BSCEE

Review

2003

Group of Banking Supervisors from Central and Eastern Europe

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INTRODUCTION

The Group of Banking Supervisors from Central and Eastern Europe (the BSCEE Group) was established in 1990. The 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.

The Group consists of the following eighteen member countries: Albania, Republic of Belarus, Federation of Bosnia and Herzegovina (since 2002), Bulgaria, Croatia (since 1996), Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Slovakia, Slovenia and Ukraine.

The Chairmanship of the BSCEE Group rotates on annual basis. In 2002 Milan Horváth, the Chief Executive Director of the National Bank of Slovakia 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 2002. 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. The Annual Report also summarizes the main events of the BSCEE Group, including two regional workshops co-organized by the Bank of International Settlement (BIS) and the Financial Stability Institute (FSI) and by the BSCEE Group. The 15th Annual Conference was organized by the National Bank of Slovakia in Bratislava on the 7-8th of October 2002.

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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MACROECONOMIC ENVIRONMENT

Albanian economy growth rates over the period 1998-2002 are considered as high. However, they have indicated a downward trend throughout the whole period. The Bank of Albania assesses that the slowdown of the annual growth rate of economy is as a result of:

- Incomplete structural reforms,
- Low level of foreign investments,
- Unfavorable international conjectures after the events of September 11th,
- The somewhat relaxed economic activity after the very high growth in years '98-'99.

Albanian economic growth of 4,7 percent for 2002, attributed to the expansion of private sector, was mainly supported by transport, services and construction sector activity, while the public sector is constantly shrinking.

However, economic growth of 2002 is the lowest as compared to the period of 1998-2002, with a deviation of 1.3 percentage points from the announced target of the beginning of the year (6 percent). Nearly all economy sectors, especially industry and agriculture, have indicated lower growth rates than the projections. The structure of Albanian economy is changing as well. Agriculture and live animal sector, which traditionally have sustained economic development, have a reducing weight, while trade and services indicate an increasing contribution. These structural changes are in accordance with the ought-to- be- taken development of a country targeting integration in EU.

However, the industry sector evidences no significant development yet. To back up a steady and longterm economy growth, we assess that it is important that government authorities view the promotion of industrial production as a priority. Agricultural production for 2002 grew with 2.1 percent. It is a long time from now that agriculture does not contribute 50 percent in the national economy any more. It seems that this sector's annual growth rate can not be based anymore on its extensive aspect. This sector needs restructuring, which will lead to productivity increase. Relating to troubles in agriculture, they have to do with: parceling lands and conflicts resulted from ownership, prohibition of long- term investments in this sector, lack of investments in technology, undeveloped rural infrastructure in agriculture, and considerable disparity from one region of the country to another, limited capacities for preserving agricultural products and live animals' products, as well as insufficient financing provided to this sector. Additionally to these troubles, agriculture encountered damage from floods in autumn 2002. The somewhat better development of animal and rural industry is compensating problems of agricultural sector.

Industrial output was increased by 2 percent in 2002, indicating the lowest growth rate as compared to the rest of the sectors. Industry has been mostly suffering from the electric power problems, which have been present for almost three years, at least. As it is already clear to everybody, resolving this problem is vital for the country's advancement. However, I should stress that the situation is even more distressing. Starting from the Bank of Albania periodical surveys on businesses that operate in industry sector, it is emphasized that the situation of electric power in the country has led to a falling optimism on developing future businesses, which means that the economic growth stability may be put in danger.

Transport sector keeps on displaying high growth rates. In 2002, production from this sector reflected a 9.1 percent growth. Construction has got a slowdown trend. This is a natural trend as a consequence of innumerous new buildings and the meeting of requests during the previous decade. Attempts to formalize the construction activity will also provide impact in short term.

In general, the lowest economic growth for 2002 has been consequence of a lower level of foreign investments, shrinkage of capital expenditures, as well as political developments, which were associated with somewhat frequent changes of government. Foreign direct investments have been 31 percent less as compared to 2001. Given that the political and macroeconomic situation in the country resembles that of the previous year, the reduction of foreign investments is due to the lack of privatization of strategic subjects, especially that of Savings Bank and Albtelecom. On the other hand, capital expenditures have been realized in lower levels. Concretely, in 2002, about 73 percent of planned capital expenditures were carried out, against 96 percent of the previous year. Real capital expenditures were 13,8 percent less as compared to the previous year.

At the end of 2002, the employed number reached 921 thousand. The employment changing structure in the country has taken place in accordance with economy developments and its structural changes. Hence, the employed persons in agriculture comprises 57 percent of the total employees from 71.5 percent in the previous year. Migratory movements towards the cities as well as the expansion of the private sector have absorbed a considerable part of this labor force. Therefore, employment in non-agriculture private sector represents 23 percent of the total employment from 11 percent in the previous year.

However, Albania indicates a high unemployment rate of 15.8 percent. The expansion of the private sector activity and public investments are not yet in such paces as to generate sufficient work places.

However, the fact that Albanian economy has ensured an economic growth for the fifth year successively made the income per capita increase. For 2002, income per capita, calculated as GDP denominated in USD, in ratio with the country's population, is estimated to be on average USD 1500. Although such income rate remains the lowest in the region, we may say that the implementation of the Strategy for Social and Economic Developments is providing effects. Emigrants' remittances remain an important resource for Albanian families. For 2002, they reached USD 606,8 million, covering 52.2 percent of external trade deficit.

Albanian economy performance in 2002 has also reflected the impact of a general slowdown of world economy growth, especially the impacts of the concerns that have accompanied the economies of the region and main trading partners.

External sector and exchange rate developments

Albanian economy competitiveness, either in domestic or international market, is very low. External trade deficit had a rising trend during three recent years. For 2002, external trade deficit resulted as much as 24.6 percent of GDP. The extension of external trade deficit is attributed to the higher growth of imports, as compared to exports.

Albanian exports indicate a higher volume of USD 330,2 million. At 74 percent, re-exports hold the main share in Albanian exports, whereas exports from domestic production remain at low rates. Albanian exports are limited in producing raw material, due to the non-expansion of processing capacities in the country. Therefore, exports from the domestic production could not be accompanied by expansion of investments and the provision of new work positions. Regarding re-exports, they must be somewhat contributing in employment, using the relatively free labor force in Albania. This activity represents also the most important investments from both neighbor countries: Italy and Greece to Albania. However, it remains unclear whether such investments are accompanied by advanced technology investments, which would serve as a premise to increase the productivity.

Albanian imports reached the volume of USD 1,5 million. Imports include consumer goods and machinery and equipment. Machinery and equipment comprise about 16 percent of imports or nearly 5 percent of the GDP. This indicator indicates to us indirectly that there has been an increase of private investments.

Current deficit was deteriorated, recording 9.5 percent of GDP, from 6.1 percent in the previous year. The deterioration of the current deficit resulted from extension of trade deficit. The current account deficit financing was enabled mainly from emigrant remittances and tourism activity. The current deficit, recording USD 447,4 million, has been financed from capital inflows at 75 percent. Foreign direct investments (USD 143 million) and external debt (USD 142,7 million) occupied the main weight in financing the deficit.

The somewhat unfavorable developments in the external sector did not exercise strong pressures on the depreciation of the domestic currency. In 2002, Lek exchange rate to other foreign currencies has tracked previous year developments and exchange rate performance of major currencies internationally. Compared to average rate in the previous year, Lek depreciated by 3.03 percentage points in ratio to Euro and appreciated by 2.32 percentage points in ratio to USD. Banks panic of March –April is considered as an important factor for Lek depreciation, accompanied by the wavering confidence in domestic currency and the extension of currency in circulation. However, the international market developments are the ones that define the domestic currency developments. EUR/USD exchange rate by international market also defined Lek depreciation to EUR.

Subordinate to these developments in 2002, the Bank of Albania interventions in the foreign exchange domestic market have taken place in two periods: March – April and December. In both periods, interventions were effected in opposite direction. In the first period, USD 4,94 million has been sold at an average rate of Lek 145.02, and EUR 0,4 million at an average exchange of Lek 131.4. In December, USD 1,8 million have been purchased at an average exchange of Lek 133.74 and EUR 0,2 million at Lek 136.2 average rate.

Inflation

Annual inflation rate at the end of 2002 reached 2.1 percent. *Consumer price developments* during 2002 disclosed a reverse trend as compared to the previous year. Whether in 2001, inflation remained in relatively low rates and within the target band, the pressures for a higher inflation were added in the last two months, making inflation rate at the end of the year reach 3.5 percent. Year 2002 started with high inflation rates, almost the double of the upper target rate.

Higher rates than the target were present throughout the entire year and were significantly lowered during the two last months of the year. In general, inflation on the medium term has shown a rising trend. Inflation annual average rate went up from 0.4 and 0.1 percent in 1999 and 2000 to 3.1 and 5.4 percent respectively for 2001 and 2002, due to a more inflationist environment in 2002.

A number of operating determinants have dictated the consumer price developments in 2002. Such determinants have been active in both directions, either in demand or supply.

These determinants, operating by certain ratios, as well as the fact that demand side determinants acted one after another, giving longer-term impacts, made the Bank of Albania react with prudence.

Amongst the most important determinants that affected inflation performance, we may mention:

- The increase beyond the projection of currency outside banks for certain periods of the year, as well as the rising share of the most liquid aggregate M1 in monetary supply in the first half of the year,
- Domestic currency deprecation, also in the first half of the year,
- The increase of foodstuff prices in the markets, where Albania imports from, and an inflation higher than the Euro area target,
- The increase of electric power price in December 2001, which was carried on consumer prices, especially in the first half of the year. Also, the unstable electric power situation acted as an important factor on higher prices.
- Weather conditions, such as the cold weather at the begging of the year and the floods of autumn, exercised a higher impact on the rise of transportation prices and food prices as an aftermath,
- The speculative increase of prices, especially on the eve of the year-end holidays.

As the operating intensity of these determinants was stronger in the first half of the year, inflation rates were higher in this period and gradually started to drop. A reduced inflation was also affected by the care in performing budgetary investments, price reduction in "communication" group, due to the invigoration of mobile telecommunication services in Albania and the Bank of Albania campaign, which was undertaken at the end of the year to alleviate the phenomenon of consumer price speculation.

BANKING SYSTEM DEVELOPMENTS

Albanian banking system situation for 2002 is sound. The banking system is expanded with almost Lek 21 billion or 3.4 percent in real terms. Net profit result is Lek 3,9 billion. Capital position is further strengthened and capital adequacy ratio has reached 31.5 percent from 12 percent that is the allowed minimum.

Albanian banking system has been expanded with new banks and has further expended its network. In 2002, the Credit Bank of Albania was licensed.

Currently, 14 commercial banks operate in Albania, which expanded their networks with 9 branches and 1 new agency. Except banks, new financial entities are being created and licensed, which will influence on the financial system development in Albania and will lead to the reduction of the banking weight in it. Hence, in 2002: 1 non-bank institution; 20 foreign exchange bureaus; 113 savings and credit associations and 2 unions of these association are granted a license.

The increasing number of financial entities and the expansion of their activity will add the level of financial intermediation in Albania. Notwithstanding the positive developments in Albania during the recent three years, yet the financial intermediation is at low levels, ever lower than the region. Time deposit ratio comprises nearly 40.1 percent of GDP from nearly 50 percent average of East and Central European countries.

Meantime, domestic credit is nearly as much as 35.1 percent of GDP, however credit to economy is only 7.2 percent against 40 percent average of East and Central European countries. The difference between domestic credit index and credit to economy, represents banking credit to Government. The still high demand of Albanian government to finance the budgetary deficit, as compared to the most developed countries, keeps the lending activity somewhat deformed. Nevertheless, recent years developments have been positive. The ratios of domestic credit and credit to economy against GDP of the previous year have been 45 and 4.6 percent respectively.

Positive is the fact that the expansion of the banking system is due to a more intensive activity of private and joint-venture banks. In this way, premises are being created even for a constant reduction of the dominating position of the Savings Bank.

However, as compared to the previous year, the dynamics of expanding banking activity and the profitability indicators reflect a slight deterioration. Net income expressed in ratio to average assets and banks own funds for 2002 have resulted 1.2 and 19.1 percent from 1.5 and 21.6 percent in the previous year. This situation reflects the panic effect on the banking system in March – April 2002. Accordingly, the Bank of Albania concludes that the banking system is sound and the stability remains fragile yet.

Banks' credit to domestic economy has recognized adequate development. New credits extended from banks have been Lek 62,6 billion from 40,6 billion in year 2001. Outstanding credit of the banking system at the end of 2002 is Lek 47,4 billion or 16.6 percent of the deposits held in the system. Credit indicators have been generally improved. In 2001-2002, the new credits extended reaches to Lek 103,2 billion. This means that the annual average lending for the recent two years is five times more than in the period of 1993-2000. The expanding network of banks and their activity makes us feel optimistic on the rising credit in the future.

Additionally to banks, the expansion of micro credit schemes and non-bank institutions is another useful development that will lead to the increase of credit to economy. These institutions are estimated to have extended Lek 4 billion credits during 2002. Micro-credit schemes have a priority because they stretch in areas where there is no banking activity, especially in rural areas of the country, as well as they create credit possibilities to small- size business. That is why it is assessed that informal credit is shrinking.

Credit extended by the banking system in 2002 has maintained its structural characteristics. Thus, it has been 67 percent in foreign currency, 100 percent to the private sector and 71 percent short- term. Apart from that, the trade sector continues to be the most preferred for lending.

Bank credit, irrespective of its acceleration in the recent years, is not accompanied with deterioration of the credit portfolio quality. Also, the structure of bad loans has not undergone any changes, showing no disturbances on the increase of higher risk category, which is the category of lost loans.

BANKING SUPERVISION

Bank supervision comprises the second important pillar of the Bank of Albania activity. The Bank of Albania mission as a regulatory authority is:

- to ensure banking system stability and defend the interests of depositors and the public at large,

- to ensure a safe and sound banking system, whose activity should be transparent and oriented towards market economy,
- to increase the confidence of investors and depositor by supporting the developing of the banking industry and its efficiency.

The main strategic objective is the one announced by BIS Basel Committee on the banking supervision: "***No unit must escape banking supervision and supervision must be adequate"*** , as well as the observance of 25 basic principles of this Committee on a prudential banking supervision.

Banking supervision activity for 2002 has been concentrated in compiling and revising the regulatory framework, analyzing and inspecting banks or other financial institutions, which are supervised by the Bank of Albania. In the regulatory framework, a number of new rules were drafted, which aim at not letting the activity of any entities outside banking supervision.

During the 2002, there took place 13 full inspections and 11 partial inspections, and it was observed that:

- the expansion of lending activity is accompanied by an improvement of credit portfolio, though there are evidenced some deficiencies such as: the outset of lending activity, without previously ensuring a trained staff or team; non-basing on accurate and complete,
- the public confidence has been turned back, after the prevailing panic in March- April 2002,
- generally, the high management of banks has reacted positively towards the findings presented in the examinations performed, but no proper care is shown on: improving bank activity procedures and policies; completing the regulatory framework of bank activity; executing the bank's business plan.

During the examinations performed, findings of various violations have been noticed. Generally, these violations have been assessed as unimportant, containing no serious consequences for banks. According to the violations highlighted, the corrective measures or penalties have been defined, pursuant to provisions of Law " On Banking System in the Republic of Albania" and Bank of Albania rules and regulations, such as: recommendations or suggestions to correct minor inconsistencies; the requirement to submit to the Bank of Albania a program of measures to rectify the current bank state, on the event of encountering irregularities, setting forth the respective terms; penalties to administrators, who have to do with the violations observed against laws and bylaws in force.

Given the significance of the bank supervision, a mid-term banking supervision development plan has been prepared, in cooperation with the World Bank, and it will have effect until 2004. The implementation of this plan aims at enhancing the banking system security in Albania, by applying efficiently the standards on a safe and sound banking activity.

Strengthening the supervisory capacities is considered an important duty to prevent problems and minimize risks, against which the banking system is exposed. This undertaking is even more important in the face of efforts and in implementation of measures for further liberalization of economy and for increasing its integration standards.

STATISTICAL TABLES

Number of Banks
(at year-ends)

Type of Banks*	2000	2001	2002
State-owned banks (100%) (G1)	1	1	1
Joint-ventures (G2)	2	2	2
Banks with foreign capital (G3)	10	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 on the basis of registered capital (%)

Item	Type of banks			Total 2002
	G1	G2	G3	Banking System
State ownership	100.0	40.0	0.0	13.5
Other domestic ownership	0.0	0.0	0.0	0.0
Domestic ownership total	100.0	40.0	0.0	13.5
Foreign ownership (private banks)	0.0	0.0	100.0	73.6
Other foreign ownership (joint-venture)	0.0	60.0	0.0	12.9
Foreign ownership total	0.0	60.0	100.0	86.5
Banks, total	**100.0**	**100.0**	**100.0**	**100.0**

Item	2000	2001	2002	2002/2000
State ownership	13.4	13.9	13.5	0.7
Other domestic ownership	0.0	0.0	0.0	0.0
Domestic ownership total	13.4	13.9	13.5	0.7
Foreign ownership	71.7	72.7	73.6	2.6
Other foreign ownership (in j-v)	14.9	13.4	12.9	-13.4
Foreign ownership total	86.6	86.1	86.5	-0.1
Banks, total	**100.0**	**100.0**	**100.0**	–

Distribution of market shares in balance sheet total (%)

Type of banks	2000	2001	2002
G1	64.8	59.2	54.1
G2	6.2	5.8	5.6
G3	29.0	35.0	40.3
Banks, total	**100.0**	**100.0**	**100.0**

**based on assets*

The structure of assets and liabilities of the banking system in 2002 (%) (at year-ends)

Assets	2000	2001	2002
Treasury operations and interbank	88.4	85.7	80.6
Operations with customers (net)*	6.1	8.6	11.4
Securities transactions (net)	2.9	3.3	4.9
Other assets	0.6	0.4	0.9
Fixed assets	1.9	1.8	1.8
Total accrued interest	**0.1**	**0.3**	**0.5**
Liabilities and shareholders' equity	**2000**	**2001**	**2002**
Treasury operations and interbank transactions	2.3	3.6	5.3
Operations with customers	84.8	86.2	84.0
Securities transactions	0.0	0.0	0.0
Other liabilities	4.6	3.0	2.9
Permanent resources	7.1	6.2	6.7
Total accrued interest	**1.2**	**1.1**	**1.2**

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

Solvency ratio of banks

Type of banks	2000	2001	2002
G1	44.5	29.9	33.3
G2	39.4	40.4	43.6
G3	41.8	35.7	28.9
Banks,average	**42.0**	**35.3**	**31.6**

Asset portfolio quality of the banking system (%)

Asset classification	2000	2001	2002
Standard	59.1	88.3	89.9
Special mentioned	7.4	4.6	4.6
Substandard	3.3	4.0	3.0
Doubtful	4.1	1.7	0.7
Loss	26.0	1.3	1.8
Overdue loans/Total of loans	42.8	6.9	5.6
Classified Total	**100.0**	**100.0**	**100.0**
Provisions	**30.1**	**4.4**	**4.2**

The structure of deposits and loans in 2002 (%) (at year-end)

	Deposits	Loans
Households	84.8	18.5
Public sector	5.9	0.1
Private sector	9.3	81.4
Foreign	32.7	79.0
Total	**100.0**	**100.0**

The structure of deposits and loans in 2002 (%) (at year-end)

Maturity of deposits		Loans	
At sight	29.8	Short-term loans	47.7
Within one year	70.2	Medium-term loans	23.3
Over one year	0.0	Long-term loans	7.6
		Real estate loans	17.1
		Other loans	4.3
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		
	2000	2001	2002	2000	2001	2002
G1	15.5	16.5	14.1	15.2	16.5	14.1
G2	92.1	88.0	85.2	88.2	85.5	78.7
G3	62.9	64.8	62.2	41.3	64.2	61.8
Banks, average	**34.0**	**37.6**	**37.5**	**27.3**	**37.2**	**36.9**

Structure of incomes and expenses for banks

Incomes	2000	2001	2002
GI	73.3	61.2	57.1
G2	5.1	8.6	5.8
G3	21.6	30.2	37.1
Banks, total	**100.0**	**100.0**	**100.0**
Expenses			
G1	70.2	59.7	57.4
G2	5.7	9.9	6.2
G3	24.1	30.4	36.4
Banks, total	**100.0**	**100.0**	**100.0**

Structure of registered capital and own funds of banks in 2002

(in mio of USD)

Type of banks	Registered capital	/Total assets	Own funds	/Total liabilities
	USD	%	USD	%
G1	5.2	0.4	39.9	2.9
G2	23.4	16.4	26.4	18.5
G3	79.9	7.8	95.4	9.3
Banks, average	**108.5**	**4.3**	**161.7**	**6.4**

Note: Rate of exchange USD/Lek =133.74

Profitability of banks

Type of banks	2000		2001		2002	
	ROA	ROE	ROA	ROE	ROA	ROE
G1	2.9		1.7	58.8	1.2	47.6
G2	0.6	2.8	0.1	0.6	0.6	3.4
G3	0.7	3.0	1.3	11.4	1.3	13.1
Banks, average	**2.1**	**20.7**	**1.5**	**21.6**	**1.2**	**19.1**

Average balance sheet items

(in mio USD)

Items	2000	2001	2002
Average balance sheet total (assets total)	1,794.5	2,152.9	2,408.0
Average own capital	179.9	145.4	150.9

Profit and loss statement

(in mio USD)

Items	2000	2001	2002
Interest income	164.3	164.2	176.0
Interest expenditure	109.7	100.6	109.8
1) Net interest income	54.6	63.6	66.2
2) Profit from other financial and investment services (including devidentes)	14.8	17.4	17.9
Of that: Profit from commissions	10.6	11.4	13.1
b) Net provisions	-11.2	5	7.9
3) Gross financial and investment services profits (1+2-b)	80.6	76	76.1
4) Overheads	53	35.1	41.4
5) Extraordinary profits	0.5	0.4	2.9
6) Pre-tax profit (3-4+5)	53.1	40.8	37.6

Components of the banking sector return on assets (%)

Items	2000	2001	2002
In proportion to the average balance sheet-total			
Interest income	9.2	7.6	7.2
Interest expenditure	6.1	4.7	4.5
1) Net interest income	3.0	3.0	2.7
2) Profit from other financial and investment services (including dividents)	0.8	0.8	0.7
Of that: Profit from commissions	0.6	0.5	0.5
b) Net provisions	-0.6	0.2	0.3
3) Gross financial and investment services profits (1+2-b)	4.5	3.5	3.1
4) Overheads	1.6	1.6	1.7
5) Extraordinary profits	0.0	0.0	0.1
6) Pre-tax profit (3-4+5)	2.9	1.9	1.5

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

Type of banks	2000	2001	2002
G1	N.A	0.0	0.0
G2	N.A	7.7	10.5
G3	N.A	8.4	14.1
Banking System	**N.A**	**4.0**	**13.9**

2002 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF BELARUS

MACROECONOMIC ENVIRONMENT IN BELARUS

National Bank in concert with the Government of the Republic of Belarus ensured fulfillment of the Republic of Belarus monetary policy guidelines for 2002 approved by Edict of the President of the Republic of Belarus No 641 dated November 8, 2001.

Implementation of the Guidelines is characterized by the attainment of objectives and tackling of tasks of monetary policy, formation of monetary indicators and monetary policy instruments which create favorable conditions for dynamic social and economic development of the country.

The following was ensured in 2002: maintenance of smooth and predictable dynamics of official exchange rate of the Belarusian ruble and lower effect of monetary factors on inflation; development and strengthening of the banking system of the Republic of Belarus which became apparent in the growth of resources, own capital and authorized capital, inflow of foreign capital into the banking system of the Republic of Belarus, expansion of banks' active transactions and improvement of banks' asset structure; and efficient, sound, and safe functioning of the payment system.

Along with the attainment of underlying objectives of monetary policy its instruments were also used to deal with important tasks of the national economy, i.e. to expand involvement of the banking system in financing republican budget deficit and lending to the real sector of the economy and to increase monetary authorities' net foreign assets (including gold and foreign exchange reserves).

Implementation of the Guidelines created adequate environment for successfully tackling the tasks of economic and social development of the country stipulated in Edict of the President of the Republic of Belarus No 640 "On Approval of Overriding Parameters of Social and Economic Development of the Republic of Belarus for 2002" dated November 8, 2001, and the Law of the Republic of Belarus "On Budget of the Republic of Belarus for 2002."

DEVELOPMENT OF THE BANKING SYSTEM

Performance of the banking system of the Republic of Belarus in 2002 was rather stable. Six leading banks (Joint-Stock Savings Bank "Belarusbank", open joint-stock companies "Belagroprombank", "Belpromstroibank", "Belinvestbank", "Priorbank", "Belvnesheconombank") play a significant part in pursuing the Government's social and economic policy. These banks currently account for 88.9% in the total amount of active transactions performed by Belarusian banks.

In 2002, a trend towards influx of foreign capital into the banking system of the Republic of Belarus became visible. Four new banks with foreign capital participation were set up – closed joint-stock companies "Astanaeximbank" and "UBS Bank", open joint-stock companies "Lorobank" and "Mezhdunarodny Reservny Bank". As at January 1, 2003, 23 out of 28 functioning banks are banks with foreign capital participation, of which five are wholly foreign-owned banks. On the whole, non-residents' investment in authorized capital of Belarusian banks in 2002 increased 2.35 times, or by USD11 million and EUR7 million. In 2002 three offices representing foreign banks opened, now 11 offices function in Belarus (Russian, Lithuanian, Latvian, German, and Polish banks), Banks' authorized capital increased in 2002 by 90.9%, own capital grew by 52%, bank resources (liabilities) increased by 13,6% (all – in real terms).

One significant positive peculiarity of banking performance in 2002 was a change in the structure of banks' cumulative net assets (both foreign and domestic). In particular, the share of net domestic assets in cumulative net assets climbed by 8.8% whilst the share of net foreign assets dropped by the same amount. These changes suggest that banks tend to be more and more inclined to engage in rendering financial services to economic and social development of the Republic of Belarus.

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

In 2002, the methodological framework of banks' regulation and supervision was rationalized. On January 11, 2002, new Rules regulating banks' operation were introduced, whereby banks authorized to attract households' funds must bring own capital up to EUR10 million, banks authorized to perform operations under the master license up to EUR5 million. Said Rules substantially enhance financial soundness of Belarusian banks.

A comprehensive system for analyzing banks' financial standing was devised and put in place. This system is used to evaluate financial strength of banks, the extent of their efficiency, prospects for their functioning in the future, as well as to identify banks' problems as early as possible. On the basis of International Accounting Standard No 27 Rules for compiling banks' consolidated financial statements were prepared and approved. Efforts are being undertaken to introduce prudential accounts of banking groups and supervision thereof on a consolidated basis.

Work on streamlining bank accounting continued in 2002. A number of national accounting standards developed in accordance with international standards were adopted ensuring appropriate transparency, adequacy, and completeness of produced figures.

Methodological recommendations on how to organize and carry out banks' inspections that are designed primarily to assess actual financial standing of a bank and risks involved in its operation were developed and introduced.

Improvement of economic norms intended to pre-empt banks' systemic risks continued. To this end, amendments and modifications to the Rules regulating operation of banks and non-bank credit and financial institutions were prepared and made effective.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2002.

In 2002, the National Bank made 12 comprehensive and 9 subject inspections of banks. Following such inspections a wide range of measures is implemented. For instance, BYR 297.3 billion were recovered from banks in fines, 10 meetings with bank management were held, 10 orders to remedy revealed deficiencies were sent.

Tracking developments in the banking system and exercising individual supervision over each bank resulted in fact that banks basically complied with the economic norms set by the National Bank. Their macroprudential indicators are characterized by the following data. As at January 1, 2003, ratio of own funds (capital) to risk-weighted assets for all the banks was 24.2% (the norm for a bank being at least 10%). At the end of 2002, ratio of highly liquid assets to total assets was 16% (the norm being at least 10%), ratio of actual liquidity to required (short-term) liquidity 1.39% (the norm being at least 1%), ratio of assets due on demand to liabilities due on demand (instant liquidity) 52.6% (the norm being at least 20%), and ratio of current assets to current liabilities (current liquidity) 67.3% (the norm being at least 70%).

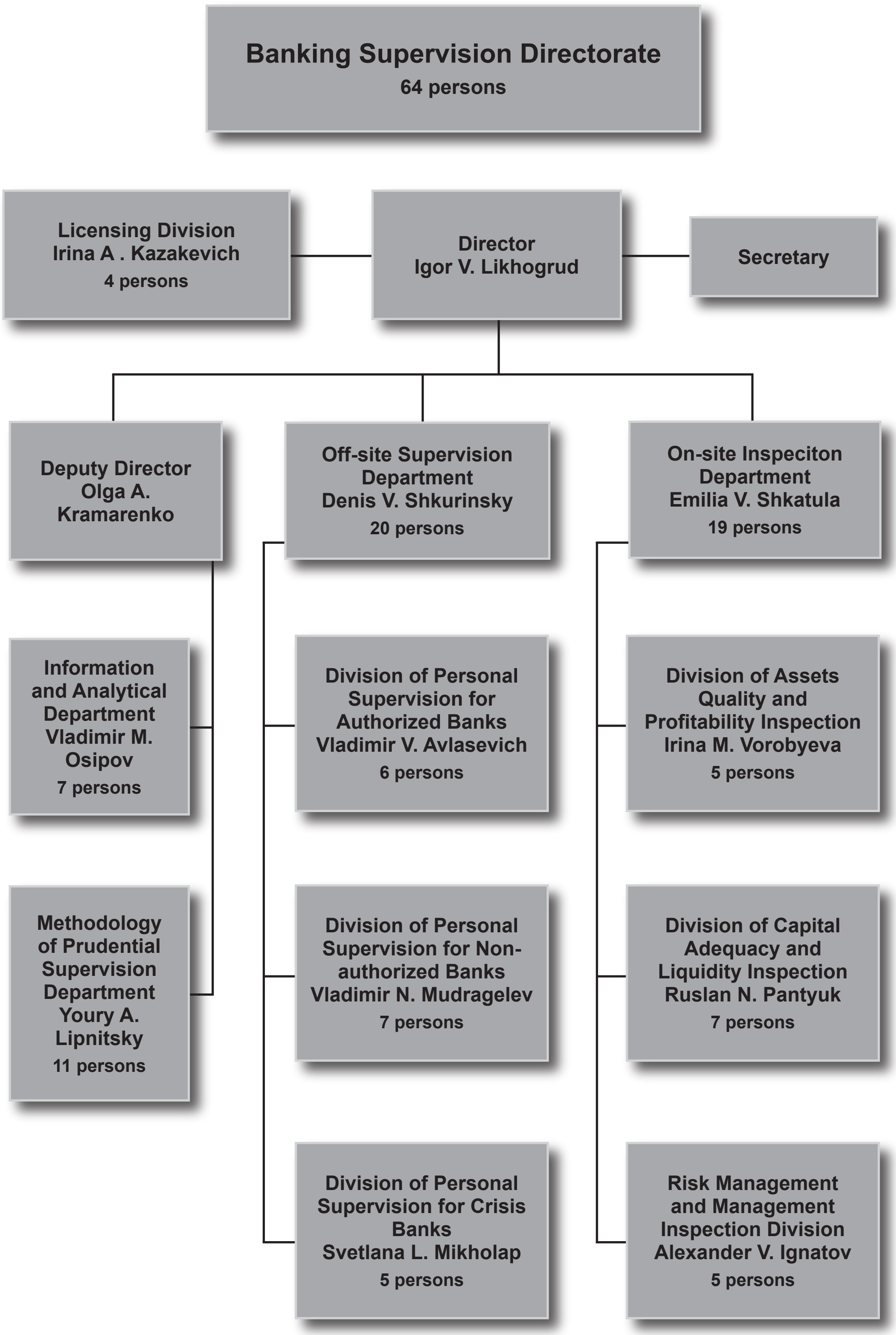
LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN BELARUS

The Banking Code is the basic document securing legal regulation of the banking system of the Republic of Belarus. According to Article 26 of the Code, the function of supervision is assigned to the central bank of the Republic of Belarus, carrying out the following:

- 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 therefor,
- Eestablishes 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 of he National Bank.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISION DIRECTORATE



INTERNATIONAL ACTIVITIES OF THE SUPERVISORY AUTHORITY

Central to international cooperation of the Belarusian banking system in 2002 was cooperation with the Russian banking system which was carried out in accordance with the inter-state Agreement on the introduction of a single currency and establishment of a single center of issue and inter-governmental Agreement on actions rtsegarding creation of conditions for introduction of a single currency. It was based on implementing measures stipulated in the 2002-2005 Joint Actions Plan of the Government of the Republic of Belarus, the National Bank of the Republic of Belarus, the Government of the Russian Federation and the Central Bank of the Russian Federation intended for the introduction of a single currency of the Union State. In 2002, the Bank of Russia granted to the National Bank two credit tranches, RUR1.5 billion each, and it was decided to extend the first tranche (BYR1.5 billion).

Cooperation with other CIS countries in 2002 effected as part of the activities of the CIS Inter-State Currency Committee and the Council of Governors of Central (National) Banks set up in accordance with the Eurasian Economic Community Establishment Treaty. Cooperation with international financial organizations was aimed at preparing an economic program of the Republic of Belarus which would be used as a basis for obtaining the IMF's «stand-by» loan and at collaborating with international rating companies and agencies so that the Republic of Belarus could be given a rating.

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

As for bilateral relations with foreign central banks, on 26.04.2002 the Memorandum of Mutual Understanding in the field of bank supervision with the Bank of Lithuania was signed.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BELARUS

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 2003

In 2003, banks will continue to build up their equity and to expand their resource base by attracting funds from foreign and domestic 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.

Development and strengthening of the banking system is aimed at enhancing sustainability of the banking system, expanding and upgrading banking services, protecting depositors' and creditors' interests and will be attained through widening banks' resource base, streamlining assets and liabilities structure, increasing capitalization of banks, reducing all kinds of risks, and improving the quality of bank governance.

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

One of the major tasks dealt with while implementing the Guidelines was to ensure a rise in gold and foreign exchange reserves of the state. Monetary authorities' net foreign assets which are critical for creating gold and foreign exchange reserves increased in 2002 by USD212.1 million amounting to USD441.2 million as at January 1, 2003, or 8.3% above the upper limit of this parameter according to the indicative indicators of the Guidelines. Coverage of the monetary base in Belarusian rubles by monetary authorities' net foreign assets jumped from 53.2% as at January 1, 2002, to 88.9% as at January 1, 2003, whilst coverage of goods and services import by gross foreign assets constituted 29 days at the end of 2002 against 19 days at the end of 2001.

STATISTICAL TABLES

Number of financial institutions *
(at year-ends)

Type of financial institution	1998	1999	2000	2001	2002
Commercial banks	37	36	31	25	28

**) Number of acting financial institutions*

Ownership structure of financial institutions in 2002
on the basis of registered capital (%)
(at year-ends)

Item	Commercial banks
State ownership	80.12
Other domestic ownership	11.15
Domestic ownership total	91.27
Foreign ownership	8.73
Financial institution, total	**100.00**

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

Item	1999	2000	2001	2002	2002/ 1999
State ownership	90.97	87.52	76.32	80.12	88.07
Other domestic ownership	4.54	8.00	14.11	11.15	245.59
Domestic ownership total	95.51	95.52	90.43	91.27	95.56
Foreign ownership	4.49	4.54	9.57	8.73	194.43
Financial institution, total	**100.00**	**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		2002	
	Quantity of banks	market share	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%**	**28**	**100.00%**
incl.										
negativ equity capital	2	13.51%	1	0.79%	2	1.82%	0	0.00%	1	3.57%
to 1 bln. roubles	16	8.47%	10	3.85%	1	0.06%	2	0.25%	2	7.14%
from 1 to 10 bln. roubles	8	78.02%	14	41.25%	18	10.70%	11	10.65%	7	25.00%
from 10 to 40 bln. roubles	0	0.00%	0	0.00%	5	33.24%	8	24.90%	13	46.43%
more than 40 bln. roubles	0	0.00%	2	54.11%	2	54.18%	4	64.20%	5	17.86%

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

Assets	2000	2001	2002
Cash assets, gold, precious metals	1.0	2.2	2.3
Assets in the National Bank of the Republic of Belarus	2.6	1.3	1.7
Correspondent accounts in other banks	9.4	13.3	11.5
Required reserves	0.0	5.7	4.6
Securities	4.6	8.2	9.1
Credit to individuals and enterprises	29.2	60.5	63.0
Permanent assets and intangibles	2.3	7.1	6.3
Other assets	50.9	1.7	1.5
Total	**100.0**	**100.0**	**100.0**
Liabilities			
Settlement and current accounts	43.5	36.4	20.0
Correspondent accounts of other banks	2.0	2.7	2.1
Deposits of other banks	1.9	2.2	1.0
Deposits of individuals and enterprises	20.9	37.3	51.2
Interbank credits	10.1	21.4	18.0
Other liabilities	21.6	0.0	7.7
Total	**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	2002
Commercial banks	143.80	157.16	131.63	193.10	197.71

Solvency ratio of financial institutions (%)

Type of financial institution	1998	1999	2000	2001	2002
Commercial banks	11.30	31.48	24.43	20.70	24.20

Asset portfolio quality of the banking system

mln.roubles

Asset classification	1998	1999	2000	2001	2002
Loans, total	**241,607.5**	**524,344.4**	**1,701,805.3**	**2,726,594.8**	**4,286,479.8**
Extended loans	12,396.3	19,285.7	72,207.0	75,675.4	64,518.7
Past due loans	3,455.3	6,304.9	36,037.7	78,163.9	76,672.9
Doubtful loans	24,108.3	43,132.6	150,129.1	2,388,441.9	214,643.3
Past due interest					
up to 30 days	1,951.2	3,756.1	13,415.9	15,642.1	8,552.5
more than 30 days	9,945.0	17,554.3	75,936.3	116,725.8	167,565.5
Special reserves	12,106.2	30,617.5	122,294.3	137,937.5	66,208.5

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

	Deposits	Loans
Commercial organizations	10.0	81.9
Households	61.0	12.6
Non-commercial organizations	26.4	4.1
Non-bank financial institutions	2.6	1.4
Total	**100.0**	**100.0**

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

Types of deposits		Types of loans	
Demand deposits	30.79	Long-term lending	65.55
Time deposits	69.21	Short-term lending	34.45
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			
	1999	2000	2001	2002	1999	2000	2001	2002
Commercial banks	40.28	55.75	45.62	54.40	38.80	54.16	44.24	60.50

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 (%)

Items	1999	2000	2001
In proportion to the average balance-sheet total			
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 revenues and expenditures of financial institutes (at year-end)

bln.roubles

	1998	1999	2000	2001	2002
Revenues					
Interest revenues	29.9	165.9	551.1	604.2	903.4
Commission	5.9	25.3	65.5	147.1	250.0
Other revenues	12.6	41.5	96.3	356.5	498.4
Other operational revenues	1.0	2.1	3.2	5.4	8.1
Reserve settlement	0.7	2.1	6.2	15.1	20.7
Unanticipated revenues	0.0	0.0	0.2	0.0	0.2
Total revenues	**50.1**	**236.9**	**722.5**	**1,128.3**	**1,680.8**
Expenses					
Interest expenses	19.6	103.0	387.1	370.6	525.4
Commission	1.0	3.4	6.4	17.8	25.4
Other expenses	8.0	31.1	54.6	307.0	437.2
Other operational expenses	15.0	74.0	215.5	365.1	579.3
Allocation to reserve	4.4	16.1	40.4	39.1	59.7
Unanticipated expenses	0.0	0.0	0.0	0.0	0.0
Total expenses	**48.0**	**227.6**	**704.0**	**1,099.6**	**1,627.0**
Economic revenue	**2.1**	**9.3**	**18.5**	**28.7**	**53.8**

Excluding banks under liiqudation

Structure of registered capital and own funds of financial institutes in 2002

Type of the financial institutions	Registered capital /total assets		Own funds / total liab.	
	EUR	%	EUR	%
Commercial banks	409.3	7.4	608.3	24.5

2002 DEVELOPMENTS IN THE BANKING SYSTEM OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

MACROECONOMIC CIRCUMSTANCES

In last year, banking sector of the Federation of BiH was distinguished by further growth, consolidation and stabilization of the system, stronger competition, new services and products offers and adoption of changes and additions to regulations. In short, the transition is in the final phase. In future period we can expect more complete implementation of international standards in operations and establishment of modern market environment.

Based on the non-audited balance sheet from banks, at the end of last year, total balance sheet in banks in the Federation of BiH was KM 4.6 billion which is larger by 828 million or 22% in comparison to the end of 2001. Satisfying growth ratio in the system was achieved thankfully to expansion of private banking. Privately owned banks recorded assets growth of 25% and at the same time, state owned banks recorded reduction of eight percent. If we observe that from another perspective, the growth of balance sheet resulted from increased depository potentials by 628 million or 22% and, which is very significant, growth of capital by 124 million or 25%. The capital increased out of cash payments of KM 114.3 million, 110 million out of that amount was paid by foreign investors. Part of those assets was spent for settling earlier losses (83.7 million) and it resulted in decrease of remaining unsecured losses from 93 to 9.3 million of KM, that is, the losses decreased by 90%, if we do not include losses from 2002 in the calculation.

The whole banking system, consist of 29 banks, attained positive financial results. As it was recorded by banks, 20 bank closed previous year with profit of 39,7 million of KM, and eight banks had loss of total KM 22.3 million. Therefore, the whole system earned profit of KM 17.4 million. These indicators do not include Hercegovacka Bank that is under Provisional administration by the order of the High Representative.

Although maturity adjustment of assets and liabilities is not satisfactory yet (75.9% were short term}, especially in comparison to the loan maturity adjustment, it is necessary to emphasize that this structure is continuously changed and long-term loans increased from 9.5% (in 2000) to 14.7% (in 2001) and in 2002 they were 24.1%). Participation of deposits in total liabilities was 76.8%t thus that makes our banks almost in line with international average that is 80%.

After boom in 2001, citizens' savings recorded growth in 2002 as well. Total deposits given by citizens to banks were KM 1.44 billion which is 10% more in comparison to the end of 2001, and in comparison to 2000 savings were more than tripled!

Loan portfolio in banks increased during last year by 967 million of KM or by 56%. The major operations were borrowings to citizens. That activity recorded growth of KM 637 million or 102%! Borrowings to privately owned enterprises increased by 40% or KM 308 million. Maturity adjustment of assets and liabilities was not satisfactory and it can have negative impact to banks' liquidity in future period.

Together with satisfactory financial results, banking sector recorded further consolidation and stabilization of the system in last year. After impetuous changes in previous years, the last year there was not need or cause for instituting provisional administration in any bank. The FBA started a liquidation procedure (ICB) after request of the bank's owner. The regulator capital of KM 15 million was successfully attained. Majority of banks timely provided additional capital, and 10 banks merged in order to adjust to this regulation. That additionally helped increasing of large banks and decreasing number of small banks.

Although banks' capital base strengthened in last year, it is obvious that this sector still has weaknesses, which can affect safety in some banks and system in whole. Capitalization of banks (capital to assets ratio) decreased. In 2001 it was 16.2% and it decreased to 15.4% in 2002. Also, capital adequacy ratio for the whole system reduced from 26.3% in 2000, to 22.4% in 2001 and at the end of last year it was 19.8%. Essentially, capital growth, especially in large banks did not follow the growth of risk assets. According to its legal authorities, the FBA will implement corrective actions in order to resolve these weaknesses as soon as possible.

Significant results were achieved in the field of introduction of new banking products. That is mainly related to the credit card operations. 6 banks in the Federation of BiH have established their own data processing center and have already issued over 8,000 credit cards locally. At the same time, 12 banks issued international debit and credit cards. Banks should devote their full attention to non-monetary payment system, but this should be also helped by other institutions in the system.

Certain number of banks, very few so far, started electronic (on-line) banking. Some banks announced SMS banking, ATM network is still expanding, but it is still not expanded enough. Banks introduced savings for housing loans, etc.

Banks have, successfully and in the short period of time, taken over the entire internal payment system, which functions without any problems. However, that introduced increased danger of banks "being involved" in money laundering and terrorism financing. Few such attempts were registered and banks undertook actions to eliminate it. As supervisory institution, the FBA cooperated with banks to prevent money laundering and terrorism financing, and also coordinated its actions with the Financial Police, Ministry of Internal Affairs (MUP), Tax Administration, Prosecutor's Office, etc. After 12 target examinations performed in banks and their branches, and after findings in full scope examinations, the FBA ordered actions for correcting identified weaknesses and/or informed authorized institutions on their findings.

In August last year, Law on Changes and Additions to the Law on Banks was passed as continuation of system reforms: prudential principles are more severe, public revenues were protected, new actions for prevention of money laundering and terrorism financing were instituted etc. After all these changes and additions, the FBA have passed new, that is complied old, regulations to the new Law as of December 24th 2002, which was done within the regulated time frame.

BANKING SYSTEM REFORM

A key element of financial stability in every country and one of the important preconditions for success of an overall economic reform of any country is strength and stability of the banking sector, which were goals established for reform and restructuring efforts in the Federation of BiH. The starting points for those plans were:

- elimination of problems inherited from previous system and induced by the war,

- transformation of ownership through the capital privatization in state banks and its sale in mainly privately owned banks,
- attraction of foreign investors and stronger competition,
- improvement of efficiency and objectivity of banking operations, strengthening capital base, introduction of international standards and new products, accepting worldwide organizational systems, operations and supervision.

Preconditions for 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 around 4 billion KM. If we include inappropriate, socialistic and insufficient regulatory framework, interference of the state, nonexistent market, lack of staff and other inadequacies, we can picture the complexity of the reform process, and its time consuming character.

Five years later, it is possible to conclude that significant progress and results were achieved. Net capital in banks is positive today, that is, it reached 697 million KM. The system became more stable, there are more larger banks now and all banks were strengthened. The new regulatory framework was developed and statutory regulations were designed displaying that we are leaving transition period and entering phase of creating true market environment.

Unfortunately, successful transformation of banking industry was not followed by changes in other sectors, especially in the real economy sector, which is still stagnating and, unless rate of reform becomes higher, this can become an impediment to further development of the banking sector. 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 courts' executive orders, that is, to improve legal protection of the creditors.

Privatization and restructuring

Bank privatization process should be finalized in 2003 by change of capital owners or by liquidation procedures.

We are expecting that number of banks in the Federation of BiH will decrease and will continue to do so, although that process will slow down in comparison to the previous period. New minimum capital requirement of KM 15 million (paid-in shareholders' capital and net capital) resulted in several mergers of banks in last year – Vakufska Bank and Depozitna Bank, Central Profit Bank and Travnicka Bank, Raiffeisen Bank BH and Reiffeisen HPB, ABS Bank and Seh-in Bank, Gospodarska Bank Sarajevo and LT Komercijalna Bank Livno.

If we observe this by size of assets, there were radical changes in the system. Only two largest banks, with over 500 million in assets, have a concentration of 35.9% of total assets in the system. In next three largest banks, with assets between 300 and 500 million, have a concentration of 25.5% of total assets. On the other hand, 8 banks in the Federation of BiH had assets under KM 50 million. Foreign investors own 67.3% of shareholders capital in the system.

The Banking Agency

The Banking Agency of the F BiH, as independent institution for supervision and licensing of banks, was founded at the end of 1996. From the very beginning, its activities were designed to create strong and stable banking system, market oriented and adjusted to international business and supervision standards in banks. The Law on the Banking Agency established its 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).

In implementing reform process in the banking system, the FBA gave its full contribution, although it often faced disagreements.

Since the leading objective of the Agency is to protect money and interests of depositors, the Banking Agency of the FBiH initiated provisional administration in 19 banks in period between foundation of the Agency until end of 2002, while the High Representative initiated provisional administration in one bank. Out of this number, there are 3 banks that are still under provisional administration. Provisional administration was successfully resolved in three cases by mergers of those banks, liquidation process was initiated in 8 banks, out of that number, two liquidations were completed without negative outcome for depositors and shareholders, and one resulted in merger. The Agency filed requests for bankruptcy process in 6 banks, and this process is still pending with courts. Liquidation process is currently going on in 4 banks. In 2002, the FBA did not initiate liquidation in any bank, and in one bank the liquidation procedure was established upon the request of the owner.

International experience and international rules 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 regulations and laws passed by the FBA and criminal actions. Responsibility for that laws with managing and governing bodies of banks.

Bank supervision

Since 1975, the Basel Committee for Bank Supervision explores methods and declares actions to strengthen financial stability all over the world.

In order to promote and provide for an overall macroeconomic and financial stability, in 1997 the Basel Committee adopted 25 core principles, which should be respected in order to have efficient supervisory system.

These core principles are minimum requirements to be implemented and in many cases it is necessary to supplement them with other actions in order to comply with specific conditions and to regulate risks of financial systems of individual countries. The principles are related to preconditions for effective supervision of banks, licensing, prudential regulations and requirements, methods for continued supervision of banks, necessary information, official authorization of supervisors and cross-border banking.

Although they are, to certain extent, adjusted to actual conditions in our country, legal and regulatory framework for bank operations in FBiH is mostly consistent with international standards. Certainly, the degree of compliance of local regulatory framework to Basel Principles will be improved in the future period, all the more so since the Law on Changes and Additions to the Law on Banks that was declared in August 2002 provides in Article 69 that "The regulations passed by the Agency… are based on the core principles for supervision of banks as regulated by the Basel Committee for Bank Supervision."

OPERATIONAL PERFORMANCE OF BANKS IN THE FEDERATION OF BIH

As of 12/31/02, there were 29 banks in the FBiH holding banking licenses issued by the FBA. All banks have been performing banking operations and had a duty to report to the FBA, except Hercegovacka Bank dd Mostar, and information related to operations of that bank was not included to this information. The FBA reviewed reports (off-site review) and performed on-site examinations as regulated by law.

Structure of the banking sector

Licenses for inception and establishment of bank operations and other approvals

In 2002, the FBA revoked five banking licenses from the following banks: Depozitna Bank dd Sarajevo, which merged to Vakufska bank d.d. Sarajevo, Šeh in Bank dd Zenica which merged to ABS Bank d.d. Sarajevo, Mostarska Bank d.d. Mostar due to merger with Gospodarska Bank Mostar, International Commerce Bank p.l.c. Sarajevo that was under liquidation procedure as requested by the Bank Assembly and Travnicka Bank dd Travnik due to status change (merger to Central Profit Bank dd Sarajevo). In the same period, the FBA issued one license for inception and operation of HVB Bank BiH d.d. Sarajevo.

At the end of 2002, FBiH banks had 7 organizational units in the Republika Srpska and 6 RS banks opened their organizational units in the FBiH.

As of 12/31/02, three banks were under provisional administration:

- Gospodarska Bank dd Mostar
- Hercegovačka Bank dd Mostar and
- UNA Bank dd Bihać.

Aside from Hercegovačka Bank dd Mostar (Provisional administration was initiated by the decision of the High Representative in BiH), the reason for initiation of Provisional Administration in other banks was failure to meet operating conditions required by law.

The license for internal payment operations was given to 28 banks as of 12/31/02, which is related to inter-bank transactions. In comparison to the end of 2001, the license for inter-bank transactions were approved to HVB Bank BiH dd Sarajevo. Applications for license for internal payment system operations are still accepted by the FBA.

Ownership Structure

As of 12/31/02, ownership structure in banks[1] was evaluated upon available information and bank examinations[2] and is was as follows:

- Private and majority privately owned 25 banks (79.3%)
- State and majority state owned 6 banks (21.7%).

[1] Criteria for classification of banks by type of ownership refers to shareholders capital in banks.

[2] General overview of ownership structure in banks in the F BiH as of 12/31/02 resulted from received reports, and registration at authorized courts (changes in capital and shareholders structure).

Ownership structure can be observed from aspect of financial results, which is by the value of total capital[3].

Ownership structure by total capital

-In 000 KM-

BANKS	12/31/00		12/31/01[4]		12/31/02		RATIO	
							3/2	4/3
1	2		3		4		5	6
State banks	240.139	48%	90.800	18%	88.834	14%	38	97
Private banks	255.135	52%	413.691	82%	542.664	86%	162	131
Total	**495.274**	**100%**	**504.491**	**100%**	**628.498**	**100%**	**102**	**122**

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

Participation of state capital in the total shareholders' capital in banks as of 12/31/02 is lower by 1.7% in comparison to 12/31/01. This resulted from increase of (absolute amount and in percentage) of foreign capital. As of 12/31/02, participation of remaining, state owned capital in privately owned banks was only 1% or KM 6.4 million.

Major changes in the ownership structure in 2002 were related to participation of private (national) and foreign capital.

In comparison to 12/31/01, participation of privately owned capital (residents) in total capital for whole banking sector was decreased from 22.4% to 20.5%, while at the same time, participation of foreign capital increased from 63.2% to 66.8%. These changes relate mainly to privately owned banks, and it resulted from two components: foreign capital coming into the system through purchase of shares (trading with shares) from earlier owners (residents - institutions and citizens), and additional capitalization of 2 banks owned by foreigners.

Progress made in reform efforts and stabilization of banking system led to a larger inflow of foreign capital, mainly from foreign banks. Positive trend of increase of foreign capital investments in banks in the Federation will probably continue in the future period.

CONCLUSION

Consolidation and stabilization of banking sector in the Federation of BiH in last year resulted in new development reflected in significant growth of assets and capital, decreasing number of small banks, introduction of new products, designing new regulative framework in order to provide stronger implementation of international operational standards.

Banks achieved better financial results in comparison to previous years, but still, seven banks showed operational loss.

[3] Information from Balance sheet – FBA schedule.

[4] All schedules contain information as of 12/31/01 were included after audit of financial reports (after external audit).

In future period the main activities of the FBA will be stronger control of risk, before all, credit risk, and to insist on establishment of more harsh policies and procedures and their application in banks. At the same time, the FBA will undertake actions for strengthening internal control, external and internal audits and capital strengthening in banks.

Continuation of positive trends should include uninterrupted activities of all participants in the reform of banking system and implementation of actions that would lead to fast finalization of transition process.

Involvement of authorized institutions and entities in the Federation of BiH will effect further positive changes, such as:

- fastening of reform process in material sector, followed by progress in monetary and banking system;
- finalization of privatization process in state banks within expected deadlines;
- establishing regulatory framework to support process of increasing number of large banks;
- improvement of environment for bank operations in the area of whole Bosnia and Herzegovina;
- transfer of succession assets to development, through commercial banks;
- faster and more efficient implementation of Law on Collateral;
- accelerating court procedures, passing judgments and their implementation;
- establishing efficient procedure for performance of pledges;
- appointing law for protection of creditors and higher and more concrete responsibility of banks' debtors;
- further improvement of legal and institutional framework for the reform of banking system and whole financial system, with respect of Basle Principles and European guidelines;
- support to the initiative to allow the Central Bank to issue bonds and treasury bills, etc.

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

- continuous supervision of banks in order to provide for effective protection of depositors and eliminate weakness in banks;
- finalization of remaining provisional and liquidation administrations in banks;
- special supervision of banks with high amounts of savings (citizen savings) and banks with growth above average (fast expansion);
- special supervision of operations with related entities;
- control over implementation of new standards for banking operations regulated by laws and regulations;
- further development of regulations under authority of the Agency (FC risk, capital standards, etc.), in accordance with Basel Principles;
- further education and training of FBA staff;
- intensified activities for implementation of regulations for prevention of money laundry and financing of terrorism, and implementation of cooperation with other supervisory and control institutions;

- establishment of data base on non-performing clients which are considered special credit risk for banks;
- improvement and application of IT systems for early warning and prevention of weaknesses in banks;
- efficient cooperation with Association of Banks;
- establishment of cooperation with supervisory institutions in countries whose natives are investors in our banking system;
- advising on application and further development of regulations passed by the FBA, etc.

And, as the most important part of the system, banks have to undertake the following activities:

- further strengthening of capital in correlation with growth of assets and risk;
- improve quality of assets;
- strengthen internal control systems and establish internal audits, and provision of their independence;
- adopt and implement new principles for operations, policies and procedures in accordance with competitive market conditions;
- exchange of information on non-performing debtors, that is, reporting to the FBA on debtors that are considered special credit risk for banks which would provide for conditions to establish special data base;
- faster development of credit/debit card operations and electronic banking;
- development of procedures for control and improvement of IT;
- implement more strict criteria and their implementation in matter of competency and expertise of managerial staff in banks;
- improvement of staff and training in order to establish better relations with customers, especially small and middle-sized enterprises, hence, this includes new services, common all over the world, that is, banks should develop financial management operations;
- efficient participation in global process of preventing money laundering and terrorism financing, etc.

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

1. Law on Banking Agency of the Federation of BiH (“Official Gazette of the F BiH”, 9/96, 27/98, 20/00, 45/00 and 58/02),
2. Law on Central Bank of BiH (“Official Gazette of the F BiH”, 1/97 and 29/02),
3. Law on Banks (“Official Gazette of the F BiH”, 39/98,32/00, 48/01, 27/02, 41/02 and 58/02),
4. Law on Deposit Insurance in Banks of BiH(“Official Gazette of BiH”, 20/02),

5. Law on Financial Performance ("Official Gazette of the F BiH", 2/95, 13/00 and 29/00),
6. Law on Internal Payment System ("Official Gazette of the F BiH", 15/00-cleared version, 54/01 and 40/99),
7. Law on Foreign Exchange ("Official Gazette of the F BiH", 35/98),
8. Law on Securities ("Official Gazette of the F BiH", 39/98 and 36/99),
9. Law on Prevention of Money Laundering ("Official Gazette of the F BiH", 8/00),
10. Law on Notes ("Official Gazette of the F BiH", 32/00),
11. Law on Cheques ("Official Gazette of the F BiH", 32/00),
12. Law on Payment Transactions ("Official Gazette of the F BiH", 32/00),
13. Law on Obligations ("Official Gazette of the F BiH", 2/95),
14. Law on Commercial Enterprises ("Official Gazette of the F BiH", 23/99, 45/00 and 2/02),
15. Law on Bankruptcy and Liquidation ("Official Gazette of the F BiH", 23/98),
16. Labor Law ("Official Gazette of the F BiH", 43/99 and 32/00),
17. Law on Executive Procedure ("Official Gazette of the F BiH", 42/98),
18. Law on Procedure of Registration of Legal Entities into the Court Registry ("Official Gazette of the F BiH", 4/00, 19/00, 49/00, 32/02 and 58/01),
19. Law on Administrative Procedure ("Official Gazette of the F BiH", 2/98 and 48/99),
20. Law on Violations Representing a Breach of Federal Regulations ("Official Gazette of the F BiH", 9/96 and 29/00),
21. Law on Treasury of BiH Institutions ("Official Gazette of the F BiH", 27/00),
22. Law on Bank Privatization ("Official Gazette of the F BiH", 12/98, 29/00 and 37/01),
23. Law on Opening Balance Sheet of Enterprises and Banks ("Official Gazette of the F BiH", 12/98 and 40/99),
24. Law on Securities Registry ("Official Gazette of the F BiH", 39/98 and 36/99),
25. Law on Securities Commission ("Official Gazette of the F BiH", 39/98 and 36/99),
26. Law on Accounting ("Official Gazette of the F BiH", 2/95, 14/97 and 12/98).

