National Bank of Serbia

Report on the Financial System of the Republic of Serbia in 2005

Foreword

The year 2005 was a very successful year for the Republic of Serbia, as evidenced, among other things, by upward revision of Serbia's country rating to BB- by Standard&Poor's, the level usually awarded to economies in transition that have attained relative macroeconomic stability. Such credit rating opens the door to further and diversified forms of foreign investment in the Serbian economy, as confirmed by the fact that net foreign direct investments in 2005, having grown by 62% on a year earlier, stood at USD 1,550 million.

Majority of these investments were channeled into privatization of banks, which is indicative of just how important for further ownership transformation of the banking sector were the efforts of the National Bank of Serbia on developing its supervisory and regulatory function. This became particularly apparent in 2005. Buyers participating in the acquisition of privately-owned or privatization of state-owned banks were first-rate strategic investors, who, in order to enter the Serbian market, were willing to pay a price equaling several times the book value of the property. However, the most important thing for the entire process is that by insisting on the observance of strict criteria for the assessment of investors' solvency, the NBS created conditions which ensured that only such banks whose track record and experience in banking operations promised to contribute to the development of the banking sector should enter the Serbian market. At the same time, none of these banks hold a sufficiently large share in Serbia's banking sector to enable it to set up a monopoly. The change in the ownership structure of Serbia's banking sector, in which, at the end of 2005, two-thirds of the balance sheet total or one half of all capital were in majority ownership of foreign legal entities and natural persons, significantly contributed to the growth and development of this sector.

The principal source behind banking sector growth in 2005 was deposit potential, which rose by 54.7% in the preceding year to reach 62.5% of all banking sources before the end of the year. Of this, household deposits recorded a respectable growth of 67.3%, reaching CSD 206,348 million or 26.6% of total bank sources.

End-2005 banking sector capital adequacy ratio stood at 26.0%, which is well above the prescribed 12-percent minimum and higher than this indicator's average value in the countries of the region.

The year 2005 was also marked by a "credit boom," which, understandably, triggered a necessary response on the part of the National Bank of Serbia. Enacted measures coming under the remit of the National Bank of Serbia proved to be effective, as confirmed by the fact that the growth in lending activity recorded in the year 2005 (47.8%), although high, was brought down to a level below the increase in the balance sheet total of the banking sector (52%), compared to a year earlier.

For the first time since the start of reforms, Serbia's banking sector operated at a profit of CSD 7,272,000. Such financial result came as a consequence of the fact that the process of "cleaning" long-standing dubious entries from banks' balance sheets is nearing its end, that operational costs have been rationalized, and that business activities of commercial banks are growing both in volume and diversity.

Steady development in banking sector within the region and in Serbia itself called for a change in the regulatory framework for bank operations. In 2005, the National Bank of Serbia participated actively in drafting of the new Law on Banks which entered into force in December 2005, and was to be implemented as of 1

October 2006. The new Law on Banks is the starting point for the application of Basel II principles, in that it prescribes a state-of-the-art system of bank management, necessary systems and procedures for identification, measurement, valuation and monitoring of banking risks, operational transparency for banks, introduction of consolidated supervision, regulating at the same time the relationship of commercial banks and the National Bank of Serbia with external auditors, and a range of other important issues relevant for bank operations. In conformity with its legal obligation, the National Bank of Serbia enacted secondary legislation necessary for the implementation of this law within the set time frame, i.e. by 30 June 2006.

Development of the banking sector in Serbia has been underpinned, inter alia, by the development and improvement of the regulatory framework and operations of the entire financial sector. Namely, having been entrusted with insurance supervision in 2004, the National Bank of Serbia introduced in 2005 a strict market and regulatory framework in the insurance sector. Although the number of insurance companies dropped by approximately 50%, total insurance premium gained 53%, number of insurance sector employees increased by 35%, with the volume of operations and capital rising by 51% and 19%, respectively. The quality of investment of technical reserves used for settling obligations assumed in respect of issued policies also largely improved, with technical reserves recording a 99% growth. Insurance sector reforms can be expected to continue next year, with a view to bringing the development of the insurance sector in Serbia closer to what it is in the countries of the region.

Amendments to the Law on Financial Leasing and the enactment of the Law on Voluntary Pension Funds and Pension Schemes in 2005 lay down a regulatory framework for developing another two, very important segments of Serbia's financial sector. After the National Bank of Serbia was put in charge of supervising the operations of financial leasing companies and voluntary pension fund management companies, conditions were created for the central bank to efficiently perform one of its most significant functions – integrated supervision of financial sector operations.

In view of the present ownership and management structure in insurance companies and legal entities engaged in providing financial leasing services, and of their present connection with banks, consolidated banking supervision, which subject to the new Law on Banks is to start in 2006, will necessarily be the next step in further development of the financial sector supervision.

Governor of the National Bank of Serbia

Radovan Jelasic

CONTENTS

Title *page*

LIST OF TABLES

LIST OF CHARTS

MACROECONOMIC ENVIRONMENT

Economic activity in Serbia in 2005, as measured by GDP growth rate, went up by 6.3% in real terms on a year earlier. The rise in real added value contributed 4.6 percentage points to this increase, whereas the contribution of a rise in taxes was 1.7 percentage points.

Growth in aggregate demand, including high increase in commercial bank lending to households and the corporate sector, was the principal generator of economic growth recorded in the year 2005.

The above growth in economic activity was recorded in the context of higher-than-projected inflation, slight narrowing of the current account deficit, high foreign trade deficit and restoration of fiscal equilibrium on the back of a fiscal surplus.

Current account deficit to GDP ratio declined to 9.1%, grants included, as a result of faster growth in export and slower growth in import of goods and services. The most significant source of financing the current account deficit over the medium term was high capital inflow originating from foreign direct investments and remittances. Foreign exchange reserves of the National Bank of Serbia (hereinafter: NBS) increased by USD 1.59 billion to USD 5.84 billion, and now cover approximately six months of total import of goods and services.

The rate of unemployment continues to climb. In 2005, it stood at 26.9%, which is an increase compared to the rate of 26.0% recorded in 2004. Average wages grew at a slower pace in real terms compared to a year earlier (10.4% in 2004 and 6.2% in 2005), accommodating estimated productivity gains in the entire economy. Growth in public sector wages continued to slow down. The share of total pension payments in estimated GDP stood at approximately 14.1%, which is close to the level recorded in 2004.

2005 inflation, as measured by the retail price growth rate, stood at 17.7%. Bank lending to corporate and household sectors grew at a very high rate in 2005. The debt of both these sectors went up, bringing about a real growth in aggregate demand. Growth in credits to the private sector was 57% (partly on account of the low-base effect). Domestic credits to the private sector accounted for around 10% of GDP. Private sector saving deposits with banks also increased to 18% of GDP (12% households and 6% corporate sector). External debt of enterprises and banks recorded an increase. Foreign debt of the business sector accounted for approximately 26% of GDP late in the year (the same as the level of government external debt).

Total consolidated public revenues in 2005 stood at 43.8% of GDP, with government expenditure amounting to 41.8% of GDP. According to the Ministry of Finance data, consolidated surplus was CSD 32.4 billion or 2% of GDP.

Investment rate, as the ratio of total investment in fixed assets to GDP, is estimated at around 17.5% of GDP in 2005, which is below the required level, especially given the potential of the Republic of Serbia.

Net foreign direct investment in 2005 amounted to approximately USD 1,550 million compared to USD 966 million in 2004 with the majority of funds invested in the purchase of parts of state- or socially-owned enterprises and banks in the process of privatization.

On the international economic plane, the year 2005 was very successful for Serbia. Eminent institutions such as the World Bank and the European Bank for Reconstruction and Development declared Serbia to be the leading reform country, awarding it the highest grade. Among transition countries of Central, Eastern and South East Europe, the Baltic countries and the Commonwealth of Independent States ranked by reference to progress achieved in structural reforms, Serbia ranked best and was awarded the highest grade of 4 (grades range from 1 to 4+).

In July 2005, Serbia's credit rating improved to BB-, as awarded by *Standard&Poor's*, which is a rating level usually awarded to transition economies that have attained relative macroeconomic stability.

FINANCIAL SECTOR OF SERBIA

In addition to exercising its long-standing function of banking supervision (supervision of banks and other financial organizations), as of mid-2004 the National Bank of Serbia has been entrusted with insurance supervision, and, as of 2005, financial leasing supervision and supervision of voluntary pension fund management companies.

All other market participants come under the remit of the Securities Commission – supervision of stock exchange, broker-dealer companies, management companies, investment funds, Central Securities Depository.

Table 1: End-2005 structure of the part of the financial sector of the Republic of Serbia coming under the remit of the NBS

(in CSD mln)

	Banks	Other financial organizations	Insurance companies	Lessors	Voluntary pension fund management companies
Number	40	8	19	13	-
Balance sheet total	775,413.5	2,257.4	46,419.6	51,788.3	-
Share in GDP[1]	44.3%	0.1%	2.6%	3.0%	-

Source: NBS.

Balance sheet total of the portion of the financial sector supervised by the NBS as at 31 December 2005 amounted to CSD 875,878.8 million, which constituted 50.0% of GDP[1].

Other financial organizations include savings banks, credit and savings organizations, and credit and savings cooperatives. In conformity with the new Law on Banks enacted in 2005, these organizations have the obligation to either transform into a bank, merge with a bank or stop operating within one year from the effective date of the new Law, i.e. by 10 December 2006. Intense scrutiny of these organizations from 2003 until 2005 led to a decline in their number. Namely, as a result of either voluntary cessation of operations or license withdrawal by the NBS, their number declined from 14 in late 2003 to 8 in late 2005.

After the NBS assumed the function of insurance supervision, it immediately launched into accomplishing its objectives in this sector – to ensure that insurance companies are sound and stable, and to safeguard policyholders and prevent any threats to their interests by introducing minimum standards for adequate operations and by limiting risk exposure while, at the same time, organizing efficient supervision of their operations. The number of insurance companies declined substantially, from 39 in late 2003 to 19 in late 2005.

By contrast, financial leasing sector expanded, both in terms of increased number of lessors (at the end of 2003 there were only 6) and in terms of intensification of their activities.

Until the end of 2005, the NBS did not issue any license to voluntary pension fund management companies, as the law governing their operations was to be implemented

[1] GDP estimate for 2005.

only as of 1 April 2006, but regulated this field of activity by enacting necessary legislation and building up its supervisory capacities.

The most significant participants in Serbia's financial market are banks, which account for 88.5% of the overall balance sheet total of the portion of the financial sector coming under the remit of the NBS. The banking sector in 2003-2005 was characterized by:

- successful implementation of reforms and restructuring,
- restoration of confidence in banks and replenishment of savings,
- entry of foreign capital and, along with it, capital increase, enhanced competition, fresh expertise and experience from international markets, including new banking products,
- privatization of largest state-owned banks,
- intense lending activity, especially lending to households,
- clean-up of long-standing dubious items from banks' balance sheets,
- strengthening capital base,
- improvement of supervisory regulations with a view to harmonizing them with the European Union regulations and basic principles of the Basel Committee on Banking Supervision,
- application of international accounting standards.

In 2005, the National Bank of Serbia actively participated in drafting of a new Law on Banks, which entered into force in December 2005, while its application was to start on 1 October 2006. The new Law on Banks was a starting point for the application of Basel II principles – in that it prescribed a state-of-the-art efficient system of bank management, necessary systems and procedures for identification, measurement, valuation and monitoring of banking risks, operational transparency for banks, introduction of consolidated supervision, the relationship of commercial banks and the National Bank of Serbia with external auditors, and a range of other important questions relevant for bank operations. In conformity with its legal obligation, the National Bank of Serbia enacted secondary legislation necessary for the implementation of this law within the set time frame, i.e. by 30 June 2006.

NOTE: This report is based on reports that banks, insurance companies and financial lessors submitted to the NBS in conformity with applicable regulations.

Data presented in this report have not been reviewed by an independent auditor or examined during on-site supervision by the NBS.

BANKING SECTOR

Given that banking sector dominance is the key feature of Serbia's financial system and that it has been undergoing extremely dynamic development over the past several years, attended by changes in the ownership structure of banks, the analysis was made from the perspective of the entire banking sector, with individual groups of banks classified by ownership structure.

Banks have been classified depending on whether their majority shareholders are domestic legal entities and natural persons (hereinafter: private banks), foreign legal entities and natural persons (foreign banks) or banks in which the Republic of Serbia is the majority shareholder, or, individually, directly or indirectly, the largest shareholder (state-owned banks).

Number of Banks

At the end of 2005, Serbia's banking sector numbered 40 banks. Banking sector reform, a five-year process of consolidation and restructuring, is about to enter its final stage. Reform started in 2001 by a comprehensive diagnosis of the inherited situation and, since then, the banking sector had undergone significant changes. Operating licenses were revoked from insolvent and illiquid banks (at the start of 2002, bankruptcy proceedings were instituted in respect of 4, then largest, banks, which accounted for 57% of the balance sheet total of the banking sector). Smaller, undercapitalized banks either merged with or were acquired by larger banks and, as a result of this process, at end-2002 there were 50 banks holding an operating license granted by the National Bank of Serbia.

During 2003 and 2004, the National Bank of Serbia revoked the operating license from two banks; one bank rendered a decision to cease operations; bankruptcy proceedings were instituted in respect of one bank; and three banks merged with other banks. As a result, at the end of 2004 there were 43 banks operating in Serbia.

During 2005, the number of banks declined by three more (one bank had its operating license revoked and two merged with other banks), whereby the number of banks was halved compared to the time when the banking sector reform was begun.

In the period under review, the NBS did not issue a single operating license to any new bank, while the last time a bank was founded was in 2001 (when 5 banks in majority foreign ownership and 1 bank in majority domestic ownership were set up).

Balance Sheet Total of the Banking Sector

Overall balance sheet total of the banking sector reached CSD 775,413 million at the end of 2005, which is an increase by CSD 265,321 million or 52.0% compared to end-2004. Although the number of banks had been declining from year to year, overall balance sheet total in the period under review had been growing at an accelerated pace (16.1% in 2003 and 38.8% in 2004). Real growth in balance sheet total stood at 8.3% in 2003, 25.1% in 2004 and 34.3% in 2005[2].

Growth in deposit potential was the principal source of increase in the balance sheet total. Deposit potential accounted for over 60% of total increase in the balance sheet total and recorded a faster per annum growth than balance sheet total. In 2005, this increase

[2] Retail price growth stood at 7.8% in 2003, 13.7% in 2004 and 17.7% in 2005.

was CSD 171,428 million or 54.7%. Another significant source of growth in deposit potential was external borrowing, which recorded an increase of CSD 57,560 million or 114.0% in 2005. Own sources (capital) rose by 26%.

A breakdown by individual bank shows that only two banks recorded a decline in balance sheet total in 2005 compared to 2004. Over one half (63.8%) of the increase in banking sector balance sheet total in 2005 was recorded by 5 banks, 4 of which were in majority foreign and 1 in majority state ownership.

Table 2: Ratio of banking sector balance sheet total to GDP

(in CSD bln)

	2003	2004	2005
Balance sheet total	367.5	510.1	775.4
GDP	1,171.6	1,431.3	1,750.0
Balance sheet total/GDP	31.4%	35.6%	44.3%

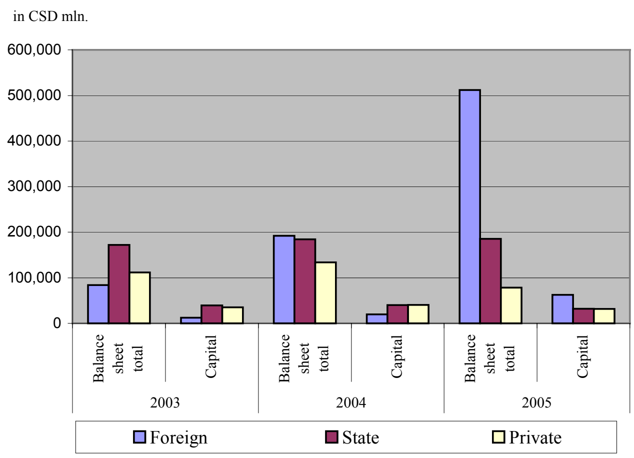
Source: NBS, GDP estimate for 2005. Republic Statistical Office.

Although the share of the banking sector in GDP is growing, it is still much lower than in other countries of the region. Towards the end of 2005, this share stood at 11.5% in Croatia, over 90% in Slovenia and over 78% in Bulgaria, whereas in the European Union it was higher than 300%.

