Center for Research and Policy Making

CRPM

Macedonian Banking System & Changes in Regulation

Occasional Paper N. 11

March, 2007
Skopje, Macedonia

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Executive Summary

After 15 years of monetary independence we are about to witness an entry of a well-known European commercial bank on the Macedonian market. With the acquisition of Ohridska Banka by Société Générale we believe that a certain era of mediocre banking practices applied by the Macedonian banks (as well as foreign banks with 'Macedonian corporate culture') is coming to an end. CRPM team turns your attention to the draft Law on the Macedonian Banking System. This legal framework is expected to provide for further liberalization of the financial market in the country, improvement of the legal and regulatory environment, and banking supervision. Reforms in all these areas can be considered as crucial to increase the efficiency and existing confidence in the local banking sector.

Yet within the draft legislation there are certain technical issues that can and should be improved. For example, the proposed concentration of power into a single person – the Governor of the National Bank can be considered as one of the biggest potential problems of the draft legislation. An additional problematic aspect of the draft law is the criteria for deciding who can be a shareholder or 'person having special rights and responsibilities' within the bank. These persons should under the proposed new law be of integrity i.e. honest, competent, and industrious (hard working). However, the decision about who fulfils such personal characteristics is left to the discretion of the Governor and thus prone to subjectivity. Despite some shortcomings the proposed reforms can be considered as significant step forward in improving the Macedonian banking system.

I. Introduction

Throughout the world the process of consolidation in the banking industry (M&A-mergers and acquisitions) is one of the most important developments in the financial sector. The main driving force behind this trend were different structural and institutional changes that have taken place in developed countries, such as the United States, European Union and Japan. This seems to be a very obvious consequence of the process of globalization, which in turn resulted in new kind of economic pressures for increased efficiency in the financial sector.

A significant structural change in the European Union was the completion of a single market program. The objective was to bring synchronization of the existing administrative regulation, legislation to increase competition. In response to the changes in regulation, European financial institutions have attempted to improve their efficiency and attract new customers by increasing their geographical reach and the range of products they offer.[1] The desire to preserve falling (interest) margins by increasing market share and to attract new customers is often fulfilled by M&A that allow financial institutions to rapidly increase their size and to improve their knowledge of new products and markets.

In recent years one of the most dynamic markets for mergers and acquisitions was the one in Central and Eastern Europe (CEE). This should not come as a surprise especially having in mind the process of privatization (transformation of the state capital) and rehabilitation of the entire banking system. Just for illustration, foreign banks acquired more than 50 financial

[1] Dean Amel, Colleen Barnes, Fabio Panetta & Carmelo Salleo, *Consolidation and Efficiency in the Financial Sector: A Review of the International Evidence*, CEIS Tor Vergata - Research Paper Series, Vol. 7, No. 20, 2003.

institutions from South East Europe (SEE)[2] in the period between 2000 and 2005.

However, Macedonia is an exception. It seriously lags regarding this trend. Realizing this weakness, the Macedonian Government led by VMRO-DPMNE has decided to undertake steps aiming at full financial liberalization. Among other things a new banking legislation is proposed. This paper gives a brief overview of the Macedonian banking system. In addition, some specific developments will be discussed by making a comparative analysis. However, its main focus is on the draft version of the proposed bank legislation and its possible implications for the Macedonian economy.

[2] SEE refers to following set of countries: Albania, Macedonia, Serbia, Bosnia and Herzegovina, Montenegro, Croatia, Bulgaria, and Romania.

II. The Process of Consolidation

During the 1980's, banking and markets for financial services in developed countries have experienced major structural changes, including significant reduction in the number of independent entities. A simple comparison of the concentration ratio between the US and the EU[3] area as a whole[4] indicates that this trend is far from being over. Namely, this ratio is high for each country when observed independently while the concentration on pan-European level is significantly lower despite the process of full financial integration. A similar trend can be observed in all 'transition' economies from Central and Eastern Europe (CEE). Domestic markets are highly concentrated, meaning that the banking sector is characterized by large number of banks, few of which clearly dominate in terms of a market share. The assets of the top five banks in each country from CEE accounts between 60% and 87% of total banking sector assets.[5]

