National Bank of the Republic of Macedonia
Supervision, Banking Regulation and Financial Stability Sector
Financial Stability and Banking Regulations Department

REPORT ON RISKS IN THE BANKING SYSTEM OF THE REPUBLIC OF MACEDONIA IN THE SECOND QUARTER OF 2014

October 2014

CONTENTS

Summary

The activities of the Macedonian banks continued to grow during the second quarter of 2014, whereby the level of financial intermediation in the Republic of Macedonia increased further. At the end of June 2014, total assets of the banking system rose by 5.7% on an annual basis, with the pace of growth being slightly slower compared to the previous few quarters. Generator of the growth of the banks' sources of funding were the deposits of non-financial entities, particularly household deposits, which directly reflects the public confidence that banks enjoy. In the currency structure of deposits, the trend of positive changes continued, in the sense of increased share of Denar deposits at the expense of the reduced share of deposits with currency component. In addition, the driving force of the quarterly and annual growth in the second quarter of 2014 were deposits with contractual maturity greater than one year, which led to an increase in their share in the maturity structure of total deposits. Hence, the propensity of clients for long-term savings increased, mainly driven by the higher yield on long-term deposits, but also because of the modest supply of suitable investment alternatives.

In the second quarter of 2014, the total investments of banks in securities declined, mainly due to the lower portfolio of treasury bills. Banks used the released financial sources of funding on the basis of disinvestment of securities, and the newly-collected sources of funding for placements in loans to non-financial entities, which was fully the reason behind the quarterly growth in banks' assets. The recovery of the domestic economic activity and the gradual increase of banks' risk appetite, made the loans to non-financial entities register an accelerated annual growth for three quarters in a row, and at the end of June 2014 their annual growth rate was 8.6%. Growth in lending was somewhat more pronounced in the loans to households, but acceleration was registered also in the annual growth of the credit support to the corporate sector. Along with the positive changes in the currency composition of deposits, the trend of denarization was registered also in banks' lending activity.

The profit of the Macedonian banking system in the first half of 2014 tripled in comparison with the same period of 2013, which adequately reflected in the improved profitability indicators. The main factor behind the increase in profits was the reduction of banks' expenditure components, both the interest expenses and the impairment of financial assets - primarily the loans. The reduction in interest expenses is concentrated in the household sector, primarily due to the downward trend in the interest rates on time deposits. Banks continue to allocate provisions for covering the credit risk, but to a lesser extent compared with the first six months of 2013, which corresponds to the lower six-month growth rate of non-performing loans. The decline in the impairment of assets acted toward reducing the share of the net interest income that is used for its covering.

Credit risk remains the most significant risk to the performances and the stability of banks in the Republic of Macedonia. The quality of the loan portfolio of the banking system deteriorated in the second quarter of 2014, but at a slower pace compared to the same period last year. The growth of non-performing loans was more intensive in the loans to companies, compared with the non-performing loans to households. This shows that the recovery of the economic activity and the increased growth rate of the Macedonian economy, does not cause noticeable effects on the performances of the companies that have debts toward domestic banks. On the other hand, the coverage of non-performing loans with impairment was maintained at a relatively high level, thus reducing the risk to the stability of the banks from

total non-collectibility of non-performing loans. Under the assumption of full non-collectibility of non-performing loans banks would use 13.2% of their own funds to absorb the losses.

The solvency of the Macedonian banking system is stable and with capital adequacy ratio that is twice higher than the statutory minimum. Due to reinvesting profits in 2013, in the second quarter of 2014 there was a more rapid increase in the amount of own funds of the banking system, compared with the growth of the banks' activities, which is why the capital adequacy ratio improved and equaled 16.9% as of 30 June 2014. Banks use most of the quarterly increase in the own funds to raise the excess capital above the minimum level necessary to cover the risks.

Indicators of banking system's liquidity in the second quarter of 2014 remained satisfactory. The high and stable solvency of the banking system and the satisfactory banks' liquidity level have contributed to the strong resilience of the banking system during simulated liquidity and credit shocks.

Part 1 Risks in banking operations

1. Credit risk

In the second quarter of 2014, banks' credit portfolios continued to grow due to the increased credit support to households and businesses, at the expense of their reduced exposure to financial institutions and the government. Despite the improvement in the first quarter, in the second quarter of 2014 there was a certain deterioration of the loan portfolio quality. Non-performing loans to total loans ratio increased by 0.7 percentage points, and reached 11.8%. The increase in the non-performing loans continued after the cut-off date of this Report, with the rate of non-performing loans reaching 12.2% in August 2014. Given the fact that non-performing loans have high coverage with allocated impairment (78.7% with their own and over 100% with total impairment), the threat for the banking system's own funds from their possible default is minimal.

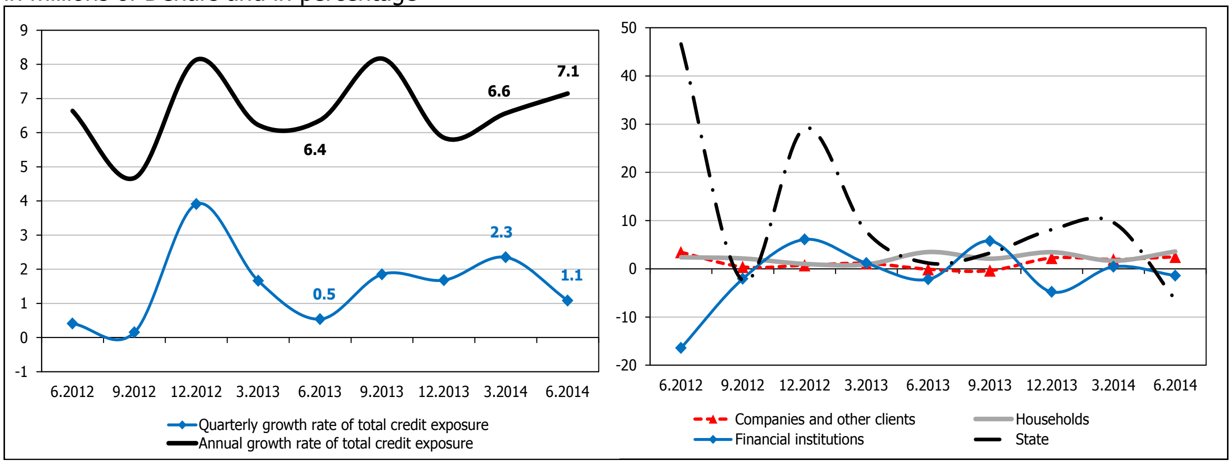
1.1. Banking system's loan portfolio quality

In the second quarter of 2014, total credit exposure[1] of the banking system grew by Denar 4,294 million and reached Denar 400,338 million. Thus, the rate of growth slowed in this quarter compared to the previous quarter by 1.3 percentage points and was reduced to 1.1%. Unlike previous quarters when the growth of total credit exposure was triggered by the exposure to non-financial entities and to financial institutions and the government, **in the second quarter this growth stemmed entirely from the increased credit support to non-financial entities.** Credit exposure to non-financial entities increased quarterly by Denar 8,101 million, or 2.9%, which was almost equally caused by the growth of credit exposure to companies[2] (Denar 4,224 million or 2.5%) and to households (Denar 3,877 million, or 3.6%).

[1] The total credit exposure includes balance sheet (loans and deposits, financial leasing, payments made on the basis of given guarantees, letters of credit, warrants and other off-balance sheet positions, interest, fees and commissions, investments in securities and other financial instruments available for sale or held to maturity, etc.) and off-balance sheet claims (unused irrevocable credit lines, unused irrevocable credits based on overdrafts and on credit cards, letters of credit, guarantees and other contingent liabilities for the bank), which expose the bank to a credit risk.

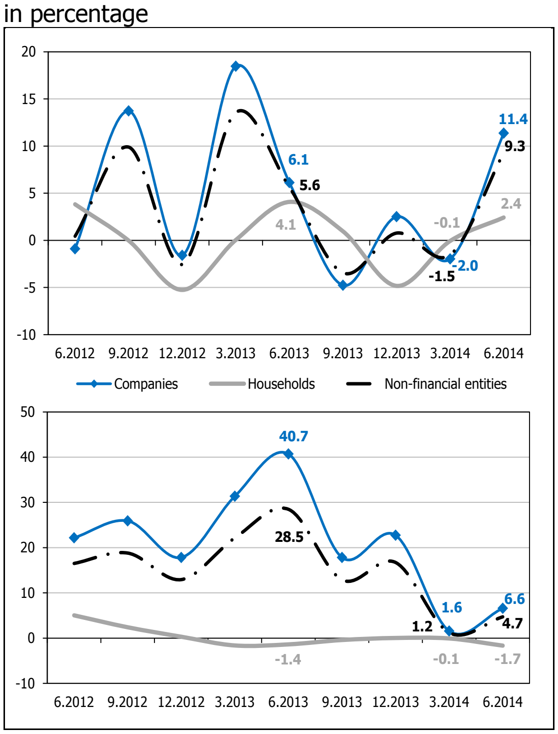
[2] "Companies" refer to companies and other clients. Other clients refer to clients of the activities: "education", "activities of health and social care", "arts, entertainment and recreation", "other services", "activities of households as employers" and "activities of extraterritorial organizations and bodies".

Chart 1
Change of the total credit exposures and quarterly change of the credit exposure by sector
in millions of Denars and in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

Chart 2
Quarterly (up) and annual (down) growth rate of non-performing loans
in percentage



Source: NBRM, based on the data submitted by banks.

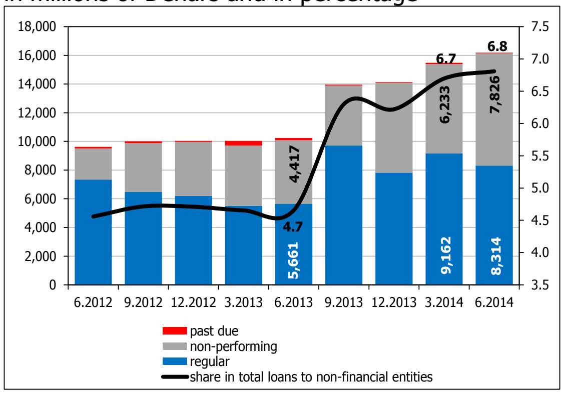
Despite the improvement in the first quarter, in the second quarter of 2014 there was a certain deterioration of the loan portfolio quality. The quarterly growth rate of non-performing loans reached 9.3%, which comes entirely from the increase in the non-performing loans to companies and reflects the deteriorating performance of certain clients from the activities "wholesale and retail trade", "activities related to real estate" and "food industry". Upward movement, but with significantly lower intensity was registered also in non-performing loans to households, especially in consumer loans, loans based on issued credit cards and housing loans.

The annual growth rate of non-performing loans also accelerated, but it is still a single digit (4.7%). However, the accelerated movement of non-performing loans continued at a fast pace also in August 2014, when the annual growth rate reached 11.2%.

The analysis of the dynamics of the non-performing loans should take into account **the share of the restructured loans in the total loans to non-financial entities[3], which at**

[3] Source: Credit Registry of the National Bank. In the analyses where the source for the data for loans is the Credit Registry, loans to non-financial entities include loans to enterprises and households.

Chart 3
Structure of restructured loans by their status (regular/non-performing), by quarters
in millions of Denars and in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

the end of the second quarter of 2014 was 6.8% (6.7% as of 31 March 2014)[4].

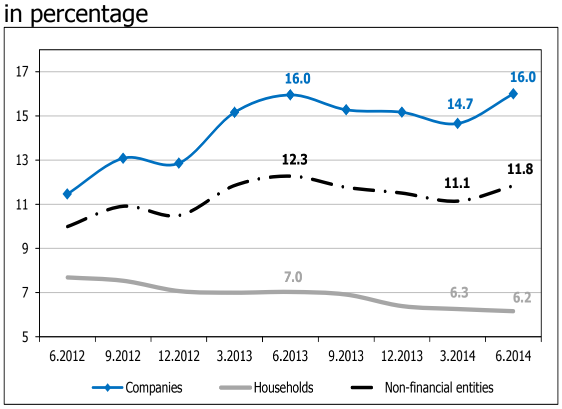
The increase in restructured loans is completely a result of the restructured non-performing loans, which in circumstances of reduction of restructured regular loans suggests that this growth, apart from the new restructured non-performing loans, results from the previously restructured claims that received a non-performing status in this quarter. Restructured loans[5] that became non-performing in the second quarter cause about two-thirds of the growth in total non-performing loans to non-financial entities, while their share in these loans totaled 5.6% as of 30 June 2014. These movements indicate that some banks made a delay in the restructuring of their claims to clients facing serious financial difficulties and whose liabilities acquired non-performing status. At the same time, this shows that part of the restructured regular loans made in previous periods have not been successfully restructured, and therefore they received a non-performing status.

Companies are still drivers of the increase in the total restructured loans. At the end of the second quarter, 11.1% of total corporate loans were restructured (10.9% as of 31 March 2014). The growth of non-performing loans to enterprises comes in part from previously restructured loans that became non-performing during the quarter. More than half of the total restructured loans to enterprises (52.7%) are with an agreed grace period[6], which in some cases reaches three years. The approved grace period could put off the possibility to see the success of the restructuring.

Write-offs performed during the second quarter were in the amount of Denar 25.6 million, which is a higher level compared to the same period last year, but they have a negligible influence on the movement of non-performing loans. Most of the written-off claims (60.4%) are

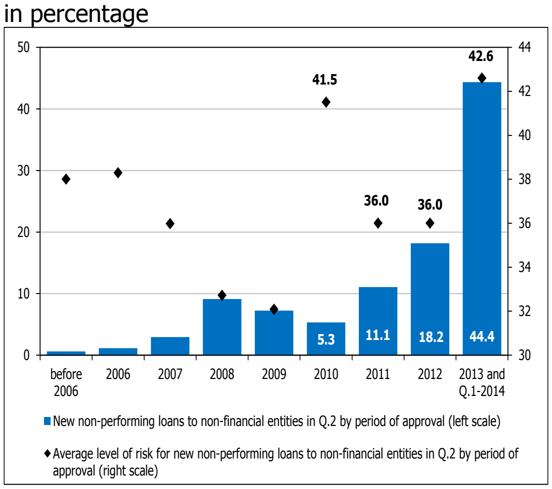
[4] Share of prolonged and restructured loans in the total loans to non-financial entities was 12.7% (13% as of 31 March 2014)
[5] The average risk level of the total restructured loans increased to 41.8% (39.1%, as of 31 March 2014).
[6] Approved grace period was not yet expired on 30 June 2014 or expired in the period between 30 June 2013 and 30 June 2014.

Chart 4
Share of non-performing to total loans to non-financial entities and by sectors
in percentage



Source: NBRM, based on the data submitted by banks.

Chart 5
Distribution of new non-performing loans as of 30 June 2014, by period of approval
in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

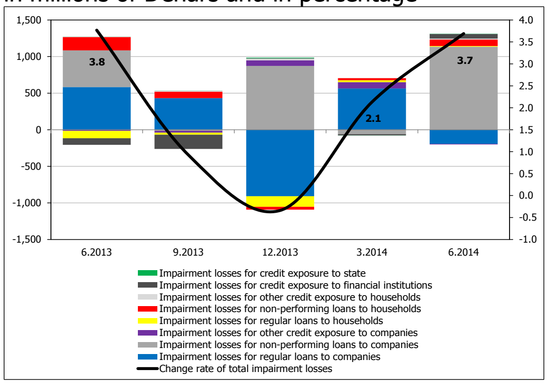
related to companies, while in the overall recovery of already written-off claims, most frequent are the collections from natural persons, with 72.6%.

The growth of non-performing loans contributed to their increased share in total loans. At the end of June 2014, the rate of non-performing loans reached 11.8%. In the second quarter of 2014, there was another more pronounced deterioration in the companies' credit portfolio quality, despite the moderate credit support for this sector. On the other hand, the rate of non-performing loans to households continued to decline, which is due to the growth of total loans, amid a slight increase in non-performing loans.

The rate of non-performing loans continued to move upwards also after the cut-off date of this Report and it reached 12.2% in August 2014.

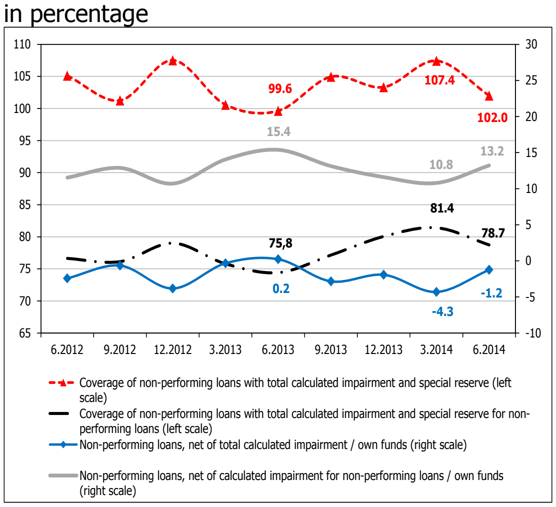
The majority of new non-performing loans generated in banks' balance sheets come from the post-crisis period. According to the approval period, about 70% of the loans that received non-performing status in the second quarter, but were regular as of 31 March 2014, had been approved in the past three years. The average level of risk of these loans is in risk category "C". The new non-performing loans at the end of the second quarter, which were approved in 2013 and in the first quarter of 2014 relate to the corporate sector, more precisely to the customers from the activities "wholesale and retail trade" and "industry". However, one should bear in mind that most of the growth in non-performing loans in the second quarter of 2014 accounted for a relatively small number of exposures (customers).

Chart 6
Quarterly change of impairment losses for certain sectors
in millions of Denars and in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

Chart 7
Coverage of non-performing loans and share of net non-performing loans in banks' own funds
in percentage



Source: NBRM, based on the data submitted by banks.

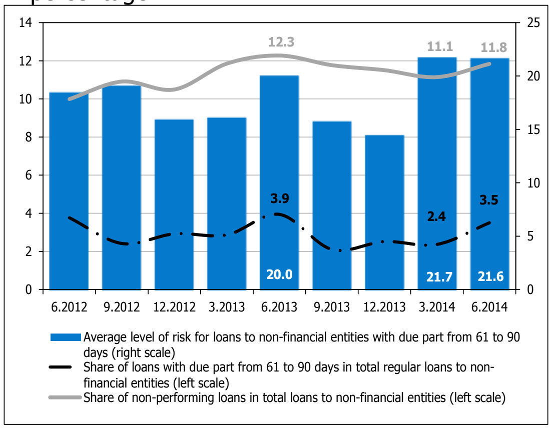
The growth of non-performing loans was followed by an accelerated quarterly growth in total impairment losses of Denar 1,116 million, or 3.7%. This growth comes entirely from the impairment losses for non-performing loans to companies.

The coverage of non-performing loans with total impairment losses still exceeds 100%. The faster growth of non-performing loans compared to the growth of impairment caused a reduction in their coverage with the impairment allocated for that purpose, to 78.7%.

Amid rapid growth of non-performing loans compared with the growth of impairment losses, an increase was registered in the share of the non-collateralized non-performing loans in the own funds of the banking system. Thus, under assumption of full non-collectability of non-performing loans, at the end of this quarter, own funds would decrease by 13.2% (2.4 percentage points more compared to the assumed decrease at the end of the first quarter).

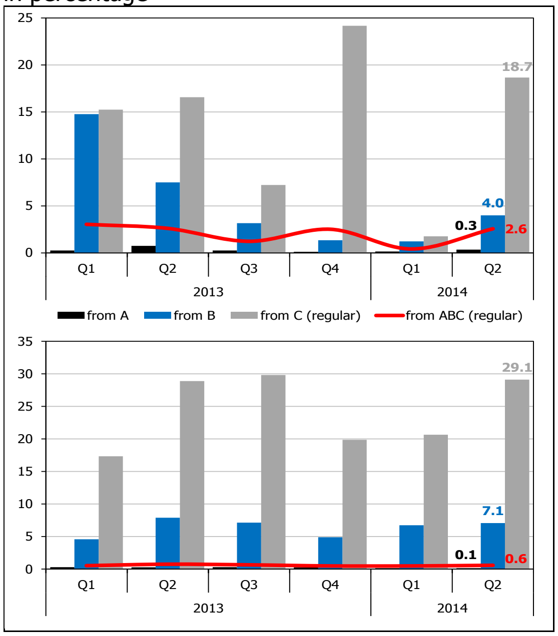
In the second quarter of 2014, as a result of the faster growth of the impairment losses compared to the growth of the total credit exposure, the average level of risk in the loan portfolio of the banking system increased to 7.8% (7.6% as of 31 March 2013).

Chart 8
Average risk level for loans with due part of 61 to 90 days
in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

Chart 9
Quarterly shift of credit exposure to companies (top) and natural persons (bottom) from regular to non-performing status
in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

Past due loans with a period of delay in repayment of 61 to 90 days pose a potential risk of increase in the non-performing loans in the next month. Thus, if none of these loans is collected over the following month, 3.5% of the total performing loans as of 30 June 2014 would turn into non-performing. Only on this basis, non-performing loans would increase by Denar 7,439 million, or 26.1%. However, the growth in the following month (July 2014) is significantly lower and equals 0.6% or Denar 159 million, indicating a significant recovery of the loans with past due part of 61 to 90 days.

In the corporate sector, most significant activities in terms of the credit risk are "industry" and "wholesale and retail trade", and according to individual products of the household sector, most significant are credit cards and consumer loans (Annexes 23 and 24). According to the currency structure, the highest risk-bearing credit exposure is that in Denars with foreign currency clause (Annex 22).

