



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

INFORMATION
ON BANKING SYSTEM OF
THE FEDERATION OF BOSNIA AND HERZEGOVINA
As of June 30th, 2008

Sarajevo, August 2008

Information on banking system of the Federation of BiH (as of June 30th, 2008) is prepared by the Banking Agency of the Federation of BiH, as a regulatory authority conducting supervision of banks, based on reports of banks, and other information and data submitted by banks. Findings and data from on-site examinations and analysis performed at the Agency (off-site financial analysis) have also been included.

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I INTRODUCTION

The banking sector of the Federation of BiH, over the first six months of 2008, has continued with moderate growth, while retaining some positive development and stabilization trends from the past period. Along way with large banks becoming larger, and more intensified competition, banks have continued expanding the network of their organizational units. Banks from the Federation of BiH opened 40 new organizational units (one was opened in District Brčko), and, at the end of the first six months of 2008, there were total of 7.842 employees.

As of 30.06.2008., there were 21 banks with the banking license issued in the Federation of BiH (HVB Central Profit Bank d.d. Sarajevo was integrated into UniCredit Zagrebačka bank d.d. Mostar at the end of February 2008), while UNA bank d.d. Bihać, Hercegovačka bank d.d. Mostar and Privredna bank d.d. Sarajevo were under provisional administration.

Aggregate balance sheet of banks in the Federation of BiH, as of 30.06.2008., amounted to KM 14,9 billion, which is higher by 5% or KM 708 million than at the end of 2007. Majority of banks during the observing period recorded increase of the balance sheet between 4% and 15%, while there is still domination of the five largest banks in the system, „holding“ approximately 80% of the market (74,4% at the end of 2007) of loans and deposits.

Inflow of the new, green capital coming from additional capitalization of four banks, and profit generated over the first six months of 2008, resulted in capital being increased by KM 83 million or 6%, thus, as of 30.06.2008., the capital was KM 1,6 billion (regulatory capital of banks was KM two billion).

Strong growth of loans has continued in the second quarter of 2008, representing a cumulative growth over the six months of 2008 of 14% or KM 1,25 billion (as of 30.06.2008., loans amounted to KM 10,13 billion). Three largest banks in the Federation of BiH increased their credit placements by KM 740 million, representing 63% of total increase at the banking system level (three largest banks with loans amounting to KM 6,9 billion participate with 68% in total loans at the system level).

Loans originated to private companies increased by 17% or KM 687 million, and to citizens by 12% or KM 519 million, while their participation, as of 30.06.2008., was 46,2% and 49,2% respectively. As for the aspect of loan structure by purpose, there has been longer period that loans originated to finance consumer goods (including card-based operations) have the highest participation of approximately 71%, housing loans of 23%, and loans to small handcrafts, small business and agriculture represent the remaining 6%.

Deposits, over the six months of 2008, generated growth of 4% or KM 381 million, so, with participation of 70,9% and value of KM 10,6 billion, they still represent the most significant financing source of banks in the Federation of BiH. In the segment of deposits, we should especially emphasize a moderate and stable growth of savings, which have increased by 6,1% or KM 250 million, reaching the amount of KM 4,37 billion. Of total increase, 65% or KM 162 million was generated by the three largest banks in the system.

Banks in the FBiH, at the end of the first six months of 2008, generated profit of KM 29 million, representing a significant decrease of 64% in comparison to the same period in 2007, which is only 27% of the profit generated in 2007. Based on some analytical data, as well as on indicators used to assess productivity and effectiveness of performance, overall profitability of the system has significantly deteriorated if compared to the same period in 2007, and the adverse financial result is predominantly related to the loss-expenses based on securities trading operations, mainly of one bank, then increased financing expenses-interest expenses, that is, decreased net interest income, and in some way to deteriorated assets quality and increased poor quality assets.

II BUSINESS PERFORMANCE OF BANKS IN THE FEDERATION OF BIH

1. STRUCTURE OF THE BANKING SECTOR

1.1. Status, number and business network

As of 30.06.2008., there were 21 banks with the banking license issued in the Federation of BiH. Number of banks has decreased by one if compared to 31.12.2007. The approval has been issued for a status change of integration of HVB Central Profit Bank d.d. Sarajevo to UniCredit Zagrebačka bank d.d. Mostar that has also changed the name into UniCredit Bank d.d. Mostar. The integration process finalized on 29.02.2008.

As of 30.06.2008., there were three banks under provisional administration (UNA bank d.d. Bihać, Hercegovska bank d.d. Mostar and Privredna bank Sarajevo d.d. Sarajevo).

Over the first six months of 2008, banks have continued expanding the network of their organizational units. Banks from the Federation of BiH have founded 40 new organizational units, while at the same time one organizational unit has been closed. Out of the newly established, one organizational unit has been opened in Republic Srpska. If compared to 31.12.2007., when banks had 569 organizational units, the mentioned figure represents an increase of 7,03%.

As of 30.06.2008., seven banks from the Federation of BiH had 54 organizational units in Republic Srpska, and 11 banks had 16 organizational units in District Brčko. Six banks from Republic Srpska had 22 organizational units in the Federation of BiH.

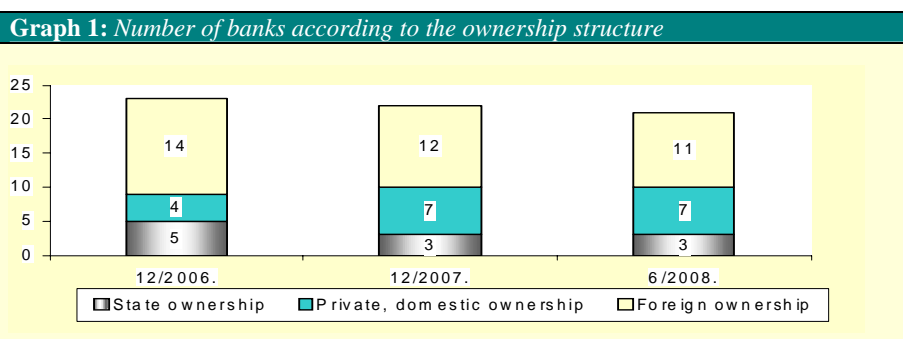
The license for inter-bank transactions in the internal payment system was issued to all banks as of 30.06.2008. There were 14 banks with deposit insurance program.

1.2. Ownership structure

As of 30.06.2008., ownership structure in banks¹ was assessed based on the available information and on-site visits to banks², as follows:

- Private and majority private ownership 18 banks (86%)
- State and majority state ownership³ 3 banks (14%)

Seven banks, of 18 banks with majority private ownership, are majority owned by domestic legal entities and individuals (residents), while 11 banks have majority foreign ownership.

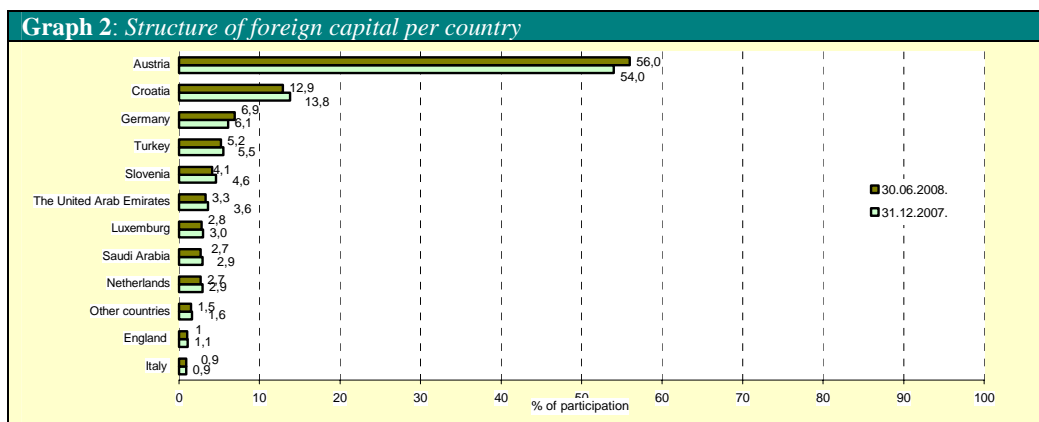


¹ Criterion for classification of banks by ownership type is ownership over banks' share capital.

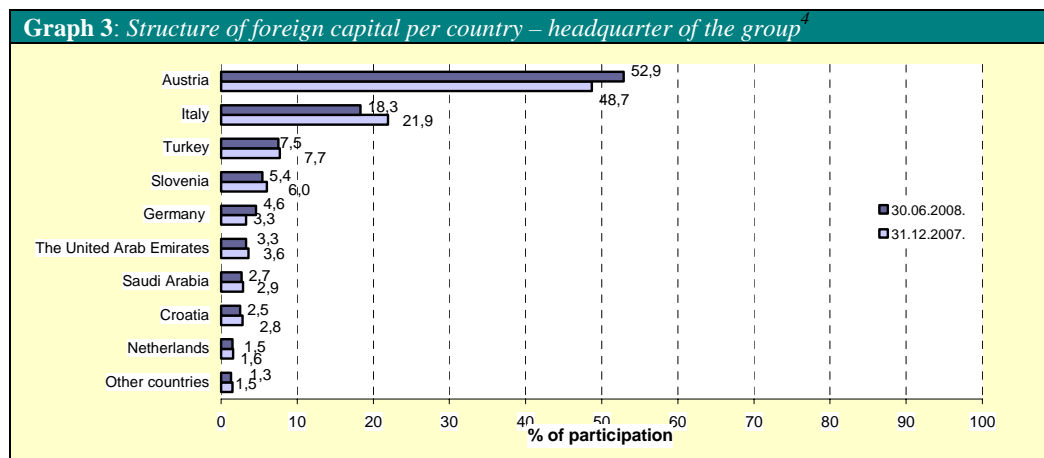
² General overview of ownership structure of banks in the F BiH as of 30.06.2008. resulted from received documentation, and registrations at authorized courts (changes in capital and shareholders structure of banks).

³ State ownership refers to domestic, state capital of BiH.

If only foreign capital is analyzed based on the criteria of the shareholder's home country as of 30.06.2008., 56% of foreign capital was owned by the shareholders from Austria, followed by 12,9% shareholders from Croatia, while other countries participated below 7%.



If we, however, take into account the capital correlation, we could take the criteria of headquarter of the parent institution or the group that have majority ownership (direct or indirect through the group members) over banks in the Federation of BiH. According to this criteria, as of the first six months of 2008, there was also majority participation of banking groups and banks from Austria (52,9%), followed by the Italian banks with participation of 18,3%. Other countries recorded participation below 7,5%.



Minor changes in the ownership structure, based on the both criteria mentioned, during the observing period in 2008, result from additional capitalization of two banks majority owned by banks from Austria, which has caused increase of capital participation from this country by two percentages, or, based on headquarter of the group, by 4,2%.

The ownership structure could be viewed from the aspect of financial indicators, which is based on the value of total capital⁵.

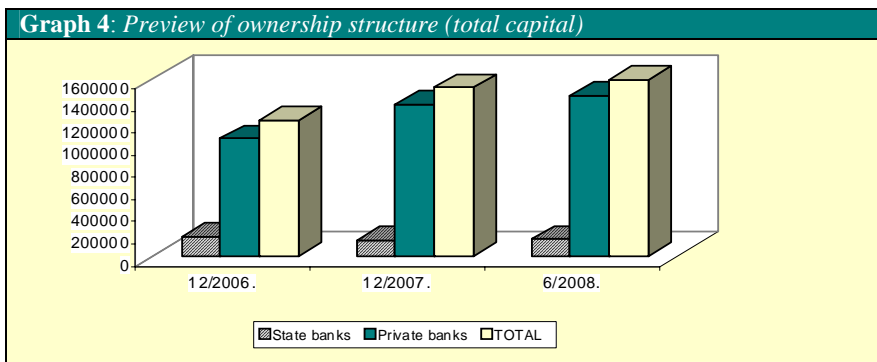
⁴ Apart from the country of the headquarter of the parent-group whose members are the banks from the F BiH, the countries of all other foreign shareholders of the banks from the FBiH are also included.

⁵ Information from balance sheet - FBA schedule: shareholders capital, premium issue, undistributed profit and reserves, and other capital (financial results of current period).

-in 000 KM-

Table 1: Ownership structure by total capital

BANKS	31.12.2006.		31.12.2007. ⁶		30.06.2008.		RATIO	
	1	2	3	4	5	6	3/2	4/3
State banks	170.680	14%	147.022	10%	148.953	9%	86	101
Private banks	1.055.905	86%	1.363.020	90%	1.444.218	91%	129	106
TOTAL	1.226.585	100%	1.510.042	100%	1.593.171	100%	123	106



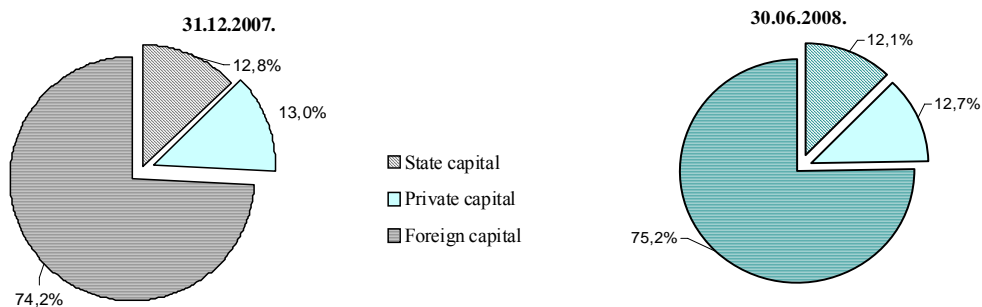
Analyzing participation of state, private and foreign capital in the share capital of banks, we get more precise picture of the capital ownership structure in banks of the Federation of BiH.

- in 000 KM-

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

SHARE CAPITAL	31.12.2006.		31.12.2007.		30.06.2008.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	5/3	7/5
1	3	4	5	6	7	8	9	10
State capital	135.019	15,2	133.582	12,8	133.582	12,1	99	100
Private capital (residents)	83.077	9,3	135.728	13,0	140.402	12,7	163	103
Foreign capital (nonresidents)	670.695	75,5	775.912	74,2	829.584	75,2	116	107
TOTAL	888.791	100,0	1.045.222	100,0	1.103.568	100,0	118	106

Graph 5: Ownership structure (share capital)



⁶ All data in the Information referring to 31.12.2007. come from the audited financial statements of banks (audit conducted by the external auditor at 21 banks in the Federation of FBiH).

