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Former Yugoslav Republic of Macedonia: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Payment Systems, Monetary and Financial Policy Transparency, and Anti-Money Laundering and Combating the Financing of Terrorism

This Financial System Stability Assessment paper for **Former Yugoslav Republic of Macedonia** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **September 29, 2003.** The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Former Yugoslav Republic of Macedonia** or the Executive Board of the IMF.

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FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and the European I Departments

Approved by Ulrich Baumgartner and Susan Schadler

September 29, 2003

The Financial System Stability Assessment (FSSA) is based on the work of the joint IMF-World Bank Financial Sector Assessment Program (FSAP) missions to the former Yugoslav Republic of Macedonia (FYR) Macedonia in May–June 2003. The team met with senior government officials, including the Minister of Finance and the Governor of the National Bank of the Republic of Macedonia (NBRM), as well as with staff of the Ministry of Finance (MOF) and the NBRM, of agencies involved in regulation and supervision of the financial system, banks and other financial institutions, and other private sector participants.

The FSAP team consisted of Messrs. Hormoz Aghdaey (World Bank, Mission Chief) and Marc Quintyn (IMF, Deputy Mission Chief), Philip Schellekens, Anita Tuladhar, and Judit Vadasz (all IMF), Robert Gourley, Peter Kyle, Rodney Lester, Svitlana Lewis, Melinda Roth, Hannah Thomas, Jasminka Varnalieva, Richard Zechter (all World Bank), Paul van Sluijs (The Netherlands Bank, banking supervision—IMF expert) and Nick Roberts (Reserve Bank of Australia, payment system—IMF expert). Mr. Kevin Ross (IMF resident representative) participated in some meetings.

Development of the Macedonian financial system shows the marks of the country's turbulent first decade of independence. Intermittent conflicts and disturbances have had an adverse impact on the development of the institutions necessary to support the transition to a market economy and on the governance of those institutions. As a result, the financial system is still very small and its role as intermediator of financial flows limited. Nonetheless, soundness of the banking system has been improving in recent years. A core group of banks with relatively prudent and sound practices is emerging. The entrance of foreign strategic investors, in combination with enhancements in regulation and supervision, has fostered this process. However, the system remains vulnerable to weak governance in smaller banks and weaknesses in the banks' balance sheets. Macroeconomic vulnerabilities could stem from the effect on banks of potential exchange rate instability, or a dramatic reversal in donor support.

The mission's recommendations are aimed at two levels. At the general level, corruption, money laundering, and weak implementation and enforcement of laws need to be addressed as preconditions for improving the integrity of the financial system and its role in the economy. Specific recommendations with respect to the operation of the financial system include (a) strengthening the regulatory framework for banking; (b) sharpening banking supervision practices in the direction of risk-based assessments and to enhance governance practices; (c) establishing a framework for emergency lending at the NBRM; (d) developing a government securities market as the basis for financial market development; (e) developing supervisory capacity for the insurance market and the planned pension fund market; and (f) cautious development of the second pension pillar, given its potential impact on the country's fiscal position.

The main authors of this report are Marc Quintyn and Judit Vadasz.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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Glossary

AML	Anti-money laundering
AML/CFT	Anti-money laundering/combating the financing of terrorism
BCP	Basel Core Principles for Effective Banking Supervision
CAR	Capital adequacy ratio
CBBs	Central bank bills
CFT	Combating the financing of terrorism
CPSIPS	CPSS Core Principles for Systemically Important Payment Systems
CSD	Central Securities Depository
DIF	Deposit Insurance Fund
FATF	Financial Action Task Force
FDI	Foreign direct investment
FIU	Financial intelligence unit
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FYR	Former Yugoslav Republic
GDP	Gross domestic product
IAS	International Accounting Standards
KIBS	Clearing Interbank System
MFP Transparency Code	IMF's Code of Good Practices on Transparency in Monetary and Financial Policies
MIPS	Macedonian Interbank Payment System
MOF	Ministry of Finance
MOUs	Memoranda of Understanding
MSE	Macedonian Stock Exchange
NBRM	National Bank of the Republic of Macedonia
NPK	National Payments Card Company
NPL	Nonperforming loans
POL	Payment Operations Law
ROAA	Average return on assets
ROAE	Average return on equity
RTGS	Real time gross settlement
SEC	Securities and Exchange Commission

I. Overall Assessment of Stability and Development Issues

A. Context for Financial Intermediation

1. **FYR Macedonia has not yet fully recovered from the breakup of Yugoslavia and the subsequent economic and political upheavals.** Following independence in 1991, the country had to cope with the loss of its foreign exchange deposits held in the National Bank of Yugoslavia, a breakdown in its trade linkages due to the embargo on Yugoslavia, the blockade by Greece, the 1999 Kosovo conflict, and the internal civil strife in 2001.

2. **These intermittent conflicts and disturbances have had an adverse impact on the development of the institutions necessary to support the transition to a market economy and on the governance of those institutions.** By many accounts, there has been a significant degree of corruption in the public sector, manifested in the use of public office for private gain. Corruption and bad governance in the wider economy have been compounded by the chosen methods of privatization. The judicial system is considered to be ineffective, because of excessive politicization, lack of independence, and intimidation of the judges, as well as deficiencies in the procedures and operations of the courts.

3. **Weak institutions and governance have taken a significant toll on economic development and growth in the past decade.** Indeed, FYR Macedonia does not present an environment conducive to attracting investment, whether foreign or domestic. As a result, FYR Macedonia is only midway in the transition to a stable market-oriented economy.

4. **Not surprisingly, these deficiencies have also had a negative impact on financial sector development and on intermediation.** On the one hand, financial integrity has often been threatened by opportunities for corruption and abuse, diverting resources away from potentially productive uses in the economy. On the other hand, it has been difficult for banks to develop lending activities in an environment of weak corporate governance and legal uncertainty.

5. **To address these deficiencies at their roots, a two-pronged strategy is needed.** Remedying weak financial intermediation and regaining the confidence of the population and foreign investors is both a matter of preserving macroeconomic stability and addressing the problems of governance and corruption. The government has taken steps in both areas. These efforts are seen as the keystone for building a sound and stable financial system that, in turn, can actively contribute to economic development and growth.

B. Vulnerabilities and Soundness of Banking

6. **Despite the difficult environment, the soundness of the Macedonian banking system has been improving in recent years.** The sector is still small and relatively underdeveloped. Most of the deposits and assets are concentrated in the top three banks. These three banks are gradually emerging as a core group with relatively prudent and sound banking practices. The entrance of foreign strategic investors, following these banks' privatization, has fostered this process.

7. **More than a decade of political and economic upheaval notwithstanding, Macedonia's macroeconomy has been relatively stable.** The economy is recovering very slowly from the current recession due to the lingering effects of the security situation in 2001. Although the economy remains fragile and potentially volatile, there appear to be no immediate macroeconomic threats to the stability of the financial system. Nonetheless, the authorities need to remain vigilant for potential risks that could stem from exchange rate instability in a highly euroized environment, or a drastic reduction in donor support.

8. **The financial system remains vulnerable to weak governance in smaller banks and also to weaknesses in the banks' balance sheets.** Weak governance in smaller banks is mainly a result of practices during the early transition years. Some banks still have a dispersed ownership structure with one strong manager. Others have a weak management structure. In a few banks, the ownership structure is nontransparent. The authorities do not have the full range of legal instruments to address these problems, but in the short term they are recommended to attract reputable strategic investors to help overcome these weaknesses. Balance sheet weaknesses are reflected in the high percentage of nonperforming loans (NPLs).

9. **Banking is characterized by high real interest rates, large spreads, and a limited appetite for lending.** Interest rate spreads are above 8 percentage points, reflecting lack of competition, inefficient operations (overstaffing), and high credit risk. Most banks are expanding lending only modestly, reflecting their own weak balance sheets as well as a legal environment not conducive to repayment and loan recovery.

10. **Euroization of bank assets and liabilities is substantial. About 64 percent of deposits and 40 percent of banks' total loans are denominated in foreign currency.** Foreign currency deposits are subject to the same reserve requirement as denar deposits. Although banks are adequately hedged against foreign exchange risks (supervisors monitor the open positions closely), they are exposed to potential credit risks from borrowers who are not foreign exchange earners. To monitor this risk, the NBRM will require banks to set up a reporting system to gauge their borrowers' foreign exchange exposure.

11. **Stress tests indicate that the banking system is relatively resilient to the direct effects of individual shocks, with credit risk having the greatest impact.** However, the combined effects of an exchange and interest rate shock, together with a drop in credit quality could result in significant strain on the system. Larger banks appear more vulnerable than smaller banks, because they are lending more actively and because of lingering portfolio problems.

12. **Deficiencies in the framework for the banks' liquidity management are developmental in nature but need to be addressed to avoid systemic problems.** Issues to be addressed include expanding the range of eligible instruments for collateral to access the central bank and supporting secondary market development by reducing the frequency of central bank bill auctions. Some banks are vulnerable because of the presence of sizeable

individual deposits on their balance sheets. The interbank market is still too shallow for the larger banks.

13. **The establishment of the Macedonian Interbank Payment System (MIPS) is a step forward in developing the appropriate infrastructure for financial sector development.** Based on the assessment of compliance with the Core Principles for Systemically Important Payment Systems (CPSIPS), improvements could be made in defining the central bank's oversight role and establishing a remote back-up facility. The legal requirement that the NBRM execute payment guarantees between commercial bank clients should be revised because it creates legal risks for the NBRM and liquidity risks for the payment system.

14. **The quality of banking supervision continues to improve as confirmed by the assessment of compliance with the Basel Core Principles for Effective Banking Supervision (BCP).** Supervisors have made great progress in moving beyond the level of formal checking on the basis of rules and regulations. They are encouraged to move to more risk-oriented supervision—with a constant eye on the banks' risk management techniques and internal controls; develop their strategic thinking on the future of the sector; and include elements of financial sector soundness in their off-site analysis.

15. **The regulatory framework for banking should be further strengthened.** Recent amendments in the wake of the FSAP assessment include improvements to the fit and proper regulations, stricter reporting of investments in banks and of significant bank investments—all Achilles' heels in Macedonia's turbulent context—and to the range of corrective actions for weak banks. Further modifications are suggested to strengthen the role and power of the administrator of weak banks, as well as the role of supervisors in anti-money laundering and combating the financing of terrorism (AML/CFT); and the adoption of internationally accepted accounting standards to improve transparency of bank operations and governance.

C. Broader Framework for Finance

16. **For financial intermediation to play a more prominent role, it is essential that implementation and enforcement of the legal framework be strengthened.** While the core legal framework supporting financial operations is generally sound, implementation and enforcement of laws are lacking in important areas. Low respect for the law and abuse of the system has led to a culture of noncompliance and nonpayment. Improvements in the operation of the court system will play a crucial role in this regard.