The dynamics of the loan portfolio deterioration is also confirmed by the analysis of the so-called transition matrix. The percentage of credit exposure with regular status, which in less than a quarter translates into exposure with a non-performing status[7] increased to 1.7% at the end of the second quarter of 2014 (0.4% at the end of the first quarter). Analyzed by individual sectors, 2.6% of the regular exposures to companies and 0.6% of these exposures to households received a non-performing status in one quarter.

According to the agreed maturity[8] of principal, it is expected that 20.4% of the total credit exposure to non-financial entities as of 30 June 2014, will fall due for payment by the end of this year. Moreover, given their average level of risk, serious

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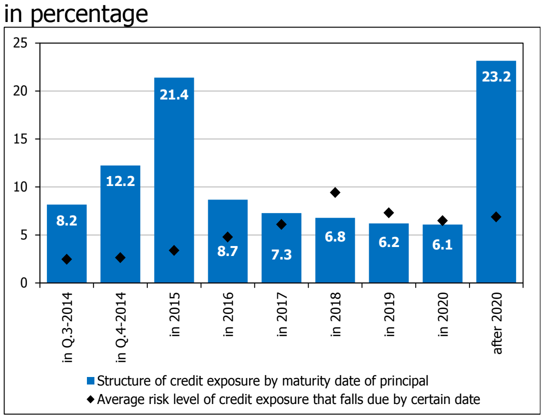
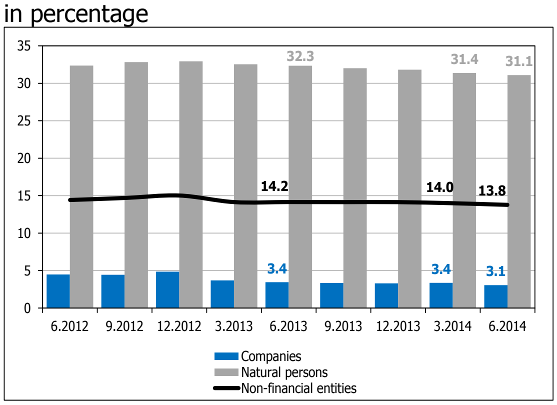
[7] The analysis does not include the credit exposure which was closed due to restructuring and prolonging and the credit exposure approved during the quarter.
[8] Refers to the maturity date of principal.

Chart 10
Structure and average risk level of the credit exposure to non-financial entities, by maturity of principal
in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

Chart 11
Share of uncollateralized exposure in the total credit exposure of non-financial entities and of individual sectors
in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

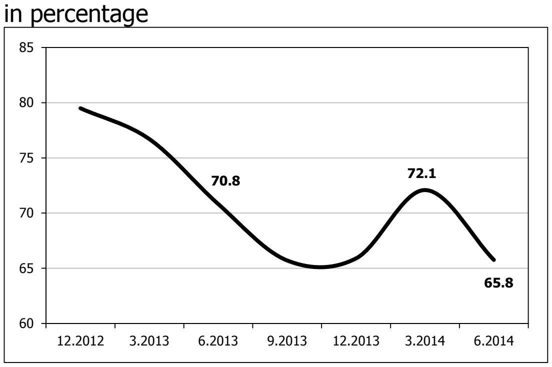
difficulties in the collection of these exposures should not be expected. The credit exposure classified in risk categories "A" and "B" accounts for 97.1% of the total credit exposure which falls due by the end of 2014, about half of which (46.3%) refers to companies, i.e. customers from the activities "wholesale and retail trade" and "industry", whose average risk level is in the risk category "B".

At the end of the second quarter of 2014, **the share of the uncollateralized credit exposure in the total credit exposure to non-financial entities,** but also to individual sectors, decreased. This decrease corresponds with the raised collateral requirements when approving corporate loans, and the assessment of the risk from default on foreclosure as a factor that contributes to the tightening of credit conditions for households and companies, according to the results of the Lending Survey from July 2014. The share of the non-collateralized exposure to natural persons, excluding the exposure based on overdrafts on current accounts and credit cards[9] increased to 14.9% (14.5% as of 31 March 2014), due to the growth of non-collateralized consumer loans.

Credit risk concentration, observed through the share of large exposures[10] to non-financial entities in the banks' own funds, decreased at the end of the second quarter of 2014. Analyzed by bank, the share of large exposures to non-financial entities[11] ranges from 12.2% to 264.4%. Moreover, about half of the large exposures at the system level account for one bank. By including the banks' exposures to financial institutions and investments in CB bills and government securities, the share of large exposures in the banks' own funds is significantly higher and amounts to 193.7%. Analyzed by bank, this share ranges between 11.8% and

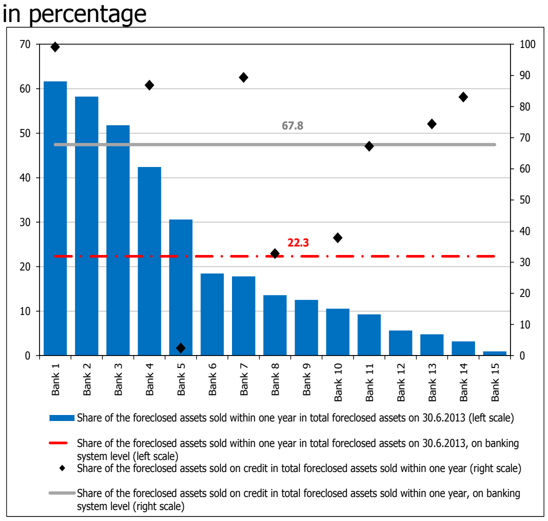
[9] Most collections of this credit exposure are covered by the monthly income of borrowers.
[10] Large exposure to a person or persons related thereto is an exposure equal to or higher than 10% of bank's own funds.
[11] Six banks do not have large exposures to non-financial entities.

Chart 12
Share of large exposures to non-financial entities in banks' own funds
in percentage



Source: NBRM, based on the data submitted by banks.

Chart 13
Foreclosed assets as of 30 June 2013 that are sold within one year
in percentage



Source: NBRM, based on the data submitted by banks.

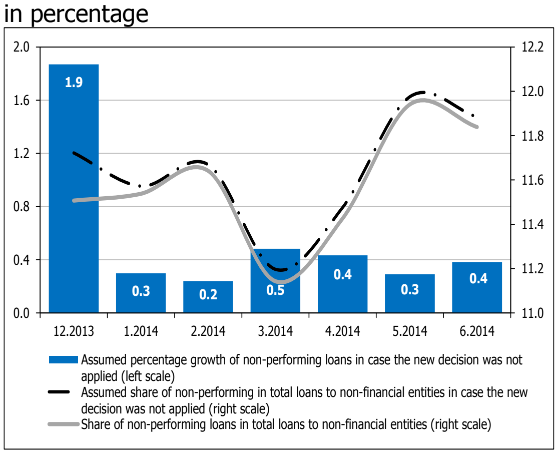
696.1% and is within the maximum prescribed limit[12].

At the end of the second quarter of 2014, there was an **annual decline in the foreclosed assets** in the banks' balance sheets due to the decline in the net foreclosed assets as a result of the obligatory impairment of foreclosures, and of the sales of foreclosed assets, suggesting that regulatory changes in their accounting treatment[13] showed adequate effects. Thus, over a period of one year (30 June 2013 - 30 June 2014) 22.3% of the total assets foreclosed as of 30 June 2013 were sold. Analyzed by individual bank, this ratio ranges from 1.0% to 61.7%. According to the method of sale, **67.8% of the total assets foreclosed as of 30 June 2013 are sold in whole or in part on credit**[14] over the following year. Analyzed by bank, sales of foreclosures on credit ranges from 2.4% to 99.1%. The largely used sales on credit by certain banks indicates the willingness of banks to approve loans in order to sell the foreclosed assets more quickly, given the shallow and insufficiently liquid real estate market. Of particular importance is the sale on credit to be structured properly, in order to avoid the impression of a mere delay of the impairment of foreclosed assets. Part of the loans intended for sale of banks' foreclosures are approved to companies with a grace period of three years[15], during which the client has no obligation to make repayments, and therefore the bank could have no insight into the actual creditworthiness of the client. Loans with grace period further postpone the collection of the foreclosed assets.

[12] The total amount of large exposures must not exceed eight times the amount of banks' own funds.
[13] Decision on the accounting and regulatory treatment of foreclosures based on outstanding claims ("Official Gazette of the Republic of Macedonia" no. 50/13). This Decision has introduced the requirement for obligatory annual impairment of the value of the foreclosed assets of at least 20% of its accounting value. Moreover, the regulation introduced an initial impairment of the foreclosed asset of at least 20% and an obligation to present the revaluation reserve as the difference between the amount of derecognized impairment/special reserve for the uncollected claim and the initial impairment of the foreclosed asset.
[14] Six banks do not sell foreclosures on credit.
[15] As of 30 June 2014, three banks have credits for sale of foreclosed assets of enterprises with a grace period of up to three years, with the grace period for this credits not yet been expired on 30 June 2014 or expired during the period from 30 June 2013-30 June 2014 (meaning that these loans were approved up to four years ago).

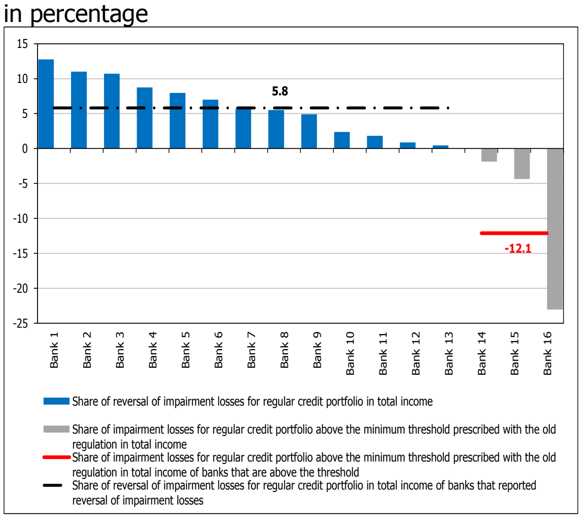
Effects of the new Decision on the credit risk management on the growth of non-performing loans and on the amount of impairment/special reserve

Chart 14
Effect of the new Decision on the credit risk management on the growth of non-performing loans and the rate of non-performing loans
in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

Chart 15
Effect of the changed limits for the impairment for each category of risk for the regular exposure on the amount of impairment allocated by banks
in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.

In order to determine the effect of the new Decision on the credit risk management[16], two analyses were conducted: (1) of the assumed growth of non-performing loans in case the provision for excluding from the non-performing status of claims for which the full amount that is past due for more than 31 days was collected (zero days under previous regulations) was not applied and (2) of the effect of the lowered limits for impairment by individual risk categories for the regular loan portfolio, on the level of impairment that banks allocate.

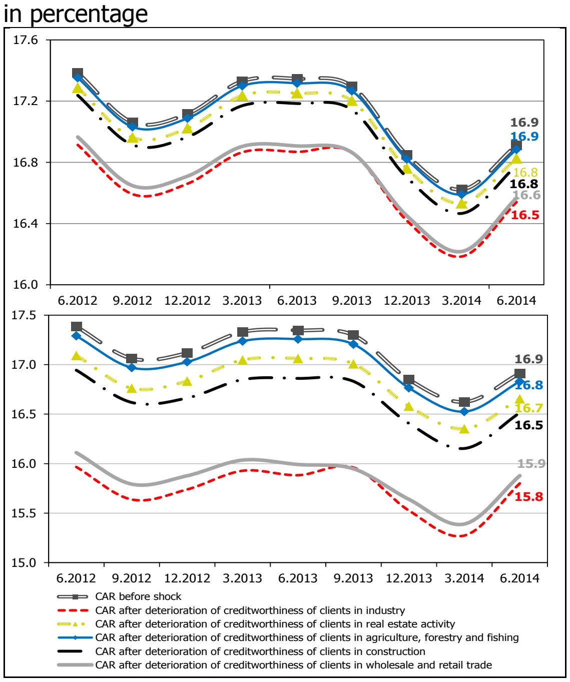
The analysis of the level of non-performing loans showed that at the end of 2013, the additional growth of non-performing loans would be 1.9 percentage points, if this new provision of the Decision was not applied. Since early 2014, the assumed growth of non-performing loans would be, on average, by 0.4 percentage points higher on a monthly basis, if this provision was not applied. Under this assumption, the share of non-performing loans in total loans would be higher by 0.2 percentage points as of 31 December 2013 and by 0.1 percentage points at the end of June 2014.

The second analysis helped to determine the amount of impairment that should be set aside by each bank if the minimum limits for impairment losses in accordance with previous regulations were applied[17]. The results showed that the change in the limits contributed to the reversal of impairment losses in thirteen banks, while with the other three banks the percentage of impairment for each risk category is above the minimum requirement according to the old regulation, which suggests that these banks do not implement the easing provided with the new regulation and still have a more conservative approach to the credit exposures in their portfolio, which is probably due to the increased risk of these exposures and lower probability of collection. With the banks that made a reversal, the share of the reversed impairment losses in the total income generated from 1 December 2013 to 30 June 2014 ranges from 0.5% to 12.7%, and in six banks this share exceeds the

[16] "Official Gazette of the Republic of Macedonia" no. 50/13 and 157/13)".
[17] In the previous Decision the minimum limits were by 5 percentage points higher for each risk category. Thus, in this analysis, for the credit exposures in risk category "B" the applied rate of impairment is 10% wile for the exposures in risk category "C" the applied rate of impairment is 25%.

share at the system level[18]. Nine of the thirteen banks that registered a reversal of impairment losses have made profit for this seven-month period (since the start of the implementation of the new regulation), and the share of the reversed impairment losses in the profit of an individual bank ranges from 5.1% to 189.7%, with a median of 22.5% and third quartile of 40.5%. **This suggests that the reversal of impairment losses contributes to the profits with some of the banks, while in one bank it generates the entire profit, i.e. the bank would show no profit if the limits for the impairment for individual risk categories of the regular loan portfolio were not lowered.**

Chart 16
Capital adequacy ratio, by activity, before and after the first (up) and the second (down) simulation for both sectors
in percentage



Source: NBRM, based on the data submitted by banks.

1.2. Stress test simulation of the banking system's resilience to a rising credit risk

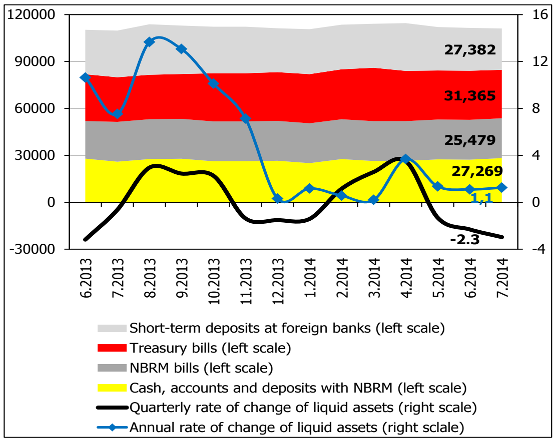
In order to examine the sensitivity of the banking system to deterioration of the quality of certain loan portfolio segments, regular stress-tests are conducted. They consist of simulations of hypothetical migration of 10% (first simulation) and 30% (second simulation) of the credit exposure to companies (by activity) and households (by credit products), separately, and to both sectors together, to the next two higher risk categories. Compared to the previous quarter, certain improvements in the results and further resilience of the banking system to the simulated shocks were registered, while in some banks there was deterioration. In both simulations for the different activities, the greatest reduction in the capital adequacy ratio was noticed in the deterioration of the creditworthiness of the customers from "industry" and "wholesale and retail trade" (Annex 26).

2. Liquidity risk

In the second quarter of 2014, liquid assets declined on a quarterly basis, but their level remains high. The quarterly decrease in liquid assets results primarily from the reduction in the amount of banks' investments in treasury bills, but also from the investments in short-term deposits in foreign banks. Liquidity indicators are satisfactory although they slightly decreased in the second quarter of 2014, mainly due to the drop in total liquid assets. After three consecutive quarters of banks' deleveraging to their parent entities, in the second quarter of 2014, the used sources from parent entities increased slightly. Stress testing has shown sufficient resilience of the banking system to different liquidity shocks. According to the latest available data, as of August 2014, the banking system still maintains the satisfactory liquidity position, as evidenced by the share of the liquid in the total assets of over 30%.

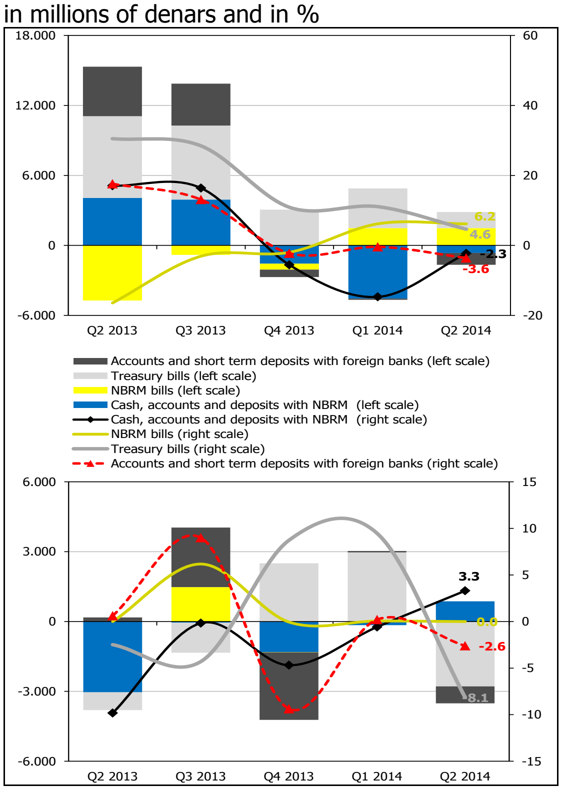
[18] This share at the level of the banking system applies only to banks that released impairment.

Chart 17
Banks' liquid assets structure and dynamics
in millions of denars and in %



Source: NBRM, based on the data submitted by banks.

Chart 18
Annual (top) and quarterly (bottom) absolute and relative change of financial instruments that constitute liquid assets
in millions of denars and in %



Source: NBRM, based on the data submitted by banks.

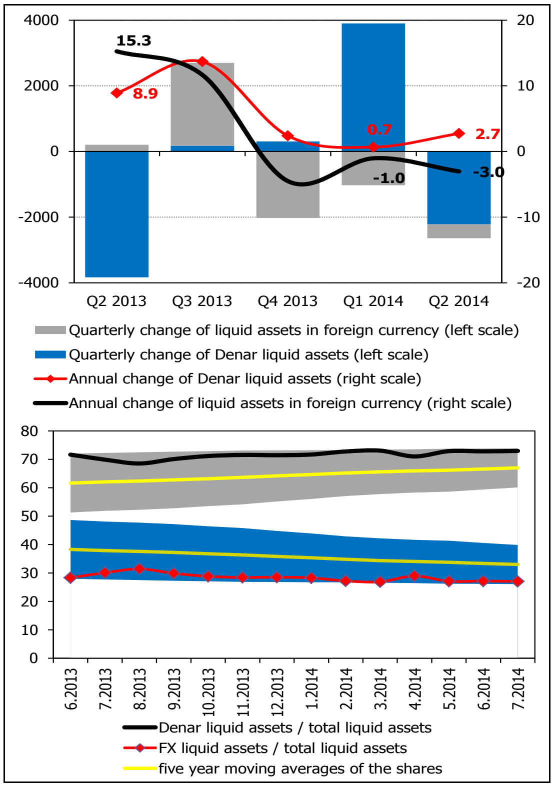
2.1. Dynamics of liquid assets

At the end of the second quarter of 2014, liquid assets[19] of the banking system amounted to Denar 111,495 million which is by Denar 1,212 million, or 1.1% more, on annual basis. As of August 2014, liquid assets still registered an annual growth of 2.9%. Observed on a quarterly basis, liquid assets in the second quarter of 2014 decreased by Denar 2.643 million, or 2.3%. These changes in the banks' liquid assets point to gradual increase in their appetite for taking credit risk, which is confirmed by the accelerated annual growth in lending to the private sector. Moreover, the financing of the domestic private sector brings about greater yield for the banks compared to investing in liquid instruments, primarily from placing assets in foreign banks, but also from investments in the instruments on the domestic money market.

The possibility of more intense growth of banks' investments in CB bills is influenced also by the manner in which the NBRM conducts the CB bills auctions. The quantitative limit of the offered amount of CB bills, in circumstances of consistently higher demand by banks, actually prevents the banks' unlimited placing of funds in this instrument and hence affects the reallocation of banks' investments in other financial instruments, including loans. Given that banks' investments in CB bills have been virtually unchanged for three consecutive quarters, **the quarterly decline in liquid assets in the second quarter of 2014 was mainly due to the fall in treasury bills** owned by banks by 8.1%, i.e. Denar 2,781 million. However, **on annual basis, treasury bills in the balance sheets of Macedonian banks grew** by 4.6% and their share in the structure of liquid assets (of 28.1%) increased by 0.9 percentage points. Besides treasury bills, banks were also oriented towards longer-term investments. As of the end of the second quarter of 2014, **their**

[19] Liquid assets include cash and assets on accounts with the National Bank, CB bills, correspondent accounts and short-term deposits with foreign banks and investments in short-term securities issued by the government. For the purposes of analyzing liquidity, assets and liabilities in Denar with FX clause are being regarded as Denar assets and liabilities.