Share capital of banks in the Federation of BiH, over the first six months of 2008, has increased by 5,6% or by KM 58,3 million. In four banks, share capital increased through additional capitalization in the amount of KM 76,4 million, of which participation of nonresidents was KM 70,6 million, and of residents was KM 5,8 million. Status change of one bank's integration (with majority foreign participation in capital) to the other bank that is also with majority foreign participation in capital, with the amount of capital lower than the nominal amount (the difference in favor of the issue exchange premium), has caused decrease of the share capital of nonresidents in the first quarter of 2008, so additional capitalization and increase of share capital do not have the same nominal amount.

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

Participation of state capital in total share capital, as of 30.06.2008., was 12,1 %, which is lower by 0,7% if compare to the end of 2007.

If compared to the end of 2007, participation of private capital (residents) in total share capital of the banking sector has decreased from 13% to 12,7%, although there has nominal increase of KM 4,7 million, but due to significantly higher increase of nonresidents' capital, relative participation decreased. The following changes have had minor influence: share trading between residents and nonresidents (by seven banks), net effect is decrease by KM 1,1 million, and increase resulting from purchase of shares from additional capitalization in one bank in the amount of KM 5,8 million by domestic buyer.

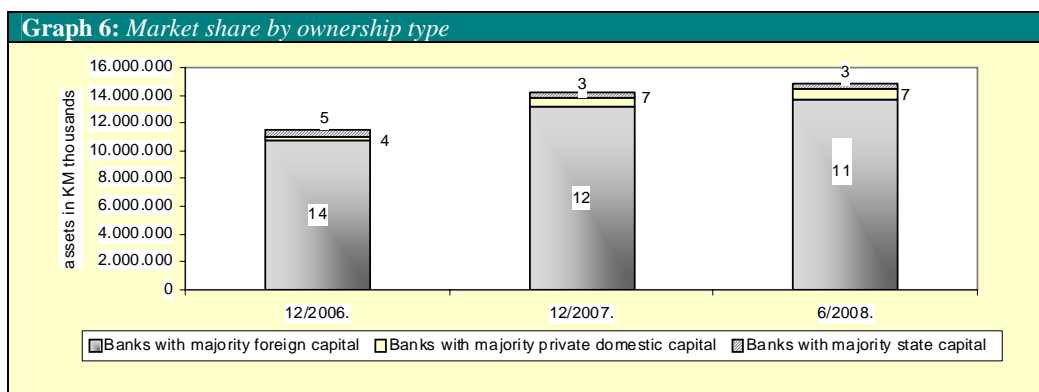
Participation of foreign capital increased by from 74,2% to 75,2%, that is, by KM 53,7 million a result of the following: additional capitalizations caused increase of KM 70,6 million in four banks, above mentioned share trading between residents and nonresidents in seven banks (net effect on foreign capital is increase of KM 1,1 million), and decrease of KM 18,1 million in process of integration of two banks.

Participation, that is, market share and position of banks grouped by majority ownership, in share capital as criteria, is almost unchanged in comparison to the end of 2007. Market share of banks with majority foreign ownership, as of 30.06.2008., was high of 92,3%, banks with majority domestic private capital of 4,9%, the same as of the end of 2007, and share of banks with majority state capital was 2,8%.

Integration processes from the past period were performed with purpose of stronger market positioning, resulting by concentrations in the banking sector by largest banks becoming larger, decreased number of banks, and intensified competition. Over the observed period, one integration process finalized (status change of integration) as of 29.02.2008. Such processes should result by decreased number of banks, strengthening of the resulting bank and further concentrations in the banking sector of the Federation of BiH.

- in %-

Table 3: Market share of banks by ownership type (majority capital)									
BANKS	31.12.2006.			31.12.2007.			30.06.2008.		
	No. of banks	Partic. in total capital	Partic. in total assets	No. of banks	Partic. in total capital	Partic. in total assets	No. of banks	Partic. in total capital	Partic. in total assets
1	2	2	3	7	5	6	10	8	9
Banks with majority state capital	5	13,9	4,1	3	9,7	2,7	3	9,3	2,8
Banks with majority private domestic capital	4	3,7	2,9	7	10,9	4,9	7	11,4	4,9
Banks with majority foreign capital	14	82,4	93,0	12	79,4	92,4	11	79,3	92,3
TOTAL	23	100,0	100,0	22	100,0	100,0	21	100,0	100,0



1.3. Staff

In banks of the FBiH, as of 30.06.2008., there were total of 7.842 employees, of which 4% in banks with majority state capital, and 96% in private banks.

Table 4: Bank employees in the FBiH

BANKS	NUMBER OF EMPLOYEES						RATIO	
	31.12.2006.		31.12.2007.		30.06.2008.		3:2	4:3
1	2	3	4	5	6	7	8	9
State banks	423	6%	342	5%	346	4%	81	101
Private banks	6.183	94%	7.019	95%	7.496	96%	114	107
TOTAL	6.606	100%	7.361	100%	7.842	100%	111	107
Number of banks	23		22		21		96	95

Over the first six months of 2008, number of employees increased by 7% or 481 employees, of which 477 were new employees in private banks.

Table 5: Qualification structure of employees

EDUCATION	NUMBER OF EMPLOYEES						RATIO	
	31.12.2006.		31.12.2007.		30.06.2008.		4:2	6:4
1	2	3	4	5	6	7	8	9
University qualifications	2.408	36,5%	2.725	37,0%	2.968	37,9%	113	109
Two-year post secondary school qualifications	714	10,8%	799	10,8%	842	10,7%	112	105
Secondary school qualifications	3.391	51,3%	3.759	51,1%	3.954	50,4%	111	105
Other	93	1,4%	78	1,1%	78	1,0%	84	100
TOTAL	6.606	100,0%	7.361	100,0%	7.842	100,0%	111	107

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

Table 6: Assets per an employee

BANKS	31.12.2006.			31.12.2007.			30.06.2008.		
	No. of empl.	Assets (000 KM)	Assets per an empl.	No. of empl.	Assets (000 KM)	Assets per an empl.	No. of empl.	Assets (000 KM)	Assets per an empl.
State	423	474.793	1.122	342	381.036	1.114	346	410.516	1.186
Private	6.183	11.023.562	1.783	7.019	13.814.886	1.968	7.496	14.493.222	1.933
TOTAL	6.606	11.498.355	1.741	7.361	14.195.922	1.929	7.842	14.903.738	1.901

At the end of first six months of 2008, there was KM 1,9 million of assets per an employee at the level of the banking system, which is slightly lower than at the end of 2007, as a result of higher growth rate of employees' number over the banking system assets. This indicator is much better with the private bank sector, which is expected, having in mind stagnation or decreased volume of business activities of state banks, and, consequently, excessive number of employees.

Table 7: Assets per an employee by groups

Assets (000 KM)	31.12.2006.	31.12.2007.	30.06.2008.
	Number of banks	Number of banks	Number of banks
Up to 500	5	2	2
500 to 1.000	7	7	8
1.000 to 2.000	4	7	6
2.000 to 3.000	6	4	4
Over 3.000	1	2	1
TOTAL	23	22	21

Analytical indicators of respective banks range from KM 319 thousand to KM 4,1 million of assets per an employee. The indicator of six banks is better than the one for the whole banking sector, and the indicator of three largest banks in the system exceeds KM 2,4 million.

And finally, we could say that conditions under which banks service their customers, both legal entities and citizens, as well as conditions under which banks offer their services and finance their customers, have significantly improved in terms of quality.

2. FINANCIAL INDICATORS OF BANKS' PERFORMANCE

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

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

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

In accordance with the provisions of Law on Opening Balance Sheet of Banks, banks with majority state owned capital have to report to the FBA “full” balance sheet divided into: passive, neutral and active sub-balance sheet. In order to get realistic indicators of banks' performance in the Federation of BiH, all further analysis of the banking system will be based on the indicators from the active sub-balance sheet of banks with majority state owned capital⁷.

⁷ Some state banks in their “full balance sheet” report passive and neutral items, which will be taken over by the state upon finalization of the privatization process. As of 30.06.2008., these items amounted to KM 590 million.

2.1. Balance sheet

Aggregate balance sheet of banks in the Federation of BiH, according to the balance sheets submitted as of 30.06.2008. amounted to KM 14,9 billion, which is higher by 5% or KM 708 million than at the end of 2007. The banking sector, after the minimum growth of 1% in the first quarter of 2008, has continued with moderate growth in the second quarter and has cumulatively generated increase of 5% over the first six months of 2008.

Table 8: Balance sheet						
DESCRIPTION	AMOUNT (in 000 KM)			RATIO		
	31.12.2006.	31.12.2007.	30.06.2008.	3/2	4/3	
1	2	3	4	5	6	
ASSETS:						
Cash funds	4.286.202	4.894.973	4.381.843	114	90	
Securities ⁸	45.922	48.565	36.633	106	75	
Placements to other banks	105.390	69.314	54.568	66	79	
Loans	6.820.154	8.874.984	10.131.716	130	114	
Loan loss provisions (LLP)	288.433	334.139	376.301	116	113	
Loans – net value (loans minus LLP)	6.531.721	8.540.845	9.755.415	131	114	
Business premises and other fixed assets	341.671	405.116	418.635	119	103	
Other assets	187.449	237.109	256.644	126	108	
TOTAL ASSETS	11.498.355	14.195.922	14.903.738	123	105	
LIABILITIES:						
LIABILITIES						
Deposits	8.379.322	10.190.977	10.572.104	122	104	
Borrowings from other banks	2.890	3.289	3.289	114	100	
Loan Commitments	1.420.944	1.856.471	1.973.152	131	106	
Other liabilities	468.614	635.143	762.022	136	120	
CAPITAL						
Capital	1.226.585	1.510.042	1.593.171	123	106	
TOTAL LIABILITIES (LIABILITIES AND CAPITAL)	11.498.355	14.195.922	14.903.738	123	105	

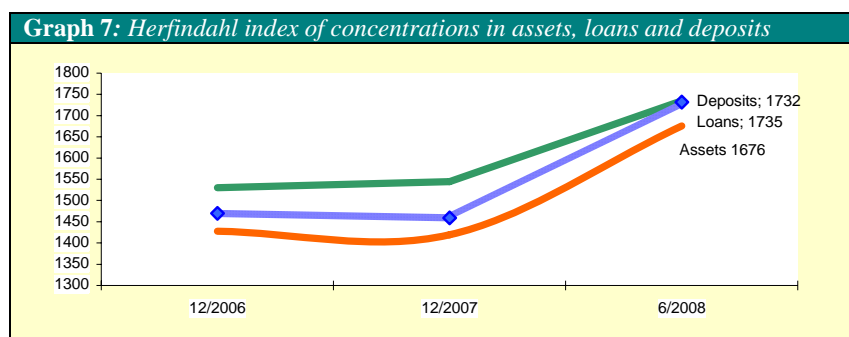
Table 9: Assets of banks based on the ownership structure											
BANKS	31.12.2006.			31.12.2007.			30.06.2008.			RATIO	
	Number of banks	Assets (000 KM)		Number of banks	Assets (000 KM)		Number of banks	Assets (000 KM)		5/3	7/5
1	2	3	4	5	6	7	8	9	10	11	12
State	5	474.793	4%	3	381.036	3%	3	410.516	3%	80	108
Private	18	11.023.562	96%	19	13.814.886	97%	18	14.493.222	97%	125	105
TOTAL	23	11.498.355	100%	22	14.195.922	100%	21	14.903.738	100%	123	105

Over the observed period, majority of banks recorded increase of the balance sheet total between 4% and 15%; the assets of three banks were lower than at the end of 2007 (between 1% and 6%), and only one bank (with assets below KM 100 million) recorded a significant growth of the balance sheet total of 63%.

Two of the three largest banks in the system recorded growth rate of 7,8% and 10,9%, while the assets of the third bank, which had experienced a status change of merger in the first quarter of 2008, the assets were lower by 5,1% or KM 184 million if compared to the aggregate data at the end of 2007. The amount of KM 355 million or 50% of the aggregate growth of the balance sheet sum of the banking sector refers to these three banks.

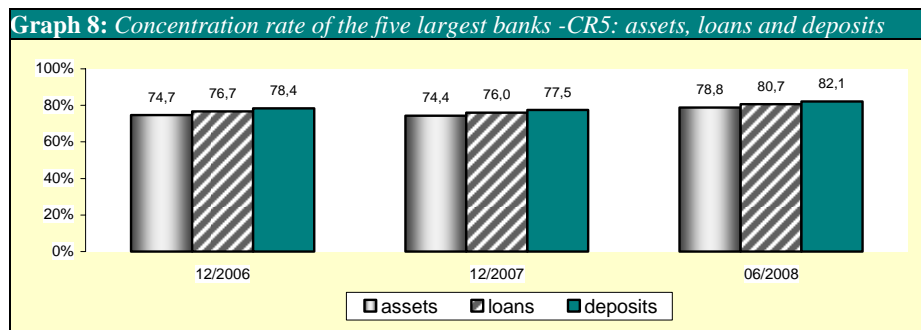
⁸ Trading securities and securities held to maturity.

Indicator of concentrations in the three most significant segments of banking performance in assets, loans, and deposits, is the value of the Herfindahl index⁹.



Over the first six months of 2008, the Herfindahl indexes for concentration of assets, loans and deposits have experienced an enormous growth (by 257, 191 and 273 units) and their values, as of 30.06.2008., were 1.676, 1.735 and 1.732 units. The reason of this increase of concentration indicators is integration of two banks that was performed in the third month of 2008. Since these are the two large banks in the system, the mentioned indicators have had a huge increase, and have reached the amount of 1.800 units, which is, according to the standard, the marginal value of moderate concentration, that is, the HHI value over this amount is an indicator of high concentration¹⁰.

Second indicator of concentration in the banking system is the ratio of market concentration, that is, the concentration rate¹¹ (hereinafter: CR), which indicates total market participation of the largest institutions in the system in the selected relevant categories: in assets, loans and deposits. The CR5 of market participation for loans and deposits of the five largest banks in the system were 78,8%, 80% and 82,1% at the end of the first six months in 2008, and the increase in comparison to the end of 2007 was the result of including another bank to the group of the five largest banks in the system, after integration of two banks from this group in the first quarter of 2008. Domination of the five largest banks in the system is obvious. They „hold” approximately 80% of the market (74,4% at the end of 2007), of loans and deposits.



