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

I N F O R M A T I O N

ON BANKING SYSTEM
OF THE FEDERATION OF BOSNIA AND HERZEGOVINA
AS OF DECEMBER 31, 2005

Sarajevo, March 2006

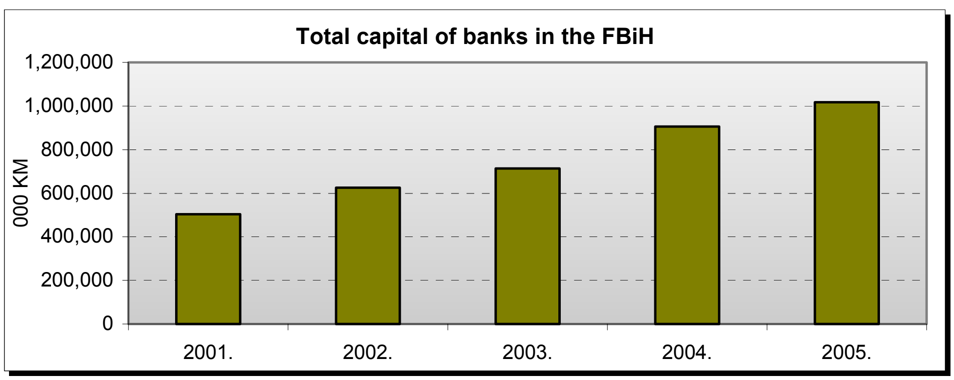
Banking Agency of the Federation of BiH, as a regulatory authority performing bank supervision, prepared Information on banking system of the Federation of BiH (as of December 31, 2005 according to the final non-audited data) based on reports of banks, and other information and data submitted by banks. We also included findings and data resulting from on-site examinations and analysis performed by the Agency (off-site financial analysis).

I. INTRODUCTION

Banking sector in the Federation of BiH has maintained and improved existing trends and characteristic of past years in all performance segments, which contributed to an improved stabilization and strengthening of the entire system. Trend of moderate growth continues; stability of the sector is strengthened, business indicators improved; new foreign investments are attracted; capital base is stronger; deposits and savings increased; credit portfolios enlarged; risks are controlled and reduced; management is enhanced; network of organizational units is expanded; new products are introduced; competition is fortified; higher level of working quality is achieved; international operating and supervision standards are applied. All of the mentioned resulted in better effectiveness and profitability of the entire system.

During 2005, the most significant changes could be summarized as growth and development of the system, positioning of banks in the market and intensified competition.

• ***Growth:*** At the end of 2001, there were 33 banks with the banking license issued in the F BiH, and at the end of 2005 there were 24 banks, the same as at the end of 2004. Inverted to this reduction, almost all other indicators increased in the observed period. Based on the analysis given by «the Banker», a respectable financial magazine from London, among 50 banks from the Central Europe, two banks from the F BiH recorded the fastest growth of capital, assets and income in period 2001, 2002 and 2003.



Positioning: For the last three years, the competition has intensified for purpose of better positioning in market positions among several largest banks, which caused further concentration and polarization in the system among «the large four» banks and other banks. At the end of 2005, four largest banks with assets of KM 6.5 billion take the market share of 69%. Deposits of the four largest banks represent 72% of total deposits, and loans represent 71% of total loans. Although there are smaller oscillations, we could say that the largest banks reached the targeted market shares. In addition, there is a continued trend of growth in participation of foreign capital in share capital, which for the last three years has increased from 66.7% or KM 361 million (at the end of 2002) to 70.2% or KM 561 million at the end of 2005. At the same time, participation of domestic private capital decreased from 20.5% to 12.9%, while state capital increased from 12.8% to 16.9%, which is primarily a result of additional capitalization made by Investment Bank of the FBiH. If we compare the same indicators to other countries, we find that at the end of 2004 participation of foreign capital in Slovakia is 89.6%, in Croatia

is 91.5%, in Czech Republic is 83.1%, in Bulgaria is 74.3%, in Hungary is 80.4%, in Romania is 69.3%, in Macedonia is 47.6%, and in Slovenia is 32.3%[1].
In 2005, foreign investors (banking groups) purchased two banks of majority domestic private ownership, so there is now total of 12 banks in majority foreign ownership, six banks with majority domestic private capital, and six banks are still majority state owned. Observed from the aspect of assets size, banks with full or predominant foreign ownership had 75.8% of total banking assets at the end of 2002, and at the end of 2005, they had 89% of total KM 9.4 billion of assets.

There are eight banks in the FBiH with full foreign ownership with KM 410.5 million of capital. In four banks, foreign capital is majority owned (KM 124 million), and in seven banks the foreign participation is between 0.1 and 43% with total amount of KM 26.5 million.

• ***Competition:*** Stabilization of the sector and its segments and strengthening of safety and soundness of banking institutions, resolution of internal weaknesses and staff and organizational improvement, resulted in more competition in the market. Especially emphasized is the competition for attraction and taking over of good quality customers, which banks mainly accomplish through interest rate policy (favorable loan interest rates), and through type and quality of their services. Banks in foreign ownership are in more favorable position, since they have access to financial markets and are able to obtain borrowings, along with obvious financial support that they receive from their «parent banks» or the group members through deposits. At the end of 2005, banks reported liabilities for borrowings of KM 1,153 million, which is twice as much as at the end of 2003. In order to improve capital adequacy, banks used portion of borrowings as subordinated debts, which at the end of 2005 amounted to KM 132 million, which is also twice as much as at the end of 2003. Most of their borrowings banks use for long-term placements in order to make maturity adjustment between sources and placements. Two banks received a significant financial «injection» from their «parent banks» in form of long term deposits, which at the end of 2005 amounted to KM 887 million. In order to attract customers, banks offer new products, such as issuance of cards or loans without guarantors, electronic banking, earmarked savings, housing loans, etc. They encourage massive use of credit and debit cards as non-cash payment. Banks invest significant efforts and funds to improve this segment of their services. Only during last year they installed 100 new ATMs, so there are total of 322 ATMs. At the same time, number of POS terminals increased by 2,012, so it is possible to make payments for goods at 7,826 POS Terminals.

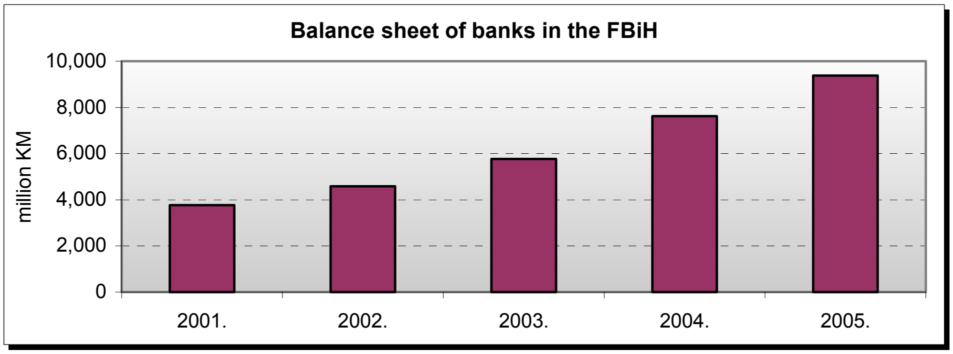
Banks have recognized and expressed their interest in the segment of credit support to small customers and in that way have expanded their business operations towards microcredit organizations, so the five largest banks with their credit funds already entered the microcredit organizations.

Balance sheet

According to final non-audited data, aggregate amount of the balance sheet of banks in the Federation of BiH was KM 9.4 billion as of 12/31/2005. In comparison to previous year, it represents growth of 23% or KM 1.8 billion.

In last five years, that is, in period from beginning of 2001 to the end of 2005, the aggregate amount of the balance sheet increased by four times. Thanks to this growth, for the first time one of our banks took 41st position among the 100 biggest banks in the Central and Eastern Europe.

[1] Data source: BSCEE Review 2004 (BSCEE: Bank Supervisors of Central and Eastern Europe).



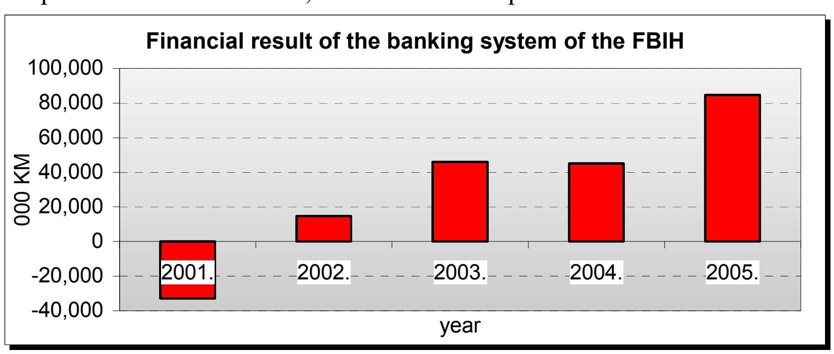
Balance sheet, that is, amount of assets is once again getting close to common European standard. However, commonly used indicator of the banking system's strength is ratio between assets and GDP. In developed countries bank assets are twice or more higher then GDP. In transition countries, the ratios are more moderate. According to these criteria, banking sector of the Federation of BiH has a solid result, since in 2005 the assets reached approximately 95% of the estimated GDP for the FBiH.

The growth of the aggregate balance sheet resulted from growth of deposits by KM 1.3 billion or 23%, borrowings of KM 302 million, which represents increase of 36% in comparison to 2004, and growth of capital by KM 112 million or 12%.

Total deposits, as major source of financial potential, reached KM 6.9 billion, and aggregate capital of banks exceeded one billion KM. In assets of banks, the most significant item are loans of KM 5.5 billion and cash assets of KM 3.5 billion.

Income statement

According to final non-audited data, the banking system reported profit of KM 60.9 million, which is higher by 34.7% or KM 15.7 million if compared to 2004. Out of this amount, 19 banks reported profit of KM 87 million, and five banks reported loss of KM 26.1 million.



In 2005, aggregate income was KM 593.1 million and it was higher by 21% than in 2004. As for the structure, net interest income continues to increase from 54.5% in 2004 to 57.2% in 2005. Unlike previous year, 2005 recorded faster growth of interest income on loans (29%) than growth of loan placements (25%). The main reason of this change is improved quality of loan portfolio by new sound loans and decreased poor quality placements not bearing income.

Two most significant indicators of profitability: ROAA (return on average assets) of 0.73% and ROAE (return on average equity) of 7.83% are better if compared to 2004, but they are still not in accordance with the feasible standards. These are the same indicators for 2004 in Slovakia of 1.21% and 29.03%, in Croatia of 1.68% and 16.05%, in Czech Republic of 1.26% and 23.4%, in Bulgaria of 2.06% and 20.02%, in Hungary of 1.97% and 23.4%, in Romania of 2.04% and 15.58%, in Macedonia of 1.1% and 6.2%, and in Slovenia of 1.05% and 13.34%.

II. TRANSITION OF THE BANKING SYSTEM

Reform process, transformation, rehabilitation and consolidation of the banking system in the Federation of BiH are reaching its final stage. It is necessary to emphasize that it was completed without any investments of public revenues. Based on some estimations, other transition countries allocated significant funds for above-mentioned purpose: in Croatia 27%, in Czech Republic 25%, Hungary 13% and in Poland 8% of respective GDP.

Banking system has a leading position in the financial sector of the Federation of BiH; therefore stability of the system is important for the overall economic development. A decade after the war, we can make conclusion that consolidation process of the banking system has reached its end:

- majority of problems inherited from previous system and induced by the war were eliminated,
- three fourths of total number of banks are privately owned now, and they hold 95% of the banking system assets,
- we are expecting finalization of privatization process in remaining banks owned by the state by the end of 2006,
- foreign investors own 70.2% of share capital in the system,
- entrance of foreign investors introduced more competition, contemporary know-how, new banking products,
- capital base in banks was strengthened, efficiency and effectiveness of banking operations were improved and they are closer to the international standards,
- international supervision standards were accepted and implemented, management of risks was improved etc.

Unfortunately, successful transformation of banking industry was not followed by changes in other sectors, especially in the core economy sector, which is essential for further development of banking. Slow recovery process of economy brings danger of multiple consequences, which will, if trends remain the same, affect banking as well.

The weakest link is privatization of state owned banks. There are still six banks in the system owned by the state, out of which the status of one bank (Investment Bank of the FBiH) will be solved when the new law becomes effective. Other state banks have been stagnating for last two or three years, because they were unable to catch up with changes in the market. It is the high time to finalize the process, through privatization, liquidation or bankruptcy of those banks.

1. RESTRUCTURING

It is indisputable that number of banks in the Federation of BiH will continue to decrease, although this process will be slowed down in comparison to the previous period. Two banks with the same owner are in process of integration, which will be finalized, sometime mid-2006, and there are some indications that foreign investors will come in two more banks.

If we observe size of assets, there were radical changes in the system. The list of banks, listed by size of assets, shows huge variety. Four banks own assets higher then a billion of KM, and the largest of them owns the assets of KM 2.5 billion, while on the other side there are eight banks in the Federation of BiH with the assets below KM 100 million.

2. BANKING AGENCY

Banking Agency of the F BiH extensively contributed to the banking system reform, although, often actions set up by the Agency were misunderstood. FBA, as an independent institution for supervision and licensing of banks, was founded at the end of 1996. From the very beginning the activities of the Agency were designed to create strong and stable banking system, market oriented and complied with the international business and supervision standards in banks. The Law on Banking Agency established main duties of the Agency which, in short, are licensing banks for inception and operations, passing regulations, supervising banks and undertaking actions as regulated by the Law (this includes provisional administration and liquidation in banks or initiation of bankruptcy). According to the assessments made by both domestic and foreign experts, the FBA has in past 10 years reached the level of high proficiency, with the employees that have the best expertise in the area of supervision gained through many educations in country and abroad.

