities trading.

Prior to the establishment of the Insurance Supervisory Agency, the above-mentioned institutions were under the scrutiny of the Insurance Supervision Authority of the Republic of Slovenia operating within the framework of the Ministry of Finance. The Insurance Supervisory Agency has 28 employees responsible for supervision of 14 insurance companies and some other institutions.

The Banking Supervision Department of the Bank of Slovenia comprises three separate units:

- Licensing
- Off-site supervision of banking operations
- On-site supervision of banking operations

The nucleus of the Banking Supervision Department was a 17-strong staff that increased by the end of June 2004 to 53 people. The breakdown of the headcount at end-June 2004 shows that there are 8 people in the management of the department, 20 employees work in the off-site supervision unit, 22 people are engaged in on-site examinations, while 3 employees handle licensing issues.

Core tasks carried out by individual units of the Banking Supervision Department

Granting authorisations (Licensing):

- Preparation of secondary legislation that governs licensing requirements
- Advising on the implementation of secondary legislation that governs licensing requirements
- Processing applications and the preparation of reports for two committees of the Bank of Slovenia
- Drafting decisions and explaining grounds for the decisions taken
- Monitoring of the enforcement of the decisions issued.

Off-site supervision:

- Drawing up the legal framework for the carrying out supervision and surveillance of credit institutions
- Monitoring international recommendations and standards in the field of supervision
- Counselling in the implementation of banking legislation
- Preparation of instructions with regard to implementation of accounting standards and accounting counselling
- Controlling operations carried out by credit institutions on the basis of prudential reports and statutory returns

- Corrective actions launched with the aim of resolving non-compliance identified in operating activities of credit institutions, and monitoring of implementation of such corrective actions
- Analysis of bank performance
- Co-operation with domestic and international institutions
- Participation in the preparation for on-site examinations in credit institutions
- Legal counselling
- Electronic data processing and other related services.

On-site supervision:

- Preparatory activities leading to on-site examination on the basis of prudential reports and other statutory returns of credit institutions
- On-site examinations of credit institutions, elaboration of reports and proposals for corrective measures
- Implementation of corrective measures designed to mitigate deficiencies that have been detected in operations of credit institutions
- Monitoring of the enforcement of corrective measures taken against credit institutions
- Preparation of measures aimed at preventing deterioration in the financial position of credit institutions
- Assessing conditions for instituting special administration in credit institutions
- Assessing conditions for liquidation and bankruptcy of credit institutions
- Governing and managing credit institutions in special cases
- Co-operation with local and foreign supervisory authorities
- Co-operation with chartered accountants/certified auditors, etc.

ACTIVITIES OF THE BANKING SUPERVISION DEPARTMENT IN 2003

Issuing authorisations to credit institutions is one of the Bank of Slovenia's most important responsibilities. As well as authorisations to provide banking services and other financial services, the Bank of Slovenia issues authorisations for acquiring a qualifying shareholding, undertaking a merger or an acquisation, establishing a branch abroad, establishing a branch of a foreign bank in Slovenia, establishing a representative office of a foreign bank, and serving as a member of a bank's management board. Decisions to grant or refuse an authorisation were taken in 2003 by the Governing Board of the

Bank of Slovenia on the basis of an opinion Banking Supervision Department experts, except in the case of authorisations to serve as a member of a management board, where the decision is based on an opinion by a committee of the Governing Board.

	Type of authorisation	2002		2003	
		Granted	Refused	Granted	Refused
1	Authorisation to provide banking services	0	0	0	0
2	Authorisation to provide other financial services	4	2	13	0
3	Authorisation to a foreign bank to establish a branch	0	0	0	0
4	Authorisation for a merger of a bank or a savings bank	1	0	0	0
5	Authorisation to a foreign bank to establish a representative office	0	0	0	1
6	Authorisation to acquire a qualifying holding	3	2	6	2
7	Authorisation to serve as a member of a management board	20	0	4	0
	Total	**28**	**4**	**23**	**3**

Off-site analysts continuously monitor the bank performance on the basis of statutory returns and information and monitor compliance with prudential regulations. They are involved in preparing documentation for the issue or variation of authorisations for different types of activities of credit institutions, evaluate proposed new systemic solutions, advise on the implementation of standards of safe and sound banking, are involved in preparations for on-site examinations in credit institutions and in discussions with the management of credit institutions and meetings with other institutions, compile various written documents for bodies of the Bank of Slovenia, etc. On discovering a departure from the normal activity of a credit institution, analysts immediately notify the inspectors and management of the Banking Supervision Department, who may accordingly decide to launch an on-site examination of the institution concerned.

On discovering an irregularity in the conduct of a credit institution, both analysts and inspectors take appropriate action and monitor the remedial steps taken.

A credit institution may be examined more than once in a given year. The scope of the examination is determined on the basis of prior information and analysis of the institution's activities, initiated by the management of the Bank of Slovenia or by external bodies. Risk assessments in the area of IT constitute a special area of examination. The examinations permit an in-depth investigation of areas of heightened risk or areas in which the Bank of Slovenia lacks adequate information or data.

In view of the fact that the most significant source of risk at credit institutions is credit risk, the emphasis in an examination is on the appropriate classification of on- and off-balance-sheet items. Special attention is given to consolidated supervision – the examination of a bank and its connected parties. In on-site examinations of credit institutions during 2003, inspectors from the Banking Supervision Department, in addition to the standard areas of examination, focused particularly on supervision of capital and capital adequacy, management of market risk and other risks, implementation of the Consumer Loans Act, implementation of the Prevention of Money Laundering Act, corporate payment systems and information technology. In the first half of 2003 Bank of Slovenia inspectors also supervised banks' readiness to convert personal accounts into transaction accounts.

In addition to 11 full-scope examinations (seven banks, one savings bank, and three savings and loan undertakings), there were 25 partial examinations undertaken on banks and savings banks (including savings and loan undertakings) and other companies in relation to specific areas of activity, excluding examinations of IT systems in 2003. Examinations of IT systems were included in full-scope examinations or were undertaken as independent examinations.

The Bank of Slovenia's supervisory powers extend to other persons suspected of providing banking services without authorisation from the Bank of Slovenia. In 2003, on the basis of referrals from relevant government institutions (primarily the Ministry of the Economy and the Market Inspectorate of the Republic of Slovenia) or at the instigation of members of the Governing Board of the Bank of Slovenia, Bank of Slovenia inspectors undertook 9 on-site examinations of companies suspected of engaging in business activities without the appropriate Bank of Slovenia authorisation. The Bank of Slovenia reported one company to a misdemeanours judge.

In line with the Core Principles for Effective Banking Supervision, the Banking Supervision Department of the Bank of Slovenia maintains regular contacts with the management of banks and savings banks, through channels including regular annual meetings held at the completion of full-scope examinations or specially. These meetings are primarily devoted to assessing the bank performance and learning about its strategy.

