BOSNIA AND HERZEGOVINA
FEDERATION OF BOSNIA AND HERZEGOVINA
BANKING AGENCY OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

I N F O R M A T I O N

ON BANKING SYSTEM
OF THE FEDERATION OF BOSNIA AND HERZEGOVINA
AS OF SEPTEMBER 30, 2005

Sarajevo, November 2005

Banking Agency of the Federation of BiH, as a regulatory authority performing bank supervision, prepared Information on banking system of the Federation of BiH (as of June 30, 2005) based on reports of banks, and other information and data submitted by banks. We also included findings and data resulting from on-site examinations and analysis performed in the Agency (off-site financial analysis).

I. INTRODUCTION

Through the three quarters of 2005, the banking sector in the Federation of BiH continued with positive trends from previous periods in all performance segments, which is an additional factor to further stabilization and strengthening of the banking system. In 2005, number of banks remained the same (24 banks), however, banks continued expanding their business network, introducing new products and offering new services, improving quality and efficiency of their performance.

General characteristics of financial performance of banks in 2005 are the following: moderate growth financed by new deposits and credit sources, significant growth of citizen savings as a confirmation of citizens' trust in banks and their safety and stability, good liquidity based on satisfactory maturity adjustment between financial assets and liabilities, and other favorable indicators of banks' exposure to liquidity risk, as well as improved profitability measured through both quantitative and qualitative indicators.

At the banking system level as of 09/30/2005, balance sheet total amounted to KM 8.75 billion, which is higher by 15% or 1.1 billion than at the end of 2004. This has been financed from the two most significant balance sheet aggregates: deposits (increased by 15% or 819 million KM) and borrowings (increase rate of 20% or 173 million KM). Savings recorded significant growth of 20.5% or 437 million KM and amounted to KM 2.56 billion as of 09/30/2005. There should be emphasis on a continued growth of long term saving deposits, which amounted to one billion KM or 39.6% of total savings.

Liquidity of the banking system, along with increase of cash funds of 13% or 374 million KM, amounting to KM 3.2 billion, participation of 37% and trend of further improvement in maturity adjustment among assets and liabilities items, is rated satisfactory.

At the end of September 2005, loan portfolio of banks amounted to KM 5.2 billion, with participation in the assets of 60%. In comparison to 2004, there has been an increase of 18% or 784 million KM. In the observed period, loans to citizens increased by 21% or 445 million KM, and they amounted to KM 2.6 billion or 49.6% of total loans as of 09/30/2005, and increase rate of loans placed to private enterprises was 18% or 349 million KM, so at the end of September they amounted to 2.3 billion KM or 43.9% of total loans.

Although both capitalization rate (12.6%) and capital adequacy rate (17.6%) are somewhat lower than at the end of 2004, capital strengthening of banks continues, especially of the largest ones in the system, which is important for safety and stability of the entire banking sector. At the same time, banks have been strengthening their core and additional capital; core capital increased by KM 76.7 million, and additional capital increased by KM 19.1 million.

Profitability at the system level has been significantly improved in comparison to the same period last year. Reported profit was KM 61.6 million, which is higher by 47% than at the same period in 2004, out of which 18 banks reported profit of 68.1 million, while six banks reported loss of 6.6 million KM. At the system level, ROAA (return on average assets) was 1.01%, and ROAE (return on average equity) was 10.63%, which is better in comparison to the last year, and is closer to the international practice standards. Improved quality, structure and quantity of total income, increase of loan risk and related loan loss provisioning, trend of decrease in interest rates, along with interest margin, increase of long term loans and increase of their participation in total loans, as well as increase of interest expenses, are all the key determinants of profitability and financial results of our banks.

In the segment of ownership structure and market share of banks, there is still a dominant role of banks in foreign ownership with 83.4%, and there is an obvious asset concentration in four largest banks, participating with market share of 68.4%, and there is a group of remaining 20 banks with market share of 31.6%.

II. BUSINESS PERFORMANCE OF BANKS IN THE FBiH

1. STRUCTURE OF BANKING SECTOR

1.1. Status, number and business network

As of 09/30/2005, there were 24 banks[1] with the banking license issued in the Federation of BiH. Number of banks remained the same as of 12/31/2004.

Provisional administrator was initiated in five banks as of 06/30/2005 (UNA bank d.d Bihać, Hercegovačka bank d.d. Mostar, Ljubljanska bank d.d. Sarajevo, Poštanska bank BiH d.d. Sarajevo and Privredna bank d.d. Sarajevo).

In the first nine months of 2005, banks tried to further expand their organizational network. Banks from the Federation of BiH have founded 31 new organizational units, out of which four in Republic of Srpska. In comparison to 12/31/2004, at the time when banks constituted of 439 organizational units, this represents an increase of 7.1%.

As of 09/30/2005, 11 banks from the Federation of BiH had 25 organizational units in Republic of Srpska and 11 in Brčko District. Number of organizational units of banks from Republic of Srpska in the Federation of BiH increased in comparison to 12/31/2004, that is, three banks from Republic of Srpska had 13 organizational units in the Federation of BiH.

License to perform inter-bank transactions in the internal payment system was granted to all banks as of 09/30/2005. There were 15 banks with deposit insurance.

1.2. Ownership structure

As of 09/30/2005, ownership structure in banks[2] was rated upon available information and insight in banks[3], as follows:

- Private and predominately privately owned 18 banks (75%)
- State and predominately state owned 6 banks (25%).

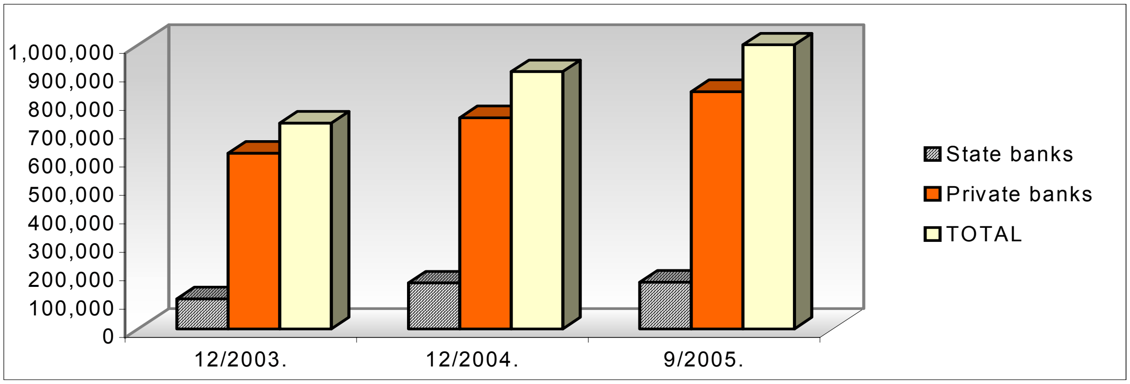
Ownership structure can also be observed from the aspect of financial indicators, which is, by the value of total capital[4].

Table 1: *Ownership structure by total capital* -in 000 KM-

BANKS	31.12.2003.		31.12.2004.[5]		30.09.2005.		RATIO	
							3/2	4/3
1	2		3		4		5	6
State banks	106,105	15%	161,915	18%	164,615	16%	153	102
Private banks	607,430	85%	743,495	82%	835,031	84%	123	112
TOTAL	713,535	100%	905,410	100%	999,646	100%	127	110

[1] Starting form 09/30/04, financial indicators include information from Hercegovačka Bank d.d. Mostar (in period from April 2001 when Provisional Administrator was instituted in Hercegovačka Bank until 09/30/04 information for the whole banking system did not include the data from this bank).
[2] Criteria for dividing banks by type of ownership are the ownership of shareholder capital in banks.
[3] General overview of ownership structure of banks in the F BiH as of 06/30/05 resulted from received reports, and registration in authorized courts (changes in capital and bank shareholders).
[4] Information from balance sheet - FBA schedule: share capital, value over the issue shares, undistributed profit and reserves and other capital (financial results from the current period).
[5] All data in the Information related to 12-31-2004 come from the audited financial statements of banks (audit performed by external auditor).

Graph 1: *Ownership structure review (total capital)*



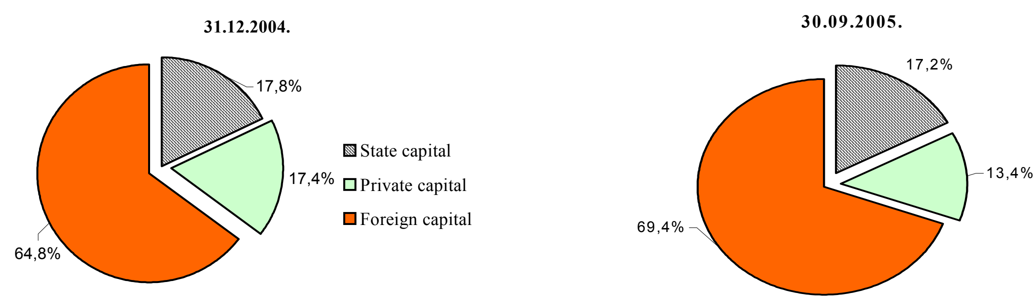
Analysis of participation of state, private and foreign capital in share capital of banks gives a more detailed picture of the capital ownership structure in banks of the Federation of BiH.

Table 2: *Ownership structure by participation of state, private and foreign capital*

- in 000 KM-

SHARE CAPITAL	31.12.2003.		31.12.2004.		30.09.2005.		RATIO	
	Amount	Particp. %	Amount	Particp. %	Amount	Particp. %	5/3	7/5
1	3	4	5	6	7	8	9	10
State capital	75,636	12.6	135,350	17.8	135,350	17.2	179	100
Private capital (residents)	115,411	19.2	132,785	17.4	105,153	13.4	115	79
Foreign capital (nonresidents)	408,882	68.2	493,227	64.8	545,531	69.4	121	111
TOTAL	599,929	100.0	761,362	100.0	786,034	100.0	127	103

Graph 2: *Ownership structure (share capital)*



Analysis of the ownership structure of banks, from the aspect of shareholder capital, most explicitly shows the changes and trends in the banking system of the FBiH, especially in the segment of ownership structure changes.

As of 09/30/2005, proportion of state capital in total share capital was 17.2 % and it was less by 0.6% in comparison to 12/31/2005. Proportion of the remaining state capital in private banks is below 1%, that is, it amounts to KM 1.2 million.

Participation of private capital (residents) in total capital of the banking sector decreased in comparison to 12/31/2005 from 17.4% to 13.4%, and participation of foreign capital increased from 64.8% to 69.4%. Participation growth of foreign capital of 4.6% is based upon the following: two banks in foreign ownership performed additional capitalization of KM 28 million, ownership structure changes (foreign banking group acquired one bank with majority domestic private ownership), and sale of the residents' shares (in five banks) to foreign buyers (non-residents) in total amount of approximately KM 9 million.

