

VII. Supervision of Banks and Savings Houses

7.1. Supervision of banks

7.1.1. Regulatory framework

The regulatory framework of the supervision of banks in the Republic of Macedonia is based on the International Supervisory Standards and Basic principles for efficient banking supervision established by the Basle Committee for Banking Supervision.

During October 1999, upon the request of NBRM, an expert team from IMF and World Bank representatives made an assessment of the harmonization of the banking supervision of the Republic of Macedonia with the Basle principles. Afterwards, the experts' team of the World Bank and IMF gave a very high assessment on the harmonization of the banking supervision in the Republic of Macedonia with the main principles of efficient banking supervision.

7.1.2. Supervision function

NBRM fulfills the supervision function on three levels:

- Licensing function, i.e. processing of requests for issuing licenses and approvals, in accordance with the Banks and Savings Houses Act;
- Supervisory control on the operations of banks and savings houses and
- Taking corrective measures in those banking institutions where certain operating irregularities are identified.

In 1999, on each of these levels, NBRM undertook some activities in the frame of its supervising function. Thus, in 1999, three applications were submitted for acquiring licenses for establishment of savings houses, out of which one was approved (Savings House "Al Kosa" a.d. Stip) and the other two are still under consideration. Also, an agreement was made for opening a branch of the Nova Ljubljanska Banka from the Republic of Slovenia. In the same period, due to serious problems identified in its operations, decisions were made for withdrawal of the operating licenses of "Aka banka" - a.d. Skopje Branch, Savings House "Liberti internacional" - d.o.o. Bitola and Savings House "Uniprokom" - a.d. Skopje, which are final in administrative procedure.

During 1999, on the basis of the Annual Plan for banks and savings houses controls made by the Governor of NBRM, a total of 47 on-site supervisory controls of banks and savings houses were performed, out of which, 26 full-scale and 21 partial controls. Full-scale supervisory controls were performed in 16 banks, 9 savings houses, and in the Deposit Insurance Fund. Partial controls were performed in 17 banks and 4 savings houses. In this manner, the 1999 Annual Plan for full-scale supervisory controls was fully accomplished. The partial supervisory controls performed during 1999 were mainly directed toward monitoring and direct control of the implementation of the undertaken corrective measures, direct control of certain conditions identified during the off-site monitoring of banks operation, etc.

At the end of 1999, banks and savings houses in the Republic of Macedonia had the following composite operating grades: 1 bank and 2 savings houses were awarded with the worst grade "5"; 9 banks and 3 savings houses with composite grade "4"; 6 banks and 9

savings houses with composite grade "3"; and 5 banks and 1 savings house were awarded with composite grade "2". No bank was graded with summary operating grade "1".

Due to identified liquidity problems, monitoring the implementation of corrective measures, opening a rehabilitation or bankruptcy procedure or withdrawing the approval for a manager, in 1999, authorized employees of NBRM organized the work, on a temporary or permanent basis, by verifying the payment orders and by performing a permanent supervisory control in 4 banks and 4 savings houses.

Regarding the control activities of the NBRM, in the domain of inspection control of the implementation of the regulations in the field of monetary and foreign exchange operations, in 1999, 94 controls were made, out of which, 32 controls referred to banks' operations, and 62 controls referred to authorized exchange offices. The overall foreign exchange operations in the banks were subject to 13 controls, while the other controls were partial and referred to certain foreign exchange aspects (fulfillment of necessary conditions for realizing the payment operations and foreign credit operations, control of non-residents' accounts, foreign exchange position, foreign market and so forth).

The performed control activities of NBRM in 1999 indicated that still the most significant problem that the banks are facing is generating bad placements. This is due to the inadequate credit systems of banks related to approving, monitoring and undertaking necessary measures for liquidation of banks' credits, as well as the long and difficult procedure for realization of the mortgage rights in the courts. The external shock that the Macedonian economy experienced in the first half of 1999, as a consequence of war in FR Yugoslavia had an extremely unfavorable effects on bad placements. In some banking institutions inadequate and non-transparent accounting records were identified that did not reflect the real value of the assets, their adequate capitalization and the profitability potential. The problem of generating bad placements has a direct impact on the profitability potential and the banks' liquidity position. In some banks, the existing problem of maintaining the liquidity position results in permanent indebtedness on inter-bank market. Also, within the activities aimed at reaching the capital census, irregular activities were identified in some banks, which resulted in part of their capital being put in question.

