ANNEX – Republic of North Macedonia

A. Overview of the banking sector

Overview of the financial system

1. The financial system of the Republic of North Macedonia has a relatively simple structure in terms of type of financial institutions, financial products and services offered to customers and the modest interconnections and mutual activities. Total assets of the financial system represent 92.4% of GDP (as of 31.12.2018), while the share of banking sector's assets in total financial system assets is about 82%, hinting at the dominance of banks over other types of financial intermediaries (see Table 1 below).

Table 1. Overview of the North Macedonia financial sector

Type of institution	Number	Assets in mil.denars	Growth in %	Share in %
Deposit taking	**17**	**505.483**	**9,0**	**82,9**
Banks	15	503.469	9,0	82,5
Saving houses	2	2.014	3,6	0,3
Non deposit taking	**126**	**104.395**	**12,7**	**17,1**
Pension Funds	4	65.941	13,2	10,8
Compulsory	2	64.386	13,1	10,6
Voluntary	2	1.555	19,5	0,3
Insurance	16	21.369	6,7	3,5
Nonlife	11	14.275	2,0	2,3
Life	5	7.094	17,5	1,2
Leasing	7	4.923	24,9	0,8
Investment Funds	15	6.378	18,1	1,0
Financial companies	22	2.707	30,9	0,4
Other	62	3.077	3,9	0,5
Total	**143**	**609,912**	**9,6**	**100,0**
Total in mil.EUR		**9,901**		

Source: National Bank of North Macedonia

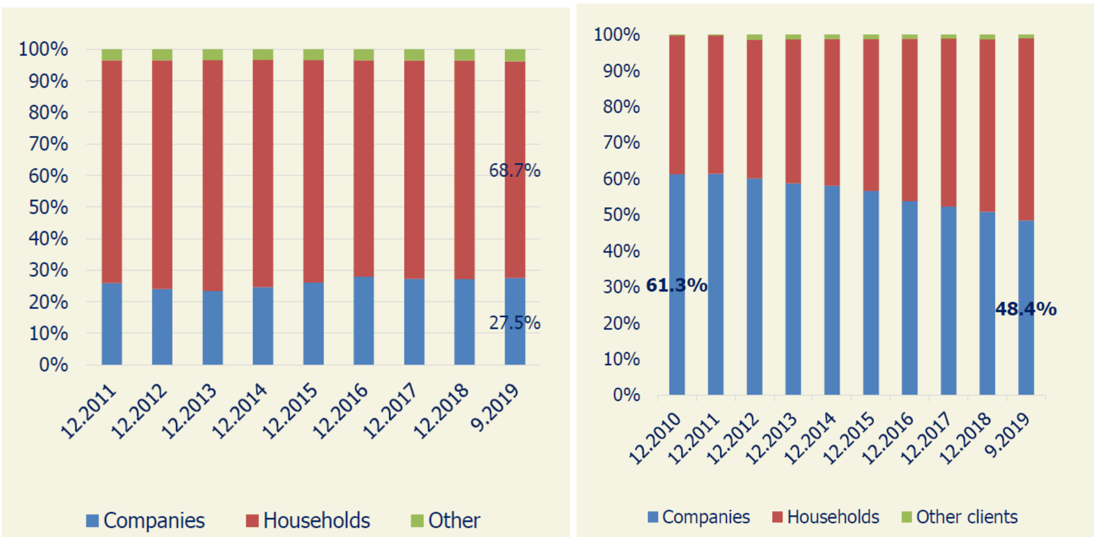
2. The number of banks (15) has remained relatively stable over the last years. The banking sector is characterised by the strong presence of non-domestic institutions and by a relatively high degree of concentration. Six banks are subsidiaries of foreign institutions and the market share of the three largest banks equals around 55% of the total banking assets. Domestic commercial banks are characterised by quite a simple and traditional business model – collecting deposits from the domestic private sector and placing them in loans to the non-financial sector. The amount of banks' trading portfolio is negligible.

