BSCEE

Review

2008

INTRODUCTION

The Group of Banking Supervisors from Central and Eastern Europe (the BSCEE Group) was established in 1991. 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 and Operational Bylaws that determine its organizational structure and the rules governing its operations. As of today it is signed by twenty two member institutions from twenty one member countries: Albania, Austria (signing of the Accord on the Accession at the XXI Conference in Belgrade, 2008), Republic of Belarus, Bosnia and Herzegovina (Banking Agency of the Federation of Bosnia and Herzegovina and Banking Agency of Republika Srpska of Bosnia and Herzegovina, which officially joined the Group by signing the Accord on the Accession during the Regional Meeting at the XV ICBS Conference in Brussels, 2008), Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia and Ukraine. The Chairmanship of the BSCEE Group rotates on annual basis. In 2008 Ms. Mira Erić-Jović, Vice Governor of the National Bank of Serbia, chaired the Group.

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 BSCEE Group Secretariat is to provide technical assistance in organizing conferences, leader's meetings, workshops and training seminars. The Secretariat also facilitates cooperation among the member countries, the Basel Committee on Banking Supervision (BCBS) and other international institutions and organizations in the sphere of banking supervision. The permanent Secretariat of the Group until 2005 was located at the premises of the Hungarian Financial Supervision Authority (HFSA) and as of January 2006 is located in Poland, at the Polish Financial Supervision Authority (PFSA).

According to the previous years practice the Annual Review of the BSCEE Group summarizes the developments of the member countries in 2008. This publication gives an overview of the macroeconomic circumstances in the twenty-one 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 the workshops co-organized by the Financial Stability Institute (FSI) and other regional seminars. The XXI Annual Members Conference was organized by the National Bank of Serbia in Belgrade, Serbia on April 10 – 12, 2008.

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

I hope that you will find this publication informative and useful. I am sure that this will help you 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 Basel Committee.

BSCEE Secretariat

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2008 DEVELOPMENTS IN THE ALBANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

Albanian economy performance was generally characterised by positive features over the year 2008. Albanian economy marked satisfactory rhythms of economic growth during the first 9 months period of year, under the preservation of the main indicators of macroeconomic stability. Meanwhile, the last quarter of year reflected a more explicitly different view of the economic developments. The domestic economic activity, under the effect of financial and global economic crisis, has manifested slowdown signs while monetary indicators have fluctuated considerably.

Domestic economic growth is mainly grounded on the rapid increase of the domestic demand. All components of this demand have been increased: consumption, investments and government expenditures. This demand, at the largest portion, has been financed by the domestic financing sources, accompanied by a rapid growth of credit extended to economy.

Annual inflation peaked to 4.6 percent as at May, whose value marks the highest level of inflation during the past 5 years. Meanwhile, the calmness of offer's shocks and the slowdown of the domestic demand during the last quarter were accompanied by the progressive decline of inflation value, pointing to 2.2 percent in December.

The domestic demand was reflected also on the rise of trade deficit and of current account deficit over the year 2008. Hence, current deficit account pointed to 14.9 percent of GDP, mainly affected by the rapid growth in imports and the slowdown of remittances during the second part of year, due to the strengthening of the economic crisis' effects on the economies of neighbouring countries.

Fiscal policy appeared with a more expanding character during year 2008. This character is reflected on the growth of public investments and of the budget deficit. The level of public deficit increased during the year 2008, accounting for 55.6 percent of GDP compared with 52.2 percent in the previous year.

The rapid growth of credit extended to economy encouraged relatively high rhythms of monetary expansion over the year 2008. The annual average growth rhythm of M3 pointed to 12.3 percent, marking a slight slowdown from 15.8 percent recorded during year 2007. Interest rates fluctuated significantly over the year, depending on the liquidity performance in the system and on the developments occurring throughout the international markets, while exchange rate has been steady in general over the year 2008.

The financial and economic crisis that swept across the global economy marked the most important development of 2008. The impact of this crisis on the domestic economy was gradually increased during the last quarter of year. The ambiguity transmitted by the turmoil of the global financial system was manifested in the withdrawal of a part of deposits from the system during the last quarter of year. These withdrawals brought about liquidity problems in the system and were accompanied by tendencies regarding the increase of interest rates over this period. On the other hand, this situation affected naturally the reduction of the system's willingness to extend credit to economy and thereof the notable slowdown of lending rhythm over the last quarter of year. This development, accompanied with a fall in remittances over this period, affected the slowdown of the economic activity during the forth quarter. Bank of Albania, for the purpose of responding to this phenomenon, took the measures to inject liquidity and to preserve public confidence in the banking system. Bank of Albania at the same time strengthened the supervision regulations throughout the year 2008, to consolidate the stability of financial system. These measures resulted effective, and the Albanian banking system has successfully dealt with the first shock of the global economic and financial crisis.

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

Mixed and less steady developments characterised year 2008. The analysis estimates an increasing risk rate and a decrease of the financial power of the banking system. The first half of year, in general, is estimated with a better performance than the second half, when particularly the last quarter was highlighted for a significant contribution to the deterioration of some of the main indicators of the banking system. Notwithstanding, the fluctuations and the less well performance of some main financial indicators, have not effected the compatibility balance of regulatory capital level against risks level undertaken from the banking system as a whole.

Banking system at the end of 2008 continues to concentrate its activity on the gathering of deposits from public and the granting of loans, mainly to households and companies. Sources and assets of the system increased, but at a notable lower rate compared to the previous years. Developments reveal an increase of banking system's exposure against credit risk. Non-performing loans have increased rapidly and the loan portfolio quality deteriorated significantly. Therefore, the profitability of banking system as estimated through the return on assets was worsened owing to the great increase of expenses on provisions of losses from loans.

The growth of deposits base was slowdown also notably due to deposits flows out of the banking system during the last quarter of year, and due to ambiguities being created and perceived by the public at large during the global financial crisis wave. Highlights during the last part of 2008 imposed a challenge to the management of liquidity.

In more concrete terms, the financial situation of banking system at the end of 2008, compared to the end of 2007, reflects some of the characteristics and trends as follows:

- Net result is estimated at 26.5 percent lower than the previous year, while RoAA indicator is estimated at 0.91 percent and rather lower than the yearend 2007 of 1.48 percent;
- NIM appears steady, at about 4.13 percent, against 4.09 percent;

- Assets increased at about 12 percent against 19 percent, loan portfolio raised at 35.7 percent against 47.7 percent, while deposits increased at the low rate of 2.4 percent;
- "gross non-performing loans/gross loan portfolio" index deteriorated at the level 6.64 percent from 3.37 percent;
- Non-performing loans index undressed from the effect of new loans within the term of one year was considerably deteriorated, from 5 percent to 9 percent;
- Loan portfolio in ALL continues to be more problematic regarding its quality by disclosing indicators of loan portfolio quality at the level 7.5 percent against 6.3 percent;
- Deterioration of the banking system capabilities of covering with capital the possible losses from loans, assessing this from a high increase of "net non-performing loans/regulatory capital" ratio, from 11.1 percent to 25.7 percent.
- Capital adequacy appears steady above the level 17 percent and far from the required minimum level;
- Ratio of assets on shareholder capital of the system, or differently financial system leverage is decreased gradually over year 2008. Increase of leverage from 13.1 to 11.7 throughout one year, implies that the system is less based on the debt for the financing of assets;
- The overall covering rate of system of 144 percent, at the end of December, is considerably higher than the limit rate of no less than 100 percent;
- Increased activity in foreign currency, as an expression of a greater increase of sources in foreign currency and the loan portfolio;
- Almost equal levels of assets, deposits and loans concentration indicators estimated according to Herfindahl index;
- Deterioration of banking sector efficiency compared with other economy, as an expression of decreased net share to GDP, from 1.1 percent to 0.7 percent.

Loan portfolio quality, under these conditions is expected to deteriorate and thus profitability indicators are projected at similar levels with the yearend 2008. At last, we assess that the performance of ALL exchange rate against foreign currencies, especially versus EUR, recently is turned into a warranting signal regarding the deterioration of the borrowers' conditions, who owns already a loan in foreign currency. Thereof, a considerable worsening of their capacity to pay the obligations related to the granted loans is an expectation not far from the reality.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The Law "On Banks in the Republic of Albania" and the implementation on ongoing basis of long-term and short-term objectives of the Bank of Albania, consolidated further the work on the review of the supervisory legal framework regarding the compliance with the provisions stipulated in the Law, the combination with the implementation of the reviewed principles of Basel Committee on an effective supervision and new concepts of New Accord of Capital, Directives of European Council and the best practices in the filed of supervision arrangement of financial institutions licensed by the Bank of Albania.

Year 2008 concluded the compilation of new regulation and introduced amendments in some other regulations of banking supervision. The regulations compiled and approved during this year include the Regulation "On the internal control system in banks and branches of foreign banks", "On the transparency regarding banking products and services" "On the minimum requirements of information publication from banks and branches of foreign banks", and the Regulation" On the minimum technical and security conditions of premises where the financial and banking activities are carried out". Meanwhile, amendments in the regulatory framework were carried out in the regulation "On credit risk management", "On capital adequacy ratio" "On risk management from the large exposures of banks" and in the Regulation "On risk management in the activity carried out from branches of foreign banks".

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

Bank of Albania, in accordance with its legal functions, as the supervisory authority of banks and other subjects, licensed by it, is committed to:

- Ensuring a sound banking activity that is in good harmony with the Bank of Albania legal and regulative framework, with the purpose the prevention of financial crises and to protects depositors;
- Safeguarding the banking system stability and even broader, by monitoring the market development, and recommending adequate measures, in order banks adopt these developments and are continuously managed according to the best principles;
- Strengthening the public confidence on the banking system and promoting the market discipline, by requiring higher transparency in the banking system;
- Providing a fair competition in the banking system and beyond, and ensuring equal treatment of licensed entities and their clients;
- Providing continuous and professional communication with financial market operators and other institutions which influence the activity of the Bank of Albania, in the framework of enhancing the functioning of financial market and its operators.

The Bank of Albania accomplishes it supervisory function, through:

a) Continuous establishment and improvement of the supervisory regulatory framework, so that it is in harmony with the best international principles and applicable in practice;
b) On-site and off-site examinations of licensed institutions indices, as well as through corrective measures taken for sorting out various problems;

c) Orientation of supervisory process towards risk identification the licensed institutions are faced with, recommending proper solutions;
d) Building up policies, which focus toward a development-oriented banking system;
e) Co-operation with financial institutions under supervision and with other domestic financial institutions, as well as with international supervisory authorities;
f) Ongoing improvement of the supervisory capacities.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

Banking activity incurred various developments over the year 2008. The first part witnessed the ongoing expansion of the activity, increase of work volume, of baking services, of credit extended to economy, a higher expansion of branches network. It is concluded a significant increase of competition, expressed in the products supplied and their prices. These developments have withdrawn the attention of supervisors to carefully observe the financial performance, the quality of the adopted decisions and their consequences.

Second half of year, encountered a general tightening of the banking system. This was due to the appearance of international financial crisis, but differently from the other countries where this latter was stimulated by the internal developments, the problems appearing in the Albanian banking system owed to the withdrawal of deposits from customers due to a manifested lack of confidence. This lack of confidence is owed to the information arriving from international markets and the informal rumours circulating within the country at that time. Due to these occurrences and the estimations on a fall of the country economic growth during the year 2009, banks have reviewed their strategic plans by adopting a more conservative approach against the increase of the activity.

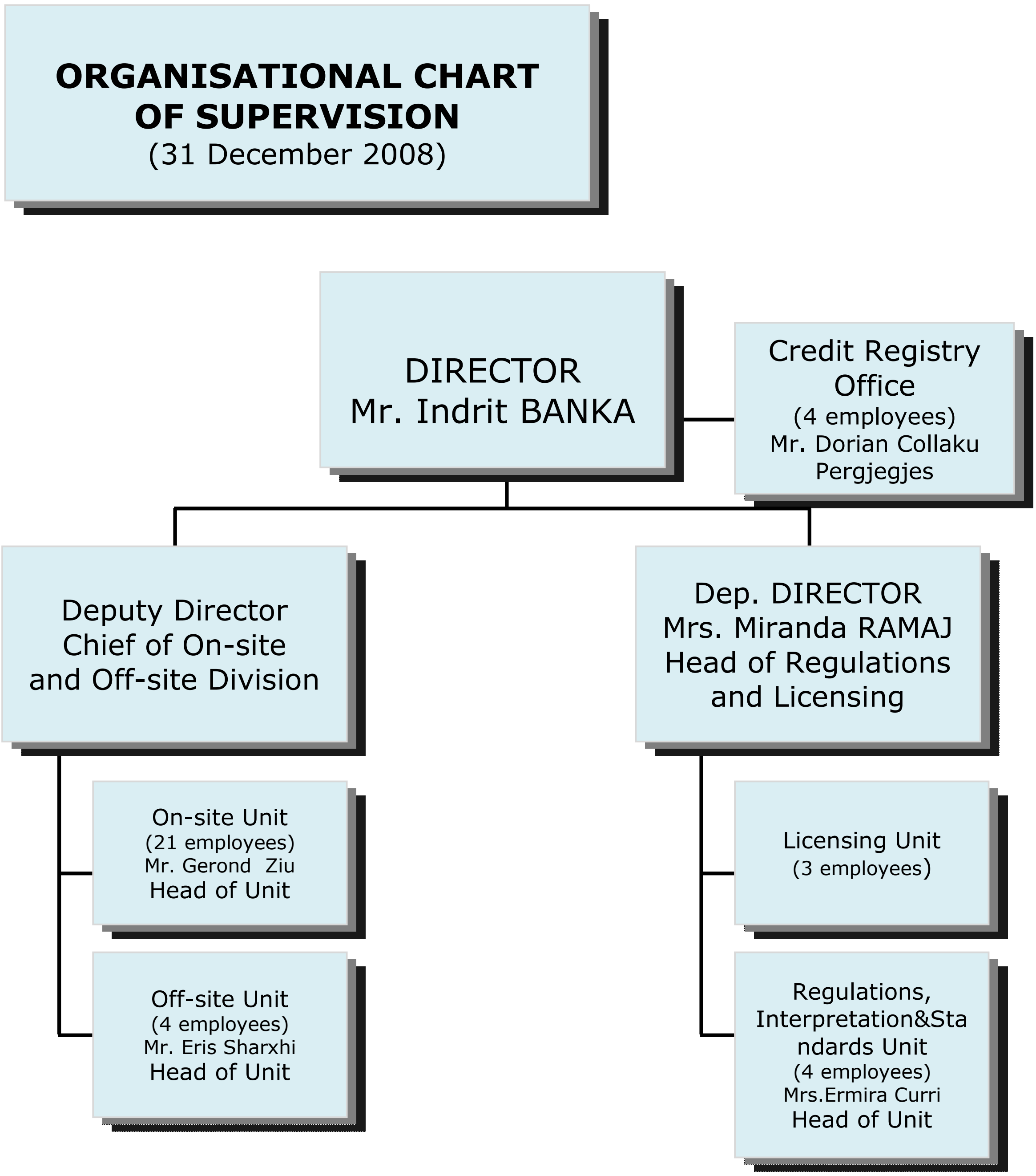
Regarding the situation of the last quarter pf 2008, the developments in the banking system are observed in an intensive way. For this purpose it is required the reporting on daily basis of deposits' withdrawals situation of customers and of special items of balance-sheet that are directly related with the challenge of the phenomenon. It is established the needed database and they are elaborated to prepared informing and analysing materials related to the developments in the system on weekly basis. In addition it is maintained a continuous contact with each bank to receive information in real time on the regular performance of the activity or of social developments implying a supervisory concern.

The development of risk management function was the special focus of banks.

The attention of directing organs and the work quality on risks management were continuously prioritised. On-site examinations were particularly focused on banks' capital level, credit risk expansion in different branches of economy, preservation of liquidity level and its adequate management and the providing of funds needed to afford difficult situations.

Maximum efforts are made to take the measures to address in time the appeared phenomena, particularly regarding loans portfolio quality, the way of interest rates application and furthermore the management of liquidity situation, by dealing with particular attention the claims of customers, whose increasing number reveals an increasing awareness of public on banks services, that imposes the need on a continuous attention on the right addressing of problems.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY AND COOPERATION WITH OTHER SUPERVISORY BODIES IN ALBANIA

Taking into consideration the financial market developments, particularly those of the last months of year and the importance of extended banks' presence with foreign capital, attention is paid to the cooperation with other supervisory bodies. This cooperation has been mainly with countries where the capital of banks carrying out their activity in Albania comes from and with countries of the region.

In the framework, multilateral cooperation agreements were finalised with six countries of the region, with the purpose the promotion of a structured coordination in banking supervision, it is accomplished the exchange of information regarding the supervisory peculiarities of each country and there are made the steps to expand and realise the cooperation.

Cooperation with the Bank of Greece, the banking supervisory authority in that country, has been strengthened, through the exchange of experience and through the joint examination carried out to one of the banks having the capital origin from Greece, a subsidiary of a bank founded in Greece.

Continuous efforts have been carried out to provide legal spaces for the purposes of signing cooperation agreements with the supervisory authorities of these countries.

A close collaboration, with the responsible Anti-Money Laundering Authority, has taken place. In the framework of twining project of this institution with its German homologue, financed from the European Community, it is provided the continuous participation.

The exchange of information and the coordination of activity with the Insurance Deposits Agency are intensified, particularly during the last months of 2008, in the framework of managing the liquidity situation of banks.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2006	2007	2008
Commercial Banks	17	16	16
Non-bank Financial Institutions	6	6	7
Exchange bureaux	60	112	189
Saving&Credit Associations (SCAs)	125	130	133
Unions of SCAs	2	2	2
Representative Offices of Foreign Banks	1	1	1
Financial institutions, total	**211**	**267**	**348**

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

Item	2006	2007	2008
Public sector ownership	1.70	1.255	1.11
Other domestic ownership	13.46	7.412	6.97
Domestic ownership total	15.16	8.667	8.08
Foreign ownership	84.84	91.333	91.92
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	55.32	73.61
Credit Cooperatives		
Financial Institutions		
Savings Cooperatives		
Specialized Credit Institutions		

Return on Asset (ROA) by type of financial institutions

Type of financial institution	2006	2007	2008
Bank	1.36	1.57	0.91
Credit Cooperatives			
Financial Institutions[1]	6.11	5.5	11.8
Savings Cooperatives[2]	0.83	2.35	1.43
Specialized Credit Institutions[3]	4.58	4.00	3.88

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2006	2007	2008
Bank	20.17	20.74	11.35
Credit Cooperatives			
Financial Institutions	13.64	5.50	16.81
Savings Cooperatives	3.78	12.00	3.66
Specialized Credit Institutions	9.58	4.00	9.18

[1] Nonbank financial institutions, other from Savings and Loans Associations, which report to Bank of Albania and do not provide loans.
[2] Savings and Loans Associations including their Unions.
[3] Nonbank Financial Institutions that report to Bank of Albania and provide loans.

Distribution of market shares in balance sheet total (%)*

Type of financial institution	2006	2007	2008
Banks			
G1 (< than 2% of total banks assets)	4.84	3.4	4.0
G2 (2% - 7% of total banks assets)	25.86	31.6	31.0
G3 (> 7% of total banks assets)	69.30	65.0	65.0
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2006	2007	2008
Treasury operations and interbank transactions	50.63	39.45	30.14
Operations with costumers	31.53	39.11	47.25
Securities transactions	14.73	17.95	19.99
Other assets	0.86	1.30	1.01
Fixed assets	1.52	1.49	1.82
Total accrued interest	1.27	1.32	1.30
Liabilities	**2006**	**2007**	**2008**
Treasury operations and interbank transactions	50.63	39.45	11.84
Operations with costumers	31.53	39.11	75.98
Securities transactions	14.73	17.95	0.00
Other assets	0.86	1.30	1.14
Fixed assets	1.52	1.49	9.64
Total accrued interest	1.27	1.32	1.40

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

Type of financial institution	2006	2007	2008
Banks	42.28	54.84	89.08

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Banks	18.02	17.08	17.23

Asset portfolio quality of the banking system

Type of financial institution	2006	2007	2008
Standard	93.63	91.80	88.2
Special Mentioned	3.34	4.80	5.3
Substandard	1.10	1.68	3.9
Doubtful	0.89	0.79	1.4
Loss	1.03	0.82	1.2
Nonperforming loans/Total loans	**3.05**	**3.36**	**6.64**
Classified total	**100.0**	**100.0**	**100.0**
Specific reserves[4]	**1.20**	**1.25**	**1.33**

[4] Specific reserves as a % of total gross loans.

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	82.06	35.30
Government sector	3.14	2.93
Corporate	14.80	61.77
Foreign		
Other		
Total	**100.0**	**100.0**

The structure of deposits and loans in 2008 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	24.2	Long term loans	46.6
Within one year	72.6	Medium-term loans	20.0
Over one year	2.7	Short-term loans	33.4
Total	**100.0**	**Total**	**100.0**

Proportion of foreign exchange assets and liabilities[5]*
(at year-ends)

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Banks	44.23	46.75	48.9	44.03	46.92	48.5

[5] Specific reserves as a % of total gross loans.

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

Revenues	2006	2007	2008
Total interest income	35,988.82	48,642.55	60,159.25
Treasury and Interbank Transactions	4,446.6	6,334.47	5,961.44
Interest Received from costumers	15,049.07	23,415.69	32,787.89
Interest Received from securities	16,327.32	18,791.08	21,310.63
Other interest received	165.83	101.31	99.29
Total interest expense	14,452.06	21,222.44	29,380.91
Interest expense on treasury and interbank transactions	520.17	1,266.95	3,184.17
Interest paid to costumers	13,341.90	19,057.11	25,494.19
Interest expense on securities	528.19	842.87	619.18
Other interest income	61.79	55.51	83.36
Net interest income = total interest income minus total interest expenses	21,536.77	27,420.11	30,778.34
Other income	6,110.68	6,704.55	9,963.06
Other expense	1,771.45	1,068.75	3,388.08
Net result-other income minus other expense	4,339.23	5,635.80	6,574.99
Provisioning expenses	2,615.18	3,466.10	8,454.13
Gross income	23,260.81	29,589.82	28,899.21
Gross expense Of which: Personnel Expenses	13,504.80 5,072.73	16,244.42 6,264.79	20,123.72 7,696.70
Net income	9,756.01	13,345.39	8,775.49
Net extraordinary income (Loss)	-75.58	209.56	28.33
Taxes other than income taxes	34.23	47.75	94.94
Income before taxes	9,646.20	13,507.21	8,708.88
Income tax	2,195.63	2,940.54	1,373.20
Net income after taxes	**7,450.58**	**10,566.67**	**7,335.68**

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds[6]	/Total liab.[7]
	In million EUR	%	In million EUR	%
Banks	412.87	6.13	473.47	7.03
Financial institutions, average				

[6] Regulatory capital
[7] Liabilities + Capital

2008 DEVELOPMENTS IN THE AUSTRIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2008, the economic boom in Austria came to an end. At 1.6%, full-year 2008 GDP growth had been slashed in half compared with the previous years of dynamic expansion: from 2005 to 2007, the Austrian economy had posted annual growth rates of between 3.0% and 3.3%. Despite the drop, Austria still fared significantly better than most other EU Member States in 2008. In light of the troubled external environment, Austria's economic growth stayed astonishingly strong even toward the end of 2008 because exports declined only comparatively moderately and because private consumption increased fairly vigorously. The Austrian economy is likely to have benefited from the extraordinarily buoyant employment growth observed in 2007 and 2008 and, toward end-2008, the clear downtrend in inflation. Furthermore, country-specific factors helped bolster economic growth: Owing to solid order books, construction remained relatively robust, and tourism turned in a stellar performance.

The harmonized index of consumer prices (HICP) was down to 1.5% in December 2008, having peaked at 4.0% (against the same month of 2007) in June 2008. Annual inflation thus averaged 3.2%, the highest level since 1993. The upward pressure on prices was mainly fueled by the massive global rise in crude oil and commodity prices. In the final months of 2008, the base effect of the decline in the price of crude oil since October 2008 as well as easing food price pressures substantially dampened inflation.

The labor market benefited significantly from the past economic boom. At 3.5%, the unemployment rate (Euro stat definition) was lowest in May 2008. Averaged out over the year, unemployment equaled 3.8%, the lowest yearly rate since 2001. Of the EU-27 group (average 7.0%), Austria posted the third-lowest jobless rate. The marked economic slowdown started to leave its mark on the labor market as of November 2008. Employment growth weakened noticeably on the previous months.

The general government deficit of 2008 remained comparatively small at 0.4% of GDP (2007: 0.5%). Extraordinarily strong employment growth in the first three quarters of 2008 and relatively high inflation favored revenue developments. The effects of measures aimed at mitigating inflationary effects on households and previously agreed tax increases (e.g. of the petroleum tax) were relatively minor in 2008. By contrast, the debt ratio expanded from 59.4% (2007) to 62.5% (2008) of GDP, which was partly due to reserves set up for the bank support package.

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

With regard to structured credit products Austrian banks have benefited from their relatively moderate exposure totaling only 1.5% of the total balance sheet. Therefore, the direct impact of the subprime crisis was limited. Nevertheless profitability was markedly hit by indirect effects of financial market turbulences. But due to the solid business model of the Austrian banks, profitability was also positive in 2008 even though positive results where driven by Central, Eastern and Southeastern Europe (CESEE) activities.

Most important source of income was interest income which increased by 11.5% yoy by the end of 2008. Negative effects could be seen in fee and commission income which reduced at the same time by 10.4% yoy, a negative trading income of approximately 0.8 bn EUR and increasing risk costs. Nevertheless (also driven by one-time effects and non-repetitive events in securities and investment earnings) total operating income increased by 17.4% yoy. Due to a smaller growth of operating expenses (5.2% yoy) the unconsolidated cost-income ratio decreased to 55.5%.

The ongoing dynamic activities of the Austrian banks in CESEE contributed substantially to a positive result. In 2008, Austrian banks' CESEE business already accounted for 31% of consolidated total assets. Taking also these activities into consideration consolidated Return on Asset (after taxes) was 0.1% and Return on Equity (after taxes) was 1.9% per 2008. Despite a stronger performance in the first quarter of 2009 than in recent periods, macroeconomic developments will have negative impact on loan quality and will lead to increasing provisioning for Austrian banks.

Despite financial market turmoil Austrian banks were able to sustain their risk-bearing capacity in 2008. Furthermore, the Austrian banking support package will lead to further increasing capital ratios in 2009. Per end of 2008, Austrian banks had a consolidated capital adequacy ratio of 11.0% and a consolidated Tier I ratio of 7.7%.

By the end of 2008 total consolidated assets of Austrian banks amounted to approximately 417% of Austrian GDP.

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

Legal and institutional framework – Scope of responsibility

The Austrian Financial Market Authority (FMA) is an independent, autonomous and integrated supervisory authority for the Austrian Financial Market, established as an institution under public law. It is responsible for the supervision of credit institutions („banks"), insurance undertakings, pension funds, staff provision funds, investment funds, investment service providers, companies listed on the stock exchange as well as stock exchanges themselves.

Reform of 2008 – Banking Supervision NEW

In 2008 a new reform called "Banking Supervision NEW" entered into force. In the field of banking supervision there is now a division of tasks between the FMA and the OeNB (Oesterreichische Nationalbank – Austrian Central Bank).

Under the new regulatory framework tasks are divided between the FMA and OeNB according to their core area of skills. Generally, the OeNB is entrusted with fact-finding tasks (e.g. reporting, economic analysis and on-site inspections) whilst the FMA is the decision-making body, in the capacity of the authority that assesses, takes decisions and enforces the law.

Thus the FMA remains the independent, autonomous and integrated supervisory authority solely responsible to enforce the law, conduct official processes (e.g. granting of licenses) and promotes further development of the law. In terms of international cooperation, it is also the FMA, in the capacity of consolidating supervisor, who is in charge.

Mission and legal competence

In accordance with its statutory mandate, the FMA is responsible for monitoring the credit institutions' compliance with the statutory framework provisions pertaining to the banking business (minimum capital requirements, large exposure rules, fit & proper requirements etc.), ascertaining facts in cases involving the endangering of creditors' interests and taking appropriate remedial measures.

In order to carry out these tasks, the FMA is obliged and authorized to take a number of supervisory measures [see answer to Question 5]. These include exercising the right to demand information from credit institutions, to prevent them from taking certain actions or to intervene in their affairs. Furthermore the FMA may ask the OeNB (Austrian Central Bank) to carry out on-site inspections or special analyses of a special credit institution. As written above the FMA now bases its decisions related to an institution's financial situation mainly (if not exclusively) on the findings of the OeNB.

If there is a danger to the fulfillment of the credit institution's obligations towards its creditors (i.e. if there is danger of insolvency), the FMA may prohibit the withdrawal or distribution of capital and earnings, appoint a special government commissioner to supervise the credit institution from within, remove management personnel or completely or partly prohibit the continuation of business operation.

In case of persistent and serious violation of legal obligations the FMA may impose fines or interest payments, remove management personnel or even withdraw the license.

In case the violation of the BWG results in an inadequate coverage of the risks faced by the (group of) credit institution(s), the FMA shall – irrespective of other measures – oblige the respective institution to hold own funds in excess of the minimum level (capital – add on).

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

The FMA's mains strategic objects in the field of banking supervision for 2008 were:

- **Strengthening the supervision by further**
    - increasing the number and intensity of on-site inspections and
    - by introducing a risk-based structured dialogue with the industry (management talks, CEE-talks, risk talks);
- Efficient handling of **national and cross-border IRB- and AMA-approval processes**;
- **Internal processes** and relation to the OeNB (Oesterreichische Nationalbank) are adapted to the new regulatory framework:
    - Intensifying collaboration and dialogue with the OeNB.
    - Establishment of a single point of contact (SPOC) in both FMA and OeNB for every credit institutions.
    - Joint database of FMA and OeNB.
- **Strengthening the involvement of the external auditor and the state commissioner** in the supervisory process; Auditors and state commissioners realize their role in the hierarchy of supervision.
- Further improvement of **analytical tools and systems**;
- Further intensifying of the concept of **consolidating supervision** and contributing to the Lamfalussy Process.
- **Know-How and expertise of supervisory staff is further improved**.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Sources of information

In 2008, the banking supervisory authority made use of its right to demand information in about 179 cases. Apart from these formal ad-hoc information request the FMA based its decisions on various sources such as the credit institution's financial statements, the reports of auditors and state commissioners, as well as on standardized meetings with the management of numerous credit institutions, the so called management talks.

Another important source of information is the on-site inspections and analyses now solely conducted by the OeNB. In 2008, the OeNB conducted 39 on-site inspections on behalf of the FMA.

Licensing

As banking supervisor the FMA is also responsible for granting, extending or withdrawing licenses. In 2008 the FMA granted 5 new licenses and enlarged 15 existing ones[8]. In one case it refused to grant a license and in another it declared a license to be expired.

[8] Extending a license means to allow an existing credit institution to conduct additional banking business.

Supervisory measures to enforce the law

As mentioned above the FMA my take supervisory measures if there is danger to the fulfillment of a credit institution’s obligations (danger of insolvency) or if a credit institution persistently breaches the law. In 2008 no measures had to be taken due to a danger to fulfillment of a credit institution’s obligation.

However in two cases a formal order to cease a breach of law had to be issued. Since the two institutions involved complied immediately, now follow-up measures (e.g. fines) were necessary.

Furthermore, the FMA may impose interest payments on a credit institution if the institution’s capital exceeds or falls below certain regulatory threshold, e.g. concerning liquidity rules or minimum capital. In 2008 the FMA had to impose interest payments 46 times.

Model approval

Since implementation of the Basel II Directives on January 1, 2007, credit institutions and groups of credit institutions with head offices in Austria have been permitted, with the approval of the FMA, to apply internal ratings-based models (IRB) for calculating their regulatory capital requirements in the area of credit risk. With the beginning of 2008 they are also allowed to apply models to calculate their capital requirements in the area of market and operational risk.

In 2008 the FMA approved 14 models to calculate the credit risk capital requirement, one operational risk model and one market risk model.

The model approval procedure is slightly more complex in the case of a cross-border group: as home supervisor for a patent credit-institution and its subsidiaries the FMA has to coordinate all national supervisors involved to allow the agreement on a joint decision. The joint decision allows for an approved model to be used by all credit institutions of a group. In 2008 the FMA conducted and completed two cross-border model approval procedures. Further cross-border procedures of internationally active groups were initiated in 2008 and are expected to be completed in 2009.

Consolidating supervision

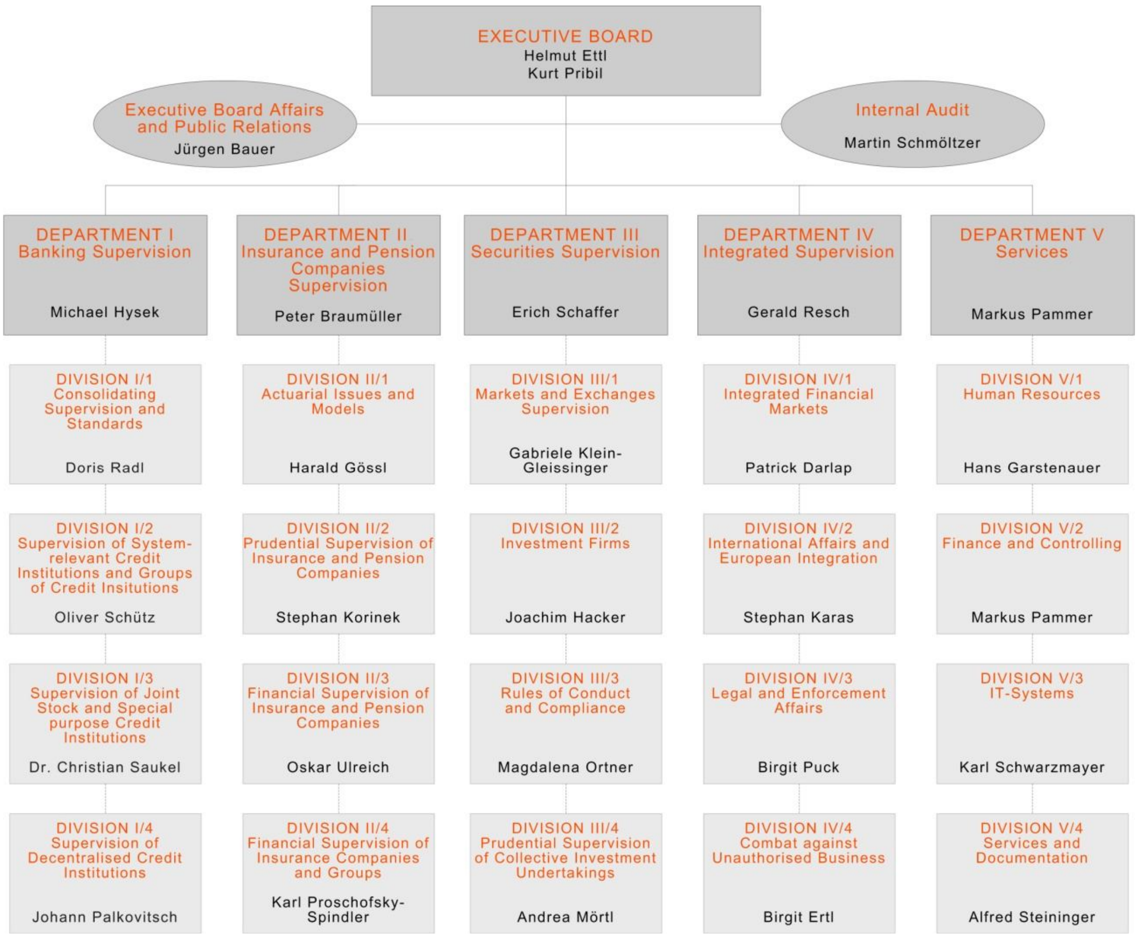
The role of the consolidating supervisor (i.e. the home supervisor) of a European group of credit institutions includes steering the cross-border approval processes (see "Model approval"), as well as coordinating continued supervision of the entire group of credit institutions. In both cases, employees from the European supervisory authorities meet regularly. In the case of model approval processes these meetings are referred to as cooperation meetings, whilst they are referred as supervisory colleges when dealing with general, continued supervision. Cooperation meetings and supervisory colleges are conducted in close cooperation with OeNB.

As said above, in 2008 two central cooperation meetings with the FMA acting in the capacity of home supervisor were held as part of ongoing approval processes. Up to seven supervisory authorities from other Member States participated in these. Smaller working meetings were also held in parallel.

The supervisory colleges deal with continued supervision issues, particularly the overall risk situation and management of a group of credit institutions as defined under Pillar 2 of Basel II (SREP - Supervisory Review and Evaluation Process).

The FMA, in the capacity of home supervisor, held three supervisory colleges devoted to cross-border groups of credit institutions in autumn 2008. Representatives from a total of 17 supervisory authorities took part in the supervisory colleges. The authorities involved were predominantly those of the Member States in which the Austrian credit institutions are particularly strongly represented (see "Market presence of Austria's major banks in Central, Eastern and South-Eastern Europe")

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY AND COOPERATION WITH OTHER SUPERVISORY BODIES IN AUSTRIA

International cooperation and fostering relationship with other supervisory authorities, with a special focus on CESEE countries is one of the major goals of the FMA.

To this end, the FMA organised jointly with the World Bank and the Joint Vienna Institute a follow up measure to the CESEE conference which was held in Austria in June 2007. This follow up event, which took place between 16 and 19 March 2009 was especially addressed to CESEE countries and aimed at information exchange and information sharing on a broad range of issues of common supervisory challenges. Apart from presentations and discussions on various topical issues pertaining to on-site inspections, aspects of colleges, model validation within the framework of Basel II implementation, it also served as a very useful tool of personal networking mechanism at a more technical level. The fact that this event proved to be a very successful and fruitful event can also be credited to the active participation of many participants from CESEE countries.

As CESEE countries are at the core of FMA activities reflecting the business activities of the main larger Austrian banking/ insurance groups, the FMA endeavours to further improve the cooperative dialogue and the existing fruitful contacts with supervisory authorities of Central and Eastern and South Eastern countries in particular. Special attention is being paid to those countries where market presence of the Austrian financial institutions is particularly strong.

Accordingly, supervisory colleges organised by the FMA as home supervisor within the concept of the Capital Requirement Directive are not limited to EU Member States, but open to all those CESEE countries which belong to the consolidating Austrian banking groups, irrespective whether they are EU Members or not. This very open approach served as a model for other EU Member States.

In addition, high level visits by FMA's CEOs took place in several CESEE countries as a personal trust building measure as well as enhancing coordinated measures in the field of banking supervision. These high level meetings were complemented by various bilateral meetings as part of strategic partnerships and ongoing cooperation in various areas of supervision and at different technical levels.

In 2008, meetings were held with the banking regulators of the following countries: Bulgaria, Croatia, Germany, Hungary, Romania, Russia, the Slovak Republic, Slovenia, Turkey and Ukraine. In 2009 already high level meetings with Rumania, Croatia and Hungary took place. At the level of Managing Director meetings were held with the authorities of Bosnia and Herzegovina, to be followed by a workshop with the Russian Central Bank in July on various technical issues and macro information sharing.

Each year, the so-called "4-Länder Treffen" (the Meeting of Liechtenstein, Switzerland, Germany and Austria) takes place in order to discuss current challenges that are specific for those countries.

Further to the tenth meeting "Integrated Financial Supervisors Conference" which was held in Vienna in June 2008, the CEO of the FMA participated actively in this year's meeting held in Amsterdam (June 2009), which was particularly devoted to lessons learnt from the current financial crisis and related issues.

In addition, the FMA is in regular contact with the relevant supervisory authorities in the USA, in order to foster information exchange in the banking and insurance area.

On a more operational level FMA staff also visited fellow authorities abroad for the purpose of training and exchange of experience, while the FMA/ OeNB also hosted similar events.

Concluding, the FMA is represented in CEBS (Committee of European Banking Supervisors), CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) and CESR (Committee of European Securities Regulators) and actively participates in several respective working groups.

Last but not least, the Managing Director of the FMA Insurance Department currently chairs the International Association of Insurance Supervisors

COOPERATION WITH OTHER SUPERVISORY BODIES IN AUSTRIA

<u>Cooperation with the OeNB</u>

The new supervisory framework introduced a new division of tasks between FMA and OeNB (see answer to question 3). The clearly demarcated division of labor requires ongoing intensive dialogue between the two institutions at all levels. New coordination mechanisms and institutions have therefore been developed and applied to the individual institutions being supervised.

SPOC system

A single point of contact (SPOC) has now been appointed for each credit institution at both the FMA and OeNB. These contacts are responsible for ensuring that both institutions always have access to the same level of information and knowledge on the credit institution in question and that all activities on the part of the FMA and OeNB with regard to this institution are coordinated. At the same time, these single points of contact are the credit institution's direct contact persons within the supervisory system. A central contact person for supervision, the "banking SPOC", is also to be appointed in 2009 for each credit institution.

Individual bank forum (EBF)

The EBF deals with issues specific to the individual bank and ensures that all of the relevant information and perspectives are incorporated into the decision-making process on any official measures to be taken by the FMA. The forum is constituted on a case-by-base basis, with its potential members representing all levels, from the SPOCs through to the Executive Board/Governing Board.

ALF & KOFO

The two coordination mechanisms which have long been institutionalized - the heads of department forum (ALF) and the coordination forum (KOFO) -

will remain in place. Whilst cooperation at the level of heads of department is coordinated and strategic supervisory issues considered in the ALF, the KOFO deals with fundamental supervisory issues between the FMA and OeNB at the level of the Executive Board/Governing Board.

Cooperation FMA – OeNB – Ministry of Finance (MoF)

In order to develop a platform for the institutions responsible for the Austrian financial market, the Financial Market Committee was established. It consists of one representative of each of the three bodies (FMA, MoF, OeNB) and meets at least on a quarterly basis at the Federal Ministry of Finance. The committee was designed to encourage cooperation as well as giving feedback on the economic situation and challenges of the Austrian financial sector. Some of the topics discussed can be domestic legal issues, political aspects concerning the financial market or upcoming EU directives and their impact on Austria.

Other cooperation

Apart from the continuous and intensive dialogue with the Ministry of Finance and the Austrian Central Bank, the FMA is also in regular contact with all public authorities or enterprises relevant, e.g. the Austrian stock exchange, the police or the department of public prosecution.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Joint stock banks and private banks	48	51	52
Savings banks	56	56	55
State mortgage banks	10	11	11
Raiffeisen credit cooperatives	567	558	551
Volksbank credit cooperatives	70	69	68
Building and loan associations	4	4	4
Special purpose banks	116	121	126
Financial institutions, total	**871**	**870**	**867**

Source: OeNB

Ownership structure of the financial institutions[9]
on the basis of registered capital (%)
(at year-ends)

Type of financial institution	2006	2007	2008
Public sector ownership	2.4	2.4	5.4
Other domestic ownership	71.7	62.2	66.6
Domestic ownership total	74.1	64.6	72.0
Foreign ownership	25.9	35.4	28.0
Financial institutions, total	**100.0**	**100.0**	**100.0**

Source: OeNB. Only stakes above 50% are included. Ownership shares are weighted with 100%.

[9] Financial institutions are credit institutions which are reported at OeNB.

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

Type of financial institution	2006	2007	2008
Public sector ownership	5.1	5.2	6.3
Other domestic ownership	73.0	68.1	52.3
Domestic ownership total	78.1	73.3	58.6
Foreign ownership[10]	21.9	26.7	41.4
Financial institutions, total	**100.0**	**100.0**	**100.0**

Source: OeNB. Only stakes above 50% are included. Ownership shares are weighted with 100%.

Concentration of asset by the type of financial institutions (within type of institution)

Type of institutions	The first three largest (%)	The first five largest (%)
Joint stock banks and private banks	77.73	85.31
Savings banks	71.39	80.04
State mortgage banks	58.2	75.3
Raiffeisen credit cooperatives	54.65	61.01
Volksbank credit cooperatives	65.86	71.29
Building and loan associations	91.37	100.0
Special purpose banks	66.48	73.07

Source: OeNB. Unconsolidated data.

Return on Asset (ROA) by type of financial institutions[11] (%)

Type of financial institution	2006	2007	2008
Joint stock banks and private banks	1.45	0.81	0.26
Savings banks	0.65	0.77	0.2
State mortgage banks	0.49	0.32	-0.42
Raiffeisen credit cooperatives	1.09	0.99	0.35
Volksbank credit cooperatives	0.41	0.46	0.53
Building and loan associations	0.28	0.31	-0.47
Special purpose banks	0.32	0.28	0.15*

Source: OeNB. Consolidated data.
* adjusted by one reclassification

[10] Includes also subsidiaries from foreign credit institutions.
[11] ROA = Profits after taxes/Total assets

Return on Equity (ROE) by type of financial institutions[12] (%)

Type of financial institution	2006	2007	2008
Joint stock banks and private banks	34.1	16.74	5.61
Savings banks	19.69	21.84	5.24
State mortgage banks	15.53	7.88	-8.78
Raiffeisen credit cooperatives	20.73	17.28	6.05
Volksbank credit cooperatives	9.05	10.55	8.86
Building and loan associations	6.14	6.2	-14.53
Special purpose banks	18.34	18.57	10.51*

Source: OeNB. Consolidated data.
* adjusted by one reclassification

Distribution of market shares in balance sheet total (%)

Type of financial institution	2006	2007	2008
Joint stock banks and private banks	30.06	28.32	28.76
Savings banks	17.54	17.24	16.51
State mortgage banks	9.13	9.94	9.05
Raiffeisen credit cooperatives	24.11	23.95	24.89
Volksbank credit cooperatives	6.47	7.59	7.39
Building and loan associations	2.68	2.4	2.08
Special purpose banks	10.02	10.56	11.32
Financial institutions, total	**100.0**	**100.0**	**100.0**

Source: OeNB. Unconsolidated data.

[12] ROE = Profits before taxes/Core capital

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

Assets	2006	2007	2008
Cash Reserve	2.22	2.46	3.0
Claims against Credit Institutions	19.90	19.67	n.a.
Claims against Customers	49.14	51.29	n.a.
Total Claims	n.a.	n.a.	69.62
Bonds, Stocks, debt instrument	8.48	6.77	18.34
Shares in affiliated enterprises	12.19	11.32	1.38
Other Assets	6.02	6.27	7.66
Total Assets	**100**	**100**	**100**
Liabilities	**2006**	**2007**	**2008**
Amounts owed to credit institutions	23.18	22.35	21.84
Amounts owed to customers (nonbanks)	40.19	41.05	40.62
Debt evidenced by certificates	21.29	21.08	28.97
Supplementary capital	2.64	3.24	n.a.
Equity	5.01	5.17	5.45
Other Liabilities	7.69	7.11	3.13
Total Liabilities	**100**	**100**	**100**

Source: OeNB. Consolidated data.
*In 2008 structural break due to change in consolidated financial reporting.

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

Type of financial institution	2006	2007	2008
Joint stock banks and private banks	340	426.29	322.2
Savings banks	252.55	257.54	314.51
State mortgage banks	96.69	84.4	83.64
Raiffeisen credit cooperatives	143.56	142.61	147.81
Volksbank credit cooperatives	178.38	182.6	184.32
Building and loan associations	19.03	23.19	17.29
Special purpose banks	85.22	77.53	73.0
Financial institutions, total	**208.13**	**228.56**	**211.16**

Source: OeNB. Unconsolidated data. Off-balance sheet items including derivatives.

Solvency ratio of financial institutions (%)

Type of financial institution	2006	2007	2008
Joint stock banks and private banks	11.93	11.68	10.05
Savings banks	10.02	10.6	9.58
State mortgage banks	11.9	12.34	12.09
Raiffeisen credit cooperatives	12.01	11.92	11.95
Volksbank credit cooperatives	11.64	11.97	10.46
Building and loan associations	22.39	23.52	12.9*
Special purpose banks	10.0	11.7	12.2
Financial institutions, total	**11.60**	**11.59**	**11.02**

Source: OeNB. Consolidated data.
*Decline due to reclassification in banking sample.

Asset portfolio quality of the banking system[13]

Asset classification	2006	2007	2008
Non performing loans	2.1	1.7	n.a.
Specific loan loss provisions	2.9	2.4	2.3

Source: OeNB.

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	70.56	39.36
Government sector	4.73	8.12
Corporate	16.08	43.28
Other[14]	8.63	9.23
Total	**100.0**	**100.0**

Source: OeNB. Unconsolidated data for domestic customers (nonbanks) in local and foreign currency.

[13] All data are in percent of total claims.

[14] Including (amoung others) nonbanks, financial intermediaries

The structure of deposits and loans in 2008 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	21.24		
Within one year	50.78	Within one year	39.05
Over one year	27.77	Over one year	53.05
Undefined	0.2	Undefined	7.9
Total	**100.0**	**Total**	**100.0**

Source: OeNB. Unconsolidated data for banks and nonbanks.

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Joint stock banks and private banks	18.38	17.93	23.59	16.28	13.52	19.91
Savings banks	25.73	23.69	23.77	24.44	21.87	19.4
Raiffeisen credit cooperatives	20.71	19.61	17.19	19.46	17.36	13.72
Volksbank credit cooperatives	19.92	16.71	18.58	13.29	9.42	9.52
Building and loan associations	-	-	-	-	-	-
Special purpose banks	8.01	10.75	9.57	32.27	31.64	30.76
State mortgage banks	16.77	15.63	16.5	21.09	18.81	19.81
Financial Institutions, total	**18.67**	**17.79**	**19.78**	**19.91**	**17.73**	**18.32**

Source: OeNB. Unconsolidated data.

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

Revenues	2006	2007	2008
Interest and similar income	29,366	37,656	45,845
Income from securities and participations	2,878	3,521	7,193
Fee-based income	6,126	6,658	6,036
Net profit or loss on financial operations	688	289	-812
Other operating income	1,580	1,592	1,710
Interest and similar income	29,366	37,656	45,845
Expenditures	**2006**	**2007**	**2008**
Interest payable and similar charges	22,196	30,256	37,597
Total fees payable	1,837	1,948	1,818
General administrative expenses	8,960	9,171	9,727
Depreciation and amortization	647	614	641
Other Operating expenses	1,180	1,063	1,047

Source: OeNB. Unconsolidated data.

Structure of registered capital and own funds of financial institutions in 2007

Type of financial institution	Registered capital in 1000 EUR	/Total assets in %	Own funds in 1000 EUR	/Total liab. in %
Joint stock banks and private banks	4,397,370	1.33	20,326,258	6.13
Savings banks	634,026	0.32	11,727,160	5.82
State mortgage banks	1,157,667	1.12	7,104,209	6.88
Raiffeisen credit cooperatives	723,137	0.21	26,544,712	7.82
Volksbank credit cooperatives	510,230	0.66	6,193,194	8.07
Building and loan associations	72,413	0.42	821,126	4.71
Special purpose banks	561,251	0.6	1,858,819	2.0
Financial institutions, average	**8,056,094**	**0.69**	**74,575,478**	**6.35**

Source: OeNB. Consolidated data.

2008 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF BELARUS

MACROECONOMIC ENVIRONMENT

Macroeconomic situation in the Republic of Belarus in 2008 was characterized by positive dynamics of the main macroeconomic indicators. In 2008 Q4, the pace of product manufacturing and sales was slowing which had an adverse effect on the economic condition of some enterprises and foreign exchange market and brought about an increase in non-payments and finished stock of industrial organizations.

In 2008, GDP increased by 10 % on the previous year.

Inflation in the consumer market was 13.3 %, compared with 12.1 % in 2007.

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

As at January 1, 2009, the banking sector of the Republic of Belarus included 31 operating banks and 323 branches. Eight representative offices of foreign banks were operating in the Republic of Belarus.

Foreign capital participated in the authorized capital of 25 banks, including eight wholly-foreign owned banks. As at January 1, 2009, the share of non-residents in the aggregate authorized capital of the Belarusian banks amounted to 17 %. In four banks the share of the state (the State Committee on Property of the Republic of Belarus) exceeded 50 % of the authorized capital.

In 2008, the banks' aggregate authorized capital grew by 91.9 %, amounting to BYR8,678.6 billion as at January 1, 2009 (EUR2.8 billion in equivalent).

In the year under review, the assets (liabilities) of the banking sector increased by 51.3 %, amounting to BYR63,061.7 billion (EUR20.5 billion in equivalent), and "assets/GDP ratio" rose from 35.2 to 39.7 %.

The banks' profits in 2008 amounted to BYR729.8 billion, exceeding 1.2 times the profit obtained in 2007. Profitability indicators15 of the banking sector were as follows:

- "profit/assets ratio" – 1.4 % (compared with 1.7 % as at January 1, 2008); and
- "profit/own capital ratio" – 9.6 % (compared with 10.7 % as at January 1, 2008).

[15] Profit after taxation is used in the calculation of the indicator.

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

In 2007, the National Bank performed self-assessment of legislation of the Republic of Belarus and its implementation for compliance with the revised version of the Core Principles for Effective Banking Supervision published by the Basel Committee on Banking Supervision in 2006. Following consultations with the World Bank/IMF experts in September 2008, a Plan of Actions was designed for implementing the IMF/WB recommendations under the FSAP (2008).

With a view to liberalizing conditions for attracting foreign investments to the banking sector of the Republic of Belarus the participation (quota) of foreign capital in the Belarusian banking system was raised from 25% to 50%.

On January 1, 2009, the minimum regulatory capital requirement applied to the operating banks which are licensed to attract natural persons' deposits as well as to those banks that claim such right was increased from EUR10 million to EUR25 million, in the equivalent.

The enactment of the Law of the Republic of Belarus "On Credit Histories" dated November 10, 2008 contributed to the development of the banking sector's infrastructure. Under the Law, the following types of agreements concluded by banks will be included in credit histories beginning August 21, 2009: credit agreements, overdraft lending agreements, loan agreements, pledge agreements, surety agreements, and guarantee agreements.

The National Bank has streamlined the procedures for bank auditing, continued its efforts to improve corporate management and banks' risk management, to bring the requirements for provisioning for assets and contingent liabilities exposed to credit risk into line with international standards, and to enhance consolidated banking supervision.

LEGAL COMPETENCE OF THE BANKING SUPERVISION AUTHORITY

In the Republic of Belarus the supervisory functions are entrusted to the central bank of the country - the National Bank, which incorporates a special supervisory unit - the Banking Supervision Directorate.

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

- state registration of banks and licensing of banking activity;
- development of the corresponding economic standards with a view to maintaining stability and soundness of the banking system;
- development of rules and procedures for banking operations;
- on-site inspection of a bank and evaluation of risks related to its functioning;

- revealing infringements of banking legislation and application of corresponding sanctions;
- execution of foreign exchange control;
- specification of the rules of publication and contents of information which is published to assess the degree of reliability of banks and non-bank financial institutions;
- analyses of banks' reports;
- regulation of the foreign capital access to the banking system of the country; and
- regulation of banks' reorganization and liquidation.

Besides, the system of guaranteeing the repayment of funds attracted by banks from natural persons is used in the Republic of Belarus. It is governed by the regulations of the Republic of Belarus and is formed at the expense of the monthly irrevocable payments of banks licensed to accept deposits from natural persons that are accumulated with the Agency of Deposit Compensation.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

In 2008, the primary objective of the National Bank was to ensure stability of the banking system of the Republic of Belarus and protection of the banks' creditors and depositors. The above-mentioned objective was achieved by:

- setting up prudential limits with respect to banking risks, capital and reserves adequacy requirements which are in conformity with international practice and take into account the economic situation in the country;
- execution of the efficient day-to-day supervision over banks by analyzing their official reports and inspecting them;
- timely application of remedial measures which ensure the banks' paying capacity, liquidity, and soundness;
- assuring adequate professional skills and reputation of the banks' top managers.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

The National Bank carries out a three-way supervision of banks: off-site supervision, inspections of banks and macroprudential supervision.

Off-site supervision is a component part of the ongoing supervision over a bank and is based on the analyses of balance sheet and prudential reports, inspection materials, and other relevant information provided by banks.

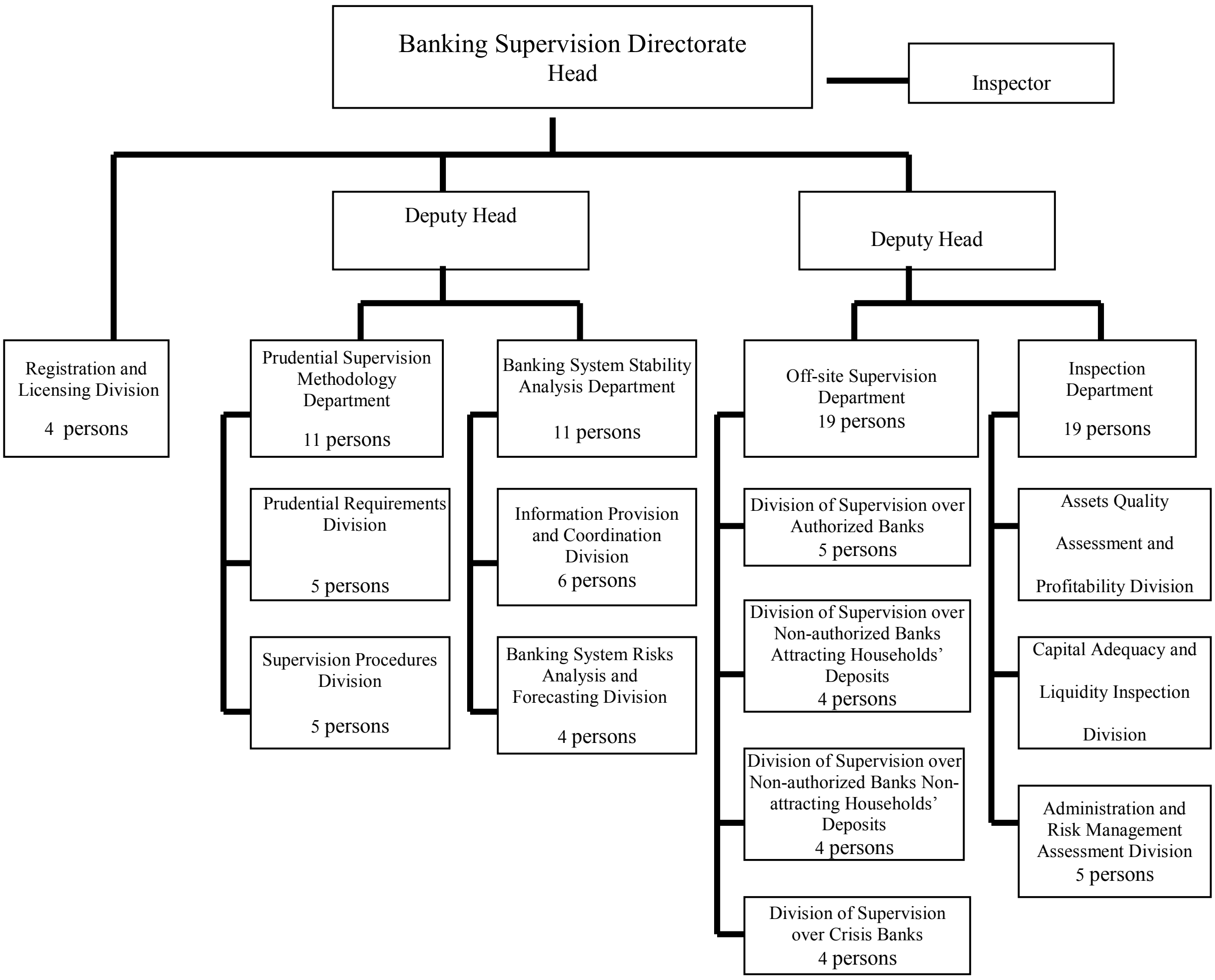
The banks' compliance with the secure functioning requirements was constantly followed throughout the year. Efforts directed towards discontinuation of granting preferences regarding banks' compliance with the prescribed prudential regulations and limitations continued. The National Bank was engaged in strengthening supervision in the area of an in-depth analysis of performance indicators, early identification of negative trends and crisis situations, and implementation of the entire range of supervisory response measures.

The National Bank inspects banks in order to reveal on-site their real financial situation and to assess the risks assumed by the bank, the state of the internal control system, organization of management, compliance with the prescribed prudential requirements, accuracy of transactions in book-keeping, and validity of reports.

In 2008, the National Bank conducted eight comprehensive inspections in the banks.

In 2008, development of macroprudential supervision aimed at facilitating stable functioning of the banking sector as a whole by means of the comprehensive assessment of the systemic banking risks continued at the National Bank of the Republic of Belarus. Alongside with the monitoring and analysis of the tendencies in the dynamics of the financial stability indicators the key instruments of the macroprudential analysis are the analysis of scenarios, stress-tests and systems of early warning of problem situations.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE 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 in which the representative offices of Belarusian banks are located and whose banks have set up subsidiaries and representative offices in the Republic of Belarus. By end-2008, eleven bilateral agreements with foreign banking supervision agencies were in force, chiefly from the CIS member-states and Baltic countries.

In May 2008, the National Bank, in concert with the Group of Banking Supervisors from Central & Eastern Europe (BSCEE) and the Financial Stability Institute (FSI), held in the Republic of Belarus an international seminar - "The Revised Core Principles for Effective Banking Supervision". 38 participants from 18 member states of the BSCEE and FSI, including representatives of the National Bank of the Republic of Belarus, discussed problems relating to the improvement of banking supervision, including the methodology of implementing the principles of effective banking supervision and assessment of risk-management.

In January-February and in September 2008, the IMF missions visited the National Bank with a view to holding consultations on:

- the improvement of procedures for credit risk management in banks;
- the development of a system for macroeconomic stress-testing and preparation of the financial stability report; and
- the review of the FSAP.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE REPUBLIC OF BELARUS

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

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF 2008

More detailed information about the development of the banking system and the banking supervision in the Republic of Belarus may be obtained at the official site of the National Bank of the Republic of Belarus (www.nbrnb.by/engl/publications/regulrep/).

STATISTICAL TABLES

Number of financial institutions (head offices/branches) (at year-ends)

Type of financial institution	2006	2007	2008
Commercial banks	30	27	31

*) Number of acting financial institutions

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

Type of financial institution	2006	2007	2008
Public sector ownership	87,92	86,27	80,58
Other domestic ownership	4,24	3,89	2,46
Domestic ownership total	92,16	90,16	83,04
Foreign ownership	7,84	9,84	16,96
Financial institutions, total	**100,00**	**100,00**	**100,00**

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

Type of financial institution	2006	2007	2008
Public sector ownership	79,03	76,50	77,88
Other domestic ownership	6,32	3,84	1,56
Domestic ownership total	**85,35**	**80,34**	**79,44**
Foreign ownership	14,65	19,66	20,56
Financial institutions, total	**100,00**	**100,00**	**100,00**

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Bank	71,20	69,79	63,83	86,71	85,95	85,09

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

Type of financial institution	2006	2007	2008
Bank	1,70	1,70	1,37

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

Type of financial institution	2006	2007	2008
Bank	9,55	10,70	9,60

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

Type of financial institution	2006		2007		2008	
	Quantity of banks	market share	Quantity of banks	market share	Quantity of banks	market share
Bank's capital	29	100,00%	27	100,00%	31	100,00%
incl.						
negativ capital	1	0,28%	0	0,00%	0	0,00%
to 10 bln. roubles	4	0,10%	0	0,00%	0	0,00%
from 10 to 30 bln. roubles	7	1,34%	8	1,01%	5	0,28%
from 30 to 70 bln. roubles	10	7,60%	8	3,80%	14	3,41%
from 70 to 500 bln. roubles	5	27,69%	9	35,34%	7	11,22%
from 500 to 1000 bln. roubles	0	0,00%	0	0,00%	3	21,26%
more than 1000 bln. roubles	2	62,99%	2	59,85%	2	63,83%

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

Assets	2006	2007	2008
Cash assets, gold, precious metals	2,5%	2,6%	2,9%
Assets in the National Bank of the Republic of Belarus	1,8%	1,9%	2,6%
Accounts in other banks	5,2%	7,7%	7,4%
Required reserves	4,5%	2,4%	1,7%
Securities	8,7%	7,1%	6,8%
Credit to individuals and enterprises	72,0%	73,4%	74,1%
Permanent assets and intangibles	3,6%	3,4%	2,9%
Other assets	1,7%	1,5%	1,6%
Total Assets	**100,0%**	**100,0%**	**100,0%**
Liabilities	**2006**	**2007**	**2008**
Own capital	17,8%	15,8%	17,5%
Settlement and current accounts	12,8%	12,5%	12,8%
Correspondent accounts of other banks	0,5%	0,8%	0,3%
Deposits and credit resources of other banks	11,8%	14,0%	12,2%
Deposits of individuals and enterprises	47,6%	48,1%	47,2%
Credit resources of the National Bank of the Republic of Belarus	5,3%	3,8%	4,9%
Other liabilities	4,2%	5,0%	5,1%
Total Liabilities	**100,0%**	**100,0%**	**100,0%**

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

Type of financial institution	2006	2007	2008
Commercial banks	150,89%	154,07%	143,19%

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Commercial banks	24,4%	19,3%	21,8%

Asset portfolio quality of the banking system

Asset classification	2006	2007	2008
Loans, total	22 271,5	32 304,1	50 306,9
Extended loans	32,3	39,0	129,6
Past due loans	225,1	171,4	168,5
Doubtful loans			
Past due interest		9,4	
up to 30 days	147,1	131,2	76,7
more than 30 days			
Special reserves	330,7	398,8	609,4

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Commercial organizations	15,0%	23,6%
Households	50,6%	28,1%
Noncommercial organizations	32,6%	47,5%
Nonbank financial institutions	1,9%	0,8%
Total	**100,0%**	**100,0%**

The structure of deposits and loans in 2008 (%)
(at year-end)

Types of deposits		Types of loans	
Demand deposits	39,24%	Long-term lending	72,84%
Time deposits	60,76%	Short-term lending	27,16%
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.		
	2006	2007	2008	2006	2007	2008
Commercial banks	31,91%	36,45%	29,70%	31,79%	36,45%	29,71%

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

Revenues	2006	2007	2008
Interest revenues	2 082,4	3 215,1	4 776,5
Commission	878,3	1 060,7	1 481,3
Other revenues	313,0	422,3	1 035,2
Other operational revenues	92,6	140,5	96,6
Reserve settlement	109,7	178,2	252,1
Unanticipated revenues	-	-	11,5
Total revenues	**3 476,0**	**5 016,8**	**7 653,2**
Expenditures	**2006**	**2007**	**2008**
Interest expenses	1 195,6	1 980,9	3 182,2
Commission	102,7	162,2	233,1
Other expenses	33,5	63,8	511,2
Other operational expenses	1 515,8	1 914,3	2 413,1
Allocation to reserve	208,4	311,0	582,9
Unanticipated expenses	-	-	1,0
Total expenses	**3 056,0**	**4 432,2**	**6 923,5**
Economic revenue	**420,0**	**584,6**	**729,8**

Excluding banks under liqiudation

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR mln	%	EUR mln	%
Banks	2820,3	12,96%	3 676,8	16,89%

2008 DEVELOPMENTS IN THE BANKING SYSTEM OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

MACROECONOMIC ENVIRONMENT

According to the preliminary estimates[16], the nominal value of the GDP for Bosnia and Herzegovina in 2008 was KM 25.1 bn, which represents a nominal growth of 15.95%, compared to the year 2007 (KM 21.647 bn). The estimated growth rate of the real GDP was approximately 5.5%, which indicates that the growth trend from previous years continued, but this year, for the first time since 2005 (3.9%), somewhat slowly than the previous year (as of 2007, 6.84%).