⁹ It is also called the Hirschmann-Herfindahl index or HHI as calculated in the formula $HI = \sum_{j=1}^n (S_j)^2$,

representing the sum of square of percentage shares of concrete values (e.g. assets, deposits, loans,...) of all market participants in the system. We should mention that the index is not linearly increasing, and the value of e.g. 3000 does not mean the concentration in the system is 30%. Hypotetically, if there is only one bank in the system, the HHI would be maximum at 10000.

¹⁰ If the HHI value is below 1000, the opinion is that there is no concentration in the market; for the index value between 1000 and 1800 units, concentration in the market is moderate; and if the HHI value exceeds 1800, it indicates high concentration.

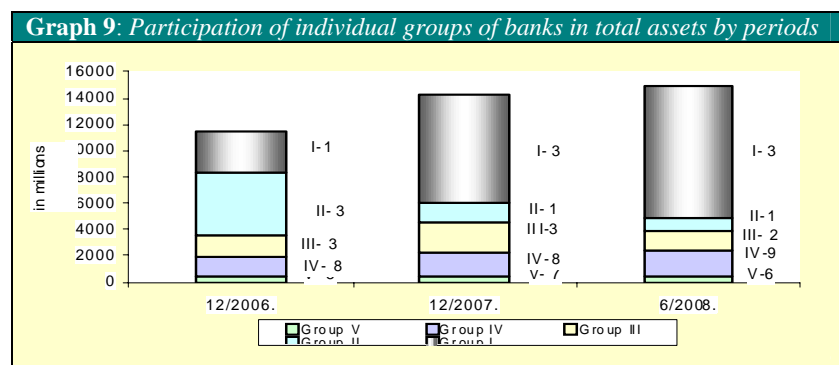
¹¹ Engl.: Concentration Ratio (CR), assigned according to the number of institutions included in the calculation.

The banking sector could be analyzed from the aspect of several groups, formed by assets size¹². Individual groups recorded smaller changes in the number of banks and their participation, as a result of assets growth in majority of banks and completion of the integration process in one bank.

At the end of first six months of 2008, and after integration of two banks (as of 31.12.2007. these banks were in groups I and II), three largest banks in the system (group I) still have dominant participation of 66,9%. One bank from Group III, with assets exceeding one billion KM, moved to Group II, which has caused decrease in participation and number of banks in Group III. The largest group IV (nine banks) with the assets ranging between KM 100 and 500 million has increased by another bank, whose assets exceed KM 100 million, which resulted by increase of this group's participation from 12,3% to 13,6%. Decrease in number and participation of the last group of six small banks continues in 2008.

The following table presents review of amounts and participations of individual groups of banks in total assets by periods (amounts presented in KM millions).

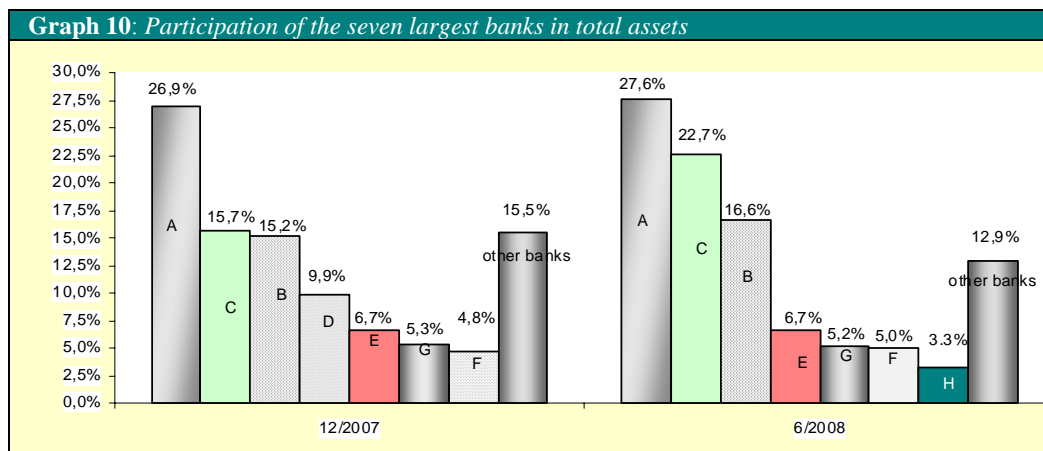
Table 10: Participation of individual groups of banks in total assets through periods										
ASSETS		31.12.2006.			31.12.2007.			30.06.2008.		
		Amount	Particip %	No. of banks	Amount	Particip %	No. of banks	Amount	Particip %	No. of banks
I-	Over 2.000	3.098	26,9	1	8.203	57,8	3	9.966	66,9	3
II-	1000 to 2000	4.836	42,1	3	1.409	9,9	1	1.002	6,7	1
III-	500 to 1000	1.723	15,0	3	2.392	16,8	3	1.517	10,2	2
IV-	100 to 500	1.382	12,0	8	1.741	12,3	8	2.027	13,6	9
V-	Below 100	459	4,0	8	451	3,2	7	392	2,6	6
TOTAL		11.498	100,0	23	14.196	100,0	22	14.904	100,0	21



The following graph presents the structure and participation trend of the seven largest banks¹³ in the banking system of the Federation of BiH:

¹² Banks are divided into five groups, depending on the assets size.

¹³ Banks are market with letters A to G.



Growth of the balance sheet sum (1% or KM 708 million) in the sources has been primarily financed by deposit growth (by 4% or KM 381 million), borrowings (by 6% or KM 117 million), and capital (by 6% or KM 83 million).

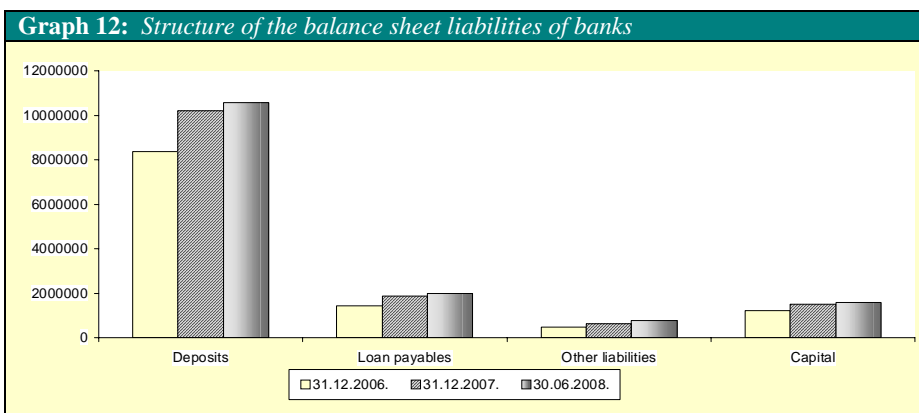
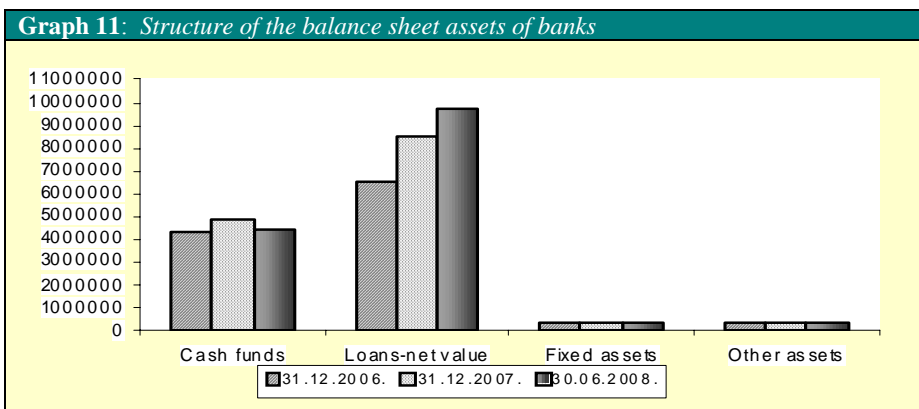
The same as in the first three months of 2008, when loans had growth of 6% or KM 548 million, strong growth of 8% or KM 709 million continued in the second quarter, representing a cumulative growth of 14% or KM 1,26 billion, hence, as of 30.06.2008., loans exceeded KM 10 billion, that is, they amounted to KM 10,13 billion. The mentioned has caused a downfall of cash funds by 10% or KM 513 million (as of 30.06.2008. they amounted to KM 4,4 billion).

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

- in % -

Table 11: Balance sheet structure of banks

DESCRIPTION	PARTICIPATION		
	31.12.2006.	31.12.2007.	30.06.2008.
ASSETS:			
Cash funds	37,3	34,5	29,4
Securities	0,4	0,3	0,2
Placements to other banks	0,9	0,5	0,4
Loans	59,3	62,5	68,0
Loan loss reserves (LLR)	2,5	2,4	2,5
Loans- net value (loans minus LLR)	56,8	60,1	65,5
Business premises and other fixed assets	3,0	2,9	2,8
Other assets	1,6	1,7	1,7
TOTAL ASSETS	100,0	100,0	100,0
LIABILITIES:			
LIABILITIES			
Deposits	72,9	71,8	70,9
Borrowings from other banks	0,0	0,0	0,0
Loan commitments	12,3	13,1	13,2
Other liabilities	4,1	4,5	5,2
CAPITAL			
Capital	10,7	10,6	10,7
TOTAL LIABILITIES (LIABILITIES AND CAPITAL)	100,0	100,0	100,0



In the structure of the balance sheet liabilities of banks, from the aspect of the most significant balance sheet categories, the trend of previous periods has continued, which is a slow trend of downfall in participation of deposits and growth of loan payables. With the amount of KM 10,6 billion and participation of 70,9%, deposits still represent a dominant source of financing for banks in the Federation of BiH.

Changes in the assets structure are the result of greater growth of loans over the first six months of 2008, that is, increases of their participation from 62,5% to 68%, while participation of cash funds decreased from 34,5% to 29,4%.

Table 12: Cash funds of banks

CASH FUNDS	31.12.2006.		31.12.2007.		30.06.2008.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Cash	241.561	5,6	311.436	6,4	298.506	6,8	129	96
Reserve accounts with CBBiH	2.258.035	52,7	2.805.568	57,3	2.652.549	60,5	124	95
Accounts with deposit institutions in BiH	21.354	0,5	12.304	0,3	842	0,0	58	7
Accounts with deposit institutions abroad	1.764.210	41,2	1.764.757	36,0	1.427.528	32,6	100	81
Cash funds in collection process	1.042	0,0	908	0,0	2.418	0,1	87	266
TOTAL	4.286.202	100,0	4.894.973	100,0	4.381.843	100,0	114	90

At the end of the first six months of 2008, cash funds of banks in the Federation of BiH on the reserve accounts with the Central Bank of BiH decreased by 5% or KM 153 million, amounting to KM 2,65 billion or 60,5% of total cash funds, which is higher by 3,2% than at the end of 2007. As of 01.01.2008., required reserve rate increased from 15% to 18%. Banks' funds

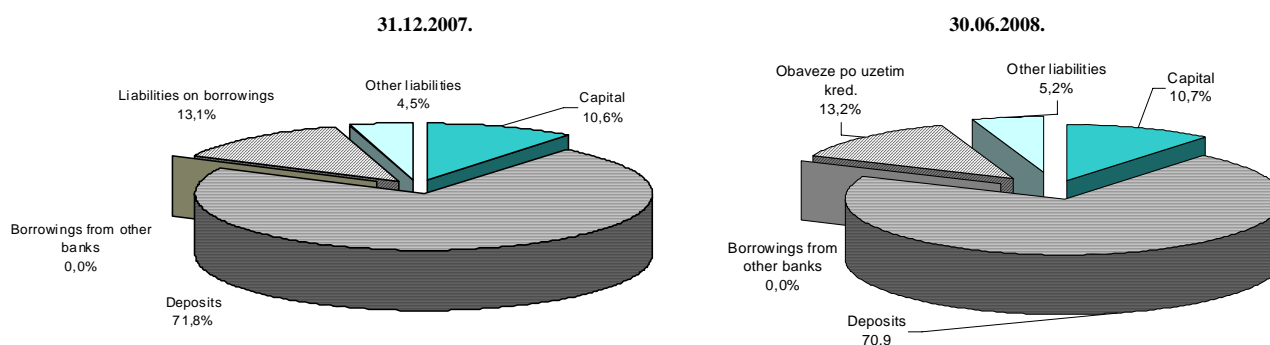
maintained at the accounts of depository institutions abroad decreased more significantly (by 19% or KM 337 million), amounting to KM 1,43 billion or 32,5% of total cash funds at the end of the observed period (36,1% at the end of 2007). Banks' funds held as cash in vaults and tellers amounted to KM 299 million as of 30.06.2008., representing 6,8% of total cash funds, which is higher by 0,4% than at the end of 2007.

The mentioned changes have influenced the currency structure of cash funds, that is, further growth of domestic currency participation have continued in the observed period, that is, participation of domestic currency has increased from 61,4% to 65,4%, resulting by decrease in participation of funds in foreign currency.

2. 1. 1. Liabilities

Structure of liabilities (liabilities and capital) in the balance sheet of banks as of 30.06.2008. is presented in the following graph:

Graph 13: Liabilities structure of banks



Changes in the liabilities structure of banks from prior periods have continued over the first six months of 2008, representing trend of decrease in participation of deposits and increase of credit indebtedness. Deposits, after a minimum downfall of KM 20 million in the first quarter of 2008, have generated growth over the six months of 4% or KM 381 million, hence, with participation of 70,9% and amount of KM 10,6 billion, they still represent the most significant source of financing for banks in the Federation of BiH. Following high growth in 2007, credit indebtedness of banks over the first six months of 2008, is recording slightly slower growth of 6% or KM 117 million, while in the same period of the prior year, credit liabilities, as the second most significant financing source, and have increased by 19% or KM 264 million. These liabilities, with the amount of KM 1,97 billion, have reached the participation in liabilities of 13,2% (0,1% more than at the end of 2007). If we add to these liabilities the subordinated loans of KM 207 million, which banks have borrowed to strengthen their capital and capital adequacy, then total credit funds in the sources would have participation of 14,6%.

Injection of new, green capital through additional capitalization of four banks, and profit generated over the first six months of 2008, resulted by increase of capital by KM 83 million or 6%. Consequently, as of 30.06.2008., capital amounted to KM 1,6 billion, representing participation of 10,7%.