3. One out of fifteen banks is the state-owned Development Bank of North Macedonia, which mainly operates as an intermediary that directs the credit lines from international financial institutions to the real sector via other commercial banks.

4. Over the past five years, total assets in the North Macedonian banking system have been increasing at an average 6.3% annual growth rate. However, the level of financial intermediation levels has not changed significantly, as asset-to-GDP ratio has remained unchanged (75.9%), while credit-to-GDP ratio and deposit-to-GDP ratio have increased only marginally (by 0.3 p.p., to 48.2% and by 1.1 p.p., to 55.5% respectively).

5. Banks are predominantly funded by deposits (80% of total liabilities), mainly from households (68% of total deposits). In banks' loan structure, the share of household and corporate loans is relatively similar, around 49% of total loans to non-financial sector. However, while the structure of deposits has remained relatively stable, North Macedonian banks have changed their lending strategies and become predominantly oriented at lending to households given the lower credit risk of this sector and higher portfolio diversification (see Figure 1 below).

Figure 1. Structure of total deposits (left) and loans (right) in the non-financial sector



Source: National Bank of North Macedonia

6. Fully funded pension insurance is the second largest segment of the financial sector with a share of 11% in total financial system assets as of the end of 2018. Private pension funds are an important segment in the system that is primarily composed of institutional investors, but they also play an important role in terms of financial stability given their role for the long-term social security of households.

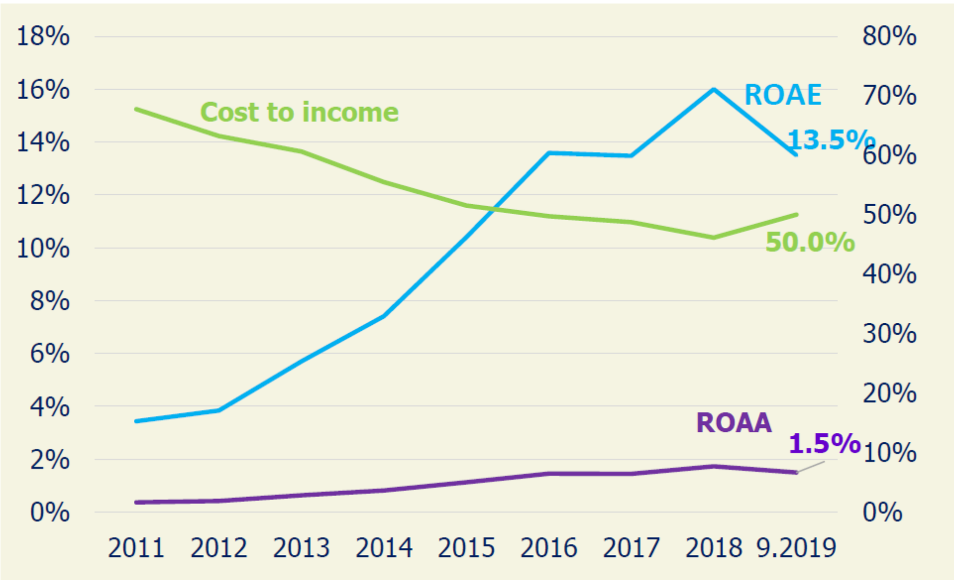
7. Insurance companies and other intermediaries (insurance brokers and agents) are the third largest segment of North Macedonian financial system. Their share in total financial system has been relatively stable in the last years and equaled 3.5% at the end of 2018; their activities have been characterised by a steady increase in the life insurance products in the last several years, which now accounts for about one third of the overall insurance sector.

8. Savings houses are important for financial inclusion as they provide access to credit for certain categories of households. They are the only institutions that, in addition to banks, collect deposits from individuals. However, their relevance for the financial stability is negligible due to their low share of assets (0.2% of financial system) and low degree of interconnectedness with the rest of the banking sector.