As the main objective of the Agency is to protect money and interests of depositors, since its establishment to the end of 2005 the FBA has initiated measures (provisional administration, liquidation or bankruptcy) in 25 banks. Provisional administration was initiated in 23 banks. Bankruptcy process without prior provisional administration was initiated in one bank, and liquidation process was initiated also in one bank (which was finalized through payout of liabilities towards creditors and shareholders). In one bank, provisional administration was initiated based on the order issued by the High Representative of BiH.
Out of those banks in which provisional administration was initiated:

- Four banks were merged to other banks,
- Bankruptcy process was initiated in six banks. According to the information available to the FBA, this process was finalized in one bank, and in other five it is ongoing.
- Liquidation process was initiated in eight banks. Liquidation process was finalized in four banks (in three banks all liabilities were paid out to creditors and shareholders and one bank was sold).
- Provisional administration process is ongoing in five banks (in one bank provisional administration was initiated upon order issued by the High Representative of BiH, and in four banks provisional administration was initiated by the FBA).

Out of 25 banks in which the measures were undertaken, the process was finalized in 10 banks. In one bank bankruptcy process was finalized, and four banks were merged to other banks, one bank was sold, and in four banks all liabilities were paid out to creditors and shareholders. There are 15 banks under the measures. Bankruptcy process is ongoing (with authorized Canton courts) in six banks, liquidation process is ongoing in four banks, and provisional administration is ongoing in five banks.

3. PAYMENT SYSTEM

During 2005, banks have continued successfully performing internal payment system, as one of the most complex and most significant reform changes.

According to the information received from the Central Bank of BiH for 2005, banks in the Federation of BiH performed total of 42 million of transactions in total value of KM 59.5 billion.

Out of that, 27.7 million were inter-bank-transactions with total value of KM 32.9 billion, and they also performed 14 million of intra-bank-transactions with total value of KM 26.6 billion. Therefore, out of total number, 66.4% were inter-bank-transactions, and 33.6% were intra-bank-transactions. Based on the value, 55.3% were inter-bank-transactions, and 44.7% were intra-bank-transactions.

For the whole Bosnia and Herzegovina, banks in the Federation of BiH performed 73% of all inter-bank-transactions and 61% of intra-bank-transactions. Based on the value, banks in the Federation of BiH performed 62% of inter-bank-transfers and 74% of intra-bank-transfers of the whole payment system of BiH.

Individual participation of banks in the payment system transactions in the Federation of BiH ranges between 0.02 and 10.52 by number and between 0.13 and 13.91 by value of transactions performed.

4. PREVENTION OF MONEY LAUNDERING AND TERRORISM FINANCING

Full scope and targeted examinations and reviews of the reports submitted by banks to the Agency indicated that banks adopted minimum standards for prevention of money laundering and terrorism financing and passed policies as regulated by the Decision on Minimum Standards for Prevention of Money Laundering and Terrorism Financing in Banks. As it is regulated by the Decision, banks passed Programs for Implementation of Activities for Prevention of Money Laundering and Terrorism Financing with the following obligatory segments:

- Customer Acceptance Policy,
- Customer Identification Policy,
- Policy on Continuous Monitoring of Accounts and Transactions,
- Policy on Management of Money Laundering and Terrorism Financing Risk.

Banks also appointed coordinators for compliance of bank's activities with the requirements for anti-money laundering and terrorism financing activities, and, in order to increase competence and efficiency of staff, prepared comprehensive guidelines, including laws and regulations which set up prevention of money laundering and terrorism financing. In order to eliminate operational risks, subsequent from money laundering and terrorism financing (reputation risk, operational risk, legal risk, assets and deposits concentration risk) numerous banks paid special attention to those risks and established sections in its organizational structure with the main task being compliance of bank's operations to the above mentioned regulations. As direct result of the activities undertaken, we can conclude that quality of management of those risks in the banking sector of the Federation of Bosnia and Herzegovina has an increasing trend, along with maintaining the quantity of the risk within moderate level.

In general, implementation of the adopted policies is the following:

Customer Acceptance Policy: Customer acceptance criteria have been defined, and banks have organized special customer profile registries, which in some banks require additional development.

Customer Identification Policy: Banks have adopted customer identification as core element of the «know your customer» standard. Banks apply customer identification policy in process of establishment of business relationships with customers. However, banks are still facing the issue of documentation updating that is used as support documentation for establishment of those relationships with already established business relationships.

Policy on Continuous Monitoring of Accounts and Transactions: Implementation of this Policy has started more effectively and there is less of formal monitoring of customer accounts and transactions, that is, there is less of «malicious» compliance of banks' performance. In order to arrive at more effective monitoring of customer accounts and transactions, based on implementation of know your customer policy, banks created lists of customers whose transactions of KM 30,000.00 or more are excluded from reporting requirement, which should result in reporting on customers with suspicious transactions.

Policy on Management of Money Laundering and Terrorism Financing Risk: Elements of the mentioned Policy are defined in the programs prepared by banks. Reporting lines, both external and internal, are defined. In 2005, banks reported 159,968 transactions, which is higher by 20% in comparison to previous year, and it represents 0.38% of total transactions performed in the banking system of the Federation of Bosnia and Herzegovina (41,668,841 transactions performed) of KM 7,237,201,772.00, which is less by 3% in comparison to previous year and it makes 12.15% of total value of the transactions performed in the banking system of the Federation of Bosnia and Herzegovina (KM 59,541,851,547.00). Banks reported 72 transfers before they were executed, which is less by 70% in comparison to previous year and it makes 0.05% of total reported transfers of KM 54,554,084.00, which is higher by 427% in comparison to previous year, and it represents 0.75% of total value of reported transfers in this year. Majority of the reported transfers were transfers, which banks reported upon their execution, within regulated time line. The number of those transfers was 158,411, which is higher by 23% in comparison to previous year, and it represents 99% of total number of reported transfers in this year of KM 7,103,951,090.00, which is less by 3% in comparison to previous year and it makes 98.15% of total value of reported transfers. Banks also reported on transfers after the regulated time line for reporting. There were 1,485 transfers of that kind, which is less by 60% in comparison to previous year, and it represents 0.95% of total number of reported transfers in this year of KM 78,696,598.00, which is less by 20% in comparison to previous year, and it represents 1.10% of total value of reported transfers. The data regarding number and value of transfers reported before execution indicates decrease in quantity of risk, and the data on number and value of transfers reported after the regulated time line for reporting indicates increase in quality of management of money laundering and terrorism financing risk. Other indicators from banks reports (number and value of transfers: stopped by Financial Police, executed after approval of Financial Police, executed after deadline of 5 days, without request for additional information) also confirm the assessment of risk quantity and risk management quality. Training of staff, as significant element of policy for managing money laundering and terrorism financing risks, has become a continuous process in the banking system, as regulated by the Decision.

Based on the above, we can conclude that quantity of money laundering and terrorism financing risk in the banking system has a decreasing trend and it is moderate, and quality of management over this risk has an increasing trend and it is satisfactory. Hence, there is no reason to have any supervisory concern for the banking system of the Federation of Bosnia and Herzegovina in the area of exposure to the risks coming from money laundering and terrorism financing.

5. BANKING SUPERVISION

Based on the need of the overall macroeconomic and financial stability, the Basle Supervision Committee adopted twenty-five core principles in 1997, which have to be respected in order to have efficient supervisory system within banking.

The core principles are minimum requirements to be implemented and in many cases it is necessary to supplement them with other measures in order to comply with specific conditions and regulate risks of financial systems in respective countries. The principles regulate preconditions for effective bank supervision, licensing, prudential regulations and requirements, methods for continuing supervision of banks, necessary information, official authorization of supervisors and cross-border banking with other countries.

Legal and regulatory framework for banking operations in the Federation of BiH is consistent with the international standards. The Law on Changes and Amendments to the Law on Banks that was passed in August 2002 provides in Article 69 that "The regulations passed by the Agency… are based on the core principles for bank supervision as regulated by the Basle Committee for Bank Supervision." The FBA is fully in compliance with this standard in process of preparation and adoption of regulations implemented from the beginning of 2003. The regulations also include some of the standards from the European Banking Directives.

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 12/31/2005, there were 24 banks[2] with the banking license issued in the Federation of BiH. Number of banks remained the same as of 31. 12. 2004.

As of 12/31/2005, there were five banks under provisional administration (UNA Bank d.d Bihać, Hercegovačka Bank d.d. Mostar, Ljubljanska Bank d.d. Sarajevo, Poštanska Bank BiH d.d. Sarajevo and Privredna Bank d.d. Sarajevo).

In 2005, banks tried to continue expanding the network of their organizational parts. Banks in the Federation of BiH have founded 41 new organizational parts, out of which six are in RS. In comparison to 12/31/04, when banks constituted of 439 organizational parts, this represents an increase of 9.3%.

As of 12/31/05, 11 banks from the Federation of BiH had 27 organizational parts in Republic of Srpska and 11 in Brčko District. In comparison to the 12/31/04, number of organizational parts from Republic Srpska in the Federation of BiH increased from 9 to 17, that is, three banks from Republic Srpska had 17 organizational parts in the Federation of BiH.

The license for inter-bank-transactions in internal payment system was issued to all banks as of 12/31/05. There were 15 banks with deposit insurance.

[2] Starting form 09/30/04, financial results include information from Hercegovačka Bank d.d. Mostar (in period from April 2001 when Provisional Administrator was instituted in Hercegovačka Bank until 09/30/04 information for the whole banking system did not include results from this bank).

1.2. Ownership structure

As of 12/31/2005, ownership structure in banks[3] was assessed based on the available information and on-site visits to banks[4], which is the following:

- Private and majority private ownership 18 banks (75%)
- State and majority state ownership 6 banks (25%)

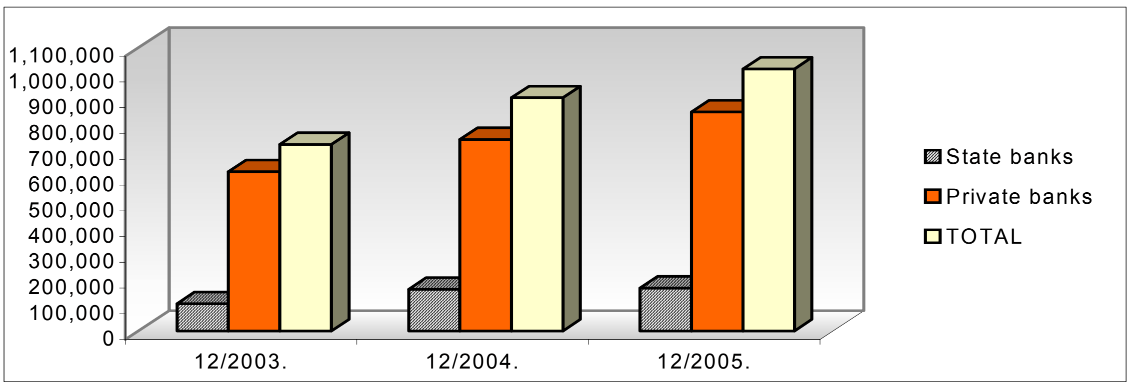
Ownership structure can be observed from aspect of financial results, which is by the value of total capital[5].

Table 1: *Ownership structure by total capital*

-in 000 KM-

BANKS	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
							3/2	4/3
1	2		3		4		5	6
State banks	106.105	15%	161.915	18%	166.771	16%	153	103
Private banks	607.430	85%	743.495	82%	850.469	84%	123	114
TOTAL	713.535	100%	905.410	100%	1.017.240	100%	127	112

Graph 1: *Review of ownership structure (total capital)*



More detailed picture on ownership structure of banks in the Federation of BiH can be viewed from the analysis of participation of state, private and foreign capital in share capital of banks.

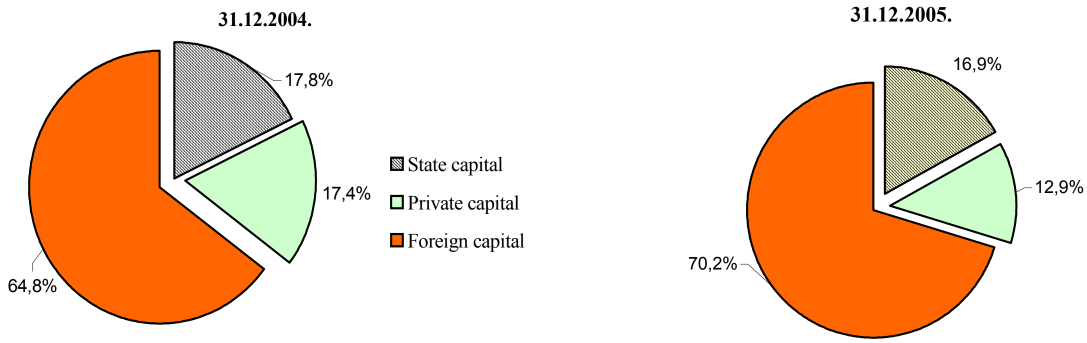
Table 2: *Ownership structure by participation of state, private and foreign capital*

- in 000 KM-

SHARE CAPITAL	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
	Amount	Particip. %	Amount	Particip. %	Amount	Particip. %	5/3	7/5
1	3	4	5	6	7	8	9	10
State capital	75.636	12,6	135.350	17,8	135.344	16,9	179	100
Private capital (residents)	115.411	19,2	132.785	17,4	103.026	12,9	115	78
Foreign capital (non-residents)	408.882	68,2	493.227	64,8	561.117	70,2	121	114
TOTAL	599.929	100,0	761.362	100,0	799.487	100,0	127	105

[3] Classification criteria of banks by type of ownership is ownership over share capital of banks.
[4] General overview of ownership structure of banks in the F BiH as of 12/31/05 resulted from received documentation, and registrations at authorized courts (changes in capital and shareholders structure).
[5] Information from balance sheet - FBA schedule: shareholders capital, premium issue, undistributed profit and reserves, and other capital (financial results of current period).

Graph 2: *Ownership structure (share capital)*



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

As of 12/31/2005, participation of state capital in total share capital of banks amounted to 16.9 % and it is less by 0.9% in comparison to 12/31/2004. Participation of remaining state capital in private banks is below 1%, that is, it amounts to KM 1.2 million.

If compared to 12/31/2004, participation of private capital (residents) in total capital of the banking sector has decreased from 17.4% to 12.9%, and participation of foreign capital has increased from 64.8% to 70.2%. Increase in participation of foreign capital of 5.4% is result of the following: additional capitalization of KM 47 million in five banks (three banks in foreign ownership, one bank with majority domestic capital and one state owned bank), ownership structure changes (two foreign banking groups purchased two banks that were majority domestic private owned), and sale of residents' shares (in four banks) to foreign buyers (nonresidents) in total value of approximately KM 7 million.