Ownership Structure of the Banking Sector

After the conversion of claims in respect of Paris and London Club credits and frozen foreign currency savings deposits, the Republic of Serbia acquired ownership in 18 banks. The Law on Regulating the Relations Between the Federal Republic of Yugoslavia and Legal Entities and Banks on the Territory of the Federal Republic of Yugoslavia That are Original Debtors or Guarantors in Respect of Paris and London Club Creditors (from 2002) prescribed the obligation for the government to sell the bank shares it has acquired in this way. In the period from 2003 to 2005, activities were focused mainly on consolidation of state-owned banks and their privatization, revocation of operating licenses from insolvent banks, acquisition or merger of smaller undercapitalized banks, and rigorous assessment of solvency of potential acquirers of bank shares. In addition, during this period, ownership structure of the banking sector was analyzed in detail, down to ultimate owners, i.e. natural persons – shareholders of the bank.

Chart 1. Ownership structure of banks

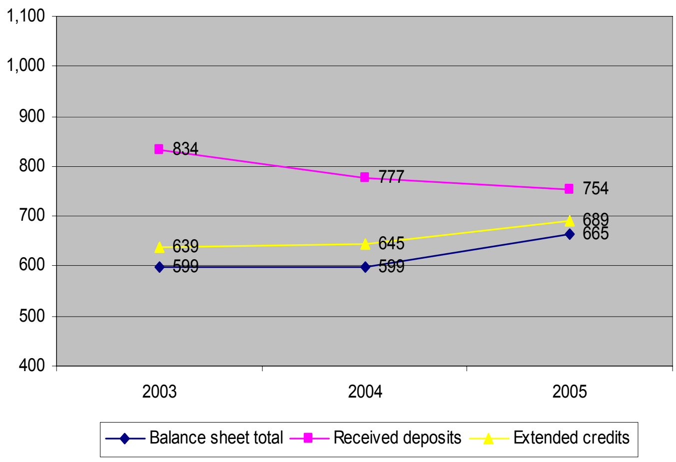


Entry of foreign capital proved to be the principal driver behind the change in the ownership structure of the banking sector. In 2003, foreign owners acquired majority ownership in 5 private banks, whereas in 2005 privatization of 3 state-owned banks, as well as capital increase and acquisition of 4 private banks, were completed in this manner.

As a result of these changes, 17 foreign banks now account for 66.0% of the balance sheet total and 49.6% of banking sector capital. As the process of their privatization neared its end, state-owned banks (11 of them) reduced their share to one quarter. The share of private banks (12 banks) acquired by foreign shareholders also declined (10.1% of balance sheet total and 24.5% of banking sector capital).

Market Concentration in the Banking Sector

Chart 2. Herfindahl's index of concentration



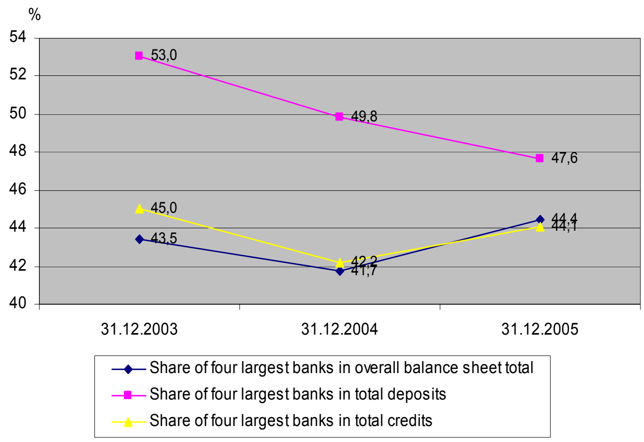
Market concentration in Serbia's banking system is not overly pronounced. After remaining unchanged for two years, the value of the HHI – Herfindahl-Hirschman Index[3] of concentration of balance sheet assets rose by 66 units at the end of 2005 compared to end-2004. The value of HHI credit concentration rose by 6 units in the period from 31 December 2003 until 31 December 2004, and 44 units in the period from 31 December 2004 until 31 December 2005, which points to an upward trend in the level of concentration. A reverse trend was noted with respect to deposits collection activity, as the computed values of HHI of deposit concentration declined in the above annual periods by 57 units and 22 units, respectively, which is indicative of reduced concentration of collected deposits in individual banks in the sector.

[3] Herfindahl-Hirschman (HHI) index, as a measure of market concentration, has been used since 1982. This indicator is calculated by squaring the share (e.g. in balance sheet, deposits, credits…) of each bank competing in the market, and then summing the resulting numbers. An HH index below 1000 indicates no concentration in the market, an HH index between 1000 and 1800 indicates "moderate concentration" in the market, while an HH index above 1800 indicates "high concentration."

In the period under review, the degree of concentration of bank assets increased in the group of largest banks as well. The number of largest banks, as measured by their balance sheet total (in excess of CSD 50,000 million), was 4 at the end of 2005, compared to 2003 when banks in that category did not even exist. Their relative share in banking sector balance sheet total at the end of 2005 and 2004 stood at 44.5% and 34.5%, respectively. Balance sheet assets of this group of banks rose from CSD 176,256 million as at 31 December 2004 to CSD 344,496 million on the last day of 2005. The share of the bank with highest balance sheet assets in overall balance sheet total of banks had been rising and amounted to 12.0%, 13.6% and 15.4% at the end of 2003, 2004 and 2005.

However, at the end of 2005, most banks belonged to the groups of banks with the balance sheet total between CSD 10,000 million and CSD 20,000 million (11 banks with a share of 18.1%) and with the balance sheet total of up to CSD 5,000 million (10 banks with a share of 4.3% in overall balance sheet total).

Chart 3: Relative share of four largest banks in overall balance sheet total, deposits and credits



At the same time, concentration of credit and deposit activity on four banks (with most approved credits and collected deposits) did not increase in the period under review. The share of deposits of four banks with the largest volume of collected deposits in total deposits of the banking sector had been steadily declining: from 53.0% in 2003 and 49.8% in 2004 to 47.6% at the end of 2005. The share of approved credits of four banks with strongest lending activity in total credits of banks first declined – from 45.0% in 2003 to 42.4% in 2004 – and then grew to 44.1% in 2005.

Network of Banks

During the past two years, banks continually expanded their network, as a result of growth in their business activities and increased competition, which implies the need for banks to cater to the needs of their retail clients..

In 2004, banks opened 236 and, in 2005, 158 business units, branches, branch offices and teller units. At the end of 2005, network of banks included a total of 1,867 business units, branches, branch offices and teller units.

Foreign banks expanded their network of units most (by 65 organizational units in 2004 and 614 organizational units in 2005), whereas state-owned and private banks first increased the number of their organizational units by 133 and 38, respectively, in 2004, only to cut down on this number in 2005 by 200 and 256, respectively. Such developments came partly as a result of an increase in the number of banks joining the group of foreign banks, with a decline in the number of banks that are part of the group of private and state-owned banks in the period from 2003 until 2005.

Number of Employees in the Banking Sector

The number of employees in the banking sector had been growing steadily and reached 25,680 at the end of 2005. The above growth was the result of expansion of business activity and, consequently, organizational network of banks.

Table 3: Comparative overview of the number of organizational units and employees

Country[4]	Number of credit institutions	Number of organizational units	Number of employees	Number of employees/ Number of organizational units	Number of organizational units/Number of credit institutions	Number of employees/ Total population
1	*2*	*3*	*4*	*5=4/3*	*6=3/2*	*7*
Germany	2.148	45.505	712.300	16	21	0,9
Greece	62	3.403	59.337	17	55	0,5
France	897	26.370			29	
Italy	787	30.946	336.979	11	39	0,6
Austria	796	4.360	72.858	17	5	0,9
Turkey	51	6.564	138.657	21	129	0,2
Serbia	40[5]	1.867	25.680	14	47	0,3[6]

Source: Financial Stability Report for 2005, Central Bank of Turkey.

Annual growth in the number of banking system employees in the period 2003/2002, 2004/2003 and 2005/2004 stood at 3,405 or 18.0%, 1,142 or 5.1% and 2,219 or 9.5%, respectively.

The number of employees in the group of foreign banks went up from 2,490 and 3,798 at the end of 2003 and 2004 to 12,410 at the end of 2005. Foreign banks, therefore, employed 11.1%, 16.2% and 48.3% of all banking sector employees at the end of 2003, 2004 and 2005, respectively. Such rise in employment in foreign banks is a consequence of increased business activity of these banks, but also of the fact that the group of foreign banks consisted of 11 banks at the end of 2003 and 2004, and of 17 banks at the end of 2005.

The number of employees in the group of private banks declined from 7,046 and 6,567 in late 2003 and 2004, respectively, to 3,064 in late 2005 (this group numbered 19, 18 and 12 banks at the end of 2003, 2004 and 2005, respectively), while the number of employees in state-owned banks in the same period dropped from 12,783 and 13,096 to 10,206 employees (this group numbered 17, 14 and 11 banks at the end of 2003, 2004 and 2005, respectively). For this reason, the share of private and state-owned banks in the total number of employees in the banking sector dropped to 11.9% and 39.8%, respectively, as at 31 December 2005.

[4] 2005 data for Serbia and Turkey; 2004 data for other countries.
[5] Credit institutions include banks.
[6] Population without Kosovo and Metohija for 2004, Republic Statistical Office.

BANKING SECTOR BALANCE SHEET

Liabilities – Sources of Funds of the Banking Sector

At the end of 2005, obligations to clients, accounted for 74.9% (CSD 580,715 million) of total sources of funds (CSD 775,413 million) having recorded a constant increase in the period under review (from 60.8% in 2003 to 67.8% in 2004). Next in size is capital (16.2% or CSD 125,661 million) followed by obligations to banks (4.6% or CSD 35,803 million). In terms of size, these three items are the only significant items in banking sector liabilities, making up a total of 95.7%. As opposed to obligations to clients, the respective shares of the latter two items declined.

Obligations to clients refer to deposits of other clients (other than banks) and deposits of foreign banks[7] and amounted to CSD 465,708 million or 80.2%, whereas external credits (taken out with foreign banks or foreign legal entities and natural persons) stood at 108,053 million or 18.6%.

Obligations to banks, which comprise deposits of domestic banks and those of subsidiary and related banks amounted to CSD 18,976 million (53.0%), whereas their credits stood at CSD 16,827 million (47.0%).

End-2005 **capital** of the banking sector was CSD 125,661 million, which makes up 16.2% of balance sheet liabilities. As capital did not grow as quickly as balance sheet total (capital growth being 15.32% in 2004 and 26.4% in 2005), its share in total balance sheet liabilities of the banking sector dropped from 23.5% to 16.2%.

A breakdown by end-2005 capital level reveals that:

- 2 banks have capital of over CSD 10 billion,
- 6 banks have capital between CSD 5 billion and CSD 10 billion,
- 28 banks have capital between CSD 1 billion and CSD 5 billion,
- 4 banks have capital below CSD 1 billion.

In the largest number of banks (14), the share of capital in overall balance sheet total ranged from 10% and 20%. In the period 2003-2005 there was a decline in the share of capital in balance sheet total, both for the banking sector as a whole (from 23.5% to 16.2%) and for individual banks (in late 2005, only 4 banks recorded capital whose share in overall balance sheet total amounted to over 50%, as opposed to end-2003 when there were 11 such banks).

One half of bank capital is owned by foreign banks where average capital per bank is EUR 42.9 million, but it has the lowest share of 12.2% in balance sheet liabilities. The other half of total capital is almost evenly distributed among state-owned (average capital per bank EUR 34.1 million, with the share of 17.3% in balance sheet liabilities) and private banks (average capital per bank EUR 30.4 million, but with the largest, 40.0% share in balance sheet liabilities of these banks).

[7] In line with the Chart of Accounts, the definition of clients encompasses foreign banks (in addition to foreign legal entities and natural persons).

Table 4: Comparative overview of the share of capital in balance sheet liabilities of the banking sector

Country	2003	2004	2005
Bosnia and Herzegovina	17.0	15.7	15.0[8]
Croatia	8.9	8.7	8.7
Slovenia	8.3	8.1	7.4[8]
Romania	10.9	8.5	8.8
Bulgaria	13.1	11.0	10.5
Hungary	8.5	8.6	9.1[8]
Poland	8.3	8.0	7.8
Czech Republic	5.7	5.6	5.8[9]
Turkey	14.2	15.0	13.5
Austria	5.8	6.0	7.4
France	5.4	5.1	4.4
Germany	4.5	4.3	4.4
Italy	7.0	6.9	7.3
Greece	6.9	6.8	5.0[10]
Republic of Serbia	23.5	19.5	16.2

Source: Global Financial Stability Report – IMF September 2006, NBS data for the Republic of Serbia

Foreign banks increased their capital most (more than five-fold compared to end-2003), not only because of the increase in the number of foreign banks in the period under review, but also because of the fact that three foreign banks recorded the largest nominal increase in capital (of CSD 15,171 million, altogether) and two foreign banks had the highest relative increase (by 360% and 307%). The reason for such growth were new issues of shares and an increase in reserves from profit.

State-owned and private banks recorded a nominal decline in capital, which, in private banks, occurred primarily because of a drop in the number of banks (acquisition by foreign investors). The group of state-owned banks comprises mostly banks undergoing privatization. Their capital declined because they had been cleaning their balance sheets to the debit of their expenditures account and operating at a loss.

The increase in capital resulted, on the one hand, from more successful operations of banks in 2005 (banking sector recorded a positive financial result for the first time in a number of years), which led to a reduction of loss, increase of profit and larger reserve allocation. On the other hand, the largest increase was recorded for share capital resulting from new issues, not just in smaller banks that needed to meet minimum capital requirement, but rather and predominantly in largest (foreign) banks which needed to provide sources for financing the credit expansion that occurred in 2005 and for covering potential risks.

As a consequence, 2005 share capital increase of approximately CSD 8.7 billion resulted from new issues of approximately CSD 16.1 billion (with one foreign bank accounting for almost a third), from covering losses from previous years in the amount of approximately CSD 9.4 billion (one state-owned bank accounted for close to 90% of this amount) and from profit distribution.

[8] Data for November 2005.
[9] Data for September 2005.
[10] Data for June 2005.

Table 5: Structure of banking sector capital

(in CSD million)

Capital	2003	2004	2005
Share capital	89,054	96,991	105,701
Issue premium	127	309	1,776
Revaluation reserves	893	2,484	5,934
Legal reserves	5,351	7,177	13,234
Profit [11]	7,257	9,103	11,568
Uncalled capital and own shares	7	80	645
Loss [11]	16,373	16,534	11,907
TOTAL	86,302	99,450	125,661

Source: NBS.

A breakdown of capital structure by groups of banks (depending on type of ownership) indicates that over one half of share capital of the banking sector (53.8%) and legal reserves (61.1%) is in balance sheets of foreign banks, but as these banks also record 91.1% of total losses, they account for 49.6% of total banking sector capital.

At the beginning of the 2003–2005 period, banks were required to keep the ratio of risk-weighted assets to capital at no less than 8%. Subject to 2005 amendments to regulations, capital adequacy ratio was raised to the 10% minimum (obligation to comply with this ratio level by 31 March 2005) and then to 12% (obligation to comply with this ratio level by 31 December 2005). Although capital adequacy ratio of banking institutions was declining (31.3% in 2003, 27.9% in 2004 and 26.0% in 2005), it was still well above the prescribed minimum. Only in late 2003 one bank failed to meet the minimum capital adequacy ratio.

Regulatory capital[12] rose by CSD 28,207 million or 29.4% in 2005; this increase was also attended by a change in structure. The most significant changes were the rise in share capital and a decline in losses (items that form part of core capital), so that the share of core capital, accounting for 90.7% of regulatory capital in 2004, dropped to 84.4% at the end of 2005. This was primarily the result of a 259% increase in subordinated obligations. At the end of 2005, these obligations made up 41.8% of supplementary capital, whereas their end-2004 share was 25.4%. Hence the share of subordinated obligations in regulatory capital rose as well (from 2.4% to 6.6%), as did the share of total subordinated obligations in balance-sheet liabilities (0.2% in 2003, 0.4% in 2004 and 1.4% in 2005).

[11] Earlier years and the current year.

[12] Capital taken into account when computing bank business indicators, which comprises core and supplementary capital, including certain deductibles.

