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INTRODUCTION

The Group of Banking Supervisors from Central and Eastern Europe (the BSCEE Group) was established in 1990. The BSCEE Group has started its traditional activity since the Stockholm International Conference of Banking Supervisors (ICBS). The BSCEE Group is operating according to its Agreement that determines its organizational structure and the rules governing its operations. It was originally signed by seventeen member countries: Albania, Republic of Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Slovakia, Slovenia and Ukraine. In 2001 the BSCEE Group has expanded its' membership to the Federation of Bosnia and Herzegovina. The Chairmanship of the BSCEE Group rotates on annual basis. In 2001 the Director of the Credit Institution Supervision Department at the Bank of Lithuania chaired the Group.

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

According to the previous years tradition the Annual Report of the BSCEE Group summarizes the developments of the member countries in 2001. This publication gives an overview of the macroeconomic circumstances in the 18 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.

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

Deák Andrea

Andrea Deák
Senior Coordinator
of the Secretariat

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2001 DEVELOPMENTS IN THE BANKING SYSTEM OF THE MEMBER COUNTRIES

2001 DEVELOPMENTS IN THE ALBANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The Albanian economy maintained growth rates in the most important sectors as well as equilibrium of the main macroeconomic indicators, in spite of difficult moments it passed because of power crisis.

Production growth at year-end was estimated at 6.5% almost equal with that projected as a key element for the economy to move up. The major part of this increase happened during the first half of year because the second one was characterized by a general restraint on economic activity, which was a direct result of electric energy lack.

Characteristics of the Albanian economy during this year were:

- **First:** The expansion and strength of private economy versus the passivity and contraction of economic state sector.
- **Second:** Vitality of some sectors of economy such as transport services and investments, mainly in infrastructure.
- **Third:** Decline of importance of such sectors as construction and agriculture, which a year before had a greater impact on gross domestic product than this year.
- **Fourth:** National industrial production, mostly the mining sector, continues to follow last year's decreasing tendency and compared with the previous year, a drastic decrease in the production of electric energy.
- **Finally:** An increase in state investment, especially in infrastructure, is reflected in transport, construction and road construction growth.

The seasonal effects have had their positive and negative impact on the Albanian economy even in this year.

The labour market is characterized by changes in its structure because of many factors such as the privatization process, free movement of population that has changed the proportion between the urban and rural population, decline in average number of family members, emigration, etc.

Meantime, the developments in the fiscal sector look positive marking a decrease in budget deficit relative to that projected. Income and expenses indicators were within compiled predictions on budget plan, but their rate has not been the same. While the incomes are collected systematically, expenses are concentrated mainly in two months, June and December.

Compared with the past years, income and expense level is gradually raised while the budget deficit was on equilibrium.

That inflation remained within planned limits, 3.5 per cent, was an achievement. However, it should be stressed that inflation tendency has been raised compared with the previous year because of some events that happened in and out of the country last year. The impacts of such events were wanes and phasing out of seasonal influences on inflation level.

DEVELOPMENT IN THE BANKING SYSTEM

During 2001, the banking system revealed its positive and negative aspects. A SWOT analysis reveals its strengthens, weaknesses, opportunities and threats.

Banking system strengthens

- Albanian banking system benefited from the stable macroeconomic situation and under continued improvements has further development potential;
- Expansion of banking networks more and more via branches, agencies or representative offices, etc;
- The improvement and expansion of banking services technology;
- Banking system structure seems to be in favour of private capital especially if foreign (privatization process of Savings Bank);
- Banking system capitalization is at satisfactory levels;
- Entrance into the market of other financial institutions (non-bank institutions, and microcredit institutions);
- System's financial results appear positive creating the image of an efficient system;
- Continuous lending activity to clients and improvement of loan portfolio quality for all banking system;
- Liquidity is satisfactory as long as system assets will be concentrated in treasury bills and short-term loans.

Weaknesses

- System suffered from the lack of a developed payment system;
- Competition is still weak and banks appear to be non aggressive in the market (slow expansion in risk activities and slow presentation of a wider range of products);
- A sole bank domination within the system reduces competition;
- Deficiency of a developed interbanking market;
- Banks do not have well-developed credit policies and strategic plans for development.
- Evidence in some banks of deviation from the business plan;
- The lack of an efficient legal framework for the banking system;
- It is more safe for banks to invest in foreign banks and treasury bills than extending to lending activity;
- Country economic development still does not dictate the necessity to open specialized banks such as those of investments, cooperative etc.

Opportunities

- Macroeconomic stability in the country;
- Foreign capital presence in the banking system brings new culture in bank administration and has a great impact for new concepts and practices that foreign banks represent;
- High capital adequacy ratio gives banks the possibility to increase their Return on Assets in the future;

- Competition among banks within system first will lead them in one side to expand their activity in prospective and improvements of quality and on the other side to find possible ways to decrease costs.

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

Banking supervision has made efforts to implement recommendations of the Basle Committee for effective banking supervision by adopting the best practices.

During this year are made some changes in the **legal framework** as:

On May of the year 2000, People's Assembly of the Republic of Albania passed the Law No. 8610 dated 17.05.2000 "On Prevention of Money Laundering". This law entered into force on December 2000. Among subjects that should apply this law are banks, foreign exchange bureaus, and other non-bank financial institutions licensed and supervised from the Bank of Albania.

The law on "Banking Law in Republic of Albania" determines the bank's compulsion to impede concealment, convertibility and transfer of money or property when banks identify or suspect that they come from potential criminal activity.

According to the law on "On Prevention of Money Laundering", is created a "Responsible Authority" at the Ministry of Finance level named "Agency Coordinating the Combat Against Money Laundering". Authority establishment provides the action cycle necessary to prevent money laundering in financial institutions. This cycle includes identification, evidence, information, investigation, and legal actions up to penal proceeding. Banks, and other entities defined in the law, apply all the identification and report procedures of the responsible authority. This authority stands at the end of the cycle by collecting reports, respective verifications, entities' fines, suspicious action suspension and takes verification measures. The "Responsible Authority" reports to the prosecution after assessing and collecting sufficient facts of an offence.

During the year 2001 a new law, No. 8782, dated 03.05.01 "On Saving and Loan Association" was approved, the revised variant of a previous law. Main amendments were the clear definition of the Bank of Albania position as supervisory authority and of Savings and Loan Association in reference to technical assistance and members' financing and supervision. During the year 2001 the number of Savings and Loan Associations reached 100, and they were characterised by a growth tendency both in the rural and urban areas. The Bank of Albania is completing two important draft regulations: "On the granting of the license to the Savings and Loan Association and its Unions" and "On supervisory norms of Savings and Loan Association and its Unions".

During 2001 bank regulations objective has been the review **of supervision regulatory framework.** This review had two main aspects: general review of some regulations and improving the comprehensiveness of some others.

In these aspects:

A) Reviewed and approved from Supervisory Council:

1. The regulation "On foreign exchange operations" with Decision No. 12 date 21.02.01

   The review of this regulation aimed at the increase of the allowed amount for outgoing transfers (outside Albania) from 10 thousand to 20 thousand

USD, adjustments concerning commercial transfers and their payment before or after good's arrival.

2. The regulation "On credit risk management", with Decision No. 13 date 21.01.01.

   The review aimed at the determination of financial position of the borrower as primary element when assessing loan portfolio quality.

3. The regulation "On banks participation in the equity of commercial companies "with Decision No. 42 date 06.06.01.

   In this regulation were clarified the criteria for free investments and investments that need approval from Bank of Albania, made by banks on the equity of commercial companies, different from banks and financial institutions.

B) Improved and approved from Supervisory Council:

1. Advisory "On regulatory capital" with Decision No. 40 date 16.05.01. On the reporting form of regulatory capital was added a part to reflect regulatory capital deductible elements because of the provisions of regulations "On credit risk management", "On banks participation in the equity of commercial companies", "On the amount and make up of minimum initial capital for allowed activities of banks and branches of foreign licensed banks".

2. The regulation "On the control of significant risks" with Decision No. 92 date 05.12.01. In this regulation was made the difference between exposition limits for bank and non-bank beneficiary risks.

C) Approved as an addition to regulatory framework:

Advisory "On certificates of deposits" with Decision No. 79 date 03.10.01. by Supervisory Council.

The composition of this advisory was necessary as a part of Manual on Bank Accounting to discipline further the issuing, using and accounting of certificates of deposits as a new bank product.

As licensing and supervisory authority of saving and loan associations, Bank of Albania is committed on preparing the regulations for this purpose.

The institutional framework doesn't change.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

As an important part of banking supervision, during 2001 on-site inspections improved both in global (covering all the banks inside the system with full-scope inspections) and qualitative aspects.

The improvement of inspection quality has been achieved mainly through various training for inspectors; seminars from foreign specialists of different areas or from more experienced inspectors, transmitting their experience to younger inspectors.

The characteristics of the inspections of this year are as follows:

- **First:** more intensive cooperation between inspectors and second-tier banks managers in order to achieve banking supervision goals: strengthening of banking system, protecting the depositors, especially the small ones.
- **Second:** the evolution of the inspection program, focusing more on banking risk areas than on the review of banking activity, creating a different and more specialized auditing area compared to the control performed by external auditors. For the first time this program was based on the strategies for each bank, designed by respective inspectors, focusing on the problems that have occurred during previous examinations, or from early warning system etc.
- **Third:** the improvement of work effectiveness, which decreases not only the inspectors work time, but also the time needed from the banks to respond to inspection recommendations. The duration of each examination has been reduced to 2-3 weeks.
- **Fourth:** the improvement of inspection quality, focusing on CAMELS analysis, using recent analysis methods.

During 2001, 13 full-scope examinations and 10 partial inspections were carried out, compared to 11 full-scope examinations and 5 partial inspections during year 2000.

The licensing unit continue its activity as last year. During 2001 the number of banks that carry out their activity in Albania has remain 13, but the number of their branches inside Albania is augmented.

According to the approved regulatory framework for non-bank financial institutions in the Republic of Albania, Alba – Post (Albanian Post) Sh.a. and "Credins" Sh.a. were licensed as non-bank financial institutions.

Exchange bureaus are also subject to Bank of Albania supervision. They are licensed and carry out their activity according to the regulation "On foreign currency operations" and its advisories. During 2001 18 new exchange bureaus were licensed.

During 2001 the following entities have had the license to carry out their activity in Albania:

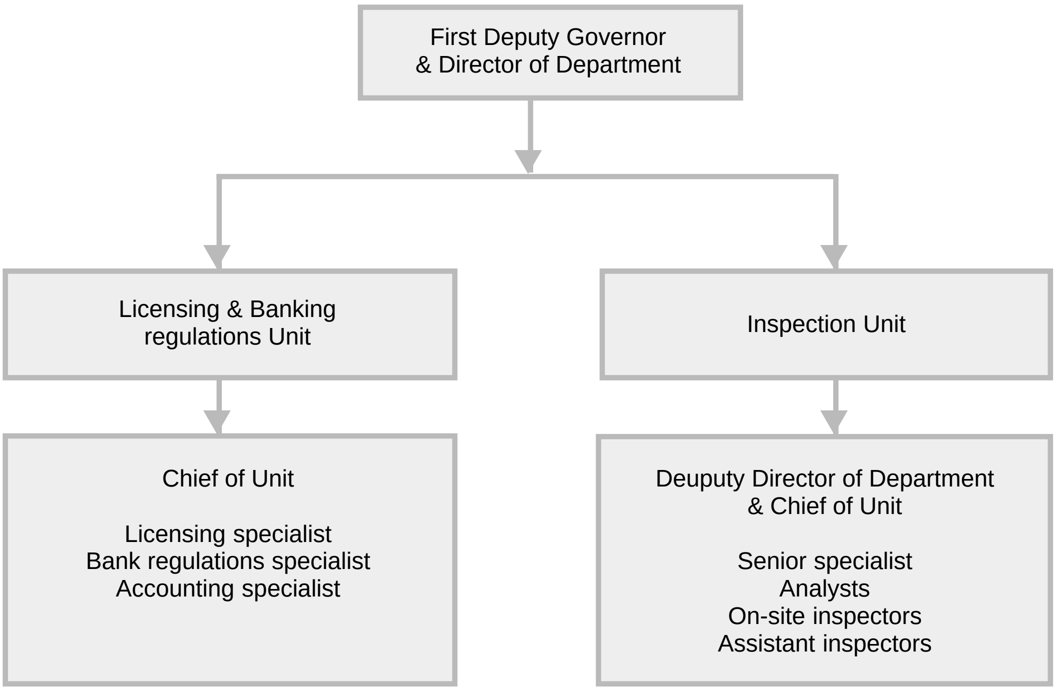
Commercial banks and branches of foreign banks	13
Exchange bureaus	38
Non-bank financial institutions	4

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The legal competence of the banking Supervisory Authority in our country (BOA) based on the law no. 8269, dated 23.12.1997: "On the Bank of Albania" and law no. 8365, dated 02.07.1998: "On banks in Republic of Albania". The main legal competence is the same compare with the last year.

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

Currently, the organisational chart of Bank Supervision Department of the Bank of Albania is as follows:



COOPERATION WITH OTHER SUPERVISORY BODIES

Bank of Albania has cooperation with supervisory bodies but not under any official agreement.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2001

The main supervisory authority objectives during 2001 were as follows:

i. Banks engagement in safe and sound activities.
ii. Identification of specific banks or banking activities that requires the attention of supervisory authority.
iii. Completion, approval and supervision of bank's policies, procedures and other bank's internal regulations by bank's board of directors.

STATISTICAL TABLES

Number of banks (at year-ends)

Type of Banks*	1999	2000	2001
State-owned banks (100%) (G1)	2	1	1
Joint-ventures (G2)	2	2	2
Banks with foreign capital (G3)	9	10	10
Banks, total	**13**	**13**	**13**

**G1= State owned banks (100%); G2- Joint-venture banks; G3= banks with foreign capital hereinafter in all tables*

Ownership structure of banks in 2001 on the basis of registered capital (%)

Item	Type of banks			Total 2001
	G1	G2	G3	
State ownership	100.0	40.0	0.0	13.9
Other domestic ownership	-	-	-	-
Domestic ownership total	100.0	40.0	0.0	13.9
Foreign ownership (private banks)	0.0	-	100.0	72.7
Other foreign ownership (joint-venture)	-	60.0	-	13.4
Foreign ownership total	0.0	60.0	100.0	86.1
Banks, total	**100.0**	**100.0**	**100.0**	**100.0**

Item	1999	2000	2001
State ownership	37.0	13.4	13.9
Other domestic ownership	-	-	-
Domestic ownership total	37.0	13.4	13.9
Foreign ownership	44.0	71.7	72.7
Other foreign ownership (in j-v)	19.0	14.9	13.4
Foreign ownership total	63.0	86.6	86.1
Banks, total	**100.0**	**100.0**	**100.0**

Distribution of market shares in balance sheet total (%)

Type of banks	1999	2000	2001
G1	81.4	64.8	59.2
G2	5.8	6.2	5.8
G3	12.8	29.0	35.0
Banks, total	100.0	100.0	100.0

**based on assets*

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

Assets	1999	2000	2001
1. Treasury operations and interbank	81.2	88.4	85.7
2. Operations with customers (net)	10.7	6.1	8.6
3. Securities transactions (net)	0.8	2.9	3.3
4. Other assets	4.3	0.6	0.4
5. Fixed assets	3.0	1.9	1.8
Total accrued interest	**0.1**	**0.1**	**0.3**
Liabilities and shareholders' equity	**1999**	**2000**	**2001**
1. Treasury operations and interbank transactions	1.3	2.3	3.6
2. Operations with customers	82.9	84.8	86.2
3. Securities transactions	0.0	0.0	0.0
4. Other liabilities	8.9	4.6	3.0
5. Permanent resources	4.8	7.1	6.2
Total accrued interest	**2.0**	**1.2**	**1.1**

Solvency ratio of banks

Type of Banks	1999	2000	2001
G1	-11.0	44.5	29.9
G2	44.8	39.4	40.4
G3	43.5	41.8	35.7
Banks, average	**8.2**	**42.0**	**35.3**

Asset portfolio quality of the banking system (%)

Asset Classification	1999	2000	2001
Standard	48.0	59.1	88.3
Special mentioned	2.9	7.4	4.6
Substandard	6.6	3.3	4.0
Doubtful	2.4	4.1	1.7
Loss	36.6	26.0	1.3
Overdue loans/Total of loans	32.7	42.8	6.9
Classified Total	**96.5**	**100.0**	**100.0**
Provisions	**44.0**	**30.1**	**4.4**

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

	Deposits	Loans
Households	83.9	15.1
Public Sector	6.4	1.9
Private Sector	9.7	83.0
Foreign	33.0	81.7
Total	**100.0**	**100.0**

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

Maturity of Deposits		Loans	
At sight	38.3	Short-term loans	55.1
Within one year	61.2	Medium-term loans	19.0
Over one year	0.5	Long-term loans	5.4
		Real estate loans	14.9
		Other loans	5.6
Total	**100.0**	**Total**	**100.0**

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

Type of banks	FOREX Assets/Total Assets			FOREX Liabilities/Total liab&Equity Capital		
	1999	2000	2001	1999	2000	2001
G1	21.9	15.5	16.5	18.1	15.2	16.5
G2	93.3	92.1	88.0	91.6	88.2	85.5
G3	81.7	62.9	64.8	81.2	41.3	64.2
Banks, average	**21.9**	**34.0**	**37.6**	**30.5**	**27.3**	**37.2**

Structure of incomes and expenses for banks

Incomes	1999	2000	2001
GI	88.8	73.3	61.2
G2	2.8	5.1	8.6
G3	8.4	21.6	30.2
Banks, total	**100.0**	**100.0**	**100.0**
Expenses			
G1	89.2	70.2	59.7
G2	2.3	5.7	9.9
G3	8.5	24.1	30.4
Banks, total	**100.0**	**100.0**	**100.0**

Structure of registered capital and own funds of banks in 2001

Type of Banks	Registered Capital USD	/Total Assets %	Own Funds USD	/Total Liabilities %
G1	5.1	0.4	28.7	2.1
G2	22.9	15.8	25.5	18.7
G3	74.9	9.2	82.3	10.2
Banks, average	102.9	4.4	137.4	5.9

Note: Rate of exchange USD/Lek =137.69

Average balance sheet items

in mio USD

Items	1999	2000	2001
Average balance sheet total (assets total)	1680.7	1794.5	2152.9
Average own capital	57.3	179.9	145.4

Profitability of banks

Type of Banks	1999		2000		2001	
	ROA	ROE	ROA	ROE	ROA	ROE
G1	0.5	–	2.9	–	1.7	58.8
G2	1.6	6.1	0.6	2.8	0.1	0.6
G3	0.3	2.0	0.7	3.0	1.3	11.4
Banks, average	**0.6**	**16.4**	**2.1**	**20.7**	**1.5**	**21.6**

Profit and loss statement

in mio USD

Items	1999	2000	2001
Interest income	191	164.3	164.2
Interest expenditure	152.7	109.7	100.6
1) Net interest income	38.3	54.6	63.6
2) Profit from other financial and investment services (including devidentes)	8.6	14.8	17,4
Of that: Profit from commissions	6.7	10.6	11.4
b) Net provisions	11.4	-11.2	5
3) Gross financial and investment services profits (1+2-b)	35.5	80.6	76
4) Overheads	23.4	53	35.1
5) Extraordinary profits	1.4	0.5	0.4
6) Pre-tax profit (3-4+5)	13.3	53.1	40.8

Components of the Banking Sector Return on assets (%)

Items	1999	2000	2001
In proportion to the average balance sheet-total			
Interest income	11.4	9.2	7.6
Interest expenditure	9.1	6.1	4.7
1) Net interest income	2.3	3	3
2) Profit from other financial and investment services (including dividents)	0.5	0.8	0.8
Of that: Profit from commissions	0.4	0.6	0.5
b) Net provisions	0.7	-0.6	0.2
3) Gross financial and investment services profits (1+2-b)	2.1	4.5	3.5
4) Overheads	1.4	1.6	1.6
5) Extraordinary profits	0.1	0	0
6) Pre-tax profit (3-4+5)	0.8	2.9	1.9

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

Type of banks	1999	2000	2001
G1	N.A	N.A	0
G2	N.A	N.A	7.7
G3	N.A	N.A	8.4
Banking System	N.A	N.A	4

2001 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF BELARUS

MACROECONOMIC ENVIRONMENT

Monetary policy in 2001 was pursued in line with the Republic of Belarus Monetary Policy Guidelines for 2001 having regard to the existing macroeconomic conditions and was aimed at ensuring economic and social development of the country stipulated by Edict of the President of the Republic of Belarus #505 "On Approval of Overriding Parameters of Social and Economic Development Forecast of the Republic of Belarus for 2001" dated September 19, 2000, Law of the Republic of Belarus "On Budget of the Republic of Belarus for 2001" and Edict of the President of the Republic of Belarus #749 "On Updating Certain Parameters of the Budget of the Republic of Belarus for 2001," dated December 17, 2001.

The most critical monetary policy measures have been devised and implemented by the National Bank in concert with the Government of the Republic of Belarus. The principal objectives of a single state monetary policy in 2001 were as follows: to protect and deliver stability of the Belarusian ruble, including its purchasing power and the rate of exchange relative to foreign currencies, to develop and strengthen the banking system of the Republic of Belarus, and to ensure effective, reliable, and safe functioning of the payment system.

Development and strengthening of the banking system of the Republic of Belarus are characterized by an increase in the aggregate authorized fund and own capital of the banks and in the share of foreign capital in the banks' authorized funds as well as by expansion of active banking operations.

Effective, reliable, and safe functioning of the payment system has been assured. With respect to major characteristics, the payment system of the Republic of Belarus meets the most recent international standards.

Along with attaining principal objectives of monetary policy, its instruments were used in 2001 to address important tasks of the national economy such as banks' lending for the needs of Republican budget deficit, real sector of the economy, state programs and measures.

DEVELOPMENT OF THE BANKING SYSTEM

In 2001, the composition of banks did not undergo, by and large, changes. Two new banks were established, i.e. closed joint-stock companies "Atom-Bank" and "Severny Investitsionny Bank" (Northern Investment Bank); four banks were removed from the banking services market as a result of merger and liquidation (open joint-stock companies "Belorusskiy Bank Razvitiya" (Belarusian Development Bank) and "Belbiznesbank", limited liability company "BelBaltia", and closed joint-stock company "BelKomBank"). Twenty-five banks were operating under normal conditions in the Republic of Belarus in 2001, of which 20 joint banks with foreign capital participation that account for 26% of the banking system assets.

Also, there are two foreign-owned banks whose share in the banking system assets is 0.5%. The branch network is made up of 509 branches. Finally, there are nine representative offices of foreign banks and credit and financial institutions of Russia, Baltic states, Germany, and Poland.

In 2001, the banks' authorized fund grew, in real terms, by 3.2%, whilst that of the authorized banks entitled to service government programs and measures (joint-stock savings bank "Belarusbank", open joint-stock companies "Belagroprombank", Belinvestbank", "Belpromstroibank", "Belvnesheconombank", and "Priorbank" open joint-stock company) decreased by 6.1%. Banks' own capital increased, in real terms, in 2001 by 4.6%; that of the authorized banks by 2.8%.

During 2001, sustainable growth of the share of foreign capital in banks' authorized funds was observed: from 4.54% at early 2001 to 9.57% at the end of 2001. Foreign investments in the authorized funds of Belarusian banks amounted to USD8.6 million and EUR0.5 million in 2001, coming from the British Commonwealth, USA, Austria, Lybia, Switzerland, Cyprus, Russia, Lithuania, and Latvia.

As of January 1, 2002, 16 banks formed their own capital in the amount of over EUR5 million and 10 banks in the amount exceeding EUR10 million.

In 2001, profit-earning capacity of banks reduced and their profitability in relation to the authorized fund accounted for 9.1%, that of the authorized banks – 7.3%, compared with 16.2% and 27.1 %, respectively, in 2000. Profitability of banks in relation to expenditures in 2001 amounted to 2.6%, of the authorized banks – 1.9%, compared with 2.6% and 4.5%, respectively, in 2000. One of the main factors influencing the reduction of banks' profit-earning capacity and their financial stability was non-payment of interests for granted credits by economic entities. As of January 1, 2002, overdue interest payments amounted to BYR132.4 billion (of which 93.2% being the share of the authorized banks), while in 2001 the banking sector earned profit in the amount of BYR28.7 billion.

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

Key aspects of activities of banks and non-bank credit and financial institutions of the Republic of Belarus were legally settled with the enactment on January 1, 2001, of the Banking Code of the Republic of Belarus. Efforts were undertaken to harmonize banking legislation of the Republic of Belarus and the Russian Federation.

To protect depositor interests, the National Bank has prescribed certain economic standards for banks which are intended to limit the risk which might be incurred by natural persons depositing funds: the standard of own capital has been raised with respect to banks that have been issued a license to attract deposits from natural persons; a standard of maximum amount of funds attracted from natural persons which may not exceed a bank's own capital has been set; and a maximum ratio between funds attracted from natural persons and low-risk level assets has been set. A system guaranteeing household deposits in Belarusian banks is in place. To limit high-risk placement of funds in foreign countries, the maximum aggregate amount of risk with respect to the funds placed in non-OECD member countries has been prescribed which may not exceed a bank's own capital, and minimum requirements have been imposed on non-resident banks of the Republic of Belarus whose observance makes it possible for Belarusian banks to place funds therein.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2001, the National Bank was improving methodology and organization of control and supervision over banks' performance. Bringing this methodology closer to the international standards recommended by the Basle Committee on Banking Supervision as much as possible, harmonization of banking legislation with that of the Russian Federation, and development of methodology for banks' supervisory bodies in regard to analysing balance sheets, reports, and bank risks as well as conduct of on-site inspections form the basis of such improvement. The main activities of the National Bank in this respect were as follows:

- to reorganize banking supervision services and concentrate supervisory functions in the main office of the National Bank;
- to track developments in the banking system and to exercise individual supervision over each bank;
- to inspect a bank in whole as well as its certain operations; and
- to enhance liability of a bank's management for its performance.

In 2001, the National Bank made 11 comprehensive and 40 subject inspections of banks. Following such inspections a wide range of measures is implemented – from orders to remedy revealed deficiencies to fine recovery and referral of banks' managers for performance re-evaluation. In 2001, for instance, BYR130.8 million were recovered from banks in fines, performance of two managers of branches was re-evaluated and 16 administration sanctions were imposed.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

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

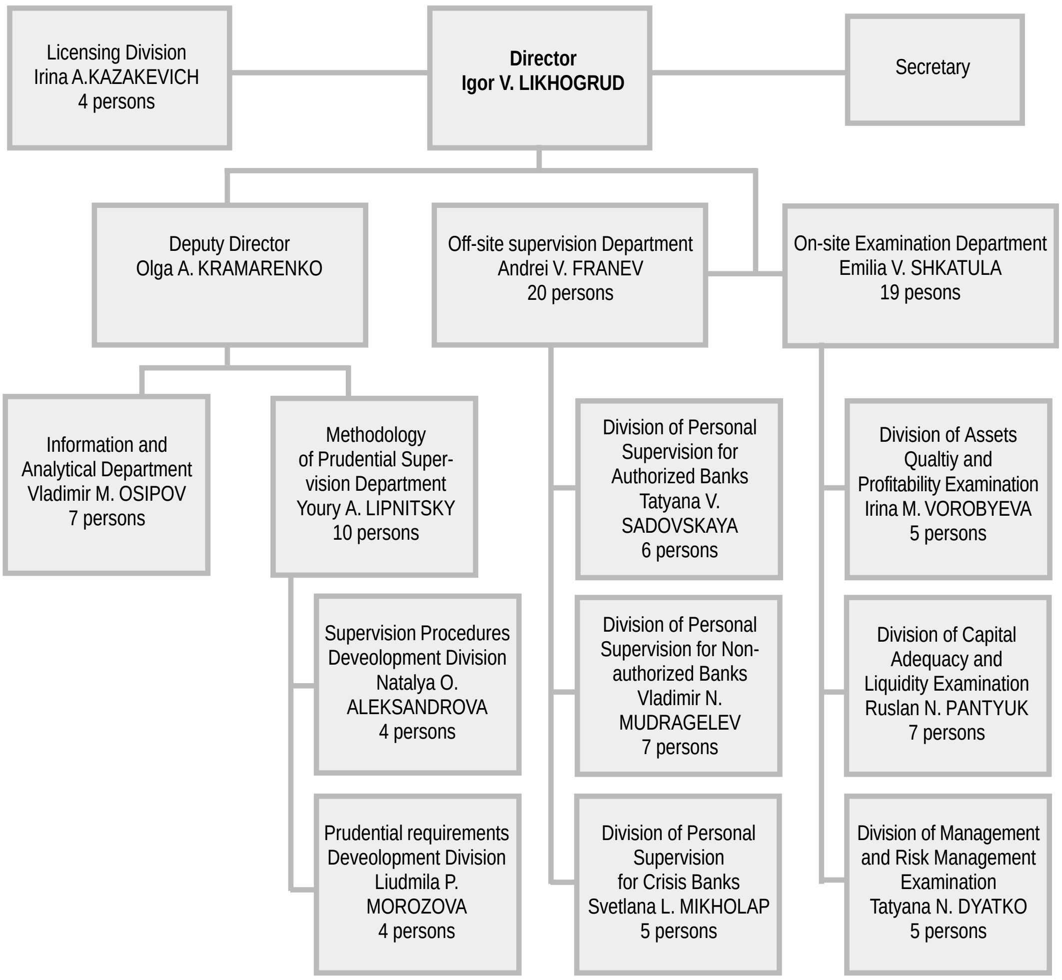
In carrying out banking supervision in the Republic of Belarus, the National Bank carries out the following functions:

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

The majority of the above functions is carried out by the Banking Supervision Directorate, whose new structure was approved in April 2001.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISION DIRECTORATE

Banking Supervision Directorate
63 persons



INTERNATIONAL COOPERATION OF THE SUPERVISORY AUTHORITY

International contacts with the Basel Ñommittee on Banking Supervision (Basel) and the Secretariat of Group of Banking Supervisors from Central and Eastern Europe (Budapest) are maintained. Information on the banking system of the Republic of Belarus requested by the IMF and EBRD was given to their representa-tives.

During 2000, the National Bank of the Republic of Belarus, in concert with the Central Bank of Russia, was focusing its efforts on the unification of principles and mechanisms of monetary policy of Belarus and Russia. Four meetings of the Inter-bank Currency Council were held, each of them resulting in crucial decisions in that area.

Over the course of the past 2 years transboundary supervision contracts with the supervisory bodies of Russia, Ukraine, Armenia, and Cyprus were made. On 09.03.2001 the Memorandum of Mutual Understanding in the field of bank supervision with the Bank of Latvia was signed.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

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

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2001

In 2002, banks will continue to build up their equity and to expand their resource base by attracting funds from legal entities and the general public. Improvement of banks' financial standing should be based on the enlargement of banks' active operations in the real sector of the economy and on an increase of the share of credit and investment operations. Structural reorganization of banks will be realized by speeding up withdrawal of problem banks from the banking system and transfer of the National Bank's share in the banks' authorized funds to the Government of the Republic of Belarus.

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

As regards international cooperation, in 2001, cooperation of the banking system of the Republic of Belarus with that of the Russian Federation was considered a matter of priority and was aimed at converging monetary systems of Belarus and Russia and creating conditions for the introduction of a single currency of the Union State. According to the inter-state Agreement on the introduction of a single currency and establishment of a single centre of issue of the Union State, in March 2001, at the meeting of the Inter-bank Currency Council, the Plan of joint actions for 2001-2005 intended for creating conditions for the introduction of a single currency as regards issues within responsibilities of central banks of the Republic of Belarus and the Russian Federation was adopted. In pursuance of the above-mentioned Agreement, the first tranche of a credit from the Bank of Russia in the amount of RUR1.5 billion was extended to the National Bank and the agreement on granting the second tranche of the credit was signed.

The National Bank activated the work on ensuring integration in the sphere of banking within the Eurasian Economic Community and the CIS. Agreements on setting up the Council of Governors of central (national) banks' of the Treaty on the Eurasian Economic Community member states and on establishing the Advisory Council of central banks of the Republic of Belarus and Ukraine were concluded.

In 2001, efforts were directed towards restoring confidence of the world community in the Republic of Belarus economic policy and resuming large-scale cooperation with international financial organizations, principally with the International Monetary Fund and the World Bank. As a result of consistent transformations in the sphere of monetary and foreign exchange policies, the Staff Monitored Program aimed at monitoring the economic situation in the Republic of Belarus was being implemented during April 1 – September 30, 2001. It will be a basis for conducting negotiations concerning a Standby Arrangement in 2002. As regards cooperation with the European Bank for Reconstruction and Development (EBRD), implementation of the Line of Credit for the development of small and medium enterprises in Belarus was continuing. Within the framework of the Line of Credit, the Micro Lending Program was agreed upon and entered into force. In connection with the process of the Republic of Belarus' joining the World Trade Organization, the work on liberalization of access for foreign companies to the financial and banking services markets of the country is being carried out in line with its requirements.

As for bilateral relations with foreign central banks, in 2001, the Memorandum of Understanding in the sphere of banking supervision with the Bank of Latvia and the Agreement on cooperation with the People's Bank of China were concluded.

STATISTICAL TABLES

Number of financial institutions *
(at year-ends)

Type of financial institution	1998	1999	2000	2001
Commercial banks	37	36	31	25

**) Number of acting financial institutions*

Ownership structure of financial institutions in 2001
on the basis of registred capital (%)
(at year-end)

Item	Commercial banks
State ownership	76.32
Other domestic ownership	14.11
Domestic ownership total	90.43
Foreign ownership	9.57
Financial institution, total	**100.00**

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

Item	1999	2000	2001	2001/1999
State ownership	90.97	87.52	76.32	83.90
Other domestic ownership	4.54	8.00	14.11	310.79
Domestic ownership total	95.51	95.52	90.43	94.68
Foreign ownership	4.49	4.54	9.57	213.14
Financial institution, total	**100.00**	**100.00**	**100.00**	

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

Type of financial institution	1998		1999		2000		2001	
	Quantity Of banks	market share	Quantity Of banks	market share	Quantity Of banks	market share	Quantity Of banks	market share
Bank's equity capital	**26**	**100.00%**	**27**	**100.00%**	**28**	**100.00%**	**25**	**100.00%**
incl.								
Negativ equity capital	2	13.51%	1	0.79%	2	1.82%	0	0.00%
to 1 bln. roubles	16	8.47%	10	3.85%	1	0.06%	2	0.25%
from 1 to 10 bln. roubles	8	78.02%	14	41.25%	18	10.70%	11	10.65%
from 10 to 40 bln. roubles	0	0.00%	0	0.00%	5	33.24%	8	24.90%
more than 40 bln. roubles	0	0.00%	2	54.11%	2	54.18%	4	64.20%

Solvency ratio of financial institutions (%)

Type of financial institution	1998	1999	2000	2001
Commercial banks	11.30	31.48	24.43	20.70

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

	1998	1999	2000	2001
Assets				
Credit to national economy	45.7	47.1	50.4	30.9
Credit to individuals	6.7	8.9	5.2	4.1
Credit to General Government, Local Government	7.0	7.7	8.0	4.9
Securities issued by legal entities (excluding banks)	0.2	0.7	0.9	6.0
Own debt securities	0.0	0.0	0.1	0.1
Required reserves	5.0	6.0	4.6	3.7
Cash assets, gold, precious metals	1.7	1.6	1.9	1.4
Assets in other banks	18.0	11.3	13.0	5.3
Participations	0.1	0.1	0.4	0.1
Permanent assets and intangibles	2.8	3.6	4.9	6.3
Correspondent accounts in other banks	8.4	7.9	6.5	3.2
Other assets	4.6	5.1	4.2	34.0
Total	**100.0**	**100.0**	**100.0**	**100.0**
Liabilities				
Funds and undistributed profits	6.9	16.5	14.8	10.3
Incl. Statutory fund	1.4	12.2	8.0	5.0
Budget accounts	1.5	1.3	1.4	8.5
Accounts of individuals	13.3	11.3	15.8	13.0
Accounts of enterprises	36.4	37.4	35.2	13.4
Non budgetary resources and funds and				
resources of fiscal organizations	4.1	5.3	4.1	1.4
Debt securities	0.6	1.1	1.0	1.0
Correspondent accounts of other banks	3.4	2.0	1.4	1.2
Deposits of other banks	20.1	11.7	12.1	3.2
Credit from General Government	1.7	1.0	3.0	5.1
Other liabilities	12.1	12.4	11.1	37.9
Total	**100.0**	**100.0**	**100.0**	**100.0**

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

Type of financial institution	1998	1999	2000	2001
Commercial banks	143.80	157.16	131.63	193.10

Asset portfolio quality of the banking system

mln.roubles

Asset classification	1998	1999	2000	2001
Loans, total	**241,607.5**	**524,344.4**	**1,701,805.3**	**2,726,594.8**
Extended loans	12,396.3	19,285.7	72,207.0	75,675.4
Past due loans	3,455.3	6,304.9	36,037.7	78,163.9
Doubtful loans	24,108.3	43,132.6	150,129.1	2,388,441.9
Past due interest				
up to 30 days	1,951.2	3,756.1	13,415.9	15,642.1
More than 30 days	9,945.0	17,554.3	75,936.3	116,725.8
Special reserves	12,106.2	30,617.5	122,294.3	137,937.5

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

	Deposits	Loans
Commercial organizations	44.3	88.3
Households	49.1	10.5
Noncommercial organizations	3.4	1.0
Nonbank financial institutions	3.3	0.2
Total	**100.0**	**100.0**

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

Types of Deposits		Types of Loans	
Demand Deposits	56.25	Long-term Lending	37.40
Time Deposits	43.75	Short-term Lending	62.60
Total	**100.00**	**Total**	**100.00**

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

Type of financial institutions	Forex Assets/ Total Assets				Forex Liabilities / Total Liabilities			
	1998	1999	2000	2001	1998	1999	2000	2001
Commercial banks	52.36	40.28	55.75	45.62	50.21	38.80	54.16	44.24

Profit and loss statement

mln.USD

Items	1999	2000	2001
Interest income	518.4	467.0	382.4
Interest expenditure	321.8	328.0	234.5
1) Net interest income	196.6	139.0	147.9
2) Profit from other financial and investment services (including dividends)	-94,2	-63.5	-51.2
Of that: profit from commissions	68.4	50.0	81.8
Of that: net provisions	43.7	28.9	15.1
3) Gross financial and investment services profits (1+2)	102.4	75.5	96.7
4) Overheads	73.4	59.8	78.4
5) Extraodinary profits	0.0	0.1	0.0
6) pre-tax profit (3-4+5)	29.0	15.6	18.3

Average balance sheet items

mln.USD

Items	1999	2000	2001
Average balance sheet items (assets total)	4,227.8	3,674.7	4,410.9
Average own capital	417.0	328.5	374.7

Components of the banking sector return on assets (%)
(In proportion to the average balance-sheet total)

Items	1999	2000	2001
Interest income	12.3	12.7	8.7
Interest expenditure	7.6	8.9	5.3
1) Net interest income (interest margin)	4.7	3.8	3.4
2) Profit from other financial and investment services (including dividents)	-2.2	-1.7	-1.2
Of that: profit from commissions	1.6	1.4	1.9
Of that: net provisions	1.0	0.8	0.3
3) Gross financial and investment services profits (1+2)	2.4	2.1	2.2
4) Overheads	1.7	1.6	1.8
5) Extraodinary profits	0.0	0.0	0.0
6) Pre-tax profit (ROA)	1.59	1.03	0.78

Structure of registered capital and own funds of financial institutes

Type of the financial institutions	Registered capital / Total assets		Own Funds / Total liab.	
	USD mln	%	USD mln	%
Commercial banks	200.7	4.5	374.7	0.8

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

bln.roubles

	1998	1999	2000	2001
Revenues				
Interest revenues	29.9	165.9	551.1	604.2
Commission	5.9	25.3	65.5	147.1
Other revenues	12.6	41.5	96.3	356.5
Other operational revenues	1.0	2.1	3.2	5.4
Reserve settlement	0.7	2.1	6.2	15.1
Unanticipated revenues	0.0	0.0	0.2	0.0
Total revenues	**50.1**	**236.9**	**722.5**	**1,128.3**
Expenses				
Interest expenses	19.6	103.0	387.1	370.6
Commission	1.0	3.4	6.4	17.8
Other expenses	8.0	31.1	54.6	307.0
Other operational expenses	15.0	74.0	215.5	365.1
Allocation to reserve	4.4	16.1	40.4	39.1
Unanticipated expenses	0.0	0.0	0.0	0.0
Total expenses	**48.0**	**227.6**	**704.0**	**1,099.6**
Economic revenue	2.1	9.3	18.5	28.7

Excluding banks under liquidation

2001 DEVELOPMENTS IN THE BANKING SYSTEM OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

Reconstruction of the banking sector in the Federation of BiH has achieved significant results in year 2001. Assets in banks attained value of 3.8 billion KM which is higher by 49 per cent in comparison to previous year. Further, money assets increased by 74, and loans by 38 per cent. If we observe banks individually, growth of assets in private banks was between 4 to 325 per cent, and in state banks there was no change. In two banks assets are over 500 million KM, and in three banks assets are between 200 and 300 million KM, which is considered as medium-sized banks by international standards (asset of 150 to 250 million US$). The ratio of non-performing assets has decreased from 10 to 6 per cent, and that has resulted in a decreased allocations of general and special reserves for potential loan losses.

If we observe previous years, excluding inherited losses, it is the first time after the war, that the whole banking system has earned positive financial results. As it is stated in the reports of banks, 25 banks have earned income of 32.6 million of convertible marks, and seven banks had a loss of 59.7 million KM. Eighty-eight per cent of that loss was created in one private bank mainly due to resolving debts from the past, based on purchase of part of assets and assumption of liabilities from another bank, which was done in agreement with the owner. Total loss in the bank will be offset by additional capital, which is in progress, and that will be completed by mid April 2002. Six banks have posted a loss of 7.7 million KM at the end of last year.

Deposits, the most important source of financial potential in banks, increased by 1.1 billion KM, or 65 per cent in last year. The major part of this growth is based on savings of citizens (185 per cent of growth or 853 million KM), which positively influenced the status of the banking sector, starting operations of the Deposit Insurance Agency and the most, conversion of European currencies to Euro. Although the maturity schedule of deposits is still not satisfactory (85 per cent are short-term), it is important to emphasize that it is gradually changing, and there are more long-term deposits. Long-term deposits increased from 9.5 per cent (2000) to 14.7 per cent in 2001. Deposits to total liabilities were 76.8 per cent which makes local banks more alike to international average, which is around 80 per cent. There is also a trend of decrease in assets that our banks possess in banks abroad. At the end of last year that was 43 per cent of banks' money assets, or 769 million KM. Last year that figure was about 60 per cent. At the same time, the amount of assets at reserve accounts at the Central Bank of BiH increased to almost 36 per cent of total money assets in banks (obligatory, regulatory reserves are 10 per cent).

Growth ratio (3 per cent or 75 million KM) of total capital, compared to other balance sheet positions, was low. That resulted from decreased capitalization ratio (capital against assets) from 22 per cent in 2000 to 15 per cent in 2001. That trend is due to a decision of the Government of F BiH to decrease capital in Investment Bank F BiH by 108 million KM and to "clean" the sub-balance in Central Profit Bank and Privredna Bank Sarajevo. That resulted in a decrease in capital in those banks by 51 million KM. Finally, four banks with capital of 21 million KM were closed, and information for Hercegovaèka Bank, which is under provisional administration, was not included. Strengthening capital in banks will remain the most important task in future.

Loan portfolios in banks were increased by 432 million KM or 38 per cent during last year. It is evident that focus of loan operations is transferred to citizens' loans. In that sector, banks achieved an increase of 262 million KM or 72 per cent. Loans to private enterprises were increased by 35 per cent or 202 million KM. Due to significantly increased total assets, participation of interest-bearing assets in total assets was decreased from 52 to 46 per cent, although the loan portfolio increased. The maturity of assets and liabilities is not matched and it could have negative effect on liquidity in banks during future period.

Aside from the above-mentioned satisfactory financial results, significant developments of last year included the transfer of the internal payment system from ZPP to commercial banks, the commencement of privatization in banks, changes in ownership structure by foreign investments, and first licenses issued by the Deposit Insurance Agency.

Very significant development in the reconstruction of banking sectors and financial sector as a whole was the transfer of all internal payment operations from ZPP to commercial banks. On one hand, banks gained the possibility to increase liquid assets and deposits and to achieve additional income by taking over those operations, and on the other, banks were in position to reduce expenses related to ZPP fees. According to the reports, banks utilized that opportunity well, and general opinion is that banks took over internal payment operations fast and successfully.

Starting from the January 5th until end of 2001, all banks in the Federation of BiH had 89,953 accounts, and they have performed 16.3 million of payment transactions in total value of 32.3 billion KM.

The privatization of banks owned by the state has been initiated during the last month of the last year. Sarajevo Privatization Venture (SPV) has signed a contract with the Government of the F BiH and privatized Central Profit, Travnièka and Privredna Bank Sarajevo. This resolved the solidarity responsibility of banks, which earlier were part of the PBS system. At the same time, ABS bank purchased the state capital in Šipad Bank and merged that bank.

Investment Bank F BiH, Union Bank, Una Bank, Gospodarska Bank Mostar, Ljubljanska Bank and Poštanska bank are still to be privatized. The government of F BiH decided the final dead line for privatization, May 31st 2002. All banks that are not privatized by that time, will be placed in liquidation process.

In 2001, there were radical changes in the ownership structure in banks in the Federation of BiH. Based on preliminary reports, foreign capital in banking sector became predominant: out of total share capital (460 million KM) about 290 million KM or 63 per cent is owned by foreign investors. Comparing to the previous year, the growth of this aspect of capital was over 150 million KM or almost 115 per cent.

Number of banks in the Federation of BiH

DATE	TOTAL	Pre-dominantly state capital	Predominantly local foreign capital	Pre-dominantly private capital
12/31/1999	44	8	26	10
12/31/2000	38	12	16	10
12/31/2001	33	16	11	6

Out of total banks, six are hundred per cent owned by foreign investors, and in ten banks investors from abroad own 60 to 99 per cent of the share capital. Those banks hold 73 per cent of total assets in the banking sector.

Deposit insurance up to KM 5,000 significantly contributed to recovering of trust in the banking system and that has resulted in increased savings and total deposits. During last year, the Deposit Insurance Agency issued licenses to seven banks in the Federation of BiH: UPI Bank dd Sarajevo, Raiffeisen Bank BH dd Sarajevo, Volksbank BH dd Sarajevo, Zagrebaèka Bank BH dd Mostar, Universal Bank dd Sarajevo, MEB Bank dd Sarajevo and Turkish Ziraat Bank Bosnia dd Sarajevo. Banking Agency of the F BiH has offered undivided support to the Deposit Insurance Agency by cooperation in all areas, and especially, by sharing information and data. Procedures for institution of unified Deposit Insurance Agency for whole state of BiH are currently going on.

REFORM OF BANKING SYSTEM

Stability and strength of the banking sector, as leading factors of financial stability in each country and one of the important conditions for success of complete revision of the economy, were established as goals of reform and reconstruction of the banking sector in the Federation of BiH. The setting for those objectives was:

- elimination of problems inherited from previous system and war damage,
- ownership transformation by privatization of capital in state bank by selling it to predominantly privately owned banks,
- development of efficiency and soundness of banking operations, strengthening of capital base, implementing international standards, accepting worldwide accepted organizational standards, operations and supervision.

Conditions for the reform

The amount and complexity of inherited problems is presented in the best way by information that at the beginning of the reform, negative net capital in banks amounted to about four billion of KM. If we add inappropriate, socialistic and insufficient regulatory framework, interference of the state, lack of market, lack of staff and other inadequacies, we can form a realistic picture showing the complexity of the reform, which was time-consuming.

Four years later, it is possible to conclude that significant progress and results were achieved. Net capital in banks is positive today, that is, it is higher than 500 million of KM. Regulatory framework was developed and statutory regulations were designed to satisfy transitional period. With certain adjustments and additions, those regulations will be adequate for market oriented environment that is still developing.

Unfortunately, successful transformation of banking industry was not followed by changes in other sectors, especially in the core economy sector, which is still stagnating. It is necessary to provide additional development of regulatory framework for any further progress, mainly by passing more adequate procedures for judgments and implementation of educational judicial procedures, that is, to improve legal protection of the trustees.

Privatization and reconstruction

It is realistic to expect that banks owned by the state will "disappear" by the middle of current year by executing regulated liquidation in banks if they do not adjust to privatization time lines.

At the same time, it is reasonable to expect that number of banks in the Federation will continue decreasing. There is more and more evidence for that statement. By the end of year, banks have to acquire regulatory capital (paid share and net capital) of 15 million KM. It is very probable that some of the banks will not be able to abide by that regulation, consequently, they will have to merge between themselves. Conversely, the liquidation in those banks will be inevitable. The more intensive competition and expansion of foreign capital is unlikely to allow the existence of Lilliputian banks. Currently in the Federation of BiH, 14 banks have assets less than 50 million KM, and capital in five of them is even smaller than 20 million! It goes without saying that banks will not be expected to just that capital, but to have adequate capital as well. If they do not find resolutions to provide fast additional capital, if they don't merge, it will be hard for them to survive.

Banking Agency

Banking Agency of the F BiH, as an independent institution for supervision and licensing of banks, was founded at the end of 1996. From the very beginning the activities of the Agency were designed to create a strong and stable banking system, one hat is market-oriented and adjusted to international business, and the supervision of standards in banks. The Law on Banking Agency has defined the main duties of the Agency which, in short, are licensing banks for inception and operations, passing regulations, supervising banks and undertaking actions as regulated by the Law (this includes provisional administration and liquidation in banks, that is, initiating bankruptcy in those banks).

It can be declared with certain reservations that our banking system is more or less freed from weak and incompetent banks, but that is still an unfinished process. During that process, there were many misunderstandings of operations and actions undertaken by the Agency. First, it is a problem of misunderstanding the role, duties and authorities of the Agency which supervises banks' operations, but is not responsible of their operational results. Exclusive responsibility for operational results in banks is on managing and governing bodies in the bank. It is overlooked that banks are operating with money of customers, citizens and enterprises, and that their capital is just small part of assets that they use and manage. Therefore, in order to protect investors and depositors whose money the banks use to operate, there are effective standards for operations, continuing control and austere supervision. Implementation of that practice in our state faced disagreements, and even resistance.

Activities performed by the Agency are specific and therefore, the Agency cannot report on its activities in more detail and more often to public. Publication of actions and orders installed in some banks by the Agency after the examination so the bank can correct irregularities or weaknesses could cause additional problems. Each information disclosing that there are weaknesses in a bank would be a reason to depositors of that bank to withdraw their money, and that would cause the downfall of banks even stronger and larger than those in our country. Therefore, preventive actions undertaken by the Agency will continue to be unavailable for the public. The outcome of those situations is usually adverse and often unjustifiable. Occasionally the Agency receives criticism that corrective actions were not imposed in time, that the Agency is responsible for business failures made by bank's management and government. There are even charges at court filed by discontented bankers, depositors and shareholders.

Having in mind that the basic aim of the Agency is to protect money and interests of depositors, Banking Agency of the Federation of BiH set up provisional administration in 19 banks in the period between the foundation of the Agency and the end of 2001. The High Representative set up provisional administration in one bank. There are currently five banks under provisional administration. Provisional administration was successfully resolved in two cases by merging of those banks, liquidation was initiated in seven banks, two liquidation procedures were completed without negative outcome for depositors and shareholders, and one resulted in merging. The Agency filed requests for bankruptcy procedure in six banks, and legal procedure is currently going on. Liquidation procedures are implemented in four banks.

International experience and rule saying that banks are the most often destroyed "from inside" has been confirmed by examples in the Federation of BiH. Analysis performed during and after provisional administration and liquidation procedures displayed that main sources of problems in those banks were operations with related entities, disregarding of regulations and laws passed by the Agency and crime. Responsibility for that was on managers and governing bodies in banks.

Banking supervision

Weaknesses of the banking system can endanger financial stability in each country and cause more extensive consequences. The Basle Committee for the supervision of banks has been working on that issue ever since 1975 by seeking systems and setting actions to strengthen financial stability all over the world.

In order to promote and secure whole macroeconomic and financial stability, in 1997 the Basle Committee adopted twenty-five core principles that have to be respected in order to have effective supervisory system.

The core principles are minimum actions to be implemented and in many cases it is necessary to supplement them with other actions in order to comply with specific conditions and regulate risks of financial systems in particular countries. The principles regulate conditions for the efficient supervision of banks, licensing, prudence, methods for continuing supervision of banks, necessary information, official authorization of supervisors and banking with other countries.

Legal and regulatory framework for banking operations in Federation of BiH is mainly adjusted to international standards. Anyhow to a certain point, they are adjusted to existing conditions in F BiH also. Therefore, rating of implementation of Basle Principles could be presented in levels – from adjusted to unadjusted, including one principle, which is completely inapplicable in our reality.

OPERATIONAL PERFORMANCE OF BANKING OPERATIONS IN F BIH

As of 12/31/01, 33 banks had banking licenses in the Federation of BiH issued by the Agency. All banks have performed banking operations and had a duty to report the Agency that performed examinations (on-site and off-site) as it is regulated by the Law.

Structure of the banking system

Banking licenses and Approvals

In 2001, the Agency have revoked five banking licenses, to following banks: Šipad Bank dd Sarajevo (merged to another bank in purchase agreement due to privatization process), Camelia Bank dd Bihać, Kredit Schweizer Bank dd Sarajevo and Posavska Bank dd Orašje, because their capital was not complied with prescribed minimum for paid in and net equity, and to Komercijalna Bank dd Tuzla, because the bank was illiquid, insolvent and had inadequate capital.

The Agency did not receive any requests for new licenses during the same period.

Provisional administration remains in five banks as of 12/31/01:

- Gospodarska bank dd Mostar,
- Mostarska Gospodarska Bank dd Mostar,
- Hercegovačka Bank dd Mostar,
- UNA Bank dd Bihać,
- Šeh -in Bank dd Zenica.

Except Hercegovačka Bank dd Mostar, where provisional administration was initiated by the decision of the High Representative in BiH, in other banks provisional administration was initiated, because banks did not comply with performance requirements set by the Law.

In 2001, banks mainly complied their operations to the laws and regulations instituted by the Agency regulating approvals and licenses for status and statutory changes, changing of General Manager, instituting new operational units, investing in other legal entities, issuance and purchase of shares, performing internal payment operations.

The license for internal payment operations was issued to 30 banks as of 12/31/01. Two banks were approved to perform intra-bank transactions, and 28 of them to perform inter-bank transactions. Currently one application is in the review process. Applications for internal payment operations can be submitted to the Agency anytime.

Ownership Structure

Evaluation of ownership structure in banks[1] was performed upon available information and insight in banks as of 12/31/01 as it follows:

- Private and predominately privately owned — 27 banks (82%)
- State and predominately owned by state — 6 banks (18%)

In comparison to 12/31/00, changes in ownership structure are related to changes of status in banks (merging) and revoking licenses.

[1] Classification criteria for banks by ownership is ownership over equity in banks.

Ownership Structure Changes

	State Banks	Private Banks	Banks in the Process of Registration	TOTAL
12/31/00	10	28	-	38
Changes in 2001 :				
– revoked licenses	-1	-4		-5
– privatization	-3	+3		
12/31/01	6	27	-	33

The special problem in the ownership structure defined in previous period is related to changes of ownership structure in banks. More banks became privately owned, and it was necessary to determine ownership structure in "old state/social banks".

In the fourth quarter of 2001 four state banks were privatized: three banks from former PBS system of banks (Privredna bank Sarajevo dd Sarajevo, Travnicka Bank dd Travnik and Central Profit Bank dd Sarajevo). The privatization in these banks was performed by the contract on purchase of shares and contract on registration of shares and shareholders, as part of privatization strategy of PBS banks, while Šipad Bank dd Sarajevo was merged to ABS Bank dd Sarajevo by purchase method.

Based on the documents received by the Agency and/or intervention in meantime, and based on the registration at courts related to changes of capital and shareholders in banks, the global ownership structure of banks in F BiH was changed in comparison to the position as of 30/09/01.

Ownership structure can be observed from the aspect of financial results, that is, by the value of total capital[2] .

Ownership Structure by Total Capital

-in million KM-

BANKS	12/31/99		12/31/00				12/31/01				RATIO 3:2	RATIO 4:3
1	2		3		3a*		4		4a**		5	6
State banks	377	56%	304	54%	240	48%	109	21%	92	18%	81	36
Private banks	301	44%	255	46%	255	52%	419	79%	419	82%	85	164
TOTAL	**678**	**100%**	**559**	**100%**	**495**	**100%**	**528**	**100%**	**511**	**100%**	**82**	**94**

* *Total capital in active balance sheet – FBA schedule.*
** *Same.*

Ownership structure by participation of state, private and foreign capital

-in 000 KM-

SHARE CAPITAL	12/31/00 Amount	12/31/00 participation %	12/31/01 amount	12/31/01 participation %	RATIO 4/2
1	2	3	4	5	6
State capital	220,847	42.9	66,742	14.5	30
Private capital (residents)	159,325	30.9	103,117	22.4	65
Foreign capital (non-residents)	135,201	26.2	289,947	63.1	215
TOTAL	**515,373**	**100.0**	**459,806**	**100.0**	**89**

[2] Information from Balance sheet – FBA schedule.

Analysis of ownership structure in banks – shareholders capital shows explicitly changes and trends in banking system in the Federation of BiH, it is visible in two segments: privatization of existing state capital in mainly privately owned banks and further inflow of foreign capital (mainly foreign banks).

Participation of state capital in total share capital of banks as of 12/31/01 is lower by 28.4% comparing to 12/31/00. That resulted from the increase of foreign capital (absolute amount and in percentage), and further sale (privatization) of state capital in privately owned banks, and because of decreased capital in Investment Bank of the Federation of BiH by the Government's decision as founder of the bank. As of 31/12/01, participation of remaining state-owned capital in privately owned banks is only 2% or KM 6.6 million.

In 2001 major changes occurred in the ownership structure of private (domestic) and foreign capital.

By comparison to 12/31/00, participation of privately owned capital (residents) to total capital of whole banking sector decreased from 31% to 22.4%, at the same time, participation of foreign capital increased from 26.2% (as it was at the end of 2000) to 63.1% as of 12/31/01. Those changes relate mainly to privately owned banks, and it resulted due to two components: foreign capital came in to the system through purchase of shares (trading with shares) from earlier owners (residents – legal entities and individuals), new foreign capital came in and three previously state owned banks (PBS system) were privatized.

Development of revision and stabilization of banking system resulted in large inflow of foreign capital, mainly foreign banks. This positive trend of increased participation of foreign capital in banks in the Federation will probably be continued in the next period.

CONCLUSION

Last year brought the first results of reconstruction and positive changes implemented in the banking system of the Federation of BiH, but there still are some outstanding problems.

Last year, we noticed a large growth of assets, deposits and approved loans. Financial result at the level of the banking system improved by comparison to earlier years, but there still are seven banks that operated with a loss. The volume of transactions with related entities is decreasing, but it is still excessive. A privatization process has been initiated, internal payment operations were successfully transferred to banks, there were significant changes in the ownership structure and leading owners are now foreign investors.

In order to maintain and improve positive trends, all participants in the banking system reform should continue with their activities and with implementation of actions that would lead this process to its completion in the shortest possible time.

The involvement of authorized institutions and entities in the Federation of BiH will affect further positive changes, such as:

- finalization of privatization process in state banks within expected deadlines;
- establishing adequate environment for a more successful transformation in the material sector, followed by changes in the monetary and banking system;
- supporting the process of forming larger banks in the system;
- further strengthening of supervision in banks;

- transferring succession funds to development projects through commercial banks;
- adopting law on collateral;
- accelerating legal proceedings, passing judgments and their implementation;
- establishing more efficient procedures for collection of collateral;
- adopting law on protection of creditors and increasing responsibilities of bank's debtors;
- further improvement of legal and institutional framework for banking system reform, with respect to Basle Principles, etc.

The duties of the Banking Agency of the Federation of BiH in future period will be:

- continued supervision of banks in order to effectively protect depositors and eliminate weaknesses in banks;
- finalize provisional administration and liquidation processes;
- special supervision of banks with large savings (citizens deposits) and banks with unusual growth;
- special supervision of operations with related entities;
- control of application of new operating standards for banks, as regulated by the law and other regulations;
- further development of regulations under authority of the Agency, related to Basle Principles;
- participation in preparations of new laws;
- further education and training of Agency staff;
- establishment of cooperation with supervisory institutions in countries whose banks are investors in our country.