Changes in the ownership structure reflected to the participation, that is, market share and positioning of banks grouped according to the criteria of majority ownership to shareholder capital. However, market share of banks with majority foreign ownership increased by 4.1%, and, as of 09/30/2005, it was 83.4%. Market share of banks with majority domestic private capital was 12%, and there was a continued trend of further decrease in the share of state banks, which was only 4.6%.

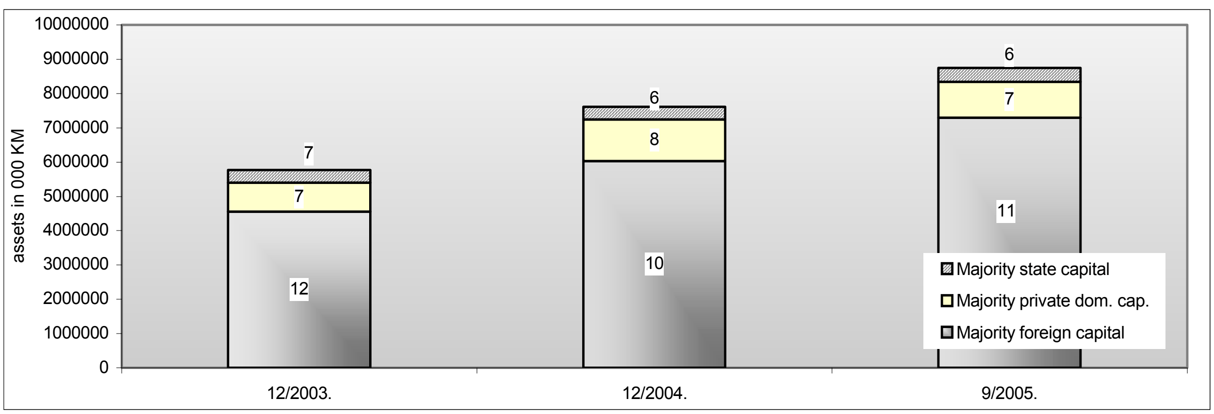
Integration processes in the earlier period were also in the function of stronger market positioning, which resulted in concentration in the banking sector through larger banks becoming even larger, decreased number of banks, and stronger competition. More significant changes will happen in future period, as a result of the on-going activities related to the changes in ownership structure with two banks.

Table 3: *Market share of banks by ownership type*[6]

- in %-

BANKS	31.12.2003.			31.12.2004.			30.09.2005.		
	No. of banks	Partcp. in total capital	Partcp. in total assets	No. of banks	Partcp. in total capital	Partcp. in total assets	No. of banks	Partcp. in total capital	Partcp. in total assets
1	2	2	3	7	5	6	10	8	9
Banks with majority state capital	7	14.9	6.4	6	17.9	4.9	6	16.5	4.6
Banks with majority private domestic capital	7	19.7	14.7	8	16.9	15.8	7	12.9	12.0
Banks with majority foreign capital	12	65.4	78.9	10	65.2	79.3	11	70.6	83.4
TOTAL	26	100.0	100.0	24	100.0	100.0	24	100.0	100.0

Graph 3: *Market share of banks by ownership type*



6 According to majority capital (participation over 50%).

1.3. Staff

As of 09/30/2005, there were total 5,915 employees in banks of the Federation BiH. Out of total number, 8% worked in banks with predominantly state capital and 92% in privately owned banks.

Table 4: *Employees in banks of the FBiH*

BANKS	NUMBER OF EMPLOYEES						RATIO	
	31.12.2003.		31.12.2004.		30.09.2005.		3:2	4:3
1	2		3		4		5	6
State banks	549	10%	490	9%	475	8%	89	97
Private banks	4,845	90%	5,197	91%	5,440	92%	107	105
TOTAL	5,394	100%	5,687	100%	5,915	100%	105	104
Number of banks	26		24		24			

In nine months of 2005, number of employees increased by 4% or 228 employees, which refers only to private banks.

Table 5: *Educational structure of employees*

LEVEL OF EDUCATION	NUMBER OF EMPLOYEES			RATIO	
	31.12.2003.	31.12.2004.	30.09.2005.	3:2	4:3
1	2	3	4	5	6
Graduate Degree	1,847	2,016	2,124	109	105
Under Graduate Degree	546	596	626	109	105
High School	2,825	2,962	3,059	105	103
Other	176	113	106	64	94
TOTAL	5,394	5,687	5,915	105	104

In 2005, banks continued their policy of hiring people with graduate degree and under-graduate degree, which did not significantly reflect to the changes in the educational structure, because the highest participation of 52% is still of the employees with high school education.

One of the indicators influencing rating of the performance of individual banks and the banking system is efficiency of employees, shown as ratio between assets and number of employees, that is, amount of assets per an employee. The higher ratio, the better efficiency of performance of both a bank and the system as a whole.

Table 6: *Assets per an employee*

BANKS	31.12.2003.			31.12.2004.			30.09.2005.		
	No. of empl.	Assets (000 KM)	Assets per emp.	No. of empl.	Assets (000 KM)	Assets per emp.	No. of empl.	Assets (000 KM)	Assets per emp.
State	549	369,974	674	490	373,064	766	475	403,701	850
Private	4,845	5,402,076	1,115	5,197	7,240,166	1,393	5,440	8,342,555	1,534
TOTAL	5,394	5,772,050	1,070	5,687	7,613,230	1,339	5,915	8,746,256	1,479

At the end of September 2005, for individual employee there was approximately KM 1.48 million of assets for the whole banking system. The indicator was much better in the private bank sector, which was expected, since operations in state owned banks were stagnating or decreasing with exceeding number of employees.

Table 7: *Assets per an employee by groups*

Assets (000 KM)	31.12.2003.	31.12.2004.	30.09.2005.
	Number of banks	Number of banks	Number of banks
Up to 500	9	7	7
500 to 1.000	5	5	5
1.000 to 1.500	8	4	3
1.500 to 2.000	3	7	5
Over 2.000	1	1	4
TOTAL	26	24	24

Analytical indicators for individual banks range from KM 161 thousand to KM 2.8 million of assets per an employee. Ten banks reported better indicator than the whole banking sector, and four largest banks in the system reported over KM 1.9 million. Finally, we can say that the conditions under which banks service their customers have been improved, both for legal entities and individuals, as well as the conditions under which banks make placements to their customers.

2. FINANCIAL INDICATORS OF THE PERFORMANCE OF BANKS

Examination of banks through analysis of banks' reports is conducted by review of reports regulated by FBA and reports of other institutions. Those reports represent a database based on three sources:

1. Information on balance sheet for all banks submitted monthly, including quarterly attachments to balance sheet containing more detailed information on cash funds, loans, deposits and off-balance sheet items, and some general statistical information,
2. Information on solvency of banks, information on capital and capital adequacy, asset classification, concentrations of various types of risk, liquidity position, exposure to foreign exchange risk, and based on the reports regulated by FBA (quarterly) and
3. Information on operating results of banks (income statement - FBA format) and reports on cash flows, submitted to FBA quarterly.

Aside from the mentioned standardized reports, the database includes information derived from additional reports requested by FBA in order to have the best quality monitoring and analysis of banks' operations in the Federation of BiH. Also, the database includes reports on audit of financial statements prepared by independent auditor, and all other information relevant to the assessment of operational results for banks individually and banking system as a whole.

As it is regulated by the Law on Opening Balance Sheet of Banks, banks with predominantly state capital have to report to FBA based on "a full" balance sheet, which would be divided into: passive, neutral and active sub-balance sheet. In order to have more realistic indicators of operational indicators of the banks in Federation of BiH, all further analysis of banking system will be based on information from the active sub-balance for banks with predominantly state capital[7].

2.1. Balance sheet

Aggregated balance sheet totals of the banks in the Federation of BiH, according to the balance sheet submitted as of 09/30/2005, were KM 8.75 billion, higher by 15% or KM 1.1 billion than as of 12/31/2004. Although, in comparison to the same period last year, the increase rate was 23%, we can say that a moderate and stable trend of growth of the banking system should continue.

[7] Some state owned banks reported passive and neutral items in their "full" balance sheet, which will be taken over by the state upon the finalization of privatization process.

Table 8: *Balance Sheet*

DESCRIPTION	AMOUNT (in 000 KM)			RATIO	
	31.12.2003.	31.12.2004.	30.09.2005.	3/2	4/3
1	2	3	4	5	6
ASSETS:					
Cash assets	2,059,285	2,859,489	3,232,966	139	113
Securities	25,017	19,430	25,001	78	129
Placements to other banks	36,369	81,624	91,667	224	112
Loans – net value	3,238,270	4,184,579	4,951,442	129	118
Premises and other fixed assets	304,680	299,189	286,431	98	96
Other assets	108,429	168,919	158,749	156	94
TOTAL ASSETS	**5,772,050**	**7,613,230**	**8,746,256**	**132**	**115**
LIABILITIES:					
PAYABLES					
Deposits	4,292,709	5,602,238	6,421,394	131	115
Borrowings from other banks	3,779	3,329	3,369	88	101
Loan payables	589,012	850,833	1,024,295	144	120
Other liabilities	173,015	251,420	297,552	145	118
CAPITAL					
Capital	713,535	905,410	999,646	127	110
TOTAL LIABILITIES (PAYABLES AND CAPITAL)	**5,772,050**	**7,613,230**	**8,746,256**	**132**	**115**

In the observed period of 2005, most of banks experienced increase of their assets by 8% or 31 million KM, while privately owned banks had the increase rate of 15% or 1,102 million KM.

Although most of banks had a moderate increase of assets, with the rates in range from 5% to 20%, yet six banks had the growth rate higher than 20%. Four banks (all in provisional administration) experienced a small decrease of assets. Since the four largest banks had a growth rate from 11.4% to 36.3%, they make 72% or KM 812 million of the total balance sheet growth of the banking sector.

If the banking system is analyzed from the aspect of asset size and certain groups within that, we can determine minor changes in the participation and number of banks within the individual groups.