17. **Some of the key elements of a proper corporate governance framework are in place, but much remains to be done to translate these principles into practice.** Improvements in the protection of shareholder rights and enforcement of directors' duties are a priority, as is the requirement that Macedonian companies prepare financial statements consistent with International Accounting Standards (IAS) and improve auditing practices.

Box 1. Main Recommendations

1. Banking

- The quality of bank ownership could be further improved by continued efforts to attract reputable strategic owners.

2. Banking regulation and supervision

- Regulations should be strengthened in the areas of market risk, internal risk management, interest rate risk, corrective actions, and powers for the official administrator overseeing weak banks. Regulations for accounting and disclosure standards for banks need to be promulgated.
- Supervisors should develop a strategy to minimize the ownership of nonfinancial corporates in the banking system.
- Supervisors should require the banks to monitor and report on their borrowers' foreign exchange exposure.
- Supervisors should establish a list of financial sector soundness indicators, in order to monitor the aggregate soundness of the banking system.
- Supervision should be more risk-oriented. Contacts with bank managers could be intensified.
- Supervisors should have a more active role in AML/CFT implementation and enforcement.
- The NBRM should publish a "mission statement" for its banking supervisory function.

3. Market development

- The development of government securities market, as a basis for financial market promotion, should be a priority.
- Liquidity management could be improved through the expansion of instruments available for collateral to access the central bank facilities.

4. Payment system

- The NBRM's role in setting objectives for the development of a payment infrastructure in FYR Macedonia should be better defined.
- A remote back-up facility for MIPS should be established.
- The obligation for the NBRM to decide on, and execute, guarantees between third parties should be removed. A mechanism should be found to involve courts.

5. Financial safety nets

- A framework and procedures for emergency lending by the NBRM should be established.

6. Legal and judicial framework

- The judicial system needs to be reformed and the implementation and enforcement of laws strengthened to create respect for the rule of law and the judicial system.
- Financial sector regulators should be provided legal authority to impose sanctions on financial institutions.

7. AML/CFT

- The legal framework for AML/CFT should be strengthened and implementation expedited.

18. **Bank supervisors' efforts to improve the integrity of the banking system need to be complemented by efforts to enforce the AML/CFT legal framework.** The newly established financial intelligence unit (FIU) in the MOF should be instrumental in implementing the strategy, but a greater role should be assigned to the respective financial sector supervisory agencies. Ways need to be identified to overcome their lack of legal authority to enforce compliance with the laws.

D. Nonbank Financial System

19. **The securities markets are small and present little systemic risk to the financial sector.** The development of a government securities market is expected to contribute to financial deepening. Equity market development has been adversely affected by managerial control over the voting rights on shares held by employees.

20. **The insurance sector remains insignificant by most standards.** In order to allow the sector to develop, it is important that the legal framework for conducting insurance business and its supervisory framework be strengthened.

21. **Legislation has been passed to implement a mandatory second pension pillar, but its introduction poses a number of significant challenges for Macedonia's fledgling financial markets.** The two most important challenges are the financing of the fiscal transition deficits and the creation of financial instruments for investment.

II. Overview of the Financial System

A. Financial Institutions

22. **The Macedonian banking system remains small compared to the size of the economy with assets at 39 percent of GDP (Table 1).** At the end of 2002, 21 banks and 17 savings houses[1] were licensed, a high number for a country of 2 million inhabitants. Banks hold 98.9 percent of total bank and savings house assets. By most accounts, the system is one of the smallest in Central and Eastern Europe (Table 2). Commercial banks operate under a two-tier licensing system, requiring separate licensing to undertake foreign exchange operations. Eighteen banks have this license, enabling them to undertake international payments, credit, and guarantee operations.[2]

[1] The saving houses provide financial services to private individuals. Founders must have at least EUR 150,000 capital. A new regulatory framework for savings houses is under construction.

[2] Banks are required to have minimum capital of EUR 9 million for a foreign operations license and EUR 3.5 million for a domestic operations license.

Table 1. FYR Macedonia: Financial System Structure, 1998–2002

	1998		1999		2000		2001		2002	
	Number	Assets in Millions of MKD	Number	Assets in Millions of MKD	Number	Assets in Millions of MKD	Number	Assets in Millions of MKD	Number	Assets in Millions of MKD
Banks	23	59,093	23	72,279	22	81,999	21	105,623	21	93,213
Largest three banks	3	34,818	3	44,794	3	52,460	3	66,872	3	59,619
Private banks	22	58,254	22	71,375	21	81,067	20	104,214	20	91,362
Domestic	16	50,533	17	63,027	14	37,310	12	50,277	13	50,335
Foreign 1/	6	7,721	5	8,348	7	43,757	8	53,937	7	41,027
MDB 2/	1	839	1	904	1	932	1	1,409	1	1,851
Savings houses	18	755	16	760	19	1,038	17	676	17	956
Insurance companies	5	8,480	5	10,121	5	11,172	5	11,987	7	11,843
Life 3/	1	132	1	235	1	276	1	327	1	611
Nonlife	4	8,348	4	9,886	4	10,896	4	11,660	6	11,232
Total financial system	45	68,328	43	83,160	45	94,209	42	118,286	44	106,012

	1998		1999		2000		2001		2002	
	In Percent of Total Assets	In Percent of GDP	In Percent of Total Assets	In Percent of GDP	In Percent of Total Assets	In Percent of GDP	In Percent of Total Assets	In Percent of GDP	In Percent of Total Assets	In Percent of GDP
Banks	86.5	30.3	86.9	34.6	87.0	34.7	89.3	45.2	87.9	39.0
Largest three banks	58.9	17.8	62.0	21.4	64.0	22.2	63.3	28.6	64.0	24.9
Private banks	85.3	29.9	85.8	34.1	86.1	34.3	88.1	44.6	86.2	38.2
Domestic	74.0	25.9	75.8	30.2	39.6	15.8	42.5	21.5	47.5	21.1
Foreign 1/	11.3	4.0	10.0	4.0	46.4	18.5	45.6	23.1	38.7	17.2
MDB 2/	1.2	0.4	1.1	0.4	1.0	0.4	1.2	0.6	1.7	0.8
Savings houses	1.1	0.4	0.9	0.4	1.1	0.4	0.6	0.3	0.9	0.4
Insurance companies	12.4	4.3	12.2	4.8	11.9	4.7	10.1	5.1	11.2	5.0
Life 3/	0.2	0.1	0.3	0.1	0.3	0.1	0.3	0.1	0.6	0.3
Nonlife	12.2	4.3	11.9	4.7	11.6	4.6	9.9	5.0	10.6	4.7
Total financial system	100.0	35.0	100.0	39.8	100.0	39.9	100.0	50.6	100.0	44.4

Sources: Ministry of finance; National Bank of the Republic of Macedonia; and Fund staff calculations.

1/ Banks with foreign capital exceeding 50 percent of their capital structure are regarded as foreign banks.
2/ Macedonia Development Bank. This bank is state owned and does not attract deposits from the public.
3/ One insurance company is composite (i.e., provides both life and nonlife insurance).

Table 2. FYR Macedonia: Comparison of the Macedonian Banking System with Selected Central and Eastern European Countries

(December 31, 2002)

	Albania	Bulgaria	Czech Republic	Hungary	FYR Macedonia	Poland	Slovenia
Number of banks	13	34	37	39	21	62	20
Concentration in banking system 1/	59.2	43.4	62.2	58.6	64.0	53.6	55.3
Total banking assets/GDP	52	46	110	64	39	61	80
Of which: credit to GDP 2/	35	19	39	39	28	26	65
Capital adequacy ratio (CAR)	35	25	14	13	28	15	12
Foreign ownership 3/	6	70	82	61	44	63	33
Nonperforming/classified loans	5.5	9.8	16.9	3.7	15.9	21.4	7.0
Average return on assets (ROAA)	1.2	2.0	1.1	1.7	0.4	0.5	1.1
Average return on equity (ROAE)	19.1	15.6	...	18.7	2.1	6.7	13.3
Net interest margins	3.3	5.0	2.4	3.9	8.2	3.2	3.7
Number of employees 4/	2,680	2,1616	4,0625	2,6947	4,569	13,1900	11,258
Operating expenses/total assets	...	4.6	1.9	3.6	4.4	3.4	3.2

Sources: Reports of the bank supervisors, statistical offices, and ministries of labor of the individual countries, and Fund staff calculations.

1/ The share of the largest three banks in the total assets of the banking system, except in the Czech Republic (the four largest) and in Hungary and Poland (the five largest banks).

2/ For Albania, domestic credit to GDP.

3/ For FYR Macedonia, foreign ownership in banks exceeding 50 percent, while in other countries it is the share of foreign investment in total bank equity.

4/ For Slovenia, December 31, 2001.

23. **The system is highly concentrated and privatized.** At the end of 2002, the three largest banks managed almost 73 percent of total deposits, and 64 percent of total bank assets. This concentration is due to these banks' vast branch network and to a "search for quality" on behalf of bank customers. State ownership of banks is as low as 14 percent and foreign ownership amounted to almost 45 percent of total bank capital at the end of 2002.

24. **The NBRM is a well-run institution.** The assessment of the observance of the IMF's Code of Good Practices or Transparency in Monetary and Financial Policies (MFP) for monetary and financial policies indicates that the NBRM practices a high degree of transparency with regard to its roles, responsibilities, and objectives, as well as with respect to the process for formulating and disclosing its policies. Areas where transparency could be enhanced include: (i) disclosing the lender-of-last-resort role of the central bank and publishing, ex post, aggregate information on the use of emergency credit facilities; (ii) providing more detailed financial information to the public; and (iii) disclosing the internal governance standards and the code of conduct governing its employees, expanding the requirement of conflict of interest statements to all managerial staff, and disclosing the extent of legal protection of staff. Accountability arrangements of the NBRM were

strengthened in the wake of the FSAP, by requiring the governor to appear at least every six months before parliament.

25. **Nonbank financial sectors in FYR Macedonia are still very small and therefore pose little systemic risk to the financial sector.** Total equity market turnover in 2002 was EUR 26 million; turnover in other instruments was an additional EUR 21 million. The Macedonian Stock Exchange (MSE) has 12 members, including three banks and nine brokerages.[3] Clearing and settlement occurs through the Central Securities Depository (CSD), which maintains records in dematerialized form. The CSD is modern, efficient, and utilizes best international practices. Securities markets are supervised by the Securities and Exchange Commission (SEC). The SEC is an independent agency but lacks enforcing capacity.

26. **The Securities Law was amended in 2002 to require all companies meeting the MSE listing requirements to list their shares on the MSE.** The profit tax is reduced by 50 percent for three years for any listed company. About 100 companies were mandated to list their securities. The regulations provide for voluntary withdrawal after the termination of the legal obligation, or de-listing from the MSE. While such a provision is not consistent with a free market philosophy, the MSE's official market may end up with more listings, which is the intent. Moreover, the listed companies will be subject to disclosure requirements that provide more information to shareholders and possibly improved corporate governance.