Bank regulations

1. Decision on Bank Supervision and Procedures of Banking Agency of the Federation of BiH ("Official Gazette of the F BiH", 3/03),
2. Decision on Minimum Standards for Bank Capital management ("Official Gazette of the F BiH", 3/03),
3. Decision on Minimum Standards for Bank Credit Risk and Assets Classification Management ("Official Gazette of the F BiH", 3/03),

4. Decision on Minimum Standards for Bank Risk Concentration Management (“Official Gazette of the F BiH”, 3/03, ispr. 6/03),
5. Decision on Minimum Standards for Bank Internal and External Audit (“Official Gazette of the F BiH”, 3/03),
6. Decision on Minimum Standards for Bank Internal Control System (“Official Gazette of the F BiH”, 3/03),
7. Decision on Minimum Standards for Bank Liquidity Risk Management (“Official Gazette of the F BiH”, 3/03),
8. Decision on Minimum Standards for Bank Foreign Exchange Risk Management (“Official Gazette of the F BiH”, 3/03),
9. Decision on Minimum Standards for Operations with Bank Related Entities (“Official Gazette of the F BiH”, 3/03),
10. Decision on Minimum Standards for Recording Bank Lending Activities (“Official Gazette of the F BiH”, 3/03),
11. Decision on Reporting Non-Performing Clients Who are Considered Special Credit Risk (“Official Gazette of the F BiH”, 3/03),
12. Decision on Minimum Scope, Form and Content of the Program and Report on Economic-Financial Audit of Banks (“Official Gazette of the F BiH”, 3/03),
13. Decision on Reporting Forms Which Banks Submit to Banking Agency of the Federation of BiH (“Official Gazette of the F BiH”, 3/03),
14. Decision on Conditions When Bank is Considered Insolvent (“Official Gazette of the F BiH”, 3/03),
15. Decision on Minimum Requirements Bank has to Fulfill in Order to Perform Internal Payment System (“Official Gazette of the F BiH”, 46/01),
16. Decision on Procedure to Determine Claims and Allocation of Assets and Liabilities in Bank Liquidation Process (“Official Gazette of the F BiH”, 3/03),
17. Internal Rating Criteria by Banking Agency of the F BiH (“Official Gazette of the F BiH”, 3/03, ispr. 6/03),
18. Decision on Minimum Standards to Issue License for Internal Payment System for Branches of Banks from Republic Srpska (“Official Gazette of the F BiH”, 50/01),
19. Decision on Minimum Standards for Banks Activities on Prevention of Money Laundering and Terrorism Financing (“Official Gazette of the F BiH”, 3/03),
20. Decision on Financial Disclosure (“Official Gazette of the F BiH”, 3/03),
21. Decision on Calculation of Interest and Fees on Dormant Accounts (“Official Gazette of the F BiH”, ...),
22. Decision on Amount and Conditions for Approving Loans to Bank Employees (“Official Gazette of the F BiH”, ...),
23. Guidelines for Licensing and Other Consents from Banking Agency of the F BiH (“Official Gazette of the F BiH”, 46/02).

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2000	2001	2002
Banks	38	33	29

Ownership structure of financial institutions in 2002 on the basis of registered capital (%) (at year-end)

Item	Banks
Public sector ownership	12.7
Other domestic ownership	20.5
Domestic ownership total	33.2
Foreign ownership	66.8
Financial institutions, total	**100.0**

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

Item	2000	2001	2002	2002/2000
Public sector ownership	42.9	14.4	12.7	0.30
Other domestic ownership	30.9	22.4	20.5	0.66
Domestic ownership total	73.8	36.8	33.2	0.44
Foreign ownership	26.2	63.2	66.8	2.55
Financial institutions, total	**100.0**	**100.0**	**100.0**	–

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

Assets	2000	2001	2002
Cash and securities	40.6	48.7	36.3
Placements to other banks	0.8	0.7	0.4
Loans - net value	45.0	41.7	54.5
Premises and oth. fixed ass.	11.2	7.2	6.5
Other assets	2.4	1.7	2.3
Liabilities	**2000**	**2001**	**2002**
Deposits	69.4	77.0	76.8
Borrow. from banks	0.3	0.2	0.1
Loans payables	7.4	6.7	6.8
Other liabilities	3.4	2.7	2.6
Capital	19.5	13.4	13.7

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

Type of financial institution	2000	2001	2002
Banks	18.2	13.69	14.65

Solvency ratio of financial institutions liab./assets

Type of the financial institution	2000	2001	2002
Banks	80.5	86.6	86.3

Asset portfolio quality of the banking system (%)

Asset classification	2000	2001	2002
A	80.1	85.8	86.1
B	10.0	8.3	8.8
C	3.8	2.5	2.5
D	5.7	3.3	2.5
E	0.4	0.1	0.1
Classified total	**100.0**	**100.0**	**100.0**
Specific reserves	**26.6**	**23.1**	**21.5**

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

The structure of deposits and loans in 2002 (%)
(at year-end)

	Deposits	Loans
Households	42.0	46.8
Government sector	12.5	1.2
Corporate	33.6	49.4
Foreign	-	-
Other	11.9	2.6
Total	**100.0**	**100.0**

The structure of deposits and loans in 2002 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	57.0	Long term loans	70.0
Within one year	18.9	Medium-term loans	-
Over one year	24.1	Short-term loans	30.0
Total	**100.0**	**Total**	**100.0**

Active sub-balance sheet

000 KM

No.	Description	2000.12.31	2001.12.31	2002.12.31
	Assets			
1.	Cash funds and deposit accounts with deposit institutions	1,025,813	1,783,234	1,595,153
1a	Cash and non-interest bearing deposit accounts	369,061	1,039,914	587,969
1b	Interest-bearing deposit accounts	656,752	743,320	1,007,184
2.	Trading securities	3,912	47,192	50,459
3.	Placements to other banks	20,311	25,355	19,952
4.	Loans, leasing type receivables and past-due receivables	1,308,259	1,723,663	2,690,531
4a	Loans	1,128,546	1,526,180	2,525,356
4b	Leasing type receivables	0	0	0
4c	Loans and leasing type past-due receivables	179,713	197,483	165,175
5.	Securities held to maturity	440	4,244	22,691
6.	Business premises and other fixed assets	272,979	263,547	284,233
7.	Other real-estate	10,457	10,434	15,017
8.	Investments to non-consolidated related companies	35,094	17,211	32,351
9.	Other assets	50,377	71,689	90,635
10.	MINUS: reserves for potential losses	188,324	178,082	204,934
10a	Reserves for the items in position 4 of the assets	165,608	151,504	186,946
10b	Reserves for the assets items, except for position 4	22,716	26,578	17,988
11.	**Total assets**	**2,539,318**	**3,768,487**	**4,596,088**
	Liabilities			
12.	Deposits	1,763,000	2,900,613	3,528,209
12a	Interest-bearing deposits	1,064,739	1,999,170	2,871,780
12b	Non-interest-bearing deposits	698,261	901,443	656,429
13.	Borrowings – past-due liabilities	8,662	7,637	5,295
13a	Past-due, not paid liabilities	1,093	78	477
13b	Not fulfilled – called for payment off-balance sheet liabilities	7,569	7,559	4,818
14.	Borrowings from other banks	6,761	5,550	3,352
15.	Liabilities to government	350	1,225	8,068
16.	Liabilities on loans and other borrowings	188,448	253,269	313,010
16a	with remaining number of maturity days up to 1 year	13,940	36,072	61,615
16b	with remaining number of maturity days over 1 year	174,508	217,197	251,395
17.	Subordinated debts and subordinated bonds	4,771	5,179	21,040
18.	Other liabilities	72,051	90,523	89,337
19.	**Total liabilities**	**2,044,044**	**3,263,996**	**3,967,590**
	Capital			
20.	Permanent priority shares	14,336	5,698	14,759
21.	Common shares	491,075	452,788	524,002
22.	Surplus over per value	0	5,565	4,766
22a	of permanent priority shares	0	0	0
22b	of common shares	0	5,565	4,766
23.	Undivided profit and capital reserves	41,320	72,483	66,200
24.	Exchange rate differences	-840	0	0
25.	Other capital	-50,616	-32,043	18,771
26.	**Total capital (20. to 25.)**	**495,275**	**504,491**	**628,498**
27.	**Total liabilities and capital (19 +26)**	**2,539,318**	**3,768,487**	**4,596,088**
	Pasive and neutral sub-balance sheet	**1,187,175**	**859,296**	**102,934**
	Total balance sheet sum of banks	**3,726,494**	**4,633,450**	**4,699,022**

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

Type of the financial institutions	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2000	2001	2002	2000	2001	2002
Banks	27.9	20.4	28.6	31.2	N/A	59.6

Structure of registered capital and own funds of financial institutions in 2002

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	EUR	%	EUR	%
Banks	275,468	11.7	45,882	2.3

2002 DEVELOPMENTS IN THE BULGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2002 *Gross domestic product in Bulgaria* increased by 4.8% in real terms owing mostly to the stable growth rates of domestic consumption and net exports in the third quarter. *The industry* was gradually overcoming the negative dynamics in mid-2001. Total sales exceeded in real terms by 1.3% previous year's volume. The growth of 3.5% in gross value added by industry was mainly driven by the exports. A growing industrial output was indicated in production of machines, appliances and household equipment, clothing, radio and telecommunications equipment, textiles, wood and wood products. Gross output and gross value added in the *agricultural sector* rose respectively by 4.1% and 5.1%. Production of basic agricultural crops increased. *Services* continued to be the most dynamic sector of theeconomy. Communications experienced a rapid growth, especially after licensing the second GSM mobile telephone operator. Road transport grew by more than 20% on year base. Travel also enjoyed high rates of development in the three most recent years.

The average annual *CPI inflation* fell from 7.4% in 2001 to 5.8% in 2002 and was mostly driven by state administered prices of energy and heating, and by fuel and food prices. The introduction of VAT on medicines, patent taxes and the excise increases also maintained the rate of inflation. Increase of crude oil prices during 2002 was compensated by the Euro (Lev) appreciation against the US dollar.

In 2002 the situation on the *labor market* moderately improved. Trade and repair sector and processing industry contributed most essentially to employment growth. Government administration and healthcare employment also picked up. The total number of registered employees rose by 2.9% by end-2002 on end-2001 level. Unemployment rate fell from 19.5% by end-2001 to 16.8% in December 2002.

Overliquidity and money supply in the interbank market during 2002, within the boundaries of the currency board arrangement, and in combination with continuing fall-down of USD and Euro interest rates, predetermined a light but steady drop in *the official interest rate* from average 4.56% in 2001 to average 3.96% in 2002.

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 growth of quasi-money, which is continuing in a forth-consecutive year, is indicative of a significant amount of funds acquired by the commercial banks and also demonstrates the consolidated trust of the public. 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* to non-financial institutions and the public exceeded the money supply dynamics, where the total value of the loans grew by BGN 1 890 million, what is near on 46% in nominal but 59% in real.

DEVELOPMENT IN THE BANKING SYSTEM

In 2002 the Bulgarian banking sector comprised of 34 banks, incl. 28 local or foreign banks and 6 foreign bank branches. At the close of the year the number of full-time employed in the banking system was 21,616 (against 22,266 at the end of 2001). The privatisation deal for Biochim Commercial Bank, the forth-size bank in Bulgaria, ended in the second half of 2002. Thereafter, the new owner BankAustria Creditanstalt, which presently belongs to the German HVB-group, merged its local based subsidiary with bank Biochim. Furthermore the institution is working under its original local name. As a result state ownership of banking system assets decreased from 17.6% at the end of 2001 to 14.2% at the end of 2002. Municipal ownership remained at 2.4%. The other 83.4% of total banking assets were owned privately. The share of bank assets owned by foreign banks and investors also changed, reflecting the Biochim sale: it rose from 70% at the end of 2001 to 72%. Most of the top Bulgarian banks 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, Biochim Commercial Bank owned by BankAustria Creditanstalt, Expressbank owned by Société Générale, Hebrosbank owned by SWC B.V., Post Bank owned by ALICO/CEN BH Ltd., and BNB-Paribas (Bulgaria) and Raiffeisenbank (Bulgaria) owned by BNP-Paribas and Raiffeisenbank, respectively).

Substantial interest rate cuts on the international markets in 2002, coupled with livelier business in Bulgaria and the attendant increased demand on borrowing funds were the main driver for banks in Bulgaria to decrease their deposits with foreign banks and boost domestic lending. The trend to growth in the volume of banking operations sustained over several years continued during the last year. Total banking system assets indicated a growth of 19.9% over the close of 2001. To a great extent this growth reflected an increase in the banks' deposit base in terms of the lev component. Since banks consistently maintain forex assets and liabilities almost entirely in US dollars and Euro, and since over the year the dollar/lev rate fell by 15%, the increase in assets and liabilities in real terms was even greater.

Year-on-year return on assets (ROA) was 2.01% compared with 2.74% in 2001 and year-on-year return on equity (ROE) was 15.58% against 20.49% in 2001. These values indicated a good average level of operational income and pointed to availability of bank potential for endogenous capital growth. Despite the slight net interest income reduction (from 4.35% at the end of 2001 to 4.02% at the end of 2002), stabilisation of spread and income at levels ensuring permanent and significant total interest income was reported. Interest income in 2002 was 2.41% for deposits, 10.95% for loans, 7.79% for security investments, and 7.76% for interest bearing assets. Over 2002 the financing price of operations accounted for 2.21%. Increased operational volumes at banks offset reduced prices. Therefore, the *return on assets* measured through the so-called *adjusted ROA*[5] indicated a banking sector average of 2.57%.

Market concentration and dispersion in the Bulgarian banking system were relatively low. In 2002 owing to the high activity of almost all banks in terms of lending and deposits attraction, the *Loans, Deposits from Clients* in the nonfinancial sector and *Total Assets* aggregates, measured by the Herfindahl-Hirschman Index[6], indicated a lack of market concentrations.

[5] Adjusted ROA is calculated by subtracting net reintegrated provisions from operating pre-tax profit/loss and the result is correlated to assets.

[6] The Herfindahl-Hirschman Index (HHI) accepts values of up to 10,000. A value of below 1000 indicates a lack of concentration; values between 1000 and 1800 indicate acceptable concentration, and values of over 1800 are regarded as high concentration.

Given the changes in the macroeconomic environment, the banking system was gradually restoring its financial intermediary role in the economy. As a result of the sustained banking system stabilisation over recent years which broadened the range and improved the quality of banking services, the amount of bank assets increased. Measured by the *Banking System Assets to GDP* ratio their growth over 2002 amounted to 45.3%. Bank lending measured by the *Credit to GDP* ratio also rose by 19.8% in 2002. A similar trend emerged in the *Deposits to GDP* ratio which increased to 34.9% reflecting the extent of consumer confidence in banks. However, total deposit level in the country remained below the developed economy standards. It should also be borne in mind that transformation of deposits into credit measured by the *Credits/Deposits* ratio stayed at levels comparable with those of developed market economies: the ratio rose from 48.5% at the end of 2001 to 56.7% a year later.

Banking system *risk profile* retained its major features: a high degree of borrowed funds covered with liquid investments; proper diversification of credit risk through enhanced retail and mortgage lending; commercial lending to credible borrowers covered by eligible credit risk mitigatory products (CRM-techniques); moderate growth of investment portfolios in developed and emerging markets.

Despite the decrease by some 6% on the end of 2001, the banking system's *Capital Adequacy Ratio* remained high at 25.16%. This was attributable to a faster growth of the total risk weighted assets (RWA) compared with own funds. RWA-growth reflects the increase in total banking system assets (19% on an annual basis) accompanied by continuous restructuring and lending expansion. Share of placements of zero or low risk range of counterparties exhibited a decline. Banking system own funds have been increasing mostly at setting up of additional capital reserves.

Despite the increase and restructuring of assets during the whole 2002, their *quality indicators* remained stable. Classified assets as a share of capital and provisions accounted for 25.5% (against 28.8% in 2001). Classified loans provided to non-financial institutions fell to 6.5% of total loans against 7.7% a year earlier. Credit risk acuteness in the banking system clearly remained low irrespective of progressive lending.

Throughout 2002 *liquidity risk* stayed low. There were no banks experiencing liquidity deficiencies, with a higher share of trading assets eligible for repurchase on money markets. Asset growth (especially loans) continued to be funded from stable inflow sources and thereby share of complementary funds remained limited (9.92%). Their cover with trading assets increased more than four folds.

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 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

The amendments on the Law on Banks adopted by the National Assembly in the first half of 2002 were intended to apply the principle of ownership and group transparency of banks in a consistent manner. The philosophy of the new adopted Law on Bank Bankruptcy rests on the need for faster and more efficient bankruptcy proceedings against insolvent credit institutions, and for more stringent control over assignees-in-bankruptcy intended to ensure fair repayment to depositors and other creditors.

A new Regulation No. 9 on Evaluation of Risk Exposures of Banks and Allocation of Provisions to Cover the Risk Related Thereto was adopted, in consistence with the enforcement of the principles prescribed by International Accounting Standards for Financial Institutions (IAS): IAS 39, *Financial Instruments: Recognition and Measurement*; IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*; and IAS 32, *Financial Instruments: Disclosure and Presentation*. The new Regulation provides for the enforcement of International Accounting Standards claims evaluation principles. Risk exposures shall be classified individually and on a portfolio basis. Special provisions on exposures to individual countries shall be allocated. A new approach shall be applied in considering high-liquid securities (of best quality): they shall be included in the expected cashflow of respective claims.

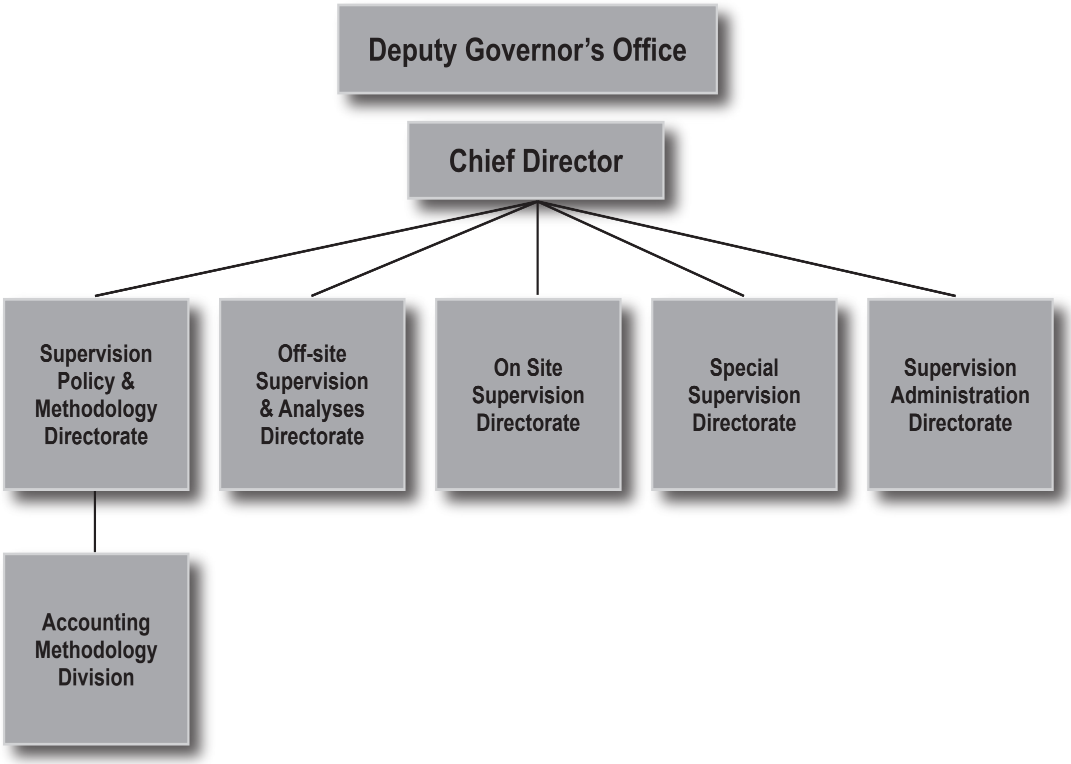
LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN BULGARIA

According to the laws, the Governor of the central bank is empowered to grant or revoke a bank license, taken on a motion by the Deputy Governor in charge of banking supervision. The head of BNB has also a central role in the orderly resolution of a problem bank case, as powers independent to appoint a conservator, to approve a merger or take-over, to sell a liquidated bank, and to petition the court to institute bankruptcy proceedings. Finally, to draw all levels of competence, the Deputy Governor of BNB in charge of 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 directorates. 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 2002 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. Off-site supervision efforts were concentrated in improving methods for early risk identification based on banks' supervisory reports; designing and enforcing a stress test establishing the sensitivity of banks to major risks (credit, forex, interest rate and liquidity); improving supervisory methods at problem banks; assisting the development of packages of reporting forms; issuing supervisory regulations and instructions consistent with International Accounting Standards and with directives on the operation of credit institutions.

The *On-site* teams worked in close cooperation with the *Off-site* supervisors and analysts in verification and assessment of banks' performances and prudential behavior 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 non-banking equities. Structural changes implemented in a number of banks resulted in positive trends. To improve asset management, fund management powers were centralised: a precondition for minimising bank risks and further strengthening the sound banking practice.

INTERNATIONAL ACTIVITIES

Bulgarian progress on compliance with Copenhagen criteria on the freedom to provide financial services was deliberated in negotiations with European Commission Subcommittee 2 held in April 2002 on Bulgarian accession to the EU. The Committee noted the significant degree of harmonising the legal framework for banking and banking supervision with the EU-directives on credit institutions.

Prior to the last European Commission review in November 2002, experts from EU member states supervisory institutions conducted *a peer review* of the state of Bulgaria's financial sector and the progress of supervision over it. The team evaluated the state of the financial sector and of supervision as very good in the context of the Core Principles of the Basle Committee on Banking Supervision and of the European Community Directives. The amendments to the Law on Banks and the new adopted Law on Bank Bankruptcy were also positively appraised.

In respect of BNB and banking sector preparations for smooth accession and full integration into the EU financial system, a Twinning Covenant was concluded between the BNB on the one hand, and the Banque de France and De Nederlandshe Bank on the other. In the field of banking supervision the project under the covenant includes further harmonisation of banking legislation and regulations in Bulgaria.

In 2002 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. 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, four agreements (Memorandums of Understanding) have been concluded in the past years with the OCC of the United States, and with the respective supervisory authorities of Austria, , Greece and Cyprus. In 2002 three more MoUs with the supervisors of the Netherlands, Italy and Albania have been prepared and officially signed in 2003. The BNB has started recently negotiations with the supervisory authorities of France, Hungary and Macedonia. They are supposed to become effective in 2003 as well.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BULGARIA

Besides the cooperation with the Deposit Insurance Fund based on a MoU since 1999, the BNB took part in the Council of the financial supervisors in Bulgaria, initiated by the central bank and established in 2002. The latter acted till the adoption of the new Law on the Commission on Financial Supervision (CFS) in the begin of 2003. The law on the Commission merged the supervision over the insurance and investment companies and pension funds. It also established and set the rules for the so-called Financial Stability Council (FSC), comprising of the Minister of Finance, the Governor of the BNB and the Chairman of the Commission, The Council activities will cover several areas: financial stability tasks and strategic development issues, regulation rules and methodology harmonization, sharing and exchange of information and supervisory expertise, joint examinations and actions, etc.

MAIN STRATEGIC OBJECTIVES

The regulative framework developed by BSD was 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 of the harmonogramme for consistency with the EC 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 continue to be focused on the full compliance of the domestic supervisory rules and practice with the European Banking Directives. A special plan for the full application of the European Directives has been designed. It defines the major tasks, measures and activities, that need to be conducted in the coming years before the accession to the EU. The completion of the plan has already started 2002. Besides the legal harmonisation the BNB launched its preparation for the implementation of the New Capital Accord of the Basle Committee. It includes staff training, analytical and methodological work, and discussions with the industry.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS – QUANTITATIVE IMPACT STUDY - 3 (QIS 3)

On 1 October 2002 the Basle Committee on Banking Supervision submitted to national supervisory authorities a set of questionnaires, a technical guidance and working instructions to test the draft of the New Accord, which will replace the 1988 one. The so-called Quantitative Impact Study 3 (QIS 3) was aimed at establishing how the new methods of calculation risk-weighted assets and operational risk will impact the capital adequacy ratios of banks in individual countries. The results will be used to improve the draft. The Bank for International Settlements and the European Commission agreed that EU accession countries would be represented in the test by large banks concentrating a significant portion of banking system assets. Eight banks holding 64 per cent of banking system assets represented Bulgaria. This participation and study made will help organise the enactment of the future supervisory requirements.

Upon implementation of the new Basle Accord under its standardised approach, capital requirements on credit risk (mostly in country- and bankexposures) are expected to increase. The capital base will be additionally burdened due to introduction of operational risk requirements. If the present levels of own funds remain stable till the introduction of the New Capital Accord, Bulgarian banks would comply with capital adequacy requirements.

STATISTICAL TABLES

Number of banks
(operating at year-ends)

Type of bank	1997	1998	1999	2000	2001	2002
Commercial banks	34	34	34	35	35	34
of which:						
Large banks	3	3	3	3	3	3
Small and medium-sized banks	25	24	24	24	25	25
Foreign bank branches	6	7	7	8	7	6
Banks, total	**34**	**34**	**34**	**35**	**35**	**34**

Ownership structure of banks in 2002 (%)
on the basis of registered capital
(at year-end)

Item	Type of banks			Total
	Large banks	Small and medium-sized banks	Foreign banks	
State ownership	27.9	5.3	-	13.0
Other domestic ownership	1.0	39.3	-	20.4
Domestic ownership total	***28.9***	***44.6***	-	***33.4***
Foreign ownership	71.1	55.4	100.0	66.6
Banks total	**100.0**	**100.0**	**100.0**	**100.0**

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

Item	1998	1999	2000	2001	2002	2002/1998
State ownership	42.6	44.9	14.2	15.1	13.0	0.3
Other domestic ownership	14.0	8.5	17.7	18.2	20.4	1.5
Domestic ownership total	***56.6***	***53.4***	***31.9***	***33.3***	***33.4***	0.6
Foreign ownership	43.4	46.6	68.1	66.7	66.6	1.5
Banks total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	-

Distribution of market shares in balance sheet total (%)

Type of bank	1997	1998	1999	2000	2001	2002
Commercial banks						
of which:						
Large banks	56.1	51.5	51.7	49.9	46.1	43.4
Small and medium-sized banks	40.1	43.6	41.9	42.4	45.8	50.4
Foreign bank branches	3.9	4.9	6.5	7.7	8.1	6.1
Banks, total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

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

Assets	1997	1998	1999	2000	2001	2002
Cash in vault & funds in current account with bnb	12.8	10.6	11.2	7.6	10.5	8.6
Due from banks & other financial institutions	31.5	32.8	32.4	39.8	33.3	24.2
Securities in trading portfolio	20.6	16.7	12.7	10.9	12.5	11.8
Loans extended to non-financial institutions and other clients	15.3	24.6	29.2	30.9	33.9	41.2
Securities in investment portfolio	3.9	6.4	7.5	4.5	4.2	7.6
Fixed assets	3.6	4.4	4.3	4.2	3.8	4.6
Other assets	12.3	4.5	2.7	2.1	1.8	2.1
Total assets	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Liabilities and capital						
Deposits by banks and other fin. Institutions	9.5	7.6	7.7	7.6	7.5	8.4
Deposits by nfis and other clients	67.7	69.2	69.9	65.7	70.8	68.6
Total deposits	77.2	76.8	77.6	73.3	78.3	77.0
Other liabilities	10.8	8.7	6.8	11.4	8.3	9.4
Subordinated debt						0.0
Capital	4.3	8.9	10.8	11.3	9.7	9.2
Reserves	7.7	5.6	4.8	4.0	3.7	4.4
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	2002
Large banks	120.0	6.5	7.2	5.7	5.7	5.0
Small and medium-sized banks	60.9	12.6	19.3	18.6	17.1	20.6
Banks, total	**94.2**	**9.6**	**13.0**	**12.1**	**11.8**	**13.8**

Solvency ratio of banks

Type of banks	1998	1999	2000	2001	2002
Large banks	45.5	50.0	42.0	37.0	28.7
Small and medium-sized banks	31.6	36.1	30.5	27.3	23.3
Foreign banks	27.0	25.0	27.4	25.1	19.5
Banks, average	**36.7**	**41.3**	**35.5**	**31.1**	**25.2**

Asset portfolio quality of the banking system

Assets classification	1997	1998	1999	2000	2001	2002
Amount in BGN Millions	**3,805,501**	**4,561,125**	**6,576,939**	**7,420,375**	**8,722,129**	**10,067,439**
Standard %	78.8	83.5	88.3	91.7	92.3	93.5
Watch %	3.7	4.7	3.8	2.9	3.2	2.9
Substandard %	2.7	2.4	1.1	1.4	1.1	1.0
Doubtful %	2.0	0.7	1.2	0.9	0.9	0.5
Loss %	12.9	8.6	5.5	3.0	2.5	2.1
Classified total %	**100.0**	**100.0**	**100.0**	**99.9**	**100.0**	**100.0**
Specific reserves %	22.7	12.3	8.9	6.3	4.9	3.6

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

Item	1997		1998		1999		2000		2001		2002	
	Dep.	Claims	Dep.	Claims	Dep.	Claims	Dep.	Claims	Dep.	Claims	Dep.	Claims
House-holds	35.5	3.5	43.0	7.2	48.4	7.5	49.6	6.9	51.9	7.7	47.7	9.2
Govern-ment sector	9.8	9.6	7.1	23.7	4.5	17.6	4.4	13.0	4.8	12.4	3.5	13.8
Corpo-rate	43.2	38.6	39.9	28.2	38.8	33.2	33.5	31.8	31	31.6	38.8	44.8
Foreign	10.5	46.3	8.7	40.6	7.2	41.3	10.5	47.0	10.1	41.4	8.7	26.4
Other	1.0	2.0	1.3	0.3	1.1	0.4	2.0	1.3	2.2	6.9	1.3	5.8
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

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

Deposits	1997	1998	1999	2000	2001	2002
At sight	57.5	55.8	47.7	47.0	46.3	47.1
Within one year	35.6	39.5	49.7	49.2	49.9	48.5
Over one year	6.9	4.7	2.6	3.8	3.8	4.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Loans	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Short term	76.1	49.1	73.7	74.6	71.4	65.7
Medium term	2.9	14.1	16.5	15.9	20.5	30.3
Long term	20.3	13.6	9.0	8.0	7.7	3.8
Other	0.7	23.2	0.8	1.5	0.4	0.2
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

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	2002	1998	1999	2000	2001	2002
Large banks	53.8	55.6	60.3	60.5	51.5	48.9	46.5	48.7	55.9	53.4
Small and medium-sized banks	53.6	54.5	55.3	56.9	56.5	56.8	58.6	57.3	59.3	57.8
Foreign bank branches	72.4	75.2	72.8	64.0	65.6	81.3	79.4	76.7	64.9	67.2
Banks, average	**54.6**	**56.4**	**59.1**	**59.2**	**54.9**	**54.2**	**54.0**	**54.8**	**58.2**	**56.6**

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

Revenues	1997	1998	1999	2000	2001	2002
Interest earned	26.3	103.2	52.4	52.4	62.1	62.8
Net income from fees and commissions	2.4	21.7	14.4	14.5	18.0	20.2
Securities income/loss (net)	0.3	-35.2	8.3	26.7	11.4	12.6
Forex operations income/ loss (net)	53.1	-4.1	11.0	2.8	4.4	3.5
Other banking operations revenues	13.4	11.7	14.1	2.6	1.2	0.0
Extraordinary revenues/ expenses (net)	4.5	2.7	-0.2	1.0	2.9	0.9
Total revenues	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Expenses						
Interest paid	17.7	29.8	14.3	16.3	19.2	18.5
General operating costs	9.7	81.3	47.2	36.0	50.0	51.1
Reserve and provisions creation/reintegration (net)	48.6	-71.9	5.6	7.2	-6.8	1.0
Other operating costs	2.4	13.1	1.5	5.3	0.0	0.0
Total expenses	**78.4**	**49.2**	**68.6**	**64.7**	**62.4**	**70.6**
Pre-tax profit	**21.6**	**50.8**	**31.4**	**35.3**	**37.6**	**29.4**
Taxes	7.5	17.4	10.6	11.3	10.6	7.1
Net profit	**14.1**	**33.4**	**20.8**	**23.9**	**27.1**	**22.2**

Structure of registered capital and own funds of banks in 2002

Type of banks	Registered capital / total assets		Own funds / total liab.	
	EUR in thous.	%	EUR in thous.	%
Large banks	171,957	5.3	520,920	19.1
Small and medium-sized banks	305,951	7.2	495,731	13.3
Banks, average	**477,908**	**6.4**	**1,016,651**	**15.7**

2002 DEVELOPMENTS IN THE CROATIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2002, the upward trend in macroeconomic growth, which started in 2000, continued. The GDP growth rate has been on the increase every year since, amounting to 5.2% in 2002. The GDP growth has been mostly influenced by personal consumption. The annual growth rate of personal consumption was 6.6% and its contribution to the GDP growth amounted to 4.0 percentage points. An increase in consumption in 2002 was mainly financed by new borrowing of households with banks. Deposit money banks' household loans increased by an average of 35.5%, in nominal terms, and by 43.0% in December. Government consumption in 2002 continued to fall for the third consecutive year. A three-month GDP estimate shows that a real decrease in government consumption in 2002 amounted to 1.8% relative to the previous year. Investments in gross capital formation, increasing at an annual rate of 10.0% in real terms, strongly contributed to an increase in domestic demand in 2002. In the same year, more significant investments in road infrastructure construction began.

For the second consecutive year, Croatia recorded the annual RPI inflation rate below 3.0%. This inflation stood at only 2.3% in December 2002, a 0.3 percentage point fall compared to December 2001. The average annual growth rate of retail prices was reduced to 2.2% in 2002, after 4.9% recorded in 2001.

Croatia has managed to maintain successfully a relative stability of the general level of prices for 10 years now. A stable nominal exchange rate of the kuna against the euro remains the main nominal anchor. The central bank contributed to the stability of the exchange rate of the kuna against the euro by interventions in the foreign exchange market. In 2002, along with the stable exchange rate of the kuna against the euro, various other factors were present, contributing to the stability of retail prices - moderate wage growth, reduction in customs duties due to foreign trade liberalization, competition strengthening in retail trade, and relatively low rates of change in domestic industrial product prices.

A strong credit activity and foreign trade liberalization caused imports growth and, consequently, current account deficit, reaching 6.9% of GDP in the previous year. Since the increase in current account deficit may adversely affect the stability of the exchange rate and prices in the mid-term, the central bank issued decisions in 2003 that should contribute to a slow-down in credit expansion and a decrease in foreign borrowing of deposit money banks.

BANKING SYSTEM

At the end of 2002, the banking system comprised 50 banking institutions: 46 commercial banks, 3 housing savings banks and 1 savings bank, which is 12 less than at end-2001. This was the result of several banks' and savings banks' merger with other banks and the initiation of liquidation and bankruptcy proceedings in several savings banks. The share of banks in majority foreign ownership in total bank assets rose from 89.3% in 2001 to 90.2% at end-2001. The banking system consolidation process continued in 2002, and market concentration declined. Three banking groups accounted for 57.9% of total assets at end-2001, whereas 6 banking groups accounted for 79.5% of total assets at the banking system level at end-2002. These groups are in majority foreign ownership. Competition among banks and banking groups has been rising, as is clearly visible in the continued decline in interest rates.

The Balance Sheet Structure of the Banks

Total bank assets amounted to HRK 174.1bn at end-2002, which is a 17.3% increase over that at the end of 2001. This increase was mostly the result of the rise in net loans to other clients (non-banking sector), which increased 40% over that at end-2001. To finance this increase banks mostly used funds resulting from the deposit growth and loans received. The share of loans to other clients in the structure of bank assets rose from 43.3% at end-2001 to 51.8% at end-2002. The strong credit activity related to households, which started in the previous years, continued into 2002. The share of household loans almost reached the share of corporate loans at the banking system level in late 2002. Deposits with banking institutions decreased by 15.7% in 2002 compared with end-2001, and their share in assets was 11.6%, or significantly less than at end-2001 (16.1%). This decrease resulted from the reallocation of these funds into loans. Following a record high growth in 2001, induced by the inflow of funds for the purpose of the euro conversion, money assets of banks recorded a strong decline in 2002. In contrast, deposits with the Croatian national bank continued on their upward trend.

Deposits predominate in the bank liability structure. At end-2002, they accounted for 71.5% of total liabilities, which is somewhat more than at end-2001 (70.5%) In 2002, total deposit growth amounted to HRK 19.7bn, while total credit growth was higher, HRK 26.4bn. Received loans (loans from financial institutions and other loans) in the liability structure rose from 13.2% at end-2001 to 13.5% at end-2002.

Bank Capital

At end-2002, the regulatory capital of banks amounted to HRK 16.8bn, which is a 20.8% increase over that at end-2001 when it stood at HRK 13.9bn. The capital adequacy ratio of banks amounted to 17.2% at end-2002, which is less than at end-2001 when it stood at 18.5%. At end-2002, all banks reported capital adequacy above the minimum prescribed ratio of 10%. The downward trend in the capital adequacy ratio, which was recorded over the last three years, resulted from a faster growth in risk-weighted assets than in risk-based capital.

Asset Quality

At the end of 2002, fully recoverable placements (groups A and B) grew by 22.5% compared to 2001 and accounted for 94.2% of total risk assets. Partly recoverable placements (groups C and D) and placements whose present value equals zero (group E) accounted for 3.5% and 2.3%, respectively, of total risk assets. Specific reserves had a strong downward trend, both in its absolute amount and relative to total risk assets, which resulted from an increase in the share of groups A and B.

Bank Earnings

In 2002, the banks reported a profit of HRK 2,074.8m. Net interest income increased by 13.5% as compared to 2001 due to interest income growth larger than interest expenses growth. Net non-interest income rose by a high 73.1% compared to the previous year, due to a strong growth in fee income from payment transaction services. Net interest income against average interest bearing assets fell from 4.0% in 2001 to 3.6% in 2002 owing to a fast asset growth. Earned profit grew by 132.0% over that in the previous year, which triggered the upward trend in the return on average assets (ROAA) indicator from 0.94% in 2001 to 1.58% in 2002 and return on average equity (ROAE) indicator from 6.62% in 2001 to 13.74% in 2002.

Bank Liquidity

The liquidity of banks remained high in 2002. The data on Croatian national bank bills subscription show that subscribed kuna and foreign currency Croatian national bank bills stood at HRK 5,805.9m and HRK 1,226.9m, respectively, at the end of 2002, compared to HRK 6,214.9m and HRK 2,808.4m at the end of 2001.

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

The financial sector of the Republic of Croatia consists of banks, housing savings banks, insurance companies, pension funds, investment funds, privatization investment funds and savings and loan associations. Deposit money banks, with a share of 88% in the financial sector assets, account for the largest part of the Croatian financial market.

The Croatian National Bank is authorized for the operation and supervision of banks and housing savings banks, Croatian Securities Commission is authorized for the operation and supervision of investment funds, Directorate for the Supervision of Insurance Companies is responsible for the operation and management of insurance companies, Agency for Supervision of Pension Funds and Insurance supervises pension funds and Ministry of Finance supervises savings and loan associations.

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.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2002

Banking supervision in the Republic of Croatia consists of off-site and on-site supervision. Apart from an ongoing supervision of banks' operations, preparation of analyses and indicators of the banking system performance, as well as regular and irregular on-site examinations of banks, the Bank Supervision Area employees were engaged during 2002 in the preparation of the new banking regulation and interpretation of its application. More specifically, following the enactment of the new Banking Law in July 2002, the new prudential regulation began to be prepared. The new regulation is outlined in the following chapter. In 2002, the Bank Supervision

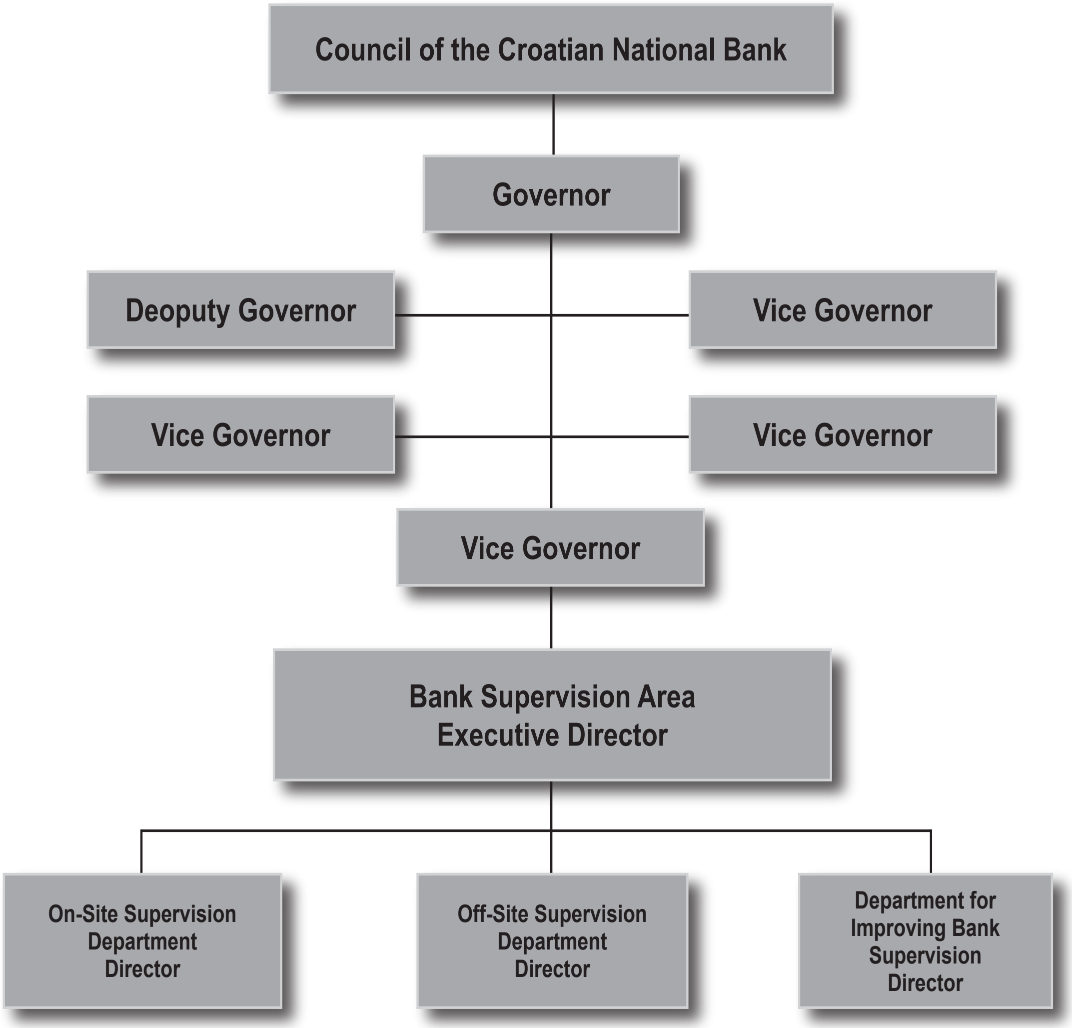
Area continued a practice of organizing interactive workshops with deposit money banks related to the preparation of the improved prudential regulation. A program of the banks' information technology supervision was also introduced.

Following the events in Riječka banka d.d., Rijeka (the third largest bank by the size of its assets in Croatia) which marked the banking system in 2002, the majority of activities and resources of the Bank Supervision Area were directed towards solving problems in this bank. After the fraudulent activities related to foreign exchange market transactions were discovered in March 2002, the Croatian National Bank immediately took part in the problem resolution process. Since this bank was sound, the above mentioned problem was successfully resolved in 2002. The fundamental supervisory function of the Croatian National Bank, i.e. the maintenance of banking system stability and confidence in the banking system, was thus fulfilled.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

As previously mentioned, the Banking Law is the fundamental law governing banking regulation. The new Banking Law, which came into force in July 2002, is adjusted to the EU regulations in all essential elements. The new Banking Law contains the following provisions: provisions on co-operation with other supervisory authorities with the 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; customer protection provisions. Pursuant to this law, early 2003 saw the enforcement of prudential decisions that regulate the method of classifying placements and contingent liabilities, the capital adequacy and currency risk management. These decisions were joined by the decisions related to the organization and method of performing bank examination, which stipulate in detail the method of supervising bank operations, consolidated supervision of banking groups and the scope and content of the audit of financial reports. In addition, the decision defining in detail the methods and procedures for protecting the freedom of market competition and the new decision regulating operations of foreign bank representative offices also came into force. The following decisions are currently being prepared: the decision regulating liquidity management, the decision stipulating the conditions for the establishment and operation of foreign bank branches. Due to the complexity of these issues, especially in the part relating to market risk management, the transitional and final provisions of these prudential decisions stipulate that most of their provisions are to be applied as of 1 January 2004. Hence, the effects of the new prudential regulations will not be fully visible until that year.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY AND COOPERATION WITH OTHER SUPERVISORY BODIES

Several foreign banks from the EU member states have taken ownership in some Croatian banks. One bank domiciled in the Republic of Croatia owns subsidiaries outside the Croatia's borders. Maintenance of contacts and cooperation with the bank supervisory bodies in the EU member states and in other countries are of a special interest to the supervision development in the Republic of Croatia. Actions have thus been taken to establish cooperation and exchange of information between supervisory authorities.

In addition, the cooperation with the IMF and other international institutions has continued.

In 2002, the proposals for performing supervision of financial institutions and financial markets on the consolidated basis started to be prepared. Apart from the Ministry of Finance, the Croatian National Bank, Croatian Securities Commission, Directorate for the Supervision of Insurance Companies, Agency for Supervision of Pension Funds and Insurance, and State Agency for Deposit Insurance and Bank Rehabilitation also participate in this project. In addition, in 2002, cooperation was fostered with other institutions in the Republic of Croatia.

THE MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISORY AUTHORITY

The main strategic objectives of the supervisory authority in 2002 were: to achieve harmonization with the EU regulations, to ensure successful implementation of the new Banking Law and new subordinate legislation pursuant to the new Banking Law; to establish co-operation with foreign supervisors, to introduce supervision on the consolidated basis. As previously described in 2002 a considerable steps and efforts were made to strengthen the Bank Supervision Area. These strategic objectives remained continuously important for the banking supervisory development in the near future.

STATISTICAL TABLES

Type of financial institution

Type of financial institution	2000	2001	2002
Banks	43	43	46
Saving banks	26	19	4
Financial institutions, total	**69**	**62**	**50**

Ownership structure of financial institutions in 2002 on the basis of registered capital (%) (at year end)

Item	Type of financial institution		Total
	Banks	Savings banks	
State ownership	8.1	0.0	8.0
Other domestic ownership	13.8	10.9	13.7
Domestic ownership total	21.9	10.9	21.7
Foreign ownership	78.1	89.1	78.3
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Item	2000	2001	2002	2002/2000 (indeks)
State ownership	8.6	10.5	8.0	93.0
Other domestic ownership	19.9	14.7	13.7	68.8
Domestic ownership total	28.5	25.2	21.7	76.1
Foreign ownership	71.5	74.8	78.3	109.5
Financial Institutions, total	**100.0**	**100.0**	**100.0**	–

Distribution of market shares in balance sheet total (%)

Type of financial institution	2000	2001	2002
Banks	98.6	98.4	98.7
Savings banks	1.4	1.6	1.3
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Type of financial institution	2001	2002
Banks	13.2	14.5
Savings banks	1.0	0.2
Financial institutions, total	**13.0**	**14.3**

Solvency ratio of financial institutions

Type of the financial institution	2000	2001	2002
Banks	21.3	18.5	17.2
Savings banks	33.5	37.4	34.2
Financial institutions, average	**21.4**	**18.7**	**17.2**

** Capital adequacy ratio*

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

Assets	2000	2001	2002
Money assets	1.3	5.3	1.3
Deposits with CNB	8.9	9.7	11.0
Deposits with banking institutions	15.8	16.1	11.6
Treasury bills and CNB bills	5.4	6.5	5.8
Trading portfolio of securities	2.2	3.2	4.8
Loans to financial institutions	1.0	1.0	1.2
Loans to other clients	44.8	43.3	51.8
Investment portfolio of securities	12.7	8.6	7.3
Investment in subsidiries and affiliated companies	2.2	1.5	1.4
Foreclosed and repossessed assets	0.5	0.3	0.2
Tangible assets and software	2.9	2.4	2.2
Interests, fees and other assets	2.8	2.9	2.3
General provisions	-0.6	-0.8	-0.9
Liabilities	**2000**	**2001**	**2002**
Borrowings from financial institutions	3.1	2.4	2.3
Giro and current account deposits	11.3	11.1	13.4
Savings deposits	15.8	17.8	13.8
Time deposits	37.9	41.6	44.3
Other loans	14.6	10.8	11.2
Subordinated debt instruments	0.3	0.2	0.4
Hybrid instruments	0.2	1.6	1.3
Interests, fees and other liabilities	4.9	5.3	3.8
Equity capital	7.7	6.0	5.6
Current year profit or loss	1.0	0.4	1.1
Retained profit (loss)	0.3	0.1	0.5
Reserves	2.9	2.7	2.3

Asset portfolio quality of the banking system

in million HRK

Asset Classification	2000	2001	2002
A	108,489.8	137,195.6	168,693
B	3,708.5	3,391.0	3,558
C	3,090.3	3,193.4	3,718
D	3,832.8	3,526.2	2,756
E	4,803.1	4,287.3	4,245
Classified Total	**123,924.5**	**151,593.3**	**182,970**
Specific Reserves	9,355.4	7,912.1	7,303

The Structure of Deposits and Loans in 2002 (%) (at year-end)

	Deposits	Loans
Households	58.4	44.5
Government sector	3.5	7.3
Corporate	21.3	45.0
Foreign	11.3	0.5
Other*	5.4	2.7
Total	**100.0**	**100.0**

** Financial sector is included*

The structure of deposits and loans in 2002 (%) (at year-end)

Maturity of Deposits		Loans	
At sight	22.4	Long term loans	32.5
Within one year	42.8	Medium-term loans (1 to 3 years)	24.6
Over one year	34.8	Short-term loans	42.9
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 liabilities		
	2000	2001	2002	2000	2001	2002
Banks	31.0	35.0	28.8	64.1	67.6	64.8
Savings banks	8.5	1.0	1.6	41.9	3.0	6.5
Financial institutions, average	**30.7**	**34.7**	**28.5**	**63.8**	**67.0**	**64.1**

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

in million HRK

Revenues	2000	2001	2002
Interest income	8,398.0	8,973.6	9,940.4
Non-interest income	2,878.9	3,230.8	4,107.2
Expenditures			
Interest expense	4,073.0	4,315.5	4,655.0
Non-interest expense	898.1	1,974.1	1,931.9
General and administrative expenses	3,577.7	3,878.1	4,427.2
Provisions for identified and Unidentified losses	1,298.6	807.9	488.8
Income taxes	123.3	334.6	470.0

Structure of registered capital and own funds of financial institutions in 2002

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	000 USD	%	000 USD	%
Banks	1,364,072	5.6	2,352,622	9.7
Savings banks	25,660	7.7	18,107	5.5
Financial institutions, average	**1,389,732**	**5.6**	**2,370,729**	**9.6**

2002 DEVELOPMENTS IN THE CZECH BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The year 2002 witnessed continuing economic growth, although its pace was slightly slower than in 2001. Gross domestic product recorded growth of 2.1% in 2002, a decrease of 1.1 points from a year earlier. GDP totalled CZK 1,542.2 billion at constant 1995 prices. The GDP growth in 2002 was due mainly to increasing domestic demand, and in particular to rising household consumption.

In addition to the external influence of the weak economic growth recorded by the Czech Republic's major trading partners, the Czech economy experienced strong appreciation of the koruna's exchange rate against the euro and the dollar. The koruna's average exchange rate against the euro firmed from CZK 34.08 in 2001 to CZK 30.81 in 2002, while against the dollar it appreciated from CZK 38.04 to CZK 32.74.

The koruna's appreciation was one of the most important factors counteracting price growth in 2002. This, coupled with falling food prices, was the main reason why inflation decelerated in the course of the year. In December 2002, inflation was 1.8%, which represents a year-on-year decrease of 2.9 points.

By December 2001 the unemployment rate had reached 9.8%, a rise of 0.9 points on a year earlier. The key reason for this rise was the slowdown in economic growth. The average nominal wage increased by 7.3% in 2002. Growth in real wages reflected the low inflation rate and was considerably slower (at 5.4%).

DEVELOPMENTS IN THE BANKING SYSTEM

The Czech banking sector consisted of 37 banks and branches of foreign banks at the end of 2002, a decrease of one bank by comparison with the end of 2001. One bank had its licence withdrawn (IP banka, under conservatorship), the foreign branch of Société Générale merged with one of the biggest Czech banks, Komerční banka, as a result of the privatisation of the latter, and a new specialised mortgage bank was established – Wüstenrot hypoteční banka.

Foreign investors had an 81.9% share in the total core capital of the Czech banking sector as of 31 December 2002, an increase of 12.0 points on a year earlier. There were only two banks in the entire Czech commercial bank sector with predominant state and municipality ownership (representing 4.1% of the total registered capital of the sector). These banks focus mainly on exporters, municipalities and small businesses. In terms of total assets, foreign entities controlled 93.3% of the banking sector.

The increase in productivity and efficiency in 2002 is confirmed by improved sector performance accompanied by a long-running decrease in the number of bank employees and banking outlets. At the close of 2002, there were 40,625 people working in the Czech banking sector, 0.6% less than a year earlier. The number of banking units as of 31 December 2002 was 1,722, a 1.7% decline compared with a year earlier.

The Czech banking sector as a whole was profitable for the third consecutive year in 2002. Net income exceeded CZK 28 billion, an increase of more than 60% in year-on-year comparison. The optimistic expectations as regards the trend in poorer quality assets were fully met. The proportion of non-performing loans fell considerably below 10% during 2002. In absolute terms the amount of non-performing loans decreased by about 40%. There were two main reasons for the improvement in asset quality in the period under review. First, banks started imposing very stringent criteria on newly granted credits. Second, some selected poorer quality assets were transferred from the banking sector to the bailout agency Česká konsolidační agentura (Czech Consolidation Agency), which is the legal successor of the former Konsolidační banka. The solvency ratio of Czech commercial banks is traditionally high. At the end of 2002 it was well above the minimum requirement of 8%.

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

The main player in the overall financial services market is the commercial banks sector. The fundamental law governing banking regulation in the Czech Republic is the Act on Banks. A pivotal amendment to this Act, known as the "harmonisation amendment", had been in the legislative process since the end of 1999. Having been repeatedly revised, the amendment was passed in 2002 and took effect in May 2002, except for several harmonisation provisions which will take effect when the Czech Republic's Treaty of Accession to the European Union enters into force. This amendment brought the Czech banking legislation into compliance with EC banking legislation and other relevant international standards. The amended Act on Banks covers, among others, the following crucial points:

- the principle of the single banking licence, including all related principles, e.g. home country supervision;
- the setting of tighter and more transparent licensing proceedings and proceedings to grant prior consent to the acquisition or increasing of a qualifying holding in a bank, in accordance with Directive 2000/12/EC;
- transparency of the relations between a bank, its major shareholders and related entities
- supervision on a consolidated basis and related co-operation with partner supervisors;
- the establishment and operation of a Central Register of Credits;
- prohibition of anonymous deposits.

Banking business is governed and regulated by some important provisions of other acts as well. Of particular importance to the banking sector is an amendment to the Accounting Act extending the range of applicable valuation methods to include fair value and stipulating the preparation of consolidated financial statements. Banks will have to comply with the Payment System Act passed in 2002 and in the near future also with the Insolvency Act and a number of other legal rules under preparation.

All commercial banks are subject to supervision by the Czech National Bank. Besides the Act on Banks, the other basic act regulating the Czech banking sector is the Act on the Czech National Bank. However, financial intermediation is continuing to expand. In particular, insurance companies, pension funds and some unit trusts are gradually gaining a more important position as regards collecting households' funds. The Ministry of Finance of the Czech Republic is responsible for the stability of insurance companies and pension funds. The Securities Commission supervises the most important capital market participants. Their position, however, is being affected by the persisting low liquidity of the Czech capital market, despite the fact that there are hardly any restrictions on cross-border securities investment still in place. The Czech financial system also consists of credit unions, leasing companies, credit purchase companies and a number of other non-regulated and non-supervised companies operating in the field of financial services.

THE ACTIVITIES OF THE CZECH NATIONAL BANK IN THE FIELD OF BANKING SUPERVISION IN 2002

Several key provisions and decrees regulating the commercial banking sector were approved and adopted in 2002. These will enter into force during the course of 2003. The most important of them are:

- a CNB Provision on the Internal Management and Control System, which stipulates the duties of the board of directors and supervisory board as regards the efficient and effective internal management and control system of a bank.
- a CNB Provision on Market Risk Management in Banks and a Provision on Credit Risk Management in Banks, which set forth requirements for banks relating to credit risk and market risk management and thus create preconditions for limiting any losses ensuing from such risks.
- a CNB Decree stipulating the Prudential Rules of Parent Undertakings on a Consolidated Basis and a CNB Provision on Capital Adequacy of Banks and other Prudential Rules on a Solo Basis, which set forth limits on capital adequacy, large exposures and so on, in compliance with the relevant EU Directives.
- a CNB Decree on the essential elements of a banking licence application.
- a CNB Provision stipulating rules for the assessment of financial receivables and the creation of provisions and reserves, and rules for the acquisition of certain types of assets.
- a CNB Provision stipulating the minimum requirements for disclosure of information by banks and foreign bank branches.

The Central Register of Credits (CRC) started operation on 1 November 2002 in compliance with a CNB provision stipulating the methodology for submission of selected data by banks and branches of foreign banks to the Czech National Bank. The CRC is an information system that pools information on the credit commitments of individual entrepreneurs and legal entities and facilitates the efficient exchange of this information between CRC participants.

In 2002, CNB Banking Supervision continued using two basic supervisory methods – off-site surveillance and on-site examinations. Inspections carried out directly in banks are gradually becoming the main tool of banking supervision. CNB Banking Supervision performed inspections in ten banks, one of them comprehensive and nine focusing on specific types of risk. Off-site surveillance involves permanent monitoring of banks' activities using all available information returns submitted by banks in compliance with the CNB's standard methodology, auditors' reports, information obtained directly from banks on an ad hoc basis, publicly available databases, etc. The role of external auditors is incorporated into, and co-operation with the central bank more closely elaborated, in the CNB Provision stipulating requirements for the testing of a bank's management and control system. Under this Provision, testing of the management and control system should be performed, and a report prepared, by an external auditing company.

LEGAL COMPETENCE OF THE CZECH NATIONAL BANK IN THE FIELD OF BANKING SUPERVISION

Banking supervision in the Czech Republic is performed by the Czech National Bank. According to the CNB Act, the supervision of banking activities involves seeing to "the sound operation and purposeful development of the banking system in the Czech Republic". This broadly defined objective means in particular supporting the sound development, market discipline and competitiveness of banks, preventing systemic crises, strengthening public confidence in the banking system and protecting the small clients of banks.

CNB Banking Supervision defines the prudential framework for banking business and checks whether the banks are adhering to that framework. Banks' activities are governed by the Act on Banks, as amended. Under this Act, the CNB is authorised to issue regulations (known as "provisions" and "decrees") containing the terms and conditions of entry into the banking sector and setting prudential rules for specific areas of banking business.

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

The emphasis put on supervision on a consolidated basis necessitates closer co-operation with foreign supervisory bodies from countries of parent banks and central headquarters of banking institutions operating in the Czech Republic. The amendment to the Act on Banks adopted in 2002 facilitates effective co-operation with foreign partner supervisors.

Closer co-operation has so far been developed with the regulatory bodies of Slovakia, Austria, Germany, France, Belgium and the USA, based on memoranda of understanding. The memorandum of understanding with Slovakia was renegotiated in 2002 in order to correspond to new requirements. The memoranda define principal areas of co-operation such as exchange of information and common procedures for supervision of subsidiaries and branches of foreign banks. Analogous documents are also being prepared with the supervisory authorities in the Netherlands and Italy, which have banks operating in the Czech Republic through subsidiaries or branches.

International co-operation is one of the main preconditions for achieving desirable results in the preparatory phase and, later on, the phase of implementation of the New Basel Capital Accord. CNB Banking Supervision is actively involved in the preparation of the NBCA. Apart from Russia, the Czech Republic is the only Eastern European country to have been given the chance to participate in the preparation of the NBCA, through direct participation in the Core Principles Liaison Group and the Working Group on Capital. Active co-operation with the relevant EU committees and working groups has already started.

