FINANCIAL SECTOR ASSESSMENT

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BASED ON THE JOINT IMF-WORLD BANK FSAP UPDATE

This Financial Sector Assessment (FSA) provides a summary of the main findings and recommendations of the joint IMF-World Bank Financial Sector Assessment Program (FSAP) Update team that visited Macedonia from March 26 to April 8, 2008.[1] The principal objective of the FSAP Update was to assist the authorities in evaluating development progress and future challenges and assessing the potential vulnerabilities of the financial system in Macedonia. In addition to the Aide Mémoire summarizing the key findings, six Technical Notes (TN) were prepared, including an update of compliance with the Basel Core Principles for Banking Supervision and TNs on stress testing, the financial safety net, securities markets, the insurance sector and the pension sector.

[1] The FSAP Update team comprised Sonja Brajovic-Bratanovic (World Bank, leader), Salim Darbar (IMF, deputy), Alexander Pivovarsky, Stéphanie Stolz, David Parker (all IMF), Gregory Gordon Brunner (World Bank), Keith Bell (banking supervision,World Bank expert), Tyge Rasmussen (securities market,World Bank expert), Martin Overbeek (insurance sector,World Bank expert) and Jasna Vukoje (World Bank, team support).

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OVERALL ASSESSMENT

Both the 2003 FSAP and the 2008 FSAP Update concluded that the financial system in Macedonia did not seem to be particularly vulnerable to immediate macroeconomic or financial sector shocks. Substantial progress has been achieved since the 2003 FSAP in strengthening the regulatory and supervisory framework of the banking system, but significant challenges remain in improving nonbank financial sector supervision.

The recent turmoil in global credit markets has not directly affected Macedonian banks, as the credit growth has primarily been financed by domestic deposits. However, risks of indirect impacts have increased, with the recent deterioration in the external current account and the existing vulnerabilities to worsening terms of trade, reduction in remittances and regional instability.

Overall, the financial sector, and particularly the banking sector, has undergone positive evolution since the 2003 FSAP, helped by improved macroeconomic conditions. Since 2004, banking sector growth averaged over 20 percent per annum with assets amounting to MKD 224 billion as of end 2007 (66.3 percent of GDP), bringing Macedonia into line with regional averages. Nevertheless, protracted recession of major trading partners, worsening terms of trade, lower remittances, inflationary pressures, and regional instability could pose risks to the financial system. Also, the exchange rate anchor will remain critical to maintain financial system stability.

Banking system financial soundness indicators are satisfactory. While the stress tests do not indicate major vulnerabilities for the banking system as a whole, the situation in large banks should be followed more closely, as the stress tests indicate that they might be more vulnerable to shocks. Capital adequacy ratios have been falling, mostly due to credit growth, but remain comfortably above the statutory minimum. While rapid, the rate of credit growth does not currently give rise to major concerns, as the banking sector is in the process of catching up to comparator country norms. One risk in such an environment is that banks may lower credit standards in order to maintain profits. The NBRM should continue to monitor credit growth and enhance stress testing analysis, particularly of credit risk.

Financial safety net arrangements need further refinement. The agencies responsible for the financial safety net need to develop contingency plans. A crisis simulation exercise should be undertaken to test various elements of the system (lender of last resort, deposit insurance, contingency planning and problem bank resolution) and cooperation arrangements, both domestically and cross-border. The new Banking Law provides adequate authority to resolve problem institutions, as demonstrated by the recent closure of a medium size bank.

Very good progress has been achieved since the 2003 FSAP in improving the quality of banking supervision. The existing legal framework (particularly with the enactment of the new Banking Law in 2007), regulations and supervisory policy manual provide a sound base for banking supervision. Supervisory independence and legal protection for supervisors is clearly addressed in the law. The NBRM has been effective in developing the supervisory capacity. Supervisory practices remain reasonably comprehensive and, with some minor exceptions, comply with the Basel core principles, as revised in October 2006.

The NBRM independence and supervisory powers continue to be tested. The recent Constitutional Court's rulings will limit the NBRM's supervisory powers vis-à-vis "fit and proper" testing. Another provision that authorized the NBRM to dismiss an administrator of a bank in the event the administrator is convicted of a crime was also declared invalid by the Constitutional Court. The authorities are reviewing options to unify financial supervision. However, uncertainty that would arise from a significant change in the supervisory structure for banks would clearly outweigh any possible benefits.

Securities markets are small and illiquid and the Macedonian Securities Exchange Commission (MSEC) has a challenging task to find a proper balance between providing space for innovation and keeping an adequate degree of regulation, supervision and enforcement. The EU peer assessment found that most IOSCO principles were at least partly implemented, but made many recommendations. Better cooperation with NBRM is another critical need, especially regarding the over-the-counter market of NBRM and government securities, and supervision of brokerage and dealership functions operated within banks. The Macedonia Stock Exchange is participating in regional exchange cooperation initiatives and seeking to forge strong relations with other exchanges in the region.

Insurance sector is small and recent growth has been modest, while the critical issue is the lack of effective regulatory and supervisory authority. Since 2004, market concentration has been reduced and a number of foreign insurance companies entered the insurance market. The market is still dominated by the motor-third-party-liability (MTPL) insurance. Despite some positive developments, the framework for setting minimum and maximum premiums for the MTPL is not functioning and the lack of guiding criteria for non-material damages are serious problems. The lack of standards for technical provisions is another regulatory issue to be addressed. The most critical issue, however, is the regulatory vacuum that has been created by the delay to establish the new supervisory authority in September 2007, as mandated by the new Insurance Law.[2]

Challenges remain in the pension system. The second pillar was introduced in 2006 and the number of contributors has been much larger then expected. Pension companies are licensed and supervised by Macedonian Pension Supervisory Agency, which has successfully started its operations. Investments of the two pension funds have been conservative in the initial period. However, for pension funds to achieve returns above the rate of wage inflation, adjustments in their current investment and risk management practices and reduction in operating cost are required. Ultimately, the key social issue to be addressed is the low participation in both pillars of the pension system, as the employers are still failing to register employees and make contributions to both the first and the second pillar.

[2] Consequently, the former supervisory authority has lost capacity to regulate, supervise and enforce compliance in the insurance industry.