Performance of the banking sector

9. The profitability of the banking sector has kept increasing over the last five years, with Return-On-Average-Assets (ROAA) and Return-On-Average-Equity (ROAE) increasing from 0.8% and 7.4% in 2014 to 1.4% and 13.1% respectively in H1 2019 (see Figure 2). The net-interest income has been the main driver behind this trend: total interest expenses have been decreasing and banks have managed (in the environment of declining interest rates) to maintain their gross interest income roughly stable as they have directed their lending more towards the household sector, which can bring higher interest income compared to the lending to the corporate sector. In addition, lower impairment losses and a more efficient cost-income ratio have also contributed to a good performance over the past years.

Figure 2. Profitability and cost efficiency metrics



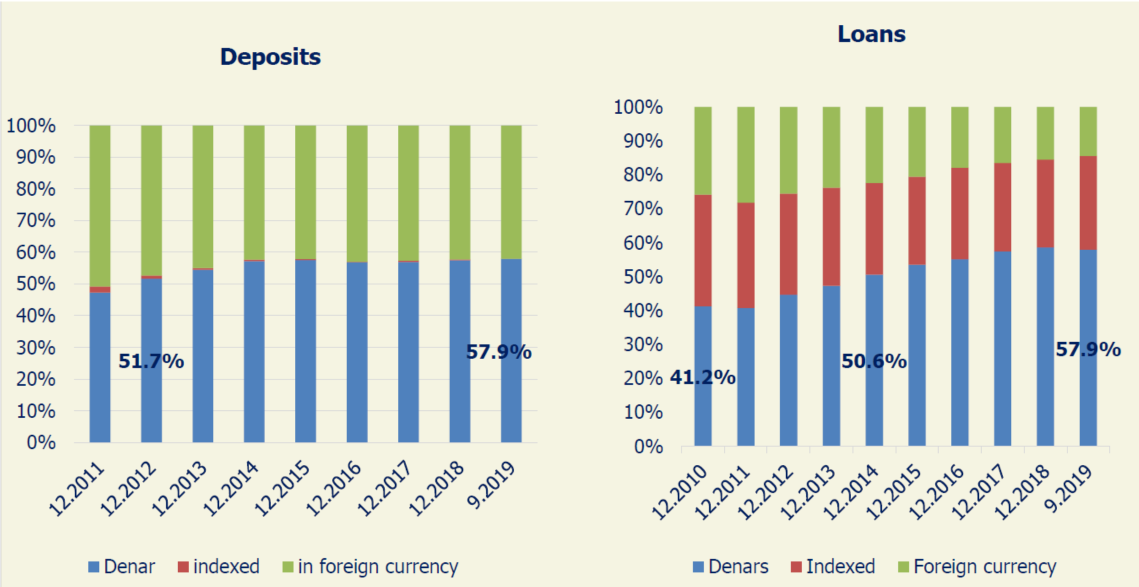
Source: National Bank of North Macedonia

10. The share of Non-Performing Loans out of total loans to non-financial sector has been declining over the past years and stood at 5% in September 2019 (8.0% for the corporate sector and 2.1% for the household sector). This happened mainly due to the regulatory measure introduced by the NBRNM in 2016, which requires banks to regularly write-off NPLs that are fully covered with loan-loss provisions for at least two years[1].

[1] From 1.7.2019, this measure has been extended to non-performing loans that are fully covered with loan loss provisions for at least 1 year.

11. The amount of loans in foreign currency (mainly EUR) is still quite significant, but it has been declining over the past years and the progressive denarisation strategy has brought the share of loans in foreign currencies (either direct or indexed) to balance the share of corresponding deposits. The currency component in total loans and deposits amounted to 41.7% and 42.4% respectively at the end of June 2019 (see Figure 3 below).

Figure 3. Deposits and loans in local and foreign currency



Source: National Bank of North Macedonia

12. The banking system is liquid and adequately capitalized; one third of total assets are liquid assets that cover about 60% of household deposits, while loan-to-deposit ratio stands at around 86%. As of June 2019 Total Capital ratio stood at 17.4% and CET1 ratio at 15.7%, while leverage ratio was at 10.8%.