CO-OPERATION WITH OTHER SUPERVISORY BODIES IN THE CZECH REPUBLIC

Following the adoption of the amendment to the Act on Banks, banks are subject to supervision on a consolidated basis, i.e. supervision with respect to their membership in groups of related entities. These groups typically include an insurance company, a pension fund, an investment company, investment funds, a financial leasing company, a factoring company and so on. Quality consolidated supervision above all requires close co-operation with other regulators. In the Czech Republic this means in particular the Ministry of Finance, which regulates insurance companies and pension funds, and the Czech Securities Commission, which is responsible for overseeing investment companies, investment funds, securities traders and, to some extent, pension funds. Rules for co-operation between regulators are set forth in a tripartite agreement on mutual co-operation between the CNB, the Ministry of Finance and the Securities Commission. The agreement on co-operation was signed in 1998 and amended in 2002. Among other things, this agreement envisages the establishment of working groups involving staff from all the institutions concerned. The working groups are to be made up of inspectors overseeing the individual entities within consolidated groups. Based on the agreement, a Committee on Co-ordinated Supervision of the Financial Market was established. The Committee is the main platform for discussing optimal arrangements for the supervision of the financial market in the Czech Republic.

Co-operation is also continuing with the professional organisations active in the banking sector. At present the Czech National Bank co-operates with the Czech Banking Association and with the Czech Chamber of Auditors within a special project on NBCA implementation. CNB Banking Supervision also closely liaises with the Czech Institute of Internal Auditors, especially on issues relating to internal management and control systems, including internal auditing, and corporate governance.

MAIN STRATEGIC OBJECTIVES OF THE CZECH NATIONAL BANK IN THE FIELD OF BANKING SUPERVISION IN 2002

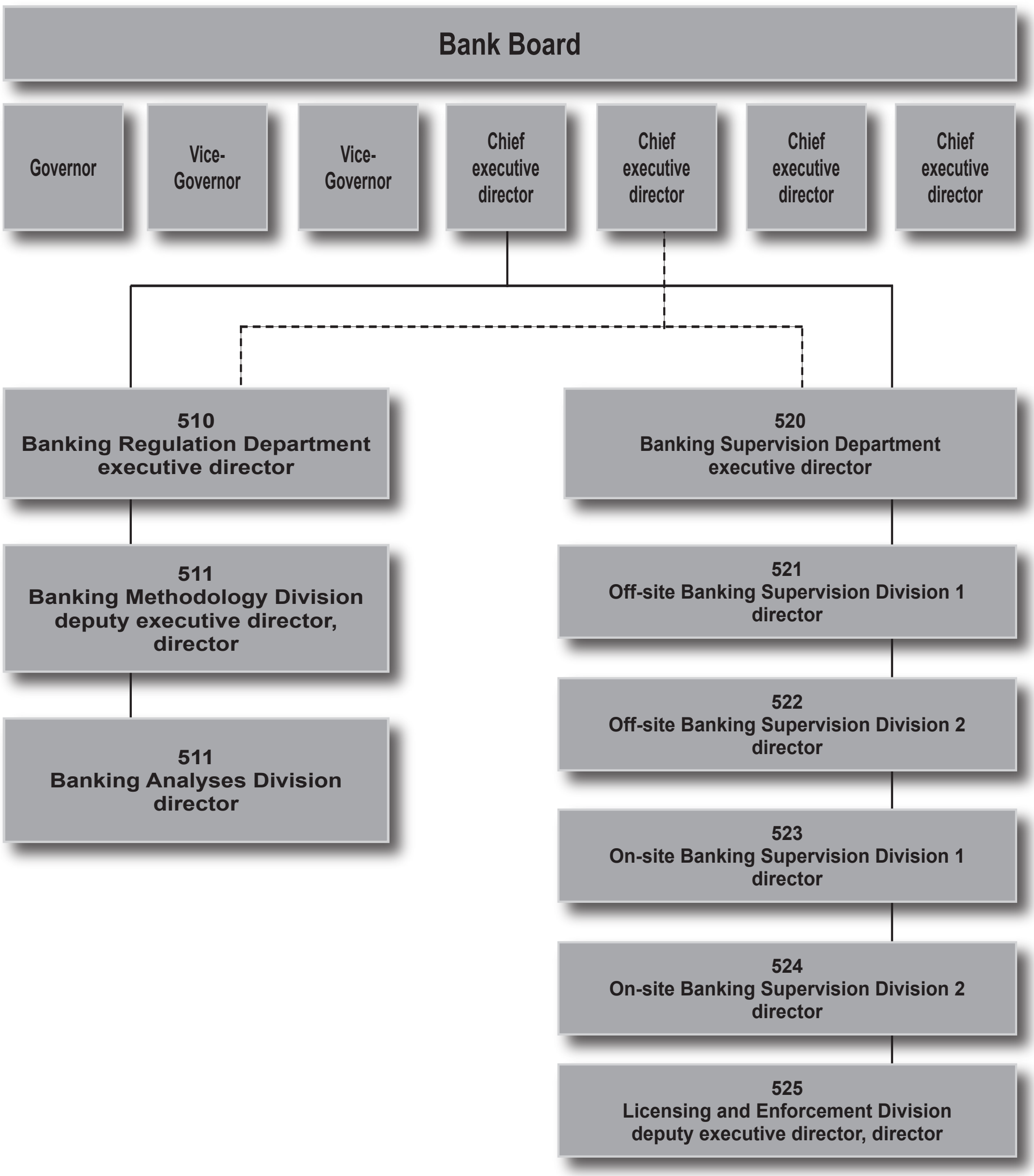
At the beginning of 2002, a new medium-term banking supervision plan was approved for the period 2002–2004. The main tasks for this period focus on the completion of full harmonisation with European Community law and on raising the quality of supervisory work to internationally recognised standards. The main objectives of this plan, which is based not only on the recommendations ensuing from the assessment programmes of international institutions (e.g. the Financial Sector Assessment Program of the IMF and the subsequent missions of the European Commission), but also on the CNB's own endeavours to improve the quality and effectiveness of its supervision, have been set as follows:

- to establish a comprehensive regulatory framework for banks and consolidated groups containing banks that will steer them towards prudential business yet not curb fair competition. This framework must meet the requirements and recommendations of international organisations;
- to monitor the latest world trends in banking and regulation and to engage actively in co-operation with international institutions;
- to create a comprehensive system to monitor the risk profiles of individual banks;

- to monitor and assess the effectiveness of banking supervision itself;
- to develop an effective system of communication and co-operation with other domestic and foreign regulators;
- to co-operate with domestic professional organisations;
- to develop analysis of the banking sector, incorporating prudential indicators, macroeconomic factors and the competitiveness and stability of the sector;
- to enhance the transparency of banking business and supervisory activities;
- to exercise high quality professional supervision.

Some of these objectives are long term in nature. However, work on addressing most of them was commenced in 2002, as evidenced by the Czech banking supervisory authority's achievements in 2002 mentioned in the preceding sections.

ORGANIZATIONAL CHART OF THE CNB BANKING SUPERVISION AS OF 31 DECEMBER 2002



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STATISTICAL TABLES

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

Type of financial institution	2000	2001	2002
Large banks	4	3	4
Medium-sized banks	11	10	9
Small banks	8	8	9
Foreign bank branches	10	10	9
Building societies	6	6	6
Banks under conservatorship	1	1	0
Financial Institutions, total	**40**	**38**	**37**

Ownership structure of financial institutions in 2002 on the basis of registered capital (at year-end, banks with licences as of 31 December 2002, %)

Item	Type of financial institution				Total banking sector
	large banks	medium-sized banks	small banks	building societies	
State ownership	0.5	17.8	1.1	0.0	4.1
Other domestic ownership	4.0	21.6	40.3	45.6	14.0
Domestic ownership total	4.5	39.4	41.4	45.6	18.1
Foreign ownership	95.5	60.6	58.6	54.4	81.9
Financial institutions, total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

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

Item	2000	2001	2002	2002/2000
State ownership	23.6	4.3	4.1	0.2
Other domestic ownership	21.9	25.7	14.0	0.6
Domestic ownership total	45.5	30.0	18.1	0.4
Foreign ownership	54.5	70.0	81.9	1.5
Financial institutions, total	**100.0**	**100.0**	**100.0**	**1.0**

Distribution of market shares in balance sheet total (at year-ends, banks with licences as of 31 December 2002, %)

Type of financial institution	2000	2001	2002
Large banks	65.1	64.6	62.2
Medium-sized banks	14.7	14.8	16.6
Small banks	2.2	2.3	3.4
Foreign bank branches	12.2	12.1	9.6
Building societies	5.8	6.2	8.2
Financial institutions, total	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-ends, banks with licences as of 31 December 2002)

Assets	2000	2001	2002
Deposits with CNB	12.7	12.8	19.9
Deposits with banks	25.0	22.4	15.9
Credits	35.8	36.9	36.1
Securities	18.6	19.1	18.4
Fixed assets	2.6	2.3	2.3
Other assets	5.3	6.5	7.4
Liabilities			
Clients´ deposits	58.1	60.5	64.6
Banks´ deposits	15.8	14.7	12.0
Sources from central bank	0.2	0.2	0.1
Bond issues	12.1	9.5	7.5
Equity capital	7.9	7.3	8.0
Other liabilities	5.9	7.8	7.8

Development of off-balance sheet activities
(at year-ends, banks with licences as of 31 December 2002, off-balance sheet items/ balance sheet total, %)

Type of financial institution	2000	2001	2002
Large banks	76.4	106.8	127.7
Medium-sized banks	179.6	200.6	201.1
Small banks	21.6	14.1	14.2
Foreign bank branches	345.7	461.9	326.9
Building societies	5.2	2.7	4.4
Financial institutions, total	**119.3**	**154.9**	**145.2**

Solvency ratio of financial institutions
(at year-ends, banks with licences as of 31 December 2002, %)

Type of financial institution	2000	2001	2002
Large banks	13.7	14.8	13.4
Medium-sized banks	17.7	16.0	16.4
Small banks	21.6	22.4	17.4
Building societies	17.7	16.2	13.6
Financial institutions, average	**14.9**	**15.4**	**14.2**

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Asset portfolio quality of the banking system
(at year-ends, banks with licences as of 31 December 2002)

CZK in mil.

Asset classification	2000	2001	2002
Standard	606,280	765,032	789,374
Watch	85,814	75,984	76,201
Substandard	54,910	32,295	29,514
Doubtful	27,276	29,725	12,361
Loss	89,762	71,862	42,302
Non-performing total	171,948	133,882	84,177
Classified total	**257,762**	**209,866**	**160,378**
Reserves and provisions	**77,141**	**79,193**	**62,305**

The structure of deposits and loans in 2002
(at year-end, banks with licences as of 31 December 2002, %)

	Deposits	Loans
Non-financial	21.2	48.5
Financial	5.6	7.6
Government sector	10.3	18.8
Small business	3.5	2.4
Households	55.0	17.5
Other	4.4	5.2
Total	**100.0**	**100.0**

The structure of deposits and loans by time in 2002
(at year-end, banks with licences as of 31 December 2002, %)

Maturity of Deposits		Loans	
At sight	41.9	Short term loans	29.3
Within one year	43.1	Medium term loans	28.2
Over one year	15.0	Long term loans	42.5
Total	**100.0**	**Total**	**100.0**

Proportion of foreign exchange assets and liabilities
(at year-ends, banks with licences as of 31 December 2002, %)

Type of the financial institution	FOREX Assets/Total Assets			FOREX Liabilities/Total Liabilities		
	2000	2001	2002	2000	2001	2002
large banks	19.3	19.2	15.8	16.1	15.0	13.4
medium-sized banks	37.3	27.3	19.6	36.3	25.7	22.4
small banks	22.3	20.5	13.6	23.1	19.6	13.4
foreign bank branches	40.3	45.8	36.5	40.7	43.5	40.3
Financial Institutions, aver.	**23.4**	**22.3**	**17.1**	**21.3**	**19.2**	**16.4**

Structure of revenues and expenditures of financial institutions (banks with licences as of 31 December 2002)

CZK in mil.

Revenues	2000	2001	2002
Interest earned	135,090	143,129	122,604
Fees and commissions earned	21,351	25,767	29,962
Profit from shares and units	654	942	1,134
Profit from foreign exchange activities	9,831	7,154	5,536
Profit from other financial operations (incl.derivatives)	-380	3,456	6,085
Expenditures			
Interest paid	84,476	86,204	66,522
Fees and commissions paid	4,797	4,797	6,174
Administrative costs	41,840	47,939	47,916
Reserve and provisions creations (net)	59,549	22,228	12,853
Taxes	-2,100	5,046	11,476

Structure of registered capital and own funds of financial institutes in 2002 (at year-end, banks with licences as of 31 December 2002)

Type of the financial institution	Registered Capital/Total Assets		Own Funds /Total Liab	
	EUR in mil.*	%	EUR in mil.*	%
Large banks	1,403.7	2.8	4,271.8	8.7
Medium-sized banks	457.5	3.5	1,139.2	8.6
Small banks	229.9	8.6	300.9	11.3
Foreign bank branches	92.9	1.2	253.5	3.3
Building societies	140.8	2.2	343.4	5.3
Financial institutions, aver.	**2,324.9**	**2.9**	**6,308.8**	**8.0**

** Rate of exchange CZK/EUR= 31,6*

2002 DEVELOPMENTS IN THE ESTONIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN ESTONIA

Despite weak external demand the Estonian GDP increased by 5,8% in 2002 which is higher than the 5,4% growth in 2001. Both domestic demand and higher private sector borrowing activity sustained the growth. Although the current account deficit was exceeding 12% of GDP compared to the 6,2% of GDP in 2001, Estonia and its economy were increasingly credible due to the integration into the European Union and NATO. The government surplus was 1,2% and the inflation rate was reaching 3,6% in 2002.

Weak external demand was best reflected in Estonia's deteriorating terms of trade and recession in subcontracting. In spite of low external demand, the growth rate of Estonia's normal export (export of goods without subcontracting) in current prices was as rapid as in 2001, reaching 11% and exceeding considerably trade partner's average growth of import volumes. This indicates that trade turnover of Estonia's main trading partners grew above EU average and the market position of Estonian goods with higher value added strengthened.

Similar to 2001, also in 2002 the domestic demand was primarily sustained by investments, which together with stock building gained 23% in constant prices. Rapidly growing domestic demand and investment activity was reflected in the production side of the GDP throughout 2002.

The growth of investments to about 30% of GDP was accompanied by a soaring current account deficit in 2002, which was 12% of GDP in 2002. Apart from growing investment activity, also shrinking saving level of Estonian economy necessitated involvement of supplementary external resources. The financial sector used external resources to meet domestic credit demand and undertakings – to finance large investment projects. These developments have soared the gross debt of Estonian economy by 2,5 percentage points to 63,6% of GDP.

The consumer price index in 2002 reached 3,6% (CPI in December against the year-ago period). The prices of nontradables were increasing, but the prices of imported goods slowed down Estonia's inflation rate. Consumer prices in Estonia were primarily exposed to an oversupply-caused food price decline in Europe, which caused the decline in food prices by about 4 percentage points (from 6,6% in 2001 to 2,7% in 2002) in Estonia.

In 2002, for the second time since 1997, the government sector budget had surplus, which reached 1,3 billion kroons and amounted 1,2% of GDP. The surplus resulted from the better tax administration and favorable environment for the collection of indirect taxes.

The year 2002 proved that the foundations of Estonian economy are strong and Estonia's high reputation is also reflected in country ratings assigned by leading rating agencies in the world. While in 2001 two rating agencies (Standard&Poor's and FitchRatings) had lifted Estonia into the highest group (A group), in 2002 the third rating agency, Moody's, did the same.

DEVELOPMENT IN THE BANKING SECTOR

Six credit institutions, one branch of a foreign credit institution and seven representative offices of foreign banks operated in Estonia at the end of 2002. In 2001 there were six representative offices of foreign banks operating in Estonia, but two more were added in 2002 (International Bank of St Petersburg from Russia and Akciju komercbanka 'Balticums' from Latvija) and the representative office of Svenska Handelsbanken terminated its activity. Of the banking sector's share capital 86,7% belonged to the foreign owners and 13,3% to the residents. The majority of the non-resident owners formed foreign banks whose holdings in the banking sector share capital grew from 63,3% to 78,9% over the year.

There were no significant changes in Estonian banking market in 2002 – AS Hansapank and AS Eesti Ühispank still occupied 82,8% of the sector's total assets. Branch of Nordea Bank was characterized by rapidly increased market share, mainly through loan growth. As a result, Nordea Bank assets rose to the third position and the market shares of most other banks decreased. Hansabank Group, the largest banking group on the market that includes banking and leasing companies in Estonia, Latvia and Lithuania, among others managed to further increase its market share in the Baltic States.

The Estonian banking sector was characterized by relatively rapid growth in loans in 2002. This was assured by the favorable borrowing and leasing conditions offered by banks, as well as the continuing economic optimism of individuals and companies. As the growth rate of customer's deposits decreased, foreign borrowing increased in the second half of 2002. As far as 78,9% of the share capital of Estonian banking sector belongs to the foreign banks, the borrowing from parent companies was particularly common. The loans and deposits ratio grew from 95,4% to 102,4% during the year.

Active lending boosted the assets of banks in 2002 more than 13,3 billion kroons. By the end of the year, total assets of credit institutions amounted 81,7 billion kroons, the growth of the customer's loan portfolio accounted for over two-thirds of the increase in assets. The real estate financing continued to dominate the banking sector in 2002, the emphasis was on private housing loans, resulting in a continuing development of the real estate market. The loan portfolio quality has not deteriorated despite of the rapid growth in loan volumes and the quality of the loan portfolio of banking sector as a whole may be assessed as satisfactory – 89,2% of the total loan portfolio of customers classified as "standard loans" and the share of overdue loans was 3,9%. Under conditions of rapid loan growth the maintenance of the loan portfolio quality was crucial for Estonian banks. In October 2002 the Bank of Estonia and the Estonian Financial Supervision Authority (FSA) warned the banks of the risks accompanying rapid loan growth. Banks were advised to pay more attention to the factors affecting economic cycles when granting loans and assessing risks, and not to compromise internationally recognized principles of lending with their borrowers.

Besides active lending activities, the banking sector was characterized by high profitability, capitalization and liquidity. Rapidly developing electronic services facilitate the customers' communication with the banks and save costs.

On the liabilities side of credit institutions the growth of deposits could not keep up with the growth of loans and the growth of deposits was 3 billion kroons less than loan portfolio growth and forced banks to use external financing.

The Estonian banking sector earned profit of 1,2 billion kroons in 2002. Compared to the sector's record profits in 2001, this period's profit was smaller by 0,5 billion kroons, but the profit for 2001 included 0,6 billion kroons of income from dividends on financial investments as extraordinary income.

Capital adequacy rose from 14,4% at the end of 2001 to 15,3% at the end of 2002 (minimum requirement 10%). Primarily invested profits of 2001 and to some extent also new capital adequacy guidelines enforced on 2 July 2002, contributed to the growth in capital adequacy.

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

The Estonian legal environment, including the financial sector regulations in recent years, has been characterized by rapid and dynamic development. Major changes in 2002 for entities operating in the financial sector resulted from laws being harmonized with European Union regulations.

The Securities Market Act became effective at the beginning of 2002 and it established all the relevant requirements contained in the EU directives for public offer of securities, provision of investment services, prudential requirements for investment firms, regulated securities markets, trade on such markets and admission of securities for trading, disclosure of price-sensitive information and use of inside information, regulated takeover bids and the organization of securities settlement systems.

The regulatory environment of the banking sector has been generally stable in recent years. The legal framework of the Estonian banking system is established by 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 last amendments in the Credit Institutions Act became effective on 1 July 2002 and they improved and specified the requirements for guaranteeing the financial soundness of credit institutions and reporting requirements, the organization of supervision upon Estonia's accession to the EU, and specified and harmonized terminology used in the legislation. The applicable regulation is based on EU directives, the guidelines of the Basel Banking Supervision Committee and international practice.

New guidelines of the new capital adequacy calculation became effective for credit institutions on 1 July 2002. Main improvements of the guidelines were:

- 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.

FSA started preparations for the implementation of the new capital adequacy (Basel II) framework in Estonia at the end of 2002, for which a respective working group was set up.

FSA also participated in the development of the legal basis for prevention of money laundering and financing of terrorism in 2002. FSA reviewed the money laundering prevention measures used by the supervised entities. On 19 June 2002 the management board of FSA approved "Additional guidelines for prevention of money laundering in credit and financial institutions".

THE ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY LAST YEAR

To carry out the objectives of financial supervision, FSA regularly monitors the financial sector and the supervised entities. Monitoring as a supervisory process implies constant observation and analysis of the operations and the status of supervised entities, identification of the main risk areas and supervision of compliance with the law.

The organizational side of the banking supervision process has developed constantly in 2002. Supervision is no longer clearly divided into off-site and on-site supervision, but based on the specificity of the risks inherent to banking. Supervisory responsibilities are divided into two main areas: assessment of the more quantitative or measurable risks of banking activities (e.g. credit risk, market risk, liquidity risk) and assessment of the more qualitative risks (e.g. operational risk, internal control systems).

For efficient assessment of the banks' risks, a regular monitoring cycle was developed which helps to identify the main risk areas of banking activities. Regular monitoring of banks consists of constant observation and analysis of the banks' status via the reports submitted to FSA, information obtained from public sources and from visits to the banks, as well as other information received in the course of supervisory activities.

There is prepared a throughout overview of the main developmental trends of bank and their consolidation groups, the main risk areas and problems every quarter to help plan further supervisory activities and to identify the areas that require greater attention.

The rapid increase in the volume of loans granted by banks, especially the increasing real estate loans by the banks as well as the consolidated groups companies is the area that has received the greatest attention during the 2002. Therefore, much attention has been paid to the banks' exposure to credit risk and to internal credit risk management and control systems of consolidated groups, as well as developments in the economic environment.

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.

There were 11 on-site inspections of the banks in 2002. All the main areas of banks were inspected on-site in 2002, paying greatest attention to:

- assessment of the internal risk management and control systems of different areas;
- assessment of risks related to lending and leasing activities, compliance of the banks' lending activities with the law and their own internal regulations;
- the internal audit function and its efficiency in assessing different areas of activity and the internal control systems;
- evaluation of the measures for the prevention of money laundering.

Besides the above, also assessment of information technology risks is an important area of on-site inspections.

LEGAL COMPETENCE OF THE BANKING SUPERVISION AUTHORITY IN ESTONIA

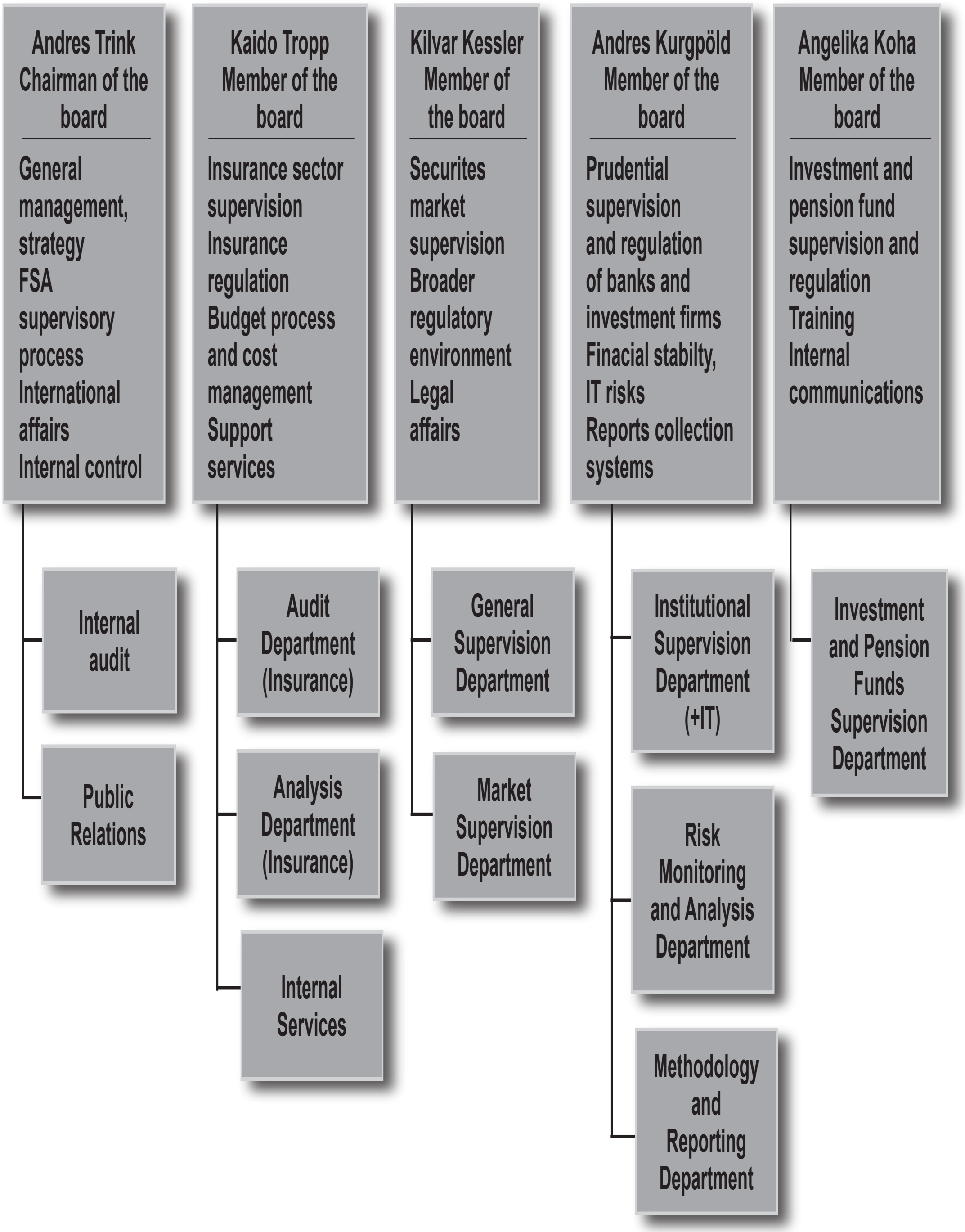
The competence of the FSA founded on 1 January 2002, in respect of banking supervision, is regulated by the Financial Supervision Authority Act, Credit Institutions Act and several other legal acts regulating banking activities (e.g. Securities Market Act, Money Laundering Prevention Act, decrees and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

Banking supervision covers supervision of 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.

The activities of FSA are directed by the management board, which has the authority to make all the decisions concerning financial supervision. Among issues concerning banking supervision, the management board has the authority to issue and cancel activity licenses and other matters related to activity licenses, to give consent, approval or permission, to issue precepts, to apply administrative coercive measures, to impose administrative penalties, to order special audits or expert assessments, to establish moratorium or special regime, to file a bankruptcy petition and to carry out related activities.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISION AUTHORITY

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.



INTERNATIONAL ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY

International co-operation is an important part of the FSA due to several subsidiaries, branches and representative offices of foreign credit institutions operate in the Estonian banking market. In addition, the Financial Supervision Authority Act specifies co-operation with international financial supervisory agencies and other competent agencies or individuals of foreign countries as one of the functions of FSA and provides legal basis for signing co-operation agreements, i.e. memorandums of understanding, with respective bodies of other countries. The FSA has signed the memorandums of understanding with financial supervision institutions in six countries – Latvia, Lithuania, Finland, Sweden, Germany and Denmark. In 2003 the MoU with Swedish Financial Supervision Authority regarding banking supervision area was signed.

FSA co-operation with international organizations in 2002 consisted of continuing participation in the work of associations of different supervisory authorities of the financial sector, meeting with various international financial institutions and rating agencies, and sending replies to their inquiries.

FSA participates in the activities of BSCEE. At the annual meeting of the co-operation group in 2002, Estonian FSA was elected the presiding member of the organization for 2003.

COOPERATION WITH OTHER SUPERVISORY BODIES IN ESTONIA

Being an integrated supervision authority, FSA has signed the trilateral agreement with the Bank of Estonia and Ministry of Finance with regard to co-operation in the field of promoting financial sector stability. The agreement defined the bases for common action in the exchange of financial information, working out legal acts, in cases that have substantial influence on the financial sector, in the area of international and public relations and training.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY 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.

The strategic goals of the FSA for the years 2002-2003 were approved by the supervisory board of FSA.

The strategic goals of supervisory activities in the area of banking supervision:

- to be prepared for efficient supervision upon the implementation of the Securities Market Act;
- to unify the standards and methodology of the supervision process for the banking market;
- to develop a procedure for consolidated supervision over financial groups acting in different parts of the financial sector and different geographical areas;

- to focus supervision on the systemically critical risk areas and supervised entities, from the perspective of the financial sector's risks and development;
- actively to collaborate with the supervisory authorities of foreign countries that are of primary importance for the supervision of the Estonian financial sector, and to sign co-operation agreements with them. To increase participation in the work groups of the Basel Banking Supervision Committee;
- to develop with the Bank of Estonia and the Ministry of Finance a co-operation framework for drafting financial sector regulations, collecting reports and exchanging information, as well as solving crisis situations;
- to continue the introduction of European Union and other international standards to the financial sector regulation and supervision process, based on the principles of efficiency and practicality;
- actively to participate in the drafting and analysis of legislation concerning the financial sector;
- to launch a system which informs the customers and investors of supervised entities of major changes in the financial sector regulations and principles. This system should include the web site of FSA.

STATISTICAL TABLES

Number of financial institutions

Type of financial institution	2000	2001	2002
Banks	6	6	6
Foreign Bank's branch	1	1	1
Financial institutions total	**7**	**7**	**7**

Ownership structure of financial institutions in 2002 on the basis of registered capital

Item	Type of financial institution
	Banks
Public sector ownership	0
Other domestic ownership	13.3
Domestic ownership total	13.3
Foreign ownership	86.7
Financial institutions, total	**100.0**

Ownership structure of financial institutions in 2002 on the basis of registered capital

Item	2000	2001	2002	2002/2000
Public sector ownership	0.0	0.0	0.0	0.0
Other domestic ownership	17.1	14.3	13.3	-3.8
Domestic ownership total	17.1	14.3	13.3	-3.8
Foreign ownership	82.9	85.7	86.7	3.8
Financial institutions, total	**100.0**	**100.0**	**100.0**	**–**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2000	2001	2002
Banks	100.00	100.00	100.00

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

Assets	2000	2001	2002
Cash	2.31	2.33	1.71
Claims on central bank	9.88	5.53	4.36
Claims on credit institutions	8.75	13.22	12.38
Claims on customers	59.24	59.52	61.18
Allowance for uncollectible claims	-0.92	-0.88	-0.64
Securities	14.40	15.83	17.27
Intangible assets	1.45	0.92	0.59
Tangible assets	2.12	1.56	1.27
Other assets	2.78	1.97	1.89
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2000**	**2001**	**2002**
Amounts owed to credit institutions and central bank	10.85	9.43	14.54
Amounts owed to customers	60.14	62.41	59.74
Government lending funds and counterpart funds	0.78	0.45	0.29
Issued debt securities	8.98	8.57	8.47
Other liabilities	4.78	3.87	3.19
Subordinated liabilities	1.78	1.93	1.54
Provisions	0.11	0.07	0.08
Equity capital	12.59	13.27	12.14
Total	**100.00**	**100.00**	**100.00**

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

Type of financial institution	2000	2001	2002
Banks	28.88	23.92	23.99

Solvency ratio of financial institutions

Type of financial institution	2000	2001	2002
Banks	13.21	14.39	15.26

Asset portfolio quality of the banking system

Asset classification	2000	2001	2002
Identifinite	5.79	0.00	0.00
Standard	80.75	83.14	89.19
Special mention	8.19	10.62	6.86
Substandard	2.26	2.89	1.77
Doubtful	1.73	2.52	1.43
Loss	1.28	0.83	0.75
Classified total	**100.00**	**100.00**	**100.00**
Specific reserves (mio of EEK)	**451**	**515**	**364**

The structure of deposits and loans in 2002 (%)

	Deposits	Loans
Households	42.20	25.74
Government sector	7.99	4.38
Corporate	39.54	38.30
Foreign*	13.06	2.05
Other	10.27	31.58
Total	**100.00**	**100.00**

**deposits and loans from total amounts*

The structure of deposits and loans in 2002 (%)

Maturity of deposits		Loans	
At sight	59.57	Long term loans	60.05
Within one year	32.27	Medium-term loans	31.67
Over one year	8.16	Short-term loans	8.28
Total	**100.00**		**100.00**

Proportion of foreign exchange assets and liabilities

Type of financial institution	FOREX assets/total assets			FOREX liabilities/total assets		
	2000	2001	2002	2000	2001	2002
Banks (only balance sheet items)	60.56	63.64	70.26	43.69	39.56	41.3

Structure of registered capital and own funds of financial institutions in 2002

(th of EUR)

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR	%	EUR	%
Banks	131,108	2.51	633,831	13.82

Structure of revenues and expenditures of financial institutions

(th of EUR)

Revenues	2000	2001	2002
Interest income	239,249	275,275	271,792
Net interest profit/loss (+/–)	123,474	139,452	151,469
Income from financial investments	2,290	45,227	4,650
Commission income	61,678	67,897	76,845
Profit on financial operations	48,242	44,137	65,904
Value adjustments of claims and off-balance sheet commitments (income)	14,420	15,919	15,761
Value adjustments of financial fixed assets (income)	640	7,579	398
Other operating income	4,714	4,230	3,432
Extraordinary income	0	0	0
Expenditures	**2000**	**2001**	**2002**
Interest expense	115,775	135,823	120,323
Commission expense	16,352	18,074	21,305
Loss on financial operations	15,934	15,818	42,936
Administrative expenses	87,770	101,205	112,317
Value adjustments of tangible and intangible fixed assets (expenses)	42,701	34,414	26,569
Value adjustments of claims and off-balance sheet commitments (+/–)	34,858	21,314	24,482
Value adjustments of financial fixed assets (expenses)	8,925	12,327	717
Other operating expenses	9,743	12,418	12,510
Extraordinary expenses	0	0	0
Profit/loss of the reporting period	39,174	107,565	73,690

2002 DEVELOPMENTS IN THE HUNGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

External conditions

In 2002, the domestic financial sector operated in an ambivalent international environment, deteriorating in several respects. The growth of the world economy considerably slowed down and corporate profitability typically declined, while unemployment increased all over the world. Simultaneously, the threat of international terrorism escalated, energy prices rose significantly and currency exchange rates fluctuated substantially.

The above circumstances adversely affected financial service providers all over the world. Because of a slowdown in income growth, the quality of existing loans deteriorated. The fast paced decline of stock prices continued to create significant losses in all segments of the economy. At the same time, administrative and management errors were uncovered at several major corporations of leading economies, as a result of which investors' confidence in economic information and regulatory systems weakened. A substantial part of the losses attributable to the economic slump and credit quality, plunging stock prices and terrorism were realized by the financial service providers (banks, insurers and brokerage firms, etc.).

Domestic economy

These adverse changes in the international climate were typically mitigated in the 2002 activities of the Hungarian economy. The slowdown in economic growth was moderate, domestic demand increased unusually rapidly in some areas, while unemployment increased only slightly. Due primarily to the significant appreciation of the forint, the rate of inflation continued to drop. Stock prices remained unchanged rather than falling. Unfavourable trends in leading economies manifested primarily in the softening of industrial export demand, in the layoffs and plant closures by foreign companies in Hungary, in the fall of corporate investment and inventory levels and in the slowdown of direct investment inflow. All these were largely offset by the extensive fiscal policy and, as a consequence, by the quick growth in demand for consumer goods and residential real estate. Simultaneously, the deficits of the government budget and the current account increased, which markedly raises the question of the sustainability of the followed path of growth. The December 2002 decision adopted by the governments of the European Union on the 2004 accession of Hungary had a significant stabilizing effect on the Hungarian economy. The perspective of the approaching accession considerably improved the risk assessment of investments into Hungary, including more favourable international credit ratings, and offered more flexibility in the area of economic policy adjustments than before. At the same time, the fast approaching date of EU accession creates expectations with respect to structural adjustment, regulatory preparation and improved competitiveness. The government will also need to be prepared to manage potential transitional difficulties that may go together with the accession, a typical example of which was the wave of currency speculation in January 2003.

DEVELOPMENT IN THE BANKING SYSTEM

In 2002 the number of banks decreased altogether by two compared to the end of the preceding year, thus 39 credit institutions operated as joint stock companies at the end of December. OTP Jelzálogbank (OTP Mortgage Bank) launched its operation, while a few foreign banks (Rabo, SG) exited the Hungarian market to be replaced in 2003 by a new bank (Bank of China). It was the first time that the average employee headcount increased from 26,270 in 2001 to 26,947 in connection with the dynamic expansion of retail lending. The overall increase in the sector resulted from 1,067 new employees hired and 390 aid off.

Main indicators of the banks (credit institutions operating as stock corporations)

Foreign ownership is still dominant, although the proportion of direct domestic participation in registered capital grew to 36.0 percent, which was primarily attributable to the government's capital increase in the Hungarian Development Bank. Direct foreign participation in the bank sector's registered capital was 60.5 percent at the end of 2002. (Preferred stocks and repurchased stocks amounted to 3.5 percent.)

Institutional concentration remained high and eased only a little, mainly in deposit collection, but also in lending. The consolidated share of the ten big banks exceeded their share of equity. The development of credit institutions in 2002 was peculiar. For the most part of the year, during the first nine months the banks secured funding for their expanding lending activity mostly by rearranging their liquid assets, the total assets hardly changed at all, throughout the 9-month period the total nominal growth was merely 4.5 percent. In contrast to that from October large-scale deposit collection started as a result of which the total assets were 9 percent above the end of September and 14 percent above the end of December figure, reaching HUF 10,825 billion by the end of 2002. (The growth would have even been faster, had the strengthening of the forint not lower the forint denominated amount of total assets.)

The fourth quarter dynamic, 10.5 percent increase in the deposit portfolio is only partially explained by the usual seasonal fluctuation. The growth in the deposit portfolio from October 2002 was the result of the income and wage increases in the private sector and the inflow of foreign capital. Income and wage increase of households in October raised the level of gross retail savings, manifested in the growth of bank deposits. The foreign capital influx also started in October, following the positive results of the Irish referendum, which had decisive importance with respect to our accession to the EU. During this period foreigners mainly purchased government bonds from the treasury, but also from residents (including other financial intermediaries and financial enterprises), who put a good part of the money received in exchange for government papers into bank deposits. Naturally the dominant part of the liabilities, 56.8 percent, still originated from residents' bank deposits. The deposits would have increased at a faster rate, had the strengthening of the forint not caused a fall in the volume and forint value of foreign exchange liabilities. The expectations of the further strengthening of the forint exchange rate and the low interest rate on foreign exchange deposits, however, urged clients to reduce their foreign exchange deposits. The intense lending activity, characterizing the year as a whole, strengthened from quarter to quarter until October and although it became milder in the last quarter, still remained substantial. As a consequence of dynamic lending activities the share of loans in the total assets increased from 54.1 percent at the end of 2001 to 60.4 percent.

According to the total assets/GDP ratio the sectors role in financial intermediation declined further, however, according to the loans/GDP ratio it increased again. Although the growth rate of corporate lending lagged behind the expansion of retail landing, the annual portfolio increase exceeded the rate of inflation in this segment as well. Based on the first three years' trend growth would have been faster, in the last quarter, however, the corporate loan portfolio decreased, because a few large loans were moved from the corporate to the public debt category. Retail lending increased extremely fast primarily because of the government's interest subsidy on housing loans. The portfolio of housing loans increased more than two and half times in a year reaching HUF 695 billion. Thus the proportion of retail loans reached 10.7 percent of the total assets at the end of 2002. The quality composition of retail loans improved due to the new, typically problem-free placements. At the same time the quality of the corporate credit portfolio deteriorated, since the growth rate of new placements substantially lagged behind the rate at which problem loans increased. Nevertheless, it is to be noted that the proportion of the problem portfolio is still small, 3.5 percent in average among commercial banks (below average 1.3 percent, doubtful 1.1 percent and bad 1.1 percent). Overall the quality of the portfolio did not deteriorate, because the weight of positively rated off-balance sheet items increased in the portfolio. On average the proportion of problem items was 2.0 percent in the portfolio of commercial banks at the end of 2002. (At the end of 2001 it was 2.2 percent.) In 2002 the profitability of commercial banks increased even in real terms, their consolidated HUF 151.3 billion pre-tax profit was 17.3 percent above the previous year, whilst foreign mother institutions struggled with several problems. Profitability of the entire bank sector, however extraordinarily decreased as a consequence of the Hungarian Development Bank's loss of value and provision creating expenditures. The sector's consolidated pre-tax profit of HUF 16.8 billion was merely 12.4 percent of the previous year's result.

The bank sector's profitability slightly improved, the return on assets (ROA) grew from 1.60 percent in 2001 to 1.71 percent, while the return on equity (ROE) increased from 18.62 percent to 18.65 percent.

The bank sector's capital adequacy remained stable, although according to our calculations the capital adequacy ratio fell from 15.64 percent at the end of 2001 to about 14 percent. The decline in the capital adequacy ratio called attention to the increasing capital requirement of the lending activity, however, did not represent a risk that could have threatened the stability of the bank sector's capital supply.

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

The HFSA's powers

Since the establishment of integrated supervision in April 2000 financial supervision and the underlying criteria have undergone bold changes. The Hungarian Financial Supervisory Authority (hereinafter 'HFSA' or 'Supervision') has evolved in line with expectations at the time of its establishment, it has realized its objective of integrating the three constituent parts and, in doing so it has earned domestic and international recognition. Defining its strategy and fulfilling its responsibilities the Supervision's evolution has been much shaped by the need to take the substantial international integration and international ownership of the domestic financial system into consideration, to keep track of international supervisory standards and the worldwide appreciation of the role of financial supervisions and to adapt to and prepare for the new situation required by accession to the European Union. When *in 2002 the Supervision started its work, the basis of its supervisory autonomy and the statutory basis of autonomy had considerably solidified and most elements of autonomy were in fact granted*, meeting in part most of the international expectations. As of 1 January 2002 the law provides for the most important element of independence, namely that responsibilities may only be prescribed to the Supervision by the Act, or by other statutes on the basis of the Act. In particular the Supervision may not be instructed in the exercise of its competence. As a step in the direction of independent business management the Supervision has been granted the right to have its budget appear separately within the Ministry of Finance's chapter. Moreover, the Act provides that as a further step the Supervision gains full independence as of January 1 2003 when HFSA is assigned a separate chapter in the budget. 2002 was the first year when the Supervision financed its activities exclusively from its own revenues without any government support. The almost complete harmonization of supervisory fees paid by supervised organizations effective from the beginning of 2002 and the adjustment of fee structure to a firm's activities have made available the resources needed to match the Supervision's duties. The development of the legal environment and supervisory expertise, the growth of transparency and the spread of the preventive and risk based approach together ensured the conditions which guarantee the Supervision's measured and appropriate action in relation to the tasks that fall within its competence over the year. *The missing element of independence is the statutory power to make regulations, which is in the norm for international organizations. Additionally, the adoption of a few statutes on the activities of the supervised sectors and the accession to the European Union,* which was postponed in 2002, *has to be completed*. *The issue of consolidated supervision is highlighted among these*. Its regulation was postponed to 2003, significantly cutting back on the time available for the affected financial institutions to make preparations. The definitions used by financial legislation and by EU directives must also be harmonized prior to EU accession. With respect to the Insurance Act, in addition to leaving less time available for preparation, important amendments have been removed from the Bill. In the light of experience HFSA initiates statutory amendments necessary to fulfil its responsibilities, and to increase transparency of the market and the players' activities but at present lacks the statutory power to carry these through and has to rely on other bodies to implement the legislation it needs. The Supervision believes that these are essential steps to reinforce consumer confidence and the stability of the financial system in the long run.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Assessment of results of supervision

Based on the Supervision's experience drawn from on-site and off-site inspections it is clear that there are no systemic difficulties endangering the stability of the financial system, its proper functioning, or the clients' assets. The majority of the supervised institutions are stable and their operation is prudent. Normally, supervisory inspections reveal problems of smaller weight, but none of these represent general problems either in the sector, or in a part thereof. Deficiencies are always investigated by the Supervision, and if necessary appropriate measures are taken. *Looking at the entire financial sector accounting deficiencies occurred relatively often and operational risks can also be regarded as general.* A summary study was prepared within the Supervision on the role of operational risks in the financial sector, with a view to international projects on the subject (especially in Basel) and supervisory experiences.

Ownership control and the level of management: ownership control is satisfactory in all areas, it is particularly powerful in case of banks and insurance companies, thus certain foreign-owned institutions practically function as branch offices in Hungary. The skills and expertise of the management is overall satisfactory or better; the formerly frequent problems with savings cooperatives related to the lack of proper qualification were eliminated. Funds organized at the workplace with fewer members and assets than large bank or insurer-owned funds are normally better organized than in the recent past and face fewer problems. It is worth noting that some of the insurer – owned funds place the interests of the background institution in front of the members' interests The Supervision gives notice to such firms that it always takes a firm stand against that.

Internal audit: deficiencies in internal audit, which plays a fundamental role in discovering and preventing operational risk, were revealed in several sectors, in particular at financial undertakings, investment enterprises and insurers. Most often the problem was caused by the lack of internal audit rules and work plan, discord between regulations and practice, and lack of the internal auditor's independence, or here and there the merely formal role of internal audit. In parallel with the strengthened management of other risks, the management of operational risk still represents a bottleneck domestic financial organizations must make definite advances in respect of all elements of operational risks, including internal audit.

Capital position and profitability: the capital position is stable in the financial sector, the level of the institutions' capitalization offers an appropriate basis for the further expansion of activities, indeed, insurance companies based on their capital adequacy ratio and profitability figures may qualify as being over-capitalized. The capital position of investment enterprises gradually improved, the opportunities associated with the growth of business activity were reflected in 2002 in higher profits and in the growth of own capital. The investment return on the funds assets was positive after the negative result in 2001.

Risk management, investment, deposit and asset management, fundamentally the risk management systems are adequate in each sector; generally they are in line with the size of the risks undertaken. The Supervision will focus on the supervision of this field in the future as well. In order to move forward institutions must start, or continue to implement the risk management related changes connected to the New Basel Capital Accord. It is necessary to make advances with respect to managing banks' large exposure limits in the near future. Here additional capital requirement can be expected following the introduction of consolidated regulation and capital adequacy requirements, in contrast to the current possibility of redistribution within the group, if limit excesses prevail. Although massive payments are not expected for the years to come, the funds must already develop and test the risk management methods that ensure continued coverage when payments will have to be started. In case of savings cooperatives the question whether the continued expansion of active business branches goes hand-in-hand with an improved level of risk management receives much attention. Similarly, the Supervision takes a harsh stand whenever the security of client receivables is at danger, or harmed. Escrow account management must be strengthened and escrow account managers must take extreme care to ensure that they fully comply with their statutory obligations.

Well functioning escrow account management would allow HFSA to reduce on-site presence in the areas where escrow account managers also control the supervised institutions. Areas falling under *actuarial assessment*: the role of the actuary is in case of each institution to assess and quantify future risks using appropriate mathematical methods. In this respect the day-to-day supervisory work involves the control of three activities, insurance, the fund's operation, and the assessment of the so-called internal models at institutions keeping a trading book. No problems endangering operation emerged here either. HFSA suggests employing actuarial methods for decision-making support even where it is not required by statutes, when the nature of and/or risks associated with the activity justify that (such as reinsurance decisions). In case of life insurance the Supervision expects special foresight from insurers, where a substantial part of the contracts were negotiated using the previous high technical rates of interest. At present about two-thirds of the life insurance portfolio (62 percent of mathematical reserves) is tied to policies with higher than 5 percent technical rate of interest. In a macroeconomic environment that offers consistently lower yields this contract structure renders special significance to adequate provisioning.

Accounting and record keeping discipline, supervisory relationships the Supervision expects substantial improvement from the institutions in respect of eliminating minor accounting imperfections and improving the accounting basis of the data describing activities, just as it is definitely necessary to improve the accuracy of the data supplied to the Supervision. HFSA intents to have the institutions burdened by on-site inspections as little as possible and for the shortest possible length of time, however given the lack of appropriate quality data the Supervision is only able to progress at a slower pace than planned. Supervisory inspections uncovered accounting deficiencies in each sector that auditors should have indicated, being bound by law. The Supervision intends to rely on the work of auditors to a greater extent than before, and would like to implement a higher level of cooperation in accord with international trends, as it would enable significant reduction of the supervisory burden on the supervised institutions in the field of accounting. However, auditors performing their job on a high-level with the highest standards of care is an essential prerequisite of this.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

Responsibilities related to legislative work

Ongoing maintenance of the supervisory activities' statutory background and monitoring the market developments and keeping track of international recommendations set HFSA various legal responsibilities affecting different activities of the Supervision. These do not appear as independent legislative tasks, rather initiatives for amendments based on international supervisory experience and lessons learned from inspections and active participation in drafting statutes. In 2002 HFSA participated in drafting 55 statutes, including 14 acts, 22 government decrees and 19 ministerial decrees. *HFSA set a threefold objective in respect of its 2002 legislative tasks. Over the past two years there was relentless work aiming at harmonizing the five most important acts applied by the Supervision* (the Credit Institution Act, the Capital Market Act, the Insurance Act and the Act on Voluntary and Private Pension Funds). Additionally, strengthening the regulation pertaining to the settlement of legal disputes with consumers and the establishment of the statutory background necessary to promote market development came into the forefront of legislative work. In relation to the harmonization of the acts defining the objectives, both drafting the related recommendations and incorporating them in the acts were made necessary by the fact that the organizational integration of HFSA had not been followed by a comprehensive review and standardization of the legal institutions included in the acts applied by the Supervision. The closing of that statutory loophole would improve the efficiency of integrated supervision and, in turn, of governmental work. This conclusion is especially true in case of group-level, consolidated supervision, when credit institutions, investment enterprises, insurers and funds that belong to one and the same group of owners are currently supervised according to different rules, following different procedures. As the result of the recommendations pertaining to integration the partial implementation of standardized supervisory procedures and the incorporation of the system of standardized supervisory measures within the Capital Market Act deserve to be mentioned. Significant achievements were made in creating standardized licensing and supervisory procedures and in taking standard measures in the course of amending the Insurance Act, the Credit Institution Act and the Capital Market Act. However, *in connection with the amendment of the Voluntary and Private Pension Fund Act HFSA was not able to push through its harmonization objective pertaining to standardized supervisory procedures. That remains a legislative objective for 2003.*

In connection with the amendment of the Insurance Act the Supervision tabled several proposals increasing the sector's transparency. Part of these would substantially alter the structure and conditions of the Hungarian insurance market according to market players; therefore, their introduction could only be gradual over a long period of time. *HFSA has accepted the request for gradual introduction, but maintains its position according to which these proposals must be incorporated in the statutes in the medium term.*

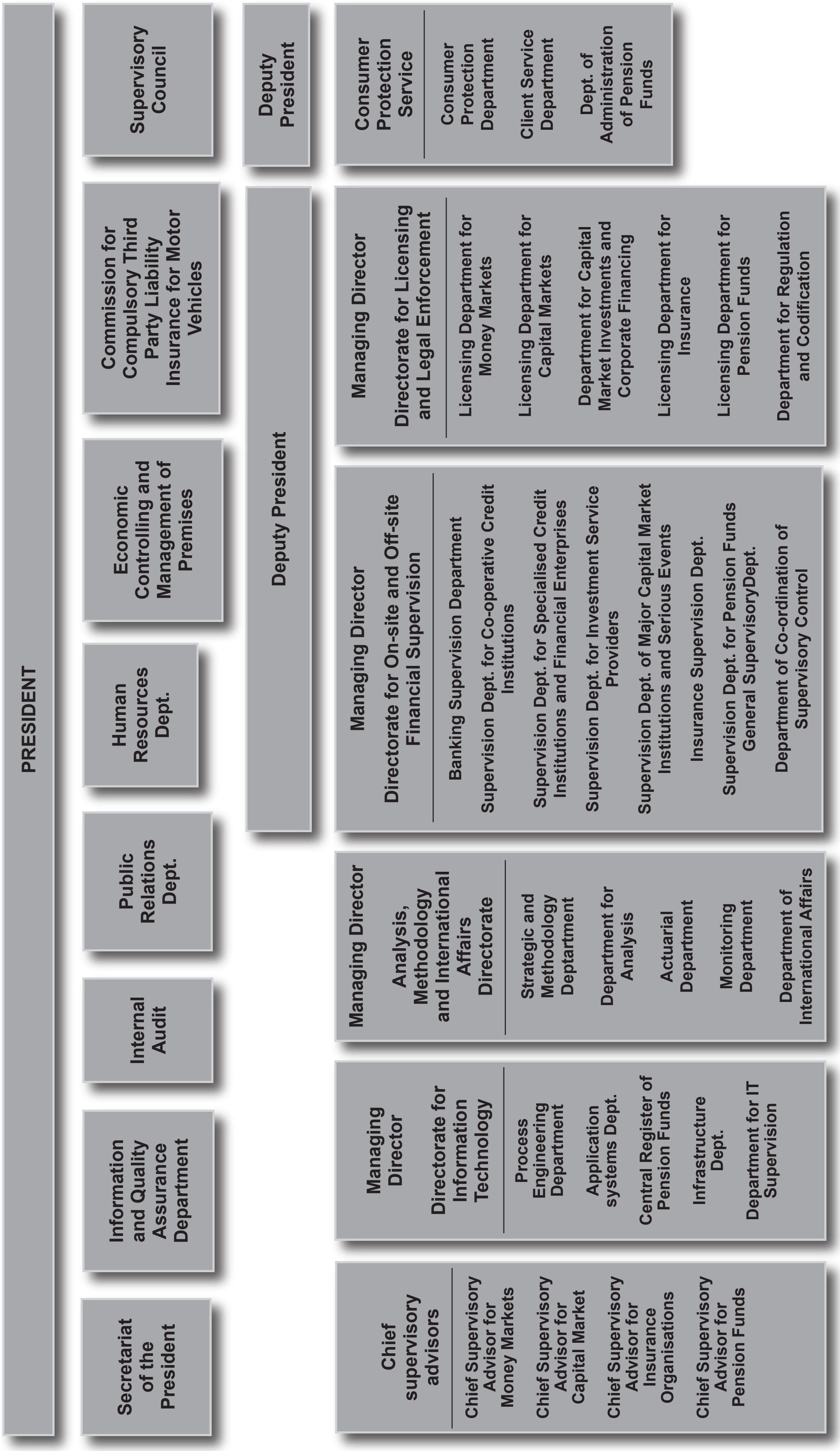
Licensing

It is HFSA's fundamental responsibility to contribute to the continuous improvement of the financial sector's stability and transparency through its activities. The Supervision's first opportunity to screen out players who pose a potential risk to the sector and/or clients occurs through its responsibility for licensing. Of *the total of 5,661 resolutions adopted in 2002 more than 80 percent were licensing resolutions.*10 Many of these concern regulations and amendments of regulations, changes in executive personnel, licenses related to brokers and, in mixed market segments (banks and capital market) the number of licenses related to the expansion of the scope of activities was also significant. The ongoing adjustment of the regulation to international standards and market development is also the source of several licensing resolutions. *In 2002 players were still both concentrating their operations and expanding the scope of their activities.*

In order to speed up licensing processes a *'Licensing Guideline'*, compiled by lawyers involved in licensing, has been placed on the Supervision homepage, where the legal requirements are supplemented by practical advice for each supervised sector. As a result of that *the number of incomplete licence applications fell, significantly reducing the time needed for licensing.*

The transfer of licensing bureaux de change activities from the National Bank of Hungary into HFSA's competence as of 1 January 2002 meant further responsibilities for the Supervision. Simultaneously a *new government decree was issued allowing bureaux de change activities* exclusively to be pursued by credit institutions or their brokers. In the course of the proceedings HFSA adopted 860 resolutions related to moneychangers, of which 293 were moneychanger broker licenses. This means that about half of the almost six hundred former moneychangers were able to meet the new regulations aimed at fighting money laundering.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The main consequence of the crises the approach to financial supervision underwent a fundamental change; not only were the supervisions reinforced, but the former 'monitoring and sanctioning' model was *internationally pushed into the background by the concept of service providing supervision, which focuses on prevention, which is risk-sensitive and engages in dialogue with the supervised sectors. A key strategic objective of HFSA is to promote the realization of the above objectives by the development and consistent implementation of the international work carried out here relying on its already established international relationships and those that are to be developed in the future. The Supervision's strategic objectives are to contribute to the international integration of the Hungarian financial sector and the Supervision, to employ and pass on the latest skills and international standards and to promote the adaptation of the domestic financial sector to these. Ensuring actual compliance with EU standards at the earliest time was highlighted among these goals* in order to ensure that in the moment of accession the market, the market players and the Supervision are equally and fully prepared to meet the European Union's expectations.

Fundamentally four areas stood in the focus of the work completed in 2002: accession to the European Union, intensification of international integration via the development of international relations, active participation in the work of international organizations and transfer of acquired experience to other countries interested in HFSA's experiences.

Preparation for the accession to the European Union

The preparation for the accession to the European Union has outstanding importance in supervisory work. With the accession we shall become part of the integrated internal market in the field of financial services, which is going to change not only the market conditions, or the reactions of the market and the individual players, but it will modify the supervisory tasks as well. In preceding years important steps were taken toward the accession, as a result of which the readiness of the entire financial sector in most areas may be seen as comprehensive, or almost comprehensive. The EU requirements have been adopted and the harmonization of the domestic regulatory environment has been for the most part completed. *The progress of the accession process is monitored not only by HFSA; the European Union assesses the accession countries achievements in the framework of regular peer reviews. In the course of the comprehensive survey* conducted in 2001 and *completed in February 2002 the EU put forth several recommendations for the Hungarian financial sector, the regulatory environment and the Supervision itself.* HFSA can meet part of these within its own sphere of competence, however, for the most part the expectations defined concern the regulatory environment beyond the scope of the Supervision's competence:

Among *the recommendations concerning the legal and regulatory environment* the continued reinforcement of supervisory independence was highlighted. Preparation for the New Basel Capital Accord was given strong emphasis. That involved giving greater flexibility to HFSA in determining the capital requirement of individual institutions, improving cooperation between external auditors and the Supervision, and making the least harmonized insurance provisions conform to EU standards.

The recommendations that could be met by HFSA independently included the establishment and development of the principles and methods of consolidated supervision, closer monitoring of relationships inside financial groups, stepping up the fight against money laundering, simplifying licensing procedures and relieving the burdens of license applicants as much as possible.

Based on the EU recommendations the Supervision developed an action plan in April 2002 for the scheduled implementation of the tasks contained in the recommendations until the accession date. The agenda of legal harmonization developed with HFSA's participation and embraced by the Ministry of Finance have since been in part incorporated in financial legislation, however, *no substantial progress has been made in the most critical areas of the legal environment.* Further progress can be expected from the incorporation of the elements of *consolidated supervision* into the law and from the *new insurance act*, which is also waiting to be submitted to the Parliament. *It cannot be foreseen at the time of writing whether and in what manner the regulatory power will be given to the Supervision* and whether it will take place prior to the accession, or not.

At the same time *the part of the recommendations that could be met by HFSA independently scheduled for 2002 was fully met.* As a positive element, the European Commission appreciated HFSA's overall supervisory activities and the realized professional development with respect to the success of the preparation for EU accession, while it called urgent attention to the above mentioned shortcomings concerning the legal framework of supervision in its country report published at the end of October 2002.

T*he position of the International Monetary Fund is in accord with the above EU conclusions:* in the framework of its worldwide Financial Sector Assessment Program (FSAP) for assessing the financial system's stability and risks the IMF updated its records on the Hungarian financial sector and supervision and investigated the fight against money laundering in February 2002. In several areas IMF noted with satisfaction the progress made compared to the survey completed in 2000, however, in two areas it maintained its previous position: *although the practice of consolidated supervision has developed considerably, the appropriate legislative background is still missing, just as the important element of supervisory independence, i.e. HFSA's regulatory power.*

Accession to the EU also means for HFSA that it must join at various levels discussions fora, workshops and consulting bodies of the EU. Designating the date of accession made it possible for the Supervision to take part as an observer before the accession in the work going on in the EU (so far in 8 bodies). From HFSA's point of view the most important bodies are the Banking Advisory Committee, the Insurance Committee, the Committee of European Securities Regulators and the Contact Group in Banking (Groupe de Contact). Of the organizations listed actual participation with an observer status took place in case of two in 2002 (BAC and Group de Contact) and there is informal contact with the others.

As part of the accession a successful PHARE project titled "Regulation of the financial sector and reinforcement of supervisory work" was completed with HFSA's financial support and the active participation of the Supervision's staff. The study that was presented among the methodological papers and prepared on *consolidated supervision*, an area previously identified by HFSA and also criticized by the European Commission, was completed under this framework and a special banking dictionary was compiled. The two-year *PHARE project, called 'Consensus III' also ended in 2002.* This program aimed at getting familiar with the European regulation on social services provided for migrant employees.