7.2. Structure of the banking system

The character and state of the banking system in the Republic of Macedonia is based on regulatory framework established with the National Bank of the Republic of Macedonia Act and the Banks and Savings Houses Act. In accordance with the existing legislative framework, the banking system has a universal character. At the end of 1999, the banking system of the Republic of Macedonia consisted of 22 banks, one branch of a foreign bank and 16 savings houses. The branch of the foreign bank and 16 banks have the so-called full license for conducting foreign payment operation and credit and guarantee operations abroad, while the other 6 banks have only a license for conducting domestic operations. In comparison with December 31, 1999 the number of banking institutions in the Republic of Macedonia decreased, due to withdrawal of operating licenses of "Aka banka" - a.d Skopje branch, savings house "Liberti Internacional" - Bitola and savings house "Uniprom" - a.d Skopje, and the introduction of bankruptcy and liquidation procedure.

In 1999, there were no major changes in the structural shares of the two main segments of the banking system of the Republic of Macedonia - the banks and the savings houses. Regarding their functions and their 99% share in the total financial potential, the banks represent almost the entire Macedonian banking system. Beside the classical function of collecting deposits and granting credits, the banks have an opportunity to perform other activities, for which, in some countries that do follow the concept of universal banking,

specialized banking institutions exist. Among other function, banks can also participate in the capital market by issuing their own securities and intermediating in the trading with securities between other entities.

The analysis of the banking system according to the volume of operations, or market share, the size of the financial potential and banks' own assets, shows an asymmetrical structure. Namely, the three largest banks in the Republic of Macedonia account for 63.2% of the total volume of banking operations¹⁸, as well as 62% of the collected financial potential. Regarding the capital strength, the three largest banks have a share of 38.4%, which relative to December 31, 1998 is a 1.1 percentage point decline. The decline of the concentration of the three largest banks' own potential is a result of the dynamic harmonization of banks with the legally prescribed capital census for conducting foreign payment operations and foreign credit and guarantees operations, that has been already fulfilled by the three largest banks, as well as the establishment of new banking institutions in the Republic of Macedonia.

As of December 31, 1999, the rate of privatization of the banking capital in the Republic of Macedonia was 76.8%, and relative to December 31, 1998 it is by 0.4 percentage points lower. The decline is due to the establishment of two state-owned banks: "Macedonian Bank for Development Promotion" and the branch of "T.C. Ziraat Bankasi" from the Republic of Turkey. If these two banking institutions are excluded during the analysis, on December 31, 1999, the rate of privatization of the remaining banks in the Republic of Macedonia is 86.7%. The analysis of each bank separately, except the two entirely state-owned banking institutions, shows that the rate of privatization ranges between 46.5% and 100% with 5 banks.

At the end of 1999, the average share of foreign capital in the total equity capital of banks in the Republic of Macedonia equaled 19.3%. In comparison to December 31, 1998, it increased by 3.1 percentage points, due to the establishment of the branch of "TC Ziraat Bankasi". With regard to individual banks, foreign capital exists in 15 banks, and its share is between 0.3% and 100%.

From a regional aspect, the structure of the banking system in the Republic of Macedonia confirms its asymmetry, with a tendency of further strengthening. At the end of 1999, out of the total of 22 banks, 1 branch of foreign bank and 16 savings houses, only 6 banks and 4 savings houses are located out of Skopje, and out of them, only 3 banks have an authorization to perform foreign payment operations and foreign credit operations. The financial potential of these 10 banking institutions is 11.6% of the total financial potential of the Macedonian banking system. Relative to the end of 1998, a decline of 4.4 percentage points in the share of the financial potential of the banks and savings houses located out of Skopje can be noticed. This tendency, is mainly a result of the establishment of new banking institutions in the capital city.