Changes in the ownership structure have also reflected through participation, that is, market share and positioning of banks that grouped based on the criteria of majority ownership in share capital. Market share of banks with majority foreign ownership increased by 9.5%, and as of 12/31/2005, it was 89%. Market share of banks with majority domestic private capital was 6.5%, and trend of further decrease of share of state banks continued and it was only 4.5%.

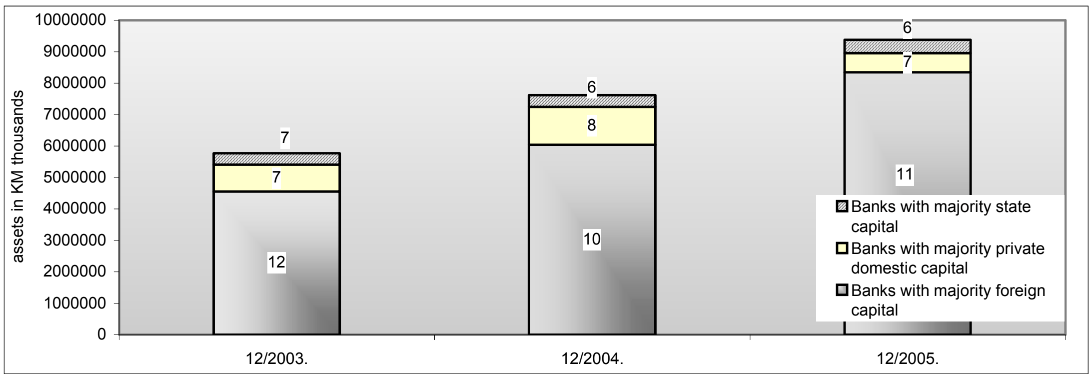
Integration process in past period have also been focused to stronger market positioning, which resulted by concentrations in the banking sector through growing of the largest banks, decreased number of banks, and intensified competition. There will be some changes in near future as a result of the current activities and related to the integration process of two banks.

Table 3: *Market share of banks by type of ownership*[6]

- in %-

BANKS	31.12.2003. No. of banks	31.12.2003. Partic. in total capital	31.12.2003. Partic. in total assets	31.12.2004. No. of banks	31.12.2004. Partic. in total capital	31.12.2004. Partic. in total assets	31.12.2005. No. of banks	31.12.2005. Partic. in total capital	31.12.2005. Partic. in total assets
1	2	2	3	7	5	6	10	8	9
Banks with majority state capital	7	14,9	6,4	6	17,9	4,9	6	16,4	4,5
Banks with majority private domestic capital	7	19,7	14,7	8	16,9	15,8	6	8,0	6,5
Banks with majority foreign capital	12	65,4	78,9	10	65,2	79,3	12	75,6	89,0
TOTAL	26	100,0	100,0	24	100,0	100,0	24	100,0	100,0

Graph 3: *Market share by type of ownership*



1.3. Staff

As of 12/31/05, there were total of 6,015 employees of banks in the Federation BiH. Out of total number, 8% worked in banks with majority state owned capital and 92% in private owned banks.

Table 4: *Employees of banks in the FBiH*

BANKS	NUMBER OF EMPLOYEES 31.12.2003.		31.12.2004.		31.12.2005.		RATIO 3:2	RATIO 4:3
1	2		3		4		5	6
State banks	549	10%	490	9%	475	8%	89	97
Private banks	4.845	90%	5.197	91%	5.540	92%	107	107
TOTAL	5.394	100%	5.687	100%	6.015	100%	105	106
Number of banks	26		24		24			

In 2005, number of employees increased by 6% or 328 employees, and it refers only to private banks.

[6] According to majority owned capital (participation over 50%).

Table 5 : *Qualification structure of employees*

EDUCATION	NUMBER OF EMPLOYEES			RATIO	
	31.12.2003.	31.12.2004.	31.12.2005.	3:2	4:3
1	2	3	4	5	6
University qualifications	1.847	2.016	2.165	109	107
Two-year post secondary school qualifications	546	596	642	109	108
Secondary school qualifications	2.825	2.962	3.102	105	105
Other	176	113	106	64	94
TOTAL	5.394	5.687	6.015	105	106

In 2005, banks continued implementing policy of hiring employees with university and two-year postsecondary school qualifications, although that did not have any significant reflection on the structure of qualifications, since employees with secondary school qualifications still have the highest participation of 52%.

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	31.12.2003.			31.12.2004.			31.12.2005.		
	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 owned	549	369.974	674	490	373.064	766	475	423.349	891
Private owned	4.845	5.402.076	1.115	5.197	7.240.166	1.393	5.540	8.956.242	1.616
TOTAL	5.394	5.772.050	1.070	5.687	7.613.230	1.339	6.015	9.379.591	1.559

At the end of 2005, there was KM 1.6 million of assets per an employee on the level of the banking system. This indicator is much better in the sector of private banks, which is to expect based on stagnation or decrease of business capacity of state banks and consequently excessive number of employees.

Table 7: *Assets per an employee by groups*

Assets (000 KM)	31.12.2003.	31.12.2004.	31.12.2005.
	Number of banks	Number of banks	Number of banks
Up to 500	9	7	5
500 to 1.000	5	5	7
1.000 to 1.500	8	4	3
1.500 to 2.000	3	7	3
Over 2.000	1	1	6
TOTAL	26	24	24

Analytical indicators of respective banks range from KM 168 thousand to KM 3.1 million of assets per employee. The indicator of nine banks is better than the one for the whole banking system, and the indicator of four largest banks of the system exceed the amount of KM 1.9 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 finance their customers, have improved.

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 capital[7].

2.1. Balance sheet

Aggregate balance sheet of banks in the Federation of BiH, according to the balance sheets submitted as of 12/31/2005, amounted to KM 9.4 billion, which is higher by 23% or KM 1.8 billion in comparison to 12/31/2004. Growth rate realized in 2005 is smaller by nine index points than in 2004, and the highest increase of 7% or KM 634 million was realized in the fourth quarter of 2005. Based on the mentioned indicators, we can conclude that moderate and stable trend of increase of the banking system continues.

[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 12/3172005, these items amounted to KM 680 million.

Table 8: *Balance sheet*

DESCRIPTION	AMOUNT (IN 000 KM)			RATIO	
	31.12.2003.	31.12.2004.	31.12.2005.	3/2	4/3
1	2	3	4	5	6
ASSETS:					
Cash assets	2.059.285	2.859.489	3.533.700	139	124
Securities	25.017	19.430	20.010	78	103
Placements to other banks	36.369	81.624	68.811	224	84
Loans- net value	3.238.270	4.184.579	5.285.193	129	126
Business premises and other fixed assets	304.680	299.189	307.029	98	103
Other assets	108.429	168.919	164.848	156	98
TOTAL ASSETS	**5.772.050**	**7.613.230**	**9.379.591**	**132**	**123**
LIABILITIES:					
LIABILITIES					
Deposits	4.292.709	5.602.238	6.864.048	131	123
Borrowings from other banks	3.779	3.329	2.912	88	87
Liabilities for borrowings	589.012	850.833	1.152.910	144	136
Other liabilities	173.015	251.420	342.481	145	136
CAPITAL					
Capital	713.535	905.410	1.017.240	127	112
TOTAL LIABILITIES (LIABILITIES AND CAPITAL)	**5.772.050**	**7.613.230**	**9.379.591**	**132**	**123**

Table 9: *Assets of banks by ownership structure*

BANKS	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
							3/2	4/3
1	2		3		4		5	6
State banks	369.974	6%	373.064	5%	423.349	5%	101	113
Private banks	5.402.076	94%	7.240.657	95%	8.956.242	95%	134	124
TOTAL	5.772.050	100%	7.613.721	100%	9.379.591	100%	132	123

Assets of banks with majority state owned capital were increased by 13% or KM 50 million, while private banks reported increase of 24% or KM 1.7 billion. Participation of both sectors remained the same as at the end of 2004.

Assets of five banks slightly decreased (four of which are under provisional administration), while most of banks (12 banks) reported moderate increase by the rates in range from 15% to 25%, and six banks reported growth rate higher of 25%, out of which three banks reported growth of approximately 46%. Since the four largest banks reported growth rate from 20% to 46.1%, that represents 75% or KM 1.3 billion of total growth in the balance sheet of the banking sector.

If the banking system is analyzed from the aspect of assets size and certain groups within this frame, changes in number of banks and participation of individual groups are the result of the assets growth of majority of banks.

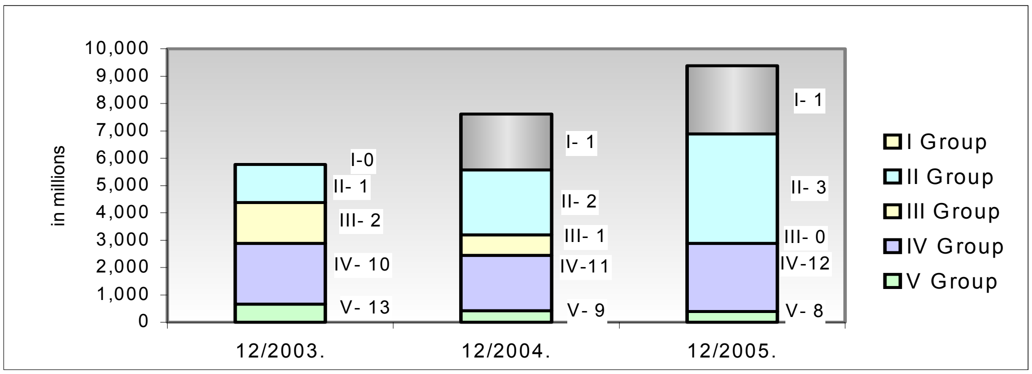
The following table presents amounts and participations of individual groups of banks[8] in total assets in time line (amounts in million KM):

[8] Banks are divided into five groups, depending on the assets size.

Table 10: *Participation of individual groups of banks in total assets through periods*

ASSETS	31.12.2003.			31.12.2004.			31.12.2005.		
	Amount	Particip %	No. of banks	Amount	Particip %	No. of banks	Amount	Particip %	No. of banks
I- Over 2.000	0	0,0	0	2.043	26,9	1	2.495	26,6	1
II- 1000 to 2000	1.395	24,2	1	2.382	31,3	2	3.996	42,6	3
III- 500 to 1000	1.487	25,8	2	741	9,7	1	0	0,0	0
IV- 100 to 500	2.238	38,7	10	2.036	26,7	11	2.504	26,7	12
V- Below 100	652	11,3	13	411	5,4	9	384	4,1	8
TOTAL	5.772	100,0	26	7.613	100,0	24	9.380	100,0	24

Graph 4: *Participation of individual groups of banks in total assets through periods*



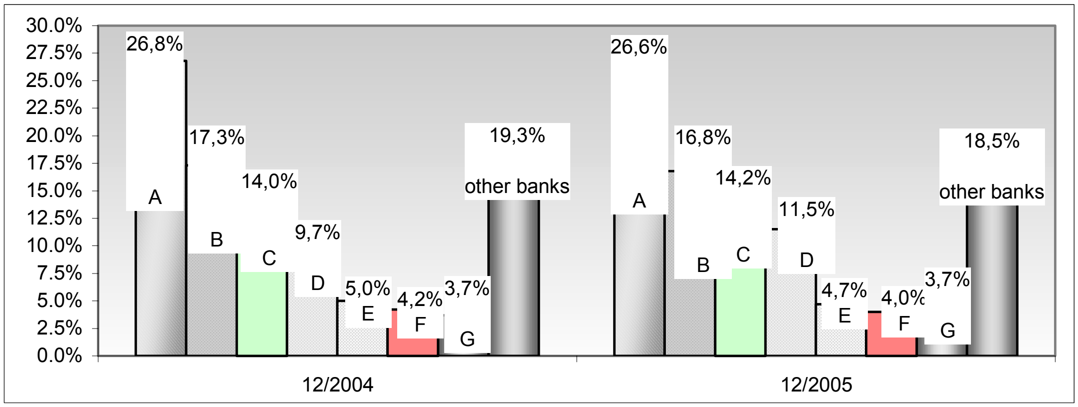
As a result of further growth of the largest banks in the system, one bank from Group III moved to Group II. Thus, as of 12/31/2005 three banks had assets between one and two billion KM, and one bank had assets over two billion KM. This resulted in increase of participation of the four largest banks in the system in comparison to the end of 2004 by 1.3%. There were some changes in the participation within this Group, which was caused by intensified competition and contend in the market among the banks of «the big four»

Majority of banks (12 banks in Group IV) have assets in range from KM 100 to 500 million (out of which nine banks have assets between KM 100 and 205 million, and three banks have assets between KM 345 and 440 million) with market share of 26.7%, which is the same as at the end of 2004, although number of banks increased by one. In the last group, Group V (eight banks), number of banks keeps going down, which is causing some decrease of their participation, amounting to only 4.1% at the end of 2005, which includes four banks with assets between KM 10 and 36 million.

Based on all indicators, we can conclude that in regard to market positioning there has been certain stagnation and reaching the level of planned participations, especially of the larger banks in the system. Further increase of participation could be expected from new integration processes (mergers and acquisitions) of both banks in the Federation of BiH (two banks with the same owner have started integration process, which should be finalized in the first six months of 2006), and banks in both entities of BiH that have the same owner (primarily owned by foreign financial institutions), which will probably happen next year.

The following graph shows structure and trend of participation of seven largest banks[9] in the banking system of the Federation of BiH:

Graph 5: *Participation of seven largest banks in total assets*



Growth of the aggregate balance sheet in sources is a result of growth in deposits (by 23% or KM 1.3 billion), borrowings (by 36% or KM 302 million), subordinated debts (by 57% or KM 48 million) and capital (by 12% or KM 112 million).