COOPERATION WITH OTHER SUPERVISORY BODIES

In parallel with the development of EU relations and connected to that HFSA further expanded its bilateral relations in 2002. Although Hungary's inclusion in FATF's blacklist significantly hindered the formal confirmation of relations, negotiations continued and in addition to the already working supervisory co-operations, 5 new agreements were signed24, and yet another 5 were fully prepared. *The guiding principle* in negotiating the cooperation agreements *was to develop an international supervisory network, which includes the supervisory authorities of all parent institutions of important institutions operating on the Hungarian market, the present and future EU members.* Of these agreements the agreement negotiated with the National Bank of Slovakia on banking supervision was of outstanding importance due to OTP's interests. In most EU countries cooperation agreements are important supplements to EU decrees, directives and national statues, which set the general framework for supervision and, therefore, offer rather conceptual and much less practical support for day-to-day work. The agreements make the exchange of information, or even on-site inspection possible when needed. In 2002 hfsa needed to use this possibility on several occasions in the course of inspections25, while two partner supervisions, the Belgian and the New York supervision, participated in the inspection of Hungarian subsidiaries.

In 2002 Mr. Fritz Bolkestein, *the commissioner responsible for EU's internal market*, paid a visit to Hungary. The Supervision's executives assessed the institution's status, independence and preparation for EU accession with Mr. Bolkestein and presented the results achieved in the fight against money laundering. Upon the Supervision's invitation, on the occasion of signing cooperation agreements, or on occasion of conferences *16 foreign supervisory authorities' presidents* were hosted by HFSA last year, including Sir Howard Davies, the president of the integrated UK supervision and 24 New York State Banking Supervision, Austrian Insurance Supervision, insurance supervisory agreement with the integrated German supervision, National Bank of Slovakia and the Cyprus Securities and Capital Market Supervision. Jochen Sanio, the president of the integrated German supervision. These visits created an opportunity for the Supervision to further strengthen its international ties and exchange experience on the issues of EU accession and the Basel capital accord, and furthermore, on the results of integrated supervisory functions.

Participation in the work of international organizations

Similarly to the already mentioned international activities, first and foremost related to the EU, HFSA took an active role in other international financial organizations as well. As a result of the efforts of HFSA in the past and the contribution to the work of committees and workshops international organizations today specifically contact HFSA in the course of developing surveys that affect the financial sector, at times of making comparisons and in elaborating international recommendations. This way the Supervision may join the work of these organizations as an equal partner. In the cooperation with the *World Bank* the focus shifted, as a consequence of the country's development, from on-site inspections to surveys by filling out questionnaires touching upon several different topics in the area of finance (integrated supervision, credit institution crisis management, or credit information systems, etc.).

OECD has several expert committees, of which the Financial Markets Committee, the Insurance Committee and the Funds Working-party stand out from a supervisory perspective. HFSA regularly and actively participated in their meetings and in the preparatory efforts.

The international organization responsible for insurance, *IAIS* and its working committees also request regular, personal and written contributions from HFSA. In case of the international organization of securities, *IOSCO*, personal participation is limited to the annual general meetings, although the Supervision always takes part in big tasks (e.g. in 2002 the implementation of IOSCO Principles in individual countries) and in surveys by questionnaire. HFSA will probably be able to join the IOSCO multilateral supervisory cooperation agreement in the late spring of 2003.

The representative of HFSA has an executive position in the International Network of Pensions Regulators and Supervisors (*INPRS*). Similarly to previous years HFSA fulfils the secretarial position in the Group of Banking Supervisors from Central and Eastern Europe *(BSCEE)*, which substantially raises the prestige of the Hungarian supervision both in the group involving 18 countries and in international organizations. The group's annual report is regularly prepared by HFSA and in 2002 the Supervision cooperated in the organization of the annual general assembly and two seminars as well.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY

Fight against money laundering

Stepping up the fight against money laundering was in the focus of supervisory efforts already in 2001. Later this gained special emphasis by the fact that in the middle of the year FATF listed Hungary among non-cooperative countries in the fight against money laundering. Although that had no immediate and severe consequences that would have paralyzed the financial market, it caused several difficulties to domestic players. The market sanctions meant a real and continuous threat to the Hungarian economy and resulted in worse terms and conditions in contracts and agreements. *In case of the Supervision it was an obvious drawback that the prepared international supervisory agreements, which had been agreed in details and ready for signing,* were not concluded because the developed countries' supervisory authorities could not sign an agreement with the supervision of a country on FATF's list. By the end of 2001 the radical changes needed in the statutory environment were completed. HFSA had a leading role in that. However, to be removed from FATF's list declaring the principle is not enough, actual implementation is just as strictly monitored. As a result of the work carried out in that respect, which was for the most part coordinated by *the Supervision, on the 21st of June, the closing day of FATF's June 2002 meeting, Hungary was officially removed after barely a year from the list of non-cooperating countries.* In 2002 the Supervision's 2001 recommendation related to money laundering was revised before the legislative amendments. HFSA developed the sample regulation on the fight against money laundering and sent it to more than two thousand concerned institutions, on the basis of which these institutions drafted their own rules. After the necessary modifications and additions the Supervision approved these regulations. HFSA organized and conducted the studies of the Council of Europe, IMF and FATF focused on money laundering. The three international organizations inspected the actual fight against money laundering on site consulting with all of the relevant authorities (Ministry of Finance, Ministry of Justice, the Prosecution and the Police, etc.) and a representative group of domestic market players. In all areas criticized during the 1998/1999 inspection of the Council of Europe (anonymous deposits, poor coordination between authorities and insufficient police resources for the fight against money laundering) the changes were assessed positively. The last agreement to be negotiated with the French banking supervision is under finalization. In addition to the previous achievements the Council highlighted the active supervisory control over the financial institutions' practices in the fight against money laundering. Ms. Clarie Lo, the President of FATF, also praised the progress made with respect to fighting money laundering during her visit to the Supervision.

HFSA has taken a lion's share of the work conducted in the Interdepartmental Committee Against Money Laundering3 and in its sub-committee for codification dealing with the necessary amendments to the Act on money laundering and the preparations for three related government resolutions. The Supervision joined the work of drafting FATF's new recommendations, prepared several reports for FATF and other international organizations on the implementation of money laundering related provisions. HFSA coordinated the debate on the draft FATF report preparing the removal of Hungary from the list as it played an active role in the discussions and international negotiations aiming at Hungary's removal from the list. Furthermore, the Supervision was also active in the communication work related to money laundering (via its Internet homepage, radio, or television, etc.) and organized a successful international conference about the topic in March 2002. Money laundering was incorporated into the comprehensive supervisory inspections' program and special investigations focused on money laundering were also conducted. The majority of special purpose inspections, which amount to 36 percent of all on-site inspections, were directed toward institutional practices in the fight against money laundering. *Based on those the overwhelming majority of the supervised institutions complied fully with the strict prescriptions related to money laundering and acted with due diligence and care in the course of their day-to-day operations.* Exceptions mostly occurred in the insurance sector, primarily because of the complete lack of deficiencies in, personal identification and the absence of compulsory internal training. In these cases the Supervision took strict actions against the institutions. Most money laundering related reports were received from banks; certain banks introduced highly sophisticated electronic screening systems to identify suspicious transactions. Most of the reports were about cash transactions; typically these reports were related to non-resident private individuals' transactions. The use of non-registered deposit books was abolished and 90 percent of the owners of anonymous deposits had been identified by the end of the year. This accomplishment exceeded the international expectations.

Quality management

In order to further develop quality management, tighten internal regulations and meet the most stringent requirements the Supervision aimed at *creating and developing a quality oriented set of values and introducing advanced quality management tools and methods.* For that reason in 2002 HFSA introduced its quality management system and *in November 2002 acquired the ISO 9001:2000 certification.* The certifying auditor, SGS Switzerland SA International Certification Services (Zurich), awarded the quality management certificate without written qualification. By organizing supervisory processes into procedures under the quality management system the efficiency of internal regulation has improved, while the scope of individual responsibilities has become clearer. The process-centered approach has strengthened in professional work, employees are more intensively involved in decision-making and cooperation between the specialized fields has become more efficient. The activities' permanent control is assured by regular internal audits. The quality control was developed with high-level executive support and involved many staff members. However, the aim of *the Supervision* was not merely to obtain an ISO certificate, rather it *intended to have a complete quality audit of its activities as the first among domestic institutions of public administration.* As part of the integrated quality control system and simultaneously with the establishment of the ISO based quality management system HFSA was the first to employ the domestic model of the *Common Assessment Framework (CAF)* developed in the European Union, a tool for the development of public administration. At the same time a survey was completed about staff satisfaction, how well the Supervision is known and what its reputation was like. The *staff's level of satisfaction was surveyed* in order to better understand the background of the CAF results. The survey covered the relationship between employees and the institution, how managers were seen, the factors that most influenced employee satisfaction, identification with institutional objectives, the degree of commitment and dedication and the factors that had the biggest effect on performance. 93.4 percent of employees participated in the survey according to which the level of employee satisfaction at HFSA is 64.4 percent. The IIASA-Shiba Foundation awarded a certificate in recognition of outstanding work in the field of quality control within the public administration and public service category to the Supervision in 2002.

Data rationalisation and it developments

Following the establishment of integrated supervision and based on its statutory obligations HFSA defined the methodological framework of its activities and clearly identified its supervisory responsibilities. The necessary developments were identified and prepared in 2001 and the projects were implemented in 2002.

Following the clear identification of supervisory duties and the clarifications of the Supervision's expectations with respect to information supply, as a first move, *the Supervision carried out a complete review of the data supply and then rationalised information supply within the framework of the data rationalization project that ended in April 2002.5* Starting from open questions approximately 400 relevant indicators were identified, offering supervisory information on the capital position of the supervised sectors, the quality of assets, liquidity and profitability and the possibility of making related forecasts. The data required for these indices was one of the starting points for the data rationalization project. The objective was that, while the quantity of data should be decreased as much as possible, the utilization of the information received should improve.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

Since its foundation in April 2000 the Hungarian Financial Supervisory Authority (HFSA) has quickly become a service provider focusing on prevention and engaged in dialogue with the supervised sectors in contrast to HFSA's enforcement oriented predecessors. That way the Supervision has earned a high reputation in the Hungarian markets, while foreign experts regard it as a pioneer of consolidated supervision. In this period a single unified supervisory institution emerged and consolidated its position in Hungary. When the HFSA started attending to its specific tasks in 2002, for the most part the statutes guaranteeing supervisory independence were already in place. Independence was solidified by the fact that last year, for the first time after the harmonization of the fee structure effective from the beginning of the year, the Supervision financed its activities strictly from its own revenues, with no government support. However, its own regulatory powers are still needed to ensure the institution's full autonomy.

The creation of the system of consolidated supervision could be cited among last year's major achievements. Integrated supervisory procedures and methods were extended to all types of financial institutions, ahead of many of the supervision's international counterparts.

STATISTICAL TABLES

Number of the financial institutions (at year-ends)

Type of financial institution	2000	2001	2002
Banks and specialized credit institutions	42	41	39
Saving cooperatives	192	186	183
Credit cooperatives	7	7	6
Financial institutions, total	**241**	**234**	**228**

Ownership structure of financial institutions in 2002 on the basis of registered capital (%) (at year-end)

Item	Type of financial institution			Total
	Banks	Saving cooperatives	Credit cooperatives	Financial institutions
Public sector ownership	27.3	6.3	0.0	26.6
Other domestic ownership	8.7	93.4	100.0	11.3
Domestic ownership total	36.0	99.8	100.0	38.0
Foreign ownership	60.5	0.2	0.0	58.6
Preferential and repurchased stocks	3.5	0.0	0.0	3.4
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	2001	2002
Public sector ownership	24.5	26.6
Other domestic ownership	11.4	11.3
Domestic ownership total	35.8	38.0
Foreign ownership	61.0	58.6
Preferential and repurchased stocks	3.1	3.4
Financial institutions, total	**100.0**	**100.0**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2000	2001	2002
Banks	94.0	93.7	93.3
Saving cooperatives	5.9	6.2	6.6
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	2000	2001	2002
Cash and settlement accounts	8.2	6.8	4.5
Securities for trading purposes	6.9	5.4	4.5
Securities for investment purposes	8.8	10.9	11.1
Central bank and inter-bank deposits	18.1	16.0	13.4
Credits	51.3	54.1	60.4
Proprietary interests	2.3	2.8	2.1
Own assets	2.2	1.8	1.8
Other assets	2.2	2.2	2.2
Balance sheet total	**100.0**	**100.0**	**100.0**
Liabilities	**2000**	**2001**	**2002**
Deposits	63.7	63.8	62.0
Inter-bank deposits	9.6	8.3	7.3
Borrowing	8.8	8.7	9.8
Dept securities	1.6	2.8	5.3
Subordinated liabilities	1.8	1.4	1.3
Special provisions	1.1	1.0	1.3
Own capital	9.3	9.7	9.4
Other liabilities	4.1	4.2	3.6
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	2000	2001	2002
Balance sheet total (HUF billion)			
Banks	8,427.4	9,499	10,825
Other credit institutions	532.5	638.0	779.0
Financial Institutions, total	**8,959.9**	**10,137.0**	**11,604.0**
Off balance sheet total (HUF billion)			
Banks	3532	4,773.8	7,511.8
Other credit institutions	12.4	19.7	27.0
Financial Institutions, total	**3,544.4**	**4,793.5**	**7,538.8**
Off balance sheet / balance sheet (%)			
Banks	41.9	50.3	69.39
Other credit institutions	2.3	3.1	3.5
Financial Institutions, total	**39.6**	**47.3**	**65.0**

Solvency ratio of the financial institutions (%)

Type of the financial institution	2000	2001*	2002 *
Banks	15.21	14.15	12.21
Credit cooperatives	15.11	15.32	14.32
Financial institutions, average	**15.21**	**14.20**	**12.31**

· Preliminary data

Portfolio Quality of the Banking System

Asset classification	2000		2001		2002	
	HUF billion	%	HUF billion	%	HUF billion	%
Problem free	8,382	91.5	10,190	87.7	14,009	90.8
Special mention	522	5.7	1 086	9.4	843	5.5
Non-performing	253	2.8	337	2.9	568	3.7
– substandard	79	0.9	158	1.4	266	1.7
– doubtful	97	1.1	89	0.8	166	1.1
– bad	76	1.0	90	0.8	136	0.9
Classified Total	**9,157**	**100.0**	**1,1613**	**100.0**	**15,421**	**100.0**
Specific Reserves (HUF billion)	**144.0**	**-**	**180.1**	**-**	**291.3**	**-**

The structure of deposits and loans of the financial institutions in 2002 (%) (at year-end)

	Deposits	Loans
Households	54.1	20.9
Government sector	3.1	6.6
Corporate	28.7	52.1
Foreign	7.6	6.2
Other	6.6	14.2
Total	**100.0**	**100**

The structure of deposits and loans of the financial institutions in 2002 (%) (at year-end)

Maturity of deposits		Loans	
At sight	33.4	Long term loans	67.5
Within one year	60.6	-	-
Over one year	5.94	Short-term loans	32.5
Total	**100.0**	**Total**	**100.0**

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

Type of the financial institutions	FOREX assets / total assets			FOREX liabilities / total liab.		
	2000	2001	2002	2000	2001	2002
Banks	36.39	34.40	29.75	36.52	34.77	28.87
Saving cooperatives	0.04	0.04	0.05	0.002	0.01	0.01
Credit cooperatives	0.00	0.00	0.03	0.00	0.0	0.00
Financial institutions, average	**36.39**	**32.24**	**27.75**	**36.52**	**32.58**	**26.93**

Profit and loss statement of banking sector

in HUF million

Items	2000	2001	2002
Interest income	791.7	806.6	863.4
Interest expenditure	481.5	458.5	477.1
1) Net interest income	310.2	348.1	386.4
2) Profit from other financial and investment services (including dividends)	90.0	74.5	-25.9
Of that: Profit from commissions	78.9	99.6	128.7
Of that: Net provisions	-48.5	..	..
3) Gross financial and investment services profits (1+2)	400.2	422.5	360.4
4) Overheads	294.1	307.2	350.7
5) Extraordinary profits	-9.3	20.0	7.1
6) Pre-tax profit (3-4+5)	96.8	135.3	16.8

Average balance sheet items of the banking sector

in HUF billion

Items	2000	2001	2002
Average balance-sheet total			
(assets total)	7,770.0	8,611.6	9,736.5
Average own capital	699.1	860.5	1008.8

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

Items	2000	2001	2002
In proportion to the average balance –sheet total			
Interest income	10.19	9.37	8.87
Interest expenditure	6.20	5.32	4.90
1) Net interest income (interest margin)	3.99	4.04	3.97
2) Profit from other financial and investment services (including dividends)	1.16	0.86	-0.27
Of that: Profit from commissions	1.02	1.16	1.32
Of that: Net provisions	-0.62	..	..
3) Gross financial and investment services profits (1+2)	5.15	4.91	3.70
4) Overheads	3.79	3.57	3.60
5) Extraordinary profits	-0.12	0.23	0.07
6) Pre-tax profit (ROA)	1.25	1.57	0.17

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

in billion HUF

Revenues	2001	2002
1. Interest income	883.4	947.8
2. Other net non interest income	78.5	-22.4
Of which: Net income from commissions	107.6	138.8
Dividends	5.6	4.5
3. Extraordinary income	33.9	19.4
Revenues total (1.+2.+3.)	**995.8**	**944.8**
Expenditures	**2001**	**2002**
1. Interest expenditures	497.8	518.5
2. Overheads	340.8	389.3
3. Extraordinary expenditures	15.6	11.3
Expenditures total (1.+2.+3.)	**854.2**	**919.1**

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

Type of the Financial institutions	Registered capital	/Total assets	Own funds	/Total liab.	Total assets
	HUF billion	%	HUF billion	%	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**

Structure of registered capital and own funds of financial institutions in 2002

Type of the financial institutions	Registered capital	/Total assets	Own funds	/Total liab.	Total assets
	HUF billion	%	HUF billion	%	HUF billion
Banks	445.4	4.1	1,021.1	9.4	10,825.0
Cooperative financial institutions	14.0	1.8	50.3	6.5	779.0
Financial Institutions, average	**459.4**	**4.0**	**1,071.4**	**9.2**	**11,604.0**

2002 DEVELOPMENTS IN THE LATVIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The national economy of Latvia continued to show stable growth in 2002. As a result of high domestic demand, GDP increased by 6.1%.

In 2002, the number of unemployed persons registered with the State Employment Service declined by 2.1%, and the unemployment rate dropped to 7.6% of economically active population. Consumer price inflation in Latvia is among the lowest in the countries of Central and Eastern Europe. The annual average inflation was 1.9%.

The general government consolidated budget posted a fiscal deficit of 131.1 million lats, or 2.5% of GDP at the end of the year.

In 2002, the current account deficit of the balance of payments equalled 7.8% of GDP (9.6% in 2001). Growth in exports of goods and services exceeded that in imports, and the ratio of goods and the balance on current transfers against GDP improved.

DEVELOPMENT IN THE BANKING SYSTEM

In 2002, sustainable growth of the Latvian banking sector continued, which is evidenced by an increase in all major indicators of banking activities.

At the end of 2002, the banking sector of Latvia still comprised 22 banks and one branch of a foreign bank (Latvian Branch of Nordea Bank Finland Plc (Finland).

In 2002, changes in the structure of the total paid-up share capital of banks took place and the share of foreign capital in the paid-up share capital of banks comprised 54.4% at the end of the year. Foreign shareholders owned more than 50% of the bank's share capital in nine banks and the market share of these banks accounted for 42.8% of the banking sector's total assets. Six banks were subsidiaries of foreign banks. The Government held shares only in 2 banks. In 2002, the paid-up share capital of fully Government-owned *JSC Latvijas Hipoteku un zemes banka* was increased considerably from 7.7 million lats to 17.8 million lats and the Government holding in total accounted for 7.3% of the paid-up share capital of banks at the end of 2002.

In 2002, banks' assets increased by 27.9%, loans by 29.9%, deposits by 31.8%, and equity by 24.4%.

The reporting year saw a rapid growth in bank lending. At the end of the reporting year, 88.9% of total loans were granted to domestic borrowers. The ratio of loans issued by banks to residents to gross domestic product had grown from 29.5% at the end of 2001 to 36.4% by the end of 2002.

The remarkable growth of lending did not result in deterioration of the loan portfolio quality, share of non-performing loans decreased from 2.8% of total loans at the end of 2001 to 2.0% at the end of 2002.

Mortgage lending developed particularly rapidly. Its growth rate in the reporting period amounted to 72.8%; consequently, the share of mortgage loans in the loan portfolio of banks increased to 19.9% at the end of 2002. The ratio of mortgage loans to gross domestic product had grown from 5.0% at the end of 2001 to 7.9 % by the end of 2002.

The amount of deposits in 2002 grew by 31.8%, totalling 3 070.3 million lats at the end of the year. Deposits of residents increased by 25.0% (including deposits of private persons, which grew by 29.5%). In the reporting period, deposits of private persons constituted the largest share in total deposits made by residents, i.e. 51.5%, while the share of private undertakings constituted 32.5%. Export of financial services is an important business line for Latvian banks and 54.3% of deposits were non-resident deposits.

In 2002, the audited profit of the banking sector grew by 21.2%, reaching 56.5 million lats by the end of the reporting period. Capital adequacy ratio was 13.1% at the end of 2002, comfortably above the required minimum of 10%. If banks are split into three groups by the amount of their assets (I - with assets up to 100 million lats, II - with assets from 100 to 300 million lats, III – with assets more than 300 million lats), a strong correlation between the capital adequacy ratio and the amount of assets is revealed. Smaller banks have considerably higher capital adequacy ratio than average and big banks. In 2002, the difference between the capital adequacy ratio for different groups of banks narrowed, although remained notable. In 2002, the capital adequacy ratio decreased by 11.7 percentage points, from 42.1% to 30.4%, for banks of group I; by 3.2 percentage points, from 17.7% to 14.5%, for banks of group II; by 0.3 percentage points, from 11.4% to 11.1%, for banks of group III.

Lending rates fell rapidly in 2002. Interest rates on loans in lats reported the most marked decline. The weighted average interest rates on loans in lats to domestic enterprises and private persons decreased notably for both short-term and long-term transactions (by 4.5 percentage points, from 9.9% to 5.4%, for short-term loans; and by 2.4 percentage points, from 9.8% to 7.4%, for long-term loans). Such a downslide in lending rates resulted from the Bank of Latvia's monetary policy, competition among banks, and a gradual reduction in the money market interest rates in 2002, to which the interest rates of bank loans with a floating rate are pegged[7].

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

The legislative framework for the banking sector complies with the requirements of the EU directives in all material aspects. The strategy of the Financial and Capital Market Commission (hereinafter – the Commission) provides for further enhancement of the regulatory framework to keep it in line with the new *acquis*, international standards and best practices and developments in the financial sector.

In 2002, several new regulations as well as some amendments to previously approved regulations of the Commission were approved, which came into effect either within the year 2002 or on 1 January 2003.

The Regulations for Obtaining Permits of the Financial and Capital Market Commission Regulating the Operation of Credit Institutions and Credit Unions and for Providing Information were formulated taking into account amendments made to the Law on Credit Institutions (previously required formal permission to acquire

[7] Annual Report of the Bank of Latvia for 2002.

or increase a qualifying holding in a bank has been substituted by non-objection procedures). In accordance with the said regulations persons acquiring a qualifying holding in a bank will henceforth notify the Commission of their intention to acquire, increase, decrease, or dispose of the qualifying holding. In order that the Commission may ascertain the compliance of supervisory board members, executive board members, the head of a foreign bank subsidiary with legislative requirements, the credit institution will have to submit to the Commission notification, an expanded professional biography and copies of identification documents of the supervisory board, executive board members, the head of the foreign bank subsidiary.

Taking into account requirements of the EU Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, the Regulations on the Provision of Information Regarding Persons with whom a Credit Institution has Close Links were adopted. The Regulations determine procedures as to how information to the supervisory authority is to be provided, if a credit institution has established close links with third persons.

In 2002, in order to ensure an efficient procedure for out-of-court settlement of disputes between a credit institution and its customers, the Commission prepared Recommendations for the Formulation of Efficient Procedures for Out-of-court Settlement of Disputes between a Credit Institution and Its Customers regarding Credit Transfers and Electronic Transactions, which set basic principles for a more efficient dispute settlement process than provided by the general procedures for court settlement of disputes. The Ombudsman of the Association of the Latvian Commercial Banks, who reviews complaints of banks' customers regarding credit transfers and electronic transactions, has been operating since 1 January 2003. Decisions taken in settling disputes will be recommendations only, thus the rights of parties involved in a dispute to apply to public authorities or court pursuant to general procedures will not be restricted.

In order to enhance transparency of activities of banks and to promote the market discipline, Regulations on Credit Institutions' Quarterly Reports to the Public (effective as of 23 January 2003) were formulated. The Regulations set the minimum requirements for quarterly disclosures of the information on credit institutions' activities and financial standing.

THE ACTIVITIES OF THE COMMISSION IN THE FIELD OF BANKING

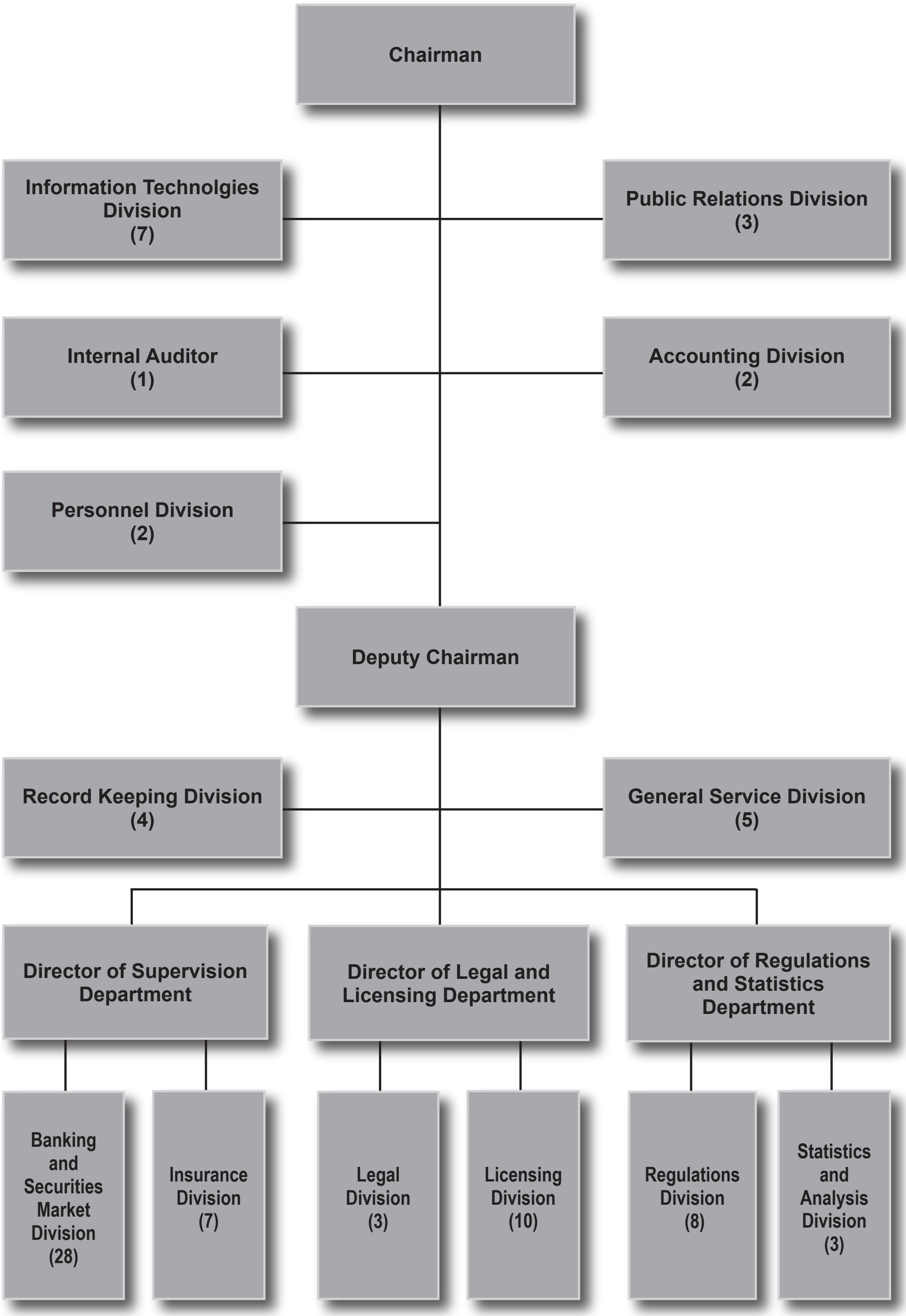
In 2002, no credit institution operating licence was issued or cancelled.

In 2002, the supervision of operations of market participants carried out by the Commission was based on on-site examinations and an off-site analysis of risks inherent in banking activities. The purpose of the supervision was to timely detect causes of possible problems and find solutions to prevent deterioration of the situation in order to decrease the possible effects of a market participant's deficiencies on the entire market.

According to the Law on Credit Institutions, every bank has to be examined not less than once every two years. In 2002, the Commission conducted 44 bank examinations. As in previous years, the quality of assets was assessed, the risk management and internal control system analysed.

In 2002, lending continued to increase substantially. The Commission paid particular attention to the evaluation of the banks' credit risk management systems in order to identify any shortcomings and potential problems related to loan repayment. The banks' strategies, as well as their policies and procedures regarding the granting of loans were also assessed. The Commission also assessed the compliance of bank procedures for identifying clients and detecting unusual and suspicious financial transactions with the requirements of the Law on the Prevention of Laundering of Proceeds Derived from Criminal Activity.

STRUCTURE OF THE FINANCIAL AND CAPITAL MARKET COMMISSION



FINANSU UN KAPITĀLA TIRGUS KOMISIJA

INTERNATIONAL ACTIVITIES

In the reporting year, the Commission was engaged in active cooperation with major international organisations in the field of supervision of the financial and capital market.

At the end of the reporting year, representatives of the Commission were invited, as of 2003, to participate as observers in meetings of several committees of the European Commission, namely, the Banking Advisory Committee, the Insurance Committee, the European Securities Committee, the UCITS Contact Committee, the Committee of European Securities Regulators, the Banking Supervision Committee of the European Central Bank, as well as in several working groups.

Although Latvia will participate in these committees only as an observer until it formally joins the European Union in May 2004, this participation will allow it to follow first-hand the latest developments in regulatory requirements for financial market activities and in supervisory practice.

Within the framework of the Financial Sector Assessment Programme, the World Bank and the IMF gave a positive evaluation of the Latvian financial sector, which confirmed the general competitiveness of the Latvian financial market and the quality of the supervision. In April 2002, supervisory practices were assessed by the team of EU experts within the Peer Review framework. The Final Report recognised that standards of supervisory practices are good. The follow-up mission in May 2003 confirmed the previous positive opinion.

The Commission co-operates with foreign financial supervisory authorities. All in all, by the end of December 2003, the Commission had concluded 16 agreements on mutual exchange of information with financial supervisory authorities of various countries, out of which 9 in the field of banking supervision.

STATISTICAL TABLES

Number of financial institutions (at year-end)

Type of financial institution	2000	2001	2002
Banks	21	22	22
Credit unions	17	22	26
Foreign bank branches	1	1	1
Financial institutions, total	**39**	**45**	**49**

Ownership structure of financial institutions in 2002 on the basis of registered capital (%) (at year-end)

Item	Type of financial institution		Total
	Banks	Credit unions	
State ownership	7.3	-	7.3
Other domestic ownership	38.3	100.0	38.4
Domestic ownership total	45.6	100.0	45.7
Foreign ownership	54.4	-	54.3
Financial institutions, total	**100.0**	**100.0**	**100.0**

FINANSU UN KAPITĀLA TIRGUS KOMISIJA

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

Item	2000	2001	2002	2002/2000
State ownership	3.8	4.5	7.3	192.1
Other domestic ownership	26.4	27.8	38.4	145.5
Domestic ownership total	30.2	32.3	45.7	151.3
Foreign ownership	69.8	67.7	54.3	77.8
Financial institutions, total	**100.0**	**100.0**	**100.0**	–

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

Type of financial institution	2000	2001	2002
Banks	96.82	96.6	95.97
Credit unions	0.04	0.05	0.06
Foreign bank branches	3.14	3.35	3.97
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Assets	2000	2001	2002
Cash and balances with the Bank of Latvia	6.3	5.9	5.7
Claims on credit institutions	28.3	24.2	25.2
Loans	40.3	47.3	48.1
Bonds and other fixed interest securities	17.7	16.3	15.6
Shares and other variable yield securities	1.3	0.9	0.7
Participating interest and other financial investments	0.3	0.5	0.6
Other assets	5.8	4.9	4.1
Liabilities	**2000**	**2001**	**2002**
Amounts owed to the Bank of Latvia	1.6	0.6	0.7
Amounts owed to credit institutions	11.5	15.0	14.4
Deposits	69.1	67.4	69.4
Other liabilities	7.2	6.5	5.5
Provisions	2.2	1.6	1.3
Total equity	8.4	8.9	8.7

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

Type of financial institution	2000	2001	2002*
Banks	24.0	39.9	9.0
Credit unions	1.4	1.6	0.6
Foreign bank branches	56.7	112.1	24.5
Financial institutions, total	**25.0**	**42.3**	**9.6**

* As of 1 January 2002, currency and interest rate futures and forwards are shown in a balance sheet

Solvency ratio of financial institutions

Type of financial institution	2000	2001	2002
Banks	14.3	14.2	13.1

Asset portfolio quality of the banking system

Asset classification	2000	2001	2002
Standard	93.3	95.8	97.1
Watch	2.1	1.4	0.9
Substandard	2.5	1.7	0.9
Doubtful	1.1	0.7	0.7
Lost	1.0	0.4	0.4
Classified total	100.0	100.0	100.0
Specific reserves	**2.9**	**1.7**	**1.5**

The structure of deposits and loans in 2002 (%) (at year-end)

	Deposits	Loans
Households	23.5	19.8
Government sector	2.7	2.0
Corporate	18.6	66.3
Foreign	54.3	11.1
Other	0.9	0.8
Total	**100.0**	**100.0**

The structure of deposits and loans in 2002 (%) (at year-end)

Maturity of deposits		Loans	
At sight	71.9	Long term loans	36.9
Within one year	21.3	Medium-term loans	44.4
Over one year	6.8	Short-term loans	18.7
Total	**100.0**	**Total**	**100.0**

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

Type of financial institution	FOREX assets / Total assets			FOREX liabilities / Total liab.		
	2000	2001	2002	2000	2001	2002
Banks	65.1	64.3	64.2	66.21	65.8	65.6
Credit unions	14.5	15.2	25.2	10.0	16.3	25.4
Foreign bank branches	57.0	42.1	38.5	69.4	66.4	71.0
Financial institutions, average	**65.1**	**64.3**	**64.2**	**66.2**	**65.8**	**65.6**

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

Revenues	2000	2001	2002
Interest income, incl.:	55.8	58.8	57.2
interest on loans	34.3	38.3	40.4
interest on deposits with credit institutions	11.1	8.2	5.5
interest on bonds and other fixed income securities	9.9	10.9	9.6
interest income on futures and forwards	0.3	1.2	-
Dividends	0.1	0.1	0.1
Commission received	23.8	23.1	24.6
Profit/loss from securities and currencies trading	9.2	8.9	10.4
Other	11.1	9.1	7.7
Expenditures	**2000**	**2001**	**2002**
Interest expense	28.1	32.7	29.1
Commission paid	4.8	5.1	5.6
Operating expenses	40.2	38.9	42.8
Depreciation	7.5	7.8	8.4
Loan loss provision expense	15.2	11.1	8.5
Other	4.2	4.4	5.6

Structure of registered capital and own funds of financial institutions in 2002

in thousands of EUR

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liab.
	EUR	%	EUR	%
Banks	465,138	6.7	562,528	7.8
Credit unions	818	18.5	1,109	25.0
Foreign bank branches	-	-	-	-
Financial institutions, average	**465,956**	**6.7**	**563,637**	**7.8**

2002 DEVELOPMENTS IN THE LITHUANIAN BANKING SYSTEM

LIETUVOS BANKAS

MACROECONOMIC ENVIROMENT

The growth of the Lithuanian economy that started in 2000 continued and was reflected by 6.7 per cent growth of the Gross Domestic Product (GDP) in 2002. The year was successful from other perspective as well: Lithuania made marked progress in the integration into the EU process and was invited to become a member of the Union as well join the NATO.

Last year the GDP increase was largely determined by the development of economy branches that were oriented towards the growing internal demand. Finance, construction, telecommunications and retail trade sectors developed especially quickly. Economy growth was supported by further growth of exports that was influenced by quick modernization of manufacturing and increasing investments. The most important economy branch is manufacturing: the value added produced in this branch of economy was 19.4 per cent ahead of the figure for the last year to account for 18.0 per cent of GDP. Such industries as light industry, manufacture of articles of wood, paper and furniture developed rapidly.

Macroeconomic stability was maintained through a balanced public finance policy, owing to which the current account deficit stood at 5.3 per cent in 2002 and inflation remained negligible. 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.

Foreign trade balance data report about maintaining close trade relations with EU countries in 2002, exports to which comprised nearly half of the domestically produced output and services. Although the economic growth of the main trade partners in the EU slowed down in 2002, goods' export scope from the country increased by 10.7 per cent. This proves that Government measures encouraging competitiveness and growing investments had positive impact on the country economy. 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 13.5 per cent share in the total exports, Russia (12.1 %) and Germany (10.3 %). Major exports comprised mineral products, textile articles and agricultural products. As to imports, most goods, again, were imported from EU countries (49.4 % of total imports of goods); CIS countries were second by significance with a 25.3 per cent share in the total import value. Import increase in 2002 was conditioned by the growing consumption and investments (the scope of imported production last year increased by 12.4 per cent).

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[8], should speed up further integration of national economy into the EU economic area. According to the volume of foreign direct investment in Lithuanian economy in late 2002, the leadership was with Scandinavian countries (Sweden and Denmark), Estonia and Germany. The bulk of investment (about 29.3 % of the total) went to manufacturing, financial intermediaries (20 %) and trade (17.3 %). Not only the enterprises, but individuals as well experienced the rise of economy: dynamically developing enterprises established new working places, average unemployment ratio reduced from 12.5 to 11.3 per cent, average wage increased by more that 5 per cent.

In 2002, financial sector preserved the tendencies of stability and growth. Foreign assets of the Bank of Lithuania augmented by EUR 390 million or 20 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 (average interest rate for long term loans in national currency reached 6.1 per cent) and more favourable borrowing possibilities appeared for both economic entities and the population, which increasingly used the services provided by commercial banks. In 2002, not only the banks, but leasing and insurance companies also successfully developed their activities.

Further progress of the Lithuanian finance system and economy growth were positively evaluated by the largest international rating agencies that in 2002 issued higher borrowing ratings for the country. Rating agency Fitch noted that Lithuanian finance system is sound and stable, country has achieved significant progress when Government followed strict fiscal policy and constantly implemented structural reforms, therefore, at the end of 2002, they increased Lithuanian credit rating for long term loans in foreign currency from BBB– to BBB and rating agency Moody's issued by three points higher rating increasing it from Ba1 to Baa1. At the beginning of 2003, "Standard&Poor's" reviewed their rating and issued Lithuania long term borrowing in foreign currency rating BBB+ instead of the previous BBB.

DEVELOPMENT OF THE BANKING SYSTEM

In late 2002, the Lithuanian banking system comprised:

- 10 commercial banks with 119 branches in different regions throughout the country;
- 4 branches of foreign banks;
- 2 representative offices of foreign banks.

In 2002, German investors intensified their activities in the domestic banking sector. In February 2002 there was a transaction signed regarding the selling of 76 per cent share block of the Lithuanian agricultural bank that was managed by the Government of the Republic of Lithuania to the German bank Norddeutsche Landesbank Girozentrale that received the Bank of Lithuania permission to acquire and manage more than 2/3 of bank shares. Strategic investor acquired third according to the size Lithuanian commercial bank that at the beginning of 2002 managed around 12 per cent of the market according to the assets.

By the end of 2002, foreign investor-owned capital prevailed in the domestic banking sector, the share of which rose from 81.1 per cent to 88.1 per cent. In 7 out

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

of 10 commercial banks foreign investors owned the better half of the share capital, whereas the influence of local investors, including state-owned shares, contracted visibly (from 18.9 % to 11.9 %).

Privatisation of state banks and intensifying activity of foreign investors contributed to the occurrence of noticeable changes in the banking sector in 2002. 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 April 2002, a license 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.

In 2002, banks successfully developed their activities by expanding crediting, increasing securities portfolio and developing services provided by daughter companies. Banking system assets increased by 12.2 per cent up to LTL 17.2 billion, loans issued to clients (lending to financial sector enterprises excluded) increased by 23.8 per cent and achieved nearly LTL 7.9 billion; deposits and LCs increased by 12.1 per cent and amounted to LTL 11.7 billion including deposits of individuals that increased by more than 8 per cent up to LTL 6.9 billion; shareholders' equity in 2002 increased by 20 per cent and exceeded LTL 1.7 billion.

In 2002, concentration in banking sector slightly reduced and the most important place was occupied by three largest banks having strategic investors. These banks managed 74 per cent of the banking system assets and had 83 per cent of individual deposits; they issued 72 per cent of the banking sector loans to private enterprises.

LEGAL AND INSTITUTIONAL FRAMEWORK FOR SUPERVISION OF FINANCIAL INSTITUTIONS

The role of the Bank of Lithuania and its responsibilities in supervising credit institutions are defined in the Law on the Bank of Lithuania, the new edition of which was adopted in 2001. These functions are directly performed by one of the structural units of the Bank of Lithuania, i.e. Credit Institutions Supervision Department.

The Department implements ongoing supervision of credit institutions using internationally recognized 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 licenses for Republic of Lithuania credit institutions;
- Management of the filing of licensed credit institutions and licenses 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;
- Drafting of legal acts for the regulation of activities of credit institutions;
- 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;

- 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.

KEY ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2002

In 2002, the Bank of Lithuania devoted a lot of attention to further improvement of risk management process and implementation of effective internal control system in banks. Internal control system has to ensure thorough risk (including credit, market, liquidity and operational) assessment, monitoring and control. Banks are recommended to use stress testing, i.e. having evaluated strategic activity aspects identify bank weaknesses and foresee in advance what highest loss it would incur under certain unfavourable conditions on the market as well as respectively prepare for that: establish management activity strategy under such conditions and identify alternative financing resources. In 2002, the Bank of Lithuania in its turn started testing potential unfavourable credit and liquidity risk scenarios of the banking system. In 2003, the assessment of probable impact of certain risk elements to the banking system results (by first of all analysing interest rate change influence on banks' net interest income) was started.

When continuing the program of EU legal acts harmonization with the requirements of EU directives, in 2002, the Bank of Lithuania completed implementation of the new procedure on capital adequacy calculation that is in compliance with the requirements of EU directives CADI and CADII. Banks started evaluating not only credit, but market risk (i.e. interest rate, equity securities' price, foreign currency exchange, transaction party, commodities' price, large positions) as well and calculating capital requirement to amortize this risk.

In 2002, the Bank of Lithuania paid considerable attention to further credit risk management in banks and started implementing the new conception of centralized loan risk database. Reformed database will create possibilities to better assess financial condition of potential borrowers, moreover, there will be preconditions created for implementing internal and external rating systems of borrowers as well as VaR models in the banks as it is foreseen in EU directives and the new Basle Capital Accord.

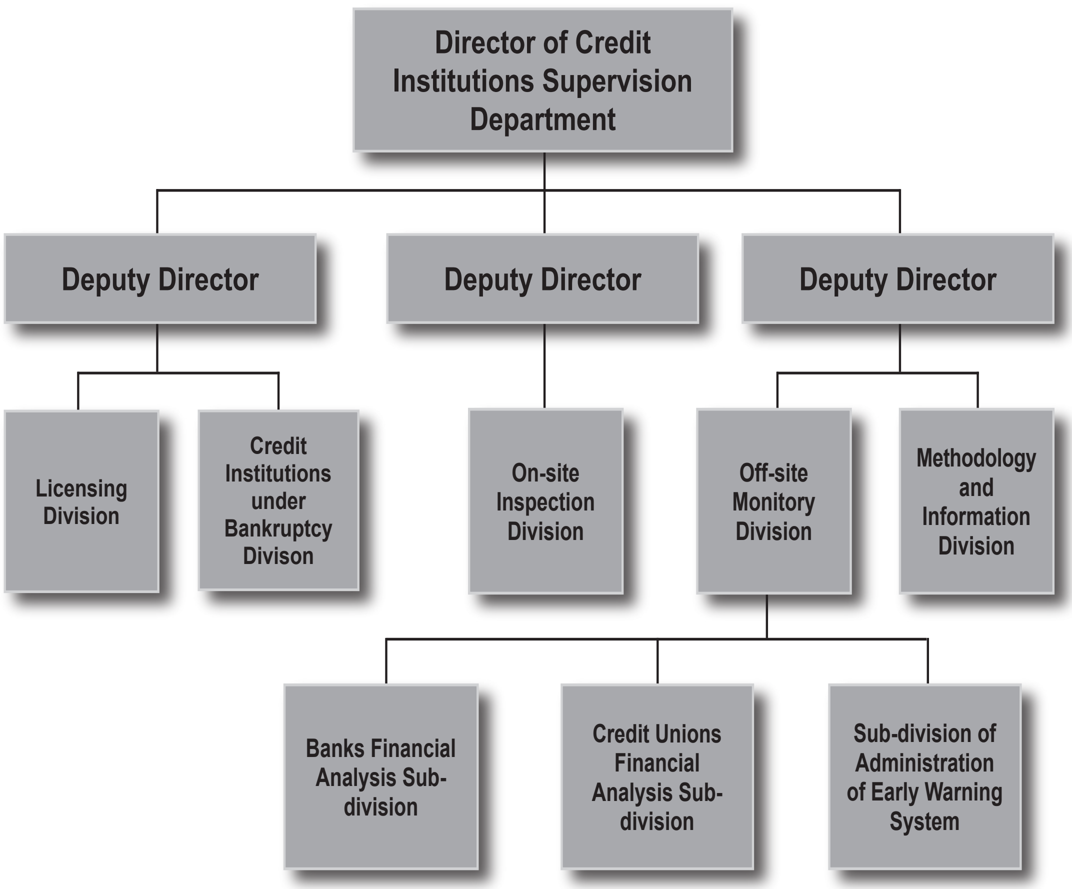
At the end of 2002, the Bank of Lithuania approved Methodological Recommendations to Banks Regarding Application of Internal VaR models. Methodological Recommendations prepared continuing EU legal acts implementation process and taking into consideration that banks expand operations with trading assets. Due to that in further perspective it is planned to create possibilities to calculate capital requirement by applying not only standard procedures but also using alternative risk assessment methods, such as VaR model based on statistical calculations as a result of which it is possible to receive assessment of potential losses for a certain period with a certain probability.

International experience proves that society trust in banks is increased by higher transparency of their activities and possibilities for market participants to get acquainted with bank financial ratios. In 2002, Bank of Lithuania set Minimum Requirements for Public Information and authorized banks to disclose the most important information about their financial status, asset quality, compliance with prudential requirements, etc. more frequently than it used to be before in their websites. The Bank of Lithuania every quarter in its website provides consolidated financial statements of the banking system and credit unions as well as informs the society about banking system activity ratios.

As well as in the previous years, in 2002, the Bank of Lithuania paid a lot of attention to the improvement of credit institution financial accounting and reporting. In this area close co-operation with international audit companies was continued, especially regarding the problems of implementation of IAS 39. As in 2001 the new EU directive regulating application of real value method in financial assets recognition and assessment was adopted, the Bank of Lithuania decided not to apply any restrictions for those banks that were prepared to apply IAS 39 and respectively adjusted financial statement for supervisory purposes forms.

At the beginning of 2003, Bank of Lithuania approved General Provisions for Classification of Doubtful Assets and Formation of General Provisions. This legal act embeds new outlook towards assessment of doubtful assets: it is foreseen to apply a more flexible and liberal asset classification procedure by creating possibilities to better evaluate risk of these assets, for example, the risk of each loan can be assessed individually and according to general criteria for that particular loan category. The Bank of Lithuania will set only minimum requirements and banks will have according these criteria to prepare their asset classification rules. These provisions will come into force as of 31 December 2003.

THE STRUCTURE OF CREDIT INSTITUTIONS SUPERVISION DEPARTMENT OF THE BANK OF LITHUANIA AT THE END OF 2002



INTERNATIONAL ACTIVITIES

During the preparation for membership in the EU, one of the monitoring measures of fulfilment of Lithuania's obligations during negotiations became *peer review*. In 2002, in Lithuania according to peer review model there was an assessment program of financial institutions' supervisory authorities performed. European Commission acknowledged progress of the banking sector and stated that banking system asset quality considerably improved, bad loan portfolio is constantly reducing and banking system is well capitalized. It is European Commission opinion that Lithuanian credit institution supervisory system complies with international practice and EU requirements and is able to ensure prevention of appearance of problem banks in the sector.

CO-OPERATION WITH OTHER SUPERVISORY AUTHORITIES

With strengthening globalisation processes in the banking sector, co-operation of the supervisory authorities 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, 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.

In 2002, Bank of Lithuania expanded working relations with Swedish financial institutions' supervisory authority, amended co-operation agreement with Polish supervisory authority and signed co-operation agreement with the National Bank of Belarus.

During the recent years co-operation between the Bank of Lithuania and other supervisory authorities of the financial sector has strengthened. 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 2002

In 2002, the Bank of Lithuania further improved and strengthened credit institution supervision by encouraging the development of safe, sound and competitive banking system in the country. Constantly continuing work that was started in previous years, the main attention was paid to the following areas of activity:

- further harmonization of credit institution supervisory system of the country with respective EU directives, continuation of implementation of the Basle Committee Core Principles for Effective Banking Supervision and other recommendations,
- improvement of thorough risk management in banks and respective preparation for ensuring activity continuation under extraordinary conditions,
- promoting transparency of bank activity and market discipline by disclosing more information to the public about the activities,
- during on-site inspection together with traditional bank activity areas starting analysing and assessing new risk factors, such as reliability of informational technologies,
- improving Early Warning System, analysis of bank activity ratios and forecasting methods of possible threats by creating preconditions for timely blocking negative processes that could influence bank stability,
- improvement of bank financial accounting and reporting order, keeping close contacts with international audit companies that audit banks,
- expanding and strengthening co-operation with respective foreign countries' financial sector supervisory authorities by exchanging the information necessary to ensure effective banking supervision.

STATISTICAL TABLES

Number of financial institutions (at year-end)

Type of financial institution	2000	2001	2002
Commercial banks	10	9	10
Foreign bank branches	3	4	4
Banks operating under special laws	1	-	-
Credit unions	38	41	54*

* including Central Credit Union

LIETUVOS BANKAS

Ownership structure of financial institutions in 2002 on the basis of registered capital (%) (at year-end)

Item	Type of financial institutions			Total
	Commercial banks	Foreign bank branches*	Credit unions	
Public sector ownership	0.1	-	41.1	0.5
Other domestic ownership	11.8	-	58.9	11.5
Domestic ownership total	11.9	-	100.0	12.0
Foreign ownership	88.1	100.0	-	88.0
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	2000	2001	2002	2002/2001
Public sector ownership	27.2	7.6	0.5	-92.1
Other domestic ownership	12.9	10.1	11.5	+28.8
Domestic ownership total	40.1	17.7	12.0	-23.1
Foreign ownership	59.9	82.3	88.0	+20.8
Financial institutions, total	**100.0**	**100.0**	**100.0**	**+13.0**

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

Type of financial institution	2000	2001	2002
Commercial banks	89.1	93.0	92.2
Foreign bank branches	3.7	6.8	7.4
Banks operating under special laws	7.1	-	-
Credit unions	0.1	0.2	0.4
Financial institutions, total	**100.0**	**100.0**	**100.0**

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

Assets	2000	2001	2002
Cash in hand	2.9	3.8	3.8
Claims on banks and other financial institutions	24.8	24.2	18.7
Securities	19.8	20.1	22.5
Loans granted*	42.1	41.3	45.6
Other assets	10.4	10.6	9.4
Liabilities	**2000**	**2001**	**2002**
Liabilities to banks and other financial institutions	14.4	14.7	14.8
Deposits and L/C	65.6	67.9	67.8
Other liabilities	10.0	7.5	7.4
Bank capital	10.0	9.9	10.0

** Net value*

LIETUVOS BANKAS

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

Type of financial institution	2000	2001	2002
Commercial banks	10.8	12.9	16.8
Foreign bank branches	13.1	18.7	10.6
Banks operating under special laws	-	-	-
Credit unions	-	-	-
Financial institutions, total	**11.3**	**13.3**	**16.3**

Solvency Ratio of Financial Institutions (%) (at year-end)

Type of financial institution	2000	2001	2002
Commercial banks	16.3	15.6	14.8
Foreign bank branches*	-	-	-
Banks operating under special laws	13.6	-	-
Financial institutions, average	**16.3**	**15.6**	**14.8**

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

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

Asset Classification	2000	2001	2002
Standard loans	56.6	70.4	76.2
Watch loans	32.7	22.2	18.0
Substandard loans	4.4	3.1	4.1
Doubtful loans	3.6	2.6	1.5
Bad loans	2.7	1.7	0.2
Non-performing loans/ Total loan portfolio	**10.7**	**7.4**	**5.8**

The structure of deposits and loans in 2002 (%) (at year-end)

	Deposits	Loans
Households	57.7	15.4
Government sector	6.9	8.9
Corporate	28.6	71.8
Foreign	4.9	3.6
Other	1.9	0.3
Total	**100.0**	**100.0**

LIETUVOS BANKAS

The structure of deposits and loans in 2002 (%) (at year-end)

Maturity of Deposits		Loans*	
At sight	**53.6**	**Long-term loans****	**24.2**
Within one year	43.7	Medium-term loans***	29.1
Over one year	2.7	Short-term loans****	46.7
Total	**100.0**	**Total**	**100.0**

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

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

Type of financial institution	FOREX assets/total assets			FOREX liabilities/total l iabil.		
	2000	2001	2002	2000	2001	2002
Commercial banks	52.4	49.8	32.1	52.6	50.1	41.2
Foreign bank branches	86.3	71.1	75.7	79.5	81.0	83.5
Banks operating under special laws	69.3	-	-	70.6	-	-
Financial institutions, average	**54.8**	**51.3**	**45.3**	**55.1**	**52.3**	**44.5**

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

Revenues	2000	‘2001	2002
Interest income	70.3	66.2	58.8
Profit from operations in foreign exchange	6.7	4.8	6.6
Income from services and commissions	19.1	22.3	23.3
Other bank income	3.9	6.7	11.3
Total revenues	**100.0**	**100.0**	**100.0**
Expenditures	**2000**	**2001**	**2002**
Interest expenses	34.7	30.1	23.7
Operational expenses	36.1	37.5	45.6
Expenses for specific provisions	9.5	9.4	7.3
Other expenses	19.7	23.0	23.4
Total expenses	**100.0**	**100.0**	**100.0**

Structure of registered capital and own funds of financial institutions in 2002 (at year-end)

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liabilities
	EUR million	%	EUR million	%
Commercial banks	321.4	7.0	502.2	12.2
Foreign bank branches	24.4	6.6	-1.0	-0.3
Credit unions	2.2	10.8	2.4	13.6
Financial institutions, average	**348.0**	**6.9**	**503.6**	**11.2**

2002 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MACEDONIA

MACROECONOMIC ENVIRONMENT

The macro economic performances of the Macedonian economy in 2002 were severely influenced by the security crisis evidenced during the previous year, which was a serious shock with long lasting consequences. The recovery of the capacities, the renewal of the connections with the foreign partners, the implementation of the ongoing projects, as well as the return of the confidence of the domestic and the foreign investors were considered to be the key prerequisites for re-acceleration of the economic growth and achievement of satisfactory growth rates. The macroeconomic indicators for 2002 confirm the necessity of a longer period of recovery from the effects of the crisis and more dynamic functioning of the overall economy. Thus, in 2002, the Macedonian economy registered a real growth rate of the GDP of 0.7%, with a fall being registered in the activity of the industrial sector.

The general monetary layout in 2002 was based on the maintenance of the price stability, as an ultimate legally defined monetary goal by conducting flexible monetary policy based on the Denar exchange rate targeting strategy (against the Euro starting from this year). Thus, in 2002, the achieved average inflation rate equaled 1.8%. Such inflation performances are within the framework of the medium-term inflation goal of the European Central Bank, which is of a great importance, taking into consideration the long-term orientation of the Republic of Macedonia towards the European Union.

In accordance with the accepted monetary strategy, in 2002 the NBRM took an active role on the foreign exchange market, where the supply of and the demand for foreign exchange mostly reflected the unfavorable developments in the foreign trade. The difficulties regarding the renewal of the lost markets and canceled contracts with the foreign partners due to the crisis in 2001, as well as the environment of high demand on the domestic market made the export of goods drop by 3.9%. Taking into account the dependence of the Macedonian economy on the imports (and the additional measures aimed at creating favorable conditions for import of used vehicles), the imports picked up by 15.9%, resulting in higher demand for foreign exchange for servicing the foreign liabilities. In such circumstances, the NBRM managed to close the gap between the supply and the demand for foreign exchange and to preserve the exchange rate stability by a net sale of foreign exchange. Nevertheless, at the end of 2002, the NBRM gross foreign exchange reserves remained at a satisfactory level, covering 4.5 - months of import. However, in 2002, the deficit in the current account of the balance of payments of the Republic of Macedonia increased. The realization of a portion of the donations from the donor conference and the private transfers enabled partial financing of the trade deficit. In this context, it is essential to mention the enforcement of the new Law on Foreign Exchange Operations (October 2002) which allows high degree of liberalization of the capital transactions, thus bringing the Republic of Macedonia closer to the contemporary market economies.

The outcome of the efforts for reforming, modernizing and restructuring of the banking system, made throughout many years, became particularly evident in 2002, in the time of the transfer of the payment operations to the banks and the Euro conversion. The reform of the payment system is regarded as one of the most successful reforms in the Macedonian economy. The NBRM plays the leading role in the new payment system, by settling the large-value payments between the banks through the RTGS system. In 2002, the NBRM also provided technical assistance for reforming the payment systems of other central banks worldwide, which is a proof of the excellent concept and efficiency of the reform. The new payment system operates on the basis of the principle of real time gross settlement and it is compatible with the payment systems in the developed economies. From the aspect of the banks, the reformed payment system provided enhanced capacity for liquidity monitoring and management, and introduced a new type of services the banks offer to the clients.

The Euro-conversion was an exceptional opportunity for mobilizing the households' foreign exchange savings in the banking system. It should be underlined that the Republic of Macedonia is among the top countries in transition according to the amount of funds that remained in the banks after the conversion (70%). Such situation confirms the strengthened confidence in the banking system and emphasizes the significance of the interest income as a source of income for the households.

In 2002, the currency in circulation was preserved at a high level, under the influence of the Euro-conversion and the reform of the payment operations. Taking into consideration the high level of currency in circulation and the increase of the transaction deposits, in 2002, the monetary aggregate M1 registered annual increment of 4.3%. Simultaneously, in 2002, the money supply M2 – Denar component increased by 7.9%. The change in the broadest money supply M4 in December was negative (9.8%), indicating the high comparison base due to the conversion of the "in-currencies" into Euro.

In 2002, the banks' credit policy showed certain responsiveness to the stabilization of the situation, the lower country risk and consequently, the lower credit risk of the clients. The lower amount of overdue claims of the banks indicates higher efficiency in the credit portfolio management, improved selection and higher financial reliability of the clients. In 2002, the banking system played an important role in the process of supplementing the households' financial potential, by more intensive extension of consumer and long-term housing credits. This increases the role of the banks in inducing the joint consumption and the investments, as factors of the economic development.

