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, 2006

Sarajevo, November 2006

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 September 30, 2006) 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 by the Agency (off-site financial analysis).

I. INTRODUCTION

In three quarters of 2006, the banking sector of the Federation of BiH has maintained positive trends in all performance segments from earlier period, which has contributed to further stabilization and strengthening of the entire system. Banks have continued expanding the network of their organizational units, reaching the number of 497 as of 30. 09. 2006., representing an increase of 17 new organizational units in 2006 (12 in the Federation and 5 in Republic Srpska).

General characteristics of the financial performance of banks for the nine months of 2006 were the following: moderate growth and development financed primarily from deposits and credit funds, decrease in number of banks by one (from 24 to 23 – one bank merged, license revoked and liquidation of state bank under provisional administration and banking license issued to a new bank that started operating in October), increase of share of banks in foreign ownership and concentration of the most significant balance sheet categories (market share, loans, deposits and savings, capital and profit) in four largest banks, followed by satisfactory liquidity measured by general indicators of exposure of banks to this risk, further profit growth, as well as moderate credit growth and relatively good indicators of assets quality on the system level, but with trend of slow downfall.

At the end of third quarter of 2006, the aggregate balance sheet amounted to KM 10,8 billion, which is higher by KM 1,4 billion or 15% if compared to the end of 2005, with four largest banks generating 71% or KM one billion of total increase of the aggregate balance sheet of the banking sector. As for financial potential, the highest increase was recorded in deposits (15% or KM 1,1 billion) and borrowings (15% or KM 178 million), while capital increased by 8% or KM 82 million.

During the observed period, loans increased by 15% or KM 826 million, and cash items increased by 16% or KM 571 million. Observed by sectors, banks primarily financed citizens, so those placements, if compared to the end of 2005, increased by KM 515 million or 18%. Placements to private enterprises had growth of 13% or KM 321 million. As for maturity, long term loans increased by 16% or KM 661 million, while short term loans increased by 12% or KM 135 million.

Structure of the balance sheet categories in assets and liabilities has not changed much, so in sources, deposits still have the highest participation of 73,4%, and in the assets, loans of 56,4%.

Continuous, stable and moderate growth of savings and their increase over the nine months of 2006 of 17% or KM 453 million, reaching the amount of KM 3,1 billion, are the result and confirmation of further strengthening of confidence in the banking system.

Indicators of banks' performance on the system level are good, however, if analyzed by banks, profitability of majority of banks is marginal to satisfactory, and few banks report loss in their performance from one period to another. Profit reported on the system level was KM 73,1 million, which is higher by 19% if compared to the same period last year. Profit of KM 79,9 million was generated by 16 banks, while six banks reported loss in total amount of KM 6,8 million.

Two, the most significant indicators of profitability, ROAA (return on average assets) and ROAE (return on average equity) are better if compared to the same period last year. If calculated on annual level, ROAA was 0,99%, and ROAE was 12,14%.

Changes in the ownership structure have continued in favor of increase in share of foreign capital, reaching 72,3% as of 30. 09. 2006. The same trend is present in regard to market shares and their reallocation, that is, banks with majority foreign capital have the share of 89,7%, with concentration in four largest banks «holding» 69,5% of the entire banking assets.

Capital, capitalization rate and capital adequacy are still one of the key segments of performance both of individual banks and the entire system, focusing on the largest banks that have capital adequacy rate higher than the minimum prescribed by the Law (12%) by minor 0,6% to 1,9%. Although the capital growth with those banks has been supported internally through the profit gained, it is obvious that they need capital strengthening from external sources as well, which is a priority for the future period, not only with the largest banks, but other banks as well, in line with adopted strategic and operating capital plans adjusted to the level and profile of existing and potential risk of individual bank, providing, alongside, for sound, solid and successful performance.

II. BUSINESS PERFORMANCE OF BANKS IN THE FEDERATION OF BIH

1. STRUCTURE OF THE BANKING SECTOR

1.1. Status, number and business network

As of 30. 09. 2006., there were 23 banks with the banking license issued in the Federation of BiH. Number of banks decreased in comparison to 31. 12. 2005.: CBS Bank d.d. Sarajevo was merged to Tuzlanska Bank d.d. Tuzla; banking license was issued to Validus Bank d.d. Sarajevo, and banking license was revoked from Ljubljanska Bank d.d. Sarajevo – portion of assets and liabilities was assumed by Validus Bank, and remaining portion is subject of liquidation process.

As of 30.09.2006., Validus Bank has not yet started operating[1].

As of 30. 09. 2006., there were five banks under provisional administration (UNA bank d.d. Bihać, Hercegovačka bank d.d. Mostar, Poštanska bank BiH d.d. Sarajevo, Privredna bank d.d. Sarajevo and Investicijska bank Federacije BiH Sarajevo).

In the nine months of 2006, banks continued expanding the network of their organizational units. Banks from the Federation founded 17 new organizational units, out of which 12 in the Federation of BiH and five in Republic Srpska. In comparison to 31. 12. 2005., when banks constituted of 480 organizational units, this represents an increase of 3,5%.

As of 30. 09. 2006., 11 banks from the Federation of BiH had 35 organizational units in Republic Srpska and 12 in District Brcko. As of 31.12.2005., number of organizational units of banks from Republic Srpska in the Federation of BiH decreased from 18 to 16, since one bank from Republic Srpska closed its two organizational units in the Federation of BiH.

[1] All indicators for the banking sactor as of 30.09.2006. refer to 22 banks, which have been operating and reporting to the FBA.

The license for inter-bank-transactions in internal payment system was issued to all banks as of 30.09.2006. There were 15 banks with deposit insurance.

1.2. Ownership structure

As of 30.09.2006., ownership structure of banks[2] was assessed based on the available information and on-site visits to banks[3] as it follows:

- Private and majority private ownership 18 banks (78%)
- State and majority state ownership[4] 5 banks (22%)

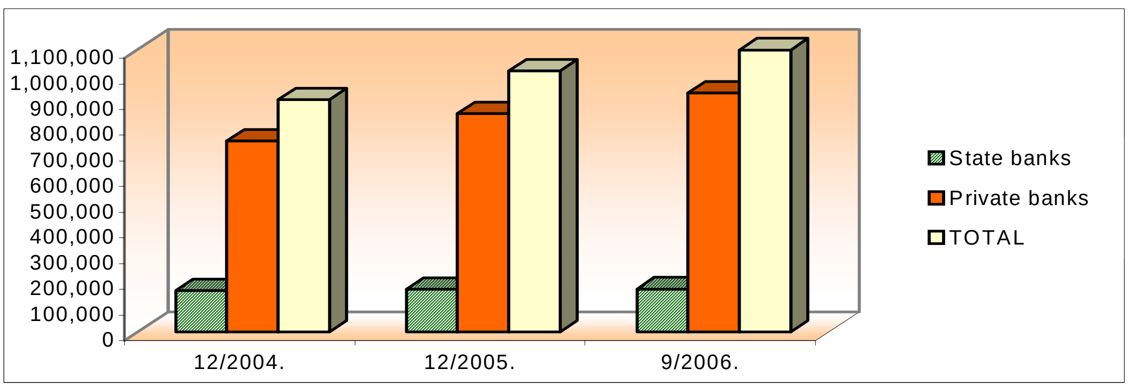
Ownership structure can be observed from the aspect of financial results or by the value of total capital[5].

Table 1: *Ownership structure by total capital*

-in 000 KM-

BANKS	31.12.2004.		31.12.2005. [6]		30.09.2006.		RATIO	
							3/2	4/3
1	2		3		4		5	6
State banks	161.915	18%	166.494	16%	167.922	15%	103	101
Private banks	743.495	82%	850.223	84%	931.217	85%	114	110
TOTAL	905.410	100%	1.016.717	100%	1.099.139	100%	112	108

Graph 1: *Review of ownership structure (total capital)*



More detailed picture on ownership structure of banks in the Federation of BiH can be viewed from the analysis of participation of state, private and foreign capital in share capital of banks.

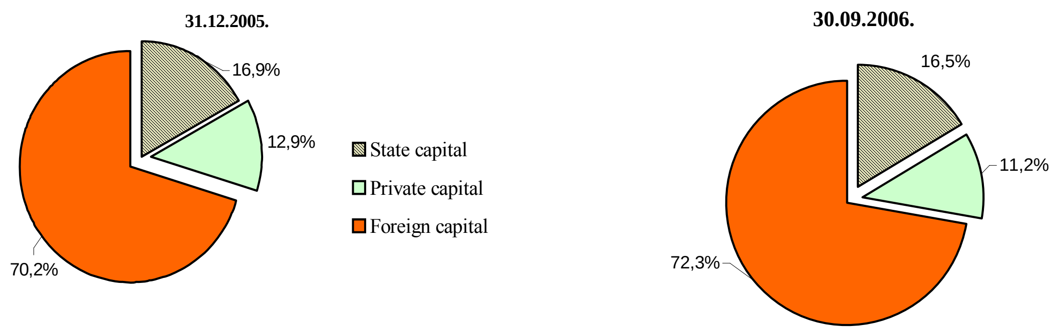
2 Classification criteria of banks by type of ownership is ownership over share capital of banks.
3 General overview of ownership structure of banks in the F BiH as of 30.09.2006. resulted from received documentation, and registrations at authorized courts (changes in capital and shareholders structure).
4 State ownership is defined based on domestic, state capital of BiH.
5 Information from balance sheet - FBA schedule: shareholders capital, premium issue, undistributed profit and reserves, and other capital (financial results of current period).
6 All the data presented in the Information referring to 31.12.2005. come from the audited financial statements of banks (audit performed by external auditor).

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

- in 000 KM-

SHARE CAPITAL	31.12.2004.		31.12.2005.		30.09.2006.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	5/3	7/5
1	3	4	5	6	7	8	9	10
State capital	135.350	17,8	135.344	16,9	135.019	16,5	100	100
Private capital (residents)	132.785	17,4	103.026	12,9	92.372	11,2	78	90
Foreign capital (nonresidents)	493.227	64,8	561.117	70,2	594.665	72,3	114	106
TOTAL	761.362	100,0	799.487	100,0	822.056	100,0	105	103

Graph 2: *Ownership structure (share capital)*



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

As of 30.09.2006., participation of state capital in total share capital of banks was 16,5%, which is less by 0,4% in comparison to 31.12.2005.

If compared to 31.12.2005., participation of private capital (residents) in total share capital of the banking sector decreased from 12,9% to 11,2%, and participation of foreign capital increased from 70,2% to 72,3%. Increase in the participation of foreign capital of 2,1% is a result of the following: additional capitalization of KM 30 million in two banks (of foreign ownership), sale of residents' shares (in six banks) to foreign buyers (nonresidents) in total value of approximately KM 10,7 million, along with decrease in share capital in one bank (of foreign ownership) in the process of merger of approximately KM 6,7 million.

Changes in the ownership structure have also reflected through the participation, that is, market share and positioning of banks that grouped based on the criteria of majority ownership in share capital. Market share of banks with majority foreign ownership increased by 0,7% and, as of 30.09.2006., it was 89,7%. Market share of banks with majority domestic private capital was 6,3%, which is less by 0,2% if compared to the end of 2005. Share of state banks has also decreased from 4,5% at the end of 2005 to 4,0% as of 30.09.2006.

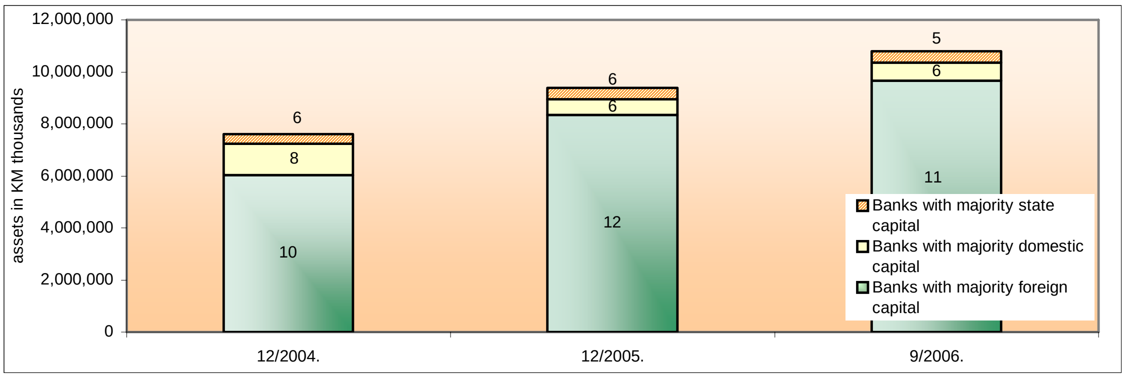
Integration process in the past periods has also been focused on stronger market positioning, which resulted in concentrations of the banking sector through growing of the largest banks, decreased number of banks, and intensified competition. The changes have also occurred due to the merger process that was finalized by 30. 06. 2006., that is, the resulting bank has been in existence since 01. 07. 2006.

