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 FIRST QUARTER OF 2014

July 2014

Contents

SUMMARY

In the first quarter of 2014, the banking system retained the high and stable liquidity and solvency position. The total assets of the banking system grew on both the quarterly and annual basis, although with different intensity. Despite the lower quarterly growth rate of bank loans, on annual level lending accelerated, which was primarily registered in the credit support to the corporate sector. Also, as of March 2014, monthly changes in the lending activity show acceleration, mainly with the corporate sector, which remained in the subsequent months. This indicates gradual improvement of the perceptions of domestic banks about the risk profile of the credit demand. Denarization in the main banking activities continued also in this quarter. Denar long-term deposits of the household sector were the generator of the growth of the deposit activity whereby the trend of positive changes continued, in the currency, but also in the maturity profile of the banks' sources of funds. The increased interest in long-term savings is on the one hand an indicator of public confidence in the banks, but it is also associated with the higher interest rates on long-term deposits.

In the first quarter of 2014, the banking system registered profit, thus interrupting the several-year trend of achieving negative financial results at this time of the year. The main factors for the increased earnings were the reduced interest expenses due to the downward trend in the deposit interest rates, and the lower impairment of financial assets (loans). On the other hand, based on the changes in the regulations on foreclosures in 2013, the impairment of non-financial assets increased and nearly equaled the amount of the impairment of financial assets. Indicators of profitability of banks have improved significantly, and the operational capability of banks of generating revenues that cover the costs of operation has increased, too.

The growth of the domestic economy, and further positive economic trends in the Euro-zone as our most important trading partner, had a favorable impact on the quality of the loan portfolio of the banking system in the first quarter of 2014. On a quarterly basis, non-performing loans decreased. Their annual growth slowed significantly and for the first time since 2011 they have registered a single-digit growth rate of 1.2%. The small annual growth of non-performing loans is primarily based also on the collections of non-performing loans. As of 31 March 2014, the share of non-performing in total loans was reduced to 11.1%. However, after the cut-off date of this Report, i.e. at the end of May 2013, the rate of non-performing loans was back to the average level for 2013 (11.9%). Credit risk remains the most common risk in the banking system of the Republic of Macedonia. However, the constant supervision by the National Bank, good credit risk management systems of banks and full coverage of the non-performing loans with total impairment, reduce the risk of their default for the solvency of banks.

High and stable solvency and liquidity of the banking system are the pillars of its stability and reliability, which contribute to the resilience of the system in the simulation of extreme liquidity and credit shocks. As of 31 March 2014, the capital adequacy ratio was twice the legally prescribed minimum and equaled 16.6%. Liquidity continues to strengthen, which is mainly due to the increased investments of banks in treasury bills, which beside being low-risk, also represent an appropriate liquidity management instrument. Nearly one-third of the banks' assets are liquid assets that provide high coverage of short-term bank liabilities. It is particularly significant that the Macedonian banks hardly depend on the use of loans from their parent entities, whose amount decreased in the first quarter of 2014.

Part 1 Risks in banking operations

I. Risks in banking operations

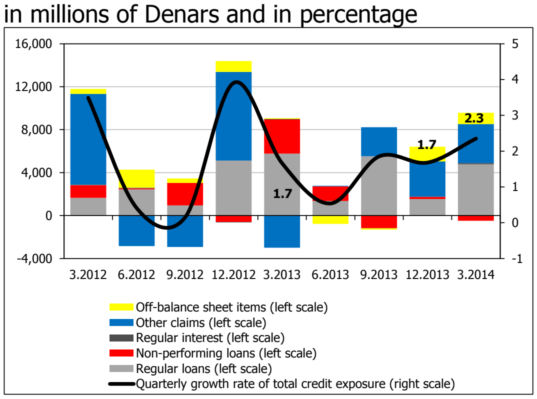
1. Credit risk

The growth of the domestic economy and further positive economic trends in the Euro zone as our most important trading partner, in the first quarter of 2014 contributed to the improvement of the banks' perception of the riskiness of the corporate sector and its creditworthiness, as evidenced by the growth of the credit exposure to this sector for the second consecutive quarter. The small annual growth of non-performing loans is based on the collections of non-performing loans. Non-performing loans to total loans ratio decreased by 0.4 percentage points in the first quarter, and was reduced to 11.1%. However, the upward movement of non-performing loans after the cut-off date of this Report caused the rate of non-performing loans in May 2014 to return to the average level for 2013 (11.9%). The threat for the own funds of the banking system from the non-collection of non-performing loans is minimal, given that these loans have high coverage with allocated impairment (81.4% with their own and over 100% with total impairment).

1.1 Banking system's loan portfolio quality

In the first quarter of 2014, total credit exposure[1] of the banking system grew by Denar 9,092 million and reached Denar 396,044 million. This is an acceleration of the growth compared with the previous quarter by 0.6 percentage points to 2.3%, mostly as a result of the growth of the credit exposure to non-financial entities and the government. Credit support to non-financial entities continued, although at a slower pace, also in the first quarter of 2014. Thus, this exposure (excluding the exposure to financial institutions and the government) registered a quarterly increase of Denar 5,023 million, or 1.8% (2.7% as of 31 December 2013) and contributed with 55.2% to the growth of the total credit exposure. Guided by the more attractive yields and wider offer of government securities, banks increased their credit exposure to the government (by Denar 3,753 million, or 9.6%) with the investments in treasury bills and longer-term government bonds.

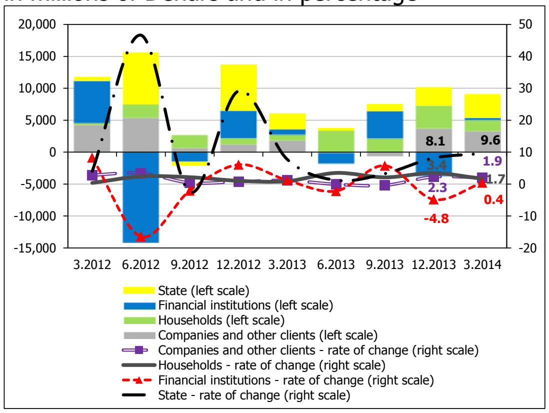
Chart 1
Quarterly growth of credit exposure, by item
in millions of Denars and in percentage



Source: NBRM's Credit Registry, based on data submitted by banks.
Other claims, besides fees, commissions etc., also include banks' investments in CB and treasury bills and government bonds.

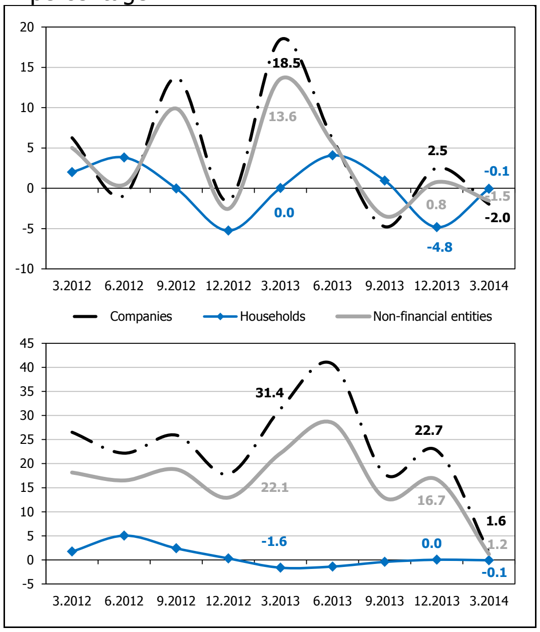
[1] The total credit exposure includes balance sheet (loans and deposits, financial leasing, payments made on the basis of given guarantees, letters of credit, warrants and other off-balance sheet positions, interest, fees and commissions, investment in securities and other financial instruments available 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.

Chart 2
Quarterly growth of credit exposure, by sector
in millions of Denars and in percentage



Source: NBRM, based on data submitted by banks.

Chart 3
Quarterly (top) and annual (bottom) growth rate of non-performing loans
in percentage



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

Unlike last year, when the credit exposure to households caused most of the growth of the exposure to the non-financial entities, in the first quarter of 2014 two-thirds of this growth resulted from the growth of the credit exposure to companies and other customers[2] (Denar 3.249 million or 1.9%). More active credit support from banks was mostly provided to customers from the activities "industry", "transport and storage", "professional, scholar and technical activities" and "electricity, gas, steam and air conditioning". The intensification of lending to the corporate sector points to improved banks' perceptions of the riskiness of this segment, for a second consecutive quarter, but some of these changes can be linked with the non-standard measures taken by the monetary authorities[3] to encourage lending and with the utilization of the funds from the EIB[4]. The slower growth of the credit exposure to households (Denar 1,774 million or 1.7%) results from the slower growth in consumer and housing loans.

In the first quarter of 2014, the quality of the loan portfolio significantly improved. The quarterly growth rate of non-performing loans has a negative value of 1.5%, which comes entirely from the reduction of non-performing loans to companies. The reduction of these loans reflects the improved performance of some of the customers in the activities "construction" and "other processing industry". Non-performing loans to households remained at the same level, and within their framework a downward movement was registered in all loan products, with the exception of non-performing residential loans and overdrafts on current accounts.

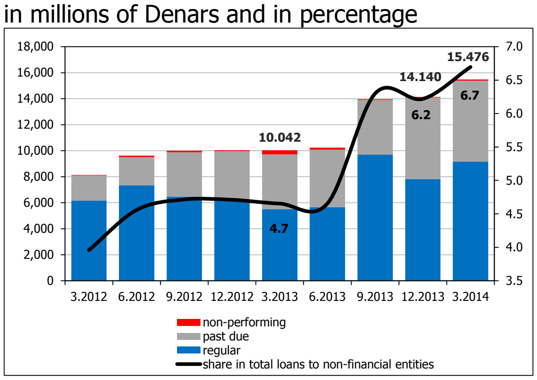
The annual growth rate of non-performing loans slowed significantly and for the first time since 2011 it is a single digit (1.2%). Repayments of non-performing loans have the largest contribution to the slowdown in their

[2] Hereinafter: companies.
[3] The non-standard measures of the National Bank were aimed at encouraging lending for net exporters and producers of electricity. On this basis, in the first quarter of 2014, banks placed another Denar 2,035 million, with the overall amount of these loans (since the introduction of the measure in January 2013) as of March 2014 equaling Denar 9,030 million.
[4] In the first quarter of 2014, Euro 6.3 million from the credit line from EIB for financing small and medium enterprises were placed (the credit line is placed through MBPR AD Skopje).

growth. Changes in the regulation on the credit risk management, which enable exclusion of the claims in which the full amount that is due more than 31 days[5] is collected from the non-performing status, also give certain contribution. The slower movement of non-performing loans on an annual basis was terminated in the following month and in May 2014 the annual growth rate was 6.9%.

The analysis of the dynamics of the non-performing loans should take into account the share of the restructured and prolonged loans to total loans to non-financial entities[6], which at the end of the first quarter of 2014 was 13.0% (12.8% as of 31 December 2013 and 11.9% as of 31 March 2013). In case they were not restructured or prolonged, part of these loans would probably receive a non-performing status, which would be appropriately reflected in the movement of non-performing loans. The main objective of the restructuring is the adjustment of credit conditions to the current financial conditions of customers, in order to facilitate the settlement of their credit liabilities. The new Decision on the credit risk management[7] also encourages timely restructuring of claims (before they get a non-performing status). But if the restructuring of credit liabilities of customers is not realistically set, only a time delay of the recognition of the credit losses is made. The increase in restructured loans in the first quarter is entirely a result of restructured regular loans, which suggests that banks perform the restructuring of the claims upon noticing the financial difficulties of the customer before they get a non-performing status. After the expiration of six months from the completed restructuring[8] it could be seen if they were properly set. Companies are still drivers of the increase of the

Chart 4
Restructured loans in the quarters
in millions of Denars and in percentage

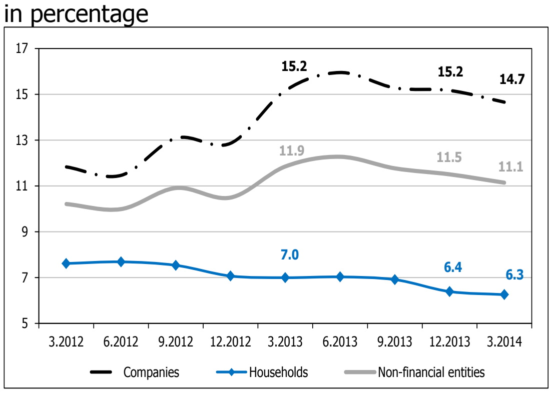


Source: NBRM's Credit Registry, based on data submitted by banks.

[5] Decision on Credit Risk Management ("Official Gazette of RM" no. 50/13 and 157/13), which is effective starting from 1 December 2013. Detailed processing of the changes introduced by this Decision is given in the Report on the risks in the banking system in the Republic of Macedonia in 2013, pages 21-23.
[6] 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 companies and households.
[7] The Decision provides at least 30% impairment for non-performing credit exposures.
[8] According to the Decision, if the bank has made restructuring of a certain claim, it is required to classify that claim in the same risk category for at least another six months and during this period it may not generate income based on release of impairment that is not result of collection of the claim.

total restructured loans. At the end of the first quarter, 10.9% of total corporate loans are restructured (10% as of 31 December 2013, 7.3% as of 31 March 2013). The average level of risk of total restructured loans decreased to 39.1% (39.7% as of 31 December 2013), due to the slower growth of impairment for restructured loans relative to the growth of the restructured loans in the first quarter.

Chart 5
Share of non-performing to total loans of non-financial entities and by sectors
in percentage

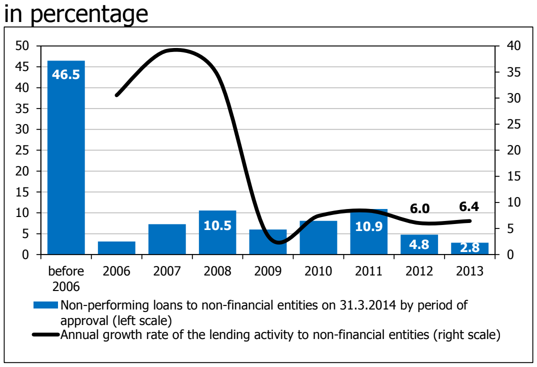


Source: NBRM, based on the data submitted by banks.

Prolonged loans registered a slight downward movement (2.5%). Write-offs in the first quarter are on almost identical (low) level with the same period last year and do not affect the movement of non-performing loans. Companies are the most common in the total debts written off during the first quarter of 2014 with 69.8%, while the total collection of already written off claims completely refers to collections from natural persons.

Downward trend in the non-performing loans contributed to a decline in their share in total loans, where in the first quarter, this rate fell by 0.4 percentage points and was reduced to 11.1%. With the companies, the share of non-performing to total loans was reduced to 14.7%. This stems from the reduction of non-performing loans amid moderate increase of the credit support to companies. The rate of non-performing loans to households decreased slightly due to the growth of total loans, amid almost unchanged level of non-performing loans.

Chart 6
Distribution of non-performing loans as of 31.03.2014, by period of approval and dynamics of banks' lending activity
in percentage



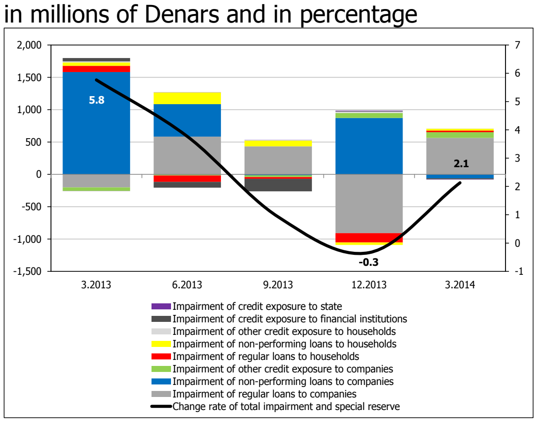
Source: NBRM's Credit Registry, based on data submitted by banks.

The rate of non-performing loans registered an upward movement after the cut-off date of this Report and in May 2014, it returned to the average level for 2013 (11.9%).

According to the approval period, only 2.8% of the total non-performing loans as of 31 March 2014 were approved during 2013. Most of the loans (or 78.3%) approved during the previous year that received a non-performing status by the end of the first quarter of 2014 refer to the sector "companies"[9], more precisely

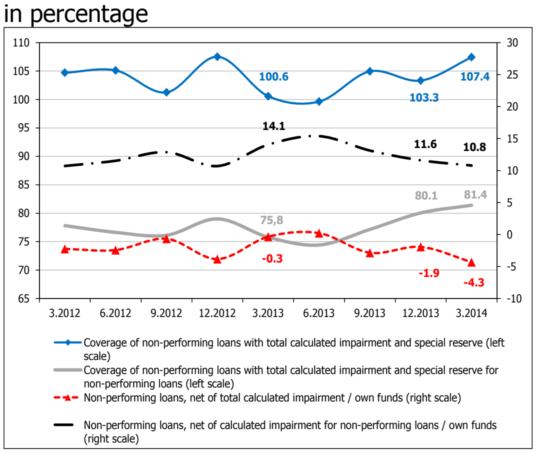
[9] The average level of risk of these loans is 57.2%.

Chart 7
Quarterly change of impairment for invididual sectors
in millions of Denars and in percentage



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

Chart 8
Coverage of non-performing loans and share of net non-performing loans in banks' own funds
in percentage



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

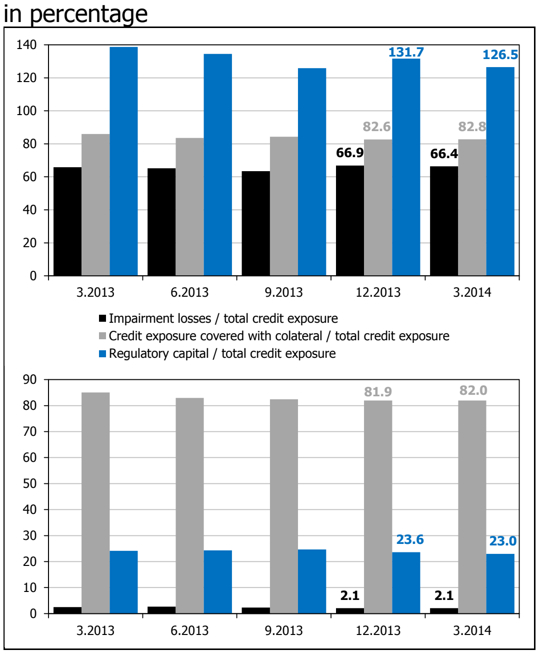
customers from the activities "wholesale and retail trade" and "manufacturing". As of 31 March 2014, nearly half of the non-performing loans originate from the years before the massive credit growth (before 2006).

The decrease of non-performing loans was followed by a quarterly growth of total impairment of Denar 626 million, or 2.1%. This growth comes entirely from the impairment for regular loans to enterprises and to a lesser extent from the off-balance sheet exposure to companies. According to the activity, the growth of overall impairment is due to the impairment for the activities that show the highest growth of credit exposure, but also of the activity "wholesale and retail trade", in which one third of the total credit exposure to companies is concentrated.

Given the downward movement of non-performing loans, growth of impairment caused an increased coverage of non-performing loans with total impairment by 4.1 percentage point. As of 31 March 2014, the coverage of non-performing loans with impairment calculated for them increased to 81.4%.