And, as the most important part of the system, banks have to take responsibility to:

- strengthen capital in correlation with growth of assets;
- continue expansion and development of internal payment system, including establishment of unified registry of accounts;
- improve quality of assets;
- strengthen internal control systems and establish internal audits;
- adopt and implement new principles for operations, policies and procedures in accordance with competitive market conditions (maintenance of existing savings level, possibilities for expansion of loans and decreasing interest rates etc);
- development of credit/debit card operations and electronic banking;
- implement more severe criteria and their implementation in matters of competency and expertise of managerial staff in banks;
- improve training for the staff in order to establish better relations with customers, especially small and middle sized enterprises, hence, that includes new services, and the banks should develop financial management operations;

- finalize activities related to the association of banks and the banking institute;
- take part in the global anti-terrorist activities, etc.

LEGAL FRAMEWORK FOR THE OPERATIONS OF THE BANKING AGENCY OF THE FEDERATION OF BIH AND FOR OPERATIONS OF BANKS IN THE FEDERATION OF BIH

1. Law on the Banking Agency of the Federation of BIH (Official Gazette of the FBIH" No. 9/96, 27/98, 20/00 and 45/00),
2. Law on the Central Bank of BIH ("Official Gazette of the FBIH" No. 1/97),
3. Law on Banks ("Official Gazette of the FBIH" No. 39/98,32/00 and 48/01),
4. Law on Deposit Insurance ("Official Gazette of the FBIH" No. 41/98,13/00 and 29/00),
5. Law on Financial Operations ("Official Gazette of the FBIH" No. 2/95, 13/00 andi 29/00),
6. Law on Internal Payment System ("Official Gazette of the FBIH" No. 15/00-cleared text, 54/01),
7. Law on Foreign Currency Operations ("Official Gazette of the FBIH" No. 35/98),
8. Law on Securities ("Official Gazette of the FBIH" No. 39/98 and 36/99),
9. Law on Anti-Money Laundering ("Official Gazette of the FBIH" No. 8/00),
10. Law on Notes ("Official Gazette of the FBIH" No. 32/00),
11. Law on Checks ("Official Gazette of the FBIH" No. 32/00),
12. Law on Payment Transactions ("Official Gazette of the FBIH" No. 32/00),
13. Law on Obligations ("Official Gazette of the FBIH" No. 2/95),
14. Law on Commercial Enterprises ("Official Gazette of the FBIH" No. 23/99, 45/00 and 2/02),
15. Law on Bankruptcy and Liquidation ("Official Gazette of the FBIH" No. 23/98),
16. Labour Law ("Official Gazette of the FBIH" No. 43/99 and 32/00),
17. Law on Executive Proceedings ("Official Gazette of the FBIH" No. 42/98),
18. Law on Recording Legal Entities into the Court Registry ("Official Gazette of the FBIH" No. 4/00),
19. Law on Administrative Proceedings ("Official Gazette of the FBIH" No. 2/98 and 48/99),
20. Law on Violations of the Federal Regulations ("Official Gazette of the FBIH" No. 9/96 and 29/00),
21. Law on Treasury of BIH Institutions ("Official Gazette of the FBIH" No. 27/00)
22. Law on Banks' Privatization ("Official Gazette of the FBIH" No. 12/98, 29/00 and 37/01),
23. Law on Opening Balance Sheets of Companies and Banks ("Official Gazette of the FBIH" No. 12/98 and 40/99),

24. Law on Financial Operations ("Official Gazette of the FBIH" No. 2/95, 13/00 and 29/00),
25. Law on Securities Registry ("Official Gazette of the FBIH" No. 39/98),
26. Law on Accounting ("Official Gazette of the FBIH" No. 2/95, 14/97 and12/98).

REGULATIONS DETERMINING BANKS' OPERATIONS

1. Decision on Supervision of Banks and Activities of the Banking Agency of the Federation of BIH ("Official Gazette of the FBIH" No. 47/98),
2. Decision on Minimum Standards for Banks' Capital Management ("Official Gazette of the FBIH" No. 47/98, 46/99, 25/00),
3. Decision on Minimum Standards for Credit Risk Management and Classification of Assets of Banks ("Official Gazette of the FBIH" No. 47/98, 46/99, 48/01),
4. Decision on Minimum Standards for Risk Concentrations Management in Banks ("Official Gazette of the FBIH" No. 47/98),
5. Decision on Minimum Standards for Internal and External Audit in Banks ("Official Gazette of the FBIH" No. 47/98),
6. Decision on Minimum Standards for the Internal Control System in Banks ("Official Gazette of the FBIH" No. 47/98),
7. Decision on Minimum Standards for Liquidity Risk Management in Banks ("Official Gazette of the FBIH" No. 47/98, 6/01),
8. Decision on Minimum Standards for FC Risk Management in Banks ("Official Gazette of the FBIH" No. 47/98),
9. Decision on Minimum Standards for Operations with Entities Related to the Bank ("Official Gazette of the FBIH" No. 47/ 98),
10. Decision on Minimum Standards for Documenting Lending Activities of Banks ("Official Gazette of the FBIH" No. 47/98),
11. Decision on Reporting of Unsound Customers that Represent Special Credit Risk ("Official Gazette of the FBIH" No. 47/98),
12. Decision on Minimum Scope, Form and Content of Programs and Reports on Economic-Financial Audit of Banks ("Official Gazette of the FBIH" No. 17/99, 48/01),
13. Decision on form of Reports that Banks submit to the Banking Agency of the Federation of BIH ("Official Gazette of the FBIH" No. 47/98, 34/99, 46/99, 25/00, 6/01, 13/01),
14. Decision on Conditions when Banks is Considered Insolvent ("Official Gazette of the FBIH" No. 17/99),
15. Decision on Minimum Documentation and Conditions for Issuing Banking License ("Official Gazette of the FBIH" No. 17/99, 16/01)
16. Decision on Minimum Conditions that Banks Need to Fulfill to Perform Internal Payment System Transactions ("Official Gazette of the FBIH" No. 46/01),
17. Decision on Process Needed to Establish Claims and Distribute Assets and Liabilities During Liquidation of Banks ("Official Gazette of the FBIH" No. 3/00, 53/00),

18. Criteria for Internal Rating of Banks by the Banking Agency of FBIH ("Official Gazette of the FBIH" No. 54/00),
19. Decision on Minimum Conditions for Issuing Internal Payment System License to Branches of Banks from Republic Srpska ("Official Gazette of the FBIH" No. 50/01),
20. Proclamation on Establishment of the Banks' Privatization Unit ("Official Gazette of the FBIH" No. 22/98),
21. Proclamation on Determining Criteria for Acquiring a License to Engage in Banks' Privatization Process ("Official Gazette of the FBIH" No. 22/00).

STATISTICAL TABLES

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

Item	1999	2000	2001	2001/1999
State ownership	44.2	42.9	15.1	0.34
Other domestic ownership	41.5	30.9	22.3	0.54
Domestic ownership total	85.7	73.8	37.4	0.44
Foreign ownership	14.3	26.2	62.6	4.38
Financial Institutions, total	**100.0**	**100.0**	**100.0**	

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

Assets	1999	2000	2001
Cash and securities	40.4	40.5	48.5
Loans to other banks	0.2	0.8	0.7
Loans – net value	44.0	45.1	41.7
Premises & other fixed assets	11.1	11.1	7.3
Other assets	4.3	2.5	1.8
Liabilities	**1999**	**2000**	**2001**
Deposits	66.6	69.3	76.8
Borrowing from banks	0.7	0.3	0.1
Liabilities on borrowings	6.1	7.4	6.7
Other liabilities	2.8	3.2	2.7
Capital	23.8	19.8	13.7

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

Type of financial institution	1999	2000	2001
Banks	23.86	18.20	13.69

Solvency ratio of financial institutions (%) (liabilities/assets)

Type of the financial institution	1999	2000	2001
Banks	76.3	80.2	86.5

Asset portfolio quality of the banking system

Asset Classification	1999	2000	2001
A	47.4	80.4	85.9
B	4.8	9.9	7.7
C	1.9	3.8	2.7
D	1.5	5.5	3.5
E	44.4	0.4	0.2
Classified Total	**100.0**	**100.0**	**100.0**
Specific Reserves*	4.3	94.5	98.1

** % of needed*

The structure of deposits and loans in 2001 (%) (at year-end)

	Deposits	Loans
Households	46.0	36.2
Government sector	11.7	1.1
Corporate	35.5	59.8
Foreign	-	-
Other	6.8	2.9
Total	**100.0**	**100.0**

The structure of deposits and loans in 2001 (%) (at year-end)

Maturity of Deposits		Loans	
At sight	61.3	Long term loans	77.1
Within one year	23.9	Medium-term loans	-
Over one year	14.8	Short-term loans	22.9
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.		
	1999	2000	2001	1999	2000	2001
Banks	26.4	27.9	20.4	32.3	31.2	N/A

Profit and loss statement

in 000km

Items	2000	2001
Interest income	**192,782**	**199,438**
Interest expenditure	52,117	52,881
1) Net interest income	140,665	146,557
2) Profit from other financial and investment services(including dividends)	197,074	215,215
Of that: Profit from commissions	N/A	N/A
Of that: Net provisions	N/A	N/A
3) Gross financial and investment services profits (1+2)	337,739	361,772
4) Overheads*/total costs	384,912	384,866
5) Extraordinary profits	-	-
6) Pre-tax profit (3-4+5)	-47,172	-23,094

**: incl. Reserves for potent, loan losses*

Average balance sheet items

In 000 KM

Items	1999	2000	2001
Average balance sheet total (assets total)	2,344,550	2,539,318	3,774,154
Average own capital	515,650	505,411	465,375

Components of the banking sector return on assets (%)

Items	1999	2000	2001
In proportion to the average balance – sheet total			
Interest income			
Interest expenditure			
1) Net interest income (interest margin)	1.65	3.59	3.05
2) Profit from other financial and investment services(including dividends)	2.15	5.03	4.47
Of that: Profit from commissions			
Of that: Net provisions			
3) Gross financial and investment services profits (1+2)	3.81	8.62	7.52
4) Overheads	4.79	9.83	8.00
5) Extraordinary profits	-	-	-
6) Pre-tax profit (ROA)	-1.01	-1.27	-0.56

Structure of registered capital and own funds of financial institutions in 2001

Type of the financial institutions	Registered capital 000 KM	/Total assets %	Own funds 000 KM	/Total liab. %
Banks	459,810	12.18	50,803	1.35

2001 DEVELOPMENTS IN THE BULGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2001 Bulgaria recorded a decreasing rate of *GDP real growth* of 4% compared with (+5.8%) for 2000. Given the slowdown in the world economy this growth may be considered as a success. Final consumption increased by 4.5% in real terms comprising the largest share of overall GDP growth – 3.9%. Between January and December *industrial sales* matched the 2000 level, with domestic market sales growing by 1.1%. Sales for export fell by 2.6%. Metallurgy and the mineral products and oil industry experienced serious difficulties due to weakened external demand. The crisis in tobacco industry continued. High dynamics in the engineering, electrical and clothes industries were a positive change in industry structure. *Service*s, indicating a 4.2% increase and generating 58% of GDP value added, contributed most significantly to the overall growth.

Net exports remained negative. Despite the real increase of exported goods and services (8.5%), imports rose at a faster rate (13.5%). As a result the foreign trade balance/GDP ratio worsened: from -5.4% in 2000 to -7.5% in 2001.

Domestic demand did not prompt price rises due to free production capacities and import elasticity. *Producer prices* matched previous year's level. During 2001 international prices of major raw material feedstock and crude oil decreased. This had an anti-inflationary effect on domestic prices. *Consumer price goods* remained relatively stable until August when the accumulated inflation from early 2001 was 0.9%. By the end of 2001 inflation rapidly accelerated, reaching 4.8%. On 1 October prices of energy and district heating were raised by 10% and prices of local telephone services provided by the Bulgarian Telecommunication Company, by 20%. These prices rises were the reasons for the significantly accelerated inflation in the services and the general price index, respectively.

Unfavourable trends in the *balance of payments* current account were mitigated by several factors such as the relative high value of direct investments (6.2% of GDP) and the surplus of portfolio investments in the country following the Eurobonds issuance in the third quarter. Selling the securities released after reverse repurchase of Brady bonds also supported reserves in foreign currency. BNB net foreign currency purchases that additionally helped increase Bulgaria's foreign exchange reserves resulted in withdrawal of euro-zone national currencies from circulation.

Financial stability in 2001 largely resulted from *fiscal sector stability*. Conservative centralized budgeting made cash balance in the 2001 Consolidated State Budget rendered a low deficit (BGN 255.2 million), thus for a third consecutive year its level stayed close to 1% of GDP.

Within the year under review *unemployment rate* dropped. According to the National Statistics Institute labour surveys based on the International Labour Organization definition, by end-2001 the unemployment rate was 19.5% against 21.6% in early 2001. The share of long-term jobless people remained high, accounting for

63.2% of all unemployed. Processing industry employment fell most significantly (3.9%) following the trend of structural changes in recent years. Industries indicating employment growth are hotels and catering (11.1%), real estate transactions and business services (8.9%), government administration (5.6%) and finance, credit and insurance (by 4.7%). However, the social effect of employment growth in these sectors is insignificant, given their relatively small share in total employment.

During 2001 the currency board arrangement continued to be the monetary regime applied in Bulgaria. The real growth reported in monetary and most credit aggregates is an indicative of the ongoing *recovering of money demand and monetarization of the economy*. In the conditions of sustained external financial stability the central bank did not have a proactive effect on money supply. It was entirely governed by the level of foreign exchange reserves and money demand by economic agents. The banking system remained stable and there was no need for changes in the level of minimum required reserves, or BNB to act as lender of last resort. The quasi-money growth dating from mid-1999 is indicative of a significant amount of funds acquired by the commercial banks. Their placing in credits to real sector companies depends on various aspects of commercial bank lending policies as well as on the accelerated economic restructuring and modernization to increase efficiency.

Domestic credit dynamics moved in line with money supply dynamics. The domestic credit total value grew by BGN 816.7 million (17.5% in nominal and 12.2% in real). This was mainly due to the lev component. The preference of economic agents for lev credits reflected their cautiousness in face of currency risk and comparable interest rates. The upward trend in claims on private companies continued growing by 15.6% in real terms. Claims on the public increased faster than other credit aggregates (38.5% in real terms). Lending to real sector to total claims shows weak dynamics upward, because commercial banks still prefer placing funds in foreign assets.

DEVELOPMENT IN THE BANKING SYSTEM

In 2001 the banking sector operated under relatively stable conditions. The stagnant world economy affected the real sector more than finance. During 2001 banking system assets increased by 25% compared to 2000 and credits by over 30%. Most of these were extended to private enterprises and the public, and a smaller portion to the remaining state-owned enterprises. However, a significant credit potential of financial institutions remained unrealized. Relatively high risk in the economy and the poor and inefficient legal protection of creditors were the major reasons for prudent commercial bank lending policy.

Market concentration and dispersion (the Herfindahl-Hirschman index) in the Bulgarian banking system were relatively low. For assets and deposits the index indicates acceptable concentration (1,166 p. and 958 p., respectively) and for credits, a lack of concentration (719 p.).

During 2001 no significant changes occurred in bank ownership. State ownership of banking system assets approximated its previous year's level of 17.6%, and municipal ownership was 2.3%. The share of private banks in total bank assets remained almost unchanged at 80.1%. The share of bank assets owned by foreign banks and investors increased slightly to 75%, reflecting the faster growth reported by bigger banks owned by foreign investors. Neither mergers nor other intercorporate deals in banking sector were reported. Most of the top Bulgarian banks comprising 55% of total banking assets belong to large international banks and financial groups (i.e. Bulbank owned by UniCredito Italiano, the United Bulgarian

Bank owned by the National Bank of Greece, Expressbank owned by Société Générale, Hebrosbank owned by First Regent Group Ltd., Post Bank owned by ALICO/PFIH Ltd., and BNB-Paribas (Bulgaria) and Raiffeisenbank (Bulgaria) owned by BNP-Paribas and Raiffeisenbank, respectively).

Despite the overall *asset growth*, the placements with banks and other financial institutions almost matched the previous year's level. The decrease in these operations reflected the reduced interest rate levels and lower yield from interbank deposits. The increase in total assets was evenly distributed between the following groups:

- In absolute terms cash rose by 70%, increasing its share from 7.6% to 10.5% in total assets. To a certain extent this reflects the need for higher liquidity in the banking system by the end of the year, associated with the merging of 12 European currencies into the euro;
- Securities in trading portfolio grew by 43% in absolute terms on 2000. Their share in total assets increased by 1.6% to reach 12.5%, a result of the purchased eurobonds issued by the Bulgarian government at the end of 2001;
- Claims on nonfinancial institutions increased by more than 37% in absolute terms. The share of these claims in total banking system assets grew by 3% to reach 34%. The bulk of the credits were disbursed to private enterprises, while credits to households and individuals increased more slowly. The manner of assets restructuring clearly indicated that banks intended to increase their revenue without taking additional risks.

In 2001 banking system liabilities show an *increase* of 28% *in borrowed fund*s. Growth in deposits from nonfinancial institutions by 35% exceeded this of borrowed funds from banks (23%). Proportion of Forex to Lev components in total borrowed funds overlapped the same pattern as in previous years (2.9/2.1 against 2.8/2.2 in 2000). The slight change was basically driven by the conversion of 12 euro-zone national currencies into the euro at the end of 2001.

Given the changes in the macroeconomic environment, the banking system was gradually restoring its financial intermediary role in the economy. Despite of this, the *domestic credit to GDP ratio* remained about 17% as in 2000. In comparison with the same indicator in developed economies it shows a poor level of financial intermediation. However, the *deposits to GDP* ratio should be also taken into account. During 2001 it rose by 32% against 27% a year earlier. Obviously, the lending of the banks was also limited by the slow recovering of depositors' trust after the 1996/97 financial crisis. Total deposit level in the country remained below the developed economy standards.

In 2001 the Bulgarian banking system reported a *Net Profit increase* of 9.1% as compared to end of 2000 supporting the upward trend in last years. Despite banks credit portfolios growth, the also raised total net interest income of 14% did not cover operating expenditure *on proviso*. *Operating profit* prior to extraordinary operations and taxes, which is a direct result of regular bank operations and indicates banking activity efficiency, recorded a 3% decrease. This reflected primarily on the significantly lower net income from commercial operations in 2001. This item of bank revenues indicated grave variance since 1998. Other noninterest revenue continued to comprise a significant share in operating profit. However, since 1999 it has showed falling growth dynamics (46% in 1999, 15% in 2000 and 7% in 2001), which is an indication for depletion of earnings from fees and commissions under business conditions nowadays.

Growth dynamics of *operating expenditure* since 1999 were relatively steady: 15% in 1999, 20% in 2000, and 17% in 2001, and followed growth rates of net interest income in the banking system. In general, this indicates the efforts of bank managers to limit operating costs by business planning in line with net interest income.

Banking sector's *Return on Assets (ROA)* of 2.9%, valued in national currency, almost matched the previous year's level (3%). All ROA ratio components indicated slight decrease (see Table: Components of the Banking Sector Return on Assets). The rate of monthly values also dropped slightly following the fall in interest rate and the net interest margin. *Net interest income* in the sector, based on average interest-earning assets, declined from 5.7% in 2000 to 5.5%. This pertains to the *lower return on interest-earning asset*s: gross interest income accounted for 8.3% in 2000 and 8% in 2001. During 2001, *slumping in interbank offered rates worldwide* affected adversely the return on claims of financial institutions. For Bulgarian banks this was 5.4% in 2000 and fell to 4.4% in 2001.

The bulk of *bank institutions adhered to the requirements of prudential banking*, and to banking supervision regulations. The required minimum own funds, capital adequacy ratio, and degree of asset coverage were met in 2001. Following the increased amount of credits and respectively asset risk, which were covered by higher profit on banks' own funds, the *overall capital adequacy* of the banking sector decreased a bit in 2001 to reach 31.1%. Compared on the previous year, this ratio fell by 4.4%, indicating cautious restructuring of bank assets. The capital of most banks is sufficient to support assets' growth and to provide adequate coverage of their risk component. In general, high capital adequacy ratios maintained by the banking sector continued to reflect the conservative policy pursued by most banks of systemic significance that are placing financial resources in low risk investments.

The insignificant changes in the structure of assets helped *sustain the values of assets' quality indicators almost unchange*d. The characteristics of *classified assets* experienced no changes in 2001 and stayed close to the previous year's values. These accounted for 7.7% of total assets in the banking sector (see Table: Assets' Portfolio Quality of the Banking System). The share of credits classified as doubtful and loss decreased from 2.3% in 2000 to 1.8% at the end of 2001. In general, commercial bank policies in terms of provisioning complied with banking supervision requirements. Banks that allocated greater provisions were able to use accumulated reserves as an emergency cushion, while banks with provisions close to the bottom limit were threatened by capital erosion in case of worsened asset quality.

Large exposures did not give any grounds for concern. The total share of large exposures stayed at 69% on the overall capital base in the sector (against 62.4% and 60.3% in 2000 and 1999 respectively), well below the admissible 800% level. This suggests little threat of banking system capital erosion due to credit risk concentration.

Liquidity risk was low for most of the banks. This reflected to a great extent the continued practice of keeping large value of high-liquid unprofitable assets rather than efficient liquidity management. While the Real Time Gross Settlement System to be launched in 2002 will pose new challenges for managing cashflow, and it will provide bank managers with the opportunity to increase their income. The conservative approach in liquidity management reflected on the primary and secondary *liquidity* ratios of the sector, which remained stable at 13.5% and 25.5%. Liquid assets matched the liability structure and the risk profile of banks.

LEGAL AND INSTITUTIONAL FRAMEWORK FOR OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS

In addition to the macroeconomic stabilisation, the contemporary bank legislation and adequately efficient supervision contributed for strengthening the banking sector. The Law on Banks is the primary law on banking. Together with other laws such as the Commercial Law, the Law on Securities, Stock Exchanges and Investment Companies, the Law on Accounting and the Law on Measures against Money Laundering it creates the legal base for banking in Bulgaria. The LoB defines a bank only as "a joint stock company "...which is engaged in the business of publicly accepting money on deposits and uses these funds to make loans and investments for its own account and at its own risk". It also specifies a list of fifteen different commercial activities that a bank may conduct. This list is very similar to the one in Annex I in the EU's Directive 2000/12 relating to the taking up and pursuit of the business of credit institutions.

The 1997 newly adopted Law on the BNB significantly changed the functions of the Bulgarian National Bank. Its Banking Supervision Department (BSD) is the only supervisory authority for banks. The Law on the BNB defines its supervisory task as regulation and supervision over activities of other banks in the country for the purpose of ensuring the stability of the banking system and protecting depositors' interests. The laws and a number of prescribed, in forms of detailed Regulations, issued by the Management Board of BNB, provide minimum prudential standards that banks must meet. Banking laws and regulations have in recent years been updated in line with developments in the banking sector and following changes in international standards and EU legislation.

New developments

In 2001 supervision *regulations were amended* and further improved in line with the principles of prudent banking and convergence to international standards and the *acqui*s.

In *Regulation No. 4* on foreign currency positions of banks was amended. The method of calculating risk-bearing net open foreign currency positions was changed. Limits for open foreign currency positions were reduced. Provisions on foreign currency positions of foreign bank branches, respectively limits, were repealed.

With a view to easing restrictions for the assessment of credit risk concentration to an individual customer or related party, *Regulation No. 7* on large exposures of banks was amended. Changes concern reporting short-term interbank exposures reduced by conversion factors. Risk exposure to a guarantor assuming an irrevocable obligation to pay *in lieu* of the borrower also was involved in calculation, respectively regulation of risk concentration.

Regulation No. 8 on capital adequacy of banks was amended, raising some restrictions in assessing credit risk by banks. The capital base components were supplemented and changed both in positions of primary capital and deductions in own funds. Changes provide for a greater precision in calculating the capital base on individual and consolidated basis, and simplify reporting on risk component in balance sheet and off-balance sheet items.

Changes were adopted in *Regulation No. 9* on the evaluation of risk exposures of banks and the allocation of provisions to cover risk of losses. They require that every bank have to keep sufficient information on borrowers' financial state, more comprehensive definitions of classification groups of claims, and clear rules for reclassification of risk exposures. Reporting on risk-free collateral for netting risk exposures was supplemented. Insurance policies issued on account of the government under the Export Insurance Law allows banks to grant credits for the export of goods and services, and the State Agency for Export Insurance covers the political risk.

A new *Regulation No. 17* on determining the amount of bank investments under Article 30 of the Law on Banks (State Gazette, issue 19 of 2 March 2001) was issued.

It defines the scope of bank investments in fixed assets and nonbanking equities, their reporting and limitation to capital base in order to prevent this from risk of inordinate investments in less-liquid and non-profitable assets.

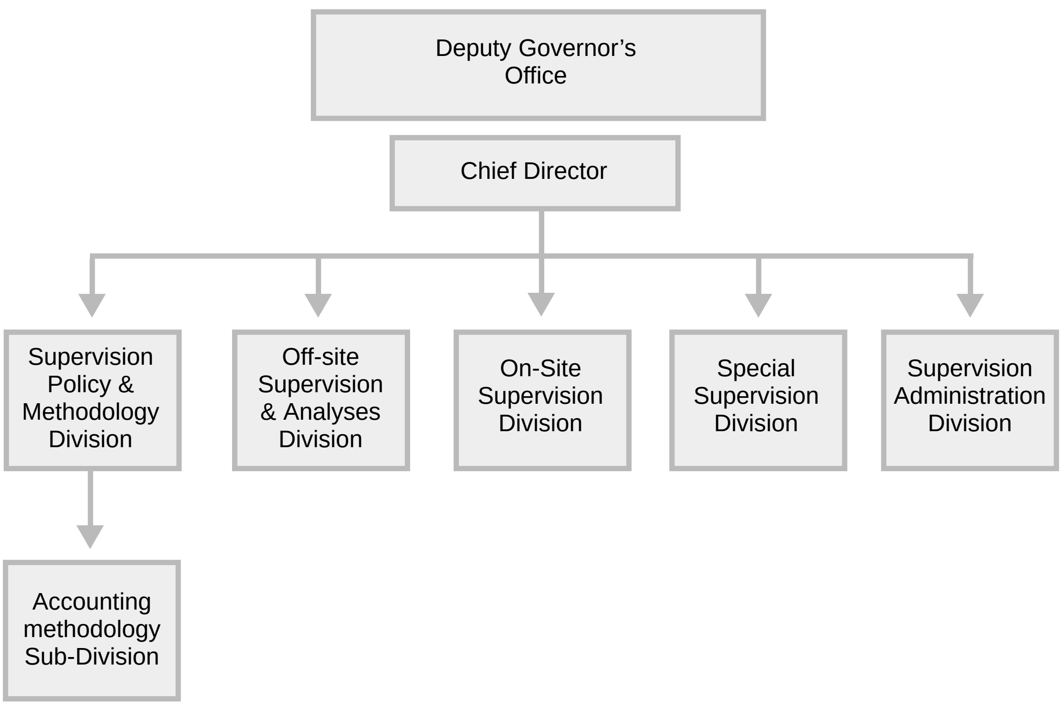
LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

According to the laws, the Governor of the central bank is authorized to grant or revoke a bank license, taken on a motion by the Deputy Governor in charge of banking supervision. The head of BNB has also a central role in the orderly resolution of a problem bank case, as powers independent to appoint a conservator, to approve a merger or take-over, to sell a liquidated bank, and to petition the court to institute bankruptcy proceedings. Finally, to draw all levels of competence, the Deputy Governor of BNB in charge of 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, be submitted, and may appoint on-site inspections fulfilled by officers and other persons that authorized by him.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISION DEPARTMENT

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 comparatively small staff of 75, divided into five divisions. The overall structure of Banking Supervision is developed according to the internationally accepted norms and practices.

Banking Supervision Department



ACTIVITY OF THE BANKING SUPERVISION DEPARTMENT

In 2001 the Banking Supervision Department further improved and applied the risk-based approach in preparing analytical reports on all banks and the sector as a whole. Banks' financial indicators were carefully monitored and analysed, and quarterly *CAEL* ratings were assigned. Work on improving and further optimising the *Early Warning System* continued, by means of which examiners find out potential problems before these get out of control. The *On-site* teams worked in close cooperation with the *Off-site* supervisors and analysts in verification and assessment of banks' performances and prudential behaviour based on the *CAMELS/ AIM* composite system on bank assessment. In several cases they proposed recommendations and enforced together with the Supervision Administration Unit supervisory measures on banks and bank managers for breaches and weaknesses found. Most common breaches concerned large exposures, internal credits, and investments in fixed assets and several related nonbanking equities. During the reporting period there were neither license revocation or conservator appointment.

During the year 19 *full-scope inspections* were carried out according to the annual schedule, inclusive 15 banks and four foreign bank branches. As a result, several banks were assigned higher ratings consistent with improved risk management and control, fulfilled supervisory remedial measures prescribed in previous inspections, and compliance with laws and internal rules. In general, the capital base level was consistent with the scope of activity and the risk profile of banks. A weakness in some financial institutions was the combination of low income from core business activity with high-rise overhead expenses and provisions.

Targeted examinations were carried out in 30 banks and 27 financial houses. Inspections of commercial banks aimed to review compliance with the provisions of the LoB, the Foreign Exchange Law, the Law on the Measures against Money Laundering, and the Law on Bank Deposit Guaranty. Obscure share capital that held by companies registered in offshore zones was a ground to pay regard to several banks. Therefore the central bank proposed afterwards amendments in the Law on Banks to improve ownership transparency.

The process of *liquidation of bankrupt banks* continued in 2001 under the oversight of the banking supervision. An operating bank acquired one of the closed financial institutions and the assets of two other bankrupt banks were transferred to the State Revenue Agency. Following the adoption of the LoB in 1999 the Agency is holding now the assets of five closed banks. During the year one institution was sold as estate and two working banks acquired other two on purchase and assumption agreements. Of total 19 closed banks during the 1996/97 financial crisis, bankruptcy and liquidation procedures of the rest ten have to be continued.

The extremely inefficient process of liquidation of the closed banks made the BNB seek legal amendments to speed it up. A Draft law was made for amending the Banking Law, which was afterwards passed by the members of Parliament. It supplements the bank insolvency procedures in the Banking Law with new special procedures, so that most of the already closed banks could end their insolvency proceedings. For the remaining banks, as well as for future bank failures, a new law on bank insolvency is initiated, which will next have to be passed by Parliament.

INTERNATIONAL ACTIVITIES

In 2001 BSD was involved in the work with the missions of the IMF and the World Bank in line with the agreements and close cooperation of the Bulgarian Government with the international financial institutions in recent years. A study was conducted, where the BSD prepared a Self-Assessment on the Compliance with the Core Principles of Effective Banking Supervision drawn up by Basle Committee for Banking Supervision, and a Data Profile of the whole financial sector, as well as other questionnaires in the frame of the Financial Sector Assessment Programs (FSAP) of Bulgaria.

Globalisation of financial activities, enhanced level of supervisory functions and privatisation of Bulgarian banks by foreign investors call for close cooperation and with foreign supervisory authorities. In view of the need to exchange supervisory expertise and information on business and state of Bulgarian bank branches abroad and foreign bank subsidiaries and branches in Bulgaria, one agreement (Memorandum of Understanding) was concluded with the Office of the Comptroller of the Currency (OCC) of the United States. Negotiations with the supervisory authorities of Italy, Greece and the Republic of Macedonia have also been conducted. Outlines of the coming memorandums with them provide for information exchange and cooperation in the field of banking supervision.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BULGARIA

After the memorandum for cooperation between BSD and the Deposit Insurance Fund concluded in 1999 a memorandum between BSD and the other financial sector's supervisors is underway to be undersigned. It draws up for establishing a steering committee of the supervisors in banking, securities and stock exchange, insurance, pension insurance (the committee was built in spring 2002). Supervisory cooperation in financial sector will cover several areas, as: strategic development issues, regulation rules and methodology harmonisation, sharing and exchange of information and supervisory expertise, joint examinations and actions, etc.

MAIN STRATEGIC OBJECTIVES

The regulative framework developed by BSD was also validated in the process of negotiations with EU. Bulgaria has not asked for any transitional periods and postponements in the area of banking, and has declared its readiness to implement European banking standards several years ahead of its accession into the EU. This position is based on the harmonogramme for consistency with the EU Consolidated Banking Directive 2000/12, which has shown that a larger number of its items have already been in place.

The major efforts of the Bulgarian banking supervision in the coming years will be focused on the full compliance with the European Banking Directives, and special actions will be undertaken for an extended scope of application of the capital adequacy Directives. The New Capital Accord of the Basle Committee will require a serious preparation for its implementation not only by bank supervisors, but by bankers as well.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS – FINANCIAL SECTOR ASSESSMENT PROGRAM (FSAP)

As mentioned above, in 2001 the Bulgarian financial sector was tested under the new program designed by the IMF and the World Bank. The Financial Sector Assessment Program (FSAP) includes a set of questionnaires and criteria for the assessment of the extent of financial sector development, banking supervision effectiveness, presence and level of systemic risk and transparency of supervision measures and policies. In fact, the first assessment of the banking sector was conducted in 1999. The second review in 2001 was based on a new, more sophisticated program encompassing the entire financial sector. Bulgaria is among the first 20 countries in the world undergoing independent assessment by the IMF and the World Bank.

According to the FSAP assessment, in the conditions of ongoing real sector restructuring and competition-driven contracting margins, banks in Bulgaria are expanding their credit portfolios. In line with these trends and related higher risks banking supervision is assessed as very good and effective. A high degree of compliance with the Core principles for effective banking supervision and implementation of regulations in practice was achieved. Based on the criteria of the Basle Committee on Banking Supervision Bulgaria applies 17 core principles in full and with 7 CPs is largely compliant, while one CP is not satisfactory applied (country risk). Also, banking supervision policies and measures correspond to the Code of Sound Practices of Transparency in Monetary and Financial Policies: something valued highly by the IMF and the World Bank.

According to the FSAP assessment, banks are highly capitalized, middle winning and still slightly prone to risk assumption in their operations. The stress tests revealed that the Bulgarian banking system is extremely resilient to forex and interest risks, and to a lesser extent to credit risk. However, the higher risk component in bank portfolios entails a catching-up policy and measures to improve the legal framework and judicial practices for creditor protection, corporate management and transparency.

Based on the assessment by the IMF and the World Bank mission some recommendations for changes in supervision requirements were made, focusing on ownership transparency and related parties, especially on the origin of funds coming from offshore zones. Another forecast was shared by the Mission related to the increasing possibility of crowding out small banks from the market as a result of enhanced competition and forthcoming accession to the European Union.

LIST OF MAIN ACTS AND REGULATIONS

Basic laws:

- Law on the Bulgarian National Bank, effective since June 1997, last improved in 1999;
- Law on Banks, effective since July 1997, last improved 2000;
- Law on Bank Deposit Guaranty, effective since 1998, last improved 1999;
- Law on the Measures against Money Laundering, effective since 1998;
- Law on the Public Supply of Securities, effective since 2000;
- Law on Information about Nonperforming Credits, effective since 1997;
- Law on Accounting, since 1991, last improved 1999;

Prudential Regulations of the BNB:

- Regulation No. 1 on Bank Deposit Insurance;
- Regulation No. 2 on the Licences and Permits issued by the BNB;
- Regulation No. 3 on Payments;
- Regulation No. 4 on Foreign Currency Positions of Banks;
- Regulation No. 7 on the Large Exposures of Banks;

- Regulation No. 8 on the Capital Adequacy of Banks;
- Regulation No. 9 on Evaluation of Risk Exposures of Banks and Allocation of Provisions to Cover theRisk Related Thereto;
- Regulation No. 10 on the Internal Control in Banks;
- Regulation No. 11 on Banks' Liquidity Management and Supervision;
- Regulation No. 12 on Consolidated Bank Supervision;
- Regulation No. 16 on Payments by Bank Cards;
- Regulation No. 17 on Art. 29 of Law on Banks and Credit Business (now Art. 30 of the Law onBanks);
- Regulation No. 20 on Issuance of Certificates under Art. 9, Para. 2 of the Law on Banks;
- Regulation No. 21 on the Minimum Required Reserves Maintained with the BNB by Banks;
- Regulation No. 22 on Central Credit Register of Banks;
- Regulation No. 23 on the Terms and Procedures for Payment of Insured Amounts on Deposits with Banks with Revoked Licenses;
- Regulation No. 26 on Foreign Exchange Transactions of Brokerage Financial Houses;
- Rules on Applying the Law on Measures against Money Laundering;

STATISTICAL TABLES

Number of banks
(operating at year -ends)

Type of bank	1996	1997	1998	1999	2000	2001
Top banks	2	3	3	3	3	3
Large banks	8	4	4	4	4	5
Small and medium-sized banks	30	18	17	17	17	17
Foreign banks *	7	9	10	10	11	10
Banks, total	**47**	**34**	**34**	**34**	**35**	**35**

** Foreign banks' branches and subsidiaries established in Bulgaria. Existent and privatised Bulgarian banks by foreign investors remain in the other groups as of their size.*

Ownership structure of banks in 2001 on the basis of registered capital (%)
(at year-end)

Item	Type of banks			Total
	Top Banks	Large banks	Small and medium-sized banks	
State ownership	22.4	26.9	7.2	15.1
Other domestic ownership	4.5	3.5	43.8	18.2
Domestic ownership total	***26.9***	***30.4***	***51.0***	***33.3***
Foreign ownership	73.1	69.6	49.0	66.7
Banks total	**100.0**	**100.0**	**100.0**	**100.0**

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

Item	1997	1998	1999	2000	2001	2001/1997
State ownership	15.0	42.6	44.9	14.2	15.1	0.7
Other domestic ownership	50.2	14.0	8.5	17.7	18.2	-63.7
Domestic ownership total	***65.2***	***56.6***	***53.4***	***31.9***	***33.3***	-48.9
Foreign ownership	34.8	43.4	46.6	68.1	66.7	91.7
Banks total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	-

Distribution of market shares in balance sheet total (%)

Type of bank	1996	1997	1998	1999	2000	2001
Top banks	48.1	56.2	51.5	51.7	49.9	46.1
Large banks	19.3	18.8	20.3	18.7	18.5	22.8
Small and medium-sized banks	7	17.1	17.4	16.3	17.7	16.5
Foreign banks *	2	7.9	10.8	13.3	13.9	14.6
Banks under conservatorship	23.6	-	-	-	-	-
Banks, total	**100**	**100**	**100**	**100**	**100**	**100**

** Foreign banks' branches and subsidiaries established in Bulgaria. Existent and privatised Bulgarian banks by foreign investors remain in the other groups as of their size.*

Structure of assets and liabilities of the banking sector (%)

Assets	1996	1997	1998	1999	2000	2001
Cash in vault & funds in current account with BNB	8.2	12.8	10.6	11.2	7.6	10.5
Due from banks & other financial institutions	19.3	31.5	32.8	32.4	39.8	33.3
Securities in trading portfolio	20.0	20.6	16.7	12.7	10.9	12.5
Loans extended to non-financial institutions and other clients	45.8	15.3	24.6	29.2	30.9	34
Securities in investment portfolio	0.6	3.9	6.4	7.5	4.5	4
Fixed assets	1.4	3.6	4.4	4.3	4.2	3.8
Other assets	4.7	12.3	4.5	2.7	2.1	1.8
Total assets	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100**
Liabilities and capital						
Deposits by banks and other fin. institutions	31.9	9.5	7.6	7.7	7.6	7.5
Deposits by NFIs and other clients	39.1	67.7	69.2	69.9	65.7	70.8
Total deposits	**71.0**	**77.2**	**76.8**	**77.6**	**73.3**	**78.3**
Other liabilities	6.0	10.8	8.7	6.8	11.4	8.3
Subordinated debt						
Capital	10.1	4.3	8.9	10.8	11.3	9.7
Reserves	12.9	7.7	5.6	4.8	4.0	3.7
Total liabilities & own funds	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

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

Type of bank	1997	1998	1999	2000	2001
Top banks	120	6.5	7.2	5.7	5.7
Large banks	31.5	4.7	7.7	7.2	9.4
Small and medium-sized banks	88.8	14.8	14	17.6	13.8
Foreign banks *	82.5	24.8	40.6	33.9	33
Banks, total	**94.2**	**9.6**	**13**	**12.1**	**11.8**

** Foreign banks' branches and subsidiaries established in Bulgaria. Existent and privatised Bulgarian banks by foreign investors remain in the other groups as of their size.*

Solvency ratio of banks

Type of banks	1996	1997	1998	1999	2000	2001
Top banks	-	39.4	44.8	50	42	37.0
Large banks	19.3	18.7	29.7	28.8	27.4	21.8
Small and medium-sized banks	11.1	23.7	33.3	42.7	34.7	35.6
Foreign banks (subsidiaries)	36.2	17.2	27	21.4	24.9	22.6
Banks, average	**17.7**	**26.9**	**36.7**	**41.3**	**35.5**	**31.1**

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

Item	1997		1998		1999		2000		2001	
	Dep.*	Claims	Dep.	Claims	Dep.	Claims	Dep.	Claims	Dep.	Claims
Households	35.5	3.5	43.0	7.2	48.4	7.5	49.6	6.9	51.9	7.7
Government sector	9.8	9.6	7.1	23.7	4.5	17.6	4.4	13.0	4.8	12.4
Corporate	43.2	38.6	39.9	28.2	38.8	33.2	33.5	31.8	31	31.6
Foreign	10.5	46.3	8.7	40.6	7.2	41.3	10.5	47.0	10.1	41.4
Other	1.0	2.0	1.3	0.3	1.1	0.4	2.0	1.3	2.2	6.9
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

** Dep. = Deposits*

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

Deposits	1997	1998	1999	2000	2001	Loans	1997	1998	1999	2000	2001
At sight	57.5	55.8	47.7	47.0	46.3	Short term	76.1	49.1	73.7	74.6	71.4
Within one year	35.6	39.5	49.7	49.2	49.9	Medium term	2.9	14.1	16.5	15.9	20.5
Over one year	6.9	4.7	2.6	3.8	3.8	Long term	20.3	13.6	9.0	8.0	7.7
						Other	0.7	23.2	0.8	1.5	0.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**Total**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Asset portfolio quality of the banking system

Banking groups	Classified Risk Exposures (gross)		Dec.1997	Dec.1998	Dec.1999*	Dec.2000*	Dec.2001*
Top 3 banks	**Amount in BGN Millions**				**3,177,462**	**3,659,686**	**3,837,183**
	Standard	%			95.1	96.5	96.8
	Watch	%			2.3	1.4	1.0
	Substandard	%			0.7	0.6	0.6
	Doubtful	%			0.4	0.4	0.2
	Loss	%			1.4	1.0	1.4
	Provisions	%			4.9	4.1	4.1
Large banks	**Amount in BGN Millions**		**2,921,023**	**3,211,288**	**1,551,247**	**1,602,328**	**2,233,936**
	Standard	%	78.7	83.6	74.9	85.7	90.9
	Watch	%	2.2	3.6	4.3	3.8	3.4
	Substandard	%	1.8	1.0	0.7	0.9	1.3
	Doubtful	%	2.3	0.4	2.9	1.0	0.4
	Loss	%	15.0	11.4	17.2	8.7	4.0
	Provisions	%	25.8	13.7	19.3	11.1	5.8
Small & medium-sized banks**	**Amount in BGN Millions**		**488,917**	**661,662**	**1,320,040**	**1,461,647**	**1,754,657**
	Standard	%	76.2	76.8	87.0	85.7	83.1
	Watch	%	13.8	12.1	4.9	7.1	8.6
	Substandard	%	0.2	5.0	2.9	2.0	2.2
	Doubtful	%	1.1	2.7	1.6	2.5	2.3
	Loss	%	8.8	3.4	3.6	2.7	3.8
	Provisions	%	14.6	11.9	8.1	7.5	6.3
Foreign bank branches	**Amount in BGN Millions**		**395,561**	**688,176**	**528,190**	**696,714**	**896,353**
	Standard	%	83.0	89.6	89.7	92.6	94.8
	Watch	%	2.0	2.9	9.1	0.6	1.5
	Substandard	%	11.7	6.5	0.4	5.7	0.6
	Doubtful	%	1.5	0.3	0.0	0.0	2.2
	Loss	%	1.8	0.8	0.8	1.1	1.0
	Provisions	%	10.1	6.0	4.1	4.2	4.0
Total of the banking system	**Amount in BGN Millions**		**3,805,501**	**4,561,125**	**6,576,939**	**7,420,375**	**8,722,129**
	Standard	**%**	**78.8**	**83.5**	**88.3**	**91.7**	**92.3**
	Watch	**%**	**3.7**	**4.7**	**3.8**	**2.9**	**3.2**
	Substandard	**%**	**2.7**	**2.4**	**1.1**	**1.4**	**1.1**
	Doubtful	**%**	**2.0**	**0.7**	**1.2**	**0.9**	**0.9**
	Loss	**%**	**12.9**	**8.6**	**5.5**	**3.0**	**2.5**
	Provisions	**%**	**22.7**	**12.3**	**8.9**	**6.3**	**4.9**

* *Banks classified into five groups.*
** *1999 & 2000 include groups III & IV as of the banks' classification in five groups.*

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

Type of banks	FOREX Assets/Total Assets				FOREX Liabilities/Total Liab.			
	1998	1999	2000	2001	1998	1999	2000	2001
Top banks	53.8	55.6	60.3	60.5	48.9	46.5	48.7	55.9
Large banks	46.8	46.2	55.8	58	51.2	51.1	58.9	61.9
Small and medium-sized banks	59.6	61.3	54.8	55.7	62	65	55.6	55.9
Foreign banks' branches	72.4	75.2	72.8	64	81.3	79.4	76.7	64.9
Banks, average	**54.6**	**56.4**	**59.1**	**59.2**	**54.2**	**54**	**54.8**	**58.2**

Profit and loss statement

in thous. of USD

Items	1999	2000	2001
Interest income	231,530	285,937	309,067
Interest expenditure	66,651	88,821	95,376
1) Net interest income	164,879	197,116	213,691
2) Profit from other financial and investment services (incl. dividends)	146,300	214,797	207,717
Of that: Profit from commissions	70,796	79,085	89,503
Of that: Net provisions	5,096	38,790	-33,592
3) Gross financial and investment services profit (1+2)	311,179	411,913	421,407
4) Overheads	202,508	224,743	248,529
5) Extraordinary profits	38,392	5,108	14,607
6) Pre-tax profit (3-4+5)	147,063	192,278	187,485
7) Taxes paid	40,723	61,825	52,647
8) Net profit	106,340	130,454	134,838

Components of the banking sector return on assets (%)

Items	1999	2000	2001
In proportion to the average balance-sheet total			
Interest income	5.6	6.6	6.2
Interest expenditure	1.6	2.0	1.9
1) Net interest income (to average assets)	4.0	4.5	4.3
2) Profit from other financial and investment services (incl. dividends)	3.5	4.9	4.2
Of that: Profit from commissions	1.7	1.8	1.8
Of that: Net provisions	0.1	0.9	-0.7
3) Gross financial and investment services profit (1+2)	7.5	9.4	8.4
4) Overheads	4.9	5.2	5.0
5) Extraordinary profits	0.9	0.1	0.3
6) Pre-tax profit (ROA)	3.6	4.4	3.8
7) Taxes paid	1.0	1.4	1.1
8) Net profit	2.6	3.0	2.7

Average balance sheet items*

in tous. of USD

Items	1999	2000	2001
Average balance-sheet total (assets total)	4,140,096	4,362,962	4,996,189
Average own capital	635,185	665,305	712,343

** Year's average on monthly base*

Structure of revenues and expenditure of banks in % of total revenues

Revenues	1997	1998	1999	2000	2001
Interest earned	26.3	103.2	52.4	52.4	62.1
Net income from fees and commissions	2.4	21.7	14.4	14.5	18.0
Securities income/loss (net)	0.3	-35.2	8.3	26.7	11.4
Forex operations income/loss (net)	53.1	-4.1	11.0	2.8	4.4
Other banking operations revenues	13.4	11.7	14.1	2.6	1.2
Extraordinary revenues/expenses (net)	4.5	2.7	-0.2	1.0	2.9
Total revenues	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Expenses					
Interest paid	17.7	29.8	14.3	16.3	19.2
General operating costs	9.7	81.3	47.2	36.0	50.0
Reserve and provisions creation/reintegration (net)	48.6	-71.9	5.6	7.2	-6.8
Other operating costs	2.4	13.1	1.5	5.3	0.0
Total expenses	**78.4**	**49.2**	**68.6**	**64.7**	**62.4**
Pre-tax profit	**21.6**	**50.8**	**31.4**	**35.3**	**37.6**
Taxes	7.5	17.4	10.6	11.3	10.6
Net profit	**14.1**	**33.4**	**20.8**	**23.9**	**27.1**

Structure of registered capital and own funds of banks in 2001

Tipe of Banks	Registered Capital USD in thous.	/Total assets %	Own Funds USD in thous.	/Total Liab. %
Top banks	140,738	5.6	362,387	16.7
Large banks	65,760	5.2	157,658	14.4
Small and medium-sized banks	140,367	15.5	165,863	22.4
Foreign banks*	41,771	5.2	50,795	6.7
Banks, average	**388,636**	**7.1**	**736,703**	**15.5**

** Foreign banks' branches and subsidiaries established in Bulgaria. Existent and privatised Bulgarian banks by foreign investors remain in the other groups as of their size.*

2001 DEVELOPMENTS IN THE CROATIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The economic growth that began in 2000 after the 1999 recession continued in 2001. Real GDP grew by 4.1% compared with 2000. It is particularly encouraging that one of the major contributors to growth was investment, a key to increased output and competitiveness. Investment was facilitated by declining interest rates and the recovery of bank lending to enterprises, which grew by 21.3% in 2001 after having grown by only 0.9% in 2000. Growing investment can also be seen as a sign of enterprises´ optimism about future growth prospects. Steady economic growth also led to growth in total employment in 2001. This increase of 1.4%, albeit modest, was the first annual increase in employment in many years.

Monetary policy contributed to low inflation by keeping the exchange rate within stable bounds. Experience has shown that this is the best way to control inflationary pressures and to contain imported inflation. During the spring and summer of 2001, the exchange rate was unusually turbulent. Indeed, appreciation pressures typical of the summer months appeared as early as April.

In the last quarter of 2001, the foreign exchange market experienced unusual appreciation pressures. Savers brought large quantities of euro-in currencies (mainly German marks) to the banks for conversion into euros and in order to avoid conversion fees. This enormous inflow of foreign exchange into the banking system strengthened the exchange rate and led to large increases in the broadest money and currency in circulation.

The average inflation rate fell by 1.3 percentage points in 2001 to 4.9%, while year-on-year inflation fell from 7.4% in December 2000 to 2.6% in December 2001. Core inflation, which excludes administrative prices and prices of agricultural products and thus corresponds more closely to the inflation rate that the central bank is able to control, fell 0.4 percentage points in 2001 to an average of 3.6%. The discrepancy between retail price inflation and core inflation underlines the fact that price increases in the recent period have mainly been the result of increases in the world market price of crude oil and energy (especially in the first quarter of 2002) and increases in administrative prices. Monetary policy contributed to low inflation by keeping the exchange rate within stable bounds.

Consumption grew by 4.5%, stimulated by growth in the wage bill. Bank lending to households grew strongly, which supported consumption. As planned, government consumption decreased during the year. The decrease in government consumption allows taxation to decrease; it helps decrease government borrowing needs and facilitates private sector growth. Government revenues decreased from 47.3% of GDP in 1999 to 41.9% in 2001, marking a shift away from the situation in which the government plays a dominant role in allocating economic resources. Fiscal consolidation was the centrepiece of the Government's 2001 economic program.

The current account deficit remained moderate during 2001, increasing from 2.3% of GDP in 2000 to 3.1%. The merchandise trade deficit rose from USD 3.2bn to USD 4.0bn. In part this was due to a one-time large-scale import of cars. Another major and economically favourable factor was the increase in capital goods imports, which should lead to greater productivity and export competitiveness. At the same time, exports grew by 5.1%, and the share of exports going to the more demanding markets of developed countries increased from 60.1% in 2000 to 62.2% in 2001. Even more important to the overall current account balance, however, was the jump in net tourism income, which grew by 24.6% in 2001 compared to 2000. Net tourism income reached USD 2.7bn and thereby provided a substantial offset to the merchandise trade deficit.

BANKING SYSTEM

At the end of 2001, the banking system of the Republic of Croatia comprised 43 banks, 14 savings banks and 4 housing savings banks. Savings banks and housing savings banks did not have a significant influence since they accounted for only 1.6% of the banking system assets. Total assets of the banking system amounted to HRK 151bn, a 33.1% rise compared to the end of 2000. The relatively large asset growth of the banking system was partly caused by the growth of received deposits in euro-in currencies for euro conversion and partly by the large asset growth of individual banks in majority foreign ownership.

The 24 banks in majority foreign ownership accounted for 89.3% of bank assets, the 3 banks in majority state ownership accounted for 5%, and the remaining 16 banks in majority private ownership of domestic shareholders accounted for 5.7%. The concentration of the banking system strengthened, and the share of banks with assets exceeding HRK 5bn in total assets grew from 66.3% at end-2000 to 70.7% at end-2001. In 2001, there was stronger competition among the banks and bank groups that strengthened their position in the Croatian market.

The balance sheet structure of the banks

Net loans to the non-banking sector (amounting to HRK 64.4bn) had a downward trend in the bank asset structure, despite a 28.5% growth. Corporate loans had the largest share (49%) in the loan structure, followed by household loans with a somewhat smaller share (42.6%).

Deposits with banking institutions increased by 35.1% compared to end-2000, and their share in assets grew from 15.8% at end-2000 to 16.1% at end-2001.

The large increase of the money assets of banks can be accounted for by a strengthened inflow of funds into the banks at the end of the year for the purpose of the euro conversion.

Deposits with the Croatian National Bank amounted to HRK 14.3bn or 9.7% of total assets. Their considerable growth of 44% was a result of an increase in the reserve requirements set aside with the Croatian National Bank (as a result of deposit growth) and a strong growth in funds in settlement accounts. The investments in Ministry of Finance treasury bills and CNB bills continued to grow considerably.

The investment portfolio of securities had a downward trend. The trading portfolio of securities grew by a significant 94.8%.

The share of total deposits in total bank liabilities moved upward (65.0% in 2000, 70.5 in 2001). As in the previous years, the majority of deposits were denominated in foreign currency (74.9%).

Bank capital

At the end of 2001, the risk-based capital of banks amounted to HRK 13.9bn, which is a 7.8% increase over that at the end of 2000 when it stood at HRK 12.9bn.

The capital adequacy ratio at the banking system level at the end of 2001 amounted to 18.4%, which is less than at the end of 2000 when it stood at 21.3%. Capital grew more slowly than bank assets, despite capital strengthening on the basis of distributed profit. The lower ratio of capital to assets brings the domestic banks closer to the banks in Western Europe, which is a natural trend but implies certain hazards and risks.

Asset quality

Losses arising from partly recoverable placements (categories C and D) and placements whose present value equals zero (placements graded E) represent bank expenses of the amount by which the asset items are reduced and strongly affect bank performance. Although placements graded A and B are not subject to individual reduction corresponding to the value of loss, banks are obliged to form reserves for them for unidentified losses. For placements classified into category B, banks are obliged to form reserves according to their policy.

At the end of 2001, fully recoverable placements (categories A and B) accounted for 92.8% of total risk assets. Partly recoverable placements (categories C and D) accounted for 4.4% of total risk assets, while non-recoverable placements (category E) accounted for 2.8% of total risk assets.

The share of total reserves in total risk assets has a downward trend that was especially pronounced in 2001. This downward trend of total impairment, both in its absolute amount and relative to total placements, resulted from an increase in the share of categories A and B.

Bank earnings

In 2001, the banks reported a profit of HRK 894.2m. Net interest income increased by 7.7% as compared to 2000 due to interest income growth larger than interest expenses growth. Net non-interest income decreased by 36.6% compared to the previous year due to a growth in non-interest expenses (because of losses of one bank). Net interest income against average interest bearing assets fell from 4.6% in 2000 to 3.9%, since interest income growth was slower than assets growth.

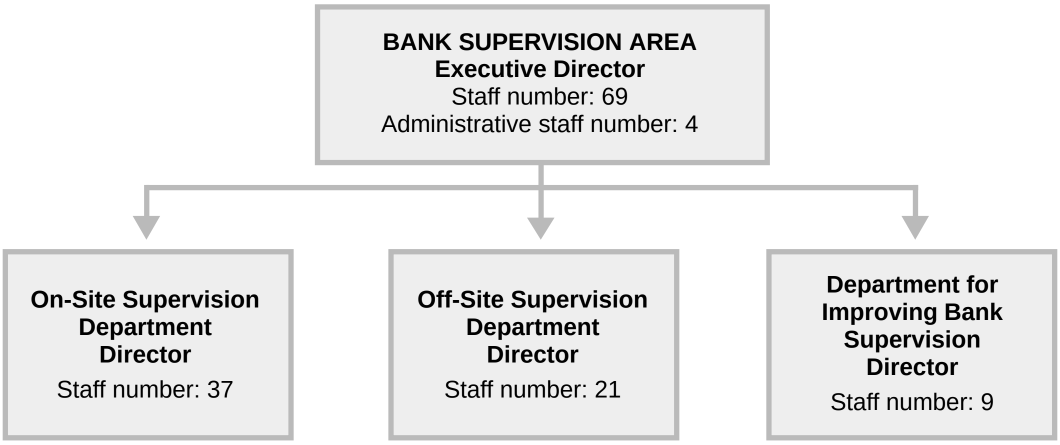
The 37.8% reduction in loan loss provision expenses is a result of the previously reported increase in fully recoverable placements along with a fall in partly recoverable placements and placements whose present value equals zero.

Bank liquidity

In order to assure their liquidity reserve, banks place part of their assets in securities that bear lower interest and can easily be converted into liquid assets. According to the average daily balances for December 2001, HRK 2,656.2m in CNB bills denominated in kuna were purchased. HRK 1,892.7m of CNB bills denominated in foreign currency were also purchased. At the end of 2001, CNB loans were not utilized by any of the banks. The high liquidity of banks in 2001 was mostly due to the previously mentioned deposit growth in bank liabilities.

SUPERVISION OF BANKS AND SAVINGS BANKS

In order to perform all the prudential bank supervision tasks more efficiently and effectively, the Bank Supervision Area is divided into three departments: the On-Site Supervision Department, the Off-Site Supervision Department and the Department for Improving Bank Supervision. The Foreign Trade Transactions Control Department is also within the organizational structure of the Bank Supervision Area. At the end of 2001, the Bank Supervision Area had a staff of 69[3]. The organizational strengthening was in compliance with the Strategic Development Plan.



THE LEGAL AND INSTITUTIONAL FRAMEWORK

The Croatian National Bank performs supervision of banks and savings banks pursuant to the authorities prescribed by the Law on the Croatian National Bank and the Banking Law. Prudential bank supervision, established in 1993 as the Bank Supervision Area within the Croatian National Bank, has followed the BIS recommendations since its establishment and has continuously enhanced its performance, which depends, among other things, on the conditions in the environment. Upon the enactment of the Banking Law, at the end of 1998, and the set of regulations based on this Law, the process of adoption of the basic supervisory regulations was completed. For the purpose of further compliance with the European Union regulations, a Banking Bill has been prepared. The aim of the Banking Bill is to create the preconditions for regular banking operation through a high level of prevention, which primarily must be assured by banks themselves. In 2002 the Croatian Parliament adopted the Banking Bill. Pursuant to the new Banking Law, new subordinate legislation will also be adopted.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2001

The outcome of the Bank Supervision Area's regular activities in 2001 was as follows:

[3] The total number of employees does not include those employed with the Foreign Trade Transactions Control Department nor those responsible for administrative tasks.

- a total of 32 regular examinations of bank operations were carried out (in 23 banks and 9 savings banks), which accounts for 52.46% of the banking system in terms of the number of institutions or 52.98% of the banking system in terms of the share in assets (in 2000, on-site supervision was conducted in 24 banks and 21 savings banks, which is 56.46% of the overall system),
- six examinations of the implementation of measures for the improvement of condition were carried out (in 2 banks and 4 savings banks,)
- three examinations of liquidation process were carried out (in 2 banks and 1 savings bank),
- six off-site examination findings were prepared,
- twenty-nine orders for the improvement of conditions and the elimination of illegal and irregular activities were issued – these measures partly refer to the establishment of time-limits for complying with prescribed exposure limitations,
- twenty-eight citations were processed (26 minor offence citations, 6 citations for financial infractions and 11 citations for infringement of currency regulations).

Additionally, in accordance with the provisions of the Banking Law, a total of 67 applications of banks and savings banks for various approvals were processed, which resulted in issuing bank operating licenses (3), granting approvals for exceeding the investment limitations (15), extending time-limits set by various decisions (5), granting specific prior consents (42) and withdrawing licenses (2).

In 2000, the majority of activities and resources were directed towards solving problems that remained from the previous years and towards completing the banking system consolidation process. Although more examinations of banking operations were carried out in 2000, the banks examined in 2001 were considerably larger by size and volume of operations than the banks examined in the previous year.

