BSCEE

Review

2005

Group of Banking Supervisors from Central and Eastern Europe

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INTRODUCTION

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

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

According to the previous years practice the Annual Review of the BSCEE Group summarizes the developments of the member countries in 2004. This publication gives an overview of the macroeconomic circumstances in the 19 member states, and it describes the banking sector as well as the supervisory activities. It was prepared on the basis of the information given by the member countries. The Annual Review also summarizes the main events of the BSCEE Group, including two regional workshops co-organized by the Bank of International Settlement (BIS) and the Financial Stability Institute (FSI) and by the BSCEE Group. The 17th Annual Conference was organized by the Croatian National Bank in Dubrovnik, Croatia on the 27-28th of May 2004.

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

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

Deák Andrea

Senior Coordinator
of the Secretariat

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

Type of financial institutions	2002	2003	2004
Bank	13	15	16
Nonbanking financial institution	5	7	7
Savings and credit association	127	136	132
Financial institution, total	**145**	**158**	**155**

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

Item	2002	2003	2004
Public sector ownership	13.5	10.0	7.0
Private domestic ownership		4.0	8.0
Domestic ownership total	*13.5*	*14.0*	*15.0*
Foreign ownership (private banks)	73.6	76.0	77.0
Other foreign ownership (joint-venture)	12.9	10.0	8.0
Foreign ownership total	86.5	86.0	85.0
Banks, total	**100.0**	**100.0**	**100.0**

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

tem	2002	2003	2004
Public sector ownership (100%)	54.0	52.0	3.0
Private domestic ownership		1.0	3.0
Domestic ownership total	*54.0*	*53.0*	*6.0*
Foreign ownership (private banks) 100%	40.0	42.0	91.0
Other foreign ownership (joint-venture)	6.0	5.0	3.0
Foreign ownership total	46.0	47.0	94.0
Banks, total	**100.0**	**100.0**	**100.0**

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

Type of financial institutions	The first 3 largest	The first 5 largest
Bank	69	83

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

Type of financial institutions	2002	2003	2004
Bank	1.20	1.24	1.28

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

Type of financial institutions	2002	2003	2004
Bank	19.20	19.50	21.10

Distribution of market shares in balance sheet total (%)

Type of banks	2002	2003	2004
G1 (< 2 % of total banks assets)	3.8	4.6	6.4
G2 (2 % - 7% of total banks assets)	10.4	10.6	10.4
G3 (> 7% of total banks assets)	85.8	84.8	83.2
Banks, total	**100.0**	**100.0**	**100.0**

**basetd on assets*

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

Assets	2002	2003	2004
1. Treasury operations and interbank	80.6	76.5	72.4
2. Operations with customers (net)*	11.4	13.5	16.4
3. Securities transactions (net)	4.9	5.4	7.0
4. Other assets	0.9	0.8	0.9
5. Fixed assets	1.8	1.5	1.7
Total accrued interest	**0.5**	**2.6**	**2.1**
Liabilities and shareholders' equity	**2002**	**2003**	**2004**
1. Treasury operations and interbank transactions	5.3	4.4	4.5
2. Operations with customers	84.0	87.5	87.0
3. Securities transactions	0.0	0.0	0.0
4. Other liabilities	2.9	0.7	1.0
5. Permanent resources	6.7	6.2	6.3
Total accrued interest	**1.2**	**1.2**	**1.1**

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

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

Type of financial institutions	2002	2003	2004
Bank	13.8	7.4	15.0

Solvency ratio of banks

Type of financial institutions	2002	2003	2004
Bank	31.6	28.5	21.6

Asset portfolio quality of the banking system (%)

Asset classification	2002	2003	2004
Standard	89.9	92.3	92.7
Special mentioned	4.6	3.1	3.2
Substandard	3.0	1.9	1.0
Doubtful	0.7	0.5	1.0
Loss	1.8	2.1	2.1
Overdue loans/total of loans	5.6	4.6	4.2
Classified total	**100.0**	**100.0**	**100.0**
Provisions	**4.2**	**4.3**	**4.0**

The structure of deposits and loans at year-end 2004 (%)

Type of deposits	as a % of total deposists	Loans	as a % of total loans
Current accounts	12.7	Short term loans	26.7
Demand deposits	6.2	Medium term loans	35.3
Time deposits	78.8	Long term loans	15.7
Other deposits	2.1	Real estate loans	15.1
Certificates of deposits	0.1	Leasing contracts	0.0
		Other loans	7.1
Classified total	**100.0**		**100.0**
Public sector deposits	4.9	Public sector loans	0.2
Private sector deposits	8.3	Private sector loans	68.8
Households and others	86.8	Households and others	31.0
Classified total	**100.0**		**100.0**
Deposits in leks	68.6	Loans extended in leks	19.5
Deposits in foreign currency	31.4	Loans extended in foreign currency	80.5
Classified total	**100.0**		**100.0**

The structure of deposits by final maturity at year-end 2004 (%)

Maturity of Deposits	as a % of total deposists
At sight	36.0
Within one year	61.9
Over one year	2.0
Total	**100.0**

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

Type of financial institutions	FOREX assets/Total assets			FOREX Liabilities/ Total liab&equity capital		
	2002	2003	2004	2002	2003	2004
Bank	37.5	36.3	37.4	36.9	35.9	37.0

Structure of Incomes and Expenses of Banks

in million of Lek

Items	2002	2003	2004
I. Total interest income	23,538.1	27,838.0	26,394.5
Treasury and interbank transactions	2,581.5	2,203.5	2,329.8
Interest received from customers	2,981.6	3,885.1	5,177.5
Interest received from securities	17,957.4	20,980.7	18,700.3
Other interest received	17.6	768.7	186.9
II. Total interest expenses	14,690.8	16,687.8	14,731.2
Interest expenses on treasury and interbank transactions	508.8	173.8	171.3
Interest paid to customers	13,915.4	16,150.8	14,406.1
Interest expenses on securities	126.0	230.7	13.8
Other interest expenses	140.5	132.5	140.0
Net interest income (I-II)	8,847.3	11,150.2	11,663.3
Noninterest income	3,361.7	3,277.1	5,871.1
Noninterest expenses	971.3	1,078.9	1,973.1
Net noninterest income	2,390.5	2,198.1	3,898.0
Provisioning expenses	1,062.9	907.9	1,039.5
Gross operating income	10,174.9	12,440.5	14,521.8
Overhead expenses	5,562.0	6,066.5	7,643.1
of which: personnel expenses	2,328.9	2,423.2	3,045.0
Net operating income	4,612.8	6,373.9	6,878.7
Net extraordinary income (loss)	423.4	(116.5)	38.8
Taxes other than income taxes	47.6	41.1	53.9
Net income (loss) before tax	4,988.6	6,216.3	6,863.6
Income tax	1,094.7	1,761.3	1,757.5
Net income (loss) after tax	**3,894.0**	**4,454.9**	**5,106.1**

Structure of registered capital and own funds of banks in 2004

in mio of EUR

Type of financial institutions	Registered capital	/Total assets	Own funds	/Total liabilities
	EUR	%	EUR	%
Bank	186.7	5.5	205.4	6.1

Note: Rate of exchange EUR/Lek =126.35

2004 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF BELARUS

MACROECONOMIC ENVIRONMENT IN THE COUNTRY

Social and economic development of the Republic of Belarus in 2004 was characterized by positive dynamics of the main macroeconomic indicators.

As a result of dynamic and sustainable performance of the principal sections of the economy, GDP grew by 111% relative to 2003, the 2004 forecast being 109-110%.

The rate of growth of investment in the fixed capital in 2004 amounted to 120,4% compared with 2003.

Economic growth in 2004 is accompanied by better financial performance of the economy's real sector organizations.

Profitability of sold products, works, and services grew up with 10% in 2003 to 13,4% in 2004. The share of loss making enterprises dropped from 36,2% to 21%.

Households' real monetary income grew by 13,6% compared with 2003. Higher incomes facilitated the expansion of consumer demand which boosted retail trade and paid services to the general public.

Foreign trade turnover in 2004 was $29.9 billion, a 39.7% increase. CIS countries accounted for $19.0 billion (64% of foreign trade turnover), including Russia's $17.5 billion (58%) and the rest of the world $10.9 billion (36%), including EU's $7.4 billion (25%). Trade balance was negative in the amount of $2.1 billion (9% of GDP).

Accelerated economic growth in this country creates favorable environment forenhancing stability of banks and the banking system as a whole.

DEVELOPMENT OF THE BANKING SYSTEM

As at January 1, 2005, there were 32 Belarusian banks operating under normal conditions. Of these, 7 were residents of free economic zones.

The number of banks' affiliates reduced during the previous year by 10 affiliates amounting by the end of 2004 to 463. The bulk of banks' branches are also located in Minsk and Minsk region.

As at January 1, 2005, 12 representative offices of foreign banks were operating in the Republic of Belarus (Russian, Lithuanian, Latvian, Kazakh, German, and Polish banks).

In 2004, the assets increased by Br4`835,9 billion, or by 45,7%, and amounted to Br15`421,5 billion. By the end of 2004, the assets of the national banking system amounted to the equivalent of USD7,1 billion, «assets/GDP ratio» macroeconomic indicator increased from 29,5% to 31,2%.

As mentioned above, in 2004 the banks' aggregate authorized capital increased in nominal terms by 49,4% (in 2003, by 77,3 times). The increase in real terms (adjusted for inflation) amounted to 30,6%. As of January 1, 2005, aggregate authorized capital of the banking system amounted to Br2`161,3 billion, or the equivalent of USD995,96 million.

In the previous year, the volume of the banking system's own capital increased by 41,4% and as of January 1, 2005, amounted to Br2`895,6 billion (or the equivalent of EUR979,7 million). Investments in the banks' authorized capital and profits were the main source of capital build-up in the banking system as a whole.

Authorized capital of 27 banks was formed with participation of foreign investments. In 2004, their total share in the aggregate authorized capital ranged from 7,5% to 11,8%. In 2004, the share of foreign investors in the aggregate authorized capital rose from 7.5 to 11.8%.

The banks' profits in 2004 amounted to Br180,7 billion (in 2003, to Br131,5 billion). All banks except two enjoyed profit at the end of the year.

As at January 1, 2005, problem (extended, overdue, and doubtful) credits accounted for 2.77% of the credit portfolio. Nine banks had no problem debts on credit operations.

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

To streamline the economic standards system, the National Bank has reworded the regulatory legal act prescribing standards for banks which came into effect in 2005. The Instructions on economic standards for banks and non-bank credit and financial institutions approved by Resolution of the Board of the National Bank No.92 dated June 26, 2004, provides for the following:

- Capital adequacy computation includes market and operational risks coverage requirements. A modified assessment of credit risks based on the standardized approach stipulated by Basle-2 accord is used.
- Credit risk assessment is based on information about potential losses resulting from assets operations with different counterparties (countries, banks, and other legal persons) depending on the external credit rating assigned to them. This information is derived from outside rating agencies.
- The minimal capital adequacy requirement is 8%.
- For the purpose of obtaining by the National Bank of more efficient and adequate information about the state of risks, the new Instruction provides for a daily compliance by banks with the major economic standards, such as liquidity, maximum size of major risks, and others.

Legal competence of the Banking Supervisory Authority

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

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

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

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2004

In 2004, the main strategic objectives of the Banking Supervision Directorate were the maintenance of stability of the banking system of the Republic of Belarus and protection of the banks' depositors and creditors. The above-mentioned objectives were achieved through:

- ensuring that the banks' top managers had adequate professional skills and reputation;
- setting up prudential restrictions regarding banking risks and capital and reserves adequacy requirements which comply with the international practice and take into account economic situation in the country;
- execution of the effective day-to-day supervision of banks' activities by analyzing official reports and carrying out inspections in banks;
- timely application of corrective measures which ensure solvency, liquidity and reliability of banks; and
- timely removal of banks whose condition cannot be improved from the market, as well as minimization of consequences related to the banks' bankruptcies for the banking system and creditors.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2004

A self-assessment of Belarusian banking supervision conformity to the Core Principles for Effective Banking Supervision laid down by the Basel Committee was made.

The National Bank has devised and submitted to the National Assembly draft amendments to the Banking Code pertaining to control over the legality of capital coming to the banking system and over qualifications of managers of banks' executive bodies, as well as to consolidated supervision over banks having regard to their subsidiaries, parent entities, and also legal entities that could otherwise materially affect banks' operation and financial standing.

The National Bank focused in 2004 on abandoning, beginning in 2005, the practice of granting to banks privileges and preferences regarding compliance with the economic standards and other requirements of the Belarusian banking legislation.

The Banking Supervision Directorate continued its work on the establishment and automation of an integrated system of collection, processing and analyses if information about operation of each bank registered in the Republic of Belarus which is required to determine banks' real financial standing and to identify and evaluate the level of existing risks.

In 2004, specialists of the National Bank of the Republic of Belarus carried out 17 comprehensive inspections of Belarusian banks.

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

During the year, for breach of banking legislation banks were fined in the amount of Br177,5 million.

INTERNATIONAL COOPERATION OF THE SUPERVISORY AUTHORITY

The National Bank is endeavoring to establish and develop contacts and exchange of information with foreign banking supervision agencies. Of particular interest is cooperation with those countries which have representative offices of Belarusian banks and whose banks have set up subsidiaries and representative offices in the Republic of Belarus. Nine bilateral agreements with foreign banking supervision agencies had been concluded, chiefly from the CIS member-states and Baltic countries.

An international seminar “New Basel Capital Accord: Rules, Implementation, and Building Internal Ratings-based Systems for Measuring Credit Risk” was held on May 10—14, 2004, at the Training Center of the National Bank of the Republic of Belarus. Its attendants discussed the key elements of the new Basle capital accord (Basle-2). The seminar was attended by 31 participant from 16 member-states of the Group.

In November 2004, representatives of the International Monetary Fund and the World Bank assessed the financial sector of the Republic of Belarus under the FSAP program. In particular, they assessed compliance of Belarusian banking supervision with the Core Principles for Effective Banking Supervision. Following examination of the draft of detailed assessment of compliance with the Basel Principles by the Republic of Belarus submitted by the IMF and World Bank experts, the National Bank specialists prepared their comments and opinions which will be communicated to the experts. Final conclusions and assessments of the mission will be made in 2005.

In June 2004, the IMF's technical assistance mission on anti-money laundering and combating the financing of terrorism visited the Republic of Belarus. The mission analyzed current Belarusian legislation pertaining to these issues and came up with recommendations and proposals which will be considered and taken into account while redrafting the Law of the Republic of Belarus "On Measures Designed to Prevent Legitimization of Illegal Income".

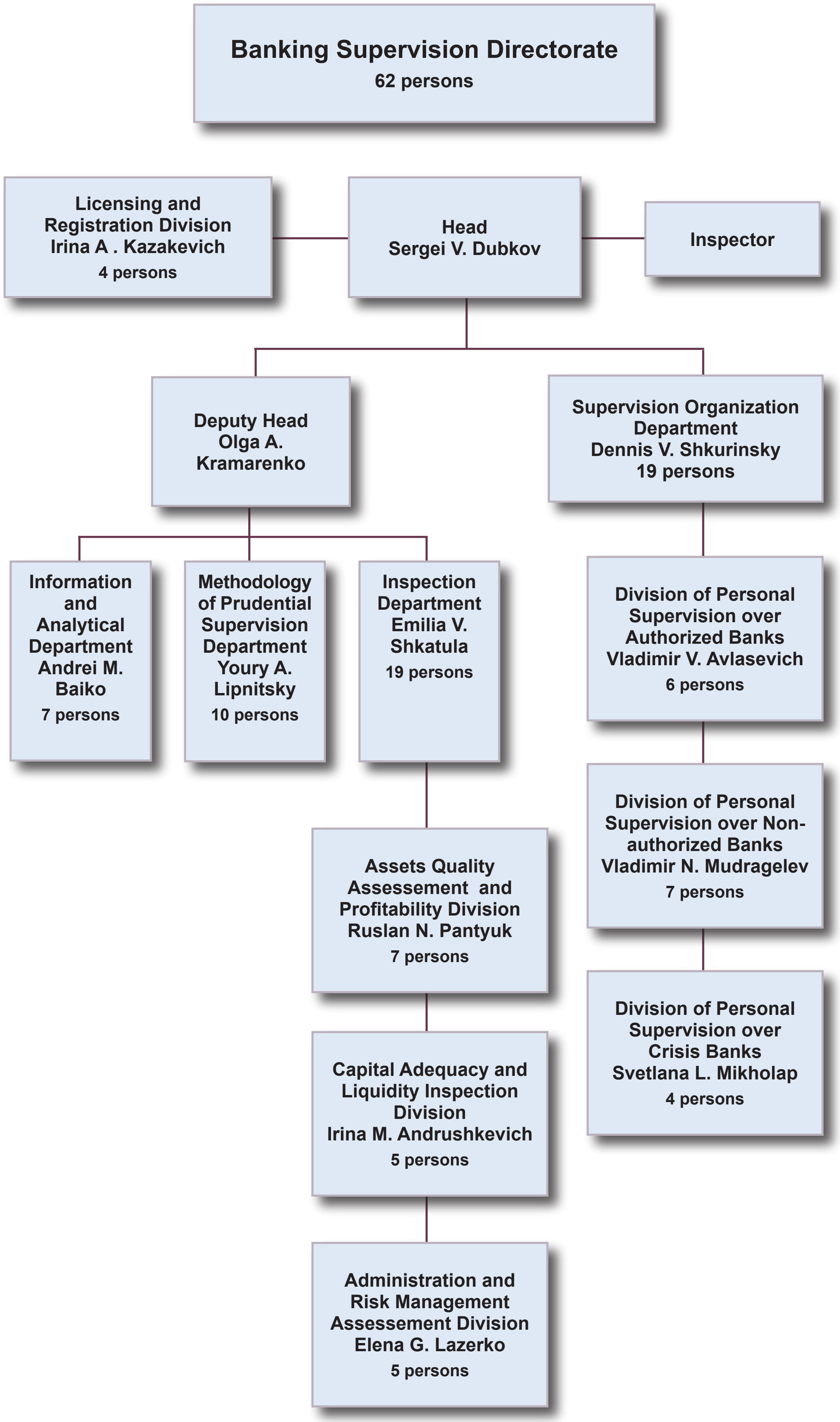
COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

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

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

More detailed information about banking system and banking supervision in the Republic of Belarus is published on the National Bank's website at www.nbrb.by/engl/publications/regulrep/.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISION DIRECTORATE



STATISTICAL TABLES

Number of financial institutions *
(at year-ends)

Type of financial institution	2002	2003	2004
Commercial banks	28	30	32

**) Number of acting financial institutions*

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

Item	2002	2003	2004
State ownership	80.12	85.04	81.90
Other domestic ownership	11.15	7.44	6.31
Domestic ownership total	*91.27*	*92.48*	*88.21*
Foreign ownership	8.73	7.52	11.79
Financial institution, total	**100.00**	**100.00**	**100.00**

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

Item	2002	2003	2004
Public sector ownership	58.91	56.96	75.16
Other domestic ownership	35.59	23.75	6.50
Domestic ownership total	*94.50*	*80.71*	*81.66*
Foreign ownership	5.50	19.29	18.34
Financial institution, total	**100.00**	**100.00**	**100.00**

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

Type of institutions	The first three largest		The first five largest	
	2003	2004	2003	2004
Bank	69.12	69.2	83.87	84.92

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

Type of institution	2002	2003	2004
Bank	0.99	1.56	1.45

**) In previous reviews of banking system development, the average value of assets exclusive of the amount of assets at the start of the period under review was used for computing ROA. In this review, the average value of assets calculated on the basis of the amount of assets at the start of the period under review was used for computing ROA.*

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

Type of institution	2002	2003	2004
Bank	6.53	8.40	7.75

**) In previous reviews of banking system development, ROE was computed as the ratio of profit in the year under review to own capital at the end of the year under review. In the 2004 review, the average value of own capital in the year under review was used for computing ROE.*

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

Type of financial institution	2002		2003		2004	
	Quantity of banks	market share (%)	Quantity of banks	market share (%)	Quantity of banks	market share (%)
Bank's capital	**28**	**100.00**	**30**	**100.00**	**31**	**100.00**
incl.						
negativ capital	1	3.57	1	3.33	1	3.23
to 1 bln. roubles	2	7.14	0	0.00	0	0.00
from 1 to 10 bln. roubles	7	25.00	7	23.33	7	22.58
from 10 to 40 bln. roubles	13	46.43	16	53.33	15	48.39
more than 40 bln. roubles	5	17.86	6	20.00	8	25.81

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

	Assets	2002	2003	2004
1	Cash assets, gold, precious metals	2.3	2.5	2.7
2	Assets in the National Bank of the Republic of Belarus	1.4	2.1	2.0
3	Correspondent accounts in other banks	11.5	11.4	9.8
4	Required reserves	4.6	4.4	4.4
5	Securities	9.1	8.5	6.9
6	Credit to individuals and enterprises	63.0	63.9	67.8
7	Permanent assets and intangibles	6.3	5.5	5.0
8	Other assets	1.8	1.7	1.4
	Total	**100.0**	**100.0**	**100.0**
	Liabilities			
1	Settlement and current accounts	20.0	22.3	18.1
2	Correspondent accounts of other banks	2.1	2.0	1.5
3	Deposits of other banks	1.0	1.8	1.7
4	Deposits of individuals and enterprises	51.2	50.9	54.7
5	Interbank credits	18.0	15.5	14.8
6	Other liabilities	7.7	7.5	9.2
	Total	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2002	2003	2004
Commercial banks	197.71	175.74	152.60

Solvency ratio of financial institutions (%)

Type of financial institution	2002	2003	2004
Commercial banks	24.2	27.3	25.2

Asset portfolio quality of the banking system

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Asset classification	2002	2003	2004
Loans, total	**4,286,479.8**	**6,959,087.8**	**10,439,430.8**
Extended loans	64,518.7	30,394.2	23,303.4
Past due loans	*76,672.9*	*58,182.6*	*37,336.2*
Doubtful loans	214,643.3	165,927.5	228,263.5
Past due interest			
up to 30 days	8,552.5	7,286.0	15,178.6
more than 30 days	167,565.5	180,738.9	169,312.2
Special reserves	66,208.5	109,201.9	150,272.0

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

	2004	
	Deposits	Loans
Commercial organizations	14.2	29.3
Households	52.6	21.2
Noncommercial organizations	31.6	49.0
Nonbank financial institutions	1.6	0.5
Total	**100.0**	**100.0**

Time structure of deposits and loans (%) (at year-end in 2004)

Types of deposits		Types of loans	
Demand deposits	44.64	Long-term lending	47.94
Time deposits	55.36	Short-term lending	52.06
Total	**100.00**	**Total**	**100.00**

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

Type of financial institutions	Forex assets / Total assets			Forex liabilities / Total liabilities		
	2002	2003	2004	2002	2003	2004
Commercial banks	45.57	42.87	40.66	44.59	42.08	40.45

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

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		2002	2003	2004
	Revenues			
1	Interest revenues	901.4	1,120.1	1,338.0
2	Commission	250.0	354.9	501.7
3	Other revenues	102.3	189.0	208.6
4	Other operational revenues	23.6	41.3	143.6
5	Reserve settlement	19.5	29.3	69.7
6	Unanticipated revenues	0.2	0.5	0.1
	Total revenues	**1,297.0**	**1,735.1**	**2,261.7**
	Expenses			
1	Interest expenses	524.6	617.0	742.1
2	Commission	25.4	31.9	42.8
3	Other expenses	29.0	34.5	48.6
4	Other operational expenses	608.7	805.0	1 127.7
5	Allocation to reserve	59.4	115.2	119.9
6	Unanticipated expenses	0.0	0.0	0.0
	Total expenses	**1,247.1**	**1,603.6**	**2,081.1**
	Economic revenue	**49.9**	**131.5**	**180.6**

Excluding banks under liquidation

Structure of registered capital and own funds of financial institutes in 2004

Type of the financial institutions	Registered capital	/Total assets	Own funds	/ Total liab.
	EUR mln.	%	EUR mln.	%
Commercial banks	731.2	8.64	979.7	11.57

2004 DEVELOPMENTS IN THE BANKING SYSTEM OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

MACROECOMIC ENVIRONMENT

Recent macro trends reflect this issue. The momentum of economic growth appears strong. Assuming that the CPI is accurately gauging price trends, evidence from the velocity of money, tax ratios, and sectoral output indicators suggest that real output expanded in the upper end of the 5-6 percent range in 2004, buoyed by some 20 percent export growth and a continued expansion of credit to the private sector of somewhat 25 percent, with mining in the RS, and manufacturing and electricity in the Federation growing quickest. But, partly as a result of the buoyancy of demand, imports – including consumption goods – have surged. In this context, the external current account deficit strenghtened by just ½ a percent of GDP in 2004. Given structural constraints on supply, demand is growing as fast as it can consistent with avoiding a deterioration in the external balance.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL/GDP)

Banking sector in the Federation of BiH has maintained and improved existing trends and situation characteristic for past five years, especially during last two years. The growth trend continued; business indicators improved; capital base of the whole system became stronger; new foreign investments were attracted; deposits increased; credit portfolios enlarged; risks were controlled and reduced; stability of the whole sector was improved; network was expanded; new products were introduced; competition was fortified; higher level of working quality was achieved; international operational and examinational standards were applied.

In 2003 and 2004, the most significant changes could be summarized as growth of large banks, growth in general, positioning in the market and intensified competition.

Growth of larger banks and decreasing number of small banks: Raiffeisen Bank started its operations in BiH. At the same time, LT Gospodarska Bank Sarajevo was set up by merging Gospodarska Bank Sarajevo and LT Komercijalna Bank from Livno. Another "family" arrangement was created into UniCredit Zagrebačka Bank. Finally, HVB Central Profit Bank was "born" from merging HVB and Central Profit Bank, both owned by Bank Austria. We already received notice about merging of two Hypo Alpe Adria Bank-s in BiH.

Growth in general: At the end of 2000, 37 banks had banking license in F BiH, and there were 24 banks at the end of 2004. Inverted to this reduction, all other indicators increased in the observed period. By the analysis given by respectable London financial magazine, The Banker, among 50 banks from Central Europe two banks from F BiH have recorded the fastest growth of capital, assets and income in period 2001, 2002 and 2003.

Positioning: Taking better positions and taking up larger part of the market is process which lasts for several years. Participation of foreign share capital was about 2/3 of total share capital in banks in F BiH.

Competition: Strengthening and stabilization of the sector and its parts, solution of internal weaknesses and staff and organizational improvement resulted in more competition in market. Although opinion that interest rates are (too) high is not uncommon, the fact is that the rates are slowly, but definitely, getting lower and getting closer to lowest possible level. At the end of 2004 they were (IMF methodology: 8,23 – 9,92). On the other hand, the battle for attraction of deposits is visible, especially if we speak of long-term deposits by offering lucrative interest rates and other advantages offered by banks. The ratio between passive and active interest rates is getting close to the acceptable level. In the contest for clients, banks use new products such as issuance of cards or approving loans without guarantors, introduction of earmarked savings, housing loans, etc. Banks encourage more popular use of debit and credit cards as non-cash payment possibility. Banks invest significant effort and assets to increase this type of products. Only during last year they installed 97 new ATM and there are total 222 ATMs. AT the same time, number of POS terminals increased by 1,635 so it is possible to make payment of for goods in 5,587 POS.

Total balance sheet in banks in the Federation of BiH was KM 7.6 billion as of 12/31/04. In comparison to previous year it represents growth of 32% or KM 1.8 million.

In last five years, that is, in period from beginning of 2000 to end of 2004, balance sheet assets in banks increased by three times! Thanks to this growth, for the first time one of our banks took 41st position among 100 biggest banks in Central and Eastern Europe.

Balance Sheet, that is, assets in Balance Sheet are getting close to common European standard. Commonly used indicator of banks' strength is assets against GDP. In developed countries bank assets are twice or more times larger then GDP. In countries in transition the results are more modest. So, total assets in banks in Bulgaria are 50% of GDP, in Poland are 66% of, in Hungary 78%, in Croatia and Czech Republic little bit over 100%. By these criteria, **banking sector in the Federation of BiH has decent results because assets were 90,9% of GDP in 2004.**

The growth of balance sheet resulted from growth of deposits by KM 1.3 million or 31%, borrowings of KM 262 million which represents growth of 44% in comparison to the previous year and growth of capital by KM 193 million or 27%.

Total deposits, as major source of financial potential, reached KM 5.6 billion, and that is over 60% of estimated GDP. In other countries that ratio was: 40% in Poland and Hungary, 60% in Croatia and Czech Republic and 67% in Slovakia.

Total net income was KM 490.6 million in 2004 or 6% more than in 2003. In the income structure, the participation of net interest income from 51.8% in 2003 to 54.4% in 2004. It was obvious that growth of interest income (11%) was not followed by credit placements (28%). Main reasons for these trends were decreased interest rates, that is, credit margins, written off receivables and significant amount of suspended interest.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

A) Laws

1. Law on Banking Agency of the Federation of BiH ("Official Gazette of the F BiH", No 9/96, 27/98, 20/00, 45/00, 58/02, 13/03 and 19/03),
2. Law on Central Bank of BiH ("Official Gazette of BiH", No 1/97, 29/02 and 13/03),
3. Law on Banks ("Official Gazette of the F BiH", No 39/98,32/00, 48/01, 27/02, 41/02 and 58/02, 13/03, 19/03 and 28/03),
4. Law on Financial Operations ("Official Gazette of the F BiH", No 2/95, 13/00 and 29/00),
5. Law on Internal Payment System ("Official Gazette of the F BiH", No 15/00-cleared text, 54/01),
6. Law on Foreign Exchange Operations ("Official Gazette of the F BiH", No 35/98),
7. Law on Securities ("Official Gazette of the F BiH", No 39/98 and 36/99),
8. Law on Securities Registry ("Official Gazette of the F BiH", No 39/98 and 36/99),
9. Law on Securities Commission ("Official Gazette of the F BiH", No 39/98 and 36/99),
10. Law on Prevention of Money Laundering ("Official Gazette of the F BiH", No 8/00),
11. Law on Bill of Exchange ("Official Gazette of the F BiH", No 32/00 and 28/03),
12. Law on Check ("Official Gazette of the F BiH", No 32/00),

13. Law on Payment Transactions ("Official Gazette of the F BiH", No 32/00 and 28/03),
14. Law on Obligations ("Official Gazette of R BiH", No 2/92, 13/93 and 13/94 and "Official Gazette of the F BiH", No 29/03),
15. Law on Enterprises ("Official Gazette of the F BiH", No 23/99, 45/00, 2/02, 6/02-correction and 29/03),
16. Law on Bankruptcy Procedure ("Official Gazette of the F BiH", No 29/03),
17. Law on Liquidation Procedure ("Official Gazette of the F BiH", No 29/03),
18. Law on Labor ("Official Gazette of the F BiH", No 43/99, 32/00 and 29/03),
19. Law on Executive Procedure ("Official Gazette of the F BiH", No 32/03),
20. Law on Registration of Legal Entities into Court Registry ("Official Gazette of the F BiH", No 4/00, 19/00, 49/00, 32/02, 58/01, 13/03, 19/03 and 50/03),
21. Law on Administrative Procedure ("Official Gazette of the F BiH", No 2/98 and 48/99),
22. Law on Violations of Federal Regulations ("Official Gazette of the F BiH", No 9/96 and 29/00),
23. Law on Treasury in the F BiH ("Official Gazette of the F BiH", No 19/03),
24. Law on Bank Privatization ("Official Gazette of the F BiH", No 12/98, 29/00 and 37/01),
26. Law on Accounting ("Official Gazette of the F BiH", No 2/95, 14/97 and 12/98).

B) Prudential regulations issued by our Agency

1. Decision on Bank Supervision and Actions by the Banking Agency of the Federation of BiH ("Official Gazette of the F BiH", No 3/03),
2. Decision on Minimum Standards for Capital management in Banks ("Official Gazette of the F BiH", No 3/03 and 18/03),
3. Decision on Minimum Standards for Loan Risk and Assets Classification Management in Banks ("Official Gazette of the F BiH", No 3/03),
4. Decision on Minimum Standards for Risk Concentration Management in Banks ("Official Gazette of the F BiH", No 3/03, correction 6/03, 18/03),
5. Decision on Minimum Standards for Internal and External Audit in Banks ("Official Gazette of the F BiH", No 3/03),
6. Decision on Minimum Standards for Internal Control System in Banks ("Official Gazette of the F BiH", No 3/03),
7. Decision on Minimum Standards for Liquidity Risk Management in Banks ("Official Gazette of the F BiH", No 3/03),

8. Decision on Minimum Standards for Foreign Exchange Risk Management in Banks ("Official Gazette of the F BiH", No 3/03 and 31/03),
9. Decision on Minimum Standards for Operations with Related Entities in Banks ("Official Gazette of the F BiH", No 3/03),
10. Decision on Minimum Standards for Documenting Loan Activities in Banks ("Official Gazette of the F BiH", No 3/03),
11. Decision on Reporting about Non-performing Customers Considered a Special Loan Risk ("Official Gazette of the F BiH", No 3/03),
12. Decision on Minimum Scope in Form and Content of Program and Reporting about Economic-Financial Audit in Banks ("Official Gazette of the F BiH", No 3/03),
13. Decision on Reporting Forms Submitted by Banks to the Banking Agency of the Federation of BiH ("Official Gazette of the F BiH", No 3/03, 18/03 and 52/03),
14. Decision on Conditions when Bank is Considered Insolvent ("Official Gazette of the F BiH", No 3/03),
15. Decision on Minimum Conditions Banks have to Fulfill to Perform Internal Payment System ("Official Gazette of the F BiH", No 46/01),
16. Decision on Procedure for Determination of Claims and Distribution of Assets and Liabilities in Liquidation of Banks ("Official Gazette of the F BiH", No 3/03),
17. Criteria for Internal Rating of Banks by the Banking Agency of the Federation of F BiH ("Official Gazette of the F BiH", No 3/03, correction 6/03),
18. Decision on Minimum Requirements for Issuance of License to Perform Internal Payment System to Bank Branches Located in Republic Srpska ("Official Gazette of the F BiH", No 50/01),
19. Decision on Minimum Standards for Activities of Banks in Prevention of Money Laundering and Terrorism Financing ("Official Gazette of the F BiH", No 3/03),
20. Decision on Financial Disclaimer ("Official Gazette of the F BiH", No 3/03),
21. Decision on Interest and Fee Accrual for Dormant Accounts ("Official Gazette of the F BiH", No 7/03),
22. Decision on Amount and Conditions for Origination of Loans to Bank Employees ("Official Gazette of the F BiH", No 7/03),
23. Guidelines for Licensing and Other Approvals Issued by the Banking Agency of the Federation of the F BiH ("Official Gazette of the F BiH", No 46/02 and 18/03).

Legal competences of our Agency are as follow:

a) Issuing licenses for establishment of banks, licenses for changes of the organization and type of activities, and approvals for appointment of their managing staff;

b) Supervising banking operations, undertaking appropriate measures in accordance with law;
c) Revoking banking licenses in accordance with law;
d) Managing or supervising the procedure of rehabilitation or liquidation of banks, and starting the procedure of banks bankruptcy;
e) Declaring sub-legal acts regulating banks work;
f) Performing evaluation of conditions and issues approval to banks for next issue of shares;
g) Performing actions in the support of anti-terrorist measures related to banks;
h) Taking all such actions as may be appropriate, which may include the blocking of customer accounts in any bank or banks within the jurisdiction of the Federation Banking Agency, in order to prevent the funding of activities which are, or which threaten to be, obstructive of the peace implementation process as pursued under the aegis of the General Framework Agreement for Peace in Bosnia and Herzegovina and requiring the Central Bank of Bosnia and Herzegovina to open a special reserve account; requiring the bank of banks in which accounts are blocked under item h aforesaid and transfer criminal funds to the safe keeping of the Central Bank of Bosnia and Herzegovina, or one of its main units and undertake numerous actions related to above mentioned issues including revocation of banking liceses and other kinds of authorizations.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY

a) To make new steps to continue process to amend and develop the Laws, regulations and procedures in accordance with Core Basel principles and EU directives;
b) To start preparation of regulations for consolidated supervision of financial conglomerates;
c) To improve our precedures for dealing with week banks and banks under our Agency administration and liquidation;
d) To on-site examine more banks than previous year;
e) To improve our IT system and make iz 100% useable for off-site examination of banks and improve reporting system;
f) To make our banking industry more stable and more atractive for foreign capital; and so on.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

a) Numerous activities related to improvement of our prudential regulations;
b) Comprihensive on-site examinations in 12 banks;
c) 65 targeted on-site examinations;
d) Colection and analysis of about 30 reports, per bank, per quater, plus monthly balance-sheets, dayly reports on FX position by 24 banks and so on;
e) 4 regular (quaterly) informations about banking system and a number ad hoc informations for internal and external needs;
f) Participation in the work of BSCEE;
g) Participation of our empyees in 7 seminars outside our Agency including outside our country and 3 internal seminars; and so on.

INTERNATIONAL ACTIVITIES OF THE AUTHORITY

Our Agency has already signed MoU with supervisory authorities of 3 countries, and currently we are in negotiations with another 3 authorized authorities.

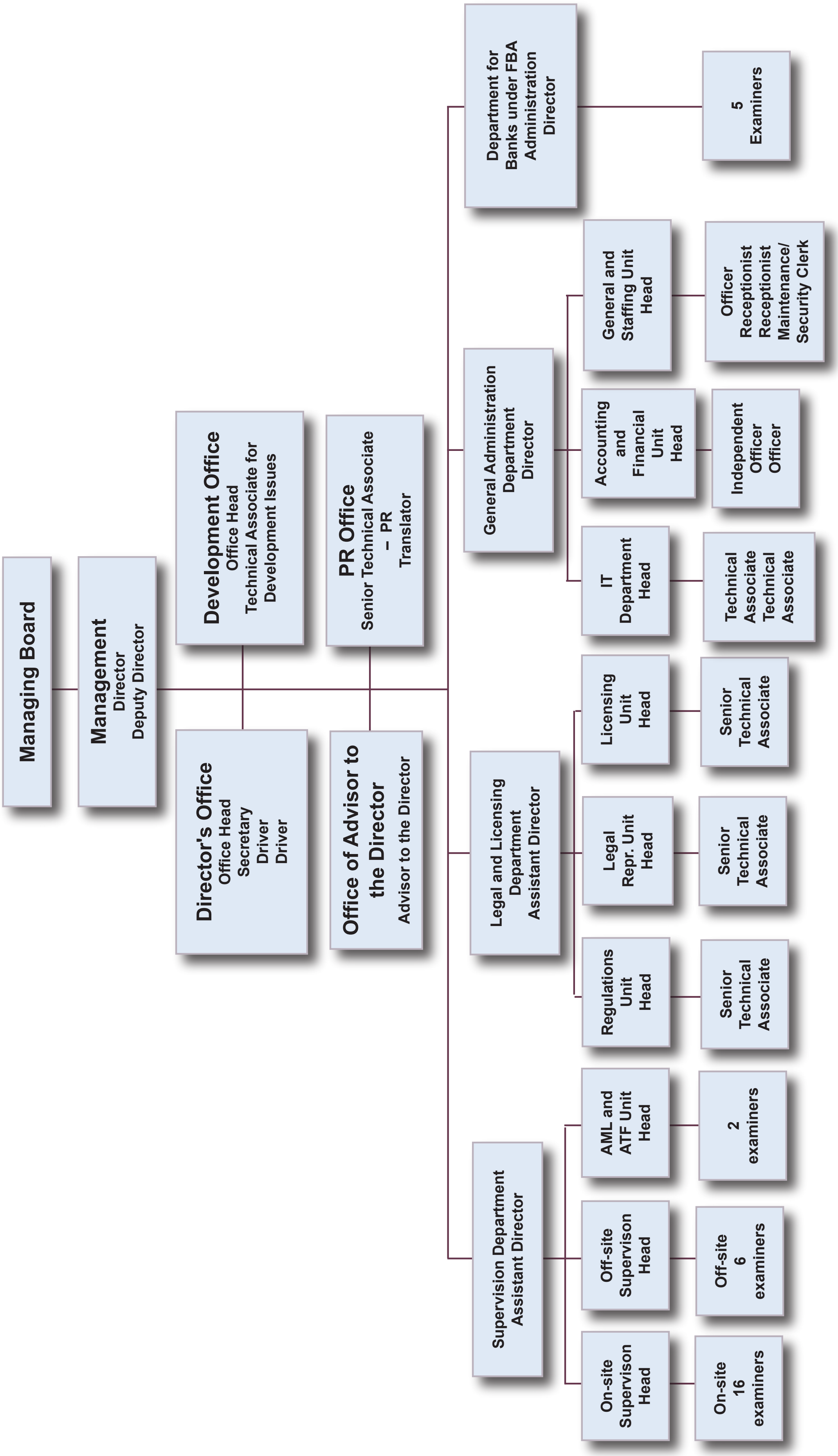
COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

Our Agency strongly cooperates with Central banka of Bosnia and Herzegovina (MoU); banking Agency of Republic Srpska; Deposit Insurance Agency in Bosnia and Herzegovina (MoU); Insurance supervision Agency (MoU); and with all other institutions including issues of prevention of money laundering and combat finance terrorism.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF 2004

We were strongly working on bilding of unique banking supoervision authority under «ambrela» of Central bank of Bosnia and Herzegovina. It was not finished.

BANKING AGENCY OF THE FEDERATION BIH



STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2002	2003	2004
Banks	29	27	24
Financial institutions, total	**29**	**27**	**24**

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

Item	2002	2003	2004
Public sector ownership	12.8	12.6	17.8
Other domestic ownership	20.5	19.2	17.4
Domestic ownership total	*33.3*	*31.8*	*35.2*
Foreign ownership	66.7	68.2	64.8
Financial institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of financial institutions on the basis of assets total (%)
BANKS

Item	2002	2003	2004
Public sector ownership	7.9	6.4	4.9
Other domestic ownership	16.4	14.7	15.8
Domestic ownership total	*24.3*	*21.1*	*20.7*
Foreign ownership	75.7	78.9	79.3
Financial institutions, total	**100**	**100**	**100**

Concentration of asset by type of financial institutions (%)

Type of financial institution	The first three largest	The first three largest
Bank	58.1	72.9
Financial institutions, total	**100.0**	**100.0**

Return on asset (ROA) by type of financial institutions

Type of financial institution	2002	2003	2004
Bank	0.36	0.88	0.72

Return on equity (ROE) by type of financial institutions

Type of financial institution	2002	2003	2004
Bank	3.00	8.17	6.89

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

Assets	2002	2003	2004
Cash and securities	36.4	36.1	37.8
Placements to other banks	0.4	0.6	1.1
Loans – net value	54.6	56.1	55.0
Premises and oth. fixed ass.	6.4	5.3	3.9
Other assets	2.2	1.9	2.2
Liabilities	**2002**	**2003**	**2004**
Deposits	76.8	74.4	73.6
Borrow. from banks	0.1	0.1	0.1
Loans payables	6.8	10.2	11.2
Other liabilities	2.7	2.9	3.2
Capital	13.6	12.4	11.9

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

Type of financial institution	2002	2003	2004
Banks	15.11	12.96	16.1

Solvency ratio of financial institutions liab./assets (%)

Type of the financial institution	2002	2003	2004
Banks	86.4	87.6	88.1

Asset portfolio quality of the banking system %

Asset classification	2002	2003	2004
A	85.9	87.2	88.4
B	8.8	8.4	8.2
C	2.7	2.3	1.6
D	2.5	2.0	1.8
E	0.1	0.1	-
Classified total	**100.0**	**100.0**	**100.0**
Specific reserves	**21.8**	**20.4**	**18.1**

** % of classified asset (B,C,D,E)*

The structure of deposits and loans in 2004 (%)
(at year-end)

	Deposits	Loans
Households	38.8	48.4
Government sector	10.7	0.8
Corporate	29.7	48.3
Foreign	-	-
Other	20.8	2.5
Total	**100.0**	**100.0**

The structure of deposits and loans in 2004 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	47.5	Long term loans	72.8
Within one year	15.8	Medium-term loans	-
Over one year	36.7	Short-term loans	27.2
Total	**100.0**	**Total**	**100.0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2002	2003	2004	2002	2003	2004
Banks	32.8	26.8	27.8	59.7	52.6	54.2

Structure of registered capital and own funds
of financial institutions in 2004

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	000 EUR	%	000 EUR	%
Banks	389,278	10.0	74,288	1.9

2004 DEVELOPMENTS IN THE BULGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2004 Bulgaria's economy managed 5.6% growth. The past year was the seventh in a row to see Bulgaria attaining relatively high growth. The greatest contribution to *Gross domestic product* came from households' consumption and investment in fixed assets. Growth in goods and service imports outstripped that of exports, with the balance of payments contributing negatively to GDP growth. This negative contribution was much smaller, however, due to acceleration of export growth. *Final household expenditure* grew by 5.5% in real terms. A trend towards more favourable consumer expenditure patterns has emerged over the past few years, indicating gradual lifestyle improvements. *Consumer demand* growth boosted *retail trade*, which grew by 13.8% in real terms year on year. Dynamic trade boosted *budget revenues* from *indirect taxes*, as well as the demand for cash. *Fixed capital investment* grew by 12% in real terms. The increase in non-government sector lending (by a nominal 74.8% to households and 38.3% to non-financial corporations) provided additional funds for consumer spending and investment.

The rate of export growth was an important driver for the high rates of industrial increase in 2004. Goods and services exports in euro grew by 20.1% over the previous year. The contribution of exports to GDP growth exceeded almost twofold that of household consumption. Increased domestic demand was the main driver of imports growth. Balance of payments data shows *goods and services imports* in euro growing by 19.9%.

Increasing employment was an important factor in household income growth and hence consumption. Employment growth was pronounced in sectors with prevailing private ownership and is a reflection of increased economic activity. The registered *unemployment rate* fell to 12.2% or 1.3% lower than in late 2003.

Average annual inflation in 2004 was 6.2%, and is largely a reflection of price developments in 2003. End of period inflation was 4%. International crude oil prices were an inflationary factor, which had a direct effect on fuel prices and, with a lag, on transportation, other services and commodities. The declining unit labour costs in industrial production, as well as stable international prices of imported consumer goods helped keep *CPI inflation* down.

Growth rates of monetary aggregates in 2004 remained high due to the increased amount of cash transactions, increased banking system deposits, and a continuing credit expansion. Monetary aggregate M3 rose by 23.1%. *Quasi-money*, including deposits with maturities of up to two years and deposits redeemable at notice of up to three months, grew by 18.6%.

Gross international foreign exchange reserves reached EUR 6.770 billion in end-2004, growing by EUR 1461 million over the end of 2003.

DEVELOPMENT IN THE BANKING SYSTEM

In 2004 the Bulgarian banking sector was made up of 35 banks, incl. 29 local banks or subsidiaries of foreign banks and 6 foreign bank branches. Banking privatization was finished with the deal for Bank DSK in 2003 (his new owner is the Hungarian OTP Bank). Only Nasarchitelna Banka (Encouraging Bank) remains in state ownership. In 2004 Hebros Bank was absorbed by Bank Austria subdivision in Bulgaria HVB Bank Biochim. The share of bank assets controlled by foreign banks and other foreign investors was 82%. Most of the large Bulgarian banks belong to international banks and financial groups.

Commercial banks behaviour over 2004 was characterized by greater lending, with the quality of assets remaining high. *Earnings* were high, ensuring adequate returns on assets and equity. The higher 2004 result (421 mio BGN against 319 mio BGN in 2003) predetermined a 2.06 % return on assets (ROA) against 2.04 % in 2003, and 20.02 % return on equity (ROE) against 18.73 % in 2003.

The total amount of commercial bank assets grew by 7.5 bn BGN to 24.9 bn BGN, a 43.57 % growth. Lending increased by 47.15 %, showing the most dynamic development. Deposits grew by 5.9 bn BGN or 43.58 %. The banks' capital base rose by 7.78 %.

Transactions throughout 2004 continued to sharpen banking system *risk profile*. *Credit risk* remained the major risk for most banks despite various supervisory and financial measures initiated to curb lending growth. During the last 12 months foreign financing attracted by banks increased as a result of significant bank innovations and banks ambition for extending market niches. This meant enhanced competition between commercial banks. New bank product prices tended to fall, especially in the consumer and mortgage segments.

Sensitivity to *currency risk* remained low. Major banks kept US dollar positions short and euro ones long. The system position was short, accounting for 4.39 % of equity.

Price risk played an insignificant role in the banking system balance sheet. Despite some banks pursuit for increasing trading activities with investment instruments up to quite high level of market speculation, sensitivity to changes in securities prices and interest rate levels was low.

Enhanced lending was the leading idea of 2004 commercial bank behaviour. Despite significant lending growth *the quality of assets* remained good. Most banks had to devote more and more financial and human resources to managing their sizable credit volumes. By the end of 2004 classified assets accounted for 3.86% of total banking assets against 4.26 % at the end of 2003. Classified loans comprised 7.06 % of total bank credit (against 7.97 % at the end of the previous year).

Intensive 2004 credit growth, coupled with a steady increase in interest income and income from fees and commissions allowed banks to counterbalance the effect of the funding price rise to some extent and narrowed interest rate spreads. With the greater number of new products and services in both lending and deposits, fee and commission earnings became more significant. On the other hand, the change in the makeup of the sources of financing (as regards funds borrowed from abroad to make up insufficient domestic resource) slowly pushed up asset funding rates. The increase in non-interest expenditures did not exert serious pressure on banks' profitability due to the ability to generate economies of scale. The extraordinary profit remained an income component in only a few banks, and the effect of foreign exchange operations was insignificant. In most banks, credit and market risk levels did not worsen the quality and quantity of earnings due to additionally allocated provisions and did not imply significant interest rate fluctuations on earnings.

A gradual worsening of commercial banks *capital positions* characterized the last 12 months. This involved both the structure and volume of asset risk components and capital base growth. Against 43.57 % asset growth and 47.15 % credit growth in 2003, the capital base grew by 7.78 % to 2.3 bn BGN, a major factor behind falling capital indicators. Regulatory ratios were also affected by the amendments to Regulation No. 8 of the BNB establishing the mechanism for including current profit into banks' capital bases. Despite the capital adequacy ratio falling from 22.20 % at the end of 2003 to 16.58 % at the end of 2004, banking system excess capital was 641 mio BGN against 989 mio BGN at the end of 2003.

Banking *liquidity* in 2004 remained high. Liquidity was among the banking system financial indicators which have sustained their basic characteristics for over 12 months. Most banks' indicators were good, allowing more flexible asset management. There were no signs of depositor nerves, this ensuring stable funds and conditions for longer-term investment decisions (including increased lending). In 2004 banks succeeded in maintaining asset and financing structures, ensuring adequate liquidity.

LEGAL AND INSTITUTIONAL FRAMEWORK FOR OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS
NEW DEVELOPMENTS; LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN BULGARIA

The Law on Banks is the primary law on banking. Together with other laws such as the Commercial Law, the Law on Securities, Stock Exchanges and Investment Companies, the Law on Accounting and the Law on Measures against Money Laundering, it creates the legal base for banking in Bulgaria.

The Law on the BNB defines its supervisory task as regulation and supervision over activities of other banks in the country for the purpose of ensuring the stability of the banking system and protecting depositors' interests. The laws and a number of prescribed, in forms of detailed Regulations, issued by the Management Board of BNB, provide minimum prudential standards that banks must meet.

New developments

Bulgarian bank legislation is harmonized to a high degree with EU law. In 2004 the BNB helped prepare amendments to the legal framework regarding the central bank, the banking sector, and payment systems aimed at further harmonization with *acquis communautaire*. BNB goals were to adopt the amendments in the shortest time, thus enabling the banking sector to prepare for participation in the EU internal market. The prepared amendments were discussed with representatives of the banking sector. With a view to full harmonization with EU law, legislation was drafted, the main *foci* being central bank independence, banks' capital adequacy, fund transfers, electronic payment instruments, and payment systems.

By the final adoption of the Amendments to the Law on the Bulgarian National Bank in early 2005, the Bank's legal framework was brought into line with *acquis* and with commitments negotiated on the *Economic and Monetary Union* Chapter, while retaining the currency board conditions and principles. According to the amendments, the primary objective of the Bulgarian National Bank is "to maintain price stability through ensuring the stability of the national currency." Additional guarantees related to institutional, personal, financial and functional central bank independence were introduced in compliance with the Treaty Establishing the European Community and with the Statutes of the European System of Central Banks (ESCB) and the European Central Bank (ECB). Other amendments pertain to payment systems oversight, protection of banknotes and coins against counterfeiting, and central bank internal audit. The amendments to the Law introduced complete prohibition of government financing by the central bank.

The BNB amended its *Regulation No. 9* on the evaluation and classification of risk exposures of banks and the allocation of provisions to cover impairment losses. The former Doubtful and Loss Exposures have been merged into a Nonperforming Exposures group on which not less than 100 % provision is required. The maximum default term for an obligation classified under this group has been cut from 180 to 90 days. Conditions under which banks restore restructured exposures to more favourable groups have been tightened.

In April 2004 Regulation *No. 8* on the capital adequacy of banks was amended by setting out terms under which banks may include current profits into primary capital. The amendments provide for applying risk weights which correspond to the guarantor's risk weight on the guaranteed portions of bank exposures partially covered by zero-risk or low-risk assets.

In 2004 seminars and consultations with experts from the French and Dutch central banks were organized under their *Twinning Covenants* with the BNB. They addressed the introduction of capital requirements on market risk in determining banks' capital adequacy ratios according to the specific Bulgarian conditions and in compliance with EU directives.

In fulfillment of pre-accession commitments by the close of the year, a new *Regulation No. 8* on the capital adequacy of banks was adopted to include market risk capital requirements. The changes addressed the banks forming significant trading portfolios of financial instruments. Banks may apply two approaches to measuring and reporting market risk (a function of capital requirement from the second half of 2005): a standard one, or one based on value-at-risk (VaR) internal models. The standard approach will be mandatory for initial measuring of market risk, while the internal models applied by banks will be recognized for supervisory purposes where sufficient expertise is demonstrated and a number of qualitative criteria is met.

The new Regulation on bank capital adequacy provides for greater precision in reporting risks faced by the banks and ensures the relevant capital coverage under existing credit risk requirements. Credit risk weights are retained and include an additional requirement to mortgages loans risk-weighted at 50 % that the amount of loan may not exceed 70 % of property value. Where this ratio is violated, exposures have to be assigned a 100 % risk weight. The new requirements are expected to help restrain excessive credit risk in mortgage lending.

In line with the above, amendments to *Regulation No. 7* on the large exposures of banks provide for an equal approach by recognizing partial guarantees in computing regulatory limits. The scope of exceptions for certain cases was widened to include banks' exposures to parent banks or subsidiary credit institutions within local or foreign bank groups. The range of related entities covered by constraints for related entities lending has been extended. An additional provision on measuring and reporting large trading portfolio exposures was included.

Supervisory report forms were changed to reflect amendments to the above regulations. New capital adequacy report forms accounting for market risk are pending.

Legal competence of the Banking Supervisory Authority

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

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2004

By the end of June 2004 the Basle Committee on Banking Supervision adopted the new *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*. The new capital adequacy framework known as Capital Accord II, and Bulgaria's pending accession to the European Union in 2007, predetermined Bulgaria's banking supervision strategy. It complies with EU Commission views on establishing a common financial services market, and with the European supervisory framework on financial services.

To accomplish these goals and cope with the ensuing challenges, the Banking Supervision Department announced to the banking community its plan for preparing and applying the new capital requirements consistent with the expected amendments to Directive 2000/12/EC on credit institution activity. A special working group aims to organize an efficient and timely implementation of the Banking Supervision Department's major task. Specialized subgroups within it shall design a new national framework for measuring and reporting risk and capital requirements to banks.

ACTIVITY OF THE BANKING SUPERVISION AUTHORITY

Following a cycle of surveys on the development of the Bulgarian economy and consultations with the International Monetary Fund, a new review under the Financial Sector Assessment Program (FSAP) was prepared in 2004. It included financial market developments in the context of macroeconomic growth and the need to maintain stability. Along with a positive assessment on the BNB's enhanced institutional capacity and on regulatory framework progress, the banking sector and banking supervision section also included possible measures to curb lending and balance banks' lending policy.

Supervisory on-site inspections primarily aimed to identify risk zones and levels, and determine managements' capability to measure, control and manage risks effectively. Also checked were: capital adequacy, shareholder quality (support), credit risk (extent and management), management actions, internal rule and procedure quality, observance of banking legislation, earnings adequacy and trends, liquidity management, market risk (extent and management), off-balance sheet commitment risks, the scope and quality of internal control, and information technology reliability. Given enhanced lending, more than 70% of on-site inspection time was spent reviewing and assessing asset quality. Breaches found involved mostly incorrect classification of risk exposures, credit concentrations exceeding statutory limits, insufficient methodology for reporting credits through the method of net current value based on the effective interest rate and impairment of risk exposures under International Accounting Standard 39.

In 2004 major emphases in off-site supervision involved:

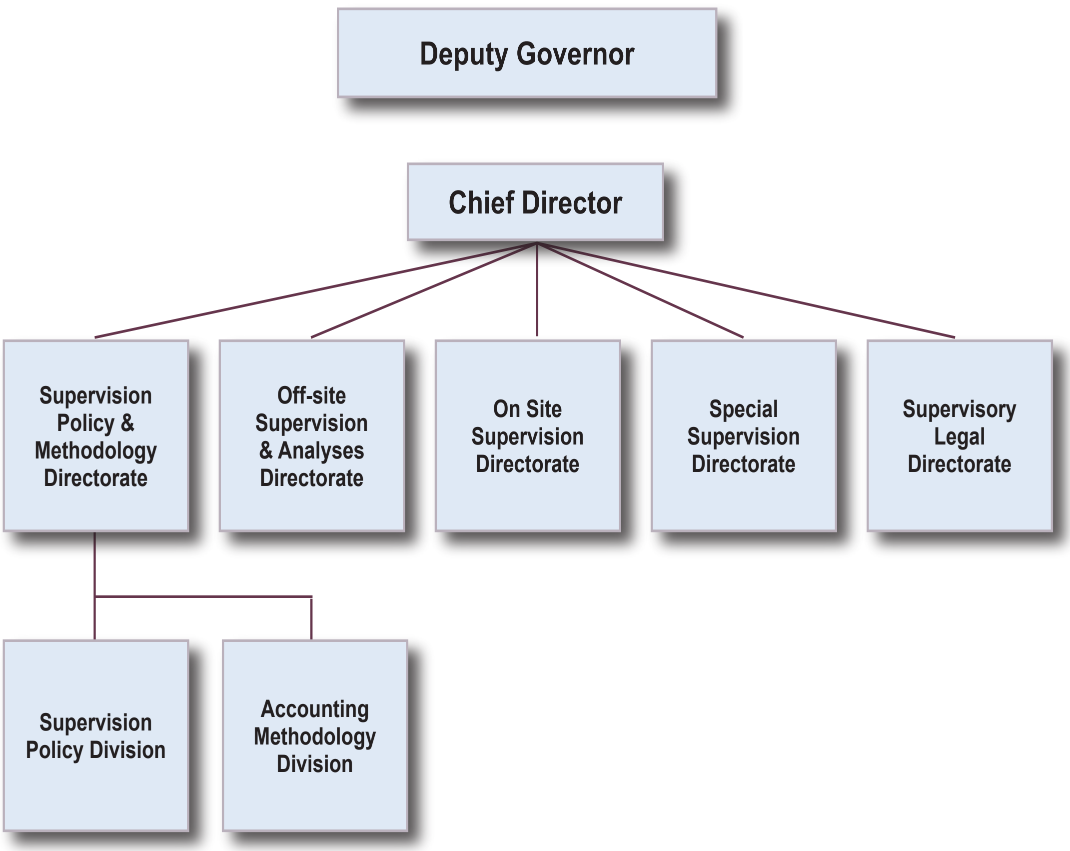
- Analysis of commercial banks' current performance based on financial reports submitted for supervisory purposes;
- Assigning three-month CAMELS ratings by four components: capital adequacy, asset quality, earnings, and liquidity, and identifying the respective trend in the risk profile of each commercial bank (steady, downward, or upward);
- Preparing three-month analyses of banking system performance, including reviewing major trends and risk zones and modeling the direction and sharpness of future risks based on stress tests;
- Analyzing the financial performance of foreign institutions with subsidiaries in Bulgaria with regard to financial backing where necessary.