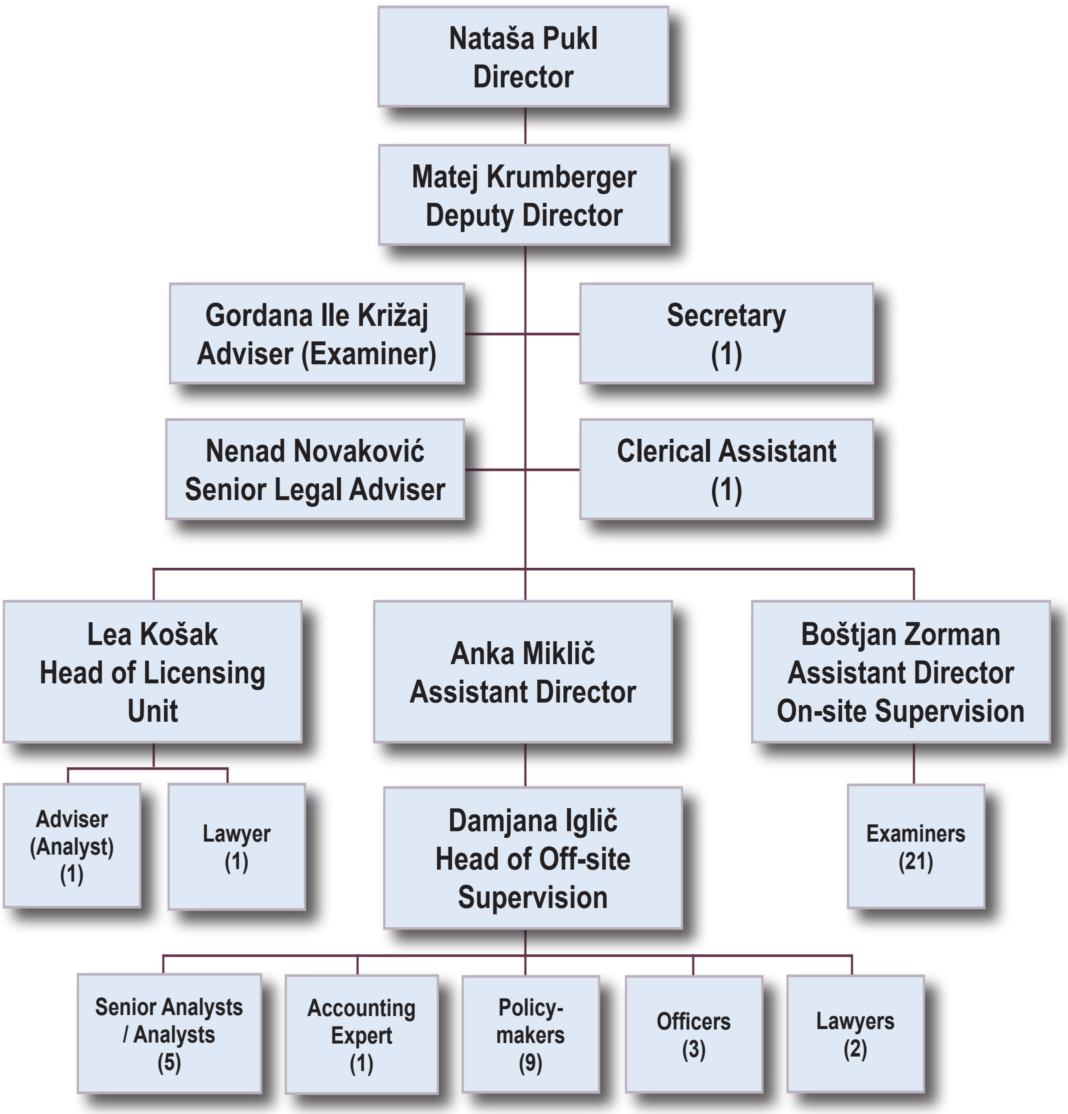
CO-OPERATION WITH OTHER DOMESTIC SUPERVISORY AUTHORITIES

In accordance with the Code of Practice for the co-operation between domestic supervisory authorities a co-ordinating body headed by the Minister of Finance has been established. The Governor of the Bank of Slovenia, the President of the Council of Experts of the Securities Market Agency, and since September 2000, also the President of the Council of Experts of the Insurance Supervision Agency are members of the co-ordinating body.

In addition, the commission for co-operation between domestic supervisory authorities monitors the issues in relation to the implementation of financial regulations and reports to the co-ordinating body. The commission for co-operation between domestic supervisory authorities consists of the Deputy Governor of the Bank of Slovenia, the Director of the Banking Supervision Department, the Director of the Securities Market Agency and the Director of the Insurance Supervision Agency.

There are memoranda of understanding (MoUs) between the Bank of Slovenia and the Securities Market Agency and the Bank of Slovenia and the Insurance Supervision Agency. In addition, a MoU was signed between the Securities Market Agency and the Insurance Supervision Agency.

MoUs include the details of the nature and method of collaboration between the signatories, as well as the channels for the dissemination of information. Supervisory authorities must notify one another concerning irregularities they find in the course of supervision, if such findings are also important for other supervisory authorities. Supervisory authorities must fulfil the professional secrecy requirements regarding information that they obtain and may use the information only for the purposes for which it was obtained.



CO-OPERATION WITH FOREIGN SUPERVISORY AUTHORITIES

BANKA SLOVENIJE

To date the Bank of Slovenia has concluded memoranda of understanding with the following regulatory institutions:

- January 2000: the State of New York Banking Department (because LBS, a subsidiary of the largest bank in Slovenia, is no longer owned by the bank, the memorandum is no longer required)
- January 2001: Austria's Bundesministerium für Finanzen (the Austrian Federal Ministry of Finance, which on 1 April 2002 merged with other financial sector regulators to form the Austrian Financial Market Authority or Finanzmarktaufsicht)
- April 2001: Germany's Bundesaufsichtsamt fur das Kreditwesen (the Federal Banking Supervisory Office, which on 1 May 2002 merged with other financial sector regulators to form the German Financial Supervisory Authority or Bundesanstalt für Finanzdienstleistungsaufsicht)
- June 2001: the National Bank of the Republic of Macedonia
- November 2001: Bosnia-Herzegovina's Banking Agency (a Bosnian Federation and Republika Srpska authority) and the Central Bank of Bosnia-Herzegovina
- November 2001: the Bank of Italy
- October 2002: France's Commission Bancaire (the French Banking Commission)
- August 2003: Belgium's Commission Bancaire et Financiere (the Banking and Finance Commission)
- October 2003: the Central Bank of Montenegro
- December 2003: the Bulgarian National Bank
- June 2004: the National Bank of Serbia.

There has been a substantial progress in consolidated supervision of subsidiaries and branches of banks abroad. As regards the exchange of information, the same rules apply as for the exchange of information between domestic supervisory authorities.

STATISTICAL TABLES

BANKA SLOVENIJE

Number of credit institutions*
(at year-end)

Type of credit institution	2000	2001	2002	2003
Banks	25	21	20	20
Savings banks	3	3	2	2
Savings and loan undertakings	64	45	25	11
Credit institutions, total	**92**	**69**	**47**	**33**

** The amount of initial capital for banks is set at SIT 1.2 billion, the amount of initial capital for savings banks and savings and loan undertakings is set at SIT 245 million*

Ownership structure of banks on the basis of shareholders' equity (%)

Item	2000	2001	2002	2003
Central Government	36.8	37.0	20.3	19.4
Other domestic ownership	51.2	47.0	47.2	48.2
Domestic ownership total	88.0	84.0	67.5	67.6
Foreign ownership	12.0	16.0	32.5	32.5
Bank, total	**100.0**	**100.0**	**100.0**	**100.0**

Distribution of market shares measured by total assets (%)

Type of credit institution	2000	2001	2002	2003
Banks	97.8	98.1	98.6	98.7
Savings banks	0.4	0.4	0.3	0.4
Savings and loan undertakings	1.8	1.6	1.1	0.9
Credit institutions, total	**100.0**	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

Assets	2000	2001	2002	2003
Cash and balances with CB	3.2	5.3	3.1	2.8
Loans to banks	11.7	10.2	8.4	6.8
Loans to customers	52.3	49.4	47.9	50.2
Securities	25.4	28.6	34.0	34.0
Other assets	7.5	6.5	6.6	6.2
Liabilities				
Deposits from banks	12.8	11.7	12.8	16.5
Deposits from customers	69.0	71.2	69.1	65.1
Liabilities from securities	2.2	2.9	3.9	4.3
Capital and subordinated liabilities	11.4	9.8	9.9	10.2
Other liabilities	4.6	4.5	4.3	3.9

Development of off-balance sheet activities (%) (off balance sheet items / total assets)

Type of credit institution	2000	2001	2002	2003
Banks	22.5	21.2	19.7	20.9
Savings banks	0.3	0.4	1.0	1.0

Solvency ratio of credit institutions

Type of credit institution	2000	2001	2002	2003
Banks, average	13.5	11.9	11.9	11.5
Savings banks, average	11.3	11.1	9.2	8.8

Assets portfolio quality of the banking system

in SIT millions

Assets Classification	2000	2001	2002	2003
A	2,418,844	2,755,349	2,943,971	3,363,863
B	266,315	348,333	467,919	522,938
C	75,507	91,012	113,470	119,360
D	53,692	62,188	63,434	70,428
E	56,572	78,947	79,483	81,870
Classified Total	**2,870,931**	**3,335,829**	**3,668,276**	**4,158,459**
Specific Provisions	**168,175**	**212,079**	**228,868**	**244,902**

The structure of deposits and loans as at 31 December 2003 (%)

	Deposits	Loans
Households	64.9	24.8
Government sector	4.8	5.6
Corporate	18.8	62.9
Foreign	2.4	2.6
Other	9.1	4.1
Total	**100.0**	**100.0**

BANKA SLOVENIJE

The structure of deposits and loans by maturity as at 31 December 2003 (%)

Deposits	
At sight	33.8
Within one year	57.3
Over one year	8.9
Total	100.0
Loans	
Long-term loans	47.2
Medium-term loans	
Short-term loans	52.8
Total	**100.0**

Proportion of foreign exchange assets and liabilities (at year-end)

Type of credit institution	Forex assets / Total assets				Forex liabilities / Total liabilities			
	2000	2001	2002	2003	2000	2001	2002	2003
Banks	33.5	34.4	33.0	33.4	34.9	35.3	33.9	34.6
Savings banks	0.3	0.3	0.1	0.1	0.0	0.0	0.0	0.0

Profit and loss account of banks

	2000		2001		2002		2003	
	SIT million	USD million	SIT million	USD million	SIT million	USD million	SIT million	USD million
Net interest income	126,134	555	115,930	462	143,407	649	145,678	769
Net fees and commissions	37,858	166	41,523	165	53,962	244	54,907	290
Net financial operations	14,442	64	20,805	83	21,205	96	19,490	103
Net other	-8,193	-36	-5,080	-20	5,808	26	8,862	47
Gross income	**170,240**	**749**	**173,179**	**690**	**224,382**	**1,015**	**228,937**	**1,209**
Operating expenses	100,436	442	112,949	450	133,914	606	143,169	756
- labour costs	48,717	214	53,181	212	66,169	299	72,015	380
Net income	**69,804**	**307**	**60,230**	**240**	**90,467**	**409**	**85,768**	**453**
Net provisions and write-offs	-37,233	-164	-44,783	-178	-44,450	-201	-38,006	-201
Profit before taxation	**32,571**	**143**	**15,447**	**62**	**46,017**	**208**	**47,762**	**252**