Table 3: *Market share of banks by type of ownership* [7]

- in %-

BANKS	31.12.2004.			31.12.2005.			30.09.2006.		
	No. of banks	Partic. in total capital	Partic. in total assets	No. of banks	Partic. in total capital	Partic. in total assets	No. of banks	Partic. in total capital	Partic. in total assets
1	2	2	3	7	5	6	10	8	9
Banks with majority state capital	6	17,9	4,9	6	16,4	4,5	5	15,3	4,0
Banks with majority private domestic capital	8	16,9	15,8	6	8,0	6,5	6	7,7	6,3
Banks with majority foreign capital	10	65,2	79,3	12	75,6	89,0	11	77,1	89,7
TOTAL	24	100,0	100,0	24	100,0	100,0	22	100,0	100,0

Graph 3: *Market share by type of ownership*



1.3. Staff

As of 30.09.2006., there were total of 6.408 employees of banks in the Federation of BiH. Out of total number, 7% was employed by the banks with majority state capital, and 93% by private banks.

Table 4: *Employees of banks in the FBiH*

BANKS	NUMBER OF EMPLOYEES						RATIO	
	31.12.2004.		31.12.2005.		30.09.2006.		3:2	4:3
1	2		3		4		5	6
State banks	490	9%	475	8%	424	7%	97	89
Private banks	5.197	91%	5.540	92%	5.984	93%	107	108
TOTAL	5.687	100%	6.015	100%	6.408	100%	106	107
Number of banks	24		24		22			

In three quarters of 2006, number of employees increased by 7% or 393 employees, which is by one percent higher than the rate reached in 2005. More intensified employment of new staff within the banking industry is a result of expansion of the business network of banks,

[7] According to majority owned capital (participation exceeding 50%).

introduction of new products and services, that is, growth and development of the banking sector.

Table 5: *Qualification structure of employees*

EDUCATION	NUMBER OF EMPLOYEES						RATIO	
	31.12.2004.		31.12.2005.		30.09.2006.		4:2	6:4
1	2	3	4	5	6	7	8	9
University qualifications	2.016	35,4%	2.165	36,0%	2.328	36,3%	107	108
Two-year post secondary school qualifications	596	10,5%	642	10,7%	707	11,0%	108	110
Secondary school qualifications	2.962	52,1%	3.102	51,6%	3.286	51,3%	105	106
Other	113	2,0%	106	1,7%	87	1,4%	94	82
TOTAL	5.687	100,0%	6.015	100%	6.408	100,0%	106	107

It has been a while that banks show trend of improvement in the qualification structure and increase in number of employees with university and two-year post secondary school degree, which has caused changes in the structure of qualifications, so, as of 30. 09. 2006., participation of employees with secondary school qualifications was 51,3%, which is less by 0,3% if compared to the end of 2005.

One of the indicators influencing assessment of performance of respective banks and the banking system is effectiveness of employees, which is shown as ratio between assets and number of employees, that is, amount of assets per an employee. The higher ratio, the better effectiveness of performance, both of a bank and of the system.

Table 6: *Assets per an employee*

BANKS	31.12.2004.			31.12.2005.			30.09.2006.		
	No. of empl.	Assets (000 KM)	Assets per an empl.	No. of empl.	Assets (000 KM)	Assets per an empl.	No. of empl.	Assets (000 KM)	Assets per an empl.
State	490	373.064	766	475	422.680	890	424	430.457	1.015
Private	5.197	7.240.166	1.393	5.540	8.956.027	1.617	5.984	10.360.071	1.731
TOTAL	5.687	7.613.230	1.339	6.015	9.378.707	1.559	6.408	10.790.528	1.684

At the end of third quarter of 2006, there was KM 1,68 million of assets per an employee on the level of the banking system. This indicator has been slightly improved with state banks if compared to the end of 2005, which is due to a significant decrease in number of employees of 11% (after banking license was revoked from one state bank), but it is still much worse that the indicator in the sector of private banks.

Table 7: *Assets per an employee by groups*

Assets (000 KM)	31.12.2004.	31.12.2005.	30.09.2006.
	Number of banks	Number of banks	Number of banks
Up to 500	7	5	4
500 to 1.000	5	7	7
1.000 to 1.500	4	3	3
1.500 to 2.000	7	3	2
Over 2.000	1	6	6
TOTAL	24	24	22

Analytical indicators of respective banks range from KM 156 thousand to KM 3,2 million of assets per an employee. The indicator of seven banks is better than the one for the whole banking system, and the indicator of four largest banks of the system exceeds the amount of KM 2,1 million. In conclusion, we could say that banks have made significant progress in improving the quality and conditions under which banks service their customers, both legal entities and citizens, as well as conditions under which banks finance their customers have improved.

2. FINANCIAL INDICATORS OF BANKS' PERFORMANCE

Examination of banks based on reports is performed in the way to use the reports prescribed by the FBA and the reports of other institutions, representing database of three groups of information:

1. Information on balance sheet for all banks submitted monthly, including quarterly attachments, containing more detailed information on funds, loans, deposits and off-balance sheet items, and some general statistic information,
2. Information on bank solvency, data on capital and capital adequacy, asset classification, concentrations of certain types of risks, liquidity position, foreign exchange exposure, based on the reports prescribed by the FBA (quarterly),
3. Information on performance results of banks (income statement – FBA format) and cash flow reports submitted to the FBA quarterly.

Aside from the mentioned standardized reports, the database includes the information obtained from additional reporting requirements prescribed by the FBA in order to have the best conditions for monitoring and analysis of banks' performance in the Federation of BiH. The database also includes audit reports of financial statements of banks prepared by independent auditor, as well as all other information relevant to the assessment of performances of individual banks and the entire banking system.

In accordance with the provisions of Law on Opening Balance Sheet of Banks, banks with majority state owned capital have to report to the FBA "full" balance sheet divided into: passive, neutral and active sub-balance sheet. In order to get realistic indicators of banks' performance in the Federation of BiH, all further analysis of the banking system will be based on the indicators from the active sub-balance sheet of banks with majority state owned capital[8].

2.1. Balance sheet

Aggregate balance sheet of banks in the Federation of BiH, according to the balance sheets submitted as of 30.09.2006., amounted to KM 10,8 billion, which is higher by 15% or KM 1,4 billion in comparison to 31.12.2005. There was the same growth rate of 15% or KM 1,1 billion realized in the same period last year. Almost half (47% or KM 657 million) of total growth in 2006 was realized in the third quarter.

[8] Some state banks in their "full balance sheet" report passive and neutral items, which will be taken over by the state upon finalization of the privatization process. As of 31.12.2005., these items amounted to KM 680 million.

Table 8: *Balance sheet*

DESCRIPTION	AMOUNT (in 000 KM)			RATIO	
	31.12.2004.	31.12.2005.	30.09.2006.	3/2	4/3
1	2	3	4	5	6
ASSETS:					
Cash assets	2.859.489	3.533.700	4.105.127	124	116
Securities	19.430	20.010	23.159	103	116
Placements to other banks	81.624	68.811	90.690	84	132
Loans- net value	4.184.579	5.284.922	6.083.846	126	115
Business premises and other fixed assets	299.189	306.637	313.789	103	102
Other assets	168.919	164.628	173.917	98	106
TOTAL ASSETS	**7.613.230**	**9.378.708**	**10.790.528**	**123**	**115**
LIABILITIES:					
LIABILITIES					
Deposits	5.602.238	6.864.048	7.923.420	123	115
Borrowings from other banks	3.329	2.912	2.915	87	100
Liabilities for borrowings	850.833	1.152.910	1.331.120	136	115
Other liabilities	251.420	342.121	433.934	136	127
CAPITAL					
Capital	905.410	1.016.717	1.099.139	112	108
TOTAL LIABILITIES (LIABILITIES AND CAPITAL)	**7.613.230**	**9.378.708**	**10.790.528**	**123**	**115**

Table 9: *Assets of banks by ownership structure*

BANKS	31.12.2004.		31.12.2005.		30.09.2006.		RATIO	
							3/2	4/3
1	2		3		4		5	6
State banks	373.064	5%	422.680	5%	430.457	4%	113	102
Private banks	7.240.657	95%	8.956.028	95%	10.360.071	96%	124	116
TOTAL	7.613.721	100%	9.378.708	100%	10.790.528	100%	123	115

State banks have realized minimum growth of 2% or KM 8 million, while private banks have had significant increase in the balance sheet of 16% or KM 1,4 billion.

The four largest banks represent 71% or KM one billion of total growth in the aggregate balance sheet of the banking sector.

If the banking system is analyzed from the aspect of assets size and certain groups within this frame, changes in number of banks and participation of individual groups are the result, from one side, of decrease in number of banks (integration of two banks and license revoked from one bank), and, from the other side, growth of assets with majority of banks.

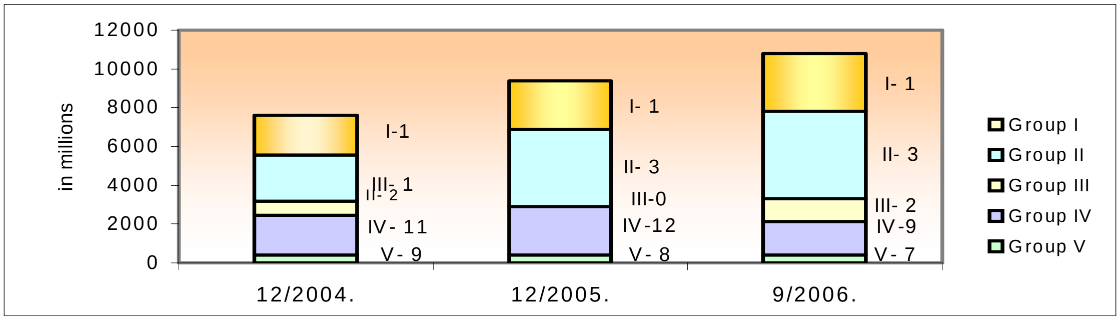
Participation of the largest bank in the system, if compared to the end of 2005, has increased by 1,1% (from 26,6% to 27,7%). However, although participation of three banks from Group II has been decreased by 0,8%, this Group still has the highest participation of 41,8%. After long period of time, two banks from Group IV moved to Group III, and their participation, as of 30.09.2006., was 10,6%. Major changes in number of banks, that is, decrease by three banks, was recorded in the largest Group IV, since one bank had a status change of merger, after which the resulting bank moved to Group III, along with another bank whose assets in the third quarter of 2006 exceeded the amount of KM 500 million. The same as earlier, downfall in participation of banks from Group V has continued (from 4,1% to 3,7%), along with decrease in number of banks within this group from eight to seven, which is a result of license being revoked from one bank.