In the assets of banks, loans[10] increased by 25% or KM 1.1 billion, which is less by 3% than in 2004. Cash assets increased by 24% or KM 674 million.
The following table and graphs present structure of the most significant balance sheet assets and liabilities positions of banks through periods:

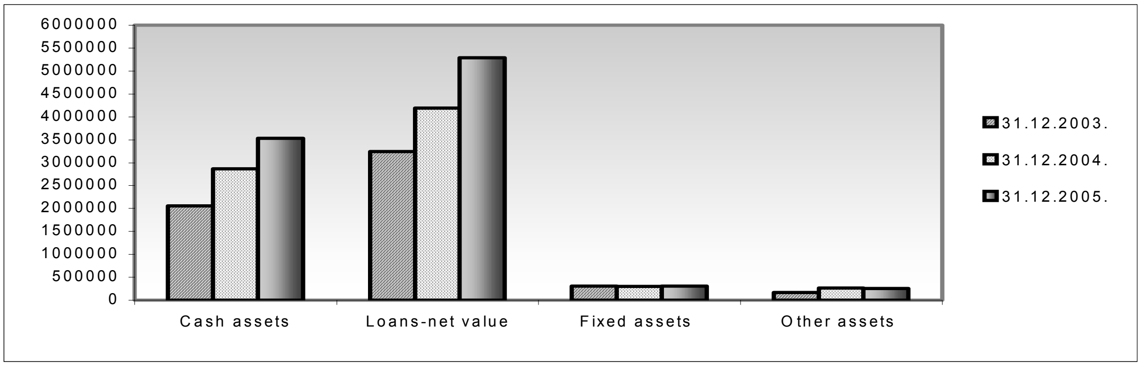
Table 11: *Structure of balance sheet of banks*

- in % -

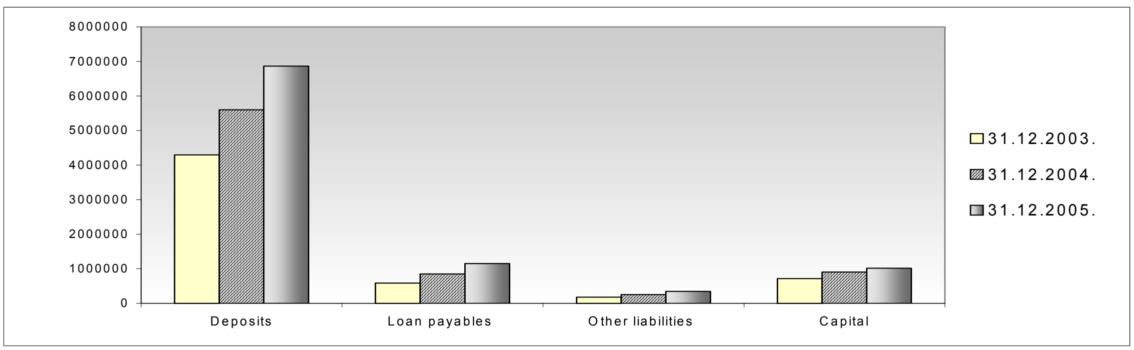
DESCRIPTION	PARTICIPATION		
	31.12.2003.	31.12.2004.	31.12.2005.
ASSETS:			
Cash assets	35,7	37,6	37,7
Securities	0,4	0,2	0,2
Placements to other banks	0,6	1,1	0,7
Loans- net value	56,1	55,0	56,3
Business premises and other fixed assets	5,3	3,9	3,3
Other assets	1,9	2,2	1,8
TOTAL ASSETS	100,0	100,0	100,0
LIABILITIES:			
LIABILITIES			
Deposits	74,4	73,6	73,2
Borrowings from other banks	0,1	0,1	0,0
Liabilities for borrowings	10,2	11,2	12,3
Other liabilities	2,9	3,2	3,7
CAPITAL			
Capital	12,4	11,9	10,8
TOTAL LIABILITIES (LIABILITIES AND CAPITAL)	100,0	100,0	100,0

[9] Banks are marked with letters from A to F.
[10] Gross loans (balance sheet data): short term, long term, past due claims, paid-called guarantees and claims from leasing operations.

Graph 6: *Structure of the balance sheet assets of banks*



Graph 7: *Structure of the balance sheet liabilities of banks*



Changes in the structure of balance sheet liabilities of banks from the aspect of participation of the most significant balance sheet categories in sources continued following the trend from previous periods. Participation of deposits keeps slightly decreasing, but the rate of 73.2% is still dominant. In 2005, we noted significant growth of liabilities for borrowings, which was reflected through increase of their participation from 11.2% to 12.3%. Participation of capital was decreased by 1.1%.

The most significant change in the assets structure is increase of participation of capital from 55% to 56.3%, while participation of cash assets increased from 37.7% by only 0.1% in comparison to 2004.

Table 12: *Cash assets of banks*

CASH ASSETS	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
	Amount	Particip %	Amount	Particip %	Amount	Particip %	4/2	6/4
1	2	3	4	5	6	7	8	9
Cash	189.599	9,2	215.543	7,5	231.874	6,6	114	108
Reserve accounts with CBBiH	719.621	35,0	1.177.935	41,2	1.679.194	47,5	164	143
Accounts with deposit institutions in BiH	4.168	0,2	47.798	1,7	24.241	0,7	1.147	51
Accounts with deposit institutions abroad	1.143.819	55,5	1.416.779	49,5	1.596.932	45,2	124	113
Cash assets in collection process	2.078	0,1	1.434	0,1	1.459	0,0	69	102
TOTAL	2.059.285	100,0	2.859.489	100,0	3.533.700	100,0	139	124

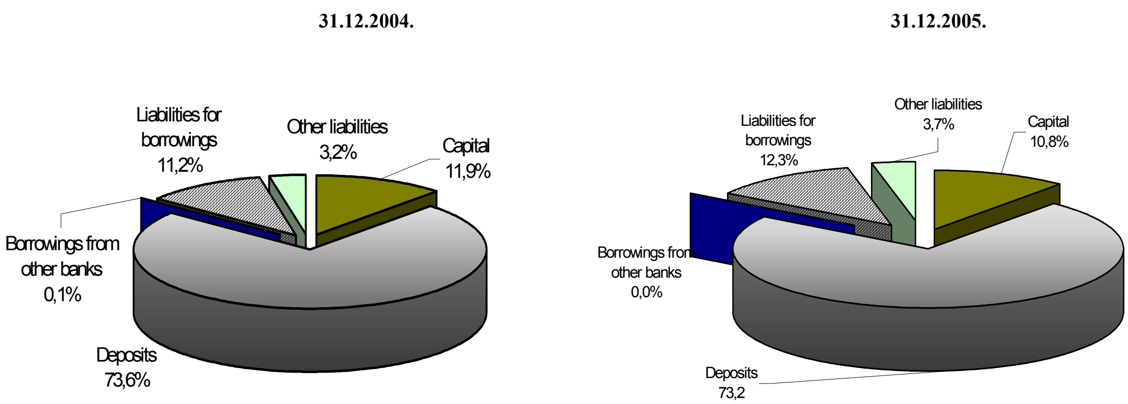
At the end of 2005, banks in the Federation of BiH maintained on the accounts of deposit institutions abroad the amount of KM 1.6 billion (most of it in EUR) or 45.2% of total cash assets, which is less by 4.3%, although the funds are nominally higher by 13% or KM 180 million in comparison to 2004. On the reserve accounts with the Central Bank of BiH, there is KM 1.7 billion or 47.5% of total cash assets, which is higher by 6.3% in comparison to the end of 2004. Banks held cash in vault and tellers of 6.6% or KM 232 million of cash assets.

The changes that happened in 2005 as those of further increase of deposits in domestic currency on the side of sources, increase of loan portfolio on the assets side, then existing regulation on bank exposure to foreign exchange risk and limitations to net open foreign currency position, and, as the most significant, changes of regulation on required reserves, that is, increase of required reserves provisioning in the second half of 2005, all resulted in decrease of participation in cash assets in foreign currencies. This has caused changes in the currency structure of cash assets and decrease of participation of funds in foreign currencies from 54% to 48%, that is, increase of participation of funds in domestic currency from 46% to 52%. This is the first time that domestic currency has higher participation than foreign currency.

2. 1. 1. Liabilities

As of 12/31/2005, structure of liabilities (liabilities and capital) in the balance sheet of banks is presented in the following graph:

Graph 8: *Liabilities structure of banks*



Trend of changes in the structure of liabilities from previous periods continued in 2005. Participation of deposits decreased by 0.4% and it represents 73.2%. At the same time, further increase of borrowings resulted in increase of their participation from 11.2% to 12.3%, while participation of capital decreased by 1.1% and it represents 10.8%.

In 2005, banks continued borrowing abroad. Five major creditors with 68% of total borrowings were: Raiffeisen Zentralbank Osterreich A.G. (RZB), European Bank for Reconstruction and Development (EBRD), Bank Polska OPIEKI, OEWAG Wien and Kreditanstalt fur Wiederaufbau (KfW).

In 2005, deposits increased by 23% or KM 1.3 billion, out of which the increase in third quarter was KM 454 million, and in fourth quarter the increase was KM 443 million. The same as earlier, the increase primarily comes from private bank sector.

Based on information reported by banks, out of total deposits only 4% were deposits collected by organizational parts of the banks from the Federation of BiH operating in Republic Srpska and Brcko District as of 12/31/05.

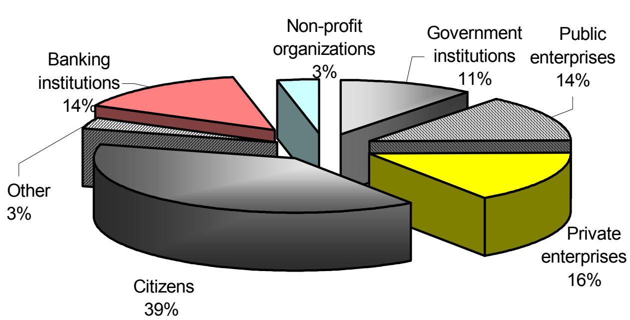
Table 13: *Deposit structure by sectors*[11]

- in 000 KM-

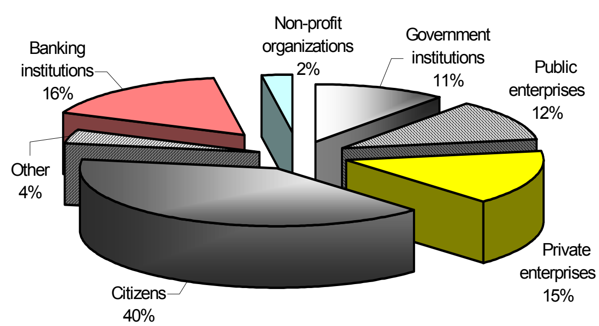
SECTORS	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Governmental institutions	498.132	11,6	599.060	10,7	733.881	10,7	120	123
Public enterprises	567.677	13,2	783.655	14,0	806.321	11,7	138	103
Private enterprises and assoc.	607.046	14,1	876.831	15,7	1.066.022	15,5	145	122
Non-profit. organizations	147.606	3,5	180.705	3,2	169.005	2,5	122	94
Banking institutions	557.166	13,0	808.112	14,4	1.102.161	16,1	145	136
Citizens	1.737.238	40,5	2.173.228	38,8	2.717.081	39,6	125	125
Other	177.844	4,1	180.647	3,2	269.577	3,9	102	149
TOTAL	4.292.709	100,0	5.602.238	100,0	6.864.048	100,0	131	123

Graph 9: *Deposit structure by sectors*

31.12.2004.



31.12.2005.



In 2005, analysis by sectors indicates that citizen deposits maintained the same rate of growth as in 2004 (25%), but they recorded the highest nominal growth of KM 544 million, along with increase in participation by 0.8%. Represented by rate of 36% or KM 294 million deposits of banking institutions recorded significant growth in 2005, which increased their participation by 1.7%. Almost the same rate of growth (23 % and 22%) was observed in deposits of government institutions and private enterprises, but nominal increase was KM 135 million, that is, KM 189 million, and participation was almost the same as at the end of 2004 (10.7% and 15.5%). Although deposits of public enterprises had a slight increase of 3%, their participation was decreased from 14% to 11.7%.

[11] Information from attached form BS-D submitted by banks each quarter with balance sheet - FBA format.

Currency structure of deposits remained almost the same as at the end of 2004. Out of total amount of deposits, 41.4% or KM 2,844 million were deposits in domestic currency, and 58.6% or KM 4,020 million were deposits in foreign currency, with dominant participation of EUR.

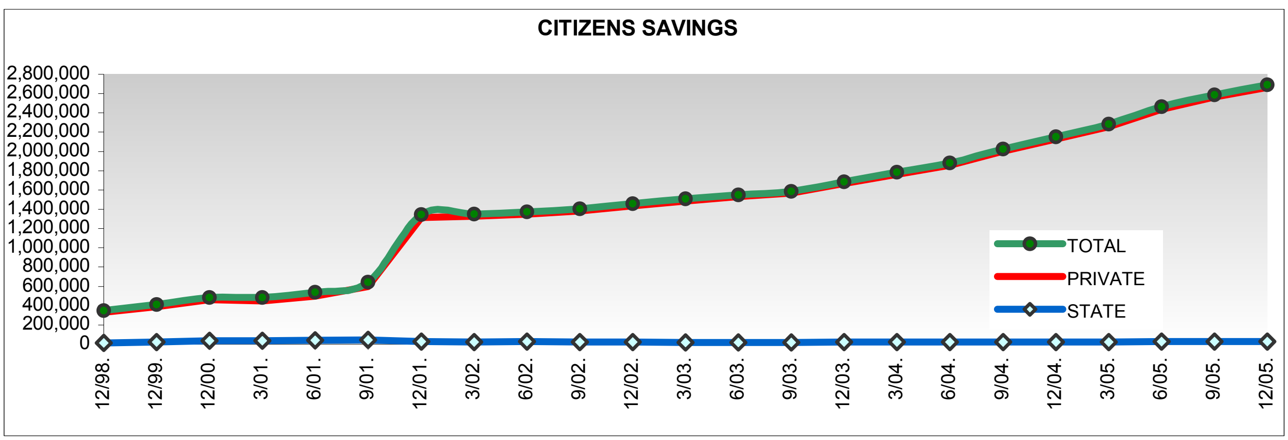
In 2005, saving deposits, as the most significant segment of both deposit and financial potential of banks, continued growing in a moderate and stable way, reaching the rate of 25% or KM 538 million. Only two banks showed that saving deposits slightly decreased, and remaining banks recorded increase of saving deposits. Majority of banks (14) reported increase in savings between 20% and 50%, and three banks showed rate of growth higher than 50%. However, 73% or KM 394 million of reported increase refers to four banks in the system.