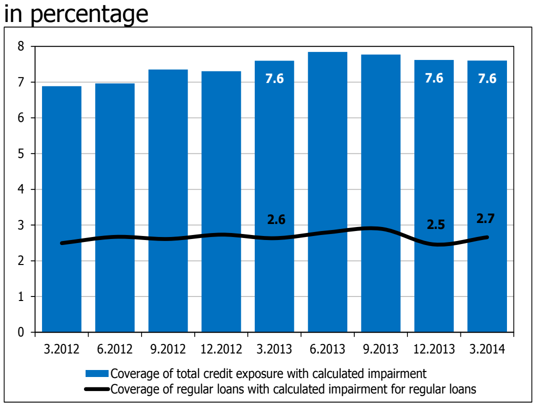
In conditions of improved quality of the loan portfolio, the already low share of the uncollateralized part of the non-performing loans in the own funds of the banking system was further reduced. Thus, under assumption of full non-collectability of non-performing loans, at the end of this quarter, own funds would decrease by 10.8% (0.8 percentage points less compared to the assumed decrease at the end of 2013).

Chart 9
Coverage of loans to customers who pay their liabilities irregularly (top) and coverage of loans to customers who pay their liabilities regularly (bottom)
in percentage



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

Chart 10
Average risk level for the total credit exposure and for regular loans
in percentage



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

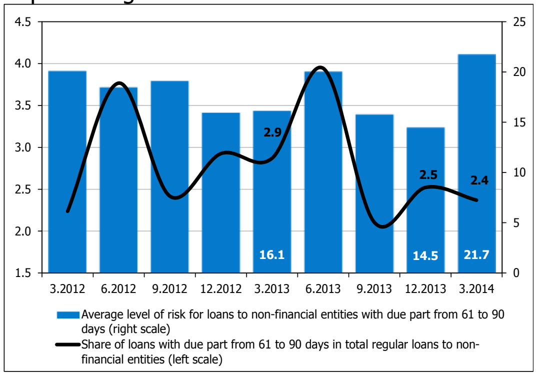
Indicators of the coverage of credit exposure indicate a satisfactory capacity of the banking system to absorb potential credit losses. Thus, 66.4% of the amount of loans to non-financial entities that do not repay the liabilities[10] regularly is covered by the impairment determined for them. Additionally, 82.1% of loans to non-financial entities (whether they regularly pay their liabilities or not) are covered by some type of collateral. The own funds of the banking system fully cover the total amount of loans that are irregularly repaid or are not repaid at all, while 23.0% of the loans to non-financial entities that are regularly paid off, are covered with own funds. Coverage of loans that are regularly repaid with impairment, or the level of expected losses from these loans is usually set relatively low, and at the end of the first quarter of 2014 it was 2.1%.

In the first quarter of 2014, the average risk level of the loan portfolio of the banking system remained unchanged as a result of the almost identical growth rate of impairment and of total credit exposure. In contrast, the average risk level of regular loans has increased due to the quarterly growth of impairment for them (by Denar 630 million or 10.2%), given the increase of the impairment of exposures in risk category "C regular" (by 21.2%), amid moderate increase of the total regular loans (by Denar 4,767 million, or 1.9%)

Past due loans with a period of delay in repayment of 61 to 90 days are a potential risk for increasing the non-performing loans in the next month. The average level of risk of these loans reached 21.7%, which corresponds to the risk category "C". The increase in the average level of risk arises from the growth of impairment due to the reduction in loans overdue 61 to 90 days, which means that for part of these loans customers repaid the debt past due over 31 days and began to settle their liabilities regularly while

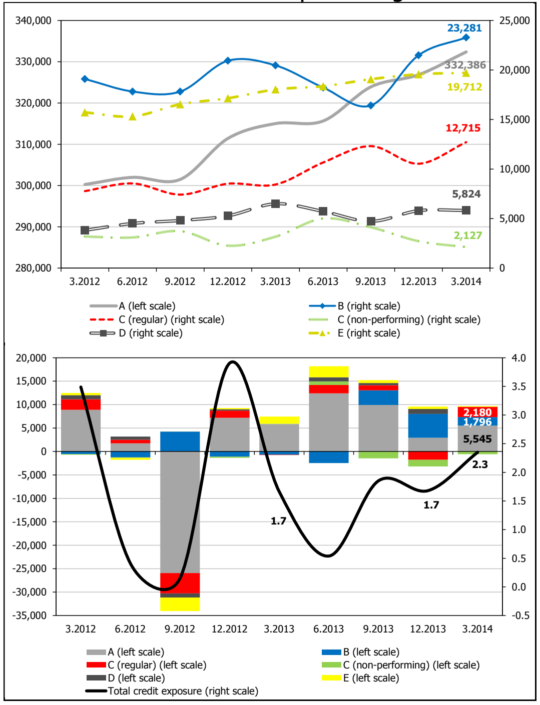
[10] The analysis included non-performing loans, regular restructured loans, past due restructured loans and past due but unrestructured loans overdue 61 to 90 days to non-financial entities. The analysis excludes prolonged loans because it is assumed that the extension of the maturity of these loans is not a consequence of the worsening financial condition of the customers (which is consistent with the regulatory requirements in this area).

Chart 11
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 12
Credit exposure, amount (top) and absolute annual growth (bottom), by risk category
in millions of Denars and in percentage



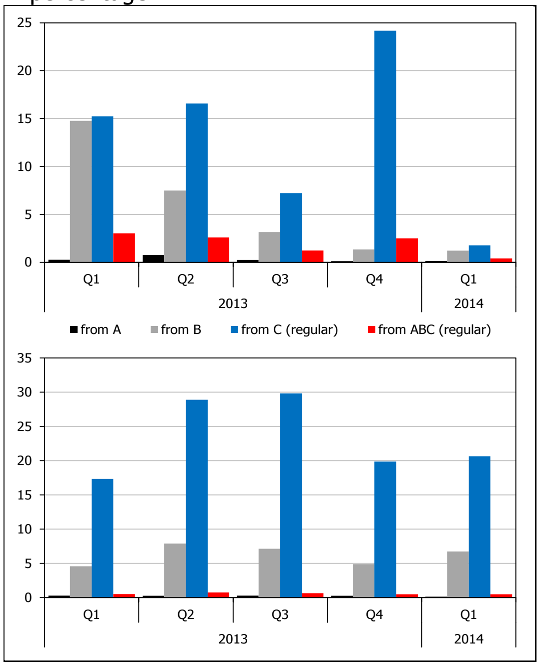
Source: NBRM's Credit Registry, based on data submitted by banks.

the rest of these loans further deteriorated in quality, resulting in higher impairment and coverage. The deterioration in the credit quality of the loans containing part that is past due 61 to 90 days, on the one hand suggests a greater likelihood for their migration to a non-performing status, but on the other hand emphasizes the willingness of banks to cover the potential losses from these loans. Assuming that all loans containing part that is past due 61 to 90 days will not be collected in the following month, 2.4% of the total regular loans as of 31 March 2014, would migrate to non-performing, making the non-performing loans rise to Denar 4,927 million, or 18.9%. But the growth registered in the following month (April 2014) is significantly lower, and equals 2.4% or Denar 617 million.

The quarterly growth of total credit exposure arises entirely from the exposure with a regular status, mostly (61.0%) from the exposure in risk category "A". The increased exposure in this risk category (by Denar 5,545 million, or 1.7%) often presents the new credit exposures approved during the quarter. Reclassification to a better risk category of certain credit exposures that previously had a non-performing status partly contributed to the growth of the exposure in the risk categories "C regular" (by Denar 2,180 million, or 20.7%) and "B" (by Denar 1,796 million or 8.4%). The decrease in the non-performing credit exposure is driven by the downward movement in the risk category "C non-performing", mainly to companies, which besides the improved classification of certain credit exposures arises also from the collections of some non-performing claims.

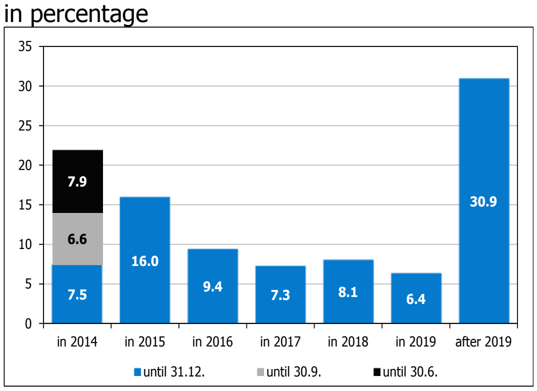
According to individual activities in the corporate sector, the credit risk is the highest in "industry" and "construction", while according to individual products of the household sector, it is the highest in credit cards and consumer loans (Annexes 24 and 25). According to the currency structure, the highest risk-bearing credit exposure is that in Denars with foreign currency clause (Annex 16).

Chart 13
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.

Chart 14
Structure of credit exposure to non-financial entities, by maturity of principal
in percentage



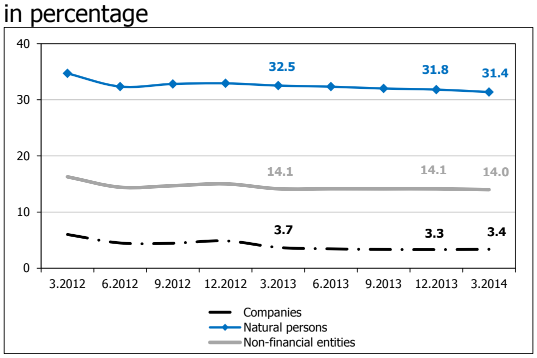
Source: NBRM's Credit Registry, based on data submitted by banks.

The percentage of credit exposure with regular status, which for a period of one quarter receives a status of a non-performing exposure[11] increased at the end of the first quarter of 2014 (to 0.4% from 1.6% at the end of 2013). Analyzed by individual sectors, 0.5% of the regular exposures to natural persons and 0.4% of these exposures to companies received a non-performing status in one quarter. In the first quarter of 2014, the share of the credit exposures to companies that within one quarter received a non-performing status was reduced significantly. Thus, only 1.8% of the exposures to companies in risk category "C" received a non-performing status at the end of the quarter (24.2% at end-2013). This movement confirms the improvement of the quality of banks' loan portfolio, but it is also an effect of the performed restructuring.

The analysis of the credit exposure to non-financial entities according to the maturity of the principal, as of 31 March 2014, showed that 21.9% of the amount falls due by the end of 2014, and more than half falls due after 2016. The exposure with an average risk level of up to 20% (risk categories "A" and "B") accounts for 95.3% of the total credit exposure which falls due by the end of the next quarter and the largest proportion of which (69.2%) 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".

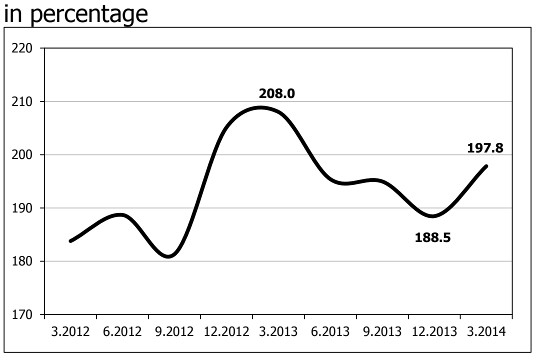
[11] The shift of a credit exposure with a performing status in an exposure with a non-performing status is calculated as the ratio between the credit exposure which received non-performing status at the end of the quarter and the credit exposure at the beginning of the analyzed quarter. The analysis does not include the credit exposure which was closed due to restructuring and prolonging and the credit exposure approved during the quarter.

Chart 15
Share of uncollateralized exposure in total credit exposure of non-financial entities and of sectors
in percentage



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

Chart 16
Share of large exposures in banks' own funds
in percentage



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

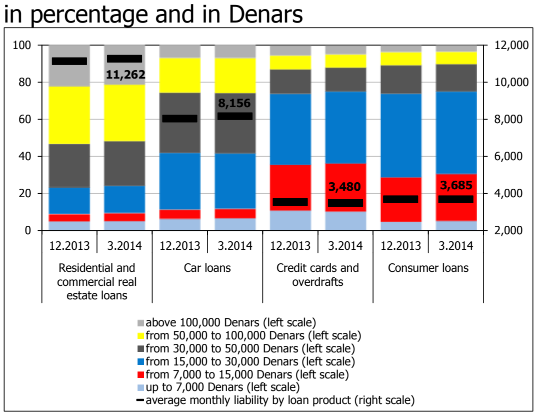
The share of uncollateralized credit exposure in the total credit exposure to non-financial entities in the first quarter of 2014 remained almost unchanged. In individual sectors, reduced share of the uncollateralized part is registered with natural persons, primarily in consumer loans (although in the Lending Survey from April 2014, banks estimated the requirement for allocating collateral as unchanged compared to the previous quarter). The share of the uncollateralized exposure to natural persons was reduced to 14.5% (if the exposure based on overdrafts on current accounts and credit cards is excluded[12]).

At the end of the first quarter of 2014, there was an increase in the concentration of credit risk, measured by the share of large exposures in the banks' own funds. Analyzed by bank, the share of large exposures in the own funds ranges between 11.8% and 738.0% and is within the maximum prescribed limit[13] (including the exposures to financial institutions)[14]. If the exposures of banks to financial institutions and placements in CB bills and government securities are excluded, the concentration is clearly lower, i.e. the share of large exposures to non-financial entities in the banks' own funds was reduced to 69.9%[15]. Analyzed by bank, the share of large exposures to non-financial entities in the own funds ranges from 10.8% to 358.6%. Moreover, little less than half of the large exposures at the system level account for one bank.

In conditions of slower growth in the credit support to households, the average debt per person (only for persons who are indebted) remained at the same level as in the previous quarter. As of 31 March 2014, most indebted are the persons with monthly income of up to Denar 30.000, constituting two thirds of the total banks' exposure to natural persons and 73.6% of the total exposure intended for consumption (Annex 25). Analyzed by individual persons, most

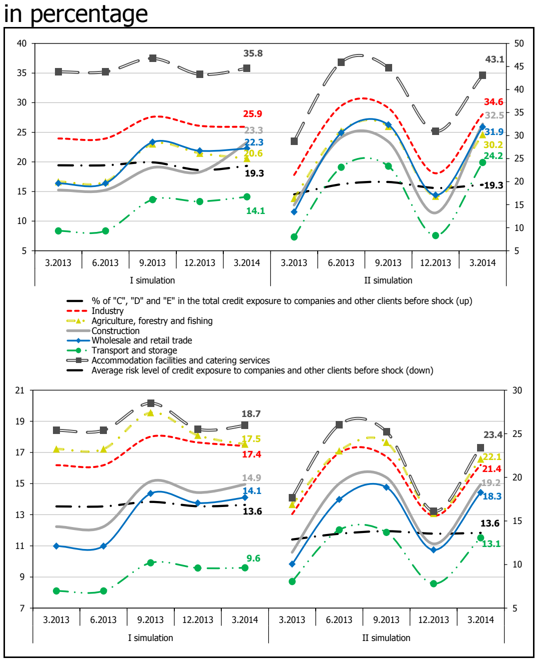
[12] Most collections of this credit exposure are covered by the monthly income of borrowers.
[13] The total amount of large exposures must not exceed eight times the amount of bank's own funds.
[14] Large exposure to a related person or persons is an exposure equal to or higher than 10% of bank's own funds.
[15] Five banks have no large exposures to non-financial entities.

Chart 17
Structure of credit exposure to individual credit products, by monthly income of borrowers (natural persons)
in percentage and in Denars



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

Chart 18
Share of the exposure with higher risk level in the total credit exposure (top) and the average level of risk (bottom) by individual activities, after the first and second simulation
in percentage



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

indebted are natural persons with monthly income above Denar 100,000 (average debt of Denar 629 thousand per person), which is a result of the banks' adjustments of the amount of debt to the amount of the monthly income of natural persons. The average monthly liability, depending on the loan product ranges between Denar 3.5 thousand (for credit cards and overdrafts on current accounts) and Denar 11.3 thousand (for loans for purchasing and renovation of residential and commercial properties). According to the type of credit product, persons with monthly income of over Denar 30,000 have a share of 75.7% in the credit exposure based on residential loans, while those with monthly income up to Denar 30,000 have the largest share in the credit exposure based on consumer loans and credit cards and overdrafts on current accounts (75.2% and 75.3%, respectively).

1.2 Stress test simulation of the resilience of the banking system to increasing credit risk

Regular stress tests are aimed at examining the sensitivity of the banking system during the deterioration of the quality of certain segments of the loan portfolio. They consist of simulations of hypothetical migration of 10% (first simulation) and 30% (second simulation) of credit exposure to companies (by activity) and households (by credit product), separately, and to the two sectors jointly, to the following two higher risk categories. The results of the simulations show that the banking system remains resilient to simulated shocks. However, compared with the previous quarter, there is some deterioration in the results of individual banks. In both simulations for the different activities, the greatest reduction in the capital adequacy ratio is noticeable in the deterioration of the creditworthiness of the customers from "industry" and "wholesale and retail trade", followed by "construction" (Annex 26).

In terms of the indicators of the loan portfolio quality, the largest increase of the indicator of share of the exposure with higher risk level (classified in risk categories "C", "D" and "E") in the total credit exposure is registered with the activities which had highest growth of credit exposure, "industry" and "transport and storage", while the average level of risk registers the greatest deterioration in the activities "agriculture, forestry and fishing" and "activities related to real estate."

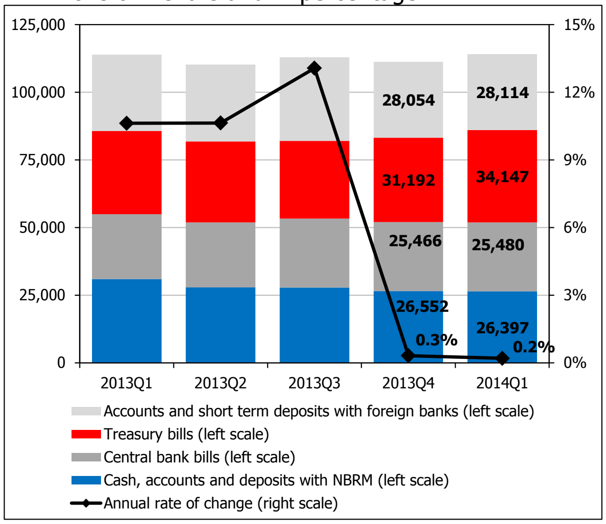
2. Liquidity risk

In the first quarter of 2014, the level of liquid assets that banks in the Republic of Macedonia had at their disposal remained high. Liquid assets have increased on a quarterly basis, mainly due to the growth of banks' investments in treasury bills. Observed annually, liquid assets were stagnant, which corresponds to the acceleration of the annual rate of credit growth. Liquidity indicators registered a stable movement. Reduction of the banks' sources of funding originating from their parent entities continued in the first quarter of 2014, so that the deposits of non-financial entities were generators of the quarterly increase in the sources of funding for banks. In the first quarter of 2014, the positive changes in the maturity profile of assets and liabilities of banks continued. Driver of this phenomenon was the stronger preference for saving in the long run, especially among the households, which resulted in more rapid growth of liabilities with greater residual maturity, amid growth of the assets with shorter remaining maturity due to the gradual maturity of the banks' portfolio of low-risk securities. Stress-test shows that the banking system is resilient to liquidity shocks. According to the latest available data, as of May 2014, the banking system has maintained the high liquidity position, as evidenced by the share of the liquid in the total assets of over 30% and the coverage of short-term liabilities of almost 55%.