The following table presents amounts and participations of individual groups of banks[9] in total assets in time line (amounts in million KM):

Table 10: *Participation of individual groups of banks in total assets through periods*

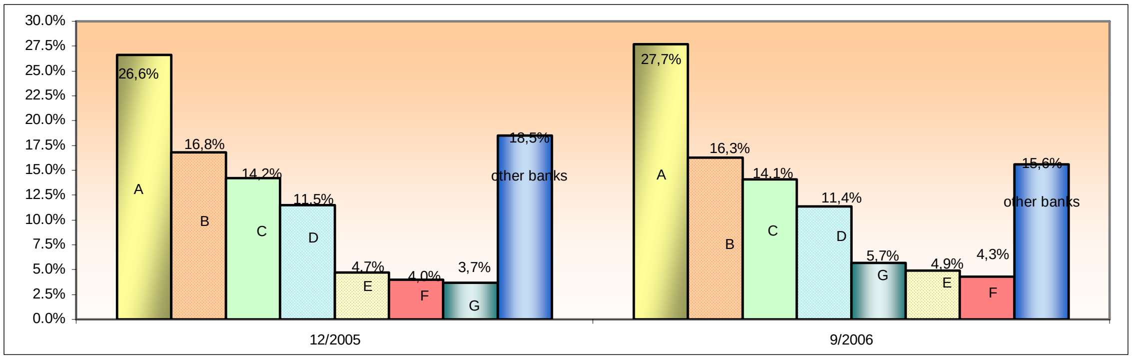
ASSETS	31.12.2004.			31.12.2005.			30.09.2006.		
	Amount	Partic. %	No. of banks	Amount	Partic. %	No. of banks	Amou nt	Partic. %	No. of banks
I- Over 2.000	2.043	26,9	1	2.495	26,6	1	2.986	27,7	1
II- 1000 to 2000	2.382	31,3	2	3.996	42,6	3	4.512	41,8	3
III- 500 to 1000	741	9,7	1	0	0,0	0	1.146	10,6	2
IV- 100 to 500	2.036	26,7	11	2.504	26,7	12	1.745	16,2	9
V- Below 100	411	5,4	9	384	4,1	8	402	3,7	7
TOTAL	7.613	100,0	24	9.379	100,0	24	10.791	100,0	22

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



The following graph shows structure and trend of participation of seven largest banks[10] in the banking system of the Federation of BiH:

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



[9] Banks are divided into five groups, depending on the assets size.
[10] Banks are marked with letters from A to F.

Growth of the aggregate balance sheet in sources has been financed from the growth in deposits (by 15% or KM 1,1 billion), borrowings (by 15% or KM 178 million) and capital (by 8% or KM 82 million).

In the assets, cash items have increased by 16% or KM 571 million, and loans[11] by 15% or KM 826 million.

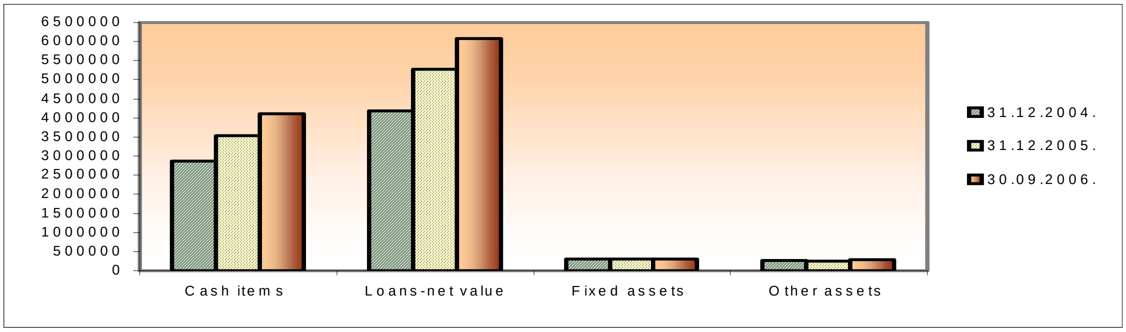
The following table and graphs present structure of the most significant balance sheet positions of banks.

Table 11: *Structure of balance sheet of banks*

- in % -

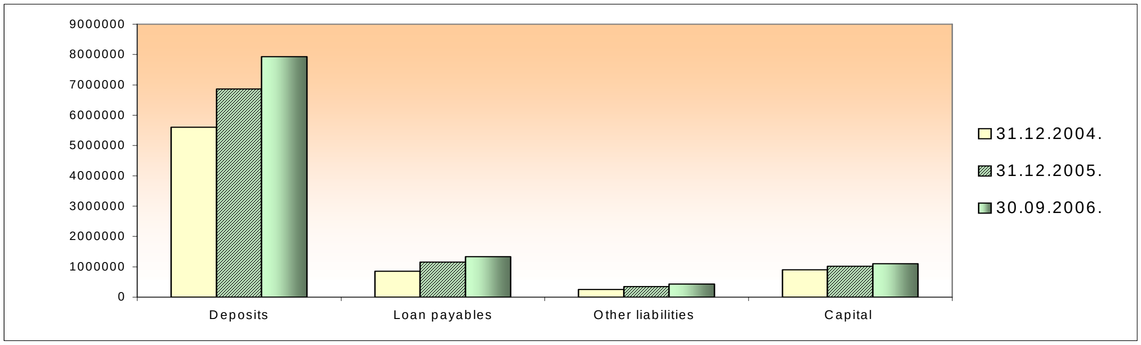
DESCRIPTION	PARTICIPATION		
	31.12.2004.	**31.12.2005.**	**30.09.2006.**
ASSETS:			
Cash assets	37,6	37,7	38,0
Securities	0,2	0,2	0,2
Placements to other banks	1,1	0,7	0,8
Loans- net value	55,0	56,3	56,4
Business premises and other fixed assets	3,9	3,3	2,9
Other assets	2,2	1,8	1,7
TOTAL ASSETS	100,0	100,0	100,0
LIABILITIES:			
LIABILITIES			
Deposits	73,6	73,2	73,4
Borrowings from other banks	0,1	0,0	0,0
Liabilities for borrowings	11,2	12,3	12,3
Other liabilities	3,2	3,7	4,1
CAPITAL			
Capital	11,9	10,8	10,2
TOTAL LIABILITIES (LIABILITIES AND CAPITAL)	100,0	100,0	100,0

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



[11] Gross loans (balance sheet data): short term, long term, past due claims, paid-called guarantees and claims from leasing operations.

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



As for the changes in the balance sheet liabilities of banks, from the aspect of the most significant balance sheet categories in the sources, we should emphasize and advise about further decrease in participation of total capital by 0,6%. Such change leads to the conclusion that growth of the aggregate balance sheet is not supported by adequate increase of capital, both from external and internal sources through the generated profit.

More intensive increase of deposits in the third quarter of 2006, even with the rate twice higher (8%) than the increase of loans in the same period (4%), has positively influenced the changes in the assets structure and increase in participation of cash items by 0,3% in comparison to the end of 2005 (from 37,7% to 38%). Participation of net loans has increased by only 0,1% (from 56,3% to 56,4%).

Table 12: *Cash funds of banks*

CASH FUNDS	31.12.2004.		31.12.2005.		30.09.2006.		INDEX	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Cash	215.543	7,5	231.874	6,6	225.502	5,5	108	97
Reserve accounts with CBBiH	1.177.935	41,2	1.679.194	47,5	2.113.261	51,5	143	126
Accounts with deposit institutions in BiH	47.798	1,7	24.241	0,7	985	0,0	51	4
Accounts with deposit institutions abroad	1.416.779	49,5	1.596.932	45,2	1.764.020	43,0	113	110
Cash assets in collection process	1.434	0,1	1.459	0,0	1.359	0,0	102	93
TOTAL	2.859.489	100,0	3.533.700	100,0	4.105.127	100,0	139	116

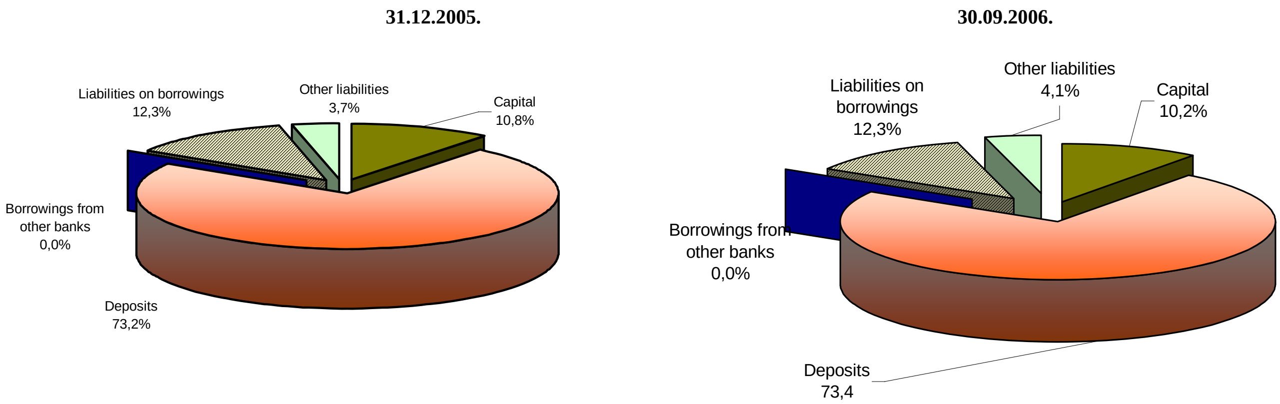
At the end of third quarter, banks in the Federation of BiH maintained on the accounts of deposit institutions abroad the amount of KM 1,8 billion (most of it in EUR) or 43,0% of total cash funds, which is less by 2,2% in comparison to the end of 2005, while the nominal value of the funds is higher by 10% or KM 167 million. This is the first time, as of 30. 09. 2006., that banks held on the reserve accounts with the Central Bank of BiH over 50% of their cash funds or KM 2,1 billion, which is higher by 4% in comparison to the end of 2005. Remaining 5,5% or KM 225 million, banks held as cash in vaults and tellers.

From the aspect of currency structure of the cash funds, the mentioned changes have also influenced the participation of funds in domestic and foreign currency, that is, increase of domestic currency from 52% to 55,3%, and, as influenced by the same change, decrease in participation of the funds in foreign currency.

2. 1. 1. Liabilities

Structure of liabilities (liabilities and capital) in the balance sheet of banks as of 30.09.2006. is presented in the following graph:

Graph 8: *Liabilities structure of banks*



After longer period of time, we see that downfall in participation of deposits has stopped. We even see that deposits, with growth rate of 15% in three quarters of 2006, have shown increase in participation by 0,2%. On the other hand, although liabilities on borrowings have increased by 15%, their participation remained on the same level as at the end of 2005 (12,3%). As mentioned, the most significant change in the liabilities is decrease in participation of capital by 0,6%. It is obvious that, as of 30. 09. 2006., participation of 10,2% of capital has reached the lowest percentage until now and that, in future, banks have to plan to increase and maintain the level of capital to be adequate and adjusted to growth and development of their performance and future activities in order to minimize undertaken and potential risks to which any bank is exposed.

Credit indebtness of banks in 2006 have increased by 15% or KM 178 million. As of 30. 09. 2006., banks' liabilities were highest with the following creditors (five out of 51), making 66% of total credit liabilities: Raiffeisen Zentralbank Osterreich A.G. (RZB), OEWAG Wien, Bank Polska OPIEKI, International Finance Corporation (IFC) and European Fund for Southeast Europe (EFSE).

In the three quarters of 2006, deposits increased by 15% or KM 1,1 billion. The same as earlier, the increase primarily comes from the private bank sector.

Based on the information reported by banks, out of total deposits as of 30.09.2006., only 4,6% were deposits collected by organizational units of the banks from the Federation of BiH operating in Republic Srpska and Brčko District.

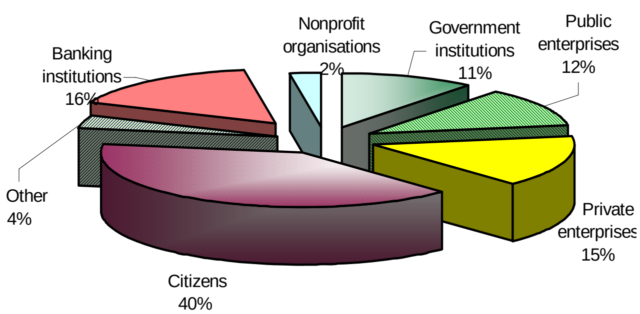
Table 13: *Deposit structure by sectors* [12]

- in 000 KM-

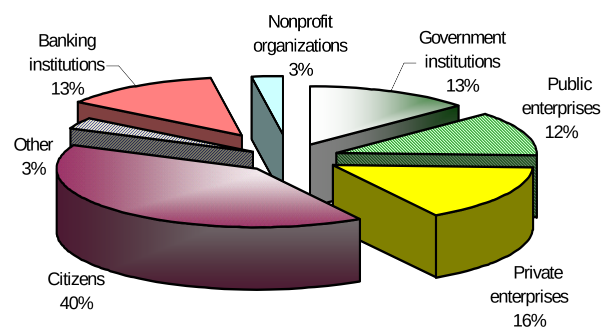
SEKTORS	31.12.2004.		31.12.2005.		30.09.2006.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Governmental institutions	599.060	10,7	733.881	10,7	1.059.150	13,4	123	144
Public enterprises	783.655	14,0	806.321	11,7	958.249	12,1	103	119
Private enterprises and assoc.	876.831	15,7	1.066.022	15,5	1.263.794	16,0	122	119
Non-profit. organizations	180.705	3,2	169.005	2,5	189.134	2,4	94	112
Banking institutions	808.112	14,4	1.102.161	16,1	1.027.860	13,0	136	93
Citizens	2.173.228	38,8	2.717.081	39,6	3.175.714	40,1	125	117
Other	180.647	3,2	269.577	3,9	249.519	3,0	149	93
TOTAL	5.602.238	100,0	6.864.048	100,0	7.923.420	100,0	123	115

Graph 9: *Deposit structure by sectors*

31.12.2005.