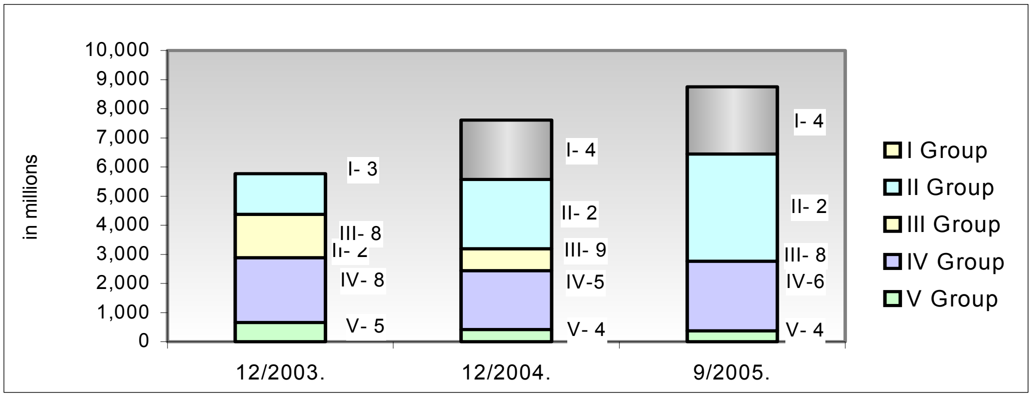
The following table shows a preview of amounts and participations of individual groups of banks[8] within the total assets through periods (amounts are presented in millions of KM):

Table 9: *Participation of individual groups of banks in total assets through periods*

ASSETS VALUE	31.12.2003.			31.12.2004.			30.09.2005.		
	Amount	Particp %	No. of banks	Amount	Particp %	No. of banks	Amount	Particp %	No. of banks
I- Over 2000	0	0.0	0	2,043	26.9	1	2,297	26.3	1
II- 1000 to 2000	1,395	24.2	1	2,382	31.3	2	3,681	42.1	3
III- 500 to 1000	1,487	25.8	2	741	9.7	1	0	0.0	0
IV- 100 to 500	2,238	38.7	10	2,036	26.7	11	2,388	27.3	12
V- Below 100	652	11.3	13	411	5.4	9	380	4.3	8
TOTAL	5,772	100.0	26	7,613	100.0	24	8,746	100.0	24

[8] Banks are divided into five groups, depending on their asset size.

Graph 4: *Participation of individual groups of banks in total assets*



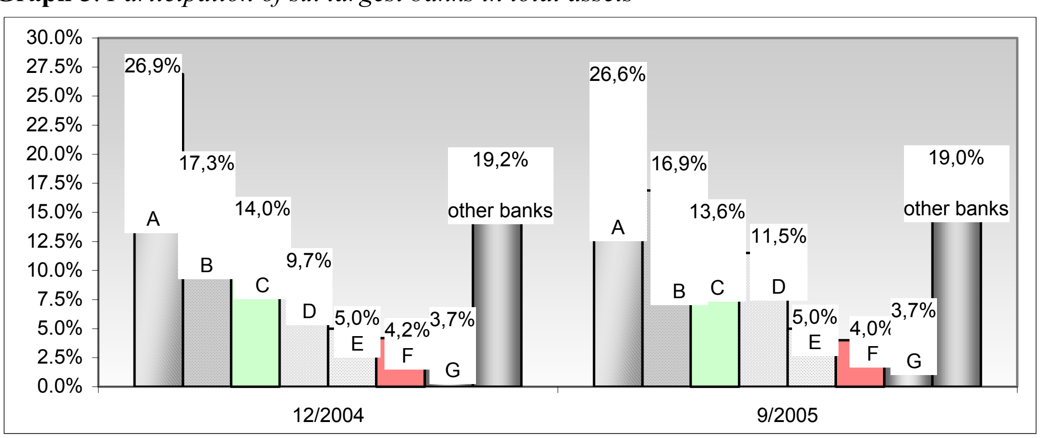
As a result of a continuous growth of the largest banks in the system, one bank from the group III was shift to group II, so, as of 09/30/2005, three banks had assets between one and two billion KM, and one bank over two billion KM. This is a result of an increased participation of the four largest banks in the system in comparison to the end 2004 by only 0.5%, although there had been some changes in participation within this group, which was an outcome of a stronger competition and fight for market share between the banks of «The Big 4».

Most of banks (12 from group IV) have assets in range from 100 to 500 million KM with market share of 27.7%, which represents an increase of 0.6% in comparison to the end of 2004, resulting from the shift of one bank from group V to group IV. The last group, group V (eight banks) has the smallest market share of only 4.3%, and it includes four banks with assets between 10 and 33 million KM.

Based on the mentioned, we can conclude, as for market positioning, that there was some sort of stagnation and reaching the level of the planned market shares for most of the banks in the system. Further increase of participation should be expected based on new integration processes (mergers), both of banks from the Federation of BiH (two banks with the same owner has already began integration process that should be finalized by the end of first quarter of 2006), and banks in both entities of BiH that have the same owner (mainly owned by foreign financial institutions), which will probably happen next year.

The following graph shows participation structure and trend of the seven largest banks[9] in the banking system of the Federation of BiH:

Graph 5: *Participation of six largest banks in total assets*



[9] Banks are marked with letters from A to G.

Growth of the balance sheet total is a result of deposit growth (by 15% or KM 819 million), borrowings (by 20% or KM 173 million), subordinated debts (by 35% or KM 30 million) and capital (by 10% or KM 95 million).

On the assets side of banks, loans[10] increased by 18% or KM 784 million, which is less by four percent than the rate in the same period last year. Cash funds increased by 13% or KM 374 million.

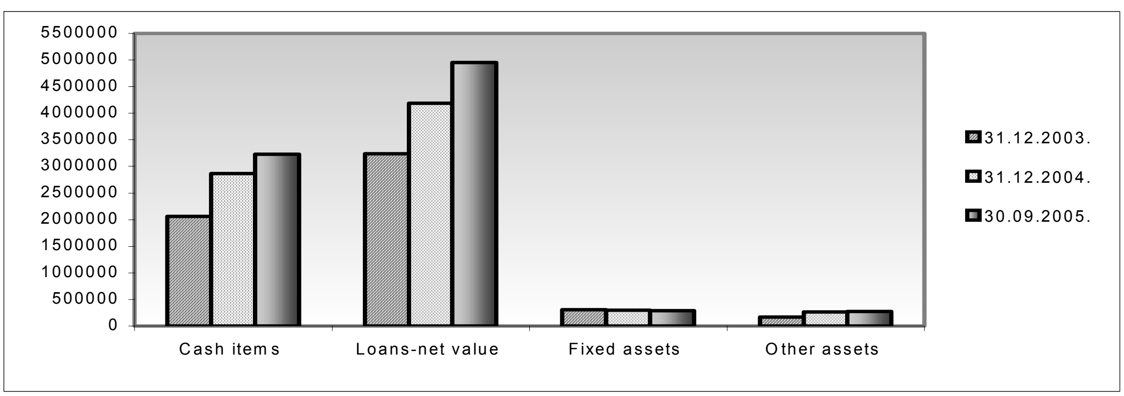
The following table and graphs show the structure of the most significant positions in the balance sheet assets and liabilities of banks through periods:

Table 10: *Balance sheet structure of banks*

- in % -

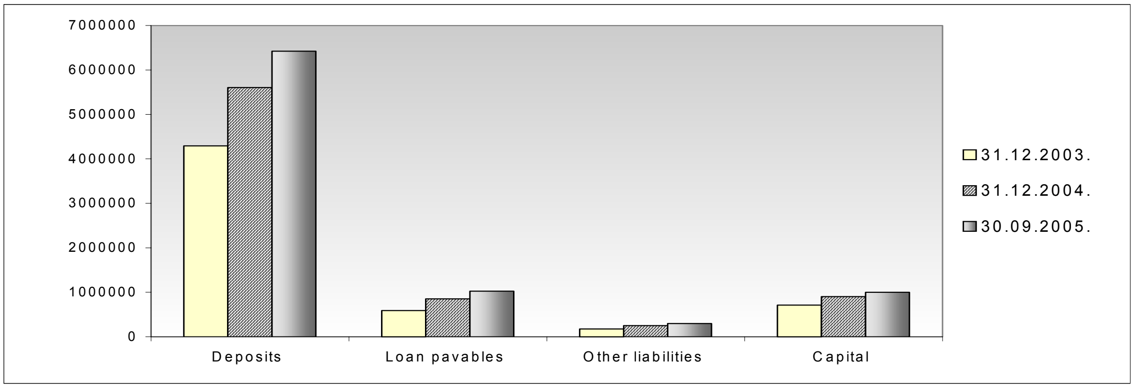
DESCRIPTION	PARTICIPATION		
	31.12.2003.	**31.12.2004.**	**30.09.2005.**
ASSETS:			
Cash assets	35.7	37.6	37.0
Securities	0.4	0.2	0.3
Placements to other banks	0.6	1.1	1.0
Loans – net value	56.1	55.0	56.6
Premises and other fixed assets	5.3	3.9	3.3
Other assets	1.9	2.2	1.8
TOTAL ASSETS	100.0	100.0	100.0
LIABILITIES:			
PAYABLES			
Deposits	74.4	73.6	73.4
Borrowings from other banks	0.1	0.1	0.1
Loan payables	10.2	11,2	11.7
Other liabilities	2.9	3.2	3.4
CAPITAL			
Capital	12.4	11.9	11.4
TOTAL LIABILITIES (PAYABLES AND CAPITAL)	100.0	100.0	100.0

Graph 6: *Structure of balance sheet assets of banks*



10 Gross loans (data from balance sheet)

Graph 7: *Structure of balance sheet liabilities of banks*



On the liabilities side of banks, from the aspect of participation of the most significant balance sheet categories in sources, the trend from earlier periods has continued. Participation of deposits is still slowly decreasing, but with the rate of 72.3% it is still dominant. In 2005, there has been a significant increase of liabilities for borrowings, which resulted in increase of their participation from 11.2% to 11.7%. Participation of capital has decreased by 0.5%

There have been some changes in the asset structure. Although deposits had significant growth in the three quarters of 2005, which resulted in increase of cash funds, still relative participation of cash funds decreased by 0.6%. Loans, with the increase rate of 18%, have reached thus far the highest participation in assets of 56.6%, which is higher by 1.6% than at the end of 2004.

As of 09/30/2005, banks in the Federation of BiH maintained on their accounts with depository institutions abroad the amount of KM 1.61 billion (most of it in EUR) or 49.9% of their total cash funds, which is higher by 0.5% or KM 196 million than at the end of 2004. On the reserve accounts with the Central Bank of BIH there was total of KM 1.38 billion or 42.8% of cash funds, which is higher by 1.6% than at the end of 2004. Banks held 6.7% or KM 218 million of their cash in vaults and tellers.