Dynamic credit institution development through 2004 entailed a number of changes to update market profiles and improve service quality. Organizational structures, information and management information systems, and control mechanisms in banks changed, key personnel to drive the changes through were recruited, flexible staff training was introduced, and closer interdependence between performance and personal responsibility was brought in. Remarks addressed to banks' senior management were associated mostly with supervisory violations, the lack of comprehensive strategies, the need to improve market and operational risk assessment, imprudent dividend policies, and insufficient shareholder support.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISION AUTHORITY

In parallel with the work on the regulative framework, the Banking Supervision Department has been working on its institutional set-up. Banking supervision performs its functions with a staff of 76 persons, divided into five directorates. The overall structure of Banking Supervision is developed according to the internationally accepted norms and practices.

Banking Supervision Department



INTERNATIONAL ACTIVITIES OF AUTHORITY

The two-year PHARE 2001 program financed project on cooperation between the BNB and the French and Dutch central banks was completed in September 2004. Its essential purposes were to improve BNB administrative capacity, to adopt and apply European Community law, and to introduce best European practice to the BNB in the process of preparing for membership in the European System of Central Banks and the financial system of the European Union.

The project was implemented in two stages. In the first year specialists from the BNB and the French and Dutch central banks analyzed BNB organization, functions and activities with a view to identifying divergences from EU and ESCB requirements and to defining specific action for the 11 components of the agreement. During the second stage BNB specialists and their French and Dutch partners conducted various actions in order to improve BNB organization and operations, and raise staff qualifications.

The Strategy for Bulgarian National Bank Development between 2004 and 2009 was prepared with the help of partners from the French central bank. Based on it, a Road Map of measures and terms for their implementation was designed with a view to preparing the BNB for its full ESCB and Eurosystem membership.

Two bilateral cooperation agreements were signed with the French and Dutch central banks. One of the main *foci* is banking supervision along with other areas such as accountancy, foreign exchange reserve management, statistics, cash operations, and BNB preparations for participation in ESCB monetary operations.

As part of the Bank's preparation for the forthcoming BNB membership in the ESCB and in relation with its 125th anniversary, in June 2004 a seminar was held on challenges facing the BNB on its way. Lecturers from the central banks of France, the Netherlands, and Poland presented the ESCB and Eurosystem's institutional organization, the role of national central banks, the changes stemming from EU accession, and the challenges to central banks associated with European System of Central Banks membership.

In 2004 the BNB signed a new memorandum with The Commission Bancaire of France. The memorandum aims to regulate and facilitate the exchange of bank information and supervisory cooperation. Signing of a similar memorandum between the BNB and the Turkish supervisory body is pending. Thereafter, countries which own banks in Bulgaria and countries where Bulgarian banks operate through branches or subsidiaries will be fully covered.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BULGARIA

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

STATISTICAL TABLES

Number of financial institutions
(operating at year -ends)

Type of financial institution	2002	2003	2004
Commercial Banks	34	35	35
of which:			
Large banks*	3	3	5
Small and medium-sized banks	25	26	24
Foreign bank branches	6	6	6
Nonbanking financial institutions	72	83	84
Leasing companies	39	45	60
Fianancial institutions, total	**145**	**163**	**144**

** Banks with total assets over 1 milliard EUR in 2004*

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

Item	2002	2003	2004
Public sector ownership	13.0	3.4	3.1
Other domestic ownership	20.4	20.3	22.6
Domestic ownership total	*33.4*	*23.7*	*25.7*
Foreign ownership	66.6	76.3	74.3
Banks, total	**100.0**	**100.0**	**100.0**

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

Item	2002	2003	2004
Public sector ownership	14.23	0.42	0.38
Other domestic ownership	12.25	16.91	18.01
Domestic ownership total	*26.48*	*17.33*	*18.39*
Foreign ownership	73.52	82.67	81.61
Banks, total	**100.00**	**100.00**	**100.00**

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

Type of institutions	The first 3 largest	The first 5 largest
Commercial banks	36.26	52.19
Nonbanking financial institutions	72.00	80.19

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

Type of institutions	2002	2003	2004
Commercial banks	2.05	2.04	2.06
Nonbanking financial institutions	1.37	0.69	2.57

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

Type of institutions	2002	2003	2004
Commercial banks	16.20	18.73	20.02
Nonbanking financial institutions	5.82	4.79	20.38

Distribution of market shares in balance sheet total (%)

Type of institutions	2002	2003	2004
Commercial banks	99.15	98.85	98.73
Nonbanking financial institutions	0.85	1.15	1.27

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

Type of bank	2002	2003	2004
Large banks	5.0	8.8	13.9
Small and medium-sized banks	20.6	19.6	15.6
Banks, total	**13.8**	**14.6**	**14.8**

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

Assets	2002	2003	2004
Cash in vault & funds in current account with BNB	8.6	9.4	10.7
Due from banks & other financial institutions	24.2	14.9	15.8
Securities in trading portfolio	11.8	8.6	8.7
Loans extended to non-financial institutions and other clients	41.2	52.0	53.6
Securities in investment portfolio	7.6	10.0	7.3
Fixed assets	4.6	4.6	3.4
Other assets	2.1	0.6	0.5
Total assets	**100.0**	**100.0**	**100.0**
Liabilities and capital	**2002**	**2003**	**2004**
Deposits by banks and other fin. institutions	8.4	8.6	11.2
Deposits by NFIs and other clients	68.6	70.0	67.3
Total deposits	77.0	78.5	78.5
Other liabilities	9.4	8.0	10.0
Subordinated debt	0.0	0.4	0.5
Capital	6.4	5.4	4.1
Reserves	7.2	7.8	6.9
Total liabilities & own funds	**100.0**	**100.0**	**100.0**

Solvency ratio of banks

Type of banks	2002	2003	2004
Large banks	28.7	27.7	15.9
Small and medium-sized banks	23.3	18.8	21.9
Banks, average	**25.2**	**22.2**	**16.6**

Asset portfolio quality of the banking system

Assets classification	2002	2003	2004
Amount in BGN Millions	10,067,439	11,568,572	17,725,769
Standard %	93.5	93.5	94.5
Watch %	2.9	3.1	2.7
Substandard %	1.0	0.8	1.2
Doubtful* %	0.5	0.6	1.6
Loss* %	2.1	2.0	
Classified total %	**100.0**	**100.0**	**100.0**
Specific reserves %	**4.9**	**3.7**	**2.7**

** The BNB amended its Regulation N 9 on the evaluation and classification of risk exposures of banks and the allocation of provisions to cover impairment loss. The former Doubtful and Loss Exposures have been merged into a Non-performing Exposures group on which not less than 100 per cent provision is required.*

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

Item	2002		2003		2004	
	Deposits	Claims	Deposits	Claims	Deposits	Claims
Households	47.7	9.2	47.3	19.1	41.2	22.2
Government sector	3.5	13.8	6.6	0.2	4.7	0.1
Corporate	38.8	44.8	35.8	56.9	32.1	51.8
Foreign	8.7	26.4	10.3	16.1	22.0	15.8
Other	1.3	5.8	0.0	7.7	0.0	10.1
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

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

Deposits	2002	2003	2004	Claims	2002	2003	2004
At sight	47.1	47.0	46.5	Short term	65.7	52.0	52.6
Within one year	48.5	44.0	42.6	Medium term	30.3	35.7	30.5
Over one year	4.4	8.9	10.9	Long term	3.8	12.2	16.8
				Other	0.2	0.1	0.1
Total	**100.0**	**100.0**	**100.0**	**Total**	**100.0**	**100.0**	**100.0**

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

Type of banks	FOREX assets/total assets			FOREX liabilities/total liab.		
	2002	2003	2004	2002	2003	2004
Large banks	51.5	45.8	50.8	53.4	47.8	56.4
Small and medium-sized banks	56.5	51.7	54.6	57.8	56.1	58.6
Foreign bank branches	65.6	53.9	40.4	67.2	36.8	41.2
Banks, average	**54.9**	**49.4**	**51.6**	**56.6**	**51.7**	**56.0**

Structure of registered capital and own funds of banks in 2004

Type of Banks	Registered capital / Total assets		Own funds / Total liab.	
	EUR in thous.	%	EUR in thous.	%
Large banks	224,332	3.4	805,573	13.8
Small and medium-sized banks	301,488	5.0	591,368	10.8
Banks, average	**525,820**	**4.1**	**1,396,940**	**12.3**

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

BGN millions

Revenues	2002	2003	2004
Interest earned	740	1,015	1,408
Net income from fees and commissions	238	264	332
Securities income/loss (net)	148	60	89
Forex operations income/loss (net)	41	34	40
Other banking operations revenues	0	60	44
Extraordinary revenues/expenses (net)	11	8	10
Total revenues	**1,178**	**1,441**	**1,923**
Expenses			
Interest paid	218	261	365
General operating costs	602	721	892
Reserve and provisions creation/ reintegration (net)	12	43	143
Other operating costs			
Total expenses	**820**	**982**	**1,257**
Pre-tax profit	346	416	523
Taxes	84	97	102
Net profit	**262**	**319**	**421**

2004 DEVELOPMENTS IN THE CROATIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In Croatia, the year 2004 saw economic growth and low inflation. Real GDP grew at a rate of 3.8%, which was a relatively lower growth rate than the 4.3% GDP growth rate registered in 2003. The average inflation rate went up from 1.8% in 2003 to 2.1% in 2004. In addition to a slowdown in the growth of investments this lower growth rate of real GDP was influenced by a mild slowdown in the growth of personal and government consumption. Fixed capital formation slowed down in 2004, while capital investments grew by 4.4% in real terms, down 12.4 percentage points as compared to 2003. Despite stronger growth of foreign sources of finance private investments also slowed down. The slowdown in the growth of investments also contributed to the slowdown in the growth of total imports in 2004. Exports of goods and services also grew at a slower rate, however, still faster than imports, which contributed towards redressing the imbalance in international trade. The average rate of administrative unemployment totalled 18.5%, i.e. 0.2 percentage points less than at the end of 2003, while the average real salary grew by 3.8% in 2004. The average daily exchange rate of the kuna against the euro grew nominally by 0.9% as compared to 2003. The long-term appreciation trend of the nominal kuna exchange rate against the dollar continued through 2004, when the the kuna strengthened 7.9% against the dollar. At the end of 2004, external debt totalled 82.1% of GDP, largely due to the inflow of foreign capital. As a result, in 2004 the CNB policy was directed at limiting external debt growth by discouraging the borrowing of domestic commercial banks abroad. Banks' external debt amounted to 33.7% of the total external debt of the overall economy. The balance of payments deficit reduced by 1.2 percentage points as compared to 2003 and in 2004 amounted to 4.6% of GDP. In 2004, exports of goods totalled EUR 6.5bn and imports of goods EUR 13.3 bn.

BANKING SYSTEM

At the end of 2004, the banking system of the Republic of Croatia comprised 37 banking institutions and 4 housing savings banks, which is 4 less than at the end of 2003. The total number of banks in 2004 reduced as a consequence of the decrease in the number of banks in majority foreign ownership. The reason for this is to be found in the continuation of the consolidation process in the banking system and merger of banks with their parent banks. The number of banks in total or majority private ownership of domestic shareholders did not change in 2004. At the end of the year, total assets of banks and housing savings banks stood at HRK 234.7bn or 110.7% of GDP. As a result of the rise in assets of individual banks in majority or total foreign ownership their share in total bank assets went up in 2004 to 91.3% as compared to 2003. The remaining 8.7% of total bank assets were made up by the assets of two banks in domestic state ownership and the assets of 20 banks in domestic private ownership. In 2004, the largest number of banks was owned by Italian shareholders (7 banks), six banks were owned by Austrian shareholders, while one was owned by German shareholders and one by shareholders from Great Britain.

The banking system was dominated by six largest banks in majority foreign ownership, including the two largest banks, which at group level account for 43.9% of total banking system assets.

Total bank assets increased by 12.3% on 2003. This was largely influenced by the growth of net loans, up 14.2% on 2003. Loans accounted for the largest share (54,6%) in the asset structure at end-2003, up 0.8 percentage points on a year earlier. As over the previous years, in 2004 banks continued intensifying their activities in the segment of household lending, which led to household loans accounting for one half of the loans in the structure of total approved loans, while all other sectors together accounted for the remaining half. To finance this growth banks used funds collected through an increase in deposits and received loans. Deposits predominated in the bank liability structure at the end of 2004 with a share of 67.7%, rising at a rate of 8.1% as compared to 2003. As over the previous years, the majority of deposits were denominated in foreign currency (67.2%). The share of loans received from financial institutions and other loans increased from 15.8% at the end of 2003 to 17.4% at the end of 2004. The lion's share of total loans was received from foreign financial institutions (75.5%), largely from parent banks.

At end-2004, banks' regulatory capital totalled HRK 21.1bn, up 9.6% as compared to end-2003 when it stood at HRK 19.3bn. Bank capital adequacy ratio reduced from 16.2% at end-2003 to 15.3% at end-2004. All banks posted capital adequacy ratios at levels exceeding the minimum statutory limit of 10%. The reason for the reduction of capital adequacy ratio is the faster growth of risk weighted assets over regulatory capital. In addition, the decline in capital adequacy ratio was also influenced by the implementation of the Decision on the Capital Adequacy of Banks, as a result of which exposure to currency risk, position risk, settlement/counterparty risk and risk of exceeding the permissible exposure limit are included in the calculation of the capital adequacy ratio.

Total placements and contingent liabilities went up 14.8% as compared to 2003. Increase in borrowing combined with quality new debtors and adequate instruments of collateral contributed to the increase of fully recoverable placements (group A), which increased by 19.33% as compared to 2003 and accounted fro 95.4% of total placements. The share of total bad placements (groups B and C) in total gross placements amounted to 4.6%, the lowest ratio in the past three years. Total value impairments and provisions for contingent liabilities, which include provisions for unidentified losses, went up 3.5% on 2003. However, resulting from the increased rate of growth of placements and contingent liabilities and better quality of positions exposed to credit risk, their share in total placements fell from 4.1% in 2003 to 3.7% in 2004.

In 2004, banks generated profits 21.2% higher than in 2003, which pushed up the profitability indicators, that is, the rate of return on average assets (ROAA) and the rate of return on average equity (ROAE). ROAA went up from 1.6% at the end of 2003 to 1.7% at the end of 2004, while ROAE rose from 14.5% to 16.1%. The largest contribution to the increase in profits came from net non-interest income which went up 31.3% on 2003, while net interest income increased by 2%.

The banking system was liquid in 2004, with banks having no problems in servicing their obligations. The ratio of total deposits to approved loans increased from 76.6% at the end of 2003 to 80.7% at the end of 2004. Total received loans increased by 23.7% in 2004 as compared to 2003. Since their growth outstripped the growth of assets, the ratio of received loans to total assets increased from 15.8% at end-2003 to 17.4% at end-2004.

THE LEGAL AND INSTITUTIONAL FRAMEWORKS OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS AND LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The financial sector of the Republic of Croatia consists of banks, housing savings banks, insurance companies, investment funds, leasing companies and savings and loan associations. The Croatian National Bank is authorised to supervise the operations of banks and housing savings banks. The Croatian Securities Commission is authorised to supervise the operations of the securities market, while the operations of insurance companies are supervised by the Directorate for Supervision of Insurance Companies. The Agency for Supervision of Pension Funds and Insurance supervises the operations of pension funds, while the Ministry of Finance of the Republic of Croatia supervises the operations of savings and loans associations.

The Croatian National Bank supervises the operations of banks and housing savings banks pursuant to the Croatian National Bank Act and the Banking Act. In accordance with the Banking Act, in force since 2002, bank supervision encompasses the entry of banks into the market, their operations and exit from the market, definition of responsibilities of their owners for banks' operations, definition of ways to manage risks as well as consolidated supervision of banks, consumer protection, protection of the employees of the Croatian National Bank who carry out the supervision of banks as well as cooperation with other supervisory bodies in the country and abroad. New subordinate legislation has been issued in line with the Banking Act and has been applied as from the beginning of 2004. It is aimed at regulating the exposure of banks to different types of risk, bank reporting requirements as well as regulating terms and conditions for providing banking and other financial services. The starting point for the creation of this regulation was to harmonise Croatian regulation with EU guidelines, Basel Committee Recommendations and International Accounting Standards (IAS 32 and IAS 39).

MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISORY AUTHORITY

The most important strategic objective of the Prudential Regulation and Bank Supervision Area in the forthcoming period is the implementation of Basel II into Croatian regulations. To this aim a special working group has been formed within the Area. In addition, new subordinate legislation is to be passed, aimed at regulating the work of institutions issuing electronic money. Regulations are to be harmonised with EU guidelines as regards the winding-up proceedings of banks and work is expected to start on the passing of legislation which will regulate the supervision of financial conglomerates.

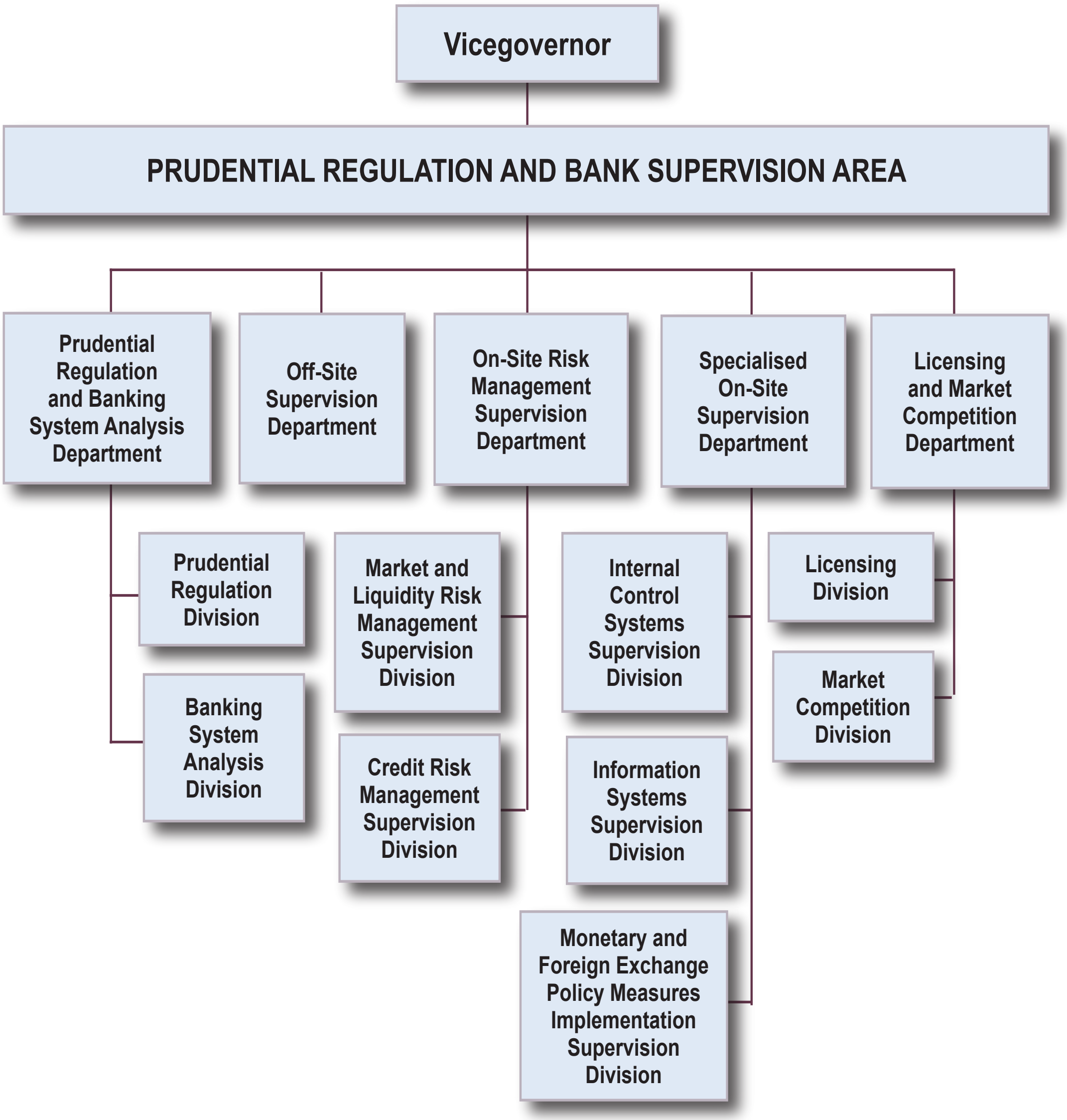
THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2004

The Republic of Croatia adopted the National Programme for the Integration of the Republic of Croatia into the European Union. The Prudential Regulation and Bank Supervision Area of the Croatian National Bank has participated in the creation of the part relating to harmonisation of Croatian legislation with *acquis communautaire* in the segment of banking since the programme's inception in 2002. The tasks of the CNB in this part of the National programme were related to adoption of EU's legal norms and harmonisation of regulation. As a result, in addition to the Banking Act subordinate legislation was passed and has been applied as of 1 January 2004. In accordance with the need to strengthen the supervision function of the Croatian National Bank in line with the Basel principles for effective banking supervision and EU requirements, in the first quarter of 2004 efforts were invested in implementing the new organisation of the Prudential Regulation and Bank Supervision Area.

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

Prudential Regulation and Bank Supervision Area of the Croatian National Bank is responsible for enactment and harmonisation of prudential regulation international supervisory standards, for analysis of financial reports and data of individual banks, on-site supervision of the operations of banks, subsidiaries and representative offices of foreign banks in the Republic of Croatia, data and indicator analysis and preparation of standard reports at banking system level. In addition, Prudential Regulation and Bank Supervision Area of the Croatian National Bank is responsible for licensing and protection of market competition. The new organisation of the Area entered into force on 1 April 2004 and is aimed at intensifying its business activity, increasing the efficiency and quality of performed tasks as well as increasing the level of specialist knowledge of its employees.

The organisational chart of the Prudential Regulation and Bank Supervision Area of the Croatian National Bank is as follows:



Prudential Regulation and Banking System Analysis Department is responsible for drafting legislative documents and subordinate legislation, harmonising the existing legislation in accordance with international standards and monitoring EU regulations on an on-going basis and giving proposals for harmonisation of Croatian legislation with EU legislation in the area of banking. It is also responsible for analysing banking system data in the Republic of Croatia and preparing the Banks' Bulletin, a regular CNB publication, as well as other reports for central bank needs.

In addition to its on-site bank supervision function, the **Off-Site Supervision Department** is also responsible for on-going supervision of banks on the basis of supervisory reports submitted by banks to the Croatian National Bank pursuant to the Banking Act and relevant subordinate legislation.

On-site supervision is the responsibility of the **Risk Management On-Site Supervision Department** and **Specialised On-Site Supervision Department**. The Risk Management On-Site Supervision Department provides for strict specialization of employees in terms of specific risks: market risk, liquidity risk, interest rate risk, currency risk, operational risk and other risks. The Specialised On-Site Supervision Department performs on-site supervision of IT systems in banks, internal control systems, regulatory compliance, in particular supervision of the implementation of measures of monetary and foreign exchange policies and observance of legislative and other provisions, internal procedures and payment system procedures.

The Licensing and Market Competition Department is responsible for the preparation and processing of applications for authorisations and approvals as prescribed by the Banking Act, The Building Societies and Relevant Government Incentives Act and the National Payment System Act. Since 2002 Banking Act, the CNB's functions and activities also include the protection of free market competition in the banking sector, the responsibility for which has been entrusted to the Licensing and Market Competition Department. Original competence of the Croatian National Bank in this area covers the prevention of illicit agreements, anti-cartel action, prevention of misuse of dominant market position and concentrations control.

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

In October 2004, the Government of the Republic of Croatia adopted the Decision on the procedure of integration of supervisory institutions in the non-banking financial sector into one unique independent institution accountable to the Government and the Parliament of the Republic of Croatia. All supervisory authorities in the Republic of Croatia (the CNB, the Croatian Securities Commission, the Directorate for Supervision of Insurance Companies, the Agency for Supervision of Pension Funds and Insurance) agreed on and adopted the Programme for Supervision of Financial Institutions and the Financial Market on the Consolidated Basis, so initial efforts towards their integration have been made. However, this does not include bank supervision which will remain within the responsibility of the CNB. The Government intends to issue draft legislation aimed at integrating non-banking supervisory institutions, which falls within the scope of the responsibility of the Ministry of Finance. In 2004, the CNB continued efforts directed at establishing co-operation with supervisory authorities of banks owning Croatian banks as well as banks owned by Croatian banks. In addition to the Memorandum of Understanding and Co-operation in Banking Supervision being signed with the agency responsible for bank supervision in Bosnia and Herzegovina in 2003, positions on future co-operation with authorities responsible for bank supervision in Austria and Italy were harmonised in 2004.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2002	2003	2004
Banks	46	41	37
Housing savings banks	4	4	4
Financial institutions, total	**50**	**45**	**41**

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

Item	2002	2003	2004
Public sector ownership	8.0	7.7	7.6
Other domestic ownership	13.7	13.5	13.6
Domestic ownership total	*21.7*	*21.2*	*21.2*
Foreign ownership	78.3	78.8	78.8
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Item	2002	2003	2004
Public sector ownership	4.0	3.3	3.0
Other domestic ownership	5.8	5.5	5.5
Domestic ownership total	*9.7*	*8.8*	*8.5*
Foreign ownership	90.3	91.2	91.5
Financial Institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institution (%)

Type of institution	The first three largest	The first five largest
Banks	54.3	74.3
Housing savings banks	92.6	100.0

Return on asset (ROA) by type of financial institution*

Type of institution	2002	2003	2004
Banks	1.58	1.59	1.68
Housing savings banks	1.55	-0.32	0.32

** ROAA*

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

Type of institution	2002	2003	2004
Banks	13.74	14.46	16.05
Housing savings banks	21.55	-6.39	7.37

** ROAE*

Distribution of market shares in balance sheet total (%)

Type of institution	2002	2003	2004
Banks	98.76	98.30	97.72
Housing savings banks	1.2	1.7	2.3
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2002	2003	2004
Banks	14.6	12.8	13.7
Savings banks	0.2	0.3	0.2
Financial institutions, total	**14.4**	**12.6**	**13.4**

Solvency ratio of financial institutions*

Type of the financial institution	2002	2003	2004
Banks	17.2	16.2	15.3
Savings banks	34.2	31.0	27.7
Financial institutions, average	**17.2**	**16.3**	**15.4**

** Capital adequacy ratio*

Asset portfolio quality of the banking system

Asset Classification	2002	2003	2004
1. Fully recoverable placements (category A)	94.1	94.1	94.9
2. Partly recoverable placements (category B)	3.5	3.5	3.5
3. Irrecoverable placements (category C)	2.3	2.3	1.6
Classified total	**100.0**	**100.0**	**100.0**
Specific Reserves*	5.0	4.1	3.7

**specific reserves / classified total*

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

ASSETS	2002	2003	2004
1. Money assets and deposits with the CNB	12.3	13.7	15.2
1.1. Money assets	1.3	1.4	1.3
1.2. Deposits with the CNB	11.0	12.3	13.9
2. Deposits with banking institutions	11.6	15.3	14.5
3. MoF treasury bills and CNB bills	5.8	3.8	1.6
4. Securities and other financial instruments held for trading and available for sale	5.2	3.8	7.2
4.1. Securities and other financial instruments held for trading	0.0	0.0	2.9
4.2. Securities and other financial instruments available for sale	0.0	0.0	4.3
5. Securities and other financial instruments held to maturity and bought on issue directly from the issuer	7.2	5.3	3.3
5.1. Securities and other financial instruments held to maturity	0.0	0.0	2.9
5.2. Securities and other financial instruments bought on issue directly from the issuer	0.0	0.0	0.4
6. Derivative financial assets	0.0	0.0	0.1
7. Loans to financial institutions	1.2	1.5	1.4
8. Loans to other clients	51.5	52.3	53.2
9. Investments in subsidiaries and associates	1.4	1.2	0.7
10. Foreclosed and repossessed assets	0.2	0.2	0.2
11. Tangible assets (net of depreciation)	2.2	2.0	1.7
12. Interest, fees and other assets	2.3	1.8	1.9
13. Net of: Specific reserves for unidentified losses	-0.9	-0.9	-0.9
Total assets	**100.0**	**100.0**	**100.0**
LIABILITIES	**2002**	**2003**	**2004**
1. Loans from financial institutions	2.3	3.5	3.7
1.1. Short-term loans	0.7	1.8	1.6
1.2. Long-term loans	1.7	1.7	2.1
2. Deposits	71.5	70.4	67.7
2.1. Giro account and current account deposits	13.4	12.4	11.1
2.2. Savings deposits	13.8	12.1	11.0
2.3. Time deposits	44.3	45.9	45.6
3. Other loans	11.2	12.3	13.7
3.1. Short-term loans	2.6	1.7	2.3
3.2. Long-term loans	8.6	10.6	11.4
4. Derivative financial liabilities and other financial liabilities held for trading	0.0	0.0	0.1
5. Debt securities issued	0.0	0.0	1.5
5.1. Short-term debt securities issued	0.0	0.0	0.0
5.2. Long-term debt securities issued	0.0	0.0	1.5
6. Subordinated instruments issued	0.4	0.4	0.4
7. Hybrid instruments issued	1.3	1.1	0.7
8. Interest, fees and other liabilities	3.8	3.4	3.6
Total liabilities	**90.5**	**91.1**	**91.4**
Total capital	**9.5**	**8.9**	**8.6**
Total liabilities and capital	**100.0**	**100.0**	**100.0**

The Structure of Deposits and Loans in 2004 (%) (at year-end)

	Deposits	Loans
Households	56.0	50.0
Government sector	2.4	7.2
Corporate	21.3	39.6
Foreign	15.9	0.2
Other*	4.4	2.9
Total	**100.0**	**100.0**

** Financial sector is included*

The structure of deposits and loans in 2004 (%) (at year-end)

Maturity of deposits		Loans	
At sight	16.5	Long term loans	68.4
Within one year*	58.3	Medium-term loans	19.9
Over one year	25.2	Short-term loans	11.6
Total	**100.0**	**Total**	**100.0**

** Total savings deposits are included*

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liabilities		
	2002	2003	2004	2002	2003	2004
Banks	28.8	30.4	31.3	64.8	61.8	61.9
* fx off balance sheet items / total liabilities				6.0	6.6	4.1
Housing savings banks	1.6	4.5	3.6	6.5	0.0	0.1
* fx off balance sheet items / total liabilities				0.0	0.0	0.0
Financial institutions, average	**28.5**	**30.0**	**30.6**	**64.1**	**60.7**	**60.5**

Structure of registered capital and own funds of financial institutions in 2004

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	EUR*	%	EUR*	%
Banks	2,566	8.6	27,326	91.4
Housing savings banks	20	2.9	677	97.1
Financial institutions, average	**2,586**	**8.5**	**28,003**	**91.5**

** in millions of EUR*

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

Revenues	2002	2003	2004
Interest income	70.8	71.1	70.5
Non-interest income	29.2	28.9	29.5
Expenditures	**2002**	**2003**	**2004**
Interest expense	40.5	38.2	41.0
Non-interest expense	16.8	18.5	15.7
General and administrative expenses	38.5	38.6	38.6
Provisions for identified and unidentified losses	4.2	4.7	4.7

2004 DEVELOPMENTS IN THE CZECH BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN THE CZECH REPUBLIC

The year 2004 saw continuing economic growth. The rate of growth of gross domestic product was 4.0% in 2004 at constant prices. As at December 2004 gross domestic product totalled CZK 2,751.1 billion at nominal prices. Economic growth was driven mainly by investment, whereas the influence of consumer demand, which dominated in the previous year, declined. In the second half of 2004, growth was also supported by buoyant exports.

The inflation rate (the increase in the average annual CPI) reached 2.8% at the end of 2004 compared to the very low level of 0.1% one year earlier.

The nominal exchange rate of the koruna continued to appreciate against the dollar, from an annual average of CZK 28.23 in 2003 to CZK 25.70 in 2004. The koruna's annual average exchange rate against the euro in 2004 was CZK 31.90, which is roughly the same as in 2003. The stronger koruna made imports cheaper, especially in the case of goods paid for in dollars (most notably energy-producing materials). It thus helped to dampen the effects of high raw material prices on world markets and maintain a low level of inflation.

The average unemployment rate was 10.3% in 2004, which is the same figure as in 2003. The unemployment rate according to Eurostat methodology was 8.3% at the end of December 2004. The average nominal wage increased by 6.6% in 2004 and the average real wage by 3.7% in the same period.

DEVELOPMENTS IN THE BANKING SYSTEM

As of 31 December 2004, 35 banks and foreign bank branches were active in the Czech Republic, the same number as at the end of 2003. All nine foreign bank branches active in the Czech Republic automatically switched to the single licence regime. In addition, many foreign banks registered for cross-border provision of services in the Czech Republic under the single licence (i.e. without establishing a branch). As of 31 December 2004, there were 63 such entities.

As of 31 December 2004, foreign entities held an 83.1% share in the total equity capital of the sector, a decrease of 1.8 points from a year earlier, and controlled 96.1% of the total assets of the sector. In only four banks, two of which are state-owned banks supporting government policies, do Czech owners have a majority share in the equity capital now.

During 2004, the number of bank employees continued to decline. At the end of 2004, there were 38,160 people working in the Czech banking sector, 2.2% less than a year earlier. The number of banking units was 1,785, a 6.9%

increase compared with a year earlier (mainly due to the opening of small kiosks providing basic services).

As of 31 December 2004, banking assets stood at CZK 2,635.6 billion, 4.3% more than a year before. This was due mainly to an annual increase in loans provided (of CZK 77 billion) and higher receivables from banks. The increase in loans provided was due to continuing growth in loans to households, which increased by 34.4% in 2004, as well as to an expansion of loans to corporations of 7.5%. The share of loans in banks' assets reached almost 41% at the end of 2004. The ratio of total assets to GDP at current prices was 0.96 at the year end. The group of four large banks accounted for 59.8% of the banking sector's assets, 2.3 points less than a year before.

The year 2004 saw a continuing reduction in the volume of non-performing loans, which dropped by CZK 5.1 billion to CZK 44.5 billion, or 4% of total loans provided (compared to 4.9% a year before). The coverage of classified loans by provisions and high-quality collateral is sufficient.

The regulatory capital used to calculate capital adequacy grew by CZK 4.3 billion to CZK 148 billion. However, there was an increase in the volume of risk-weighted assets and capital charges, connected with the growth in loans provided, which resulted in the capital ratio falling from 14.5% to 12.6% year on year. The banking sector recorded a net profit of CZK 32.9 billion in 2004, up by CZK 2.7 billion on 2003. Return on Tier 1 capital reached 23.35% and return on assets was 1.26%.

Detailed information on developments in the banking sector and supervisory activities is published in the CNB's annual Banking Supervision publications, which are available, together with other analytical publications and the latest banking sector indicators, at http://www.cnb.cz/en/bd_bsindex.php.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF BANKING INSTITUTIONS

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN THE CZECH REPUBLIC

There are four regulatory bodies in the Czech Republic. The Czech National Bank's banking supervisory authority (CNB Banking Supervision) is responsible for the stability of the banking sector, including building societies. The Czech Securities Commission supervises investment companies and investment funds. The Ministry of Finance of the Czech Republic is the surveillance body for insurance companies and pension funds. The Credit Union Supervisory Authority regulates credit unions. In accordance with a government decision, a two-step process will take place to integrate the supervisory authorities within the next five years (see below).

The harmonisation of five pieces of legislation governing and/or related to banking business with EU legislation came into effect in 2004 (the Act on Banks, the Capital Market Undertakings Act, the Act on Bonds, the Act on Collective Investment and the Anti-Money Laundering Act):

- in the Act on Banks, provisions on the single licence and on the duty of banks to introduce effective systems for discharging clients' claims came into effect;
- in the Act on Collective Investment, certain provisions were introduced with the aim of reducing the regulatory burden on banks that are simultaneously securities brokers/dealers. Under the Act, banks that are broker/dealers are obliged to contribute to the Guarantee Fund for securities brokers/dealers;
- the most important change in the Act on Bonds was that real estate in pledge covering a mortgage credit may be situated not only on the territory of the Czech Republic, but also in any EU Member State. The law also sets out principles for real estate pricing;
- a new provision was inserted into the Act on Collective Investment setting rules for banks with a depository function;
- on 1 September 2004 a broad harmonisation amendment to the Anti-Money Laundering Act came into effect, introducing an amended definition of suspicious transactions with regard to terrorist financing and the duty of the regulated institutions to set "know your customer" rules.

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

- on the internal control system of a bank, which specifies requirements for the management of credit risk, market risk, operational risk and liquidity risk; most of the requirements were transferred from previous provisions. The requirements for internal audit, management of operational risk and information systems, which are new, came into effect on 3 February 2004 (A);
- stipulating rules for assessment of financial receivables and creation of provisions and reserves, and rules for the acquisition of certain types of assets; this was amended to reflect the introduction of IFRS in banks and introduce the new option of asset portfolio provisioning (A);
- stipulating the content, method of keeping and requisites of the records of coverage of mortgage bonds in circulation (N).

A survey of the valid provisions, degrees and official announcements in the field of prudential supervision can be found at http://www.cnb.cz/en/leg_bd.php.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2004

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

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

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

In 2004, a new medium-term banking supervision plan for the period 2005–2010 was approved. This emphasises preparation for the New Basel Capital Accord, enhancement of co-operation with domestic and foreign supervisory bodies, preparation for the integration of the domestic supervisory authorities, and greater transparency of supervisory activities.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2004

In May 2004, when the Czech Republic entered EU, the single licence came into force. The responsibilities of home and host supervisor were newly defined. The CNB's banking supervision competences have been reduced. Nine foreign bank branches have been under supervision by the supervisors of their country of origin since May. From this point of view the CNB has been responsible for the issue of liquidity and some duties arising under the Act on Banks. Notification of monitoring of foreign banking institutions providing cross-border banking activities under the single licence principle started to be a part of supervision. In 2004, 63 foreign banks from EU member states announced their intention to provide banking activities in the Czech Republic under the single licence. Intensified co-operation with EU member state regulators is expected as a result of the single licence principle.

The re-licensing of banks, launched at the end of 2002 in connection with the process of harmonisation of the Act on Banks with the European banking directive, was completed in the first half of 2004 with the granting of banking licences to the remaining 15 banks. In addition, 16 administrative decisions were issued in the area of licensing and authorisation relating to banks' applications for the extension of licences, consent to acquire qualifying holdings in banks, prior approvals for mergers, plans to establish a branch in an EU Member State, etc.

In 2004, CNB Banking Supervision undertook 15 on-site inspections in 15 banks. Four of them were full-scope inspections and 11 partial monitoring of selected types of risks. The supervisors focused primarily on the systems used for credit risk and market risk management, the prevention of money laundering, the functionality and effectiveness of internal management and control systems and the area of risks connected with information systems and technology.

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

CNB Banking Supervision is involved in international co-operation in different ways, ranging from bilateral co-operation based on Memoranda of Understanding (MoUs) with foreign regulators through to active participation in the work of international organisations. Collaboration with the working groups of the Bank for International Settlements and the committees and working groups of the European Union, including the European Central Bank and the European Commission, was extended in 2004.

Co-operation with regulators from six countries based on MoUs (with Austria, Germany, France, Belgium, Slovakia and the USA) continued successfully. New MoUs with Italy and Netherlands were signed in 2004. The bilateral co-operation is closely linked with supervision on a consolidated basis and preparation for the implementation of the future Capital Requirements Directive.

Czech National Bank representatives are members of the Committee of European Banking Supervisors (CEBS) and the Banking Supervisory Committee (BSC). A representative of the CNB has been working as a technical expert in the European Banking Committee (EBC). Banking supervision employees have been working actively in four expert groups/task forces established by the CEBS. They have also contributed to the preparation of recommendations and standards developed by other expert groups by means of written comments. Czech National Bank experts are members of the Working Group on Macro-prudential Analysis (WGMA) and the Working Group on Developments in Banking (WGDB). Membership in the Credit Register Working Group is also envisaged in the future.

The Czech Republic was involved in the preparation and implementation of the New Basel Capital Accord in the Core Principles Liaison Group (CPLG) and Working Group on Capital (WGC). This enabled us to share information and express our opinions on the process. In 2004, the meetings focused on several core aspects of the New Capital Concept, mainly national discretions and home/host issues.

Co-operation with EU banking supervisory authorities continued in 2004. This focused mainly on exchange of information about the financial situation of parent banks and subsidiaries and experience with preparing for the implementation of the Capital Requirements Directive. The Czech National Bank's interest in co-operation is driven by the fact that it is almost exclusively in the position of host supervisor. That is why we are striving for early establishment of clear principles with home supervisors regarding our participation in model approvals, validation and on-going supervision of the banks of EU groups with a presence on the Czech banking market.

CO-OPERATION WITH OTHER SUPERVISORY BODIES IN THE CZECH REPUBLIC

The three main supervisory bodies of the Czech financial sector, i.e. the Czech National Bank, the Ministry of Finance of the Czech Republic and the Czech Securities Commission, signed a tripartite Co-operation Agreement in 1998. This was amended in 2003 with a view to promoting the smooth development of supervision on a consolidated basis.

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

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

The committee of senior representatives of the parties involved met several times during 2004. The core topic of the discussions was the issue of integration of supervisory institutions. First, the draft of the two-step government plan for the establishment of a single regulator was discussed. After government approval in May 2004, concrete steps were discussed for the unification of supervision of banks and credit unions in the Czech National Bank on the one hand, and supervision of insurance companies, pension funds and the securities market in the Czech Securities Commission (in future to be known as the Financial Market Commission) on the other hand. After the first step of the integration process has been completed (1 January 2006), there will be two supervisory authorities on the Czech financial market. Full integration of supervision within a single institution is planned for about 2010. What kind of institution it will be is still an open issue.

The plan of work in the five joint working groups established under the Agreement (licensing, ongoing supervision, accounting and disclosure, conglomerates and data exchange) was revised. The youngest joint working group – that on exchange of information on financial sector indicators – focused on developing the definitions and scope of the financial indicators needed for evaluating financial stability.

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

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

Consultations with experts from the World Bank and IMF and the Czech National Bank took place in 2004 as part of two assessment projects: Corporate Governance in Banking and Insolvency of Banks. In the first project, the Czech Republic offered to test the World Bank's new assessment methodology. Both assessments were completed in April 2005.

An update of the FSAP assessment was performed in 2004. The results showed that CNB Banking Supervision is largely compliant with all the relevant criteria. There were only minor recommendations for improvement.

The Central Register of Credits, run by the Czech National Bank, has been offering its services to banks and branches of foreign banks operating in the Czech Republic for three years. In all, 241,000 clients and 260,000 claims were registered in the database as at the end of 2004. A total of 1,916 users work with the data in banks. Information on the credit exposure and debt repayments of clients from the business sector has become an important component of credit risk management in banks. In 2004, banks sent a total of 2,423,661 enquiries regarding the total credit exposure of present and future clients. At the same time, 85 extracts were issued during the year at clients' request.

Organisational chart

The structure of the Banking Regulation and Supervision Department was changed on 1 February 2005 (new organisational chart: http://www.cnb.cz/en/pdf/bd_orgsch_2005_en). The number of off-site and on-site divisions was reduced. The responsibilities of some divisions were modified accordingly (Supervisory Support, Regulation).

ORGANIZATIONAL CHART OF THE CNB BANKING REGULATION AND SUPERVISION (AS OF 31 DECEMBER 2004)

Bank Board

governor | vice-governor | vice-governor | chief executive director | chief executive director | chief executive director | chief executive director

530
Banking Regulation and Supervision Department
executive director,
two deputy executive directors

531
Banking Methodology Division
director

532
Banking Analyses Division
director

533
Off-site Banking Supervision Division 1
director

534
Off-site Banking Supervision Division 2
director

535
On-site Banking Supervision Division 1
director

536
On-site Banking Supervision Division 2
director

537
Licensing and Enforcement Division
director

STATISTICAL TABLES

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

Type of banks	2002	2003	2004
Large banks	4	4	4
Medium-sized banks	9	10	10
Small banks	9	6	6
Foreign bank branches	9	9	9
Building societies	6	6	6
Banks, total	**37**	**35**	**35**

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

Item	2002	2003	2004
State ownership	4.1	4.4	4.4
Other domestic ownership	14.0	10.7	12.5
Domestic ownership total	*18.1*	*15.1*	*16.9*
Foreign ownership	81.9	84.9	83.1
Banks, total	**100.0**	**100.0**	**100.0**

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

Item	2002	2003	2004
State ownership	4.6	3.1	2.9
Other domestic ownership	2.1	1.0	1.0
Domestic ownership total	*6.7*	*4.1*	*3.9*
Foreign ownership	93.3	95.9	96.1
Banks, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of banks (%)
(at year-ends, banks with licences as of 31 December 2004)

Type of financial institution	The first three largest	The first five largest
Large banks	-	-
Medium-sized banks	47.5	70.2
Small banks	77.1	-
Foreign bank branches	72.2	94.1
Building societies	74.6	-
Banks, total	**54.4**	**64.0**

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

Return on asset (ROA) by type of banks (%)
(banks with licences as of 31 December 2004)

Type of banks	2002	2003	2004
Large banks	1.44	1.37	1.58
Medium-sized banks	0.79	1.14	1.09
Small banks	0.16	1.32	-0.06
Foreign bank branches	1.00	0.86	0.61
Building societies	0.92	0.50	0.39
Banks, total	**1.24**	**1.21**	**1.26**

Return on equity (ROE) by type of banks (%)
(banks with licences as of 31 December 2004)

Type of banks	2002	2003	2004
Large banks	30.99	25.80	27.78
Medium-sized banks	12.86	16.78	13.83
Small banks	1.49	11.50	-0.59
Foreign bank branches	-	-	x
Building societies	20.31	13.38	12.37
Banks, total	**27.4**	**23.8**	**23.4**

Note: For equity Tier 1 is used.

Distribution of market shares in balance sheet total (%)
(at year-ends, banks with licences as of 31 December 2004)

Type of banks	2002	2003	2004
Large banks	62.7	62.1	59.8
Medium-sized banks	17.3	15.8	15.9
Small banks	1.9	2.0	2.3
Foreign bank branches	9.7	9.6	10.0
Building societies	8.3	10.5	12.0
Banks, total	**100.0**	**100.0**	**100.0**

Development of off-balance sheet activities (%)
(off balance sheet items-receivables / balance sheet total)
(at year-ends, banks with licences as of 31 December 2004)

Type of banks	2002	2003	2004
Large banks	127.7	146.7	165.9
Medium-sized banks	195.0	207.8	227.0
Small banks	16.4	39.7	43.5
Foreign bank branches	326.9	306.2	346.0
Building societies	4.4	3.4	3.7
Banks, total	**146.4**	**154.4**	**171.3**

The structure of assets and liabilities of the banking system (%)
(at year-ends, banks with licences as of 31 December 2004)

Assets	2002	2003	2004
Deposits with CNB	20.0	19.2	17.1
Deposits with banks	15.9	11.8	15.2
Credits	35.9	39.4	40.7
Securities	18.5	21.2	20.1
Fixed assets	2.2	2.2	2.0
Other assets	7.4	6.2	4.9
Liabilities			
Clients´ deposits	64.8	65.9	65.7
Banks´ deposits	12.2	11.3	13.7
Sources from central bank	0.1	0.0	0.0
Bond issues	6.5	7.8	7.6
Equity capital	6.4	7.0	7.2
Other liabilities	10.0	8.1	5.8

Solvency ratio (%)
(at year-ends, banks with licences as of 31 December 2004)

Type of banks	2002	2003	2004
Large banks	13.41	13.56	11.04
Medium-sized banks	15.98	16.29	17.1
Small banks	37.19	29.02	19.42
Building societies	13.59	13.28	10.81
Banks, total	**14.34**	**14.48**	**12.55**

Asset portfolio quality of the banking system
(banks with licences as of 31 December 2004)

CZK in mil.

Asset classification	2002	2003	2004
Standard	785,348	908,074	981,375
Watch	71,332	64,404	74,320
Substandard	27,515	19,299	19,344
Doubtful	11,689	6,913	5,306
Loss	36,566	23,398	19,857
Non-performing total	**75,770**	**49,610**	**44,506**
Classified total	**147,102**	**114 014**	**118,826**
Reserves and provisions	**58,689**	**38,265**	**30,877**

The structure of deposits and loans in 2003 (%)
(at year-end, banks with licences as of 31 December 2004)

	Deposits	Loans
Non-financial	23.0	45.5
Financial	4.7	8.0
Government sector	7.5	11.4
Small business	4.0	2.8
Households	57.1	28.0
Other	3.7	4.3
Total	**100.0**	**100.0**

The structure of deposits and loans by time in 2004 (%)
(at year-end, banks with licences as of 31 December 2004)

Maturity of deposits		Loans	
At sight	49.9	Short term loans	25.6
Within one year	33.2	Medium term loans	25.6
Over one year	16.9	Long term loans	48.8
Total	**100.0**	**Total**	**100.0**

Proportion of foreign exchange assets and liabilities (%)
(at year-ends, banks with licences as of 31 December 2004)

Type of the banks	FOREX assets/Total assets			FOREX liabilities/Total liabilities		
	2002	2003	2004	2002	2003	2004
Large banks	15.8	16.5	20.0	13.4	13.3	15.1
Medium-sized banks	20.1	21.2	21.3	22.7	24.9	24.3
Small banks	13.7	17.3	17.3	13.1	19.4	17.0
Foreign bank branches	36.5	24.7	26.0	40.3	49.7	47.1
Banks, total	**17.2**	**16.3**	**18.4**	**16.5**	**17.4**	**18.0**

Structure of registered capital and own funds of banks in 2004
(at year-end, banks with licences as of 31 December 2004)

Type of the banks	Registered capital	/Total assets	Own funds	/Total liab
	EUR in mil.*	%	EUR in mil.*	%
Large banks	1,458.5	2.8	4,141.2	8.0
Medium-sized banks	530.5	3.9	1,401.7	8.9
Small banks	163.0	8.0	212.7	10.5
Foreign bank branches	13.3	0.2	90.5	1.0
Building societies	146.1	1.4	337.8	3.3
Banks, total	**2,311.4**	**2.7**	**6,183.9**	**7.1**

** Rate of exchange of 31 December 2004 CZK/EUR = 30,465*

Structure of revenues and expenditures of banks
(banks with licences as of 31 December 2004)

CZK in mil.

Revenues	2002	2003	2004
Interest income	121,162	99,773	102,644
Fees and commissions income	29,647	35,657	38,085
Profit from shares and units	1,122	824	1,369
Profit from foreign exchange activities	5,441	6,347	9,567
Profit from other financial operations (incl. derivatives)	6,088	2,436	1,464
Expenditures			
Interest expenses	65,962	45,470	42,885
Fees and commissions expenses	6,133	9,314	6,760
Administrative expenses	46,975	47,513	48,819
Net creation of reserves and provisions, write-offs and receivables-transfer expenses	8,537	744	10,256
Taxes	11,223	11,074	12,490

2004 DEVELOPMENTS IN THE ESTONIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The Estonian economic growth maintained its pace in 2004 as well resulting in 6.2% compared to the previous year. The structure of economic growth improved significantly as the share of domestic demand, which had meanwhile expanded too quickly, decreased and that of net exports increased. Inflation has sped up during 2004 – prices for goods and services increased by 3%, mainly due to higher prices for motor fuel and groceries. The upturn of the Estonian economy encourages the people's optimistic attitude towards the future that along with low base interest rates and favourable lending conditions offered by banks resulted in the growth of borrowing.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

At the end of 2004, there were six licensed credit institutions, three branches and six representative offices of foreign credit institutions operating in Estonia. The ratio of banking sector's total assets to GDP was 96%.

In 2004, the banking sector could be characterized by strong competition in the lending market. At the end of 2004, two leading Estonian banks captured 79.8% of the lending market.

In 2004, the volume of banks' assets increased 36% or approximately 35 bn kroons and they totalled 133.6 bn kroons as of December 31, 2004. The increase in assets resulted mainly from the increased loan portfolio, constituting 34% or 23.4 bn kroons. By the end of 2004, the banks' gross loan portfolio reached to 92.6 bn kroons, or 69.3% of total assets. Of the gross loan portfolio, 35% were business loans and 31% household loans. In 2004, lending by both customer groups increased. The household loan portfolio grew by 51% or 9.8 bn kroons in 2004. The growth was mainly backed by the increase in housing loans, reaching to 56% or 8.4 bn kroons. The business loan portfolio grew by 38% or 8.8 bn kroons, mostly due to the significant growth in the real estate, leasing and business activities sector – 59% or 4.5 bn kroons.

Banks were able to maintain the sound quality of loan portfolio in 2004. The share of loans overdue more than 60 days among the loans to the non-financial sector was 0.6% at the end of 2004, having decreased by 0.3% compared to 2003.

The volume of deposits experienced accelerated growth in 2004. As of December 31, 2004, banking sector's deposits amounted in 64.8 bn kroons – 21% or 11.3 bn kroons more than last year. At the end of 2004, household deposits constituted 40% and business deposits 42% of the overall volume. Compared to the previous year, 2004 meant faster annual growth in household as well as in business deposits, respectively constituting 16% or 3.6 bn kroons and 23% or 5.2 bn kroons.

Regardless of the growth rate in depositing, it was still outpaced by the lending growth. The loan-deposit ratio has reached up to 143% by the end of 2004, compared to 129% a year ago. The increased loan-deposit ratio is a proof that traditional financing of lending by deposits depositing growth is gradually being replaced by foreign institutional funding.

In 2004, the banking sector maintained a high level of profitability. Similarly to 2003, the banks received their main revenue from the traditional banking activity, lending. By the end of 2004, the interest revenue constituted 54% of total revenue – 60% in 2003. The net income from fees and commissions constituted 18.9% of the total revenue at the end of 2004, decreasing 0.3% compared to the previous year. During the year, both the return on equity and on assets have gone up, respectively constituting by 20% and 2.1% as of December 31, 2004.

Despite the accelerated growth of loan volumes, the banks retained their capitalization on a high level, in 2004 down from 14.5% to 13.4% on a solo basis due to the growth of risk-weighted assets.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

For the Estonian Financial Supervision Authority (FSA), the last year was a year of fast development characterized by full integration with the EU supervision network, and our financial market joining the single EU financial market. All this resulted in a broader access to financial services for consumers. In 2004, the FSA became a full member in the network of EU financial supervision authorities. Already for years, the leading Estonian financial institutions have been controlled by foreign investors; hence, their strategy and sustainable growth are affected by developments and decisions outside Estonia. In this respect, the FSA has been seen as not only having the opportunity but direct responsibility to be involved in the development of the regulatory framework for a single European financial market and to strengthen cooperation with foreign supervision authorities. In the longer run, this will create premises for continuous, fast and stable growth of our financial sector.

FSA operation is managed and organized by the Management Board, which is simultaneously both an administrative and management body. The Management Board is authorized to organize the entire FSA operation and make all decisions concerning financial supervision. Among issues concerning financial supervision, the Management Board has the authority to issue or revoke activity licenses; to grant consent, approval or permissions; to pass resolutions relating to performance of the registration obligation and maintaining respective persons in official lists; to apply administrative enforcement measures and impose administrative penalties; to order extraordinary audits or expert evaluations; to establish moratorium or a special regime, file bankruptcy petitions and perform other acts relating to bankruptcy proceedings.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY

In the spring of 2004, the FSA drafted a new strategy laying out priorities for the next three years. The strategy is focused on effective performance of tasks provided by the Financial Supervision Authority Act. The goal of the FSA is to create competitive financial services supervision in an expanded European Union. The strategy of the FSA is based on four main pillars: first, to ensure stability of financial services providers; second, to protect the interests of consumers by increasing transparency of financial services; third, active involvement in the development of financial market regulation by considering possible effects to the market; and fourth, professional, open and efficient operations.

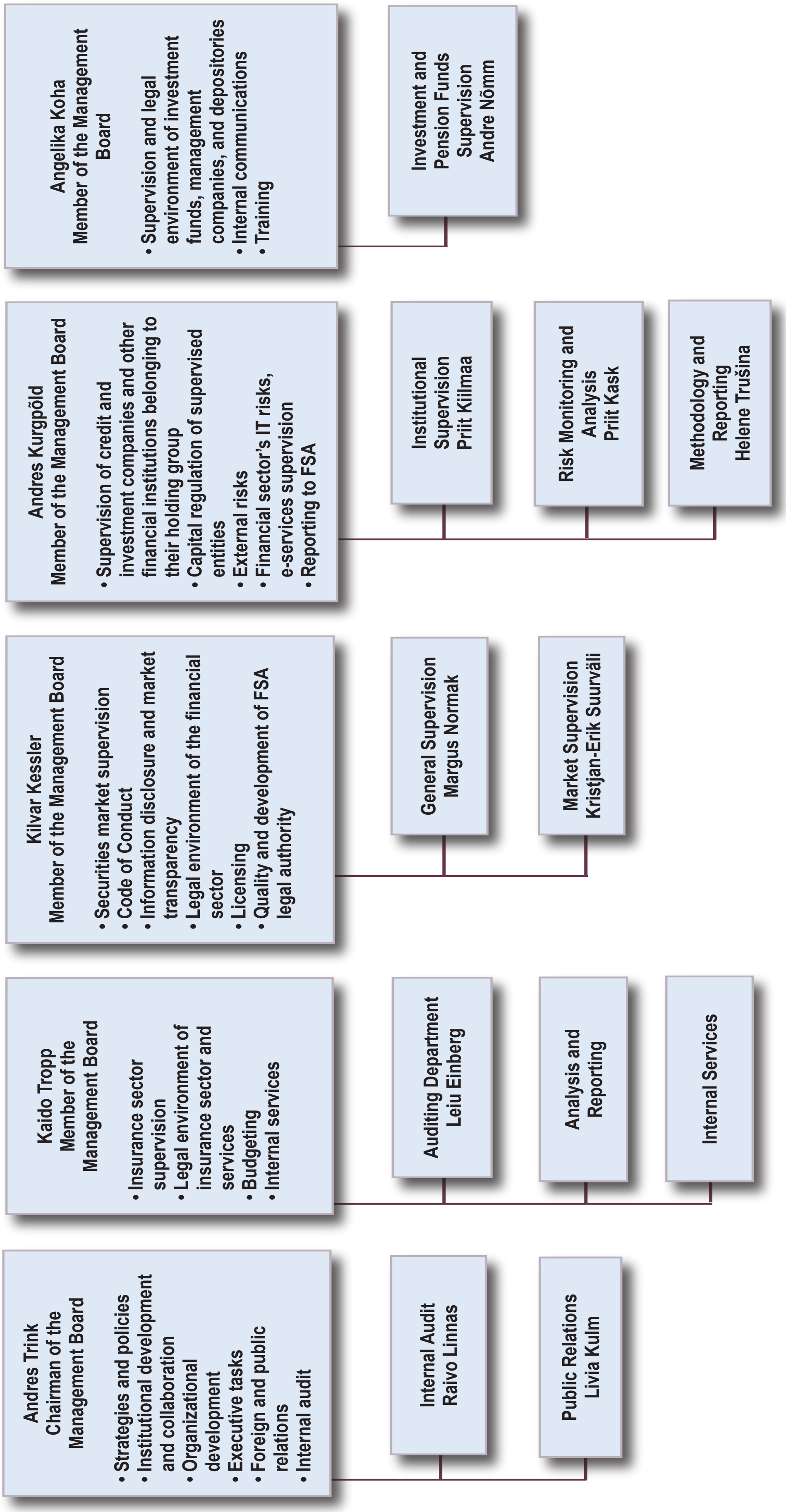
THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY LAST YEAR

In 2004, the FSA issued a license to open a branch of foreign credit institution in Estonia on two occasions. In the second half of the year, we issued a license to open a branch in Estonia to one non-life insurer. Five companies were granted license to acquire qualifying holding. Additional activity licenses were issued to two insurance companies. We also granted one fund management company a license to open a branch in Lithuania. The FSA registered in 2004 two new investment funds. Due to the new Investment Funds Act in force since May 1, 2004, the FSA registered amendments to 35 investment fund rules.

To improve the assessment of operation by supervised entities and accompanying risks, the FSA has designed regular, monthly and quarterly monitoring cycles to determine main risk areas. We monitor and analyse regularly the status of banks based on the reporting to us, information from public sources, information obtained by our on-site inspections and other supervisory activities. In 2004, the FSA focused on the credit risk, operational risks due to lending activities and assessment of internal control mechanisms used in the credit area. As for assessment of operational risks, our major project in 2004 was mapping out credit institutions' operational continuity process. We based our evaluation of operational continuity on the principles of COBIT – standard of good IT management and control practices – and other international good practices.