27. **Equity market development has been adversely affected by the worker/employee role in privatization in FYR Macedonia, which has effectively blocked trading in many shares.** In many companies, employees have ceded their voting rights on shares to management. If the shares are sold, the voting rights do not transfer, reducing the attractiveness of the shares to potential buyers. In addition, the By-Law to Foreign Exchange Law imposes a higher cost to foreign investors if they repatriate their money before one year, because they have to open a custodian account. Such a regulation serves to limit foreign portfolio investment.

28. **Macedonia's insurance sector is one of the smallest in Europe, both absolutely and in relation to the population.** The sector suffers from weak governance practices and the supervisory capacity is limited. There are currently seven insurance companies licensed to perform insurance operations, and three insurance brokerage houses licensed to perform insurance and brokerage activities. The former state-owned insurance company dominates the market. Life insurance only represents two percent of premiums.

[3] Given the low level of activity and the size of the equity market, regional integration should be considered. The MSE has already made progress with an informational link with Slovenia and there are planned future links with other former Yugoslav countries as well as with the exchanges in Greece.

B. Markets and Infrastructure

29. **The interbank money market and the foreign exchange market are currently the only operating spot and short-term markets in FYR Macedonia.** Plans exist to establish a government securities market, starting in early 2004. The interbank money market is still not deep enough to offset liquidity risks (in May 2003, e.g., the average daily turnover on the interbank money market and the bilateral deals between banks was only about MDen 160 million, roughly $2.5 million). Foreign exchange market turnover has grown 47 percent in the first four months of 2003 over the same period last year due to lower precautionary balances, improved accessibility and macroeconomic stability. All licensed banks participate, although three banks account for over half of the turnover volume. Since January 2003, the bid-ask spread has narrowed from around 60 basis points to around 40 basis points. Overall, the fungibility of domestic and foreign currency has improved. As a result, foreign exchange swaps are emerging as one of the main tools of commercial bank liquidity management.

30. **Cash payments are still very common in FYR Macedonia with households making limited use of noncash payment services.** Denars on issue are 6 percent of GDP and there are unknown quantities of euros and U.S. dollars in circulation. The noncash payment system is relatively concentrated. The NBRM initiates most payments through the clearing system (about a quarter of total value), while the two largest banks account for a further 30 percent of value exchanged.

31. **The major components of the payment system are the MIPS and the Clearing Interbank System (KIBS)—the clearinghouse for low-value payments.** The MIPS is a real-time gross settlement system owned and operated by the NBRM, used for all large-value (more than Mden 3 million) payments and for any urgent or priority payments. There are 27 participants in the MIPS including all banks, the clearinghouses, the MOF and the NBRM. The MIPS has a connection to the CSD and provides the platform for securities settlement on a delivery versus payment basis.

32. **The operation of the MIPS follows closely best international practices.** Two areas that deserve attention are the need for clarification and strengthening of the NBRM's oversight role over the system and the need to establish a remote back-up facility.

C. Recent Economic Developments

Despite repeated setbacks from external disturbances (sanctions on former Yugoslavia, Greek economic embargo, and the Kosovo crisis) as well as internal political instability (ethnic civil unrest in 2001), macroeconomic performance in FYR Macedonia over the past decade has been relatively stable. After an initial period of decline, the economy grew at an average rate of around 4 percent in the late nineties with a low average inflation rate of about 2 percent (Table 3). Price stability has been maintained through a de facto exchange rate peg to the euro. This stable performance can be attributed to sound macroeconomic

Table 3. FYR Macedonia: Basic Economic Indicators, 1998–2002

	1998	1999	2000	2001	2002
		(Percent change)			
Real economy					
Real GDP	3.4	4.3	4.5	-4.5	0.7
Consumer prices, period average	-0.1	-0.7	5.8	5.3	2.4
Real wages, period average	3.7	3.6	-0.3	-1.7	4.5
Unemployment rate (average) 1/	34.5	32.4	32.2	30.5	31.9
		(In percent of GDP)			
Government finances 2/					
General government balance	-1.7	0.0	1.8	-7.2	-5.7
Central government balance	-0.8	0.8	2.7	-5.8	-5.4
Government debt (gross) 3/	52.0	57.4	53.2	51.6	50.1
		(In percent of GDP)			
Money and credit					
Broad money (M3) 4/	16.0	19.4	21.5	34.1	30.3
Total credit to private sector	15.7	14.5	15.1	15.5	16.4
Short-term lending rate	20.5	20.0	19.0	19.2	17.7
Money market rate	18.1	11.6	7.2	11.9	14.4
Balance of payments					
Trade balance (percent of GDP)	-14.4	-13.5	-19.3	-15.2	-20.3
Current account balance including grants (percent of GDP)	-7.5	-0.9	-2.1	-6.8	-8.6
Official gross reserves (US$ million; end of period)	290	450	700	756	735
Official gross reserves-foreign currency deposit ratio	2.4	3.3	4.0	1.4	1.6
Reserve cover (in months of next year's imports of goods and nonfactor services)	1.8	2.4	4.3	4.2	3.6
External debt-service ratio 5/	9.5	12.4	13.0	19.0	16.6
External debt-to-GDP ratio (in percent) 6/	38.5	39.2	40.1	38.0	38.8
		(Percent change, period average)			
Exchange rates 7/					
Nominal effective exchange rate	0.9	12.4	12.4	3.3	0.7
Real effective exchange rate (CPI-based)	-7.0	2.9	4.0	-6.1	-2.5

Sources: Data provided by the Macedonian authorities; World Bank; and Fund staff estimates.

1/ Persons seeking employment as percent of total labor force.
2/ Excludes revenue and expenditure of the special revenue and expenditure accounts of line ministries.
3/ Includes domestic debt of central government and external debt of the public sector. Figures include bonds issued in 2001 for frozen foreign currency deposits, as well as liabilities assumed by the government as of end-March 2000 on account of bank and enterprise restructuring, but exclude obligations for retroactive payments to pensioners.
4/ Includes foreign currency deposits.
5/ Debt service due, including IMF, as a percentage of exports of goods and services.
6/ Including IMF.
7/ An increase means appreciation of the denar. Partner countries include former Federal Republic of Yugoslavia and Bulgaria.

policies, supported by some progress in structural reform and a few large foreign direct investments (FDI).[4]

33. **A great deal of the progress thus made was disrupted by the 2001 security crisis, which led to a sharp economic recession.** Growth was negative (-4.5 percent) and fiscal balances declined from a surplus of 1.8 percent to a deficit of over 7 percent of GDP, largely due to security-related spending.

34. **Since 2002, the economy has been recovering slowly but the investment climate remains stagnant due to political uncertainty and an unfavorable business environment.** Output growth remained relatively flat at 0.7 percent in 2002. Stronger growth is projected for 2003 (2.7 percent). Fiscal pressure is easing considerably owing to a decline in security-related and pre-election spending and extraordinary inflows of donor finance. The central government deficit is expected to narrow to 1.4 percent of GDP in 2003 from 5.4 percent in 2002. The decline in spending has helped to stabilize the foreign exchange market, and eased monetary conditions. The inflation rate remained low at an average of 2.4 percent for 2002 with very low inflationary pressures in the first half of 2003 (average of 0.3 percent year-on-year).

III. Vulnerabilities and Soundness of the Financial System

A. Macroeconomic Sources of Risk to Financial Stability

35. **Given the fixed exchange regime, external competitiveness is of potential concern.** While the current account deficit is quite high (11.2 percent of GDP excluding grants and 8.6 percent including grants, in 2002), real exchange rate indicators do not suggest an overvaluation. Remittance transfers, exceptional FDI, and donor finance have helped to maintain the international reserve position. Despite expected improvements, concerns remain regarding the current account sustainability in the longer run, given the heavy reliance on donor inflows.

36. **A potential macroeconomic risk in the banking sector could therefore result from exchange rate instability.** In Macedonia's highly euroized environment, the greatest risk for banks lies in the credit risk posed by borrowers who might have unhedged exchange rate positions.[5] This risk is to some extent mitigated by the banks' net long position in foreign currency exposure, relatively high capital adequacy ratios, and some degree of real euroization in the economy. Nonetheless, the stress tests show (see below), that a combined effect of a devaluation and credit defaults would have a significant impact on the banking

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[4] The impact of structural reforms has been limited since enterprises were sold mostly to insiders and could not benefit from additional capital and know-how. Except for a few large privatization-related investments, FDI has not been sustained.

[5] Indexed loans for households and enterprises have been common practice for a long time. Amendments to the new Foreign Exchange Law in 2003 have fully liberalized domestic lending in foreign currency. The NBRM is developing bylaws to determine the conditions and manner under which such loans can be provided.

system. The authorities are therefore taking measures to urge the banks to analyze and report their clients' exchange rate exposure.

37. **A drastic reduction in donor support could also make the fiscal position unsustainable.** To date, the budget has been supported significantly through privatization receipts, especially from FDI, as well as donor help. Were these inflows to taper off, the government would need to rely on new domestic borrowings for which it has yet to develop an adequate debt management capacity. A large fiscal financing requirement from unforeseen events or the inability to place government bills could result in high interest rates, unsustainable debt levels, and crowding out of private investment and credit flows.

B. Risks and Vulnerabilities

38. **The soundness of the Macedonian banking system has been improving in recent years (Table 4).** Stronger supervision, the involvement of a few strategic foreign investors, and the ongoing cleaning up of the balance sheets of the three largest bank are fostering the emergence of a core group of banks in which the quality of management and internal risk management practices have been raised. These banks account for 64 percent of the banking system's assets and 45 percent of total capital.

39. **Despite recent improvements, vulnerabilities remain.** More specifically, the system remains vulnerable to lingering governance problems—especially in the smaller banks—which could undermine the credibility of the sector, and weaknesses in the structure of the banks' balance sheets.

Governance issues

40. **Governance problems affecting several (mostly smaller) banks are reflected inter alia in nontransparent, and in some cases, weak ownership (and management) structures.** Many of the banks have their origin in the former Yugoslavia, with enterprises retaining their shares in one or more banks. A number of banks have very dispersed and disinterested ownership as a legacy of the banks' policies in the early 1990s to require potential borrowers to subscribe to "compensating shares" in proportion to their loans to overcome the scarcity of domestic capital. In these cases, management is in a powerful position. Finally, a subset of investments (both foreign and domestic) could not undergo an appropriate vetting by the supervisors in recent years, due to the stipulation that changes in bank ownership only need to be approved if these exceed 10 percent of equity capital.[6]

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[6] Recent rulings by the Constitutional Court (May 2003) have created further uncertainty about the quality of the financial institutions' ownership. The rulings invalidated provisions in the banking, securities, and insurance laws stipulating that persons with criminal records may not be shareholders, board members, or managers. These and similar recent rulings—striking down the legality of other types of ownership limitations (e.g., in case of bank restructuring)—severely limit the ability of bank supervisors to keep dubious elements out of the banking system. Meanwhile, new fit and proper articles have been enacted in the respective laws, but they remain untested in court.