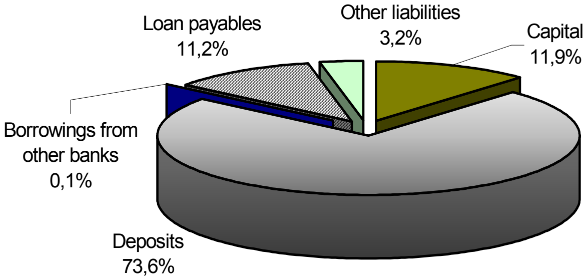
In the third quarter of 2005, changes in financial sources through significant growth of deposit funds in domestic currency, followed by further trend of growth in credit placements, as well as existing regulation on bank exposure to foreign exchange risk and limitations related to net open foreign currency position, have all stopped the existing trend of growth in participation of cash items in foreign currencies. All the mentioned have resulted in the changes in the currency structure of cash items, and decrease in participation of funds in foreign currencies from 54% to 52.5%, that is, increase of participation of funds in domestic currency from 46% to 47.5%.

2. 1. 1. Liabilities

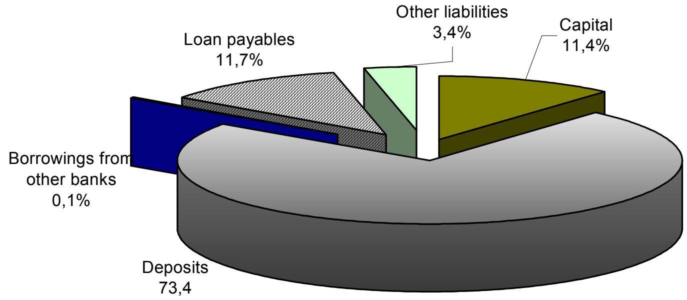
Structure of liabilities (payables and capital) in the balance sheet of banks as of 09/30/2005 is presented in the following graph:

Graph 8: *Liabilities Structure of Banks*

31.12.2004.



30.09.2005.



Trend of changes in the structure of liabilities from the earlier period continued in the three quarters of 2005. Participation of deposits decreased by 0.2% and amounted to 73.4%. At the same time, further growth of liabilities for borrowings resulted in increase of their participation from 11.2% to 11.7%, while participation of capital decreased by 0.5% and it was 11.4%.

In 2005, banks continued borrowing abroad. Four major creditors, with 56% out of total borrowings were: Raiffeisen Zentralbank Osterreich A.G. (RZB), European Bank for Reconstruction and Development (EBRD), Bank Polska OPIEKI, and Kreditanstalt fur Wiederaufbau (KfW).

In the reporting period, deposits increased by 15% or KM 819 million, and, just in the third quarter, deposit increased by KM 454 million. As in the previous periods, the increase almost entirely relates to private bank sector.

Based on information reported by banks, out of total deposits, 3.9% were deposits accepted in the organizational units of banks from the Federation of BiH operating in Republic Srpska and Brcko District as of 09/30/2005.

There were some smaller changes in maturity structure of deposits within the two basic groups divided by their maturity. Increase in demand deposits of 15% resulted in increase of their participation from 47.5% to 47.8%. Viewed on the system level, the highest participation of 36.5% is by demand deposits from citizens. In short-term deposits, deposits with term over three months increased by 36%, which resulted in increase of their participation by 1.6%, with the highest participation of citizen deposits (48.7%) within this group.

Although long-term deposits increased by 11%, their participation decreased by 1.3%. It should be emphasized that citizen deposits make 60.2% of term deposits up to three years, and funds of banking institutions sector participate with 67.1% with term deposits over three years.

Table 11: *Maturity structure of deposits*

- in 000 KM-

DEPOSITS	31.12.2003.		31.12.2004.		30.09.2005.		RATIO	
	Amount	Partp %	Amount	Partp %	Amount	Partp %	4/2	6/4
1	2	3	4	5	6	7	8	9
Savings and demand deposits	2,215,925	51.6	2,663,053	47.5	3,066,632	47.8	120	115
Up to 3 months	303,203	7.1	389,395	7.0	408,053	6.3	128	105
Up to 1 year	447,952	10.4	490,685	8.8	666,541	10.4	110	136
1. Total short-term deposits	2,967,080	69.1	3,543,133	63.3	4,141,226	64.5	119	117
Up to 3 years	715,648	16.7	1,367,882	24.4	1,494,924	23.3	191	109
Over 3 years	609,981	14.2	691,223	12.3	785,244	12.2	113	114
2. Total long-term deposits	1,325,629	30.9	2,059,105	36.7	2,280,168	35.5	155	111
TOTAL (1 + 2)	4,292,709	100.0	5,602,238	100.0	6,421,394	100.0	131	115

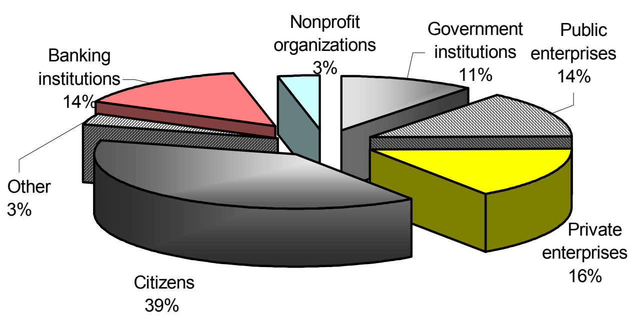
Table 12: *Deposit structure by sectors*[11]

- in 000 KM-

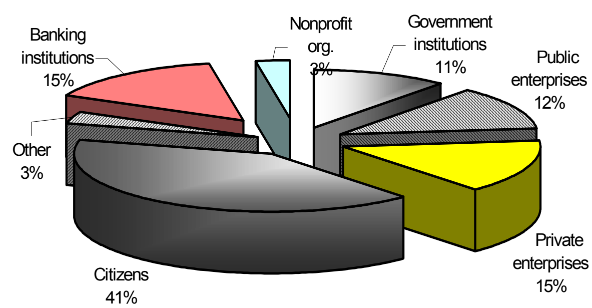
SECTORS	31.12.2003.		31.12.2004.		30.09.2005.		RATIO	
	Amount	Partp %	Amount	Partp %	Amount	Partp %	4/2	6/4
1	2	3	4	5	6	7	8	9
Governmental institutions	498,132	11.6	599,060	10.7	710,719	11.1	120	119
Public enterprises	567,677	13.2	783,655	14.0	777,019	12.1	138	99
Private enterprises and associations	607,046	14.1	876,831	15.7	975,919	15.2	145	111
Non-profit organizations	147,606	3.5	180,705	3.2	170,941	2.7	122	95
Banking institutions	557,166	13.0	808,112	14.4	961,152	15.0	145	119
Citizens	1,737,238	40.5	2,173,228	38.8	2,609,397	40.6	125	120
Other	177,844	4.1	180,647	3.2	216,247	3.3	102	120
TOTAL	4,292,709	100.0	5,602,238	100.0	6,421,394	100.0	131	115

Graph 9: *Deposit structure by sectors*

31.12.2004.



30.09.2005.



Analyzed by sectors, within the observed period of time, there was increase of citizen deposits of 20% or KM 436 million, along with increase of the participation by 1.8%. Deposits of banking institutions increased by 19% or KM 153 million, which represents an increase in their participation by 0.6 index points, while the same rate of growth was recorded with the deposits of government institutions with their nominal increase of KM 112 million. After a slight growth in the first six months of 2005, deposits of private enterprises significantly increased in the third quarter, so the overall rate of growth within the observed period of time was 11% or KM 99 million. Deposits of public enterprises and non-profit organizations decreased both nominally and relatively in the course of their participation in total deposits.

Out of total deposits, 42% or KM 2,675 million were in domestic currency, and 58% or KM 3,746 million were in foreign currencies.

Saving deposits, as the most significant segment of deposit and financial potential of banks, continued maintaining moderate and stable growth in 2005. Within the observed period of time, savings increased by KM 437 million or 20.5%. Only two banks had minor decrease of saving deposits, and other banks recorded increase of saving deposits. In eight banks, growth rate was below 20%; in ten banks between 20% and 50%; and in three banks the rate was higher 50%. However, out of total growth of saving deposits, 70% or KM 308 million refers to the four largest banks in the system.

Viewed by sectors, almost all savings are held with private banks, that is, only 1.1%, out of total savings, is held on the accounts of five state banks.

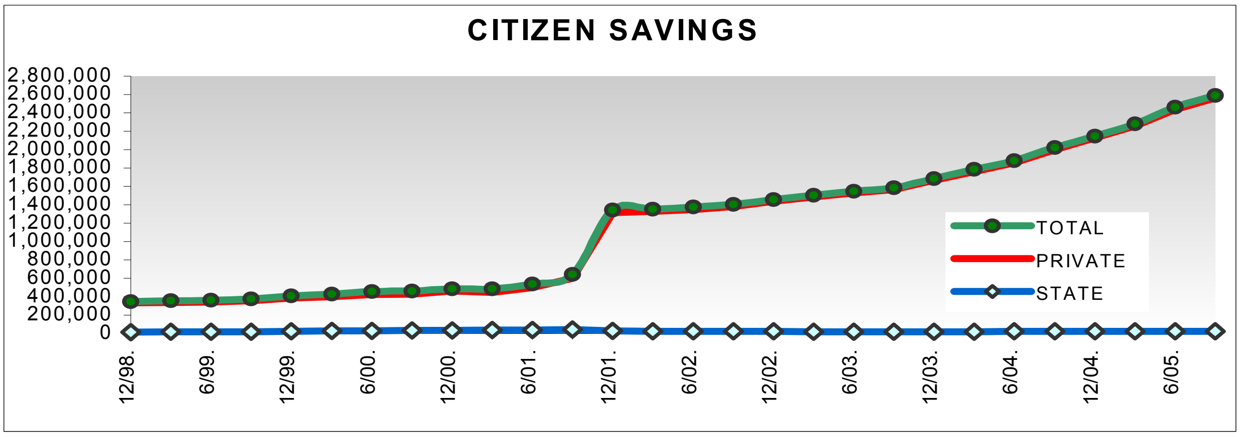
[11] Data from supporting form BS-D submitted by banks quarterly attached to balance sheet in FBA format.