One of the most important reasons for mergers and acquisitions in the financial sector is to secure unrealized scale and scope economies.[6] Some in the academic community relate the difficulties associated with cross-border mergers and acquisitions,to the differences in the corporate culture.[7] According to them the easiest M&A are usually those where the partner or the acquired entity is geographically close, when institutions operate in similar legal and regulatory framework, and possibly share the same (or similar) language and culture. The only specific benefit, from cross border consolidation, is associated with the extra gains that might arise from diversifying the macroeconomic risk related with bank's portfolio of loans

[3] This refers only to EU-12, without new member states.
[4] Danthine, J.-P., F. Giavazzi, X. Vives, and E.-L. von Thadden, *The Future of European Banking*, CEPR London, 1999, Ch. 4 and 5
[5] CRPM data base on banks in SEE.
[6] Molyneux, P., Y. Altunbas and E. Gardner, *Efficiency in European Banking*, 1997, Ch 8
[7] Hoisted G., "*Culture's Consequences: International Differences in Work Related Values*", Sage Publications, Beverly Hills CA, 1980: Kotter J., "*Corporate Culture and Performance*", Free Press, 1992

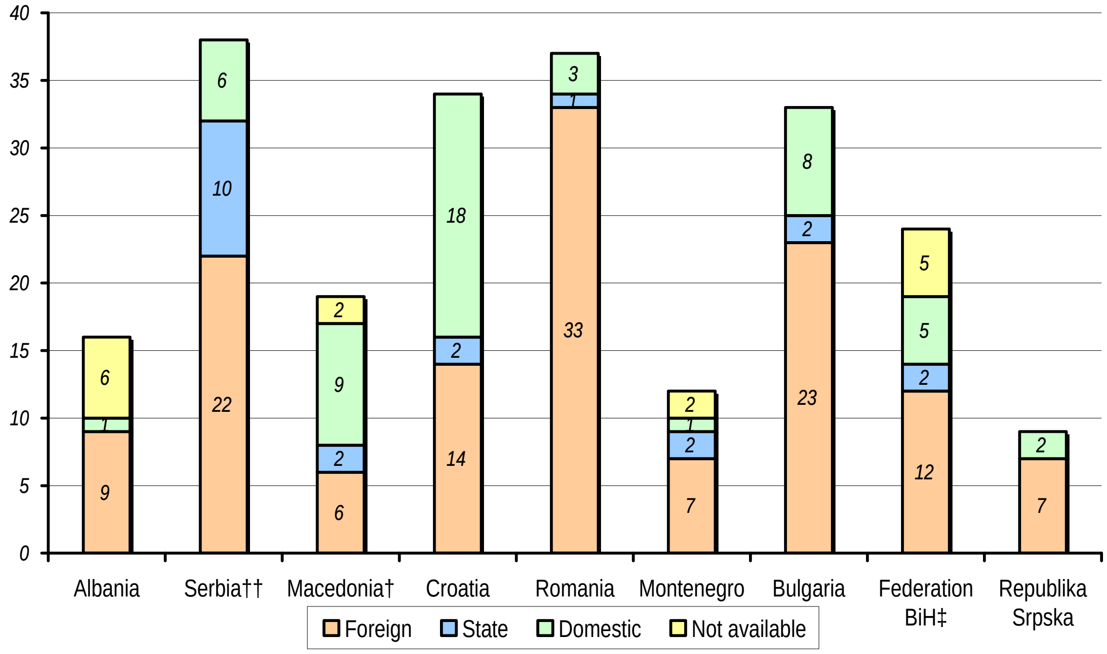
and deposits. Equally important are the improvement in performance and increased efficiency. Recent examples in Europe were the merger of UniCredito and HVB/Bank Austria Credit Anstalt (BA-CA), which resulted in cost savings[8] and presence in 16 CEE countries with significant market share, and the acquisition of Banca Nazionale Del Lavoro by BNP-Paribas.