Other activities

For the purpose of further compliance with the European Union regulation, a Banking Bill was prepared. The Banking Bill introduces new provisions or amends the existing provisions, of which most important are the following: provisions on the freedom of banks of the EU Member States to provide banking and other financial services; provisions on co-operation with other supervisory authorities, with a special emphasis on co-operation with the supervisory authorities of the EU Member States; provisions on risk management, including market risk and other risks; provisions on bank supervision on the basis of consolidated financial reports.

In co-operation with the Research and Statistics Department, and for the purpose of better consumer protection, the Decision on the Uniform Method of Expressing the Effective Lending and Deposit Interest Rate was adopted. For the purpose of improving the compliance of the existing subordinate legislation with International Accounting Standard 39 – Recognition and Measurement, the Decision on the Method of Improving the Compliance of the Croatian National Bank Subordinate Legislation with the International Accounting Standards was also issued.

Additionally, considerable efforts were made within the Bank Supervision Area in the following operating segments:

- improvement of transparency in informing the public about the conditions in the system (the Banks Bulletin publication was started),

- internal organization and procedure improvement (internal reorganization was carried out and supervisory function operating procedures were prepared),
- development of the data base and information system for the banking system financial report and overall banking system analysis,
- further improvement in the application of the CAMEL method in the area of bank supervision in general,
- setting up the Central Banks' Records,
- co-operation with other government bodies regarding issues related to the area of bank and savings bank supervision,
- co-operation with government bodies from other countries regarding issues related to the area of bank and savings bank supervision,
- active participation in projects at the Croatian National Bank level,
- active participation in inter-institutional projects (in the areas related to money laundering and fighting terrorism),
- intensifying activities aimed at employees' professional training. Bank (seminars and other forms of training in the country (organized by reputable Croatian institutions in the area of banking and finance) and abroad (organized by BIS, Financial Stability Institute, IMF, JVI, Ministry for the European Integration and several European central banks).

THE MAIN STRATEGIC GOALS OF THE BANKING SUPERVISORY AUTHORITY

Further improvement in bank supervision quality was the main strategic goal of the supervisory authority in 2001. As previously described, in 2001 a considerable effort was made to strengthen the Bank Supervision Area.

A further development and strengthening of prudential bank supervision is one of the Croatian National Bank's long-term strategic goals. The guidelines for the development of the supervisory function in the near future are the following:

- regulatory improvement, i.e. enactment of the new subordinate legislation pursuant to the new Banking Law;
- continuation of efforts to issue written rules and procedures;
- performing supervision on the consolidated basis;
- strengthening co-operation with other financial supervisory authorities;
- strengthening co-operation with foreign supervisory authorities;
- strengthening co-operation with external bank auditors;
- continuous training of employees;
- strengthening bank operation transparency.

STATISTICAL TABLES

Number of financial institutions

Type of financial institution	1999	2000	2001
Banks	53	43	43
Saving banks	34	26	18
Financial institutions, total	**87**	**69**	**62**

Ownership structure of financial institutions in 2001 on the basis of registered capital (%) (at year end)

Item	Type of financial institution		Total
	Banks	Savings banks	
State ownership	10.9	0.0	**10.5**
Other domestic ownership	13.5	43.4	**14.7**
Domestic ownership total	24.4	43.4	**25.2**
Foreign ownership	75.6	56.6	**74.8**
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Item	1999	2000	2001	2001/1999 (indeks)
State ownership	37.5	8.6	10.5	28.0
Other domestic ownership	31.6	19.9	14.7	46.5
Domestic ownership total	69.1	28.5	25.2	36.5
Foreign ownership	30.9	71.5	74.8	242.1
Financial institutions, total	**100.0**	**100.0**	**100.0**	**100.0**

Distribution of market shares in balance sheet total (%)

Type of financial institution	1999	2000	2001
Banks	98.5	98.6	98.4
Savings banks	1.5	1.4	1.6
Financial institutions, total	**100.0**	**100.0**	**100**

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

Type of financial institution	2000	2001
Banks	15.8	13.2
Savings banks	0.7	1.0
Financial institutions, total	**15.7**	**13.0**

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

Assets	1999	2000	2001
Money assets	1.3	1.3	5.3
Deposits with CNB	9.1	8.9	9.7
Deposits with banking institutions	11.0	15.8	16.1
Treasury bills and CNB bills	3.4	5.4	6.5
Trading portfolio of securities	1.1	2.2	3.2
Loans to financial institutions	1.3	1.0	1.0
Loans to other clients	48.5	44.8	43.3
Investment portfolio of securities	16.5	12.7	8.6
Investment in subsidiries and affiliated companies	1.9	2.2	1.5
Foreclosed and repossessed assets	0.5	0.5	0.3
Tangible assets and software	3.4	2.9	2.4
Interests, fees and other assets	2.8	2.8	2.9
General provisions	-0.8	-0.6	-0.8
Liabilities	**1999**	**2000**	**2001**
Borrowings from financial institutions	5.6	3.1	2.4
Giro and current account deposits	9.9	11.3	11.1
Savings deposits	14.6	15.8	17.8
Time deposits	36.5	37.9	41.6
Other loans	16.0	14.6	10.8
Debt securities issued	0.0	0.0	
Additional capital	-	-	
Subordinated debt instruments	0.1	0.3	0.2
Hybrid instruments	0.3	0.2	1.6
Interests, fees and other liabilities	5.2	4.9	5.3
Equity capital	8.8	7.7	6.0
Current year profit or loss	0.5	1.0	0.4
Retained profit (loss)	0.1	0.3	0.1
Reserves	2.4	2.9	2.7

Solvency ratio of financial institutions

Type of the financial institution	1999	2000	2001
Banks	19.3	21.3	18.5
Savings banks	49.7	33.5	37.4
Financial institutions, average	**19.8**	**21.4**	**18.7**

** Capital adequacy ratio*

Asset portfolio quality of the banking system

in million HRK

Asset Classification	1999	2000	2001
A	92,061.5	108,489.8	137,195.6
B	4,507.0	3,708.5	3,391.0
C	3,749.9	3,090.3	3,193.4
D	3,393.7	3,832.8	3,526.2
E	3,903.3	4,803.1	4,287.3
Classified Total	**107,615.4**	**123,924.5**	**151,593.3**
Specific Reserves	**8,673.6**	**9,355.4**	**7,912.1**

The structure of deposits and loans in 2001 (%)
(at year-end)

	Deposits	Loans
Households	68.4	42.6
Government sector	2.3	6.2
Corporate	19.2	49.0
Foreign	5.0	0.5
Other*	5.1	1.7
Total	**100.0**	**100.0**

** Financial sector is included*

The structure of deposits and loans in 2001 (%)
(at year-end)

Maturity of Deposits		Loans	
At sight	18.4	Long term loans	42.9
Within one year	45.6	Medium-term loans (1 to 3 years)	27.5
Over one year	36.0	Short-term loans	29.6
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 Liabilities		
	1999	2000	2001	1999	2000	2001
Banks	27.6	31.0	35.0	64.6	64.1	67.6
Savings banks	9.5	8.5	1.0	40.4	41.9	3.0
Financial institutions, average	**27.3**	**30.7**	**34.7**	**64.3**	**63.8**	**67.0**

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

in million HRK

Revenues	1999	2000	2001
Interest income	7,816.1	8,398.0	8,973.6
Non-interest income	2,962.4	2,878.9	3,230.8
Expenditures			
Interest expense	3,922.7	4,073.0	4,315.5
Non-interest expense	926.9	898.1	1,974.1
General and administrative expenses	3,211.1	3,577.7	3,878.1
Provisions for identified and unidentified losses	1,898.4	1,298.6	807.9
Income taxes	104.8	123.3	334.6

Structure of registered capital and own funds of financial institutions in 2001

Type of the financial institutions	Registered Capital 000 USD	/Total assets %	Own funds 000 USD	/Total liab. %
Banks	1,073 060	6.0	1,668,356	9.4
Savings banks	45 045	15.9	35,290	12.4
Financial institutions, average	**1,118 104**	**6.2**	**1,703,646**	**9.4**

2001 DEVELOPMENTS IN THE CZECH BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The year 2001 confirmed the gradual recovery of the Czech economy, a trend that emerged during 2000. In 2001, gross domestic product recorded a second consecutive year of growth. GDP growth of 3.6% was recorded in 2001, an increase of 0.7 points on a year earlier. Gross domestic product amounted to CZK 1,499.2 billion at constant prices in 2001.

Inflation was 4.1% in December 2001 and fluctuated within the 4%-6% range throughout the year. In December 2001, net inflation was 2.4%, which meant that the end-2001 inflation target range of 2%–4% was hit.

One of the anti-inflationary factors was an appreciation of the koruna's exchange rate against the euro. From an annual average of CZK 35.61 to the euro in 2000, the koruna strengthened to CZK 34.08 to the euro in 2001. The koruna's average exchange rate against the dollar firmed from CZK 38.59 to CZK 38.04 in the same period.

By December 2001 the unemployment rate had reached 8.9%, which was 0.1 points higher than a year earlier. The average nominal wage increased by 8.5% and the average real wage by 3.6% in 2001.

DEVELOPMENT IN THE BANKING SYSTEM

As of 31 December 2001, the Czech banking sector was made up of 38 banks and foreign bank branches. The number of banks fell by two in 2001 because of the merger of HypoVereinsbank CZ and Bank Austria Creditanstalt Czech Republic (to form HVB Bank Czech Republic a.s.) and the conversion of Konsolidační banka into Česká konsolidační agentura (Czech Consolidation Agency).

In 2001, the share of foreign owners in the equity capital of the banks in the Czech banking sector continued to grow sharply. Foreign entities held a 70.0% stake in the total equity capital of the Czech banking sector as of 31 December 2001, an increase of 15.5 percentage points on a year earlier, and controlled 94.2% (including banks owned indirectly by foreign entities through subsidiaries operating in the Czech Republic) of the total assets of the sector.

At the end of 2001, there were 40,871 people working in the Czech banking sector, 9.0% less than a year earlier. The number of banking units as of 31 December 2001 was 1,751, a 3.1% decline compared with a year earlier. The new technology in banking is facilitating reductions in the number of bank employees and branch networks without any decrease in the scope and quality of services.

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

The financial sector in the Czech Republic consists of banks, insurance companies, pension funds, investment companies, investment funds and brokerage houses, credit unions, leasing companies and some other inessential enterprises operating on the financial market. The banking sector dominates in the structure of the financial sector with 81.1 % of total assets (at the end of 2001).

The Banking Supervision of the Czech National Bank is responsible for the stability of the commercial banks sector, the Ministry of Finance supervises insurance companies and pension funds and the Securities Commission is the surveillance body concerning investment companies and investment funds. Credit unions are not included in the banking sector according to the Act on Banks; the Credit Union Supervisory Authority regulates them.

The fundamental law governing banking regulation is the Act on Banks. The other basic act regulating the Czech banking sector is Act on the Czech National Bank.

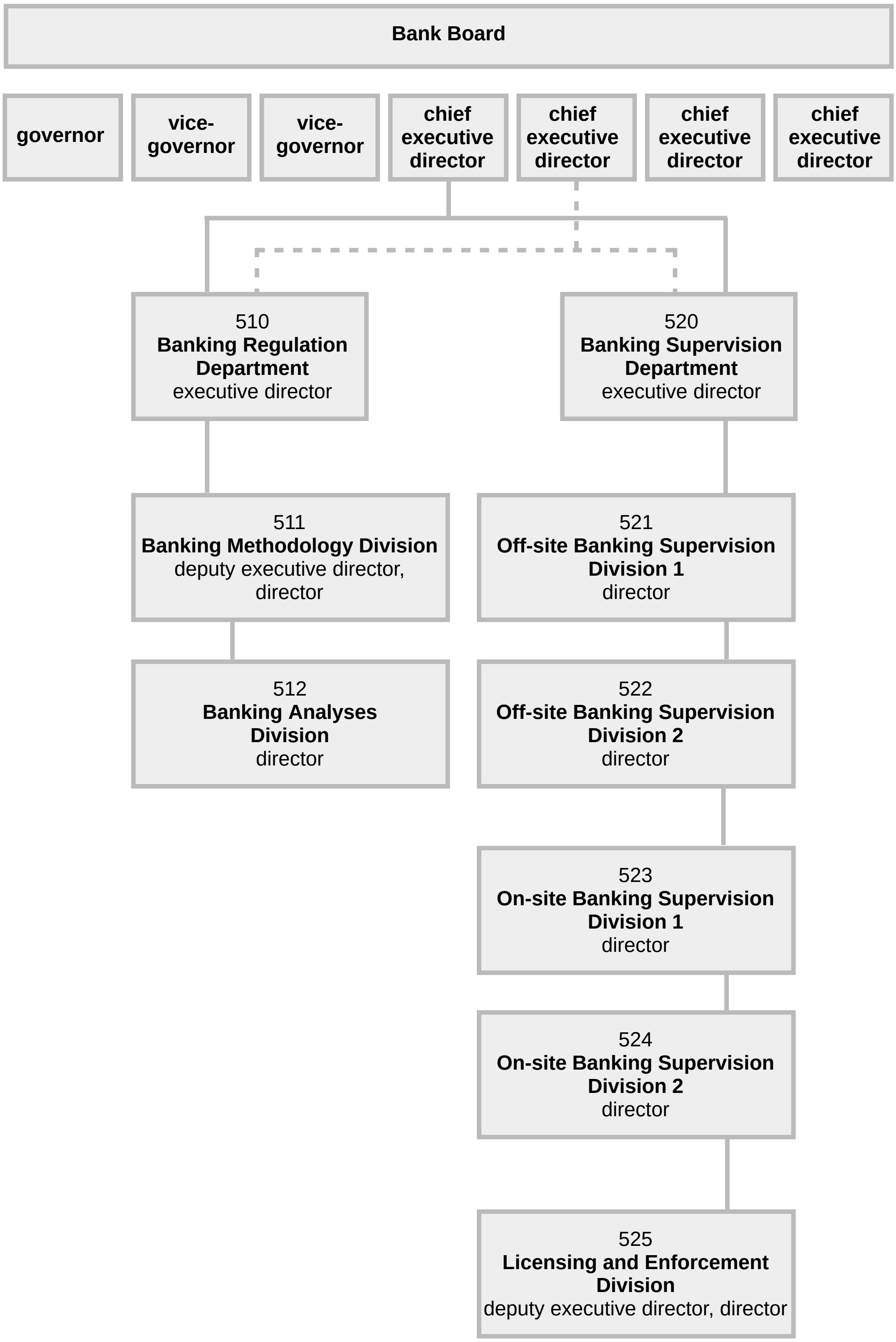
THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2001

Banking supervision in the Czech Republic in practice takes the form of off-site supervision and on-site supervision. In 2001 the CNB's activities in the area of off-site surveillance focused largely on processes linked with the restructuring of the banking sector, which in 2001 meant chiefly the completion of the privatisation of large banks and the further concentration of the banking sector by way of mergers and sales of businesses. The regular monitoring of banks' activities is mainly based upon quarterly analyses of their financial situation and review of compliance with the prudential rules and limits.

CNB Banking Supervision carried out twelve on-site examinations in 2001. In line with global trends, on-site examinations are focusing increasingly on verifying and assessing the adequacy, effectiveness and stability of the systems used to identify, measure, monitor and manage the risks to which each bank is exposed.

ORGANISATIONAL CHART OF THE CNB BANKING SUPERVISION

as of 1 January 2002



LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN THE CZECH REPUBLIC

In addition to the general legal regulations applicable to other businesses and the Act of Banks, banks are specifically subject to provisions (regulations) of the Czech National Bank, which under Czech law functions as the Banking Supervisory Authority in the Czech Republic (full text of relevant regulations is available on CNB's website at http://www.cnb.cz/).

Bank regulation on a solo basis is almost fully compatible with European law and other key international standards. A key amendment to the Act on Banks, known as the "harmonisation amendment", was passed and promulgated as Act No. 126/2002 Coll. The Act took effect on 1 May 2002, save for a number of harmonisation provisions which will take effect when the Treaty of Accession of the Czech Republic to the European Union enters into force.

In order to align the supervisory procedures in the Czech Republic with international practices, and also to achieve compliance with the relevant EC directives, CNB Provision No. 2 of 8 July 1999 Stipulating Terms and Conditions for Performing Supervision on a Consolidated Basis, as amended, was implemented in 1999. However, this applies only to financial groups headed by a bank. The limited scope of the CNB's consolidated supervision led to a negative assessment of its compliance with European directives and the Core Principles for Effective Banking Supervision. Consequently, one of the main ideas behind the amendment to the Act on Banks was to lay the groundwork for further enlarging the concept of consolidated supervision to include groups controlled by financial holding companies and mixed-activity holding companies, as required by the relevant EC directive. This amendment required the CNB to set forth in a decree the prudential rules for parent companies on a consolidated basis. The decree took effect on 1 August 2002.

Banking supervision on a consolidated basis, however, does not mean supervision of the individual members of the group, but supervision of the group as a whole with respect to the bank's membership of that group (i.e. business, financial and personal interrelations and associated risks). The CNB will not exercise supervision on a consolidated basis over groups subject to comparable consolidated supervision by other domestic or foreign supervisory authorities, including groups that form part of wider groups supervised by the CNB itself. It will, however, exercise supervision of every group controlled by a bank that has its head office in the Czech Republic (i.e. domestic banks and their subsidiaries and affiliate companies).

INTERNATIONAL ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN THE CZECH REPUBLIC

Co-operation with regulators from other countries is based on agreements (known as Memoranda of Understanding) defining principal areas of co-operation, such as exchange of information and common procedures for supervision of subsidiaries and branches of foreign banks. An agreement on supervisory co-operation was signed with the National Bank of Slovakia in 1999, similar agreements were signed with the Austrian Ministry of Finance in 2001 (available on the CNB's website) and with the surveillance body in France in June 2002. Analogous documents have also been prepared with the supervisory authorities in Belgium, the Netherlands and Germany, i.e. the countries that have banks operating in the Czech Republic through subsidiary banks or branches.

The year 2001 saw continuing informal practical co-operation with banking supervisors in other countries, chiefly by way of providing information on shortcomings detected in the activities of foreign banks and their branches operating on the Czech market to foreign regulators (in Germany, Austria, France and Slovakia) or in the form of consultations during informative visits by foreign regulators to such banks.

The EU Institution-Building Programme (known as "twinning") was completed in 2001. This programme set out to align the Czech banking supervision regulations and supervisory methods and procedures with practices in the EU. Implemented in the banking area by the German Federal Ministry of Finance in co-operation with the National Bank of Greece, the project generated a wealth of valuable information in different areas.

In collaboration with the Financial Stability Institute at the BIS, special seminars were organised in 2001 for experts from Central and Eastern Europe. A seminar on the theme of credit risk, attended by 32 representatives from 12 nations, took place in Prague in May 2001.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE CZECH REPUBLIC

The banking sector's key position in the Czech financial system, and the existence and growth of financial groups are together increasing the need for the Czech National Bank to communicate and co-operate effectively with the other domestic regulators.

The qualitative shift in the approach to regulation and the preparations for introducing consolidated supervision, which will focus on monitoring and controlling the risks in the group as a whole, requires not only the drafting and issuance of appropriate regulations, but also systematic co-operation with other regulators on the domestic and foreign market. In 2001, CNB Banking Supervision started work on a new tripartite co-operation agreement between the CNB, the Securities Commission and the Ministry of Finance. This should define more clearly the forms of co-operation, especially as regards supervision of consolidated groups. Consolidated supervision, which is expected to start in 2003, will chiefly concern banking groups, which currently predominate in the Czech Republic.

So, following the adoption of the amendment to the Act on Banks, banks will be subject to supervision on a consolidated basis, i.e. supervision with respect to their membership of groups of related entities (consolidated groups). Three types of consolidated groups are envisaged:

- parent bank groups, i.e. groups comprising a parent bank and its subsidiaries and associate companies,
- financial holding company groups, i.e. groups in which a bank is controlled by a financial institution (other than an insurance company) the subsidiaries of which are mainly other financial institutions (such a parent financial institution being referred as a "financial holding company"),
- mixed-activity holding company groups, i.e. groups in which a bank is controlled by an entity other than a bank or a financial holding company (such an entity being referred to as a "mixed-activity holding company"); the group also includes the other subsidiaries of the mixed-activity holding company.

Co-operation is also being developed with the professional organisations active in the banking sector (in particular the Czech Banking Association and the Chamber of Auditors of the Czech Republic) in the areas of the methodology and practical conduct of banking supervision. New draft regulations are being discussed with the Czech Banking Association, and in particular with its new Commission for Banking Regulation. The centre of attention at the moment is the New Basle Capital Accord, which is to be introduced in 2006. This will be a very demanding process, so, to smooth the path, the CNB, the Czech Banking Association and the Chamber of Auditors are preparing a common strategy.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2001

In 2001, CNB Banking Supervision focused chiefly on making further progress with harmonising the Czech regulations with European Community law and with implementing international standards into banking supervisory practice.

One of the most important changes affecting the economic environment as a whole was the revision of the Act on the Czech National Bank. An amendment to this Act with effect from 1 January 2001 curbed the independence of the central bank. Subsequently, the Constitutional Court rescinded some of the problematic passages of the Act, ruling that they were unconstitutional. Then, with effect from 1 January 2002 and 1 May 2002 respectively, two amendments (Act No. 482/2001 Coll. and Act No. 127/2002 Coll.) were passed which should ensure full compatibility of the CNB's legislative status with the requirements of Community law.

Furthermore, a revision to the deposit guarantee scheme in the Czech Republic was adopted in September 2001. This increased the upper limit for coverage of insured deposits to the equivalent of EUR 25,000 in the event of insolvency of a bank. The guarantee remains limited to 90% of the insured deposit. At the same time, the deposit insurance was expanded to include foreign currency deposits, and branches of foreign banks were given the right to opt out of the Czech deposit guarantee scheme where they can demonstrate that the scheme in which they do participate ensures eligible persons a level of protection at least the same as that offered by the Czech scheme.

In the area of accounting, CNB Banking Supervision played an active part in the comments procedure of the amendment to the Accounting Act, which was passed with effect from 1 January 2002. Among the main changes introduced by the amendment are an extension of the applicable valuation methods to include fair value and the option of preparing consolidated financial statements in accordance with international accounting standards.

As regards the secondary legislation falling within the purview of CNB Banking Supervision, decrees and regulations (known as "provisions") implementing the aforementioned harmonisation amendment to the Act on Banks were drafted during the course of 2001. In connection with the preparation and operation of the Central Register of Credits database, the CNB issued a provision stipulating the methodology for submission of selected data by banks and foreign bank branches to the Czech National Bank. This allows information on banks' debtors to be entered into the register. A new CNB provision on liquidity management standards applies to banks with effect from 1 July 2001. This is based on a new recommendation of the Basle Committee on Banking Supervision in this area.

The new Act No. 321/2001 Coll., on Certain Terms and Conditions for Arranging Consumer Credit is aimed at aligning the procedures for offering and concluding consumer credit agreements. It enacts certain preferential treatment of the consumer relative to the credit provider.

OTHER INFORMATION

At the turn of 2000/2001, a joint mission of the IMF and the World Bank conducted a Financial Sector Assessment Program (FSAP) in the Czech Republic. A "Peer Review" subsequently took place at the end of 2001. This programme – co-ordinated by experts from the European Commission – focused on the one hand on verifying and evaluating the progress made in harmonising Czech law with European law in the areas of banking and financial markets and transactions, and, on the other hand, on the success with which the law is being implemented in the practical supervision of banks and other subsystems of the Czech financial system.

The FSAP and Peer Review projects resulted, among other things, in a series of recommendations for raising the quality of banking supervision in the Czech Republic. is devoting considerable attention to all these areas. An "Action Plan" has been drawn up by the CNB Banking Supervision responding to all recommendations and specifying individual tasks and a schedule for executing them.

The FSAP assessment praised the progress made by CNB Banking Supervision in the recent past. The Peer Review concluding report states that following the adoption of the amendment to the Act on Banks, banking supervision in the Czech Republic is up to an internationally acceptable standard, both in terms of the legislation and the quality of supervisory work. The CNB has sufficient means and professional staff for its supervisory duties, is independent and is working towards the implementation of modern methodologies and concepts.

STATISTICAL TABLES

Number of financial institutions*
(at year-ends)

Type of financial institution	1999	2000	2001
Large banks	5	4	3
Medium-sized banks	12	11	10
Small banks	9	8	8
Foreign bank branches	10	10	10
Building societies	6	6	6
Banks under conservatorship	0	1	1
Financial institutions, total	**42**	**40**	**38**

**: banks carrying on activities as of 31 December of the given year, excl. central bank*

Ownership structure of financial institutions in 2001
on the basis of registered capital (%)*
(at year-end)

Item	Type of financial institution					Total
	large banks	medium-sized banks	small banks	building societies	banks under conservatorship	banking sector
State ownership incl. municipalities	2.9	11.1	6.4	0.0	0.0	**4.3**
Other domestic ownership	14.7	20.1	41.0	45.6	51.2	**25.7**
Domestis ownership total	17.5	31.2	47.5	45.6	51.2	**30.0**
Foreign ownership	82.5	68.8	52.5	54.4	48.8	**70.0**
Financial Institutions, total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

**: banks with licences as of 31 December 2001*

ČNB

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

Item	1999	2000	2001	2001/1999
State ownership incl. municipalities	27.0	23.6	4.3	0.2
Other domestic ownership	24.7	21.9	25.7	1.0
Domestis ownership total	51.7	45.5	30.0	0.6
Foreign ownership	48.3	54.5	70.0	1.4
Financial Institutions, total	100.0	100.0	100.0	1.0

**: banks with licences as of 31 December of the given year*

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

Type of financial institution	1999	2000	2001
Large banks	63.2	58.6	58.2
Medium-sized banks	17.7	21.3	21.2
Small banks	1.8	2.2	2.3
Foreign bank branches	12.5	12.0	12.0
Building societies	4.8	5.2	5.7
Banks under conservatorship	0.0	0.7	0.6
Financial institutions, total	**0.0**	**100.0**	**100.0**

**: banks with licences as of 31 December 2001*

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

Assets	1999	2000	2001
Deposits with cnb	11.7	11.4	11.3
Deposits with banks	24.4	22.5	20.2
Credits	34.9	32.2	33.1
Securities	21.5	26.1	26.7
Fixed assets	2.7	2.4	2.1
Other assets	4.8	5.4	6.6
Liabilities			
Clients´ deposits	52.2	50.3	53.0
Banks´ deposits	16	14.2	13.2
Sources from central bank	0.2	0.2	0.2
Equity capital and reserve funds	7.2	6.8	6.0
Other liabilities	24.4	28.5	27.6

**: banks with licences as of 31 December 2001*

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

Type of financial institution	1999	2000	2001
Large banks	60.5	63.3	89.2
Medium-sized banks	150.7	142.3	169.4
Small banks	14.9	19.0	12.6
Foreign bank branches	185.4	324.4	424.8
Building societies	3.5	5.2	2.6
Financial Institutions, total	**88.4**	**110.8**	**141.0**

**: banks with licences as of 31 December 2001*

Solvency ratio of financial institutions (%)* (at year-ends)

Type of financial institution	1999	2000	2001
Large banks	12.1	13.7	14.8
Medium-sized banks	17.7	16.3	15.9
Small banks	21.6	21.6	22.4
Building societies	15.8	17.7	16.2
Financial institutions, average	**13.6**	**14.9**	**15.4**

**: banks with licences as of 31 December 2001 excl. banks under conservatorship*

Asset portfolio quality of the banking system* (at year-ends)

CZK in mil.

Asset classification **	1999	2000	2001
Standard	614,331	606,280	765,102
Watch	92,124	85,814	75,984
Substandard	39,379	54,910	32,295
Doubtful	38,433	27,276	29,725
Loss	121,125	89,762	71,862
Classified total	291,061	257,762	209,866
Reserves and provisions	**103,783**	**77,141**	**78,898**

**: banks with licences as of 31 December 2001 excl. banks under conservatorship*
***: Gross loans excl. the loan to Slovenská inkasní jednotka*

The structure of deposits and loans in 2001 (%)*
(at year-end)

	Deposits	Loans
Households	61.5	12.3
Government sector	5.3	17.2
Non-financial	20.5	56.0
Financial	4.9	6.4
Small business	3.5	2.4
Other	4.4	5.6
Total	**100.0**	**100.0**

**: banks with licences as of 31 December 2001*

The structure of deposits and loans by time in 2001 (%)*
(at year-end)

Maturity of Deposits		Loans	
At sight	37.2	Long term loans	45.8
Within one year	47.5	Medium term loans	20.0
Over one year	15.3	Short term loans	34.3
Total	**100.0**	**Total**	**100.0**

**: banks with licences as of 31 December 2001*

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

Type of the financial institution	FOREX Assets/Total Assets			FOREX Liabilities/Total Liabilities		
	1999	2000	2001	1999	2000	2001
Large banks	17.7	16.0	16.7	15.6	13.1	12.9
Medium-sized banks	30.0	31.1	23.3	28.6	29.9	21.4
Small banks	23.2	19.8	18.4	24.5	20.4	17.6
Foreign bank branches	37.5	39.4	42.8	31.9	38.6	40.1
Building societies	0.0	0.0	0.0	0.0	0.0	0.0
Financial institutions, aver.	**21.5**	**21.1**	**20.2**	**19.3**	**19.2**	**17.2**

**: banks with licences as of 31 December 2001*

Profit and loss statement

USD in mil

Items	1999	2000	2001
Interest income	4,268	3,501	3,710
Interest expenditure	2,696	2,091	2,226
1) Net interest income	1,572	1,410	1,484
2) Profit from other financial services	937	709	1,064
Of that: Profit from commissions	411	458	578
Of that: Net provisions	-2	989	-129
3) Gross financial profit (1+2)	2,509	2,119	2,548
4) Overheads	1,419	1,391	1,551
5) Other operating and extraordinary profits	-1,214	-389	-384
6) Pre-tax profit (3-4+5)	-125	339	613

**: banks with licences as of 31 December 2001*
Note: Rate of exchange CZK/USD= 35,979 as of 31 Dec. 1999; 37,813 as of 31 Dec. 2000; 36,259 as of 31 Dec. 2001

Average balance sheet items*

USD in mil

Items	1999	2000	2001
Average balance-sheet total	62,893	63,826	72,983
Average own capital	4,401	4,737	5,407

**: banks with licences as of 31 December 2001*

Components of the banking sector return on assets (%)*

Items	1999	2000	2001
In proportion to the average balance-sheet total			
Interest income	6.8	5.5	5.1
Interest expenditure	4.3	3.3	3.1
1) Net interest income	2.5	2.2	2.0
2) Profit from other financial services	1.5	1.1	1.5
Of that: Profit from commissions	0.7	0.7	0.8
Of that: Net provisions	0.0	1.5	-0.2
3) Gross financial profit (1+2)	4.0	3.3	3.5
4) Overheads	2.3	2.2	2.1
5) Other operating and extraordinary profits	-1.9	-0.6	-0.5
6) Pre-tax profit (3-4+5)	-0.2	0.5	0.8

**: banks with licences as of 31 December 2001*

Structure of revenues and expenditures of financial institutions (%)*

USD in mil.

Revenues	1999	2000	2001
Interest earned	4,268	3,501	3,710
Fees and commissions earned	555	604	711
Net securities revenues	159	-15	78
Net revenues from foreign exchange activities	280	276	197
Net revenues from derivatives transactions	49	-32	187
Expenditures			
Interest paid	2,696	2,091	2,226
Fees and commissions paid	144	146	133
General operating costs	1,419	1,391	1,551
Reserve and provisions creations (net)	2	-989	129
Other banking operations costs	1,287	719	309
Taxes	30	-56	143

**: banks with licences as of 31 December 2001*

ČNB

Structure of registered capital and own funds of financial institutes in 2001* (at year-end)

Type of the Financial institution	Registered Capital USD in mil.**	/Total Assets %	Own Funds USD in mil.*	/Total Liab %
Large banks	1,084	2.4	3,051	6.8
Medium-sized banks	502	3.1	1,257	7.7
Small banks	199	11.3	202	11.4
Foreign bank branches	0	0.0	241	2.6
Building societies	123	2.8	288	6.6
Financial institutions, aver.	**2,278**	**3.0**	**5,042**	**6.6**

**: banks with licences as of 31 December 2001*
***: Rate of exchange CZK/USD= 36,259*

2001 DEVELOPMENTS IN THE ESTONIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

Estonian economic growth in 2001 was relatively high – 5.4%, comparing with the 6.9% growth in 2000. The growth can be attributed to higher productivity and the fact that internal risks in the Estonian economy did not increase. The economy remained balanced. The current account deficit was unchanged at 6.2% of GDP and a budget surplus of 0.4% was achieved. The temporary acceleration of the inflation rate to 5.8% mostly resulted from external price pressures during the first half year.

The slowdown of world economic growth and decline of international goods flows brought about a considerable slowdown in the growth of Estonia's export in 2001. The worsening of external demand environment was most distinctly reflected in the declining volume of the re-export of machinery and equipment, which fell by 7% in 2001 and was a direct result of the decline in the Nordic precise electronics industry. While foreign trade activity declined, the growth of the services export continued growing and increased by nearly 10% against 2000.

At the same time, the growth of internal demand also slowed down, but not significantly. The growth of internal demand was mostly based on the growth of investment activity, which was encouraged by the exhaustion of the companies' free production resources and favourable lending conditions. The share of investments exceeded 25% of GDP. Despite the growth of investment activity, the need to attract foreign financial resources into Estonian economy was just as high as it had been in 2000, because the saving investment balance remained unchanged, i.e. the current account deficit remained at 6.2% of GDP.

The average annual consumer prices grew by 5.8% and year-on-year inflation had fallen to 4.2% by the end of the year. In Estonia the prices are influenced by two major factors – changes in the price of imported goods and faster price increase in the sheltered sector due to productivity differences with the open sector. Estonian price surge followed the respective indicator of the euro area with approximately one-month delay. Such a development of inflation confirms that Estonian economy is extremely tightly linked with the rest of Europe through trade and financial ties.

The monetary policy environment of Estonia was expansive regarding interest rates. Interest rates of the Estonian money market followed the movement of the rates of euro area. As a result of the reliable economic policy the spread between interest rates in Estonia and the euro area dropped to the lowest level of all times.

The growth rate of money supply decreased by 7.3 percentage points to 24.2%. The growth of money supply was sustained by corporate deposits and households' demand deposits.

In 2001, for the first time since 1997, the general government budget had a surplus, which amounted to 0.4% of GDP. The surplus resulted from the improved tax administration and strict expenditure management policy on the central government level.

The year 2001 proved that the foundations of Estonian economy are strong enough to maintain balanced development also in the conditions of weakening world economy. The reliability of the economy is best characterised by the high credit rating (A-) assigned to Estonia by the rating agencies Standard & Poor's and Fitch in autumn 2001.

DEVELOPMENT OF THE BANKING SECTOR

At the end of 2001, six credit institutions, one branch of a foreign credit institution and six representative offices of foreign credit institutions operated in Estonia. Three new representative offices of foreign credit institutions were opened in 2001 – Norddeutsche Landesbank Girozentrale (Germany), Vereins- und Westbank (Germany) and Parekss Banka (Latvia). At the end of 2001, over 85% of the share capital of the banks belonged to foreign owners. No significant changes occurred in the division of the banking market – AS Hansapank and AS Eesti Ühispank occupied 83% of the sector's total assets. Considerable competition to the two leading banks in several fields of activities was offered by AS Sampo Pank and a branch of Finnish Bank Nordea, which both strengthened their positions, providing a more personal approach to the clients. While the local banking market remained stable, market share increased in a neighbouring country – AS Hansapank acquired Lietuvos Taupomasis Bankas in Lithuania and increased its share capital.

Active lending boosted the assets of banks in 2001 by more than 10.5 billion kroons. By the end of the year, total assets of credit institutions amounted to 68.4 billion kroons, of which two thirds were loans. In 2001 the formation of the loan portfolio was characterised by long-term loans related to the real estate purchases and development. The quality of the loan portfolio was stable throughout the year – loans overdue more than 60 days accounted for about 3% of the loan volume of the public and the real sector. Provisioned loan claims were stable at just 2% of the loan portfolio.

As a normative factor, the securities portfolio was affected by the introduction of its limits to foreign assets that could be applied to the Central Bank (CB) reserve requirement. Since the introduction of liquidity portfolio option as a part of the fulfilment of the CB reserve requirement, banks have used it actively and the share of the debt securities increased on the account of stocks kept for the trading purposes. The securities portfolio of credit institutions amounted to 16% of the total banking assets.

In spite of the decreasing interest rates, non-bank deposits grew by 23% and amounted to 43 billion kroons. This was mainly caused by local deposits growth, both companies and private individuals.

The banking sector earned a record profit of 1.69 billion kroons in 2001. The general decline of interest rates on the whole and a considerable increase of interest bearing assets supported banks' profits.

Capital adequacy increased from 13.2% in December 2000 to 14.4% in December 2001 (minimum requirement is 10%). The improvements in the banks' risk management and the stability of the economic environment has had a positive impact on the banking sector development.

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

The legal framework of the Estonian banking system is established by the Credit Institutions Act which regulates the principles of credit institutions' activities, founding conditions and requirements, fit and proper requirements, internal audit, prudential ratios, reporting, merger issues, moratorium, liquidation, supervision and liability. The legal framework covering banking operations and supervision is based on the regulations and recommendations of the European Union and Basel Committee. The last amendments in the Credit Institutions Act became effective on 1 July 2002.

With the enforcement of the Amendment Act to the Credit Institutions Act Estonia's legislation is materially harmonised with the current EU *acquis communautaire* in the area of banking services. In a few areas Estonia applies even somewhat stricter rules than those provided by the *acquis*.

The Bank of Estonia has additionally enforced several decrees in relation to the implementation of the Credit Institutions Act and more precise definition of established requirements and conditions. According to the Financial Supervision Authority Act, which became effective on 1 January 2002, the Financial Supervision Authority has the right to establish recommendatory guidelines serving to make financial supervision more efficient for guidance and explanation of legal acts. At present the financial Supervision Authority has issued money laundering prevention instructions.

The new capital adequacy calculation guidelines were issued on the basis of the Amendment Act to the Credit Institutions Act. Main improvements of the new guidelines compared to the current version are the following:

- new guidelines regulate the calculation of commodity risk;
- new guidelines allow to use contractual nettings in calculating the credit risk of off-balance sheet transactions;
- several definitions have been set more precisely.

New guidelines became effective for credit institutions on 1 July 2002.

The International Monetary Fund and the World Bank assessed Estonian banking supervisory framework for compliance with the 25 Basel Core Principles (CP) within the Financial Stability Assessment Program (FSAP) in March 2000. At that time one CP was assessed as non-compliant and two as materially non-compliant. By the time of the Peer Review mission (April 2001) several recommendations by the FSAP mission have been already implemented and situation improved further during 2001. According to the self-assessment of Estonian financial sector authorities as of April 2002, following the entering into force of the new capital adequacy regulation on 1 July 2002 the Estonian banking sector regulation is in full compliance with the Core Principles established by the Basel Committee on Banking Supervision.

Since 1 January 2002 a unified financial supervisory institution, i.e. the Financial Supervision Authority, exercises banking supervision. The Financial Supervision Authority united the banking, securities and insurance supervision and has actively continued efficient supervision in the entire financial sector.

THE ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY IN 2001

Off-site inspection was actively monitoring and analysing the status of credit institutions based on the reports submitted, information collected from public sources and also on the information acquired via other supervisory activities. Off-site inspection tasks also covered the participation in the elaboration of banking regulations, incl. prudential ratios and accounts.

The monitoring of banks involved regular monthly and quarterly banking analyses, which covered overviews of main risk areas and developments. Quarterly overviews were also based on credit institutions' consolidated data that, apart from credit institutions, also covered commercial undertakings of other banking groups. Quarterly monitoring also involved analysis workshops, the aim of which was to plan operation strategy of supervision activities.

The most important focus was set on banks' credit risk and loan growth issues related to it, mostly in respect of property financing. The attention of credit institutions was drawn to prudential ratios and issues related to reporting. Instructions were issued to meet the requirements pursuant to legal acts.

A task force especially established for that in 2001 worked out and formulated recommendations regarding credit institutions' prudential ratios in respect of improvement of capital adequacy and risk concentration calculation methods. In the course of this work several methodological changes were included in the respective instructions of the mentioned prudential ratios. These changes were made to eliminate disharmony of the Estonian requirements with the respective EU directives and international guidelines.

On-site inspection in credit institutions is based on the principles of "Credit institutions on-site inspection handbook" whose aim is to give guidelines for carrying out on-site inspection in different risk areas. The compilation of the handbook proceeded from the legal acts in force and the handbook is in harmony with the recommendations of the Basel Banking Supervision Committee and EU directives.

On-site inspections in 2001 were carried out by the quarterly plan that was worked out following the major risk areas that became evident in the course of credit institutions' current monitoring activities. Last year at least one on-site inspection was carried out in each credit institution and there were total 10 on-site inspections.

Planning and carrying out on-site inspections covered banks' consolidated groups as a whole. Inspections were also carried out in the undertakings situated abroad but belonging to the Estonian credit institutions' consolidated group.

Last year on-site inspections were carried out in all major risk areas and focus was more on the following aspects:

- credit institutions' lending activities correspondence with internal regulations and effective legal acts;
- assessment of activities of leasing companies belonging to credit institutions' consolidated group;
- assessment of credit institutions' internal risk monitoring and control systems;
- analysis of organisation and management structure, and correspondence of management system with main activity lines and risk areas;
- assessment of money laundering prevention methods.

LEGAL COMPETENCE OF THE BANKING SUPERVISION AUTHORITY

The competence of the Financial Supervision Authority founded on 1 January 2002, in respect of banking supervision, is regulated by the Financial Supervision Authority Act, Credit Institutions Act and several other legal acts regulating banking activities (e.g. Securities Market Act, Money Laundering Prevention Act, decrees and regulations of the Ministry of Finance and the Bank of Estonia, etc.). The Financial Supervision Authority also has the right to issue recommendatory guidelines for agents subject to supervision.

Banking supervision covers supervision over Estonian credit institutions and their subsidiaries, branches and representative offices located abroad unless otherwise agreed upon with the supervision authority abroad, also over subsidiaries, branches and representative offices of foreign credit institutions in Estonia unless otherwise agreed upon with the host country supervision authority. In addition, supervision also covers undertakings belonging to credit institutions' consolidated group.

With the aim to intensify supervision the Financial Supervision Authority collaborates both with international institutions and domestic authorities.

The Financial Supervision Authority actively monitors the correspondence of credit institutions' activities with the set requirements and assesses whether prudential ratios are met. The aim of supervision is to eliminate past violations or misconduct and prevent failures in credit institutions' operations. The Financial Supervision Authority has the right to collect information from credit institutions and third persons.

In order to guarantee the efficiency of supervision, the Financial Supervision Authority has the right to implement administrative coercion, i.e. to impose a fine in case of violations or issue instructions to eliminate or prevent violations. It is planned to introduce penalty payment in the near future which aim is to more efficiently meet the requirements of the issued instructions. If the interests of depositors or investors have been considerably violated or the stability of financial environment is endangered, the Financial Supervision Authority has the right to intervene in credit institutions' operations by a moratorium or bankruptcy procedure. If elements of criminal offence become evident, records of such elements are forwarded to the police.

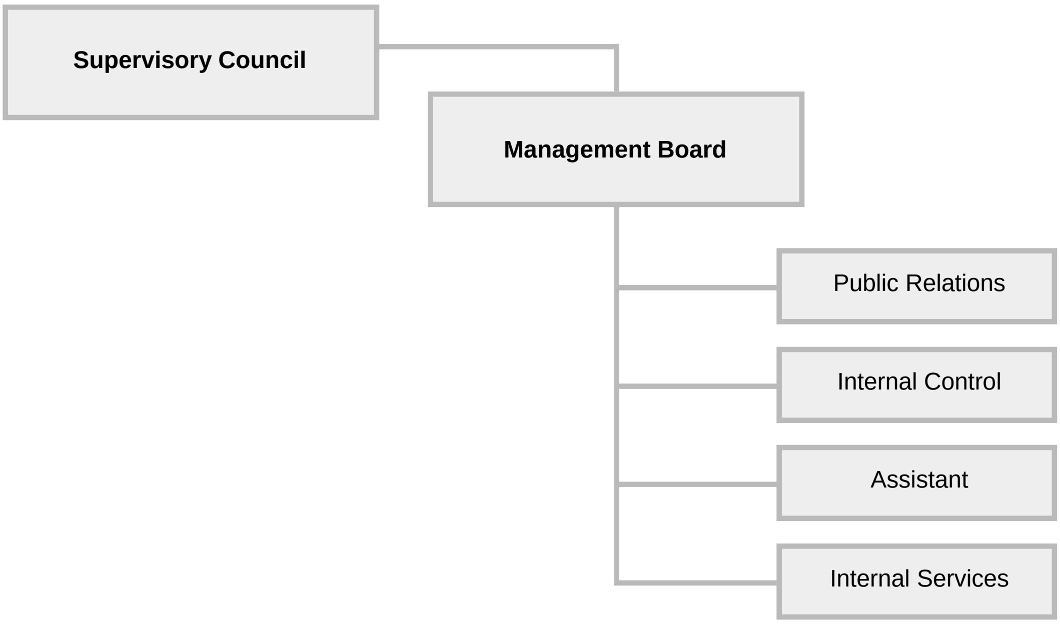
The Financial Supervision Authority in not responsible for the loss caused to the agent in the course of carrying out its supervision tasks if it was impossible to prevent the loss by even fully following the fit and proper rules.

ORGANISATIONAL CHART OF THE BANKING SUPERVISION

In 2001 the Banking Supervision Department of the Bank of Estonia consisted of 20 employees. The department was divided into three divisions: on-site supervision (including an IT-auditor), off-site supervision and general supervision. The Head and a Deputy Head managed the Banking Supervision Department. An assistant and a legal adviser assisted them.

Since the beginning of 2002 when the Financial Supervision Authority was founded, banking supervision is exercised mostly through two units of the Authority, i.e. Capital Supervision Division and General Supervision Department (see the Chart: Organisational Structure of the Financial Supervision Authority).

Organisational structure of the Financial Supervision Authority



INTERNATIONAL ACTIVITIES OF THE FINANCIAL SUPERVISION AUTHORITY

Due to the fact that several subsidiaries, branches and representative offices of foreign credit institutions operate in the Estonian banking market, international co-operation is an important part of the FSA. Active co-operation has been carried out in the licensing procedures and exchange of information related to supervision.

According to the Financial Supervision Authority Act, the Supervision Authority has the right to send confidential information necessary for the performance of its functions to foreign financial supervision authorities and other competent foreign bodies or persons and to obtain such information there from and exchange such information therewith. Information sent, received or exchanged in this manner is deemed to be confidential. The Supervision Authority has the right to communicate confidential information to a foreign financial supervision authority or other competent foreign body or person only if the receiver of the confidential information is obliged to maintain the confidentiality of the information received and the information is used only for the purposes of financial supervision.

In order to intensify co-operation with supervision authorities of various countries, the Supervision Authority has signed co-operation agreements with financial supervision institutions of Latvia, Lithuania, Germany, Finland and Denmark. Under preparation are agreements with financial supervision institutions of Sweden and other countries.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISION AUTHORITY IN 2002

The main objective of the financial supervision is to enhance the stability, reliability, transparency and efficiency of the financial sector, to reduce systemic risks and to promote prevention of the abuse of the financial sector for criminal purposes, with a view of protecting the interests of clients and investors by safeguarding their financial resources, and thereby supporting the stability of the Estonian monetary system.

Main strategic objectives in 2001 were related to the establishment of the Financial Supervision Authority, which started its operations from 1 January 2002. In September 2001, the Council of the Financial Supervision Authority approved the strategy of the FSA for the next 3-18 months. The main strategic objectives of the Financial Supervision Authority in 2002 are as follows:

In the area of conducting the merger process of supervisory agencies and organizational development:

- maintain the continuity of supervisory activities during the period of winding up the activities of the Securities Inspectorate, Insurance Supervision Authority and Banking Supervision Authority and start-up the activities of the Financial Supervisory Authority;
- develop an integrated, flexible and cost-effective organization;
- develop internal rules and regulations, policies and procedural rules in the areas of strategy, planning, budgeting and administration;
- establish high professional standards with regard to its employees, and implement those standards on the basis of a competitive remuneration policy;
- fully apply the requirements deriving from the Financial Supervision Authority Act to the management, administration, co-operation with other institutions, budgeting and reporting of the Supervision Authority;
- achieve acknowledgement by the general public, subjects of supervision and domestic and international co-operation partners.

In the area of supervisory activities:

- harmonize the major standards and methods of the supervision process with regard to the supervision of banking, insurance and securities markets, paying special attention to strengthening the supervision of the securities market;
- develop a work process for conducting consolidated supervision over financial groups operating in different parts of the financial sector as well as in different geographic regions;
- in exercising supervision, focus primarily on the systemically relevant risks and areas of risk from the aspect of the risks and development of the financial sector;
- conduct active co-operation with the foreign supervisory agencies;
- together with the Bank of Estonia and Ministry of Finance, develop a co-operative framework for preparation of financial sector rules and regulations, collection of reports and exchange of information;
- together with the Bank of Estonia and Ministry of Finance, develop the rules of conduct and exchange of information to solve possible crises situations;
- continue intensively the inclusion of the EU and other international standards in the financial sector rules and regulations and in the supervisory process according to the principles of effectiveness and expediency;
- participate actively in the preparation and analysis of legislation regulating the financial sector.

In pursuit of its objectives, the Financial Supervisory Authority shall operate pursuant to good international practice and shall consider it important to explain the objectives and functions of financial supervision and the operating principles of the financial sector to the general public to enhance the transparency and reliability of the financial market.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	1999	2000	2001
Banks	6	6	6
Forein Bank's branch	1	1	1
Financial institutions, total	**7**	**7**	**7**

Ownership structure of financial institutions in 2001 on the basis of registred capital (%) (at year-end)

Item	Type of financial institution
Banks	
State ownership	0.00
Other domestic ownership	14.25
Domestic ownership total	14.25
Foreign ownership	85.75
Financial institutions, total	**100.00**

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

Item	1999	2000	2001	2001/1999
State ownership	11.64	0.01	0.00	-99.95
Other domestic ownership	26.12	16.08	14.25	-40.12
Domestic ownership total	37.76	16.09	14.25	-58.56
Foreign ownership	62.24	83.91	85.75	31.13
Financial institutions, total	**100.00**	**100.00**	**100.00**	

Distribution of Market Shares in Balance Sheet Total (%) – only banks

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

Type of financial institution	1999	2000	2001
Banks	27.69	28.88	23.92

Solvency ratio of financial institutions (%)

Type of financial institution	1999	2000	2001
Banks	16.05	13.21	14.39

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

Assets	1999	2000	2001
Cash	2.67	2.31	2.33
Claims on central bank	10.31	9.88	5.53
Claims on credit institutions	7.00	8.75	13.22
Claims on customers	56.65	59.24	59.52
Allowance for uncollectible claims	-1.65	-0.92	-0.88
Securities	16.46	14.40	15.83
Intangible assets	2.59	1.45	0.92
Tangible assets	2.94	2.12	1.56
Other assets	1.25	1.20	1.00
Accrued income and prepaid expenses	1.77	1.58	0.98
Liabilities	**1999**	**2000**	**2001**
Amounts owed to central bank	0.02	0.01	0.01
Amounts owed to credit institutions	13.23	10.83	9.42
Amounts owed to customers	56.15	60.14	62.41
Government lending funds and counterpart funds	1.15	0.78	0.45
Issued debt securities	7.49	8.98	8.57
Other liabilities	2.15	3.32	2.40
Accrued expenses and deferred income	1.90	1.46	1.47
Provisions	0.00	0.11	0.07
Subordinated liabilities	2.44	1.78	1.93
Equity capital	15.47	12.59	13.27

Asset portfolio quality of the banking system (%)

Asset classification	2000	2001
Indefinite	5.79	0.00
Standard	80.75	83.14
Special mention	8.19	10.62
Substandard	2.26	2.89
Doubtful	1.73	2.52
Loss	1.28	0.83
Classified total	**100.00**	**100.00**
Specific reserves (millions of EEK)	**451**	**515**

The structure of deposits and loans in 2001 (%) (at year-end)

	Deposits	Loans
Households	43.06	22.42
Government sector	6.41	3.43
Corporate	40.13	43.19
Foreign	-	-
Other	10.40	30.96
Total	**100.00**	**100.00**

The structure of deposits and loans in 2001 (%) (at year-end)

Maturity of Deposits		Loans	
At sight	62.75	Long-term loans	51.03
Within one year	32.20	Medium-term loans	35.32
Over one year	5.05	Short-term loans	13.65
Total	**100.00**	**Total**	**100.00**

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

Type of financial institution	FOREX Assets / Total Assets			FOREX Liabilities / Total Liabilities		
	1999	2000	2001	1999	2000	2001
Banks (only balance sheet items)	59.04	60.56	63.64	40.59	43.69	39.56

Profit and loss statement

in thousands of USD

Items	1999	2000	2001
Interest income	225,687	222,609	243,505
Interest expenditure	115,117	107,722	120,148
1) Net interest income	110,570	114,886	123,358
2) Profit from other financial and investment services (incl dividends)	16,408	3,229	62 473
Of that: Profit from commissions	36,924	42,174	44,073
Of that: Net Provisions	-22,585	-19,017	-4,772
3) Gross financial and investment services profits (1+2)	126,979	118,115	185,831
4) Overheads	84,777	81,665	89,525
5) Extraordinary profits	0	0	0
6) Pre-tax Profit (3-4+5)	42,202	36,450	96,306

Average balance sheet items

in thousands of USD

Items	1999	2000	2001
Average balance-sheet total (assets total)	2,973,218	3,069,226	3,621,770
Average own capital	470,191	433,424	461,703

Components of the banking sector return on assets (%)

Items	1999	2000	2001
Interest income	7.59	7.25	6.72
Interest expenditure	3.87	3.51	3.32
1) Net interest income (interest margin)	3.72	3.74	3.41
2) Profit from other financial and investment services (incl dividends)	0.55	0.11	1.72
Of that: Profit from commissions	1.24	1.37	1.22
Of that: Net Provisions	-0.76	-0.62	-0.13
3) Gross financial and investment services profits	4.27	3.85	5.13
4) Overheads	2.85	2.66	2.47
5) Extraordinary profits	0.00	0.00	0.00
6) Pre-tax Profit (ROA)	1.42	1.19	2.66

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

Revenues	1999	2000	2001
Interest income	66.15	64.45	59.81
Income from financial investments	2.52	0.62	9.83
Commission income	15.56	16.61	14.75
Profit on financial operations	9.57	12.99	9.59
Value adjustments of claims and off-balance sheet commitments (income)	2.22	3.88	3.46
Value adjustments of financial fixed assets (income)	1.63	0.17	1.65
Other operating income	2.36	1.27	0.92
Total revenues	**100.00**	**100.00**	**100.00**
Expenditures	**1999**	**2000**	**2001**
Interest expense	38.50	34.87	38.65
Commission expense	5.40	4.92	5.14
Loss on financial operations	1.96	4.80	4.50
Administrative expenses	28.35	26.43	28.80
Value adjustments of tangible and intangible fixed assets (expenses)	12.04	12.86	9.79
Value adjustments of claims and off-balance sheet commitments (expenses)	10.09	10.50	6.07
Value adjustments of financial fixed assets (expenses)	0.74	2.69	3.51
Other operating expenses	2.91	2.93	3.53
Total expenditures	**100.00**	**100.00**	**100.00**
Net profit (millions of EEK)	665	613	1 683

Structure of registered capital and own funds of financial institutions in 2001

Type of financial institution	Registered capital (thousands of USD)	/ Total assets %	Own funds (thousands of USD)	/ Total liab %
Banks	131,260	2.99	583,439	13.27

2001 DEVELOPMENTS IN THE HUNGARIAN BANKING SYSTEM

PÉNZÜGYI SZERVEZETEK
ÁLLAMI FELÜGYELETE

MACROECONOMIC ENVIRONMENT

The Hungarian economy produced good results in the last year. Although economic growth slowed down, it was still double the average of the European Union. The internal and external balances remained stable, the deficit of the balance of payments and the balance of trade decreased. The restructuring of the exchange rate system and the full liberalization of the foreign exchange transactions were major changes. The forint strengthened considerably helping to break the inflationary momentum. The National Bank of Hungary shifted to target inflation and changed tools and procedures in a euro-conform manner. After a temporary drop household savings started to climb again, savers turned again to bank deposits and other savings instruments. The upswing of unit-linked insurance products fell back. It seemed that after a long time the issue was settled: commercial banks play the lead role in financing in Hungary.

DEVELOPMENT IN THE BANKING SYSTEM

The strong **competition** that had been characterizing the financial markets for years continued in 2001. Credit institutions employed methods common in **international practice** to preserve and further improve their **competitiveness**. Their activities **were marked by innovation**, the introduction of new products and methods, and the use of tools improving efficiency. The **elimination** of the losses of the not so successful, or **loss-making subsidiaries** started in 2001. Doing so parent institutions either merged or sold subsidiaries that had not been able to perform according to the expectations for years. Several banks improved efficiency by **expanding in size through mergers and acquisitions.** Big banks tried to attract new clients by providing an even broader selection of services, while small banks attempted to gain advantages in individual market segments by offering special services. **The big banks' move toward universal banking and the small banks' efforts at specialization simultaneously characterized the market**.

The concentration of institutions led to the decrease in the credit institutions' number. The number of stock companies (41 at the end of the year) diminished by one only compared to the end of 2000 (ABN AMRO and KH, furthermore, BA-CA and HypoVereins merged, however, the Dresdner Bank opened its doors in November). The number of savings cooperatives decreased by 6 to 186, mainly because of the pressure to concentrate capital, while the number of credit cooperatives remained 7.

In the adoption of methods and products customary in international practices the dominance of foreign ownership played a key role. **At the end of 2001 foreign owners directly controlled 62.2 percent of the banks' subscribed capital.** Compared to the end of 2000 the foreign ownership ratio decreased slightly, partly because state ownership increased (in 2001 MFB received a considerable capital injection) and partly because of the merger of KH and ABN AMRO, as the subscribed capital of the new bank was lower than the non-consolidated capital of the two banks before.

Compared to the end of 2000 the **banks' total assets increased at a pace well in excess of the rate of inflation** (December/December increase in consumer prices was 6.8 percent), **almost by 13 percent, thus reaching HUF 9,506 billion at the end of 2001**. **The financial intermediary role of banks remained unchanged** according to the total assets/GDP ratio (64.2 percent), while it increased slightly according to the lending/GDP ratio (from 33.1 percent in 2000 to 34.7 percent). **By international standards this remains low**.

The expansion of total assets was predominantly manifested in the growth of the loan portfolio and to a lesser extent in the growth of the securities portfolio.

Lending increased at a varied pace during the year. The customer loan portfolio grew by 18.9 percent, thus their share in the total assets rose from 51.3 percent at the end of 2000 to 54.1 percent. Following its quick rise earlier retail lending slowed down a little during the fourth quarter. Nevertheless, the **54 percent nominal increase for the year** (44.5 percent in real terms) could still be seen as rather dynamic. Because of that the share of retail loans in the total assets increased from 5.1 percent to 6.9 percent. **Within retail loans, consumer loans expanded at the fastest rate, the housing loan portfolio grew rapidly by 72.8 percent compared to the end of the previous year.**

Although the expansion of **corporate loans** lagged behind the increase in retail loans and behind the increase in all facilities extended to clients, it still amounted close **to 4.5** in real, or 11.6 percent in nominal terms. As a consequence of the 36.8 percent increase in the portfolio of investment purpose facilities the 17.0 percent nominal growth of the securities portfolio came close to expansion of lending. Thus their share in total assets rose from 15.7 percent at the end of the previous year to 16.3 percent.

The banks achieved the expansion of the loan and securities portfolios by attracting new liabilities for the most part (two-thirds) deposits and, additionally, they used part of formerly liquid assets for placements too. The liquid assets on cash and settlement accounts decreased by about 8 percent, while central bank and interbank placements fell by 1.1 percent. **64.9 percent of the increase in banks' liabilities consisted of client deposits, 16.1 percent of owners' capital contribution (equity), securities issues amounted to 12.3 percent and 8.7 percent was borrowed funds.**

Within the liabilities the deposit portfolio (63-64 percent of the liabilities) started to grow in the second half of the year following stagnation in the first six months and at the end of the year exceeded last year's year-end figure by 5.9 in real terms. Owners considerably increased the equity (10.1 percent of the liabilities) in 7 banks, in particular in OTP and MFB. The utilization of inter-bank resources fluctuated in a cyclical way throughout the year and eventually the portfolio was somewhat lower at the end of the year than a year before.