At the end of the first quarter of 2014, the liquid assets[16] of the banking system amounted to Denar 114,138 million which is by Denar 227 million, or 0.2% more, on annual basis. According to the latest available data, as of May 2014, liquid assets are growing by 1.4%, annually. On a quarterly basis, liquid assets increased by Denar 2,874 million, or 2.6%, compared to the decline in the fourth quarter of 2013 by 1.5%. Annually, the modest growth of banks' liquid assets mainly arises from the increased banks' propensity to take credit risk, as

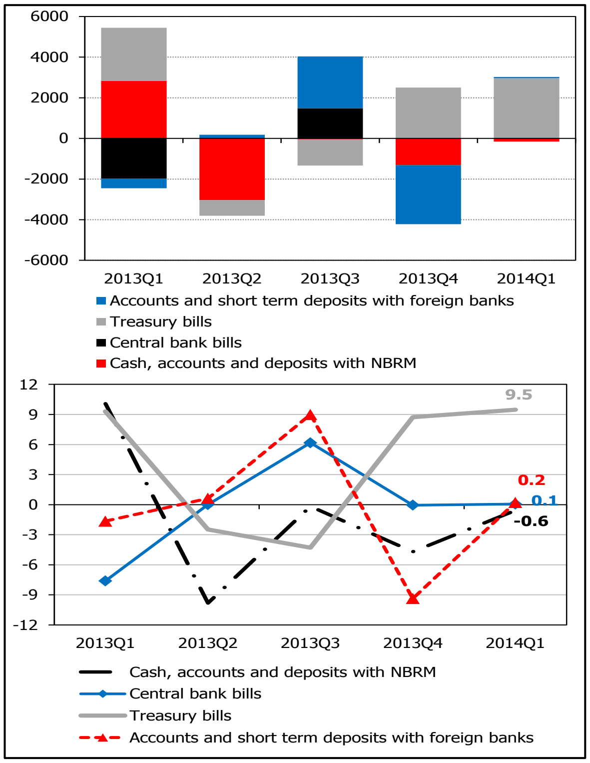
[16] Liquid assets include cash and assets on accounts with the National Bank, CB bills, correspondent accounts and short-term deposits with foreign banks and investments in short-term securities issued by the government. For the purposes of analyzing liquidity, assets and liabilities in Denar with FX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

Chart 19
Banks' liquid assets structure
in millions of Denars and in percentage



Source: NBRM, based on data submitted by banks.

Chart 20
Quarterly absolute (top) and relative (bottom) change in the positions comprising liquid assets
in millions of Denars

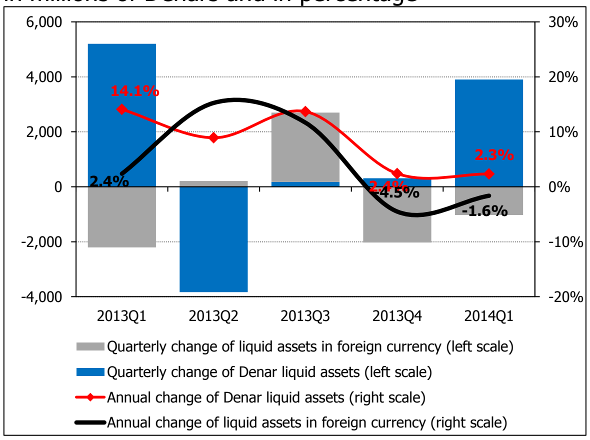


Source: NBRM, based on data submitted by banks.

evident from the gradual acceleration of the growth in lending to the private sector. The change in the manner the NBRM conducts auctions of CB bills (limiting the amount offered) also has a moderate impact on the growth in the banks' liquid assets. It actually prevents unlimited placement of banks' funds in this instrument in order to redirect them toward support of the economy. It should also be borne in mind that liquid financial instruments, especially those denominated in foreign currency, carry relatively low yield compared to other financial instruments, which reduces the propensity of banks to make larger investments in liquid financial instruments in foreign currency. By bank, liquid assets in the first quarter of 2014 increased in eight banks (in the interval from 0.6% to 26.9%), whose share in the total assets at the level of the banking system as of 31 March 2014 was 62.0%. In the other eight banks, liquid assets in the first quarter of 2014 decreased in a range between 0.7% and 11.1%.

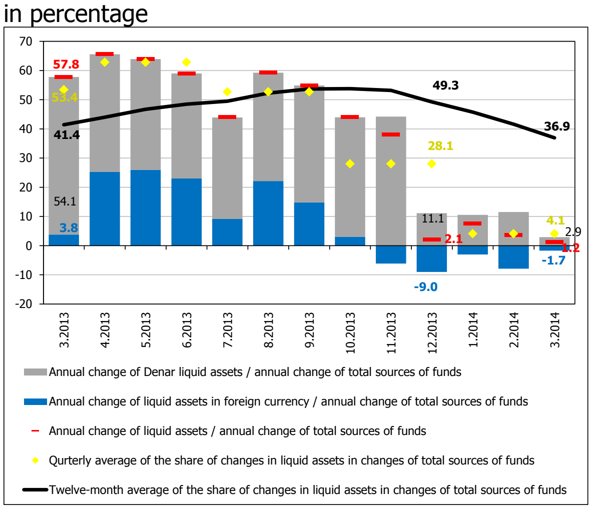
The growth of liquid assets in the first quarter of 2014 was mainly determined by the dynamics of banks' investment in treasury bills. Namely, as of 31 March 2014, the banks' investment in treasury bills grew by 9.5% on a quarterly basis (11.1% on an annual basis), determining the overall growth of total liquid assets. Amid small changes in the investment in other liquid instruments, the share of treasury bills in the structure of liquid assets increased on a quarterly basis by 1.9 percentage points and as of 31 March 2014, it was 29.9%, which makes them the most common instrument in banks' liquid assets. For two quarters in a row, CB bills have registered minor changes, while short-term deposits placed with foreign banks, after the perceived decline in the last quarter of 2013, register a modest quarterly growth of 0.2% in the first quarter of 2014.

Chart 21
Quarterly and annual growth of liquid assets, by currency
in millions of Denars and in percentage



Source: NBRM, based on data submitted by banks.

Chart 22
Change of liquid assets by currency / change of total sources of funds
in percentage



Source: NBRM, based on data submitted by banks.

As of 31 March 2014, the banks have government bonds in the amount of Denar 6,511 million, representing 1.7% of total assets[17]. At the end of the first quarter of 2014, government bonds registered quarterly growth of Denar 755 million, i.e. 13.1%.

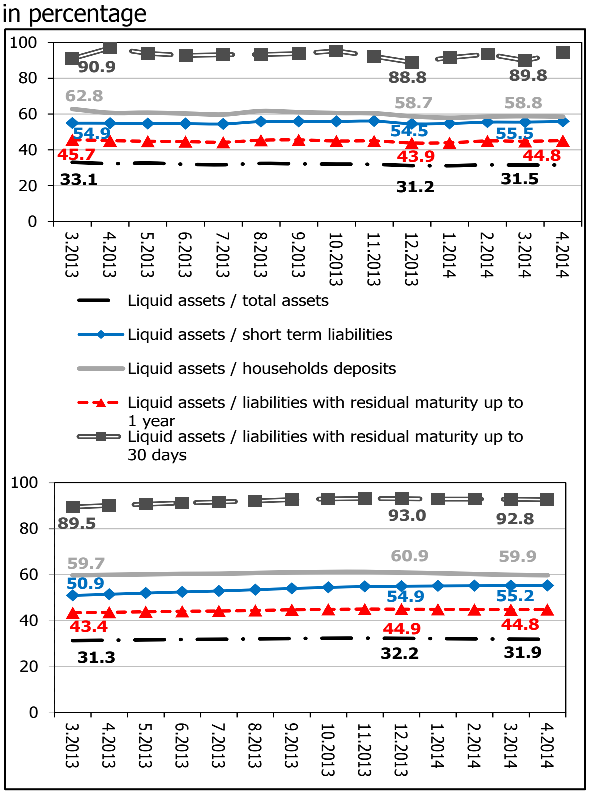
In the first quarter of 2014, changes in the currency structure of liquid assets were in the direction of growth of Denar liquid assets, while liquid assets in foreign currency decreased. Hence, at the end of the first quarter of 2014, the share of the Denar component in the currency structure of liquid assets was 73.1%, which compared with the end of 2013, is an increase of 1.6 percentage points.

In the first quarter of 2014, the downward trend in the share of the change in liquid assets in the change in total sources continued. Thus, in the first quarter of 2014, banks have invested only a little bit over 4% of their new funding sources in liquid financial instruments. Also, the downward trend in the twelve-month moving average of the share of the annual change in liquid assets in the annual change in the total sources of funds, continued as well. These trends illustrate the gradual intensification of the credit activity and the increase in the propensity of banks to take credit risk. During the first quarter of 2014, the change in the total sources of funds was a result of the positive contribution of the growth of Denar liquid instruments, as opposed to the growth of foreign currency liquid instruments, where there is a tendency for banks' disinvestment.

Indicators of liquidity of the banking system[18] in the first quarter of 2014 remained satisfactory. Different categories of banks' liabilities have relatively high levels of coverage with liquid assets, which is the highest among the liabilities with residual maturity of up to 30 days. Stable liquidity position of domestic banks

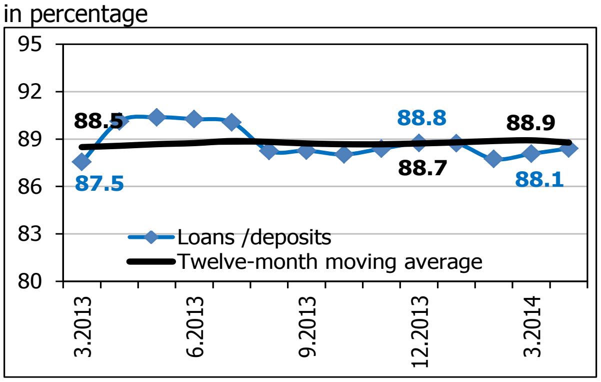
[17] According to the list of securities for implementing monetary operations ("Official Gazette" no. 26/11), government bonds are accepted by the National Bank as an instrument for ensuring the implementation of monetary operations. Given their maturity (over 1 year), they are not covered under the liquid assets.
[18] The calculation of the liquidity of the banking system does not take into account the resident interbank assets and liabilities.

Chart 23
Liquidity ratios of the banking system – levels (top) and twelve-month moving average (bottom)
in percentage



Source: NBRM, based on data submitted by banks.

Chart 24
Loan to deposit ratio
in percentage

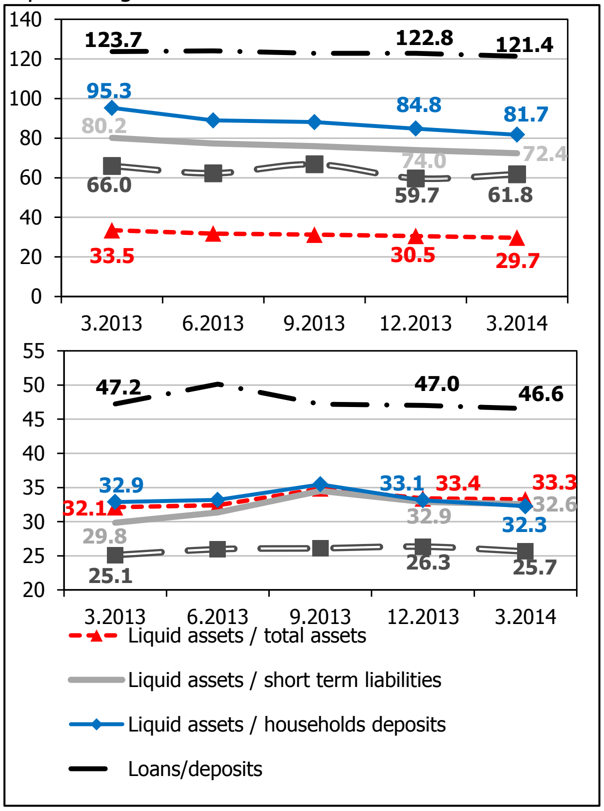


Source: NBRM, based on data submitted by banks.

is confirmed by the dynamics of the twelve-month moving average of liquidity indicators. Thus, the twelve-month moving average of the share of liquid assets to total assets in the first quarter of 2014 is more than 30%, and the coverage of household deposits with liquid assets is about 60%. By individual bank, the coverage of short-term liabilities with liquid assets on a quarterly basis, decreased in six banks whose share in the total assets of the banking system amounted to 27.9% as of 31 March 2014. The coverage of liabilities with residual maturity of up to 30 days, decreased in four banks, while the coverage of household deposits with liquid assets decreased in ten banks.

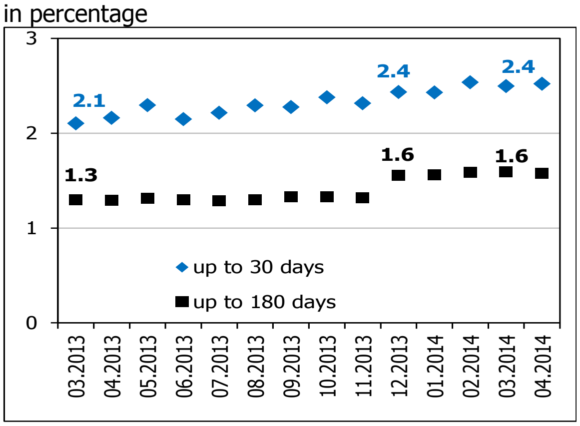
The indicator of the loans to deposits ratio also shows stability in the dynamics, and its twelve-month average has been maintained below 90% for three years in a row. In the first quarter of 2014, this indicator decreased by 0.7 percentage points, due to the more dynamic quarterly growth in deposits (2.5%) compared with the quarterly credit growth (1.7%). On a quarterly basis, this indicator increased in five banks, while full use of the deposits for lending to the private sector, i.e. indicator value of over 100%, was recorded with four banks, with a share in total assets of the banking system by 14.7%.

Chart 25
Liquidity ratios of the banking system by currency - Denar (top) and foreign currency (bottom)
in percentage



Source: NBRM, based on data submitted by banks.

Chart 26
Liquidity ratios
in percentage



Source: NBRM, based on data submitted by banks.

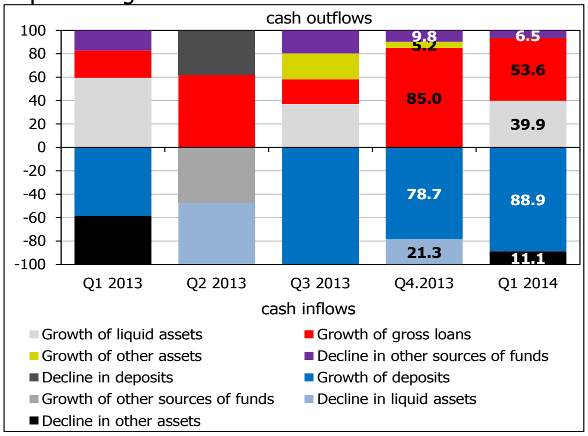
In this quarter, a slight decrease in the liquidity indicators in terms of currency, was registered. Amid more dynamic quarterly growth of the Denar component of banks' liabilities, compared with the foreign currency component, the reduction is more notable in the Denar liquidity indicators. This is particularly evident in the coverage of household deposits and short-term liabilities with appropriate liquid assets, where the decline in the Denar indicators in the first quarter of 2014 is significantly faster than the fall in the foreign currency indicators. The moderate quarterly growth of the foreign currency component of the banks' liabilities, amid simultaneously declining foreign currency liquidity, caused the reduction of liquidity indicators in foreign currency in the first quarter of 2014 to be significantly lower compared with that in Denars. The loan to deposit ratio declined on a quarterly basis in both Denars and in foreign currency. The decrease was slightly more pronounced in the indicator in Denars due to the more dynamic quarterly growth of Denar deposits, but also because of the small share of foreign currency lending in total quarterly credit growth.

Banking system liquidity ratios[19], presented as ratios between assets and liabilities that mature in the next 30 days or 180 days, during the first quarter of 2014 demonstrated stable movement and are at a higher level compared to the average level of these ratios over 2013[20].

During the first quarter of 2014, most of the inflow of new sources of funding for the banking system arises from the growth of deposits of non-financial entities. Thus, the growth of deposits accounted for 88.9% of the

[19] The method of calculation of liquidity ratios of banks is determined by the Decision on liquidity risk management of banks ("Official Gazette" no. 126/11, no. 19/12 and no. 151/13) and the respective guidelines.
[20] This stems from the changes in the regulations (in force starting from December 2013), which reduced the percentage of deposits that should be covered by liquid assets, from 80% to 60%.

Chart 27
Structure of cash inflows and outflows of the banking system
in percentage



Source: NBRM, based on data submitted by banks.
The category of "other assets" includes assets that are not loans to nonfinancial entities and are not included in the category of liquid assets (long-term loans in foreign and domestic banks, foreign exchange reserve requirement, foreclosures, fixed assets, etc.) as well as the decrease of impairment of financial and nonfinancial assets.
The category of "other sources of funds" includes all sources of funding which are not deposits of nonfinancial entities (equity and reserves, deposits of financial institutions, loans, subordinated instruments etc.) and the increase of impairment of financial and nonfinancial assets.

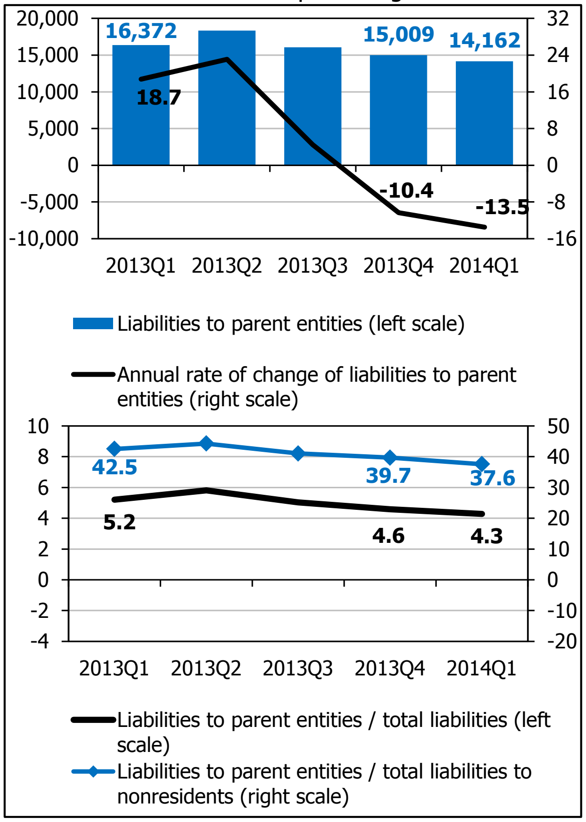
cash flow structure[21] of the banks in the first quarter of 2014. On the other hand, predominant in the structure of the cash outflows of banks was lending to non-financial entities, with a share of 53.6%, followed by banks' investment in financial instruments. Analyzed on annual basis, the share of the growth of deposits in the structure of cash inflows and the share of loans in the structure of cash outflows is over 90%, which clearly shows that banks are mostly financed by inflows from the domestic deposit market and that are oriented toward placing the newly-collected sources of funds in loans to the domestic private sector, with a gradual reduction of their credit risk aversion.

In the first quarter of 2014, funding sources based on borrowings, interbank transactions and deposits from financial institutions decreased, mainly as a result of the fall of the liabilities to parent entities. Regarding the currency, the largest contribution (81.6%) in the quarterly increase in banks' total sources of funding was that of long-term sources, mainly due to the growth of deposits of non-financial entities, and within these the household deposits. In the first quarter of 2014, short-term sources of funding have demonstrated a minimal growth of 0.1%, mainly due to the reduction of liabilities to parent entities. Households' preference for saving in the long run also had its share in the decline of short-term funding sources, thus changing the maturity profile of household deposits in order to increase the long-term component, at the expense of short-term deposits.

The sources of funding of banks originating from their foreign parent entities decreased for the third consecutive quarter. Thus the trend of gradual deleveraging of the domestic banks to their parent entities continued, followed by a reduction of their already minor importance for

[21] Cash inflows and cash outflows 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. write-offs of loans, revaluation of securities available for sale or held for trading, depreciation of fixed assets, net exchange differences, etc.) is an integral part of the change in the corresponding balance sheet items, the respective inflow or outflow refers to.