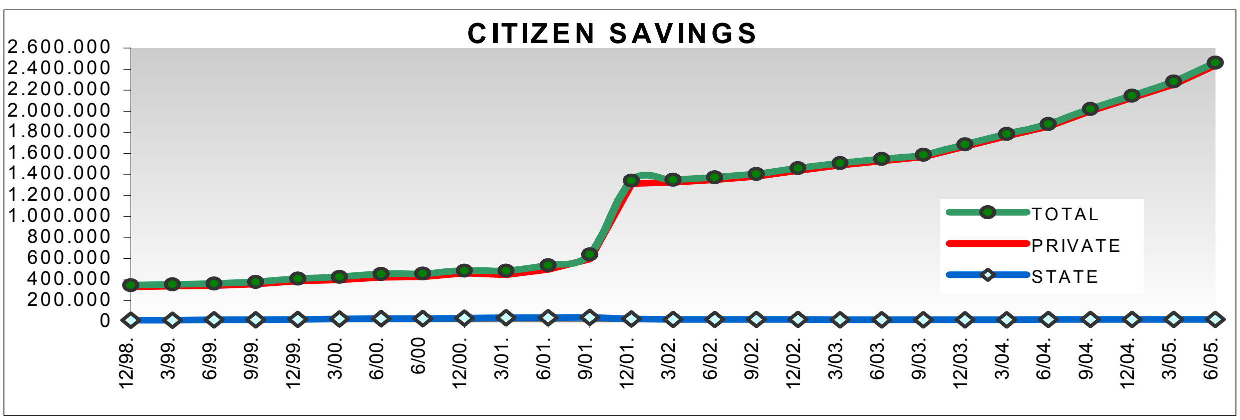
Table 13: *New citizen savings by periods*

- in 000 KM-

BANKS	AMOUNT (in 000 KM)			RATIO	
	31.12.2003.	31.12.2004.	30.09.2005.	3/2	4/3
1	3	3	4	5	6
State	20,758	22,342	25,881	108	116
Private	1,645,991	2,105,167	2,538,347	128	121
TOTAL	1,666,749	2,127,509	2,564,228	128	120

Graph 10: *New citizen savings by periods*





As in other segments, there is an obvious existence of a strong concentration of savings in larger banks, because 76% of total savings is held with four largest banks.

Out of total amount of savings, 28.6% relates to saving deposits in domestic currency, and 71.4% in foreign currency.

Table 14: *Maturity structure of citizen savings by periods*

BANKS	AMOUNT (in 000 KM)						RATIO	
	31.12.2003.		31.12.2004.		30.09.2005.		3/2	4/3
1	3		3		4		5	6
Short-term saving deposits	1,228,261	73.7%	1,360,285	63.9%	1,547,896	60.4%	111	114
Long-term saving deposits	438,489	26.3%	767,224	36.1%	1,016,332	39.6%	175	132
TOTAL	1,666,749	100.0%	2,127,509	100.0%	2,437,613	100.0%	128	120

Maturity structure of saving deposits, as well as of total deposits, has a positive trend of changes, mainly due to a constant improvement of the condition of the banking sector and strengthening of confidence in banks, which resulted in faster growth of long-term saving deposits. Special emphasis should be given to stability and high level of growth rates in long-term saving deposits, which is a positive indicator for future time.

Aside from the activities implemented by FBA, growth of savings in banks of the FBiH resulted from deposit insurance system, which was implemented in January 2001, immediately after the inception of the Deposit Insurance Agency of F BiH. The Law on Deposit Insurance in Banks of BiH was passed in August 2002 and shortly after that the Deposit Insurance Agency of BiH was founded. Total of 15 banks from the Federation of BiH became part of the deposit insurance program and received certificates on deposit insurance. Analytical data showed that participation of deposits in those banks, out of total deposits, was 94% of total deposits and 97% of total savings. The admission of banks in the deposit insurance system for the Federation of BiH is entering the closing phase, because within nine remaining banks, which don’t have certificates, six are state banks and they cannot apply for certificate (they do not have appropriate ownership structure), because of regulations set up by the Deposit Insurance Agency. Safety of deposits is guaranty and incentive for further growth of savings, not only in those banks, but all other banks.

2.1.2. Capital – Strength and Adequacy

Capital[12] of banks in the FBiH, as of 09/30/2005, amounted to KM 1,133 million.

Table 15: *Regulatory capital* -in 000 KM-

DESCRIPTION	31.12.2003.		31.12.2004.		30.09.2005.		RATIO	
							3/2	4/3
1	2		3		4		5	6
STATE BANKS								
1.Core capital before deduction	122,937		163,061		163,875		133	100
2. Off-setting items	17,687		2,607		3,212		15	123
a) Core capital (1-2)	105,250	97%	160,454	98%	160,663	98%	152	100
b) Additional capital	3,061	3%	3,639	2%	3,846	2%	119	106
c) Total capital (a + b)	108,311	100%	164,093	100%	164,509	100%	152	100
PRIVATE BANKS								
1. Core capital before deduction	584,221		744,519		814,393		127	109
2. Of-setting items	34,311		88,598		82,010		258	93
a) Core capital (1-2)	549,910	75%	655,921	75%	732,383	76%	119	112
b) Additional Capital	183,681	25%	217,639	25%	236,538	24%	118	109
c) Total capital (a + b)	733,591	100%	873,560	100%	968,921	100%	119	111
Total								
1. Core capital before deduction	707,158		907,580		978,268		128	108
2. Off-setting items	51,998		91,205		85,222		175	93
a) Core capital (1-2)	655,160	78%	816,375	79%	893,046	79%	125	109
b) Additional Capital	186,742	22%	221,278	21%	240,384	21%	118	109
c) Capital (a + b)	841,902	100%	1,037,653	100%	1,133,430	100%	123	109

In the first three quarters of 2005, capital[13] was increased by 9% or KM 95.8 million in comparison to the end of 2004, out of which the increase of core capital was KM 76.7 million, and the increase of additional capital was KM 19.1 million.

Increase of core capital was primarily influenced by additional capitalization, that is, an increase of shareholder capital in two banks by KM 28.3 million, along with decrease in the amount of KM 3.4 million in one bank based on coverage of losses from previous years, then allocation of profit for 2004 to retained undistributed profit of KM 16.6 million and reserves of KM 20.1 million, as well as paid in surplus over paid value of shares in one bank per new issue of shares in the amount of KM 9.3 million.

[12] Regulatory capital defined under Articles 8 and 9 of Decision on Minimum Standards for Bank Capital Management.

[13] Data source is quarterly Report on Bank Capital Balance (Form 1-Table A), regulated by the Decision on Minimum Standards for Bank Capital Management.

Offsetting items (which decreased core capital) were decreased by KM 6 million, and the most important changes were the following: coverage of uncovered losses from previous years by KM 13.3 million KM (in four banks), current losses of KM 6.6 million, and increase of intangible assets by KM 0.9 million.

Increase of additional capital by KM 19.1 million is primarily result of increase in subordinated debts of KM 29.6 million in two banks, including audited current profit in one banks of KM 14 million and increase of general reserves of loan losses of KM 17.6 million, along with decrease of KM 42 million due to distribution of profit from 2004 to core capital.

The mentioned changes did not influence the structure of regulatory capital, so participation of core capital is still 79%, and additional is 21%.

Growth of regulatory capital of 9% positively influenced net capital, which in first nine months of 2005 had the same growth rate of 9% or KM 96 million, so, as of 09/30/2005, it amounted to KM 1.1 billion.

Capitalization rate of banks, observed as ratio of capital and assets, still has a moderate trend of downfall, and, as of 09/30/2005, it was 12.6%, which is lower by 0.6% in comparison to 2004, the main reason being that increase of capital has not been adequately followed by increase of assets.

One of the most important indicators of strength and adequacy of capital[14] in banks is capital adequacy ratio calculated as relationship between net capital and risk-weighted assets. As of 09/30/2005, calculated on the level of banking sector, this ratio was 17.6%, which is less by 1% than at the end of 2004.

Decrease of the ration on the system level is a result of downfall of the ratio in state banks from 59.1% (2004) to 53.8%, and a continuous slight downfall of the ratio in private banks from 16.5% (2004) to 15.7%.

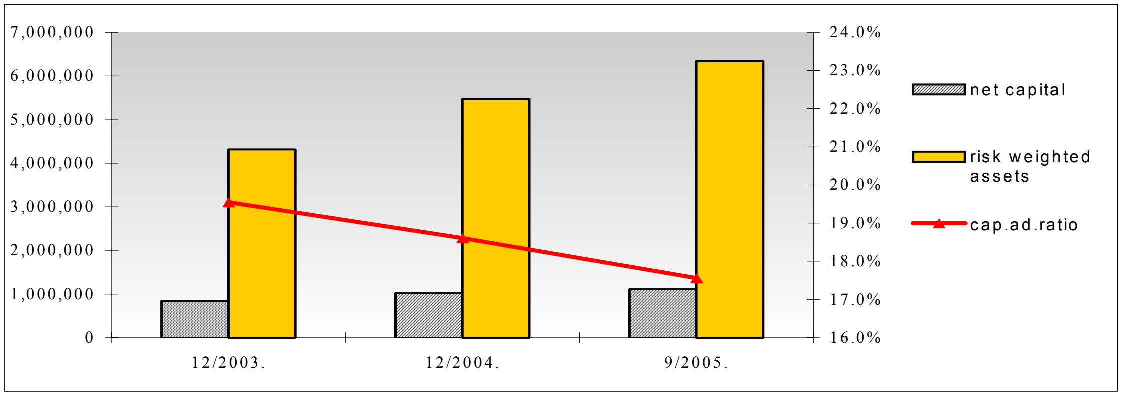
While performing supervision of performance and financial condition of banks in the F BiH, according to the authority prescribed by the Law and in order to strengthen safety of both banks individually and the system as a whole, FBA has been ordering banks to take proper actions for strengthening of capital base and providing for adequate capital up to the level and profile of existing and potential exposures to all risks immanent to any banking activity.

Table 16: *Net capital, risk-weighted assets, and capital adequacy rate*

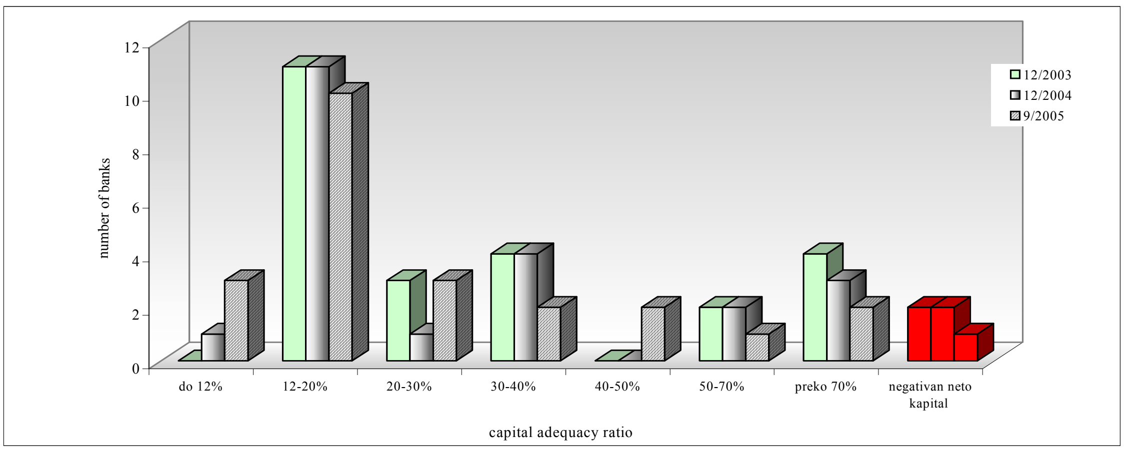
DESCRIPTION	31.12.2003.	31.12.2004.	30.09.2005.	RATIO	
				3/2	4/3
1	2	3	4	5	6
NET CAPITAL	840,605	1,018,626	1,114,403	121	109
RISK WEIGHTED ASSETS AND CREDIT EQUIVALENTS	4,306,774	5,472,154	6,344,494	127	116
NET CAPITAL RATE (CAPITAL ADEQUACY)	19.5%	18.6%	17.6%	95	95

[14] Minimum capital adequacy rate of 12% prescribed by the Law.