30.09.2006.



Analyzed by sectors, during the observed period of 2006, the highest rate of growth of 44% or KM 325 million was recorded by the deposits of government institutions. Deposits of private and public enterprises had the same rate of growth of 19%, which in nominal value is KM 198 million with the private sector and KM 152 million with the deposits of public enterprises sector. Deposits of citizens, with the growth rate of 17%, have reached the highest nominal growth of KM 459 million, which resulted by increase of participation in those four sectors. However, deposits of citizens still have the highest participation of 40,1%.

In 2006, currency structure of deposits have changed in favor of domestic currency, that is, participation of deposits in KM has increased from 41,4% to 43,7% (KM 3,5 billion), while participation of deposits in foreign currency have decreased from 58,6% to 56,3% (KM 4,4 billion), along with dominant participation of EURO.

Saving deposits, as the most significant segment of deposit and financial potential of banks, have maintained the trend from earlier periods, that is, moderate, continuous and stable growth, and, as of 30. 09 2006., they exceeded the amount of KM 3 billion. In the three

[12] Information from attached form BS-D submitted by banks each quarter with balance sheet - FBA format.

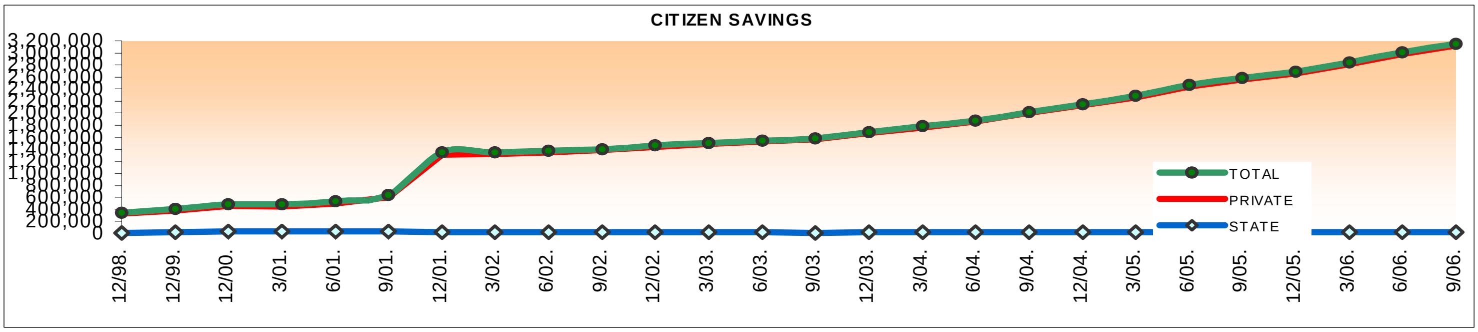
quarters of 2006, savings increased by 17% or KM 453 million. Out of total increase that has been achieved, 74% or KM 334 million was generated by four largest banks in the system.

Table 14: *New citizen savings by periods*

- in 000 KM-

BANKS	AMOUNT (in 000 KM)			RATIO	
	31.12.2004.	31.12.2005.	30.09.2006.	3/2	4/3
1	3	3	4	5	6
State	22.342	26.886	27.262	120	101
Private	2.105.167	2.638.391	3.090.534	125	117
TOTAL	2.127.509	2.665.277	3.117.796	125	117

Graph 10: *New citizen savings by periods*



As in other segments, there is an obvious strong concentration of savings in larger banks, since the four largest banks hold 76,2% of total savings.

Out of total savings, 31% are savings deposits in domestic currency, and 69% are savings in foreign currency.

Table 15: *Maturity structure of citizen savings deposits by periods*

BANKS	AMOUNT (in 000 KM)						RATIO	
	31.12.2004.		31.12.2005.		30.09.2006.		3/2	4/3
1	3		3		4		5	6
Short term savings deposits	1.360.285	63,9%	1.567.617	58,8%	1.734.755	55,6%	115	111
Long term savings deposits	767.224	36,1%	1.097.660	41,2%	1.383.041	44,4%	143	126
TOTAL	2.127.509	100,0%	2.665.277	100,0%	3.117.796	100,0%	125	117

Stability, safety and constant improvement of the banking system's condition has strongly influenced this segment of banking performance, and all data indicates further strengthening of confidence in banks. This is especially reflected through the improvement of maturity structure and savings and total deposits, and we should especially emphasize continuity and high level of growth rate in long term savings deposits, which resulted by increase of their participation in total savings deposits close to 50%.

Along with well functioning and effective banking supervision conducted by the FBA, existence of deposit insurance system is also significant for the growth of savings in banks of the FBiH, with primary purpose to increase stability of both banking and financial sector and to protect savers. Total of 15 banks from the Federation of BiH was accepted to the deposit insurance program, and, according to the reported data, banks-members deposit 96% of total deposits and 98% of total savings. Remaining seven banks cannot submit applications, since they do not meet the criteria prescribed by Deposit Insurance Agency: five state banks - due to their ownership structure; and two private banks – for being under provisional administration. Safety of deposits is a guaranty and incentive for further growth of savings, not only in those banks, but also in all other banks.

2.1.2. Capital – strength and adequacy

As of 30.09.2006., capital[13] of banks in the FBiH amounted to KM 1.275 million.

Table 16: *Regulatory capital*

-in 000 KM-

DESCRIPTION	31.12.2004.		31.12.2005.		30.09.2006.		RATIO	
							3/2	4/3
1	2		3		4		5	6
STATE BANKS								
1. Core capital before reduction	163.061		166.737		167.240		102	100
2. Offsetting items	2.607		4.200		5.492		161	131
a) Core capital (1-2)	160.454	98%	162.537	96%	161.748	96%	101	100
b) Additional capital	3.639	2%	7.107	4%	6.450	4 %	195	91
c) **Capital (a + b)**	164.093	100%	169.644	100%	168.198	100%	103	99
PRIVATE BANKS								
Core capital before reduction	744.519		828.196		915.244		111	111
Offsetting items	88.598		98.341		99.066		111	101
a) Core capital (1-2)	655.921	75%	729.855	72%	816.178	74%	111	112
b) Additional capital	217.639	25%	290.758	28%	290.537	26%	134	100
c) Capital (a + b)	873.560	100%	1.020.613	100%	1.106.715	100%	117	108
Total								
1. Core capital before reduction	907.580		994.933		1.082.484		110	109
2. Offsetting items	91.205		102.541		104.558		112	102
a) Core capital (1-2)	816.375	79%	892.392	75%	977.926	77%	109	110
b) Additional capital	221.278	21%	297.865	25%	296.987	23%	135	100
c) Capital (a + b)	1.037.653	100%	1.190.257	100%	1.274.913	100%	115	107

In the observed period of 2006, capital[14] increased by 7% or KM 85 million in comparison to the end of 2005, which is the result of increase in core capital.
Growth of core capital is mainly caused by allocation of profit from 2005. After implementation of legal procedure to make and adopt decision on allocation of profit by the assemblies, profit of 19 banks generated in 2005 of KM 87 million was allocated to core capital of 80% (KM 45 million or 51% to reserves and KM 23,6 million or 28% to retained-undivided profit), while 1% or KM 0,5 million with two banks was used to cover losses from previous years. Five banks have made decision to pay dividends in total amount of KM 17,1 million, which represents 20% of the profit generated on the level of the banking system.

Growth of core capital, aside from the mentioned, was also influenced by additional capitalization with two banks (KM 29,6 million).

Offsetting items (causing decrease of core capital) increased by KM 2 million.

Additional capital remained almost the same as at the end of 2005, but the structure has reflected some changes: allocation of profit from 2005 of KM 43,4 million to core capital,

[13] Regulatory capital is defined by Article 8 and 9 in the Decision on Minimum Standards for Managing Capital

[14] Data source: quarterly Report on Capital Balance in Banks (Form 1-Table A) prescribed by Decision on Minimum Standards for Capital Management in Banks.

increase of general reserves for loan losses of KM 19,8 million, increase of current audited profit (one bank) of KM 13,1 million, and increase of subordinated debts of KM 9,6 million.

The mentioned changes have influenced the structure of regulatory capital in the way that the participation of core capital increased from 75% to 77%, and additional capital decreased from 25% to 23%.

Growth of regulatory capital of 7% positively reflected on net capital that in the three quarter of 2006 also increased by 7% or KM 85 million, and, as of 30. 09. 2006., it amounted to KM 1.258 million (KM 1.090 million with private banks, and KM 168 million with state banks).

Capitalization rate of banks, expressed as ratio between capital and assets, as of 30.09.2006., 11,5%, which was lower by 0,8% if compared to the end of 2005.

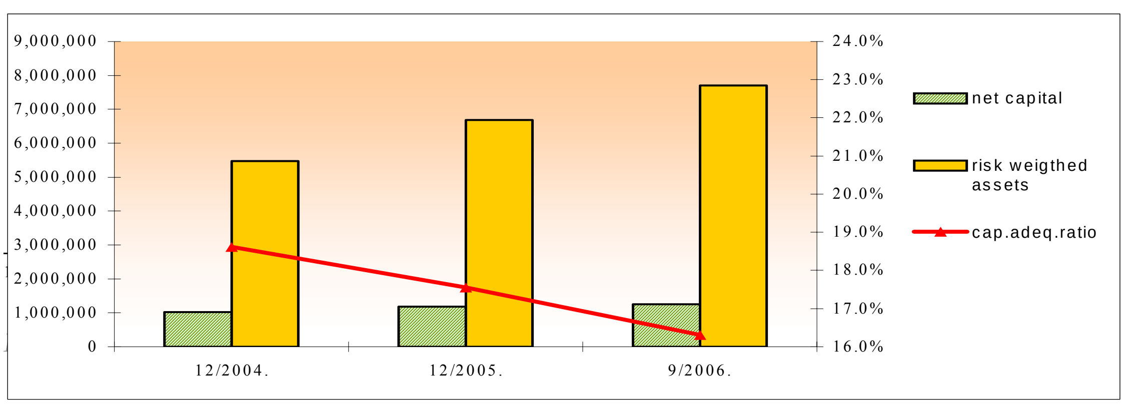
One of the most significant indicators of capital strength and adequacy[15] of banks is capital adequacy ratio calculated as ratio between net capital and risk weighted assets. On the level of the banking sector as of 30. 09. 2006., this ratio was 16,3%, which is less by 1,3% than at the end of 2005. Reason for this downfall is increase of risk weighted assets by 15%, primarily due to increase of credit placements, while net capital experienced increase per rate lower by 8%. However, we should keep in mind the fact that over the year net capital accrual has included only audited current income, which has been the case with one bank (KM 13,1 million). If we include the amount of remaining financial result into the calculation, that is, profit of KM 60 million generated on the level of the banking system for the nine months of 2006, adequacy rate becomes better of 17,1%, which is less by 0,5% than at the end of 2005.

While conducting supervision of operations and financial positions of banks in the F BiH as regulated by the Law, the FBA issues orders to banks to undertake actions for strengthening of capital base and provision of adequate capital in order to strengthen safety in banks individually and in the entire banking system, according to the level and profile of existing and potential exposure to all risks relevant to the banking operation.