One of the most dynamic markets world-wide for M&A in the banking sector was certainly CEE. This should not come as a surprise especially having in mind the reforms of the defunct socialist economies, the process of privatization (the transformation of the state capital), and the rehabilitation of the entire banking system. CRPM estimates that there were more than 50 mergers and acquisitions only in South East Europe (SEE) in the period between 2000 and 2005. The scale of M&A was even more pronounced at the beginning of the transition period because most of the banks were state owned (directly or indirectly-through state owned enterprises). For example, approximately 20 banks were acquired only in Serbia (in the period between 2001 and 2005). Since the transformation of the state capital is over, this trend will continue in the future but definitely at a slower pace. The following figure describes the bank ownership for several countries from SEE.

At the first glance it seems that the consolidation process of the Macedonian banking system is in its initial phase. The number of banks in Macedonia is far grater when compared to the market size (see also figure 3 for complete comparison). Furthermore, there are huge differences regarding the bank ownership across CEE. Namely, when foreign portfolio investments are excluded then the foreign ownership in Macedonia is approximately around 50%, which is the lowest in CEE.[9] Just for illustration, the share of foreign ownership in 2005 was roughly 70% in Serbia[10] and Montenegro, reaching an impressive 92% and 95% in Croatia and Romania.

[8] The estimated cost savings only for Poland were approximately € 600 million.
[9] CRPM data base on banks in SEE.
[10] The foreign ownership will further increase due to the ongoing process of privatization of remained state owned banks.

Figure 1
Bank ownership (SEE, as of 31.12.2005)



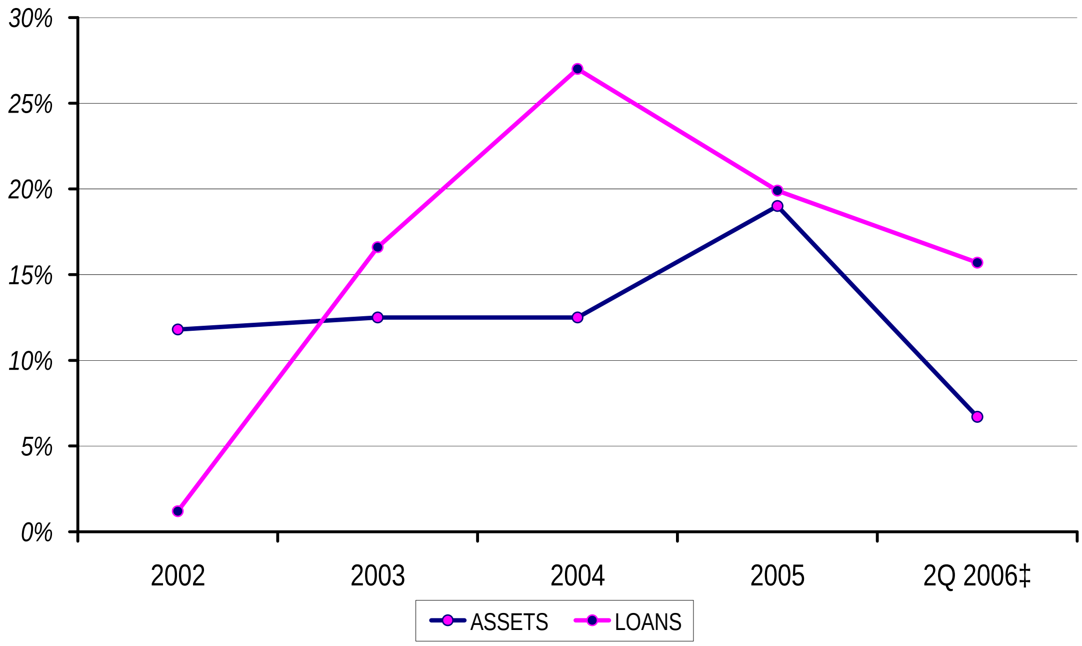
† In Macedonia, foreign owners are essentially from Slovenia, Bulgaria and Greece
‡ Not available-same five banks which are in process of liquidation and under provisional administration from Banking Agency of the Federation BiH
†† 3 banks are still marked as state owned although the privatization process started (but not finished) during 2005
Source: Bank of Albania, National Bank of the Republic of Macedonia, National Bank of Serbia, Central Bank of Federation BiH, Central bank of Montenegro, Central Bank of Croatia, Bulgarian National Bank and National Bank of Romania