Chart 19
Quarterly change in absolute and in relative terms (top) and structural shares (bottom) of liquid assets by currency
in millions of denars and in %



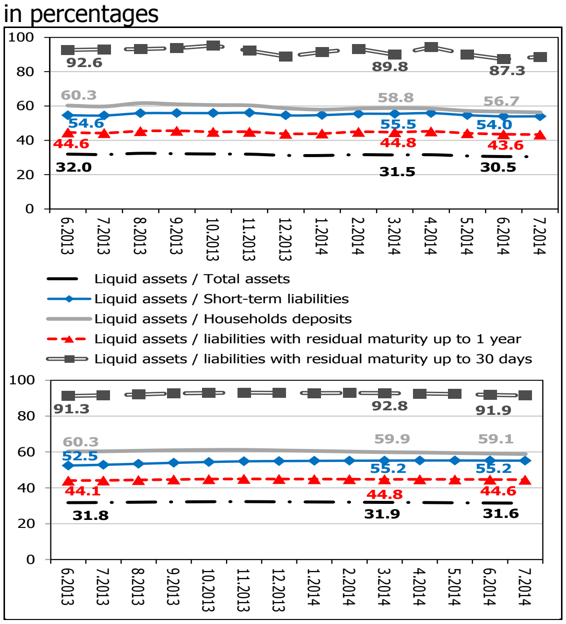
Source: NBRM, based on the data submitted by banks.
Note: The shaded part of the chart denotes the range of one standard deviation above and below the five-year moving average of the structural share.

investments in government bonds rose on an annual basis by Denar 3,402 million, i.e. 112.3%. However, the share of these financial instruments is still modest, occupying 1.7% of the total banks' assets as of 30 June 2014. Given that according to the list of securities for conducting monetary operations[20] the National Bank accepts government bonds as collateral in conducting monetary operations, they can be used in addition to banks' liquid assets in case of a sudden need of a larger amount of liquidity.

Short-term deposits placed in foreign banks at the end of the second quarter of 2014 decreased on both quarterly (by 2.6%), and on an annual basis (by 3.6%). Their share in the structure of liquid assets decreased by 1.2 percentage points on an annual basis and equaled 24.6% as of 30 June 2014. Such dynamics of short-term deposits in foreign banks as the most important foreign currency instrument in liquid assets, caused a decline in the foreign currency component of the liquid assets of 3.0% annually. At the end of the second quarter of 2014, the Denar component accounts for 72.8%, while the foreign currency component accounts for 27.2% in the currency structure of liquid assets. Analyzed historically, the share of the Denar component is considerably high, versus the extremely low share of the foreign currency liquidity[21], and confirms the stronger propensity of banks to invest in Denars compared with foreign currency liquid instruments.

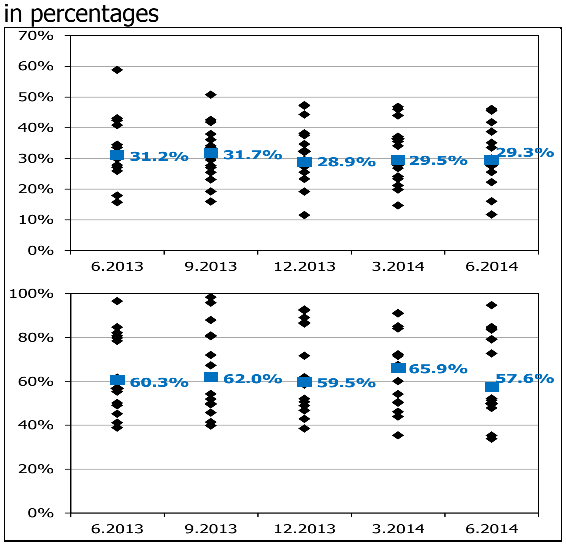
[20] "Official Gazette of the Republic of Macedonia" no. 126/11).
[21] This is confirmed by the fact that foreign exchange liquidity is almost one standard deviation away from the five-year moving average

Chart 20
Liquidity ratios of the banking system – level (top) and twelve-month moving average (bottom)
in percentages



Source: NBRM, based on the data submitted by banks.

Chart 21
Dynamics of the share of liquid in total assets (top) and of the coverage of short-term liabilities with liquid assets (bottom) by bank
in percentages



Source: NBRM, based on the data submitted by banks.

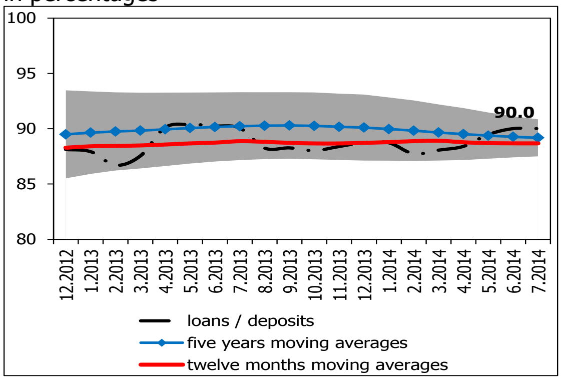
2.2. Liquidity ratios

In the second quarter of 2014, indicators of banking system liquidity[22] remained satisfactory despite the quarterly decrease in liquid assets. Stable liquidity position of domestic banks is confirmed also by the dynamics of the twelve-month moving average of liquidity indicators. It is worth noting that at the end of the second quarter of 2014, the value of all liquidity indicators is lower than their twelve-month average, as a result of the stagnation of total liquid assets during the six months of 2014[23].

The ratio of liquid assets to total assets by bank ranges between 11.7% and 46.1% as of 30 June 2014. Greater dispersion by individual bank is observed in the indicators for coverage of certain categories of liabilities with liquid assets. Thus, as of 30 June 2014, the coverage of short-term liabilities with liquid assets ranges from 33.8% to 94.6%. The coverage of the total deposits of non-financial entities by bank at the end of the second quarter of 2014 ranged from 26.1% to 83.6%, while the coverage of liabilities with residual maturity up to one year, from 27.0% to 71.3%.

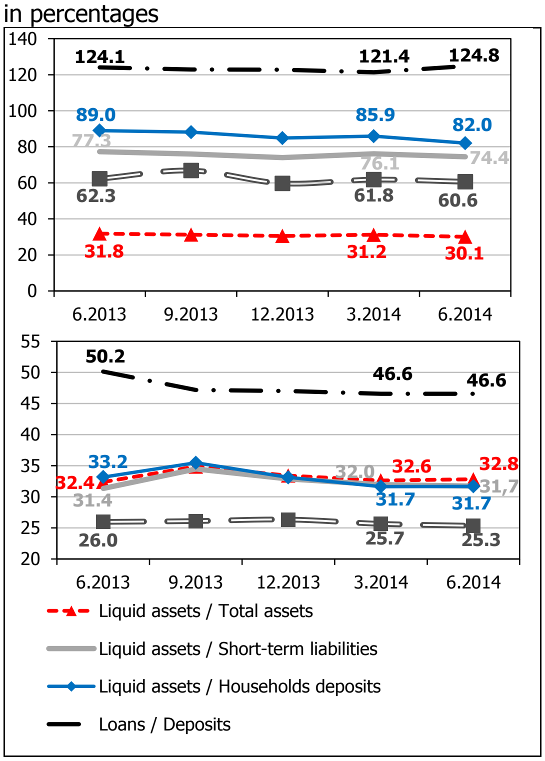
[22] The calculation of the liquidity of the banking system does not take into account the resident interbank assets and liabilities.
[23] The growth of liquid assets in the first half of 2014 amounted to Denar 230.8 million, or 0.2%.

Chart 22
Dynamics of loan/deposit ratio
in percentages



Source: NBRM, based on the data submitted by banks.
Note: The shaded part in the chart denotes the range of one standard deviation above and below the five-year moving average of the share.

Chart 23
Liquidity ratios of the banking system by currency - Denar (top) and foreign currency (bottom)
in percentages



Source: NBRM, based on the data submitted by banks.

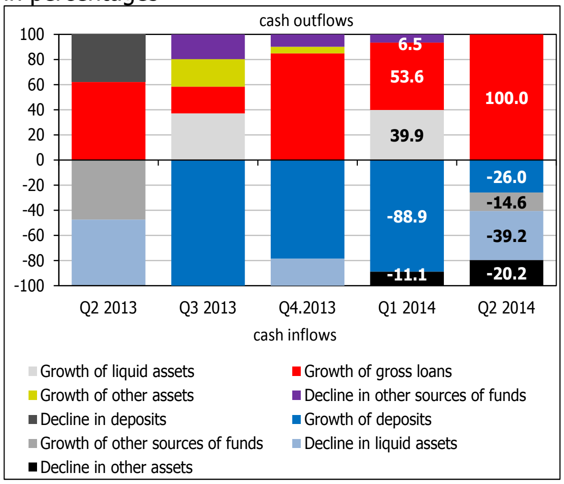
The ratio between loans and deposits of non-financial entities showed steady movement around the level of 90%, also in the second quarter of 2014. Hence, at the end of the second quarter of 2014, the value of the ratio between loans and deposits was over its twelve-month and five-year moving average. By bank, as of 30 June 2014, this indicator ranged from 52.3% to 129.5%, while five banks registered full utilization of deposits for lending to the private sector.

In the second quarter of 2014, a slight decrease in the liquidity indicators from currency aspect was registered. This reduction is slightly more pronounced in the liquidity indicators in Denars due to the more intensive quarterly decline in Denar liquidity.

Banking system liquidity ratios[24], presented as a ratio between assets and liabilities that mature in the next 30 days and 180 days, at the end of the second quarter of 2014 were high and equaled 2.4 and 1.5 respectively, and compared with the end of the first quarter of 2014 they registered a modest decline (by 0.1 points).

[24] The method of calculation of banks' liquidity ratios is determined by the Decision on banks' liquidity risk management ("Official Gazette of the Republic of Macedonia" no. 126/11, no. 19/12 and no. 151/13).

Chart 24
Structure of cash inflows and outflows of the banking system
in percentages



Source: NBRM, based on the data submitted by banks.
* The category of other assets includes assets that are not loans to non-financial companies and are not included in the category of liquid assets (placements in securities that are not part of the liquid assets, long-term placements in foreign and domestic banks, foreign exchange reserve requirement, foreclosures, fixed assets, etc.) and the effect of the impairment of financial and non-financial assets, the increase of which leads to a decline in the other assets.
** The category of other funding sources includes all sources of funding which are not deposits of non-financial entities (equity and reserves, deposits of financial institutions, borrowings, subordinated instruments etc.)

Increased appetite of banks for taking credit risk is reflected also in the structure of the cash outflows[25]. Thus, **during the second quarter of 2014, banks used all newly acquired sources of funding to support lending to the private sector.** On the other hand, **the structure of the banks' cash flows in the second quarter of 2014 is far more diverse.** Most of the inflow of new sources of funding for the banking system arises from the disinvestment of financial instruments which constitute liquid assets, followed by cash inflows from new deposits and cash inflows from disinvestment of other types of assets. However, observed annually, financing of banks from the domestic deposit market almost completely determines the cash inflows of banks (about 99% as of 30 June 2014), while predominant in the structure of the cash outflows are outflows for lending (about 86.7%).

In the second quarter of 2014, the positive dynamics of deposits of non-financial entities contributed with 61.7% to the quarterly change in the total sources of funding for banks. Sources of funding based on used loans declined on a quarterly basis by 1.6% mainly due to the fall in the liabilities on loans from non-residents (which were partly a result of the used loans from parent entities). Regarding the currency, the largest contribution (54.1%) to the quarterly increase in banks' total sources of funding was that of long-term sources of funding, which was mainly due to the growth of the long-term household deposits. On the other hand, short-term deposits from non-financial entities registered quarterly decline, which was fully offset by an increase in the short-term liabilities to parent entities.

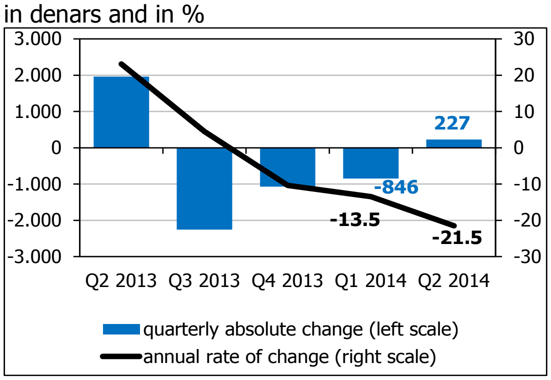
[25] Cash outflows and cash inflows of banks are obtained in an indirect way, i.e. by changing the balances of individual accounts of the banks' balance sheet. The effect on the cash flows of the banks, which is due to the income and expenditures that do not represent cash outflow or inflow (e.g. loan write-offs, revaluation of securities available for sale or held for trading, depreciation of fixed assets, net foreign exchange differences, etc.) is an integral part of the change in the corresponding balance sheet items the respective inflow or outflow refers to.

Table 1 Sources of funding for banks
in millions of denars and in %

Types of sources of funds	31.3.2014		30.6.2014		Quarterly change	
	Ammount (in millions of Denars)	Share	Ammount (in millions of Denars)	Share	Absolute	Relative
Deposits of non-financial enteties	**265,912**	**71.1%**	**267,616**	**71.1%**	**1,704**	**0.6%**
-o.w. parent enteties	0	0.0%	0	0.0%	0	0.0%
Deposits of financial institutions	**15,586**	**4.2%**	**16,233**	**4.3%**	**648**	**4.2%**
-o.w. parent enteties	4,820	1.3%	5,156	1.4%	336	7.0%
Loans, issued debt securities subordinated liabilities and hybrid capital instruments	**42,960**	**11.5%**	**42,290**	**11.2%**	**-670**	**-1.6%**
-o.w. parent enteties	9,271	2.5%	9,152	2.4%	-119	-1.3%
Equity and reserves	**44,789**	**12.0%**	**45,317**	**12.0%**	**528**	**1.2%**
Other sources of financing	**4,522**	**1.2%**	**5,072**	**1.3%**	**550**	**12.2%**
-o.w. parent enteties	72	0.0%	81	0.0%	10	13.8%
Total sources of financing	**373,768**	**100.0%**	**376,528**	**100.0%**	**2,760**	**0.7%**
Long-term sources of financiang	**144,595**	**38.7%**	**146,089**	**38.8%**	**1,494**	**1.0%**
-o.w. parent enteties	11,480	3.1%	9,779	2.6%	-1,701	-14.8%
Shrot-term sources of financing	**179,862**	**48.1%**	**180,050**	**47.8%**	**188**	**0.1%**
-o.w. parent enteties	2,611	0.7%	4,529	1.2%	1,919	73.5%
Equity and reserves	**44,789**	**12.0%**	**45,317**	**12.0%**	**528**	**1.2%**
Other sources of financing	**4,522**	**1.2%**	**5,027**	**1.3%**	**550**	**12.2%**
-o.w. parent enteties	72	0.0%	81	0.0%	10	13.8%
Total sources of financing	**373,768**	**100.0%**	**376,528**	**100.0%**	**2,760**	**0.7%**

Source: The data are submitted by the banks on the basis of a specific request from the National Bank and therefore there might be differences relative to the balance sheet data that banks submit on a regular basis in accordance with the Decision on submitting data on the balances and turnover on the accounts from the banks' Chart of accounts and the financial reports.

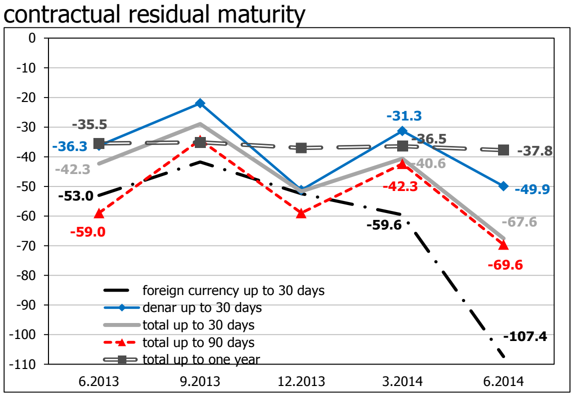
Chart 25
Change of the used sources of funding from parent entities
in denars and in %



Source: NBRM, based on the data submitted by banks

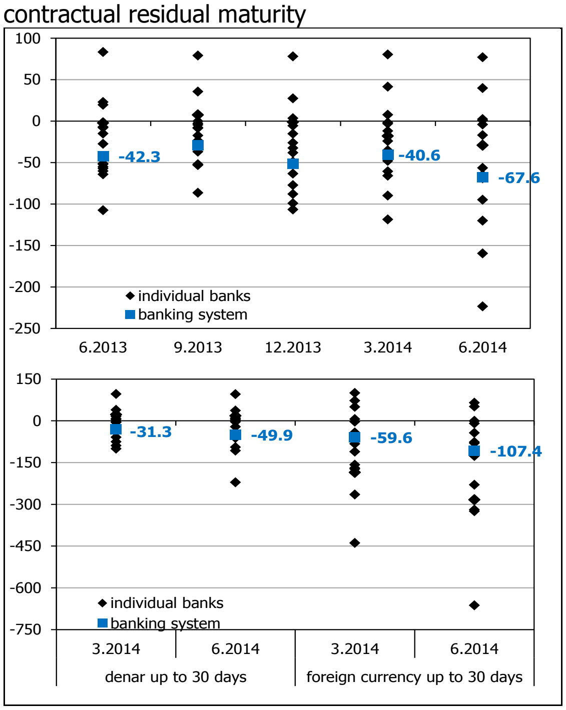
After three consecutive quarters of deleveraging of banks to their parent entities, in the second quarter of 2014, the sources used by the parent entities registered a small increase. Quarterly increase in the liabilities to parent entities is most present in one bank, on the basis of a short-term deposit invested by its parent entity. Simultaneously, the maturity structure of the used sources coming from parent entities registered a decrease in the long-term component, as opposed to the increase in the short-term liabilities, which is also most present in one bank. As of 30 June 2014, the share of liabilities to parent entities in the total liabilities of banks is 4.3%, which is unchanged compared with the end of the first quarter of 2014. On an annual basis, the share of the used sources from parent entities in the total liabilities of banks decreased by 1.5 percentage points. Their share in total banks' liabilities to non-residents at the end of the second quarter of 2014 was 38%, which is a quarterly increase of 0.4 percentage points (on an annualized basis this share decreased by 6.3 percentage points).

Chart 26
Cumulative difference between banks' assets and liabilities according to the contractual residual maturity
percentage of cumulative assets with the same contractual residual maturity



Source: NBRM, based on the data submitted by banks.

Chart 27
Cumulative difference between banks' assets and liabilities according to the contractual residual maturity of up to 30 days, by bank, total (top) and by currency as of 30 June 2014 (bottom)
percentage of cumulative assets with the same contractual residual maturity



Source: the NBRM calculations, based on data submitted by banks

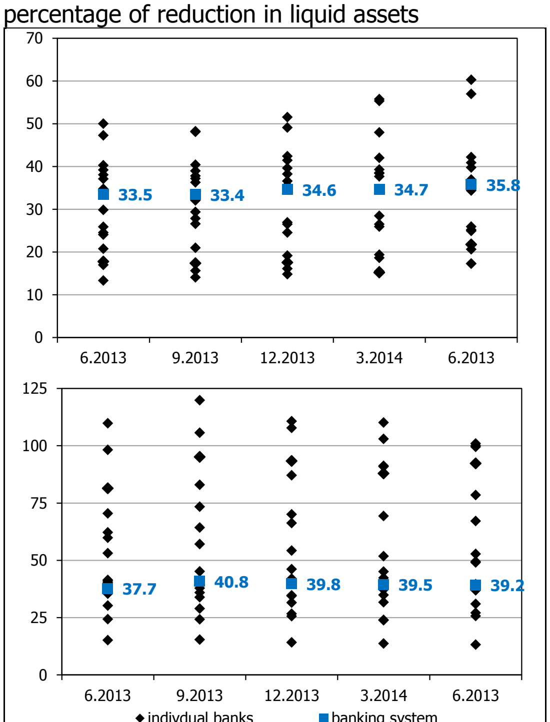
2.3. Maturity structure of assets and liabilities

Reduction in the liquid assets of banks in the second quarter of 2014 caused changes in the structure of the assets according to the contractual residual maturity (Annex 28). Changes in the maturity profile of assets and liabilities of the banks led to a more prominent deepening of the relative importance of the aggregate negative difference between assets and liabilities of banks according to the contractual residual maturity in the second quarter of 2014. The cumulative negative gap between banks' assets and liabilities with residual maturity of up to 30 days, expressed as a percentage of cumulative assets of the same contractual maturity, increased by almost 27 percentage points on a quarterly basis. This movement was caused by the quarterly decline of the assets with residual maturity of up to 30 days by Denar 16,127 million, in circumstances when the liabilities with the same contractual maturity rose by Denar 672 million. The increase is significantly stronger in the foreign exchange component of the aggregate difference between assets and liabilities with residual maturity of up to 30 days. The relative importance of the cumulative difference between banks' assets and liabilities with residual maturity of up to 90 also widened on a quarterly basis. By bank, it is obvious that in the second quarter of 2014 there was a significant increase in the dispersion of the relative importance of the aggregate difference between assets and liabilities by contractual residual maturity of up to 30 days, which also is more prominent in the foreign exchange component of this difference. Moreover, in three banks, the negative difference between assets and liabilities with residual maturity of up to 30 days is greater than total assets with contractual maturity of up to 30 days. But for the most part those are banks that pursue a policy of attracting sight deposits that have historically shown a high percentage of stability. This is confirmed also by the **banks' expectations according to which, the cumulative difference between assets and liabilities is positive in all maturity**

buckets (Annex 29). This suggests that the **banks have positive expectations regarding the stability of deposits** as the main source of funding for their activities. Thus, as of 30 June 2014, banks expect that 84.3% of the deposits with residual maturity of up to three months (78.8% as of 31 March 2014) should be stable and remain in the banks in the following three months.