The exchange-rate exposure within the banks' consolidated balance sheet remained relatively low throughout the entire year. Following the widening of the band on May 4 the surplus of foreign exchange liabilities over foreign exchange assets became smaller and smaller. Later this trend turned around again, however, even on the peak of the open position it amounted to merely 2 percent of the total assets.

The rate of HUF assets growth was over twice as fast as the growth rate of foreign exchange assets. The difference in the pace of growth was even greater in case of client loans extended in foreign currencies, since while HUF loans increased by 27.6 percent, foreign exchange facilities grew only by 7.1 percent. The portfolio of corporate foreign exchange loans outright fell compared to the end of the preceding year. In contrast to that foreign exchange placements grew more rapidly than HUF lending in the retail segment. The ratio of assets denominated in foreign currencies in the total assets decreased to 34.6 percent (from 36.4 percent), in the total client loan portfolio to 38.2 percent (from 42.4 percent), while in the corporate loan portfolio to 33.9 percent (from 39.4 percent). The still small proportion of foreign exchange loans among retail facilities climbed from 2.1 percent to 3.1.

The banks' willingness to undertake risks increased in 2001. Risk bearing balance sheet items increased by 21.6 percent, while off-balance sheet items grew by 37 percent, thus the total portfolio[4] exceeded that of last years' by 27.5 percent. **As a result of dynamic lending almost three-quarters of the bank sector's assets became riskier market placements, i.e. these were not risk-free facilities extended to the government, or to the central bank. While the absolute and relative risks of the sector's lending activity did not change in essence, among the risk bearing items the problem-free, special mention and problem items equally increased. This may be regarded as normal at times of fast credit expansion.** The loss of value settled in the books for the expected losses of problem and special mention items, except for retail loans, grew at a lesser pace than the entire portfolio, therefore, the **level of value loss decreased**.

Due to the loss of value the balance sheet items bearing risks took up 2.4 percent, corporate loans 1.9 percent and retail loans 3.7 percent less in the balance sheet at the end of the year than their original gross values would have been.

The rapid increase in potentially risk bearing transactions (lending and off-balance sheet activities) resulted in a small negative shift within the portfolio in terms of quality, in spite of the fact that the expansion of new problem-free placements substantially exceeded the special mention and earlier portfolios that became problematic. Problem-free balance sheet items increased by 17.6 percent, at the same time 5.5 percent of the assets that was still problem-free at the end of 2000 became special mention and 1.5 percent turned problematic. **At the end of 2001 85.2 percent of the sector's balance sheet items was problem-free (88.2 percent at the end of 2000), 10.2 percent belonged to the special mention category (7.6 percent at the end of 2000) and 4.6 was in the problem portfolio (4.3 percent at the end of 2000).** In case of off-balance sheet items the qualitative composition also deteriorated, the special mention portfolio increased from 2.8 percent to 7.2 percent, while the problem portfolio grew from 0.4 percent to 0.7 percent.

The growth of the bank sector's profit was outstanding in 2001. The sector's total consolidated pre-tax profit reached HUF **144.7 billion, almost** 50 percent more than in the preceding year. **This figure was the result of the HUF 151.4 billion profit generated by the profitable banks and the HUF 6.7 billion loss created by the 12 loss-making banks.**

The following had a positive effect on the profit:

- the 12.5 percent increase in the net interest margin to HUF 38.8 billion;
- the 24.8 percent, or HUF 19.6 billion increase in the commission income;
- income from foreign exchange trade and exchange rate changes grew by 30.8 percent, or HUF 10.9 billion;

[4] Portfolio means in this case portfolio to be classified, thus own assets and risk-free assets against the state and the central bank are not included.

- no new extraordinary losses incurred, indeed, some of the banks had extraordinary profits, and thus the HUF 9.3 billion of extraordinary losses in 2000 was replaced by HUF 20.4 billion extraordinary revenue.
- overheads increased only by 3.9 percent, below the rate of inflation.

However, the huge, almost HUF 39.3 billion increase in other losses, which includes loss of value and provisioning expenses too, was a **negative change**.

The bank sector's profitability increased considerably, the average return on assets (ROA) grew from 1.25 percent to 1.68, while the return on equity (ROE) increased from 13.84 percent to 16.82 percent in the sector. The following contributed to that:

- the increase in the interest margin (from 3.99 percent to 4.05 percent);
- the fact that the import of non-interest type commission income continued to rise (from 1.02 percent in the previous year to 1.14 percent of the total assets);
- the large-scale increase in certain banks' extraordinary profit.
- the improvement of operating efficiency (overheads decreased from 3.79 percent to 3.55 percent of the total assets).

Profitability was weakened by the fact that the expenditures related to loss of value, provisining and other costs increased in proportion to the total assets.

Overall the bank sector's capital adequacy remained stable. As a result of increased activities risk weighted total assets grew faster than the capital covering the risks, although the capital adequacy ratio remained high enough in spite of the decrease (14.15 percent; it was 15.21 percent at the end of 2000).

The deposit portfolio grew by 21.1 percent, their share of the total liabilities continued to increase reaching 90 percent. The expansion of own capital was slower than the expansion of liabilities, however, it increased by 16.6 percent, well above the rate of inflation. The own capital adequacy (own capital / total assets) changed from 6.8 percent at the end of 2000 to 6.7 percent taking the sector's average.

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

Legislative tasks

In addition to the priority responsibilities the Supervision participated in drafting 10 new statutes and amending 26 statutes that had already been in force, in particular in the amendment of the acts on insurance and on credit institutions. On several occasions these introduced several new legal institutions and procedures, never regulated before, as part of the legal environment. Since the majority of the most important acts regulating the financial sector came into force in the previous years, **in 2001 HFSA's legislative initiatives were directed at fine-tuning rules and ensuring concordance among overlapping statutes.** The effect of the modifications on the financial sector and on supervisory enforcement will become apparent from 2002.

Drafting the Capital Market Act and the amendment of the acts on funds[5] at significant points stood out in terms of magnitude among the tasks undertaken in the modernization of financial legislation. The Supervision took an active role in drafting these acts.

In case of the Capital Market Act the EU consultant was also involved in the work. **The new capital market regulation brought about full legal harmonization with the EU in the field of investment services. Drafting the act replacing the preceding laws with consolidated provisions, reflecting market changes in the statutory environment and giving more emphasis to investor protection were important criteria.**

The amendment of the rules governing corporate acquisitions was a priority. Based on the experiences related to the acquisition of BorsodChem the Supervision initiated a full review of the acquisition rules and their amendment much sooner than the deadline for the amendment of the entire Capital Market Act. The judgment in the case related to a bank's role in the acquisition of BorsodChem fully confirmed the firm action taken by the Supervision.

Overall the new Capital Market Act made the operation of capital markets more open, complex and also more secure, while it gave several new, or changed responsibilities to the Supervision (modification of reporting, rethinking inspections, or amending internal procedures, etc.). These will be solved in part in 2002. However, one must not forget that the **development of EU regulation in this field presents a permanent challenge,** since the capital markets are in the focus of the so-called Financial Services Action Plan. With the approval of the Lámfalussy process is expected to speed up even in the short run.

The modification of the acts on funds, based on the experiences gathered during the inspections, aimed at strengthening the security of the fund sector's operation and increasing the fund members' protection by eliminating the most urgent regulatory shortcomings. From the beginning of 2002 the force of both the Private Fund Act and the Voluntary Fund Act was extended to escrow account management, property management, or administrative service providers in addition to funds. Membership recruitment and the procedures related to changing the funds' status (such as reorganization) were made clearer. In case of voluntary funds the procedures pertaining to foundation, secrecy and settlements with and payments to members were clarified.

The comparison of the established legal positions related to regulatory issues and the corresponding EU requirements were commenced in order to promote legal harmonization with the EU. The modifications made in 2000 and 2001 were aimed at the elimination of significant regulatory differences. This has been completed in most segments; in areas full harmonization is to be achieved next year. **The Supervision treats the amendment of the Act on Insurance[6] as a priority as presently the biggest backlog is there in the legal harmonization efforts.** The comparison of EU and Hungarian insurance regulations started already at the end of 2001, but its completion stretched over to 2002.

[5] Act No.LXXXII of the year 1997 on Private Pensions and the Private Pension Funds and the Act No.XCVI. of the year 1993 on Voluntary Mutual Insurance Funds
[6] Act No.XCVI of the year 1995 on Insurance Institutes and Insurance Activities

THE ACTIVITIES OF THE FINANCIAL SUPERVISORY AUTHORITY LAST YEAR

As a new instrument HFSA published recommendations **presenting the Supervision's expectations and the practices found best by the Supervision to the supervised institutions. These recommendations are not mandatory but according to HFSA they are in the fundamental interests of clients, owners and organizations. The HFSA have published** interpretations of statutes, position papers and manuals **and it intends to help the market with** guidelines **as well in the future.**

Year 2000 was devoted to laying down the foundations of the new institution and 2001 was, among others, used to develop a **unified philosophy, integrated methods and procedures**. First the HFSA developed and **published the principles** of its operation and then built our strategic objectives and policies upon them. Since the HFSA had put the main emphasis on prevention, it reorganized and rationalized the reporting system of the supervised institutions accordingly. The HFSA have established the procedures and guidelines that support preventive supervision. The HFSA have started to develop inspection manuals for all supervised sectors. The HFSA have set up **advanced risk management and monitoring systems** helping to recognize large exposures. Using these systems the HFSA prepare regular internal assessment of all organizations. The HFSA have also set up a **market monitoring system** to continuously trace market movements and to be able to intervene when things requiring supervisory measures happen.

HFSA's work was much supported by the participation of market players. By setting up the **"institution manager" system** in 2001 the direct daily contact between the institutions and the Supervision continued to strengthen. The HFSA worked closely together with the supervised institutions, which enabled it to quickly identify and handle problems and to give improved protection to customers' interests. It was part and parcel of the open partnership that the Supervision also supported the market actors in several ways. The HFSA regularly organizes **professional consultations** for the managers and specialists of supervised institutions, where partnership becomes tacit in the dialogue.

HFSA supervises without any bias in a fair and equal manner with the intention of preventing risks and providing services. For that reason the Supervision's decisive and consistent control is welcome by most, HFSA's conclusions and measures taken within its official competence are accepted.

In addition to the afore-mentioned tasks the Supervision finds it especially important to maintain confidence in the supervised sectors, to protect the public and customers and to prevent abuses and due to these facts the practical work is characterized by market orientation, equal treatment of the sectors, consolidated supervision and risk awareness.

LEGAL COMPETENCE OF THE FINANCIAL SUPERVISORY AUTHORITY

Legal competence of the HFSA includes three fields: **licensing, legal enforcement** and participating in drafting and amending statutes. As the **legislative tasks** were mentioned earlier, this section focuses on the other fields.

Licensing

The relationship between the Supervision and the supervised institutions starts with **licensing**. The first step in providing market players an incentive to behave voluntarily in conform with the law is the inspection associated with licensing, which also extends to checking compliance with prudential requirements helping to identify institutions and persons that may threaten the interests of clients, or the stability of the institution, or the markets through their activities. This way **the first prudential sorting out vis-à-vis the supervised institutions are part of the Supervision's licensing procedure, which – in justified cases – may even hinder the entry into the market. At the same time licensing is an administrative competence continuously** exercised by HFSA from the time an institution is founded until it is removed from the market.

In 2001, similarly to preceding years, the appearance of new market players was not much characteristic to the financial sector, rather it was dominated by mergers and changes in activities. **In the course of the year altogether 5308 supervisory resolutions were made, of which 2300 resolutions were issued within the scope of HFSA's licensing competence.**

The Supervision issued two foundation licenses and one activity license for banks in the credit institution sector, furthermore, approved the merger in the case of three banks and seven savings cooperatives. **Of the completed mergers the fusion of ABN-AMRO and K&H banks stood out in terms of size and market impact.** In 2001 the number of foundation licenses issued to financial enterprises entering the market increased. The distribution of resolutions also reflects the continuously decreasing number of actors in capital markets. Altogether 16 new operating licenses were issued, while 26 were returned. This trend is also suggested indirectly by the big number of resolutions suspending operating licenses and the big number of resolutions extending the suspension, since in our experience the suspension of the operating license is generally followed by either the withdrawal or the return of the operating license. This is supported by the still high number of resolutions approving the transfer of assets.

The high number of resolutions on the modification of the scope of activities was still attributable to licensing universal banking activities and applications for expansion. As a result of rationalization within the banking group the number of investment enterprises owned by banks decreased simultaneously with obtaining the universal banking license. Although as of January 1, 1999 the banks are entitled to engage in the whole range of investment service activities, the restructuring of the market took time. The process is expected to end in 2002.

The year was earmarked by capital accumulation by corporations through private placements in terms of securities issues, no new public offerings were made. The reduction of the number of public stock corporations continued, primarily as a result of restructuring as private stock corporations. Subsequent to their reorganization these companies are waived from the mandatory supply of public information in a supervisory procedure. The number of approved public corporate acquisitions was 16. The first series of publicly issued mortgage bond was introduced on the market in 2001.

The appearance of an insurer active in providing legal protection insurance counted as a novelty on the insurance market. While in 2001 the number of insurance institutions grew, the number of operating licenses issued to insurance brokers and insurance consultants decreased in comparison to the preceding year. The amendment of Act XCVI 1995 on Insurance Institutes and Insurance Activities (hereinafter 'Insurance Act') effective January 1, 2001 introduced the institution of multiple insurance agency. The Insurance Act ties the exercise of intermediary role to supervisory license.10 percent of the activity licenses issued in 2001 were generated by the multiple agency applications of those who were engaged previously in insurance brokerage.

Among the funds the concentration of the market is shown by the fact that the number of operating licensing procedures decreased, but the number of mergers and resolutions passed in connection with them increased. No new private pension funds were founded, no new operating licenses for private pension funds issued and no new voluntary pension funds started to operate in 2001. With respect to voluntary health and income replacement funds the number of foundations continued to climb. Functioning as the primary filter the Supervision rejected the application for foundation of 9 funds because of failing to meet the necessary conditions. In the course of licensing funds special attention must be given to ensure that the funds have complied with the principle of self-governance.

Legal enforcement

In enforcing legal compliance from the supervised institutions the Supervision endeavored **to act more firmly, decisively** and **conclusively** than before and **simultaneously** take into consideration the supervised institution's willingness to cooperate. The available means of legal enforcement allowed of that **differentiation**. Primarily HFSA shapes the supervised institutions legal compliance through the resolutions concluding inspections. In them the Supervision identifies statutory violations and shortcomings and calls upon the supervised institutions to eliminate or correct them. The Supervision proposes measures to tackle the problems that emerged in supervisory **resolutions and executive letters**. Supervisory **fines** are imposed when an institution repeatedly violates the law in spite of previous warnings, or when there is only a single violation, but that is severe. **Activity licenses** had to be **revoked** on a relatively few occasions only.

In the credit institution sector most of the resolutions imposing fines concerned the shortcomings of internal regulation and accounting policy, however, problems related to compliance with anti-money laundering rules also occurred. As to capital markets one of the biggest challenges over the past few years was presented by inspecting the acquisition of influence in public stock corporations, however, the protection of customer claims was also an emphatic issue kept always in focus. In case of insurers fine are typically imposed upon the closure of inspections because of the shortcomings uncovered during on-site inspections. Because of that the resolutions concern several different types of non-feasance, among which insurance companies' reserves creation and the brokers' activity were frequently criticized. Incidents of unlawful conduct were classifiable in correspondence to the phases of the funds' evolution. In the first phase of initial development the problems mostly concerned membership recruitment, by-laws and operation, later on, because of the growth of membership and assets, the record keeping, accounting and investment problems stood out. In the third phase problems emerged with respect to settlement techniques and services, which directly affected the fund members through the difficulties associated with the distribution of yield, the settlement of valuation difference and the correspondence between individual and coverage reserves.

In order to increase the transparency of the financial system as a prime rule HFSA publishes its resolutions, which have a significant disciplinary effect by itself, even without the **imposed penalties**. Institutions may not only make use of the published resolutions in a direct manner by identifying the improper practice, but they also receive information about what areas are in the focus of the Supervision's attention. This practice is pioneering even in international comparison. Although this form of transparency is not yet common everywhere, the trends definitely point into this direction.

In 2001, although their numbers were few, in all areas there were incidents when the suspicion of unauthorized activities (activities pursued without license from the Supervision) was raised. In cases when the given activity constituted a violation of law according to the Criminal Code the Supervision initiated criminal procedures, while it banned unauthorized activities that did not fall within the scope of the Criminal Code with immediate effect. In order to cut back on unlawful activities in the insurance business a special, multi-phase action plan was developed. In the first phase the insurers themselves screened out the agents who were engaged in multiple-agency activities without a supervisory license. Subsequently the Supervision stepped up against those engaged in unauthorized activities based on the information received from insurers.

INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In 2001 HFSA's activity was characterized by the systematic strengthening of international relations. The institution strove to strengthen international relations in all fields of supervisory activities and to adopt international requirements related to the supervised institutions and markets. Establishing relations with the world's leading supervisions and strengthening the existing ones were priority tasks for the HFSA in order to get acquainted with and to move toward compliance with the expectations these institutions faced.

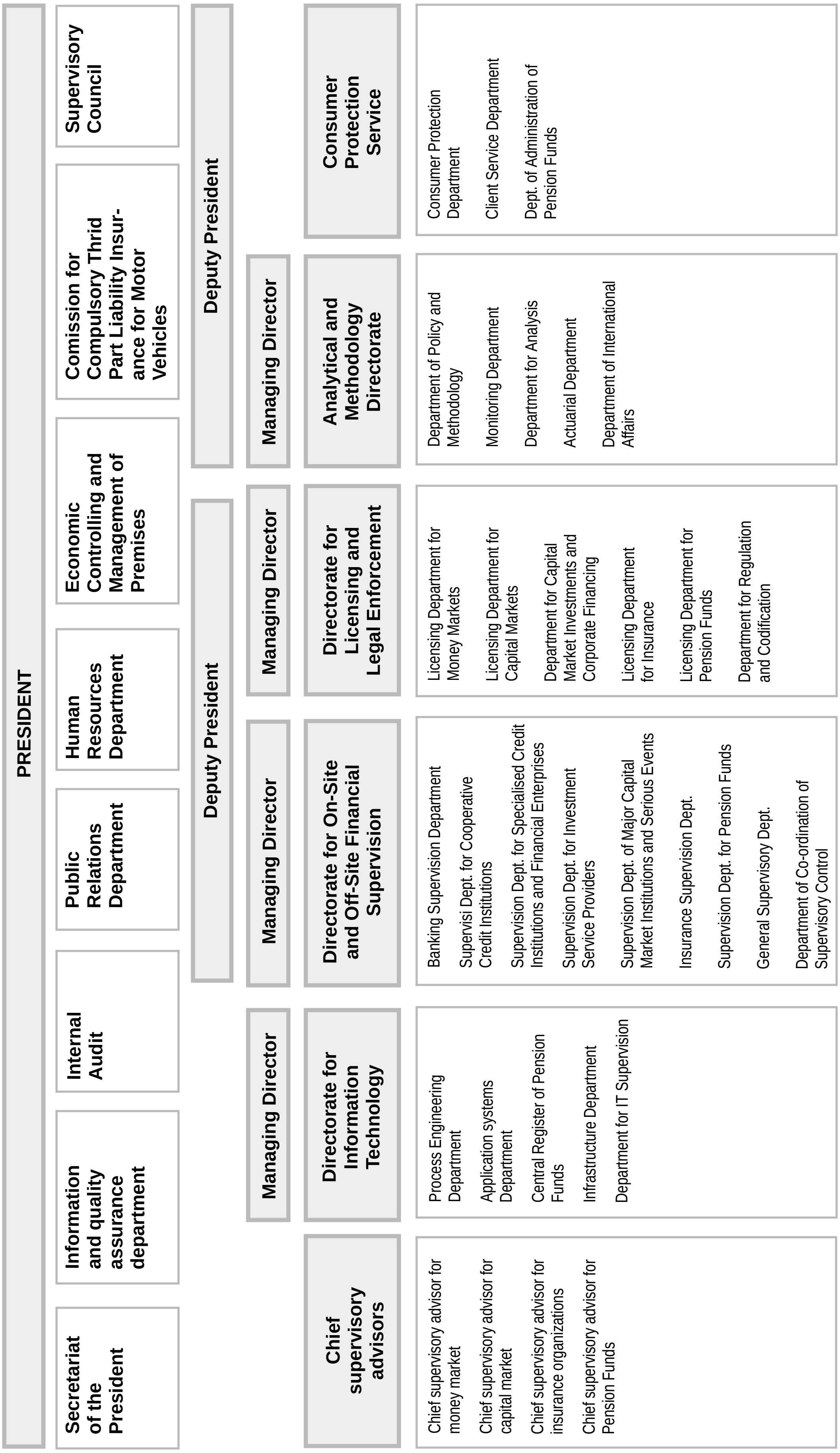
In line with the country's efforts directed at integration the European Union was given special attention. HFSA passed the screening /"peer review" that the **European Commission** had the experts of the member states conduct. It is to be highlighted that in its report the Commission **qualified HFSA as a well prepared organization**, while identified the operation of an effective and consolidated supervision and the perfection of supervisory methods as ongoing tasks. The report found the independence of the Supervision limited especially missing the independent right to issue decrees. Among EU member states information was gathered on consolidated supervision. Based on the document made on that the Supervision prepared several drafts for statutory amendments.

The development of consolidated supervisory practices continued together with building up the related international cooperation with the help of the PHARE program.

- In 2001 regulation and practice related to supervision on consolidated basis launched under the PHARE Project "Strengthening the Regulation and Supervision of Financial Institutions" were much relevant topics for the Supervision. **One part of the program finances technical assistance** in the areas of consolidation, insurance sector and the fund sector. **The aim of the program is to prepare full conformity with the EU and to get acquainted with EU member states' practices in connection with the introduction of EU rules. The other branch of the program consists of the project for IT development** aimed at developing the Supervision's database, managing system.
- HFSA, as the organization responsible for the supervision of the financial sector, is also a beneficiary, together with other organs of public administration, of the legal harmonization and institutional development project to provide social insurance for migrant employees.
- In order to ensure EU conformity of the consumer protection activity, which constitute a significant part of the supervisory efforts, HFSA applied successfully for participation in the PHARE "Twinning Light" Program. It is expected to be implemented in 2002.

Furthermore, the Supervision submitted applications in several topics through the TAIEX Office, which helps the preparation of the associated countries in terms of legal harmonization. This is also expected to be completed in 2002.

ORGANIZATIONAL CHART OF THE HUNGARIAN FINANCIAL SUPERVISORY AUTHORITY (as of July, 2002)



As a professional recognition of the work done at the Supervision, **upon the request of IMF HFSA's experts regularly participate in investigations organized by IMF the purpose of which is the assessment of the financial systems and supervisions of the most diverse countries in the world.** The Supervision is in working relation with the relevant Directorate General of the European Commission and maintains good relations with the OECD Secretariat.

Members of HFSA's staff are still active participants in the various international organizations of supervisory authorities, or their regional groups in the areas of banking (Basel Committee on Banking Supervision), securities (IOSCO) and insurance (IAIS), pension funds (INPRS). The work associated with the new Basel Capital Accord is ongoing at the Supervision. This also has direct connections with the European Union since the EU will also issue the rules pertaining to banks and investment service providers as directives. The Supervision gave detailed answers to IOSCO on the questionnaires for the development of capital market regulation, to their assessment surveys and participated in the similar activities of IAIS too, aimed at the development of insurance principles issued not long ago.

Following Germany (in September, 2000) **the bank supervision cooperation agreement was signed with Austria** as well in December 2001. Additionally, similar negotiations have started with the supervisions of several EU member states (Italy, Belgium, The Netherlands and France) in the banking, insurance and capital market areas to conclude similar agreements. **The agreement initiated with the National Bank of the Slovakia is especially important** because of OTP Bank's interests in Slovakia, since the Supervision is regarded in that relation as the mother country's supervision. Currently the details of the agreement are being discussed.

Four international conferences and seminars were organized by HFSA, or with the Supervision's participation in Budapest in 2001: the International Conference of Consolidated Supervisions, the Conference of European Insurance Supervisions, the disclosure related to securities issue (together with the US Securities and Exchange Commission) and the management of market risks (together with the Basel Financial Stability Institute). The Supervision received several delegations for bi-lateral discussions, briefed market players, strategic investors, or credit rating agencies, etc. on supervisory activities, the regulatory environment of the Hungarian market, and on the development of the supervised sectors.

COOPERATION WITH OTHER SUPERVISORY BODIES IN HUNGARY

As a consequence of being an integrated supervision, the cooperation with other financial supervisory bodies means a well-functioning within-the-staff cooperation.

Some aspects of the cooperation with the other authorities are included in the respective acts. Additionally, the HFSA has MoU-s with the most important partner authorities in Hungary, such as the State Tax Office, the consumer protection supervision, Competition Office, National Bank of Hungary.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2001

In 2001 the Supervision took part in fulfilling several priority tasks that determined the development of the financial sector on the long run and also represented major harmonization steps in approaching international standards. These often required cooperation not only within the Supervision, but called for broader cooperation involving the administration. HFSA took an active, often initiative part in that work.

Last year strengthening the fight against money laundering was a major challenge even on a national level requiring cooperation between several areas of public administration, in which HFSA played a leading role. The Supervision started to develop a comprehensive supervisory recommendation back in the first half of 2001, which followed the practices of OECD and EU member states in terms of content and procedures. Simultaneously, the Supervision initiated speeding up the statutory amendment aiming at the abolishment of anonymous deposit passbooks and other legislative changes. **Recommendation No. 7 of 2001 of the Supervision on the prevention and fight against money laundering** was published right before the September 11 terrorist attack. In addition to providing firm support to speeding up legal amendments HFSA established a close working relationship with FATF, the investigative group of the Council of Europe (PC-R-EV) and the European Commission. With that the Supervision made a significant contribution to clarify for all concerned parties what legal and practical steps were required for the country's removal from the FATF blacklist. HFSA actively participated in strengthening the cooperation with other authorities, **consulted with the supervisory authorities of several countries and its staff attended training courses**. The special inspections directed at the anti-money laundering practices of the supervised institutions, which were conducted subsequent to the enactment of Act LXXXIII of 2001 aimed to step up the fight against terrorism and money laundering, confirmed that Hungarian financial institutions not only comply with statutory requirements, but also with additionally recommended norms and procedures both in practice and in their internal regulations. Nevertheless, during the series of inspections on a few occasions warning were issued, furthermore, organizational changes were suggested to several banks. During the year 1309 money laundering related resolutions were passed. **In the beginning of 2002 the Supervision mailed the new model rules aimed at the prevention of money laundering to more than two thousand institutions.**

The trading book, effectively enforced as of April 1, 2001, was introduced equally in all sectors, i.e. it **stipulated identical capital requirement to cover market risks for all investment service activities**. In addition to taking a rather active role in adopting EU principles and in drafting the statutes, the Supervision also assisted financial players. The data reporting decree corresponding to the statute was also drafted together with the instructions for completing the form, which was of considerable assistance in the interpretation of the expectations according to the supervised institutions. HFSA organized a professional consultation where the institutions concerned received detailed responses to their questions pertaining to preparation, introduction and operation. In order to enhance efficiency of supervisory actions a methodological guideline was prepared containing the procedures and criteria of individual supervisory tasks related to the trading book. The management of the trading book and the stipulations pertaining to the capital requirement to cover market risks are in accord with EU requirements.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	1999	2000	2001
Banks and specialized credit institutions	43	42	41
Saving cooperatives	209	192	186
Credit cooperatives	8	7	7
Financial Institutions, total	**260**	**241**	**234**

Ownership structure of financial institutions in 2001 on the basis of registered capital (%) (at year-end)

Item	Type of financial institution			Total
	Banks	Saving cooperatives	Credit cooperatives	Financial institutions
State ownership	25.6	7.9	0.0	25.0
Other domestic ownership	8.9	91.9	100.0	11.6
Domestic ownership total	34.5	99.8	100.0	36.6
Foreign ownership	62.2	0.2	0.0	60.2
Preferential and repurchased stocks	3.3	0.0	0.0	3.2
Financial Institutions, total	**100.0**	**100.0**	**100.0**	**100.0**

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

Item	1999	2000	2001
State ownership	19.7	21.0	25.0
Other domestic ownership	18.2	15.0	11.6
Domestic ownership total	37.9	36.0	36.6
Foreign ownership	62.1	64.0	60.2
Preferential and repurchased stocks	..	..	3.2
Financial Institutions, total	**100.0**	**100.0**	**100.0**

Distribution of market shares in balance sheet total (%)

Type of financial institution	1999	2000	2001
Banks	94.2	94.0	93.7
Saving cooperatives	5.7	5.9	6.2
Credit cooperatives	0.1	0.1	0.1
Financial Institutions, total	**100.0**	**100.0**	**100.0**

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

Assets	1999	2000	2001
Cash and settlement accounts	7.0	8.2	6.7
Securities for trading purposes	6.9	6.9	5.6
Securities for investment purposes	8.9	8.8	10.7
Central bank and inter-bank deposits	25.4	18.1	15.9
Credits	44.4	51.3	54.1
Proprietary interests	2.4	2.3	2.9
Own assets	2.4	2.2	1.8
Other assets	2.6	2.2	2.4
Balance sheet total	**100.0**	**100.0**	**100.0**
Liabilities	**1999**	**2000**	**2001**
Deposits	63.5	63.7	63.9
Inter-bank deposits	9.2	9.6	8.2
Borrowing	9.3	8.8	8.8
Dept securities	1.5	1.6	2.8
Subordinated liabilities	2.0	1.8	1.4
Special provisions	1.2	1.1	0.9
Own capital	8.6	9.3	10.1
Other liabilities	4.7	4.1	3.9
Balance sheet total	**100.0**	**100.0**	**100.0**

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

Type of financial institution	1999	2000	2001
Balance sheet total (HUF billion)			
Banks	7,336.1	8,427.4	9,506
Other credit institutions	451.4	532.5	638.9
Financial Institutions, total	**7,787.5**	**8,959.9**	**10,144.9**
Off balance sheet total (HUF billion)			
Banks	3,173.7	3532	4,823.4
Other credit institutions	6.2	12.4	19.0
Financial Institutions. total	**3,179.9**	**3,544.4**	**4,842.4**
Off balance sheet / balance sheet (%)			
Banks	43.3	41.9	50.7
Other credit institutions	1.4	2.3	3.0
Financial Institutions, total	**40.8**	**39.6**	**47.7**

Solvency ratio of financial institutions (%)

Type of the financial institution	1999	2000	2001
Banks	15.02	15.21	14.15
Saving cooperatives	18.67	15.11	15.32
Financial Institutions, average	**15.16**	**15.21**	**14.20**

Asset portfolio quality of the banking system

Asset Classification	1999		2000		2001	
	HUF billion	%	HUF billion	%	HUF billion	%
Problemfree	7,120	91.1	8,382	91.5	10,284	88.0
Special mention	406	5.2	522	5.7	1,047	9.0
Problem	286	3.7	253	2.8	347	3.0
– substandard	72	0.9	79	0.9	177	1.5
– doubtful	119	1.5	97	1.1	80	0.7
– bad	95	1.2	76	1.0	90	0.8
Classified Total	**7,812**	**100.0**	**9,157**	**100.0**	**11,678**	**100.0**
Specific Reserves (HUF billion)	**157.3**	**-**	**144.0**	**-**	**178.7**	**-**

The structure of deposits and loans in 2001 (%) (at year-end)

	Deposits	Loans
Households	51.5	12.3
Government sector	3.6	2.4
Corporate	29.7	65.4
Foreign	11.2	8.6
Other	4.0	11.2
Total	**100.0**	**100.0**

The structure of deposits and loans in 2001 (%) (at year-end)

Maturity of Deposits		Loans	
At sight	32.1	Long term loans	64.3
Within one year	60.2	Medium-term loans	-
Over one year	7.7	Short-term loans	35.7
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.		
	1999	2000	2001	1999	2000	2001
Banks	36.25	36.39	34.64	35.88	36.52	34.65
Saving cooperatives	0.04	0.04	0.05	0.00	0.002	0.02
Credit cooperatives	0.00	0.00	0.00	0.00	0.00	0.00
Financial Institutions, average	**36.25**	**36.39**	**32.46**	**35.88**	**36.52**	**32.47**

Average balance sheet items

in HUF billion

Items	1999	2000	2001
Average balance-sheet total (assets total)	6,691.0	7,770.0	8,611.6
Average own capital	581.3	699.1	860.5

Profit and loss statement of banking sector

in HUF million

Items	1999	2000	2001
Interest income	873.3	791.7	807.6
Interest expenditure	596.5	481.5	458.6
1) Net interest income	276.8	310.2	349.0
2) Profit from other financial and investment services (including dividends)	29.2	90.0	81.1
Of that: Profit from commissions	60.8	78.9	98.5
Of that: Net provisions	-74.4	-48.5	..
3) Gross financial and investment services profits (1+2)	306.0	400.2	430.1
4) Overheads	271.0	294.1	305.7
5) Extraordinary profits	2.0	-9.3	20.3
6) Pre-tax profit (3-4+5)	37.0	96.8	144.7

Components of the banking sector return on assets (%)

Items	1999	2000	2001
In proportion to the average balance – sheet total			
Interest income	13.05	10.19	9.38
Interest expenditure	8.91	6.20	5.33
1) Net interest income (interest margin)	4.14	3.99	4.05
2) Profit from other financial and investment services (including dividends)	0.44	1.16	0.94
Of that: Profit from commissions	0.91	1.02	1.14
Of that: Net provisions	-1.11	-0.62	..
3) Gross financial and investment services profits (1+2)	4.57	5.15	4.99
4) Overheads	4.05	3.79	3.55
5) Extraordinary profits	0.03	-0.12	0.24
6) Pre-tax profit (ROA)	0.55	1.25	1.68

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

Revenues	1999	2000	2001
1. Interest income	944.4	861.2	877.1
2. Other net non interest income	30.5	91.6	82.7
Of which: Net income from commissions	64.2	84.1	103.7
Dividends	12.5	6.8	4.3
3. Extraordinary income	32.0	16.9	35.7
Revenues total (1.+2.+3.)	**1,006.9**	**969.7**	**995.5**
Expenditures	**1999**	**2000**	**2001**
1. Interest expenditures	640.4	518.7	495.8
2. Overheads	295.2	323.1	334.6
3. Extraordinary expenditures	30.4	26.4	15.2
Expenditures total (1.+2.+3.)	**966.0**	**868.2**	**845.6**

Structure of registered capital and own funds of financial institutions in 2001

Type of the Financial institutions	Registered capital HUF billion	/Total assets %	Own funds HUF billion	/Total liab. %	Total assets HUF billion
Banks	419.2	4.4	956.4	10.1	9,506.0
Cooperative financial institutions	13.8	2.2	42.5	6.7	638.9
Financial Institutions, average	**433.0**	**4.3**	**998.9**	**9.8**	**10,144.9**

2001 DEVELOPMENTS IN THE LATVIAN BANKING SYSTEM

FINANSU UN KAPITĀLA TIRGUS KOMISIJA

MACROECONOMIC ENVIRONMENT

2001 was marked by continued growth in the Latvian economy. Growth across the major sectors of the national economy ranked Latvia high among the countries of Central and Eastern Europe in terms of GDP growth. In 2001, GDP increased by 7.6% in Latvia.

No marked changes were observed in the unemployment rate, which was 7.7% in December 2001. Influenced by external factors, average annual inflation rose slightly. During the year, inflation ranged between 0.7% and 3.6%, and in December, the annual rate of inflation was 3.2%.

The country's fiscal position improved in the reporting year: the fiscal deficit in the general government budget was 87.2 million lats (a year-on-year decrease of 27.3%) or 1.8% of GDP (2.8% in 2000).

In 2001, the balance-of-payments current account deficit equalled 10.1% of GDP (6.9% in 2000). A year-on-year increase was reported in the services surplus. The foreign trade deficit increased, as imports of goods rose at a more rapid pace than exports. Capital and intermediate goods were dominating in imports, which promoted modernization and growth in the national economy. Foreign currency inflow into Latvia was larger than needed to cover the current account deficit; and therefore, the balance of payments was in surplus.

DEVELOPMENT OF THE BANKING SYSTEM

At the end of 2001, the banking sector of Latvia comprised 22 banks and one branch of a foreign bank, the Latvian branch of *Nordea Bank Finland Plc.* In 2001, the aggregate paid-up share capital of banks increased by 17.6% and amounted to 236.9 million lats at the end of the year. The share of foreign capital in the paid-up share capital of banks accounted for 67.8%. Foreign shareholders owned more than 50% of the bank's share capital in 10 banks and the market share of these banks comprised 65.2% of the banking sector's total assets. Five banks were subsidiaries of foreign banks.

In 2001, the share of the Estonian and German capital in the share capital of Latvian banks continued to grow. This was related to the consolidation of activities of the Estonian bank *Hansapank*, a subsidiary of the Scandinavian bank *ForeningsSparbanken AB (Swedbank)*, and the German bank *Nordddeutsche Landesbank Girozentrale*, in the banking sector of Latvia.

In the reporting period, the assets of banks increased by 28.2% reaching 3,458.5 million lats by the end of the period. As a result of the development of the banking sector, the structure of banks' assets changed. As loans increased by 50.5%, their share in the banks' assets rose from 40.3% to 47.3%. The share of five major banks increased and amounted to 66.2% of assets, 73.0% of loans, and 69.0% of deposits.

The ratio of loans issued (to residents) to gross domestic product had grown from 21.7% in 2000 to 29.5 % by the end of 2001.

The national economy was actively engaged in borrowing. At the end of 2001, 85.9% of total loans were granted to domestic borrowers. The rapid growth of the national economy determined the increase in loans in all the major national economy sectors. Mortgage lending developed rapidly. Its growth rate in the reporting period amounted to 112.1%, consequently, the share of mortgage loans in the loan portfolio of banks increased from 10.9% at the beginning of 2001 to 15.2% at the end of 2001.

In 2001, the amount of lending substantially increased and the stable tendency of the loan quality to improve continued. By the end of the year, banks had assessed 95.8% of the loan portfolio as standard and only 1.4% – as close-watch. The share of non-performing loans (substandard, doubtful, lost) in the total of loans granted to non-banks dropped from 4.5% to 2.8%, and their volume decreased as a result. In the reporting year, the ratio of specific provisions to the total of loans granted to non-banks decreased to 1.7% at the end of 2001, attesting to the overall improvement of quality of the banking sector's loan portfolio.

In 2001, the amount of deposits grew by 24.9%, totalling 2,329.7 million lats. The deposits of residents grew by 25.1% and amounted to 1,121.7 million lats, including deposits of private persons, which grew by 40.8%, amounting to 557.4 million lats.

Banks should maintain liquid assets (vault cash, claims on the Bank of Latvia, claims on credit institutions and liquid securities) in amounts sufficient to meet their obligations but not less than 30% of their total current liabilities. The liquidity ratio of the banking sector accounted for 65% at 31 December 2001.

In 2001, the audited profit of the banking sector reached 46.6 million lats, compared to 36.7 million in 2000. The main sources were income from the interest on loans issued to non-banks and fee and commission income: respectively 38.3% and 23.1% of total income.

Ensuring maximum compliance with EU directives, capital adequacy calculations made by banks as of 1 January 2001 included not only the credit risk and currency risk capital requirement but also capital requirement for the position, commodities, settlement and counter-party risk inherent in the trading book. At 31 December 2001 the capital adequacy ratio of the banking sector was 14.2% (regulatory requirement – 10%).

THE LEGAL AND INSTITUTIONAL FRAMEWORK FOR THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS

According to the Law on the Financial and Capital Market Commission the Financial and Capital Market Commission (Commission) commenced its activities on 1 July 2001 thereby becoming the legal successor to the rights, obligations and liabilities of the Insurance Supervision Inspectorate, the Securities Market Commission, administration of the Deposits Guarantee Fund as well as to the rights, obligations and liabilities of the Bank of Latvia in the field of credit institution supervision.

The Commission is an autonomous public institution and the purpose of its activities is to promote the protection of interests of investors, depositors and the insured and the development and stability of the financial and capital market. To this end, the Commission regulates and supervises the financial and capital market and activities of its participants.

In order to perform supervision effectively the Commission is authorized by law:

- to issue regulatory enactments and ordinances binding on market participants;
- to license financial and capital market participants as well as individual financial products; to grant permits for the increase of capital, changes in the composition of shareholders, etc.;
- to control the implementation of regulatory enactments and ordinances;
- to compile, analyse and publish information concerning the financial and capital market (a quarterly report to the Bank of Latvia and the Ministry of Finance, an annual report to the *Saeima* (Parliament of the Republic of Latvia), monthly statistics);
- to prepare proposals regarding improvements to regulatory requirements and their harmonisation with EU regulations;
- to carry out risk assessment at the level of an individual financial market participant and an individual financial market sector as well as at the level of the entire system;
- to ensure the asset accumulation and management of the deposit guarantee fund and the fund for the protection of the insured, and the payment of compensations from such funds; and
- to co-operate with foreign financial and capital market supervisory authorities, international financial organisations, the Bank of Latvia, the Ministry of Finance of the Republic of Latvia and to provide methodological assistance to the Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity.

THE ACTIVITIES OF THE COMMISSION IN THE FIELD OF BANKING

In 2001, credit institution operating licences were issued to two banks (the joint-stock company *Akciju komercbanka Baltikums* and the joint-stock company *Reìionâlâ investîciju banka)*. One banking licence was revoked as a result of a bank's reorganisation (the joint-stock company *Saules banka* was acquired by the joint-stock company *Rietumu Banka*).

The purpose of the supervision of banks is to duly establish causes of possible problems that may arise in relation to their activities and, within the scope of competence of the Commission, to take preventive measures and decrease the possible effects of a bank's problems on the entire financial and capital market.

When supervising banks, particular attention was devoted to their compliance with laws and regulations of the Commission. The supervision is based on an off-site analysis of financial statements and prudential reports and on-site examinations.

In 2001, the Commission staff conducted 25 examinations of banking operations. As in previous years, special attention was paid to the evaluation of asset quality and the analysis and evaluation of the internal control systems.

In 2001, the amount of issued loans substantially increased, therefore, particular attention was paid to the evaluation of the credit risk management policies and procedures (identification, measuring, monitoring and control) of banks during examinations in order to duly identify possible shortcomings and problems related to loan repayment. The strategy, policies and procedures regarding the granting of loans were also assessed.

On 1 January 2001, the Regulation for Calculating Capital Adequacy determining the capital requirement for the market risk in the trading book of credit institutions came into force. The Commission staff evaluated the policies and procedures for the trading book management of banks and, when carrying out examinations, assessed their adequacy and observance in practice.

By the inception of the Commission on 1 July 2001, immense work had already been completed setting up a framework of regulatory requirements governing activities of the financial and capital market and its participants.

In the second half of 2001 the Commission, as required by the Law on the Financial and Capital Market Commission, approved 82 regulatory enactments (for the most part it involved re-approving the regulatory enactments issued by the Securities Market Commission, the Insurance Supervision Inspectorate, the Bank of Latvia, the Deposit Guarantee Fund, and the Cabinet governing the activities of financial and capital market participants and the procedures for calculating the relevant indicators as well as those for preparation of annual accounts. Within the course of re-approval of these documents, amendments to the regulatory enactments were made and harmonisation of requirements regulating the operation of the various financial and capital market sectors was carried out.

The Regulation on the Annual Accounts of Banks has been prepared taking into account amendments made to IAS since 1996 as well as amendments No. 2001/65/EEC to EC Directive No. 86/635/EEC on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions. This regulation provides for the procedures regarding classification of financial assets and financial liabilities according to their type and their initial recognition in the balance sheet, as well as for the procedures regarding subsequent valuation in accordance with the requirements of IAS 39. Moreover, the contents of notes to financial statements of a bank has been expanded by requiring the provision of qualitative and quantitative information concerning material risks in banking operations, including market risk.

The Law on the Protection of Investors ensures the implementation of the requirements of EC Directive 97/9/EC on Investor-Compensation Schemes, establishing a scheme for the protection of investors that, in cases where the providers of investment services are not able to meet their obligations, will entitle the investor to compensation. Its purpose is to compensate for any default on obligations in the amount of 90% of the value of irreversibly lost financial instruments, or losses caused by a non-executed investment service. Said law came into effect on 1 January 2002.

The amendments to the Law on Natural Person Deposit Guarantees, which will become effective on 1 January 2003, provide for the implementation of the requirements of EC Directive 94/19/EC on Deposit-Guarantee Schemes. The present applicable Law on Natural Person Deposit Guarantees sets forth only guarantees for deposits made by natural persons, whereas said directive determines the application of a deposit-guarantee scheme to both natural and legal persons.

Amendments to the Law on Credit Institutions have been formulated (passed on April 2002) in order to implement the requirements of EC Directive 95/26/EC. The purpose of the amendments is to improve the overall supervision of credit institutions and grant the Commission relevant powers to prevent close links between a credit institution and third party in cases where such links might jeopardise the financial stability of the credit institution or restrict the supervisory body from performing functions prescribed by said law. The Commission also formulated amendments to the Law on Credit Institutions that will implement the "single license" principle with respect to setting up branches of banks registered in

EU and European Economic Area countries and providing financial services in Latvia and vice versa. As a result of the introduction of the "single license" principle, a bank registered in a relevant country will not have to receive an operating licence in the country where it intends to open a branch or provide financial services. This provision will take effect upon accession.

INTERNATIONAL ACTIVITIES

In 2001, the Commission actively co-operated with major international organisations in the field of the financial and capital market supervision.

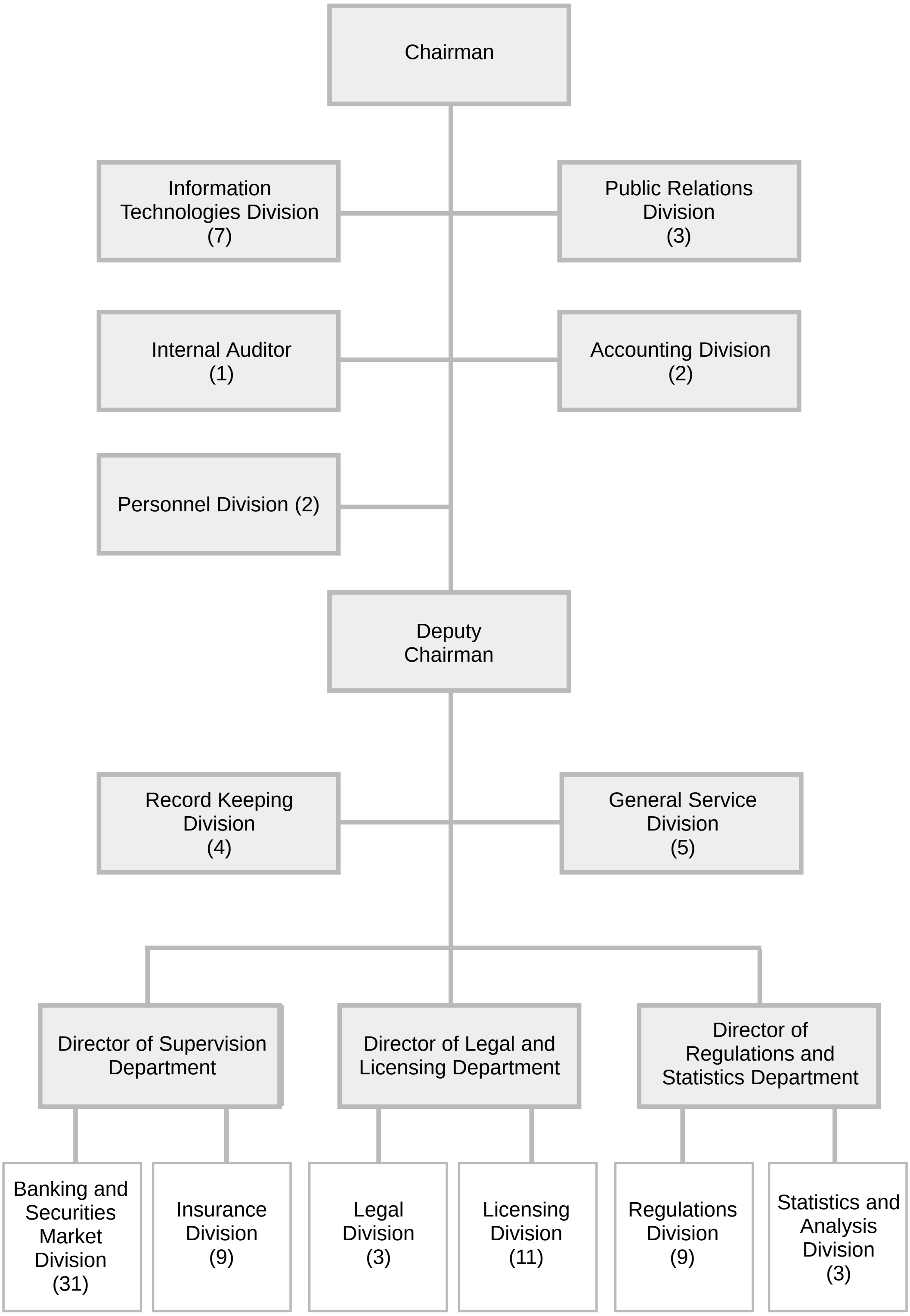
In 2001, the Commission actively participated in the processes related to the integration of Latvia into the EU by submitting proposals for the harmonisation of laws and regulations with EC directives and by formulating regulatory requirements that would enhance conformity to EU norms.

In 2001, fruitful co-operation was developed with the Directorates-General for Internal Market and Economic and Financial Affairs of the European Commission, which assisted in efficient harmonisation of the Republic of Latvia regulatory enactments with the EU *acquis communautaire*.

Within the framework of the Financial Sector Assessment Programme, the World Bank and the International Monetary Fund gave an evaluation of the Latvian financial sector. A report prepared by experts of the Programme included a positive opinion on the regulatory environment of the banking, insurance and securities market as well as the course of pension system reform. The report underscored the stability of the macroeconomic environment that ensured favourable preconditions for further development of the financial sector. It noted that the regulatory basis governing activities of financial market participants, which was formed by taking into account Latvia's aim to enter the EU, had improved considerably in recent years. The evaluation concluded that Latvia was compliant or largely compliant with all the Basel Committee Core Principles for Effective Banking Supervision.

Commission had agreements on mutual exchange of information (Memoranda of Understanding) with 12 (7 of which are in the field of credit institution supervision) financial supervisory authorities of various countries.

STRUCTURE OF THE FINANCIAL AND CAPITAL MARKET COMMISSION



FINANSU UN KAPITĀLA TIRGUS KOMISIJA

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	1999	2000	2001
Banks	23	21	22
Credit unions	9	17	22
Foreign bank branches	1	1	1
Financial institutions, total	**33**	**39**	**45**

Ownership structure of the financial institutions in 2001 on the basis of registered capital (%) (at year-end)

	Type of financial institution		Total
	Banks	Credit unions	
State ownership	4.5	0.0	4.5
Other domestic ownership	27.7	100.0	27.8
Domestic ownership total	32.2	100.0	32.3
Foreign ownership	67.8	0.0	67.7
Financial Institutions, total	**100.0**	**100.0**	**100.0**

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

	1999	2000	2001	2001/1999
State ownership	3.7	3.8	4.5	121.6
Other domestic ownership	30.1	26.4	27.8	92.4
Domestic ownership total	33.8	30.2	32.3	95.6
Foreign ownership	66.2	69.8	67.7	102.3
Financial Institutions, total	**100.0**	**100.0**	**100.0**	

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

Type of financial institution	1999	2000	2001
Banks	98.31	96.82	96.60
Credit unions	0.03	0.04	0.05
Foreign bank branches	1.66	3.14	3.35
Financial institutions, total	**100.00**	**100.00**	**100.00**

** based on assets*

Average balance sheet items of banking system (at year-ends)

in thousands of USD

Items	1999	2000	2001
Average balance-sheet total (assets total)	2,964,628	3,728,136	4,774,989
Average own capital	283,031	306,608	384,599

FINANSU UN KAPITĀLA TIRGUS KOMISIJA

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

Assets	1999	2000	2001
Cash and balances with the Bank of Latvia	9.4	6.3	5.9
Claims on credit institutions	22.4	28.3	24.2
Loans	43.4	40.3	47.3
Bonds and other fixed interest securities	15.7	17.7	16.3
Shares and other variable yield securities	1.1	1.3	0.9
Participating interest and other financial investments	0.5	0.3	0.5
Other assets	7.5	5.8	4.9
Liabilities	**1999**	**2000**	**2001**
Amounts owed to the Bank of Latvia	3.2	1.6	0.6
Amounts owed to credit institutions	12.2	11.5	15.0
Deposits	65.8	69.1	67.4
Other liabilities	5.4	7.2	6.5
Provisions	3.6	2.2	1.6
Total equity	9.8	8.4	8.9

Development of off-balance sheet activities of the financial institutions (off balance sheet items/ balance sheet total. %) (at year-ends)

Type of financial institutions	1999	2000	2001
Banks	19.5	24.0	39.9
Credit unions	0.0	1.4	1.6
Foreign bank branches	30.9	56.7	112.1
Financial institutions, total	**19.7**	**25.0**	**42.3**

Solvency ratio of banks (%) (at year-ends)

	1999	2000	2001
Solvency Ratio of Banks	16.0	14.3	14.2

Asset portfolio quality of the banking system (%) (at year ends)

Asset Classification	1999	2000	2001
Standard	89.4	93.3	95.8
Watch	4.4	2.1	1.4
Substandard	2.7	2.5	1.7
Doubtful	2.0	1.1	0.7
Lost	1.5	1.0	0.4
Classified total	**100.0**	**100.0**	**100.0**
Specific Reserves	4.2	2.9	1.7

FINANSU UN KAPITĀLA TIRGUS KOMISIJA

The structure of banks deposits and loans in 2001 (%) (at year-end)

	Deposits	Loans
Households	23.9	14.6
Government sector	2.9	3.2
Corporate	20.7	67.0
Foreign	51.8	14.1
Other	0.7	1.1
Total	**100.0**	**100.0**

The structure of banks deposits and loans in 2001 (%) (at year-end)

Maturity of Deposits		Maturity of Loans	
At sight	68.1	Short-term loans (up to 1 year)	26.2
Within one year	25.4	Medium-term loans (1-5 years)	44.8
Over one year	6.5	Long term loans (over 5 years)	29.0
Total	**100.0**	**Total**	**100.0**

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

Type of financial institution	FOREX Assets / Total Assets			FOREX Liabilities / Total Liabilities		
	1999	2000	2001	1999	2000	2001
Banks	65.9	65.4	65.1	65.2	66.1	65.8
Credit unions	4.7	14.5	15.2	5.7	10.0	16.3
Foreign bank branches	56.4	57.0	42.1	67.7	69.4	66.4
Financial institutions, average	**65.8**	**65.1**	**64.3**	**65.3**	**66.2**	**65,8**

Profit and loss statement of banks (at year-ends)

in thousands of USD

Items	1999	2000	2001
Interest income	214,256	252,023	299,555
Interest expenditure	79,015	109,480	141,122
1) Net interest income	135,241	142,543	158,433
2) Profit from other financial and investment services (including dividends)	72,967	115,755	134,323
Of that: Profit from commissions	76,696	88,780	95,773
Of that: Net provisions	35,623	18,272	23,646
3) Gross financial and investment services profits (1+2)	208,208	258,298	292,756
4) Overheads	172,655	185,591	201,676
5) Extraordinary profits	1,221	248	812
6) Pre-tax profit (3-4+5)	36,774	72,955	91,892

FINANSU UN KAPITĀLA TIRGUS KOMISIJA

Components of the banking sector return on assets (%) (at year-ends)

Items	1999	2000	2001
In proportion to the average balance-sheet total			
Interest income	7.23	6.76	6.27
Interest expenditure	2.67	2.94	2.96
1) Net interest income (interest margin)	4.56	3.82	3.32
2) Profit from other financial and investment services (including dividends)	2.46	3.10	2.81
Of that: Profit from commissions	2.59	2.38	2.01
Of that: Net provisions	1.20	0.49	0.50
3) Gross financial and investment services profits (1+2)	7.02	6.93	6.13
4) Overheads	5.82	4.98	4.22
5) Extraordinary profits	0.04	0.01	0.02
6) Pre-tax profit (ROA)	**1.24**	**1.96**	**1.92**

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

Revenues	1999	2000	2001
Interest income. incl.:	55.5	55.8	58.8
interest on loans	37.2	34.3	38.3
interest on deposits with credit institutions	6.4	11.1	8.2
interest on bonds and other fixed income securities	11.7	9.9	10.9
interest income on futures and forwards	0.1	0.3	1.2
Dividends	0.1	0.1	0.1
Commission received	23.5	23.8	23.1
Profit loss from securities and currencies trading	10.2	9.2	8.9
Other	10.7	11.1	9.1
Expenditures	**1999**	**2000**	**2001**
Interest expense	22.2	28.1	32.7
Commission paid	3.9	4.8	5.1
Operating expenses (incl. salaries)	40.9	40.2	38.9
Depreciation	7.7	7.5	7.8
Loan loss provision expense	17.9	15.2	11.1
Other	7.4	4.2	4.4

Structure of registered capital and own funds of financial institutions in 2001 (at year-ends)

Type of	Registered thousands of USD	/Total %	Own thousands of USD	/Total %
Banks	371,452	7.1	446,704	8.5
Credit unions	583	22.5	695	26.8
Foreign bank branches	-	-	-	-
Financial institutions, average	**372,035**	**7.1**	**447,389**	**8.5**

2001 DEVELOPMENTS IN THE LITHUANIAN BANKING SYSTEM

LIETUVOS BANKAS

MACROECONOMIC ENVIRONMENT

The year 2001 was the most successful for Lithuanian economy ever since 1997. Following a few years' recession, a marked growth of Lithuanian economy was observed, which is reflected by a 5.9 per cent increase in the Gross Domestic Product (GDP). Foreign trade intensified and branches of economy orientated towards the internal market developed quite rapidly as well. Macroeconomic stability was maintained though a balanced public finance policy, owing to which the current account deficit, which stood at 4.8 per cent in 2001, narrowed further and inflation remained negligible (some 2 per cent). Privatisation of state-controlled banks was successfully accomplished; structural reforms pushed forward in several areas, including restructuring of the energy sector; conditions for the development of small and medium businesses were improved; the country hastened preparation for the membership of the European Union.

Similarly to 2000, last year the GDP increase was largely determined by the development of manufacturing: the value added produced in this branch of economy was 18.0 per cent ahead of the figure for the last year to account for 22.9 per cent of GDP. Extraction of crude petroleum and manufacture of petroleum products were particularly notable; however, other industries also developed rapidly, such as light industry, manufacture of articles of wood, paper and furniture.

Since Lithuania is an open economy, its development relies largely on the export growth. The foreign trade balance data report about maintaining close trade relations with EU countries in 2001, exports to which comprised nearly half of the domestically produced output and services. On the other hand, with the recovery of CIS markets, the country succeeded in expanding export volumes to these eastern countries. The main trade partners included Great Britain with some 14 per cent share in the total exports, Latvia and Germany (13% each). Major exports comprised mineral products (23.4% of total exported goods), textile articles (16.3%) and agricultural products (12.4%). As to imports, most goods, again, were imported from EU countries (44% of total imports of goods); CIS countries were second by significance with a 29.4 per cent share in the total import value. A decline in the prices for imported mineral products (primarily petroleum and petroleum products) decided a much lesser increase in the imports of goods compared to the exports of goods.

Exporter-unfavourable depreciation of the euro against the USD, to which the national currency, litas was pegged, had some negative impact on the performance of trade with EU countries. It was a reason that prompted a decision to repeg the national currency litas to the euro. The repeg, implemented in February 2002[7], should speed up further integration of national economy into the EU economic

[7] Official exchange rate is EUR 1 = LTL 3.4528

area. According to the volume of foreign direct investment in Lithuanian economy in late 2001, the leadership was with Scandinavian countries: Denmark with some 19 per cent investment share and Sweden with its 16 per cent. The bulk of investment (nearly 26% of the total) went to manufacturing, trade and financial intermediaries (20% each). As the largest part of investment was meant for upgrading production, improving the infrastructure and increasing labour efficiency, and the scope of public investment was quite modest continuing the tight saving policy, new jobs created in 2001 were relatively insignificant. Because of said reasons the rate of unemployment remained on quite a high level (according to the Labour Exchange – 12.5%) and the nominal wages and salaries of the employed increased slowly.

Positive shifts were also evident in those branches of economy, the growth of which rests on the growth of consumption in the domestic market. These include trade, communications, and construction industry.

In 2001, the financial sector preserved the tendencies of stability and growth. Foreign assets of the Bank of Lithuania augmented by USD 310.6 million or 22.9 per cent and the ratio of bank assets to domestic GDP kept increasing. There was an especially notable drop in the interest rates on the domestic market and more favourable borrowing possibilities appeared for both economic entities and the population, which increasingly used the services provided by commercial banks.