Financial sector infrastructure has also been strengthened significantly. Payment system architecture, which received high marks from the 2003 FSAP team, has seen further improvements. The regulatory framework has been amended, and NBRM is modernizing the Real Time Gross Settlement (RTGS) system. The two systems (for low value payment and credit cards) that are operated by the industry are also meeting performance and safety standards. NBRM is introducing major improvements to its credit risk registry and the Banking Association has taken the initiative to develop a credit bureau with much broader access. Both will facilitate credit risk management and are expected to improve financial discipline, as well as access to finance. There was also significant progress in accounting and auditing reforms. The IFRS implementation in the banking sector, expected in 2009, will provide a solid basis for transparent reporting and thus improve systemic risk management.

The key challenges that remain to be addressed in the short- to medium-term are to:

- Continue to enhance effective bank supervision and ensure that banks implement the large volume of new regulations expected to become effective in the near future. Monitor credit developments, as large banks seek to increase market share and the small banks with new owners begin to expand.
- Address the legal vacuum surrounding insurance supervision by either establishing the new insurance supervisory authority or unified supervision. Interim measures need to be taken to temporarily restore supervisory powers at the MOF to enable supervision of insurance companies to continue until the new authority is ready to take over.
- Implement risk based supervision and regulation in the securities market keeping in mind the cost of compliance. While the near term efforts should be focused on developing local markets and infrastructure, the medium-term emphasis should be on greater regional integration.
- The challenge for the payment infrastructure is to start an effective oversight and ensure integrity of the infrastructure related to the e-payment instruments.

The key recommendations from the Macedonia FSAP Update are provided below.

Box 1. Summary of Key Recommendations

Banking Supervision

- Ensure all banks upgrade risk management policies and processes in line with regulations (Decisions Nos. 17 and 31/08) including financial risk management (liquidity, currency and credit risk) and information system security.
- Revise reporting formats to implement IFRS-based accounting in 2009.

Liquidity management

- Include coordination with monetary policy among the objectives of the government's cash and debt management policy.
- Improve the forecasting of the government's cash balances and design a formal model to forecast currency in circulation.

Financial sector stability and safety nets

- Strengthen stress testing analyses, in particular by increasing the complexity of credit risk tests. Continue to encourage stress testing among commercial banks.
- Develop contingency planning for crisis management, both domestically and cross-border, in the agencies responsible for financial safety net (MoF, NBRM, and DIF).
- Improve lender-of-last-resort process by (i) undertaking internal simulation exercises; and (ii) developing instructions regarding an assisted bank's collateral adequacy for third party banks.
- Invest in high-quality foreign instruments to better diversify and maximize DIF returns.

Capital markets

- Develop government bond markets as a foundation for other bond products. Establish a yield curve with a few large benchmark-series that are likely to stimulate secondary market development.
- Strengthen MSEC supervision and enforcement capacities. Introduce risk-based principles in prudential regulation and supervision, keeping in mind the cost of compliance and supervision.
- Improve cooperation between NBRM and MSEC. Clarify responsibilities regarding oversight of the OTC market. Improve cooperation for supervision of brokerage/dealership functions in banks.

Insurance supervision

- Address the vacuum in insurance supervision. Promptly establish the new Insurance Supervisory Agency (or proceed with plans for unified supervision). In the meantime, temporarily restore the capacity to supervise/enforce regulations until the new supervisor is ready to take over the functions.
- Issue regulations and implement standards for the calculation of technical provisions.
- Improve framework for setting MTPL premiums. Amend the insurance law to include guidelines for levels of non-material damages. Introduce measures to reduce the number of uninsured vehicles.
- Create an active Insurance Association as a facility to agree on product and service standards, consumer protection, disputes resolution and staff development aspects.
- Increase the quality of insurance companies' financial accounts and improve financial reporting.

Pension supervision

- Continue with efforts to introduce risk-based supervision. Re-evaluate supervision methodologies to improve efficiency.
- Re-evaluate limits on pension funds investments to allow higher returns.
- Allow banks to provide custodian services to reduce cost.

Payment systems

- Complete remote back-up facilities for the RTGS.
- Establish more effective reporting links for the RTGS oversight. Establish operating standards, beginning with oversight of payment infrastructure not operated by NBRM.
- Introduce some form of collateral or loss coverage agreement for KIBS in order to improve management of the credit and liquidity risks.
- To reduce costs, introduce a national net settlement service for card payments in domestic currency. Set standards for national e-payment infrastructure.

I. SUMMARY OF THE 2004 FSAP RECOMMENDATIONS

1. **The 2003 FSAP generally concluded that the key issues in the financial sector were weaknesses in the regulatory framework and gaps in its implementation.** For the banking sector, the most critical priority was considered to be improving the quality of ownership, the legal framework and the quality of banking supervision. Recommendations related to liquidity management and financial safety nets were provided. The focus in the insurance sector was on improving the regulatory environment, building supervisory capacity and more effective MTPL system. Finalizing the preconditions to introduce the second pillar provided the emphasis for the pension sector. Recommendations for the securities markets aimed to improve supervision and stimulate equity and bond market development. Payment system recommendations focused on improving the payment system oversight.

2. **All key 2003 FSAP recommendations have been implemented at least partially.** The regulatory framework has improved to address identified weaknesses and start harmonizing with the EU directives. The ownership structure of banks has improved. The central bank support functions have been strengthened, including the liquidity support and safety nets. The second pillar of the pension system became operational. However, improving supervision remains a challenge, except in the banking sector. The payment systems infrastructure has been strengthened, and there were improvements in the legal framework for accounting and auditing practices. Annex I provides the 2003 FSAP recommendations summary.

II. MACROECONOMIC OUTLOOK AND RISKS

3. **Economic growth has been robust in recent years, and stood at around 5 percent in 2007**. Increased employment and real wages are boosting domestic demand leading to higher imports. Exports are also increasing strongly, led mainly by iron and steel products. Overall, the external position has been comfortable. Though the trade deficit has steadied at around 20 percent of GDP, it has been offset largely by remittances, so that the current account deficit is estimated to have reached only 3 percent of GDP in 2007. On the negative side, inflation has risen sharply in recent months following years of relative price stability with CPI inflation reaching 10 percent in March 2008.[3]

4. **While Macedonia's medium-term economic outlook is generally favorable, it is subject to a number of risks.** The most important risks include: worsening global economic environment affecting output growth in the main trading partners that would translate into slower export growth and a slowdown in remittances and other foreign inflows; sustained inflation pressures emanating from domestic demand pressures (including public sector wages and pension increases in the next three years pre-announced by the government in 2007); and regional political instability, including obstacles on the path to EU accession.

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[3] Higher food prices, which increased by around 20 percent year-on-year, as well as higher energy prices, are the main causes. At 4 percent, non-food inflation is lower.