However, the disproportion in the supply of financial services is partly being alleviated by the relatively extended network of branches, subsidiaries, windows, operational units and representative offices. At the end of 1999, Macedonian banks had 20 branches, 79 subsidiaries, 8 operational units, 101 windows and 4 representative offices. The windows of the "Macedonian Post Offices" Public Enterprise should also be mentioned (total of 600 throughout the whole territory of the Republic of Macedonia) that are operated through the "Postenska Stedilnica" savings house.

¹⁸ The largest bank has a share of 36.8% in the total volume of the banking operations in the Republic of Macedonia

7.3. Performances of the banking system

7.3.1. Asset quality

The assets quality was previously one of the main problems of the banking system in the Republic of Macedonia. The high share of risky placements in the total credit exposure, the low level of collection, high interest rate margins, problems in the realization of mortgages that cover banking placements, etc. are the main problems in this area, that have direct influence on the other performances of the operations of Macedonian banks.

In 1999, asset quality ratios registered a significant deterioration. That was a consequence of the strong external shock that hit the Macedonian economy in the first half of 1999. It resulted in loss of foreign markets, increase in the transportation costs for exporting Macedonian goods, decline in output, deterioration in the liquidity of the economy, etc. Such conditions in the real sector of Macedonian economy were transmitted to the banking sector, with negative implications both on the quality of the placements, and on the banks and savings houses profitability indicators. That was a result of the reduced ability of economic agents to service their own liabilities toward banks and increase in their risk ratings, because of which banks were forced to have high levels of reservations for potential losses, thus increasing their expenses. It should be taken into account, that the risks of such an external shock basically can not be anticipated, despite the existence of most advanced and sophisticated mechanisms for identification and measurement of different types of risks facing the banks.

External developments had an exceptionally unfavorable impact on the credit portfolio of the Macedonian banks, as the most important segment of their assets. Namely, at the end of 1999, the share of the claims and off-balance sheet items classified in risk categories C, D and E in the total portfolio accounted for 41.3%. Thus, the tendency of improving the quality of the credit portfolio of the Macedonian banks, which resulted in a reduction of the share of the claims and off-balance sheet items classified in risk categories C, D and E in the total credit portfolio from 44.4% at the end of 1995 to 32.9% at the end of 1998, was stopped in 1999.

If the analysis of the negatively classified items in C, D and E, takes into account the adequate amount of provisions for potential losses, the uncovered part of these claims would account for 21.2% in the total credit portfolio, i.e. 74,6% of the guarantee capital of the Macedonian banks as of December 31,1999. If the worst scenario is assumed, meaning no collection of the banks' placements classified in risk groups C, D and E, than two-thirds of the guarantee capital of the Macedonian banks should be used for losses coverage.

As of December 31, 1999, the average rate of risk of the credit portfolio of banks in the Republic of Macedonia, expressed as a ratio between the observed amount of potential losses and the total credit exposure, is 22.6%. Compared to the end of 1998, the risk rate of the credit portfolio is 5.1 percentage points higher.

7.3.2. Capital Adequacy

One of the most important aspects during the assessment on the performance of the banking system in the Republic of Macedonia is quantification of the level of capitalization of financial institutions. Control of the level of risk exposure in its largest part is performed on the basis of the externally established financial reliability rules and principles of behavior of financial institutions. One of these financial reliability rules refers to the maintenance of the

adequate capitalization level in banks, having in mind that the capital represents the main shock absorber of possible operational losses.

As of December 31, 1999, the capitalization level in banking institutions in the Republic of Macedonia, quantified through several indicators, is as follows:

1. Capitalization rate as a ratio between the banks' own funds and the total amount of assets. This indicator defines the level of coverage of the balance activities with banks' own funds. As of December 31, 1999, the average level of capitalization of the Macedonian banks and savings houses was 20.7%. Compared to the end of 1998, this indicator shows 4.5 percentage points decline. However, the permanent declining trend of this indicator shows that Macedonian banks are characterized with a high capitalization level.