Observed by sectors, almost all savings are held by private banks, that is, only 1.1% of total savings are held by five state banks.

Table 14: New citizen savings by periods - in 000 KM-

BANKS	AMOUNT (in 000 KM)			RATIO	
	31.12.2003.	**31.12.2004.**	**31.12.2005.**	**3/2**	**4/3**
1	3	3	4	5	6
State owned	20.758	22.342	26.886	108	120
Private owned	1.645.991	2.105.167	2.638.391	128	125
TOTAL	1.666.749	2.127.509	2.665.277	128	125

Graph 10: *New citizen savings by periods*



As in other segments, there is an obvious strong concentration of savings in larger banks, since four largest banks hold 76% of total savings.

Out of total savings, 29% are saving deposits in domestic currency, and 71% are saving deposits in foreign currency.

Table 15: *Maturity structure of citizen saving deposits by periods*

BANKS	AMOUNT (in 000 KM)						RATIO	
	31.12.2003.		**31.12.2004.**		**31.12.2005.**		**3/2**	**4/3**
1	3		3		4		5	6
S-T savings deposits	1.228.261	73,7%	1.360.285	63,9%	1.567.617	58,8%	111	115
L-T savings deposits	438.489	26,3%	767.224	36,1%	1.097.660	41,2%	175	143
TOTAL	1.666.749	100,0%	2.127.509	100,0%	2.665.277	100,0%	128	125

Maturity structure of saving deposits, as well as total deposits, showed a positive trend of changes, mainly due to a continuing improvement of the entire banking sector and strengthening of trust in banks, which resulted in faster growth of long term saving deposits. We should especially emphasize stability and high level of growth rate in long term saving deposits, consequently their participation already exceeded two fifth of total deposits.

Aside from activities initiated by FBA, growth of savings in banks of the FBiH resulted from deposit insurance system, which was founded in January 2001, immediately after the inception of the Deposit Insurance Agency of F BiH. The Law on Deposit Insurance in Banks of BiH was passed in August 2002 and shortly after that the Deposit Insurance Agency for BiH was founded. There was total of 15 banks from the Federation of BiH that became part of the deposit insurance program and received certificate on deposit insurance. Analytical data on level of deposits by banks indicate that in those banks there was 94% of total deposits and 97% of total savings. The admission of banks in the deposit insurance system for the Federation of BiH is entering the closing phase. Out of remaining nine banks, eight cannot apply for deposit insurance certificate, since they are not meeting the criteria prescribed by Deposits Insurance Agency: a reason for six state owned banks is ownership structure, and two private banks are under provisional administration. Safety of deposits is a guaranty and incentive for further growth of savings, not only in those banks, but also in all other banks.

2.1.2. Capital – strength and adequacy

As of 12/31/2005, capital[12] of banks in the FBiH amounted to KM 1,186 million.

Table 16: *Regulatory capital*

-in 000 KM-

DESCRIPTION	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
							3/2	4/3
1	2		3		4		5	6
STATE BANKS								
1. Core capital before reduction	122.937		163.061		166.737		133	102
2. Offsetting items	17.687		2.607		3.923		15	150
a) Core capital (1-2)	105.250	97%	160.454	98%	162.814	96%	152	102
b) Additional capital	3.061	3%	3.639	2%	7.107	4%	119	195
c) **Capital (a + b)**	108.311	100%	164.093	100%	169.921	100%	152	104
PRIVATE BANKS								
1. Core capital before reduction	584.221		744.519		828.196		127	111
2. Offsetting items	34.311		88.598		98.341		258	111
a) Core capital (1-2)	549.910	75%	655.921	75%	729.855	72%	119	111
b) Additional capital	183.681	25%	217.639	25%	286.672	28%	118	132
c) Capital (a + b)	733.591	100%	873.560	100%	1.016.527	100%	119	116
Total								
1. Core capital before reduction	707.158		907.580		994.933		128	110
2. Offsetting items	51.998		91.205		102.264		175	112
a) Core capital (1-2)	655.160	78%	816.375	79%	892.669	75%	125	109
b) Additional capital	186.742	22%	221.278	21%	293.779	25%	118	133
c) Capital (a + b)	841.902	100%	1.037.653	100%	1.186.448	100%	123	114

In 2005, capital[13] increased by 14% or KM 148.8 million in comparison to the end of 2004, out of which increase of core capital was KM 76.3 million, and of additional KM 72.5 million.

[12] Regulatory capital is defined by Article 8 and 9 in the Decision on Minimum Standards for Managing Capital

Growth of core capital is mainly caused by additional capitalization, that is, increase of share capital in four banks by KM 44.4 million, along with decrease of KM 8.6 million in two banks based on coverage of losses from previous years, then allocation of profit from 2004 to retained undistributed profit of KM 18.7 million and reserves of KM 23.8 million, and paid in issue premium in one bank for new issue of shares in the amount of KM 9.3 million.

Offsetting items (causing decrease of core capital) increased by KM 11 million, and the most significant changes were the following: coverage of uncovered losses from earlier years by KM 6.9 million (in five banks), increase of current losses of KM 14 million, and increase of intangible assets by KM 4.2 million.

Increase of additional capital of KM 72 million is primarily result of increase of subordinated debts of KM 48 million in three banks, increase of share capital in one state bank of KM 2.6 million and increase of general loan loss reserves of KM 24.6 million, while amount of non-audited current profit that was included in additional capital was less by KM 2.7 million than at the end of 2004[14].

The mentioned changes influenced the structure of regulatory capital, so participation of core capital was decreased from 79% to 75%, and additional capital was increased from 21% to 25%.

Growth of regulatory capital of 14% was positively reflected on net capital that in 2005 had the same rate of growth of 15% or KM 150.6 million, which amounted to KM 1,1 billion as of 12/31/2005.

Capitalization rate of banks, viewed as ratio between capital and assets, still has a slight trend of decrease and as of 12/31/2005 it was 12.3%, which is less by 0.9% than at the end of 2004. The main reason for such trend is the fact that increase of capital was not adequately followed by increase of assets.

One of the most significant indicators of capital strength and adequacy[15] of banks is capital adequacy ratio calculated as ratio between net capital and risk weighted assets. As of 12/31/2005, this ratio was 17.5% for the whole system, which is less by 1.1% in comparison to the end of 2004.

Observed on the sector level of state banks, the ratio was decreased from 59.1% (2004) to 57.2%, while there was a continuous slight decrease in private banks (from 16.5% at the end of 2004 to 15.7%).

While conducting supervision of operations and financial positions of banks in the F BiH as regulated by the Law, the FBA issued 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.

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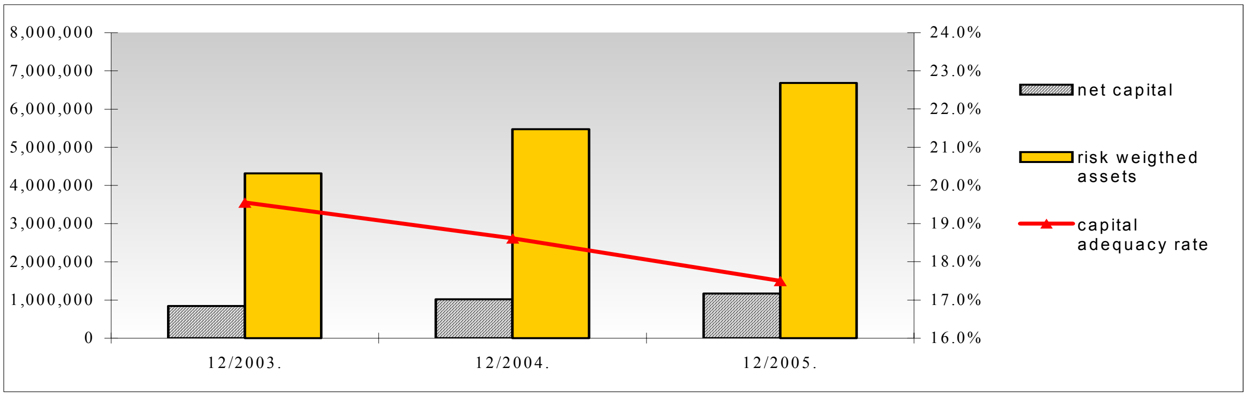
[13] Data source is quarterly Report on Capital Positions in Banks (Form 1-Schedule A) regulated by the Decision on Minimum Standards for Managing Capital in Banks.
[14] Profit for 2005 was audited in nine banks, while in other banks the audit is in process.
[15] The Law prescribes minimum capital adequacy rate of 12%.

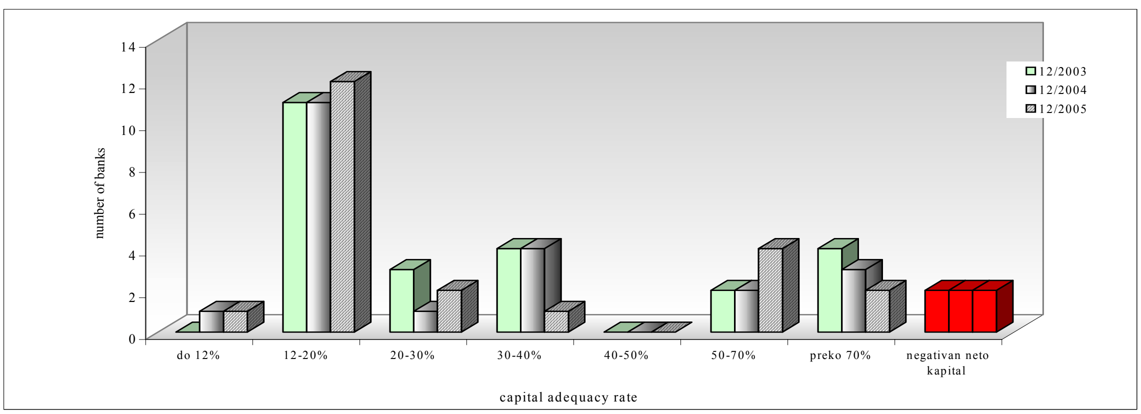
Table 17: *Net capital, risk weighted assets and capital adequacy rate*

DESCRIPTION	31.12.2003.	31.12.2004.	31.12.2005.	RATIO	
				3/2	4/3
1	2	3	4	5	6
NET CAPITAL	840.605	1.018.626	1.169.213	121	115
RISK WEIGTHED ASSETS AND CREDIT EQUIVALENTS	4.306.774	5.472.154	6.682.394	127	122
NET CAPITAL RATE (CAPITAL ADEQUACY)	19,5%	18,6%	17,5%	95	94

Graph 11: Net capital, risk weighted assets and capital adequacy rate



Graph 12: *Capital adequacy rate of banks*



There were 21 banks out of total of 24 banks in the FBiH, as of 12/31/2005, with capital adequacy ratio higher than minimum requirement of 12%. One bank had capital adequacy ratio below 12%, while two banks had negative capital adequacy. Those three banks are under provisional administration.

In majority of banks, we have noticed a continuous trend of slight decrease of capital adequacy ratio, although the number of banks by groups within the ranges given is not significantly changing. In the second, the largest group (ratio between 12% and 20%), number of banks increased from 11 to 12. Within this group, seven banks had the ratio between 12.3% and 15%. There are two banks in the next group (ratio between 20% and 30%), while number of banks with ratio between 31% and 40% is decreased from four to one. There were some changes in the remaining groups, resulting from downfall of adequacy ratio, which eventually resulted in decrease of ratio on the level of the banking system by 1.1% in comparison to 2004. However, although four largest banks by assets size have capital adequacy ratio somewhat higher than the minimum requirement (between 13.4% and 14.1%), we should mention that in order to have stronger capital base and capital adequacy three banks had additional capitalization, and two banks increased additional capital based on subordinated debt.

Any further increase of risk assets, and especially credit placements, will necessarily require adequate capital growth, therefore banks are obliged to adopt program for capital management and continuous monitoring of its implementation in order to assure and maintain capital quantities and qualities at least on the level of minimum standards prescribed.

Further strengthening of capital base will be priority task in majority of banks, especially in the largest banks in the system, which is necessary to strengthen stability and safety of both banks and the banking system. The FBA will take appropriate measures and issue decisions necessary to strengthen capital base in banks, which will guaranty their stability and safety.

2.1.3. Assets and asset quality

Decision on Minimum Standards for Loan Risk Management and Assets Classification of Banks (the Decision) determines 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.

Gross assets[16] of the balance sheet of banks in the FBiH, as of 12/31/2005, amounted to KM 9.7 billion, which is higher by 24% or KM 1.8 billion than at the end of 2004. Off-balance sheet risk items amounted to KM 1.4 billion and they increased by 33% or KM 344 million.

Total assets with off-balance sheet items (assets)[17] amounted to KM 11 billion, which is higher by 24% than at the end of 2004.

Table 18: *Assets, off-balance sheet items and potential loan losses* -in 000 KM-

DESCRIPTION	AMOUNT (in 000 KM)						RATIO	
	31.12.2003.	Struct. %	31.12.2004.	Struct. %	31.12.2005.	Struct. %	4:2	6:4
1.	2	3	4	5	6	7	8	9
Loans	3.272.569	54,5	4.208.295	53,5	5.326.900	55,0	129	127
Interests	26.395	0,4	29.856	0,4	37.537	0,4	113	126
Past due claims	171.821	2,9	209.218	2,7	214.274	2,3	122	102
Claims for paid guarantees	5.353	0,1	5.026	0,1	4.132	0,0	94	82
Other placements	50.906	0,9	40.811	0,4	23.950	0,2	80	59
Other assets	2.468.073	41,2	3.378.320	42,9	4.051.255	42,1	137	120
TOTAL ASSETS	5.995.117	100,0	7.871.526	100,0	9.658.048	100,0	131	124
OFF-BALANCE SHEET	749.382		1.046.809		1.391.183		140	133
ASSETS AND OFF-BALANCE SHEET	6.744.499		8.918.335		11.049.231		132	124
General loan risk and Potential loan losses	247.369		282.412		313.851		114	111
General and Special loan loss reserves already established	247.411		285.090		314.133		115	110

16 Data source: Report on classification of balance sheet assets and off-balance sheet items of banks.
17 Assets defined by Article 2 of Decision on Minimum Standards for Loan Risk Management and Assets Classification of Banks.