Table 4. FYR Macedonia: Financial Soundness Indicators, 1998–2002

	1998	1999	2000	2001	2002
Capital adequacy					
Regulatory capital/risk weighted assets	25.9	28.7	36.7	34.3	28.1
Tier I capital/risk weighted assets 1/	28.6	29.8	37.4	35.1	28.3
Asset composition and quality					
Sectoral loans to nonfinancial enterprises/total loans					
Enterprises	66.4	53.0	47.1	42.1	37.3
Households	4.9	4.9	6.1	5.9	7.9
Foreign currency lending					
Foreign currency lending/total credit to private sector	...	21.3	14.0	13.8	22.2
Foreign currency indexed lending/total credit to private sector	...	...	...	...	16.8
Gross nonperforming exposures/total credit exposure 2/	32.9	41.3	34.8	33.7	15.9
NPLs net of provision /capital	70.5	74.6	43.6	52.4	41.6
Large exposures/capital	...	139	60	93	220
Connected lending					
Banking system exposure to shareholders/capital	...	...	...	...	11.8
Banking system equity investments/capital	5.2	9.2	5.8	6.7	7.3
Earning and profitability					
ROAA	2.0	0.8	0.8	-0.7	0.4
ROAE	8.2	3.5	3.8	-3.2	2.1
Interest margin/gross income	39.5	25.2	29.1	22.2	27.9
Noninterest expenses/gross income	84.4	92.1	90.9	92.1	94.6
Personnel expenses/noninterest expenses	45.9	45.3	46.9	42.4	44.2
Interest rate spreads (in percentage points)					
Local currency	8.5	9.0	7.7	9.5	8.8
Foreign currency	...	...	...	3.3	5.4
Interbank market	3.9	12.9	6.9	13.1	5.9
Liquidity					
Liquid assets/total assets 3/	37.7	52.6	47.5	54.6	44.8
Liquid assets/total short-term liabilities 3/	67.1	86.6	76.6	79.4	69.4
Customer deposits/total (noninterbank) loans	55.0	72.0	83.8	163.0	130.2
Foreign currency deposits/total deposits	45.9	42.5	49.8	71.9	63.9
Central bank credit to banks/bank liabilities	4.3	1.4	0.6	0.2	0.2
Sensitivity to market risk					
Net FX position /capital	24.6	79.4	54.0	60.5	56.2

Sources: NBRM's Banking Supervision Department; and Fund staff estimates.

1/ Capital includes common shares, general and revaluation reserves, and undistributed profits, net of specific provisions.
2/ Based on the new methodology in which interbank loans are included in total credit exposure. The ratio is close to a third of all loans based on the previous methodology.
3/ Liquid assets are defined as cash and balances with the NBRM, securities rediscounted by the NBRM, and short-term bank placements. Short-term liabilities are defined as deposits and other liabilities with a maturity of one year or less.

41. **In addition, some small banks are "pocket banks" of enterprise groups or individuals, who use them for treasury operations, as sources of cheap liquidity, and equity investment**. Not surprisingly, this category of banks corresponds to some extent to the category of banks with undesired or unchecked owners. The opportunity for these banks to operate in spite of the presence of proper regulatory and supervisory rules is related to the broader problem of the lack of information on ownership structures of corporations, making it difficult for supervisors to detect connected and insider lending among banks, enterprises, and major entrepreneurs.

Balance sheet weaknesses

42. **Weaknesses in the internal credit risk systems of banks and limited available information on borrowers could lead to the erosion of loan quality, exacerbating the still weak loan portfolio of banks.** The 1999 Kosovo crisis and the security crisis in 2001 exposed the sector's vulnerability to adverse shocks. Although loan quality and profitability have recovered significantly from earlier low levels (Table 4), NPLs are still about 15.9 percent of all loans.[7] The burden of this NPL portfolio might hinder the banks in meeting credit demand, if this continues to pick up. Furthermore, the large NPL portfolio dampens the banks' cash flow, which in itself limits their ability to provide fresh credit.

43. **Recognizing the risks associated with a weak credit portfolio, provisioning of NPLs is based on international best practices, is strictly enforced, and given a favorable tax treatment.** Most banks have provisioned at required levels. A constant monitoring of the provisioning rules is warranted, given that a loan, once classified, might only have a small chance of recovery under the current circumstances in FYR Macedonia. Supervisors should collect information to calculate historical recovery rates and proactively change provisioning requirements, if warranted. Monitoring of loan classification is also warranted in cases when borrowers' exchange rate risk leads to credit risk for the lending bank.

44. **In light of the potential volatility of bank liabilities, banks and supervisors should ensure that the system remains sufficiently liquid.**[8] Volatility could stem from the fact that (i) the bulk of deposits are short term and potentially unstable (sight deposits comprise 39 percent of assets, of which household sight deposits are 21 percent of assets); (ii) a significant portion of the deposits are denominated in foreign currency (34 percent of assets, of which household foreign currency deposits are 25 percent of assets); (iii) in a number of banks deposits are highly concentrated, with a single depositor accounting for 25 percent to 40 percent of the deposit base; and (iv) in recent episodes public deposits (3 percent to 7 percent of assets in the largest banks) were shifted abruptly between banks, allegedly because of ties with political parties.

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[7] NPLs remain also high because of the problems banks face with the loan recovery process.

[8] During the 2001 security conflict, banks were able to meet all deposit withdrawals.

45. **Shifting large amounts of public funds between banks can have detrimental effects on the banks' liquidity positions and indirectly on the banking system.** Public funds should be placed in the central bank as a sub-account of the Treasury. However, the funds should be transferred gradually to minimize the impact on bank liquidity positions.[9]

46. **Due to the insufficient depth of the markets, banks have to hold precautionary balances both in domestic currency and foreign exchange.** Lack of trading volumes is demonstrated on tax and pension payments days when all banks tend to be on the same side of the market. As a consequence, banks hold substantial short-term deposits in foreign banks (31 percent of assets) to match the currency and maturity profile of their short-term foreign currency liabilities. Also, banks experience a significant buildup of reserves with the NBRM before tax and pension payment days. The shallowness of the markets constrains the banks' ability to extend longer-term credit domestically.

C. Stress Testing

47. **Combining macro-risks and bank vulnerabilities, stress tests indicate that the banking system is relatively resilient to individual credit, currency, and interest rate shocks, but that their combination could cause significant strain on the system.** System-wide CAR could fall by up to 6.5 percentage points in response to individual shocks. Credit shocks are the most damaging, but they seem manageable for the banking system as a whole. Deterioration in asset quality comparable to the Kosovo crisis may, however, cause strain for the larger banks. Currency risk matters insofar as it induces credit risk through deterioration in the balance sheets of bank borrowers. Interest rate risks matter only marginally owing to high repricing frequencies. The combined effects of these shocks (20 percent depreciation of denar, 20 percentage point increase in denar interest rates, and an increase of 30 percent in NPLs) may result in a reduction of the system-wide CAR by 13.5 percentage points, and would push three banks below the 8 percent CAR, although they would remain solvent.

IV. Managing Risks and Addressing Vulnerabilities

A. Prudential Regulation and Supervision

48. **The authorities have made substantial progress in enhancing the legal and supervisory framework for the banking system, as is confirmed by the assessment of BCP.** The legal framework has been strengthened in critical areas through the enactment of a new Banking Law in 2000. Prudential banking regulations are constantly being refined and improvements are being made to the methods and practices of loan classification and loan loss provisioning by the banks. Much emphasis has been placed on further improvements in the practice of on-site inspections and off-site monitoring. Those preconditions for effective

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[9] Some banks estimated the size of the public deposits to be as large as 25 percent of their deposit base depending upon the transaction cycle.

banking supervision that are not met—in particular a weak court system—are outside the NBRM's control.

49. **Recent amendments to the Banking Law in the wake of the FSAP further removed some weak areas.** The strengthening of regulations governing fit-and-proper requirements, on reporting of investments in (and changes of ownership of) banks, and of investments by banks are expected to give the supervisors more power to ensure proper governance structures in the commercial banks. The streamlining of the range of prompt corrective actions will also facilitate their intervention in weak banks.

50. **Nonetheless, the legal and regulatory framework needs further strengthening in some key areas.** The role and power of the official administrator in weak banks should be strengthened. Bank should be required to monitor the exchange role exposure of their foreign currency borrowers. Furthermore, regulations on market risk need to be developed; accounting and disclosure standards should be imposed; anti-money laundering (AML) policies are still in their infant stages and need urgent attention; and it is time to give attention to the development of consolidated accounting and supervision standards.

51. **Bank supervisors are perceived as professional by the financial community.** In legal and regulatory matters, they often take a proactive stance. A recent example is their start of AML monitoring, despite the fact that the legal framework has not yet been implemented. Their reputation and credibility could benefit from further developing a more strategic approach with respect to the structure of the banking system. Stronger banks are likely to lead to more competition in the sector. Publication of a "mission statement" by the NBRM could improve public understanding of the supervisors' work.[10]

52. **Supervisors need to keep a constant eye on critical prudential regulations—including large exposure limits, connected lending, loan classification, and loan loss provisioning—given the still shaky ownership and management structures in some banks.** A sharp eye on these regulations will assist in protecting the integrity of the system by insulating the banking system from opportunities for abuse and corruption. In this context, supervisors should assist banks in searching for reputable strategic investors and should develop strategies to diminish the role of nonfinancial corporate owners in banks.

53. **The supervisory framework for other financial subsectors needs significant strengthening.** Recent amendments to the Securities Law provide greater independence for the SEC. However, there is scope for further improvements in the regulatory framework, including: (i) providing immunity to securities regulators performing the legitimate discharge of their duties; (ii) imposing strict conflict of interest guidelines and trading restrictions for

[10] More frequent contact with bank managers (and boards) could also foster transparency.

members and employees of the SEC, MSE, and CSD; (iii) developing a system to handle investor complaints; and (iv) disclosing legal insider buying and selling for greater transparency.

54. **The regulatory and supervisory framework for the insurance sector remains underdeveloped.** The new insurance supervision law is a step in the right direction, but is still far away from EU requirements. Insurance supervision is housed in the MOF. However, the agency is understaffed and lacks experience. Urgent action is needed to ensure that the emerging sector applies good governance practices from the initial stages. Finally, if the government decides to go ahead with its plans for a second pension pillar (see below), the development of a supervisory function becomes a pressing need.

B. Management of Systemic Liquidity

55. **The nascent financial markets in FYR Macedonia mainly pose developmental problems**. However, the problems should be addressed now to avoid that they turn into systemic stability threats. The major issues are the shallowness of the interbank market, which cannot offset liquidity risks, particularly not in the case of large banks; a shortage of collateral in the market.

