

Financial sector of Macedonia

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Domestic financial sector in spite of recent rapid growth is yet to achieve the depth and maturity of developed financial markets. In the near future, the retail banking is where the opportunities will come from. Hence, the orientation toward satisfying household's needs is currently reshaping the country's banking industry.

The country's financial sector continues to evolve towards matured market economies financial systems, therefore becoming a major pillar of the overall economic growth. In recent years, this sector has developed on a continuous base, providing greater lending and saving opportunities to various economic agents. Analysed from the structural viewpoint, banks dominate the financial system and have a crucial influence on the movements and developments in this sector. However, increased diversification of the financial system may be noticed, both from the aspect of the type of financial institutions and from the aspect of the type and quality of financial services, as well.

Increased confidence, long term price stability and strong economic growth, have considerably contributed to the overall growth

of the banking activities therefore improving their overall business performance. The entry of foreign capital and know-how to this segment of the economy set the ground for the higher standards of corporate governance and risk management, offering wide range of products and services tailored to meet clients' needs at competitive pricing. In this regard, the increasing trend of financial intermediation has been a significant factor in attaining high and sustainable rates of economic growth in the country and in accelerating the process of the country's EU integration.

In such conditions, the banks' role in the process of efficient channelling of financial resources was increased and deepened, which is clearly shown by the basic indicators through which financial intermediation is measured. Namely, at the end of 2007, the ratio of the total assets, gross loans and total deposits to GDP reached 66.2%, 37.0% and 47.4%, respectively. Increased loan activity in 2007 contributed to the annual growth rate of loans to reach 39.1%, the highest so far. In line with this, total deposits grew by 30.0%, hence

Figure 1: Structure of the financial system according to the total assets

Financial institutions	Total assets in €000		Structure in %		Number of institutions	
	2006	2007	2006	2007	2006	2007
Deposit financial institutions	2,884,293	3,701,635	90.10	91.59	31	30
Banks	2,846,254	3,654,463	88.91	90.42	19	18
Saving houses	38,039	47,172	1.19	1.17	12	12
Non-depository financial institutions	317,062	339,795	9.90	8.41	27	41
Insurance companies	238,794	180,959	7.46	4.48	10	12
Leasing companies	44,708	85,341	1.40	2.11	2	4
Pension funds	20,303	51,044	0.63	1.26	2	2
- Companies for pension funds management	3,204	3,350	0.10	0.08	2	2
Stock broker firms	10,053	17,777	0.31	0.44	11	16
Investment funds	0	1,078	0.00	0.03	0	3
- Companies for investment funds management	0	245	0.00	0.01	0	2
Total	3,201,355	4,041,430	100.00	100.00	58	71

Source:

being stable source for the banks' credit expansion. However, it should be noted that, financial sector is still shallow in comparison with characteristics of matured market economies. Cross-country comparison has revealed that, despite considerable loan growth rates since 2005, the banking sector has one of the lowest rates of financial intermediation. This should not come as a surprise if one considers the low loan activity recorded in the banking sector prior to 2003 and insufficient development of the country's financial markets. On the other hand, the share of total loans to total deposits (being indicators of the degree banks' employ their deposits toward issuing new loans) is 77.9%, indicating that the banks can further expand their loan-related activity financed by this traditional source of funds.

The comparison of the banking system from the aspect of other structural characteristics with the systems in the new EU member-states suggests a continuous improvement of household and business accessibility to bank services. This trend is especially visible with the indicator of the average number of households using the services of a single ATM, which indicates the continuous expansion of the ATM network. Nevertheless, despite high number of banks (18 at the end of 2007), the indicator of average number of citizens per banking unit significantly falls behind the average in the new EU member-states, indicating a still underdeveloped branch network of banks.

The largest three banks in the country account for 67.1% of total assets, 70.3% of total loans and 72.2% of deposits, which is common feature for banking industries in small economies. Among them, at the end of 2007 Stopanska Banka AD Skopje was the largest bank measured by total assets and total equity.

In parallel with the process of mergers and consolidations in the previous several years, there was also a trend of decrease in the number of banks in dominant domestic ownership. The main trigger of increased role of internationally active banks on the domestic market were acquisitions of local banks by foreign investors, but also the continuous inflow of foreign portfolio investments. At the end of 2007, participation of foreign ownership in the total banking capital amounted to 69.1%. Moreover, in the course of 2007, the number of banks in dominant ownership of foreign shareholders increased from eight to eleven out of 18 banks.

Increased loan activity has been a major feature of the country's banking system in the recent period. This trend has mostly resulted from the following developments:

- increased deposit potential of local banks;
- entry of internationally active banks on the local market;

- favourable macroeconomic framework and increased investment activity;
- low depth of financial markets and need to catch up with matured market economies.