Structure of registered capital and own funds of credit institutions (as at 31 December 2003)

Type of credit institution	Registered capital	in Total assets	Own funds	in Total liabilities
	USD million	%	USD million	%
Banks	433.7	1.6	1,919.4	7.2
Savings banks	4.1	3.9	7.0	6.7

Ownership structure of the financial institutions on the basis of total assets

Item	2001	2002	2003
Central Government	41.6	24.9	23.8
Other domestic ownership	42.0	40.4	40.2
Domestic ownership total	*83.6*	*65.4*	*64.0*
Foreign ownership	16.4	34.6	36.0
Bank, total	**100.0**	**100.0**	**100.0**

Concentration of assets by the type of credit institutions (%) (as at 31 December 2003)

Type of credit institution	The first three largest	The first five largest
Banks	53.3	67.4
Savings banks	100.0	
Savings and loan undertakings	90.7	96.8

Return on asset (ROA) by type of credit institutions

Type of credit institution	2001	2002	2003
Banks	0.45	1.11	1.00
Savings banks	1.62	0.94	1.04
Savings and loan undertakings	-0.77	-2.18	0.68

Return on equity (ROE) by type of credit institutions

Type of credit institution	2001	2002	2003
Banks	4.77	13.30	12.47
Savings banks	17.31	12.02	15.42
Savings and loan undertakings	-9.34	-29.30	11.77

2003 DEVELOPMENTS IN THE UKRAINEN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN UKRAINE

In 2003 the tendency of macroeconomic performance growth in Ukraine persisted. The real gross domestic product increased by 9,3% for 2003.

The industrial output increased by 15.8%. A higher than average growth rate of production in industry was observed in the branches oriented to satisfy the investment demand of enterprises and consumer demand of the population of Ukraine; in machinery construction – by 35,8%, in food industry and processing of agricultural products – by 20,0%.

The total volume of direct investments in Ukraine by the end of 2003 increased in comparison with the beginning of the year by 27,5% and made USD 7,5 bln., including: USD 7,1 bln. – stock capital and reinvested profits, USD 0,4 bln. – credits that were granted by the direct foreign investors.

The dynamics of real efficient rate of exchange was favorably stable for Ukrainian exporters.

The current account surplus was kept at a rather high level - USD 2,9 bln. or 5,9% of GDP in 2003. Exports of goods and services increased in comparison with the previous year by 24,0%, imports – by 28,7%.

During 2003 the situation of foreign exchange market in Ukraine was stable.

For the reported year the National Bank of Ukraine continued to carry out interventions in the interbank foreign exchange market by retiring the extra supply of foreign currency. As a result the reserve assets increased by USD 2 bln. and by the end of the year made USD 6,9 bln.

The nominal income of the population for 2003 in comparison with the previous year increased by 13,7% while the real income – by 5,8%.

STATE OF THE BANKING SYSTEM

As of January 1, 2004, 158 banks operated in Ukraine including: 133 joint-stock company banks, out of them 94 – open joint-stock companies (including 2 state participation banks), 39 – closed joint-stock companies; 25 banks – limited liability companies.

As of 01.01.2004, 19 banks with foreign capital participation operated in Ukraine, including 7 with 100% foreign capital. In 2003 the share of foreign capital within the registered authorized capital decreased from 13,7% to 11,3% or by 2,4 percentage points as a result of the fact that the foreign capital increased slower in comparison with the rates of growth of the total volume of banks' authorized capital.

In 2004 in functioning and development of the Ukrainian banking system there were observed the tendencies that evidence its strengthening and reinforcement of its favourable influence on the socioeconomic development of the country.

The total volume of banks' capital increased by 31,4% and that of the authorized capital – by 35,3%.

The average amount of the authorized capital per 1 operating bank increased in 2003 by 34,6%.

As of 01.01.2004 the number of the banks with the amount of the regulatory capital more than EUR 5 mln. was 120 (76% of the total number of operating banks), including with the capital above EUR 10 mln. – 45 (28,5% of the total number of operating banks).

The total amount of banks' liabilities increased by 62%. In their structure the highest rate of growth the deposits of natural persons (by 68,2%) had, which are the main source for formation of the base of resources.

Their share within the total liabilities made 36,8% against 35,4% in 2002. That testifies to the increase of the population confidence in the banking system and growth of the possibilities to transform the funds attracted from the population to credits and investments in the country economy.

The volume of the total banks' assets increased by 55.7%. The growth of the banks' assets was due mainly to the credit portfolio increase that made 57,1%. The indebtedness under the loans granted to economic entities grew by 51.8% and made 78.9% as of 01.01.2004. At that, the highest rate was observed in the long-term loans that grew 2,6 times (in the same period of the previous year – 1,9 times), and their share within the credit portfolio increased from 22,9% to 38,35%. The credits for investment activity increased by 74.3%.

The bank activity became more and more socially oriented. The credits, granted to natural persons in 2003 increased 2.7 times and their share within the credit portfolio increased from 7.0% to 12.1%.

The rehabilitation of the banking system took place owing to liquidation and reorganization of the insolvent and financially unstable banks. During 2003, 8 banks were excluded from the State Register, including 7 – due to the liquidation procedure completion and 1 – owing to reorganization by means of merger with another banks as a branch. In the same period 5 new banks were registered.

LEGAL AND INSTITUTIONAL FRAMEWORKS FOR BANKING AND SUPERVISION OF FINANCIAL INSTITUTIONS

The Laws "On Banks and Banking" and "On the National Bank of Ukraine" constitute the legal framework for the banking activities.

In accordance with the mentioned laws, the regulation of banking activities and banking supervision is performed in Ukraine by the National Bank of Ukraine being a special central body of the public administration.

The General Banking Supervision Department operates as an organizational unit of the National Bank of Ukraine and in 2003 it consisted of the following subdivisions:

- Department for Banking Supervision Methodology and Planning;
- Department for State Registration and Licensing of Banks;
- Department for Off-Site Supervision and On-Site Inspection;
- Department for Work with the Problem Banks.

In March of 2004 instead of Department for Banking Supervision Methodology and Planning established were the Department for Banking Supervision Strategic Development and an independent Office for Banking Supervision Methodology.

ACTIVITY OF BANKING SUPERVISION BODIES IN 2003

In 2003 the National Bank of Ukraine continued the work on putting the legal and regulatory frameworks in the matters of regulation and supervision in line with the Law of Ukraine "On Banks and Banking" with taking into account the Core Principles of Effective Banking Supervision developed by the Basel Committee for Banking Supervision.

Practical implementation of the National Bank of Ukraine provisions continued.

Four new subordinate legislation acts were developed and approved, on the following matters:

- basic activity principles of the Committee on Certification of Banks' Auditors;
- certification of banks' auditors;
- procedure of submitting auditors' reporting (auditor's opinion) to the National Bank of Ukraine after the annual audit of the financial statements;
- procedure for determination of the fair value and value deterioration of securities.

Made were 24 amendments to 12 regulations of the National Bank of Ukraine (NBU) in the part referring to:

- clarification of the list of the documents confirming the origin of natural person's (bank partner's) funds as well as strengtheining the requirements to bank managers;
- settlement of the issue on obtainment of the NBU written permission (certificate) to hold an essential share in a parent (main) bank by a bank

holding group and participants in a banking corporation whose share within the authorized capital of the banking corporation makes 10, 25, 50, 75 per cent;

- strengthening the requirements to non-bank financial institutions with regard to obtainment of licenses to perform certain banking transactions by them;
- raising the value of the capital adequacy ratio from 8% to 10%;
- the procedure of granting loans in the amounts exceeding 25% of the maximum credit risk normative per one counterpart;
- setting up the normative value of the total investment amount for specialized clearing banks – not more than 10%;
- supervision of the banks on the basis of consolidated financial statements and calculation of economic indicators on the consolidated basis;
- prevention of using banks and other financial institutions with the aim of laundering the income obtained in a criminal way;
- improvement of credit risk provisioning;
- supplementation of the factors constituting the basis for evaluation of the risks in activities of a bank, etc.

Another area of banking supervision work was performance of the off-site monitoring and inspections of banks.

During 2003 about 1 600 inspections of banks and banking institutions were done by the National Bank of Ukraine banking supervision function.

During the inspections examined were the authenticity of banks' reports, observance of the laws and NBU regulations by banks. Special attention was paid to the matters of capitalization, efficiency of the systems in place at banks to manage the risks typical for banking, evaluation of the management level, internal controls, adequacy of provisioning for operations with assets, availability in banks of the necessary rules and procedures for counteraction against the banking fraud, legalization of the funds obtained in an illegal way, financing of the terrorism.

Depending on the inspection results each bank got a rating by CAMELS system and adequate measures of influence were used, if necessary.