56. **Development of interbank money markets is hampered by credit risk due to uncertainties in realizing collateral.** Moreover, interbank money market transactions are not always secured. These factors have led to increased reliance on bilateral transactions outside the institutional money market that are better secured through contractual agreements. The central bank should monitor transactions in the interbank money market and ensure sufficient information flows on the number of transactions, volumes, and interest rates by maturities.

57. **The stipulation in the Payment Operations Law (POL), obligating the NBRM to execute payment guarantees between commercial bank clients, should be revised and ultimately handled outside the payment system.** Such a requirement, unknown in other countries, poses two risks. First, there is a legal risk for the NBRM. The central bank is not in a position to investigate cases between private agents that have entered contracts, and hence could be sued for inaccurate judgment. Second, the requirement also increases liquidity risks to the MIPS participants and there is no ready mechanism for managing these risks.

58. **The current set of monetary instruments (reserve requirements, Lombard facility, central bank bills (CBBs), foreign exchange swaps) is generally adequate for liquidity management**. Given the high liquidity of the system (banks hold voluntarily nonremunerated excess reserves of about 20 percent of required reserves), CBBs are the NBRM's most actively used instrument. Resort to the Lombard facility only happened occasionally in the past two years.

59. **CBBs are also used as a signaling tool for monetary policy.** The central bank conducts open market type operations through primary market auctions of 28-day bills 3 times a week. Since April 2003, the NBRM switched to a volume tender format where

interest rates are announced, together with an upper limit on the volume. The NBRM should discontinue this practice and if using volume tenders, should stand ready to accommodate all market demand. Secondary market development could be fostered by reducing the frequency of primary auctions and starting repo operations to mitigate credit risk by facilitating ownership transfer of underlying collateral in case of a default. Master Repurchase Agreements should be signed with all banks as soon as possible.

60. **Even after the introduction of treasury bills, CBB issues should be used as a monetary policy instrument to ensure the operational autonomy of the central bank.** The use of treasury bills as a monetary instrument should be gradually phased in as the NBRM acquires enough treasury bills through its secondary market operations. To prevent market fragmentation, to minimize the NBRM's interest burden,[11] and develop a yield curve that can serve as a benchmark for other instruments, treasury bills with a longer maturity structure than CBBs should be issued. Nonbank ownership of CBBs should be limited so that they can function purely for liquidity management purposes. A registry of pledged collateral should also be developed for promoting and monitoring the use of the existing government bonds.

61. **If resort to the Lombard facility is needed, access for the larger banks could be difficult because of a shortage of eligible instruments for collateral in their portfolios.** Currently CBBs are in practice the only eligible instrument, and they constitute only 0.6 percent of their assets. Some government bonds are eligible, but in practice are not usable because ownership transfer of these bonds can take place only through the stock exchange, which operates on a T+3 schedule.

62. **Given the high degree of euroization in the banking sector, the introduction of uniform reserve requirements on foreign currency deposits since June 2003 is a significant measure to enhance the stability of the financial system.** These requirements are to be met in foreign currency. It is expected that imposing a higher cost on the foreign exchange deposits will tilt the present bias towards local deposits.[12] In the longer term averaging provisions should apply to both categories of deposits.

[11] In 2002, this amounted to Mden 568 million (1 percent of central bank assets or 0.2 percent of GDP), an increase of 57 percent from 2001.

[12] Unlike reserve requirements on domestic currency deposits, there are no averaging provisions and the reserve accounts will be frozen during the maintenance period for required reserves on foreign currency deposits.

C. Financial Safety Nets

Deposit insurance

63. **The Deposit Insurance Fund (DIF) functions as a payout box with no supervisory authority over the banks.** The DIF insures deposits of natural persons, including foreign currency denominated deposits held in commercial banks, and savings houses. It covers 100 percent of deposits up to EUR 10,000 equivalent and 90 percent of the next EUR 10,000 equivalent, per depositor per institution. Compared to the average size of deposits, the combination of these provisions is generous. Currently, a flat premium of 0.7 percent is charged on all household deposits. As of May 2003, the reserve fund of the DIF covered 3.27 percent of the deposit base. The fund is being built up through an initial capital contribution of the government, premium contributions from member banks, and investment returns. The reserve fund is targeted to reach 4 percent of the deposit base. In case of a shortfall, the DIF is allowed to receive payments from member banks up to a prespecified limit, borrow from domestic or foreign sources, as well as from the government. The DIF is generally transparent in its policies related to insurance coverage and operations. Procedures on compensation (payouts), internal governance, and confidentiality have also been made publicly available.

Emergency lending facility

64. **A shortcoming in Macedonia's safety net infrastructure is the lack of legal provisions for an emergency credit facility for systemically important banks**. While the NBRM may extend collateralized short-term liquidity support to banks, this standing facility is designed essentially for overnight lending as an extension of intra-day credit for payments. In the event of a crisis in one of the larger banks, the NBRM does not have any legal tools or provisions to provide emergency support. It is recommended that legal provisions be developed to give the NBRM such authority, including a policy framework on the terms and conditions for such support. This should specify the decision-making roles and responsibilities of the various departments within the NBRM, coordination with the MOF, the eligibility of special collateral, and the disclosure policy. To prevent moral hazard, these policies may be kept internal. In designing such policies, the discretionary authority should be balanced with requirements for ex-post transparency with an appropriate delay.

V. Improving the Foundations for Intermediation

65. **The Macedonian banking system is hampered in its intermediation role, as is reflected in its limited lending activities.** In spite of a marked credit expansion in 2002 (Table 3) and an even higher rate in 2003 (in February 2003, the annualized growth in the banks' denar placements to the nongovernment sector equaled 10.6 percent), domestic lending has not yet reached the level from before the internal crisis of 2001.

66. **Improving intermediation requires a broad based approach.** In the specific case of FYR Macedonia, improving intermediation depends as much on the typical textbook requirement of creating more competition among banks, as on the requirement to improve the

broader context for financial operations. Enhancing the broader institutional framework and its governance—with special attention for the judicial framework and the AML efforts—will indeed lead to more efficient intermediation, through protecting the integrity of financial activities.

A. Problems with Intermediation

67. **In addition to the governance issues, other circumstances also explain the current low level of intermediation.** Aside from the general lack of confidence in the economy and weak credit demand, bank lending has been constrained by the interaction of the following factors: (i) high real rates and spreads; (ii) operational inefficiencies; (iii) a lack of viable projects due to governance problems in the enterprise sector compounded by problems in accounting and auditing; and (iv) the euroization of assets and liabilities. These factors, combined with weak bank governance result in low profitability and thus limit price competition.

68. **Problems with intermediation are reflected in the aggregate capitalization of the sector, which—albeit decreasing during the last two years—is still high (Table 4).** Risk-weighted capital was 28.1 percent at the end of 2002. Individual bank CARs ranged from 17.1 percent to 156.8 percent as of December 31, 2002. The high figures reflect more the limited role of banks in intermediation than strong profitability or fresh injections of capital. However, in the Macedonian circumstances—a high degree of euroization of bank balance sheets and poor quality of loan portfolios—the required capital adequacy ratio should be higher than 8 percent, even in the future.

69. **Inefficiencies in the operation of the banking system are reflected in low profits—despite wide interest rate spreads.** After a disastrous 2001—when the average return on assets was negative—banks registered 0.4 percent return on assets in 2002 and a mere 2.1 percent return on equity with a cost-to-income ratio close to one (0.91).[13] Indications of this inefficiency are very high operating expenses (amounting to 167 percent of net interest income, only a slight improvement over the previous years). However, banks differ considerably in their cost and revenue efficiency, with some of the best banks showing scope for improving lending methods and increasing efficiency, even under the current circumstances.

70. **The low level of lending is also a consequence of high real interest rates and spreads that prevent the emergence of viable projects that could earn enough profits to be financed by the banks.** Potential borrowers under these circumstances would likely be requiring financing for high risk/high return projects (adverse selection) that could ultimately lead to a deterioration of loan quality.

[13] Operating expenses were more than 67 percent higher than net interest income before provisions (salaries alone amounted to 91 percent of interest income).

71. **High nominal interest rates in recent years were to some extent also the outcome of the monetary policy stance, geared to supporting the exchange rate peg.** High interest rates on risk-free CBBs made these securities highly attractive for banks—in practice to smaller banks—as investment opportunities, more than lending. This situation has been moderated recently.

72. **Governance problems in the corporate sector, especially weak accounting practices that impede both loan evaluation and the early recognition of loan impairment, make lending practices of banks more conservative.** Although there is a requirement under the law, in practice the corporate sector does not produce financial statements consistent with IAS.

73. **The euroization of liabilities also constrained the intermediation activities of the banks.** Because lending opportunities to viable projects that could earn enough foreign exchange have been limited, and banks had to avoid breaching the open foreign exchange limits, they had to keep a significant ratio of their assets abroad, thus limiting funds available for domestic financial intermediation.

B. Market Development

74. **Capital market development should receive full attention.** The planned introduction of treasury bills will contribute to financial deepening by increasing investment opportunities and mobilizing savings from households as well as nonbank financial institutions. Issues of government paper at different maturities will help develop a yield curve that can serve as a benchmark for other instruments.

C. Developing the Pension System

75. **Macedonia's plans to introduce a two-pillar pension system by 2005 pose two major challenges given the fledgling state of the financial markets and institutions.** The first is the financing of the transition deficits.[14] If low GDP growth, i.e., below 3 percent annually, accompanies the introduction of the second pillar, the transition deficits could amount to 1.5 percent of GDP per year, gradually threatening the country's fiscal sustainability. The second challenge is posed by the shortage of financial instruments in which the pension funds could invest**.** At the moment, bank deposits are almost the only available financial asset. Too high a level of foreign investments by pension funds could threaten Macedonia's external position.

76. **A slow and cautious approach to developing the pension system is recommended.** A precondition is the development of a government securities market that would facilitate both aforementioned challenges. Government securities would help

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[14] These are the deficits that will occur during the transition from a one-pillar to a two-pillar system, caused by the transfer of pension contributions to second-pillar assets.

financing an increase in the fiscal deficit, to the extent that it remains sustainable, and would also provide investment opportunities for the pension funds. Moreover, government securities would stimulate the development of other investment opportunities.

D. Legal and Judicial Framework

77. **While Macedonia's legal framework for financial operations is generally sound, implementation and enforcement are perceived as weak.** The lack of enforcement had led to corruption, a lack of respect for the law, and a culture of noncompliance and nonpayment. All of these factors have contributed to the existence of a weak environment for governance and acted as a deterrent for financial intermediation.

