



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

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*FBA*

INFORMATION  
ON BANKING SYSTEM IN  
THE FEDERATION OF BOSNIA AND HERZEGOVINA  
As of 09/30/03

**Sarajevo, November 2003**

Banking Agency of the Federation of BiH, as regulatory institution performing supervision of banks, has completed Information on the banking system of the Federation of BiH (as of September 30<sup>th</sup> 2003) based on the reports of banks, and other information and data submitted by banks. The information also includes findings and information attained during on-site examinations and analysis performed in the Agency (off-site financial analysis).

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## ***ATTACHMENTS***

## I. INTRODUCTION

Banking sector in the Federation of BiH in the first three months of 2003 maintains the trends observed in the previous two years. The achieved results represent a reliable basis for making an estimate that until the end of the year the planned goals on the system level will be realized, but we have to conclude that there is a difference when individual banks are viewed. E.g., out of total growth of the balance sheet in the system, 73% or 559 million KM was performed by the five largest banks. On the other hand, remaining banks have assets less than in 2002.

Total assets on the system level increased to 5.35 billion KM, which is by 766 million KM or by 17% higher than at the end of 2002. The sources of growth primarily come from deposits increased by 514 million KM and or 14% and capital that has been increased by 80 million KM or 13%. There is also a slow trend of increase observed in loans as source of financial strength. At the end of September, they represented 8% of sources, which is by 1.2% higher than at the end of 2002.

In the assets structure, total loans increased by 21% or by 577 million KM, and cash assets by 14% or 223 million KM. Loans to citizens increased by 27%, and to private companies by 23%. This is a significantly favorable ratio in comparison to the previous year, when loans to citizens increased according to the rate of 103%, and to private companies according to 40%. When we talk about cash assets, we have noticed they changed direction. In foreign banks, deposits amounted to 1.1 billion KM or 59% of total cash assets, which in comparison to the end of 2002 amounts less by 5%, and in comparison to the first two quarters of the current year amounts represents a decrease by 20%. At the same time, deposits of banks at the reserve accounts in the Central Bank of BiH increased by 7% in comparison to the end of last year.

On the system level, there was a positive financial result performed of 37.8 million KM. At the same time, 17 banks reported profit of 53.3 million KM, and nine banks reported loss in total amount of 15.5 million KM. Negative result was reported by six private and three state banks. In the income structure, increase in interest income is noticeable that now makes 71% of total income in comparison to 61% in the same period last year. On the system level, we have noticed better profitability indicators: return on average assets (ROAA) is 1.04 % , and return on average equity (ROAE) is 7.44%, which is significantly better than last year.

In the observed period, we have noticed some intensified activities between banks and the Agency on prevention of money laundering and terrorism financing. Banks apply policies that are defined by FBA's Decision on Minimum Standards for Prevention of Money Laundering and Terrorism Financing, but, first of all, Policy on Customer's Identification. However, other policies have not been completely defined, that is, do not provide enough elements for assessment of risk management quality or of its quantification. Practically, in some program segments, banks are more formally than essentially complied with the Decision and international standards. More quality changes can be expected in the next period, after adoption of changes to the provisions of the Law on Banks and its compliance with the Law on Prevention of Money Laundering, which is especially related to the definition of term of the transactions that are subject to reporting and reporting models. All banks have adopted programs and appointed Coordinators (Coordinator for Bank's Compliance with Prescribed Standards for Prevention of Money Laundering and Terrorism Financing).

## II. OPERATIONAL PERFORMANCE IN BANKS OF THE FEDERATION OF BiH

As of 09/30/2003, 27 banks in the Federation of BiH had licenses for banking operation issued by FBA, and all of them performed banking operation. Regular reporting obligation was performed by all banks, except by Hercegovacka Bank d.d. Mostar, whose financial indicators were not included in the Information. In accordance with its authorization prescribed by the Law, FBA performed examinations of bank reports (off-site examination) and examinations in banks (on-site examinations).

### 1. STRUCTURE OF BANKING SECTOR

#### 1.1. Banking Licenses, Approvals, and Consents

In the third quarter of 2003, FBA revoked three banking licenses: Gospodarska Bank d.d. Sarajevo and LT Komercijalna Bank d.d. Livno due to statutory change of merger in LT Gospodarska Bank d.d. Sarajevo, and Raiffeisen Bank HPB d.d. Mostar due to merger to Raiffeisen Bank d.d. BH, Sarajevo. In the statute change of merger, a license for establishment and performance was issued to LT Gospodarska Bank d.d. Sarajevo.

As of 09/30/2003, nine banks from the Federation of BiH had twelve organizational units in Republic Srpska and nine in Breko District, and three banks from Republic Srpska had five organizational units in the Federation of BiH.

As of 09/30/2003, provisional administration was present in five banks:

- Gospodarska Bank dd Mostar,
- Hercegovacka Bank dd Mostar,
- Ljubljanska Bank dd Sarajevo,
- Poštanska Bank BiH dd Sarajevo and
- UNA Bank dd Bihac.

Reason for initiation of provisional administration was noncompliance with operational requirements prescribed by the Law. However, provisional administration in Hercegovacka Bank dd Mostar was initiated based on decision made by the High Representative for BiH.

As of 09/30/2003, 26 banks had Internal Payment System Operation License (all for interbank transactions), out of which 25 banks operationally performed payment system services.

#### 1.2. Ownership Structure

As of 09/30/2003, ownership structure in banks<sup>1</sup> was assessed based on available information and on-site in banks, as follows:

- In private or majority private ownership      20 banks (74%)
- In state or majority state ownership            7 banks (26%)

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<sup>1</sup> A criterion for classification of banks by type of ownership is ownership in share capital of banks.  
*Information on Banking System of the Federation of BiH*

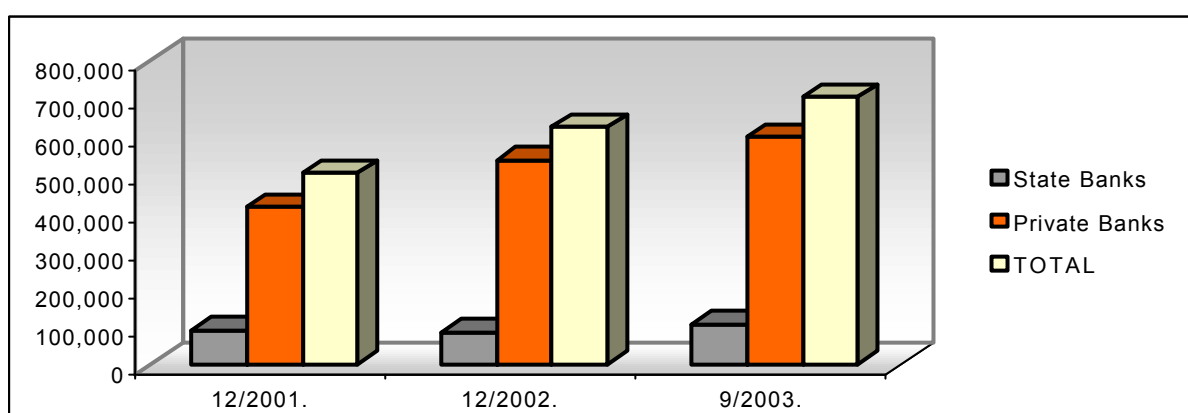
Ownership structure can also be viewed from the aspect of financial indicators or according to the value of total capital<sup>2</sup>.

**Table 1:** *Ownership Structure according to Total Capital*

-in 000 KM-

| BANKS         | 12/31/2001 |      | 12/31/2002 <sup>3</sup> |      | 09/30/2003 |      | RATIO |     |
|---------------|------------|------|-------------------------|------|------------|------|-------|-----|
|               | 1          | 2    | 3                       | 4    | 5          | 6    | 3/2   | 4/3 |
| State Banks   | 90,800     | 18%  | 85,491                  | 14%  | 105,928    | 16%  | 94    | 124 |
| Private Banks | 413,691    | 82%  | 540,305                 | 86%  | 599,722    | 84%  | 131   | 111 |
| TOTAL         | 504,491    | 100% | 625,796                 | 100% | 705,650    | 100% | 124   | 113 |

**Graph 1:** *Review of Ownership Structure (Total Capital)*



More detailed picture of ownership structure of capital in banks in the Federation of BiH is obtained by analysis of participation of state, private and foreign capital in share capital of banks.

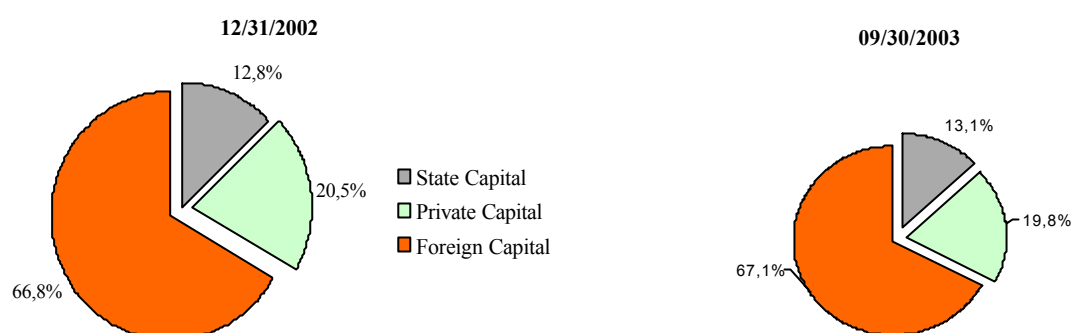
**Table 2:** *Structure of Ownership according to Participation of State, Private and Foreign Capital*

- in 000 KM-

| SHARE CAPITAL                  | 12/31/2001 |             | 12/31/2002 |             | 09/30/2003 |             | RATIO |     |
|--------------------------------|------------|-------------|------------|-------------|------------|-------------|-------|-----|
|                                | Amount     | Particip. % | Amount     | Particip. % | Amount     | Particip. % | 5/3   | 7/5 |
| 1                              | 3          | 4           | 5          | 6           | 7          | 8           | 9     | 10  |
| State Capital                  | 65,862     | 14.4        | 69,249     | 12.8        | 76,747     | 13.1        | 111   | 111 |
| Private Capital (Residents)    | 102,943    | 22.4        | 110,605    | 20.5        | 116,953    | 19.8        | 108   | 106 |
| Foreign Capital (Nonresidents) | 289,951    | 63.2        | 360,758    | 66.7        | 395,894    | 67.1        | 103   | 110 |
| TOTAL                          | 458,756    | 100.0       | 540,612    | 100.0       | 589,594    | 100.0       | 105   | 109 |

<sup>2</sup> Data from the balance sheet according to the FBA Schedule.