LEGISLATIVE POWERS OF THE BANKING SUPERVISOR IN THE COUNTRY

The National Bank of Ukraine performs state regulation of banking in the forms of the administrative and indicative regulation.

Supervisory activities of the National Bank of Ukraine cover all banks, their subdivisions, affiliated and related persons thereof on the territory of Ukraine and abroad as well as other artificial and natural persons in the part relating to compliance with the requirements of the laws and regulations in force related to banking.

When performing the banking supervision, the National Bank of Ukraine has the right to demand from the banks and their managers to eliminate violations of banking laws in order to avoid or to overcome the undesirable consequences that may put into the danger safety of the funds trusted to these banks or harm the proper banking activity.

While performing the banking supervision, the National Bank of Ukraine has the right to use services of other institutions in accordance with separate agreements.

The National Bank of Ukraine performs the banking supervision on the individual and consolidated bases and uses the enforcement measures for infringement of banking law requirements.

CONSTITUENT DOCUMENTS FOR BANKING SUPERVISION ORGANIZATION

In 2003 the National Bank of Ukraine exercised the functions of banking regulation and supervision following the next legal acts and regulations:

- Regulations on the Order of Establishment and State Registration of Banks, Opening Their Branches, Representative Offices, Subbranches;
- Regulations on the Order of Granting the Banks the Banking Licenses, Written Permissions and Licenses to Conduct Some Operations;
- Instruction on the Order of Regulation and Analysis of Banks' Activities in Ukraine;
- Regulations on the Order of Formation and Usage of the Reserve for Covering Possible Losses in Crediting Transactions of Banks;
- Regulations of the Procedure for Formation and Usage of the Reserve for Covering Possible Losses under Receivables of Commercial Banks;
- Regulations on the Order of Calculation of the Reserve for Covering Possible Losses from Operations with Securities;
- Regulations on Applying by the National Bank of Ukraine the Enforcement Measures for Violation of the Banking Laws;
- Regulations on Planning and Way of Carrying Out Inspections;
- Methodological Instructions on Inspection of Banks in Ukraine;
- Rules for Registration of the Correspondent Accounts by the National Bank of Ukraine and Others.

INTERNATIONAL ACTIVITIES OF BANKING SUPERVISION

In 2003 the National Bank of Ukraine continued collaboration with the international organizations in the field of the control over the state of implementation of the banking sector reforming programs: with the World Bank under the project “Program Adjustment Loan to Ukraine“, with IMF in the context of the Program of Extended Fund Facility (EFF), with the IBRD on the grant for implementation of the program of financial sector reforming (Dutch grant TF 027889).

MAIN STRATEGIC GOALS OF BANKING SUPERVISION

The main goal of banking regulation and supervision is the safety and financial stability of the banking system, protection of the depositors’ and creditors’ interests.

The achievement of this goal is foreseen by the way of providing high efficiency of banking supervision and its compliance with the Core Principles of Effective Banking Supervision developed by the Basel Committee.

A number of tasks should be performed for this purpose, the main of them for the nearest future are:

- raising the banking system capitalization level;
- introduction of the risk-based supervision;
- introduction of consolidated supervision;
- drawing attention to the means of preventive control over banks and to the system of early warning;
- providing proper interaction of banking supervision and external bank auditors.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2001	2002	2003
Banks	152	157	158

Ownership structure of financial institutions on the basis of registered capital (%)
(at year-ends)

Item	2001	2002	2003
Public sector ownership	4.5	4.9	5.7
Other domestic ownership	82.0	81.4	83.0
Domestic ownership, total	*86.5*	*86.3*	*88.7*
Foreign ownership	13.5	13.7	11.3
Financial Institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of financial institutions on the basis of assets total

Item	2001	2002	2003
Public sector ownership	12.0	11.8	9.5
Other domestic ownership	76.2	75.7	78.1
Domestic ownership total	*88.2*	*87.5*	*87.6*
Foreign ownership	11.8	12.5	12.4
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions (%)

Type of institutions	The biggest three	The biggest five
Banks	27.3	38.1

Return on asset (ROA) by type of financial institutions

Type of institutions	2001	2002	2003
Banks	1.27	1.27	1.04

Return on equity (ROE) by type of financial institutions

Type of institutions	2001	2002	2003
Banks	7.50	7.97	7.61

The structure of assets and liabilities of the banking system (%)
(at year-ends)

Assets	2001	2002	2003
High liquidity assets	16.3	13.3	15.2
Credit portfolio	61.2	69.0	69.6
Investments into securities	9.0	6.5	6.2
Debt receivable, total	4.0	2.1	1.1
Main funds and non-material assets	7.6	7.3	6.2
Other assets	1.9	1.8	1.7
Total assets	**100.0**	**100.0**	**100.0**
Banks	**2001**	**2002**	**2003**
Banks liabilities	**100.0**	**100.0**	**100.0**
NBU facilities	2.8	2.4	2.7
Budget facilities and non-budget funds	3.9	3.2	1.3
Interbanks credits and deposits	10.9	11.9	12.4
Other facilities of economic activities entities	39.5	36.5	32.0
Individual persons deposits	28.1	35.4	36.8
Facilities of non-banks financial institutions	-	-	3.8
Credits granted by international and other financial organizations	1.1	1.5	1.0
Own debt securities	1.2	1.4	0.9
Subordinated debt	2.0	1.6	1.3
Creditor indebtedness for operations with banks and bank clients	2.9	1.6	1.9
Other liabilities	7.6	4.5	5.9

Development of off-balance sheet activities (%)
(off balance sheet items / balance sheet total)

Type of financial institution	2001	2002	2003
Banks	64.9	58.8	49.7

Solvency ratio of financial institutions

Type of financial institution	2001	2002	2003
Banks	20.69	18.01	15.11

Asset portfolio quality of the banking system (credit portfolio %)

Assets classification	2001	2002	2003
Standard credits	39.12	37.65	66.57
Under control	36.59	40.49	5.15
Substandard	14.77	14.68	21.06
Doubtful	3.64	3.05	4.56
Bad	5.88	4.12	2.67
Classified total	**100.0**	**100.0**	**100.0**
Specific reserves	**2,958.1**	**3,574.8**	**4,631.2**

The structure of deposits and loans in 2003 (%) (at year-ends)

	Deposits	Loans
Households	49.5	13.7
Governmental sector	0.0	0.1
Corporate sector	49.5	86.2
Other	1.0	0.1
Total	**100.0**	**100.0**

The structure of deposits and loans in 2003 (%) (at year-ends)

Maturity of deposits		Loans	
At sight	43.7	Long-term	43.6
Within one year	26.0	Medium-term	
Over one year	30.3	Short-term	56.4
Total	**100.0**	**Total**	**100.0**

Proportion of foreign exchange assets and liabilities (at year-ends)

Type of the financial institution	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2001	2002	2003	2001	2002	2003
Banks	38.0	37.3	37.5	44.8	38.9	40.0

Structure of revenues and expenditures of financial institutions (at year-ends)

Revenues	2001	2002	2003
Revenues	**100.0**	**100.0**	**100.0**
Interest yields	66.5	65.9	68.1
Commission income	26.7	24.8	24.8
Results from trade operations	4.2	6.4	5.3
Other operation revenues	1.2	1.7	1.1
Other revenues	0.4	0.6	0.3
Return of written off assets	0.9	0.5	0.4
Unexpected revenues	0.1	0.0	0.01
Expenditures	**2001**	**2002**	**2003**
Expenditures	**100.0**	**100.0**	**100.0**
Interest expenditures	34.8	37.4	37.5
Commission expenditures	4.0	3.1	2.9
Other operation expenditures	6.0	6.1	6.1
Total administration expenditures	38.9	41.1	36.9
Allocation to reserve	13.1	9.5	13.1
Unforeseen costs	0.1	0.0	0.0
Profit tax	3.1	2.8	3.4

Structure of registered capital and own funds of financial institutions in 2003

Type of financial institution	Registered capital	Total assets	Own funds	/Total liab.
	1,227,706	8.2	1,933,565	12.9

MAIN BSCEE GROUP EVENTS OF THE YEAR 2003

REPORT OF THE 16TH ANNUAL CONFERENCE OF THE BSCEE GROUP
Tallin, Estonia 29-30 May 2003.

The first day of consultation at the 16th BSCEE Group conference was devoted to the expected effects of the EU accession. The moderator of the conference of the supervisory authorities of 18 countries was Mr. Kaarlo Jannari, president of the Finnish integrated supervisory authority. Four invited speakers delivered presentations on possible consequences of accession: Mr. Jannari discussed the Finnish experience, Mrs. Mandrup senior counsellor of the Danish supervisory authority on the Lamfalussy process, Mr. Andres Trink, the host of the conference, the president of the supervisory authority of Estonia discussed the issue for the aspect of the Baltic states, Mr. László Seregdi Head of Department at the Hungarian Financial Supervisory Authority (HFSA) delivered a brief presentation on the theme from a Hungarian angle.