Chart 28
Sources of funding originating from parent entities (top) and their relative importance to the banking system (bottom)
in millions of Denars and in percentage



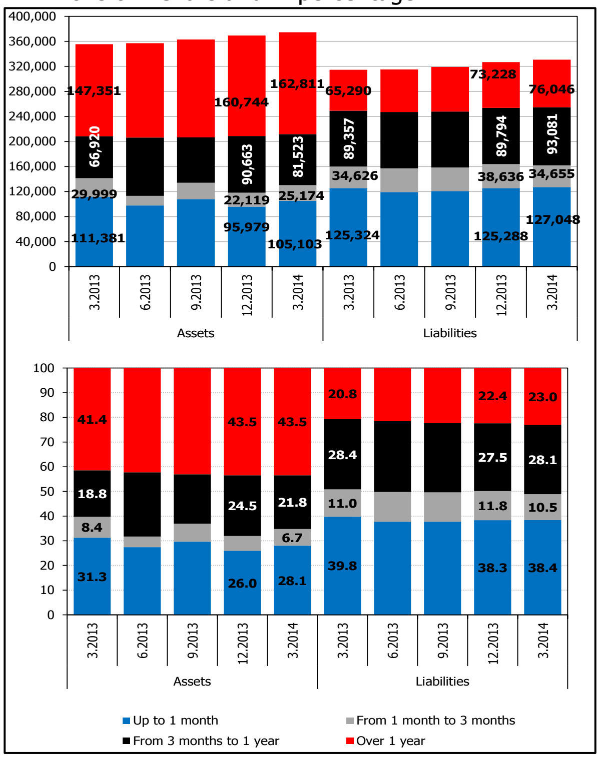
Source: NBRM, based on data submitted by banks.

the banks' total sources of funding. Thus, the share of liabilities to parent entities in the total banks' liabilities reduced, and at the end of the first quarter of 2014 it was 4.3%. The decline in the used sources of funding from parent entities (which on a quarterly basis amounted to Denar 846 million, i.e. 5.6%), almost entirely derived from the withdrawal of short-term deposits in domestic banks by foreign parent entities.

Given the intensified growth of the long-term component of the deposits as the main source of funding for banks in the first quarter of 2014, the trend of growing average maturity of the banks' liabilities analyzed by the contractual residual maturity, continued. The highest annual growth rate of 16.4%, was recorded in the liabilities with residual maturity of over one year, which corresponds to the more intensive growth of long-term household deposits. In the first quarter of 2014, in the structure of the liabilities under the remaining contractual maturity, a reduction was registered in the liabilities with residual maturity of one month to three months, at the expense of the increase in the shares of the liabilities of the other maturity buckets. In the structure of bank assets according to the contractual residual maturity in the first quarter of 2014, an increase was registered in the funds with residual maturity of up to one month at the expense of the decline in the assets in the maturity bucket of three months to one year, which was primarily due to the gradual "maturing" of long-term securities held by banks. Changes in the maturity profile of the claims on other domestic and foreign banks also had their influence on this phenomenon. As a result of such structure of assets and liabilities of banks according to the remaining contractual maturities at the end of the first quarter of 2014, only in the maturity bucket from 8 to 30 days, there is a positive difference between banks' assets and liabilities according to their contractual residual maturity (Annex 28).

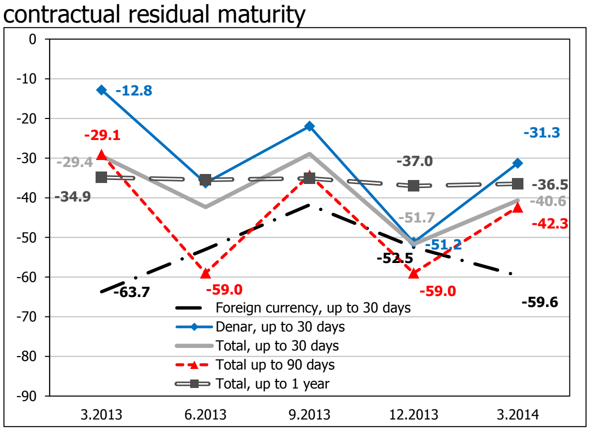
Improved maturity profile of banks' assets and liabilities and hence the satisfactory level of liquidity they have at their disposal, is evident

Chart 29
Assets and liabilities of banks according to the contractual residual maturity - absolute amount (top) and structure (bottom)
in millions of Denars and in percentage



Source: NBRM, based on data submitted by banks.

Chart 30
Cumulative difference between banks' assets and liabilities according to the contractual residual maturity
as percentage of cumulative assets with the same contractual residual maturity



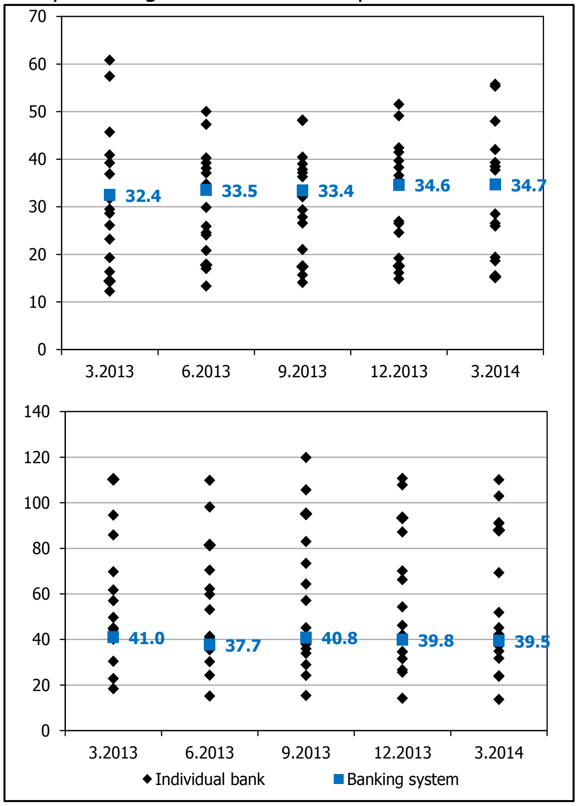
Source: NBRM, based on data submitted by banks.

also from the change in the indicators for the relative importance of the cumulative negative gap between assets and liabilities. The cumulative negative gap between assets and liabilities of banks with residual maturity of up to 30 days, expressed as a percentage of cumulative assets of the same contractual maturity, decreased by 11.1 percentage points in the first quarter of 2014. This positive movement was caused primarily by the quarterly growth of the assets with contractual residual maturity of up to 30 days by Denar 9,124 million, as opposed to the liabilities with same residual contractual maturity that rose by Denar 1,760 million. Generator of these changes is the Denar component of the aggregate difference between assets and liabilities with residual maturity of up to 30 days, where this reduction is far stronger (on a quarterly basis it is almost 20 percentage points). On the other hand, with the cumulative difference between the foreign assets and liabilities with residual maturity of up to 30 days in the first quarter of 2014, the negative gap widened by more than 7.0 percentage points. Also, the relative importance of the cumulative difference between banks' assets and liabilities with residual maturity of up to 90 days significantly improved in the first quarter of 2014.

According to expected maturity, the cumulative difference between assets and liabilities of banks in all maturity segments is positive (Annex 29), which is due to the banks' expectations for stability of deposits as the main source of funding for their activities. Namely, according to the banks' expectations, as of 31 March 2013, 78.8% of deposits with residual maturity of up to three months (83.0% as of 31 December 2013) are stable and should remain in the banks in the next three months.

In the first quarter of 2014, the resilience of the Macedonian banking system to simulated liquidity shocks was satisfactory, due to the relatively high amount of liquid assets that banks have. The largest decrease in the liquid assets of the banking system would be noticed in the simulated withdrawal of deposits of the 20

Chart 31
Results from the simulations for withdrawal of:
- 20% of households' deposits (top) and
- deposits of twenty largest depositors (bottom)
as a percentage of reduction in liquid assets



Source: NBRM, based on data submitted by banks.

largest depositors. Thus, in this simulation, liquid assets would decrease by 39.5%, the share of liquid assets in the total assets of the banking system would be reduced from 31.1%[22] to 21.5%, and the coverage of short-term liabilities[23] would reduce from 54.1% to 41.6%.

Amid simulation for withdrawal of 20% of the household deposits, liquid assets would decrease by 34.7%, their share in total assets would be 22.8% and the coverage of short-term liabilities would decrease by 10.6 percentage points.

Liquid assets are sufficient to cover a more extreme simulation for withdrawal of 50% of the household deposits, when they would decline by 86.6%, and their share in total assets would be 5.7%.

The stable liquidity position of Macedonian banks is confirmed also by the results of the simulation of outflow of the sources of funding used by the foreign parent entities of domestic banks[24], in which case the reduction in the liquid assets of the banking system would be 6.8%, and the share of the liquid assets in total assets would be lower by only 2.6 percentage points.

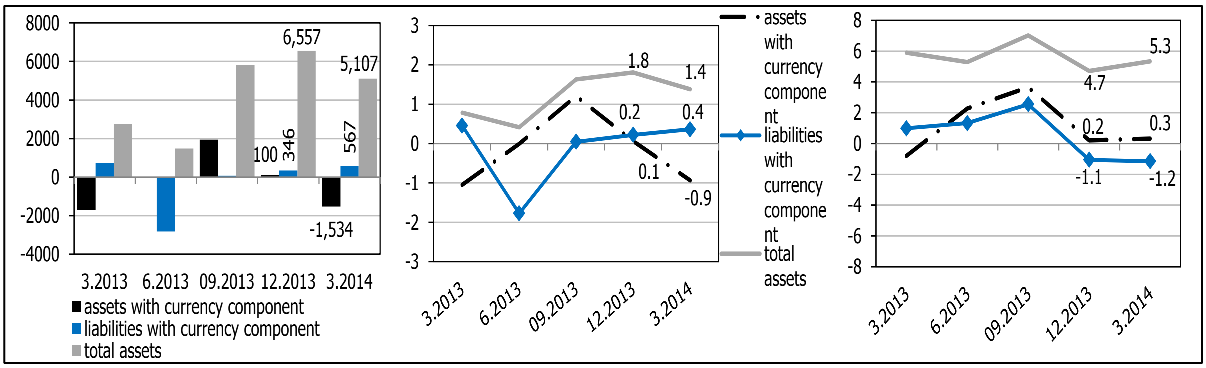
A simulation is made also for full use of certain categories of banks' off-balance sheet liabilities[25] and their conversion into claims, which would cause an appropriate liquidity outflow for banks. Here, the liquid assets of the banking system would be reduced by 19.6%, while the share of liquid assets in total assets and coverage of short-term liabilities with liquid assets would be lower by 6.1 and 10.7 percentage points respectively.

[22] The initial level of all indicators in the presentation of the results of the simulations is without the effect of the Macedonian Bank for Development Promotion AD Skopje, which is excluded from the simulated liquidity shocks due to the legal limit for participation in the deposit market.
[23] The simulations assume that deposits that are flowing out of the banks are of short-term maturity and are included in the short-term liabilities.
[24] Banks' liabilities to parent entities based on subordinated instruments and hybrid capital instruments are excluded from the simulation, because, according to the regulations for determining capital adequacy, the possibility for their early repayment is limited.
[25] This simulation includes off-balance sheet liabilities of banks based on unused limits on credit cards, irrevocable credit limits and unsecured letters of credit.

3. Currency risk

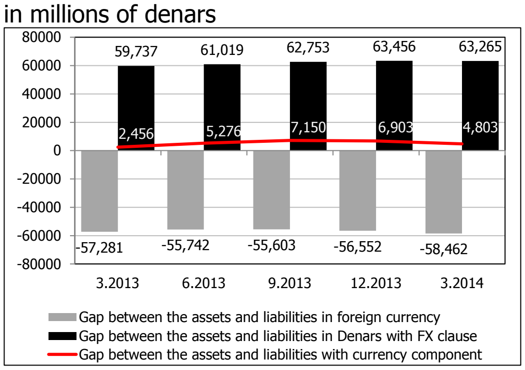
In the first quarter of 2014, banks maintained low exposure to currency risk, which as measured by the share of the gap between assets and liabilities with foreign currency component in the banks' own funds, declined further. Deeuroization continued, which is evident from the further reduction in the share of the currency component in both the assets and the liabilities of the banking system.

Chart 32
Quarterly (left and middle) and annual (right) growth of assets and liabilities with currency component
in millions of Denars and in %



Source: NBRM, based on data submitted by banks.

Chart 33
Structure of the gap between assets and liabilities with currency component
in millions of denars

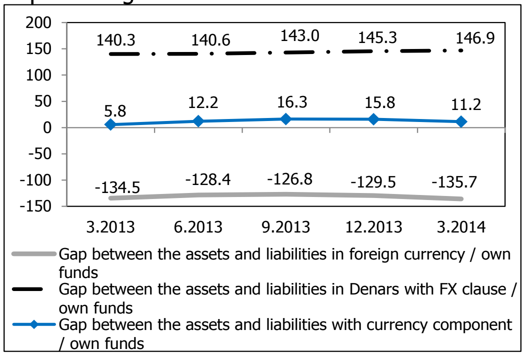


Source: NBRM, based on data submitted by banks.

In the first quarter of 2014, the gap between assets and liabilities with currency component[26] amounted to Denar 4,803 million, and compared to 31 December 2013, it declined by Denar 2,101 million or 30.4%. This reduction mostly stems from the foreign assets, which in this quarter are lower by Denar 1,662 million[27]. Liabilities with currency component increased by Denar 567 million, so their contribution to the reduction of the gap between assets and liabilities with foreign currency component is lower. The composition of assets and liabilities with a currency component is shown in Annexes 30 and 31.

[26] The gap between assets and liabilities with a currency component is the difference between assets and liabilities with a currency component as determined in the regulation for managing currency risk, where the assets with currency component are presented on a net basis, i.e. less the impairment of assets with currency component classified in C, D and E risk categories.
[27] This reduction comes mostly from foreign currency cash (Denar 1,090 million) and current accounts in foreign banks (Denar 1,963 million). On the other hand, banks' deposits in foreign currency increased by Denar 1,805 million.

Chart 34
Share of the gap between assets and liabilities with a currency component in the banks' own funds
in percentages



Source: NBRM, based on data submitted by banks.

By reducing the gap between assets and liabilities with foreign currency component its share in the capital of the banks also lowered (by 4.6 percentage points), which reduced the already low exposure of banks to currency risk.

Table 1
Share of the assets and liabilities with a currency component* in the total assets of banks
in percentages

Item	12.2013	3.2014
Assets in foreign currency	27.0	26.1
Assets in Denars with FX clause	18.7	18.5
Assets with currency component	**45.7**	**44.6**
Liabilities in foreign currency	43.1	42.6
Liabilities in Denars with FX clause	1.1	1.2
Liabilities with currency component	**44.2**	**43.8**

Source: NBRM, based on data submitted by banks.
*In the structure of the assets with a currency component, loans and interest receivables are on a net basis (adjusted for impairment). "MBPR" AD Skopje is not included.

The share of assets and liabilities with currency component in the total assets of the banking system continued to decline.

The euro dominates the structure of assets and liabilities with a currency component, accounting for nearly 90%.

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

Currency	30.3.2013		31.12.2013		31.3.2014	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Euro	88.6	88.1	88.8	88.4	88.8	88.4
US dollar	6.9	7.6	6.8	7.3	6.8	7.2
Swiss franc	2.0	2.0	2.3	2.1	2.1	2.1
Other	2.4	2.3	2.2	2.2	2.4	2.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: NBRM, based on data submitted by banks.

As of 31 March 2014, the aggregate currency position of all banks was within the prescribed limit (30% of own funds).

Table 3
Distribution of banks by share of open foreign currency position and aggregate foreign position in own funds (by currency)

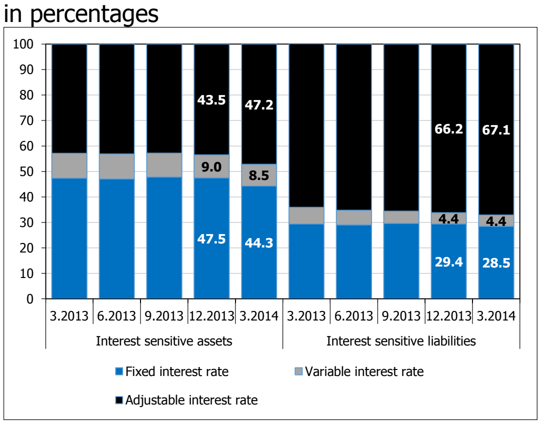
Description	Number of banks								
	Open foreign currency by currency/own funds								Aggregate foreign currency position/own funds
	Euro		US Dollar		Swiss Franc		Other		
	Long	Short	Long	Short	Long	Short	Long	Short	
under 5%	4	3	11	3	10	3	13	1	7
from 5% to 10%		2							1
from 10% to 20%	2	1							4
from 20% to 30%	3								3
over 30%									

Source: NBRM, based on data submitted by banks.

4. Interest rate risk in the banking book

The exposure of the banks in the Republic of Macedonia to interest rate risk in the banking book is small. The reason for the modest role of this risk arises from the practice of banks to apply adjustable interest rates[28] in most of the contracts for loans and deposits (which are the dominant banking products). By avoiding this risk, banks transfer it to the borrowers, turning it into indirect credit risk.

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

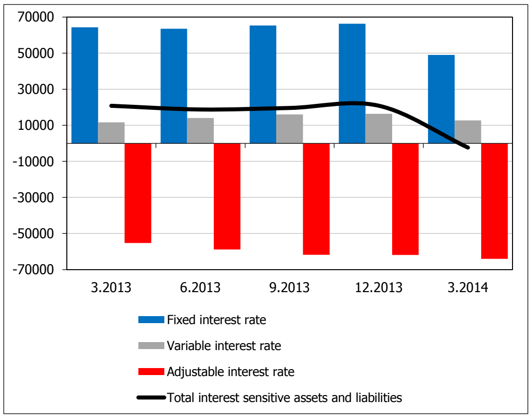


Source: NBRM, based on the data submitted by banks.

In the first quarter of 2014, items with adjustable interest rates, with a share of 47.2%, took over the dominance over the items with fixed interest rates (44.3%) in the structure of interest rate-sensitive assets, primarily due to the increased presence of the adjustable interest rates in loans and the exclusion of the allocated reserve requirement as an interest rate-sensitive item, which was with fixed interest rates[29]. Loans are the most numerous financial instruments in the structure of interest rate-sensitive assets, with 68.2%. Loans with adjustable interest rate have a share of 69.0% in the total loans and cover almost all assets (99.8%) with adjustable interest rates. Despite the decrease, the presence of the items with fixed interest rates remains high (44.3%) and is due to the high presence of these interest rates in the

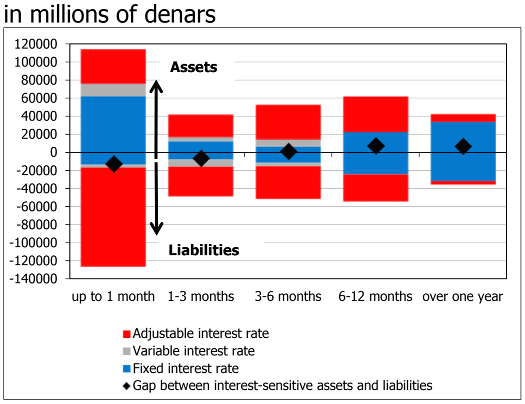
[28] Interest rates are adjusted unilaterally because of the changes in interest rate policy of the bank, rather than due to a particular interest rate or index. The use of adjustable interest rates ensures transfer of the interest rate risk to customers and could serve as an instrument for managing liquidity and profitability.
[29] With the Decision amending the Decision on the reserve requirement ("Official Gazette of the Republic of Macedonia" no. 166/2013) starting from 1 January 2014, the NBRM is exempted from paying reserve requirement remuneration (previously, this remuneration equaled 1% for the Denar reserve requirement and 0.1% for the reserve requirement in Euros).

Chart 36
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.