III. THE FINANCIAL SECTOR

Banking Sector

5. **While dominating the financial sector and with a high growth trend, the banking sector is still relatively small.** Total assets of the sector amount to about 66 percent of the GDP, with credit equivalent to about 37 percent of GDP. This is below the average of other transition economies in the region and well behind the new EU-members (Annex 3, Table 1). The lower level of financial intermediation is partially the consequence of the widespread use of cash in the economy, fuelled in large part by remittances.

6. **Foreign participation in the banking sector has increased significantly.** Banks with majority foreign ownership accounted for almost 86 percent of total assets in the banking system at end-2007 compared with about 47 percent at end-2004. The top three banks (all foreign owned) account for 67 percent of the banking sector assets: the rest are small players.

7. **Credit growth picked up significantly in the last two years.** Facilitated by the favorable domestic economic conditions, annual average credit growth in 2006–07 was 35 percent (or 6 ½ percentage points of GDP). Credit to households, especially through credit cards, grew faster than to enterprises. The use of overdraft facilities increased. As with other countries in the region, a high share of credit is denominated in foreign currencies and/or indexed to a foreign currency. Rapid credit growth can have important implications for financial stability and thus needs to be continuously monitored.

8. **Unlike some other countries in the region, credit growth in Macedonia has primarily been financed by customer deposits**. Banks also do not carry the interest rate risk, as the rates on most credit products are adjustable**.** Given that banks transfer interest rate risk and foreign exchange risk into credit risk, the credibility of the de-facto peg is critical for the stability of the financial system**.** NBRM needs to continue to monitor credit developments and be prepared to take appropriate measures to safeguard financial stability as necessary.

9. **Financial soundness indicators suggest a reasonably healthy banking sector.** The risk-weighted capital adequacy ratio **(**CAR) for the aggregate banking system decreased to 17.2 percent at end 2007, but still remains comfortably above the statutory minimum. The CAR is much higher for small and medium size banks. The non performing loan ratios are on a declining trend, but will have to be watched given the increasing indebtedness of the household and corporate sectors. Profitability is high compared with the regional average and rising, reflecting high spreads. However, competition among banks increasingly puts pressure on spreads.

10. **The stress test results suggest that banks, especially the large ones, are vulnerable to credit risk.**[4] The large banks were also less resilient to combined shocks than the small and medium-sized banks. Liquidity risk is relatively low. Market and contagion risks are minor. While spill-over effects cannot be ruled out, knock-on effects through interbank contagion seems to be a low risk. The NBRM needs to strengthen its stress testing analyses, in particular for credit risk. Scenario analyses need to be made more macro-consistent. The NBRM should continue to encourage stress testing among commercial banks.

Insurance Sector

11. **Insurance sector is small and growing modestly**. While premium growth has shown an upward trend, the total gross premiums in 2006 were equivalent to about 1.84 percent of GDP. This places Macedonia behind a number of other markets in the region. The positive changes since the 2003 FSAP include reduced concentration and improvements in ownership structure. Of the 12 insurance companies, two are engaged in life insurance. Weak domestic and regional shareholders were replaced by experienced insurance companies from EU so that the sector is now mostly foreign owned. The new owners can provide more capital and more experienced management to build institutional capacity faster. This will further strengthen the insurance sector and increase competition.

12. **The market is dominated by compulsory motor-third-party-liability (MTPL).** MTPL accounts for about 50 percent of the insurance market, and motor-related insurance for about 62 percent **– a** structure similar to most countries in the region. In 2007, the National Insurance Bureau introduced a new database system allowing for better management of insurance market. However, further initiatives are needed to increase compliance levels.

13. **On-going issues could negatively affect insurance sector growth perspectives.** The framework for setting minimum and maximum premiums for MTPL is not functioning, which is a serious problem. The MTPL Commission set premiums in 2006 that are still in force. Attempts to set new premiums have failed, as the industry and the MOF representatives could not reach consensus. Another issue is the lack of guiding criteria for non-material damages. Concerns about the rapid rise in the amount of awards made by the courts led to an agreement on a set of criteria for non-material damages to be used by judges. However, these criteria have been ruled invalid by the Constitutional Court.

14. **The insurance industry would benefit from the creation of a nationwide insurance association.** It could provide a forum to agree on products and service standards, educational and training opportunities for insurance staff, and perhaps even take a role in consumer protection by supporting an industry code of practice and developing dispute resolution mechanisms. An association of insurance companies was formed within the Economic Chamber of Macedonia in 2006. However, without recourses and permanent

[4] The tests included single factor sensitivity tests and macro-scenarios. The shocks were calibrated using a combination of expert judgment and the study of stress episodes in other countries in order to make up for data limitations.

funding, it is not active. Recognition that the industry can only expect to have influence by presenting a common approach to issues, particularly in dealing with the MOF, is increasing.

Pension Sector

15. **The second pillar of the pension system began operation in January 2006.** Two mandatory private pension funds selected through international tender are financed by 7.42 percent of gross earnings diverted from the employer's 21.2 percent contribution to the state Pension and Disability Insurance Fund (PDIF).[5] The number of members who joined the second pillar was larger then expected amounting to 168,000 contributors, mainly from new entrants to the workforce. An increase of the number of pension funds is being planned, which will increase competition.

16. **The success of the second pillar will depend on pension funds' capacity to have investment returns above the rate of wage inflation**. In the first two year of operations, pension companies received funds equivalent to 0.95 percent of GDP.[6] Their investments were rather conservative.[7] Returns from January 2006 to March 2008 have been around 6 percent on an annual basis, a little below wage growth for the same period. Regulations impose risk limits on the structure of pension fund portfolios. However, the expected advantages of the second pillar will not materialize, if it does not generate higher returns. The challenge for the pension funds will be to decide how to move up the risk/return curve.

17. **The downward pressure on fees should be maintained.** Contribution fees charged by pension companies, as well as fees for the collection services provided by the PDIF and fees for custody services provided by NBRM, have all been reduced. The supervisory agency (MAPAS) has also reduced its fees from 1.5 percent to 1.0 percent of contributions. Projections over the working life of an average worker indicate that the weighted charge ratio in Macedonia is lower then for many Eastern European countries. Nevertheless, given the challenge of ensuring good returns, all opportunities to further lower fees should be pursued.

18. **Another measure to improve efficiency and reduce cost would be to allow banks to provide custodian services.** The level of fees charged by NBRM appears high by global standards, even though it is not providing the range of services that are typically provided by effective custodians. The local banking industry has now developed the capacity to provide custodian services to investment management industry and could also accommodate the two pension funds. The applicable regulations will need to be amended to allow banks to provide custodian services to the pension industry.