It becomes obvious that the Macedonian banking system failed to attract strategic foreign investments in the banking sector. This partly can be explained by the lack of reforms and the legal framework in this segment of the economy, discouraging foreign investors and prominent foreign-owned banks. Foreign owners currently in Macedonia are essentially from Slovenia, Bulgaria and Greece (Nova Ljubljanska Banka, UniBanka, National Bank of Greece). However, their presence produced only small changes. Namely, as competition has increased only slightly, very few new products and services have been introduced on the market.

III. Macedonian Banking System

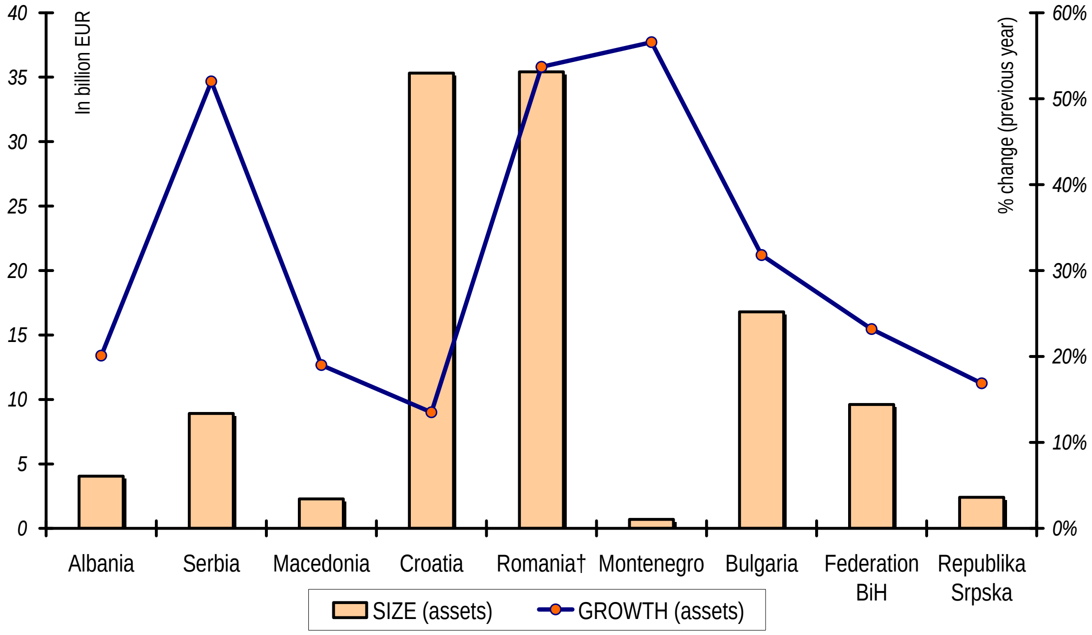
In general, Macedonia is experiencing a trend of permanent increase in banking activities (figure 2). However, there is a big possibility for further expansion in this market segment when compared with other countries from SEE (figure 3). The following figures illustrate this point by showing the size and developments of the market.

Figure 2
Developments in Macedonian Banking Sector



‡ Until the end of first quarter 2006
Source: National Bank of the Republic of Macedonia

Figure 3
Size of the Banking Sector (SEE; as of 31.12.2005)



† The growth of asset size in Romania was additionally increased when expressed in € (EUR) due to appreciation of Romanian LEU
Source: Bank of Albania, National Bank of the Republic of Macedonia, National Bank of Serbia, Central Bank of Federation BiH, Central bank of Montenegro, Central Bank of Croatia, Bulgarian National Bank and National Bank of Romania

Although growth of bank credit to the enterprise sector has been recorded, banks rarely manage to meet enterprise needs in terms of maturity and collateral requirements. Shortage of funds (access to cheap financing), lack of credit skills and unavailability of good lending opportunities are among the many possible factors responsible for low level of bank credit to the private sector.[11] In addition, domestic financial institutions fail to provide the medium and long-term financing for SMEs due to:

- Requirement of collateral - typically from 150% to 300% in hard asset is required as security for a loan
- Lack of adequate policies and procedures on the part of financial institutions dealing with small borrowers

[11] Domestic Credit/GDP is approximately 3 times lower when compared with EU-12 average; *Source:* EBRD.