2.4. Stress test simulations for liquidity shocks

Chart 28
Results of the simulations for withdrawal of:
-20% of households' deposits (top) and
- deposits of the twenty largest depositors (bottom)
percentage of reduction in liquid assets



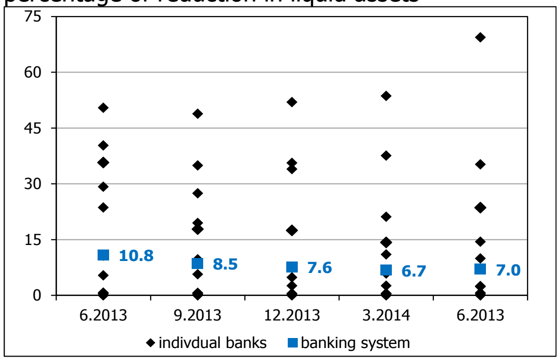
Source: the NBRM calculations, based on data submitted by banks

Given the level of liquid assets of Macedonian banks, **the results of different simulated liquidity shocks indicate a stable liquidity position of banks**. The decline in the liquid assets of the banking system would be the largest in the simulated withdrawal of deposits of the twenty largest depositors of individual banks. In the event of such a liquidity shock, liquid assets would decrease by 39.5%, whereby their share in total assets of the banking system would be reduced from 30.4%[26] to 20.9%. Amid such a shock, the coverage of short-term liabilities[27] with liquid assets would be reduced from 53.2% to 37.5%. By bank, the decline in the liquid assets amid such hypothetical liquidity outflow would be from 13.2% to 101.0%, while in two banks liquid assets would be fully utilized. The share of liquid assets in the total assets would range in the interval from 0% (for banks which fully use the liquid assets) to 38.0%, while the coverage of short-term liabilities with liquid assets would be from 0% to 69.2%.

Amid a simulated withdrawal of 20% of the household deposits, at the level of the banking system, liquid assets would decrease by 35.8%, their share in total assets would be 21.8% and the coverage of short-term liabilities with liquid assets would be 39.2%. By bank, the decline in liquid assets would range from 17.3%

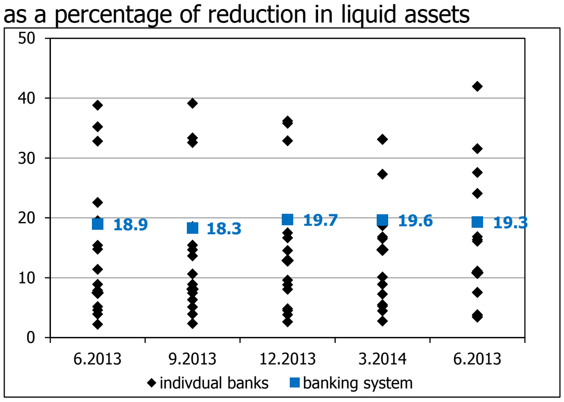
[26] In the presentation of the results of the simulations for liquidity shocks, the initial level of all indicators is shown without the effect of the Macedonian Bank for Development Promotion AD Skopje, which is excluded from the simulation because of the statutory limitation for participation in the deposit market.
[27] In the simulations it is assumed that the outflow of deposits according to the maturity structure corresponds proportionally with the maturity structure of total deposits as of 30 June 2014.

Chart 29
Results of the simulations for withdrawal of the used sources of funding of banks by foreign parent entities
percentage of reduction in liquid assets



Source: the NBRM calculations, based on data submitted by banks Excluding the liabilities of domestic banks to parent entities on the basis of subordinated debt instruments and hybrid capital instruments

Chart 30
Results from the simulation for converting off-balance sheet liabilities into balance sheet claims of banks
as a percentage of reduction in liquid assets



Source: NBRM, based on the data submitted by banks.

to 60.3%, and their share in total assets would range between 7.1% and 41.4%. Liquid assets of Macedonian banks are sufficient to cover also a more extreme shock - withdrawal of 50% of the household deposits, when the absorption of this outflow would consume 89.5% of the liquid assets, and their share in the total assets would be 4,4%.

The banking system would not have significant problems even in case of a complete withdrawal of the used sources of funding from banks' foreign parent entities[28]. Amid such a hypothetical outflow, liquid assets of the banking system would be reduced by 7% and would take 29.8% of the total bank assets. By bank, the results of this simulation show relatively large dispersion, which corresponds to the differences in the structure of the sources of funding of banks and the role of the financial support from parent entities in this framework. Thus, amid such hypothetical liquidity shock, the decline in the liquid assets by bank would move in the range from 0% (for banks that do not have any liabilities to the parent entities) to 69.4%.

Full conversion of certain categories of off-balance sheet liabilities of banks[29] into balance sheet claims, which actually implies an adequate liquidity outflow, could also be presented as a hypothetical liquidity shock for the Macedonian banks. In this simulation, the liquid assets of the banking system would be reduced by 19.3%, while the share of liquid assets in ther total assets and the coverage of short-term liabilities with liquid assets would be lower by 6.0 and 10.3 percentage points respectively. By bank, the decline in liquid assets would range from 3.4% to 41.9%, while their share in total assets would range between 9.4% and 42.6%.

The banking system would not have enough liquid assets only in case of an extreme

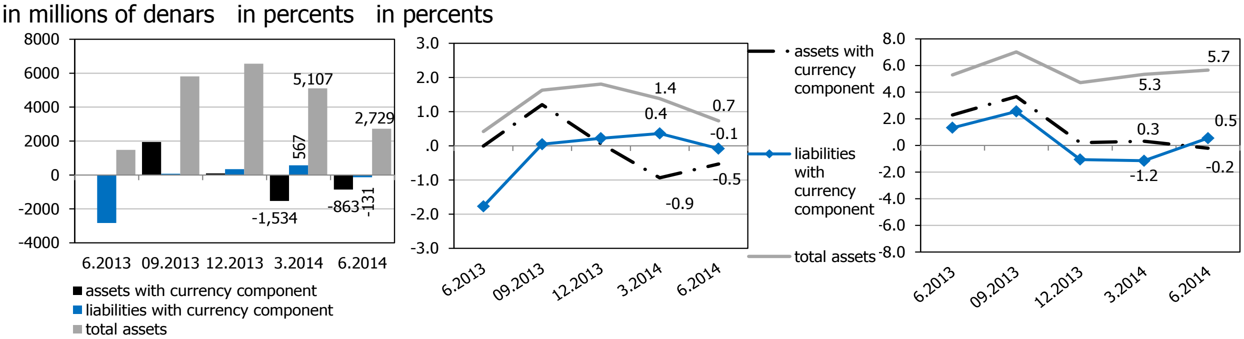
[28] Banks' liabilities to parent entities based on subordinated instruments and hybrid capital instruments are excluded from the simulation, because, according to the respective regulation of the National Bank, the possibility for their early repayment is limited.
[29] This simulation includes banks' off-balance sheet liabilities based on unused limits on credit cards, irrevocable credit limits and unsecured letters of credit.

liquidity shock, which in a time frame of 30 days would mean outflow of deposits of the twenty largest depositors, of 20% of household deposits, of the liabilities to the parent entities (excluding the liabilities based on equity instruments), of 50% of the liabilities to non-residents (excluding the liabilities to non-resident parent entities of banks) and conversion of certain off-balance sheet liabilities of banks into balance sheet claims. Only five banks accounting for 45.3% of the total assets as of 30 June 2014 would have sufficient liquidity to bridge this integrated liquidity shock, with their share in total assets ranging from 1.0% to 18.2%. However, if the scope of liquid assets is expanded with other financial instruments for which there is a substantial likelihood that they will bring liquidity inflow for the banks within 30 days, a much more favorable result is obtained, which leads to a conclusion that the banks are highly resilient even in such an extreme liquidity scenario. Thus, if we take into account the banks' investments in government securities, the loans to non-financial entities that have contractual maturity of up to 30 days and the effect of lowering the reserve requirement in foreign currency (the part allocated in foreign currency), due to the simulated drop in household deposits, the banking system as a whole would use 90.7% of such expanded liquid assets to deal with the consequences of this integrated liquidity shock. In such an expanding range of liquid assets, seven banks with a share of 26.3% in the total assets would not have sufficient liquid assets as of 30 June 2014, and would need Denar 12,659 million to bridge this liquidity shock. In the other eight banks, after such an integrated liquidity shock the share of liquid assets in the total assets would range from 4.4% to 19.7%, while the coverage of short-term liabilities with liquid assets would range from 10.3% to 37,9%.

3. Currency risk

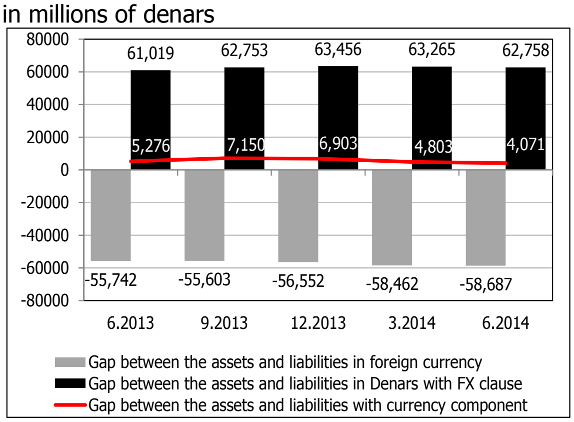
The exposure of the banks in the Republic of Macedonia to currency risk is low, and in the second quarter of 2014 it declined even more. The share of the gap between assets and liabilities with a currency component in the banks' own funds continued to move downwards, and the share of the currency component of assets and liabilities of the banking system was also decreasing. As of 30 June 2014, the aggregate currency position of all banks was within the prescribed limit (30% of own funds).

Chart 31
Quarterly (left and middle) and annual (right) growth of assets and liabilities with currency component
in millions of denars in percents in percents



Source: the NBRM, based on data submitted by banks.

Chart 32
Structure of the gap between assets and liabilities with currency component
in millions of denars

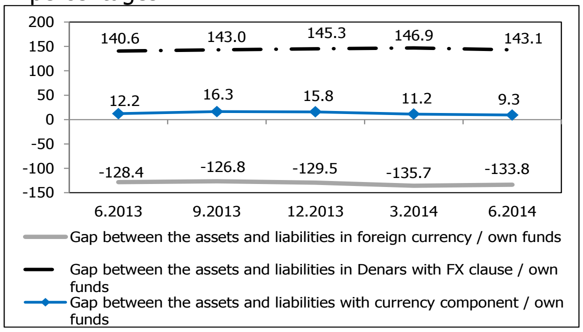


Source: the NBRM, based on data submitted by banks.

In the second quarter of 2014, the gap between assets and liabilities with currency component fell by Denar 732 million, or 15.2%, reducing to Denar 4,071 million at the end of the quarter. This reduction arises from the greater decline in the assets with currency component (by Denar 863 million) relative to the liabilities with currency component (by Denar 131 million)[30].

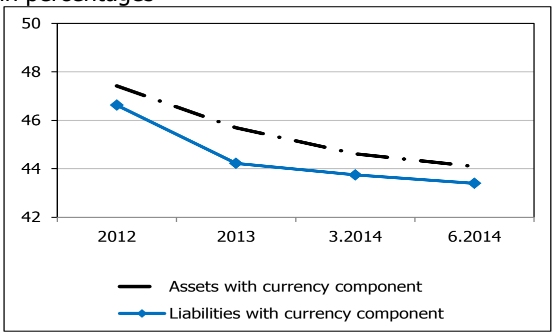
[30] The decline in the assets with currency component was due to the lower balances on current accounts in foreign currency in foreign banks (Denar 3,204 million). On the other hand, banks' deposits in foreign currency increased also in this quarter, by Denar 2,500 million.

Chart 33
Share of the gap between assets and liabilities with currency component in the banks' own funds
in percentages



Source: the NBRM, based on data submitted by banks.

Chart 34
Share of the assets and liabilities with currency component in the total assets of banks
in percentages



Source: the NBRM, based on data submitted by banks.

The composition of assets and liabilities with currency component is shown in Annexes 30 and 31.

The reduced gap between assets and liabilities with currency component has led to further deterioration of its share in the banks' own funds (by 1.9 percentage points), indicating further reduction of the banks' exposure to currency risk, which was already low.

The share of assets and liabilities with currency component in the total assets of the banking system[31] continued to decline also in the second quarter of 2014.

The Euro still dominates the structure of assets and liabilities with a currency component.

As of 30 June 2014, the aggregate currency position of all banks was within the prescribed limit (30% of own funds).

Table 2 Currency structure of assets and liabilities with currency component
in percentages

Currency	31.12.2013		31.3.2014		30.6.2014	
	Assets	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
Euro	88.8	88.4	88.8	88.4	88.7	87.8
US dollar	6.8	7.3	6.8	7.2	6.8	7.5
Swiss franc	2.3	2.1	2.1	2.1	2.1	2.1
Other	2.2	2.2	2.4	2.4	2.4	2.5
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: the NBRM, based on data submitted by banks.

[31] In the structure of the assets with currency component, loans and interest receivables are on a net basis (adjusted for the impairment). "MBPR" AD Skopje is not included.

Table 3 Classification of banks according to the share of the open foreign currency position by currency and the aggregate foreign currency position in the own funds

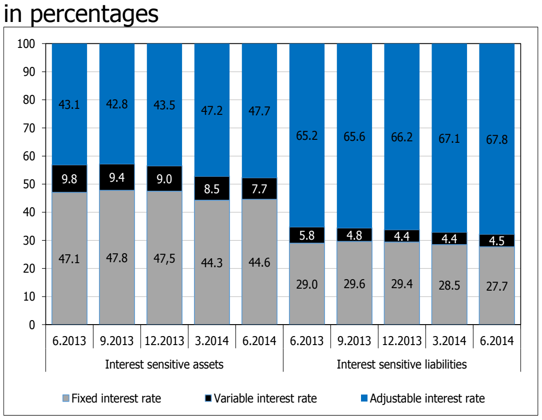
Item	Number of banks								
	Open currency position by currency / own funds								Aggregate currency position/own funds
	Euro		US Dollar		Swiss franc		Other		
	Long	Short	Long	Short	Long	Short	Long	Short	
under 5%	3	2	9	5	7	6	12	2	4
from 5% to 10%	2	1							5
from 10% to 20%	2	2							3
from 20% to 30%	3								3
over 30%									

Source: the NBRM, based on data submitted by banks.

4. Interest rate risk in the banking book

The exposure of banks in the Republic of Macedonia to the interest rate risk in their banking books is negligible in comparison with their exposure to other risks they face with throughout their operations. This is a result of the massive use of adjustable interest rates[32] in the banking activities, which reduces the importance and the need for "real" interest rate risk management by banks. Although these hedging clauses in loans have been used minimally, however, the possibility for the banks to use them poses a potential credit risk. On the other hand, in practice, much more often the adjustment of interest rates on deposits is applied.

Chart 35
Structure of interest sensitive assets and liabilities, by type of interest rates
in percentages



Source: NBRM, based on the data submitted by banks.

Assets and liabilities with adjustable interest rates are the main items in the structure of the banks' interest sensitive assets and liabilities. At the end of June 2014, they accounted for 47.7% and 67.8% of the interest sensitive assets and liabilities, respectively. They are followed by the items with fixed interest rates[33], while for five quarters a downward trend has been registered in the already low share of the items with variable interest rate[34].

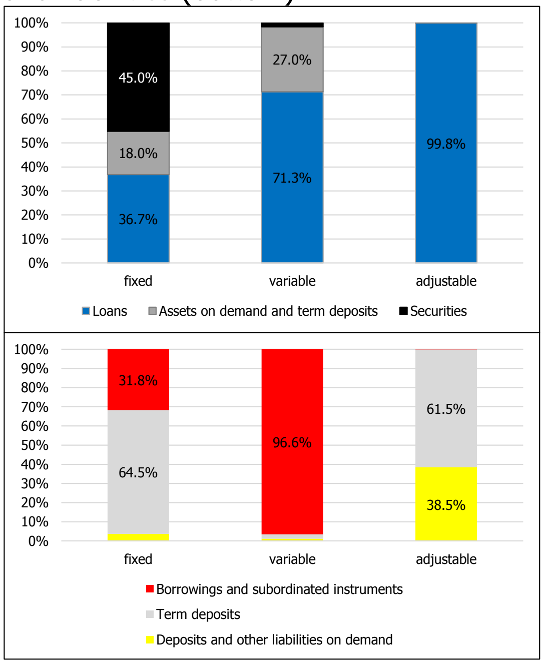
Almost entirely, or 99.8% of the interest sensitive assets with adjustable interest rate are loans, of which 95.7% are loans with an option for early repayment. Similar is the structure of the interest sensitive assets with a variable interest rate in relation to the dominant share of

[32] Adjustable rate - interest rate which is adjusted on the basis of a decision of an appropriate authority of the bank, rather than on the basis of a reference interest rate or index. By using the unilaterally adjustable interest rates, banks pass their own interest rate risk on their customers, and they may serve as an instrument for managing banks' liquidity and profitability.

[33] Fixed interest rate - interest rate which remains unchanged over the entire term of the contract with the customer, and the bank has no right to change the interest rate, which is nominally set in the contract.

[34] Variable (floating) interest rate - interest rate that is directly dependent on a reference interest rate (EURIBOR, SKIBOR, LIBOR, etc.) increased by a certain interest margin, according to the regulations of the bank. The change in the interest rate depends on the change in the reference interest rate, but also on the change of the established margin (mostly by unilateral decision of the bank).

Chart 36
Structure of interest sensitive assets (top) and liabilities (bottom)

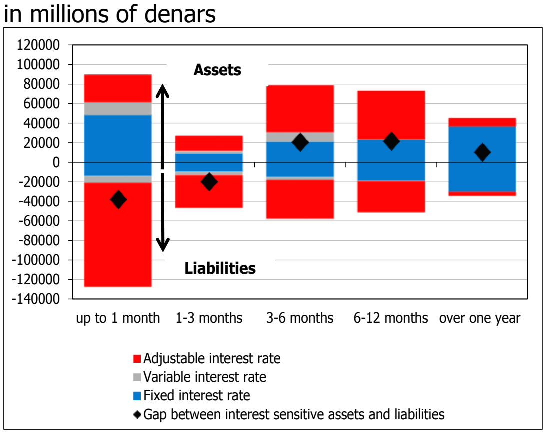


Source:NBRM, based on data submitted by banks.

the loans. Most of the interest sensitive assets with fixed interest rate account for banks' placements in securities.

The large share of the items with adjustable interest rates in the interest sensitive liabilities is a result of time deposits and liabilities on demand. Time deposits with adjustable interest rate account for 69.9% of the total time deposits (68.2% as of 31 March 2014), while 96% of sight deposits are with adjustable interest rate. In the items with variable interest rate, 57% account for borrowings, while deposits and liabilities on demand are minimized. In the liabilities with fixed interest rates significant 64.5% account for time deposits.

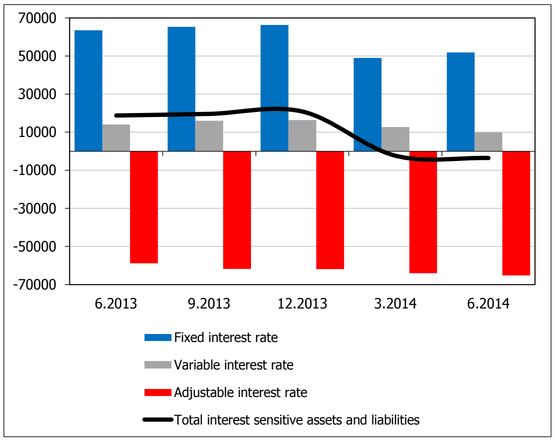
Chart 37
Interest sensitive assets and liabilities, by maturity and type of interest rate
in millions of denars



Source: NBRM, based on the data submitted by banks.

Analyzed by maturity, adjustable interest rates play the main role in most maturity buckets of the interest sensitive assets and liabilities up to one year. Exception are interest sensitive assets in the maturity bucket up to one month, where the positions with fixed interest rate prevail, as a result of banks' placements in securities (Denar 27.6 million as of 30 June 2014). In the same maturity bucket, on the liabilities side, the largest part accounts for transaction accounts, i.e. liabilities on demand with adjustable interest rate. The maturity structure of items with adjustable interest rates represents the banks' expectations for the period of possible adjustment of the interest rates.

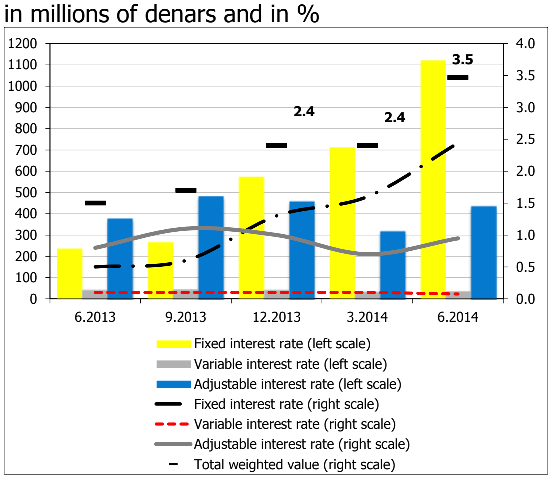
Chart 38
Gap between interest sensitive assets and liabilities, by type of interest rate
in millions of denars



Source:NBRM, based on the data submitted by banks.

At the end of June 2014, the gap between interest sensitive assets and liabilities was positive in the items with fixed and variable interest rate, and negative in the items with adjustable interest rate. Except the gap with the variable interest rates, which is narrowing, the gaps in the other two types of interest rates widened. The widening of the positive gap in the fixed interest rates was due to the credit growth and the decline in time deposits with fixed interest rate. The widening of the negative gap in the adjustable interest rates was a result of the more substantial increase in time deposits on the liabilities side, relative to the increase in the loans on the assets side. The narrowing of the gap in the positions with variable interest rates was determined by the decline in the assets on demand and rising liabilities based on borrowings.

Chart 39
Weighted value (left scale) and total weighted value of banking book to own assets ratio (right scale), by type of interest rate
in millions of denars and in %



Source: NBRM, based on the data submitted by banks.

