SM/07/391
Correction 1

January 24, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Montenegro—Financial System Stability Assessment**

The attached corrections to SM/07/391 (12/19/07) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 11, para. 9, lines 4 and 5: ", which is supervised by the Ministry of Finance," removed

Page 12, Table 2, stub "Foreign majority owned", column "2006": for "9" read "8"

Page 34, para. 76, line 7: for "The last bank license was issued in December 2005,"
read "A new bank license was issued in December 2005,"

Page 35, para. 80, line 2: for "CKB, NLB Montenegro Bank, Podgoricka Bank, and have rated parent institutions,"
read "CKB, NLB Montenegro Bank, Podgoricka Bank, and Hypo-Alpe-Adria Bank have rated parent institutions,"
para. 83, line 7: for "Lovcen, the dominant market player, is 49 percent owned by foreign interests."
read "Lovcen, the dominant market player, is majority-owned by foreign interests."

Questions may be referred to Mr. Driessen, MCM (ext. 36257).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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II. Key Financial Sector Risks and Vulnerabilities

6. **Main vulnerabilities are associated with the extremely rapid growth of the banking system—stress tests confirmed growing credit and liquidity risk**. These vulnerabilities are exacerbated by stock market buoyancy, a weak disclosure regime, and the absence of the traditional lender-of-last resort function given unilateral euroization.

7. **The banking sector has grown at a very rapid pace, particularly since 2006**. Growth in assets was supported by an increase in deposits related to high capital inflows, and a greater formalization of the economy. There is a large and growing foreign presence in the banking sector: the largest bank was purchased in 2006 by Hungarian banking group OTP, and a foreign bank that commenced operations in 2006 already ranks fourth in terms of assets. However, not all foreign bank owners are internationally-rated financial institutions that can provide risk management expertise, as well as capital and liquidity support. There are also recent indicators that foreign banks are stepping up foreign borrowing now that a slowdown in deposit growth is observed. Some domestic banks have also been pursuing aggressive expansion strategies.

8. **Financial soundness indicators, while not yet alarming, are rapidly deteriorating (see Table 3)**. Capitalization remains at a high level—the overall capital adequacy ratio for the banking system at end-June 2007 stood at 18.7 percent, but well below the over 30 percent rate at end-2004—reflecting bank efforts to establish a more efficient balance sheet structure.[3] However, liquidity indicators are becoming much tighter, with liquid assets falling to 25 percent of total assets at end-June 2007, and the loan-to-deposit ratio increasing to 95 percent—up from 88 percent one year earlier. Recently, earnings have increased on the back of growing interest margins—in sharp contrast to what was observed at the time of the FSAP missions, when strong competition for market share depressed profits and kept net interest margins under pressure. Although falling overhead costs have contributed to the rebound in profits, growth in bank employees has lagged well behind the credit expansion.

9. **Appendix II provides greater detail on financial sector structure, including on the nonbank financial sector**. The latter has experienced solid growth over the last few years, although well below that of the banking sector. Assets of the nonbank financial sector at end-2006 stood at about 16 percent of total financial sector assets. Leasing activity~~, which is supervised by the Ministry of Finance,~~ has taken off after the introduction of the Law on Leasing in 2005. Two stock exchanges compete for trading, mostly in a number of domestic investment funds.

[3] Excluding the effect of the reduction in risk weights on residential mortgages (from 100 to 50 percent) introduced in October 2006, capital adequacy would have fallen even further.

Table 2. Montenegro: Structure of the Financial System, 2002–2006

	2002	2003	2004	2005	2006	
Number						
Banks	10	10	10	10	10	
Domestic majority owned	na	7	7	3	1	
State owned	na	2	2	2	0	
Private owned	na	5	5	1	1	
Foreign majority owned	na	3	3	7	8	
Insurance Companies	4	5	6	6	6	
Leasing Companies	0	0	0	0	5	
Micro credit enterprises	2	2	2	2	4	
Investment Funds	6	6	6	6	6	
Management Companies for Investment Funds	6	6	6	6	7	
Brokers	5	5	6	9	15	
of which with dealer licence	0	1	1	1	3	
NEX Montenegro Stock Exchange						
A/B listed companies	0	1	1	3	3	
Free market companies	311	374	426	373	310	1/
Montenegro Stock Exchange						
A/B listed companies	0	11	10	19	23	
Free market companies	346	368	375	368	368	1/
Financial system assets (in million of euro)						
Banks	340.5	349.8	444.4	695.8	1431.4	
o/w 3 largest banks	na	207	264.8	462.3	912.5	
o/w foreign majority owned	na	82.1	137.8	610.2	1329.2	
o/w domestic majority owned	na	267.7	306.6	85.6	102.2	
state owned	na	67.1	72.8	35.5	0	
private owned	na	200.6	233.8	50.1	102.2	
Insurance Companies	17	23	25	31	31	2/
Leasing Companies	0	0	0	0	42	3/
Micro credit enterprises	na	11	14	19	33.8	
Investment Funds	13.8	76.2	84.4	151.3	209.6	4/
Management Companies for Investment Funds	1.8	1.7	1.8	1.5	1.8	4/
Brokers	0.3	0.3	0.3	0.6	0.9	4/
of which with dealer licence	0	0.1	0.1	0.1	0.6	4/
Assets as percent of GDP						
Banks	26.2	24.4	28.9	42.3	72.3	
Non-bank institutions	na	7.8	8.2	12.4	16.2	