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.

placements in securities (99.2%) and placements in deposits (95,0%).

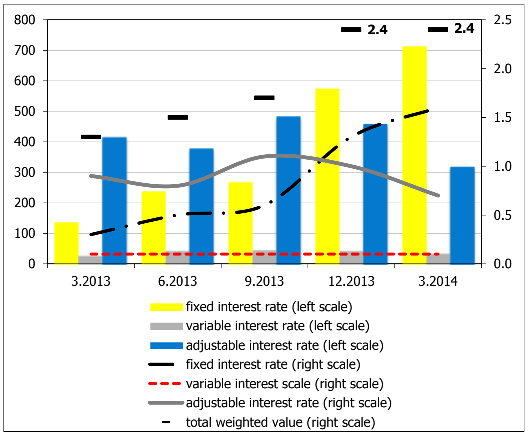
On the other hand, the adjustable interest rates further strengthened their role in the structure of interest rate-sensitive liabilities (67.1%). All sight deposits are with adjustable interest rates (100%) and a significant presence of the adjustable interest rates is registered in also in time deposits (68.2%)[30].

The gap between interest sensitive assets and liabilities is positive in the positions with fixed and variable interest rate[31], and negative in the positions with adjustable interest rate[32]. In the first quarter of 2014, the gap expanded only with the adjustable interest rates, generally because of the faster increase in the liabilities on demand and time deposits relative to the claims on loans with adjustable interest rates. However, this expansion does not imply greater exposure of the banking system to interest rate risk because of the nature of this kind of interest rates, i.e. the possibility for banks to change interest rates in accordance with their needs. Due to the exclusion of the reserve requirement from the interest sensitive assets with fixed interest rates and the decline in the assets on demand with variable interest rates, the gap between interest sensitive assets and liabilities with fixed and floating rates narrowed.

In the first quarter of 2014, the adjustable interest rates play the leading role in most maturity buckets of interest sensitive assets and liabilities, with the most pronounced share being that of the interest sensitive liabilities with lower maturities, due to the demand deposits. Banks' expectations for the period until the next "adjustment" of the level of interest rates, represented by the maturity structure of the positions with adjustable interest rates, are from

[30] Sight deposits and time deposits with adjustable interest rate account for 5.4% and 61.3%, respectively, in the total interest rate-sensitive liabilities with adjustable interest rates.
[31] The positive gap of fixed interest rate positions arises from the fact that this type of interest rate prevails in securities and banks' investments in deposits. The positive gap of positions with variable rate is a result of sight deposits which are mostly with variable interest rates.
[32] The negative gap in the positions with adjustable interest rates stems from the fact that significant portion of time deposits and almost all sight liabilities have adjustable interest rates.

Chart 38
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.

six to twelve months for assets with adjustable interest rates and up to one month for liabilities with adjustable interest rates.

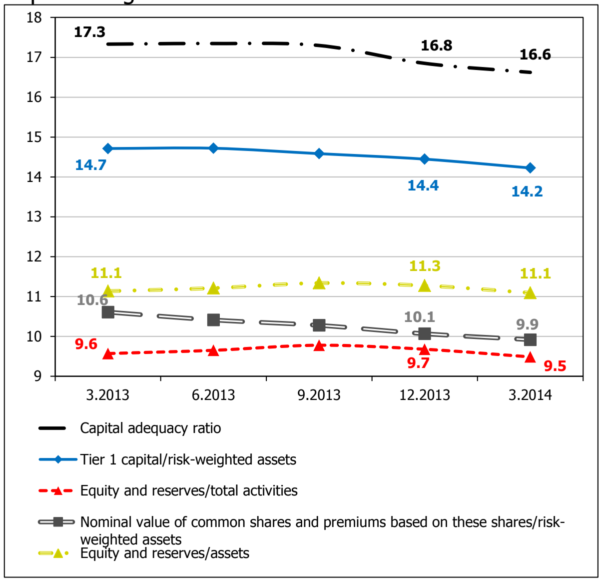
The moderate presence of the risk of changing interest rates in the banking book of the banks in the Republic of Macedonia is confirmed by the share of the total weighted value of the banking book[33] in their own funds, which in the first quarter of 2014 remained relatively low (2.4%). Analyzing by banks, the ratio between the total weighted value of the banking book and own funds ranges from 0.1% to 10.4% with a median of 2.4% and a third quartile of 4.4%, with the highest ratio being registered in one bank that does not apply adjustable interest rates.

5. Insolvency risk

In the first quarter of 2014, the solvency of the banking system remained high, despite the minimal reduction of the indicators for solvency and capitalization of the banking system. The amount of own funds of the banking system is smaller due to the loss recognized in some banks in the first three months of 2014, but also due to the proper application of the accounting rules in determining the solvency position of two banks on a consolidated basis[34]. The regulatory capital required to cover the risks of the banking system declined, which is entirely due to the decline in the capital requirements for currency risk. Capital requirements for credit risk increased (albeit modestly) that mostly stems from the increased claims on other companies and claims covered by residential buildings. However, the slower growth of the risk-weighted assets, compared with the growth of total assets, suggests that banks are still cautious when taking risks. The results of the stress test conducted on 31 March 2014 are somewhat worse than at the end of 2013, but the banking system retained the resilience to hypothetical shocks.

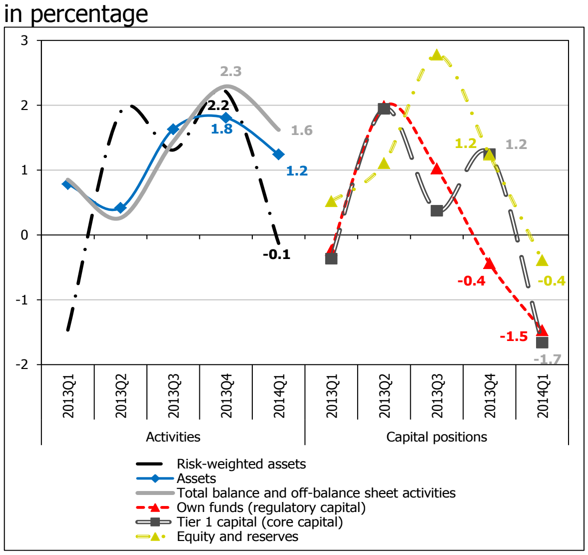
[33] The total weighted value of the banking book shows the change of the economic value of this portfolio as a result of the assessment of the change in the interest rates by using a standard interest rate shock (parallel positive or negative change in interest rates by 200 basis points). The total 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%.
[34] In this section of the Report, the two banks from the group of small banks, Eurostandard Banka AD Skopje and Post Bank AD Skopje, are treated as a single entity, i.e. in the presented data and analyzes, as of 31 March 2014, these two banks are included on consolidated basis. Namely, after Eurostandard Banka AD Skopje acquired 100% stake in Post Bank AD Skopje (in January, 2014), the appropriate authorities of the two banks adopted Decisions on initiating a procedure for status change (in February and March, 2014) - acquisition of Post Bank AD Skopje to Eurostandard Banka, which ended on 30 June 2014.

Chart 39
Solvency ratios
in percentage



Source: NBRM, based on data submitted by banks.

Chart 40
Quarterly growth of solvency ratios components
in percentage



Source: NBRM, based on data submitted by banks.

5.1 Indicators for the solvency and capitalization of the banking system

In the first quarter of 2014, all analyzed indicators of solvency and capitalization of the banking system declined by 0.2 percentage points. This stems from the quarterly decline in the capital positions of the banking system amid simultaneous increase in its activities (excluding risk weighted assets which recorded minimum quarterly decline of 0.1%). Quarterly changes in the individual components of the indicators of solvency of the banking system are largely determined by the conducted capital investment of one bank into another (from the group of small banks) and the determination of the solvency position of the two banks on a consolidated basis.

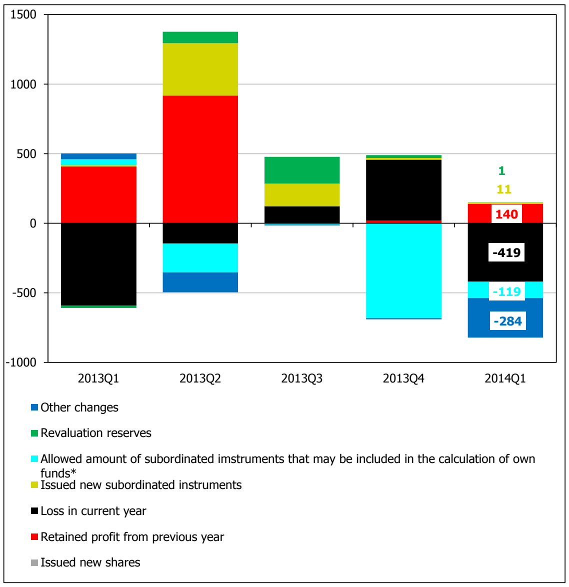
In the first quarter of 2014, the growth rates in all components of the solvency indicators noted downward movement, and the quarterly change in capital positions entered into negative zone. Risk weighted assets recorded minimal adverse change, which in conditions of growth (though slower) of the total balance sheet and off-balance sheet activities suggests further caution of banks in taking risks.

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

In the first quarter of 2014, the own funds of the banking system declined by Denar 671 million, or 1.5%. Amid complete absence of new issues of shares, modest amount of reinvested earnings[35] and relatively small amount of new subordinated instruments issued (total Denar 11 million, with one bank from the group of small banks), the current loss for the first three months of 2014 (in banks who realized loss) had the highest contribution to the quarterly decline of own funds of the banking system. On the other hand, more than half of the quarterly reduction in own funds of the banking system stemmed

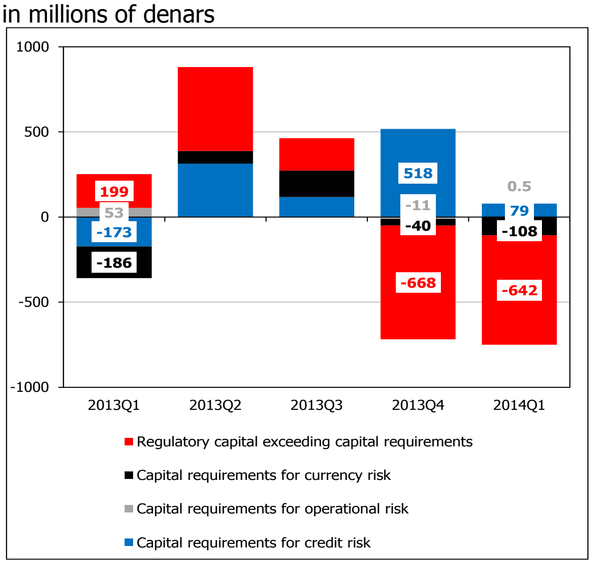
[35] At the end of 2013, 13 banks showed a profit from operations in the amount of Denar 2,486 million. As of 31 March 2014, only three banks reinvested the profits earned in 2013 in own funds, totaling Denar 140 million. In the coming months of 2014, reinvestment of part of the profit from 2013 by other banks can be expected.

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



Source: NBRM, based on data submitted by banks.
Note: *Refers to the change in the amount of already issued subordinated instruments arising from fulfilling (or failure to fulfill) of the regulatory rules for inclusion of these instruments in the calculation of own funds.

Chart 42
Structure of quarterly growth of own funds, by the purpose for covering risks
in millions of denars



Source: NBRM, based on data submitted by banks.

from the equity investment performed by one bank into another and determining the own funds of the two banks on a consolidated basis.

The structure of the own funds of the banking system remained unchanged in the first quarter of 2014, with a share of the core capital (before deductions from core capital and supplementary capital) of 85.5% in the total own funds. It could be expected that in the coming months of 2014, a larger number of banks will also reinvest their profits earned during 2013, making positive effect on the amount and quality of own funds of the banking system.

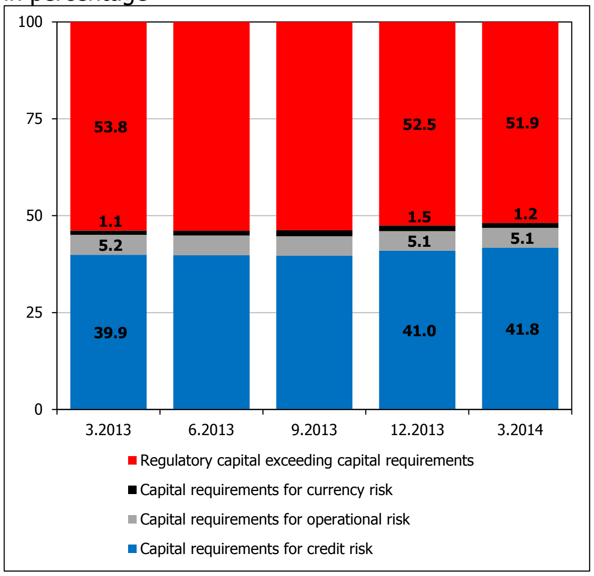
More details about the level of own funds of individual groups of banks are presented in Annex 33.

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

Most of the quarterly reduction of own funds was covered by "free" capital of the banking system. However, the regulatory capital required to cover the risks of the banking system (or capital requirements)[36] dropped, although minimally, by 0.1% (or by Denar 28 million). Reduction of the capital requirements for covering risks is entirely due to the lower amount of regulatory capital required to cover currency risk (by Denar 108 million or 16.2%), which was most evident with three banks[37]. At the same time, capital requirements for credit risk increased by 0.4% (or by Denar 79 million), mostly as a result of the growth of claims on other companies and claims covered by

[36] Capital requirements are determined at the level of 8% of risk weighted assets.
[37] The reasons are different for the three banks. So as of 31 March 2014, one of the banks met the requirement according to which it is not required to determine and dispose of capital requirement for currency risk (as opposed to 31 December 2013, when it was obliged to determine and dispose of the capital), with another bank the quarterly growth of liabilities in foreign currency exceeded the growth in assets and also there was a reduction of the open currency position in off-balance sheet items, and in a third bank the quarterly decline in bank assets in foreign currency is greater than the fall of liabilities.

Chart 43
Structure of own funds according to usage for covering risks
in percentage



Source: NBRM, based on data submitted by banks.

residential buildings. Despite the quarterly decline in the part of the own funds that exceeds the minimum level necessary to cover the risks, "excess capital" still dominates the structure of total own funds, with 51.9%.

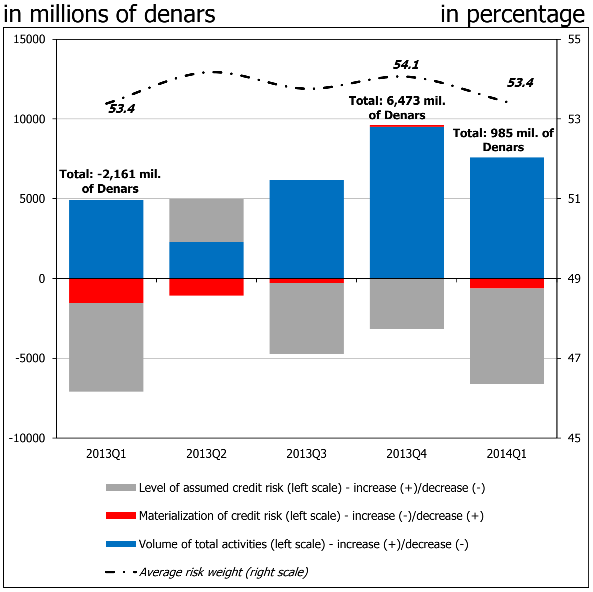
Table 4
Capital requirements for credit risk, by categories of exposure
in millions of denars, unless stated otherwise

Capital requirements for credit risk arising from certain categories of exposure:	31.3.2013	31.12.2013	31.3.2014	Changes			
				Quarterly (31.12.2013-31.3.2014)		Annual (31.3.2013-31.3.2014)	
				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%
Claims on local self-government and regional government	37	45	48	3	6.3%	11	30.0%
Claims on public institutions	105	152	130	-22	-14.3%	25	23.9%
Claims on multilateral development banks and international organizations	0	0	0	0	0.0%	0	0.0%
Claims on banks	1,011	1,124	1,102	-22	-1.9%	91	9.0%
Claims on other companies	7,404	7,824	7,924	100	1.3%	521	7.0%
Retail credit portfolio	5,103	5,745	5,761	15	0.3%	658	12.9%
Claims secured by residential property	420	365	426	61	16.6%	6	1.4%
Claims secured by commercial real estate	2,090	1,898	1,892	-6	-0.3%	-197	-9.4%
Holdings in investment funds	0.73	0.79	0.80	0.01	1.8%	0.1	9.0%
Other positions	1,540	1,504	1,453	-51	-3.4%	-87	-5.7%
Total capital requirements for credit risk:	***17,710***	***18,658***	***18,737***	***79***	***0.4%***	***1,027***	***5.8%***

Source: NBRM, based on data submitted by banks.

The quarterly growth rate of credit risk weighted assets (0.4%) is several times smaller than the growth of assets (1.2%) and total balance sheet and off-balance sheet activities (1.6%) of banks. At the same time, the average risk weight of the total balance sheet and off-balance sheet exposure of the banking system, measured as the ratio between credit risk weighted assets and total balance sheet and off-

Chart 44
Structure of the quarterly growth in credit risk weighted assets and average risk weight
in millions of denars in percentage



Source: NBRM, based on data submitted by banks.
Note: The change in the total volume of activity is measured by the change in the gross amount of 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 on-balance and off-balance sheet exposure of banks

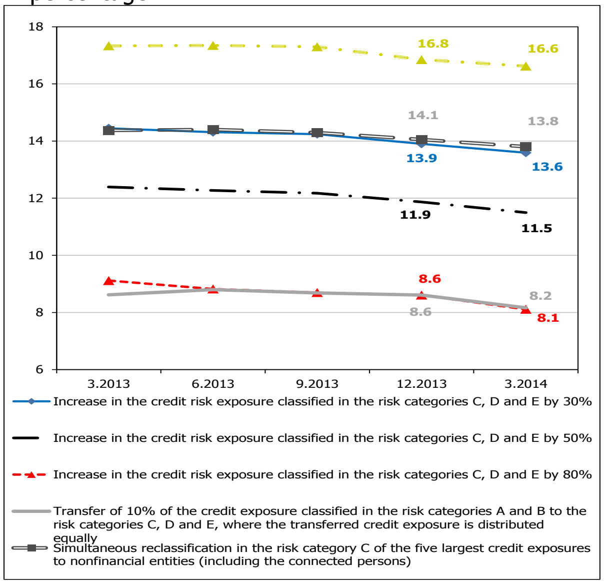
balance sheet exposures, registered a decrease of 0.7 percentage points, indicating that banks are still cautious in taking risks.

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

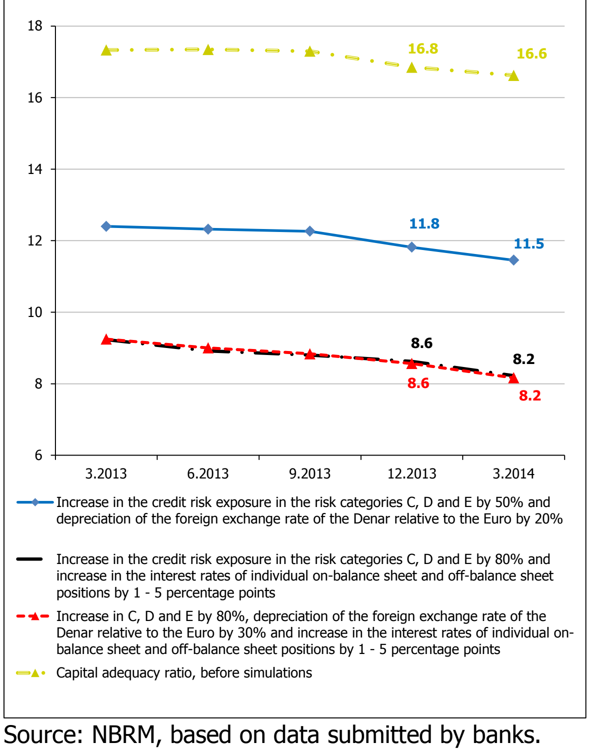
Conducted testing of the resilience of the banking system and of individual banks in the Republic of Macedonia to simulated shocks indicates slightly weaker results compared with the end of 2013. They are partly due to the quarterly reduction of the capital adequacy of the banking system, but also arise from the somewhat more emphasized sensitivity of individual banks to assumed shocks, compared with the end of 2013. Capital adequacy of the banking system does not go below 8% in any of

Chart 45
Capital adequacy ratio of the banking system, prior to and after the simulations of credit shocks
in percentage



Source: NBRM, based on data submitted by banks.