According to the preliminary estimates, GDP for the Federation of Bosnia and Herzegovina for the year 2008 amounted to KM 15.080 mil, while GDP/capita amounted to KM 6.480. Comparing to the data of the year 2007, when GDP for the Federation of Bosnia and Herzegovina amounted to KM 13.735 mil, while GDP/capita amounted to KM 5.899, GDP nominal growth rate in the year 2008 was 9.8%.

During the year 2008 the industrial production volume continued to grow in Federation of Bosnia and Herzegovina (FB&H), despite the large drop of economic activities and global slowing that occurred and was increased by 7.9%, compared to 2007. When the industrial production trend is viewed in the course of 2008, compared with the 2007 respective months, FB&H recorded the growth of the industrial production in all of those months, but March 2008. The analysis of monthly trend of the industrial production index in 2008 indicates that the average monthly growth rate of the industrial production volume was 0.7% in FB&H. If the structure of the industrial production index is analyzed on a monthly basis 2007-2008 and decomposed among sectors, FB&H recorded production volume growth in mining by 21.4% and manufacturing industry by 11.3%, while the sectors of electricity, gas and water supply recorded decline of the production volume by 1.4%. Within the manufacturing industry, half out of 22 industry branches recorded production volume growth, with high growth rates (production of chemicals and chemical production, publishing and printing, production of tobacco products, production of metals, etc.).

Annual inflation in Bosnia and Herzegovina (B&H) in December 2008 amounted to 3.8% and is significantly lower than annual inflation rate in July (9.9%); the greatest increase of prices was recorded in the following items: housing, water-, electricity- and gas supply, etc. The most significant monthly increase of prices was recorded in January 2008, while in November and December of 2008 prices declined by 0.6%.

Average inflation in B&H during 2008, compared to 2007, amounted to 7.4% and is 5.9% higher than inflation in the year 2007 (average price

[16] Final data for the year 2008 will be available at the end of July 2009.

growth in 2007, compared to 2006, was 1.5%). Consumer Price Index composition in 2008 indicates that the greatest and average price increase was recorded among food and non-alcoholic beverages (12.1%) and transport (11.2%).[17] The annual inflation rate, recorded in December 2008 in B&H was only by 2.2% higher than the rate in the Euro Zone and by 1.6% higher than the inflation rate within EU 27.

The average net wage in the fourth quarter of 2008 in B&H amounted to KM 785, which constituted an increase of 2.3%, compared with the previous quarter, while it recorded an increase of 16.9% compared with the same period of the previous year.

The labor force survey in B&H for the year 2008 indicates a drastic decrease of unemployment in B&H: the unemployment rate decreased by 5.6 index points, compared to 2007. Number of unemployed persons during 2008 in B&H is around 272.000 persons (unemployment rate 23.4%), while the previous year recorded unemployed 347.000 persons. The highest unemployment rate in 2008 was recorded in Brcko District (31.9%), while FB&H recorded 25% unemployment rate.

In the fourth quarter of 2008, significant changes in the composition of gross foreign exchange reserves were recorded. Central Bank of B&H (CBBH) reduced deposits with non-residential banks by KM 440.5 million (by 8.5%). Also, investments in securities were reduced by KM 226 million (14.8%). Contrary to that, the amount of foreign currency held in the CBBH vaults increased by KM 125.1 million (by as much as 143.6%). Gross foreign exchange reserves, due to such significant decline in the fourth quarter, have also recorded a substantial decline at the annual level, in the amount of KM 402.8 million (6%).

At the end of the fourth quarter of 2008, the weighted average value of all active interest rates of commercial banks in B&H amounted to 8.21%, which is an increase by 28 basis points compared to the September 2008 level, and the increase by 42 basis points compared to the end of the fourth quarter of the previous year. During the fourth quarter, active interest rates of commercial banks in B&H slightly increased, as it was expected. In December 2008, the spread between active interest rates of commercial banks in B&H and twelve month EURIBOR was 4.76%, which is by 221 basis points higher than in September 2008.

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

Banking sector in the FB&H, over a very turbulent year of 2008, due to the spillover effect of the global economy and financial crisis in B&H, which became more apparent in the fourth quarter, has succeeded in the business sense to maintain a positive trend of growth and has confirmed that loans and deposits represent core products of FB&H banks, whose stability is secured by highly liquid reserves and position of a debtor and not a creditor in the unstable markets.

[17] When price growth of these two components is excluded, average inflation rate in 2008 would amount to 1.9%.

The following are some key factors, which have higly contributed that the banking sector, under such newly created and difficult conditions of banks' performance, especially in the last quarter of 2008, as the time when the crisis expands and moves to other sectors and economic subjects, remains stable, safe, solvent and liquid:

- the established regulatory framework regulating performance of banks, especially in the segment of credit and liquidity risks, along with the effective supervision of banks and control mechanism in the area of legitimacy of their work;
- implementation of regulations and maintenance of the standards that have been set forth;
- improvements in the management and governance quality in majority of banks.

Banks have continued expanding the network of their organizational units, alongside with the number of employees, that at the end of 2008 increased to total number of employees of 7.991.

At the end of 2008, there were 20 banks with the banking license issued in the F B&H. This number is lower by two banks in comparison to the end of 2007, as the result of:

1. HVB Central Profit Bank d.d. Sarajevo was integrated into UniCredit Zagrebačka bank d.d. Mostar (the new name of the bank is *UniCredit Bank d.d. Mostar*),
2. the special law regulated establishment and work of Development Bank of the FB&H Sarajevo, that has become a legal successor of Investment Bank of the F B&H d.d. Sarajevo, since 1.7.2008.

Dated on 12.9.2008, the FBA issued a resolution to finalize the provisional administration process in Privredna bank d.d. Sarajevo, while provisional administration is still in place at UNA bank d.d. Bihać and Hercegovačka bank d.d. Mostar.

Ownership structure of banks in the FB&H at the end of 2008 was the following:

- 2 banks with majority state ownership;
- 18 banks with majority private ownership, out of which:
  - 6 banks were majority owned by domestic legal entities and individuals (residents),
  - 12 banks were majority foreign owned.

Integration processes have been implemented in function of stronger market positioning, resulting by decreased number of banks and, consequently, the largest system banks becoming even larger. The process has been characterised by strengthening of capital base and more intensified competition and increased concentration in the banking sector of the FB&H.

It is quite encouraging that, under the newly created difficult financial conditions, domestic banks in the FB&H, owned by foreign banking groups, have received a significant financial support from the groups through long-term and short-term/revolving credit lines, deposits, new stand-by arrangements and finally through inflow of new capital (just in the fourth quarter of 2008 amounted to KM 130 million), which has strengthen capital base of individual banks and the banking sector in the FB&H.

At the end of 2008, positive financial result-profit was generated at the system level of KM 52 million, representing a decrease of high 52,8% or KM 58 million if compared to 2007. The profit has decreased due to the influence of the following: slower growth of interest income and downfall of credit activities in the last quarter of 2008, as well as growth of interest expenses or financing sources expenses of banks.[18]

Unlike previous years, all significant indicators of the banking sector performance recorded low to moderate growth in 2008. The banks' assets recorded growth of 6% or KM 876 million, reaching the amount of KM 15,1 billion. Over the past five years or in the period from the beginning of 2004 to the end of 2008, the aggregate balance sheet of the system increased its amount by more than 2,5 times.

Total capital of banks amounted to KM 1,6 billion (shareholders' was KM 1,1 billion), representing an increase of 9%. The capital increase is primarily caused by inflow of new capital – additional capitalization in eight banks amounts KM 220 million. If compared to 2007, this represents an increase of 21% or KM 38 million.

As a part of their preparation for better market positioning, FB&H's banks, apart from public subscription of shares, have initiated collecting financial assets through issue of bonds in 2008, which was successfully completed in two banks that was at the same time confirmation of confidence in the banking system, its safety and stability.

For the year 2008, the most explicit changes of FB&H banking system could be summarized as: slower growth of the system; downfall of profitability and significantly lower profit at the level of the sector, followed by decreased number of banks through integration processes, which, furthermore resulted by higher concentration in three key segments of banking performance (assets, loans and deposits); strengthening of capital base; inflow of new foreign investments and deposits funds; additional capitalization, resulting by changes in the ownership structure and participation of state, foreign and private domestic (resident) capital in the overall equity.

In developed, industrialised countries, assets are two times or even more higher than their GDP, while in transition countries this indicator is below 100%. The banking sector of the FB&H has solid performance, and according to the data for 2007, the assets reached 103,3% of the GDP for the FB&H.

[18] Positive financial result was reported by 16 banks in total amount of KM 90,1 million, which is lower by 23,7% or KM 28 million than in 2007 (18 banks), while four banks reported loss of KM 38,2 million, which is higher by 3,7 times or KM 30 million than prior year.

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

A) LAWS (new developments in 2008):

1. Law on modifications and amendments of the Law on Banking Agency of the Federation of B&H ("Official Gazette of the F B&H", No. 48/08),
2. Law on Leasing ("Official Gazette of the F B&H", No. 85/08),
3. Law on Development Bank of the Federation of Bosnia and Herzegovina ("Official Gazette of the F B&H", No. 37/08),
4. Decree on modification and amendments to the Decree on criteria for and manner of conducting supervision of operations of the Development Bank of the Federation of Bosnia and Herzegovina ("Official Gazette of the F B&H", No. 77/08),
5. Law on Investment Funds ("Official Gazette of the F B&H", No. 85/08),
6. Law on Securities Market ("Official Gazette of the F B&H", No. 85/08),
7. Law on modification and amendments of the Law on Opening Balance Sheet of Enterprises and Banks ("Official Gazette of the F B&H", No. 38/08),
8. Law on Deposit Insurance in B&H ("Official Gazette of the B&H", No. 100/08).

B) PRUDENTIAL REGULATIONS ISSUED BY FBA (new developments in 2008):

1. Decision on Minimum Standards for Capital Management in Banks ("Official Gazette of the F B&H", No. 3/03, 18/03, 53/06, 55/07, 81/07 and 6/08),
2. Decision on Minimum Standards for Liquidity Risk Management in Banks ("Official Gazette of the F B&H", No. 3/03, 12/04, 88/07 and 6/08),
3. Decision on Reporting Forms Submitted by Banks to the Banking Agency of the Federation of B&H ("Official Gazette of the F B&H", No. 3/03, 18/03, 52/03, 64/03, 6/04, 14/04, 54/04, 5/05, 43/07, 55/07, 81/07, 88/07 and 6/08),
4. Decision on Amount and Conditions for Origination of Loans to Bank Employees ("Official Gazette of the F B&H", No. 03/03 and 83/08),
5. Guidelines for Licensing and Other Approvals Issued by the Banking Agency of the F B&H ("Official Gazette of the F B&H", No. 46/02, 18/03, 27/04 and 6/08 changes and cleaned text),
6. Decision On Minimum Standards For Bank Market Risks Management ("Official Gazette of the F B&H", No. 55/07, 81/07, 6/08 and 52/08),
7. Decision on Minimum Standards for Operational Risk Management in Banks ("Official Gazette of the F B&H", No. 6/08).

Legal competences of FBA:

1. Issuance of license for establishment and work of banks, micro-credit organizations and leasing companies, issuance of license for changes of organizational system of banks, micro-credit organizations and leasing companies, type of activity and approvals for appointment of their managing staff;
2. Supervision of banks, micro-credit organizations and leasing companies, undertaking of measures in accordance with law;
3. Revoking work license from banks, micro-credit organizations and leasing companies in accordance with law;
4. Administration or supervision of bank rehabilitation and liquidation process and initiation of bank bankruptcy procedure;
5. Adoption of sub-legislation regulating work of banks, micro-credit organizations and leasing companies;
6. Evaluation of conditions and issuance of approval to banks for the next issue of shares;
7. Implementation of actions in the support of anti-terrorist activities related to banks;
8. 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 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 licenses and other kinds of authorizations.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

FBA set up the following priorities for the year 2008:

1. to continue the process of amending and developing the laws, regulations and procedures in accordance with the Core Basel principles and the EU directives;
2. to further enhance and strengthen supervision process;
3. to continue the process of implementation of Basel II requirements in the FB&H;
4. to take measures and activities within FBA's jurisdiction to cope with and mitigate the negative effects of the global financial crisis on the banking sector in the FB&H;
5. to continue the implementation of activities under its jurisdiction and to improve the efforts of creating the banking supervision at the state level;

6. to continue the operational improvements of information system that will enable early warning system and preventive action to resolve weaknesses in business operations of banks;
7. to expand cooperation with the authorized supervisory institutions, domestically and internationally;
8. to continue work on permanent education of the FBA's staff.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

1. Adoption of new regulation and changes to the present regulation;
2. Activities aimed to implement the Strategy for implementation of Basel II requirements in the FB&H;
3. Regular activities related to: examination of banks and micro-credit organizations (full-scope and targeted on-site examinations, examinations conducted by the Prevention of Money Laundering and Terrorism Financing in Banks Unit and examinations conducted by the Department for the supervision of micro-credit organizations);
4. Administration of previously initiated provisional or liquidation administrations in FB&H banks;
5. Collection and analysis of prudential reports submitted by banks (quarterly, monthly or daily based);
6. Preparation of reports (annually and quarterly based) about the banking system of the FB&H, and any other information for internal and external purposes;
7. Introducing more frequent reporting from banks in some particular areas, emphasizing the issues in the field of liquidity management in the context of the influence of global financial crisis on the banking system in FB&H;
8. Adoption of laws and preparation of sub-laws for regulation and supervision of leasing companies;
9. Active participation in the work of the Group of Banking Supervisors of the Central and Eastern Europe (BSCEE);
10. Continued education of the FBA's staff, domestically and internationally, and providing assistance in form of a specialized education of the staff of other supervisory bodies and institutions of the FB&H, etc.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

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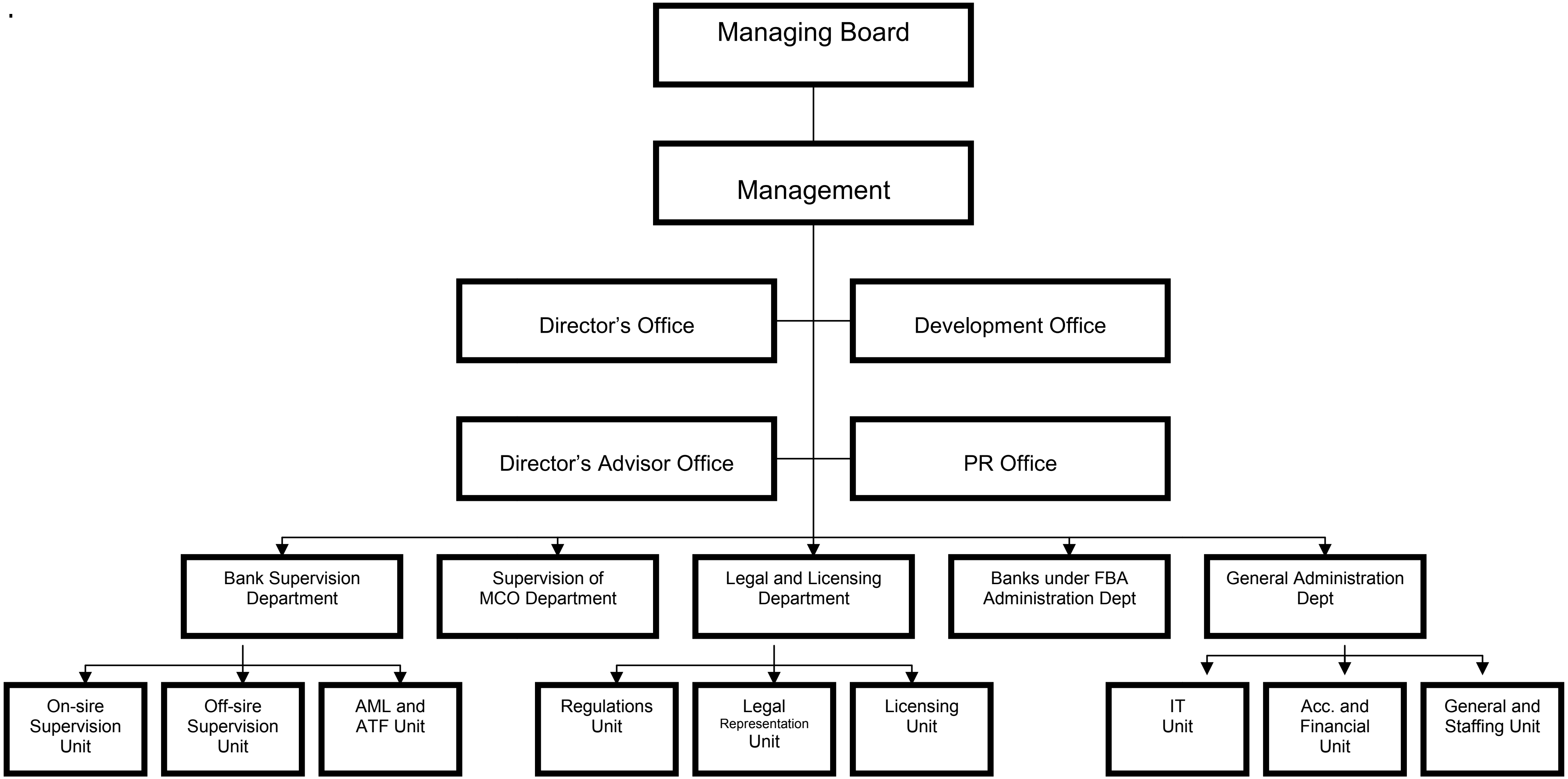


INTERNATIONAL ACTIVITIES OF THE AUTHORITY

At the beginning of 2008, a Memorandum of Understanding was signed in Greece, among the representatives of Bosnia and Herzegovina (three institutions represented: Central Bank of B&H, Banking Agency of the Federation of Bosnia and Herzegovina and Banking Agency of Republika Srpska) and central banks of the Southeast Europe countries (Albania, Bulgaria, Cyprus, FYR of Macedonia, Greece, Montenegro, Romania, and Serbia), with the aim to further advance international cooperation in the area of banking supervision.

Also, in June 2009. FBA signed the Memorandum of Understanding with the Banking Regulation and Supervisory Agency of Turkey.

Bosnia and Herzegovina is in a final stage of signing Memorandum of Understanding with Bank of Italy.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BOSNIA AND HERZEGOVINA

The FBA has established cooperation with many supervisory bodies and other institutions in our country (e.g. Memorandum of Understanding with:

- Central Bank of Bosnia and Herzegovina
- Deposit Insurance Agency of B&H
- Insurance Companies Supervision Agency
- Intelligence-Security Agency of B&H
- other domestic institutions).

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF 2008

In December 2008 FBA created „The Strategy of Introducing the Internal Accord for Capital Measurement and Capital Standards – Basel II". Bosnia and Herzegovina is in the initial stage of its implementation.

FBA plans to move from Basel I to Basel II in prudential manner, gradually and to undertake the evolutional development, based on the principles of implementation. In the beginning phase, FBA aims to implement some more simple approaches for the measurement of credit, market and operating risks, but in the next stages to move toward more complex approaches.

STATISTICAL TABLES

Number of financial institutions (head offices/branches) (at year-ends)

Type of financial institution	2006	2007	2008
Banks	23	22	20
Microcredit Organizations (MCOs)[19]	N/A	N/A	20[20]
Financial institutions, total			

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

Type of financial institution	2006	2007	2008
Public sector ownership	15.2%	12.8%	4.1%
Other domestic ownership	9.3%	13.0%	12.8%
Domestic ownership total	24.5%	25.8%	16.9%
Foreign ownership	75.5%	74.2%	83.1%
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

[19] Microcredit organization (MCO) is a non-deposit financial institution whose main activity is provision of microcredits (MCOs cannot take deposits). MCO is a legal entity which may be founded and operate as a microcredit company - MCC (for-profit MCO) or as a microcredit foundation - MCF (nonprofit MCO). Of these 20 MCOs, 19 are registered as MCFs, and 1 as an MCC.

[20] According to the Law on Microcredit Organizations („Official Gazette of the Federation of B&H", No. 59/06) (hereinafter: New MCOs Law), an MCO which on the day this law comes into effect exists and conducts business in compliance with the Law on Microcredit Organizations ("Official Gazette of the Federation of B&H", No. 24/00) (hereinafter: Old MCOs Law) is obliged within the period of 12 months from the day this law comes into effect, to adopt the decision on changing its legal form and organizing into an MCF, adopt the Statute, appoint the bodies, obtain a proper permit and apply for incorporation into an authorized register. Any MCO that fails to undertake the actions aforementioned shall cease to exist. An MCF that is organized pursuant to aforementioned, by virtue of the New MCOs Law is a legal successor of assets, rights and liabilities of an MCO that has adopted the decision on changing its legal form and organizing into an MCF.
It is important to mention that before the New MCOs Law came into effect, 36 MCOs in total were registered in the Federation of B&H (according to the Old MCOs Law), of which only 19 changed their legal form an obtained FBA working permit as MCF, meaning that 17 MCOs cease to exist. Many of them operated since 1997 in a form of humanitarian organizations but since the adoption of the Old MCOs Law in 2000, they were registered as microcredit organizations (at that time only one form of MCOs, a nonprofit one, was allowed by the Law).
MCFs in the Federation of B&H obtained FBA working permit in 2007 and 2008, and all of them finalized the procedure of the incorporation into the authorized register (MCCs into a court register and MCFs into a Federal Ministry of Justice' register) during the year 2008. Thus the comprehensive data for all MCOs are available for 2008 and not previous years, with first reports being delivered to FBA in 2008.

Type of financial institution	2006	2007	2008
Public sector ownership	4.1%	2.7%	1.3%
Other domestic ownership	2.9%	4.9%	4.4%
Domestic ownership total	7.0%	7.6%	5.7%
Foreign ownership	93.0%	92.4%	94.3%
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Bank	66.6%	79.0%
Credit Cooperatives		
Financial Institutions		
Savings Cooperatives		
Specialized Credit Institutions / MCOs	62%	83%

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

Type of financial institution	2006	2007	2008
Bank	0.86	0.85	0.36
Credit Cooperatives			
Financial Institutions			
Savings Cooperatives			
Specialized Credit Institutions/ MCOs-AROA[21]	N/A	N/A	3.1%

[21] MCOs are obliged to report on the Adjusted Return on Assets and Equity (ARO and AROE) that include adjustments for inflation, market cost of capital and non-cash donations. According to the FBA regulation, MCO's AROA must be positive.

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

Type of financial institution	2006	2007	2008
Bank	10.64	11.64	5.22
Credit Cooperatives			
Financial Institutions			
Savings Cooperatives			
Specialized Credit Institutions/ MCOs-AROE[2]	N/A	N/A	16.1%

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

Assets	2006	2007	2008
Cash and securities	37.7%	34.8%	28.1%
Placements to other banks	0.9%	0.5%	0.6%
Loans- net value	56.8%	60.2%	66.6%
Premises and other fixed assets	3.0%	2.9%	3.1%
Other assets	1.6%	1.6%	1.6%
Liabilities	**2006**	**2007**	**2008**
Deposits	72.9%	71.8%	69.4%
Borrowings from banks	0%	0%	0%
Loans payables	12.3%	13.1%	14.4%
Other liabilities	4.1%	4.5%	5.3%
Capital	**10.7%**	**10.6%**	**10.9%**

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

Assets	2006	2007	2008
Cash	N/A	N/A	3%
Net loans	N/A	N/A	90%
Business premises and other fixed assets	N/A	N/A	5%
Long-term investments and other assets	N/A	N/A	2%
Liabilities	**2006**	**2007**	**2008**
Short-term loans	N/A	N/A	19%
Long-term loans	N/A	N/A	77%
Other liabilities	N/A	N/A	4%

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

Type of financial institution	2006	2007	2008
Banks	17.52%	19.54%	19.33%
Microcredit organizations	N/A	N/A	1.9%
Financial institutions, total			

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Banks	89.3	89.4	89.1

Asset portfolio quality of the banking system

Asset classification	2006	2007	2008
Category A	90.0	89.8	90.2
Category B	7.9	8.7	8.0
Category C	1.1	0.8	0.9
Category D	1.0	0.7	**0.9**
Category E	**-**	**-**	**-**
Classified total	**100**	**100**	**100**
Specific reserves	**14.2**	**11.9**	**13.1**

Asset portfolio quality of the microcredit system

Asset classification	2006	2007	2008
PAR (over 30 days)[22]	N/A	N/A	4%
Non-risk portfolio	N/A	N/A	96%
Classified total			
Specific reserves			

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	40.0%	49.3%
Government sector	6.7%	0.7%
Corporate	26.1%	48.5%
Foreign	-	-
Other	27.2%	1.5%
Total	**100.0**	**100.0**

[22] MCOs are obliged to maintain $PAR_{(30)} < 5\%$.

The structure of deposits and loans in 2008 (%)
(at year-end)

Types of deposits		Types of loans	
At sight	40.0	Long term loans	75.4
Within one year	13.8	Medium-term loans	-
Over one year	46.2	Short-term loans	24.6
Total	**100.0**	**Total**	**100.0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Banks	20.8	15.6	13.5	59.9	60.3	65.0

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

Revenues	2006	2007	2008
Interest income and similar type of income	68.6	73.5	74.8
Operating income	31.4	26.5	25.2
Expenditures	**2006**	**2007**	**2008**
Interest- and similar expenses	28.6	32.1	36.0
General loan risk and potential loan losses provisioning	17.3	17.6	13.1
Other business and direct expenses	6.5	5.8	5.4
Operating expenses	47.6	44.5	45.5

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

Revenues	2006	2007	2008
Interest income and similar income	N/A	N/A	95%
Operating income (service fees 95%, other operating income 5%	N/A	N/A	5%
Expenditures	**2006**	**2007**	**2008**
Interest expenses and similar expenses	N/A	N/A	32%
Operating expenses (salaries and contributions 59%, business premises, other fixed assets and utilities expenses 19% and other operating expenses 22%)	N/A	N/A	48%
Expenses for loan loss reserves and other expenses	N/A	N/A	20%
Interest expenses and similar expenses	N/A	N/A	32%

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	000 EUR	%	000 EUR	%
Banks	571.641	7.4%	266.268	3.9%

2008 DEVELOPMENTS IN THE BANKING SYSTEM OF REPUBLIKA SRPSKA OF BOSNIA AND HERZEGOVINA

MACROECONOMIC ENVIRONMENT

One of the most important problems of economy of Republika Srpska (RS) is a large external deficit. Major portion of the state owned capital privatization process in enterprises should be completed by the end of 2009.

Republika Srpska 2007 GDP at current prices amounted to EUR 3.8 billion, and in 2008 (an estimation) EUR 4.3 billion.

Republika Srpska 2007 GDP/citizen amounted to EUR 2,613, and in 2008 (an estimation) EUR 3,009 per citizen.

Estimated inflation in Republika Srpska for 2008 amounted to 5.6%, and coverage of import by export was 47%.

Growth of GDP in 2008 (an estimation) was 7.5%.

Share of investments in GDP in 2008 amounted to 18.9%.

In the course of 2008 a significant progress in European and closer regional integrations was achieved. Early this year the CEFTA – Free Trade Agreement came into force, and in the second half of the year the Agreement on Stabilization and EU Integration was signed, which has enabled further development of EU Integration process, i.e. obtaining a status of a candidate country.

The main source of economy growth, i.e. growth of GDP, originates from investments into economy. After transition recession growth of investments was faster than growth of household consumption. And, although public investments are important everywhere, especially into infrastructure, a decisive role was played by foreign private investments. Public investments are adjusted with fiscal policy, where public expenditures are covered by public revenues.

The following are basic goals of economy policy of the Republika Srpska Government in 2009:

- macroeconomic stability maintenance,
- continuation of economy reforms,
- to increase dynamics of economy activities,
- employment maintenance and growth,
- equal regional development in Republika Srpska, and
- to improve citizens’ living standard and social security.

Preconditions necessary to achieve those goals are macroeconomic stability, continuation of economic reforms, continuation of European integrations, as well as significant increase of investments.

DEVELOPMENT IN THE BANKING SYSTEM

In Republika Srpska there are 10 banks in operation having their HQs in Republika Srpska licensed for operation by the Banking Agency of Republika Srpska. Also, there are a number of smaller organizational units of banks having their HQs in other entity, i.e. Federation of Bosnia and Herzegovina.

As of 31.12.2008 assets of 10 RS banks amounted to a total of EUR 3 billion, which was EUR 983 thousand per employee (3063 employees in the banking sector).

Banks' total assets (EUR 3 billion) and GDP (an estimation for 2008 is EUR 4.3 billion) ratio was 0.70%.

All banks operating in Republika Srpska are in possession of certificate issued by the Deposit Insurance Agency. In 2008 due to a modification of the Law on Obligatory Insurance of Deposits in Banks the amount of an insured deposit was increased from EUR 3,800 to EUR 10,000, and a proposal to increase that amount to EUR 25,000 is in preparation.

The global financial crisis slowed down the growth of balance sheet amount of the banking sector of Republika Srpska in the fourth quarter of 2008.

Nevertheless, the banking sector of Republika Srpska maintained positive trends in all segments of operation.

As of 31.12.2008 total assets consisted of the balance sheet assets in an amount of EUR 3 billion with a growth rate of 7% in comparison with 2007, while off-balance sheet assets amounted to EUR 475 million with a growth rate of 10% in comparison with 2007.

In 2008 banks additionally strengthened their shareholders' capital by issuing new shares in an amount of EUR 26 million or 14% in comparison to 2007. In the shareholders' capital ownership structure share of private capital was 99%, and 1% was state-owned, while in the private capital structure 87% was foreign capital and 13% was domestic capital.

In 2008 core capital increased by 20% in comparison to 2007.

As of 31.12.2008 Republika Srpska banks' capital adequacy rate amounted to 15.7%, which was considerably larger than 12%, which is the minimum required by both Republika Srpska and Federation BiH. Stricter requirements related to capital adequacy are seen as an additional guaranty of the banking sector's soundness. Deposits had a growth of 3%, and their share in cash funds amounted to 82%. All banks complied with requirements prescribed for maintaining liquidity. The banking sector was highly liquid, and cash funds and reserves at the CBBH amounted to 36% of total assets. Total loans increased at the rate of 33%, and loans to citizens at the rate of 27%. The share of loans due in total loans was 2.6%.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, LEGAL COMPETENCE OF THE BANKING SUPERVISION IN RS AND BH

The following are key elements of the legal framework constituting the basis for operation and supervision of financial institutions in Republika Srpska:

- The Law on Banking Agency of Republika Srpska ("Official Gazette of Republika Srpska" No. 67/07),
- The Law on Banks of Republika Srpska ("Official Gazette of Republika Srpska" No. 44/03 and 74/04),
- The Law on Microcredit Organizations ("Official Gazette of Republika Srpska" No. 64/06),
- The Law on Saving-Credit Organizations ("Official Gazette of Republika Srpska" No. 93/06),
- The Law on Leasing ("Official Gazette of Republika Srpska" No. 70/07),
- The Law on Insurance of Deposits in Banks of Bosnia and Herzegovina ("Official Gazette of Bosnia and Herzegovina" No. 20/02, 18/05, 100/08),
- The Law on Prevention of Money Laundering (("Official Gazette of Bosnia and Herzegovina" No. 29/04).

Basic tasks of the Agency as prescribed by the Law on Banking Agency of Republika Srpska are the following: issuing and revoking licenses for banks' operation, supervision of banks' business activities and undertaking appropriate measures in accordance with the Law on Banks of Republika Srpska (hereinafter: the Law) and in accordance with Decisions and other legal enactments based on the Law, managing and monitoring banks' recovery and liquidation procedures, granting approvals for share issuance, etc.

The Agency's control and supervision of banks is primarily based on monitoring solvency, liquidity and profitability of every individual bank, and the banking sector as a whole, with a goal to discover and prevent timely risks threatening banking sector in order to maintain sound and stable banking sector.

Under the Law, the Agency's role is also to create conditions for deposit safety and stability in banks.

The Agency performs banking supervision by means of reports submitted by banks under prescribed method and frequency (off-site examination), as well as by means of examining bank's operation in the very bank (on-site examination). Examinations are performed under procedures prescribed by the CAMELS system (review of capital, assets, management, i.e. running the bank, earnings, liquidity, market and operational risks etc.).

The regulatory role of the Agency is implemented through issuance of sub-legal enactments in accordance with Article 128 of the Law based on

basic principles of efficient banking supervision published by Basel Committee for Bank Supervision.

Sub-legal enactment that Agency has issued based on the Law are related, primarily, to minimum standards for managing capital, liquidity risk, credit risk and concentration risk, operation with related persons, foreign currency risk, risk of money laundering and terrorism financing, and a series of other provisions regulating bank operation.

In compliance with the Law on Leasing, the Law on Microcredit Organizations, and the Law on Saving-Credit Organizations, the Agency has also passed sub-legal enactments (regulation) regulating closer their operation and supervision.

When the Agency determines violation of the Law or sub-legal enactments, the Agency sanctions financial institutions in question (banks, microcredit organizations, leasing companies and saving-credit organizations) by imposing measures provided by the laws (written warnings, written orders, special requests for prudent operation of individual institutions, starts legal proceedings, etc. as required).

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

Strategic objectives of the Banking Agency of Republika Srpska in 2008 were maintenance of stability and soundness of banking system, as well as improvement of it safe and quality operation.

In line with the statement above the Agency paid special attention to the following issues:

- Further development and improvement of banking system supervision.
- Strengthening cooperation and coordination with other regulatory institution in RS and BH, as well as with regulators from our banks' home countries.
- In accordance with the Bank Supervision Operational Plan focus is on both on-site and off-site examinations of assets liquidity and quality, and related to that on strengthening banks' capital bases (emphasis is put primarily on internal controls and staff strengthening through a continuous education).
- Complete adjustment of regulation covering bank supervision with standards under Basel I (the year of 2009 is the final deadline).
- Activities enabling implementation of "International Agreement on Measuring Capital and Capital Standards" - Basel II in forthcoming years have been started, and the Strategy for Basel II Introduction has been adopted.
- (Defining and putting into realization of all activities is technically assisted by USAID through a project of technical assistance to financial sector in Bosnia and Herzegovina - Partnership for Advancing Reforms in Economy - PARE, which should last for 4 years.).

ACTIVITIES OF THE RS BANKING AGENCY IN 2008

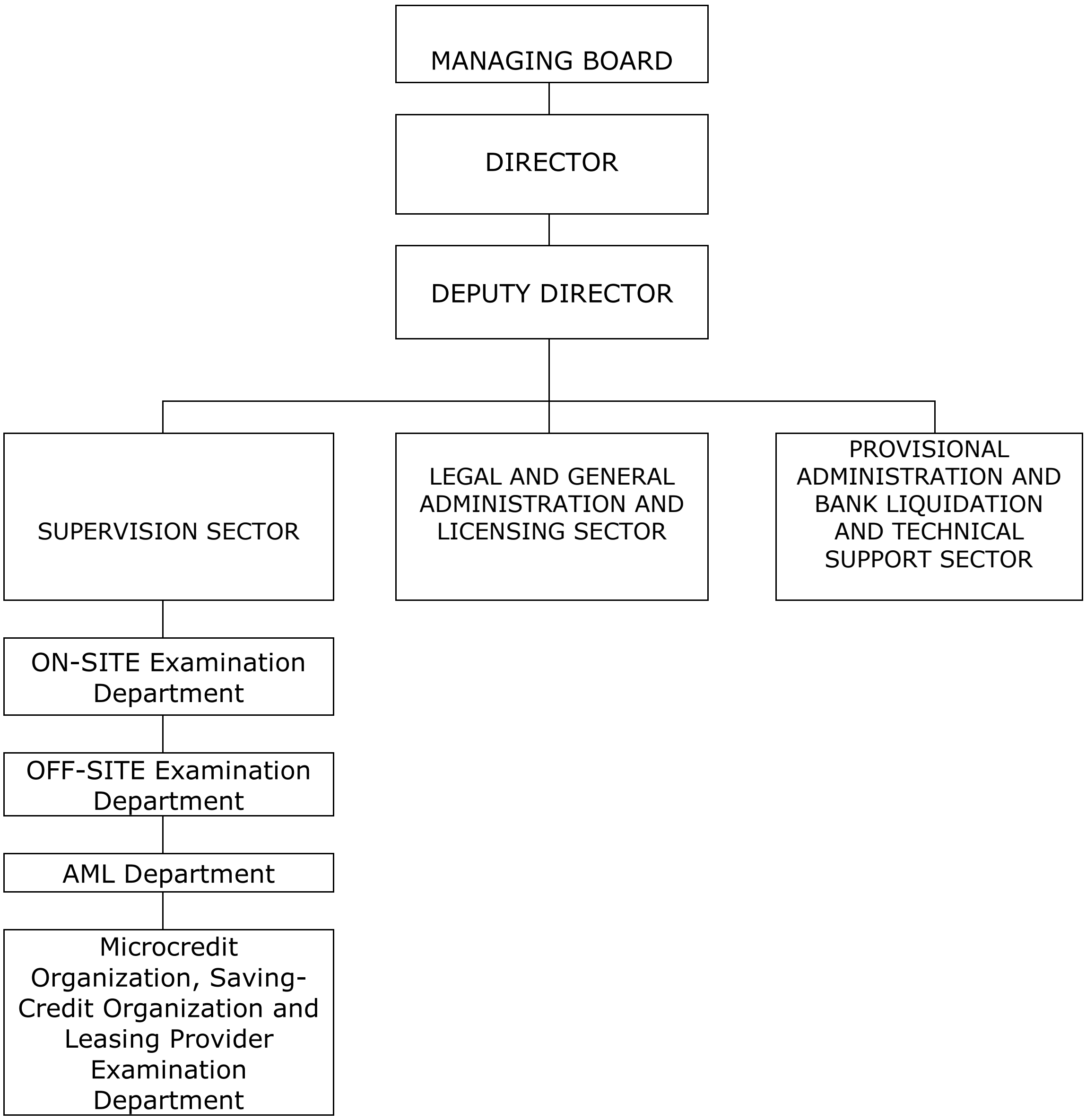
Pursuant to the Supervision Plan and implementing complete legal regulation prescribed, in 2008 the Agency performed overall and targeted examination of those financial institutions for which the Agency is in charge within its scope of authority (banks, microcredit organizations, saving-credit organizations and leasing companies).

Since October 2008 and in order to enhance its supervision the Agency has introduced additional off-site reports (which primarily relate to current liquidity – daily reporting, and maturity adjustment of financial assets and liabilities – monthly reporting). In the course of 2008 besides continuous off-site supervision over financial organizations, the Agency performed 5 overall on-site examinations of banks under CAMELS system, and 7 targeted examinations of banks (On-Site Supervision Department). The Department for Anti-Money Laundering and Prevention of Financing Terrorism performed 8 overall on-site examinations of banks, and 5 targeted bank examinations from its scope of supervision. Also, the Department for Microcredit Organizations, Saving-Credit Organizations, and Leasing Providers performed on-site examinations of 7 micro-credit organizations, 4 saving-credit organizations, and 1 leasing provider. After on-site examinations completed, and based on irregularities found out in implementation of the law, provisions and maintenance of standards prescribed the Agency passed 29 Decisions, and issued 182 orders for removal of irregularities within deadlines prescribed. In its regular operation the Department for Legal and General Administration issued to financial organizations various licenses and approvals in accordance with the Instruction for Licensing and Other Approvals of the Banking Agency of Republika Srpska. Under the Law on Micro-Credit Organizations and due to failures to meet requirements for further operation, the Agency issued 13 decisions on revoking licenses for operation of micro-credit organizations. A bankruptcy procedure in a former state-owned bank was still in the process, while the Agency was still resolving a liquidation procedure in another stat-owned bank.

In 2008 the Agency had a regular correspondence and information exchange with financial organizations supervised, as well as with other organizations and institutions in charge.

In 2008 the Agency passed two very important sub-legal enactments as follows: the Decision on Minimum Standards for Market Risk Management in Banks, and the Decision on Minimum Standards for Operation Risk Management in Banks. Also, modifications and amendments were made to the regulation related to management of capital and liquidity.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE RS BANKING AGENCY

The Agency has established cooperation with bank supervisors from neighboring countries, and countries whose banks have and equity share in banks of Republika Srpska and Bosnia and Herzegovina. Up to now Memoranda on Understanding (MoUs) have been signed with bank supervisors from the following countries: FRY Macedonia, Romania, Bulgaria, Serbia, Montenegro, Cyprus, Croatia, Slovenia, Albania, Greece, and Turkey. A MoU with bank supervisors from Italy is in final stage, while preparations are made for MoU with Austria.

In 2007 the Agency participated in consolidated supervision of banking group from Austria (Hypo Alpe-Adria Group). A similar consolidated supervision of the same group was scheduled for September 2009 where Banking Agency of Republika Srpska intends to take an active part.

Intensive cooperation has been maintained with IMF, World Bank, European Commission, European Council - MONEYVAL, USAID, Joint Vienna Institution, National Banks of Serbia, Slovenia, Croatia, Montenegro, FRY Macedonia, etc.

COOPERATION WITH OTHER SUPERVISORY BODIES IN REPUBLIKA SRPSKA (RS) AND BOSNIA AND HERZEGOVINA (BH)

Banking Agency of Republika Srpska has signed Memoranda on Cooperation with Central Bank of Bosnia and Herzegovina, Deposit Insurance Agency of Bosnia and Herzegovina, as well as with Banking Agency of Federation of Bosnia and Herzegovina. The cooperation is regulated by legal and sub-legal provisions, and it has been strengthened daily, especially in the period since the first signs of financial crisis in BH (October 2008).

Dynamic development of financial market and sophisticated modern financial services require further building-up of the current supervision of all participants in the financial market. Although regulators and supervisors of financial sector have already been obligated and directed to mutual cooperation in accordance with provisions covering their operation, in everyday practice it is necessary to improve it and make it more efficient in order to obtain supervisory goals.

The current international financial crisis, its negative impact and increased risks require efficient cooperation and coordination of operation of supervisory bodies of financial sector in Republika Srpska, in order to preserve its efficiency and stability.

More efficient cooperation and coordination of supervisory bodies will be put into realization by issuance of the Law on Committee for Coordination of Supervision of Financial Sector of Republika Srpska, which will establish, organization wise, a unique system of financial sector supervision, which is actually an ultimate objective.

The Law will regulate establishment, mode of operation, and scope of authority of the Committee for Coordination of Supervision of Financial Sector of Republika Srpska, and defines cooperation, mutual relationships and obligations of Securities Commission of Republika Srpska, Banking Agency of Republika Srpska, and Insurance Agency of Republika Srpska.

Under this law individual rights and responsibilities of supervisory bodies, as stipulated by positive legal provisions, remain unchanged.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2006	2007	2008
Banks	9	10	10
MCO	-	6	7
Financial institutions, total	**9**	**16**	**17**

*Microcredit organizations (MCO) have been supervised by the Banking Agency of Republika Srpska since the second half of 2007.
**Four saving-credit organizations (SCO) have been established in Republika Srpska, which started their operation in the second half of 2008, and they are still in the phase of organizing their operation.
*** Leasing Providers (1) have been supervised by the Banking Agency of Republika Srpska since the fourth quarter of 2008.

Ownership Structure of the Financial Institutions
on the Basis of Registered Capital (%)
(at year-ends)

Item	2006	2007	2008
Public sector ownership	0.8	0.7	0.7
Other domestic ownership	12.8	17.1	22.1
Domestic ownership total	13.6	17.8	22.8
Foreign ownership	86.4	82.2	77.2
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Item	2006	2007	2008
Public sector ownership			
Other domestic ownership	2.2	7.0	8.1
Domestic ownership total	2.2	7.0	8.1
Foreign ownership	97.8	93.0	91.9
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Bank	67.4	86.3
Credit Cooperatives		
Financial Institutions	99.4	99.8
Savings Cooperatives		
Specialized Credit Institutions		

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

Type of financial institution	2006	2007	2008
Bank	0.88	0.78	0.55
Credit Cooperatives			
Financial Institutions (MCO)	-	3.7	2.8
Savings Cooperatives			
Specialized Credit Institutions			

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

Type of financial institution	2006	2007	2008
Bank	7.74	8.62	6.48
Credit Cooperatives			
Financial Institutions (MCO)	-	17.6	14.3
Savings Cooperatives			
Specialized Credit Institutions			

Distribution of market shares in balance sheet total (%)*

Type of financial institution	2006	2007	2008
Banks	100.0	95.5	94.9
MKO	-	4.5	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	2006	2007	2008
Cash Funds	30.5	39.3	32.7
Net Loans	61.4	50.6	61.9
Office Space and Other Fixed Assets	4.9	3.4	3.5
Other Assets	3.2	6.7	1.9
Total:	**100.0**	**100.0**	**100.0**
Liabilities	**2006**	**2007**	**2008**
Deposits	81.0	81.5	77.6
Obligations per Loans Taken	4.5	7.3	10.2
Capital	12.1	8.9	9.7
Other Liabilities	2.4	2.3	2.5
Total:	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2006	2007	2008
Banks	9.6	8.9	11.1
MCOs	-	0.3	0.5
Financial institutions, total	**9.6**	**8.5**	**10.6**

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Banks*	18.3	16.5	15.7
MCOs**	-	-	-
Financial institutions, average	**18.3**	**16.5**	**15.7**

*The Law on Banks of Republika Srpska stipulates capital adequacy rate of 12%.
**There is no capital adequacy rate prescribed for MCOs.

Asset portfolio quality of the banking system

Asset classification	2006	2007	2008
Category A	2,033.4	2,792.8	3,702.4
Category B	305.1	368.0	475.8
Category C	52.9	61.2	78.6
Category D	33.6	37.0	51.9
Category E	0.0	0.0	0.0
Classified total	**2,425.0**	**3,259.1**	**4,308.7**
Specific reserves	**92.0**	**116.0**	**160.2**

The structure of deposits and loans in 2008 (%) (at year-end)

	Deposits	Loans
Households	24	43
Government sector	37	6
Corporate	38	50
Foreign	-	-
Other	1	1
Total	**100.0**	**100.0**

The structure of deposits and loans in 2008 (%) (at year-end)

Types of deposits		Types of loans	
At sight	31	Long term loans	74.4
Within one year	40	Medium-term loans	-
Over one year	29	Short-term loans	25.6
Total	**100.0**	**Total**	**100.0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Banks*	49.2	57.9	57.8	48.2	57.3	57.3
MCOs**						
Financial Institutions, average						

*Off-balance assets and liabilities included.
**FC structure of assets is not taken into consideration in case of MCOs.

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

Revenues	2006	2007	2008
Banks	289.6	402.5	486.5
MCOs	-	37.2	52.1
Expenditures	**2006**	**2007**	**2008**
Banks	264.2	364.7	450.9
MCOs	-	27.1	42.2

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	000 EUR	%	000 EUR	%
Banks	267.6	9.1	209.7	7.9
MCOs	31.5	19.9	24.6	19.4
Financial institutions, average	**299.1**	**9.7**	**234.3**	**8.4**

2008 DEVELOPMENTS IN THE BULGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

Bulgaria's GDP growth rate in 2008 was 6%, preserving the trend of relatively strong growth performance. Fixed capital formation growth was strong at 20.4%. Thus the contribution of investment was well above that of the consumption expenditure. The expansion of real agricultural output in 2008 by 24.6% partially compensated the contraction in 2007 by 29.7%. The demand for labour remained high during the year due to the economic growth. As a result of the improvement of the labour market conditions in 2008, unemployment dropped down to 5.6%.

During 2008 inflation dropped down to 7.2%. Major contribution to inflation was that of services (3.4 pp). The trade balance deficit reached 8.8 billion euro in 2008 (25.7% of GDP), which is a growth of 1.5 billion euro compared to 2007 (affected by the excess of physical volumes of growth of import compared to export and also the higher international prices of energy resources). The nominal export of goods in 2008 grew by 1.8 billion euro (13.1%) compared to 2007, while the import of goods grew by 3.3 billion euro (15.8%).

According to preliminary data the inflow of FDI in 2008 is 6.2 billion euro (18.1% of GDP), which covers the current and capital account deficit of the balance of payments by 73.7%. In 2008 the combined current and capital account deficit reached 8.4 billion euro (24.5% of GDP). The current account deficit alone reached 8.6 billion euro in 2008 (25.3% of GDP).

At the end of the year the growth of the monetary aggregates slowed down as a result of the slower growth of the deposits in the banking system and the amount of money in circulation. Broad money grew with 1.89 billion euro (8.8% yearly base), while M1 declined with 4.4%.

For 2008 the central bank's gross international reserves grew with 777 million euro (6.5%) in market value compared to the end of 2007, which is an increase by 2.3% of GDP. 3-month SOFIBOR increased from 7.1% in June 2008 to 7.6% in December 2008. The yield on the long-term government securities moved up as well increasing from 5.17% in June 2008 to 7.76% in December 2008.

DEVELOPMENT IN THE BANKING SYSTEM

The Bulgarian financial system is predominantly bank based. At the end of 2008 the total assets of the Bulgarian banking sector amounted to EUR 35.6 billion. The ratio of banking sector assets to the GDP is 104% in 2008. In total there are 30 credit institutions, including 6 branches of foreign banks. The public sector ownership (state or municipal) is insignificant – below 2%. Top five banks hold 57.14% of the market in terms of total assets and their development is a significant determinant of the processes in the banking system as a whole.

During 2008 the number of domestically controlled institutions is 8, which is the same as in 2007. Their market share in terms of total assets decreased from 17.3% to 16.09%. The market share of total assets of the EU institutions operating in Bulgaria rises from 79.4% to 81.21%. The biggest market share is held by banks and branches under the control of Greek shareholders.

The banks in Bulgaria are licensed as universal credit institutions, offering a broad range of products and services both to the corporate and the household sectors. There is no narrow specialisation of banks into investment banks, savings institutions, etc.

At the end of 2008 there were 80 points of sale (branches, offices, representative offices and remote workstations), 67 ATMs and 710 POS terminals per 100 000 inhabitants. The banks have been increasingly using the alternative distribution channels like debit and credit card issuers, leasing companies registered as banking subsidiaries, asset management companies, pension and insurance companies, etc. New saving and investment products have been offered to the growing number of clients.

During 2008 banks maintained good asset quality by taking timely actions for risk classification and loan loss provisioning whenever necessary.23 The NPL ratio to total gross loans is 2.42% (2.1% in 2007). The accumulated provisions serve as an extra buffer for mitigating the severity of the credit risk. They guarantee 114% coverage of the non-performing loans.

The system generated 702.5 Million EURO profit for 2008 – 19.5% higher than the previous year. In spite of the strong performance, ROA is 2.12% or with 25 b.p. lower than Dec. 2007, ROE is 20.26% (23.9% Dec.2007) - its decline is affected by the increase in equity for the 12 months with 0.87 billion euro. Cost-to-income ratio is 51.67% for 2008 compared with 51.5% for 2007. During 2008 a steady tendency of slower growth of the 12 month financial result was observed.

At the end of 2008 the solvency position is stable and has the capacity to absorb the development of the risk profile of the banking sector. The banking system has the resources to cover changes in asset quality. Current level of own funds is good and adequate to the risk profiles. The overall solvency ratio is 14.93%, Tier 1 ratio is 11.2% at the end of 2008 (The regulatory minimum in Bulgaria is 12%). Capital adequacy ratios grew against 2007 figures. This tendency shows two opposite processes. The first is linked to the reduction of credit activity and the second to the growth of the capital base.

In times of difficult market conditions, the credit institutions continued to manage without significant problems their liquidity position and striving to meet their commitment as financial intermediaries. Loans-to-deposit ratio is 83.99% (corporate and household loans to total funds), Liquid assets ratio is 21.65%. The tendency of decline of the liquidity ratios for the last 12 months was too volatile on a monthly basis during the last

[23] Bulgarian National Bank was following very tight level of impairment – loans, past due more than 90-days are considered NPL and should be provisioned 100%. Similarly, supervisory requirements for provisioning of loans in less riskier categories are higher than those under IFRS. By a stress testing model, the BNB has analyzed the institutions' capabilities of absorbing future shocks in terms of different types of risks – credit, liquidity and market - typical for bank portfolios. The effect of applied shocks indicates that the banking system has the capacity to absorb possible negative impact due to the deterioration in the quality of assets and liquidity position.

quarter of 2008. The liquidity pressure on the banking sector was driven by stressed domestic interbank market, in direct consequence of the global financial turbulences, the higher cost of attracted resources and continuing high demand for credit.

The changes in the minimum reserve requirements lead to a decrease in the required reserves and decline of cash. The banks transformed a significant part of this resource into other profitable liquid assets, which contributed to a gradual change of some of the indicators measuring liquidity.

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

The Law on Credit Institutions 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. There are also other specific laws about credit institutions such as the Law on Bank Deposit Guaranty, the Law on Bank Bankruptcy, and the Law on Consumer Credit.

The Law on the Bulgarian National Bank 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, detailed Regulations, issued by the Management Board of BNB, set minimum prudential standards that banks must meet.

New developments

The harmonisation of national regulatory framework with the EU Directives in the field of supervision of credit institutions was one of the main priorities of the supervisory policy during the year. The twinning project with the Banque de France, De Nederlandsche Bank, and the Banca d'Italia which aimed at preparing BNB for full-fledged membership in the ESCB and the Eurosystem ended successfully on 2 October 2008.

Work on the development and implementation of changes in regulatory framework continued and an essential part of the efforts focused on the evaluation and classification of risk exposures of banks and the allocation of provisions to cover credit risk. The main amendments to Ordinance No 9 of BNB on the Evaluation and Classification of Credit Exposures ensured uniform provisioning within international banking groups. Synchronisation of the framework was also aimed at preparing banks for implementation of the internal rating based approach for credit risk under Basel II.

Ordinance No 8 on the Capital Adequacy of Credit Institutions was also amended. Changes allow banks to include semi-annual current profits in their capital base, subject to stringent conditions under Directive

2006/48/EC relating to the taking up and pursuit of the business of credit institutions.

BNB adopted four guidelines in accordance with the Committee of European Banking Supervisors' framework on Pillar 2 regarding the Basel II Supervisory Review Process. Provisions on supervisory reviews, bank portfolios' interest risk management, concentration risk management and stress testing within the process of supervisory review reflect CEBS' policy on banking supervision. Preparations to introduce other CEBS instructions continued. Over the review period instructions on outsourcing, and the assessment, validation and implementation of internal models were adapted for domestic use. BNB developed its policy for international cooperation between home and host supervisors, and supervisory criteria for distinction of banks' specialised lending.

A number of information applications were introduced as part of the consolidated Financial Reporting Framework in the package for financial reporting (FINREP) of credit institutions in the EU member states.

Legal power 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 the Banking Supervision Department. The head of BNB also has a central role in the orderly resolution of a problem bank case, powers such as to appoint independently 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 banking supervision carries out the tasks of running supervisory enforcement and measures. In this relation, he may require any accountings and other records, as well as any information on banks' activities to be submitted, and may appoint on-site inspections fulfilled by officers and other persons authorised by him.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

Due to the continuing crisis, which presented the banking system with a unique set of challenges, the major priority in the activities of BNB as supervisory authority in 2008 was the maintenance of financial stability and preservation of external and internal for the banking system resources. In this regard, under the aegis of the Committee of European Banking Supervisors (CEBS), efforts were directed at improving the regulatory framework, increasing the effectiveness of supervisory tools, under the current accounting framework and off-site supervision, through on-site inspections, thus building strong risk management systems that operate independently of banks' business lines. Central bank's activities were also directed at testing the sensitivity of the banking and financial system to various kinds of risks. For this purpose a stress test was developed and conducted together with the credit institutions, which included a combination of several macro scenarios about the economic development and used assumptions and methodologies that were adjusted to reflect the situation of each bank. The main objective of the active supervisory activities were research and analysis of the channels of impact for the banking and financial system.

The monitoring and preventive supervisory activities aimed at counteracting possible attempts of financial frauds and money laundering through the banking system. Along with the supervisory strategy for the banking system, internal and international economic environment, the BNB supervisory policy was especially focused on subsidiaries of international banking groups or financial conglomerates.

More than ever, managing liquidity risk was a key challenge for financial institutions as the crisis changed their behaviour. The Basel Committee and CEBS drew on work in the area of liquidity risk management to draft guidelines that should encourage cross-border banking groups to bolster their internal systems while promoting convergence in supervisors' prudential practices.

The cooperation between supervisory authorities in international supervisory colleges continued by means of information-sharing, planning and performing cooperative supervisory activities. Further great challenges would be drawing joint assessments and supervisory decisions, and setting common goals and tasks. As a host supervisor, the Bulgarian National Bank has been involved in the colleges of banking groups, presented in Bulgaria via subsidiaries. Under the current crisis one of the main tasks is to exchange supervisory information and assessments on liquidity and capital position of the banking groups as a whole, and in particular of the subsidiaries active on the local market.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The past year was characterized by intensive supervisory activities due to the adverse developments in international financial markets and the negative effects of the global financial and economic crisis. Supervisory policy in times of crisis is aimed as a whole at keeping financial stability, and thus enabling accumulated resources to be preserved within the banking system. In this rapidly changing business environment, the Banking Supervision undertook actions, which results at the end of the year indicated that credit institutions have the capacity to withstand consequences of the financial and economic crisis.

In 2008 supervisory on-site inspections laid special emphasise on banks' internal systems for risk control and risk management, and on compliance with the supervisory framework. Assessments of institutions' risk profiles involved CAMELOS criteria.

At the beginning of the second half of the year supervisory monitoring moved on to monthly assessments of data and supervisory returns of banks, and more than 20 special-targeted supervisory inspections were made.

Special attention was placed on the impact of the crisis on credit and liquidity risks, and the assessment of the level of capital adequacy and other imminent risks.

In the fourth quarter of 2008, the time of very turbulent global markets, statistical data from regular reports, accordingly verified in course of inspections, showed that Bulgaria's credit institutions managed with keeping adequate solvency ratio and acceptable levels of liquidity by means of tightening lending standards, lowering credit risk tolerance, and thus consolidating their liquidity position.

One of the main priorities in terms of the off-site supervision was monitoring and analysing the dynamics of risks that credit institutions were running. Thorough analysis of increased risk areas in banking formed a part of preventive measures for maintaining national financial stability.

In terms of the negative trends on international financial markets BNB intensified information exchange with credit institutions and other related supervisory authorities abroad.

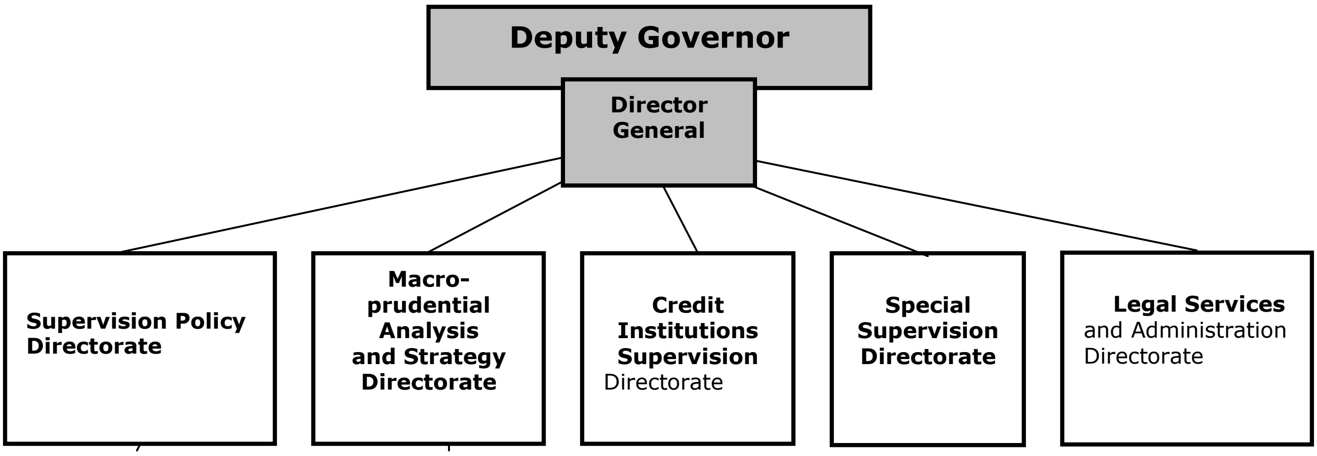
Ongoing analysis of the system's capacity and credit institutions' ability to absorb market shocks was carried out, and stress testing methods for assessing their effects were tuned up.

Over the review period consistent measures were applied against money laundering, terrorist financing and financial frauds. It was established that banks and finance houses adhere to international standards on combating money laundering and have in place adequate policies and procedures to minimize risks of transferring funds with unclear or criminal origin. The BNB's contribution to preventing the involvement of credit and financial institutions in financial crime and money laundering was appreciated in the Bulgaria report by the European Council's MONEYVAL Committee.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY 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 81 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

In 2008 the process of establishing supervisory colleges within the EEA was kicked-off, wherein BNB as host supervisor was involved too. Colleges will be permanent, although flexible structures for cooperation and coordination among the authorities responsible for and involved in the supervision of the different entities of cross-border banking groups.

Over the review period BNB, in partnership with other EU sister institutions attended twinning projects for technical assistance of central banks outside ESCB jurisdiction.

On 1 September 2008 BNB joined and co-signed a Memorandum of Understanding for technical cooperation between the European Central Bank and national central banks of the European Union, on one hand, and the National Bank of Serbia, on the other hand. Within e period of nine-months, until May 2009, it is aimed at establishing the nnecessary regulatory and operational framework of the National Bank of Serbia, and enabling it to implement policies and practices in line with the acquis communitaire.

On 26 November 2008 the BNB joined a Memorandum of Understanding for technical cooperation in the area of bank supervision under the aegis of the European Central Bank, in partnership with the central banks of the Czech Republic, Germany, Greece, France, Italy and

Romania, on one hand, and the Central Bank of Egypt, on the other. This is a three-year program starting on 1 January 2009, which key objective is strengthening of Egypt's banking supervision and its alignment with the Basel II principles.

On 3rd of October 2008 the Bulgarian National Bank hosted the regular governors' meeting of the Bank of Albania, the Bulgarian National Bank, the Central Bank of Bosnia and Herzegovina, the Central Bank of Cyprus, the National Bank of the Republic of Macedonia, the Bank of Greece, the Central Bank of Montenegro, the National Bank of Romania and the National Bank of Serbia, as well as the Heads of the Banking Agencies of Bosnia and Herzegovina and Republika Srpska. The meeting was held within the framework of the multilateral Memorandum of Understanding and aimed to reinforce co-operation in the area of banking supervision in South Eastern Europe (SEE) and safeguard financial stability in the region. Governors also acknowledged heightened uncertainties to the outlook of SEE economies stemming from a possible further deceleration in the growth rates of world output and trade in the event the prolonged period of global financial distress. Against this background, they stressed the importance of preserving sound financial and economic fundamentals in the region.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BULGARIA

BNB continued pursuing an active policy of supervisory transparency and information exchange on its participation in the European Process. The institution periodically prepares surveys on new developments in European policy and supervisory regulations in the banking and financial sector, which are provided to the relevant domestic stakeholders.