<sup>3</sup> All data from the Information related to 12/31/2002 are from the audited financial statements of banks (audit performed by external auditor).

**Graph 2: Review of Ownership Structure (Share Capital)**

Analysis of ownership structure, from the aspect of share capital, most precisely shows changes and trends in the banking system of the FBiH in the segment of changes in the ownership structure through the inflow of foreign capital (primarily from foreign banks).

Participation of state capital in total share capital of banks as of 09/30/2003 is higher by 0.3% in comparison to 12/31/2002. As of 09/30/2003, in the structure of share capital, participation of remaining state capital in private banks is below 1% or 1.2 million KM.

The most changes in the ownership structure in 2003 relate to the participation of capital from private (domestic) sector.

In comparison to 12/31/2002, participation of private capital (residents) in total capital of the banking sector was decreased from 20.5% to 19.8%, and at the same participation of foreign capital was increased from 66.8% to 67.1%.

Besides, the reform changes and stabilization of the condition in the banking system have caused higher inflow of foreign capital, primarily by foreign banks. The trend of increase of foreign capital participation in banks in the Federation will probably be continued in the near future, because of a need for capital basis strengthening and increase of capital adequacy ratio.

### 1. 3. Staff

As of 09/30/2003, in the banks in the FBiH there was total 5,341 employee (11% in banks in majority state ownership and 89% in private banks).

**Table 3: Employees in Banks of the FBiH**

| BANKS           | NUMBER OF EMPLOYEES |            |            | RATIO |     |
|-----------------|---------------------|------------|------------|-------|-----|
|                 | 12/31/2001          | 12/31/2002 | 09/30/2003 | 3:2   | 4:3 |
| 1               | 2                   | 3          | 4          | 5     | 6   |
| State Banks     | 554                 | 558        | 566        | 101   | 101 |
| Private Banks   | 4,056               | 4,543      | 4,775      | 112   | 105 |
| TOTAL           | 4,610               | 5,101      | 5,341      | 111   | 105 |
| Number of Banks | 32                  | 28         | 26         |       |     |

In the first nine months of 2003, number of employees was increased by 5% or 240 employees, primarily in private banks. Increase in number of employees in state banks is exclusively caused by ownership structure changes in one bank and its joining to the sector of state banks.

Increase in number of employees in banks is caused by new activities or increased operations and expansion of business units.

**Table 4:** *Qualification Structure of Employees*

| EDUCATION                      | NUMBER OF EMPLOYEES |            |            | RATIO |     |
|--------------------------------|---------------------|------------|------------|-------|-----|
|                                | 12/31/2001          | 12/31/2002 | 09/30/2003 | 3:2   | 4:3 |
| 1                              | 2                   | 3          | 4          | 5     | 6   |
| University Degree              | 1,434               | 1,683      | 1,822      | 117   | 108 |
| Two-year Post Secondary School | 467                 | 533        | 538        | 114   | 101 |
| Secondary School               | 2,483               | 2,665      | 2,772      | 107   | 104 |
| Other                          | 226                 | 220        | 209        | 97    | 95  |
| TOTAL                          | 4,610               | 5,101      | 5,341      | 111   | 105 |

In the observed period, number of employees with university degree increased by 8% or 139 employees. However, highest participation of 52% is still of the employees with secondary school.

One of the indicators of a successful banking system, and individual bank, is ratio between assets and number of employees or amount of assets per an employee. Higher ratio is an indicator of higher success in the performance of both bank and the whole system.

**Table 5:** *Assets per an Employee*

| BANKS   | 12/31/2001   |                 |                  | 12/31/2002   |                 |                  | 09/30/2003   |                 |                  |
|---------|--------------|-----------------|------------------|--------------|-----------------|------------------|--------------|-----------------|------------------|
|         | No. of empl. | Assets (000 KM) | Assets per empl. | No. of empl. | Assets (000 KM) | Assets per empl. | No. of empl. | Assets (000 KM) | Assets per empl. |
| State   | 554          | 378,256         | 684              | 558          | 345,299         | 619              | 566          | 371,728         | 657              |
| Private | 4,056        | 3,390,231       | 836              | 4,543        | 4,242,567       | 934              | 4,775        | 4,982,242       | 1,043            |
| TOTAL   | 4,610        | 3,768,487       | 818              | 5,101        | 4,587,866       | 899              | 5,341        | 5,353,970       | 1,002            |

As of 09/30/2003, on the banking system level, for each employee there would be approximately a million KM of assets, which is an increase in comparison to the end of 2002, both for the system and state and private bank sector.

Analytical indicators for individual banks vary from 152,000 KM to 2,343,000 KM of assets per employee. Nine banks had assets per employee less than 500,000 KM, which indicates high number of employees in comparison to the assets amount. In regard to that, high operating expenses have adverse impact to the profitability of those banks. On the other hand, ten banks had assets per employee higher than a million KM.

## 2. FINANCIAL INDICATORS OF BANKING OPERATIONS

Examination of banks through analysis of banks' reports is executed by review of reports regulated by FBA and reports for other institutions that compose a database based on three sources:

1. Information on Balance Sheet for all banks that are submitted monthly, including quarterly attachments to balance sheet - containing more detailed information on cash funds, loans, deposits and off balance sheet items, and some general statistical data.
2. Information on solvency of banks, information on capital and capital adequacy, assets classification, concentration for certain types of risks, liquidity position, exposure to foreign currency risk, based on the reports regulated by the FBA (quarterly) and
3. Information on operational results in banks (income statement - FBA format) and reports on cash flows, submitted to FBA quarterly.

Aside from the above listed standardized reports, data base also includes information from additional reports requested by FBA from banks in order to have the best conditions for monitoring and analysis of banks' operations in the Federation of BiH. Also, database includes audit reports of financial reports of banks prepared by independent auditor, and all other information relevant for rating of operational results for each bank individually and banking system in whole.

As it is regulated by the Law on Opening Balance Sheet in Banks, banks with predominantly state capital have to report to FBA a "full" balance sheet which would be classified in: passive, neutral and active sub-balance sheet. In order to have realistic indicators of banks' operational results in the Federation of BiH, all further analysis of banking system will be based on information from active sub-balance sheet for banks with predominantly state capital<sup>4</sup>.

## **2.1. Balance Sheet**

Based on the balance sheets submitted by banks in the Federation of BiH as of 09/30/03, total balance sheet was KM 5.4 billion, which is higher by 17% or 766 million KM in comparison to 12/31/02. The same growth ratio was achieved in the observed period and previous year 2002 (in comparison to the end of 2001), while in 2002 it was 22%. That implies moderate and stable trend of growth in the banking sector.

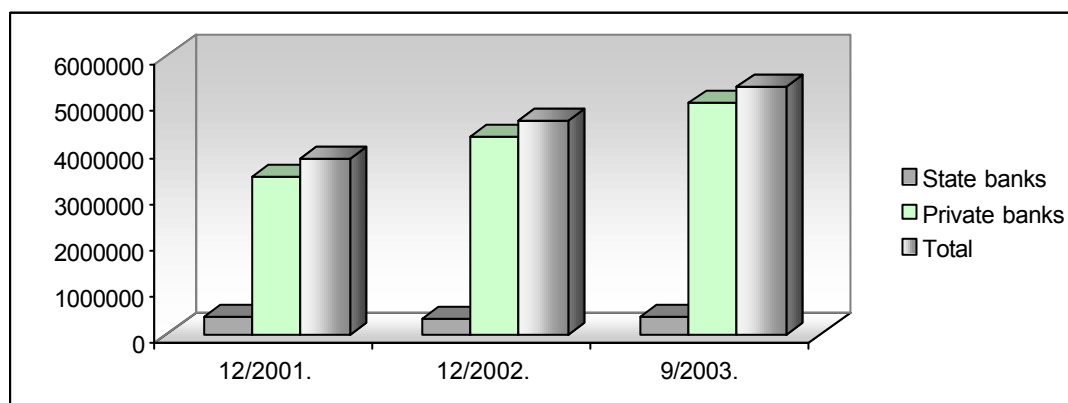
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<sup>4</sup> Some state owned banks reported passive and neutral items in their "full" balance sheet, which will be taken over by the state upon the finalization of the privatization process.



**Table 6 : Balance Sheet**

| DESCRIPTION                                     | AMOUNT ( in 000 KM ) |                  |                  | RATIO      |            |
|---|----------------------|------------------|------------------|------------|------------|
|   | 12/31/2001           | 12.31.2002       | 09/30/2003       | 3/2        | 4/3        |
| 1   | 2                    | 3                | 4                | 5          | 6          |
| <b>ASSETS:</b>                                  |                      |                  |                  |            |            |
| Cash assets                                     | 1,783,234            | 1,595,154        | 1,817,905        | 89         | 114        |
| Securities                                      | 51,436               | 73,150           | 24,494           | 142        | 33         |
| Placements to other banks                       | 25,355               | 19,952           | 40,918           | 79         | 205        |
| Loans – net value                               | 1,572,159            | 2,504,415        | 3,071,790        | 159        | 123        |
| Business premises and other fixed assets        | 273,981              | 295,578          | 297,042          | 108        | 100        |
| Other assets                                    | 62,322               | 99,617           | 101,821          | 160        | 102        |
| <b>UKUPNA AKTIVA</b>                            | <b>3,768,487</b>     | <b>4,587,866</b> | <b>5,353,970</b> | <b>122</b> | <b>117</b> |
| <b>LIABILITIES:</b>                             |                      |                  |                  |            |            |
| <b>PAYABLES</b>                                 |                      |                  |                  |            |            |
| Deposits  | 2,900,613            | 3,524,555        | 4,038,104        | 122        | 115        |
| Borrowings from other banks                     | 5,550                | 3,352            | 3,783            | 60         | 113        |
| Loan payables                                   | 253,269              | 313,009          | 427,502          | 124        | 137        |
| Other liabilities                               | 104,564              | 121,154          | 177,931          | 116        | 147        |
| <b>CAPITAL</b>                                  |                      |                  |                  |            |            |
| Capital   | 504,491              | 625,796          | 706,650          | 124        | 113        |
| <b>TOTAL LIABILITIES (PAYABLES AND CAPITAL)</b> | <b>3,768,487</b>     | <b>4,587,866</b> | <b>5,353,970</b> | <b>122</b> | <b>117</b> |

**Graph 3 : Assets of Banks according to Ownership Structure**

The mentioned growth was achieved exclusively by private banks. If we eliminate the influence of increase in assets due to changes in the ownership structure of one bank, we can make conclusion that state banks, as a sector, have assets less than at the end of 2002, which is a result of uncompleted privatization process, and, in that regard, stagnation or decrease in the volume of performance in these banks.