Figure 46
Capital adequacy ratio at the level of the banking system, before and after simulations of combined shocks
in percentage



Source: NBRM, based on data submitted by banks.

the simulations, although individual banks reveal hypothetical need for recapitalization in the event of possible materialization of the simulated extreme shocks.

The hypothetical shocks on the part of the credit risk have the greatest impact on the stability of the banking system. In the most extreme simulations presented in this report (increased credit exposure in risk categories "C", "D" and "E" by 80% and migration of 10% of the credit exposure classified in each of the risk categories "A" and "B" to higher risk categories), the capital adequacy of the banking system is reduced to a level (of 8.1% and 8.2% respectively), which is close to the statutory minimum of 8%. The simulations show that the reduction of the capital adequacy of the banking system to the statutory minimum level of 8% requires an increase of 81.3% (85.2% as of 13 December 2013) of the credit exposure with a higher risk level, i.e. migration of 10.2% (10.6% as of 13 December 2013) of the credit exposure classified in each of the risk categories "A" and "B" to higher risk categories (these simulations would lead to a doubling of the share of non-performing loans in total loans, from the current 10.6% to 20.8%).

Isolated shocks on the side of currency risk and interest rate risk have no significant impact on the level of capital adequacy. However, their materialization would cause shocks on the part of the credit risk, whose impact on the capital adequacy of the banking system was already presented above.

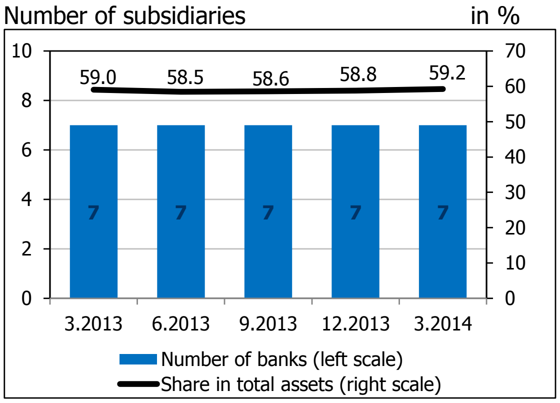
Part 2 Structural features, significant balance sheet changes and efficiency and profitability of the banking system

II. Structure of the banking system

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

As of 31 March 2014, the banking system in the Republic of Macedonia consisted of sixteen banks and relative to 31 December 2013, this situation remained unchanged. In July 2014, as a result of the completion of the procedure for acquisition of one domestic bank by another, the number of banks reduced to fifteen.

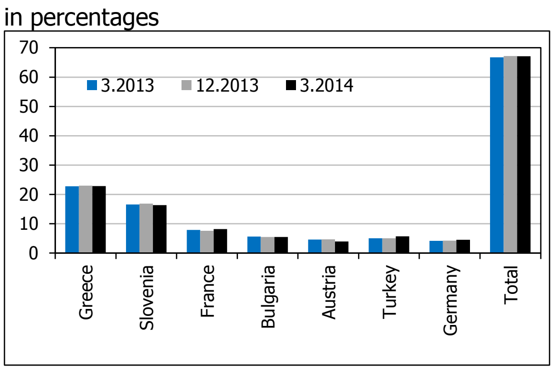
Chart 47
Foreign bank subsidiaries, number and share in total assets



Source: NBRM, based on data submitted by banks.

Eleven banks are predominantly owned by foreign shareholders, and seven of them are foreign bank subsidiaries. Compared with the previous quarter, this situation remained unchanged. The share of subsidiaries of foreign banks in the total assets of the banking system increased by 0.4 percentage points[38] .

Chart 48
Market share (assets) of banks by country of origin of the dominant foreign shareholder*

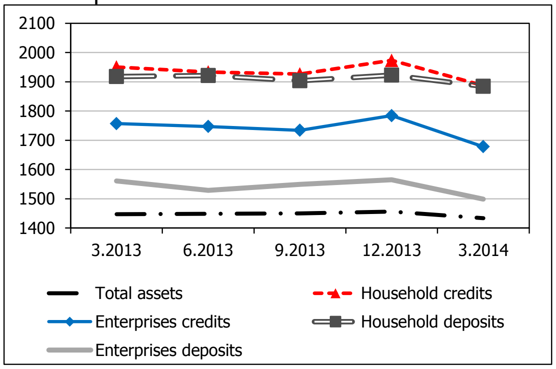


Source: NBRM, based on data submitted by banks.
*Banks in domestic ownership and banks without major owner are not included in the figure.

Predominantly foreign owned banks retained the lead role in the major balance sheet positions of the banking system. Their market share (by asset size) increased by 0.4 percentage points and at the end of the first quarter it was 68.7%. The individual market share of these banks ranges from 0.5% to 21.2%. The market share of banks predominantly owned by shareholders from the European Union accounted for 59.7%.

[38] Four subsidiaries of foreign banks increased their activities in the first quarter of 2014 and fully participated in the growth of total assets of the banking system.

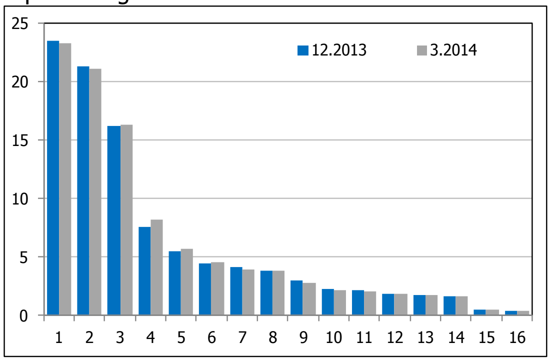
Chart 49
Herfindahl index
in index points



Source: NBRM, based on data submitted by banks.

Concentration in the banking system in the first quarter of 2014 decreased, but remains high. The level of concentration above the acceptable level according to the Herfindahl index[39] is typical for household loans and deposits, but the value of the indicator is constantly decreasing.

Chart 50
Share of individual banks in the total assets of the banking system
in percentages



Source: NBRM, based on data submitted by banks.

The share of individual banks in total bank assets also indicates a concentration in the banking system. Ten out of sixteen banks, banks have an individual share below 4%, and these banks account for 20.8% of the total assets of the banking system.

2. Banks' activities

In the first quarter of 2014, total assets of the banking system grew at a slower pace, while annually their growth accelerated, as observed primarily in lending. Thus, compared with December and March 2013, the annual growth rate of loans increased by 1.2 and 2.4 percentage points, respectively, and reached 7.6%. Moreover, in the period from March to May 2014, lending to non-financial entities intensified, indicating a gradual improvement in the perceptions of domestic banks regarding the risk profile of the credit demand.

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[39] 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 is 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 to be acceptable.

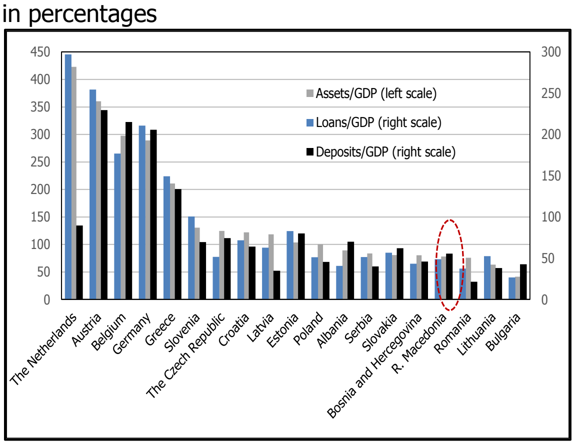
In addition, banks have increased their investments in instruments issued by the government, which despite being low-risk, also represent an appropriate instrument for liquidity management. Denarization continued, in both loans and deposits. Generators of the growth of deposit activity were Denar long-term deposits of the household sector.

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

Balance sheet	Amount in millions of Denars			Structure (in percent)			Change 3.2014/12.2013		Change 3.2014/3.2013	
	31.3.2013	31.12.2013	31.3.2014	31.3.2013	31.12.2013	31.3.2014	In millions of Denars	In percent	In millions of Denars	In percent
Cash and balances with NBRM	44,104	38,783	38,719	11.9	10.5	10.3	-64	-0.2	-5,384	-12.2
Securities portfolio	57,899	63,767	67,724	16.3	17.3	18.1	3,957	6.2	9,825	17.0
Placements with banks and other financial institutions	43,473	44,442	43,500	12.2	12.0	11.6	-942	-2.1	27	0.1
Loans of nonfinancial entities (net)	190,533	201,835	205,064	53.6	54.6	54.7	3,228	1.6	14,530	7.6
Gross loans of nonfinancial entities	217,407	230,132	233,994	61.1	62.3	62.5	3,863	1.7	16,587	7.6
Accumulated amortization of loans of nonfinancial entities	-957	-935	-919	0.0	0.0	0.0	16	-1.7	38	-4.0
Impairment (provisions) of loans to nonfinancial entities	-25,917	-27,362	-28,012	0.0	0.0	0.0	650	-2.4	2,095	-8.1
Accrued interest and other assets	9,802	9,209	8,076	2.8	2.5	2.2	-1,133	-12.3	-1,725	-17.6
Fixed assets	9,841	11,469	11,529	2.8	3.1	3.1	60	0.5	1,688	17.2
Unallocated loan loss provisions	0	0	0	0.0	0.0	0.0	0	0.0	0	0.0
Total assets	**355,652**	**369,505**	**374,612**	**100.0**	**100.0**	**100.0**	**5,107**	**1.4**	**18,961**	**5.3**
Deposits from banks and other financial institutions	17,669	17,143	15,547	5.0	4.6	4.2	-1,596	-9.3	-2,122	-12.0
Deposits from nonfinancial entities	248,328	259,299	265,704	69.8	70.2	70.9	6,405	2.5	17,377	7.0
Borrowings (short-term and long-term)	34,812	34,910	34,998	9.8	9.4	9.3	87	0.2	186	0.5
Liability component of hybrid and subordinated instruments	7,739	7,991	7,970	2.2	2.2	2.1	-20	-0.3	232	3.0
Other liabilities	6,582	7,591	7,434	1.9	2.1	2.0	-158	-2.1	852	12.9
Provisions for off-balance sheet items	924	913	958	0.3	0.2	0.3	45	4.9	34	3.7
Capital and reserves	39,598	41,657	42,001	11.1	11.3	11.2	344	0.8	2,403	6.1
Total liabilities	**355,652**	**369,505**	**374,612**	**100.0**	**100.0**	**100.0**	**5,107**	**1.4**	**18,961**	**5.3**

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.

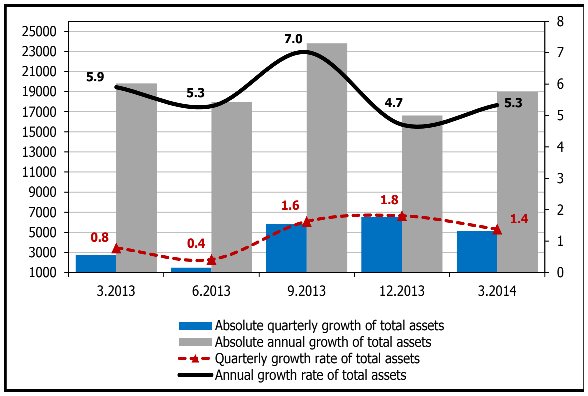
Chart 51
Level of financial intermediation, by country
in percentages



Source: NBRM, based on the data submitted by banks.
Note: Data for the Republic of Macedonia are as of 31 March 2014, while for the other analyzed countries as of 31 December 2013.

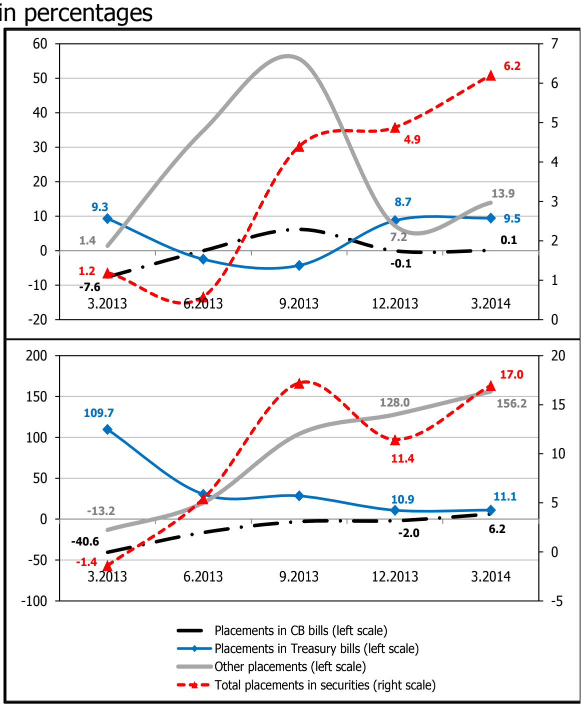
As of 31 March 2014, the financial intermediation of the domestic banking system, measured by the ratios of assets, loans and deposits to GDP, was 78.2%, 48.8% and 55.5%, respectively (as compared to the first quarter of 2013 it is an increase of 0.5, 1.3 and 1.2 percentage points, respectively). The level of financial intermediation in the country is still lower than in most of the analyzed EU member states, but it is at a similar level compared to some of the new EU member states, as well as countries in the region (regarding the ratio of deposits and loans to GDP).

Chart 52
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 53
Quarterly (top) and annual (bottom) growth rate of securities
in percentages



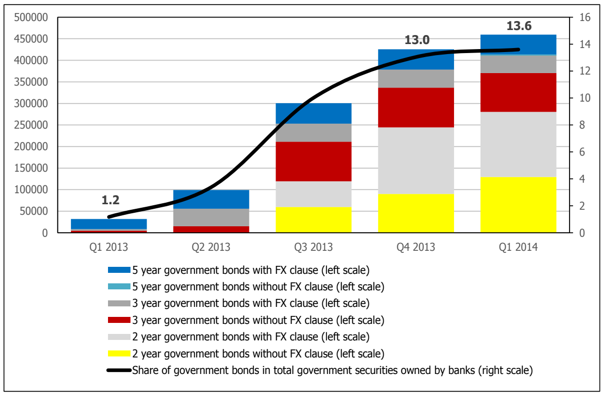
Source: NBRM, based on the data submitted by banks. Most of the other investments (80.4%) are investments in government bonds).

As of 31 March 2014, the total assets of the banking system amounted to Denar 374,612 million. In the first quarter of 2014, they grew at a slower pace compared with the growth in the previous quarter (Q4 2013), as opposed to the annual growth, which has accelerated. In conditions of slower quarterly growth of the credit activity[40], the growth of deposits[41] of non-financial entities, as a category that determines the movement of assets, reflected in the growth of banks' investments in liquid securities.

In the first quarter of 2014, the growth of investments in government securities was a driving force of growth of the banks' overall securities portfolio. Compared with the end of 2013, banks increased their investments in government securities by Denar 3,694 million, or 10.0%, with 80.0% of this growth being due to investments in short-term treasury bills, and the rest to investments in government bonds. Most (or 61.0%) of the investments in government bonds are in the two-year government bonds in Denars and in Denars with foreign currency clause. Banks' placements in CB bills on a quarterly basis were almost unchanged. These developments contributed to a further increase in the share of government securities in the banks' securities portfolio at the expense of the reduced share of CB bills.

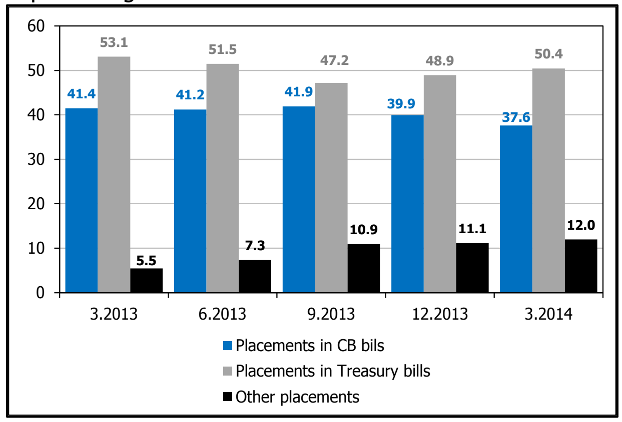
[40] For more details, see section 2.1. Loans to nonfinancial entities
[41] For more details, see section 2.2. Deposits of non-financial entities.

Chart 54
Banks' investments in government bonds (nominal value), by currency and maturity
in thousands of denars and in %



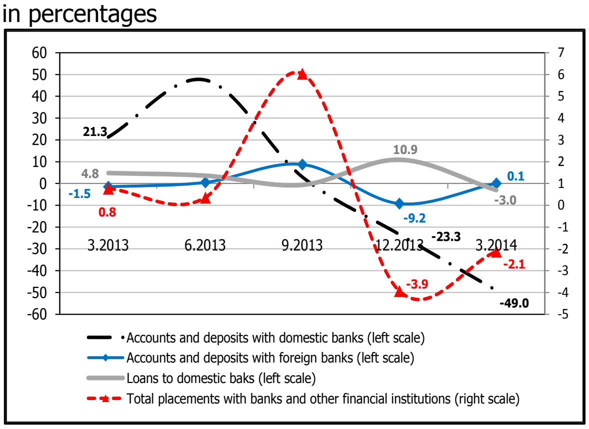
Source: NBRM, based on the data submitted by banks.

Chart 55
Structure of the securities portfolio
in percentages



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

Chart 56
Placements with banks and other financial institutions (quarterly change)
in percentages



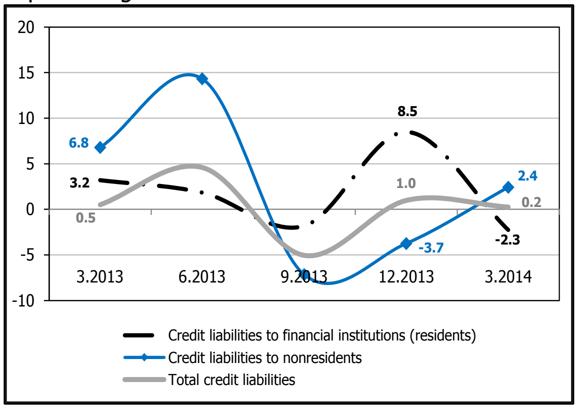
Source: NBRM, based on the data submitted by banks.

Placements with banks and other financial institutions account for 11.6% of the total assets of banks and decreased in the first quarter of 2014. This change stems from the reduction in short-term deposits in domestic banks[42] in Denars and in foreign currency and the reduction of long-term loans to domestic banks (by "MBPR" AD Skopje[43]) in foreign currency. On the liabilities side, this was reflected in the reduction of long-term loans in foreign currency to domestic banks (to MBPR).

[42] Assets in domestic banks declined by Denar 448 million and determined 47.6% of the reduction in the placements with banks and other financial institutions. This decrease stems from the decline of short-term time deposits in foreign currency (by about Denar 241 million) in one large and one small bank, and the reduction of short-term time deposits with domestic banks in Denars in one small bank (by Denar 130 million).