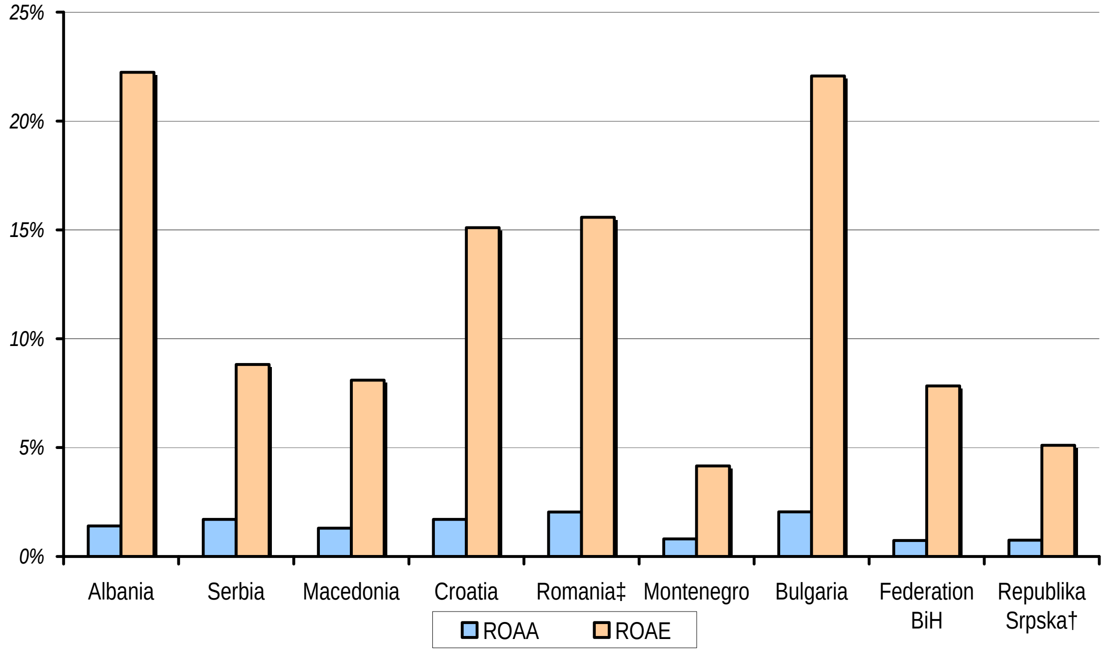
- High level of risk
- Relatively high operational costs, and
- A great number of small enterprises are not officially registered rendering them ineligible for formal credit or equity.

The growth of specialized bank and non-bank institutions specifically targeting micro and SMEs has been a partial response to the lack of credit available to this sector. Various institutions and programs have evolved, such as credit unions and micro and SME lending institutions developed by donors and non-governmental organizations (NGOs). These bank and non-bank financial institutions have often proven to be better suited than commercial banks in serving SME borrowers.[12]

The Macedonian banking system in 2005 experienced a positive trend regarding the profitability (although still lagging behind when compared with some other countries from SEE) reaching on average 1.3% and 8.1% for ROAA (return on average assets) and ROAE (return on average equity) respectively. This was mainly due to the considerable improvement in the profitability of the group of small banks. The main driving force behind this development was the increase in net income together with a better cost efficiency in their operating activities, which is certainly an important aspect for maintaining the stability and security of the entire banking system.[13] The following figure describes the profitability ratios.

[12] They offer a more flexible approach, adequate training of loan officers, etc.
[13] More detailed information is given in: NRMB, *Report on Banking System and Banking Supervision of the Republic of Macedonia in 2005*, May 2006.