Analytical information by banks shows that in most of banks assets increased, and 11 banks had growth rate higher than 15%. Out of six banks with decreased assets, five of them are state owned, and only two banks reported significant decrease in the rate (11%, that is, 54%).

However, we should emphasize that out of total growth in the balance sheet total, 73% or 559 million KM relate to five largest banks in the system.

If the banking system is analyzed from the aspect of assets size and certain groups within that, changes in the participation and number of banks in individual groups are result of acquisitions/mergers in the first quarter of 2003 and assets growth in couple of larger banks. On the other hand, 13 banks had assets less than 100 million KM and their number and assets in absolute amount, and relatively through participation, have trend of decrease, which is continuation of the strengthening process in the banking sector.

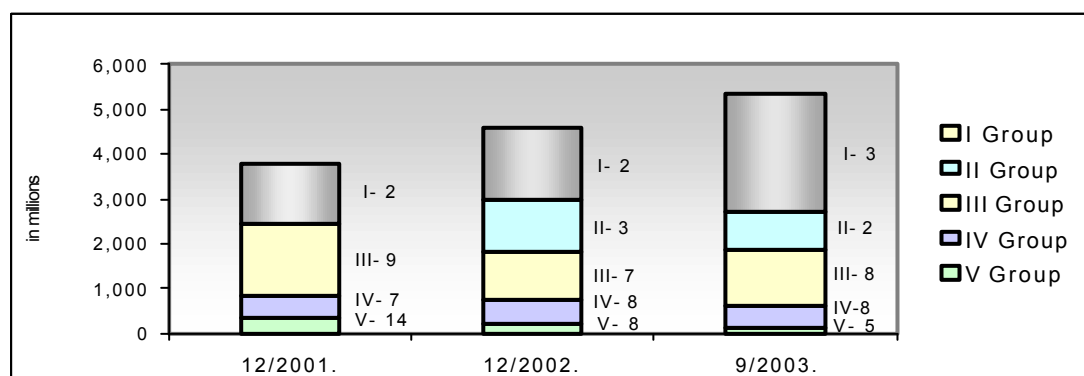
Indicators of further concentration in the assets amount in smaller number of banks is the information that participation of three largest banks in total assets of the banking sector have trend of increase, and as of 09/30/2003 it amounts to 49.8% or 2,666 million KM, which is by 574 million KM or 4.2% higher than at the end of 2002, while 13 banks from the first three groups have participation of 89.1%.

In the next table, we presented the schedule of amounts and participation of individual groups of banks<sup>5</sup> within total assets through periods (amounts are expressed in millions KM):

**Table 7:** *Participation of Individual Groups of Banks within Total Assets through Periods*

| ASSETS AMOUNT   | 12/31/2001 |             |              | 12/31/2002 |             |              | 09/30/2003 |             |              |
|-----------------|------------|-------------|--------------|------------|-------------|--------------|------------|-------------|--------------|
|                 | Amount     | Particip. % | No. of banks | Amount     | Particip. % | No. of banks | Amount     | Particip. % | No. of banks |
| I- Over 500     | 1,315      | 34.9        | 2            | 1,606      | 35.0        | 2            | 2,666      | 49.8        | 3            |
| II- 300 to 500  | -          | -           | -            | 1,163      | 25.3        | 3            | 812        | 15.2        | 2            |
| III- 100 to 300 | 1,632      | 43.3        | 9            | 1,072      | 23.4        | 7            | 1,259      | 23.5        | 8            |
| IV- 50 to 100   | 460        | 12.2        | 7            | 543        | 11.8        | 8            | 520        | 9.7         | 8            |
| V- Below 50     | 362        | 9.6         | 14           | 204        | 4.5         | 8            | 97         | 1.8         | 5            |
| TOTAL           | 3,769      | 100.0       | 32           | 4,588      | 100.0       | 28           | 5,354      | 100.0       | 26           |

**Graph 4 :** *Participation of Individual Groups of Banks within Total Assets through Periods*



Growth in the balance sheet total is mainly result of increase in sources of deposits (by 15% or 514 million KM) and capital (by 13% or 80 million KM).

<sup>5</sup> Banks are divided into five groups, depending on their assets size.

On the other hand, in the assets of banks, loans<sup>6</sup> continued further growth with the rate of 21% or 577 million KM, and cash assets increased by 14% or 223 million KM.

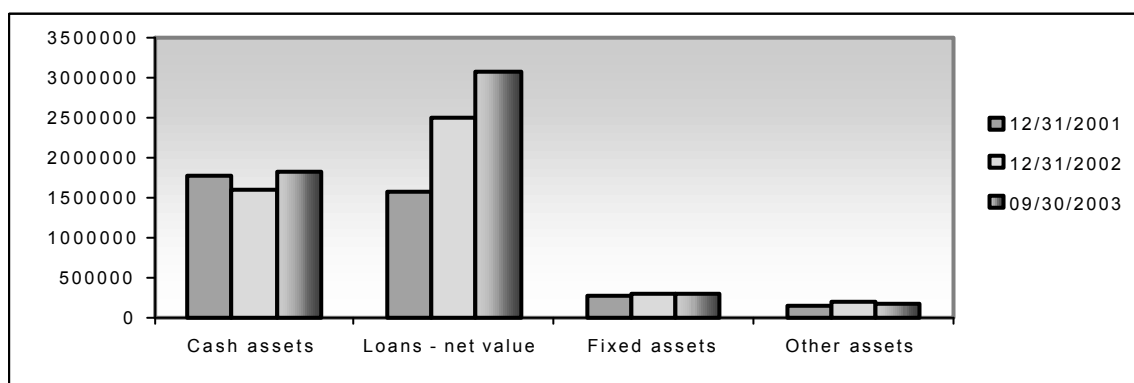
In the following table and graphs, we presented a comparative schedule of the most significant assets and liabilities balance sheet positions of banks:

**Table 8 : Structure of Balance Sheet of Banks**

- in % -

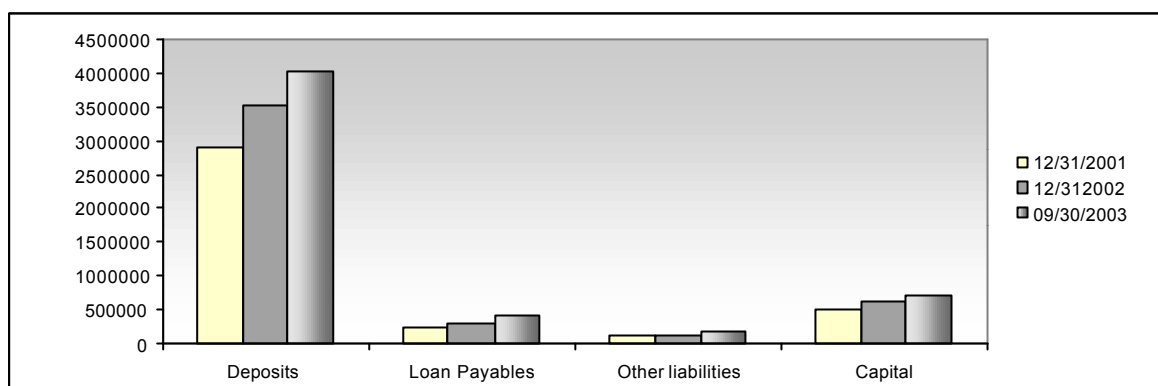
| DESCRIPTION                                     | PARTICIPATION |              |              |
|---|---------------|--------------|--------------|
|   | 12/31/2001    | 12/31/2002   | 09/30/2003   |
| <b>ASSETS:</b>                                  |               |              |              |
| Cash assets                                     | 47.3          | 34.8         | 34.0         |
| Securities                                      | 1.4           | 1.6          | 0.5          |
| Placements to other banks                       | 0.7           | 0.4          | 0.8          |
| Loans- net value                                | 41.7          | 54.6         | 57.4         |
| Business premises and other fixed assets        | 7.2           | 6.4          | 5.5          |
| Other assets                                    | 1.7           | 2.2          | 1.8          |
| <b>TOTAL ASSETS</b>                             | <b>100.0</b>  | <b>100.0</b> | <b>100.0</b> |
| <b>LIABILITIES:</b>                             |               |              |              |
| <b>PAYABLES</b>                                 |               |              |              |
| Deposits  | 77.0          | 76.8         | 75.4         |
| Borrowings from other banks                     | 0.2           | 0.1          | 0.1          |
| Loan payables                                   | 6.7           | 6.8          | 8.0          |
| Other liabilities                               | 2.7           | 2.6          | 3.3          |
| <b>CAPITAL</b>                                  |               |              |              |
| Capital   | 13.4          | 13.6         | 13.2         |
| <b>TOTAL LIABILITIES (PAYABLES AND CAPITAL)</b> | <b>100.0</b>  | <b>100.0</b> | <b>100.0</b> |

**Graph 5 : Structure of Balance Sheet Assets of Banks**



**Graph 6 : Structure of Balance Sheet Liabilities of Banks**

<sup>6</sup> Gross-loans (information from the balance sheet)



Balance sheet liabilities structure remains almost unchanged in comparison to the end of 2002, and deposits with participation rate of 75.4% are still dominant in establishment of financial strength of banks.