The key elements of the Finnish presentation were as follows:

It is very difficult to compare the situation of the founding Member States, the ones that joined later and those to become members next year The late 1980s were characterised by a high degree of liberalisation of money and capital markets which substantially prepared the subsequent globalisation of international markets. While the late 1980s were characterised by an oligarchic situation, which was at the same time under a kind of a national protection of financial – including banking – markets competition has markedly intensified by today. In comparison to the late 1980s a high degree of concentration had taken place and the number of banking staff as well as the number of institutions/branch offices dropped by about 50 %.

EU accession and the development from 1993 of the single internal market in the area of financial services lead to a significant increase in the case of Finland of the actual volume of cross border financial services. At the same time a significant number of applications were submitted to the Finnish supervisory authority by credit institutions registered in other EU Member States of intents to provide services in Finland directly, though in reality there are substantially smaller number of entities actually providing such services.

International supervisory cooperation has increased extremely both in relation to specific supervisory operations as well as in respect of regulatory issues. In the case of Finland before EU membership the supervisory authorities of only the Nordic states consulted one another at regular meetings and they had bilateral supervisory relationships - without any regular form of cooperation - with supervisory authorities of countries that had institutions operating in Finland as well.

EU membership substantially broadened the circle of employees within the Finnish supervisory authority whose members had to undertake participation in international work. After a while the large number of committees and working groups within the European Union necessitated the setting up of certain priorities as well. After accession, the Finnish supervisory authority was represented initially in all of the EU committees, later on, however, priorities were defined in view of the lessons drawn.

At that time this caused serious tensions in terms of resources and the identification of certain types of skills (e.g.. language proficiency). The practical internalisation of mechanisms characterising work processes within the European Union took some time along with the understanding of the informal means along the committee structures that can be applied in influencing decision-making. The lessons drawn by Finnish expert: we need to train ourselves in respect of the theoretical and practical aspects of the operation of the EU mechanisms. It should also be recognised that the particular EU mechanism involves very slow work processes at times therefore the performance of EU related work takes much patience. The EU accession will certainly increase the work-loads borne by the supervisory authorities concerned.

As a consequence of the EU accession and the development of the financial markets the appearance of European level or sub-regional financial groups and holdings has to be increasingly expected in the case of which the concepts of a traditional sharing of supervisory responsibilities between the home country and the host country cannot really function in practice. An excellent example for this in the case of Finland is the presence in northern countries of the group called NORDEA: the conglomerate is present in Sweden, Finland, Denmark, Estonia and Norway and it has a very complicated structure of management and operations. It is managed, for instance, from Sweden, but is performing some 80 % of its insurance activities outside Sweden. For this reason the supervisory authorities concerned have signed a cooperation agreement on the way of the distribution of the operations of the group and the various sub-sectors among themselves in order to enable real group level supervision. According to the Finnish delegate conglomerates of such complexity, that cannot be associated exclusively with the parent authority of a single country should be expected to appear in growing numbers in the markets of Europe and particularly in the area of Poland, Latvia, Lithuania and the Nordic countries.

According to the Finnish authority it will be an important question after the date of accession whether the banks concerned prefer to provide cross border services through subsidiaries or branch offices or else, they prefer to provide services without physical presence.

The costs of supervision will probably increase, banking techniques and technologies will become increasingly sophisticated which will demand increasingly skilled and more and more specialised experts to be employed by supervisory authorities as well. And good professionals have to be paid well.

As a matter of course it should also be taken into account that the EU accession process is taking place simultaneously with other global processes including for instance the introduction in 2006 of the Basel II Capital Accord. And the supervisory application of the second pillar of Basel II will entail a special challenge on European supervisory authorities in terms of training and the development of a certain kind of supervisory knowledge and the strengthening of international cooperation. Furthermore, the second pillar will demand at a European level an increase of the discretional powers of supervisors and an increased harmonisation of supervisory practices on a European plane.

According to the Finnish conclusion accession is a major challenge not only for the newly acceding countries but also for the existing Member States as well as the Commission. They are convinced that this will eventually lead to more efficient supervision at a European level.

In addition to remarks of a general nature the Estonian presentation contained conclusions in many ways similar to those of the Hungarian supervisory authority.

As for the impacts following accession, according to the Estonian conclusions the date of accession will probably be followed by a growth of the number of cross border financial service providers. Sharing of responsibilities between the supervisory authorities of the parent and the host country may become less clear-cut in some cases. National supervisory authorities will be increasingly involved in international work. According to the Estonian experts the balance between supervision and regulation will be shifted towards the latter, i.e. supervisory authorities will have to gradually completely be involved in the domestic regulatory coordination process. Expectations to be met by the supervision in respect of issues of consumer protection will increase in Estonia and consumer awareness will grow stronger.

Membership will have substantial cost and resource implications in the case of the Estonian supervisory authority (e.g. in terms of membership fees, travelling costs, time). They are making efforts to understand the internal rules and processes of the European Union and to be able to effectively participate in the operation of the working groups. It is important that instead of regarding the European regulation proposals only as mere automatisms they be assessed together with analyses of impacts on the market. The role of domestic inter-institutional coordination will grow in importance, owing to the sharing of EU information with other organisations concerned and in some cases eliciting opinion of supervised institutions and their information of EU processes will become important.

The Estonian supervisory authority is making efforts to improve and strengthen day-to-day cooperation with foreign supervisory authorities retaining priority of prudential supervision they intend to pay more attention to developments in the market and to rules on consumer protection, they intend to participate in functional policy debates pertaining to the domestic financial sector, they are making major efforts to provide employees with training opportunities to enable them to participate more efficiently in EU level work.

The chief counsellor of the Danish supervision described primarily the Lamfalussy process including its expected extension to the banking sector. In this aspect it should be noted that like the CESR that has been created in the securities market area the European Banking Committee comprising the regulatory authorities will also be separated from the Committee of Banking Supervisors comprising supervisory authorities. This latter is likely to set up a separate secretariat in some European capital (London being referred to as the probable venue), to the maintenance of which the member supervisory authorities will have to make financial contributions as in the case of the CESR. An informal discussion of these processes will take place between the 15 Member States on 23 June in Salzburg on the day preceding the official BAC meeting. It should be noted that a separate Financial Conglomerates Committee was also set up in April 2003, which will handle issues of the supervision of conglomerates (within the European Union and in third countries). Two interesting comments were made by the chief counsellor in describing their own practices: preparations are made in Denmark for the introduction of a single financial act and the Danish supervision carries out onsite examinations about once every 3-4 years.

In the course of the discussion the majority of the supervisory authorities of the candidate countries were interested primarily in the growing workloads, the increasing number of trips, the transparency of the operations of the numerous EU committees and the way of raising the necessary resources, not so much in the possible changes of the expected concrete supervisory work. In respect of the appearance of branches the representatives of Hungary, the Czech Republic, Poland, Slovenia and Slovakia also considered the possibility of new entrants or the transformation of existing subsidiaries into branch units but they agreed in that none of them expect a large number of such branches to open.

The key theme of the second day of the conference focused on the methodology of consolidated supervision and its problems.

The first presentation on the theme was delivered by Jason George, representing the Financial Stability Institute. He said that the role played by conglomerates has definitely increased recently, while in 1995 the enterprises belonging to financial conglomerates accounted for about 40 % of the 500 largest companies both in terms of number and balance sheet total, by year 2000 this ratio had increased to almost 60 % (87 % of conglomerates are lead by banks). It is clear therefore that supervision on an individual basis is no longer efficient enough and emphasis is to be laid on group level examinations. According to a definition elaborated in 1998 by the Bank of England consolidated supervision is a comprehensive approach applied to banking supervision which is aimed at assessing the strength of a group as a whole, taking all risks that may influence the operation of a bank into account, regardless of whether such risks are stated in the books of the Bank or in those of related enterprises. This definition is still valid, together with the comment that consolidated supervision supplements but does not replace individual supervision.

In exercising consolidated supervision in addition to the means applied in individual supervision, supervisory authorities need to pay attention primarily to the threat of the spreading of financial problems within a group, to the autonomy and quality of management, group level risk assumption and the transparency and accessibility of information on the operation of the given group making sure that consolidated supervision does not mean the assumption of responsibility for institutions not supervised. FSAP analyses carried out by IMF and the World Bank have revealed that some 55 % of countries could not meet the Basel supervisory principles pertaining to consolidated supervision.

The second presentation was delivered by Thomas Thorsen - representing the European Commission - on the EU directive concerning the supplementary supervision of financial conglomerates. He described primarily the definitions applied in the directive, fundamentals of the methods of the calculation of capital requirements, the roles of the examination of intra-group transactions, the requirements to be met by internal risk management, the role of the coordinator and the necessity of supervisory cooperation.

In relation to the presentation the Polish delegates said that they had carried out a survey according to the findings of which there is no financial group in Poland that would meet the definition of a financial conglomerate as applied in the directive. In response to questions raised by the Hungarian participants Mr. Thorsen said that the EU is planning to carry out the harmonisation of the various sectoral directives but no concrete completion date has been set for this task. It is possible that this work will involve the definition of the capital requirement of the lending and market risks of insurers but he could give no definite details on this yet.