As of 30.06.2008, the highest bank commitments came from following creditors (six of total 56), representing 62,2% of total credit commitments: Raiffeisen Zentralbank Osterreich A.G. (RZB), OEWAG Wien, ComercBank AG Frankfurt, European Investment Bank (EIB), European fund for Southeast Europe (EFSE), Bank Polska OPIEKI.

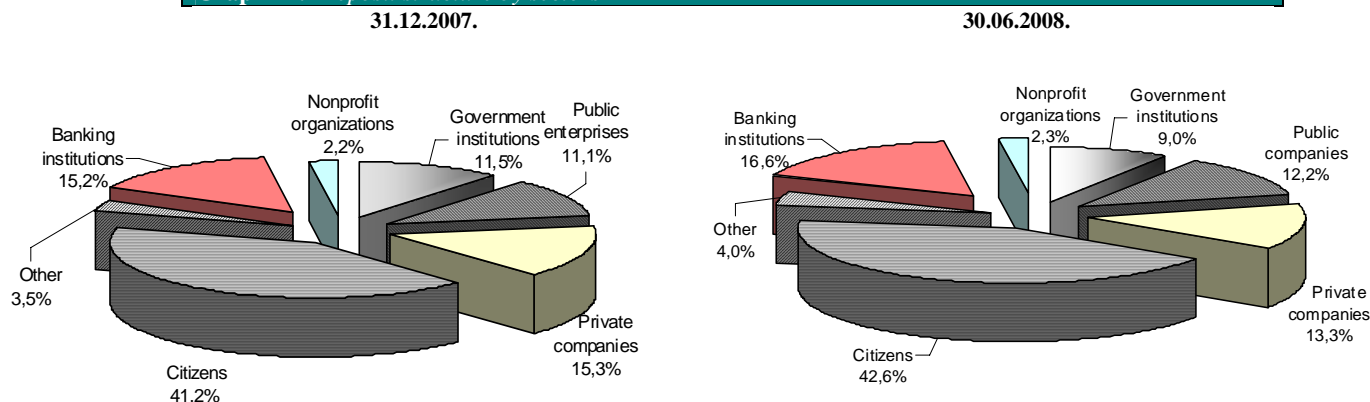
According to the data submitted by banks, out of total deposits, as of 30.06.2008., only 4,8% were deposits collected by organizational units of banks from the Federation of BiH, operating in Republic Srpska and Brčko District.

- in 000 KM-

Table 13: Deposit structure by sectors¹⁴

SECTORS	31.12.2006.		31.12.2007.		30.06.2008.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Governmental institutions	1.033.902	12,3	1.171.095	11,5	956.349	9,0	113	82
Public enterprises	996.110	11,9	1.126.838	11,1	1.285.807	12,2	113	114
Private enterprises and assoc.	1.342.538	16,0	1.554.693	15,3	1.410.002	13,3	116	91
Non-profit. Organizations	193.009	2,3	225.866	2,2	237.315	2,3	117	105
Banking institutions	1.136.450	13,6	1.548.619	15,2	1.750.108	16,6	136	113
Citizens	3.403.443	40,6	4.202.161	41,2	4.503.272	42,6	123	107
Other	273.870	3,3	361.705	3,5	429.251	4,0	132	119
TOTAL	8.379.322	100,0	10.190.977	100,0	10.572.104	100,0	122	104

Graph 14: Deposit structure by sectors



Deposit growth of KM 381 million or 4%, over the observed period, has influenced deposit structure by sectors. Citizen deposits, with growth rate of 7%, have realized the highest nominal growth of KM 301 million, amounting, as of 30.06.2008., to the amount of KM 4,5 billion and participation of 42,6%. We should point out a significant increase of the banking institutions deposits (KM 201 million or 13%), and almost all funds are coming from the banks from the groups (mainly shareholders) of three largest banks (approximately KM 326 million), while in one bank deposits of the „parent“ bank were significantly decreased (approximately KM 93 million). In this way domestic banks get the financial support and secured inflow of new funds for financing from the group whose member they are, which is directly correlated with the growth of liquidity risk and dependence on management over this risk at the level of the group to which the bank belongs to. Following citizens sector, deposits of financial institutions with the amount of KM 1,75 billion and participation of 16,6% (15,2% at the end of 2007) represent the second significant deposit source of financing for banks in the Federation of BiH.

Deposits of public enterprises have also increased (by KM 159 million or 14%), amounting to KM 1,3 billion and participation of 12,2% at the end of the observing period. Two sectors recorded a significant downfall of deposits: public institutions by 18% or KM 215 million, and with the amount of one billion KM, their participation was 9%, which is lower by 2,5% than at

¹⁴ Information from the attached form BS-D submitted by banks each quarter with balance sheet - FBA format.

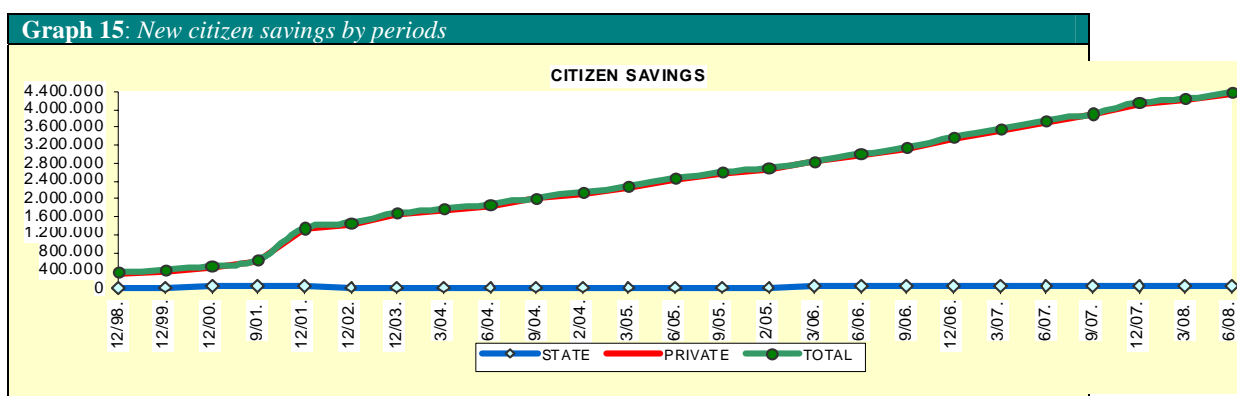
the end of 2007. Second sector are private companies, whose deposits have also significantly decreased (by 9% or KM 145 million) and such downfall happened in the first quarter of 2008, their participation decreased from 15,3% to 13,3%, amounting to KM 1,4 billion at the end of the observing period.

After longer period of time, currency structure has changed in favor of foreign currency, that is, deposits in foreign currency (with dominant participation of EUR) in the amount of KM 6,0 billion recorded participation of 56,7% (55% at the end of 2007), while deposits in domestic currency in the amount of KM 4,6 billion recorded participation of 43,3% (45% at the end of 2007).

Savings deposits, as the most significant deposit and financial potential of banks, continued with moderate and stable growth in 2008, that is, their increase was 6,1% or KM 250 million, arriving at KM 4,37 billion. Of the overall increase generated, three largest banks in the system make 65% or KM 162 million.

Table 14: New citizen savings by periods

BANKS	AMOUNT (in 000 KM)			RATIO	
	31.12.2006.		30.06.2008.	3/2	4/3
	1	3	4	5	6
State	31.723	30.469	32.036	96	105
Private	3.308.413	4.086.820	4.334.908	124	106
TOTAL	3.340.136	4.117.289	4.366.944	123	106



Three largest banks in the system hold 74,1% of savings, while 11 banks show participation below 1%, representing only 4,6% of total savings in the system.

Savings deposits in domestic currency represent 32%, while in foreign currency 68% of total savings.

Table 15: Maturity structure of citizen saving deposits by periods

BANKS	AMOUNT (in 000 KM)			RATIO				
	31.12.2006.		30.06.2008.	3/2	4/3			
	1	3	4	5	6			
Short term savings deposits	1.851.173	55,4%	2.174.863	52,8%	2.402.266	55,0%	117	110
Long term savings deposits	1.488.963	44,6%	1.942.426	47,2%	1.964.678	45,0%	130	101
TOTAL	3.340.136	100,0%	4.117.289	100,0 %	4.366.944	100,0 %	123	106

Over the first six months of 2008, in the maturity structure of savings deposits, participation of long term deposits has slightly declined, which is the result of higher growth rate in short term

deposits (10% or KM 227 million) than long term deposits (1% or KM 22 million). Within short term deposits, we should emphasize the significant growth of 34% or KM 171 million of term deposits up to one year, while demand deposits were higher by 3,3% or KM 56 million, which has increased participation of short term deposits from 52,8% to 55%.

Permanent growth and positive trends in the segment of savings in banks of the FBiH are primarily the result of, on one side, strengthening of safety and stability of the overall banking system, where the key importance is given to the existence of functional, effective and efficient banking supervision conducted by the FBA, and, on the other side, deposit insurance system with the main purpose to increase stability of the banking, that is, financial sector and protection of savers. There is total 14 banks from the Federation of BiH that were accepted to the deposit insurance program, and according to the submitted data, there is total 96% of total deposits and 98% of total savings deposited in these banks. As for remaining banks, six of them cannot apply to be accepted since they do not qualify with the criteria prescribed by the Deposit Insurance Agency: three state owned banks due to their ownership structure, one private bank with participation of state capital exceeding 10%, and two private banks under provisional administration, while one bank is currently in process of acceptance to the insurance program.

2.1.2. Capital - strength and adequacy

Capital¹⁵ of banks in the FBiH, as of 30.06.2008., amounted to KM 2,0 billion.

-in 000 KM-

Table 16: Regulatory capital						
DESCRIPTION	31.12.2006.	31.12.2007.	30.06.2008.	RATIO		
				3/2	4/3	
1	2	3	4	5	6	
STATE BANKS						
1. Core capital before reduction	169.829	145.802	148.699	86	102	
2. Offsetting items	5.034	2.018	2.011	40	100	
a) Core capital (1-2)	164.795	143.784	146.688	96%	102	
b) Supplementary capital	9.370	6.017	5.563	4%	92	
c) Capital (a + b)	174.165	149.801	152.251	100%	102	
PRIVATE BANKS						
1. Core capital before reduction	1.029.002	1.316.424	1.479.674	128	112	
2. Offsetting items	104.704	124.137	149.739	119	121	
a) Core capital (1-2)	924.298	1.192.287	1.329.935	72%	112	
b) Supplementary capital	374.448	531.057	512.693	28%	97	
c) Capital (a + b)	1.298.746	1.723.344	1.842.628	100%	107	
Total						
1. Core capital before reduction	1.198.831	1.462.226	1.628.373	122	111	
2. Offsetting items	109.738	126.155	151.750	115	120	
a) Core capital (1-2)	1.089.093	1.336.071	1.476.623	74%	111	
b) Supplementary capital	383.818	537.074	518.256	26%	97	
c) Capital (a + b)	1.472.911	1.873.145	1.994.879	100%	107	

Over the first six months of 2008, capital¹⁶ increased by 7% or KM 122 million in comparison to 2007, while due to some more significant changes in core and supplementary capital, certain changes in the structure of regulatory capital have occurred. The core capital increased by 11% or KM 141 million, while the supplementary capital decreased by 3% or KM 19 million, resulting by the following structure of the regulatory capital as of 30.06.2008.: core capital was 74% and supplementary capital was 26%.

¹⁵ Regulatory capital as defined by Article 8 and 9 of Decision on Minimum Standards for Capital Management in Banks (Official Gazette of the Federation of BiH, number 3/03, 18/03, 53/06, 55/07, 81/07, 6/08).

¹⁶ Data source is quarterly Report on Capital Positions of Banks (Form 1-Schedule A) regulated by the Decision on Minimum Standards for Managing Capital in Banks.

Growth of core capital is primarily based on distribution of profit reported for 2007 into the capital. Following legal procedure for decision on distribution of the audited profit that has been processed and adopted by the assemblies, the profit realized in 2007 (by 18 banks, while four banks reported loss of KM 8,2 million) of KM 118,1 million has been distributed of 71% in the core capital (reserves or retained-undistributed profit). Six banks have made decision to pay out dividends in total amount of KM 33,3 million, representing approximately 29% of the generated profit. However, one bank has allocated additional KM 6,3 million for dividends from its retained profit.

Increase of shareholder's capital from the inflow of new, green capital-additional capitalization of KM 74,4 million in four banks with realization of the exchange premium of eight million has significantly influenced, among other things, the growth of core capital. At the same time, as a result of the status change of integration of two banks, share capital decreased by KM 18 million by which the exchange premium of the resulting bank has increased. In addition to that, revaluation reserves of three banks have increased by KM 5,2 million, based on adjustment of fair value of financial instruments (equity securities) classified in the portfolio available for sale.

Offsetting items (causing decrease of core capital) have increased by KM 25,6 million, mainly as a result of current loss amounting to KM 24 million.

Supplementary capital decreased by KM 19 million, and the most significant changes are: profit in 2007 of KM 94 million was transferred to core capital, general reserves for loan losses increased by KM 27 million, subordinated debts by KM 15 million, and hybrid items and permanent character liabilities by KM 10,5 million. Two banks included the audited profit for the first six months of 2008 in their supplementary capital in total amount of KM 22,4 million.

The mentioned changes have influenced the structure of regulatory capital, so participation of core capital increased from 71% to 74%, and supplementary capital decreased from 29% to 26%.

Net capital, as well as regulatory capital, had the same absolute and relative growth of 7% or KM 122 million, amounting to KM 1,98 billion as of 30.06.2008.

Capitalization rate of banks, expressed as ratio between capital and assets, as of 30.06.2008., was 13%, which is higher by 0,1% if compared to the end of 2007.