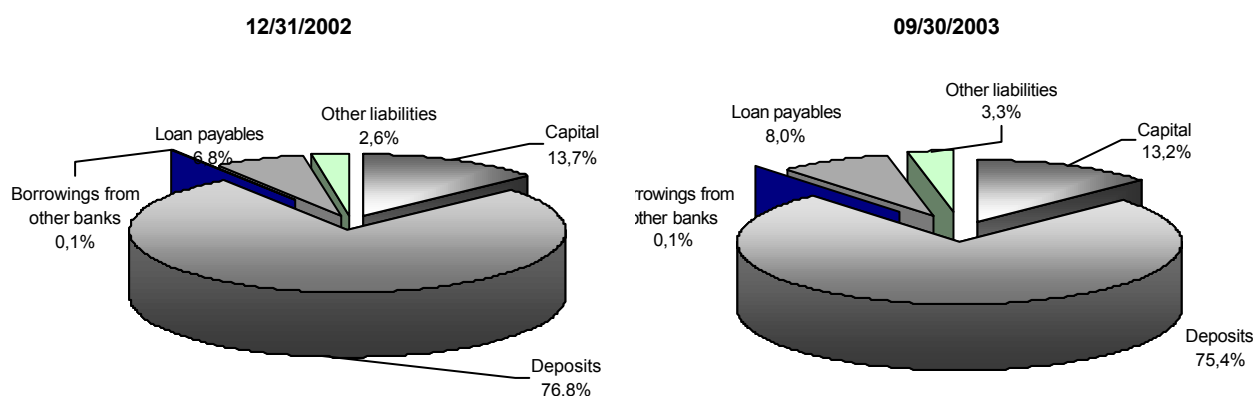
The most significant change in the assets structure is increase in participation of loans by 2.8%, so, as of 09/30/2003, net loans amounted to 57.4% of banks' assets. At the same time, participation of cash assets decreased by 0.8% (from 34.8% to 34.0%).

Banks in the Federation of BiH still hold significant cash assets on the accounts of deposit institutions abroad. However, in comparison to the previous two quarters when approximately 71% of the assets was deposited in banks abroad, in the third quarter of 2003 we had significant decrease of these assets and their transfer to the reserve account at the Central Bank of BiH. As of 09/30/2003, 59% or 1.1 million KM was deposited in banks abroad out of total cash assets, that in comparison to 2002 represents decrease by 5%. On the other hand, participation of assets on the reserve accounts at the Central Bank of BiH increased in comparison to the end of 2002 by 7% (from 23.3% to 29.9%). The mentioned changes reflected on currency structure of cash assets, that is, there was decrease in participation of cash assets in foreign currencies from 70.4% to 64.1%, and increase in participation of local currency from 29.6% to 35.9%.

### 2. 1. 1. Liabilities (Payables and Capital)

As of 09/30/2003, structure of liabilities and capital in the balance sheet is presented in the following graphs:

**Graph 7 : Structure of Liabilities in Banks**



Liabilities structure is slightly changed in comparison to the end of 2002. Although deposits as primary source of financing still have the highest participation of 75.4%, they are still in comparison to the end of 2002 decreased by 1.4%, as well as participation of capital that is less by 0.5%. Evidently, we still have a slight trend of increase in loans as sources.

In nine months of 2003, deposits increased by 15% or 514 million KM, exclusively in private banks (by 16% or 523 million KM), while in state banks, in comparison to the end of 2002, deposits decreased by 4% or 9 million KM.

In private banks, participation of deposits in liabilities amounted to 77%, and in state banks to 58%.

In 2003, trend of slight improvement in maturity structure of deposits continued. Higher rate of increase in long-term deposits (30.9%) than in short-term deposits (9.4%) in nine months of 2003 resulted in some changes in participation in the structure, and increase of participation of long-term deposits from 24% to 27.4%, although generally maturity structure of deposits is still not satisfactory.

**Table 9 : Maturity Structure of Deposits**

- in 000 KM -

| DEPOSITS                    | 12/31/2001 |             | 12/31/2002 |             | 09/30/2003 |             |
|-----------------------------|------------|-------------|------------|-------------|------------|-------------|
|                             | Amount     | Particip. % | Amount     | Particip. % | Amount     | Particip. % |
| Savings and Demand Deposits | 1,779,672  | 61.4        | 2,012,241  | 57.0        | 2,188,694  | 54.2        |
| Up to 3 months              | 413,465    | 14.2        | 317,862    | 9.0         | 318,137    | 7.9         |
| Up to 1 year                | 280,243    | 9.7         | 349,586    | 9.9         | 425,606    | 10.5        |
| 1. Total short-term         | 2,473,380  | 85.3        | 2,679,689  | 76.0        | 2,932,437  | 72.6        |
| Up to 3 years               | 242,924    | 8.4         | 416,718    | 11.8        | 594,888    | 14.7        |
| Over 3 years                | 184,309    | 6.3         | 428,148    | 12.2        | 510,778    | 12.7        |
| 2. Total long-term          | 427,233    | 14.7        | 844,866    | 24.0        | 1,105,666  | 27.4        |
| TOTAL (1 + 2)               | 2,900,613  | 100.0       | 3,524,555  | 100.0       | 4,038,103  | 100.0       |

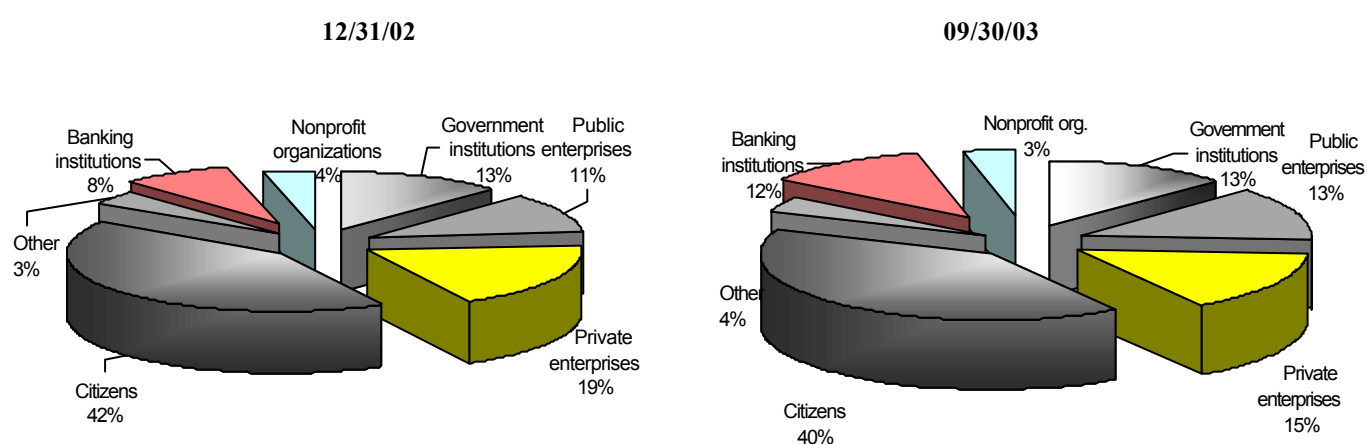
Maintaining adequate maturity match between sources and placements is one of the most important segments of risk management or bank's exposure to liquidity risk. Any mismatch in the maturity represents actually a danger for future liquidity position, which can eventually endanger the overall financial condition of bank and question its solvency and further performance.

**Schedule 10 : Deposits structure by industry areas<sup>7</sup>**

- in 000 KM -

| INDUSTRY AREAS                       | 12/31/01  |                 | 12/31/02  |                 | 09/30/03  |                 |
|--------------------------------------|-----------|-----------------|-----------|-----------------|-----------|-----------------|
|                                      | Amount    | Participation % | Amount    | Participation % | Amount    | Participation % |
| Government institutions              | 339,364   | 11.7            | 440,778   | 12.5            | 516,514   | 12.8            |
| Public enterprises                   | 359,390   | 12.4            | 388,271   | 11.0            | 522,084   | 12.9            |
| Private enterprises and associations | 536,324   | 18.5            | 658,076   | 18.7            | 608,446   | 15.1            |
| Nonprofit organizations              | 132,452   | 4.6             | 135,849   | 3.9             | 142,703   | 3.5             |
| Banking institutions                 | 77,272    | 2.7             | 296,215   | 8.4             | 465,687   | 11.5            |
| Citizens                             | 1,334,337 | 46.0            | 1,480,946 | 42.0            | 1,630,136 | 40.4            |
| Other                                | 121,474   | 4.1             | 124,420   | 3.5             | 152,533   | 3.8             |
| TOTAL                                | 2,900,613 | 100.0           | 3,524,555 | 100.0           | 4,038,103 | 100.0           |

<sup>7</sup> Information from the subsidiary schedule BS-D which banks submit quarterly along with the Balance sheet (FBA format).

**Graph 8 : Deposits structure by industry areas**

Analyzing the structure by industry areas for the mentioned time period, taking into account both - absolute amounts and the relevant ratio, the biggest growth was identified with deposits of banking institutions (57% or 169 million KM), with public enterprises (34% or 134 million KM) and with government institutions (17% or 75 million KM). At the same time, deposits of private enterprises decreased by 8% or 50 million KM.

Still, there were no significant changes in the deposits structure by industry areas since the citizens area is still having the largest participation of 40%, while the trend of increase in participation of banking institutions area continues from the previous year, so for the mentioned period his participation increased for 3.1% (from 8.4% to 11.5%). These are mostly long term deposits which founders-depositors (foreign banks) invested for a purpose of ensuring additional long term sources of funds for financing, in most part, area of citizens and area of private enterprises.