78. **One of the weakest institutions in FYR Macedonia is its judicial system.** The judiciary suffers from a lack of staff trained in financial and commercial matters, low levels of funding, poor infrastructure and conditions of service, and a high level of public mistrust. Allegations of undue influence by politicians and others are widespread. Judges are not perceived as independent and the appointment process has been excessively politicized. Court performance is weak, efficient case management systems are nonexistent and computerization is very limited. Security for judges is poor and intimidation of witnesses and judges is common. Cases are often determined on procedural rather than substantive grounds. Appeals and adjournments are excessively easy to obtain. Training for judges and court staff is very limited.[15]

79. **Areas in the legal framework and its implementation that need attention from the financial system's point of view include**:

- The implementation of the new company law that incorporates a number of much needed corporate governance improvements. The concept of corporate governance is still not widely understood and much remains to be done to translate it into practice and to improve the quality of directors, administrators, accountants, and auditors.

- The gradual enforcement of compliance with IAS. Accounting and auditing laws and standards need to be updated and a professional organization should be established to organize the profession, register auditors, set professional ethical standards and control the quality of audit activity.

- The practice of employers forcibly removing the voting and other rights of shareholders needs to be terminated. Measures should be taken to prevent such abuses.

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[15] The authorities are aware of the deficiencies in the judicial sector and are taking steps to improve the situation, with donor assistance. Anecdotal evidence also suggests that the judges want to see, and will be strong supporters of serious judicial reform.

- Arbitration, mediation and other techniques of dispute resolution should be promoted to take the pressure off the court system.

- The Law on Bankruptcy of 1999 appears to work satisfactorily where private parties are involved. Problems arise when the State is an interested party and inappropriate attempts are made to influence the process. Given the special complexities of bankruptcy law, consideration should be given to assigning bankruptcy cases only to judges who are specialized in this area.

- The debt recovery framework works well in the case of uncontested debts. A mechanism exists whereby notaries can resolve debt recovery cases without referral to the courts. Recovery is generally quick and inexpensive. Where a court hearing is required, however, substantial delay is the norm and the outcome is unpredictable. Deficiencies in the Codes on Civil Procedure and Court Procedure allow the process to be abused and have encouraged a culture of nonpayment given the lack of effective sanctions for noncompliance. The pledge register is reasonably efficient, but the cadaster register needs more attention.

E. The Anti-Money Laundering Framework

80. **FYR Macedonia is a natural transit country for trafficking of illicit goods and of people. This and the presence of organized crime facilitate money laundering activities.** Proceeds of financial crimes are also believed to be laundered in FYR Macedonia. Recognizing the country's high vulnerability to money laundering, the authorities have taken important steps in recent years to build and implement a coherent legal framework to combat money laundering and the financing of terrorism. However, these efforts are still in their early stages. Much remains to be done to effectively counter money laundering**.**

81. **The UN resolutions relating to the prevention and suppression of the financing of terrorist acts are being implemented.** In 1998, the parliament adopted a Declaration Against Terrorism that obliges competent authorities to strengthen activities in detecting terrorist acts. Additionally, in July 2002, the government established an inter-ministerial coordinative body for fighting international terrorism, and is currently preparing a new law against terrorism.

82. **An AML Law was enacted in 2001 and a Law on Prevention of Corruption in 2002.** The act of money laundering is defined in the Criminal Code and includes an "all crimes" approach to predicate offenses. It permits the prosecution of money laundering separate from the predicate offense; however, no convictions for money laundering have yet occurred. Amendments to the AML Law are currently before parliament.

83. **The MOF has taken a lead role in coordinating the AML strategy.** Pursuant to the AML Law, a FIU was established in the ministry to receive and analyze reports of suspicious transactions and carry out related activities**.** At this time, the FIU lacks the capacity to analyze the volume of cash and suspicious transaction reports it receives, monitor

and enforce compliance with financial sector entities obligated to have AML policies and procedures in place, and lead efforts to coordinate AML activities with all relevant governmental bodies. Enhancing the financial and human resources available is a priority.

84. **Financial sector supervisory agencies lack appropriate legal authority to monitor compliance of the entities they supervise with AML/CFT laws.** The role of these agencies could be more effective if appropriate laws were amended to give them authority to monitor compliance and impose administrative sanctions for noncompliance without having to resort to court orders to enforce such sanctions. In addition, these agencies need specific legal authority enabling them to share information on transaction activities in which money laundering or terrorist financing is suspected directly with counterpart agencies in other countries. They would also benefit from specific AML/CFT capacity training.

85. **Law enforcement agencies similarly lack wide enough legal authority to fulfill their roles in a coordinated AML/CFT strategy.** Certain legal and constitutional limitations on the authority of the Public Prosecutor and Investigative Judges to effectively investigate and prosecute cases inhibit their ability to play a more effective role. Limitations include prohibitions against the use of wiretapping and other recognized modern investigative techniques to trace criminal activities, as well as constitutional and other legal impediments to the ability of law enforcement authorities to confiscate or seize/freeze assets of suspected criminals. Additionally, these limitations inhibit the ability of relevant government bodies to provide mutual legal assistance to counterpart agencies in other countries to investigate and prosecute cases that involve cross-border activities. Law enforcement agencies would also benefit from enhanced financial and human resources to dedicate specialists to learning techniques of investigating and prosecuting AML/CFT cases.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains summary assessments of Macedonia's adherence to the Basel Core Principles for Effective Banking Supervision, the Core Principles for Systemically Important Payment Systems, the Code of Good Practices on Transparency in Monetary and Financial Policies, and the Financial Action of Task Force Recommendations for AML/CFT. The detailed assessments have been undertaken in May–June 2003 as part of the Joint World Bank/IMF FSAP and have served as a basis for the summary assessments.

The assessments have been used to gauge the risks and vulnerabilities as well as the developmental needs of the financial sector. For those areas, covered by the assessments, which have not yet been fully aligned with these international codes, the FSAP team made recommendations to the authorities, who expressed their willingness to implement these suggestions as soon as feasible and hence to further strengthen the institutional and legal basis of the financial system.

FYR Macedonia is making considerable progress in observing the international standards and codes that were assessed. The agencies in charge of financial sector oversight also strive for transparency and openness in their policies and procedures. The area needing most effort is the AML/CFT. Cross-sector issues that need attention in order to support financial sector integrity include legal protection for regulators and supervisors, clearly defined enforcement powers, and publication of mission statements and of conflict of interest rules for staff.[1]

In banking supervision, assessors noted the need for further strengthening of regulations with respect to the role and power of the official administrator in weak banks. Regulations are needed in the areas of market and interest rate risk. Accounting and disclosure standards for banks should be developed and consolidated accounting and supervision should be initiated. Supervisory practices should develop further in the direction of risk-oriented supervision. Supervisors should be legally empowered to play a more active role in AML issues. Finally, the publication of a mission statement should support the public understanding of their work.

The MIPS meets most international standards for systemically important payment systems. Improvements have been suggested to give the National Bank of the Republic of Macedonia a clear role in establishing policies for, and an oversight role of, a national payments infrastructure. In the near term, the authorities should also consider building a back-up facility for MIPS at a remote location.

Assessment of the observance of the MFP code reveals a great degree of transparency through publications and websites, as well as a presumption in favor of consultation with major stakeholders. The NBRM could take advantage of the establishment of a public affairs office to make its roles and those of the financial system better known.

The assessment of the AML/CFT framework reveals the need to strengthen the legal framework and to expedite its implementation. The latter crucially depends on allocating more human resources to the agencies involved. Financial sector supervisors should be given a greater role in monitoring and enforcing compliance with the laws.

[1] Even though not formally assessed through the respective codes, these shortcomings also apply to the SEC and the insurance supervisors.

I. Basel Core Principles for Effective Banking Supervision

A. General

86. The assessment is based on a review of the legal framework governing banking and bank supervision as well as a detailed examination of the policies and practices of the NBRM, the institution in charge of banking regulation and supervision.[16]

87. FYR Macedonia has made substantial progress in enhancing its supervisory and legal framework for banking institutions with significant donor help. The legal framework for effective supervision has been strengthened and prudential regulations refined, especially through the Banking Law enacted in 2000. Supervisory practices have been made more effective and, through training, improvements have been made in on-site inspections and off-site monitoring.

88. In the wake of the BCP assessment, amendments to the Banking Law have already been passed, strengthening the fit-and-proper rules, regulatory control over significant changes in bank ownership, investments by banks, and the range of corrective actions to intervene in problem banks. Further amendments are planned to strengthen the role and power of an administrator appointed to oversee insolvency proceedings in banks under enhanced monitoring. However, modifications are still needed in the areas of investments of nonfinancial corporates in banks, assessing market risk, accounting and disclosure standards, money laundering, and consolidated accounting and supervision.

89. With the new legal framework in place, the focus should be on full implementation. Gradually the system of laws, decisions and instructions for the banks, as well as internal manuals for the supervisors should become a stabilized system establishing the required legal and procedural environment for banking supervision. Experience will enable the NBRM to move further toward a more risk-based supervisory system, away from one that is largely compliance focused.

Institutional and macroprudential setting, market structure—overview

90. Commercial banking is governed by the Banking Law of 2000. Activities of savings houses are still governed by the 1996 Act on Banks and Savings Houses, pending the planned 2004 enactment of a new law on savings houses. Until then no new licenses are being issued to savings houses. In 2002 the Law on Microfinancing Banks came into force. One microfinance bank has been licensed under the new law. According to the Banking Law and the Law on the NBRM, the latter supervises banks and savings houses.

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[16] The assessment was undertaken by Paul J. van Sluijs, the Netherlands Bank, and Marc Quintyn, IMF. A previous BCP assessment was done in 1999.

91. The banking system consists of 21 banks and 17 savings houses (end of 2002). It is concentrated, with the three largest banks accounting for 64 percent of the systems' total assets. Owing to the introduction of foreign strategic owners, the largest banks have increasingly sound operations and improving governance structures. Some smaller banks suffer from weak management and ownership structures, a source of vulnerability for the system. Banking activities are relatively straightforward. The savings houses are small, which makes profitable business increasingly difficult.

General preconditions for effective banking supervision

92. FYR Macedonia is making progress in meeting the preconditions for effective banking supervision although more effort is needed. The macroeconomic situation is relatively stable, despite several sources of disturbance in the past decade. The broader legal framework is generally sound. The weaker links are implementation and enforcement of laws. Excessive delays, questionable court decisions, perceived political interference, and corruption have led to a lack of respect of law and a culture of noncompliance and nonpayment. On occasion, these weaknesses undermine the work of banking supervisors. The authorities are strengthening procedures for effective resolution of banks and the mechanisms for providing an appropriate level of systemic protection.

B. Main findings

Objectives, autonomy, powers, and resources (CP 1)

93. The legal framework is clear with respect to the objectives of banking supervision and the functions and powers of the NBRM. The Banking Law clearly regulates the operations of the banks. The central bank is an independent agency. The supervision department is directly responsible to the governor, while supervisory decisions are taken by the NBRM Council. The law empowers the NBRM to take measures to improve the conditions of the banking system. Measures are defined in the law as well as conditions under which they may be exercised. Since recently, supervisors are legally protected while exercising their profession. Publication of a mission statement could improve the public's understanding of the supervisors' work.