The interest rate risk in the banking books of the banks in the Republic of Macedonia is low, despite the increased share of the total weighted value of the banking book[35] in the own funds. Analyzed by bank, the ratio between the total weighted value of the banking book and own funds ranges from 0.2% to 12.2% with a median of 4.4% and a third quartile of 5.9%. The low ratio of total weighted value of the banking book and own funds, means that the changes in interest rates would not have a significant impact on the economic value of the banking book.

[35] The total weighted value of the banking book shows the change of the economic value of this portfolio as a result of the assessment of the change in the interest rates by using a standard interest rate shock (parallel positive or negative change in interest rates by 200 basis points). The total weighted value of the banking book of the banking system is obtained by aggregating the weighted values of the banking book of individual banks. For an individual bank, the ratio between the weighted value of the banking book and the bank's own funds may equal up to 20%.

5. Insolvency risk[36]

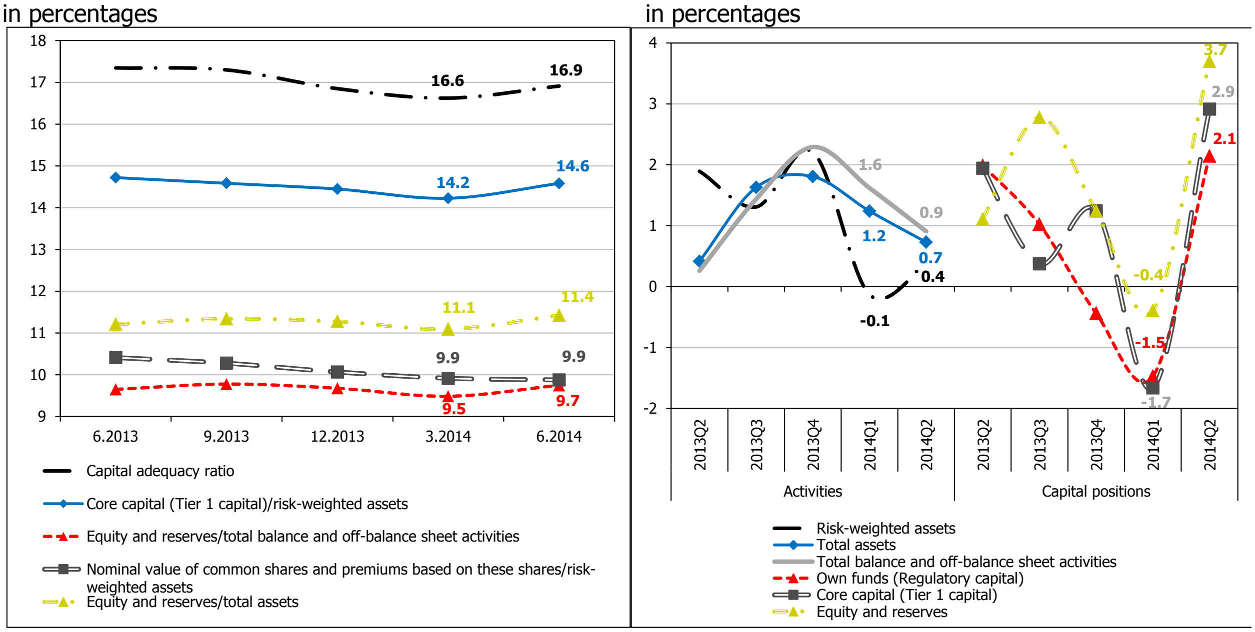
Solvency and capitalization of the banking system improved in the second quarter of 2014, which was a result of the rising level and quality of capital positions. The amount of own funds of the banking system increased, which is mostly a result of reinvested profits earned in 2013. Capital requirements for credit risk registered quarterly growth, which was mostly a result of the increase in the retail loan portfolio. In contrast, the capital requirement for currency risk declined, for the third consecutive quarter. Despite the imminent increase in the risk appetite, reflected by bringing the rate of growth of risk weighted assets closer to that registered in total assets, generally, banks remain cautious in taking risks. The results of the stress test conducted on 30 June 2014, point to satisfactory resilience of the banking system to hypothetical shocks.

5.1. Indicators of solvency and capitalization of the banking system

The indicators of solvency and capitalization of the banking system improved in the second quarter of 2014. The rates of change of the capital positions of the banking system registered a more significant upward movement, thus entering deeply into the positive zone and exceeding by several times the generally slower quarterly growth rates of the banking system activities. Thus, the ratio between core capital and risk-weighted assets grew by 0.4 percentage points, indicating at the same time an increase in the level and quality of capital positions of the banking system.

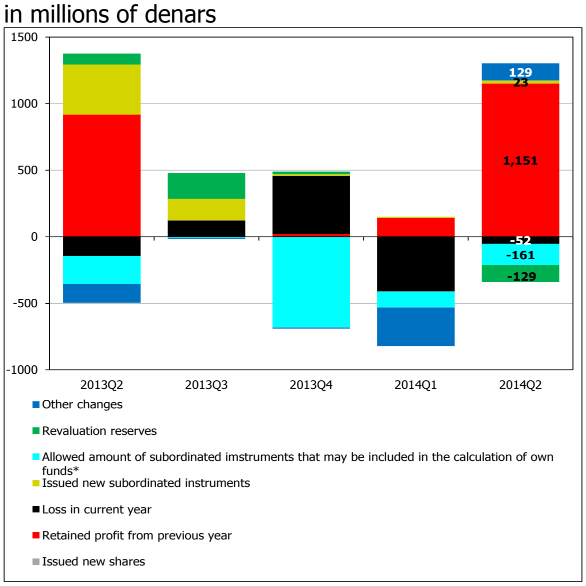
[36] In this section of the Report, data for 2014 include "Eurostandard Bank" AD Skopje and "Post Bank" AD Skopje on a consolidated basis, which commenced operations as a single bank on 1 July 2014.

Chart 40
Indicators for solvency (left) and quarterly growth rates of their components (right)
in percentages | in percentages



Source: NBRM, based on the data submitted by banks.

Chart 41
Structure of the quarterly growth of own funds
in millions of denars



Source: NBRM, based on the data submitted by banks.
Note: *Refers to the changes in the amount of already issued subordinated instruments arising from the compliance/non-compliance with the regulatory rules for inclusion of these instruments in the calculation of own funds.

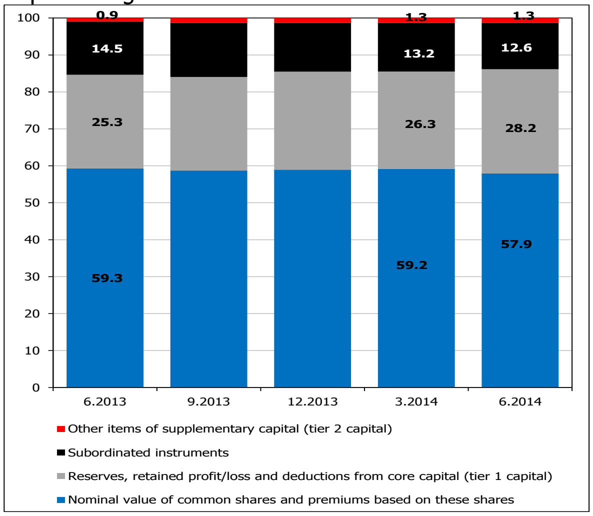
5.2. Movements and quality of the own funds of the banking system

In the second quarter of 2014, the own funds of the banking system went up by Denar 962 million, or 2.1%[37]. Amid complete absence of new share issues and relatively small amount of new subordinated instruments issued (total of Denar 23 million in one bank from the group of small banks), **reinvested profits earned in 2013 were the most significant source of increasing the own funds of the banking system in the second quarter of 2014**. In the analyzed period, seven banks reinvested the profits earned in 2013 in own funds, in total amount of Denar 1,151 million. Also, one bank from the group of small banks turned one part of the subordinated instruments into hybrid instruments, in the total amount of Denar 116.5 million.

The quality of own funds improved further, which was reflected by an increase in the share of core capital[38] in the total own funds,

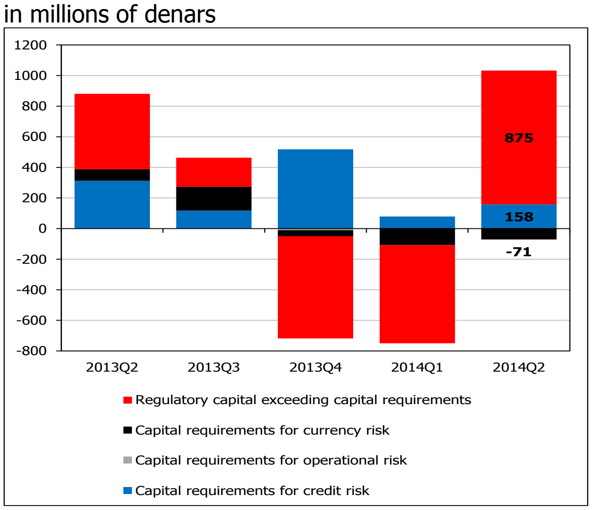
[37] On annual basis, own funds grew by Denar 554 million, or by 1.2%.
[38] Before deductions from core capital and supplementary capital.

Chart 42
Structure of own funds, before deductions from core capital and supplementary capital
in percentages



Source: NBRM, based on the data submitted by banks.

Chart 43
Structure of quarterly growth of own funds, by the purpose for covering risks
in millions of denars



Source: NBRM, based on the data submitted by banks.

from 85.5% at the end of the first quarter of 2014, to 86.1% as of 30 June 2014.

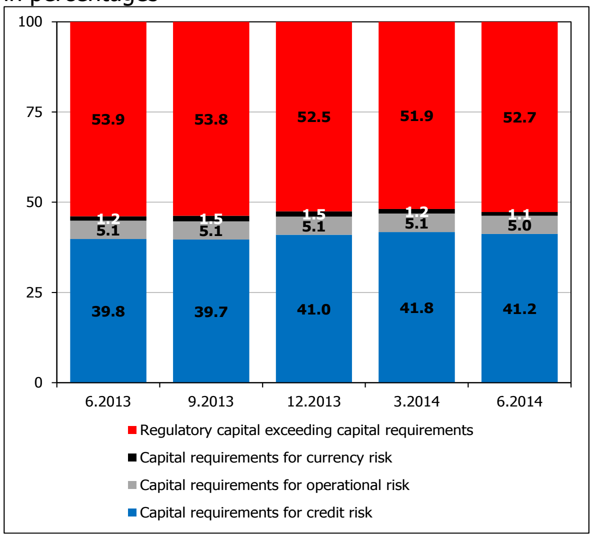
More details about the level of own funds of individual groups of banks are presented in Annex 33.

5.3. Developments and structure of capital requirements and available capital of the banking system

Most of the quarterly growth of own funds was used for increasing the "free" capital of the banking system. Thus, after two consecutive quarters, the trend of accumulation of surplus capital above the minimum level necessary to cover the risks in the banking system, continued. However, the regulatory capital required to cover the risks of the banking system (or capital requirements)[39] grew, albeit modestly, by Denar 87 million, or 0.4%[40]. The increase in the capital requirements to cover risks is entirely a result of the higher amount of regulatory capital required for credit risk (by Denar 158 million or 0.8%), mostly as a result of the growth of claims based on the small loans portfolio and claims secured by commercial real estate[41]. At the same time, capital requirements for currency risk decreased by 12.7% (or Denar 71 million), which was mostly present in three banks[42]. The quarterly increase in the portion of own funds that exceeds the minimal level necessary to cover the risks

[39] Capital requirements are determined at the level of 8% of the risk weighted assets.
[40] On annual level, capital requirements for covering risks increased by Denar 799 million (or 3.8%).
[41] The movements in the capital requirements for credit risk in the second quarter of 2014 were under a certain influence also of the regulatory changes that came into force in May 2014. Pursuant to the Decision amending the Decision on the methodology for determining the capital adequacy ("Official Gazette of the Republic of Macedonia" no. 71/14), among other things, a lower conversion factor was prescribed (20% instead of 50%) for the assumed off-balance sheet liabilities based on performance guarantees, in calculating the credit risk weighted assets and capital requirement for credit risk. On this basis, in the second quarter of 2014, capital of about Denar 156 million was released, which banks can use to cover the risks of establishing new credit exposures.
[42] In one bank from the group of large banks, the quarterly growth of liabilities in foreign currency exceeded the growth in assets, while in other two banks (one from the group of large banks and one from the group of medium-sized banks), the quarterly decline in foreign currency assets was greater than the decline in the liabilities, which caused narrowing of the open foreign exchange position.

Chart 44
Structure of own funds according to the use for covering risks
in percentages



Source: NBRM, based on the data submitted by banks.

emphasized the dominant share of "excess capital" in the structure of total own funds.

Table 4 Capital requirements for credit risk, by categories of exposure

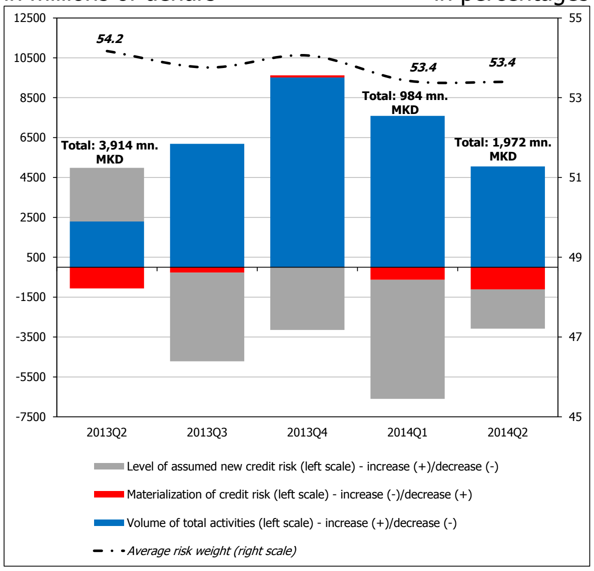
Capital requirements for credit risk arising from certain categories of exposure:	30.6.2013	31.12.2013	31.3.2014	30.6.2014	Change					
					2014Q1		2014Q2		Annual change (30.6.2013-30.6.2014)	
					in millions of Denars	in %	in millions of Denars	in %	in millions of Denars	in %
Claims on central banks and central governments	0	0	0	0	0	0.0%	0	0.0%	0	0.0%
Claims on local self-government and regional government	40	45	48	57	3	6.3%	9	19.3%	17	42.1%
Claims on public institutions	116	152	130	160	-22	-14.3%	30	23.0%	43	37.3%
Claims on multilateral development banks and international organizations	0	0	0	0	0	0.0%	0	0.0%	0	0.0%
Claims on banks	1,040	1,124	1,102	1,110	-22	-1.9%	8	0.7%	70	6.7%
Claims on other companies	7,259	7,824	7,924	7,785	100	1.3%	-139	-1.8%	525	7.2%
Retail credit portfolio	5,543	5,745	5,761	6,050	15	0.3%	290	5.0%	507	9.1%
Claims secured by residential property	424	365	426	345	61	16.6%	-81	-19.1%	-80	-18.7%
Claims secured by commercial real estate	2,042	1,898	1,892	1,973	-6	-0.3%	80	4.2%	-69	-3.4%
Holdings in investment funds	0.74	0.79	0.80	0.83	0.01	1.8%	0.03	3.5%	0.09	11.8%
Other positions	1,557	1,504	1,453	1,415	-51	-3.4%	-38	-2.6%	-142	-9.1%
Total capital requirements for credit risk:	***18,023***	***18,658***	***18,737***	***18,895***	***79***	***0.4%***	***158***	***0.8%***	***872***	***4.8%***

Source: NBRM, based on the data submitted by banks.

The quarterly growth rate of credit risk weighted assets (0.8%) is twice higher than that achieved in the first quarter of 2014 (0.4%), which exceeded the quarterly growth rate of assets (0.7%) but is still below the quarterly growth rate registered in total balance sheet and off-balance sheet activities (0.9%) of banks. On the other hand, the average risk weight of the total balance sheet and off-balance sheet exposure of the banking system[43] remained at a level of 53.4% (after the registered decline of 0.7

[43] Calculated as a ratio between credit risk weighted assets and total balance sheet and off-balance sheet exposure of banks

Chart 45
Structure of the quarterly growth in credit risk weighted assets and average risk weight
in millions of denars in percentages



Source: NBRM, based on the data submitted by banks.
Note: The change in the total volume of activities is measured by the change in the gross amount of the total balance sheet and off-balance sheet exposure of banks.
The change in the materialization of the credit risk is measured by the change in the impairment of the overall balance sheet and off-balance sheet exposure of banks
The change in the level of assumed credit risk is measured by the change in the difference between credit risk weighted assets and total net balance sheet and off-balance sheet exposure of banks.
The average risk weight is calculated as a ratio between credit risk weighted assets and total net balance sheet and off-balance sheet exposure of banks

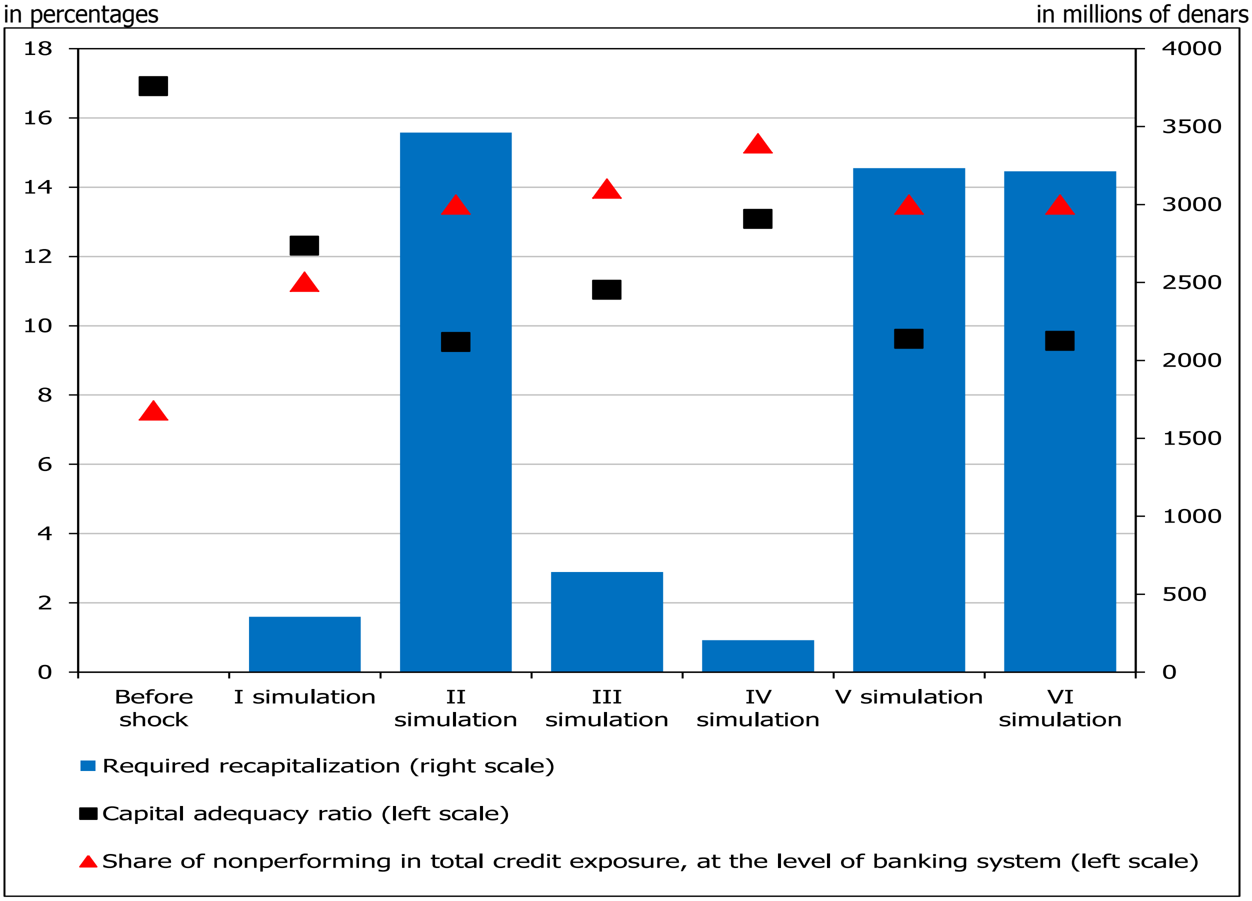
percentage points in the first quarter of 2014). These developments indicate some increase in the risk appetites, but generally banks remain cautious in taking risks.

More details on capital requirements for covering risks and on the capital adequacy ratio, by groups of banks, are provided in Annex 34.

5.4. Stress test of the resilience of the banking system to hypothetical shocks

Results of the stress test indicate satisfactory resilience of the banking system. Thus, the capital adequacy of the banking system does not go below 8% in any of the simulations, although individual banks reveal hypothetical need for recapitalization in the event of possible materialization of the simulated extreme shocks.