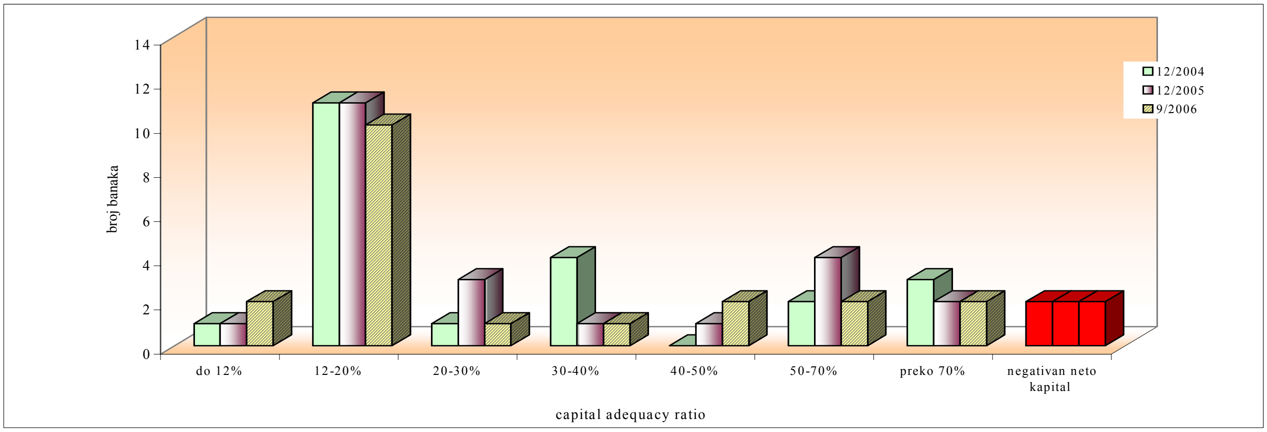
Table 17: *Net capital, risk weighted assets and capital adequacy rate*

DESCRIPTION	31.12.2004.	31.12.2005.	30.09.2006.	RATIO	
				3/2	4/3
1	2	3	4	5	6
NET CAPITAL	1.018.626	1.173.022	1.257.677	115	107
RISK WEIGTHED ASSETS AND CREDIT EQUIVALENTS	5.472.154	6.681.510	7.711.136	122	115
NET CAPITAL RATE (CAPITAL ADEQUACY)	18,6%	17,6%	16,3%	95	93

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



Graph 12: *Capital adequacy rate of banks*



Out of 22 banks in the FBiH as of 30. 09. 2006., 18 banks had capital adequacy ratio higher than the minimum prescribed by the Law of 12%, and four banks (all under provisional administration) had capital adequacy ratio below 12% (two of them, and two had negative capital adequacy ratio).

Here is the range of capital adequacy rates of 18 banks in relation to the minimum requirement of 12%:

- Four largest banks had the rate from 12,6% to 13,9%,
- Ten banks had the rate between 12% and 20%,
- Four banks had the rate between 21% and 50%,
- Two banks had the rate between 51% and 70%,
- Two banks had the rate higher than 70%.

Further strengthening of capital base is a priority task in most of banks, especially in the largest banks of the system, which is necessary to strengthen stability and safety of both banks and the entire banking system. While following expansion of banks and conducting regular supervision of this segment, the FBA has been taking towards banks, depending on the assessment of their capital adequacy and risk profile of an institution, different corrective and supervisory measures, such as: adoption of strategy to maintain level of capital and plan that will ensure quantity and quality (structure) of capital in accordance with the nature and complexity of banks' present and future business activities, as well as undertaken and potential risk, than intensified supervision and monitoring of bank, request to provide for additional capital in order to strengthen capital base, limitation and decrease of exposure to credit risk related to certain types of concentrations, monitoring of implementation in adopted capital plans, especially in providing additional capital from external sources, supervision of compliance and implementation of the ordered measures, etc.

All of this has resulted in improvement of the condition in this segment, guarantying safety and stability of banks and the entire system.

2.1.3. Assets and assets quality

Decision on Minimum Standards for Loan Risk Management and Assets Classification of Banks determines criteria for evaluation of bank's exposure to loan risk based on evaluation of their assets quality and adequacy of reserves for loan and other losses according to the risk of placements and balance sheet and off-balance sheet items.

Gross assets[16] of the balance sheet of banks in the FBiH, as of 30.09.2005., amounted to KM 11,1 billion, which is higher by 15% or KM 1,4 billion than at the end of 2005. Off-balance sheet items amounted to KM 1,7 billion and they increased by 23% or KM 321 million.

Total assets with off-balance sheet items (assets)[17] amounted to KM 12,8 billion, which is higher by 16% than at the end of 2005.

Table 18: *Assets, off-balance sheet items and potential loan losses*

-in 000 KM-

DESCRIPTION	AMOUNT (in 000 KM)						RATIO	
	31.12.2004.	Struct. %	31.12.2005.	Struct. %	30.09.2006.	Struct. %	4:2	6:4
1.	2	3	4	5	6	7	8	9
Loans	4.208.295	53,5	5.326.900	55,2	6.123.748	55,2	127	115
Interests	29.856	0,4	37.531	0,4	34.839	0,3	126	93
Past due claims	209.218	2,7	214.045	2,2	243.335	2,2	102	114
Claims on paid guarantees	5.026	0,1	4.132	0,0	3.961	0,0	82	96
Other placements	40.811	0,4	23.950	0,2	29.958	0,3	59	125
Other assets	3.378.320	42,9	4.050.650	42,0	4.653.064	42,0	120	115
TOTAL ASSETS	7.871.526	100,0	9.657.208	100,0	11.088.905	100,0	123	115
OFF-BALANCE SHEET	1.046.809		1.391.183		1.712.380		133	123
ASSETS WITH OFF-BALANCE SHEET	8.918.335		11.048.391		12.801.285		124	116
RISK ASSETS WITH OFF-BALANCE SHEET	5.762.704		7.091.338		8.319.320		123	117
General loan risk and Potential loan losses	282.412		313.873		340.796		111	109
General and Special loan loss reserves already established	285.090		314.175		342.202		110	109

Non-risk items amount to KM 4,5 billion or 35% of total assets with off-balance sheet, which is higher 13% than at the end of 2005 that primarily comes from the increase in cash funds. On the other hand, risk assets with off-balance sheet amount to KM 8,3 billion, representing an increase by KM 1,2 billion or 17% in 2006.

Credit placements, for the nine months, have increased by 15% or KM 826 million, but with almost the same participation in the structure of assets of 59%. Past due claims increased by 14%, and their participation in the assets structure is 2,3%.

Analytical data by banks indicate that six banks (five under provisional administration) reported decrease of credit placements. Five banks had rate of growth in credit placements between 2% and 10%, while ten banks had the increase between 10% and 32%.

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

Four largest banks in the FBiH increased the credit placements by KM 639 million, representing 77% of total increase in the banking sector, and their participation in total loans increased from 70,5% to 71,4%.

Based on the analysis of loan structure by sectors, we can see that the highest increase of KM 515 million or 18% was recorded in placements to citizens, which is why their participation increased from 50,2% to 51,8%. Placements to private companies increased by 13% or KM 321 million, along with decrease in participation from 44,1% to 43,4%. According to the data submitted by banks as of 30.09.2006, from the aspect of citizen loan structured by purpose, the highest participation of approximately 71% had loans for financing consumer goods[18], 24% had housing loans, and remaining 5% had loans for SMEs and agriculture.

Other sectors recorded smaller changes in both nominal and relative amount.

The four largest banks in the system originated loans to citizens of 73% of total loans originated to this sector, and this is less by 1% in comparison to the end of 2005, while the same indicator for the sector of private enterprises was 71%, which represented an increase of 2% in comparison to the end of 2005.

Changes in participation of individual sectors in the overall structure of loans are presented in the following table:

Table 19: *Structure of loans by sectors*

-in 000 KM-

SECTORS	31.12.2004.		31.12.2005.		30.09.2006.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Government institutions	31.810	0,7	35.513	0,6	32.779	0,5	112	92
Public enterprises	203.698	4,6	188.143	3,4	174.283	2,7	92	93
Private enterprises and assoc.	1.933.595	43,7	2.446.358	44.1	2.767.446	43,4	127	113
Non-profit organizations	3.619	0,1	9.276	0,2	16.607	0,3	256	179
Banking institutions	34.082	0,8	33.123	0,5	32.656	0,5	97	99
Citizens	2.139.699	48,4	2.784.053	50,2	3.298.855	51,8	130	118
Other	76.036	1,7	48.611	1,0	48.418	0,8	64	100
TOTAL	4.422.539	100,0	5.545.077	100,0	6.371.044	100,0	125	115

Since placements, that is, loans represent the most risky portion of banks' assets, their quality represents one of the most significant elements of stability and successful performance. Evaluation of assets quality is actually evaluation of exposure to loan risk of banks' placements, that is, identification of potential loan losses that are recognized as loan loss provisioning.

Quality of assets and off-balance sheet risk items, general loan risk, potential loan losses by classification categories[19] and off-balance sheet items are presented in the following table:

[18] Including card based operations.
[19] As it is regulated in the Article 22 of the Decision on Minimum Standards for Managing Credit Risk and Assets Classification in Banks, banks have to allocate and maintain reserves for general and special loan losses in percentages according to classification categories: A 2%, B 5% to 15%, C 16% to 40%, D 41% to 60% and E 100%.

Table 20: *Assets classification, general loan risk (GLR), potential loan losses (PLL) and off-balance sheet items (assets charged off and suspended interest)*

Classification categories	AMOUNT (in 000 KM) AND PARTICIPATION (in%)									RATIO	
	31.12.2004.			31.12.2005.			30.09.2006.				
	Assets classif.	Partic. %	GLR PLL	Assets classif.	Partic. %	GLR PLL	Assets classif.	Partic. %	GLR PLL	5/2	8/5
1	2	3	4	5	6	7	8	9	10	11	12
A	4.725.199	82,0	94.501	5.943.367	83,8	118.864	6.946.311	83,5	138.924	126	117
B	730.737	12,7	53.633	831.403	11,7	62.512	1.058.466	12,7	77.816	114	127
C	143.586	2,5	42.104	157.310	2,2	41.915	163.635	2,0	38.615	110	104
D	162.299	2,8	91.294	159.224	2,3	90.551	150.859	1,8	85.419	98	95
E	883	0,0	880	34	0,0	31	49	0,0	22	4	64
Risk assets (A-E)	5.762.704	100,0	282.412	7.091.338	100,0	313.873	8.319.320	100,0	340.796	123	117
Nonrisk assets[20]	3.155.631			3.957.053			4.481.965			125	113
TOTAL	8.918.335			11.048.391			12.801.285			124	116
OFF-BALANCE SHEET ITEMS											
E	343.472	83,3		385.601	87,6		398.751	89,1		112	103
Suspended interest	68.680	16,7		54.426	12,4		48.790	10,9		79	90
TOTAL	412.152	100,0		440.027	100,0		447.541	100,0		107	102

Risk assets with off-balance sheet (A-E) amount to KM 8,3 billion, and it has been increased by KM 1,2 billion or 17%, and non-risk assets by KM 4,5 billion, and it is higher by 13% than at the end of 2005, which is primarily the result of increase in cash funds.

If we analyze the quality of risk assets, we see there is increase in classified assets (B-E) by 20% or KM 225 million, especially in special mentioned placements (category B) by 27% or KM 227 million, while poor quality assets themselves (C-E) has decreased by 1% or KM 2 million. Increase of special mentioned assets (category B) and concentration of items in this category leads to the conclusion there is a slight trend of deterioration in assets quality, as well as doubt that portion of placements reported in this category have quality worst than shown and they should be categorized as poor quality assets. This is proven by the indicators of assets quality shown as ratio, that is, participation of individual categories in risk assets. As of 30.09.2006., ratio between classified assets and risk assets was 16,5%, showing deterioration by 0,3% in comparison to the end of 2005, due to faster increase in classified assets (20%) than the increase in risk assets (17%). However, if we analyze the ratio and trend of only poor quality assets and risk assets, this ratio, as of 30.09.2006., was 3,8%. This is relatively low ratio, however, in comparison to the end of 2005, it has even improved by 0,7%. Finally, the highest participation of category B of 12,7% in risk assets and its increase by 1% in 2006, along with decrease in participation of poor quality assets from 4,5% to 3,8%, are the facts indicating that the credit risk is increasing. That is why, it is extremely important that banks assess the quality of their placements and establish adequate reserves for loan losses as realistic as possible, especially due to the fact that those are relatively new loans with long maturities, that is why the issues related to the assets quality are not timely detected, that is, they are in a certain way hidden through the highest increase in category B.