Table 6: Comparative overview of movements in the capital adequacy ratio

Country	2003	2004	2005
Bosnia and Herzegovina	19.5	18.0	17.6[13]
Croatia	15.7	14.1	13.9[8]
Slovenia	11.5	11.8	10.5
Romania	20.0	18.8	20.2
Bulgaria	22.2	16.1	15.2
Hungary	11.8	12.4	12.0
Poland	13.8	15.4	14.5
Czech Republic	14.5	12.6	11.9
Turkey	30.9	28.8	24.2
Austria	14.5	14.7	14.5
France	11.9	11.5	11.4
Germany	13.4	13.2	13.4[14]
Italy	11.4	11.6	11.6
Greece	12.0	12.8	13.2
Serbia	31.1	27.9	26.0

Source: Global Financial Stability Report, IMF, September 2006; NBS data for Serbia.

Movements in **deposit potential** in the period under review were characterized by the following

- stock of total deposits of the banking sector reached CSD 484,684 million at the end of 2005, which represented 62.5% of banking sources of funds and was the largest share ever (at the start of reforms, deposits made up less than one third of balance-sheet liabilities, and 60.7% in 2003 and 61.4% in 2004);
- deposit growth did not only accelerate from year to year, but it was also faster than the growth in other banking sources or total balance sheet liabilities (28.7% in 2003, 40.3% in 2004 and 54.7% in 2005);
- in comparison to total deposit growth, the growth in foreign currency deposits was higher (45.2% in 2003, 58.8% in 2004 and 63.2% in 2005), for which reason in late 2005 70.7% of all deposits were denominated in foreign currency;
- maturity structure of deposit potential also improved, as time deposits recorded faster growth (short-term by 260.0% and long-term by 332.3% in the period 2003-2005) than demand deposits (57.4%). This led to a change in the structure of deposits from 2003 (71.5% of all deposits were demand deposits) until 2005 (43.5% were time deposits with the maturity of under one year);
- as opposed to previous years when savings deposits were practically nonexistent, in the period under review households became the most significant depositor of, primarily foreign currency funds, accounting for 43.8% of all deposits and 55.5% of foreign currency deposits at the end of 2005.

[13] Data for September 2005.
[14] Preliminary data for December 2005.

Table 7: Deposit potential of the banking sector

(amounts in CSD mln/share in %)

DEPOSITS	2003		2004		2005			
	Amount	Share	Amount	Share	Total	Clients	Banks	Share
Demand deposits	159,353	71.4	183,856	58.7	250,898	238,536	12,362	51.8
- dinar	72,892	32.7	75,946	24.2	99,854	97,977	1,877	20.6
- foreign currency	86,461	38.7	107,910	34.4	151,044	140,559	10,485	31.2
Short-term deposits	58,587	26.2	120,646	38.5	210,932	153,842	57,090	43.5
- dinar	17,189	7.7	26,200	8.4	40,863	35,474	5,389	8.4
- foreign currency	41,398	18.5	94,446	30.1	170,069	118,368	51,701	35.1
Long-term deposits	5,286	2.4	8,754	2.8	22,854	20,027	2,827	4.7
- dinar	982	0.4	1,295	0.4	1,494	1,445	49	0.3
- foreign currency	4,304	1.9	7,459	2.4	21,360	18,582	2,778	4.4
TOTAL	223,226	100.0	313,256	100.0	484,684	412,405	72,279	100.0

Source: NBS.

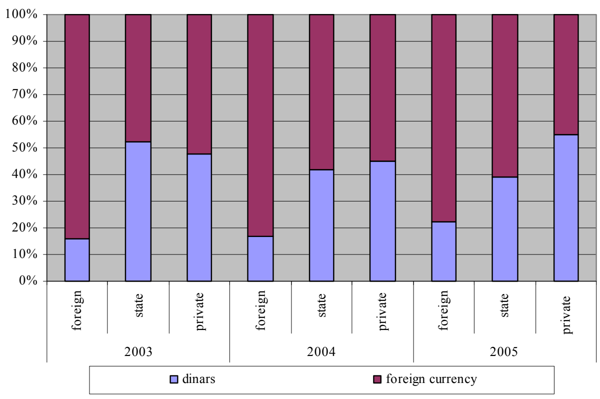
A breakdown by ownership structure shows that at the end of 2005 foreign banks accounted for:

- 65.6% of all deposits,
- 49.7% of all dinar deposits,
- 72.2% of all foreign currency deposits,
- 62.8% of all household deposits, and
- 68.2% of all short-term and 74.5% of all long-term time deposits.

The share of private banks is below 10% in almost all segments of deposit potential, with the exception of total dinar deposits where they hold 15.7% and household transaction deposits in which their share is 10.6%.

Out of total deposit potential, CSD 72,279 million refers to deposits from other banks, of which CSD 47,288 million are deposits from banks abroad (CSD 45,229 million are short-term time deposits), which makes up 9.8% of total deposits. End-2003 stock of these deposits was CSD 2,894 million or 1.3% of the then total deposits, which was indicative of the fact that external financing through deposits increased in the period under review.

Chart 4: Currency structure of deposit potential



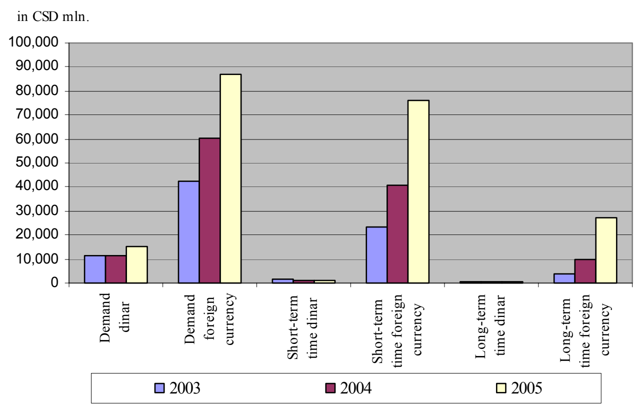
Such high growth of deposit potential was encouraged by regulations ensuring enhanced security for depositors and improved liquidity of banks, but it was also the result of banks' efforts to attract the largest possible number of depositors by widening their business network, diversifying their offer, advertising, and thereby intensifying market competition.

Most of all, these measures helped bring about an increase in **household savings.** Deposits of natural persons reached CSD 206,348 million at the end of 2005, accounting for 26.6% of total balance sheet liabilities. Early in 2002[15], the share of household deposits in total banking sources stood at 7.6%.

The new Law on Deposit Insurance enacted in 2005 prescribes compulsory insurance of deposits that natural persons hold in banks. Namely, banks are required to insure deposits of natural persons (money deposits, savings deposits, current accounts or other money accounts) with the Agency for Deposit Insurance, which insurance covers the amount of up to EUR 3,000.

By enacting a Decision on the Conditions and Manner of Ensuring Liquidity Necessary for Redemption of Foreign Currency Savings Deposits of Natural Persons by Banks, the NBS introduced an obligation for banks to deposit a portion of foreign currency savings in order to ensure liquidity for the above purpose. Initially, banks were required to deposit 50% of total savings, but this percentage was later decreased to 41% at the end of 2005.

Chart 5: Structure of savings deposits



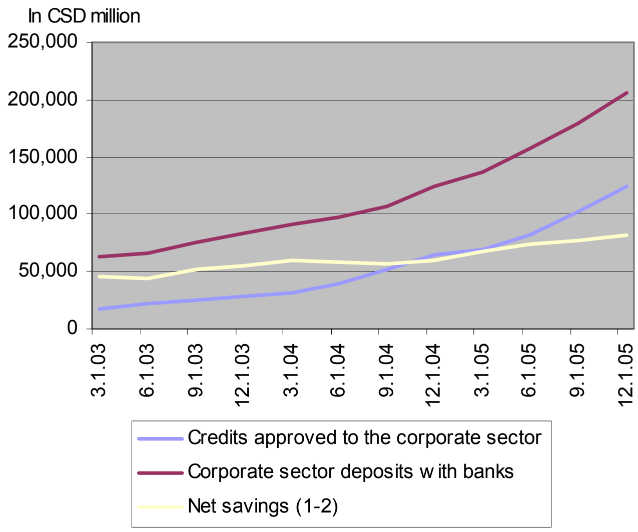
Term structure of savings points to an increase in term deposits, which at the end of 2005 accounted for one half of all deposits. This is, in part, the result of expansion of bank credit in the period under review. Namely, with a view to reducing credit risk, the NBS prescribed an obligation for banks to make special provision amounting to 25% of claims to cover potential losses, in cases when monthly loan installment to a natural person exceeds 30% of such person's net income or the deposit made by such natural person is lower than 20% of the approved credit amount.

The bulk of savings was in foreign currency. End-2005 share of foreign currency savings reached 92.0%. Savings in dinars were mostly time savings deposits and amounted to CSD 15,251 million, while savings deposits with the maturity of under one year amounted to CSD 834 million and savings deposits with the maturity of over one year to only CSD 440 million. In order to stimulate dinar savings, towards the end of 2005, the NBS issued dinar savings bills, which yield a competitive interest rate.

A substantial portion of savings deposits were collected by 3 banks (2 foreign and 1 state-owned), which accounted for 47.5% of total savings at the end of 2005. Growth in savings recorded by these 3 banks from 2003 until 2005 represented 47.8% of growth recorded in the entire banking sector. In total, foreign banks accounted for 62.8% of total savings, state owned for 32.5% and private banks for 4.8%. Breakdown by type of deposits shows that 73.8% of total transaction deposits were held with foreign banks, 41.8% of all long-term time deposits with state-owned banks, while private banks had the highest, albeit relatively small, share in short-term time deposits (5.5%).

[15] Data did not include 4 large banks which, in early 2002, lost their operating license issued by the NBS.

Chart 6: Net savings deposits, approved credits to households and household deposits with banks in 2003- 2005



When movements in household savings are analyzed and compared with the amount of credits approved to households, it can be seen that household savings were, growing faster than the value of approved credits to households. Hence, in December 2005, the value of net household savings, as the difference between household deposits and credits approved to households, stood at CSD 82 billion, accounting for 5.02% of GDP.

At the end of 2005, total external **credit borrowing** by banks amounted to CSD 108,053 million, of which CSD 104,942 million was borrowed from foreign banks (97.1%) and CSD 3,111 million from other foreign legal entities and natural persons. Borrowing was entirely in foreign currency and 95.9% had the maturity of over one year.

External borrowing by banks recorded strong growth in the period under review (306% in 2004 and 114% in 2005). Foreign banks accounted for its major portion and two banks in particular (66.1% of total debt of the banking sector at the end of 2005). External borrowing by one of these two banks was as large as to amount to three times the value of its total deposit potential, or seven times the value of its capital.

In order to neutralize such developments that were partly the source of bank credit expansion, the NBS, towards the end of 2004, included these credits in the deposit base for calculation of reserve requirement, and increased the ratio from 26% to 38% in the course of 2005.

Assets – Banking Sector Claims

Intense lending activity was the principal cause of accelerated growth in balance sheet assets of the banking sector in the period under review. In order to neutralize credit growth, during 2004 and 2005 the NBS implemented a range of monetary policy measures, acting primarily through expanding the reserve requirement base and through raising the reserve requirement ratio. The results of these measures were other changes within the structure of balance sheet assets.

Lending to clients still dominates the end-2005 structure of balance sheet assets of the banking sector with a share of 55.0% or CSD 426,528 million. Lending to banks recorded a both absolute and relative decline and, with a 4.3% share in total assets (CSD 33,206 million), occupies the fifth position, right behind fixed assets. This decline was the result of transfer of deposited foreign currency savings with the NBS[16] from item Lending to Banks to the foreign currency reserve requirement account – within item Deposits with the Central Bank and Securities Refinanceable with the Central Bank. This was the amount of CSD 64,210 million, deposited by banks late in November 2005. In this way the item Deposits with the Central Bank and Securities Refinancable with the Central Bank reached the amount of CSD 150,827 million.

Banks allocated CSD 146,956 million, or 18.9% of total balance sheet assets, to the foreign currency reserve requirement account with the NBS, which comprises the above amount of foreign currency savings deposits of CSD 64,210 million and foreign currency reserve requirement in the amount of CSD 82,746 million. Compared to end-2004, the amount of foreign currency reserve requirement alone increased by CSD 64,406 million or by 351.2%, which means that its share in total balance sheet assets rose by 7.1 percentage points.

End-2005 total allocated foreign currency reserve requirement stood at CSD 146,956 million, of which foreign banks allocated CSD 111,182 million or 75.7%, state-owned banks CSD 29,359 million or 20.0%, and private banks CSD 6,415 million or 4.3%. The share of funds immobilized against foreign currency reserve requirement in total balance sheet assets was highest for foreign banks (21.7%), as opposed to state-owned (15.8%) and private banks (8.2%).

End-2005 total cash and cash equivalents of the banking sector amounted to CSD 72,781 million, of which 50.1% was in the domestic currency. The structure of this item is a consequence of the possibility given to banks to maintain dinar reserve requirement on gyro account and not in special accounts with the NBS. Namely, at the end of 2003, banks disclosed the reserve requirement of CSD 16,241 million in item Deposits with the Central Bank and Securities Refinanceable with the Central Bank, whereas in late 2004 and 2005 the amount of CSD 20,953 million and CSD 26,046 million, respectively, were disclosed within item Cash and Cash Equivalents.

Lending to clients, the largest item in balance sheet assets of the banking sector, stood at CSD 426,528 million at the end of 2005, and was the result of lending in the amount of CSD 528,028 million, individual allowances for loan impairment of CSD 55,661 million and general allowances for loan impairment of CSD 46,739 million.

Lending to clients (in the net amount) was characterized by:

- 81.5% was lending in dinars,
- 58.3% was lending with the maturity of under one year,
- 10.5% reduction on account of individual allowances for loan impairment (primarily in the part of short-term foreign currency credits),
- 8.8% reduction on account of general allowances for loan impairment (primarily in the part of long-term foreign currency credits),
- 37.0% extended by 3 banks (foreign).

Net lending to clients as disclosed in balance sheets of foreign banks stood at CSD 290,654 million, or 68.1% of lending to clients of the banking sector, whereas in balance sheets of state-owned banks lending to clients amounted to CSD 94,940 million or 22.3%, while the share of private banks was only 9.6%.

[16] In conformity with the Decision on the Measures for Maintaining Foreign Currency Liquidity of Banks for the Purpose of Redemption of Foreign Currency Savings Deposits (amounts to 41% of these savings deposits).

In 2005, banking sector increased net lending to clients by CSD 135,729 million or 46.7%, of which only foreign banks recorded an increase (by CSD 167,771 million or 136.5%), while state-owned and private banks recorded a decline in net lending to clients, primarily on account of a decline in their number. Of ten banks that recorded a drop in net lending to clients in 2005, 6 were private, 3 state-owned and one was foreign (state-owned bank privatized in 2005). Four foreign banks accounted for 61.8% of total increase in net lending to clients recorded by the banking sector (with one of them accounting for 24.3%).

If items Lending to Banks and Lending to Clients are considered concurrently, it can be concluded that **lending activity** of the banking sector reached CSD 459,734 million, which, compared to end-2004, represents an increase by 102,977 million or 28.9%. However, as in December 2005 foreign currency savings deposited with the NBS[17] were transferred from Lending to Banks to foreign currency reserve requirement account, the real increase was CSD 148,704 million or 47.8%, i.e. 3.3% on a monthly basis. Compared to end-2003, the increase was 119.3%. Whereas in 2004 lending activity of the banking sector grew much faster than total balance sheet assets (28.8%), intense lending activity continued in 2005, but it was slower than the growth in balance sheet assets in this period (52.0%). Taking into account the 2004 and 2005 inflation growth of 13.7% and 17.7%, respectively, the fact that 75% of credits were denominated in foreign currency or were indexed to a foreign currency clause, and that dinar depreciated against the euro by 15.5% and 8.4%, respectively, end-2005 nominal credit growth which, compared to end-2003, amounted to 119.3%, in real terms amounted to only 66.7%.

Growth in lending activity was characterized by:
- faster growth in dinar credits and lending (by 74.6%) in 2005 (foreign currency credits declined by 10.5% in the same period);
- faster growth in credits and lending with the maturity of over one year (by 58.5%) in 2005, compared to a 41.7% growth in short-term credits;
- credits and lending were oriented mostly to households (increase of 126.3% in 2004 and 93.7% in 2005).