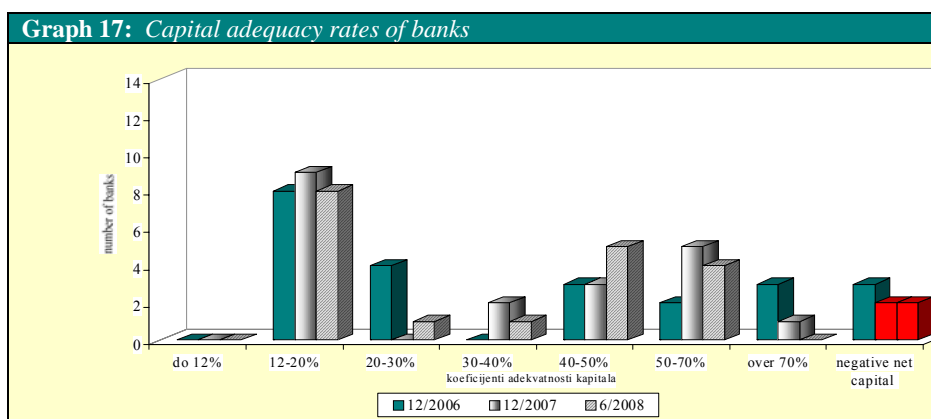
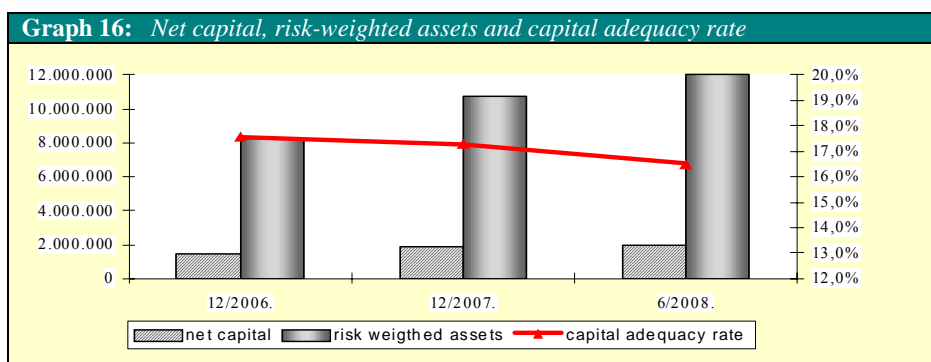
One of the most significant indicators of capital strength and adequacy¹⁷ of banks is capital adequacy ratio calculated as ratio between net capital and risk weighted assets. As of 30.06.2008., this ratio calculated at the system level was 16,5%, which is lower by 0,8% than at the end of 2007. This is relatively significant downfall, but also expected from the two reasons: higher growth rate of risk weighted assets (12%) than of net capital (7%), and methodology of capital adequacy accrual during the year, that is, not including the amount of the generated current profit. If non-audited profit for the first six months of 2008 is included in the calculation, capital adequacy rate would be 16,8%.

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

¹⁷ The Law prescribes minimum capital adequacy rate of 12%.

- 000 KM -

DESCRIPTION	31.12.2006.	31.12.2007.	30.06.2008.	RATIO	
				3/2	4/3
1	2	3	4	5	6
NET CAPITAL	1.455.675	1.857.109	1.978.843	128	107
RISK WEIGHED ASSETS AND CREDIT EQUIVALENTS	8.282.086	10.740.880	11.994.347	130	112
NET CAPITAL RATE (CAPITAL ADEQUACY)	17,6%	17,3%	16,5%	98	95



Of total 21 banks in the FBiH as of 30.06.2008., capital adequacy rate of 19 banks was higher than minimum prescribed by the law of 12%, while two banks, under provisional administration, recorded capital adequacy rate below 12%, that is, negative adequacy rate. The rate of individual banks was moving in both ways: capital adequacy of five banks was better than at the end of 2007, of which in four banks this was the result of additional capitalization performed in the first six months of 2008, while 14 banks recorded downfall of capital adequacy.

Preview of capital adequacy rates of 19 banks in comparison to the minimum prescribed by the law of 12% is the following:

- Eight banks had the rate between 12,5% and 20%, and three largest banks from 12,9% to 14,7%,
- Seven banks had the rate between 21% and 50%,
- Four banks had the rate between 51% and 70%.

Further strengthening of capital base will be priority task in majority of banks as it has been the case so far, especially in the largest banks of the system, which is necessary to strengthen stability and safety of both banks and the entire banking system. Following bank expansion and performing regular supervision of this segment, when acting towards banks, depending on the evaluation of their capital adequacy and risk profile, the FBA initiates different corrective and supervisory measures, such as: adoption of strategy to maintain certain level of capital and plan which will provide for quantity and quality (structure) of that capital in accordance with the nature and complexity of bank's present and future business activities and undertaken and potential risk, then intensified supervision and monitoring of bank, request to supply additional capital in order to strengthen capital base, limitation and decrease of credit risk exposure with some concentrations, monitoring of capital plan implementation, especially for additional capital supplied from external resources, supervision of compliance and implementation of the ordered measures, etc.

2.1.3. Assets and asset quality

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

Total assets with off-balance sheet items (assets)¹⁸ of banks in the FBiH, as of 30.06.2008. was KM 17,9 billion, which is higher by 6% or KM 936 million than at the end of 2007.

Gross assets¹⁹ of the balance sheet amounted to KM 15,3 billion, which is higher by 5% or KM 750 million than at the end of 2007. Off-balance sheet risk items amounted to KM 2,6 billion, representing an increase by 8% or KM 186 million.

-in 000 KM-

Table 18: Assets, off-balance sheet items and potential loan losses								
DESCRIPTION	AMOUNT (in 000 KM)					RATIO		
	31.12.2006.	Struct. %	31.12.2007.	Struct. %	30.06.2008.	Struct. %	4:2	6:4
1.	2	3	4	5	6	7	8	9
Loans	6.609.302	56,0	8.660.761	59,6	9.928.183	64,9	131	115
Interests	36.210	0,3	53.512	0,4	55.676	0,4	148	104
Past due claims	206.720	1,8	210.585	1,4	199.821	1,3	102	95
Claims for paid guarantees	4.132	0,0	3.638	0,0	3.712	0,0	88	102
Other placements	47.739	0,4	61.910	0,4	52.328	0,3	130	85
Other assets	4.893.407	41,5	5.552.875	38,2	5.053.300	33,1	113	91
TOTAL ASSETS	11.797.510	100,0	14.543.281	100,0	15.293.020	100,0	123	105
OFF-BALANCE SHEET	1.826.980		2.453.214		2.639.689		134	108
ASSETS WITH OFF-BALANCE SHEET	13.624.490		16.996.495		17.932.709		125	106
RISK ASSETS WITH OFF-BALANCE SHEET	8.871.314		11.624.445		13.063.221		131	112
General loan risk and Potential loan losses	343.737		409.833		454.432		119	111
General and Special loan loss reserves already established	345.067		409.895		454.468		119	111

¹⁸ Assets defined by Article 2 of Decision on Minimum Standards for Loan Risk Management and Assets Classification of Banks (Official Gazette of the FBiH, number 3/03, 54/04, 68/05).

¹⁹ Data source: Report on classification of balance sheet assets and off-balance sheet items of banks.

Non-risk items amount to KM 4,9 billion or 27% of total assets with off-balance sheet items and they decreased by 9% in comparison to the end of 2007, which is primarily the result of cash funds decrease. On the other hand, risk assets with off-balance sheet amount to KM 13,1 billion and they increased by 12% or KM 1,4 billion over the six months of 2008.

Credit placements²⁰ increased by 14% or KM 1,3 billion in comparison to 2007, reaching the amount of KM 10,1 billion and participation in the assets structure of 68%. Past due claims decreased by 5%, and their participation in the assets structure amounts to 1,4%.

Three largest banks in the FBiH increased their credit placements by KM 740 million, representing 59% of total increase at the level of the banking sector, so, as of 30.06.2008., three largest banks with loans of KM 6,9 billion had participation of 68% in total loans at the system level.

From the aspect of sectors to which banks have originated loans, we should emphasize that positive trend of 2007 has remained over the first six months of 2008, that is, lending to private companies was higher than lending to citizens. Placements to private companies recorded increase of 17% or KM 687 million, which has increased their participation from 45% to 46,2%. Slightly lower growth of 12% or KM 519 million was recorded in loans to citizens, while their participation decreased from 50,3% to 49,2%. According to the data submitted by banks as of 30.06.2008., from the aspect of citizen loan structure by purpose, there has been longer period of time without changes, that is, the highest participation of approximately 71% was recorded in loans originated to finance consumer goods²¹, followed by housing loans of 23%, and remaining 6% were loans to small crafts and small business and agriculture.

Other sectors recorded smaller changes in nominal and relative amount.

Three largest banks in the system financed 68% of total loans originated to citizens, and 69% to private companies, which for both sectors is unchanged in comparison to the end of 2007.

Trend and changes in participation of individual sectors in the overall structure of loans are presented in the following table.

-in 000 KM-

Table 19: Structure of loans by sectors

SECTORS	31.12.2006.		31.12.2007.		30.06.2008.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Government institutions	27.084	0,4	32.556	0,4	70.355	0,7	120	216
Public enterprises	192.394	2,8	211.465	2,4	188.983	1,9	110	89
Private enterprises and assoc.	3.029.964	44,4	3.998.141	45,0	4.685.374	46,2	132	117
Non-profit organizations	28.445	0,4	26.768	0,3	25.169	0,2	94	94
Banking institutions	52.279	0,8	114.084	1,3	140.668	1,4	218	123
Citizens	3.471.829	50,9	4.461.965	50,3	4.981.275	49,2	129	112
Other	18.159	0,3	30.005	0,3	39.892	0,4	165	133
TOTAL	6.820.154	100,0	8.874.984	100,0	10.131.716	100,0	130	114

Currency structure of loans has also been unchanged for longer period of time: loans financed with currency clause had the highest participation of 73% or KM 7,4 billion, loans in domestic currency of 25% or KM 2,6 billion, and loans in foreign currency had the lowest participation of only 2% or KM 192 million.

²⁰ Short term and long term loans, past due claims and claims based on paid-called for payment guarantees.

²¹ Including card based operations.

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

Quality of assets and off-balance sheet risk items, general loan risk, potential loan losses by classification categories²² and off-balance sheet items are presented in the following table:

Table 20: Asset classification, general loan risk (GLR), potential loan losses (PLL) and off-balance sheet items (charged off assets and suspended interest)											
Classification category	AMOUNT (in 000 KM) AND PARTICIPATION (in%)									RATIO	
	31.12.2006.			31.12.2007.			30.06.2008.			5/2	8/5
	Assets classif.	Partic. %	GLR PLL	Assets classif.	Partic. %	GLR PLL	Assets classif.	Partic. %	GLR PLL		
1	2	3	4	5	6	7	8	9	10	11	12
A	7.513.553	84,7	150.390	9.876.208	85,0	197.719	11.251.103	86,0	225.292	131	114
B	1.073.906	12,1	79.451	1.478.711	12,7	105.446	1.497.490	11,5	105.584	138	101
C	147.718	1,7	36.574	143.658	1,2	35.717	163.593	1,3	41.120	97	114
D	135.980	1,5	77.181	122.003	1,1	67.086	147.188	1,2	78.589	90	121
E	157	0,0	141	3.865	0,0	3.865	3.847	0,0	3.847	2462	100
Risk assets (A-E)	8.871.314	100,0	343.737	11.624.445	100,0	409.833	13.063.221	100,0	454.432	131	112
Non-risk assets²³	4.753.176			5.372.050			4.869.488			113	91
TOTAL	13.624.490			16.996.495			17.932.709			125	106
OFF-BALANCE SHEET ITEMS											
	409.108	89,7		430.069	90,1		440.090	89,4		105	102
Suspended interest	46.546	10,3		46.929	9,9		52.388	10,6		101	112
TOTAL	455.654	100,0		476.998	100,0		492.478	100,0		105	103

Risk assets with off-balance sheet items (A-E) amount to KM 13,1 billion. They increased by 12% or KM 1,4 billion. Non-risk items amount to KM 4,9 billion, and they decreased by 9% in comparison to the end of 2007, as a result of the cash funds decrease.

If we analyze the quality of risk assets, we notice further increase of classified assets (B-E) which, over the six months of 2008, increased by 4% or KM 64 million, due to the growth of substandard assets (category C) of 14% or KM 20 million, doubtful assets (category D) by 21% or KM 25 million, while the special mentioned placements (category B) increased by 1% or KM 19 million. Classified assets, as of 30.06.2008., amounted to KM 1,8 billion. Poor quality assets (C-E) increased by 17% or KM 45 million, amounting to KM 315 million at the end of the first six months of 2008, noting that in the same period there was the assets charge off (write off to the off-balance sheet) of KM 32 million. The assets quality indicators expressed as ratio, that is, participation of individual categories in risk assets have changed, which is the result of the above mentioned. The ratio of classified assets and risk assets, due to faster growth of risk assets (12%) than classified assets (4%) has slightly improved, and, if compared to the end of 2007, it is lower by 1,1%, amounting to 13%.

If we analyze only the ratio and trend of poor quality assets and risky assets, as of 30.06.2008., it was 2,4%, which is relatively low ratio, and, if compared to the end of 2007, it is higher by 0,1%. However, if we take into account that participation of category B in risky assets amounts to 11%, expressing doubt that portion of placements reported under this category have worst quality and should be placed under the category of poor quality assets, that is, some banks

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

²³ Assets items that are not, according to Article 22, Paragraph 7 of Decision on Minimum Standards for Bank Credit Risk and Assets Classification Management, subject to accrual of general loan loss provisions of 2%.

practice not to timely establish adequate loan loss provisioning (as confirmed through on-site examinations, resulting by insufficient loan loss reserves), we could make conclusion there is still a slight trend of deterioration in the assets quality. That is why it is of key importance that banks more realistically evaluate quality of placements and establish adequate loan loss reserves, especially for the fact that these are new loans with long maturity (especially citizen loans), so the issues related to the assets quality have not been timely detected, that is, they are in some way hidden through the highest increase of category B.

The analysis of data by sectors is based on the indicators of loan quality granted to the two most significant sectors: private companies and citizens. The two mentioned indicators for these sectors are significantly different and indicate higher loan risk exposure, and also the exposure to potential loan losses with the loans originated to legal entities.