The positive changes in implementing structural reforms and privatisation of the banking sector were assessed by international rating agencies, which assigned better ratings of borrowing for Lithuania. In May 2001, the international credit rating agency "Fitch" raised Lithuania's credit rating for long-term loans in foreign currency from BB+ to BBB-. Another rating agency, "Standard & Poor's," improved Lithuania's rating for long-term borrowing in foreign currencies from BBB- to BBB in April 2002.

DEVELOPMENT OF THE BANKING SYSTEM

In late 2001, the Lithuanian banking system comprised:

- 9 commercial banks with 156 branches in different regions throughout the country;
- 4 branches of foreign banks;
- 2 representative offices of foreign banks (other 3 banks, two of which had branches operating in Lithuania, decided to wind up their representative offices).

In April 2002, a licence was issued to the 10th bank, Joint-Stock Company VB Housing Credits and Bonds Bank, which intends to release a new financial instrument, mortgage bonds into the market.

Privatisation of state banks and intensifying activity of foreign investors contributed to the occurrence of observable changes in the banking sector in 2001. These were the key factors to have provided favourable possibilities for further development of domestic banking. With the enhancement of market competition, banks devoted greater attention to quality improvement and increase of their operating efficiency.

In December last year, the Government of the Republic of Lithuania sold to a strategic investor, which happened to be the Estonian bank AS "Hansapank" within the group of the Swedish bank "Swedbank", its 90.7 per cent holding in the JSC Savings Bank of Lithuania (LTB), owned by the state by right of ownership. The strategic investor acquired the bank, which was second by asset size in the banking system and the leader in the retail market in early 2001 (holding nearly 45% of the total amount of individuals' deposits with banks). In satisfaction of additional conditions for the acquisition of LTB, the new owner of the bank committed itself to redeeming a new share issue. The extra funds were meant for investment in upgrading information systems and reorganisation of the bank's branches in order to maintain leadership in retail banking in the future.

Last year, tendencies of consolidation carried on in the banking sector. In September 2001, the new shareholders of the JSC Savings Bank of Lithuania adopted a decision to merge LTB with a subsidiary of the Estonian bank AS "Hansapank", JSC Bank "Hansabankas", which operated in Lithuania. The reorganisation was completed in late 2001 and the title of the JSC Savings Bank of Lithuania was changed into JSC Bank "Hansa-LTB".

Over 2001, the share capital of the banking system augmented by one fifth to amount nearly to LTL 978 million late in the year (an equivalent of EUR 280 million). By the end of 2001, foreign investor-owned capital prevailed in the domestic banking sector, the share of which rose from 57.7 per cent to 81.1 per cent. In 6 out of 9 commercial banks foreign investors owned the better half of share capital, whereas the influence of local investors, including state-owned shares, contracted visibly (from 42.3 % to 18.9%).

In 2001, German investors intensified their activities in the domestic banking sector. In January last year, the Bank of Lithuania issued an authorisation to a branch in Vilnius of the German bank *Vereins-und Westbank AG*, which started operating in April. Moreover, in the autumn of 2001 the Government of the Republic of Lithuania entered into negotiations on selling its 76 per cent holding in the last state-controlled JSC Agricultural Bank of Lithuania to the strategic investor German bank *Norddeutsche Landesbank Girozentrale.* The transaction was signed in March 2002.

In 2001, the Bank of Lithuania adopted several decisions with regard to other banks. At the end of the year, the Republic of Poland bank *Raiffeisen Bank Polska S.A.* was issued an authorisation to begin operating its representative office. Another operating representative office is of the Austrian bank *CA IB Investmentbank Aktiengesellschaft.*

LEGAL AND INSTITUTIONAL FRAMEWORK FOR SUPERVISION OF FINANCIAL INSTITUTIONS

In 2001, the Seimas of the Republic of Lithuania adopted a new version of the Law on the Bank of Lithuania, which defined more clearly than the previous law the role of, and the authority vested in, the central bank in implementing credit institution supervision, entrusted upon it.

The Credit Institutions Supervision Department represents a structural unit of the Bank of Lithuania, bearing direct responsibility for the supervision of credit institutions holding a licence of the Bank of Lithuania.

The Department implements ongoing supervision of credit institutions using internationally recognised methods and taking into consideration Basle Committee on Banking Supervision recommendations and provisions contained in the directives of the European Union, the membership of which is Lithuania's target for 2004.

The functions of the Credit Institutions Supervision Department include:

- Analysis and appraisal of applications and other documents submitted for the issuance and revocation of licences for Republic of Lithuania credit institutions;

- Analysis and appraisal of applications and other documents submitted for the issuance and revocation of permits to establish and operate branches and representative offices of foreign credit institutions;
- Management of the filing of licensed credit institutions and licences issued (the function of legal registration of credit institutions was transferred to the Ministry of Economy of the Republic of Lithuania);
- Analysis of applications for the acquisition, increase or decrease of bank blocks of shares;
- Oversight of the activities of Republic of Lithuania credit institutions and branches of foreign credit institutions operating in the Republic of Lithuania in the manner prescribed by laws and other legal acts, submission of proposals for the application of enforcement measures to credit institutions;
- Drafting of legal acts for the regulation of activities of credit institutions;
- Working out proposals for the principles of financial accounting of Republic of Lithuania credit institutions and branches of foreign credit institutions operating in the Republic of Lithuania and for the establishment of the reporting procedure;
- Maintaining relations with international financial institutions, co-operation and exchange of information with the supervisory authorities of foreign credit institutions.

Based on the Department's submitted findings and other information, the Board of the Bank of Lithuania adopts decisions on the issuance of licences and permits to credit institutions, application of enforcement measures to them, procedure for the calculation of prudential requirements and establishment of their ratios, approval of other legal acts for the regulation of activities of credit institutions, etc.

KEY ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITYIN 2001

Last year, the Board of the Bank of Lithuania approved a few other legal acts, significant to banking activities, putting particular emphasis on the thorough improvement of the risk management process in banks. Whereas banks improved the range of their services in terms of diversity and complexity, their operating risk and, consequently, the role of internal control in ensuring the efficiency of bank management, control of asset quality and organisation of the proper risk management process increased, new **General Provisions for Organising the Internal Control of the Bank** were approved. This legal act specified the role of the bank's council and board in the process of control and the requirements for the risk identification, assessment and control system, putting particular emphasis on the bank's relations with its customers and management of related risk. The system of internal control must ensure that the risk, which might have negative influence on seeking the bank's objectives, is identified and weighted on a permanent basis. Risk weighting must cover all types of risk (credit, market, liquidity, operating, legal, reputation, etc.) the bank or the whole bank group faces. A particularly significant role in a modern bank rests on information systems. Therefore the requirement is to ensure that the operation of information systems was safe and they were ready for contingencies.

In 2001, Lithuanian banks started developing new methods of service provision; there was a particular acceleration in the development of electronic banking.

Given the extending scope of provision of banking products and services through electronic communication means, the Board of the Bank of Lithuania approved **General Provisions for the Monitoring and Management of the Risk Involved in Electronic Banking.** Banks were obliged to evaluate the scope of their electronic banking services and its influence over the bank's operating policy, and to ensure designing of an adequate system for the monitoring and management of the risk involved in this new activity. The Regulations regulate key aspects of the e-banking safety control process; development of the supervisory process of the bank's e-banking external links and subjection to third parties; measures to ensure information confidentiality; integrity of transactions, records and information, and methods to establish the identity of the customer.

Supervision encourages commercial banks to implement progressive methods for risk management, which have been justified in other countries. Internationally growing attention is focussed on stress testing as one of the latest and increasingly applied bank methods for risk management, which is becoming an integral part of an effective risk management system. By virtue of testing banks can, in modelling various scenarios for market development or the development of individual factors (e.g., interest rates on loans and deposits, securities market prices, foreign currency exchange rates), make a detailed assessment of the aspects of, and prospects for, their activities, and forecast the losses the bank itself and the whole bank group might incur in the future with a certain unfavourable turn in market circumstances. This method to forecast likely losses justifies particularly in transit economies with an insufficiently developed financial market, in which statistical methods of risk weighting are still hardly applicable. In 2001, the Board of the Bank of Lithuania approved **General Regulations for Stress Testing** and recommended banks to use this method for risk management, incorporating it in the bank's general policy for risk management. Analysis of testing results sets preconditions for highlighting weak points of the bank thus helping the bank's management in adopting proper decisions: to envisage in advance the operating strategy under stress conditions and alternative sources of financing should the bank's own funds proved insufficient to cover likely losses and adjust the current business policy to minimise likely losses.

More stringent requirements for **the periodicity of Calculating Prudential Requirements of the Bank** were established last year. Commercial banks must ensure their compliance with all 5 currently applied prudential requirements (capital adequacy, liquidity, maximum open position in foreign currencies and precious metals, maximum exposure and large exposure) not on reporting dates only, but also on a daily basis.

Strengthening competition in 2001 also influenced the expansion of the scope of operation of bank subsidiaries thus enhancing the importance of consolidated supervision of banks and their controlled enterprises. In early 2001, the Bank of Lithuania revised the **Rules of Consolidation of Financial Statements and of Supervision on a Consolidated Basis.** The new version of the Rules adjusted the approach towards insurance undertakings: according to the provisions effective to date, financial statements of insurance undertakings were consolidated by equity approach only, irrespective of whether the parent bank exercises control over them or has significant influence in them. Given the fact that in many cases banks enjoy full ownership in the share capital of established insurance undertakings, a possibility of applying the method of full consolidation to insurance undertakings was provided for in the case of control. The said method enables evaluating and reflecting more precisely the financial state of a bank and the whole group, and to limit the risk involved in the bank's investments. Also, proportionate consolidation was legitimised, as provided by EU Directive 2000/12/EB. This method of consolidation is to be applied to jointly controlled undertakings, i.e. credit institutions or undertakings, whose economic activities or assets are controlled on a contractual basis by two or more parties to the contract.

INTERNATIONAL ACTIVITIES

The International Monetary Fund, in co-operation with the World Bank, is assessing national financial systems seeking to encourage stability of financial markets and to bar the way for likely financial crises both in individual countries and globally. While carrying out the Financial Sector Assessment Programme, experts of the Fund analyse and evaluate every aspect of the strengths and weaknesses of the financial system of each country participating in the programme, focussing significant attention to the analysis of macroeconomic situation, likely risks and threats, ability to maintain market stability upon an unfavourable turn in market circumstances, and help the supervisory authorities of national financial institutions draw up an action plan for further enhancement of the efficiency of supervision and approximation to international standards.

Lithuania's Financial Sector Assessment Programme was carried out in 2001. In the course of the Programme it was assessed how Lithuania implemented the Code of Good Practice in Monetary and Financial Policy Transparency and supervision of banks and insurance undertakings; functioning of payment systems was also assessed. The Bank of Lithuania was a participant in a part of the Programme when IMF and World Bank specialists evaluated the compliance of banking supervision in Lithuania with Basle Committee Core Principles for Effective Banking Supervision. The results of the Lithuanian Financial Sector Assessment Programme were published in February 2002. The assessment concluded that visible progress was made in the field of banking supervision over several recent years in improving prudential requirements for banks and approximating them to the practice employed in European Union countries (this particularly applies to the new procedure for calculating capital adequacy); a sizeable amount of work was also put in establishing relations and strengthening co-operation with other competent Lithuanian and foreign financial institution supervisory authorities. The findings acknowledge that the current pattern of banking supervision in Lithuania virtually complies with the requirements of the Core Principles for Effective Banking Supervision.

In May 2001, the Bank of Lithuania held an annual conference of the Group of Banking Supervisors from Central and Eastern Europe, at which presented the current practice of calculating capital adequacy and the changes projected for the future, as well as shared experience in the field of co-operation with other domestic and foreign financial sector supervisory authorities.

The Bank of Lithuania constantly works with a number of international organisations, such as Financial Stability Institute, international audit companies, institutions involved in the EU enlargement processes and other, submits material and exchanges the necessary information, prepares proposals regarding the harmonisation of the Lithuanian legal acts regulating activities of credit institutions with the EU requirements.

CO-OPERATION WITH OTHER SUPERVISORY AUTHORITIES

With the development of financial markets and collaboration between the supervisory authorities of separate financial sectors co-operation on the international level is becoming increasingly important. Due to the growth of direct and indirect foreign investments, there is a need to formalize the contacts with foreign states supervisory authorities. Our main aim is to sign co-operation agreements with neighbour states' supervisory authorities and those states the banks of which expand their activities in Lithuania through their branches and subsidiary banks and visa versa. The Bank of Lithuania signed co-operation agreements in the area of credit institutions' supervision with the following foreign institutions: the central bank of Russia, the Finnish Financial Supervision Authority, the Bank of Latvia, and the Commission for Banking Supervision of the Republic of Poland. Continuing co-operation process last year, co-operation agreements were signed with the Bank of Estonia and the German Federal Banking Supervisory Office. These agreements provide for co-operation principles in performing joint bank supervision on the international level, including licensing requirements and capital ownership control, on-site inspections, subsidiaries' control, application of prudential requirements, principals for mutual exchange of information, and general actions in supervising banks or bank branches established in either country.

During the recent years co-operation between the Bank of Lithuania and other supervisory authorities of the financial sector has strengthened. Information on bank compliance with prudential requirements is provided to the Deposit Insurance Fund where banks insure household deposits and the State Insurance Supervisory Authority that supervises activities of insurance companies and is reporting to the Ministry of Finance of the Republic of Lithuania. The Bank of Lithuania also co-operates with the Securities Commission that issues licences and supervises activities of financial brokerage, investment management and consulting companies as well as the activities of other capital market participants and registers securities' issues. The agreement between the Bank of Lithuania, the Securities Commission and the State Insurance Supervisory Authority under the Ministry of Finance signed in 2000 helps to better co-ordinate the actions between the authorities and exchange information on fundamental changes in the activities of the supervised institutions. According to this agreement, the Bank of Lithuania and other financial sector supervisory authorities at least twice a year exchange information on credit institutions, securities' market participants, the supervision of which is performed by the Securities Commission, on insurance companies and insurance intermediaries. The agreement defines the obligations to exchange information on material changes that might endanger the stability of the activities of credit institutions, securities' market participants, insurance companies and insurance intermediaries. Upon receipt of information from other financial sector supervisory authorities about violations of credit institution activities, expeditious examinations of credit institutions are performed in order to find out the scope of violations made and then, timely enforcement measures are applied to the credit institutions.

MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISORY AUTHORITY IN 2001

In implementing credit institution[8] supervision, the Bank of Lithuania continually promoted the development of an efficient, stable and competitive banking system in Lithuania, ensuring proper management of the risk assumed.

Last year, particularly great emphasis was put on the preparation of legal acts to define adequate management of risk processes and achievement that banks duly

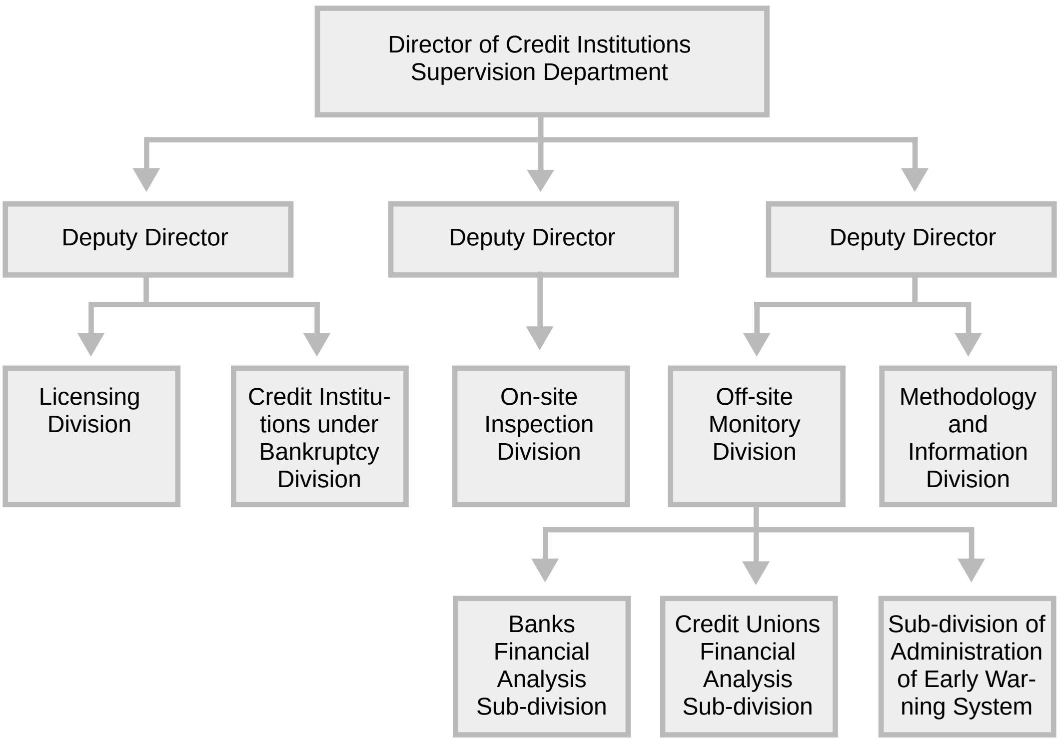
[8] That is the commercial banks holding a licence of the Bank of Lithuania, credit unions, and foreign bank branches operating in Lithuania.

identify and assess the market risk and amortise it by their own capital through the capital adequacy system. The Bank of Lithuania requirements underscore that a bank should be managed, and the related responsibility should be borne, by the board appointed by the owners of the bank, which should take care of appropriate management of the risk assumed. Whereas the Bank of Lithuania, having established certain criteria and requirements for risk management procedures, oversees that they are implemented and that the bank management takes necessary corrective actions where operating deficiencies are established during on-site inspections of the Bank of Lithuania or independent audits.

Concurrently, other objectives were implemented as follows:

- to harmonise further the supervisory system of domestic credit institutions and requirements for it with respective provisions of European Union (EU) directives and standards applied, to carry on the implementation of the Core Principles for Effective Banking Supervision of the Basle Committee and other recommendations;
- to ensure that banks, in accordance with the Bank of Lithuania legal acts, consolidated fully the financial statements of their own and those of their subsidiaries;
- in order to weight and manage the risks emerging in banks better, to improve the legal acts of the Bank of Lithuania by incorporating new areas relating to the implementation of the provision "Know your customer";
- to enhance the Early Warning System so that the Bank of Lithuania could undertake timely adequate measures to ensure prevention of potential failures in the banking system or eliminate their effects;
- to expand co-operation with other credit and financial institution supervisory authorities in the country and abroad.

THE STRUCTURE OF CREDIT INSTITUTIONS SUPERVISION DEPARTMENT OF THE BANK OF LITHUANIA AT THE END OF 2001



STATISTICAL TABLES

Number of financial institutions
(at year-end)

Type of financial institution	1999	2000	2001
Commercial banks	10	10	9
Foreign bank branches	3	3	4
Banks operating under special laws	2	1	-
Credit unions	33	38	41

Ownership structure of financial institutions in 2001
on the basis of registered capital (%)
(at year-end)

Item	Type of financial institutions			Total
	Commercial banks	Foreign bank branches*	Credit unions	
State ownership	8.3	-	-	7.6
Other domestic ownership	10.6	-	100.0	10.1
Domestic ownership total	18.9	-	100.0	17.7
Foreign ownership	81.1	100.0	-	82.3
Financial institutions, total	100.0	100.0	100.0	100.0

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

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

Item	1999	2000	2001	2000/1999
State ownership	36.9	27.2	7.6	-69.2
Other domestic ownership	17.8	12.9	10.1	-51.6
Domestic ownership total	54.7	40.1	17.7	-61.1
Foreign ownership	45.3	59.9	82.3	+193.9
Financial institutions, total	**100.0**	**100.0**	**100.0**	**+36.1**

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

Type of financial institution	1999	2000	2001
Commercial banks	95.8	89.1	93.0
Foreign bank branches	3.1	3.7	6.8
Banks operating under special laws	1.0	7.1	-
Credit unions	0.1	0.1	0.2
Financial institutions, total	100.0	100.0	100.0

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

Assets	1999	2000	2001
Cash in hand	3.4	2.9	3.8
Claims on banks and other financial institutions	23.6	24.8	24.2
Securities	14.7	19.8	20.1
Loans granted*	49.5	42.1	41.3
Other assets	8.8	10.4	10.6
Liabilities	**1999**	**2000**	**2001**
Liabilities to banks and other financial institutions	16.4	14.4	14.7
Deposits and L/C	61.7	65.6	67.9
Other liabilities	10.2	10.0	7.5
Bank capital	11.7	10.0	9.9

** Carrying amount*

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

Type of financial institution	1999	2000	2001
Commercial banks	12.9	10.8	12.9
Foreign bank branches	1.6	13.1	18.7
Banks operating under special laws	6.1	-	-
Credit unions	-	-	-
Financial institutions, total	**12.4**	**11.3**	**13.3**

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

Type of financial institution	1999	2000	2001
Commercial banks	17.4	16.3	15.7
Foreign bank branches*	-	-	-
Banks operating under special laws	9.1	13.6	-
Financial institutions, average	**17.1**	**16.3**	**15.7**

**- solvency ratio of foreign bank branches is not calculated*

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

Asset Classification	1999	2000	2001
Standard loans	64.3	56.6	70.4
Watch loans	23.8	32.7	22.2
Substandard loans	4.4	4.4	3.1
Doubtful loans	3.7	3.6	2.6
Bad loans	3.8	2.7	1.7
Non-performing loans/ Total loan portfolio	**11.9**	**10.7**	**7.4**

The structure of deposits and loans in 2001 (%)
(at year-end)

	Deposits	Loans
Households	59.8	11.0
Government sector	7.4	14.3
Corporate	26.3	69.9
Foreign	4.7	4.5
Other	1.8	0.3
Total	**100.0**	**100.0**

The structure of deposits and loans in 2001 (%)
(at year-end)

Maturity of Deposits		Loans*	
At sight	51.2	Long-term loans (over 3 years)	18.3
Within one year	46.3	Medium-term loans (1-3 year)	30.5
Over one year	2.5	Short-term loans (1 year and less)	51.2
Total	**100.0**	**Total**	**100.0**

** net value*

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

Type of financial institution	FOREX Assets/Total Assets			FOREX Liabilities/Total Liabil.		
	1999	2000	2001	1999	2000	2001
Commercial banks	48.1	52.4	49.8	52.9	52.6	50.1
Foreign bank branches	88.3	86.3	71.1	87.3	79.5	81.0
Banks operating under special laws	60.0	69.3	-	34.5	70.6	-
Financial institutions, average	**49.6**	**54.8**	**51.3**	**53.7**	**55.1**	**52.3**

Profit and loss statement
(at year-end)

USD million

Revenues	1999	2000	'2001
Interest income	212.2	220.0	217.3
Interest expenses	87.9	104.6	100.2
1) Net interest income	124.3	115.4	117.1
2) Profit from other financial and investment services (including dividends)	61.8	81.9	97.6
Of that: profit from commissions	49.5	50.1	60.4
3) Gross financial and investment services profit (1+2)	186.1	197.3	214.7
4) Overheads*	182.9	184.6	220.2
5) Extraordinary profit	2.8	-	0.4
6) Pre-tax profit (3-4+5)	6.0	12.7	-5.1

** Including expenses for specific provisions*

LIETUVOS BANKAS

Average balance sheet items
(at year-end)

USD million

Items	1999	2000	2001
Average balance sheet total (assets total)	2783.4	3212.4	3583.8
Average own capital	336.9	320.4	341.9

Components of the banking sector return on assets (%)
(at year-end)

Items	1999	2000	2001
In proportion to the average balance-sheet total			
Interest income	7.6	6.9	6.1
Interest expenses	3.2	3.3	2.8
1) Net interest income (interest margin)	4.5	3.6	3.3
2) Profit from other financial and investment services (including dividends)	2.2	2.6	2.7
Of that: profit from commissions	1.8	1.6	1.7
3) Gross financial and investment services profit (1+2)	6.7	6.1	6.0
4) Overheads	6.6	5.8	6.1
5) Extraordinary profit	0.1	-	-
Pre-tax profit (ROA)	**0.2**	**0.4**	**-0.1**

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

Revenues	1999	2000	2001
Interest income	71.8	70.3	66.2
Profit from operations in foreign exchange	5.0	6.7	4.8
Income from services and commissions	20.1	19.1	22.3
Other bank income	3.1	3.9	6.7
Total revenues	**100.0**	**100.0**	**100.0**
Expenditures	**1999**	**2000**	**2001**
Interest expenses	30.3	34.7	30.1
Operational expenses	36.9	36.1	37.5
Expenses for specific provisions	11.9	9.5	9.4
Other expenses	20.9	19.7	23.0
Total expenses	**100.0**	**100.0**	**100.0**
Net profit (loss), USD million	**3.7**	**13.2**	**-5.6**

Structure of registered capital and own funds of financial institutions in 2001
(at year-end)

Type of financial institution	Registered Capital USD million	/Total assets %	Own Funds USD million	/Total Liabilities %
Commercial banks	244.5	6.8	363.1	11.3
Foreign bank branches	21.4	8.2	18.6	7.7
Credit unions	1.0	11.9	1.1	15.4
Financial institutions, average	**266.9**	**6.9**	**382.8**	**11.1**

2001 DEVELOPMENT IN THE MACEDONIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The year 2001 was an extremely tough period for the Republic of Macedonia. The political and security crisis and the war upheavals severely affected the total economic movements in the country, evident through the lower economic activity of the economic agents, declined industrial output, lower foreign trade and reduced foreign exchange inflows. Thus, after five years of continuous upward trend, in 2001 a real GDP decline of 4.1% was registered in the Republic of Macedonia, which reflects the extreme deterioration in conditions.

Monetary aggregates in 2001 were affected by the overall situation in the economy and the psychological factors due to the war crisis, as well as by certain extraordinary factors, like the conversion of the 12 European currencies into euro and the payment system reform. Thus, the money supply M1 increased by 14.5% in 2001 relative to the previous year, while the broader monetary aggregates realized exceptionally high growth rates, which is due to the effect from deposited foreign currencies in the banks prior to the actual replacement of the 12 European currencies with the new euro currency. Thus, the money supply M2 increased by 70%, while the broadest monetary aggregate M4 by 66.1%.

Deteriorated security in the country in 2001 had a negative impact on the foreign trade, mainly because of the cancelled contracts with the foreign partners and indirectly, because of the lowered domestic output. Thus, in 2001 the foreign trade of the Republic of Macedonia decreased by 16.5%, with a decline in the exports and the imports by 12.4% and 19%, respectively. In 2001, the deficit in the current account of the balance of payments increased by more than three times, mainly due to the increased deficit in services and transfers. In 2001 the highest amount of foreign investments of US Dollar 442 million was registered, as a result of the privatization of the Macedonian Telecom in January 2001. Gross foreign exchange reserves of the National Bank of the Republic of Macedonia increased by US Dollar 62 million in 2001 (mainly as a result of increased Government foreign currency deposits) and as of December 31, 2001 reached US Dollar 775 million. Having in mind the decline in the imports, it resulted in an increased average import coverage, equalling 5.5 months. Despite the difficult situation in 2001, the Republic of Macedonia continued with the regular repayment of the foreign liabilities, retaining the position of a less indebted country. Since the amount of repaid liabilities exceeded the withdrawn funds, the foreign debt of the Republic of Macedonia decreased by 3.2%, compared to the previous year, and in the end of 2001, it equalled US Dollar 1,440 million.

In such difficult circumstances, 2001 was an exceptional example of a successful coordination of the monetary and the foreign exchange policies with the fiscal policy, aimed at maintaining macroeconomic stability. Namely, in a period when it was necessary to increase budget expenditures for security needs, as a factor that acts towards liquidity increase in the economy, the monetary policy was necessarily directed towards reserve money withdrawal, in order to neutralize the effects from the increased budget spending. This contributed to a reduction of the potential destabilizing factors that affect the exchange rate, as well as the inflationary impulses from the high liquidity in the economy, which in the end resulted in maintained price stability. Thus, the realized average inflation rate of 5.5% in 2001 was almost at the same level as in the previous year (5.8%).

The strategic goal of the Republic of Macedonia is its entrance in the European Union. Hence, in 2001 the Stabilization and Association Agreement with the European Union was signed, and its positive effects are expected in the coming years. The year 2001 was marked with a number of reforms in the financial sector. Despite the situation in the economy, the payment system reform was successfully completed. Herewith, in the beginning of 2002 the payment system was transferred to the banks, while the settlement among the banks is conducted through the NBRM. The pension system reform, the activities related to the money laundering prevention and many other reforms for further development of the financial system are in process. Simultaneously, several new laws related to the economic issues were prepared, and most of them became effective in 2002. In this context, especially important is the new Law on the National Bank of the Republic of Macedonia (effective since January 2002), as a modern law, compatible with the EU standards, which should mainly provide higher independence of the Central Bank.

DEVELOPMENT OF THE BANKING SYSTEM

Structure of the banking system

a lábjegyzet számát kérem beírni

At the end of 2001, the banking system of the Republic of Macedonia consisted of 21 commercial banks and 17 savings houses; 18 banks are authorized to conduct all financial activities, while remaining three banks are authorized to conduct only domestic banking operations. Based on the experience from the other countries, where special-purpose banks exist, several years ago, a special bank[9] for development promotion was established in the Republic of Macedonia.

Compared to December 31, 2000, the number of banks dominating the banking system of the Republic of Macedonia, decreased. Also, the general downward trend in the number of savings houses, present over the past years, continued. The basic reason for the decreased number of banks is the process of consolidation of the banking system in the Republic of Macedonia, which started in 2001. This trend was a result of the higher competition in the banking system resulting from the strategic foreign investment in some of the larger banks in the Republic of Macedonia in 2000, as well as due to the reforms of the payment operations and their transfer to the commercial banks.

The banks are the core element of the Macedonian banking system. As of December 31, 2001, the share of the savings houses assets in the total assets of the banking system of the Republic of Macedonia, accounted for 0,6%, and compared to the end of 2000, it decreased by 0,8 percentage points.

One of the main features of the banking system structure is the significant concentration of the financial services, offered by the two largest banks. As of

9 The name of the bank is Macedonian Bank for Development Promotion, established in 1998, in accordance with a special Law. The main purposes of this Bank are supporting the foundation and operation of small and medium enterprises and supporting and financing the export activities. This Bank is a shareholding company, with the Government of the Republic of Macedonia being the main shareholder.

December 31, 2001, the two largest banks hold 55,8% of the total assets of the banking system, while their market share in the total volume of on-balance sheet and off-balance sheet activities of the banking system, accounted for 55,5%. The market share of the remaining 19 banks ranged from 0,6% to 7,7% in the total scope of activities of the banking system.

The concentration of the banking system is even more significant, if the amount of mobilized total deposits into the banks is used as an indicator for analysis. As of December 31, 2001, the two largest banks hold 66,5% of the total deposits. On the other hand, if the analysis is based on the capital strength of the banking institutions, the concentration of the banking system into the two largest banks is not so significant. As of December 31, 2001, the own funds of the two largest banks accounted for 29,6% of the total own funds of the banking system.

As of December 31, 2001, the level of privatization of the Macedonian banks equalled 84,3%. If "Macedonian Bank for Development Promotion", as a 100% state-owned bank, is excluded from the analysis, the level of the privatization of the banking capital equalled 88,6%. This indicates a good progress in decreasing the role of state ownership in the banking system.

The share of foreign capital in the total capital of the Macedonian banks equals 40,1% and it is present in 17 banks, ranging from 0,3% to 100%. Foreign investors with more than 50% of their capital own eight banks, and as of December 31, 2001, those banks controlled 51,1% of total assets of the banking system. Generally, the entrance of foreign banking capital into the Macedonian banking system gives a very important incentive for increasing the level of competition among banks. The real effects of the entrance of the foreign banking capital should be expected in the following years. Introduction of new financial instruments, declining of the interest rates, improvement of the corporate governance of the banks and improvement of the banks efficiency are some of the effects that are expected to reflect in the banking system. The local banks will be forced to follow the trend of implementing the innovations and the worldwide standards of banking, introduced by the foreign banks, which of course, will be reflected on the overall performances of the banking system of the Republic of Macedonia.

Activities of the Macedonian banks

The upward trend of the total assets of the banks in the Republic of Macedonia registered over the past years was interrupted in 2001, due to the political and security crisis. The deteriorated security and the more restrictive measures of the monetary policy in the first half of 2001 inevitably affected the volume and the structure of the total activity of the banks in the Republic of Macedonia.

The normalization of the political and security situation in the Republic of Macedonia in the fourth quarter of 2001 and firm support of the positions of consistent macroeconomic policy in the country, incurred the process of normalization of the overall economic courses at the end of the year. Simultaneously, the actual replacement of the 12 European currencies with the new euro currency, as a major characteristic of the foreign exchange and exchange offices market in the last months of the year and the possibility for free conversion of the households' foreign currency savings into euro, if deposited in a bank, resulted in considerable increase in the foreign currency deposits in the banks.

The replacement of the 12 European currencies with the new euro currency has an especially important effect on the Macedonian economy representing a historical opportunity for pulling out the savings of the households kept "under the mattresses" and depositing them in the banks, which was done in order to avoid the commission for conversion. This provided a more precise information about the amount of the non-mobilized households savings (in the last quarter of 2001 around US Dollar 360 million were deposited in the banks), and it was a unique opportunity for the banks to increase their deposit potential through conducting an active policy of attracting funds, and what is even more important, through retaining the deposits in the banks after the conversion. The banks' deposit base was increased by 50% compared to December 31, 2000, while the households' foreign currency deposits increased by 209%.

Extension of credits and deposit taking operations are still the dominant activities of the Macedonian banks. Thus, as of December 31, 2001, the placements to clients and other banks represent 56.9% of the total assets, while the total deposits represent 68.5% of the total source of funds of the banking system in the Republic of Macedonia.

Main indicators for the quality of the credit portfolio of the banks calculated as of December 31, 2001 show a trend of deterioration in 2001. The share of the total exposure classified in the risk categories C, D and E in the total portfolio of banks as of December 31, 2001 equalled 38.2%, which is an increase of 3.4 percentage points compared to December 2000. The risk level of the credit portfolio of the Macedonian banks that shows the relation between the calculated potential losses and the total credit exposure equalled 23.6%, as of December 31, 2001.

The average capital adequacy ratio of the banks in the Republic of Macedonia, as a relation between the guarantee capital and the risk-weighted assets, equalled 34.3% at the end of 2001. All banks in the Republic of Macedonia meet the prescribed minimum capital adequacy ratio of 8%.

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

The character and the constitution of the banking system of the Republic of Macedonia are based on the regulatory framework, given with the National Bank of the Republic of Macedonia Act (*Official Gazette of RM* No.3/2002), the Banking Law (*Official Gazette of RM* No.63/2000 and 37/2002), as well as the other prudential regulation. In 2001, the activities of the National Bank of the Republic of Macedonia in this domain of the supervisory function were focused on completion of the process that followed after the adoption of the Banking Law, primarily directed toward clarification of certain provisions of the Banking Law by adoption of adequate by-laws, as well as further compliance of the domestic supervisory regulation and the supervisory practices with the international supervisory standards and the 25 Core Principles for Effective Banking Supervision.

Therefore, in the first half of 2001, the package of new supervisory regulations was completed, which replaced the existing decisions passed in 1995 and 1996. The new supervisory decisions incorporate the contemporary Basle Principles and Practices for Prudent Operations of the banks and regulate the core supervisory standards, such as calculation of the banks' capital adequacy, credit risk assessment by prescribing a methodology for classification of the banks' risk assets, identification, measuring and monitoring the country risk; identification, measuring and monitoring the credit concentration limits, etc. Due to the complexity of these supervisory standards, their application went into force starting March 31, 2002. The adjustment period was necessary for the banks to adopt adequate changes in the their internal systems and software programs, as well as considering the expected effects on the financial position of the banks.

In 2001, the Anti-Money Laundering Law (*Official Gazette of the Republic of Macedonia* No. 70/2001) was adopted, which stipulates the measures and actions for money laundering identification and prevention, as well as the entities authorized to undertake these measures and actions. The National Bank of the Republic of Macedonia has been involved in the anti-money laundering process, through the provisions of this Law, primarily regarding the control of the internal anti-money laundering systems of the banks and the savings houses.

THE ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY

National Bank of the Republic of Macedonia, as an authorized supervisory body, performs its supervisory function at the following levels: 1/ Licensing function, by processing the submitted applications for issuing licenses and approvals, in compliance with the regulations; 2/ Examination of the operations of the banks and savings houses; and 3/ Undertaking corrective actions against banks and savings houses.

Within the framework of the licensing activities, in 2001, the National Bank of the Republic of Macedonia issued three licenses for changes in the status: (two acts of acquisition and one act of merger among domestic banks). Also, during 2001, a new foreign bank was established in the Republic of Macedonia and the Postal Savings House was transformed into a Postal Bank. During the previous year, the license of one savings house was revoked and the liquidation procedure was opened.

In the area of issuing approvals on various bases, in accordance with the provisions of the Banking Law, the National Bank of the Republic of Macedonia performed the following activities: issuing approvals for appointing an executive body of the banks; issuing approvals for changes in the ownership structure of the voting shares; issuing approvals for changes in the Statute; for establishing a brokerage company; issuing approval for change in the name; for issuing a prior approval for access to a report, etc.

According to the legal framework, each bank in the Republic of Macedonia is subjected to a full-scope examination by the National Bank of the Republic of Macedonia, at least once in 18 months. In 2001, the National Bank of the Republic of Macedonia carried out 47 on-site supervisory examinations, 19 of which full-scope supervisory examinations and 28 targeted supervisory examinations. The full-scope on-site examination was carried out in 9 banks and 10 savings houses. Moreover, 28 targeted examinations were carried out in 12 banks and 5 savings houses. The full-scope on-site examination is carried out on the basis of the CAMEL rating system, which covers risk analysis and assessment of several segments of the operations of the financial institutions.

The National Bank of the Republic of Macedonia, within its legal authorizations and in order to preserve the stability and the soundness of the banking institutions and the stability and the soundness of the overall banking system, undertakes corrective actions against banks and savings houses, in which certain irregularities have been identified based on on-site examination and off-site surveillance. According to the Law on the National Bank of the Republic of Macedonia and the Banking Law, the National Bank of the Republic of Macedonia applies wide range of corrective actions in a manner that ensures rapid solution of the problems that can endanger the stability and the soundness of the financial institution.

During 2001, the most common corrective measures and actions undertaken against banks and saving houses were the following: revocation of an approval for executive body; prohibition of lending to certain shareholders; ban on performing all or certain banking operations within a certain period of time; ban on taking deposits of legal entities; action for reducing the credit exposure within the prescribed limits; action for bank exclusion from the foreign exchange market; action for exclusion of the net debtors from the bank's Board of Directors; ban on lending to clients classified in risk categories C, D and E; action for allocation of compulsory reserve of banks aimed at preserving the daily liquidity, and other corrective measures.

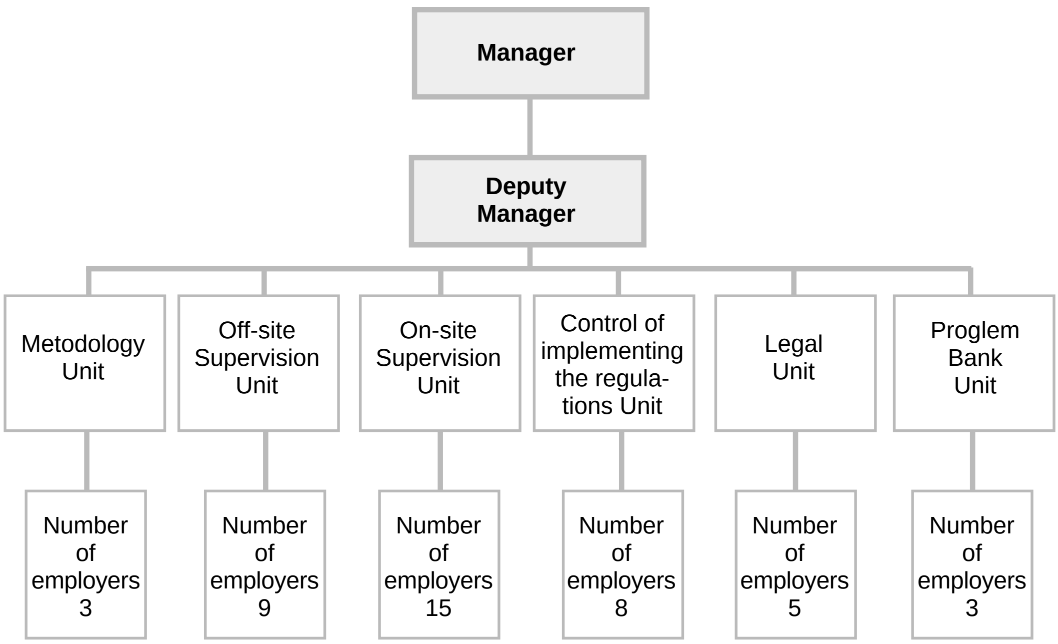
LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN THE REPUBLIC OF MACEDONIA

The legal framework for bank supervision is set out in two laws, the Law on the National Bank of the Republic of Macedonia (*Official Gazette of RM* No.3/2002) and the Banking Law (*Official Gazette of RM* No.63/2000 and 37/2002). Under the current legal framework, the National Bank of the Republic of Macedonia (NBRM) is the only agency involved in the supervision of banks and savings houses. Simultaneously, National Bank of the Republic of Macedonia is the only agency involved in the process of licensing of banks and savings houses in the Republic of Macedonia. This process is clearly defined in the above-mentioned laws and by-laws passed by the National Bank of the Republic of Macedonia Council.

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

SUPERVISION DEPARTMENT ORGANIZATIONAL CHART

(Total number of employers: 43)



INTERNATIONAL ACTIVITIES OF THE SUPERVISION AUTHORITY

The direct investments of several foreign banks in the Macedonian banking system imposed the need for regulating the cooperation with the supervisory bodies of the home countries of parent banks. According to the legal regulations, NBRM may exchange information with foreign supervisory agencies with relation to supervision of internationally active banks. All issues regarding the mutual rights and obligations of supervisory agencies are resolved by concluding bilateral agreements. For that purpose, bilateral agreements have been concluded with the Bank of Slovenia and the Central Bank of the Russian Federation, and the conclusion of such agreement with the Bank of Greece, Bulgarian National Bank and the Banking Regulation and Supervision Agency of Turkey, is in process. These agreements clearly define all elements needed for timely and adequate conduct of the supervision of cross-border Establishments.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE REPUBLIC OF MACEDONIA

Currently, there are three domestic supervisory agencies operating in the Republic of Macedonia: National Bank of the Republic of Macedonia, as an authorized body for banking supervision, Agency for Supervision of the Insurance Companies; Securities and Exchange Commission, as an authorized body for supervision of investment funds. There is an ongoing procedure for enacting the Law on Private Investment Funds, which, among other aspects, also regulates the establishment of a special agency for supervision of pension funds. Despite the fact that so far there was no need for regulating the relations among domestic supervisory authorities, a significant intensification of the cooperation among them is expected in the future, which should be regulated through certain bilateral agreements, i.e. Memorandum of Understanding.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2001

The main objectives of the Supervisory Authority in 2001 were focused on strengthening of the institutional and operational framework and implementation of more effective operational and supervisory rules. The improvement of the regulatory framework was made for the purpose of compliance with the European legislative in the area of banking and the Basle Core Principles for effective Banking Supervision.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

During the last quarter of 2001, Banking Supervision Department carried out a self assessment in order to determine the level of compliance of the banking supervision of the Republic of Macedonia with the 25 CPs (25 Core Principle on Effective Banking Supervision). The self – assessment has been based mainly on two Basel documents: "Core Principles Methodology" (October, 1999) and "Conducting a Supervisory Self-Assessment – Practical Application (April 2001). According to these methodologies, five levels of compliance of the banking supervision are determined: compliant, largely compliant, materially non-compliant, non-compliant and not applicable. Based on the conducted self-assessment, the results are as follows: the level of compliance is determined for 7 Principles; 16 CPs are largely compliant; 4 CPs are materially non-compliant; 1 CP is non-compliant and 2 CP's are not applicable. In order to achieve large compliance with the CPs, the future activities of the banking supervision in the Republic of Macedonia should be focused on the following issues: adoption of regulation on consolidated supervision; regulation and supervisory procedures for identification, measurement and control of market risk and other material risks; implementation of the risk management concept by the Macedonian banks; defining the role of the regulatory bodies in the process of anti-money laundering and development of adequate supervisory procedures in this regard.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	1999	2000	2001
Banks	23	22	21
Savings houses	16	19	17
Brokerage firms			10
Deposit insurance funds	1	1	1
Insurance companies	5	4	4
Stock exchange	1	1	1
Money market	1	1	1
Financial Institutions, total	**47**	**48**	**55**

Ownership structure of financial institutions in 2001 on the basis of registered capital (%) (at year-end)

Item	Type of financial institution * Banks	Total
State ownership	4.90	4.90
Other domestic ownership	51.60	51.60
Domestic ownership total	56.50	56.50
Foreign ownership**	43.50	43.50
Financial institutions, total	**100.00**	**100.00**

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

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

Item	1999	2000	2001	2001/1999 in percentage points
State ownership	6.47	4.90	4.90	-1.57
Other domestic ownership	82.07	50.10	51.60	-30.47
Domestic ownership total	88.54	55.00	56.50	-32.04
Foreign ownership	11.46	45.00	43.50	32.04
Financial institutions, total	**100.00**	**100.00**	**100.00**	

** Data for the other financial institutions are N/A*

Distribution of market shares in balance sheet total (%)

Type of financial institution	1999	2000	2001
Banks	99.00	98.60	99.40
Savings houses	1.00	1.40	0.60
Financial institutions, total	**100.00**	**100.00**	**100.00**

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

Assets	1999	2000	2001
1 Cash and balance with nbrm	7.90	8.20	25.10
2 Securities rediscounted by nbrm	2.40	5.30	1.80
3 Debt securities	11.50	9.40	7.20
4 Placements to other banks	31.00	33.30	28.00
5 Placements to clients	33.70	33.40	28.90
6 Accrued interest and other assets	5.90	3.40	2.40
7 Capital investments	1.90	1.30	1.20
8 Fixed assets	5.70	5.70	5.40
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**1999**	**2000**	**2001**
1 Deposits of banks	4.24	6.04	2.30
2 Sight deposits	38.37	39.86	43.40
3 Short-term deposits up to one year	11.46	13.28	18.70
4 Short-term borrowings up to one year	6.88	2.86	4.50
5 Other liabilities	3.73	3.10	2.80
6 Long-term deposits over one year	5.14	3.74	4.10
7 Long-term borrowings over one year	7.97	6.68	5.30
8 Provisions for off-balance sheet liabilities	1.54	1.14	0.80
9 Owned funds	20.67	23.30	18.10
Total liabilities	**100.00**	**100.00**	**100.00**

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

Type of financial institution	1999	2000	2001
Banks	19.39	17.07	14.62
Financial Institutions, total	**19.39**	**17.07**	**14.62**

Solvency ratio of financial institutions

Type of financial institution	1999	2000	2001
Banks	28.67	36.73	35.30
Savings houses	45.81	N/A	N/A
Financial institutions, average	**28.79**	**36.73**	**35.30**

Asset portfolio quality of the banking system

in (000) denars

Asset classification	1999	%	2000	%	2001	%
A	21,617,057	42.69	21,529,559	42.57	23,303,434	40.97
B	8,083,135	15.96	11,432,165	22.60	11,844,422	20.83
C	8,217,902	16.23	6,121,207	12.10	7,891,319	13.87
D	9,174,895	18.12	7,122,007	14.08	7,740,221	13.61
E	3,541,401	6.99	4,371,554	8.64	6,095,506	10.72
Classified total	**50,634,390**	**100.00**	**50,576,492**	**100.00**	**56,874,902**	**100.00**
Provisions	**11,359,719**		**10,842,231**		**13,447,837**	

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

	Deposits	Loans
Households	57.78	9.76
Public sector	4.74	0.28
Corporate	31.32	78.98
Domestic banks	2.71	6.31
Foreign	0.58	0.00
Other	2.87	4.67
Total	**100.00**	**100.00**

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

Maturity of deposits		Maturity of loans	
At sight	64.78	Long term loans*	49.92
Within one year	29.01	Medium term loans	
Over one year	6.21	Short term loans**	50.08
Total	**100.00**	**Total**	**100.00**

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

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

Type of the financial institution	Forex assets/Total assets 1999	2000	2001	Forex liabilit./Total liabilit. 1999	2000	2001
Banks	55.46	55.29	63.77	39.63	42.16	53.07
Fin. institution, average	**55.46**	**55.29**	**63.77**	**39.63**	**42.16**	**53.07**

Profit and loss statement

in thousand USD

Items	1999	2000	2001
Interest income	79,707	79,068	64,812
Interest expenditure	44,160	39,366	37,953
1) Net interest income	35,546	39,702	26,859
2) Profit from other financial and investment services (including dividends)	49,434	31,686	40 307
Of that: Profit from commissions	34,113	28,564	26,053
Of that: Net provisions			
3) Gross financial and investment services profits (1+2)	84,980	71,388	67,166
4) Provisions for potential losses	56,557	44,725	36,752
5) Overheads	65,956	60,807	67,049
6) Extraordinary profits	48,586	46,526	29,208
7) Pre-tax profit (3-4-5+6)	11,054	12,382	-7,428

Average balance sheet items

(in thousand USD)*

Items	1999	2000	2001
Average balance-sheet total (assets total)	1,060,137	1,166,178	1,172,585
Average own capital	238,050	260,837	276,862

** Calculated by the exchange rate of NBRM on December 31. 2001*

Components of the banking sector return on assets (%)

Items	1999	2000	2001
Interest income	7.52	6.78	5.53
Interest expenditure	4.17	3.38	3.24
1) Net interest income (interest margin)	3.35	3.40	2.29
2) Profit from other financial and investment services (including dividends)	4.66	2.72	3.44
Of that: Profit from commissions	3.22	2.45	2.22
Of that: Net provisions	0.00	0.00	0.00
3) Gross financial and investment services profits (1+2)	8.02	6.12	5.73
4) Provisions for potential losses	5.33	3.84	3.13
5) Overheads	6.22	5.21	5.72
6) Extraordinary profits	4.58	3.99	2.49
7) Pre-tax profit (ROA)	1.04	1.06	-0.63

Note: the average assets and the average own capital are calculated by dividing the sum of the quarterly amounts with 4

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

in (000) denars

Revenues	1999	2000	2001
Interest income	4,809,470	5,165,359	4,483,177
Other income	5,563,471	5,109,455	4,808,419
Expenditures	**1999**	**2000**	**2001**
Interest expenses	2,664,626	2,571,715	2,625,280
Provisions for potential loan losses	3,412,630	2,921,778	2,542,221
Other expenses	3,628,687	3,972,418	4,637,877
Income tax	164,085	163,729	106,551

Structure of registered capital and own funds of financial institutions in 2001

Type of financial institutions	Registered capital USD* million	/ Total assets %	Own funds USD million	/ Total liabilities %
Banks	256	16.75	277	18.14
Fin. Institutions, average	**256**	**16.75**	**277**	**18.14**

** Calculated by the exchange rate of NBRM on December 31, 2001*

THE DEVELOPMENT OF THE BANKING SYSTEM OF THE REPUBLIC OF MOLDOVA IN 2001

MACROECONOMIC ENVIRONMENT

The following macroeconomic achievements were registered in 2001:

- Gross Domestic Product in 2001 amounted to MDL 19019.3 million, exceeding by 6.1% in real terms the level of the previous year;
- Industrial output increased by 14.2% in real terms as compared to 2000 and amounted to MDL 10348.0 million;
- Agricultural output from all types of farms amounted to MDL 9141.0 million in current prices, exceeding by around 4.0% in comparable prices the level in 2000;
- Fix capital investments in national economy in 2001 amounted to MDL 1621.5 million, which is by 2.0% (in real terms) less than in 2000;
- Retail sales of goods amounted to MDL 7661.6 million and exceeded by 18.2% the value of the previous year;
- Paid services to the public amounted to MDL 3273.7 million, or by 19.4% more than in the previous year;
- The average monthly salary of an employee in national economy amounted to MDL 519.2, increasing in real terms by 15.9% as compared to the previous year;
- The increase of the level of consumer prices at the end of 2001 accounted for 6.3%. At the end of 2000 the same indicator constituted 18.4%;
- Export (FOB) of goods in 2001 amounted to US$ 567.2 million, which is by 19.0% more than in 2000. Import (FOB) of goods increased by 14.2% as compared to the previous year and totaled US$ 893.6 million. The deficit of the balance of payments in 2001 amounted to US$ 326.3 million or by 6.7% more than in 2000.

DEVELOPMENT IN THE BANKING SYSTEM

There were 19 commercial banks on the territory of the Republic of Moldova as of 31.12.01, including 3 branches of foreign banks authorized by the National Bank of Moldova. In 2001 the NBM did not authorize the establishment of any new bank and withdrew the license to perform financial activity from one bank.

The banking organizational structure was subject to a significant modification. The total number of banking offices accounted for 739, including 19 offices of banks (based in Chişinău), 147 branches, 193 representative offices and 380 agencies; the number of banking related units increased by 148 institutions (25.9%) as compared to the beginning of the year. The larger network of commercial banks' subdivisions generated the territorial diversification of the network and covered a greater number of localities served by banking subdivisions. The extensions allowed also for the diversification of the spectrum of services rendered to the public and economic agents from outlying districts.

Both qualitative and quantitative indicators of the banking system evolved during the year. Total assets of the banking sector increased by MDL 1308.8 million (28%) and amounted as of 31.12.2001 to MDL 5976.5 million.[10] Taking into consideration the inflation level, assets increased in real terms by 20%.

The higher value of assets was due to the larger value of banks' liabilities by MDL 1094.8 million (33.8%) and of the share capital by MDL 214 million (15%).

Credits and net financial leasing hold the largest share in total assets – 48.6%, which is by 5.2 percentage points more than in the previous year.

The credit portfolio quality followed its positive trend due to the substantial development of internal control, the consolidation of banking internal procedures on credits provision and supervision, including problematic credits and the improvement of the activity of internal control subdivisions. Thus, the share of credits classified as unfavourable (substandard, doubtful and compromised) reduced by 10.2 percentage points; the weight of credits classified as standard and supervised increased by same value and accounted as of 31.12.2002 for 89.6% of total credit portfolio. Following the reduction of credit portfolio related the ratio between credit loss provisions (risk fund) and total credits decreased by 3.8 percentage points and accounted for 7.9%.

Liquid assets increased during the reported period by MDL 418.4 million (25.3%); the high liquidity ratios contributed to reduce the risk of clients' failure to pay in due time. As of 31.12.2001, banks were in position to pay both long-term and current liabilities; the weight of liquid assets (cash, deposits with NBM, state securities, net interbank credits with the term of up to 1 month) in total assets of the banking system accounted for 34.7%.

The total regulatory capital within the banking system amounted as of 31.12.2001 to MDL 1640.7 million, increasing by 17.2% as compared to the beginning of the year. The main source of capital increase was the net income gained by commercial banks; this income amounted in 2001 to MDL 222.1 million.

The average of the risk weighted capital sufficiency within the banking system accounted for 43.1% as against the minimum level of 12%. All these fact point to the solid coverage of assets with own capital and, at the same time, to large reserves unused by banks related to the increase of assets.

Foreign investments in the banking capital increased in 2001 by 1.3 percentage point and accounted as for 31.12.2001 for 60.9%.

Deposits hold the largest weight in banking liabilities – 79.5% or MDL 3445.1 million, which is by 38.4% more than at the beginning of the year. Deposits by individuals accounted for 48.8% in total deposits, deposits by businesses – 49.7% and deposits by banks – only 1.6%.

Efficiency of assets accounted for 4.3% and of share capital – 14.3%.

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

The banking legislation of the Republic of Moldova was subject to revision and modification within the context of significant development of national economy during the period of 1991 to 1995 and the adherence of the Republic of Moldova to

[10] USD 1 = MDL 13.0909 as of 31.12.2001

international financial entities. In July and June 1995 the Parliament adopted new laws to regulate the activity of the National Bank of Moldova and of financial institutions.

The Law on the National Bank of Moldova comprises issues on the consolidation of the NBM role in the establishment and implementation of monetary and foreign exchange policies and the ensurance of a stable and viable financial system.

The Law on Financial Institutions is targeted to protect depositors, to avoid excessive risks in the financial system, to promote a strong and competitive financial sector and to facilitate market forces in rendering financial services. The Law imposes limits on banking activities and an authorization system by the National Bank of Moldova and provides a system of remedy measures for banks that fail to conform to regulations.

In 2001 the Law on Financial Institutions was subject to significant modifications directed towards the adjustment of current norms to new relationship and exclusion of drawbacks. The adoption of these modifications and completions shall contribute to the harmonization and increase of both financial institutions' activity and public confidence in it.

Up to November 2001 the National Bank of Moldova had the right to appoint a administrator responsible for the management and the control of a certain bank in case the legislation or other regulations were violated. Following the modification of the Law on Financial Institutions (15 November 2001), as and when provided by the legislation, the National Bank of Moldova withdraws the bank's authorization to perform financial activities and starts in the relevant court the insolvency process in accordance with the current legislation.

These Laws conform to international standards and set the legal framework fir a stable and viable financial system. Banks are supervised as in accordance with the BASLE Committee core principles for an efficient banking supervision.

Currently, the Republic of Moldova has a two-tier banking system: the National Bank of Moldova and the commercial banks that perform their activity according to the Law on the National Bank of Moldova and the Law on Financial Institutions.

The National Bank of Moldova is placed on the first level; the Bank was set up as an independent legal entity responsible to the Parliament and the public for its activity. The National Bank sets and promotes the monetary and foreign exchange policies; licenses, supervises and regulates the activity of financial institutions; supervises the system of payments of the Republic of Moldova and facilitates the efficient functioning of the interbank payments system; acts as single issuer of national currency; and maintains and manages the state foreign exchange reserves.

The second tier comprises 19 commercial banks that are organized in form of joint stock companies and act on competitive basis.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2001

With the view to ensuring a higher banking security and the increase of the banking capacity to satisfy national and public needs for banking services, the National Bank of Moldova promoted in 2001 the further consolidation of the banking system.

The financial stability of banks is directly dependent on capital investments. Taking into consideration this fact, the National Bank made continuous effort to consolidate banking stability by encouraging banks to conform to minimum capital requirements.

Prudential regulations and internal procedures of the National Bank are subject to permanent revision taking into consideration the generally accepted international practice, the modification of banking situation and other factors with impact upon banking financial system. Within this context and following Basle Committee principles for an efficient banking supervision the NBM has modified the minimum required capital. These requirements shall enter into force on 30 September 2002. Thus, the 1st level capital shall be reduce with net non-material assets determined as in accordance with International Accounting Standards and the 2nd level capital shall be excluded reserves to re-evaluate fixed means and shall be added subordinate debts. At the same time, the minimum required capital the bank has to dispose to perform banking activities shall de set starting from 30.09.2002 as against the base capital (1st level capital).

With the view to efficiently stimulating financial discipline and to increasing credibility into banking system, the National Bank enlarged the requirements on disclosure by commercial banks of information on performed financial activity. To maintain the high level of transparency in the banking system, the National Bank has been, during its on-site controls, supervising the conformance of commercial banks to criteria and methods to disclose information on banking activity as stipulated in the regulations of the National Bank of Moldova.

To ensure and efficient functioning of the financial sector, special focus is put upon the establishment by banks of internal control systems upon which banking functioning in accordance with the current legislation depends. The National Bank supervises the maintenance by commercial banks of these systems at a relevant and adequate level as to ensure the performance of financial operations in a secure and prudent manner. Within the context of banking supervision the NBM examines the policies, regulations and relationship related to issuance – execution – reporting – control of management dispositions approved with the view to correctly and efficiently managing the activity of financial institutions.

With the view to establishing an adequate method to protect commercial banks from implication in transactions that may facilitate illicit activities, the NBM initiated in 2001 draft Recommendations on the elaboration by banks of the Republic of Moldova of programs to prevent money laundering; these Recommendations represent a follow-up of the ones on internal control systems within the banks of the Republic of Moldova.

The National Bank undertook a number of measures to further continue the consolidation of banking supervision and to improve the impact this process has upon the effort to remove negative phenomena in the banking practice.

During the previous year the National Bank introduced a series of modifications to existent normative acts that were ultimately implemented in the activity of commercial banks. Thus, the NBM modified the stipulations related to provision of credits to affiliated persons, establishing the situations when the bank's council may delegate its power to preliminary accept the agreements with the bank's affiliated persons to the executive body of the bank. The requirements on large credit provision was modified as to reduce the net debt on credits extended by the bank to a person or to a number of persons acting in common from 30% of the total regulatory capital to 25%. At the same time, the modified requirement on the aggregate amount of all the bank's credits that this bank is permitted to have outstanding to the ten largest borrowers, including groups of persons acting in common, should not exceed 50% of total credit portfolio. Internal procedures regarding the on-site controls were modified as to include new provisions related to IT, forex operations and money laundering prevention. These modifications were implemented taking into consideration the international practice, including the core principles for an efficient banking supervision issued by the Basle Committee.