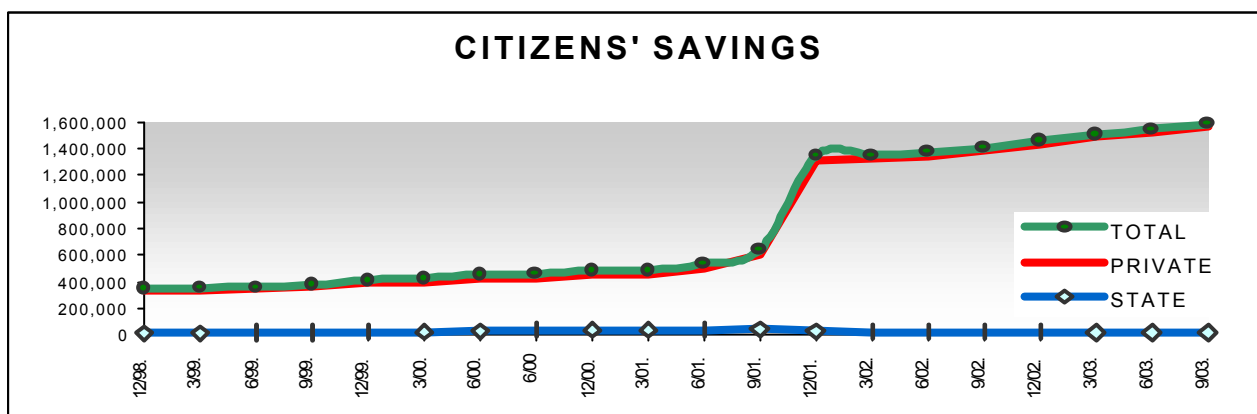
In the deposits structure by industry areas, the largest segment is represented by savings deposits, which are at the same time the largest segment of the banks' financial strength in general. Also in the first nine months of 2003, a positive trend continues to show in regards to stability and level of growth rate so savings deposits increased by 9% or 131 million KM. Out of the total amount of savings, 23.4% relates to savings deposits in domestic currency and 76.4% to savings deposits in foreign currencies.

We need to emphasize that, as in other segments, there is a strong concentration of savings in just a few banks, since 67% of total savings is located with three largest banks (covered with deposit insurance), which represents 6% more if compared to the end of 2002, which means that 90% of total savings was deposited in eight private banks.

**Schedule 11 : New citizens' savings by time periods**

- in 000 KM -

| BANKS   | AMOUNT (IN 000 KM) |           |           | RATIO |     |
|---------|--------------------|-----------|-----------|-------|-----|
|         | 12/31/01           | 12/31/02  | 09/30/03  | 3/2   | 4/3 |
| 1       | 3                  | 3         | 4         | 5     | 6   |
| State   | 28,787             | 22,072    | 18,984    | 76    | 86  |
| Private | 1,285,803          | 1,414,814 | 1,545,851 | 110   | 109 |
| TOTAL   | 1,314,590          | 1,436,888 | 1,567,835 | 110   | 109 |

**Graph 9 : New citizens' savings by time periods**

Along with FBA's activities in relation to the growth of savings in FBiH banks, it is important to mention the existence of the deposit insurance system since January 2001 when the Deposit Insurance Agency became operational in FBiH, after which in August 2002 the Law on Deposit Insurance of Banks in BiH was declared, therefor establishing the the BiH Deposit Insurance Agency. Until 09/30/2003, 13 banks in the FBiH received membership in the deposit insurance program and analytical data on the level of deposits by banks show that a trend of increase in deposits of those particular banks. Their participation in total deposits as of 09/30/03 was 78 %, which is 10% more that at the end of 2002. Safety of deposits guarantees and motivates further growth of savings not only in these banks, but in all other banks.

**2.1.2. Assets and assets quality**

Decision on Minimum Standards for Credit Risk Management and Assets Classification of Banks (the Decision) determines criteria for estimating banks' exposure to credit risk through an evaluation of the quality of their assets and adequacy of their reserves for loan and other losses according to the risk inherent in the placements and funds in the balance sheet and off-balance sheet.

Gross assets<sup>8</sup> in the balance sheets of banks in FBiH as of 09/30/03 amounted to 5.6 billion KM, which is 16% or 772 million KM more than at the end of 2002. Off-balance sheet risk-bearing items amounted to 0.7 billion KM and had also increased for 7% or 48 million KM.

Total assets (together with off-balance sheet items) (the assets)<sup>9</sup> amounted to 6.3 billion KM and it increased for 15% in comparison to the end of 2002.

<sup>8</sup> Source of information: Report on classification of balance sheet assets and of off-balance sheet items of banks.

<sup>9</sup> Assets defined in Article 2 of the Decision on Minimum Standards for Credit Risk Management and Assets Classification in Banks.

**Schedule 12 : Assets, off-balance sheet items and potential loan losses**

-in 000 KM-

| DESCRIPTION  | AMOUNT ( in 000 KM ) |              |                  |              |                  |              | RATIO      |            |
|--|----------------------|--------------|------------------|--------------|------------------|--------------|------------|------------|
|  | 12/31/01             | Struct. %    | 12/31/02         | Struct. %    | 09/30/03         | Struct. %    | 4:2        | 6:4        |
| 1.   | 2                    | 3            | 4                | 5            | 6                | 7            | 8          | 9          |
| Loans  | 1,526,178            | 38.7         | 2,527,745        | 52.7         | 3,077,633        | 55.3         | 166        | 122        |
| Interest   | 17,646               | 0.4          | 25,897           | 0.5          | 29,509           | 0.5          | 147        | 114        |
| Past-due receivables                                     | 189,630              | 4.8          | 156,351          | 3.3          | 185,129          | 3.3          | 82         | 118        |
| Receivables on paid guarantees                           | 7,853                | 0.2          | 7,486            | 0.1          | 5,995            | 0.1          | 95         | 80         |
| Other placements   | 28,083               | 0.7          | 68,945           | 1.4          | 61,405           | 1.1          | 246        | 89         |
| Other assets   | 2,177,185            | 55.2         | 2,006,672        | 42.0         | 2,205,805        | 39.7         | 92         | 110        |
| <b>TOTAL ASSETS</b>                                      | <b>3,946,575</b>     | <b>100.0</b> | <b>4,793,096</b> | <b>100.0</b> | <b>5,565,476</b> | <b>100.0</b> | <b>121</b> | <b>116</b> |
| <b>OFF-BALANCE SHEET</b>                                 | <b>495,029</b>       |              | <b>693,300</b>   |              | <b>741,154</b>   |              | <b>140</b> | <b>107</b> |
| <b>ASSETS AND OFF-BAL. SHEET</b>                         | <b>4,441,604</b>     |              | <b>5,486,396</b> |              | <b>6,306,630</b> |              | <b>123</b> | <b>115</b> |
| General credit risk and potential loan losses            | 201,778              |              | 228,522          |              | 236,769          |              | 113        | 104        |
| Already allocated general and special loan loss reserves | 198,234              |              | 224,641          |              | 235,870          |              | 113        | 105        |

In the mentioned time period, a trend of increase of loan placements continued and it amounts 21% or 577 million KM, as well as the trend of increase of cash funds of 14% or 223 million KM, which all resulted in changes to the assets structure in a way that participation of loans increased by 2.4% (from 58.7% to 61.1%) and participation of cash funds decreased by 0.8% (from 34.8% to 34.0%).

Out of the total increase of loan placements, 444 million KM or 77 % relates to three largest banks in the system.

Based on the analysis of loan structure by industry areas, it can be concluded that the largest growth is related to loans granted to citizens, which have increased by 27% or 335 million KM, so, out of total loans, 49% was directed to citizens and 41% to private enterprises.

Three largest banks hold a participation in the total loans to citizens of approximately 58%, which is higher than the banking system average. These three banks granted citizens 62% of their total loan placements issued to this area of industry. It can be concluded that few larger banks have a clear strategy of increasing the volume of citizens lending since the risk exposure inherent in these loans is at the minimum, having in mind loan policies and procedures prescribed and applied by bank, especially in relation to the collateral.

**Schedule 13 : Loans structure by industry areas**

-in 000 KM-

| INDUSTRY AREAS          | 12/31/01 |             | 12/31/02 |             | 09/30/03 |             | RATIO |     |
|-------------------------|----------|-------------|----------|-------------|----------|-------------|-------|-----|
|                         | Amount   | Particip. % | Amount   | Particip. % | Amount   | Particip. % | 4/2   | 6/4 |
| 1                       | 2        | 3           | 4        | 5           | 6        | 7           | 8     | 9   |
| Government institutions | 26,033   | 1.5         | 30,194   | 1.1         | 30,284   | 1.0         | 116   | 100 |



|                                      |                  |              |                  |              |                  |              |            |            |
|--------------------------------------|------------------|--------------|------------------|--------------|------------------|--------------|------------|------------|
| Public enterprises                   | 246,437          | 14.3         | 247,603          | 9.2          | 222,489          | 6.8          | 100        | 92         |
| Private enterprises and associations | 770,703          | 44.7         | 1,078,795        | 40.1         | 1,329,254        | 40.6         | 140        | 123        |
| Nonprofit organizations              | 6,370            | 0.4          | 2,834            | 0.1          | 2,732            | 0.1          | 44         | 96         |
| Banking institutions                 | 42,480           | 2.5          | 46,439           | 1.7          | 34,387           | 1.0          | 109        | 74         |
| Citizens                             | 623,219          | 36.2         | 1,262,146        | 46.9         | 1,597,600        | 48.9         | 203        | 127        |
| Other                                | 8,422            | 0.4          | 23,571           | 0.9          | 52,015           | 1.6          | 280        | 221        |
| <b>TOTAL</b>                         | <b>1,723,663</b> | <b>100.0</b> | <b>2,691,582</b> | <b>100.0</b> | <b>3,268,761</b> | <b>100.0</b> | <b>156</b> | <b>121</b> |

As for maturity, it should be emphasized that the trend of increase in long term loans continues (72% of total loans), especially in relation to loans to citizens (91% long term loans) and to private companies (57% long term loans) .

**Schedule 14 : Maturity structure of loans**

-in 000 KM-

| LOANS   | 12/31/01         |              | 12/31/02         |              | 09/30/03         |              | RATIO      |            |
|---|------------------|--------------|------------------|--------------|------------------|--------------|------------|------------|
|   | Amount           | Particip %   | Amount           | Particip %   | Amount           | Particip %   | 4/2        | 6/4        |
| 1   | 2                | 3            | 4                | 5            | 6                | 7            | 8          | 9          |
| Past-due receivables and receivables based on paid guarantees | 197,633          | 11.4         | 163,837          | 6.1          | 191,127          | 5.8          | 83         | 117        |
| Short term loans  | 459,617          | 26.7         | 620,572          | 23.0         | 714,842          | 21.9         | 135        | 115        |
| Long term loans   | 1,066,560        | 61.9         | 1,907,173        | 70.9         | 2,362,792        | 72.3         | 179        | 124        |
| <b>TOTAL LOANS</b>  | <b>1,723,663</b> | <b>100.0</b> | <b>2,691,582</b> | <b>100.0</b> | <b>3,268,761</b> | <b>100.0</b> | <b>156</b> | <b>121</b> |

As a result of above mentioned, there is certain number of banks with impaired maturity structure of financial assets and liabilities, which means that longer term placements were financed using sources of funds with shorter maturities. If this mismatch in the maturity structure of sources of funds and placements is too significant and if, at the same time, there is a trend of impairment of assets quality, banks could experience liquidity problems in the future. Most banks have problems with providing for longer term sources of funds, including primary sources of funds (deposits) and secondary sources of funds (loans), as well as capital.