Structure of total credits and lending of the banking sector at the end of 2005 changed compared to end-2003:
- 80.9% were dinar credits (increase by over 20%),
- 61.2% were credits with the maturity of under one year (decline by over 2%),
- 59.2% were credits to enterprises (decline by over 5%),
- 27.0% was lent to households (two-fold increase),
- 10.1% was lent to other banks (decline by over 5%).

In terms of ownership structure, foreign banks accounted for most of the lending activity. At the end of 2005, 68.0% of all credits and lending was extended by foreign banks, 22.0% by state-owned banks and 10.0% by private banks, as opposed to the end-2003 situation when state-owned banks accounted for 48.1% of credits and lending of the banking sector, with private and foreign banks accounting for 28.4% and 23.5%, respectively.

This is not just a consequence of an increase in the number of foreign banks, as leading banks in 2005 were three foreign banks which accounted for 36.2% of total credits and lending and had a 49.0% share in the increase recorded since the end of 2003.

[17] In further analysis of lending activity, data used will not include foreign currency savings deposits.

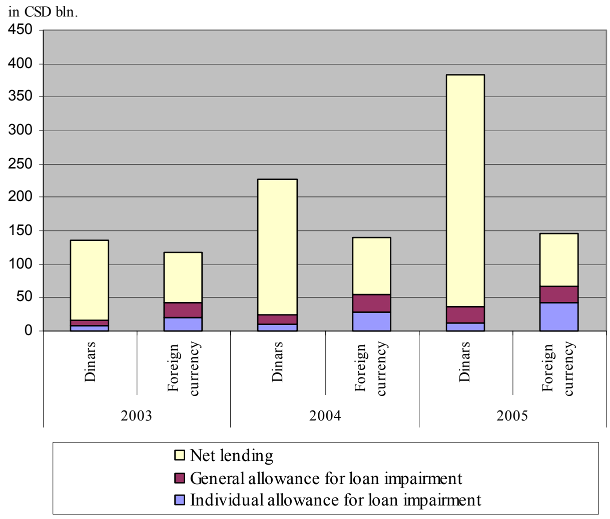
Table 8: Lending activity of the banking sector

(in CSD mln)

	2003	2004	2005
Total credits and lending [18]	209,612	311,030	459,734
In dinars	126,906	213,206	372,167
In foreign currency	82,706	97,824	87,567
Short-term	133,277	198,476	281,302
Long-term	76,335	112,554	178,432
Banks[19]	32,026	39,309	46,237
Enterprises[20]	136,192	190,937	272,135
Public sector[21]	6,256	8,487	5,637
Other clients[22]	2,914	1,730	3,810
Foreign persons[23]	872	2,742	5,104
Households	28,336	64,136	124,222
Other	3,016	3,689	2,589

Source: NBS.

Chart 7: Collectibility of lending to clients in the banking sector



Degree of collectibility, as measured by allowances for loan impairment, has improved. Namely, in the period from 2003 to 2005, there was a decline in the level of write-off of loans, both on account of individual as well as general allowances for loan impairment. In the case of dinar credits, at the end of 2003, banking sector reduced the level of lending by 6.1% on account of individual allowances for loan impairment, compared to a reduction of 3.4% at the end of 2005. Reduction on account of general allowances for loan impairment declined from 6.5% in 2003 to 6.0% in 2005. As regards foreign currency credits and lending to clients, the percentage of reduction of gross value on account of general allowances for loan impairment also declined from 18.6% in 2003 to 16.4% in 2005. However, with respect to individual allowances for loan impairment, there was an evident increase from year to year, from 17.8% in 2003 to 19.7% in 2004 and 29.4% in 2005.

The structure of bank portfolio changed due to intensive lending activity, whose principal thrust was provision of credits to households and the clean-up of dubious and disputable

[18] Items Lending to Banks and Lending to Clients, less foreign currency savings deposits.
[19] Domestic, foreign, subsidiary and related banks, NBS, other financial organizations and insurance companies.
[20] Public and other.
[21] Serbia and Montenegro, Republic of Serbia and local government.
[22] Education, health system and other.
[23] Legal entities and natural persons.

claims of banks either privatized or in the process of privatization,. The risk of default declined as the share of newly extended credits, with enhanced instruments of security, increased. These credits were, for most part, extended to households, which still represent the least risky sector. On the other hand, certain banks, predominantly state-owned or state-owned until recently, continued to write off bad loans, primarily long-term foreign currency credits to enterprises (mostly in respect of Paris and London Club creditors).

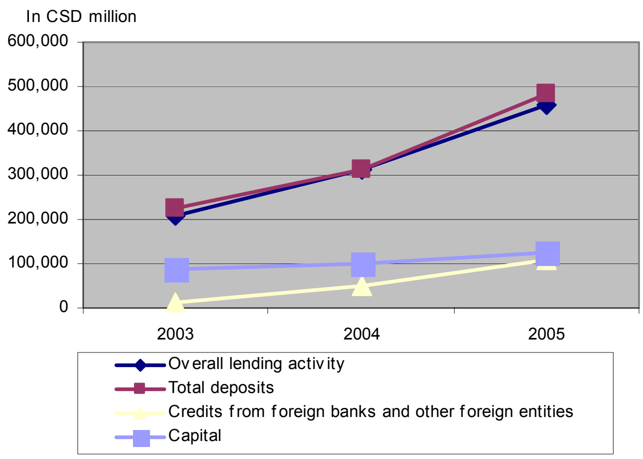
Foreign banks reduced foreign currency credits and lending (gross value) in late 2005 by 10.6% (on account of individual loan impairment) and 12.7% (on account of general loan impairment). Of total loan impairment in the amount of CSD 11,653 million, three banks privatized in 2005 accounted for CSD 10,002 million.

State-owned banks reduced foreign currency credits and lending to clients (gross value) by 31.9% and 22.3% on account of individual and general loan impairment, respectively

Private banks reduced foreign currency credits and lending (gross value) by 70.6% (on account of individual) and 1.4% (on account of general loan impairment).

In addition to credit risk and risk of default, banks are, in the present circumstances, also exposed to credit risk arising from movements in the exchange rate.[24]

Chart 8: Banking sector lending and sources of finance



Analysis of **movements in banking sources and lending** indicates a high level of correlation between credits and deposits. The level of capital, at the same time, remained practically unchanged, whereas external credits recorded growth.

The ratio of extended credits to collected deposits by sector shows that deposits exceeded credits in all sectors, except for the corporate sector, which stood out as a net borrower from banks. From year to year, household deposits were growing faster then credits to households, so that in late 2005 the difference reached CSD 82,126 million, or 39.8% of deposits and 66.1% of credits. On the other hand, in the corporate sector, the difference between the level of deposits and the volume of credits was also growing, but in favour of credits, so that, towards the end of 2005, the gap reached CSD 120,747 million, or 79.8% of deposits and 44.4% of credits.

[24] For further elaboration, see section: Credit risk arising from movements in the exchange rate.

Table 9: Ratio of banking sector credits to deposits

in %

	2003	2004	2005
Banking sector	94	99	95
Households	34	52	60
Corporate sector	142	158	180
Foreign banks	80	110	98
Households	32	81	74
Corporate sector	120	185	199
State-owned banks	107	100	80
Households	34	32	33
Corporate sector	196	182	160
Private banks	89	83	113
Households	39	41	72
Corporate sector	103	112	133

Source: NBS.

In the case of foreign banks, as the most active group of banks in terms of credit extension in the period under review, the ratio of credits to sources of funds shows that the robust credit activity of such banks was sustained by their deposits and capital. However, as other balance sheet items of these banks also recorded significant growth (cash and deposits with the NBS recorded more than eighth fold increase, investment in securities[25] and share in capital more than three fold, and fixed assets and intangible investments more than seven fold increase), lending activity needed to be supported from external sources as well. Credits obtained from foreign banks and foreign persons grew from CSD 6,541 million at the end of 2003 to CSD 102,980 million at the end of 2005.

Table 10: Ratio of bank lending to sources of finance in banks in majority foreign ownership

(in CSD million)

	2003	2004	2005
Total credits	49.181	131.902	312.786
- short-term	38.051	82.298	182.057
- long-term	11.130	49.604	130.729
Total deposits	61.597	119.626	317.774
- demand	41.269	63.748	156.953
- time	20.328	55.878	160.821
Credits/deposits ratio	79,8%	110,3%	98,4%
Capital	12.386	19.605	62.303
External credits	6.535	43.236	102.980

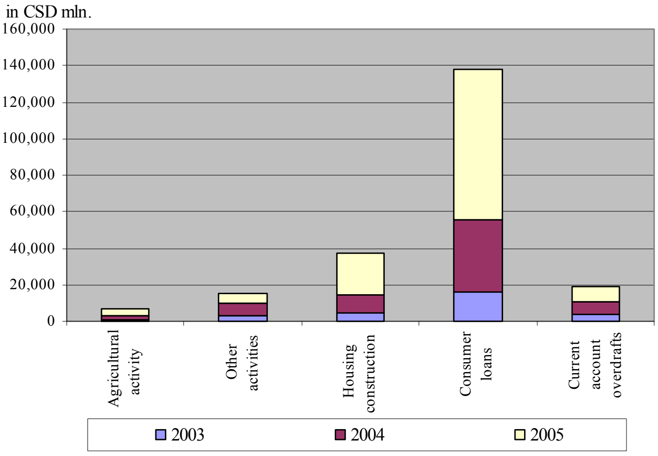
Source: NBS.

Credits and other lending to households represented a particularly important segment of lending activity of the banking sector in the period under review**.** In late 2002[26] these credits made up only 6.5% of total credits. Coupled with a growth of 126.3% in 2004 and

[25] At end-2005, NBS obligations to the banking sector in respect of repo operations stood at CSD 16,894.4 million. On 31 January 2005, for the first time, the NBS organized a repo auction of securities as part of its open market operations, with a view to regulating banking sector liquidity.
[26] As special provisions for covering potential balance sheet losses were dealt with differently prior to Annual Accounts for 2003, data from earlier periods are not entirely comparable.

93.7% in 2005, they reached a share of 27.0% of total credits of the banking sector at the end of 2005.

Chart 9: Credits and lending to households



The share of household credits in GDP rose during the period under review. The share of mortgage loans went up from 0.4% in 2003 to 1.4% at the end of 2005, while the share of (the sum of) consumer and other credits rose from 1.5% to 5.1%.

Late-2005 structure of total credits and lending of the banking sector to households was as follows:

- all credits were extended in dinars, but approximately 75% had a foreign currency clause,
- 83.1% were credits with the maturity of over one year (increase by more than 20 percentage points from end-2003),
- 37.6% were other credits (increase by 10 percentage points from end-2003),
- 28.9% was lent in the form of consumer credits (unchanged share in total credits),
- 18.8% were credits for housing construction (increase by 3 percentage points from end-2003).

Principal drivers of lending activity were foreign banks, whose end-2005 share in total credits to households was 76.7% (their end-2003 share was 31.8%). The extent to which foreign banks contributed to growth in these credits is well illustrated by the fact that the same 11 foreign banks (both in late 2003 and late 2005) recorded a 736.2% growth, whereas total credit to households increased by 338.4%.

Most credits to households were granted by foreign banks. In fact, one foreign bank accounted for 18.5% of all credits to households, two foreign banks accounted for 26.9%, and five banks (4 of which were foreign) accounted for 48.8% of these credits. Twenty-three banks, each on their own, accounted for less than 1% of total banking sector credits to households, whereas 9 banks each accounted for 1% to 5% of such credits.

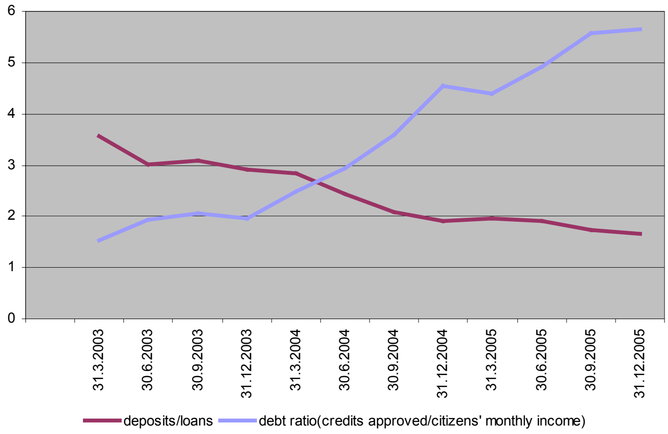
Bank statistics on allowances for impairment on household lending indicate that the degree of collectibility has been on the decline. In late 2003, when the period of household credit expansion commenced, allowances for general loan impairment amounted to 5.3% on short-term household credits and to 1.3% on long-term credits. At the end of 2005, short-term credits were reduced by 11.1% and long-term credits by 4.2% on this account.

Although this is a relatively new type of lending with a high degree of collectibility, potential risks originate from:

- inadequate procedures at the time of credit approval,
- contracting a foreign currency clause (if the borrower did not safeguard against risks in the same manner),
- lack of adequate security or collateral.

With the aim of reducing credit risk, the NBS has, by amending regulations, tried to increase the alertness of banks at the time of approving credits to natural persons, as well as to increase allocation of provisions for covering potential loan losses.[27]

Chart 10: Net household savings deposits and ratio of household indebtedness in 2003-2005



Given the present tempo of new household borrowing, overindebtedness of households seems a likely development in the near future. The ratio of indebtedness is one of the indicators of the level of household debt. This ratio, calculated as a monthly level of approved credits to monthly income – household wages, points to rising household debt in Serbia, and reached 5.65 in December 2005. This means that 5.65 dinars of credit are granted against every dinar of household income. (For the sake of comparison, let us note that the value of this ratio in Croatia is 17.92).

As a protective measure for consumers, the NBS introduced the obligation for banks to disclose the effective interest rate. Due to the expansion of consumer, cash and other household credits, there was a need for enhanced transparency of all costs to be borne by the client when obtaining a credit with a bank, including criteria for revaluation and indexation of credits or deposits.

Payment Cards

Following stagnation in the payment card business in Serbia in the 1990s, Serbia is now making notable steps towards using plastic money to the extent to which it is being used by other countries of the region, with the aim of migrating from cash to electronic payment as the principal way of payment. Namely, card business is one of the key ways to combat money laundering in financial flows and to reduce cash payment transactions. It also has a positive impact on the increase in the turnover of money and further growth in banking potential.

[27] For further explanations, see section “Credit Risk” of this report.

Table 11: Payment card transactions in terms of numbers and amounts in 2004 and 2005

Period	Number of cards				Number of transactions with cards issued in RS			
	Debit	Credit	Business	Total	Debit	Credit	Business	Payments and cash withdrawals outside RS[28]
2004	2,109,086	28,224	20,642	2,157,952	9,471,582	326,015	138,782	422,672
2005	3,443,015	382,158	33,129	3,858,302	6,992,989	1,267,451	206,788	192,203

Source: NBS.

Table 12: ATMs and POS terminals – number and turnover in 2004 and 2005

Period	ATMs				POS terminals			
	Number of ATMs	Number of transactions	Turnover of transactions		Number of points of sale	Number of transactions	Turnover of transactions	
			Total	Cards issued outside of RS in RS			Total	Cards issued outside of RS in RS
2004	450	5,703,617	20,164	2,991	16,266	5,046,699	12,307	3,802
2005	837	4,463,898	18,312	1,597	31,816	4,331,344	12,350	1,744

Source: NBS.

OFF-BALANCE SHEET ITEMS OF THE BANKING SECTOR

Growth in balance sheet total in the period under review was attended by growth in off-balance sheet items of the banking sector. Their end-2003 level was CSD 378,665 million, with total off-balance sheet items reaching as much as CSD 726,007 million at the end of 2005, having increased by CSD 347,342 million or 91.7%. Growth in off-balance sheet items was accelerated as well (34.9% in 2004 and 42.1% in 2005).

Analysis of concentration of off-balance sheet items indicates that two banks (both foreign owned) accounted for over one third of potential obligations of the banking sector in 2005. Breakdown by type of ownership shows that in 2003 state-owned banks accounted for 49.7% of total off-balance sheet items, with private and foreign banks accounting for 40.1% and only 10.2%, respectively, and that the situation changed significantly in 2005 (when foreign, state-owned and private banks accounted for 71.0%, 21.6% and only 7.4%, respectively).