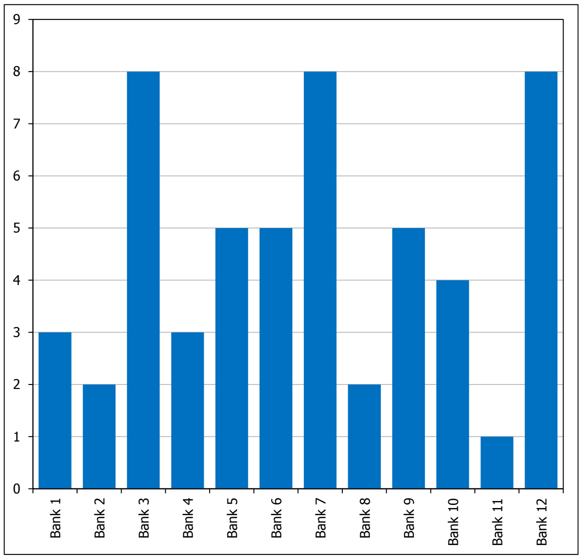
Chart 46
Results from simulations of credit and combined shocks, as of 30 June 2014



Source: NBRM, based on the data submitted by banks.
*Stress testing includes the following simulations:
I simulation: Increasing the non-performing credit exposure to non-financial entities by 50%;
II simulation: Increasing the non-performing credit exposure to non-financial entities by 80%;
III simulation: Migration of 10% of the regular to a non-performing credit exposure to non-financial entities;
IV simulation: Reclassification in "C - non-performing" of the five largest credit exposures to non-financial entities (including related entities);
V simulation: Increasing the non-performing credit exposure to non-financial entities by 80% and increase in interest rates from 1 to 5 p.p.;
VI simulation: Increasing the non-performing credit exposure to non-financial entities by 80%, depreciation of the Denar exchange rate by 30%, and increase in interest rates from 1 to 5 p.p.;
**Note: Credit exposure to non-financial entities includes the total credit exposure decreased by the exposure of banks to financial institutions and the government, i.e to customers from the "financial activities and insurance activities" and "public administration and defense and compulsory social security"

The hypothetical shocks on the part of the credit risk have the greatest impact on the stability of the banking system. Within the credit exposure to non-financial entities, the simulations show that a decline of capital adequacy of the banking system to the statutory minimum of 8% requires an increase of 95.2% of the non-performing credit exposure, i.e. migration of

Chart 47
Number of largest credit exposures to non-financial entities, whose potential reclassification in risk category "E" would reduce the capital adequacy below 8%
number



Source: NBRM, based on the data submitted by banks.
Note: The analysis was made taking into account the ten largest credit exposures to non-financial entities for each bank individually (including the related entities). The chart does not show the banks (total of three), where the possible reclassification of the ten largest credit exposures to non-financial entities in the risk category "E" does not lower capital adequacy below 8%.

14.5% of the regular to a non-performing credit exposure. These simulations would result in almost doubling of the share of non-performing in the total credit exposure to non-financial entities (from the current 10.4% to 20.3%). These are rather extreme and unlikely simulations, especially in the short term, given the fact that, generally, the materialization of the credit risk in banks' portfolios usually "evolves" gradually and provides space for taking timely corrective measures and actions. One of the factors that can accelerate the process of deterioration of the quality of banks' credit exposure is the potential presence of a high concentration in their portfolios. In this context, the results of stress tests show that banks would have sustained relatively successfully a reclassification of the ten largest credit exposures to non-financial entities in the risk category "C - non-performing", but the possible more extreme deterioration of the creditworthiness of the largest customers (reclassification in risk category "E") could quickly lower the rate of capital adequacy below 8%.

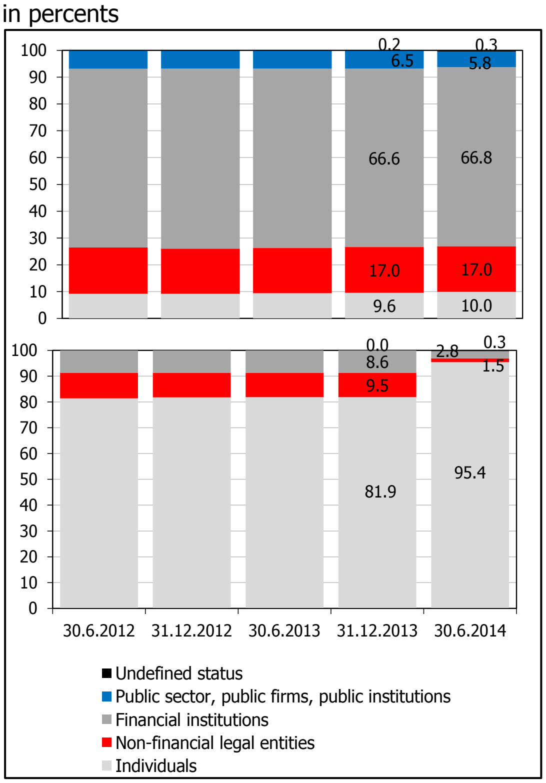
Part 2 Structural features, major balance sheet changes and efficiency and profitability of the banking system

1. Structure of the banking system

1.1. Number of banks and ownership structure of the banking system

In the second quarter of 2014, the banking system in the Republic of Macedonia consisted of sixteen banks, and the total number of banks remained unchanged relative to 31 March 2014[44].

Chart 48
Ownership structure of common shares (top) and preference shares (bottom) in the banking system
in percents



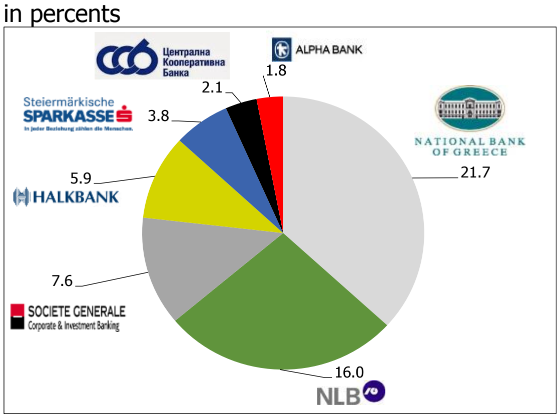
Source: NBRM, based on data submitted by banks.
Note: The term "undefined status" includes the shares owned by entities that can not be identified, which are in bankruptcy or liquidation proceedings or whose bankruptcy or liquidation proceedings were closed.

There were no significant changes in the ownership structure of common shares at the level of the banking system and financial institutions are still predominant in this structure. The share of the government in the structure of these shares fell by 0.7 percentage points[45].

The share of natural persons in the structure of the preference shares increased (by 13.6 percentage points), at the expense of the reduced share of non-financial legal entities (by 8.0 percentage points) and financial institutions (by 5.8 percentage points), whose preference shares of one medium-sized bank were converted into common shares.

[44] On 30 June 2014, the Central Registry of the Republic of Macedonia adopted a Decision on the registration of a status change - acquisition of "Post Bank" AD Skopje by "Eurostandard Banka" AD Skopje. However, the Decision of the Central Registry of the Republic of Macedonia was issued on 01 July 2014, when the "Post Bank" AD Skopje ceased to exist as a separate legal entity and the number of banks was reduced to fifteen.
[45] The procedure of acquisition of "Post Bank" AD Skopje by "Eurostandard Banka" AD Skopje, was preceded by the purchase of the state's share in the "Post Bank" by "Eurostandard Banka" (on 24 January 2014, through a public auction conducted on the Macedonian Stock Exchange), whereby "Eurostandard Banka" AD Skopje became full owner of "Post Bank" AD Skopje.

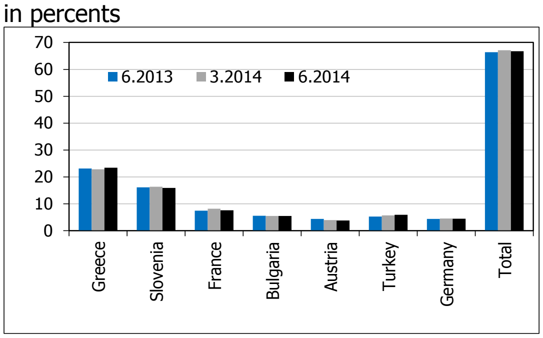
Chart 49
Foreign bank subsidiaries' market share (assets)
in percents



Source: NBRM, based on data submitted by banks.

Eleven banks are predominantly owned by foreign shareholders, and seven of them are foreign bank subsidiaries. Due to the reduction in the assets of some of the subsidiaries, the market share of the subsidiaries of foreign banks decreased by 0.4 percentage points compared to the previous quarter and totaled 58.9% on 30 June 2014.

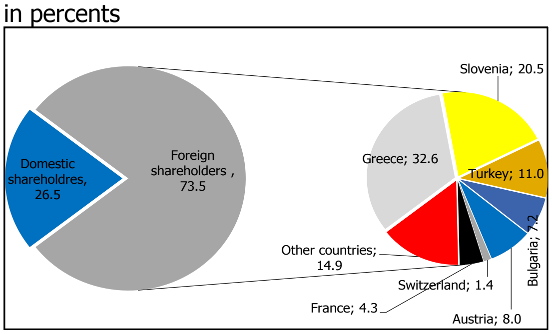
Chart 50
Market share (assets) of banks by country of origin of the predominant foreign shareholder*
in percents



Source: the NBRM, based on data submitted by banks.
*The bank in domestic ownership and banks without major owner are not included in the chart.

A minimal decline was registered also in the market share of banks that have dominant foreign shareholder (by 0.3 percentage points), and at the end of the second quarter of 2014 their share in the total assets of the banking system was 66.7%. The individual market share of these banks ranges from 0.5% to 21.7%.

Chart 51
Structure of capital and reserves, by country
in percents

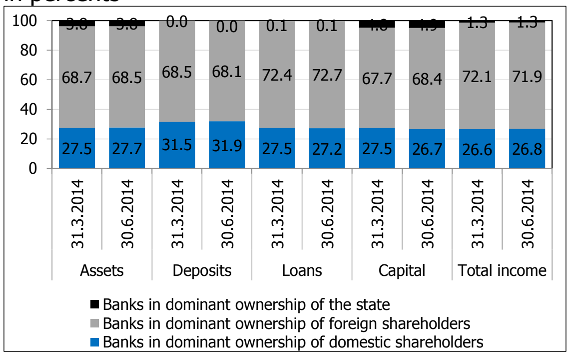


Source: NBRM, based on data submitted by banks.

According to the origin of the shareholder, the foreign capital is most present and covers 73.5% of the total capital of the banking system[46]. Over 80% of this foreign capital is owned by shareholders who come from the European Union Member States.

[46] The calculation refers to the position "capital and reserves".

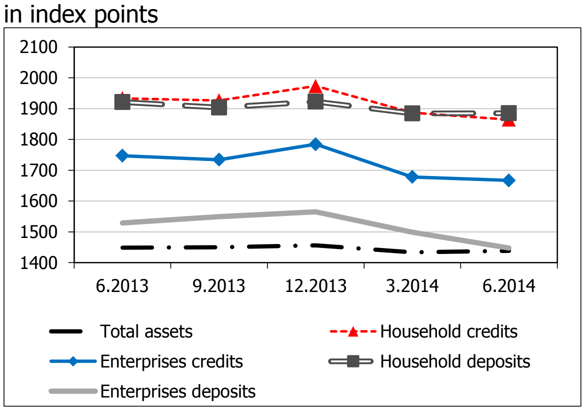
Chart 52
Structure of major banks' balance sheet positions, by banks' majority ownership
in percents



Source: NBRM, based on data submitted by banks.

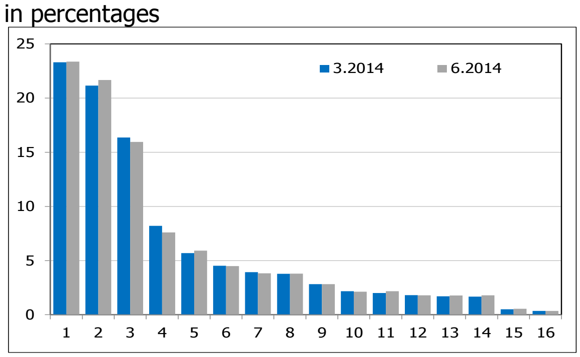
The banks that are predominantly in foreign ownership, occupy most of the major positions of the banks' balance sheets, accounting for over 68%.

Chart 53
Herfindahl index
in index points



Source: NBRM, based on data submitted by banks.

Chart 54
Share of individual banks in the total assets of the banking system
in percentages



Source: NBRM, based on data submitted by banks.

Concentration in the banking system, as measured by the Herfindahl index[47] is above the acceptable level in the retail banking activities. According to the CR5 ratio, the highest concentration is registered in the household deposits (80.8%), which is high also according to the total assets, of which 74.5% are concentration of the five largest banks.

[47] The Herfindahl index is calculated according to the formula $HI = \sum_{j=1}^{n} (S_j)^2$, where S is the share of each bank in the total amount of the analyzed category (e.g., total assets, total deposits, etc.), where n denotes the total number of banks in the system. When the Herfindahl index ranges from 1,000 to 1,800 units, the concentration ratio in the banking system is considered acceptable.

2. Banks' activities

In the second quarter of 2014, total assets of the banking system grew at a slower pace, primarily affected by the lower banks' deposit base from the corporate sector (due to the usual payment of dividends to foreign investors at this time of year). Generators of the growth of the deposit activity were households' Denar deposits, which continued the trend of positive changes in the currency profile of the banks' sources of funds. In the second quarter of the year, lending activity grew at a faster pace and was mostly directed to households, but also to the further credit support of the corporate sector. In addition, banks have cut investments in securities issued by the government. Credit growth continued in July and August 2014, suggesting gradual stabilization of the banks' perceptions of risk influenced by the positive performances in the national economy and the second-round effects of past monetary loosening on the credit activity. Denarization in banks' balance sheets continued, but at a faster pace with assets compared to liabilities.

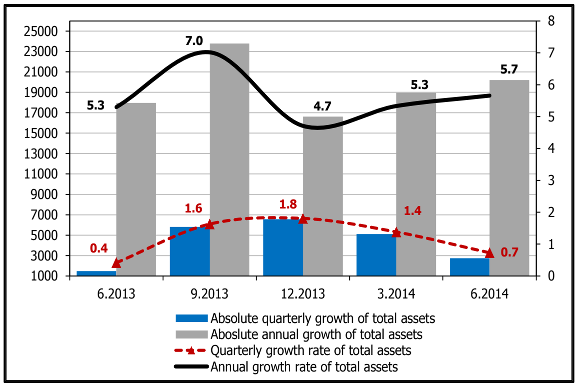
Table 5 Structure of the assets and liabilities of the banking system

Balance sheet	Amount in millions of Denars			Structure (in percent)			Change 6.2014/3.2014		Change 6.2014/6.2013	
	30.6.2013	31.3.2014	30.6.2014	30.6.2013	31.3.2014	30.6.2014	In millions of Denars	In percent	In millions of Denars	In percent
Cash and balances with NBRM	40,902	38,719	39,783	10.9	10.3	10.5	1,064	2.7	-1,119	-2.7
Securities portfolio	58,236	67,724	64,848	16.3	18.1	17.2	-2,875	-4.2	6,612	11.4
Placements with banks and other financial institutions	43,629	43,500	42,702	12.2	11.6	11.3	-798	-1.8	-927	-2.1
Loans of nonfinancial entities (net)	193,684	205,064	210,787	54.2	54.7	55.9	5,723	2.8	17,103	8.8
Gross loans of nonfinancial entities	221,741	233,994	240,738	62.1	62.5	63.8	6,744	2.9	18,997	8.6
Accumulated amortization of loans of nonfinancial entities	-939	-919	-878	0.0	0.0	0.0	40	-4.4	61	-6.5
Impairment (provisions) of loans to nonfinancial entities	-27,117	-28,012	-29,074	0.0	0.0	0.0	1,062	-3.8	1,957	-7.2
Accrued interest and other assets	9,700	8,076	7,662	2.7	2.2	2.0	-414	-5.1	-2,038	-21.0
Fixed assets	10,982	11,529	11,559	3.1	3.1	3.1	30	0.3	577	5.3
Unallocated loan loss provisions	0	0	0	0.0	0.0	0.0	0	0.0	0	0.0
Total assets	**357,132**	**374,612**	**377,341**	**100.0**	**100.0**	**100.0**	**2,729**	**0.7**	**20,209**	**5.7**
Deposits from banks and other financial institutions	18,848	15,547	16,235	5.3	4.2	4.3	687	4.4	-2,613	-13.9
Deposits from nonfinancial entities	245,680	265,704	267,455	68.8	70.9	70.9	1,751	0.7	21,775	8.9
Borrowings (short-term and long-term)	36,411	34,998	34,269	10.2	9.3	9.1	-728	-2.1	-2,142	-5.9
Liability component of hybrid and subordinated instruments	7,862	7,970	7,993	2.2	2.1	2.1	23	0.3	131	1.7
Other liabilities	7,449	7,434	6,880	2.1	2.0	1.8	-554	-7.4	-569	-7.6
Provisions for off-balance sheet items	848	958	961	0.2	0.3	0.3	3	0.3	113	13.3
Capital and reserves	40,036	42,001	43,547	11.2	11.2	11.5	1,546	3.7	3,511	8.8
Total liabilities	**357,132**	**374,612**	**377,341**	**100.0**	**100.0**	**100.0**	**2,729**	**0.7**	**20,209**	**5.7**

Source: NBRM, based on the data submitted by banks.
Note: The position "placements with the central bank" of Annex 1, is included in the position "cash and balances with the NBRM" in this table.

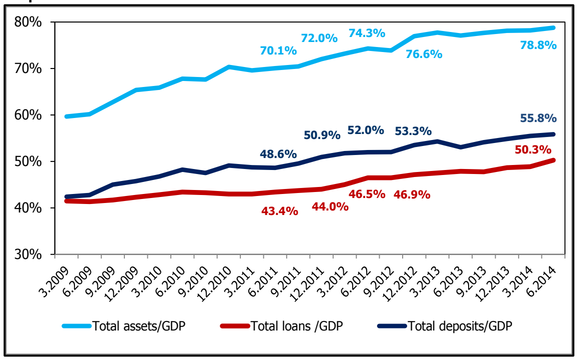
As of 30 June 2014, **the total assets of the banking system amounted to Denar 377,341 million.** On a quarterly basis, assets grew at a slower pace, as opposed to the annual increase, which accelerated.

Chart 55
Quarterly and annual growth of assets of the banking system
in millions of denars and in %



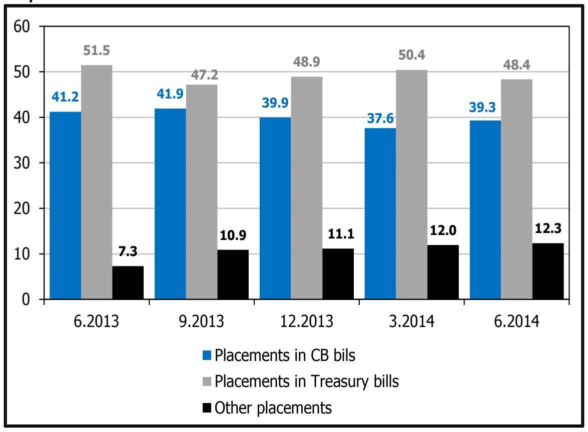
Source: NBRM, based on the data submitted by banks.

Chart 56
Level of financial intermediation in the Republic of Macedonia
in percents



Source: NBRM, based on the data submitted by banks.

Chart 57
Structure of the securities portfolio
in percents



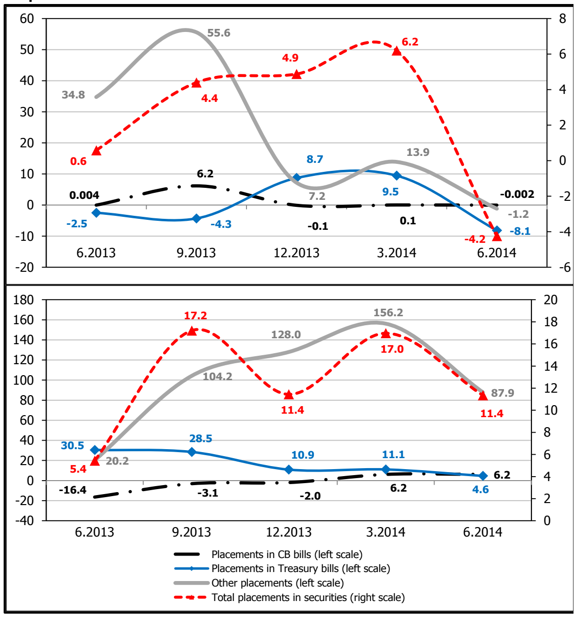
Source: NBRM, based on the data submitted by banks.

More significant changes in the assets in the second quarter of 2014 are the following: accelerated growth in lending activity[48], growth in Denar cash assets and reduced investments in securities. On the part of the liabilities, worth noting is the slower growth of deposits[49] of non-financial entities and reduced liabilities on the basis of loans.

In contrast to the growth in the past few quarters, the banks' **securities portfolio** in the second quarter of 2014 decreased by Denar 2,875 million, or 4.2%, due to the lower investments in treasury bills (by Denar 2,781 million, or 8.1%). Quarterly reduction was noted also in the banks' investments in government bonds. Despite their decline, the share of government bonds in the structure of the portfolio of government securities continued to grow. Banks' investments in CB bills did not register significant changes amid unchanged supply and unchanged interest rate on CB bills by the National Bank. All this has caused a reduction in the structural share of the investments in government securities at the end of the second quarter of 2014.

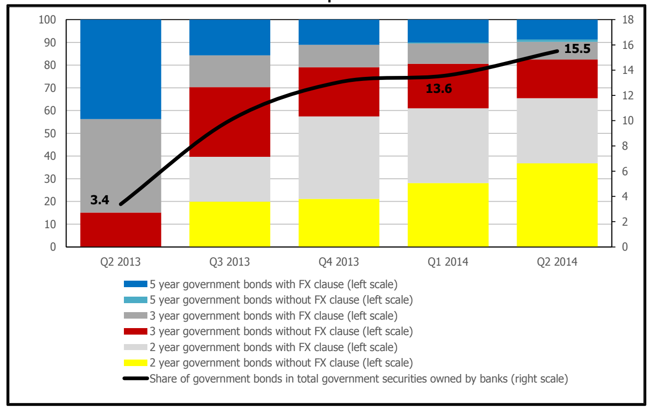
[48] For more details, see section 1.1. Loans to non-financial entities
[49] For more details, see section 1.2. Deposits of non-financial entities.