Licensing and structure (CPs 2–5)

94. The legal framework governing the licensing of banks has been further strengthened following the FSAP assessment. Permissible activities are clearly defined in the Banking Law. A recent amendment had made the misuse of the word "bank" a criminal offense. New fit-and-proper criteria have been set forth—following a rejection by the Constitutional Court in May 2003 of the existing criteria—and regulatory control over significant changes in ownership has been strengthened. The threshold above, for which prior approval is now required, has been lowered to 5 percent of the total amount of voting shares that is more

appropriate for Macedonia's current circumstances. Rules for major acquisitions by banks have been established.

Prudential regulations and requirements (CPs 6–15)

95. Most essential prudential regulations are well specified in the Banking Law with NBRM decisions adding further details. The NBRM has put great effort in the now well implemented loan classification and loan loss provisioning rules. Regulations on large exposures and connected lending are on occasion hard to implement given the shaky ownership structure in some banks. Systems to control and monitor market risk by banks are only in a preparatory stage, but supervisors received training to develop a methodology and reporting system. On credit risk, until now the supervisors have not required the banks to develop internal procedures for monitoring their clients' foreign exchange exposures. Implementation of the AML law has only started and the law itself also needs strengthening. The supervision department might not have enough resources for the fulfillment of these new tasks.

Methods of ongoing supervision (CPs 16–20)

96. In a few years' time, considerable energy has been spent to set up an effective system of on-site inspections and off-site monitoring. Both systems now go beyond the level of formal checking based on rules and regulations. Contacts with banks are frequent but should nevertheless be intensified. Consolidated supervision and reporting is not practiced, but at the moment it is not an issue.

Information requirement (CP 21)

97. At present there are no specific accounting standards for banks. The need is still limited because balance sheets are relatively simple. However, the government should take initiative in this area.

Formal powers of supervisors (CP 22)

98. Supervisors have a fairly broad range of corrective measures at their disposal, supplemented by an article allowing the NBRM to take "any action" when deemed necessary. Nonetheless some of the measures can only be invoked late in the process. In practice, supervisors have used these powers to take corrective actions and to press charges against banks (in 2002, 34 such actions were taken). However, in some cases more forceful intervention would be desirable. Within the Banking Supervision Department, a special unit deals with banks under enhanced supervision.

Cross-border banking (CPs 23–25)

99. The law empowers the supervisors to undertake globally consolidated supervision and to establish contacts with host country supervisors. However, no Macedonian banks are currently active abroad. Contacts with home supervisors have always existed de facto, and

the obligation has only recently been put in the law. Memoranda of Understanding (MOUs) are under preparation with several countries.

Table A.1. Recommended Actions to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
CP 1	Further strengthening of the application of corrective actions would be welcome. Some of them can only be applied late in the process, which could constrain supervisory action. A mission statement of the NBRM's supervisory function could be published. Priority should be given to the codification of the rules and procedures that govern the work of the supervisors.
CP 2–5	With respect to permissible activities, it would be useful if the NBRM had broader powers to investigate suspicions of banking activities without license. As a priority, supervisors should develop a strategy to diminish the ownership role of nonfinancial corporates in commercial banks.
CP 6–15	Urgent progress needs to be made in preparing rules and regulations for market risk, as well as in training the supervisors in this area. In medium term a framework to control interest rate risk needs to be developed. Implementation of the AML Law needs to be expedited as a high priority. The supervision department needs more resources for this task. In general, a much more forceful attitude should be developed against money laundering.
CP 16–20	The authorities should further move to more risk-oriented on-site inspections and to include in the off-site monitoring elements of soundness of the banking system at the aggregate level. Contacts with managers of banks should be intensified. In the medium term preparations for consolidated supervision and reporting should be started.
CP 21	Preparation of accounting standards for banks should be started in the coming years.

Authorities' response

100. The authorities are in broad agreement with the BCP assessment. Several amendments to the Banking Law and the Law on the NBRM were adopted following the

FSAP missions to correct weaknesses identified during the assessment. The authorities are determined to further improve the legal framework for banking and its supervision, and the supervisory methods. On the introduction of accounting standards for banks, they noted that this can only happen after the government has established uniform national accounting standards.

II. CPSS Core Principles for Systemically Important Payment Systems

A. General

101. This assessment of observance by FYR Macedonia of the CPSIPS, and associated oversight responsibilities focuses on the MIPS, the cornerstone in the country's payments and settlement infrastructure.[17] The other main payment system is the KIBS used for payments between corporate entities and that carries 22 percent of noncash payments by value. All payments of more than 3 million denars must be made through the MIPS, while the average value of KIBS transactions is relatively low, at about 22,000 denars (US$420). KIBS is not used for securities clearings or to support activity in any other organized financial market.

102. The assessment is based on a review of the Law on the NBRM and the POL, as well as on interviews with relevant staff of the NBRM and input from the MOF.

Institutional and market structure

103. The legal framework governing payments and payment systems has been considerably revised over the past three years. The objectives for the central bank in the area of payment systems are specified in the Law on the NBRM. The POL was passed in April 2001. This law gives greater definition to the payments responsibilities of the NBRM and the MOF and requires that banks wishing to conduct payment operations should be licensed by the NBRM. The conditions that have to be met by licensed banks are set out in a regulation.

104. The noncash payment system is mainly used between corporate entities and banks. There are 21 banks involved in payment clearing and settlement (July 2003). The system is relatively concentrated, with the NBRM initiating most payments through the clearing system (about a quarter of total value), and the two largest banks a further 30 percent. Cash is still the major means of payment for individuals. Macedonian denars on issue are 6 percent of GDP with an unknown quantity of euros and U.S. dollars in circulation.

B. Main Findings

105. The MIPS meets the CPSIPS requirements in most respects. Finality of payments is well supported and MIPS' rules and procedures are clear to all participants. Some

[17] The assessment was conducted by Nicholas Roberts, Reserve Bank of Australia.

improvement to governance arrangements is warranted and the oversight of the system should be more broadly defined than at present. The NBRM should also be given legal power to define broad objectives and a strategy for developing Macedonia's payments infrastructure.

106. While liquidity risks are mostly manageable in MIPS, the NBRM's obligation to debit participants' accounts without prior notice should be lifted.

107. The system is reliable and has generally good security features. However, without a remote site or clear procedures for rapid reconstruction of the MIPS system at an alternative site, the MIPS remains vulnerable to disabling events, such as the primary site being unavailable due, for example, to bomb scares or natural disasters.

Legal foundation (CP I)

108. The NBRM Law (January 2002), defines the objectives of the NBRM in the area of payment system as regulating the system, coordinating interbank settlements, acting as the government's international banker, and distributing cash. The POL refines the payment system responsibilities of the NBRM and requires NBRM licensing of banks for payment operations. In addition, some provisions in the Banking Law and the Law on Data in Electronic Form and Electronic Signature have an impact on payment operations.

109. The laws support the finality of payments through MIPS. However, the POL specifies some unusual obligations for banks, such as allowing creditors to take funds from debtors' accounts. The laws give the NBRM considerable leverage over the participants in the payment system through the conditions they have to meet before obtaining and retaining a license to conduct payment operations. These conditions are set out in regulations. However, there is no legal support for a broad policy role for the NBRM in the payment system, and the current legislation focuses on the NBRM regulating individual institutions rather than the payment system as a whole. In addition to the NBRM, the MOF also issues regulations for the design of payment instruments, limits on the size of cash payments by enterprises, and the processes of payments under court orders.

Understanding and management of risks (CPs II–III)

110. The rules and procedures of MIPS are new and were developed in close consultation with all participants and outside experts. Once the rules were finalized, a number of seminars were held to discuss their implications. The rules are available to participants both in hard copy and on the NBRM's website. In general, risks in the MIPS system are transparent to participants and mostly easily managed.

111. An important source of liquidity risk is that the NBRM may unexpectedly debit the accounts of participants if instructed to do so by court orders or if a bank's client instructs the NBRM to execute a payment guarantee on its behalf. Debits related to bank guarantees can be large and requests to exercise guarantees can arrive without prior notice to either the affected bank or the NBRM. For court orders banks are informed at least 15 days before the

order is executed but there is still uncertainty about the exact timing of payments that may be made at any time after the 15-day notice period has passed.

Settlement (CPs IV–VI)

112. The MIPS is a real time gross settlement (RTGS) system providing prompt settlement throughout the day. Once in MIPS, a payment will only fail to be executed if a bank has insufficient funds in its central bank account. Banks licensed to conduct domestic payment operations are required to hold such an account through which all interbank payments are settled. Hence settlements have no credit or liquidity risks.

Security and operational reliability, and contingency arrangements (CP VII)

113. System security in the MIPS and the reliability of the primary site is good. However, the MIPS does not have a remote back-up site. Further, an integrated approach to risk management in the physical environment is lacking.

Efficiency and practicality of the system (CP VIII)

114. The MIPS offers a good basis for efficient liquidity management; it is well adapted to Macedonia's payments needs, running with only three staff and still having ample capacity. The costs of transactions are internationally comparable.

Criteria for participation (CP IX)

115. The technical requirements for entry to MIPS are set by the NBRM and are publicly available. Article 5 of the POL specifies all institutions that may open an account at the NBRM, and hence participate in MIPs.

Governance of the payment system (CP X)

116. There are only a few formal requirements for transparency in the governance of MIPS, which is a weakness. However, the Payments Department keeps the NBRM Council informed and the NBRM Annual Report contains details of developments in the MIPS. The NBRM has conducted follow-up surveys of participants' experiences with the MIPS.

Central bank responsibilities in applying the CPs

117. The law defines as the oversight responsibility of the NBRM the regulation and supervision of existing institutions, but gives it no role in formulating payment policy. The NBRM should define its objectives in formulating payment policy encompassing stability, efficiency, competitiveness, smooth functioning, and development of the payment system.

118. Since there is no clear separation at the level of the NBRM between oversight and operation of MIPS, the NBRM should continue to encourage outside scrutiny by publishing material on the MIPS and getting input from external assessors.

119. The MOF also has a regulatory role in some areas of the payment system. Interaction between the NBRM and the MOF is managed through regular meetings between staff of the agencies, with minutes kept of significant meetings.

Table A.2. Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank's Responsibilities in Applying the CPs

Reference Principle	Recommended Action
Legal foundation	
CP I	In the next round of modifications to the legal framework, the NBRM should be made responsible for ensuring the efficient development of the country's payment and settlement system, its smooth running, and its stability. Some unusual obligations for banks should be urgently removed from the POL.
Understanding and management of risks	
CPs II–III	The obligation on the NBRM to execute payment guarantees and court orders should be revised immediately.
Security and operational reliability, and contingency arrangements	
CP VII	The NBRM should give high priority to the establishment of a remote site that can be activated quickly in case of need. An officer should be designated with responsibility for risk assessment of the physical environment for MIPS.
Efficiency and practicality of the system	
CP VIII	The NBRM should continuously analyze queuing behavior and the reasons for significant delays in payments when these occur.
Governance of the payment system	
CP X	The NBRM should commit publicly to reporting on the development and operation of MIPS. This commitment could include publication of follow-up surveys of participants' assessment of the operations of MIPS.