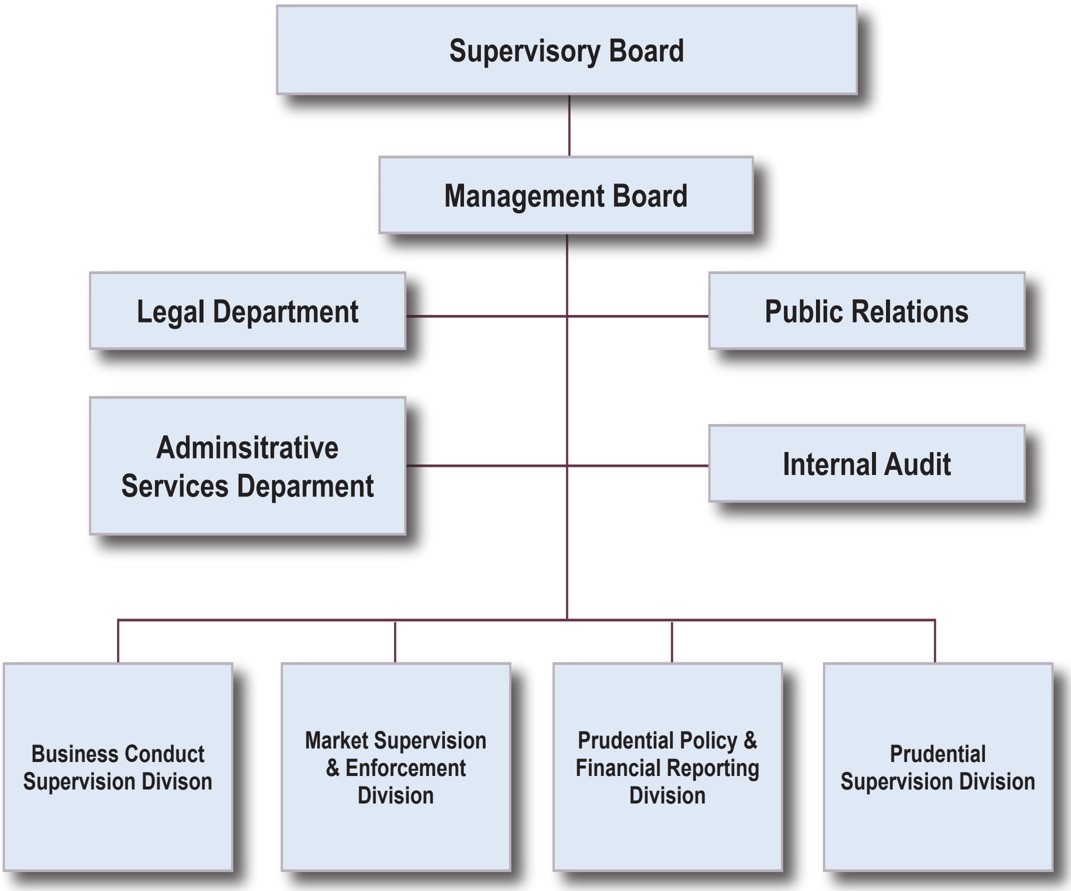
In banking sector's on-site inspections, we prioritised evaluation of risks accompanying lending activities. In 2004, three credit institutions were inspected. Due to the rapid growth in e-banking and importance of information technology, we had on-site inspections at credit institutions to assess the risks accompanying these areas. As of 2004, the FSA forwards information obtained during on-site inspections based on cooperation agreements to the home country financial supervision agency of the company's parent undertaking.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



Organizational structure of the Estonian Financial Supervision Authority as on 31 December 2004

By its resolution, the FSA Supervisory Board decided to reduce the number of Management Board members from five to three in 2005. Likewise, the Supervisory Board gave approval in principle to separate prudential and market conduct supervision functions within the FSA organizational structure. The relevant changes have entered into force since 1 June 2005.



Organizational structure of the Estonian Financial Supervision Authority from 1 June 2005

INTERNATIONAL ACTIVITIES OF THE AUTHORITY

As of May 1, 2004, the Estonian financial market opened up to service providers from other EU Member States. This increases opportunities for more efficient partnership between group undertakings of EU financial groups. In 2004, we started to exchange information on cross-border services as required by EU legislation and advanced activities set forth by the Memoranda of Understanding (MoU) with other financial supervision agencies. We focused mainly on the co-operation with home country financial supervision agencies of parent companies of Estonian financial institutions. Our cooperation with Finnish, Latvian, Lithuanian and Swedish supervision agencies has become increasingly closer and more meaningful. Since the FSA sees harmonization of supervisory practices as one of its priorities, we also emphasized last year our extended involvement in working groups of EU committees of supervisors (so-called Level 3) in our international collaboration. We were most active in the working groups related to the practical supervisory collaboration and information exchange (CESR-Pol; *Groupe de Contact*, etc.), financial reporting (EGAA; CESR-Fin, etc.) and implementation of Basel 2 and Solvency 2.

COOPERATION WITH OTHER SUPERVISORY BODIES

Being a uniform financial supervision authority, in 2004 the FSA was actively involved in shaping financial policy and legal environment with the Ministry of Finance, Bank of Estonia, other state agencies and financial market participants. Legislative activities were primarily focused on sound and effective adaptation of EU *acquis communautaire* relating to financial services.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2002	2003	2004
Banks	6	6	6
Foreign bank's branch	1	1	3
Financial institutions, total	**7**	**7**	**9**

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

Item	2002	2003	2004
Public sector ownership	0.0	0.0	0.0
Other domestic ownership	13.3	14.3	10.2
Domestic ownership total	*13.3*	*14.3*	*10.2*
Foreign ownership	86.7	85.7	89.8
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Item	2002	2003	2004
Public sector ownership	0.0	0.0	0.0
Other domestic ownership	79.3	82.1	79.2
Domestic ownership total	*79.3*	*82.1*	*79.2*
Foreign ownership	20.7	17.9	20.8
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Type of institutions	The first three largest	The first five largest
Bank	89.87	98.55

Return on asset (ROA) by type of financial institutions

Type of institution	2002	2003	2004
Bank	1.6	1.7	2.1

Return on equity (ROE) by type of financial institutions

Type of institution	2002	2003	2004
Bank	14.7	14.2	20.0

Distribution of market shares in balance sheet total (%)

Type of financial institution	2002	2003	2004
Bank	100.0	100.0	100.0

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

Assets	2002	2003	2004
Cash	1.71	1.44	1.08
Claims on central bank	4.36	5.12	5.76
Claims on credit institutions	12.38	11.68	14.37
Claims on customers	61.18	70.02	69.29
Allowance for uncollectible claims	-0.64	-0.56	-0.50
Securities	17.27	9.71	8.01
Intangible assets	0.59	0.44	0.29
Tangible assets	1.27	0.82	0.59
Other assets	1.89	1.33	1.04
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2002**	**2003**	**2004**
Amounts owed to credit institutions and central bank	14.54	16.83	20.28
Amounts owed to customers	59.74	54.17	48.52
Government lending funds and counterpart funds	0.29	0.21	0.10
Issued debt securities	8.47	13.90	18.71
Other liabilities	3.19	2.32	1.81
Subordinated liabilities	1.54	1.19	0.43
Provisions	0.08	0.08	0.07
Equity capital	12.14	11.30	9.81
Total	**100.00**	**100.00**	**100.0**

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

Type of financial institution	2002	2003	2004
Banks	23.99	28.25	17.70

Solvency ratio of financial institutions

Type of the financial institution	2002	2003	2004
Banks	15.26	14.51	13.37

Asset portfolio quality of the banking system

Asset classification	2002	2003	2004
Standard loans	84.49	85.73	88.58
Watch loans	9.81	10.19	8.53
Doubtful loans	2.56	2.29	1.86
Insecure loans	2.07	0.99	0.40
Uncollectible loans	1.08	0.80	0.63
Classified total	**100.00**	**100.00**	**100.00**
Specific reserves (mln EEK)	**364**	**395**	**464**

The structure of deposits and loans in 2004 (%)
(at year-end)

	Deposits	Loans
Households	42.1	31.7
Government sector	7.9	3.0
Corporate	44.5	35.3
Foreign*	13.0	1.9
Other	5.5	30.0
Total	**100.0**	**100.0**

**Deposits and loans of total amounts*

The structure of deposits and loans in 2004 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	64.9	Long term loans	67.2
Within one year	31.5	Medium-term loans	24.3
Over one year	3.6	Short-term loans	8.5
Total	**100.0**	**Total**	**100.0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2002	2003	2004	2002	2003	2004
Banks (only balance sheet items)	70.3	73.7	73.8	41.2	45.6	52.1

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

mln EUR

Revenues	2002	2003	2004
Interest income	271.85	268.36	296.86
Net interest profit/loss (+/-)	151.50	145.77	158.44
Income from financial investments	4.65	15.75	65.66
Commission income	76.86	85.71	103.41
Profit on financial operations	65.92	62.05	62.51
Value adjustments of claims and off-balance sheet commitments (income)	15.76	8.59	10.54
Value adjustments of financial fixed assets (income)	0.40	0.25	0.41
Other operating income	3.43	4.73	6.71
Extraordinary income	0.00	0.00	0.00
Expenditures	**2002**	**2003**	**2004**
Interest expense	120.35	122.59	138.42
Commission expense	21.31	22.66	28.41
Loss on financial operations	42.94	36.21	38.08
Administrative expenses	112.34	112.79	132.92
Value adjustments of tangible and intangible fixed assets (expenses)	26.57	16.07	14.15
Value adjustments of claims and off-balance sheet commitments (+/-)	24.49	15.11	22.55
Value adjustments of financial fixed assets (expenses)	0.72	0.43	0.68
Other operating expenses	12.51	12.04	9.30
Extraordinary expenses	0.00	0.00	0.00
Profit/loss for the reporting period	73.71	96.67	157.46

Structure of registered capital and own funds of financial institutions in 2004

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	EUR	%	EUR	%
Banks	292,551,608.6	3.4	837,720,015.8	10.9

2004 DEVELOPMENTS IN THE HUNGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN YOUR COUNTRY

In line with the global and European trends the growth of the economy of Hungary slowed down somewhat in the second half of 2004. During the last quarter, however, deceleration came to an end and the rate of the growth of GDP over the whole of the year ended up at 3.8 %, only half a percentage point below the peak observed in the first quarter. Consequently, the difference between the GDP growth rate of Hungary and the EU-25 continued to grow and at the same time Hungary got half a percentage point closer to that of the new EU Member States. During the fourth quarter the growth of all sectors accelerated on the supply side – except for services – while on the demand side, despite the declining export dynamic, the balance of exports and imports improved.

Despite the favourable development of GDP statistics on the fourth quarter the economy of Hungary was clearly on a decelerating growth path. The expansion of supply was largely a result of the outstanding performance of agriculture – an approx. 40 % output growth – during the second half of 2004, which itself was a result of the favourable weather conditions last year and the resulting outstanding grain harvests, which should therefore be considered as a one-off event. At the same time, in view of the whole of the second half, the growth of industry decelerated substantially, the main reason for which was definitely a significant weakening of demand abroad. The dynamic of orders placed in the manufacturing industry clearly declined during the recent months and in January 2005 the total portfolio of orders from export markets was below the portfolio registered one year before.

Future trends in industry, which is the dominant factor of Hungary's economic growth, will very likely be determined by the development of industrial output in the European Union. According to data on the previous 8 years the development of the industrial output of the Union (or, more precisely, the development of the annual growth rate of industrial output measured on a monthly basis), made up more than three quarters of the impact of factors determining the expansion of the economy of Hungary. This close relationship is due primarily to the high degree of vertical integration of Hungarian and other European industrial enterprises, which has been spreading towards the new Member States during the past 1-2 years. As a consequence of this trend the opportunities for exporting Hungarian industrial output will be determined by the degree to which the economy of West Europe manages to cope with the impacts of a strengthening Euro and the extent to which demand for consumption and investment can be stimulated. Our own analysis shows that in this respect in year 2005 a slow decline, rather than acceleration should be expected for year 2005.

On the demand side the most important trend in 2004 was the discontinuation of the earlier, disproportionately fast growth of consumption and the increase of spending on consumption dropped to below the growth curve of GDP. The primary reason for this was related to the endeavours of income policy, in the wake of which in year 2004 the two digit growth of real wages – which characterised earlier years – was replaced by a slight decline. As had been expected, the new trend of real wages was followed by retail turnover only to some extent and at a substantial lag, the results of which are also indicated by the increase of demand for consumption loans, in the second half. In the wake of the decline of demand for services the substantial deceleration of the expansion of consumption took place despite the above trend, which is a favourable trend partly from the aspect of internal price stability and particularly from that of the external balance.

Another important trend on the demand side was a significant upswing in fixed investment in year 2004. The volume of investments increased in 2004 by 8.3 % – the fastest rate since 1998 – within which special mention should be made of a 15 % growth of investments in the manufacturing industry the output of which is (to be) sold abroad. The increase of investment was also reflected by the 4.6 % increase of the performance of labour on the level of the national economy (GDP/employment), which is the highest rate since 1997. On the other hand however, the rate of unemployment also increased slightly. The rapid growth of the performance of labour is definitely improving domestic competitiveness and the stability of the HUF. In terms of its effects the average domestic labour cost per unit of output, expressed in Euros, increased only by 2-3 % in 2004 (2003: 6 % up), and in our estimate it equalled 42 % of the average of the EU-15.

The equilibrium of the domestic economy improved substantially in 2004, though the balance of the budget and the current balance of payments continue to shows major tensions and they are still accompanied by substantial macroeconomic risks.

One crucial change in respect of the internal equilibrium of the economy is that the annual rate of consumer inflation declined significantly, exceeding even the expectations of the market. This development was not really surprising in that to a significant extent it originated from the spill over effects of the increase of indirect taxes in early 2004, which, of course, could be calculated in advance. Furthermore, however, the process of declining inflation was very likely strengthened by a significant deceleration of the outflow of wages and pensions, the weakening of demand for consumption and the HUF which has been steadily in a strong position within the intervention band. As a combined effect of the above the annual inflation rate dropped by 440 basis points in 9 months and in February 2005 it was at 3.2 %. This was the lowest rate in decades.

Another important trend during the recent period, contributing to an improving equilibrium, was the perceptible deceleration of the growth of credits and of monetary expansion. On the one hand, the annual growth of the domestic instruments of credit institutions (credits and bonds) dropped from the 35 % peak in January 2003 to 15 % in January 2005, on the other hand, the annual growth of the amount of money in circulation in the broad sense of the term dropped from the 17 % peak in July 2004 to about 10 %. The deceleration of monetary expansion was primarily a result of the increase of the costs of credits. On the one hand, the 11.3 % average base rate of the central bank in 2004 exceeded that of the previous year by 280 basis points. On the other hand, the tightening in 2003 of the conditions of subsidies on housing loans increased the burdens borne by borrowers substantially through the reduction of the interest subsidy and the related PIT allowance, as a result of which demand for this type of credit contracted substantially in 2004. This latter change cut out the key driving force of the vigorous credit expansion witnessed before 2004.

The development of the position of the budget was much less clear-cut from the aspect of total domestic demand and the macro-economic equilibrium. During the two years since 2002 – and in respect of the accrual based data in 2004 – there has been a clear decline in the general government deficit: the deficit calculated according to the Eurostat methodology dropped from 8.5 % to 6.2 % of GDP in 2003, and to 4.5 % in 2004. According to cash-based data, which provide a more direct view of the level of current demand however, the situation is not quite so clear-cut, for according to such data the deficit dropped substantially in 2003 but it remained more or less unchanged in 2004. In view of these two different types of statistics the year 2004 position of the budget may be regarded as one that ‘was slightly improving’.

The external balance of the economy of Hungary improved in 2004 despite the fact that the demand for external financing (the aggregate of the current deficit and the capital balance) is still high and that it diminished only slightly over a one year period from the peak value of the 12 month period ending in September 2003 (from 9.3 % to 8.8 % of GDP). From the aspect of the positions of the domestic income owner sectors this was enabled primarily by the growth of the net financial savings of households which, after several years of decline, increased for the first time in 2004, in the wake of the decrease of demand for real estate credits.

Besides the decline of demand for financing, the improvement in 2004 of the external balance was also stimulated by a change of the structure of financing. For in the advanced economies after the expiry of the programmes of economising in the corporate sector, which characterised earlier years, the net influx of direct investments started to grow again and in the 12 month period ending in September 2004 it equalled 3.4 % of GDP. The effects of this rise in investment were reflected by an upswing of fixed investment and in the improvement of the productivity of labour. From the aspect of the balance of payments however, in a shorter run it more important that the part of the external financing demand that is not covered by direct investment dropped substantially – from 7.8 % to 5.4 % of GDP – as a consequence of which the demand of the economy of Hungary on foreign capital markets also declined. This had a definitely positive effect on the cost of financing and the state of the domestic financial markets. In year 2004 the MAX index that is characteristic of the price of the longer than one year government bonds denominated in HUF increased by 14 %, the BUX index which shows the development of the domestic exchange share prices increased by 57 %. The HUF grew stronger: during the year it strengthened against the Euro by an average of 1 %, in the December to December period it grew by almost 7 % relative to the Euro and in the second half of the year it hang on to the upper intervention point, staying in the 240-250 HUF/EUR band.

The improving ratios of equilibrium (inflation, balance of payments) and the strengthening of the position in the market of financial instruments denominated in HUF (primarily the HUF itself) created favourable circumstances for easing the notebank's interest rate policy. From March 2004 up to end-February 2005 the base rate of the notebank was reduced by 425 basis points, almost in line with the decline with the annual consumer inflation rate. The resulting 8.25 % base rate was still substantially higher than the 2 % refinancing rate of the CBE, partly as a consequence of the budget deficit, which was significantly higher than the average (2.7 % of GDP in 2004) of the Euro zone and to a substantial extent as a result of the exchange rate risk of the HUF. On the long side of the yield curve however, convergence is much more advanced, in that the premium of the 10 year HUF government bonds over similar West European Euro bonds dropped to about 300 basis points by end-February 2005.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

Much attention was paid to the domestic banking sector in year 2004, in Hungary and abroad as well.

Expectations were focused on three sets of questions:

- How will Hungary's accession to the European Union in May 2004 affect the number of the entities operating in the Hungarian banking sector, will the foreign owners dominating the sector decide on any organisational changes and will cross-border services be launched, will branches be opened abroad? How will the single European market affect competition, the standards of services and the behaviour of the participants of the market, including customers?
- Will the growth of the role of banks as intermediators in the market continue, including the rapid growth of lending operations observed in recent years and in particular in 2003, especially in the area of retail lending? How will the demand for housing loans change in the wake of the tightening of the conditions of state subsidies to housing loans twice in 2003 and as a result of the peak of demand for credits in the first half and at the end of 2003? Will the trend of increasing demand for credits denominated in foreign exchange continue? What sources will banks finance the high rate of growth of activities?
- How does the dynamically growing lending activity affect the level of capitalisation of Hungarian banks, their liquidity, lending and exchange rate risks? Does the 'ageing' of the credit portfolio entail a decline of the quality of the portfolio? Can the year 2003 level of profitability of the banking sector – which was highly favourable by international standards – be maintained?

As a consequence of Hungary's EU accession the domestic banking market – as the entire money and capital market – became part of the single European market. The characteristics of the increasingly harmonised market, however, are growing perceptible only through a gradual though probably not too slow process. One of the most important possibilities of the single market is the possibility to provide cross border services, but – as far as we know – it was not started in Hungary in 2004. Many – 66 by the end of December – of the foreign credit institutions registered in the EU Member States notified the Supervision of their intents to start such activities in the future, but in year 2004 no such operations were performed, rather, the entities concerned took the necessary steps to meet the legal conditions required for the performance of such operations.

Three of the domestic banks (MKB, BB and CIB) have notified the Supervision of their intents to provide cross-border services in the future. They are not aiming specifically to expand their markets so much as making preparations for the future, i.e. they are taking the necessary steps to meet legal requirements in time, to obtain licence by the national Supervision and to provide services to domestic customers that are actively operating in foreign markets in relation to Hungarian exports (financing goods, services, projects), as they have got accustomed to in Hungary.

Through the 'single European passport' the single market has made it easier to establish branches abroad. Only one of the parent banks operating in the EU Member States (*Dresdner Bank)* has decided on turning its domestic subsidiary – which was unprofitable in 2004 – into a branch. This process is, however, carried over into year 2005 therefore the number of the participants of the sector was not changed by this transformation in year 2004.

The number of the participants of the sector dropped by one in comparison to the number recorded at end-2003, as a consequence of the expansion and market building intents of two foreign and one Hungarian-owned credit institution. The privatisation of Postabank and Konzumbank reduced the number of banks by two for two foreign (EU) owned large banks (Erste Bank and Magyar Külkereskedelmi Bank) merged the acquired banks in 2004. At the same time, the number of the participants of the sector was increased as a result of the decision of one savings cooperative (ELLA) to transform itself into a bank, in view of the growing opportunities in the market.

Competition in the sector – which was rather strong even before 2004 – was not yet intensified in 2004. No perceptible change took place in services either, since under the influence of foreign owners the foreign parent banks had been providing substantial assistance to the operations of their subsidiaries in Hungary, to product development and the raising of standards. The behaviour of customers did not change materially either, though the development of housing and car loans denominated in foreign exchange show that perhaps partly as a result of Hungary's EU accession borrowers are not so afraid of exchange rate and interest rate risks. Information has been received on the 'borrowing tourism' of Hungarians living near the western borders of Hungary – borrowing in Austrian banks near the border – but, as far as we know now, these transactions have not yet reached a material scale where they could threaten the market positions of Hungarian banks.

In year 2004 the financial intermediator role of the banking sector continued to growth though at a decelerating rate in comparison to 2003. The ratio of the credit portfolio relative to GDP increased from 36.4 % in 2002, through 43.7 % in 2003, to 46.4 % in 2004. The expansion of lending resulted in a 16 % growth of the balance sheet total, which – though falling short of the 26 % increase in the preceding year – was substantially higher than the approx. 10 % nominal growth of GDP, as a consequence of which the penetration rate (balance sheet total/GDP) increased from the 69.2 % at the end of 2003 to 73.0 % by the end of 2004.

Development of the financial intermediating role of the banking sector (%)

The spectacular 33.3 % growth of the lending activities of banks observed in 2003 was not repeated in 2004: the approx. 16.7 % expansion however, still provided for a dynamic growth. The role of lending makes up a share in the operations of banks that is considerable even by international standards, at the end of 2004 the aggregate HUF 9,483 billion credit portfolio of the bank sector equalled 63.5 % of the total assets of about HUF 14,926 billion (balance sheet total). The same ratio was 53.1 % in the EU-15 at end-2003, while in the new EU Member States it was 48.7 % at the same time. At end-2004 the HUF 2,597 billion bank loan portfolio of households exceeded the amount registered one year before by almost 0 % and though this growth rate fell short of the 66 % stated at end-2003, it was still a lot higher than the growth rates observed in previous years, as well as the rate of increase of Hungary's GDP. The demand for housing loans broke records at end-2003 in view of the expected contraction of state subsidies, and in 2004 – after appraisal of loan applications accepted in late 2003 and the placements relating to those applications – it shrunk substantially in 2004. The housing loan portfolio almost doubled in 2003, in 2004 it increased by about a third, so growth was quite dynamic in 2004 as well. The demand for credit on the part of businesses increased at a much less dynamic rate – by 14.5 % – falling short of the 22.7 % increase recorded in 2003. Consequently, at end-2004 the total bank credit portfolio of businesses amounted to HUF 4,614 billion, accounting for 31 % of the total asset portfolio. The credit portfolio of households and businesses increased by almost the same amount – HUF 597 and HUF 583 billion, respectively – during year 2004. An increasing proportion of transactions was denominated in foreign exchange in both areas, about 70 % of the increment of corporate loans and almost half of the retail credit increment was made up of foreign exchange loans or HUF loans based on foreign exchange.

In addition to traditional banking operations banks got increasingly involved in the provision of investment services. Banks performed over 80 % of their customer asset management activities on the basis of deposit management orders received from customers. They also carried out custodian, deposit safekeeping and asset management orders.

At end-2004 the nominal value of the assets of customers managed by banks exceeded the amount booked one year before by almost 25 %, after an increase exceeding that of the balance sheet total. The total of funds intermediated by the banking sector – which includes the banks' balance sheet total and the customers' assets managed by banks – increased by a dynamic 19 %.

The trends in the assets intermediated by the banking sector

Banks were financing their lending activities by raising new funding sources. At end-2004 the total liabilities of the banking sector exceeded the amount registered at the end of 2003 by some HUF 2,066 billion. About a third of the increment of liabilities originated from domestic deposits and from abroad, 4.1 % from mortgage bonds owned by domestic investors, 13.3 % from domestic interbank deposit and credit sources and 12 % came from the growth of shareholders' equity.

The decelerating though still dynamic growth of the banking sector did not, on the whole, jeopardise the stability of the sector, at the same time it provided outstanding profitability. The exchange rate risk did not increase despite the increasing proportions of transactions denominated in foreign exchange, since the long foreign exchange positions in the balance sheet were hedged by the banks outside the balance sheet. Though in the case of entrepreneurial loans the ageing of the loan portfolio lead to a slight increase of the portfolio of non-performing items, the proportion of such items did not exceed 3.92 % of the total entrepreneurial credit portfolio, even at the end of 2004. The quality composition of entrepreneurial loans is acceptable by international standards, for at the end of 2003 the ratio of non-performing loans was above an average of 4 % in the credit portfolios of the banks of the EU-15 countries. The ratio of non-performing items among retail credits did not increase, it remained at the 2.4 % registered at the end of 2003. The capital position of the sector is stable, as a result of the internal capital accumulation enabled by the profitability of the sector. The weighted average liquidity ratio of the banking sector (approx. 12.25 %) was practically identical with the 12.26 % recorded at the end of the preceding year, reaching the average of the 15 old EU Member States (of 12.2%), slightly exceeding the desirable 10 %.

The sector booked HUF 275 billion profit after taxes (58% up on that of 2003), indicating a profitability that is rather high by international standards. In 2004 the weighted average ratio of profitability of assets calculated form the profit after taxes in the banking sector (ROA) stood at 1,97 %, the return on equity (ROE) stood at 23.40 %, exceeding the 8.3 % and the 10.9 % ratios of both the old and the new Member States, respectively. The rapid growth of profitability was enabled by a combined effect of a 19.7 % increase of the average asset portfolio, including an average of almost 23 % increase of the average credit portfolio and the relatively large – 3.91 % – margin caused by the high rate of return, which hardly diminished during the year. The improvement of the profitability of the sector was enabled primarily by maintaining the level of the interest margin and the improvement of operating cost effectiveness.

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

Transposition of EU rules and directives

For Hungary and the Supervision, the greatest change in 2004 in respect of the regulation of the financial market was the entry into force of a number of rules that were *applicable only to EU Member States*. The application of the single passport principle greatly simplified, for financial organisations established in one of the Member States of the expanded EU, the taking up of activities in other Member States. Hungarian regulations contain identical rules in respect of financial institutions, investment service providers and insurance companies alike, with the exception of a few details.

The Supervision actively participated in the transposition of directives related to financial services into Hungarian law. The Ministry of Finance, which has the main responsibility for law harmonization, involved the Supervision in the preparation of legislation.

The Supervision cooperated in the transposition of the following directives into Hungarian law

The implementation of Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, which was *transposed*, in respect of the supplementary supervision of financial conglomerates, by Act *LXXXIV of 2004*. Pursuant to the Directive, in Hungary the OTP group is considered a conglomerate, and in their case, the Supervision acts as coordinator in the course of the supplementary supervision of the conglomerate. The implementation of Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, which was transposed by Act XXXV of 2004 on specialised credit institutions issuing electronic money. The transposition of Directive 2002/47/EC on financial collateral arrangements, which is contained in Act XXVII of 2004 on the amendment of certain financial acts for law approximation purposes amending the Civil Code and the Bankruptcy Act. Furthermore, the Supervision participated in the preparation of a number of directives, which are still in the process of being transposed.

Legal amendments due to the responsibilities of the Supervision

Last year the Supervision, in addition to many other proposals, *submitted a proposal to amend Act CXII of 1996 on Credit Institutions and Financial Undertakings (Credit Institutions Act.).* The amendment re-regulated the consolidated supervision of credit institutions, also incorporating in the Act a directive on the liquidation of credit institutions, and containing a number of clarifications and supplementary clauses necessitated by harmonisation with the *acquis*. The amendment of Act CXX of 2001 on the Capital Markets (Capital Markets Act) incorporated the rules of consolidated supervision pertaining to investment undertakings, as well as the harmonisation of two new EU directives in the amendment of the chapter on investment funds, as well as minor modifications, which were nevertheless important for certain areas.

The Supervision placed emphasis on the trends to amend the capital adequacy rules of the supervised institutions in 2004 as well. Following several years of preparatory work, the Basle Committee on Banking Supervision published the *new Basle Capital Accord (Basle II*) in June 2004, which the EU also proposes to adopt. Following the adoption of the draft directives amending the calculation system of the capital requirements of credit institutions and investment enterprises (capital requirements directives) by the Commission in July, the Supervision continues to actively participate in the European committees working on the new regulatory system. The Supervision also actively participated in the meetings organised by the Ministry of Finance to establish Hungary's position during the discussion of the draft directives in the European Council, during this exercise, we could utilise the experiences gained in the course of the committee work. The Supervision held discussions with the Hungarian Banking Association concerning the tasks relating to the implementation of the new capital rules in Hungary, as a result of which a survey was made on the possible difficulties of introducing the new capital adequacy rules in Hungary.

In addition to the usual annual questionnaire survey, in 2004 the Supervision started to directly examine the efforts of the most important credit institutions to develop their internal classification systems, and, starting in the end of 2004, this subject became part of the examination programme of the regular on-site examinations.

In 2004, Act LX of 2003 on Insurance Companies and Insurance Activities was amended twice. Essentially, the rules applicable to insurance intermediation and insurance consultancy were amended, but the amendment also specified the content of asset management for mutual pension funds and private pension funds. The rules governing permanent establishments and relating to third-country insurers and to insurance mutuals were also clarified. *Legal regulations governing pension funds* were amended regarding the membership relationship, the rules of designating a beneficiary, the organisation of funds, the rules of secrecy and asset management. Under the new regulations, the members of pension funds as well as of health and income supplement funds can also appoint a beneficiary. As of 1 January 2004, the board of directors of funds have been allowed to take decisions outside sessions. The processing of complaints has been made the fundamental responsibility of funds, therefore the Supervision forwards complaints received to the funds for investigation. The regulation of real estate investment of funds and the rules of supervisory control have become more detailed. After the end of the waiting period or upon reaching retirement age, pension fund members may offer as collateral at most 50% of the balance on their individual accounts to agreements concluded with credit institutions falling under the scope of the Credit Institution Act, as long as they provide that the pension fund freeze the amount on the individual pension account. The more detailed regulation of transfers back to the social security system in case of members who became disabled affected exclusively private pension funds. In case of disabled persons, the fund must, upon request, inform the member without delay about the sum of the expected annuity. As of May 2004, in conjunction with EU accession, the definition of career starters and of voluntarily joining members was re-regulated. *The new Hungarian Act on the fight against money laundering and the financing of terrorism* came into effect on 16 June 2003. In that context, the Supervision prepared a new recommendation at the beginning of 2004, which was made available to the participants of the financial sector. As new elements, the recommendation contained the most frequent typologies and the chapter on the financing of terrorism was revised based on the list of EU sanctions. At the beginning of 2004, the Supervision updated the anti-money-laundering model rules disclosed to the supervised financial institutions.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2004

The key features of the operation of the Supervision in 2004 were determined by market trends, fundamental risks and the supervisory objectives revised to reflect such risks.

Objectives and tasks of the supervision

As a member of the supervisory community of the European Union, on the integrating financial market, the Supervision

- assures the reliable, continuous and transparent operation of financial markets;
- promotes the confidence in the financial markets;
- promotes the development of financial markets relying on fair competition;
- protects the legitimate interests of market participants;
- helps reducing the risk of consumer decisions by making available the necessary information;
- actively participates in combating financial crime.

Accordingly, the activities of the supervision fall into two large categories:

- "classic" prudential supervision, which means primarily assuring the continuous and reliable operation of the supervised institutions, the enforcement and enforceability of rules at present and in the future,

- market oversight activities, monitoring the effects of the cooperation of market participants (i.e., service providers and consumers) on the transparent operation of the market.

Risk assessment, examination findings

During 2004, the Supervision supervised, or had in its registers, two thousand and forty-seven institutions, companies with legal entity and over eighteen thousand natural persons in the money market, capital market, insurance and pension fund sectors. As part of prudential supervision, the authority prepares risk assessment on the supervised institutions on a quarterly basis. In the course of that risk assessment, the personal, operational and commercial risks are analysed based on the available information (mandatory reporting, other publicly available information). During the year, 560 institutions were assessed each quarter on average. The regular risk assessment of the supervised institutions indicated that in the course of 2004 the level of risks remained practically unchanged in the financial sector, the number of institutions in the high-risk category went down. The general assessment of risks indicates that the money of account owners and depositors, the capital of investors, pension fund members and life policy holders, the coverage of property and loss insurance holders was fundamentally safe during last year. In addition to the quarterly risk assessment, the Supervision conducted some four hundred examinations in 2004.

The on-site examinations and off-site supervision were either comprehensive, targeted or ad hoc. The law regulates the frequency of comprehensive examinations, while most of the targeted and ad hoc examinations are triggered by risk assessment. The examinations look at legality, compliance, and place increasing emphasis on the assessment of the quality of financial products and services. The supervisory measures following the examinations included resolutions as well as, increasingly, hitherto little used instruments such as consultations, as well as supervisory recommendations and information sessions. Sector of financial institutions Last year large *banks* suffered no perceivable portfolio deterioration, and the Supervision considered the risk assumption process to be sufficiently prudent. On the other hand, the findings of examinations revealed that a substantial part of the credit risks of banks operating in financial groups can be interpreted together with the other group members only, but the evaluation of the liquidity, exchange rate and interest rate risks also reveals a true picture only in conjunction with the other group members. Therefore, the methods of integrated supervision have been improved on several points. In line with the new international requirements, in the course of on-site examinations the Supervision staff placed special emphasis on the measuring and management of the operating risks of banks. The findings of examinations indicate that few financial institutions address this issue in depth; in most places there is no management commitment to make available the necessary resources.

In the *cooperative sector*, no severe deficiencies were identified in relation to the capital position of credit cooperatives, which was a priority during comprehensive examinations. In this sector, risks arise from irregular lending practices (inadequate assessment of collateral and sureties), and the intransparent management and ownership structures. In the course of examinations, special emphasis was placed in the verification of the prevention of money laundering. No major deficiencies were found in the banks examined, our experiences show that banks strive to comply with legal regulations. Among *financial enterprises*, the number of firms increased continuously, many new, non-bank-owned financial enterprise entering the market. The Supervision pays special attention to their licensing. The risk level of financial enterprises was stable in 2004, at a moderate level. In the group of financial enterprises not affiliated to bank groups, risk levels were above average, probably due to the absence of the tight control of banks. In the case of these firms, the risk was caused by inadequate capital position, insufficient commercial activity, or the continuously deteriorating asset portfolio ending up in the bad category. The latter phenomenon was related to the increasing problems encountered in vehicle financing. Examinations revealed a discrepancy in that the regulation of factoring activities in the Capital Market Act is not uniform at present, and there is no differentiation between current factoring and work-out type activities. The legal separation of the two activities and the appropriate modification of the regulation would promote the more efficient supervision of current factoring, which provides short term finance, and work-out type activities, which are rather different in their objective and implementation.

Capital market

Among investment enterprises, there has been no substantive change in the risk position, any negative movement was found only in operating risks, in particular the operation of control and information systems. The most notable irregularities related to the violation of settlement transaction limitations (some of the companies perform for their clients operations that belong to the scope of settlement services beyond the limits of investment service activities) or to the improper management and protection of assets owned by clients. Further problems were found in the field of separation of organisation units and functions performing the various activities, the formulation of internal procedures, by-laws and internal control system and the outsourcing of certain activities (occurring problem in the field of information technology). On the whole, the capital position of the companies is deemed to be adequate.

The risk level of *investment fund managers* is low. The examinations performed at fund managers revealed that the standard of ownership control was adequate. At the same time, the accelerating of commercial activity and the expansion of the scope of activities demanded the radical transformation of internal control systems as well. Both management control and in-process control strengthened last year. In general, the supervised institutions complied with legal regulations, the violation of investment limits became less frequent in the environment of increased control, but it still happens.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY LAST YEAR

The management and governance system of the supervision

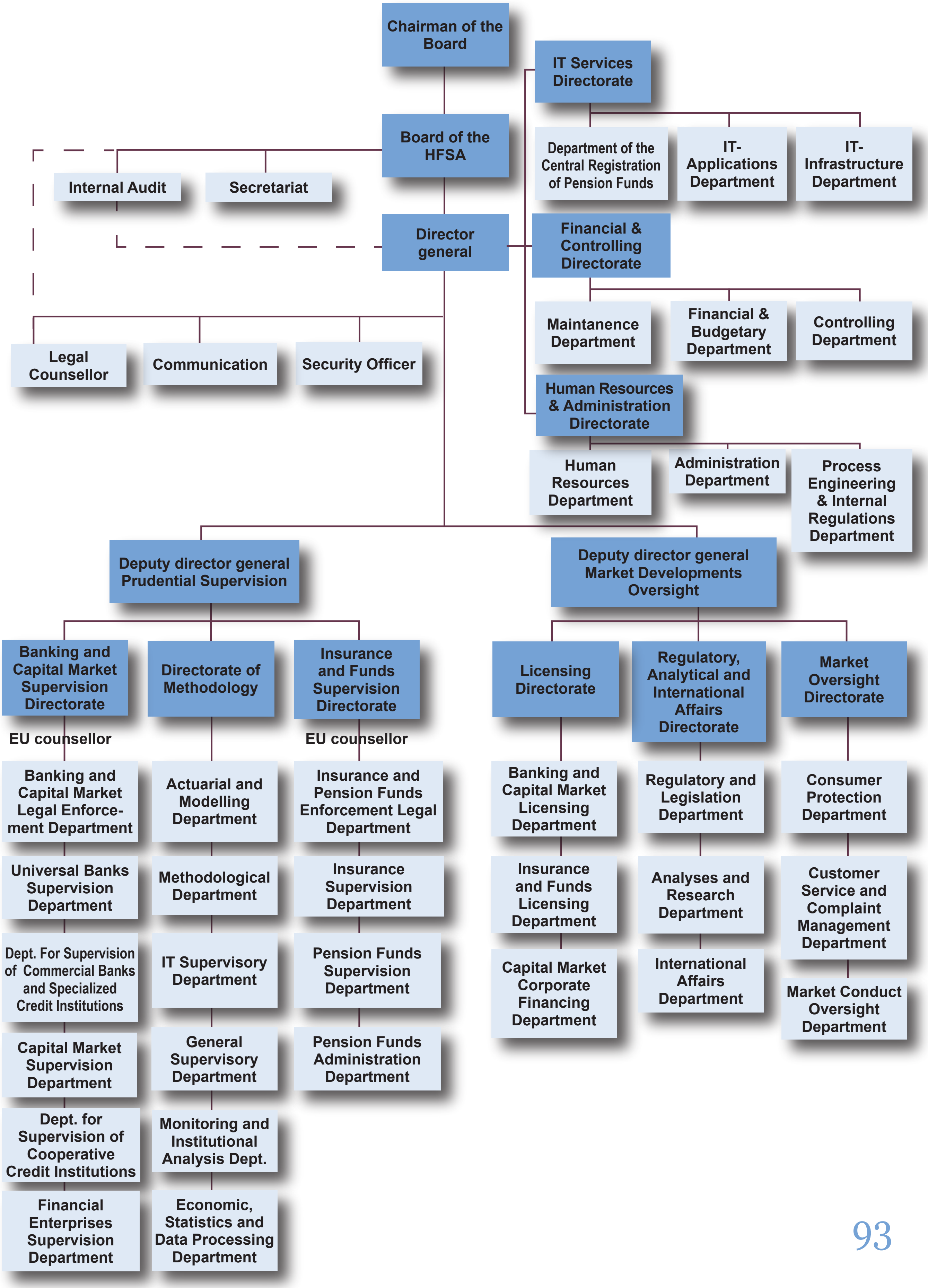
Pursuant to Act XXII of 2004 on the amendment of certain acts relating to the increased protection of investors and depositors, regulations pertaining to the Supervision were also changed. Pursuant to the law, after 18 May 2004, the HFSA Board became the main strategic management and decision making body of the institutions, while the Director General heading the Office has responsibility for operative management. A more efficient organisation structure more adapted to the market challenges was developed during the year. As the main element of the organisational change, which is also enshrined in the new organisational and operational rules approved by the Minister of Finance, the prudential supervision block as well as the market oversight block have been reinforced. As discussed in the pervious chapters of the annual report, operational risks are of utmost importance not only within the individual institutions but also between institutions. This is indicated by the fact that from the second half of the year the two main organisations of the Office have operated under the management of two deputy director generals, with equal importance. By balancing the prudential supervision and market oversight, the emphasis on prevention, more sensitive response to market processes and reliance on dialogue and cooperation with market participants have become reinforced in the Supervision's work. In the new approach, the strengthening of strategic thinking based on expected market developments, the increase of decision making independence and responsibility were given more importance; as a result, the formerly highly centralised organisation model became more decentralised, and decision making competences were moved to lower levels. It is a notable phenomenon in the Hungarian financial sector that financial services are becoming increasingly complex, and one institution would offer many different products to consumers. Accordingly, the Supervision has the task of accelerating the process of establishing an integrated supervision in compliance with the changing circumstances. The process, which started some four years ago, means that the Supervision has competence over every sector (money market, insurance market, capital market, funds), and also that it performs its work under uniform principles and methodologies. Accordingly, the various institutions and products can be supervised based on uniform principles if the institutions and products are analysed along a common element, i.e., the risk. We must not disregard the fact, however, that risks, mainly operational risks, add up on the level of single institutions. Thus they relate to institutions and their supervision is also a must. Within the Supervision's organisation, this function is performed by the system of designated supervisor, where every supervised institution (financial group) has a designated contact person or supervisor. The complexity of services, the permeability of the lines between institutions and the better utilisation of professional skills, however, demand that, in addition to the necessarily hierarchical structure of the Office, the Supervision also establish horizontal professional committees that make better use of professional competences and assure a uniform approach. These committees, to ease the rigidity of directorates and departments, are mainly functional in nature, for instance the committee of European affairs, the accounting, asset management or legal committees. Special mention should be made of the Conglomerate committees, meant to assure group-level supervision. Thus, in the approved organisation, an equilibrium has been achieved, which is necessary to fulfil the fundamental goals of the Supervision. This is expressed by the co-ordinated, mutually interdependent structure of the organisations and bodies below, which supplement and control each other:

- HFSA Board and the Office: the setting of objectives and strategies and monitoring of implementation – organisation and practical management of the implementation of tasks;
- Prudential supervision and market oversight: the supervision of the sound operation of the supervised institution – identification and elimination of anomalies in operation and the market environment;
- Functional supervision and the system of designated supervisors: maintaining financial risks between limits – supervision of operational risks so that they cannot cause destructive financial risks later;
- Hierarchical structure and inter-organisational committees: reliable, though somewhat rigid traditional governance system – more flexible system able to give professional responses to changing market challenges, combining the professional competences existing in the various units of the supervisory organisation.

Internal regulation

In addition to more comprehensive organisational changes, modifications promoting the efficiency, transparency and controllability of daily operations were also made in 2004. For instance, a controlling unit was established, which focuses on the comparable and measurable utilisation of the budget of the Supervision, and internal audit was strengthened, becoming an organisational unit. In 2004, the chartering and regulation of previously unregulated areas as well as the review and updating of existing regulations continued. To promote uniform supervisory internal rules, the new regulation entered into force to clarify the content and formal elements of internal rules and to regulate procedural issues. In addition, a number of new rules were adopted during the year. Because of the organisational change in the Supervision, the review of the necessary regulations was also commenced. Following the entry into force of the new Organisational and Operational Rules, the directive of the Director General on the detailed tasks of the various units of the Office was prepared.

ORGANIZATIONAL STRUCTURE OF THE HUNGARIAN FINANCIAL SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF YOUR AUTHORITY

Cooperation within the European Union

In 2004, the EU accession and the related tasks were the most significant events for Hungary. The HFSA started preparation for the new environment by participating in the work of various EU level committees and working groups, in respect of cross-border services and implementation of EU provisions and changes in supervisory methodologies and procedures. The experts of the HFSA have contributed to the work of various committees as observers since 16 April 2003, the date of signing the accession treaty, and as members since the accession. The HFSA has become a member of the organisations of the financial supervisory authorities of the European Economic Area, which are sectorally organised as Level 3 committees according to the Lamfalussy process. The authorities of the 28 countries form the CEBS in the field of banking, the CEIOPS for insurance and pension funds, and the CESR for securities (capital markets). At present, the representatives of the HFSA participate in the work of 39 committees and working groups in the fields of banking, capital market, insurance, pension fund, financial conglomerates and anti-money-laundering. In addition to innumerable exchanges of e-mails the committee members attended 150 meetings in 2004. Last year, the HFSA joined the *CESR-Pol Joinder Agreement*, while in case of the CEIOPS the HFSA became party to the document providing for the supplementary supervision of insurance undertakings in insurance groups (*Helsinki Protocol*) and the document on the cooperation of insurance supervisory authorities (*Siena Protocol*) by the accession. In addition to numerous other cooperation agreements, the HFSA signed the multilateral memoranda of understanding of the European Central Bank on crisis management, and on payment systems.

Cooperation outside the European Union

OECD

The OECD operates with several expert committees; of these, the Committee on Financial Markets, the Working Party of Governmental Experts on Insurance and the Pension Fund Working Group are of outstanding importance from a supervisory aspect; the HFSA regularly and actively participate in their meetings and in the preparatory work. The most important projects of 2004 were as follows: financial education, consumer awareness, competition in the financial sector, corporate governance in the financial sector, aging population and its effects on pension schemes and structure of investments.

IAIS

In 2004, the HFSA, as a member of the association, participated in the 11th annual meeting of the International Association of Insurance Supervisors, and attended the meetings of 7 committees and subcommittees of the IAIS on 9 occasions.

Between 29 March and 1 April 2004, the Executive Committee, the Technical Committee and its sub-committees and the Emerging Markets Committee and Education Subcommittee held their quarterly sessions in Budapest. Related to the committee meetings, the HFSA organised a regional seminar on 1-2 April 2004 for the staff of Central and Eastern European insurance supervisory authorities, with 61 participants. The HFSA prepared its self-assessment exercise, examining compliance with the new Insurance Core Principles approved in 2003, and was one of the first institutions submitting it to the IAIS Secretariat in December.

IOSCO

IOSCO is the international organization of securities commissions, where our personal participation is limited to the annual conferences (in May 2004 the 29th annual conference of the IOSCO was held in Jordan), while we always participate in major projects and in questionnaire surveys. In 2004, IOSCO launched or continued several projects that promote international cooperation.

IOPS

In 2004, after lengthy preparation, the International Organisation of Pension Supervisors was established, with the HFSA as one of its founding members. The representative of the HFSA holds a senior position in the organisation that was formerly affiliated to the OECD, but operates independently since 2004. After its establishment, the organisation now considers the elaboration of common supervisory standards as its most important task.

BSCEE

Since 1996 HFSA and its predecessors has been hosting the Secretariat of the Group of Banking Supervisors from Central and Eastern Europe. During 2004, the representatives of the HFSA attended the 17th conference of the group, as well as the seminars organised twice a year (jointly with the Financial Stability Institute – FSI).

Conference of integrated financial supervisory authorities

The 6th conference of the Integrated Financial Supervisory Authorities was held in Singapore on 13-17 August 2004. The 2004 conference of the organisation, with the supervisors of 16 countries as its members, focused on assessing the efficiency of supervision and discussing the issues of cost-sensitive supervision.

AML Working Group

The HFSA participated in the work of the Anti-Money Laundering working group, which elaborated the new 3rd anti-money laundering directive of the EU, and contributed to the formulation and representation of the Hungarian position. Furthermore, the experts of the HFSA participated in the work of the AML Contact Committee, which fosters the anti-money laundering internal relations of the EU and the relations between the EU and international antimony laundering organisations (FATF, MONEYVAL, etc.), to help formulate the EU's position. In 2004, the HFSA headed the Hungarian delegation to Moneyval.

COOPERATION WITH OTHER SUPERVISORY BODIES IN YOUR COUNTRY

In respect of the cooperation of the financial control bodies, the tripartite agreement of the Ministry of Finance, the National Bank of Hungary and the Supervision is of outstanding importance; it has the objective of assuring the stability of the system of financial intermediation and the coordination of the macro- and micro-prudential supervision, control, regulation and monitoring of the sector. This arrangement, which is widely used internationally, has the additional objective of assisting the work of the three institutions in assuring financial stability. In addition to many other agreements, the Supervision has signed a bilateral cooperation agreement with the Tax and Financial Control Authority and the Parliamentary commissioner for citizens' rights. The Supervision placed great emphasis on reviewing, together with the trade associations of the financial sector, the existing and potential areas of professional relations. Accordingly, the HFSA Board engaged in consultation with the major interest representation bodies and trade associations of the financial sector (Hungarian Banking Association, Association of Hungarian Insurers, BAMOSZ, Fund associations, BSZSZ). In addition to the strengthening of relations with interest representation and trade associations, the Supervision organised a number of consultations, held presentations and organised successful conferences for practitioners working in the financial sectors.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

In 2004, the Hungarian Financial Supervisory Authority (HFSA) focused on the implementation of the reformulated objectives. It is not that a "different" supervision was created; rather, an organic development process was started, building on our existing values such as the highly qualified staff. All this aimed to assure that the HFSA complies with the modern organisational and operational principles set forth in the Act on the Supervision adopted last year, and that simultaneously it finds its place in the supervisory community of the European Union. Among its fundamental objectives, the HFSA set out to shorten its response time to market problems, to speed up the adoption of measures and to reinforce its preventive function. We also had to meet the expectation that our supervisory activity should encompass the screening of all financial, operational and consumer protection risks arising at the financial institutions. In the course of its modernisation, the Supervision focuses on assuring the conditions of professionalism and integrity. The resulting organisational structure provides the equilibrium that supports efficient supervisory work from all aspects. To supplement the "classic" prudential supervision, greater emphasis has been placed on market oversight within the organisation of the HFSA. In that context, the HFSA takes actions against irregularities to protect the interests of all market actors, from service providers to the consumers. The responsibilities of the market oversight function include not only consumer protection activities – complaint procedures, client service, information – but also the detection of unlicensed service providers and identification of information indicative of insider trading. The market oversight function, which monitors sensitive information, performs examinations requiring timely action and outstanding capabilities. To accelerate procedures and bring legal considerations closer to the daily work of financial institutions, law enforcement work has been integrated into audit and economic activities both in prudential supervision and in the equally important market oversight. More efficient work is promoted by the altered decision making mechanism and the decentralisation of decision making powers. The number of units directly reporting to the operative head of the Supervision has been decreased while the directorates working in the prudential and market oversight lines have received greater discretionary decision making powers and the concomitant greater responsibility. Within the governance structure of the HFSA, the Board sets the objectives and strategies for the entire Supervision and monitors their implementation. On the other hand, the Office, headed by the Director General and supported by the operative management meeting to prepare decisions, is responsible for the implementation and practical management of the tasks. The HFSA continues to maintain its institution-based supervisory structure. However, alongside the hierarchical structure, working groups have been set up from delegates of several organisation units, which promote consolidated, integrated and activity-based supervision in horizontal cooperation. This is how the more efficient supervision of increasingly complex financial services and innovative products can be assured. The bank holding supervision groups, as well as the working groups looking at activities characteristic of more than one sectors, such as asset management, operate along those lines. In its contacts with market participants and peer authorities, the Supervision strives for partnership and dialogue. Accordingly, in the autumn of 2004 the Supervision, the National Bank of Hungary and the Ministry of Finance concluded a tripartite agreement on the coordination of tasks to assure the stability of the financial sector. A number of consultations were held with the participation of the trade associations and representative bodies of the supervised sectors, which are also represented in the working groups of the Supervision. From among the market and consumer protection measures, we should highlight the introduction of the register of insurance agents to promote the more efficient identification of insurance intermediaries, the preparation of the system of electronic returns by employers to private pension funds, and the reinforcement of the investigation of unauthorised financial activities. The Supervision informed consumers in a series of information booklets and continuously updated product comparison tables last year as well. This was also promoted by the transformation of the client service and complaint handling procedures to make them more customer-friendly and smoother. During the whole year, special emphasis was placed on the preparation for the legal definition of the annual percentage rate (APR), the supervisory measures relating to addressing the problems of the Interbank Debtor and Credit Information System (BAR), and the theme audits relating to mortgage lending practices and the oversight activities of banks employing currency exchange agents. The HFSA took a major role in the preparation for the transposition of EU rules and directives into Hungarian law. Our staff actively participated in the work ongoing in the committees of organisations of the supervisory bodies of the European Economic Area. In order to coordinate information flows relating to the European Union, a separate EU working group was set up within the HFSA, combining representatives of different specialities. In order to more effectively implement the procedures of Basle II, the new Basle capital accord, the establishment of a comprehensive cooperation procedure has been started with peer agencies and the supervised institutions, and a further training programme was launched within the Supervision. The work of the HFSA doubtlessly contributed to the fact that in the financial sector, consisting of more than two thousand institutions, the risk levels did not change last year, and fewer institutions received high risk ratings.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2002	2003	2004
Banks and specialized credit institutions	37	36	35
Saving and credit cooperatives	189	182	178
Financial institutions	**226**	**218**	**213**

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

Item	2003		2004	
	HUF billion	%	HUF billion	%
Public sector ownership	3.6	0.9	3.6	0.9
Other domestic ownership	49.2	13.1	44.2	11.5
Domestic ownership total	*52.8*	*14.0*	*47.8*	*12.4*
Foreign ownership	308.0	81.9	309.6	80.4
Preferential and repurchased stocks	15.1	4.0	27.6	7.2
Banking system, total	**375.9**	**100.0**	**385.0**	**100.0**

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

Item	2003		2004	
	HUF billion	%	HUF billion	%
Public sector ownership	1.3	9.0	1.1	6.8
Other domestic ownership	13.4	90.9	15.2	93.2
Domestic ownership total	*14.8*	*99.8*	*16.3*	*100.0*
Foreign ownership	0.0	0.2	0.0	0.0
Preferential and repurchased stocks	0.0	0.0	0.0	0.0
Saving and credit cooperatives, total	**14.8**	**100.0**	**16.3**	**100.0**

Concentration of asset by the type of financial institutions

HUF billion

Type of institutions	The first three largest	The first five largest	Total
Bank and specialized credit institutions	6,120.0	8,425.0	14,926.4
Saving and credit cooperatives	84.3	125.7	1,064.4
Financial institutions	**6,204.3**	**8,550.7**	**15,990.8**

Return on asset (ROA) by type of financial institutions

Type of institution	2004		
	After-tax profit (HUF billion)	Average assets (HUF billion)	ROA (%)
Bank specialized credit institutions	275.2	13,952.5	1.97
Savings and credit cooperatives	8.2	817.3	1.01
Financial institutions	**283.4**	**14,769.8**	**1.92**

Return on equity (ROE) by type of financial institutions

Type of institution	2004		
	After-tax profit (HUF billion)	Average own equities (HUF billion)	ROE (%)
Bank and specialized credit institutions	275.2	1,176.3	23.40
Savings and credit cooperatives	10.1	65.3	15.51
Financial institutions	**285.3**	**1,241.6**	**22.98**

Balance sheet total
(at year-end)

HUF billion

Type of financial institution	2002	2003	2004
Bank and specialized credit institutions	10,195.6	12,860.0	14,926.4
Savings and credit cooperatives	779.1	923.4	1064.4
Financial institutions	**10,974.7**	**13,783.4**	**15,990.8**

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

Assets	2002	2003	2004
Cash and settlement accounts	4.8	3.6	4.9
Securities for trading purposes	4.5	5.3	4.01
Securities for investment purposes	10.4	11.5	10.1
Central bank and inter-bank deposits	14.2	10.0	10.8
Credits	59.8	63.2	63.5
Proprietary interests	1.9	2.0	1.6
Own assets	1.9	1.8	2.0
Other assets			3.2
Balance sheet total	**100.0**	**100.0**	**100.0**
Liabilities	**2002**	**2003**	**2004**
Deposits	65.3	56.6	52.9
Inter-bank deposits	7.1	8.2	9.8
Borrowing	7.8	12.3	12.0
Dept securities	4.5	8.5	9.9
Subordinated liabilities	1.3	1.3	1.2
Special provisions	1.1	1.0	0.9
Own capital	8.7	8.5	8.9
Other liabilities			4.6
Balance sheet total	**100.0**	**100.0**	**100.0**

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

Assets	2002	2003	2004
Cash and settlement accounts	5.9	5.9	5.3
Securities for trading purposes	29.0	26.5	23.0
Securities for investment purposes	6.1	5.8	5.3
Central bank and inter-bank deposits	12.7	11.9	12.5
Credits	40.5	44.2	47.2
Proprietary interests	0.3	0.3	0.7
Own assets	3.3	3.4	3.6
Other assets	2.2	2.2	2.5
Balance sheet total	**100.0**	**100.0**	**100.0**
Liabilities			
Deposits	90.1	89.7	89.5
Inter-bank deposits	0.5	0.5	0.4
Borrowing	0.2	0.4	0.5
Dept securities	0.0	0.0	0.0
Subordinated liabilities	0.4	0.4	0.8
Special provisions	0.4	0.4	0.3
Own capital	6.4	6.6	6.7
Other liabilities	2.1	2.1	1.8
Balance sheet total	**100.0**	**100.0**	**100.0**

Development of off-balance sheet activities

Type of financial institution	2002	2003	2004
Balance sheet total (HUF billion)			
Banks and specialized credit institutions	10,196	12,860	14,926
Savings and credit cooperatives	779	923	1,064
Financial institutions	**10,975**	**13,783**	**15,990**
Off balance sheet total (HUF billion)			
Banks and specialized credit institutions	7,320	9,693	8,765
Savings and credit cooperatives	26	37	45
Financial institutions	**7,346**	**9,730**	**8,810**
Off balance sheet / balance sheet (%)			
Banks and specialized credit institutions	71.8	75.4	58.7
Savings and credit cooperatives	3.4	4.0	4.2
Financial institutions	**66.9**	**70.6**	**55.1**

Solvency ratio of financial institutions

Type of the financial institution	Guaranteed capital (HUF billion)	Weighted assets (HUF billion)	Solvency ratio (%)
Bank and specialized credit institutions	1,114.2	9,639.5	11.56
Savings and credit cooperatives	64.5	489.1	13.19
Financial institutions, average	**1,178.7**	**10,128.6**	**11.64**

Portfolio quality of the banking system

Asset classification	2002		2003		2004	
	HUF billion	%	HUF billion	%	HUF billion	%
Problem free	13,516	92.8	18,863	94.6	19,601	94.8
Special mention	743	5.1	739	3.7	680	3.3
Non-performing	300	2.1	339	1.7	397	1.9
- substandard	142	1.0	166	0.8	202	1.0
- doubtful	78	0.5	82	0.4	79	0.4
- bad	80	0.6	92	0.5	116	0.5
Classified total	**14,559**	**100.0**	**19,941**	**100.0**	**20,677**	**100.0**
Specific reserves (HUF billion)	**156**		**170.0**		**163**	

The structure of deposits and loans of banking system in 2004 (%) (at year-end)

	Deposits		Loans	
	HUF billion	%	HUF billion	%
Households	4,279.3	54.2	2,597.1	27.4
Government sector	265.4	3.4	278.4	2.9
Corporate	2,399.2	30.4	4,613.8	48.7
Foreign	490.3	6.2	429.4	4.5
Other	462.9	5.9	1,564.5	16.5
Total	**7,897.1**	**100.0**	**9,483.2**	**100.0**

Proportion of foreign exchange assets and liabilities in 2004 (HUF bn, %) (at year-end)

Type of the financial institutions	FOREX assets	Total assets	FOREX assets / Total assets	FOREX liab.	Total liab.	FOREX liabilities / Total liab.
Bank and specialized credit institutions	5,006.6	14,926.4	33.5	4,096.0	14,926.4	27.4
Savings and credit cooperatives	1.4	1,064.4	0.1	1.1	1,064.4	0.1
Financial institutions	**5,008.0**	**15,990.8**	**31.3**	**4,097.1**	**15,990.8**	**25.6**

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

HUF bn

Revenues	2002	2003	2004
1. Interest income	846.4	1,045.4	1,440.6
2. Net non interest income	107.8	150.1	194.8
Of which: Net income from commissions	128.8	167.2	181.0
Dividends	8.3	12.8	15.7
3. Extraordinary income	8.6	12.6	3.5
Revenues total (1.+2.+3.)	**1,099.9**	**1,388.1**	**1,835.6**
Expenditures	**2002**	**2003**	**2004**
1. Interest expenditures	459.8	595.3	895.1
2. Overheads	341.9	387.9	416.3
3. Extraordinary expenditures	5.6	9.0	3.7
Expenditures total (1.+2.+3.)	**807.3**	**992.2**	**1,315.1**

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

HUF bn

Revenues	2002	2003	2004
1. Interest income	84.6	93.8	124.9
2. Net non interest income	4.0	3.0	6.9
Of which: Net income from commissions	10.1	12.3	14.2
Dividends	0.0	0.0	0.2
3. Extraordinary income	0.2	0.7	0.7
Revenues total (1.+2.+3.)	**88.8**	**97.5**	**132.6**
Expenditures	**2002**	**2003**	**2004**
1. Interest expenditures	41.4	41.7	68.8
2. Overheads	38.7	45.6	51.1
3. Extraordinary expenditures	0.1	0.2	0.6
4. Taxes paid	1.5	1.8	1.9
Expenditures total (1.+2.+3.)	**81.8**	**89.3**	**122.5**

Structure of registered capital and own funds of financial institutions in 2004

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	HUF bn	%	HUF bn	%
Bank and specialized credit institutions	384,963	2,6	1,323,827	8,9
Savings and credit cooperatives	16,3	1,5	71,5	6,7
Financial institutions	**401,263**	**2,5**	**1,395,327**	**8,7**

2004 DEVELOPMENTS IN THE LATVIAN BANKING SYSTEM

MACROECONOMIC ENVIROMENT

In 2004, the robust economic growth of Latvia was supported by the strong domestic and rising foreign demand. In terms of current prices, gross domestic product (GDP) amounted to 7.4 billion lats, with real GDP exceeding last year's indicator by 8.5%.