It should be noted that the year 2002 was of an exceptional importance for the NBRM as a monetary power of the Republic of Macedonia. In April 2002, the tenth anniversary of the monetary independence of the Republic of Macedonia, was celebrated, meaning ten-year of existence of the national monetary unit and the Central Bank. Throughout this period, the NBRM has developed into a modern institution with proved capacity for achieving the set goals. Therefore, the maintained price stability and the Denar exchange rate stability, the increase in the foreign exchange reserves up to the level of optimum import coverage, as well as the gradual strengthening of the supervisory function and the stability of the banking system should be stressed as the most significant accomplishments of the NBRM in the past decade of monetary independence. In this context, it should be underlined that the Republic of Macedonia is one of the rare countries in transition that avoided the systemic banking crisis, in spite of the numerous unfavorable circumstances. On the eve of the new challenges, the NBRM permanently improves its operations, and through the flexible conduct of the monetary policy and the clear determination to preserve the stability in the economy, it acts towards supporting the positive trends and accelerating the economic growth.

DEVELOPMENT OF THE BANKING SYSTEM

Structure of the banking system

As of December 31, 2002, the Macedonian banking system was consisted of 21 banks and 17 savings houses[9]. The savings houses did not have any significant influence in the performance of the banking system, since they accounted for only 0.97% of the total banking assets. The future perspectives and status of this segment of the banking system is an open question that needs to be resolved in the near future.

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 December 31, 2002, the two largest banks hold 54.1% of the total assets of the banking system, while their market share accounted for 52.8%. If the amount of mobilized deposits into the banks is used as an indicator for analysis, the concentration of the banking system is even more significant. As of December 31, 2002, the two largest banks hold 64.8% of the total deposits.

As of December 31, 2002, the share of the foreign capital in the total capital of the Macedonian banking system accounted for 44.4%. The foreign capital was present in 16 banks in the Republic of Macedonia, out of which 7 banks were in majority foreign ownership, representing 44% of the total assets of the banking system. From the remaining 13 banks, 12 banks were in majority private ownership of domestic shareholders and accounted for 54%, and 1 bank was 100% state owned and accounted for 2% of the total banking assets.

The balance sheet structure

The total assets of the banking system as of December 31, 2002 accounted for 93.213 million denars, that represent a decrease of 11.8%, compared to December 31, 2001.

The liquid assets had a dominant share in the total banking assets accounting for 44.8%, despite the trend of their moderate decrease during the 2002. Net loans to non-banking sector accounted for 34.4% of the total banking assets. Other significant part of the total assets of the banking system was the placements to banks, accounting for 36.3% of the total assets.

As of December 31, 2002, the total deposits represented 62.1% of the total sources of funds. The households' deposits mostly influence the movements of the total deposits, since their share accounted for 59.7% of the total deposits. It should be noted that more than 70% of the funds from households deposited with the Euro conversion remained in the banks after the conversion, which is an indicator for the strengthened confidence in the Macedonian banking system.

Capital adequacy ratio

As of December 31, 2002, the total capital of the Macedonian banks represented for 20.7% of the total sources of funds. 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, equaled 28.1% at the end of 2002, which represents a decrease of 6.2 percentage points, compared with December 31, 2001. An impor-

[9] At the beginning of 2003, the receivership procedure was initiated in one bank. In order to get more real indicators for the structure, the activities and the performances of the banking system of the Republic of Macedonia, this bank was exempted from the further analysis of the banking system.

tant aspect, which should be taken into consideration when analyzing the banks' capital adequacy ratio, are the changes in the methodology for determining its two main components: guarantee capital and risk weighted assets. The modification of the methodology for determining the banks' guarantee capital during the year 2000 was followed by changes in the methodology for determining the risk weighted assets, which the banks started to implement on March 31, 2002. In line with the changes in the methodology for determining the risk weighted assets, besides the credit risk, the calculation of the capital adequacy also includes the foreign exchange risk, by including the aggregate open foreign exchange position in the calculation. Nevertheless, despite the introduction of the new element in the calculation of the capital adequacy ratio, all banks in the Republic of Macedonia (excluding the bank, which is under receivership) met the prescribed minimum level of capital adequacy of 8%.

Asset quality

Main indicators for the quality of the credit portfolio of the banks calculated as of December 31, 2002 show a trend of improvement in 2002. 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, 2002 equaled 15.94%, which is a decrease of 17.7 percentage points compared to December 2001. This improvement of the quality of the credit portfolio is a result mainly of the changes in the credit risk methodology, but also is a result of the strengthened credit policies and practices of the Macedonian banks. 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 equaled 8.76%, as of December 31, 2002.

The income statement structure and ratios

The financial result of the banking system in the Republic of Macedonia in 2002 was positive and it amounted to Denar 396 million on aggregate level. Fifteen banks, which represent 69.8% of the total financial potential of all banks, registered positive financial result in their balance sheets. The positive financial result of the banks in 2002 stems from the positive net interest income after provisioning, given the negative disparity between other income and other expenditures. The achieved positive financial result in 2002 reflects positive values of the indicator rate of return on assets (ROAA) and rate of return on equity (ROAE). The ROAA indicator points to the fact that during 2002, 100 units of assets of the banks in the Republic of Macedonia generate 0.4 units of profit, whereas the ROAE indicator shows that 100 units of capital of the banks in the Republic of Macedonia generate 2.06 units of profit.

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

During the past several years, the legal prudential framework has undergone significant changes. The objective of these changes was to achieve higher level of consistence and compatibility of the Macedonian banking regulation with the international procedures and practices and the EU Directives, having in mind the specific environment in which the banking system in the Republic of Macedonia operates. Hence, during the 2002, changes of the 2 main legal acts that determine the banking operation and supervision in the Republic of Macedonia were made: enactment of the new Law on the National Bank of the Republic of Macedonia and amendments of the existing Banking Law.

The new Law on the National Bank of the Republic of Macedonia entered into force in January 2002, with the NBRM operations being largely harmonized with the modern central banks operations in the developed economies. The Law emphasizes the independence of the NBRM, which is one of the major preconditions for consistent and effective conduct of the monetary policy and provides further strengthening of the supervisory role of the National Bank of the Republic of Macedonia, by expanding the range of corrective measures that could be undertaken against the banks or the savings houses in the Republic of Macedonia.

The most essential amendments to the Banking Law are related to the authorization of the National Bank of the Republic of Macedonia to verify the source of funds for each payment of capital and for each change in the ownership structure of the banks. This amendment was made within the framework of the activities the government undertook, for prevention of money laundering through the banking system of the Republic of Macedonia. Other amendments to the Banking Law pertain to the following: possibility of transforming a savings house into a bank, setting standards for preparing and implementing security in the information system, on the basis of which the banks' information systems adequacy is assessed, specifying cases of disclosure of information and etc.

THE ACTIVITIES OF THE BANKING SUPERVISION AUTHORITY

The supervisory function of the National Bank of the Republic of Macedonia, regarding the 3 main activities (licensing, on-site and off-site supervision and undertaking corrective measures) was performed as follows:

- Within the licensing framework, during the 2002 the main activities of the National Bank of the Republic of Macedonia were in the area of issuing approvals on various bases, in accordance with the provisions of the Banking Law: issuing approvals for appointing an executive body of the banks; issuing approvals for changes in the ownership structure of the voting shares; issuing approvals for changes in the Statute of the banks; approval for establishing a brokerage company; issuing approval for change in the bank's name, etc.
- The basis of the supervision lies on the assessment of the risk level of the overall operations of the banks and the savings houses and assessment of the compliance of their operations with the supervisory standards and regulations. In 2002, the full-scope on-site examinations were supplemented with the assessment of the compliance of the operations of the banks and the savings houses with the Anti-Money Laundering Law. In 2002, the National Bank of the Republic of Macedonia carried out 47 on-site supervisory examinations, 19 of which were full-scope supervisory examinations and 28 were targeted 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 CAMELS rating system;
- Within its legal authorizations, the National Bank of the Republic of Macedonia undertakes corrective actions against banks and savings houses in which violations and irregularities were identified in order to preserve the stability and the safety of the banks and the savings houses and the stability

and the safety of the overall banking system. During 2002, the most common corrective measures and actions undertaken against banks and saving houses were the following: ban on performing certain banking operations within a certain period of time; measure for reducing the credit exposure within the prudential limits; ban on lending to clients classified in risk categories C, D and E; further bank capitalization; ban on capital investment; allocation of additional provisions for loan losses.

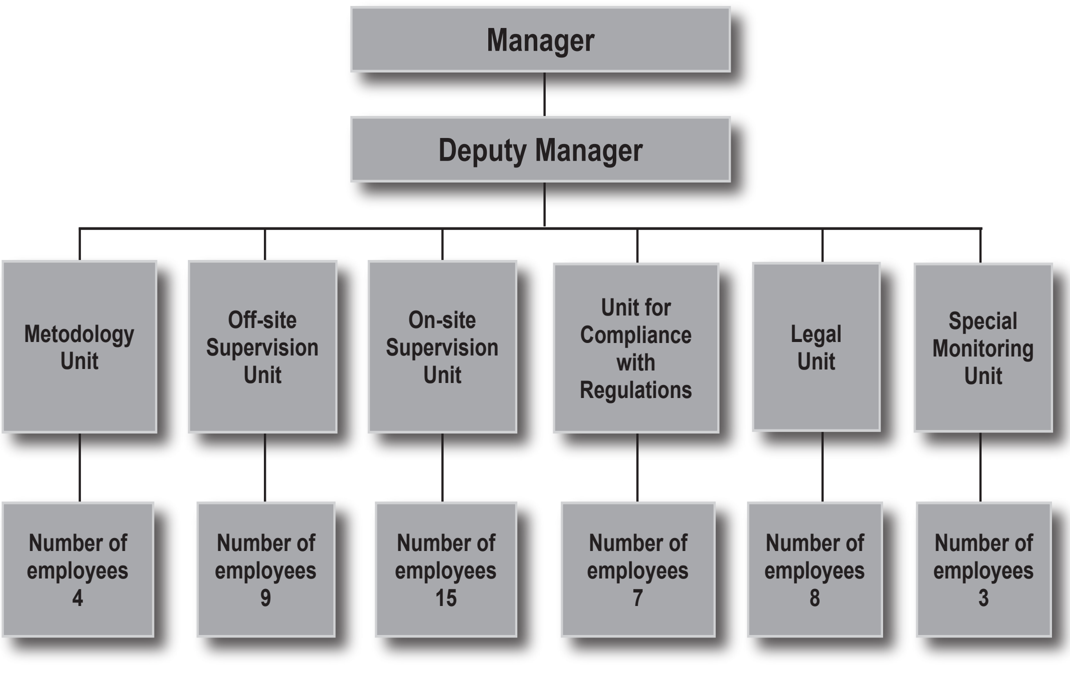
LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN THE REPUBLIC OF MACEDONIA

The competence of the National Bank of the Republic of Macedonia as a sole banking supervisory body, is regulated by the Law on the National Bank of the Republic of Macedonia and the Banking Law, as well as other laws and prudential regulation that govern the operation of the banks.

National Bank of the Republic of Macedonia is an independent institution in conducting its functions, including the supervisory function. The new Law on the National Bank of the Republic of Macedonia provides further strengthening of the functional, institutional and financial sovereignty and independence of the National Bank of the Republic of Macedonia. In order to avoid the political influence, the new Law does not allow members of political parties to become members of the Council of the National Bank of the Republic of Macedonia, while two of them shall be professionally engaged in the National Bank of the Republic of Macedonia. It strengthens the professionalism, the responsibility and the transparency in the operations of the bodies of the National Bank of the Republic of Macedonia.

Within the National Bank of the Republic of Macedonia, a special department – Supervision Department, conducts the supervisory function. According to the organizational chart of the National Bank of the Republic of Macedonia, the Supervision Department is directly liable for its operations to the Governor of the National Bank of the Republic of Macedonia.

SUPERVISION DEPARTMENT ORGANIZATIONAL CHART



INTERNATIONAL ACTIVITIES OF THE SUPERVISION AUTHORITY

The globalization of the financial system and the privatization of several Macedonian banks by foreign investors imposed the need for regulating the cooperation with the supervisory bodies of the home countries of parent banks. According to the regulation, National Bank of the Republic of Macedonia may exchange information with foreign supervisory agencies with relation to supervision of internationally active banks. Furthermore, the National Bank may approve an on-site examination of a foreign bank and foreign bank subsidiary in the Republic of Macedonia conducted by supervisory bodies of the home country. In order to assert this right, the National Bank require the supervisory bodies from other countries to provide legal and operational capability to ensure confidentiality of the data.

At the same time, all issues regarding the mutual rights and obligations of supervisory agencies are resolved by concluding bilateral agreements (Memorandum of Understanding), which define the principal areas of co-operation, exchange of information and common procedures for supervision of subsidiaries of foreign banks. For that purpose, bilateral agreements have been concluded with the Bank of Slovenia and the Central Bank of the Russian Federation and conclusion of such agreement with the Bank of Greece, Bulgarian National Bank and the Banking Regulation and Supervision Agency of Turkey, is in process. Based on the signed agreements, during the 2002, the first joint examination was carried out with supervisors from the Bank of Slovenia. This examination proved to be an excellent example of successful cross-border supervision.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE REPUBLIC OF MACEDONIA

The preparations for introducing consolidated supervision, which will focus on monitoring and controlling the risks in the banking group as a whole, will draw a necessary attention on the systemic co-operation between the domestic regulators and supervision bodies. Currently, in the Republic of Macedonia there are three domestic supervisory agencies: National Bank of the Republic of Macedonia, as an authorized body for banking supervision, Agency for supervision of the insurance companies and Securities and Exchange Commission, as an authorized body for supervision of capital market, brokerage houses and investment funds. The enactment of the Law on compulsory capital-financed pension insurance regulates the establishment of an Agency for supervision of pension funds, which will be the forth supervisory agency in the Republic of Macedonia. A significant intensification of the cooperation among these agencies is expected in the near future, and the first steps are already undertaken between the National Bank of the Republic of Macedonia and the Securities and Exchange Commission. The undertaken activities should result with the signing of bilateral agreement, which should define more clearly the co-operation, exchange of information and forms of joint activities.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY

The main objectives of the Supervisory Authority in 2002 were focused on making further progress with harmonizing the Macedonian banking regulation with the EU Directives and the Basle Core Principles for effective Banking Supervision. During the last year, the major challenge, even on a national level, was the strengthening of the fight against money laundering, requiring co-operation between all segments of the financial system. For that purpose, the National Bank of the Republic of Macedonia developed procedures for assessing banks' systems for preventing money laundering. The training of the supervisors, followed by the constant testing and improvement of these procedures, will enable the supervisors to get the necessary knowledge, as well as, experience for adequate analysis of the banks' policies and practices for anti-money laundering.

In the coming years, the major efforts of the National Bank of the Republic of Macedonia will be focused on achieving full compliance with the EU Banking Directives. The New Basle Capital Accord will be an enormous challenge for the supervision in the Republic of Macedonia, as an emerging country that will have to follow the international financial trends.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

The 2002 was characterized with several technical assistance provided to the National Bank of the Republic of Macedonia by the DeNederlandishe Bank, USAID (Financial Services Volunteers Corps, Macedonian Financial Sector Strengthening Project). The assistance covers the following issues: regulation and supervisory procedures for identification, measurement and control of market risk, implementation of the International Accounting Standards in banking, adoption of regulation on consolidated supervision, e-banking and IT supervision, strengthening of the off-site supervision and determining the level of compliance of the Macedonian banking regulation with the EU Directives. The conclusion of this ongoing technical assistance will provide a base for even higher qualitative improvement of the supervision within the National Bank of the Republic of Macedonia that will enable a significant compliance with the Basle Principles and European Banking Directives.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2000	2001	2002
Banks	22	21	21
Savings houses	19	17	17
Brokerage firms		10	9
Deposit insurance funds	1	1	1
Insurance companies	4	4	6
Stock exchange	1	1	1
Money market	1	1	1
Financial Institutions, total	**48**	**55**	**56**

Ownership structure of financial institutions in 2002 on the basis of registered capital (%) (at year-end)

Item	Type of financial institution*	Total
	Banks	
State ownership	4.90	4.90
Other domestic ownership	50.50	50.50
Domestic ownership total	55.40	55.40
Foreign ownership**	44.60	44.60
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	2000	2001	2002	2002/2000
State ownership	4.90	4.90	4.90	100.00
Other domestic ownership	50.10	51.60	50.50	100.80
Domestic ownership total	55.00	56.50	55.40	100.73
Foreign ownership	45.00	43.50	44.60	99.11
Financial institutions, total	**100.00**	**100.00**	**100.00**	–

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

Distribution of market shares in balance sheet total (%)

Type of financial institution	2000	2001	2002
Banks	98.60	99.40	99.03
Savings houses	1.40	0.60	0.97
Financial institutions, total	**100.00**	**100.00**	**100.00**

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

Assets	2000	2001	2002
Cash and balance with nbrm	8.20	25.10	6.50
Securities rediscounted by nbrm	5.30	1.80	2.10
Debt securities	9.40	7.20	7.66
Placements to other banks	33.30	28.00	36.30
Placements to clients	33.40	28.90	34.40
Accrued interest and other assets	3.40	2.40	4.80
Capital investments	1.30	1.20	1.54
Fixed assets	5.70	5.40	6.70
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2000**	**2001**	**2002**
Deposits of banks	6.04	2.30	3.10
Sight deposits	39.86	43.40	39.00
Short-term deposits up to one year	13.28	18.70	19.40
Short-term borrowings up to one year	2.86	4.50	3.10
Other liabilities	3.10	2.80	2.50
Long-term deposits over one year	3.74	4.10	3.70
Long-term borrowings over one year	6.68	5.30	7.90
Provisions for off-balance sheet liabilities	1.14	0.80	0.50
Owned funds	23.30	18.10	20.70
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	2000	2001	2002
Banks	17.07	14.62	13.54
Financial Institutions, total	**17.07**	**14.62**	**13.54**

Solvency ratio of financial institutions

Type of financial institution	2000	2001	2002
Banks	36.73	34.30	28.10
Savings houses	N/A	N/A	N/A
Financial institutions, average	**36.73**	**34.30**	**28.10**

Asset portfolio quality of the banking system

in million denars

Asset Classification	2000	%	2001	%	2002	%
A	21,530	42.57	23,303	40.97	67,337	72.24
B	11,432	22.60	11,844	20.83	11,018	11.82
C	6,121	12.10	7,891	13.87	6,269	6.73
D	7,122	14.08	7,740	13.61	6,497	6.97
E	4,372	8.64	6,095	10.72	2,094	2.25
Classified total	**50,577**	**100.00**	**56,873**	**100.00**	**93,215**	**100.00**
Provisions	**10,842**	–	**13,444**	–	**8,166**	–

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

	Deposits	Loans
Households	56.82	14.05
Public sector	3.93	1.34
Corporate	30.51	75.94
Domestic banks	4.36	4.41
Foreign banks	0.44	2.57
Other	3.94	1.70
Total	**100.00**	**100.00**

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

Maturity of deposits		Maturity of loans	
At sight	60.56	Long term loans*	54.77
Within one year	33.45	Medium term loans	–
Over one year	5.93	Short term loans**	45.23
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 (%)			Forex liabilities/total liability (%)		
	2000	2001	2002	2000	2001	2002
Banks	55.29	63.77	55.43	42.16	53.07	43.90
Fin. institution, average	**55.29**	**63.77**	**55.43**	**42.16**	**53.07**	**43.90**

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

in million denars

Revenues	2000	2001	2002
Interest income	5,165	4,483	5,428
Other income	5,109	4,808	4,945
Expenditures	**2000**	**2001**	**2002**
Interest expenses	2,572	2,625	2,999
Provisions for potential loan losses	2,922	2,542	1,798
Other expenses	3,972	4,638	5,107
Income tax	164	107	74

Structure of registered capital and own funds of financial institutions in 2002

Type of financial institutions	Registered capital	/ Total assets	Own funds	/ Total liabilities
	EUR (million)*	%	EUR (million)*	%
Banks	281	18.42%	316	20.68%
Fin. Institutions, average	**281**	**18.42%**	**316**	**20.68%**

** Calculated by the exchange rate of NBRM on December 31, 2002*

2002 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MOLDOVA

MACROECONOMIC ENVIRONMENT

Positive development trends consolidated in all sectors of the national economy in 2002.

- Gross Domestic Product amounted, as according to preliminary data, to lei 22040.4 million, exceeding by 7.2% in real terms the value recorded in the previous year;
- Industrial output increased by 10.6% as compared to 2001 and totalled lei 11870.8 million;
- Agricultural output amounted (according to estimations) to lei 9408.0 million in current prices and increased by 3.0% in comparable prices as against in 2001;
- Investments in fixed capital allocated to national economy totalled lei 2074.7 million, recording a 4.0%-increase in real terms;
- Retail sales increased by 22.3% and amounted to lei 10106.8 million;
- Services rendered to the public against payment rose by 11.4% and amounted to lei 3979.9 million;
- The average monthly employee wage in national economy accounted for lei 691.5, which is by 20.9% in real terms more than in 2001;
- Consumer prices displayed the lowest growth rate of 4.4% since the introduction of the national currency (as compared to 6.3% in 2001);
- Current account of the balance of payments closed with a deficit of US$ 104.98 million (6.5% of GDP), surpassing by 17.0% the level in the previous year. Exports (FOB) of goods totalled US$ 659.8 million or by 16.3% more than in 2001. Imports (FOB) of goods increased by 18.2% as compared to 2001 and amounted to US$ 1038.05 million. The trade balance deficit constituted US$ 378.3 million, or by 21.5% more than in 2001;
- Public external debt amounted to US$ 968.3 million, exceeding by 4.2% the value of 2001. The ratio of Government administrated debt to GDP accounted for 50.3% as at the end of 2002;
- The consolidated budget deficit amounted to lei 109.7 million and accounted for 0.5% of GDP.

DEVELOPMENT IN THE BANKING SYSTEM

There were 16 commercial banks of which 2 branches of foreign banks licensed by the National Bank of Moldova operating on the territory of the Republic of Moldova as on December 31, 2002. The NBM withdrew licences to perform financial operations from three commercial banks in 2002.

The total number of banking offices accounted for 719, of which 16 central offices of commercial banks (with the headquarters in the city of Chiºinãu), 156 branches, 130 representative offices and 417 agencies.

The banking sector of the Republic of Moldova displayed in 2002 positive development trends. Total assets within the banking system increased by lei 1967.4 million (32.9%) and amounted as on 31.12.2002 to lei 7943.9 million.[10]

The larger assets' value was due to the increase of the balance of banks' liabilities by lei 1775.1 million (41%) and of the share capital by lei 192.4 million (11.7%).

Positive dynamics was noted within all items of assets' structure. Net credits increased by lei 1093 million (37.6%). Cash rose by lei 114.6 million or 41.4%; money means due from banks and the NBM – by lei 494.3 million or 36.6%; securities – by lei 198.5 million; and other assets – by lei 67 million or 7.8%.

Net credits held the largest weight in total assets with 50.3%, denoting a 1.7 p.p.–increase since the beginning of the year. Credits have been mainly extended to industry/trade – 46.3% and agriculture/food industry – 28% of total credits.

The consolidation of the credit portfolio denoted the same positive trend as in the previous year. The weight of substandard credits decreased by 0.8 p.p.; of doubtful credit – by 1.6 p.p.; and of compromised credits – by 0.3 p.p. The decrease of the weight of unfavourable credits (substandard, doubtful and compromised) from 10.4% down to 7.6% of total credits generated the reduction of credit loss provision in total credits (by 1.7 p.p.) that accounted for 6.2% as on 31.12.2002 .

Liquid assets denoted a significant increase by lei 776.1 million or 37.4% during the reported period. Liquidity ratios showed high values and essentially mitigated the risk of non-honouring clients' demands in due time. Thus, long-term liquidity (assets with the term exceeding 2 years / financial resources exceeding 2 years £ 1) constituted 0.5. The level of this indicator denotes reserves in banks' provision of long-term credits.

Current liquidity (liquid assets (expressed in cash; deposits with NBM; securities; net interbank credits with the term up to 1 month) / total assets ^{3} 20%) constituted 35.9% as at year-end.

Tier-1 Capital amounted to lei 1707.7 million as on 31.12.2002 and recorded an increase of lei 145.5 million (9.3%). Banks' net income totalling lei 302.1 million was the main source of capital increase in 2002.

The average risk weighted capital adequacy (total regulatory capital / risk weighted assets) in the banking system accounted for 36.4% as on 31.12.2002 (as against the 12%-minimal level in the Republic of Moldova). At the same time, this indicator denoted slight descendant trends during the year as a result of larger credit portfolio (that is mainly included in the 100%-risk category) and higher attractiveness of the banking sector denoted by the increased value and weight of financing sources, especially of deposits.

The essential share of foreign investments in the banking capital, which accounted for 59.8% as on 31.12.2002 demonstrates the banking sector' attractiveness to foreign investors.

Within banks' liabilities deposits accounted for the largest weight of 83.8% totalling lei 5118.1 million (a 48.6%-increase since the beginning of the year). Deposits by individuals accounted for 46.8% of total deposits; by businesses – for 51.7%; and by banks' – for only 1.5%.

Efficiency of banking assets (net income / average assets) accounted for 4.5% in 2002. Efficiency of share capital (net capital / average share capital) accounted for 17.5%.

[10] US$ 1 = lei 13.8220 as on 31.12.2002

LEGAL AND INSTITUTIONAL FRAMEWORK OF FINANCIAL INSTITUTIONS' OPERATION AND SUPERVISION

The National Bank of Moldova conducts its basic activity, as well as the banking supervision and regulation of commercial banks in the territory of the Republic of Moldova in accordance with the Law on the National Bank of Moldova and the Law on Financial Institutions.

The Law on the National Bank of Moldova provides the competence, main objective and basic attributions of the National Bank of Moldova, as well as the NBM exclusive right to issue the national currency.

The Law on Financial Institutions stipulates the fundamental principles of banking supervision and regulation. The Law provides, also, the requirements related to the activity of financial institutions, as well as the relevant remedy measures towards those commercial banks that do not comply with current legislation.

Based on current legislative provisions (the Law on the National Bank of Moldova, the Law on Financial Institutions), the National Bank has elaborated and continuously consolidates the mechanism to supervise and regulate risks assumed by commercial banks during their operation process. The National Bank conducts banking supervision and regulation by imposing a number of requirements within its regulations and normative acts, which have mandatory status for all financial institutions. The NBM worked out prudential regulations taking into account the stipulations of Basle Committee in the field of banking supervision.

The 2-tier banking system of the Republic of Moldova (the National Bank of Moldova and commercial banks) operates according to general market principles. The National Bank of Moldova, which is a legal autonomous institution responsible to the Parliament, has the following general functions: to act as the sole issuer of domestic currency in the Republic; to formulate and to promote the state monetary, credit and foreign exchange policy; to license, supervise and regulate the activity of financial institutions; to supervise the balance of payments; and to hold and manage the state foreign exchange reserves.

There are 16 commercial banks organized as joint stock companies currently operating on the territory of the Republic of Moldova under competitive principles. Commercial banks have the right to accept deposits or deposit equivalents with the view to making investments on own name and risk, as well as to conducting banking operations. Considering the capitalisation level, 15 commercial banks have the right to perform international operations.

ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2002

The competitiveness, as well as the prudent development of banking activity, largely depends on the efficiency of banking prudential regulation. In 2002 the National Bank of Moldova conducted a number of measures aimed at revising banking regulation and bringing it into compliance with the current legislation and international practice.

Within this context, the National Bank introduced modifications and completions to existent normative acts considering the new stipulations of the Law on Financial Institutions in force as from November 2001 and the accepted international practice, the modified situation of banks, as well as other factors that may have impact upon the bank's financial situation.

According to the modification of commercial banks' licensing procedure, the National Bank of Moldova shall issue the NBM licence to conduct financial activities only if the capital of the establishing bank complies with the relevant minimum required capital plus expenditures related to bank's establishment. The NBM has also modified the conditions of licence provision considering the Regulation on Risk Weighted Capital Sufficiency in effect from September 30, 2002 as follows: the required minimal capital set as against Tier-1 Capital amounts to lei 32 million; the same requirement towards banks conducting international operations amounts to lei 64 million.

With the view to avoiding favoured provision of services to commercial banks' employees – affiliated persons, the NBM modified the relevant regulation as follows: credit provision by banks to such employees shall be strictly subject to the normative act regulating the procedure of agreement conclusion with commercial banks' affiliated persons, as well as of loan provision.

At the same time, to avoid abuses as a result of loan provision to affiliated persons, the NBM clarified the definition of "affiliate of the bank". According to introduced modifications, banks have to maintain special registers of affiliated persons, as well as registers of agreements concluded with such persons.

The NBM modified also the procedure on shareholders' approval as to stipulate maintenance of substantial equity in banks' capital. Within this context, based on current normative acts, the National Bank shall provide its written permission to hold substantial equity, as well as equity exceeding the set limits of 25%, 33% and 50% only if fully assured that the activity of these shareholders shall create all premises for an adequate activity of the bank in accordance with legislative provisions and rules of sound and prudent practice.

With the view to mitigating money laundering related risks and to implementing stipulations of the Law on Anti-Money Laundering, the National Bank approved in April 2002 the Recommendations on Elaboration by Banks of the Republic of Moldova of Programs on Money Laundering Prevention and Fight (mandatory normative act). These Recommendations have been elaborated on the basis of Basle Committee documents as follows: "Client Identification by Banks", principle 15 of the Methodology of Basic Principles; internationally accepted principles in the field of anti-money laundering: FATF 40 Recommendations. These recommendations are aimed at assisting banks in elaborating own anti-money laundering programs as to stimulate banks to attract legitimate means from legitimate clients and to avoid money laundering, image, operational, legal, concentration and IT risks. The Recommendations represent a follow-up of the Recommendations on Internal Control Systems that provide the fundamental objects in the filed of money laundering prevention and fight. The implementation of these Recommendations shall ensure the non-implication of banks in money laundering operations.

Within the context of modified requirements on capital structure and methodology of capital sufficiency calculation in force since 30.09.2002, the NBM respectively modified the Instruction on Elaboration and Submission by Banks of Financial Statements. The capital structure was modified as to reduce net non-material assets from Tier-I Capital and not to include fixed means revaluation reserves in, and to add subordinated debts to, Tier-II Capital. With regard to calculation of capital sufficiency, the weight of a certain asset's risk is determined now as in accordance with stipulations of the Basle Committee on International Convergence of Capital Calculation and Capital Standards (July 1998 with modifications as in April 1998).

With the view to consolidating off-site banking supervision in the filed of money laundering prevention and fight the National Bank completed in July 2002 the Instruction on Elaboration and Submission by Banks of Financial Statements. According to the current Instruction, the National Bank of Moldova conducts the monitoring of banking activity in the filed of anti-money laundering based on relevant commercial banks' statements (first reporting set for December 31, 2002).

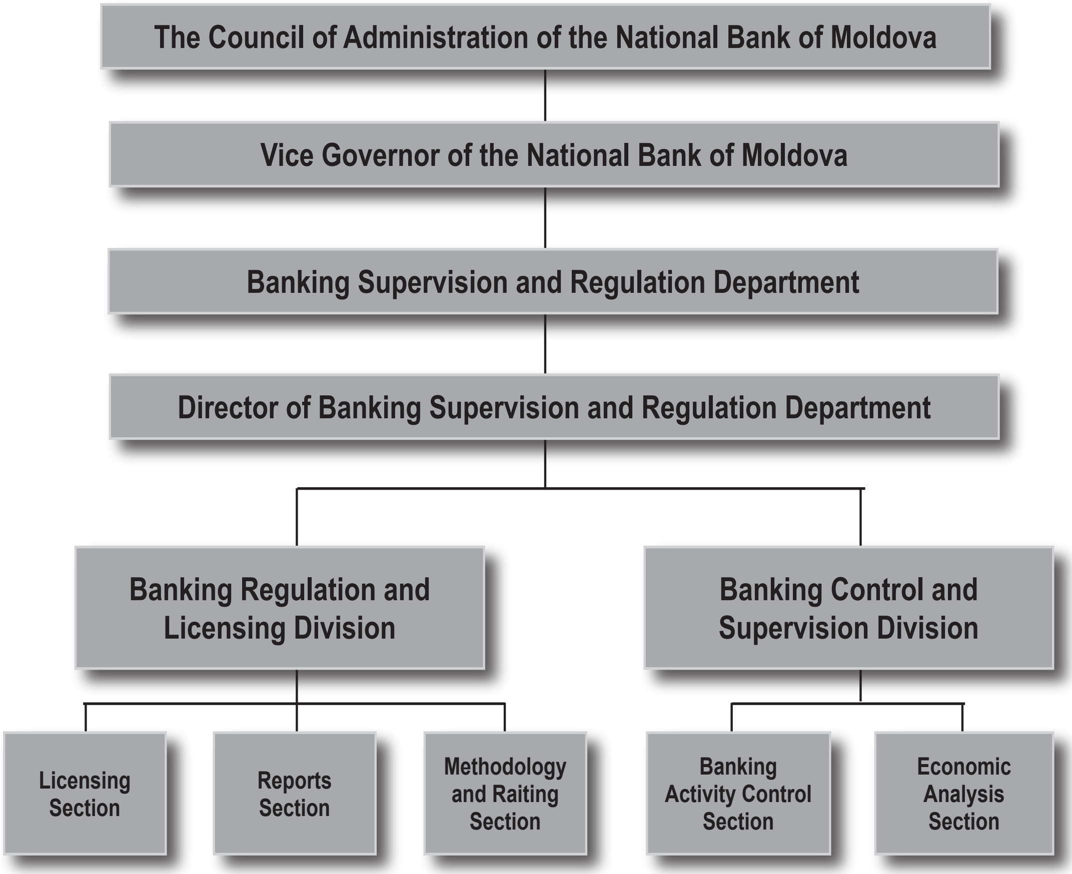
Considering the international practice, the National Bank shall constantly consolidate the mechanism of banking supervision and regulation having as target the mitigation of banking risks.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

According to the Law on the National Bank of Moldova, the National Bank is the sole institution vested with the authority to conduct licensing, supervision and regulation of financial institutions. Within this context, the National Bank has the following functions:

- To issue normative acts and to perform relevant measures with the view to exercising powers and attributions stipulated in the relevant Laws by issuing licenses to financial institutions and working out supervision standards; to decide upon the application of normative acts and mentioned measures;
- To perform controls over all banks and to examine banks' records, documents and accounts, condition of operation, as well as compliance to 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, licensing conditions, fiduciary duties; 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 actions;
  - issuance of written instructions to cease infractions and to undertake remedial action;
  - indisputable imposing and payment of fines;
  - dismissal of administrators from position in a bank;
  - limitation or cease of financial institution's activity;
  - revocation of license.

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITY OF THE BANKING SUPERVISORY AUTHORITY

Considering the establishment of a relevant legal framework to ensure co-operation in the field of information exchange on banking supervision, the National Bank of Moldova conducted negotiations with the National Bank of Ukraine for conclusion of bilateral agreement in banking supervision.

The National Bank of Moldova responded also to external authorities inquiring relevant banking information notwithstanding the existence of absence of adequate agreements. Thus, the NBM submitted data on commercial banks licensed by the National Bank of Moldova with regard to the activity of certain administrators, as well as information on a number of owners that hold more than 3% of bank's equity.

To ensure prudent operation of the banking sector, the National Bank initiated interpellation to supervision authorities of other countries. Thus, in order to issue permission to non-residents to hold substantial shares in the capital of commercial banks of the Republic of Moldova, the National Bank requested information for the verification of applicants, their commercial or professional activity, as well as capital origin.

Within the context of anti-money laundering and terrorism prevention, the National Bank addressed in February 2002 to central banks of Germany, Austria, France, Switzerland, Netherlands, Latvia, Russia, Ukraine and Byelorussia.

CO-OPERATION WITH OTHER SUPERVISORY BODIES OF THE REPUBLIC OF MOLDOVA

The information quarterly received by the National Bank of Moldova from the State Supervision of Civil Savings and Credit Associations allows the NBM to analyse the impact of these associations upon the banking system.

Also, with the view to efficiently ensure the securities market, the National Bank co-ordinated the normative acts related to banking issuance of different types of financial instruments with the National Securities' Commission, which is the supervision authority of the securities market.

At the same time, to ensure a transparent activity of the securities market and to consolidate the protection of investors' interests, the National Securities Commission and the National Bank of Moldova commonly established the rules on information disclosure by the issuers – open joint stock banks, as well as the contents of specialised reports by professional participants in the securities market.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2003

The stability of the banking system of the Republic of Moldova is determined by the consolidation level. Thus, the main objective of banking authorities for 2003 provides the further consolidation of the banking sector. This process shall unfold under competitive conditions for all banks and shall stay under the active supervision of the National Bank of Moldova within the NBM basic attributions. In this regard, the National Bank provided a number of measures on further development of the NBM supervision and regulation capacities.

Thus, the National Bank shall supervise the actions undertaken by banks' owners and administrators with the view to mitigating banking operation related risks, to increasing risk coverage with own capital and to consolidating bank management instruments.

To ensure an efficient operation of the banking sector, the NBM shall undertake all relevant measures to improve internal control systems taking into consideration the requirement to mitigate activity risks.

Prudential regulation and supervision methods shall be further improved in accordance with international general standards on banking supervision.

STATISTICAL TABLES

Number of financial institutions (at year–ends)

Type of financial institution	2000	2001	2002
Banks, including	20	19	16
branches of foreign banks	4	3	2

Ownership structure of the financial institutions in 2002 on the basis of registered capital (at year–end)

Item	Weight (%)
Public sector ownership	2.18
Other domestic ownership	38.03
Domestic ownership total	40.21
Foreign ownership	59.79
Banks, total	**100.0**

Ownership structure of capital of the financial institutions in 2002 on the basis of registered capital (%) (at year–ends)

Item	2000	2001	2002	2002/2000
Public sector ownership	3.9	3.57	2.18	0.56
Other domestic ownership	36.49	35.57	38.03	1.04
Domestic ownership total	40.39	39.14	40.21	0.99
Foreign ownership	59.61	60.86	59.79	1.003
Banks, total	**100.0**	**100.0**	**100.0**	-

Distribution of market shares in balance sheet total (%)

Type of financial institution	2000	2001	2002
Commercial banks	95.05	95.1	95.37
Foreign branches	4.95	4.9	4.63
Banks, total	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system in 2002 (%) (at year–end)

Assets	2000	2001	2002
Cash	3.47	4.63	4.92
Due from banks and BNM	29.05	22.59	23.22
Net loans and financial leasing	43.36	48.63	50.34
Total securities	8.69	9.86	9.91
Others	15.43	16.92	11.61
Total assets	**100**	**100**	**100**
Liabilities	**2000**	**2001**	**2002**
Deposits by natural persons	20.7	28.13	30.16
Deposits by legal persons	32.62	29.52	33.29
Others	16.06	14.86	13.45
Shareholder capital	30.62	27.49	23.10
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	2000	2001	2002
Banks, total	10.43	8.21	10.05

Solvency ratio of financial institutions

Type of financial institution	2000	2001	2002
Capital adequacy ratio on banking system, average (≥ 12%)	48.56	43.11	36.39

Asset portfolio quality of the banking system (%)

Asset Classification	2000	2001	2002
Standard	48.95	58.76	58.32
Supervised	30.41	30.82	34.07
Substandard	14.14	6.16	5.36
Doubtful	6.08	3.84	2.15
Bad	0.41	0.43	0.10
Total	**100.00**	**100.00**	**100.00**
Specific Reserves/Total Loans	**11.72**	**7.87**	**6.20**

The structure of deposits and loans in 2002(%)
(at year–end)

Deposits	%	Loans	%
Natural persons	46.81	Credits to agriculture and food industry	27.98
State budget and local budgets	12.95	Credits for real estate, construction and development	7.08
Legal persons	38.72	Consumer credits	2.56
Banks' deposits	1.52	Credits to the Government	2.47
		Credits to energy and fuel industry	5.34
		Credits to industry/commerce	46.34
		Credits for road construction and transportation	2.49
		Other credits	5.74
Total	**100.0**	**Total**	**100.00**

The structure of deposits in 2002
(at year–end)

Maturity of Deposits	million lei	%
Sight	2,736.86	53.47
Time and long-term	2,381.23	46.53
Total	**5,118.09**	**100.00**
Inclusive in foreign currency	2236.7	43.7

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

Type of the financial institutions	FOREX Assets/Total Assets (%)			FOREX Liabilities/Total Liabil. (%)		
	2000	2001	2002	2000	2001	2002
Banks	41.93	39.16	39.68	51.74	45.71	47.29

Structure of revenues and expenditures of financial institutes in 2002 (at year–ends)*

(million MDL)

Revenues	2000	2001	2002
Total Interest Income	**588.15**	**684.10**	**744.54**
inclusive:			
interest income on credits and financial leasing	445.15	551.95	656.13
interest income from securities	65.09	74.01	44.17
interest income from other assets	77.91	58.15	44.24
Total Income non-interest	378.90	376.23	499.35
Expenditure	**2000**	**2001**	**2002**
Total interest expenditure	203.15	254.70	281.86
Total non-interest expenditure	428.26	517.81	562.01
Provision for Loan Losses	18.95	36.30	55.34
Total net income	288.92	222.11	302.10
Net income / Average Assets	7.36	4.27	4.45

**USD 1 = MDL 12.3833 as of 31.12.2000*
USD 1 = MDL 13.0909 as of 31.12.2001
USD 1 = MDL 13.8220 as of 31.12.2002

Structure of registered capital and own funds of financial institutions in 2002

Type of financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	thousand USD	%	thousand USD	%
Banks	54,651.11	9.51	132,787.14	30.05

2002 DEVELOPMENTS IN THE POLISH BANKING SYSTEM

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MACROECONOMIC ENVIRONMENT IN 2002

The condition and performance of the banking sector is directly influenced by the economic environment in which banks operate. According to the estimates of the Central Office of Statistics, the **GDP** grew only slightly faster in 2002 than in 2001. GDP growth year-on-year amounted to 1.3% (compared to 1.0% in 2001). The most important is not only the scale of this acceleration, but the fact that the growth rate increased progressively every quarter (0.4% in Q 1, 0.8% in Q 2, 1.6% in Q 3 and 2.1% in Q 4).

The main factor contributing to the faster growth was **exports**. They increased by 13% on 2001 (to $41.0bn), while imports grew by 9.0% ($55.1bn). Another factor was domestic demand, which rose by 0.8% (while it fell by 1.7% in the previous year), mainly as a result of a 3.3% rise in personal consumption.

The situation in **industry** improved. Output, which fell in the 1st and 2nd quarters (by 1.6% and 0.4%, respectively), grew in the 3rd and 4th quarters (by 3.3% and 4.6%). As a result, after the four quarters of 2002, output[11] was 1.5% higher than in the corresponding period of the previous year. **Labour productivity** (measured as output per employee) rose by some 8%, while the average employment was 5.6% lower.

The situation on the **labour market** remained unfavourable. Between January and December, the number of people out of work increased by 101.8 thousand (to 3,217 thousand) and the unemployment rate went up 0.6 point (to 18.1%): in 2001 these figures were, respectively, 412.5 thousand people and 2.3 percentage points.

Annual **CPI** inflation (December-on-December) stood at 0.8 (compared to 3.6% in 2001). The twelve-month inflation rate reached 1.9% in December (compared to 5.5% in 2001) and was 2.6 percentage points lower than had been assumed in the Budget on 2002. Twelve-month core inflation indices decreased further. According to preliminary data, industrial prices rose by 2.2%, while the year 2001 had seen them fall by 0.4%.

Because of the favourable development of factors restricting inflationary pressure and the lack of threats to the achievement of the short- and medium-term inflation targets, the **Monetary Policy Council cut interest rates eight times** last year, the cuts totalling 2.75 to 6.75 percentage points. At the end of December 2002, the reference rate was 6.75% (11.5% in December 2001), the rediscount rate 7.5% (compared to 14%), the lombard rate 8.75% (15.5%) and the deposit rate 2.75% (7.5%).

[11] Companies with more than 9 employees.

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THE POLISH BANKING SECTOR IN 2002

In 2002, the **number of commercial banks** in Poland fell from 71 to 62, of which the number of banks **conducting operating activities** decreased from 69 to **59** banks. This was mainly the result of consolidation processes. The merger between Powszechny Bank Kredytowy SA and Bank Przemys³owo-Handlowy SA led to the creation of the third largest bank in Poland. However, consolidation processes mainly applied to a group of co-operative banks affiliating, as a result of which their number fell from 10 to 3.

There were small changes in the ownership structure of banks. **The Treasury controlled 7** operating banks (three of them directly). Their share in the total assets of the banking sector accounted for 25.3%. The number of operating banks **controlled by foreign investors** (45) decreased by 1 (2 started operations, 2 ceased them and 1 lost its legal status). The capital and assets of these banks represented 78.4% and 67.2% of the whole banking sector, respectively (compared to 80.2% and 68.7% at the end of 2001).

The number of co-operative banks dropped from 642 at year-end 2001 to **605** as a result of completed mergers. Their share in the total assets of the banking sector rose by 0.4 point (to 5.0%).

Compared to the end of 2001, **the number of domestic offices** of commercial banks fell by **759**[12] (the number of branches went up by 159, but that of remaining offices fell by 908) due to consolidation processes and the rationalisation of the office distribution as a result of the growth in electronic banking and the banks' efforts to reduce costs. The number of co-operative bank branches actually rose by 63, and the number of their other offices by 135.

2002 was the third year in succession to see a decrease in the employment level at commercial banks (from 138,822 to 131,874 persons)[13]. The employment reduction stemmed to a great extent from consolidations, the introduction of new, centralised IT systems, the growth in electronic banking and the banks' efforts to cut costs in response to the increasing competition and unsatisfactory trading earnings. In contrast, the growth of the office network of co-operative banks resulted in an increase in employment (by 472 persons).

At the end of 2002, the total authorised capital of the commercial banks, together with the member's share funds at cooperative banks, amounted to 11,147m zloty.

In 2002, the **total assets** of the banking sector fell for the first time since 1993. They amounted to 467.1bn zloty and were 0.6% lower than in 2001. This resulted from the situation of commercial banks, which play a decisive role in the development and stability of the sector. Assets of co-operative banks increased by 8.9% and their market share rose by 5%. The proportion of the banking sector assets to the GDP decreased to 60.7% (from 65.1%). In 2002, the **assets of commercial banks shrank** by 1.0%.

The slower growth in loans to non-financial customers (by 2,9%) was brought about, among other factors, by the low corporations' demand for credit, and making by banks loans less available to customers in unstable financial situation.

A phenomenon never observed before was the **fall** (by 3.6%) **in deposits of non-financial customers** (in the previous two years, these increased by 14.8% and 12.5%, respectively). The reasons behind it were the decrease in the population's savings and the yield on bank deposits being lower than that on financial instruments offered by investment funds or the Treasury, following the cuts in interest

[12] Including a decrease of 10 due to the reduced number of banks.
[13] in full time equivalents.

rates and the imposition of a personal incomes tax. As a result of these factors, some savings were transferred from deposit accounts to investment funds, to Treasury bonds as well as to asset management institutions (operating within or outside the organizational structures of banks).

The quality of claims on non-financial customers continued to deteriorate in 2002. **The proportion of irregular classifications in the loan portfolio** of commercial banks increased by 3.3 points (to 21.9%). The deteriorating portfolio quality was mainly brought about by the increasing credit risk of financing corporations. The quality of claims on households also deteriorated, but was still much better that that on corporations.

As a result of the slow-down in the development of commercial banks' operations growth-rate of the **net income on banking activity** dropped to only 0.2% (against 4.6% in 2001 and 26.6% in 2000). The increasing disproportion between the growth of this income and the net provisioning expense made the **pre-tax earnings** fall by 27.1% (to 3.9bn zloty). Net earnings of commercial banks amounted to 2.4bn zloty and were 39.8% lower than in 2001 due to increase in income tax (by 8.3%).

Return on assets went down by 0.5 point (to 0.5%) and **return on equity** by 6.4 points (to 6.7%). The cost/income ratio (i.e. the ratio of total costs to total income) rose by 2.1 points (to 99.9%).

The main reasons for the stagnation of the **net income on banking activities** for 2002 was the small (2.1%) growth in the net interest income, which did not enable banks to recover the pre-2001 level, as well as lower non interest income resulting from the fall in income from foreign exchange and financial trading.

The interest margin, defined as the ratio of net interest income to average total assets (minus interest accrued on irregular exposures), fell significantly in the first quarter (by 0.47 percentage points) and then rose systematically in subsequent quarters to a level of 3.2% at the end of the year, but failed to reach the level of the previous year (0.3 point short).

An important constituent of the **net income** from banking activity was the net fee income, which rose by 7.0% (though at a rate 2.9 points slower than in 2001) due to the soaring fee income on loans, settlements and other banking operations, achieved in the second half of the year mainly by increasing the unit fees for banking services.

Additional information is available at web page:
http://www.nbp.pl/en/statistics/wyniki/wyniki/.html

THE NEW DEVELOPMENTS IN THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTION IN POLAND IN 2002.

The amendments to the Banking Act from August 23, 2001 entered into force on: January 1, 2002, and January 7, 2002.

The main objective of those amendments was to adjust the Polish law to Directive 2000/12/WE of the Council of the European Parliament.

The most important modifications are:

- Modification of the provisions concerning cooperation and exchange of information between the Commission for Banking Supervision and other domestic and foreign financial supervisory bodies.
- Enforcement of a consolidated supervision.
- Introducing definition of the declaration of will set down on the electronic data carrier.

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- Changes of prudential supervision of an operative credit institution, modification of the regulations concerning solvency ratio.
- Enforcement of definition of electronic money institution and definition of the issue, settlement and redemption of electronic money, and performance of payments using such money as a banking operations.
- Enforcement of prudential purposes definition of: financial institution, financial group and mixed activity group, parent undertaking, significant influence, close links.
- Extension of the duty to inform about banking operations.
- Change the scope of administration form for the Commission for Banking Supervision.
- Enforcement of a possibility for the Commission for Banking Supervision to revoke authorisation granted to the bank when it has became subsidiary undertaking of parties who, due to provisions of law in force in the place where they have their registered office or residence, or due to their links to other parties, prevent the Commission for Banking Supervision from performing effective supervision of the bank.
- Enforcement of the provisions relating to cross - border transfer.
- Modification of the provision referring to transfer of share between the banks incorporated as public limited companies.

The other important amendment to the Polish law relating to the Commission for Banking Supervision came into force in the amendments to the Act of July 5, 2002 on Mortgage Bonds and Mortgage Banks. The Commission for Banking Supervision took over the supervision on the mortgage banks from National Bank of Poland. The Commission for Banking Supervision gained the authorisation to appoint the trustee, at the request the supervisory board.

THE ACTIVITIES OF THE POLISH BANKING SUPERVISION

The basic regulatory responsibilities of banking supervision in 2002 involved developing prudential regulations to limit banking risk, in the broadest sense of that term, and adapting the Polish banking system to conform to the requirements of the European Union and the recommendations of the Basle Committee on Banking Supervision.

The Banking Act

Banking supervision played an active part in work on a Bill amending Poland's Banking Act. The new provisions subsequently incorporated in that Act:

- govern new areas of banking activities related to:
  - the principles for banks' subcontracting operations related to banking activities to other entities (outsourcing),
  - the securitisation of bank claims, in particular to mitigate the bank's risk related to ensuring security,
- amend existing and applicable regulations specifying:
  - new prudential regulations with respect to large exposures, capital base and capital adequacy standards,
  - the procedures for banks to diclose information subject to the obligation of bank confidentiality,

– consolidated supervision of banks,
– the control of share ownership transfers at banks incorporated as public limited companies,
– bank rehabilitation and liquidation proceedings.

The amendments performed to the Banking Act have significantly strengthened the stability of the banking sector through the establishment of new, and the modification of existing prudential regulations.

Other legislation

Banking supervision also participated actively in developing draft acts on:

- amendments to the Consumer Credit Act primarily in the area of handling renewable credit facilities and credits connected to credit cards,
- electronic payment instruments
- Bank Gospodarstwa Krajowego and amendments to some acts
- postal services – in the area of co-operation between the Polish Postal Service and banks,
- amendments to the Act on the Operations of Affiliating Banks, their Affiliation and Cooperative Banks,
- amendments to the Act on Preventing the Use in Financial Trading of Assets Derived from Illegal or Undocumented Sources and on Combating Terrorist Financing
- mortgage bonds and mortgage banks
- real-estate management in the area applicable to banks.

Implementing regulations

In 2002, banking supervision was extensively involved in the development of implementing regulations that constituted the fulfillment of statutory authority of the Commission for Banking Supervision and the Minister of Finance contained in 8 resolutions and 2 drafts of regulations.

LEGAL COMPETENCE OF THE COMMISSION FOR BANKING SUPERVISION

The main legal competence of the Commission of Banking Supervision are defined in the Polish Banking Act from August 29, 1997.

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.

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In performance of its supervisory responsibilities, the Commission for Banking Supervision may issue recommendations to banks, involving, in particular:

- taking the necessary measures to restore liquidity or to achieve and observe the standards required by law,
- increasing capital,
- desisting from particular forms of advertising.

The Commission for Banking Supervision may also order a bank to cease pay-outs from net earnings or refrain from opening new offices until such time as liquidity is restored or the bank achieves the standards referred to above.

Where it is determined that a bank is failing to comply with the recommendations, or that the bank's activity is in contravention of the law or its articles of association, or is endangering the interests of accountholders, the Commission for Banking Supervision may:

- apply to the appropriate directing body of the bank for the recall of the president, vice president or other member of the management board directly responsible for the irregularities noted,
- suspend from office the members of the management board pending the adoption of a resolution on the application for their recall at the next meeting of the supervisory board; suspension from office shall involve such persons being excluded from participation in decisions of the bank in respect of its financial rights and obligations,
- restrict the scope of the bank's activity,
- impose on the bank a financial penalty,
- revoke authorization to establish the bank and order the bank's liquidation.

The Commission for Banking Supervision shall recall a member of the management board in the event of that person's final and conclusive conviction of a criminal offence and also may do it where:

- that person has been charged with a criminal or fiscal offence,
- that person has caused the bank major financial loss.

The Commission for Banking Supervision may also restrict bank's activities where it is determined that the bank:

- no longer fulfils the conditions laid down in its authorization,
- obtained the authorization on the basis of false documents or untrue statements, or through other unlawful actions,
- has not engaged in banking activity for over six months,
- has become the subsidiary undertaking of parties who, due to the provisions of law in force in the place where they have their registered office or residence, or due to their links to other parties, prevent the Commission for Banking Supervision from performing effective supervision of the bank.

The Commission for Banking Supervision shall revoke authorization to establish a branch of a foreign bank if the competent supervisory authorities of the country where the foreign bank has its registered office or place of management have revoked authorization for that bank to conduct the business of banking.

Since the beginning of the 2001 KNB is entitled to supervise banks operating in financial groups on the consolidated basis.

ORGANIZATIONAL CHART OF THE NATIONAL BANK OF POLAND AND COMMISSION FOR BANKING SUPERVISION

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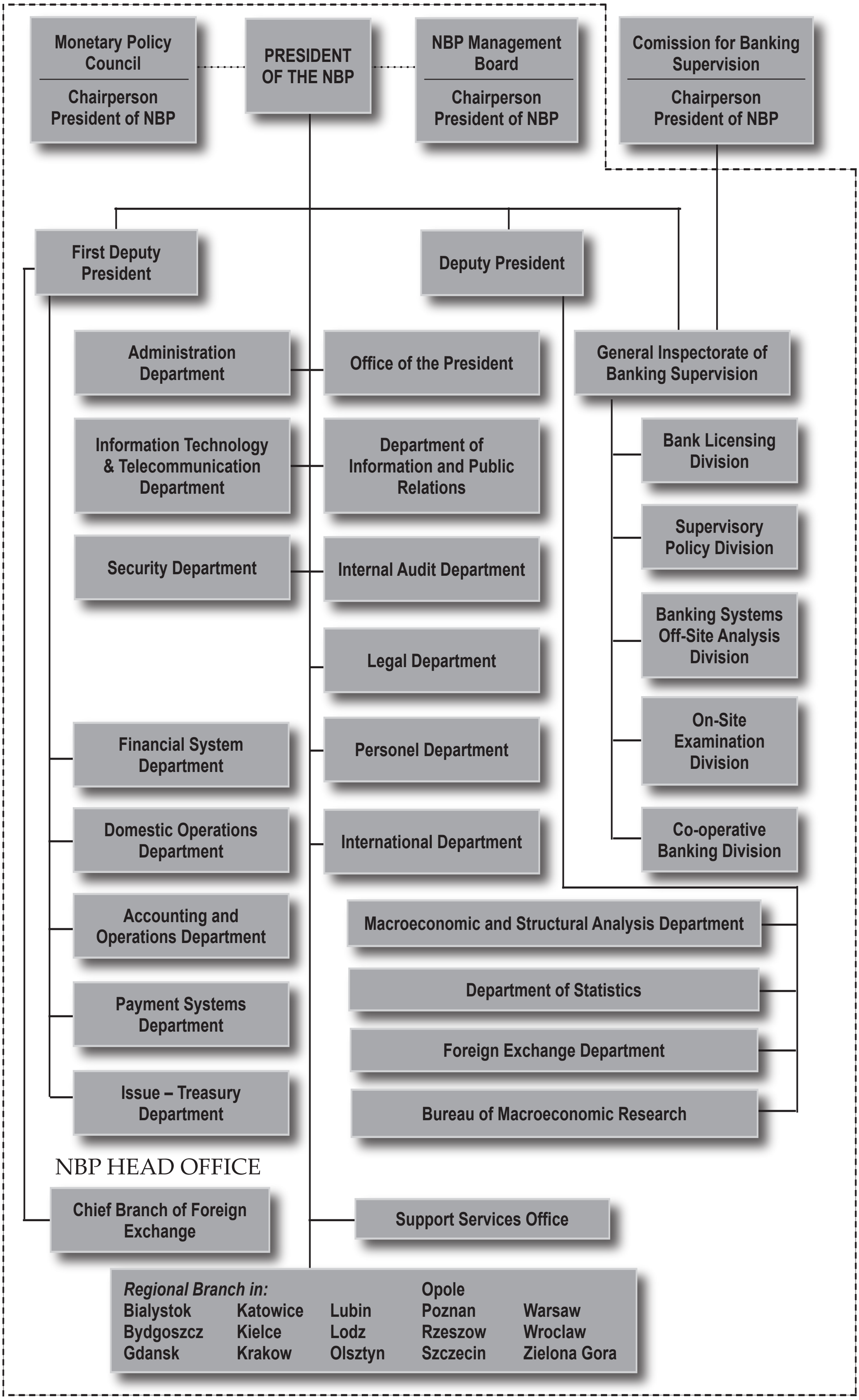

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INTERNATIONAL ACTIVITIES OF THE POLISH BANKING SUPERVISION

In 2002, the Polish banking supervision co-operated with:

- European Commission Internal Market Directorate General on the Report of peer review in 2001 and amendments to the Banking Law,
- Bank of Italy and Bank of France within the scope of twinning agreement,
- Basel Committee in the scope of New Basel Capital Accord, in particular concerning the Polish banks participation in the QIS 3 Study,
- International Monetary Found on the application of stress testing and monitoring of financial stability, following the recommendations of the Financial Sector Assessment Program (FSAP) in 2000 and changes of the Polish prudential regulations,
- Rating agencies (e.g. S&P) on the questionnaire on provisions concerning mortgage loans and mortgage bonds.

COOPERATION WITH OTHER SUPERVISORY BODIES IN POLAND.

Since March 1, 2002 the General Inspector of Banking Supervision has an advisory vote in the Commission for Insurance and Pension Fund Supervision as a result of the continuation of cooperation between supervisory agencies in Poland. The new draft of the Memorandum of Understanding between the Commission for Banking Supervision and the Commission for Insurance and Pension Fund Supervision, as well as, the Memorandum of Understanding between the Commission for Banking Supervision and the Polish Securities and Exchange Commission will allow to have joint on-site examinations. It is expected to conclude both Memoranda in 2003.

MAIN STRATEGIC OBJECTIVES OF THE POLISH BANKING SUPERVISION IN 2002

The main objective of the Polish banking supervision 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 associations and the rulings issued on authorization to establish these banks.