The developments of new retail products, changed preferences of households and shift from cash to paperless transactions were the main factors that were dictating retail expansion in recent years. The fact that the average debt level of households has been considerably lagging behind the debt levels of citizens in the neighbouring countries indicates a great potential within the country's population of entering into additional debts – which implies the possibility of increased loan expansion of banks in this segment in the future. On the other hand, the population traditionally appears as an entity having a dominant role in the creation of the deposit base. Analyses have shown that our citizens prefer to deposit their available funds for a short time period, most often for a year. Another positive trend, indicating strong public trust in denar exchange rate stability, has been the re-orientation of the private sector towards saving in local currency rather than foreign. This effect was especially evident since 2006. This has also been recently confirmed by the accelerated increase in denar deposits. In the conditions of increased foreign currency inflows and favourable macroeconomic environment, the population is expected to remain the basic surplus entity contributing to the growth of banks' deposits in the future. Stopanska Banka AD Skopje, as a leader in innovations in retail banking, has introduced the first credit card in the country, first co-branded credit card, Internet banking for households, different type of mortgages and diversified structure of savings products. This was adequately acknowledged by the households, therefore at the end of 2007, Stopanska Banka AD Skopje has been serving more than half of the country's population making it the bank for every family in the country. This is a big recognition that our bank understands the needs of its customers and designs products and services tailored to meet their specific needs.

In an environment of an underdeveloped capital market, the main source for obtaining external funds for companies has been banks debt. Thus, despite the higher annual growth rate of retail loans, banks placements to corporate sector still dominate the banking industry loan portfolio, thus occupying 61.1% of total loan book. In addition, the accelerated growth rate of long-term loans represents another demonstration that long term horizon decisions are dominating over short term horizon decisions. Furthermore, in addition to strong credit growth in 2007, all structural indicators for portfolio quality are showing significant improvements due to continuous enhancement in

Figure 2: Banking system profitability and efficiency indicators

Indicator	2004	2005	2006	2007
Rate of return on average assets (ROAA)	0.6	1.2	1.8	1.8
Rate of return on average equity (ROAE)	3.1	7.5	12.3	15.2
Cost to income ratio	75.6	68.1	63.6	58.4
Wage expenses/Total regular income	31.5	28.7	26.2	23.2
Loan loss provisions/Net-interest income	66.7	50.8	26.0	29.0
Net-interest income/Average assets	3.5	3.9	4.0	3.8
Net-interest income/Total regular income	49.6	53.8	57.1	57.0
Net-interest income/Non-interest expenditures	65.6	79.0	89.7	94.5
Financial result/Total regular income	7.8	17.1	25.6	27.5
Number of employees	4,635	4,633	5,010	5,390
Assets per employee (in €000)	416	495	566	678
Financial result per employee (in €000)	2.12	5.56	9.15	11.11

Source:

processes of monitoring and collection of claims.

Continuous upward trend of the scope of bank activities, accompanied by the continuous change in the asset mix, in favour of higher yield categories of assets, enabled maintaining of the trend for improving bank profitability and efficiency. Thus, at the end of 2007, the total profit of the banking system amounted to 959.6m, which compared to the previous year registers a growth of 30.4%. Despite the increased activities of the banks, the annual growth of operating costs was more moderate compared to the growth of the income categories, which lead to improvement of the cost-to-income indicator, which decreased by 5.2 percentage points and at the end of 2007 was 58.4%. Return On Average Equity (ROAE) at the end of 2007 amounted to 15.2% and marked an improvement by 2.9 percentage points compared to 2006, while the indicator of Return On Average Assets (ROAA), in conditions of intensive activities growth, remained at the same level as in 2006. However, reorganisation of banking industry that is underway, is expected further to boost industry's profitability, and by 2010, the reward to shareholders to reach 25% per invested unit of capital. The largest three banks in the country account for 73.2% of the total profit in the banking system, where Stopanska Banka AD Skopje alone records one-third of the total profit in the industry. Better utilisation of capital on banking system level was materialised in reduction of capital adequacy ratio to 17% at the end

of 2007, but still high to preserve soundness of the banking sector.

Strong economic growth, healthy competition, implementation of the best banking and corporate governance practices and good regulation and control mechanisms in the banking sector have been the main driving force of the positive developments, trend which is expected to continue in the future. It is anticipated that in the coming years, competition will increase significantly in parallel with entrance of additional international players, and liberalisation of capital transactions, with the implementation of the Second Stage of the Stabilisation and Association Agreement, scheduled for June 2008. Also, the process of international economic integration along with the process of liberalisation is expected to enhance the level of financial intermediation. Credit growth is projected to remain strong as growing competition reduces interest rate margins and reforms improve the business environment. However, despite the positive developments in corporate banking, in the future the retail banking is where the opportunities will mainly come from.

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