In 2004, the annual average inflation in Latvia was 6.2%, with prices for consumer goods rising at a faster pace (6.5%), but those for services increasing by 5.6% on average. Annual consumer price inflation was 7.3%. In 2004, the average monthly gross wage and salary and the average monthly net wage and salary of persons employed in the national economy were LVL 211.06 and LVL 150.35, respectively. Compared with the previous year, the average gross wage and salary increased by 9.6%, and the average net wage and salary rose by 8.9%. The rise in wage and salaries exceeded the annual inflation rate; hence year-on-year, the real gross wage rose by 3.2% and the real net wage by 2.5%.

In 2004, the general government consolidated budget posted a fiscal deficit of 55.0 million lats or 0.7% of GDP based on the accrual principle used for evaluating compliance with the Maastricht criterion. According to the cash flow principle applied in central government budgeting, the general government consolidated budget recorded a fiscal deficit of 79.0 million lats or 1.1% of GDP, which was considerably lower than in 2003 (1.8% of GDP) and below the projections (2.2% of GDP); it was achieved on account of better revenue collections and moderate Government expenditure. Just as in 2003, the fiscal deficit accumulated only at the end of the year and for the first eleven months of the year the general government consolidated budget ran a surplus.

Despite the buoyant economic activity in 2004, the number of the unemployment registered with the State Employment Agency increased slightly (to 8.8% of the total economically active population; 8.6% in 2003).

DEVELOPMENTS IN THE BANKING SYSTEM

At the end of 2004, 22 banks, the Latvian Branch of *Nordea Bank Finland Plc* and 32 credit unions were registered in the Republic of Latvia.

At the end of 2004, the banks' paid-up share capital amounted to 383.8 million lats (an increase of 24.7% over the end of 2003). Nearly all banking industry, except one bank is in private hands in Latvia. At the end of 2004, the Government's stake in the banking sector's paid-up share capital was a mere 5.9%. The Latvian State is the sole owner of the JSC *Latvijas Hipotēku un Zemes banka*. The share of foreign capital in the banks' total paid-up share capital increased slightly to 57.8% (53.9% at the end of 2003).

In 2004, all major bank performance indicators continued to grow rapidly, including assets, which expanded by 37.3% (to 7 850.1 million lats), loans (including transit credit) and deposits, which grew by 46.0% (to 4 380.6 million lats) and 36.6% (to 5 094.3 million lats), respectively. A rise of 30.6% (to 629.2 million lats) was recorded in the banks' equity.

In 2004, loans continued to gain importance in the structure of the banks' assets, reaching 55.8% (including a 17.0% rise in lending to households), and the share of claims on credit institutions also grew slightly (to 24.7%).

Compared to the end of 2003, the share of long-term loans granted to non-banks (with a maturity of over 5 years) increased from 41.6% to 47.3% of the loan portfolio, whereas the share of short-term loans (with a maturity over 1 year) declined from 20.3% to 16.5%.

In 2004, the share of non-banks deposits in the banks' liabilities remained broadly unchanged (64.9% at the end if 2004), whereas liabilities to banks grew by 2.2 percentage points (to 21.1%).

Deposits received from non-banks by banks grew at a slower rate than loans granted to non-banks in 2004. With the share of short-term deposits on total deposits received by banks growing (from 20.1% to 22.5%), that of demand deposits decreased (by 1.0 percentage point, to 72.2%). The share of medium-term deposits (with a maturity of 1 year to 5 years) shrank by 1.2 percentage points (to 4.8%).

In 2004, the assets of credit unions grew by 24.5% (to 4.9 million lats), loans and deposits increased by 27.7% (to 4.1 million lats) and 21.6% (to 3.2 million lats), respectively. Credit unions' profit was 78.8 thousand lats (a year-on-year increase of 34.5%). In 2004, their paid-up capital and reserves expanded by 33.2% (to 0.9 million lats) and 31.8% (to 1.2 million lats), respectively. Although credit unions develop rather rapidly in Latvia, their impact in the financial sector is yet insignificant.

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

In the reporting year the FCMC continued to harmonize banking legislation and regulations with the requirements of the EU directives and the Basle Core Principles for Effective Banking Supervision.

1. Amendments to the **Law on Credit Institutions**, according to which:
   - The minimum capital adequacy requirement was reduced from 10% to 8%;
   - The law was supplemented with a new type of credit institution – the electronic money institution, whose sole purpose of operations is to issue and service electronic money. The law stipulates the regulatory norms governing the operations of such institutions. The law provides an exception for electronic money institutions that do not plan to issue more than five million euro in electronic money. These institu-

tions do not need to obtain a license from the Financial and Capital Market Commission;
- In order to protect the rights of creditors and third parties in all of the EU member states, the law was supplemented with norms that regulate the reorganization, bankruptcy and liquidation of credit institutions. The law specifies the roles of the competent authorities involved in reorganisation measures or winding-up.
- The law was supplemented with norms that specify the principles for supervision on a consolidated basis of banks that are subsidiaries of the EU financial holding companies. It also specifies the co-operation in exchange of information in involved supervisory institutions;
- The law specifies the requirements that credit institutions must meet, when outsourcing accounting, internal audit function, the management or development of information technologies and the provision of financial services.

MAIN STRATEGIC OBJECTIVES OF THE FCMC IN 2004

1. The supervision of the Latvian financial and capital market by off-site analysis and by conducting on-site examinations of market participants.
2. Improvements to Latvian legislative enactments and their harmonization with EU requirements, with the recommendations of international financial supervisory authorities and with the best international best practices in this field, so as to continue the smooth integration p of the Latvian financial and capital market into the EU market.

The Commission's Action Plan for 2004 and 2005 is available on the Commission's Internet home page at www.fktk.lv.

THE ACTIVITIES OF THE FCMC IN THE FIELD OF BANKING SUPERVISION IN 2004

The Supervision Department, which comprises two divisions (the Banking and Securities Market Division and the Insurance Division) is the largest department of the Commission. Around half of the Commission's budget is spent to ensure the performance of functions of the Supervision Department.

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

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

In 2003 the Commission started its work on developing a system that would ensure a continuous and systematic evaluation of risks incurred by individual market participants. This system, which is designed to assess risks, will also be required for the implementation of the new Basel Capital Accord. This project continued during 2004.

For the purpose of ensuring efficient supervision, providing for equal treatment of all market participants, the Commission has formulated a Supervision Manual, which establishes guidelines and procedures for conducting examinations.

INTERNATIONAL ACTIVITIES OF THE FCMC

The European Union

Following Latvia's accession to the European Union (EU) on May 1st, 2004, the Commission continued the work that it had already begun in harmonizing Latvia's normative acts with EU directives. It also participated in the drafting of new EU directives. In order to present a strong Latvian position and submit recommendations concerning various draft EU normative acts affecting the financial and capital market, and which were reviewed last year at the European Council's ECOFIN and COREPER meetings, the Commission prepared Latvia's national positions and drafted instructions. Within the spheres of its competence, the Commission also reviewed and evaluated draft positions and instructions prepared by other Latvian institutions.

International organizations

During the reporting year the Commission continued to cooperate with such international organizations as the Group of Banking Supervisors from Central and Eastern Europe, the World Bank and the International Monetary Fund. Commission experts also took part in meetings of the Selected Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL). The Commission also cooperated with foreign financial market supervisory institutions to prevent the use of Latvia's financial market for money laundering purposes.

Following Latvia's accession to the EU, the Commission became a party of several European agreements. It signed the Memorandum of Understanding on Co-operation Between Payment Systems Overseers and Banking Supervisors in Stage Three of Economic and Monetary Union, the Memorandum of

Understanding on High-level Principles of Co-operation Between the Banking Supervisors and Central Banks of the European Union in Crisis Management Situations.

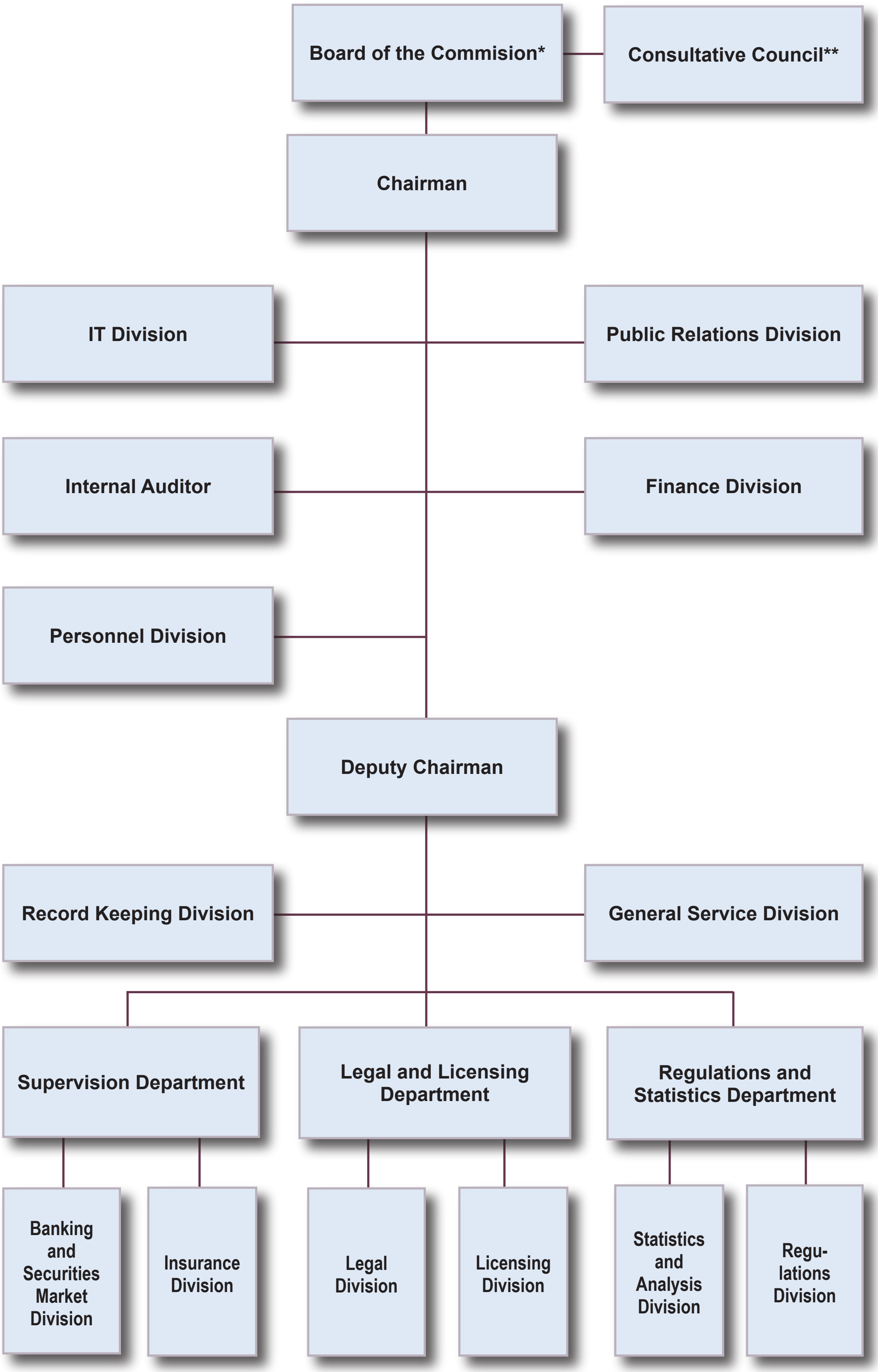
Foreign financial market supervisory institutions

The Commission expanded its sphere of co-operation with foreign financial market supervisory institutions and has reached an agreement with the Federal Bank Commission of Switzerland on exchange of information. In total Commission have been signed 18 agreements with other financial market supervisory institutions.

COOPERATION WITH OTHER SUPERVISORY BODIES

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

ORGANIZATIONAL CHART OF THE FCMC



* The Board consists of five Board members Chairman of the Commission, Deputy Chairman of the Commission and three Board members, who are simultaneously directors of the departments of the Commission.
** The Consultative Council of the Financial and Capital Market is formed on a parity basis from representatives of the Commission and heads of professional organisations of financial and capital market participants.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2002	2003	2004
Banks	22	22	22
Credit unions	26	28	32
Foreign bank branches	1	1	1
Financial institutions, total	**49**	**51**	**55**

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

Item	2002	2003	2004
Public sector ownership	7.3	6.3	5.9
Other domestic ownership	38.3	39.8	36.3
Domestic ownership total	*45.6*	*46.1*	*42.2*
Foreign ownership	54.4	53.9	57.8
Banks, total	**100.0**	**100.0**	**100.0**

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

Item	2002	2003	2004
Public sector ownership	4.0	4.1	4.0
Other domestic ownership	49.2	46.3	47.4
Domestic ownership total	*53.2*	*50.4*	*51.4*
Foreign ownership*	46.8	49.6	48.6
Banks, total	**100.0**	**100.0**	**100.0**

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

Concentration of assets in 2004 (%)

	The first three largest	The first five largest
Banks	49.1	62.4

Return on assets (ROA) (%)

	2002	2003	2004
Banks	1.5	1.4	1.7

Return on equity (ROE) (%)

	2002	2003	2004
Banks	16.4	16.7	21.4

Distribution of market shares in balance sheet total (%)

Type of financial institution	2002	2003	2004
Banks	96.0	95.4	94.9
Foreign bank branches	4.0	4.6	5.1
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Assets	2002	2003	2004
Cash and balances with the Bank of Latvia	5.7	4.5	4.6
Claims on credit institutions	25.2	23.2	24.7
Loans	48.1	52.5	55.8
Bonds and other fixed interest securities	15.6	15.3	11.2
Shares and other variable yield securities	0.7	0.3	0.2
Participating interest and other financial investments	0.6	0.6	0.7
Other assets	4.1	3.6	2.8
Liabilities	**2002**	**2003**	**2004**
Amounts owed to the Bank of Latvia	0.7	1.0	0.2
Amounts owed to credit institutions	14.4	18.9	21.1
Deposits	69.4	65.3	64.9
Other liabilities	5.5	5.2	4.7
Provisions	1.3	1.2	1.1
Total equity	**8.7**	**8.4**	**8.0**

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

	2002	2003	2004
Banks (incl. foreign bank branch)	9.6	12.4	11.6

Capital adequacy of banks (%)

	2002	2003	2004
Banks	13.1	11.7	11.7

Asset portfolio quality of the banking system (%)

Asset classification	2002	2003	2004
Standart	97.1	97.6	98.0
Watch	0.9	1.0	0.9
Substandart	0.9	0.6	0.5
Doubtful	0.7	0.5	0.3
Lost	0.4	0.3	0.3
Classified total	**100.0**	**100.0**	**100.0**
Specific provisions	**1.5**	**1.2**	**1.1**

The structure of deposits and loans in 2004 (%) (at year-end)

	Deposits	Loans
Households	24.5	29.9
Government sector	2.5	1.5
Corporate	18.3	54.8
Other	0.7	0.6
Foreign	54.0	13.2
Total	**100.0**	**100.0**

The structure of deposits and loans in 2004 (%) (at year-end)

Maturity of deposits		Maturity of loans	
At sight	72.2	Long term loans	47.4
Within one year	22.5	Medium-term loans	36.1
Over one year	5.3	Short-term loans	16.5
Total	**100.0**	**Total**	**100.0**

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

	FOREX assets / Total assets			FOREX liabilities / Total liabilities		
	2002	2003	2004	2002	2003	2004
Banks (incl. foreign bank branch)	64.2	65.2	68.8	65.6	65.0	68.6

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

Revenues	2002	2003	2004
Interest income, incl.:	57.2	54.3	58.1
interest on loans	40.4	39.4	43.3
interest on deposits with credit institutions	5.5	4.4	5.4
interest on bonds and other fixed income securities	9.6	9.5	8.0
other	1.7	1.0	1.4
Dividends	0.1	0.04	0.04
Commission received	24.6	25.6	24.4
Profit/loss from securities and currencies trading	10.4	11.2	10.0
Other	7.7	8.8	7.5
Expenditures	**2002**	**2003**	**2004**
Interest expense	29.1	25.8	28.0
Commission paid	5.6	6.4	6.5
Operating expenses	42.8	43.6	44.3
Depreciation	8.4	7.7	6.8
Loan loss provision expense	8.5	8.9	7.6
Other	5.6	7.6	6.8

Structure of registered capital and own funds of banks in 2004

in thousand of EUR

	Registered capital	/Total assets	Own funds	/Total liabilities
	EUR	%	EUR	%
Banks	546,100	4.9	835,545	7.5

2004 DEVELOPMENTS IN THE LITHUANIAN BANKING SYSTEM

LIETUVOS BANKAS

MACROECONOMIC ENVIROMENT

The growth of the Lithuanian economy that started in 2000 continued and was reflected by 6.7 per cent growth of the Gross Domestic Product (GDP) in 2004. Further progress of the Lithuanian financial system and economic growth were positively evaluated by the largest international rating agencies. At the beginning of 2004 the rating agency Fitch upgraded their rating for long-term loans in foreign currency from BBB to BBB+. Standard&Poor's also reviewed their rating and issued Lithuania a long-term borrowing in foreign currency rating A- instead of the previous BBB+; Moody's, accordingly, upgraded the credit rating to A3.

In its 2004 annual report on Lithuania, Moody's Investors Service said its A3 country-ceiling credit rating for foreign currency debt, foreign bank deposits, and government bonds was based on advanced economic and financial integration with Western Europe – an integration that was further enhanced by membership in both NATO and the European Union earlier in the year. Lithuania's investment-grade credit rating and its positive outlook were also supported by the continued strengthening of public sector finances, which were underpinned by steady reforms in the tax system, municipal finances, and pension and health sectors. Moreover, entry to the Economic and Monetary Union, which could occur as early as in 2007 now that the country is in ERM II, reduces concerns about possible external payment disruptions. The pace of economic activity remains brisk, fuelled by EU-related financing and rapid credit expansion.

The development of the domestic economy depends to a significant extent on the expansion of foreign trade. According foreign trade balance data, Lithuanian exports increased last year by approximately 27 per cent, and imports by 14 per cent. The trends of Lithuania's export to both old and new EU Member States remained on the upside in 2004. Exports to EU-15 countries in 2004 made up about 49 per cent of the domestically produced output and services (in 2003 this market accounted for 42 per cent of the total export of goods). Last year Lithuanian exports to the new EU-10 Member States amounted to 20 per cent of the total export of the country. Trade with the CIS countries occupied a rather significant place, however, for several years in turn exports to these countries were declining (in 2003 these exports made up 17 per cent, in 2004 15 per cent of the production), partially due to an unfavourable customs policy and political uncertainty in relation to these countries. The largest part of exports consisted of mineral products, re-exported vehicles, agricultural and textile products.

The main trade partners included France with a 10.7 per cent share in total exports, Germany (10.2%) and Russia (9.0%). As to imports, most goods, again, were imported from EU-25 countries (54.5% of the total imports of goods); CIS countries ranked second with a 34.0 per cent share in the total import value.

Developments in the GDP structure in 2004 showed that most of the value added was created in the manufacturing and domestic retail sectors. A higher-than-average growth rate was also recorded in transport, storage and communications, and hotels and restaurants sectors. Continuing economic expansion and new labour mobility opportunities following EU accession determined rising employment and higher average wages and salaries. Average annual unemployment ratio declined from 12.4 to 11.4 per cent, average monthly wage increased by 8.5 per cent. On the other hand, in the context of growing energy prices, inflation reached 2.9 per cent after a longer period of lower inflation; thus, prices on food products rose by 5 per cent, transport services by 5.4 per cent, and house maintenance expenses by 3.7 per cent.

In 2004, the banking sector preserved the tendencies of stability and growth, banking assets to real GDP ratio grew from 39.5 to 47.1 per cent. Banks implemented modern information technologies, developed e-services and provided customers with more sophisticated financial products via their subsidiary companies. Although borrowing demand remained high in the light of the continuing consumer activity, interest rates on loans stood at record-low levels (for example, the average annual interest rate on mortgage loans in the national currency for residents at the end of 2003 was 4.57 per cent, and at the end of 2004 4.47 per cent).

DEVELOPMENT OF THE BANKING SYSTEM

In late 2004, the Lithuanian banking system consisted of:

- 10 commercial banks with 118 branches in different regions throughout the country;
- 2 branches of foreign banks;
- 3 representative offices of foreign banks.

In addition, the Bank of Lithuania had received 48 notifications from the financial services supervisory authorities of various EU countries informing about the intentions of credit institutions supervised by them to exercise the freedom to provide services and start activities in Lithuania without establishing local subdivisions (branches). For the most part, these were banks from the United Kingdom (18 banks), Austria (9 banks), and Germany (8 banks).

By the end of 2004, foreign investor-owned capital (mostly Scandinavian and German) prevailed in the domestic banking sector, the share of which comprised 87.3 per cent. Domestic banks continued to strengthen their capital base last year, thus creating preconditions for their further development: 4 banks registered a higher share capital, 3 banks were permitted to include subordinated loans in Tier II capital.

Investment by financially strong foreign strategic partners contributed to the strengthening of the Lithuanian banking system. In 2004, the share capital of the banking system increased by 8.6 per cent and reached EUR 388 million. Banks continued organisational structure reforms in order to use more effectively the resources and increase their efficiency under the conditions of growing competition and at the same time hold the current position in the market and ensure further business development. The assets of the domestic banks made up EUR 8.4 billion at the end of 2004, increasing over the year by 32.3 per cent.

The result of banks' performance in 2004 was a profit of EUR 86.7 million that was the best during the banking history from the reestablishment of independence. This shows that consistent increase of bank operating efficiency, use of progressive information technologies, improvement of loan portfolio and development of new financial services has yielded positive results, banks have successfully adjusted to the increasing market competition and increased their profitability, although the real interest margin has been gradually declining over the past few years.

The analysis of banking performance in 2004 allows distinguishing several main business segments, which, compared to 2003, had a positive effect on bank profitability. Bank results were primarily influenced by income generated from the growing loan portfolio. Such income was the main factor behind the increase in net interest income by 21.7 per cent. In addition, a wider range of services and higher fees on services in some banks resulted in the increase of net income from services and commissions of 14.6 per cent. Rapid economic development of the country as well as the growing popularity of leasing and insurance services had a positive impact on the business results of bank subsidiaries. In 2004, banks earned 2.8 times higher profits from investment in the equity of these companies. The growth of bank net profit was slowed down to some extent last year by the increased expenditure on specific provisions related to the rapid growth of the loan portfolio of the banking system. Moreover, the growing volume of deposits in banks resulted in higher expenses on deposit insurance contributions. At the end of last year domestic banks held EUR 5.2 billion of deposits, of which EUR 2.8 billion were deposits of natural persons. The total amount of deposits increased over the year by 31.6 per cent, and deposits of natural persons grew by 24.4 per cent.

Last year, banks continued to abandon certain activities and purchased bank ancillary services from third parties, reducing in this way the number of employees. In 2004, the number of bank employees went down by 5.7 per cent, yet the effect of this process on the operating expenses was not that noticeable as they declined by a mere 1.1 per cent. These results were related to the further development of the bank network.

Owing to ongoing economic expansion, favourable economic expectations and low interest rates, loan demand has remained high, although the loan portfolio growth rate subsided somewhat in comparison with 2003. The share of the loan portfolio in total banking assets that increased to 58 per cent confirms that credit risk remains the most important of risks faced by banks.

The total loan portfolio in 2004 increased 1.4 times and reached EUR 4.9 billion. A further increase of long-term loans was supported by favourable borrowing conditions, positive evaluation of business development prospects after accession to the EU, growing purchasing power of individuals and government policy supporting lending for house purchase through the application of personal income tax exemptions. The amount of long-term loans granted to private companies, compared to 2003, increased 1.4 times, and loans to individuals went up as much as 1.9 times.

In 2004, the concentration in the banking sector slightly declined, while three largest banks predominated in the market. These banks held 68 per cent of the banking system assets and 75 per cent of individual deposits; they granted almost 74 per cent of the banking sector loans to private enterprises.

LEGAL AND INSTITUTIONAL FRAMEWORK FOR THE SUPERVISION OF FINANCIAL INSTITUTIONS

As stated in the Law on the Bank of Lithuania, the Bank of Lithuania supervises the activities of credit institutions holding a licence of the Bank of Lithuania according to the procedure provided for by laws and other legal acts. The supervision of the activities of credit institutions which hold a licence of the Bank of Lithuania consists of:

(1) licensing – consideration of applications for issuing licences, permissions and consents established by laws, and adoption of decisions, as well as other activities related thereto;
(2) collection and analysis of information obtained for the purposes of supervision in the form of reports, as well as assessment of activities of credit institutions and their financial situation on the basis of the said information, taking into account prudential and other requirements of the activities of credit institutions established by legal acts;
(3) inspection of the activities of credit institutions — verification of the correctness of the compilation of financial reports presented to the Bank of Lithuania and assessments of the activities and financial situation (capital, quality of assets, profitability) of credit institutions, as well as assessment of the efficiency of the management of risks (credit, liquidity, market, operational, others) and of the management of a credit institution;
(4) application of enforcement measures prescribed by laws to credit institutions.

In performing supervision of the activities of credit institutions, the Bank of Lithuania has the right to:

(1) receive information necessary for the performance of the supervisory function from state institutions, credit institutions, their subsidiaries, as well as from other enterprises, institutions and organisations;
(2) inspect (examine) credit institutions holding a licence issued by the Bank of Lithuania, and, in the cases established by laws, other persons as well;
(3) in the cases and manner established by laws, apply enforcement measures to credit institutions and other persons holding a licence issued by the Bank of Lithuania; and
(4) take measures in order to ensure efficient operation of the credit system.

The information received by the Bank of Lithuania for the purposes of supervision of credit institutions may not be disclosed publicly, released to anyone or made public in any other way, except in the cases specified by the laws regulating the activities of credit institutions.

Ongoing supervisory functions are performed by the Credit Institutions Supervision Department, a structural unit of the Bank of Lithuania. The Board of the Bank of Lithuania is empowered to resolve issues pertaining to the issuance and revocation of licenses, permissions, consents to credit institutions, to apply enforcement measures established by laws to credit institutions, to decide on issues regarding initiation of bankruptcy proceedings against credit institutions, etc.

MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISORY AUTHORITY IN 2004

In 2004, the Bank of Lithuania continued to focus on the implementation of a credit institution supervisory framework conforming to the international practice, encouraging banks to improve their internal control systems, adequately assess, control and manage traditional risks and identify in due time the emerging problems, as well as provide for measures to be undertaken in order to maintain the stability of banking activity under unfavourable market conditions. The main goals for the year 2004 were as follows:

- Seeking soundness, transparency and competitiveness of the domestic banking system.
- Improving the legal regulatory framework and aligning national legislation with the requirements of EU directives.
- Preparing for implementation of the provisions of the new EU Capital Requirements Directive (CAD III) provisions in Lithuania;
- Implementing risk-focused on-site inspection; during inspections, focusing on the assessment of credit, liquidity, market, operational and other risk management effectiveness, introducing assessment of other areas (real estate assessment, mortgage credit, etc.).
- Improving off-site monitoring and assessment of operations of credit institutions, continuing and improving stress testing of individual banks and the banking system.
- Expanding and strengthening co-operation with respective foreign financial sector supervisory authorities by exchanging the information necessary to ensure effective banking supervision.

KEY ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2004

In performing the function of the supervision of credit institutions, in 2004 the Bank of Lithuania focused on the regulation of risk management processes in banks and improvement of internal control systems, encouraging banks to adequately assess, control and manage traditional risks and to identify in due time the problems arising in the provision of banking services, as well as be prepared to operate in emergency situations.

The year 2004 was characterised by a large number of amendments introduced to legal acts regulating bank operation stemming from Lithuania's membership of the EU and in line with the new provisions of the Law of the Republic of Lithuania on Banks and the Law on the Bank of Lithuania. Seeking to ensure realisation of a simplified market entry procedure for the banks outside the jurisdiction of the EU Member States that wish to start operating in our country, amendments to some rules regulating licensing procedures were introduced. In addition, the procedure for the establishment of the banks of the Republic of Lithuania and associated financial undertakings and/or the provision of financial services in another EU Member State without establishing a branch as well as the procedure for the implementation of the right to provide financial services in the Republic of Lithuania by foreign banks licensed in other EU Member States and financial undertakings under their control were defined.

Taking into account the changed conditions of banking activities after EU accession and the development of the banking sector, amendments to the calculation of the capital adequacy ratio were adopted in 2004. In order to establish equal competitive conditions for the banks of Lithuania in the EU environment, the capital adequacy ratio applied to the banks of the Republic of Lithuania was reduced from 10 to 8 per cent and the maximum open position ratio in foreign currency and precious metals was changed by establishing an unlimited euro position held by banks.

In 2004, the Bank of Lithuania updated a number of legal acts on accounting and accountability, including the Rules on Consolidation of Financial Group Accounts and Joint (Consolidated) Supervision. The rules specify that the procedure of consolidated supervision performed by the Bank of Lithuania will depend on whether the parent bank of the financial group or the financial holding company falls under the jurisdiction of an EU Member State or the jurisdiction of a third country. In addition, new Rules for Supervision of Foreign Bank Branches Operating in the Republic of Lithuania were approved. These rules establish different supervisory conditions for foreign bank branches licensed in the EU Member States and foreign bank branches licensed in the third countries other than the EU Member States.

The Bank of Lithuania continued to focus considerable attention on strengthening risk management processes in banks in 2004. Considering the recent trends in the operations of domestic banks related to abandoning certain activities (e.g. security, cash collection, information system maintenance, and software development) and concluding agreements with third parties with regard to outsourcing bank ancillary services, and in order to ensure stability and reliability of bank operation after the conclusion of such agreements as well as avoid obstacles for the supervisor to perform its functions effectively, the Rules for Outsourcing Bank Ancillary Services were approved. They define certain key principles to be followed by banks as they enter into such agreements.

The Bank of Lithuania has initiated the implementation of a new concept of the centrally managed Loan Risk Database in 2004 in order to improve credit risk management and to provide possibilities for banks for gradually introducing internal borrower rating systems, as recommended in the New Capital Accord and relevant EU directives. Subsequent to the planned changes, borrowers will be classified into separate categories by the nature of their business and information will be collected about cases of default on the basis of established criteria. Later on, the collected information will enable computing the probability of defaults which is necessary in preparing for the introduction of internal rating models.

One of the key tasks of the Bank of Lithuania in the area of supervision of credit institutions in 2004 was the preparation for the implementation of the New Basel Capital Accord and the new European Union Capital Directive. To this end, the Bank of Lithuania organised a number of meetings with bank representatives to assess the level of preparation of banks for the implementation of the new capital requirements, especially when assessing credit and operational risk, to draw the attention of banks to the essential aspects of these requirements, and to identify the key problems and the intentions of banks to move to more complex capital requirement calculation methods in the future. In addition, domestic banks were requested to carry out preparatory work for the capital adequacy calculation on the basis of the former and new requirements yet to be implemented. At the end of 2004, the Bank of Lithuania started developing the procedure for the calculation of capital adequacy under the requirements of the new EU Capital Directive with respect to the planned calculations in the transitional period.

Taking into consideration progressive practices of foreign supervisory authorities, the Bank of Lithuania has continued to enhance supervisory methods and tools. In 2004, the Bank of Lithuania reviewed its inspection procedures as one of the key tools of ongoing supervision. The previous CAMELS rating-based inspection methodology was replaced by the risk-focused inspection system. The general inspection focuses on bank management and internal control, the efficiency of the risk management system in the key risk areas, including credit, liquidity, market and operational risks, to allow timely identification, assessment, monitoring and management of the risks, while targeted inspections focus on particular areas requiring special attention.

INTERNATIONAL ACTIVITIES AND CO-OPERATION WITH OTHER SUPERVISORY BODIES

In 2004, considerable attention was given to issues of cross-border co-operation. Representatives of the Bank of Lithuania participated as full members in the work of various EU institutions and ECB working groups, discussing further the issues related to changes in the operation of the banking sector and supervisory institutions in the context of the implementation of the common supervisory standards in line with the provisions of the new EU Capital Directive and the New Basel Capital Accord. Discussions in the working groups included such issues as cross-border supervision of financial groups, crisis management policy, convergence of supervisory practices under the provisions of the new EU Capital Requirements Directive, harmonisation of the international accounting and audit standards with EU law, etc.

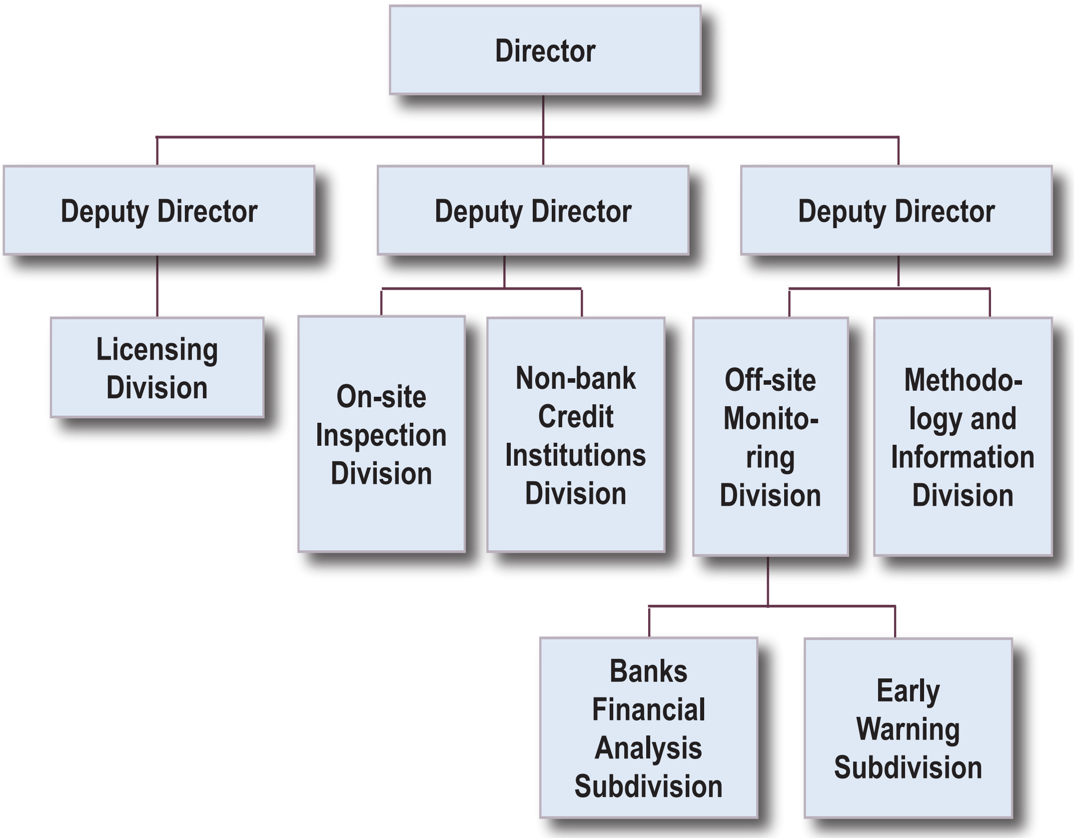
Last year, the Bank of Lithuania further strengthened co-operation with foreign financial sector supervisory authorities. An agreement on co-operation with the Swedish Financial Supervisory Authority was signed in early 2004; its representatives later visited the Bank of Lithuania to discuss issues related to the application of new capital requirements.

Such co-operation agreements were signed earlier with the respective supervisory authorities of Poland, Finland, Latvia, Estonia, Germany, Russia, and Belarus. These agreements provide for co-operation principles in performing joint bank supervision on the international level, including licensing requirements and capital ownership control, on-site inspections, subsidiary control, application of prudential requirements, principles for mutual exchange of information, and general actions in supervising banks or bank branches established in each country. Representatives of the National Bank of Ukraine visited the Bank of Lithuania in 2004 to get acquainted with the Lithuanian banking system, various aspects of the organisation of banking supervision and applicable supervisory requirements.

In view of the strengthening relations between the financial sector and the insurance sector and their influence on the business of credit institutions, the Bank of Lithuania continued close co-operation with other financial and insurance supervisory authorities of Lithuania. This co-operation was coordinated by the Commission for the Regulation of the Business of Financial Institutions and Coordination of Supervision, which was set up in 2003. The Commission includes representatives of all the three financial and insurance supervisory authorities of Lithuania. The Commission, in consultation with the representatives of banks, other financial institutions and insurance undertakings, seeks to ensure a more efficient coordination and improvement of the supervisory processes in individual sectors of the Lithuanian financial market, development of a supervisory strategy and identification of its priorities; it submits proposals to the Seimas (Parliament) on the amendments to the laws and other legal acts regulating the provision of financial and insurance services, the business and the supervision of financial institutions and insurance undertakings.

THE STRUCTURE OF CREDIT INSTITUTIONS SUPERVISION DEPARTMENT OF THE BANK OF LITHUANIA AT THE END OF 2004

LIETUVOS BANKAS



STATISTICAL TABLES

LIETUVOS BANKAS

Number of financial institutions (at year-end)

Type of financial institution	2002	2003	2004
Commercial banks	10	10	10
Foreign bank branches	4	3	2
Credit unions	54*	58*	62

* *including Central Credit Union*

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

Item	2002	2003	2004
Public sector ownership	0.5	0.3	0.2
Other domestic ownership	11.5	11.7	13.7
Domestic ownership total	*12.0*	*12.0*	*13.9*
Foreign ownership	88.0	88.0	86.1
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

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

Item	2002	2003	2004
Public sector ownership	N/a	N/a	N/a
Other domestic ownership	N/a	N/a	N/a
Domestic ownership total	*87.0*	*89.1*	*84.4*
Foreign ownership	13.0	10.9	15.6
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of assets by the type of financial institutions in 2004 (%) (at year-end)

Type of institutions	The first three largest	The first five largest
Banks	67.6	79.5
Credit unions	28.9	34.9
Financial institutions	-	-
Savings cooperatives	-	-
Specialized credit institutions	-	-

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

Type of institutions	2002	2003	2004
Banks	0.93	1.26	1.20
Credit unions *	0.65	0.71	0.52
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

** Without Central Credit Union*

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

Type of institutions	2002	2003	2004
Banks	9.8	13.37	13.52
Credit unions*	4.9	5.5	4.85
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

** Without Central Credit Union*

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

Type of financial institution	2002	2003	2004
Commercial banks	92.2	90.7	89.5
Foreign bank branches	7.4	8.6	9.7
Credit unions	0.4	0.7	0.8
Financial institutions, total	**100.0**	**100.0**	**100.0**

LIETUVOS BANKAS

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

Assets	2002	2003	2004
Cash in hand	3.8	3.1	2.3
Claims on banks and other financial institutions	18.7	21.1	24.4
Securities	22.5	15.8	12.4
Loans granted*	45.6	54.4	57.6
Other assets	9.4	5.6	3.3
Liabilities	**2002**	**2003**	**2004**
Liabilities to banks and other financial institutions	14.8	22.6	22.7
Deposits and L/C	67.8	61.6	61.3
Other liabilities	7.4	5.3	7.3
Bank capital	10.0	10.5	8.7

**Net values*

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

Type of financial institution	2002	2003	2004
Commercial banks	16.8	23.6	16.1
Foreign bank branches	10.6	22.9	33.4
Credit unions	-	-	-
Financial institutions, total	**16.3**	**23.4**	**17.8**

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

Type of financial institution	2002	2003	2004
Commercial banks	14.8	13.2	12.4
Foreign bank branches*	-	-	-
Credit unions	16.5	16.6	16.5
Financial institutions, average	**14.8**	**13.3**	**12.5**

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

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

Asset Classification	2002	2003	2004
Standard loans	76.2	79.6	74.8
Watch loans	18.0	17.7	23.1
Substandard loans	*4.1*	*1.7*	*1.1*
Doubtful loans	1.5	0.9	1.0
Bad loans	0.2	0.1	0.1
Non-performing loans/ Total loan portfolio	**5.8**	**2.6**	**2.1**

LIETUVOS BANKAS

The structure of deposits and loans of the banking system in 2004 (%) (at year-end)

	Deposits	Loans
Households	53.9	26.2
Government sector	2.5	0.5
Corporate	31.1	65.1
Foreign	6.0	0.7
Other	6.5	7.5
Total	**100.0**	**100.0**

The structure of deposits and loans of the banking system in 2004 (%) (at year-end)

Maturity of deposits		Loans*	
At sight	59.3	Long-term loans**	39.1
Within one year	38.0	Medium-term loans***	24.4
Over one year	2.7	Short-term loans****	36.5
Total	**100.0**	**Total**	**100.0**

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

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

Type of financial institution	FOREX assets/Total assets			FOREX liabilities/ Total liabilities		
	2002	2003	2004	2002	2003	2004
Commercial banks	32.1	46.4	54.4	41.2	42.0	40.7
Foreign bank branches	75.7	77.4	83.0	83.5	82.2	86.6
Financial institutions, average	**45.3**	**49.1**	**57.2**	**44.5**	**45.9**	**45.5**

LIETUVOS BANKAS

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

Income	2002	2003	2004
Interest income	58.8	59.0	61.0
Profit from operations in foreign exchange	6.6	12.9	7.4
Income from services and commissions	23.3	27.5	27.9
Other bank income	11.3	0.6	3.7
Total Income	**100.0**	**100.0**	**100.0**
Expenses	**2002**	**2003**	**2004**
Interest expenses	23.7	23.4	25.7
Operational expenses	45.6	53.6	46.3
Expenses for specific provisions	7.3	-4.0	2.5
Other expenses	23.4	27.0	25.5
Total expenses	**100.0**	**100.0**	**100.0**

Structure of registered capital and own funds of financial institutions in 2004
(at year-end)

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liabilities
	EUR million	%	EUR million	%
Commercial banks	387.6	5.1	724.6	10.5
Foreign bank branches *	11.3	1.4	13.1	1.6
Credit unions	7.4	11.1	8.3	14.2
**Financial institutions, average ** **	**33.2**	**4.7**	**61.5**	**9.6**
Financial institutions, average * **	**5.5**	**4.8**	**10.1**	**9.6**

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

2004 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MACEDONIA

MACROECONOMIC ENVIRONMENT

Macroeconomic performances of the Macedonian economy in 2004 can be assessed as relatively satisfactory, especially from the viewpoint of the Central Bank, having in mind the trend of preserving price and financial stability, the favourable developments in the banking system and the development of financial markets.

In 2004, the real GDP growth equalled 2.9%, which represents an insignificant acceleration of the growth relative to the previous year (2.8%). Such performances are to a large extent a result of the high concentration of the domestic output, i.e. the reduced activity in industry, which is the dominant component of the GDP. Contemporaneously, the current account deficit reached 7.7% of GDP, mainly as a consequence of the broadening of the trade deficit. At the same time, the high structural unemployment (in 2004 the unemployment rate equalled 37.2%) represents a signal of the necessity for conducting high-quality reforms on a microeconomic level, incurring the investment activity and attracting foreign direct investments.

In addition, during 2004, the monetary policy was directed toward creating favourable environment for economic activity through further maintaining of the price stability, as the main monetary policy objective. The monetary strategy of a „de facto” targeting of the nominal exchange rate of the denar against the euro was maintained. Consequently, the exchange rate remains to be a nominal anchor, which contributes to stable inflation expectations and maintaining of a low and stable inflation. In 2004, the average change in the rate of inflation was negative and equalled 0.4%, which was primarily due to non-monetary factors, i.e. lower costs of food due to the reduction of the customs duties on imports in line with the Stabilization and Association Agreement with the EU and the membership in the World Trade Organization (WTO). With this, the extremely high increase in the price of crude oil on the international markets in 2004 was completely offset and there was no transmission effect on the domestic inflation.

The pressures on the foreign exchange market (caused by the broadening of the current account deficit, unrealized inflows from abroad and speculations), as well as the uncertain distribution of the budget spending during the year, represented the main factors of the changes in the monetary policy stance in 2004. In the course of 2004, the National Bank of the Republic of Macedonia (NBRM) increased the interest rates on CB bills on several occasions (so that the interest rate on CB bills with maturity of twenty-eight days reached 10% p.a.), which was made in order to stabilize the movements on the foreign exchange market and preserve the exchange rate stability. Simultaneously, in December, NBRM adopted a decision on increasing the compulsory reserve requirement from 7.5% to 10% (effective since January 2005). The higher reserve requirement on denar deposits should contribute to the reduction of the structural excess liquidity in the banking system and creation of an additional supply on the foreign exchange market. On the other hand, the higher rate of reserve requirement in foreign exchange is of a prudential character, given the intensive lending in foreign currency, after the liberalization of the lending in foreign currency in July 2003. Such changes in the monetary instruments resulted in an insignificant amount of net-sale of foreign currency on the foreign exchange market by the NBRM in 2004. Gross foreign exchange reserves in 2004 registered an annual increase of US Dollar 82.3 million (which is mainly due to foreign exchange gains), with their level providing coverage of 3.6 months of import of goods and services from the current year.

From a viewpoint of the fiscal policy, in 2004 the central budget registered surplus of 0.1% of GDP, while the general government budget was almost balanced. The accomplished budget balance for 2004, however, deviated from the projection (projected deficit in the central and in the general government budget of 0.8% of GDP and 1.9% of GDP, respectively), where the budget spending during the year signalled uncertainty, which implied adequate precautionary measures of the monetary policy. In 2004, the fiscal sector significantly contributed to the development of the financial market by issuing the first short-term government securities (three-month and six-month Treasury bills), with which the sources of budget financing expanded. At the same time, the diversification of the securities portfolio is aimed at further promotion of the monetary set of instruments, i.e. it is a basis for conducting open market operations. To the end of supporting the development of the domestic financial market and integrating the Macedonian economy into the global financial flows, the Republic of Macedonia was given the first international credit rating, made by the international rating agency "Standard & Poor's", which granted the Republic of Macedonia rating BB/B for the debt in foreign currency and BB+/B for the debt in domestic currency, with positive expectations for the future.

Despite the increase in the interest rates on the CB bills and the short-term Treasury bills, the downward trend in the lending and deposit interest rates of banks continued also in 2004. Thus, the average weighted lending interest rate (on short-term denar credits) registered an average annual decline of 3.5 percentage points and equalled 12.5%, while the decline in the average weighted deposit interest rate on the three-month denar deposits equalled 1.4 percentage points, thus being reduced to 6.5%. The decline in the banks' interest rates reflects the increased deposit potential of banks, the higher quality of the credit portfolio, the improved efficiency and reduction of the costs of the banks, the higher level of competition in the banking system, as well as the need for maintaining good business relations with creditworthy clients. The higher efficiency of the banking system and the higher level of competition are confirmed also with the decline in the costs of financial intermediation, expressed through the narrowing of the interest rate spread by 2.1 percentage points. Yet, despite the downward trend, the interest rates of banks in the Republic of Macedonia are higher relative to those in the advanced countries in transition, which points to the need for further improvement of the banking operations.

In 2004, current account deficit deteriorated (7.7% of GDP, compared to 3.3% of GDP in 2003), primarily generated from the significant broadening of the trade deficit, which reflects certain special circumstances in 2004 (restarting of one of the major metallurgic plants, increase in the price of oil on the world markets, intensified import of vehicles before the reintroduction of excises on motor vehicles), but is also an effect of the gradual trade liberalization in line with the Stabilization and Association Agreement with the EU and the membership of the Republic of Macedonia in the WTO. Current transfers still represent the dominant source of the trade deficit financing. The degree of coverage of the current account deficit with inflows from foreign direct investments and portfolio investments in 2004 equalled 36.2%, but further keeping of the foreign direct investments at the level of 2% of GDP points to the need of incurring this long-term and stable source of financing, which should also enable an increase in the productivity, faster economic growth and higher employment rate. In 2004, the total external debt registered an annual increase of US Dollar 203.6 million, with almost half of the realized growth being due to the realized foreign exchange gains. The Republic of Macedonia, however, is still in the group of less, i.e. moderately indebted countries, and all indicators of the degree of indebtedness in 2004 registered improvements relative to the previous year.

In 2004, the Republic of Macedonia confirmed its firm determination to get closer to the European Union and actively integrate in the international trade and financial flows. In March 2004, the Republic of Macedonia formally filed the application for membership in the EU, while in April 2004 the Stabilization and Association Agreement with the EU became effective, after it had been ratified by all countries-members of the EU. With this, the Republic of Macedonia gained the status of a country with associative membership, and successfully continued the process of gradual convergence to the EU, as its strategic objective.

The key challenge for the Macedonian economy is to supplement the consistent macroeconomic framework with structural reforms, to strengthen the corporate governance and the institutional framework and to create favourable investment climate. NBRM will continue to be focused on preserving the price stability, as the main monetary objective, so that the monetary policy will contribute in the most adequate manner to the creation of an environment for initiating and maintaining faster economic growth. Thus, NBRM successfully converges towards the position of the central banks in the developed economies and gives its contribution for faster integration of the Republic of Macedonia in the EU.

DEVELOPMENT OF THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL/GDP)

Structure of the banking system

The Macedonian banking system is consisted of two main segments: banks and saving houses. As of December 31, 2004 the banking system was consisted of 21 banks and 15 saving houses. The saving houses play a marginal role in the total performances of the banking system, since they account 1.3% of the total assets. Consequently the rest of 98.7% of the total assets belongs to the banks.

In order to achieve a better quality of the analysis of bank's performances, the banks in the Republic of Macedonia are divided in three ”peer groups” according to total assets criterion:

- Large banks (with assets over Denar 15 billion)
- Medium size banks (with assets from Denar 2 to 15 billion); and
- Small-size banks (with assets less than Denar 2 billion)

The criterion of the size of total assets determines that as of December 31, 2004 the decisive group is the group of large banks. Altogether 3 banks are included in this group, while the group of medium-size banks contained 8 banks and the group of small-size banks was consisted of 10 banks.

Same as in the preceding year, the analysis as of December 31, 2004 showed relatively high level of concentration of the Macedonia's banking system within large banks group according to almost all criteria. So, according the size of total assets, the group of large banks was most influential group with 66.8% share of the total assets. The remaining 33.2% belongs to the other two groups, whereas 22.0% refers to the medium-size banks and 11.2% refers to the small size banks. The concentration of the banking system according to the capital strength criteria analysed by banking groups indices that the dominant group is the large banks group with their share of 42.4% of the total banking capital (32.6% for the medium-size and the rest of 25.0% for the small-size banks).

The level of concentration of the banking system from aspect of the total assets can be quantified also with the Herfindahl Index[1]. As of December 31, 2004 Herfindahl Index amounts to 1685 units and shows level of acceptable concentration[2] of the banking system of the Republic of Macedonia.

The dominant position of the large banks group in all banking areas structure is confirmed by their market share of 67.7% of the total banking activities (on and off balance-sheet activities). If the bank's credit activity[3] is taken in consideration, the share of the group of the large banks in the credit activity of all banks equals 66.2% as of December 31, 2004. The most evident concentration

[1] H=i (assets of each bank/total assets of all banks*100)

[2] According to the Herfindahl if the Index ranges between 1.000 and 1.800 units, the concentration of the assets is considered acceptable, while up to 1.800 units, the concentration is considered significant

[3] Credit placements to the non-financial entities (corporate and household sector)

by the large banks group was ascertained in the analysis of the bank's deposit activity[4]. As of December 31, 2004 the group of large banks mobilized 75.5% of the total deposits.

As of December 31, 2004, foreign capital was present in 15 banks, with share of 47.5% in the total banking capital. Out of aforementioned 15 banks, 8 banks are owned and controlled by foreign shareholders, engaging 47.6% of the total capital and 47.3% of the total assets. Domestic private shareholders had ownership over 12 banks covering 47.5% of the total banking capital and 50.8% of the total assets, and 1 bank is 100% state owned. This bank[5] covers 4.9% of the total banking capital and 1.9% of the total assets. Analysed by group of banks, 56.9% of the capital of the group of large banks is foreign capital, while the respective percentages for the group of medium-size banks and small-size banks are 34.2% and 48.8%. Thus, the foreign capital has the highest share in the group of large banks.

The balance sheet structure

The growth of the deposit potential, as a main determinant for intensification of the bank's credit activity, had a positive impact on the continuos strengthening of the degree of financial intermediation in the Macedonian economy. Thus, as of December 31, 2004 this indicator calculated as a ratio of the banks' total assets, the gross credits extended to clients and the total deposits to the gross domestic product (GDP) of the Republic of Macedonia, was 44.6%, 21.7% and 31.1%, respectively. The same indicators as of 31.12.2003 were 41.4%, 17.8% and 27.7%, respectively.

The total assets of the banks in the Republic of Macedonia continued to increase, as a result of the continuos upward trend of total deposits, as major source of banks' funds. The total assets of the banks as of December 31, 2004 amounted to Denar 117.985 million, which represents an increase of 12.5% compared to December 31, 2003. Analysed by banking groups (large, medium-size and small-size banks), the increase of the banks' total assets was solely due to the growth in the assets by the group large banks. Thus, comparing December 31, 2004 with December 31, 2003, the assets of the group of large banks went up by 35,4%, due to transfer of one bank from the group of medium-size to the group of large banks, as well as due to the increase of the assets of large group banks. At the same time, three banks moved from the group of small-size banks to the group of medium-size banks. Thus, the assets of the group of medium-size and small-size banks, decreased by 11.9% and 23.4%, respectively, in the observed period. Nevertheless, despite such movements, on December 31, 2004, compared to December 31, 2003, the group of large banks remained with dominant share in the total assets.

[4] Deposits to the non-financial legal entities (corporate and household sector)

[5] This state owned banks is with special determined function and has primary task to support the development, which shall be performed through the following sectors: 1/ financing investments of small and medium enterprises;2/ promoting exports; and 3/ implementing foreign loans and donation.

The total assets growth was almost solely reflected by the growth of credits to non-financial entities (enterprises and households) as most evident asset category relative to the increase in the analysed period, as well as due the dominant share in the total assets. So, the amount of gross credits registered growth of Denar 12.182 million or 27.0%, confirming the fact that in 2004 the banks placed whole amount of collected deposits in credits.

As of December 31, 2004, the structure of the assets registers slight movements compared to December 31, 2003. The credits to non-financial entities accounting 40.7% of the total assets (35.4% -31.12.2003), took the first place which was previously held by placements to banks which make up 34.2% (35.6% – 31.12.2003). Aggregately, the above two categories constitute 74.9% of the total assets, thus comprising its two most significant segments.

The upward trend of deposit potential registered in previous years continued in 2004. On 31.12.2004 the amount of total deposits achieved the highest level from Macedonian monetary independence which confirms the permanent growth of the confidence in the Macedonia's banking system. As of December 31, 2004 the total deposits to non-financial legal entities and households amounted Denar 82.284 million or 69.8% from the total sources of funds, thus remaining most important source of funds for Macedonian banks. Compared on annual basis, they registered growth of Denar 12.096 million or 17.2%. Analysed by banking groups (large, medium-size and small-size banks), almost the whole increase of total deposits was determined by the increase of the group of large banks deposits.

The income statement structure and ratios

In 2004 the banks in the Republic of Macedonia, on aggregate level, showed positive financial result in the amount of Denar 1.247 million, which represents increase by 178.3% compared to 2003. This increase is indicator for significant improvement of the Macedonian banks profitability in 2004, even though the number of banks which showed positive financial result decreased to 16 (in 2003 there were 17 banks), thus registering higher net income of Denar 594 million compared to the December 31, 2003. The remaining 5 banks, showed negative financial result which is lower for Denar 205 million compared to the December 31, 2003. Analysed by banking groups, the largest effect on Macedonian banking system profitability had the group of large banks, which achieved profit equalled 82.8% of the total financial result of all banks in the Republic of Macedonia.

Similar to 2003, also in 2004 the positive financial result was mainly based on registered extraordinary income, but a positive trend of increasing the share of income from main banking activities on the burden of decreasing the dominant share of extraordinary income was registered. The realized profit in 2004 had positive impact on the major profitability ratios for banks in 2004. So, ROAA (return of average assets) for 2004 is 1.1% and ROAE (return of average equity) is 6.2%, which represent improvement by 0.6 and 3.9 percentage points, respectively.

Credit risk

The credit risk still represents most dominant risk on which the banks in the Republic of Macedonia are exposed to. The key indicators for credit portfolio quality show that during 2004 there was slight improvement of the credit portfolio quality. As of December 31, 2004 the share of the total exposure classified in the risk categories C, D and E in the total credit portfolio of banks was 13.2%, which is a decrement of 1.9 percentage points compared with December 31, 2003. The average level of risk of the credit portfolio, calculated as a ratio between calculated potential losses and the total credit exposure, equalled 9.7%, which correspond to average risk category B. Compared with 31.12.2003 the indicator for average level of risk of the credit portfolio shows decrease of 0.6 percentage points. These improvements confirm the continuous improvement of Macedonian banks credit policies and practices. Analysed by groups of banks, the share of total exposure classified in the risky category C, D and E in the total credit exposure is highest within small-size banks and equals 21.3%, then follow the group of large banks with rate of 13.1% and medium-size banks with 10.1%. The average level of risk of the credit portfolio is highest within group of small-size banks and amounts 14.5%, followed by the group of large banks with 9.6% and medium-size banks with 8.0%.

Capital adequacy ratio

As of December 31, 2004 the own funds of the Macedonian banks accounts 17.0% of the total sources of funds. As a result in the movement of the guarantee capital, risk-weighted on- and off-balance sheet assets and open foreign exchange position, the average capital adequacy ratio of the banks in the Republic of Macedonia equalled 23.0% as of December 2004, which represents a decrease of 2.8 percentage points, compared to December 31, 2003. Analysed by groups of banks the lowest capital adequacy ratio belongs to the group of large banks (15.1%), while capital adequacy ratio of small-size banks is 45.1% and 34.0% for medium-size banks. The reason for such high level of capital adequacy ratio within the small-size banks group is due to the simpler structure of the sources of financing, whereas the own source of funds have significant share. Contrary to that, the most significant sources of funds within the group of large banks is deposit base, what is the reason for the lowest capital adequacy ratio and for higher efficiency in performing the financial intermediation.

As of December 31, 2004 all banks in the Republic of Macedonia had fulfilled the prescribed minimum of 8%. At the end of 2004 banks with capital adequacy ratio in the rank between 30-50% are dominant. Also, it can be consider that there is structural movement of the banks in direction from rank of higher capital adequacy toward rank of lower capital adequacy.

During the previous years the banking system of the Republic of Macedonia had maintained relatively high and stable level of capital adequacy ratio which equalled above 30.0% what is indicator for the stable solvent position of the banks. There is a trend of permanent decreasing of the capital adequacy ratio (average quarterly decreasing of 0.3 percentage points, starting from the beginning of 2002 when the ratio equalled 25.9%) what is positive with regard to improvement of the efficiency of the financial intermediation of banks in the Republic of Macedonia.

Liquidity risk

During the year 2004 the banks in the Republic of Macedonia maintained satisfactory liquidity position. In that context the continuing trend of increasing in the deposit base, as a dominant source of funds was a positive precondition which caused reduced usage of secondary source of funds. In the 2004, the average share of the liquid assets defined in the broaden sense[6] in the total assets equalled 43.1%, which represent decreasing of 1.9 percentage points, compared to December 31, 2003.

The residual maturity structure on expected inflows and outflows represent high level of maturity match of assets and liabilities, mostly due to high rate of stable sight deposits.