In December 2008, jointly with the Ministry of Finance and the Financial Supervision Commission (FSC), a seminar on "Changes in the European Financial Services Legislation and their Impact on the Bulgarian Financial Market" was held.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2006	2007	2008
Commercial Banks	32	29	30
of which:			
Large banks*	10	5	5
Small and medium-sized banks	18	19	19
Foreign bank branches	4	5	6
Financial Institutions (**Financial houses**)	86	82	80
Leasing companies	**54**	**63**	**66**

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

Item	2006	2007	2008
Public sector ownership	1.97	1.71	7.56
Other domestic ownership	25.28	25.48	20.72
Domestic ownership total	27.25	27.19	28.29
Foreign ownership	72.75	72.81	71.71
Banks, total	**100.0**	**100.0**	**100.0**

Ownership structure of the banking sector on the basis of assets total (%)
(at year-ends)

Item	2006	2007	2008
Public sector ownership	0.26	0.39	0.62
Other domestic ownership	19.64	17.31	15.47
Domestic ownership total	19.90	17.70	16.09
Foreign ownership	80.10	82.10	83.91
Banks, total	**100.0**	**100.0**	**100.0**

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

Item	2006	2007	2008
Public sector ownership	0	0	0
Other domestic ownership	93.74	94.3	92.35
Domestic ownership total	93.74	94.3	92.35
Foreign ownership	6.26	5.70	7.65
Financial houses, total	**100.0**	**100.0**	**100.0**

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

Item	2006	2007	2008
Public sector ownership	0	0	0
Other domestic ownership	93.74	94.3	92.35
Domestic ownership total	93.74	94.3	92.35
Foreign ownership	6.26	5.7	7.65
Financial houses, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Banks	39.44	57.14
Financial Institutions (Financial houses)	77.37	86.56

Return on Average Asset (ROAA) by type of financial institutions

Type of financial institution	2006	2007	2008
Banks	2.15	2.37	2.12
Financial Institutions (Financial houses)	1.01	2.9	-0.2%

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

Type of financial institution	2006	2007	2008
Banks	23.70	23.89	20.26
Financial Institutions (Financial houses)	23.70	59.31	-9.31

Distribution of market shares in balance sheet total (%)*

Item	2006	2007	2008
Banks	90.4%	87.2%	85.3%
Financial Institutions (Financial houses)	4.2%	5.9%	6.0%
Leasing companies	5.4%	6.8%	8.7%
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Assets	2006	2007	2008
Cash in hand, balances with central banks	10.83	12.16	9.67
Loans and advances to credit institutions	20.52	13.41	9.71
Loans and advances to customers	52.86	62.55	70.46
Financial assets at fair value through profit or loss, held-to-maturity investments, available-for sale assets and investments in associates, subsidiaries and joint ventures	12.81	9.36	7.49
Tangible assets and Intangible assets	2.44	2.16	2.19
Residual assets	0.53	0.36	0.47
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2006**	**2007**	**2008**
Amounts owed to credit institutions	14.40	18.25	21.98
Amounts owed to customers	72.38	66.00	60.33
Debts evidenced by certificates	0.00	1.98	1.35
Residual liabilities	1.37	0.98	2.16
Provisions	0.11	0.17	0.14
Subordinated liabilities	1.34	2.10	2.64
Equity (including valuation adjustments)	8.53	8.57	9.42
Profit or loss for the financial year	1.86	1.95	1.98
Total liabilities and equity	**100.00**	**100.00**	**100.00**

The structure of assets and liabilities of the financial houses (%)
(at year-end)

Assets	2007	2008
Cash and cash equivalent	5.92	3.36
Clients' portfolio - shares	89.74	89.85
Clients' portfolio - other securities	0.62	0.44
Financial instruments held by clients	1.19	3.33
Trading portfolio	1.44	1.11
Non-current assets	0.36	0.44
Other receivables	0.73	1.47
Liabilities	**2007**	**2008**
Amounts owed t ocustomers - securities contracts	91.47	90.63
Amounts owed to customers - other contracts	2.27	1.41
Equity	4.84	2.13
Current payables	1.23	2.65
Other liabilities	0.20	3.18

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

Type of financial institution	2006	2007	2008
Large banks	18.6	19.3	16.22
Small and medium-sized banks	16.2	16.4	22.51
Foreign bank branches	57.0	85.3	7.98
Banks, total	**19.3**	**21.4**	**18.12**

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

Type of financial institution	2006	2007	2008
Financial houses, total	9.42	14.93	11.60

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Large banks	14.14	13.32	14.89
Small and medium-sized banks	15.83	14.75	14.99
Banks, average	**14.51**	**13.86**	**14.93**

Asset portfolio quality of the banking system

Asset classification	2006	2007	2008
Amount in **EURO'000**	16 056	23 464	29 109
Standard %	95.58	96.40	95.1
Watch %	2.19	1.57	2.1
Substandard %	0.65	0.36	0.7
Non-performing %	1.59	1.67	2.1
Classified total	**100**	**100**	**100**
Specific reserves %	**2.20**	**2.16**	**2.4**

The structure of deposits and loans in 2007 (%)
(at year-end)

	Deposits	Loans
Households	37.0	36.2
Government sector	4.1	0.3
Corporate	22.6	60.6
Foreign	30.5	1.2
Other	5.8	1.7
Total	**100.0**	**100.0**

The structure of deposits and loans in 2008 (%) (at year-end)
Monetary statistic data

Maturity of deposits		Loans	
At sight	27.6	Long term loans	47.9
Within one year	57.1	Medium-term loans	24.1
Over one year	15.3	Short-term loans	28.0
Total	**100.0**	**Total**	**100.0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Large banks	53.4	50.8	54.7	55.4	55.2	55.9
Small and medium-sized banks	51.4	59.3	57.9	50.9	61.5	64.6
Foreign bank branches	42.6	74	73.0	56.8	72.8	69.3
Banks, average	**52.6**	**55.2**	**56.9**	**54.5**	**58.6**	**60.0**

Structure of revenues and expenditures of the banking sector (at year-ends) EUR'000

Assets	2006	2007	2008
Net interest income	817 438	1 111 439	1 427 440
Dividends and other income from variable yield securities	2 354	1 308	2 638
Commissions (net)	290 244	345 235	396 582
Trading and foreign exchange results	50 468	70 193	52 593
Other operating income	39 413	51 601	23 078
Total operating income	1 199 916	1 579 775	1 902 331
Expenditures	**2006**	**2007**	**2008**
Staff costs	222 514	276 439	360 987
General administrative expenses and Value adjustments in respectof tangible and intangible assets	438 627	473 252	594 515
Total operating expenses	661 141	749 691	955 502
Impairment losses (net) on financial assets and provisioning	67 865	179 527	174 681
Profit or loss from discontinued operations and from consolidated entities	2 430	1 698	5 896
Profits before taxes	473 340	652 255	778 044
Tax charges	71 486	63 815	75 638
Profits after taxes	401 853	588 440	702 406

Structure of revenues and expenditures of financial institutions (financial houses) (at year-ends) EUR'000

Assets	2007	2008
Trading and foreign exchange **net** results	7 528	6 181
Income from operations with financial assets and instruments	130 540	58 868
Other financial operations	25 659	8 332
Interest income	3 598	4 528
Income on share capital	483	1 497
Operating income	6 764	2 713
Expenditures	**2007**	**2008**
Expenses for operations with financial assets and instruments	30 168	69 450
Other financial operations	5 665	2 150
Interest expenses	1 078	1 410
Operating expenses	20 258	14 181
Extraordinary expenses	218	171

Structure of registered capital and own funds of the banking sector in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR mln	%	EUR mln	%
Large banks	644 307	3.2	14.1	12.4
Small and medium-sized banks	697 134	5.2	13.0	11.5
Banks, average	1 341 441	3.8	12.9	11.40

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR mln	%	EUR mln	%
Financial houses, **average**	38 544	1.54	55 130	2.20

2008 DEVELOPMENTS IN THE CROATIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The first quarter of 2008 was marked by exceptionally strong growth of prices, while the remainder of the year was marked by the negative impact of the spillover of the world's financial crisis into the real economy. The balance of payments current account imbalance widened, while the pronounced and constant dependence of domestic sectors on the savings of non-residents additionally worsened indicators of external indebtedness. Aware of the risks that can cause sudden and quick volatility of the exchange rate in a highly euroised economy, at the beginning of the year the CNB first set out to soften the appreciation pressures and then at the end of the year to soften the pronounced depreciation pressures. In using monetary policy instruments and in adopting amendments to monetary policy instruments, the CNB continued to concentrate on maintaining the exchange rate stability and thus accomplishing its primary goal of maintaining the price stability. Together with a more restrictive money supply, the curbing of bank lending was also directed at helping the anti-inflation effects of the monetary policy.

The 2008 saw the lowest economic growth rate since 1999, with the gross domestic product rising by only 2.4% in real terms. In addition, economic activity saw an uninterrupted slowdown. The slowdown in the growth of personal consumption, due to unfavourable changes in real available income of households, as well as due to more pronounced consumer pessimism, contributed the most to the movements of the total real growth.

The average annual inflation rate of consumer prices went up to 6.1% in 2008, which was 3.2 percentage points more than the year before. This was a consequence of the significant transfer of inflation from 2007 (3.3 percentage points), and also of a sizeable growth of food and energy prices seen in the first seven months of 2008 amid high growth of prices of raw materials in the world's markets. The second half of the year saw the start of a noticeable slowdown in consumer prices inflation, which went down to 2.9%.

Croatia's gross external debt increased by EUR 5.9bn in 2008, totalling EUR 39.1bn at the end of December. External debt growth accelerated relative to the previous year, primarily due to intensive borrowing of enterprises. External debt growth in 2008 outpaced the growth of the nominal GDP, resulting in a noticeable deterioration of the relative indicators of external indebtedness: at the end of 2008 gross external debt, shown as a percentage of GDP, totalled 82.6% and net debt 44.2%.

DEVELOPMENTS IN THE BANKING SYSTEM

The banking sector in the Republic of Croatia consisted of 33 banks, 1 savings bank and 5 housing savings banks in 2008. Total banking system assets were HRK 377.1bn and accounted for 109% of GDP[24]. In total banking system assets, banks' assets (including the one savings bank) accounted for 98.2% and housing savings banks accounted for 1.8% of the total.

At the end of 2008, 20 institutions were majority foreign owned. The assets of these institutions accounted for 90.8% of total banking system assets. The remaining 9.2% of total banking system assets went to assets of 16 institutions in majority domestic ownership and 3 state-owned institutions.

The banking sector of the Republic of Croatia employed 22,481 persons at the end of 2008, an increase of 7.1% compared with the end of the previous year. Assets per employee rose insignificantly (0.1%) relative to the end of 2007.

The annual rate of change of total placements and contingent liabilities, i.e. total exposure to credit risk went down from 13.4% in 2007 to 6.8% in 2008. Due to faster growth of bad (partly recoverable and irrecoverable) placements and contingent liabilities, which rose by 10.4%, the quality of total bank placements and contingent liabilities deteriorated, reversing the years-long trend of declining level of bad placements and contingent liabilities. The ratio of bad to total placements and contingent liabilities increased from 3.1% at the end of 2007 to 3.2% at the end of 2008.

The growth of loans granted slowed down slightly in 2008 (13.8% relative to 14.8% in 2007), primarily thanks to the slowdown in the growth of the most significant item - loans to households. On the other side, the growth of loans to enterprises, primarily in construction and real estate business and of loans to government units accelerated, with loans to government units rising at an exceptionally high rate of 50.1%. The share of loans in banks' balance sheet and in total placements and contingent liabilities continued growing, reflecting their adjustment to changed conditions in the economic and regulatory environment.

Regardless of the continued slowdown in the growth of placements in 2008 banks managed to increase their profit after tax by 13.4%. ROAA remained at the same level as the year before (1.6%), while ROAE continued its years-long downward trend, reducing by one percentage point, from 10.9% to 9.9%. The main source of profit growth was the increase in interest income, resulting from asset restructuring, i.e. the growth of loans granted paired with the rise in active interest rates.

Bank capital adequacy ratio remained high in 2008, totalling 15.16% at the end of the year. Original own funds, the highest quality share of own funds, was at the same time their most important constituent (95.8%). Of the total amount of own funds, 65.9% was used to cover the capital requirement, i.e. 34.1% of own funds remained available in case of a growth of risk exposure. The capital adequacy ratio fell by little over 1 percentage point relative to the end of 2007, which was, paired with the

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[24] The Croatian Bureau of Statistics adjusted the GDP calculation with the international statistical standard ESA 95, which changed the reported ratio relative to the past year.

growth of foreign currency and foreign-currency indexed placements, also affected by the tightening of regulations relating to these placements, i.e. the increasing of the weight from 75% to 100% for collaterised and from 125% to 150% for uncollaterised foreign currency (and foreign-currency indexed) claims on clients with unmatched foreign exchange position. In this context it should be noted that intensive lending to government units, regardless of the exposure to currency-induced credit risk (CICR), did not contribute to the amount of banks' weighted assets because of the applied 0% weight.

The repealing of the marginal reserve requirement, followed by the increase in the amount of deposit insurance, swiftly and efficiently dealt away with the disturbances in the liquidity position of some banks at the beginning of October 2008. The last quarter of 2008 saw a strong growth of the sources of funds from majority foreign owners, which, paired with the sizeable growth of household deposits (especially after the end of the tourist season), resulted in the 6.8% annual growth rate of total deposits. The growth of household deposits was, both in the absolute amount and in relative terms, more prominent than over the previous year, which may be attributed to the increased attractiveness of saving with banks resulting from unfavourable developments in the capital market and the growth of deposit rates. The effects of global economic changes and their spillover to the domestic environment were reflected in the decline of deposits of enterprises and a fall in deposits of other banking institutions (investment funds, etc.). The share of deposits in total bank sources of funds went up regardless, while banks' liquid position was additionally strengthened by increased investments in low risk and easily marketable securities.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The Croatian National Bank is responsible for the supervision of banks, savings banks, housing savings banks and credit unions with a view to safeguarding depositors and ensuring stability and safety of the banking system. Supervisory tasks of the CNB include issuing authorisations to and withdrawing authorisations from these institutions and other approvals as prescribed by law, enacting relevant subordinate legislation and supervision of the operations of these institutions. The Croatian National Bank conducts supervision of the operation of banks in accordance with the provisions of the Act on the Croatian National Bank and the Banking Act.

Verification of legality of banks' operations and banks' risks management is carried out by means of on-site examinations, specialised on-site examination and off-site supervision. On-site examinations are conducted in accordance with a previously determined schedule. In case of indications of deviations from standards or in case of banks more prone to risks, examinations are carried out more often.

Other supervisory bodies operating in the area of financial system supervision are the Ministry of Finance and the Croatian Financial Services Supervisory Agency (HANFA). Their competencies include the regulation and supervision of non-banking financial services.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

The Republic of Croatia is undergoing the process of alignment of domestic legislation with the EU acquis communautaire, a requirement that has to be met if the country is to achieve full membership in the EU. Aiming at the alignment of the domestic legislation in the field of banking with the acquis communautaire, intensive supervisory activities in 2008 were related to the creation of the new regulatory framework for the operation of banks and other financial institutions supervised by the CNB. The supervisory objective relating to the introduction in the banking regulation of new risk management rules, including all three pillars of the Basel II standard, was met when the process of creation of the Credit Institutions Act was completed. The Act was adopted by the Croatian Parliament in September 2008 and its provisions entered into force on 1 January 2009, replacing the applicable Banking Act.

The Credit Institutions Act was adopted primarily in order to fully harmonise the domestic banking regulations with Directives 2006/48/EC and 2006/49/EC and ensure conditions for application of the Basel II standards. However, since the new departures in certain segments are extremely important, credit institutions were provided with an additional adjustment period until 1 July 2009 to adjust their operation with the provisions of this Act, which was then subsequently extended until 31 March 2010. Since in the meantime amendments were adopted to the Directive 2006/48/EC which significantly altered the provisions of the Act and certain new subordinate legislation, it was considered prudent to postpone the deadline for application of those provisions of the regulations which will be changed again and thus provide credit institutions with a single deadline for adjustment with those fully harmonised regulations. In addition, the Act contains certain provisions which can be implemented when the Republic of Croatia becomes a full member of the European Union and therefore these provisions will enter into force upon the accession of the Republic of Croatia to the European Union.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

The adoption of the Credit Institutions Act initiated changes in the entire body of subordinate legislation, which led to the publication of a set of 22 Decisions in January 2009, of which a majority will enter into force on 31 March 2010.

The entire new body of regulations was publicly discussed prior to final adoption. Within the framework of the discussions a presentation of the draft Act and Decisions were held, as well as seminars for credit institutions. The Act and subordinate legislation, which had been harmonised with the acquis, were also presented to the European Commission in June 2008.

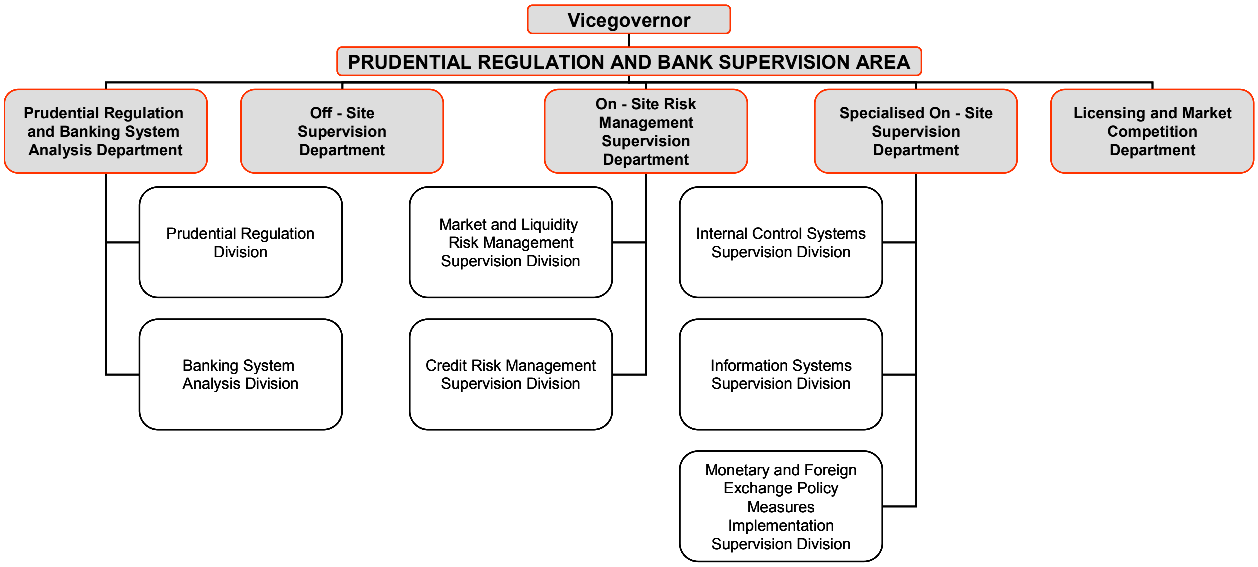
In addition to the Credit Institutions Act, the Croatian National Bank also prepared a proposal of the Act on Electronic Money Institutions in the first half of 2008, transposing the Directive 2000/46/EC. The Act on Electronic Money Institutions regulates the area which has so far not been regulated by a special law and introduces for the first time a definition of electronic money that is to contribute to a uniform identification of electronic money institutions in the Republic of Croatia. The Act was adopted by the Croatian Parliament in September 2008 and entered into force on 1 January 2009.

The Financial Conglomerates Act was adopted in December 2008, transposing the Directive 2002/87/EC. For the purpose of the drafting of this Act, a mixed working group was established, consisting of representatives of the Ministry of Finance, the Croatian Financial Services Supervisory Agency (HANFA) and the Croatian National Bank.

In the field of on-site examination of credit institutions' operations over the past year, stress was laid on the control of the risk management quality. In addition to traditional banking risks, on-site examinations during the past year were directed at operational risk, as a new type of risk for which banks are required to meet capital requirements. Adequate completion of on-site examination tasks requires expert knowledge and appropriate organisation of tasks, which contributed to further specialisation of employees carrying out on-site examinations as regards individual types of risks.

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

At the end of 2008, the Prudential Regulation and Bank Supervision Area had a staff of 103.
Organisational scheme of the Prudential Regulation and Bank Supervision Area:



INTERNATIONAL ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Based on provisions of the Act on the Croatian National Bank and the Banking Act, the Croatian National Bank has concluded memoranda on co-operation in the area of supervision with foreign institutions. The basic principles and the contents of these memoranda are based on relevant documents of the Basel Committee on Banking Supervision.

In the past several years, the following memoranda of understanding and co-operation were concluded:

- Memorandum of Understanding between Commission Bancaire and the Croatian National Bank in the Field of Banking Supervision,
- Memorandum of Understanding between the Croatian National Bank and the Austrian Federal Ministry of Finance and the Austrian Financial Market Authority concerning their Co-operation in the Field of Banking Supervision,

- Memorandum of Understanding and Co-operation in Banking Supervision between the Croatian National Bank and the Central Bank of Bosnia and Herzegovina, Banking Agency of the Federation of Bosnia and Herzegovina and Banking Agency of Republika Srpska,
- Memorandum of Understanding between the Banca d'Italia and the Croatian National Bank in the Field of Banking Supervision,
- Memorandum of Understanding between the Hungarian Financial Supervisory Authority and the Croatian National Bank in the Field of Banking Supervision.

During 2008, based on signed memoranda of understanding, co-operation with foreign supervisors of banking groups to which domestic banks belong intensified. A series of meetings was held with representatives of relevant parent bank regulators, at which information was exchanged regarding the business operations and the quality of operations of the parents or their subsidiaries operating in the Republic of Croatia. Participants also exchanged experiences in the practical application of individual segments of these regulations. One of the examples of this co-operation is participation of the representatives of the CNB at meetings associated with advanced approaches to measuring credit and operational risk, i.e. prevalidation procedures in case of banking groups with members operating in the Republic of Croatia.

COOPERATION WITH OTHER SUPERVISORY BODIES IN CROATIA

The CNB has concluded the following agreements with other supervisory bodies in the Republic of Croatia:

- Agreement on co-operation with the Croatian Financial Supervisory Agency,
- Agreement on co-operation with the Office for the Prevention of Money Laundering,
- Agreement on co-operation in the area of protection of market competition in banking and financial services market with the Croatian Competition Agency,
- Agreement on co-operation and exchange of information in the area of anti-money laundering and combating of terrorism financing with the Ministry of Finance.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF 2008

For further information on supervisory activities of the CNB, the legislative framework used as a basis for its supervisory activities, as well as individual regulations please visit CNB's web pages at (www.hnb.hr).

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2006	2007	2008
Banks	33	33	33
Savings banks*	-	-	1
Housing savings banks	5	5	5
Financial Institutions, total	**38**	**38**	**39**

* included in *Banks* in all tables

Ownership Structure of the Financial Institutions
on the Basis of Registered Capital* (%)
(at year-ends)

Item	2006	2007	2008
Public sector ownership	4,9	3,2	2,9
Other domestic ownership	8,6	6,0	6,5
Domestic ownership total	13,4	9,2	9,4
Foreign ownership	86,6	90,8	90,6
Financial Institutions, total	**100,0**	**100,0**	**100,0**

* share capital

Ownership Structure of the Financial Institutions
on the basis of assets total (%)
(at year-ends)

Item	2006	2007	2008
Public sector ownership	4,1	4,6	4,4
Other domestic ownership	4,9	4,8	4,8
Domestic ownership total	9,0	9,4	9,2
Foreign ownership	91,0	90,6	90,8
Financial Institutions, total	**100,0**	**100,0**	**100,0**

Concentration of asset by the type of financial institutions*

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Banks	53,9	72,2
Housing savings banks	80,7	100,0

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

Type of financial institution	2006	2007	2008
Banks	1,50	1,57	1,61
Housing savings banks	-0,94	-0,68	0,30

* ROAA

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

Type of financial institution	2006	2007	2008
Banks	12,41	10,93	13,96
Housing savings banks	-26,34	-20,51	4,65

* ROAE

Distribution of market shares in balance sheet total (%)

Type of financial institution	2006	2007	2008
Banks	98,0	98,1	98,1
Housing savings banks	2,0	1,9	1,9
Financial institutions, total	**100,0**	**100,0**	**100,0**

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

Assets	2006	2007	2008
Money assets and deposits with the CNB	16,3	14,9	11,5
Money assets and deposits with the CNB	1,3	1,3	1,5
Deposits with the CNB	15,0	13,6	10,1
Deposits with banking institutions	8,5	10,2	9,6
MoF treasury bills and CNB bills	2,7	2,5	2,7
Securities and other financial insturments held for trading	2,5	2,5	1,8
Securities and other financial instruments available for sale	4,2	3,3	3,4
Securities and other financial instruments held to maturity	1,1	1,0	1,3
Securities and other financial instruments not traded in active markets but carried at fair value	0,2	0,2	0,2
Derivative financial assets	0,1	0,1	0,0
Loans to financial institutions	1,3	2,0	1,6
Loans to other clients	60,3	60,7	65,1
Investments in subsidiaries and associates	0,6	0,5	0,5
Foreclosed and repossessed assets	0,1	0,1	0,1
Tangible assets (net of depreciation)	1,5	1,3	1,2
Interest, fees and other assets	1,6	1,6	1,8
Less: Specific reserves for unidentified losses	0,9	0,8	0,8
Total Assets	**100,0**	**100,0**	**100,0**
Liabilities	**2006**	**2007**	**2008**
Loans from financial institutions	5,0	6,0	5,2
Short-term loans	2,4	3,3	2,2
Long-term loans	2,6	2,7	3,0
Deposits	66,6	67,6	67,0
Giro account and current account deposits	12,4	13,1	11,2
Savings deposits	8,7	7,8	6,9
Time deposits	45,5	46,6	48,9
Other loans	13,1	9,2	8,9
Short-term loans	3,3	1,6	2,1
Long-term loans	9,8	7,6	6,7
Derivative financial liabilities and other financial liabilities held for trading	0,1	0,1	0,4
Debt securities issued	1,2	1,0	0,9
Short-term debt securities issued	0,0	0,0	0,0
Long-term debt securities issued	1,2	1,0	0,9
Subordinate instruments issued	0,2	0,1	0,0
Hybrid instruments issued	0,2	0,2	0,6
Interest, fees and other liabilities	3,4	3,4	3,6
TOTAL LIABILITIES	89,7	87,4	86,5
TOTAL CAPITAL	10,3	12,5	13,5
Total Liabilities	**100,0**	**100,0**	**100,0**

* banks only (in 2008 one savings bank is included), housing savings banks are not included

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

Type of financial institution	2006	2007	2008
Banks	20,1	20,0	19,5
Savings banks	1,4	1,8	1,6
Financial institutions, total	**19,7**	**19,6**	**18,5**

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Banks	14,0	16,4	15,2
Savings banks	18,7	14,5	13,2
Financial institutions, total	**14,0**	**16,3**	**15,1**

* Capital adequacy ratio

Asset portfolio quality of the banking system*

Asset classification	2006	2007	2008
1. Fully recoverable placements (category A)	338 310,4	384 204,2	408 397,9
2. Partly recoverable placements (category B)	7 147,3	7 952,4	9 865,7
3. Irrecoverable placements (category C)	4 173,1	4 264,2	4 214,6
Classified total	**100,0**	**100,0**	**100,0**
Specific Reserves**	2,6	2,5	2,4

* banks only (in 2008 one savings bank is included), housing savings banks are not included
**specific reserves / total asset portfolio

The structure of deposits and loans* in 2008 (%) (at year-end)

	Deposits	Loans
Households	54,9	49,8
Government sector	2,4	8,5
Corporate	19,9	38,3
Foreign	15,1	0,8
Other**	7,7	2,5
Total	**100,0**	**100,0**

* banks only (in 2008 one savings bank is included), housing savings banks are not included
** Financial sector is included

The structure of deposits and loans in 2008* (%)
(at year-end)

Types of deposits		Types of loans	
At sight	16,7	Long term loans	66,9
Within one year**	58,6	Medium-term loans	12,6
Over one year	24,7	Short-term loans	20,6
Total	**100,0**	**Total**	**100,0**

* banks only (in 2008 one savings bank is included), housing savings banks are not included
** 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 liab.		
	2006	2007	2008	2006	2007	2008
Banks	65,0	57,5	60,7	60,1	51,2	53,0
Housing savings banks	91,8	93,0	90,0	91,7	92,5	90,3
Financial Institutions, average	**65,5**	**58,2**	**61,3**	**60,7**	**51,9**	**53,7**

Type of the financial institutions	FOREX off balance sheet items / total liabilities		
	2006	2007	2008
Banks	7,8	7,1	6,4
Housing savings banks	0,2	0,5	0,8
Financial Institutions, average	**7,7**	**7,0**	**6,3**

* include items denominated in foreign currency and items with a currency clause

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

Revenues	2006	2007	2008
Interest income	73,0	74,4	76,6
Income from fees and commissions	17,7	17,2	15,3
Other non-interest income	9,3	8,5	8,1
Expenditures	**2006**	**2007**	**2008**
Interest expenses	44,6	49,9	52,1
Expenses on fees and commissions	8,5	7,0	6,0
Other non-interest expensses	5,6	4,1	3,8
General administrative expenses and depreciation	37,1	34,0	33,2
Loss provision expenses	4,2	5,0	4,8

* banks only (in 2008 one savings bank is included), housing savings banks are not included

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR mln	%	EUR mln	%
Banks	3 860	7,6	43 695	86,5
Housing savings banks	62	6,5	908	95,5
Financial Institutions, average	**3 924**	**7,6**	**44 620**	**86,7**

* share capital
** in millions of EUR

2008 DEVELOPMENTS IN THE CZECH BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN THE CZECH REPUBLIC

In 2008 unfavourable macroeconomic development influenced the economic situation of the Czech business companies and the other entrepreneurial bodies. Unlike previous years, annual GDP growth in the Czech Republic was only 3.1%, but the Czech Republic belonged to the group of more successful countries within EU. Real GDP growth was also markedly lower (1.3%) this period in Germany, which has long been biggest trading partner. Gross domestic product in the Czech Republic was CZK 3,705.9 billion at current prices.

The GDP growth continued to be driven mostly by domestic demand, which was affected in particular by household consumption. The contribution of gross capital formation was negative, mostly due to change in inventories. The contribution of foreign trade to GDP growth was only in the first three quarters but it was negative in the 4Q2008.

Inflation gradually increased in 2008 compared to the previous year. The average figure in 2008 was 6.3%, up by 3.5 percentage point compared to a year earlier mostly due to VAT and price development of raw materials and foodstuff. Consumer prices growth was over 7%.

The koruna's appreciation trend against the euro and the dollar continued up to 3Q2008. The bulk of exports and imports are traded in these two currencies. The strengthening koruna reduced the prices of most imported commodities, thereby decelerating an inflation growth. From an annual average of CZK 27.8 to the euro in 2007, the koruna firmed to CZK 25.0 in 2008. The koruna's annual average exchange rate against the dollar appreciated even more substantially – from CZK 20.3 to CZK 17.1.

The balance of payments stuck to previous level. The current account deficit felled down by 0.1 percentage point to 3.1% of GDP, or CZK 113.9 billion. The persisting deficit was due to a widening of the income deficit, reflecting a rapid increase in non-residents' FDI profits. There were higher dividends paid. As in previous years, the financial account showed a surplus of CZK 151.2 billion in 2008, which is roughly the same as the period from 2003 to 2005. Growth in net direct investment inflow remained its principal component.

The labour market situation started deteriorating at the end of 2008. The number of job vacancies was decreased and unemployment rate started increasing. Long-term unemployment was about 2.1% on average. The labour market was affected by seasonal factors in individual months of 2007. The registered unemployment rate under the existing methodology reached 5.5% level. Average gross monthly nominal wages increased by 8.6% year on year, up by 1.3 percentage point on the previous year. Average real wages increased by 2.1% year on year, a lower rise of 2.3 percentage point compared to 2007. Aggregate labour productivity grew by 2.0% year on year

Despite the slowdown of economic growth, the absolute deficit declined compared to the previous year, to CZK 52.1 billion, or 1.4% of GDP. The public debt-to-GDP ratio, which was little changed in 2008, finished at 29.8% at the end of the year.

The CNB changed its key interest rates four times during 2008 (in February, August, November and December). The monetary policy decisions were based on forecasts for the Czech economy and inflation and the external economic outlook. Interest rates were decreased in 2008 by 1.25 percentage points altogether compare to 2007 year end. The domestic two-week repo rate went down from 3.50% to 2.25%, the discount rate from 2.50% to 1.25% and the Lombard rate from 4.50% to 3.25%.

DEVELOPMENT IN THE BANKING SYSTEM

As of 31 December 2008, the Czech banking sector consisted of 37 banks and foreign bank branches. Compared to the end of 2007, the number of banks was unchanged and the same numbers of entities were offering banking services in the domestic banking sector.

As of 31 December 2008, a total of 20 banks (4 large banks, 4 medium-sized banks, 7 small banks and 5 building societies, one bank has not started business yet) and 16 foreign bank branches were offering banking services to clients in the Czech Republic. The group of four large banks is still the main component of the domestic banking market. The share of their assets in total banking sector assets slightly exceeded the 58% level in 2008, which means a slight drop by 3 p.p.

A total of 252 banks from EU Member States were ready to provide banking services under the freedom to provide services as of the end of 2008. These banks had notified the CNB of their activities. They can offer banking services without establishing a branch in the Czech Republic pursuant to Article 21 of Directive 2000/12/EC of the European Parliament and of the Council.

Banking services were also offered in other EU Member States by banks having their head offices in the Czech Republic. As in 2007, only two banks notified the CNB providing cross-border services, both in respect of Slovakia. In 2008, no other bank gave notification of the provision of such activities. Until the end of 2008, two banks based in the Czech Republic were also offering services through foreign branches in EU countries.

The shareholder structure of the Czech banking sector is stable. At the end of 2008, as in the previous year, foreign capital dominated the sector's capital, with a direct share of 81.0% (this refers to cases where a legal entity registered outside the Czech Republic holds a direct share in a bank). A total of 97.1% of the sector's total assets were controlled by foreign owners at the end of 2008. Owners from EU countries dominate.

A total of 39,003 people were employed in the Czech banking sector at the end of 2008, a drop of 2,204 on the previous year. The annual decline of growth of the sector's workforce at the end of 2008 was 5.3%, on the contrary the assets of the banking sector rose by 7.9% in 2008. The banking sector's activities in 2008 were less dynamic compared to 2007, mainly thanks to slower rates of growth of lending activities.

Clients' debt with domestic banks continued rising in 2008, however the rate of growth tend to slow down. The total volume of loans increased by 16.4%, in previous years the rise was 26.4% (2007) and 19.9% (2006).

Private individuals' debt with domestic banks was rising by 20.9% in 2008. Mortgage loans for housing increased by 18.9% during the year to account for 49.1% of all the loans provided to individuals.

Bank loans to non-financial corporations rose by 14.1% in 2008. The lower increase of corporate loans began at the end of 2008 mainly because of weaken economy.

The ratio of total assets to GDP at current prices was 112.1% at 2008 year end.

The total value of loans in default rose by 37.1% to CZK 71.1 billion in 2008. In result, the ratio loans in default increased by 0.5 p.p. up to 2.86%.

The banking sector has adequate liquidity at its disposal. The liquidity crisis resulting from insufficient liquidity in some European countries was not observed in the Czech Republic, although during the fall of the last year banks were loosing their willingness to provide loans on the interbank market. However, at the end of 2008 the situation improved significantly.

Capital requirements increased only by 2.1%, mainly due to implementation of Basel II. The capital ratio of the banking sector edged up by 0.79 percentage point to 12.34% in 2008, mainly due to faster growth in regulatory capital. Tier 2 capital was affected by an increase in subordinated debt. Tier 1 still has a dominant position in the sector's capital, accounting for roughly 95% of total regulatory capital.

The banking sector recorded a net profit of CZK 45.7 billion in 2008, down by CZK 1.3 billion on 2007 (3% year on year).

Return on Tier 1 (RoE) was 21.6% at the end of 2008, down by 3.8 percentage points on 2007. And as of 31 December 2008, the RoA was 1.16%.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN THE CZECH REPUBLIC

The Czech National Bank is responsible for performing supervision: banking sector and credit unions, the capital market and collective investment and insurance companies and private pension schemes.

As an integrated regulator, the CNB is responsible for the financial regulation and supervision of the business activities of regulated financial institutions. The first mentioned competency (regulation) consists mainly in the CNB, under the relevant laws, issuing subordinate legal rules and thereby setting detailed prudential rules for regulated financial institutions, and the latter competency (supervision) involves licensing, off-site supervision, on-site supervision and imposition of remedial measures. Primary legislation falls within the field of competence of the Finance Ministry.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

Since 1 January 2008, the CNB has been applying a functional model in its supervisory activities as the next step in the integration of the supervisory departments of the CNB. On this date, the newly established Financial Market Regulation and Analyses Department, Licencing and Enforcement Department and Financial Market Supervision Department began work. Financial market supervisory activities in the new organisational set-up are governed by a single supervisory concept. The CNB, as the integrated regulatory and supervisory authority, focused on unifying its licensing, authorisation and supervisory procedures. When implementing the single supervisory concept and conducting supervision, the CNB takes into account the individual risk profiles of the supervised entities.

The Consumer Protection Department was established at the CNB on 1 September 2008. Its work involves receiving and investigating consumers' complaints in accordance with competences arising under the Consumer Protection Act. Complaints are made against entities operating on the financial market and mostly relate to breaches of the prohibition of unfair commercial practices, discrimination against consumers and requirements for proper information about prices.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

Since the adoption of Act No. 36/2008 Coll.[25] (amending Consumer Protection Act) in February 2008, the CNB has started to carry out supervisory power in the area of unfair commercial practice. The scope of CNB's supervision is limited to above stated (see part 3) sectors. The new Act on Takeover Bids (No 104/2008 Coll.[26]) is effective from 1 April 2008. On 1 July 2008 a new legal Act on Transformation of Companies and Cooperatives (no. 125/2008 Coll.[27]) entered into force. Simultaneously the Act No. 230/2008 Coll. and five related CNB's Decrees have entered into force finally introducing MiFID rules to Czech financial market. In autumn 2008 new Anti-Money-Laundering Act (No. 253/2008 Coll.[28]) and two related CNB's Decrees have entered into force.

All above stated acts and decrees have significantly influenced supervision of financial institutions performed by CNB as an integrated supervisory authority in the Czech Republic.

In 2008, off-site supervision focused more on the potential impacts of the global market turbulence caused by the financial crisis on the performance of domestic financial institutions. In this context, the portfolios of individual institutions were inspected and their exposure to the risk entities and risk instruments. Volumes of risk exposure were relatively low

[25] Transposition of Directive 2005/29/EC
[26] Transposition of Directive 2004/25/EC
[27] Transposition of Directive 2005/56/EC
[28] Transposition of Directive 2005/60/EC and Directive 2006/70/EC

and so their impacts on institutions financial results were only limited. Significant attention was given to liquidity of the key financial institutions. In this case the intensive communication was high priority.

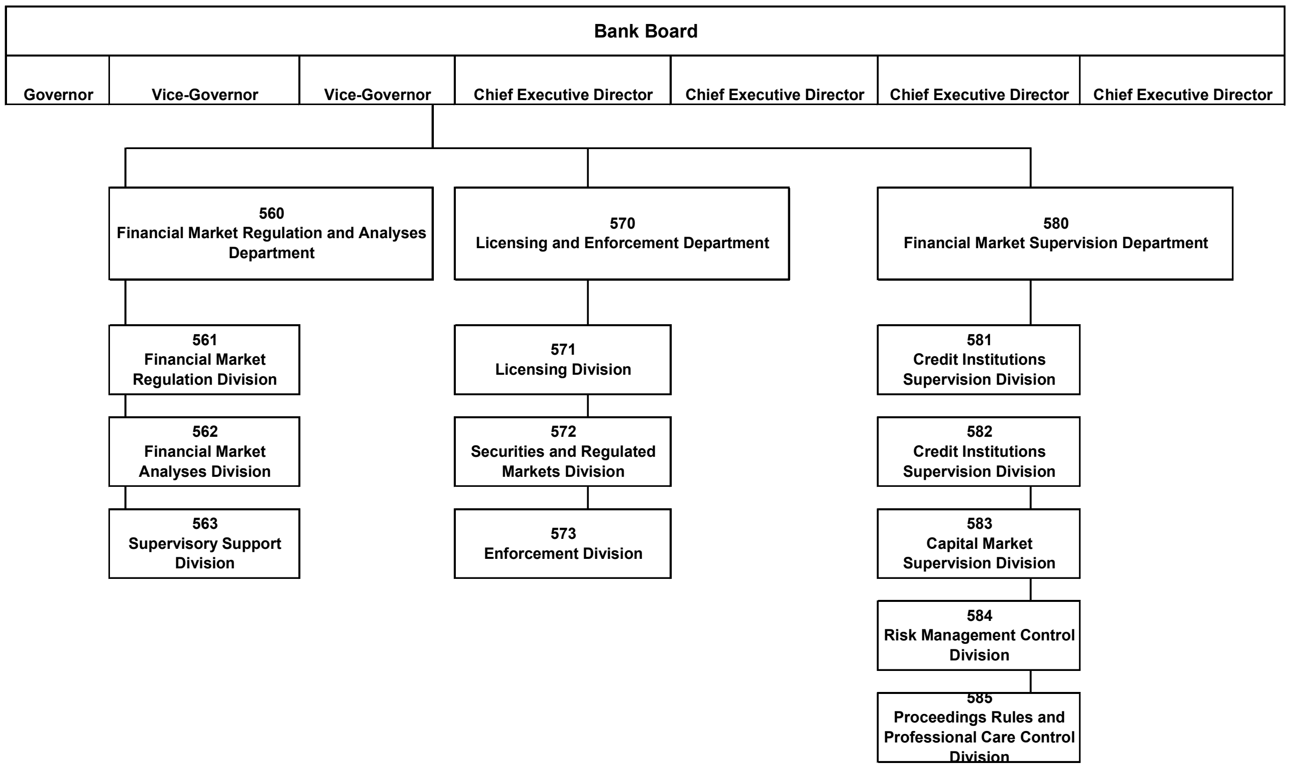
As a consequence of the financial market crises all over the world the Czech financial sector CNB as a supervisor decided to extend duty of data collection since 1 October 2008 on daily basis. Total range of extraordinary data was widen step by step and nowadays we collect on daily bases data concerning liquidity, volume and structure of quick assets, deposits development, loans granted. Banks are obliged to inform immediately about transactions in terms of decreasing of quick assets and internal limits against domestic or foreign institutions. We have not mentioned yet any unfavorable indications concerning development of liquidity even if in some banks we have mentioned temporarily stronger liquidity management. Engagement limits are respected. Banking supervision has run smoothly up to now without any extraordinary events. Apart from liquidity questions CNB´s supervision concerns on development credit loans portfolio and capital adequacy.

As part of the supervision of banks and credit unions, 9 on-site examinations were carried out in 2008, all of which at banks. All of them were partial examinations. These examinations focused on the management of credit risk, compliance, market risks and operational risks, including information systems risks, as well as on the prevention of money laundering and on overall assessment of the internal control systems of banks. Liquidity in credit institutions was examined only in one bank. Validation of advanced methods or other methods of risk measurement and management requiring a supervisor approval was effected in five credit institutions.

ORGANIZATIONAL CHART OF BANKING AUTHORITY

Organisational structure of CNB Financial Market Supervision

as of 1 January 2008



Vice-Governor Luděk Niedermayer's term of office ended on 26 February 2008. Effective 1 March 2008, the Czech President appointed Mojmír Hampl as Vice-Governor of the CNB and Eva Zamrazilová as Chief Executive Director and Member of the Bank Board of the CNB.

INTERNATIONAL ACTIVITIES OF THE CZECH NATIONAL BANK

In 2008, about one-third of the supervisory departments' staff was involved in various ways in the activities of international organisations and working committees (13 committees and 50 working groups and subgroups). 2008 was a year of deepening crisis in the financial markets, and this was reflected in the focus of international cooperation.

Within EU structures, participation in the meetings of the European Commission's committees and working groups – above all the Lamfalussy Level 3 committees (CEBS, CESR, CEIOPS) and the European Central Bank's committees – was of key importance.

The aims of the Committee of European Banking Supervisors (CEBS), in which the CNB has a representative, are to achieve better regulation, to promote convergence in approaches to regulation and supervisory practices, and to enhance cooperation between supervisors. CEBS works to achieve these aims through three standing expert groups, in which the CNB is actively involved (the Group de Contact, the Expert Group on Prudential Regulation and the Expert Group on Financial Information).

The Committee of European Securities Regulators (CESR) aims to improve the coordination and cooperation among regulators and ensure consistent and timely implementation of EU legislation in the Member States. The CNB is represented in all its major working groups (CESR-Fin, CESR-Pol, CESR-Tech, MiFID Level 3, the Prospectus Expert Group, the Investment Management Expert Group and recently also the Post-Trading Expert Group).

The CNB took part in Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), it continued working on the new Solvency II prudential framework. In 2008, CEIOPS also focused on the preparation, implementation and assessment of the fourth round of the quantitative impact study (QIS4).

The CNB was active in cooperation within the structures of the European Central Bank. The CNB is represented in the Banking Supervision Committee (BSC) and its Working Group on Macroprudential Analysis (WGMA), Working Group on Developments in Banking (WGBD) and Working Group on Credit Registers (WGCR). In addition to supervisory issues, the Banking Supervision Committee and its working groups and sub-groups also devote much attention to the area of financial stability. The CNB's experts on supervision and financial stability, who are jointly represented in these structures, work together very closely in this field of activity.

The CNB is represented in the International Liaison Group (ILG), established by the BCBS as a successor to the Core Principles Liaison Group (CPLG), which achieved much in creating the revised Core Principles for Effective Banking Supervision. The Core Principles have become an internationally acknowledged standard for banking supervision.

The Czech Republic is represented in the Joint Committee on Financial Conglomerates (JCFC). Working in this Committee is beneficial for the Czech Republic, as there is one financial conglomerate active on the Czech market and it is supervised by the CNB. The CNB also acts as coordinator vis-à-vis foreign supervisors and cooperates with them in the supervision of five other conglomerates from EU countries.

The CNB is a signatory to the International Organization of Securities Commissions (IOSCO) Multilateral Memorandum of Understanding, under which the CNB is continuing to work in cooperation with other member states. In June, the CNB became a signatory to the Multilateral Memorandum of Understanding on Cross-Border Financial Stability, whose objective is to enhance cooperation in the management and resolution of cross-border financial crises.

Attention was focused on the work of supervisory colleges, above all the effort to create supervisory colleges for all cross-border groups, support information sharing and harmonise the supervisory practices of the individual colleges. The signing of memoranda of understanding should be a further step towards strengthening the work of supervisory colleges and cooperation between partner supervisory authorities.

The CNB was also involved in the International Association of Insurance Supervisors (IAIS) in 2008, actively monitoring work on individual standards and guidelines and participating in various surveys conducted by the IAIS.

Cooperation also continued within the International Organisation of Pension Supervisors (IOPS), which the CNB joined in 2007. This membership provides the Czech Republic with access to detailed information about pension systems in the individual member states and gives it more opportunities to find the optimal configuration for its pension reform.

The CNB was also actively involved in cooperation within, for example, the International Association of Insurance Supervisors (IAIS) and the Group of Banking Supervisors from Central and Eastern Europe (BSCEE), attended an annual conference on the impacts of globalisation in the financial services area on the activity of regulators, contributed to various surveys and actively monitored work on the preparation of standards and recommendations.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE CZECH REPUBLIC

The domestic financial market is supervised by two authorities in the Czech Republic. There are Czech National Bank and Ministry of Finance of the Czech Republic. Ministry of Finance is primarily responsible for legislation process and CNB is responsible for regulation and supervision particularly. Both CNB and MF cooperate very close. In 2006, the CNB and the Czech Ministry of Finance signed an agreement on cooperation in the field of preparation of new legislation and other legal documents concerning financial market. In 2007, the CNB and the Czech Ministry of Finance signed an agreement on cooperation in the exchange of information relating to the financial market. Under this agreement, the two institutions regularly exchange aggregated data on the financial market.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF 2008

In the context of the current turbulence on advanced financial markets, the Czech National Bank is closely monitoring and analysing the situation on the Czech financial market.

The Czech financial system continues to be relatively isolated from global turbulence. It remains true that domestic financial institutions are not members of the global financial groups that have been affected most by the crisis. The exposures of the most important players on the Czech financial market – i.e. banks – to risky assets and troubled global banks are marginal, thanks mainly to their strong focus on the conservative business model on the still under saturated Czech market. This focus is also reinforced by the predominance of foreign ownership of domestic financial institutions, as the foreign owners let their subsidiaries generate profit chiefly from dynamically expanding retail banking activities, while the management of securities and derivatives portfolios is usually concentrated in their branches in international financial centres. The stability of the domestic banking sector is also aided by the still high levels of balance sheet liquidity, financing of loan expansion mainly by primary deposits, which results in minimum dependence on funds from foreign markets, and only marginal use of loan securitisation.

Available information and analyses indicate that the Czech banking sector does not face the risk of a crisis similar to that going on in the United States. This is due, among other things, to stricter credit standards and loan provision criteria (relatively conservative credit securing using pledges and a higher required debtor creditworthiness) as well as the traditional method of interest rate fixation and smaller reliance on external mortgage underwriters. Domestic banks have sufficient capital to cover the risks they assume. The share of default receivables in the overall investment portfolio in the Czech Republic is now relatively low, reaching 2.86% in 2008 year end.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2006	2007	2008
Banks	37	37	37
Credit unions	20	19	17
Insurance companies	49	52	53
Pension funds	11	10	10

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

Type of financial institution	2006	2007	2008
Public sector ownership	4.3	4.2	4.3
Other domestic ownership	13.1	13.2	14.7
Domestic ownership total	17.4	17.4	19.0
Foreign ownership	82.6	82.6	81.0
Credit institutions, total	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2006	2007	2008
Public sector ownership	2.2	2.4	2.9
Other domestic ownership	0.8	0	0
Domestic ownership total	3.0	2.4	2.9
Foreign ownership	97.0	97.6	97.1

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)
Banks	50.7	62.1
Credit unions	75.0	85.4

Return on Asset (ROA) by type of financial institutions

Type of financial institution	2006	2007	2008
Banks	1.23	1.34	1.16
Credit unions	1.20	0.92	0.63

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2006	2007	2008
Banks	22.5	24.5	21.6
Credit unions	6.3	5.5	5.7

Distribution of market shares in balance sheet total (%)

Type of banks	2006	2007	2008
Banks	99.9	99.8	99.7
Credit unions	0.1	0.2	0.3
Banks, total	**100.0**	**100.0**	**100.0**

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

Assets	2006	2007	2008
Cash	1.1	1.1	1.0
Deposits with central banks	16.4	11.6	8.2
Financial assets held for trading	5.3	7.1	9.8
Financial assets designated at fair value through profit or loss	0.0	0.0	1.8
Available-for-sale financial assets	6.1	7.4	7.6
Loans and receivables	55.7	58.5	59.1
Held to maturity investments	11.3	10.2	8.7
Derivatives - hedge accounting (positive fair value)	0.4	0.4	0.3
Fair value changes of the hedged items in portfolio hedge of interest rate risk	0.0	0.1	0.0
Tangible assets and intangible assets	1.7	1.5	1.2
Investments in associates. subsidiaries and joint ventures	1.2	1.4	1.8
Other assets	0.8	0.7	0.6
Liabilities	**2006**	**2007**	**2008**
Deposits. loans and other fin. liabilities vis-à-vis central banks	0.0	0.0	0.9
Financial liabilities held for trading	2.4	2.7	5.3
Financial liabilities designated at fair value through profit or loss	0.0	4.0	1.7
Financial liabilities measured at amortized cost	87.6	84.1	83.0
Derivatives - hedge accounting (negative fair value)	0.2	0.2	0.3
Fair value changes of the hedged items in portfolio hedge of interest rate risk	0.0	0.0	0.0
Provisions	0.3	0.3	0.3
Other liabilities	2.0	1.7	1.2
Equity. total	**7.4**	**6.8**	**7.2**

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

Type of banks	2006	2007	2008
Banks	248.9	290.2	297.0
Credit unions	64.6	90.8	82.1

Solvency ratio of financial institutions

Type of banks	2006	2007	2008
Banks	7.4	6.8	7.2
Credit unions	n/a	14.1	9.6

Asset portfolio quality of the banking system

Asset classification	2006	2007	2008
Without default	1809.5	2139.2	2410.8
Standard	1706.9	2076.0	2324.0
Watch	102.6	63.2	86.8
With default	54.2	51.8	71.1
Substandard	21.1	16.3	23.2
Doubtful	9.0	8.7	10.9
Loss	24.1	26.8	36.9
Specific reserves	-	-	-

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	56.1	41.0
Government sector	11.4	2.6
Corporate	23.0	40.9
Foreign	3.6	7.2
Other	5.9	8.3
Total	**100.0**	**100.0**

The structure of deposits and loans in 2008 (%)
(at year-end)

Types of deposits		Types of loans	
At sight	52.2	Long term loans	60.0
Within one year	41.1	Medium-term loans	17.4
Over one year	6.7	Short-term loans	22.6
Total	**100.0**	**Total**	**100.0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Banks	20.9	21.1	17.8	16.9	18.0	15.4

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

Revenues	2006	2007	2008
Interest income	124 114	156 436	191 914
Fees and commissions income	41 093	44 830	46 778
Dividend income	1 675	5 886	3 730
Other operating income	2 507	2 201	3 094
Exchange differences, net	4 212	7 759	11 938
Expenditures	**2006**	**2007**	**2008**
Interest expenses	52 567	71 738	93 871
Fees and commissions expenses	8 174	8 989	10 655
Other operating expenses	3 835	3 770	3 956
Administrative costs	55 652	59 713	61 681
Impairment	5 163	6 525	15 472
Tax expenses	11 132	12105	8 364

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR mln	%	EUR mln	%
Banks	2 748	1.83	8 579	5.71
Credit unions	42.93	9.6	50.6	11.3

* Exchange rate as of 31 December 2008: CZK/EUR = 26.93

2008 DEVELOPMENTS IN THE ESTONIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

Year 2008 witnessed a significant setback in the global economic environment and the uncertainty over the future continues. Also the economies of Estonia's main trading partners are weakening, putting additional pressure on our economic prospects. Estonia's economic expansion turned into recession in 2008: the total decline in GDP was 3.6%. While the first quarter of the year still witnessed an expansion of 0.2%, the decline experienced in the second, third and fourth quarter was -1.1%, -3.5% and -9.7%, respectively. Economic downturn was mostly driven by the drop in domestic demand, caused by the deterioration of business conjuncture in main economic sectors as well as by decrease in consumers' sense of security. First months of 2009 have not shown any increase in both operators' and consumers' sense of security. Due to a decrease in external demand also the export of goods and services declined in 2008. Import of goods and services decreased by 7.9%, export by 1.1%. Import has decreased more than export due to the decline in consumption and investments, implicating the improvement of trade balance and reducing current account deficit. According to the estimates of the Bank of Estonia, Estonia's economic decline may reach up to 12.3% in 2009 due to the drop in external demand. Economic growth is expected to recover in 2010. The inflation rate increased in 2008 at a much faster pace than in the previous year: average growth in consumer prices was 10.4% (6.6% in 2007). Growth in consumer prices was mostly driven by increasing housing expenses and higher prices of food, fuel, alcoholic beverages and tobacco products. First months of 2009 have witnessed a significant drop in the pace of inflation and the Bank of Estonia estimates that the inflation rate is likely to remain below 2% in 2009. Unemployment rate that had remained on a low level in the first half of 2008 increased considerably in the second half and reached its highest level in three years by the end of the year. Unemployment rate reached 5.5% in 2008 (4.7% in 2007). Average annual employment actually even increased as compared with 2007. Still, the number of employed people dropped significantly in the last quarter – by 8000 persons in total. Year 2009 is expected to witness continuing growth in the unemployment rate and decreasing employment.

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

As at 31 December 2008, there were six locally authorized credit institutions and ten branches of foreign credit institution operating in Estonia. The ratio of banking sector's total assets to GDP was 138%.

Competition of banks on the credit market was still very intense in 2008. Estonian branches of Nordea Bank Finland PLC and Danske Bank A/S as well as the Estonian branch of Bank DnB NORD A/S increased their market shares on the credit market. They increased their market shares on the account of major banks – Swedbank AS and AS SEB Pank. Year 2009 is expected to witness continuing expansion and growth of branches of foreign banks in grabbing the market share.

Total assets of banks increased by 7% in 2008 and totalled 341.5 billion kroons as at 31 December 2008. Asset volume increase was mostly driven by the 9% growth in clients' loan portfolio (35% in 2007). The combined loan portfolio of banks amounted to 260.4 billion kroons at the end of 2008, forming 76% of total assets. As at 31 December 2008, the combined loan portfolio of banks was structured as following: loans to companies 45%, loans to individuals 46%, loans to financial institutions 7% and loans to the public sector 2%. In 2008, the growth in financing both individuals and companies continued to slow down. While loans to individuals increased 63% in 2006 and 33% in 2007, the growth in financing individuals slowed down to 11% by the end of 2008. This is also true for the growth in financing companies, which was 60% in 2006, 31% in 2007, and which slowed down to 6% by the end of 2008. Slowdown in the growth of loans to individuals is increasingly driven by the decrease in customers' sense of security. Slowdown in the growth of loans to corporate clients is mostly driven by the slowdown in financing the real estate sector. Based on the global and national economic decline, the slowdown in the growth of loan portfolio is expected to continue also in future.

The quality of banks' loan portfolio deteriorated significantly in 2008. Due to the economic decline, the volume of overdue loans has started to grow, both in absolute terms and as a share of the whole loan portfolio. The growth was especially strong in loans overdue for more than 90 days in 2008. The percentage of these overdue loans formed 0.5% of banks' loan portfolio at the end of 2007, but by the end of 2008 this percentage had reached to 2.1%. Also, the coverage of long-term loans overdue with provisions has declined. Although banks made many new provisions during the years, the volume of overdue loans increased in a much faster pace. While the coverage of loans overdue for more than 90 days was 103% at the beginning of 2008, it had declined to 57% by the end of December. 83% of banks' combined loan portfolio was classified as non-problem loans[29]. Loans classified as doubtful, risky or unlikely formed in total 6% of the composite loan portfolio (3% in 2007). Based on recent developments in the economic environment, the growth of overdue loans and provisions is expected to continue also in 2009.

By the end of 2008, the total volume of resources in the banking sector had reached 303 billion kroons, growing by 7% in 2008. By the type of resources, the most substantial increase was in the funds from parent banks, mainly obtained in the form of loans. Therefore also the share of external institutional borrowing increased: while these loans accounted for 46% of total resources in 2007, their share had increased to 48% by the end of 2008. Clients' deposits formed 48% of total resources of the banking sector at the end of 2008. The share of client deposits has decreased as the financing by parent banks has increased. Local resources deficit is also evident from the loan-deposit ratio that increased by the year-end, reaching the level of 175% (168% in 2007). As the liquidity risk of banks

[29] Classification is based on the Decree No 9 of the Governor of the Bank of Estonia, 27 June 2000.

operating in Estonia is generally managed at the level of parent bank groups, the occurrence of risk is directly depending on the ability of the parent bank to refinance its liabilities on money markets and to involve additional funds.

In 2008, banks operating in Estonia earned on solo basis a net profit of 3.9 billion kroons, which is approximately twice as small as in 2007. Still, we have to remember that profits earned in 2007 include extraordinary income of Swedbank AS (AS Hansapank) received as dividends from subsidiary undertakings. Without this extraordinary income, the 2008 profit of banks was only 19% smaller than the profit in 2007. Profits decreased primarily due to significantly higher loan loss provisions: annual increase in loan loss provisions was about fourfold. Banking groups' net profit amounted to 7.6 billion kroons, which was 29% less than in 2007. Due to the decrease in net profits, also the composite Return on Equity (ROE) has considerably decreased both on solo and consolidated basis: solo ROE was 13.5% and consolidated ROE 17% (30% and 28.3% respectively in 2007). Based on prospects of global and national economy, the profitability of banks is expected to decrease also in future.

As at 31 December 2008, the composite capital adequacy of banks on a solo basis was 18.82% (14.78% in 2007). Consolidated capital adequacy of banking groups was 13.32% at the end of 2008 (10.84% in 2007). Also Tier 1 capital ratio remained on an adequate level both on solo and consolidated basis: Tier 1 capital ratio was on a solo basis 13.08% and on a consolidated basis 10.40% at the end of 2008. Credit risk is still the major risk for the banking sector.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

Pursuant to Article 6(1)(5) of the Financial Supervision Authority Act, one of the tasks of the Financial Supervision Authority in developing the legal environment is to make proposals for the establishment and amendment of Acts and other legislation concerning the financial sector and related supervision, and participate in the drafting of such Acts and legislation. According to the Financial Supervision Authority Act, draft legislation regulating supervised entities or the activities of the Financial Supervision Authority or having otherwise an effect on the achievement of objectives of financial supervision must be approved by the Financial Supervision Authority.

On 28 January 2008 the new Money Laundering and Terrorist Financing Prevention Act entered into force, transposing to the Estonian legal system the Directives of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (Third Money Laundering Directive) and on implementing the Third Money Laundering Directive.

On 1 November 2008 the Advertising Act entered into force, laying down an obligation of the Financial Supervision Authority to exert supervision over the advertising of financial services that are provided to clients by banks, insurance companies, insurance intermediaries, investment firms, fund management companies, investment and pension funds, participants on the securities market and other entities subject to financial supervision pursuant to Article 2 of the Financial Supervision Authority Act.

Amendments to the Act amending the Funded Pensions Act, the Estonian Central Register of Securities Act, the Investment Funds Act, the Insurance Activities Act, the Guarantee Fund Act and the Income Tax Act entered into force on 14 November 2008. Amendments were based on the need to elaborate and update the system of mandatory funded pension by eliminating deficiencies revealed by analyses and to establish a legal basis for making mandatory funded pension payments. The Ministry of Finance examined the functioning of and developments on pension funds' market together with the Financial Supervision Authority and some of the amendments are based on results of the Authority's analyses.

The Financial Supervision Authority presented also its opinion on motions to amend the regulation of acquisition and disposal of qualifying holdings in entities subject to financial supervision. With the draft act that amends the Insurance Activities Act, the Securities Market Act, the Credit Institutions Act, the Investment Funds Act and the Estonian Central Register of Securities Act it is envisaged to harmonize the national legislation with procedures and criteria for evaluating the reliability applied to acquisition and increasing of qualifying holdings in the financial sector. In addition, provisions of the Investment Funds Act will be elaborated in respect of the arrangement for conflicts of pension fund managers' interests and provisions of the Insurance Activities Act on own funds will also be amended.

The Financial Supervision Authority was involved in the preparation of the Emergency Situation Draft Act by designing the framework for regulating an essential service in the financial system and the liability for supervision. The Draft Act allows the state to be faster and more flexible in interfering with the prevention and resolution of financial crisis. The Authority considers it essential in the state of emergency that the state is capable of involving adequate resources from the market and investing them quickly. In cooperation with the Bank of Estonia and the Ministry of Finance, the Authority drafted the plan for amending the Credit Institutions Act – motions to amend for extending the competence of the supervisory authority, dividing of credit institutions and expropriation of holdings. Amendments are necessary for ensuring that the state can adequately react in potential situations of financial crisis.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

The Financial Supervision Authority's strategy for 2007–2010 sets the following main objectives for the Authority's activities: to improve cross-border supervisory capabilities; to increase the share of preventive supervisory methods; to raise the awareness level of financial services customers; to promote an open communication and working culture and to increase the effectiveness and minimize red tape through ensuring the competitiveness of Estonia's financial sector at the international level.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN2008

In 2008, the Financial Supervision Authority granted authorizations to three new fund management companies and issued a supplementary license to one fund management company already operating on the market. Fund management licenses were granted to AS Limestone Investment Management and AS Redgate Varahaldus (now AS Redgate Asset Management). Nordea Pensions Estonia AS was authorized as a fund management company for managing mandatory and voluntary pension funds. ERGO Varahalduse AS received a supplementary license for managing voluntary pension funds.

In 2008, the risk analysis of credit institutions was based on traditional monthly and quarterly reports. Major risk areas of credit institutions – credit risk, operational risk, liquidity risk, market risk, etc. – are evaluated during such an analysis based both on quantitative and qualitative information. Results of this analysis provide an important input for planning supervisory activities and are regarded as a primary source of information for planning and performing on-site inspections.

In the light of developments in economic environment and on real estate market, the Financial Supervision Authority focused its attention on the compliance by banks to risk management procedures related to mortgage loans and to lending standards. Due to developments on global financial markets, the Financial Supervision Authority focused especially on monitoring the liquidity risk. It performed on regular basis the mapping of banks' situation in ensuring the liquidity and drafted estimates on the occurrence of liquidity risk, as well as assessed the procedures and internal regulations related to the management of liquidity risk.

In 2008, the Financial Supervision Authority conducted on-site inspections in the following credit institutions: AS BIGBANK, AS SEB Pank, Swedbank AS and Tallinna Äripanga AS. These on-site inspections covered the following areas:

- Credit activities and management of credit risk;
- Reporting on credit activities;
- Performance consistency arrangement;
- Conformity of procedures for the prevention of money laundering and terrorist financing with the provisions of the new Money Laundering and Terrorist Financing Prevention Act and international practices;

- Due diligence measures applied to clients registered in low tax regions and efficiency of respective control mechanisms;
- Processes for the management of changes to IT and incidents related to IT, as well as adequacy of measures designed for the management of associated risks;
- Conformity with requirements pursuant to MiFID amendments in assessing the suitability and adequacy of services for clients and in settling of complaints;
- Granting and servicing of loans and solvency of borrowers;
- Procedural arrangements for the evaluation of granted loans and conformity with these arrangements;
- Recovery process of overdue loans;
- Actions of Internal Audit;
- Actions of the management and reporting to the management.

As the implementation of internal risk assessment methods is allowed only when approved by the Financial Supervision Authority, the Authority commenced with examining applications that were submitted by credit institutions in 2008 for switching over to internal assessment systems for credit risk and operational risk. It assessed the conformity of internal risk assessment methods used by banks for measuring credit and operational risks with regulative quantitative and qualitative requirements. Quantitative requirements cover primarily the forecasting capacity and statistical reliability of internal risk assessment methods. Qualitative requirements cover the reliability of IT infrastructure of risk assessment methods, availability of transparent documentation, functioning of adequate internal controls and integration of risk assessment results into day-to-day decision making processes of the bank. The Financial Supervision Authority carried out several on-site inspections with the participation of supervisory authorities from Sweden and other Baltic countries. In 2008, the Financial Supervision Authority issued one permit to use internal risk assessment methods for credit risk and one permit to use internal risk assessment methods for operational risk.

As Basel II is based on principles and provides some interpretation freedom for both supervisory authorities and market participants, the Financial Supervision Authority pays great attention to drafting respective advisory guidelines, in order to increase the transparency of supervisory activities and promote the application of good risk management practices on the marketplace.