During the discussions following the presentations each of the delegates described the stage of the development of consolidated supervision and the problems they are facing. The following are worth mentioning from among the comments made:

In Poland the rules on consolidated supervision were adopted last year and their problems are related primarily to the involvement of non-banking institutions in the calculation of capital adequacy. From the month of June this year credit institutions are obliged to submit semi-annual reports of consolidated data to the supervision. The Polish delegate raised the necessity of the BSCEE Group member countries sharing information with one another concerning banks that are operating in several countries of the region for example in the area of experience on the controlling of subsidiaries from abroad.

The Czech Republic also implemented the EU directive in 2002 and the problems they encountered related primarily to the question whether the rules on parent companies and subsidiaries apply only to legal persons or to natural persons as well. In the Czech Republic there are nine banking groups and three groups headed by holding companies engaged in diverse operations. The groups report to the supervision once a quarter concerning the satisfaction of the prudential regulations in terms of balance sheet data, profit and loss statement, capital adequacy, large risks and investments, on a consolidated basis, within 35 days of the end of the quarter reported on. The central bank carrying out the tasks of banking supervision is still working on the manual on consolidated supervision.

Bulgaria has implemented a reorganisation exercise and though the banking supervision function has been left with the central bank, the supervision of the rest of the financial organisations have been integrated in a single institution.

The Hungarian contribution covered the regulation applied so far in Hungary in the field of consolidated supervision, the proposed legislation to be adopted by Parliament, the simultaneous group level examination practices of the integrated Supervision, the consolidated level extraordinary data provision, the methodology guidance issued by the Supervision in relation to the risk management and controlling of financial groups as well as the group examination manual to be put together. Since it is closely related to the theme, we mentioned that the preparation of the implementation of the EU directive pertaining to financial conglomerates has already been launched.

BSCEE Group conducted an informal discussion of the future of the organisation in the light of the fact that 8 of its members will soon become Member States of the European Union. The agenda was definitely informal and it was not aimed at making any formal decision.

Secretariat's report

Since 1996 the permanent Secretariat of the BSCEE Group is operating at the Supervision, disclosing secretarial reports on the annual conferences. The secretariat's report contained the key themes pertaining to the Group this year as well, which were discussed with the involvement of the management of the organisation.

The BSCEE Group meets once a year, at a managerial level. The presidency is held on a rotating and voluntary basis, this year by the Estonian Supervisory Authority of Financial Organisations. For this reason the 16th annual Conference of the BSCEE Group was held in Tallin. The Group will have two additional workshops, organised jointly by FSI and BIS. The first workshop in 2003 was held in Zagreb by the National Bank of Croatia, between 5 and 9 May, on the 'New Basel Capital Accord'. The second one will take place between 22 and 26 September in Prague, on 'Credit Risk and Risk Mitigation'.

The Annual Report of the BSCEE Group is put together by the Secretariat, summing up the activities of the Group, its developments and providing an overview of the market conditions of the 18 member countries. The member countries submit their contributions by 15 June, and by September the annual report is distributed on CDs. (In earlier years the publication was brought out in the form of a book as well but this year for the first time the Group decided to have the annual report published only on CD).

The accounts of the BSCEE Group is managed and kept by the Secretariat. The secretariat prepares annual audited reports, which are distributed to the members and are analysed and discussed in detail at the annual conferences. The Secretariat has brought out two proposals for years to come:

- To cut costs the Secretariat proposed that the annual reports be published only on CD. This proposal has been approved by the member countries of the Group.
- The Secretariat proposed that the USD based account be replaced by an Euro based account from 1 January 2004. (In 2004 eight of the eighteen

member countries of the Group will become EU Member States). The proposal has been approved by the Group. This change, however, will necessitate a slight amendment to the basic documents of the Group where the amount and denomination of the annual membership fee is defined. The correction and the precise description of the process will be carried out by the Secretariat.

The Secretariat has announced the Chairman for year 2004. Mr. Cedo Maletic The Deputy Governor of the National Bank of Croatia applied for the position. Accordingly, the next year the – 17^{th} – conference will take place in Croatia, in Dubrovnik.

Mr. Samu Nucic of the National Bank of Slovenia informed the Group of additional potential candidates: as far as he know the Federation of Serbia and Montenegro is interested in membership. Serbia-Montenegro has a new constitution. Within the federation both member states has its own central bank and banking supervisory authority. In this sense, therefore, two banking supervisory authorities would have to be invited from a single country. It is a task for the Secretariat to ask the applicants for the necessary information and to review the data to see how they meet the criteria laid out in the basic documents of the Group. After the official request the Secretariat will carry out the administration of the accession process by providing ongoing information to the members and at the 17^{th} annual conference the members may vote on the admission of the new member. The representative of Bosnia and Herzegovina noted that owing to the similar federative set up in their country the invitation of the Serbian Bosnian Banking Supervision should also seem desirable.

The Secretariat informed the member countries and asked for their opinions on the issue of an application: the Banking and Payments Authority of Kosovo (BPK) wishes to join the BSCEE Group. The application was unanimously rejected owing to the format obstacle that Kosovo is not a country on her own. The BSCEE Group is an organisation comprising exclusively Central and Eastern European countries and their national banks as well as banking supervisory authorities.

Mr. Piotr Bednarski – of the National Bank of Poland – proposed more active operations and participation of the Group and the Secretariat, the preparation of joint position papers and analyses. The members noted that two members of the Group (the Czech Republic and Russia) are already present in the CPLG – since 1997. And that the two countries already in the Basel Group should be more active in providing information to the rest of the group on the work carried out in Basel.

FSI-BSCEE WORKSHOP: ON THE NEW BASLE CAPITAL ACCORD
5-9 May 2003, Zagreb, Croatia

The Group of Banking Supervisors from Central and Eastern Europe (BSCEE Group) and the Financial Stability Institute (FSI) held its workshop between 5 and 9 May 2003. The workshop was hosted by the National Bank of Croatia. The workshop was dedicated to the presentation and processing of the new rules on Basel capital adequacy rules. The central banks and/or the financial supervisory authorities of all Central and Eastern European countries - with the exception of Romania and the Ukraine - participated in the workshop with one or more representatives. The overwhelming majority of the presentations including a general description of the new capital adequacy proposal, the three pillars of the accord, securitisation and the case studies, were delivered by Mr. Jean-Philippe Svoronos, of the FSI. Further presentations were delivered by Mr. Laurent Le Mouel - of FSI - on risk mitigation techniques and operational risks - as well as by Mr. Jesus Saurina of Banco de Espana, on the details of the dynamic provisioning technique referred to as ‘the Spanish method’. The last day of the workshop was dedicated to presentations on the practical issues and problems of the measurement and management of operating risks, by an expert of each of Zagrebacka Banka, Privredna Banka and Banca Intesa.

Considering the fact that exhaustive analyses have already been produced and descriptions have been published on the first pillar of the new Basel capital adequacy proposal, particularly on the methods of the measurement of credit risks, this report focuses on the second and third pillars of the accord in more detail, and the practice of law enforcement and the performance of operative supervisory tasks.

The second pillar of the new Basel capital adequacy accord (supervisory review)

The three well-known pillars of the accord are: minimum capital requirement, the supervisory review of capital adequacy and market discipline. These three pillars together should ensure that the level of capital is comparable to the risk profile of the bank. Supervisory review may lead to early supervisory intervention if the bank’s capital seems to be inadequate or if its internal procedures concerning the allocation of capital are considered inappropriate.

Supervisory review lays a constant emphasis on the bank’s own assessment, for supervisory officers need to establish whether the internal assessment procedures applied by the bank are adequate and appropriate. A supervisor has to ascertain that the bank meets the requirements of the first pillar (capital adequacy), including external and internal assessment methods, the requirements of the application of risk mitigation techniques, the criteria of securitisation, or the modes of the measurement of operating risks. Furthermore, the second pillar also contributes to the satisfaction of the requirements of the third pillar (market discipline).

A supervisory review is based on four fundamental factors:

- the bank's own appraisal of its own capital adequacy,
- the procedure of supervisory review,
- capital exceeding regulatory minimum,
- possibility of supervisory intervention.

The level and sophistication of the procedure of the bank's appraisal of its own capital adequacy is aligned to the bank's operations and the risks entailed by such activities. This is why there is no 'best technique' in the establishment and application of such procedure though some fundamental features need to be included in any relevant procedure. The management of the bank needs to elaborate the policies and procedures to ensure that the bank identifies, measures, monitors and control all of its risks (i.e. credit risks, market risks, operating risks etc.). This takes a regular and consistent procedure that is capable of identifying the capital required for the given level of risks, of establishing the capital adequacy objectives in view of the bank's strategy and business policy and that has proper internal auditing to ensure the integrity of the procedure as a whole. To this end, management needs to take statutory requirements into account along with the expectations of the shareholders, competitors and rating agencies, the concentrations of the various risks and other qualitative and subjective factors. Strategic planning is an especially important part of this process for this promotes the adaptation of the structure to expectations, turning it into a pro-active structure. Strategic planning is to clearly establish the desirable capital level, external sources of capital and the expected capital requirement and costs.