The rate of the stable sight deposits with maturity up to seven days at the level of the whole banking system accounts 74.6%, which represents an increase of 5.8 percentage points compared to December 31, 2003. Such a high level of stable deposits is mostly due to the high level of stable sight deposits of large banks (83.4%). The improved stability position of the deposits indicates lower level of deposits outflow. Thus, in accordance with the expectations of the banks in the Republic of Macedonia, only 14.9% of the total deposits with maturity of up to seven days will outflow (19.2% – December 31, 2003). The high rate of stable sight deposits is confirmed through the percentage of the stable share of the Denar sight deposits within the maturity profile of up to seven days equals 78.3%, while it equals 71.7% of the foreign exchange deposits.

Foreign Exchange rate risk

As of December 31, 2004 foreign exchange assets accounts 57.8% of the total assets, while foreign exchange liabilities equalled 49.4%. Compared to the same ratios in the previous years there is an increasing trend due to household's preference to make foreign exchange savings. Because of the short-term character of these savings, the banks hold larger proportion of liquid foreign exchange assets in foreign banks.

The aggregate open foreign exchange position accounts 51.2% of the guarantee capital of the banks at the end of 2004, which represents an increase of 7 percentage points compared to the end of 2003. The banking system exposure toward the Euro as a dominant currency in the foreign exchange assets and liabilities structure equalled 43.9% from the guarantee capital, compared with 50.6% on December 31, 2003.

[6] The liquid assets, in broaden sense, encompasses the funds and the balances with the National Bank of the Republic of Macedonia, the CB bills, the short-term debt securities, the short-term credits with domestic and foreign banks and balances on the accounts with domestic and foreign banks.

Analysed by groups of banks, the large banks group has dominant influence over the long aggregate open foreign exchange position, which is 79.7% of the guarantee capital for this group. This ratio is 35.3 % and 19.0% for the group of medium-size and small-size banks respectively. The long open position to Euro accounts 74.2% for the group of the large banks, 25.7% for the group of medium size banks and 11.5% for the group of small-size banks.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN MACEDONIA

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

In the first half of 2004, within the overall changes in the organizational structure of the National Bank of the Republic of Macedonia, the organizational structure of the banking supervision was also a subject to changes. The operative implementation of the supervisory function of the National Bank of the Republic of Macedonia was conducted by the Supervision Department which, besides the on-site and off-site supervision of the operations of each bank was also responsible for implementing the regulatory function and for analysing and monitoring the risks in the overall banking system. The organizational changes in 2004 resulted in segregation of the supervisory function from the regulatory one, by forming two separate Departments within the National Bank of the Republic of Macedonia, i.e. the Supervision Department and the Banking Regulations Department.

The Supervision Department remained responsible for direct implementation of the supervisory function, i.e. licensing the banks and savings houses, on-site and off-site supervision of their operations and undertaking corrective measures against institutions suffering problems, irregularities and non-compliance with the regulations.

The Banking Regulations Department is responsible for the activities related to establishment and improvements of the banking supervision regulatory framework, promotion of the supervisory practices and following of the international standards in banking and supervision. Also, this Department is responsible for financial stability analysis which, at the same time, is a new activity of the National Bank of the Republic of Macedonia.

The competence of the National Bank of the Republic of Macedonia is regulated by the Law on the National Bank and the Banking Law, as well as other regulation related to banks.

During 2004, the prudential framework has undergone several changes, in line with the World Bank mission recommendations and achieving a higher level of compliance of the Macedonian banking supervision with the Basle Core Principles for effective Banking Supervision.

Since 1998 within the National Bank exist a Registry on data on the banks' and savings houses credit exposures to legal and natural persons. In 2004, the National bank issued a Decision on the content and manner of Credit Registry functioning and a Manual for executing this Decision that obtain a legal basis for the Credit Registry functioning. The data in the Credit Registry are for supervisory purposes for more adequate assessment of the credit risk for each separate banks borrower. In order to decrease and control the banks exposure to credit risk, the National bank enabled the banks to use aggregate information from the Credit Registry. The aforementioned Decision was issued on the basis of a certain changes in the Law on National Bank.

The legal basis provided in the Law on National Bank and adoption of the corresponding by-law regulation, were steps toward implementation of the World Bank Recommendations as a part of the FESAL arrangement. At the same time, the opportunities for promotion and improvement of the Credit Registry were broaden.

Within the enforcement of the licensing criteria, which is one of the activity of the supervisory function, in November 2004 a Decision on the documentation necessary for granting approvals to the banks and submitting notification of the change in the ownership structure of voting shares was established. With this Decision, the criteria for the part of the banks financial activities executed abroad were improved, as well as for brokerage operation with transferable securities. So, in order to be able to trade on the financial markets, the banks should have adequate electronic system for access to financial markets information, as well as the employees' who execute duties connected to these financial activities should hold corresponding certificate for financial market operations.

The aforementioned improved criteria represent one of the main preconditions which will enable the banks in the Republic of Macedonia to have access to financial markets in the country and abroad, as well as to manage the risk connected to foreign exchange market operations.

In the direction of further promotion of the regulatory package which pertains to the liquidity risk management, after the adoption of the Decision on identifying, assessing and managing the banks' liquidity risk and the respective Instructions which established the fundaments for the liquidity risk management, a Supervisory Circular No. 6 – Liquidity Risk Management was developed in June 2004. The primary objective of the Circular is to provide guidelines for efficient implementation of the liquidity risk management process by the banks and to give an integrated review of all aspects affiliated to this process, having in mind the recommendations of the Basle Committee.

In 2004, The Supervision Department and the Banking Regulations Department started with preparation of several changes in the existing regulation in direction of increasing the stability and soundness of the banking system. The new regulation is expected to become effective during 2005. The main purposes of the changes are: strengthening the "fit and proper" criteria for new shareholders, creating a legal power for the National Bank to revoke previously issued license for bank shareholder, further harmonization of the Macedonian banking regulation with the EU Directives in banking, increasing the efficiency of the receivership, bankruptcy and liquidation procedure, provisions on consumer protection etc.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY

In 2004, the main activities of the National Bank were focused on the implementation of the FSAP recommendations and harmonisation of the banking legislation with the EU Directives.

Following the FSAP recommendations the Supervision Department and Banking Regulation Department in 2004 defined several strategic objectives which main objective is to ensure increased efficiency and sustainable stability of the banking system and drafted time-frame for their implementation.

The main strategic objectives of the supervisory authority can be summarized as follows:

a) Changes in the legal framework that will enable the National Bank to:
   - strengthen the licensing criteria for bank shareholders and improve the corporate governance in the banks;
   - revoke previously issued licences for shareholders that are no longer fulfilling fit and proper criteria for bank shareholders;
   - enhance the risk management standards;
   - improve the accounting and internal auditing;
   - improve financial reporting and public disclosure;
   - further strengthening of the corrective measures that can be undertaken by the supervisory authority against weak banks;
   - improve the efficiency of the rehabilitation and receivership of troubled banks i.e. more efficient procedures fore dealing with troubled banks; and
   - introduce provisions for customer protection and market competition.

b) Changes in the legal framework that will enable its harmonization with the EU Directives especially EU Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions – codified directive and Capital Adequacy Directive 93/6/EC and 98/31/EC);

c) Transition from compliance focused supervision to risk-based supervision. This will be a long-term process that will have to be implemented in to several stages. The concept of the risk-based supervision is planed to be introduced in line with World Bank technical assistance. During 2005 the National Bank and the World Bank will draft a Supervisory Development Plan that will contain all the necessary activities in order for the National Bank to efficiently transfer to risk-based supervision;

d) Changes in the accounting framework in line with the requirement of IFRS that will enable better financial reporting and disclosure and enhance bank transparency.

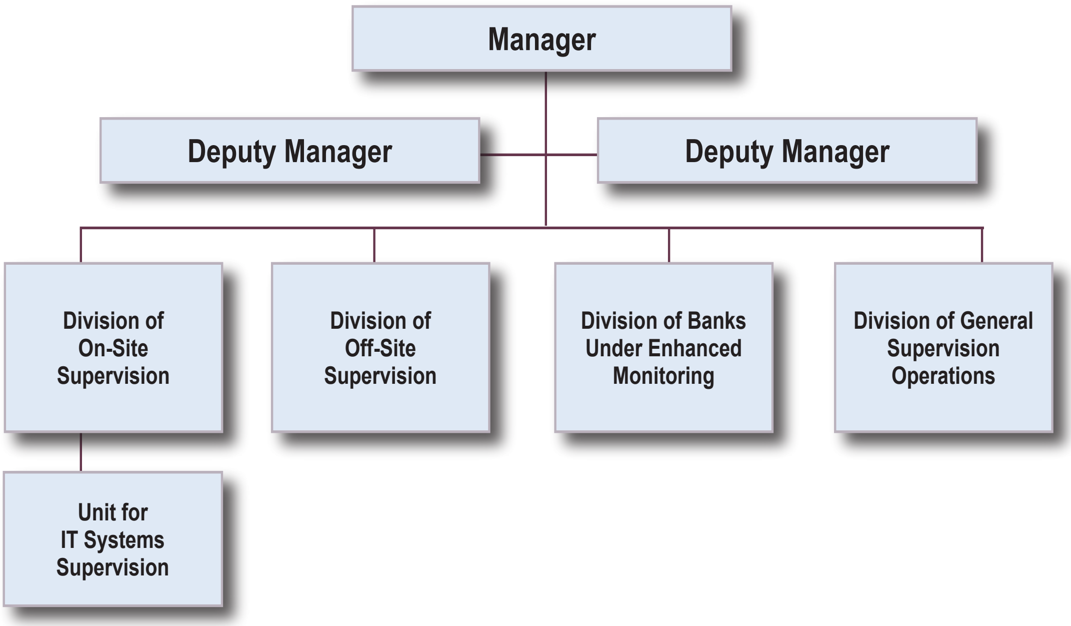
THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The supervisory function of the National Bank of the Republic of Macedonia is performed through 3 main activities: licensing, on-site and off-site supervision and undertaking corrective measures. The main steps taken during 2004, toward fulfilling these activities of the National Bank of the Republic of Macedonia are as follows:

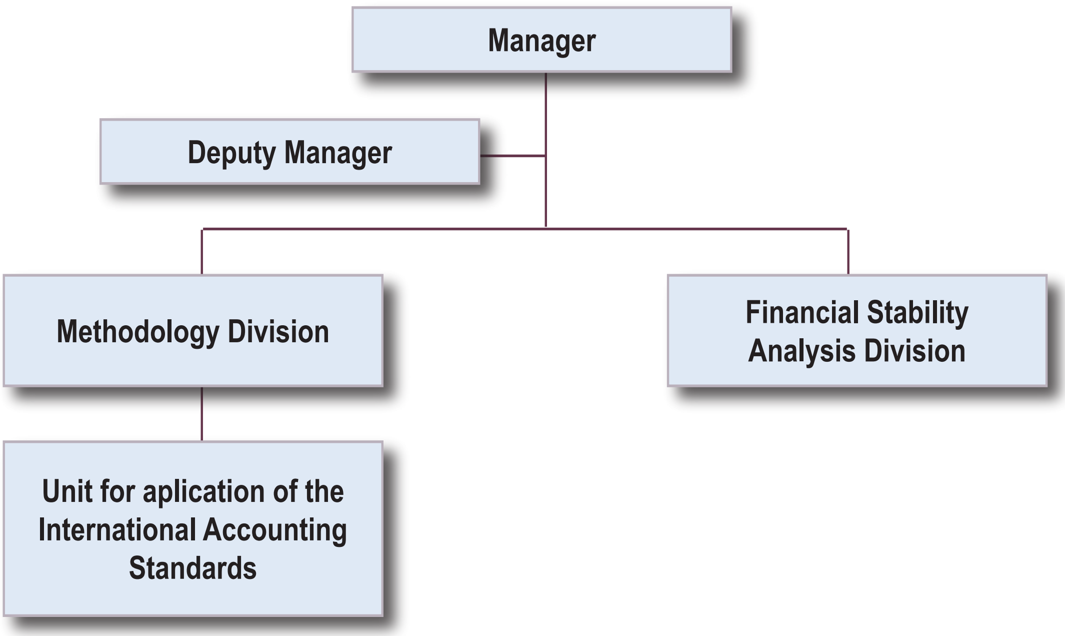
- Within the licensing framework, the National Bank of the Republic of Macedonia issues 14 different types of licenses and approvals among which the main activities in 2004 were related to issuing approvals for appointing an executive body of the banks, issuing approvals for changes in the ownership structure of the voting shares, issuing approvals for changes in the Statute of the banks, etc.
- In 2004, he National Bank of the Republic of Macedonia carried out 41 on-site supervisory examinations, 21 of which were full-scope supervisory examinations and 20 were targeted examinations. The full-scope on-site examinations are carried out on the basis of the CAMELS rating system, where dominant component is the credit risk assessment. The full-scope examination were supplemented with assessment of the anti-money laundering systems of banks and saving houses in the Republic of Macedonia, from the aspect of the internal Customer Due Diligence policies and procedures, their adequacy and implementation, identification of suspicious transactions, the role of the management and the internal audit, etc;
- Within its legal authorizations, the National Bank of the Republic of Macedonia undertakes corrective actions against banks and savings houses in which violations and irregularities were identified in order to preserve the stability and the safety of the banks and the savings houses and the stability and the safety of the overall banking system. During 2004, the National Bank of the Republic of Macedonia issued 28 Decision with corrective measures towards 13 banks and 4 saving houses. Also, in the first half of 2004 National Bank of the Republic of Macedonia has revoked the operating license of one bank and one saving house. The most common corrective measures and actions undertaken against banks and saving houses were: ban on performing certain banking operations within a certain period of time; revocation of the issued license for executive body; measure for reducing the credit exposure within the prudential limits; ban on lending to clients classified in risk categories C, D and E; acquiring higher capital adequacy ratio; ban on capital investments; allocation of additional provisions for loan losses; prohibition on dividend payments; permanent oversight over the implementation of the imposed measures.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

Banking Supervision Department



Banking Regulations Department



INTERNATIONAL ACTIVITIES OF YOUR AUTHORITY

According to the existing legal framework, the National Bank of the Republic of Macedonia may exchange information with foreign supervisory agencies with relation to supervision of internationally active banks. Furthermore, the National Bank may approve an on-site examination of a foreign bank foreign bank subsidiary and a foreign bank branch in the Republic of Macedonia conducted by supervisory bodies of the home country of the founding bank. In order to assert this right, the National Bank requires from the supervisory bodies of other countries to provide legal and operational capability to ensure confidentiality of the data.

Based on this legal framework, National Bank of the Republic of Macedonia has signed Memorandums of Understanding (MoU's) with several supervisory agencies. These bilateral agreements define the principal areas of co-operation, exchange of information and common procedures for supervision of subsidiaries of foreign banks. Thus, besides the MoU's that were concluded in the previous years with the Bank of Slovenia, the Central Bank of the Russian Federation and the Bulgarian National Bank, in 2004 the National Bank of the Republic of Macedonia has signed a MoU with the Bank of Albania.

In June-September, 2004 the long-term technical assistance provided by the European Agency for Reconstruction, was finalized. The National Bank of the Republic of Macedonia was an end user or participant in 4 projects organized by this institution (Implementation of the International Accounting Standards, Approximation with the European Directives in the field of banking, Preparation for implementation of the New Capital Accord – Basel II, Creation of Bank File).

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

The co-operation between domestic regulators and supervisory bodies is regulated by the existing framework which enables the National bank to exchange information with other domestic supervisory bodies. So far, the National bank, as an authorized body for banking supervision has signed agreements for co-operation with several domestic authorities.

At the end of 2004, the National Bank has signed a Memorandum of understanding (MoU) with the Security Exchange Commission, as an authorized body for supervision of capital markets, brokerage houses and investment funds. This MoU sets the base for regular exchange of information (at least quarterly), as well as for organization and performance of joint examinations on the entities that are under the supervision of both supervisory bodies regarding the operation with securities.

In order to expand the data base and information contained in the Credit Registry[7], at the end of 2004 the National Bank has signed an agreement with

[7] The Credit Registry within the National Bank is established in 1998.

the State Statistics Office of the Republic of Macedonia. Upon this agreement the National Bank uses following information: economic sector codes, full name, address and ID number of legal entities, publications etc. Few years ago, the National Bank has signed an agreement for co-operation with Macedonian bank for Development Promotion for determination the country risk weights.

In favour of improvement of the supervisory function, in the middle of 2004 the National Bank has signed an agreement with the Central Securities Depository.

The National bank has started with initial activities in the area of financial stability analysis that creates the need for further development of co-operation with other domestic financial institutions.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

During 2004 the IT supervision on banks was enhanced by creation a methodology for the Information Systems Security including its presentation to the banks, monitoring of banks from the aspect of the implementation of their Policies on information security. Also, in 2004, the IT Supervision has gained two certificates related to IT supervision: CISSP – Certified Information System Security Professional, issued by ISC and BS 7799 Lead Auditor, issued by BSI – British Standard Institute.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2002	2003	2004
Banks*	21	21	21
Savings houses	17	15	15
Brokerage firms	9	8	8
Deposit insurance funds	1	1	1
Insurance companies	6	7	9
Stock exchange	1	1	1
Money market	1	1	1
Leasing companies		6	8
Financial institutions, total	**56**	**60**	**64**

**As of 2004 out of 21 banks, 6 banks have brokerage firms which operates in the name and account of the bank.*

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

Item	2002	2003	2004
State ownership	4.90	4.80	4.90
Other domestic ownership	50.50	46.60	47.50
Domestic ownership total	*55.40*	*51.40*	*52.40*
Foreign ownership*	44.60	48.60	47.60
Financial institutions, total	**100.00**	**100.00**	**100.00**

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

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

Item	2002	2003	2004
State ownership	2.00	1.80	1.90
Other domestic ownership	54.00	51.30	50.80
Domestic ownership total	*56.00*	*53.10*	*52.70*
Foreign ownership	44.00	46.90	47.30
Financial institutions, total	**100.00**	**100.00**	**100.00**

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

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

Type of financial institution	The first three largest	The first five largest
Banks	66.84	76.24

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

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

Type of financial institution	2002	2003	2004
Banks	0.40	0.45	1.1

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

Type of financial institution	2002	2003	2004
Banks	2.06	2.28	6.2

Distribution of market shares in balance sheet total (%)

Type of financial institution	2002	2003	2004
Banks	99.03	98.80	98.70
Savings houses	0.97	1.20	1.30
Financial institutions, total	**100.00**	**100.00**	**100.00**

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

Assets	2002	2003	2004
Cash and balance with NBRM	6.50	5.40	4.30
Nbrm bills	2.10	3.80	3.80
Debt securities	0.90	0.90	1.40
Placements to other banks	36.30	35.60	34.20
Placements to clients	34.40	35.40	40.70
Accrued interest and other assets	4.80	5.80	4.70
Securities investments	8.30	7.00	5.80
Fixed assets	6.70	6.10	5.50
Nonalocated reserves for potential losses	0.00	0.00	-0.50
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2002**	**2003**	**2004**
Deposits of banks	3.10	2.10	1.30
Sight deposits	39.00	41.00	37.20
Short-term deposits up to one year	19.40	22.70	29.70
Short-term borrowings up to one year	3.10	1.80	0.70
Other liabilities	2.50	2.90	3.30
Long-term deposits over one year	3.70	3.20	2.90
Long-term borrowings over one year	7.90	6.60	7.50
Provisions for off-balance sheet liabilities	0.50	0.50	0.50
Owned funds	20.70	19.10	17.00
Total liabilities	**100.00**	**100.00**	**100.00**

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

Type of financial institution	2002	2003	2004
Banks	13.54	11.46	10.23
Financial institutions, total	**13.54**	**11.46**	**10.23**

Solvency ratio of financial institutions

Type of financial institution	2002	2003	2004
Banks	28.10	25.80	23.03
Savings houses	/	/	/
Financial institutions, average	**28.10**	**25.80**	**23.03**

Asset portfolio quality of the banking system

in million denars

Asset classification	2002	%	2003	%	2004	%
A	67,337	72.24	77,686	74.48	91,394	76.69
B	11,018	11.82	10,871	10.42	12,025	10.09
C	6,269	6.73	4,602	4.41	4,826	4.05
D	6,497	6.97	5,735	5.50	4,191	3.52
E	2,094	2.25	5,413	5.19	6,744	5.66
Classified total	**93,215**	**100.00**	**104,307**	**100.00**	**119,180**	**100.00**
Provisions	**8,166**		**10,719**		**11,591**	

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

	Deposits	Loans
Households	56.68	26.06
Public sector	2.00	1.02
Corporate	*36.69*	*69.73*
Domestic banks	1.29	1.29
Foreign banks	**0.54**	**1.19**
Other	**2.80**	**0.71**
Total	**100.00**	**100.00**

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

Maturity of deposits		Maturity of loans	
At sight	53.18	Long term loans*	63.95
Within one year	42.61	Medium term loans	
Over one year	4.22	Short term loans**	36.05
Total	**100.00**	**Total**	**100.00**

** In the amount of Long term loans, the amount of Non-performing loans is included.*
*** In the amount of Short term loans, the amount of Past-due but still performing loans is included.*

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

Type of the financial institution	Forex assets/Total assets (%)			Forex liabilities/Total liability (%)		
	2002	2003	2004	2002	2003	2004
Banks	55.43	56.22	57.85	43.90	45.78	49.38
Fin. institution, average	**55.43**	**56.22**	**57.85**	**43.90**	**45.78**	**49.38**

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

in million denars

Revenues	2002	2003	2004
Interest income	5,428	5,161	5,920
Other income	4,945	5,188	5,129
Expenditures	**2002**	**2003**	**2004**
Interest expenses	2,999	2,625	2,310
Provisions for potential loan losses	1,798	2,334	1,979
Other expenses	5,107	4,858	5,326
Income tax	74	83	186

Structure of registered capital and own funds of financial institutions in 2004

Type of financial institutions	Registered capital	/ Total assets	Own funds	/ Total liabilities
	EUR (million)*	%	EUR (million)*	%
Banks	314	16.30	327	16.97
Fin. institutions, average	**314**	**16.30**	**327**	**16.97**

** Calculated by the exchange rate of NBRM on December 31, 2004.*

2004 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MOLDOVA

MACROECONOMIC ENVIRONMENT

The nominal Gross Domestic Product (GDP) in 2004 amounted to 31991.7 million lei, denoting a 7.3%-increase in real terms.

Industrial output produced by enterprises of all property forms rose by 6.9% in real terms over the year and totalled 17533.0 million lei. Labour productivity in the industrial sector recorded during 2004 an average growth rate of 5.8%.

Agricultural output (according to preliminary estimates of NBS for 2004) within all categories of farms amounted to 12600.8 million lei in current prices, increasing by 20.4% in real terms from the previous year.

Investments in fixed capital allocated in the national economy in a value of 5140.0 million lei increased by 8.0% in real terms from the previous year.

Retail sales of goods amounted to 16575.8 million – by 5.6% more than in 2003.

Paid services rendered to the public rose by 5.3% and totalled 6970.4 million lei.

Average monthly salary of en employee in the national economy totalled 1103.1 lei, recoding an increase by 23.9% in nominal terms and by 10.2% in real terms.

Consumer prices in 2004 denoted an annual growth of 12.5%, including as follows: food products – 13.1%; non-food products – 11.9%; and services rendered to the pubic – 11.8%.

The current account of the balance of payments recorded a deficit of US$ 112.9 million (minus 4.4% of GDP). The trade deficit of goods and services totalled US$ 813.1 million, increasing by 21.6% from the previous year. However, the growth rate of import of goods and services (23.3%) was inferior to that of exports (24.4%). The coverage of imports by exports in 2004 accounted for 61.8% (61.3% in 2003).

Total external debt of the Republic of Moldova as of 31.12.2004 amounted to US$1924.5 million (similar to the end of 2003). The public and publicly guaranteed external debt amounted to US$ 884.1 million, decreasing by US$ 126.4 million (12.5%) from the previous year.

Domestic public debt totalled 3714.1 million lei as of 31.12.2004. Within total domestic debt loans extended by the National Bank of Moldova amounted to 2338.0 million lei and state securities in circulation – to 1376.1 million lei (including in the NBM portfolio – 400.0 million lei).

The consolidated budget was closed with a surplus of 131.4 million lei, accounting for 0.4% of GDP.

BANKING SYSTEM DEVELOPMENT

As of December 31, 2004 there were 16 commercial banks, including 2 branches of foreign banks authorised by the National Bank of Moldova acting on the territory of the Republic of Moldova.

The total number of banking offices included 866 units, out of which: 16 head offices of banks (placed in the city of Chişinău), 195 branches, 210 representative offices and 445 agencies.

The development of the banking sector of the Republic of Moldova over the reported year denoted positive trends. Total assets of the banking sector rose by 3012.5 million lei[8] (29.3%) and amounted to 13295.5 million lei as of December 31, 2004. Their weight in GDP increased from 37.7% to 41.6%.

The larger value of assets was mainly due to increases in the balances of banking liabilities by 2603.2 million lei (32.0%) and equity capital by 409.4 million lei (19.0%).

All the components of assets' structure displayed upward evolution. Cash means increased by 186.3 million lei (34.0%); money means owed by banks and NBM – by 1003.5 million lei (45.6%); securities – by 248.6 million (34.5%); and other assets – by 119.9 million lei (11.6%). The largest increase was recorded by credit portfolio (net) – by 1454.2 million (25.2%).

Net credits accounted for the largest share of 54.4% in total assets, reducing by 1.8 p.p. from 31.12.2003. Credits have been mainly extended to industry/ trade – 47.8% and agriculture/food industry – 24.1% of total credits.

With regard to qualitative parameters of the credit portfolio, unfavourable credits (substandard, doubtful and compromised) accounted for 6.9% of total credits as of 31.12.2004, denoting a relatively low level of concentration of risks related to credit portfolio. As compared to the end of 2003 this indicator displayed an insignificant increase of 0.5 p.p.

The ratio of credit loss provisions (risk fund) to total credits accounted for 5.9%, increasing by 0.3 p.p. as compared to the end of 2003.

Liquid assets increased over the year by 1532.9 million lei (46.4%) and amounted to 4836.7 million lei. Liquidity ratios of the banking sector reflected the banks' capacity to honour both current and long-term commitments.

Thus, long-term liquidity as of 31.12.2004 (assets with a term over 2 years / financial resources with a term over 2 years ≤ 1) constituted 0.5. The level of this indicator denotes the availability of resources to be invested in long-term credits.

Current liquidity (liquid assets (expressed in cash, deposits with the NBM, state securities, net interbank credits with a term up to 1 month) / total assets ≥ 20%) accounted for 36.4% as at year-end.

Tier-1 Capital as of 31.12.2004 increased by 404.8 million lei (19.9%) and amounted to 2434.1 million lei mainly due to the net income gained by banks (423.0 million lei) and the closing of share issue at seven commercial banks on the account of additional contribution by shareholders (112.8 million lei).

[8] US$ 1 = 12.4600 lei as of December 31, 2004.

The average risk weighted capital adequacy (total regulated capital to risk weighted assets) within the banking sector accounted for a high value of 31.4% as at year-end (as against 12% set as minimum level in the Republic of Moldova). However, this indicator displayed over the year a slight downward trend due to the better management within banks, including re-distribution, of available money means flows.

The significant share of 52.4% at year-end accounted for by foreign investments in the banking capital of the Republic of Moldova illustrates the attractiveness of the internal banking system for external bankers.

Within banking liabilities deposits held the largest share of 88.6% as of 31.12.2004; their weight increased by 4.1 p.p. Out of total deposits: deposits by individuals accounted for 45.3%; deposits by legal entities – for 40.7%; and deposits by banks – for 2.6%. Other loans and other liabilities constituted 8.7% and 2.7%, respectively.

Assets profitability (net income to average assets) accounted for 3.7% in 2004. Equity capital profitability (net income to average equity capital) accounted for 17.8%.

LEGAL AND INSTITUTIONAL FRAMEWORK OF BANKING OPERATION AND SUPERVISION, NEW MODIFICATIONS LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The Republic of Moldova has a 2-tier banking sector: the National Bank of Moldova and 16 authorised commercial banks, including two subsidiaries of foreign banks.

The activity of the National Bank of Moldova in the filed of banking regulation and supervision of commercial banks placed in the Republic of Moldova in stipulated in the Law on the National Bank of Moldova, which provides the competence, main objective, basic attributions of the National Bank and it relationship with financial institutions. The Law on Financial Institutions is the basic law that regulates the activity of financial institutions, including of banks.

Based on general accepted standards worked out by the Basel Committee on Banking Supervision, the National Bank of Moldova promotes a dynamic policy in the field of banking supervision and regulation of banks' activity through as follows: establishment of criteria to be used for banks' authorisation, of limits on banks' ownership and quotas, of requirements towards banks' administrators, of capital requirements; establishment of requirements aimed at improving the banks' internal control systems, including of procedures related to anti-money laundering, especially of "know-your-client" rules; establishment and supervision of compliance with prudential requirements for the purpose to reduce banks' exposure to activity risks; performance of measures related to correction actions, including sanctions, towards banks that violate the legislative requirements. The implementation of these measure contribute to the further consolidation of the banking sector, promoting a sound and competitive financial sector and thus consolidating the security level of banking sector. All the prudential requirements are available on the official web site of the NBM at www.bnm.org.

Paying due consideration to the achievements within bank consolidation, NBM created all the relevant premises for the implementation of deposit guarantee system. Thus, the Law on Guarantee of Individuals' Deposits in the Banking Sector became effective on 1 July 2004. According to the provisions of this Law, the Guarantee Fund of deposits within the banking system was established as legal entity of public law that accumulates financial means on the account of contributions paid by commercial banks. All the authorised banks within the Republic of Moldova have access and are obliged to participate in the formation of Fund means.

The financial sector of the Republic of Moldova, including the banking sector, was subject in 2004 to an evaluation study of the International Monetary Fund and World Bank within the Financial Sector Assessment Program. FSAP results denoted that the banking legislation of the Republic of Moldova is sound and in line with the EU Directives and best practices within central banking.

MAIN STRATEGIC OBJECTIVES OF THE BANKING AUTHORITY IN 2004

Over 2004 the National Bank of Moldova promoted a coherent policy aimed at ensuring the stability and consolidation of the banking sector by:

- maintaining the minimum required capital as to ensure the compliance of the capital of banks conducting international transactions with UE standards;
- supervising the implementation by commercial banks of adequate and efficient internal control systems for the purpose of contributing to the increase of banks' competitiveness and mitigating risks, including through increase of transparency level of banks' shareholders;
- supporting the security of the banking system by promoting requirements related to the diversification of risks of active transactions of banks, establishment of provisions to cover these risks, establishment of maximum limits on exposures to risks related to agreements concluded with affiliated persons and provision of "large" credits in accordance with best international practice;
- regular examination of data disclosed by banks and, if required, implementation of measures to ensure data completeness, timeliness, and correctness with the view to consolidate the market discipline and credibility of the banking sector.

ACTIVITY OF THE BANKING SUPERVISORY AUTHORITY IN 2004

The National Bank of Moldova is the only institution to supervise and regulate the financial institutions' activity. As in accordance with the mandate and rights granted by the Law on the National Bank of Moldova, the NBM performs both off-site and on-site banks' controls.

With a view to performing off-site supervision, the National Bank of Moldova, based on its normative acts on reporting, receives, on monthly and quarterly basis, financial statements on commercial banks' activity. According to data from financial statements, the analysis of existing development trends in each bank and of the banking system as a whole is carried out, using the Distant Banking Supervision System (BOSS). Following the analysis, the monthly statement on the banking system's financial situation is compiled to be submitted for examination to the National Bank. In event a negative trend is traced out in the activity of a certain bank, a decision is adopted regarding the necessary measures to improve its financial situation.

To ensure a continuous supervision, the National Bank of Moldova is performing systematic on-site controls (at least once a year) in all commercial banks. In case the financial statements' analysis reveals unfavourable dynamics in some banks, the NBM carries out a thematic control in these banks. Thus, 16 complex controls and 11 thematic controls were performed in 2004.

Within on-site controls, inspectors mainly analyse and assess the following critical issues of a bank's operations and situation: credits classification and credit loss provisioning, overdue credits, credits extended to affiliates, to employees, "large" credits, interbank credits, transactions in foreign currency, capital adequacy, dynamics of assets and liabilities, dynamics of incomes and expenses, liquidity planning and management, information technologies, bank's compliance with the banking legislation as well as regulations and recommendations worked out by the NBM etc. The drawbacks in the bank's activity and deviations from the normative acts accepted by the bank and detected within complex and thematic controls are subject to analysis, followed by the establishment of remedy measures.

Under the scope of relevant improvement of prudential regulation and supervision methods in line with the new generally accepted standards, including those of the Basel Committee, the National Bank of Moldova has performed modifications and completions to the NBM existent normative acts.

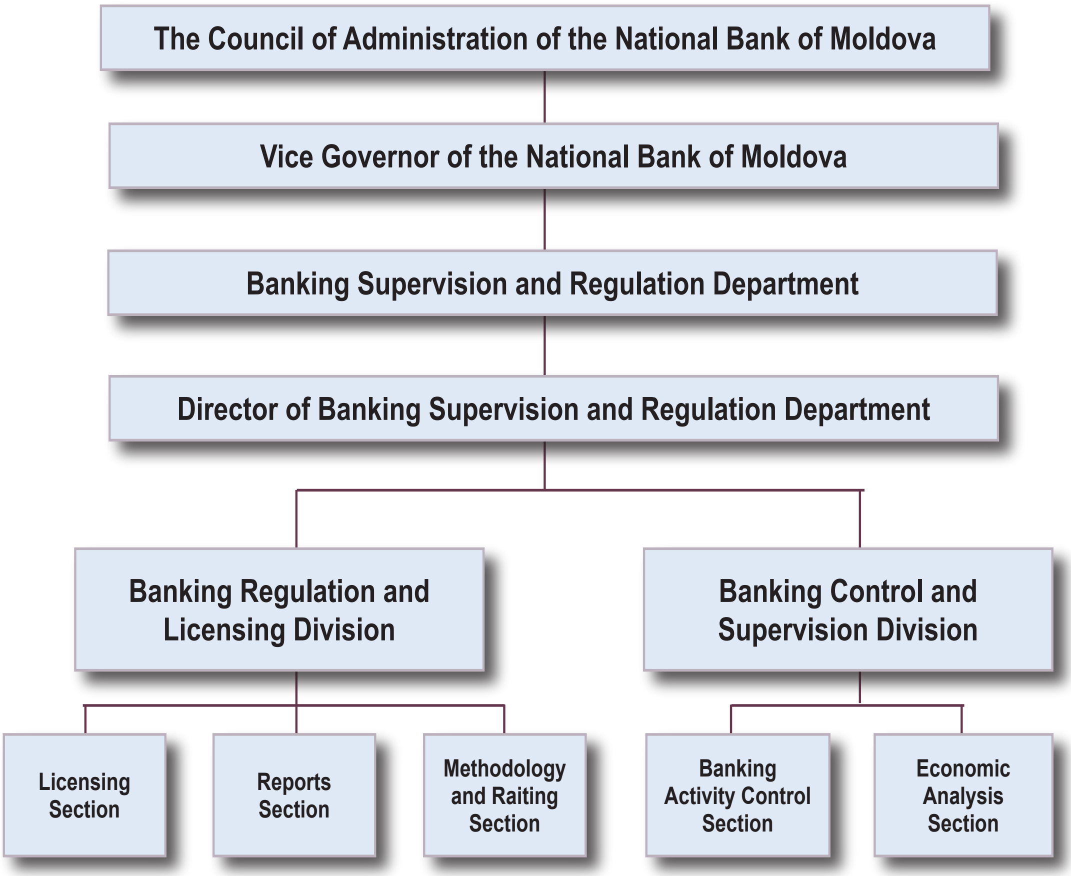
The National Bank made all efforts to contribute to the stability of commercial banks within the country by increasing the minimum required capital to a level in line with current requirements in the majority of European states. To maintain the capital in compliance with capital requirements, the National Bank has supervised over the year the efficiency of measures undertaken by banks in the context of activity compliance with new capital requirements.

With a view to improving the process of disclosure by banks of the information on their activity, the National Bank of Moldova has, additionally to existing requirements, set up that commercial banks publish a number of financial indicators, based on which the public has the possibility to determine assets' quality, return on assets, as well as return on share capital. Under the scope of banking supervision, the National Bank verifies the degree of public disclosure by commercial banks of the information on their activity, establishing the compliance of commercial banks with relevant requirements.

To facilitate the extension of "small" credits, there were additionally explained some aspects of their classification. A distant banking supervision system was established to monitor these credits.

The report on the National Bank's activity containing a section on supervision and regulation of the banking activity, including financial indicators of the banking system is published annually and is available on www.bnm.org.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL COOPERATION OF THE BANKING SUPERVISORY AUTHORITY

Currently, the National Bank maintains agreement relationship in the field of banking supervision with the supervision authorities of central banks from Romania, Russia, Belarus and Kazakhstan. These agreements serve as basis for bilateral relations and relevant exchange of information related to previous activity of persons proposed for the position of administrator in the banks of the Republic of Moldova, as well as of the information with regard to the activity of certain administrators of Moldovan banks proposed for the position of administrator in some banks of mentioned countries.

COOPERATION WITH OTHER SUPERVISORY AUTHORITIES OF MOLDOVA

Under the scope of further monitoring of risks related to banking activity in the Republic of Moldova, the National Bank cooperates with other supervision authorities of Moldova. Thus, to analyse the impact of the activity of savings and loan associations upon the banking system, NBM cooperated with the Ministry of Finance with the view to exchanging information on citizens' savings and loan associations based on data provided by the State Service of Supervision of citizens' savings and loan associations.

To monitor and supervise banks' activity in the securities' market and related risks, the National Bank has, in common with the National Commission of Securities, further regulated the conditions and procedure of issuance and circulation of securities issued by banks. The National Commission of Securities, in its turn,]in common with the National Bank of Moldova, establishes the procedure of elaboration, submission and publication of specialised reports, as well as of public offer prospectuses of professional participants of securities' market.

To confirm the nominees for the position of administrator according to the "fit and adequate" principle, the National Bank of Moldova cooperates with the relevant authorities with the view to obtaining information of possible criminal records, civil actions against individuals, sanctions applied by regulators of similar industries, implication in doubtful activities, etc.

Under the scope of provided intensification of banking monitoring in the field of anti-money laundering and combating of terrorism financing, the National Bank cooperates with a series of relevant state authorities through informing and provision of respective materials to law establishments.

OTHER RELEVANT INFORMATION AND TRENDS IN 2004

The financial sector of the Republic of Moldova, including the banking sector, has been subject, over 2004, to an evaluation study conducted by a joint commission of experts from the World Bank, the International Monetary Fund and some central banks of developed countries of the European Union and the

USA within the Financial System Assessment Program. Thus, a detailed examination was made of the compliance of the financial sector, including banks, with standards and best practices and codes of transparency within monetary and financial policies; of the compliance of banking supervision with the core principles of the Basel Committee for efficient banking supervision, accounting and audit standards, principles of corporate governance, etc.

According to FSAP evaluation results, the Republic of Moldova achieved certain success in the establishment of a functional market economy. It was stated that: the banking legislation of the Republic of Moldova is sound and in line with the banking Directives of the European Union and modern practices of central banks; the National Bank is duly authorised to undertake adequate measures towards banks implying excessive risks; the banking supervision and regulation is adequately comprehensive and conforms, in general terms, to the Core Principles of the Basel Committee on Banking Supervision. According to made conclusions, the banking sector denotes, in general terms, impressive levels of income, capitalisation and liquidity, as well as reduces values of non-performing assets. Within the context of different analytical and stress tests. Evaluators did not reveal systemic vulnerabilities of the banking sector.

To further promote the stability of the financial condition of the banking sector of the Republic of Moldova and paying due consideration to FSAP conclusions, the National Bank of Moldova has, in common with the Government of the Republic of Moldova, worked out the Development Strategy of the Financial Sector of the Republic of Moldova for the years 2005 -2010 and completed the section related to the banking sector for the National Program of the RM-EU Plan Implementation. The main objective of the Strategy of financial sector development for the years 2005 – 2010 provides the development and further consolidation of the financial and fiscal system, inflation reduction and inflation maintenance at low positive level acceptable for a sustainable economic growth, the increase of Government and NBM role in the elaboration, promotion and correlation of budgetary, fiscal, monetary, foreign exchange, credit and investment policies for the purpose of continuous development of a viable and stable financial, including banking, system.

The promotion of oriented strategic measures shall support the development and further consolidation of the banking sector, thus contributing to the increase of public confidence in the banking sector and the improvement of system capacity to support with relevant resources structural reforms, establishment of adequate entrepreneurial and investment environment in line with sustainable economic growth.

STATISTICAL TABLES*

Number of financial institutions (at year-ends)

Type of financial institution	2002	2003	2004
Banks including:	16	16	16
Subsidiaries of foreign banks	2	2	2

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

Item	2002	2003	2004
Public sector ownership	2.18	2.06	3.6
Other domestic ownership	38.03	37.74	44.0
Domestic ownership total	*40.21*	*39.8*	*47.6*
Foreign ownership	59.79	60.20	52.4
Financial institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of the financial institutions on the basis of assets total (%)

Item	2002	2003	2004
Public sector ownership	7.52	8.69	10.10
Other domestic ownership	54.63	54.60	54.90
Domestic ownership total	*62.15*	*63.29*	*65.00*
Foreign ownership	37.85	36.71	35.00
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of assets by type of financial institutions (%)

Type of institution	The first three largest	The first five largest
Commercial banks	52.23	70.43

Return on assets (ROA) by type of institutions

Type of institution	2002	2003	2004
Commercial banks	4.27	4.38	3.72

* Data are adjusted according to the results of the external audit.

Return on equity (ROE) by type of financial institutions

Type of institution	2002	2003	2004
Commercial banks	16.74	19.72	17.81

Distribution of market shares in balance sheet total (%)

Type of financial institution	2002	2003	2004
Commercial banks	95.37	95.11	95.60
Subsidiaries of foreign banks	4.63	4.89	4.40
Total banks	**100.0**	**100.0**	**100.0**

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

Assets:	2002	2003	2004
- Cash	4.94	5.33	5.52
- Due from banks and NBM	23.29	21.42	24.11
- Loans and net financial lease	50.46	56.21	54.41
- Total securities	9.94	7.01	7.29
- Other	11.37	10.03	8.67
Total assets	**100.00**	**100.00**	**100.00**
Liabilities:			
- Deposits to individuals	30.25	32.71	36.53
- Deposits to legal entities	34.37	32.61	32.81
- Other	12.39	13.69	11.35
- Share capital	22.99	20.98	19.31
Total liabilities and share capital	**100.00**	**100.00**	**100.00**

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

Type of financial institution	2002	2003	2004
Total banks	10.47	14.45	7.68

Solvency ratio of financial institutions

Type of financial institution	2002	2003	2004
Average of risk-weighted capital sufficiency for the banking system (> 12%)	36.39	31.58	31.36

Loan portfolio quality of the banking system (%)

Loan classification	2002	2003	2004
Standard	57.36	58.21	59.21
Under supervision	34.99	35.41	33.90
Substandard	5.23	4.86	5.00
Doubtful	2.29	1.32	1.55
Loss	0.13	0.21	0.34
Total	**100.00**	**100.00**	**100.00**
Specific reserves to total loans	**6.31**	**5.60**	**5.89**

Structure of deposits and loans in 2004 (%)
(at year-ends)

Deposits		Loans	
Individuals	51.12	Industrial / commercial loans	47.79
Legal entities	35.46	Agricultural/food industry loans	24.10
State budgets and local budgets	10.45	Real estate / construction and development loans	5.95
Deposits to banks	2.97	Energy resources and fuel loans	4.40
		Other loans	9.08
		Consumer loans	3.55
		Road construction and transportation loans	2.60
		Loans to banks	1.49
		Government loans	1.04
Total	**100.0**	**Total**	**100.0**

Structure of deposits and loans in 2004 (%)
(for year-ends)

Maturity of deposits		Loans	
At sight	38.08	Short-term loans	40.29
Time deposits	61.92	Medium and long-term loans	59.71
Total	**100.0**	**Total**	**100.0**

Foreign exchange assets and liabilities*
(at year-ends)

Type of institution	Net Forex assets / Total assets			Net Forex liabilities / Total liabilities		
	2002	2003	2004	2002	2003	2004
Banks	39.62	41.92	37.46	47.14	48.61	44.45

**Regulation position is not included (accounts "Placements in bank's central office and subsidiaries", "Subsidiaries' "Nostro " accounts") and off-balance sheet accounts.*

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

Revenues:	2002	2003	2004
- Total interest income including:	744.32	982.72	1,258.72
- Interest income for loans and financial leasing	655.91	832.08	1,082.39
- Interest income for securities	44.18	85.38	121.14
- Interest income for other assets	44.24	65.26	55.19
- Total non-interest income	498.32	591.31	682.68
Expenditures:			
- Total interest expences	281.86	334.99	525.87
- Total non-interest expences	498.32	669.94	797.96
- Allowances for loan losses	62.52	101.00	127.01
Total net income	289.63	399.66	423.03

Structure of registered capital and own funds of financial institutions in 2004

Type of financial institutions	Registered capital	/Total assets	Own funds	/ Total liabilities
	EUR (thousand)	%	EUR (thousand)	%
Commercial banks	64,158.42	8.18	151,419.42	23.93

As of 31.12.2004 1 EURO –16.9542 lei

Structure of off-balance items as of December 31,2004

Conditional assets	/Total assets (%)	Conditional liabilities	/ Total liabilities (%)
Acquisitions to current operations	0.87	Sales to current operations	1.08
Acquisitions to time operations	0.28	Sales to time operations	0.40
Acquisition of loans and securities	0	Sale of loans and securities	0.03
Total conditional assets	**1.15**	**Total conditional liabilities**	**1.52**

2004 DEVELOPMENTS IN THE MONTENEGRIN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The macroeconomic situation in 2004 improved in comparison with the previous year. It was characterized by an increase in production output, a downfall in inflation, a reduction in the fiscal deficit, an increase in savings and granted loans, and an increase in the current account deficit and a growth in foreign borrowing. Table 1 shows the most important macroeconomic indicators.

Table 1. Macroeconomic indicators

Macroeconomic indicators	2003	2004
GDP (EUR million)	1.375	1.475
GDP increase rate (%)	2.53	2.97
Inflation (%)	6.7	4.3
Current account balance (EUR million)	-114	-182
Foreign direct investments (EUR million)	43.8	61.9
Savings (EUR million)	45	80
Granted loans (EUR million)	201	284
M 21	494	547

The inflation rate in 2004 was on a downtrend. Measured by the retail price index and the cost of living index it amounted to 4.3% and 1.5%, respectively. The facts that inflation is lower than the projected level of 4.5%, and that it has been on a downward trend for three years in a row are certainly encouraging. It has approached the EMU inflation rate (which is the goal to be reached in the long term), being at the same, and even slightly below the level of the aforementioned interest rate until the fourth quarter of the year.[9] If we analyse the factors which led to the increase in prices, we find that the main culprits are the prices of services whose growth can explain for 80% of this year's inflation. Since these are solely the prices of non-tradable services by suppliers enjoying monopoly or oligopoly position, the enactment of antimonopoly regulation is a sine qua non for restricting inflation in 2005. However, we can conclude that a declining inflation rate is the price to be paid in the economic reform process.

[9] Inflation was 2.5% until December, but an increase in the prices of telecommunication services of 100% led to inflation of 1.8% in the last month of the year, which represents the highest monthly inflation in the last three years, with the exception of April 2003 when VAT was introduced. Such an increase in prices raises doubts about the existence of an abuse of a monopoly position, which is prohibited in all developed market economies.

Positive trends were also present in the monetary sector. Banks` potential rose by 27%, granted loans by 42%, savings by 79%, and total deposits by 30%. Observed as a whole, the banking sector was characterized by a high liquidity level. To wit, the total liquid assets and discharged debts amounted to EUR 101 million and EUR 24 million, respectively. A continuous increase in term deposits, which now make up more than half of the total deposits (55%), represents a very positive trend unlike two years ago when they made up less than 30%.

The money supply is also increasing. The broadest monetary aggregate, M21, amounted to EUR 547 million, showing an increase of more than EUR 50 million since last year. Bearing in mind that the movements in the balance of payments in euro (dollarized) economies are the sources of an increase and/or a decrease in the money supply, we can conclude that the real situation is much more favourable than recorded in the statistics, that is, there is a substantial amount of income which was not recorded.

Interest rates are still high, thus making the economy's business activities harder. The main culprits for the high level of interest rates are: high country risk, client risk, inadequate working procedures of the judicial system, inflation still higher than that in the EMU, and so on. The sizeable difference between interests receivable and interests payable indicates that there is enough space for their further decrease. With regard to the stabilisation of economic and political situations, a gradual fall in interest rates could be expected in 2005.

Net salaries grew by 11.7% in comparison with the previous year. In the last two year, salaries have grown much faster that the cost of living, which has led to a real growth in the living standard. However, the continuation of a faster growth of salaries than productivity, i.e. the GDP rate of increase, may bring about numerous negative trends, such as higher operating costs, a rising pressure on the budget, growth in inflation, deterioration in the current account deficit, and so on.

Industrial production recorded an extremely high growth, 13.8%, which is by far the highest in the region. It can be mostly explained by the privatisation and the reforms carried out in the last few years which are yielding positive results after a certain time delay. However, this year's level of industrial output is just 70% of that achieved in 1990. The main contributors in the structure of industrial production are electricity and semi-finished products. With a view to achieving high rates of economic growth it is necessary to continue with the restructuring of large systems, complete the privatisation process, upgrade the quality of production, and achieve international quality standards.

Tourism is the branch that recorded the most dynamic development in 2004. The number of tourists who visited Montenegro rose by 17.4%, whereby the number of overnight stays increased by 14.7%. The estimated revenues from tourism amounted to some EUR 180 million (19% more than in 2003), which is very important from the aspect of the current account deficit. The number of foreign tourists is increasing steadily. The declining number of tourists who visited mountain resorts can be explained by the lack of modern well-equipped hotel enterprises. Bearing in mind the extraordinary natural potential for the development of mountain tourism, the restructuring of these enterprises is essential with a view to attracting foreign investors. What Montenegrin tourist offer lacks most are the non-existence of high-class hotel capacities and the absence of renowned hotel chains. With regard to the great potential for Greenfield investments it is important to strive towards attracting renowned investors. Although the number of registered overnight stays is 54.2% lower than that recorded in 1989, some indicators (the number of roaming users, accommodation capacities, electricity consumption) suggest that the actual number of tourists was much larger.

Increases were also recorded in forestry and agriculture, and a fall in the construction industry. As for transportation, road transport of passengers, air traffic and transportation via railways are on the increase, whereas a downtrend was recorded with other forms of transportation.

The labour market recorded falls both in the number of employed and the number of unemployed people of 9.4% each. Such trends are explained by the increased number of pensioners and those who were removed from the Employment Bureau records due to the non-fulfilment of legally prescribed conditions. Although the unemployment rate fell by some 3.5% in comparison with the previous year, it is still high, 22%, and it will represent one of the biggest problems in 2005.

The balance of payments current account deficit deteriorated from EUR 114 million in 2003 to EUR 183 million in the reporting year. However, the dilemma remains whether this is the actual deterioration or a result of statistical omissions from the previous year which was, therefore, represented as falsely low.[10] Some half of the increase in the current account deficit can be explained by the increased prices of oil and oil derivatives. The balance of payments problems are mainly concentrated in the trade balance, as a result of the increased import of consumer goods and intermediate goods (this category can indirectly contribute to a growth in production). An uptrend in the import, as well as a downtrend in the export of agricultural-consumer products gives some reasons for concern if the existing natural conditions for the development of this sector are taken into account. The main culprits for the deficit are the following factors: uncompetitive domestic products, the expansion of domestic demand (through increases in salaries and consumer loans), a liberal foreign trade regime, the low employment of capacities, and the substantial amount of non-registered income as well. However, we must be aware of the fact that almost all transitional economies (including those who have become members of the EU) still face balance of payments current account deficits.

The dynamics of the inflow of foreign investments is not as expected. Almost half of them are in the service sector. However, what gives reason for concern is a drastic increase in loans. To wit, net loans amounted to EUR 122 million, which is three times the amount achieved last year.

Although the level of foreign indebtedness shows that Montenegro belongs to the group of low-indebted countries, a certain concern represents the fact that foreign borrowing is on the increase; its contribution to GDP is 34%, and it

[10] There is a doubt that a part of the December 2003 transactions was registered in January 2004. Also, VAT was introduced in April 2003, and the customs records were transferred from the Federal Customs Office to the Montenegro Customs Office. In this adjustment period of several months, a falsely low level of imports was registered.

was 32% in 2003. Further, foreign borrowing policy should be very restrictive, otherwise all future surpluses will go to foreign debt repayments.

Montenegro was assigned a `BB-` credit rating by the international rating agency Standard&Poors'. It is a very favourable rating, much higher than that assigned to most of the countries in the region. This will certainly have a positive effect on Montenegro's position in the international capital market, the movement of interest rates, and the inflow of foreign investments. Of course, one should not expect the situation to improve radically, but to treat this credit rating as the confirmation that the reforms have been on the right track and that they should continue as planned.

The grey economy is still widespread, so measures to suppress it must continue. On one hand, it acts as unfair competition, while on the other it reduces budgetary revenues. Bearing in mind the social dimension of the grey economy, the accent should be put on its conversion into legal flows by allowing tax relief wherever possible.

Montenegro should stay on a course of accelerated movement towards international organisations whose member it is yet to become, these primarily being the European Union and the World Trade Organisation. The EU has allowed the so-called "dual track" approach, and the WTO the separate membership of Serbia and Montenegro. These are actually precedents which have not been granted to any other country in the world, so any further delay will only be our fault. The most important demands to be imposed by the EU have already been fulfilled by the Central Bank of Montenegro, and these relate to its full independence, the implementation of international standards with regard to bank supervision, the prevention of lending to the Government, and the banning of the public sector's privileged access to sources of finance. The condition that is yet to be fulfilled is the free appearance of banks from the EU, including the right to open only subsidiaries. The fulfilment of this condition would be counterproductive at this moment because the restructuring and the privatisation of the banking sector should be finished first; other economies in transition fulfilled this condition immediately before their joining the European Union.

Any scenario of future economic development must be based on a high investment rate. Taking into account a relatively limited domestic accumulation of capital, the emphasis must be put on attracting foreign investors. The role of the state in this context is to create a stimulating business environment. This means freeing up business activities, the continuation of the reduction in interest rates (as well as all administration costs), the following of an active policy of the suppression of the grey economy, the creation of an efficient legal and judicial system, with a withdrawal of the state from the production process at the same time.

The strategic preference of Montenegro should be liberalism and high level of openness, but this does not exclude the possibility of the protection of some sensitive products for a limited period of time. Montenegro has to trade most of its domestic products in the world market, which implies the specialisation in those sectors that could achieve comparative advantages. The domestic market should be protected by all the measures used by developed countries, including antidumping procedures, the prohibition of the import of products that do not meet quality standards, the prohibition of the import of non-certified products, and so on.

DEVELOPMENT IN THE BANKING SYSTEM

If 2001 represented the year when the establishment of effective bank supervision had started and when the reform of banking system had begun, then 2002 represented the year when this reform was intensified. If 2003 represented the year when this reform was internationally recognized and when it gave the results, then the year 2004 can be characterized as a year of continuous development in banking sector and achievement of high level of bank supervision effectiveness.

Ten banks are operating in the banking system of Montenegro. During one-year comparable period, no changes occurred in the number and structure of banks. The key trends in the banking industry in Montenegro are the following:

1. Total assets of banks have significantly increased by EUR 94.6 million during one-year comparable period, or 27% in relation to total assets as of December 31, 2003.
2. Increase of concentration in the banking system. The total assets of three banks account for 60% of the total financial potential. These three banks granted 63% of all loans. Capital of these three banks makes 47% of total capital of all banks. Three banks with the largest deposits potential have 62% of all deposits in banking system.
3. Lending activity of banks is significant. Total loans increased by EUR 81 million, or by 40%, in the period between 12/31/03 and 12/31/04. Loan growth in one-year period exceeds the growth of total assets by 27% in this period.
4. Total deposits of banks increased by EUR 62 million, or by 29.47% during the last year. Deposits of individuals increased significantly in the one-year period, by EUR 35 million, or by 78%. Their share in total deposits increased from 21% to 29% in the same period.
5. Loans to deposit ratio is high and amounts to 103.03%, which represents an increase in relation to 95.08%, as of 12/31/03. The level of this indicator is significantly above the acceptable.
6. Long-term loans increased in one-year period. The share of long-term loans in total loans increased from 25% to 40% in this period.
7. Loans granted to privately owned companies and individuals (83% of all granted loans at the system level) increased in one-year period as well as their share in total loans.
8. Majority of loans in banking sector were granted to trade industry (42%) and this trend is evident in the observed one-year period. Banks' clients from trade industry are the most important net borrowers of funds from banks. Negative creditor/depositor relation regarding trade industry amounts to minus EUR 59 million at 2004 year-end.
9. Positive creditor/depositor relation was achieved by retail sector in the amount of EUR 5.5 million.
10. Asset quality of the banks at the industry level needs improvement, as seen in the one-year period. Assets classified as substandard, doubtful and loss (C, D, E) to total capital and reserves at the system level report a growth in the one-year period. All categories of poor quality assets grew in the observed period.

11. Total criticized assets achieved a significant growth of 116% in this period due to increase of special mention assets by 152%. There is a risk in asset quality of the banking system due to constant increase of special mention assets. Loans that are past due at the system level are significant and amount to 5.17%.
12. All banks in the banking system achieve growth of total capital in the observed period, except for one bank, which reports a significant decline. Total capital of banks in the one-year period grew by 1.76%. Excluding the negative impact of the capital decline in one bank on the total capital trends in the system, the total capital of banks at the annual level increased by EUR 8.8 million, or at the rate of 16.63%. During 2004, five banks provided additional capital through new issues of shares.
13. In the structure of total capital at the end of the fourth quarter 2004, the state capital has a share of 25.76%, private capital 36.35% and foreign capital 37.89%. The ownership structure of total capital did not significantly change in relation to end 2003.
14. Liquidity of the banks is satisfactory, although key ratios during 2004 show negative movements.
15. There is maturity mismatch of financial assets and liabilities at the aggregated level in period from 1-7 days. This mismatch has negative influence on cumulative gap in the system, which is negative in period up to 180 days. Maturity mismatch in the system is also evident in period over 5 years.
16. Depositor/creditor relationship with the state is concentrated with three banks, of which one does not have dominant market share in the system. Out of all state deposits with banks, these three banks hold 83.5%, while at the same time they have extended 61.3% of all the loans to the state sector. At the system level, the state sector is a net depositor of funds in the amount of EUR 8,709 thousand.
17. Financial outcome at the system level at the end of 2004 is negative and amounts to minus EUR 1,116 thousand. All banks made profits at the end of the observed period, except for one bank that had a loss of EUR 7,280 thousand, which resulted in a negative aggregate financial outcome.
18. Interest rate spread in the one-year period has a declining trend. As of 12/31/03, this indicator was 9.62%, while at the end of 2004 it was 7.61%.
19. Risk management by commercial banks depends on the complexity and scope of risks assumed by banks. Generally, measures taken by banks include risk reduction and strengthening of risk management process. This trend will continue to be intensified in the future in the light of the passing the decisions on minimum standards for market risk management, operational risk management and country risk management.

The picture of all the events happened in relation with the banking sector would not be completed if unrealized expectations were not mentioned. It refers to delay in further bank privatization, low growth of deposits from private companies, insufficient decline of interest rates, lack of full implementation of deposit protection scheme and inability to finalize initiated bankruptcy and liquidation proceedings in banks.

Bank supervision did reach a considerable level of effectiveness, but there is also challenge to maintain and further improve reached level. Therefore, there are numerous tasks that bank supervision should fulfill. Achieved level of effectiveness provides the grounds for considering how and when to pursue to Basel II. One of the open questions that needs to be resolved heading towards challenges of Basel II implementation is the issue of strengthening the institutional knowledge in Montenegrin banking. It is one of the largest guarantors of strengthening the corporate governance in banks, and its further development on the grounds of safe and sound operations.

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

Proposal of the Law on amendments to Law on Banks was prepared at the end of 2004. The proposed amendments intensify the institutional strength of the Central Bank during licensing process of new banks and during assessments of non solid operations the may expose the bank to excessive risks in operations. In addition, new solutions will enable the preparation for implementing particular principles from Basel II in the following period, having in mind its approach of higher sensitivity to risks in operations of banks.