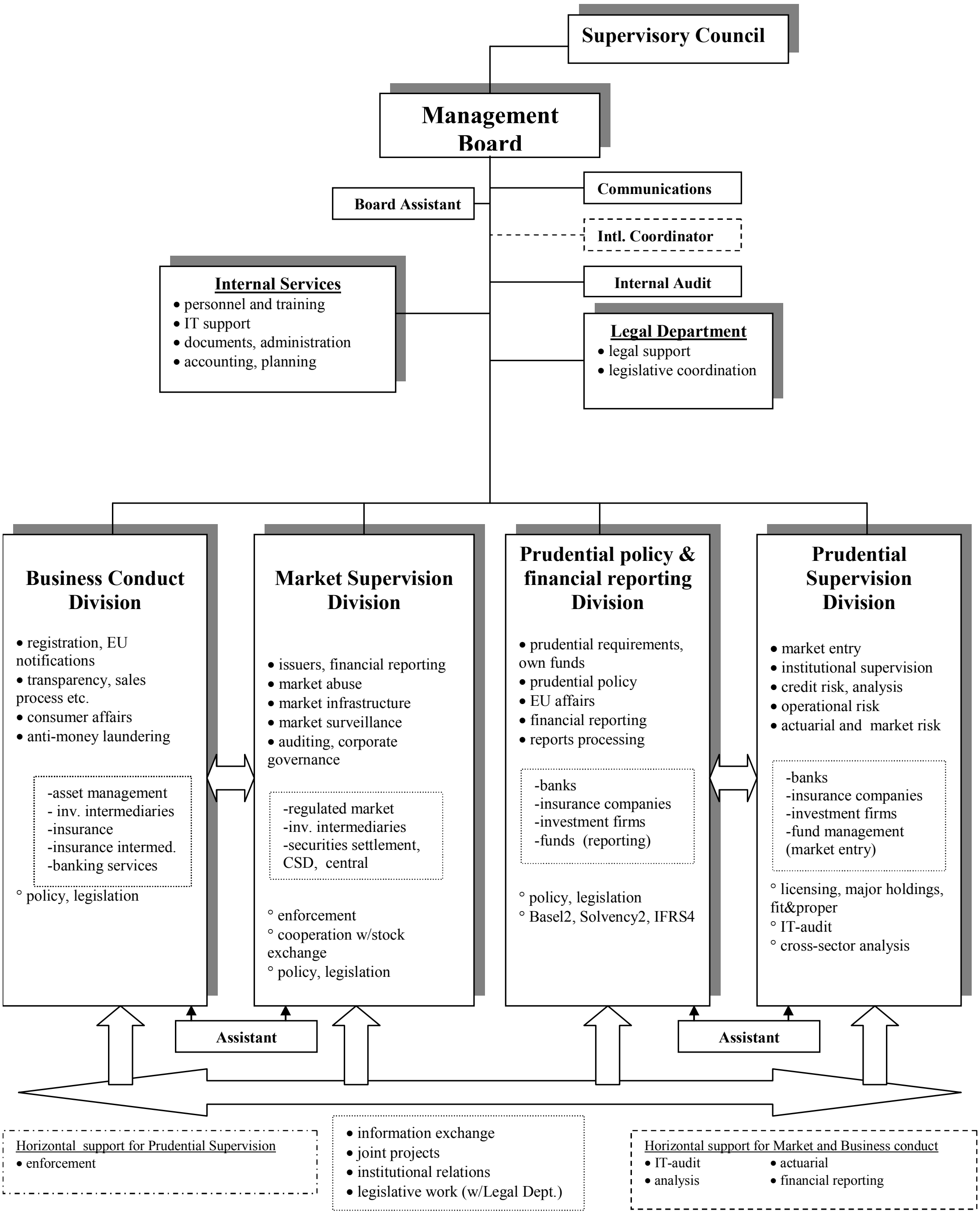
In 2008, the supervision of the prevention of money laundering and terrorist financing was focused primarily on the control of due diligence measures applied by market participants. The efficiency of the application of amendments related to the enforcement of the new MLTFPA was evaluated in five credit institutions. Also, the establishment of relationships with non-resident clients is constantly monitored.

One of the tasks of the Financial Supervision Authority is to identify existing risks for consumers and to give them information and support for making the right choice of financial services. A consumer who is acquainted with financial services enters into a contract with higher level of awareness, limiting thus the possibility of subsequent disputes with the financial services provider. The competence of a consumer in concluding a contract adds significant value to ensuring the effective functioning of the market.

In the light of these objectives, the Authority launched and developed further its online portal www.minuraha.ee addressed to consumers. In 2008, significant efforts were made in this area for reaching different social groups. The Financial Supervision Authority launched cooperation projects with the Ministry of Social Affairs for supporting and educating debt advisors and with the Ministry of Education and Research for supplementing national curricula with preparatory training in financial services and products.

ORGANISATIONAL STRUCTURE OF THE ESTONIAN FINANCIAL SUPERVISION AUTHORITY

The activities of the EFSA are managed and organized by the Management Board, which consists of four members (Mr. Raul Malmstein, Mr. Andres Kurgpõld, Mr. Kaido Tropp and Mr. Kilvar Kessler) and is simultaneously the management body and the administrative body. The Management Board has competence over the organization of all activities of the EFSA and making decisions related to the financial supervision.



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The Financial Supervision Authority is able to influence the shaping of international supervision customs and policies that have an impact on the Estonian financial market by participating in the work of the EU financial sector supervisory committees: CESR, CEIOPS and CEBS.

On 26 August 2008 the Russian Central Bank and the Financial Supervision Authority signed the Memorandum of Understanding between the Central Bank of the Russian Federation and the Estonian Financial Supervision Authority, i.e. the cooperation memorandum on banking supervision which had been elaborated for many years. Preparing of the draft of this memorandum started already in spring 2005. The aim of agreeing on cooperation principles was to ensure the stability of banking system in exerting prudential supervision.

In June 2008, the Financial Supervision Authority signed the cooperation memorandum between financial supervisory authorities, central banks and ministries of finance of EU Member States in order to guarantee cross-border financial stability.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Banks	7	7	6
Branches of foreign credit institutions	7	8	10
Financial institutions, total	**14**	**15**	**16**

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

Item	2006	2007	2008
Public sector ownership	0.0	0.0	0.0
Other domestic ownership	5.6	4.3	5.9
Domestic ownership total	5.6	4.3	5.9
Foreign ownership	94.4	95.7	94.1
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Item	2006	2007	2008
Public sector ownership	0.0	0.0	0.0
Other domestic ownership	0.9	1.3	1.8
Domestic ownership total	0.9	1.3	1.8
Foreign ownership	99.1	98.7	98.2
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Bank	82.0	94.8

Return on Asset (ROA) by type of financial institutions

Type of financial institution	2006	2007	2008
Bank	1.7	2.6	1.2

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2006	2007	2008
Bank	19.8	30.0	13.5

Distribution of market shares in balance sheet total (%)

Type of financial institution	2006	2007	2008
Bank	100.0	100.0	100.0

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

Assets	2006	2007	2008
Cash	0.89	0.75	0.68
Claims on central bank	7.13	5.47	8.23
Claims on credit institutions	9.24	11.29	10.27
Claims on customers	74.18	74.60	76.24
Allowance for uncollectible claims	-0.31	-0.39	-0.91
Securities	7.38	6.36	5.02
Intangible assets	0.18	0.13	0.13
Tangible assets	0.26	0.19	0.20
Other assets	1.05	1.60	0.14
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2006**	**2007**	**2008**
Amounts owed to credit institutions and central bank	27.25	34.88	37.55
Amounts owed to customers	51.47	44.70	43.60
Government lending funds and counterpart funds	0.03	0.02	0.05
Issued debt securities	7.34	5.31	4.39
Other liabilities	2.35	2.69	2.43
Subordinated liabilities	3.08	3.70	3.13
Provisions	0.06	0.06	0.06
Equity capital	8.42	8.64	8.79
Total liabilities and capital	**100.00**	**100.00**	**100.00**

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

Type of financial institution	2006	2007	2008
Banks	40.59	26.87	27.40

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Banks	13.14	14.78	18.86

Asset portfolio quality of the banking system

Asset classification %	2006	2007	2008
Standard loans	90.35	87.37	82.54
Watch loans	7.48	9.61	11.41
Doubtful loans	1.78	2.36	3.28
Insecure loans	0.22	0.36	1.30
Uncollectible loans	0.17	0.30	1.47
Classified total	**100.00**	**100.00**	**100.00**
Specific reserves	**0.28**	**0.36**	**0.96**

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	36.19	44.20
Government sector	6.33	2.07
Corporate	33.31	43.28
Foreign	16.23	4.45
Other	7.94	6.00
Total	**100.0**	**100.0**

The structure of deposits and loans in 2008 (%)
(at year-end)

Types of deposits		Types of loans	
At sight	46.88	Long term loans	53.91
Within one year	51.39	Medium-term loans	35.26
Over one year	4.51	Short-term loans	10.83
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.		
	2006	2007	2008	2006	2007	2008
Banks (balance sheet items only)	70.3	72.7	75.0	59.8	68.1	61.6

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

Revenues	2006	2007	2008
Interest income	596.95	987.62	1285.52
Income from financial investments	7.66	154.00	11.35
Commission income	163.29	201.02	204.04
Profit on financial operations	94.97	153.19	64.53
Other operating income	22.25	66.55	68.71
Expenditures	**2006**	**2007**	**2008**
Interest expenses	309.65	598.69	872.50
Commission expenses	42.25	52.41	51.90
Administrative expenses	204.18	266.60	274.81
Value adjustments of claims and off-balance sheet commitments (+/-)	18.88	38.45	125.65
Other operating expenses	19.03	31.51	33.71
Profit/loss for the reporting period	**230.63**	**472.47**	**251.34**

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR mln	%	EUR mln	%
Banks	294,860,353.0	1.4	2,230,023,136.0	11.2

2008 DEVELOPMENTS IN THE HUNGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The Hungarian economy went through a difficult period in 2008. GDP growth slowed from 1.1% in 2007 to an average 0.5%. Previously, starting from mid-2006, the economy underwent a major fiscal adjustment effort, as a result of which the general government deficit was reduced sharply, to 3.4% of GDP in 2008 from 9.2% of GDP in 2006. Economic growth was already slowed down significantly by that fiscal adjustment. In H1 2008, domestic demand started to recover and GDP growth moved to a year-on-year 2% by Q2. However, external demand, the key growth factor, lost momentum during the year and caused a break in the trend of recovery during Q3. External conditions turned even more unfavourable in October, when, due greatly to global factors, investor sentiment towards the CEE region turned negative and risk spreads rose sharply, while exports fell significantly on declining European demand. As a result, the domestic economy slid into a recession in Q4, when GDP fell by 2.3% year-on-year, and the unemployment rate rose to 8%. The Hungarian currency (Forint) also weakened, by roughly 5% against its historically typical EURHUF 250 exchange rate by year-end, and further to 10%-15% below this historical rate in Q2 2009. However, inflation, contained by the weak economy, fell to 3.1% year-on-year by December, and the corporate liquidation ratio, which had been pushed up by fiscal restrictions previously, eased back to an annualised 2.2% in Q4.

The outlook for 2009 is determined by several significantly negative, and some positive factors. On the positive side, Hungary managed to conclude an EUR20bn financing agreement with the IMF and the EU in November 2008, which, combined with an EUR5bn repo facility from the ECB, provided full coverage for Hungary's total maturing external liabilities for more than a year ahead. On the negative side, however, external demand, mainly from Europe, remains weak, and markets continue to be difficult. Amidst the conditions of a global recession, and of continued efforts to keep the fiscal deficit below 4% of GDP, the domestic economy is likely to fall by 6-7% in 2009. As a consequence, unemployment and the corporate liquidation ratio are likely to rise, too. Positively, markets have started to normalise and risk spreads have decreased since April, mostly on global factors, but partly in view of continued good performance of the ongoing IMF/EU financing agreement.

DEVELOPMENTS IN THE BANKING SYSTEM

Despite the unfavourable conditions of the global financial and economic crisis, the Hungarian banking sector performed remarkably well in 2008. Total assets rose by 20% in HUF terms, and reached 109% of GDP at year-end, significantly up from 96% in 2007. The sector proved significantly profitable, with an average ROE of 14%, after 18% in the previous year. Most banks, including all the major ones remained profitable. Losses due to credit risk remained contained, at 0.7% of the stock of customer loans, and the average capital adequacy ratio kept stable during the year, with an 11.4% level in December. The Tier 1 ratio was 9.1% at the same time. Asset quality deteriorated moderately during the year, and problem assets (bad, doubtful and substandard) gave 2.7% of the total stock of claims at end-2008.

Nonetheless, the good performance of the banking sector cannot hide away some difficult periods and deteriorating trends that occurred during the year. Most notably, domestic banks went through a period of significant difficulty in October, when funding costs rose sharply, and the FX swap market – together with the government bond market – dried up temporarily. It took a series of government and central bank measures to return to normality, and no similar functional disorder has been repeated since that time. Yet, growth in the balance sheet has slowed down to single digit annual rates since October 2008, as risk spreads have failed to return to their pre-crisis levels, funds and capital remain scarce, and banks have tightened lending conditions, in view of growing credit risk.

The outlook for 2009 is weakened by the existence of unusually high risks, of which credit risk seems to be outstanding. Domestic banks were still significantly profitable in Q1, but the problem loan ratio rose further to 3.3% of total claims. Significant further deterioration is likely during the rest of the year, as the negative impact of the recession and the weak forint – in view of FX-denominated loans – is increasingly felt. However, the Hungarian authorities and non-resident parent banks stand ready to support banks if necessary. The government set up a bank support facility in late 2008, which has been used so far to provide capital support to one bank and direct loans to three banks in early 2009. In May 2009, major non-resident parent banks issued a joint declaration to stress commitment to their subsidiaries, in terms of funding and capital support as necessary.

See the attached statistical table as well

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

In Hungary the Hungarian Financial Supervisory Authority (HFSA) as an integrated authority is responsible for the authorization and supervision of the financial institutions from 2000.

The HFSA is not a regulatory authority (it is the Ministry of Finance concerning financial institutions), but according to the Act CXXXV of 2007 on the Hungarian Financial Supervisory Authority (hereinafter referred to as "Act on HFSA") it has the right to deliver its opinion when decisions and laws affecting the financial system or the institutions and persons under its control as well as its task and scope are being made or prepared, and it shall make proposals concerning legislation.

The HFSA is a government office. The Authority's resolutions and rulings shall not be reversed, overruled or modified, and the Authority may not be compelled to conduct certain specific proceedings under supervisory competence. The HFSA's decisions may not be subject to appeal trough administrative channels, but its resolution may be subject to judicial review by the Municipal Court of Budapest.

The tasks and duties of the Authority are prescribed by the Act on HFSA. The purpose of this Act is to establish a regulatory regime for the supervision of market participants with a view to ensure the smooth and successful functioning of the money and capital markets, to provide a clear and accurate picture of market conditions, to facilitate fair market competition, and to improve confidence in the financial markets in accordance with the relevant legislation of the European Communities.

The most important Hungarian pieces of legislation relevant to the HFSA and the supervised sectors and institutions:
http://www.pszaf.hu/en/topmenu/legislation/naitonal_legislation

The mayor changes in the institutional and legal framework of the financial institutions in 2008:

2 savings unions have changed into banks, 1 bank has changed into financial enterprise and 1 bank has been transformed into branch. Main new regulations:

- Act CIII of 2008 on Modification of certain acts applying to financial services (with the implementation of Directive 2007/44/EC),
- Act CIV of 2008 on Strengthening the stability of the financial intermediary system.

MAIN STRATEGIC OBJECTIVES OF THE HFSA IN 2008

Priorities of supervision in 2008:

The HFSA's objective is to facilitate the reliable operation of supervised institutions and their compliance with applicable laws. Therefore, like in recent years, the HFSA set priorities for supervision also in 2008 and published them in line with the principle of transparent operations. Based on the integrated supervision approach, these priorities apply to all supervised sectors. The priorities set for 2008 were as follows:

- Investigation of liquidity
  From an international viewpoint, liquidity was selected as a priority due to the direct and indirect effects of the subprime crisis that broke out in 2007; the major bank scandals of the recent past (Northern Rock); and, from a domestic viewpoint, due to the increasing indebtedness of Hungarians.
- Risk transfers
  Products that convey risk transfers began to grow extensively in the Hungarian finance sector in recent years. The range of unit-linked insurance schemes, combined bank deposits, life insurance-backed housing loans, etc. is growing continuously. Increasingly risky, bank-refinanced customer loans provided by financial enterprises are becoming more and more frequent along with risk transfers within

groups. Therefore, the HFSA focuses its attention to risks inherent in these schemes and activities.

- Internal governance: reliable and transparent operation of decision-making, reporting and controlling mechanisms within and between organizations.

When setting priorities, the HFSA took into consideration the significant risks and kept in mind the related threats and impacts in its day-to-day operations. At the same time, supervisory experiences also revealed some general correlations and risks. As of 31 December 2008, 2,533 financial market, capital market, insurance institutions, legal entities and healthcare, pension and self-support funds were registered with the HFSA. When carrying out on-site and off-site examination, market supervisory investigations at these institutions, the HFSA strove for enforcing the priorities discussed herein, just like upon prudential discussions.

ACTIVITIES OF THE HFSA IN 2008

Allocation of supervisory resources:

The volume of resources allocated to on-site investigation showed a nearly 80 % increase on the previous year in 2008. The reason of this growth (in accordance with the supervisory priorities) was first and foremost the financial and liquidity crisis, as the HFSA's efforts to respond to it inevitably resulted in the increase of resources allocated to investigations. Furthermore, the turbulent market environment also caused fiercer competition which generated a threefold growth of capacities devoted to investigations in the market supervision area parallel to the revealing of internal governance issues.

In 2007, the HFSA turned to risk-based supervision, a methodology the efficiency of which surpasses that of formerly applied approaches in every way. As a consequence, supervisory methodologies have changed in the case of certain institution types (financial enterprises, pension, healthcare and self-support funds, insurance associations) and now thematic supervision is applied. The emphasis shifted from on-site investigations (i.e. from on-site information gathering) to ongoing supervision, where information is collected as part of continuous contact keeping with the institution and where risks are assessed on an ongoing basis. Instead of comprehensive investigations that used to encompass all activities of the institutions under review, targeted and thematic investigations came to the forefront. These exercises focused on risks identified during ongoing supervision and risk assessment.

A significant part of 2008 investigations were mandatory validation and SREP procedures which were required by law and carried out in the framework of on-site and off-site examination. Another effort that deserves mentioning was a comprehensive thematic investigation that extended to all supervised financial sectors and focused on the operation of agents and intermediaries. One of the purposes of that exercise was to lay down the establishment of unified legal regulations on these activities.

New supervisory measures policy:

The HFSA's findings reflected the vulnerability of financial markets while HFSA and the MNB (National Bank of Hungary) reports pointed out market disturbances. With a view to the fact that the HFSA's role is to provide for the reliable operations of financial markets, there were solid reasons for releasing a stricter and clearer measures policy. As this policy addresses all supervisory activities which are aimed at influencing the behaviour of market players, it encompasses all the competences of the HFSA, in particular the new mandates arising in relation to the Act on Credit Institutions and Financial Enterprises and the Act CXXXVIII of 2007 on Investment Firms and Commodity Dealers, and on the Regulations Governing their Activities. At the same time, the new policy sets out a stricter penalizing approach for the HFSA.

Contrary to current regulations, the principles of the new policy go beyond legal requirements and apply to other HFSA procedures and actions. The HFSA applies risk-based supervision methodologies for an expanding range of institutions and therefore it will assign a higher weight to the market impact of each breaching of laws in the future. This weight will be proportionate to the market share and influence of the institution concerned.

Measures taken in the wake of the financial crisis:

The impact of liquidity problems on international markets, the deceleration of the world economy, deepening recession, and the significant rise of crediting losses and the extensive lack of confidence surfaced on the Hungarian market in the second half of 2008. While these phenomena did not overwrite the HFSA's priorities (what is more, they confirmed them), the emphasis had to be shifted in some areas. In this respect, the HFSA took the following steps:

- The HFSA paid special attention to detecting the presence of dangerous or toxic assets in the risk-taking approaches of domestic service providers in 2007 already when the subprime crisis began to unfold.
- Contact keeping and the exchange of information with Level 3 supervisory committees (CEBS, CESR, CEIOPS) became even stronger and got extended to new channels
- The HFSA set up an operational and a professional (methodology, analysis, monitoring) work group for managing money and capital market developments.
- There were continuous contact with and close supervision over the supervised institutions. The HFSA established intense relationships with the leaders and contact persons of banks. Communication and information exchange with home state supervisors of parent banks was similarly intense in 2008.
- On 27 October 2008, the Chairman of the HFSA Board and the Director General wrote a letter to the managers of the parent institutions of Hungary's eight most significant banks, requesting them to declare their long-term commitment to their subsidiaries and thereby contribute to the restoration of market confidence.
- The HFSA and the MNB were in daily contact. As part of that cooperation, the MNB sent to the HFSA a liquidity analysis of the forint, foreign exchange and government bond interbank markets and

also reported the EUR, USD, CHF and other swap transactions of domestic banks. The HFSA sent the MNB data on a daily basis regarding daily liquidity reports received from banks.

- As part of a joint and standardised effort of capital market supervisory authorities in EU member states, effective 29 September 2008 the HFSA ordered financial institutions to report their short selling deals (including day trade transactions) completed in the trading system of the Budapest Stock Exchange (BSE). The HFSA subjects the reported deals to a separate analysis in order to detect front running transactions.
- ● Market turbulence amplified attempts to influence the market. Therefore, the HFSA among others carried out several investigations regarding attacks on the forint.
- The HFSA introduced extraordinary data reporting requirements for insurers as well whereby the supervisory authority was able to detect any repurchase (asset withdrawal) waves and monitor the change of portfolios. The HFSA also examined exposure to reinsurers.
- With a view to market developments (extensive withdrawal of capital which hit real estate investment funds hard), in order to minimize the expected losses of the owners of real estate investment fund units and to sustain the trade with these instruments, the HFSA suspended the trading of investment units of open-ended real estate funds for ten trading days on 7 November 2008. Simultaneously to that move, the HFSA obliged fund managers to inform investors more thoroughly and to change their rules of asset management so that it offers the longest settlement period allowed by law (180 days).
- The HFSA took an active role in elaborating the bill on strengthening the stability of the financial intermediation system. With a view to the significance of this sector, the purpose of this bill is to safeguard and reinforce the stability of this system, to restore investors and depositors confidence in it and to balance the interests of the public and that of the owners of certain financial institutions.
- The HFSA’s customer service received increasing number of personal and phone inquiries about the level of insurance for deposits and investments. A menu item titled “Security of deposits” was added to the HFSA’s internet home page, presenting an FAQ section with plain wording and contents that comply with applicable laws.

Supervisory measures and penalties:

10 percent of the 1,486 resolutions and orders released in the financial market sector were prudential, 85 percent were market supervisory and 5 percent were other resolutions and orders respectively. The HFSA passed 10 penalty resolutions with aggregate penalties of HUF 13 million. (The amounts shown here only refer to actually imposed penalties.)

Regarding the capital market sector, 31 percent of the 215 resolutions and orders were prudential, 59 percent were market supervisory and 10 percent were other resolutions and orders. The HFSA passed 25 penalty resolutions with aggregate penalties of HUF 184 million.

A total of 862 market supervisory resolutions were released concerning capital market investments.

757 resolutions and orders were issued regarding the insurance sector. Penalties were imposed on 74 occasions, their amounts totalled to HUF 52 million.

Regarding pension, healthcare and self-support funds, 123 resolutions and orders were passed. The HFSA imposed penalties in eight cases with a total amount of HUF 13 million.

Supervision of institutions

At an average, six expert days were spent on investigations per institution in 2008. With a view to the fact that on-site investigations are concentrated in terms of risks and due to legal provisions, HFSA investigations involved fewer institutions than in the previous year but these exercises were more thorough.

As a result of project efforts started in 2006, the HFSA implemented a new Risk-Based Supervision Methodology. Using extensive international experience as a basis, the purpose of the risk-based supervision methodology is to establish sector-independent supervisory procedures (as much as possible) relying on the changed supervisory environment (integrated supervisors), the changed or unforeseeably changing regulatory framework (e.g. CRD, Solvency II) and on the resources available to the HFSA. The key element of the new methodology is that it subjects market players to a different level of supervision in terms of intensity and depth depending on the impact of those institutions on the entire financial system.

Supervision of market processes, licensing:

By migrating to KOMÓD, i.e. to a risk-based approach in ongoing supervision, the assessment of market supervision also became part of the supervision of institutions. This way, KOMÓD channels market and prudential findings into a single view. The experiences of recent periods show that the consolidation of these findings improved the complexity of supervision.

Besides thematic supervision (intermediaries), we carried out institution-specific investigations as well (Brokernet Group, Axon Zrt.). The processing of complaints supplied important input to several on-site and off-site investigations while the HFSA's prudential departments provided assistance to the management of crisis situations.

In the financial and capital markets sector, a total of 1,252 licensing resolutions were issued in 2008. Nine new branch offices were established and 410 cross-border service providers were registered.

In 2008, the HFSA kept receiving a substantial number of applications for operating licence from independent insurance intermediaries and the number of new market entrants surpassed that of entities that either exited the market or were forced to do so.

The number of players in the pension, healthcare and self-support funds market continued to decrease in 2008.

Consumer protection and complaint handling:

Ensuring fair market behaviour is a key supervisory duty and consumer protection is an important element of it. It includes the monitoring and examination of financial markets from a consumer protection viewpoint, the informing of consumers, the development of financial culture, the operation and development of complaint management institutions and the revealing and sanctioning of deviant market behaviour. Effective 1 September 2008, the relevant law (Act on the Essential Conditions of and Certain Limitations to Business Advertising Activity) names the HFSA as the authority in charge with taking action regarding the unfair market practices of financial organisations.

Actions against financial fraud:

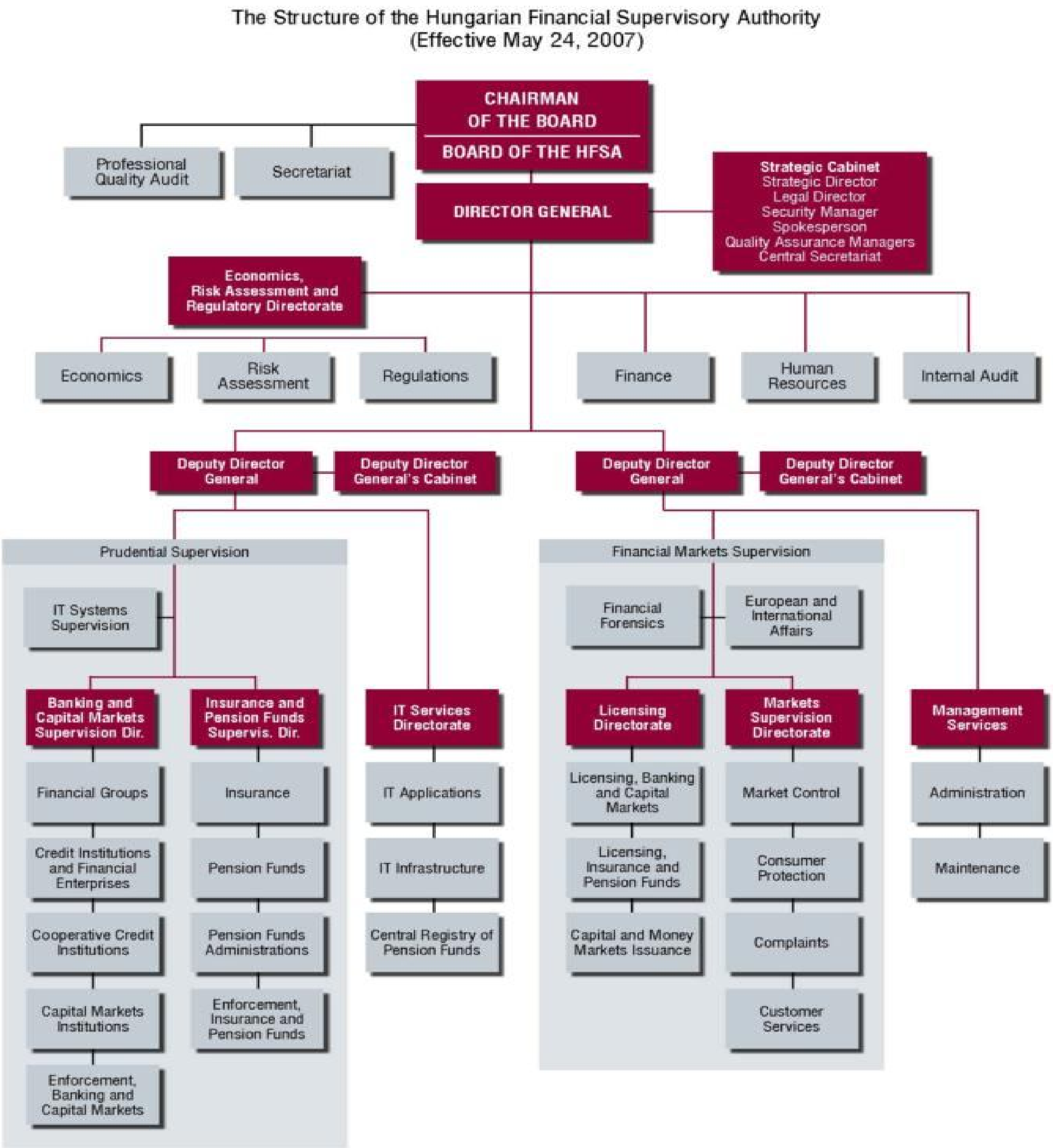
Within responsibilities for ensuring the fairness and security of financial markets, actions to combat financial fraud, money laundering and the financing of terrorism are priority tasks for the HFSA. In conjunction with actions against financial fraud, money laundering and the financing of terrorism, the HFSA carried out 18 targeted and 9 thematic investigations.

Contribution to the preparation of laws, supervisory developments to help the implementation of legal requirements:

Among others, as part of a joint effort with experts from the Ministry of Finance and the Hungarian National Bank, the specialists of the HFSA participated in the assessment of the European Commission's proposal regarding the amendment to the CRD.

In the first half of 2008, the most significant piece of work was the HFSA's contribution to the preparation of amendments to the Act on Capital Markets in conjunction with MiFID implementation and to the Act on Investment Enterprises.

ORGANIZATIONAL CHART OF THE HFSA



INTERNATIONAL ACTIVITY OF THE HFSA

In 2008, 311 HFSA participated in a total of 295 meetings and work group sessions of EU relevance. Most of these were level 3 committee meetings.

The HFSA concluded two bilateral cooperation agreements in that year: one with the Serbian National Bank on the banking and insurance sector (January 10) and one with the Central Bank of the Russian Federation on banking supervision issues (March 28).

The Hungarian authority staged the second conference of OTP Group supervisors with representatives from six partner supervisory authorities on 3 December 2008.

The HFSA received several delegations among others for consultations and exchange of experience in relation to banking supervision, capital market and anti-money laundering matters.

The 15th annual meeting and conference of the IAIS and the related quarter 3 committee meetings were hosted by the Hungarian Financial Supervisory Authority, as well, and the Hungarian authority participated in the work of the international supervisory organisations (IAIS, IOSCO, IOPS, BSCEE).

COOPERATION WITH OTHER SUPERVISORY BODIES

An agreement on the principles and framework of cooperation between the HFSA, the Hungarian National Bank and the Ministry of Finance in crisis situations entered into effect in January 2009. The purpose of this agreement is to support the stability of the financial intermediation system and to improve the efficiency of crisis management.

In May, an agreement made between the Hungarian National Bank and the HFSA on promoting the development of financial culture entered into effect.

On 1 September 2008, a cooperation agreement was signed by the National Consumer Protection Authority (NFH), the Hungarian Competition Authority (GVH) and the HFSA. The agreement was concluded to fulfil the provisions of the Act on the Essential Conditions of and Certain Limitations to Business Advertising Activity, to provide for the efficient protection of consumer rights and to establish a calculable legal environment for the enterprises subject to this law.

The HFSA continued the cooperation with partner authorities and organisations, the establishment of the framework and scope for preventing and combating money laundering and terrorism financing.

In conjunction with efficiently fulfilling its duties, the HFSA organised a number of events in 2008. The 44 professional meetings served dialogue with various market players.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Credit institutions	207	200	195
Commercial banks	32	32	31
Specialized banks	5	5	5
Savings and credit cooperatives	166	157	148
Financial enterprises	235	250	259
Investment companies	20	21	24
Investment companies	17	17	21
Branches of non-resident investment companies	3	4	3
Asset managers	24	27	31
Insurance companies and associations	62	62	65
Insurance companies	27	30	33
Insurance associations	35	35	30
Branches of non-resident insurers	7	11	14
Pension, health & mutual self-assistance associations	176	158	141
Total	**734**	**736**	**731**

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

Type of financial institution	2006	2007	2008
Domestic ownership	13,0	14,5	12,3
Public sector	0,9	0,8	0,1
Private sector	12,1	13,7	12,2
Foreign ownership	80,9	79,5	82,0
Other/*	6,1	6,0	5,7
Total	**100,0**	**100,0**	**100,0**

*/ Other = preferred and repurchased shares, unidentified ownership

Concentration of asset by the type of financial institutions

Type of the financial institutions	Top 3 institutions			Top 5 institutions		
	2006	2007	2008	2006	2007	2008
Banks	40,6%	40,7%	41,6%	58,0%	58,4%	59,9%
Savings and credit cooperatives	8,4%	8,8%	10,4%	12,7%	13,4%	15,6%
Financial enterprises	22,7%	22,4%	22,5%	32,7%	31,4%	31,9%
Investment companies	79,0%	78,2%	65,6%	87,8%	88,6%	78,7%
Asset managers	50,7%	53,1%	50,3%	67,8%	67,3%	66,9%
Insurance companies and associations	53,4%	48,5%	46,9%	76,6%	70,6%	70,1%
Pension, health & mutual self-assistance associations	49,1%	50,4%	52,0%	66,8%	68,6%	71,5%

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

Type of financial institution	2006	2007	2008
Banks	1,86	1,48	1,17
Savings and credit cooperatives	0,72	0,75	0,68
Financial enterprises	1,53	2,04	1,04

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

Type of financial institution	2006	2007	2008
Banks	23,0	17,9	14,3
Cooperative credit inst's	10,7	10,8	10,1
Financial enterprises	20,4	24,3	16,9
Investment companies	29,6	30,4	33,8
Insurers	23,9	20,2	17,6
Asset managers	63,9	68,7	n.a.
Total	**22,9**	**18,3**	**14,9**

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

End-period data		2006	2007	2008	2006	2007	2008
		HUF bn	HUF bn	HUF bn	Percent	Percent	Percent
By institutions							
Banks, specialised credit	total assets	20838	24376	29222	*61,5*	*60,9*	*66,5*
institutions	assets in management/*/**	1809	2211	1468	*5,3*	*5,5*	*3,3*
	total	**22647**	**26587**	**30690**	***66,8***	***66,4***	***69,9***
Investment companies	assets in management/*/**	689	841	705	*2,0*	*2,1*	*1,6*
Asset managers	assets under mgmt/**	2681	3353	2747	*7,9*	*8,4*	*6,3*
Leasing & factoring companies	total assets	2200	2675	3369	*6,5*	*6,7*	*7,7*
Insurers	total assets	1956	2259	2206	*5,8*	*5,6*	*5,0*
Pension & health care funds	asset value/**	2350	2807	2618	*6,9*	*7,0*	*6,0*
Cooperative credit institutions	total assets	1360	1505	1577	*4,0*	*3,8*	*3,6*
Total assets in intermediation		**33882**	**40027**	**43912**	***100,0***	***100,0***	***100,0***
By activities							
Lending		24397	28556	34168	*72,0*	*71,3*	*77,8*
Insurance		1418	1521	1563	*4,2*	*3,8*	*3,6*
Asset management		8067	9950	8181	*23,8*	*24,9*	*18,6*
Total assets in intermediation		**33882**	**40027**	**43912**	***100,0***	***100,0***	***100,0***

*/ excluding assets in custody; **/ at market value

Structure of bank assets (at year end)

	2006	2007	2008	2006	2007	2008
	HUF bn	HUF bn	HUF bn	Percent	Percent	Percent
Cash & deposits at banks	**3068**	**2428**	**2041**	***14,8***	***10,0***	***7,0***
Cash & current accounts	689	803	605	*3,3*	*3,3*	*2,1*
Deposits at central bank	1205	446	500	*5,8*	*1,8*	*1,7*
Interbank deposits	1174	1179	936	*5,7*	*4,8*	*3,2*
Securities	**2485**	**3390**	**4672**	***12,0***	***13,9***	***16,0***
Loans (net value)	**13462**	**16439**	**19873**	***64,8***	***67,5***	***68,0***
Non-financial companies	5716	6419	7019	*27,5*	*26,4*	*24,0*
Households	4243	5358	7130	*20,4*	*22,0*	*24,4*
Government	401	428	363	*1,9*	*1,8*	*1,2*
Domestic MFIs	630	841	822	*3,0*	*3,5*	*2,8*
Other domestic FIs	1548	1788	2088	*7,5*	*7,3*	*7,1*
Nonresidents	855	1506	2432	*4,1*	*6,2*	*8,3*
Others	70	98	18	*0,3*	*0,4*	*0,1*
Investments	**488**	**542**	**629**	***2,3***	***2,2***	***2,2***
Other assets	**1260**	**1556**	**2007**	***6,1***	***6,4***	***6,9***
Total assets	**20763**	**24356**	**29222**	***100,0***	***100,0***	***100,0***

Structure of bank liabilities (at year end)

	2006	2007	2008	2006	2007	2008
	HUF bn	HUF bn	HUF bn	Percent	Percent	Percent
Liabilities to domestic banks	**1796**	**2769**	**2740**	***8,6***	***11,4***	***9,4***
Deposits by banks	1011	1449	1111	*4,9*	*6,0*	*3,8*
Loans from banks	785	1320	1629	*3,8*	*5,4*	*5,6*
Debt securities	**2030**	**2441**	**3024**	***9,8***	***10,0***	***10,3***
Domestic customer deposits	**9371**	**10088**	**11192**	***45,1***	***41,4***	***38,3***
Non-financial companies	3326	3377	3465	*16,0*	*13,9*	*11,9*
Households	4864	5173	6022	*23,4*	*21,2*	*20,6*
Government	289	447	577	*1,4*	*1,8*	*2,0*
Other domestic FIs	594	764	930	*2,9*	*3,1*	*3,2*
Others	297	327	199	*1,4*	*1,3*	*0,7*
Liabilities to nonresidents	**3985**	**5049**	**7315**	***19,2***	***20,7***	***25,0***
Deposits by banks	1674	2566	3715	*8,1*	*10,5*	*12,7*
Deposits by others	679	658	1019	*3,3*	*2,7*	*3,5*
Loans from banks	1631	1825	2582	*7,9*	*7,5*	*8,8*
Other liabilities	**1867**	**1978**	**2655**	***9,0***	***8,1***	***9,1***
Own capital	**1715**	**2030**	**2296**	***8,3***	***8,3***	***7,9***
Total liabilities	**20763**	**24356**	**29222**	***100,0***	***100,0***	***100,0***

Off-balance sheet positions of banks (at year-end)

	Items	Items	Items
	HUF bn	HUF bn	HUF bn
	2006	2007	2008
Off-balance sheet items, total	8566	11454	7704
Ratio of off-balance sheet items to total assets	**57,4%**	**65,2%**	**26,4%**

Average solvency ratio (at year-end, %)

Type of financial institution	2006	2007	2008
Banks	11,54	11,60	11,43
Savings and credit cooperatives	15,26	15,82	13,67
Insurance companies /*	216,3	223,5	234,2

*/ Available solvency margin as % of required solvency

Portfolio quality at banks (at year-ends, as % of total)

Problem = substandard, doubtful and bad, total

	Problem-free				Substandard		
	2006	2007	2008		2006	2007	2008
All items	**89,8**	**91,9**	**89,9**	**All items**	**0,8**	**0,7**	**1,0**
Securities for trading	61,5	99,8	96,1	Securities for trading	0,5	0,1	0,0
Securities for investment	99,6	100,0	99,6	Securities for investment	0,0	0,0	0,1
Claims on credit inst's	98,8	99,0	99,1	Claims on credit inst's	0,0	0,0	0,1
Corporate loans	82,9	86,2	78,9	Corporate loans	1,2	0,8	1,7
Loans to households	91,5	90,3	92,5	Loans to households	0,7	0,8	1,3
Claims on non-residents	88,9	98,5	93,8	Claims on non-residents	1,4	0,1	0,7
Other assets	82,2	82,6	93,8	Other assets	1,2	8,1	0,9
- Investments	85,8	86,2	89,6	- Investments	0,9	6,6	1,6
	Watchlisted				Doubtful		
	2006	2007	2008		2006	2007	2008
All items	**7,7**	**5,7**	**7,3**	**All items**	**0,6**	**0,7**	**0,8**
Securities for trading	37,9	0,0	3,2	Securities for trading	0,0	0,1	0,1
Securities for investment	0,3	0,0	0,0	Securities for investment	0,1	0,0	0,4
Claims on credit inst's	1,2	1,0	0,8	Claims on credit inst's	0,0	0,0	0,0
Corporate loans	13,5	10,1	16,2	Corporate loans	1,0	1,1	1,3
Loans to households	5,9	6,8	4,4	Loans to households	0,8	1,0	0,9
Claims on non-residents	9,2	1,3	5,4	Claims on non-residents	0,3	0,0	0,1
Other assets	8,6	2,4	2,2	Other assets	0,8	0,6	2,5
- Investments	7,1	1,7	3,9	- Investments	0,5	0,5	4,2
	Problem				Bad		
	2006	2007	2008		2006	2007	2008
All items	**2,5**	**2,5**	**2,7**	**All items**	**1,0**	**1,0**	**1,1**
Securities for trading	0,5	0,2	0,7	Securities for trading	0,4	0,0	0,0
Securities for investment	0,1	0,0	0,4	Securities for investment	0,0	0,0	0,0
Claims on credit inst's	0,0	0,1	0,1	Claims on credit inst's	0,0	0,0	0,0
Corporate loans	3,6	3,6	4,9	Corporate loans	1,3	1,4	1,7
Loans to households	2,6	2,9	3,1	Loans to households	1,1	1,2	1,2
Claims on non-residents	1,9	0,2	0,8	Claims on non-residents	1,2	0,2	0,1
Other assets	9,2	15,0	4,0	Other assets	6,3	7,2	6,3
- Investments	7,1	12,1	6,5	- Investments	7,7	5,7	5,0

Structure of bank loans and deposits by sector (at year-end)

	2006	2007	2008
Loans	**100,0%**	**100,0%**	**100,0%**
Non-financial companies	42,5%	39,1%	35,3%
Households	31,5%	32,6%	35,9%
Domestic FIs	16,2%	16,0%	14,6%
Government	3,0%	2,6%	1,8%
Nonresidents	6,3%	9,2%	12,2%
Others	0,5%	0,6%	0,1%
Deposits	**100,0%**	**100,0%**	**100,0%**
Non-financial companies	26,1%	22,9%	20,3%
Households	38,2%	35,0%	35,3%
Nonresidents	18,5%	21,8%	27,8%
Domestic FIs	12,6%	15,0%	12,0%
Government	2,3%	3,0%	3,4%
Others	2,3%	2,2%	1,2%

Term structure of loans from credit institutions (at year-end)

	2006	2007	2008
Loans to domestic non-banks, total	**100,0%**	**100,0%**	**100,0%**
Maturity up to 1 year	26,1%	24,0%	22,5%
Maturity between 1 and 5 years	23,8%	23,6%	19,9%
Maturity over 5 years	50,1%	52,5%	57,5%
- Loans to non-financial enterprises	**100,0%**	**100,0%**	**100,0%**
Maturity up to 1 year	38,9%	36,4%	35,5%
Maturity between 1 and 5 years	27,8%	26,5%	25,9%
Maturity over 5 years	33,4%	37,1%	38,7%
- Loans to financial enterprises	**100,0%**	**100,0%**	**100,0%**
Maturity up to 1 year	35,3%	30,3%	33,5%
Maturity between 1 and 5 years	41,8%	44,0%	34,4%
Maturity over 5 years	22,9%	25,7%	32,1%
- Loans to households	**100,0%**	**100,0%**	**100,0%**
Maturity up to 1 year	6,7%	7,1%	6,1%
Maturity between 1 and 5 years	12,9%	9,1%	6,6%
Maturity over 5 years	80,4%	83,9%	87,3%

Term structure of deposits at credit institutions (at year-end)

	2006	2007	2008
Deposits by domestic non-banks, total	**100,0%**	**100,0%**	**100,0%**
At sight	36,7%	35,7%	27,4%
Maturity up to 1 year	55,1%	55,7%	65,3%
Maturity between 1 and 2 years	2,6%	2,0%	1,5%
Maturity over 2 years	5,6%	6,7%	5,7%
- Deposits by non-financial enterprises	**100,0%**	**100,0%**	**100,0%**
At sight	53,4%	54,1%	48,6%
Maturity up to 1 year	45,4%	44,4%	49,9%
Maturity between 1 and 2 years	0,3%	0,3%	0,3%
Maturity over 2 years	0,9%	1,2%	1,2%
- Deposits by financial enterprises	**100,0%**	**100,0%**	**100,0%**
At sight	31,9%	20,6%	23,7%
Maturity up to 1 year	40,8%	44,0%	41,4%
Maturity between 1 and 2 years	1,0%	2,3%	2,7%
Maturity over 2 years	26,3%	33,1%	32,3%
- Deposits by households	**100,0%**	**100,0%**	**100,0%**
At sight	27,3%	27,3%	21,9%
Maturity up to 1 year	62,5%	62,7%	69,6%
Maturity between 1 and 2 years	4,2%	3,2%	2,3%
Maturity over 2 years	6,0%	6,8%	6,1%

Foreign currency shares in banks' balance sheet

	2006	2007	2008
Total assets	**42,9%**	**49,5%**	**54,8%**
Cash & deposits	16,0%	17,9%	28,1%
Deposits at MFIs	39,4%	46,7%	34,7%
Securities	7,6%	8,5%	9,9%
Loans to customers & MFIs /*	**54,1%**	**62,7%**	**71,8%**
- Non-financial enterprises/*	47,3%	53,0%	60,3%
- Households/*	46,8%	59,0%	70,7%
- Other financial institutions/*	86,5%	86,7%	90,2%
- Nonresidents/*	94,2%	97,4%	97,9%
- Credit institutions/*	54,5%	69,8%	74,9%
Other assets	20,1%	22,3%	23,4%
Total liabilities	**35,9%**	**38,9%**	**42,0%**
Deposits from customers	**25,8%**	**24,3%**	**25,0%**
- Non-financial enterprises	35,7%	30,6%	30,4%
- Households	17,1%	17,9%	17,6%
Deposits from MFIs	62,5%	65,8%	75,0%
Loans received	76,1%	74,2%	75,9%
Debt securities	34,1%	42,9%	50,5%
Other liabilities	18,6%	21,0%	18,0%
Net long on-BS FX position	**7,0%**	**10,6%**	**12,8%**

*/ Gross values

Revenues and expenditures of banks

	HUF billion			ROA components		
	2006	2007	2008	2006	2007	2008
Net interest revenue	**706,9**	**718,1**	**724,7**	**3,65%**	**3,28%**	**2,78%**
- Interest revenue	1520,7	1848,4	2436,4	7,85%	8,44%	9,36%
- Interest expenditure	813,8	1130,4	1711,6	4,20%	5,16%	6,58%
Net non-interest revenue	**368,2**	**390,3**	**385,9**	**1,90%**	**1,78%**	**1,48%**
- Fees and commissions	232,9	245,9	241,0	1,20%	1,12%	0,93%
- Trading and other	135,2	144,4	144,9	0,70%	0,66%	0,56%
Operating expenses	**-526,2**	**-588,3**	**-634,4**	**-2,72%**	**-2,68%**	**-2,44%**
Net operating income	**548,9**	**520,1**	**476,2**	**2,83%**	**2,37%**	**1,83%**
Loan losses and provisions	-142,4	-129,7	-175,3	-0,74%	-0,59%	-0,67%
Extraordinary revenue	27,6	4,6	16,4	0,14%	0,02%	0,06%
Corporate tax	-71,5	-68,8	-44,0	-0,37%	-0,31%	-0,17%
Profit after tax	**362,6**	**326,1**	**303,2**	**1,87%**	**1,49%**	**1,17%**
Profit after tax (ROE)				**22,98%**	**17,45%**	**14,34%**

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

2006	Registered Capital (EUR)	/Total assets	Own funds (EUR)	/Total assets
Banks	1 710 150 614	2,1%	6 798 882 283	8,3%
Savings and credit cooperatives	75 022 842	1,4%	362 418 728	6,7%
Financial enterprises	252 863 916	0,9%	639 467 860	4,5%
Financial ititutions	**2 038 037 372**	**1,8%**	7 800 768 870	**7,7%**
2007	**Registered Capital (EUR)**	**/Total assets**	**Own funds (EUR)**	**/Total assets**
Banks	1 827 965 265	1,9%	7 908 975 725	8,2%
Savings and credit cooperatives	82 582 917	1,4%	395 156 325	6,6%
Financial enterprises	261 627 638	0,9%	692 613 554	4,3%
Financial ititutions	**2 172 175 820**	**1,6%**	8 996 745 605	**7,6%**
2008	**Registered Capital (EUR)**	**/Total assets**	**Own funds (EUR)**	**/Total assets**
Banks	1 746 476 320	1,6%	8 449 531 687	7,5%
Savings and credit cooperatives	87 361 394	1,5%	411 396 246	6,9%
Financial enterprises	263 384 176	2,1%	752 977 022	5,9%
Financial ititutions	**2 097 221 890**	**1,6%**	**9 613 904 955**	**7,3%**

2008 DEVELOPMENTS IN THE LATVIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

Following several years of buoyant economic development, the pace of growth subsided in 2008. A 4.6% drop in real GDP was triggered by abating domestic demand over the year and a weaker external demand towards the close of the year under the impact of a slowdown in global economic activity and deteriorating competitiveness. Although inflation declined steeply, its average annual rate remained high (15.4%). At the beginning of the year, the high rate of inflation was supported by the domestic demand, rapidly rising global energy prices and the resulting cost upswing as well as by tax harmonisation with the EU legislation. Thereafter in June, inflation started to decline rapidly due to weakening economic activity, this decline well-supported by favourable global energy price trends.

The weakening in the domestic demand in 2008 was on account of both postponed investment plans and shrinking private consumption. Contractions in investment were determined by slower pace of lending, deteriorating corporate financial performance, real estate price drops, moderating activity and contracting number of new orders in construction, residential construction in particular, and negative development perspectives of the domestic and external demand.

Sharply moderating domestic economic activity reduced external imbalances, with foreign trade deficit narrowing notably and resulting also in a smaller current account deficit of the balance of payments in 2008 (to 12.6% of GDP). Contractions in imports are expected to cause further improvements in the current account, while the abating external demand at the close of the year contributed negatively to the export outlook.

DEVELOPMENT IN BANKING SYSTEM

Currently, 21 banks and 6 European Union (EU) bank branches are operating in Latvia. New market participants entered the market at the end of 2008 (JSC Pasta banka and Estonian BIG bank branch).

Integration of Latvian banks in global financial market and in particular in the EU single financial market has boosted their qualitative and quantitative development, however put them at more risks. This impact of the global financial turmoil has been strongly felt in terms of availability and cost of funding in the international and domestic markets.

In 2008

- total banking assets rose by 6% or 1.3 billion lats and were 23.2 billion lats at the end of December;
- total loans grew by 11% and constituted 16.6 billion lats at the end of the year;

- total deposits decreased by 4 % and accounted for 9.8 billion lats at the end of 2008. Over past five years the amount of bank deposits had annually increased by 21% – 37% on average, but since the autumn of 2008 there has been a downward trend;
- Latvian banks earned 60 million lats (unaudited profit). However, this is almost 84% less than a year ago;
- upon a decrease in total profits in the banking sector, also banking profitability ratios fell sharply and at the end of the year ROA was 0.27% and ROE – 3.63% (compared to 1.99% (ROA) and 24.16% (ROE) in 2007).

High lending growth rates of previous years (on the average 55% annually) have been succeeded by decreasing growth rates since autumn of 2008. At the same time there was observed new tendency: the growth rate of loans to corporates (13.1%) outpaced the household lending growth rate (7.0%). The above developments result from the economic situation (high inflation rate, unemployment, GDP decline) as well as indicate to the deteriorating of households creditworthiness.

In 2008 loan loss provisions surged significantly, i.e., by 285 million lats or 348% compared to 2007. Banking loan loss provisions reached 2.1% of banking loan portfolio at the end of the year (compared to 0.8% at the end of 2007). Overall, the share of loans with 90 days overdue payments in the total banking loan portfolio has grown from 0.8% at end of 2007 to 3.6% by the end of 2008.

In view of the global financial situation that affects availability of resources and their costs, the liquidity indicator of the banking sector has a decreasing tendency, however still exceeding regulatory requirement, 30%, and at the end of the year it was 52.8% (compared to 55.7% at the end of 2007).

Major financing sources for banks are liabilities to banks (42% of total assets), mainly – to parent banks (31% of total assets), and deposits (42% of total assets). In 2008, the amount of funding attracted from parent banks increased by 1.2 billion lats, i.e. by 21% up from late 2007.

The average capital adequacy ratio of the banking sector at the end of 2008 was 11.8%, slightly higher than a year ago (11.05%). This increase was also influenced by introduction of Basel II as from January 2008. Capital adequacy ratio for all banks (except one) was above 8% (the minimum regulatory capital adequacy ratio). To assist the second largest Latvia's bank by assets to overcome financial problems arising from the global financial crisis, in November 2008 the Latvian Government took over the controlling interest in the JSC *Parex banka*.

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

In year 2008 some legislative initiatives taken were related to the transposition of the EU Directives while others were triggered by the financial crisis.

A new Law on the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing came into force on 13 August 2008. It transposes EU directives 2005/60/EC and 2006/70/EC and introduces the risk based approach to customer due diligence. A regulation of 27.08.2008 adopted by the Financial and Capital Market Commission (the FCMC) determines the situations when enhanced due diligence is required and sets the minimum measures that banks and other financial institutions have to take in these situations.

By the amendments to the Deposit Guarantee Law, made on 16 October 2008, a state guaranteed compensation to the clients of the Latvian banks and credit unions (both to natural and legal persons) was increased from EUR 20 000 to EUR 50 000 (LVL 35 000).

On 18 December 2008 the Latvian Parliament passed the Law on Bank Takeover, which sets the legal framework for bank takeovers by the state. According to this Law, bank takeover by the state is permissible in exceptional cases, when the stability of the banking system of Latvia and the smooth operation of payment systems is seriously threatened or could be threatened if the bank takeover would not take place and the bank therefore is not or would not be able to comply with the requirements regulating banking activities determined by the law.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY (THE FCMC)

The FCMC is an autonomous public institution, which carries out the supervision of Latvian banks, insurance companies and insurance brokerage companies, participants of financial instruments market, as well as private pension funds.

The FCMC ensures enhancing stability, competitiveness and development of the financial and capital markets as well as protection of the interests of investors, depositors and insured persons.

The competence of the FCMC in the banking sector is set forth in the Financial and Capital Market Commission Law and Credit Institution Law.

As regards banking sector, the FCMC has authority to issue regulations and directives governing activities of banks; to request and receive information necessary for the execution of its functions from banks; to set forth restrictions on the activities of banks; to examine compliance of the activities with the legislation, and regulations and directives of the FCMC; to apply sanctions set forth by the regulatory requirement on banks and their officials in case said requirements are violated.

At the beginning of the year 2009 the amendments to the Credit Institution Law were made establishing a mechanism for early remedial actions, including effective emergency powers for the FCMC. The amendments, made on 12 February 2009, allow the FCMC to take different measures before the bank's capital reaches the regulatory minimum, if a credit institution fails to adhere to the provisions of legal acts, or if the activities of a credit institution are threatening its stability or solvency, security or stability of the credit institution sector in Latvia, or if such activities impose threat to cause significant loss to the national economy, or if an excessive outflow of deposits or other assets is occurring from a bank.

One of the measures mentioned above is appointment of the FCMC's authorized person.

MAIN STRATEGIC OBJECTIVES OF FCMC IN 2008

1. Considering chances and challenges offered to Latvia by its participation in the EU and global financial markets, and for the purpose to become an efficient and dynamic supervisory institution that ensures high standards in the financial service area and enhances the financial and capital market development in Latvia, the FCMC has decided to develop a new strategy for the period from 2009 to 2011.
2. In relation with the global financial crisis - maintaining public confidence in the Latvian financial system
3. Continuing the implementation of the EU directives in the Latvian financial and capital market.
4. To provide an interactive financial and statistical report submission system and publishing of templates, the FCMC has decided to implement an electronic data reporting system.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2008, supervision of the financial sector was notably influenced by the following two factors:

- continuing crisis in the global financial system that triggered freezing of the financial instruments market, liquidity problems of financial institutions and problems in the real estate market;
- changes in the regulatory environment of financial institutions linked with the introduction of the capital requirements directive on 1 January 2008.

All in all neither the supervision methods nor the existing practice changed in 2008 and, as in previous years, they were based on assessing operational risks of market participants using closely interrelated methods:

- analysis of financial statements;
- on-site inspections.

In light of the events in the global financial system, in 2008 the FCMC also performed off site inspections; thereby it could immediately receive the latest information and respond swiftly to the rapid changes in the financial market.

During the reporting year, the FCMC performed 29 inspections in banks during which it paid particular attention to assessing capital adequacy, lending procedure and risk management functions for managing credit risk, operational risk, interest rate risk, foreign exchange risk, liquidity risk and compliance function.

In relation with the global financial crisis the task of the supervision strategy was to maintain public confidence in the Latvian financial system, to identify, within a possibly short time period and with utmost precision, the risks relevant to banking in the financial crisis conditions and to take immediate measures to mitigate the influence of these risks and stabilise the financial market.

To accomplish these tasks, the FCMC took measures to ensure that banks appropriately identify and prudently manage risks and are in a position to maintain sufficient capital and ensure going concern and timely meeting of their liabilities.

Capital Adequacy

As of 2008, in line with the capital requirements directive that was also incorporated in the Credit Institutions Law, all banks registered in Latvia had to start using the new procedure for calculating capital adequacy and the FCMC had to introduce the so-called second pillar or the supervisory review process. The second pillar includes two interrelated processes – internal capital adequacy assessment (ICAA), performed by the institution itself, and the supervisory review and assessment, performed by the supervisory authority.

In 2008 the FCMC performed two interrelated reviews – it assessed the volume of an institution's risk and the quality of the risk management system and assessed an institution's ICAA. When assessing the volume of risk, the quality of risk management and ICAA, the FCMC used off site analysis and also carried out 13 inspections of banks. The results of inspections uncovered areas in which banks needed improvements, including the capital planning process, the procedure whereby the capital that is needed to cover the material risks inherent in its current and planned activity is established, the methods used for stress tests and for analysing the results.

In 2008 the FCMC started developing regulatory requirements for evaluating capital adequacy assessment process that were aimed at providing guidelines to banks for establishing the capital adequacy assessment process and were approved at the beginning of 2009.

Credit Risk

In the reporting year, 17 inspections were carried out during which the FCMC's staff assessed the quality of banks' credit portfolios and credit risk management systems (whereby credit risk is identified, measured, monitored and controlled) to establish, in a timely manner, the deficiencies and the possible problems related with loan repayment. The banks' strategy, policy and procedures for issuing loans and implementation thereof were assessed.

In 2008, the total balance of granted loans started to diminish and the quality of separate credit portfolio segments started to deteriorate. Banks notably increased provisions for non-performing loans and at the end of the year the volume of provisions was 345 million lats.

During inspections the FCMC paid more attention to the provisioning policy, real estate valuation procedures and the conditions for granting new loans. In most cases the FCMC pointed out deficiencies in assessing creditworthiness of real estate developers and private persons because they increased the risk incurred in loans to buying housing. The FCMC established and controlled the measures for eliminating these deficiencies and, where appropriate, assessed a bank's capital adequacy to its credit portfolio quality.

In light of the adverse developments in the quality of banks' credit portfolios, in 2008 the FCMC extended the scope of reported information and requested more frequent reporting. In reports, it paid more attention to the trends for the increasing number of problem loans and banks' policy for managing those loans.

Liquidity Risk

Turmoil in the global financial market and the resulting unusually large ebbing of deposits from the Latvian banking system as of September 2008 were the reasons for the Commission to pay particular attention to the supervision of bank liquidity. In order to continuously monitor banks' cash flows in emergency, in September 2008 the Commission changed the procedure whereby banks submitted liquidity reports and banks were required to report, on a daily basis, the dynamics of deposits. The Commission also enhanced the monitoring of liquidity management in a group including subsidiaries of foreign banks because, for maintaining liquidity, such banks often rely on the funds allocated by parent banks.

INTERNATIONAL ACTIVITIES OF FCMC

In order to ensure efficient cooperation with EU institutions, supervisory authorities of the EU Member States and of other countries as well as international organisations and in view of the decision of the Council of the European Union to ensure that the European dimension is included in the mandates of national supervisory authorities and to foster the activities aimed at convergence of the supervisory practice and cooperation in the EU, and also in light of the continuously increasing workload related to the EU issues, the EU and International Affairs Division was established at the FCMC in 2008.

Convergence of the supervisory practice and cooperation in this area in the EU have also been determined as a separate activity in the FCMC's strategy approved in 2008.

Participation in the Work of EU Bodies

Taking into account the situation in financial markets, the issues that fall within the competence of the FCMC – stability of the financial sector and issues related with financial services – were high on the agenda of various EU institutional fora, e. g., the European Council, the Economic and Financial Affairs Council (ECOFIN Council), the Economic and Financial Committee and the Financial Services Committee, and the following aspects were addressed in particular:

- situation in financial markets;
- development of legal instruments and framework for action in the financial crisis (e.g., transfer of assets, available crisis management tools in Member States, early intervention, likely state aid measures to the financial system, and others);
- strengthening of the role of the supervisory committees – Committee of European Securities Regulators, Committee of European Banking

Supervisors and Committee of European Insurance and Occupational Pension Supervisors;
- the possible reform of the EU financial sector supervision;
- improved disclosure of information in the financial market;
- improving prudential supervision and risk management instruments;
- standards for valuating financial instruments.

Overall in these fora the FCMC contributed to the development of about 90 national positions and instructions.

In 2008, many new draft EU legal acts were submitted for approval, in particular amendments to the directive relating to undertakings for collective investment in transferable securities, the capital requirements directive, the directive on financial collateral arrangements, the directive on settlement finality in payment and securities settlement systems, the directive on deposit-guarantee schemes and the directive on electronic money institutions.

A new directive on solvency of insurance undertakings (Solvency II) and a new draft regulation on credit rating agencies were prepared for a discussion. During the preparation phase the FCMC assessed the effect of the proposals on the Latvian financial market and developed proposals that represented Latvia's interests and were accordingly elaborated in the instructions and positions.

The FCMC's staff participated in the decision-making in the EU by taking part in the work of 42 committees and working groups in the Lamfalussy framework in 2008. To ensure convergence of supervision in the EU, participation in third level supervisory committees (Committee of European Banking Supervisors, Committee of European Securities Regulators and Committee of European Insurance and Occupational Pension Supervisors) and their working groups was of utmost importance. In the reporting year, these committees performed in-depth analysis to compare the authority of the supervisory authorities of Member States and the sanction regimes, assessed the possibility of delegating the authority and the tasks as established in the directives governing the financial sector, worked out joint guidelines for the activity of colleges of supervisors and assessed various sector-related issues. As a participant of these committees the FCMC prepared answers to 62 information requests.

Cooperation and Exchange of Information with the Financial and Capital Market Supervisory Authorities of Member States and of Other Countries and with International Financial Institutions

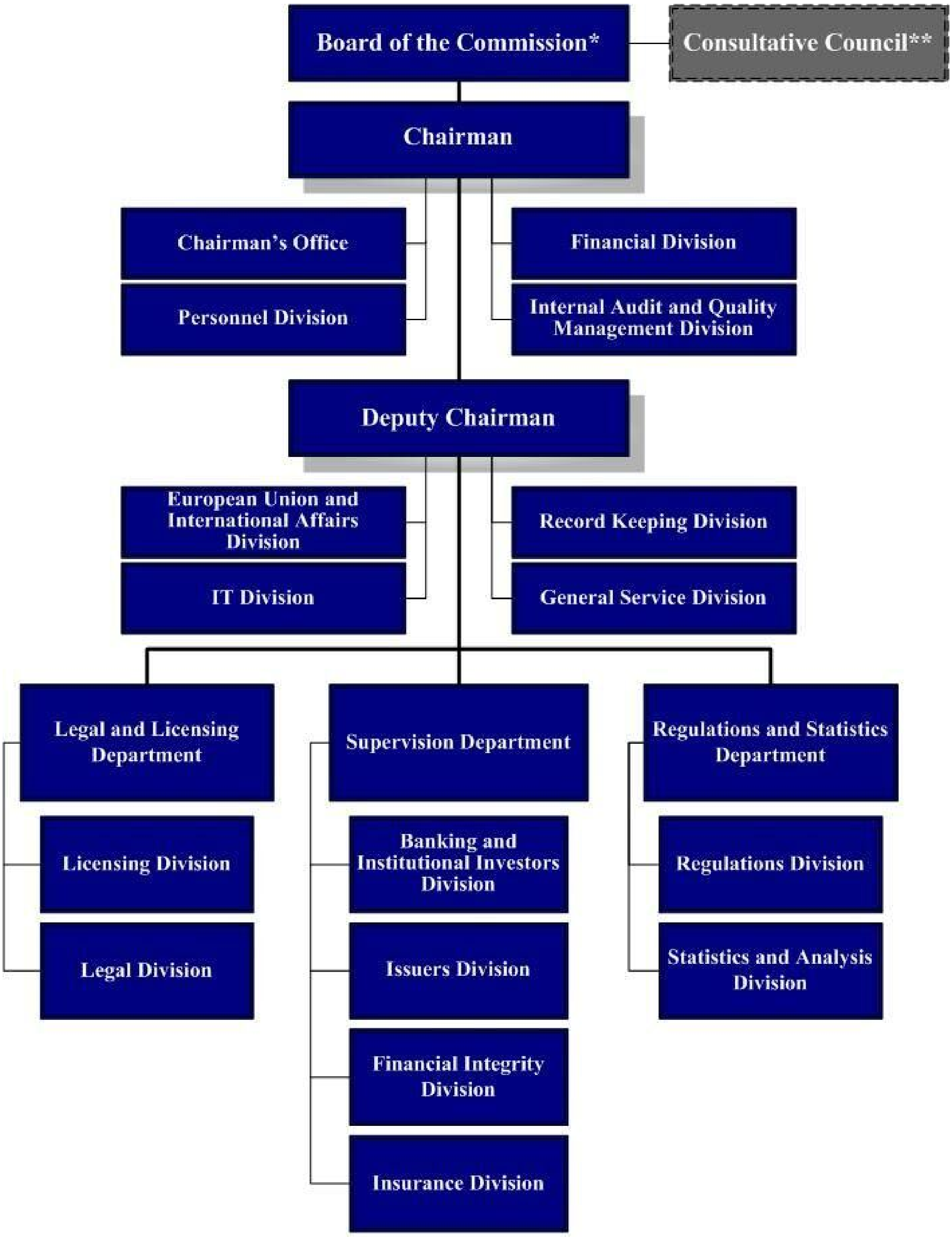
In view of the goal stated by the Economic and Financial Affairs Council (ECOFIN Council) in its conclusions of 14 May 2008 to enhance the role of colleges and establish such colleges for all cross-border financial groups in the EU to ensure cooperation and exchange of information among the supervisory authorities of those Member States in which a financial group carries out important activities, negotiations on six new agreements on cooperation and exchange of information in relation to the supervision of bank groups took place in the reporting year.