The reporting and control process was subject to modification, too. The periodical submission of financial reports (on a quarterly and monthly basis) and the performance of on-site controls (complex control at least once per year, thematic control at banks with reduced prudential level on a quarterly basis) allow the National Bank to permanently supervise the development of the financial situation of both every commercial bank and the general banking sector. The National Bank, upon necessity, reacts within limited terms by imposing relevant measures to settle negative phenomena.

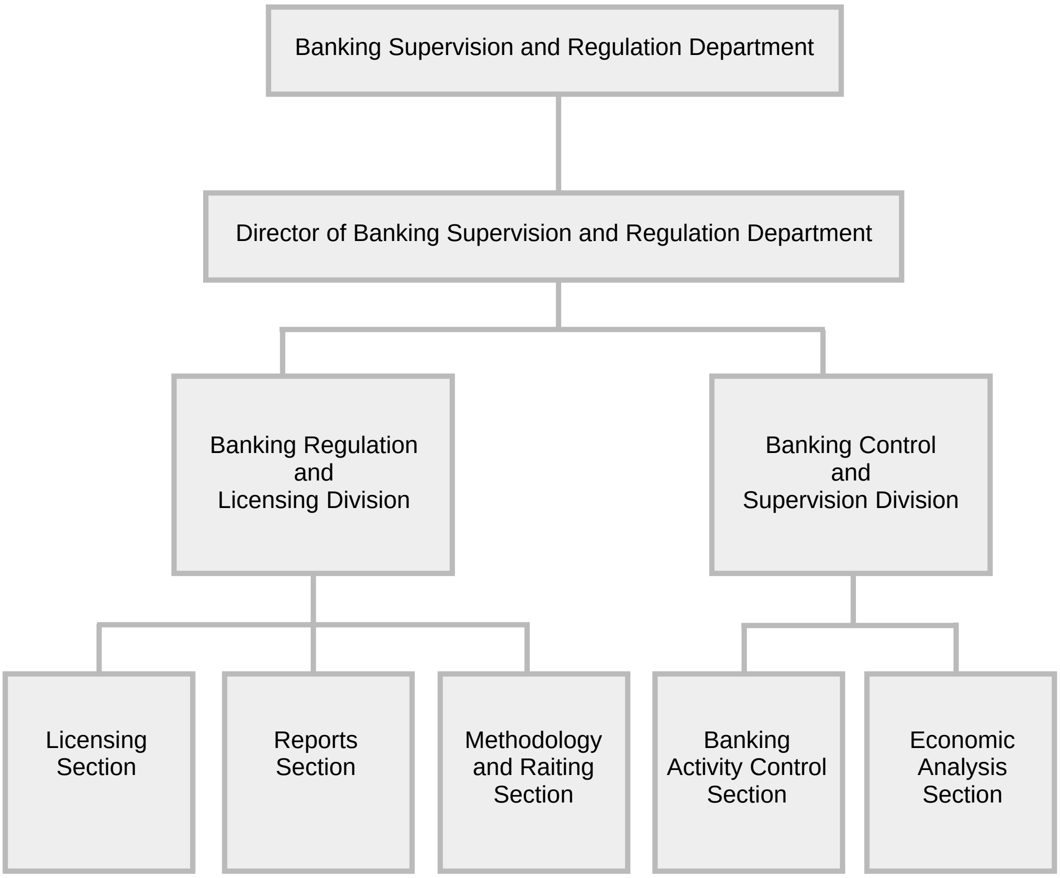
The banks that are, following the on-site controls, evaluated as having a reduced prudential level, are subject to special supervision, which provides the elaboration and implementation of a special program for the bank's financial recovery. As a rule, the implementation of such programs contributes to the reestablishment of a normal banking operation. Thus, following set measures, the reduced number of banks admitting excessive risks in their activity generated the reduction of the weight of assets held by problematic banks in total banking assets from 39.4% to 18.2%.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The base provisions of the Law on Financial Institutions and of the Law on the National Bank of Moldova that stipulate the powers of the banking supervisions authorities are as follows:

- To issue normative acts and to perform relevant measures to exercise powers and attributions as stipulated in nominated Laws by issuing licenses to financial institutions and working out supervision standards and to decide upon the application of normative acts and mentioned measures;
- To perform controls over all the banks and to examine their records, documents and accounts, and the condition under which banks perform their activity and conform to the current legislation.
- To require any employee of the bank to furnish relevant information to the National bank with the view to supervising and regulating the activity of financial institutions.
- To take remedial measures if determining that the bank, its owners or administrators have violated the current legislation, the NBM normative acts, the conditions attached to an authorisation, the breach of a fiduciary duty or have engaged in risky or doubtful operations; these measures may provide as follows:
  - issuance of written warnings;
  - conclusion of an agreement providing for remedial auctions;
  - issuance of written instructions to cease and desist from infractions and undertaking of remedial action;
  - indisputable imposing and payment of fines;
  - dismissal of administrators from position in a bank;
  - cease and desist of financial institution's activity;
  - revocation of license.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES

In September 1999 the National Bank of Moldova and the Central Bank of the Russian Federation signed the Agreement on Collaboration in the field of Supervision of Credit Institutions' Activity.

In July 2001 the National Bank of Moldova and the National Bank of Romania signed the Agreement on Cooperation in the field of Banking Supervision.

The necessity of these agreements was especially determined by the international character of banking operations performed in the Republic of Moldova, the majority of operations being performed with these countries. Such documents are provided to create the relevant legal framework required to reach efficient levels on consolidated basis.

COOPERATION WITH OTHER SUPERVISORY BODIES FROM THE REPUBLIC OF MOLDOVA

With the view to studying the effect of savings and loan associations upon the banking system, NBM quarterly performs analysis of information received from the State Service of Supervision with regard to savings and loan association.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2001

The main strategic objective of the National Bank of Moldova for 2000 is the further consolidation of the banking system, having as target the further improvement of banking functioning and the ultimate higher security of banking activity and increased banking capacity to satisfy demands of national economy and public.

With the view to reach this target and based on market rules, the National Bank of Moldova creates all incentives to promote processes directed towards banking consolidation. Each bank follows same directions separately and within the banking system in general.

The National Bank of Moldova stimulates the consolidation of each separate bank via measures directed towards the reduction of risks related to active operations of the bank, the increase of risk coverage level with own capital, the improvement of methods applied to manage assets and liabilities, the development of the internal control system and of the management activity.

Within the banking system in general, the National Bank of Moldova supports the consolidation process through restricting or suspending the activity of problematic banks with regard to attraction of deposits from the financial market, creating in such a way favourable conditions to concentrate temporary available on financial market means within banks with high prudential level. NBM supports also banking merging and association, allowing banks to get more competitive on the market. In case banks admit deviations from legislative stipulations and other banking norms that result or may result in losses and substantial or total reduction of capital, NBM withdraws the licence. At the same time, the National Bank maintains efficient prudential requirements with regard to banking licensing, having as target the formation of new banks that at the moment of licensing do not have any indices of possible further problems. In such a way the National Bank of Moldova promotes the consolidation of the banking sector based on commercial initiatives submitted by banks.

STATISTICAL TABLES

Number of financial institutions
(at year–ends)

Type of financial institution	1999	2000	2001
Banks, including	20	20	19
branches of foreign banks	3	4	3

Ownership structure of the financial institutions in 2001
on the basis of registered capital
(at year–end)

Item	Weight (%)
State ownership	3.57*
Other domestic ownership	35.57
Domestic ownership total	39.14
Foreign ownership	60.86
Banks, total	**100.0**

**: The state is defined here to include the federal, regional and municipal levels*

Ownership structure of capital of the financial institutions in 2001 on the basis of registered capital (%) (at year–ends)

Item	1999	2000	2001	2001/1999
State ownership	4.16	3.9	3.57	0.86
Other domestic ownership	46.96	36.49	35.57	0.76
Domestic ownership total	51.12	40.39	39.14	0.77
Foreign ownership	48.88	59.61	60.86	1.25
Banks, total	**100.0**	**100.0**	**100.0**	

Distribution of market shares in balance sheet total(%)

Type of financial institution	1999	2000	2001
Commercial banks	95.67	95.05	95.1
Foreign branches	4.33	4.95	4.9
Banks, total	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system in 2001 (%) (at year–end)

Assets	1999	2000	2001
Cash	2.95	3.47	4.63
Due from banks and BNM	29.70	29.05	22.59
Net loans and financial leasing	40.60	43.36	48.63
Total securities	9.53	8.69	9.86
Others	17.22	15.43	16.92
Total assets	**100**	**100**	**100**
Liabilities	**1999**	**2000**	**2001**
Deposits by natural persons	19.29	20.7	28.13
Deposits by legal persons	30.31	32.62	29.52
Others	21.50	16.06	14.86
Shareholder capital	28.9	30.62	27.49
Total liabilities and shareholder capital	**100.0**	**100.0**	**100.0**

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

Type of financial institution	1999	2000	2001
Banks, total	**N/A**	10.43	8.21

Solvency ratio of financial institutions

Type of financial institution	1999	2000	2001
Capital adequacy ratio, average (≥ 12%)	46.04	48.56	43.11

Asset portfolio quality of the banking system

thou MDL

Asset Classification	1999	2000	2001
Standard	621,281.08	1,122,290.55	1,853,775.37
Supervised	507,695.84	697,311.83	972,209.46
Substandard	221,441.41	324,214.08	194,190.06
Doubtful	213,821.72	139,339.04	121,151.66
Bad	33,395.40	9,510.09	13,413.10
Classified total	1,597,635.45	2,292,665.59	3,154,739.65
Specific Reserves	298,004.13	268,781.56	248,394.55

The structure of deposits and loans in 2001(%) (at year–end)

Deposits	%	Loans	%
Natural persons	48.79	Credits to agriculture and food industry	26.53
State budget and local budgets	9.66	Credits for real estate, construction	7.32
Legal persons	40.00	Consumer credits	2.76
Banks' deposits	1.55	Credits to the Government	2.12
		Credits to energy and fuel industry	5.97
		Credits to industry/commerce	46.46
		Credits for road construction and transportation	3.20
		Other credits	5.64
Total	**100.00**	**Total**	**100.00**

The structure of deposits in 2001 (at year–end)

Maturity of deposits	thousand lei	%
Sight	1,854,435.78	53.83
Time and long-term	1,590,707.15	46.17
Total	**3,445,142.94**	**100.00**
Inclusive in foreign currency	1,477,264.84	42.88

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

Type of the financial institutions	FOREX assets/Total assets (%)			FOREX liabilities/Total liabil. (%)		
	1999	2000	2001	1999	2000	2001
Banks	42.44	41.93	39.16	55.51	51.74	45.71

Average balance sheet items

thou USD

Items	1999	2000	2001
Average balance-sheet total (assets total)	292,855.87	316,789.46	397,716.56
Average own capital	67,994.33	93,355.44	118,977.10

Profit and Loss Statement

thou USD

Items	1999	2000	2001
Interest income	41,936.66	47,495.18	52,257.92
Interest expenditure	15,808.46	16,405.43	19,455.93
1) Net interest income	26,128.2	31,089.75	32,801.99
2) Profit from other financial and investment services (including dividends)	16,191.51	29,067.57	25,966.64
Of that: Profit from commissions	13,598.21	16,296.91	17,102.29
Of that: Net provisions	10,103.14	1,530.46	2,773.17
3) Gross financial and investment services profits (1+2)	42,319.71	60,157.32	58,768.63
4) Overheads	27,852.93	34,583.84	39,554.79
5) Extraordinary profits	0	0	26.47
6) Pre-tax profit (3 – 4 + 5)	14,466.77	25,573.48	19,240.31

Components of the banking sector return on assets (in %)

Items	1999	2000	2001
In proportion to the average balance-sheet total			
Interest income	14.32	14.99	13.14
Interest expenditure	5.40	5.18	4.89
1) Net interest income	8.92	9.81	8.25
2) Profit from other financial and investment services (including dividends)	5.53	9.18	6.53
Of that: Profit from commissions	4.64	5.14	4.30
Of that: Net provisions	3.45	0.48	0.7
3) Gross financial and investment services profits (1+2)	14.45	18.99	14.78
4) Overheads	9.51	10.92	9.95
5) Extraordinary profits	0	0	0.01
6) Pre-tax profit (3 – 4 + 5) (ROA)	4.94	8.07	4.84

Structure of revenues and expenditures of financial institutes in 2001 (at year–end)

thou MDL

Revenues	1999	2000	2001
Total interest income. Inclusive:	486,054.22	588,147.04	684,103.2
Interest income on credits and financial leasing	383,376.08	445,151.45	551,945.05
Interest income from securities	64,206.21	65,089.37	74,011.57
Interest income from other assets	38,471.93	77,906.22	58,146.58
Total income non-interest	304,760.28	378,904.66	376,230.06
Expenditure	**1999**	**2000**	**2001**
Total interest expenditure	183,223.16	203,153.35	254,695.60
Total non-interest expenditure	322,821.06	428,262.11	517,807.80
Provision for loan losses	117,097.47	18,952.16	36,303.33
Total net income	141,466.67	288,921.25	222,110.95
Net income / average assets	4.17	7.36	4.27

Structure of registered capital and own funds of financial institutions in 2001

Type of financial institutions	Registered capital thousand USD	/Total assets %	Own funds thousand USD	/Total liab. %
Banks	62,899.93	13.78	125,507.05	37.91

2001 DEVELOPMENTS IN THE POLISH BANKING SYSTEM

NBP

MACROECONOMIC ENVIRONMENT IN 2001

The activity and financial performance of the banking sector in 2001 were directly impacted by the development of the Polish economy. Economic growth, which in the first quarter was still running at 2.3% year-on-year, slackened to some 0.9% in the second and third quarters, dipping to 0.2% in the fourth. Annual **GDP** growth is estimated to have come to 1.0% (as against 4.0% in 2000). The prime reasons for this slowdown were sluggish domestic demand and a decrease in capital spending. Growth continued to be propped up by exports. Over the twelve months of 2001, the **growth of exports** outpaced that of imports. Export receipts increased 14.0% (to US$ 36.1bn), while imports were up 2.7% (to US$ 50.3bn). **Poland's trade** gap thus amounted to US$ 14.2bn (as against US$ 17.3bn a year earlier).

Industrial output was 0.2% lower in 2001 than the year before, with the first quarter seeing output rise 4.1%, yet the subsequent quarters bringing a decline of 0.9%, 1.2% and 2.3%, respectively. **Labour productivity**, as measured by output per employee, was up around 5% compared to the year 2000.

Annual **CPI** inflation (December-on-December) stood at 3.6% (compared to 8.5% in 2000). Annualised average inflation came to 5.5% (compared to 10.1% in 2000), which was 1.5 points less than projected in the Budget. Industrial producer prices in December were down 0.3% year-on-year. The various indices of core inflation all fell on an twelve-monthly basis.

The situation on the labour market deteriorated. At year end, the jobless total amounted to 3.15 million (up 15.3% on the previous year), while the **rate of unemployment** stood at 17.4%, an increase of 0.6 points on the month before and 2.3 points compared to December 2000. Average monthly employee earnings in the **corporate sector** went up 7.1% in 2001, to stand at 2,203 zloty (gross). The purchasing power of average wages was up 1.6% on the year before, while that of **old age and disability pensions** rose 4.5%.

The official interest rates of the NBP were cut six times in 2001, by a total of seven and a half points, which led to a fall in both the lending and deposit rates offered by the banks to their customers and in the yields on basic money market instruments.

DEVELOPMENT IN THE BANKING SYSTEM

The **number of commercial banks** in Poland went down from 74 at year end 2000 to 71 in 2001, with the number conducting operating activity down from 73 to 69. This decline is attributable to the consolidations that took place, which meant that more banks left the industry than entered it. Since 1999, the Polish Treasury has controlled seven banks. Their share in the total assets of the banking sector increased to 23,3%. The year 2001 saw a decrease in the number of private-sector banks in operation, which fell from 66 to 62, including a fall in the number with majority Polish equity, down from 20 to 16. By contrast, there was no change in **the number of banks controlled by foreign investors** (46). At the end of 2001, the 46 banks controlled by foreign investors accounted for 69.0% total assets of the whole banking sector.

In the course of 2001, the **number of cooperative banks** declined by 38, going from 680 to 642, chiefly as a result of mergers and acquisitions Total assets of the banking sector amounted to 4.5% the banking sector.

Compared to year end 2000, the number of **domestic offices** of commercial banks fell by 736 during 2001 (the number of **branch offices** increased 429, while the number of other offices decreased 1,165); by contrast, 203 new offices of cooperative banks came into operation (52 branches and 151 other offices).

The number of **staff employed** within the banking sector has been shrinking for two years. In 2001, the decline in total staffing was just as steep as it had been the year before (a decrease of 5,413 in 2001, compared to 5,401 in 2000). Employment at the commercial banks dropped to 138,824, which represents a lower figure than in 1996, while at the cooperative banks it increased by 706 (to stand at 26,403).

At the end of 2001, the total authorised capital of the commercial banks, together with the member's share funds at cooperative banks, amounted to 9,966.2m zloty.

The year 2001 was not an easy one for the Polish banking sector, a fact reflected in the slightly slower growth reported in **total assets**. These rose 11.4%, (to stand at 477.4bn zloty), whereas growth in 1999 and 2000 had come to 14.0% and 17.9%, respectively. Nevertheless, the expansion of the banks' operations was well above growth in the economy as a whole, with the result that the ratio of banking sector assets to GDP went up to 66.1%, from 62.1% in 2000.

The slacker growth of the banking industry is primarily traceable to weaker growth in the **assets of the commercial banks**, which came to 11.1% (compared to 17.9% a year earlier), bringing these assets to a total of 455.9bn zloty; this slowdown stemmed from flagging growth in claims on financial institutions (down from 52.2% to 3.1%) and on non-financial customers (down from 15.4% to 5.6%). Over one quarter of the assets of the commercial banks were denominated in foreign currencies (compared to 23.1% in 2000), and asset growth was therefore additionally held back by the appreciation of the zloty.

The small increase recorded in **claims on non-financial customers** (12.0bn zloty, gross, as against 25.2bn zloty a year before) was a consequence of both declining loan demand caused by a deterioration in corporate finances and the poorer outlook for household incomes (due to the difficult employment situation), and was also associated with the banks applying stricter lending procedures in response to the rising proportion of adverse classifications in their loan books.

The negative impact on the growth of non-financial sector borrowings exerted by the relatively high rates charged on zloty loans by certain banks (despite repeated cuts in NBP official interest rates) was partly offset by these banks offering their customers cheaper foreign currency loans.

Total **deposits from non-financial customers** went up 12.5% in the course of 2001 (8.6% in real terms). This increase was mainly fed by a 16.6% rise in corporate balances. The announcement that interest income on bank deposits was to become taxable led to an outflow of personal savings in the fourth quarter (which thereby fell 0.9% compared to the end of September), with these savings being moved into investment funds and used to purchase Treasury bonds. As a result, **personal deposits** (totalling 199.8bn zloty in December 2001) were up only 11.4% year-on-year (as against growth of 20.7% in 2000). This was accompanied by a shift in the matu-

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rity structure of the banks' deposit base, with an increase in the relative proportion of funds deposited for periods of from one to two years (up from 0.7% to 3.8%) and over two years (up from 2.4% to 8.6%).

A direct consequence of these changes was a reduction in liquidity risk at the banks which was expressed in a reduction in their asset/liability mismatch out to one month, a ratio of crucial importance for the safety of these institutions (this 1M liquidity gap narrowed from 11.9% of total assets in 2000 to 8.7% in 2001); as a result, the ratio of assets to liabilities maturing in up to one month improved, going from 75% to 80.4%.

The year 2001 brought a strengthening of the overall capital position of the banking sector. The **capital base of the commercial banks** (as adjusted for regulatory deductions) rose 6.7bn zloty (23.0%), to total 35.9bn zloty.

Thanks to this swift capital growth at the commercial banks, their average **risk-based capital ratio** went up 2.1 points, to stand at 15.0%. Only three banks, all under rehabilitation, reported a ratio of under 8%. The shortfall in credit risk capital at these banks (262m zloty in all) represented 30% of that recorded twelve months previously.

In 2001, the commercial banks failed to achieve any significant reduction in the growth of **irregularly classified claims on non-financial customers** (which rose 25.3%, to total 35.1bn zloty). Given that growth in outstanding loans had diminished, this meant a further worsening of loan portfolio quality. The proportion of adverse classifications in total advances to non-financial customers went up 2.8 points (as against 1.8 points in 2000), to come to 18.3%, with irregular claims on companies up 3.0 points (to 20.9%), and those on persons up 2.1 points (to 10.8%).

The commercial banks ended the year 2001 showing **pre-tax earnings** of 5.8bn zloty, up 4.3% on the previous year (although down 1.1% in real terms), and **net earnings** of 4.2bn zloty, up 7.9% (up 2.3% in real terms). The increase in pre-tax earnings was 11.7 points less than in 2000, mainly due to a decline in net interest income (NII, which fell 11.3%), and also because of slower growth in fee income and "other income".

The decrease in **net interest income** was related to a contraction of 0.72 points in **net interest margins** (which narrowed to 3.31%) owing to the greater weight in loan portfolios and interbank placements of foreign currency items, earning lower rates of interest, and also to the higher proportion of non-performing loans (those classified doubtful or loss). However, as was the case in 2000, this process was accompanied by powerful growth in FX spreads and gains on FX trading (including trading in derivative instruments), and also in gains on securities transactions.

The muted earnings growth reported by the commercial banks led to a decline in all the average ratios of operating efficiency, with pre-tax profitability down 2.3 points (to 2.6%), net profitability down 1.5 points (to 1.9%), return on equity (**ROE**) down 1.6 points (to 12.9%), and return on assets (**ROA**) down 0.1 point (to 1.0%). The average cost/income ratio rose 2.0 points (to 97.4%).

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

Since the beginning of 2002 some new provisions regulating banking system passed by the Parliament in 2001 has been brought into force. They stipulate that **the Commission for Banking Supervision (KNB)** is entitled to execute supervision over banks on the consolidated basis.

The amendments introduced to the Banking Act a few definitions, i.e. the definition of financial institution.[11] Following the provisions of the amended Banking Act, KNB is empowered to require any information concerning activity of the financial institution and its subsidiaries, if at least one of its subsidiaries is a bank. This does not mean that the KNB will replace other functional regulators. The supervision of financial sector institutions will remain entrusted to the functional supervisors responsible for banking, securities and exchange, and pension funds and insurance: KNB, the Securities and Exchange Commission, and the Commission for the Supervision of Insurance and Pension Funds[12] respectively.

THE ACTIVITY OF THE COMMISSION FOR BANKING SUPERVISION (KNB)

The measures instituted by the **KNB** in 2001 were directed towards the effective performance of the statutory objective of banking supervision, which is to ensure the safety of funds held on bank accounts and compliance by the banks with the provisions of the Banking Act, the Act on the National Bank of Poland, their articles of association, and the rulings issued on authorisation to establish those banks.

A particularly important area of activity for the KNB in 2001 was the work undertaken to bring the provisions of Polish law fully into correspondence with the Directives in force in the European Union and to implement regulations necessary for the effective exercise of banking supervision.

In this framework, the year 2001 saw the issue of numerous legal instruments of key significance for the Polish banking sector. The new regulations concluded the process of adapting Polish law to conform to European Union requirements and international standards. Poland's parliament revised the Banking Act. Pursuant to that Act, the KNB subsequently issued implementing regulations, while the Minister of Finance, acting under statutory authorisation provided in the Accounting Act, issued a number of ordinances addressed to banks. All of these regulations were either developed by banking supervision or drafted with a large input from banking supervision.

In terms of banking supervision, the most significant changes were those enacted to the Banking Act. Thanks to the new provisions it contains, the Polish banking sector became subject to a system of consolidated supervision as of the year 2002. This will allow a substantial reduction in the level of risk posed to banks by connected undertakings, the activity or financial condition of which could have a major impact on the soundness of a given bank. In addition, in view of the presence of foreign investors within the Polish banking sector and the increasingly international character of the business being conducted by Poland's banks, a particularly important factor is the capacity to exercise cross-border supervision. The new provisions of the Banking Act facilitate cooperation and exchange of information between the KNB and banking supervision agencies in other countries.

[11] A financial institution is an undertaking other than a bank, which generates at least 75% of its income from its conduct of business activity involving acquiring and disposing of shares in private or public companies, extending internally funded loans, making available assets under lease finance agreements, providing services relating to the acquisition and disposal of debt, providing money transmission services, issuing and administering payment instruments, extending guarantees or endorsements, or entering into other commitments not reported in the balance sheet, trading, for its own account or that of another natural or juridical person, in forward-value instruments, participating in share issues or providing services related to such issues, providing asset management services, providing financial advice, including investment advice, providing brokerage services on the money market.

[12] The latter – KNUiFE – was established in 2002 via a merger of the State Agency of Insurance Supervision and the Agency for the Supervision of Pension Funds.

Another significant development was the preparation and adoption by the Commission of a regulation implementing in Poland the European Union Capital Adequacy Directive. This regulation establishes a much better connection than before between a bank's capital requirements and the risk exposure inherent in its activity; at the same time, due to its complexity, it constitutes a major challenge for both banking supervision and the banks themselves. Furthermore, the Commission issued amended prudential regulations on large exposures and the calculation of a bank's capital base.

It should also be added that the revised Accounting Act, adopted in 2000, which brings Polish regulations in this area into line with the standards of the European Union and with International Accounting Standards, has transferred to the Minister of Finance the power to issue the relevant implementing regulations applicable to banks, which power was previously vested in the KNB. Nonetheless, the development of implementing regulations of this kind in 2001 was carried out by banking supervision, which drew on its many years of experience in this field, while acting in consultation with the Minister of Finance.

The measures taken by the KNB in 2001 were not only focussed on the performance of its statutory responsibilities and strategic objectives, but were also related to the ongoing situation within the banking sector, with direct oversight here being carried on by the executive arm of the KNB, the **General Inspectorate of Banking Supervision (GINB).**

In 2001 banking supervision in Poland continued to be involved in restructuring and consolidation of the banking sector. The actions taken, including those on an ad hoc basis, together with the continuous monitoring of the condition of the banks, made it possible to avoid any more serious threats to the stability of the banking system in 2001. Credible investors were found for certain problem banks, allowing these to be recapitalised and paving the way for their rehabilitation or their acquisition by other banks. Various supervisory measures were instituted in relation to all the banks implementing rehabilitation programmes in order to speed up the efforts made by the directing bodies of those banks to strengthen the capital of those institutions. In addition, other ad hoc actions were carried out in this area, through the issue of appropriate recommendations to particular banks, and also of instructions or prohibitions, pursuant to the relevant provisions of law, these being based on an ongoing assessment by banking supervision of a given bank's risk exposure.

LEGAL COMPETENCE OF THE KNB

The activity of banks, branches and representative offices of foreign banks, is subject to supervision conducted by the KNB. The responsibilities of the Commission include, in particular: setting out principles for the conduct of banking activity that ensure the safety of the funds held by the customers at banks, supervising compliance by the banks with statute, their articles of association and other legal regulations, and also with mandatory financial standards, performing periodic assessments of the financial condition of banks, and evaluating the impact of monetary, tax and supervisory policies on the development of banks, giving its opinion on the organisational structure of banking supervision and establishing procedures for the performance of such supervision.

The KNB consists of the President of the NBP (the Chairperson of the Commission), the Minister of Finance or a delegated representative thereof, this being a Secretary or Under-secretary of State at the Ministry of Finance (the Deputy Chairperson of the Commission), a representative of the President of the Polish Republic, the President of the Management Board of the Bank Guarantee Fund, The Chairperson of the Securities and Exchange Commission, or a deputy thereof, a representative of the Minister of Finance, The General Inspector of Banking Supervision. A representative of the Polish Banking Association participates in meetings of the commission concerning matters relating to supervisory regulations, with consultative vote.

The decisions of the KNB, together with the responsibilities it assigns, are carried out and co-ordinated by the General Inspectorate of Banking Supervision, a separate organisational unit within the structure of the NBP.

The main goals of banking supervision are described in Art. 133 of the Banking Act. According to the provision, the objective of supervision is to ensure the safety of funds held on bank accounts, compliance by banks with the provisions of the Banking Act, the Act on the National Bank of Poland, their articles of association, and the rulings issued on authorisation to establish those banks.

Since the beginning of the 2001 KNB is entitled to supervise banks operating in financial groups on the consolidated basis.

INTERNATIONAL ACTIVITIES OF YOUR AUTHORITY

In 2001, the General Inspectorate of Banking Supervision (GINB) carried on consultations with the European Commission Internal Market Directorate General within framework of document "A Review of Regulatory Capital Requirements for EU Credit Institution and Investment Firms" concerning credit risk including his mitigation, role of market discipline and supervisory review process.

The GINB also submitted his comments on the Consultative Document: New Basle Capital Accord (January 2001) issued by Basle Committee for Banking Supervision.

In 2001 GINB co-operated with European Commission services in the scope of peer-review final report on Polish supervision capacity to fulfil EU single financial market requirements.

The representatives of GINB participated also in activities of association institutions. These included in particular the EU-PL Subcommittee on Internal Market where questions of implementation of Polish obligations and perspectives for future co-operation with the Community were discussed.

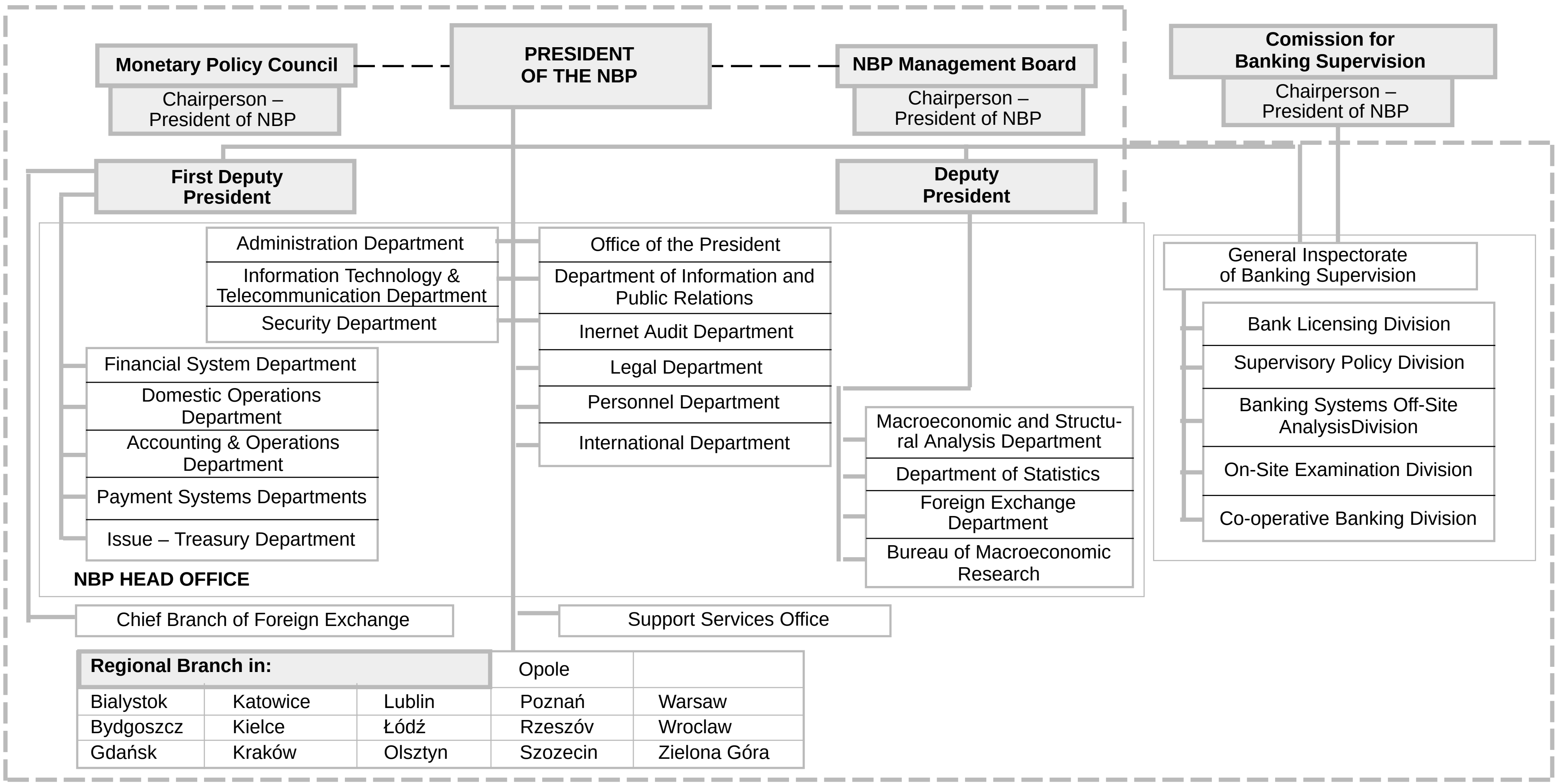
In February 2001 Polish and Lithuanian bank examiners carried out joint inspection in the branch of Polish Kredyt Bank SA in Vilnius. This inspection and the reciprocal visits of the heads of banking supervision related to the joint inspection proved to be an excellent example of successful cross-border supervision.

In July 2002 the KNB signed the amended Memorandum of Understanding with Bank of Lithuania. At present negotiations on MoU's with over twenty foreign banking supervisory authorities are being continued.

COOPERATION WITH OTHER SUPERVISORY BODIES IN POLAND

The supervision of institutions operating pursuant to the acts regulating individual sectors of the financial market has been entrusted to the KNB, the Securities and Exchange Commission, and the Commission for the Supervision of Insurance and Pension Funds. The detailed conditions and procedure for communicating information by the KNB to the other financial market supervisors in Poland are laid down in agreements concluded between these agencies and the KNB. At present,

ORGANIZATIONAL CHART OF THE NATIONAL BANK OF POLAND AND BANKING SUPERVISORY AUTHORITY (KNB AND GINB)



such an agreement has been signed with the Securities and Exchange Commission, and one will also be signed with the Commission for the Supervision of Insurance and Pension Funds.

In addition, pursuant to Article 35 of the Banking Act, the KNB may participate in registration proceedings involving banks.

Further, it should be noted that a representative of the National Bank of Poland (at present, this is the General Inspector of Banking Supervision) is a member of the Securities and Exchange Commission, while the Chairperson of the Securities and Exchange Commission, or their deputy, is a member of the KNB. In addition, the General Inspector of Banking Supervision is entitled to participate, with consultative vote, in meetings of the Commission for the Supervision of Insurance and Pension Funds.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2001

The main objective of Polish banking supervision was to enhance the supervisory framework to ensure the safety of funds held on bank accounts and compliance by the banks with the provisions of the Banking Act, the Act on the National Bank of Poland, their articles of association, and the rulings issued on authorisation to establish these banks.

In the view of Poland's accession to the EU the new challenge for banking supervision was to adapt the Polish law to Community legislation, which was, done both at statutory laws and implementing regulation levels.

The recent changes in the field of prudential regulations in Poland aimed primarily at adjusting Polish rules and regulations to the European Union legislation. The most important regulatory areas, based on amendment of Banking Act are briefly described below.

1. **Resolution No. 5/2001 of the KNB of Dec. 12, 2001, on the scope and specific rules of the determination of capital requirements for individual risks, including excess of exposure concentration limits, the manner and specific rules of the calculation of bank's solvency ratio, accounting for the links between banks and other subsidiaries or entities operating in the same holding, and the determination of bank's balance sheet additional items included together with own funds in the capital adequacy calculation, and the scope and manner of their determination.**

The Resolution has introduced all the provisions of the European Union directive on capital adequacy (CAD) and the amendment to that directive (CAD II).

According to the KNB resolution on capital adequacy banks shall maintain the capital base at a level adequate to risk incurred as the result of performed operations. The capital base to calculate the capital adequacy was determined as the value of own funds, increased by short-term capital (as determined by the KNB) and diminished by the amount of excess of capital concentration threshold. The overall capital requirement is the total of capital requirements for separate risk of banking activities (credit risk, market risk, other risks). The resolution specifies those risks, as well as the method of calculating capital requirements. The Resolution allows calculating the capital requirement to cover each risk according to methods of varied level of complexity – from simplified methods to the method using the Value at Risk (VaR) methodology. The solutions entailed by the Resolution are consistent with the methodology adopted in the CAD Directive. However, in the standard methodologies higher rates of capital charges against some risks have been adopted, which is meant to take into account the specificity of Polish market (higher market risk) and also to ensure a lesser relative restrictiveness of advanced methods. Such a design enables each bank to choose the option best suited to its own needs and at the same time it favours a higher precision of risk management.

2. **Resolution No. 6/2001 of the KNB of Dec. 12,2001 on the determination of detailed rules for calculation of own funds of that banks belong to banking capital group for the purposes of application of normative and limits set out in the Banking Act, amount, detailed scope and conditions for the decrease of bank's core funds, bank's balance sheet other items included in bank's supplementary funds, amount and conditions of their inclusion, other deductions of bank's own funds, amount and conditions for deducting them from own funds and accounting for the links between banks and other subsidiaries or entities operating in the same holding, in the determination of the procedure for own funds calculation.**

At present the own funds of banks are regulated by the Banking Act and by the Resolution of KNB on own funds of banks.

The amended Banking Act abolished the following deviations of Polish regulations on own funds, as compared with the requirements of the Directive 2000/12/EC:

- the lack of provisions concerning the possibility of early payment, at KNB consent, of subordinated loans taken,
- the obligation, existing in the current wording, to obtain KNB consent to include the revaluation reserve in the supplementary capital.
- The method of calculating own funds in Poland is entirely based on the Directive 2000/12/EC. Slight differences between solutions suggested by the EU and the solutions adopted in Poland result from the specificity of the Polish banking sector:
- The Polish resolution does not provide for inclusion of interim profits into own funds (which under certain requirements is allowed by the Directive),
- The resolution requires deduction of any current losses from own funds (while the Directive requires such deduction only in the case of significant losses).

Furthermore, intangible assets are currently deducted only in part. According to 2000/12/EC Directive, full deduction of these assets will be enforced by the end of 2004. Such a schedule was negotiated during screening in the field of "Free movement of services" and was agreed by the EU.

3. **Resolution No. 7/2001 of the KNB of Dec. 12,2001 on specific rules and conditions of accounting for claims and granted off-balance sheet liabilities in the assessment of the observance of exposure concentration limits, accounting for banks' links with other subsidiaries or entities operating in the same holding, and other claims and granted off-balance-sheet liabilities to which the provisions on exposure concentration limits with regard to specific undertakings do not apply.**

The amendment to the Banking Act extended the basic list of exclusions. It includes also the delegation for the KNB to determine the method of taking into account balance sheet and off balance sheet items when calculating large exposures and to specify other exclusions. These solutions are consistent with the

Directive 2000/12/EC. The KNB Resolution, executing the amended statutory delegation, specified the method of taking into account, in the calculation of large exposures, the individual claims and extended off balance sheet commitments as well as other listed claims and extended off-balance sheet commitments, to which large exposures standards shall not apply.

Described resolutions took effect since Jan. 1, 2002.

The provision of the amended Accounting Act has transferred the responsibility to prepare the regulations on specific provisions from GINB to the Ministry of Finance. At present the specific provisions are set out by the Regulation of the Minister of Finance on procedures for provisioning against the risk of banking operations (by 31st December 2001 the issue of specific provisions was regulated by the resolution of the KNB).

The most important amendment to the previous regulations of specific provisions, consist on presenting every category of claims except the "normal" category in three groups depending on quality of collateral:

- exposures with "first class" collateral (e.g. endorsements of the State Treasury, banking guaranty),
- exposures with "average" collateral (e.g. in this category Transfer of ownership rights of a current asset, according to conditions specified in a contract, until the entire amount of loan along with interest and commission is repaid),
- uncollateralised exposures.

This solution will enable the better analysis of claim categories.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

In 2001 the Training Initiative for Banking Supervision (TIBS) – a new training centre for the supervisors from Central, Eastern, and Southern Europe entered in a pilot stage. This centre is funded by the National Bank of Poland with some support – for limited period of time – from the United States Agency for International Development. The mission of the TIBS is to promote regional cooperation and an exchange of practical experiences in implementation of the core principles of effective supervision between middle-level banking supervisory staff from the countries of the region, with the possibility of extending this to the remaining countries of the former USSR, primarily in Trans-Caucasia. TIBS lays emphasis on offering training to countries from the region that face similar challenges and are pursuing a similar path in altering their supervisory culture. The training events held under the aegis of the TIBS are designed to go beyond the general knowledge on banking supervision but rather focus on best supervision practices, methods and techniques and their implementation. TIBS intends to draw on more than 10 years of experience in successful developing, applying and enhancing supervisory policies and tools in Poland and other countries in the region. Presenting these experiences, in a practical and interactive manner – mostly case based is one of characteristic features of the TIBS. The objective of TIBS is to deliver 2 high quality, case-based 5-day seminars a year.

A successful pilot 5-day workshop on the subject of ***FX Risk: Regulations and Examination in Banks. CAD implementation in Poland*** was organised by the NBP in November 2001, gathering 27 representatives of 17 countries. The participants had opportunity to review and analyse implementation of CAD 1 and 2 in Poland and some other countries in the region, enhance their understanding in VAR calculation and non-linear instruments handling in CAD, work in group on real life examples of FX risk, share ideas over FX examination in banks, and discuss international practices based on the presentation concerning implementation of CAD in Germany.

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STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	1999	2000	2001
Commercial banks	77	73	69
Cooperative banks	781	680	642
Banking system	**858**	**753**	**711**

Ownership structure, commercial banks on the basic of registered capital (%) (at year end)

Item	1999	2000	2001	2001/1999
State ownership	17.7	14.9	15.3	86.4
Other domestic ownership	11.9	17.4	10.3	86.6
Domestic ownership total	29.6	32.3	25.6	86.5
Foreign ownership	56.0	56.6	61.3	109.5
Dispersed holdings	14.4	11.1	13.1	91.0
Total commercial banks	**100.0**	**100.0**	**100.0**	**x**

Distribution of market shares in balance sheet total (%)

Type of financial institution	1999	2000	2001
Commercial banks	94.9	95.0	95.5
Cooperative banks	5.1	5.0	4.5
Banking system	**100.0**	**100.0**	**100.0**

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

Type of financial institution	1999	2000	2001
Commercial banks	85.2	153.5	235.5
Cooperative banks	5.5	6.0	7.1
Banking system	**81.8**	**147.3**	**225.0**

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

Assets	1999	2000	2001
Cash and balance with Central bank	4.6	3.8	6.1
Interbank deposits	14.2	18.4	20.0
Due from non-financial and government entities	47.8	45.2	44.2
Securities	23.8	22.2	20.2
Other assets	9.6	10.4	9.5
Liabilities	**1999**	**2000**	**2001**
Borrowing from Central bank	1.6	1.3	0.9
Interbank deposits	9.3	10.8	8.3
Deposits from non-financial and government entities	64.0	63.0	63.5
Bonds	0.4	0.5	0.6
Other liabilities	16.4	16.1	17.6
Capital and reserves	8.3	8.3	9.1

Solvency ratio of financial institutions*

Type of the financial institution	1999	2000	2001
Commercial banks	13.2	12.9	15.0
Cooperative banks	12.8	12.8	13.9
Banking system	**13.1**	**12.9**	**15.0**

*: *Arithmetic mean %.*

Asset portfolio quality of the banking system (%)

Asset classification	1999	2000	2001
Consumer loans classified satisfactory	17.3	18.1	17.3
Special mention claims	6.3	6.3	6.2
Irregular claims. of which:			
– substandard	5.1	4.4	4.7
– doubtful	3.4	5.1	4.8
– loss	4.8	5.5	8.1
Classified total	**13.3**	**15.0**	**17.6**
Specific reserves (mln zl)	**9,356.9**	**11,775.6**	**15,914.9**

The structure of deposits and loans in 2001 (%) (at year end)

	Deposits	Loans
Households	70.5	26.8
Government sector	4.6	1.3
Corporate	21.6	71.5
Foreign	1.6	0.5
Other	3.3	0.4
Total	**100.0**	**100.0**

*: *Deposits are included in others items.*

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The structure of deposits and loans in 2001 (%)

Maturity of Deposits (from non-financial sect or)		Loans (for non-financial sector)
At sight	23.0	13.7
Within one year	68.4	33.2
Over one year	8.6	53.1
Total	**100.0**	**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.		
	1999	2000	2001	1999	2000	2001
Commercial banks	21.4	23.1	25.7	19.9	17.9	18.8
Cooperative banks	0.0	0.0	0.0	0.0	0.0	0.0
Banking system	**20.5**	**22.1**	**24.5**	**19.0**	**17.1**	**17.9**

Profit and loss statement

in USD

Items	1999	2000	2001
Interest income	8,298.6	12,125.2	12,178.3
Interest expenditure	5,231.7	8,370.3	8,712.4
1) Net interest income	3,066.9	3,755.0	3,466.0
2) Profit from other financial and investment services (including dividends)	1,960.6	2,509.6	3.350.1
Of that: Profit from commissions	967.5	1,246.7	1,424.1
Of that: Net provisions	735.7	1,056.5	1,265.6
3) Gross financial and investment services profits (1+2)	5,027.5	6,264.6	6.816.0
4) Overheads	3,878.5	4,930.9	5,405.9
5) Extraordinary profits	0.0	0.3	0.0
6) Pre-tax profit (3-4+5)	1,149.0	1,334.0	1,410.1

Average balance sheet items

in USD

Items	1999	2000	2001
Average balance sheet total (assets total)	87,608.8	103,419.2	117,848.7
Average own capital	6,211.4	7,407.0	9,480.3

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Components of the banking sector-return on assets (%)

Items	1999	2000	2001
In proportion to the average balance – sheet total			
Interest income	10.6	13.1	11.7
Interest expenditure	6.7	9.0	8.3
1) Net interest income (interest margin)	3.9	4.0	3.3
2) Profit from other financial and investment services (including dividends)	2.5	2.7	3.2
Of that: Profit from commissions	1.2	1.3	1.4
Of that: Net provisions	0.9	1.1	1.2
3) Gross financial and investment services profits (1+2)	6.4	6.7	6.5
4) Overheads	4.9	5.3	5.2
5) Extraordinary profits	0.0	0.0	0.0
6) Pre-tax profit (ROA))	1.5	1.4	1.4

Structure of revenues and expenditures of financial institutions in 2001 (at year-end)

million zloty

Revenues	1999	2000	2001
Commercial banks	76,304.0	119,386.2	170,000.5
Cooperative banks	2,609.0	3,568.6	4,139.7
Banking system	**78,913.0**	**122,954.8**	**174,140.2**
Expenditures	**1999**	**2000**	**2001**
Commercial banks	71,537.4	113,859.2	164,379.3
Cooperative banks	2,285.5	3,091.0	3,643.7
Banking system	**73,822.9**	**116,950.2**	**168,023.0**

Structure of registered capital and own funds of financial institutions in 2001

Type of the financial institutions	Registered capital million USD	/Total assets %	Own funds million USD	/Total liab. %
Commercial banks	2,387.7	2.1	9,024.4	8.0
Cooperative banks	112.4	2.0	455.9	8.3
Banking system	**2,500.1**	**2.1**	**9,480.3**	**8.0**

2001 DEVELOPMENTS IN THE ROMANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The key points of the economic and financial programme of the government that took office in the wake of elections held in November 2000 were the progress of economic growth and sharp reduction of inflation rate with a view to preparing Romania for EU accession.

In 2001, *macroeconomic indicators* further mirrored the economic upturn; GDP growth was stronger versus 2000, achievements outpacing even the original target, but inflation rate was 10.4 percentage points below the level of 2000, the record low of the last twelve years. Aggregate demand increased, annual growth rates of the main constituents – final consumption and fixed capital formation – posting the largest and most balanced levels in the past five years. Supply, on the other hand, moved up compared to 2000, with higher performance in sectors providing GDP resources. Throughout the year, economic growth was bolstered by domestic demand; yet the latter was met on behalf of a net import exceeding 8 per cent of GDP.

Most macroeconomic objectives of the 2001 programme were achieved or even outperformed as follows:

- GDP growth reached 5.3 per cent in 2001, the highest level among the EU candidate countries, as compared with the initially projected level of 4.1 per cent, subsequently being revised to 4.5 per cent;
- the inflation outcome in 2001 (30.3 per cent) reflected the progress in disinflation, as consumer price growth rate was by more than 25 per cent lower than in 2000. This move appeared consistent with the improvement of real economy;
- the deficit of the consolidated general government was limited to 3.3 per cent of GDP, below the target of 3.5 per cent;
- the current account deficit reached 5.8 per cent of GDP, below the projected level of 6 per cent;
- official reserves neared USD 4.9 billion against the target of USD 4.6 billion;
- unemployment rate dropped from 10.5 per cent (in December 2000) to 8.6 per cent (in December 2001), thus achieving the goal of reducing unemployment rate below 10 per cent.

GDP growth of 5.3 per cent was driven by favourable developments in industry and agriculture, with gross value added increasing by 7.9 per cent and 21.2 per cent respectively. Despite the 1.7 per cent rise in services, they accounted for 46.4 per cent of GDP while industry and agriculture contributed 25.8 per cent and 13.4 per cent to GDP. From this perspective, Romania aims at bringing the GDP structure in line with that of developed countries.

As regards GDP by expenditure, the share of gross fixed capital formation and that of household consumption rose to 21.9 per cent (against 19.7 per cent in 2000) and to 79.9 per cent respectively (against 79 per cent in 2000) while public consumption fell from 6.9 per cent to 6.3 per cent as a share of GDP. Net imports of goods and services increased to 8.1 per cent (against 5.7 per cent in 2000); behind this performance stood the strong export growth, which continued for the second year in a row, as reflected by the 9.8 per cent increase after having expanded by 13.9 per cent during January-September 2001; however, export growth was offset by faster rise in imports (19.1 per cent).

The *monetary and exchange rate policies* remained cautious in an attempt to consolidate the downward trend of inflation expectations and to counteract the negative signal induced by adjustment of administered prices. Against this background, the following three stages can be detected.

In the first two months of 2001, monetary policy stance remained prudent pending the economic policy steps of the new government. During March-July monetary policy was eased, the NBR interest rates dropped along with the fall in yields on government securities launched by the Treasury and the budget deficit was kept under a tight rein with financing requirements being particularly met from external sources.

Starting August, monetary policy reverted to the prudent stance, against the backdrop of adjustment in some administered prices and pending the seasonally-induced higher inflation during the last few months of the year. However, monetary tightening did not translate into a further hike in interest rate but into holding them in the real positive territory. Under the circumstances, broad money rose by more than 12 per cent, in real terms, at end-2001, compared with end-2000 and non-government credit went up about 21 per cent as a result of increase in ROL-denominated loans, thereby contributing to the economic upturn.

Fiscal policy also provided an underpinning to the achievement of monetary policy objectives by keeping a check on the deficit of consolidated general government and by ensuring two thirds of financing needs (about 2.2 per cent of GDP) from externally supplied funds. Romania's re-entering on the international capital market had a bearing on external borrowing; the Eurobond issue launched in November 2000 was re-opened in January 2001 for an amount of Euro 150 million while a new benchmark 7-year Eurobond issue was offered to investors, resulting in funds worth EUR 600 million. The two government bond issues were oversubscribed in the primary market and were well traded in the secondary market, closing the year with a spread of 1.7 percentage points over the German Bonds, below their launch level.

DEVELOPMENT IN THE BANKING SYSTEM

In 2001, the composition of the banking system experienced three major change: completion of Banca Agricolă's privatisation (by the purchase of 98.8 per cent equity stake of the bank's share capital consortium made up of Raiffeisen Zentralbank and the Romanian-American Investment Fund) and the purchase by foreign investors of a majority stake in the case of two private banks. These changes strengthened the uptrend in the market share held by banks with foreign capital (from 50.9 per cent to 55.2 per cent) concurrently with the erosion of the monopoly position of the state-owned sector (whose share of balance sheet assets in aggregate assets diminished from 46.1 per cent to 41.8 per cent) as well as with the slight narrowing of the segment of banks with domestic private capital. Privatisation of Banca Comercială Română, the largest Romanian bank, will represent a major stage of the Romanian banking system restructuring, thereby contributing to the increase in the weight of banks with private capital at 90 per cent.

Major changes were also detected in banking system capitalisation mainly as a result of completion of the first stage of increasing minimum share capital, of recapitalisation of Banca Agricolã which preceded its privatisation and of the increase in the share capital of other private banks. In 2001, total volume of banks' share capital doubled (from ROL 14,024.8 billion to ROL 28,144.6 billion).

Against this background, the financial performance indicators in the banking system (excluding foreign banks branches) improved markedly as follows:

- solvency ratio (> 12 per cent) rose from 23.8 per cent to 28.8 per cent;
- leverage ratio went up from 8.6 per cent to 12.1 per cent;
- return on assets (ROA) increased from 1.5 per cent to 3.1 per cent;
- return on equity (ROE) improved from 12.5 per cent to 21.8 per cent.

Moreover, the Romanian commercial banks' net profit amounted to ROL 9,839.8 billion, up 136 per cent, in real terms, against the previous year.

The rise in balance sheet net assets of the banking system was due to the increase in real terms (by around 20 per cent) of two categories of assets which accounted for more than 75 per cent of total, namely Treasury and interbank operations and client operations. Loans to non-government clients grew by about 20 per cent in real terms, unlike 2000, when it contracted by 6.4 per cent. Therefore the change in banks' behaviour towards real economy and implicitly resumption of its traditional financial intermediation function is obvious, which is also supported by the 20.5 per cent rise in real terms in the volume of deposits form individuals.

Overdue and doubtful claims taken at net value, posted no significant fluctuations in 2001, both in assets and attracted and borrowed sources (0.3 per cent for each said indicator) and of own capital (2 per cent).

Another positive development was detected in the case of loans under "doubtful" and "loss', whose share in total loan portfolio was 1.3 percentage points lower from a year earlier (from 3.83 to 2.54 per cent).

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF BANKS, NEW DEVELOPMENTS

One of the NBR permanent concerns in the banking regulation field is bringing the banking legal framework in line with EU directives and international standards.

The measures taken in this respect, in 2001, included the elaboration of pieces of legislation capable to ensure fulfilment of the general objectives set in the „Medium-term strategy for the banking system development" and the up-dating and supplementation of the regulatory framework in the field of prudential and accounting practices.

In this respect, the measures taken in view of harmonisation of Romanian legislation with that of European Union and with principles of the Basle Committee materialised in:

- establishment of more severe criteria in licensing banks' executives, managers and shareholders;
- extension of the scope of the law concerning bankruptcy proceedings for banks and credit cooperatives and enhanced prerogatives of the NBR and the Bank Deposit Guarantee Fund in case of bankruptcy;

- increased protection of the supervisory authority and establishment of the legal framework to enable the NBR to cooperate with other supervisory authorities across the country and abroad.

Along with these pieces of legislation drafted together with the Romanian Government, the NBR issued new regulations, of which the following deserve mention:

- banks' commitment to fight criminal acts by checking each beneficiary of forex transaction in accordance with the list provided by the UN Security;
- introduction of a liquidity indicator the banks should meet;
- imposition of limits on open forex positions for both total foreign currencies (maximum 20 per cent of bank's own funds) and each foreign currency (maximum 10 per cent of bank's own funds);
- organisation and functioning of the Payment Incident Bureau pursuant to the new regulation;
- issuance of accounting regulations in line with the Directive No. 86/635 EEC and the international accounting standards for credit institutions, according to which a large part of banks implement international accounting standards (IAS) starting January 2002 and since 2003 all banks are required to implement IAS.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY LAST YEAR

One of the key objectives of prudential supervision set by the NBR in the "Medium-term strategy of the banking system development" (based on the "Medium-term National Strategy for of Romania's Economic Development) is the creation of a stable competition-driven banking sector made up of banks capable to provide efficient financial intermediation. The measures required to attain such an objective were focused mainly on: strengthening prudential supervision; improving procedures to find solutions for insolvent banks; supporting privatisation of state-owned banks; putting credit co-operatives under regulation and supervision by the NBR; restoring the public's confidence in the banking system and implicitly encouraging saving, by increasing the role of the Bank Deposit Guarantee Fund in the banking system; enlargement of co-operation with other local and foreign supervisory bodies.

In 2001, the NBR focused on the quality of supervision activity:

- **Improvement of the Uniform Bank Rating System – CAMEL** by including two components (quality of shareholding and Management[13], vital in establishing banks' risk profile, development policies and strategies and in meeting prudential supervision requirements. Assessment of the component " Liquidity" was improved by the introduction, in July 2001, of a new indicator calculated as a ratio between effective liquidity and required liquidity. The manner of calculation allows supervision of liquidity by maturity of assets and liabilities in line with the Basel principles.
- **Maintaining a permanent contact with the banking community** by periodical meeting with banks' management and a majority shareholder, with

[13] The decision to introduce the 2 components was taken in December 2000 and implemented in early 2001

representatives of independent auditors and Romanian Banking Association. These meeting were aimed at assessing banks' own development strategies namely strategies for banks to get back on a sound footing and at the manner banks observed the measures and sanctions imposed by the central bank as well as the recommendations made by its management. The use of such a supervision means is required mainly in solving, at an early stage, where this is possible, of negative aspects in *on-* and *off-site* inspections.

- **Augmenting the annual inspection programme** with numerous dedicated inspections (implementation of measures taken through on-site inspections, checking of the sources suggested for share capital increase, identification of causes behind the severe deterioration of some indicators, etc.) or initiated based on complaints.

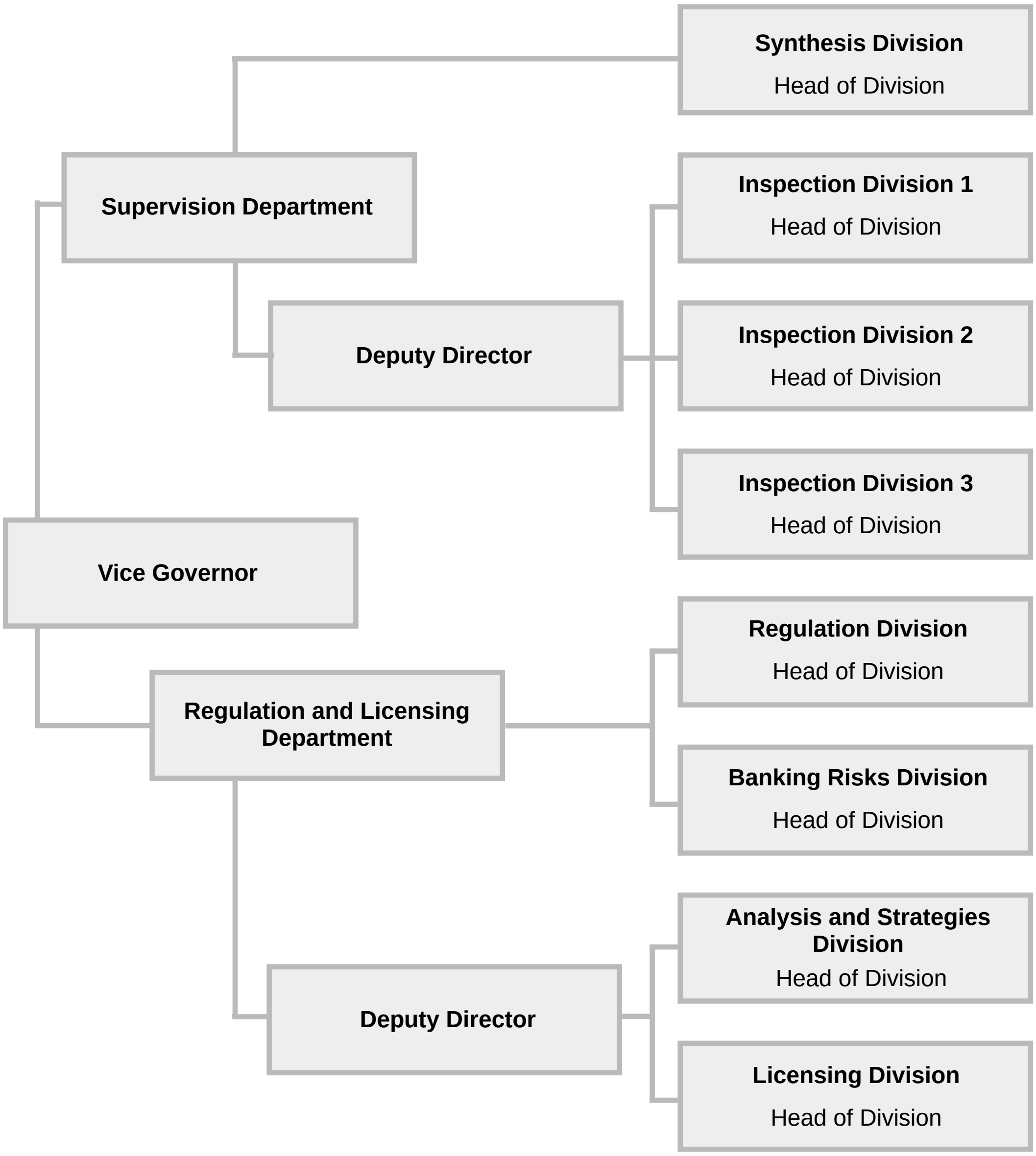
  Starting 2000, the number of on-site inspections dropped as a result of supervision staff retrenchment. Therefore, all the banks were subject to on-site inspections in 2001.
- **Increased rigour in checking and imposing sanctions on banks**, materialised in the sending of 67 letters of warning and observation (which addressed mainly the foreign exchange position, changes in banks' financial statements, limitation of credit risk, calculation of own funds, of net assets, reserve requirements, minimum capital requirements) as well as in imposition of sanctions and implementation of other measures in the case of 19 banks and 5 branches of foreign banks, where the severity of the situation required such measures.
- **Bringing credit co-operatives under regulation and supervision by the NBR** according to the new regulatory framework for credit co-operatives. At the present the licensing process is in progress.
- **Continuation of supervisors' training policy** by attending refresher courses organised by dedicated institutions in Romania (Romanian Banking Institute) and abroad (International Monetary Fund, World Bank, Federal Reserve Bank, Federal Deposit Insurance Corporation, Joint Vienna Institute, Banque de France, and other central banks in the EU).
- **Using foreign technical assistance**, along with turning to account of domestic resources, in developing projects to improve the quality of supervision based on international expertise in the field.