As to the issue of supervisory procedure, under the second pillar of the proposal supervisory procedure is to be focused primarily on the assessment of whether the capital positions of banks are in line with the given operating environment, whether their capital positions are properly monitored by the management teams of the banks in the system and whether the capital structures of the banks are in line with their scopes of operations and business policies. Carrying out such tasks takes substantial development of supervisory skills, which my entail improvement of the quality of supervisory techniques and an enhancement of the size of the supervisory apparatus.

The supervisory review procedure requires both banks and supervisory authorities to assume some costs and resources. The development or improvement of risk management takes substantial resources on the part of banks though improved risk management may pay off at a later stage. Yet the costs of the introduction of the new technique may be substantial even in the case of a smaller savings cooperative. The supervisory authorities also need to raise adequate funding sources and the implementation of effective cross-border supervision will be of importance.

The introduction of the supervisory review process itself is a major human resource issue for the performance of the new tasks takes more and different knowledge on the part of individual supervisors. Such knowledge is currently held by only a few professionals, therefore almost all stakeholders (banks, supervisory authorities, the Basel Committee) are competing for experts of special knowledge (on credit risk modelling, evaluation of special transactions etc.).

The human resource problem involves not only the issue of special knowledge but also the employment of a sufficient number of supervisors for supervision 'tailored' to individual institution takes more supervisors than does general supervision. The employment of a sufficient number of supervisors is, as a matter of course, not enough in itself, there is also a need for proper training and practice (i.e. optimum distribution of supervisors to banks). In the UK and in the USA the average number of supervisors per institution is below one, while in the Philippines an average of seven supervisors deal with a bank yet the latter system does not necessarily work more effectively. The issue of providing human resources is a challenge for all supervisory authorities, to varying degrees. For instance the German supervisory authority has announced the necessity of the hiring of hundreds of new supervisors considering that the majority of German banks will apply the internal rating models.

Detailed presentations were delivered on the possibilities of supervisory intervention as well, along with the role of the second pillar in certain special areas (e.g. operating risks, securitisation etc.) along with the steps of the introduction of the new technique. In order to facilitate the introduction of the new procedure the Basel Committee has set up a separate working group charged with enabling exchange of methods, experience and information, enhancing the uniformity of practical application, identifying the areas where there is a need for harmonised regulation and indicating problem areas to the Basel Committee.

The third pillar: the disciplinary power of the market (disclosure requirements)

This pillar is often regarded as the 'poor relative' of Basel II despite the substantial contribution of this pillar to the reliability of the market sector. The problem with the current disclosure practices of banks is that though sufficient information on operations, capital and profits is imparted, questions remain with respect to (levels and quality of) risks and the modes of risk management.

The supervisory benefit of the third pillar - the disclosure obligation - is definitely that this ensures that the disciplinary power of the market also contributes to the attainment of the supervisory objectives. At the same time, disclosure provides information for participants of the market and not for supervisors who need to acquire the necessary information by means of the second pillar.

Since disclosures are based for the most part on accounting standards and rules, the question arises as whether the supervisors or external auditors should verify the correctness of the disclosed data. Another problem in the case of institutions performing cross-border activities may lie in the difficulties of comparing information based on internal accounting norms. The Basel Committee recognises the existence of this problem but it cannot solve the problem for the Committee, cannot establish standards outside the scope of banking supervision.

The fundamental principles of disclosure obligation are summarised as follows:

- it applies to the highest level of consolidation,
- banks belonging to a group do not usually have to meet disclosure obligations with the exception of capital adequacy,
- the various national supervisory authorities will be able to prescribe disclosure obligations on lower levels of consolidation as well,
- supervisory authorities will be able to introduce additional disclosure obligations with reference to the requirement of prudent and safe operations,
- the requirements of the third pillar need to be complied with in the framework of the accounting disclosure obligation as well,
- institutions will decide themselves on which data they will disclose on the basis of the *principle of materiality* (a piece of information is material if its non-disclosure or incorrect disclosure may distort or influence decisions taken by those relying on such information),
- the selection of the data to be disclosed will be up to the banks themselves for the objective of disclosure is to enable market participants to have an insight in the risk assumption and risk management system of the banks but such choices are supervised by supervisors under the framework of the second pillar,
- banks have to comply with interests relating to business and banking secrecy even in the course of the satisfaction of the disclosure obligation,
- as a general rule, such disclosures have to be made on a semi-annual basis but annual disclosure cycles are also possible in the case of larger subjects (e.g. the operation of the risk management system of a bank),
- large international banks have to report on the aggregate capital adequacy ratio and its components once a quarter though the disclosure on a quarterly basis of quickly changing data is a requirement to be met by all banks,
- from the aspect of the contents of the various disclosures banks need to report on the goals and concepts of risk management in respect of each (credit and market) risk area, along with strategies and procedures, the structure and organisation of the relevant risk management function, the area and nature of the reporting and measuring system, the methods of risk prevention and mitigation,
- banks need to have disclosure policies in place, as approved by their boards of directors.

The content elements of disclosure are identified by this proposal as follows:

- application area (name of controlling enterprise, entities covered by consolidation, aggregate capital surplus/deficit on a group level)

- capital structure (aggregate value, components, deductions),
- capital adequacy,
- general information on credit risks and special risks depending on technique applied (standard or internal measurement approach) and on type of placement,
- special risk types,
- market risks, depending on mode of measurement,
- operating risks.

The third pillar comprises a total of 13 tables but only the largest banks are likely to apply all of them. Smaller banks, particularly those applying the standard method only, will disclose information only on the area of application, capital structure and adequacy and the general information on risk types.

Information on capital structure will include total amount and the elements of capital, the features of capital elements/assets, for these are material details that will inform participants of the market concerning the loss absorbing capacity of a bank.

Disclosure on risks will include risk types (credit risk, dividend and interest risks, asset securitisation risks, market risks, operating risks) along with credit risk management techniques, risk management systems and procedures concerning the identification, measuring monitoring and controlling of placements.

On the closing day of the course representatives of three banks delivered presentations on their preparations for Basel II and their practical experience. Thereafter the representative of the Italian Banca Intesa approached the representatives of the HFSA and offered to give a presentation on his special field of expertise during a visit to Hungary in September 2003 along with the practices of the management of operating risks, to the Hungarian supervisory personnel. The presentation had been delivered between 10 and 12 September.

FSI-BSCEE WORKSHOP: ON CREDIT RISK AND CREDIT RISK MITIGATION
Prague, Czech Republic, September 23-26

The main lecturers of the conference were Mr. Roland Raskopf and Mr. Jean-Philippe Svoronos, from the FSI. Besides them, Mr. Alexander Batchvarov from Merrill Lynch, Mr. Bernd Zugenbühler from Dresdner Bank and Mr. Jirí Witzany from Komercni Bank held more speeches.

The first day of the conference, started with the speech of Pavel Racocha, Chief Executive Director, Member of the Bank Board, who welcomed the participants in the name of the CNB. Following the welcoming speech, Mr. Raskopf started his lecture about the portfolio view of credit risk. The participants learned about the development of credit and market risk techniques, from recovery given default to integrated VAR and from maturity gap to operational VAR. Credit risk management was transaction oriented in the past, now it is portfolio oriented. From the examination of creditworthiness and credit monitoring the emphasis transmitted on active loan portfolio management. As time passed, credit institutions could use more and more sophisticated rating methods and used more data, so credit risk became measured in a portfolio view. The structural risk models are top-down and bottom-up risk models. Top-down models are profit and loss models, while bottom-up models are modelling risk factors. A type of bottom-up models are building block models, which use factors like LGD (Loss given default), rating, aggregation, EDF (expected default frequency), etc. Another type of categorization is default mode models, which deal with losses on a basis of default and market-to-market ones, which deal with losses on the basis of market price changes. Naturally duration, securities and rating are key elements in default. When duration grows, the numbers of defaults rise slowly. When rating decreases, the numbers of defaults rise rapidly. The more secured the credits are, the less is the final loss at a default.

What will come in the future? According to the current situation, integrated portfolio approaches will spread, while diversification effects will be reflected in prices. As regulators will ask for more and more for the approval of the models, the better-trained resources will be needed. The following questions were asked: Do we have to go to school again, or participate on trainings? Is our experience not enough? The answer is categorically yes on both questions, and continuous training is needed.

Half of the risks are in the universal banks and credit risks are in the non-life insurance companies, while the life-insurance companies have less than 10% of credit risk in its risk portfolio. Market risk is just the opposite: while in universal bank its share reaches 20%, in a non-life insurance company ca. 30% and a life-insurance company 55%. The losses of a financial company can be divided into two parts: expected loss and unexpected loss. Expected loss consists of high amount of small losses. Unexpected losses are the losses, which are bigger, than the biggest expected loss. Though the frequency decreases as loss increases, but there are some extreme high losses (stress losses) with very low frequency. That is the tail of the loss distribution.