FBA has ordered banks violating prescribed limitations related to assets and liabilities maturities to take measures to comply this segment of their operations with the prescribed standards, all based on the determined schedule and deadlines. Positive effects of implementation of ordered measures were already seen at the end of the first quarter of 2003 and banks are being continuously monitored, especially in relation to compliance with prescribed schedule determined to reduce the number of violations identified.

Since placements, that is loans, are the riskiest part of banks' assets, their quality represents one of the most significant factors of stability and success of their operations. Evaluation of assets quality is in fact evaluation of credit risk of banks, that is identification of potential loan losses that are being acknowledged as provisions for loan losses.

Quality of assets and off-balance sheet risk-bearing items, general credit risk and potential loan losses sorted by classification categories are given in the following schedule:

**Schedule 15 : Assets classification, general credit risk (GCR) and potential loan losses (PLL)**

| Classification category | AMOUNT ( in 000 KM ) AND PARTICIPATION ( in% ) |          |          | RATIO |
|-------------------------|--|----------|----------|-------|
|                         | 12/31/01                                       | 12/31/02 | 09/30/03 |       |

|              | Assets<br>classif. | Particip.<br>% | GCR<br>PLL | Assets<br>Classif. | Particip<br>% | GCR<br>PLL | Assets<br>Classif. | Particip<br>% | GCR<br>PLL | 5/2 | 8/5 |
|--------------|--------------------|----------------|------------|--------------------|---------------|------------|--------------------|---------------|------------|-----|-----|
| 1            | 2                  | 3              | 4          | 5                  | 6             | 7          | 8                  | 9             | 10         | 11  | 12  |
| <b>A</b>     | 3,808,548          | 85.8           | 51,377     | 4,713,349          | 85.9          | 60,161     | 5,451,049          | 86.4          | 68,732     | 124 | 116 |
| <b>B</b>     | 370,292            | 8.3            | 31,339     | 482,988            | 8.8           | 42,037     | 559,587            | 8.9           | 46,475     | 130 | 116 |
| <b>C</b>     | 109,695            | 2.5            | 28,852     | 148,267            | 2.7           | 40,676     | 162,607            | 2.6           | 41,839     | 135 | 110 |
| <b>D</b>     | 147,288            | 3.3            | 84,429     | 134,419            | 2.5           | 78,275     | 126,405            | 2.0           | 72,741     | 91  | 101 |
| <b>E</b>     | 5,781              | 0.1            | 5,781      | 7,373              | 0.1           | 7,373      | 6,982              | 0.1           | 6,982      | 128 | 95  |
| <b>TOTAL</b> | 4,441,604          | 100.0          | 201,778    | 5,486,396          | 100.0         | 228,522    | 6,306,630          | 100.0         | 236,769    | 122 | 115 |

If we analyse the assets quality together with the off-balance sheet items, we can identify that there is a decrease in participation of poor-quality assets (C-E) from 5.3% to 4.7%, although sub-standard assets (C) increased for 14.3 million KM or 10%, while at the same time there is an increase in total assets (with the off-balance sheet) of 15% or 820 million KM and classified assets (B-E) increased for 82 million KM or 11%, which is the results of nominal growth of assets classified under B and C categories.

According to the reports, banks have allocated reserves for loan losses in accordance with regulations and the level of credit risk evaluated.

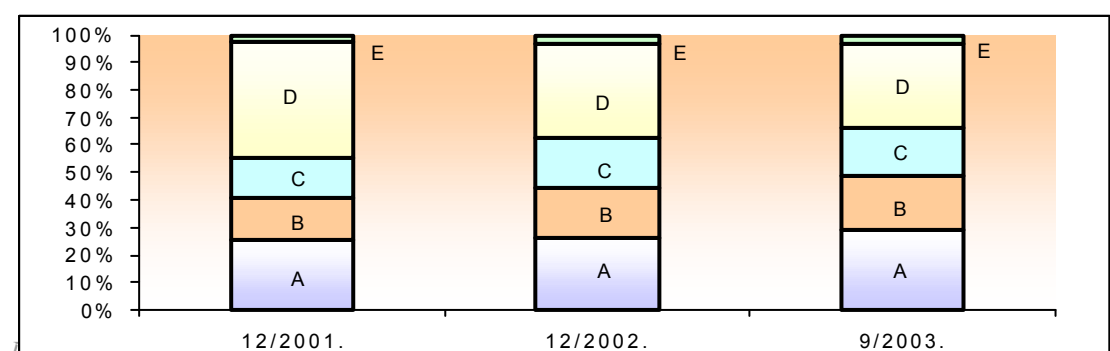
Analysing the level of allocated reserves by total amounts and by classification categories in relation to the end of 2002, reserves for general credit risk and potential loan losses increased by 5%. In the mentioned time period, banks have allocated reserves for the B category in an average of 8.4%, for the C category 25.8%, for the D category 60% and for the E category 100% and this was deemed as satisfactory.

Level of general credit risk and estimated losses by classification categories, that was determined in accordance with criteria and methodologies prescribed by the FBA, their trend and structure at the level of the banking sector are given in the following schedule and graph:

**Schedule 16:** Structure and trend of general credit risk and potential loan losses

| Classification<br>category | AMOUNT (in 000 KM) AND STRUCTURE (in %) |       |          |       |          |       | RATIO |     |
|----------------------------|---|-------|----------|-------|----------|-------|-------|-----|
|                            | 12/31/01                                |       | 12/31/02 |       | 09/30/03 |       | 4/2   | 6/4 |
|                            | 2                                       | 3     | 4        | 5     | 6        | 7     | 8     | 9   |
| <b>A</b>                   | 51,377                                  | 25.5  | 60,161   | 26.3  | 68,732   | 29.0  | 117   | 114 |
| <b>B</b>                   | 31,339                                  | 15.5  | 42,037   | 18.4  | 46,475   | 19.6  | 134   | 111 |
| <b>C</b>                   | 28,852                                  | 14.3  | 40,676   | 17.8  | 41,839   | 17.7  | 141   | 103 |
| <b>D</b>                   | 84,429                                  | 41.8  | 78,275   | 34.3  | 72,741   | 30.7  | 93    | 193 |
| <b>E</b>                   | 5,781                                   | 2.9   | 7,373    | 3.2   | 6,982    | 3.0   | 128   | 95  |
| <b>TOTAL</b>               | 201,778                                 | 100.0 | 228,522  | 100.0 | 236,769  | 100.0 | 107   | 104 |

**Graph 10:** Structure and trend of general credit risk and potential loan losses



General credit risk and potential loan losses of banks have increased during the mentioned time period of 2003 for 4% and have amounted 237 million KM, that is 3.8% of total assets (with the off-balance sheet) and that is 0.4% less than at the end of 2002. Changes in the structure of loan losses have shown that there is a larger participation of reserves for categories A and B, while participation has decreased for categories C, D and E for 3.9%, which is a result of banks' activities on resolving problems with poor quality loans and on consistent implementation of FBA regulations. Analysis of assets quality, that is of loan portfolio of individual banks, as well as on-site examinations in banks, showed that a key risk with most banks is still credit risk, that is existence of problem loans approved to legal entities (enterprises).

For banks with poor quality assets, FBA ordered corrective measures related to development of a program which must contain plan of activities for improvement of existing credit risk management practices, that is assets quality management, for decreasing existing concentrations and for resolving problems with poor-quality assets through the supervision follow-up process and based on reports and other documentation submitted by banks, as well as based on on-site examinations in banks for purposes of reviewing the mentioned.

### ***Transactions with related entities***

During their operations banks are exposed to different types of risk, out of which especially important is risk related to transactions with entities related to the bank.

According to the Basle Standards, FBA has established certain prudential principles and requirements related to transactions with entities related to the bank<sup>10</sup>, which are regulated in the Decision on Minimum Standards for Banks' Operations with Related Entities which prescribes conditions and methods of banks' operations with related entities. Based on this Decision and the Law on Banks, bank's supervisory board, based on the director's proposal, is required to issue special bank policies for operations with related entities and to monitor their implementation.

FBA decisions also prescribed a special package of reports covering transactions with one segment of related entities, meaning loans and potential and received off-balance sheet obligations (guarantees, letters of credit, loan obligations received) as the most frequent type of transactions with high risk between banks and related entities. The package of regulatory reports includes information on loans granted to the following categories of related entities:

- Bank shareholders with over 5% of voting rights;
- Members of the supervisory board and senior management of the bank; and
- Subsidiaries and other companies related to the bank through capital.

### **Schedule 17: *Transactions with related entities***

- in 000 KM -

| Description  | LOANS GRANTED |                     |          |
|--|---------------|---------------------|----------|
|  | 12/31/01      | 12/31/02            | 09/30/03 |
| Shareholders with over 5% of voting rights, subsidiaries and other entities related based on capital | 46,071        | 59,241              | 32,704   |
| Members of Supervisory board   | 48            | 315                 | 667      |
| Bank management and employees  | 3,580         | 2,699 <sup>11</sup> | 1,760    |

<sup>10</sup> Article 39, paragraph 2 of the Law on Changes and Amendments to the Law on Banks defines the term "entities related to the bank", which no longer includes bank employees.

<sup>11</sup> Excluding loans to bank employees, which is in accordance with changes and amendments to the Law on Banks.

|  |        |        |        |
|--|--------|--------|--------|
| TOTAL  | 49,699 | 62,255 | 35,131 |
| Potential and off-balance sheet obligations taken over | 4,906  | 6,684  | 9,049  |

For these reasons, FBA has paid special attention (during on-site examinations) to banks' operations with related entities. FBA on-site examiners issued orders for elimination of detected deficiencies within certain time lines and initiated violation proceedings. An integral part of these activities was monitoring and supervision of implementation of mentioned orders, which bore certain results in the practice since the amount of loans to related entities for the first half of 2003 decreased for 20 million KM.