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[5] Second pillar pensions are expected to provide an income replacement rate of 40-50 percent for an average worker. Contributors to the second pillar gain access to their accumulated assets when they reach the statutory retirement age, which is 64 years for men and 62 years for women. They must use the accumulated assets to purchase a lifetime annuity from a specialist provider or through a program for scheduled withdrawals offered by the pension fund in which they are a member.

[6] By 2040, contributions are projected to rise to 2.6 percent of GDP per annum, and the total pension funds assets to stabilize at around 70 percent of GDP.

[7] Equities comprised 17 percent of the pension funds portfolio, while foreign equities accounted for about 2 percent as of February 2008. The bulk was in bank deposits and Government securities.

19. **Low participation in both pillars of the pension system is the key social issue to be addressed.** The membership of the PDIF is around 440,000 (out of the total labor force of 900,000) with about 168,000 participants in the second pillar. High levels of unemployment, the existence of a large informal workforce and employers' avoidance of social security contributions, mean a large number of people remain outside the pension system. In 2006, MAPAS reported that 30 percent of employers were making payments late and 11 percent of individual accounts did not receive any contributions. The PDIF has been improving its databases and enforcement action. However, many employers still fail to register their employees and make contributions to the first and second pillar.

Securities Sector and Markets

20. **The money market is small and dominated by the primary issues of NBRM bills.** In the first quarter of 2008, gross weekly issuance of 28-day NBRM-bills auctions averaged MKD 5.6 billion (1.7 percent of GDP) while their outstanding stock reached MKD 21.8 billion (6.5 percent of GDP) at end-March 2008. The stock of Treasury securities issued for fiscal purposes has declined to less than 5 billion MKD (1.5 percent of GDP). Plans for introducing a system of primary dealers of government securities had to be placed on hold. The interbank money market has a small turnover of only MKD 20.5 billion (6.1 percent of GDP) in 2007, most of it in the overnight segment. A handful of small corporates issue bonds, although only one corporate bond is outstanding.

21. **Further development of a government bond market is needed,** as the existence of a yield curve for government bonds on a liquid secondary market is a necessary precondition for developing other bond markets such as corporate or mortgage bonds. Price discovery in the active part of the market has not been effective, so the government and NBM need to focus on developing a well-structured government bond market with a smaller number of large-volume benchmark issues to establish a yield curve and stimulate development of the secondary market.

22. **The equity market is small.** Trading activity has increased in the strong "bull market" where the market index MBI 10 increased ten fold from early 2005 to autumn 2007. The market has experienced a strong correction (-40 percent) in the last six months, bringing the still young market to a crucial test – especially as the market still has an undeveloped institutional investor base.

23. **Macedonia Stock Exchange (MSE) is the only exchange.** It is organized as a closed joint stock company and recognized as a self-regulatory organization. MSE operates an electronic trading system and has 22 members, of which 16 are brokerage companies. The trading applies a "concentration rule" for all non-government securities that is strictly enforced. There are 38 listed joint stock companies[8] with a total market value of MKD 113,5 billion (34 percent of GDP) and the end of 2007. In addition, around 100 companies are on a

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[8] These never applied for listing, but were included in the "official listing" during the introductory phase of equity market development and chose not to delist later. The official list is further divided into a super list (4 companies) and an ordinary list.

list of publicly held companies and the remaining joint stock companies (a total of around 750) can be registered for trading. There has never been a true initial public offering (IPO) in the post-privatization period, but several companies have raised additional capital in the market. MSE is taking part in regional exchange cooperation initiatives and trying to forge strong relations with other exchanges in the region.

24. **The market has an uneven investor base and very few foreign investors.** Total turnover for the listed companies in 2007 was MKD 22.6 billion (equal to 20 percent of market capitalization and 7 percent of GDP). There are a large number of very small shareholders (from privatizations) and a few very large shareholders owning control stakes. An institutional investor base (pension and investment funds) appeared quite recently. Foreign participation increased during the bull market, accounting for about half of the buy-side in 2007. Anecdotal evidence suggests that the households were active in the bull market for speculative reasons.

IV. Financial Regulation and Supervision

Banking Supervision

25. **NBRM has committed major resources to complete the regulatory framework and the related procedural manuals.**[9] New secondary legislation addresses capital adequacy, all major facets of risk management including credit, liquidity and currency risks, information system security and exposure limits. In addition, there is legislation on corporate governance, audit scope and financial reporting. Almost all of the new decision are planned to be implemented by early 2009.

26. **Bank regulation and supervision remain reasonably comprehensive and, with some minor exceptions, comply with the revised BCPs.** The NBRM and the banks now face a major challenge in implementing the large volume of new secondary regulations. Pursuant to the enactment of the 2007 Banking Law, a host of new secondary legislations to address capital adequacy, all major facets of risk management including credit, liquidity and currency risks, information system security and exposure limits were issued. In addition, there was legislation on corporate governance, audit scope and financial reporting. Almost all of these secondary legislations are scheduled to become effective by in mid-2009. NBRM human resources appear generally adequate in number. The planned gradual introduction of the Basel II requirements is adequate, given the structure of the banking sector and its market dynamics.

27. **Financial safety net arrangements are adequate, except for contingency planning for crisis management.** The safety net arrangements include: (i) emergency liquidity

[9] The BCP assessment under the 2003 FSAP concluded that of the 30 Basel Core Principles, 23 were assessed as Fully Compliant or Largely Compliant and three as “Not applicable” in the Macedonian context. The FSAP provided 18 recommendations that provided a platform for NBRM Supervisory Development Plan. Most were implemented through the new Banking Law and secondary legislation (“Decisions”) issued by NBRM Council.

assistance that may be offered by NBRM on a short-term basis with an unstipulated interest rate other than that it be higher than the money market rate and requires collateral; (ii) regulatory and supervisory framework that enables early identification of problem banks and provides for corrective remedies. NBRM has an adequate and effective authority for progressive enforcement actions needed for prompt bank resolution with low costs and minimal disruption to the overall system; (iii) a limited deposit guarantee system that protects small depositors drafted with close adherence to the EU Directive on deposit insurance. In addition, the Macedonian authorities should develop a contingency plan for crisis management and conduct crisis simulation exercises, both domestically and internationally.

Insurance Sector Supervision

28. **Failure of the government to create the Insurance Supervision Agency is a major concern.** The new Insurance Law of 2007 called for a new Insurance Supervision Agency (ISA) to start operations in September 2007. However, ISA has not yet been established and the MOF no longer has the power to issue regulations or effectively impose sanctions, creating a vacuum. Three requests by the MOF to impose sanctions have been challenged and subsequently rejected by the courts, because the MOF was considered to be operating outside its powers.