Graph 11: Net capital, risk weighted assets, and capital adequacy rate



Graph 12: *Capital adequacy ratios in banks*



As of 09/30/2005, out of 24 banks in the FBiH, 20 banks had capital adequacy ratio higher than the minimum of 12% prescribed by the Law, three banks under provisional administration had capital adequacy ratio below 12%, and one bank (under provisional administration) had a negative adequacy ratio.

Majority of banks have shown a continuous moderate trend of downfall of the capital adequacy ratio, although number of banks by groups within given ranges have not significantly changed. There are ten banks in the second, the largest group (ratio between 12% and 20%), while in the next group the number increased from one to three banks (ratio between 20% and 30%). Earlier change was a result of downfall in the capital adequacy ratio below 30% in two banks, so as of 09/30/2005 only two banks remained in the group with the ratio in range from 30% to 40%. With the remaining five banks, the ratio was over 40%, but the highest capital adequacy ratio was 77.4%. However, although four banks largest by the size of assets had the capital adequacy ratio slightly higher than minimum prescribed by the Law (between 13.3% and 14.4%), we should emphasize that two banks performed additional capitalization in order to strengthen their capital base and capital adequacy, and one bank increased its additional capital through subordinated debt.

Any further growth of risk assets and especially growth of loan placements will necessarily require adequate growth of capital, and, in that sense, banks are obliged to prepare program for capital management and continuously monitor its implementation in order to assure and maintain capital quantities and qualities at least on the level of minimum standards prescribed by the Law.

Further strengthening of capital base should represent a priority task for most of banks, focusing on the largest banks in the system, which is necessary to strengthen stability and safety of banks and entire banking system. FBA will take proper measures and issue decisions based on which banks will strengthen their capital base, which will guarantee their stability and safety.

2.1.3. Assets and asset quality

Decision on Minimum Standards for Bank Loan Risk Management and Asset Classification (Decision) determines the criteria for assessing bank's exposure to loan risk by rating their asset quality and adequacy of reserves for loan and other losses, depending on risk of placements and balance sheet assets items and off-balance sheet items.

As of 09/30/2005, gross assets[15] from the balance sheet of banks in the FBiH amounted to KM 9 billion, which is by 15% or KM 1.1 billion higher than at the end of 2004. Off-balance sheet risk items amounted to KM 1,3 billion and have been increased by 23% or KM 236 million.

Total assets with off-balance sheet items (assets)[16] amounted to KM 10.3 billion and are higher by 16% than at the end of 2004.

Table 17: *Assets, off-balance sheet items, and potential loan losses*

-in 000 KM-

DESCRIPTION	AMOUNT (in 000 KM)						RATIO	
	31.12.2003.	Struc. %	31.12.2004.	Struc. %	30.09.2005.	Struc. %	4:2	6:4
1.	2	3	4	5	6	7	8	9
Loans	3.272.569	54,5	4.208.295	53,5	4.965.016	55,0	129	118
Interests	26.395	0,4	29.856	0,4	34.573	0,4	113	116
Past due receivables	171.821	2,9	209.218	2,7	236.833	2,6	122	113
Receivables on paid guarantees	5.353	0,1	5.026	0,1	4.802	0,1	94	96
Other placements	50.906	0,9	40.811	0,4	30.697	0,3	80	75
Other assets	2.468.073	41,2	3.378.320	42,9	3.748.771	41,6	137	111
TOTAL ASSETS	5.995.117	100,0	7.871.526	100,0	9.020.692	100,0	131	115
OFF BALANCE SHEET	749.382		1.046.809		1.282.697		140	123
BALANCE SHEET AND OFF BALANCE SHEET	6.744.499		8.918.335		10.303.389		132	116
General credit risk and potential loan losses	247.369		282.412		306.847		114	109
Allocated general and special reserves for loan losses	247.411		285.090		307.120		115	108

Out of total assets with off-balance sheet items, non-risk items represent KM 3.6 billion or 34.6%, which is by 0.8% less than at the end of 2004.

Growth of loan placements (18%) resulted in changes of the structure of risk assets and increase of participation of loan placements from 58.1% to 59.5%, along with decrease in participation of cash funds from 37.6% to 37%. It should be emphasized that past-due receivables increased by 13%, while their participation in the asset structure remained on almost the same level as in 2004.

Analytical indicators by banks show that five banks (three under provisional administration) had decrease in their loan placements. Majority of banks (12) had growth rate of loan placements between 7% and 20%, while three banks showed a significant growth with the rate higher than 30%. Four largest banks in the F BiH increased their loan placements by KM 609 million, which is 78% of total increase on the level of banking sector, which is reflected through the increase in participation of those banks in total loans from 69% to 70%.

Based on the analysis of loan structure by sectors, we can conclude that most of the increase of KM 445 million or 21% was in placements originated to citizens, which is why their participation in total loan structure by sectors increased from 48.4% to 49.6%. There was significant growth of KM 349

[15] Data source: Report on classification of balance sheet assets and off-balance sheet items of banks.
[16] Assets defined under Article 2 of Decision on Minimum Standards for Bank Loan Risk Management and Asset Classification.

million or 18% in placements originated to private enterprises and associations, along with increase of participation from 43.7% to 43.8 %. Other sectors show minor changes both in nominal and relative amount.

Change in participation of individual sectors in total loan structure is presented in the following table:

Table 18: *Loan structure by sectors*

-in 000 KM-

SECTORS	31.12.2003.		31.12.2004.		30.09.2005.		RATIO	
	Amount	Partp. %	Amount	Partp. %	Amount	Partp. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Government institutions	24.526	0,7	31.810	0,7	32.100	0,6	130	101
Public enterprises	217.587	6,3	203.698	4,6	177.101	3,4	94	87
Private enterprises and assoc.	1.439.009	41,7	1.933.595	43,7	2.282.757	43.9	134	118
Nonprofit organizations	3.015	0,1	3.619	0,1	7.310	0,1	120	202
Banking institutions	33.281	1,0	34.082	0,8	37.252	0,7	102	109
Citizens	1.676.325	48,6	2.139.699	48,4	2.584.436	49,6	128	121
Other	55.999	1,6	76.036	1,7	85.695	1,7	136	113
TOTAL	3.449.742	100,0	4.422.539	100,0	5.206.651	100,0	128	118

As for maturity of loans, we should emphasize that, in the first three quarters of 2005, there was faster growth of long-term loans (growth rate of 20%), while short-term loans increased by 10%, which influenced growth of participation of long-term loans in total loans from 72.8% to 74.4%. Analysis by sectors shows that participation of long-term loans in total loans originated to citizens is 90%, and to private enterprises 60%.

Table 19: *Maturity structure of loans*

-in 000 KM-

LOANS	31.12.2003.		31.12.2004.		30.09.2005.		RATIO	
	Amount	Partp. %	Amount	Partp. %	Amount	Partp. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Pastdue receivables and paid off-balance sheet liabilities	177,174	5.1	214,244	4.8	241,635	4.6	121	113
Short-term loans	776,014	22.5	991,183	22.4	1,091,103	21.0	128	110
Long-term loans	2,496,554	72.4	3,217,112	72.8	3,873,913	74.4	129	120
TOTAL LOANS	3,449,742	100.0	4,422,539	100.0	5,206,651	100.0	128	118

Since the placements, that is, loans represent part of the assets holding most of risk, their quality is one of the most significant determinations of stability and success of their performance. Asset quality rating is actually rating of exposure of bank's placement to loan risk, that is, identification of potential loan losses that are recognized as provisions for loan losses.

Asset quality and off-balance sheet risk items, general loan risk, potential loan losses by classification categories[17] and off-balance sheet items are presented in the following table:

[17] In accordance to Article 22 of Decision on Minimum Standards for Loan Risk Management and Asset Classification, banks are obliged to establish and continiously maintain reserves for GCR and SLL in following percentiges by categories: A 2%, B 5% do 15%, C 16% do 40%, D 41% do 60% and E 100%.

Table 20: *Classification of Assets, General Credit Risk (GCR), and Potential Loan Losses (PLL) and Off-Balance Sheet Items (assets charged off and suspended interest)*

Classification category	AMOUNT (in 000 KM) AND PARTICIPATION (in %)									RATIO	
	31.12.2003.			31.12.2004.			30.09.2005.				
	Asset classif.	Partp. %	GCR PLL	Asset classif.	Partp. %	GCR PLL	Asset classif.	Partp. %	GCR PLL	5/2	8/5
1	2	3	4	5	6	7	8	9	10	11	12
A	5,881,803	87.2	70,974	7,880,830	88.4	94,501	9,161,939	88.9	111,925	134	116
B	563,498	8.4	46,657	730,737	8.2	53,633	825,656	8.0	60,366	130	113
C	152,581	2.3	44,593	143,586	1.6	42,104	150,898	1.5	41,104	94	105
D	139,311	2.0	77,839	162,299	1.8	91,294	164,642	1.6	93,198	117	101
E	7,306	0.1	7,306	883	0.0	880	254	0.0	254	12	29
TOTAL	6,744,499	100.0	247,369	8,918,335	100.0	282,412	10,303,389	100.0	306,847	132	116
OFF-BALANCE SHEET ITEMS											
E	341,166	79.8		343,472	83.3		378,429	86.0		101	110
Susp. interest	86,205	20.2		68,680	16.7		61,349	14.0		80	89
TOTAL	427,371	100.0		412,152	100.0		439,778	100.0		96	107

If we analyze asset quality with off-balance sheet risk items, we will notice increase of classified assets (B-E) by 10% or KM 104 million, along with increase in poor quality assets by 3% or KM nine million. However, based on analysis of analytical data, we can see that poor quality assets related to placements originated to citizens have trend of faster increase (13%), while poor quality assets related to legal entities increased only by 1%, which is to expect, since after loan expansion in 2002 and years later, lending to citizens has been intensified. It is obvious that part of loans from this portfolio in some banks is becoming a problem and goes from the category of good assets to worst classification categories. Poor quality assets related to citizens in total originated loans is 2.6% or KM 68 million, and is experiencing growth of 13% or KM 8 million in comparison to the end of 2004. Although we mention absolute figures relative growth that are not high, taking into account the trend shown, in future we will divert our attention to rating and changes in quality of those loans, as well as activities of banks to minimize adverse effects in this segment of loan portfolio and improve management practices.