Analysis of analytical indicators by sectors is based on the indicators of assets quality presented for the two most significant sectors: private enterprises and citizens. The two indicators we have just mentioned are quite different and they indicate existence of higher

[20] Assets items that are not, according to Article 22, Paragraph 7 of Decision on Minimum Standards for Credit Risk Management and Assets Classification in Banks, subject to any accruals of reserves for general loan losses of 2%

exposure to credit risk, consequently to potential credit losses with the loans originated to legal entities, along with slight trend of deterioration in these parameters. As of 30. 09. 2006., out of total loans originated to legal entities, KM 1.187 million or 38,6% was classified into categories B to E (35,5% at the end of 2005), while with citizens loans it was KM 186 million or 5,6% (6% as of 31.12.2005.). Deterioration of loans originated to legal entities resulted from the increase of loans in category B by KM 236 million or 33%, since poor quality assets in the loans originated to legal entities increased by 1% and, as of 30. 09. 2006., it was KM 223 million or 7,6% of total loans originated to this sector. Poor quality assets in the loans originated to citizens amounted to KM 77 million or 2,3% of total loans originated to citizens.

In the first half of 2006, banks charged off from balance sheet to off-balance sheet, that is, they charged off claims of KM 62,9 million and suspended interest of KM 18,3 million. In the same period, there was permanent charge off of assets items of KM 15,9 million and suspended interest of KM 12,6 million. Banks succeeded in the same period to collect previously charged off assets of KM 28,5 million and KM 9,5 million of suspended interest, which was positively reflected on their profitability.

At the end of the third quarter of 2006, balance of charged off assets was KM 399 million, which was higher by 3% than at the end of 2005, while the balance of suspended interest was KM 49 million, which was lower by 10% or KM 5,6 million than at the end of 2005.

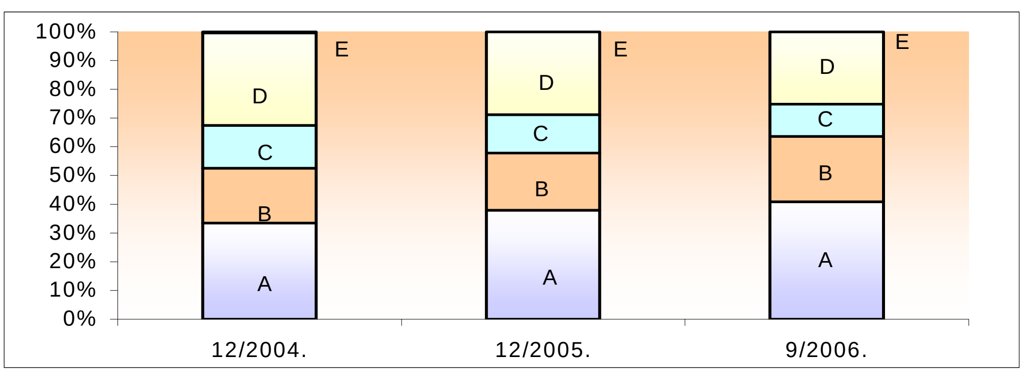
Out of total assets charged off, assets charged off based on loans originated to citizens were KM 54 million or 14%, and suspended interest was KM 6,8 million or14%.

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

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

Classification category	AMOUNT (in 000 KM) AND STRUCTURE (in%)						RATIO	
	31.12.2004.		31.12.2005.		30.09.2006.		4/2	6/4
1	2	3	4	5	6	7	8	9
A	94.501	33,5	118.884	37,9	138.924	40,8	126	117
B	53.633	19,0	62.517	19,9	77.816	22,8	117	124
C	42.104	14,9	41.954	13,4	38.615	11,3	100	92
D	91.294	32,3	90.465	28,8	85.419	25,1	99	94
E	880	0,3	31	0,0	22	0,0	4	71
TOTAL	282.412	100,0	313.851	100,0	340.796	100,0	111	109

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



As reported in the statements, banks have established loan loss reserves in accordance with the regulations and level of evaluated loan risk.

According to the analysis of established reserves in total amount and by classification categories, if compared to the end of 2005, reserves for general loan risk and potential loan losses have increased by 9% and they amounted to KM 342 million, that is, 4,1% of risk assets with off-balance sheet items, which is lower by 0,3% than at the end of 2005. As of 30. 09. 2006., banks in average allocated reserves for category B of 7,4%, category C of 23,6%, category D of 57,5% and category E of 100%.

Analysis of assets quality, that is, loan portfolio of individual banks, based also on on-site examinations of banks, indicates that loan risk is still a dominant risk in majority of banks, that certain number of banks have inadequate management practices, that is, practices of assessment, measuring, monitoring and control of credit risk and assets classification.

In banks with poor quality assets, the FBA ordered correction measures in regard to preparation of operating programs which have to include action plan aimed to improve existing loan risk management practices, that is, assets quality, decrease existing concentrations, and resolve issues of poor quality assets and prevent their further deterioration. The FBA continuously monitors implementations of the orders through follow up procedures based on reports and other documentation submitted by banks, as well as through checks and controls during on-site examinations.

Transactions with related entities

While operating, banks are exposed to different types of risks, but the most significant is the risk of transactions with related entities of banks.
In accordance with the Basle Standards, the FBA has established certain prudential principles and requirements related to transactions with related entities of banks[21], which is regulated in Decision on Minimum Standards for Bank's Operations with Related Entities, prescribing requirements and method of operations with related entities. The Decision and Law on Banks regulate the duty of Supervisory Board of a bank, which has to adopt, upon the proposal of the General Manager, special policies regulating operations with related entities and to monitor their implementation.
The FBA Decisions prescribe a special set of reports, which include transactions with one segment of related entities, such as loans and potential and undertaken off-balance sheet liabilities (guarantees, letters of credit, undertaken loan commitments) as the most frequent and the most riskiest form of transactions between a bank and related entities. The set of prescribed reports include data on loans originated to the following categories of related entities:

- Bank's shareholders over 5% of voting rights,
- Supervisory Board members and bank senior management and
- Subsidiaries and other enterprises related to a bank through capital

[21] Article 39, Paragraph 2 of Law on Changes and Amendments to the Law on Banks defines term “entities related to a bank”, excluding employees from this list.

Table 22: *Transactions with related entities*

-000 KM-

Description	LOANS ORIGINATED			RATIO	
	31.12.2004.	31.12.2005.	30.09.2006.	3/2	4/3
1	2	3	4	5	6
Shareholders over 5% of voting rights, subsidiaries and other enterprises related to a bank through capital	40.084	28.520	21.376	71	75
Supervisory Board members	141	101	36	72	36
Bank Management and employees	2.392	2.663	1.893	111	71
TOTAL	42.617	31.284	23.305	73	74
Potential and undertaken off-balance sheet liabilities	3.235	911	387	28	42

The FBA pays special attention (in on-site examinations) to bank's operations with related entities. The FBA on-site examiners issue orders for elimination of determined weaknesses within certain deadlines and initiate violation procedures, and part of the activity is also to monitor and supervise implementation of the issued orders. This has had a positive influence on this segment of operations, since the level of transactions with related entities has a decreasing trend, causing decrease in risk exposure to those entities.

2.2. Profitability

According to the data from income statements of banks in the Federation of BiH for the first half of 2006, banks in the Federation of BiH reported positive financial result – profit of KM 73,1 million, which is higher by 19% than in the same period of 2005, that is, by 20% higher than the profit generated in 2005.

Positive financial result of KM 79,9 was generated by 16 banks, which is higher by 17,4% or KM 11,8 million than in the same period of 2005. At the same time, six banks reported loss in their performance of KM 6,8 million (two state and four private banks), which is slightly higher if compared to the same period of 2005 (4,3% or KM 0,3 million).

More detailed information is presented in the following table.

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

-000 KM-

Date/Description	Banking system		Private banks		State banks	
	Amount	No.of banks	Amount		Amount	No.of banks
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
30.09.2006.						
Loss	-6.844	6	-5.210	4	-1.634	2
Profit	79.956	16	76.572	13	3.384	3
Total	73.112	22	71.362	17	1.750	5

Similar to other segments, concentrations exist in this segment as well: out of total profit (KM 79,9 million), 74,6% or KM 59,7 million was generated by four largest banks in the system; and out of total loss (KM 6,8 million), 85,6% or KM 5,8 million was reported by three banks (one state and two private banks). Financial result of state banks does not have any significant influence on overall profitability of the banking sector.

Based on analytical data, as well as parameters for evaluation of profitability quality (level of realized financial result – profit/loss and ratios used for evaluation of profitability, productivity and effectiveness of performance, and other parameters related to evaluation of performance), we can conclude that overall profitability of the system has improved as result of general trend of improvement and stabilization of the banking sector.

Total income on the system level was KM 489 million; rate of growth was 14% or KM 58,4 million. Net interest income within the structure of total income is still increasing, representing 57,7% of total income (56,7% in the same period of 2005), while participation of operating income has decreased from 43,3% to 42,3%, although rate of growth was 11%.

Total interest income of this period, if compared to the same period last year, has increased by 21%, amounting to KM 450 million, while at the same tine interest expenses have increased faster by 31%, amounting to KM 168 million, so net interest income on the level of the banking system reported slightly lower rate of growth (16%), amounting to KM 282 million.

If compared to the same period last year operating income increased by 11%, and its participation in the structure of total income decreased by only 1,0%.

Total non-interest bearing expenses increased by 13% or KM 46,8 million in comparison to the same period last year, amounting to the high 85% of total income. Within those expenses, salaries and contributions increased by 11%, and fixed assets and overhead expenses increased by 10%. Loan loss provisioning increased by 12% and their participation in the structure of non-interest expenses of 22% remained the same.

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

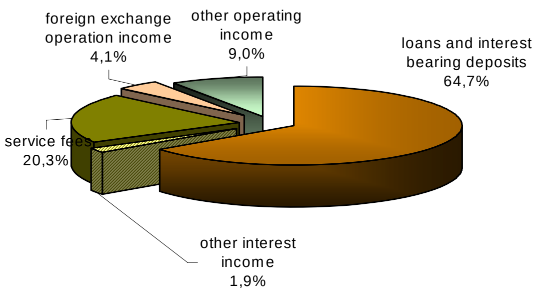
Table 24*: Structure of total income*

-in 000 KM-

Structure of total income	30.06.2004.		30.06.2005.		30.09.2006.		RATIO	
	Amount	%	Amount	%	Amount	%	4/2	6/4
1	2	3	4	5	6	7	8	9
I Interest income and similar type of income								
Interest bearing deposit accounts with depository institutions	19.834	4,5	31.107	5,6	46.151	7,0	157	148
Loans and leasing	256.263	58,1	330.528	59,1	389.577	59,3	129	118
Other interest income	8.097	1,8	10.805	1,9	14.317	2,2	133	133
TOTAL	284.194	64,5	372.440	66,6	450.045	68,5	131	121
II Operating income								
Service fees	93.291	21,2	113.616	20,3	123.289	18,8	122	109
Foreign exchange income	19.508	4,4	22.775	4,1	23.754	3,6	117	104
Other operating income	43.894	10,0	50.065	9,0	59.924	9,1	114	120
TOTAL	156.693	35,5	186.456	33,4	206.967	31,5	119	111
TOTAL INCOME (I + II)	440.887	100,0	558.896	100,0	657.012	100,0	127	118

Graph 14: *Structure of total income*

30.09.2005.



30.09.2006.