Figure 4
Profitability of the banking sector (SEE, as of 31.12.2005)[14]



‡ The profitability ratios for Romania refers to 31.12.2004
† The latest available data for Republika Srpska was 31.12.2004
Source: Bank of Albania, National Bank of the Republic of Macedonia, National Bank of Serbia, Central Bank of Federation BiH, Central bank of Montenegro, Central Bank of Croatia, Bulgarian National Bank and National Bank of Romania

[14] Finally, it is important to see the developments of all indicators presented in this section during 2006. However, at this stage is not feasible due to the fact that official data will be available at the beginning April 2007.

IV. The New Banking Regulation

While the number of banks in the region is experiencing a continuous downward trend the process of consolidation of the Macedonian banking system is basically at an initial stage. Following regional trends it was reasonable to expect an entry of prominent foreign commercial banks on the Macedonian market well before 2006. However, what is somehow unique for Macedonia is that the banking sector remained closed for renowned foreign financial institutions. In certain cases this is not due to a lack of foreign interest, which is apparently present.[15] However, whether certain financial institution will be acquired or not mainly depends on the willingness of the current ownership structure to sell their shares and step down from their privileged positions, which is always very difficult.

It is obvious that banks in Macedonia make extra profit. This is mainly due to the low-inflation environment in which they operate and the (unreasonably) high interest margins charged for their products (regarding the risk and cost of capital). There are serious negative implications on the economy and its growth potential. Consequently, the most important factor concerning the current state of affairs in the Macedonian banking system is the lack of serious foreign competition from strong financial institutions that have practically unlimited access to:

- Cheap financing
- Technical support, and
- Superior management

[15] Some examles are: Postenska banka, Moznosti, Rado Banka, Makedonska Banka, Komercijalna Banka, etc.

The present Macedonian Government is aware of the problem and is committed to resolve this issue. A new bank regulation[16] has been prepared and is expected to become a law in the next few months. This draft policy measure is a very important step to increase the existing confidence in the local banking sector. It is set to improve the legal and regulatory environment, and the field of banking supervision. The new banking legislation sets out the possibility for the foreign financial institutions to open branches on the Macedonian market. Namely, banks from the EU will be able to carry out all activities for which they are licensed in the country of their origin.[17] However, certain conditions have to be fulfilled, such as:

- A minimum capital requirement in the amount of € 5 million
- An obligation for preparing financial statements and periodical reports for the National Bank of Macedonia for the purpose of monitoring 'bank' liquidity and its operating activities
- Preparing and publishing financial reports on annual basis
- Adopting minimum standards for prevention of money laundering.

In addition, all deposits collected from the Macedonian public will be included in a compulsory bank insurance system according to the existing rules and regulation from the country of origin.[18] This might create favorable conditions for attracting larger amount of deposits simply because better protection system against the possible losses might be offered by the branches in comparison with the Macedonian banks. The following table describes bank insurance systems for several European countries.

[16] Available at the web page of the Ministry of Finance: (*http://www.finance.gov.mk/zakoni/predlozi/predlog_zakon_za_bankite.pdf*)
[17] Banks from third countries can also open branches under similar rules and conditions that are applied for institutions originating from EU, conditional on reciprocity agreement.
[18] This refers only to branches opened by financial institutions from EU. Branches from third countries have to act in accordance with the rules and regulations applied for Macedonian banks.

Table 1
Compulsory bank insurance system

Country	*Deposit coverage*
Belgium	Fully up to € 11,820.00
France	Fully up to € 57,310.00
Germany	Up to 30% of bank equity
Italy	Fully up to € 130,290.00 and 75% of next € 521,170.00
The Netherlands	Fully up to € 18,600.00
UK	75% of the first € 28,570.00
Switzerland‡	None
Macedonia	Fully up to € 10,000.00, or 90% up to € 20,000.00

‡ Included only for illustration.
Source: Burda, M. and Wyplosz, Ch. Macroeconomics: a European text, second edition, Oxford University Press, 1997

It should be pointed out that according to the current legal regulation full liberalization in this market segment was planned for 1st of January 2008. The intention of the current Macedonian Government and the new legislation is to accelerate (or shorten) this process by removing all administrative barriers and simplifying the procedures for prominent financial institutions to enter the Macedonian market. This should not come as a surprise especially having in mind the situation in our banking system and its weaknesses. The final outcome of this process should result with an increased competition, new banking products and finally, significant reduction of interest rates. In addition, the new banking legislation also prevents from possible entry of ‘undesirable’ (suspicious) capital that might put the entire Macedonian banking system at risk.