The amount of non-risk items, out of total assets with off-balance sheet items, was KM 3.9 billion or 35.8%, which is higher by 0.4% than at the end of 2004, which is primarily the result of increase of cash assets by 24.5% or KM 695 million and placements covered by deposits by 58% or KM 93 million.

Growth of credit placements (25%) caused changes in the structure of risk assets and increase of participation of credit placements from 58.1% to 59.1%, while participation of cash assets increased from 37.6% to 37.7%. Past due claims increased by 2%, while their participation in the assets structure decreased from 2.8% to 2.3%.

Analytical data by banks indicate that six banks (four under provisional administration) reported decrease of credit placements. Most of banks (nine) had rate of growth in credit placements between 15% and 30%, four banks had rate of growth higher than 30%, while other banks reported growth in range from 3% to 15%. Four largest banks in the FBiH increased credit placements by KM 873 million, which represented 78% of total increase on the level of the banking sector, which was also reflected on participation increase of those banks in total loans from 69% to 70.5%.
Based on the analysis of loan structure by sectors, we can see that placements to citizens recorded the highest increase of KM 644 million or 30%, which is why their participation in overall loan structure by sectors increased from 48.4% to 50.2%. According to the data submitted by banks as of 12/31/2005, from the aspect of citizen loan structure by purpose, the highest participation of approximately 73% had loans for financing consumer goods[18], 22% had housing loans, and remaining 5% had loans for SMEs and agriculture.

Significant growth of KM 513 million or 27% had placements to private enterprises and associations, along with increase of participation from 43.7% to 44.1%. Other sectors recorded smaller changes in both nominal and relative amount.

Four largest banks in the system originated loans to citizens of 74% of total loans originated to this sector, while the same indicator for the sector of private enterprises is 68%.

Changes in participation of individual sectors in overall structure of loans is presented in the following table:

Table 19: *Structure of loans by sectors*

-in 000 KM-

SECTORS	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
	Amount	Partic %	Amount	Partic %	Amount	Partic %	4/2	6/4
1	2	3	4	5	6	7	8	9
Government institutions	24.526	0,7	31.810	0,7	35.513	0,6	130	112
Public enterprises	217.587	6,3	203.698	4,6	188.143	3,4	94	92
Private enterprises and assoc.	1.439.009	41,7	1.933.595	43,7	2.446.591	44.1	134	127
Non-profit organizations	3.015	0,1	3.619	0,1	9.272	0,2	120	256
Banking institutions	33.281	1,0	34.082	0,8	33.123	0,5	102	97
Citizens	1.676.325	48,6	2.139.699	48,4	2.784.053	50,2	128	130
Other	55.999	1,6	76.036	1,7	48.611	1,0	136	64
TOTAL	3.449.742	100,0	4.422.539	100,0	5.545.306	100,0	128	125

[18] Including card 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 categories[19] and off-balance sheet items are presented in the following table:

Table 20: *Assets classification, general loan risk (GLR), potential loan losses (PLL) and off-balance sheet items (assets charged off and suspended interest)*

Classification category	AMOUNT (in 000 KM) AND PARTICIPATION (in %)									RATIO	
	31.12.2003.			31.12.2004.			31.12.2005.				
	Assets classif.	Partic. %	GLR PLL	Assets classif.	Partic. %	GLR PLL	Assets classif.	Partic. %	GLR PLL	5/2	8/5
1	2	3	4	5	6	7	8	9	10	11	12
A	5.881.803	87,2	70.974	7.880.830	88,4	94.501	9.901.365	89,6	118.884	134	126
B	563.498	8,4	46.657	730.737	8,2	53.633	831.166	7,5	62.517	130	114
C	152.581	2,3	44.593	143.586	1,6	42.104	157.515	1,4	41.954	94	110
D	139.311	2,0	77.839	162.299	1,8	91.294	159.151	1,5	90.465	117	98
E	7.306	0,1	7.306	883	0,0	880	34	0,0	31	12	4
TOTAL	6.744.499	100,0	247.369	8.918.335	100,0	282.412	11.049.231	100,0	313.851	132	124
OFF-BALANCE SHEET ITEMS											
E	341.166	79,8		343.472	83,3		385.366	87,6		101	112
Suspended interest	86.205	20,2		68.680	16,7		54.420	12,4		80	79
TOTAL	427.371	100,0		412.152	100,0		439.786	100,0		96	107

If we analyze quality of assets with off-balance sheet risk items, we see that there is increase of classified assets (B-E) by 11% or KM 110 million, with simultaneous increase of poor quality assets by 3% or KM 10 million. Further analysis of analytical data by sectors is based on the indicators of loan quality originated to two, the most significant sectors: citizens and private enterprises. Poor quality assets related to the placements originated to the sector of citizens have faster trend of increase (23%) and they amount to KM 77 million, which represents 2.8% of total loans originated to citizens (at the end of 2004, it was KM 62 million or 2.9% of total loans originated to citizens), while poor quality assets related to legal entities increased by only 1% and it amounts to KM 237 million or 8.6% of total loans originated to other sectors. This was expected, since lending to citizens after credit expansion in 2002 and following years has been intensified. Taking into account the presented trend, in the following period special attention will be directed to evaluation and changes in quality of those loans, and the activities banks will take to minimize adverse effects in this segment of loan portfolio and to improve their management practices.

In 2005, banks charged off from balance sheet to off-balance sheet, that is, they charged off claims of KM 82.7 million and suspended interest of KM 9.7 million. In the same period, there was permanent charge off of assets items of KM 13.8 million and suspended interest of KM 6.7 million. Banks succeeded in the same period to collect earlier charged off assets of KM

[19] As it is 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%.

31.2 million and suspended interest of KM 10.5 million, which positively reflected on their profitability.
At the end of 2005, balance of charged off assets was KM 385 million and it was higher by 12% than at the end of 2004, while balance of suspended interest was KM 54 million, which is less by 21% or KM 14 million than at the end of 2004.

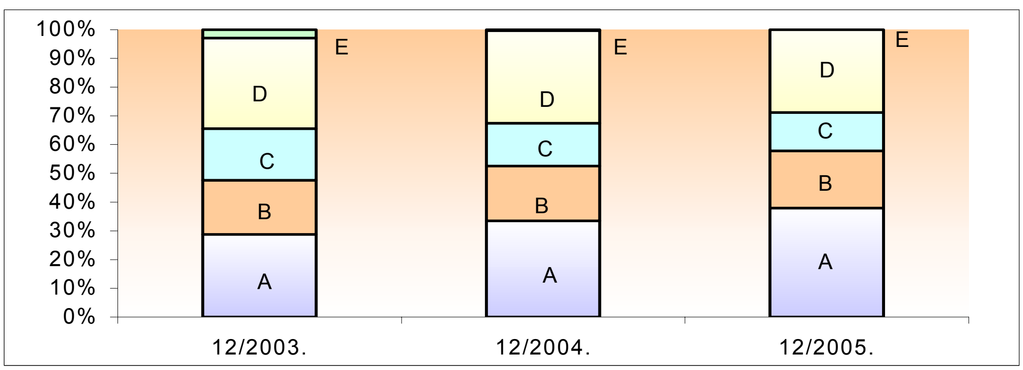
Out of total assets charged off, assets charged off based on loans originated to citizens were KM 39 million or 10.2%, and suspended interest was KM 5.6 million or 10.3%.

Level of general loan risk and potential loan losses by classification categories, as determined in accordance with the criteria and methodology prescribed by the FBA's Decisions, their trend and structure on the level of banking sector is presented in the following table and graph.

Table 21: *Structure and trend of general loan risk and potential loan losses*

Classification categories	AMOUNT (in 000 KM) AND STRUCTURE (in%)						RATIO	
	31.12.2003.		31.12.2004.		31.12.2005.		4/2	6/4
1	2	3	4	5	6	7	8	9
A	70.974	28,7	94.501	33,5	118.884	37,9	133	126
B	46.657	18,9	53.633	19,0	62.517	19,9	115	117
C	44.593	18,0	42.104	14,9	41.954	13,4	94	100
D	77.839	31,5	91.294	32,3	90.465	28,8	117	99
E	7.306	2,9	880	0,3	31	0,0	12	4
TOTAL	247.369	100,0	282.412	100,0	313.851	100,0	114	111

Graph 13: *Structure and trend of general loan risk and potential loan losses*



As reported in the statements, banks established loan loss reserves in accordance with the regulations and level of evaluated loan risk.

According to the analysis of established reserves in total amount and by classification categories, if compared to the end of 2004, reserves for general loan risk and potential loan losses are higher by 11% and they amounted to KM 314 million, that is, 2.8 % of total assets with off-balance sheet items. At the end of 2005, banks in average allocated reserves for category B of 7.5%, for category C of 26.6%, for category D of 56.8% and E 100%, which can be rated satisfactory.

Analysis of assets quality, that is, loan portfolio of individual banks, and based on on-site examinations in banks, indicates that loan risk is still a dominant risk in majority of banks, that is, existence of problem loans originated to legal entities (enterprises).

In banks with poor quality assets, the FBA ordered correction measures to prepare operating programs which have to include action plan aimed to improve existing loan risk management practices, that is assets quality, decrease existing concentrations, and resolve issues of poor quality assets and prevent their further deterioration. The FBA continuously monitors implementations of the orders through follow up procedures based on reports and other documentation submitted by banks, as well as through checks and controls during on-site examinations.

Transactions with related entities

While operating, banks are exposed to different types of risks, but 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[20], which is 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, which include 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 senior management and
- Subsidiaries and other enterprises related to a bank through capital

Table 22: *Transactions with related entities*

-000 KM-

Description	LOANS ORIGINATED			RATIO	
	31.12.2003.	31.12.2004.	31.12.2005.	3/2	4/3
1	2	3	4	5	6
Shareholders over 5% of voting rights, subsidiaries and other enterprises related to a bank through capital	37.050	40.084	28.520	108	71
Supervisory Board members	388	141	101	36	72
Bank Management and employees	1.670	2.392	2.663	139	111
TOTAL	39.108	42.617	31.284	109	73
Potential and undertaken off-balance sheet liabilities	8.689	3.235	911	37	28

These are reasons why the FBA is emphasizing (in on-site examinations) bank's 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 activity is also to monitor and supervise implementation of the issued orders. This has had a positive influence on this segment of operations, since the level of transactions with related entities is decreasing, causing decrease in risk exposure to those entities.

[20] Article 39, Paragraph 2 of Law on Changes and Amendments to the Law on Banks defines term “entities related to a bank”, excluding employees from this list.

2.2. Profitability

According to the non-audited data of financial performance of banks in 2005, banks in the Federation of BiH reported positive financial result – profit of KM 60.9 million, which is higher by 34.7% than in 2004. Trend of increase in profitability of the system is a result of general trend of improvement and stabilization of the banking sector.

Total profit resulted from profit earned by 19 banks in total amount of KM 87 million, which is higher by 52% or KM 29.7 million than in 2004, and loss reported by five banks (four in provisional administration) of KM 26.1 million, which is higher by 116% or KM 14 million than in 2004.
More detailed information is presented in the following table.

Table 23: *Financial result reported: profit/loss*

-000 KM-

Date/Description	Banking system		Private banks		State banks	
	Amount	Number of banks	Amount	Number of banks	Amount	Number of banks
31.12.2003.						
Loss	-15.384	8	-14.823	6	-561	2
Profit	61.375	18	58.543	13	2.832	5
Total	45.991	26	43.720	19	2.271	7
31.12.2004.						
Loss	-12.100	6	-11.608	5	-492	1
Profit	57.316	18	53.982	13	3. 334	5
Total	45.216	24	42.374	18	2.842	6
31.12.2005.						
Loss	-26.121	5	-24.502	2	-1.619	3
Profit	87.034	19	82.798	16	4.236	3
Total	60.913	24	58.296	18	2.617	6

Based on analytical data, as well as parameters for evaluation of profitability quality (level of realized financial result – profit / loss and ratios used for evaluation of profitability, productivity and effectiveness of performance, and other parameters related to evaluation of performance), we can conclude that improvement of the general profitability of the system comes from individual profitability of smaller number of large private banks. Financial result of state banks does not have any significant influence on general profitability of the banking system.

Out of total profit, only three large banks (assets of 57.6% of the banking system assets) reported profit of KM 55.4 million, which represents 63.6% of total profit of the banking system, and from the aspect of level of reported financial result in 2005, 16 banks have better financial result than in 2004.

Out of total loss reported, one private bank under provisional administration reported KM 21.7 million or 83.2%.

Analysis of all quantitative indicators and factors, influencing sustainability and/or quality of profitability of individual banks, indicate that two banks have serious profitability problems and they have to take adequate measures and activities to improve this segment of performance, so that new losses do not cause further erosion of their capital, which was ordered by the FBA, after full scope supervisory review of performance in those banks.

Total income on the system level was KM 593.1 million; rate of growth was 21% or KM 104 million, which represents increase of 15 index points in comparison to previous year. Total non-interest bearing expenses were KM 527.3 million with rate of growth of 19% or KM 85 million, and it represents increase of 12 index points in comparison to previous year.

Total interest income increased by 31%. However, due to faster increase of interest expenses of 39%, there was somewhat slower increase of net interest income of 27%, although it represents growth of 16 index points in comparison to 2004.

Increase of interest income on loans of 29% in 2005 is faster than increase of credit placements that increased by 25%, which is primarily result of improvement in loan portfolio quality with new sound loans and decrease of poor quality placements not barring income (according to the classification of banks) from 6,5% in 2004 to 5.4% in 2005.

Significant growth of 61% in comparison to previous year is realized on the basis of interests on deposit accounts with depository institutions.

Based on the mentioned, quality of structure of banks' total income improved in favor of interest income, since total interest income in comparison to 2004 in structure of total income increased from 80.5% to 87.2%. However, due to faster growth of interest expenses, increase of participation of net interest income is slower, that is, it increased from 54.5% in 2004 to 57.2% in 2005.