Following resolutions took effect since January 1, 2002

- Resolution No. 5/2001 of the Commission for Banking Supervision on the scope and specific rules of the determination of capital requirements for individual risks – the Resolution has introduced all the provisions of the European Union directive on capital adequacy (CAD) and the amendment to that directive (CAD II),
- Resolution No. 6/2001 of the Commission for Banking Supervision on the determination of detailed rules for calculation of own founds – the method of calculating own funds in Poland is based on the Directive 2000/12/EC,
- Resolution No. 7/2001 of the Commission for Banking Supervision on observance of exposure concentration limits – the solutions are in accordance with the Directive 2000/12/EC.

Regulation of the Minister of Finance on procedures for provisioning against the risk of banking operations

The most important amendments:

- extension of the using of valuation of assets and off-balance-sheet commitments on the level of expense for provisioning purposes, in order to achieve uniform treatment of all purchased claims,
- adding to the list of the eligible collateral the insurance of export contracts extended by the Corporation of Export Credit Insurance S.A. in order to uniform prudential treatment of equivalent collateral (e.g. insurance policy and quarantee issued by the Corporation),
- clarification of requirements for letters of comfort, i.e. introduction of the criterion of good financial standing and limitation of the total sum of the letters of comfort issued, in order to achieve uniform treatment of guarantee/ endorsement and letters of comfort,

Amendments of recommendations

In 2002 the Polish banking supervision reviewed the prudential recommendations and the Commission for Banking Supervision approved the new versions.

The most important amendments cover:

- Recommendation A regarding risk management involved in derivatives – recognition of netting as an instrument reducing counter party risk,
- Recommendation B concerning limitation of bank financial investment risk – the scope of recommendation was extended from the capital investment to all possible long term investments; this approach is compatible with a division of the bank activity into trading book and banking book,
- Recommendation C regarding management of risk connected with large concentration – adjustment to Directive UE and indication that large exposure may consist of both capital and credit concentration,
- Recommendation D regarding risk management involved in information technology used by banks – added some issues connected with electronic banking in order to be in accordance with Basel Committee principles,
- Recommendation G regarding management of interest rate risk in banks – none essential changes,
- Recommendation H regarding internal control in banks – added a chapter concerning internal control in order to be in accordance with Basel Committee, defined the board of directors and senior management responsibilities, pointed that risk map should be created and that banks should satisfy conditions concerning outsourcing agreement,
- Recommendation I regarding currency risk management in banks and the principles of banks transactions burdened with currency risk – correction of board of directors responsibilities in monitoring process of currency risk and addition of some conditions in order to use „stop loss" limits by small banks,
- Recommendation P concerning liquidity monitoring system – defined liquidity risk in order to control risk connected with particular banking products and services, defined the role of board of directors and senior management in monitoring process, pointed at the necessity of factors identification in order to placed them into contingency plans.

THE ACTIVITY OF THE TRAINING INITIATIVE FOR BANKING SUPERVISION (TIBS) IN 2002

In 2002 the Training Initiative for Banking Supervision (TIBS) – a training center for the supervisors from Central, Eastern, and Southern Europe organized two seminars. The first seminar ***"Optimization of bank inspection process: regional application of best practices"*** was held between 1 – 7 June, 2002 and focused on the issues related to:

- Inspection planning - scare resources management
- Determinants of the organization, scope and complexity of the inspection
- Cooperation between the analytical and inspection sections
- Communication with other supervisors and institutions
- Cooperation with the external auditors
- On site supervision of the market risk
- Credit Risk evaluation criteria: judgmental sampling of the commercial loan portfolio
- Bank evaluation - bank ratings (case study)
- Supervisory cycle
- On -site inspection of problem banks
- Examination of large banks and banking groups
- Risk -focused audit in banks: emerging

The second seminar ***"Assessment of banks' credit risk: current practices, future challenges"*** was organized between 18 - 22 November 2002 and discussed the following topics:

- Credit risk and its links with basic supervisory standards
- Specific provisions in Poland: typical solutions
- Measurement methods used to assess the future credit exposure in netting agreements: basic assumptions
- Credit risk exposure of derivatives
- Large exposure limits in Poland
- Methods of monitoring the structure and quality of credit portfolio applied by the banking supervision in Poland: macroprudential perspective
- Key credit risk problems in banks in Poland and selected countries in the region
- Basel credit risk capital requirements: challenge for the emerging markets
- Credit risk factors and methods applicable top the credit risk measurement
- Overview of mathematical techniques related to the credit risk
- Evaluation of credit risk models - US experience

Following its mission Training Initiative for Banking Supervision lays emphasis on offering trainings to countries from the region, which face similar problems and challenges and are pursuing a similar path in altering their supervisory culture.

Information on TIBS activities you can find at the following web site address: http://www.nbp.pl/tibs/index.html

STATISTICAL TABLES

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Number of financial institutions (at year-ends)

Type of financial institution	2000	2001	2002
Commercial banks	73	69	59
Cooperative banks	680	642	605
Banking sector	**753**	**711**	**664**

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

Item	2000	2001	2002	2002/2000
Public sector ownership	14.9	15.3	17.3	116.1
Other domestic ownership	17.4	10.3	9.5	54.6
Domestic ownership total	32.3	25.6	26.8	83.0
Foreign ownership	56.6	61.3	63.2	111.7
Dispersed holdings	11.1	13.1	10.0	90.1
Total commercial banks	**100.0**	**100.0**	**100.0**	**–**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2000	2001	2002
Commercial banks	95.0	95.5	95.7
Cooperative banks	5.0	4.5	4.3
Banking sector	**100.0**	**100.0**	**100.0**

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

Assets	2000	2001	2002
Cash and balance with Central bank	3.8	6.2	4.6
Interbank deposits	18.4	19.5	16.7
Due from non-financial and government entities	45.2	44.5	46.2
Securities	22.2	20.4	22.6
Other assets	10.4	9.4	9.9
Liabilities	**2000**	**2001**	**2002**
Borrowing from Central Bank	1.3	0.9	0.6
Interbank deposits	10.8	14.1	13.4
Deposits from non-financial and government entities	63.0	66.0	61.1
Bonds	0.5	0.6	0.8
Other liabilities	16.1	9.2	14.0
Capital and reserves	8.3	9.2	10.1

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

Type of financial institution	2000	2001	2002
Commercial banks	153.5	213.0	234.9
Cooperative banks	0.3	0.3	0.4
Banking sector	**153.8**	**213.3**	**235.3**

Solvency ratio of financial institutions

Type of the financial institution	2000	2001	2002
Commercial banks	12.9	15.1	14.1
Cooperative banks	12.8	13.9	13.4
Banking sector	**12.9**	**15.0**	**14.0**

Asset portfolio quality of the banking system

Asset classification*	2000	2001	2002
Consumer loans classified satisfactory	18.1	17.3	16.9
Special mention claims	6.3	6.2	6.4
Irregular claims. of which:			
- substandard	4.4	4.6	4.8
- doubtful	5.1	5.1	5.5
- loss	5.5	8.2	10.7
Classified total	**15.0**	**17.9**	**21.0**
Specific reserves	**11,775.6**	**15,914.9**	**18,341.4**

** From non-financial institutions*

The structure of deposits and loans in 2002 (%) (at year-end)

	Deposits	Loans
Households	72.7	39.2
Government sector	5.9	6.4
Corporate	18.5	53.9
Foreign*	1.3	0.5
Other	2.9	0.5
Total	**100.0**	**100.0**

** Deposits and loans are included in others items*

The structure of deposits and loans in 2002 (%)
(at year-end)

Maturity of deposits (from non-financial sector)		Loans (from non-financial sector)	
At sight	30.2	Long term loans (over one year)	54.2
Within one year	60.6	Medium-term loans (within one year)	30.3
Over one year	9.2	Short-term loans (authorised overdrafts)	15.5
Total	**100.0**	**Total**	**100.0**

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

Type of the Financial institutions	FOREX assets / total assets			FOREX liabilities / total liab.		
	2000	2001	2002	2000	2001	2002
Commercial banks	23.1	25.7	23.9	17.9	18.8	18.0
Cooperative banks	0.0	0.0	0.2	0.0	0.0	0.0
Banking sector	**22.1**	**24.7**	**22.7**	**17.1**	**18.0**	**17.1**

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

(million zloty)

Revenues	2000	2001	2002
Commercial banks	119,386.2	169,616.9	390,360.3
Cooperative banks	3,568.6	4,142.6	3,660.3
Banking sector	**122,954.8**	**173,759.5**	**394,020.6**
Expenditures	**2000**	**2001**	**2002**
Commercial banks	113,859.2	164,316.5	386,686.7
Cooperative banks	3,091.0	3,652.8	3,158.2
Banking sector	**116,950.2**	**167,969.2**	**389,844.9**

Structure of registered capital and own funds of financial institutions in 2002

Type of the Financial institutions	Registered capital	/Total assets	Own funds	/Total liab.
	EUR	%	EUR	%
Commercial banks	2,654.6	2.3	8,942.6	7.7
Cooperative banks	118.1	0.1	452.1	0.4
Banking sector	**2,772.7**	**2.4**	**9,394.7**	**8.1**

2002 DEVELOPMENTS IN THE ROMANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The macro economical results of 2002 can be considered as the best obtained by Romania during the transition period. This is an event because it had been obtained under a gloomy international environment, with small growth in the main partner countries from the European Union.

The objectives of the 2002 economical program had been reached, and in many cases, had been exceeded:

- The GDP growth estimated initially at 5 percent and revised subsequently at 4.7 percent, reached 4.9 percent, one of the highest growth obtained by the candidate countries to the accession to the European Union;
- The inflation rate (December/December) expressed through the consumption price index was 17.8 percent, significantly better than the initial target of 22 percent;
- The deficit of the consolidated budget was 2.6 percent of GDP, below the programmed deficit of 3 percent, revised then at 2.9 percent;
- The deficit of the current account was 3.4 percent of GDP, below the targeted 4.9 percent level;
- The international reserves exceeded US$7.3 billion, above the US$ 6.1 billion targeted;
- The unemployment rate declined from 8.8 percent of the total labor force in December 2001 to 8.1 percent as of December 2002, besides a temporary increase in the first months of 2002.

DEVELOPMENT IN THE BANKING SYSTEM

The main characteristics of 2002 have been the consolidation and the expansion of the banking sector. The process of consolidation has transformed the banking sector into a more safe and efficient system, under the circumstances of the assets expansion which was mainly supported by granting loans to real economy. The expansion of the granting loans activity was mainly supported by the consolidation of the macro-economic stability, confirmed by the positive trend of the main basic economic indicators: economic growth, disinflation, foreign exchange rate and interest rate evolution, fiscal and checking accounts adjustment. This change of the behaviour was also stimulated by the constant diminishment of the profitability of other two investment alternatives: operations with the central bank and Government securities.

The NBR focused on the quality of supervision process and the improvement of the economic environment in Romania, and these were the main factors of consolidation of the favorable evolution of the main indicators defining a healthy banking system. Their positive trends were supported in a large measure, also by the growing capitalization of the banking system (+21.6 per cent in December 2002 compared with December 2001, nominal values), as a result both of the completion on May 31, 2002 of the second stage of the increase of minimum share capital of the banks – NBR Norms 9/2000, and of the consolidation of the financial position of the foreign shareholding in the case of varied banks.

The expansion of the aggregated balance sheet assets (+15 per cent in real terms) mainly due to the contribution of operations with clients (nearly a half of the total) is relevant for 2002.

The structural dynamics of assets shows the change of the attitude of the banks relative to the repartition and the orientation of financial sources to granting loans activity, mainly during the last period of 2002. This attitude was also favored by the ascendant evolution of this segment's turnover. The real growth index of 30 per cent, superior to that registered the precedent year (19 per cent) determined operations with clients to be considered the most dynamic component of aggregated assets portfolio.

The expansion of granting loans activity in 2002 is also showed by the growth, from 39.7 to 42.7 per cent, of general risk ratio. The increase of general risk was accompanied by a positive evolution of banking capitalization. The banks' own funds (growing with 13.1 per cent in real terms against the end of 2001), assured a level of solvability much over the limits established by the NBR for the well capitalized banks (with 9.6 percentage points, in the case of solvency ratio 1).

The expansion of loans portfolio was not contrary to the quality or the banks' liquidity. Moreover, the indicators for credit risk quantification reveals a progress compared with 2001. The level recorded as of the end of the analyzed period was inside the limits assigned with rating 1. At the same time, the value of liquidity indicator (1.4) is still over the regulatory limit (1).

While the competition in the banking market increased, during 2002 the spread between active and passive interests related to the operations with non-banking clients decreased, as well as the turnovers in the case of the alternative investments (Government securities and deposits to the central bank). This adjustment of profit margin, correlated with a higher rhythm of growth of banking assets and own capital, contributed to a slowly contraction, registered during the last half of the year, in the case of the both profitability indicators (ROA and ROE).

Thinking about the totality of the criteria established by the NBR inside the banking rating system, we note the polarization of the banking system in the superior ratings (1 and 2). At the end of 2002, the banks within the rating 2 were the majority but they decreased the weight over the total banking assets (from 76.4 per cent in December 2001, to 62.6 per cent in December 2002), in favor of the banks in rating 1 (growing from 3.4 to 14.2 per cent) and rating 3 (from 16 to 19.2 per cent).

The levels registered by the main economic, financial and banking prudence indicators confirm that the Romanian banking system gets close to the European integration requests.

As of the end of December 2002, Romanian banking sector comprised 39 banks (of which 8 foreign banks' branches).

Regarding the diversification of the institutional typology inside the banking sector, we note the apparition within the Romanian financial market of the first bank specialized in micro-loans and the completion, at the end of September 2002, of the process of licensing the first credit co-operative net. The activity of the co-operative organizations cover an important social component by providing financial services to a well delimited market segment: the low income people.

At the same time, the weight of banks with fully or majority private capital reached 59.6 per cent of the aggregate volume of banking assets and 70.1 per cent of the total volume of share capital respectively.

It should be pointed out that foreign owned banks play a key role in the Romanian banking system, with 56.4 per cent from the total assets and 64.9 per cent from the total share capital respectively. The privatisation of Banca Comerciala Romana, the largest Romanian bank, will represent a major stage of restructuring the Romanian banking system, thereby contributing to the increase of the weight held by private owned banks up to 90 per cent.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF BANKS, NEW DEVELOPMENTS

In the field of regulation, the main activities performed by the central bank in order to improve the safety of the banking system, mainly focused on risk management instruments used by credit institutions both in order to increase their number and to improve the quality of the existing instruments.

Among the regulations issued during 2002, we note the following:

- norms on "know your customer" standards; the problems relative to the minimum requests for knowing the clients were tackled both from the perspective to ensure a necessary framework for the prevention of money laundering and from the prudential perspective;
- prudential norms on loan classification and provisioning in accordance with Basle Committee Principles;
- norms regarding the transactions performed using electronic payment instruments and the relationship between the participants to transactions, which made the banking system to be more safety. The main newly element brought by this regulations was "debtor's financial performance", a supplementary criterion for the classification of loans and investments, besides the existing criteria (the debt's service and the performance of legal procedures);
- norms regarding the minimum capital of banks and of foreign banks' branches, which provides the increase of the minimum limit of share capital and own funds up to 370 billion ROL;
- the regulations applicable to credit co-operative organizations regarding minimum own funds, solvability, large exposures and connected loans and the regulations for loans and investments classification;
- norms regarding the consolidated financial statements issued by credit institutions, which are supposed to allow correct and appropriate presentation of financial performance and position of a group (consolidated firms and affiliates) as well as comparability and equivalence of the information inside the group;
- the regulations regarding the transfer of large value funds focused on the efficiency of the payment systems in Romania, on the preparation of the banks in order to implement the real time settlement system and on the regulations within the regulatory framework, existing in the field;
- a package of norms in order to regulate, from prudential and accounting perspective, some operations with derivatives which may be performed by banks. The exposures resulting from these operations were also followed from credit risk perspective, by establishing appropriate capital requirements.

To be in conformance with the communitarian directives and to eliminate the restrictions identified in the case of the performance of some foreign exchange operations, were the permanent concern of the NBR regarding the foreign exchange regulatory activity.

THE ACTIVITIES PERFORMED BY THE BANKING SUPERVISORY AUTHORITY

Following the achievement of its fundamental objective – a stable, modern and competitive banking system – containing banks able to ensure the financial intermediation based on efficiency criteria, the NBR focused on a healthy banking sector, on making the supervision quality to be in accordance with the international standards as well as on the improvement of some instruments which indirectly support the banking supervision activity: the Credit Risk Bureau, the Payments Incidents Bureau and the Bank Deposits Guarantee Fund.

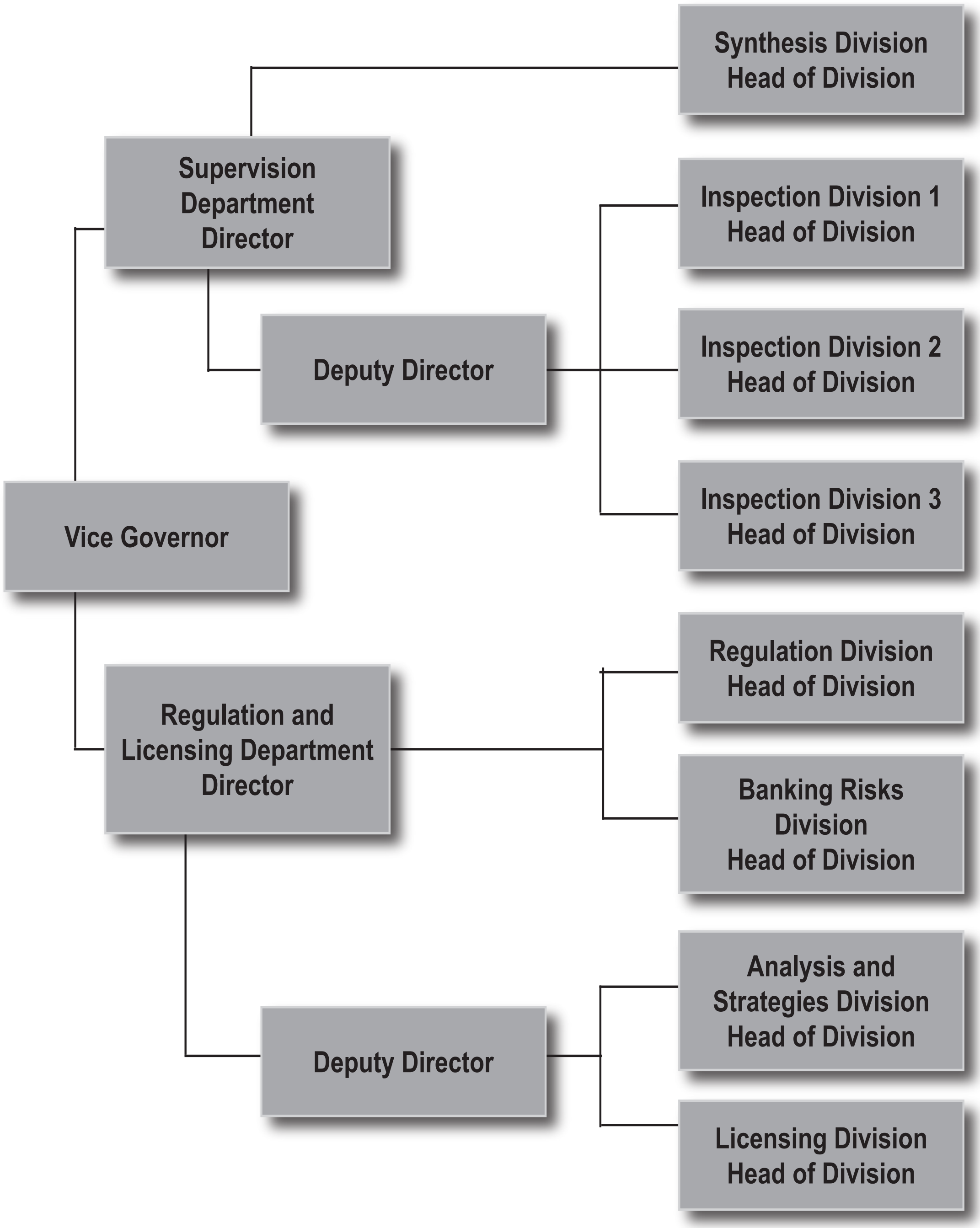
The result of the action performed in order to get solutions for the problem banks, was the removal, from the banking sector, of the un-viable entities. The advantages were evident: the system has again an intermediation role through starting the process of granting loans to banking projects and not based on an adverse selection; the safety of the deponents increased; the banking activity started to operate in an equitable environment.

At the same time, the NBR mainly focused on the other quality aspects of the supervision process: to bring credit co-operatives under the NBR's regulation and supervision, according to the newly regulatory framework for credit co-operatives; to maintain a permanent contact with the banking community by periodical meeting with the banks' management and the majority shareholder, with representatives of independent auditors and the Romanian Banking Association; to continue the supervisors' training policy by participating to courses organized in Romania and abroad; to intensify the co-operation with the supervisory authorities from the home country of the invested capital; to increase the co-operation with the authorities involved in prevention of the terrorism and money laundry.

LEGAL COMPETENCE OF THE NBR IN THE AREA OF BANKING REGULATION AND SUPERVISION

The NBR has the exclusive competence to issue licences and is responsible for prudential supervision of the banks, according to the banking law. It issues regulations, takes measures for their observance and applies sanctions for their infringement. In addition to the off site inspections performed based on the periodic reports submitted by the banks, on site inspections are conducted by the NBR at least once a year and more frequently when irregularities are detected. In case of any violation of the regulations, the NBR can impose penalties.

SUPERVISION DEPARTMENT AND REGULATION & LICENSING DEPARTMENT ORGANIZATION STRUCTURE



INTERNATIONAL ACTIVITIES OF NBR

The NBR regularly informs the European Commission on supervisory topics. In this respect, the Supervision Department provided information for the Commission's regular annual report, participated in the meetings and provided professional opinion to help in formulating the Romanian negotiations position.

During the period between 2nd and 6th December 2002 a team of seven experts from European supervisory organisations in the area of financial services visited Romania in order to review the progress made in setting up adequate supervision over the financial sector and meeting the European requirements for effective home country control in view of full participation in the unified open markets.

Meetings were held mainly at the supervisory authorities (Insurance Supervision Commission, National Bank of Romania, National Securities Commission) and at the Ministry of Public Finance. The topics discussed included the developments in supervisory practices and the progress on supervisory and related matters in legislation, both of which are essential for a sound financial services sector. These discussions focused on recent changes in legislation as well as the proposed legislation to be introduced as part of the requirements for the EU accession, and on improving effective supervisory practices.

The visit was done as a "peer review" to evaluate the authorities competent for supervision over the banking, insurance and securities markets in Romania. The peer review report concluded that Romanian financial markets are in a crucial transitional period and in a stage of development significantly different from that of most accession countries.

Having in view a closer co-operation with supervisory authorities in the country of origin of capital invested in Romania, the NBR have finalized the negotiations with six supervisory authorities (National Bank of Moldova – 07.27.2001, Supervision and Regulation Agency from Turkey – 02.19.2002, Central Bank of Cyprus – 04.10.2002, Bank of Italy – 12.12.2002, Bank of Greece – 01.24.2003 and Federal Office for Banking Supervision from Germany – 03.04.2003) and with other four supervisory bodies the negotiations are in progress (Bank of Netherlands, Bank of Austria, Banking Commission from France and Bank of Portugal).

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

The NBR made official the co-operation with National Commission for Securities and Insurance Supervisory Commission, by signing, in April 2002, a co-operation protocol with these authorities.

MAIN STRATEGIC OBJECTIVES OF THE NBR IN 2003

At the present, we deem that the banking system is a stable one. However, there are some objectives, which should be achieved:

- the improvement of the Early Warning System through new econometric formulas in order to detect any potential banking bankruptcy and systemic crisis and of the Uniform Rating System based on the implementation of a new component – Sensitivity to market risk;
- the further improvement of the legal framework on prudential regulations in the banking system in order to come in line with the EU requirements and the recommendations of the Basel Committee;
- the incorporation of the provisions regarding consolidated supervision of credit institutions into Romanian banking legislation;
- the conclusion of a formal arrangements with Romanian Banking Association, National Office for Prevention and Combating of the Money Laundering;
- the privatisation of the largest Romanian bank - Banca Comerciala Româna;
- the restructuring of the saving bank - Casa de Economii si Consemnatiuni - in view to its privatisation;
- the operational restructuring of Eximbank as a bank specialised in export-import operations.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institutions	2000	2001	2002
Commercial banks	33	33	31
Branches of foreign banks	8	8	8
Total banking system	**41**	**41**	**39**

Ownership structure of financial institutions in 2002 on the basis of the registered capital (%) (at year-end)

Item	Type of financial institutions
	Commercial banks
State ownership	29.9
Other domestic ownership	5.2
Domestic ownership, total	35.1
Foreign ownership	64.9
Total banking system	**100.0**

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

Item	2000	2001	2002	2002/2000
State ownership	38.4	34.6	29.9	190.9
Other domestic ownership	7.8	4.8	5.2	163.0
Domestic ownership, total	46.2	39.4	35.1	186.2
Foreign ownership	53.8	60.6	64.9	295.7
Total banking system	**100**	**100**	**100**	**245.1**

Distribution of market shares in balance sheet total (%)

Type of financial institutions	2000	2001	2002
Commercial banks	92.2	92.1	92.6
Branches of foreign banks	7.8	7.9	7.4
Total banking system	**100**	**100**	**100**

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

Assets	2000	2001	2002
Cash and claims on banks	41.2	43.0	41.9
Net loans	32.5	34.0	38.1
Securities	16.2	14.5	12.5
Fixed assets and other assets	10.1	8.5	7.5
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2000**	**2001**	**2002**
Due to other banks and financial institutions	11.8	10.5	10.5
Due to clients	71.3	72.0	73.7
Other liabilities	5.0	3.5	1.6
Own capital	11.9	14.0	14.2
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 institutions	2000	2001	2002
Commercial banks	36.9	16.4	18.2
Branches of foreign banks	10.2	27.9	23.8
Total banking system	**34.8**	**17.3**	**18.6**

** commitments in favour of banking and non-banking customers*

Solvency ratio of financial institutions

Type of financial institutions	2000	2001	2002
Commercial banks	23.8	28.8	25.0
Branches of foreign banks	–	–	–
Total banking system	**23.8**	**28.8**	**25.0**

Asset portfolio quality of the banking system

Mill EUR

Asset classification	2000	2001	2002
Standard	5,693	7,030	7,792
Watch	36	26	21
Substandard	46	30	62
Doubtful	31	15	11
Loss	137	123	45
Classified total	**5,943**	**7,224**	**7,931**
Specific reserves	145	130	58

According to the classification statement of Commercial Banks
Beginning with October 2000, the asset portofolio which is classified includes not only loans, but also placements to other banks and off-balance sheet items

The structure of deposits and loans in 2002 (%)
(at year-end)

	Deposits	Loans
Households	42.1	8.0
Government sector	3.9	16.3
Corporate	40.7	58.0
Foreign	8.9	15.2
Other	4.4	2.5
Total	**100.0**	**100.0**

The structure of deposits and loans in 2002 (%)
(at year-end)

Maturity of deposits		Loans	
At sight	29.3	Short-term loans	65.7
Time deposits	70.7	Medium and long-term loans	34.3
Total	**100.0**	**Total**	**100.0**

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

Type of financial institutions	FOREX assets/total assets			FOREX liabilities/total liabilities		
	2000	2001	2002	2000	2001	2002
Commercial banks	43.3	45.7	40.9	41.1	38.5	37.6
Branches of foreign banks	82.4	77.7	70.6	77.2	73.1	65.1
Total banking system	**46.3**	**48.2**	**43.1**	**43.9**	**41.2**	**39.6**

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

Revenues	2000	2001	2002
Interest income	22.3	28.1	25.6
Income from securities transactions	11.6	11.3	8.7
Recoveries from provisions	23.1	8.4	6.8
Income not derived from interest	42.7	52.0	58.8
Extraordinary income	0.3	0.2	0.1
Expenditures	**2000**	**2001**	**2002**
Interest expenses	22.9	24.5	19.1
Expenses for securities transactions	0.2	0.3	2.0
Provisions expenses	27.0	10.4	7.8
Expenses, other than interest	48.2	61.7	68.9
Extraordinary expenses	0.2	1.0	0.4
Profit tax	1.5	2.1	1.8

Structure of registered capital and own funds of financial institutions in 2002

Type of financial institution	Registered capital	/Total assets	Own funds	/Total liabilities
	Mill. EUR	%	Mill. EUR	%
Commercial banks	914.9	7.3	1,554.7	12.5
Branches of foreign banks	69.4	7.0	108.4*	10,9
Total banking system	**984.3**	**7.3**	**1,663.1**	**12.4**

* *own capital*

2002 DEVELOPMENTS IN THE RUSSIAN BANKING SYSTEM

MACROECONOMIC DEVELOPMENT

Key macroeconomic indicators looked set to sustain positive growth in 2002 – Russia's economy continued developing steadily while inflation showed signs of abating. In 2002, GDP increased by 4.3% (in 2001 – by 5%). The rise in the volume of production was accompanied by the creation of new jobs, reduction in the unemployment rate and growth in real money incomes of the population.

In 2002, the unemployment rate decreased from 9% to 8%. Compared with 2001, real money incomes of the population increased by 9%, whereas real imputed wages - by 16%. Price movements in Russia's economy were influenced by a balanced policy of the Bank of Russia and stability in the ruble exchange rate. Concerted actions of the Bank of Russia and the Government of the Russian Federation helped substantially to slow down growth in consumer prices. In 2002, prices grew by 15.1% (in 2001 – by 18.6%).

Sustainable development of the economy in 2002 made it possible to increase the federal budget revenues and, as in the previous year, to produce a budget surplus which amounted to Rbs 156.2 billion, or 1.4% of GDP.

A favourable economic situation in the world market helped Russian exporters increase the volumes of export. The export of goods in 2002 reached its highest for the period after 1992. Steady hard currency export earnings helped to sustain a strong balance of payments, increase official international reserves and amortise foreign debt. Russia's international reserves in 2002 grew from $36.6 billion to $47.8 billion. In 2002, Russia's external debt decreased from $113.2 billion to $104.7 billion.

The 2002 results demonstrate a steady development of Russia's economy, a decline in risks and improvement in the investment climate.

BANKING SECTOR DEVELOPMENT

Development trends in 2002. In 2002, sustained higher rates of growth in Russia's banking sector prevailed over those in the economy as a whole. The stable development of the economy was facilitated by a favourable macroeconomic situation.

The rates of growth in banking assets in real terms outpaced growth rates of GDP 4 times, in banks' capital - 2.6 times, and in loans to non-credit institutions – 5 times. During 2002, the banking assets increased from 34.9% to 38.2% of GDP, and the aggregate capital of credit institutions grew from 5.0% to 5.4% of GDP. The ratio of loans to non-credit institutions to GDP rose from 13.0% to 14.6%. There was also growth in the number of credit institutions: from 1,319 to 1,329 (see Table 1).

Movements in the basic parameters, characterising the state of the banking sector in 2002, indicate that it has overcome the effects of the 1998 banking crisis and strengthened its upward trend. Deposits and other retail customer funds were the last among the basic quantitative indicators of the banking sector that reached the pre-crisis level (as of 01.07.1998) – it happened in mid-2002.

In early 2003, the amount of retail deposits in real terms exceeded pre-crisis level by 22%. During 2002, the amount of deposits and retail customer funds in real terms grew by 35%, or 8 times higher than growth of GDP. As a result, the share of deposits and other retail customer funds in the structure of liabilities of the banking sector rose from 21.5% in early 2002 to 24.8% in early 2003 (see Table 5). Growth in retail customer deposits was generated by an increase in household incomes, confidence of depositors in credit institutions', decline in the rate of inflation and stabilisation of the ruble exchange rate.

Among the asset-side transactions in 2002 bank lending, in particular to non-credit institutions, showed a high growth rate: its volume in real terms increased by 21.2%.

Results for 2002 showed that the credit institutions earned Rbs 93 billion, or 40% higher than the figure for 2001 (Rbs 67.6 billion). The number of profit-making banks increased from 93% of the total number of credit institutions in 2001 to 96% in 2002. Growth in the volume of active transactions accompanied by an insignificant decline in the interest margin was the main factor contributing to an increase in earnings of the credit institutions.

Despite a positive growth in major indicators of the banking, it would be wrong to underestimate potential systemic risks which the credit institutions face, primarily the risks involving the real economy. For a little more than 10 years of operating in the market, Russian banks have never been so dependent on the financial stability of the economy and corporate borrowers. The regulatory authorities intend to take a highly conservative approach to evaluating the capabilities of credit institutions to take extra risks in the real sector of the economy, building up adequate capital to match such risks and allocating sufficient provisions to cover possible losses.

Development Outlook. The strategic aim of the government with respect to the banking sector is to enhance the efficiency of the banks' financial intermediation and their functional role in the country's economic development. To achieve the aims the Bank of Russia in cooperation with the Government of the Russian Federation intends to take a number of measures designed to strengthen the depositors' confidence in the banking sector, create conditions which will stimulate competition in the banking sector and add to its transparency.

Provided the rates of growth in the economy and banking sector are sustained, the ratio of the banking assets to GDP by the end of 2003 has to exceed 40% and the volume of credits extended to the non-financial sector of the economy surpass 16%. By Bank of Russia estimates, the ratio of assets to GDP will grow at an annual rate of 1.5 percentage points and by January 1, 2007, it will reach 45%.

UPGRADING THE BANKING SUPERVISION SET-UP

In 2002, the Bank of Russia paid attention to the improvement of supervision. To co-ordinate the supervisory efforts the Bank of Russia created a Main Inspection of Credit Institutions.

The Main Inspection of Credit Institutions is called to provide development of substantial approach at revealing infringements in activity of credit institutions with rules and focus on such important aspects as: the motivated judgements on assumed risks, the soundness of risk classification and creation of reserves for possible losses, the effect of detected non-compliance and shortcomings on a credit institution's standing and future prospects. The task of improving the quality and efficiency of inspections is rather challenging in view of the forthcoming introduction of a deposit insurance scheme and related large-scale inspections of banks.

The mission of the new Inspection is to control over the observation by credit institutions of the obligatory bank normatives. The objective of inspections is to analyse substantive aspects of the banking activities that assumes switching over from a formalised criteria of banks' activities assessment to motivated judgements regarding risk-taking, the justification of risk classification and creation of reserves for possible losses, the effect of detected non-compliance and shortcomings on the credit institutions' financial standing and future prospects.

As part of the effort to improve supervision it was decided to launch a programme designed to establish a body of curators of credit institutions. The principal aim of curators is to detect the degree of risks inherent in the banking business and provide assistance in optimising such risks through close co-operation with credit institutions.

The prime function of curatorship will be a qualitative analysis of the credit institutions' financial standing and its future prospects that foresees switching over from a formalised evaluation of a bank's financial standing, its compliance with mandatory standards to a complex assessment of the quality of its internal systems of control and risk management.

Starting from August 2002, the Bank of Russia has been carrying out an experiment in exercising curatorship of banks in 10 regions of the Russian Federation.

BANK REGULATION AND SUPERVISION MEASURES OF THE BANK OF RUSSIA IN 2002

In 2002, the Bank of Russia was actively involved in upgrading the laws regulating credit institutions' activities. The work was carried out in accordance with the Strategy of Russia's Banking Sector Development.

The amendments to the applicable banking laws that came into force in 2002 were of great importance for further development and improvement of the legal framework for banking supervision, the regulation of the procedures for registering credit institutions and licensing their banking activities, preventing bankruptcies and regulating the liquidation practices. The coming into force of these amendments allowed to make corresponding modifications to Bank of Russia regulatory standards.

One of the most important federal laws adopted in 2002 was the new Law on the Central Bank of the Russian Federation. This law contains a number of modifications relating to the banking regulation and supervision. The most important of them are:

- the Bank of Russia is entitled to exercise supervision over not only credit institutions but banking groups as well;
- the Bank of Russia may set mandatory standards for banking groups;
- the requirements of the Bank of Russia for the candidates for executive positions in a credit institution are laid down in accordance with the established standards;
- the Bank of Russia may exchange information with the supervisory authorities of foreign states.

The Bank of Russia continued bringing the current system of banking regulation in conformity with the internationally accepted principles, including reflected in the documents of the Basel Committee on Banking Regulation and Supervisory Practices, as well as the international accounting standards.

The most important step in this direction was drafting of the new version of the Bank of Russia regulation entitled "On the Procedure for Making by Credit Institutions " and the new version of the instruction "On the Procedure for Making and Applying Reserves for Possible Loan Losses." To improve the quality of banking capital the Bank of Russia drafted a regulation entitled "On the Methodology of Determining the Size of Own Funds (Capital) of Credit Institutions" which foresees eliminating from the calculation of the capital of credit institutions the portion of own funds that was created fictitiously.

The Bank of Russia also drafted an operational instruction entitled "On the Related Party Lending" which recommends banks to enhance their risk control in the event of related party lending (the instruction came into effect in early 2003).

While continuing to promote advanced foreign experience relating to banking regulation and supervision, the Bank of Russia notified credit institutions of the recommendations issued by the Basel Committee on Banking Regulation entitled "Internal Audit in Banks and Supervisor' Relationship with Auditors" and "Supervisory Guidance on Dealing with Weak Banks".

In accordance with the Strategy of Russia's Banking Sector Development starting from December 2002 the Internet site hosted by the Bank of Russia (www.cbr.ru) carries an Internet monthly version of "The Survey of the Banking Sector of the Russian Federation". This informational and analytical survey provides a general data of the state of the banking sector of the Russian Federation, its institutional characteristics, discloses the most important consolidated indicators relating to the credit institutions' activities, as well as the macro-prudential indicators of the banking sector, including capital adequacy, credit and market risk exposures, and the state of liquidity of credit institutions. The disclosure of such information will allow credit institutions, investors, supervisory authorities and other stakeholders to carry out regular monitoring of Russia's banking sector performance.

The Bank of Russia actions in the area of off-site supervision were aimed, first of all, at evaluating the nature and profile of the risks taken by the banks, analysing their financial stability, and optimising the supervisory procedures. The adequacy of supervision was ensured by an objective evaluation of the situation taking into account the most likely prospects of its development and the optimal realisation by the supervisory authority of the opportunities and powers granted by the applicable legislation.

The dynamics of the sanctions applied to credit institutions in 2002 demonstrate a downward trend in the total number of failures to comply with the established standards. Thereupon, there is a stable trend towards primarily preventive measures and cutting down the frequency of compulsory measures applied to credit institutions.

OUTLOOK FOR THE DEVELOPMENT OF BANKING REGULATION AND SUPERVISION

The development objectives of the banking sector and the ways to accomplish them are defined in the Strategy of Russia's Banking Sector Development accepted by the Government of the Russian Federation and Bank of Russia in December 2001.

In the mid-term outlook, the major development objective of Russia's banking sector is to create conditions for enhancing its efficiency and strengthening its functional role in the economy. To accomplish this objective it is necessary to reduce the systemic risks of the banking activities, the cost of banking services, primarily in lending, for the real economy and households; extend maturities and reduce the price of bank borrowings; increase the quality of own funds (capital), reduce the expenses incurred by the credit institutions, associated, first of all, with the onerous administrative burden.

The measures proposed for 2003-2005 to create better conditions for banking activities are also aimed at cutting down administrative expenses incurred by the banks, increasing their competitiveness, defending the interests of banks and their lenders, and enhancing the efficiency and promptitude of the banking supervision.

Among the tools used to achieve the objectives in the near future is the adoption by enterprises and credit institutions of sound international practices, including international accounting standards, the creation of deposit insurance schemes; the preparation and approval of a package of legislative amendments aimed at creating more favourable conditions for banking activities; the improvement of Bank of Russia regulatory and supervisory procedures.

The banking supervision will continue to develop substantive approaches which foresee the evaluation of future prospects for credit institutions and the implementation of supervisory measures considering, first of all, the economic substance and real assessment of the risks relating to the banking activities and their potential impact on the stability of credit institutions.

In order to continue improving the supervisory function it is necessary to provide the Bank of Russia with a legally vested right to make supervisory decisions taking into consideration such parameters in credit institutions' activities as the profile of risks, the adequacy of judgements of credit institutions about their real levels, the quality of intra-bank systems of risk management and control.

It is necessary to implement the measures aimed at developing preventive functions of the banking supervision including further perfection of the system of early prevention of violations, and the development of supervision on a consolidated basis. The Bank of Russia will pay special attention to the quality of banks' capital that will entail a comprehensive evaluation of the financial standing of founders and acquirers of substantial stakes in the capital of credit institutions and the prevention of using fraudulent schemes of capitalisation of credit institutions.

STATISTICAL TABLES

Number of financial institutions
(at year end)

Type of financial institution	2000	2001	2002
Total number of operating credit institutions	**1,311**	**1,319**	**1,329**
Including:			
Banks	1,274	1,276	1,282
Non-bank credit institutions	37	43	47

Structure of assets of credit institutions grouped by the type of investment

	Assets	1.01.01		1.01.02		1.01.03	
		Bn rubles	%	Bn rubles	%	Bn rubles	%
1.	Cash, precious metals and gemstones	47.1	2.0	70.3	2.2	91.2	2.2
2.	Accounts with Central Bank of RF	273.6	11.6	303.9	9.6	416.8	10.1
3.	Correspondent accounts with banks	236.3	10.0	315.3	10.0	300.9	7.3
4.	Securities purchased by banks Including:	473.2	20.0	562.0	17.8	779.9	18.8
4.1	Federal bonds of Russian Federation	310.6	13.1	338.4	10.7	412.8	10.0
5.	Debt on loans	1,082.5	45.8	1,561.7	49.4	2,148.8	51.8
6.	Other assets	249.8	10.6	346.5	11.0	407.7	9.8
	Total assets	**2,362.5**	**100.0**	**3,159.7**	**100.0**	**4,145.3**	**100.0**

Structure of liabilities of credit institutions grouped by the sources of funding

	Liabilities	1.01.01		1.01.02		1.01.03	
		Billion rubles	%	billion rubles	%	billion rubles	%
1.	Funds and income of banks	336.1	14.2	510.3	16.2	652.5	15.7
2.	Loans granted to banks by Central Bank of the Russian Federation	11.1	0.5	46.6	1.5	6.2	0.1
3.	Bank accounts	119.3	5.1	164.7	5.2	176.5	4.3
4.	Loans, deposits and other funds received from other banks – total	178.7	7.6	203.1	6.4	315.4	7.6
5.	Customer accounts						
	Including:	1,223.9	51.8	1,647.7	52.1	2,194.5	52.9
5.1	Corporate and institutional funds	722.1	30.6	902.6	28.6	1,091.4	26.3
5.2	Retail deposits and other funds	445.7	18.9	677.9	21.5	1,029.6	24.8
6.	Debt obligations issued by banks	200.8	8.5	272.5	8.6	450.6	10.9
7.	Other liabilities	292.6	12.4	314.8	10.0	349.6	8.4
	Total liabilities	**2,362.5**	**100.0**	**3,159.7**	**100.0**	**4,145.3**	**100.0**

Structure of quality of credit portfolio (%) (according to consolidated bank financial statements)

Loan Quality	as of 1.01.01	as of 1.01.02	as of 1.01.03
Standard	87.2	89.4	90.1
Substandard	5.1	4.3	4.3
Doubtful	2.5	2.1	1.8
Loss	5.2	4.2	3.8

Credit portfolio (%)

Indicator	as of 1.01.01	as of 1.01.02	as of 1.01.03
Loans to government sector	1.4	1.1	1.4
Loans to banks	20.0	13.9	14.9
Loans to private individuals	4.2	6.1	6.6
Loans to legal entities	74.5	78.9	77.1

Dynamics of bank risk-weighted assets

billion rubles

Risk-weighted assets	as of 1.01.91	as of 1.01.02	as of 1.01.03
1 group (Ap 1) (risk ratio = 2%)	0.9	1.4	1.8
2 group (Ap 2) (risk ratio = 10%)	30.8	31.8	39.5
3 group (Ap 3) (risk ratio = 20%)	73.1	88.4	100.1
4 group (Ap 4) (risk ratio = 70%)	76.0	77.1	128.3
5 group (Ap 5) (risk ratio = 100%)	1,160.1	1,790.1	2,365.4
Total risk-weighted assets of credit institutions	**1,340.9**	**1,988.8**	**2,635.2**

Dynamics of the share of foreign exchange assets and liabilities in the aggregate assets and liabilities of the banking system

	as of 1.01.91	as of 1.01.02	as of 1.01.03
Foreign currency assets as % of total assets	41.9	37.9	36.2
Foreign currency liabilities as % of total liabilities	32.8	32.1	31.7
Difference in the ratio of foreign currency component of assets and liabilities, % points	9.1	5.8	4.4

Structure of income and expenses of operating credit institutions (%)*

	1.01.01	1.01.02	1.01.03
Total income	**100.0**	**100.0**	**100.0**
Including:			
– interest received on loans, deposits and other investments	11.43	13.05	18.03
– income received from operations with securities	8.02	6.52	10.13
– income received from operations with foreign exchange and other currency values	40.11	32.71	27.76
– penalties and fines	0.23	0.55	0.56
– other income	40.20	47.17	43.49
including:			
– recovery of sums from accounts of funds and reserves	33.53	41.15	35.31
– commissions received	2.92	3.00	3,77
Total expenditure	**100.0**	**100.0**	**100.0**
Including:			
– interest paid for loans taken	0.91	0.98	1.14
– interest paid to legal entities for borrowed funds	2.16	2.44	2.49
– interest paid to private individuals on deposits	6.03	3.46	5.04
– expenditures on operation with securities	2.68	3.15	5.42
– expenditures on operation with foreign exchange and other currency values	39.75	32.73	28.03
– administration expenditures	3.30	4.35	6.47
– penalties and fines	0.05	0.31	0.05
– other expenditures	45,12	52.57	51.35
including:			
– allocations to funds and reserves	37.61	45.30	41.20
– commissions paid	0.26	0.32	0.48

**) According to the Income and Loss Statements provided by credit institutions (form 102).*

2002 DEVELOPMENTS IN THE SLOVAKIAN BANKING SYSTEM

ECONOMIC DEVELOPMENT

The macroeconomic and monetary development in 2002 was typified by a decrease in the inflation rate, the gradual acceleration of economic growth and the continued deficit of the foreign trade and the balance of payment current account.

Consumer Prices

The inflation rate in 2002 decreased to 3.4 % from 6.5 % reported in 2001, owing to the narrower scope of regulated prices adjustments and the deceleration of growth in the remaining basic segments of consumer prices. Core inflation in 2002 decreased by 1.3 points to 1.9 %. Its development was mainly influenced by the increased fuel prices, owing to the growth in oil prices on the world markets, which was offset by a decrease in foodstuff prices. Prices in the tradable sector, which prices reflected the appreciation of the exchange rate of the Slovak koruna owing to the high share of imports to the domestic market, had a stabilizing effect on the price development. The increased domestic demand in the environment of strong retail competition did not create negative incentives for the consumer prices growth. The consumer prices growth in 2002 fell in comparison with 2001, while the year-on-year inflation rate, measured by the consumer prices index, was 3.4 % in December (as compared with 6.5 % in the same period in the preceding year). The average inflation rate in 2002 was 3.3 %.

Gross domestic product development

The development of GDP in 2002 continued to show an accelerated performance of the Slovak economy. As compared with the previous year, the GDP in constant prices went up by 4.4 % (in 2001 an increase of 3.3 %). The rate of economic growth gradually accelerated from 3.9 % in the first quarter, through 4.0 % in the second quarter and 4.3 % in the third quarter, up to 5.4 % in the last quarter. The growth rate of GDP thus reached its highest level in the last five years. The GDP volume in constant prices was SKK 1,073.6bn, which was more by 8.5 % than in the preceding year. The characteristic feature of economic growth in 2002 was the acceleration of its year-on-year dynamics. A favourable aspect of the GDP development was the positive impact of net exports on the GDP growth, due to the growth rate of exports being higher than that of imports. A moderate increase in export efficiency (measured by the exports to GDP ratio) was also reflected in a decrease of the external trade deficit. An increase in domestic demand was fuelled mainly by final consumption and an increase of stocks combined with a decrease of investment demand. One of the factors contributing to the acceleration of the final consumption of households was a growth in real wages higher than work productivity growth. This unfavourable disproportion was mainly due to the high increase of wages in particular in the public sector. The final expenditures of public sector also developed relatively dynamically; however, their growth decelerated in the second half-year owing to the approved austerity measures. The fiscal deficit to GDP ratio decreased moderately to 7.2 % in 2002 from 7.3 % in 2001 (according to the ESA 95 methodology).

Wages

The average nominal monthly salary in Slovakia in 2002 was SKK 13,511.0. Its year-on-year increase was 9.3 %, which was 1.1 percentage points higher than in 2001. The real wage went up by 5.8 % and its year-on-year growth rate accelerated by 5 percentage points. The increase in real wages (the highest since 1997) was based both on the nominal wage increase and low average inflation.

Balance of payment current account

Dynamic development of domestic demand and its export demanding character, along with a low economic growth in the EU member countries in 2002, was reflected in the continued high deficit of the balance of payment current account. Despite the trade balance deficit being moderately lower, an increased deficit in incomes and a decreased surplus of trade balance and current transfers caused an increase in current account deficit to SKK 87.9bn from SKK 84.4bn in the preceding year. However, its share in GDP fell to 8.2 % (from 8.5 % in 2001).

Capital and financial account

The capital and financial account ended in a surplus of SKK 234.3bn. As compared with the same period in the preceding year, the surplus was SKK 151.2bn higher, i.e., more than 187 %. This increase was influenced mainly by a higher income from foreign direct investments, due to the sale of state-owned property to foreigners.

Foreign exchange reserves

The foreign exchange reserves of the NBS were USD 9,195.5m at the end of 2002, and as compared with the figure as of December 2001 they increased by USD 4,404.4m. Incomes from privatisation activities of the government were decisive factors positively influencing the income side. The expenditure side was determined mainly by the government debt service and the central bank interventions. The development of the NBS's foreign exchange reserves during the year was also affected by movements in the exchange rates of freely convertible currencies on the world financial markets.

External debt of Slovakia

According to preliminary data, total gross external debt at the end of December 2002 was USD 13.2bn. Despite an increase in the total gross external debt in 2002, this debt's share in GDP in Slovak koruna decreased by 4.9 percentage points to

49.2 %. The year-on-year increase of the external debt, by USD 1.8bn, was also influenced by the exchange rate development, in particular the EUR/USD cross exchange rate. The volume of external debt calculated at the fixed exchange rate as of 1 January 2002 confirmed that the exchange rate differential represented as much as 66 % of the total increase in the 2002 external debt.

Budgetary performance

The total public deficit for 2002 was planned in the amount of SKK 36.8bn, i.e. 3.5 % of GDP (pursuant to Article 1 para 2 of the Act on the 2002 State Budget). The 2002 real deficit, less expenditures of bank restructuring, was SKK 29.8bn, i.e. 2.8 % of GDP. Taking into account the forthcoming accession of Slovakia to the EU, it was necessary to adjust the system of recording and accounting data in the area of public finance in the ESA 95 methodology also. According to this methodology, the fiscal deficit of the public sector in 2002 was SKK 77.8bn, i.e. 7.2 % of GDP. As the budgetary deficit for 2002 was not planned in accordance with this methodology, its real figures cannot be compared with the planned figures.

DEVELOPMENT OF THE BANKING SECTOR

In the year 2002, the results of restructuring of the banking sector were gradually manifested. There was recorded an improvement of the productivity of banks as well as other financial indicators, increased competition in the market for bank products, notably in the lending area, and also a favourable development with regard to the observation of prudent banking indicators.

In 2002, there was a significant increase from 60.6% (as of Dec. 31, 2001) to 85.3% (as of Dec. 31, 2002) in the share of foreign investors in total subscribed share capital of banks and funds provided by foreign banks to their branch offices. This growth was mainly caused by the sale of state-owned interests in the share capital of banks to foreign investors and the dissolution of Konsolidačná banka Bratislava, š.p.ú.

In its capacity of the founder of Konsolidačná banka Bratislava, š.p.ú., the Ministry of Finance of the SR issued a decision in January 2002, whereby the bank was terminated without liquidation with effect from Jan. 31, 2002. Slovenská konsolidačná, a.s., Bratislava became its legal successor. On June 17, 2002, Konsolidačná banka Bratislava, š.p.ú. was deleted from the corporate register.

In March 2002, on the basis of an approval granted by the National Bank of Slovakia, Bank für Arbeit und Wirtschaft Aktiengesellschaft, Vienna acquired a 100 percent interest in the share capital of Istrobanka, a.s. (by purchasing the shares from Slovenská poisťovňa, a.s. – 82 % and Bratislava, and those held by Bratislava, the Capital of the SR – 18 %).

On April 4, 2002 shares of Investičná a rozvojová banka, a.s. was transferred to OTP Bank Rt. Budapest, which by virtue of its 95.7% share in the bank's share capital became its majority shareholder.

The National Property Fund (FNM) of the SR announced the third tender to sell shares of Banka Slovakia, a.s. In this respect, Banka Slovakia, a.s. asked the National Bank of Slovakia to grant an approval to disclose information protected by banking secrecy (approval for due diligence to be performed in the bank by a potential investor that would enable it to make an investment decision with regard to the bank). On the basis of applications submitted by Banka Slovakia, a.s., the National Bank of Slovakia issued only one prior consent to a foreign investor, namely MEINL BANK Aktiengesellschaft, Vienna in January 2002.

Slovenská konsolidačná, a.s., a shareholder of Poštová banka, a.s., announced a tender to sell its share (55.16%) in the said bank. On the basis of an application from the bank for a prior consent to the disclosure of information protected by banking secrecy, the National Bank of Slovakia granted four decisions giving prior consent to Tatra banka, a.s., Bratislava, Kulczyk Holding S.A., Warszaw, ING Bank N.V., Amsterdam and Česká pojišťovna, a.s., Prague in March and May of 2002. The company Kulczyk Holding S.A., Warszaw did not use the opportunity to get acquainted with the information subject to banking secrecy. Offers to purchase shares were presented by Tatra Banka, a.s., Bratislava and Česká pojišťovna, a.s., Prague within the set deadline. At their meeting of August 22, 2002, the Board of Directors and then the Supervisory Board of Slovenská konsolidačná, a.s. decided not to accept any of the offers relating to the privatisation of Poštová banka, a.s. on the grounds of a failure to meet the required parameters.

On October 1, 2002, Slovenská záručná a rozvojová banka, š.p.ú. was transformed into a joint-stock company (by a decision of the Ministry of Finance of the SR and the National Bank of Slovakia).

As of Dec. 31, 2002, twenty banking entities (eighteen banks and two branch offices of foreign banks) and seven representation offices of foreign banks were active in the Slovak banking sector. Three of the eighteen banks mentioned above were housing construction saving banks. Of the fifteen universal banks, eight banks and one branch office of a foreign bank hold a mortgage banking license (HVB Bank Slovakia, a.s., Istrobanka, a.s., Ľudová banka, a.s., OTP Banka Slovensko, a.s., Slovenská sporiteľňa, a.s., Tatra banka, a.s., UniBanka, a.s., Všeobecná úverová banka, a.s. and Československá obchodní banka, a.s., a of a foreign bank branch in the SR).

Two banks changed their business names: as of April 1, 2002, Poľnobanka, a.s. changed its name to UniBanka, a.s. and as of August 1, 2002, Investičná a rozvojová banka, a.s. changed its name to OTP Banka Slovensko, a.s.

In the course of 2002, four representation offices of foreign banks were closed – those of Česká spořitelna, the Czech Republic, Bank für Arbeit und Wirtschaft Aktiengesellschaft, Austria (in connection with the acquisition of a 100% stake by Bank für Arbeit und Wirstchaft Aktiengesellschaft, Vienna in the share capital of Istrobanka, a.s.), Magyar Külkereskedelmi Bank Rt, Hungary and Societé Générale, France. On September 17, 2002 a new representation office of the joint-stock commercial bank FORA-BANK, Russia was registered.

The volume of subscribed share capital of banks (excluding the NBS) decreased by SKK 14.7 billion year-on-year, from SKK 53.2 billion to SKK 38.5 billion. This development of the share capital was mainly influenced by the termination of Konsolidačná banka Bratislava, š.p.ú. without liquidation as of Jan. 31, 2002 (a reduction of SKK 13.8 billion), the charging of losses of previous years against the share capital in two banks as well as the subscription of new shares in two banks.

Funds provided by foreign banks to their branch offices decreased by SKK 2.1 billion, from SKK 4.9 billion to SKK 2.8 billion (due to a change in the accounting treatment of funds provided to a branch office of a foreign bank).

As of Dec. 31, 2002, the balance sheet amount (the total net value of assets) of the banking sector of the SR increased year-on-year by SKK 88.5 billion (by 9.53%) to the amount of SKK 1 017.3 billion. (On subtracting KOBL, this increase became SKK 90.7 billion, since the net assets value of KOBL totalled SKK 2.2 billion.) Such a development of the banking sector's balance sheet amount was influenced by an increase of SKK 25.5 billion in primary resources (by 3.86%) to the volume of SKK 686.3 billion (with a negligible impact of KOBL). The volume of non-anonymous deposits grew by SKK 37.1 billion (by 10.22%) to SKK 400.0 billion. Secondary resources increased by SKK 25.0 billion (by 14.99%) to the amount of SKK 191.6

billion (as of Dec. 31, 2001, KOBL reported secondary resources in the amount of SKK 12.3 billion).

The development of primary resources of the banking sector was in particular influenced by an increase of SKK 18.8 billion in the volume of funds in deposit accounts and credit received from clients, an increase of SKK 2.5 billion in miscellaneous and earmarked liabilities (deposits with designated purpose) and an increase of SKK 7.0 billion in the central and local government accounts (first and foremost, there were increases of SKK 3.7 billion and of SKK 1.5 billion in the funds deposited by local governments and the National Labour Office respectively, and furthermore there were increases of SKK 1.0 billion and SKK 1.0 billion in deposits made by the Social Insurance Company and other funds respectively), and, also by a decrease of SKK 2,9 billion in the volume of certificates of deposit issued.

The development of secondary resources was primarily influenced by an increase of SKK 32.2 billion in securities payable – the amount of NBS bills payable as reported by banks went 33.4 billion up, the amount of payables from shares and other variable-income securities went SKK 0.7 billion down and the amount of securities payable to clients went SKK 0.5 billion down.

Own resources for the banking sector as a whole dropped by SKK 12.7 billion. In comparison with December 2001, the volume of funds generated from profits fell by SKK 1.7 billion and the volume of reserves decreased by SKK 1.4 billion. There was an increase in the volume of subsidies (of 0.7 billion), the profit and loss account (of 3.5 billion) and retained earnings (of 3.1 billion).

Interest-bearing assets in the banking sector increased by 84.3 billion, to 930.7 billion. Their share of total assets as of Dec. 31, 2002 reached 91.49%, mainly as a result of investment by banks of their available resources in securities.

Liquidity risk

Liquidity risk – a risk arising from an inability of banks to meet their obligations against clients within the required time limit and required amounts. Overall stability of banks, their solid reputation and sufficient volume of highly liquid assets on a sustainable basis are all preconditions for eliminating the liquidity risk. Banks must have a sufficient volume of liquid funds to match the volume of liabilities and eventual immediate demands of clients for withdrawals of deposits. One of the principal tools of liquidity management is to optimise the maturity structure of assets and liabilities, with steadily good liquidity position of residual maturities across all time bands constituting the basis.

The share of assets and liabilities with a maturity of up to 1 year (current ratio) developed evenly during the course of 2002, oscillating around 94%.

Credit risk

Credit risk is associated with the provision of loans, which is one of classic banking activities, and can be characterised as the risk that a loan or its part is not repaid, or the terms and conditions laid down in the contract are not observed, for example due to late payment of individual instalments. The provision of new loans is also influenced by the experienced lengthy collection of claims.

Claims on loans reported by banks as of Dec. 31, 2002 totalled SKK 342.3 billion. Classified claims on loans decreased by SKK 36.8 billion, to SKK 37.7 billion, i.e. by 49.43 %, with the KOBL impact on this decrease being SKK 31.5 billion. The largest portions of classified claims continued to be concentrated within the branches of industry, trade, agriculture and construction. Banks reported provisions created in the amount of SKK 27.7 billion. As of the end of the period subject to assessment, classified claims were covered by the provisions created to 73.50%. The proportion of classified claims to total claims dropped to 11.01%.