Negotiations were held with the Swedish Deposit Guarantee Board and with the Deposit Guarantee Fund of Portugal on memoranda for deposit guarantees and compensations to depositors. In autumn 2008, negotiations were started about signing a regional Nordic-Baltic memorandum for crisis management issues among banking supervisory authorities, central banks and ministries of finance.

COOPERATION WITH OTHER SUPERVISORY BODIES IN LATVIA

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

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



*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 organizations of financial and capital market participants.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Banks	21	21	21
Credit Unions	35	35	35
Foreign bank branches	3	4	6
Financial institutions, total	**59**	**60**	**62**

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

Item	2006	2007	2008
Public sector ownership	8.2	5.5	12.8
Other domestic ownership	23.0	16.3	9.9
Domestic ownership total	31.2	21.8	22.7
Foreign ownership	68.8	78.2	77.3
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Item	2006	2007	2008
Public sector ownership	4.3	4.2	19.5
Other domestic ownership	30.4	29.2	12.6
Domestic ownership total	34.7	33.4	32.1
Foreign ownership	65.3	66.6	67.9
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions (within type of institution)

Type of institutions	The first three largest (%)	The first five largest (%)
Banks	51.1	69.5

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

Type of financial institution	2006	2007	2008
Banks	2.1	2.0	0.3

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

Type of financial institution	2006	2007	2008
Banks	25.6	24.2	3.6

Distribution of market shares in balance sheet total (%)

Type of financial institution	2006	2007	2008
Banks	93.9	92.1	88.5
Foreign bank branches	6.1	7.9	11.5
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Assets	2006	2007	2008
Cash and balances with the Bank of Latvia	8.7	7.5	5.7
Claims on credit institutions	12.9	16.0	10.7
Loans	68.4	68.1	71.4
Bonds and other fixed interest securities	7.2	5.6	8.7
Shares and other variable yield securities	0.4	0.3	0.2
Participating interest and other financial investments	0.5	0.5	0.6
Other assets	1.9	2.0	2.7
Liabilities	**2006**	**2007**	**2008**
Amounts owed to the Bank of Latvia	0.0	0.0	2.8
Amounts owed to credit institutions	37.3	40.1	41.9
Deposits	48.8	46.5	42.0
Other liabilities	5.7	4.9	4.3
Provisions	0.6	0.6	1.7
Total equity	7.6	7.9	7.3

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

Type of financial institution	2006	2007	2008
Banks (incl.foreign bank branches)	13.8	13.2	10.6

Solvency ratio of financial institutions (%)

Type of financial institution	2006	2007	2008
Banks	10.2	11.1	11.8

Asset portfolio quality of the banking system

Asset classification	2006	2007	2008
Standart	99.3	99.2	94.1
Watch	0.3	0.4	3.5
Substandart	0.2	0.2	1.8
Doubtful	0.1	0.1	0.4
Lost	0.1	0.1	0.2
Classified total	**100.0**	**100.0**	**100.0**
Specific provisions	**0.5**	**0.5**	**1.9**

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	29.5	38.4
Government sector	9.4	1.0
Corporate	21.7	49.3
Foreign	38.8	11.2
Other	0.6	0.1
Total	**100.0**	**100.0**

The structure of deposits and loans in 2008 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	49.7	Long term loans	59.1
Within one year	44.2	Medium-term loans	27.2
Over one year	6.1	Short-term loans	13.7
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.		
	2006	2007	2008	2006	2007	2008
Banks (incl. foreign bank branches)	72.9	79.7	80.5	71.2	75.2	75.2

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

Revenues	2006	2007	2008
Interest income, incl.:	65.8	72.5	76.4
interest on loans	50.9	57.6	61.3
interest on deposits with credit institutions	8.8	9.1	9.1
interest on bonds and other fixed income securities	5.6	4.4	4.5
Dividends	1.2	1.1	1.2
Commission received	17.8	13.9	12.5
Profit/loss from securities and currencies trading	8.8	7.3	6.4
Other	6.4	5.2	3.5
Expenditures	**2006**	**2007**	**2008**
Interest expense	42.9	52.4	47.9
Commission paid	5.9	4.9	3.6
Operating expenses	36.0	30.0	22.6
Depreciation	3.7	2.5	2.0
Loans loss provision expenses	3.9	3.9	19.0
Other	7.6	6.3	4.9

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	in 1000 EUR	in %	in 1000 EUR	in %
Banks	1,264, 281	3.8	2,543,055	7.7

2008 DEVELOPMENTS IN THE LITHUANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2008, the development of the economy of Lithuania slowed down. Deteriorating results of Lithuania's manufacturing industry, worsening future expectations due to a decrease in demand in domestic and foreign markets, more stringent lending conditions were behind the essential developments of investment. The growth of private consumption was hampered by rising inflation, increasing unemployment, higher household debt servicing expenses and less favourable lending conditions.

According to preliminary data, the GDP created in Lithuania in 2008 made up LTL 111,520.1 (EUR 32,298.45) million at then current prices, and the growth rate of real GDP slowed down to 3.1 per cent, compared to 2007.

In 2008, investment development trends underwent major changes. For the first time in eight recent years, the real gross fixed capital formation decreased. In the last quarter of the year, the real expenditure of gross capital formation dropped by 19 per cent.

At the end of the year, the annual core inflation started to decrease. Having fluctuated at around 6.5 per cent for a half of the year, at the end of the year core inflation dropped to less than 6 per cent. This was materially influenced by domestic demand, which weakened due to pessimistic expectations, decreasing employment and tighter credit conditions.

In the first half of 2008, the main labour market indicators changed marginally. In the context of decreasing employment, the unemployment rate rose, reaching 7.9 per cent in the fourth quarter (a year ago it stood at 4.2 per cent), the number of people unemployed for less than a month grew significantly, and in December 2008 the number of the unemployed registered in the Lithuanian Labour Exchange was about a third higher than a year ago.

DEVELOPMENT OF THE BANKING SYSTEM

9 commercial banks holding a banking licence issued by the Bank of Lithuania (BoL), 8 foreign bank branches and 5 representative offices operated in Lithuania.

In 2008, the banking system's growth rate was significantly lower in all major areas of banking activities compared to 2007. During the course of the year, the assets of banks grew by LTL 8.8 billion (EUR 2.55) (10.9%) to LTL 89.8 (EUR 26.0) billion on 1 January 2009. The loans to customers increased by 18.9% per cent in comparison with 2007. The amount of deposits held with banks declined by 4.7 per cent over the year to LTL 38.2 (EUR 11.06) billion on 1 January 2009. The decrease was driven by a fall of 19.4 per cent in deposits of private enterprises and the fact that the deposits of central and local government-owned enterprises decreased nearly by a half. Notwithstanding a lower credit growth rate and decelerating growth of bank assets, the credit share in the asset composition kept growing further in 2008. This share (including credits to financial institutions) surged by 5 percentage points to account for 79.6 per cent.

The borrowing by Lithuanian banks from parent banks and other foreign banks within the same group was the major reason for the growth of the share of non-residents in bank liabilities from 45.3 to 52.2 per cent. Deposits of private enterprises accounted for the biggest share (73.1%) of the said deposits by non-residents, while deposits of residents of other countries and financial institutions made up respectively 20.7 per cent and 5.6 per cent.

Profit of domestic banks was LTL 867 (EUR 251.1) million (LTL 1,156 (EUR0.334) million in 2007). The profit of the banking system decreased for the first time in six years. The result of bank operations worsened in 2008, largely due to the increase in the expenses related to loan impairment and specific provisions. Bank losses due to impairment and specific provisions were LTL 456.4 (EUR 132.18) million, i.e. five times higher than in 2007.

The banking system's efficiency indicator, the ratio of operating expenses and amortisation to the profit from core operations, increased (deteriorated) over the year by 3.2 percentage points to 48.9 percent on 1 January 2009. This ratio shows the share of the banks' net income from core operations used to cover operating and amortisation expenses.

In the course of 2008, the banking system's capital (capital base), which is used to calculate the required capital adequacy ratio, grew by LTL 994 (EUR 287.88) million to LTL 7.190 (2.08) billion on 1 January 2009. At the same time, the authorised capital of the banking system grew over the year by LTL 431 (124.82) million to LTL 3.5 (1.01) billion. Furthermore, the banks' capital base was also improved by subordinated loans to banks in 2008.

On 1 January 2009, the banking system's capital adequacy ratio stood at almost 13 % (the required minimum set by the BoL is 8 %), which comprises a year-on-year increase of 2 percentage points. All commercial banks complied with the established capital adequacy ratio.

On 1 January 2009, the bank loan portfolio, including loans to financial institutions, accounted for 64.1 per cent of Lithuania's GDP in 2008.

The banking system's liquidity ratio was 39.1 per cent on 1 January 2009, almost 9 percentage points higher than the minimum set by the Bank of Lithuania. Liquid assets accounted for 18.6 per cent of the banks' total assets. All banks complied with the liquidity ratio set by the BoL.

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

As stated in the Law on the Bank of Lithuania, the BoL supervises the activities of credit institutions holding a licence of the BoL. The supervision of the activities of credit institutions 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 (off-site supervision);
3. inspection of the activities of credit institutions — verification of the correctness of the compilation of financial reports presented to the BoL 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 (on-site supervision);
4. application of enforcement measures prescribed by laws to credit institutions.

In performing supervision of the activities of credit institutions, the BoL 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 against credit institutions and other persons holding a licence issued by the BoL;
4. take measures in order to ensure efficient operation of the credit system.

Ongoing supervisory functions are performed by the Credit Institutions Supervision Department, a structural unit of the BoL. The Board of the BoL 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 2008

The goal of credit institution supervision is to monitor the compliance of credit institutions with the standards of safe and reliable banking as set by the laws and legislation of the BoL, International Financial Reporting Standards (IFRS) and recommended by the Basel Committee on Banking Supervision.

The main objectives of the banking supervisory authority in 2008 were:

- Seek to ensure the reliability, transparency and competitiveness of the national credit institutions system.
- To ensure consistent implementation of the EU directives: 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and 2006/49/EC on the capital adequacy of investment firms and credit institutions.
- Even in the course of licensing process try to prevent unreliable market participants with bad reputation from entering the banking market.
- To supervise how banks observe prudential requirements and implement the requirements set forth by legal acts regulating the operation of banks.
- Try to ensure an effective prevention of emerging risks in credit institutions and assure maximum early identification of potential problems.
- To further improve the regulation of banking accounting and reporting taking into account the latest EU directives, IFRS provisions and developments in financial markets.
- In the course of the implementation of the aforementioned directives to maintain constant relations with the industry and interested supervisory authorities of other EU member states.
- To ensure proper preparation for the implementation of new supervisory inspection and assessment process.
- To guarantee proper representation of the national credit institutions supervision at relevant structures of the EU, to expand and develop contacts with credit institutions supervision authorities of foreign countries.

THE ACTIVITIES OF BANKING SUPERVISORY AUTHORITY IN 2008

The provisions of the new capital requirement directives on measuring prudential ratios for banks were introduced in practice in 2008. To this end, banks not only calculated the need for regulatory capital, but also performed the evaluation of the internal capital adequacy assessment process, taking into account the new requirements. The BoL was engaged in the banks' supervisory review and assessment to see if banks are able to ensure risk management and their capital is sufficient to cover potential risk. The assessment was done on an individual basis. Since the new capital adequacy directives create the grounds for banks to introduce new risk measurement methods, the BoL continued to work in 2008 on the recognition of one bank's internal ratings based (IRB) credit risk assessment approach: the Bank's representatives took part in the meetings between representatives of supervisory authorities from Sweden, Estonia and Latvia and representatives of the applicant bank group to discuss the countries' attitudes towards the requirements for the IRB approach and documents to be submitted. Later, the document check-up was performed, a target inspection was conducted and recommendations on the improvement of the preparation for the use of this approach were issued.

The BoL summarized the stress-testing results and discussed them with each bank separately. The most risky areas of the banks' operations were identified for banks to select risk mitigation measures and plans designed to diminish the financial crises impact on their activities.

The banking supervision measures implemented to stabilize the financial market are designed primarily for the prevention of financial crisis. Because of the situation in international markets and particularly the countries where parent banks are operating, the BoL took a number of additional supervisory measures to monitor and control the situation (in particular, liquidity situation) in the domestic banking sector. For that reason, the banks were requested to send information on a daily basis about structural changes in their assets and liabilities. Upon noticing any major changes in the composition of assets and liabilities, banks are requested to explain their reasons and provide for the measures to be taken to cover potential liquidity risk.

The Board of the BoL adopted legal acts on additional requirements for the strengthening of internal control and risk management processes in banks and other credit institutions. Special attention was given to the management of credit and liquidity risks. Banks were obliged by this document to reassess their risk management processes, to review the introduced limits, etc.

To provide the public with as much information on the activities of credit institutions as possible and alleviate supervisory burden for banks, several legal acts were adopted, which regulate accountability and reporting of credit institutions. With regard to information related to the credit institutions supervision, some amendments were made to the public disclosure mechanism, and the requirements for the information released by credit institutions were revised. Banks were obliged to provide wider information about the use of risk management and internal control processes, as well as the assessment of risks that have significant effects on their financial status and operational results.

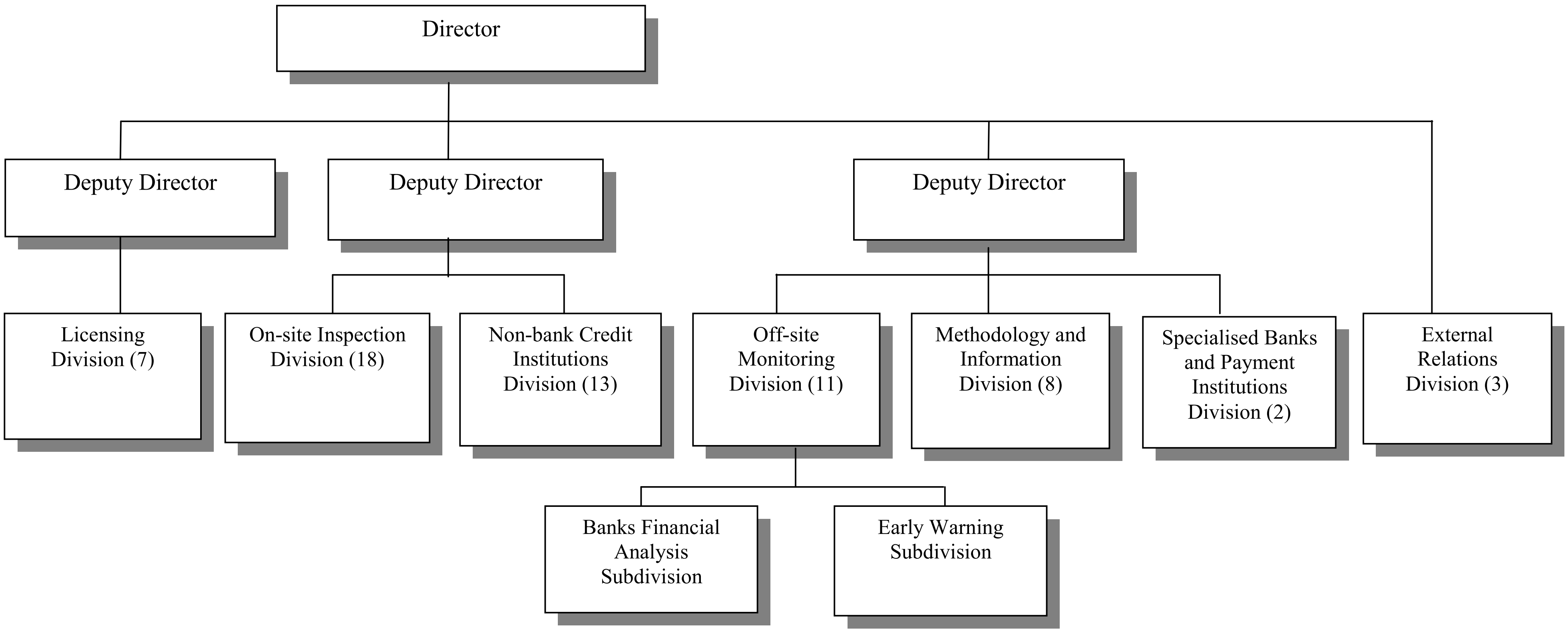
The review of information flow was done to change the regularity of some reports; however the requirement to present all the financial statements once a year remained. Amendments to some IFRS served the basis for revision of conditions set out in the Rules on the Consolidation of Financial Reports and Joint (Consolidated) Supervision of a Financial Group, specifying the cases when financial statements are not consolidated and joint supervision is not performed. The Main Principles of the Policy of Financial Accounting and Preparation of Financial Statements of Credit Institutions were supplemented and approved to ensure collective responsibility of the members of companies' management and supervisory bodies (Supervisory Council) for the preparation and publication of financial statements and to harmonise the provisions of legal acts regulating the activities of credit institutions.

The European Commission adopted a regulation to approve the amendments to International Accounting Standard 39 and IFRS 7 on regrouping of financial assets and disclosure of information on such regrouping made by the International Accounting Standards Board. Accordingly, the Board of the Bank of Lithuania issued permission for credit institutions to amend their accounting policies. Permission to reclassify these assets was expected to prevent unjustified profit (loss) fluctuations, while the actual decline in real value during the course of the financial year was obtained in a depreciation test.

After the Seimas of the Republic of Lithuania adopted the Law on Amendments to the Law on Credit Unions, the Board of the BoL approved legal acts regulating the requirements for the calculation of the new maximum exposure and large exposure ratios of credit unions, as well as the foundation, licensing, reorganisation and liquidation of credit unions.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

THE STRUCTURE OF CREDIT INSTITUTIONS SUPERVISION DEPARTMENT OF THE BANK OF LITHUANIA AT THE END OF 2008*



* Total staff 68 (including Chief Lawyer, Assistant to the Director)

INTERNATIONAL ACTIVITIES

The BoL is a part of the ESCB and participates in the preparation and adoption of decisions of the ESCB and EU institutions. It cooperates with international and foreign financial organisations in all major areas of its activity.

Representatives of the BoL participate in the ESCB committees, their working and task groups, such as WG on Developments in Banking, WG on Macro–Prudential Analysis, WG on Crises Management and participate in the activities of the working and task groups of the committees of the European Commission – the European Banking Committee, the Committee of European Banking Supervisors.

The BoL cooperates closely with the supervisory authorities of the EU Member States in implementing the supervision of banks operating in different countries but within the same bank group. Pursuant to the provisions of new capital directives, the supervision of each such bank group is conducted by establishing the colleges with the participation of supervisory representatives of all parties concerned. The BoL agreed to take part in the activities of the college initiated by the Swedish Financial Supervisory Authority and has an invitation to participate in the supervisory college organised by the Danish Financial Supervisory Authority. In 2008, a draft memorandum of understanding on cooperation in setting up a college with the Latvian and Estonian supervisory authorities was prepared.

One the banks operating in Lithuania has a subsidiary abroad; therefore the BoL, as an institution performing a consolidated supervision of this bank, has invited supervisory institutions of the Latvian and Estonian financial sectors to participate in the activities of the established college. A multilateral cooperation agreement of financial sector supervisory institutions on the establishment of a college was signed.

The BoL continued cooperation and exchange of information with the supervisory authorities of the EU Member States responsible for the situation in the banking system. In 2008, the representatives of the BoL attended the meetings with the representatives of the Danish, Estonian, Latvian, Finnish and German supervisory authorities organised by the Swedish Financial Supervisory Authority on the coordination of further actions in the assessment of credibility of one of the operational risk assessment methods applied by a bank group.

COOPERATION WITH OTHER SUPERVISORY BODIES

In view of the strengthening relations between the financial sector and the insurance sector and their influence on the business of credit institutions, the BoL continued close co-operation with other financial and insurance supervisory authorities of Lithuania. This co-operation is coordinated by the Commission for Co-ordination of Regulation and Supervision of the Activities of Financial Institutions and Insurance Undertakings. 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.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Commercial banks	9	9	9
Foreign bank branches	2	5	7
Credit unions	67	68	68
Financial institutions, total	**78**	**82**	**84**

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

Type of financial institution	2006	2007	2008
Public sector ownership	0.05	-	-
Other domestic ownership	11,59	14,3	17,2
Domestic ownership total	11,64	14,3	17,2
Foreign ownership	88,36	85,7	82,8
Financial institutions, total	**100,0**	**100,0**	**100,0**

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

Type of financial institution	2006	2007	2008
Public sector ownership	-	-	-
Other domestic ownership	-	-	-
Domestic ownership total	83,6	85,3	88,3
Foreign ownership	16,4	14,7	11,7
Financial institutions, total	**100,0**	**100,0**	**100,0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Bank	65,5	82,1
Credit unions	24,0	32,0
Financial Institutions		
Savings Cooperatives		
Specialized Credit Institutions		

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

Type of financial institution	2006	2007	2008
Bank	1,32	1,71	1,01
Credit unions	0,62	0,5	0,1
Financial Institutions			
Savings Cooperatives			
Specialized Credit Institutions			

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

Type of financial institution	2006	2007	2008
Bank	20,29	25,93	13,54
Credit unions	5,3	4,3	0,8
Financial Institutions			
Savings Cooperatives			
Specialized Credit Institutions			

Distribution of market shares in balance sheet total (%)

Type of financial institution	2006	2007	2008
Commercial banks	91,8	90,9	81,3
Foreign bank branches	7,2	8,1	17,7
Credit unions	1,0	1,0	1,0
Financial institutions, total	**100,0**	**100,0**	**100,0**

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

Assets	2006	2007	2008
Cash in hand	1,9	1,7	1,7
Claims on banks and other financial institutions	18,2	16,4	10,0
Securities	12,4	9,8	7,1
Loans granted	65,6	70,1	79,5
Other assets	1,9	2,0	1,7
Liabilities	**2006**	**2007**	**2008**
Liabilities to banks and other financial institutions	31,5	36,1	43,1
Deposits and L/C	51,4	45,9	42,9
Other liabilities	10,4	10,7	6,3
Bank capital	7,0	7,3	7,6

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

Type of financial institution	2006	2007	2008
Commercial banks	20,6	18,9	16,4
Foreign bank branches	31,9	32,9	16,5
Credit unions	1,8	1,4	1,6
Financial institutions, total	**21,3**	**19,8**	**16,3**

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Commercial banks	10,75	10,9	12,9
Credit unions	16,66	16,3	16,8
Financial institutions, average	**11,12**	**11,22**	**12,78**

Asset portfolio quality of the banking system

Asset classification	2006	2007	2008
Commercial banks	117,30	180,43	953,1☼
Classified total	**117,30**	**180,43**	**953,1**
Specific reserves	**108,32**	**130,33**	**252,2**

☼ From 1 July 2008, the quality of loan portfolio is evaluated on the basis of anew method that was developed in view of new requirements set by the 7th International Financial Reporting Standard and the EU common reporting. While calculating the indicators instead of a previously used loan net value the total value of loan portfolio is assessed. In addition, the loans are divided into the loans overdue, which are non-impaired, and the impaired loans

The structure of deposits and loans in 2008 (%) (at year-end)

	Deposits	Loans
Households	63,2	40,0
Government sector	3,0	1,9
Corporate	27,7	52,3
Foreign	**5,4**	**2,3**
Other	6,1	5,8
Total	**100,0**	**100,0**

The structure of deposits and loans in 2007 (%) (at year-end)

Types of deposits		Types of loans	
At sight	43,3	Long term loans	50,1
Within one year	55,4	Medium-term loans	18,9
Over one year	1,3	Short-term loans	31,0
Total	**100,0**	**Total**	**100,0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Commercial banks	54,5	55,8	61,0	**46,2**	49,4	58,5
Foreign bank branches	74,4	74,3	80,4	74,1	82,5	83,5
Credit unions	1,3	0,83	2,6	1,5	2,2	8,2
Financial Institutions, average	**55,4**	**47,8**	**63,8**	**56,8**	**51,6**	**62,8**

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

Revenues	2006	2007	2008
Interest income	68,9	73,3	80,9
Profit from operations in foreign exchange	4,1	3,3	2,3
Income from services and commissions	21,1	17,5	14,4
Other bank income	5,9	5,9	2,4
Total	**100,0**	**100,0**	**100,0**
Expenditures	**2006**	**2007**	**2008**
Interest expenses	41,6	50,4	58,5
Operational expenses	34,0	30,5	23,3
Expenses for specific provisions	4,3	2,6	0,3
Other expenses	20,1	16,5	17,9
Total	**100,0**	**100,0**	**100,0**

Structure of registered capital and own funds of financial institutions in 2007

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR mln	%	EUR mln	%
Commercial banks	1022,2	4,8	1966,4	10,1
Credit unions	28,9	21,4	32,4	27,3
Financial institutions, average	**13,7**	**4,9**	**25,6**	**10,2**

2008 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MACEDONIA

MACROECONOMIC ENVIRONMENT IN THE REPUBLIC OF MACEDONIA

In 2008, the world faced with the most severe financial and economic crisis experienced so far. The Macedonian economy, as a small and open economy, was not isolated from the effects of the global financial crisis. The relatively small financial integration and simple structure of financial instruments enabled to maintain the stability and safety of the domestic banking system. However, the implications for the financial activity and the direct effects for the real sector were experienced in the last quarter of the year, signaling their clear reversal in the domestic economy. The exports sector was directly hit by the global recession, through a decline in the prices of the main export products and reduced demand for domestic products. The increased uncertainty, refraining from undertaking risks and from investing in general, resulted in a decline in the capital inflows in the country. These have increased the external imbalances which were manifested through deepening of the current account deficit.

During the first half of 2008, given the strong pressures from the import prices, stronger domestic demand and high inflation expectations, inflation was at a level higher than usual. The average inflation in the first half of the year was 9.7%, while core inflation reached 2.8%, and although relatively low and with emphasized stability in this period, still significantly exceeded the one registered in 2007. Such a combination of growing inflation and expectations about deterioration of the external position of the economy imposed a need for monetary reaction with a rise in the key interest rate. In the first half of the year, the interest rate on the Central Bank bills was increased on three occasions, and the last increase was made in May, 2008, when it was set at 7%. At the same time, the rapid growth of household credits was considered to be a factor which creates pressures on the inflation and the growing imports, and therefore in June, 2008 a decision on a compulsory deposit of banks with the NBRM was adopted, the aim of which was to discourage the excessive growth of household credits.

The second half of the year was, in global terms, marked by sharp reversal of the trends in world prices of food and energy, the decline of which, together with the exhaustion of the low comparison basis from the preceding year led to a significant deceleration of the domestic inflation. The annual inflation slowed down continuously, and fell down to 4.1% in December. However, with the movements in the first half of the year, the average inflation rate in 2008 was 8.3%. The world crisis also created psychological pressures on the domestic agents, which became evident through the growth of the demand for foreign exchange and change in the currency structure of the savings from domestic into foreign currency. Such a condition on the markets, accompanied by the outflows of foreign exchange for payment of dividend to foreign shareholders and the smaller intensity of foreign investments, resulted into a massive sale of foreign exchange from the official reserves in the last quarter of the year. Fiscal policy created an additional pressure, which from a zone of a budget surplus in the first three quarters, in a short time registered a budget deficit in the last quarter of the year, with the budget deficit for the whole 2008 equaling 0.9% of GDP.

NBRM maintains the existing strategy of a de facto targeting of the exchange rate, assessing that the stable exchange rate, especially in periods of shocks, is the key anchor which stabilizes the expectations in the Macedonian economy and contributes to the accomplishment of price stability, as the main monetary objective.

Although the consequences from the global crisis for the Macedonian economy started to become more intensive towards the end of the year, generally, in 2008, the pace of steady growth was maintained. The achievement of a real growth rate of 5% in 2008, after the growth of 5.9% in the preceding year, indicated that the Macedonian economy is on the right way to gradually increase the degree of real convergence to the EU. Although this percentage is still low and it equals around 30% in 2008[30], it points to a continuous progress in a time frame of four years, as opposed to the relative stagnation in the preceding period. The assessed decomposition of the growth generators in 2008 indicates that growth is still far from balanced, with dominant contribution of the domestic demand and negative contribution of the net-export demand. However, the growing role of the investments and the fact that in 2007 and 2008 they registered an intensive growth is an indicator of the possible increase in the intermediate productivity of the economy.

The sensitivity of the external sector of the Macedonian economy, primarily due to the high concentration of the exports and its sensitivity to the fluctuations in the world prices became evident in 2008. In 2008, the current account deficit reached 13.1% of GDP, which is a significant rise compared with the preceding year (7.2% of GDP). The increase in the deficit is a combination of several factors. One of them is the growth in the domestic demand, significant part of which is directed to imports. However, observed from a viewpoint of the gap between saving and investments, despite the investments growth, the broadening of the current deficit is a reflection, to a great extent, of the decrease in the saving. Additional factor are the prices of the energy products on the international markets, the growth of which in the first half of 2008 created large pressures on the import. However, the main export sector, the metal manufacturing, has great significance for the negative movements in the current account, which was affected rapidly and directly by the global crisis through the drop in the prices of metals and the reduced export demand. Thus, the sensitivity of the exports to external shocks and the large dependence on the current transfers, emphasized as key risks in the external sector for many times so far, reflected in 2008, with their additional intensification being expected for the following year.

[30] GDP per capita according to the Purchasing Power Parity, as a percentage of the average of EU 27.

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

With the intensification of the global financial crisis and its spreading on the European ground, the NBRM, as an authorized supervisory body, permanently and intensively monitors the situation and the developments in the banking system of the Republic of Macedonia. All analyses indicate that there are no signs of more serious deterioration of the stability and resistance of the banking system. No direct negative effects were felt, since the banks in the Republic of Macedonia did not make investments on the market of structural credit products at all and they had no credit exposure to the financial institutions affected by the crisis. Simultaneously, the current structure of the sources of funds of the banking system of the Republic of Macedonia is characterized with dominant participation of the domestic sources of funds and small dependence of the banks on the sources of financing from abroad (however, certain banks, as a result of relatively higher dependence on the non-resident sources of financing of their activities show slightly higher sensitivity to the developments on the international financial markets). The banking system of the Republic of Macedonia is more influenced by the indirect transmission channels, primarily through the channel of the real sector and due to the psychologically induced pressures.

As a reaction to the first signs of deterioration of certain macroeconomic variables and the global movements, in 2008 the NBRM undertook a variety of measures for limiting the risks in the banking system, such as:

- tightening of the treatment of the banks' claims on the basis of credit cards and overdrafts when determining the banks' solvency (increase in the weight from 100% to 125%);
- limiting the risks of more intensive credit growth to households, through introduction of marginal reserve requirement (for the amount exceeding the prescribed credit growth rate);
- enhanced monitoring of the Macedonian banks' exposure towards foreign banks, as well as lowering the limit for the exposure to first-class banks to 25% of the bank's own funds;
- daily monitoring of the level of the households' deposits with the banks in the Republic of Macedonia;
- setting the minimal liquidity level, individually for Denars and in foreign currency assets and liabilities.

Information on the performances of the banking system of the Republic of Macedonia (as of December 31, 2008)

As of December 31, 2008, the banking system of the Republic of Macedonia consisted of eighteen banks and eleven savings houses (the role of the savings houses is insignificant; their share in the total credits, total deposits and total assets of the banking system is below 2% in each of these categories).

The banking system of the Republic of Macedonia is the main financial intermediary in the Republic of Macedonia. At the end of 2008, for the first time in the past six years, the level of financial intermediation stagnated from a viewpoint of the total assets and deposit activity, and equaled 62.9% and 45.4% of GDP, respectively. However, such movement is not common also from a viewpoint of the banks' credit activity. Financial intermediation, measured through the total credits to GDP ratio, still registers an upward trend and on December 31, 2008 it reached 42.9% (which is a rise of 6.9 percentage points relative to the previous year).

As of December 31, 2008, the total assets of the banks in the Republic of Macedonia reached the amount of Denar 250.7 billion. The annual growth rate of the assets of 12.1% has been the lowest asset growth rate in the past six years. Decelerated growth of the banks' assets was mainly determined by the slower dynamics of attracting deposits in 2008. Despite such dynamics, deposits are still dominant source of funds, and they were the main generator of their growth, as well as the growth of total assets. On annual level, deposits went up by 12.8%, and as of December 31, 2008 they reached the amount of Denar 180.9 billion. Despite the fact that this is the lowest growth rate registered in the past six years, it generated about 76% of the annual growth of the total banks' assets. The psychological pressure caused by the daily unfavorable information from the international financial markets and the crisis that spilled over the world, and in conditions of a significant euroization of the Macedonian economy, beside growth deceleration, has also caused increased transformation of the deposits' currency structure. For the first time in the last three years, foreign currency deposits registered a significantly higher growth in absolute and in relative terms compared with Denar deposits. As of December 31, 2008, the accomplished annual growth rate of foreign currency deposits of 22.1% was the peak registered in the past six years and it was by significant 16.8 percentage points higher relative to the annual growth rate of Denar deposits. As of December 31, 2008, 52% of the deposit base was in Denars, while 48% was in foreign currency. From a viewpoint of the structure by sector, household deposits are still dominant with 59.2%.

Most of the Macedonian banks' activities are financed from the deposits collected from domestic entities. Thus, as of December 31, 2008, the share of the deposits and borrowings from non-residents in the total liabilities is 10.9%. Placements to non-residents are on a historically lowest level and they are somewhat below 9% of the total claims.

Banks' solvency remains relatively high. At the end of 2008, the capital adequacy ratio was 16.2% and it is twice higher than the legally prescribed minimum of 8%. Additionally, all simulations made by the

National Bank on regular basis indicate that the banking system shows high degree of resilience to various hypothetical shocks.

As of December 31, 2008, the share of the foreign capital in the total shareholders' capital of banks equals 74.3%. In 2008, the number of banks dominantly owned by foreign shareholders increased by three banks, and the total number now is fourteen. Among them, eight banks are owned by foreign banks, whose share in the total assets of the banking system is 59%. The increase in the number of banks which are in dominant ownership of foreign shareholders caused their share in the total assets and in the total capital at the level of the banking system to reach 92.7% and 84.2%, respectively as of December 31, 2008. As to the country of origin of the dominant bank owners, the largest part of the assets of the banking system remained concentrated with the banks with dominant owners from the EU countries.

During 2008, the banks in the Republic of Macedonia serviced their liabilities to the depositors in a timely manner, and they were never in need of using liquidity support by the National Bank in the form of a lombard credit or short-term liquidity credit. In 2008, the average amount of liquid assets[31] was Denar 65,576 million, while the average amount of highly liquid assets[32] was Denar 40,939 million. The amount of highly liquid assets that the banking system disposes of is one sixth of the total assets and provides a satisfactory level of coverage of household deposits. Highly liquid assets cover around 39% of the total sight deposits, as of December 31, 2008. If short-term assets kept in foreign first-class banks are added to these most liquid assets, the coverage of sight deposits reaches 77%. According to the expectations and the empirical analyses of the banks, the level of stable sight deposits up to seven days reaches 84.5%.

In 2008, certain deceleration in the banks' credit activity was registered. The annual growth rate of credits to non-financial entities for 2007 equaled 39.1%, while at the end of 2008 this growth rate was reduced down to 34.4%. Credit growth was financed by the growth of the deposit base, but also by the structural transformation of the assets (expressed through a decline in the placements in foreign banks, at the expense of the rise in the placements in the domestic economy). In 2008, the first signs of increased risk for the credit portfolio of the banking system appeared. On the one hand, this deterioration appears as a result of a decelerated growth of credit exposure, which started at the end of 2007. On the other hand, it is a result of the so-called "maturing" of the credit portfolio formed in more relaxed terms of lending, common for the past period of credit expansion. As of December 31, 2008 the share of the exposure classified in risk categories C, D and E in the total credit exposure at the level of the banking system equaled 6.6%, which is by 0.7 percentage points higher relative to the end of 2007. On the other hand, allocated credit risk provisions (impairment) cover high 91% of the exposure classified in risk categories C, D and E.

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[31] Liquid assets, in the broader sense, covers the highly liquid assets, assets placed with foreign banks in a short run, and placements in other short-term debt securities.

[32] Highly liquid assets cover cash and balances with the NBRM, central bank bills of the NBRM, correspondent accounts with foreign banks, and short-term placements in government securities.

In 2008, the banking system of the Republic of Macedonia realized profit in the amount of Denar 3.4 billion, which is by 6.6% less relative to 2007. Main generator of banks' profitability are the revenues from regular operations, which created 95% of the banks' total revenues. ROAA is 1.4%, while ROAE is 12.5%.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN MACEDONIA

According to the Law on the National Bank of the Republic of Macedonia (NBRM), the NBRM is the authorized banking supervisory authority in the Republic of Macedonia.

The supervisory and regulatory function of the National Bank of the Republic of Macedonia is performed by the Supervision, Banking Regulations and Financial Stability Division. The Supervision, Banking Regulations and Financial Stability Division includes three Departments: 1) Off-site Supervision and Licensing, 2) On-site Supervision, and 3) Financial Stability, Banking Regulations and Methodology. In addition, a Supervisory Committee chaired by the Division's General Manager, reviews the major supervisory and regulatory issues, for the purpose of uniform implementation of the legal framework and the internal supervisory methodology. Risk based supervisory approach is applied.

The NBRM has completed the banking regulatory package (by-laws) which enable an adequate implementation of the law and the international supervisory standards. In 2008, the following bylaws of higher importance were adopted:

- Decision on managing the interest rate risk in the banking book;
- Decision on the contents and the manner of functioning of the Credit Registry and Instructions for the implementation of the Decision on the contents and the manner of functioning of the Credit Registry;
- Decision on managing the banks' liquidity risk and Instructions for implementation of the Decision on the banks' liquidity management;
- Decision on amending the Decision on the methodology for determining the capital adequacy and Instructions for amending the Instructions for implementation of the Decision for determining capital adequacy (for the purpose of amending the current methodology with requirement for operational risk capital charge);
- Decision on amending the Decision on the bank's information system security.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

The year 2008 was marked by the realization of the following strategic objectives:

a) *Transition from compliance focused to risk-based supervision;*

At the beginning of 2008, the Governor of the NBRM adopted the new methodology for risk based supervision. It covers the Supervisory Framework (Supervisory approach) and the Risk Assessment System (assessment of seven risk categories identified as inherent in the Macedonian banking system). Based on the methodology, during the first quarter of 2008, NBRM started the supervisory cycle with on-site examinations, off-site monitoring and supervisory corrective actions, characterized with the concentration on the quantity of risks and the quality of banks risk management systems.

b) *Completion of the set of bylaws - the new regulatory framework based on the Banking Law from 2007;*

As a result of this process, the Council of the NBRM adopted 23 bylaws, regulating the capital adequacy, banks risk management including separate bylaws on the management of the main risks, licensing, corporate governance, transparency, bank rehabilitation etc. The aim of this framework has been to establish the adequate regulatory environment that allows more efficient banking supervision and more prudent behavior of the market participants. Also, the changes in the legal framework has been made with intention to enable its further harmonization with the New Capital Accord for Banks (Basel II).

c) *Completion of the process of re-licensing of the banks according to the Banking Law from 2007*

The process of re-licensing that started during the second half of 2007 was completed in December 2008. Within this,

- all shareholders of the banks, with participation of 5% or more than 5 % of total issued shares, have gone through the fit and proper test;
- all members of the supervisory boards of the banks also gone through the fit and proper test,
- the banks were obliged to submit documentation as a proof that they have in place adequate organization, risk management systems and internal control systems in order to get/renew the license for conducting certain financial activities (for example trading with securities, fx trading, custodian activities, underwriting activities etc.

d) *Monitoring on transition process of banks toward adoption of the changes in the accounting framework in line with the requirements of IFRS;*

The new accounting regulation was adopted by the NBRM Council in September, 2007, and started with application by the banking industry as of January 01, 2009. Before adoption the documents were distributed to the banks, which gave the industry an opportunity to comment on the proposed accounting and financial disclosure regulation.
The year 2008 was marked with the activities for monitoring the transition process of the banking industry toward the adoption of the new accounting framework which includes complex decision making on different aspects of prudential framework and avoiding possible conflicts between them.

e) *Monitoring and permanent communication with the banking industry in order to act in a preventive manner against all possible risks that eventually might arise as a consequence of the world financial crisis.*

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

The supervisory function of the NBRM is carried out through 3 main activities: (1) licensing (issuing licenses and approvals to banks and savings houses), (2) supervision of the operations of the banks and the savings houses and undertaking corrective measures. During 2008, NBRM performed the following activities:

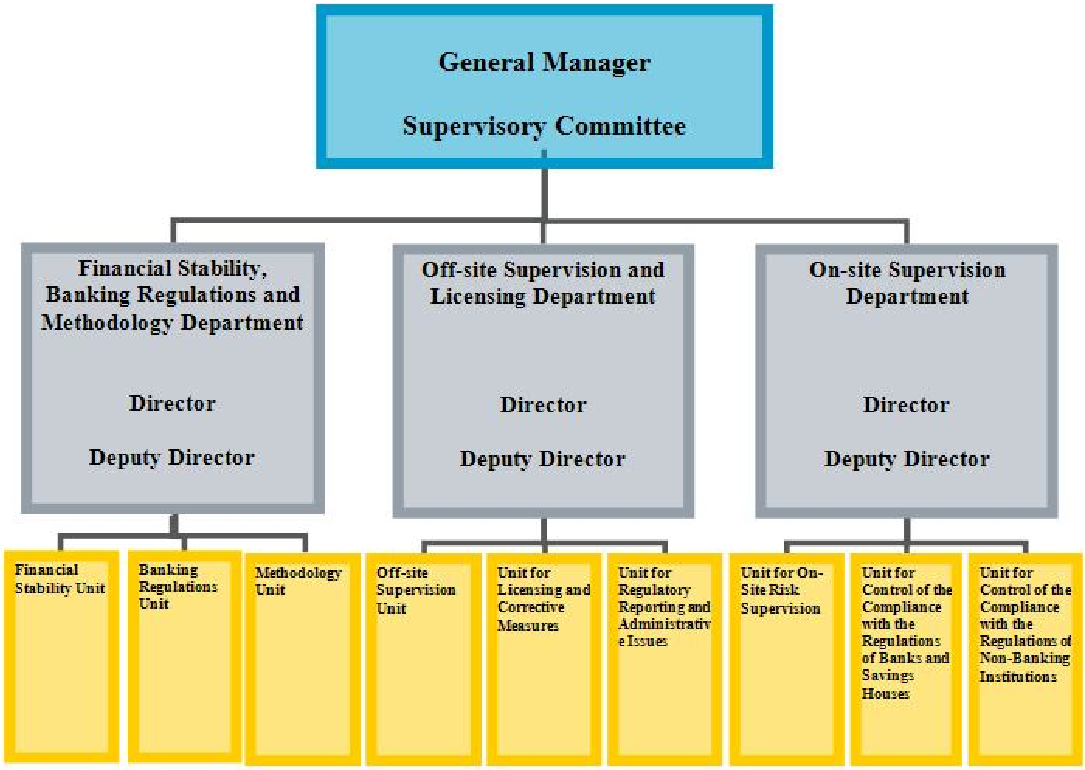
- Within the licensing framework, the NBRM in 2008 completed the process of licensing of the banks in order to comply with the provisions of the new Banking Law, referring to the statute, the amount of the initial capital, the financial activities and the bank's bodies. Also, the current shareholders with qualified holding in a bank were required to comply with the strengthen criteria for a qualified shareholder, envisaged in the new Law.
- At the beginning of 2008, NBRM started using the risk-based supervisory approach. In the process of planning and implementing of the supervision on the banks' operating, this approach focuses on the material risks they are exposed to. In determining the risk profile of the bank, its risk exposure and method of risk management is assessed, so the aggregate risk profile is determined on the basis of previously defined risk matrices. In 2008, 10 on-site supervisions on the operating of banks and saving houses in the Republic of Macedonia were performed. Seven of them were full-scope examinations of 5 banks and 2 saving houses, whereas 3 were targeted examinations. In conditions of constant growth of banks' activities in the Republic of Macedonia, in 2008, the primary focus of on-site supervision was the assessment of the system of internal controls and the adequacy of the established risk

management systems, with respect to the support of the realized growth. NBRM continued to monitor the manner of the banks for credit risk management with due care, especially in the area of loans to households, loans in denars with FX clause and long-term loans.

- Within the process of undertaking corrective measures to banks and saving houses, in the period from January 1, 2008 to December 31, 2008, NBRM imposed 16 written warnings to 7 banks and 5 saving houses, as well as 5 written recommendations to 2 banks and 3 saving houses. Also, on the basis of the provisions from the Banking Law for initiating misdemeanor procedure, in this period 11 procedures for intermediation were initiated to 6 banks and to the responsible persons in those banks and to 5 saving houses and the responsible persons of those saving houses.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

Supervision, Banking Regulations and Financial Stability Division



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In direction of strengthening of the cooperation with the foreign supervisory bodies, in previous years NBRM has signed Memorandum of Understanding with the supervisory bodies of Albania, Slovenia, Bulgaria, Russia, Montenegro and Greece. In addition, in the fist half of 2008, bilateral Memorandum, in the area of the supervisory and regulatory function, was concluded with the National Bank of Serbia.

On the basis of the indications of the EC Peer Assessment Mission, the NBRM initiated signing of the Memoranda of Understanding also with the supervisory bodies of Italy, France, Bosnia and Herzegovina and Turkey.

Within the regional cooperation, the multilateral Memorandum of Understanding and coordination between the supervisory bodies of South-East Europe is especially important. As part of the regional efforts for strengthening of the banking supervision, in July 2007, NBRM together with the supervisory bodies of Albania, Greece, Bulgaria, Cyprus, Romania, Serbia, Bosnia and Herzegovina, Republic of Srpska and Montenegro, signed a Memorandum for Understanding with the principles for cooperation and coordination. The goal of this memorandum is to promote the organized cooperation in the area of the banking supervision for the purpose of strengthening the financial stability of South East Europe, as well as for strengthening of the efficiency of the supervisory measures. In accordance with this Memorandum, in January 2008 in Thessaloniki a meeting was held and a working group was formed for analyses of the regional supervisory practices and regulations in the area of: treatment of the non-functional credits and allocation of provisions; stress testing; liquidity risk management etc. The purpose of this working group as to create conditions for approximation to the supervisory practices in the countries from the region and appliance of the best practices, the recommendations of the Basel Committee of Banking Supervision and the respective European directives and the instructions given by the Committee of European Banking Supervisors.

COOPERATION WITH OTHER SUPERVISORY BODIES IN MACEDONIA

The National Bank of the Republic of Macedonia collaborates with other domestic financial supervisory authorities (Ministry of Finance, as a supervisor of the insurance companies and leasing companies, Securities and Exchange Commission, as an authorized body for supervision of the issuance and operation with securities, Agency for Supervision of Fully Funded Pension Insurance). The National Bank of the Republic of Macedonia has signed Memorandum of Understanding with the Security Exchange Commission and the Agency for Supervision of Fully Funded Pension Insurance. According to this MoU's, contractual parties exchange information and data related with the licensing process, examination reports and findings, uncovered irregularities and non-compliances and other relevant issues.

The National Bank has also signed Memorandum of Understanding with the Office for prevention of Money Laundering and Terrorism Financing.

OTHER RELEVANT INFORMATION AND DEVELOPMENT IN THE COURSE OF 2008

Activities for introducing the New Capital Accord - Basel 2

NBRM continued with the activities for gradual implementation of the New Capital Accord - Basel 2. At the end of 2007, Decision on reports and data disclosure by the bank was adopted, thus creating conditions for the implementation of the Pillar 3 of the new Capital Accord (market discipline). Also, with the introduction of the new approach for the risk-based supervision in the beginning of 2008, preconditions for implementation of a part of the elements set forth with Pillar 2 of Basel 2 were created. The adoption of the Decision on the interest rate risk in the banking book in 2008 was the following step of the NBRM for introduction and implementation of these complex regulations. In 2009, the regulations pertaining to the determining the capital requirement for coverage of operational risk (Basic Indicator Approach and Standardized Approach) and credit risk (Standardized Approach) will be finalized. Regarding the implementation of the advanced approaches for determining the level of capital requirement for covering credit, i.e. operational risk, i.e. Internal Ratings-based Approaches) and the Advanced Measurement Approaches, the NBRM considers that there are still no preconditions in the banking system of the Republic of Macedonia for their prescribing and implementation.

Financial Sector Assessment Program

In March 2008, the joint team of the International Monetary Fund and the World Bank performed the second Financial Sector Assessment Program in the Republic of Macedonia. The main goal was the analysis and the assessment of the stability, efficiency and the level of development of the financial system in the country, as well as identification of the basic problems and weaknesses in its operating. An analyses and assessment of the progress concerning the compliance of the NBRM's supervisory function with the Basel principles for efficient banking supervision was conducted. The general assessment is that the Banking Law from 2007, the new by-laws adopted on the basis of this Law and the supervisory policies, procedures and practices, considerable improve and strengthen the supervisory function of the National Bank. Thus, the Macedonian banking regulation and supervision is fully compliant with 10 CPs and largely compliant with the rest 20 CPs.

Within the analyses of the banking system of the Republic of Macedonia, the IMF's and the World Bank's team also performed a stress test analyses of the stability and vulnerability of the banking system to credit risk, currency risk, liquidity risk, indirect credit risk and interest rate risk. The analyses confirmed the ascertainment for credit risk domination in the operating of banks.

Improvements of the NBRM Credit Registry

Aiming at achieving better efficiency in the utilization of the Credit Registry when estimating the credit risk the banks are exposed to, as well as performing the supervisory function by the NBRM, in 2008, the NBRM completed the activities related to the improvement of its Credit Registry (the project was run by the NBRM staff). The final stage of the implementation of this project was the adoption of the relevant secondary regulation. This Registry represents a data and information base on the credit exposure of the banks and the savings houses in the Republic of Macedonia to legal entities and natural persons.

By improving the Credit Registry, the following is achieved:

- widening of the type and the scope of data it maintains (reporting based on credit agreement, compared to the previous reporting based on client, inclusion of additional data, such as: date and the amount of the credit when approved, the level and the type of the interest rate, the data on the due claims, the days of delay, the manner of credit repayment (one-time or annuity repayment), credit status (restructured, prolonged), information on client's currency position, the type and the value of the collateral etc.);
- reduction of the reported individual exposure threshold (from Denar 500 thousand for the exposure to individual non-financial legal entity to Denar 300 thousand, and from Denar 150 thousand for exposure to individual natural person to Denar 5 thousand);
- shortening of the deadlines for submission and processing of data;
- monthly reporting, compared to the previous quarterly reporting and
- improvement in the reporting forms of the registry.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Banks	19	18	18
Savings houses	12	12	11
Brokerage firms	11	16	20
Deposit insurance fund	1	1	1
Insurance companies	10	12	12
Stock Exchange	1	1	1
Money Market	0	0	0
Leasing companies	4	5	8
Pension funds	2	2	2
Pension fund management companies	2	2	2
Investment funds	0	3	8
Investment fund management companies	0	2	5
Private fund management companies	0	4	4
Clearing House KIBS AD Skopje	1	1	1
Central Securities Depository	1	1	1
Financial Institutions, total	**64**	**80**	**94**

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

Type of financial institution	2006	2007	2008
State ownership	4,7	5,8	5,4
Other domestic ownership	45,3	20,9	10,3
Domestic ownership total	50,0	26,7	15,7
Foreign ownership*	50,0	73,3	84,3
Financial institutions, total	**100,0**	**100,0**	**100,0**

Note: Savings Houses are not included due to their marginal share in the total registered banks and savings house capital
'* Foreign owned banks are considered banks with foreign capital exceeding 50% of their capital structure
** The ownership structure is calculated on the basis of participation of the total capital of the each financial institution in the total capital of the banking system

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

Type of financial institution	2006	2007	2008
State ownership	1,6	1,4	1,2
Other domestic ownership	45,2	12,7	5,2
Domestic ownership total	46,8	14,1	6,4
Foreign ownership	53,2	85,9	93,6
Financial institutions, total	**100,0**	**100,0**	**100,0**

Note: The table includes data for the ownership structure of the banks.

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Banks	66,1	76,0
Saving Houses	90,0	94,1
Insurance companies	55,4	73,8
Brokerage houses	57,7	72,6
Leasing companies	92,6	99,9

*Source: On the basis of data obtained from the supervisory bodies of each type of financial institution

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

Type of financial institution	2006	2007	2008
Banks	1,8	1,8	1,4

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

Type of financial institution	2006	2007	2008
Banks	12,3	15,2	12,5

Distribution of market shares in balance sheet total (%)

Type of financial institution	2006	2007	2008
Banks	98,7	98,7	98,6
Savings houses	1,3	1,3	1,4
Financial institutions, total	**100,00**	**100,00**	**100,00**

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

Assets	2006	2007	2008
Cash and balance with nbrm	6,4	6,9	10,8
Nbrm bills	5,4	9,4	7,0
Debt securities	7,6	5,9	4,0
Placements to other banks	27,1	20,9	10,8
Placements to clients	45,7	50,9	61,5
Accrued interest and other assets	2,9	2,2	2,1
Securities investments	0,9	0,6	0,5
Fixed assets	4,0	3,2	3,3
Nonalocated reserves for potential losses	0,0	0,0	0,0
Total assets	**100,0**	**100,0**	**100,0**
Liabilities	**2006**	**2007**	**2008**
Deposits of banks	3,5	4,7	4,8
Sight deposits	32,8	31,2	29,1
Short-term deposits up to one year	35,0	36,6	36,4
Short-term borrowings up to one year	0,1	1,3	0,3
Other liabilities	3,1	3,1	3,0
Long-term deposits over one year	2,9	3,9	6,7
Long-term borrowings over one year	8,9	7,5	7,8
Provisions for off-balance sheet liabilities	0,4	0,4	0,4
Owned funds	13,3	11,4	11,5
Total liabilities	**100,0**	**100,0**	**100,0**

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

Type of financial institution	2006	2007	2008
Banks	14,0	17,8	17,8
Financial Institutions, total	**14,0**	**17,8**	**17,8**

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Banks	30,9	17,0	16,2
Savings Houses	/	/	/
Financial institutions, average	**30,90**	**17,00**	**16,20**

Asset portfolio quality of the banking system
in million denars

Asset Classification	2006	%	2007	%	2008	%
A	143 707	80,2	198 617	83,6	215 278	81,3
B	21 931	12,2	25 484	10,7	32 467	12,3
C	3 807	2,1	4 469	1,9	6 531	2,5
D	3 435	1,9	3 219	1,4	3 884	1,5
E	6 307	3,5	5 867	2,5	6 517	2,5
Classified Total	**179188**	**100,0**	**237 656**	**100,0**	**264 677**	**100,0**
Provisions	**11762**		**12 690**		**15 341**	

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	55,5	38,5
Public sector	1,2	0,3
Corporate	32,0	58,5
Domestic Banks	3,0	0,6
Foreign banks	3,3	1,9
Other	5,0	0,2
Total	**100,0**	**100,0**

The structure of deposits and loans by time at year-end in 2008 (%)

Maturity of Deposits		Maturity of Loans	
At sight	38,4	Long term loans*	68,2
Within one year	52,5	Medium term loans	
Over one year	9,0	Short term loans**	31,8
Total	**100,0**	**Total**	**100,0**

* 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-ends)

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Banks	56,7	52,0	52,3	50,6	47,4	49,0

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

Revenues	2006	2007	2008
Interest income	9 553	12 688	16 641
Other income	4 974	5 985	6 433
Expenditures	**2006**	**2007**	**2008**
Interest expenses	3 311	5 125	7 542
Provisions for potential loan losses	1 623	2 190	2 489
Other expenses	6 501	7 425	9 162
Income tax	292	284	470

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR mln	%	EUR mln	%
Banks	471	11,5%	552	13,5%

* Calculated by the exchange rate of NBRM on December 31, 2008

2008 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MOLDOVA

MACROECONOMIC ENVIRONMENT

In 2008 year the nominal Gross Domestic Product increased in real terms by 7.2 % as against 2007 and amounted 62840.3 million lei.

Industrial output produced by enterprises of all property forms amounted 29654.6 million lei in 2008 year, inceasing by 2.7% in real terms as against the previous year.

Agricultural output according to preliminary assessment amounted 16410.0 million lei in 2007 year, increasing by 31.9% in real terms as against previous year.

Investments in fixed capital allocated in the national economy valuing 17710.3 million lei exceed the achievements in 2007 year by 0.4 % in real terms.

Average monthly salary* of en employee in the national economy totalled 2529.7 lei, recoding an increase by 8.7 % in real terms as against the previous year.

The increasing rhythm of consumer prices in 2008 totalled 7.3 % in comparison with 13.1 % in the previous year. Prices to food products increased by 6.5 %, to non-food products – 2.1% and services rendered to the public – 17.4%.

The current account of the balance of payments recorded a deficit of US$ 1009.3 million, registering an increase by 45.2 % as against the previous year. The value of external trade with goods and services rose from 2007 by 29.5%, amounting US$ 8190.4 million. The coverage degree of imports by exports totalled 43.8 % and as regard to previous year diminished by 3.1 p.p.

Deficit of foreign trade with goods and services reached the level of US$ 3197.5 million (in FOB prices). The balance of income registered in 2008 a surplus of US$ 593.9 million. The income of resident work abroad was estimated at US$ 842.0 million. The current transfers registered a surplus of US$ 1594.3 million. The largest weight (60.8 %) in total inflows of current transfers from abroad had the transfers performed by moldovian employees abroad amounting US$ 1046.0 million.

Capital and financial account of balance of payments resulted in a net inflow amounting US$ 925.8 million. The net direct foreign investments in national economy constituted (according to the assessment) US$ 712.8 million, increasing by 1.4 times as against 2007 year.

Total external debt of the Republic of Moldova as of 31.12.2008 amounted to US$ 4125.5 million. The public and publicly guaranteed external debt amounted to US$ 957.0 million, increasing by 1.4 % as against previous year.

The external non-guaranteed private debt has increased by 33.0 % in current year to US$ 3168.4 million.

* enterprises with 20 workers or more

As of December 31, 2008, domestic public debt totalled 3509.9 million lei. From total domestic public dept, the debt of National Bank of Moldova constituted 2213.4 million lei.

BANKING SYSTEM DEVELOPMENT

Within the territory of Republic of Moldova as of December 31, 2008 were activating 16 commercial banks, including 3 subsidiaries of foreign banks, authorised by the National Bank of Moldova.

The total number of banking offices included 1180 units, out of which: 16 head offices of banks (placed in the city of Chişinău), 299 branches and 865 agencies.

During 2008 year the development of the banking sector of the Republic of Moldova denoted positive trend. Total assets of the banking sector rose by 7065* million lei (22.1%) and as of 31.12.2008 amounted 39067.0 million lei. At the same time, their weight in GDP increased from 59.9% to 62.2%.

The larger value of assets was mainly due to increases in the balances of banking liabilities by 5629 million lei (21.3%) and equity capital by 1436 million lei (25.9%).

All the components of assets' structure displayed upward evolution. Increases were recorded as follows: cash - by 189.9 million lei (11.3%); money means due from banks and NBM – by 2481.2 million lei (40.6%); securities – by 195.6 million lei (8.6%); and other assets – by 553.6 million lei (26.8%). The largest increase was recorded by loan portfolio (net) – by 3644.7 million lei (18.3%).

Net credits form the maximum weight in total assets with about 60.2 %, thus decreasing by 1.9 p.p. as against December 31, 2007. Within the context of distribution of risks and targeting of investment operations, the largest weight in total credit portfolio hold the credits lend to industry and trade – 48.7 %, followed by credits lend to mortgage, construction and development – 14.6 %, credits lend to agriculture and food industry – 13.3 % and consumer credits – 12.9%.

In reported period, was recorded the rise within total loans by 2.2 p.p. of nonperforming loans (substandard, doubtful and loss (5.9% of total loans as of 31.12.2008) and, respectively, by 0.8 p.p. of credit loss provisions (5.0% of credit portfolio as of 31.12.2008).

Liquid assets as of 31.12.2008 amounted 11983.8 million lei, increasing over the year by 2687.5 million lei (28.9%). The liquidity indicators of banking system show the banks' capacity to pay both current liabilities as well as long-term liabilities.

Thus, long-term liquidity as of 31.12.2008 (assets with a term over 2 years / financial resources with a term over 2 years ≤ 1) constituted 0.6. The level of this indicator shows the available resources that can be used for long-term investment.

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 30.7% as at the 2008 year-end.

* as of December 31, 2008, 1USD = 10.4002 lei

Tier-1 Capital as of 31.12.2008 increased by 1384.1 million lei (26.5%) and amounted 6611.6 million lei. The main sources for its increase were net income gained by banks (1219.2 million lei) and the share issuance at four commercial banks on the account of additional contribution by shareholders (143.9 million lei).

The average of risk-weighted capital sufficiency (total regulated capital to risk-weighted assets) for the banking sector accounted for a high value of 32.1% as at year-end (as against 12% set as minimum level in the Republic of Moldova).

In this period the banking system maintained its attractiveness for foreign investors, fact that is confirmed by significant interest of foreign investments in banks' capital. As of 31.12.2008 the share of foreign investments in the banking capital accounted for 74.1%.

Within banking liabilities deposits held the largest share of 84.8% as of 31.12.2008; their weight decreased by 2.5 p.p. as against December 31, 2007. Out of total deposits: deposits by individuals accounted for 53.3%; deposits by legal entities – for 23.8%; and deposits by banks – for 7.7%, other loans and other liabilities constituted 12.9% and 2.3%, respectively.

Net income for 2008 amounted 1219.2 million lei, increasing by 132.5 million lei (12.2%) in comparison with 31.12.2007.

Return on assets in the banking system (net income to average assets) accounted for 3.4% in 2008. Return on equity (net income to average equity capital) accounted for 19.1%. As against the beginning of the year the return on assets and return on equity decreased respectively by 0.5 p.p. and 4.9 p.p.

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

The banking system in Republic of Moldova consists of two levels: the National Bank of Moldova and commercial banks**.**

The activity of the National Bank of Moldova, as an institution authorised to regulate and supervise the activity commercial banks is based on the Law on the National Bank of Moldova, which provide the competence, main objective, basic attributions of the National Bank and its relationship with financial institutions.

National Bank of Moldova is the only institution which provides the licensing, supervision and regulation of the activity of financial institutions. For supervision and regulation of the activity of financial institutions purposes, National Bank has the right to issue regulatory acts, to perform inspections on these institutions, to examine registers, balance sheets and other documents, as well as to attempt any other action to fulfil its tasks.

As in accordance with banking legislative provisions, the National Bank established the mechanism of banking activity supervision and regulation through a number of requirements stipulated in the regulations worked out by the National Bank of Moldova. These regulations are under permanent revision and updating with the view to complying them with new legislative provisions, international general principles, especially recommendations of the Basel Committee on Banking Supervision and EU Directives. The prudential regulations issued by the National Bank of Moldova are available (in Romanian and English) on the NBM official WEB page at www.bnm.org.

During the year 2008, the Financial Institutional Law has been amended. The amendments provide the establishing the capital minimum amount for all banks, establishing the procedures for issuing of authorised copies of the license for bank branches and representations, establishing the procedures for reissuance of bank licenses and issuance of duplicate bank licenses, etc.

MAIN STRATEGIC OBJECTIVES OF THE BANKING AUTHORITY IN 2008

In order to support the financial stability of banking system based on the impact of market situation and the effective implementation of banks internal procedures on risk assessment and supervision, National Bank of Moldova has continued to contribute to improving banks internal control systems, based on increasing transparency of banking transactions. Particular attention was given to:

- promoting efficient procedures of assets' evaluation, including other than bank loans and contingent engagements;
- promoting an increased transparency level of owners and banking exposures;
- bank activities for the identification and acceptance of clients and their beneficiaries, as well as for ongoing monitoring of accounts and transactions;
- improving the methods of risk analysis related to banks activities in the market stress conditions and determining the weaknesses of banks and banking system in any crisis situation that may occur.

ACTIVITY OF THE BANKING SUPERVISORY AUTHORITY DURING 2008

In the course of 2008 a series of actions was undertaken with a view to maintaining the stability of the banking system, as well as to further developing it. With this purpose, there were improved the prudential regulations and the supervision methods, taking into account the existent normative framework and the generally accepted standards by the banking supervision.

Further, were promoted policies on knowing the shareholders with significant influence upon bank's management and activity with the aim to determine the owners' structure.

With a view to perform the bank regulation and supervision, the activity of financial institutions is undertaken both for an on-site and off-site supervision. For insuring an ongoing supervision, National Bank monitors the activity and the financial performance of each financial institution individually, as well as the whole banking sector. The off-site supervision is performed based on periodically financial reports submitted by banks, as well as based on the information obtained from other sources, such as audit reports, annual financial institutions reports, data on banks' activity as a professional participant on the capital market of supervisory authority of a financial non-banking market.

Under market stress conditions and determining the weaknesses of banks and banking system in any crisis situations that may occur were improved the methods of risk analysis related to banks' activity, including by the implementation of new stress tests and using more shock parameters to perform scenarios risk.