The structure of off-balance sheet items changed as well. Pursuant to the Law on Regulating the Public Debt of the Federal Republic of Yugoslavia in Respect of Foreign Exchange Savings of Households, in 2002 claims/obligations in respect of frozen foreign currency savings deposits were transferred to off-balance sheet items; the amount transferred equaled approximately CSD 70 billion, which then made up over 20% of balance sheet total. For this reason, at the end of 2003, over 60% of all off-balance sheet items referred to deposited foreign currency savings bonds (CSD 228,281 million). At the end of 2005, total bonds reached CSD 268,693 million, but their share in total off-balance

[28] All cards.

sheet items dropped to 37.0%, whereas one bank accounted for 56.2% of total amount of bonds.

Other off-balance sheet assets/liabilities[29] recorded faster growth in the period from 2003 to 2005, so that at the end of 2005 they reached CSD 255,068 million (4-fold increase compared to end-2003) or 35.1% of all off-balance sheet items. Three banks (two foreign and one state-owned) accounted for 61.9% of other off-balance sheet assets/liabilities.

BANKING SECTOR PROFIT AND LOSS ACCOUNT

Financial Result

For the first time since the start of the banking sector reform, banks recorded a net positive pre-tax **financial result** (total profit minus total loss) equaling CSD 7,272 million for the period 1 January 2005 until 31 December 2005.

Table 13: Financial position of banks

(in CSD million)

	2003		2004		2005	
	Amount	Number of banks	Amount	Number of banks	Amount	Number of banks
1. Loss	7,105	13	13,651	11	4,026	8
2. Profit	6,050	34	8,661	32	11,298	32
Financial result (2-1)	-1,055	47	-4,990	43	7,272	40

Source: NBS.

Positive financial position of the banking sector in 2005 resulted mainly from the clean up of banks' balance sheets at the expense of their expenditures, rationalization of operational costs, enlargement and diversification of bank activities, and in particular, expansion of credit and deposit activity.

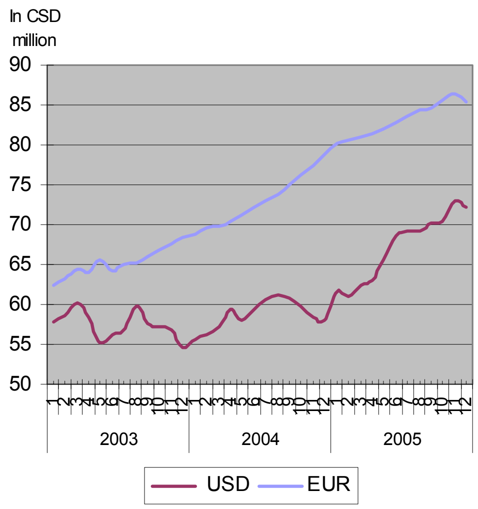
All three groups of banks, in terms of ownership, operated at a profit. Private banks recorded the highest profit of CSD 4,684 million; then followed foreign banks with a profit of CSD 2,226 million and state-owned banks with a profit of CSD 361 million. Of 8 banks that ended the business year 2005 with a loss, 5 were foreign, 2 were state-owned and 1 bank was private.

When banks are considered individually, one bank accounted for 29.9% of total losses of the banking sector, while two banks (one private and one foreign) accounted for 38.3% of all profits of the banking sector.

[29] This item comprises mainly the received guarantees and other warranties given as collateral for lending.

Structure of Revenue and Expenditures

Chart 11: Nominal exchange rate of the dinar



As in 2003-2005, exchange rate gains (47% of total revenue) and exchange rate losses (44.4% of total expenditures) accounted for the largest share in the **structure of revenue and expenditures** in 2005. From January 1 until December 31, 2005, the dinar depreciated against the euro and the dollar by 8.4% and 24.6%, respectively. The same three banks (in foreign ownership) accounted for around 40% of all exchange rate gains and losses of the banking sector. The share of exchange rate gains/losses in total revenue/expenditures was above 55% in foreign banks, above 35% with state-owned banks and below 20% with private banks.

At the level of the overall banking sector, 27.8% of total revenue in 2005 resulted from interest payment and fees (CSD 72,493 million), which apart from the CSD 22,133 million increase in absolute terms, also represents an increase in relative terms. Revenue from interest charged on corporate (53.3%) and household lending (28.0%) made up the largest share of interest revenue. Despite the fact that interest expenditures had a relatively small share in total expenditures (5.7%), in the course of 2005 they went up by 71.3%. The largest shares are those of expenditures in respect of interest charged on lending to households (28.0%) and enterprises (23.5%).

The monthly weighted average lending rate of banks mildly fluctuated throughout 2005, only to trend up in the last quarter. In December, it reached 1.15% on a monthly level, which corresponds to 14.41% at annual level.

The weighted average fee charged by banks on a one-off basis on the entire amount of approved loan varied in the course of 2005 and was by 0.09 percentage points lower at yearend than at end-2004. (In December, it stood at 0.28% - 0.23% for short-term loans and 0.42% for long-term loans).

The monthly weighted average interest rate on total dinar deposits in the fourth quarter of 2005 remained unchanged from the level established in the beginning of the year; in December it stood at 0.31% on a monthly basis (3.71% p.a.).

Interest rates paid on foreign currency deposits varied from one bank to another in terms of both maturity and the level of savings deposits. If deposit rates paid by eight banks leading in terms of foreign currency saving deposit levels are analyzed, we can observe a decline in the weighted average interest rate on demand deposits and one year time deposits relative to the preceding year, and a mild rise in the weighted average interest rate on time foreign currency deposits with the maturity of three and six months. Interest margin on long-term loans and foreign currency deposits remained unchanged lingering between 6 and 9 percentage points. Other operating revenue in 2005 made 22.0% of total revenue. The largest amount of revenue came from cancelling outstanding write-offs of loans and provisioning. Five banks (2 foreign, 2 private and 1 state-owned) account for 62.1% of such revenue and 81.8% of its increase from 2004.

The second largest item within total expenditures were expenditures in respect of indirect write-offs of loans and provisioning in the amount of CSD 73,396 million. Their share in total expenditures was 28.9%, of which the largest share accounted for expenditures with respect to general loan loss provisioning against balance sheet items in the amount of CSD 43,342 million (increase of CSD 14,794 million or by 51.8%). It is noteworthy that 2 foreign banks and 1 private bank participated with 49.5% in these expenditures and with 83.9% in their increase from 2004.

Other operating expenditures in the amount of CSD 47,061 million participated with 18.6% in total expenditures. They went down by 12.2% from 2004, primarily as a result of a decline (by CSD 14,358 million) in expenditures from earlier years established with a delay.

Table 14: Cost of wages (gross) per employee in the banking sector

(in CSD thousand)

BANKS	2003	2004	2005
Foreign	588	748	757
State-owned	441	502	628
Private	423	572	811
Banking sector total	452	561	712

Source: NBS

Costs of net wages, tax, contributions and other personal expenditures per employee (as in December 2005) varied from one bank to another. The highest costs (CSD 1,621 thousand) were recorded for one private bank, while the lowest (CSD 309 thousand) were recorded for a Kosovo-based bank.

Performance Indicators

Table 15: Banking sector performance indicators

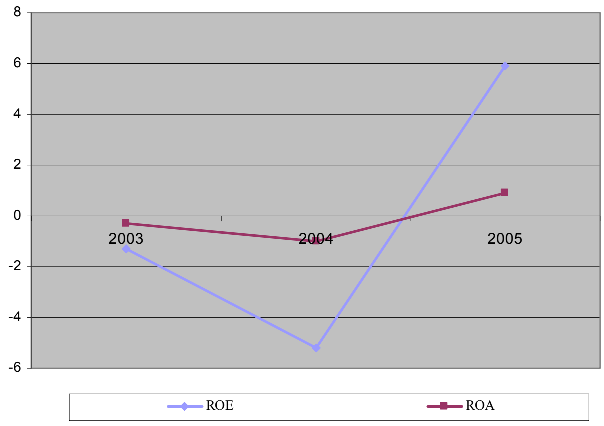
(in CSD million/ratio in %)

INDICATORS	Private	State-owned	Foreign	Banking sector total		
	2005	2005	2005	2005	2004	2003
Balance sheet assets per employee	25,504	18,165	41,247	30,195	21,740	16,465
Total revenue per employee	13,035	6,768	12,230	10,155	8,201	4,904
Operating expenditures per employee	1,884	1,286	1,943	1,675	1,363	1,125
Total deposits per employee	13,258	12,374	25,606	18,874	13,351	9,989
Total credits per employee	14,984	9,900	25,204	17,902	13,256	9,392
Revenue from fees relative to total revenue	7.9	13.4	7.3	9.0	9.4	15.1
Operating expenditures relative to total assets	4.4	3.8	2.3	2.9	3.1	3.4
Operating expenditures relative to total deposits	14.2	10.4	7.6	8.9	10.2	11.3
Operating expenditures relative to total credits	12.6	13.0	7.7	9.4	10.3	12.0

Source: NBS

All employee-related indicators show that banks operated in the period 2003-2005 more prudently, foreign banks in particular. However, some of them deviated substantially from the average for the overall banking sector. While the average operating costs per employee in the banking sector equaled CSD 962 thousand, foreign banks were running these costs at CSD 1,186 thousand. However, the average operating costs per employee in some foreign banks in the process of expanding their network exceeded CSD 2 thousand.

Chart 12: Movements in the ROE and ROA of the banking sector



Net return on assets (ROA) and net return on equity (ROE) were 0.9% and 5.9%[30], respectively.

Table 16: Comparative overview of ROA and ROE indicators

Country	ROA			ROE		
	2003	2004	2005	2003	2004	2005
Bosnia and Herzegovina	0.6	0.6	0.8[31]	3.4	5.8	7.0[23]
Croatia	1.4	1.4	1.4	15.6	16.6	16.0
Slovenia	1.0	1.1	1.0	12.5	13.3	13.8
Romania	2.7	2.5	1.9	20.0	19.3	15.4
Bulgaria	2.4	2.1	2.1	22.7	20.0	22.1
Hungary	1.5	2.0	2.0	19.3	25.4	25.1
Poland	0.5	1.4	1.6	5.8	17.1	20.7
Czech Republic	1.2	1.3	1.4	23.8	23.3	25.3
Turkey	2.3	2.3	1.7	16.0	16.4	11.8
Austria	0.7	0.8	0.8	6.3	9.3	11.4
France	0.4	0.5	0.6	8.5	10.6	11.9
Germany	- 0.1	0.1	0.2	-1.5	1.9	3.5
Italy	0.4	0.6	0.7	6.7	10.7	13.3[32]
Greece	0.6	0.3	0.9[33]	8.9	5.6	16.2
Serbia	- 0.3	- 1.0	0.9	-1.3	-5.3	5.9

Source: Report on Global Financial Stability, IMF, September 2006; NBS data for Serbia.

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[30] Calculated based on the balance of assets, i.e. regulatory capital, as at December 31 of a particular year.

[31] Data for September 2005.
[32] Data for March 2005.
[33] Data for June 2005.

RISK MANAGEMENT IN THE BANKING SECTOR

Regulatory framework for monitoring exposure to banking sector risks includes:

- Decision on Detailed Requirements in Implementing Articles 26 and 27 of the Law on Banks and Other Financial Organizations (defines the monetary portion of the share capital, capital adequacy ratio, capital asset ratio, large and largest permissible loan ratio, liquidity ratio and foreign exchange risk ratio).
- Decision on Criteria for the Classification of Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Special Provisions of Banks and Other Financial Organizations.

Credit Risk

Subject to the Decision on Criteria for the Classification of Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Special Provisions of Banks and Other Financial Organizations, banks are obligated to calculate and allocate special provisions against potential losses[34] on assets and off-balance sheet items of a specific level of collectibility. Special provisions consist of provisions for identified losses (receivables classified in categories B, C, D and E), formed as part of expenditures and recorded as indirect write-offs of lending in respect of balance sheet assets (general allowance for loan impairment) and as provisions against losses on off-balance sheet assets, and of provisions for unidentified losses (receivables classified in category A) on balance and off-balance sheet items, formed from retained earnings and recorded within provisions allocated from earnings.

Overall, classification of balance sheet assets and off-balance sheet items by the level of collectibility shows that the share of classified assets in total balance sheet assets and off-balance sheet items is growing – at end-2004 it stood at 41.5%, at end-2004 it was 42.6% and 43.2% at end-2005.

As at December 31, 2005, balance sheet assets accounted for 79.1% of the gross value of classified assets, of which. 72.7% was accounted for by gross classified long-term and short-term loans plus due receivables. As regards classified off-balance sheet items, the share of payable guarantees equaled 33.2%, while contingent liabilities accounted for 33.1%.

Due to the individual allowances for loan impairment, gross value of classified balance sheet and off-balance sheet items decreased by CSD 69.9 billion, or 9.7%, while their book value declined by CSD 176.0 billion, or 27.1%, on account of deductibles. The largest individual deductible (32.5% of the total) was a reduction in the book value by 50% of the amount of balance sheet receivables secured by mortgage on real estate, and reduction on account of receivables secured by cash deposits with a bank (19.4% of all deductibles).

Banking sector assets classified by level of collectibility are presented in the table below.

[34] Special provisions equal 1-2% for receivables classified in category A, 5% for receivables in category B, 25% for receivables in category C, 50% for receivables in category D and 100% for receivables in category E.

Table 17: Quality of banking sector assets

(in CSD million)

Category	2003		2004		2005	
	Classified assets	Special provisions	Classified assets	Special provis.	Classified assets	Special provis.
A	161,646	3,233	194,535	3,154	256,719	4,149
B	37,008	1,850	68,608	3,431	106,509	5,325
C	20,885	5,221	33,330	8,333	65,911	16,478
D	21,667	10,834	15,713	8,275	15,822	7,911
E	15,074	15,074	30,931	30,931	27,839	27,839
Total	256,280	36,212	343,117	54,124	472,800	61,702

Source: NBS

Bad assets (assets classified in categories C, D and E) amounted to CSD 109,572 billion and constituted 23.2% of classified assets after deductibles. Compared to end-2004, bad assets increased by CSD 29,598 million, or 37.0%. In the same period, total classified assets (after deductibles) rose by 37.8%, so that the relative share of bad assets in total classified assets remained almost unchanged. In 2003, the share of bad assets in total classified assets was 22.5%.

Table 18: Comparative overview of the share of provisions on bad loans in total bad loans

(in %)

Country	2003	2004	2005
Bosnia and Herzegovina	79.5	96.1	-
Croatia	60.8	60.3	58.0
Slovenia	35.0	34.0	-
Romania	33.5	34.3	31.4
Bulgaria	50.0	48.5	45.3
Hungary	47.3	51.1	-
Poland	47.3	58.0	59.4
Czech Republic	76.7	69.4	62.6[35]
Turkey	88.5	88.1	89.8
France	57.7	57.6	59.0[36]
Greece	49.9	51.1	-
Serbia	54.0	58.9	47.7

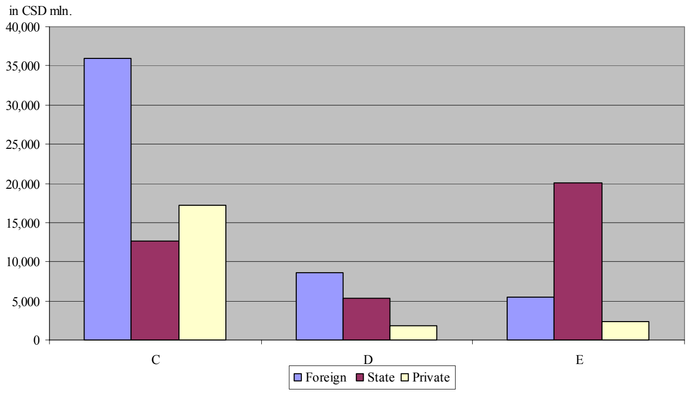
Source: Report on Global Financial Stability, IMF, September 2006; NBS data for Serbia.

[35] Data for September 2005.
[36] Data for June 2005.

Increase in classified assets in 2005 (37.8%) lagged behind the 48.5 per cent growth in gross balance sheet assets and off-balance sheet items subject to classification in that year. Such mismatch in rates of growth was a consequence of an exceptionally sharp rise in deductibles (by CSD 88,692 million or 101.5%). At the same time, the share of bad assets in classified assets remained broadly unchanged (23%).

Breakdown by individual category of classified assets shows that only the lowest quality receivables classified in category D declined (by CSD 3,092 million) on a year earlier. The largest nominal increase was registered for assets classified in category A (by CSD 62,184 million), while the largest increase in relative terms was registered for categories C (by 97.7%) and B (by 55.2%).