Table 21: Classification of loans originated to citizens and legal entities											
Classification category	AMOUNT (in 000 KM) AND PARTICIPATION (in%)										RATIO
	31.12.2007.					30.06.2008.					
	Citizens	Partic. %	Legal entities	Partic. %	TOTAL	Citizens	Partic. %	Legal entities	Partic. %	TOTAL	11/6
1	2	3	4	5	6 (2+4)	7	8	9	10	11 (7+9)	12
A	4.176.207	93,60	3.273.549	74,18	7.449.756	4.675.596	93,86	3.967.925	77,04	8.643.521	116
B	199.186	4,46	970.657	22,00	1.169.843	191.552	3,85	994.526	19,31	1.186.078	101
C	56.100	1,26	82.244	1,86	138.344	74.374	1,49	84.923	1,65	159.297	115
D	30.454	0,68	86.569	1,96	117.023	39.753	0,80	103.067	2,00	142.820	122
E	18	0,00	0	0,00	18	0	0,00	0	0,00	0	0
TOTAL	4.461.965	100,00	4.413.019	100,00	8.874.984	4.981.275	100,00	5.150.441	100,00	10.131.716	114
Classified assets (B-E)	285.758	6,40	1.139.470	25,82	1.425.228	305.679	6,14	1.182.516	22,96	1.488.195	104
Poor quality assets (C-E)	86.572	1,94	168.813	3,83	255.385	114.127	2,29	187.990	3,65	302.117	118
Loan structure		50,28		49,72	100,00		49,17		50,83	100,00	
Participation by sectors in classified assets, poor quality assets and category B:											
Classification B-E		20,05		79,95	100,00		20,54		79,46	100,00	
Poor quality C-E		33,90		66,10	100,00		37,78		62,22	100,00	
Category B		17,03		82,97	100,00		16,15		83,85	100,00	

As of 30.06.2008., of total loans originated to legal entities in the amount of KM 5,1 billion, KM 1,2 billion or 23% was classified in categories B to E (KM 1,1 billion or 25,8% was at the end of 2007), and of total loans originated to citizens in the amount of KM five million, KM 306 million or 6,1% was classified in categories B to E (KM 286 million or 6,4% was at the end of 2007).

Poor quality assets represent KM 188 million or 3,7% of all the loans originated to legal entities (as of 31.12.2007., they amounted to KM 169 million or 3,8%). As for the sector of citizens, loans classified as poor quality represent KM 114 million or 2,3% of total loans originated to this sector (as of 31.12.2007, they amounted to KM 87 million or 2%).

Observed indicators of the quality of loans originated to legal entities and citizens have slightly deteriorated if compared to 2007, while in order to make more realistic assessment we should take into account the amount of loans that banks, in the meantime, have charged off to the off-balance sheet, which is presented in the following table.

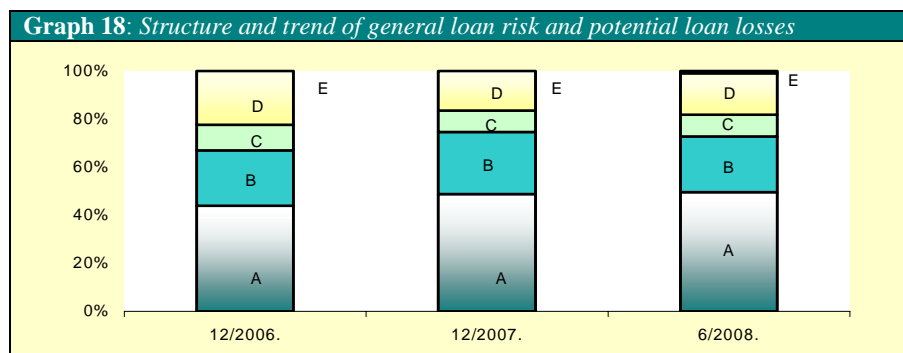
-000 KM-

DESCRIPTION	CITIZENS		LEGAL ENTITIES		TOTAL	
	Charged off assets	Suspended interest	Charged off assets	Suspended interest	Charged off assets	Suspended interest
1	2	3	4	5	6	7
Opening balance as of 31.12.2007.	66.060	7.187	364.009	39.742	430.069	46.929
<i>Changes in 2008:</i>						
- new charge offs (current year)	18.069	3.141	13.723	6.819	31.792	9.960
- payments made in the current year	7.464	2.019	9.774	1.671	17.238	3.690
- permanent charge off	123	190	4.410	621	4.533	811
Balance as of 30.06.2008.	76.542	8.119	363.548	44.269	440.090	52.388

Balance of the charged off assets as of 30.06.2008. was KM 440 million and it maintains the level from 2007, while the balance of suspended interest was KM 52 million and it was higher by 12% if compared to the end of 2007.

Level of general loan risk and estimated potential loan losses in the classification categories, as determined in accordance with the criteria and methodology prescribed by the FBA's decisions, their trend and structure at the level of the banking sector are presented in the following tables and graphs.

Classification category	AMOUNT (in 000 KM) AND STRUCTURE (in %)						RATIO	
	31.12.2006.		31.12.2007.		30.06.2008.		4/2	6/4
1	2	3	4	5	6	7	8	9
A	150.390	43,8	197.719	48,2	225.292	49,6	131	114
B	79.451	23,1	105.446	25,7	105.584	23,2	133	100
C	36.574	10,6	35.717	8,7	41.120	9,0	98	115
D	77.181	22,5	67.086	16,4	78.581	17,3	87	117
E	141	0,0	3.865	1,0	3.847	0,9	2.741	100
TOTAL	343.737	100,0	409.833	100,0	454.432	100,0	119	111



As reported, banks have established loan loss provisions in accordance with the regulations and level of the estimated credit risk.

Based on the analysis of the established provisions, in total amount and by classification categories, if compared to the end of 2007, general loan risk and potential loan loss provisions have increased by 11%, amounting to KM 454 million, that is, 3,5% of risk assets with off-balance sheet, the same as at the end of 2007. As of 30.06.2008., banks in average allocated for category B 7,1%, for category C 25,1%, category D 53,4% and E 100%.

Analysis of assets quality, that is, loan portfolio of individual banks, as well as on-site examinations at banks, indicate loan risk as still dominant risk with majority of banks, and concern that some banks still have inadequate management practices, that is, evaluation, measuring, monitoring and control of loan risk and assets classification, which was determined in on-site examinations through significant amount of insufficient loan loss reserves that banks have established based on the orders issued by the FBA. However, the problem is not essentially resolving.

The FBA has ordered corrective measures to those banks whose assets quality was rated poor by the examination in sense of preparation of the operating program that has to contain action plan aimed to improve existing practices for loan risk management, that is, assets quality management, decrease of existing concentrations and resolution of the poor quality assets issue and prevention of their further deterioration. Implementation of the FBA's orders is continuously monitored in the follow-up procedure based on reports and other documentation submitted by banks, which are checked through targeted on-site examinations.

Transactions with related entities

While operating, banks are exposed to different types of risks, of which the most significant is the risk of transactions with related entities of banks.

In accordance with the Basle Standards, the FBA has established certain prudential principles and requirements related to transactions with related entities of banks, as regulated in Decision on Minimum Standards for Bank's Operations with Related Entities, prescribing requirements and method of operations with related entities. The Decision and Law on Banks regulate the duty of Supervisory Board of a bank, which has to adopt, upon the proposal of the General Manager, special policies regulating operations with related entities and to monitor their implementation.

The FBA Decisions prescribe a special set of reports, including transactions with one segment of related entities, such as loans and potential and undertaken off-balance sheet liabilities (guarantees, letters of credit, undertaken loan commitments) as the most frequent and the most riskiest form of transactions between a bank and related entities. The set of prescribed reports include data on loans originated to the following categories of related entities:

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

-000 KM-

Description	ORIGINATED LOANS ²⁴			RATIO	
	31.12.2006.	31.12.2007.	30.06.2008.	3/2	4/3
	1	2	3	4	5
Shareholders over 5% of voting rights, subsidiaries and other related enterprises	21.333	26.083	83.112	122	319
Supervisory Board and Audit Board members	38	145	261	382	180
Bank Management	1.962	2.355	2.112	120	90
TOTAL	23.333	28.583	85.485	123	299
Potential and undertaken off-balance sheet liabilities	1.072	1.936	6.742	180	348

²⁴ It includes, apart from loans, other claims, deposited funds and placements to shareholders (financial institutions) with voting rights exceeding 5%.

Based on reporting data we can conclude this would be a small amount of loans granted to the mentioned categories of legal entities, so, in general, level of risk is low. The FBA pays special attention (in on-site examinations) to banks' operations with related entities. The FBA on-site examiners issue orders for elimination of determined weaknesses within certain deadlines and initiate violation procedures, and part of the activities is also to monitor and supervise implementation of the issued orders in the follow up procedure. This has had a positive influence on this segment of operations, since the risk management quality has improved; level of transactions with related entities has decreased, causing decrease in risk exposure to these entities.

2.2. Profitability

According to the data from income statement, banks in the Federation of BiH, in the first six months of 2008, reported positive financial result-profit of KM 29 million, representing a significant decrease of 64% or KM 52 million at the system level if compared to the same period of 2007. We should elaborate that decrease of the financial result has been under the following influence: accrued tax (KM four million) and bank's profit (integrated into another bank as of 29.02.2008.) for two months of 2008 was KM 1,8 million (as of 01.03.2008. on the accounts of capital).

Positive financial result of KM 53,3 million was generated by 15 banks, which is lower by 36% or KM 30 million than in the same period of 2007. At the same time, six banks reported loss of KM 24 million, which is higher by KM 21,7 million than in the same period of 2007.

More detailed information is presented in the following table:

-000 KM-

Date/Description	At the system level		State banks		Private banks	
	Amount	No. of banks	Amount	Amount	No. of banks	Amount
30.06.2006.						
Loss	-8.451	9	-2.928	4	-5.523	5
Profit	53.219	15	1.768	2	51.451	13
Total	44.768	24	-1.160	6	45.928	18
30.06.2007.						
Loss	-2.224	4	-	-	-2.224	4
Profit	83.265	19	3.146	3	80.119	16
Total	81.041	23	3.146	3	77.895	20
30.06.2008.						
Loss	-23.957	6	-3	1	-23.954	5
Profit	53.279	15	2.219	2	51.060	13
Total	29.322	21	2.216	3	27.106	18

Similar to other segments, there are concentrations in this segment: of total profit generated (KM 53,3 million) 70,5% or KM 37,5 million was generated by the two largest banks in the system, whose participation in the banking system assets is 50,3%. The reported loss of KM 24 million of the overall loss refers to one foreign bank that, with its participation in assets of 16,6% holds third position in the system. The loss reported by this bank is the result of extremely high expenses caused by securities trading.

Financial result of state banks does not have any significant influence to the overall profitability of the banking sector.

Based on analytical data and indicators of profitability quality assessment (level of generated financial result-profit/loss and ratios used for assessment of profitability, productivity and

effectiveness of performance and other parameters related to the assessment of performance), overall profitability of the system has significantly deteriorated if compared to the same period last year. Generally in the system, and especially in the large banks-holders of profitability, the generated profit has been increasing at slower pace or has been lower than in majority of banks in the system as a result of faster growth of interest and non-interest-bearing expenses in comparison to the overall income. However, adverse financial result is mainly under influence of the financial result-loss of one bank, which is, as mentioned, related to the securities trading. It should be emphasized that this bank, in the first six months of last year, reported extremely high profit on the same basis.

Total income realized on the system level was KM 397 million, which is lower by 1% or KM 5,1 million if compared to the same period last year, while significantly lower if compared to the comparative period 2007/06 (growth of 25% or KM 81 million). Total noninterest bearing expenses amount to KM 364 million, with growth rate of 13% or KM 42,7 million, representing a downfall of three index points of compared to the previous year, which has negatively reflected on the overall financial result of the sector.

If we analyze the structure of total income and changes in the most significant categories, we may conclude that there is still increase in participation of net interest income, representing 62,9% of total income (59,2% in the same period of 2007), while participation of operating income has decreased from 40,8% to 37,1%.

Total interest income amounts to KM 447 million, and if compared to the same period last year, it has increased by 16% or KM 60,1 million, but the growth rate realized is lower by 15 index points. In the structure of total income, its participation increased from 96,3% to 112,6%. This positive trend is the result of a continuous growth of credit placements, but with somewhat apparent slower growth of interest income than growth rate of interest-bearing assets of 25,1%, and to some extent as a result of implementation of the IAS 18. On the other hand, suspension of interest income due to increase of poor quality assets of 12,8% during the observing period has, among other things, resulted by decrease of growth rate of interest income.

On the other hand, if compared to the growth of interest income, interest expenses recorded faster growth, that is, the rate of 32% or KM 48 million, amounting to KM 197,3 million, and their participation in the structure of total income has increased from 37,1% to 49,7% in comparison to the same period last year. If compared to the growth of average interest-bearing sources (rate of 15,1%), the expenses recorded the trend of faster growth.

Growth of interest expenses based on deposits of 28% is the result of faster growth of term and interest-bearing deposits (23%) than total deposits (13%) and trend of increased interest rates on term deposits. Increase of long term credit indebtedness of banks, primarily from foreign financial institutions of 17%, subordinated debts of 36%, in the period from 30.06.2007. to 30.06.2008., as well as increased reference interest rates, Euribor and Libor, have caused the increase of interest expenses for borrowings by 46%.

Although due to faster growth of interest expenses, net interest income of KM 249,7 million recorded lower growth rate (5% or KM 11,7 million) than interest income, its participation in the structure of total income has still increased from 59,2% to 62,9%.

However, apart from a bad financial result of the system, growth of participation of net interest income in the overall income of banks is a positive indicator of increasing trend of quality and stability of earnings, since banks now realize more profit from their core activity, that is, their lending activity.

Operating income amounts to KM 147,2 million and, if compared to the prior year, it decreased by 10% or KM 16,8 million, along with decrease in the structure of the overall income from

40,8% to 37,1%. This deterioration is mainly caused by enormous downfall of securities trading income (from KM 16,2 million to KM 0,2 million) of one bank due to the extreme changes of prices in the securities market, also due to decreased fee income for loans by 60%, as a result of the accounting policies changes in the segment of treatment methodology and recognition of fee income related to loans, and especially due to more present growth of long term loans if compared to short term loans. Within operating income, both nominally and in percentages, in comparison to the same period last year, fee income recorded faster growth by KM 5,6 million or 9%.

Total non-interest bearing expenses recorded faster growth than net interest income (5%), amounting to KM 363,6 million as of 30.06.2008., and they are higher by 13% or KM 42,7 million if compared to the same period last year. At the same time their participation in the structure of total income has increased from 79,8% to 91,6%. However, if we compare their relative and nominal growth for the period of six months in 2007 to the same period in 2006 (16% or KM 44,4 million), the conclusion is that banks were good at managing non-interest bearing expenses, growth rate was even lower by three percentages, while the main cause of such worst financial result is decreased total income and significant downfall of operating income based on trading, and net interest income, due to the above mentioned reasons.