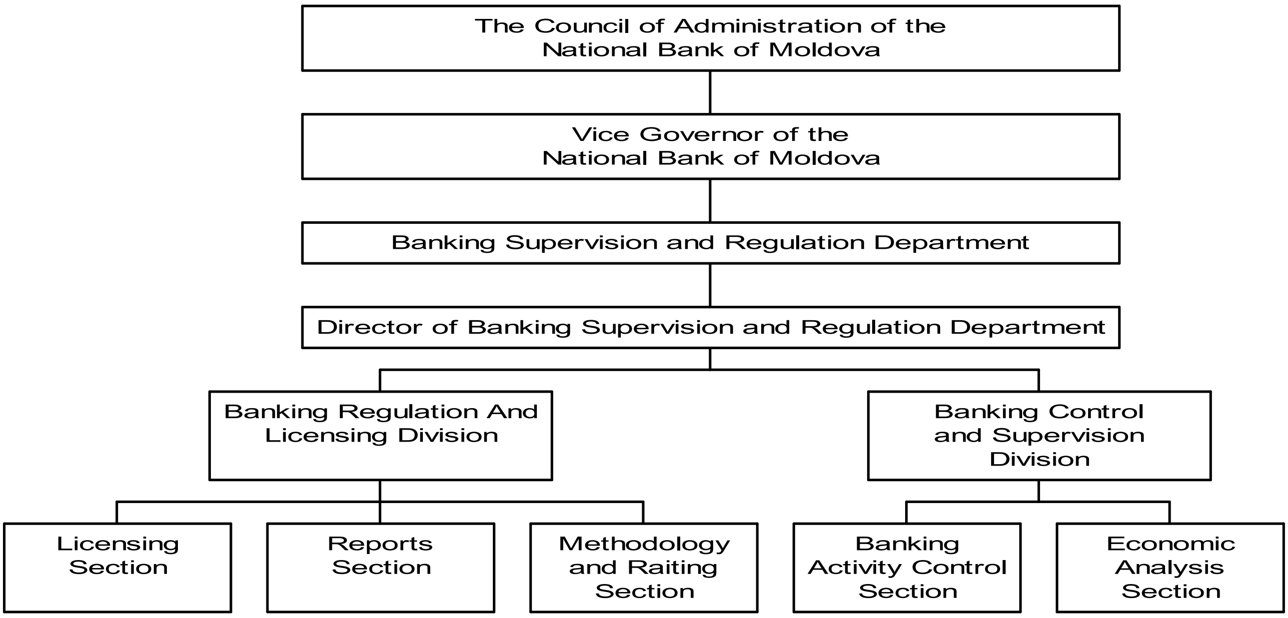
The cooperation with the national supervisory authority of a financial non-banking market and the banking supervisory authorities from abroad continued.

Following the enforcement of the Law on modification and completion of some legislative acts no.109-XVI of 16.05.2008, by which the Law on financial institutions was modified, modifications and completions were operated on some normative acts of the National Bank of Moldova, related to the establishment of a single amount of capital for all banks; establishment of procedures of issuing the license's authorised copy for branches and its representative offices; establishment of procedures on the issuance of the re-concluded license and its duplicate, etc.

Modifications and completions were operated on the legislation in force on money laundering and terrorism financing prevention and combating. Thus, amendments for requirements related to information that should be stored by banks in the process of identification of individuals, businesses and their beneficiary, including while performing occasional transactions; verification requirements; specific issues requiring attention in the identification process; requirements on the continuous monitoring of accounts and transactions, as well as minimal requirements on the storage of information were introduced. Simultaneously, as the notion „effective beneficiary" was introduced, banks were required to introduce procedures related to the well known of direct owners and of the effective beneficiaries.

Also, requirements related to identification of subjects of legalization within the bank's activity related to the procedure of funds legalization were established.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL COOPERATION OF THE BANKING SUPERVISORY AUTHORITY

To assure consolidated banking supervision, the National Bank of Moldova concluded cooperation agreements in the filed of banking supervision with the supervision authorities of central banks of Romania, Russia and Belarus, Kazakhstan as well as a relevant agreement on cooperation in the filed of exchange of information and research in the financial and banking sector with the National Bank of the Republic of Kazakhstan.

To promote a strong and competitive financial sector and to prevent the excessive risk there, during 2008 the National Bank of Moldovan has been initiated and sent to the banking supervisory authorities of France, Italy, Austria the draft agreements on cooperation in the filed of banking supervision.

In 2008 year the National Bank of Moldova continued to collaborate with central banks of other countries. Within the framework of bank licensing process, were solicited relevant information from similar supervision authorities (central banks and other authorities) and were sent similar information to supervision authorities at their request.

The National Bank of Moldova became part of the Bank Supervisors' Group of Central and Eastern Europe (BSCEE) in June 1996 by signing the Agreement on the rules of BSCEE Group organization and management.

The membership of BSCEE Group allows the National Bank of Moldova to participate in the exchange of experience between the group members, in the process of on-going professional training of the personnel, in the elaboration of new standards, as well as to benefit from methodological assistance in the field of banks' prudential regulation.

The mentioned facts facilitate the increment of the local banking sector competition, its capacity to attract new investments, including foreign investments, which result in the increase of banks' possibility to satisfy the requirements of different branches of the national economy in bank services.

COOPERATION WITH OTHER SUPERVISORY AUTHORITIES IN MOLDOVA

Under the scope of further monitoring of risks related to banking activity in the Republic of Moldova, the National Bank cooperates with other national supervision authorities. As a result of cooperation relationship established between the banking supervision authority with the supervision authority of the financial non-banking market, has been obtained the information regarding banks' activity on the securities market, this information being taken as the basis for estimation of commercial banks' activity as professional participants on the securities market. It has been worked actively with the National Commission of Financial Market to develop a Memorandum of Understanding between the National Bank of Moldova and the National Commission of Financial Market related to information exchange.

With the aim to intensify the banks' monitoring activity in the domain of prevention and combat of money laundering and terrorism financing, the National Bank of Moldova collaborates with different state bodies in this field by informing and submitting the respective materials to law enforcement bodies.

OTHER INFORMATION AND RELEVANT TRENDS IN 2008

In the period of December 8-12, 2008, the 28th plenary meeting of the Committee of experts on money laundering prevention and combating - MONEYVAL took place at Strasbourg, France, with the participation of a delegation of the Republic of Moldova of representatives of the Centre for Combating of Economic Crimes and Corruption, the Ministry of Justice, the National Bank of Moldova and the National Financial Market Commission of the Republic of Moldova. Within the framework of the meeting, the progress report on the implementation of recommendations elaborated by the experts of MONEYVAL Committee was submitted, following the third evaluation round.

STATISTICAL* TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Banks including:	15	16	16
Subsidiaries of foreign banks	3	3	3

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

Type of financial institution	2006	2007	2008
Public sector ownership	2.6	2.0	2.2
Other domestic ownership	34.7	26.1	23.7
Domestic ownership total	37.3	28.1	25.9
Foreign ownership	62.7	71.9	74.1
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2006	2007	2008
Public sector ownership	8.89	5.6	5.3
Other domestic ownership	54.39	42.0	46.0
Domestic ownership total	63.28	47.6	51.3
Foreign ownership	36.72	52.4	49.2
Financial institutions, total	**100.0**	**100.0**	**100.0**

* Data for 2006, 2007, 2008 are adjusted following the modifications made by some banks according to the external audit.

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Commercial Banks	44.2	63.3

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

Type of financial institution	2006	2007	2008
Commercial Banks	3.40	3.91	3.35

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

Type of financial institution	2006	2007	2008
Commercial Banks	20.47	23.97	19.13

Distribution of market shares in balance sheet total (%)

Type of financial institution	2006	2007	2008
Commercial Banks	87.75	78.80	76.10
Subsidiaries of foreign banks	12.25	21.20	23.90
Total banks	**100.0**	**100.0**	**100.0**

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

Assets	2006	2007	2008
Cash	*5.07*	*5.26*	*4.76*
Due from banks and BNM**	20.51	19.08	22.04
Net loans and financial leasing	*57.66*	*62.12*	*60.22*
Total securities**	9.96	7.08	6.30
Other**	6.8	6.46	6.68
Total assets	100	100	100
Liabilities	**2006**	**2007**	**2008**
Deposits by natural persons	40.63	44.07	43.80
Deposits by legal persons	30.35	22.66	19.55
Others	11.75	15.94	18.78
Shareholder capital	17.27	17.33	17.87
Total liabilities and shareholder capital	**100**	**100**	**100**

**Starting with 31.12.2007 the articles: Due from banks and BNM, Total securities and Other are reflected at net values.

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

Type of financial institution	2006	2007	2008
Total banks	30.16	23.28	9.22

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Average of risk-weighted capital sufficiency for the banking system (≥ 12%)	27.86	29.07	32.06

Asset portfolio quality of the banking system (%)

Loan classification	2006	2007	2008
Standard	54.85	65.32	62.05
Supervised	40.76	30.98	32.09
Substandard	2.86	2.73	4.26
Doubtful	1.51	0.91	1.46
Bad	0.02	0.06	0.13
Classified total	**100**	**100**	**100**
Specific Reserves/Total Loans	5.2	4.2	5.0

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits		Loans
Natural persons	62.9	Credits to industry/commerce	48.72
Legal persons	27.9	Credits for real estate, construction and development	14.63
Banks' deposits	9.1	Credits to agriculture and food industry	13.27
State budget and local budgets	0.2	Consumer credits	12.92
		Other credits	6.61
		Credits to energy and fuel industry	1.98
		Credits for road construction and transportation	1.57
		Credits to the Government	0.18
		Credits to banks	0.12
Total	**100.0**	**Total**	**100.0**

The structure of deposits and loans in 2008 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	24,84	Long term loans	25,38
Time deposits	75,16	Short-term loans	74.62
Total	**100.0**	**Total**	**100.0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Banks	41.59	43.44	42.07	49.90	51.34	50.89

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 year-ends)

Revenues	2006	2007	2008
Total Interest Income inclusive:	2122.37	3242.88	4440.67
interest income on credits and financial leasing	1866.68	2717.37	3873.33
interest income from securities	115.55	353.91	416.05
interest income from other assets	1982.23	171.61	151.38
Total Income non-interest	973.31	1344.09	1781.81
Expenditures	**2006**	**2007**	**2008**
Total interest expenditure	1007.63	1630.3	2671.15
Total non-interest expenditure	1079.34	1494.59	1899.96
Provision for Loan Losses	206.91	190.69****	447.95*
Total net income	684.81	1086.66	1219.19

* Provisions for interest bearing assets losses

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR mln	%	EUR mln	%
Commercial banks	143.3	5.4	473.6	21.8

At 31.12.2008 1EURO -14.7408 lei.

Structure of off-balance items as of December 31, 2007

Conditional assets	/Total assets (%)	Conditional liabilities	/ Total liabilities (%)
Acquisitions to current operations	6.93	Sales to current operations	8.39
Acquisitions to time operations	7.67	Sales to time operations	9.79
Acquisition of loans and securities	0.08	Sale of loans and securities	0.009
Total conditional assets	14.99	Total conditional liabilities	18.18

2008 DEVELOPMENTS IN THE MONTENEGRIN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

If we consider the macroeconomic trends in 2008, we could conclude that we had one more successful year. A progress has been achieved in terms of extreme economic growth, the unprecedented inflow of foreign direct investments, positive balance of budget, the decrease in the participation of public depth in Gross Domestic Product, the decrease of inflation rate etc.

However, the global financial crisis, which has started in the half of 2007, started to be more evident in Montenegro in the last quarter of 2008. The crisis has strong influence on the aggravation of many indicators, such as declining of the industrial production and civil engineering level, decreasing of public income inflow, withdrawal of deposits, deteriorating of bank system and whole economy liquidity, decreasing of import and export etc. But, one positive fact is that we still have relatively high inflow of foreign direct investments in the last quarter.

The inflation rate that expressed the growth in cost of living was 7, 2% in 2008, which is for 0, 5 percentage points below in comparison with the previous year. The annual inflation rate has increased till July, and from July it has the decreasing tendency influenced by decrease of fuel derivates and raw material prices. On of accompanying positive effect of global financial crisis will be in the inflation rate decrease in 2009.

The lower aggregate demand, the difficulties in sales of production, the increase of unemployment rate will certainly have impact on price policy of many companies in terms of price decreasing or price increase abstention. Such tendencies will be presented on global as well as on national level, which is very important since Montenegro imports a significant number of goods. Therefore, we expect further rate of inflation decrease in 2009.

Global financial crisis strongly impinged the bank system, reflected in withdrawal of deposits, deteriorating of bank system liquidity and in increase of percentage of credits with payment delay. These were extremely shocking situations, which all banks, except one, have succeeded to overcome till now.

The effective weighted average interest rate was 9, 40% in the end of 2008, which was for 0, 11 percentage points higher in comparison to previous year. It is moderate increase, but this tendency will continue in 2009, mostly because of lower available offer in terms of liquidity assets, more expensive financial resources and higher risks. The passive interest rates have shown a higher increase, as an expected response of banks due to deterioration of liquidity and way of attracting additional deposits.

The fiscal policy was conducted on the healthy basis during 2008. The positive balance of consolidated budget was 51 million of Euros or 1.5% of projected GDP. Nevertheless, slowing down in „charging" of budget was obvious in last quarter, which indicates the slowing down of real sector activities. Regarding 2009, it is certain that projected growth was unrealistic and that is necessary to rebalance of the budget for the purpose of decreasing the public expenditures level. It is possible, that, in addition to rebalance of the budget, external borrowing will be necessary to „flatten" the financial gap. Anyhow, the conveinient occasion is that Montenegro is low charged, as a result of proper politics in previous years, so there is a space for significant external borrowings.

Industrial production has achieved negative rate of growth with -2%. In the segment of industrial production, energetics and food industry have effectuated dynamic growth, so they could become leaders in the further period.

The number of tourists is increased for 4, 8%, while the number of dwellings is increased for 6, 9%. In spite of good results, the process of slowing down of growth is very evident.

The construction sector has achieved the extremely high rate of growth in 2008. However, the effects of crisis were evident in the last quarter, when the negative rate of growth was achieved. The crisis will have a strong impact on construction segment in 2009. That will be reflected in decreasing of prices and decreasing demand.

The deficit of balance of payments was Euro 1.005,7 millions and its participation in GDP was increased.

The foreign direct investments have reached an unprecedented level and the net inflow was 568 millions of Euros, as for 8% higher in comparison to previous year. The structure of payments received from foreign direct investments was enhanced, that is the real property investments decreased. Regarding portfolio investments, they were to paid off in the amount of 15, 5 millions of Euros. Such pay off is, primarily, result of deteriorating of global liquidity, difficulties in the capital market functioning as well as the higher risk in the further period.

The crisis on capital market has started in the middle of 2007 and has been continued in 2008. All stock exchange indexes achieved the significant decline in comparison to the end of previous year (in range from 71% to 85%).

There were some positive tendencies on the labor market during 2008. The amounts of salaries in nominal and real terms were increased, the number of employees was increased for 6, 2% and number of unemployed persons was decreased for 9, 9%. Nevertheless, it is slightly possible, that such tendency will continue in 2009 or it is objective to expect the increase of unemployment rate due to global financial crisis.

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

The negative effects of the world financial crisis are being felt in Montenegro as well. They are affecting the banking business operations to a significant extent. In the fourth quarter, influenced by the crisis, there has been a considerable decrease of the deposit potential of the banks and the credit activity of the banks has been almost completely stopped.

- Banks' total assets amounted to EUR 3,309 million, as of 12/31/2008, and rose at the rate of 11.23% in relation to the same one-year period, that is 5.70% in relation to the previous quarter. All banks, except one bank, in the system reported growth in total assets in the one-year period. Total assets' share in GDP amounted to 99.11%.

- Total loans disbursed by banks amounted to EUR 2,797 million, which represents the annual growth of 24.57%. Total loans' share in GDP amounted to 83.77%.
- Total banks' deposits as of 12/31/2008 amounted to EUR 1,990 million and they decreased by 4.81% in relation to the same one-year period. Total deposits' share in GDP amounted to 59.6%.
- Four large banks incorporate 77.8% of total assets of the banking sector.
- In the loan portfolio structure long-term loans (over one year) make up 72.12% of overall granted loans in the system.
- The most important loan users are private companies (58.87%) as well as natural persons (37.09%). From the aspect of granted loans classification by sectors, most loans in the banking system was granted to households to the amount of EUR 1,019 million (36.42%) but it appeared as net borrower of funds to the amount of EUR 159 million. Trade sector was also a significant user of loans to the amount of EUR 633 million (22.66%), which is simultaneously the largest net borrower with EUR 420 million. The highest net lender of assets was the finances sector amounting to EUR 142 million. Besides financing sector, administration and other public services sector was also important net lender of assets.
- At the system level, the level of loans exceeds the deposits level by EUR 806.9 million.
- Non-performing assets of banks (C, D and E) amounted to EUR 212 million and accounted for 6.42% in overall assets. At the aggregate level, non-quality assets increased by 181.62% in the one-year period.
- The level of criticized assets (B, C, D i E) was high and it represents 237.01% of assets and reserves. These assets in one-year period increased by 50.72%, primarily due to the increase in the observed assets (B) by 33.36%. The share of criticized assets in capital and reserves increased by 21 percentage points in the one-year period, under the impact of the new Decision on Assets Classification, Provisions for Loan Losses and Reserves for Credit Risk.
- Percentage of past due loans at system level amounted to 11.50% as of 12/31/2008. In relation to the annual comparative period this indicator increased by 7.79 percentige points. %. Out of total past due loans, 77.31% are in the category of due to 90 days, 16% are in the category due to more than 90 days to which the interest rate is calculated, and 6.69% are loans to which the interest rate is not calculated. The structure of total past due loans shows the highest share of loans granted to private companies 43.34% and loans to households 27.34%.
- Total capital of banks as of 12/31/2008 amounted to EUR 279 million. Capital growth rate in the one-year period amounted to 17.91%. The dominant share in the structure of total capital had foreign capital with 79.87%, then follows private capital with a share of 17.34%, and state with 2.79% of the share. Share of total state capital in the one year comparable period increased by 0.3 percentage points and of foreign capital by 4.43 percentage points, while the share of domestic private persons decreased by 4.14 percentage points. As of 12/31/2008 two

banks were majority private owned, while other nine banks were majority (five banks) or 100% foreign owned (four banks). Banks with majority foreign capital controlled 85% of the banking market in Montenegro.

- Liquidity of the banking sector was characterized by the decrease of key coefficients in relation to the same comparable period 2007. Coefficient of liquid assets in relation to the total assets amounted to 11.20% and it decreased by 6.86 percentage points in relation to the one-year period. The achieved growth of banks credit activity of 24.57% in one year period considerably outstands deposits which at the 2008 year end decreased by 4.81%, which influenced considerably to the increase of loan coefficient compared to deposits to 140.54%, which shows to the increased crediting of banks from borrowings and capital. The adequate coverage of loans by deposits was evident in the short term, while the growth of long term loans was not followed by the increase of long term deposits.
- Maturity compliance of the financial assets and financial obligations on the aggregate level shows that the maturity gap is negative in the periods of 8-15 days, 156-30 days, 31-90 days and 181-365 days. Total cumulative gap in the system level is positive and amounts to EUR 41.3 million making 1.39% of total sources of assets.
- Total deposits of banks as of 12/31/2008 amounted to 1.990 million and recorded an annual decrease at the rate of 4.81% or EUR 100.4 thousand. The most important depositors of banks were natural persons with the share of 43.02% as well as private companies with 31.87% of the share.
- Of total deposits in the system, 36.52% referred to demand deposits. The highest concentration of deposits was exposed in the sectors of households, trade, finances, administration and transport (80.96% of total deposits). Deposits of four big banks make up 80.61% of total deposits.
- Financial result of banks as of 31.12.2008 was negative and amounted to EUR 19.6 million. Negative financial result was achieved by four banks. RoA in the aggregate level was negative and amounted to 0.62% and it decreased in relation to the same comparative period 2007 when it amounted to 0.72%. Level and the trend of return to average assets, observed by banks, was different. Good level of return to average assets as of 31/12/2008 was achieved by three banks. Four banks in the system had the return to average assets in the acceptable limits, the remaining four banks did not have satisfactory value of the coefficient, i.e. they recorded negative value of the coefficient. Banks' ROE at the aggregated level was not satisfactory amounting to -6,90% as of 31 December 2008. In comparison with the same period from the previous year, this ratio significantly decreased by 13.07 percentage points.
- Interest rates spread in the one-year period had declining trend and amounted to 3.55% as of 12/31/2008. Interest rates spread on the level of individual banks ranges between 2.49% to 10.65%.
- As of 12/31/2008 banks in Montenegro operated with an expanded network of 196 organisational units and 263 installed ATMs. The total number of employees in the banking sector in the one-year period increased by 285 reaching the figure of 2.264 employees.

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

Parliament of Montenegro in February 2008 has adopted a new Law on Banks.

While the new Law on banks is a significant step forward compared to the previous law, in the coming period will be necessary to find solutions that will go in the direction of strengthening the capacity of the Central Bank, which is particularly related to:

- provision of additional powers of the Central Bank, and interim manager, related to the temporary managment in the banks, which will create the legal prerequisites for the implementation of efficient measures for the recovery of banks in crisis;
- ensuring efficient mechanism to eliminate illegal participants of qualified share
- from the banks
- clearer definition of the Central Bank powers, in accordance with internationally accepted standards, has been applied the so-called "Fit & proper" test when deciding on the issuing of consent for members of the Board of Directors of banks;
- Implementation on new EU derectives that change and supplement directives that are basis on text of current Low.

CBCG Council during 2008 has adopted 15 by-low regulations in order to operationalized Low on Banks.

Capital act is Decision on the capital adequacy of banks in which they have implemented a new methodology for calculating the required capital of banks, based on the European Union Directive no. 2006/48 and 2006/49, which in calculating the required capital, in addition to credit and other risks include the risks that banks are exposed in the business (market, operational, etc.).

The Decision on conditions for credit-garantee affairs is adopted, which provide the establishment and operation of credit-garantee funds, as a specialized financial institutions, which deal with the business of publishing in order to guarantee the performance of credit obligations client banks.

In the field of risk management a set of decisions has been adopted which prescribed minimum standards for the managing major risks in the business of banks, and to:

1. Decision on Minimum Standards for Credit Risk Managment in Banks
2. Decision on Minimum Standards for Market Risk Managment in Banks
3. Decision on Minimum Standards for Interest Rate Risk Managment Not Originating From Bank`s Trade Activities
4. Decision on Minimum Standards for Liquidity Risk Managment in Banks
5. Decision on Minimum Standards for Managing Bank with Persons Related with Bank
6. Decision on Methodology for Country Risk Measuring in Banks

Also, there are adopted decisions based on new solutions from the Law on Banks, upgraded and compliant with the new legal arrangements that are regulating certain areas:

1. Decision on the documentation that is attached to the requests for the approval of the Law on Banks;
2. Decision on the manner and content of registers of banks, branches of foreign banks, micro-credit financial institutions, credit unions and representations of foreign banks;
3. Decision on the basis of internal control systems in banks;
4. Decision on Internal Audit in Banks;
5. Decision on Accounting Frame for Banks;
6. Decision on the Reports are submitted to the Central Bank of Montenegro in accordance with the Law on Banks;
7. Decision on the Central Bank Fee for Performing the Supervisory Function.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

Key steps of the regulatory and supervisory actions of CBM in 2008 referred to:

- Improvement of the institutional regulatory frame: new Low on Banks and many Decisions have been adopted (Decision on the capital adequacy of banks, Decisions in the field of risk management and many others Decisions that are compliant with the new legal arrangements)
- More intensive monitoring monitoring of the risk to which the banks are exposed and many suprvisory controls.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

During 2008, most of activities of the Bank Supervision Department were related to regulatory area and supervisory activities during many supervisory controls based on portfolio management approach of supervision.

In 2008. banking supervisory was intensive, especialy in the part of banking sector exposure to credit risk and liquidity risk, so in the last quarter in 2008 it resulted full scope supervisory after negative effects of global crisis. During last year The Bank Supervision Department performed more targeted supervisions comparing to full scope supervisions, in order to the integration of direct and inderect controls that continuosly monitor all risk that banks are exposed to. The quality of performed supervisions and coverage of supervised risks are improved, as a consequence of supervisors' specialization for individual types of risks and more intensive monitoring of the banks significant for the system, observed from their market participation aspect as well as from the aspect of evaluation of different areas in each of the banks.

The Bank Supervision Department performed five full scope and sixteen targeted supervisions in 2007, while in 2008 it performed six full scope and twenty targeted supervisions. During supervisions, special attention was dedicated to the preparation phase of planned supervisions, especially through the improved usage of Regulatory Credit Bureau resources, continuous credit risk monitoring, improvement of the system of reporting and usage of results of the stress testing of banks. Supervision of banks performing resulted with the grade of bank`s capability to manage risks and grade of banks performing adjustment to Low and Central Banks regulation.

Although in 2008 year loan portfolio rates of banks achieved moderate growth, from the aspect of control of credit risk coverage significant results were achieved. Those results are presented in percentage of coverage of the loan portfolio and off balance obligations of banks during their controls. Coverage control loan portfolio has been ranging from 50% to 75%, while the average coverage of off- balance obligations of banks amounted to 55%. Credit risk is controlled in eight banks, through a comprehensive control and in five target control.

Operating risk, especially in the segment of IT systems in banks, adequacy of management reporting system and the functioning of the system of internal control was the subject of control in the eight banks.

Market risks and liquidity risks were controlled in the eight banks in the system, through comprehensive, and in the five target control. During the control, quality and reliability of the technique of measuring risk used by banks were especially estimated and there were given recommendations for its improvement.

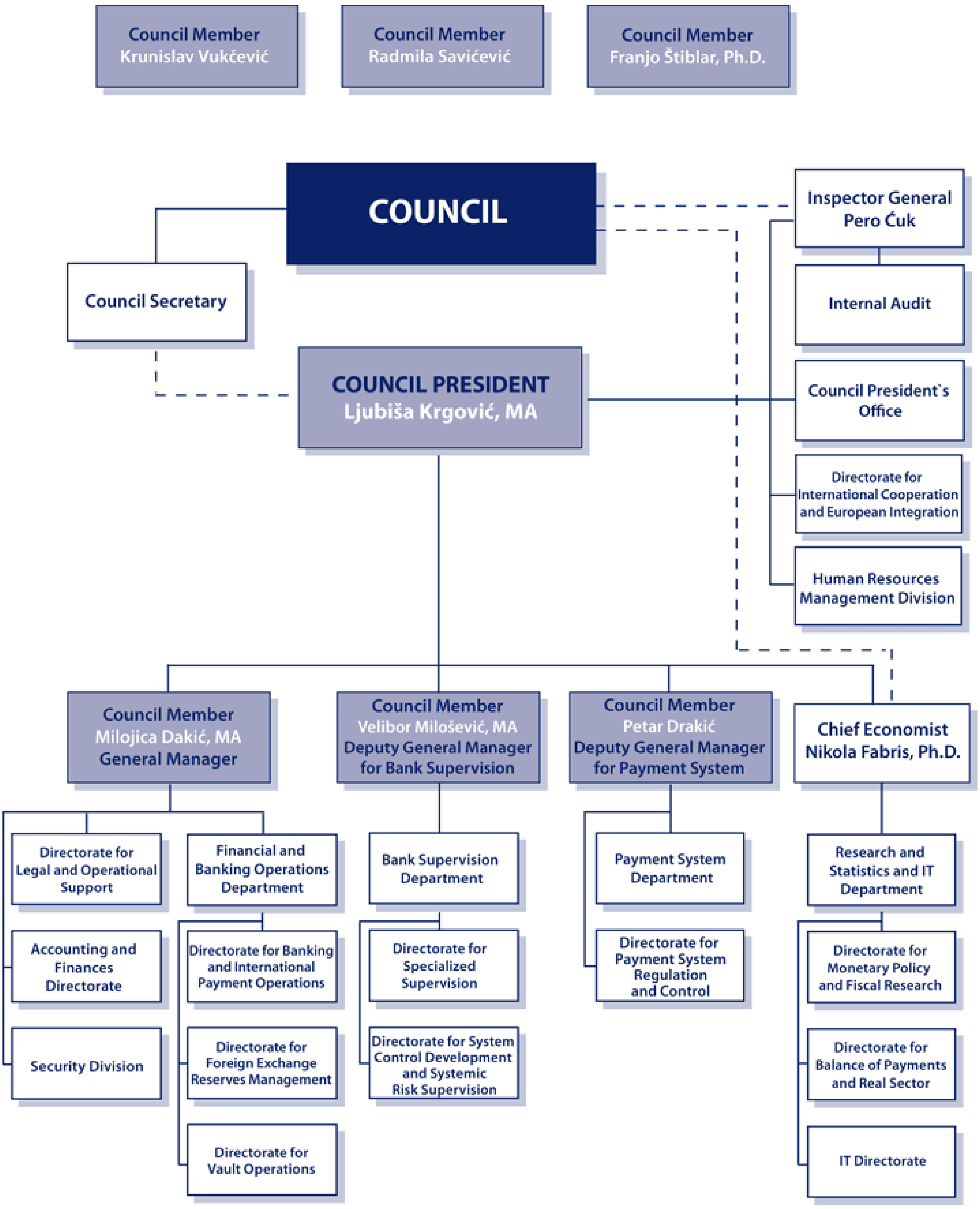
Control compliance of banks with the regulation in the field of money laundering and terrorism financing, as well as respecting regulations of bank`s mandatory reserve in the Central Bank of Montenegro was made in the nine banks. There were found violations in the majority of cases referred to the provisions of the Law on prevention for money laundering and financing of terrorism, which prescribed process of identification of clients, and in three cases were evident contrary actions to the regulation of the Decision on bank`s mandatory reserve at the Central Bank of Montenegro.

During 2008 the stress testing of sensitivity of banking system and individual banks to the credit risk, market risk and liquidity risk were done through the creation of various stress scenarios. The results of stress testing have confirmed that the credit risk is the most important risk in the Montenegrin banking system, as well as the banking system sensitivity to liquidity risk, while the sensitivity to interest rate risk and exchange risk, was almost negligible.

Regulatory Credit Bureau information is currently used only by commercial banks and MFIs. Bank Supervision Department concluded the four-year project by starting the data exchange. Therefore, as February 2008, operationalization of the exchange of data between CBCG, micro-credit banks and financial institutions (MFI) The Central Bank has encircled the project in which the improvement is done the last four years. At the same time, banks and MFI were the instrument for more efficient management of credit risk, because their access to information about the exposure of all legal and natural persons in the banking system.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

Organizational Scheme of Central Bank



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

AGREEMENTS ON COOPERATION IN BANK SUPERVISION AREA

Concluded with	Date
South-East Europe Supervisory Authorities (Bank of Greece, Bank of Albania, Bulgaria National Bank, Central Bank of Bosnia, the Central Bank of Cyprus, National Bank of the Republic of Macedonia, National Bank of Romania, National Bank of Serbia, the Banking Agency of Bosnia-Herzegovina, the Agency for Banking of the Republic of Serbian)	08 February 2008
National Bank of France	08 August 2008

COOPERATION WITH OTHER SUPERVISORY BODIES IN MONTENEGRO

Central Bank of Montenegro has a good cooperation with Administration for the Prevention of Money Laundering and Securities and Exchange Commission. The cooperation is based on the signed cooperation agreement.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Banks	10	11	11
Financial Institutions, total	**10**	**11**	**11**

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

Type of financial institution	2006	2007	2008
Public sector ownership	18	22	17
Other domestic ownership	3	2	3
Domestic ownership total	21	24	20
Foreign ownership	79	76	80
Financial Institutions, total	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2006	2007	2008
Public sector ownership	-	-	-
Other domestic ownership	15	21	15
Domestic ownership total	15	21	15
Foreign ownership	85	79	85
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)
Banks	63.62	84.5

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

Type of financial institution	2006	2007	2008
Banks	1.07	0.72	-0.62

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

Type of financial institution	2006	2007	2008
Banks	6.82	6.17	-6.90

Distribution of market shares in balance sheet total (%)

Type of financial institution	2006	2007	2008
1 bank	38	34	34
3 banks	67	64	64
5 banks	84	84	84
7 banks	94	94	91
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Assets	2006	2007	2008
Cash Funds & Deposit Accounts with Depository Institutions	35.76	22.32	14.30
Loans and Lease Operations	59.18	75.48	84.53
Securities Held to Maturity	0.61	0.01	0.07
Business Premise and Other Fixed Assets	2.36	1.37	1.47
Acquired Assets	0.14	0.07	0.14
Equity Investments	1.41	1.08	0.89
Other Assets	1.93	1.39	2.05
Less: Reserves for Losses	-1.39	-1.72	-3.45
Total Assets	**100.0**	**100.0**	**100.0**
Liabilities	**2006**	**2007**	**2008**
Deposits	75.15	70.25	60.14
Borrowings Taken from Other Banks			
Obligations on Taken Loans and Borrowings	11.01	17.50	25.36
Obligations to Government	1.03	0.75	2.29
Reserves	0.30	0.26	0.30
Other Obligations	2.11	2.37	2.34
Subordinate debt		0.91	1.12
Total Liabilities	**89.60**	**92.04**	**91.56**
Total Capital	10.40	7.96	8.44
Total Liabilities and Capital	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2006	2007	2008
Banks	13.29	7.34	33.5
Financial Institutions, total	**13.29**	**7.34**	**33.5**

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Banks	21	17.12	15.04
Financial institutions, average	**21**	**17.12**	**15.04**

Asset portfolio quality of the banking system

Asset Classification	2006	2007	2008
Pass (A)	62.66	60.32	59.53
Special Mention (B)	19.58	22.42	22.92
Substandard (C)	3.84	2.88	5.71
Doubtful (D)	0.55	0.13	0.45
Loss (E)	0.14	0.14	0.25
Classified total (000)	**880.947**	**2.302**	**2.941**
Specific reserves	**3.59**	**2.32**	**4.00**

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Government sector	6.03	0.63
Municipalities	3.40	0.80
State Owned Companies	2.27	1.00
Private Companies	31.87	58.87
Banks	7.42	0.06
Financial Institutions	2.30	0.80
Natural person	43.02	37.09
Other	3.69	0.75
Total	**100.0**	**100.0**

The structure of deposits and loans in 2008 (%)
(at year-end)

Maturity of Deposits		Maturity of Loans	
At sight	36.52	Long term loans	72.12
Within one year	34.10	Short- term loans	27.88
Over one year	29.38		
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.		
	2006	2007	2008	2006	2007	2008
Banks	2.83	1.47	5.11	2.77	4.19	5.41
Fin. institution, average	**2.83**	**1.47**	**5.11**	**2.77**	**4.19**	**5.41**

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

Revenues	2006	2007	2008
Interest Income	59.41	66.27	77.87
Fee Income	32.98	25.51	20.13
Other Operating Income	7.60	8.19	1.54
Extraordinary Income	0.01	0.03	0.46
Expenditures	**2006**	**2007**	**2008**
Interest Expense	26.96	33.28	40.41
Provision for losses	10.58	20.66	24.42
Fee Expenses	7.38	5.82	4.72
Operating Expenses	53.60	38.87	29.80
Extraordinary Expenses	0.24	0.13	0.09
Taxes	1.23	1.23	0.56
Net Profit / Loss (000 EUR)	**9.009**	**13.907**	**-19.687**

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	000 EUR	%	000 EUR	%
Banks	250.148	7.56	2.226.206	74,29
Financial institutions, average	250.148	**7.56**	**2.226.206**	**74,29**

2008 DEVELOPMENTS IN THE POLISH BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

2008 can be divided into two periods. The first period covered approximately the first three quarters, which despite the symptoms of economic downturn were characterised by fast economic growth. Second covered the period from mid-September to the end of the year, in which a "second wave" of financial crisis started in 2007, passed through global financial markets. It led to serious disturbance in the functioning of financial markets, sharp increase of aversion towards risk and to reduction of access to credit and increase of financing costs. Together with the previous symptoms of weakening of US and EU economy, it resulted in a sharp deterioration of economic situation and deterioration of perspectives for world economic upturn. As the result a strong slowdown of Polish economy's growth rate occurred.

Key points:

- ✓ Gross domestic product increased in 2008 by 4.8%. Deterioration of economic conditions resulted in significant weakening of foreign trade and slowing retail sales. Reduction of the portfolio of foreign and domestic orders, difficulties in acquiring funds and uncertainty concerning development of economic situation caused industrial production increase only by 3.3%. Construction remained relatively strong (11.0%).
- ✓ Financial situation of enterprises was gradually deteriorating just like economic climate index in industry and construction. Nevertheless, good economic conditions for considerable part of the year led to significant improvement in the labour market (unemployment rate decreased to 9.5%; purchasing power of salaries was higher by 5.9%). Unfortunately, toward the end of the year this favourable image began to change, decrease of salaries' growth rate and increase in number of unemployed occurred, as well as a very strong decline of customers' satisfaction index.
- ✓ The situation of the national budget was favourable till the end of the third quarter of the previous year. In the full year, the deficit was slightly lower than planned, which however was achieved through cutting some expenses.
- ✓ In the first half of 2008 the Monetary Policy Council (MPC) increased NBP interest rates, which resulted from accelerated inflation processes. In the second half of the year, MPC decided to change monetary policy and started a cycle of quick interest rates cuts. In the first half of 2008 the situation on the financial market can be considered relatively stable (sharp decline occurred mainly in the stock market). In the second half of the year strong disturbance in functioning of individual areas of the market occurred. However situation in Polish interbank market can be considered quite good in comparison to disturbance occurring in other countries (WIBOR 3M rate, which is a reference rate for majority of domestic currency loans, increased from 5.7% at the end of 2007 to

5.9% at the end of 2008). Yield on Treasury bills per annum decreased (10-year bonds decreased from 6.1% to 5.3%), however the difference between the yield on Polish Treasury bills and bills issued by the governments of the most stable countries was observed. Till the middle of the year appreciation of PLN had been taking place, resulting in PLN reaching the highest levels in last years in relation to main currencies. In the second half of the year the sharp deterioration of mood in global financial markets led to strong depreciation of PLN. Warsaw stock exchange fallowed global markets (the main WIG Index declined 51.1%).

Although strong weakening, the macroeconomic situation of Poland, compared to other EU countries, looks relatively good so far.

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

Banking operations in 2008 can also be divided into two periods. The first period, covering approximately three first quarters, was characterised by fast development thanks to relatively favourable macroeconomic conditions, as well as high optimism of enterprises and households. The key factor for fast development was the dynamic increase in lending activity, financed on the basis of funds from the financial market, as well as increased deposit base. In the second period covering Q4, lending activity slowed down and banks intensified their activity aimed at acquisition of deposits (the so-called "deposit war") and increased their investments in Treasury and NBP securities in order to increase liquidity reserves in a situation of high uncertainty in the market. In this period the strong deterioration of banking performance was also observed. It was caused by the "second wave" of the financial crisis, deteriorated financial situation of certain borrowers and write-offs related to currency derivative transactions.

Key points:

- ✓ Banking sector structure did not change significantly. At the end of the year, 649 banks and branches of credit institutions conducted operations (foreign investors controlled 42 commercial banks and all branches of credit institutions, and their market share measured by assets accounted 72.3%).
- ✓ In 2008 the total balance sheet of the banking sector increased by 31.4%. Consequently the share of banks' assets in GDP rose from 67.5% in 2007 to 82.2% in 2008.
- ✓ Loans for the non-financial sector increased by 38.8%, which was the highest growth rate in the present decade - loans for the households increased by 45.0%, while corporate loans increased by 29.7%. Such high growth rate of lending was not only the consequence of increase of contracts but also depreciation of Polish currency. In Q4, due to the "second wave" of financial crisis, lending activity slowed down.

  Mortgage loans increased by 64.8%. It was caused by rapid growth in foreign currency debt of households (mortgage loans in foreign currencies rose by 107.2%, while PLN loans by 12.4% only). In Q4 of

2008 the lending policy was tightened, especially banks tightened currency loans policy so that such loans became hardly accessible for many borrowers. From the point of view of banking sector safety, such measures should be considered positive. However, it should be pointed out that certain banks were forced by banking supervision to suspend lending in foreign currencies due to the lack of adequate sources of long-term financing, adequate to asset structure.

- ✓ Banks financed the development of lending activity mainly through increase of liabilities towards financial sector and through increase of deposits from the non-financial sector. Amounts owed to the financial sector increased by 53.3% (great part of funds of non-residents originates from parent companies and has of long-term nature). Deposits from non-financial sector increased by 17.8%. Deposits from households increased by 26.1%, which was the highest growth rate in the decade. Such a high increase in household deposits resulted from more attractive deposits offered by banks ("deposit war"), higher wages and salaries and final breakdown of bull run on the stock market, which resulted in withdrawal of the part of funds from investment funds and their investment in the banking system. Corporate deposits increased only by 3.0%, which in turn was one of the lowest growth rates in the decade and together with other data confirms that the economic conditions in the corporate sector are visibly worse.
- ✓ The relatively positive macroeconomic condition in the first half of 2008 and extension of the scale of banking sector operations were reflected in higher financial results. Net financial result of the banking sector amounted to PLN 13.9 billion, which was the historical peak, but it was higher by only 2.1% than in 2007. Better results were mainly the consequence of the increase in net interest income (by 23.0%) and foreign exchange result. Although record profits, in Q4 of 2008 there was a strong deterioration of banking sector results (net profit in that quarter accounted for only ca. 30% of the profit generated in each of the previous quarters of this year). Significant deterioration of results derived from increased write-offs resulting from the deterioration of the financial standing of the part of borrowers, write-offs for derivative transactions in foreign currencies, write-offs for operations in Ukraine, and increased administrative costs (a negative balance of provisions/impairment write-offs almost tripled). Despite very poor results in Q4, throughout 2008 banks managed to maintain high performance or even improved it in certain areas (cost to income ratio decreased from 56.3% to 54.7%; return on equity dropped slightly from 22.5% to 21.2%).
- ✓ Banking sector liquidity remains satisfactory. The major source of the risk of liquidity loss is the mismatch between contractual maturities of assets and liabilities and turbulence on global financial markets (consequently to the escalation of the financial crisis and further decrease in confidence between market participants there was a limitation of market liquidity and practical elimination of transactions with longer maturities).
- ✓ Loan portfolio quality was satisfactory - the share of non-performing loans in total receivables decreased from 5.2% at the end of 2007 to 4.4% at the end of 2008 (enterprises, from 6.9% to 5.9%, households, from 4.1% to 3.5%). However, an alarming symptom is the fast

increase in non-performing and „watch list' loans that occurred in Q4 of 2008. A situation of maintained weak PLN, deteriorating situation in the labour market and financial position of the corporate sector, in the coming periods may considerably deteriorate loan portfolio quality.

- ✓ Capital adequacy of the banking sector was satisfactory. However the increase in the total capital requirement was not offset by a sufficiently large increase in own funds, and caused the average capital adequacy ratio of the banking sector decreased from 12.1% at the end of 2007 to 10.8% at the end of 2008.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The main objective of regulatory policy implemented in 2008 was continuation of measures aimed at improvement of risk management of banks.

Due to the need resulting from the Act on Financial Market Supervision regarding the issue by Polish Financial Supervision Authority (KNF) of executive acts to the Banking Law, issued by Commission for Banking Supervision (CBS) and expiring with the end of 2008, banking supervision prepared drafts amending CBS resolutions (KNF is a successor of CBS). They were adopted by KNF in December 2008. In general, KNF resolutions transposed the provisions of CBS resolutions, whereas in certain CBS resolutions technical amendments were introduced resulting from the submitted doubts as to interpretation and necessary completions.

Aiming to extend protection of market participants KNF issued Recommendation S II. The Recommendation introduces suggestions that are additional to those included in Recommendation S, related to the obligation to inform customers about currency spread, burdens and risk related to differences between the sell rate and buy rate of foreign currencies before and during the period of validity of the credit agreement in the case of loans granted in foreign currency or indexed to foreign currency. In accordance with the new recommendations, the banks should permit the customer upon request to repay installments in the indexation currency in case of the loan indexed to foreign currency (change in the manner of repayment should cover all installments from the date of amendment of the agreement, which means that it may occur only once throughout the agreement validity period). In the opinion of KNF, these amendments will improve the relations between banks and customers who will be better informed about the consequences of their decisions.

There were also works on Recommendation T defining best practices in credit risk management for household loans and implementation of customer creditworthiness assessment standards. The draft document was subject to broad consultations with banking environment (at present the consultations are analysed as to their potential inclusion in Recommendation provisions) and the process itself resulted in adequate self-regulatory reactions of banks. In the opinion of banking supervision authority, introduction of the rules described in Recommendation T will improve risk management and thus banking sector safety.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

Supervision focused on main directions:
- ✓ assessment of stability of the banking sector identification of systemic risks, preventive measures and providing adequate recommendations to banks,
- ✓ assessment of situation of individual banks, in particular quality of risk management process,
- ✓ necessary regulatory changes described above.

In response to escalation of critical events KNF took necessary preventive and adjusting measures towards the supervised entities.

Banking supervision immediately responded to signals regarding problems of capital groups which could translate to the situation of subsidiaries operating in Poland. Supervisory measures focus on a number of areas: additional recommendations and suggestions, monitoring activities, meetings with banks' management boards, contacts with parent entities, participation in the works of Financial Stability Committee.

Within those measures e.g.:
- ✓ banks were obliged to verify their investment policy and structure of the sources of financing,
- ✓ banks were obliged to review their contingency plans with the view of taking into account potential lack of liquidity in the local market or limited support from parent entity,
- ✓ banks were asked to assess current situation in the interbank market and to provide information on measures aimed at limitation of liquidity risk, in particular financing of currency and currency-indexed mortgage loans,
- ✓ monitoring of exposures towards specific entities or regions was conducted (such as the US, Iceland, Russia, Ukraine);
- ✓ monitoring of exposures of banks exposed to foreign financial entities was conducted (information on type of instruments and maturities and the method of hedging of risk related to those exposures);
- ✓ introduction of the obligation to report new exposures to foreign entities every day and warning against transactions that may involve unjustified transfer of funds to parent entities;
- ✓ introduction of obligation of weekly reporting of currency liquidity,
- ✓ monitoring and analyses of derivative transactions in foreign currencies concluded with non-financial sector entities;
- ✓ necessary individual measures were taken towards the selected banks with respect to the abovementioned areas.

Meetings with bank management boards are essential element of supervisory activities. Conclusions from those meetings show that up-to-date events on financial markets are not a direct threat to banking system stability. However, decreased mutual confidence between financial market participants, reflected in limitation of the scale of transactions on the interbank market (expressed in transaction value and deadlines) is worrying. At the same time, KNF regularly meets representatives of parent entities in order to learn their economic condition and strategic plans towards subsidiaries. Considering global nature of the crisis, banking supervision remains also in regular contact with supervision authorities from other countries, thanks to which e.g. it is possible to verify assessment of situation of parent entities towards institutions operating in Poland.

INTERNATIONAL ACTIVITIES OF THE POLISH FINANCIAL SUPERVISION AUTHORITY (KNF)

In 2008 the international activities of the Polish Financial Supervision Authority (KNF) concentrated both on bilateral agreements on cooperation with supervisory bodies from other countries as well as regular international cooperation within the EU and various international organizations.

Memoranda of Understanding regulate the international cooperation within various sectors, therefore many times the KNF is the party to more than one sectoral agreement with the same foreign institution. As from January 1st, 2008 the General Inspectorate of Banking Supervision (which was part of Poland's central bank) became part of the KNF, all agreements concluded by the Commission for Banking Supervision had to be revalidated. The MoUs with the following institutions were revalidated in the course of last year:

- Bundesanstalt für Finanzdienstleistungsaufsicht,
- Banca d'Italia,
- CBFA,
- China Banking Regulatory Commission,
- De Nederlandsche Bank,
- Federal Deposit Insurance Corporation,
- Board of Governors of the Federal Reserve System,
- New York State Banking Department,
- Office of the Comptroller of the Currency,
- Office of Thrift Supervision,
- Banque de France,
- Bank of Lithuania,
- Banco de Portugal.

The KNF is fully aware of the fact that the participation of Polish representatives in the process of developing current decisions regarding the shape of future supervision architecture is crucial.

Therefore, the employees of the KNF are involved in the largest possible number of international initiatives. These are, in particular:

- works in the 3L3 Committees: CEIOPS, CEBS, CESR,
- works in the working groups of these Committees,
- participation in coordination committees within insurance groups and in other supervisory meetings, including supervisory colleges,

- developing the bilateral cooperation with other supervisors, especially with the so called New Europe's countries,
- works in such international organizations as: IAIS, IOSCO, IOPS, OECD, ECB, the Basel Committee and their working groups,
- close cooperation with the Polish representatives in the European Parliament.

As for the CEBS working groups, the representatives of the KNF attend the meetings of: Group de Contact (GdC), Sub-group on Operational Networks (SON), Liquidity Risk Management Task, Pillar 2 Convergence Network (P2CN), Review Panel, Expert Group on Financial Information (EGFI), Expert Group on Prudential Regulation, Working Group on Cyclicality, Subgroup on validation issues concerning operational risk (SOVI-O) and the Subgroup on validation issues concerning credit risk (SOVI-C).

The representatives of the KNF participate also in the works of the European Central Bank. Within the Banking Supervision Committee, one of the ECB's bodies, the KNF experts are cooperating with four working groups: Working Group on Macroprudential Analysis (WGMA), Working Group on Developments in Banking (WGDB), the Joint Task force on the Impact of the New Capital Framework (TFICF) and the Joint Task Force on Crisis Management (CMTF).

As for the Basel Committee on Banking Supervision, the employees of the KNF attend the meetings of the Accord Implementation Group's Operational Risk Subgroup (AIGOR), Accord Implementation Group – Validation (AIGV) and the International Liaison Group (ILG).

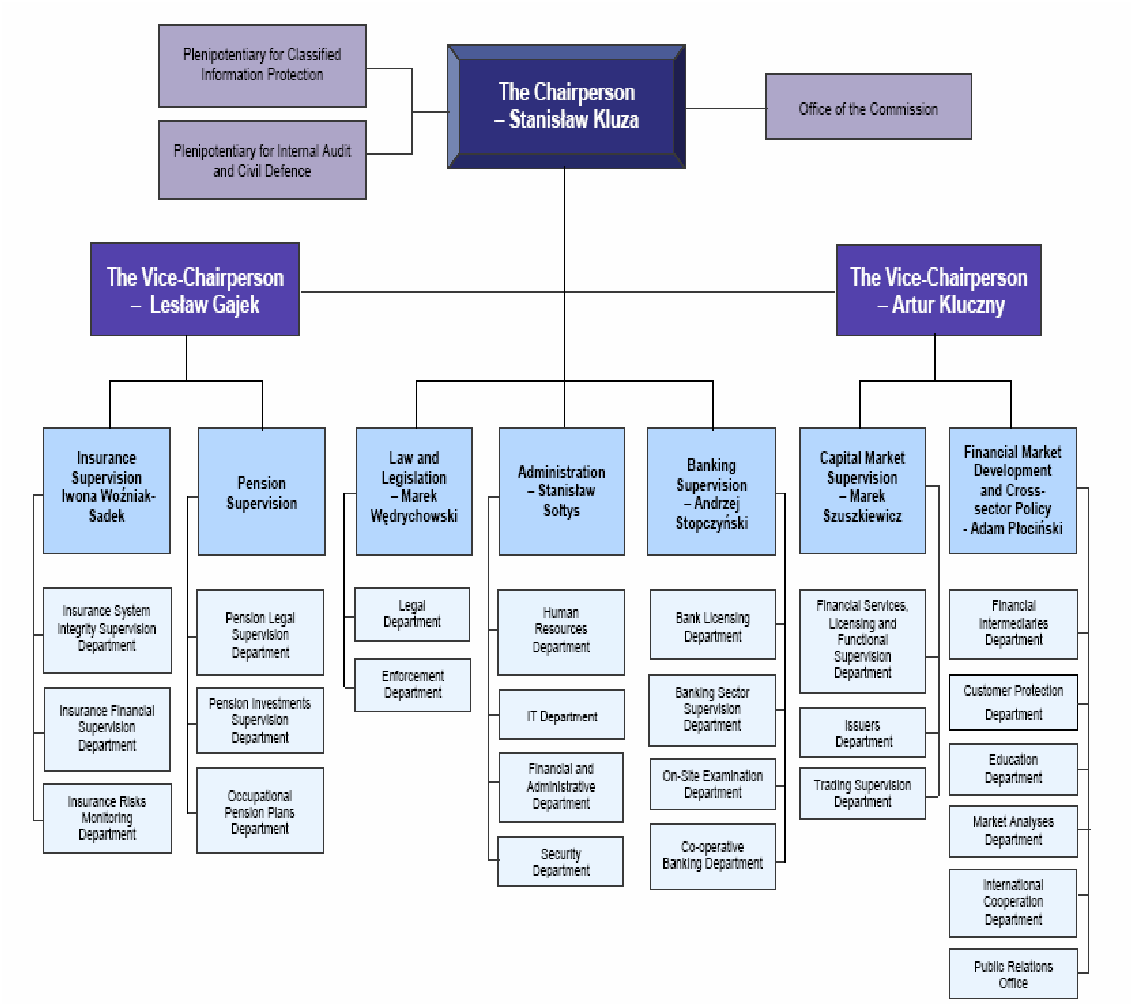
The international cooperation in 2008 concentrated also on activities regarding the works of the Banking Supervisors from Central and Eastern Europe (BSCEE) Secretariat. The BSCEE Secretariat is located in Poland since January 2006. The Secretariat is responsible for the cooperation between the Group Member countries, the Basle Committee, the FSI and other institutions or regional groups.

COOPERATION WITH OTHER SUPERVISORY BODIES IN POLAND

Throughout the 2008, the Polish Financial Supervision Authority (KNF) took part in preparing the Polish stance to the documents covering the financial market issues and decisions taken by the EU institutions in close cooperation with the Ministry of Finance, which is the leading institution in this respect in Poland. Among other EU bodies, the KNF's opinions were issued to documents prepared by: the European Securities Committee (also the EBC and EIOPC), the Financial Services Committee and the ECOFIN.

At present, the Polish Ministry of Finance is taking active part in the EU works with respect to the financial stability and crisis management, intensified as the response to the global financial turmoil on the financial markets. Also in this area, the Polish Financial Supervision Authority assists the Ministry in its efforts.

ORGANIZATIONAL CHART OF THE POLISH FINANCIAL SUPERVISION AUTHORITY:



STATISTICAL TABLES

Number of financial institutions

Type of financial institution	2006	2007	2008
Commercial banks	51	50	52
Branches of Credit Institutions	12	14	18
Co-operative banks	584	581	579
Total banking sector	**647**	**645**	**649**

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

Type of financial institution	2006	2007	2008
Public sector ownership	16.3	16.1	15.2
Other domestic ownership	11.3	11.2	10.6
Domestic ownership total	27.6	27.3	25.7
Foreign ownership	72.4	72.7	74.3
Total banking sector	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2006	2007	2008
Public sector ownership	19.8	18.3	17.3
Other domestic ownership	10.5	10.8	10.4
Domestic ownership total	30.3	29.1	27.7
Foreign ownership	69.7	70.9	72.3
Total commercial banks	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Commercial banks	36.4	50.1
Branches of Credit Institutions	70.8	85.2
Co-operative banks	6.0	8.3
Total banking sector	**32.5**	**44.7**

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

Type of financial institution	2006	2007	2008
Commercial banks	1.8	1.8	1.5
Branches of Credit Institutions	(0.6)	(0.1)	0.5
Co-operative banks	1.3	1.5	1.7
Total banking sector	**1.7**	**1.7**	**1.6**

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

Type of financial institution	2006	2007	2008
Commercial banks	23.1	22.9	21.0
Branches of Credit Institutions	n/a	n/a	n/a
Co-operative banks	14.5	17.2	19.6
Total banking sector	**22.5**	**22.5**	**21.2**

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

Type of financial institution	2006	2007	2008
Commercial banks	90.7	89.6	89.2
Branches of Credit Institutions	3.1	4.3	5.4
Co-operative banks	6.2	6.2	5.4
Total banking sector	**100.0**	**100.0**	**100.0**

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

Assets	2006	2007	2008
- Cash and balance with Central bank	3.4	3.6	3.8
- Interbank deposits	19.7	15.8	10.4
- Due from non-financial and government entities	49.5	55.9	58.8
- Secuirties	20.9	17.1	17.4
- Other assets	6.5	7.6	9.7
Liabilities	**2006**	**2007**	**2008**
- Borrowing from Central Bank	0.7	0.4	1.7
- Interbank deposits	17.5	20.0	23.3
- Deposits from non-financial and government entities	61.1	59.7	53.7
- Bonds	2.3	1.6	1.2
- Other liabilities	9.7	9.8	12.2
- Capital and reserves	8.7	8.6	7.9

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

Type of financial institution	2006	2007	2008
Commercial banks	380.4	440.6	328.0
Branches of Credit Institutions	945.4	1 008.2	766.4
Co-operative banks	9.2	8.9	11.4
Total banking sector	**374.8**	**436.7**	**334.4**

Solvency ratio of financial institutions (%)

Type of financial institution	2006	2007	2008
Commercial banks	13.2	12.0	10.7
Branches of Credit Institutions	n/a	n/a	n/a
Co-operative banks	14.0	13.8	13.2
Total banking sector	13.2	12.1	10.8

Asset portfolio quality of the banking system

Asset Classification		2006	2007	2008
- Special mention claims		3.9	3.1	3.6
- Irregular claims, of which:				
- substandard		**0.9**	**0.8**	**1.0**
- doubtful		0.9	0.7	0.8
- loss		5.5	3.7	2.8
Classified total		7.4	5.2	4.5
Specific reserves	zloty million	**15 584.8**	**15 621.1**	**16 602.8**

[a] of total claims

The structure of deposits and loans in 2008 (%) (at year-end)

Maturity of Deposits		Maturity of Loans	
At sight	45.6	Long term loans[33]	57.0
Within one year	49.9	Medium-term loans[34]	25.8
Over one year	4.5	Short-term loans[35]	23.1
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.		
	2006	2007	2008	2006	2007	2008
Commercial banks	25.9	22.7	27.1	18.4	17.1	19.1
Branches of Credit Institutions	27.4	19.5	29.2	21.7	22.0	37.3
Co-operative banks	0.7	0.8	0.7	0.7	0.8	0.7
Total banking sector	**24.3**	**21.2**	**25.8**	**17.3**	**16.3**	**19.1**

[33] >5 years.
[34] (1-5] years
[35] (0-1] years including authorised overdrafts.

Structure of revenues and expenditures of financial institutions

million zloty

Revenues	2006	2007	2008
Interest income (net)	20702.2	24339.5	29946.5
Commissions (net)	9142.0	10997.7	11323.9
Other operating income (net)	5906.7	7138.2	8379.6
Other items (net)	115.5	1.6	
Total banking sector	20702.2	24339.5	29946.5
Expenditures	**2006**	**2007**	**2008**
Staff costs	10737.7	12277.9	13796.6
Other administrative expenses	10443.4	11784.0	13343.3
Impairment losses (net)	1667.0	1713.0	5230.5
Tax expense	2321.0	3059.9	3244.9
Other items (net)			100.0
Total banking sector	25169.1	28834.8	35715.3

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	000 EUR	%	000 EUR	%
Commercial banks	3699.6	1.7	16733.1	7.5
Branches of Credit Institutions	n/a	n/a	n/a	n/a
Co-operative banks	150.1	1.1	1242.0	9.2
Total banking sector	3849.7	1.5	17975.1	7.2

2008 DEVELOPMENTS IN THE ROMANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2008, Romania was in its 8th consecutive year of economic growth; the annual rate of growth continued at a high level, despite the deterioration in international conditions for GDP growth, particularly in the second half of the year, which saw an international financial crisis. As in the most countries across the region, domestic demand and consumption have been the main growth factor. Compared with the other EU member states, in 2008 per capita GDP in Purchasing Power Standards ("PPS") was 11,300 PPS, representing about 43.5 per cent of the EU-25 average, as against 2007 when it was 10,000 PPS, which represented about 40.7 per cent of the EU average. Household spending was boosted by the easy availability of credit and a strong labour market. The annual inflation rate measured by the consumer price index (CPI) stood on average at 7.85 percent. However, according to the Harmonised Index of Consumer Prices (HICP) used by the European Commission and the European Central Bank, inflation rate equalled 7.9 percent compared to the reference value of 4.0 percent, i.e. 1.5 percentage points above the average of the three best performing EU Member States).

DEVELOPMENT IN THE BANKING SYSTEM

At end-2008, there were 43 credit institutions operating in Romania (42 banks and one credit cooperative organisation). As for banking system composition by equity ownership, 2 banks were state-owned, 4 had majority domestic private capital (including credit cooperative network), and 37 had majority privately-owned foreign capital (including branches of foreign banks). Majority privately-owned banks held 94.8 percent of total assets in the Romanian banking system, the remaining 5.2 percent being accounted for majority state-owned banks. Moreover, the share of assets owned by banks with majority foreign capital, including branches of foreign banks, ran at 88.2 percent of total.

The Romanian banking sector is still relatively highly concentrated. Top-five banks (in terms of assets) held 54.4 percent of aggregate assets on the credit institutions' balance sheets, 53.5 percent of loans, 54.1 percent of deposits, 44.1 percent of government securities outstanding and 48.5 percent of tier-one capital.

According to 2008 developments, the Romanian banking system can be describes as fundamentally sound, with a level of liquidity and solvency over the prudential requirements. This is somewhat the result of lack of exposure to "toxic assets" and of the prevalence of the "originate and hold" model. Thus, Romanian banks have had reasonable capital adequacy ratios and manageable levels of non-performing loans. The system-wide capital adequacy ratio was 13.76 percent as of the end of December 2008 by 5.76 p.p. above the regulatory level; while all banks meet the mandatory 8 percent ratio, 17 have ratios above system average. Some of the loans quality indicators registered a deterioration during 2008 further to the increased volatility of local currency and the deterioration of the macro environment condition; for example the past due and doubtful loans over total gross loans increased by only 0.60 p.p. during 2008 (from 0.77 percent to 1.37 percent). It is worth to notice that the non-government loans have had a modest evolution compared with the previous year, the climbing being by only 34 percent. The most dynamic segment of loans continued to be that to households who have had a growth rate of 39 percent against 29 percent for loans to non-financial corporations and other loans. Loans to households were heavily denominated in foreign currencies (+54 percent) while those in Romanian lei was only +22 percent. Anyway, despite the slowdown of the lending activity, banking assets and non-government loans in GDP added 1.5 percentage points and 5.3 percentage points to 62.3 percent and 41.5 percent respectively at end-2008. The causes for the aforementioned developments in non-government loans are related to both loan demand and supply even if the growth was lower than in the previous year.

The banking sector was profitable, with return on equity of 17.04 percent and a return on assets of 1.56 percent at end-December 2008 significantly higher than December 2007 (9.43 percent and 1.01 percent respectively). Responsible for this trend was the more accelerated dynamic of net profit against than that of equity and assets, mainly due to the selling of four banks participation into an insurance company.

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

LEGAL COMPETENCE OF THE ROMANIAN BANKING SUPERVISORY AUTHORITY

The NBR has adopted a new prudential reporting system, harmonised with COREP and FINREP requirements and is in the process of drawing up and adopting new regulations which will transpose the guidelines issued by the Committee of European Banking Supervisor (CEBS) applicable to credit institutions.

These new regulations will cover the governance arrangements, internal capital adequacy assessment process and outsourcing of the activities of credit institutions and management of significant risks.

As concerns the documents issued by CEBS, the documents referred to the external credit assessment institutions (Guidelines on the recognition of External Credit Assessment Institutions) and to the operational risk – standardised approach (Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches) have been transposed into national legislation. At the same time, the documents issued by CEBS related to Pillar II (Guidelines on the Application of the Supervisory Review Process under Pillar 2), IRB and AMA validation

(Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches) are being transposed into the national legislation.

The new regulation transposing Pillar II will also transpose other CEBS documents (such as those relating to the concentration risk, outsourcing, stress testing, liquidity, interest rate risk in the banking book, remuneration policy, risk management). At the same time, the new regulation that will replace the existing rules No. 17/2003 concerning organization and internal control of the business of credit institutions and material risks management, as well as the organization and internal auditing of credit institutions will also transpose documents of Basel Committee concerning risk management, internal control and audit (Core Principles for Effective Banking Supervision; Framework for internal control systems in banking organisations, Internal audit in banks and the supervisor’s relationship with auditors), responsibilities of the management body (Enhancing corporate governance for banking organisations), compliance function (Compliance and the compliance function in banks), residual risk, securitization and operational risk (International Convergence of Capital Measurement and Capital Standards – Basel II), liquidity risk (Principles for Sound Liquidity Risk Management and Supervision).