Chart 13: Bad assets by group of banks according to type of ownership at end-2005



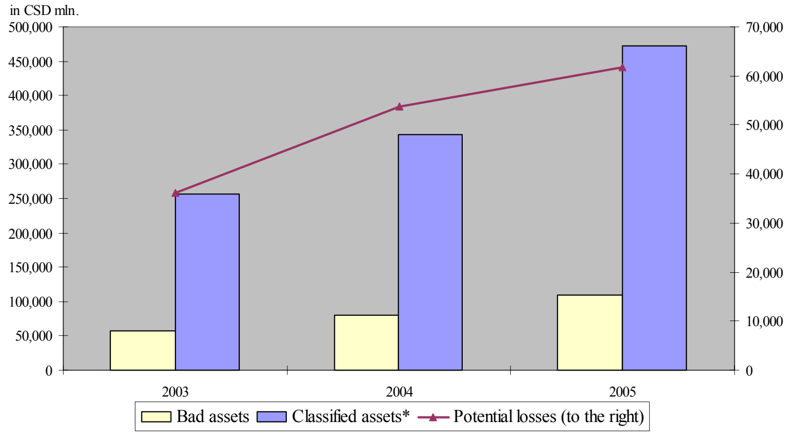
Breakdown by ownership structure shows that the largest share of bad assets in total classified assets after deductibles was reported for private banks (42.2%), followed by state-owned (28.8%) and foreign banks (17.3%). Compared to end-2004, the value of this indicator with state-owned banks dropped by 5.2 percentage points, while the quality of assets of foreign and private banks deteriorated – this indicator rose by 9.1 and 18.7 percentage points, respectively. It is important to note that foreign banks accounted for the largest share in total classified assets (after deductibles) and bad assets of the banking sector (61.4% and 45.7%, respectively), followed by state-owned (27.9% and 34.7%, respectively) and private banks (10.7% and 19.5%, respectively).

Out of three banks with the largest share of bad assets in total classified assets after deductibles, one was state-owned (84.1%) and two were private (69.3% and 65.8%). Five banks with the largest amount of bad assets accounted for 51.2% of the banking sector bad assets. At the same time, these five banks accounted for 47.3% of total classified assets in the banking sector after deductibles.

As at December 31, 2005, potential losses (special provisions) equaling CSD 61,702 million, made up 49.7% of total banking sector capital. Compared to end-2004, this share dropped by 6.7 percentage points, whereas compared to end-2003, it went up by 5.9 percentage points. Potential losses amounted to 91.6%, 37.9% and 31.3% of the capital of state-owned, foreign and private banks, respectively. It is noteworthy that state-owned banks accounted for 45.4% of potential losses of the banking sector, foreign banks for 40.8%, and private banks for 13.8%.

In four cases (two foreign and two state-owned banks), potential losses exceeded the available capital, and in one of these two state-owned banks, potential losses were double the amount of capital.

Chart 14: Movements in asset quality by category



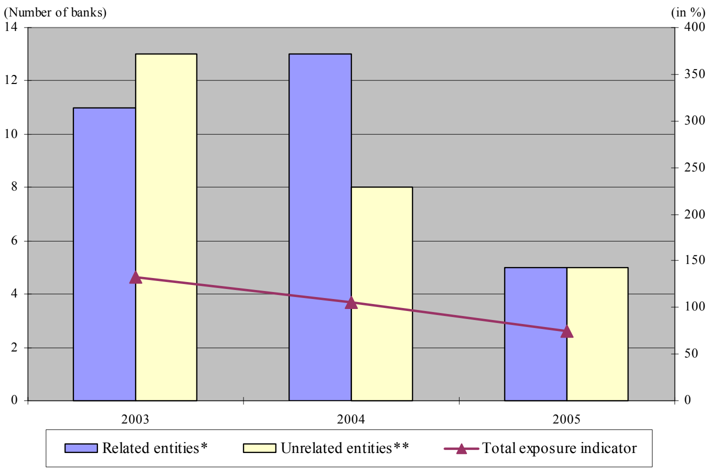
* Classified assets after deductibles

Single Entity Risk Exposure

Single entity risk exposure of a bank represents total amount of receivables and off-balance sheet items pertaining to such entity or a group of related entities (loans, investments in debt securities, ownership stakes and shares, issued guarantees and sureties, etc.).

Pursuant to current legislation, a large bank loan is understood to mean a loan granted to a single entity that exceeds 10% of the bank's capital. The largest permissible loan made available to the borrower is a loan that does not exceed 25% of the bank's capital, and if the borrower is an entity related to the bank, that does not exceed 5% of such bank's capital. The sum of all large and the largest permissible loans may not exceed 400% of the bank's capital.

Chart 15: Single entity risk exposure indicators



*Number of banks not in compliance with the permitted exposure to an entity related to the bank
**Number of banks not in compliance with the permitted exposure to an entity not-related to the bank

As at December 31, 2005, the average value of large and the largest permissible loans ratio for the overall banking system equaled 74.2% and was by 31.6 percentage points lower than the corresponding data reported at end-2004. During 2005, the value of large and the largest permissible loan ratios for foreign, state-owned and private banks declined by 86.3, 49.0 and 28.2 percentage points and equaled 97.7%, 64.7% and 27.8%, respectively.

As opposed to 2003 when one state-owned bank reported the large and largest permissible loan ratio of 420.0%, in 2005 and 2004 all banks brought their operations in line with the prescribed large and largest permissible loan ratio.

As at December 31, 2005 two state-owned banks each reported two loans that exceeded 25% of their capital, while another three banks (two foreign and one state-owned), each in one instance, reported non-compliance with the current regulations on risk exposure. One state-owned bank breached the permitted exposure limit to a related entity (5%) with four loans, while another four banks (two private, one state-owned and one foreign) failed to comply with the same regulation in one instance each.

Credit Risk Arising from Exchange Rate Movements

The increase in lending activity was accompanied by the increase in the share of foreign currency clause-indexed loans in total loans. Compared to end-2004, when the share of foreign currency clause-indexed loans stood at around 57%, their share reached around 70% at end-2005. In such circumstances, in addition to standard credit risks, the banks were exposed to the default risk arising from exchange rate movements. Namely, in case of significant depreciation of the dinar exchange rate, such risk is particularly pronounced for borrowers that have no foreign currency earnings or any foreign currency assets.

At end-2005, 98.5% of foreign currency clause-indexed loans were tied to the euro, while 1.0% was tied to the US dollar. A particularly significant risk was associated with the Swiss franc-indexed loans, which appeared in the market as a new banking product in late 2005 offering a somewhat lower interest rate than the euro-indexed loans. Out of total approved foreign currency clause-indexed loans, foreign banks accounted for 86.8%, state-owned banks for 9.0% and private banks for 4.2%.

By amending regulations, the National Bank of Serbia aimed to increase the banks' vigilance in approving foreign currency clause-indexed loans. In June 2005, the National Bank of Serbia prescribed the obligation for banks to adopt a new methodology for adequate identification and measuring of credit risk arising from the effect of the dinar exchange rate fluctuations on the borrower's financial standing as well as the methodology for managing such risk.

Subject to amended regulations, when assessing the borrower's financial standing and creditworthiness, banks were obligated to conduct an analysis of the borrower's exposure to foreign **exchange rate risk**, and, unless the borrower's credit file contains the assessment of the impact of the dinar exchange rate risk on its classification, to classify receivables from the borrower whose liabilities with respect to the bank were contracted in foreign currency or in dinars with a foreign currency clause, into a category one step below the category into which they would otherwise have been classified. All borrowers whose liabilities towards the bank are equal to or exceed 10 million in the dinar equivalent need to be assessed for such risk.

Foreign Exchange Risk

Compliance with the ratio of foreign exchange risk, as regulated by the NBS, measures negative effects on the bank's financial result and capital due to changes in the exchange rate. Total risk-weighted foreign currency position of a bank (sum of short and long open net foreign currency positions per specific currencies – EUR, USD and other currencies, and precious metals) may not exceed 30% of the bank's capital.

The ratio of foreign exchange risk for the overall banking sector stood at 15.8% at end-2005, at 16.9% at end-2004 and at 14.4% at end-2003. Non-compliance was recorded in 2003 only, and in case of three banks (two state-owned and one foreign).

Total open foreign currency position amounted to CSD 19,624 million, which is by CSD 4,366 million more than at end-2004. Total open long foreign currency position of the entire banking sector came to CSD 13,866 million and total open short position to CSD 5,758 million. Compared to a year earlier, total open long foreign currency position increased by CSD 1,928 million and total open short position of the banking sector by CSD 2,438 million.

Twelve banks were exposed to a prominent foreign exchange risk – their net open short position in respect of all currencies totaled CSD 4,112 million (at end-2004 there were 10 banks with a total net open short position of CSD 1,579 million).

At end-2005, the lowest foreign exchange risk ratio was reported by state-owned banks, i.e. 12.9%. Foreign banks recorded a 13.5% foreign exchange risk ratio, while private banks accounted for the highest level, i.e. 24.7%.

Capital Asset Risk

Subject to effective legislation, banks are obligated to maintain their capital asset ratio (the sum of all stakes that a bank holds in the capital of legal entities plus investment into its capital assets) at a level below 60% of their capital. The bank's stake in the capital of a single legal entity may not exceed 15% of the bank's capital.

As at December 31, 2005 the average value of capital asset ratio for the banking system as a whole equaled 34.7%, which implies a 1.6 percentage point drop from the corresponding figure at end-2004. Compared to end-2004, the value of capital asset ratio of foreign and state-owned banks rose by 8.2 and 5.0 percentage points, respectively, and amounted to 29.0% and 50.5%, respectively. This ratio for private banks declined by 4.2 percentage points and came to 30.9%.

At end-2005, six banks (four state-owned and two private) reported non-compliance with the prescribed limit on capital asset ratio, while two banks (one private and one state-owned) each reported a stake in the capital of another legal entity above the permitted 15% of their capital. At end-2003 and end-2004, four banks reported capital asset ratio above 60%, three of which (2 state-owned and one private Kosovo-based bank) showed non-compliance with the requirement for three years in a row.

Liquidity Risk

Banks are required to keep the liquidity ratio (ratio between aggregate first-degree liquid receivables and second-degree liquid receivables on the one hand and, on the other, aggregate obligations payable on demand with no agreed maturity and obligations with agreed maturity) at least equal to 1 (calculated as the average of all business days in a month), equal to 0.8 (calculated for one business day only) and at least equal to 0.9 (when calculated for three business days in a row).

Liquidity ratio of the overall banking sector equaled 2.06 at end-2005, 2.19 at end-2004 and 2.45 at end-2003. It is important to note that the non-compliance with the limit on the liquidity ratio limit was reported only once in 2003 (at a monthly level) by a state-owned bank that later on merged with another bank.

As at December 31, 2005, ten banks used required reserve assets in the amount of CSD 1,403 million or 10.49% of their total calculated reserve requirements. No daily liquidity loans were used by any of the banks.

Table 19: Banking sector liquidity as at December 31, 2005

(in CSD thousand)

Banks	Gyro-account balances	Calculated reserve requirement	Difference (2-3)	Deposited excess liquidity	Daily liquidity loans
Total in Serbia	27,999,902	26,045,923	1,953,979	4,759,000	-

Source: NBS

INSURANCE SECTOR

Level of Development of the Insurance Market

Serbian insurance sector is underdeveloped. In fact, in terms of the level of development, it is well below the average for the EU member countries. This is confirmed by the insurance market development indicators – total premium payment to GDP ratio and total premium payment per capita. Namely, according to the 2.1% share of premium payment in GDP in 2005 (1.7% in 2004), Serbia ranks 58 in the world. The premium payment to GDP ratio in Slovenia stood at 5.7%, in Croatia at 3.2%, while reaching as much as 8.4% in the 25 EU member countries. The highest percentage share of premium payment in GDP in 2005 was recorded for Taiwan, followed by the Republic of South Africa and Great Britain.

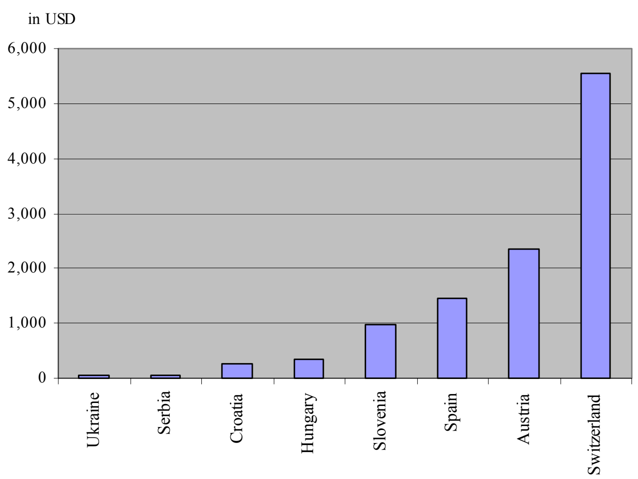
Table 20: Premium payment to GDP ratio in 2005 in Serbia and some European countries

(in %)

	Life-insurance	Non-life insurance	Total
Great Britain	8.9	3.5	12.4
Switzerland	6.2	5.0	11.2
Malta	3.2	2.7	5.9
Slovenia	1.7	4.0	5.7
Czech Republic	1.5	2.5	4.0
Croatia	0.8	2.4	3.2
Poland	1.3	1.8	3.1
Hungary	1.4	1.7	3.1
Serbia	0.2	1.9	2.1
Greece	1.0	1.1	2.1
Turkey	0.2	1.3	1.5

Source: Swiss Re, Sigma No.5/2006

Chart 16: Per capita premium in 2005 in some European countries



With 2004 per capita premium payment of around USD 50 (i.e. around EUR 40), Serbia ranks 70th in the world. The first place is occupied by Switzerland with USD 5,716, followed by Great Britain and Ireland, whereas Slovenia with USD 920 and Croatia with USD 248 occupy the 28th and 41st place, respectively.

Source: Swiss Re, Sigma No.5/2006

In 2004, Serbia occupied the 66th place in the world with total premium payment of USD 433 million.

Although both of the above indicators improved in 2005 (ratio of premium payment to GDP was 2.1%, and per capita premium payment USD 64 or around EUR 54), this sector is still underdeveloped as can be seen from the table below.

Table 21: Serbian insurance sector development indicators

	2004	2005
Per capita premium - in dinars	3,033	4,648
- in EUR	38	54
- in USD	52	64
Share of premium payment in GDP, in %	1.7	2.1

Source: NBS

Insurance market development, as measured by the growth in premium payment, points to an upward movement. Total premium payment in 2005 relative to 2004 gained 53%. As retail prices grew by 16.5% in the same period, this means that total insurance premium payment increased substantially in real terms, which is a significant accomplishment in a year in which roughly 50% of insurance companies lost their operating licenses, and in which serious work on stabilizing and reforming the insurance sector began.

Number of Insurance Companies and Other Participants in the Insurance Market

In 2005, the number of insurance companies declined by 50% (from 40 to 19); four companies underwent voluntary liquidation proceedings and one insurance company merged with another. On 31 December 2005, there were 19 insurance companies in the market, of which 16 engaged in insurance activities only, 2 only in reinsurance business and 1 in both insurance and reinsurance activities. Of the companies engaged in insurance activities, 1 company engaged in life insurance only, 7 companies provided non-life insurance only, and 8 companies engaged in both life and non-life insurance.

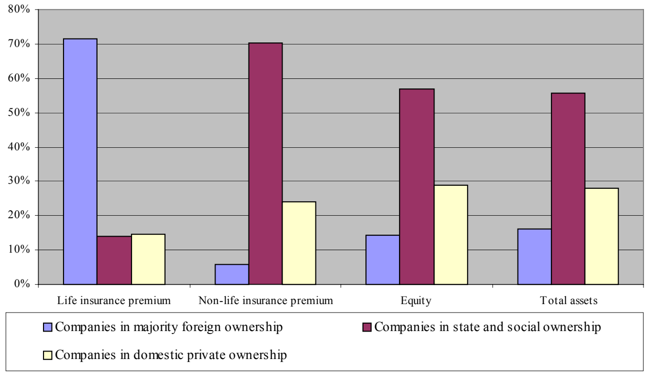
Insurance companies are required to segregate their insurance activities from reinsurance activities, and life from non-life insurance activities until 31 December 2007. Hence, subject to other status changes, such as mergers and acquisitions, it is realistic to expect a change in the number of insurance companies in the oncoming period.