Results of operations of the banking sector

Net profits reported by banks as of Dec. 31, 2002 stood at SKK 12.5 billion. This represents a year-on-year increase of SKK 3.5 billion (by 38.17%) and, on eliminating the impact of KOBL as of Dec. 31, 2001, an increase of SKK 3.6 billion (by 40.30%). The year-on-year development of the results of operations was marked by an increase in the net result of financial operations (of SKK 8.7 billion) and influenced in particular by a decrease in the volume of provisions and reserves written back to revenues (of SKK 19.0 billion) and also by a decrease in their creation (by 13.1 billion).

A net result of financial operations (a difference between the revenues from financial operations and the cost of financial operations as reported by banks in their monthly profit and loss statements) as of Dec. 31, 2002 stood at SKK 42.0 billion (with the revenues from financial operations reported by banks as of the end of the reviewed period amounting to SKK 197.3 billion and the cost of financial operations amounting to 155,3 billion). Banks wrote reserves and provisions worth SKK 29.6 billion back to revenues. They created reserves and provisions in the amount of SKK 24.5 billion, charging them against costs. This write-back of sources of funding to cover against risks had positively influenced the results of operations by SKK 5.1 billion. The net cost of writing down claims was SKK 6.6 billion. Net extraordinary revenues stood at SKK 0.4 billion.

Operating costs of banks (general operating costs, the cost of transferring investment securities, fixed assets, and other operating costs) adjusted for other operating revenues (SKK 28.1 billion) and income tax advances (0,2 billion) caused the net profits of the banking sector to fall to SKK 12.5 billion.

General operating costs grew by SKK 2.4 billion to SKK 24.3 billion year-on-year, notably due to an increase of SKK 1.6 billion in transactions purchased and an increase of SKK 0.5 billion in wage costs incurred on employees, at a concurrent decrease in the average number of people employed in the banking sector.

As of the end of the reviewed period, cumulative income recorded a positive trend as of Dec. 31, 2002, and a profit in the amount of SKK 22.7 billion was reported for the banking sector – which means that there was a year-on-year shift from a loss to a profit.

Return on equity and return on assets – the banking sector's income for the period subject to assessment (as of Dec. 31, 2002) and its year-on-year development is characterised by profitability ratios, calculated on the basis of profit and loss, average value of assets and share capital.

Return on assets – an indicator describing the performance of assets, i.e. net income from overall activities of the banking sector less interest on classified assets over average assets less classified claims. As of Dec. 31, 2002, the banking sector reached a return of 3.95 haliers per 1 SKK of assets.

The development of the ROA indicator as of Dec. 31, 2002 was due to a more rapid rate of growth of net income from banking operations (by 33.93%) compared year-on-year to an increase in the average volume of assets (of 14.61%). The net income from banking operations increased by SKK 10.1 billion, to SKK 40.0 billion. This increase in the net income was influenced by several factors. First of all it was due to a higher year-on-year increase in revenues from financial operations (by 44.9 billion) compared to an increase in the cost of financial operations (by SKK

36.2 billion), as well as to a reduction of SKK 1.4 billion in the volume of interest on classified claims reported by banks.

Net interest margin expresses a net interest income (interest earned less interest incurred) on excluding the impact of interest on classified claims, charges, commissions over the average aggregate of assets less classified loans and legal reserves.

The year-on-year development of a net interest margin on interbank operations, operations with clients and securities operations had impact on the growth of net interest income (by SKK 7.1 billion, i.e. by 35.27%), at a concurrent increase in the average volume of assets (by SKK 129.2 billion, i.e. by 14.61%). This development of net interest income was positively influenced by a year-on-year increase in the balance from securities operations (of SKK 1.7 billion), an increase in the net revenue from interbank operations (of SKK 1.9 billion) and a decrease of SKK 3.4 billion in the net loss of operations with clients.

RULES FOR PRUDENT BANKING BUSINESS AND LIMITS SET BY BANKS

Capital adequacy

Capital adequacy within the Slovak banking sector grew by 1.31% year-on-year, reaching 21.06%.

The increase on this indicator was due to a more rapid rate of growth (of 18.45%) of capital and reserves included in the calculation of capital adequacy for the banking sector as a whole compared to an increase in risk-weighted assets (of 11.10%).

Over the course of 2002, the capital adequacy limit was met by all the banks.

Concentration of assets

Limit on credit exposure of banks against their clients (25%)

From February 2002 onwards, the said limit was met by all the banks.

The limit, i.e. the sum of all large exposures by banks (800%), was met by all the banks throughout the year 2002.

Liquidity rules

Monthly liquidity limit (the proportion of monthly assets and liabilities may not fall below 0.9):

met by all the banks as of August 31, 2002

Limit on the ratio of aggregate fixed and non-liquid assets to own resources and reserves (may not be greater than 1):

Starting from May 2002, the said limit was met by all the banks.

Limit on loans to related persons. A bank may make loans to persons related thereto and provide guarantees on their behalf or otherwise secure obligations of such persons against third parties that are not fully secured under a separate regulation only if it reaches a capital adequacy of more than 8%, and it may do so up to the aggregate amount by which its capital and reserves exceed 8% of the adjusted value of risk weighted assets, but not to more than 20% of the capital and reserves.

Over the course of the year, three banks violated the said limit.

Liquidity of banks and liquidity of branches of foreign banks and rules for safe operation related thereto.

Liquidity indicators for banks or branch offices of foreign banks set by the NBS Decree No. 2 dated July 26, 2002 with effect from September 30, 2002:

Liquidity indicator for banks or branches of foreign banks **for a period of time of up to 7 days (included)** (at the level of at least 1.00)

During the course of the year, this limit was broken by four banks.

An indicator of liquidity of fixed assets and non-liquid assets to the sum of a bank's own resources and reserves (set at the level of no more than 1.00) as of Sept. 30, 2002, Oct. 31, 2002, Nov. 30, 2002 and Dec. 31, 2002 was met by all the banks.

Rules for prudent banking business and reports related thereto – exposure to related persons

Limits related to the ratio between a bank's credit exposure to a related person and its own resources set by the NBS Decree No. 3 dated July 26, 2002 with effect from September 30, 2002:

A ratio of credit exposure against natural persons to own resources, set at the level of **no more than 2%,** was met by all the banks.

A ratio of credit exposure against legal entities to own resources, set at the level of **no more than 10%,** was broken by two banks in the course of 2002.

As of Dec. 31, 2002 the limit was observed by all the banks.

A ratio of credit exposure against a bank seated within a member state of the OECD to own resources, set at the level of **no more than 40%,** was met by all the banks.

Open foreign exchange positions (OXP)

Limits on open F/X positions set by the NBS decree (a limit of 15% on EUR, a limit of 10% on GBP, USD, CHF, CZK and other currencies, a limit of 25% on the aggregate open F/X position) were met by all the banks until July 2002. In August 2002, one bank reported an overnight breach of the aggregate open F/X position limit. In September, October, November and December 2002 the set limits were met by all the banks.

Conclusion

The Slovak banking sector saw a positive change in the structure of profits generated and an enhanced return on assets. The volume of loans increased by approximately 11%. The development of the structure of assets in the banking sector shows a trend towards improvement – the proportion of classified claims continues to fall. However, the high proportion of standard claims subject to reservation still persists. In addition to better volume indicators and ratios for the banking sector as a whole, improvements as regards the compliance with the limits on prudent banking business were also recorded.

PERFORMANCE OF BANKING SUPERVISION

Over the course of 2002, there were seven on-site inspections conducted in six banks:

In addition to the aforementioned inspections, the Banking Supervision Division dealt with violations of the Banking Act and other legislation.

The Banking Supervision Division of the National Bank of Slovakia issued 135 decisions in the area of licensing, including decisions relating to the suspension of proceedings, proceedings on violation of law, and/or enforcement of remedial action.

Auditor reports play an important part in performing the banking supervision and the information used in its operations. They help to provide a more complete picture of any bank, which is primarily obtained through on-site inspections and off-site supervision performed and should become a part of risk-oriented supervision with a view towards getting auditors involved in the system of actively preventing crisis situations in banks. Pursuant to a new strategy, the banking supervision chose to follow the route of closer co-operation with external auditors, which has resulted in the need to define requirements on methods, form and content of information to be presented by auditors to the banking supervision.

For the said reasons, working meetings with external auditors and representatives of banks were held in the course of August 2002 in order to clarify outstanding issues, unclear points and certain findings made during the analysis of auditor reports for the year 2001. In addition to the analysis and discussion of specific conclusions from auditor reports, the understanding and deeper familiarisation with methods and procedures applied by auditors in performing their audits seem to be an important part of mutual communication. That is why there were follow-up meetings held in the third quarter of 2002 with audit companies approved as auditors for the year 2002, at which the companies presented the methods and procedures used thereby. Apart from other things, these steps were taken with the aim of determining more precise criteria for the selection and approval of auditors and also achieving a more significant degree of utilising such reports in performing the banking supervision as a highly valuable complementary source of information.

At its meeting held in October 2002, the Bank Board of the NBS approved new principles for the selection of auditors to apply from 2003, which reflect the modified law and newly passed regulations governing the issues in question. Pursuant to these principles, „Criteria for evaluating and selecting auditors" were developed, which define more precisely obstacles and restrictions on the performance of audit with the main focus on independence, objectiveness, quality and communication of auditors. These criteria will not only be applied to a bank or a branch office of a foreign bank in which the audit is performed, but also persons related to the bank or the foreign branch. These criteria draw upon the Recommendation of the European Commission No. 2002/590/EC and recommendations of the Basle Committee on Banking Supervision (The relationship between banking supervisors and Banks external auditors, BIS, January 2002).

Pursuant to the new criteria for evaluating and approving auditors, a general change in the treatment of audit companies was presented by the NBS at a working meeting held between representatives of the NBS, the Slovak Chamber of Auditors and audit companies in November 2002. In its further stage, the co-operation should become closer, more co-ordinated and directed at quality. The approval of auditors for the year 2003 will be based on the assessment of quality of respective auditor reports for the year 2002 and the new criteria for evaluating audit companies, once they are approved by the Bank Board of the NBS.

REINFORCING THE REGULATION OF BANKING SUPERVISION

Laws

One of the principal legal standards regulating the conduct of banking supervision is the Banking Act No. 483/2001 Z. z., which became effective on Jan. 1, 2002. This Act covers the core principles of effective banking supervision developed by the Basle Committee of Banking Supervision. It also sets out requirements on the operation of banks and branch offices of foreign banks, including the requirements on prudent banking, and raises the accountability of members of supervisory boards of banks and statutory bodies of banks for adverse economic development of banks. The Act sets a legislative framework for performing the banking supervision on a consolidated basis. It creates prerequisites for taking speedy remedial action in troubled banks, for example in cases where a bank's capital adequacy drops excessively, and regulates issues related to receivership. It also sets more stringent requirements on co-operation between auditors of banks and the National Bank of Slovakia. The Act also incorporates proven standards of accounting, banking secrecy and disclosure of banking details and sets out the obligations and rights of banks in relation to the protection against illegal banking operations. The particular contribution made by the new law is embodied in the provisions directed at furthering the mortgage business.

The aforementioned law was amended twice during the year subject to review, namely by way of Act No. 430/2002 Z. z. on Bonds and Act No. 510/2002 Z. z. on Payments. The first amendment with effect from September 1, 2002 mainly concerned a change in the period for which banks and branch offices of foreign banks are obligated to retain data and copies of documents attesting to the identity of clients and documents attesting to the ownership of funds used by clients to execute deals from ten to five years, and the other alteration concerned the extension of security on municipal loans for a pledge on real property of higher-level territorial units and a change in the threshold level at which banks and branch offices of foreign banks are obligated to ascertain the ownership of funds used by the client in carrying out the deal from „above SKK 100 000 " to „at least EUR 15 000 ".

The second amendment with effect from September 1, 2002 extended the provision of § 7(14) on professional competence of natural persons nominated to a bank's statutory body, nominated as heads of branch offices of foreign banks or their deputies, as executives directly reporting to a bank's statutory body or to the heads of branch offices of foreign banks or to their deputies and those nominated as heads of internal control and internal audit departments, making it possible to substitute the requirement for completed University-level education with the requirement for completed secondary professional education and at least ten years of experience.

Besides the Banking Act mentioned above, the Act on Securities and Investment Services was adopted with effect from Jan. 1, 2002, which directly relates to the conduct of banking business. The Act makes it possible to create a standard capital market environment, sets rules for the provision of investment services and capital adequacy rules for securities dealers, regulates the conditions for issuing securities, allows for the application of instruments and procedures for securities trading and enhances the standard for the protection of securities dealers and investors in the capital market.

On February 5, 2002, the National Council passed a new law on the financial market supervision, which governs the organisation, operation and financial management of the Financial Market Authority (hereinafter the „FMA"), the rules for performing supervision and the FMA procedures. This Act took effect on April 1, 2002.

The Civil Code is another law amended with effect from January 1, 2003. The new statutes provide creditors and debtors with a wide range of options for determining the security method so as to match their mutual requirements and the circumstances of individual business transactions. Moreover, as a result of the establishment of the Register of Collaterals at the Chamber of Public Notaries, the whole system will become more transparent (the data in the register is public and accessible free of charge via the Internet). Through a concurrent modification of the Act on Administration of Taxes and Fees, a pledge established under a contract was put on an equal footing with a pledge in favour of a tax administrator which so far had a priority. The new framework for collaterals is expected to lead to an increased volume of loans, particularly those made to small and middle-sized business persons.

A new law with impact on the conduct of banking business and banking supervision is represented by the Payments Act effective from January 1, 2003. This Act constitutes the first comprehensive arrangement of payments in the Slovak system of law. Its primary objective is to make the relations between banks and their clients transparent with regard to payments, to protect the banks' clients as consumers, as well as to protect payment systems against risks that may arise from potential insolvency of parties involved in the payment system. The Act governs the execution of domestic and cross-border fund transfers, the issuance and use of electronic payment instruments, the creation and operation of payment systems, the supervision of payment systems and payments, as well as complaints and the resolution of disputes related to payments.

Norms of legal power lower than law

Banking supervision is performed on the basis of decrees relating to licensing and prudent banking business.

As of January 1, 2002, a number of decrees relating to licensing became effective (on the grant of a banking license, on the grant of a banking license to a foreign bank for the conduct of banking business via its branch within the territory of the SR, on the registration of a representation office of a foreign bank or a similar foreign financial institution conducting banking business, on a prior consent to establish a branch in a foreign country, on the grant of a prior consent as per § 28(1) of the Banking Act, on the requisites of a notification required to determine other persons related to a bank or a branch office of a foreign bank as a result of their relationship to the person making the notification, a regulation of the NBS and the MoF SR on the registration of mortgages and details of the position and activities of a mortgage controller and its deputy). A new decree stipulating the prescribed contents of a detailed audit-report for banks and branches of foreign banks took effect from Jan. 1, 2002 as well.

Decrees on prudent banking business perform the function of regulating the activities of banks, notably the management of their capital adequacy, credit exposure and liquidity. On the basis of newly adopted decrees, which draw upon the Banking Act No. 483/2001 Z.z., EU Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions setting the basic framework for the establishment of regulatory instruments of banking supervisory authorities in EU member states and EC Directive 93/6/EEC on the capital adequacy of investments firms and credit institutions, there were introduced rules for safe operation of banks in selected types of banking operations and the area of informing the public at large became more tightly regulated.

Over the course of 2002, the following decrees relating to prudent banking business were gradually approved and became effective:

- on rules for safe operation of banks and branch offices of foreign banks trading in foreign exchange funds, gold and financial instruments (with effect from Oct. 1, 2002). This decree stipulates certain obligations for banks, notably in the area of management, requirements on the organisational structure, internal regulations and procedures for trading in foreign currencies, gold and financial instruments, which may restrict potential losses due to improper conduct of banking operations.

- on liquidity of banks and liquidity of branch offices of foreign banks and rules for their safe operation and reports related thereto (with effect from Sept. 30, 2002). This decree lays down liquidity indicators and the method for their determining and the rules for safe operation to ensure solvency and uninterrupted liquidity of banks and branch offices of foreign banks. A substantial change in comparison with the previous decree is represented by the introduction of a seven-day liquidity report. At the same time, banks are obligated to present monthly liquidity reports and reports on assets and liabilities.
- on the rules for prudent banking business and reports related thereto (with effect from Sept. 30, 2002). The purpose of the said decree was to stipulate limits on credit exposure to related persons (individuals, legal entities and banks with their registered office within an OECD member state) There is an amendment to this decree currently underway, which mainly concerns a reduction of the limit applicable to banks from 40% to 25%.
- on the rules for safe operation of banks and branch offices of foreign banks making loans (with effect from Oct. 1, 2002). This decree stipulates certain obligations for banks, especially in the area of management, requirements on the organisational structure, internal regulations and procedures for making loans in order to restrict potential losses caused by the mismanagement of banks.
- on adequacy of banks' own resources (with effect from Jan. 1, 2003).
  In comparison with the previous decree on capital adequacy, this decree is new in its nature, since it not only defines the structure of a bank's own resources, but also lays down a method for measuring market risks and their inclusion in the calculation of an indicator of adequacy of own resources. The generation of own resources is arranged accordingly. The decree also contains a section devoted to monitoring of adequacy of own resources on a consolidated basis. A decree relating to limitations on open foreign exchange positions of banks was repealed thereby, since the monitoring of risks arising from foreign currency banking operations became part of this particular decree.
- on classification of assets and liabilities of banks and branch offices of foreign banks, the adjustment of their valuation, creation and cancellation of reserves and reports related thereto (with effect from Jan. 1, 2003).
  Compared to the regulation in force so far, this decree also gives the classification of debt securities held by banks to maturity in addition to the funds receivable and payable. In line with international practice, requirements on the classification of receivables and payables to respective classes became more stringent (especially in terms of overdue days and their payment) and the definition of the range of security instruments that may be recognised in adjusting the valuation of assets and liabilities was made more detailed and accurate.
- on credit exposure of banks (with effect from Jan. 1, 2003).
  The reason why this decree was developed was the completion of the process of approximation in this area (together with a new arrangement of adequacy of own resources) and the harmonisation especially with Directive No. 2000/12/EC relating to the taking up and pursuit of the business of credit institutions.
- on disclosure of information by banks and branch offices of foreign banks and the method for publication of annual reports of banks and foreign banks doing business within the territory of the Slovak Republic (with effect from Jan. 1, 2003).

Compared to the previous decree, the said decree has been extended for the disclosure of information on the structure of a consolidated or sub-consolidated bank group of which the bank is a part, and stipulates the method for publishing annual reports by banks.

In 2002, the Banking Supervision Division issued, in pursuit of pro-active approach to banking supervision, five methodological guidances relating to laws and norms other than laws, as well as two recommendations. The recommendations do not have a binding character – they are meant to express the opinion of the Banking Supervision Division on certain issues related to banking supervision.

EVALUATION OF IMPLEMENTATION OF PRINCIPAL TASKS OF THE LONG-TERM PLAN FOR THE DEVELOPMENT OF BANKING SUPERVISION (LPDBS)

The Long-Term Plan for the Development of Banking Supervision (hereinafter the „LPDBS") was adopted by the Bank Board of the NBS in December 2001. The tasks are scheduled until the 2003 yearend. Since then, its accomplishment has been monitored by the Banking Supervision Division on a quarterly basis and reports have been regularly presented at the sessions of the NBS Bank Board. Following to that, a summary of progress made is sent to the World Bank, since the monitoring of the implementation of LPDBS is related to the assessment of how the conditions for releasing of EFSAL (Enterprise and Financial Sector Adjustment Loan) tranches are met in 2003. During the last evaluation as of the end of 2002, the status of individual tasks was summarised as follows:

- of 9 areas covered by the LPDBS, 3 tasks have been accomplished and other 6 areas are covered with tasks that are still pending or performed continuously.

ACCOMPLISHMENT OF TASKS FOLLOWING FROM THE FSAP (FINANCIAL SECTOR ASSESSMENT PROGRAM) EVALUATION

The FSAP evaluation was made by representatives of the International Monetary Fund and the World Bank in the SR in February and March of 2002. A summary report was published in September 2002. Tasks for the Banking Supervision Division were determined in the course of the development of a comprehensive material for the Bank Board of the NBS in November 2002. A prevailing part of tasks has been accomplished (since they have already been covered by the LPDBS), their smaller portion is of the nature necessitating their fulfilment on a continuous basis (such as the arrangement of regular meetings with auditors and the top management of banks) and certain tasks related to gradual introduction of pro-active approach to banking supervision on a consolidated basis in accordance with the new Banking Act are pending (such as internal guidelines for different areas of banking supervision) and have been incorporated in the LPDBS.

As part of the FSAP evaluation, the standard of coverage of 25 Basle core principles for effective banking supervision in the SR was analysed. The analysis showed that 6 principles are fully implemented, 8 principles are incorporated to a great extent, 15 principles require further adjustments, since the standard of their application is basically unsatisfactory and 1 principle is inadequately covered.

ACCOMPLISHMENT OF TASKS FOLLOWING FROM THE SMP (STAFF MONITORING PROGRAM)

The SMP was completed in the SR in May 2002. The tasks relating to the Banking Supervision Division have been accomplished thereby or are continuously accomplished. They included:

- the application of pro-active approach to banking supervision (the tasks have been included in the LPDBS),
- increasing the staffing of the Banking Supervision Division (implemented in the course of 2002),
- the application of new assessment of banks (based on the CAMEL system) in the performance of on-site inspections starting from the beginning of 2002,
- the adoption of the new Banking Act with effect from Jan. 1, 2002 (Act No. 483/ 2001 Z.z. on Banks),
- filling the position of a standing advisor to the NBS banking supervision (the standing advisor has been working for the Banking Supervision Division since 2000),
- the introduction of a new organisational structure of the Banking Supervision Division (in force from Jan. 1, 2002).

ACCOMPLISHMENT OF TASKS FOLLOWING PEER REVIEW

At the end of May 2002, a peer review was undertaken by the European Commission in the SR as one of the EU candidate countries. The report was delivered on October 2002. The conclusions of the report comprise recommendations that are identical with conclusions from the FSAP assessment to a great extent. Towards the end of 2002, the Banking Supervision Division adopted, on the basis of these recommendations, a plan for incorporating these recommendations (the Action Plan) containing 7 specific tasks, of which 3 are to be fulfilled continuously and for the remaining 4 there were deadlines set by the end of 2003. Roughly in mid-2003, another peer review mission should be conducted by the European Commission.

As part of the peer review, the standard of coverage of 25 Basle core principles of effective banking supervision in the SR was subjected to analysis. 10 principles were said to be fully implemented, 14 principles were found to be incorporated to a large extent, 4 require further elaboration, since the standard of their application is basically unsatisfactory and 2 principles have been assessed as unsatisfactorily incorporated.

CO-OPERATION BETWEEN THE BANKING SUPERVISION DIVISION AND LOCAL AND INTERNATIONAL INSTITUTIONS

Bilateral agreements on co-operation for the performance of banking supervision.

On December 3, 2002, there was signed the Agreement on co-operation between the National Bank of Slovakia and the Financial Market Authority for the performance of supervision of banking business, payment systems and the foreign exchange system and the financial market supervision of the capital market and insurance business (hereinafter the „Agreement”).

The scope of the Agreement mainly covers the exchange of information for the performance of supervision on a consolidated basis, the co-ordination of activities of parties to the Agreement, and the co-operation in control activities.

On December 30, 2002 there was signed the Agreement on co-operation between the National Bank of Slovakia and the Presidium of the Police Corps of the Ministry of Interior of the SR (hereinafter the „Agreement ").

The Agreement covers co-operation, co-ordinated procedure and exchange of information in performing the tasks relating to the conduct of banking supervision of the National Bank of Slovakia, as well as the activities of the Office of Financial Police of the Administration of Criminal and Financial Police of the Presidium of the Police Corps directed towards revealing illegal financial operations and the protection against laundering of proceeds from criminal activity.

In 2002, Memoranda of Understanding (hereinafter the "MoUs") were concluded and signed between the National Bank of Slovakia and:

- Bundesaufsichtsamt für das Kreditwesen (Germany) signed on April 17, 2002
- Hungarian Financial Supervisory Authority (Hungary) signed on June 11, 2002
- Commission Bancaire (France) signed on Nov. 28, 2002
- Èeská národní banka (the Czech Republic) signed on Nov.8, 2002
- Banca d´Italia (Italy) signed on Nov.8, 2002

A co-operation was commenced between the National Bank of Slovakia and the Office of the Comptroller of the Currency (one of the institutions entrusted with the performance of banking supervision in the U.S.) on the basis of Letters of Understanding covering co-operation between the supervisory authorities through the exchange of information. The Letters of Understanding were signed in June 2002 and August 2002.

The final version of the MoU between the NBS and De Nederlandsche Bank was signed in February 2003.

Negotiations with the Austrian supervisory authority (the Financial Market Authority) are currently underway.

In February 2003, based on a proposal for co-operation, the Central Bank of Cyprus sent to the National Bank of Slovakia a draft MoU, which is currently subject to review and comments.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISION AUTHORITY

The Banking Supervision Division (the "BSD") is the department of the NBS responsible for overseeing all areas of domestic and international banking in Slovakia.

The BSD consists of three main departments: Licensing and International Cooperation Department, Supervision Department and Risk Management Methodology Department.

The Licensing and International Cooperation Department current consists of two Sections; Banking Supervision and International Cooperation Section and Administration and Regulatory Section.

The Banking Supervision and International Cooperation Section is mainly involved in the licensing procedure of new banks and also in reviewing applications for branch licences by foreign banks. It also registers foreign banks and foreign financial institution representative offices. Another important task of the section is to review applications for so called "prior approval" procedures. This relates to the regulation of the changes in existing shareholders of banks and control of banks' equity investments in non-bank entities, Mergers and acquisitions taking place in the banking sector of the Slovak Republic must also be approved by this Section of the Banking Supervision Division. Accordingly this Section takes part in issuing secondary legislation for licensing, prior approvals, mergers and acquisitions and representative offices registration procedures. Section is responsible for the cooperation with international agencies, such as IMF, World Bank, OECD, ECB, etc. and foreign supervisors institutions.

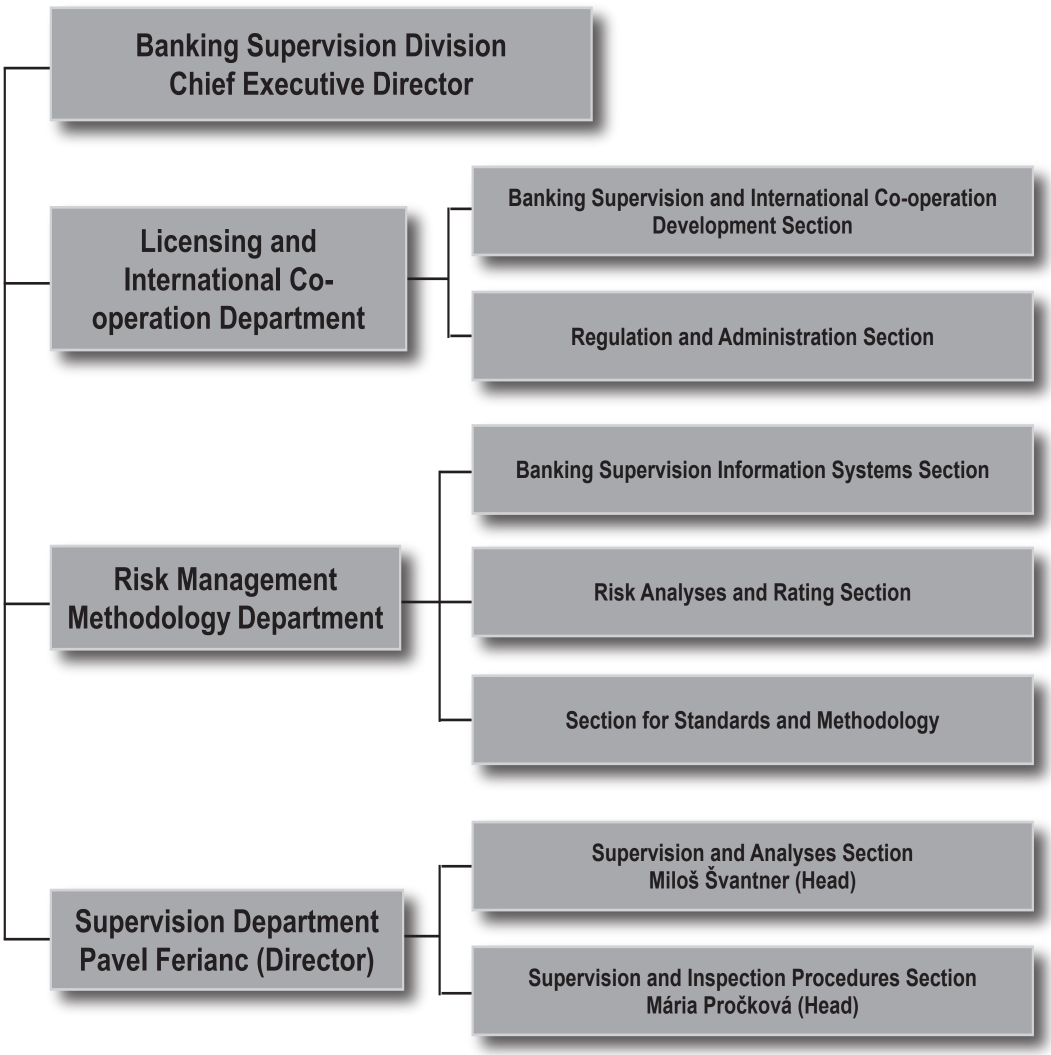
The Administrative and Regulatory Section participates in all above mentioned tasks to ensure compliance with the banking legislation and actively takes part in corrective actions procedures. It is also involved in imposing a forced administration regime on a certain bank and in the resolution to withdraw a banking licence. The supervision of banks is exercised by Supervision Division combining off-site monitoring and on-site inspections.

The Off-Site Supervision Department systematically monitors and analyses the financial condition and performance of banks. For this purpose, it has created, a Banking Supervision Information System, as an early warning system aimed at monitoring the risks undertaken by commercial banks in their activities.

The On-Site Supervision Department makes comprehensive and target-orientated examinations of banks. The main goal is to focus on the credit portfolio of the banks, connected lending, management of assets and liabilities, on the assessment of management, on the adequate creation of reserves and provisions and on classification of the assets.

Risk Management Methodology Department

Department ensures supervisory functions while identifies , monitors and regulates risks connected with banking and finacial institutions activities and defines methodology of these processes.



STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2000	2001	2002
Banks	21	19	18
Joint stock companies	16	14	15
State financial institutions	2	2	-
Building savings banks	3	3	3
Branches	2	2	2
Financial institutions, total	**23**	**21**	**20**

Ownership structure of financial institutions in 2002 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	5.4	-	-	-	5.4
Other domestic ownership	6.4	-	2.9	-	9.3
Domestic ownership total	11.8	-	-	-	14.7
Foreign ownership	72.9	-	5.5	6.9	85.3
Financial Institutions, total	**84.7**	**0.0**	**8.4**	**6.9**	**100.0**

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

Item	2000	2001	2002	2002/2000
State ownership	50.9	28.8	5.4	0.1
Other domestic ownership	21.0	10.6	9.3	0.4
Domestic ownership total	71.9	39.4	14.7	0.2
Foreign ownership	28.1	60.6	85.3	3.0
Financial institutions, total	**100.0**	**100.0**	**100.0**	–

Distribution of market shares in balance sheet total (%)

Type of the financial institutions	2000	2001	2002
Joint stock companies	81.54	82.09	82.88
State financial institutions	2.37	1.78	0.00
Building savings banks	6.45	5.99	5.69
Branches	9.64	10.15	11.42
Financial institutions, total	**100.00**	**100.01**	**100.00**

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

Assets	2000	2001	2002
Deposits and credits with banks	29.16	25.60	24.43
Granted credits	40.00	29.84	31.08
Securities	19.89	28.95	30.95
Tangible and intangible assets	10.95	15.61	13.55
Total assets	**100.00**	**100.00**	**100.00**
Liabilities	**2000**	**2001**	**2002**
Deposits and credits from banks	18.44	17.59	19.93
Received deposits	70.72	71.54	69.97
Reserves	3.51	2.84	2.57
Initial capital	7.33	8.03	7.53
Total liabilities	**100.00**	**100.00**	**100.00**

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

Type of the financial institutions	2000	2001	2002
Joint stock companies	56.71	42.98	92.09
State financial institutions	3.56	2.57	0.00
Building savings banks	3.75	4.80	4.52
Branches	3.88	5.13	18.32
Financial institutions, total	**67.89**	**55.48**	**114.94**

Solvency ratio of financial institutions (%)

Type of the financial institutions	2000	2001	2002
Joint stock companies	12.12	20.07	21.68
State financial institutions	34.80	11.58	0.00
Building savings banks	13.56	19.91	17.75
Branches	0.00	0.00	0.00
Financial institutions, average	**12.48**	**19.75**	**21.30**

Asset portfolio quality of the banking system

in mil. SKK

Asset classification	2000	2001	2002
Substandard	6,880	6,260	7,335
Doubtful	9,015	6,170	3,257
Loss	72,725	62,083	27,637
Classified Total	**88,620**	**74,513**	**38,229**
Specific Reserves	70,968	62,268	29,609

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

	Deposits	Loans
Households	53.06	23.30
Government sector	20.99	6.76
Business sphere	25.16	69.44
Foreign	0.59	0.45
Other	0.20	0.06
Total	**100.00**	**100.00**

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

Maturity of deposits		Maturity of loans	
At sight	33.79	Long term loans	31.55
Within one year	54.87	Medium-term loans	29.83
Over one year	11.34	Short-term loans	38.63
Total	**100.00**	**Total**	**100.00**

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

Type of the financial institutions	Foreign exchange assets / total assets		
	2000	2001	2002
Joint stock companies	18.00	19.13	13.89
State financial institutions	3.17	5.26	0.00
Building savings banks	0.35	0.35	0.35
Branches	36.74	26.49	13.05
Financial institutions, average	**18.32**	**18.51**	**13.02**

Type of the financial institutions	Foreign exchange liabilities / total liabilities		
	2000	2001	2002
Joint stock companies	16.02	17.50	14.66
State financial institutions	6.03	7.84	0.00
Building savings banks	0.03	0.03	0.05
Branches	32.12	27.82	26.04
Financial institutions, average	**16.30**	**17.31**	**15.64**

Profit and loss statement

in th. USD(EUR)

Ratios	2000	2001	2002
Net interest income from interbank operations	41,940	98,562	162,179
Net interest income from client operations	45,143	- 50,070	-5,907
Net interest spread	**87,084**	**48,491**	**156,272**
Income from FX operations	110,450	111,568	112,389
Income from securities operations	359,962	428,136	613,690
Income from banking operations (core activities)	**557,496**	**588,195**	**882,351**
Other operational income	53,698	49,999	37,237
Operational expenses	438,161	451,690	584,342
Income from current operations	**173,033**	**186,504**	**335,246**
Net expenses from provisions and reserves	- 110,714	- 229,309	-109,705
Net losses from irrecoverable debt	203,966	236,989	160,142
Extraordinary income	48,835	27,209	32,570
Extraordinary expenses	19,759	13,974	13,097
Net icome from extraordinary operations	**29,076**	**13,234**	**19,474**
Applicable income taxes	16,482	4,900	6,893
Net icome/loss	**92,375**	**187,158**	**297,389**
USD	47,389	48,467	x
EUR	x	x	41,722

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

Type of the financial institutions	Registered capital	/Total assets	Own funds
	in mil. EUR	%	in mil. EUR
Joint stock companies	887.35	4.40	2 060.63
State financial institutions	0.00	0.00	0.00
Building savings banks	77.18	5.58	309.37
Branches	0.00	0.00	90.28
Financial institutions, total	**964.53**	**3.97**	**2 460.28**

SKK/EUR = 41,722

2002 DEVELOPMENTS IN THE SLOVENIAN BANKING SECTOR

BANKA SLOVENIJE

MACROECONOMIC ENVIRONMENT

Inflation in the first half of 2002 was still relatively moderate but rose in the second half of the year on the effects of the oil price rise and lower interest rates. Slovenia's main economic partners recorded low levels of growth in 2002. In Slovenia the moderate economic growth in 2001 carried through into 2002 – real GDP rose by 3.2% and industrial output by 2.4%. Wage growth was roughly in line with the growth in economic activity. Employment levels stopped rising in the middle of the year and the fall in unemployment came to a halt.

Consumer goods prices grew by 7.2%. The causes of this relatively strong rise were high world oil prices, fiscal policy and administered price policy. Producer price growth of 3.7% was significantly lower than in 2001.

The two main reasons for the large surplus in the current account of the balance of payments (1.8% of GDP) were the strong exports to the countries of the former Yugoslavia and the improved terms of trade. Net financial inflows amounted to 5.2% of GDP, with both inflows and outflows rising compared to previous years. Inflows were dominated by direct investments, and outflows by household foreign currency and commercial credit. Foreign currency reserves rose quite rapidly as a result of balance of payments inflows, but external debt rose more slowly because a big proportion of inflows were not of a debt nature. The depreciation of the dollar against the euro also made a substantial contribution to the increase in both the foreign currency reserves and the external debt.

At the end of 2001 the government began implementing a policy of two-year budget planning by adopting a budget for 2002 and 2003. The relatively big general government deficit in 2002 was to a large extent a consequence of bringing the budget year into line with the calendar year.

Monetary policy operation was aggravated by supply-side shocks and large financial inflows through direct investments in the second half of 2002. With the aim of neutralising the effects of the large financial inflows on money supply and the exchange rate the Bank of Slovenia raised the interest rates on its instruments and intervened on the foreign currency money markets throughout the year. This was reflected in strong issuance of base money through the Bank of Slovenia buying foreign currency and through sterilisation with tolar-denominated central bank bills. The success of the sterilisation was also aided to a large degree by the so-called liquidity ladder, which prevents banks from having an excessive mismatch in maturity between their investments and liabilities. In addition, the Bank of Slovenia also made efforts to achieve economic policy coordination and continued the process of bringing its monetary policy instruments into line with European Central Bank standards.

Strong financial inflows in the second half of 2002 were reflected in fairly strong growth in broad monetary aggregates. As in 2001, domestic bank lending was quite weak, with the state share increasing and the business sector share decreasing. Favourable interest rates and the low and predictable depreciation of the tolar meant that foreign currency lending dominated. On the deposit side, the strongest growth was in long-term deposits in tolars. M1 growth was slow due to the extensive sterilisation policy.

As a result of the reduction in the inflation rate and the depreciation of the tolar, both lending and deposits rates came down during the year. In July the indexation of short-term lending and deposit rates was abolished, which helped to improve their stability.

Strong financial inflows in the second half of 2002 were reflected in an excess supply of foreign currency on the foreign currency markets. Exchange rate movements were influenced by Bank of Slovenia intervention. Over the course of the year there was a decline in the depreciation of the tolar against the euro, which was 4.0% in the year to December 2002.

DEVELOPMENT IN THE BANKING SYSTEM

The year 2002 witnessed the introduction of new Slovenian Accounting Standards, further consolidation of the banking sector and changes in banks' ownership structure. The introduction of the new Slovenian Accounting Standards (2001), in use since 1 January 2002, affected banks' financial statements for 2002, particularly the income statement. The most important change brought in by the new Slovenian Accounting Standards is the scrapping of inflation-indexed revaluation. The introduction of the new standards necessitated revisions to a number of Bank of Slovenia regulations concerning banking supervision. Consolidation of the banking sector in 2002 was not as intense as in 2001, although the merger of a minor with a major bank expanded the latter's market share, lifting it from fourth to third place by total assets. The ownership structure of banks in Slovenia was considerably altered in 2002 by the acquisition of shareholdings in Slovenian banks by foreign banks, which doubled the proportion of foreign equity between the end of 2001 and the end of 2002. It stood at 34.6% at end-2002 (16% at end-2001). Another factor in the rising share of foreign ownership in Slovenia's banks was the privatisation of the largest bank in Slovenia, Nova Ljubljanska Banka, in the summer of 2002.

The banking sector in Slovenia is the most important segment of Slovenia's financial system. Slovenia's banking sector is dominated by banks. At the end of 2002 these formed 98.6% of the market by unconsolidated total assets, with savings banks and savings and loan undertakings making up the rest. Savings banks formed 0.3% of the market and savings and loan undertakings 1.1%.

In 2002 there were 21 banks operating in Slovenia (including the branch office of a foreign bank), although on the last day of the year Banka Vipa of Nova Gorica merged with Abanka of Ljubljana. The merger left 20 banks operating in Slovenia as at 31 December 2002. This was the only merger among banks in 2002 and caused the merged entity Abanka Vipa to leapfrog SKB Banka of Ljubljana into third place among Slovenian banks by total assets. SKB Banka had been the third largest bank in terms of total assets for the previous four-and-a-half years. In addition to the 20 banks and two savings banks, there were also 25 savings and loan undertakings operating at the end of the year.

Slovenia's banks are characterised by being mostly privately owned, while its savings banks are wholly so. The majority of private owners of banks, and all owners of savings banks, are also residents. With the privatisation of Nova Ljubljanska Banka of Ljubljana, the share of state ownership in that bank and in the overall banking system decreased. The sale of 39% of the government share in Nova Ljubljanska Banka in summer of 2002 turned the government from the majority owner into a minority one. The country's second-largest bank, Nova Kreditna Banka Maribor, and Poštna Banka Slovenije remain in majority state ownership.

At the end of 2002, of the 20 banks in operation, six were in majority foreign ownership (including five subsidiaries and one branch of a foreign bank). Majority foreign shareholders come from Austria, France, Belgium and Italy. Six banks were wholly domestically owned, and the remaining eight were in majority domestic ownership. Of the last group, half had less than 1% foreign equity.

The aggregate total assets of all credit institutions (banks, savings banks and savings and loan undertakings) accounted for almost 80% of GDP at the end of 2002. Total assets of the banking system in Slovenia grew in 2002, albeit more modestly than in 2001, which was exceptional because of the introduction of the euro currency. At the end of the year, total assets of banks stood at SIT 4556.6 billion (including the branch of Nova Ljubljanska Banka in Italy), representing 17.5% nominal growth (9.6% real)[14]. Nominal total asset growth of individual banks varied between –13.4% and 60.0%. Two banks ended the year with lower total assets than at the end of 2001.

The market share of Slovenia's largest bank at the end of 2002, measured in terms of unconsolidated total assets, was 35.5%, or 39.3% including its three subsidiaries, roughly the same as a year previously. The market share of the three largest banks shrank compared with the end of 2001 due to the reduced market share of SKB Banka of Ljubljana, which even the rise in market share of Abanka Vipa due to its takeover of Banka Vipa of Nova Gorica could not counteract. On the other hand, the market share of the seven largest banks grew due to an expanded market share of the fifth, sixth and seventh largest banks. The market share of the three largest banks, measured by unconsolidated total assets accounted for 55.4%, (56.5% as of 31 December 2001) the first five banks had approximately 69.5% of the market (69.1% as of 31 December 2001) and the top seven banks held 80.6% as of 31 December 2002 (79.7% as of 31 December 2001).

Banks performed better in 2002 than in past years, ending the financial year with pre-tax profits of SIT 46.0 billion. Only three banks posted a loss. The results were up by SIT 30.6 billion on 2001 before taking into account SIT 19.5 billion in losses by a major bank. The improved performance of banks in 2002 was partly due to changes brought in by the Slovenian Accounting Standards, which no longer require compulsory inflation-indexed revaluation of capital. Under the new rules, general capital revaluation is undertaken only if appreciation of the euro against the tolar in the preceding financial year exceeds 5.5%. In 2001 this appreciation was only 4.7%.

Profitability ratios were more favourable in 2002 than in 2001 thanks to higher profits. The most significant improvement was in return on equity, which rose partly because of increased profits and partly also because of slower equity growth as a result of the absence in 2002 of general capital revaluation.

Banks' interest margin, expressed as the ratio of net interest income to average gross interest-bearing assets, was similar to 2001. The only difference was slightly faster growth of net interest income (23.7%) than of average gross interest-bearing assets (21.3%), causing a small rise in the interest margin in 2002.

Banks' capital at the end of the year, calculated in accordance with the Regulation on Capital Adequacy of Banks and Savings Banks, stood at SIT 321.9 billion, representing a capital adequacy ratio of 11.9% on risk-weighted assets of SIT 2,704.5.

The trend in non-performing assets (those classified in categories C to E) was favourable in 2002 in as much as the proportion remained unchanged at 7%.

[14] Real growth of balance sheet items is calculated on the basis of annual inflation for 2002 of 7.2%.

LEGAL AND INSTITUTIONAL FRAMEWORK FOR SUPERVISION OF FINANCIAL INSTITUTIONS

Responsibility for supervision of different segments of Slovenia's financial system is shared by three supervisory authorities in Slovenia. The Bank of Slovenia is the Slovenian central bank and it 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 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.).

The Insurance Supervision Agency is independent institution responsible for supervision of insurance undertakings, the Slovenian Nuclear Insurance and Reinsurance Pool, the Slovenian Insurance Association – guarantee fund, the Slovene Export Corporation – insurance operations, Pension Fund Management – voluntary pension insurance, insurance agency and intermediation companies, insurance agents and intermediaries, as well as some other entities.

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 52 at the end of 2002: 8 people in the executive part, 20 employees in the off-site supervision, 21 in on-site examinations, and 3 employees working on licensing.

Core tasks carried out by individual units of the Banking Supervision Department:

Granting authorisations (Licensing)
- Preparation of secondary legislation that governs licensing requirements and/or rules
- Advising on the implementation of secondary legislation that governs licensing requirements and/or rules
- Processing applications and the preparation of reports on authorisations granted
- Drafting decisions and explaining grounds for the decisions taken
- Monitoring of the enforcement of the decisions issued.

Off-site supervision:
- Drawing up the legal framework for the carrying out supervision and surveillance of banks and savings banks
- Monitoring international recommendations in the field of supervision

- Counselling in the implementation of banking legislation
- Preparation of instructions with regard to implementation of accounting standards and accounting counselling
- Controlling operations carried out by banks and savings banks on the basis of prudential reports and statutory returns
- Corrective actions launched with the aim of resolving non-compliance identified in operating activities of banks and savings banks, and monitoring of implementation of such corrective actions
- Analysis of results of operations of banks and savings banks
- Co-operation with domestic and international institutions
- Participation in the preparation for on-site examinations in banks and savings banks
- Legal counselling
- Electronic data processing and other related services.

On-site supervision:

- Preparatory activities leading to on-site examination on the basis of prudential reports of banks and savings banks and other statutory returns
- On-site examinations of business operations of banks and savings banks, elaboration of reports and proposals for corrective measures
- Implementation of corrective measures designed to mitigate deficiencies that have been detected in operations of banks and savings banks
- Monitoring of the enforcement of corrective measures taken against banks and savings banks
- Advising within on-site supervising function on the way to improve banking operations of banks and savings banks
- Monitoring banks and savings banks
- Preparation of measures aimed at preventing deterioration in the financial position of banks and savings banks
- Co-operation in assessing conditions for instituting special administration in banks and savings banks
- Co-operation in assessing conditions for liquidation of banks and savings banks
- Co-operation in assessing conditions for bankruptcy of banks and savings banks
- Governing and managing banks and savings banks in special cases
- Co-operation with local and foreign supervisory authorities
- Co-operation with chartered accountants/certified auditors, etc.

ACTIVITIES OF THE BANKING SUPERVISION DEPARTMENT IN 2002

Off-site analysts continuously monitor the operating results of banks and savings banks on the basis of statutory returns and information and monitor compliance with prudential regulations for safe and sound banking. They are involved in preparing documentation for the issue or variation of authorisations for different types of activity, evaluate proposed new systemic solutions, advise on the implementation of standards of safe and sound banking, are involved in preparations for inspections in banks and savings banks and in discussions with the management of banks, savings banks and other institutions, compile various written documents for bodies of the Bank of Slovenia, and so on. On discovering a departure from the normal activity of a bank or savings bank, analysts immediately notify the inspectors and management of the Banking Supervision Department, who may accordingly decide to launch an on-site examination of the institution concerned.

On discovering an irregularity in the conduct of a bank or savings bank, both analysts and inspectors take appropriate action and monitor the remedial steps taken.

The Banking Supervision Department's strategic plan for the period 2000-2003 envisages between seven and nine full-scope examinations of banks and around 30 examinations of particular areas of operation (including IT) each year. A bank or savings bank may be examined more than once in a given year. The scope of the examination is determined on the basis of prior information and analysis of the institution's activities, initiated by the management of the Bank of Slovenia or by external bodies.

In on-site examinations of banks and savings banks during 2002, inspectors from the Banking Supervision Department, in addition to the standard areas of examination, focused particularly on supervision of capital and capital adequacy, management of market risks, implementation of the Consumer Loans Act, implementation of the Prevention of Money Laundering Act, payment systems, card operations etc.

As regards changes in regulations of the Bank of Slovenia, the Bank of Slovenia drafted in the first half of 2002 new regulations for banks and savings banks. The reasons were the modifications to the Banking Act promulgated in 2001 and new Slovenian Accounting Standards (2001) whose implementation is mandatory as from 1 January 2002. The following regulations were changed:

- the Regulation on Books of Account and Annual Reports of Banks and Savings Banks
- the Regulation on the Classification of On-Balance Sheet Assets and Off-Balance Sheet Items of Banks and Savings Banks
- the Regulation on Establishing Specific Provisions of Banks and Savings Banks and
- the Regulation on the Minimum Scope and Content and Audit and of Auditor's Report.

The Regulation on Capital Adequacy of Banks and Savings Banks was also revised in order to take account of the new Slovenian Accounting Standards and improve harmonisation with EU directives. In 2002 a new method for calculating the total net foreign currency position and new capital requirements for market risk were introduced.

In addition, the Regulation on Electronic Money Institutions was implemented in October 2002. Its legal framework was established by the Payment Transaction Act. With the provisions of the Payment Transaction Act and the provisions of the Regulation on Electronic Money Institutions Slovenia harmonized its legislation with EU Directive 2000/28/EC and EU Directive 2000/46/EC.

COOPERATION WITH OTHER DOMESTIC 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 Supervision Agency are members of the steering committee.

In addition, the Liaison Group monitors the issues in relation to the implementation of financial regulations and reports to the Steering Committee. The Liaison Group consists of the Deputy Governor of the Bank of Slovenia, the Director of the Banking Supervision Department, the Director of the Securities Market Agency and the Director of the Insurance Supervision Agency.

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 Supervision 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 are elaborated in memoranda of understanding. During 2002, apart from the exchange of data and documentation, joint targeted examinations were conducted in two banks.

COOPERATION WITH FOREIGN SUPERVISORY AUTHORITIES

The 1999 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.

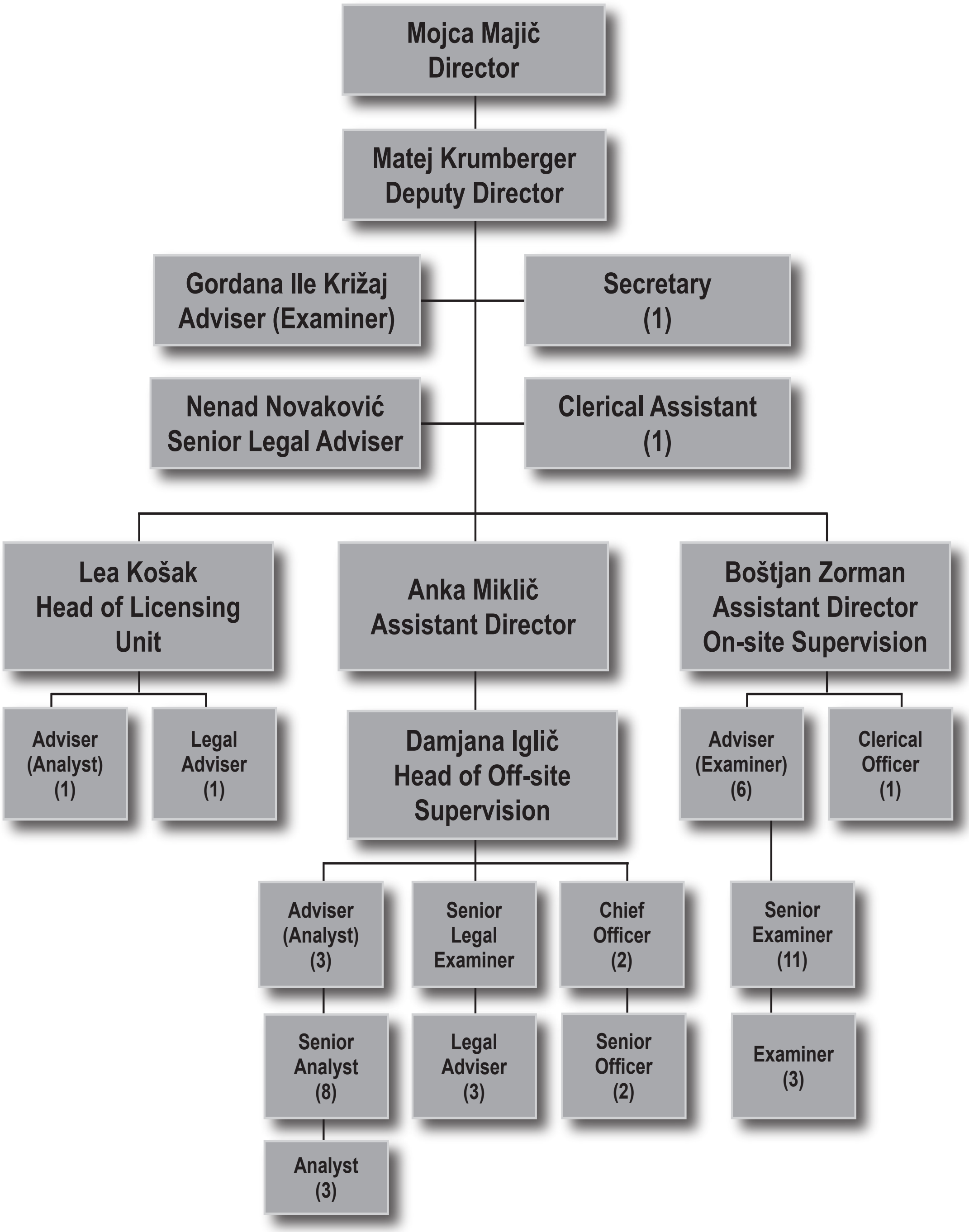
There has been a substantial progress in consolidated supervision of subsidiaries and branches of banks abroad. Memoranda of understanding have already been concluded with the State of New York Banking Department, the Bundesministerium für Finanzen (Austria's Federal Ministry of Finance), the Bundesaufsichtsamt für das Kreditwesen (Federal Banking Supervisory Office) in Germany, the National Bank of Macedonia, the Banca d'Italia (Bank of Italy), the Agency for Banking of the Federation of Bosnia and Herzegovina, as well as with Republika Srpska, the Central Bank of Bosnia and Herzegovina and the France's Commission Bancaire.

During 2002, on the basis of memoranda of understanding with authorities in other countries, three examinations of bank subsidiaries were conducted and a non-bank subsidiary of the largest bank in Slovenia abroad (in Switzerland, Macedonia and Bosnia and Herzegovina) in collaboration with local supervisors or independently.

MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISION DEPARTMENT IN 2003

- Amendments and modifications to the Banking Act
- Further implementation of consolidated supervision in practice
- Preparations for Basel II
- Further enhancement of supervision of market risks
- **Revision of recommendations (minimum standards) for performing trading operations**
- Revision of the chapter of the Manual on market risks etc.

ORGANISATIONAL CHART OF THE BANKING SUPERVISION DEPARTMENT



BANKA SLOVENIJE

STATISTICAL TABLES

Number of credit institutions* (at year-end)

Type of credit institution	2000	2001	2002
Banks	25	21	20
Savings banks	3	3	2
Savings and loan undertakings	64	45	25
Credit institutions, total	**92**	**69**	**47**

** The amount of initial capital for banks is set at SIT 1.1 billion, the amount of initial capital for savings banks and savings and loan undertakings is set at SIT 220 million.*

Ownership structure of banks on the basis of shareholders' equity (%)

Item	2000	2001	2002
Central Government	36.8	37.0	20.3
Other domestic ownership	51.2	47.0	47.2
Domestic ownership total	88.0	84.0	67.5
Foreign ownership	12.0	16.0	32.5
Bank, total	**100.0**	**100.0**	**100.0**

Distribution of market shares measured by total assets (%)

Type of credit institution	2000	2001	2002
Banks	97.8	98.1	98.6
Savings banks	0.4	0.4	0.3
Savings and loan undertakings	1.8	1.6	1.1
Credit institutions, total	**100.0**	**100.0**	**100.0**

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

Assets	2000	2001	2002
Cash and balances with CB	3.2	5.3	3.1
Loans to banks	11.7	10.2	8.4
Loans to customers	52.3	49.4	47.9
Securities	25.4	28.6	34.0
Other assets	7.5	6.5	6.6
Liabilities			
Deposits from banks	12.8	11.7	12.8
Deposits from customers	69.0	71.2	69.1
Liabilities from securities	2.2	2.9	3.9
Capital and subordinated liabilities	11.4	9.8	9.9
Other liabilities	4.6	4.5	4.3

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

Type of credit institution	2000	2001	2002
Banks	22.5	21.2	19.7
Savings banks	0.3	0.4	1.0

Solvency ratio of credit institutions

Type of credit institution	2000	2001	2002
Banks, average	13.5	11.9	11.9
Savings banks, average	11.3	11.1	9.2

Assets portfolio quality of the banking system

in millions of tolars

Assets classification	2000	2001	2002
A	2,418,844	2,755,349	2,943,971
B	266,315	348,333	467,919
C	75,507	91,012	113,470
D	53,692	62,188	63,434
E	56,572	78,947	79,483
Classified total	**2,870,931**	**3,335,829**	**3,668,276**
Specific provisions	167,654	211,676	228,432

The structure of deposits and loans as at 31 December 2002 (%)

	Deposits	Loans
Households	62.8	25.8
Government sector	6.6	9.9
Corporate	19.2	58.8
Foreign	2.4	2.0
Other	9.0	3.5
Total	**100.0**	**100.0**

The structure of deposits and loans by maturity as at 31 December 2002 (%)

Deposits	
At sight	32.1
Within one year	58.4
Over one year	9.5
Total	**100.0**
Loans	
Long-term loans	45.9
Medium-term loans	–
Short-termn loans	54.1
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		
	2000	2001	2002	2000	2001	2002
Banks	33.5	34.4	33.0	34.9	35.3	33.9
Savings banks	0.3	0.3	0.1	0.0	0.0	0.0

Profit and loss account of banks

	2000		2001		2002	
	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	126,134	555	115,930	462	143,407	649
Net fees and commissions	37,858	166	41,523	165	53,962	244
Net financial operations	14,442	64	20,805	83	21,205	96
Net other	-8,193	-36	-5,080	-20	5,808	26
Gross income	**170,240**	**749**	**173,179**	**690**	**224,382**	**1,015**
Operating expenses	100,436	442	112,949	450	133,914	606
– labour costs	48,717	214	53,181	212	66,169	299
Net income	**69,804**	**307**	**60,230**	**240**	**90,467**	**409**
Net provisions and write-offs	-37,233	-164	-44,783	-178	-44,450	-201
Profit before taxation	**32,571**	**143**	**15,447**	**62**	**46,017**	**208**

Average total assets and capital of banks

Items	2000		2001		2002	
	in millions of Tolars	in millions of USD	in millions of Tolars	in millions of USD	in millions of Tolars	in millions of USD
Average total assets	125,012	550	184,608	736	227,832	1,031
Average capital	12,669	56	16,287	65	19,017	86

Structure of registered capital and own funds of credit institutions as at 31 December 2002

Type of credit institution	Registered capital	in total assets	Own funds	in total liabilities
	USD	%	USD	%
Banks	339.3	1.6	1,456.3	7.1
Savings banks	2.9	4.2	4.6	6.7

2002 DEVELOPMENTS IN THE UKRAINIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN UKRAINE

In 2002, in Ukraine the trend towards the growth of macroeconomic indicators continued to be observed. During 2002, the real gross domestic product grew by 4.1%.