Within non-interest bearing expenses, both nominally and relatively, other operating expenses recorded the highest growth of KM 18,3 million or 36%, their participation in the structure of total income has increased from 12,8% to 17,6%, amounting to KM 69,7 million as of 30.06.2008. Within operating expenses, negative effects of securities trading were reported by two banks of KM 15,3 million, which has much negatively reflected on the profit of the entire system over the first six months of 2008. In the past two years, oscillations in certain periods expressed through generated income or expenses, both nominally and relatively, indicate a high influence of market risk from this segment to the financial result both to the banks involved in such activities and the entire banking system.

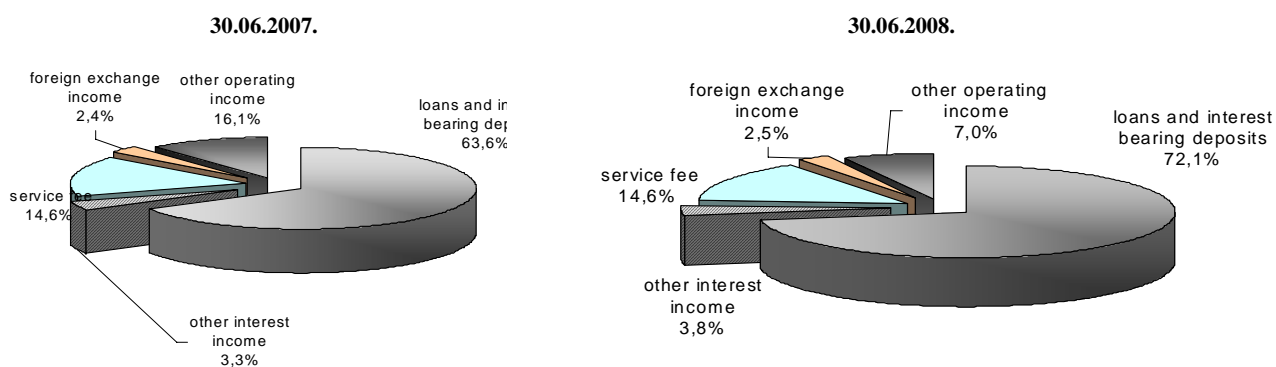
The following are salaries and contribution expenses with their growth of KM 12,6 million and growth rate of 14%, and business premises and fixed assets expenses of KM 7,7 million and rate of 13%. Loan loss provisioning recorded a slight downfall of 6% or KM 5 million, which leads to the question of adequacy of the established reserves and potentially hidden loan losses with certain number of banks.

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

- in 000 KM-

Table 26: Structure of total income									
Structure of total income	30.06.2006.		30.06.2007.		30.06.2008.		RATIO		
	Amount	%	Amount	%	Amount	%	4/2	6/4	
1	2	3	4	5	6	7	8	9	
I Interest income and similar type of income									
Interest bearing deposit accounts with depository institutions	28.904	6,7	44.365	8,0	46.112	7,8	153	104	
Loans and leasing	256.716	59,4	323.891	58,8	377.643	63,6	126	117	
Other interest income	8.636	2,0	18.675	3,4	23.229	3,8	216	124	
TOTAL	294.256	68,1	386.931	70,2	446.984	75,2	131	116	
II Operating income									
Service fees	81.983	19,0	87.602	15,9	88.325	14,9	107	101	
Foreign exchange income	14.275	3,3	15.571	2,8	15.371	2,6	109	99	
Other operating income	41.313	9,6	60.847	11,1	43.489	7,3	147	72	
TOTAL	137.571	31,9	164.020	29,8	147.185	24,8	119	90	
TOTAL INCOME (I + II)	431.827	100,0	550.951	100,0	594.169	100,0	128	108	

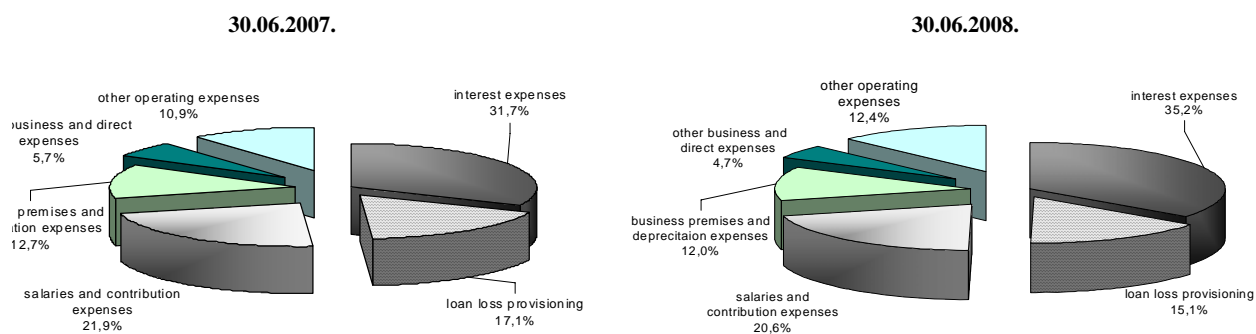
Graph 19: Structure of total income



- in 000 KM-

Table 27: Structure of total expenses

Structure of total expenses	30.06.2006.		30.06.2007.		30.06.2008.		RATIO	
	Amount	%	Amount	%	Amount	%	4/2	6/4
1	2	3	4	5	6	7	8	9
I Interest expenses and similar expenses								
Deposits	80.770	20,9	105.276	22,4	134.545	24,0	130	128
Liabilities for borrowings	25.182	6,5	37.457	8,0	52.099	9,3	149	139
Other interest expenses	4.537	1,2	6.201	1,3	10.620	1,9	137	171
TOTAL	110.489	28,6	148.934	31,7	197.264	35,2	135	132
II Total non-interest bearing expenses								
General loan risk and potential loan losses Provisioning	69.454	17,9	80.230	17,1	84.790	15,1	116	106
Salary expenses	89.964	23,2	102.979	21,9	115.610	20,6	114	112
Business premises and depreciation expenses	52.245	13,5	59.549	12,7	67.257	12,0	114	113
Other business and direct expenses	25.068	6,5	26.898	5,7	26.318	4,7	107	98
Other operating expenses	39.839	10,3	51.320	10,9	69.669	12,4	129	136
TOTAL	276.570	71,4	320.976	68,3	363.644	64,8	116	113
TOTAL EXPENSES (I + II)	387.059	100,0	469.910	100,0	560908	100,0	121	119

Graph 20: Structure of total expenses

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

- in %-

Table 28: Ratios of profitability, productivity and effectiveness by periods			
RATIOS	30.06.2006.	30.06.2007.	30.06.2008.
Return on Average Assets	0,46	0,66	0,21
Return on Average Total Capital	4,23	6,25	1,95
Return on Average Equity	5,51	8,89	2,83
Net Interest Income/Average Assets	1,88	1,94	1,79
Fee Income/Average Assets	1,41	1,34	1,05
Total Income/Average Assets	3,29	3,28	2,84
Operating and Direct Expenses ²⁵ /Average Assets	0,97	0,87	0,79
Operating Expenses/Average Assets	1,86	1,75	1,81
Total Non-interest Expenses/Average Assets	3,11	2,83	2,60

-in %-

Table 29: Ratios of profitability, productivity and effectiveness as of 30.06.2008.			
RATIOS	30.06. 2008.		
	STATE BANKS	PRIVATE BANKS	AVERAGE IN THE FBiH
Return on Average Assets	0,55	0,20	0,21
Return on Average Total Capital	1,49	2,00	1,95
Return on Average Equity	1,82	2,96	2,83
Net Interest Income/Average Assets	2,10	1,78	1,79
Fee Income/Average Assets	1,56	1,04	1,05
Total Income/Average Assets	3,67	2,81	2,84
Operating and Direct Expenses/Average Assets	0,84	0,79	0,79
Operating Expenses/Average Assets	2,20	1,79	1,81
Total Non-interest Expenses/Average Assets	3,04	2,59	2,60

Analysis of some general parameters for assessment of banks' profitability indicates that profitability of the entire banking system has deteriorated, which is presented as downfall of ROAA (return on average assets) from 0,66% to 0,21% and ROAE (return on average equity) from 6,25% to 1,95%, and also downfall banks' productivity, measured as ratio between total income and average assets from 3,28% to 2,84%. The presented indicators show that positive trend of improvement of profitability from earlier periods has been slow down, which is primarily expressed through the trend of downfall of banks' productivity.

All key financial indicators of profitability analyzed based on the ownership criteria in banks indicate that private banks operate more cost-effectively, productively and efficiently, which gives them competitive advantage if compared to state banks, emphasizing the need to finish privatization process in remaining state banks.

Profitability of banks will still mostly depend on asset quality, that is, bank's exposure to credit risk, especially related to the growth of poor quality assets resulting by suspension of interest income. The following important factor is effective management and control of operating income and expenses, and in majority of banks, as experience shows, especially those related to the securities trading activity. In addition, banks' profit, that is, financial result will be mainly under influence of price and interest rate risk, both in sources and price changes of financing sources of banks also in possibility to gain interest rate margin which will be sufficient to cover all non-interest bearing expenses, and finally to ensure adequate return to the invested capital for bank owners. That is why, the key factor of effectiveness and profitability for each bank is management quality and business policy applied, since that is the most direct way to influence its performance.

²⁵ Expenses include provisions for potential loan losses.

2.3. Liquidity

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

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

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

Liquidity risk is closely correlated with other risks and often has an adverse effect on banks' profitability.

In the structure of financing sources of banks in the Federation of BiH as of 30.06.2008. deposits still have the highest participation of 70,9%, followed by borrowings (including subordinated debts²⁶) with participation of 15%, with longer maturity, representing quality sources for long term placements, and have made a significant contribution to maturity adjustment between assets and liabilities. On the other hand, majority structure of deposits is considerably unfavorable, although it has been some time of improving trend.

- in 000 KM-

DEPOSITS	31.12.2006.		31.12.2007.		30.06.2008.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Savings and demand deposits	4.079.002	48,7	4.747.689	46,6	4.572.578	43,2	116	96
Up to 3 months	293.735	3,5	430.784	4,2	514.749	4,9	147	119
Up to 1 year	742.994	8,9	1.045.768	10,3	1.153.683	10,9	141	110
1. Total S-T	5.115.731	61,1	6.224.241	61,1	6.241.010	59,0	122	100
Up to 3 years	2.212.076	26,4	2.722.927	26,7	2.911.901	27,6	123	107
Over 3 years	1.051.515	12,5	1.243.809	12,2	1.419.193	13,4	118	114
2. Total L-T	3.263.591	38,9	3.966.736	38,9	4.331.094	41,0	122	109
TOTAL (1 + 2)	8.379.322	100,0	10.190.977	100,0	10.572.104	100,0	122	104

Analysis of maturity structure of deposits in two main groups, if compared to 2007, indicates minor positive changes, that is, decreased participation of short term deposits by 2,1% and increased participation of long term deposits by the same percentage, so their participation was 59% and 41% at the end of the first six months of 2008.

²⁶ Subordinated debts: borrowings and permanent liabilities

Within short term deposits, if compared to 2007, nominal downfall of KM 175 million or 4% was realized by demand deposits, which at the same time had the highest participation of 43,2% in total deposits, while deposits up to three months increased by KM 84 million or 19%, and deposits up to one year increased by KM 108 million or 10%. The highest participation in total demand deposits is still maintained by citizen deposits (39,7%) that have increased by 4% or KM 70 million in comparison to 2007.

We should emphasize that in long term deposits, there are two sectors with dominant participation: citizens of 46,4% and banking institutions of 28,7%, with a slight trend of increase in their participation in the first six months of 2008 (from 25,6% to 28,7%). Citizen deposits represent the highest participation of 58,8% in term deposits up to 3 years (62% at the end of 2007), while banking institutions deposits have the highest participation of 65,4% over three years (64,4% at the end of 2007).

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

-in 000 KM-

Table 31: Maturity structure of loans

LOANS	31.12.2006.		31.12.2007.		30.06.2008.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Past due claims and paid off-balance sheet liabilities	210.852	3,1	214.223	2,4	203.533	2,0	102	95
Short term loans	1.360.381	19,9	1.719.297	19,4	2.165.364	21,4	126	126
Long term loans	5.248.921	77,0	6.941.464	78,2	7.762.819	76,6	132	112
TOTAL LOANS	6.820.154	100,0	8.874.984	100,0	10.131.716	100,0	130	114

In the observing period of 2008, long term loans increased by 12% or KM 821 million (loans originated to citizens represent 61,4% or KM 504 million), while short term loans increased by 26% or KM 446 million (loans originated to private companies represent 83% or KM 371 million).

Analysis of sectors by maturity, for the two main sectors, indicates that long term loans represent 92% of total loans originated to citizens and 61,4% of loans originated to private companies.

In the assets structure, loans, as the most significant category, still have the highest participation of 68%, with constant increasing trend, which in the first six months of 2008 was relatively high of 14% or KM 1,26 billion that has been financed from deposit²⁷ and credit sources. Cash funds decreased by KM 513 million or 10%, as well as their participation from 34,5% to 29,4%.

²⁷ Decision on Changes and Amendments to Decision on Minimum Standards for Liquidity Risk Management of Banks („Official Gazette of the FBiH“, number 88/07) dated of 01.01.2008. sets the new percentages for maturity matching between financial assets and liabilities: at minimum 85% (it was 100% earlier) of sources with maturity up to 30 days engage in placements (assets instruments) with maturity up to 30 days; at minimum 80% (it was 100% earlier) of sources with maturity up to 90 days engage in placements (assets instruments) with maturity up to 90 days; and at minimum 75% (it was 95% earlier) of sources with maturity up to 180 days engage in placements (assets instruments) with maturity up to 180 days.

In 2008, banks were regularly meeting required reserves with the Central Bank of BiH. As of 01.01.2008., the required reserve has been increased to 18% (it was 15% from 01.12.2005. to 31.12.2007). Required reserve, as the most significant instrument of monetary policy in BiH under the Currency Board and relatively financially underdeveloped market, is the only instrument of monetary policy that is used to maintain a monetary control in sense of stopping fast credit growth from the past years and to decrease multiplications. On the other hand, implementation of regulation on foreign exchange risk and maintenance of currency adjustment within prescribed limits is also of significant influence on amount of funds banks keep on the reserve account with the Central Bank in domestic currency, which provides for high liquidity of individual banks and the banking sector.