Chart 58
Quarterly (top) and annual (bottom) growth rate of the securities portfolio
in percents



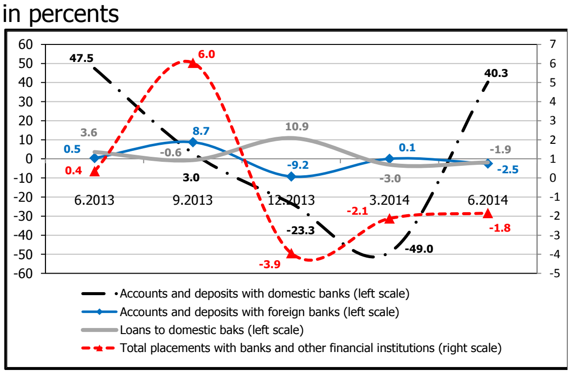
Source: NBRM, based on the data submitted by banks.

Chart 59
Structure of banks' investments in government bonds by currency and maturity
in thousands of denars and in percents



Source: NBRM, based on the data submitted by banks.

Chart 60
Placements with banks and other financial institutions (quarterly change)
in percents



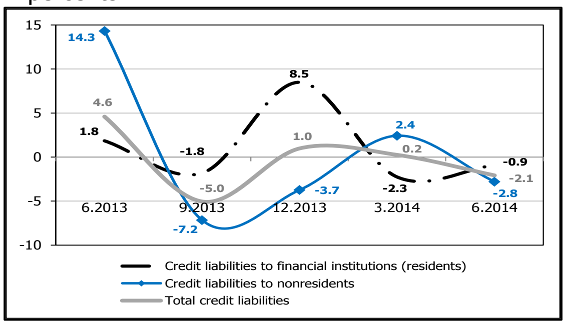
Source: NBRM, based on the data submitted by banks.

Placements with banks and other financial institutions[50] decreased, with their share in the total banks' assets being reduced to 11.3%. Reduced balances on the regular accounts[51] in foreign currency with foreign banks and reduced short-term Denar loans to domestic banks[52] fully determined the quarterly decrease in the total placements with banks and other financial institutions.

Within the liabilities, **liabilities based on loans[53]** decreased on a quarterly basis, which was in most part (75.5%) a result of the reduced liabilities on the basis of the loans from non-residents[54] and to a lesser extent of the reduced liabilities based on loans from financial

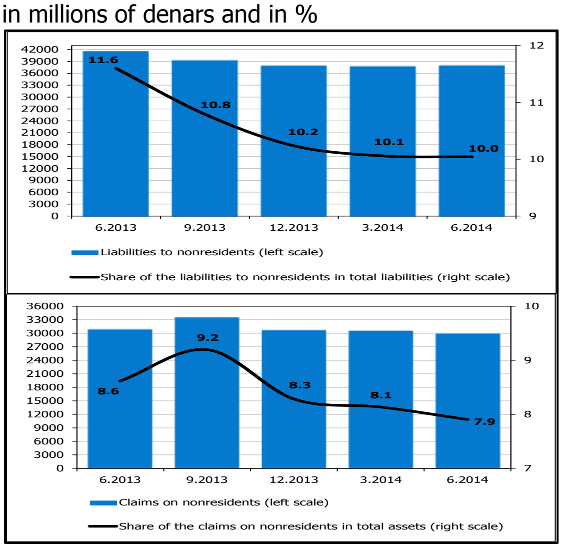
[50] Net of impairment and accumulated depreciation.
[51] Assets in foreign banks declined by Denar 730 million and determined 91.5% of the reduction in the placements with banks and other financial institutions. This movement arises from the reduction of the balance on the regular accounts in foreign currency abroad by Denar 3,217 million, amid an increase in the short-term deposits with foreign banks in foreign currency by Denar 2,470 million.
[52] Loans to domestic banks declined by Denar 236 million, which is entirely due to the decrease of Denar overnight credits in one bank.
[53] Liabilities based on loans decreased by Denar 728 million on a quarterly basis. This decrease was a result of the reduction of liabilities based on loans to non-residents (by Denar 549 million) and the reduction of the liabilities based on loans to financial companies (by Denar 132 million).
[54] As part of their liabilities based on the loans from non-residents, liabilities based on long-term loans in foreign currency to non-residents reduced (by Denar 2,077 million) due to the repayment of used loan from the parent entity. On the other hand, liabilities based on short-term loans in foreign currency to non-residents grew (by Denar 1,555 million), due entirely to the loan from the parent entity of one bank.

Chart 61
Credit liabilities, quarterly growth
in percents



Source: NBRM, based on the data submitted by banks.

Chart 62
Liabilities to (top) and claims on (bottom) nonresidents
in millions of denars and in %



Source: NBRM, based on the data submitted by banks.

companies[55].

In conditions of slower growth of deposits of non-financial entities in the second quarter of 2014, the growth in the sources of funding for banks partly resulted from the increase in deposits[56] from banks and other financial institutions.

The banking system continues to have more liabilities than claims on non-residents. The share[57] of banks' **liabilities to and claims on non-residents** in total assets is low. In the second quarter of 2014, a decrease[58] in the claims and a modest increase[59] in the liabilities to non-residents was registered.

2.1. Loans to non-financial entities

In the second quarter of 2014, lending to the non-financial sector[60] grew rapidly. Loans to non-financial entities[61] registered quarterly growth of Denar 6,744 million, and the quarterly growth rate accelerated by 1.2 percentage points (the credit growth continued to accelerate in July and August 2014). Credit growth acceleration was more pronounced

[55] As part of their liabilities based on the loans to financial companies, a reduction was registered in the liabilities based on short-term Denar loans to domestic banks (by Denar 658 million) and in the liabilities based on long-term Denar loans with FX clause to domestic banks (by Denar 55 million). At the same time, the liabilities based on long-term loans in foreign currency to domestic banks grew (by Denar 577 million), resulting from the credit line from the European Investment Bank, which the "MBPR" AD Skopje places through local banks.

[56] The growth in deposits from banks and other financial institutions (by Denar 687 million) mostly resulted from the growth of deposits of pension funds (by Denar 216 million), short-term deposits of non-residents-financial companies (by Denar 173 million) and deposits of insurance companies (by Denar 165 million).

[57] Analyzed by individual bank, the share of banks 'claims on non-residents in total assets ranges from 1.5% to 18.8%, while the share of banks' liabilities to non-residents in the total liabilities ranges from 0.3% to 33.5% (with the exception of "MBPR" AD Skopje).

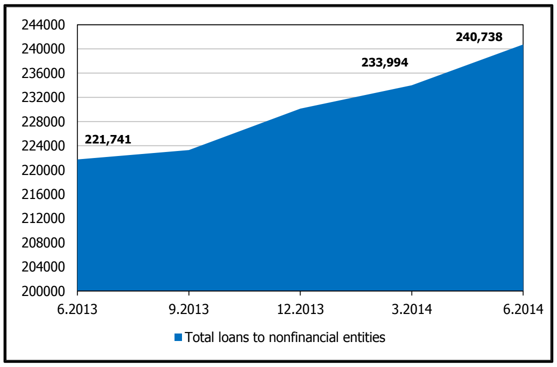
[58] Claims on non-residents decreased by Denar 647 million, entirely due to the aforementioned decrease in the placements with foreign banks.

[59] Liabilities to non-residents registered growth of Denar 213 million, much of which stems from the aforementioned increase in the short-term deposits of non-residents-financial companies in one bank.

[60] Loans to non-financial entities include the loans to resident and non-resident non-financial entities, including loans to private and public non-financial companies (corporate loans), central government, local government, non-profit institutions serving households (loans to other clients), sole proprietors and natural persons (loans to households).

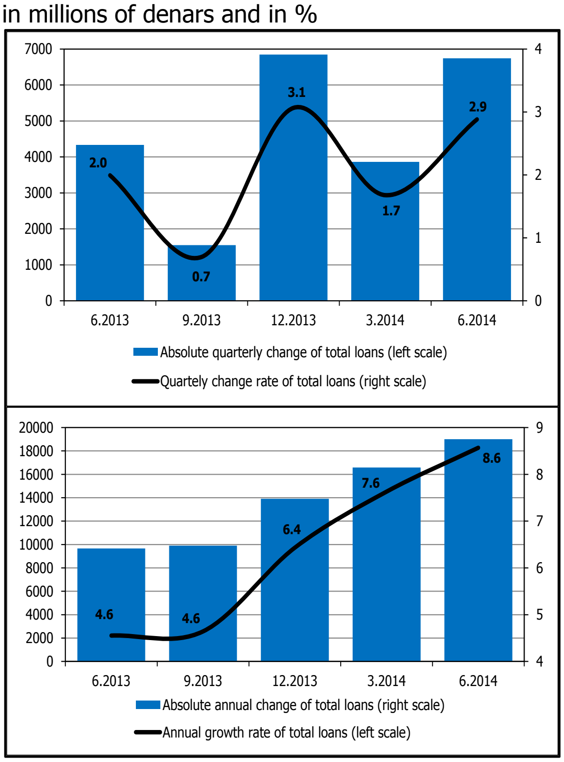
[61] Analyzed by individual bank, thirteen banks reported a quarterly increase of loans to non-financial entities (ranging from 0.8% to 12.7% for individual bank), while other banks reported a quarterly reduction of loans (ranging from 0.7% to 1.7% by individual bank).

Chart 63
Loans
in millions of denars



Source: NBRM, based on the data submitted by banks.

Chart 64
Quarterly (top) and annual (bottom) growth rate of loans to non-financial entities
in millions of denars and in %



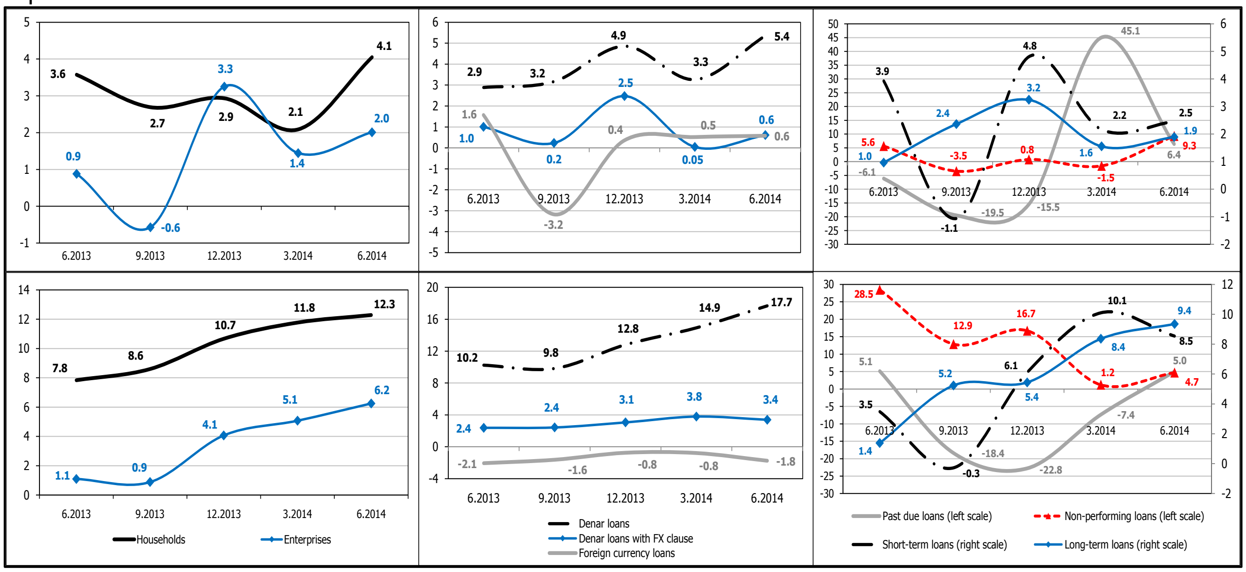
Source: NBRM, based on the data submitted by banks.

in the household sector, whose quarterly growth rate was twice higher than the growth rate of loans to the corporate sector. These developments were reflected also in the annual credit growth rate (8.6%), whose acceleration was 1.0 percentage points. Movements in the credit market are in line with the more stable banks' expectations and the knock-on effects of the monetary loosening on the lending activity.

In the second quarter of 2014, the highest share in the credit growth (of 56.4%) was that of the **loans to households**. Lending to households increased by Denar 3,802 million, or 4.1%, with the consumer loans and loans for purchasing and renovating residential and commercial properties being the most used credit products in this segment (Annex 9). The annual growth rate of loans to households accelerated by 0.5 percentage points.

Starting from the fourth quarter of 2013, **lending to the corporate sector** accelerated. In the second quarter of 2014, lending to the corporate sector registered quarterly growth of Denar 2,761 million, or 2.0% (growth acceleration of 0.6 percentage points), thus contributing to the growth of the total credit activity with 40.9%. The activities "wholesale and retail trade" and "industry" had the largest contribution to the growth in corporate loans. The annual growth of these loans was faster, by 1.1 percentage point.

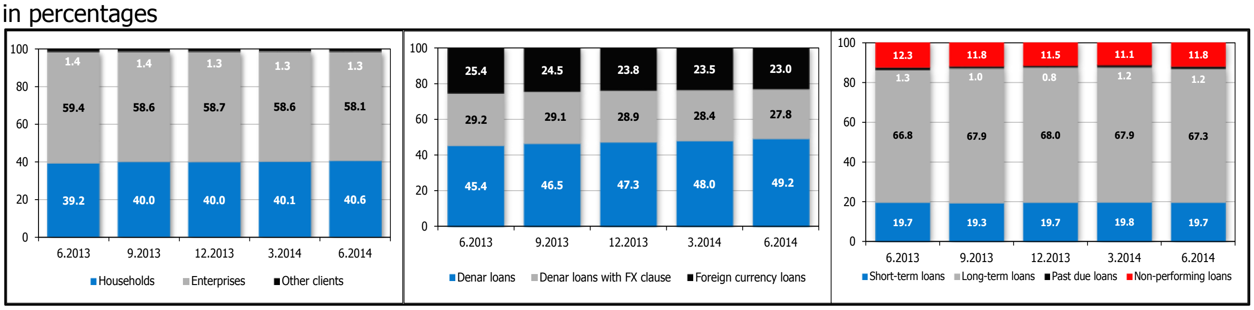
Chart 65
Quarterly (top) and annual (bottom) growth of loans by sector, currency and maturity
in percents



Source: NBRM, based on the data submitted by banks.

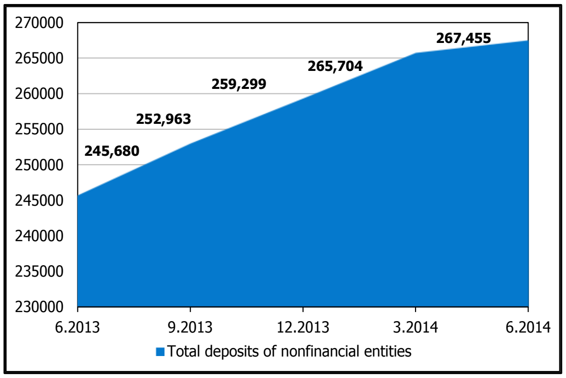
Denarization in the lending activity continued in the second quarter of 2014 and was related to the same process with deposits as the main source of funding of the banking activities. In the second quarter of 2014, most of the growth in lending activity (89.2%) came from lending in domestic currency. **Denar** loans registered a quarterly increase of Denar 6,019 million (or 5.4%), where the contribution of companies (58.2%) was higher than the contribution of households (42.0%). Loans in Denars with foreign currency clause achieved modest growth of Denar 405 million, which is entirely due to the household sector. Largest contribution to the quarterly growth of foreign currency loans (60.4%) was that of the loans to the corporate sector.

Chart 66
Structure of loans by sector, currency and maturity
in percentages



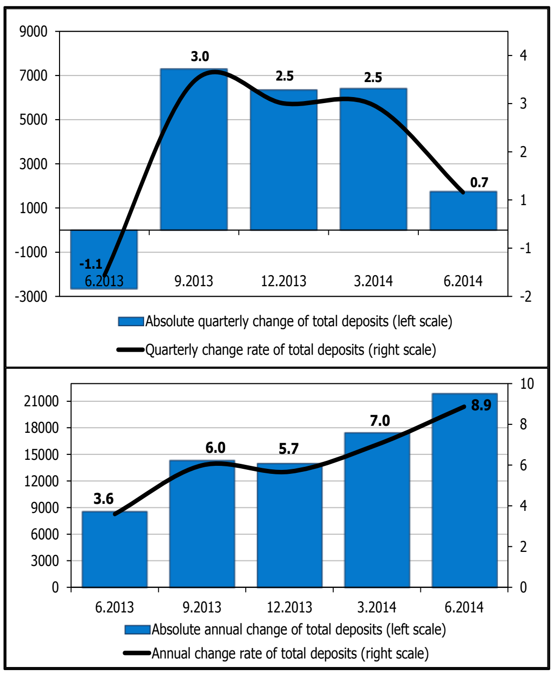
Source: NBRM, based on the data submitted by banks.

Chart 67
Deposits
in millions of denars



Source: NBRM, based on the data submitted by banks.

Chart 68
Quarterly (top) and annual (bottom) growth rate of deposits of non-financial entities
in millions of denars and in %



Source: NBRM, based on the data submitted by banks.

Long-term lending prevails in the structure of loans to non-financial entities, although there is some reduction of its share. Their contribution to the growth of total credit activity is highest and equals 44.6%. The quarterly growth of long-term loans of Denar 3,005 million (or 1.9%) arises entirely from the household sector[62], within which Denar loans have the highest contribution (62.0%). In the second quarter of 2014, non-performing loans[63] recorded a more substantial quarterly increase of Denar 2,426 million or 9.3%.

2.2. Deposits of non-financial entities

In the second quarter of 2014, deposits of non-financial entities grew at a slower pace and achieved quarterly growth of Denar 1,751 million. The quarterly deposit growth rate was 0.7% and registered deceleration of 1.8 percentage points. These changes did not affect the annual deposit growth rate, which in comparison with June 2013 is higher by 1.9 percentage points.

Household deposits increased by Denar 2,428 million, on a quarterly basis, and completely determined the growth of the total deposit base. Most (78.0%) of the growth in household deposits was due to Denar deposits, and within their framework, long-term deposits contributed with 84.6%, while the contribution of demand deposits was 32.5% (Annex 11)[64].

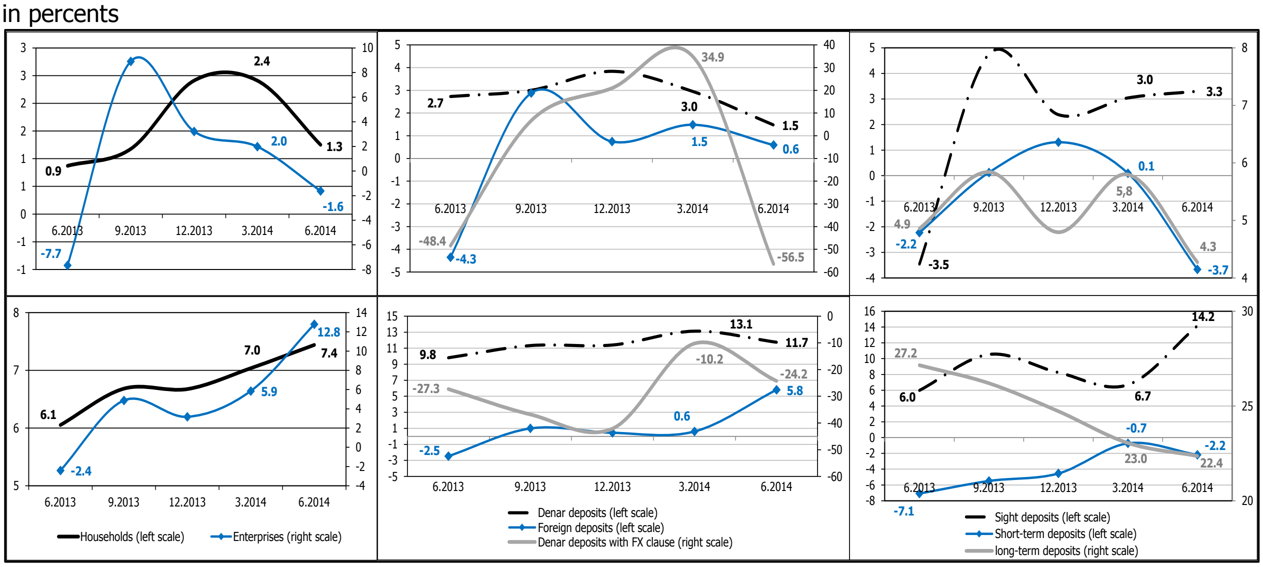
In contrast, **corporate deposits[65]** decreased by Denar 1,006 million in the second quarter of 2014, entirely due to the expected outflow of Denar deposits with foreign currency clause in one bank, as a result of the payment of dividend by one domestic company with foreign capital. If the effect of the payment of dividends is excluded, corporate deposits would have

[62] Long-term loans to households registered a quarterly increase of Denar 3,262 million, as a result of the growth of long-term Denar loans by Denar 2,021 million and the growth of long-term Denar loans with FX clause by Denar 1,171 million.
[63] See more detail in section III.1 Credit risk.
[64] The monthly growth of household deposits in August 2014 was 0.9%
[65] Corporate Denar deposits registered a moderate quarterly increase of Denar 236 million, much of which (95.7%) resulted from sight deposits. Corporate foreign currency deposits reduced by Denar 147 million, entirely due to the short-term deposits with one medium-sized bank.

registered quarterly growth of Denar 719 million[66].