Reference Principle	Recommended Action
Central bank responsibilities in applying the CPs	
Responsibilities A–D	In the medium-term the authorities should set broader objectives for the central bank, such as the stability, efficiency, smooth functioning and development of the payment system in FYR Macedonia. The NBRM should encourage outside scrutiny of its system by publishing material on the system to the public. The NBRM could encourage input from external assessors such as payment experts of other central banks and external auditors.

Authorities' response

120. The authorities were pleased with the assessment. They stressed that the MIPS has already served as an example of a modern RTGS system in several countries. They are committed to further improve the system, in particular by establishing a remote back-up site.

III. Code of Good Practices on Transparency in Monetary and Financial Policies—Monetary Policy

A. General

121. The assessment of the observance by the NBRM of the IMF's MFP Transparency Code for monetary policy is based on a review of relevant laws, regulations, and policies; documentation provided on the NBRM website and in a variety of official NBRM publications; and discussions with various departments of the NBRM.[18]

122. The legal documents that were reviewed include the Constitution of the Republic of Macedonia, the Law on the NBRM, the Law on Accountancy, the Banking Law, the Foreign Exchange Law, and the Law on Public Procurement.

B. Main findings

123. In general, the NBRM practices a high degree of transparency in most of its operations. In a number of areas further steps could be taken to improve disclosure and transparency.

[18] The assessment was conducted by Philip Schellekens, IMF.

Clarity of roles, responsibilities, and objectives of central banks for monetary policy

124. The NBRM maintains a high standard of transparency in disclosing its roles, responsibilities, and objectives to the public. The Law on the NBRM clearly defines the ultimate objective of the NBRM as the maintenance of price stability. In addition, the central bank is required to "support the economic policy of the country and the financial stability of the country without jeopardizing the realization of the main objective and adhering to the principles of the market economy." The Constitution and the Law on the NBRM guarantee the independence of the central bank with respect to the central government and its administrative bodies in pursuing its main objective. Only in exceptional circumstances can the central bank be overridden. The finance minister is allowed to attend the meetings of the central bank, but has no voting power. However, up to now he has not been invited.

125. The responsibilities of the NBRM are listed in the central bank law (also in various publications and the website of the central bank) and include the design and conduct of monetary policy; licensing banks, savings houses, and exchange offices, and their supervision; management of foreign exchange reserves and the conduct of foreign exchange policy; the conduct of payment operations; and the issuance of banknotes and coins. The main guiding principle for monetary policy is the maintenance of a de facto fixed exchange rate peg of the Macedonian denar to the euro; the main instrument is the issuance of central bank bills.

126. Until recently, the main form of accountability of the NBRM was the obligation to send its annual report to the government. The only other explicit arrangement, recently put in the Law on the NBRM, is the obligation for the governor to appear before parliament at least twice a year.

127. The NBRM is governed by the National Bank Council consisting of nine members. The central bank law discloses the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the Council. All members of the Council are appointed to and relieved from office by parliament, upon proposal of the President of the Republic.[19] Members of the Council can be dismissed "if they perform the function and competencies assigned by the law dishonestly, unscrupulously, irresponsively, unprofessionally, or not promptly."

128. The institutional relationship between monetary and fiscal operations is defined in the Law on the NBRM. Direct lending to the government is restricted to credits or loans with a maturity of one day or less (without any possibility for renewal or extension). Further, the manner in which central bank profits are allocated and how capital is maintained are defined in this law.

[19] An amendment to the current legislation provides that the vice-governors be appointed by parliament at the proposal of the governor.

129. The central bank discloses the agency roles it assumes for the government (debt and foreign exchange reserves management, representation in the international financial institutions, international payment operations, and certain banking operations).

130. No information is disclosed on the terms of government deposits with the central bank. They are regulated by an agreement between the NBRM and the MOF and these regulations are not considered by the authorities as information that should be publicly disclosed.

Open process for formulating and reporting monetary policy decisions

131. The process with which the NBRM formulates and reports monetary policy decisions is transparent. The framework, instruments, and targets that are used to pursue the objectives of monetary policy are disclosed and explained through a variety of means, such as the central bank's annual, semi-annual, and monthly reports and its website. Procedures and practices governing monetary policy instruments and operations are defined in Decisions and Manuals, some of which are also available on the central bank's website. Rules and procedures for the central bank's monetary operations and market interventions are publicly disclosed by the same means. For proposed substantive technical changes to the structure of monetary regulations, the NBRM holds consultations with relevant parties and within an appropriate period.

132. The decisions of the National Bank Council, the governing body of the NBRM, are published and explained through (often same-day) press releases as well as through the central bank's website. Its meeting schedule, however, is not disclosed. Monetary policy decisions are further explained in the central bank's periodic publications.

Public availability of information on monetary policy

133. The NBRM makes efforts to supply the public with information on monetary policy. It discloses its balance sheet on a preannounced schedule, discloses information about its monetary operations and foreign exchange reserves, maintains an active publications program, and discloses the regulations governing monetary policy. A public affairs office would add to the accessibility and transparency of the central bank.

134. At present, Macedonia does not compile and disseminate the Data Template on International Reserves and Foreign Currency Liquidity. There is also no preannounced schedule of reserves data dissemination.

Accountability and assurances of integrity by the central bank

135. The modalities of accountability are disclosed through the Law on the NBRM. The financial statements of the central bank are externally audited and disclosed to the public, as is information on the central bank's operational expenses and revenues.

136. The internal governance procedures themselves (including the internal control systems) are not disclosed to the public. Some disclosure has been achieved through the recent publication of a Research Memorandum on internal audit practices (see the central bank's website). The Internal Audit Book of Rules is not published.

137. Certain standards of behavior, namely those set by the Law on the NBRM and the Law on Corruption Prevention, are disclosed. However, the Code of Conduct of the Employees of the NBRM is not available to the public, nor are the yearly Statements on Conflicts of Interest by the members of the National Bank Council. Also, if a Council member were to declare a conflict of interest prior to an actual vote, the resulting abstention from voting would not be expected to be disclosed to the public (in line with the current practice that voting records are not disclosed).

138. While certain waivers of liability apply to the NBRM as an institution and to certain employees (e.g., the bank supervisors), the scope of protection is rather limited both in terms of the circumstances under which immunity applies and the coverage of staff in the central bank.

Table A.3. Recommended Actions to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Practice	**Recommended Action**
I. Clarity of roles, responsibilities and objectives of payment system oversight agencies	Give priority to defining and disclosing more prominently the role of the central bank in providing emergency liquidity support to illiquid but solvent banks. Disclose the terms of government deposits with the central bank.
II. Open process for formulating and reporting of payment system oversight policies	Move to a system of regularly scheduled Council meetings. Disclose the Council meeting schedule and agenda.
III. Public availability of information on payment system oversight policies	Publish more detailed audited balance sheets. Disclose, ex post, aggregate information on emergency credit facilities, exercising judgment on the timing and on the nature of the information disclosed. Establish a public affairs office.

Reference Practice	Recommended Action
IV. Accountability and assurance of integrity by payment system oversight agencies	Disclose the internal governance standards against which the integrity of operations is evaluated. Disclose the internal code of conduct that applies to the employees of the central bank. Expand the requirement of statements on conflicts of interests to all managerial staff of the central bank and disclose the content and purpose of the standards related to conflicts of interests. Disclose more clearly the modalities of legal protection of NBRM staff. Expand the scope of legal protection to all staff in the discharge of their duties.

Authorities' response

139. The authorities found this assessment to be very useful and are undertaking several initiatives to fulfill the recommendations made in this assessment.

IV. Code of Good Practices on Transparency in Monetary and Financial Policies—Financial Policies (Payment system, Banking Supervision, and Deposit Insurance)

A. General

140. The assessment of observance of the IMF's MFP Transparency Code for financial policies was carried out for payment system oversight and banking supervision in the NBRM, and for the DIF.[20] Relevant documents consulted include the Law on the NBRM, the Banking Law, the POL and—for the DIF—the Law on the Deposit Insurance Fund and its Charter, establishing its operational guidelines and the roles and responsibilities of the managing bodies. Interviews were conducted with representatives of the respective agencies.

B. Main findings

141. In general, the Macedonian authorities strive for open processes of communication with regard to their financial policies and, as such, have achieved a great degree of

[20] The assessment of the banking supervision function was carried out by Marc Quintyn (IMF), the payment system oversight was assessed by Nicholas Roberts, Reserve Bank of Australia; and the assessment of the DIF was done by Anita Tuladhar and Marc Quintyn (both IMF).

transparency. Roles and responsibilities are defined in laws and regulations available to the public through the Official Gazette and respective websites. New supervisory and payment system developments are communicated through the NBRM's Annual Report. The reforms in the payment system over the last three years have demonstrated the NBRM's commitment to transparency. The significant changes that were made were communicated to the public through a well-organized media campaign. The financial community was kept well informed through regular meetings. As the reforms were implemented a series of seminars/workshops were held.

142. Further improvements are desirable with regard to: (i) the central bank's emergency lending procedures; (ii) the NBRM's role as supervisor of the payment system; and (iii) the bank's public information services and the publication of internal governance procedures.

143. The DIF insures deposits—including foreign currency denominated deposits—of natural persons held in commercial banks and savings houses. The DIF acts as a payout box and does not have any regulatory or oversight function. It is a state-run institution with a five-member Board of Directors. Three are appointed by the MOF, one by the central bank, the chamber of commerce and the banking industry, each.

Clarity of roles, responsibilities, and objectives of financial policies

144. Most elements pertaining to the roles, responsibilities and objectives of the NBRM, with respect to its role as a banking supervisory agency and as the overseer of payment systems, are dealt with in the Law on the NBRM, published in the Official Gazette and on the NBRM's and MOF's website. The powers of the NBRM with respect to payment system oversight are defined by the licensing requirement imposed on banks. Recent amendments to the law on the NBRM have clarified and specified the relationship between the NBRM and other agencies (including the MOF) with respect to supervision and the exchange of information.

145. The functioning and policies of the DIF are clearly spelled out in the DIF Law, supplemented by the Charter. Both documents are available through the DIF's and the MOF's website, publication in the Gazette, and an information brochure.

Open process for formulating and reporting of financial policies

146. Formulating and reporting of financial policies by the NBRM happens, as a rule, in an open manner. For banking supervision, the NBRM uses "Decisions" to specify the articles in the law and "Supervisory Circulars" to further explain the purpose of decisions. A consultation process with the banking community precedes major changes to the legal framework. Following adoption of new laws or amendments, meetings are organized with the affected institutions.