[43] Loans to domestic banks declined by Denar 399 million (and determined 42.4% of the decrease in placements with banks and other financial institutions), entirely due to the reduction of long-term loans in foreign currency of "MBPR" AD Skopje to other domestic banks due to the regular repayment of due liabilities based on the used credit line from EIB.

Chart 57
Credit liabilities, quarterly growth
in percentages

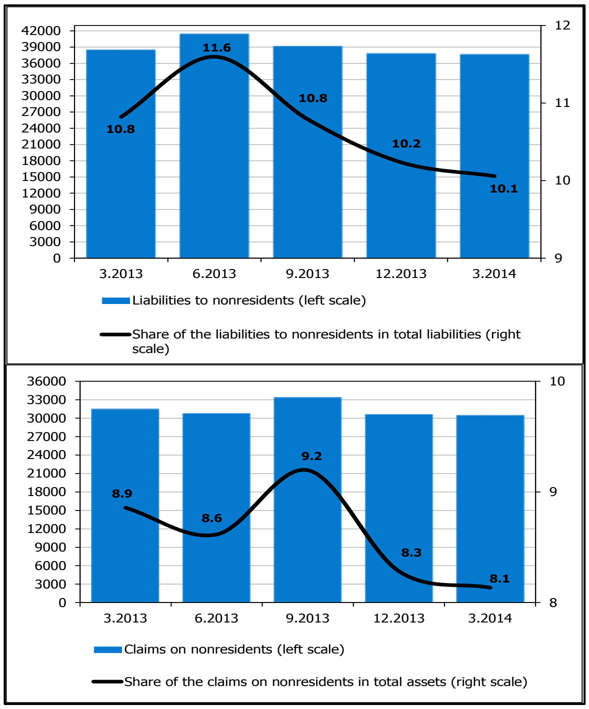


Source: NBRM, based on the data submitted by banks.

However, the total liabilities on the basis of loans registered a small increase of 0.2%, primarily due to increased liabilities based on long-term loans in foreign currency to non-residents in one medium-sized bank.

Deposits from banks and other financial institutions have declined, mostly because of the withdrawal of short-term deposits by the parent entity of a medium-sized bank and to a lesser extent due to the lower short-term deposits of domestic banks.

Chart 58
Liabilities to (top) and claims on (bottom) nonresidents
in millions of denars and in %



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

Macedonian banks perform most of their activities in the domestic market. The share[44] of banks' liabilities to and claims on nonresidents in total assets is not high, and usually moves around 10.0%. In the first quarter of 2014, these shares further reduced[45].

[44] Analyzed by individual banks (with the exception of "MBPR" AD), the share of banks 'claims on non-residents in total assets ranges from 1.6% to 18.7%, while the share of banks' liabilities to non-residents in the total liabilities ranges from 0.3% to 32.9%.

[45] Banks' claims on non-residents fell by Denar 133 million, or 0.4%. In their framework, more significant changes are noted in regular current accounts with foreign banks (reduction by Denar 1,945 million) and in term deposits abroad (increase of Denar 2,044 million). Other changes are minor but contribute to the reduction of claims on non-residents. Liabilities to non-residents decreased by Denar 146 million, fully as a result of the above mentioned withdrawal of deposits by the parent entity of one medium-size bank.

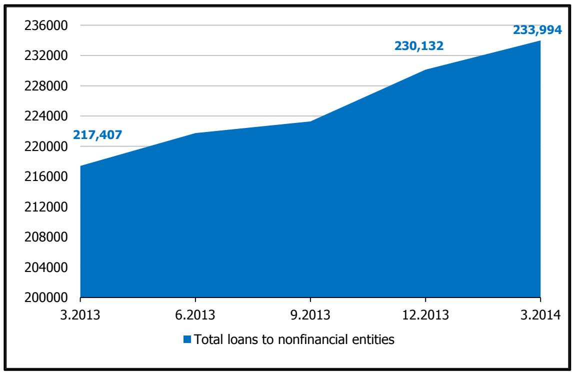
2.1 Loans to nonfinancial entities[46]

In the first quarter of 2014, loans to non-financial entities continued their growth on both quarterly and annual basis, albeit with different dynamics. Loans to nonfinancial entities[47] increased quarterly by Denar 3,863 million, at a rate which is by 1.4 percentage points lower compared to the growth rate in the previous quarter (Q4 2013). The slowdown of credit activity was most pronounced in the corporate sector, and to a lesser extent it was present also with the loans to households. However, observed on a monthly basis, the slowdown in credit growth was registered only in the first two months of the quarter, while in March, lending accelerated, particularly in the corporate sector. This trend of faster monthly growth in lending remained also in May 2014.

Moreover, the annual growth rate of loans as of 31 March 2014 was higher than the annual rate of growth at the end of the last quarter of 2013. This movement represents the more favorable expectations of banks about the risks, but it is also an effect of the current monetary loosening on banks' lending. The macroprudential measure of the National Bank in the regulation governing the liquidity risk management, from the end of 2013, encourages the increase of the credit support to the real sector[48].

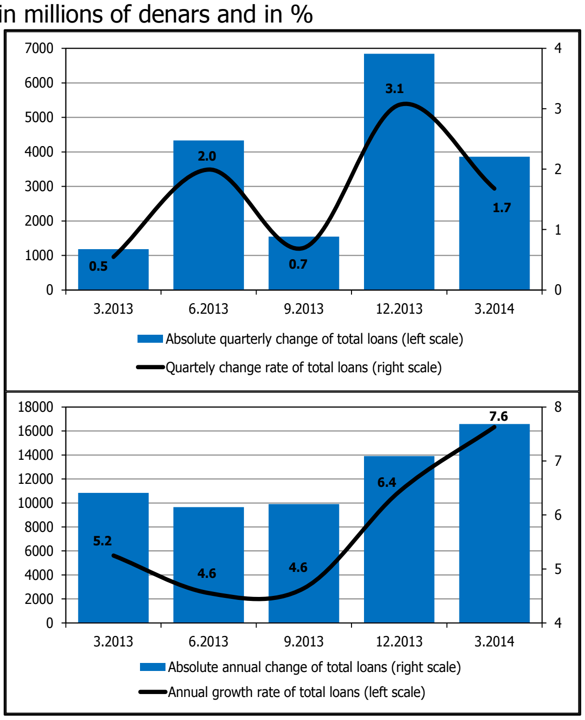
In the first quarter of 2014, contributions of the household sector (49.7%) and corporate sector (50.6%) to the total growth in lending activity are almost equal. Lending to companies registered quarterly growth of Denar 1,953 million (or 1.4%), which was mostly a result of the activity "industry" (Annex 15). Quarterly growth of loans to households amounted to

Chart 59
Loans
in millions of denars



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

Chart 60
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.

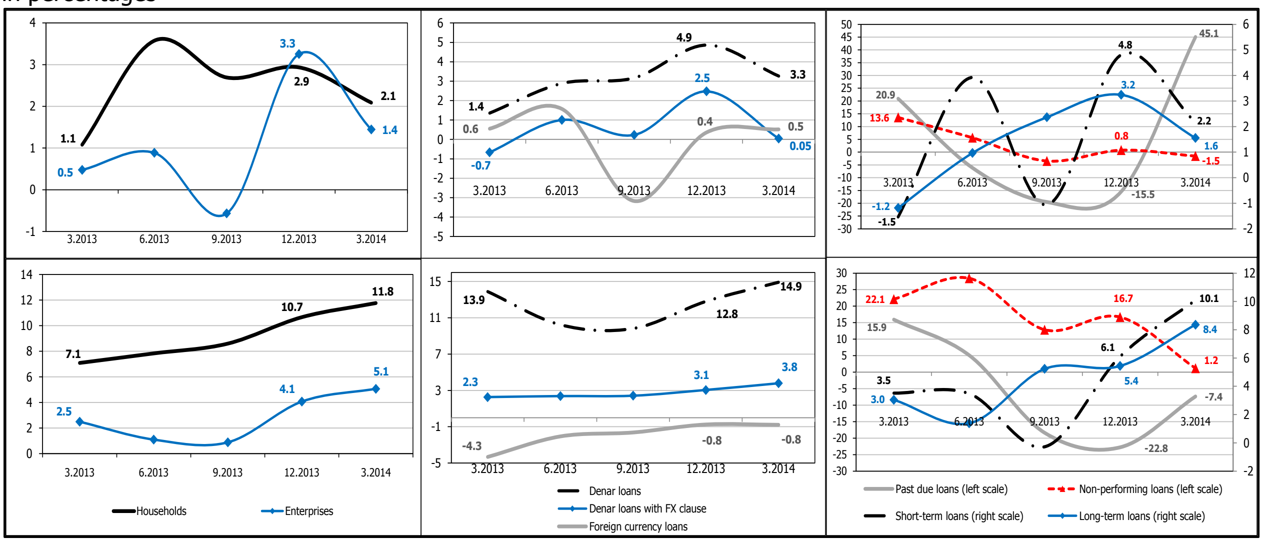
[46] Loans to non-financial entities include the loans to resident and non-resident non-financial entities, including loans to private and public nonfinancial companies (corporate loans), central government, local government, non-profit institutions serving households (loans to other clients), sole proprietors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

[47] Analyzed by individual bank, thirteen banks reported a quarterly increase of loans to non-financial entities (ranging from 0.9% to 31.8%), while other banks reported a quarterly reduction of loans (ranging from 0.9% to 2.6%).

[48] According to the amendments to the Decision on liquidity risk management, which have been applied since December 2013, in the calculation of the liquidity ratio up to 30 days and up 180 days, the percentage of term deposits which are assumed to flow out of the banks and which should be covered with liquid assets, reduced (from 80% to 60%).

Denar 1,920 million (or 2.1%), with the most popular loan products still being consumer loans and loans for the purchase and renovation of residential and commercial properties (Annex 15).

Chart 61
Quarterly (top) and annual (bottom) growth of loans by sector, currency and maturity
in percentages

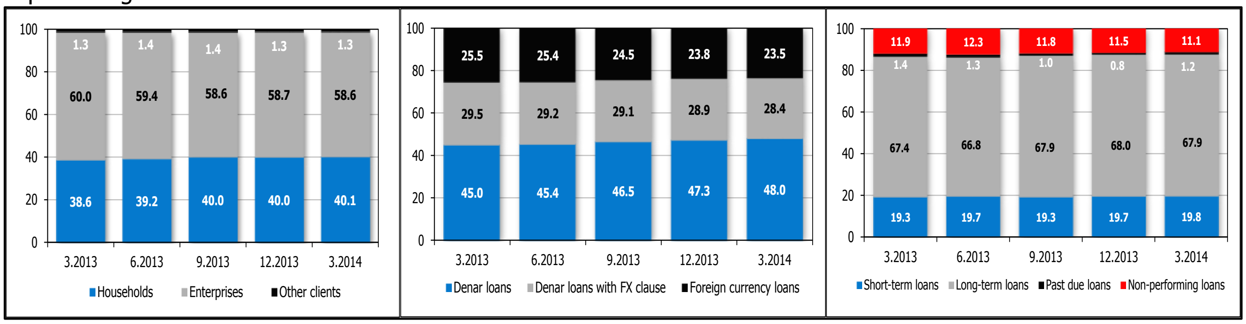


Source: NBRM, based on the data submitted by banks.

Denar loans[49] registered the fastest quarterly growth (of Denar 3,549 million or 3.3%) and gave the largest contribution (91.9%) to the growth of lending in the first quarter of 2014. Denarization of loans mirrors the same process as with deposits, which are the main source of funding of the banks' activities. Additional confirmation of denarization is the slower growth of loans in Denars with foreign exchange clause, which resulted from the reduction of these loans with the corporate sector. Foreign currency loans registered modest growth of Denar 284 million, which is solely due to loans to enterprises (Annexes 5 and 6).

[49] The corporate sector had higher contribution (67.7%) in the growth of Denar loans compared to the household sector (32.0%).

Chart 62
Structure of loans by sector, currency and maturity
in percentages



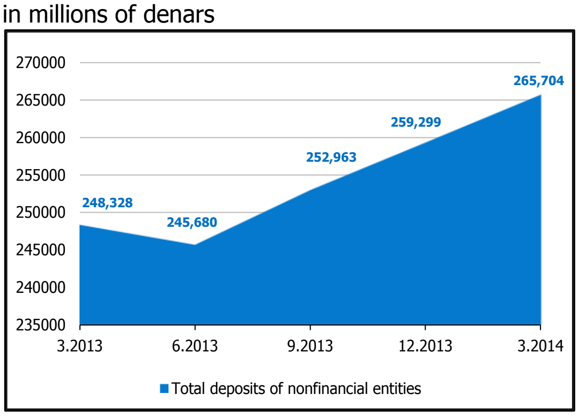
Source: NBRM, based on the data submitted by banks.

Long-term loans are most common in the structure of loans to non-financial entities, and in the first quarter of 2014 they had the largest contribution (62.9%) to the growth of total loans. The quarterly growth of long-term loans amounted to Denar 2,429 million (or 1.6%) and mostly (60.3%) comes from the household sector.

Non-performing[50] loans recorded quarterly decrease of Denar 407 million (or 1.5%).

2.2 Deposits of nonfinancial entities

Chart 63
Deposits
in millions of denars



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

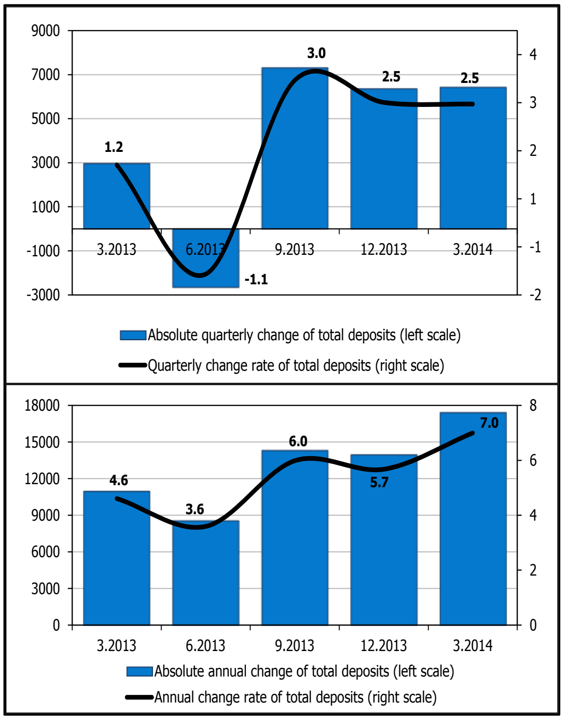
In the first quarter of 2014, deposits of nonfinancial entities registered a quarterly growth of Denar 6,405 million, while their growth rate of 2.5%[51] remained unchanged compared to the previous quarter. On annual basis, deposit activity grew at an accelerated pace (the annual growth rate is higher by 1.3 percentage points compared to December 2013). The accelerated growth of deposits continued in April and May 2014 (as of May 2014, the annual deposit growth rate was 8.7%).

Deposits of households are generators of the growth of deposit activity in the first quarter of 2014 and they registered quarterly growth of Denar 4,569 million. Most (72.9%) of this growth

[50] See more detail in Section I.1. Credit risk

[51] Analyzing by individual banks, twelve banks reported a quarterly increase of deposits (the increasing interval ranged from 0.08% to 12.1%, by bank), whereas other banks reported a quarterly reduction of deposits (the reduction ranged from 0.8% to 2.3%, by bank).

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



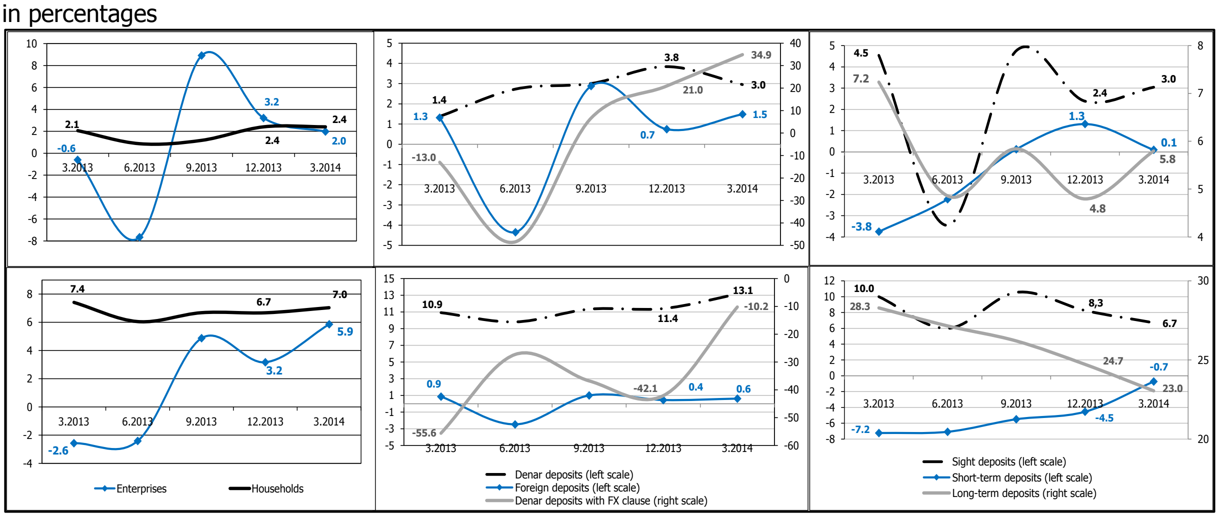
Source: NBRM, based on the data submitted by banks.

is due to households' Denar deposits, whose growth was mostly driven by long-term deposits (64.8%), while the contribution of short-term deposits was 35.9% (Annex 10).

Corporate deposits recorded quarterly growth of Denar 1,204 million, and their contribution to the total growth of the deposit base is 18.8%, which in most part (41.6%) results from the corporate Denar deposits with foreign currency clause[52] , and to a lesser extent (37.9%) from the corporate Denar[53] deposits.

In the first quarter of 2014, depositors' interest in keeping deposits in domestic currency continued to increase. Denar deposits increased by Denar 4,173 million, on a quarterly basis, and increased their share in the total deposit base. Most (79.8%) of the growth of Denar deposits was due to the household sector. The quarterly growth of foreign currency deposits amounted to Denar 1,731 million and most of it results from the long-term household deposits[54]. Denar deposits with FX clause noted a quarterly growth of Denar 502 million.

Chart 65
Quarterly (top) and annual (bottom) deposit growth by sector, currency and maturity
in percentages

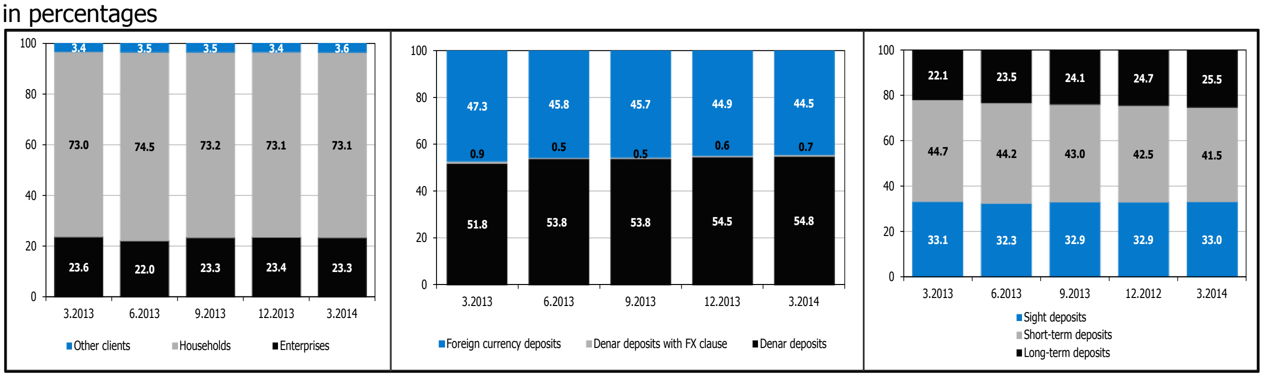


Source: NBRM, based on the data submitted by banks.