### 2.1.3. Capital - strength and adequacy

Capital<sup>12</sup> of banks in FBiH as of 09/30/03 amounted 860 million KM.

#### Schedule 18 : Regulatory capital

-in 000 KM-

| DESCRIPTION           | 12/31/01 |      | 12/31/02 |      | 09/30/03 |      | RATIO |     |
|-----------------------|----------|------|----------|------|----------|------|-------|-----|
|                       | 1        | 2    | 3        | 4    | 5        | 6    | 3/2   | 4/3 |
| <b>STATE BANKS</b>    |          |      |          |      |          |      |       |     |
| a) Core capital       | 83,505   | 93%  | 101,783  | 96%  | 120,841  | 96%  | 122   | 119 |
| b) Additional capital | 6,206    | 7%   | 3,879    | 4%   | 5,680    | 4%   | 63    | 146 |
| c) Capital ( a + b)   | 89,711   | 100% | 105,662  | 100% | 126,521  | 100% | 118   | 120 |
| <b>PRIVATE BANKS</b>  |          |      |          |      |          |      |       |     |
| a) Core capital       | 475,845  | 86%  | 536,203  | 85%  | 572,225  | 78%  | 113   | 107 |
| b) Additional capital | 74,881   | 14%  | 95,910   | 15%  | 161,274  | 22%  | 128   | 168 |
| c) Capital ( a + b)   | 550,726  | 100% | 632,113  | 100% | 733,499  | 100% | 115   | 116 |
| <b>TOTAL</b>          |          |      |          |      |          |      |       |     |
| a) Core capital       | 559,350  | 87%  | 637,986  | 86%  | 693,066  | 81%  | 114   | 109 |
| b) Additional capital | 81,087   | 13%  | 99,789   | 14%  | 166,954  | 19%  | 123   | 167 |
| c) Capital ( a + b)   | 640,437  | 100% | 737,775  | 100% | 860,020  | 100% | 115   | 117 |

During the first nine months of 2003, capital<sup>13</sup> increased by 17% or 122 million KM, when compared to the end of 2002. Out of this number, 55 million KM represents increase in core capital and 67 million KM to the increase in additional capital.

Increase in core capital included several factors: additional capitalization was performed in four banks in an amount of 51.2 million KM and, based on distribution of profit from 2002, reserves have increased by 7 million KM. At the same time, one bank covered its losses from previous year amounting to 2 million KM against its capital and decreased its retained earnings by 1 million KM.

Additional capital mostly increased based on the current income amounting to 36 million KM, including subordinated debts with two banks amounting to 22 million KM, and due to general reserves for loans losses (category A) amounting to 8 million KM.

Mentioned changes have affected the structure of regulatory capital, meaning that they have caused increase of participation of additional capital, although the participation of core capital is still dominant (81%).

<sup>12</sup> Regulatory capital is defined in articles 8 and 9 of the Decision on Minimum Standards for Managing the Capital of Banks.

<sup>13</sup> Source of information is the quarterly report on condition of banks' capital (Schedule 1-Form A), prescribed by the Decision on Minimum Standards for Managing the Capital of Banks.

Capital to assets ratio, that is rate of capitalization of banks, as of 09/30/03 is 15.5% which is slightly better than at the end of 2002 when it was 15.4%.

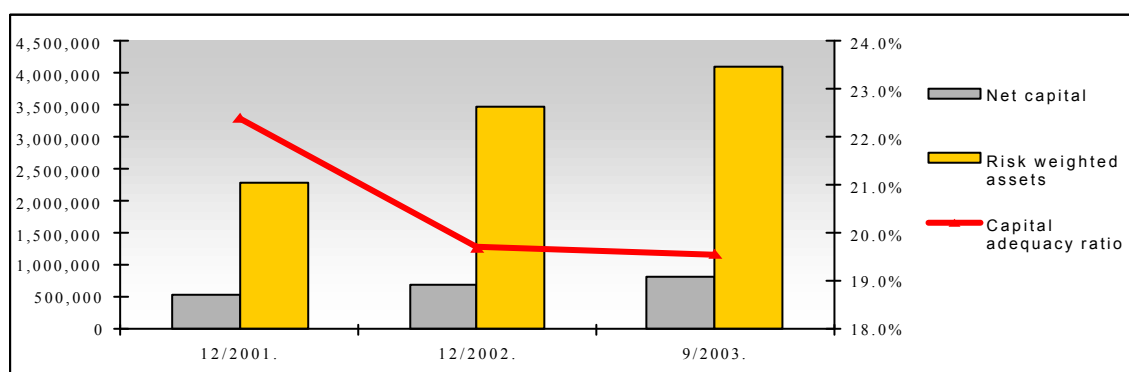
During the first nine months of 2003, mentioned changes had a positive effect to net capital which has increased by 17% or 116 million KM so that as of 09/30/03 it amounted to 804 million KM (701 million KM with private banks and 103 million with state banks).

Capital adequacy ratio, calculated as the ratio of net capital and risk weighted assets at the level of the banking system, is 19.6%, which is 0.1% less than as of 12/31/02. Significant increase in banks' lending activities that occurred in the mentioned time period caused an increase in the level of risk, but this was not followed by the relevant increase in net capital. In supervision of operations and financial condition of banks in FBiH, FBA has (according to its legal authorities), ordered banks to take certain activities to strengthen the capital base and provide for capital adequacy, all in order to improve safety of banks individually and of the system as a whole.

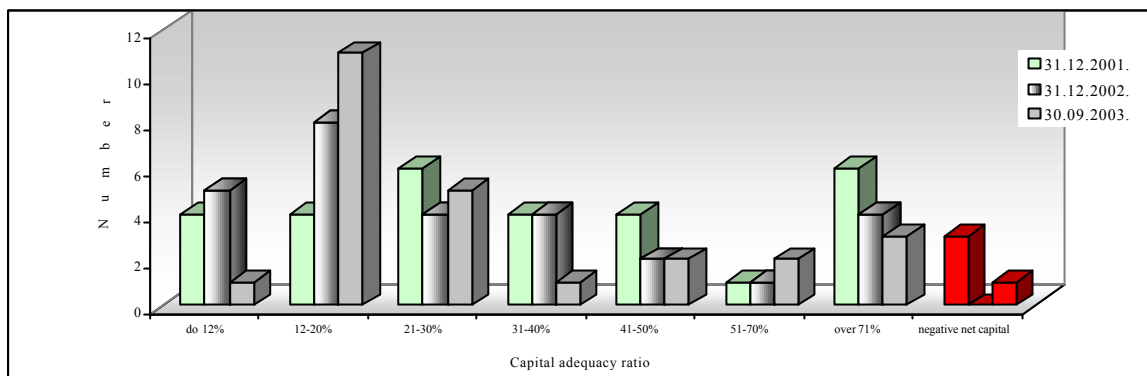
**Schedule 19 :** *Net capital, risk weighted assets and capital adequacy ratio*

| DESCRIPTION                             | 31.12.2001. | 31.12.2002. | 30.09.2003. | RATIO |     |
|---|-------------|-------------|-------------|-------|-----|
|   |             |             |             | 3/2   | 4/3 |
| 1                                       | 2           | 3           | 4           | 5     | 6   |
| NET CAPITAL                             | 535,505     | 687,576     | 803,541     | 128   | 117 |
| RISK WEIGHTED ASSETS & LOAN EQUIVALENTS | 2,388,921   | 3,489,810   | 4,107,889   | 146   | 118 |
| NET CAPITAL RATIO (CAPITAL ADEQUACY)    | 22.4%       | 19.7%       | 19.6%       | 88    | 99  |

**Graph 11 :** *Net capital, risk weighted assets and capital adequacy ratio*



Out of a total of 26 banks in FBiH as of 09/30/03, 24 banks have a capital adequacy ratio higher than the legally prescribed minimum of 12% (five banks with over 50%), while two banks (under provisional administration) have a ratio under 12%. With most of the banks this ratio had a decreasing trend, which is the result of a higher growth rate of risk assets, rather than capital. Number of banks in this second group (ratio between 12% and 20%) is increasing, so that as of 09/30/03 this group included 11 banks (three more than at the end of 2002), while five banks have a ratio between 21% and 30%. However, three out of five largest banks (based on the level of assets) have the capital adequacy ratio slightly higher than the legally prescribed minimum (between 12.5% and 13.1%), although two of these banks improved their adequacy by approximately 2% during the second quarter of 2003 based on additional capitalization and inclusion of subordinated debt into additional capital.

**Graph 12: Capital adequacy ratio in banks**

Every other growth in risk assets will necessarily require an adequate capital growth and in that sense banks would be required to develop a program for managing their capital and to continuously monitor its implementation in order to ensure and maintain the quantity and quality of capital, at least at the level of the legally prescribed minimum.

Although the banking system in the Federation BiH is getting stronger capital-wise from one time period to another, there is still a fact that it has too many small banks. Certain number of banks are undercapitalized, meaning that they don't have strong capital base that will cover all potential losses in their operations and full safety to creditors, nor does this capital base supports further growth of risk assets and development of their operations. Strengthening the capital base will be a primary task for most banks in 2003, especially for the largest banks in the system, because this would be necessary for improving stability and safety of banks themselves and of the banking system as a whole. By issuing relevant decisions, FBA will ask the banks to strengthen their capital base, which would in turn guarantee their stability and safety.

## 2.2. Profitability

According to information from the income statement for the first three quarters of 2003, banks in the Federation BiH have accomplished a positive financial result amounting to 37.8 million KM, which is far better than in the same time period in 2002 when this income amounted to 18.5 million KM.

Positive financial result of 53.3 million KM was accomplished by 17 banks, while nine banks realized a loss of 15.5 million KM.