Internal Risk Based Approach is an excellent method for calculating credit risk. It is not the supervisor or the parliament, who can monitor and assess the risk of a financial institution, but the financial institution itself. The key risk components of IRB are borrower risk, PD, LGD, transaction risk and EAD. IRB does not always mean lower capital requirements. How does IRB work in practice? According to the directive, the model has to pass several (minimum standard) tests and use an impressive quantity of data, before the supervisors authorize it. IRB is a part of competition; only huge institutions can afford a well working model. Do we say with that, that Basle II deliberately disadvantages small institutions with letting the big ones use it? The answer is no, because big institutions would use it without the force of supervisory bodies, just because they can measure their own risks better with it. While the Standardized Approach doesn't let anything to be calculated with the banks' methods, the IRB approaches (Foundation and Advanced) let banks calculate more elements (PD, Maturity, and Advanced IRB LGD and EAD as well). The bank has to give a lot of resources to fund the conversion to IRB and has to decide, how many parts it will use to satisfy supervisory needs. This depends on partly the bank's current system as well. Supervisors have to communicate their eligibility criteria to the market and other countries' supervisors and train their employees in order to understand and be able to authorize or deny authorization for the methods banks are giving them. By the end of 2005 banks should parallel calculate IRB as well, by the end of 2006 IRB and rest of Basel II comes into force.

Mr. Svoronos described the structure of the BIS, the bank of central banks and about the Basel Committee on Banking Supervision's work. BCBS's aim is to enhance banking systems' soundness and establish the level of playing field for large international banking groups. Now it has changed, BCBS expands in the direction of small and medium sized banks as well. Currently risk based supervision and higher sophistication and the use of technology oriented tools in risk management are the aims of this institution.

The Czech hosts explained how they dealt with credit risk. The speaker spoke about the roles and principles of credit risk management. The credit process is a question of corporate governance, how the bank controls and regulates the credit assessment, how it manages its portfolio, and how it deals with workouts. There are several ways, how the credit organization can be built up. The two most common are separate loan officers, credit analysts, administrators in one branch; or business unit, credit management unit and loan administration unit under board, where loan administration gives feedback to the business unit. In the case of small loans, banks use scoring, rating, expert systems and data sources in their credit process. The loan pricing is determined by three factors: net margin by business unit, expected cost of risk by risk management and cost of funds by ALM. According to the supervisors' view, banks can be split to "good banks" and "bad banks" By changing to "bad", it is necessary to find an appropriate strategy for restructuring and collecting credits. The last part was about the risk mitigation techniques and VAR analysis.

Mr. Zugenbühler's, Dresdner Bank, spoke about credit analysis, rating and risk prevention. There are two ways to analyse credit risk, ex-post and ex-ante. Ex post methods can be quantitative like net/gross provisions, write offs, or qualitative like internal and external reasons for defaults. Ex ante analysis are portfolio analysis, some mathematical-statistical methods and fundamental analysis. While corporate customers get individual criteria at risk assessment, which include elements like management, financial condition, forecasts, legal form, profit situation, etc., private customers go only through three fields: income, personal background and wealth/fortune. Three steps can improve the credit process: via a risk grade driven process (minimizing risk of credit granting), cost/return driven process (minimizing cost of credit granting), and internal/external net-return driven process (portfolio enhancement, securitisation).

In the second part of his speech, spoke about the development of credit granting. The tendency is that, it becomes more and more precise in assessing, controlling all risk elements and components. Qualitative and quantitative factors are used parallel and it uses more and more information technology for the whole credit process. Behaviour (account history) of debtor is also a key element in assessing the creditworthiness. An essential tool in credit analysis is Return on Risk Adjusted Capital (RORAC). It measures the relationship between risk and return and the economic capital employed. RORAC can be calculated by dividing adjusted return with credit risk capital. It can be used by pre-calculations, and at monitoring and management of credit portfolio.

The following day presentations spoke about the Basel II Standardised Approach and Internal Rating Based Approach. Participants learned the current status and description of these approaches, which can be found also in the web-server of several participating countries. Under Basel II Mr. Svoronos talked about the objectives of the approach, the main changes from the current accord, the external credit assessment institutions, the safeguards against Dubious Agencies, and claims on institutions (Sovereigns, Central Banks, ECA's, Banks, Corporates). The most interesting questions remained for the end of the presentation. Is Standardized Approach already too complicated for small banks? The answer was partially yes. Development in banking and banking supervision cannot stop. There may also be national discretions for small banks, or they can use the old Accord. It is still a question of the future, 2006 is far away and is not a final deadline for all.

Mr. Roland Raskopf, FSI spoke about the Internal Rating Based Approach. The participants had an exercise, how to calculate corporate exposure. They calculated twelve positions of a bank, summed it up and got the total capital charge. Then they looked at the Foundation Approach as well. Later on Mr. Svoronos held a presentation about Basel II. and credit risk mitigation techniques. These techniques are:

- Collateralisation with cash or securities (or other assets),
- Third party guarantees,
- Use of credit derivatives,
- Netting loans against deposits from some counterpart,
- Traditional securitisation (collateral, guarantees),
- New/more recent type of securitisation,
- Flexible risk management tools.

The more advanced the approach is, the more collaterals are accepted, and the more stringent risk management standards are. Collaterals must be legally certain, must have low correlation with exposure. The bank may accept eligible financial and physical collaterals. Supervisory haircuts depend on rating of securities, residual maturity and issuer. Under special conditions, banks may use own estimated haircuts as well.

VaR (Value at Risk) modelling may be used for calculating volatility of exposure and collateral for repo style transactions. The bank must use strict back testing, and according to the outcome it must use multipliers in three zones, at green zone exceptions may not exceed 99, the multiplier is 1. At yellow zone the exceptions can grow up to 199, and the multiplier grows in same intervals till 2.8. In the red zone, the number of exceptions may exceed 199, and the multiplier is 3.

With the next presentation of the seminar: was about securitisation. The first three presentations in this topic held Mr. Batchvarov from Merrill Lynch. He showed the figures, of how global securitisation market grew from year to year.

By the end of 2003 it will possibly reach USD 850 billion. USA is the leading country in the securitisation market with a share of ca. 70%. Then comes Europe with ca. 20-25% and Japan with 5-7%. At securitisation a Special Purpose Vehicle (SPV) Company is funded, for which the originator transfers the asset pool. The SPV sells the assets for investors, usually with the help of credit enhancers and a service provider company. SPV is needed because the sold assets may not be in connection with the originator any more, for the case of bankruptcy of the originator. Credit enhancement may have external forms (bank letter of credit, financial assurance company guarantee, insurance company surety bond etc.) and internal forms (senior-subordinated structure, excess spread etc.). Credit enhancement may protect against prolonged reductions in cash flow. Benefits of securitisation are clear: banks can sell their portfolio, keeping the good elements, selling the riskier ones; they get an alternate source of liquidity. Drawbacks of securitisation are possible over-reliance on it, the company retains its first loss position and asset risk transfer can be also achieved by other means as well. The rating concepts are the Expected Loss Approach and the First Dollar Loss Approach. Fitch, Moody's and S&P rate majority of bonds. At the end of presentations, he went through asset classes, basic securitisation structure types, the problem of credit cards and case studies.

Mr. Svoronos presentation was about Basel II securitsation framework and regulatory issues. The first part of the presentation was about securitisation framework; the common elements in proposed approaches and the specialities in Standardized Approach and the "Double-Checked IRB" Approach. The Basel II principle is capital neutrality before / after transaction, because no new credit risk was created. The question is, whom the banks can sell the portfolio? The answer is simple, only for non-banks; because banks wouldn't buy a portfolio for the same reasons of the other bank wants to sell them. Then the group discussed a case study of regulatory issues in the Basel II.

Last day's presentation was: Economics – Economic considerations of ABS transactions. Mr. Froitzheim spoke about the aims of ABS transactions, revealed the difference between synthetic and true sale transactions. Financial aims of such transactions are:

- Attracting funds
- It provides direct access to capital market
- Investor base is broader
- Tax optimisation
- Liquidity management
- Rating arbitrage
- Cost of funding optimisation.

The composition of balance sheet can be better with these transactions, as well as balance sheet ratios and ROA. In terms of risk aims, the risk of credit ranking and liquidity risk is smaller. Asset fungibility, interest and FX-Risk is more manageable, while industry risks of countries (regions) is smaller. These transactions also have qualitative aims; rating, reputation and standing of the company partially depends on these transactions as well. The regulatory bodies are interested in safe and sound operation and transactions, compliance with BIS I and Basel II. If a transaction is not clear, legally sound and possibly deceive investors, regulatory bodies need to interfere.

A synthetic transaction is much cheaper, simpler and legally less complex than true sale, but in contrast with it, it does not relieves balance sheet. The aims are often mutually exclusive of this kind of transaction, so it does not exist a perfect ABS transaction. In order to make the Cash-Flow Model, several input parameters are needed, from asset side the portfolio and liquidity parameters, from liability side refinancing (first, second loss instruments, spread to investors, etc.). At the end of the presentation, we went through a case-study: “Building Comfort 2003-1”. ABS transactions can cause positive and negative leverage effects as well, so it is important to calculate the possible effects, before entering such transaction.