Output of the industrial production increased by 7%. Within the industries oriented to satisfaction of investment demand of enterprises and consumption demand of households of Ukraine the rates of output growth were higher than the average ones, e.g. in engineering industry – by 11.3%, in food and agricultural production processing industries – by 8.4%.

In 2002, the enterprises active in innovations commercialized 22.8 thousand products, which is by 17% more than in 2001.

According to 2002 results, for the first time during Ukraine's independence observed was a decrease of prices in the consumption market. The consumer price index was 99.4%. The deflation took place due to the decrease in prices of food products by 2.3%; the prices of services and nonfoods increased by 3.4% and 1.6%, respectively.

For the development of the external economy sector in 2002, a considerable growth of current account surplus in the balance of payments was a characteristic feature. The balance of payments exceeded the 2001 level 2.3 times and totaled USD 3.2 billion, or 7.7% of GDP (vis-à-vis 3.7% in 2001). To a considerable extent it was owing to the 3 times increase of the trade balance surplus.

As compared with the previous year, the exports of goods and services increased by 10.7%; the imports grew by 5%.

In 2002, the net addition to direct foreign investments in the economy of Ukraine totaled USD 0.7 billion, which is by 27% more than in the previous year.

During 2002, the situation in the foreign exchange market of Ukraine was stable.

The foreign exchange inflow resulting from current transactions, earnings from sales of government securities in international markets, as well as from moderate payments on settlements and servicing of the long-term external public debt enabled to expand the international reserves of the country. The level of Ukraine's international reserves as at the end of 2002 was by 43% higher than that of the previous year and came to USD 4.4 billion.

Money income of households increased by 23.3%; the real income grew by 21.2%.

DEVELOPMENT IN THE BANKING SYSTEM

As at January 1, 2003, 157 banks were operative in Ukraine, including 136 joint stock banks; 94 of them were public corporations (including 2 state-controlled banks), 42 – closed corporations, 21 – limited partnerships.

At the date mentioned above in Ukraine operative were 20 banks with foreign capital participation; among them there were 7 banks with 100% foreign capital. The share of foreign capital within the authorized capital of banks made up 13.7%.

In 2002, some trends in operation and development of the banking system of Ukraine manifested themselves attesting its strengthening and intensification of its beneficial impact on the socio-economic development of the country.

The total capital of banks increased by 26%, the total authorized capital – by 31%.

Average authorized capital stock of one operative bank grew in 2002 by 27%.

As of January1, 2003, number of the banks with the regulatory capital of more than 5 million euros totaled 112 (71% of the total number of operative banks); among them 45 banks had the capital exceeding 10 million euros, i.e. 29% of all the operative banks.

Total liabilities of banks grew by 36%. Within the liabilities structure the deposits of natural persons, being the main source for the base of resources, increased at the highest rate (by 71%). Their share within the total liabilities amounted to 35.4% versus 28% in 2001. It is an evidence of growing confidence to the banking system on the part of households.

Total assets of banks grew by 33.5%. The growth of bank assets was mainly due to an increase of credit portfolio which amounted to 45.6%. Debts under the loans given to economic entities increased by 44% and totaled, as at January 1, 2003, 82% of the credit portfolio.

The stability of the banking system increased thanks to liquidation of insolvent banks and reorganization of financially unstable banks. In 2002, 12 banks were removed from the State Register: 10 – due to liquidation, 2 – due to reorganization through merger.

LEGAL AND INSTITUTIONAL FRAMEWORK FOR OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS

The Laws of Ukraine "On Banks and Banking" and "On the National Bank of Ukraine" are a legal framework 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.

In 2002, 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 banks, foundation of their affiliates, representative offices and branches;
- Regulations on the procedure of granting to the banks the 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 enforcement measures for violating the banking legislation;
- Regulations on planning and procedures of inspections;
- Methodological directions on bank inspections in Ukraine;
- Rules for registration of correspondent accounts by the National Bank of Ukraine and by others.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2002

In 2002, the National Bank of Ukraine continued its work on bringing into line with the Law of Ukraine "On Banks and Banking" of the normative and legal acts related to regulation and supervision taking into consideration the Core Principles for Effective Banking Supervision worked out by the Basle Committee on Banking Supervision.

The provisions of the National Bank of Ukraine were realized in practice.

New normative and legal acts have been developed, as well as amendments to those in force, which regulate the bank activities in the following directions:

- procedure of independent audit of the bank financial statements and submission of the audit report to the National Bank of Ukraine;
- procedure of establishing a subsidiary bank, branch or representative office of a Ukrainian bank on the territory of a foreign country; particular features of their closing and supervision;
- CAMELS-based rating of a bank which takes into account the bank sensitivity to market risks;
- improvement of the methods of classifying the banks' receivables by groups of risks;
- procedure of signing a written agreement with a bank to eliminate infringements detected in its operation;
- assessment of bank procedures aimed at counteracting the money laundering and fraud in banking;
- improvement of bank liquidation procedures and others.

Another direction of the banking supervision activities involved off-site monitoring and inspections of banks.

In 2002, the banking supervisory authority of the National Bank of Ukraine made about 600 inspections of banks and banking institutions.

During inspections the authenticity of reporting provided by banks were checked, as well as their observance of laws of Ukraine and normative and legal acts of the National Bank of Ukraine. A special emphasis was laid on capitalization of banks, effectiveness of the systems for monitoring the risks inherent to banks, evaluation of management level, internal control systems, and adequacy of provisions for active operations.

By the results of inspections, each bank received a CAMELS-based rating and adequate enforcement measures were applied, if necessary.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

The National Bank of Ukraine carries out the state regulation of bank activities in the form of administrative and indicative regulation.

Supervisory activity of the National Bank of Ukraine covers all banks, their branches, affiliated and related entities of banks in Ukraine and abroad, as well as other legal and natural entities as regards their compliance with effective laws and normative and legal acts in banking activities.

In effecting banking supervision the National Bank of Ukraine is empowered to demand from banks and their management to eliminate the violations of banking laws in order to avoid or eliminate undesirable effects which can threaten the security of funds entrusted to such banks or bring harm to the soundness of banking activities.

In carrying out banking supervision the National Bank of Ukraine can apply for services of other institutions according to particular agreements concluded.

The National Bank of Ukraine performs banking supervision on the individual and consolidated basis and applies enforcement measures in case of non-compliance with banking laws.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

General Department of Banking Supervision operating within the structure of the National Bank of Ukraine includes the following subdivisions:

- Methodology and Planning of Banking Supervision Department;
- Bank State Registration and Licensing Department;
- Off-Site Supervision and Inspection Department;
- Problem Bank Resolution Department.

INTERNATIONAL ACTIVITY OF THE BANKING SUPERVISORY AUTHORITY

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 Adjustment Loan" project, with the IMF in EFF Program, in EU/TACIS "Program of Three Largest Banks' Restructuring" project.

MAJOR STRATEGIC TARGETS OF THE BANKING SUPERVISORY AUTHORITY

The main aim of banking regulation and supervision is safety and financial stability of the banking system and protection of the interests of investors and creditors.

The aim is achieved through a high efficiency of the banking supervisory authority and its compliance with the Basle 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 nearest future, are:

- to put into practice the supervision on the basis of the risk management system estimation;
- to implement supervision on a consolidated basis;
- to focus an attention upon a preventive control of banks and an early warning system;
- to control the availability in banks of regulations, practices and procedures of counteracting money laundering and terrorism financing;
- to provide an appropriate interaction of the banking supervision authority and external auditors of banks;
- to improve the information and analytical base of banking supervision and others.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of a financial institution	2000	2001	2002
Banks	195	189	182

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

Banks	2000	2001	2002
State ownership	8.8	4.5	4.9
Other types of domestic ownership	77.2	83.0	81.4
Domestic ownership, total	86.0	87.5	86.3
Foreign ownership	14.0	12.5	13.7

Assets and liabilities of the banking system (%)
(at year-ends)

	2000	2001	2002
Assets	**100.0**	**100.0**	**100.0**
Cash funds and funds with the NBU	11.2	8.4	7.7
Funds on correspondent accounts in other banks	9.5	6.8	5.7
Credit portfolio	59.3	63.2	69.0
Investments in securities	5.5	8.6	6.5
Receivables	4.8	4.1	2.1
Fixed assets and intangible assets	8.0	7.1	7.3
Other assets	1.7	1.8	1.7
Liabilities	**100.0**	**100.0**	**100.0**
Including:			
NBU equity	4.6	2.8	2.4
Budget and off-budget funds	4.4	3.9	3.2
Inter-bank credits and deposits	11.1	10.9	11.9
Loans from international and other financial institutions	0	1.1	1.5
Funds of economic entities	42.7	39.5	36.5
Private deposits	21.7	28.1	35.4
Debt securities	2.1	1.2	1.4
Subordinated debt	3.0	2.0	1.6
Other liabilities	7.8	6.2	4.1

Solvency ratio of financial institutions (%)

	2000	2001	2002
Banks	15.5	20.7	18.01

Deposits in 2002 (%)
(at year-end)

Deposits	
Households	38.7
Budget and off-budget funds	3.5
Economic entities	39.9
Other	17.9
Total	**100.0**

Proportion of own funds and assets of banks (%)
(at year-ends)

	Proportion to the total assets of	
	Registered authorised capital	Own funds
Banks	9.5	15.6

Credits in 2002 (%)
(at year-end)

	Credits
Households	7.0
State administrative bodies	0.4
Economic entities	81.7
Other	10.9
Total	**100.0**

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

	FOREX assets/total assets			FOREX liabilities/total liabilities		
	2000	2001	2002	2000	2001	2002
Banks	40.1	38.0	37.3	45.6	44.8	43.9

Average balance sheet items

in USD thousand

	2000	2001	2002
Average balance sheet total (assets total)	7,335,749	9,584,707	12,709,759
Average own capital	1,197,305	1,493,868	1,872,220

Financial institutions' revenues and expenditures structure
(at year-ends)

	2000	2001	2002
Revenues	**100.0**	**100.0**	**100.0**
Interest yields	59.5	66.5	65.9
Commission	26.9	26.7	24.8
Trades revenues	7.9	4.2	6.4
Other banking transaction yields	3.6	1.2	1.7
Other non-banking transaction yields	0.6	0.4	0.6
Other revenues	1.5	1.0	0.6
Expenditures	**100.0**	**100.0**	**100.0**
Interest expenses	31.1	34.8	37.4
Commission expenses	7.3	4.0	3.1
Other banking transaction costs	5.5	6.0	6.1
Other non-banking transaction costs	33.6	38.9	41.1
Reserve allocations	19.3	13.1	9.5
Other expenses	3.2	3.2	2.8

MAIN BSCEE GROUP EVENTS OF THE YEAR 2002

15TH CONFERENCE OF THE GROUP OF BANKING SUPERVISORS FROM CENTRAL AND EASTERN EUROPE

The National Bank of Slovakia as the authority chairing the Group of Banking Supervisors of Central and Eastern Europe for 2002 was the organiser of the annual conference, which was held on 6 – 9 October 2002 in Bratislava. The conference was attended by representatives of all member countries of the BSCEE and also by representatives of Cyprus and Malta, as special guests.

Conference Discussions

The professional part of the conference was opened by the chief director of the banking supervision section of the National Bank of Slovakia, Mr. Milan Horváth, who chaired the discussions of the whole conference. Those present were also welcomed by the vice-governor of the National Bank of Slovakia, Mr. Ivan Šramko.

The first day of the conference was devoted to the topic: **"Internal rating of banks and its use in banking supervision"**. The main presentations were given by Mr Nolan, adviser to the banking supervision section, USA, Ms Musilová from the Czech National Bank, Mr Pancorbo from the Bank for International Settlements, Switzerland, Ms Szõke from the Hungarian Financial Supervisory Authority (HFSA). In their talks they focused on new methods and trends in the creation and application of internal ratings by supervisory authorities. Specific attention was in connection with this given also to the issue of the new Basel Capital Accord (Basel II).

The second half of the day was taken up by a panel discussion, where representatives of each of the BSCEE member countries presented their opinions regarding the main topic. Subsequently Mr Bednarski from the National Bank of Poland gave a presentation on the project "Training initiative for banking supervision". The Polish National Bank has in the framework of this project established a special training centre for banking supervision and Mr Bednarski offered representatives of all the BSCEE member countries the possibility to use the services of this centre in the full extent.

At the end of the conference's first day was devoted to a special side meeting was organised for the representatives of the ten accession countries - the Czech Republic, Hungary, Poland, Slovenia, Slovakia, Estonia, Latvia, Lithuania, Cyprus and Malta with Mr Pooley, chairman of the EEA Groupe de Contact, which covers seventeen banking supervisors of the Western European countries. The meeting was focused on issues concerning the expected accession of ten countries to European Union in 2004, as well as the expansion of contacts and co-operation between the supervisory bodies of the accession countries and supervisory representatives of EEA countries.

The second day of the conference was devoted to the topic **"The current role of supervisory bodies in the field of measures against money laundering"**. The main presentations were given by Mr Crisanto of the Financial Stability Institute, Switzerland, Mr Balogh of the Hungarian Financial Supervisory Authority, Mr Aspden of the Financial Supervision Commission - Isle of Man, Mr Proosdij of the De Nederlandsche Bank, and Ms Fendeková of the National Bank of Slovakia.

From the talks given it was clear how great is the attention being given by supervisory bodies to the issue of money laundering, as well as the fight against insider activities and the financing of terrorism. The presentation by Mr Crisanto gave an overview of current international standards, norms and measures being prepared by various international institutions dealing with the introduction of measures against money laundering and suppression the financing of terrorism in the financial sector. The talk also emphasised the position of supervisory bodies in the effort to apply the main principles of the fight against money laundering via the financial sector and against the possible abuse of banks in financing terrorism.

Mr Balogh offered in his presentation his experience in implementing the internationally accepted standards against money laundering in the Hungarian legal environment, where he highlighted the practical difficulties in their implementation and how to tackle with them when performing supervision. He emphasised also the necessity of co-operation of all institutions involved, without which it is impossible to implement an effective scheme of measures against money laundering in any country.

Mr Aspden in his presentation focused on the experiences of a country generally considered to be a tax haven. He pointed out the fact that despite tax advantages for investors it is still possible to enforce measures aimed at preventing the misuse of banks for money laundering purposes.

Mr Proosdij gave an interesting presentation on the activities of the Dutch supervisory body in this field. With regard to the fact that Dutch supervision is carried out by inspections in banks aimed at uncovering possible risks connected with inappropriate procedures in applying measures leading towards the effective discovery of suspicious transactions, his presentation of an actual case was highly stimulating for the audience.

The main aim of all the presentations as well as that of the panel discussion on the given topic, during which representatives of all BSCEE member countries expressed their opinion, was tight co-operation between domestic supervisory authorities and other state bodies (tax and financial police, customs office), as well as bodies active in criminal proceedings and also cross-border co-operation between supervisory authorities on a mutual basis.

The annual **summary report of the Secretariat** of the Group of Banking Supervisors from Central and Eastern Europe concerned five topics:

1. Events organized by the Group and the Financial Stability Institute in 2002
   - Regional workshop on e-banking, corporate governance and money laundering – July 17-21, 2002, Ljubljana, Slovenia
   - Regional workshop on the New Basel Capital Accord and problem bank resolution, September 2-6, 2002, Vilnius, Lithuania
2. 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. In 2002, according to the decision of the member countries, the Secretariat also published the electronic version of the BSCEE Review on a CD.
3. The accession of the Banking Agency of the Federation of Bosnia and Herzegovina

   By signing the Accord of accession the Banking Agency of the Federation of Bosnia and Herzegovina accepted the Agreement of the BSCEE Group and became the 18th official member of the Group. On behalf of the Group the Chairman, Mr. Milan Horváth and on behalf of the Banking Agency Mr. Zlatko Bar], Director signed the Accord in the course of a signing ceremony.

4. Announcing the new Chairman for the year 2003:
   The Secretariat announced that Mr. Andres Trink, Chairman of the Management Board at the Estonian Financial Supervision Authority takes the Chairmanship for the year 2003.
5. The Budget of the Group of Banking Supervisors from Central and Eastern Europe
   Since the Secretariat manages and carries out the financial duties of the Group, the audited balance for the year 2001 was distributed among the members.

REPORT ON THE E-BANKING, CORPORATE GOVERNANCE AND MONEY LAUNDERING WORKSHOP IN LJUBLJANA

The workshop was organized by the Financial Stability Institute in Ljubljana between June 17 and 21.

E-banking

The series of talks started up with greetings delivered by the colleagues from the hosting Slovenian National Bank, and was followed by the introduction of the workshop's moderator, Juan Carlos Crisanto, who presented the detailed workshop's program.

The first two talks were given by Mr. Jean-Philippe Svoronos, member of the Basel Committee's Secretariat. In his speech, titled "Introduction into e-banking", Mr. Svoronos pinpointed the four key features of e-banking: the speed of change; the increasing role of single point processing; dependence on third parties; and the transmission of banking services through open networks.

Change has become faster because of technological development and market pressure. Innovative banks introduced this service, and the others were forced to follow suit in order to avoid being left behind in the competition. While previously the introduction cycle of new products took several years, competition has shortened that period to 3 or 4 months. This time is not long enough to complete the necessary testing; therefore, the risks associated with introduction significantly grow.

Single point processing (i.e. data must be entered once only, the rest is taken care by the system) substantially reduces the number of errors, the possibility of fraud and the costs because of integration, however, dependence on system architecture is bigger. Additionally the bank's dependence on information technology, in the event of outsourced processes, on third parties, also increases. However, tighter competition presents a much greater challenge to banks: the new entrants bring along new business models to the market.

Dependence on third parties increased partly because of the faster pace of change, the appearance of new technology, and the single point of processing, and partly because of the costs, since it is much easier to buy ready-made software off the shelf, than to have new ones developed. The price to be paid for that is that direct control of the bank's management is compromised. Additionally, the proportion and complexity of outsourced activities equally increase: through the further outsourcing of outsourced activities, setting up joint ventures, establishing partnerships, and through the separation of Internet and content services gradually the network of relationships become impenetrable. Another important question is whether an undertaking has sufficient number of qualified IT specialists, because the worst-case scenario is when an activity is outsourced on account of not having the necessary human resources. Under such circumstances the contracted firm soon discovers that the client is unable to control the quality of the work, therefore, it works more expensively, potentially delivers in poor quality, as it cannot be controlled anyway.

Dependence on open networks also carries substantial risks. The network is used by unknown people, sending messages to each other through unknown locations from unknown locations. The network can be reached from anywhere in the world. For that reason the question of security gains a lot greater emphasis, than before. The technology is still in its infant stage, new developments appear every day: Internet banking, wireless networks, digital signature, authenticating authorities, smartcards, or account consolidation, etc. These technologies have not matured at all and are not widely spread either. Wireless technologies have already passed beyond the initial hardship and may become the base systems for future electronic payments. This presents a strategic challenge to banks.

With the emergence of new technologies spread the view that the time of conventional banking has passed and the world soon converts to Internet-based banking only, that virtual banks will shortly take over most of the market.

Risks involved in E-Banking (Mr. Jean-Philippe Svoronos)

Risks have changed and multiplied. Business risk is different from all other risks: it is much broader than the risks belonging to other categories. It can generally be tied to timing related topics, like in case of risks associated with technology leadership and follower behavior. The risks associated with strategic decisions concerning e-banking, account consolidation services and outsourcing are to be included here.

Security belongs to a special risk category. Development has made the management systems increasing efficient, yet at the same time immensely more sensitive to break-ins, viruses, internal fraud, data loss and DoS[165] attacks. The identification, authentication and authorization of external and internal clients appear to be problematic. Additionally, the importance of the technology applied, the system's architecture, and the internal audit employed increases, together with the risks associated with the technology.

The risks associated with outsourced activities and the operational risks also grew. The possibility of direct intervention by management decreases under such circumstances and dependency on the supplier increases. Selecting activities for outsourcing should be done with utmost care and performance should be continuously monitored. The emergence of big service providers, whose potential failure involves enormous risks, presents a problem in the United States. Altogether 10 service providers provide Internet services to three-quarters of the banks in the United States. It is a frequent mistake that problematic areas are outsourced, which is the worst of all possible solutions, since when the problems cannot be resolved internally, then they are not going to be resolved externally either, and they will only become worse.

Legal and reputational risks also have growing importance. Clients demand access to information on a 24-hour basis, which may to scaling and accessibility problems as to how many users can be simultaneously serviced by the system, and how far could that number be increased. Legal risks include cross-border trade and consumer protection; i.e. whether consumer data could be used, or abused. In order to reduce exposure firms have to improve their crisis management. Any kind of "event" may cast a shadow on the industry; therefore, it pays off to reduce risks to the absolute minimum.

Risk Management in E-Banking

The Basel Committee has set up 14 principles for the management of risks associated with e-banking:

[15] DoS attack: Denial of Service attack. A hacker sends a virus to several computers, which takes over control of the machine receiving specified command and these machines will start queries simultaneously at the service provider, whose server will hang because of the large number of simultaneous and seemingly real queries, not being prepared or equipped for such a load.

Board and Management Oversight:
- Effective management oversight of e-banking activities.
- Establishment of a comprehensive security control process.
- Comprehensive due diligence and management oversight process for outsourcing relationships and other third-party dependencies.

Security Controls:
- Authentication of e-banking customers.
- Non-repudiation and accountability for e-banking transactions.
- Appropriate measures to ensure segregation of duties.
- Proper authorization controls within e-banking systems, databases and applications.
- Data integrity of e-banking transactions, records, and information.
- Establishment of clear audit trails for e-banking transactions.
- Confidentiality of key bank information.

Legal and Reputational Risk Management:
- Appropriate disclosures for e-banking services.
- Privacy of customer information.
- Capacity, business continuity and contingency planning to ensure availability of e-banking systems and services.
- Incident response planning.

FDIC's Philosophy on the Examination of E-Banking

Ms. Sandra Thompson delivered a speech on behalf of the Federal Deposit Insurance Corporation (FDIC). She claimed that more than half of the banks are already on the web, which is on average accessed by 2 million users a month. As of January 4,900 banks had web pages, of which 3,900 facilitated transactions. By the end of 2003 approximately 80 percent of the banks will provide such services. In spite of the fast spread of Internet access still only about 15 to 20 percent of the households use the Internet for banking. E-banking has not considerably contributed to the banks' revenues, indeed, most of the banks offer such services only to keep their clients and not because of the expected revenues or cost reduction. 20 exclusively Internet-based banks operate in the United States and most of them are not profitable. The majority of the successful "e-banks" have been forced to open real branches. While in 1998 altogether 6 attacks on security systems were registered, this figure increased to 58 thousand by 2001. According to security experts the attacks on the e-banking system present the biggest threat to banks.

FDIC calls on the banks' management to complete four steps in its examination manual:

- The institutions board of directors and senior management should understand the key risks, should be committed and should provide authentic support;
- A multi-level integrated security program should be introduced, which extends to the entire enterprise;
- Compliance with the security policy should be enforced; furthermore
- Security solutions managed by third parties should be coordinated and reviewed.

The appearance of new technologies and services increased the banks dependence on outsourced activities; therefore, US supervisors emphasize the bank management's responsibility. In wake of September 11 the supervisors called for improved coordination, communication and business continuity planning. The intention was that regulation should not hinder online and electronic banking. Consequently, what they issued were rather guidelines than statutes. The following areas have been re-regulated: authentication in the electronic environment; privacy of consumer data; identifying theft and pretext calling, furthermore, risk management of outsourced activities.

US banking supervisors examine the state of information technology at banks on the basis of uniform principles; checking IT, the professionalism of IT management, system development, the appropriateness of the system purchased, the accessibility and standardization of IT functions and the system's quality and reliability form (among others) part of the banks' rating.

US banking supervisors set up supervisory processes and examination procedures, training and policies so that they focus on the key technological risks.

E-Banking in Slovenia

The host country divided its presentation into three sections: the fist speech was delivered by Mr. Goran Katusin on Slovenian banking supervision, the second by Mr. Peter Špan on Slovenian corporate payment systems, and the third by Mr. Zoran Tomsic on the security control of e-banking.

Examination of E-Banking by the Slovenian Banking Supervision

In Slovenia e-banking is regulated by Act 57 of 2000 on e-commerce and electronic signature, which fully corresponds to the relevant EU directive and to UNCITRAL's model legislation on e-banking. The act does not apply to already existing e-banking contracts. The law puts heavy emphasis on consumer protection; the relevant provisions are cogent and cannot be circumvented.

The bank act regulates licensing and continuous monitoring with no distinction made between conventional and electronic banking. Licensing of banks is conditional upon defining the services the bank intends to offer in its application, thus it is readily seen, if the bank wishes to provide e-banking services. Additionally, the banks must also furnish information about the IT solutions to be applied. Pursuant to the bank act the bank's management ensure that all risks are managed.

Banks must immediately report to the National Bank any major development in their information system, or if they introduce new services, or they become aware of any information that may have an influence of the banks' secure and prudential operation. Furthermore, banks are obliged to provide any information at the request of the National Bank. Only the general rules of on-site inspection are applicable to e-banking as well. Internal audit must examine the e-banking system.

In the future banks will themselves assess their compliance with the law and, if necessary, they channel issues toward the relevant legal basis. The development of control is shifting toward monitoring practical compliance with the rules.

A Few Examples of the Slovenian Corporate Payment Systems

Mr. Peter Špan said that the overwhelming majority of the banks (21 out of 22) already offered e-banking services in Slovenia; more than 90 percent of the corporations and 30 percent of the households had Internet access. At the same time it was clear that the number of transfers made through the Internet remained unchanged at 75 percent, while the number of retail transfers slightly increased and reached 20 percent. At the same time the monthly number of payments in the corporate sector grew from 120,000 to 160,000 from January to April 2002. Substantial developments took place in the sector during the past few years in part because of the Y2K problem, and, in part, because of the introduction of the Euro. In October 2000 a new system of payments was put in place, accounts were moved from the central institution to the commercial banks. The Bank of Slovenia coordinated the development of the new system of payment as well. Subsequently, Mr. Peter Špan talked about the general risks associated with technology.

Security Control in E-Banking – The Slovenian Example
Mr. Zoran Tomsic told the participants that the Bank of Slovenia expected compliance with ISO 17799 and the principles of Control Objectives for Information and Related Technology (COBIT) (also applied by HFSA) from the banks.

Cross-Border Supervision of E-Commerce

The paper delivered by Mr. Jean- Philippe Svoronos was on cross-border trade. With the arrival of the "Internet Age" a new, flexible and continuously accessible channel has been created. These changes were prompted by the clients in order to ensure access to anything, anywhere and anytime, and to provide personalized services. In case of financial products the actual place of the service is entirely irrelevant. As to cross-border trade cross, the borders present a real challenge to regulators.

From the banks perspective setting up a dense service network for conventional banking is very expensive, marketing is very important and the income is generated by the transactions. The arrangements are different in case of the new information model: open networks are used and a critical mass of clients is required to connect buyers with sellers; income is obtained from the distribution of profits generated in the network.

From the supervisory authorities' perspective the Internet is international as a communication channel, but the regulatory scope of the regulatory authority is fundamentally national. Banks may reach their clients without the clients leaving their offices or home, or without being physically present in the given country either. These banks can easily offer services in countries, where they are not licensed and where they are not supervised either.

Currently cross-border banking basically focuses on the corporate and not on the retail market, thus it raises no consumer protection issues (except for private banking). Differences in security considerations and legal systems present major obstacles for e-banking. As time goes by interactive solutions that help the spread of e-banking and its acceptance by consumers will most likely come along.

The supervision of cross-border trading covers the 1983 Concord, two supervisory principles according to which all foreign establishments are to be efficiently supervised, cooperation between supervisors of the relevant country and the domestic supervisors and the exchange of information between these supervisions.

The differences in licensing procedures blur the distinction between the services offered in the host country and in the other country, since if the client goes to the bank's web site, it is not always clear, where the transaction takes place (in the country of the client's residence, in the bank's country, or in the country where the web server is operating). The difference between providing and offering (advertising) the service is also blurred. According to the Concord physical presence is required to be licensed for cross-border trade. The license should preferably include the definition of the channel through which the services concerned are delivered. The requirement of physical presence is especially justifiable for supervisory purposes; therefore, in the event there is no physical presence, "cooperation between supervisions" makes no sense either. Banks may offer different services from country to country; some activities may not be licensed here or there. This question was brought to surface by e-banking.

Outsourcing beyond national borders also made the tasks of supervisions more complex. Most firms contracted for the outsourced jobs are not even banks, although they may supply essential elements of e-banking services. Control of a company operating according to foreign laws and not subject to the laws of the bank's country is mode difficult both for the management and the supervisory authority. Before a bank could engage in cross-border trade, it must assess the related risks and must develop a relevant risk management system for such activities. Compliance risk especially increases under such circumstances, especially when the activity is regulated. Under most circumstances due care includes the establishment of contact with the supervisory authorities active in both countries. Although the declarations on the web page limit the due care requirement, but their legal effect cannot be foretold and may different in each different legal system.

Multi-Channel Banking in Practice – Nordea

A Nordea bank has a presence throughout the Scandinavian region, in Poland, Germany and Russia as well. The bank altogether employs 40 thousand people at 1,370 different sites. The bank's objective is to become the leader in the regions, where it is present. E-banking is most popular in Sweden, in The Netherlands, Dania and Finland, way above the other European countries. In the same countries the number of fixed and mobile telephone lines everywhere reaches 120 over 100 inhabitants. A key slogan of the bank is that the new economy continues to develop in spite of the dotcom crisis.

According to the bank clients tend to choose banks that are well-known, which they use often and have become established. They prefer simplicity to complex solutions. They opt for convenience and not primarily low price. Reliability is especially important for them. In today's world mobile solutions come into the forefront, modern banks must be capable of providing them. Clients at Nordea may select the branch network, banking by phone, or Internet banking. The objective is to have 3.3 million users of Internet banking services by the end of 2002. The Solo system employed by Nordea is capable of executing all transfers requests, receiving loan applications, it offers secure mail services, one may open an account, or request a card, and it informs non-clients about the details of services and conditions. The telephone services and the correspondence are operated through a contact center and this center communicates with the bank's specialists to answer questions and selected clients may directly contact their own bankers. Additionally this system also performs complex securities trading functions, more than 20,000 stocks could be traded (on 11 exchanges) and 65 percent of the retail transactions are processed in this system. The system is also capable of SMS banking; SMS may be requested about account movements, account balances and stock exchange developments. The same services are available on WAP.

In addition to the retail market Nordea offers the Solo services to the corporate market as well. Solo can perform all functions that are available in branches, including analyses, support for e-commerce, opening letters of credit, or managing financial risks. Because of its early launch (1982) the system is well established, simple and clear, encompassing all of the available services.

Money Laundering
(A paper by Juan-Carlos Crisanto, titled "Anti-money laundering standards for financial institutions")

Money laundering is a process related to the financial sector, the objective of which is to conceal the illegal origin of funds. After September 11 special emphasize was put on terrorism, the accounts owned by or potentially used by terrorists had to be identified. This topic raises legal, reputational and operational risks, but without intervention from supervisions the risk profile does not change. With the supervisions intervention the reputational, legal, operating and business risks increase, and in addition to the usual fines, financial institutions must be prepared for heavier fines and banning from the financial sector, which substantially increases their exposure. Banks are in contact with financial action groups and supervisions. Supervisions coordinate and maintain relations with the financial action groups, supervise institutions and monitor the movement of funds.

The Basel Committee issued 3 documents related to the topic: Prevention of criminal use of the banking system for the purpose of money-laundering (1988), Core principles for effective banking supervision (1997), The Core Principles Methodology (1999). In 2001 their materials on the application of the principle of Customer Due Diligence, this year the papers on the share on information were published.

Financial Action Task Force on Money Laundering (FATF) is an action group dealing with the topic, set up by the G7 countries in 1989. Today 29 countries and 2 organizations are its members. Its objective is to develop procedures to fight effectively against money laundering. The fight against financing terrorism was added to its scope of activities. They issued Forty Recommendations in 1990 and updated them in 1996. They also publish the list of non-cooperating countries and annually the money laundering methods.

The first group of the Forty Recommendations is related to the legal systems. According to these money laundering should be made punishable by law and the laundered property should be confiscated. The Recommendations prescribe both formal and informal cooperation for the countries. Banks and other financial, or non-financial institutions, engaged in certain kinds of activities, must join the fight against money laundering. It is forbidden to maintain anonymous accounts; account holders must identify themselves with official documents. Institutions must know the actual owners of the accounts. Documents are to be safeguarded for at least a period of 5 years and transaction data are to be recorded at a depth that is sufficient for being used as evidence in court.

Suspicious transactions are to be immediately reported and legal protection must be provided to those submitting such reports. Cash control is only a suggested topic. Institutions must set up anti-money laundering procedures and regulations, they must employ compliance officers, train their staff on a continuous basis and internal audit should study the developments. The regulations are to be approved by all domestic and foreign branches and subsidiaries of the institutions.

FATF assesses the countries' situation in relation to money laundering, in the course of which it monitors the statutory measures taken, the measures taken in the financial sector, the operation in practice, the willingness to partake in international cooperation and the responses given to previously identified deficiencies. So far 2 such surveys were prepared, of which the second already looked at efficiency considerations. The third survey will be launched next year.

Every year the countries must prepare a self-assessment, which includes the completion of a questionnaire. The results are to be published as part of their annual report. Non-cooperating countries are classified as such on the basis of objective criteria. At the moment there are 19 countries on that list. In October 2001 FATF published its Special Recommendations on Terrorist Financing. The related self-assessment questionnaire was prepared in January 2002, supplemented with the document offering explanation and guidance in March. The Eight Special Recommendations are as follows:

- Ratification and implementation of UN instruments
- Criminalizing the financing of terrorism and associated money laundering
- Freezing and confiscating terrorist assets

- Reporting suspicious transactions related to terrorism
- International cooperation
- Wire transfers
- Non-profit organizations
- Alternative Remittance

FSA – the British Experience (A paper delivered by Erik Engstrom)

Money laundering supports criminal activities and other social crimes (terrorism, fraud, drug trafficking and organized crime). Money laundering happens where the system and the control are weak; money laundering indicates the scale of fraud and risks. The reputation of institutions mentioned in connection with money laundering is damaged. The fight against money laundering is very difficult, because it is almost impossible to discover, anti-money laundering measures are not popular among clients and the results are not often visible. Additionally, often support from the top management is also missing.

The EU's Directive on prevention of the use of the financial system for the purpose of money laundering was passed in 1991, which was followed in 1993 by regulation in Great Britain. At present the legal grounds for the fight against money laundering is provided by the Financial Services and Markets Act (2000) defining the key objective for FSA, namely to reduce financial crime, and empowering FSA to step against those who fail to comply with the anti-money laundering rules. Firms must appoint a Money Laundering Reporting Officer (MLRO), who is responsible for the training of the employees and for the appropriate adaptation of the experiences of FATF and the British Government. MLROs must prepare a report for the top management every year.

The key objective of the FSA was to set the level of compliance for the industry and to identify the most vulnerable sectors. Another goal was for FSA to identify the areas to which it should concentrate its resources and to define the measures to be taken against those who failed to comply with the rules, to prepare the "map" of money laundering of the financial sector, and to emphasize the consequences of non-compliance.

In order to assess money laundering related risks FSA collected data from several sources; from an independent industry questionnaire, from other questionnaires, from supervisory inspections and discussions with firms. The most frequent mistakes stem from the omission of the Know Your Customer (KYC) type control, the failure to recognize money laundering related risks, from poor or infrequent training, from the inadequate storage of identification data, lack of control of the clients' properties, inadequate checking of correspondence relation, and from the failure to take the clients' environment into consideration. International and domestic banking transactions, those who operate the transfer system, brokerage firms and credit cooperatives are exposed the most to the risks of money laundering.

There are four teams dealing with money laundering within FSA. The unit for financial crime policy is responsible for setting up FSA's anti-money laundering rules. The enforcement team is responsible for carrying out investigations and taking actions in the event the rules are violated. The team investigating the risks of financial crime makes thematic visits at institutions, maintains contact with the financial team and the enforcement team. Finally, the Money Laundering Advisory Committee coordinates the work related to money laundering and overviews the organization of internal and external processes.

Fight against money laundering by the Swiss UBS bank

On behalf of UBS Mr. Pierre Grumbacher delivered a speech on the anti-money laundering regulation introduced by them. UBS identifies the contracting party and the actual owner as well. The bank also questions the origin of the deposited assets and attempts to map the clients' background. USB is especially cautious with politically charged people, clients from sensitive countries and other sensitive clients. The top management's approval is required to have accounts opened for politically sensitive persons and, additionally, a separate group deals with persons like that. Maintenance of such accounts must be reviewed annually and the accounts must be continuously monitored. The list of sensitive countries is defined by UBS based on internal and external ratings. Interestingly enough, although Afghanistan was given a "RED" marking, several other countries that were classified by FATF as non-cooperating ones have not been included in the list. Several sensitive clients either operate in sensitive industries (weapons manufacturing or gambling, etc.), or are famous and important clients. A big database is being put together on "blacklisted" clients, which is to be checked before all account openings. The aim of the bank is to simplify the present system, forgiving the 'one size fits all' principle. Additionally, they intend to broaden the scope of information to be requested on the basis of the Know Your Customer (KYC) principle, including the reasons for switching between banks, and name, address and account number information for transfers.

Subsequently the Wolfsberg Statement was mentioned. 12 banks signed the Wolfsberg Statement and it contains global anti-money laundering rules. It was declared by these countries that they would not let the banks be used for money laundering purposes, that the banks had no need of the assets acquired through crime, that they would disclose their actions taken to prevent money laundering and do not compete in the area of money laundering. Additionally they help each other by sharing their experiences and coordinate with inter governmental and other organizations dealing with the prevention of money laundering. The signatories also planned to update the Statement and set up working groups for the different topics.

Finally, certain issues related to terrorist financing were touched upon. Assets financing terrorists are often hard to identify, because they originate form perfectly legal sources. An efficient solution could be sought in improving cooperation between financial institutions, the government and law enforcement institutions. Information on the patterns, techniques and processes used for terrorist financing are to be shared.

PWC – Observations of an external auditor in the investigation of money laundering

Mr. Rick Helsby delivered the paper from the polish subsidiary of PriceWaterhouseCoopers. Mr. Helsby talked about the role of external auditors and consultants. These persons have a set of responsibilities the scale of which depends on the applicable laws, while consultants occasionally engage in supervisory inspections. Auditing means the review of financial statements and the establishment whether they were compiled in accord with the financial reporting framework. Although the auditor is not responsible and cannot be made liable for failing to spot non-compliance, he must audit the management and the firm's compliance at the supervisory authority.

In case of supervisory or anti-money laundering inspections the objectives of the inspection should be clear, the conclusions should duly cover the topic, furthermore, special skills are required to conduct the investigation and to study client transaction details. The auditor proceeds in the exact opposite direction: he works his way through assessing the systems and mechanisms toward the transactions and not the other way round. Present money launderers can pursue their activities taking advantage of auditors.

Threats and vulnerability are not always measured, but even where the relevant surveys are made, they are not documented, for the risks recognized by the management are not to be revealed. Not always the right basis is used for making comparisons, and occasionally the data are too old. The consistent application of the Know Your Customer (KYC) principle presents a further difficulty; it is difficult to record particulars of established clients and to obtain reliable information about the origin of the assets. Individual particulars may be lost in the records; occasionally event electronic data can disappear. Data included in several databases are not always consistent. Additionally, it is very difficult to provide appropriate training for the MLRO and for the top management. In case of big organizations the arrangement of the training in a way to avoid stopping the entire institution also raises a complicated logistical problem. Control and reporting also present several difficulties. It happens that there are no sufficient resources for control, reports on suspicious events may “get lost” in the system, or evidence is sought to prove that certain dubious cases are not dubious after all.

The precondition of the success of the fight against money laundering is the improvement of the quality of the information collected on the basis of the Know Your Customer principle and to have them stored electronically, which makes queries easy. Additionally, there is need for artificial intelligence supervising the transactions. The information collected on the basis of the Know Your Customer principle is not only useful in combating money laundering, but it also protects against fraud and other financial crime, ensures compliance with domestic statutes and other supervisory systems. Pro-active institutions must set up a framework against money laundering, which is fully integrated into the undertakings’ business processes with the data available for any purpose, which is cost efficient and supports compliance with corporate legal and business processes. The complex IT system is capable of identifying relations within the network and, thus, potential money laundering processes.

Money laundering in the member countries of the Group of Banking Supervisors from Central and Eastern Europe

The anti-money laundering act, effective of February, was passed in Russia in 2001. The central bank issued its recommendation and two regulations pertaining to money laundering. The central bank has been investigating the banks by conducting on-site inspections since February. Thorough training was provided for the banks prior to February.

Institutions must also watch cash transactions in Albania. The national bank, which is the supervisory authority, received a one-year authorization for supervising this field. The act is based on FATF’s Forty Recommendations, according to which banks must report dubious transactions. Compliance with the Know Your Customer (KYC) principle is priority. Last year the value of transactions reported reached USD 1,500,000.

In Byelorussia the anti-money laundering act has been in place since 2000 and the supervisory authority conducts regular on-site inspections as well. Financial organizations must check every transaction exceeding USD 10,000. All persons involved in the transactions are to be identified.

In Rumania anti-money laundering legislation has existed since 1999. There is a separate authority set up for the purpose, the National Office for the Prevention and Combating of Money Laundering. All transaction exceeding EUR 10,000 are to be reported to this office. In addition, identification is mandatory in case of transactions exceeding EUR 1,000. MLROs are not employed in the country. The national bank receives information about suspicious cases.

There has been anti-money laundering legislation in place in Bosnia for 2 years now. The act is quite general and it is not broken down by types of institutions. The authority has the right to request information on all transactions from the banks and based on such information it publishes figures as to which bank laundered how many millions of euros. Unfortunately, the police cannot do much about the reported cases. After such events the banks call the office, but there is not much that can be done. Cooperation between the institutions is poor, but hopefully it will improve as a result of international pressure. The anti-money laundering office had them close the accounts of presumed terrorists, but there are no statutes to support that move.

The situation in Croatia is similar to that of Albania; banking supervisors check compliance with the Know Your Customer (KYC) principle. The Money Laundering Department is under the control of the Ministry of Finance. Institutions report suspicious events to that office. A task force has also been set up, primarily against organized crime. In addition to the usual information the full description of transactions is also to be included in the reports.

The Czech Republic has anti-money laundering legislation since 1996. The act provides for the safe storage of data, internal processes and training, furthermore, it specifies the sanctions applicable in case of non-compliance. The act on banks also provides for identification. A special supervisory authority has been set up, which monitors compliance and fines non-complying banks. Since the act was passed on-site inspections related to the issue have regularly been carried out. Auditors also have a responsibility as they have to check the report that, among others, discusses money laundering related risks.

There is anti-money laundering legislation in place in Latvia as well. Those who fail to comply with the act may count on a fine of approximately USD 8,000. They also perform on-site inspections on a continuous basis. The objective is to increase the frequency of such investigations.

Poland already has an anti-money laundering act in place since 1992, which has been amended several times since then. They have set up a task force that investigates money laundering, although it is very hard to prove anyone guilty.

In Macedonia the act has been in place since August 2001 effective as of March 2002. A separate department has been set up under the control of the Ministry of Finance for investigations in this field. The national bank deals with the problem in the framework of on-site and off-site inspections. All transactions exceeding EUR 10,000 are to be reported.

Anti-money laundering legislation existed in Slovakia since 1996, which was supplemented in 2001. However, the latter becomes effective only after Slovakia's accession to the EU. Four institutions monitor compliance with money laundering rules, including the national bank, monitoring agencies and the financial task force. The banks must employ MLROs. The task force regularly consults with the other three monitoring institutions.

In Slovenia the agency is under the control of the Ministry of Finance, including the banks' supervisors too. At the moment they do not yet have sufficient experience, there are no reports uncovering money laundering.

The basis of corporate governance in financial institutions

Juan-Carlos Crisanto delivered the keynote address on corporate control. It can be concluded about the Enron affair that the management allowed, even encouraged misleading accounting practices. Additionally, the auditors signed the misleading accounts. Both the company's internal and external auditors hid documents. Individuals grew rich from contracts negotiated with their own employer. The supervisory committee could not efficiently supervise the management's work. At AIB Mr. Rusnak's loss reached USD 691.2 million. The top management did not find the Allfirst trading particularly important. Mr. Rusnak was able to trade day and night, at home and on vacation. "I believe that the similarities between AIB and Barings are pretty close... That is frightening", said Nick Leeson.

Responses appeared in almost every European country. The German's passed a voluntary Codex, in the United Kingdom the British Chamber of Commerce reviews the role of auditors and non-managing directors, while in Switzerland they contemplate the mandatory publication of the salary of top managers. The EU obliges listed companies to introduce IAS latest from 2005 and the Basel Committee issued a recommendation on the relation between banking supervisors, external auditors and internal audit staff, furthermore, the Institute of International Finance issued a Codex on corporate governance and transparency for developing markets.

OECD published its guidance on corporate governance, including a series of incentives, and defined the relations between the management, the board of directors, the stockholders and other relevant parties. This is done using a structure, which defines objectives in the interest of the company and the stockholders that can be efficiently controlled. The directives of the Basel Committee were intended to supplement the material prepared by the OECD. The paper defines the key elements of corporate control, includes the special elements of banks' corporate governance, but does not proclaim the superiority of any one corporate governance system.

According the Basel corporate governance is a method whereby individual banks are controlled by their board of directors and top management through:

- defining objectives;
- performing operative tasks;
- considering the interests of all parties involved (including employees, consumers, governments, supervisors and others);
- meeting the expectation of safe and prudential operation in compliance with the law; and
- protecting the interests of depositors.

Strategy and values are to be defined for the establishment safe corporate governance, responsibilities and competencies are to be clearly identified. Communication and cooperation between the board of directors, the top management and the independent auditors are to be supported. A system of checks and balances must be set up. In addition the emergence of potential conflicts of interests is to be constantly monitored, an appropriate compensation system is to be set up, and the management of the company must be transparent.

The Basel Committee issued seven directives on corporate governance:

1. Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organization
2. Setting and enforcing clear lines of responsibility and accountability throughout the organization
3. Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns
4. Ensuring that there is appropriate oversight by senior management
5. Effectively utilizing the work conducted by internal and external auditors, in recognition of the important control function they provide

Recognizing the importance of the audit process and ensuring the independence and professionalism of the auditors substantially increases the efficiency of the board of directors and the top management.

6. Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment

   The board of directors must determine the compensation given to top managers and the salaries of other employees in key positions. The salaries of those employed not in key positions must be determined in such a manner that they should not depend on short-term performance.

7. Conducting corporate governance in a transparent manner

   The information to be published should include the ownership structure, the composition of the board of directors, the composition of the top management, the organizational chart, the system of compensation and the nature and scale of transactions by associated parties.

Corporate governance – Supervisory responsibilities

Paul J. van Sluis delivered the paper on supervisory responsibilities. Conventional banking supervision is supplemented by the supervision of structure and auditing. Publication of the information changes and more emphasis is laid on uniformity. Regulation is focused on risk management, codes of organization, information, communication and on the processes of inspection, survey and improvement. In that respect internal and external audits are especially important.

In analyzing corporate governance the triad of internal audit, organization and management are to be investigated. With respect to internal audit the risk management system, the management information system, the system set up to manage operational risks, the supervision of auditing and compliance, the supervision of IT and HR are to be investigated. Inspecting the organization one must look at the organizational structure, group relations, the reporting path, and the lines of responsibility. With respect to the management the quality and structure of the management, the decision-making process, the process of strategic planning and the approach to risk management are to be investigated.

Supervisors must organize supervisory meetings with the management to make them informed about the events, the direction of progress and the plans. This may take monthly, or quarterly, or even annually from the perspective of strategic planning. Supervisors must also meet internal auditors on a regular basis, together with the independent auditor in order for the supervisors to get acquainted with the report of the auditor and the content of the management letter. Inspecting the management it must be confirmed whether members of the management have adequate experience and references, whether they are trustworthy, which is to be confirmed by other references over and above those provided by the police. Members of the supervisory committee must have adequate protection and must be equally trustworthy as the management.

Efficient internal control is a critical element of a bank's management, this gives the ground for the safe and secure operation of the banking organization. Strong internal control ensures that the bank's intentions and objectives are met and that the bank achieves profits on the long run, furthermore, that the bank maintains a reliable financial and management reporting system. Internal audit tests the efficiency and the efficiency of the activities, the completeness of the information available for the managers, the timely availability and reliability of the information and compliance with the relevant statutes.

The appropriate internal audit system operates in a transparent structure, constitutes a system consisting of clearly defined processes and responsibilities, has consistent and accessible documentation, works and connects to the organization, and to the control of branches and subsidiaries on a continuous basis.

The board of directors and the top management are responsible for the spread of high ethical standards. The board of directors and the top management must emphasize the importance of internal audit through their words, actions and behavior. These ethical rules must be reflected in business negotiations equally within and outside of the organization. Internal control belongs to the responsibilities of all of the bank's employees. Report from the staff concerning operating deficiencies or non-compliance with the regulation have critical importance with respect to the efficient operation of internal audit systems. Preferably conflicting incentives are to be avoided in order not to deteriorate efficiency.

The internal audit process consists of policy, processes, documentation, organizational charts showing the lines and the division of responsibility, control and registration, reporting exceptions and periodical reports for internal audit.

The external auditor verifies whether the documents reflect a "reliable and true picture" of the company; external auditors must be independent and objective, must maintain unity, must protect confidential information, exhibit professional behavior, must have knowledge of technical norms, and exhibit professional skills and care.

Szalavetz Gábor, the President of HFSA, delivered a speech on corporate governance in Hungary, in so far as he outlined the relevant Supervisory Guideline (No. 3 of 2002), Act CXII of 1996 on credit institution and financial undertakings and Act CXLIV of 1997 on business associations.

REPORT ON THE SEMINAR ON THE NEW BASEL CAPITAL ACCORD (BASEL II) AND PROBLEM BANK RESOLUTION,

organized by FSI for the Group of Banking Supervisors from Central and Eastern Europe between September 2 and 6, 2002 – Vilnius, Lithuania

On the organization and responsibilities of FSI, about its activities (by Jason George, FSI)

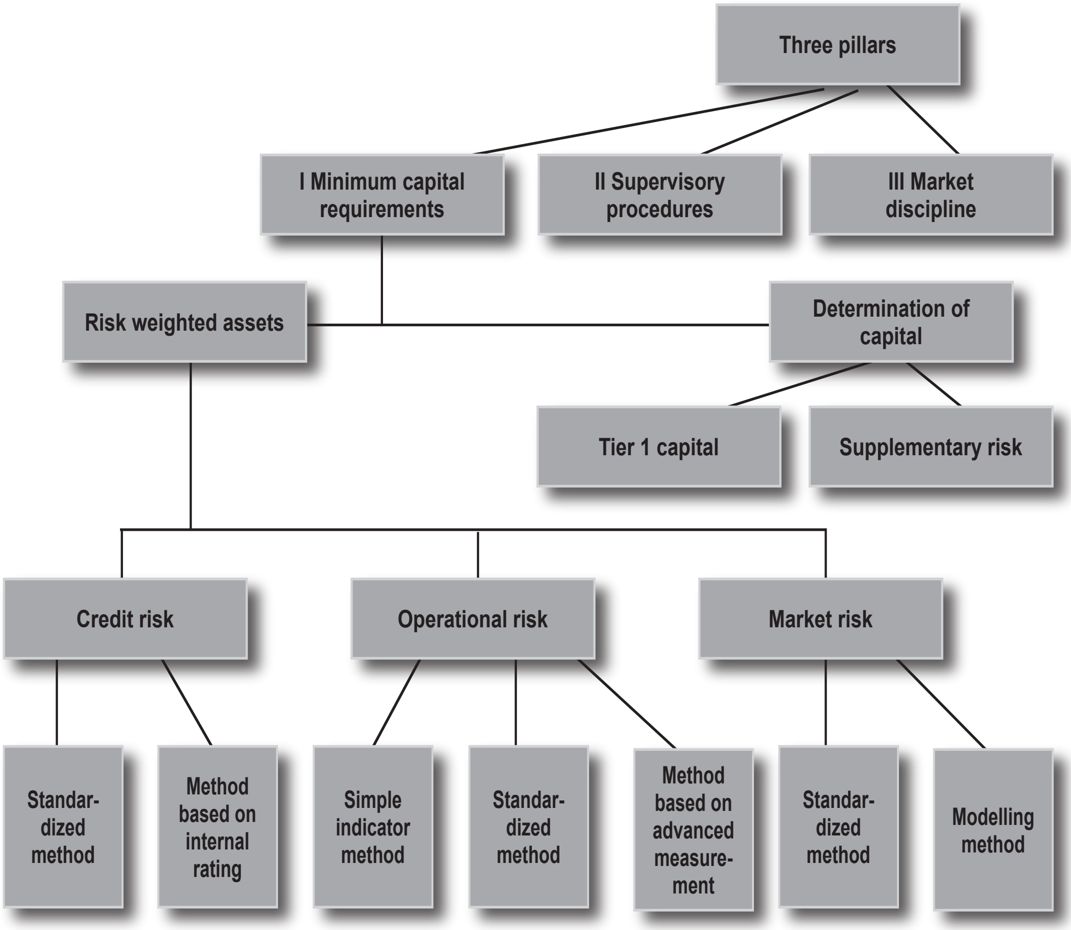
The objectives and scope of Basel II

Key objectives:

- Capital requirements should be more sensitive to risk
- Increasing the weight of risk assessment by banks
- Overall cover for risks
- Complex regulation

Apart from all their positive features risk assessment systems are not perfect, the 8 percent capital adequacy cannot be forgone and a political review of the Accord is necessary.

The structure of Basel II:



The currently effective (1988) Accord defines only a minimum capital requirement to cover credit risks. The ratio of minimum capital and weighted assets is 8 percent. The new Accord leaves the definition of the capital elements unchanged (Tier 1 and Tier 2 capital and short term short-term loan capital to cover market risks).

Scope:

- Applicable on a consolidated basis equally to banking groups and financial holdings
- Also applicable to banks active in the international markets
- Financial undertakings whose activities include financial leasing, card issue, portfolio management, deposit services and other financial services are to be included in the consolidation
- Insurers are left out of the consolidation, however, their consolidation is also possible on a national basis
- The Supervision must make sure that non-consolidated insurers are sufficiently capitalized to reduce the banks' loss potentials
- The Supervision must assess minority shares in the course of consolidation
- Undertakings in minority ownership are to be discounted or they should be consolidated on a pro-rata basis
- 50 percent of the deductions shall come from Tier 1 capital and 50 percent from Tier 2 capital

Reliability in managing credit risks (Ad Huijser, De Nederlandsche Bank)

New directions in the banks' development:

- the use of quantitative risk concepts;
- the employment of risk/yield analysis;
- the portfolio approach.

The result of that is that better (internal) risk assessment has become absolutely necessary.

The separation of the business and risk management areas (i.e. the independence of risk management) is extremely important.

The speaker outlined several minimal risk management requirements that are also provided for in Decree 14 of 2001 of the Minister of Finance in Hungary as well.

A method was presented for the calculation of expected loss: EL = PD x LGD x EAD

Where EL stands for expected loss, PD is the probability of default, LGD is the loss given default and EAD stands for exposure at default.

The speaker outlined a few models where the calculation of expected loss is done by assigning risk weights to clients, or sectors of a given risk.

Standardized methods for the measurement of credit risk in the New Accord (by Jason George)

This is the simplest method for the measurement of credit risk and probably the majority of the banks will use this.

Main changes compared to the 1988 Accord:

- Weights are much more sensitive to risks than before
- Based on external risk assessment
- Eliminates the distinction between OECD and non-OECD
- Introduces the 150 percent category
- Assigns 0 percent weight to a few international development banks
- Decreases the risk weighting of loans secured by residential real estates
- Introduces new weights for retail loans

In assigning the weights differences are to be made with respect to exposure to governments, national banks, banks and corporations. (The rating of governments, banks and corporations is based on ratings by external credit assessment institutions (ECAIs); the rating agency must be approved by the Supervision.)

The use of different weights (even down to zero) is permitted within national competence, if:

- the bank undertakes exposure in its own national currency to its own government; or
- to export credit institutions.

Two tables were put together for exposures to banks, and the supervisions have to choose which one is to be applied to the banks supervised by them.

Unrated debts to banks and corporations may not be given smaller weight, than the state of the bank and corporation would receive with respect to which the exposure would be undertaken.

The weight of unrated companies is at least 100 percent. At present there are no approved plans for retail weightings yet. The weighting of debts overdue for more than 90 days shall be 150 percent. Maturity will be an important consideration, but that would increase the cost of the method.

External credit assessment (ECAI) (by Claudia Nelson and Fitch Ratings)

Brief introduction of the company with partners and shares, etc.

Rating criteria for states and central banks:

- one of the most important basis is the rating of the national currency;
- the relation between indebtedness and economic performance;
- first the individual subjects of the inspection are rated by themselves, then they are compared with their states, since the banks' exposure is the most significant to their own local monetary environment.

The rating of the national currency is suitable to measure the extent to which local market players are able to meet their obligations on the local markets.

The rating of the state's national currency is often better than those of foreign states.

Banks' rating:

- analysis of the operating environment;
- analysis of local rules and supervision;
- questions to the bank;
- analysis of the bank;
- drafting a report;
- presenting the draft to the bank;
- publication of the report or keeping it confidential.

Reduction of credit risks (by Jason George)

- the use of collateral;
- the employment of "haircuts" to determine the risks to be covered by capital;
- guarantees and derivative transactions.

Credit risk models (by Ad Huijser)

Presentation of a few mathematical models.

Internal rating based method for the assessment of credit risk (by Ad Huijser)

- it is essential that five years of statistical data collection should precede the introduction of the method;
- according to this method the assessment of credit risk shall be based on the banks' own ratings and performed separately for each transaction;
- Problems:
- is the rating given by the bank reliable?

- the difficulties of monitoring ratings;
- because of these this assessment method is closely related to Pillar II.

Reliability in managing operational risks (by Stephen Senior, FSI)

Management and control system of operational risks (by Lars Hansén, SEB Group Risk Control)

It is possible to have historical measurement of operational risks, but that offers an opportunity for managing the risks and covering them with capital for a small circle only. SEB primarily intends to manage, prevent, or reduce operational risks, rather then to measure them.

Prevention of money laundering as a factor reducing operational risks (by Mike Stephenson, Financial Services Authority UK)

The obligations, such as identification of the actual owner, consolidation of financial movements into the same direction, training, and the placement of organizational units, etc., which are also included in the Hungarian act were cited.

Operational risk insurance (by Thomas Leddy, Swiss Re Group)

Still relatively few banks have operational risk insurance, and those that do, primarily use it to cover foreseeable, but low probability risks (such as damages arising from unlicensed transactions). Perhaps Barbi can say something smarter than that.

Pillar II: Supervisory procedures (by Dusan Stojanovich, FED USA)

New supervisory requirements and work methods in line with the Accord.

Interest risks (by Dusan Stojanovich, FED USA)

On the banking book...

Pillar III (by Stephen Senior)

Pillar III of the New Basel Capital Accord is the disciplining power of the market, since the new Capital Accord assigns great importance to the publication of information. This pillar is a catalogue of the publication requirements supporting Pillars I and II on the one hand, and on the other hand it orders them, like in case of internal ratings based approach, in case of risk reduction techniques, where publication is a precondition for the employment of certain methods.

Pillar III includes the requirement to publish information in every six months as a basic principle.

In relation to this Pillar there is tight cooperation between the Basel Committee and IASB and they are expected to finish their work by the middle of next year.

Problem banks (by Jason George)

The paper on problem banks outlined when and why corrective measures are to be taken against banks, furthermore, what are the most appropriate types of corrective measures.

The participants were briefed about the general principles of the application of corrective measures and the most important steps of the procedure, which were as follows:

- definition of the nature and gravity of the problem;
- assessment of the scope of the appropriate corrective measures;
- appropriate timing of the corrective measures;
- measures to remedy the situation;
- supervisory procedure and enforcement of compliance.

Issues pertaining to immediate measures and enforcement measures based upon the supervisory authorities' discretional powers receive special attention. With respect to the latter the written agreement to be born between supervisory authorities and banks was mentioned; the agreement serves corrective purposes in an informal manner on the basis of being mandatory.