Growth of interest income participation in total income of banks is a positive indicator of trend of improvement in quality and stability of earnings, since banks gain most of their income from their main activity, that is, lending activity.

On the other side, there was faster growth of interest expenses with the rate of 39%, along with simultaneous increase of their participation in total net income from 26% to 30% as a result of significant growth of interest-bearing sources used for financing of credit placement growth, deposits with growth of 23% and borrowings with growth of 36%.

Operating income recorded slower increase than net interest income, that is, they are higher by 14%, which is why their participation in structure of total income is decreased from 45.5% to 42.8% in comparison to 2004. Decrease is largely related to other operating income, which in nominal value is the same as previous year, and their participation in structure of total income decreased by 2.4%.

The reported rate of growth in operating income was significantly influenced by decrease in service fee income, as a result of changes in accounting policies in the segment of methodology of treatment and recognition of income based on fees related to loans[21] (applied in majority of banks).
Non-interest bearing expenses recorded slower growth with the rate of 19% in comparison to total income (growth of 21%) for last year. Within the same category, both of nominal amount and percentage, other operating expenses recorded the highest increase of KM 27 million or 40%, which influenced reporting of high losses in one private bank under provisional administration.

This increase has neutralized downfall of other non-interest bearing expenses in total income due to which participation of non-interest bearing expenses in structure of total income was decreased by only 1%, that is, from 90% in 2004 to 89% at the end of 2005.

[21]Implementation of IAS 18-Income and IAS 39-Financial instrument: recognition and measurement.

Participation of salary expenses decreased from 29.3% to 28.1%. Participation of loan loss provisioning decreased from 22.5% to 21,3%, which was a result of continuous improvement in assets quality of banks, first of all in quality of loan portfolio, since the placements classified as good assets increased in comparison to last year by 3.1%, which resulted in decreased provisioning, and the amount of assets charged off and suspended interest in 2005 was less by 32% in comparison to last year. It is necessary to mention once again that we still do not have all the data audited, that is, they are the result of risk evaluation and classification performed by banks.

Participation of business premises and other fixed assets expenses was decreased from 17.7% to 16.4% in total income, as effect of decrease of investments in fixed assets, whose participation in net assets decreased from 4.0% to 3.2% in comparison to last year.

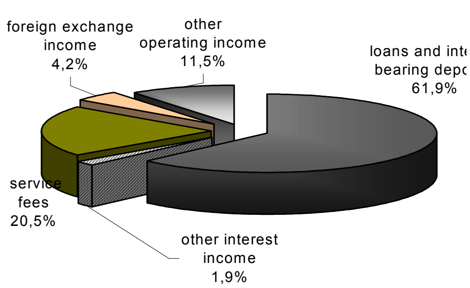
Trend and structure of total income and expenses is presented in the following tables and graphs:

Table 24: **Structure** *of total income* - in 000 KM-

Structure of total income	31.12.2003.		31.12.2004.		31.12.2005.		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	24.485	4,4	27.530	4,5	44.408	5,8	112	161
Loans and leasing	304.464	54,4	354.721	57,4	457.839	59,4	117	129
Other interest income	7.748	1,4	12.109	1,9	14.751	1,9	156	122
TOTAL	336.697	60,2	394.360	63,8	516.998	67,1	117	131
II Operating income								
Service fees	124.053	22,2	126.583	20,5	150.351	19,5	102	118
Foreign exchange income	28.968	5,2	26.257	4,2	30.266	3,9	91	115
Other operating income	69.779	12,4	70.121	11,5	73.056	9,5	102	104
TOTAL	222.800	39,8	222.961	36,2	253.673	32,9	101	114
TOTAL INCOME (I + II)	559.497	100,0	617.321	100,0	770.671	100,0	112	125

Graph 14: *Sructure of total income*

31.12.2004.



31.12.2005.

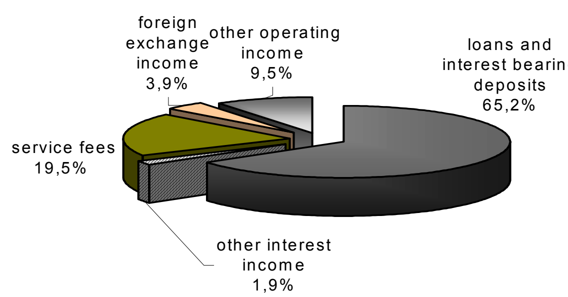


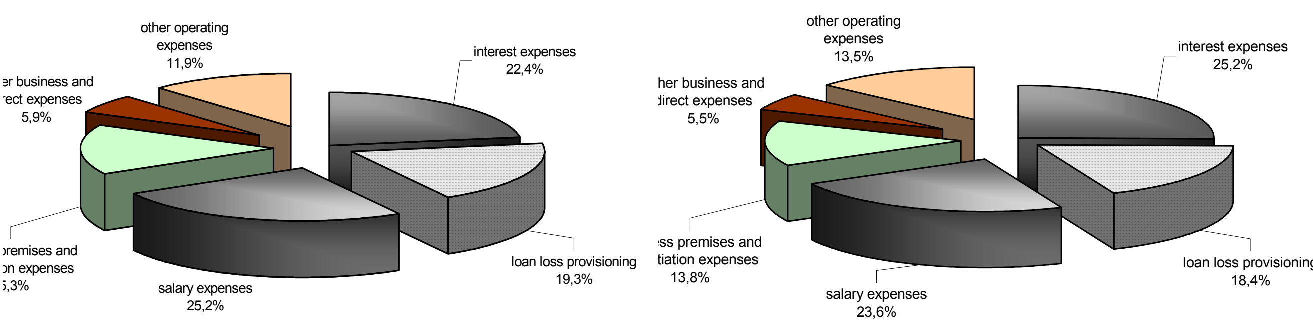
Table 25: *Structure of total expenses*

- in 000 KM-

Structure of total expenses	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
	Amount	%	Amount	%	Amount	%	4/2	6/4
1	2	3	4	5	6	7	8	9
I Interest expenses and similar expenses								
Deposits	79.808	15,6	101.848	17,9	131.063	18,6	128	129
Liabilities for borrowings	12.828	2,5	22.979	4,0	40.345	5,7	179	176
Other interest expenses	4.605	0,9	2.893	0,5	6.162	0,9	63	213
TOTAL	97.241	19,0	127.720	22,4	177.570	25,2	131	139
II Total non-interest bearing expenses								
General loan risk and potential loan losses provisioning	113.354	22,2	110.142	19,3	129.937	18,4	97	118
Salary expenses	133.912	26,2	143.631	25,2	166.621	23,6	107	116
Business premises and depreciation expenses	74.777	14,6	86.902	15,3	97.232	13,8	116	112
Other business and direct expenses	31.693	6,2	33.505	5,9	38.683	5,5	106	115
Other operating expenses	60.246	11,8	67.867	11,9	94.836	13,5	111	140
TOTAL	413.982	81,0	442.047	77,6	527.309	74,8	107	119
TOTAL EXPENSES (I + II)	511.223	100,0	569.767	100,0	704.879	100,0	112	124

Graph 15: *Structure of total expenses*

31.12.2004. **31.12.2005.**



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

Table 26: *Ratios of profitability, productivity and effectiveness by periods*

-in %-

RATIOS	31.12.2003.	31.12.2004.	31.12.2005.
Return on Average Assets	0,88	0,69	0,73
Return on Average Total Capital	6,75	5,57	6,33
Return on Average Equity	8,16	6,61	7,83
Net Interest Income/Average Assets	4,60	4,08	4,05
Fee Income/Average Assets	4,27	3,41	3,03
Total Income/Average Assets	8,88	7,49	7,07
Operating and Direct Expanses22/Average Assets	2,79	2,20	2,01
Operating Expenses/Average Assets	5,17	4,57	4,28
Total Non-interest Expanses/Average Assets	7,95	6,76	6,29

22 Expenses include provisions for potential loan losses.

Table 27: *Ratios of profitability, productivity and effectiveness as of 12/31/ 2005*

-in %-

RATIOS	31.12. 2005. STATE BANKS	PRIVATE BANKS	AVERAGE IN THE FBiH
Return on Average Assets	0,67	0,73	0,73
Return on Average Total Capital	1,59	7,31	6,33
Return on Average Equity	1,83	9,19	7,83
Net Interest Income/Average Assets	3,54	4,07	4,05
Fee Income/Average Assets	6,41	2,86	3,03
Total Income/Average Assets	9,95	6,93	7,07
Operating and Direct Expanses/Average Assets	3,87	1,92	2,01
Operating Expenses/Average Assets	4,90	4,25	4,28
Total Non-interest Expanses/Average Assets	8,77	6,17	6,29

Based on the analysis of general parameters for evaluation of profitability quality, we come to the two most important indicators of profitability: ROAA (Return on Average Assets) of 0.73% and ROAE (Return on Average Equity) of 7.83%, which are better in comparison to 2004.

Productivity of banks, measured by ration between total income and average assets (7.07%), as well as realized net income and operating income per average assets, deteriorated, which was caused by further growth of average assets (28%) to growth of net interest income (27%), then trend of decrease of interest rates, faster growth of long term loans and increase of their participation in total loans, faster growth of interest expenses, on one side, and slower growth of average interest-bearing assets and decrease of their participation by 1% in the structure of average assets, on the other side.

Criteria used in the analysis of all key indicators of profitability was ownership of banks, indicating 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 in the following period will still depend on assets quality, that is, exposure of banks to credit risk, and effective operating expenses management. That is why, the key factor of effectiveness and profitability of each bank is management quality and business policy the management is following, since this is the most direct way to influence its performance.

In addition, under the new market conditions, banks more adopt new concept of business policy aimed to market oriented banking in order to gain more profit, providing for bank stability and adequate management and control of all risks a bank is exposed to, and primarily credit risk. However, by entering international financial operations and market, banks will in future be more exposed to market risks: interest rate risk, foreign exchange and price risk, as well as indebtness risk, which will require further strengthening of capital base, not only from internal sources through increase of retained income from profit, but from external sources, which is at the same time a precondition for further expansion and growth of banks.

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 performs its liabilities as they become due.

In general, the mentioned regulation represents a framework for liquidity risk management and qualitative and quantitative provisions and requirements towards banks. It gives a detailed definition of duties and responsibilities of bank supervisory board and management in regard to adoption and implementation of liquidity risk management program, which includes liquidity policies, liquidity strategy of a bank, and effective procedures and techniques for projection, evaluation, monitoring and control of bank's liquidity. 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. In addition, it sets requirement that reports on liquidity position and maturity adjustment have to be submitted to the FBA[23].

Analysis of liquidity risk exposure and liquidity position of banks individually and of the entire banking system is based on the submitted set of reports related to the segment of liquidity, including all other relevant data from other reports, as well examination performed by on-site examiners of bank's liquidity position adequacy and practices in management of sources in relation to its risk.

In analyzing and evaluating level and trend of liquidity risk and position, it is necessary to consider several factors, both external (institutional framework, role and function of the CBBiH as Currency Board, level of development of financial market in BiH, etc.), and internal that are determined and specific to individual bank (structure and maturity of assets and liabilities, concentrations in sources, especially in deposits and stability of largest items – large depositors, ownership, access and availability of financing from the market, contingency planning, etc.).

For the last three years, banks in the Federation of BiH, upon orders issued by the FBA, have implemented intensive activities in order to improve their maturity adjustment of financial assets and liabilities, which was significantly undermined in the preceding period due to credit expansion of primarily long term loans financed from the sources (deposits mostly) that did not have adequate maturity. The implemented activities and measures had positive effect on decrease of imbalance in maturity profiles of assets and liabilities, and the result was adjustment within prescribed limits.

In the structure of financing sources of banks in the Federation of BiH, deposits have the highest participation of 73.2%, while for the last three years participation of borrowings has also increased (as of 12/31/2005, it was 12.3%), which have longer maturity and represent

[23] Report on liquidity position is submitted per decade, and Report on maturity adjustment of financial assets and liabilities and List of 15 largest sources of bank is submitted quarterly.

good quality source for long term placements, and have significantly contributed to the maturity adjustment of assets and liabilities.

On the other hand, maturity structure of deposits is much worst, although we have trend of improvement for longer period of time. Liquidity risk is closely correlated with other risks, and in this case, it has adverse effect to the profitability of banks.

Table 28: *Maturity structure of deposits* - in 000 KM-

DEPOSITS	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Savings and demand deposits	2.215.925	51,6	2.663.053	47,5	3.264.937	47,5	120	123
Up to 3 months	303.203	7,1	389.395	7,0	408.679	6,0	128	105
Up to 1 year	447.952	10,4	490.685	8,8	541.832	7,9	110	110
1. Total S-T	2.967.080	69,1	3.543.133	63,3	4.215.448	61,4	119	119
Up to 3 years	715.648	16,7	1.367.882	24,4	1.709.665	24,9	191	125
Over 3 years	609.981	14,2	691.223	12,3	938.935	13,7	113	136
2. Total L-T	1.325.629	30,9	2.059.105	36,7	2.648.600	38,6	155	129
TOTAL (1 + 2)	4.292.709	100,0	5.602.238	100,0	6.864.048	100,0	131	123

In maturity structure of deposits, we have had slight changes within two main groups of maturity. Although demand deposits recorded the highest rate of growth of 23% within short-term deposits, their participation of 47.5% remained the same. Observed on the sector level, citizen deposits recorded the highest growth of KM 544 million or 25%, out of which 41.7% were demand deposits of citizens. Term deposits up to three months and over three months up to one year increased by 5%, that is 10%, but their participation in the structure decreased in comparison to 2004.

In 2005, long term deposits increased by 29%, and their participation increased from 36.7% to 38.6%. We should emphasize that there is a dominant participation of long term deposits in two sectors: citizens of 41.6% and banking institutions of 34.9%, where citizen deposits make 56.5% of term deposits up to three years, and in term deposits over three years the funds of banking institutions participate with 67.6%.

In the function of planning 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.