Besides, normative activities in 2004 were focused on improvement of subordinate legislation and approval of new Decision. Five enabling decisions were issued: Decision on Minimal Standards for Market Risk Management, Decision on Minimal Standards for Operational Risk Management, Decision on Minimal Standards for Country Risk Management, Decision on Reports that Banks Submit to CBM and Decision on Manner and Procedures of and Fees for the Bank Supervision.

In addition, normative division participated in development of Law on Insurance, Law on Financial Leasing and Law on bill of exchange.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY

In 2004, the activities of the bank supervision department were focused on additional adoption of regulations, analyses of changes of regulation and bank supervision globally, preparation of the amendments to Law on Banks, expansion of risk supervision of the banks and intensification of international cooperation.

The additional need to amend Law on Bank came through the performance of the operations during prior years. Proposed amendments to Law on Bank create a space to gradual transition towards implementation of principles and methods of Basel II having in mind uniqueness of banking system of Montenegro.

Key proposals of the amendments to Law on Banks provide the basis for higher level of sensitivity to risks in banking operations.

Further improvement of normative infrastructure through adoption of new and improvement of current subordinate legislation shall enable more comprehensive supervision of all risks the banks in Montenegro are exposed to in their operations.

New techniques for more thorough risk assessment were introduced in on site examination. Market risk examination was comprehensively performed in all banks. In addition, examination of internal controls system and audit were performed. The examination of implementation of regulations from the area of prevention of money laundering started as well.

Significant activities of the off site examination, besides regular analysis of individual banks and banking system analysis, were improvement of software for bank analyses and preparation of establishing regulatory credit bureau. Regulatory credit bureau will start to function at the beginning of 2005 and it will significantly improve the quality of monitoring of the credit and market risks in banks. Besides, it may be used in the future for easier adoption of advanced approaches within Basel II having in mind specific Montenegrin economy.

In order to maintain the safety and soundness of the system, Central Bank of Montenegro has taken measures against banks, which corrected deficiencies noted in banks regarding asset quality and liquidity. To continuously monitor imposed measures, staff from the department for imposing and monitoring measures against banks was directly involved in monitoring the measures in banks.

2004 was particularly successful year in the area of international cooperation. Significant results were achieved through connection with other regulators from the region. Central Bank has joined, among other things, the BSCEE.

In staffing aspect, a special attention was paid to training of employees through attendance of seminars in country and overseas and practical training during examinations. Pursuant to strategic goals of supervisory function, training related to market risk and introduction with Basel II Principles represented the most significant area of training. Manuals were adopted in order to improve internal controls system, which describe in details procedures for performing activities within department.

The performance evaluation system in Bank Supervision Department, which has been additionally developed during 2004, has shown its advantages in strengthening the efficiency in performing activities within the department and served as additional tool for implementation of the supervision principles introduced within Pillar II of Basel II. Models for change of the organizational structure of the department were developed. These models should be evaluated in the following period to select the best solution of the organizational structure from projected requirements standpoint.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

During 2004, 20 on site examinations were performed. Of that, 10 were full scope examinations and 10 were target examinations. As compared to 2003, when 33 on site examinations were performed (11 full scope and 22 target), this represents a decrease primarily due to the fact that the condition of the banking system as a whole was stable and there were no need to perform such high number of targeted examinations. The average number of engaged people/days in one examination is 5 x 15. Since the average similar efficiency, from human resources and time standpoint, was achieved in 2003 and that during 2004 the scope of examination was higher, from the size of controlled portfolio standpoint as well as from the volume of controlled risks standpoint, it may be concluded that Bank Supervision Department achieved substantially higher efficiency in 2004. This was followed up by high quality, which can be seen from the fact that the banks established higher level of reserves for potential losses in 2004 than in 2003. The quality of examinations has been particularly improved since June 2004.

Having in mind a significant increase of banks' activities, particularly increase of lending activity, a special attention during examinations is paid to evaluation of asset quality, financial analysis of borrowers and evaluation of their ability to repay the loans and evaluation of financial strength in future period.

Consumer loans expansion resulted in additional attention of supervision of this part of banks' portfolio with special stress on procedures and conditions of the consumer loan approval processes.

Level of market risk, techniques of measurement and identification of these risks are controlled in all banks. During these examinations, banks are given the recommendations to improve management and control of market risk.

The adoption of the Law on Prevention of Money Laundering and establishment of Administration for Prevention of Money Laundering intensified the activities of supervision of prevention of money laundering during full scope banks examinations.

Regular, quarterly analyses of individual banks and the system as a whole were improved to give the evaluations of future movements of key parameters and trends that serve as assessment of banks.

The project of introduction of regulatory credit bureau has been brought to implementation phase, so it will start to operate in the first quarter 2005.

Measures that have been taken over during 2004 were primarily focused on correction of weaknesses and deficiencies in operations of individual banks related to asset quality, funds management and improvement of risks management process.

Orders were issued to two banks and an agreement on removing deficiencies in operations was signed with one bank. To further follow up measures taken over in particular cases, the employees from division for monitoring and imposing measures against banks were directly engaged on follow up of the measures in banks against which the measures were imposed.

Complicated proceedings, inefficiency of court system and weaknesses in legislation were the key factors of non-finalizing bankruptcy proceedings in

Jugobanka AD Podgorica. Similar has happened with the liquidation proceedings in Ekos Bank AD Podgorica.

Current experience in implementation of bankruptcy and liquidation proceedings in banks points out that Law on Bank Bankruptcy and Liquidation should be changed to increase the efficiency of these proceedings.

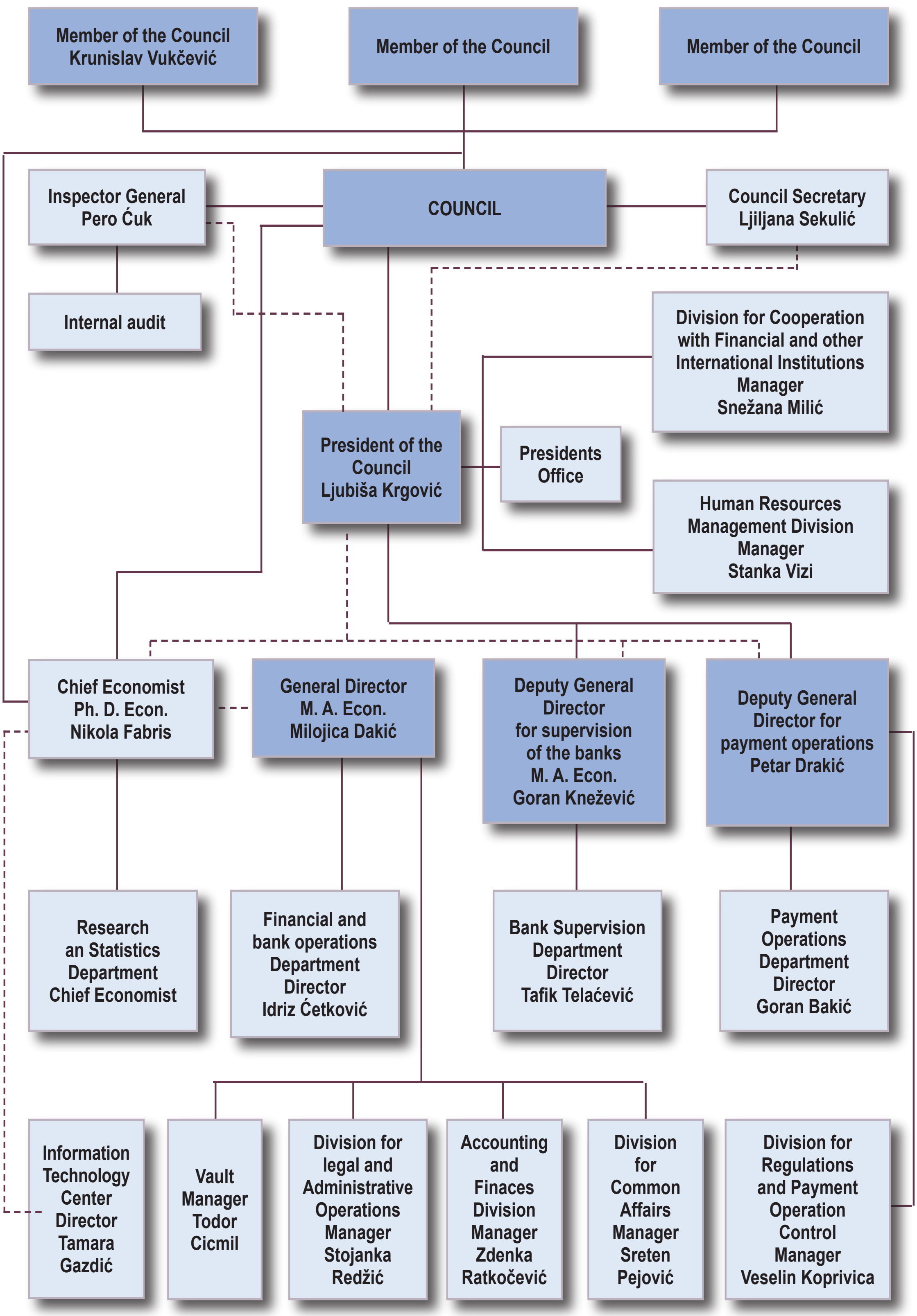
There were no requests for licensing new banks in last year. Banks continued to expand their business networks. 18 approvals for opening new organizational parts have been issued. In relation to the prior year, the number of newly opened organizational parts was significantly lower, which was expected since 44 approvals for opening new organizational parts were issued in the prior year.

In one case, the request for issuing approval for acquiring qualified share in bank's capital was denied. 3 approvals were issued for appointment of general director in three banks.

Significant staffing changes occurred in the prior year in Bank Supervision Department. New Director of the Department was appointed at the beginning of the year and Deputy for On Site and Off Site Examination as well. Management of the CBM wanted to give the opportunity to young people from the Department who affirmed themselves during the current engagement in the Department. Three employees left the Department in the prior year. On the other hand, two new employees were hired that had banking experience and assigned to perform examination operations. Having in mind that during the following year the examination will expand following up the expansion of banking activities, a need for additional employment in on site will be evident.

In the development of staffing capacity needed for the implementation of its supervisory role, the key challenge before the CBM will be to increase institutional knowledge and minimize employee turnover.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF YOUR AUTHORITY

Cross border cooperation have an important role in achieving modern regulatory and control function from consolidated supervision standpoint and from improvement of exchange of supervision information and methods standpoint.

Activities that were taken over the last years included active implementation of the reform of banking system, high compliance with Core Principles for Effective Bank Supervision and active monitoring of international trends in bank supervision as well. This resulted in joining the Association of Bank Supervisors of the Central and East European Countries (BSCEE), at 19th meeting of the Association held in Dubrovnik in May 2004.

Current engagement in this area is completed and it opens the further possibility of research, education and advanced training of supervisory activities, exchange experiences in conducting supervisory functions and know how, through close cooperation and day-to-day communication with supervisory units of the countries members of the Association. The further step of the Bank in order to intensify cooperation is participation of Bank representatives on 13th International Conference of Bank Supervisors in September 2004 in Madrid.

The Agreement with Bank of Slovenia, which was signed in 2003, has been realized in all parts completely meeting the expectations. Examiners from Bank of Slovenia participated in the full scope examination of Montenegrobank AD Podgorica, which was conducted in the middle of the year. In addition, cooperation with Bank of Slovenia was also improved in the field of exchange of experience in the areas in which Bank of Slovenia has more experience (Operational risk and Market risk).

Agreement with Bank of Albania was reconciled in the prior year and a successful cooperation was reached with National Bank of Austria.

Bank plans to intensify cross border cooperation in area of regulatory and supervisory function through signing of the bilateral agreements with almost all central banks from the surrounding countries in the near future.

COOPERATION WITH OTHER SUPERVISORY BODIES IN YOUR COUNTRY

Central bank of Montenegro has good relationship with Security Commission of Montenegro and Anti-money laundering units.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2002	2003	2004
Banks	10	10	10
Financial institutions, total	**10**	**10**	**10**

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

Item	2002	2003	2004
Public sector ownership	31	23	26
Other domestic ownership	44	44	36
Domestic ownership total	*75*	*67*	*62*
Foreign ownership	25	33	38
Financial institutions, total	**100**	**100**	**100**

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

Item	2002	2003	2004
Public sector ownership	31	19	16
Other domestic ownership	59	57	53
Domestic ownership total	*90*	*76*	*69*
Foreign ownership	10	24	31
Financial institutions, total	**100**	**100**	**100**

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

Type of institutions	The first three largest	The first five largest
Banks	60	77

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

Type of institution	2002	2003	2004
Banks	3.97	1.60	-0.29

Return on equity (ROE) by type of financial institutions

Type of institution	2002	2003	2004
Banks	15.69	6.50	-1.24

Distribution of market shares in balance sheet total (%)

Type of financial institution	2002	2003	2004
1 bank	23	27	31
3 banks	62	59	60
5 banks	80	78	77
7 banks	91	90	90
Financial institutions, total	**100**	**100**	**100**

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

Assets	2002	2003	2004
Cash funds & deposit accounts with depository institutions	41.17	27.46	24.21
Loans and lease operations	36.67	57.36	63.34
Securities held to maturity	1.48	4.58	4.22
Business premise and other fixed assets	6.46	6.91	5.06
Acquired assets	4.19	1.84	1.14
Equity investments	1.72	1.63	1.22
Other assets	12.44	2.98	3.94
Less: reserves for losses	-4.13	-2.76	-3.13
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2002**	**2003**	**2004**
Deposits	60.36	60.33	61.48
Borrowings taken from other banks	1.44	5.50	
Obligations on taken loans and borrowings	2.72	4.97	12.20
Obligations to government	0.81	1.47	1.20
Reserves			0.70
Other obligations	11.76	2.23	4.00
Total liabilities	**77.09**	**74.50**	**79.58**
Total capital	22.91	25.50	20.43
Total liabilities and capital	**100.00**	**100.00**	**100.00**

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

Type of financial institution	2002	2003	2004
Banks	15.52	16.32	19.60
Financial institutions, total	**15.52**	**16.32**	**19.60**

Solvency ratio of financial institutions (%)

Type of the financial institution	2002	2003	2004
Banks	42.03	39.44	31.28
Financial institutions, total	**42.03**	**39.44**	**31.28**

Asset portfolio quality of the banking system

Asset classification	2002	2003	2004
Pass (A)	81.71	78.02	64.93
Special Mention (B)	6.37	14.56	27.04
Supstandard (C)	3.64	4.64	4.24
Doutful (D)	7.82	2.72	2.79
Loss (E)	0.46	0.06	1.00
Classified total (000)	**179,046**	**225,838**	**303,009**
Specific reserves	**7.86**	**4.28**	**5.18**

The structure of deposits and loans in 2004 (%)
(at year-end)

	Deposits	Loans
Government sector	11.72	5.96
Municipalities	4.81	3.35
State owned companies	5.02	3.75
Private companies	28.83	58.99
Banks	6.70	0.36
Financial institutions	4.50	1.01
Households	29.02	26.43
Other	9.40	0.15
Total	**100.00**	**100.00**

The structure of deposits and loans in 2004 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	55.46	Long term loans	39.51
Within one year	40.59	Short- term loans	60.49
Over one year	*3.95*		
Total	**100.00**	**Total**	**100.00**

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

Type of the financial institutions	Forex assets / Total assets			Forex liabilities / Total liab.		
	2002	2003	2004	2002	2003	2004
Banks	6.47	6.55	3.26	6.75	6.73	5.38
Financial Institutions, average	**6.47**	**6.55**	**3.26**	**6.75**	**6.73**	**5.38**

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

Revenues	2002	2003	2004
Interest income	24.16	53.62	51.07
Fee income	18.70	38.43	43.03
Other operating income	3.46	5.04	5.89
Extraordinary income	53.68	2.91	0.01
Expenditures	**2002**	**2003**	**2004**
Interest expense	7.08	14.56	14.55
Provision for losses	25.29	14.64	21.92
Fee expenses	5.00	7.41	12.21
Operating expenses	31.17	59.87	49.65
Extraordinary expenses	26.20	1.71	0.13
Taxes	5.26	1.81	1.54
Net profit / loss (000 EUR)	**12,118**	**5,336**	**-1,116**

Structure of registered capital and own funds of financial institutions in 2004

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	000 EUR	%	000 EUR	%
Banks	71,378	16.06	303,792	68.36
Financial Institutions, average	**71,378**	**16.06**	**303,792**	**68.36**

2004 DEVELOPMENTS IN THE POLISH BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN POLAND[11]

Preliminary estimates indicate that Poland's GDP growth came to 5.3% in 2004, the highest for seven years, although growth waned from one quarter to the next.

The main drivers of GDP growth were domestic demand, which rose 4.5% over the year (as against 2.5% in 2003), gross fixed investment (up 5.1%, compared to a decline of 0.5% the previous year), and exports. Exports and imports, at 272.1bn zloty and 324.6bn zloty (current prices), were up 30.2% and 22.5%, respectively, on 2003.[12] The deficit on trade in goods thus amounted to 52.5bn zloty (having stood at 56.2bn a year earlier).

Industrial output was 11.6% greater than a year before (compared to growth of 8.1% in 2003). Strong gains were sustained in labour productivity (around 13%, as measured by output per employee), with average employment having decreased (down 0.4%).

The situation on the labour market improved slightly in 2004. At the end of December, both the jobless total (2,999.6 thousand) and the unemployment rate (19.1%) were lower than a year before, having slipped by 176.1 thousand and 0.9 points, respectively.

Immediately after Poland was admitted to the EU, an acceleration was seen in consumer price growth, primarily attributable to the increase in food and transportation prices. Annual inflation came to 3.5%, a figure 1.5 points higher than had been written into the Budget. Initial figures also show producer prices running higher than a year previously. Producer price growth averaged 7.0%, as against 2.6% in 2003.

The dollar traded at an annual average of 3.6540 against the zloty in 2004, 6.0% down on 2003, whereas the euro averaged 4.5340, up 3.1%.

For the first two months of the year, the euro strengthened against the zloty, reaching an all-time high of 4.9149 on March 1, with the dollar also making gains (valued at 4.0572 zloty on April 29). The zloty then began to firm, continuing to do so until year end. At that point, the euro had lost 13.5% to the zloty compared to the end of 2003, while the dollar had weakened 20.1% (taking these currencies to 4.079 and 2.9904 zloty, respectively).

[11] Figures in this section are based on data from the Central Statistical Office (GUS) and the NBP.

[12] Expressed in dollars, exports came to 73.8bn, while imports totalled 87.9bn (stated in euros, the relevant figures were 59.7bn and 71.1bn).

The appreciation of the zloty, particularly in the latter half of the year, was traceable to:

- interest rates that were attractive to foreign investors,
- an improvement in macroeconomic conditions,
- upbeat investor sentiment in the region as a whole (with the strengthening of the Czech and Slovak koruna, and also the Hungarian forint),
- upgrades in Poland's rating outlook from two agencies (Standard & Poor's and Moody's),
- an influx of foreign currency to fund purchases of shares in PKO Bank Polski SA.

The year 2004 was the first in the performance of Poland's *Monetary Policy Strategy beyond 2003*. The basic objective of this Strategy is to stabilise inflation at a low level (2.5% year on year, with a permissible bandwidth of ±1 point either side of that target). As of January 2004, this represents a constant inflation target. This means that achievement of the target is not reviewed in December, as was the case previously, but rather each month throughout the year.

In seeking to hit this target, the Monetary Policy Council shifted its policy stance in April from neutral to tightening, and then carried out three hikes in NBP official interest rates, raising them by half a point in June, a quarter point in July, and half a point in August.

The upshot was that the reference rate (the rate on reverse repos) rose from 5.25% to 6.50%, with the lombard rate going up from 6.75% to 8.00%, the deposit rate rising from 3.75% to 5.00%, and the rediscount rate going up from 5.75% to 7.00%. These adjustments to official rates resulted in a similar increase in money market rates. Average 1-month WIBOR (the Warsaw Interbank Offered Rate) rose from 5.5% in December 2003 to 6.7% in December 2004, while the weighted average yield on NBP money market bills climbed from 5.3% to 6.5%, and that on Treasury bills went up from 6.1% to 6.4%.

However, the final quarter of the year brought a fall in rates on money market instruments with the longest maturities. Thus, 12-month WIBOR dropped from 7.6% in mid-September to 6.6% at year end, while yields on 52-week T-bills slid from 7.5% to 6.3%.

The increase in central bank and money market rates also led to changes in the deposit and lending rates the banks were offering their customers. These changes were smaller than the moves in the reference rate. Weighted average rates on zloty time deposits rose 0.85 points (from 2.90% to 3.75%), while those on zloty loans went up 0.76 points (from 9.63% to 10.39%). The effect of this was therefore to narrow the gap between rates on loans and time deposits by 0.09 points (from 6.73% to 6.64%), to the benefit of bank customers.[13]

[13] Weighted average rates on household zloty deposits went up 0.95 points (from 2.89% to 3.84%), whereas zloty lending rates for households edged down 0.03 points (from 12.03% to 12.00%), although rates on housing loans rose 0.50 points (from 7.63% to 8.13%) and those on consumer loans were up 0.16 points (from 15.77% to 15.93%). As regards corporates, weighted average rates on zloty deposits showed an increase, up 0.4 points (from 2.98% to 3.38%), as did zloty lending rates, up 1.16 points (from 7.18% to 8.34%).

THE POLISH BANKING SECTOR IN 2004

In 2004, the banking sector exerted the determining influence on the stability of Poland's financial system, since – as in many other EU countries – it remained its largest and most developed segment.

However, due to the swifter growth of non-bank financial institutions, the proportion of financial sector assets held by banks declined to 74.4% (compared to 77.9% in 2003).

At the end of 2004, operating activity was being carried on in Poland by 650 domestic banks (53 incorporated as public limited companies, 1 state-owned bank and 596 cooperative banks) and 3 branches of credit institutions.

While the authorised capital of domestic commercial banks declined by 305m zloty in the course of 2004 (coming down to 11,256m), the members' share fund of the cooperative banks went up 13m zloty (to 525m).

At year end 2004, 14 domestic banks were listed on the Warsaw Stock Exchange, together with 1 foreign bank. Thanks to the flotation of PKO Bank Polski SA, the share of domestic banks in the capitalisation of the Exchange rose 0.9 points to 33.9%. This is significantly higher than in the other countries of Central and Eastern Europe.[14]

As of 31 December, 2004, there were 13 domestic commercial banks (out of a total of 54 with majority Polish equity. This group included 5 banks controlled by the Treasury (2 of them directly), 3 banks affiliating cooperative banks, 4 small private-sector banks and, temporarily, one large high-street bank (following the first stage of its privatisation).[15]

The remaining 41 domestic banks were controlled directly or indirectly by foreign investors. In 2004, the equity interests in domestic banks held by these investors dropped 230m zloty (to 7,086m), while their share of the authorised capital of the banking sector slipped 0.5 points (to 60.1%).

The high proportion of foreign equity in the Polish banking industry is traceable both to privatisations and to the involvement of foreign investors in the rehabilitation of distressed private-sector banks. It is worth adding that the banks established by foreign undertakings account for no more than 10% of the sector's total assets.

At the end of December 2004, investors from 17 countries were present in the banking sector. The capital involvement of investors from Belgium, the United Kingdom and Japan increased (up 302m, 40m and 16m zloty, respectively), whereas that of German, French and US investors decreased (down 350m, 202m and 178m zloty, respectively).

At the end of 2004, the ten largest banks in Poland held 71.9% of total banking sector assets and had taken 78.7% of total deposits from non-financial customers. Each of these banks had taken at least 10bn zloty in deposits and had a total footing in excess of 16bn zloty (over 20bn in the case of nine banks).

[14] At the end of 2003, this ratio stood at 18.7% in Hungary, 16.5% in the Czech Republic and 3.5% in Slovakia.

[15] As of January 2005, this bank has majority foreign equity.

The level of concentration was lower in loans than in assets, but higher in deposits. The reduction in banking industry concentration observed in recent years (as measured using both the Herfindahl-Hirschman Index[16] and the market shares of the five, ten and fifteen biggest banks[17]) is related to small and medium-sized banks expanding more swiftly than large ones.

The economic upturn had a positive impact on the development of the banking industry in 2004. The total assets of the banks rose 10% to 538bn zloty, thereby growing twice as fast as in 2003 (4.8%). Asset growth would have been even faster, at 14.3%, had it not been for the appreciation of the zloty. Following the increase in earnings, **ROE** increased by 12.2 percentage points and **ROA** by **0,9** percentage points.

THE NEW DEVELOPMENTS IN THE LEGAL FRAMEWORK OF THE SUPERVISION OF FINANCIAL INSTITUTIONS IN POLAND IN 2004

Poland's entry to the European Union had been preceded by many years in which Polish legal regulations had been brought into line with EU standards. At the date of accession, Polish banking law was in full conformity with the acquis communautaire.

The most recent comprehensive amendments to Poland's **Banking Act** were adopted by the Polish Sejm (the lower house of parliament) on April 1, 2004. In terms of the effectiveness of banking supervision, the most significant changes relate to the capital base (regulatory capital, or "own funds"), capital adequacy and large exposures; the amendments on these questions were the only ones which did not take effect until January 1, 2005.

- In accordance with Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, Article of the Banking Act was amended to include a requirement that capital holdings in insurance undertakings also be deducted from a bank's capital base.
- In terms of a bank's "interim results" (profit pending audited confirmation and current period net earnings), it was stated that, subject to fulfilment of certain conditions specified in the Act, these could be included in additional items of core capital.
- The calculation of capital adequacy was made uniform by abandoning the practice of reducing the capital base by the amount exceeding the ceiling on capital holdings, while including the relevant charge in a bank's overall capital requirement.

[16] The Herfindahl-Hirschman index (HHI) is defined as the sum of the squares of the market shares of particular companies in a given industry (e.g., the sum of the squares of the share of banks in total banking sector assets); thus, HHI = $\sum w_i^2$, where w_i is the market share of bank i (i = 1,2,3, ..., n).

[17] Referred to as the discrete concentration ratio, CR.

- In order to give a more precise content to large exposures limits, the definitions involved were expanded. These now not only refer to "credit exposures", but also to "equity exposures". On the other hand, exposures were exempted from the large exposure and clustering limits where the bank's obligor is another domestic bank or a credit institution, and where the exposures concerned mature in no longer than one year, with the exception of those items included in the capital base of the domestic bank or credit institution.
- New articles in the Act regulate the question of outsourcing, an important issue for the banking sector. The solutions adopted here attempt to reconcile the banks' drive to maximise profitability with the need to ensure the safety of deposits taken. Outsourcing agreements should allow banks to carry on their operations in compliance with legal regulations and to ensure each bank is managed in a prudent and stable manner, while also enabling the Commission for Banking Supervision to exercise effective supervision over the activities outsourced by a given bank.
- A legal framework for securitisation, long-awaited by the banking industry, was established in the Banking Act, thereby creating new methods for asset restructuring, which should contribute to a further improvement in the quality of loan portfolios. The essence of securitisation is that it is predicated on issuing securities backed by claims or receivables. Banks are the sole financial market institutions to have been given an opportunity to carry out operations of this kind, using either a securitisation fund (a particular kind of closed-end investment fund) or a special-purpose company (as the issuing vehicle).[18]
- In line with international trends in the regulation of financial markets, the Banking Act was amended to strengthen significantly the role of internal controls, by requiring banks to have an internal control system in place. This legislation also raises the status of the internal audit function, which all banks should have (with the exception of cooperative ones, where internal audit is performed by the affiliating bank). The Act clearly stipulates that these functions cannot be outsourced to third parties.
- In addition, other amendments to the Act make more precise the provisions concerning:
  - the principles governing the communication by banks of information subject to the obligation of banking secrecy,
  - the consolidated supervision of banks,
  - controls over the transfer of title to shares in banks incorporated as public limited companies,
  - rehabilitation and liquidation proceedings at banks,
  - liquidity.

[18] An important point is that the tax regulations recognise any loss incurred on the sale of assets to securitisation funds as tax-deductible expense, up to the level of the associated specific provision expensed against income.

As of January 1, 2004, amended principles are in place for **asset classification and specific provisioning**. The largest changes involve:

- extending the period of delinquency that requires a downgrade in classification,
- simplifying the classification procedures for retail loans and advances (with only one category of irregular assets, i.e., "loss"),
- allowing consideration to be given to the most robust forms of security already at the stage when an exposure is being classified,
- introducing a requirement for the bank to verify the eligible security it has taken with respect to the delinquency in the claim thus secured, setting a maximum period of eligibility (applicable to the security in whole or in part).

The implementation of this new system, which resembles the solutions applied in most European countries, concluded the period of convergence between Polish requirements and EU standards.

Following on from the amendments to the Banking Act, adjustments were made to the **prudential regulations** issued by the Commission for Banking Supervision (these took effect on January 1, 2005).

- The most significant changes to the **calculation of capital adequacy** (introduced under Commission Resolution no. 4/2004, September 8, 2004), entail the following:
  - the capital requirement for a breach of the ceiling on capital holdings has been included in the overall capital requirement,
  - securitisation, subparticipations and credit derivatives have been recognised as credit risk mitigation techniques,
  - the constraints concerning mortgage collateral in force for the purposes of specific provisioning (the LtV limit) have been moved to the calculation of credit risk capital requirements[19], and
  - the coefficients used in determining the equity price risk requirement have been lowered to the level in force in other EU countries.
- The key change introduced under Commission Resolution no. 5/2004, September 8, 2004, relates to the procedures for **deducting holdings in other financial undertakings and banks from a bank's capital base**; this derives from Article 35, paragraph 2, point 12, of Directive 2000/12/EC. This resolution requires that non-qualifying holdings also be deducted from the capital base, i.e., ones that individually are no greater than 10% of the capital base, where their aggregate amount exceeds the said limit. The effects of this provision will primarily be felt by cooperative banks, which will have to reduce their capital base by the value of their holdings in their affiliating bank and other cooperative banks.

[19] This is to encourage banks to utilise the valuations of expert appraisers and to increase the value of the collateral they take relative to the loans they make.

Further, the resolution specifies the principles governing the inclusion in the capital base of profit pending audited confirmation and current period earnings.

- Changes were also made to another prudential regulation in the wake of the amendments to the Banking Act, which – in line with Directive 2000/12/EC – employ the concept of a **large exposure limit** rather than a credit concentration limit, and which alter the scope of exempt exposures. In particular, Commission Resolution no. 6/2004, September 8, 2004, contains the following provisions:
  - it defines the conditions for exemptions from large exposure limits in the trading book, at banks with significant trading book business,
  - it gives more detailed procedures for the treatment of contingent commitments and off balance sheet trading transactions,
  - it extends the list of exempt exposures.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2004

The strategic areas of activity of the Commission for Banking Supervision in 2004 were set by the progressing changes in the Polish banking sector, implemented in relation to Poland's accession to the EU and the necessity to meet the requirements of the new environment. The performed works continued earlier trends, such as banking sector consolidation and the increase in competition among banks.

A new task of banking supervision in 2004 was the analysis of notifications submitted by relevant supervisory authorities of the home country, which specified the activities that a credit institution intended to perform within the framework of banking activities conducted by a branch, or cross-border activities. This requirement follows from the provisions of the Banking Act, according to which on May 1, 2004 credit institutions having their registered office on the territory of one of the EU Member States were authorized to pursue activities on the territory of Poland upon prior submission of relevant notification.

THE ACTIVITIES OF THE COMMISSION FOR BANKING SUPERVISION IN 2004

The Commission for Banking Supervision played an important part in the improvement of the financial standing of Polish banks. The Commission actively supported, among other things, the activities of banks' authorities aimed at raising additional capital, by referring investors interested in commencing banking activity to banks and proposing banks with larger capital to participate in recovery processes at banks threatened with bankruptcy. This enlarged their capital, helped commence recovery actions, or facilitated takeovers by other banks. The Commission's undertakings were also focused on restructuring activities and on improvement of management quality at banks.

As regards the banks in an unstable condition, certain interventions were undertaken under applicable legal regulations and depending on the ongoing assessment of the risk borne by banks, which included issued recommendations or relevant rulings.

The Commission for Banking Supervision initiated numerous activities at all the banks implementing recovery programs, in order to accelerate the banks' return to a secure level of operation. The Commission monitored on an ongoing basis the condition of banks implementing recovery programmes and it watched the progress of banks at which supervisory activities were initiated.

In the course of its activities, the Commission closely cooperated with the Bank Guarantee Fund, which was notified, on a regular basis, of any decisions obliging banks to commence recovery proceedings, of initiated supervisory activities and, in individual cases, of the condition of particular banks, especially those using the Fund's financial assistance. The Commission submitted results of examinations performed at banks that used the Fund's assistance, whereas the BFG submitted the results of its audits at those banks.

Moreover, the CBS issued permits for purchases of qualifying holdings, which allowed investors to gain control over banks. The issuance of a permit to purchase shares at a bank that was significant for the banking sector required certain declarations to be made by the strategic investor, related to e.g. retaining the local character of a bank, maintaining quotations of the bank's shares at the stock exchange, or a specific bank development strategy.

Fulfilment of the declared commitments was supervised on an ongoing basis, as well as the fact whether the implemented strategy ensured appropriate and secure development of banks.

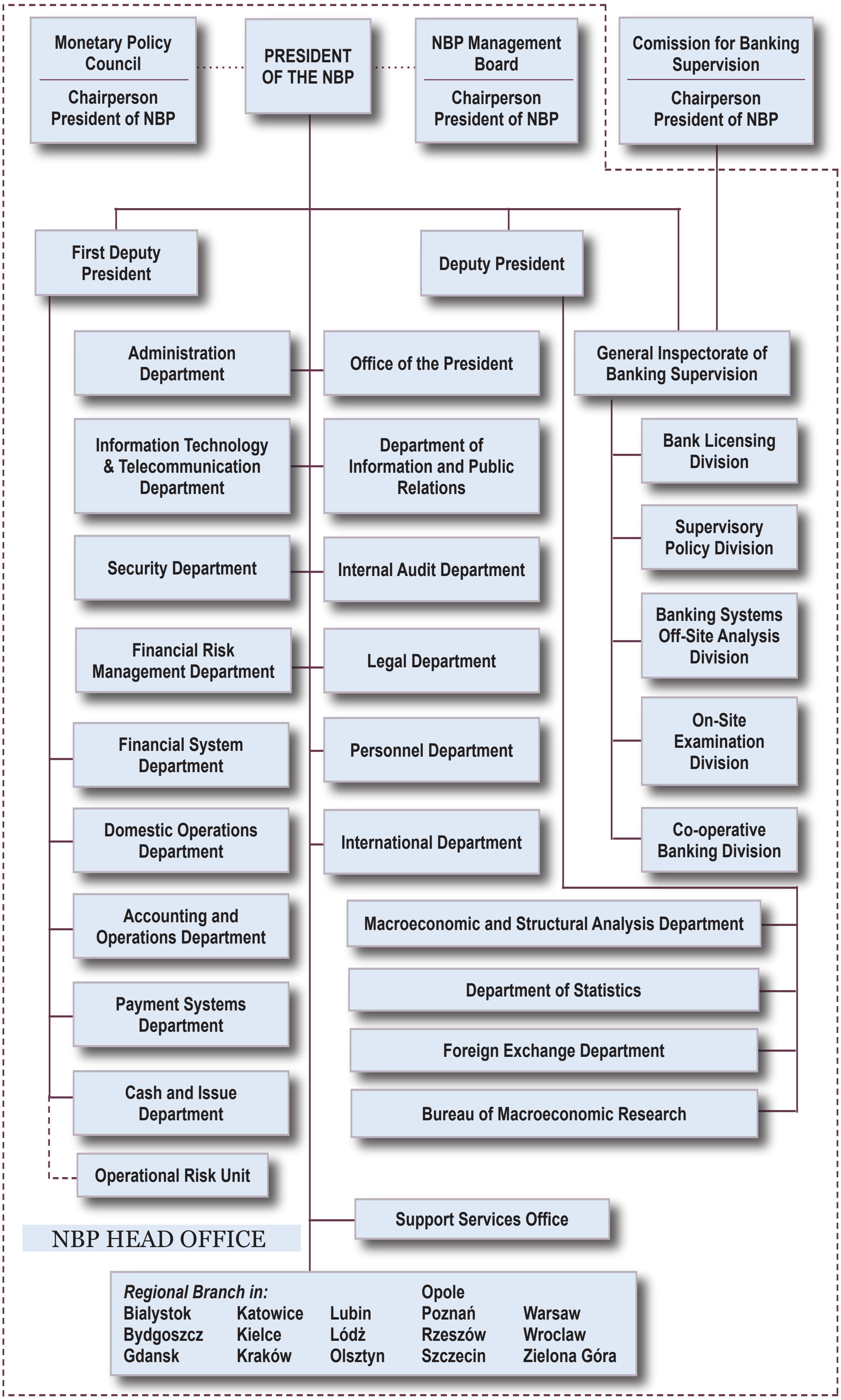
Within the framework of direct analytical supervision the Commission regularly received information on the implementation of post-examination recommendations, on the compliance of banks' operations with binding legal regulations and prudential standards, on timely submission and accuracy of statements. As a result, interventions were possible in the case of delayed implementation of recommendations or a necessity for the banks to supplement submitted information.

Within consolidated supervision[20], the Commission monitored the capital adequacy of banking groups and the impact of subsidiaries on the banks' financial standing. The financial condition of parent undertakings of Polish banks, as well as the economic condition of foreign shareholders of domestic banks and its potential impact on those banks were also analysed.

To sum up, the activities undertaken by the Commission for Banking Supervision in 2004 facilitated effective achievement of the objective set by the legislator for banking supervision, i.e. assuring security of funds held on bank accounts and banks' compliance with the provisions of the Banking Act, the Act on the National Bank of Poland, their articles of association and issued rulings on the authorization to establish a bank.

[20] In accordance with Art. 141f Section 1 of the Banking Act, consolidated supervision shall apply to those domestic banks which are the parent of another domestic bank, a foreign bank, a credit institution, a financial institution or an ancillary banking services undertaking, which have close links with another undertaking or undertakings, and operate within a financial group or a mixed-activity group.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE COMMISSION FOR BANKING SUPERVISION IN 2004

Poland's membership in the EU greatly strengthened international cooperation. The dissolution or reorganization of previously existing bodies under which the European banking supervisors operated (e.g. the Banking Advisory Committee) re-oriented the involvement of supervisors in the works on EU legislation from a political level to a purely content-oriented approach. New committees and working groups of the EU Council were established. Currently, the European supervisors operate under the **Committee of European Banking Supervisors.**

In 2004, the representatives of the Polish supervision joined the works of 25 working groups operating within the EU. Through the participation in the working groups of the European Central Bank (ECB) and the Committee of European Banking Supervisors (CEBS), Groupe de Contact (GdC) and the EU Banking Advisory Committee, Poland significantly contributes to the development of the common EU policy for the financial system supervision.

One of the crucial elements of the international cooperation was the participation of the supervisory authority in the procedures of identification and supervision of financial conglomerates. These tasks were performed together with Polish Security and Exchange Commission (KPWiG) and Commission of Supervision of Insurance Companies and Pension Funds (KNUiFE) and the Ministry of Finance.

The supervisory authority employees participated in the preparation of NBP's stance for EU committees and working groups. They were also involved in coordination of the participation of experts in the works on the EU forum (for the needs of the Ministry of Finance, the Ministry of Economy and Social Policy, the Office of the Committee for European Integration and for the needs of the NBP).

The supervisory authority actively participated in the works of the Committee of European Banking Supervisors (CEBS) and its working groups. The most important issues included the transfer of the New Capital Adequacy (NCA) provisions to the provisions of the amended Directives 2000/12/EC and 93/6/EEC.

The particularly important event for the Polish supervisory experts was the opportunity to participate in the works of working groups responsible for developing coherent and uniform for the whole EU:

- standards for financial reporting and banks' capital adequacy reporting;
- standards for the transparent operations of the supervision (the so-called supervisory disclosures);
- requirements for internal models applied by banks and procedures for their recognition by supervisory authorities in EU Member States.

The employees of the banking supervision also joined the works of the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures in Central and Eastern European Countries **(MONEYVAL)**. They focused, in particular, on the assessment of evaluation reports from Russia, Moldova and Armenia.

A particularly important aspect of the bilateral cooperation was the participation of the supervisory authority in negotiations lasting for over 2 years and leading to the conclusion of the supervisory cooperation agreement between the Commission for Banking Supervision and the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation of the United States of America in October 2004. The agreement regulates the scope and procedures of consolidated supervision over banks operating in financial groups.

Two months later, in December 2004, the Commission for Banking Supervision concluded a supervisory agreement with the German banking supervision authority, Bundesanstalt für Finanzdienstleistungsaufsicht.

TRAINING INITIATIVE FOR BANKING SUPERVISION ACTIVITIES IN 2004

In 2004, the TIBS held two seminars addressed to the supervisors from Central and Eastern Europe[21]:

- "Credit Risk Management: the Banker's and Regulator's Perspective" – May 31 – June 4, 2004,
- "Consolidated Supervision" – November 22 – 26, 2004.

Additionally, as part of the TIBS and at the request of Mr. Olexandr Shlapak, Deputy Governor of the National Bank of Ukraine (NBU), the Polish banking supervisory authority conducted a seminar in Kiev on September 5 – 10, 2004. The seminar entitled "Risk Based Supervision" was addressed to the supervisors of the Ukrainian central bank.

[21] In total, 59 persons from 22 countries participated in TIBS seminars organized in Poland in 2004. The participants represented both the regional group of supervisors from Central and Eastern European countries and the states of the former Soviet Union. The countries that have participated in the TIBS training so far include: Armenia, Belarus, Bosnia Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Serbia and Montenegro, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Slovakia, Slovenia, and Ukraine.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2002	2003	2004
Commercial banks	59	58	54
Cooperative banks	605	600	596
Banking sector	**664**	**658**	**653**

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

Item	2002	2003	2004
Public sector ownership	17.3	16.9	13.9
Other domestic ownership	9.5	9.6	9.0
Domestic ownership total	*26.8*	*26.5*	*22.9*
Foreign ownership	63.2	63.3	63.9
Dispersed holdings	13.1	10.2	13.2
Total commercial banks	**100.0**	**100.0**	**100.0**

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

Item	2002	2003	2004
Public sector ownership	26.4	25.8	25.8
Other domestic ownership	2.7	2.7	2.7
Domestic ownership total	*29.1*	*28.5*	*28.5*
Foreign ownership	70.9	71.5	71.5
Total commercial banks	**100.0**	**100.0**	**100.0**

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

Type of institutions	The first three largest	The first five largest
Commercial banks	39.7	52.3

NBP

Return on asset (ROA) by type of financial institutions

Type of institution	2002	2003	2004
Commercial banks	0.5	0.5	1.4
Co-operative banks	1.6	1.2	1.8
Banking sector	**0.5**	**0.5**	**1.4**

Return on equity (ROE) by type of financial institutions

Type of institution	2002	2003	2004
Commercial banks	5.2	5.4	17.4
Co-operative banks	18.2	12.2	18.4
Banking sector	**5.8**	**5.8**	**17.5**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2002	2003	2004
Commercial banks	95.0	94.7	94.7
Co-operative banks	5.0	5.3	5.3
Banking sector	**100.0**	**100.0**	**100.0**

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

Assets	2002	2003	2004
- Cash and balance with Central bank	4.6	3.9	3.7
- Interbank deposits	16.7	15.7	19.8
- Due from non-financial and government entities	46.3	48.4	45.9
- Secuirties	22.6	23.2	21.5
- Other assets	9.8	8.7	9.1
Liabilities	**2002**	**2003**	**2004**
- Borrowing from Central Bank	0.6	0.5	0.4
- Interbank deposits	13.4	14.9	14.6
- Deposits from non-financial and government entities	61.1	64.6	62.4
- Bonds	0.8	1.1	1.2
- Other liabilities	14.0	8.8	11.6
- Capital and reserves	10.1	10.1	9.8

NBP

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

Type of financial institution	2002	2003	2004
Commercial banks	259.1	335.1	321.5
Co-operative banks	0.4	0.6	0.8
Banking sector	**259.5**	**335.8**	**322.2**

Solvency ratio of financial institutions

Type of the financial institution	2002	2003	2004
Commercial banks	13.8	13.7	15.5
Co-operative banks	13.4	14.2	14.1
Banking sector	**13.8**	**13.7**	**15.4**

Asset portfolio quality of the banking system

Asset classification*	2002	2003	2004
- Consumer loans classified satisfactory	16.8	16.1	18.7
- Special mention claims	6.8	6.2	6.3
- Irregular claims. of which:			
– substandard	4.8	4.6	2.6
– doubtful	5.6	5.6	2.6
– loss	10.7	11.0	9.6
Classified total	**21.1**	**21.2**	**14.8**
Specific reserves	**18 341.4**	**20 001.3**	**18 886.5**

** From non-financial institutions*

The structure of deposits and loans in 2004 (%)
(at year-end)

	Deposits	Loans
Households	63.8	44.1
Government sector	7.4	8.0
Corporate	26.0	47.6
Foreign*	1.2	0.8
Other	2.8	0.3
Total	**100.0**	**100.0**

** Deposits and loans are included in others items*

NBP

The structure of deposits and loans in 2004 (%) (at year-end)

Maturity of deposits		Loans	
At sight	36.1	Long term loans	60.4
Within one year	56.7	Medium-term loans	24.3
Over one year	7.2	Short-term loans	15.3
Total	**100.0**	**Total**	**100.0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2002	2003	2004	2002	2003	2004
Commercial banks	23.9	25.2	23.5	18.8	19.1	16.8
Co-operative banks	0.2	0.2	0.6	0.0	0.2	0.4
Banking sector	**22.7**	**23.9**	**22.3**	**17.1**	**18.2**	**16.0**

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

million zloty

Revenues	2002	2003	2004
Commercial banks	86,215.4	74,275.6	77,713.4
Co-operative banks	3,657.8	3,234.9	3,453,0
Banking sector	**89,873.2**	**77,510.5**	**81,166,4**
Expenditures	**2002**	**2003**	**2004**
Commercial banks	82,884.5	71,174.2	70,282,8
Co-operative banks	3,161.9	2,832.0	2,862,9
Banking sector	**86,046.3**	**73,007.2**	**73,145.7**

Structure of registered capital and own funds of financial institutions in 2004

Type of the financial institutions	Registered capital	/Total sector assets	Own funds	/Total liab.
	EUR	%	EUR	%
Commercial banks	2,259.4	2.1	12,065.1	9.2
Co-operative banks	111.4	0.1	709.5	0.5
Banking sector	**2,870.8**	**2.2**	**12,774.6**	**9.7**

2004 DEVELOPMENTS IN THE ROMANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2004, the Romanian economy experienced accelerated growth, with real GDP expanding by 8.3 percent, faster than both the originally projected figure of 5.5 percent and the revised figure of 7.3 percent. The development was bolstered by domestic demand, with the growth rate of household actual final consumption rising by 3.6 percentage points from 2003 to 10.8 percent, amid significant increase in household incomes (including remittances) and in self-consumption against the backdrop of a bumper crop in 2004; unlike in the previous year, lending was no longer a major driver of household consumption, but high real interest rates provided an underpinning to saving. Consumption of public administration was in line with the cautious fiscal policy (4.6 percent, similar to the figure recorded in the previous year) despite the increases recorded in 2004 Q2 and Q4 associated with municipal and general elections.

Gross fixed capital formation grew at a fast pace (10.1 percent, up one percentage point against 2003), albeit lower than that of final consumption, due to the upturn in investment in retooling and construction. By contrast, net exports had further a significant negative contribution to GDP growth (2.7 percentage points); the growth rate in exports, owing to the expansion in foreign demand from key trading partners and to the favourable environment of some market segments, was further outpaced by the increase in imports triggered by the rise in domestic demand.

DEVELOPMENT IN THE BANKING SYSTEM

2004 marked, in Romania, a period of progress which contributed to the increase of the trust in the banking system, supported by its restructuring, the diversification of the banking products portfolio, the increase of the purchasing power of the population, and the macroeconomic stabilization. The expansion of the banking assets in 2004 (+35,7% in real terms compared with the previous year), higher than economic increase (+8,3%), lead to diminishing of the difference between Romania and other countries from the region in terms of the banking assets share in GDP further to its increase from 31.0% at the end of 2002 to 32.0% in December 2003, to 37.7% at end-December 2004, respectively.

Behind the increase in banks' net aggregate assets stood the real 36.0 percent pick-up in interbank operations and the 26.5 percent growth of lending to non-banks. Operations in government securities increased with 124.4 percent over the year before. As at end-December 2004, operations with non-banks held the largest share in total assets, i.e. 46.5 percent, ahead of interbank operations on 36.0 percent.

The share of the non-governmental credits in GDP increased from 15.9% in 2003 to 17.5% in 2004. Despite to this end, the loans granting activity was characterized, in 2004, by a more temperate growth rhythm compared with the previous year (real growth decreased from 50% in 2003 to 26% in 2004). The rhythm slowed down in the context of the restrictive politics imposed by the central bank by the entering into force of the norms regarding the limitation of the risk related to the consumer credit (NBR Norms no.15/2003) and mortgage credit (NBR Norms no.16/2003).

The dynamics of the non-governmental credit is still given by the credits granted to population[22], whose rhythm of real annual increase (44,8%), much lower than the previous year (215%), but higher than the non-governmental credits, explains the increase of the weight of this segment from 24,8% to 28,4%. The weight of real estate and mortgage credits increased from 25,6% at the end of 2003 to 28,4% on 31.12.2004, consumer credits representing approximately two thirds of its volume.

As far as the currency of denomination of credits is concerned, the credits in foreign currency are preferred (60,8% of the non-governmental credits[23]), in the last years the European currency imposed decisively towards the US dollar and ROL. This orientation towards EUR currency appears in the context of the extension of maturities of the credits granted to population, and, implicitly, of the need of adequate provisioning of the total costs related to credit, by reporting to a more stable currency the national currency.

Significant progresses were also made in the evolution of the indicators defining the quality of assets portfolio. The weight of the past due and doubtful credits (net value)[24] in the total of credits oscillated between 0,6% in March 2004 and 0,3% at the end of 2004, while past due and doubtful claims (net value)/ total assets ratio fluctuated in the same period between 0,2% and 0,4%. Even in the context of including the off-balance sheet past due claims in the calculation of the above mentioned ratio, it registered significant restrains between 2000 – 2004, going from 13,4% on 31.12.2000 to 6,1%, respectively 4,2% at the end of last two years.

The decreasing values of these ratios reflect both the improvement of the parameters of the banking system, as well as the increased interest of the banks for obtaining a portfolio of performing credits.

To the same conclusion lead the information provided by the reports regarding the credits' classification, reported by the credit institutions. Thus, at the end of 2004, the NPL' ratio (calculated as a weight of the credits classified as doubtful and loss in the total of portfolio), registered the lowest values (2,9%) from the moment of entering into force of the NBR Regulation no. 5/2002 (modified by the NBR Regulation no.7/2002), which provided more severe criteria for classifying the debtors.

[22] According to the information provided by the monetary balance of the credit institutions

[23] According to the monetary balance sheet

[24] Registered in the accounting balance sheet

In 2004, there was also an improvement of the efficiency of the banking sector, quantified through the ratios of financial return on equity – ROE and on assets – ROA, 15.6% and, respectively 2.0%. The analysis of the financial performance of banks revealed an increased of the aggregated net income at the end of 2004 with 4,484.7 billion ROL in comparison with the previous year, representing an increase with 33.6% in nominal terms and 22.2 in real terms, respectively, exclusively due to the supplementing with 47.2% of the interest net incomes. A major contribution to this dynamics had it the net incomes related to the lending of the non-banking clients, increasing with more than 67.5% in comparison with the previous period. A more rapid increase in terms of profitability was registered especially by the banks which increased the share on the credit market.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF BANKS, NEW DEVELOPMENTS

In 2004 good progress saw harmonization of banking legislation with EU requirements in the field. The most important laws, norms and regulations issued during 2004, are the following:

- Law no. 443 amends and supplements the provisions of Law 58/1998 on banking activity;
- Law no. 149 amends and supplements the provisions of the Insolvency Act as well as of other pieces of legislation on insolvency;
- Law no. 278 approves, amends and supplements the provisions regarding judicial reorganization and winding up proceedings of credit institutions;
- Law no. 289 regulates the legal status of consumer loans agreements for individuals;
- Regulation no.4 governs the organization and operation of the Credit Risk Bureau on the premises of the NBR;
- Norms no. 5 regulate the capital adequacy of credit institutions on a consolidated basis and on an unconsolidated basis by implementing Directive 93/6/EEC, amended by the Directive 98/31/CE and 98/33/CE;
- Norms no. 15 lay downs the principles of supervision of credit institutions on a consolidated basis and sets the prudential consolidation methods, implementation of prudential requirements at a consolidated level;
- Norms no.9 amend and supplement the provisions of NBR no.12/2003 on supervision of solvency and large exposure of credit institutions;
- Norms no.10 lay down the procedures of licensing, the terms and conditions, as well as the documents that must be submitted to the NBR for the licensing of banks, electronic money institutions other than banks, as well as savings banks for housing and branches of foreign credit institutions operating in Romania;
- Norms no.11 regulate the conditions under which changes can be made in the standing of banks, electronic money other than banks, real estate saving house and foreign banks branches.

THE ACTIVITIES PERFORMED BY THE BANKING SUPERVISORY AUTHORITY

The new co-ordinate of the Romanian banking market together with the increase of the complexity of the banking activity required the constant improvement of the supervision process. In this context, the risk based supervision was an objective necessity of the process of monitoring the banking sector, stressing especially the identification and measurement of the credit, market, operational, and reputational risk, which did not have, thou, a significant impact on the patrimonial or reputational situation of the credit institutions.

During the on site inspections, most of the deficiencies found at banks were remedied by programs of measures closely monitored by the NBR.

In addition to those mentioned above, the evaluation of the vulnerabilities of the banking system was made in 2004 through stress tests[25], which consisted in evaluations of the sensitivity towards the fundamental risks (the foreign exchange risk, the interest rate risk, the credit risk and the contamination risk on the interbank market), and on the basis of scenarios representing various combinations of possible extreme situations.

A significant contribution at making the supervision activity more efficient had it, also, the improvement of the instruments used in the current activity, with the support of the consultancy offered within projects financed from Phare, as well as purchasing a new IT application for the development of the monitoring system of the credit institutions on the basis of their reports. In this context, it is noticed the new approach in the evaluation of banks' management (component M within the uniform rating system) which allows the identification of its capacity to plan, monitor and control the banking risks, the evaluation of the quality of the corporate governance, of the quality of IT systems at banks, as well as the adequacy of the internal audit system. In order to support the new approach, there were implemented some matrices for evaluating the risks (such as scorecard), which include the most important characteristics of management and allow to give each of the abovementioned element a mark.

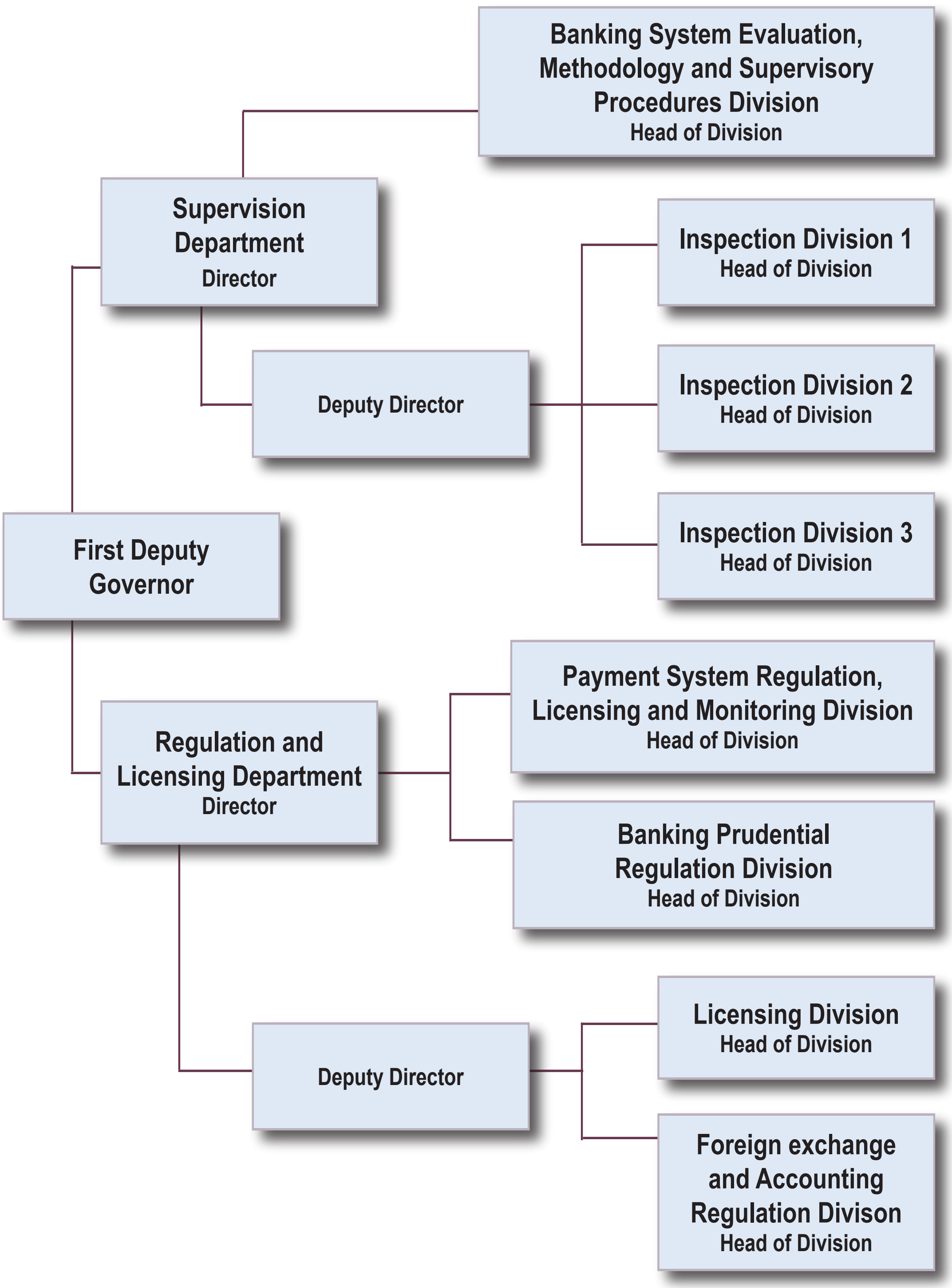
At the same time, introducing new components of evaluation within the uniform system of banking rating – CAAMPL(S), respectively the sensitivity at the market risk (S) will mark an important step in the evolution of the supervision strategy. The necessity of completing the actual banking rating system with the evaluation of the market risk appeared both as a consequence of the changes in the Romania banking industry, and of the orientation of the supervision authority towards the most advanced practices in this field.

[25] The stress test is an instrument of evaluation of the capacity of resistance of a banking system at exceptional, but credible, macroeconomic perturbations, an instrument promoted by IMF and WB within the FSAP programs. The purpose of these programs is to support various countries to identify and remove the weaknesses of the financial sector, as well as the increase of its resistance at macroeconomic shocks.

LEGAL COMPETENCE OF THE NBR IN THE AREA OF BANKING REGULATION AND SUPERVISION

The NBR has the exclusive competence to issue licences and is responsible for prudential supervision of the credit institutions. According to the banking law the credit institutions comprise banks, credit co-operative organisations, electronic money institutions and real estates savings houses. It issues regulations, takes measures for their observance and applies sanctions for their infringement. In addition to the off site inspections performed based on the periodic reports submitted by the banks, on site inspections are conducted by the NBR at least once on two year and more frequently when irregularities are detected. In case of any violation of the regulations, the NBR can impose penalties.

SUPERVISION DEPARTMENT AND REGULATION & LICENSING DEPARTMENT ORGANIZATION STRUCTURE



INTERNATIONAL ACTIVITIES OF NBR

Having in view a closer co-operation with supervisory authorities in the country of origin of capital invested in Romania, the NBR have finalized the negotiations with seven supervisory authorities (National Bank of Moldova – 07.27.2001, Supervision and Regulation Agency from Turkey – 02.19.2002, Central Bank of Cyprus – 04.10.2002, Bank of Italy – 12.12.2002, Bank of Greece – 01.24.2003, Federal Office for Banking Supervision from Germany – 03.04.2003, and Nederlandsche Bank N.V. – 01.07.2004) and with other three supervisory bodies the negotiations are in progress (Bank of Austria, Banking Commission from France and Hungarian Financial Supervisory Authority).

The goal of the agreements in the field of banking supervision consists in the establishment of an effective way to collect and to exchange supervision information in order to facilitate the performance of the supervisory authority tasks, meet the highest international standards for effective banking supervision and promote the safe and sound functioning of banks and other financial organisations in their jurisdictions.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

The NBR made official the co-operation with National Commission for Securities and Insurance Supervisory Commission, by signing, in April 2002, a co-operation protocol with these authorities.