According to the new (proposed) legislation, Macedonian banks will operate in compliance with the Basle Committee Core Principles and EU directives concerning the setting of minimum levels of capital adequacy.[19] Further improvements can also be noticed in the mandatory adaptation of

[19] They are designed to protect the banking system from individual bank risk by requiring owners’ capital to be constant fraction of total risky assets.

International Accounting Standards (IAS) by all banks. Additionally, the new banking law will strengthen the central bank enforcement and regulatory power and responsibility of the bank's management bodies.

However, the new legislation is not perfect. There are certain technical issues that can be improved. The proposed concentration of power into a single person – the Governor of the National Bank can be considered as one of the biggest potential problems of the draft legislation. On the one hand, the need for strengthening the banking sector in Macedonia is primary rational for this proposed measure. Indeed, strengthening of the central bank enforcement and regulatory power is essential. However, delegating power to a single person without establishing proper instruments for control might be counterproductive. This might lead to the creation of favorable conditions for corruption and misuse of power in the future. A serious argument against this policy measure is the negative Macedonian experience with the involvement of senior public officials (such as the Governor or Vice-Governor) from the National Bank in alleged 'criminal' activities.[20] The lawmakers should consider if it is more reasonable to delegate such power to another body (for example the Council of National Bank of the Republic of Macedonia) rather than to the Governor itself.

An additional problematic aspect of the draft law is the criteria for deciding who can be a shareholder or 'person having special rights and responsibilities' within the bank. Namely, according to the Article 11, Paragraph 3, Item 4 and 6, a person cannot become bank shareholder if he does not *possess personal integrity* and if he does not *ensure bank stability*. Similarly, according to Article 81, Paragraph 2, Item 5, a person cannot have 'special rights and responsibilities' within the bank on the same grounds.

[20] This topic received huge media coverage in Macedonia. Following list of articles (retrieved from the World Wide Web) are discussing this issue:
http://www.a1.com.mk/vesti/default.asp?VestID=28331
http://www.vest.com.mk/default.asp?id=72609&idg=4&idb=1066&rubrika=Crna+Hronika
http://www.utrinskivesnik.com.mk/?ItemID=D24B56F97CAF7E4CB55197EF5781764A
http://www.dnevnik.com.mk/?itemID=43B1B417A16BFE4EAA865A31EE21CF07&arc=1

The main problem arises due to the definition presented in Article 2, Item 29. Namely, a person having 'integrity' is described as: honest, competent, and *industrious* (hard working), that possess skills that ensure banks stability and reputation. However, the decision about who fulfils such personal characteristics is left to the discretion of the Governor and thus prone to subjectivity. In addition it is difficult to measure personal characteristics and especially the trait of '*being industrious*'.

V. Concluding Remarks

At this moment, the failure of the Macedonian financial system to respond to the demand for finance by the local private sector appears to be a significant problem for economic growth. With the capital market being underdeveloped, the burden of intermediation of savings for financing private enterprise sector development is fully on the "shoulders of the banking system", which still largely is in the need of significant reforms. Furthermore, the resulting degree of financial intermediation is much lower when compared with that in Western economies.

The Macedonian Government shows an increased awareness and commitment to resolve this issue through the new (proposed) bank regulation, which is expected to become enforceable in the next few months. It is a very important step forward concerning the liberalization of this market segment (by removing all administrative barriers and simplifying the entry procedures for prominent financial institutions on Macedonian market), the improvement in the legal and regulatory environment, and banking supervision. Reforms in all these areas can be considered as crucial to increase the efficiency and existing confidence in the local banking sector. As the new regulation is still under discussion decisive conclusions can be given only when the final version of the Law will be adopted. Despite some shortcomings the proposed reforms can be considered as significant step forward in improving the Macedonian banking system.