LEGAL COMPETENCE OF NBR IN THE AREA OF BANKING REGULATION AND SUPERVISION

According to the banking legislation, the NBR is the authority vested with the power and responsibility to licence, regulate and supervise the banking system in Romania. In order to ensure the viability of the banking system, the NBR is empowered:

- to issue regulations, to take measures, to impose the observance of regulations and to apply the legal penalties for non-observance; and
- to control and verify, based on the reports submitted by the banks, and by on site inspections, the registers, accounts and any other documents of the authorised banks, to the extent it considers necessary for the fulfilment of its supervisory functions.

SUPERVISION DEPARTMENT AND REGULATION & LICENSING DEPARTMENT ORGANIZATION STRUCTURE



INTERNATIONAL ACTIVITIES OF NBR

Starting December 1999, when Romania was invited to commence negotiations for EU accession, the role played by European Union in drafting the domestic economic policies enhanced steadily. The most important tool in this respect was negotiation of chapters related to the *acquis communitaire*. The Romanian authorities are committed to close all chapters under negotiations in the first part of 2004.

Seen from the perspective of the NBR, an utmost importance was attached to the Chapter on free movement of capital and to this end a regulation was issued by the NBR to set forth stages of capital liberalisation by the accession date.

The NBR regularly informs the European Commission on supervisory topics. In this respect, the Supervision Department provided information for the Commission 'regular annual report, participated in the meetings and provided professional opinion to help in formulating the Romanian negotiations position.

Relations of the Romanian authorities with the International Monetary Fund had as a focal point negotiations requesting a new stand-by arrangement from the IMF that started in the first quarter of 2001; at end-October 2001, the IMF Executive Board approved the stand-by arrangement for Romania worth SDR 300 million (about USD 383 million). The NBR offered a consistent support for the IMF in evaluation the state of the banking system through providing a monthly report on the banks' assessment based on rating system.

Several rating agencies upgraded Romania's foreign currency sovereign debt. Standard and Poor's and Moody's upgraded the country's long-term sovereign debt at B (positive) from B-(positive) and at B2 from B3 respectively, while Fitch IBCA rating agency upgraded the long-term domestic currency debt at B+ from B.

Having in view a closer co-operation with supervisory authorities in the country of origin of capital invested in Romania, NBR concluded agreements on the exchange of information on supervision with supervisory authorities from Turkey, Cyprus, Moldova; negotiations with other six foreign supervisory authorities are under way. Such agreements transpose provisions of EU Directive 2000/12/EC to create optimum conditions for the exchange of information with a view to exercising supervisory responsibilities, by keeping the secrecy of information.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

Strengthening of cooperation with other supervisory bodies in Romania materialised in a protocol signed between the NBR, National Commission for Securities and Insurance Supervisory Commission. These authorities are responsible for the supervision of the other segments of the financial system, respectively government securities, stock exchanges and insurance sectors. According to the law, the three authorities pursued relatively similar objectives regarding supervision of institutions under their jurisdiction, trying to prevent a systemic crisis and provide a competition-driven and level playing field for all financial market operators. To this end, efficient supervision of financial institutions requires co-operation mainly when there is a overlapping or a gap in the supervisory activity performed.

MAIN STRATEGIC OBJECTIVES OF THE NBR IN 2002

The year 2002 will witness strengthening of the Romanian banking system, with less but sounder bank able to meet the challenges of increased competition. The following developments will contribute to the creation of a sound banking system:

- merger of some banks having the same majority shareholder;
- removal of unviable banks by enforcing bankruptcy proceedings;
- change of the majority shareholder of several banks;
- increase in minimum ceiling of share capital, endowment capital and own funds to ROL 250 billion starting 31 May 2002.

The most important event of 2002 will be privatisation of Banca Comercială Românã, the largest Romanian bank, which will change significantly the Romanian banking landscape.

Among bank regulations to be issued in 2002, the following deserve mention:

- initiation of the third stage (the final one) of licensing credit cooperatives by grating licensing to central bodies and their affiliates;

- drafting some norms on "know your customer" standards;
- drafting more severe prudential norms on loan classification and provisioning in accordance with the principles of the Basle Committee;
- further reorganisation of the payments system by regulating the transfer of large-value payments and amending regulations on payments by means of cards with a view to fully incorporating Recommendation No. 97/489/EEC.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institutions	1999	2000	2001
Commercial banks	34	33	33
Branches of foreign banks	7	8	8
Total banking system	**41**	**41**	**41**

Ownership structure of financial institutions in 2001 (%) on the basis of the registered capital

Item	Type of financial institution
State ownership	34.6
Other domestic ownership	4.8
Domestic ownership, total	39.4
Foreign ownership (including foreign banks branches)	60.6
Total banking system	**100.0**

Note: *The National Bank of Romania has exclusive competence for granting banks the operation license and is responsible for the prudential supervision of the banks it authorized to operate in Romania, according to the provisions of the Banking Law.*

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

Item	1999	2000	2001	2001/1999 (Index)
State ownership	41.0	38.4	34.6	238.4
Other domestic ownership	17.2	7.8	4.8	79.2
Domestic ownership, total	58.2	46.2	39.4	191.4
Foreign ownership (including the foreign banks branches)	41.8	53.8	60.6	410.5
Total banking system	**100.00**	**100.00**	**100.00**	**282.9**

Distribution of market shares in balance sheet total (%)

Type of financial institutions	1999	2000	2001
Commercial banks	92.93	92.23	92.08
Branches of foreign banks	**7.07**	**7.77**	**7.92**
Total banking system	**100.00**	**100.00**	**100.00**

The structure of assets and liabilities of the banking system in 2001 (%) (at year end)

Assets	1999	2000	2001
Cash and claims on banks	38.32	41.23	42.97
Net loans	33.39	32.45	34.00
Securities	17.91	16.22	14.49
Fixed assets	9.37	9.30	7.98
Other assets	1.01	0.80	0.56
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**1999**	**2000**	**2001**
Due to other banks and financial institutions	14.53	11.81	10.48
Due to clients	72.79	71.28	72.04
Other liabilities	2.88	4.99	3.44
Own capital	9.80	11.92	14.04
Total liabilities and capital	**100.00**	**100.00**	**100.00**

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

Type of financial institution	1999	2000	2001
Commercial banks	52.48	36.89	86.48
Branches of foreign banks	7.37	10.23	18.86
Total banking system	**49.29**	**34.82**	**81.13**

Solvency ratio of financial institutions

Type of financial institution	1999	2000	2001
Commercial banks	17.90	23.79	28.80
Branches of foreign banks	-	-	-
Total banking system	**17.90**	**23.79**	**28.80**

Asset portfolio quality of the banking system

mil. USD

Loan classification				Loans, placements to other banks, and off-balance sheet Items classification*)	
	1999	2000	2001	2000	2001
Standard	800	2,584	3,309	5,296	6,203
Watch	742	32	22	34	23
Substandard	562	37	26	43	27
Doubtful	218	20	10	28	13
Loss	934	86	77	127	108
Classified Total	3,256	2,759	3,444	5,528	6,374
Specific Reserves	537	102	88	135	115

**) Beginning with October 2000, the asset portfolio which is classified includes not only loans, but also placements to other banks and off-balance sheet items (NBR Regulations no. 2/2000)*

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

	Deposits	Loans
Households	26.6	4.2
Government sector	5.3	24.3
Corporate	19.4	25.7
Foreign	46.6	45.3
Other	2.1	0.5
Total	**100.0**	**100.0**

The structure of deposits and loans in 2001(%) (at year-end)

Maturity of deposits		Loans	
At sight	29.4	Short-term loans	70.9
Time deposits	70.6	Medium and long-term loans	29.1
Total	**100**	**Total**	**100**

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

Type of financial institutions	FOREX Assets/Total Assets 1999	2000	2001	FOREX Liabilities/Total Liab. 1999	2000	2001
Commercial banks	44.14	43.28	45.74	40.59	41.05	38.50
Branches of foreign banks	81.96	82.41	77.75	79.01	77.16	73.13
Banking system	**46.81**	**46.32**	**48.19**	**43.30**	**43.86**	**41.15**

Profit and loss statement

in thousand USD

Items	1999	2000	2001
Interest income	2,204,601.4	1,668,560.5	1,719,995.5
Interest expenditure	1,590,249.2	1,108,026.6	1,000,781.7
1) Net interest income	614,352.2	560,533.9	719,213.8
2) Profit from other financial and investment services(including dividends)	-139,197.8	71,264.4	197,645.4
Of that: Profit from commissions	143,659.2	151,677.8	182,232.4
Of that: Net provisions	-370,851.8	-155,145.4	-56,084.4
3) Gross financial and investment services profits (1+2)	476,154.4	631,798.3	916,859.2
4) Overheads	440,750.5	424,651.0	470,310.5
5) Extraordinary profits	-10,364.2	6,317.9	-29,471.1
6) Pre-tax profit (3-4+5)	25,039.7	213,465.2	417,077.6

Average balance sheet items

in thousand USD

Items	1999	2000	2001
Average balance sheet total (assets total)	9,257,452.7	8,996,918.1	10,925,742.9
Average own capital	544,952.0	540,955.0	890,736.4

Components of the banking sector return on assets (%)

Items	1999	2000	2001
In proportion to the average balance – sheet total			
Interest income	23.81	18.55	15.74
Interest expenditure	17.18	12.32	9.16
1) Net interest income (interest margin)	6.64	6.23	6.58
2) Profit from other financial and investment services (including dividends)	-1.50	0.79	1.81
Of that: Profit from commissions	1.55	1.69	1.67
Of that: Net provisions	-4.01	-1.72	-0.51
3) Gross financial and investment services profits (1+2)	5.14	7.02	8.39
4) Overheads	4.76	4.72	4.30
5) Extraordinary profits	-0.11	0.07	-0.27
6) Pre-tax profit (ROA)	0.27	2.37	3.82

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

Revenues	1999	2000	2001
Interest income	34.18	22.29	28.08
Income from securities transactions	16.32	11.55	11.28
Recoveries from provisions	11.68	23.12	8.37
Income not derived from interest	37.68	42.75	51.99
Extraordinary income	0.14	0.29	0.28
Expenditures	**1999**	**2000**	**2001**
Interest expenses	35.01	22.88	24.51
Expenses for securities transactions	0.55	0.26	0.29
Provisions expenses	19.69	27.05	10.45
Expenses, other than interest	41.43	48.17	61.65
Extraordinary expenses	0.37	0.17	1.02
Profit tax	2.95	1.47	2.08

Structure of registered capital and own funds of financial institutions in 2001

Type of the financial institution	Registered capital Mil. USD	/Total assets %	Own funds Mil. USD	/Total liab. %
Commercial banks	846.6	8.4	1,345.1	13.4
Foreign banks branches	44.1	5.1	77.9 *)	9.0
Total banking system	**890.7**	**8.2**	**1,423.0**	**13.0**

*) own capital

2001 DEVELOPMENTS IN THE RUSSIAN BANKING SYSTEM

MACROECONOMIC INDICATORS

The dynamics of major macroeconomic indicators remained favourable in 2001: Russia's economy continued to grow, while inflation slowed down. Inflationary pressure was reduced owing to a balanced monetary policy and the stable dynamics of the ruble exchange rate. Production growth in 2001 was accompanied by the creation of new jobs and a rise in employment and household income.

In 2001, gross domestic product (GDP) expanded 5.0% against 9.0% in 2000, industrial production grew 4.9% and fixed capital investment increased almost 9%. Year-on-year real money income rose 7.2% in 2001.

Although consumer price growth was slightly faster than the official forecast, on the whole it corresponded to target parameters. Full-year consumer price growth in 2001 amounted to 18.6% against 20.2% in 2000 and industrial producer prices went up 10.7% against 31.6% in 2000.

The overall price situation in the world markets for goods making up the bulk of Russian exports was favourable during 2001. As a result, the balance of payments remained stable and capital outflow began to decrease. The value of mobilised foreign assets ensured full and timely service of the government's foreign debt and further growth in foreign exchange reserves. Russia's foreign trade turnover in 2001 expanded 4% to $157.0 billion and trade surplus amounted to nearly $50 billion. The current-account surplus amounted to $35.1 billion, of which the current-account surplus in trade with non-CIS amounted to $34.1 billion.

By and large, the results of 2001 showed that Russia's economy was growing, risks were decreasing and the country's investment climate was changing for the better.

BANKING SECTOR DEVELOPMENT

The development of the Russian banking sector in 2001 had positive dynamics, which reflected a favourable state of the Russian economy. Moreover, the rate of development of the banking sector was considerably faster than that of the economy as a whole: over the year, growth in banking sector assets exceeded three times GDP growth. As a result, the post-crisis recovery of the main parameters of the Russian banking sector was completed last year. The number of operating credit institutions rose from 1,311 to 1,319.

The scale of banking activities continued to expand in 2001. Over the year, banking sector assets increased 34% in current prices. It is highly significant that the ruble assets grew faster than foreign exchange assets.

The role of the banking sector in the country's economy increased: as of January 1, 2002, banking sector assets relative to GDP amounted to almost 35% against 32.4% as of January 1, 2001, loans to the real economy 13.5% against 10.9% and the value of funds drawn from corporate clients and private individuals 17.5% against 16.0%. The capitalisation of the banking sector continued: in 2001, the capital of operating banks increased by 167.5 billion rubles (1.6 times over) to 453.9 billion as of January 1, 2002.

The improved condition of enterprises in the real sector, growth in household money income and greater activity of the interbank loan market stimulated the flow of funds to the banking sector. The value of funds drawn by banks from enterprises and organisations in 2001 rose 25%, while their share in banking sector liabilities expanded to 28.6%. At the same time, the value of household deposits with banks increased 52%, and as of January 1, 2002, it amounted to 678 billion rubles, or 21.5% of banking liabilities.

The most rapidly growing active operations by banks was lending to the real economy and household sector. The loan portfolio, including loans to banks, in 2001 increased from 1,082.7 billion to 1,562.0 billion, a growth of 44%. The share of the loan portfolio in the assets of operating credit institutions expanded from 45.8% to 49.4%.

In 2001, operating credit institutions made a profit of 67.6 billion rubles against 17.2 billion rubles in 2000. The share of profit-making banks in the assets and total number of operating banks in 2001 exceeded 95%.

Despite the favourable dynamics of major banking sector performance indicators, one should not underestimate the exposure of credit institutions to potential systemic risks. As the experience of other countries shows, rapid growth of credit institutions is often accompanied by the accumulation of credit risks in the banking sector, and the danger of such risks increases as the general economic situation deteriorates or a recession begins in some sectors of the economy. They may eventually weaken the financial standing of borrowers and undermine their ability to service their debt to the banks. This represents one of the real factors of systemic risk in the banking sector.

There is still a number of extraneous problems impeding the development of the banking sector, such as an economic structure unfavourable for the diversification of risks, legislative gaps (inadequate protection of creditors' rights, flaws in the collateral legislation and a tax regime unfavourable for credit institutions), serious shortcomings in the law enforcement practice and a low level of transparency and market discipline.

Prospects for banking sector development. In the interest of economic progress the level of development and functional role of the banking sector should be increased significantly. On December 30, 2001, the Russian government and Bank of Russia adopted the mid-term Strategy of Russian Banking Sector Development, projected for five years.

According to this document, the principal objectives of banking sector development are strengthening its stability, raising the standard of its work in accumulating funds and turning them into loans and investments, strengthening confidence of depositors and other bank creditors, increasing the protection of their interests and preventing the use of credit institutions for dishonest commercial purposes. A major means of attaining these objectives in the near future is the conversion of Russian enterprises and credit institutions to international standards, including international accounting standards, to which the Russian economy, the banking sector included, should switch in 2004.

REGULATORY FRAMEWORK OF BANKING ADMINISTRATION AND SUPERVISION

A list of documents providing the regulatory base for banking supervision can be found in the Bank of Russia server in the Internet at www.cbr.ru.

THE ACTIVITIES OF BANKING SUPERVISION DEPARTMENT IN 2001

The principal objective of banking supervision in 2001 was to ensure banking sector stability and protect the interests of creditors and depositors. The efforts of the Bank of Russia in banking supervision (off-site and on-site inspection) were focused on the evaluation of the nature and extent of the risks assumed by credit institutions, the quality of risk management, the management of a credit institution, including the level of organisation and efficiency of its internal control system, and control over trustworthy reporting of risks by banks.

In 2001, the Bank of Russia tackled the problem of further enhancing the efficiency of supervision. To this end, it took steps to upgrade the methods of analysing the financial standing of credit institutions. It adopted in its supervisory practice the method of comprehensive analysis of the financial standing of a bank, using the corresponding software system. The method was approved by foreign experts, who recommended it to Bank of Russia specialists as a means of making a comprehensive assessment of the activities of credit institutions and identifying their problems at an early stage.

In the year under review, just as in the previous years, the inspection of credit institutions was a major element of supervision. To ensure a comprehensive approach to the supervision of multi-branch banks, the Bank of Russia in 2001 actively conducted simultaneous inspections of banks and their branches located in various regions of the country. The inspection departments of several Bank of Russia regional branches simultaneously participated in such inspections.

The choice of a supervision regime, including the use of supervisory response measures with regard to a specific bank, was also based on the results of a comprehensive analysis, conducted using inspection data and taking into consideration the extent of the risks assumed by the bank, the efficiency of its internal control system and the existence of a threat in its activities to the interests of creditors and depositors. Such an approach to supervision made it possible more efficiently to distribute the efforts of the supervisory bodies, focussing them on weaker banks that needed more attention and a more intense supervisory regime.

In the year under review, the Bank of Russia took steps to spread the use of consolidated supervision. The reports it had at its disposal allowed it to analyse the makeup and financial standing of banking groups and identify their exposure to risks. If the necessary amendments are made to the banking legislation, giving the Bank of Russia the powers to set prudential standards for banking groups and apply supervisory regulation to them, the problem of consolidated supervision will be resolved.

In 2001, the Bank of Russia continued to convert the national banking regulation system to international standards, especially those written down in the documents of the Basle Committee on Banking Regulation and Supervisory Practices.

One of the most significant moves made in this direction was the coming into force of the Bank of Russia Provision on the Procedure for Creating by Credit Institutions Reserves for Possible Loan Losses, which provided for the quantitative evaluation of the reserves made for risks connected with balance sheet assets (except the assets for which reserves are created in accordance with the Bank of Russia's earlier regulations), and off-balance sheet instruments (including forward transactions), using the international principle of creating reserves, based on a credit institution's reasoned judgement about the extent of the risk it has assumed.

Changes were made in the methodology of calculating the own funds (capital) of credit institutions, in accordance with which the value of own funds (capital) is corrected (reduced) by the value of the shortfall in the reserve for possible losses, created in accordance with the aforementioned Provision.

In 2001, the Bank of Russia developed and enforced a criterion broadening the range of credit institutions required to calculate market risks, whose value is included in the calculation of capital adequacy. The corresponding requirements now apply to credit institutions that have a trade portfolio with a total balance sheet value exceeding 5% of the total of the balance sheet. As of January 1, 2001, market risks were calculated by 808 credit institutions against 703 credit institutions that did so as of January 1, 2001.

The Bank of Russia specified the procedure for determining the financial performance of a credit institution, included in the calculation of own funds (capital). From 2001, the financial result is reduced by the value of claims made on credit institutions whose licence was revoked (net of the reserves created).

The Bank of Russia established the procedure for the prudential regulation of non-bank credit institutions conducting deposit and lending operations, which broadened the institutional possibilities of financial intermediation, especially in respect to investment activity.

In November 2001, the Bank of Russia adopted a number of documents, worked out on the basis of FATF recommendations, international banking practices and the expertise of leading Russian credit institutions.

Aware of the importance of countering the financing of terrorism, including international terrorism, the Bank of Russia made known to credit institutions the names of individuals and organisations involved in terrorist activities and its financing. Credit institutions should use this information in compliance with the applicable Russian legislation.

In 2001, the Bank of Russia continued to make efforts to improve corporate governance and internal control in credit institutions. To disseminate advanced foreign experience in this area, the Bank of Russia Bulletin published Basle Committee directives "Enhancing Corporate Governance in Banking Organisations" and "Framework for the Evaluation of Internal Control Systems."

LEGAL FRAMEWORK OF BANKING REGULATION AND SUPERVISION. STRUCTURE OF THE BANKING SUPERVISION BODY

Banking activities are supervised in Russia by the Central Bank of the Russian Federation. The legal status of the Central Bank is established by the Russian Constitution, Federal Law on the Central Bank of the Russian Federation (Bank of Russia) and Federal Law on Banks and Banking Activities.

The supervising system of the central office of the Bank of Russia comprises the Department for Banking Regulation and Supervision, Department for Licensing Credit Institutions and Their Financial Rehabilitation and Department for Foreign Exchange Regulation and Foreign Exchange Control. At the head of the supervising system of the Bank of Russia is the Banking Supervision Committee. The Bank of Russia implements its banking regulation and supervision policy through its regional branches and national banks.

STRATEGIC OBJECTIVES OF THE BANKING REGULATION AND SUPERVISION BODY

The principal long-term objective of the efforts to upgrade regulation and supervision procedures remains the development of meaningful methods of analysing the situation in the banking sector and in an individual credit institution. To upgrade the procedure for accessing credit institutions to the banking services market requires:

- first, maintaining an adequate level of requirements preventing the founding and enlargement of financially unstable credit institutions and the participation in the management of credit institutions of founders (members) with an unstable financial standing and managers with a dubious business reputation;
- second, implementing measures to remove excessive administrative barriers, optimise procedures and establish more precise and reasonable requirements for credit institutions and their founders and members, including foreigners, and for managers.

The creation of conditions for cutting costs, simplifying, optimising and reducing the duration of the procedures relating to access to the banking services market, obtaining permission for individual banking operations and opening branches and new intrabank divisions would give an additional impetus to banking sector development. The Bank of Russia supports of the changes made in legislation to simplify bank merger and acquisition procedures.

The Bank of Russia will pay special attention to the qualitative parameters of banking capital, which implies a comprehensive evaluation of the financial standing of the founders and buyers of considerable stakes (blocks of shares) in the authorised capital of credit institutions and the prevention of the use of fictitious bank capitalisation schemes. The effective solution of these problems is linked with the implementation of IAS principles.

To bolster market discipline, it is necessary to upgrade bank bankruptcy laws and procedures, especially by making open the process of liquidation and sale of assets and tightening requirements for the qualification and reputation of the receivers. The Bank of Russia supports amendments to the applicable legislation that would lead to the creation of the institute of the corporate liquidator and assign these functions on the Agency for the Restructuring of Credit Organisations.

To increase the responsibility of managers and members of credit institutions for the standard of corporate governance, it is necessary to make amendments to the banking legislation, which would bolster the mechanism of Bank of Russia control over the quality of business planning in credit institutions, tighten requirements for their managers, including the expansion of the range of bank managers and employees to whom qualification and business reputation requirements should be made, establishing business reputation requirements for the founders and members of credit institutions and further upgrading the transparency requirements for the structure of their property (including information on banking groups and bank holding companies and affiliated persons).

The expansion of the presence in the Russian market of credit institutions with foreign interest, which bring to this market advanced banking techniques, new financial products and efficient corporate governance practices, may become a major factor of the modernisation of the Russian banking sector. The preservation of the existing forms of foreign capital presence in the Russian banking services market, such as opening foreign bank subsidiaries in Russia or non-resident participation in the authorised capital of an operating credit institution, would contribute to stability of banking in this country.

The Bank of Russia will continue to make efforts to raise the standard of supervision, especially by replacing formal procedures of control over the observance of the established standards by an evaluation of the real parameters of risks (risk-oriented supervision) and enhancing its efficiency. It will pay special attention to the efficacy of the intrabank management and internal control systems.

The Bank of Russia will continue to take steps to optimise the system of required reserve ratios. It plans to propose a shorter list of Bank of Russia required reserve ratios and specify the methods of calculating some reserve ratios. This will require making amendments to the Federal Law on the Central Bank of the Russian Federation (Bank of Russia), Federal Law on Banks and Banking Activities and some Bank of Russia enactments.

Measures are to be implemented to promote the development of the proactive function of banking supervision, including further upgrading the early warning systems based on off-site data analysis and supervision on the consolidated basis. The Bank of Russia is to carry out measures to optimise the system of bank reporting. The transition to international accounting standards is a major condition of enhancing the efficiency of banking regulation and supervision.

To encourage bank lending to small businesses, the Bank of Russia intends to consider the possibility of establishing a simplified procedure for evaluating credit risks and creating reserves for possible small loan losses extended to individual entrepreneurs and private individuals.

The drafting of Bank of Russia proposals on extending the list of data published by credit institutions will help bolster market discipline in the banking sector.

The Bank of Russia also plans to draft and submit to the Government proposals on making amendments to the Federal Law on Joint-Stock Companies, which will stipulate that the annual reports, including the balance sheets, profit and loss account, the allocation of profits and the establishment of the sources of compensation for losses, should be approved by a general shareholders meeting on the basis of the data certified by an auditor.

STATISTICAL TABLES

Number of financial institutions (as of end of year)

Type of financial institution	1999	2000	2001
Total number of operating credit institutions of which:	**1349**	**1311**	**1319**
Banks	1315	1274	1276
Non-bank credit institutions	34	37	43

Structure of assets of credit institutions by kind of investment

Assets	1.01.00 billion rubles	%	1.01.01 billion rubles	%	1.01.02 billion rubles	%
1. Funds, precious metals and gemstones	45.0	2.8	47.1	2.0	70.3	2.2
2. Accounts with Central Bank	137.0	8.6	273.6	11.6	303.9	9.6
3. Correspondent accounts in banks	158.3	10.0	236.3	10.0	315.3	10.0
4. Securities acquired by banks of which:	318.9	20.1	465.8	19.7	546.8	17.3
4.1. Debt on government loans	213.7	13.5	310.6	13.1	338.4	10.7
5. Debt obligations	726.7	45.8	1,082.7	45.8	1,562.0	49.4
6. Other assets	200.6	12.6	257.0	10.9	361.4	11.4
Total assets	**1,586.4**	**100.0**	**2,362.5**	**100.0**	**3,159.7**	**100.0**

Structure of liabilities of credit institutions by sources of funds

Liabilities	1.01.00 billion rubles	%	1.01.01 billion rubles	%	1.01.02 billion rubles	%
1. Funds and profits of banks	226.8	14.3	336.1	14.2	510.3	16.2
2. Loans received by banks from Central Bank	14.2	0.9	11.1	0.5	46.6	1.5
3. Bank accounts	62.4	3.9	119.3	5.1	164.7	5.2
4. Inter-bank loans and deposits	173.4	10.9	178.7	7.6	203.1	6.4
5. Clients' funds of which:	796.6	50.2	1,223.9	51.8	1,647.7	52.1
5.1. funds drawn from corporate clients	468.8	29.6	722.3	30.6	902.8	28.6
5.2. household deposits	297.1	18.7	445.7	18.9	677.9	21.5
6. Debt obligations issued by banks	116.5	7.3	200.8	8.5	272.5	8.6
7. Other liabilities	196.5	12.4	292.6	12.4	314.8	10.0
Total liabilities	**1,586.4**	**100.0**	**2,362.5**	**100.0**	**3,159.7**	**100.0**

Credit portfolio quality structure (%)
(according to general financial statements of banks)

Quality of loan	As of 1.01.00	As of 1.01.01	As of 1.01.02
Standard	78.8	87.2	89.4
Substandard	7.8	5.1	4.3
Doubtful	2.7	2.5	2.1
Bad	10.7	5.2	4.2

Credit portfolio (%)

Indicator	As of 1.01.00	As of 1.01.01	As of 1.01.02
Loans to government	4.8	1.6	1.2
Loans to banks	14.3	10.8	8.7
Loans to private individuals	4.2	4.6	6.4
Loans to legal entities	74.8	81.9	82.4
Other	1.8	1.2	1.3

Dynamics of risk-weighted bank assets

billion rubles

Risk-weighted assets	1.01.00	1.01.01	1.01.02
Group 1 (Ar 1) (risk-benefit ratio=2%)	0.9	0.9	1.4
Group 2 (Ar 2) (risk-benefit ratio=10%)	23.1	30.8	31.8
Group 3 (Ar 3) (risk-benefit ratio=20%)	59.5	73.1	88.4
Group 4 (Ar 4) (risk-benefit ratio=70%)	48.0	76.0	77.1
Group 5 (Ar 5) (risk-benefit ratio=100%)	724.5	1,160.1	1,790.1
Total risk-weighted assets of credit institutions	**856.0**	**1,340.9**	**1,988.8**

Dynamics of share of foreign currency assets and liabilities in aggregate banking sector assets and liabilities

	1.01.00	1.01.01	1.01.02
Foreign currency assets as % of total assets	48.9	41.9	37.9
Foreign currency liabilities as % of total liabilities	37.6	32.8	32.1
Difference in ratio of foreign currency component of assets and liabilities, percentage points	11.3	9.1	5.8

Income and expenditure structure of operating credit institutions (%)*

	1.01.00	1.01.01	1.01.02
Income, total of which:	**100.0**	**100.0**	**100.0**
– interest received for loans extended	9.09	11.43	13.05
– income received from operations with securities	6.68	8.02	6.52
– income received from operations with foreign exchange and other currency values	63.85	40.11	32.71
– dividends (except shares)	0.00	0.00	0.01
– fines and penalties	0.34	0.23	0.55
other incomes	20.03	40.20	47.16
of which:			
recovery of sums from accounts of funds and reserves	13.32	33.53	41.15
commission received	2.35	2.92	3.00
Expenditure, total of which:	**100.0**	**100.0**	**100.0**
– interest paid for loans taken	1.18	0.91	0.98
– interest paid to legal entities for borrowed funds	1.83	2.16	2.44
– interest paid to private individuals on deposits	6.51	6.03	3.46
– expenditures on operations with securities	2.88	2.68	3.15
– expenditures on operations with foreign exchange and other currency values	59.94	39.75	32.73
– administration expenditures	2.33	3.30	4.35
– penalties and fines	0.12	0.05	0.31
– other expenditures	25.21	45.12	52.57
of which:			
allocations to funds and reserves	17.90	37.61	45.30
commission paid	0.25	0.26	0.32

* *According to the profit-and-loss report of credit institutions (f.102)*

2001 DEVELOPMENTS IN THE SLOVAKIAN BANKING SYSTEM

ECONOMIC DEVELOPMENT

In terms of macro-economic indicators, in 2001 economic development was characterized by an increase in economic performance, which led to a rise in the level of employment, moderate growth in real wages, slowdown in the rate of increase in consumer and producer prices, and continued growth in profits in the entrepreneurial sector. On the other hand, economic growth was accompanied by deterioration in its structure, with domestic demand becoming the main stimulus and the deficit in trade in goods and services recording a relatively steep increase. It turned out that the macro-economic balance established in the previous two years was only of a temporary nature.

Consumer prices

In 2001, the rate of increase in consumer prices slowed in comparison with 2000, when the 12-month rate of inflation, expressed in terms of the consumer price index, reached 6.5% in December (compared with 8.4% in the same period a year earlier). The average rate of inflation stood at 7.3% in 2001.

Gross domestic product development

The development of gross domestic product in 2001 followed the trend of gradual acceleration in the rate of economic growth in Slovakia. On a year-on-year basis, GDP increased by 3.3% at constant prices (compared with 2.2% in 2000).

Wages and labour productivity

In 2001, the average monthly nominal wage of an employee in the Slovak economy reached Sk 12,365, representing a year-on-year increase of 8.2%. The rate of growth was 1.7 percentage points faster than a year earlier. The development of nominal wages during the year was characterized by slower growth during the first six months and gradual acceleration over the second half, which picked up speed at the end of the year.

Labour productivity (GDP per employee in the Slovak economy) increased year-on-year by 1.8% at constant prices, representing an excess of 1 point over growth in real wages (0.8%).

Balance of payments

After two years of stable development of the balance of payments in 2001, the Slovak economy once again found itself in an environment marked by deepening external macroeconomic imbalances.

A strategic solution lies in the use of supportive measures on the side of domestic supply and the continuation of structural reforms in the public and entrepreneurial sectors (at the small-business level).

Current account

The year 2001 saw a change in development in the balance of payments on current account. In comparison with the period of stabilization in the previous two years, the deficit in the current account increased in 2001, to Sk 84.9 billion. That represented a proportion of 8.8% of GDP (compared with 3.7% in 2000 and 5.0% in 1999).

The current account deficit was caused mainly by the balance of trade, which resulted in a deficit of Sk 103.2 billion (representing 10.8% of GDP in comparison with 4.8% in 2000 and 5.5% in 1999).

Capital and financial account

The capital and financial account resulted in a surplus of Sk 83.2 billion, but failed to cover the current account deficit in full. In comparison with the same period a year earlier, the surplus was Sk 15.4 billion (i.e. almost 23%) higher in 2001.

Foreign exchange reserves

At the end of 2001, the foreign exchange reserves of the NBS reached US$ 4,188.7 million, representing a year-on-year increase of US$ 111.9 million.

External debt of the SR

On 31 December 2001, the total gross external debt of the Slovak Republic amounted to US$ 11.269 billion (according to preliminary data), representing a year-on-year increase of US$ 464.3 million.

Budgetary performance

Act No. 472/2000 Z.z. on the State Budget regulated budgetary performance in 2001, with revenue projected in the amount of Sk 180.6 billion and expenditure estimated at Sk 217.8 billion. The budget deficit was set at Sk 37.2 billion (Article 1), but Article 12 of the Act allowed the deficit to be increased by the amount of government bonds issued for the financing of motorway construction (up to Sk 6.5 billion) and bank restructuring (up to Sk 9.8 billion).

At the end of 2001, the State Budget resulted in a total deficit Sk 44.4 billion. The deficit in current budgetary performance amounted to Sk 36.4 billion, i.e. the actual deficit accounted for roughly 97.8% of the budgeted figure. In accordance with Article 12, Sk 8.0 billion was used for bank restructuring, while the construction of motorways was financed from the current budget, primarily from the higher than projected budget revenue.

DEVELOPMENT IN THE BANKING SYSTEM

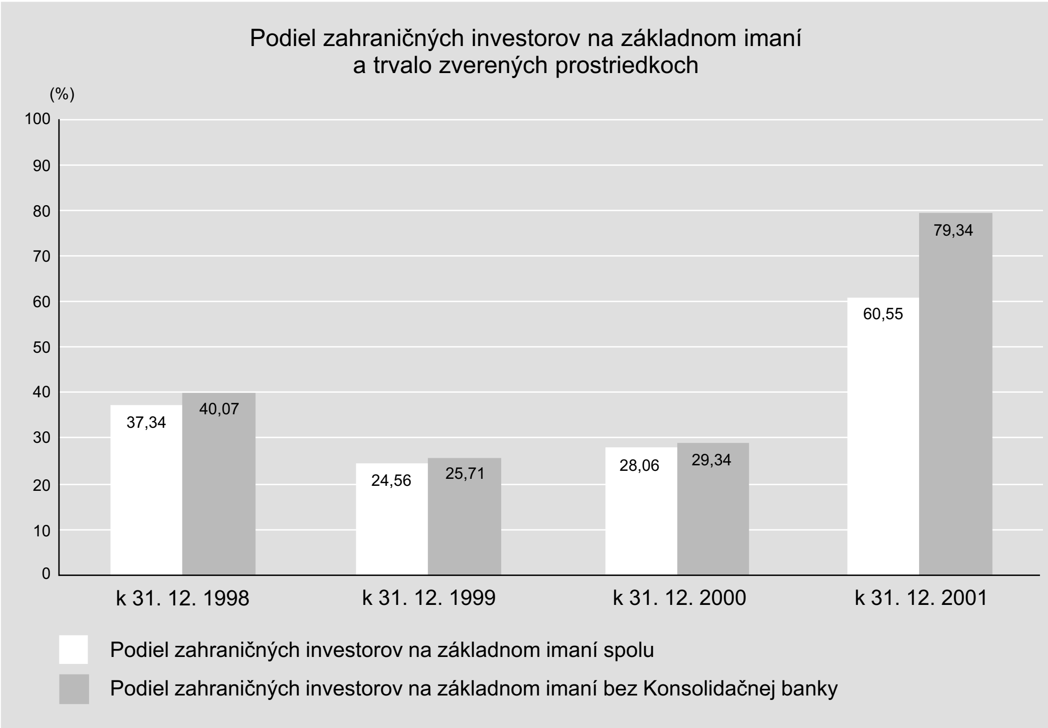
In 2001, the most important event was the completion of the restructuring and privatisation of banks with a significant share of the assets (45%) of the Slovak banking sector.

Banking sector recovery was reflected in a significant improvement in asset structure, the growth of capital adequacy of the sector and a reduction in the proportion of classified loans.

The transfer of loss-making loans and their replacement by state bonds influenced the release of funds linked to the coverage of non-performing assets. Together with the gradual restructuring of the corporate sector, this established a basis for the further growth of the Slovak economy.

One of the objectives of the privatisation of banks with significant state participation was the transfer of know-how as a stabilising element preventing a worsening of the current situation especially with regard to the development of loan activities. Foreign investors controlled a dominant proportion of banks' equity as well as banks' assets at year-end 2001.

In 2001, foreign investors' share in total subscribed equity capital of banks and permanent funds provided to branches of foreign banks by their headquarters increased significantly. The increase was due mainly to the gradual sale of state-owned equity capital to foreign investors.



In April 2001, Erste Bank der Österreichischen Sparkassen acquired a majority share in the equity capital of Slovenská sporite¾na, a. s. Bratislava, and as of the end of the monitored period it owned 67.2% of the bank's shares. In November 2001, IntesaBci, Milano, acquired a 94.47% share of the equity capital of Všeobecná úverová banka, a. s. Bratislava via its 100% subsidiary Comit Holding International, S.A. Luxembourg. In connection with the forthcoming sale of shares of Investièná a rozvojová banka, a.s., Bratislava to a foreign investor, the Ministry of Finance of the SR transferred a 65.5% share to the National Property Fund (NPF), thus increasing the NPF's holding from 4.0% to 69.56%. In December 2001, Slovenská poisťovňa, a. s. increased its holding in ISTROBANKA, a. s., Bratislava from 72.0% to 82.0% with the purchase of the 10.0% holding of ERSTE BANK in connection with the forthcoming sale of shares to a foreign investor.

HVB Bank Slovakia, a. s., Bratislava has operated in the banking sector since October 2001, following the merger of Bank Austria Creditanstalt Slovakia, a. s. and HypoVereinsbank Slovakia, a. s., Bratislava.

The banking sector restructuring process is also connected to the transformation of Konsolidaèná banka Bratislava, š. p. ú. (KOBL) to which part of problematic receivables were transferred. The MF SR, as the founder of KOBL in line with the about issued a statement winding up the bank without liquidation.

Prudential banking behaviour

The main task and role of banking supervision is the support of stability and the sound development of banks, banking systems and the protection of the interests of depositors. The basic regulation instruments of banking supervision are the rules for prudential banking behaviour and the limits set by them.

The capital adequacy of the Slovak banking sector as of 31.12.2001 increased and after excluding the influence of KOBL reached 19.72%. At the end of the monitored period, one bank did not meet the capital adequacy limit.

The uncovered estimated loss of the Slovak banking sector, compared to the loss reported as of 31.12.2000 decreased from SKK 0.01 billion to SKK 0.007 billion as of 31.12.2001. Three banks reported an uncovered estimated loss for the evaluated period.

During 2001, an overall improvement of the fulfilment of stipulated credit exposure limits was recorded. As of 31.12.2001, four banks were in breach of the limit regarding non-banking customers (excluding KOBL). One bank did not comply with the limit regarding entities with a special relationship and the aggregate net credit exposure limit.

As of 31. 12. 2001, the monthly liquidity limit (the ratio of monthly assets and liabilities may not fall below 0.9) was honoured by all banks. The limit of the ratio of the sum of fixed and non-liquid assets to own funds and reserves (which may not exceed 1) was not honoured by two banks.

Compliance with limits regarding covered foreign exchange positions stabilised and all banks fulfilled the stipulated limits as of the end of the evaluated period.

On-site inspection

In 2001, six on-site inspections were carried out at five banks, two were full-scope and four targeted.

The inspection's outcomes were discussed with banks' managements. It adopted corrective measures that were controlled by the banking supervision.

By a decision of 24 August 2001, the NBS placed DEVÍN BANKA, a. s., Bratislava under forced administration and the bank was put under a special regime. On 28 September 2001, the Bratislava Regional Court declared bankruptcy on the property of the bank. This declaration terminated the forced administration.

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

Last year meant a substantial change in the legal and economic environment for the conduct of banking supervision and banking products and services offered by banks and foreign banks branches in the Slovak Republic.

With regard to the legal background having the most crucial impact on the banking industry, two pieces of primary legislation were reconsidered and redrafted.

In May 2001, an amendment of the National Bank of Slovakia Act has entered into force. This amendment, which is fully backed by the latest amendment of the Slovak Constitution (in 2000), has substantially strengthened the position of the Central Bank, bringing it in line with the European Central Bank's requirements toward independency and transparency in conducting its key tasks. Thus the function of banking sector supervision being one of the primary roles of the National Bank of Slovakia has also been reinforced. In the area of banking supervision the role of the Ministry of Finance has been reconsidered in the light of almost finished privatisation process of the Slovak banking industry by respective authorities and now it plays only a marginal role. By the in-depth definition of all three crucial components of banking supervision of the National Bank of Slovakia provided in the amended National Bank of Slovakia Act, the actual responsibilities, powers and obligations were set up in a transparent and comprehensible way. The amendment of the National Bank of Slovakia enables the banking supervision's independent proceeding and decision-making process in the first level. Also the capacity of the Central Bank to cooperate and share confidential information with different home and foreign supervisory authorities was clarified in order to allow for prudent conduct of its supervisory role both within the country and cross-border.

The new Act on Banks was agreed in October 2001 (except for respective parts that will come into effect after the country's accession to the EU, e. g. concept of a single banking licence). The main goal of this new law was to:

- incorporate OECD recommendations and requirements raised during the Slovak Republic pre-accession discussions in 1999 and 2000 (mainly the corporate governance principles),
- implement more in-depth the EU "banking" Directives as well as some missing areas from the European Anti-Money Laundering Directive,
- enhance the overall compliance with 25 Basle Core Principles.

The major shortcomings of the Slovak legal background listed above were addressed in the new Act on Banks and will be also covered by the related secondary legislation (called Decrees of the Central Bank) that is to be issued by the National Bank of Slovakia in due course (the total number of decrees is 16, out of which already 7 is in force and the rest will be put in place not later than to the end of year 2002). As a matter of fact, decrees create regulatory framework for the conduct of banking supervision and should clarify details in such areas of supervisory activities as:

- licensing (setting up of conditions to be met before a new bank or a foreign bank's branch is allowed to enter into business, conditions of shareholder's and top management changes, prior approval procedures in existing banks and foreign bank's branches, monitoring of persons with special relationship to a bank or to a foreign bank's branch, etc.),
- on-going supervision (regular prudential behaviour reporting based on own funds ratio, large risk exposures, liquidity, asset classification and credit and guarantees register),
- also within the supervisory off-site function a separate decree on the "long form" of the auditor's report in order to serve as a reliable source of information in analysing a bank's financial strength and position.

One of the completely new concepts introduced by the new Act on Banks is banking supervision conducted on a consolidated basis. Also the law provides for monitoring of other risks inherent in the banking activities (e. g. settlement risk, debt instruments risk, business counterpart risk, foreign exchange risk, etc.). The responsibility of the top management for conducting the banking business in sound and safe manner is increased substantially by respective articles of the new Act.

Moreover, the new Act enables also a deepened cooperation with foreign supervisory authorities either by allowing joint on-site controls in subsidiaries of foreign banks in Slovakia or by providing the home country supervisor a possibility to come and verify what is necessary from his point of view on spot. Issues of mutual interest for both supervisory bodies (home and host) should be dealt with in detail in bilateral Memoranda of Understandings to be signed in the next future (currently, there was 1 in force with the Czech supervisory authority since 1999, which replaced the previous one dated 1993, negotiations were held with the German, Hungarian, Italian, Austrian, French, Dutch, Russian supervisors). With regard to cooperation with domestic supervisory authorities, negotiations were started with the FMA responsible for the capita market and insurance supervision.

Other laws that have an impact on the banking supervision and banking industry have been amended or adopted during 2001 as well.

The Commercial Code (Act No 513/1991 Coll.) amendment as of October 2001 brought that law in harmony with EU requirements especially in the area of creditors and minority shareholders rights protection and specified more in-depth the procedures of merger, consolidation and split of companies.

The Deposit Protection Act's (Act No 118/1996 Coll.) amendment entered into force in December 2001. The main objective was in particular to harmonize the Deposit Protection Act with requirements of the European Union. Thus, the amendment widened the legal protection of bank deposits by including bank deposits of some selected groups of legal entities of non-profit and non-entrepreneurial character. Following the accession of the Slovak Republic to the EU, the legal protection of bank deposits will be widened to bank deposits of other types of legal entities, so that from the viewpoint of protected bank deposits of legal entities the Slovak law would fully meet the EU standards. In particular, the changes introduced were as follows:

- deposits protected under this law that became inaccessible before the day when the Slovak Republic becomes a member of the European Union, are covered by compensation equal to 90 per cent of the volume of inaccessible deposit, however, on aggregate one depositor is entitled to the maximum compensation of thirty times the average wage, and when a deposit becomes inaccessible after June 30, 2002 forty times the average wage in the Slovak Republic for the preceding four quarters according to the Statistical Office of the Slovak Republic,
- since the date of the Slovak Republic accession to the European Union, the compensation for inaccessible deposit per one depositor in one bank will increase to EUR 20,000. A depositor will be entitled to compensation equal 90 per cent of the nominal value of an inaccessible deposit in one bank.

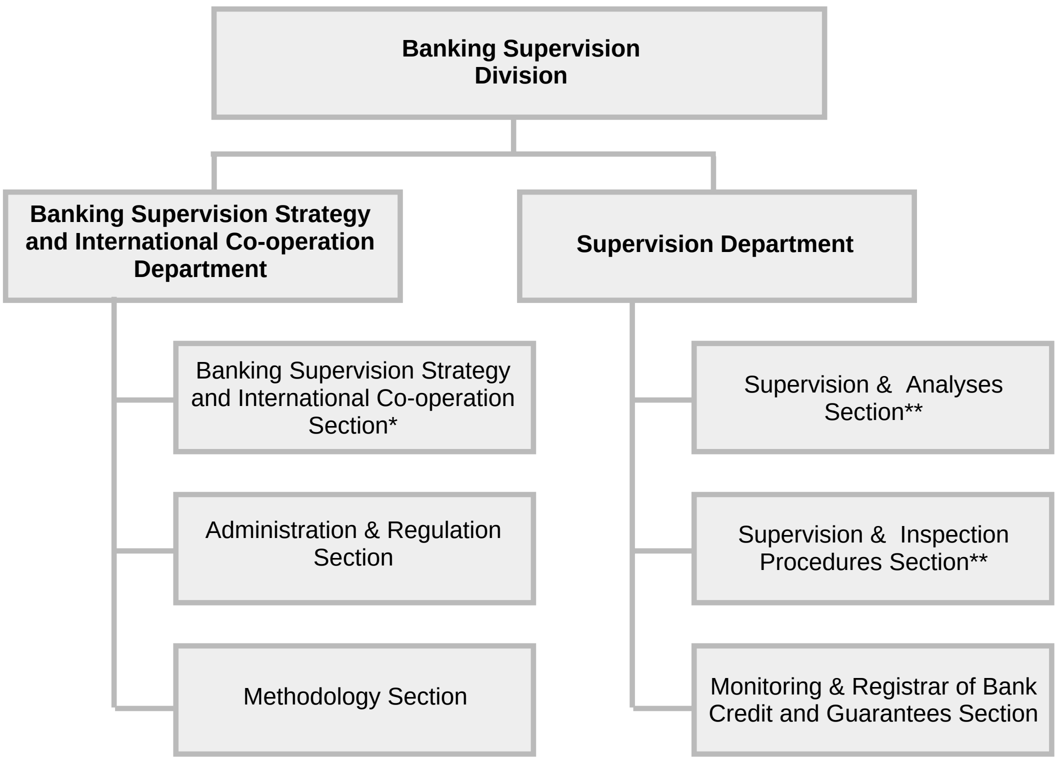
Secondary legislation

The specific conduct of banking supervision is implemented by means of secondary standards – decrees on prudential banking behaviour that specify the requirements and framework for the conduct of banking operations. The rules on prudential banking behaviour are currently included in decrees that were issued on the basis of authorising provisions in Act No. 21/1992 on banks, their content has been adapted to harmonise Slovak legislation with European Union law and with the principles of effective conduct of banking supervision issued by the Basle Committee for Banking Supervision. In 2001, pursuant to the mentioned facts, the following amended NBS decrees became effective: on limitations on unsecured currency positions of banks, on capital adequacy of banks, on liquidity rules for banks and branches of foreign banks, on disclosure of information by banks and branches of foreign banks, on rules for the limitation of a concentration of bank's property against other entities, and on the presentation of information by banks and branches of foreign banks to the National Bank of Slovakia.

The prepared NBS decree specifying the rules regulating the prudent behaviour of banks for the new Act on banks will fulfil all existing functions for the regulation of banking activities, particularly the management of capital adequacy, loan exposure and bank liquidity. There will be a tightening of the rules regarding the provision of information to the general public and the professional public, and rules for secured banking operations in selected types of banking activities will be introduced. The main reason for the issue of a completely new set of rules regarding the prudent behaviour of banks is the steadily increasing activities of banking entities on world financial markets and the globalisation of the banking sector. The first reason increases the trade portfolio of banks and exposure to risks related to financial markets operations. The other reason, on one hand diversifies the risk of owners, but on the other hand requires the monitoring of their financial situation. A further reason is harmonisation with EU law, more specifically with directives 2000/12 EC and 93/6 EC as amended by subsequent regulations. In 2001, for the stated reasons, the NBS Decree on the disclosure of information by banks and branches of foreign banks conducting business in the Slovak Republic, replaced the existing Decree of the NBS No. 3/2001 on the disclosure of information by banks and branches of foreign banks was adopted.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISION AUTHORITY

The construction of the banking supervision division was influenced by developments in legislation, in particular the most recent revision of Law 21/1992 Coll. on Banks as well as the gradual fulfilment of basic principles of banking supervision known as the Basle Core Principles.



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STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	1999	2000	2001
Banks	**23**	**21**	**19**
– Joint stock companies	19	16	14
– State financial institutions	2	2	2
– Building savings banks	2	3	3
Branches	**2**	**2**	**2**
Financial Institutions, total	**25**	**23**	**21**

Ownership structure of financial institutions in 2001 on the basis of registered capital (%) (at year-end)

Item	Type of financial institution				Total
	Joint stock companies	State financial institutions	Building savings banks	Branches	
State ownership	3.8	25.0			**28.8**
Other domestic ownership	9.0		1.6		**10.6**
Domestic ownership total	12.8				**39.4**
Foreign ownership	48.6		3.5	8.5	**60.6**
Financial Institutions, total	**61.4**	**25.0**	**5.1**	**8.5**	**100.0**

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

Item	1999	2000	2001	2001/1999
State ownership	53.0	50.9	28.8	0.5
Other domestic ownership	22.4	21.0	10.6	0.5
Domestic ownership total	75.4	71.9	39.4	0.5
Foreign ownership	24.6	28.1	60.6	2.5
Financial Institutions, total	**100.0**	**100.0**	**100.0**	

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

Type of the financial institutions	Foreign Exchange Assets / Total Assets			
	1998	1999	2000	2001
Joint stock companies	46.03	34.96	18.00	19.13
State financial institutions	0.77	0.50	3.17	5.26
Building savings banks	0.41	0.35	0.35	0.35
Branches	44.63	27.02	36.74	26.49
Financial institutions, average	22.11	15.96	18.32	18.51

Type of the financial institutions	Foreign Exchange Liabilities / Total Liabilities			
	1998	1999	2000	2001
Joint stock companies	43.96	32.54	16.02	17.50
State financial institutions	1.00	1.81	6.03	7.84
Building savings banks	0.02	0.00	0.03	0.03
Branches	49.57	31.64	32.12	27.82
Financial institutions, average	21.80	15.38	16.30	17.31

Profit and loss statement

in th. USD

Ratios	1999	2000	2001
Net interest income from interbank operations	26,061	41,940	36,497.76
Net interest income from client operations	- 32,333	45,143	-19,164
Net interest spread	**- 6,272**	**87,084**	**17,334**
Income from FX operations	127,623	110,450	16,351
Income from securities operations	366,490	359,962	19,485
Income from banking operations (core activities)	**487,840**	**557,496**	**53,170**
Other operational income	36,822	53,698	-2,105
Operational expenses	471,490	438,161	35,434
Income from current operations	**53,172**	**173,033**	**15,631**
Net expenses from provisions and reserves	619,102	- 110,714	-313
Net losses from irrecoverable debt	102,294	203,966	2,866
Extraordinary income	14,763	48,835	2,328
Extraordinary expenses	26,328	19,759	851
Net icome from extraordinary operations	**- 11,565**	**29,076**	**1,478**
Applicable income taxes	18,686	16,482	392
Net icome/loss	**- 698,474**	**92,375**	**14,163**
USD	42,266	47,389	48,467

Structure of registered capital and own funds of financial institutions in 2001 (at year-end)

Type of the financial institutions	Registered capital in mil. USD	/Total assets %	Own funds in mil. USD	/Total liabilities %
Joint stock companies	730.04	4.64	1,596.72	10.15
State financial institutions	300.22	88.24	421.91	124.01
Building savings banks	51.58	2.61	309.40	10.31
Branches	0.00	0.00	127.84	6.57
Financial institutions, total	**1,096.70**	**5.72**	**2,406.00**	**12.55**

SKK/USD = 47.389

Average balance sheet items

in mil. USD

Items	1999	2000	2001
Average Balance Sheet total (assets total)	754.26	777.06	912.56
Average own capital	32.36	27.88	57.49

Distribution of market shares in balance sheet total (%)

Type of the financial institutions	1999	2000	2001
Joint stock companies	79.96	81.54	82.09
State financial institutions	4.84	2.37	1.78
Building savings banks	6.65	6.45	5.99
Branches	8.55	9.64	10.15
Financial institutions, total	**100.00**	**100.00**	**100.01**

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

Type of the financial institutions	1999	2000	2001
Joint stock companies	53.84	56.71	42.98
State financial institutions	3.70	3.56	2.57
Building savings banks	3.42	3.75	4.80
Branches	5.43	3.88	5.13
Financial institutions, total	**66.39**	**67.89**	**55.48**

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

Assets	1999	2000	2001
Deposits and credits with banks	30.1	29.16	25.6
Granted credits	46.86	40	29.84
Securities	14.27	19.89	28.95
Tangible and intangible assets	8.77	10.95	15.61
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**1999**	**2000**	**2001**
Deposits and credits from banks	20.06	18.44	17.59
Received deposits	65.86	70.72	71.54
Reserves	3.83	3.51	2.84
Initial capital	10.24	7.33	8.03
Total liabilities	**100.00**	**100.00**	**100.00**

Solvency ratio of financial institutions (%)

Type of the financial institutions	1998	1999	2000	2001
Joint stock companies	7.15	11.05	12.12	20.07
State financial institutions	25.39	21.44	34.80	11.58
Building savings banks	40.71	26.45	13.56	19.91
Branches	0.00	0.00	0.00	0.00
Financial institutions, average	**8.70**	**12.63**	**12.48**	**19.75**

Asset portfolio quality of the banking system

in mil. SKK

Asset classification	1998	1999	2000	2001
Substandard	14,319	13,664	6,880	6,260
Doubtfull	11,843	13,820	9,015	6,170
Loss	118,962	102,194	72,725	62,083
Classified total	**145,123**	**129,678**	**88,620**	**74,513**
Specific reserves	70,195	90,462	70,968	62,268

The structure of deposits and loans in 2001 (at year-end)

Households	60.52	20.90
Government sector	12.28	4.53
Business sphere	25.95	74.08
Foreign	0.81	0.43
Other	0.43	0.05
Total	**100.0**	**100.0**

The structure of deposits and loans in 2001 (%) (at year-end)

Maturity of deposits		Maturity of loans	
At sight	57.53	Long term loans	38.74
Within one year	28.24	Medium-term loans	29.56
Over one year	14.23	Short-term loans	31.70
Total	**100**	**Total**	**100**

2001 DEVELOPMENTS IN THE SLOVENIAN BANKING SECTOR

BANKA SLOVENIJE

MACROECONOMIC ENVIROMENT

A global economic downturn observed in 2001 and a spate of unexpected and often disruptive events should be overcome in the course of 2002. Slovenia's economic growth posted in 2001 was 3.0%. The rather flat economic activity affected employment-related figures. The rate of growth in the number of employed persons has been losing pace since the second half of 2001 but unemployment rate has been going down for the third consecutive year.

The balance of cross-border transactions on the current account showed a small deficit in 2001 (0.4% of GDP). The efforts of Slovenian exporters to make up for dwindling demand from Slovenia's traditional trading partners by clinching more deals on the markets of former Yugoslavia and the Soviet Union appear to be bearing fruit, with the picture of the regional composition of trade slightly changed.

The year 2001 witnessed a sharp increase in financial flows generated largely by the euro cash changeover when the citizens of the euro zone embraced the banknotes and coins in euro and foreign direct investment landing in Slovenia. Net financial inflows made in 2001 amounted to as much as 10.3% of GDP.

The weakening of economic activity and lower prices of oil have subdued the factors that generally generate inflationary pressures around the globe. Spill-over effects of price pressures started to calm down in the second half of 2001 dampening the rise of consumer price in Slovenia and posting January – December inflation rate at 7%.

High financial flows have affected the movements in monetary aggregates and have made pressures for the appreciation of the tolar. The growth rate of the broad monetary aggregate in 2001 was 23.9%, while the M1 aggregate increased at the rate of 12.8%. Therefore, the components over the transaction money grew faster than other components. This applies mainly to time deposits denominated in tolars and foreign exchange deposits placed by households – the components that do not directly ignite the inflation flames.

The Bank of Slovenia reviewed in 2001 its operating tactics and procedures of monetary policy implementation guided by the implications of the real and nominal convergence with the EMU framework. As a consequence, the Bank of Slovenia has adopted a medium-term inflation target: to trim inflation to the 4% rate by the end of 2003. In line with the new strategy, monetary policy implementation rests on two pillars of monetary policy indicators with money and its components being included in the first pillar. A pro-active stance to steering exchange rate policy with the aim to curb inflation and partly close the interest spread between domestic and foreign interest rates remains the landmark of Slovenia's central bank.

DEVELOPMENT IN THE BANKING SECTOR

The **banking sector in Slovenia** is the most important segment of Slovenia's financial system. The aggregate total assets of all credit institutions (banks, savings banks and savings and loan undertakings) accounted for 89 per cent of GDP at the end of 2001 with the banks remaining at the forefront with a 98 per cent of the market shared by 21 banks. Since size matters, this number is still high and speaks of the need to consolidate and explore synergy mergers and acquisitions can offer. The pace of consolidation is accelerating in Slovenia. Given the fact that the day of Slovenia's membership of the European Union is approaching and larger, stronger banks will be better equipped to face foreign competition in a couple of years' time, the largest Slovenian bank Nova Ljubljanska banka took over three banks within its banking group in October 2001. In the future Nova Ljubljanska banka hopes to acquire three other banks within its banking group and increase market share from 34 to around 38 per cent. At the same time, the fourth largest Slovenian bank – Abanka – is contemplating to join forces with one of small Slovenian banks – Banka Vipa, which currently has 1.8 per cent market share as from 1 January 2003.