In 2005, the number of other insurance market participants, brokerage companies and insurance agencies, was also almost halved (declining from 149 to 75) after around 90% (133) of the total number of such companies and agencies had their operating license revoked and 59 new legal entities and entrepreneurs gained the right to engage in insurance activities. Hence, the sales network, apart from insurance companies, also includes 40 legal entities, 35 natural persons – entrepreneurs, one tourist agency and 2,578 natural persons licensed to engage in insurance agency/brokerage. The above changes have brought about significant improvement in the quality of sales network, which is to be further upgraded by enabling banks to sell insurance policies.

Ownership Structure of Insurance Companies

Analysis of ownership structure indicates that out of 19 insurance companies operating in 2005, 5 companies are in majority foreign ownership, 14 in domestic (of which 2 in state and social ownership and 12 in private ownership).

Chart 17: Market share of insurance companies by type of ownership structure in 2005



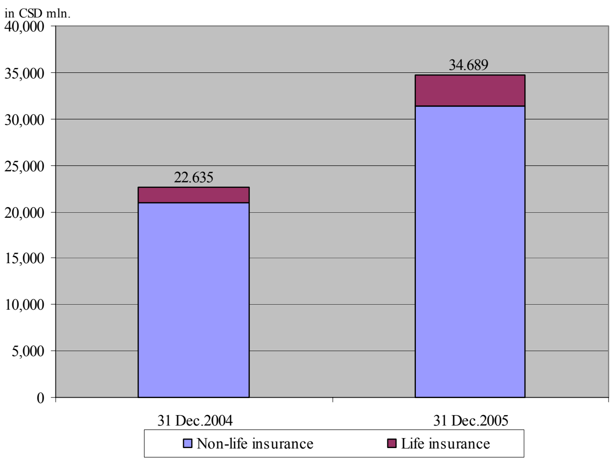
The above chart indicates that companies in majority foreign ownership have a small market share of mere 12%, but at the same time, they account for 71% of the life insurance market. Two largest companies account for 70% of the non-life insurance market.

Total Insurance Premium

Annual statements for 2004 were the first set of statistics and other data submitted by the insurance companies to the National Bank of Serbia. More detailed and wide-ranging data were later submitted in the form of quarterly reports starting from 30 June 2005. Total premium payment in 2005 amounted to CSD 34,689 million (EUR 405.7 million, or USD 480 million).

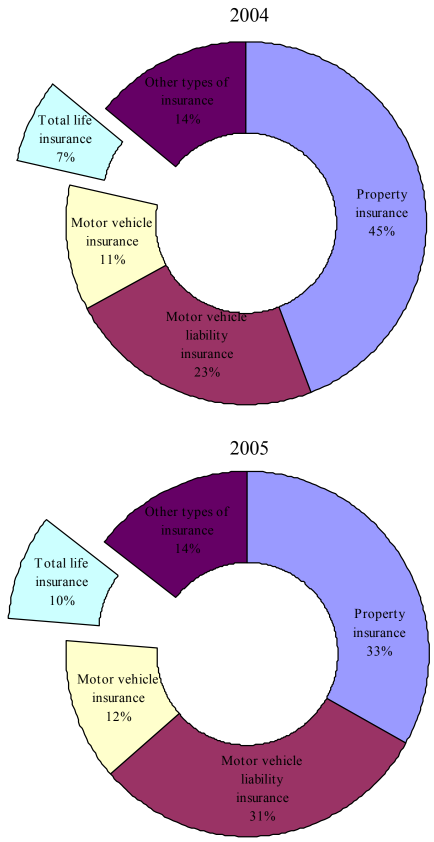
Total premium payment in 2005 exceeded the corresponding figure for 2004 (inclusive of premiums arranged by companies whose operating licenses were revoked in early 2005), of CSD 25.1 billion (EUR 318 million or USD 433 million), and points to a significant development of the insurance market in Serbia in the course of 2005.

Chart 18: Total insurance premium payment in Serbia in 2004 and 2005



Non-life insurance accounted for 90.5% of premium payment in 2005, whereas the share of life insurance was only 9.5%. Although life insurance premium payment rose by as much as 96% in 2005, with non-life insurance premium rising by 49.8%, the former accounted for an extremely low share of total premium payment – 9.5% (6.7% in 2004).

Chart 19: Premium payment by type of insurance in 2004 and 2005



Within non-life insurance premium, property insurance (property insurance against fire and other hazards and other forms of property insurance) has continually accounted for the largest share of total premium payment, reaching 33% in 2005. The second largest share was that of motor vehicle liability insurance with 31%. Although the share of voluntary pension insurance premium (the Third pillar and the type of life insurance which, for the time being, is provided by three insurance companies) in total premium payment went up from 0.6% in 2004 to 1.2% in 2005, it still remains insignificant.

Of all types of non-life insurance in 2005, the largest per annum increase in premium receipts was recorded for voluntary health insurance (142%) and motor vehicle liability insurance (104%).

Insurance Market Concentration

Breakdown by company points to a notable degree of portfolio concentration. According to the level of premium payment, insurance companies may be divided into three groups. The first group comprises two largest insurance companies accounting for 74% of total premium receipts in 2004 and for 65% in 2005. The second group is made up of three relatively sizeable companies that managed to double their total premium receipts in 2005, and accounted for 12% of total premium payment at the level of the country in 2004 and 18% in 2005. The third group includes other companies with the share in total premium receipts in 2004 and 2005 of 14% and 17%, respectively.

Table 22: Classification of insurance companies by the level of premium in 2005

Group	**Number of companies**	**Total premium, in CSD million**	**Share in total premium in %**
I	2	22,505	65
II	3	6,316	18
III	14	5,868	17
Total	19	34,689	100

Source: NBS

In 2005, two largest insurance companies accounted for 65% of the total premium and 70% of total non-life insurance premium receipts. This, coupled with the fact that the next four largest companies accounted for 19% of the premium receipts, confirms that there is a high degree of concentration in the insurance market. A single company, which accounts for only 4% of the total premium in all types of insurance, accounts for as much as 29% of total life insurance premium receipts, whereas three companies that started developing their activities in the area of life insurance also had a substantial share in total life insurance premium receipts.

The share of five companies in majority foreign ownership in the overall portfolio rose from 9% in 2004 to 12% in 2005. The share of their life insurance premium receipts in the total life insurance premium was also very significant – it increased mildly from 69% in 2004 to 71% in 2005.

In the course of less than two years since the National Bank of Serbia assumed the supervisory function, the following results have been achieved:

- insurance premium receipts increased by 53%,
- though declining, market concentration is still high (the share of two largest companies in total premium receipts shrank from 74% in 2004 to 65% in 2005),
- the share of non-life insurance (90%) in the total premium is still dominant,
- life insurance premium payment increased by 96% in 2005 from 2004, but its share in the total premium in 2005 of 10% only, is still low compared to the European Union member countries where it amounts to as much as 60%,
- companies in majority foreign ownership account for an increasing share of life insurance premium receipts, but also of non-life types of insurance premium receipts.

INSURANCE SECTOR BALANCE SHEET

Insurance Sector Balance Sheet Total

The volume of operations of the insurance sector, measured by the balance sheet total of companies holding an operating license, increased by 51% in 2005 compared to 2004, having risen from CSD 30.8 billion to CSD 46.4 billion.

Structure of Liabilities

Within the structure of liabilities as at 31 December 2005, capital and reserves accounted for 40% and technical reserves for 49%.

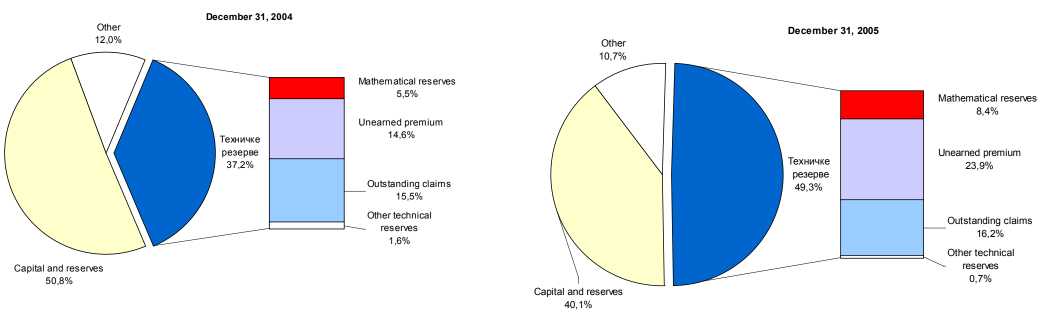
As opposed to 2004, when the major portion of liabilities referred to capital and reserves (50.8%) and the share of technical reserves stood at 37.2%, in 2005 insurance companies reduced the share of their capital so as to be able to allocate greater amount of funds into technical reserves. Concomitantly with a relative drop in the share of capital in the structure of liabilities, capital and reserves recorded a 19% nominal increase from 2004 (from CSD 15.6 billion to CSD 18.6 billion), which resulted mainly from capital increases that insurance companies effected in conformity with legal regulations.

On the other hand, technical reserves, used by insurance companies to settle obligations to policyholders, stood at CSD 22.8 billion as at 31 December 2005, which was an almost twofold increase compared to 2004 when they equaled CSD 11.5 billion. Hence, reserves increased by 99%, which, assuming they are adequately invested, is of utmost significance for the security of policyholders.

Increase in technical reserves, and particularly in unearned premium (by 100% in the period under review, i.e. from CSD 9.3 billion to 18.6 billion) was largely attributable to the application of the uniform criteria for calculation of technical reserves as prescribed by the National Bank of Serbia and to the rigorous control of the adequacy of allocation into technical reserves. Hence, the insurers were compelled to abandon their former practice of underestimating these reserves thereby jeopardizing interests of policyholders and insurance beneficiaries.

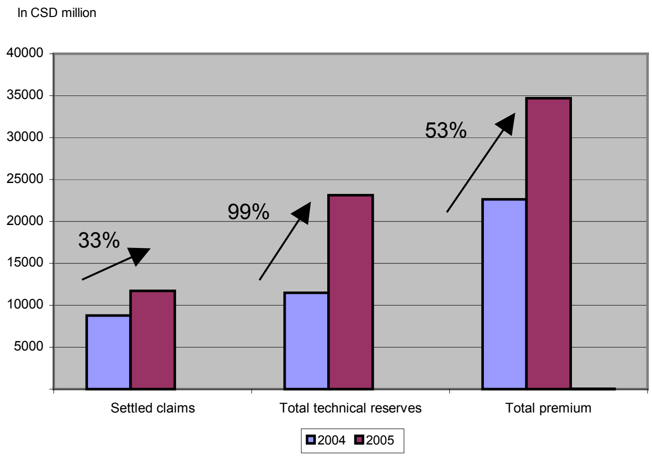
The structure of technical reserves is dependant on the insurers' portfolio structure, i.e. on the low share of life insurance in total portfolio of insurance companies. Unearned premiums (48.7%) make up the largest portion of technical reserves, and together with outstanding claims (32.9%), as the second largest item, represent more than 80% of technical reserves.

Chart 20: Structure of insurance sector liabilities in 2004 and 2005



The ratio of growth in technical reserves to total premium payment growth represents a significant indicator of the effects of activities undertaken for the purpose of stabilizing and regulating the insurance market. The 99% increase in technical reserves is well beyond the 53% increase in total premium payment, which only attests to the fact that insurance companies started breaking away from their practices of inadequate formation of technical reserves. This is illustrated by the chart below.

Chart 21: Increase in technical reserves and total insurance premium in 2005



Protection of interests of policyholders and damaged parties, i.e. timely recovery of damages, requires not only an appropriate level of technical reserves, but also their adequate investment to ensure full settlement of all obligations throughout the life of the insurance policy. In order to be able to meet its obligations, the company has to invest its funds in line with the type of insurance it engages in by taking into account maturity of obligations as well as profitability and dispersion of investments.

In 2005, technical reserves against life insurance operations were for their major part invested in securities (33%) and bonds traded in the market (30%). Technical reserves against non-life insurance operations, on the other hand, were mostly invested in real estate (30%) and kept as deposits with banks (13%).

Comparison of trends in investment of technical reserves against life insurance operations as at 30 September 2005, when reporting on technical reserve investments was first introduced, with data reported as of 31 December 2005 shows an obvious improvement. Investment in bonds that are not market-traded dropped from 37% as of 30 September 2005 to 10% on 31 December 2005, in favor of market-traded bonds, which reduces exposure to the default risk.

Albeit decreased, investment of technical reserves against non-life insurance operations into real estate effected in the preceding period is not adequate as it can seriously jeopardize settlement of obligations that are mostly short-term.

Analysis of data on insurance companies' investments as at 31 December 2004 and 31 December 2005 shows a decline in investment in related legal entities.

Non-life insurance technical reserves of companies engaged in reinsurance are mostly invested in unearned premiums at the cost of the reinsurer (32%) and cash (29%).

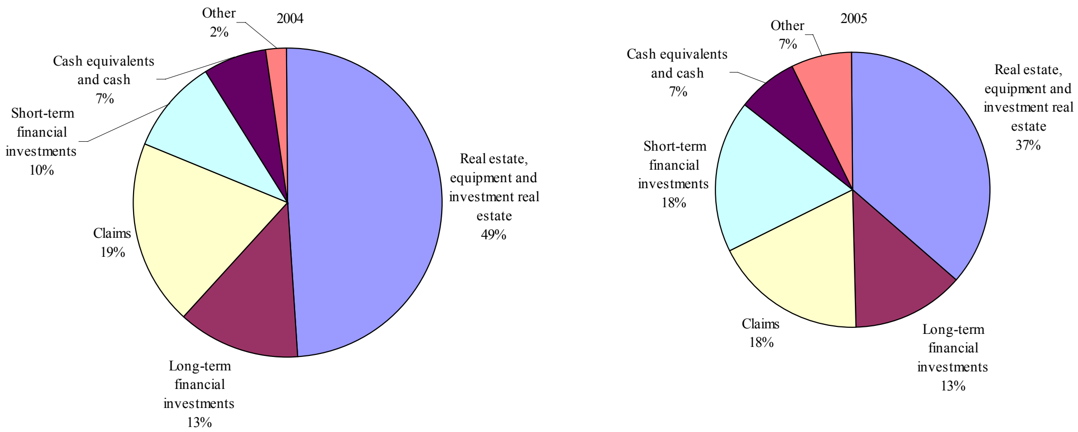
Structure of Assets

Within the structure of insurance companies' assets as at 31 December 2005, 50.2% are fixed assets (of which 36.2% real estate, and 13% long-term financial investments), whereas 49.3% are working assets (of which claims in respect of premiums and short-term financial investments account for 18% each).

Compared to 2004 when the share of fixed assets equaled 62.2% (with real estate accounting for 49% and long-term financial investments for 12.8%) and the share of working assets equaled 37.5% (with claims accounting for 19.3% and short-term financial investments for mere 10%), it may be concluded that the structure of assets has improved.

However, given the fact that the insurance market is dominated by non-life insurance operations (where obligations in respect of claims are, as a rule, of short-term character), the structure of assets, albeit improved in 2005, is still unfavorable because the largest share of investment (36%), made in the preceding period, refers to real estate, facilities and equipment, which indicates a high level of immobilization of the companies' assets.

Chart 22: Structure of insurance sector assets in 2004 and 2005



INSURANCE SECTOR PERFORMANCE INDICATORS

Relevant Technical Result

Relevant technical result in the insurance sector – loss ratio (ratio between relevant claims and relevant technical premium) as an indicator of price policy and adequacy, i.e. of the sufficiency of premiums paid for the settlement of obligations arising from insurance contracts stood at 79.99% on 31 December 2005. Negative loss ratio was achieved in four (out of 16) types of insurance activities, while in other types of insurance it ranged from 4.83 and 96.16%. According to data for 2004, loss ratio equaled 64.99%. This result should be taken with some reserve as the data were not reliable enough, above all in the sense of underestimating the companies' obligations towards the insureds, as detected in the course of supervision of insurance companies.

Negative loss ratio in 2005 recorded for accident insurance, marine vessel insurance, marine liability insurance and loan insurance, stems from more adequate provisioning for incurred damages (which increases relevant claims), more adequate provisioning for future damages (which reduces the relevant premium), and from smaller portfolio of certain types of insurance, where potential incurrence of damages has a much more unfavorable impact on the loss ratio (as is the case with marine liability insurance). It is important to note that the share of the above types of insurance in the total premium is mere 7.3%.