In the first nine months of 2005, banks written off from balance sheet to off-balance sheet, that is, charged off receivables of KM 62.3 million and suspended interest of KM 8.2 million. Charged off receivables on loans originated to citizens were KM 14.6 million, and suspended interest was KM 1.8 million. In the same period, banks performed a permanent charge off of assets items of KM 8.9 million, and permanent charge off of suspended interest of KM 3.1 million. In the same period, banks were able to collect previously charged off assets of KM 22.6 million (KM 1.2 million from citizens) and suspended interest of KM 8.4 million (KM 0.4 million from citizens), which was positively reflected on their profitability.

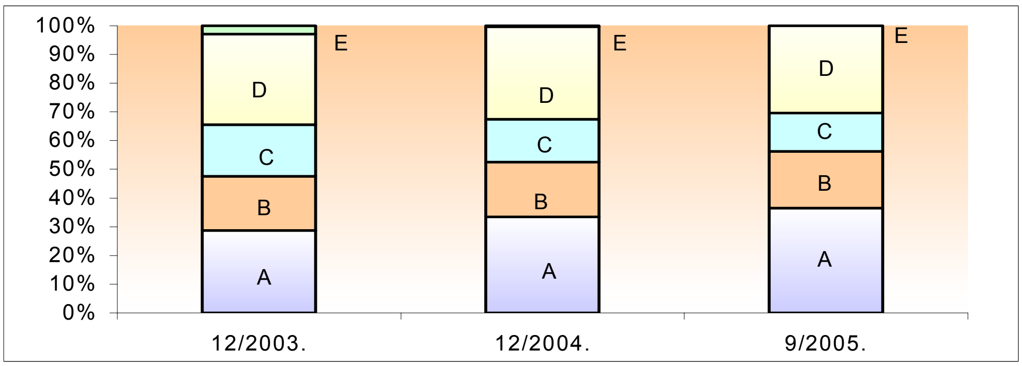
As of 09/30/2005, balance of charged off assets amounted to KM 378 million and it was higher by 10% than at the end of 2004, while balance of suspended interest amounted to KM 61 million. Out of total charged off assets, charged off assets on loans originated to citizens was KM 36 million or 9.6%, and suspended interest was KM 5.5 million or 8.9%.

Level of general loan risk and estimated losses by classification categories, determined in accordance with the criteria and methodology prescribed by the FBA's decisions, their trend and structure on the level of the banking sector is presented in the following table and graph:

Table 21: *Structure and trend of general credit risk and potential loan losses*

Classification category	AMOUNT (in 000 KM) AND STRUCTURE (in %)						RATIO	
	31.12.2003.		31.12.2004.		30.09.2005.		4/2	6/4
1	2	3	4	5	6	7	8	9
A	70,974	28.7	94,501	33.5	111,925	36.5	133	118
B	46,657	18.9	53,633	19.0	60,366	19.7	115	113
C	44,593	18.0	42,104	14.9	41,104	13.4	94	98
D	77,839	31.5	91,294	32.3	93,198	30.4	117	102
E	7,306	2.9	880	0.3	254	0.0	12	29
TOTAL	247,369	100.0	282,412	100.0	306,847	100.0	114	109

Graph 13: *Structure and trend of general credit risk and potential loan losses*



According to the reports, banks established reserves for loan losses in accordance with the regulations and up to the amount of estimated loan risk.

Analyzing the level of established reserves in total and by classification categories, in comparison to 2004, reserves for general loan risk and potential loan losses were higher by 8% and amounted to KM 307 million, that is, 3 % of total assets with off-balance sheet. At the end of third quarter of 2005, banks allocated reserves for category B in average of 7.3%, for category C 27.2%, category D 56.6% and E 100%, which can be rated satisfactory.

Analysis of asset quality, that is, loan portfolio of individual banks, as well as of on-site examinations in banks, indicates that key risk in most of banks is still loan risk, that is, existence of problem loans originated to legal entities (enterprises).

FBA has issued orders to banks with poor quality assets to implement corrective measures in sense of preparation of operating programs containing action plan to improve existing management practices for loan risk, that is, asset quality, decrease existing concentrations, and resolve issue of poor quality assets and prevent further deterioration. Performance of FBA's orders is continuously monitored in follow up procedures based on reports and other records submitted by banks, as well as in on-site examinations.

Transactions with related entities

While operating, banks are exposed to different types of risk, but the most significant is risk related to transactions with related entities.

In accordance with the Basle Principles, FBA has established certain prudential principles and requirements related to transactions with related entities[18], which are regulated by Decision on Minimum Standards for Bank's Operations with Related Entities, regulating conditions and ways of operations with related entities. Based on the Decision and Law on Banks, Supervisory Board of a bank, upon proposal of General Manager, is obliged to adopt special policies regulating operations with related entities and to monitor their implementation.

FBA Decisions determine a special set of reports containing transactions with one part of related entities, including loans and potential and accepted off-balance sheet liabilities (guarantees, letters of credit, accepted loan payables), since those represent the most frequent and the riskiest types of transactions between banks and their related entities. The set of reports includes information on loans approved to the following categories of related entities:

- Shareholders with more than 5% of voting rights,
- Members of Supervisory Board and senior management of bank and
- Subsidiaries and other enterprises related to bank through capital

Table 22: *Transactions with related entities*

-000 KM-

Description	LOANS ORIGINATES			RATIO	
	31.12.2003.	31.12.2004.	30.09.2005.	3/2	4/3
1	2	3	4	5	6
Shareholders with over then 5% of voting shares, subsidiaries and other enterprises related to the bank through capital	37,050	40,084	36,307	108	91
Members of Supervisory Board	388	141	136	36	94
Management and employees of bank	1,670	2,392	2,203	139	92
TOTAL	39,108	42,617	38,646	109	91
POTENTIAL AND ACCEPTED OFF-BALANCE SHEET LIABILITIES	8,689	3,235	1,314	37	41

From the same reasons, FBA directs special attention (during on-site examinations) to banking operations with related entities. FBA examiners issue on-site orders for elimination of found oversights, determine deadlines and initiate legal procedures. Part of those activities is monitoring and follow-up supervision. Such activity has had a positive indication on this segment of the performance, since the scope of transactions with related entities shows a decreasing trend, along with exposure to risk in those entities.

2.2. Profitability

According to the income statements, for first nine months of 2005, banks in the Federation of BiH reported positive financial result – profit of KM 61.6 million, which is higher by 47% than the same period in 2004 or 36% of the reported profit in 2004.

[18] Article 39, item 2 of the Law on Changes and Amendments to the Law on Banks defines term “entities related to bank”, excluding bank´s employees.

Positive financial result was reported by 18 banks of total KM 68.1 million, which is more by 46 % or KM 21.6 million in comparison to same period 2004. At the same time, six banks reported operating loss (three state and three private) of KM 6.6 million, which represents a decrease by 55% or KM 8 million in comparison to same period last year.

More detailed information is presented in the following schedule:

Table 23: *Financial result realized: profit/loss*

-000 KM-

Date/Description	Banking system		Private banks		State banks	
	Amount	No. of banks	Amount	No. of banks	Amount	No. of banks
30.09.2003.						
Loss	-21,172	9	-19,864	6	-1,308	3
Profit	53,332	17	50,584	13	2,748	4
Total	32,160	26	30,720	19	1,440	7
30.09.2004.						
Loss	-14,543	8	-14,016	6	-527	2
Profit	46,492	18	41,764	13	4,728	5
Total	31,949	26	27,748	19	4,201	7
30.09.2005.						
Loss	-6,559	6	-5,716	3	-843	3
Profit	68,127	18	64,569	15	3,558	3
Total	61,568	24	58,853	18	2,715	6

As in other segments, this one is characterized by concentrations: out of total profit, 68% or KM 46.6 million was reported by the four largest banks in the system. Out of total reported loss, two banks reported 81% or KM 5.3 million. Financial result of state banks does not have any significant influence on total profitability of the banking sector.

Individual analytical data from banks, as well as indicators of quality rating lead to conclusion that general profitability of the system has significantly improved due to an overall improving trend and stabilization of the banking sector.

In the structure of total income, net interest income still has growing trend and it participates with 56.5% of total income (it was 53.2% in the same period of 2004), while participation of operating income decreased from 46.8% to 43.5%.

Structure of total income of banks has improved based on qualitative indicators, apart from significant increase of participation of interest expenses from 25.3% to 29.8% in comparison to the same period 2004, through continuous higher participation of net interest income (from 55.5% to 56.7%), while participation of operating income has decreased from 44.5% to 43.3%.

Analysis of increasing trend shows that total interest income with increase rate of 31% in comparison to the same period last year increased faster than the average interest bearing assets of 28% due to faster increase in loan placements in comparison to other interest bearing placements. However, within this segment, increase of interest rates on loans was lower by 2% than the average increase of loans as a result of increase of long term loans in the structure of loan portfolio and continuous but slower decrease of interest rates. On the other side, interest expenses increased by 44% which partially caused slower rate of increase in net interest income of 25% in comparison to the same period last year, since the interest bearing sources in 2005 recorded significant growth, especially average interest bearing deposits with the rate of 26%, and interest bearing liabilities of 30%.

Operating income increased by 19% in comparison to the same period last year, but their participation in the structure of total income decreased by 1.2%, primarily as a result of downfall in fee income, which is the result of changes in accounting policy applied to the segment of methodology and recognition of fee income tied to loans[19] (applied in several banks).

[19] Application of IAS 18-Income and IAS 39-Financial instruments: recognition and measurement.

Positive effect was reached with non-interest bearing expenses of banks whose participation in total income with 90.9% in the same period last year decreased to 85.7% in this year, which caused positive profitability of banks. Operating expenses record downfall of 3.5% (participation of salaries and contributions decreased by 2.3%), and business and direct expenses have downfall of 1.7% (where participation of provisioning for loan losses decreased by 1.4%).

Operating expenses record slower increase with the rate 15% if compared to operating income which increased by 19%, where coverage of operating expenses by operating income increased from 73.5% to 75.8% in comparison to the situation from last year.