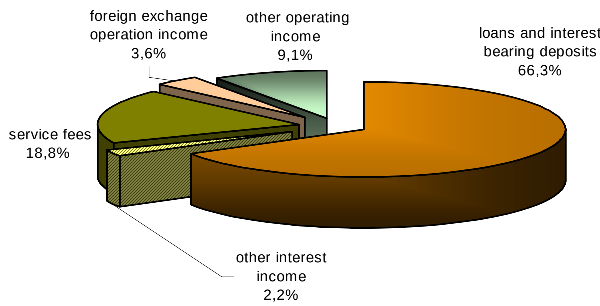


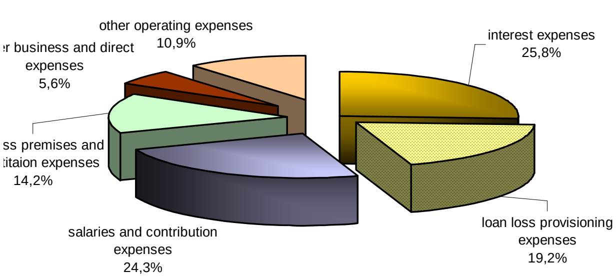
Table 25: *Structure of total expenses*

- in 000 KM-

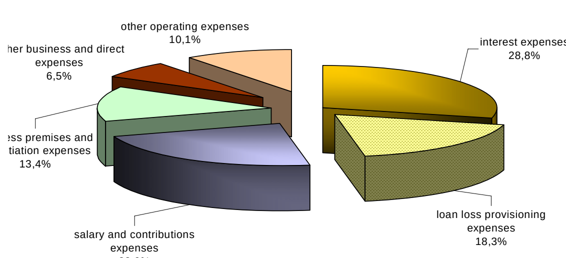
Structure of total expenses	30.09.2004.		30.09.2005.		30.08.2006.		RATIO	
	Amount	%	Amount	%	Amount	%	4/2	6/4
1	2	3	4	5	6	7	8	9
I Interest expenses and similar expenses								
Deposits	71.505	17,5	98.862	19,9	124.245	21,3	138	126
Liabilities for borrowings	15.197	3,7	24.920	5,0	36.829	6,3	164	148
Other interest expenses	2.380	0,6	4.493	0,9	6.933	1,2	189	154
TOTAL	89.082	21,8	128.275	25,8	168.007	28,8	143	131
II Total non-interest bearing expenses								
General loan risk and potential loan losses provisioning	83.080	20,3	95.683	19,2	106.991	18,3	115	112
Salary expenses	106.953	26,2	120.880	24,3	133.746	22,9	113	111
Business premises and depreciation expenses	61.590	15,1	70.744	14,2	78.003	13,4	115	110
Other business and direct expenses	23.659	5,8	27.592	5,6	37.895	6,5	117	137
Other operating expenses	44.574	10,9	54.154	10,9	59.258	10,1	121	109
TOTAL	319.856	78,2	369.053	74,2	415.893	71,2	115	113
I Interest expenses and similar expenses	408.938	100,0	497.328	100,0	583.900	100,0	122	117

Graph 15: *Structure of total expenses*

30.09.2005.



30.09.2006.



The following tables present the most significant ratios[22] for evaluation of profitability, productivity and effectiveness of banks:

Table 26: *Ratios of profitability, productivity and effectiveness by periods*

-in %-

RATIOS	31.12.2004.	31.12.2005.	30.09.2006.
Return on Average Assets	0,69	0,72	0,99
Return on Average Total Capital	5,57	6,31	9,22
Return on Average Equity	6,61	7,81	12,14
Net Interest Income/Average Assets	4,08	4,05	3,80
Fee Income/Average Assets	3,41	3,03	2,79
Total Income/Average Assets	7,49	7,08	6,59
Operating and Direct Expanses23/Average Assets	2,20	2,01	1,95
Operating Expenses/Average Assets	4,57	4,28	3,65
Total Non-interest Expanses/Average Assets	6,76	6,29	5,60

Table 27: *Ratios of profitability, productivity and effectiveness as of 30.09.2006.*

-in %-

RATIOS	30.09. 2006.		
	STATE BANKS	PRIVATE BANKS	AVERAGE IN THE FBiH
Return on Average Assets	0,57	1,00	0,99
Return on Average Total Capital	1,40	10,67	9,22
Return on Average Equity	1,61	14,66	12,14
Net Interest Income/Average Assets	3,42	3,82	3,80
Fee Income/Average Assets	5,00	2,69	2,79
Total Income/Average Assets	8,41	6,51	6,59
Operating and Direct Expanses/Average Assets	3,53	1,88	1,95
Operating Expenses/Average Assets	4,31	3,62	3,65
Total Non-interest Expanses/Average Assets	7,85	5,51	5,60

Based on the analysis of general parameters for evaluation of profitability quality, we have concluded that apart from the fact that the amount of generated profit is higher in comparison to the same period last year, and with ROAA (Return on Average Assets) being 0,99% and ROAE (Return on Average Equity) being 12,14%, productivity of banks, when measured as ratio between total income and average assets (6,59%), and net interest income realized and operating income per unit of average assets, has deteriorated due to further faster growth of average assets than total income (net interest and operating income) on one side, and significant participation of non-income-generating-assets or minimum income generating assets, fixed assets, etc., on the other side. On the expenses side, the indicators are somewhat better in comparison to previous year, which resulted from significant growth of assets, and not the improvement in expenses management.

All key indicators of profitability, analyzed upon ownership criteria in banks, indicate that private banks operate more cost-effectively, productively and efficiently, which gives them competitive advantage in comparison to state banks and it calls for necessity to finalize privatization of remaining state banks.

[22] The ratios as of 30.09.2006. are calculated on annual basis.

23 Expenses include provisions for potential loan losses.

Profitability of banks in the following period will still depend on assets quality, that is, exposure of banks to credit risk, and effective operating expenses management. That is why, the key factor of effectiveness and profitability of each bank is management quality and business policy the management is following, since this is the most direct way to influence its performance.

2.3. Liquidity

Liquidity risk management, along with credit risk, is one of the most compound and most important segments of banking operation. Maintaining liquidity in market economy is a permanent task of a bank and main precondition for its sustainability in financial market. This is also one of the key preconditions for establishment and maintenance of trust in banking system of any country.

Decision on Minimum Standards for Liquidity Risk Management prescribes minimum standards a bank has to establish and maintain in the process of managing this risk, that is, minimum standards to create and implement liquidity policy, which assures bank's ability to fully and immediately perform its liabilities as they become due.

The mentioned regulation represents a framework for liquidity risk management and qualitative and quantitative provisions and requirements towards banks. It prescribes limits banks have to meet in regard to average ten-day minimum and daily minimum of cash assets in relation to short-term sources, as well as minimum limits of maturity adjustment of the instruments of financial assets and liabilities up to 180 days.

Analysis of liquidity risk exposure and liquidity position of banks individually and of the entire banking system is based on the submitted set of reports related to the segment of liquidity, including all other relevant data from other reports, as well examination performed by on-site examiners of bank's liquidity position adequacy and practices in management of sources in relation to its risk.

For the last three years, banks in the Federation of BiH, upon orders issued by the FBA, have implemented intensive activities in order to improve their maturity adjustment of financial assets and liabilities, which was significantly undermined in the preceding period due to credit expansion of primarily long term loans financed from the sources (deposits mostly) that did not have adequate maturity. The implemented activities and measures had positive effect on decrease of imbalance in maturity profiles of assets and liabilities, and the result was adjustment within prescribed limits.

In the structure of financing sources of banks in the Federation of BiH, deposits have the highest participation of 73,4% and borrowings of 12,3%, which have longer maturity and represent good quality source for long term placements, and have significantly contributed to the maturity adjustment of assets and liabilities.

On the other hand, maturity structure of deposits is much worst, although we have trend of improvement for longer period of time. Liquidity risk is closely correlated with other risks, and in this case, it has adverse effect to the profitability of banks.

Table 28: *Maturity structure of deposits*

- in 000 KM-

DEPOSITS	31.12.2004.		31.12.2005.		30.09.2006.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Savings and demand deposits	2.663.053	47,5	3.264.937	47,5	3.854.590	48,6	123	118
Up to 3 months	389.395	7,0	408.679	6,0	289.422	3,7	105	71
Up to 1 year	490.685	8,8	541.832	7,9	711.544	9,0	110	131
1. Total S-T	3.543.133	63,3	4.215.448	61,4	4.855.556	61,3	119	115
Up to 3 years	1.367.882	24,4	1.709.665	24,9	2.101.465	26,5	125	123
Over 3 years	691.223	12,3	938.935	13,7	966.399	12,2	136	103
2. Total L-T	2.059.105	36,7	2.648.600	38,6	3.067.864	38,7	129	116
TOTAL (1 + 2)	5.602.238	100,0	6.864.048	100	7.923.420	100	123	115

In the analysis of maturity structure of deposits based on two main groups, in comparison to 2005, we noted somewhat faster growth of long term deposits (16% or KM 419 million) in relation to short term deposits (15% or KM 640 million).

In short term deposits, the highest nominal increase, in comparison to 2005, of KM 590 million (growth rate of 18%) was recorded in demand deposits, with significant increase of the deposits of government institutions of 60% or KM 344 million (only in third quarter of 2006 they increased by KM 210 million), which is most probably the result of increase of collected funds based on VAT. Term deposits over three months to one year had the highest increase of 31% or KM 170 million.

Since growth rates in both groups of deposits were almost the same, their participations remained the same as in 2005 (short-term of 61,3%, and long-term of 38,7%). We should emphasize that there is a dominant participation of long term deposits in two sectors: citizens of 45,1% and banking institutions of 28,9%, where citizen deposits make 56,9% of term deposits up to three years, and, in term deposits over three years, the funds of banking institutions participate with 62,4%.

In the function of planning necessary level of liquid resources, banks have to plan for sources and structure of adequate liquidity potential, along with planning of credit policy. Maturity of placements, that is, credit portfolio is determined by maturity of sources. Since maturity transformation of assets in banks is inherently connected to the functional characteristics of banking performance, banks continuously control and maintain maturity imbalance between sources and placements within prescribed minimum limits.

Table 29: *Maturity structure of loans*

-in 000 KM-

LOANS	31.12.2004.		31.12.2005.		30.09.2006.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Past due claims and paid off-balance sheet liabilities	214.244	4,8	218.177	3,9	247.296	3,9	102	113
Short term loans	991.183	22,4	1.134.850	20,5	1.270.331	19,9	115	112
Long term loans	3.217.112	72,8	4.192.050	75,6	4.853.417	76,2	130	116
TOTAL LOANS	4.422.539	100,0	5.545.077	100,0	6.371.044	100,0	125	115

In 2006, long term loans increased by 16% or KM 661 million (citizens loans participated with 72%), and short term loans increased by 12% or KM 135 million (private enterprises loans participated with 79%), which resulted by changes of their structure in total loans (participation of long term loans increased by 0,6%, that is, 76,2%, by which participation of short term loans decreased).
Analysis of the sector by maturity indicates that participation of long-term loans in total loans originated to citizens is 90%, and to private enterprises is 61%.

In the structure of assets, loans, as the most significant category, still have the highest participation of 59%.

In 2005, banks were regularly meeting required reserves with the Central Bank of BiH. At the end of 2005, the regulation changed and required reserves increased. The effective date of the change was December 1, 2005, when the required reserve increased from 10% to 15%. In BiH, under the environment of Currency Board and relatively financially underdeveloped market, required reserve as the most significant instrument of monetary policy is used to meet a primary monetary purpose, that is, monetary control, in sense of stopping fast credit growth from the past years and decrease multiplications. On the other hand, implementation of regulation on foreign exchange risk and maintenance of currency adjustment within prescribed limits also significantly influence the amount of funds banks keep on the reserve account with the Central Bank in domestic currency, which provides for high liquidity of individual banks and the banking sector, although it has an adverse impact to the profitability of banks.

In liquidity analysis, we use several ratios, and list of the most significant is presented in the following table:

Table 30: *Liquidity ratios*

- in % -

Ratios	31.12.2004.	31.12.2005.	30.09.2006.
1	2	3	4
Liquid assets[24] / Total assets	37,3	37,8	38,1
Liquid assets / Short term financial liabilities	60,5	63,9	61,7
Short term financial liabilities / Total financial liabilities	70,4	66,9	69,4
Loans / Deposits and borrowings[25]	68,5	69,2	68,8

Although in the first half of 2006 we have experienced minor deterioration of general indicators of liquidity, primarily due to further growth of credit placements, in spite of everything liquidity position of the banking system in the Federation of BiH is good, with satisfactory participation of liquid assets in total assets and coverage of short-term liabilities by liquid assets. Maturity structure of sources, primarily deposits, as well as realized higher increase of short-term financial liabilities (deposits) caused some slight deterioration of structural indicators for participation of short-term liabilities in total financial liabilities, although this is just conditional, since more relative indicator is the ratio of short-term liabilities and short-term financial assets based on the criteria of remaining maturity. The last indicator expressed as ratio between loans and financing sources (deposits and borrowings) is

[24] Liquidity assets in the narrow sense: cash and deposits and other financial assets with maturity below three months, except inter-banking deposits.
[25] Feasible standards: below 70%-very sound, 71%-75%-satisfactory, 76%-80%-marginal to satisfactory, 81%-85%-insufficient, over 85%-critical.

also very good and it meets the level of feasible standard, although it has decreased by 1,7% comparison to 2005.

Regulatory requirements prescribed towards banks are quite restrictive, which resulted in good liquidity of banks individually and the entire banking system. All banks continuously meet prescribed minimum over the average, requirement of ten-day average of 20% in relation to short-term sources, and daily minimum of 10% according to the same basis, which is presented in the following table.