29. **Building the capacity for regulation and supervision of the insurance industry should be a key priority.** Authorities must ensure that the necessary functions are established with adequate authority and a budget to develop the necessary systems and back-office functions and to attract qualified staff. The newly introduced minimum capital requirements and "fit and proper" management requirements would result in re-licensing of the existing 12 insurance companies. Insurance agents should also be licensed, but the regulations and the licensing process are not in place yet.

30. **Supervision standards need to be upgraded.** Off-site supervision and prudential reporting are rather basic. An insurer was not likely to be subject to supervision more than once in 2-3 years, due to the lack of capacity. Moreover, insurers and the supervisor have little understanding of risk management concepts. Insurers send financial statements and audited annual reports in paper form to the supervisor who has to manually transpose the data in spreadsheets. Data are not analyzed in a systematic way.

31. **Implementing standards for the calculation of technical provisions and increasing the quality of insurance companies' financial accounting are urgently needed.** Insurance companies now select their own methodology for calculating the needed level of technical reserves. The adequacy of the technical provisions is not tested by external actuaries. There seems to be substantial differences between companies, particularly regarding the calculation of provision for claims which have been incurred but not reported. The supervisor should, as a matter of urgency, release draft guidelines on the calculation of technical provisions to ensure a consistent approach to the calculation of technical reserves. The supervisor should ensure that international accounting standards are applied by all companies, and that auditors and actuaries receive adequate professional training.

32. **Given the growing foreign ownership of the insurance industry, MOUs should be signed with relevant foreign regulators.** The number of insurance companies owned by foreign entities has grown fast in 2007. The industry is now 75 percent owned by foreign companies. This development implies cooperation with insurance supervisors abroad. However, at the moment there are no MOU in place.

Pension Sector Supervision

33. **The only noted issue in pension sector supervision is independence.** Since 2003, pension companies have been licensed and supervised by the Macedonian Pension Supervisory Agency (MAPAS), an autonomous institution. The replacement of the MAPAS board by the new government raises questions of its independence.[10]

34. **MAPAS undertakes a very detailed compliance-based supervision, which may inhibit the flexibility of pension companies to operate efficiently.** MAPAS currently has a staff of 15 with plans to increase to 20. This compares to the staff in the pension funds of about 40. MAPAS should reevaluate the supervision methodology to increase focus on risk-based supervision. They should also determine if and how their effectiveness could be improved and costs reduced. When new second and third pillar companies begin operation, MAPAS will have to consider whether it can supervise them with current resources.

Securities Sector Supervision

35. **An EU peer assessment found that most IOSCO principles were at least partly implemented.** Therefore, the FSAP update team did not include an assessment of compliance with IOSCO principles. A follow-up action plan is under preparation and a new organization plan for Macedonian Securities Exchange Commission (MSEC) is being developed. There are also plans to establish an investor compensation scheme. The focus of the FSAP update team was on discussing priorities for achieving fuller implementation of the IOSCO core principles in light of limited resources and a small market. The cost of implementation will be an important concern when implementing the EU peer review recommendations.

36. **The MSEC has a challenging task**. While the intention to build a legal and regulatory framework in line with international practices is generally positive, this will tie up most of the limited resources for drafting/revising regulations while compliance is not adequately supervised and/or enforced. A more practical approach would be to focus on regulating the key risk areas (such as investor protection, market abuses and capital requirements) that would be followed by effective supervision and enforcement.

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[10] MAPAS is governed by a Management Board comprising 5 members appointed by the Government. Board members are appointed for 7 years, although some initial members have been appointed for shorter periods (3 and 5 years) to ensure that not all Board members will be subject to replacement at the same time. The independence of MAPAS was seriously questioned when its board was replaced by the new government in 2006 seemingly for political reasons, although Section 50(3) of the law says that the MAPAS board can only be replaced in the event of serious dereliction of duties; a criminal conviction; or professional technical issues.

37. **An orientation towards risk-based supervision of securities intermediaries should be an important priority**. The immediate focus should be on defining and collecting data needed for calculation of meaningful risk ratios and early warning signals. Securities statistics should focus on providing data needed to systematically quantify risk exposures. This is especially important in Macedonia, where the banks have a major presence in the securities market.

38. **Domestic cooperation should be further strengthened.** Responsibilities for operation of the over-the-counter (OTC) market in NBRM and government securities appear uncoordinated. Cooperation between MSEC and NBRM in supervision of brokerage and dealership functions operated within banks could be better.

V. FINANCIAL INFRASTRUCTURE

Payment Systems

39. **The payment system architecture has seen major improvements since 2003.** Macedonian Interbank Payments System (MIPS) is a real time gross settlement system (RTGS).[11] The MIPS compliance with the CP SIPS was formally assessed in 2003. It was concluded that the system is in full observance of most principles. With the exception of the remote back-up system that should be completed by the end of 2008, all FSAP recommendations were addressed. The most important advances included improvements of the payment and settlement systems related regulatory framework (all major laws were amended in 2007 and supported by the related decisions), changes in liquidity support arrangements, improvements in governance, and better transparency and information support.

40. **The low value payment system's (KIBS) risk management tools are rather basic.**[12] The rules allow for unwinding in case of failure to settle and repeating the settlement at a later point. Participants have no obligation to pledge collateral, and there is no loss-sharing arrangement. Introduction of some form of collateral or loss coverage agreements should be considered in order to improve management of the credit and liquidity risks. The Interbank Clearing House owns and operates the KIBS which currently covers only credit payment instructions. New projects include introduction of direct debit schemes and support for electronic banking.

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[11] The MIPS is owned and operated by NBRM. The system has 24 direct participants, including banks, clearing houses (KIBS and CaSys), Treasury and Central Securities Depository, where MIPS also provides the platform for securities settlement on a delivery-versus-payment basis. In 2007, MIPS processed over 2.8 million transactions with a total value of more then MKD 1,542 billion. The availability of the system has normally been 99.8 percent.

[12] The KIBS system handles payments of less than MKD 1 million. It is owned by 15 banks and is used by 17 banks with payment operations licenses. It is processing individual transactions or batches based on multilateral netting and settlement through the NBRM**.** In 2007, KIBS processed 12.5 million transactions (about 81 percent of the total transactions) with the value of about MKD 166 billion (about 10 percent of the total value).