More detailed information is given in the following schedule:

**Schedule 20 : Realized gain/loss**

- in 000 KM -

| Date/Descrip. | At the system level |              | Private banks |              | State banks |              |
|---------------|---------------------|--------------|---------------|--------------|-------------|--------------|
|               | Amount              | No. of banks | Amount        | No. of banks | Amount      | No. of banks |
| 09/30/02      |                     |              |               |              |             |              |
| Gain          | -18,280             | 9            | -12,710       | 7            | -5,570      | 2            |
| Loss          | 36,765              | 20           | 33,241        | 15           | 3,524       | 5            |
| Total         | 18,485              | 29           | 20,531        | 22           | -2,046      | 7            |
| 09/30/03      |                     |              |               |              |             |              |
| Gain          | -15,533             | 9            | -14,225       | 6            | -1,308      | 3            |
| Loss          | 53,332              | 17           | 50,584        | 13           | 2,748       | 4            |
| Total         | 37,799              | 26           | 36,359        | 19           | 1,440       | 7            |

As in other segments of operations, this segments also contains certain concentrations: certain number of banks had good profitability (three private banks realized 96% of total income), while other larger number of banks had unsatisfactory profitability from both, aspect of the amount of realized financial result (slight income was realized) and from the aspect of indicators or ratios used to evaluate profitability, productivity and efficiency of banks' operations.

If we look at the time periods, we notice a trend of increase of income based on conventional business activities of banks, so that interest income represents 71% of total income (at the same time period in 2002 this percentage was 61%). At the same time, the participation of operating income decreased to 49% (at the same time period in 2002, this percentage was 57%), which is partially a result of changed methodology of reporting income and expense items (net principle) related to foreign exchange operations and reporting income and expense items based on decreased provisions.

Participation of total expenses in total income is 89% (at the same time period in 2002, this percentage was 94%), out of which the largest percentage of 56% relates to operating expenses (including costs of employees' salaries and benefits of 28%, costs of business premises, costs of other fixed assets and utility costs of 16%, other operating expenses of 12%), while costs of reserves for general credit risk and potential loan losses have a participation of 26% (while at the same time period in 2002 this percentage was 33%).

The following schedule gives the most significant ratios relevant to evaluation of profitability, productivity and efficiency in banks:

**Schedule 19 : Ratios of profitability, productivity and efficiency by time periods**

-in %-

| RATIOS                               | 12/31/01 | 12/31/02 | 09/30/03 <sup>14</sup> |
|--------------------------------------|----------|----------|------------------------|
| Return on average assets             | -1.18    | 0.36     | 1.04                   |
| Return on average total capital      | -5.62    | 2.57     | 7.44                   |
| Return on average equity capital     | -6.15    | 3.00     | 9.28                   |
| Net interest income / average assets | 5.26     | 4.66     | 3.54                   |
| Fee income / average assets          | 7.64     | 5.77     | 3.34                   |
| Total income / average assets        | 12.89    | 10.43    | 8.23                   |

<sup>14</sup> Calculated at the annual level.

|   |       |       |      |
|---|-------|-------|------|
| Operating and direct income <sup>15</sup> /average assets | 6.54  | 3.85  | 2.22 |
| Operating income / average assets                         | 7.40  | 6.16  | 3.90 |
| Total noninterest income / average assets                 | 13.94 | 10.00 | 6.12 |

**Schedule 20: Ratios of profitability, productivity and efficiency**  
by time periods as of 09/30/03

-in %-

| RATIOS  | 09/30/03    |               |              |
|---|-------------|---------------|--------------|
|   | STATE BANKS | PRIVATE BANKS | FBiH AVERAGE |
| Return on average assets                          | 0.56        | 1.04          | 1.04         |
| Return on average total capital                   | 1.88        | 8.40          | 7.44         |
| Return on average equity capital                  | 2.68        | 10.28         | 9.28         |
| Net interest income / average assets              | 3.17        | 3.56          | 3.54         |
| Fee income / average assets                       | 6.55        | 3.10          | 3.34         |
| Total income / average assets                     | 10.13       | 8.09          | 8.23         |
| Operating and direct income/average assets        | 5.08        | 2.00          | 2.22         |
| Operating income / average assets                 | 4.24        | 3.87          | 3.90         |
| Total noninterest bearing income / average assets | 9.32        | 5.87          | 6.12         |

In the mentioned time period in 2003, if compared to the same time period last year, banking system accomplished mainly better indicators, among which we will emphasize two most important indicators of profitability: ROA (return on assets) of 1.04% and ROAE (return on average equity) of 7.44%, which is slightly better than in previous years and the first indicator of the banking system at the level of a world standard<sup>16</sup>. However, banks' productivity, measured as a ratio of total income to average assets, as well as realized net interest income and operating income by the unit of average assets, is somewhat lower due to, on one hand, further growth of assets having the higher growth rate than total income (net interest income and operating income) and, on the other hand, due to significant participation of non-earning assets.

Accomplished financial result at the level of the banking sector as of 09/30/03 is yet another indicator of positive movements in the banking system. Banks' profitability in the following time period will be mostly dependant on the assets quality, that is of approved loans, and in reference to that, it will be dependent on the banks' exposure level to credit risk and costs of reserves for loan losses, and on efficient management of operating expenses. From the above stated it can be concluded that a key factor of efficiency and profitability of every bank individually is the quality of management and business policies they maintain since that has the most direct effect on their performance.

Also, as for the new market conditions, banks will be forced to adopt a new concept of business policy applicable to the market oriented banking industry whose goal is to realize as much profit as possible, therefor providing for bank's stability and for control of exposure to risk in banks' operations. (primarily to credit risk). However, through their involvement in international financial operations and markets, banks will in the future be more exposed to market-related risks: interest rate risk, foreign exchange risk and price risk. By realizing larger profit through retained earnings as an internal source of funds, banks will have stronger capital and will increase their income base to be used for further expansion and growth.

<sup>15</sup> Income includes costs of reserves for potential loan losses.

<sup>16</sup> World standard for ROA is 1% and for ROE is 12-18%.



### III. CONCLUSION

Consolidation and stabilization of the banking sector of the Federation BiH continues in 2003 as well and it resulted in new activities towards a stable and moderate growth of assets and capital, reorganization of the banking system and introducing new products. If compared to the previous years, further improvements of financial results was accomplished, however nine banks still operated with a loss.

In the following time period, FBA will focus its activities on control of risk, predominately to control of credit risk, and will insist on adoption of stronger policies and procedures and on their consistent implementation. At the same time, measures will be taken to reinforce internal control and internal and external audit, as well as to work on capital strengthening of banks.

In order to continue with the positive trends, there is a need for maintaining the continuity in activities of all participants in the banking system reform and on implementation of measures to finalize the transition process as soon as possible.

As for the further positive changes, it is especially important to engage authorized institutions and bodies in Bosnia and Herzegovina and in the Federation BiH on:

- speeding up the process of overall reform of the real sector in order to keep up with the progress made in the monetary and in the banking sector;
- finalize the process of privatization of state banks since the deadline prescribed by the Government's decision is 12/31/03;
- create legal framework to support the process of further strengthening of banks;
- improvement of condition for banks' operations within the entire area of Bosnia and Herzegovina;
- redirect the succession funds to development activities using commercial banks;
- faster and consistent implementation of the collateral laws;
- speeding up the court proceedings, rulings and their implementation;
- establishment of an efficient process of realization of pledges;
- declaration of the law on protection of creditors' rights and more significant and concrete responsibilities of bank debtors;
- further improvement of the legal and institutional framework related to the reform of the banking sector and of the overall financial system, along with consistent implementation of the Basle Principles and EU Directives;
- establishment of the unified registry of accounts;
- upgrading the law on prevention of money laundering and terrorism financing, etc.

Tasks of the Banking Agency of FBiH in the future time period will be:

- continuous bank supervision for purposes of efficient protection of depositors and elimination of weaknesses in banks' operations
- finalization of the working cycle of remaining provisional administration and liquidation processes;
- special supervision of banks with large savings (savings deposits of citizens) and banks with above-average rate of expansion;
- special supervision of the segments of banks' operations with related entities;
- monitoring the implementation of new standards in banks' operations that were prescribed by laws and regulations;

- further improvements to the regulations within the authority of the Agency (foreign exchange risk, capital standards, etc.), all in accordance with the Basle Principles and EU Directives;
- further education and technical training of FBA staff;
- continuous activities on implementation of regulations related to prevention of money laundering and terrorism financing and improvement of cooperation with other supervisory and control authorities;
- establishment of the data base on non-performing customers who are considered as a special risk to banks;
- implementation of the early warning system in order to prevent, that is identify in the early stage those banks that are financially and operationally inefficient or that have negative trends and which therefor require special supervisory attention;
- establishment of cooperation with supervisory institutions from home countries of investors in the banking system of FBiH;
- organizing consultations on implementation and improvement of the regulations relevant to FBA, etc.

As the most important element of the system, banks will need to undertake the following activities on:

- further capital strenghtening adequate to the growth of assets and risks;
- improvement of assets quality;
- strenghtening of internal controls and establishment of internal audit and providing their full independence;
- adoption and implementation of new operating principles, policies and procedures taking into account the more severe conditions of market competitiveness;
- exchange of information of poor debtors, that is reporting to the FBA on non-performing customers who are considered as special credit risk to banks, which will in turn enable creation of a special data base;
- faster development of credit card operations and electronic banking;
- development of procedures to control and improve information technology;
- strenghtening and consistent implementation of criteria related to expertise and technical capabilities for performing management functions in banks;
- improving the staff structure and work on their technical training for purposes of establishing better quality in their relations with customers, especially with small and medium-size companies, which includes new forms of services common in the rest of the world, that is, stronger development of financial management operations;
- effective involvement in the global process of fight against money laundering and terrorism financing;
- intensify involvement in the FBiH Bankers' Association through better quality cooperation with the FBA, Central Bank of BiH, FBiH Finance Ministry, etc.

## ATTACHMENTS

- ATTACHMENT 1..... General Information about Banks in  
the F BiH
- ATTACHMENT 2..... Balance Sheet of Banks -FBA Schedule
- ATTACHMENT 3..... Citizens' Savings in Banks F BiH
- ATTACHMENT 4..... Report on Changes in Balance Sheet  
Assets  
and Off-Balance  
Sheet Risk Items
- ATTACHMENT 5..... Income Statement of Banks
- ATTACHMENT 6..... Report on Capital Balance and Adequacy
- ATTACHMENT 7..... Employees in Banks of the F BiH