Table 31: *Liquidity position –ten-day average and daily minimum*

Description	31.12.2004. Amount	31.12.2005. Amount	30.09.2006. Amount	RATIO 3/2	RATIO 4/3
1	2	3	4	5	6
1. Average daily balance of cash assets	2.502.469	2.687.043	3.204.019	107	119
2. Minimum total daily balance of cash assets	2.305.200	2.371.336	3.061.895	103	126
3. Short term sources (accrual basis)	3.598.348	4.165.268	4.750.408	116	114
4.Liabilities:					
4.1. ten-day average 20% of Item 3	719.670	833.054	950.082	116	114
4.2. daily minimum 10% of Item 3	359.835	416.527	475.041	116	114
5.Meeting requirement: ten-day average					
Surplus = Item 1 – Item 4.1.	1.782.799	1.853.989	2.253.937	104	122
6. Meeting requirement: daily minimum					
Surplus = Item.2 – Item 4.2.	1.945.365	1.954.809	2.586.854	100	132

Apart from the mentioned prescribed minimum standards, monitoring of remaining maturity of financial assets and liabilities according to the time scale is of crucial significance for the liquidity position analysis. The time scale is, from the aspect of prescribed minimum limits, created based on time horizon up to 180 days.

Table 32: *Maturity adjustment of financial assets and liabilities up to 180 days*

Description	31.12.2004. Amount	31.12.2005. Amount	30.09.2006. Amount	RATIO 3/2	RATIO 4/3
1	2	3	4	5	6
I. 1- 30 days					
1. Financial assets	3.357.819	4.051.257	4.762.508	121	118
2. Financial liabilities	3.121.488	3.668.868	4.300.103	118	117
3. Difference (+ or -) = 1-2	236.331	382.389	462.405	162	121
Accrual of requirement in %					
a) Performed %= Item 1 / Item 2	107,6%	110,4%	110,80%		
b) Required minimum %	100,0%	100,0%	100,00%		
Surplus (+) or shortage (-) = a – b	7,6%	10,4%	10,80%		
II. 1-90 days					
1. Financial assets	3.723.961	4.559.015	5.255.754	123	115
2. Financial liabilities	3.496.272	4.150.956	4.764.805	119	115
3. Difference (+ or -) = 1-2	227.689	408.059	490.949	179	120
Accrual of requirement in %					
a) Performed %= Item 1 / Item.2	106,5%	109,8%	110,30%		
b) Required minimum %	100,0%	100,0%	100,00%		
Surplus (+) or shortage (-) = a – b	6,5%	9,8%	10,30%		
II. 1-180 days					
1. Financial assets	4.188.159	5.091.381	5.839.617	122	115
2. Financial liabilities	3.877.037	4.598.836	5.349.054	119	116
3. Difference (+ or -) = 1-2	311.122	492.545	490.563	158	100
Accrual of requirement in %					
a) Performed %= Item 1 / Item.2	108,0%	110,7%	109,20%		

b) Required minimum %	95,0%	95,0%	95,00%
Surplus (+) or shortage (-) = a – b	13,0%	15,7%	14,20%

We can conclude from the schedule that as of 30. 09. 2006. banks complied with the limits prescribed, reaching better maturity adjustment between financial assets and liabilities in relation to the limits prescribed and in relation to 2005.

Liquidity of the banking system of the Federation of BiH, based on the presented indicators, is high, which is a result of existing restrictive regulation. Since this segment of performance and level of liquidity risk exposure is in correlation with credit risk, and having in mind increasing trend and level of credit risk, banks will in future have to pay more attention to liquidity risk management through establishment and implementation of liquidity policies, which will make sure that all matured liabilities of banks are timely realized, based on continuous planning of future liquidity needs and taking into account changes in operating, economic, regulatory and other segments of business environment of banks. The FBA will both through reports and on-site examination in banks monitor how banks manage this risk and if they acted in accordance with the adopted policies and programs.

2.4. Foreign exchange risk – foreign currency adjustment of balance sheet and off-balance sheet assets and liabilities

While operating, banks are exposed to significant risks coming from potential losses in balance sheet and off-balance sheet items created as a result of price changes in the market. One of those risks is foreign exchange risk (FX) created as a result of changes of exchange rates and/or imbalance in assets, liabilities and off-balance sheet items of the same currency – individual foreign currency position or all currencies together used by a bank in its operations – total foreign currency position of bank.

In order to enable implementation of prudential principles in foreign exchange activities of banks and to decrease influence of foreign exchange risk to their profitability, liquidity and capital, the FBA issued Decision on Minimum Standards for Foreign Exchange Risk Management in Banks that regulates minimum standards for adoption and implementation of programs, policies and procedures for undertaking, monitoring, control and management of foreign exchange risk.

Imbalance (difference) between the items relating to individual foreign currency in assets and liabilities of balance sheet and off-balance sheet represents an open foreign currency position (long or short), which can vary only within the minimum limits prescribed and calculated in relation to the amount of bank's core capital.[26]

Banks daily report to the FBA as part of the monitoring of prescribed limits. Based on examination, monitoring and analysis of submitted reports on foreign currency position of banks, we can conclude that banks meet prescribe limits and perform their FX activities within those limits.

Since the Central Bank functions as Currency Board and EURO is anchor currency of the Currency Board, in practice banks are not exposed to foreign exchange risk in case of the most significant currency EURO. However, during the past two years, based on the order issued by the FBA, banks have started taking significant activities to comply with the prescribed limits and to eliminate huge currency imbalances and incompliance, most of them in EURO. Method of compliance, then maintaining of foreign currency position in accordance with prescribed

[26] Article 8 of Decision on Minimum Standards for Capital Management of Banks determines limits for individual foreign currency position in EURO up to 30% of core capital, for other currencies up to 20% and foreign currency of bank up to 30%.

limits, was specific to individual bank and mostly determined by balance sheet and currency structure of balance sheet assets and liabilities.

As of 30.09.2006., currency structure of banks' assets on the level of banking system recorded participation of items in foreign currencies of 24,5% or KM 2,6 billion (26,5% or KM 2,48 billion at the end of 2005). On the other hand, currency structure of liabilities is significantly different, since participation of liabilities in foreign currency is higher of 54,3% or KM 5,9 billion (55,7% or KM 5,2 billion at the end of 2005).
Furthermore, if we analyze structure of foreign currencies, we will see a dominant participation of EURO in financial assets[27] of 81% or KM 2,1 billion (77% or KM 1,9 billion at the end of 2005), and in liabilities of 89,5% or KM 5,2 billion (89% or KM 4,7 billion at the end of 2005).

However, the accrual of FX risk exposure includes amount of indexed assets items (loans) and liabilities[28], especially significant in assets[29]. Participation of loans contracted with foreign currency clause in financial assets was 59,4% or KM 3,9 billion. Out of total net loans, 63,5% were contracted with currency clause, primarily in EURO. Participation of other assets items in EURO was 32,9% or KM 2,1 billion, and 7,7% in other currencies (at the end of 2005, indexed loans participated with 56% or KM 3,2 billion, and items in EURO with 34% or KM 1,9 billion).

On the other side, structure of financial liabilities restricts and determines structure of financial assets for individual currencies. Items in EURO (deposits mostly) have the highest participation in liabilities of 86% or KM 5,2 billion, while participation and amount of indexed liabilities is at minimum of 4% or KM 245 thousand (at the end of 2005, liabilities in EURO participated with 86% or KM 4,7 billion, and indexed liabilities with 3,5% or KM 190 thousand).
The following table presents structure and trend of financial assets and liabilities and foreign currency position for EURO as the most significant currency[30] and total:

Table 33: *Foreign currency adjustment of financial assets and liabilities (EURO and total)*
-in KM millions-

Description	31.12.2005.				30.09.2006.				RATIO	
	EURO		TOTAL		EURO		TOTAL		EURO	TOTAL
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	6/2	8/4
1	2	3	4	5	6	7	8	9	10	11
I. Financial assets										
1. Cash assets	1.217	23,8	1.706	30,0	1.423	23,9	1.866	28,7	117	109
2. Loans	598	11,7	653	11,5	612	10,3	654	10,0	102	100
3.Loans with currency clause	3.198	62,5	3.203	56,3	3.816	64,0	3.864	59,4	119	121
4. Other	105	2,0	124	2,2	106	1,8	116	1,9	101	94
Total (1+2+3+4)	5.118	100,0	5.686	100,0	5.957	100,0	6.507	100,0	116	114
II. Financial liabilities										

[27] Form 5-Foreign currency position: portion of financial assets (foreign currencies denominated in KM). According to prescribed methodology, financial assets are expressed per net principle (loan loss reserves deducted).
[28] As headging instrument for exchange rate changes, banks contract certain assets items (loans) and liabilities with currency clause – they are almost all tied to EURO (regulation allows only two-way currency clause).
[29] Financial assets, which include items in foreign currency, denominated in KM and loans with currency clause.
[30] Source: Form 5-Foreign currency position.

1. Deposits	3.447	70,9	3.956	73,1	3.795	69,1	4.371	71,6	110	110
2. Borrowings	1.052	21,7	1.093	20,1	1240	22,6	1278	20,9	118	117
3.Deposits and loans with currency clause	190	3,9	190	3,5	245	4,5	245	4,0	129	129
4.Other	170	3,5	176	3,3	210	3,8	213	3,5	124	121
Total (1+2+3+4)	4.859	100,0	5.415	100,0	5.490	100,0	6.107	100,0	113	113
III. Off-balance sheet										
1.Assets	11		13		33		107		300	823
2.Liabilities	196		197		355		357		181	181
IV.Position										
Long (amount)	74		86		146		151			
%	8,2%		9,6%		14,9%		15,4%			
Short										
%										
Limit	30%		30%		30%		30%			
Below limit	21,8%		20,4%		15,1%		14,6%			

Observed by banks and total on the level of the banking system of the FBiH, we can conclude that banks are exposed to FX risk within prescribed limits.

As of 30.09.2006., there were 18 banks with long foreign currency position, and 4 banks with short position, so on the system level long foreign currency position represented 15,4% of core capital of banks, which was less by 14,6% than the limit. Individual foreign currency position for EUR was 14,9% where financial assets items were higher than financial liabilities (long position).

Although in the environment of the Currency Board banks are not exposed to foreign exchange risk in the most significant currency EUR, they are still required to operate within prescribed limits for individual currencies and for total foreign currency position and to daily manage this risk in accordance with adopted programs, policies, procedures and plans.

III. CONCLUSION

Consolidation and stabilization of the 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, consequently, 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 consolidation and establishment of banking supervision on state level;
- Finalize privatization process of state banks, that is, define resolution of their status;
- 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, leasing companies, 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 divisions for economy;

- Establish more efficient process for realization of pledges;
- Pass laws for protection of creditors and more and concrete accountability of debtors;
- Pass law or improve existing regulation regulating the area of safety and protection of money while in bank and in transportation.

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, emphasizing targeted examination of dominant risk segments of banking operations, which will make supervision more frequent and effective;
- Continue systematic monitoring of anti-money laundering and terrorism financing activities and improve cooperation with other supervisory and examination institutions;
- Finalize remaining provisional administrations based on the Conclusion of the FBA's Management Board of 29.03.2006. and accelerate liquidation processes;
- Insist on strengthening of capital in banks, especially those that have recorded rapid growth in assets;
- In order to protect depositors, keep on with continuous supervision of banks with high concentration of savings and other deposits;
- Require from banks, through the regulations, to establish and implement effective protection of money in bank and in transportation, which will be monitored and supervised through on-site examinations by the FBA;
- Work on further development of regulations under the authority of the FBA, starting from Basle Principles and incorporating European Directives, as part of preparation process of becoming part of European Union;
- Work on continuous education and training of its own staff;
- Maintain continuity in payment system examinations;
- Continuous operational development of the new IT 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;
- Organize counseling and provide advising about implementation of banking regulations, etc.

Banks, as the most important part of the system, have to concentrate their actions to:
- Further strengthen capital in proportion with growth of assets and risks;
- Improve assets quality;
- Strengthen internal control systems and establish internal audits, which will be fully independent in their work;
- 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;
- Staff training and professional development;
- Maintaining continuity in prevention of money laundering and terrorism financing by implementation of adopted policies and procedures;
- According to the regulation, pass, establish and implement internal acts which will include adequate procedures related to safety and protection of money in bank and in transportation;
- 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;
- Regularly and timely submit data to the Central Credit Registry and Unified Central Account Registry with the Central Bank of BiH, as use the information from the Registries for their own purposes.