Source: Central Bank of Montenegro

1/ End-September 2006.
2/ End-December 2005.
3/ End-June 2006.
4/ End-July 2006.

bank corporate governance, risk management systems, and internal audit. In addition, along with the Bank of Slovenia, the CBM is organizing a seminar for banks to discuss these topics. The CBM continues to enhance its work in this area.

74. **Concerning the point on legal protection of supervisors**, the authorities pointed out that despite considerable counter-arguments put forward by the CBM, the Constitutional Court has ruled that this provision was unconstitutional.

75. **In addition, the authorities pointed out that *in practice*, examiners require more severe classification** than is the classification in category B (special mention) if the loan is past due more than 30 days. Thus, through the examination process banks apply Basel minimal standards. Moreover, it is planned, upon the adoption of the new Law on Banks, to adopt new decision on capital adequacy that would move classification of all asset items to the implementation of the standardized approach of Basel II.

APPENDIX II: FINANCIAL SECTOR OVERVIEW

Structure of the banking system

76. **There are currently ten banks in the country, the largest of which, CKB, was purchased by the Hungarian banking group OTP at end-2006**. As a result of aggressive growth (assets more than doubled in the 12-month period ending in June 2007), this bank holds 36 percent of assets, 35 percent of loans (up 120 percent in the 12-month period to June 2007), and 40 percent of deposits as of end-June 2007; however, it accounts for only 19 percent of total banking sector capital. The largest three banks represent 63 percent of total assets. ~~The last~~ A new bank license was issued in December 2005, and this bank started operating in March 2006. Two operating banks are currently under a supervisory plan. Several bank takeovers have taken place recently: in 2005, Podgorica Bank was purchased by Société Générale (France), and Euromarket Bank was purchased by Nova Ljubljanska Bank (NLB) Montenegro Bank; in 2006, Atlasmont Bank purchased a stake in Pljevaljska Bank, which was renamed Invest Bank Montenegro; OTP purchased CKB, and the state sold 30 percent in Niksicka Bank (renamed Prva—or First—Bank) to a former shareholder in CKB. A number of banks have been liquidated—one bank is still in the final stages of liquidation (Ekos Bank).

77. **Banks have grown rapidly over the last few years, with declining capital and liquidity indicators**. Deposits and loans increased sharply (by 149 and 169 percent respectively) in the 12-month period ending in June 2007.[14] Capital adequacy for the system stood at 18.7 percent as of end-June 2007 with a significant dispersion across banks, ranging from 14 percent to 169 percent. Bank profitability appears rather low, with return on assets falling from 2.5 percent in June 2005 to 1.4 percent at end-June 2007 for the banking system as a whole. The net interest margin declined from 6.9 percent in December 2004 to 1.8 percent at end-June 2007 as a result of increased competition in the context of high operating and regulatory costs. Nonperforming loans (NPLs) have fallen to 2 percent of total loans, with provisions of 104 percent of NPLs.

78. **Provisions have fallen as a percentage of total loans (see Table 3).** The loan-to-deposit ratio is at 95 percent at end-June 2007, up from 77 percent in December 2005, due to the strong growth of loans. Liquidity—quite seasonal—has declined, with liquid assets falling to 25 percent of total assets at end-June 2007. There is some lengthening of maturities, more pronounced on the assets than on the liabilities side.

79. **Privatization of banks has substantially progressed, but the state continues to hold minority shares in five banks, for a total of 4 percent of the banking system at end-2006**. The state (Ministry of Finance, the Employment Agency of Montenegro and the

[14] Property-related lending represented 45 percent of consumer loans in December 2006, of which 9 percent mortgage, 20.5 percent residential, and 15.5 percent reconstruction loans.

Development Fund) recently sold a stake in Niksicka Bank (30 percent), but the state continues to own over 14 percent of the bank after that transaction.[15]

80. **Foreign banks have a large presence in Montenegro, but not all foreign–owned banks have first-tier parent institutions**. CKB, NLB Montenegro Bank, Podgoricka Bank, and Hypo-Alpe-Adria Bank ~~and~~ have rated parent institutions—the other majority foreign-owned banks may have more limited access to know-how, capital, and liquidity.[16] [17]

81. **Concentration risk is high, both on the asset and liability sides**. Banks' net exposure to the 30 largest debtors amounted to 16 percent of loans at end-June 2006. The largest 20 depositors in each bank range from 21 percent of deposits in the least exposed bank to 91 percent in the most exposed bank; the 20 largest depositors in all banks account for 36 percent of all deposits.