So far, mergers and acquisitions have fallen short of the standard target – to lower operating costs across the banking industry, but the situation is changing to the better. At the end of 2001, operating expenses accounted for 3.1% of average total assets – a slight fall after 1999 and 2000 when this figure was 3.4%. This is a clear sign that the banks managed to control their operating costs better than in the previous years.

The market share of savings banks and savings and loan undertakings (in terms of total assets) has been very small in comparison with banks – only 1.9 per cent.

The attributes readily associated with Slovenia's banking system are the firm grip of the top banks on the domestic market, and high concentration of banks. The Number One bank in Slovenia had almost a 29 per cent share of the market in terms of unconsolidated total assets at the end of 2000. After the acquisition of three banks, which were members of NLB banking group, its market share increased to almost 35 per cent.

Over the last few years three largest banks have controlled approximately half of the Slovenian market (currently 56 per cent), the first five banks have had approximately 60 per cent of the market (currently 69 per cent), the top seven banks have held almost three-quarters of the market (currently 80 per cent). The share of the first ten banks has increased from 82 to 87 per cent.

As the **ownership structure** of banks in Slovenia, out of 21 banks, 7 were in the hands of domestic shareholders and 5 were wholly owned or controlled by foreign shareholders as at 31 December 2001. Domestic owners controlled the remaining 9 banks. Majority foreign shareholders come from Austria, France and Italy.

Foreign shareholders had 15.4 per cent at the end of 2001 following the acquisition of a 15 per cent holding in the fifth largest Slovenian bank by the Italian bank and the acquisition in the third largest Slovenian bank by the French bank. The percentage of foreign ownership (measured by equity capital) increased to 21.1 per cent as at 30 June 2002.

The banks in Slovenia are mostly in private hands. State-controlled banks are the top two banks – Nova Ljubljanska banka and Nova Kreditna banka Maribor, both taken-over by the Republic of Slovenia upon the completion of the rehabilitation process. The Government has a 14.4 per cent equity holding in the Slovenska investicijska banka, d.d. (Slovenian Investment Bank) and indirectly controls the Poštna banka Slovenije (Post Office Bank of Slovenia).

It is rather unusual that since branches of foreign banks were authorised to operate in Slovenia under the 1999 Banking Act, the first such branch – Kaerntner

Sparkasse AG – established in 1999 is still the only branch of a foreign bank in Slovenia. On the other hand, the interest of foreign investors in bank privatisation has remained strong. A year ago the Government of the Republic of Slovenia announced a framework **programme for privatisation** of Nova Ljubljanska banka and Nova Kreditna banka Maribor, whose combined market share is approximately 46 per cent. The Government expects the new owners to strengthen corporate governance, contribute to greater effectiveness of both banks and indirectly motivate all Slovenian banks to be more innovative and cost effective. At the same time, the privatisation proceeds are equally important since the rehabilitation of the two banks meant a considerable strain on public finance.

In April 2002, the Government of the Republic of Slovenia endorsed the proposal of the Privatisation Committee to sell 34% of the Nova Ljubljanska banka to the Belgian KBC Bank and decided to proceed with the second stage of privatisation as planned in the privatisation programme.

The second stage of privatisation will be a combination of a private placement of up to 14% of the shares still held by the Government, and a capital increase of up to 15%. The initial 5% of private placement was offered to the European Bank for Reconstruction and Development (EBRD).

The final ownership structure of Nova Ljubljanska banka following the second phase of the privatisation will be: 33% held by the Republic of Slovenia (including two state-owned Funds), 34% by KBC and 33% by other institutional shareholders.

Under the privatisation scenario for the second largest Slovenian bank – Nova Kreditna banka Maribor – 65% of the bank could be sold to a high-calibre strategic investor.

The Privatisation Committee eventually decided not to sell 65% of Nova Kreditna banka Maribor to the three bidders: Bank Austria HVB Group, UniCredito Italiano, Aktiva Consortium, as their offers did provide sufficient guarantees that the requirements laid out in the privatisation programme would be met.

The management and supervisory board of Nova Kreditna banka Maribor is responsible for drafting a programme for the implementation of the bank's development strategy by exploring the avenues that lead to the fulfilment of strategic objectives through the strengthening of the capital base (recapitalisation) and privatisation. The Ministry of Finance is expected to have the draft of the new programme by autumn 2002 built upon the concept of phasing in the privatisation process.

BANK PERFORMANCE IN 2001

As at 31 December 2001 Slovenian banks posted **total assets** in the amount of 3,963 billion tolars according to audited financial statements. This means a 24.1% rise in nominal terms, and this is the highest real growth of operations over the last five years. Such a high growth was enabled by booming retail deposits towards the end of 2001 following the introduction of Eurocash.

In nominal terms, banks' total assets grew in the range from 14.7 to 109.4%.

The banks generated **pre-tax profit** of 15.4 billion tolars in 2001. In comparison to the previous year, the profit fell by 17.2 billion tolars or 52.9%. It is the record low for the past six years and arises from the loss posted by one of the large banks when it was forced to make higher provisions on the basis of the asset classification in line with the criteria of the parent bank. By excluding the loss, the banking system generated pre-tax profit of 34.9 billion tolars in 2001. **After-tax profit** reached in 2001 was 1.9 billion tolars (in 2000 this figure was 19.9 billion tolars).

The **return on the average assets** amounted to 0.4% in 2001 – the record low over the past seven years. Between 1995 and 2000 this figure was in the range of 0.8% and 1.2% of the average assets. If we exclude the red figures of a major bank in 2001, the banks' return on the average assets amounted to 1.1% in 2001. The **return on the average equity** amounted to 4.8% in 2001 or to 11.9% if the loss is excluded.

The **net interest margin** being a ratio of net interest income to average gross interest-bearing assets lost almost one percentage point in 2001 landing at 3.6%. Without the loss of a major bank, the net interest margin of the banking system was 3.7% in 2001. The individual banks reached the net interest margins of very different amounts ranging between 1.1% and 6.9%.

The **interest spread** as a difference between the average annual nominal interest rate received from and paid to customers was further squeezed in 2001 following the rise in the interest rates paid and the drop in the interest rates received.

The **quality of loan portfolio** has not changed much over the past few years. The share of performing assets (claims classified in categories A and B) has ranged between 93 and 95 per cent (the share of non-performing assets being between 5 and 6 per cent), and the share of bad assets (claims in the lowest categories – D and E) has been between 3 and 4 per cent.

If we exclude claims on the Bank of Slovenia and the Government from the classification, then the portion of performing assets was 93 per cent at the end of 2001. This means, that the quality of the banks' portfolios is still satisfactory even without the said claims.

As for the **capital adequacy ratio**, it has been falling across the banking sector since 1996 and 2001 was no exception. Nevertheless, the capital adequacy ratio of 11.9 per cent as at the end of year 2001 is above the threshold. Until 1995, the capital adequacy ratio was increasing across Slovenia's banking sector as a result of more stringent capital requirements imposed by the Bank of Slovenia when a bank applied for a licence to provide certain banking services. Since 1995 when capital adequacy ratio of Slovenian banks was record high with 21.5 per cent, it has been steadily falling. The downward trend has not been reversed after the adoption of the Decree on the Calculation of Own Funds, Capital Requirements and Capital Adequacy Ratio of Banks and Savings Banks in May 1999, which introduced some innovations in relation to the calculation of capital. Under this Decree, the calculation of the capital adequacy ratio of banks and savings banks included other risk-adjusted items, adjusted for foreign exchange risk beginning at the end of June 2000.

Risk-weighted assets continued to rise in 2001. Capital grew by 7.7 per cent in 2001, while risk-adjusted assets increased by 21.6 per cent. Coupled with modest growth of capital, risk-adjusted assets further reduced capital adequacy ratio.

The figure of the capital adequacy ratio differs considerably among banks. At the end of 2001, the highest capital ratio of a bank was 26.2 per cent as opposed to 9.1 per cent.

As Slovenia's central bank, the Bank of Slovenia is an independent institution that carries out the tasks conferred upon it by the Bank of Slovenia Act. **Supervision of credit institutions** is one of the tasks of the Bank of Slovenia. The responsibility for the implementation and enforcement of the Bank of Slovenia's supervisory function is vested in the Banking Supervision Department, which derives authority and responsibility to supervise banks, savings banks and savings and loan undertakings from the Banking Act. The Banking Supervision Department celebrated its 10th anniversary in July 2002.

The organisational structure of the Banking Supervision Department is set up in three parts:

- Licensing,
- Off-site supervision of banking operations, and
- On-site supervision of banking operations.

From the initial 17 people, the Banking Supervision Department grew to 50 at the end of June 2002: 8 people in the executive part, 18 employees in the off-site (surveillance) part, 21 in on-site examinations, and 3 employees working on licensing.

In the off-site unit there are 6 analysts, 3 officers in back office, 5 people responsible for preparing secondary legislation, 2 accounting experts, 1 lawyer and head of the unit.

Seventeen on-site examiners staff the on-site unit, 3 examiners specialised for information technology, and head of the unit.

The Securities Market Agency is a self-governing and independent legal entity with power to supervise stock-broking companies, management companies, investment funds, mutual pension funds, as well as some other institutions (the Central Securities Clearing Corporation, Ljubljana Stock Exchange, etc.). 30 people were responsible for supervision of 32 stock-broking companies, 20 management companies managing 37 privatisation funds and 18 mutual funds. In addition there were 5 mutual pension funds at the end of 2001.

The Insurance Supervisory Agency became operational on 1 June 2000 as a self-governing and independent legal entity whose responsibility is the supervision of insurance companies, reinsurance companies, companies and agents who engage in insurance-related activities, as well as some other institutions. Prior to the establishment of the Insurance Supervisory Agency, the above-mentioned institutions were under the scrutiny of the Insurance Supervision Authority of the Republic of Slovenia operating within the framework of the Ministry of Finance. The Insurance Supervisory Agency had 21 employees responsible for supervision of 11 insurance and two re-insurance companies and some other institutions at the end of 2001.

COOPERATION WITH OTHER SUPERVISORY AUTHORITIES

In accordance with the Code of Practice for the **co-operation between domestic supervisory authorities** a steering committee headed by the Minister of Finance has been established. The Governor of the Bank of Slovenia, the President of the Council of Experts of the Securities Market Agency, and since September 2000, also the President of the Council of Experts of the Insurance Supervisory Agency are members of the steering committee.

In November 1999 the Bank of Slovenia and the Securities Market Agency signed a memorandum of understanding (MoU) followed by a memorandum of understanding formalising the collaboration between the Bank of Slovenia and the Ministry of Finance – Insurance Supervisory Authority of the Republic of Slovenia. Since the Insurance Supervisory Authority was transformed into the Insurance Supervisory Agency, a new memorandum of understanding was concluded in November 2000 between the Bank of Slovenia and the Insurance Supervisory Agency.

The details of the nature and method of collaboration between the signatories of the memoranda of understanding, as well as the channels for the dissemination of information were elaborated in memoranda of understanding. We have achieved some good results thanks to information sharing and joint actions.

The Banking Act has removed all major obstacles, which used to block sharing of information between the Bank of Slovenia and **foreign supervisory authorities**. Even prior to the entry into force of the Banking Act, the Bank of Slovenia carried out surveillance of branches and subsidiaries of Slovenian banks abroad by screening prudential reports and other statutory returns.

There has been a substantial progress in consolidated supervision of subsidiaries and branches of banks abroad. To facilitate supervisory processes, memoranda of understanding have already been concluded with the State of New York Banking Department, Bundesministerium für Finanzen (Austria's Federal Ministry of Finance), Bundesaufsichtsamt für das Kreditwesen (Federal Banking Supervisory Office) in Germany, the National Bank of Macedonia, the Banca d'Italia (Bank of Italy) and the Agency for Banking of the Federation of Bosnia and Herzegovina, as well as with Republika Srpska, the Central Bank of Bosnia and Herzegovina. Negotiations are still under way with France's Commission Bancaire.

First on-site examination abroad was conducted in September 1998 in the Italian branch of the largest Slovenian bank although there was no formal agreement with the Italian central bank. After signing a memorandum of understanding with the State of New York Banking Department, the Bank of Slovenia, the State of New York Banking Department and the Federal Deposit Insurance Corporation carried out a joint on-site examination of a bank subsidiary of the largest Slovenian bank in the USA (in March 2000). Joint examination of the bank subsidiary in the USA was conducted again in 2001. In addition, another on-site inspection was carried out in a foreign branch in Italy. For the first time, examiners of the Bank of Slovenia conducted inspection in a subsidiary in Germany, Bosnia and Herzegovina and Macedonia. In addition, a non-bank subsidiary in Switzerland was examined for the first time at the beginning of 2002.

LEGAL FRAMEWORK

During the last three years, the **legal framework** governing regulation and supervision of the banking sector has undergone significant changes. Our objective has been to make the Banking Act and regulations, as well as supervisory practices, consistent with international best practise and compatible with EU directives. The Financial Sector Assessment Program (FSAP), conducted in November 2000 by the International Monetary Fund in collaboration with the World Bank, proved that Slovenia complies with most of the Core Principles for Effective Banking Supervision issued by the Basel Committee. Despite a strong supervisory framework, we know that weaknesses exist in some areas concerning connected lending, implementation of consolidated supervision, and capital requirements for market risks.

In the mean time, we have addressed connected lending through changes to the Banking Act 1999, which entered into force in August 2001. Generally speaking, last year's amendments to the Banking Act 1999 raised the level of compliance with the *acquis* of the European Union and international standards.

In accordance with the recommendations made by the members of the FSAP Mission the requirement calling for a more stringent treatment of exposure of banks to shareholders and other persons in a special relationship with the bank (connected persons) has become enforceable. A three-year transitional period has been provided for a 10 per cent bank exposure to a person in a special relationship with a bank (for instance: the member of the bank's management board, member of the bank's supervisory board, etc) and a 100 per cent of all bank exposures to persons in a special relationship with a bank. In addition, the management board must notify the supervisory board of the exposure to connected clients in excess of 1 per cent of the bank's capital.

As for implementation of consolidated supervision and capital requirements for market risks are complex issues and huge efforts will be necessary to implement these requirements at a high quality level. We transposed the Directive on the Supervision of Credit Institutions on a Consolidated Basis into Slovenian regulation by issuing the Decree on the Supervision of Banks and Savings Banks on a Consolidated Basis in December 1999. The banks had one year to prepare for reporting on a consolidated basis and as of 31 December 2000, consolidated supervision is in place and the banks are required to meet capital adequacy requirements and exposure limits on a consolidated basis.

The supervision of market risk in Slovene banks has received an elevated level of attention over the past year. When discussing market risk we refer to the activities of banks in relation to foreign exchange, interest rate, price, liquidity and counter-party credit risks. The raised importance of market risk arises from our previous identification of a gap relative to the Core Principles for Effective Banking Supervision. While the assumption of market risk in Slovene banks is only moderate relative to credit risk, the level of risk is growing as banks enter into more sophisticated products in order to regain profitability lost from increased competition in traditional core loan and deposit businesses. Further, while an initial appraisal of the extent to which Slovene banks are involved with derivative products appeared nominal, the result of our increased supervisory attention identified a moderately higher level of use. Such findings validate the timeliness and appropriateness of our supervisory efforts in market risk.

Our aim is to ensure the banking sector adopts appropriate market risk measurement and risk management practices commensurate with the level of risk assumed. In the coming year we will also issue additional guidance to banks concerning our expectations in the field of market risk consistent with the best practices found globally.

A specialist team of examiners identified earlier in 2001 coordinates supervisory efforts concerning market risk. The team is dedicated to identifying enhanced methodologies for market risk supervision, raising banks' awareness of sound market risk measurement and management practices and ensuring that global minimum standards of practice for market risk are effectively tailored to meet current conditions in the local banking environment.

Concurrent with our increased efforts concerning market risk supervision, the Bank of Slovenia revised its Regulation on Capital Adequacy of Banks and Savings Banks to incorporate the requirement to calculate capital for market risk. While the Bank of Slovenia issued a new regulation in February 2001 for market risks, we subsequently began work on revisions to bring it fully in line with the EU's Capital Adequacy Directive and to address the many practical implementation issues involved with such a complex topic. A revised Regulation was issued in March 2002 with implementation to occur later in 2002.

As in other candidate countries, Slovenia is trying to achieve full compliance with EU standards. In 2001 the Companies Act was amended and the new Slovenian Accounting Standards entered into force as at 1 January 2002. In response, the Bank of Slovenia passed new regulations in March 2002 addressing the following issues:

- Large Exposures of Banks and Savings Banks
- the Classification of On-balance Sheet Assets and Off-balance Sheet Items of Banks and Savings Banks
- the Calculation of Specific Provisions of Banks and Savings Banks,
- Books of Account and Annual Reports of Banks and Savings Banks, and
- the Minimum Scope and Content of Audit and Auditor's Report.

BANKA SLOVENIJE

STATISTICAL TABLES

Number of credit institutions*
(at year-end)

Type of credit institution	1999	2000	2001
Banks	25	25	21
Savings banks	6	3	3
Savings and loan undertakings	68	64	45
Credit institutions, total	**99**	**92**	**69**

**: The amount of initial capital for banks is set at SIT 1.1 billion (approximately EUR 5 million), the amount of initial capital for savings banks and savings and loan undertakings is set at SIT 220 million (approximately EUR 1 million).*

Ownership structure of banks on the basis of shareholders' equity (%)

Item	1999	2000	2001
State ownership*	41.4	36.8	37.0
Other domestic ownership	47.3	51.2	47.0
Domestic ownership total	88.7	88.0	84.0
Foreign ownership	11.3	12.0	16.0
Bank. total	**100.0**	**100.0**	**100.0**

**: The amount of initial capital for banks is set at SIT 1.1 billion (approximately EUR 5 million). the amount of initial capital for savings banks and savings and loan undertakings is set at SIT 220 million (approximately EUR 1 million).*

Distribution of market shares measured by total assets (%)

Type of credit institution	1999	2000	2001
Banks	97.9	97.8	98.1
Savings banks	0.4	0.4	0.4
Savings and loan undertakings	1.7	1.8	1.6
Credit institutions, total	100.0	100.0	100.0

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

	1999	2000	2001
Assets			
Cash and balances with CB	3.3	3.1	5.2
Loans to banks	9.4	11.4	10.0
Loans to customers	51.7	51.3	48.3
Securities	26.4	24.8	28.0
Other assets	9.3	9.4	8.5
Liabilities			
Deposits from banks	11.5	12.5	11.5
Deposits from customers	69.2	67.6	69.7
Liabilities from securities	1.7	2.2	2.8
Capital and subordinated liabilities	11.4	11.1	9.5
Other liabilities	6.3	6.6	6.5

BANKA SLOVENIJE

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

Type of credit institution	1999	2000	2001
Banks	21.2	22.0	20.7
Savings banks	0.8	0.3	0.4

Solvency ratio of credit institutions

Type of credit institution	1999	2000	2001
Banks. average	14.0	13.5	11.9
Savings banks. average	14.4	11.3	11.1

Assets portfolio quality of the banking system

in millions of Tolars

Assets Classification	1999	2000	2001
A	2,751,937	3,264,438	3,910,043
B	196,315	277,864	363,536
C	63,123	77,144	92,655
D	46,511	58,682	66,766
E	51,794	58,352	83,888
Classified Total	**3,109,680**	**3,736,480**	**4,516,888**
Specific Provisions	136,835	168,175	212,079

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

	Deposits	Loans
Households	63.6	27.2
Government sector	5.5	8.3
Corporate	18.7	61.0
Foreign	3.0	0.8
Other	9.1	2.7
Total	**100.0**	**100.0**

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

Deposits	
At sight	34.3
Within one year	58.0
Over one year	7.7
Total	**100.0**
Loans	
Long-term loans	42.8
Medium-term loans	-
Short-termn loans	57.2
Total	**100.0**

BANKA SLOVENIJE

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

Type of credit institution	Forex Assets / Total Assets			Forex Liabilities / Total Liabilities		
	1999	2000	2001	1999	2000	2001
Banks	30.2	32.8	33.7	31.2	34.1	34.6
Savings banks	0.1	0.2	0.3	0.0	0.0	0.0

Profit and loss account of banks

	1999		2000		2001	
	in millions of Tolars	in millions of USD	in millions of Tolars	in millions of USD	in millions of Tolars	in millions of USD
Net interest income	94,770	482	123,298	542	117,167	467
Net fees and commissions	33,726	171	37,858	166	41,523	165
Net financial operations	9,541	48	13,355	59	19,096	76
Net other	-4,183	-21	-4,666	-21	-6,248	-25
Gross income	**133,854**	**680**	**169,845**	**747**	**171,539**	**684**
Operating expenses	87,318	444	100,041	440	111,309	444
– labour costs	43,701	222	49,085	216	53,510	213
Net income	**46,536**	**236**	**69,804**	**307**	**60,230**	**240**
Net provisions and write-offs	-26,401	-134	-37,233	-164	-44,783	-178
Profit before taxation	**20,134**	**102**	**32,571**	**143**	**15,447**	**62**

Average total assets and capital of banks

Items	1999		2000		2001	
	in millions of Tolars	in USD	In millions of Tolars	in USD	in millions of Tolars	in USD
Average total assets	107,504	546	127,712	562	188,706	752
Average capital	11,213	57	12,669	56	16,287	65

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

Type of credit institution	Registered Capital USD	in Total Assets %	Own Funds USD	in Total Liabilities %
Banks	298.7	1.9	1 114.5	7.1
Savings banks	3.3	5.4	5.4	8.9

2001 DEVELOPMENTS IN THE UKRAINIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2001, economic development indices grew dynamically. Real growth of the gross domestic product was 9%.

The highest growth of the gross added value was observed in the leading branches of economic activities, such as manufacturing industry, wholesale and retail trade and agriculture.

Industrial output increased by 14.2%. The highest growth rates in industrial production were observed in the branches working to meet the investment demand of enterprises and the consumer demand of the Ukrainian population. Technical re-equipment of production resulted in outstripping growth rates in machine-building products, equivalent to 18.8%. Growth rates in the volumes of food industry products and farm product processing amounted to 18.2%.

Dynamic growth in the economy took place against the background of decreasing inflation rates. One of the main achievements in 2001 was preservation of stable prices. The annual inflation was the lowest since Ukraine gained its independence and amounted to 6.1%.

Financial stability growth benefited business revival.

In 2001, a positive tendency of fixed capital investment growth steadily developed. Investments of enterprises and organizations of all types of ownership increased by 17.2%. The main sources of fixed capital investments are enterprises' funds amounting to 66% of all the capital investments. More than 44% of investments have been effected to promote enterprises of extractive and manufacturing industries and power and gas production.

Direct foreign investments into the economy of Ukraine with due regard for the proceeds from privatization increased by 20%.

Compared to the previous year, export of goods grew by 10.6%. The increase in export deliveries of machinery and equipment therewith amounted to 26%.

In 2001, current account surplus of the balance of payments of Ukraine was USD 1.4 billion (3.7% to GDP) and exceeded the previous year level by 16.2%.

The development of foreign exchange market of Ukraine in 2001 was characterized by rise in the hryvnia rate against freely convertible currency and by increase in the number of operations.

The inflow of currency on current transactions, receipts from privatization, restructuring of external debt as well as foreign exchange interventions of the National Bank of Ukraine made to prevent excessive hryvnia revaluation promoted a considerable growth of international foreign exchange reserves of Ukraine, which by the end of 2001 reached the highest level over the period of its independence.

In 2001, the total nominal money income of the population increased by 25.2%, whereas its real income grew by 9%.

DEVELOPMENT OF THE BANKING SYSTEM

As of January 1, 2002, the State Register of Banks had 189 banks, of which 164 banks (87%) were joint-stock companies including 115 public joint-stock companies (two of which were state-owned banks) and 49 private joint-stock companies and 25 banks (13%) were limited companies.

As of January 1, 2002, twenty-four banks with foreign capital participation functioned in Ukraine, six of them had 100% foreign capital and seven had a foreign capital share from 50% to 100%. Foreign capital share in the banks' authorized capital is 13.5%.

Dynamic growth of macroeconomic indices against the background of slow inflation rates favoured financial strengthening and formation of positive tendencies in the banking sector development.

Banks' total capital increased by 56% and paid-up authorized capital – by 25%.

Average paid-up authorized capital per one functioning bank grew by 26% over 2001.

The amount of banks with the regulatory capital over 5 million euro increased in 2001 from 86 to 110, including those having over 10 million euro – from 20 to 44.

Banks' total liabilities increased by 29%. The highest growth rate (68%) within the liabilities structure inhered in physical persons' deposits constituting the main source of forming the resource base. Their share in total liabilities equalled 28% against 22% in 2000.

Total bank assets increased by 28%. Bank assets grew mainly due to the credit portfolio growth, which amounted to 35%. Debts on credits extended to economic entities grew with a higher rate (46%) and reached 83% of credit portfolio as of January 1, 2002 (against 77% in 2000).

The banking system recovery was effected due to insolvent bank liquidations and reorganization of financially unstable banks. In 2001, 9 banks were expelled from the State Register: 6 – as a result of the liquidation and 3 – through their reorganization by means of merging.

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

The laws of Ukraine "On Banks and Banking" and "On the National Bank of Ukraine" are a legal base for banking activities in Ukraine.

In compliance with the above laws, the National Bank of Ukraine being a special central body of state governance fulfils regulation of bank activities and banking supervision in Ukraine.

The National Bank of Ukraine fulfils state regulation of bank activities in the forms of administrative and indicative regulation.

The year 2001 can be attributed as a crucial stage in the development of Ukrainian banking supervision.

In January 2001, the new law of Ukraine "On Banks and Banking" came into force, including some new principles of bank activity legal regulation, based on international banking and supervision standards.

To satisfy the above Law and taking into account the Basel Committee's Core Principles for Effective Supervision, the National Bank of Ukraine developed a number of normative and legal acts as a methodological base for regulation of bank activities. They include the following main trends of banking regulation:

- raising the minimum capital for the banks' state registration, obtaining the banking licenses and the NBU permits to perform separate transactions;
- limiting the level and concentration of risks inherent in banking;
- supervising the bank substantial shareholders and taking the measures of influence on them;
- developing the requirements to stainless business reputation of the bank founders who are substantial shareholders in the authorized capital, to the governor and members of the bank executive body and to the chief accountant, as well as control of these persons' business reputation;
- raising the bank role in the prevention of money laundering;
- using the harsher measures of influence to the banks violating the banking legislation.

In 2001, the National Bank of Ukraine performed banking regulation and supervision functions in compliance with the following normative and legal acts:

- Regulations on the procedure of establishment and state registration of a bank, foundation of its affiliates, representative offices and branches;
- Regulations on the procedure of granting the banks with banking licenses, written permits and licenses to perform certain transactions;
- Instruction on the procedure of regulation and analysis of bank activities in Ukraine;
- Regulations on the procedure of forming and using the provisions for possible losses on banks' credit operations;
- Regulations on the procedure of forming and using the provisions for possible losses on commercial bank receivables;
- Regulations on the procedure of calculating the provisions for bank possible losses on operations with securities;
- Regulations on applying by the National Bank of Ukraine the measures of influence for violating the banking legislation;
- Regulations on planning and procedures of inspections;
- Methodological directions on bank inspections in Ukraine;
- Rules of correspondent account registrations by the National Bank of Ukraine, and others.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISION AUTHORITY

The following subdivisions operate within the banking supervision structure of the National Bank of Ukraine:

General Department of Banking Supervision, which determines common strategy for further development and banking supervision policy, common methodological approaches, etc.;

- Bank Registration and Licensing Department;
- Bank Inspection and Monitoring Department;
- Bank Reorganization and Liquidation Department.

THE ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY IN 2001

In 2001, the work was carried out on bringing into line with the Law "On Banks and Banking" of the normative and legal acts of the National Bank of Ukraine.

The provisions of the normative and legal acts of the National Bank of Ukraine were realized in practice.

In conformity with the new procedure of banks' licensing, the banking supervision units of the National Bank of Ukraine rearranged banking licenses to conduct banking operations for all functioning banks into banking licenses and written permits.

The National Bank of Ukraine exercised control over the capital raised by banks in compliance with the requirements of Ukraine's current legislation and normative and legal acts of the National Bank of Ukraine.

In order to decrease risks of bank credit operations, the National Bank of Ukraine together with the Ukrainian Banking Association developed and put into operation the Uniform information system "Borrowers' Register".

One more direction of the banking supervision activities was inspections of banks.

In 2001, the banking supervision authority of the National Bank of Ukraine made more than 700 inspections of banks and banking institutions.

During inspections they checked the authenticity of the information provided by banks and the observance by them of legislation and normative and legal acts of the National Bank of Ukraine. Special emphasis was laid on capitalization of banks, effectiveness of their risk control systems, the evaluation of management level, of internal control systems and adequacy of provisions for active operations.

On the results of inspections performed each bank received a rating under the CAMEL system and if necessary adequate measures of influence were implemented.

In 2002, the National Bank of Ukraine continued its cooperation with international organizations in monitoring the programs of the banking sector restructuring: with the World Bank in "Program Systemic Loan" project, with the IMF in EFF Program, in EU/TACIS "Program of Three Largest Banks' Restructuring" project.

MAIN STRATEGIC AIMS OF THE BANKING SUPERVISION AUTHORITY

The main aims of banking regulation and supervision are safety and financial stability of the banking system and protection of the interests of investors and creditors.

It is anticipated to achieve these aims through higher efficiency of the banking supervision authority and its complete compliance with the Basel Committee's Core Principles for Effective Banking Supervision.

To this end it is necessary to solve a number of problems the main of which, for the near future, are:

- to put into practice the provisions of the normative and legal acts of the National Bank of Ukraine;
- to create the effective risk management system in banks, to introduce standard risk management procedures;
- to implement a consolidated supervision approach with actual fulfilment by the National Bank of Ukraine of its powers to supervise the affiliated and related entities stipulated by the Law of Ukraine "On Banks and Banking";

- to bring to the appropriate level the provisions, practices and procedures related to banks' counteraction to money laundering;
- to further improve the methodological basis for regulating the bank activities.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of a financial institution	1999	2000	2001
Banks	203	195	189

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

Banks	1999	2000	2001
State ownership	8.5	5.4	4.5
Other types of domestic ownership	68.7	74.8	82.0
Domestic ownership, total	77.2	80.2	86.5
Foreign ownership	14.3	14.4	13.5

Assets and liabilities of the banking system (%) (at year-ends)

	1999	2000	2001
Assets	**100.0**	**100.0**	**100.0**
Cash funds and funds with NBU	11.1	12.2	9.1
Funds on correspondent accounts in other banks	13.5	9.9	7.2
Credit portfolio	48.7	57.6	61.2
Investments in securities	7.1	5.0	9.0
Receivables	6.9	4.9	4.0
Fixed assets and intangible assets	10.3	8.7	7.6
Other assets	2.4	1.7	1.9
Liabilities	**100.0**	**100.0**	**100.0**
Capital	23.0	17.6	16.7
Bank liabilities	77.0	82.4	83.3
including:			
NBU equity	5.5	3.8	2.4
Budget and off-budget funds	1.9	3.7	3.2
Inter-bank credits and deposits	8.4	9.2	9.1
Loans from international and other financial institutions	-	-	0.9
Funds of economic entities	31.6	33.2	31.4
Private deposits	16.9	18.0	23.6
Debt Securities	1.2	1.7	1.0
Subordinated debt	1.1	2.5	1.7
Other liabilities	10.4	10.3	10.0

Solvency ratio of financial institutions (%)

	1999	2000	2001
Banks	19.6	15.5	20.7

Deposits in 2001 (%) (at year-end)

	Deposits
Households	28.4
Budget and off-budget funds	3.9
Economic entities	37.7
Other	30.0
Total	**100.0**

Credits in 2001 (%) (at year-end)

	Credits
Households	4.3
State administrative bodies	0.6
Economic entities	82.7
Other	12.4
Total	**100.0**

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

	Forex assets/total assets			Forex liabilities/total liabilities		
	1999	2000	2001	1999	2000	2001
Banks	44.4	40.1	38.5	53.1	45.6	43.7

Financial institutions' revenues and expenditures structure (at year-ends)

	1999	2000	2001
Revenues	**100.0**	**100.0**	**100.0**
Interest yields	56.6	59.5	66.4
Commission	23.4	26.9	26.9
Trades revenues	16.2	7.9	4.2
Other banking transaction yields	1.7	3.6	1.2
Other non-banking transaction yields	0.4	0.6	0.4
Other revenues	2.1	1.5	0.2
Expenditures	**100.0**	**100.0**	**100.0**
Interest expenses	35.0	31.1	34.4
Commission expenses	9.0	7.3	4.1
Other banking transaction costs	4.0	5.5	5.9
Other non-banking transaction costs	31.1	33.6	39.2
Reserve allocations	16.5	19.3	13.2
Other expenses	4.4	3.2	4.2

MAIN BSCEE GROUP EVENTS OF THE YEAR 2001

REPORT ON 14TH CONFERENCE OF THE GROUP OF BANKING SUPERVISORS FROM CENTRAL AND EASTERN EUROPE MAY 23-25, 2001, VILNIUS

The 14th Annual Conference of the Group of Banking Supervisors from Central and Eastern Europe was held in Vilnius. This year the host of the Conference was Kazimeras Ramonas, the President of the Bank of Lithuania.

Resulting from discussions with the members there were two topics on the agenda of the Group's 14th Conference:

- The New Basel Capital Accord
- International cooperation between banking supervisions

Overview of the comments on the Basel Capital Accord

The conference was opened by William Cohen, member of the Basel Committee's Secretariat, delivered an almost two our introduction and overview of the New Basel Capital Accord. As the Basel document is well known to us, below we provide a brief summary only.

The key points of Cohen's presentation:

- The strengths and weaknesses of the current Accord;
- Overview of the new Accord;
- The three pillars.

Most important changes since the first consultation period:

- Adopting proposals relating to any part of the Accord, especially IRB, credit risk reducing techniques with respect to operating risks and securitiziation;
- The wide-range application of IRB could be feasible;
- The elimination of sovereign ceiling;
- Favorable treatment of short term receivables from banks denominated in local currency.

Mr. Cohen emphasized that although the new Accord targeted the internationally active banks, its principles were applicable to institutions of different complexity. The "one size fits all" approach cannot be followed any longer, but the principle must be reflected in the capital adequacy regulation and supervision of all banks.

Pillar 1
Credit Risk – Standard Approach

Main changes compared to what we have today:

- risk weights that reflect exposure more accurately;
- based on credit rating by external credit rating agencies;
- introduction of the 150 percent weight;

- 20 percent credit equivalent for short term liabilities;
- 0 percent weight for certain multilateral development banks.

Mr. Cohen admitted that employing external credit rating agencies was not a perfect solution, but this ensured better differentiation according to risks and no other suggestions had been received.

Credit Risk – IRB Approach (Internal Ratings-Based Approach)

It is a much more risk sensitive approach, the application of which leads to smaller capital requirement. This is intended to be an incentive for improved risk management.

Supervisions must approve the approach.

Expected loss = PD (probability of default in percentage)* LGD (loss given default in percentage) * EAD (exposure at default in sum)

Unexpected loss = depends on PD, LGD, term, diversification and their volatility

According to present surveys the IRB approach is employed only a few banks only; for example by about 50 of the 9 thousand banks in the US.

Participants raised the question whether it made any sense to spend so much time and energy on this issue in Basel instead of looking at the elaboration of simpler methods, if the IRB approach was to be employed by so few banks in the next 3 to 5 years. In his response the speaker claimed fast development in this area, expressed confidence that the number of banks following the approach will increase, and this could be seen as the road of development.

Operational Risk

According to surveys banks allocate 15 to 20 percent of their economic capital to cover operational risks.

The challenge is presented by defining and measuring the risk.

Pillar 2

The speaker characterized the pillar as the formal expression of supervisory activity.

Pillar 3

The Committee requests feedback on how to "streamline" the proposal with respect to publication. The topics proposed for publication could be regarded as a large collection from which the most important ones are to be selected.

After the speech first the representative of the chairing Lithuania, then Dr. Ágota Ódry, on behalf of the Hungarian Financial Supervisory Authority (HFSA) outlined their position regarding the Basel proposal, followed the member states in alphabetical order.

The speakers agreed with the essence of the proposal. The comments focused on probable effects and, in part, on the difficulties of application. In their opinion the New Accord would lead to greater capital requirement (and thereby a decrease in the capital adequacy ratio). The expectation regarding Pillar 1 is that banks will normally employ the standard approach for credit risks, although the application of the IRB approach could not be excluded in case of the subsidiaries of a few international banks.

The problem is that there is no credit rating agency, or there is only one in these countries and there are few rated debtors. Several participants raised the questions concerning the reliability of ratings and the comparability of methods employed by different rating agencies.

They reacted differently to the change of risk weightings according to their position: The Poles stressed that this would have an adverse effect on the transitional economies (citing Poland, the Czech Republic, and Hungary), which had undergone substantial development and merely the change in approach would necessitate bigger capital requirement to cover exposure in dealing with them. In market terms bigger capital requirement would be an expression of a financial downturn, while the actual situation is the exact opposite. On the other hand, Slovenia, which is not an OECD member state, welcomed the change, because this meant the decrease of the 100 percent weight to 20 percent according to Rating A by S&P.

Polish representatives found also the application of ratings that were more favorable than sovereign ratings problematic, as they set different requirements vis-à-vis players active on the same market. A Czech colleague raised the question what was exactly meant by undertaking financial responsibility for a subsidiary in the course applying the mother company's rating to the subsidiary, when the mother company financially backed the subsidiary. They expressed worry that this approach could push for the conversion of subsidiary banks into branches.

The employment of the IRB approach is made more difficult by the lack of reliable historical data series, imposing a competitive disadvantage on the banks of emerging economies (as the method has a smaller capital requirement).

The Polish Supervision believed that setting up international standards for the capital requirement for operational risks was immature, as the banks did not yet have established methods. According to their proposal the development should have two phases: in the first phase the supervisions should find a solution themselves, the methods should be reviewed on a broad international basis, less developed supervisions should follow the practices established by the more developed ones. In the second phase the Basel Committee would set up international standards based on the preceding phase.

The Czech Supervision recommended elaborating special risk types.

The Lithuanian Supervision reflected on the importance of special supervisory knowledge needed to monitor operational risks.

Many emphasized in connection with the entire proposal, but especially in respect of Pillar 2, the growing responsibilities and resource requirements of supervisions, the increasing need for training supervisors and the resulting higher costs of supervision. The separation of banking and supervisory responsibilities and the approval of methods are sensitive issues, especially considering that in case of a bank's bankruptcy even court actions could be raised against the supervisions. Polish supervisors are considering the involvement of external specialists to tackle such worries. According to the Lithuanians legal protection must be ensured for the supervisors.

Czech participants suggested defining supervisory processes so as to make clear the algorithms for translating various circumstances into capital requirement on an international scale. National supervisions must standardize their stringent requirements, otherwise the banks supervised under looser procedures would be at an advantage. The Poles also raised the need for comparability between the inspections performed by the supervisors of different countries, therefore, they recommended having that Pillar developed further. The Poles saw a conflict of interest in the fact that the very same supervisor issued the license for a process that belonged under Pillar 1, who then revised it according to Pillar 2. They found the employment of an external consulting firm the control of the systems a safe and secure solution.

Czech banks asked for the imposition of a ceiling for additional capital exceeding 8 percent as a risk factor.

Concerning Pillar 3 many called the attention to the banks' worries about the confidential, trade secret or banking know-how character of the information to be published, or to the issue of making such information potentially accessible for the public. Polish supervisors believed that aggregated and synthetic indicators should be published, rather than, for example, VAR values and overly detailed figures.

Using slides, Dr. Ágota Ódry, (HFSA) touched upon four topics:

1. *The relation between Hungary and the Basel Directives*
   - The application of the current Directive for the capital requirement of credit and market risks;
   - As a future member of the EU and as a country with an international banking system we believe that the new Directive should be adopted by Hungary and we should be prepared for that.
2. *A few effects of the New Accord on Hungary*
   - Higher interest surcharge on the Hungarian sovereign debt, provided the weight increases from the current 0 percent to 20 percent on the basis of the rating;
   - Hungarian banks' weightings will generally increase from the current 20 percent to 50 percent;
   - Generally, Hungarian corporations' weightings will remain 100 percent, as most of them are not rated, or only rated BB+ Only a few blue chips may receive better weightings;
   - The application criteria of the IRB Approach (comparable market conditions and credit approval systems, etc.) are difficult to meet in a transition economy;
   - Taking the 3-year transition period also into consideration a few Hungarian banks, the most developed ones, can prepare for the employment of the IRB Approach;
   - The capital to be generated to cover operational risks will probably increase the banks' capital level.
3. *Comments and suggestions concerning the New Accord*
   - We welcome the more risk-sensitive approach, the fact that economic capital and regulatory capital are being brought closer to each other, and the capital requirement for operational risks, etc.;
   - Dr. Ódry highlighted as the key point of the proposal that the risk-weighting of the standard approach was to be made more sophisticated, as the proposed weights were too high for the investment category and failed to reflect the default rates perceived.
4. *Challenges faced by the Supervision*
   - Customized supervision, legislative powers;
   - This requires legislative amendments;
   - Important decisions are to be made that concern the entire sector;
   - International cooperation;
   - Supervisory focus on risk management and processes;
   - HFSA's short-term plan for the internal distribution of the Basel proposal, dialogue with the sector and the development of a detailed action plan.

Overview of the cooperation between supervisory institutions

Mr. Paolo Clarotti, the Honorary Director of the European Commission, provided a brief overview of the development of cooperation among banking supervisory authorities within the EU in his opening speech.

We are witnessing the dynamic development of the financial sector worldwide, which is characterized by the following:

- Markets are becoming international;
- Banking, investment services and insurance are being intertwined;
- As a result of faster technological development new financial products are appearing, together with the continuous expansion of cross-border services and activities;
- The presence and spread of the Internet in our everyday activities.

The participants of the conference agreed that the cooperation between the supervisory authorities of the various countries and the continuous exchange of information were gaining more and more importance as cross-border, international money and capital market transactions expand and become global, and as national markets were being increasingly integrated.

Naturally, in case of non-integrated supervisory authorities the need for and importance of cooperation between the supervisory authorities responsible for the different financial sectors (bank, securities and insurance) are to be emphasized as well.

An important form of international cooperation, in addition to participation in international organizations, is maintaining bilateral and multilateral relations with partner authorities operating in different countries.

The most typical tool and method of maintaining formal contact are to negotiate bilateral cooperation agreements between the supervisory authorities (Memorandum of Understanding) and to apply those in the area of information exchange.

Information exchange between supervisions can be quite broad; just to mention the most important ones, it covers information on licensing procedures, institutions providing cross-border services, handling problematic financial institutions and monitoring the activities of supervised institutions.

The content of the cooperation agreements between partner authorities in different countries is eventually determined by the intentions of the parties to the agreement, as to how deep the cooperation should be and what areas are to be covered given the relevant statutory background, even when the agreement is based on the recommendations and principles of the Basel Committee.

Generally it could be boiled down from all that was said during the conference, and from the brief presentations delivered by the representatives of the participating supervisory authorities , that, on account of the differences in the various countries' legal and regulatory environment, the critical points in the cooperation between partner authorities in different countries are ensuring that the flow of information between supervisions, which contains banking and business secrets, should be handled confidentially and used for supervisory purposes only, furthermore, ensuring reciprocity in the course of on-site inspections of financial institutions in each others' countries.

Pavel Racocha, the representative of the Czech central bank told the participants that the amendment of the Czech financial institutions act was on the agenda, as the current regulation did not allow foreign supervisions to conduct on-site inspections at foreign banks' subsidiaries, or branches operating in the Czech Republic.

In Latvia, however, the law already grants right to foreign supervisory authorities to conduct on-site inspections at their mother banks' subsidiaries and branches operating in the country.

The act regulating financial institutions has also been amended in Bulgaria in order to enable the exchange of information with foreign partner authorities.

The representative of the Bulgarian authority had negative experiences with respect to cooperation agreements, because the cooperation agreement (Memorandum of Understanding) negotiated with the Turkish banking supervision failed to ensure the proper flow of information from the Turkish authority to the Bulgarian one during the Turkish financial crisis in the autumn of 2000 and did not allow proper preparation for the negative impact on the Bulgarian banking system in time.

In brief the on the obstacles in the way of negotiating cooperation agreements cited by the participants of the Group of Banking Supervisors from Central and Eastern Europe can be summarized as follows:

- Legal constraints, legislative or administrative limits persist in the way of the exchange of information, the treatment of bank secrets, the protection of personal (client) information and the dissemination of information are different from country to country;
- Accounting rules vary;
- (Cross-border) implementation of supervision on a consolidated basis Efficient risk management and consolidated supervision call for the removal of obstacles from the flow of information between mother banks and the subsidiaries or branch offices operating abroad.

Of the 12 member organizations of the Group of Banking Supervisors from Central and Eastern Europe the 14 participating supervisory authorities of the Vilnius Conference concluded the following cooperation agreements with the supervisory authorities of other countries: (as of May 2001)

Albania	Bulgaria*
Byelorussia	Switzerland, Cyprus, USA, Lithuania, Italy
Bulgaria	Turkey
Czech Republic	Slovakia Austria, Germany, Belgium, Holland, France*
Estonia	Lithuania, Finland, Latvia
Latvia	Sweden, Finland, Germany, Estonia, Lithuania, Byelorussia Russia*
Poland	Lithuania
Lithuania	Poland
Macedonia	Russia Slovenia, Greece, Bulgaria*
Hungary	Germany Austria, Italy, Holland, Belgium*
Russia	10 ex-communist countries and Cyprus
Slovakia	Germany, Italy, Austria Holland, France*
Slovenia	USA (State of New York Banking Dept.)
	Austria, Germany*

**In preparation*

Annual summary report of the Group of Banking Supervisors from Central and Eastern Europe

The Annual Summary Report of the Group of Banking Supervisors from Central and Eastern Europe concerned five topics:

1. *Events by FSI and the Group between 2000 and 2001.*

   FSI and the Group jointly organized the following events:

- "Assessment on the Core Principles Methodology" June 2000, Bratislava, Slovakia,

- "14th International Banking Supervisory Seminar" capital Adequacy and Core Supervisory Issues, May 2001, Switzerland,
- "Credit Risk" May 2001, Prague, Czech Republic.

2. *A regional workshop to be organized jointly by FSI and HFSA / the Group in September, in Budapest*

   The next regional workshop will be organized jointly by the Group and FSI on "Market Risk" between September 10 and 14. According to preliminary arrangements the regional workshop will be organized in Budapest with the participation of HFSA.

3. *Comments on the Annual Report of the Group of Banking Supervisors from Central and Eastern Europe*

   One of the most important activities of the Group's Secretariat is the preparation of the member states' Annual Report. The Report provides an overview of the member states macroeconomic environment, bank sector and supervisory activities. A new chapter was added to the Annual Report last year. Last year, focusing on one of the most important topics of the 13^{th} conference, bank liquidity trends in the member states of the Group of Banking Supervisors from Central and Eastern Europe, the Secretariat prepared a summary paper with the help of the Supervision's Department for Analysis and Methodology. The New Basel Capital Accord shall be the special topic of the 2001 Annual Report.

4. *Bosnia-Herzegovina's intention to join / application*

   In the beginning of the year the Central Bank / Bank Institution of Bosnia-Herzegovina contacted the Secretariat of the Group of Banking Supervisors from Central and Eastern Europe with the intention to join the Group and apply for membership. The Secretariat informed the Lithuanian President of the Group of Banking Supervisors from Central and Eastern Europe and according to the relevant provisions of the Group's Agreement the 17 member states would decide by a qualified majority.

   As the Group's member states officially meet only once a year during the annual conference, we have informed the members of the membership application and agreed to decide about admittance within a month. The members have 30 days to raise objections (which they have to substantiate in writing). In the event two-thirds of the member states are in favor (which is foreseeable), we shall inform Bosnia-Herzegovina about the decision of Group of Banking Supervisors from Central and Eastern Europe and admit the new member.

5. *The 2000 Budget of the Group of Banking Supervisors from Central and Eastern Europe*

   The Secretariat's responsibilities include the management of the membership fees and the Group's budget.

"CREDIT RISK" SEMINAR
May 6-12, 2001, Prague

The Credit Risk Seminar for Central and Eastern European participants were organized by the Bank of International Settlement (BIS) and by the Financial Stability Institute (FSI).

May 7

The first day's topic was Credit Risk Management. The process, strategy and policy of risk management were defined. It was highlighted that the management played an outstanding role in the elaboration of the strategy and in the control of the risk management process. The presentation covered the credit approval process, the credit approval criteria and the approval process itself together with the relevant risks.

The issue of credit concentration was another important topic. Among the types of concentration we may differentiate linked, consolidated, regional and sector-based types. The speaker presented the four key principles of cross-border lending practices: access to information; joint licensing; shared standards and common sanctions, furthermore, the so-called home-country supervision. The flow of information between the mother company, the supervisions of the home country and the host country, furthermore, the firm's subsidiaries must be seamless, since permanent communication is of crucial importance.

In small countries one of the biggest problem related to connected lending is the lack of capital markets. The Supervision's objective is to reduce risk and fraud. To accomplish that the following means are available for the supervisory authorities: management of capital, supervision and control of the board of directors' line of responsibility and policy.

May 8

The topic for the second day was the presentation of the New Basel Capital Requirement System, which is currently still under development (the proposal will be commented in the course of comprehensive international consultations from 1999 to 2001 and the new capital requirement system will be published in light of those consultations at the end of 2001).

A comparison was made between the current system and the new regulation, and the three-pillar solution of the new regulation was outlined. In defining the minimum capital requirement the measurement of and assessment of credit risks was given a heavy emphasis, as this was the key topic of the Seminar. In relation to the measurement of credit risks the standard method and the internal rating methods were presented, while the assessment of risks using credit risk modeling was a topic later during the Seminar. The new general regulation sets important responsibilities for the supervisions as well: supervisors shall have to investigate and assess the banks' internal capital adequacy calculations (review of capital measurement, risk management, and internal audit processes) and their capital strategy.

May 9

The presentation's topic was the rating used to assess credit risks, which requires the assessment of factors beyond the preparation of a financial analysis. In addition to the analysis of financial indicators and other qualitative factors the credit rating could be determined by assessing the operating environment (business risk and country risk) and the debt (and the underlying structure of collateral), and employing models that determine the size of the potential loss.

To employ the abovementioned models one needs a huge database on which historic analysis can be performed. The Altman Z-score model and the KMV model were presented, which help to assess the probability of bankruptcy.

The presentation followed through the process of internal rating, emphasizing the separation of the concepts of exposure and credit risk, demonstrating expected and unexpected losses using functions.

May 10

The first half of the presentation was about risks, the sources of risks, the methods use to measure risks and the development of process models. Credit rating is the most important element of credit risk management, therefore, it is inseparable from the optimization of the portfolio, from the pricing of loans, forecasting losses and provisioning, together with the influence of the latter of capital, etc. The other main topic was the presentation of risk modeling, which consisted of a more detailed explanation of rating and portfolio models. This was preceded by the presentation of the various levels and means of risk management. The increasingly advanced levels of risk management are:

1. "We only have good quality loans"
2. "We consistently rate loans in line with client ratings"
3. "ROE speaks for itself"
4. "The price of the loan must cover the risks" (expected losses are calculated)
5. "We manage our loans like an investment portfolio"
6. "Our stockholders require RAROC"

It is to be noted that the majority of the Austrian banks are currently around Level 4.

May 11

The continuous management of accounting systems and the publication of data are in the interest of all banks in order to create an environment of security and trust. When there are deficiencies in any one of these areas, other areas will be adversely influenced. Loan impairment is one of the most important things that a bank may have to face, therefore, it must keep a register of the loans where that is a possibility.

On occasion of public disclosure banks must publish information on risk management and audit policy. The role of the supervisor in this process is to assess the efficiency of credit rating, furthermore, to regularly verify the existence of a prudential rating system, the efficiency of the credit monitoring system and to confirm whether the board of directors and the management have regular access to the information and whether they properly judge that information.

REPORT ON THE MEETING OF THE CHAIRMEN AND SECRETARIES OF THE REGIONAL GROUPS OF SUPERVISORS
Basel, Switzerland – November 21 and 22, 2001

Participants: Basel Committee Secretariat, Arab Committee on Banking Supervision, Association of Supervisors of banks of Americas, Committee of Bank Supervisors of West & Central Africa, East and Southern Africa Banking Supervisors, EMEAP Study Group on Banking Supervision, Group of Banking Supervisors from Central and Eastern Europe, SEANZA Forum of Banking Supervisors, The Caribbean Banking Supervisors Group, The GCC Committee of Banking Supervisors, The Offshore Group of Banking Supervisors, Transcaucasia and Central Asia Regional Group.

The following four major topics were discussed during the conference:

- Present and future tasks related to the *New Basel Capital Accord*;
- Questions related to next year's International Conference of Banking Supervisors (ICBS);
- Implementing supervisory principles in individual regions;
- The current tasks of the Basel Committee related to accounting.

The New Basel Capital Accord

During the consultation period lasting until the end of May 2001 the Committee received 250 documents of comments, which together added up to a one meter high pile of papers. In June 2001 the Committee made a press release, making its assessments of the comments public. Between July and October six working documents were published (on the system of internal rating, the handling of stocks, operational risks, on publishing, special lending and securitizing) the aim of which was to make the Committee's standpoint clear even in the questions that had not been sufficiently detailed in the previous papers. The second impact study was completed two weeks ago with the involvement of 140 banks from 25 countries. The result of that impact analysis was that the originally planned capital requirement calculations would have slightly (by 6 to 15 percent) increased the capital requirements against the Committee's earlier intentions. Therefore the Committee decided in favor of more or less reduction in case of several capital requirement calculations.

According to the Committee's plans the third consultation document will be published sometime in February 2002, with comments expected until the end of May. As it is currently planned the final material will be published by next year's ICBS (September 2002). As it stands now the Recommendation could be implemented until 2005, although it has been emphasized that the work would not stop there, because the Committee will follow up the implementation of the Recommendation and the difficulties as well, and will introduce further amendments, if necessary.

Concerning the calculation of the capital several comments have been made complaining that according to the Recommendation there is capital requirement for expected losses as well, although such losses should be covered by the specific provisions. Nevertheless, they do not intend to change their original position. The most important reason for that is that at the moment there are no universally accepted principles for the creation of specific provision, while the general reserve is part of the capital up to the allowed limit of 1.25 percent of the adjusted total assets.

In respect of the operating risks the Committee intends to reduce the previously planned capital requirement to about half of the original, at the same time they will provide some limited option for the banks to reduce the capital requirement by the amount of insurance. In that respect it was mentioned that there are potential dangers in that insurers, even though they have no methods to measure operating risks themselves, and the capital requirement does not apply to that exposure either, are willing to take over even the banks' operating risks against insurance premium.

Very harsh criticism has been put forward in the comments received concerning the standardized method, as that is risk sensitive enough. An unidentified, but important country was on the opinion, that as they stood at the moment, they would not implement the Basel Principles under any circumstance, because those would increase the current capital requirements in contrast to the original intention.

The representative of the South-East Asian bank supervisory group was asked to share his observations concerning the planned New Basel Capital Accord. In his talk Mr. David Course revealed that most of the South-East Asian countries received the standardized method with disappointment, for that was not risk sensitive enough. However, he added that in case the Committee approved the proposal in its current form, the countries in the region would incorporate it into their own regulatory systems. According to him in many countries the approach based on internal rating will not be employed due to its cost and data intensity. The New

Basel Capital Accord has raised interesting regulatory problems in some countries. In a few countries it is an accepted and proven practice that for certain banks the supervisory authority stipulates a capital adequacy ratio above the minimal eight percent. So far the justification used to be that the operation of such banks was riskier, than that of the others. However, the New Basel Capital Accord will set a capital requirement for operating risks as well, as a result of which it will be hard to justify a higher capital adequacy ratio, since the banks can rightly say that they have internationally accepted capital cover for operating risks as well.

The speaker suggested (to which several participants joined later) that in order to prolong the implementation period the currently effective capital accord should not loose force upon approval, rather it should function as a minimal capital requirement for a longer transition period. This would especially help smaller countries and smaller banks. At the same time the Committee should clearly declare that according to the new capital accord compliance with the standardized method was just as acceptable, as capital adequacy calculated using the most sophisticated methods. The new capital accord should also settle the problems of the home and the host countries as well by declaring that the supervisory authority of the home country should not only accept capital adequacy calculation methods for the given country, rather it should approve a global capital calculation embracing the given bank's subsidiaries in other countries too. Upon elaborating the new capital accord the Committee so far only concentrated on the calculation of the capital requirement for the operating risk, however, according to the speaker, it would be a lot more important to publish recommendations on the management of the operating risk.

At the time of implementing the New Basel Capital Accord the primary problem would be presented by the fact that many countries had still not approved the current capital accord, especially its parts concerning market risks.

In their response the representatives of the Committee cited the US example, where according to the plans the new capital accord would only be applied to internationally active banks, which would mean exemption for many banks in the States. The biggest problem with that is that 'an internationally active bank' is not a precise concept, as none has yet defined that in detail. The participants of the conference also remarked that the first Basel capital accord was accepted so widely precisely because it was very practical, and everybody was able to apply it the same way. However, that is not so in case of the new capital accord.

International Conference of Banking Supervisors

Next year's ICBS will be held in Cape Town, in September 2002. For the sake of efficient implementation the organizers will set up a home page, which will probably be accessible from January. The home page will provide information on hotel accommodation and the program. ICBS also intends to host the meetings of regional supervisory groups, although its key topic will be the New Basel Capital Accord (the Committee intends to time the publication for this occasion). Following the conference they would like to have a joint declaration drawn up and approved on how the individual countries will try to implement the new capital accord.

The organizers would like to update the list of invited guests; therefore the Committee will contact the secretariats of the individual supervisory groups around April with respect to the up-to-date lists. As a general principle it was laid down that only two persons may attend from each country, and an exemption from that would only be granted in special cases. They emphasize that the goal of ICBS is not to provide training, rather to create a forum where high-level supervisory managers can meet.

Implementing Supervisory Principles in Individual Regions

The representatives of the individual banking supervisory groups talked about how the countries in their region had implemented the Basel banking supervision principles. It could be ascertained from the group presentations delivered that certain developing countries faced similar types of problems, primarily in respect of market risk, consolidated supervision, operating risk, cooperation with foreign supervisory authorities, and fight against money laundering. During the presentations it was raised that the self-assessments prepared by the individual countries and the FSAP country reports often significantly differ as a problem. Certain countries (primarily New Zealand) complained that the Basel Committee did not admit that efficient supervision can be exercised and the stability of the banking system can be ensured without keeping to the principles set up by the Committee[14] .

The presentation of the BSCEE was based on the reports submitted to the Secretariat by the member states of the Group of Central and Eastern European Banking Supervisors and reported on the progress of the implementation of the Basel Principles. Mr. Charles Freeland, the representative of the Committee present, remarked in a comment after the talk that the cooperation agreements concluded with foreign supervisory authorities often hindered efficient cooperation, rather than promoting it. In his view this was so because the cooperation agreements were drawn up by lawyers, whose task was to restrict the flow of information and to define the conditions and process of information transfer, whereby cooperation became inflexible, slowing it down, or making it altogether impossible. Under such circumstances agreements blocked information transfer, which in turn could be arranged much more quickly without such a written agreement. He also pointed out that in case of Hungary developed countries noted that it was hard to negotiate a cooperation agreement with the country because of the data protection provisions in place.

Mr. Freeland's opinion was not shared by all of the participants; many remarked that the MoU's were indeed useful means of supervisory cooperation.

Accounting Issues

So far the Committee has not paid attention to accounting issues. However, as correct accounting is an essential prerequisite for prudent supervision the Committee set up a working group consisting of 24 persons dealing with the following topics:

- Banks' internal audit and the supervisor relationship with the auditors;
- Analyzing and commenting on international accounting and audit proposals;
- Methods used to determine real value;
- Booking loans.

The Accounting Working Committee prepared a paper on the booking of loans and the corresponding requirements of public disclosure. This paper has not been issued for open discussion yet, but the participants of the conference have received a copy each.

[14] New Zealand primarily intends to ensure the stability of the financial system by tightening the rules of public disclosure.

Wrapping up the conference the Committee's representatives briefed us about the work they planned subsequent to the approval of the New Basel Capital Accord. These are:

- Monitoring the implementation of the New Basel Capital Accord, amending the Accord if required;
- Review of the risk management and capital adequacy calculation recommendations published in relation to market risks earlier;
- Publishing the recommendation related to accounting issues;
- Reviewing and amending bank supervisory principles and the corresponding methodology.