In order to enhance the co-operation between NBR and the mentioned supervisory authority, a great importance had played by the setting up of a working committee designated to improve the contacts at the level of experts, especially those involved in the working out of the financial stability indicators.

Also, in October 2004, another agreement on the co-operation oriented toward the development of the National System for Governmental Financial Statistics, between Ministry for Public Finance, National Institute for Statistics, National Bank of Romania and National Commission for Prediction, had been concluded. The parties undertake to co-operate in view to exchange and disseminate the information among them on this issue.

MAIN STRATEGIC OBJECTIVES OF THE NBR IN 2005

Further harmonization of banking legislation with the EU legislation in the field and the streamlining of banking supervision, including by co-operation with other supervisory authorities are part of the NBR ongoing concern to enhance its administrative capacity. In order to consolidate de supervisory function, the NBR will act to improve the technical endowment of the bank examiners and the staff training, and to support the process of restructuring and privatization of the banking sector (the completion of the privatization process of the BCR and of CEC).

The existence of an efficient banking sector is a prerequisite for the development of the Romanian economy and for the economic growth in the years to come. The achievement of these objectives will bring the Romanian banking sector closer to the EU standards as the full restructuring of the financial sector is deemed necessary in order to preserve the confidence of the people and the Romanian and foreign investors.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institutions	2002	2003	2004
Commercial banks	31	30	32
Branches of foreign banks	8	8	7
Credit cooperatives	-	-	1
Total banking system	**39**	**38**	**39**

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

Item	2002	2003	2004
State ownership	29.9	25.7	4.8
Other domestic ownership	5.2	8.0	25.9
Domestic ownership, total	*35.1*	*33.7*	*30.7*
Foreign ownership	64.9	66.3	69.3
Total banking system*	**100.0**	**100.0**	**100.0**

**) excluding Credit cooperatives*

Ownership structure of financial institutions
on the basis of assets total

Item	2002	2003	2004
Public sector ownership	40.4	37.5	6.9
Other domestic ownership	3.2	4.3	31.0
Domestic ownership, total	*43.6*	*41.8*	*37.9*
Foreign ownership	56.4	58.2	62.1
Total banking system*	**100.0**	**100.0**	**100.0**

**) excluding Credit cooperatives*

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

Type of institution	The first three largest	The first five largest
Banks	48.2	59.2
Credit cooperatives	-	-
Financial institutions	-	-
Savings cooperatives	-	-
Specialized credit institutions	-	-

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

Type of institution	2002	2003	2004
Banks	2.64	2.21	2.04
Credit cooperatives	-	2.35	2.66
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

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

Type of institution	2002	2003	2004
Banks	18.27	15.64	15.58
Credit cooperatives	-	9.85	9.77
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

Distribution of market shares in balance sheet total (%)

Type of financial institutions	2002	2003	2004
Commercial banks	92.6	92.3	91.1
Branches of foreign banks	7.4	7.7	8.5
Credit cooperatives	-	-	0.4
Total banking system	**100.0**	**100.0**	**100.0**

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

Assets	2002	2003	2004*
Cash and claims on banks	41.9	36.0	36.0
Net loans	38.1	49.9	46.5
Securities	12.5	7.1	11.7
Fixed assets and other assets	7.5	7.0	5.8
Total assets	**100.0**	**100.0**	**100.0**
Liabilities	**2002**	**2003**	**2004**
Due to other banks and financial institutions	10.5	14.1	17.8
Due to clients	73.7	70.3	66.8
Other liabilities	1.6	1.7	2.7
Own capital	14.2	13.9	12.7
Total liabilities and capital	**100.0**	**100.0**	**100.0**

**) including Credit cooperatives*

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

Type of financial institutions	2002	2003	2004
Commercial banks	18.2	19.6	17.9
Branches of foreign banks	23.8	21.1	23.6
Credit cooperatives	-	-	0.1
Total banking system	**18.6**	**20.0**	**18.3**

** commitments in favor of banking and non-banking customers*

Solvency ratio of financial institutions

Type of financial institutions	2002	2003	2004
Commercial banks	25.0	21.1	20.6
Branches of foreign banks	-	-	-
Credit cooperatives	-	-	33.6
Total banking system	**25.0**	**21.1**	**20.6**

Asset portfolio quality of the banking system

Mill EUR

Asset classification	2002	2003	2004
Standard	7,792	4,575	7,596
Watch	21	1,695	2,406
Substandard	62	341	515
Doubtful	11	78	78
Loss	45	152	204
Classified total	**7,931**	**6,841**	**10,799**
Specific reserves	**58**	**118.2**	**171.5**

According to the classification statement of Commercial Banks

The structure of deposits and loans in 2004 (%) (at year-end)

	Deposits	Loans
Households	28.4	14.6
Government sector	3.9	5.5
Corporate	25.3	21.4
Foreign	39.5	57.2
Other	2.9	1.3
Total	**100.0**	**100.0**

The structure of deposits and loans and commitments in 2004 (%) (at year-end)

Maturity of deposits		Loans and commitments	
At sight	27.1	Short-term	43.3
Within one year	65.4	Medium-term	40.7
Over one year	7.5	Long-term	16.0
Total	**100.0**	**Total**	**100.0**

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

Type of financial institutions	FOREX assets/Total assets			FOREX liabilities/ Total liabilities		
	2002	2003	2004	2002	2003	2004
Commercial banks	40.9	45.0	45.5	37.6	43.2	45.0
Branches of foreign banks	70.6	71.4	70.4	65.1	63.3	66.5
Credit cooperatives	-	-	0.0	-	-	0.1
Total banking system	**43.1**	**47.0**	**47.4**	**39.6**	**44.8**	**46.7**

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

Revenues	2002	2003	2004*
Interest income	25.6	23.5	31.6
Income from securities transactions	8.7	3.4	3.5
Recoveries from provisions	6.8	7.6	8.4
Income not derived from interest	58.8	65.4	56.5
Extraordinary income	0.1	0.1	0.0
Expenditures	**2002**	**2003**	**2004**
Interest expenses	19.1	12.6	17.2
Expenses for securities transactions	2.0	0.5	0.7
Provisions expenses	7.8	9.7	11.5
Expenses, other than interest	68.9	75.5	68.0
Extraordinary expenses	0.4	0.0	0.0
Profit tax	1.8	1.7	2.6

**) including Credit cooperatives*

Structure of registered capital and own funds of financial institutions in 2004

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liabilities
	Mill. EUR	%	Mill. EUR	%
Commercial banks	1,163.8	5.6	2,354.8	11.4
Branches of foreign banks	-	-	142.2*	7.4
Credit cooperatives	12.3	13.0	25.1	26.6
Total banking system	**1,176.1**	**5.7**	**2,522.1**	**11.1**

** own capital*

2004 DEVELOPMENTS IN THE BANKING SECTOR AND BANKING SUPERVISION IN RUSSIA

MACROECONOMIC ENVIRONMENT

Russia continued to enjoy economic stability in 2004. It registered a federal budget surplus of 4.4% of GDP as against 1.7% in 2003, and the country's GDP expanded by 7.1% as against 7.3% in 2003.

Russia's international reserves increased by 60 % and as of January 1, 2005, they stood at $124.5 billion. Their growth contributed to the country's financial stability.

Growth in household real money income (by 9.9%) led to the expansion of consumer spending, which grew by an estimated 11.5% in 2004 as against 8.2% in 2003.

Industrial output grew by 6.1% in 2004.

In 2004 the Russian government established a Stabilisation Fund as part of the federal budget in which it accumulated extra revenues due to high oil prices on the world market. By the end of 2004 the Stabilisation Fund amounted to 522.3 billion rubles. It played a major role in easing of inflationary pressure on the economy.

Inflation, in terms of consumer price index, stood at 11.7% in 2004 as against 12% in 2003.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

Banking sector assets increased by 27.4% in 2004 as against 35.1% in 2003. Capital growth stood at 16.2% as against 40.2% a year before. Loans to the non-financial enterprise sector grew by 39.0% as against 42.4% in 2003. Household deposits were up 29.7% in 2004 as against 47.1% in previous year.

This growth profile influenced the ratio of basic indicators of banking industry to GDP. Banking sector assets to GDP practically remained at a level of the previous year (42.5% in 2004 as against 42.4% in 2003), just as household deposits to GDP that changed little from 2003 (11.7% as against 11.5%). As for banks' capital, it fell from 6.2% to 5.6% of GDP.

At the same time, banking sector operations with the real economy became the principal source of growth in banking sector assets in 2004. Loans and other funds extended to non-financial enterprises and organisations in relation to GDP reached 18.8% as against 17.2% in 2003 and the share of these operations in banking sector assets expanded from 40.5% to 44.1%.

LEGAL AND INSTITUTIONAL FRAMEWORK OF BANKING AND BANKING SUPERVISION, NEW DEVELOPMENTS LEGAL COMPETENCE OF THE BANK OF RUSSIA

The status, objectives, functions and powers of the Central Bank of the Russian Federation are established by the Constitution of the Russian Federation and Federal Law No. 86-FZ, dated July 10, 2002, "On the Central Bank of the Russian Federation (Bank of Russia)." Under this Law, the Bank of Russia is the supervisory authority in this country, it constantly monitors credit institutions' and banking groups' compliance with banking laws, Bank of Russia's regulations and required ratios.

In the course of discharge of controlling and supervisory functions the Bank of Russia makes decisions on the state registration of credit institutions and keeps the State Register of Credit Institutions, issues, suspends and revokes banking licences.

The Bank of Russia establishes mandatory rules for credit institutions and banking groups on banking operations, accounting, reporting, internal controls, compilation and filing accounting and statistical reports and other information stipulated by federal laws.

As for banking legislation, the legal framework of credit institutions' operations in Russia is established by Federal Law No. 395-1, dated December 2, 1990, "On Banks and Banking Activities" which defines a credit institution, a bank, the banking system and banking operations.

Procedures and conditions for implementation of measures to prevent insolvency (bankruptcy) of credit institutions and the specific requirements and procedures for declaring a credit institution insolvent (bankrupt) and liquidating it are established by Federal Law No. 40-FZ, dated February 25, 1999, "On Insolvency (Bankruptcy) of Credit Institutions."

Federal Law No. 115-FZ, dated August 7, 2001, "On Countering the Legalisation of Earnings Obtained in an Illegal Way (Money Laundering) and the Financing of Terrorism" provided a legal basis for control over operations with cash and other property in Russia for the purpose of preventing, detecting and cutting short the activities connected with money laundering and financing of terrorism. The Law granted the Bank of Russia the powers to establish fit and proper requirements for bank officers responsible for the observance of internal control rules and the implementation of internal control programmes, the requirements for personnel training and instruction and the requirements for the identification of customers and beneficiaries of credit institutions.

Federal Law No. 177-FZ, dated December 23, 2003, "On Insurance of Deposits of Physical Persons in Banks of the Russian Federation" regulates the relations involved in building and operation of the deposit insurance system, the formation and use of its funds, compensation payments on deposits upon the onset of the insured event, the relations arising from the implementation of government control over operations of the deposit insurance system and other relations arising in this sphere.

Federal Law No. 218-FZ, dated December 30, 2004, "On Credit Stories" established the procedure for creating, storing and using credit histories and set out the principles of co-operation between credit bureaus (registers) and borrowers, federal and local government bodies and the Bank of Russia.

Federal Law No. 152-FZ, dated November 11, 2003, “On Mortgage-backed Securities” which regulates the relations arising in the issue and negotiation of mortgage securities, except pawn-tickets, and the fulfilment of obligations on such securities, requires credit institutions issuing mortgage-backed securities to comply with additional prudential requirements set by the Bank of Russia in pursuance with this Law.

MAIN STRATEGIC OBJECTIVES OF THE BANK OF RUSSIA IN 2004

The principal objectives set for the Bank of Russia in the Guidelines for State Monetary Policy in 2004 in upgrading the banking system and banking supervision were as follows:

- creating conditions allowing the banking sector to increase its stability and functional role in the economy;
- creating optimal conditions stimulating credit institutions to expand and improve credit and settlement services to the real sector, including the development of the legal framework of mortgage lending and asset securitisation, especially through mortgage lending;
- developing approaches based on the substantive evaluation of credit institutions’ performance, establishing the banking supervision regime and using, whenever necessary, corrective actions, depending on the nature of risk assumed by a credit institution and the quality of its risk management;
- continuing the work aimed at improving the quality of banking sector capital with special emphasis on prevention of fictitious capitalisation of credit institutions;
- upgrading supervision on a consolidated basis, including the analysis of the reports by banking/consolidated groups (bank holding companies) and the evaluation of the effect of operations conducted by non-credit institutions of groups (holding companies);
- enhancing the efficiency of the Bank of Russia’s supervision through improved prudential reporting and development of IFRS based reporting;
- tightening the requirements guaranteeing that only financially sound credit institutions could get access to the market and could expand the range of their activities;
- preventing executives and real owners with dubious business reputation and unstable financial position from managing credit institutions;
- creating legal conditions allowing credit institutions to cut costs, especially administrative expenses, involved in banking activities, and simplifying, optimising and accelerating procedures connected with entry to the market and opening branches and internal structural divisions of credit institutions;
- ensuring that inspections focus on the current and long-term evaluation of the financial soundness of credit institutions and the quality of their management and internal controls on the basis of informed judgement.

THE ACTIVITIES OF THE BANK OF RUSSIA IN 2004

In 2004 the Bank of Russia continued to upgrade its licensing practices in line with the Basel Core Principles for Effective Banking Supervision. One of the major objectives in registering and licensing banking activities to which the Bank of Russia paid special attention last year was increasing transparency of the ownership structure of credit institutions and enhancing the efficiency of the Bank of Russia's control over persons capable of exerting substantial influence on the management of credit institutions by virtue of direct or indirect (through third parties) ownership of shares (stakes) in credit institutions.

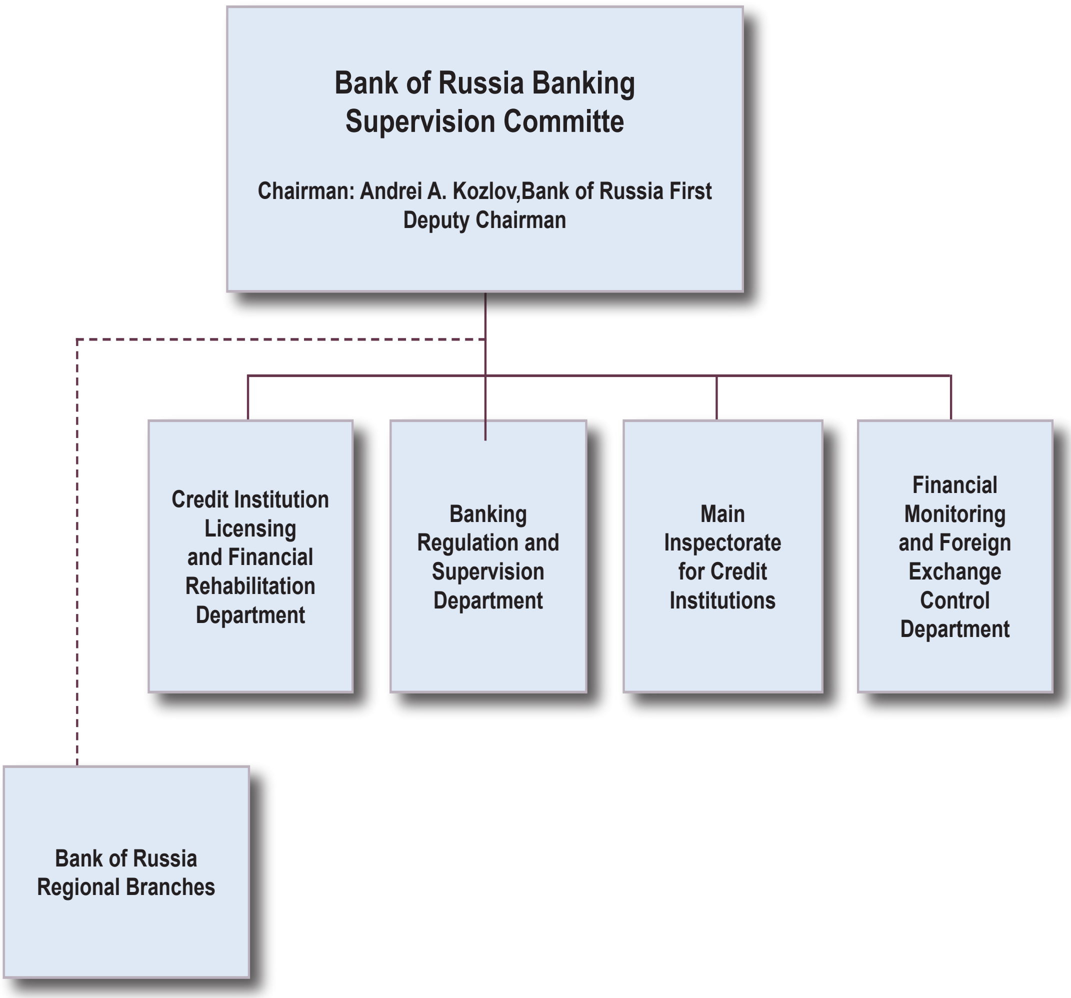
The Bank of Russia's efforts in the field of off-site supervision last year were aimed at implementing the provisions of Federal Law No. 177-FZ, dated October 23, 2003, "On Insurance of Deposits of Physical Persons in Banks of the Russian Federation", Bank of Russia regulations issued in pursuance of this Law and Bank of Russia Regulation No. 254-P, dated March 26, 2004, "On the Procedure for Making Loan Loss Provisions" which further developed the principle of informed judgement, and Bank of Russia Instruction No. 110-I, dated January 16, 2004, "On the Banks' Obligatory Normatives" which stipulated that banks must comply with the required ratios on a daily basis.

The new approaches to the substantive analysis of the situation in a bank required the use of new indicators in evaluating financial soundness, such as the transparency of ownership structure, risk management function and internal control systems, as well as bank profitability indicators.

Last year, the Bank of Russia continued to evaluate the quality of credit institutions' capital and carry out measures stipulated by Bank of Russia Ordinance No. 1246-U, dated February 10, 2003, "On Actions Aimed at Detecting the Facts (Signs) on Forming Sources of Own Funds (Capital) (a Part Thereof) Using Improper Assets".

In 2004 the Bank of Russia's inspection activity was characterised by transition from formal control over the observance by credit institutions of legislation and Bank of Russia regulations to qualitative assessment of their activities. In 2004 priority was attached to inspections of credit institutions and their branches for the purpose of increasing banking sector stability and building a deposit insurance system in pursuance of the Federal Law on Insurance of Household Deposits with Russian Banks.

ORGANIZATIONAL STRUCTURE OF THE BANK OF RUSSIA



INTERNATIONAL CO-OPERATION IN THE FIELD OF BANKING SUPERVISION

The Bank of Russia continued to co-operate with the World Bank on issues relating to the implementation of the Financial Institution Development Programme and in preparing a comparative analysis of legislation in Russia and industrialised nations in respect to the registration and licensing of banking activities.

The Bank of Russia's representatives took part in the work of the Basel Committee on Banking Supervision and its working groups and collaborated with the EU Commission in implementing "The Banking Supervision and Reporting Project and Central Bank Training Project. Stage III", launched as part of the EU/TACIS programme.

The Bank of Russia continued to look for better conditions and formats of co-operation with foreign supervisory authorities. It concluded the Agreement on Co-operation in the Field of Banking Supervision over Credit Institutions' Activities with the National Bank of Kirghizia, discussed similar agreements with banking supervisors in 15 countries and drafted new agreements with banking supervisory authorities of two countries.

The Bank of Russia representatives participated in the work of the Banks/Financial Services Sub-group of the Russian-German Intergovernmental Working Group on the Strategy of Economic and Financial Co-operation and the work carried out for the purpose of creating a single economic space in Belarus, Kazakhstan, Russia and Ukraine. In addition, Bank of Russia representatives took part in the plenary meetings of the Financial Action Task Force (FATF) and the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL).

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

Under Russian legislation, the regulation of the activities of credit institutions and their supervision are the exclusive competence of the Bank of Russia.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

Owing to the efforts made by the Bank of Russia in 2004 to build a deposit insurance system, the value of household deposits covered by the deposit insurance system as of January 1, 2005, accounted for 90% of the total value of household deposits with banks (as of April 1, 2005, that is, by the end of the first stage of the examination of banks' entry applications, 824 banks were covered by the deposit insurance system and the value of household deposits with these banks accounted for 98% of the total value of household deposits with Russian banks).

STATISTICAL TABLES

Number of credit institutions (%)
(at year end)

Type of credit institution	2002	2003	2004
Banks	1,282	1,277	1,249
Non-banking credit institutions	47	52	50
Banking sector total	**1,329**	**1,329**	**1,299**

Share in aggregate banking sector registered authorised capital (%)
(at year end)

Kind of property	2002	2003	2004
Russian credit institutions	95.1	95.3	94.8
Foreign-controlled banks (banks with non-resident interest in excess of 50%)	4.9	4.7	5.2
Banking sector total	**100.0**	**100.0**	**100.0**

Share in aggregate banking sector assets (%)
(at year end)

Kind of property	2002	2003	2004
Russian credit institutions	91.9	92.6	92.4
Foreign-controlled banks (banks with non-resident interest in excess of 50%)	8.1	7.4	7.6
Banking sector total	**100.0**	**100.0**	**100.0**

Credit institution asset concentration (%)
(share in aggregate banking sector assets)

Type of credit institution	Three largest credit institutions by assets			Five largest credit institutions by assets		
	2002	2003	2004	2002	2003	2004
Banks	37.5	37.0	39.9	44.3	43.0	45.4
Non-banking credit institutions	67.6	78.7	76.3	76.6	84.5	86.7
Banking sector total	**37.4**	**36.8**	**39.6**	**44.2**	**42.9**	**45.1**

Credit institutions' return* on assets (%)
(at year end)

Type of credit institution	2002	2003	2004
Banks	2.6	2.7	2.9
Non-banking credit institutions	1.9	1.6	0.9
Banking sector total	**2.6**	**2.6**	**2.9**

Credit institutions' return* on capital (%)
(at year end)

Type of credit institution	2002	2003	2004
Banks	18.0	17.9	20.4
Non-banking credit institutions	53.7	45.2	41.5
Banking sector total	**18.0**	**17.8**	**20.3**

** Calculated as the ratio of the current year's balance sheet profit to the average chronological value of assets (equity capital) over the accounting period.*

Share in aggregate banking sector assets
(at year end)

Type of credit institution	2002	2003	2004
Banks	99.76	99.56	99.43
Non-banking credit institutions	0.24	0.44	0.57
Banking sector total	**100.0**	**100.0**	**100.0**

Structure of credit institutions' assets
(at year end)

Assets		2002	2003	2004
1.	Money, precious metals and gemstones	2.2	2.5	2.8
2.	Accounts with the Bank of Russia	10.1	11.8	9.7
3.	Correspondent accounts with banks	7.3	5.5	3.2
4.	Securities acquired by banks of which:	18.8	17.9	15.2
4.1.	Russian government debt obligations	10.0	8.0	6.1
5.	Loan debt	51.8	54.4	62.5
6.	Other assets	9.8	8.0	6.5
Total assets		**100.0**	**100.0**	**100.0**

Structure of credit institutions' liabilities (at year end)

	Liabilities	2002	2003	2004
1.	Banks' funds and profits	15.7	14.9	14.1
2.	Loans received by banks from the Bank of Russia	0.1	0.0	0.3
3.	Banks' accounts	4.3	3.6	1.6
4.	Total loans, deposits and other funds received from other banks	7.6	9.4	10.3
5.	Customers' deposits	52.9	53.6	58.2
	of which:			
5.1.	Corporate deposits	26.3	24.7	27.8
5.2.	Household deposits and other funds	24.8	27.0	27.5
6.	Debt obligations issued	10.9	11.3	9.0
7.	Other liabilities	8.4	7.2	6.5
Total liabilities		**100.0**	**100.0**	**100.0**

Development of off-balance operations (%) (off-balance positions/balance sheet assets (liabilities)) (at year end)

Type of credit institution	2002	2003	2004
Banks	12.46	18.15	20.24
Non-banking credit institutions	0.03	0.00	0.00
Banking sector total	**12.43**	**18.07**	**20.12**

Capital adequacy indicator (at year end)

Type of credit institution	2002	2003	2004
Banks	19.1	19.1	17.0
Non-banking credit institutions	43.1	47.9	60.3
Banking sector total	**19.1**	**19.1**	**17.0**

Deposit and loan structure in 2004* (%) (at year end)

Loans, deposits and other borrowed funds		Loans, deposits and other placements	
Demand	9.2	Long-term (over 3 years)	14.7
Up to 1 year	40.5	Medium-term (from 1 year to 3 years)	24.9
Over 1 year	50.3	Short-term (up to 1 year)	60.3
Total	**100.0**		**100.0**

** Excluding overdue debt.*

**Quality of banking sector loan portfolio
(at year end, as % of total loans)**

Loan quality	2002	2003	2004
Standard loans	90.1	90.7	46.9
Substandard loans	4.3	4.3	37.1
Doubtful loans	1.8	1.5	12.2
Problem loans	-	-	1.9
Bad loans	3.8	3.4	1.9
Loan loss provisions	**6.3**	**5.9**	**5.3**

Before August 1, 2004, loan classification and provisioning were regulated by Bank of Russia Instruction No. 62a, dated June 30, 1997, "On the Procedure for Making and Using Loan Loss Provisions."

After September 1, 2004, loan classification and provisioning are regulated by Bank of Russia Regulation No.254-P, dated March 26, 2004, "On the Procedure for Making Loan Loss Provisions".

Before April 1, 2004, calculations were made according to Form No. 115 "Loan Loss Provision Calculation" (Annex No. 7 to Bank of Russia Instruction No. 17, dated October 1, 1997, "On Compiling Financial Statements").

After May 1, 2004, calculations are made according to Form 0409115 Section 1 "Information on the Quality of Loans, Loan Debt and Similar Debts" (Bank of Russia Ordinance No. 1376-U, dated January 16, 2004, "On the List, Forms and Procedure for Compiling and Presenting Reporting Forms by Credit Institutions to the Central Bank of the Russian Federation").

**Deposit and loan structure in 2004 (%)
(at year end)**

	Loans, deposits and other borrowed funds	Loans, deposits and other placements
Government financial authorities and extra-budgetary funds*	2.0	1.2
Legal entities	14.8	71.2
Private individuals	57.5	13.9
Banks	6.6	6.5
Non-residents**	19.1	7.2
Total	**100.0**	**100.0**

** Including the Central Bank of the Russian Federation*
*** Including banks and other legal entities and private individuals*

**Share of foreign currency assets and liabilities in
aggregate banking sector assets and liabilities (%)
(at year end)**

Type of credit institution	Foreign currency assets/ aggregate assets			Foreign currency liabilities/ aggregate liabilities		
	2002	2003	2004	2002	2003	2004
Banks	36.2	30.0	26.6	31.8	28.2	27.4
Non-banking credit institutions	7.5	3.1	2.9	6.6	3.0	2.7
Banking sector total	**36.2**	**29.9**	**26.5**	**31.7**	**28.1**	**27.3**

Structure of revenues and expenses of operating credit institutions (%) (at year end)

	2002	2003	2004
Revenues, total	**100.0**	**100.0**	**100.0**
of which:			
- interest received on loans, deposits and other placements	18.03	12.84	13.30
- incomes received from operations with securities	10.13	11.54	7.76
- incomes received from operations with foreign exchange and foreign currency-denominated cheques, including travel cheques	27.76	39.20	37.32
- fines and penalties	0.56	0.11	0.09
- other incomes	43.49	36.30	41.52
of which:			
recovery of sums from fund and reserve accounts	35.31	28.52	33.97
commission received	3.77	3.14	3.52
Expenses, total	**100.0**	**100.0**	**100.0**
of which:			
- interest paid on loans taken	1.14	0.71	0.83
- interest paid to legal entities for borrowed funds	2.49	1.52	1.31
- interest paid to households	5.04	3.98	3.73
- expenses on operations with securities	5.42	7.14	5.39
- expenses on operations with foreign exchange and foreign currency-denominated cheques, including travel cheques	28.03	41.00	38.69
- administrative expenses	6.47	4.81	4.47
- fines and penalties	0.05	0.03	0.01
- other expenses	51.35	40.81	45.57
of which			
- deductions to funds and reserves	41.20	32.43	37.68
- commission paid	0.48	0.40	0.43

Structure of credit institutions' registered authorised capital and equity capital in 2004

Type of credit institution	Registered authorised capital		Equity capital	
	million euros	as % of assets	million euros	as % of liabilities
Banks	10,049.5	5.4	24,999.4	13.3
Non-banking credit institutions	13.1	1.2	35.8	3.3
Banking sector total	**10,062.5**	**5.3**	**25,035.2**	**13.3**

2004 DEVELPOMENTS IN SLOVAKIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The economic environment influenced the Slovak banking sector in 2004 favourably. This applies both to external factors, such as growth in the global economy and continuing positive development in banking groups across the EU, and to domestic factors, in particular the Slovak Republic's macroeconomic development.

The effect of Slovakia's accession to the EU was not greatly apparent in Slovak banks' business. The fears of some banks as regards greater competitive pressure were not confirmed. From the aspect of regulation banks are at various stages of preparation for implementing the New Basle Capital Accord.

The recovery in the global economy in 2004 was seen also in increased growth in the Slovak economy. The level of real GDP growth in 2004 ranged above the five per cent limit, reaching 5.5% for the year as a whole. This growth was supported in particular by the continuing growth in household consumption and increased capital formation.

Both short-term and long-term interest rates continued to fall over the year. The development indicates a continuing convergence of interest rates to the EU level.

The improvement in macro-economic indicators supported the increased interest in the SKK, causing the domestic currency's appreciation against the USD and the EUR.

The perception of the economic situation by households took on a particularly positive trend; the number of households with a positive evaluation of the past as well as future development of the economic situation grew significantly. In 2004 unemployment fell, real wages grew, as did household disposable incomes.

The perception of the economic environment by the corporate sector (expressed by confidence indicators) did not change significantly over the course of 2004. Confidence in the construction sector developed positively. The corporate sector reacted negatively mainly to the development of demand in industry and the expected development of prices in the retail sector.

According to preliminary data, the corporate sector's profitability improved over the year. Almost all economic sectors significant from the aspect of the sectoral classification of bank lending saw in 2004 a year-on-year growth in receipts from own performances and goods.

DEVELOPMENT IN THE BANKING SYSTEM

As at 31 December 2004, there were eighteen banks and three branches of foreign banks operating in the Slovak banking sector. In connection with the accession of Slovakia to the European Union in May 2004, the Banking Supervision Division of the National Bank of Slovakia received, by the end of the period under review, forty-nine notifications from foreign supervisory authorities of intentions of foreign banks to freely provide cross-border banking services. Of fifteen universal banks in the Slovak banking sector, eight banks and one branch of a foreign bank have a licence to conduct mortgage transactions.

The net profit of the banking sector in 2004 increased on a year-on-year basis by 8,52%. Banks' return on equity at the end of 2004 reached 29,4%, against 27,2% for the same period in 2003. This growth in the banking sector's profit came about largely due to an increase in income from banking operations.

Despite the fall in interest rates, banks increased the largest item of their incomes, net interest income. The growth was caused by a more significant decline in interest expense than a decline in interest income of banks. The decline in interest expense occurred due to the interest policy of banks, where banks radically reduced their deposit rates, as well as due to changes in the assets and liabilities of the banking sector. On the liabilities side the volume of time and saving deposits decreased and the volume of non-interest bearing current accounts increased. On the other side, banks compensated for the decline in interest rates in their asset operations through an increased volume of lending to households.

The fall in interest rates created increased pressure on the net interest margin of the banking sector. For the first time since 2001 this was slightly reduced, at the end of 2004 reaching 2.85% against 2.91% at the end of 2003.

The course of the interest margin was to a large extent the result of competition in the banking sector. The relatively high concentration of banks, particularly in the households sector, was manifested in a growth in the interest margin of the largest banks. On the other hand at most small and medium-sized banks the interest margin decreased.

The trend of growth in non-interest income continued in 2004, where at the end of 2004 these formed 27% of the total gross income from banking operations. It is probable that with the further decline in interest rates and downward pressure on banks' interest margins, the significance of non-interest income will continue to grow. The largest item of non-interest income was formed by net income from fees. The most significant growth in fee income was recorded by banks with a dominant position in the household sector. The growth in income from trading was driven primarily by income from securities trading.

In line with the growth in banks' activities in the household sector operating costs in the banking sector also rose. Purchased performances and employee costs also grew at most banks. The process of improving operating efficiency through reducing operating costs continued at several banks.

Despite the increase in operating costs, their share in total income from banking operations (the cost-to-income ratio) in 2004 decreased to 61%.

In comparison with the same period of 2003 the banking sector significantly reduced income from the dissolution of reserves[3]. Income from the use of provisions in the banking sector increased, in connection with certain banks writing off in a higher rate claims towards customers.

THE LEGAL AND INSTITUIONAL FRAMEWORK

Legislation addressing the institutional arrangement of supervision

Central Bank is responsible for banking supervision and its competences are defined in The National Bank of Slovakia Act.

Financial Market Authority FMA is responsible for capital and insurance market supervision, pension funds (retirement system reform) and its competences are definied in The Financial Market Authority Act.

According to the Government decision as of August 2003 integrated financial market supervision will be exercised by the Central bank from 1 st January 2006.

Substantive law

On 1 May 2004 Act No 215/2004 amending and supplementing the Act on banks entered into force.

The amendment to the Act on banks has changed Article 91 paragraph 4 by adding letter l). Hereby the scope of authorities (the National Security Office, the Slovak Information Service, the Military Intelligence Service and the Police Corps for the purposes of performing security checks) to which a bank or a branch of a foreign bank reports on matters relating to a customer, which matters are subject to bank secrecy, without the customer's consent, following a written request only.

On 1 January 2005 Act No 654/2004 Coll. which amends Act No 310/1992 Coll. on home savings as amended became effective. The main reason for the mentioned amendment is an essential change in the setting of government bonus percentage. The government bonus shall be set as a percentage share from the annual volume of deposit, calculated on a basis of the formula made public by the Ministry of Finance of the Slovak Republic, which percentage share is from 5% to15% of the annual volume of the deposit, however maximally SKK 2 500 for the relevant calendar year.

With regard to changes in financial relations within the planning and budgeting of funds assigned to support building activities and improve the housing quality, the powers of the provision and settlement of the government bonus were transferred to the Ministry of Construction and Regional Development of the Slovak Republic.

With respect to the creation of equal business conditions for all entities in the Slovak banking sector, the possibilities for home savings banks to trade in financial products of money and capital markets are being extended. At the same time, the possibility to provide loans to legal entities under commercial conditions from temporary-free home savings funds has also been introduced.

On 1 January 2005 Act No 554/2004 Coll. amending and supplementing the Act on banks entered into force.

The purpose of the amendment to the Act on banks was to incorporate Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. The European Union regulates, by this Directive, conditions for the conduct of supervision of financial conglomerates. When compared prudential supervision of credit institutions, insurance undertakings and traders in securities on a solo basis with supervision on a consolidated basis, the latter is consolidated or the so-called supplementary supervision of prudential activities of those businesses from the individual financial sub-sectors, which are part of financial conglomerates. Supplementary supervision deals with solvency and risk concentration at the level of a financial conglomerate, intra-group transactions, internal procedures in the risk management at the level of a conglomerate, and an adequate and suitable type of the conglomerate management. The mentioned Amendment defines financial conglomerate, conditions under which supplementary supervision is conducted by the National Bank of Slovakia, limits for identifying financial conglomerate, requirements ensuring a secure business activities at the level of the financial conglomerate, part of which are banks or electronic-money institutions. Further there are supplemented provisions on the NBS's cooperation with relevant supervisory authorities responsible for supervision of other entities which are part of the financial conglomerate.

The amendment of Act on banks amends in Section II also Act No 510/2002 Coll. on the payment system and on amendments and supplements to certain laws (hereinafter referred to as "Act on the payment system") in such a way that the provisions of the Act on banks, which regulate supplementary supervision, apply to the electronic money institution.

Banking supervision is carried out also by means of secondary legislation, licensing decrees and prudential regulations.

In 2004, the Banking Supervision Division of the National Bank of Slovakia issued seventeen decrees and seven methodological instructions of the National Bank of Slovakia.

MAIN STRATEGIC OBJECTIVES IN 2004

In 2004, apart from issuing methodological instructions, the Banking Supervision Division focused on the implementation of the rules associated with supplementary supervision of financial conglomerates, as well as on preparation of a legal framework for integrated supervision of the financial market.

In the period under review, the expectations regarding the introduction of the "Single Passport" were not met. As at 31 December 2004, the Banking Supervision recorded 49 foreign banks freely providing cross-border banking services.

According to the notified information, there should have been five branches of foreign banks established in the Slovak banking sector; by the end of the year, however, the Banking Supervision Division had not registered a single application for an establishment of a branch of a foreign bank.

Finally it can be concluded that, in comparison with the previous years, as far as the conduct of on-site inspections is concerned an improvement was recorded in terms of the lower number of cases and the gravity of findings in bank inspections. This fact results from the new strategy of the Banking Supervision Division, which undertakes on-site inspections with greater intensity and frequency and which, in turn, has a positive impact on the banks' efforts towards improvement and qualitative growth.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In line with the plan of inspections for 2004, inspections in two banks were carried out in the first quarter. Protocols from the inspections were presented to the banks and the final review of the protocols took place in the first week of June. Both inspections had a wider scope with the aim of evaluating the quality of risk management and the degree of risk in individual banking operations.

An inspection in one bank was carried out that was not part of the plan for 2004. The objective of the inspection was to examine the existence and functionality of control mechanisms in the anti-money-laundering system of the bank and to evaluate their effectiveness. The inspection was carried out at the initiative of the Organized Crime Office, a section of the Financial Police, which asked the National Bank of Slovakia to examine the procedure used by the bank to report suspicious transactions and evaluate the correctness of the bank's procedure in cases of selected transactions.

In connection with the subject of this on-site inspection in one bank, there were four off-site inspections started: in VÚB, a.s.; Tatra banka, a.s.; UniBanka, a.s.; and SLSP, a.s.

In the second quarter, two inspections were completed with a final review of protocols. The banks accepted the findings and recommendations of the Banking Supervision Division; measures adopted for the elimination of found deficiencies will be the subject of a follow-up process.

Two full-scope inspections were carried out in line with the plan. The full-scope inspections were finished in two banks and the final review of protocols took place in September. The objective of both inspections was to assess the quality of risk management and the degree of risks involved in banking operations. The follow-up inspection was aimed at checking the implementation of measures the bank adopted based on the findings and recommendations of the inspection carried out in 2003. The inspection was completed and finished at the same time was presentation of reports on the fulfilment of the adopted measures.

Two inspections were completed in the third quarter. Both were finished with a final review of protocols at the level of the Chief Executive Director of the Banking Supervision Division. Banks were given binding instructions to adopt a plan of measures to remove and prevent shortcomings found during the on-site inspections.

In line with the plan for the third quarter, six inspections were carried out and completed with the objective of examining the measures that banks adopted based on the findings and recommendations of the inspections in 2003.

In line with the plan for the fourth quarter, three targeted inspections and one full-scope inspection were carried out. The targeted inspections were to evaluate the quality of management, evaluation of the rate of foreign exchange and interest rate risks, the quality of credit risk management system, compliance with selected Decrees, and the review of internal management and control systems, operational risks management system, including the areas of information systems and AML prevention.

The inspections in two banks were finished with a final review of protocols at the level of the Chief Executive Director of the Banking Supervision Division. The banks were given binding instructions to adopt a plan of measures to remove and prevent shortcomings found during the on-site inspections. These banks will submit their plans of corrective measures in the course of February 2005 and April 2005 respectively.

At the conclusion of two other inspections the banks received the letters of the Banking Supervision Division of the NBS of 24 January 2005 and 2 February 2005.

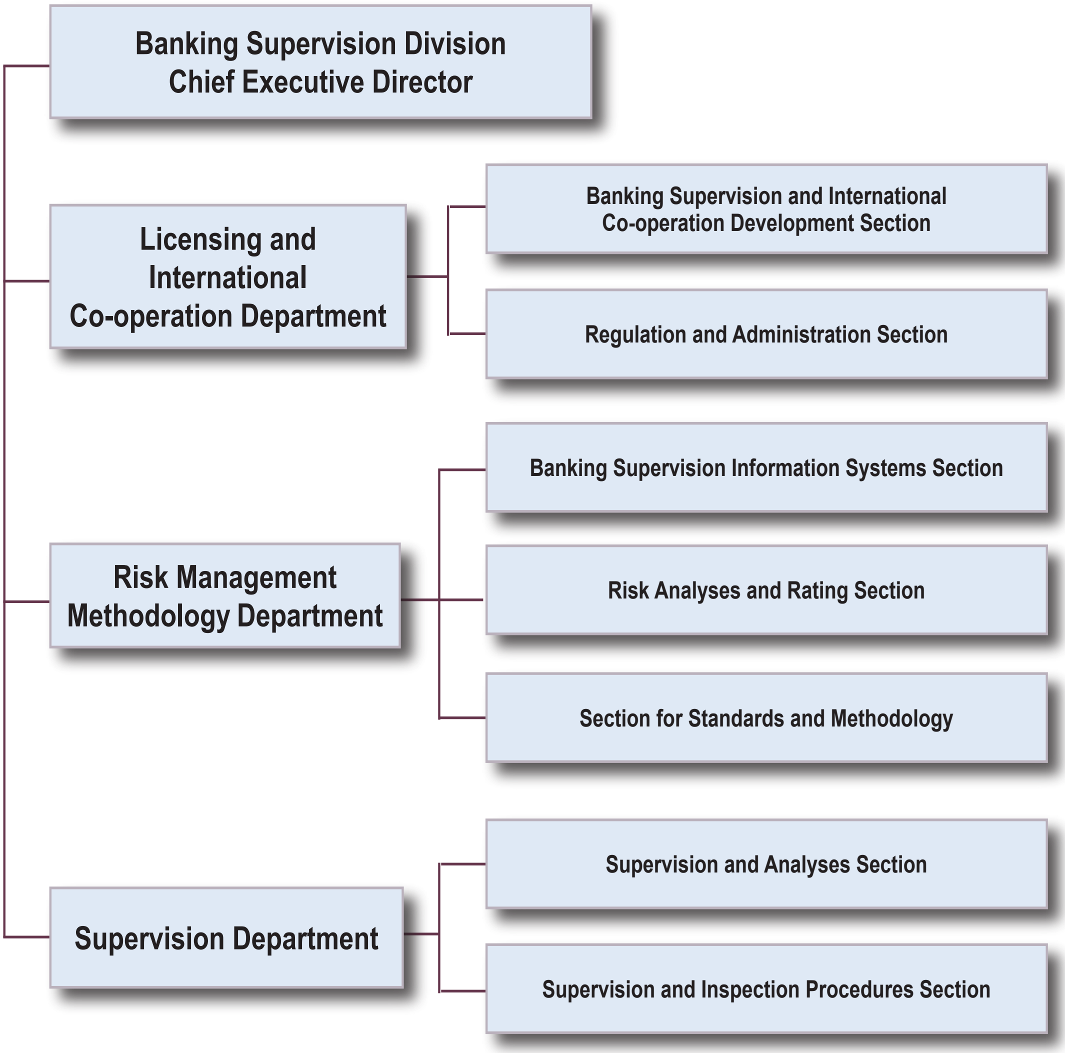
	Quarter I		Quarter II		Quarter III		Quarter IV		Quarters I-IV	
Inspections	Started	Finished	St.	Fin.	St.	Fin.	St.	Fin.	Plan	Result
Full-scope	2		2	2		2	1	1	5	5
Follow-up			1	1	6	6			7	7
Targeted	1	1	2			2	4	4	3	7
Total	**3**	**1**	**5**	**3**	**6**	**10**	**5**	**5**	**15**	**19**

INTERNATIONAL ACTIVITIES AND COOPERATION WITH OTHER SUPERVISORY BODIES

In view of the fulfilment of the tasks based on the Long-term Supervisory Development Plan, the Banking Supervision Division co-operates with both domestic and foreign supervisory authorities. On 12 February 2004, the Memorandum of Understanding was concluded and signed with the Malta Financial Services Authority.

On 12 November 2004, the Supplement to the Memorandum of Understanding with the Ministry of the Interior of the Slovak Republic, Presidium of the Police Corps, was approved and signed. The Memorandum had to be updated by the above-mentioned supplement owing to the organizational changes carried out in the Ministry of the Interior, as well as owing to the increasing importance of detecting of the financing of terrorism.

ORGANISATIONAL CHART



STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2002	2003	2004
Banks	18	18	18
– Joint stock companies	15	15	15
– State financial institutions	-	-	
– Building savings banks	3	3	3
Branches	**2**	**3**	**3**
Financial Institutions, total	**20**	**21**	**21**

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

Item	2002	2003	2004
Public sector ownership	5.4	1.9	1.9
Other domestic ownership	9.3	9.2	8.5
Domestic ownership total	*14.7*	*11.1*	*10.4*
Foreign ownership	85.3	88.9	89.6
Financial institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of the financial institutions on the basis of assets total (%)

Item	2002	2003	2004
Public sector ownership	1.9	1.5	1.3
Other domestic ownership	2.5	2.3	2
Domestic ownership total	*4.4*	*3.8*	*3.3*
Foreign ownership	95.6	96.2	96.7
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of assets by type of financial institutions in 2004 (%) (at year-end)

Type of institutions	The first three largest	The first five largest
Bank	53.14	66.55
Credit cooperatives	x	x
Financial institutions	x	x
Savings cooperatives	x	x
Specialized credit institutions	x	x

Return on assets (ROA) by type of financial institutions

Type of institutions	2002	2003	2004
Bank	1.16	1.17	1.21
Credit cooperatives	x	x	x
Financial institutions	x	x	x
Savings cooperatives	x	x	x
Specialized credit institutions	x	x	x

Return on equity (ROE) by type of financial institutions

Type of institutions	2002	2003	2004
Bank	29.43	27.98	29.03
Credit cooperatives	x	x	x
Financial institutions	x	x	x
Savings cooperatives	x	x	x
Specialized credit institutions	x	x	x

Distribution of market shares in balance sheet total (%)

Type of the financial institutions	2002	2003	2004
Joint stock companies	82.88	81.46	81.79
State financial institutions	0.00	0.00	0.00
Building savings banks	5.69	5.77	4.92
Branches	11.42	12.77	13.29
Financial institutions, total	**100.00**	**100.00**	**100.00**

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

Assets	2002	2003	2004
Deposits and credits with banks	24.43	30.01	33.78
Granted credits	31.08	37.15	35.85
Securities	30.95	29.60	27.87
Tangible and intangible assets	13.55	3.24	2.50
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2002**	**2003**	**2004**
Deposits and credits from banks	19.93	14.10	17.92
Received deposits	69.97	75.51	67.20
Reserves	2.57	1.37	5.69
Initial capital	7.53	9.02	9.19
Total liabilities	**100.00**	**100.00**	**100.00**

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

Type of the financial institutions	2002	2003	2004
Joint stock companies	92.09	133.28	143.52
State financial institutions	0.00	0.00	0.00
Building savings banks	4.52	5.32	4.06
Branches	18.32	53.49	61.62
Financial institutions, total	**114.94**	**192.09**	**209.20**

Solvency ratio of financial institutions

Type of the financial institutions	2002	2003	2004
Joint stock companies	21.68	20.71	18.17
State financial institutions	0.00	0.00	0.00
Building savings banks	17.75	30.92	24.25
Branches	0.00	0.00	0.00
Financial institutions, average	**21.30**	**21.59**	**18.68**

Asset portfolio quality of the banking system

in mil. SKK

Asset classification	2002	2003	2004
Substandard	7,335	6,812	8,287
Doubtfull	3,257	4,541	4,541
Loss	27,637	25,302	19,351
Classified total	38,229	36,655	32,179
Specific reserves	**29,609**	**28,974**	**25,490**

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

	Deposits	Loans
Households	42.71	24.76
Government sector	18.15	7.73
Business sphere	38.13	59.81
Foreign	0.96	2.73
Other	0.05	4.98
Total	**100.0**	**100.0**

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

Maturity of depostis		Maturity of loans	
At sight	35.82	Long term loans	39.96
Within one year	54.93	Medium-term loans	27.61
Over one year	9.24	Short-term loans	32.43
Total	**100.00**	**Total**	**100.00**

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

Type of the financial institutions	Foreign exchange assets / Total assets		
	2002	2003	2004
Joint stock companies	13.89	16.42	16.09
State financial institutions	0.00	0.00	0.00
Building savings banks	0.35	0.37	0.26
Branches	13.05	11.15	9.05
Financial institutions, average	**13.02**	**14.82**	**14.38**

Type of the financial institutions	Foreign exchange liabilities / Total liabilities		
	2002	2003	2004
Joint stock companies	14.66	15.34	17.23
State financial institutions	0.00	0.00	0.00
Building savings banks	0.05	0.05	0.02
Branches	26.04	47.36	36.54
Financial institutions, average	**15.64**	**19.04**	**19.35**

Structure of revenues and expenditures of banks (at year-ends)

in th. USD(EUR)

Expenditures	2002	2003	2004
Expenses from banking operations	3,720,905	5,483,065	6,049,393
Operational expenses	584,341	620,742	678,954
Provisions and reserves	625,970	726,817	797,529
Other operational expenses	280,010	322,173	353,134
Extraordinary expenses	14,485	455	5,158
Income taxes	8,387	889	46,087
Revenues	**2002**	**2003**	**2004**
Income from banking operations	4,729,538	6,443,615	7,256,995
Provisions and reserves	725,020	847,123	908,541
Other operational income	30,820	137,956	81,266
Extraordinary income	32,570	377	0
EUR	41,722	41,161	38,796

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

Type of the financial institutions	Registered capital	/Total assets	Own funds
	in mil. EUR	%	in mil. EUR
Joint stock companies	1,783.42	7.27	9,816.14
State financial institutions	0.00	0.00	0.00
Building savings banks	219.81	14.89	906.27
Branches	0.00	0.00	0.00
Financial institutions, total	**2,003.22**	**6.68**	**10,722.41**

SKK/EUR = 38.796

2004 DEVELOPMENTS IN THE SLOVENIAN BANKING SECTOR

SLOVENIAN MACROECONOMIC ENVIRONMENT IN 2004

After being rather low for several years, the *economic growth in Slovenia* was relatively high in 2004. At 4.6% annual growth exceeded growth in potential GDP for the first time in three years. The largest rises in the value added were recorded in financial intermediation services (10.4%), in manufacturing (5.4%) and in the health sector (4.9%), while the largest declines were in fishing (-2.9%) and mining (-5.2%). This structure of economic growth indicates that activity was primarily under the influence of the high level of activity by financial intermediaries and the favourable economic climate abroad. The growth in *industrial output* of 4.8%, in 2004, although growth rates slowed slightly at the end of the year compared to the higher levels reached in the first part of the year. The largest increase over the whole year was recorded in production of capital goods (9.7%), while production of consumer goods fell by 1.1%. Total stocks in industry rose by 19.3% in 2004.

In contrast to the reasonably favourable economic outlook *wage growth* was relatively slow in 2004, primarily thanks to low public sector wage growth. Year-on-year growth in gross wages averaged 5.7% in 2004, or 2.0% in real terms.

There was a favourable *employment trend* in 2004, in line with the trend in economic activity. Improvement in the labour market conditions took place throughout all the year, and only at the end of the year did a minor stalling in employment occur. *Unemployment* was down 5.0% from 2003, with the unemployment rate reaching 10.4% in December, slightly lower than the average over the year (10.6%) and lower than in December 2003 (when it was 11.0%). For the fourth successive year employment rose the most in real estate services (4.3%), while the rise in employment in public administration was also significant (2.7%).

Inflation measured by the consumer price index stood at 3.2% as from December 2003 to December 2004, or 3.6% measured as the average for 2004 against the average for 2003. The disinflation trend thus continued in 2004, with the average annual inflation rate falling by 2 percentage points. The sustained *fall in inflation* in 2004 was brought about mostly by domestic factors, namely structural factors connected with Slovenia joining the EU, and by appropriate macroeconomic policy that mitigated the effects of adverse trends in the foreign environment, high oil prices in particular. Among the domestic factors having the most significant impact on lower inflation, prime position was taken by the coordinated action of the Bank of Slovenia and the Slovenian government. The latter used acyclic adjustments in excise duties to mitigate the transmission of high oil prices on the world market into domestic prices, and through its administered prices policy prevented the automatic transmission of costs into price formation. Prior to the tolar's inclusion in the ERM II, the Bank of Slovenia was able to affect the level of nominal interest rates, and through this bring about a gradual reduction in inflation. By maintaining an appropriate level of real interest rates and gradually stabilising the exchange rate it contained inflationary pressures of a monetary nature and aggregate demand pressures. The process of nominal convergence is sustainable as is reflected in the equilibrated balance of payments and the fiscal balance.

Slovenia recorded a slight *current account* deficit for the second successive year, amounting to EUR 238 million or 0.9% of the estimated GDP. The main factors behind the widening of the current account deficit from 2003 were the trends in imports and exports in the context of slightly higher domestic demand and adverse price movements on the external market, and a decline in the surplus from transfers. The record high surplus recorded by services and the decline of more than 40% in net labour and capital outflows had a positive effect on the current account.

The *general government deficit*, which covers the four general government treasuries – the state budget, municipal budgets, the Pension and Disability Insurance Institute and the Health Insurance Institute (compulsory insurance only with regard to the latter two) – amounted to SIT 85 billion or 1.4% of GDP in 2004 according to provisional figures. The state budget and the Health Insurance Institute recorded a deficit, while the municipal budgets and the Pension and Disability Insurance Institute recorded a surplus.

The primary objective of the Slovenian *monetary policy* in 2004 is price stability. The Bank of Slovenia conducted its monetary policy in 2004 in line with the Bank of Slovenia Monetary Policy Guidelines of November 2001, and the Programme for ERM II Entry and Adoption of the Euro (the Programme), which was adopted by the Bank of Slovenia and Slovenian government in November 2003. In the joint programme they committed themselves to entering the ERM II by the end of 2004 and to creating the conditions to allow the euro to be adopted at the beginning of 2007.

Slovenia entered the ERM II on 28 June 2004. The central rate was set at SIT 239.640 to the euro in agreement with the relevant European institutions. Since entry into the ERM II, the Bank of Slovenia has maintained a high level of *stability in the exchange rate vis-à-vis the euro*. The discrepancies between the central rate and the market rate during the participation to date in the ERM II have been negligible.

Maintaining a stable exchange rate limits the Bank of Slovenia's ability to set its interest rates independently of the ECB's policy stance.

The sustained disinflation trends allowed the Bank of Slovenia to cut nominal interest rates while leaving real interest rates positive in the first half of the year. The interest rate on 60-day tolar bills was cut from 6.0% in December 2003 to 4.0% in June 2004, while the year-on-year inflation rate fell from 4.6% to 3.9%. The gap between domestic and foreign interest rates was reduced to a level that allows the stabilisation of the exchange rate in the ERM II. In line with the Programme, appropriate fiscal and incomes policies are implemented to support price stability objective.

STRUCTURE AND OWNERSHIP OF THE BANKING SECTOR

Slovenia's banking sector comprises banks, savings banks, and savings and loan undertakings, with banks having the dominant position. At the end of 2004 banks accounted for 99.4% of the market as measured by total assets (compared with 98.7% at the end of 2003), with savings banks and savings and loan undertakings sharing the remainder. Savings banks held a 0.5% market share (compared with 0.4% at the end of 2003), while savings and loan undertakings held a market share of 0.1% (compared with 0.9% at the end of 2003).

As at 31 December 2004 there were 18 banks and two branches of foreign banks operating in Slovenia. The number of banks was down by one from the end of 2003 since the smallest Slovene bank went into ordinary liquidation. However on 15 October 2004 the second branch of a foreign bank in Slovenia was entered in the companies register, namely Bank für Kärnten und Steiermark AG, bančna podružnica.

There was no change in the number of savings banks in 2004 (with two still in operation). The number of savings and loan undertakings continues to fall due to the capital and other requirements set in the 1999 Banking Act. There were 25 savings and loan undertakings in operation at the end of 2002, eight at the end of 2003, but just two at the end of 2004. In recent years a large number of savings and loan undertakings amalgamated with the Association of Savings and Loan Undertakings, while to a lesser extent savings and loan undertakings were taken over by banks or underwent voluntary liquidation and bankruptcy.

There were no major changes in ownership structure in 2004. Apart from the five subsidiaries and two branches that were under majority foreign ownership, there were five banks under full domestic ownership, and eight banks under majority domestic ownership (of these eight banks, three had less than 1% foreign capital). Foreign shareholders were mostly from Austria, France, Italy and Belgium. Although most of foreign subsidiaries and a branch had Austrian owners, the equity capital of the Belgium bank KBC was dominant.

The proportion of equity capital under the ownership of non-residents was the same at the end of 2004 as at the end of 2003 – 32.4% (of which 16.5% was held by non-residents that hold more than 50% of the voting rights). The proportion held by non-residents as measured by total assets was 3.8 percentage points more than the proportion held by non-residents as measured by equity capital as at 31 December 2004. The country's second-largest bank (as measured by total assets), Nova Kreditna banka Maribor d.d., and the 12th-largest bank Poštna banka Slovenije d.d. remain under majority state ownership.

Total assets of banks, savings banks and savings and loan undertakings are rising annually as a proportion of GDP. The aggregate total assets of all credit institutions (banks, savings banks and savings and loan undertakings) accounted for almost 87 per cent of GDP at the end of 2004.

The Slovenian banking sector is characterised by a high concentration of banks. The largest bank in Slovenia, Nova Ljubljanska banka, represented almost 33 per cent market share at end-2004. Together with the banks, which belong to the Nova Ljubljanska banka banking group, the market share amounted to 36.5 per cent. The second largest bank (Nova Kreditna banka Maribor) accounted for almost 11 per cent, and the third largest bank, Abanka Vipa amounted to 8.5 per cent. The market share of the five largest banks, measured by total assets, amounted to more than 65 per cent at the end of 2004. The market share of majority foreign-owned banks has been increasing (At end-2003: 18.9 per cent, at end-2004: 20.1 per cent).

BANK PERFORMANCE IN 2004

Since savings banks and savings and loan undertakings had only a 0.6% combined market share in terms of total assets, this section on the bank performance focuses exclusively on banks.

Banks and the two branches of foreign banks ended the 2004 with pre-tax **profits** of SIT 56.1 billion (EUR 234.8 mn at the average exchange rate for 2004), and after-tax profits of SIT 36.8 billion. The 2004 profit was up SIT 8.3 billion from that in 2003, a real[26] rise of 13.3%. The rise in profit is the result of higher earnings from net fees and net financial transactions, while earnings from net interest income continued to decline last year, despite noteworthy lending to non-financial companies and households.

The **return on average assets** has been stable in the last three years (1.1% in 2004), with banks compensating for the decline in interest income with non-interest income and lower operating costs. The **return on average equity** improved. After rising in 2002 (owing to slower growth in capital as a result of the abolition of general equity capital revaluation), it first fell slightly in 2003, then rose to 13.3% in 2004 thanks to profit growing faster than capital.

The **net interest margin** (expressed as the ratio of net interest income to average gross interest-bearing assets) was 2.8% in 2004. It continues to show a falling trend, as banks' earnings from net interest income are falling despite real growth in gross interest-bearing assets.

The non-interest margin is of increasing importance, and is strengthening significantly in the context of real growth in net fees and net financial transactions.

The cost-effectiveness ratio (operating costs per average assets) continued to improve, owing to the slowdown in labour costs and other operating costs. At end-2004 the ratio operating expenses to average assets amounted to 2.8%.

The **total assets** grew in nominal and real terms in 2004, particularly banks under majority foreign ownership continuing to record rapid growth. At the end of 2004 the total assets of the banking system amounted to SIT 5,678.5 billion (EUR 23.7 bn at the exchange rate of 31 December 2004), and were up 11.6% in nominal terms and 8.2% in real terms[27] from 2003. The nominal growth in banks' total assets ranged from –1.1% to 55.5%. Again last year there was a continuation of the above-average growth in the total assets of banks under majority foreign ownership, while small banks under domestic ownership also recorded above-average growth.

[26] Allowing for a consumer price index of 3.6% between 2003 and 2004

[27] Allowing for inflation of 3.2%

Banks' capital at the end of 2004, calculated in accordance with the Regulation on Capital Adequacy of Banks and Savings Banks, stood at SIT 440 billion (EUR 1.8 bn at the exchange rate of 31 December 2004), representing a **capital adequacy ratio** of 11.8% on risk-weighted assets of SIT 3,742 billion (EUR 15.6 bn at the exchange rate of 31 December 2004), At the end of 2004 three banks had a capital adequacy ratio lower than 10 per cent. All the banks met the minimum capital adequacy requirement as at 31 December 2004.