Solvency

Solvency of insurance companies depends on the amount of technical reserves i.e. on whether they are sufficient for the settlement of undertaken obligations, as well as on the amount of guarantee reserve which is a kind of protection of policyholders in the event of unpredicted losses, or a buffer for losses that are not covered by technical reserves.

Subject to the Insurance Law, as of 30 June 2005 insurance companies are obligated to keep the guarantee reserve above the solvency margin and this is the first time ever that such obligation has been introduced in Serbia.

Pursuant to secondary legislation, prepared in line with the EU directives, as of June 2005 the solvency margin is calculated based on the criteria that take into account type of activities that insurance companies engage in, as well as the volume of operations and amount of claims in a three-year period.

On 31 December 2005, solvency margin equaled CSD 10 billion, while guarantee reserve stood at CSD 17.1 billion.

Liquidity

Insurance company liquidity measured as a ratio between short-term assets and short-term obligations (including provisioning for future claims and provisioning for unsettled claims) went up from 0.95% in 2004 to 1.02% in 2005.

An upsurge in liquidity may be explained by the improvement of structure of assets in 2005. Namely, real estate, receivables and long-term investments participated with 67.1% in the structure of assets in 2005, while their share in 2004 was 81%.

Profitability Indicators

Return on company's total assets, as the percentage ratio of net profit to total assets, and profitability of own assets, as the ratio of net profit to company's capital assets, increased in 2005 relative to a year earlier.

Namely, return on total assets of the companies that operated in 2004 stood at 0.64%, and rose to 1.43% in 2005, which means that 1.43 dinars of return was recorded for each 100 dinars of total assets.

Profitability of own assets, which in 2004 was 1.54%, climbed to 4.37% in 2005, which means that 4.37 dinars of net profit were recorded for each 100 dinars of capital assets,.

As comparable indicators show, although the number of insurance companies dropped by approximately 50%, there have been significant positive changes in the market compared to 2004.

Total insurance premium increased by 53% and the number of employees by 35%; premium structure improved mildly, as life insurance premium increased, albeit modestly, from 6.7% to 9.5%; the volume of operations gained 51%; capital went up

19%; and technical reserves rose by as much as 99%, which is a matter of extreme importance for the safety and stability of the sector as these reserves serve for the settlement of obligations in respect of the policies issued.

Apart from this, the quality of investment of technical reserves has to a certain extent been improved in that the share of investment in real estate, related entities and securities that are not traded in the organized market, has declined. Investment of technical reserves is still not satisfactory mostly because of inappropriate maturity, quality and marketability of investment. It should be taken into account though, that being the legacy from the preceding period when immobilization of assets represented the dominant form of investment, the tendency of investing technical reserves into real estate cannot be changed in the near future.

It may, however, be concluded that the state of affairs in the insurance market and the level of its development are still not satisfactory.

FINANCIAL LEASING COMPANIES

Number of Financial Leasing Companies

The National Bank of Serbia has, in accordance with the Law on Amendments and Supplements to the Law on Financial Leasing («RS Official Gazette» No. 61/2005), granted operating licenses to 14 financial leasing companies.

At the end of 2005, there were 329 employees in the financial leasing sector.

Ownership Structure

Eight financial leasing companies are in majority ownership of foreign legal entities, three companies are in majority ownership of foreign banks, while one company is in the ownership of a domestic bank with foreign capital and foreign legal entity each participating with a 50% share in the leasing company's capital. Two financial leasing companies are in the ownership of domestic legal entities.

Financial Leasing Market Concentration

Three lessors managed to keep their leading positions in the market in 2005. However, the cumulative share of these three lessors significantly dropped compared to the preceding year – from 79.7% in 2004 it slid to 69.2% in 2005.
Increase in the level of competition is also confirmed by the Herfindahl- Hirschman Index (HHI) that declined from 2,410.1 to 1,859.1, implying that our financial leasing market turned from a highly concentrated marketplace to a moderately concentrated one.

BALANCE SHEET OF FINANCIAL LEASING COMPANIES

In two and a half years of operations, financial leasing companies posted a balance sheet total[37] of 6.7% relative to the banking sector balance sheet.

Total balance sheet assets of leasing companies as at December 31, 2004 equaled CSD 23 billion, whereas only a year later such share increased 2.3 times and came close to CSD 52

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[37] For the purpose of analysis, balance sheet and profit and loss account of financial leasing companies were adjusted in the sense that claims in respect of financial leasing were disclosed in the net amount, i.e. the amount of these claims was reduced by the amount of unearned financial revenue disclosed within liabilities. Sales revenue was also adjusted and disclosed in the net amount, i.e. it was reduced by the amount of the procurement value of sold goods. Such adjustments eliminate the overvaluation of assets and total posted revenues and bring them to fair values.

billion. Claims in respect of financial leasing accounted for 91.3% of total balance sheet assets (93.8% in 2004).

Long-term obligations had the most significant share in liabilities – 88.4% (82.2% in 2004), namely long-term foreign credits - 83.2% (73.5% in 2004) and long-term domestic credits – 4.8% (7.8% in 2004). Short-term obligations participated with 7.2% in total liabilities (14.5% in 2004), of which short-term domestic credits - 4.5% (10.7% in 2004). Capital had a very low share in total liabilities – mere 4.2% (3.2% in 2004), and most of it referred to unallocated earnings.

Balance sheet structure indicates that almost the entire amount of financial leasing investments is financed by foreign borrowing – foreign credit obligations account for 83.2% of total liabilities, while financial leasing investments account for 91.3% of total assets. Long-term domestic credits represent a mere 4.8% of total liabilities, while nearly 90% of this amount is accounted for by one leasing company only.

In 2005, the relation between domestic and foreign sources of financing shifted in favor of foreign sources. Namely, foreign obligations increased by 2.5 times from 2004 (somewhat more than total assets growth), which resulted in the growth of the share of this category of sources in total liabilities. Foreign creditors of leasing companies are mostly their founders or legal entities operating within the same banking group.

The structure of investment by lessee indicates that the most significant beneficiaries of financial leasing are legal entities, which account for 74.2% of total investment (three quarters), then follow natural persons with 14.7%, entrepreneurs with 6.8% and others with 4.3%.

With respect to the object of financing, the bulk of investments referred to the financing of passenger vehicles – 34.6% and freight vehicles, minibuses and autobuses – 31.1%.

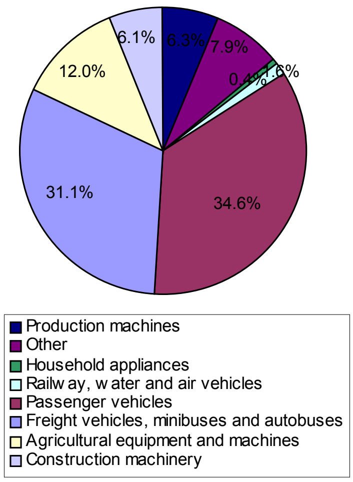

Chart 23: Structure of investments by the object of lease

In terms of sectoral distribution, the bulk of investments is accounted for by transport, warehousing and communications sector – 19.6%, trade sector – 19.1%, manufacturing industry – 16.5% and natural persons – 16.2%.

FINANCIAL LEASING PROFIT AND LOSS ACCOUNT

Total pre-tax profit recorded by the financial leasing market in 2005 stood at CSD 979,923 thousand, having increased two and a half times relative to 2004.

Lessors' most significant revenue categories were foreign exchange gains – 56.6% (43.8% in 2004). Other types of revenues may also be added to this category, mostly those revenues arising from the contracted risk safeguard (foreign currency clause). Interest revenues participated with 27.9% in the overall revenue structure.

The most significant expenditure categories were exchange rate losses – 66.9% of total expenditures (62.8% in 2004), operational expenditures – 13.5% (20.1% in 2004) and interest expenditures – 13.1% (12.3% in 2004).

Compared to 2004, expenditure growth rate (240.1%) exceeded the revenue growth rate (229.5%), which resulted in the decrease of net pre-tax profit rate – from 11.5% recorded in 2004 to 8.7% in 2005.

PERFORMANCE INDICATORS

Based on the presented performance indicators, it may be concluded that leasing companies have a relatively high return on average equity due to high leverage i.e. debt-to-equity ratio. Such manner of operating is very risky – if, in the event of any unfavorable market developments the lessors made losses, such losses would multiply and negatively impact the lessors' equity.

Table 23: Lessors' performance indicators – market average for 2005

Performance indicators	Dec. 31, 2005
Return on average assets (ROA)	1.5%
Return on average equity (ROE)	19.4%[38]
Net interest margin	4.8%
Average lending rate	9.1%
Average deposit rate	4.4%
Coverage of interest expenditures	1.7x
Operational expenditures to average investments	5.7%
Total liabilities to equity	29.9x [39]
Long-term liabilities to equity	22.6x [39]

Source: NBS.

[38] Due to negative average equity, one lessor was excluded from the calculation.
[39] One lessor reporting extreme values of these indicators (over 600) was excluded from the calculation.

VOLUNTARY PENSION FUND MANAGEMENT COMPANIES

The Law on Voluntary Pension Funds and Pension Schemes in Serbia was enacted in 2005, and was applied as of April 1, 2006.

This Law provides for the incorporation of companies for pension funds management and organization, and specifies the criteria that need to be met in order to protect the interests of pension fund members. The Law also regulates the operations of voluntary pension fund management companies, organization and management of voluntary pension funds, custody bank activities and duties, scope of competences of the National Bank of Serbia in the supervision of management companies, and other issues of significance for the functioning of voluntary pension funds.

The principal purpose of voluntary pension funds is to give citizens a possibility to increase their pension income, and to decide on the amount of money they wish to set aside for that purpose. The resources of voluntary pension funds and pension schemes are collected through payment of pension contributions by members of the voluntary pension fund or contributors for the purpose of further investment, in order for members to become entitled to draw and dispose of accumulated funds once all necessary conditions have been fulfilled.

The National Bank of Serbia has been entrusted with:

- Issuing operating licenses to management companies, issuing licenses to organize and manage funds, and issuing approval of appointment of company management,
- Approving rules of operations of companies, prospectuses and other marketing material,
- Maintaining the register of voluntary pension funds,
- Supervising the activity of voluntary pension fund management,
- Receiving daily reports from the custody bank on net asset value and investment unit value of a voluntary pension fund,
- Receiving and examining annual, semiannual and monthly reports of the voluntary pension fund management companies.

The National Bank of Serbia conducts regular supervision of voluntary pension fund management companies and issues secondary legislation necessary for the implementation of the Law on Voluntary Pension Funds and Pension Schemes.

PAYMENT SYSTEM

Payment System Reform

National payment system is one of the most important components of the monetary and financial system of the country. Payment system serves for transferring money from buyers to sellers in commercial and financial transactions. If the payment system is functioning well, total costs of transactions are lower and the scope of commercial and financial transactions in an economy is wider.

Three years ago Serbian payment system underwent complete reform – the new payment system started operating on January 6, 2003. It was then that commercial banks successfully took over payment operations from a government institution and Serbia developed a modern, reliable and efficient payment system.

Payment System Participants

Payment system participants are as follows: NBS, banks licensed by the NBS, the Ministry of Finance, Central Securities Depository and Clearing House and Serbian Banking Association.

Each bank, participant in the system, has one main account and one clearing account (for computation of net positions – clearing balance at the beginning and at end of each day equals zero).

The National Bank of Serbia performs settlement and clearing for Dina payment card (domestic payment card), as well as for the Yuba, VISA and Mastercard payment transactions in domestic payment operations.

The Ministry of Finance participates in payment transactions through Consolidated Treasury Account (CTA) made up of consolidated Republic treasury accounts and consolidated local government treasury accounts. CTA is maintained as a single account with the NBS.

Central Securities Depository and Clearing House keeps a registry of all securities issued in the territory of the Republic of Serbia and performs clearing and settlement of obligations and claims in securities and cash arising from trade in securities, i.e. it simultaneously effects transfer of ownership and payment of securities.

For the purpose of performing the pecuniary part of settlement, the Central Securities Depository and Clearing House participates in the RTGS system with single account, the balance of which equals zero at the beginning and at the end of each business day.

Central Securities Depository and Clearing House has opened a foreign currency account with the NBS for the purposes of the settlement of trade transactions in foreign currency-denominated securities.

Real Time Gross Settlement - RTGS

The National Bank of Serbia is the operator and owner of the RTGS and clearing system, configured into a single system on one platform. The system is flexible in that is allows the separation of RTGS and clearing into two independent systems operating on two platforms.

In order to participate in the RTGS system, prospective participant has to submit to the National Bank of Serbia an application for connection. Subject to the Operative Rules of Real Time Gross Settlement, along with the application, the prospective participant is also obligated to report the bank identification number (BIC code) to be used in the RTGS system, to meet the technical requirements and standards for connection to the RTGS system, to identify the persons authorized to contact the NBS in respect of these activities, and finally, to conclude a contract with the NBS whereby it fully accepts the stipulated operative rules.

Funds in accounts within the RTGS system are used for the purposes of settlement (accounts – banks, consolidated treasury account – Ministry of Finance – Public Revenues Administration, settlement accounts, the balance of which equals zero at the beginning and at the end of each business day – for Central Securities Depository and Clearing House and Serbian Banking Association). For the purposes of clearing payments under DinaCard, VISA, MASTER and YUBA cards, the National Payment Card Center has temporary accounts opened for each of these brands.

Although all payment orders may be processed in the RTGS, priority is given to payment orders for amounts in excess of CSD 200,000 ("large-value payments"), which is regulated by the operative rules of the system. In other words, payments of CSD 200,000 or above, urgent transactions and transactions whereby the participants withdraw cash from the NBS treasury – are, as a rule, executed in the RTGS system.

Transactions are processed and executed immediately after they are received in the RTGS system, namely up to the amount of funds available in the participant's account. Transactions under priorities 1-49, for whose execution the coverage in the account is not sufficient – are held in queue in order to be executed upon provision of funds according to their priority and the time they were sent until the end of the settlement day, while transactions under priorities 50–99 are returned to senders. Senders may revoke queuing payment messages or change their priority until the end of the settlement day.

"Small-Value Payments"

The NBS has a discretionary right to transfer performance of interbank clearing, interbank clearing of cheques under the citizens' current accounts and payment card clearings to another legal entity.

After adequate preparation and verification, the National Bank of Serbia entrusted the clearing of cheques to the Serbian Banking Association as of September 1, 2004. For this reason, Serbia has two systems for the settlement of "small-value payments" – the NBS clearing system (as part of the NBS RTGS and clearing system) and Serbian Banking Association system for the clearing of cheques under citizens' current accounts.

Clearing is regulated by the Decision on the Settlement and Clearing and Functioning of Clearing Accounts with the NBS and the Operative Rules of Clearing Operations. Clearing payments are the so-called "small-value payments", i.e. orders up to CSD 200,000 "packed" into SWIFT messages of MT102 format.

In January 2005, the NBS offered to the participants a new service – execution of "small-value clearing payments" in the RTGS system against a fee charged for clearing payments. This enabled banks with better liquidity status to effect payments via the RTGS system at lower cost without having to wait for the clearing cycle.

Data exchange in the RTGS and clearing system is performed by electronic messages in SWIFT format via private NBS network or SWIFT network – on which, subject to its business policy, each participant in the system has to decide for itself. In the first six months of the system's operations, only one bank opted for SWIFT network, but very soon switched to the NBS WAN network.

Statistics

In 2005, in the course of 254 business days, a total of 127.53 million individual payments worth CSD 10,361.42 billion were processed via the RTGS and clearing system of the National Bank of Serbia.

Monthly average RTGS and clearing system turnover in 2005 was CSD 863.45 billion, whereas monthly interbank payments averaged at 10.63 million.

On average, 502,067 payments worth CSD 40.79 billion were processed in interbank payment transactions per day. Daily averages of processed RTGS and clearing payments were 163,069 and 338,998, respectively.

Out of total of 127.53 million interbank payments processed in the course of 2005, 32.48%, or 41.42 million were RTGS orders, and 67.52%, or 86.11 million were clearing orders.

In 2005, clearing turnover amounted to CSD 742.39 billion, thereby accounting for 7.16% of total interbank payment turnover. Average value of clearing payments on a monthly level equaled CSD 61.87 billion, whereas daily average stood at CSD 2.92 billion.

In 2005, the availability of the NBS RTGS and clearing system was 99.96%. In the course of 254 business days and 129,225 minutes of operation there was a 55-minute stoppage in total.