52 Corporate Denar deposits with foreign currency clause increased by Denar 501 million, entirely due to the growth of short-term corporate Denar deposits with foreign currency clause in one medium-size bank.
53 Corporate Denar deposits increased by Denar 457 million, entirely due to the growth of corporate sight Denar deposits.
54 Foreign currency deposits of households rose by Denar 1,237 million and determined 71.5% of the growth of total foreign currency deposits. Long-term foreign currency deposits of households had the highest contribution (79.9%) in the growth of foreign currency deposits of households.

Long-term deposits were the main drivers of growth in the deposit base in the first quarter of 2014. The increased interest in long-term savings is an indicator of the confidence in the domestic banking system, but it is also associated with the higher interest rates on long-term deposits. Quarterly growth in long-term deposits (of Denar 3,708 million) is largely due to the growth of long-term savings of households in local currency[55]. Sight deposits grew by Denar 2,592 million, which was conditioned by the growth of Denar sight deposits (contribution of households is 54.6%, while the contribution of companies is 32.1%). Short-term deposits registered a modest quarterly increase of Denar 104 million.

Chart 66
Deposit structure by sector, currency and maturity
in percentages



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

3. Profitability

In the first quarter of 2014, the banking system registered profit in the amount of Denar 414.5 million, thus interrupting the several-year trend of achieving negative financial results at this time of the year. Lower interest expenses and lower impairment of financial assets (loans) of banks had the most pronounced effect on increasing profits. Impairment of non-financial assets (foreclosures) is rapidly growing, and operating costs of banks remained almost unchanged. Profitability indicators have improved significantly, and the operational capability of banks of generating revenues that cover the costs of operation has increased, too.

[55] Denar long-term household deposits increased by Denar 2,160 million and had the largest contribution (58.3%) in the growth of long-term deposits. The contribution of long-term foreign currency deposits of households in the growth of long-term deposits amounted to 26.7%.

Compared with March 2013, the number of banks which registered profits remained unchanged (nine banks), but due to a change in the composition of banks which registered profits, the share of assets of these banks in the total assets of the banking system declined by 2.6 percentage points, and at the end of March 2014 it was 65.7%.

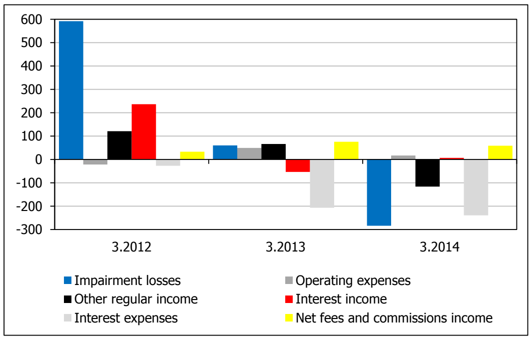
3.1 Movement and structure of income and expenses of the banking system and profitability and efficiency indicators

In the first quarter of 2014, the total income of banks (total regular income[56] and extraordinary income) rose by Denar 189.7 million, i.e. 4.4% on an annual basis. Generator of the increased income of banks is the higher net interest income (by Denar 246.5 million, or 8.6%), which increased due to the lower interest expenses (by Denar 239.3 million, or 11.7%). Net income from fees and commissions and extraordinary income increased by 6.4% and 21.2%, respectively, and a decline was registered only in other regular income[57].

Following these developments, minimal changes occurred in the structure of total revenues, and net interest income strengthened its already large share (of 68.7%).

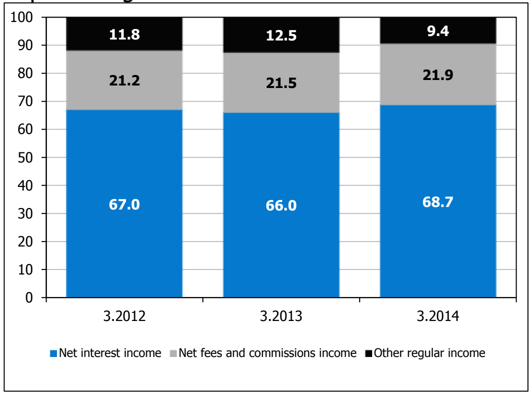
In the first quarter of 2014, compared with the first quarter of 2013, interest income recorded a small increase (of 7.1 million or 0.1%), and the interest income from non-financial companies and households still had the largest share in their formation. Despite the annual credit expansion of banks to the corporate sector, interest income from non-financial companies declined by Denar 62.3 million, or 2.9% on an annual basis, mainly due to the downward trend in lending interest rates. Interest income from financial companies dropped by Denar 23.9 million (or 6.3%), which

Chart 67
Growth of main income and expenses, compared to the same period last year
in millions of denars



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

Chart 68
Structure of total income
in percentages

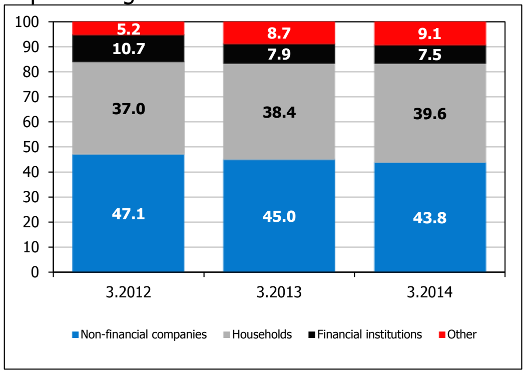


Source: NBRM, based on the data submitted by banks.

[56] 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 recovered claims previously written off).

[57] The decline in other regular income by Denar 115.9 million, or 21.5%, 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 one bank, 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 69
Sector structure of interest expenses
in percentages



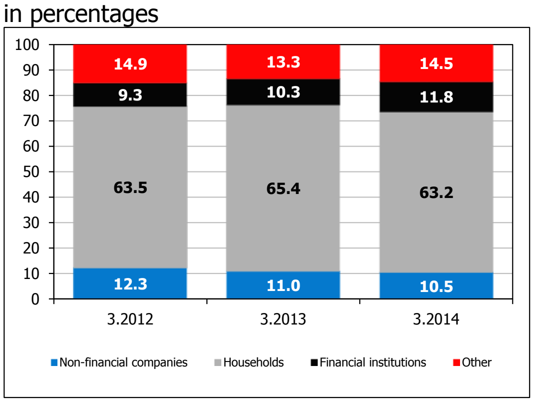
Source: NBRM, based on the data submitted by banks.

is primarily attributed to the lower banks' interest income from the reserve requirement[58].

Contrary to these movements, interest income from households increased by Denar 52.4 million, or 2.9%, which corresponds to the accelerated annual credit growth to this sector (despite the lower interest rates on household loans). Interest income from other entities in the first quarter of this year grew also (by Denar 19.9 million, or 4.8%), primarily reflecting the increased banks' investments in government securities[59].

These developments caused an increase in the share of interest income from other entities and households in the sector structure of interest income. Despite the decrease, interest income from non-financial companies is still dominant, while the lowest share is registered in the interest income from financial companies.

Chart 70
Sector structure of interest expenses
in percentages



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

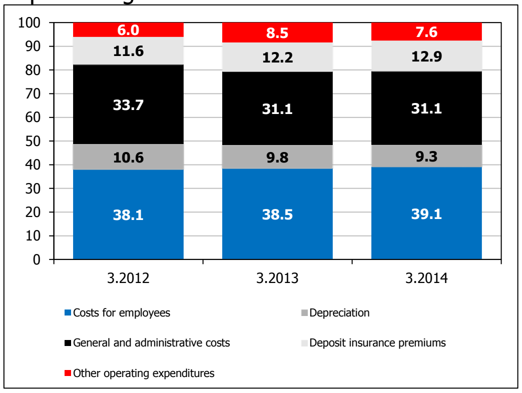
Excluding interest expenses from financial companies, which registered minimal increase (of Denar 3.7 million or 1.7%), interest expenses of banks to all other sectors decreased. The decrease in interest expenses of banks by Denar 239.4 million, or 11.7% annually, is almost entirely (82.2%) due to the lower interest expenses from the household sector (by Denar 196.8 million or 14.7%), amid a decline in the interest rates on long-term time Denar deposits (by 1.1 percentage point) and short-term time foreign currency deposits of the household sector (by 0.8 percentage points)[60], and slower growth of household deposits. However, interest expenses from the household sector still have the largest share in the structure of the interest expenses (63.2%). Additional contribution (of 14.7%) to the reduction in interest expenses of

[58] A Decision amending the Decision on reserve requirement ("Official Gazette of the Republic of Macedonia" no.166/2013) was adopted, which exempts the NBRM from paying reserve requirement remuneration (previously, this remuneration equaled 1% for Denar reserve requirement and 0.1% for euro reserve requirement). This decision came into effect on 1 January 2014.

[59] In the first three 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 37.1 million, or 12.3%. As of 31 March 2013, the amount of treasury bills totaled Denar 30,740 million, and as of 31 March 2014 it was Denar 34,147 million. Also, investments in government bonds continued to rise.

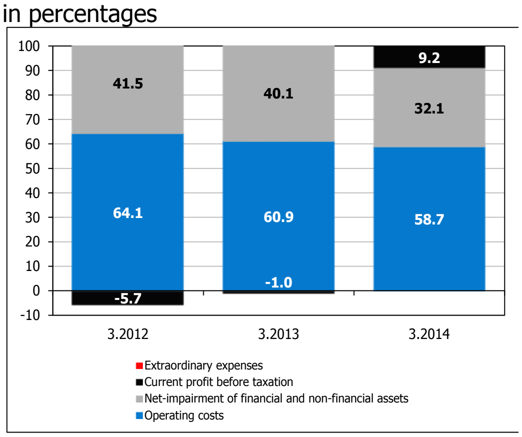
[60] Most significant decline was registered in the interest rates on short-term time Denar deposits with FX clause (by 2.0 percentage points), but the amount of these deposits is very small.

Chart 71
Structure of operating costs
in percentages



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

Chart 72
Usage of total income
in percentages



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

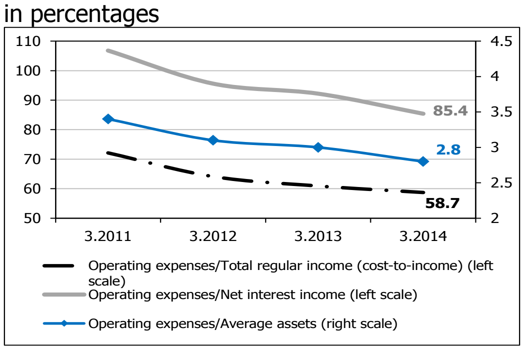
banks was given by the reduced interest expenses of non-financial companies by Denar 35.2 million, or 15.6% (amid most pronounced reduction in the interest rates on long-term Denar deposits of non-financial companies) and the interest expenses to other entities decreased by Denar 11.0 million or 4.0%.[61]

In the first three months of 2014, banks' operating costs[62] registered a slight increase (of Denar 17.2 million, or 0.7%) relative to the same period of the previous year. In these frames, the largest increase in absolute amounts was recorded in the expenses for employees (by Denar 24.3 million, or by 2.4%), while more pronounced annual increase of Denar 21.4 million or 6.7% was registered in deposit insurance premiums[63]. General and administrative expenses remained almost unchanged (minimum increase of 0.4%). Conversely, depreciation decreased by Denar 11.5 million (or 4.5%), and the decline in the category "other operating costs"[64] by Denar 20.8 million, or 9.3%, is fully due to the high base effect[65]. 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 (70.2%).

Most of the total income of banks is still spent to cover operating costs. However, their share in the banks' earnings decreased by 2.2 percentage points (amid more pronounced increase in total income and a minimal increase in operating costs), and a significant reduction (by 8.0 percentage points) was registered also in the part for covering the impairment.

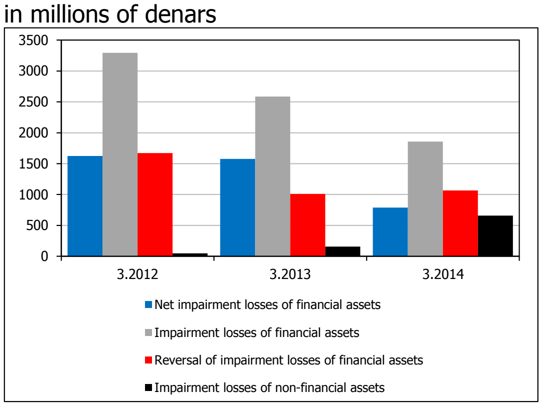
[61] Mostly due to the reduction in the interest expenses for financial institutions - non-residents based on term deposits in two banks.
[62] Banks' operating costs include: staff costs, depreciation, general and administrative expenses, deposit insurance premiums and other operating costs, except extraordinary expenses.
[63] In circumstances when banks' deposits grow by 7.0% annually.
[64] Other operating costs include: special reserve for off-balance sheet exposure, other provisions and expenses on other grounds (expenses from previous years, income taxes and contributions, expenses for fines, fees and court decisions and other costs).
[65] As of 31 March 2013, the growth of the category "other operating expenses" was for the most part determined by the growth of additional provisions for potential liabilities arising from litigations in one bank and increased expenditures on other basis in two banks in the country. Special reserve for off-balance sheet exposure, which is also part of the category of other operating costs continued to rise (by Denar 20.5 million, or 19.6%).

Chart 73
Efficiency indicators of banks
in percentages



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

Chart 74
Impairment of financial and non-financial assets
in millions of denars



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

Improved operational efficiency of the banking system, measured by the lower amount of total regular income that is 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 annual basis (Table 6).

In the first quarter of 2014, net impairment which banks recognize for the impairment of financial assets (amounting to Denar 790 million) is twice smaller (by Denar 786 million, or 49.9%), compared to the same period previous year[66]. Accordingly, the share of net interest income which is spent to cover the impairment of financial assets, of 55.2% (as of 31 March 2013), reduced to 25.5% (as of 31 March 2014).

On the other hand, in the first quarter of 2014, impairment of non-financial assets (foreclosures) continued to grow at a significantly faster pace. Compared to March 2013, it registered a fourfold increase, amounting to Denar 660 million, and became almost equal to the amount of the net impairment of financial assets.

Unlike last year's negative values, rates of return on assets and equity amounted to 0.4% and 4%, respectively.

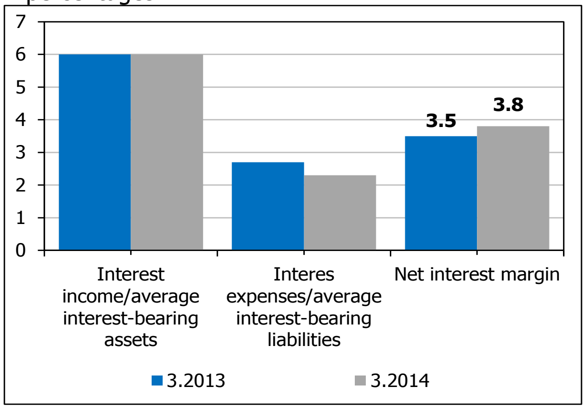
Table 6
Profitability and efficiency ratios of the banking system
in percentages

	3.2013	3.2014
Rate of return on average assets (ROAA)	-0.05	0.4
Rate of return on average equity (ROAE)	-0.4	4.0
Cost-to-income ratio	60.9	58.7
Non-interest expenses/Total regular income	66.4	64.4
Labor costs /Total regular income	23.4	23.0
Labor costs /Operating expenses	38.5	39.1
Impairment losses of financial and non-financial assets /Net interest income	60.7	46.8
Net interest income /Average assets	3.2	3.3
Net interest income /Total regular income	66.0	68.7
Net interest income /Non-interest expenses	99.4	106.6
Non-interest income/Total regular income	39.5	37.1
Financial result/Total regular income	-1.0	9.2

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

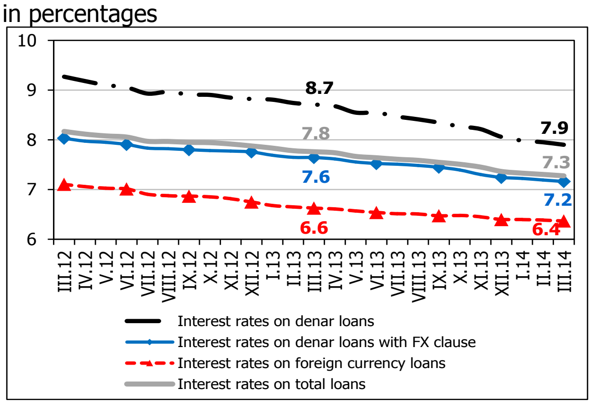
[66] For comparison, as of 31 March 2013, net impairment of financial assets (loans and similar claims), decreased by only 3.0%, on an annual basis.

Chart 75
Net interest margin
in percentages



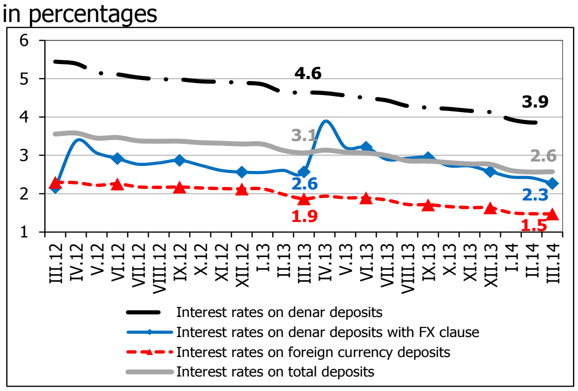
Source: NBRM, based on the data submitted by banks.

Chart 76
Lending interest rates
in percentages



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

Chart 77
Deposit interest rates
in percentages



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

Net interest margin[67] increased by 0.3 percentage points compared to March 2013, with seven out of sixteen banks earning a higher net interest margin than the net interest margin at the level of the banking system.

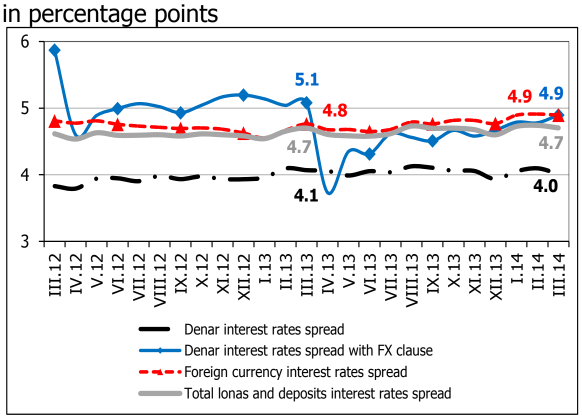
3.2 Movements in interest rates and the interest rate spread

The reduction in lending and deposit interest rates continued in the first three months of 2014, even though the key interest rate of the National Bank and the one-month Euribor remained unchanged[68].

Compared to March last year, the most pronounced downward trend was registered in the interest rates on Denar loans (by 0.8 percentage points) and smallest decline was registered in the interest rates on foreign currency loans (by 0.2 percentage points). On the part of the sources of funding, most evident decline was registered in the interest rates on Denar deposits (by 0.7 percentage points), followed by the interest rates on foreign currency deposits (by 0.4 percentage points) and Denar deposits with foreign currency clause (by 0.3 percentage points).

[67] Net interest margin is calculated as the ratio between net interest income and average interest-bearing assets. Average interest-bearing assets are calculated as an arithmetic mean of the amounts of interest-bearing assets at the end of the analyzed quarter and at the end of the previous year.
[68] The interest rate on CB bills during the first three months of 2014 retained the level of the last change in July 2013 (when it reduced to 3.25%).

Chart 78
Interest rates spread, by currency
in percentage points



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

Amid almost steady downward movements of lending and deposit interest rates, interest rate spreads in all currencies remained stable and without major changes compared to the level registered in March 2013.

ANNEXES