41. **Macedonia needs an initiative to integrate the electronic payment instruments related infrastructure,** set national standards, and organize netting and settlement in the country for card payments in domestic currency. CaSys is a privately owned[13] card processing operator also engaged in certification and maintenance of ATM and POS networks. CaSys provides authorization, clearing and settlement card transactions, card personalization and PIN generation. It is certified as MasterCard member service provider and chip-card processor for VISA and maintains connections with MasterCard and Visa settlement systems. In 2007, it processed about 491 thousand transactions with value of about MKD 2.25 billion.

Payment Infrastructure Supervision

42. **The legal framework related to NBRM's responsibility in oversight of payment infrastructure has seen major improvements.** A new Law on Payment Operations defines NBRM objectives and responsibilities for oversight of interbank payment systems, retail payment systems and settlement systems for electronic payment instruments. The related decisions address criteria and standards for operation of the payment systems and methodology for oversight of payment systems. The National Payment System Council, established in 2004, operates under a national strategy and action plan in effect until 2011. NBRM has taken initiative to better inform the stakeholders and the broader public about payment systems activity and related issues.

43. **NBRM has started to develop the oversight capacity and initiated technical cooperation with more experienced central banks, but further improvements are needed.** The Payment System Department has divisions for oversight and operations. However, the oversight division should have a direct reporting line with a higher authority to ensure full separation of the operational and oversight functions.

44. **Systems that are not operated by the NBRM (KIBS and CaSys), notably the securities settlement system, should also have oversight through an MOU.** The supervision should include *on-site technical inspections* of all payment and settlement facilities. The skills of people involved in supervision of the payment system infrastructure should include the necessary legal, operational and technical (IT) expertise.

Capital Market Infrastructure

45. **The infrastructure for the Macedonian securities markets functions well and operates on clear principles.** The two main infrastructure organizations are MSE for trading, and the Macedonian Central Securities Depository (CSD) for settlement, ownership registration and registrar functions. The money side of the securities settlements takes place in NBRM RTGS system. NBRM operates an auction and OTC trading system for NBRM-bills, T-bills and continuous government bonds and also has its own ownership registration system for NBRM-bills (which can only be owned by banks).

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[13] It is owned by a number of private shareholders and 19.9 percent by the Government of Macedonia. Its members include 11 banks from Macedonia and also banks from Bulgaria and Albania.

46. **The systems are well supported by IT.** The MSE operates a sophisticated multi-functional electronic trading system (BEST). The CSD operates a system developed in-house. Both of these central systems have their own back-up facilities. However, it seems that there are no sector-wide, coordinated tests of contingency plans. There are unused possibilities for economies of scale created by sharing facilities for back-up operations, and perhaps to offer such services to the smaller intermediaries.

Credit Registries

47. **The NBRM operated credit registry is in the process of reorganization aiming to broaden its coverage, increase banks' reporting frequency, and improve the content, structure and veracity of credit and borrowers' data.** It was first established in 1998. Its use has been correlated with the decline of nonperforming loans and improvement of credit terms. The reorganization is expected to be completed by September 2008. According to the Draft Law on NBRM, leasing companies will also join the system. It is expected to continue playing a useful role in supervision, for example, in banking statistics and credit scoring and to encourage borrowers' financial discipline.

48. **A related project of the Banking Association aims to create a private Credit Bureau with even broader data coverage and access to credit information.** The Credit Bureau will include data on credit/debt and debt service history. It will be open to banking, financial and non-financial institutions, such as utility companies, tax authorities, insurance companies and, in principle, any interested entity dealing with credit risk. The system is expected to be self-financed through payments of reporting fees. The necessary legislation has been drafted, approved by the government and submitted to the Parliament.

Accounting and Auditing

49. **Accounting and auditing reforms have been enacted since the 2003 FSAP.** Implementation of major regulatory initiatives supported by donor funding are well under way.[14] The initiatives included creation of the necessary infrastructure for accounting and auditing. The Institute of Certified Auditors was established in May 2006 and the Oversight Council in December 2006. In September 2007, NBRM enacted a new regulatory framework for accounting and financial reporting in compliance with IAS/IFRS.

50. **Banks are expected to complete the accounting reforms by 2009.** The framework incorporates a methodology for recording and measuring accounting positions and for preparation of financial statements, a new Chart of the Accounts, and financial statements templates. Given the significant changes in the scope and content of the audit, the new banking sector accounting and auditing regulatory framework will be enforced as of January 1, 2009.

[14] A new Audit Law was enacted in September 2005 and a Country Action Plan (CAP) was endorsed by the Government in August 2006. The primary benchmark for the CAP is the EU Acquis Communautaire, complemented by International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA) and international good practices. The CAP accounting and audit reform agenda is being implemented through donor funding.

ANNEX 1. RECOMMENDATIONS OF THE 2003 FSAP

2003 FSAP Key Recommendations	Status of Implementation
Banking	
The quality of ownership and management in the banking system could be upgraded by attracting new strategic investors, which would help address low levels of financial intermediation, lack of competition and inefficiency in the banking system.	Progress has been made in improving the quality of ownership in the banking system. Banks with majority foreign ownership accounted for 85.9 percent of total assets in the banking system at end-2007 compared with 47.3 percent at end-2004. The increase in foreign ownership was mostly at small banks (those with assets of 5 percent or less in the system). Of the foreign entrants only one, Société Générale SA, has a global presence. The second largest bank, although now majority foreign owned, still lacks a strategic partner.
Bank Regulation and Supervision	
Additional steps could be taken to strengthen the legal framework for supervision and to improve the supervisory function through a more proactive approach to addressing banks under enhanced supervision.	A new Banking Law (BL) was enacted in June 2007. It draws on European Directives 2006/48 and 2006/49, the Basel Committee's recommendations and principles and, as well, takes into account certain recommendations of the IMF and those made in the context of the 2003 FSAP. The revised BL sets out a more comprehensive supervisory approach to problem banks. Chapter XV details measures and corrective actions that NBRM could take against a bank, a banking group, a bank's shareholders and its governing bodies.
Supervisors should continue to search for reputable foreign strategic investors and a strategy should be developed to reduce the importance of non-financial corporate investors.	Shareholders of certain systemically unimportant banks have been encouraged to seek out reputable strategic foreign investors, with some positive outcomes (see "Banking", above).
Liquidity Management	
Liquidity management could be improved through expansion of the instruments available for collateral to access the central bank facility.	The stock of instruments eligible to serve as collateral for access to the Lombard facility reached 8 percent of GDP (or equivalent to 17 percent of the banks' domestic liabilities) at end-2007.
Repo operations should be introduced and primary auctions decreased to develop the secondary market.	Intraday and Lombard repo operations were introduced in October 2005, and repo auctions in December 2006. The frequency of NBRM bill auctions has been reduced to one per week.
Payment and Settlement Systems	
NBRM's oversight role for the payments systems needs to be clarified, and a back-up facility established.	NBRM oversight role has been more clearly defined in the new Law on Payment Systems and by the Decision on Criteria and Standards for Operations of the Payment Systems and the Decision on Process and Methodology for Oversight of Payment Systems. NBRM is in the process of establishment of the back-up facility, including optical fiber link with the main RTGS processing facility, but it is still not operational.
NBRM's obligation to execute payment guarantees between commercial bank clients should be moved outside the system.	The obligation of NBRM to provide guarantees has been cancelled.
Financial Safety Nets	
Establish framework for emergency lending for systemically important banks.	The Law on the National Bank of the Republic of Macedonia gives the legal basis for conducting lender of last resort operations by the National Bank. A related Decision details the criteria, terms and eligible collateral related to the LOLR function.