Nonbank financial sector

82. **The non-bank financial institutions sector (NBFIs) represents in total about 16 percent of GDP at end-2006**. Insurance and leasing companies are regulated by the Ministry of Finance, micro-finance providers by the CBM and capital markets by the SEC. The NBFIs have experienced substantial growth in the past couple years, although at rates well below bank assets, and a number of (mostly foreign) market participants have entered the market.

83. **The insurance sector, with EUR 31 million of assets at end-2005 remains small, though premiums grew 22 percent in 2005.** Five insurance companies and one domestic re-insurance company are currently in operation, providing property, casualty (or accident), life and motor third-party liability (MTPL) insurance. Risk exposures are concentrated amongst two insurers, Lovcen and Montenegro Insurance, which together received more than 90 percent of all premiums in 2005. Two newer small insurers are fully foreign owned and Lovcen, the dominant market player, is ~~49 percent~~ majority-owned by foreign interests. About one-half of all insurance premiums invoiced in 2005 were for MTPL, with life insurance representing the smallest amount, less than 3 percent of total invoiced premiums.

[15] Other shares are held in Invest Bank Montenegro (13 percent), Podgoricka Bank (6 percent), Hipotekarna Bank (3 percent), and NLB Montenegro Bank (2 percent).

[16] Second largest NLB Montenegro Banka is majority-owned by Nova Ljubljanska Bank (NLB) from Slovenia. Podgoricka Bank is the third largest bank, purchased in March 2006 by Société Générale. Among the medium-sized banks, Opportunity Bank is entirely foreign-owned, but not by a bank. Komercijalna Bank Budva is a small bank owned by Komercijalna Bank (Serbia). Hipotekarna Banka, historically the leading bank in Montenegro, has close to 70 percent foreign capital, but those shareholders are not a bank. Newly-licensed Hypo-Alpe-Adria Bank is wholly-owned by Austrian Hypo Group Alpe-Adria.

[17] NLB is rated A-/F2 by Fitch Ratings; Société Générale AA/F1+; OTP Bank is rated BBBpi in December 2006 by Standard & Poor's.

Total reported assets are roughly equivalent to the total realized gross 2005 insurance premium of EUR 32 million, which suggests insurers have established small reserves to date. Finally, with only one registered re-insurance provider in the country, Lovcen-Re, all such risks remain with the domestic re-insurer or are transferred to one of several foreign re-insurers.

84. **Following the introduction of the Law on Leasing in late 2005, five firms have entered the market, three of which are affiliated with foreign-owned banks**. To date, about 500 contracts have been entered into with a total value of EUR 42 million. About two-thirds of the contracts issued are financial leases for the purchase of autos and buses. As such, leasing can be seen to provide access to finance for many who would not otherwise be able to afford to buy new vehicles or other equipment. Leasing companies are required to be registered under the Business Organizations law but are not subject to any form of regulation and can thus operate with minimal capital or controls in place. While the leasing industry does not give rise to systemic risk issues, potential operational and/or credit risks may arise in the event that credit extended to bank-owned leasing companies is transferred to the banks' balance sheets. The CBM monitors such exposures.

85. **The Law on Micro Credit Financial Institutions, which came into force in 2003, has resulted in the establishment of four micro-finance institutions (MFIs)**. This sector has grown substantially in three years - as at end-2006 total assets were about EUR 34 million, up from EUR 9 million in June 2003. This sharp growth indicates a continuing strong demand for largely unsecured lending to new micro-entrepreneurs. The CBM licenses and regulates MFIs, providing annual on-site examinations and receiving regular off-site reports. MFIs are not permitted to accept deposits. The established MFIs have accumulated a substantial capital base and longer term source of funding through their successful lending practices. The micro finance industry appears to be operating well and does not give rise to any particular concerns at this stage.

86. **The exchange traded part of the capital market consists of nearly 450 companies**. In addition, six investment funds (with assets consisting of both domestic and foreign securities and real estate) are traded on the exchange with a turnover of EUR 52 million during 2006, 14 percent of total. There hardly exist domestic institutional investors, pending the creation of pension funds. The bond market is nearly non-existing. Market turnover of all bond issues on the exchanges is EUR 19 million, 5 percent of total turnover.

87. **Montenegro has developed a set of modern registry systems that facilitate the assessment and management of financial risks**. The registry systems include: (i) register of legal persons maintained in the Commercial Court; (ii) registry of pledges over movable property, also maintained in the Commercial Court; (iii) cadastre or land registry, including mortgage registry, which is maintained and operated by the Agency for Real Estate; and (iv) central securities registry/depository, which is maintained and operated by the Central Depository Agency (CDA). In addition, there is a mandatory collection of credit information in a closed registry system maintained and operated by the CBM.