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

In the international context, the first objective of NBR from the supervision point of view was to limit the impact of the international crisis on the local banking market. At that time the most likely way to affect domestic credit institutions condition appeared to be the liquidity channel. Thus, the NBR has taken a number of important measures to manage developments in this field. Also, measures to strengthen banks capital positions and to maintain access to external finance have had a high priority.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

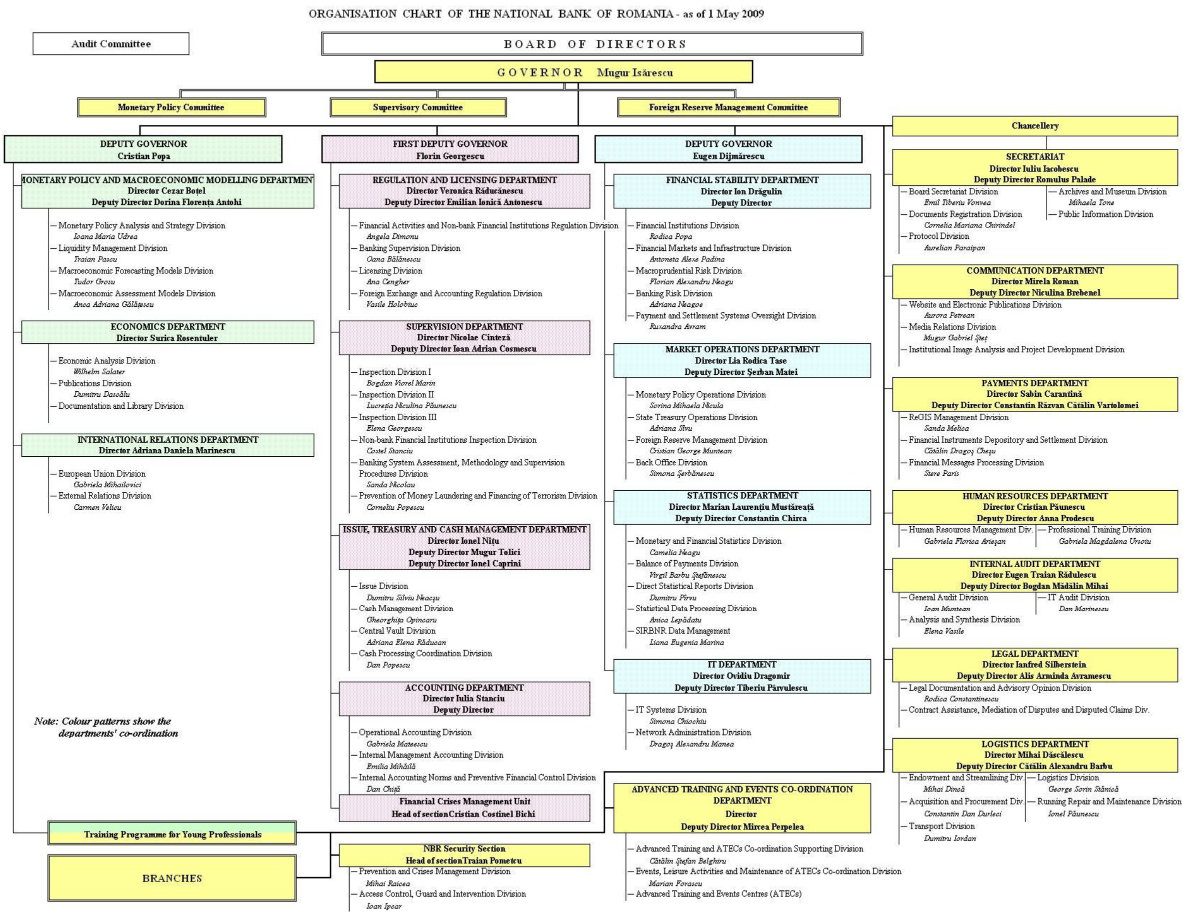
Regulatory framework developments (mainly through the recent developments in the legal framework and in NBR regulations) changed substantially the supervisory methodology, from a compliance-based approach to a risk-based assessment. In this regard, the atention was given to the methods applied by credit institutions to measure, evaluate and monitor risks, to verify whether the information used in risk management is complete, reliable and up-to-date, and also to clear definition and assignment of responsibilities to competent departments and staff members. Based on the above assessments, one may draw relevant conclusions regarding the overall performance of credit institutions and their risk profiles. During the on site inspections, most of the deficiencies found at banks were remedied by programs of measures closely monitored by the NBR.

With regard to closely monitoring of the soundness of the credit institutions, NBR paid a lot of attention to monitor inter-bank market developments and to optimize the management of liquidity imbalances at the level of individual banks. With a view to properly assess risks and devise appropriate measures for countering them, NBR representatives regularly meet banks management. Also, looking to the importance to the international financial groups and their large presence on the local market, NBR acted to enhance cooperation and coordination with foreign supervisory authority from home country.

Based on the individual assessments and case by case basis, Supervision Department required banks to have alternative financing arrangements and/or to diversify the financial resources; to purchase treasury bills representing a certain percent of the balance sheet liabilities or of the bank assets and recommended to provide short-term liquidity through foreign exchange swaps, repo operation or Lombard credit; to set up liquidity risk management scenarios; to diversify the financing resources in order to decrease the high level of concentration against a single counterparty.

The NBR also strengthen capital adequacy monitoring system and on case by case basis, NBR requested some banks to submit solvency ratio on monthly basis instead of quarterly as rule provides; to increase share capital or to reach and maintain a certain level of solvency ratio. Moreover, for several banks, increases in capital were recommended by adding 2008 profits to capital.

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF NBR

The attainment of convergence criteria in the field of supervisory practices for the banking activity at the level of competent authorities in the EU, the fulfillment of tasks incumbent on the authorities in charge of consolidated supervision, as well as the implementation of Basel II provisions nationwide require closer bilateral and multilateral co-operation of the NBR in the international area.

Against this background, the NBR formalized the bilateral cooperation with ten supervisory authorities (National Bank of Moldova, Supervision and Regulation Agency from Turkey, Central Bank of Cyprus, Bank of Italy, Bank of Greece, Federal Office for Banking Supervision from Germany, Nederlandsche Bank N.V., Banking Commission from France, Austrian Financial Market Authority, and Hungarian Financial Supervisory Authority) and with Bank of Spain the negotiation is in progress (and Bank of Portugal). To these was added a new Memorandum of Understanding with Bank of Portugal in March 2009.

In 2008, bilateral meetings were held with some representatives of the foreign supervisory authority in the spirit of developing a common culture on prudential supervision and occasioned the analysis of some issues relative to the recent developments in those countries' banking systems, especially in the banks in the respective jurisdictions, co-operation regarding the approach and validation of internal ratings-based models, scheduling of common inspections, exchange of information on crisis management and issues related to the management of credit institutions.

Cooperation and coordination within the Supervisory Colleges started to receive an increasingly importance for the NBR activity with a view to carry out banking risks assessment both on solo and consolidated basis, joint on-site inspections and risks model validation respectively. Up to now, NBR participated in 12 colleges - Crédit Agricole (Franţa), Unicredit (Italia), Intesa Sanpaolo (Italia), Erste Bank (Austria), Raiffeisen Zentralbank (Austria), Volksbank (Austria), National Bank of Greece (Grecia), Société Générale (Franţa), ING Bank (Olanda), BayernLB (Germania), Banco Comercial Portugues (Portugalia), OTP (Ungaria). Exchange of information focused on the groups' evolution during 2008, coordination between foreign supervisory authorities and setting up of the on-site inspections plans, presentation of the groups' risk profile, as well as other specific issues as the methodology used for pillar II indicators.

COOPERATION WITH OTHER SUPERVISORY BODIES IN ROMANIA

In 31 July 2007, an agreement on the co-operation in the field of financial stability and financial crisis management between the Ministry for Public Finance, National Security Commission, National Bank of Romania, Insurance Supervisory Commission, Private Pension System Supervisory Commission, had been concluded. The parties undertake to co-operate in view to exchange and disseminate the information among them on this issue, both in normal and in crisis time. As a result, the National Committee for Financial Stability was established (NCFS). During its meetings, the participants examined the key measures that have been taken with a view to strengthening financial stability at national and international level. In this context, talks focused on the terms of the multilateral precautionary arrangement agreed between Romania and the International Monetary Fund, the European Union, the World Bank, and the European Bank for Reconstruction and Development.

The members of the National Committee for Financial Stability also discussed the reform proposals regarding financial supervision in the European Union based on the document prepared by the High-Level Expert Group chaired by Jacques de Larosière and the European Commission's views as stated in the Communication of 4 March 2009. In this context, there were exchanges of views about the need to strengthen macro-prudential stability within the European Union for detecting and preventing systemic risks and to achieve a functional balance between domestic and European tasks in the field of micro-prudential supervision.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Commercial Banks	31	31	32
Branches of Foreign Banks	7	10	10
Credit cooperatives	1	1	1
Financial Institutions, total	**39**	**42**	**43**

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

Type of financial institution	2006	2007	2008
Public sector Ownership	14.9	12.8	11.5
Other Domestic Ownership	6.3	7.8	10.6
Domestic Ownership, Total	21.2	20.6	22.1
Foreign Ownership	78.8	79.4	77.9
Financial Institutions, total *	**100**	**100**	**100**

*) excluding Credit cooperatives

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

Type of financial institution	2006	2007	2008
Public sector Ownership	5.5	5.4	5.2
Other Domestic Ownership	5.9	6.7	6.4
Domestic Ownership, Total	11.4	12.1	11.6
Foreign Ownership	88.6	87.9	88.4
Financial Institutions, total *	**100**	**100**	**100**

*) excluding Credit cooperatives

Concentration of assets by type of financial institutions as of December 2008(%)

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Banks*	42.9	54.5
Credit cooperatives	-	-
Financial institutions	-	-
Savings cooperatives	-	-
Specialized credit institutions	-	-

*) commercial banks

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

Type of financial institution	2006	2007	2008
Banks*	1.27	1.01	1.56
Credit cooperatives	2.20	1.68	0.95
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

*) including foreign banks branches

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

Type of financial institution	2006	2007	2008
Banks*	10.28	9.46	17.16
Credit cooperatives	6.54	5.04	2.90
Financial institutions	-	-	-
Savings cooperatives	-	-	-
Specialized credit institutions	-	-	-

*) including foreign banks branches

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

Type of financial institution	2006	2007	2008
Commercial Banks	93.9	94.7	94.2
Branches of Foreign Banks	5.8	5.0	5.6
Credit cooperatives	0.3	0.3	0.2
Financial Institutions, total	**100**	**100**	**100**

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

Assets	2006	2007	2008
Cash and Claims on Banks	38.7	33.1	25.3
Net Loans	53.9	59.6	66.6
Securities	3.6	3.9	3.9
Fixed Assets and Other Assets	3.8	3.4	4.2
Total Assets	**100**	**100**	**100**
Liabilities	**2006**	**2007**	**2008**
Due to Other Banks and Financial Institutions	23.8	29.4	31.7
Due to Clients	60.2	56.3	52.7
Other Liabilities	3.5	3.6	6.5
Own Capital	12.5	10.7	9.1
Total Liabilities and Capital	**100**	**100**	**100**

*) including Credit cooperatives

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

Type of financial institution	2006	2007	2008
Commercial Banks	18.7	18.0	17.0
Branches of Foreign Banks	18.2	20.5	27.1
Credit cooperatives	0.6	0.8	1.2
Financial Institutions, total	**18.6**	**18.1**	**17.6**

* commitments in favor of banking and non-banking customers

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Commercial Banks	18.0	13.7	13.7
Branches of Foreign Banks	-	-	-
Credit cooperatives	38.7	34.0	31.7
Financial Institutions, average	**18.1**	**13.8**	**13.8**

Asset portfolio quality of the banking system

Mill EUR

Asset Classification	2006	2007	2008
Standard	16,038	21,618	32,106
Watch	10,604	17,619	11,887
Substandard	1,356	2,303	3,489
Doubtful	277	575	1,002
Loss	466	1,035	2,153
Classified Total	**28,741**	**43,150**	**50,637**
Specific Reserves	**430.7**	**370.5**	**335.7**

According to the classification statement of Commercial Banks

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	34.6	19.0
Government Sector	-	8.0
Corporate	26.3	19.0
Foreign	33.2	53.1
Other	5.9	0.9
Total	**100**	**100**

The structure of deposits and loans in 2008 (%)
(at year-end)

Maturity of Deposits		Maturity of Loans	
At sight	44.1	Short-term	29.2
Within one year	52.0	Medium-term	19.7
Over one year	3.9	Long-term	51.1
Total	**100**	**Total**	**100**

Proportion of Foreign Exchange Assets and Liabilities*
(at year-ends)

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008*	2006	2007	2008*
Commercial Banks	43.9	50.6	Na	42.9	42.7	Na
Branches of Foreign Banks	55.0	53.1	Na	34.0	37.2	Na
Credit cooperatives	0.1	0.1	Na	0.2	0.1	Na
Financial Institutions, average	**44.4**	**50.6**	**Na**	**42.3**	**42.3**	**Na**

*From January 1st 2008 the figures are computed from FINREP and COREP reports and are not available in requested shape

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

Revenues	2008*
Total operating income	**100.0**
Net interest income	44.8
Net fees and commissions	24.2
Net income from securities	0.5
Net gains (losses) on financial operations	26.6
Other operating income	3.9
Total operating expenses	**100,0**
Personnel expenses	42.0
Depreciation	7.1
Other administrative expenses	36.0
Other operating expenses	14.9

*From January 1st 2008 the figures are computed from FINREP and COREP reports and for previous years are not available in present shape

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	Mill. EUR	%	Mill. EUR	%
Commercial Banks	3,109.2	4.2	6,988.1	9.4
Branches of Foreign Banks	200.6	4.5	260.7*	5.9
Credit cooperatives	30.0	17.2	53.6	30.7
Financial Institutions, total	**3,339.8**	**4.2**	**7,302.4**	**9.3**

** own capital*

2008 DEVELOPMENTS IN THE RUSSIAN BANKING SYSTEM

MACROECONOMIC SITUATION IN RUSSIA

In the second half of 2008, the external conditions of the Russian economy sharply deteriorated. The contraction of world demand, aggravated by fall in oil prices, affected Russian foreign trade and capital flow dynamics. By the end of the year, the negative developments had led to the reduction in revenues, which caused domestic demand to shrink and output in the key sectors of the economy to decline. Growth of unemployment accelerated. As the crisis deepened, GDP growth slowed down. Nevertheless, the economy's performance in the first half of the year favourably affected full-year results, which demonstrated growth in the production of goods and services, fixed capital investment, and household real income, although the rates of this growth were lower than in 2007.

In 2008, GDP grew by 5.6% (as against 8.1% in 2007). The most rapid rates of growth were registered in the construction sector, agriculture, and retail trade. Industrial output increased by 2.1% (as against 6.3% a year earlier).

In 2008, consumer price inflation quickened by 1.4 percentage points year-on- year, to 13.3% (December on December). Core inflation stood at 13.6% as against 11.0% in 2007. Food, non-food and service prices in 2008 grew faster than in 2007.

The amount of foreign exchange in the household and enterprise sector increased in 2008. Foreign exchange outside banks grew last year by $24.8 billion. Net private sector capital outflow stood at $132.8 billion in 2008, whereas in 2007 Russia registered a net inflow of $83.1 billion.

After reaching the highest level in early August 2008, Russia's international reserves began to decline (in August-December 2008 they contracted by $169.5 billion). As of January 1, 2009, international reserves decreased by 10.8% as compared with the beginning of 2008 and stood at $427.1 billion.

In 2008, Russian government foreign debt contracted, whereas the private sector's foreign debt continued to grow. The debt burden[36] on the country's economy decreased.

[36] Foreign debt to GDP ratio.

BANKING SECTOR DEVELOPMENT

Most of the key indicators characterising the banking sector's role in the economy continued to grow in 2008 relative to GDP. The ratio of banking sector assets to GDP increased by 6.7 percentage points to 67.5% and the ratio of banking sector capital to GDP rose by 1.1 percentage points to 9.2%. The expansion of lending was the main source of growth in banking sector assets in 2008, as was the case in 2007. The ratio of loans to non-financial institutions and individuals to GDP grew by 2.6 percentage points to 39.7%. Loans to private individuals grew at the most rapid rates and reached 9.7% of GDP. Meanwhile, the ratio of individual deposits to GDP contracted by 1.4 percentage points to 14.2%.

The principal source of resources for credit institutions in 2008 were funds raised from enterprises: their ratio to GDP stood at 21.1% as of January 1, 2009, and they accounted for 31.3% of banking sector liabilities*.

LEGISLATIVE AND INSTITUTIONAL FRAMEWORKS FOR THE ACTIVITY OF CREDIT INSTITUTIONS AND BANKING SUPERVISION, MAIN CHANGES SUPERVISORY AUTHORITY'S LEGAL COMPETENCE

The legal and operational framework for banking in the Russian Federation is established by Federal Law No. 395-1, dated 2 December, 1990 'On Banks and Banking' (hereinafter referred to as the Law on Banks).

Federal Law No. 86-FZ, dated July 10, 2002, 'On the Central Bank of the Russian Federation (Bank of Russia)' (hereinafter referred to as the Bank of Russia Law) stipulates that the Bank of Russia is a body of banking regulation and banking supervision whose main goals are to maintain stability of the country's banking system and protect the interests of creditors and depositors. For these purposes, the Bank of Russia constantly monitors the credit institutions' and banking groups' compliance with banking legislation, legislation on countering money laundering and terrorist financing and the Bank of Russia's regulations and required ratios. Issues concerned with banking regulation and supervision are addressed separately in Chapter X of this law.

The Bank of Russia takes decisions on state registration of credit institutions, grants banking licenses to credit institutions, and suspends and withdraws them (Article 4 of the Bank of Russia Law).

According to Article 57 of the Bank of Russia Law the Bank of Russia sets binding rules for credit institutions and banking groups on banking operations, recording and reporting, organization of internal controls, and compilation and submission of accounting and statistical reports and other information specified in federal laws.

* Bank funds and profits (capital items in the balance sheet) plus liabilities on the right side of the accounting equation (total resources)

To carry out its functions, the Bank of Russia has the right to request and obtain from credit institutions information on their activity in accordance with a list established by the Board of Directors, and demand explanations on the information received.

Based on Article 62 of the Bank of Russia Law the Bank of Russia may establish the following binding ratios to ensure the soundness of credit institutions: the maximum amount of property (non-monetary) contributions to the authorized capital of a credit institution, and the list of kinds of property of non-monetary form that may be contributed in payment of authorized capital; the maximum exposure to one borrower or a group of related borrowers; the maximum of large credit exposures; liquidity ratios of a credit institution; capital adequacy ratios; exchange, interest rate, and other financial risks; minimum reserves created against risks; ratios on use of a credit institution's own funds (capital) to acquire shares in other legal entities; maximum credits, bank guarantees, and sureties granted by a credit institution (banking group) to its participants (shareholders). Binding ratios be established by the Bank of Russia for banking groups.

The Bank of Russia establishes the methods for determining a credit institution's own funds (capital), assets, liabilities, and asset risks for each standard with consideration for international standards and consultations with credit institutions, banking associations and unions. The Bank of Russia has the right to establish differentiated standards and methods of their calculation specific to different kinds of credit institutions (Article 72 of the Bank of Russia Law). Considering the provisions of articles 56, 68, 72, 74, and 75 of the Bank of Russia Law, and Federal Law No. 177-FZ, December 23, 2003 "On Insurance of Private Deposits in Banks of the Russian Federation" (henceforth -- Deposit Insurance Law), when assessing financial condition of a credit institution the Bank of Russia makes a qualified (professional) judgment.

To perform its functions of banking regulation and supervision, the Bank of Russia conducts inspections of credit institutions (their branches), gives them binding instructions on correcting violations discovered in their activity, and applies sanctions against violators prescribed by the Bank of Russia Law (Article 73, Bank of Russia Law). The inspections may be carried out by authorized representatives (employees) of the Bank of Russia by procedure established by the Board of Directors, or by auditing organizations when so ordered by the Board of Directors. Authorized representatives (employees) of the Bank of Russia obtain and verify reports and other documents of credit institutions (their branches). The procedure of inspection of credit institutions (their branches), including the responsibilities of credit institutions (their branches) to assist inspections, are determined by the Board of Directors.

If a credit institution violates federal laws, regulations or orders of the Bank of Russia promulgated in accordance therewith, fails to provide information, or provides incomplete or inaccurate information, the Bank of Russia has the right to demand correction of the revealed violations by the credit institution, to impose a fine or to restrict the credit institution from certain operations for a period of up to 6 months (Article 74 of the Bank of Russia Law). When orders of the Bank of Russia to correct violations are not carried out within the time set by the Bank of Russia, and if these violations created a real threat to the interests of its creditors (depositors), the Bank of Russia has the right to require the credit institution:

- to implement measures of financial rehabilitation;
- to replace the directors of the credit institution, the list of the positions of which is provided in Article 60 of the Bank of Russia Law;
- to reorganize the credit institution;
- to change binding standards set for the credit institution for a period of up to 6 months;
- to prohibit the credit institution from certain banking operations allowed by the banking license granted thereto for a period of up to 1 year, and from opening branches for a period of up to 1 year;
- to appoint an interim administration to manage the credit institution for a period of up to 6 months. The procedure of appointment of the interim administration and of its activity is established by federal laws, and by Bank of Russia regulations promulgated in accordance therewith;
- to prohibit reorganization of the credit institution if as a result of it grounds would arise for implementing measures to prevent bankruptcy of the credit institution as provided in Federal Law No. 40-FZ, February 25, 1999 "On Insolvency (Bankruptcy) of Credit Institutions" (henceforth -- Law on Bankruptcy);
- to ask the founders (participants) of the credit institution who are able to have an influence on decisions of management bodies of the credit institution independently or in view of agreements existing between them, or of participation in one another's capital, or of other means of direct or indirect interaction, to take actions aimed at increasing the credit institution's equity (capital) to an amount ensuring its compliance with binding standards.

The Bank of Russia has the right to revoke a credit institution's banking license on grounds set forth in the Law on Banks. The procedure for revoking a banking license is established by Bank of Russia regulations.

In 2008, the Bank of Russia continued to upgrade banking legislation, including the measures it took in line with the Bank of Russia Action Plan for the Implementation of the Russian Banking Sector Development Strategy until 2008.

In 2008, the Bank of Russia participated in drafting the following federal laws:

- Federal Law No. 46-FZ, dated April 8, 2008, ‘On Amending Article 30 of the Federal Law on Banks and Banking Activities’ (regarding the disclosure of information by a credit institution to individual borrowers);
- Federal Law No. 174-FZ, dated October 13, 2008, ‘On Amending Article 11 of the Federal Law on Insurance of Individual Deposits in Russian Banks and Some Other Laws of the Russian Federation’ (regarding the increase in the amount of insurance compensation for household deposits);
- Federal Law No. 270-FZ, dated December 22, 2008, ‘On Amending the Federal Law on Insurance of Individuals Deposits in Russian Banks and Some Other Laws of the Russian Federation’ (regarding

the criteria used by the Bank of Russia in monitoring banks' compliance with the deposit insurance system requirements);

- Federal Law No. 306-FZ, dated December 30, 2008, 'On Amending Certain Laws of the Russian Federation in Connection with the Upgrading of the Foreclosure Procedure.'

In 2008, Russia completed a major stage in the upgrading of bank merger and acquisition procedures. It passed Federal Law No. 315-FZ, dated December 30, 2008, 'On Amending the Federal Law on Banks and Banking Activities and Some Other Laws of the Russian Federation,' which cancelled the requirement to notify creditors in writing about the decision to reorganise a credit institution (the law established the alternative notification procedure – a press publication) and the restriction of creditors' right to demand that a credit institution that has taken the decision to reorganise itself should terminate or fulfil its obligations early and compensate for losses.

To provide assistance to the banking sector amid the world financial crisis and, at the same time, oversee the activities of credit institutions to make sure that they use government relief funds effectively, the Bank of Russia issued the following regulatory documents:

1. To prevent the use of funds allocated as government aid to the financial system in operations on the foreign exchange market, the Bank of Russia recommended credit institutions to maintain the average monthly balance of foreign assets at a level not higher than the actual average balance of foreign assets in the period of August 1 to October 25, 2008, and the average net currency balance sheet position at a level not higher than its actual average value in the period of October 25 to November 25, 2008 (hereinafter referred to as the base periods) and not to open a long currency balance sheet position if in the base period the credit institution had a short currency balance sheet position (Bank of Russia Letters No. 01-13-1/5713 of October 28, 2008, and No. 01-15-3/7850 of December 25, 2008). For these purposes, the Bank of Russia developed approaches to control the credit institutions' compliance with the Bank of Russia recommendations and to reduce the credit limit for credit institutions that had concluded a general agreement with the Bank of Russia, whereby the Bank of Russia provided unsecured loans to credit institutions pursuant to Bank of Russia Regulation No. 323-P, dated October 16, 2008, 'On Extending Unsecured Loans to Credit Institutions by the Bank of Russia,' (hereinafter referred to as the general agreement), when they failed to follow the Bank of Russia recommendations.
2. To monitor the open currency positions, the Bank of Russia required credit institutions that had concluded the general agreement with it to present in the fourth quarter of 2008 and in the first and second quarters of 2009 10-day statements (with a breakdown for each working day) in form 0409634 *Statement of open currency positions* (Bank of Russia Letters No. 04-15-3/7393 of December 11, 2008, No. 04-15-3/1738 of April 3, 2008, and No. 04-15-3/7851 of December 25, 2008, 'On Presenting Statements by Credit Institutions').

3. To stimulate lending to the real economy, the Bank of Russia issued a regulation[37] that allowed credit institutions not to downgrade the quality of loan debt service compared to the applicable standards of the Bank of Russia Regulation on the Procedure for Making Loss Provisions by Credit Institutions for Loans, Loan Debt and Similar Debts in the following cases:
   - if the period of overdue debt on the principal amount of the loan and (or) interest has exceeded the period established by this Bank of Russia Regulation by 30 calendar days;
   - if the loan has been restructured after October 1, 2008 (for example, because of the change in the currency of the loan or in the term of redemption of the loan (principal amount and (or) interest) or in the interest rate);
   - if after October 1, 2008, the loan has been used to repay the borrower's earlier loan.
4. To ensure that corrective action taken against credit institutions has no negative effect on their financial situation during the global financial crisis, the Bank of Russia issued Letter No. 160-T, dated December 9, 2008, 'On the Application of Corrective Actions,' in which it recommended its regional branches not to use compulsory measures, such as fines and restrictions on individual banking and other operations, for non-compliance with prudential requirements by credit institutions if their financial situation and violations of prudential standards were caused by systemic factors and posed no threat to the interests of their creditors and depositors and banking sector stability.

SUPERVISORY AUTHORITY'S MAIN STRATEGIC TASKS IN 2008

In compliance with the Russian Banking Sector Development Strategy until 2008 and the Guidelines for the Single State Monetary Policy in 2008, the Bank of Russia set itself the following tasks in the field of banking supervision:

- to further develop risk-based supervision;
- to improve the quality of the assessment of financial soundness of credit institutions;
- to draft amendments to legislation and make changes to regulatory documents aimed at introducing international approaches defined by the Basel II framework to assessing credit institutions' capital adequacy;
- to improve approaches to the procedure of making loss provisions, in particular, to specify the methodology for making provisions for the portfolio of homogeneous loans, proceeding from the primacy of content over form and liberalised requirements for the assessment of the quality of loans extended to microfinance organisations and used by the latter to provide loans to small businesses and private individuals;

[37] Bank of Russia Ordinance No. 2156-U, dated December 23, 2008, 'On the Specifics of Credit Risk Assessment for Loans, Loan Debt and Similar Debts.' The Ordinance came into force on December 31, 2008, and will remain in effect until December 31, 2009.

- to improve approaches to regulation and supervision of liquidity risk and the methodology for calculating corresponding ratios;
- to improve approaches to the assessment of risks assumed by credit institutions in the course of lending operations and transactions with a group of economically related borrowers and borrowers related with the credit institution;
- to improve approaches to assessing the quality of interest rate risk management at credit institutions, including the development of interest rate risk management systems at credit institutions for trading and banking (non-trading) portfolios of financial instruments sensitive to interest rate fluctuations;
- to improve consolidated statements and the analysis of risk exposure of banking groups and bank holdings conducted on a consolidated basis;
- to improve approaches to assessing the quality of corporate management at credit institutions, management of all existing banking risks, taking into account the improvement of automated banking systems and the development of information and analytical systems and banking service techniques;
- to further improve the early warning system for credit institutions, banking groups (bank holdings) and the system as a whole;
- to improve the methods and tools of monitoring the financial soundness of the banking sector, including work to calculate and analyse the IMF-recommended banking sector financial soundness indicators.

SUPERVISORY AUTHORITY'S ACTIVITY IN 2008

In 2008, the Bank of Russia continued to upgrade the legislative framework of banking activities, including the carrying out of measures in line with the Bank of Russia Action Plan for the Implementation of the Russian Banking Sector Development Strategy until 2008.

In 2008, the Bank of Russia issued regulations aimed at improving banking regulation and supervision, including the state registration of credit institutions, the licensing of banking activities, the organisation of off-site supervision, on-site inspections, financial rehabilitation and liquidation of credit institutions and measures to counter the legalisation of criminally obtained income and terrorist financing.

The principal objective of off-site supervision in 2008 was the implementation of risk-based approaches, which make it possible to detect problems in credit institutions at early stages, the improvement of the dialogue with banks on their governance and risk management and the enhancement of the efficiency, effectiveness and adequacy of supervisory response to problems in credit institutions.

The supervisory authority paid closer attention to the banks of systemic importance for the country or region. To improve the quality of supervision of these banks, the Bank of Russia established the so-called 'second line' of supervision in its head office. The gist of this arrangement is that the staff of the head office has taken over a part of the supervisory functions with regard to these banks, overseeing them in collaboration with the respective Bank of Russia regional branches, which continue to fulfil their supervisory duties. The second-line supervision allowed the Bank of Russia to implement the 'four-eye principle' in overseeing large banks and made its supervisory response in regard to these banks prompter and more effective.

The appointment of curators virtually to all large banks and many medium-sized regional banks was a major step forward in organising off-site supervision. The principal task for the curators is to get a good idea of the business and risk profile of the credit institution they are in charge of and constantly monitor its activities. Curators have established closer contacts with owners and managers of credit institutions they are in charge of, holding working meetings with them to discuss the current situation and the riskiest lines of business. These practices implement in the most effective way one of the Core Principles for Effective Banking Supervision of the Basel Committee on Banking Supervision.

To upgrade supervisory practices by following the Basel Committee's recommendations and the international practice of risk-based supervision, which requires the comprehensive assessment of bank activities by giving up formal procedures in favour of substantive supervision, the Bank of Russia issued Ordinance No. 2005-U, dated April 30, 2008, 'On the Assessment of the Economic Situation of Banks,' which established the methodology for assessing bank performance and harmonised the approaches taken to the assessment of banks made by the Bank of Russia in the course of supervision and the approaches taken to the assessment of banks for the purpose of ensuring their compliance with the requirements for the participation in the deposit insurance system.

In 2008, the Bank of Russia continued to improve approaches to organising consolidated supervision of credit institutions and harmonising them with international standards in this area. Specifically, the Bank of Russia is currently testing a system of the banking sector financial soundness monitoring, which consists of three interrelated modules: regular risk monitoring, stress testing and analysis of financial soundness indicators.

ORGANIZATIONAL STRUCTURE OF BANKING REGULATION AND SUPERVISION IN RUSSIA

The supervisory divisions of the Bank of Russia head office comprise the Banking Regulation and Supervision Department, Credit Institutions Licensing and Financial Rehabilitation Department, Financial Monitoring and Foreign Exchange Control Department and the Chief Inspection of Credit Institutions. The principal objectives of these divisions are to provide methodological and organisational support for the Bank of Russia's legislatively-sealed functions in the field of banking regulation and supervision within the framework of the entire 'supervisory cycle': from the licensing of credit institutions, ongoing supervision over their activities and inspection to financial rehabilitation and, if necessary, liquidation of financially unstable credit institutions.

The supervisory divisions are run by the Bank of Russia's Banking Supervision Committee headed by the Bank of Russia First Deputy

Chairman who is responsible for this area. The Committee is responsible for the drafting of decisions on the implementation of policies in the field of banking regulation and supervision.

The Bank of Russia implements its policy in the field of banking regulation and supervision over the activities of credit institutions through its regional branches (national banks and main territorial branches). As of January 1, 2009, there were 20 national banks and 59 main territorial branches operating within the Bank of Russia system.

SUPERVISORY AUTHORITY'S INTERNATIONAL ACTIVITIES

In the first half of 2008, IMF and World Bank experts had completed the assessment of compliance of the Russian banking regulation and supervision practices with the Core Principles for Effective Banking Supervision, which was conducted under the Financial Sector Assessment Programme for the Russian Federation. The experts noted that the compliance situation had improved as compared with the previous assessment made in 2001-2003.

In 2008, the Bank of Russia and European Central Bank (ECB) experts drew up and approved a cooperation plan for the implementation of the EU-financed Bank of Russia-Eurosystem Cooperation Programme on Banking Supervision and Internal Audit in 2008-2010. In line with this plan, the Bank of Russia has elaborated and discussed at a meeting of ECB and Bank of Russia experts with representatives of the Russian banking community the minimum requirements for banks for the purpose of allowing them to use the internal ratings-based approach (IRB approach).

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Banks	1143	1092	1058
Non-bank credit institutions	46	44	50
Banking sector total	**1189**	**1136**	**1108**

Share in Aggregate Banking Sector Registered Authorized Capital (%)
(at year-ends)

Type of ownership	2006	2007	2008
Russian credit institutions	85,9	79,9	76,0
including			
public sector ownership	25,0	22,6	23,7
other domestic ownerghip	60,9	57,3	52,4
Foreign-controlled banks (banks with non-resident interest in excess of 50%)	14,1	20,1	24,0
Banking sector total	**100**	**100**	**100**

Share in Aggregate Banking Sector Assets
(at year-ends, %)

Type of ownership	2006	2007	2008
Russian credit institutions	87,9	82,8	81,3
including			
public sector ownership	34,8	36,3	37,5
other domestic ownerghip	53,1	46,5	43,8
Foreign-controlled banks (banks with non-resident interest in excess of 50 %)	12,1	17,2	18,7
Banking sector total	**100**	**100**	**100**

Credit Institutions Asset Concentration
(Share in assets, %)

Type of credit institutions	Three largest credit institutions (by assets)			Five largest credit institutions (by assets)		
	2006	2007	2008	2006	2007	2008
Banks	37,3	37,3	40,8	42,7	42,5	46,5
Non-bank credit institutions	89,1	88,4	93,4	93,3	91,5	95,2
Banking sector total	**37,1**	**37,1**	**40,5**	**42,4**	**42,3**	**46,2**

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

Type of credit institutions	2006	2007	2008
Banks	3,3	3,0	1,8
Non-bank credit institutions	1,2	1,6	1,9
Banking sector total	**3,3**	**3,0**	**1,8**

Return on Capital (ROE) of credit institutions*
(at year-ends, %)

Type of credit institutions	2006	2007	2008
Banks	26,2	22,7	13,3
Non-bank credit institutions	44,5	57,2	57,6
Banking sector total	**26,3**	**22,7**	**13,3**

* Calculated as the ratio of the current years balance sheet profit to the average chronological value of assets (equity capital) over the accounting period

Share in Aggregate Banking Sector Assets
(at year-ends, %)

Type of credit institutions	2006	2007	2008
Banks	99,37	99,53	99,32
Non-bank credit institutions	0,63	0,47	0,68
Banking sector total	**100,00**	**100,00**	**100,00**

Structure of Credit Institutions' Assets
(at year-ends, %)

Asset	2006	2007	2008
Money, precious metals and gemstones	2,6	2,5	3,0
Accounts with the Bank of Russia	6,8	6,4	7,4
Correspondent accounts with banks	2,9	2,1	4,4
Securities acquired by banks	12,5	11,2	8,4
Of which:			
Russian government debt obligations	3,8	2,9	0,9
Loans	67,8	71,0	71,2
Other assets	7,4	6,8	5,6
Total assets	**100,0**	**100,0**	**100,0**

Structure of Credit Institutions' Liabilities
(at year-ends, %)

Liabilities	2006	2007	2008
Banks' funds and profits	12,8	14,0	11,1
Loans received by banks from the Bank of Russia	0,1	0,2	12,0
Bank accounts	1,0	1,0	1,2
Loans, deposits and other funds received from other banks - total	12,4	13,9	13,0
Customer funds	61,8	60,9	52,6
Of which:			
Deposits of legal entities	34,3	35,0	31,3
Individuals deposits	27,3	25,6	21,1
Debt obligations issued	6,9	5,5	4,0
Other liabilities	5,1	4,5	6,0
Total liabilities	**100,0**	**100,0**	**100,0**

Development of Off-balance Operations (off-balance sheet positions/balance sheet assets (liabilities))
(at year-ends, %)

Type of credit institutions	2006	2007	2008
Banks	27,91	33,47	21,52
Non-bank credit institutions	11,52	124,61	2,63
Banking sector total	**27,81**	**33,90**	**21,39**

Capital Adequacy Indicator
(at year-ends, %)

Type of credit institutions	2006	2007	2008
Banks	14,9	15,5	16,8
Non-bank credit institutions	100,9	117,3	37,2
Banking sector total	**14,9**	**15,5**	**16,8**

Quality of Banking Sector Loan Portfolio
(at year-ends, as % of total loans)

Loan quality	2006	2007	2008
Standard loans	51,6	53,2	51,3
Non-standard loans	35,5	35,8	35,2
Doubtful loans	10,3	8,8	9,9
Problem loans	1,2	1,0	1,8
Bad loans	1,5	1,2	1,8
Loan loss provisions	**4,1**	**3,4**	**4,5**

calculations are made according to Form 0409115 Section 1 "Information on the Quality of Loans, Loan and Similar Debts" (Bank of Russia Ordinance No, 1376-U, dated January 16, 2004, "On the List, Forms and Procedure of Compiling and Presenting by Credit Institutions Statements to the Central Bank of the Russian Federation").

Deposit and Loan Structure in 2008
(at year-ends, %)

	Loans, deposits and other funds raised by credit institutions	Loans, deposits and other funds provided by credit institutions
Government financial authorities and extra-budgetary funds*	19,5	0,8
Legal entities	21,4	60,2
Individuals	31,4	20,5
Banks	5,2	5,2
Non-residents **	22,5	13,3
Total	**100,0**	**100,0**

* Including the Bank of Russia,
** Including banks and other legal entities and individuals

Deposit and loan structure in 2008*
(at year-ends, %)

Loans, deposits and other funds raised by credit institution		Loans, deposits and other funds provided by credit institutions	
On demand	1,4	Long-term (over 3 years)	35,0
Less than 1 year	44,7	Mid-term (1-3 years)	25,0
Over 1 year	53,9	Short-term (less than 1 year)	40,0
Total	**100,0**	**Total**	**100,0**

* Excluding overdue debt,

Share of Foreign Currency Assets and Liabilities in Aggregate Banking Sector assets and liabilities
(at year-ends, %)

Type of credit institution	Foreign currency assets/ aggregate assets			Foreign currency liabilities/aggregate liabilities		
	2006	2007	2008	2006	2007	2008
Banks	24,9	23,2	32,3	25,1	23,0	28,4
Non-bank credit institutions	4,6	3,4	29,4	2,9	1,6	27,0
Banking sector total	**24,8**	**23,1**	**32,3**	**25,0**	**22,9**	**28,4**

Structure of Incomes and Expenses of Operating Credit Institutions (at year-ends, %)

	2006	2007	2008
1. Incomes, total	**100,0**	**100,0**	**100,0**
1.1. Interest income on funds provided to legal entities (without income on securities)	10,49	11,13	8,36
1.2. Interest income on loans to individuals	3,67	4,24	3,13
1.3. Incomes on securities	7,62	8,11	3,48
1.4. Incomes on operations with foreign exchange	39,33	36,90	62,27
1.5. Commissions received	4,57	4,51	2,85
1.6. Loss provisions recovery	26,14	25,78	12,84
1.7. Other incomes	8,19	9,33	7,07
Of which:			
1.7.1. penalties, fines, forfeits	0,15	0,19	0,16
2. Expenses, total (without income tax)	**100,0**	**100,0**	**100,0**
2.1. Interest expenses on funds raised from legal entities (without expenses on securities)	3,29	4,16	3,68
2.2. Interest paid to individuals	3,24	3,40	2,02
2.3. Expenses on operations with securities	5,35	6,21	3,55
2.4. Expenses on operations with foreign exchange	41,12	38,64	62,37
2.5. Commissions paid	0,51	0,48	0,38
2.6. Expenses on loss provisions	29,99	29,43	15,82
2.7. Management expenses (including personnel expenses)	5,91	6,12	3,91
2.8. Other expenses	10,59	11,56	8,28
Of which:			
2.8.1. Penalties, fines, forfeits	0,01	0,02	0,01

Structure of the Registered Authorized Capital and Equity Capital of Credit Institutions in 2008

Type of credit institution	Registered capital	/Total assets	Own funds	/Total liab.
	Mill. EUR	%	Mill. EUR	%
Banks	21 238,8	3,2	91 842,4	13,7
Non-bank credit institutions	28,7	0,6	133,5	2,9
Banking sector total	**21 267,5**	**3,1**	**91 975,9**	**13,6**

2008 DEVELOPMENTS IN THE SERBIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The world economic crises spill-over its effects in Serbia during last two quarters of 2008 and as a result Serbia's economy is facing a substantial fall in output (its GDP recorded negative quarterly growth rates in both Q3 and Q4). Both exports and domestic demand are declining more sharply than production and this is the main cause for an abrupt drop in economic activity. The bad results of economic activity also point to the weaknesses in economic growth, which relied for the most part on domestic demand stimulated by high foreign capital inflows.

Inflation rates were high in H1 2008 and low in H2 2008. RPI growth for the year as a whole amounted to 6.8% (hence overshooting the upper bound of the 3-6% end-2008 target range), while core inflation reached 10.1%. The newly adopted NBS target – consumer price index, stood at 8.6% in December.

While H1 2008 was marked by growth in oil and commodity prices, the prices observed shifted in the opposite direction in H2 to reach their historical lows. Furthermore, Q4 saw an even more radical drop in prices of agricultural products and foodstuffs, as well as a decline in aggregate demand, which implies that disinflationary factors at the year-end prevailed over inflationary pressures caused by the devalued dinar.

In 2008, the dinar depreciated nominally against the euro on average by about 2%. The exchange rate averaged 81.4 RSD/EUR. In 2008 we saw considerable fluctuations in the exchange rate. In the first half of the year, the reason for this was political instability and, in the second, it was the effects of the global financial crisis (risk premium growth), tighter access to foreign sources of finance and significantly decreased capital inflow. Additional pressure on foreign currency liquidity was suffered by the banks due to the withdrawal of household foreign currency savings. Only in October 2008 as much as EUR 864 million were withdrawn and throughout the last quarter the total of about EUR 1 billion (17% of the total amount).

The current account deficit in 2008 reached EUR 8,731 million or USD 9,043 million, grants excluded. Thus, the deficit rose 37.8% on the year before and its share in GDP upped from 15.5% to 17.1%.[38] The lowering of such a high share of current account deficit in GDP is a precondition for bringing the dynamics of foreign borrowing within sustainable boundaries.

The widening of the current account deficit in 2008 was driven by the increased trade deficit (23.3%), which resulted from vigorous growth in both exports (25.1%) and imports (24.2%)[39]. The effects of the global economic crisis, manifesting as a lower supply of foreign capital and a bout of recession, led to the depreciation of the exchange rate of the dinar and

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[38] Projection of the balance of payments of the Republic of Serbia for 2008 envisages a 12.1% current account deficit to GDP ratio, grants excluded.

[39] Projection of the balance of payments of the Republic of Serbia for 2008 envisages faster growth in exports relative to imports (34.4% v. 27.4%).

the narrowing of the trade and current account deficits starting from mid-2008 and escalating in Q4. However, depreciation of the exchange rate had no effect on export not only due to its lower elasticity to depreciation relative to other incentive factors, but also due to dramatic decline in foreign demand and prices of our export products. The root causes of such movements lie in the structural imbalances such as growth in public expenditure, investments and wages, as well as unchanged export structure attributable to delays in the privatisation process.

Outlook for 2009 is not optimistic too. We expect further drop of economic activity, as well as reduction of foreign trade connected with sharp drop of domestic demand. On the other side, such a big drop in domestic demand, despite expected continuation of dinar depreciation will contribute to further disinflation process.

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

At year-end 2008, there were 34 banks in Serbia with banking license given by the NBS.

The most significant changes in ownership structure of Serbian banking sector in 2008: two banks (acquired by NLB from Slovenia) merged, also two banks (owned by National Bank of Greece) merged and one bank from Russia established presents in Serbia.

Banking sector total balance sheet assets reached 20,1 billion EUR at year-end 2008, which represented growth of 13,6% compared to year-end 2007.

Banks recorded significant growth in own funding sources (27,9%) which resulted in increased proportion of own funds in total liabilities side of balance sheet (23,6%). This was the main source of balance sheet growth. Capital injections were mainly caused by regulatory demands whose aim was to provide capital base for further credit growth and some of which resulted in CAR ratio decline. Serbian banking sector is well capitalized, with capital adequacy ratio being significantly above regulatory minimum (21,9%).

Deposits recorded nominal growth of 6,7% in 2008. Even though the Serbian banking sector did not have direct exposure to the impact of the financial crisis, it was heavily hit by decline in confidence among savers which led to withdrawal of households foreign currency savings of 0,8 bill EUR. Outflow has stopped from the end of December, but in EUR, level of 2007 has not been reached yet.

Deposits of natural persons make 26,3% of total bank funding sources. Maturity structure of deposits has been further improved, share of short term deposits is 59,4%. Despite outflow at the end of the year, share of foreign currency deposits (69,0%) increased.

Share of banking sector balance sheet assets in GDP was decreased compared to the year-end 2007: from 67,1% to 65,7%.

Intensive growth in banks' credit activity, although stopped in 2008 (growth of 24,6%), still is primarily caused by growth of dinar (mostly fx indexed) and long term loans to enterprises and households..The global financial crisis influenced the asset side of the banking sector balance sheet

– the banks became much more risk-averse which is reflected in slow-down of credit activity, while NPL ratio is worsening. The riskiest placements are those to other enterprises, which share in total NPL is over 80%, especially placed to agriculture and construction sectors and primarily granted by banks majority owned by the state and domestic persons.

In 2008, net profit before tax was over 390 billion EUR and banks managed to increase ROA (2,1) and even ROE (9,3) and improve all performances of profitability.

Net interest income is the major contributor to banking sector profit and represents stable and sustainable source of profitability in banking sector in Serbia..

Despite expansion of banking network (business units, branches, branch offices etc) and growing number of employees, operational efficiency of the banking sector was also improved – upward trend in the ratio of net income from interest and fees to operational expenses was maintained.

Banking sector recorded satisfactory level of liquidity in spite of reduced access to foreign funds, because of strong liquidity reserves requirement and aggressive approach towards attracting customer deposits.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The NBS' activities in this field were aimed at:

- complying, as much as it is possible, with Basel I Standards (the introduction of additional capital requirements for market risks in calculation of CAR), and introduction some elements of Basel II Standards,
- standardizing risk management practices across banks, by providing a more detailed definition of the risk management system and management of individual risks to which the bank is exposed,
- creating adequate regulatory framework for strengthening and improving liquidity risk management in banks,
- closely monitoring movements in bank lending from the aspect of maturity, currency and sectoral distribution, as well as from the aspect of the volume of loans approved by individual banks, and applying measures to slow down bank lending.

Since October 2008, when global financial crisis first started to influence Serbian economy, all the steps taken by the NBS were aimed at imposing temporary measures in order to prevent or mitigate disturbances, preserve stability of Serbian banking and overall financial system, improving liquidity of the banking sector, stimulating bank credit activities, monitoring the deterioration of bank asset quality and lowering the cost of financing.

Some measures included:

- relaxation of gross household lending – to – Tier 1 ratio for effects of FX rate movements, from 150% to 200%,
- relaxation of classification rules in case of extensions of maturity,
- cancellation of general banking risks provision requirements,
- distribution of dividends and certain exceptions for large exposures limits conditioned by written shareholders' letter of commitments,
- a new set of reports was introduced.

The Parliament adopted the changes in the Deposit Insurance Law, by which the guaranteed amount of deposits was increased from EUR 3.000 to EUR 50.000, and the insured deposits were extended to SMEs and entrepreneurs.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

In 2008, activities NBS was focused on:

- further amendment and harmonization of domestic regulations with European Union directives, and international principles and standards of banking supervision,
- intensive implementation of the plan designed to improve NBS performance in carrying out supervision over banks,
- assessment of banks' risk management systems and procedures,
- improvement of communication with commercial banks,
- enhancement of operational transparency of banks in order to safeguard the interest of the users of banking services,
- improvement of human and technical resources, primarily through further education and training, and
- mitigation of impact of financial crisis and preservation of stability of Serbian banking and overall financial system.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

Working group in charge for implementation of Basel II framework completed its preliminary activies in accordance with Strategy for Implementation of Basel II framework - comparison of domestic and EU regulations and practices, recommendations for harmonization with Basel Committee's Core principles for effective banking supervision, and comparative analysis of EU member states and southeastern Europe countries' regulations.

The Working group has drawn up Operating Plan of Activities in the course of Basel II implementation in which it defined main goals, activities and deadlines for their completion. Also, a summary of discretional rights available by EU Directives 2006/48/EC and 2006/49/EC was completed. Besides that, Questionnaire on Basel II implementation was sent to banks and results were analyzed by individual banks, peer groups, ownership groups and for total banking system. The Working group has also composed a document "Main elements of Basel II implementation plan", on the basis of which the banks had to draw up their own plans and submit them to the Working group. On the basis of the Working group's recommendations, all banks had to form teams for Basel II implementation and appoint team coordinators to cooperate with the Working group in this process.

During the 2008 the Working group prepared first and second draft of regulation (6 decisions).

In 2008 NBS continued enhancing existing capabilities of stress testing methodology. Main entities developed in this period were contagion effects, CAELS rating system and scenario analyses.

Interbank contagion effect deals with spill over through insolvencies among banks based on two approaches: Pure interbank and Macro Interbank contagion. Pure interbank contagion tests what would happen with the capital of the each bank if others failed on their borrowings while macro interbank contagion is based on assumptions that shock triggers contagion effects among banks.

CAELS rating system is used to perform full evaluation of a performance for each bank. The overall grade is composed from weighted scores on each indicator and linked to the probability of default. These also enable an estimation of the most sensitive spots in business of each bank as well as composite grade before and after applied shocks.

A scenario analysis relies on Monte Carlo assumptions generator which conducts tens of thousands scenarios thereby stressing banking sector in every plausible way. The results represent statistics for every indicator used in stress test and confidence levels for assessing performance for each indicator.

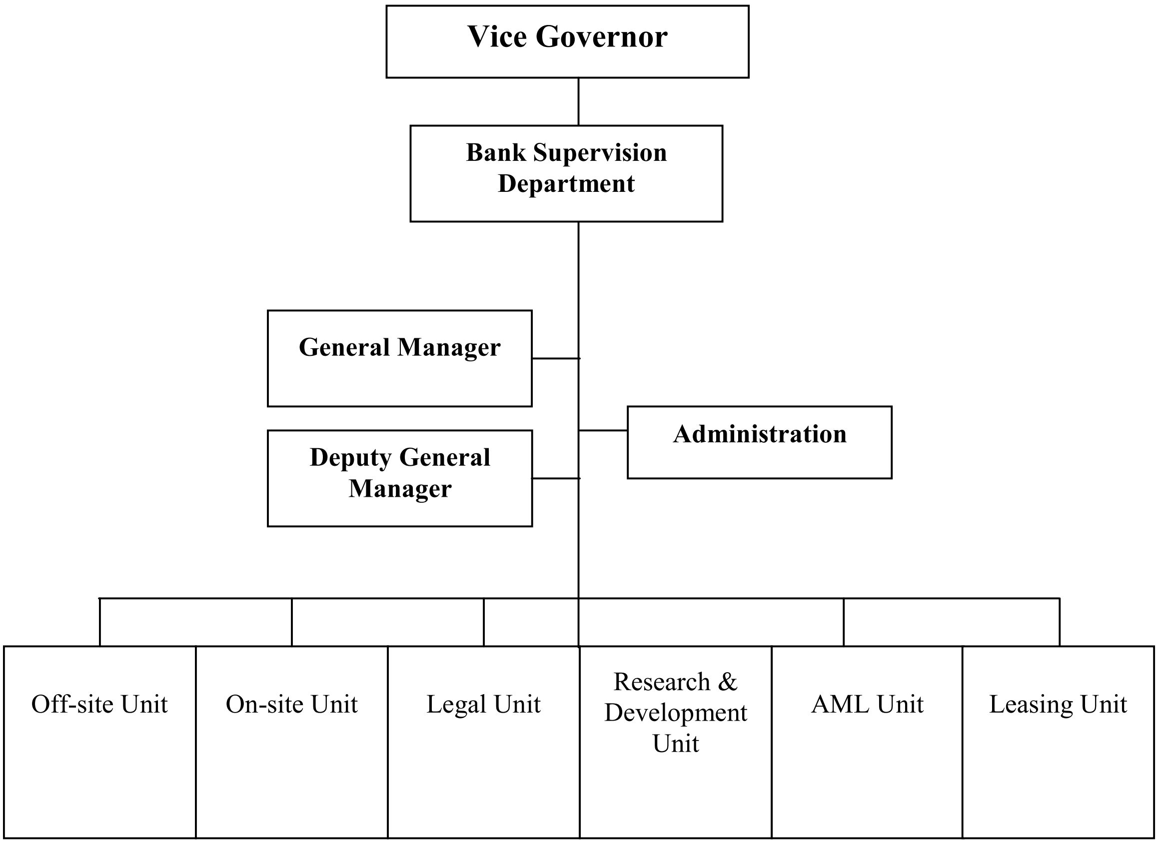
Since 2001, the NBS had used CAMEL rating system which is widely accepted methodology for bank analysis and rating. CAMEL methodology applied by the NBS is based on two sorts of analyses:

- quantitative analysis of financial and prudential reports that banks regularly produce and submit and other documentation available to the NBS,
- qualitative estimate of banks' management ability to identify, measure, monitor and control risks.

CAMEL analysis is conducted by the NBS on a regular basis (quarterly). Its conclusions can be used as a recommendation of on-site examination.

In the course of 2008, 23 on-site supervisions were conducted in a total of 18 banks. Within on-site supervision, the NBS conducted ten examinations of dinar and foreign exchange payment operations and implementation of the provisions of the Law on the Prevention of Money Laundering, the Decision on Minimum Contents of the "Know Your Client" Procedure and the Decision on Terms and Conditions of Opening, Managing and Closing a Bank Account.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

National Bank of Serbia has signed Memorandums of Understanding with following supervisory authorities:

- Central Bank of Cyprus - 27/11/2006
- Bank of Greece - 27/12/2002
- National Bank of the Republic of Macedonia - 28/05/2008
- Central Bank of Montenegro - 22/04/2003
- Bank of Slovenia - 02/06/2004
- Central Bank of the Bosnia and Herzegovina Federation Agency for Banking of the Bosnia and Herzegovina Federation Agency for Banking of the Republic of Srpska - 23/07/2004
- Banca d' Italia - 02/02/2007
- Hungarian Financial Supervisory Authority - 10/01/2008
- Bank of Russia - 19/06/2008
- Banking, Finance and Insurance Commission (CBFA) – Belgium - 4/08/2008

National Bank of Serbia also signed following multilateral agreements:

- Bank of Albania, Bank of Greece, National Bank of the Republic of Macedonia, National Bank of Romania, Bulgarian National Bank, National Bank of Serbia, Central Bank of Cyprus - 06/07/2007
- Banking Agency of the Federation of Bosnia and Herzegovina, Bank of Albania, Bank of Greece, National Bank of the Republic of Macedonia, Banking Agency of the Republic of Srpska, National Bank of Romania, Bulgarian National Bank, National Bank of Serbia, Central Bank of Bosnia and Herzegovina, Central Bank of Montenegro, Central Bank of Cyprus - 08/02/2008

National Bank of Serbia is in the process of negotiating MoU-s with FMA (Austrian supervisory authority), BaFin (Germany) and Commission Bancaire (France), and has already established very successful cooperation with those supervisory authorities, since those authorities supervise parent banks that have its subsidiaries in Serbia.

Beyond signing Memorandums of Understandings, cooperation extended thorough:

- Participation at Supervisory Colleges - NLB Group, Erste Group, Volks Group, RZB Group, OTP Group, Intesa Group, UniCredit Group. The important document, which will be signed between home and host supervisors, is MMOU. Among other things, main part of this document will be exchange of information regarding the financial crisis. Cooperation with foreign supervisory bodies (Croatian National bank and Bank of Slovenia in preparation of Basel II related regulations and Law on banks),
- Participation in joint on-site exams,
- Sharing of information connected with granting the consent on appointment of members of Board of Directors and Executive Board of banks.

COOPERATION WITH OTHER SUPERVISORY BODIES IN SERBIA

The NBS has signed, at the beginning of 2008, Memorandum of Understanding with the Commission for Competition Protection.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

During the last year:

- Supervisory Operating Policy and manuals was adopted:
- A new Chart of Accounts complied with IFRS reporting requirements was adopted and published:
- New regulation (in the field of capital adequacy, risk management and classification of balance sheet assets and off-balance sheet items) was adopted and came into force as of July 1st 2008:
- Basel II implementation roadmap was introduced:

- In order to intensify communication the NBS, sent letters to all home supervisors in countries in which banks in Serbia have parent banks regarding actions they have took, their future intentions and some problems that home parent banks may have (October 2008). This information is very important from the aspect of monitoring liquidity Serbian banks and potential negative influence of crisis in parent banks.
- In December 2008, the National Bank of Serbia sent the Letter of Commitment to all major shareholders of Serbian banks, with the purpose of obtaining written consent that they will be ready to provide additional financial support during stressful period, should the Serbian bank's financial fundamental deteriorate. All parent banks submitted signed Letter of Commitment, expressing its firm intentions to remain committed to its business operations and investment programs in Serbia.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of institution	2006	2007	2008
Banks	37	35	34
Financial institutions, total			

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

Item	2006	2007	2008
State ownership	14,3	11,8	10,5
Other domestic ownership	12,6	11,0	10,4
Domestic ownership total	26,9	22,8	20,9
Foreign ownership	73,1	77,2	79,1
BANKS total	**100.0**	**100.0**	**100.0**

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

Item	2006	2007	2008
State ownership	14,8	15,7	16,0
Other domestic ownership	6,5	8,8	8,7
Domestic ownership total	21,3	24,5	24,7
Foreign ownership	78,7	75,5	75,3
BANKS total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Bank	32,7	46,2

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

Type of institution	2006	2007	2008
Bank	1,7	1,7	2,1

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

Type of financial institution	2006	2007	2008
Bank	9,7	8,5	9,3

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

Type of financial institution	2006	2007	2008
Bank	100	100,0	100,0
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Assets	2006	2007	2008
CASH AND CASH EQUIVALENTS	6,2	5,1	15,0
CALLABLE DEPOSITS AND LOANS	35,6	35,3	15,5
RECEIVABLES IN RESPECT OF INTEREST, FEES, SALE, CHANGE IN FAIR VALUE OF DERIVATIVES AND OTHER RECEIVABLES	0,4	0,4	0,6
GRANTED LOANS AND DEPOSITS	46,1	49,5	60,1
SECURITIES (EXCLUDING OWN SHARES)	2,2	1,2	1,1
INTERESTS (STAKES)	0,4	0,4	0,3
OTHER PLACEMENTS	3,0	2,9	2,1
INTANGIBLE ASSETS	0,5	0,4	0,4
FIXED ASSETS AND INVESTMENT PROPERTY	4,3	3,7	3,7
FIXED ASSETS FOR SALE AND ASSETS FROM DISCONT. OPER.	0,0	0,0	0,0
DEFERRED TAX ASSETS	0,2	0,2	0,2
OTHER ASSETS	1,1	0,9	1,0
Liabilities	**2006**	**2007**	**2008**
TRANSACTION DEPOSITS	19,2	19,2	15,3
OTHER DEPOSITS	37,7	42,2	42,4
LOANS RECEIVED	18,4	10,8	10,7
LIABILITIES IN RESPECT OF SECURITIES	0,0	0,2	0,0
LIABILITIES IN RESPECT OF INTEREST, FEES AND CHANGE IN FAIR VALUE OF DERIVATIVES	0,1	0,2	0,1
OTHER RESERVES	0,8	0,8	0,8
TAX LIABILITIES	0,0	0,0	0,0
LIABILITIES FROM PROFIT	0,1	0,0	0,1
DEFERRED TAX LIABILITIES	0,1	0,0	0,0
OTHER LIABILITIES	5,1	5,6	7,0
CAPITAL	18,5	21,0	23,6

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

Type of financial institution	2006	2007	2008
Banks	1,00	1,01	1,21

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Banks	24,7	27,9	21,9

Asset portfolio quality of the banking system

Asset Classification	2006	2007	2008
A	285.984	353.572	550.834
B	136.864	287.040	297.251
C	107.263	159.122	133.472
D	18.075	32.302	81.334
E	79.876	102.422	114.639
Classified total	**628.062**	**934.458**	**1.177.531**
Specific reserves	**99.138**	**120.614**	**142.633**

* Because of changes in methodology, data of 2006 and 2007 are not comparable with data of 2008

The structure of deposits and loans in 2008 (%)
(at year-end) banking system

	Deposits	Loans
Households	45,6	36,1
Government sector	6,7	2,9
Corporate	26,2	48,9
Foreign	11,0	2,9
Other	10,5	9,2
Total	**100,0**	**100,0**

The structure of deposits and loans in 2008 (%)
(at year-end)

Maturity of Deposits		Maturity of Loans	
At sight	36,2	Long term loans (over 1 year)	25,6
Within one year	59,4		29,4
Over one year	4,4	Short-term loans	45,0
Total	**100,0**	**Total**	**100,0**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2006	2007	2008	2006	2007	2008
Banks	32,5	28,2	21,5	59,0	53,6	55,0

* FX indexed assets and liabilities are not included

* Please indicate off-balance Foreign Exchange sheet items/ total liabilities if possible

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

Revenues	2006	2007	2008
INTEREST INCOME	16,7	16,2	14,7
FEE AND COMMISSION INCOME	6,1	5,3	3,7
GAINS ON SECURITIES	0,4	0,5	0,1
GAIN ON FOREIGN EXCHANGE RATE	59,4	58,5	54,3
DIVIDEND AND STAKE INCOME	0,0	0,2	0,1
OTHER OPERATING INCOME	14,2	9,2	7,6
INCOME FROM PROPERTY AND OBLIGAITONS VALUE CHANGE	3,2	10,1	19,5
Expenditures	**2006**	**2007**	**2008**
INTEREST EXPENSES	6,4	7,1	6,0
FEE AND COMMISSION EXPENSES	1,4	1,2	0,9
LOSS ON SECURITIES	0,2	0,0	0,0
LOSS ON FOREIGN EXCHANGE RATE	59,3	59,4	61,2
EXPENSES FOR INDIRECTLY WRITE-OFF OF PLACEMENT AND PROVISIONS	13,9	10,7	10,0
OTHER OPERATING EXPENSES	14,4	11,4	8,5
EXPENSES FROM PROPERTY AND OBLIGAITONS VALUE CHANGE	4,4	10,2	13,4

Structure of registered capital and own funds of financial institutions in 2008

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	000 EUR	%	000 EUR	%
Banks	2.955.841	14,7	4.740.473	30,9

* Assets – own funds

2008 DEVELOPMENTS IN THE SLOVAKIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2008, the National Bank of Slovaia (NBS) implemented its monetary policy in an environment of dynamic economic growth and continued pursuing an inflation-targeting strategy under ERM II in line with its Monetary Programme for the Period until 2008. In view of the commitments arising from EU membership, the task to create conditions for the adoption of the single European currency in January 2009, and the commitment of the Government to reduce the fiscal deficit, NBS set a target rate for year-on-year inflation, expressed in terms of the Harmonised Index of Consumer Prices (HICP), below 2% for December 2008, so that the Maastricht criterion for the average 12-month inflation rate was met.

Consumer prices, expressed in terms of the Harmonised Index of Consumer Prices (HICP), dropped incomparison with the previous month by 0.1% in December. The year-on-year rate of headline inflationreached 3.5%. Core inflation (excluding energy and unprocessed food prices) recorded a year-on-yearrate of 3.8%. Measured in terms of the Consumer Price Index (CPI), consumer prices went down by 0.2% in December compared with the previous month. The 12-month headline and core inflation rates reached 4.4%and 3.3%, respectively. The M3 monetary aggregate (according to ECB methodology) grew month-on-month by SKK 11.8 billionin November, and its year-on-year dynamics increased in comparison with October to 6.1%.

The total volume of MFI receivables from residents (including securities issued by clients and held by

MFIs, according to ECB methodology) increased month-on-month by SKK 19.9 billion in November,

while the year-on-year growth rate remained unchanged (13.6%).

The average interest rate on new loans to non-financial corporations dropped in November by 0.51 of

a percentage point to 5.24%, while that on new loans to households rose by 0.61 of a percentage pointto 12.89%. Over the same period, the average rate for new deposits from non-financial corporations fell by 0.47 of a percentage point to 1.71%, and that for new household deposits remained unchanged at 1.38%.

At the end of December, the State budget of the SR resulted in a deficit of SKK 21.2 billion.

The foreign reserves of Národná banka Slovenska (at current exchange rates) stood at USD 18.8 billion in December. At the end of the month, the volume of reserves was 2.7 times greater than the volume of average monthly imports of goods and services to Slovakia during the first eleven months of 2008.The coverage of average monthly imports (imports of goods and services according to data from banking statistics) by the official foreign reserves corresponded to 3.5 times the volume of average monthly imports of goods and services to Slovakia over the first eleven months of 2008. Národná banka Slovenska (NBS) conducted no foreign exchange intervention in December.

According to preliminary data, the balance of payments on current account for December 2008 resulted in a deficit of SKK 18.0 billion (from January to December, the deficit reached SKK 114.5 billion), while the trade balance produced a shortfall of SKK 12.0 billion.

In December, the overall sterilisation position of NBS fell month-on-month by SKK 2.9 billion, to SKK 383.9 billion.

DEVELOPMENT IN THE BANKING SYSTEM

The direct impact of negative developments in financial markets on the financial sector stability was moderate in 2008.

The deepening financial crisis, an emerging economic crisis and the preparation for entering into the euro area were the main driving forces behind the developments in the Slovak financial sector throughout the year 2008.

The world-wide financial crisis that broke out at the outset of the second half of 2007 was causing major global turbulences during the whole of 2008 and became so severe at the turn of the third and fourth quarter that it began to threaten the very existence of the global financial system. Uncertainty and a plunge in confidence on financial markets caused significant decreases in financial asset prices.

Compared to other developed countries, the impact of this phase of the financial crisis on the domestic financial sector was relatively low. In the banking sector in particular, the reason why the impact was rather moderate lay in the sector's relatively strong links to domestic economy and in the fact that the share of banks' activities related to foreign countries was negligible. Among other things, they minimised their exposures against many innovative instruments of the present-day world of finance that have proven to be the main cause of the crisis spread.

Nevertheless, financial crisis in this form manifested in a more pronounced way in the sectors of collective investments and pension savings. From the clients' point of view, this chiefly meant a fall in the rate of return (down to negative nominal year-on-year performance in many cases) of products investing assets in global stock markets and, partially, in bond and other markets as well. Financial sector institutions were affected by the crisis especially in the form of a decrease in the amount of assets in some segments and of a fall in profitability.

Lower credit activity in the banking sector

In view of the fact that the Slovak banking sector is predominantly linked with domestic economy, the economic crisis constitutes a more serious threat to financial stability than the financial crisis. This crisis began to manifest more considerably especially during the last quarter of 2008 when a fall in foreign demand in the euro area and in surrounding countries significantly limited industrial production and effected a decrease in profitability. The deteriorated financial position of the corporate sector and, in particular, negative future prospects manifested relatively fast on the loans market. This was also propelled by a relatively high proportion of loans to sectors that are notably more sensitive to a fall in the economic cycle. Banks were tightening their credit standards, making the direct return of financial flows the main issue. At the same time there was a decline in the demand for loans, especially companies' demand for long-term loans. On the whole, this development was reflected in a lower accessibility of loans to the corporate sector.