2003 FSAP Key Recommendations	Status of Implementation
Securities Markets	
The capital markets should be further developed, particularly the government securities market. There is scope for further actions to strengthen the framework for securities regulation, particularly the enforcement capability of the SEC.	The government securities market is still small, dominated by short term bills (and non standard bonds) and suffers from lack of liquidity. The equity markets have shown improvements and have now more activity. Enforcement capabilities and particularly use of risk based methodologies are still challenges for SEC.
Pension System	
Before implementing the second pillar, the Government should reach consensus on key policy issues, demonstrate the viability of the government securities market, simplify the model for a transitional period, and ensure the institutional strengthening of the PSA.	Pillar II became operational on January 1, 2006. Following a public tender, two pension funds were provided with operating license. A new agency for regulation and supervision of the pension funds – MAPAS- has been established. MAPAS has received significant technical assistance and is now operational. The viability of Government securities market, and of other options for pension funds' investments, is still unclear. This can undermine the performance and viability of the Pillar II.
Insurance Sector	
Insurance supervision should be strengthened though designation of an Insurance Commissioner in the MoF and related capacity building. The third party motor liability system should be fundamentally reformed.	The new Insurance Law was enacted in mid-2007. The Law envisages creation of an independent agency for supervision of the insurance sector, but the agency has not been created yet. There were some efforts to reform the MTPL system, but no major changes. An MTPL Commission has been established to set the minimum and maximum premium. However, the MTPL Commission set premiums only in 2006, and these have not been updated. There was an agreement to limit the non-material damages -- in order to make the business more viable. The Constitutional Court ruled setting the limits on non-material damages as illegal. Proposals of the Ministry of the Interior to implement stronger enforcement, including a screen-sticker system, have not been implemented.
Legal and Judicial Framework	
The Government should move aggressively to reform and strengthen the judicial sector, and to strengthen the implementation and enforcement. Financial regulators should be provided legal authority to impose sanctions on financial institutions.	Judicial sector and the court system have not been addressed as part of the FSAP Update. The new set of regulations provides the legal basis for the regulatory and supervisory agencies to impose sanctions. However, further improvements are needed.
AML/CFT	
The MoF should enhance coordination with other agencies to implement the national AML strategy. It should coordinate activities closely with the Justice Ministry to ensure rapid adoption of International AML/CFT Conventions. Legal authority should be provided to supervisory agencies to monitor compliance with AML/CFT laws. Further capacity building is required.	The Office of Prevention of Money Laundering and Financing of Terrorism have been established at the MoF. It has signed a multilateral memorandum of understanding on cooperating with other agencies (e.g. Ministry of Interior; Public Revenue Office; Customs; Ministry of Justice; NBRM; etc) involved in dealing with AML/CFT. A new AML/CFT law was passed in January 2008 that takes into account the Third EU Directive and the 2004 FATF 40+9 Recommendations on AML/CFT.

ANNEX 2. SELECTED FINANCIAL SECTOR STATISTICS

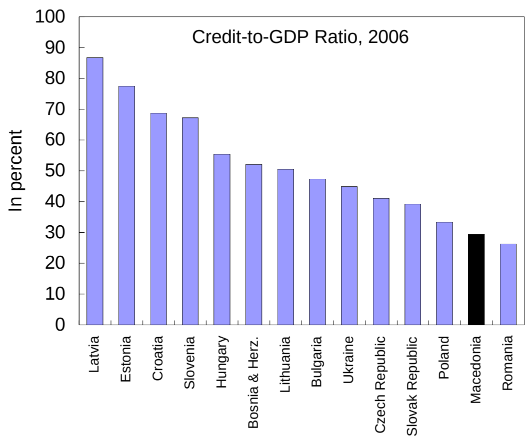
Table 1. Macedonia: Banking Sector - Regional Comparison, 2006
(in percent, unless otherwise indicated)

	Macedonia	Bosnia & Herzegovina	Bulgaria	Croatia	Hungary	Moldova	Romania	Serbia	Slovenia
Number of Banks	18	32	32	33	40	15	31	37	25
Foreign-owned banks	11	22	23	15	28	6	26	22	10
Total banking assets to GDP	66.3	82.5	78.5	120.3	86.7	49.6	29.9	53.7	113.4
Total credit to GDP ratio	36.8	52.1	47.4	68.7	55.4	26.0	26.3	24.2	67.2
Share of foreign-owned banks	85.9	94.0	80.1	90.8	82.9	22.9	87.9	78.7	29.5
Capital Adequacy Ratio	17.2	17.7	14.5	13.6	11.0	28.0	18.1	24.7	11.8
Non-performing to total loans	9.1	4.0	2.2	5.2	2.5	4.0	8.4	23.1	2.5
RoAA	2.0	0.9	2.2	1.5	1.8	3.0	1.3	1.7	1.3
RoAE	15.8	8.5	24.4	13.0	24.0	21.0	10.3	10.0	15.1

Source: IFS; WEO; national authorities (FSI); EBRD and Central Banks.
Note: Data for Macedonia is end-2007 or Q3 2007.

Figure 1. Macedonia: Credit Growth—Regional Comparison

Stock of credit remains low by regional standards...



...although credit growth picked up in 2007 closer to regional averages.