Trend and structure of total income and expenses is presented in the following tables and graphs:

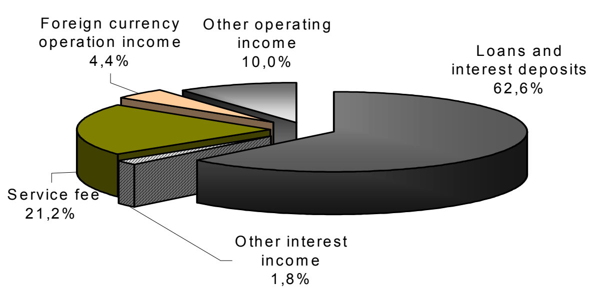
Table 24: *Structure of total income*

- in 000 KM-

Structure of total income	30.09.2003.		30.09.2004.		30.09.2005.		RATIO	
	Amount	%	Amount	%	Amount	%	4/2	6/4
1	2	3	4	5	6	7	8	9
I Interest income and similar types of income								
Interest bearing deposit accounts with depository institutions	18,891	4.7	19,834	4.5	31,107	5.6	105	157
Loans and lease financing	218,029	53.6	256,269	58.1	330,528	59.1	118	129
Other interest income	4,540	1.1	8,097	1.8	10,805	1.9	178	133
TOTAL	241,460	59.4	284,194	64.4	372,440	66.6	118	131
II Operating income								
Service Fees	91,621	22.5	93,291	21.2	113,616	20.3	102	122
Foreign Exchange Income	23,709	5.8	19,508	4.4	22,775	4.1	82	117
Other operating income	49,799	12.3	43,894	10.0	50,065	9.0	88	114
TOTAL	165,129	40.6	156,693	35.6	186,456	33.4	95	119
TOTAL INCOME(I + II)	406,589	100.0	440,887	100.0	558,896	100.0	108	127

Graph 14: *Sructure of total income*

30.09.2004.



30.09.2005.

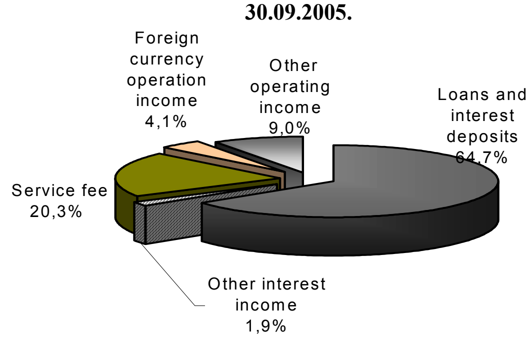


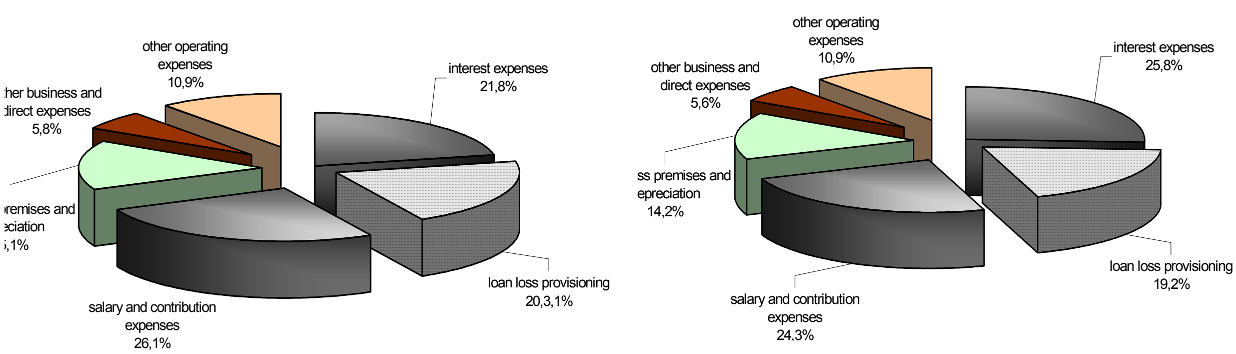
Table 25: *Structure of total expenses*

\- in 000 KM-

Structure of total expenses	30.09.2003.		30.09.2004.		30.09.2005.		RATIO	
	Amount	%	Amount	%	Amount	%	4/2	6/4
1	2	3	4	5	6	7	8	9
I Interest expenses and other similar expenses								
Deposits	56,232	15.0	71,505	17.5	98,862	19.9	127	138
Liabilities for loans and other borrowings	7,874	2.1	15,197	3.7	24,920	5.0	193	164
Other interest income	2,695	0.7	2,380	0.6	4,493	0.9	88	189
TOTAL	66,801	17.8	89,082	21.8	128,275	25.8	133	144
II Total noninterest bearing expenses								
Provisions for general credit risk and potential loan losses	94,678	25.3	83,080	20.3	95,683	19.2	88	115
Salary and contribution expenses	97,184	26.0	106,953	26.1	120,880	24.3	110	113
Business premises and depreciation expenses	54,296	14.5	61,590	15.1	70,744	14.2	113	115
Other business and direct expenses	20,399	5.4	23,659	5.8	27,592	5.6	116	117
Other operating expenses	41,071	11.0	44,574	10.9	54,154	10.9	109	121
TOTAL	307,628	82.2	319,856	78.2	369,053	74.2	104	115
TOTAL EXPENSES (I + II)	374,429	100.0	408,938	100.0	497,328	100.0	109	122

Graph 15: *Structure of total expenses*

30.09.2004. **30.09.2005.**



The following tables present the most significant ratios to rate profitability, productivity and efficiency of banks:

Table 26: *Profitability, Productivity, and Efficiency Ratios by Periods*

\- in %-

KOEFICIJENTI	31.12.2003.	31.12.2004.	30.09.2005.[20]
Return on average assets	0.88	0.69	1.01
Return on average total capital	6.75	5.57	8.64
Return on average share capital	8.16	6.61	10.63
Net interest income/ average assets	4.60	4.08	4.01
Fee income/ average assets	4.27	3.41	3.06
Total income/ average assets	8.88	7.49	7.06
Business and direct expenses[21]/average assets	2.79	2.20	2.02
Operating expenses/ average assets	5.17	4.57	4.03
Total noninterest bearing expenses/ average assets	7.95	6.76	6.05

[20] Ratios as of 09/30/2005 recalculated on annual level.

[21] Expenses include provisioning for potential loan losses.

Table 27: *Profitability, Productivity, and Efficiency Ratios as of 30.09. 2005.*

-in %-

RATIOS	30.09. 2005.		
	STATE BANKS	PRIVATE BANKS	AVERAGE IN FBiH
Return on average assets	0,93	1,01	1,01
Return on average total capital	2,20	9,99	8,64
Return on average share capital	2,53	12,47	10,63
Net interest income/ average assets	3,44	4,03	4,01
Fee income/ average assets	6,54	2,88	3,06
Total income/ average assets	9,97	6,92	7,06
Business and direct expenses/average assets	4,29	1,91	2,02
Operating expenses/ average assets	4,76	4,00	4,03
Total noninterest bearing expenses/ average assets	9,05	5,90	6,05

Analysis of basic rating parameters for profitability quality shows that, apart from other things, the amount of reported profit significantly increased in comparison to the same period last year with ROAA (return on average assets) of 1.01% and ROAE (return on average equity) of 10.63%, although productivity of banks measured with ratio of total income and average assets (7.06%), and reported net interest and operating income per unit of average assets deteriorated, because of further significantly faster growth of average assets against total income (net interest and operating income) and significant participation of non-earning assets or minimum earning assets, which is largely related to significant liquid assets that some banks hold on reserve account with the Central Bank of BiH and on the accounts of foreign banks, which is on other hand good from the aspect of liquidity risk and necessary because of the regulation related to foreign exchange risk exposure.

All key indicators of profitability, analyzed by the criteria of ownership in banks, show that private banks operate in more cost-effective, productive and efficient way, which is an advantage for them in competition with state banks, which indicates a necessity to finalize privatization in remaining state banks.

Profitability of banks in future period will still mostly depend on asset quality, that is, exposure of banks to loan risk, including efficient operating expense management. This means that the key factor of efficiency and profitability for any bank is quality of management and business policy, because that is how one can most directly influence its performances.

III. CONCLUSION

Consolidation and stabilization of banking sector of the Federation of BiH have reached an enviable level and upcoming activities should provide further progress and development of the system. This implies a continuous engagement of all parts of the system, legislative and executive authorities in order to provide for the most favorable environment in economy, which would be stimulating to banks and to the economy.

In other to meet such goals, it is necessary to have further involvement of authorized institutions and bodies in Bosnia and Herzegovina and the Federation of BiH in order to:

- Support and accelerate consolidation and establishment of banking supervision on state level;
- Finalize privatization process of state banks, that is, define resolution of their status;
- Improve environment for banks to operate in the area of whole Bosnia and Herzegovina;
- Continuously build legal regulation for banking system and financial system based on Basle Principles and European Banking Directives;
- Define and build on regulation for financial sector related to the activity and status of microcredit organization, BOR and Investment Bank of the Federation of BiH d.d. Sarajevo, etc.;

- Accelerate implementation of economic reform in the real sector in order to reach the level of monetary and banking sector;
- Accelerate establishment of special court division for economy;
- Establish more efficient process for realization of pledges;
- Pass laws for protection of creditors and more and concrete responsibility of debtors.

In the upcoming period, the Banking Agency of the Federation of BiH shall:

- Proceed with a continues supervision of banks through on-site and off-site examinations;
- Accelerate finalization of remaining provisional administrations and liquidation processes;
- Insist on strengthening of capital in banks, especially those that have recorded growth in assets above average;
- In order to protect depositors, implement special supervision in banks with high concentration of saving and other deposits;
- Work on further development of regulations under authority of the Agency starting from Basle Principles and incorporating European Directives, as part of preparation process for becoming part of European Union;
- Initiate additional education of members in Supervisory Boards of banks;
- Work on continuous education and training of its own staff;
- Maintain continuity in payment system examinations;
- Continue effective monitoring of banks activities for prevention of money laundering and terrorism financing, and improve cooperation with other supervisory and examination institutions;
- Provide effective operation of new informational system for early warning and prevention of weaknesses in banks;
- Improve cooperation with Bankers Association;
- Establish and expand cooperation with home country supervisors of the investors present in the banking sector of the FBiH;
- Take active part in preparation for passing law on banks on state level;
- Organize counseling and provide advising on application of regulations passed by the FBA, etc.

Banks, as the most important part of the system, have to concentrate their actions to:

- Further strengthen capital in correlation with growth of assets and risks;
- Improve asset quality;
- Adopt and implement new business policies and procedures complied with competitive market conditions;
- Strengthen internal control systems and establish internal audits, and provision of their independence;
- Further development of credit/debit card operations and electronic banking, and introduction of other, new products and services;
- Development of procedures for control and improvement of IT;
- Training and staff improvement;
- Maintaining prevention of money laundering and terrorism financing by implementation of adopted policies and procedures;
- Consider potential implications of the Law on Value Added Tax;
- Improve work of Bankers Association;
- Establish unified registry of irregular debtors – legal entities and individuals on the level of the Federation of BiH through Bankers Association, which will provide for data to banks in order to decrease loan risk, etc.