In the second quarter of 2014, **Denar deposits** had the largest share in the total deposit base of the banking system and in its quarterly growth. Denar deposits registered a quarterly increase of Denar 2,145 million, in which the contribution of the household sector[67] was the largest and equaled 88.3%. The quarterly growth of foreign currency deposits in the amount of Denar 700 million mostly (80.9%) resulted from the growth of household foreign currency sight deposits. On the other hand, Denar deposits with foreign currency clause fell by Denar 1,095 million, entirely as a result of the short-term corporate deposits, i.e the payment of the aforementioned dividend.

Chart 69
Quarterly (top) and annual (bottom) deposit growth by sector, currency and maturity
in percents



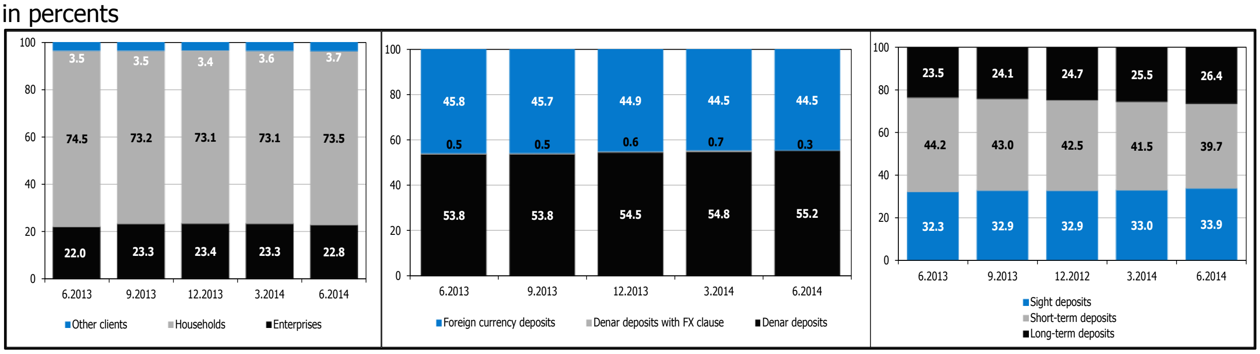
Source: NBRM, based on the data submitted by banks.

In the second quarter of 2014, **sight deposits** registered the highest quarterly increase of Denar 2,900 million and gave the largest contribution to the growth of the total deposit base. The contribution of companies and households

[66] The monthly growth in corporate deposits in August 2014 was 6.5%.
[67] Household Denar deposits increased by Denar 1,894 million, on a quarterly basis, mostly (84.6%) as a result of the growth of the long-term deposits.

to the growth of sight deposits accounted for 46.3% and 40.7%, respectively. The propensity of depositors for saving for the **long term** was retained also in the second quarter of 2014. The quarterly growth in long-term deposits (Denar 2,892 million) was almost equal to the growth of sight deposits. Long-term household savings[68] in domestic currency had the largest contribution to the growth of long-term deposits. Higher interest rates on long-term deposits contribute to higher savings in the long run and in domestic currency, which in turn is an indicator of the public's confidence in the domestic banking system. The more substantial quarterly decrease in **short term deposits** of Denar 4,041 million, was mostly (59.8%) a result of the corporate sector, within which corporate short-term Denar deposits with foreign currency clause (payment of dividends) determined almost half of this reduction. The contribution of the household sector to the reduction of the short-term deposits amounted to 29.5%.

Chart 70
Deposit structure by sector, currency and maturity
in percents



Source: NBRM, based on the data submitted by banks.

[68] Household long-term Denar deposits contributed with 55.4% to the growth in long-term deposits, while the contribution of household long-term foreign currency deposits stood at 28.8%.

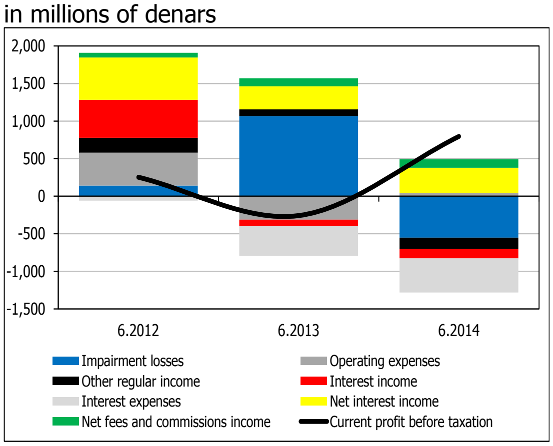
3. Profitability

In the first six months of 2014, the banking system of the Republic of Macedonia generated profit (of Denar 1,147 million), which is more than three times the profit earned in the same period last year. The reason for the increased profits are the lower interest expenses and lower impairment of financial assets (loans) of banks, despite the rapid growth of the impairment of non-financial assets (foreclosures). Profitability indicators have improved significantly, and the banks' operational capability of generating revenues that cover the costs of operation has increased, too. Compared with June 2013, the number of banks that have made profits and their share in total assets of the banking system remained unchanged (nine and 67.8%, respectively).

3.1. Movement and structure of income and expenses of the banking system and profitability and efficiency indicators

In the first six months of 2014, **total banks' income** (total regular income[69] and extraordinary income) totaled Denar 9,169.5 million, which is by Denar 292.5 million, or 3.3%, more compared with the same period last year. The largest contribution to the increase in banks' income is that of the increased interest income (by Denar 331.6 million, or 5.6%), which in turn is due to the sharper annual decline in the interest expenses compared with the decline in the interest income. Net income from fees and commissions grew (by Denar 112.7 million, or 6.0%), wile a decline was registered only in the other regular income[70] and extraordinary income.

Chart 71
Growth of the main categories of income and expenses, compared to the same period last year
in millions of denars



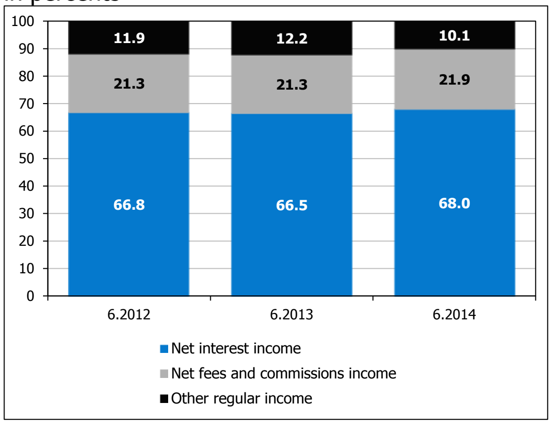
Source: NBRM, based on the data submitted by banks.

During the first six months of the year, there were no significant changes in the structure of total income, and net interest income strengthened its already large share (of 68.0%).

[69] Total regular income includes: net interest income, net commission income and other regular income (net trading income, net income from financial instruments carried at fair value, net income from exchange rate differentials, income from dividends and equity investments, net gains from sale of financial assets available for sale, capital gains from assets sales, release of provisions for off-balance sheet items, release of other provisions, income from other sources and income based on collected claims previously written off).

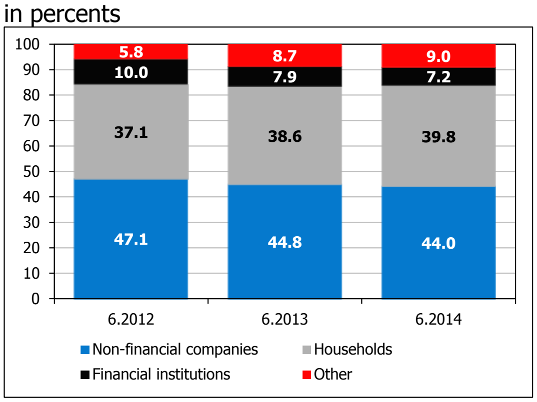
[70] The decline in other regular income by Denar 151.6 million, or 14.0%, was due to the reduction of several components: net income from trading in two banks, the release of special reserve for off-balance sheet exposure in several banks, income from previous years in one bank and collected previously written-off claims based on claims from interest in one bank in the country.

Chart 72
Structure of total income
in percents



Source: NBRM, based on the data submitted by banks.

Chart 73
Sector structure of interest expenses
in percents



Source: NBRM, based on the data submitted by banks.

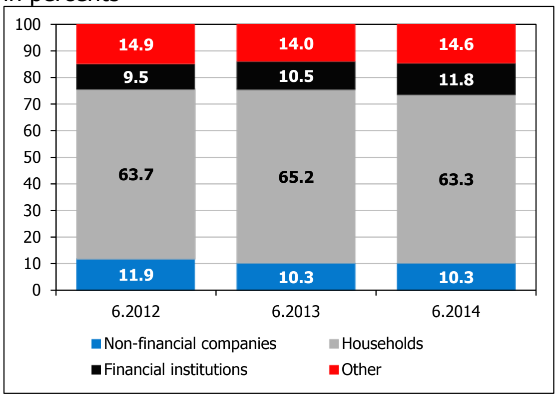
In the first half of 2014, a **decline was registered in the interest income from legal entities** (by Denar 123.4 million, or 1.2%) and from the financial and non-financial sector. Interest income from non-financial companies was lower on an annual basis (by Denar 75.0 million, or 1.7%), mainly due to the downward trend in lending rates, while the falling interest income from financial companies (by Denar 69.1 million, or 9.1%), was entirely due to the decreased interest income from the reserve requirement[71].

On the other hand, the rapid growth in the loans to the household sector enabled the **interest income from households to increase** by Denar 109.9 million, or 3.0%, despite the fact that interest rates on loans to households continue to decline. **Interest income from other entities also grew in the first six months of the year** (by Denar 37.2 million, or 4.5%), primarily reflecting the increased banks' investments in government securities[72].

The largest contribution of 79.8% to the reduction of the total interest expenses[73] was that of the interest expenses of the household sector, which were lower by Denar 363.1 million, or 13.7% on an annual basis, amid a decline in the interest rates on long-term Denar deposits (by 1.1 percentage point) and short-term and long-term foreign currency deposits of the household sector (0.7 percentage points)[74]. However, interest expenses from the household sector still have the

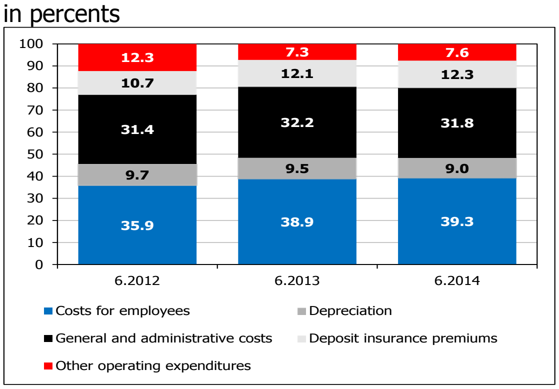
[71] According to the Decision amending the Decision on reserve requirement ("Official Gazette of R. Macedonia" no. 166/2013), the NBRM is exempted from paying reserve requirement remuneration (previously, this remuneration rate equaled 1% for the Denar reserve requirement and 0.1% for the Euro reserve requirement). This decision came into effect on 01 January 2014.
[72] In the first six months of 2014, the interest income from investments in government securities, which is included in the category of interest income from other entities, increased by Denar 57.3 million, or 9.3%. As of 30 June 2013, the amount of treasury bills totaled Denar 29,976 million, and as of 30 June 2014 it was Denar 31,365 million. The growth of investments in government bonds continued as well.
[73] Total interest expenses fell by Denar 455 million, or 11.2%.
[74] Most significant decline was registered in the interest rates on short-term time Denar deposits with FX clause (by 2.2 percentage points), but the amount of these deposits is very small.

Chart 74
Sector structure of interest expenses
in percents



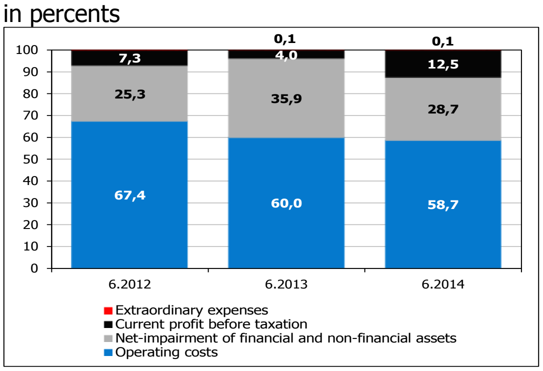
Source: NBRM, based on the data submitted by banks.

Chart 75
Structure of operating costs
in percents



Source: NBRM, based on the data submitted by banks.

Chart 76
Usage of total income
in percents



Source: NBRM, based on the data submitted by banks.

largest share in the structure of the interest expenses (63.3%).

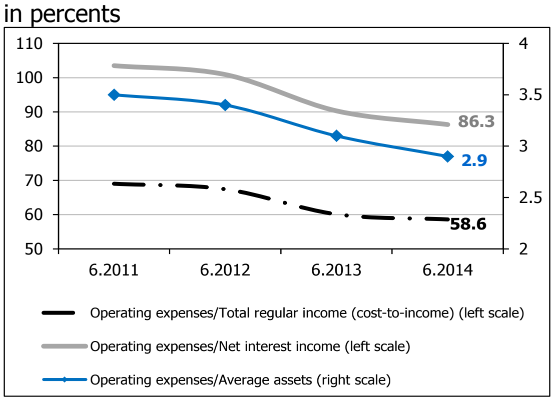
In the first six months of 2014, **banks' operating costs**[75] **increased** by Denar 46 million, or 0.9%. **The largest increase in absolute amounts was recorded in the expenses for employees** (by Denar 40.1 million, or by 1.9%), while more pronounced annual increase (of Denar 21.1 million or 5.4%) was registered in the category "other operating costs"[76]. Deposit insurance premiums grew by Denar 11.7 million, or 1.8%, corresponding to the annual growth of banks' deposits, despite the reduced insurance premium. In contrast, within the operating costs of banks, more significant reduction was registered in depreciation (by Denar 19,6 million or 3.9%) and general and administrative expenses (by Denar 7,3 million, or 0.4%). However, these movements had no major impact on the structure of operating costs, in which the costs for employees and general and administrative expenses retained the main share (71.1%).

The largest portion of banks' total income was spent to cover operating costs and impairment.

Improved operational efficiency of the banking system, measured by the lower amount of total regular income spent to cover operating costs, is confirmed by all other indicators of the ratio between the different types of costs and total regular income, which decrease on an annual basis (Table 6).

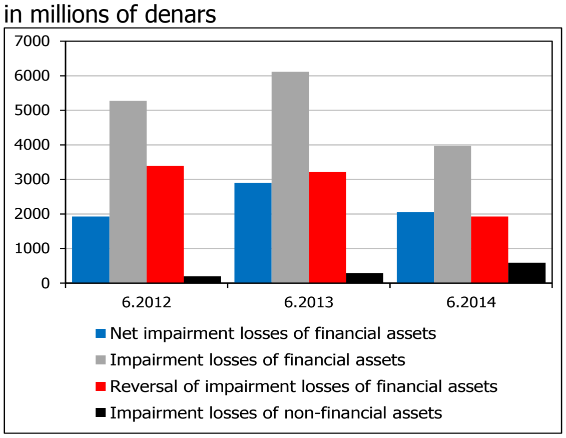
[75] Banks' operating costs include: staff costs, depreciation, general and administrative expenses, deposit insurance premiums and other operating costs, except extraordinary expenses.
[76] The growth of other operating expenses was due to the growth in the special reserve for off-balance sheet exposure (by Denar 22.4 million, or 10.7%) and the growth of the costs of fines, fees and court decisions (by Denar 19.8 million, or 72.4%).

Chart 77
Efficiency indicators of banks
in percents



Source: NBRM, based on the data submitted by banks.

Chart 78
Impairment of financial and non-financial assets
in millions of denars



Source: NBRM, based on the data submitted by banks.

Reduced impairment of claims has a significant contribution to the increased profits for banks. At the end of June 2014, **net provisions which banks recognize for the impairment of financial assets reached Denar 2,046 million, which is a decline of Denar 854 million, or 29.4% on an annual basis[77].** Accordingly, the share of net interest income spent to cover the impairment of financial assets declined from 49.1% (as of 30 June 2013) to 32.8% (as of 30 June 2014).

In contrast, **impairment of non-financial assets (foreclosures) continues to grow**, at a significantly faster pace. Thus, compared to June 2013, impairment of non-financial assets doubled and reached an amount of Denar 588 million.

Rates of return on assets and equity are tripled compared to June 2013, and account for 0.6% and 5.4%, respectively.

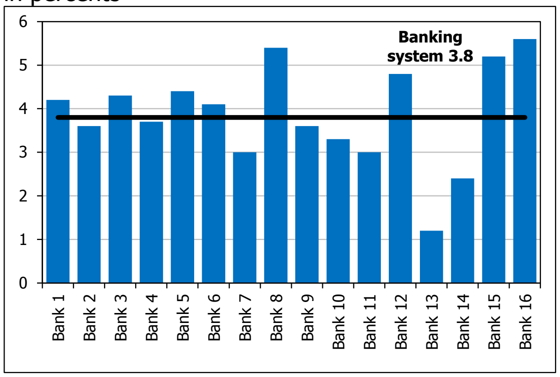
Table 6 Profitability and efficiency indicators of the banking system
in percents

	6.2013	6.2014
Rate of return on average assets (ROAA)	0.2	0.6
Rate of return on average equity (ROAE)	1.8	5.4
Cost-to-income ratio	60.1	58.6
Non-interest expenses/Total regular income	65.8	64.8
Labor costs /Total regular income	23.3	23.0
Labor costs /Operating expenses	38.9	39.3
Impairment losses of financial and non-financial assets /Net interest income	54.0	42.3
Net interest income /Average assets	3.3	3.3
Net interest income /Total regular income	66.5	68.0
Net interest income /Non-interest expenses	101.0	104.9
Non-interest income/Total regular income	39.3	38.2
Financial result/Total regular income	4.0	12.5

Source: NBRM, based on the data submitted by banks.
Indicators by groups of banks are shown in Annex 35.

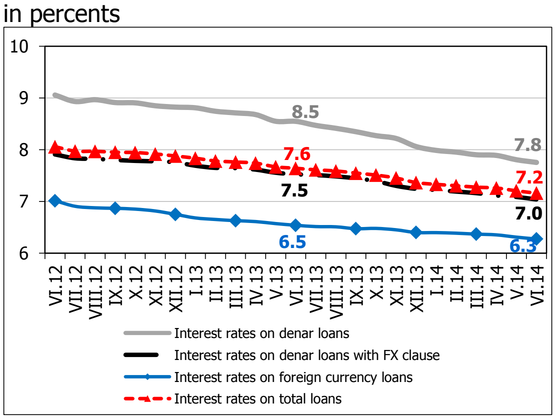
[77] For comparison, in the same period of the previous year, net impairment of financial assets (loans and similar claims), increased by Denar 977 million, or by 50.8%, on an annual basis.

Chart 79
Net interest margin, by bank
in percents



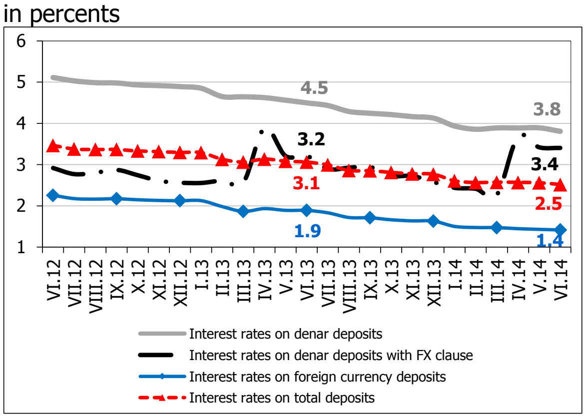
Source: NBRM, based on the data submitted by banks.

Chart 80
Lending interest rates
in percents



Source: NBRM, based on the data submitted by banks.

Chart 81
Deposit interest rates
in percents



Source: NBRM, based on the data submitted by banks.

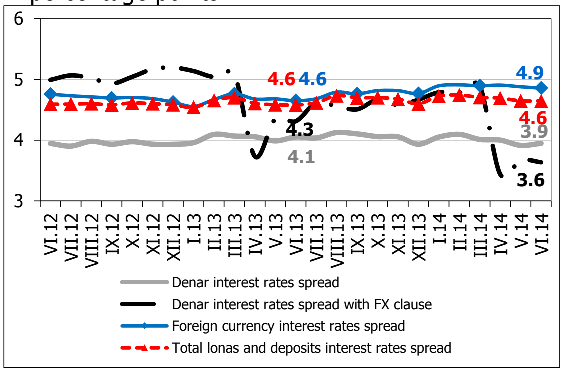
As of 30 June 2014, eight out of sixteen banks had higher net interest margin than **that achieved at the level of the banking system, which equaled 3.8%**.

3.2. Movements in interest rates and the interest rate spread

The trend of reduction in lending and deposit interest rates continued in the first six months of 2014, even though the key interest rate of the National Bank remained unchanged[78]. With the exception of the growth of the interest rate on Denar deposits with foreign currency clause (the amount of these deposits is insignificant), interest rates on all other types of loans and deposits declined. The most pronounced downward trend in interest rates relative to June 2013 was registered in the interest rates on Denar loans and deposits (by 0.7 percentage points) and the smallest decline was registered in the interest rates on foreign currency loans (by 0.2 percentage points).

[78] The interest rate on CB bills during the first six months of 2014 retained the level of the last change in July 2013 (when it reduced to 3.25%).

Chart 82
Interest rates spread, by currency
in percentage points



Source: NBRM, based on the data submitted by banks.
Calculations do not include loans based on overdrafts and credit cards.

Amid relatively steady downward movements of lending and deposit interest rates, interest rate spreads in almost all currencies remained stable and without major changes compared to the level registered in June 2013. The only significant reduction in the interest rate spread was registered in the interest rates on Denar loans and deposits with foreign currency clause, due to the opposite movement in the interest rates on Denar loans with foreign currency clause (they declined by 0.5 percentage points) and Denar deposits with foreign currency clause (they increased by 0.2 percentage points).

ANNEXES