2. Capitalization rate of banks as a ratio between banks' own funds and total banks activities, including the on-balance and off-balance sheet activities. The necessity to include the off-balance sheet operations in the capitalization level analysis of banks results on one side from the fact that the off-balance sheet operations have an increased share in the total banks activities, (as of December 31, 1999, the total off-balance sheet operations were 18% of the total on-balance sheet operations), and on the other, the realization of the off-balance sheet activities includes certain level of risk and can have an impact on the balance sheet and income statement of the banks. As of December 31, 1999, this indicator accounted for 17.3% and compared to December 31, 1998 it shows a 1.8 percentage points decline.

3. Capital adequacy ratio as a ratio between the guarantee capital and the risk-weighted assets of banking institutions. The capital adequacy ratio shows the relation between the guarantee capital, reflecting the real value of capital, and the risk-weighted assets, reflecting the total value of the on-balance and off-balance sheet assets weighted in accordance with a certain risk weight.

As of December 31, 1999, the average capital adequacy ratio of banks and savings houses is 28.8% and is almost identical with the average capital adequate ratio of banks. At the end of 1999, the capital adequacy of the savings houses is 45.8% and is 17 percentage points higher than the average rate on the level of the banking system. However, due to the marginal and trivial importance of the savings houses, this indicator has minimal influence on the average rate of the indicator for the whole banking system in the Republic of Macedonia. Contrary to the above mentioned capital indicators, which show a decline, as of December 31, 1999, compared to the end of 1998, the capital adequacy ratio of the banks shows an increase of 2.8 percentage points.

7.3.3. Profitability

According to the annual statement for 1999, the banks in the Republic of Macedonia showed a net profit of Denar 502.9 million which compared to the net profit realized in 1998 is a decline of Denars 597.1 million, or 54.3%.

As of December 31, 1999, out of the total of 22 banks and 1 branch of a foreign bank existing in the banking system of the Republic of Macedonia, 20 realized positive financial results, while the other three banks finished the year with a loss. Relative to December 31, 1998, in 1999, the financial result was reduced in half of the existing banks in the Republic of Macedonia.

It has to be taken into consideration that in December 1999, the analysis of the structural components of the aggregated financial statement of the Macedonian banks showed negative net interest income upon reservations in the amount of Denar 1.268 million. This

means that the financial result of the banks, realized from conducting their main function, intermediation function between financial surplus and financial deficit economic agents, with calculated expenditures based on potential losses for credit risk, is negative. This also means extremely low efficiency of banks with respect to the allocation of scarce financial resources in the Macedonian economy. If previously non allocated reserves for potential losses are in the amount of Denar 1.098 million¹⁹, identified during the on-site supervisory controls and not included in the banks' balance sheets as of December 31, 1999, are taken into account, the net interest income on reservations would be negative Denar 2.365 million, and the final financial result would be negative.

The rate of Return on Assets (ROA), calculated as a ratio between the presented net profit of banks in 1999 and their average assets for the same period, is 0.8% and shows that 100 units of assets of Macedonian banks generate 0.8 units of net profit. Compared to the rate of Return on Assets as of December 31, 1998 of 2%, this ratio shows a significant deterioration of the profitable potential of Macedonian banks during 1999. According to the internationally accepted standards, the rate of Return on Assets has to be above 1%.

The rate of Return on Equity (ROE), calculated as a ratio between the presented net profit of banks in 1999 and the average bank's own assets for the same period, is 3.5%, against 8.2% as of December 31, 1998. The international standard for this indicator is between 5% and 10%.

Another indicator that shows the profitability potential and the efficiency of banks is the ratio between the operational costs (other expenditures in the financial statement) and the total realized income (net interest income upon reservations and other incomes). As of December 31, 1999 this indicator was 0.86, which means that in order to produce 1 Denar of income, the Macedonian banks during 1999 need to make 0.86 Denars operational expenses. At the same time, for producing 1 Denar of income it would be necessary to make 0.35 Denars expenses for salaries.

The ratio between the expenditures made for reservations for potential losses and the net interest income is 1.59 and shows negative margin of accomplishing net interest income, i.e. for producing 1 Denar interest income in 1999, Macedonian banks made 1.59 denars expenditures based on reservations for covering the credit risk on the placements made.

¹⁹ It should be taken into account that 63.8% of the non allocated reserves for potential losses as of December 31, 1999 belong to "Almako banka" - a.d. Skopje.