Table 29: *Maturity structure of loans* -in 000 KM-

LOANS	31.12.2003.		31.12.2004.		31.12.2005.		RATIO	
	Amount	Partic. %	Amount	Partic. %	Amount	Partic. %	4/2	6/4
1	2	3	4	5	6	7	8	9
Pastdue claims and paid off-balance sheet liabilities	177.174	5,1	214.244	4,8	218.406	3,9	121	102
Short term loans	776.014	22,5	991.183	22,4	1.134.850	20,5	128	115
Long term loans	2.496.554	72,4	3.217.112	72,8	4.192.050	75,6	129	130
TOTAL LOANS	3.449.742	100,0	4.422.539	100,0	5.545.306	100,0	128	125

In 2005, there was faster growth of long-term loans (growth rate of 30%), than short-term loans (15%), which caused growth of long-term loans in total loans from 72.8% to 75.6%. Analysis of the sector by maturity indicates that participation of long-term loans in total loans originated to citizens is 90%, and to private enterprises is 61%.

Although loans, as the most significant assets category, recorded growth of 25% in 2005, and reached participation of 59.1%, cash assets had almost the same rate of growth (24%), but their participation of 37.6% remained the same as at the end of 2004.

In 2005, banks were regularly meeting required reserves with the Central Bank of BiH. At the end of 2005, the regulation changed and required reserves increased. The effective date of the change was December 1, 2005, when the required reserve increased from 10% to 15%. In BiH, under the environment of Currency Board and relatively financially underdeveloped market, required reserve as the most significant instrument of monetary policy is used to meet a primary monetary purpose, that is, monetary control, in sense of stopping fast credit growth from the past years and decrease multiplications. On the other hand, implementation of regulation on foreign exchange risk and maintenance of currency adjustment within prescribed limits also significantly influence the 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 list of the most significant is presented in the following table:

Table 30: *Liquidity ratios* - in % -

Ratios	31.12.2003.	31.12.2004.	31.12.2005.
1	2	3	4
Liquid assets[24] / Total assets	35,9	37,3	37,8
Liquid assets / Short term financial liabilities	59,3	60,5	63,9
Short term financial liabilities / Total financial liabilities	67,9	70,4	66,9
Loans / Deposits and borrowings[25]	70,7	68,5	69,2

All the mentioned indicators of liquidity indicate that liquidity position of the banking system in the Federation of BiH is good, with satisfactory participation of liquid assets in total assets and coverage of short-term liabilities by liquid assets. We can also see that the first three indicators have been improved in comparison to 2004. The last indicator expressed as ratio between loans and financing sources (deposits and borrowings) is also very good and it is in the level of feasible standard, although it has decreased (by 0.7%) in comparison to 2004.

Regulatory requirements prescribed towards banks are quite restrictive, which resulted in good liquidity of banks individually and the entire banking system. 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.

[24] Liquidity assets in the narrow sense: cash and deposits and other financial assets with maturity below three months, except inter-banking deposits.
[25] Empiric standards: below 70%-very sound, 71%-75%-satisfactory, 76%-80%-marginal to satisfactory, 81%-85%-insufficient, over 85%-critical.

Table 31: *Liquidity position –ten-day average and daily minimum*

Description	31.12.2003. Amount	31.12.2004. Amount	31.12.2005. Amount	RATIO 3/2	RATIO 4/3
1	2	3	4	5	6
1. Average daily balance of cash assets	1.701.809	2.502.469	2.687.043	147	107
2. Minimum total daily balance of cash assets	1.467.878	2.305.200	2.371.336	157	103
3. Short term sources (accrual basis)	2.911.225	3.598.348	4.165.268	124	116
4.Liabilities:					
4.1. ten-day average 20% of Item 3	582.245	719.670	833.054	124	116
4.2. daily minimum 10% of Item 3	291.123	359.835	416.527	124	116
5.Meeting requirement :ten-day average					
Surplus = Item 1 – Item 4.1.	1.119.564	1.782.799	1.853.989	159	104
6. Meeting requirement :daily minimum					
Surplus = Item.2 – Item 4.2.	1.176.756	1.945.365	1.954.809	165	100

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.

Table 32: *Maturity adjustment of financial assets and liabilities up to 180 days*

Description	31.12.2003. Amount	31.12.2004. Amount	31.12.2005. Amount	RATIO 3/2	RATIO 4/3
1	2	3	4	5	6
I. 1- 30 days					
1. Financial assets	2.373.774	3.357.819	4.051.257	141	121
2. Financial liabilities	2.415.178	3.121.488	3.668.868	129	118
3. Difference (+ or -) = 1-2	-41.404	236.331	382.389	-	162
Accrual of requirement in %					
a) Performed %= Item 1 / Item 2	98,3%	107,6%	110,4%		
b) Required minimum %	100,0%	100,0%	100,0%		
Surplus (+) or shortage (-) = a - b	-1,7%	7,6%	10,4%		
II. 1-90 days					
1. Financial assets	2.693.183	3.723.961	4.559.015	138	123
2. Financial liabilities	2.734.913	3.496.272	4.150.956	128	119
3. Difference (+ or -) = 1-2	-41.730	227.689	408.059	-	179
Accrual of requirement in %					
a) Performed %= Item 1 / Item.2	98,5%	106,5%	109,8%		
b) Required minimum %	100,0%	100,0%	100,0%		
Surplus (+) or shortage (-) = a - b	-1,5%	6,5%	9,8%		
II. 1-180 days					
1. Financial assets	3.052.165	4.188.159	5.091.381	137	122
2. Financial liabilities	3.006.331	3.877.037	4.598.836	129	119
3. Difference (+ or -) = 1-2	45.834	311.122	492.545	679	158
Accrual of requirement in %					
a) Performed %= Item 1 / Item.2	101,5%	108,0%	110,7%		
b) Required minimum %	95,0%	95,0%	95,0%		
Surplus (+) or shortage (-) = a - b	6,5%	13,0%	15,7%		

Minimum limits prescribed for maturity adjustment of assets and liabilities represent minimum standards that banks have to include in their policies. Each bank has to create and implement its own internal models for liquidity management and liquidity strategy, as composite part of its liquidity risk management program. This means a continuous measuring and monitoring of net financing source needs in order to identify in advance a possibility of having net deficit of liquid assets and to take timely activities to provide for additional funds.

Banks are also required to adopt contingency plans with clear definition of action strategy to implement in case liquidity position is undermined. This is especially important for banks in the Federation of BiH, having in mind that the Central Bank of BiH does not have a role of «lender of last resort», but on the other hand, taking into account ownership structure of our banks, majority of banks have access to financial funds and support from their founders-owners.

Liquidity of the banking system of the Federation of BiH, based on the presented indicators, is high, which is a result of existing restrictive regulation. Since this segment of performance and level of liquidity risk exposure is in correlation with credit risk, and having in mind increasing trend and level of credit risk, banks will in future have to pay more attention to liquidity risk management through 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 and off-balance sheet assets and liabilities

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 bank.

In order to enable 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 issued Decision on Minimum Standards for Foreign Exchange Risk Management 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.

Imbalance (difference) between the items relating to individual foreign currency in assets and liabilities of balance sheet and off-balance sheet represents an open foreign currency position (long or short), which can vary only within the minimum limits prescribed and calculated in relation to the amount of bank's core capital.[26]

Banks daily report to the FBA as part of the monitoring of prescribed limits.

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 those limits. FX risk management in each bank is based on adopted program that includes detailed policies FX risk management and procedures for monitoring, implementation, measuring and control of FX risk.

[26] 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%.

Since the Central Bank functions as 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. However, in the past two years, based on the order issued by the FBA, banks started taking significant activities to comply to the prescribed limits and to eliminate huge currency imbalances and incompliance, most of them in EUR. Method of compliance, then maintaining of foreign currency position in accordance with prescribed limits was specific to individual bank and mostly determined by balance sheet and currency structure of balance sheet assets and liabilities.

At the end of 2005, currency structure of banks' assets on the level of banking system recorded the highest participation of items in foreign currencies of 26% or KM 2.5 billion (at the end of 2004, it was 28% or KM 2.1 billion). On the other hand, currency structure of liabilities is significantly different, since participation of liabilities in foreign currency is 56% or KM 5.2 billion (at the end of 2004, it was 54% or KM 4.1 billion).

Furthermore, if we analyze structure of foreign currencies, we will see a dominant participation of EUR in financial assets[27] of 77% or KM 1.9 billion (at the end of 2004, it was 78% or KM 1.6 billion), and in liabilities of 89% or KM 4.7 billion (at the end of 2004, it was also 89%, which amounted to KM 3.7 billion).
However, accrual of FX risk exposure include amount of indexed assets items (loans) and liabilities[28], especially significant in assets[29] with participation of 56% or KM 3.2 billion at the end of 2005, while participation of other items in EUR is 34% or KM 1.9 billion, and in other currencies 10% (at the end of 2004, indexed loans participated with 54% or KM 2.5 billion, and items in EUR with 36% or KM 1.6 billion).

On the other side, structure of financial liabilities restricts and determines structure of financial assets for individual currencies. Items in EUR (deposits mostly) have the highest participation in liabilities of 86% or KM 4.7 billion, while participation and amount of indexed liabilities is at minimum of 3.5% or KM 190 thousand (at the end of 2004, liabilities in EUR participated with 85% or KM 3.7 billion, and indexed liabilities with 4.2% or KM 183 thousand).

The following table presents structure and trend of financial assets and liabilities and foreign currency position for EUR as the most significant currency[30] and total:

[27] Form 5-Foreign currency position: portion of financial assets (foreign currencies denominated in KM). According to prescribed methodology, financial assets are expressed per net principle (loan loss reserves deducted).
[28] As headging instrument for exchange rate changes, banks contract certain assets items (loans) and liabilities with currency clause – they are almost all tied to EUR (regulation allows only two-way currency clause).
[29] Financial assets, which include items in foreign currency, denominated in KM and loans with currency clause.
[30] Source: Form 5-Foreign currency position.

Table 33: *Foreign currency adjustment of financial assets and liabilities (EUR and total)*

-in million KM-

Description	31.12.2004.				31.12.2005.				RATIO	
	EUR		TOTAL		EUR		TOTAL		EUR	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. Financial assets										
1. Cash assets	1.156	28,1	1.566	34,1	1.217	23,8	1.706	30,0	105	109
2. Loans	383	9,3	433	9,4	598	11,7	653	11,5	156	151
3.Loans with currency clause	2.470	60,0	2.475	53,9	3.198	62,5	3.203	56,3	129	129
4. Other	107	2,6	120	2,6	105	2,0	124	2,2	98	103
Total (1+2+3+4)	4.116	100,0	4.594	100,0	5.118	100,0	5.686	100,0	124	124
II. Financial liabilities										
1. Deposits	2.775	72,2	3.203	74,3	3.447	70,9	3.956	73,1	124	124
2. Borrowings	754	19,6	784	18,2	1.052	21,7	1.093	20,1	140	139
3.Deposits and loans with currency clause	183	4,8	183	4,3	190	3,9	190	3,5	104	104
4.Other	132	3,4	140	3,2	170	3,5	176	3,3	129	126
Total (1+2+3+4)	3.844	100,0	4.310	100,0	4.859	100,0	5.415	100,0	126	126
III. Off-balance sheet										
1.Assets	11		11		11		13			
2.Liabilities	190		193		196		197			
IV.Position										
Long (amount)	93		103		74		86			
%	11,3%		12,6%		8,2%		9,6%			
Short										
%										
Limit	30%		30%		30%		30%			
Below limit	18,7%		17,4%			21,8%	20,4%			

Observed by banks and total on the level of the banking system of the FBiH, we can conclude that banks are exposed to FX risk within prescribed limits.

As of 12/31/2005, there were 14 banks with long foreign currency position, and 10 banks with short position, so on the system level long foreign currency position represented 9.6% of core capital of banks, which is less by 20.4% than the limit. Individual foreign currency position for EUR was 8.2%, where financial assets items were higher than financial liabilities (long position).

Although in the environment of 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. CONCLUSION

Consolidation and stabilization of banking sector of the Federation of BiH have reached an enviable level and upcoming activities should provide 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 banks and to the economy.

In other to meet such goals, it is necessary to have further involvement of authorized institutions and bodies in Bosnia and Herzegovina and the Federation of BiH in order to:

- Support consolidation and establishment of banking supervision on state level;
- Finalize privatization process of state banks, that is, define resolution of their status;
- Improve environment for banks to operate in the area of whole Bosnia and Herzegovina;
- Continuously build legal regulation for banking system and financial system based on Basle Principles and European Banking Directives;
- Define and build on regulation for financial sector related to the activity and status of microcredit organization, BOR and Investment Bank of the Federation of BiH d.d. Sarajevo, leasing companies, etc.;
- Accelerate implementation of economic reform in the real sector in order to reach the level of monetary and banking sector;
- Accelerate establishment of special court division for economy;
- Establish more efficient process for realization of pledges;
- Pass laws for protection of creditors and more and concrete responsibility of debtors.

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

- 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 frequent and effective;
- Accelerate finalization of remaining provisional administrations and liquidation processes;
- Insist on strengthening of capital in banks, especially those that have recorded rapid growth in assets;
- In order to protect depositors, implement special supervision in banks with high concentration of saving and other deposits;
- Work on further development of regulations under authority of the Agency starting from Basle Principles and incorporating European Directives, as part of preparation process of becoming part of European Union;
- Work on continuous education and training of its own staff;
- Maintain continuity in payment system examinations;
- Continue effective monitoring of banks activities for prevention of money laundering and terrorism financing, and improve cooperation with other supervisory and examination institutions;
- Continuous operational development of the new IT system for early warning and prevention of weaknesses in banks;
- Improve cooperation with Bankers Association;
- Establish and expand cooperation with home country supervisors of the investors present in the banking sector of the FBiH;
- Organize counseling and provide advising about implementation of regulations passed by the FBA, etc.

Banks, as the most important part of the system, have to concentrate their actions to:

- Further strengthen capital in correlation with growth of assets and risks;
- Improve assets quality;
- Strengthen internal control systems and establish internal audits, which will be fully independent in their work;
- Further development of credit/debit card operations and electronic banking, and introduction of other, new products and services;
- Development of procedures for control and improvement of IT;
- Staff training and professional development;
- Maintaining prevention of money laundering and terrorism financing by implementation of adopted policies and procedures;
- Consider potential implications of the Law on Value Added Tax;
- Improve work of Bankers Association;
- Establish unified registry of irregular debtors – legal entities and individuals on the level of the Federation of BiH through Bankers Association, which will provide for data to banks in order to decrease loan risk, etc.