The **quality of loan portfolio** has not changed much over the past few years. The share of performing on- and off-balance sheet items (claims classified in categories A and B) has ranged between 93 and 96 per cent (the share of non-performing assets has ranged between 4 and 7 per cent).

LEGAL AND INSTITUTIONAL FRAMEWORK FOR SUPERVISION OF FINANCIAL INSTITUTIONS

In Slovenia several supervisory authorities are responsible for supervision and surveillance of individual segments of the financial system.

Slovenia's central bank, the Bank of Slovenia, is an independent institution that carries out the tasks conferred upon it by the Bank of Slovenia Act. Supervision of banks, savings banks and savings and loan undertakings is one of the tasks of the Bank of Slovenia. The responsibility for the implementation and enforcement of the Bank of Slovenia's supervisory function is conferred upon the Banking Supervision Department.

The Securities Market Agency is a self-governing and independent legal entity with full power to supervise stock-broking companies, investment funds (authorised investment companies, investment companies and mutual funds), mutual pension funds, investment fund management companies and mutual pension fund operators, as well as some other institutions (the Central Securities Clearing Corporation, Ljubljana Stock Exchange, etc.).

The Insurance Supervision Agency became operational on 1 June 2000 as a self-governing and independent legal entity whose responsibility is the supervision of insurance companies, reinsurance companies, companies and agents who engage in insurance-related activities, as well as some other institutions (the Slovenian Nuclear Insurance and Reinsurance Pool, the Slovenian Insurance Association – guarantee fund, the Slovene Export Corporation – insurance operations, Kapitalska družba pokojninskega in invalidskega zavarovanja – Pension Fund Management – voluntary pension insurance).

The Banking Supervision Department of the Bank of Slovenia was reorganised on 1 January 2005. The department is divided in five sections, with certain joint functions being conducted at departmental level (e.g. duties connected with legal advice, administration).

The Banking Analysis and Inspections section has been created from the previous on-site and off-site sections. Within the Banking Analysis and Inspections there are four groups for four banking groups and four groups of specialist inspectors. Each group has its own portfolio manager, whose work is supported by an analyst. The portfolio manager is responsible for monitoring banks and savings banks and understanding them thoroughly, defining their risk profile in line with the newly developing methodology, co-ordinating supervisory activities on banks in the group, and heading on-site examinations of the banks. The portfolio managers have primary responsibility for supervising liquidity, strategic risk, reputation risk, capital risk and profitability risk. A final assessment of other risks, primarily credit risk, market risk, interest rate risk and operational risk, is conducted in conjunction with specialist inspectors. The analysts provide support to the portfolio manager, and also work with the Banking System Analysis and Methodology section.

In order to ensure the highest level of specialist expertise and its application in supervision procedures the remaining inspectors specialise in individual areas. Thus the inspectors are also divided into four groups according to a specialisation in various types of risk, which means that examiners now focus on a specific risks. The specialist groups are credit risk, market and interest rate risks, operational risk, and compliance.

A new Legal Advice sction has been created at the top of the department, bringing together in a single site lawyers who were previously assigned to the senior management at the department, the off-site section, or the licensing section. The new section provides legal support to all the department's law-related activities. Through better co-ordination, flow of information and connections, the creation of this section will see the legal experts in the department achieve greater efficiency, a good transfer of information and knowledge among themselves, and a more standardised method of working.

The Banking System Analysis and Methodology section is involved in analysis connected with the monitoring of the entire banking sector, its key function being to build and maintain an effective early warning system, while it will also work with the Financial Stability Department in drawing up joint working material, will monitor liquidity, the movement of interest rates, etc. at the level of the banking sector, will develop a database model for the purposes of prudential supervision of banks, and will be responsible for maintaining and updating the methodology for the Risk Assessment System.

A new Prudential Regulation section has been created. Up to 31 December 2004 the functions of drafting and adopting regulations had been performed at the off-site section.

The functions and activities of the Licensing section have remained unchanged, but a staffing change has seen its lawyer move to the newly created Legal Advice section.

ACTIVITIES OF THE BANKING SUPERVISION DEPARTMENT IN 2004

Issuing authorisations to credit institutions is one of the Bank of Slovenia's most important responsibilities. As well as authorisations to provide banking services and other financial services, the Bank of Slovenia issues authorisations for acquiring a qualifying shareholding, undertaking a merger or an acquisation, establishing a branch abroad, establishing a branch of a foreign bank in Slovenia, establishing a representative office of a foreign bank, serving as a member of a bank's management board etc. Decisions to grant or refuse an authorisation are taken by the Governing Board of the Bank of Slovenia.

In 2004 the Bank of Slovenia issued a total of 22 authorisations for banking and other financial services, for acquiring qualifying holdings, for holding office as a member of the management board etc. One application for acquiring a qualifying holding was rejected.

Off-site analysts continuously monitor the bank performance on the basis of statutory returns and information and monitor compliance with prudential regulations. They are involved in preparing documentation for the issue or variation of authorisations for different types of activities of credit institutions, evaluate proposed new systemic solutions, advise on the implementation of standards of safe and sound banking, are involved in preparations for on-site examinations in credit institutions and in discussions with the management of credit institutions and meetings with other institutions, compile various written documents for bodies of the Bank of Slovenia, etc. On discovering a departure from the normal activity of a credit institution, off-site analysts immediately notify the inspectors and management of the Banking Supervision Department, who may accordingly decide to launch an on-site examination of the institution concerned.

On discovering an irregularity in the conduct of a credit institution, both analysts and inspectors take appropriate action and monitor the remedial steps taken.

A credit institution may be examined more than once in a given year. The scope of the examination is determined on the basis of prior information and analysis of the institution's activities, initiated by the management of the Bank of Slovenia or by external bodies. The examinations permit an in-depth investigation of areas of heightened risk or areas in which the Bank of Slovenia lacks adequate information or data.

In view of the fact that the most significant source of risk at credit institutions is credit risk, the emphasis in an examination is on the appropriate classification of on- and off-balance-sheet items. Special attention is given to consolidated supervision – the examination of a bank and its connected parties. In on-site examinations of credit institutions during 2004, inspectors from the Banking Supervision Department, in addition to the standard areas of examination, focused particularly on supervision of capital and capital adequacy, management of market risk and other risks, implementation of the Consumer Loans Act, implementation of the Prevention of Money Laundering Act, corporate payment systems and information technology.

In addition to 2 full-scope examinations, there were 44 targeted examinations undertaken on banks and savings banks (including savings and loan undertakings) and other companies in relation to specific areas of activity. Examinations of IT systems were included in full-scope examinations or were undertaken as independent examinations.

The Bank of Slovenia's supervisory powers extend to other persons suspected of providing banking services without authorisation from the Bank of Slovenia. In 2004, on the basis of referrals from the Market Inspectorate of the Republic of Slovenia, the Bank of Slovenia inspectors undertook 6 on-site examinations of companies suspected of engaging in business activities without the Bank of Slovenia authorisation.

In line with the Core Principles for Effective Banking Supervision, the Banking Supervision Department of the Bank of Slovenia maintains regular contacts with the management of banks and savings banks, through channels including regular annual meetings held at the completion of full-scope examinations or specially. These meetings are primarily devoted to assessing the bank performance and learning about its strategy.

PROGRESS ON CAD III

In 2004 the CAD III implementation group successfully finished few important projects and established the basis for its further work.

***Slovenian Quantitative Impact Study* (SiQIS)** was as a project finished at the end of 2004. Its aim was testing the impact of simpler approaches for credit and operational risk to banks capital. In addition, it was planned to use the results of SiQIS as an input for decision-making process regarding national discretion exercise.

The Bank of Slovenia focused on:

- Standardised approach for credit risk
- Basic indicator and Standardised approach for operational risk
- CRM techniques – simple approach.

SiQIS package consisted from:

- Templates for calculation of capital requirements
- Technical guidelines
- Questionnaire.

SiQIS templates for capital requirements calculation have been designed in a way which provided us systemic analysis by 128 possible scenarios. The results of different scenarios enable us to choose the "realistic scenario" which would reflect the situation of Slovenian banking sector on the most accurate manner. This was the starting point of setting the first preliminary decisions regarding particular national discretions.

Summary of Slovenian Quantitative Impact Study (by the realistic scenario) – autumn 2004:

- The capital requirement for credit risk on the level of the whole system would decrease by 0.53% (from SIT 208.1 bn to SIT 207 bn).
- This number would represent only 3.9 % of capital requirement for operational risk, calculated by Basic indicator approach (SIT 27.5 bn).
- Total capital requirements of the system will increase by 11% (from SIT 239.9 bn to SIT 266.3 bn SIT).

Consultative document on implementation of internal rating-based systems was supported by external counsellor and finished at the end of 2004. Its aim was:

- To identify open questions regarding IRB implementation and contribute to the decisions of banks which approach for credit risk capital calculation would be the most appropriate for them. This would be the starting point for further discussions with banks regarding their readiness and ability for implementation and on-going use of IRB approach.

- To get the first impression about the current situation of banks regarding compliance with IRB standards and minimum requirements.
- To use its results as an input for decision-making process regarding the national discretion exercise.

The general impression based on the analysis was that some banks already started with preparations on IRB, but their readiness is rather poor at the moment. The Bank of Slovenia is already planning further activities regarding practical co-operation with IRB banks.

Operational risk is also an important area where the Bank of Slovenia is making significant efforts in co-operation with banks, so they would be prepared on time. The Bank of Slovenia is preparing the Recommendations (Guidelines) for operational risk management. The consultation process with banks is in the pipeline.

Furthermore, in the middle of 2004 the Bank of Slovenia conducted the second survey on operational risk issues. The aim of the survey was to recognise the intentions of banks regarding implementation of operational risk approaches and to explore awareness of the management board regarding operational risk management.

Results on operational risk survey are the following:

- Most banks will apply Basic indicator approach
- Some banks will apply Standardised approach
- A lot of work will have to be done on operational risk management area (identification, assessment, monitoring and controlling/mitigation of operational risk).

Committee of European Banking Supervisors. The Bank of Slovenia participates in many expert and working groups on the CEBS level (Groupe de Contact, Expert Group on Capital Risk Directive, ECAI WG, JWGV, Common Reporting, Supervisory Disclosures Task Force).

A lot of efforts are made in communication with banks through a number of lecturers and seminars which are provided to banks by members of Basel II Implementation Group, through articles in different banking magazines and papers, through the Bank of Slovenia website (Basel II) etc.

CO-OPERATION WITH OTHER DOMESTIC SUPERVISORY AUTHORITIES

In accordance with the Code of Practice for the co-operation between domestic supervisory authorities a co-ordinating body headed by the Minister of Finance has been established. The Governor of the Bank of Slovenia, the President of the Council of Experts of the Securities Market Agency, and since September 2000, also the President of the Council of Experts of the Insurance Supervision Agency are members of the co-ordinating body.

In addition, the committee on co-operation between domestic supervisory authorities monitors the issues in relation to the implementation of financial regulations and reports to the co-ordinating body. The committee on co-operation between domestic supervisory authorities consists of the Deputy Governor of the Bank of Slovenia, the Director of the Banking Supervision Department, the Director of the Securities Market Agency and the Director of the Insurance Supervision Agency.

There are memoranda of understanding (MoUs) between the Bank of Slovenia and the Securities Market Agency and the Bank of Slovenia and the Insurance Supervision Agency. In addition, a MoU was signed between the Securities Market Agency and the Insurance Supervision Agency.

MoUs include the details of the nature and method of collaboration between the signatories, as well as the channels for the dissemination of information. Supervisory authorities must notify one another concerning irregularities they find in the course of supervision, if such findings are also important for other supervisory authorities. Supervisory authorities must fulfil the professional secrecy requirements regarding information that they obtain and may use the information only for the purposes for which it was obtained.

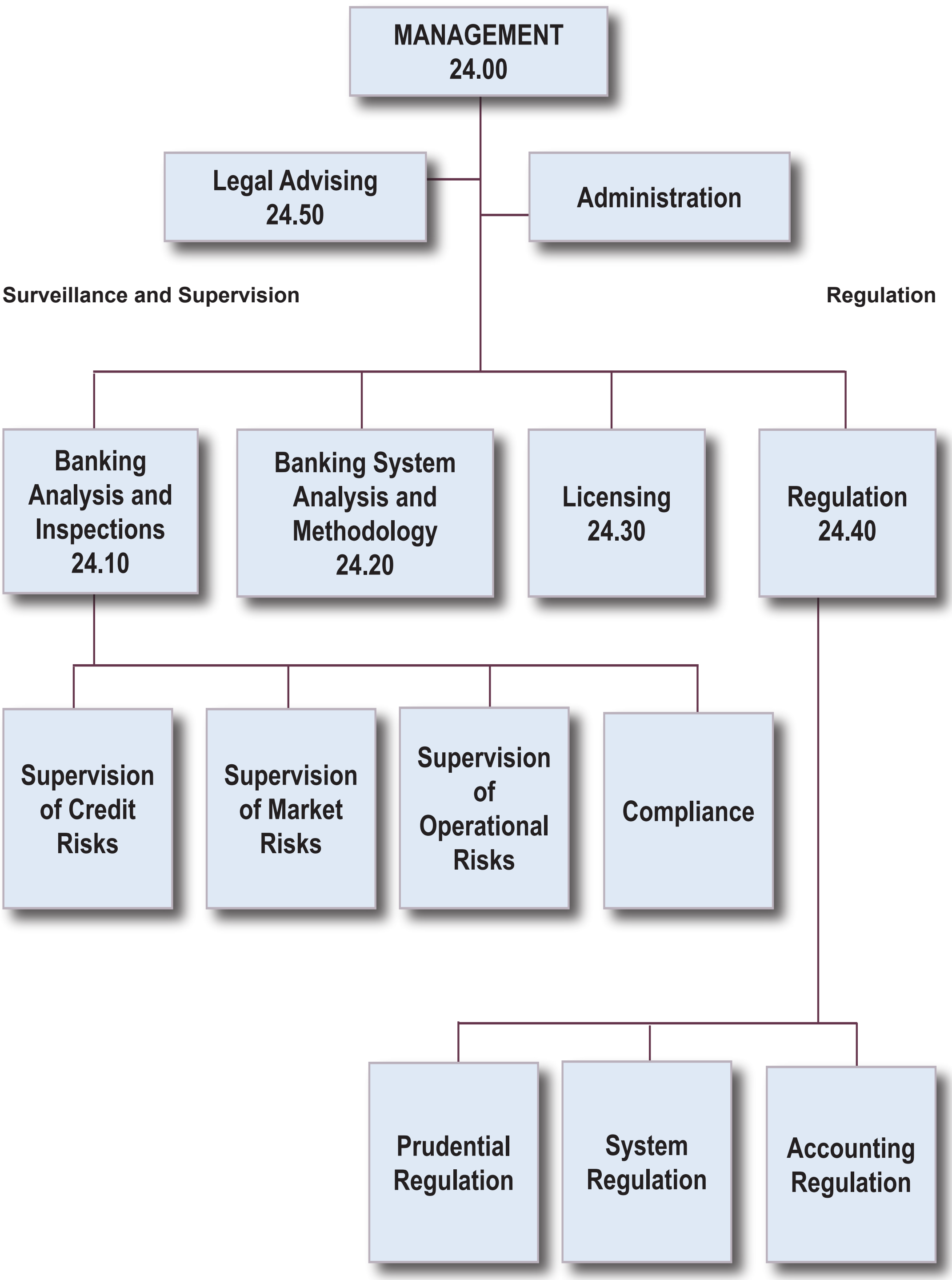
CO-OPERATION WITH FOREIGN SUPERVISORY AUTHORITIES

To date the Bank of Slovenia has concluded memoranda of understanding with the following regulatory institutions:

- January 2000: the State of New York Banking Department (because LBS, a subsidiary of the largest bank in Slovenia, is no longer owned by the bank, the memorandum is no longer required)
- January 2001: Austria's Bundesministerium für Finanzen (the Austrian Federal Ministry of Finance, which on 1 April 2002 merged with other financial sector regulators to form the Austrian Financial Market Authority or Finanzmarktaufsicht)
- April 2001: Germany's Bundesaufsichtsamt fur das Kreditwesen (the Federal Banking Supervisory Office, which on 1 May 2002 merged with other financial sector regulators to form the German Financial Supervisory Authority or Bundesanstalt für Finanzdienstleistungsaufsicht)
- June 2001: the National Bank of the Republic of Macedonia
- November 2001: Bosnia-Herzegovina's Banking Agency (a Bosnian Federation and Republika Srpska authority) and the Central Bank of Bosnia-Herzegovina
- November 2001: the Bank of Italy
- October 2002: France's Commission Bancaire (the French Banking Commission)
- August 2003: Belgium's Commission Bancaire et Financiere (the Banking and Finance Commission)
- October 2003: the Central Bank of Montenegro
- December 2003: the Bulgarian National Bank
- June 2004: the National Bank of Serbia.

In 2004, the Bank of Slovenia inspectors examined the operations of the largest Slovene bank subsidiaries abroad in cooperation with supervisors in

Macedonia and Montenegro on the basis of MoUs with foreign supervisory authorities. As regards the exchange of information, the same rules apply as for the exchange of information between domestic supervisory authorities.



STATISTICAL TABLES

BANKA SLOVENIJE

Number of credit institutions*
(at year-end)

Type of credit institution	2000	2001	2002	2003	2004
Banks (branches of foreign banks included)	25	21	20	20	20
Savings banks	3	3	2	2	2
Savings and loan undertakings	64	45	25	11	2
Credit institutions, total	**92**	**69**	**47**	**33**	**24**

* *The amount of initial capital for banks is set at SIT 1.2 billion, the amount of initial capital for savings banks and savings and loan undertakings is set at SIT 245 million.*

Ownership structure of banks on the basis of shareholders' equity (%)

Item	2000	2001	2002	2003	2004
Central Government	36.8	37.0	20.3	19.4	19.1
Other domestic ownership	51.2	47.0	47.2	48.2	48.6
Domestic ownership total	*88.0*	*84.0*	*67.5*	*67.6*	*67.7*
Foreign ownership	12.0	16.0	32.5	32.5	32.3
Bank, total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Distribution of market shares measured by total assets (%)

Type of credit institution	2000	2001	2002	2003	2004
Banks	97.8	98.1	98.6	98.7	99.4
Savings banks	0.4	0.4	0.3	0.4	0.5
Savings and loan undertakings	1.8	1.6	1.1	0.9	0.1
Credit institutions, total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Off-balance sheet activities (off balance sheet items / total assets) (%)

Type of credit institution	2000	2001	2002	2003	2004
Banks	22.5	21.2	19.7	20.9	20.5
Savings banks	0.3	0.4	1.0	1.0	1.2

Solvency ratio of credit institutions

Type of credit institution	2000	2001	2002	2003	2004
Banks, average	13.5	11.9	11.9	11.5	11.8
Savings banks, average	11.3	11.1	9.2	8.8	9.5

BANKA SLOVENIJE

The structure of assets and liabilities of banks (%) (at year-end)

Assets	2000	2001	2002	2003	2004
Cash and balances with CB	3.2	5.3	3.1	2.8	2.5
Loans to banks	11.7	10.2	8.4	6.8	8.9
Loans to customers	52.3	49.4	47.9	50.2	54.1
Securities	25.4	28.6	34.0	34.0	28.9
Other assets	7.5	6.5	6.6	6.2	5.6
Liabilities					
Deposits from banks	12.8	11.7	12.8	16.5	19.7
Deposits from customers	69.0	71.2	69.1	65.1	62.1
Liabilities from securities	2.2	2.9	3.9	4.3	4.0
Capital and subordinated liabilities	11.4	9.8	9.9	10.2	10.6
Other liabilities	4.6	4.5	4.3	3.9	3.6

Assets portfolio quality of the banking system

in SIT millions

Assets Classification	2000	2001	2002	2003	2004
A	2,418,844	2,755,349	2,943,971	3,363,863	4,001,552
B	266,315	348,333	467,919	522,938	624,126
C	75,507	91,012	113,470	119,360	121,050
D	53,692	62,188	63,434	70,428	69,614
E	56,572	78,947	79,483	81,870	79,059
Classified Total	**2,870,931**	**3,335,829**	**3,668,276**	**4,158,459**	**4,895,401**
Specific Provisions	168,175	212,079	228,868	244,902	255,598

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

	Deposits	Loans
Households	66.4	24.9
Government sector	3.8	4.7
Corporate	18.0	63.1
Foreign	2.2	3.2
Other	9.6	4.2
Total	**100.0**	**100.0**

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

Deposits	
At sight	34.8
Within one year	57.5
Over one year	7.7
Total	**100.0**
Loans	
Long-term loans	49.6
Medium-term loans	
Short-termn loans	50.5
Total	**100.0**

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

Type of credit institution	Forex assets / Total assets					Forex liabilities / Total liabilities				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Banks	33.5	34.4	33.0	33.4	35.9	34.9	35.3	33.9	34.6	38.3
Savings banks	0.3	0.3	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0

Profit ans loss account of banks

	2000		2001		2002		2003		2004	
	SIT mills	USD mills	SIT mils	USD mills	SIT mills	USD mills	SIT mills	USD mills	SIT mills	USD mills
Net interest income	126,134	555	115,930	462	143,407	649	145,678	769	143,678	815
Net fees and commissions	37,858	166	41,523	165	53,962	244	54,907	290	61,872	351
Net financial operations	14,442	64	20,805	83	21,205	96	19,490	103	30,268	172
Net other	-8,193	-36	-5,080	-20	5,808	26	8,862	47	6,934	39
Gross income	**170,240**	**749**	**173,179**	**690**	**224,382**	**1,015**	**228,937**	**1,209**	**242,753**	**1,377**
Operating expenses	100,436	442	112,949	450	133,914	606	143,169	756	147,729	838
– labour costs	48,717	214	53,181	212	66,169	299	72,015	380	76,967	437
Net income	**69,804**	**307**	**60,230**	**240**	**90,467**	**409**	**85,768**	**453**	**95,024**	**539**
Net provisions and write-offs	-37,233	-164	-44,783	-178	-44,450	-201	-38,006	-201	-38,908	-221
Profit before taxation	**32,571**	**143**	**15,447**	**62**	**46,017**	**208**	**47,762**	**252**	**56,115**	**318**

BANKA SLOVENIJE

Structure of registered capital and own funds of credit institutions (at year end)

Type of credit institution	Registered capital	in Total assets	Own funds	in Total liabilities
	USD millions	%	USD millions	%
Banks	494.3	1.5	2,496.7	7.7
Savings banks	4.4	2.9	10.3	6.8

Ownership structure of banks on the basis of total assets

Item	2001	2002	2003	2004
Central Government	41.6	24.9	23.8	23.6
Other domestic ownership	42.0	40.4	40.2	40.3
Domestic ownership total	*83.6*	*65.4*	*64.0*	*63.8*
Foreign ownership	16.4	34.6	36.0	36.2
Bank, total	**100.0**	**100.0**	**100.0**	**100.0**

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

Type of credit institution	The first three largest	The first five largest
Banks	51.9	65.1
Savings banks	100.0	
Savings and loan undertakings	100.0	

Return on asset (ROA) by type of credit institutions

Type of credit institution	2001	2002	2003	2004
Banks	0.45	1.11	1.00	1.05
Savings banks	1.62	0.94	1.04	1.06
Savings and loan undertakings	-0.77	-2.18	0.68	0.18

Return on equity (ROE) by type of credit institutions

Type of credit institution	2001	2002	2003	2004
Banks	4.77	13.30	12.47	13.34
Savings banks	17.31	12.02	15.42	16.93
Savings and loan undertakings	-9.34	-29.30	11.77	2.18

2004 DEVELOPMENTS IN THE UKRAINEN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN UKRAINE

In 2004, the trend of economic growth persisted in Ukraine. Real gross domestic product increased during the year by 12.1%.

Industrial output increased by 12.5%. The highest growth rate among the main types of industrial activities equivalent to 28% was achieved in the branch working to meet the investment demand of enterprises – machine building.

Total output in agricultural production increased by 19.1%.

Growth in volumes of retail turnover amounted to 21.9%.

Macroeconomic stability in Ukraine was to a certain extent ensured by the efforts of banking system. What is meant here are national currency stability, high level of surplus in the BoP current account, extension of the state international reserves.

Real effective exchange rate had stable dynamics for the Ukrainian exporters. Exports of goods and services increased by 37.2%, imports – by 26%. The positive current account balance made 10.5% of gross domestic product, while in 2003 this indicator was 5.8%. The increase in current account balance was accompanied by a substantial capital inflow on the financial account as a result of funds attraction from placement of bonds in international markets, increase in foreign direct investments (1.2 times comparing with the previous year), attraction of long-term credits, etc.

Total nominal money income of the population increased in 2004 by 25.1%, its real income grew by 23.8 (versus 15.2% in the previous year).

DEVELOPMENT OF THE BANKING SYSTEM

As of January 1, 2005, there were 160 banks operating in Ukraine, 133 banks out of them were joint-stock companies including 92 public joint-stock companies (two of which were state-owned banks), 40 private joint-stock companies and 28 banks were limited companies.

As of January 1, 2005, nineteen banks with foreign capital participation functioned in Ukraine, seven of them were established with 100% foreign capital. During 2004 the foreign capital share of the banks' authorised capital decreased from 11.3% to 9.6% as a result of foreign capital growing at a lower pace than the total authorised capital of banks.

In 2004 there were tendencies in operation and development of the banking system of Ukraine which were the evidence of strengthening and enhancement of the favourable impact on the socio-economic development of the country.

Total banks' capital increased by 37%, the authorized capital – by 43%.

Average authorized capital per one functioning bank grew by 41% over 2004.

As of January 1, 2005, the number of banks with the regulatory capital over 5 million Euro equalled to 130 (more than 80% of the total number of operating banks), including 59 banks with the capital being in excess of 10 million Euro (37% of the total number of operating banks).

Total amount of banks' liabilities increased by 32.7%. Deposits of individuals formed the biggest share in the liability structure. The rate of increase in individual deposits (28.3%) decreased versus the previous year, which was caused by the unstable political situation in November-December, but this unfavourable trend was successfully overcome at the beginning of 2005.

Total assets of banks increased by 34.1%. The banks' assets increased mainly due to credit portfolio growth, which made 32.3%. Debts under credits granted to the economic entities increased by 25.7% and as of January 1, 2005 comprised 75% of the credit portfolio. Long-term loans kept on growing at outstripping growth rates – by 61.8% and their share in the credit portfolio increased from 38.3% to 46.8%. The loans to investment operations increased by 75.5%.

The activities of banks become increasingly more social-oriented. The loans granted to households increased by 64.4% in 2004 and their share in the credit portfolio increased from 12% to 15%.

The rehabilitation of the banking system was performed through liquidation and reorganization of insolvent and financially unsound banks. In 2004 four banks were excluded from the State register, among them 3 as a result of liquidation procedure completion, and 1 in the process of the reorganization through the merger with another bank as a branch. In the stated period 7 new banks were registered.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE BANKING OPERATION AND SUPERVISION

LEGAL POWERS OF THE BANKING SUPERVISION AUTHORITIES

The Law of Ukraine "On Business Associations", "On Banks and Banking" and "On the National Bank of Ukraine" are the legal framework of banking in Ukraine.

In compliance with the above laws, banking regulation and supervision in Ukraine are effected by the National Bank of Ukraine, defined in the Constitution of Ukraine as the special central body of state power.

The National Bank of Ukraine performs state regulation of banking activities in the form of administrative and indicative regulation.

Supervisory activities of the National Bank of Ukraine extend to all the banks, their units, affiliated and related persons of banks in the territory of Ukraine and abroad, as well as other legal entities and individuals with regard to their abidance by the requirements of the laws in force and regulatory acts concerning the performance of banking activities.

The National Bank of Ukraine performs banking supervision on the individual and consolidated basis and applies measures of influence for the breach of current laws and regulations on banking.

Performing banking supervision the National Bank of Ukraine is entitled to require from banks and their management to rectify a breach of the banking laws in order to avoid or overcome the unwanted consequences that can endanger the safety of funds trusted to such banks or prevent proper maintenance of banking activities.

In 2004 the National Bank of Ukraine performed banking regulation and supervision in accordance with the following regulatory acts:

- Regulation on the Procedure of Establishment and State Registration of Banks, Their Branches, Representative Offices and Divisions;
- Regulation on the Procedure of Granting Banking Licenses, Written Permissions and Licenses for Performance of Certain Banking Operations;
- Instruction on the Procedure of Regulation and Analysis of Banking Activities in Ukraine;
- Regulation on the Procedure of Forming and Using of the Provisions to Compensate Possible Losses on the Lending Operations of Banks;
- Regulation on the Procedure of Forming and Using of the Provisions to Compensate Possible Losses on the Commercial Banks’ Receivables;
- Regulation on the Procedure of Fair Value Determination and Reduction of Securities Yield;
- Regulation on the Application of Measures of Influence for Banking Law Violation;
- Regulation on the Planning and Procedure of On-Site Inspections;
- Guidelines on the On-Site Inspection of Banks and Banking Institutions in Ukraine;
- Regulation on the Procedure of CAMELS Rating Assignment;
- Guidelines on the On-Site Inspection of Banks “Risk Assessment System”;
- Rules on the Organisation of Statistical Reporting Submitted to the National Bank of Ukraine;
- Regulation on the Certification of Banking Auditors;
- Instruction on the Procedure of Preparation and Release of the Financial Reporting;
- Rules on the Registration of Correspondent Accounts by the National Bank of Ukraine and Other Banks.

MAIN STRATEGIC GOALS OF THE BANKING SUPERVISION AUTHORITY

The main goals of the banking regulation and supervision are safety and financial stability of the banking system and protection of depositors’ and creditors’ interests.

It is envisaged to achieve these goals through higher efficiency of the banking supervision authority and its complete compliance with the Basel Committee’s Core Principles for Effective Banking Supervision.

Currently the strategic aims of banking supervision for the nearest future are the following:

- Phased introduction of risk based supervision together with the use of traditional approaches;
- Raising capitalization of the banking system;
- Providing banking system transparency;
- Enhancement of control over the related party lending;
- Creation of methodological basis to introduce the consolidated banking supervision procedures;
- Enhancement of corporate governance in banks;
- Refinement and broad implementation of the early response system;
- Initiating works on the introduction of the Basel II requirements;
- Providing continuous training and advanced training programs for the banking supervision staff.

ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY IN 2004

In 2004 the National Bank of Ukraine continued to bring the legal and regulatory framework on the banking regulation and supervision into line with the requirements of the EU laws and regulations as well as with the Basel Committee's Core Principles for Effective Banking Supervision.

The draft laws aimed at settlement of the following issues were elaborated and submitted to the Parliament's consideration:

- authorizing NBU to identify beneficial owners of a bank and origin of the funds directed to the share purchase;
- abolishment of the rule allowing banks to conclude contracts with related parties on more favorable terms than with other customers of the bank;
- conducting financial audit in accordance with the requirements of the International Auditing Standards as well as banking supervision authority relationship with the bank's external auditors;
- providing the legal framework for establishment of foreign bank branches in Ukraine.

Fourteen amendments were made to the regulations, which encourage:

- stimulation of banking capital inflow – through facilitation of registration procedures for the authorized capital of banks, widening the range of instruments that may be used by banks for additional capital add-on, widening the interest rate limit for the attracted subordinated capital;
- capital quality enhancement through the improvement of its calculation procedure;
- risk decrease of lending transactions, in particular of foreign exchange credits, through setting stricter requirements to provisioning for the foreign exchange loan losses;
- extension of the NBU authorities in the implementation of measures of influence against the banks that have allowed significant augmentation of the adversely classified assets; and others.

One more direction of the banking supervision activities was the off-site monitoring and inspections of banks.

During inspections the issue of banks compliance with the laws and NBU regulations was checked. Special emphasis was laid on the capitalization of banks, efficiency of their control and management systems for the banking risks, evaluation of management level, internal control systems, adequacy of provisions for active operations and availability of the provisions and procedures necessary for the counteraction to banking fraud, legalization of the proceeds from crime and financing terrorism.

On the results of inspections performed each bank received a rating under the CAMEL system and, when necessary, adequate measures of influence were implemented.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISION AUTHORITY

Within the National Bank of Ukraine the supervision function is performed by 4 departments:

- Banking Regulation and Supervision Methodology Department
- Banks Registration and Licensing Department
- Banking Regulation and Supervision Department
- Banks Dissolution Department

The above-mentioned departments are subordinate to the Deputy Head of the National Bank of Ukraine responsible for banking supervision.

INTERNATIONAL ACTIVITY OF THE BANKING SUPERVISION AUTHORITY

In 2004 the National Bank of Ukraine continued to cooperate with international organizations in the area of monitoring performance of the banking sector reform programs, in particular: with the World Bank – under the Programmatic Adjustment Loan Project and Technical Assistance Project, financed by the Dutch grant; with the IMF as a part of the Extended Fund Facility Program (EFF); with the European Commission – under the Program of the Ukrainian Banking Sector Reform.

Bilateral agreements on cooperation in banking supervision continued to be concluded with the banking supervision authorities from other countries. In 2004 such agreements were concluded with the supervision authorities of Latvia, Kyrgyz Republic and Armenia.

COOPERATION WITH OTHER SUPERVISION BODIES

Exercising the functions of banking supervision the National Bank of Ukraine coordinates the activity and information exchange with other supervision bodies of the country, in particular, State Commission for Regulation of Financial Services Markets in Ukraine, Securities and Stock Market State Commission, Department of Financial Monitoring within the Ministry of Finance, State Tax Administration, etc.

OTHER IMPORTANT INFORMATION AND EVENTS FOR 2004

In 2004 during the XVII Conference of the Group of Banking Supervisors from Central and Eastern Europe (BSCEE) in Dubrovnik, Croatia, it was agreed to hold the next annual conference of the BSCEE Group in Kyiv. Thus, under par. 4.3.2 of the BSCEE Group Agreement the National Bank of Ukraine Deputy Governor, Banking Supervision, has become the Head of the BSCEE Group starting from December 16, 2004.

In the year under review the National Bank of Ukraine initiated arrangements for the XVIII Conference of the Group of Banking Supervisors from Central and Eastern Europe held in Kyiv, May 2005.

STATISTICAL TABLES

Number of financial institutions
(at year-end)

Type of financial Institution	2002	2003	2004
Banks	157	158	160

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

Item	2002	2003	2004
Public sector ownership	4.9	5.7	5.5
Other domestic ownership	81.4	83.0	85.4
Domestic ownership, total	*86.3*	*88.7*	*90.9*
Foreign ownership	13.7	11.3	9.1
Financial institutions, total	**100.0**	**100.0**	**100.0**

Ownership structure of banking system on the basis of assets total (%)

Item	2002	2003	2004
Public sector ownership	11.8	9.5	8.0
Other domestic ownership	75.7	78.1	81.0
Domestic ownership total	*87.5*	*87.6*	*89.0*
Foreign ownership	12.5	12.4	11.0
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of assets by type of financial institutions concentration of assets

Type of financial institution	First three major banks	First five major banks
Banks	27.9	37.4

Return on assets (ROA) (%)

Type of financial Institution	2002	2003	2004
Banks	1.27	1.04	1.07

Return on equity (ROE) (%)

Type of financial Institution	2002	2003	2004
Banks	7.97	7.61	8.43

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

Type of financial institution	2002	2003	2004
Banks	58.8	49.7	51.6

Solvency ratio of financial institutions (%)

Type of financial institution	2002	2003	2004
Banks	18.01	15.11	16.81

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

	2002	2003	2004
Assets	**100.0**	**100.0**	**100.0**
High liquidity assets	13.3	15.2	16.7
Credit portfolio	*69.0*	*69.6*	*68.7*
Investments in securities	6.5	662	5.8
Accounts receivable Total	2.1	1.1	0.9
Fixed and intangible assets	7.3	6.2	6.3
Other assets	1.8	1.7	1.6
Liabilities	**100.0**	**100.0**	**100.0**
Funds of the NBU	2.4	2.7	3.5
Budgetary and off-budget funds	3.2	1.3	1.4
Inter-bank credits and deposits	11.9	12.4	11.3
Funds of economic entities	36.5	32.0	34.6
Funds of natural persons	35.4	36.8	35.5
Funds of non-banking financial institutions	-	3.8	4.1
Credits from international and other financial organizations	1.5	1.0	1.4
Own debt securities	1.4	0.9	0.5
Subordinated debt	1.6	1.3	1.2
Accounts payable on transactions with banks and bank customers	1.6	1.9	1.0
Other liabilities	4.5	5.9	5.5

Asset portfolio quality of the banking system
credit portfolio (%)

Asset classification	2002	2003	2004
Standard loans	37.65	66.57	67.0
Watch list	40.49	5.15	2.9
Substandard	14.68	21.06	22.5
Doubtful	3.05	4.56	5.5
Bad	4.12	2.67	2.1
Classified Total	**100.0**	**100.0**	**100.0**
Specific Reserves (UAH mln)	**3,574. 8**	**4,631.2**	**6,367.0**

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

Type of financial Institution	FOREX assets / Total assets			FOREX liabilities / Total liabilities		
	2002	2003	2004	2002	2003	2004
Banks	37.3	37.5	38.8	38.9	40.0	43.4

The ownership structure of bank deposits and loans in 2004 (%) (at year-end)

	Deposits	Loans
Households	48.8	17.3
General government	0.0	0.03
Corporate	50.3	82.7
Other	0.9	0.02
Total	**100.0**	**100.0**

The structure of bank deposits and loans in 2004 (%) (by terms) (at year-end)

Maturity of deposits		Loans	
At sight	42.4	Long- term	52.0
Within one year	21.3	Medium-term	-
Over one year	36.3	Short-term	48.0
Total	**100.0**	**Total**	**100.0**

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

	2002	2003	2004
Revenues	**100.0**	**100.0**	**100.0**
Interest earned	65.9	68.1	67.5
Income from commissions	24.8	24.8	23.0
Performance of trade transactions	6.4	5.3	5.3
Other operating income	1.7	1.1	3.7
Other income	0.6	0.3	0.3
Recovery of written off assets	0.5	0.4	0.2
Unexpected income	0.0	0.01	0.004
Expenditures	**100.0**	**100.0**	**100.0**
Interest paid	37.4	37.5	41.2
Commission paid	3.1	2.9	2.7
Other operating costs	6.1	6.1	6.2
General administration expenditures	41.1	36.9	34.8
Allocation to reserves	9.5	13.1	12.9
Extraordinary expenditures	0.0	0.0	0.004
Income tax	2.8	3.4	2.2

Registered capital and own funds of financial institutions in 2004

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liabilities
Banks	1,677,677 Euro in thous.	9.0	2,552,341 Euro in thous.	13.7

MAIN GROUP EVENTS OF THE YEAR 2004

REPORT OF THE 17TH ANNUAL MEETING OF THE BSCEE GROUP 26-29 MAY 2004. DUBROVNIK, CROATIA

The first day's discussion of the two day conference was focused on forward looking provisioning, the other day was devoted to the creation of an optimised organisation framework for supervision. Furthermore, the annual report of the BSCEE secretariat was presented and Montenegro – the 19th member – was admitted to the organisation.

Forward looking provisioning

The moderator of the topic was Mr. Jason George, of the FSI in Basel. In his keynote address he discussed the importance and basic principles of provisioning, the current accounting practice, stressing that reserving is, to a considerable extent, a matter of accounting. At the end of his presentation he discussed the expected future provisioning methods, from the aspect of accountancy he touched on booking at real value and from the aspect of economics he talked about the method of dynamic provisioning. The following are considered to be the main points of Mr. George's presentation:

- **Real valuation**
  The Basel Committee holds that this is suitable for stating trading positions but the valuation of the credits contained in the banking book is not without problems if the current rules of the method are applied, therefore it is not the time yet to prescribe overall booking of all instruments of banks at real value, in their financial statements.
- **The time horizon of provisioning may be divided into three phases of development,**
  - Models based on actual losses
  - Models based on expected losses – these already include forward looking elements
  - Dynamic or statistical provisioning
- **Dynamic/statistical provisioning**
  - Instead of the estimate of the loss contained in the portfolio at the time of the drafting of the current balance sheet report, provisioning for a given receivable is based on the estimate of the loss that may be expected in a long run, in the various accounting periods.
  - Long term estimate is worked out in view of the pro-cyclic nature of economy, the characteristics of the various portfolios and it produces estimates on the basis of statistics available in a long run.

– It evens out the profit generation of the bank, stabilising thereby the operation of the bank.
– It demands filling up reserves during a period of growth to be available for use during hard times.
– Forecasting loss expected in a longer run is also necessary for the purposes of pricing.
– It is to be generated from the profit after taxes so that its generation is not biased by taxation related considerations.

Dynamic provisioning was introduced first by Spain, in 2000. Mr. George brought up a number of arguments against the application of the method, primarily from the aspect of the auditor:

- This method is contrary to 39 IAS provisions
- The balance sheet report pertains to a given period of time, however, at a given point in time the bank does not state the real profit if it uses this method
- A practice of evening profits out over time does not necessarily lead to more stable financial management
- The application of this method complicates comparing and analysing costs and revenues

The next presentation was delivered by Mr. Evan Kraft, head of the Research Department of the National Bank of Croatia, who – unlike Mr. George – approached the issue from the aspect of economics. In this aspect:

- The currently applied practice of provisioning is a backward looking one, since it is based on events that have already occurred.
- This approach is supported by accounting standards because it reduces the discretional elements and it provides an adequate picture of the state of the bank in the given point in time.
- According to economists this approach prevents provisioning for losses that we know are bound to occur but we do not know when (probably during the next economic slump).
- It is not that easy to set aside provisions during an economic downturn.

Mr. Kraft went on to describe the Spanish system, how the practice of provisioning affects the spreading of profits and showed the findings of the research carried out on the applicability of the method in Croatia. The key lessons are as follows:

- Dynamic provisioning may be a very attractive method for reducing financial instability but it can be applied in stable economies on the basis of long series of data (data on 16 years are used in Spain) but the unstable market and provisioning practices of the emerging markets and the lack of a sufficient quantity of data do not realistically permit its application.

During the remaining part of the day the representative of Slovenia delivered a presentation on methods of provisioning, discussing how they are assessing the possibility to introduce the practice of dynamic provisioning. Later on, during the roundtable discussion, delegates of Hungary, the Czech Republic and Bulgaria described their provisioning practices.

The final conclusion drawn on the theme of the day was that dynamic provisioning is – owing the above mentioned factors – not considered to be a realistic alternative in the countries of the group, and prior to its introduction there are questions of accounting that need to be clarified, and the expected impacts have to be analysed through in-depth research and simulations. Meanwhile, the intended objective may be attained through other means, and it should not be forgotten that banks' management teams have always been and will always be making efforts to even out the profits, through over-provisioning in 'good times', which is also promoted by the tax-exemption granted to reserves.

At the end of the day Mr. Charles Freeland, deputy secretary general of the Basel Committee described current issues relating to Basel II, including the latest decisions published in the Press Release of 11 May. His presentation – like the Press Release – mentioned the recommendation of the Basel Committee, prompting the supervisory authorities of the host countries to turn with their questions pertaining to the subsidiaries of global groups operating in their countries, to the supervisory authorities of the home countries (instead of turning directly to the bank) during the period of preparations in relation to implementation, in order to reduce the regulatory pressure borne by banking groups that have numerous subsidiaries.

László Balogh, Managing Director of the HFSA promptly responded to this, showing that in countries with a 70-90 % presence of foreign banks in the bank sector this principle does not function because in this way the supervisory authorities would lose all control over the preparations of their banks and this is contrary to their responsibility enshrined in law. Furthermore, in the case of subsidiary banks registered as domestic credit institutions the supervisory authority bears responsibility for the protection of the deposit holders, for the stability of the system and, in case of need, for final performance, therefore, it is not possible for anybody to limit the rights of the domestic supervisory authority in monitoring and supervising the preparation process. He asked the deputy secretary general of the Basel Committee to explain the problem to the member states. The delegates of the Czech Republic, Slovakia and Poland also backed up the request and the Group agreed that Hungary would produce a draft letter drawing the attention of the Basel Committee to this impossible situation, proposing that it should review its position in a way as will ensure that the Basel Committee receives this letter before its meeting on 20 June.

The theme of the second day was the expected organisational development of the banking and money market supervisory authorities in the near future. It is a regularly recurring issue in this region as well, whether the high level integration of the financial markets and financial products does not necessitate integration of the sectorally separated organisations of supervision as well. To date, Estonia and Latvia have chosen the approach of complete integration – in addition to Hungary – while Slovakia and the Czech Republic have started a process of partial integration. The following main points were drawn from the presentations delivered on this topic:

- Croatia

  The current president of the BSCEE and at the same time the moderator of the day, Mr. Cedo Maletic, Vice Governor of the CNB summed up (instead of the representative of the World Bank who had been invited but declined participation owing to some other programme) the pros and cons of an integrated supervisory model, drawing largely on a former World Bank study: the conclusion was that both systems of arguments are widely applied, each country has to formulate the solution most appropriate to its historical development, traditions, the level of development and the requirements of the financial sector.

- Czech Republic
  Mr. Pavel Racocha, member of the Board of Directors of the National Bank of the Czech Republic, head of the board of directors of the Banking Supervision, described the existing supervisory structure and a two-tier plan for the integration of supervision. The financial sector is currently supervised by three institutions: the National Bank is supervising the banks, the Securities Supervision is supervising investment service providers, the Ministry of Finance is supervising credit and savings cooperatives, insurers and funds. In the first phase the supervision of credit and savings cooperatives will be taken over by the National Bank, in the second phase a single sectoral level supervisory organisation is planned to be created but no decision has so far been made about the institution in which integrated supervision will be performed. *The fundamental organising principle however, is that the regulatory and the supervisory power should be exercised by a single institution.* The arguments of the Czech delegate for continued integration were more or less in line with those confirmed by what Hungary has experienced: consolidated supervision, monitoring of integration in the market, strong synergetic effects, economies of scale, more comprehensive overview of the financial system.
- Slovakia
  Peter Balázs, the representative of the National Bank of Slovakia, talked about the plans of Slovakia. Two supervisory authorities are operating in Slovakia at present: the National Bank is supervising credit institutions, the money market supervision is supervising insurers, investment service providers and funds. They are planning to introduce single sectoral supervision within the framework of the national bank, by integrating the money market supervision. The new regime is expected to be launched on 1 January 2006.
- Hungary
  Mr. László Balogh, Managing Director of the HFSA, described the already completed organisational integration, summing up the experience and lessons drawn from the past four years of operation.
- Poland
  The representative of the National Bank of Poland, Mr. Piotr Bednarski, said about the Polish supervisory system, that at present both banking supervision and the supervision of insurers and funds as well as that of investment service providers, is carried out by separate institutions. Since there are no conglomerates in the Polish financial sector, the level of development of the market does not strengthen interpenetration of different financial institutions, some 80 % of the financial sector is made up of banks, they do not see it necessary to create an integrated (consolidated) supervisory authority. Owing to their roles in the sector they regard the

supervision of banks to be the most important task, which they are not planning to release from the framework of the National Bank to organise it in an independent organisation, for this is the way they see the preservation of the material, financial, regulatory, institutional and operational independence to be most reliably assured.

Roundtable discussion

The key elements o the roundtable discussion:

- The desirable supervisory structure is determined by the market structure.
- The development of consolidated supervisory structures was a result of an organic evolution process in Britain and Scandinavia, the transformation of the system of supervision was triggered by shocks, bank failures and crises while in Central and Eastern Europe decision makers are driven primarily by logical planning and alignment to EU expectations.
- It is extremely important that the development of a separate supervisory organisation should not result in the separation of the regulatory from the supervisory authority.
- The strategic preparation of consolidation is crucial, the new organisation needs to have clear cut goals and a well-defined mission statement.

During the same day the Polish delegation delivered a presentation on the goals, the achievements and this year's plans of the Banking Supervisory Training launched by the Polish National Bank. This system of training is aimed to strengthen the professional training of East-Central European banking supervisors, by transferring practical experience accumulated in the region. They are organising courses in Russian s well, to enable the widest possible access to the training. Their programmes are built up in cooperation with FSI and Toronto Centre.

Secretariat Report

Ms. Andrea Deák, Senior Coordinator of the Secretariat of the BSCEE Group, summed up the year 2003 and 2004 activities of the BSCEE regional group, along with its main tasks:

The key tasks of the Secretariat include facilitating the organisation of professional seminars in cooperation with the Financial Stability Institute (FSI) of Basel and the BSCEE Member States. The Group organises two seminars and one annual conference each year, for the regional group comprising 19 countries. The first one of the two seminars planned for 2004 has already taken place in the city of Minsk between 11 and 13 May, on the topic 'Building an IRB system'. The next seminar will be organised by the National Bank of Poland in Warsaw, between 28 and 30 September on 'Credit Risk Transfer'.

The presidency of the BSCEE Group is changed in a system of annual rotation. This year Mr. Cedo Maletic, vice-president of the Croatian National Bank – who has organised the conference as well – is the president of the regional group. The National Bank of the Ukraine has volunteered for presidency in 2005.

The BSCEE Group, which was founded in 1991, has been increased this year by the joining of its 19^{th} member, the National Bank of Montenegro. (In the Yugoslav federation Serbia and Montenegro each have its separate central bank and separate banking supervision.) The admission took place at the end of the conference, in a solemn ceremony.

The Secretariat provided information on other issues involving the Group:

Mr. Radovan Jelasic, the President of the National Bank of Serbia has noted that the National Bank of Serbia would also like to join the regional Group, as its 20^{th} member. After the submission of the official application the Secretariat will carry out the formal process of admission and at the year 2005 the new member may officially join the Group.

In the wake of preliminary consultations the Group has amended the Agreement and the Operating Code of the BSCEE Group. The modified versions were signed by 14 of the 16 countries present. The original specimens signed by each member will be distributed as follows: 1 copy will be retained by the new member (Montenegro), 1 copy will be retained by the Secretariat and 1 copy will be kept, by the Chairman. The other members will receive second copies of the documents.

The documents were modified for the following three reasons:

1) The earlier USD 1000 membership fee was, from 1 January 2004, replaced by EUR 1000.
2) One new member has joined the Group.
3) Personal changes took place in a number of Member States during recent years, so the contacts list and other addresses have also been modified.

The basic documents of the BSCEE Group were written by the then 6 members 14 years ago, therefore they need to be revised and perhaps even supplemented and modified. The members of the Group agreed on this point. Mr. László Balogh, Hungarian representative made a proposal for setting up a working group to carry out the revision of the basic documents. Volunteers are expected from among the members to carry out the revision, they should coordinate the necessary modifications by e-mail, they should coordinate with the members (producing the draft by February 2005) and submit the revised version of the basic documents to the members at the year 2005 conference.

The International Monetary Fund (IMF) was represented at the meeting by Mr. Thordur Olafsson, Senior Financial Sector Expert. This was the first annual conference of the Group, which was attended by a representative of IMF. Since when some 4-5 years ago IMF started to analyse international norms relating to financial supervision and the application of such norms in its member states as well as effective and reliable supervision in each of the countries, there has been a need for IMF collecting information directly through the regional banking supervisory groups about practical problems as well.

NEW BASEL CAPITAL AGREEMENT, RULES, IMPLEMENTATION, CREATION OF INTERNAL CREDIT RISK MODEL
BSCEE – FSI Regional Seminar
Minsk, Byelorussia, 11-13 May 2004

The seminar aimed to focus on the introduction of internal credit risk models by banks and the process of giving licences by supervisory authorities, but since the programme also intended to process the whole of the agreement, there were presentations on all themes, thus finally the seminar moved away to some extent from the original focus. The contributors of FSI laid emphasis on describing the disadvantages of forced introduction and the damage that may be caused by the forced introduction of the new rules to economies that are not sufficiently highly developed and prepared for the time being.

IRB model building
Pieter Keemink, head of Risk Management, ING

Mr. Keemink outlined the possibilities, the usually applied tools and approaches, as well as the most frequent problems. The following is a list of the points he made in addition to those contained in other similar comprehensive presentations.

- Banks' risk managers and the supervisors depend on one another in building up and particularly in the appraisal of rating systems and models: neither may succeed without the other's opinion and knowledge.
- The real 'test' of a rating system is the extent to which it is integrated in the day-to-day practices of the given bank.
- The typical problem of ready-made models and systems is that users do not familiarise themselves with such models and systems sufficiently, or that they only have superficial knowledge of their operation.
- When applying a statistical model, there usually remains some 6-8 more or less independent factors after assessing the relationships between factors. If one model is reviewed it is worth looking also at the factors that are not involved.
- It is very difficult to properly handle high quality rating factors.
- In practice, usually hybrid rating systems are applied that are based partly on statistical models, partly on experts' opinions.

Supervisory audit process (the 2nd pillar)
Jean-Philippe Svoronos, FSI

We decline to provide a general overview again, summing up only the most interesting points.

- It is not easy to standardise the supervisory audit process. Germany is trying to apply a checklist-type solution, which ensures, at any rate, that we do not forget any of the most important factors.

- In the course of an audit the emphasis is laid on the bank's shareholders' equity calculation (i.e. the supervisors do not carry out calculations), so the review is practically an audit of this calculation.
- The implementation of the 'higher than the supervisory minimum capital requirement' principle of the Basel Committee needs supervisory powers provided by legislation. Incidentally, extra capital may be prescribed at an individual or at a group level.
- There is no standard (*one size fits all*) solution or best practice for the shareholders' equity calculations of banks.
- In the course of an audit it is to be assessed whether the bank has taken into account all of the relevant risks in calculating its shareholders' equity and whether it has sufficient capital to cover such risks, whether all of these are in line with the strategic goals and whether the risk management rules and processes of the bank are adequate.
- Attention should also be paid among strategic goals to the rating that is intended to be attained by the given bank.
- A checklist seems to be the best supervisory practice but attention needs to be paid to ensuring concentration on the really important elements and not to 'get lost in detail'.
- One typical problem of supervisory audit is that the employees of the supervisory authority do not know the bank as thoroughly as its employees. This problem may be relieved partly by peer group analysis.
- The Dutch supervisory authority has set up a specific group (comprising modelling and other experts) to audit calculations.
- A supervisory audit requires qualified supervisors who need to have more and substantially different knowledge than before. Moreover, there is a shortage of the required knowledge in the market, therefore the acquisition and retaining of highly qualified experts is expensive.
- The required special knowledge includes ability to assess risk models, knowledge of new products and financial techniques, IT.
- Besides special knowledge there is a need for adequate headcounts: 'customised' supervision requires more human resources than standardised supervision.
- There is a wide variety of ways of prescribing (attaining) the extra capital, in accordance with the different cultural traditions of the various countries. Brazil for instance, prescribes 11 % across the board, the Dutch rely on the bank's own capital calculations (models), Germany has no general extra capital rule. The British practice which applies 'trigger' levels above the minimum level where specific supervisory actions are applied upon reaching those levels, may be recommended.
- Implementation is a major challenge for all supervisory authorities. From among a number of tasks and aspects that can be mentioned here, in the current phase perhaps communication with the sector may be the most important area.

Supervisory approval process
Frank Thiem, Head of the Deutsche Bundesbank in charge of onsite supervisory audits

The banking act assigns ongoing monitoring of credit institutions to the scope of responsibilities of the Bundesbank. Accordingly, the Bundesbank carries out onsite audits as part of the supervisory audit process. The measures of the Bafin rely primarily on the Bundesbank audits, but they also carry out audits using their own resources. On the basis of an agreement the IRB validation audits are carried out by the Bundesbank, on the basis of which the administrative measure is taken by Bafin, which may participate in these audits.

Since banks are scattered across Germany, the employees of the Bundesbank engaged in onsite audits are working in regional headquarters. A total of 2394 financial institutions are operating in the banking sector, the four large banks hold a 23 % market share, with 136 other large banks hold a total market share of 56 %. Foreign banks have 114 subsidiary banks and 90 branch units in Germany.

In year 2003 the Bundesbank assessed the number of banks that could be expected to opt for IRB, in order to be able to schedule the validation process and to ensure that it has sufficient time for the elaboration of the adequate methodology and for making available the necessary resources. The policy applied by the Bundesbank is to prompt its banks to adopt the IRB to facilitate the development of the risk management systems, providing them all forms of assistance – consultation, methodology – if they do adopt the IRB. In the course of the preparations the Bundesbank maintained ongoing working relationship with the banks, and the large banks started preparations last year. They discuss their proposed solutions with Bundesbank on a regular basis.

According to the findings of the survey some 850 banks are planning to apply the IRB, of which some 25-50 are planning to start using the advanced method. This equals 44 % of the banks, involving 81 % of the total balance sheet of the sector. This is a very high ratio by international comparison. The licensing of the large number of banks takes substantial resources, owing to its time requirement the methodology documents had to be produced in 2004 already. The Bundesbank published the audit manual for the process of licensing the IRB models and the operating risk models, in June 2004.

In the course of the preparation for Basel II they transformed their bank rating system with the aim of creating a more objective risk rating system, which is a tool for the planning of the audits of the banks. They have set up four risk dimensions: assets, profitability, capital and liquidity structure and development.

The presentation gave a detailed description of the minimum requirements of the application of the IRB model and the process of validation/testing. Supervisory validation was described as a puzzle, since a variety of elements need to be assessed, such as:

- Components
  - Data collection, registry, data quality
  - Quantitative processes (data processing)
  - Qualitative processes (subjective aspects of rating)

- Results: Rating, Testing
- Processes: in two dimensions: auditing the rating process and its connection to other internal processes of the bank
  - the rating system needs to be understood
  - the bank's management need to pay sufficient attention to the rating system
  - the internal auditing processes need to be operating
  - it has to be integrated in the management of the bank

and these details need to be made meaningful 'whole'.

FSI Connect
Jean Philipp Svoronos, FSI

FSI Connect is an e-learning tool developed by FSI, an accessory to the FSI program, available online. The programme is built up of training models supporting effective supervision, at present the courses on the new capital agreement, credit risk, market risk, operating risk are available, but the development of training materials on other areas is also in progress. The next themes to be made available on the Internet include accounting, prevention of money laundering, corporate governance, supervision of financial conglomerates etc. The courses fall into three categories – basic, intermediate and advanced – and the time requirement of processing the materials is also specified. The knowledge so acquired may be checked by a test. The program contains a dictionary with the definition of all of the terms used. The program is not free of charge. To promote actual use it may be used for a nominal subscription fee (of about EUR 200 per capita). The program will be launched on 1 July 2004.

CREDIT RISK TRANSFER
FSI – BSCEE – General Inspectorate of Banking Supervision of the National Bank of Poland regional seminar
Warsaw, Poland, 28-30 September 2004

The General Inspectorate of Banking Supervision of the National Bank of Poland together with cooperation of the Secretariat of BSCEE and the Financial Stability Institute organised a regional seminar for BSCEE member countries on "Credit Risk Transfer". The seminar was devoted to the techniques for transferring credit risk, such as financial guarantees and other credit risk mitigation techniques which have been a long-standing feature of the financial markets.

The agenda of the seminar focus on a description of the commonly used credit risk transfer products and their associated challenges, accounting for derivatives and hedges, and the treatment of credit risk mitigation techniques in the New Capital Adequacy Framework (Basel II).

Additionally, during the seminar were discussed regional perspectives on CRT from both the industry (banks) and BSCEE supervisors. During the roundtable discussions, participants had an opportunity to exchange views and share their countries' experiences.

The seminar was intended for senior supervisors and other technical experts responsible for the supervisory policy in their agencies. The following topics were covered during the seminar:

- Credit Risk Transfer: Products/Structures
  - Overview of Credit Risk Transfer: Asset Securitisation and Operational Issues
  - Credit Risk Transfer: A Commercial Bank Perspective
- Credit Risk Transfer: A Regional Perspective
- Credit Risk Transfer: Regulatory Approaches and Experience
- Accounting for Financial Instruments: Credit Derivatives, Hedges and International Accounting Standards
  - Financial Instruments Accounting: Overview of IAS 39
  - Overview of Accounting for Derivatives and Hedges
  - Overview of Derecognition and Securitisation
- Capital Allocation for Credit Risk in the New Basel Capital Adequacy Framework
  - The New Basel Capital Adequacy Framework
  - Credit Risk Mitigation in the New Basel Capital Adequacy Framework
  - Credit Risk Mitigation in the New Basel Capital Adequacy Framework (continued)
  - The Treatment of Asset Securitisation under the New Basel Capital Adequacy Framework

In the seminar take participation 26 representatives from 14 member countries: Albania, Belarus, Bulgaria, Czech Republic, Croatia, Estonia, Hungary, Montenegro, Latvia, Lithuania, Poland, Romania, Russia, Ukraine.