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

- in % -

Table 32: Liquidity ratios			
Ratios	31.12.2006.	31.12.2007.	30.06.2008.
1	2	3	4
Liquid assets ²⁸ / Total assets	37,4	34,5	29,2
Liquid assets / Short term financial liabilities	62,2	58,1	51,0
Short term financial liabilities / Total financial liabilities	68,0	67,3	64,9
Loans / Deposits and borrowings ²⁹	69,6	73,7	80,8
Loans / Deposits, borrowings and subordinated debts ³⁰	68,5	72,2	79,1

Over the first six months of 2008, a trend of slight deterioration of general liquidity indicators quality has continued, primarily due to further growth of credit placements. If compared to 2007, almost all observed indicators have had a negative change between 5 and 7%. However, we could still say that liquidity position of the banking system of the Federation of BiH continues to be good, with satisfactory participation of liquid assets in total assets and coverage of short-term liabilities by liquid assets, while the changes in the first six months of 2008 indicate increased liquidity risk especially due to the present financial crisis in the world which has negatively reflected to the banking systems of some European countries, and banks in BiH are owned by large European banking groups, which offer significant financial support to our banks, through deposit and credit funds. Additional concern is the fact that positive changes in the real sector of the Federation of BiH are insignificant, that is, in the overall economic environment under which banks operate in BiH.

All banks continuously meet prescribed minimum over the average, requirement of ten-day average of 20% in relation to short-term sources, and daily minimum of 10% according to the same basis, which is presented in the following table.

²⁸ Liquidity assets in the narrow sense: cash and deposits and other financial assets with maturity below three months, except inter-banking deposits.

²⁹ Empiric standards: below 70%-very solid, 71%-75%-satisfactory, 76%-80%-marginal to satisfactory, 81%-85%-insufficient, over 85%-critical.

³⁰ Prior ratio has been modified. Subordinated debts are included in the sources, which gives more realistic indicator.

- in 000 KM-

Table 33: Liquidity position – ten-day average and daily minimum					
	31.12.2006.	31.12.2007.	30.06.2008.	RATIO	
	Amount	Amount	Amount	3/2	4/3
1	2	3	4	5	6
1. Average daily balance of cash assets	3.478.292	3.974.722	3.494.456	114	88
2. Minimum total daily balance of cash assets	3.201.670	3.686.972	3.289.788	115	89
3. Short term sources (accrual basis)	5.135.086	6.094.193	6.237.360	119	102
4. Liabilities:					
4.1. ten-day average 20% of Item 3	1.027.017	1.218.839	1.247.472	119	102
4.2. daily minimum 10% of Item 3	513.509	609.419	623.736	119	102
5. Meeting requirement :ten-day average					
Surplus = Item 1 – Item 4.1.	2.451.275	2.755.883	2.246.984	112	82
6. Meeting requirement :daily minimum					
Surplus = Item.2 – Item 4.2.	2.688.161	3.077.553	2.666.052	114	87

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

- in 000 KM -

Table 34: Maturity adjustment of financial assets and liabilities up to 180 days					
Description	31.12.2006.	31.12.2007.	30.06.2008.	RATIO	
	Amount	Amount	Amount	3/2	4/3
1	2	3	4	5	6
I. 1- 30 days					
1. Financial assets	5.111.643	5.678.451	5.231.757	111	92
2. Financial liabilities	4.626.466	5.291.774	5.364.556	114	101
3. Difference (+ or -) = 1-2	485.177	386.677	-132.799	80	
Accrual of requirement in %					
a) Performed %= Item 1 / Item 2	110,5%	107,3 %	97,5 %		
b) Required minimum %	100,0%	100,0%	85,0 %		
Surplus (+) or shortage (-) = a – b	10,5%	7,3%	12,5 %		
II. 1-90 days					
1. Financial assets	5.622.709	6.283.942	5.805.788	112	92
2. Financial liabilities	5.107.109	5.957.300	5.905.371	117	99
3. Difference (+ or -) = 1-2	515.600	326.642	-99.583	63	
Accrual of requirement in %					
a) Performed %= Item 1 / Item.2	110,1%	105,5%	98,3 %		
b) Required minimum %	100,0%	100,0%	80,0%		
Surplus (+) or shortage (-) = a – b	10,1%	5,5%	18,3 %		
III. 1-180 days					
1. Financial assets	6.245.949	7.032.175	6.755.197	113	96
2. Financial liabilities	5.662.698	6.861.962	6.773.078	121	99
3. Difference (+ or -) = 1-2	583.251	170.213	-17.881	29	
Accrual of requirement in %					
a) Performed %= Item 1 / Item.2	110,3%	102,5%	99,7 %		
b) Required minimum %	95,0%	95,0%	75,0 %		
Surplus (+) or shortage (-) = a – b	15,3%	7,5%	24,7 %		

Based on the above presented, we may conclude that as of 30.06.2008., banks were compliant with the prescribed limits, and have realized better maturity adjustment between financial assets and liabilities in relation to the prescribed limits.

Liquidity of the banking system of the Federation of BiH, based on the presented indicators, is satisfactory. Although it has been assessed in majority of banks that liquidity risk is low or medium, it is obvious that the risk trend is increasing. Since this segment of performance and

level of liquidity risk exposure is in correlation with credit risk, while having in mind the above stated, banks will in future have to pay more attention to liquidity risk management and establishment and implementation of liquidity policies, which will make sure that all matured liabilities of banks are timely realized, based on continuous planning of future liquidity needs and taking into account changes in operating, economic, regulatory and other segments of business environment of banks. The FBA will, both through reports and on-site examination in banks, monitor how banks manage this risk and if they acted in accordance with the adopted policies and programs.

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

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

In order to enable application and implementation of prudential principles in foreign exchange activities of banks and to decrease influence of foreign exchange risk to their profitability, liquidity and capital, the FBA has issued Decision on Minimum Standards for Foreign Exchange Risk Management³¹ in Banks that regulates minimum standards for adoption and implementation of programs, policies and procedures for undertaking, monitoring, control and management of foreign exchange risk, and restrictions prescribed for opened individual and total foreign exchange position (long or short), calculated in relation to the amount of bank's core capital.³²

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

Since the Central Bank functions as the Currency Board and EUR is anchor currency of the Currency Board, in practice banks are not exposed to foreign exchange risk in case of the most significant currency EUR.

According to the balance as of 30.06.2008., currency structure of banks' assets on the level of banking system recorded participation of items in foreign currencies of 12% or KM 1,8 billion (at the end of 2007, 15,6% or KM 2,2 billion). On the other hand, currency structure of liabilities is essentially different, since participation of liabilities in foreign currency is significantly higher of 55,6% or KM 8,3 billion (at the end of 2007, 53,9% or KM 7,6 billion).

The following table presents structure and trend of financial assets and liabilities and foreign currency position for EUR as the most significant currency³³ and total:

³¹ Official Gazette of the FBiH, numbers 3/03, 31/03, 64/03, 54/04.

³² Article 8 of Decision on Minimum Standards for Capital Management of Banks determines limits for individual foreign currency position in EUR up to 30% of core capital, for other currencies up to 20% and foreign currency of bank up to 30%.

³³ Source: Form 5-Foreign currency position.

-in KM millions-

Table 35: Foreign currency adjustment of financial assets and liabilities (EUR and total)										
Description	31.12.2007.				30.06.2008.				RATIO	
	EURO		TOTAL		EURO		TOTAL		EURO	TOTAL
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	6/2	8/4
1	2	3	4	5	6	7	8	9	10	11
<i>I. Financial assets</i>										
1. Cash assets	1.330	17,7	1.882	22,3	1.021	12,9	1.524	17,1	77	81
2. Loans	157	2,1	205	2,4	139	1,8	180	2,0	89	88
3.Loans with currency clause	5.910	78,9	6.233	73,8	6.681	84,5	7.085	79,7	113	114
4. Other	98	1,3	130	1,5	67	0,8	103	1,2	68	79
Total (1+2+3+4)	7.495	100,0	8.450	100,0	7.908	100,0	8.892	100,0	106	105
<i>II. Financial liabilities</i>										
1. Deposits	4.632	65,8	5.518	69,0	5.064	66,3	5.991	69,5	109	109
2. Borrowings	1.752	24,9	1.806	22,6	1.872	24,5	1.924	22,3	107	107
3.Deposits and loans with currency clause	341	4,8	341	4,3	340	4,5	340	3,9	100	100
4.Other	315	4,5	325	4,1	362	4,7	373	4,3	115	115
Total (1+2+3+4)	7.040	100,0	7.990	100,0	7.638	100,0	8.628	100,0	108	108
<i>III. Off-balance sheet</i>										
1.Assets	38		41		7		15			
2.Liabilities	429		431		312		313			
<i>IV.Position</i>										
Long (amount)	64		70							
%	4,8%		5,2%							
Short					35		34			
%					2,4%		2,3%			
Limit	30%		30%		30%		30%			
Below limit	25,2%		24,8%		27,6%		27,7%			

If we analyze the structure of foreign currencies, we see a dominant participation of EUR in the financial assets³⁴, although it was decreased in 2008 by 3,6 index points (from 71,5% to 67,9%) along with decrease of nominal amount from KM 1,6 billion to 1,2 billion. Participation of EUR in the liabilities has increased from 87,6% to 88%, that is, in nominal amount from KM 6,7 billion to KM 7,3 billion.

However, calculation of the FX risk exposure also includes the amount of indexed assets items (loans) and liabilities³⁵, which is especially important in the assets (79,7% or KM 7,1 billion) that has a continuous increasing trend, which is partially the result of the increase of foreign borrowings as financing source in bank's liabilities structure that is becoming more important. Other foreign currency assets items represent 20,3% or KM 1,8 billion, of which EUR items make 13,8% or KM 1,2 billion and other currencies of 6,5% or KM 0,6 billion (at the end of 2007, loans contracted with currency clause amounted to KM 6,2 billion with participation of 73,8%, and other items in EUR of 18,7% or KM 1,6 billion). Of total net loans (KM 9,8 billion) 73% were contracted with currency clause, primarily tied to EUR (94%).

On the other hand, the structure of financial liabilities stipulates and determines the structure of financial assets, for each currency respectively. Items in EUR (primarily deposits) had the highest participation in foreign currency liabilities (KM 8,6 billion) of 84,6% or KM 7,3 billion, while participation and amount of indexed liabilities was at minimum, amounting to 3,9% or

³⁴ Source: Form 5-Foreign currency position: portion of financial assets (in foreign currencies denominated in KM). According to the methodology, financial assets are expressed based on net principle (reduced by loan loss reserves).

³⁵ In order to protect from changes of the exchange rate banks contract certain items of assets (loans) and liabilities with currency clause (regulation allow only two-way currency clause).

KM 0,3 billion (at the end of 2006, participation of liabilities in EUR was 83,8% or KM 6,7 billion, and indexed liabilities were 4,3% or KM 0,3 billion).

Observed by banks and overall at the level of the banking system of the FBiH, we may conclude that foreign exchange risk exposure of banks and the system in the first six months of 2008 ranged within the prescribed limits. However, if compared to 2007, it has improved due to increase of core capital of 9%.

As of 30.06.2008., there were 12 banks with long foreign currency position, and 9 with short position, so at the system level long foreign currency position represented 2,3% of banks' core capital, which is lower by 27,7% than the limit. Individual foreign currency position for EUR was 2,4% where financial liabilities items were higher than financial assets (short position), which is lower by 27,6% than the limit.

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

III CONCLUSIONS AND RECCOMENDATIONS

Consolidation and stabilization of banking sector of the Federation of BiH has reached an enviable level and upcoming activities should provide for further progress and development of the system. This implies a continuous engagement of all parts of the system, legislative and executive authorities in order to provide for the most favorable environment in economy, which would be stimulating to both banks and the economy.

In the upcoming period, the Banking Agency of the Federation of BiH shall:

- Continue, as so far, implementing activities, from the scope of its authority, related to consolidation of supervision on state level,
- Proceed with a continues supervision of banks through on-site and off-site examinations, emphasizing targeted examination of dominant risk segments of banking operations, which will make supervision more effective and in that regard to:
 - Continue systematic monitoring of banks' activities in prevention of money laundering and terrorism financing and improve cooperation with other supervisory and examination institutions,
 - Persist on capital strengthening of banks, especially those recording outstanding assets growth,
 - Continue permanent monitoring of banks with the highest concentration of savings and other deposits in order to protect depositors,
 - Continue working on development of regulation based on the Basle Principles and European Directives as part of the BiH's preparation to join the European Union,
 - Maintain continuity in payment system examinations,
 - Establish and expand cooperation with home country supervisors of the investors present in the banking sector of the FBiH, and other countries in order to have more effective supervision,
 - Improve cooperation with the Banks Association in all banking performance segments, organization of counseling and professional assistance in the area of implementation of banking laws and regulations, etc.,

- Continuous operational development of the new IT system for early warning and prevention in eliminating weaknesses in banks,
- Finalize remaining provisional administrations and liquidations based on the conclusion made by the Management Board as of 29.03.2006.

It is also necessary to have further involvement of authorized institutions and bodies of Bosnia and Herzegovina and the Federation of BiH in order to:

- Realize the conclusion made by the Federation of BiH Parliament to establish banking supervision at the state level,
- Finalize privatization process of two state banks,
- Define and build on regulation for financial sector related to the activity, status and performance of micro-credit organizations, leasing companies, insurance companies, etc.,
- Accelerate implementation of economic reform in the real sector in order to reach the level of monetary and banking sector,
- Based on a documented material, specialized and professionally processed in the Banks Association of BiH, and through the Ministry of Finance of the Federation of BiH, it is necessary to accelerate the activities in order to:
 - Continuously build on legal regulation for banking sector and financial system based on Basle Principles and European Banking Directives,
 - Establish specialized court departments for economy,
 - Establish more efficient process for realization of pledges,
 - Adopt law on protection of creditors and full responsibility of debtors,
 - Adopt law or improve existing legislation regulating the area of safety and protection of money in banks and in transportation.

As the most important part of the system, banks have to concentrate their actions to:

- Further capital strengthening, proportional to the growth of assets and risks, higher profitability, solvency, more consistent implementation of adopted policies and procedures in the area of prevention of money laundering and terrorism financing, and safety and protection of money in banks and in transportation, in accordance with laws and regulations,
- Strengthen internal control systems and establish internal audits, which will be fully independent in their work,
- Constant improvement of cooperation with the Banks Association in the area of professional development, change all laws and regulations which have become a limiting factor in bank development, introduction of new products, collection of claims and active involvement in the establishment of unified registry of irregular debtors – legal entities and individuals;
- Regular and updated submission of data to the Central Loan Registry and Unified Central Account Registry with the Central Bank of BiH.

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