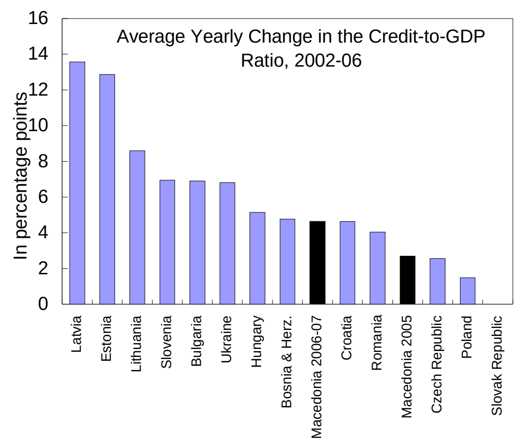


Table 2. Macedonia - Financial Soundness Indicators, 2003-2008

	2003	2004	2005	2006	2007	2008Q2
	(Percent, unless indicated otherwise)					
Capital adequacy						
Regulatory capital/risk weighted assets	25.8	23.0	21.3	18.3	17.0	15.6
Tier I capital/risk weighted assets	26.2	23.9	24.3	18.9	15.7	14.0
Asset composition and quality						
Sectoral loans to nonfinancial enterprises/total loans 1/						
Enterprises	44.4	43.5	61.7	59.0	54.9	54.3
Households	11.8	16.3	30.6	33.4	37.7	38.5
Foreign currency lending						
Foreign currency lending/total credit to private sector	16.2	20.0	25.4	26.3	24.6	23.2
Foreign currency indexed lending/total credit to private sector 2/	22.2	20.6	23.8	26.4	30.1	31.5
NPLs /gross loans 3/	22.1	17.0	15.0	11.2	7.5	6.9
NPLs net of provision /capital 3/	10.6	2.2	2.9	0.7	-5.0	-5.1
Large exposures/capital	193.0	219.0	189.7	194.7	181.4	121.0
Connected lending						
Banking system exposure to shareholders/capital	7.0	7.4	4.3	5.2	5.6	3.2
Banking system equity participation/capital	6.3	5.6	6.2	5.5	4.2	4.0
Earning and profitability						
ROAA 4/	0.5	0.6	1.2	1.8	1.8	2.2
ROAE 4/	2.3	3.1	7.5	12.3	15.0	19.1
Interest margin/gross income	46.2	49.6	53.8	57.1	57.0	59.4
Noninterest expenses/gross income	87.7	75.6	68.1	63.6	60.3	59.1
Personnel expenses/noninterest expenses	42.5	41.7	42.1	41.1	38.4	38.2
Interest rate spreads (in percentage points)						
Local currency	7.8	5.5	6.5	6.3	4.5	3.8
Foreign currency	…	5.6	6.5	6.7	6.5	5.9
Interbank market	9.8	6.9	8.7	4.9	3.1	4.6
Liquidity						
Highly liquid assets/total assets 5/	38.7	37.8	14.9	17.7	20.6	17.8
Highly liquid assets/total short-term liabilities 6/	57.4	55.0	22.0	25.6	28.7	25.1
Customer deposits/total (noninterbank) loans	140.5	143.4	142.3	137.1	128.3	118.5
Foreign currency deposits/total deposits (excluding deposits of banks)	52.7	54.4	55.7	51.8	44.5	45.4
Central bank credit to banks/bank liabilities 7/	0.4	0.9	0.7	1.3	2.0	0.5
Sensitivity to market risk						
Net open foreign exchange position /capital	56.3	52.1	51.6	47.0	38.2	29.9

Source: NBRM's Financial Stability, Banking Regulations and Methodology Department.

1/ Until 2005, total loans include deposits with banks. From end-2006 onwards, total loans include interbank loans.
2/ The ratio differs from that used in the monetary survey due to different definitions.
3/ Includes only loans to nonfinancial sector.
4/ Adjusted for unallocated provisions for potential loan losses.
5/ Highly liquid assets are defined as cash and balances with the NBRM, NBRM bills, and accounts with foreign banks. Large drop in 2006 compared to 2005 is due to change in methodology.
6/ Short-term liabilities are defined as deposits and other liabilities with a maturity of one year or less. Large drop in 2006 compared to 2005 is due to change in methodology.
7/ The increase in 2006 is due to loans channeled through NBRM, not NBRM credit to banks.

ANNEX 3. FYR MACEDONIA FINANCIAL SYSTEM STRUCTURE

	2003				2006				2007			
	Number	Assets			Number	Assets			Number	Assets		
		Denar million	EUR million	Percent of GDP		Denar million	EUR million	Percent of GDP		Denar million	EUR million	Percent of GDP
Banks	21	104,875	1,711	41.7	19	174,117	2,846	56.4	18	223,949	3,659	66.3
Foreign-majority owned	8	49,245	803	19.6	8	92,668	1,515	30.0	11	192,309	3,142	56.9
Domestic-majority owned	13	55,630	908	22.1	11	81,449	1,331	26.4	7	31,640	517	9.4
of which: majority state-owned	1	1,851	30	0.7	1	2,794	46	0.9	1	3,097	51	0.9
Branches of foreign banks	0	0	0	0.0	0	0	0	0.0	0	0	0	0.0
Savings houses	16	1,264	21	0.5	12	2,327	38	0.8	12	2,912	48	0.9
Insurance companies	7	12,236	200	4.9	10	14,608	239	4.7	12	11,074	181	3.3
Life	n/a	695	11	0.3	1	752	12	0.2	2	627	10	0.2
Mixed	1	0	0	0.0	1	0	0	0.0	1	0	0	0.0
Non-life	6	11,541	188	4.6	8	13,856	227	4.5	9	10,447	171	3.1
Collective investment institutions	0	0	0	0.0	0	0	0	0.0	3	65	1	0.0
Private closed end equity funds 1/	0	0	0	0.0	0	0	0	0.0	9	…	…	…
Mandatory fully-funded pension funds	0	0	0	0.0	2	1,242	20	0.4	2	3,124	51	0.9
Leasing companies	5	36	1	0.0	9	3,256	53	1.1	11	5,579	91	1.7
Securities dealers and brokerage houses	0	0	0	0.0	11	615	10	0.2	15	1,083	18	0.3
Investment funds management companies	0	0	0	0.0	0	0	0	0.0	2	15	0	0.0
Private equity management companies 1/	0	…	…	0.0	0	…	…	0.0	4	…	…	0.0
Pension fund management companies	0	0	0	0.0	2	196	3	0.1	2	202	3	0.1
Total financial system assets		118,411	1,932	47.1		196,361	3,210	63.6		248,003	4,052	73.4

Sources: NBRM, Ministry of Finance, and MAPAS.

1/ Data on assets are not collected from private closed end equity funds and private equity management companies.