The situation was slightly different in the household sector. Although selected indicators for the household sector reported deterioration, it was not as critical as in the corporate sector. Lower growth in the household loans market was caused especially by a fall in demand related to expectations that real estate prices would continue to decrease as well as to a slump in the population's economic sentiment as to their future economic situation.

In relation to the adoption of the single currency euro, banks recorded a relatively significant increase in primary funds from customers. In this way, customer deposits remain high above loans to clients. This is a positive phenomenon at the time of a crisis as it gives banks even greater possibility to reduce their dependence on obtaining funds from financial markets. That is to say that the negative development on financial markets also influenced banks' capability to issue bonds, mortgage bonds in particular. Soaring prices of resources coupled with low accessibility of long-term resources were limiting the option of financing by means of these instruments.

Stable financial position of the banking sector

Banking sector was able to generate a relatively high profit in 2008, with several banks having significantly increased their profitability year-on-year. Development was positive especially in large banks. On the other hand, the number of banks with a year-on-year decline in profitability increased as well. Interest income remained the main source of income in 2008.

The ratio of the total assets/GDP reached 92, 9%, in comparison with the year 2007 it incrased above 3,3 %.

In the last quarter of 2008, when the growth rate of interest income declined, profitability was one of the areas where banks recorded a negative trend. The reason for that was a fall in the amount of corporate loans, falling interest rates on loans to customers, and increasing interest expenses in the household sector. Creation of provisions in most banks virtually remained at the same level as in 2007.

Banks' opportunities to increase their profitability will be severely limited in 2009. Stagnation on the loans market will have a negative impact on interest income and on income from fees. On the other hand we assume that the fall in interest margins resulting from increased credit risk will stop. Provisioning expenses will rise if economy deteriorates as anticipated. Banks will record lower income from foreign exchange operations than in 2008. We expect that these trends will be the major contributors to the fall in profitability in 2009.

The banking sector reported a relatively good capital position at the end of 2008. Most banks were increasing their own funds in 2008, mainly so as to maintain retained profit from past years in their capital.

Quality of own funds remained high, with the Tier 1 component of capital dominating.

THE LEGAL AND INSTITUTIONAL FRAMEWORK

In exercising supervision of the financial market – in banking, the capital market, the insurance industry and pension saving – Národná banka Slovenska follows general procedural rules laid down in Act No. 747/2004 Coll. on Financial Market Supervision and amendments to certain acts as amended. This Act entered into force on 1 January 2006, the date when Národná banka Slovenska assumed the competences of an integrated financial market regulator. Until 31 December 2005, the said powers with respect to the insurance sector, capital market and pension saving had been exercised by the Financial Market Authority. The aim of financial market supervision, which falls with under the authority of a Deputy Governor of Národná banka Slovenska, is to support both the stability of the financial market as a whole and its secure and smooth operation. Based on this fact, the financial market supervision unit conducts financial market regulation, involving mainly the activities below:

- Rulemaking activities (it drafts the generally binding legal regulations of Národná banka Slovenska in the financial market field, in particular, prudential regulation, operational security rules and other requirements for the conduct of business by supervised entities, participates in preparing generally binding legal regulations issued by central government bodies and, in addition, issues methodological guidelines for supervising entities in the financial market);
- Licensing activities (it conducts proceedings, takes first-instance decisions, issues authorizations, approvals and prior approvals, and imposes sanctions and corrective measures);
- Supervision activities (it supervises financial market entities through onsite and offsite supervision);
- Analytical activities (it produces analyses regarding the overall financial market as well as about individual financial entities).

The consumer protection department, as part of the financial market supervision unit (tasked with consumer protection in accordance with the Act on the NBS and the Act on Supervision) handles petitions from the customers of financial institutions that Národná banka Slovenska supervises by virtue of the above Acts and the organizational rules of Národná banka Slovenska.

The financial market comprises four sectors: the banking sector (principally represented by banks and branches of foreign banks); the capital market (principally represented by investment firms, management companies, the stock exchange, the central securities depository, issuers and investment service intermediaries); the insurance sector (principally represented by insurance companies and branches of foreign insurance companies); and the pension savings market (principally represented by pension fund management companies and supplementary pension companies).

Slovakia's membership in the European Union means foreign-regulated entities may operate in the country without a licence from Národná banka Slovenska, provided they are authorized to conduct such activities in another EU Member State (the single passport principle).

MAIN STRATEGIC OBJECTIVES IN 2008

One of the main tasks of the acts and regulations adopted in 2008 was to establish the legal prerequisites for problem-free changeover to a new currency – the euro, valid since 1 January 2009. With this intention, the financial market supervision unit established a working group to draft legislation related to adopting the euro for all regulated financial market entities. The supervision unit issued, for example, NBS Provision No. 24/2008 governing the change in currency in all existing reports from supervised entities, NBS Decree No. 221/2008 Coll., laying down rules for dual display of some prices, payments and other values in the financial markets field and the services of financial institutions and NBS Decree No. 240/2008 Coll., determining the number of decimal places when rounding certain securities to be redenominated from Slovak currency to euros.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN THE YEAR 2008

Rulemaking activities of the supervision unit

In the field of financial market regulation, several acts, regulations, methodological instructions and recommendations governing the legal environment of regulated entities were adopted in 2008. The purpose in this section is not to list these measures, but rather to draw attention to those items which have had the greatest impact on the activities of regulated entities in individual financial market sectors in Slovakia.

The most important legal regulation for the banking and investment services sectors in 2008 was the adoption of Act No. 552/2008 Coll. of 26 November 2008, amending Act No. 566/2001 Coll. on Securities and Investment Services and on amendments to certain acts (the Securities Act) as amended and on amendments to certain acts. In addition, Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector was transposed to the above Act and several modifications were made to it following practical application in the supervision of financial market entities. The Act also amended several acts regulating other financial market sectors. In respect to the deepening crisis in the financial sector, the adoption of NBS Provision No. 18/2008 on liquidity of banks and branch offices of foreign banks in the Slovak banking sector and management of their assets and liabilities was the most significant among the regulations adopted in 2008 for the banking sector. Another important regulation was Provision No. 17/2008, amending NBS Decree No. 4/2007 concerning reserves in banks and capital requirements for banks and reserves in investment firms and capital requirements for investment firms, as amended by NBS Decree No. 10/2007. Proposed amendments to a provision determining utilizable credit risk hedges, including a definition of terms for independent valuators, calculations of proprietary involvement and risk-weighted exposures to other public authorities and legal persons other than businesses, resulted from practical application, findings made by NBS in supervision and several discussions with representatives from the Slovak Bank Association and the Slovak Association of Securities Dealers.

Licensing activities of the supervision unit

In 2008, the financial market supervision unit of NBS issued 987 decisions on licenses, where a majority of them related to the capital market and banking sector. In addition to issuing the above decisions, the supervision unit in 2008 received for all financial market sectors a number of notices from supervised entities, approved security prospectuses and acceptance bids and issued 34 other decisions related to foreign exchange activities. In the banking sector, there were 64 lending institutions and 318 investment firms which had stated their intention to provide cross-border banking activities and investment services in Slovakia.

The financial market supervision unit is the competent body of NBS to act and decide in the first instance. Within these activities, the supervision unit took action during 2008 in 51 cases against supervised financial market entities, of which 46 were begun and 31 concluded in this year. The largest number related to the insurance sector, the banking sector and investment firms.

Consumer protection

The financial market supervision unit is also tasked, in accordance with the Act on Národná banka Slovenska and the Financial Market Supervision Act, with protecting consumers of the financial market entities and, therefore, it handles petitions from consumers at the financial institutions Národná banka Slovenska supervises. In 2008, the supervision unit received 871 petitions from consumers at financial market institutions (both natural and legal persons) who were dissatisfied with the practices of financial services providers. Of the number received, the unit managed over the course of 2008 to close out 830 files, representing a 95.29% success factor in processing petitions. Most of the petitions received (561) concerned the insurance sector. The consumer protection department, in fulfilling the consumer protection role assigned to Národná banka Slovenska by the Financial Market Supervision Act and respecting the competence of Národná banka Slovenska in the above field, guaranteed dissatisfied consumers of insurance companies, banks and other supervised entities, in many cases, corrective action or a change in the decision the insurance company had made not to pay benefits on an insurance claim, without having to seek relief in the courts. Financial market entities operating under standards cooperate with Národná banka Slovenska, provide it with information about their consumers' petitions, respect the opinion presented by Národná banka Slovenska and are willing to compromise, and in some cases they will reevaluate their decision. Petitions from consumers at supervised entities are a source of information about the methods supervised entities use in conducting their activities and this information is used by the supervision unit in onsite audits conducted at specific companies.

ORGANISATIONAL CHART

Financial Market Supervision Unit

LICENSING AND ENFORCEMENT DEPARTMENT

Licensing Section

Cross-border Cooperation Section

Enforcement Section

Clients' Protection Section

REGULATORY AND RISK MANAGEMENT METHODOLOGY DEPARTMENT

Insurance Regulatory Section

Pension Savings Regulatory Section

Collective Investment Regulatory Section

Markets Regulation Section

Banking Sector and Securities Dealers Regulatory Section

Financial Market Risks Analyses Section

Risk Measurement Regulatory Models Section

SUPERVISORY DEPARTMENT

Quantitative Analyses Section

Banking Groups Supervisory Section 1

Banking Groups Supervisory Section 2

Insurance Groups Supervisory Section

Capital Market Entities Supervisory Section

Insurance and Reinsurance Mediation and Foreign Exchange Supervisory Section

INTERNATIONAL ACTIVITIES

In connection with NBS's commitments to international organizations, the European Central Bank, the European Council, etc., staff at the supervision unit regularly participate in discussions with various working groups and committees. The supervision unit, to a significant degree, is also cooperating with foreign regulators, particularly in relation to supervising banks and insurance company groups, participation in working groups and in the committees of international institutions, such as the Committee of European Bank Supervisors (CEBS), the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR), which are among the so-called "Level 3 Committees".

The CEBS gives advice to the European Commission in the area of banking. It is currently focusing on capital requirements rules for financial institutions with the aim of making sure capital at financial institutions is more closely aligned with the risks they face. In 2008, the Committee met four times.

The role of CESR is to improve coordination among securities regulators within the European Union, act as an advisory group for the European Commission and work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States. At meetings of top representatives from individual supervisory authorities in the field of regulating securities, CESR members accepted fundamental decisions regarding regulation and supervision and approved Level 3 Directives and other important documents related to CESR activities (in accordance with accepted amendments to the bylaws by a qualified majority vote of members). In 2008, CESR paid special attention to issues of positions and powers, reengineering and mutual cooperation with the

"3L3 Committees", which was also reflected in amended CESR bylaws effective on 10 September 2008. CESR has established several permanent working and expert groups, in which NBS is a representative and which have established and prepared most of the technical material submitted for approval at highest-level CESR meetings as output from the applicable group.

The goal of CEIOPS is to provide advice to the European Commission in the areas of insurance and occupational pensions, and particularly to draft regulations and implement European directives. CEIOPS is the platform for cooperation between supervisory authorities with the aim of ensuring consistent interpretation and application of Community regulations (Level 3 Lamfalussy Activities) and exchange of information about supervised entities. Since its establishment, CEIOPS's work has been determined to a substantial degree by work on Solvency II, from recommendations for preparing a framework directive to testing the effect through quantitative impact studies.

COOPERATION WITH OTHER SUPERVISORY BODIES IN SLOVAKIA

In exercising supervision of the financial market – in banking, the capital market, the insurance industry and pension saving –NBS follows general procedural rules laid down in Act No. 747/2004 Coll. on financial market supervision and on amendments to certain acts as amended. This Act entered into force on 1 January 2006, the date when NBS assumed the competences of an integrated financial market regulator.

Until 31 December 2005, the said powers with respect to the insurance sector, capital market and pension saving had been exercised by the Financial Market Authority.

The aim of financial market supervision (responsibilityfor which lies with a Vice-Governor of NBS) is to support both the stability of the financial market as a whole and its secure and smooth operation. Based on this fact, the financial market supervision unit conducts financial market regulation, involving mainly the following activities:

- rulemaking activities (it produces draft generally binding legal regulations of NBS in the financial market field, in particular, draft prudential regulation, operational security rules and other requirements for the conduct of business by supervised entities, it participates in the preparation of generally binding legal regulations issued by central government bodies),
- licensing activities (it conducts proceedings, takes first-instance decisions, issues authorizations, approvals and prior approvals, and imposes sanctions and corrective measures),
- supervision activities (it supervises financial market entities through on-site and off-site supervision),
- analytical activities (it produces analyses of the financial market as a whole, as well as of individualfinancial entities).

STATISTICAL TABLES

Number of financial institutions (head offices/branches) (at year-ends)

Type of institution	2006	2007	2008
Banks	**17**	**16**	**17**
- Joint stock companies	14	13	14
- State financial institutions	-	-	-
- Building savings banks	3	3	3
Branches	**7**	**10**	**11**[1)]
Financial Institutions, total	**24**	**26**	**28**

1) As of 31 December 2008 two branches had not begun banking activities

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

Item	2006	2007	2008
Public sector ownership	2,0	1,7	3,8
Other domestic ownership	8,4	6,4	2,9
Domestic ownership total	**10,4**	**8,1**	**6,7**
Foreign ownership	**89,6**	**91,9**	**93,3**
Financial Institutions, total	**100,0**	**100,0**	**100,0**

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

Item	2006	2007	2008
Public sector ownership	1,2	1,0	0,8
Other domestic ownership	1,8	0,0	0,2
Domestic ownership total	**3,0**	**1,0**	**1**
Foreign ownership	**97,0**	**99,0**	**99**
Financial Institutions, total	**100,0**	**100,0**	**100,0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	FOREX assets / Total assets	FOREX liabilities / Total liab.
Bank	54,00	72,00

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

Type of institution	2006	2007	2008
Bank	1,27	1,13	0,96

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

Type of financial institution	2006	2007	2008
Bank	22,34	19,3	14,09

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

Type of financial institution	2006	2007	2008
Bank	100,00	100,00	100,00
Financial institutions, total	**100,00**	**100,00**	**100,00**

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

Assets	2006	2007	2008
Deposits and credits with banks	45,57	48,22	48,71
Granted credits	27,13	28,92	31,28
Securities and other operations	23,06	19,17	16,64
Fixed assets	4,24	3,69	3,37
Total assets	**100,00**	**100,00**	**100,00**
Liabilities	**2006**	**2007**	**2008**
Deposits and credits from banks	65,88	64,67	64,68
Received deposits	15,19	18,65	18,15
Securities and other operations	10,93	9,03	8,72
Permanent founds	8,00	7,65	8,45
Total liabilities	**100,00**	**100,00**	**100,00**

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

Type of financial institution	2006	2007	2008
Bank	178,10	73,57	59,39
Financial institutions, total	**178,10**	**73,57**	**59,39**

Solvency ratio of financial institutions

Type of financial institution	2006	2007	2008
Bank	12,98%	12,78%	11,09%
Financial institutions, average	**12,98%**	**12,78%**	**11,09%**

Asset portfolio quality of the banking system

Asset Classification	2006	2007	2008
Defaulted	724 011	760 563	1 016 316
Classified Total	x	x	x
Specific Reserves	x	x	x

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	55,98	39,97
Government sector	9,21	2,44
Corporate	31,27	53,33
Foreign	3,10	4,10
Other	0,44	0,16
Total	**100,00**	**100,00**

The structure of deposits and loans in 2008 (%)
(at year-end)

Maturity of Deposits		Maturity of Loans	
At sight	38,23%	Long term loans	54,58%
Within one year	52,14%	Medium-term loans	18,34%
Over one year	9,63%	Short-term loans	27,08%
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.		
	2006	2007	2008	2006	2007	2008
Bank	15,49	16,38	15,77	20,02	24,09	20,02
Financial institutions, average	**15,49**	**16,38**	**15,77**	**20,02**	**24,09**	**20,02**

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

in th. EUR

Revenues	2006	2007	2008
Interest income	2 264 835	2 698 105	3 103 796
Non interest income	492 873	516 586	593 354
Income from banking operations	103 698	70 120	148 913
Other income	13 184	9 749	11 949
Other operational income	217 462	69 748	81 664
Expenditures	**2006**	**2007**	**2008**
Interest expenses	1 114 737	1 377 827	1 558 513
Non interest expenses	103 399	99 665	114 843
Expenses from banking operations	100 424	85 234	136 309
Other expenses	18 055	11 292	12 145
Other operational expenses	1 173 906	1 284 402	1 393 743
Income taxes	153 506	119 205	160 638
Other profit/loss (balance)	**2006**	**2007**	**2008**
Foreign exchange operations	332 805	291 961	311 928
Futures and options	-90 343	-38 040	-39 304
Provisions and reserves	-81 297	-66 192	-312 044
Other	781	772	1 406

Structure of registered capital and own funds of financial institutions in 2007

Type of financial institution	Registered capital	/Total assets	Own funds
	In mil. EUR	%	In mil. EUR
Bank	1 676 156	2,67	3 834 843
Financial institutions, average	**1 676 156**	**2,67**	**3 834 843**

2008 DEVELOPMENTS IN THE SLOVENIAN BANKING SYSTEM

SLOVENIAN MACROECONOMIC ENVIRONMENT IN 2008

The global financial crisis did not affect Slovenia until the end of 2008. The majority of economic indicators deteriorated rapidly in November. Prior to that, there was still a relatively high level of economic activity. The same held true for employment, wage growth and general government revenues and spending. However, it was already evident at the beginning of 2008 based on economic developments that the period of high economic growth was likely drawing to a close, not only as a reflection of developments in the global economy, but also stimulated by events in Slovenia.

The financial turmoil of 2008, primarily reflected in a lack of confidence and a considerable decrease in interbank lending, affected Slovenian banks. The reason is not in the fact that a significant portion of banks' investments were in securities, the market values of which were wiped out or nearly wiped out, but in the fact that the Slovenian economy is highly banking oriented. Companies finance themselves almost entirely via bank loans, while domestic savings, such as that of households, only partly pass through to banks. We cannot steer domestic savings to companies other than by banks borrowing from other banks and on the financial markets in the rest of the world. Savings not passed through to banks go through non-banking financial intermediaries abroad, and then return in the form of bank borrowing in the rest of the world. The economy will not change and become less banking oriented in order for domestic savings to pass directly to Slovenian companies, and not through the rest of the world. The banking and financial system must adapt to this characteristic of the economy. However, given the sharply lower interest rates around the world, bank borrowing in the rest of the world has resulted in more than the return of domestic savings. Slovenia's net external debt has also risen. Total gross external debt stood at EUR 15 billion or 56% of GDP at the end of 2004. In the four years ending in autumn of 2008, it had risen to EUR 40 billion, or 108% of GDP.

Following high economic growth in 2006 and 2007, economic growth remained high in the first half of 2008, at 5.6%. By the third quarter, it had already fallen to 3.9%, and was negative in the final quarter of the year. At the same time, the drivers of growth changed, particularly growth in domestic spending.

Growth in exports was down from approximately 13% in 2006 and 2007 to 8% in the first half of 2008. Taking into account seasonally adjusted figures, growth in merchandise exports had stagnated by the beginning of 2008. The main driver of growth in domestic spending was investment growth, which averaged 11% in 2006 and 2007, and was still 14% in the first half of 2008, primarily on account of investment in construction works, particularly non-residential construction. Thus in the first half of the 2008, annual growth in value added was 20% in construction, 11% in financial intermediation and 7% in retail, while annual growth in manufacturing was down to just 2.5%. Based on seasonally adjusted figures from manufacturing, we have seen stagnation since autumn 2007. Excluding the best performing sector, namely pharmaceuticals, stagnation in manufacturing was evident back in 2006.

Employment growth was also high due to the climate in sectors linked to domestic spending. In 2008 employment growth still averaged 2.2%, and 12% in the construction sector. The surveyed unemployment rate fell until the final quarter of 2008, when it stood at 4.2%, taking into account seasonally adjusted figures. Since the end of 2006, high growth in employment has translated into increased wage growth. Growth in average gross wages was around 8.5% for most of 2008. Wage growth in the trade sector fell sharply in the final months of 2008, at a time when the government significantly increased the wages of public employees.

The positive economic climate in Slovenia, falling growth in exports and the deterioration of (international) terms of trade contributed to the widening of the current account deficit to 5.5% of GDP. Inflation reached its highest level in the middle of 2008, at around 7%, but has fallen since that time. The high inflation in the middle of 2008 was the result of several external shocks. However, core inflation (inflation excluding the prices of energy, food, alcohol and tobacco) was approximately 4% during the same period. Despite its rapid fall, inflation remains significantly above the euro area average.

Since the end of October 2008, banks have not been able to borrow in the rest of the world under the same conditions as they did previously. In particular, the maturities and interest rates on loans have deteriorated, resulting in a significant drop in growth in bank loans. Thus the economy has faced liquidity problems, which are not yet critical. Weaknesses have been seen in the banking and financial system. However, banks and other financial institutions remain sound. The level of bad loans in Slovenia and non-performing investments in the rest of the world is relatively low.

The majority of difficulties faced by companies are driven by falling domestic and foreign demand. The significant decrease in investment demand is primarily the result of slowing construction activity. For example, in 2008 construction accounted for 9% of total value added. Manufacturing companies have been hit hardest. In the final two months of 2008, year-on-year growth in merchandise exports and manufacturing output was -14% and -16% respectively.

As Slovenia enters 2009 certain weaknesses in the real sector, which have been present for some time, remain. Despite adopting certain bad practices in recent years, the financial system has proven to be sufficiently robust. The main challenge in the coming years will be establishing an environment for the accelerated technological and sectoral modernisation of the economy. Only in this way will the economy provide for an appropriate level of international competitiveness, and thus a balanced balance of payments, low inflation and a stable financial system.

STRUCTURE AND OWNERSHIP OF THE BANKING SECTOR

Slovenia's banking sector is dominated by banks. Banks held a market share of 99.3% at the end of 2008 as measured by total assets, with savings banks accounting for the remainder.

As at 31 December 2008 there were 18 banks operating in Slovenia, eight of which were subsidiaries. There were also three savings banks, and three branches of foreign banks (Austrian and French). With the merger of NLB Koroška banka d.d., NLB Banka Zasavje d.d. and NLB Banka Domžale d.d. with Nova Ljubljanska banka d.d., Ljubljana, there were three fewer credit institutions than in the previous year.

In addition to the eight subsidiaries and the three branches that were under majority foreign ownership as at 31 December 2008, there were two banks under full domestic ownership (six at the end of 2007), and eight banks under majority domestic ownership (of which half had less than 3% foreign equity). The proportion of capital held by non-residents as at 31 December 2008 as measured by equity was up 0.4 percentage points on 31 December 2007 at 38.2% (of which the proportion held by non-residents holding more than 50% stood at 27.6%, or 0.8 percentage points more than a year earlier). The proportion held by non-residents as measured by total assets was 2.9 percentage points higher than the proportion held by non-residents as measured by equity as at 31 December 2008. State ownership as at 31 December 2008 as measured by equity was up 2.6 percentage points on 31 December 2007 at 17.7%, as a result of an increase in the state's share in SID – Slovenska izvozna in razvojna banka d.d., Ljubljana, the only Slovenian bank under direct majority state ownership.

Table 1: Average total assets and GDP

EUR millions	2006	2007	2008
Average total assets of banks and savings banks	34.080	42.598	47.948
GDP at current prices	31.008	34.471	37.126
Average total assets (as % of GDP)	109,9	123,6	129,1

Source: Bank of Slovenia

The ratio of total assets of banks and savings banks to GDP is rising from year to year, although it remains considerably below the EU average.

BANK PERFORMANCE IN 2008

Total assets of the banking system at the end of 2008 stood at EUR 47,498 million. Total assets rose by EUR 5,155 million during the year, an increase of 12% in relative terms. Events on the international markets had no direct effect on the Slovenian banking system, but had an indirect impact on banks' operations. Year-on-year growth in total assets over the first seven months of the year remained high at around 23%, and was followed by a rapid drop, with the lowest growth in the last five years of 11.4% recorded at the end of November. Following high growth in 2005 and 2006, the foreign banks achieved 22% growth for the second consecutive year, while the domestic banks recorded modest growth of 8%, following 26% growth in 2007. As a result, the market share of the domestic banks was down 2.4 percentage points at 68.8%40.

Banks and branches recorded a pre-tax profit of EUR 304 million in 2008. This was EUR 210 million or 40.9% down on the banking system's profit in 2007. Profit was down for the first time following continuous growth in previous years.

The banking system's gross income amounted to EUR 1,354 million in 2008, down EUR 79 million or 5.5% compared with the previous year, when an increase of 17.9% was recorded. The negative result from net trading in the amount of EUR 115 million (compared with a profit of EUR 136 million a year earlier) contributed most to the decrease in gross income. The aforementioned drop in gross income was partially offset by other categories of gross income, the largest increases recorded by net interest (up EUR 122 million or 15.0%), followed by other financial effects (up EUR 34 million or 32.0%, primarily as result of higher net income from exchange differences), while net fees and commissions (up 0.7%) were practically unchanged from the previous year.

The decline in pre-tax profit compared with 2007 also resulted in a sharp deterioration in profitability ratios. Average ROA and average ROE were halved. The former was down 0.7 percentage points at 0.7%, while latter was down 8 percentage points to 8.3%.

Gross income per average assets, which has declined slowly and steadily in recent years, fell by 0.8 percentage points, from 3.8% to 3.0%, due to the decrease in gross income, while the interest margin was down slightly (from 2.2% to 2.1%) on account of the modest increase in net interest.

As a result of modest earnings from net fees and commissions and the significant loss from financial assets and liabilities held for trading, the non-interest margin was down sharply on the previous year, from 1.6% to 0.9%.

The cost efficiency ratio (the ratio of operating costs to average assets) continues to improve (from 2.2% to 1.7%). Growth in operating costs is more modest than in previous years, and continues to lag behind (by just under 18 percentage points) growth in average assets, which had a favourable impact on this ratio.

Capital adequacy ratio stood at 11.7% as at 31 December 2008, up 0.5 percentage points on the end of 2007, and up 1.2 percentage points from the end of September 2008, reaching its highest level in the last three years. Capital adequacy ratio was up on account of a significant increase in capital compared with capital requirements in the final quarter of 2008, as a result to the temporary abolishment of original capital deduction item41 in October 2008. At the end of December 2008 capital was up 27.8% from the

[40] The market share of foreign banks stood at 31.2%.

[41] Pursuant to Article 24 of the Regulation on the Assessment of Credit Risk Losses of Banks and Savings Banks, banks must use a weighting of 0% according to the Bank of Slovenia's methodology when calculating original capital deduction items in the group assessment of financial assets and liabilities assumed under off-balance sheet items that are classified into categories A to E for the calculation of impairments and provisions.

end of 2007, and was 5.6 percentage points higher than growth in capital requirements. All banks met the minimum capital adequacy requirement as at 31 December 2008.

As at 31 December 2008, no bank had exceeded the limits on the maximum allowable exposure to individual clients (25% of capital), to groups of related clients (25% of capital), to other entities in the group (20% of capital) or to persons with a special relationship with the bank (20% of capital).

LEGAL AND INSTITUTIONAL FRAMEWORK FOR SUPERVISION OF FINANCIAL INSTITUTIONS

In Slovenia three supervisory authorities are responsible for supervision and surveillance of financial institutions.

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. The responsibility for the implementation and enforcement of the Bank of Slovenia's supervisory function is conferred upon the Banking Supervision Department. The Bank of Slovenia supervises credit and e-money institutions.

The Securities Market Agency was established as an independent institution by the Securities Market Act which entered into force on 13 March 1994 (the new Securities Market Act entered into force on 28 July 1999, and the Market in Financial Instruments Act entered into force on 11 August 2007). The Securities Market Agency supervises investment firms, management companies, investment funds, mutual pension funds and their managers, as well as some other institutions (the Central Securities Clearing Corporation and the Ljubljana Stock Exchange).

The Insurance Supervision Agency was established as an independent entity pursuant to the Insurance Act. Its responsibility is supervision of insurance undertakings, reinsurance undertakings, insurance agents and brokers, insurance agencies and insurance brokerage companies, pension companies, as well as some other institutions (the Slovenian Nuclear Insurance and Reinsurance Pool, the Slovenian Insurance Association and the Pension Fund Management).

ACTIVITIES OF THE BANKING SUPERVISION DEPARTMENT IN 2008

Licensing

Licensing credit institutions is one of the Bank of Slovenia’s most important tasks. In addition to issuing authorisations for the provision of banking services and the provision of mutually recognised and additional financial services, the Bank of Slovenia in 2008 also issued authorisations to obtain a qualifying holding in the capital of a bank, authorisation for the merger or acqusition of banks and authorisation to hold office as a member of a bank’s management board. The decision to grant or refuse an authorisation is taken by the Governing Board of the Bank of Slovenia based on the opinion of the License Committee, except in the case of authorisations to hold office as a member of a management board, where the decision is based on the opinion of the Committee of the Governing Board of the Bank of Slovenia for the Preparation of Opinions for the Issue of Authorisation to Hold Office as a Member of a Bank's Management Board.

In 2008 the Bank of Slovenia issued a total of 22 authorisations for banking and various types of mutually recognised and additional financial services, for qualifying holdings, for the merger or acqusition of banks, and for holding office as a member of the management board. It rejected two applications for authorisation to hold office as a member of a bank's management board. The majority of authorisations issued in 2008 were for the provision of mutually recognised and additional financial services (10), while 8 were issued to hold office as a member of a bank's management board and 3 for the acquisition of a qualifying holding in a bank. Authorisation was also issued for the merger of three banks. The number of authorisations issued to provide mutually recognised and additional financial services was significantly higher than in 2007, when only three authorisations were issued.[42]

Pursuant to Directive 2006/48/EC (previously: Directive 2000/12/EC) and Annex I (List of activities subject to mutual recognition), a bank of a Member State that is entitled to provide banking services and other (mutually recognised) financial services may also provide these services in Slovenia. It may provide them via a branch (in the case of permanent pursuit of business) or directly (in the case of occasional provision of services without elements of a permanent presence in Slovenia) without authorisation from the Bank of Slovenia, which must be notified in writing by the relevant supervisory authority in the home Member State. In 2008 the Bank of Slovenia received 66 notifications of the direct provision of banking and other mutually recognised financial services, and no notifications of the provision of services via a branch. A list of banks of EU Member States that have carried out the notification procedure for the provision of banking services and other financial services in Slovenia via their home banking supervisors is available on the Bank of Slovenia's website. Different arrangements apply to banks of third countries. Banks of third countries may only provide banking and other (mutually recognised) financial services via a branch, Bank of Slovenia authorisation being required to establish the branch. The Bank of Slovenia may request that the bank of a third country deposit a specific sum of cash or other eligible collateral in Slovenia, or provide other appropriate collateral as a guarantee for the settlement of liabilities from transactions concluded in Slovenia.

[42] Mutually recognised and additional financial services include: the provision of payment transaction services, the issue and management of payment instruments, trading in money market instruments, foreign legal tender, derivatives and transferable securities on own account and on behalf of clients, participation in the issue of securities, corporate consultancy services regarding capital structure, business strategy and related matters and consultancy and services related to corporate M&A activities, investment management and related consultancy services, safekeeping of securities and related services, brokering the sales of insurance policies in accordance with the law governing the insurance industry and administrative service for investment funds. Authorisation to provide banking services includes the collection of deposits from the public and the granting of loans on own account.

On-site examinations of banks and savings banks

In 2008, the Banking Supervision Department continued to conduct examinations of banks and savings banks according to its internal risk assessment methodology, which is based on assessing risks and the quality of the control environment. Examinations of specific areas were prevalent among the examinations conducted, practice having shown that shorter and thus more frequent and more detailed examinations of specific areas are more significant and more needed than comprehensive examinations (examinations of all areas of operations). The most frequently examined areas were credit risk, market risks with an emphasis on interest-rate and liquidity risk, ensuring an adequate level of capital (capital adequacy), stable deposits, structured products, the definition of the risk profiles of banks and savings banks in accordance with the Bank of Slovenia's internal risk assessment methodology, etc. Follow-ups of the implementation of requirements from orders, admonishments and recommendations (examinations of the implementation of measures) were also frequent, as it was not always clear from the documentation submitted whether the banks had rectified the irregularities.

Emphasis in 2008 was on the examination and monitoring of the implementation of the new capital framework at banks and savings banks (as a continuation of activities from 2007, when the Banking Supervision Department began the systematic monitoring of the preparations of banks and savings banks for the introduction of the new European capital framework, conducted in two cycles of examinations), and the related calculation of capital requirements for credit and operational risk in the scope of Pillar 1 and the process of calculating the required level of internal capital in the scope of Pillar 2 of Basel II.

Examinations of banks' readiness for the introduction of advanced approaches for calculating capital requirements for credit risk (IRB)[43] and operational risk (AMA)[44] continued. Primarily certain banks under majority foreign ownership opted for one of the aforementioned approaches. Banks that have chosen to begin using an advanced approach (IRB and/or AMA) for the calculation of capital requirements in the near future are included in a joint-decision making process and are a part of a joint application, which the parent bank submits to its supervisor. In such cases, the Bank of Slovenia is included in the process of issuing a joint decision as host supervisor. Cooperation with foreign supervisors, who are responsible for activities relating to joint decisions, is intensive in such cases. Only one foreign bank is currently using an advanced approach to a limited extent. The Bank of Slovenia received one additional application from a foreign bank in 2008 for the use of the IRB approach.

Based on authorisations by the Governor of the Bank of Slovenia, 60 examinations were carried out in 2008, including the following:

- 18 examinations of the accuracy of the calculation of internal capital,
- 6 examinations of the preparedness of banks for the use of banks loans as collateral for Eurosystem claims (*in addition to securities as the basis for collateral, banks may also use eligible bank loans as collateral for Eurosystem credit operations, provided that they have carried out an initial, one-time verification of procedures, as required*

[43] Internal Ratings-Based Approach (IRB)
[44] Advanced Measurement Approach (AMA)

by the Bank of Slovenia for this purpose),

- 7 specific examinations of the prevention of money laundering with regard to deposit transactions (*the Governing Board of the Bank of Slovenia adopted guidelines in the area of preventing money laundering and terrorist financing relating to changes in the prevention of Money Laundering and Terrorist Financing Act*), and several examinations of the implementation of measures (follow-up examinations) and a number of one-day examinations or monitoring of a specific area of operations.

Secondary legislation and amendments to the Banking Act related to financial turmoil

In October 2008 the Bank of Slovenia amended the Regulation on the Assessment of Credit Risk Losses of Banks and Savings Banks, eliminating the effects of the prudential filter in the formation of impairments and provisions. This produced an anti-cyclical effect and resulted in the improved capital adequacy of banks.

In November 2008 the Bank of Slovenia adjusted the liquidity ladder with regard to the value of pledged collateral at the central bank, and thus facilitated banks' greater access to liquidity at the Eurosystem.

At the end of November 2008 the Bank of Slovenia called on banks to halt the excessive raising of interest rates on sight deposits. It also called on banks to appropriately assess credit risks in the context of deteriorating economic conditions and to form an appropriate level of impairments.

In the package of measures aimed at mitigating the effect of the financial turmoil, the National Assembly adopted the new Banking Act (Official Gazette of the Republic of Slovenia, No. 109/08; hereinafter: the ZBan-1B) in November 2008, which temporarily (until the end of 2010) introduces an unlimited deposit guarantee in the event of the bankruptcy of a bank or savings bank.

In January 2009 the Bank of Slovenia sent banks recommendations linked to measuring the value and impairments of financial assets for final accounts and the compilation of annual reports for the 2008 financial year. It also amended the Regulation of the Assessment of Credit Risk Losses of Banks and Savings Banks by requiring monthly reporting on the formation of impairments and provisions and classified assets from April 2009 on. Due to the continued tightening of conditions on the financial markets, the Bank of Slovenia recommended that banks coordinate their planned credit activity with available and stable sources of funding, and retain their 2008 earning to improve banks' capital strength.

CO-OPERATION WITH OTHER DOMESTIC SUPERVISORY AUTHORITIES

Co-operation with the other two Slovenian supervisory institutions (the Securities Market Agency and the Insurance Supervision Agency) took the form of an exchange of views and information between the institutions. Co-operation between the supervisory authorities is regulated by the Rules on Co-operation between Supervisory Authorities and the signed Memoranda of Understanding (MoUs). The MoUs set out the form and content of co-operation and information exchange in more detail.

The Co-ordinating Committee was founded on the basis of the rules, presided over by the minister for finance, with cooperation from the Governor of the Bank of Slovenia, the presidents of the councils of experts at the Securities Market Agency and Insurance Supervision Agency. There is also the Committee for Co-operation between Supervisory Authorities (hereinafter: the Committee), which is in charge of implementing the tasks passed by the Co-ordinating Committee. The Committee comprises the Member of the Governing Board 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.

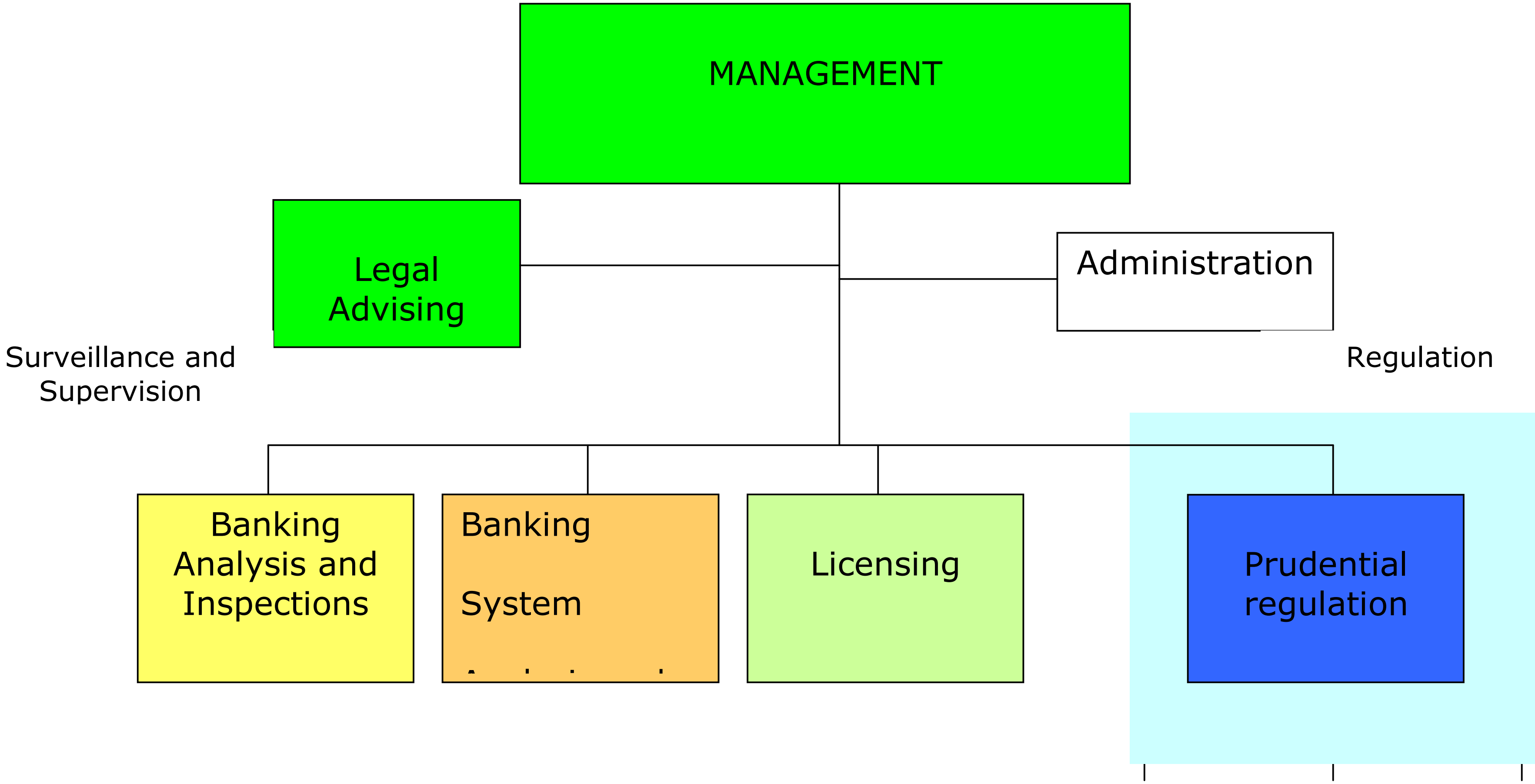
Supervisory institutions are required to inform the relevant supervisory institution if they identify any infringements that fall under the auspices of other institutions.

CO-OPERATION WITH FOREIGN SUPERVISORY AUTHORITIES

In 2008 the Banking Supervision Department continued to examine banks and other financial organisations abroad that are owned by Slovenian banks. On the basis of memoranda of understanding (the Bank of Slovenia has a total of 12 memoranda of understanding concluded with foreign supervisory institutions), the Banking Supervision Department participated in four examinations of the operations of foreign banks under the majority ownership of Nova Ljubljanska banka d.d. and Nova kreditna banka Maribor d.d., in cooperation with the supervisors in the countries where the subsidiary banks operate.

Cooperation with foreign supervisors is also connected with the Supervisory Colleges, in which on-site examiners of the Banking Supervision Department participated in 2008. In October 2008 the Bank of Slovenia's Banking Supervision Department organized Supervisory College as competent home supervisor for the Slovenian banking group, Nova Ljubljanska banka.

ORGANISATIONAL CHART OF THE BANKING SUPERVISION DEPARTMENT



STATISTICAL TABLES

Number of financial institutions (head offices/branches) (at year-ends)

Type of credit institution	2006	2007	2008
Banks	22	24	21
Savings banks	3	3	3
Credit institutions, total	**25**	**27**	**24**

Ownership structure of banks on the basis of shareholders' equity (%) (at year-ends)

Type of ownership	2006	2007	2008
Central Government	17,9	15,1	17,7
Other domestic ownership	44,4	47,2	44,1
Domestic ownership total	62,3	62,3	61,8
Foreign ownership	37,7	37,7	38,2
Bank, total	**100,0**	**100,0**	**100,0**

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

Item	2006	2007	2008
Central Government	22,4	18,6	19,2
Other domestic ownership	37,4	39,7	39,7
Domestic ownership total	59,9	58,4	58,9
Foreign ownership	40,1	41,7	41,1
Bank, total	**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 three largest (%)
Banks	48,0	59,5
Savings banks	100,0	

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

Type of credit institution	2006	2007	2008
Banks	1,25	1,36	0,68
Savings banks	0,60	1,00	0,68

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

Type of credit institution	2006	2007	2008
Banks	15,07	16,29	8,08
Savings banks	8,60	15,45	10,87

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

Type of credit institution	2006	2007	2008
Banks	99,4	99,4	99,3
Savings banks	0,6	0,6	0,7
Credit institutions, total	**100,0**	**100,0**	**100,0**

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

Assets	2006	2007	2008
Cash and balances with CB	3,1	1,4	2,6
Loans to banks	9,1	9,6	8,5
Loans to customers	60,3	66,8	70,4
Securities	22,3	17,2	14,2
Other assets	5,2	4,9	4,4
Liabilities	**2006**	**2007**	**2008**
Deposits from banks	31,9	37,6	38,1
Deposits from customers	51,7	45,8	43,3
Liabilities from securities	2,9	2,3	2,6
Capital and subordinated liabilities	11,3	11,9	11,7
Other liabilities	2,2	2,5	4,2

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

Type of credit institution	2006	2007	2008
Banks	17,7	16,6	13,7
Savings banks	1,8	3,0	1,5

Solvency ratio of financial institutions

Type of credit institution	2006	2007	2008
Banks, average	11,0	11,2	11,7
Savings banks, average	9,9	9,7	11,7

Assets Portfolio Quality of the Banking System in EUR thousands

Asset Classification	2006	2007	2008
A	24 364 110	29 942 739	34 454 540
B	5 923 145	9 324 671	10 581 758
C	494 267	550 088	494 284
D	373 072	286 353	467 389
E	426 423	437 731	382 159
Classified Total	**31 581 017**	**40 541 582**	**46 380 130**
Specific Provisions	1 240 700	1 313 061	1 406 854

The structure of deposits and loans in 2008 (%)
(at year-end)

	Deposits	Loans
Households	64,1	22,0
Government sector	9,0	1,5
Corporate	18,0	60,4
Foreign	2,3	7,5
Other	6,6	8,6
Total	**100,0**	**100,0**

The structure of deposits and loans in 2008 (%) (at year-end)

Maturity of Deposits		Maturity of Loans	
At sight	33,2	Long-term loans	62,7
Within one year	54,8	Medium-term loans	
Over one year	11,9	Short-termn loans	37,3
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.		
	2006	2007	2008	2006	2007	2008
Banks	45,9	6,0	6,1	47,1	5,0	4,9
Savings banks	3,9	0,1	0,1	5,6	0,1	0,1

Profit ans Loss Account of Banks

	2006	2007	2008
	EUR thousands	EUR thousands	EUR thousands
Net interest income	689 847	816 357	944 562
Net fees and commissions	308 537	336 333	339 658
Net income from FI held for trading	97 190	135 747	-114 596
Net other	120 031	144 582	190 532
Gross income	**1 215 605**	**1 433 019**	**1 360 156**
Operating expenses	702 130	755 894	775 992
- labour costs	367 434	401 808	412 086
Net income	**513 475**	**677 125**	**584 164**
Net provisions and impairments	-119 798	-162 954	-277 853
Profit before taxation	**393 677**	**514 171**	**306 311**

Structure of registered capital and own funds of credit institutions in 2008

Type of credit institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR thousands	%	EUR thousands	%
Banks	704 029	1,5	4 452 961	9,4
Savings banks	9 168	2,9	22 425	7,0

2008 DEVELOPMENTS IN THE UKRAINIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2008, there were changes in the trends of economic development of Ukraine compared with the previous year. In the first half of 2008, economic activity was robust. However, starting from the second half of 2008, due to the unfavorable development of world economic processes which led to the deterioration of external market situation, falling investment and consumer demand, the trend became downward in practically all types of economic activity.

Real GDP growth in 2008 made up 2.1% (in 2007 – 7.9%), industrial output declined by 3.1% and as of 1 January 2009 totaled UAH 779.1 billion, real effective household income growth slowing down to 9.6% during the year (versus 14.8% in the previous year).

The net increase in the direct foreign investments in the economy of Ukraine equaled UAH 10.7 billion, their total volume amounting to UAH 46.8 billion as of 1 January 2009.

The inflation rate from the 2008 start made up 22.3% (in 2007 – 23.3%).

In 2008, the registered unemployment rate rose to 3.0% (against 2.3% in 2007).

DEVELOPMENT IN THE BANKING SYSTEM

As of 1 January 2009, 184 banks had the NBU license to perform banking operations. Among them: 155 banks (84.2% of the total number of the banks licensed to perform banking operations) are joint-stock companies, including 116 banks (63.0%) being the open joint-stock companies and 39 banks (21.2%) - closed joint-stock companies, 29 banks (15.8%) being the limited liability companies.

In 2008, the number of banks with participation of foreign capital enlarged to 53 banks (29% of the total number of banks operating in Ukraine), 17 banks (9.3% of the total number of operating banks) out of them being with 100% foreign capital.

In 2008, the amount of foreign capital in the registered authorized capital of Ukrainian banks multiplied twice and as of 1 January 2009 became UAH 30.3 billion. The portion of foreign capital in the total registered authorized capital of the banks operating in Ukraine went up from 35% to 36.7%.

The foreign capital in Ukraine is represented by 27 countries. The largest portion in the total foreign capital falls on the capital of Cyprus (18.2%), Austria (16.7%), Russia (12.6%), France (8.7%), Hungary (6.8%), the Netherlands (6.4%), Greece (5.1%), and Sweden (5%).

Starting from the second half of 2008, the banking system of Ukraine, like the whole economy, operated under conditions of the growing influence of the world financial and economic crisis. In early October 2008, mass funds outflow from the banking system of Ukraine began, which had been mostly provoked by the panic-stricken mood of individuals. It all exerted a profound influence on the major indicators of bank activities and decelerated their growth.

In particular, the total bank assets, in 2008, advanced by 57.2% (in 2007 – by 75.3%) and as of 1 January 2009 came to UAH 973 billion.

The loan portfolio of Ukrainian banks grew by 63.2% (in 2007 – by 80%), equaling UAH 792 billion as of 1 January 2009.

The liabilities of Ukrainian banks increased by 52.3% (in 2007 – by 78%) and as of 1 January 2009 became UAH 807 billion.

The regulatory capital of banks, in 2008, climbed by 70.3% (in 2007 – by 75.6%), totaling UAH 123 billion as of 1 January 2009.

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

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN UKRAINE

Banking activity in Ukraine is regulated by the following fundamental laws:

- On Banks and Banking;
- On the National Bank of Ukraine;
- On the Deposit Insurance Fund;
- On Business Companies;
- On Joint-Stock Companies;
- On Prevention and Counteraction of Legalization (Laundering) of the Proceeds from Crime.

In accordance with the provisions of the Laws "On the National Bank of Ukraine" and "On Banks and Banking", the banking regulation and supervision in Ukraine are conducted by the National Bank of Ukraine.

In order to minimize negative consequences of the financial crisis, in October 2008 adopted was the Law of Ukraine "On the Top Priority Measures to Counteract Negative Consequences of the Financial Crisis and on Amendments to Some Legislative Acts and Enactments of Ukraine".

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2008

With the view of optimizing the organizational framework and functions of banking supervision structural subdivisions of the NBU Central Office and regional branches, enhancing efficiency of the banking activity regulation and supervision on the basis of the principles of the Basel Committee on Banking Supervision (hereinafter Core principles on banking supervision), the National Bank of Ukraine worked out Priority directions for the development and regulation of the banking activities and supervision for a period up to 2010.

The development and improvement of the banking activity regulation and supervision were concentrated on the following areas:

- Improvement of off-site banking supervision and inspection;
- Improvement of the order for establishment and licensing of banks and banking unions (associations);
- Improvement of the procedures for reorganization and liquidation of banks;
- Intensification of supervision in the area of counteraction of legalization of the proceeds from crime;
- Insuring the banking system transparency;
- Introduction of the supervision on the consolidated basis;
- Improvement of the corporate management practice in banks;
- Development of cooperation with other state supervision authorities and banking supervision bodies of other countries and international organizations in the sphere of banking supervision;
- Professional development of banking supervision officers.

In light of the necessity of minimizing the negative consequences of the financial crisis, adequate measures to stabilize the financial market, maintain liquidity and solvency of Ukrainian banks and to ensure settlements and customers' payments by banks became a top priority task in the 2008 end.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2008

In 2008, the National Bank of Ukraine continued to improve the methodological and legislative framework for banking regulation and supervision aimed at decreasing risks to bank activities and complying with the Basel Core Principles for Effective Banking Supervision and EU supervision laws.

In order to intensify the requirements to the level of bank capitalization, the National Bank of Ukraine made amendments to some NBU legislative acts and enactments (Resolution of the NBU Board of 6 August 2008 # 228) viz.:

- to the Instruction on the Order of Regulating Bank Activities in Ukraine – in the part related to setting the minimum amount of the regulatory capital at EUR 10 million – for emerging banks and a step-by-step increase to this amount in the regulatory capital of the operating banks with regulatory capital less than EUR 10 million;
- to the Regulation on the Order of Issuing to Banks the Banking Licenses, Permissions in Writing and Licenses to Perform Some Operations in the part related to intensification of the requirements to the amount of authorized capital not less than the equivalent to EUR 10 million for a bank to obtain a banking license. A similar norm for the amount of regulatory capital is envisaged when giving banks an NBU permission in writing to perform some operations. Higher requirements to the regulatory capital are set for granting permission

to perform the foreign exchange transactions, operations in the international markets and for investing.

With the view of stimulating the banks to augment their regulatory capital in order to perform transactions with assets, introduced was a new economic ratio (coefficient) of the regulatory capital to total assets (R3). This ratio has determined a portion of the transactions with assets to be performed at the expense of the capital.

With the purpose of minimizing the bank risks related to investment in securities, determining true quality of the bank assets in the form of securities and preventing the banks from performing transactions with the securities of improper quality, adopted was Resolution of the NBU Board of 23 July 2008 # 211 "On Amendments to Some Legislative Acts and Enactments of Ukraine". This Resolution intensified the requirements to determination of the fair value of securities by banks with the view of forming provisions for bank transactions with the securities accounted in the bank portfolios for sale and for redemption as well as envisaged the necessity for covering the risks to transactions with the securities accounted in the trade portfolio at the expense of bank's capital.

In order to optimize the order of formation and use of the loan loss provision, made were amendments to Resolution of the NBU Board of 1 December 2008 # 406 (came into effect on 28 December 2008). Markedly increased were the provisioning ratios (by degree of risk) for lending operations in the foreign currency with the borrowers having no foreign currency earnings (50% under debts on the loans classified as "standard" and 100% under other types of lending operations); intensified were the requirements to assessing the financial standing of the borrowers with the status of individuals and legal entities, the loan agreements with which contain no written consent for collection, storage, use and dissemination, through a credit history agency, of information about them; intensified were the requirements to the quality of the acceptable collateral.

In compliance with the requirements set forth in the Law of Ukraine "On the Top Priority Measures to Counteract the Consequences of the Financial Crisis and on Amendments to Some Legislative Acts of Ukraine" (# 639/VI of 31 October 2008) and in order to help banks recover financially, in particular through their capitalization, Resolution of the NBU Board of 1 December 2008 # 405 approved the Special Procedure of Measures for Financial Rehabilitation of Banks which determined particularities of the bank financial rehabilitation and capitalization in the context of counteracting the negative consequences of the financial crisis, namely:

- simplified were the procedures and shortened were the terms of approval the bank bylaws as well as the bank registration procedures;
- established were simplified procedures for augmenting the authorized capital at the expense of bank shareholders (participants) and investors' funds and for bank reorganization by owners' decision;
- procedures of banks capitalization with state participation as well as means of financial rehabilitation under temporary administration have been set.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISORY AUTHORITY

The following subdivisions of the National Bank of Ukraine exercised the banking supervision function during 2008:

- Banks registration and licensing department;
- Department for methodology and organization of banking regulation and supervision;
- Department for off-site banking supervision;
- Department for banks inspection;
- Department for prevention of using the banking system for legalization of proceeds from crime and terrorism financing;
- Department for reorganization and termination of banks activity;
- Office of legal support for banking supervision.

The general management of the abovementioned subdivisions was conducted by the Directorate on banking regulation and supervision.

INTERNATIONAL ACTIVITIES

During 2008, the National Bank of Ukraine continued to carry out the work aimed at establishing and strengthening cooperation with supervisory authorities of foreign countries in the area of banking supervision. Special attention is paid to the cooperation with supervisory authorities of the host countries for branches or subsidiaries of Ukrainian banks, and also with the home countries of the banks having subsidiaries on the territory of Ukraine.

In 2008, the National Bank of Ukraine signed bilateral Memorandums of Understanding on cooperation in the area of supervision over credit institutions with the Central Bank of Russian Federation and the Central Bank of Cyprus (with amendments).

COOPERATION WITH OTHER SUPERVISORY BODIES IN UKRAINE

The National Bank of Ukraine exercising its banking supervision function coordinates activities and information exchange with other supervisory authorities in the country, in particular with the State Commission for Regulation of Financial Services Market of Ukraine, the State Commission for Securities and Stock Market of Ukraine, the Ministry of Finance of Ukraine, the State Tax Administration of Ukraine and others.

OTHER RELEVANT INFORMATION FOR 2008

In 2008, with the purpose of assessing the current and prospective solvency of Ukrainian banks and their viability under the crisis conditions, the National Bank of Ukraine started a large-scale operation on conducting banks diagnostic study by leading audit firms. Program and Methods of assessment of the current and prospective banks solvency were developed with this purpose and approved by Resolution of the Board of the National Bank of Ukraine from 21.11.2008 No.389 "On Conducting Banks Diagnostic Study".

Also, Regulation on establishing and activities of the National Bank of Ukraine Committee on assessment of the current and prospective banks solvency and viability under the crisis conditions approved by Resolution of the Board of the National Bank of Ukraine from 25.12.2008 No.455, which determines the order of processing the reports on banks diagnostic study results and preparation of proposals on their basis for further actions of the National Bank of Ukraine concerning activity of certain banks has been elaborated.

With the purpose of deciding the issue of granting loans by the National Bank of Ukraine to support banks liquidity in the event of real threat to the stability of the banking system caused by instability and decline of the hryvnia exchange rate as well as other circumstances that caused substantial drop in solvency of most banks and their borrowers, Temporary Regulation on granting loans by the National Bank of Ukraine to support banks liquidity in the event of real threat to the stability of the banking system was developed and approved by Resolution of the Board of the National Bank of Ukraine from 25.12.2008 No.459.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2006	2007	2008
Banks	170	175	184

Concentration of assets by the type of credit institutions as at 31 December 2008

Type of institution	The first three largest (%)	The first three largest (%)
Banks	38,78	58,88
Credit Cooperatives		
Financial Institutions		
Savings Cooperatives		
Specialized Credit Institutions		

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

Type of institution	2006	2007	2008
Banks	1,61	1,50	1,16
Credit Cooperatives			
Financial Institutions			
Savings Cooperatives			
Specialized Credit Institutions			

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

Type of institution	2006	2007	2008
Banks	13,52	12,67	9,64
Credit Cooperatives			
Financial Institutions			
Savings Cooperatives			
Specialized Credit Institutions			

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

Assets	2006	2007	2008
High liquidity assets	12,7	10,3	8,2
Credit portfolio	76,4	78,4	81,4
Investments in securities	4,1	4,6	4,2
Accounts receivable	0,4	0,3	0,3
Fixed and intangible assets	5,3	4,5	4,0
Accrued income	0,8	0,9	1,4
Other assets	0,4	0,9	0,5
Assets in total	**100,0**	**100,0**	**100,0**
Liabilities	**2006**	**2007**	**2008**
Funds of the NBU	0,5	0,3	7,5
Correspondent accounts of other banks	2,5	2,4	1,4
Budgetary and off-budget funds	0,6	0,8	0,3
Inter-bank credits and deposits	22,8	29,1	30,9
Funds of economic entities	25,8	21,1	17,8
Funds of natural persons	35,6	30,9	26,4
Funds of non-banking financial institutions	2,5	2,7	2,2
Credits from international and other financial organizations	2,8	3,7	6,4
Own debt securities	2,1	3,7	1,3
Subordinated debt	1,6	1,5	2,0
Accounts payable on transactions with banks and bank customers	0,6	0,5	0,6
Other liabilities	1,6	2,3	1,6
Liabilities in total	**100,0**	**100,0**	**100,0**

Solvency ratio of financial institutions

Type of credit institution	2006	2007	2008
Banks	14,19	13,92	14,01
Financial institutions, average			

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

Revenues	2006	2007	2008
	100,0	100,0	100,0
Interest earned	72,7	74,6	72,0
Income from commissions	20,0	18,3	16,2
Performance of trade transactions	4,9	4,2	9,4
Other operating income	1,9	2,3	1,8
Other income	0,5	0,6	0,4
Recovery of written off assets	0,2	0,0	0,0
Unexpected income	-	-	-
Expenditures	**2006**	**2007**	**2008**
	100,0	100,0	100,0
Interest paid	44,2	46,5	44,0
Commission paid	2,0	2,3	1,9
Other operating costs	5,2	5,5	5,3
General administration expenditures	32,4	30,6	24,8
Allocation to reserves	12,5	11,8	20,9
Extraordinary expenditures	-	-	-
Income tax	3,7	3,3	2,8

MAIN GROUP EVENTS OF THE YEAR 2008

21st Annual BSCEE Members' Conference

Belgrade, Serbia, April 10 – 12, 2008

The Chairmanship of the BSCEE Group in 2008 was held by the National Bank of Serbia and Ms. Mira Erić-Jović, Vice Governor of the National Bank of Serbia was entrusted the position of the Chairwoman. Therefore, the 21st Annual BSCEE Members' Conference was hosted by the National Bank of Serbia, on April 10 – 12, 2008 in Belgrade. During the Conference the Austrian Financial Market Authority was accepted as the 21st member of the BSCEE Group.

The first day of the two day's conference was devoted to *Rapid credit growth implication on financial stability influence and implications of credit market turmoil on the CEE countries*. Presentations were made by the representatives of the following institutions:

- Austrian Financial Market Authority, *The Austrian FMA, the Austrian Banking Sector and its Supervision & the Austrian Experience with FX-loans*
- National Bank of Serbia, *Banking Sector in Serbia and Experience with Rapid Credit Growth*
- Polish Financial Supervision Authority, *Banking Sector in Poland 2007*
- Hungarian Financial Supervisory Authority, *Rapid credit growth in Hungary,*
- Central Bank of the Russian Federation, *Stability of the Russian Banking sector: challenges and risks.*

The second day focused on the influence and implications of credit market turmoil on CEE countries. Presentations were made by the representatives of the following institutions:

- New York FED, *Overview of current credit issues and implications for CEE countries*
- Basel Committee on Banking Supervision, *Influence and implications of market turmoil*
- Commerzbank London, *The impact of credit market turmoil on the CEE*

15th International Conference of Banking Supervision (ICBS)

Brussels, Belgium, September 22 -26, 2008

The XV International Conference of Banking Supervision (ICBS) on *Liquidity risk – management and supervisory challenges* and *Valuation, provisioning and risk disclosure* was organized by the National Bank of Belgium and the Banking, Finance and Insurance Commission in Brussels on September 22 – 26, 2008. The first two days of the XV ICBS Conference were dedicated to the Regional Groups' meetings.
The Group of Banking Supervisors from Central and Eastern Europe (BSCEE) held its meeting on the subject of Liquidity risk on September 22, 2008.

The first part of the meeting was dedicated to the signing of the Accord on the Accession of the Banking Agency of Republika Srpska from Bosnia and Herzegovina.

The second part of the meeting concentrated on presentations from various Member countries regarding the topics of *Liquidity risk – management and supervisory challenges* and *Valuation, provisioning and risk disclosure – a search for best practices*:

- National Bank of Serbia, *Liquidity risk – management and supervisory challenges in Serbia*,
- National Bank of the Republic of Belarus, *Liquidity risk – management and supervisory challenges in the Republic of Belarus*,
- Polish Financial Supervision Authority, *Liquidity risk – management and supervisory challenges in Poland*,
- National Bank of Romania, *Liquidity risk – management and supervisory challenges in Romania*,
- Czech National Bank, *Liquidity risk – management and supervisory challenges in the Czech Republic*,
- Austrian Financial Market Authority, *Crisis management in Austria*,
- Hungarian Financial Supervisory Authority, *Liquidity risk, Valuation, provisioning and risk disclosure*.

FSI – BSCEE Regional Seminar

Minsk, Republic of Belarus, May 27 – 29, 2008

The National Bank of the Republic of Belarus in cooperation with the Financial Stability Institute and BSCEE Secretariat organized a regional seminar for BSCEE member countries on *"Revised Core Principles for Effective Banking Supervision".*

BSCEE CONTACT LIST

Supervisory Authorities of the Member Countries	Address	Web-site address
Bank of Albania	*Sheshi Skënderbej No. 1 Tirana, Albania*	www.bankofalbania.org
Austrian Financial Market Authority	*Praterstraße 23 1020 Wien Austria*	www.fma.gv.at
National Bank of the Republic of Belarus	*Fr. Skorina Av. 20 Minsk 220008 Republic of Belarus*	www.nbrb.by
Federal Banking Agency of Bosnia and Herzegovina	*Kosevo 3, Sarajevo Bosnia and Herzegovina*	www.fba.ba
Banking Agency of Republika Srpska, Bosnia and Herzegovina	*Vase Pelagica 11A 78000 Banja Luka Republika Srpska Bosnia and Herzegovina*	*www.abrs.ba*
Bulgarian National Bank	*1, Alexander Blattenberg Square Sofia 1000, Bulgaria*	www.bnbank.org
Croatian National Bank	*TRG Hrvatskih velikana 3 Zagreb 10002, Croatia*	www.hnb.hr
Czech National Bank	*Prague 1,Na Prikope 28 115 03 Czech Republic*	www.cnb.cz
Estonian Financial Supervision Authority	*Sakala 4, Tallin 15030, Estonia*	www.fi.ee
Hungarian Financial Supervisory Authority	*Krisztina krt. 39 1013 Budapest, Hungary*	www.pszaf.hu
Financial and Capital Market Commission	*2A Kr. Valdemara str. Riga, LV-1050, Latvia*	www.fktk.lv
Bank of Lithuania	*Jogailos str. 14 Vilnius, 2629 Lithuania*	www.lbank.lt
National Bank of Macedonia	Kuzman Josifovski Pitu Blvd 1 1000 - Skopije *Macedonia*	www.nbrm.gov.mk

National Bank of Moldova	*Renasterii Ave. 7, Chisinau MD-2006 Moldova*	www.bnm.org
Central Bank of Montenegro	*Bulevar Svetog Petra Cetinjskog 7 Podgorica Montenegro*	www.cb-cg.org
Polish Financial Supervision Authority	*Plac Powstańców Warszawy 1 Warsaw, 00-950 Poland*	www.knf.gov.pl
National Bank of Romania	*25, Lipscani str. Bucharest 1, Romania*	www.bnro.ro
Central Bank of the Russian Federation (Bank of Russia)	*12 Neglinnaya str. Moscow, 103016, Russia*	www.cbr.ru
National Bank of Serbia	*Kralja Petra 12 11000 Belgrade, Serbia*	www.nbs.yu
National Bank of Slovakia	*Imricha Karvasa 1 813 25 Bratislava, Slovakia*	www.nbs.sk
Bank of Slovenia	*Slovenska 35 1505 Ljubljana , Slovenia*	www.bsi.si
National Bank of Ukraine	*Institutskaya Str. 9 252007, Kiev Ukraine*	www.bank.gov.ua
Secretariat BSCEE	*Plac Powstańców Warszawy 1 00-950 Warsaw, Poland*	*www.bscee.org*