Table 2. Performance of the North Macedonian banking sector, 2015-2019

Item	Dec-15	Dec-16	Dec-17	Dec-18	Mar-19	Jun-19
CAPITAL ADEQUACY						
CET1 Ratio	n/a	n/a	14.2	15.0	15.4	15.7
Total Capital Ratio	15.5	15.2	15.7	16.5	17.0	17.4
Leverage ratio	n.a.	n.a.	10.1	10.5	n.a.	10.8
Composition of RWAs (in %)						
Credit risk	86.9	86.9	87.7	88.3	88.4	88.5
Currency risk	2.7	2.7	1.9	1.7	1.7	1.8
Operational risk	10.4	10.4	10.4	10.0	10.0	9.7
Market risk	0.0	0.0	0.0	0.0	0.0	0.0
PROFITABILITY						
Return on Assets (ROAA)	1.1	1.5	1.4	1.7	1.5	1.4
Return on Equity (ROAE)	10.4	13.6	13.5	16.0	13.5	13.1
Cost/Income ratio	51.6	49.8	48.7	46.2	50.9	50.9
ASSET QUALITY						
NPL ratio (non-financial sector)	10.8	6.6	6.3	5.2	5.2	5.5
Non-financial companies	15.2	9.9	10.0	8.0	8.1	8.8
Households	5.2	2.6	2.4	2.3	2.3	2.4
Coverage Ratio (non-financial sector)	86.7	80.9	77.2	76.3	76.5	74.6

Source: National Bank of North Macedonia

Risks and main trends

13. North Macedonia is a small and open economy, and – as such – remains vulnerable to external shocks and unfavorable global and regional developments, in particular those originating from the EU countries that are the largest trading partners. Moreover, the consequences of a potential political crisis in the country can impact expectations for households (in terms of savings) and for corporates (in terms of investments).

14. The gradual liberalisation of the supply of financial services could lead to higher competition for domestic banks and non-bank financial institutions. While this usually implies higher efficiency and a wider range of potential investment opportunities, it would also require significant investments (especially in IT and human capital) and continuous innovation of business models. This would push many financial institutions to increase their efforts to withstand increasing competition and possibly some restructuring of the sector.

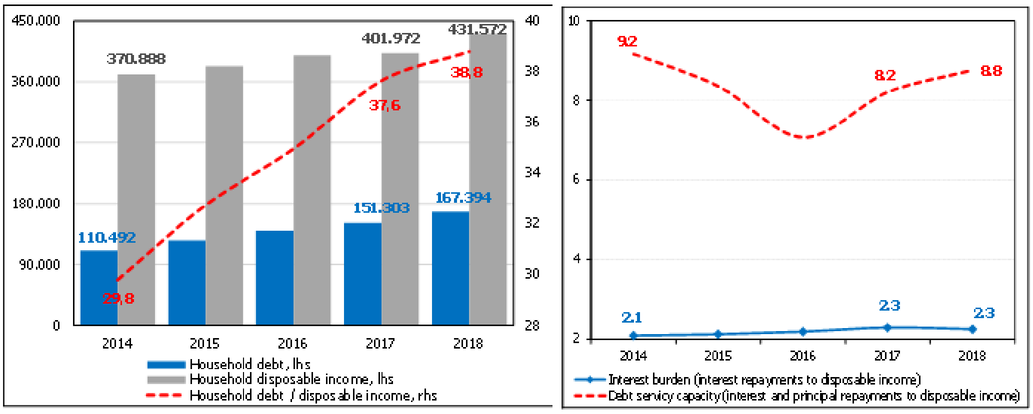
15. Corporate debt appears sustainable but some vulnerabilities remain. Although rising in absolute terms, it declined as a share of total banking assets from 54.3% in 2008 to 47.7% in 2018. The financial position of the corporate sector has strengthened and profitability improved as well as the debt-servicing capacity. The main risks currently come from interest rate risk and foreign currency-denominated debt (the latter is approximately two thirds of total corporate debt), although the exchange rate targeting strategy of the North Macedonian Denar against the Euro largely contains this risk. While the share of debt with variable or adjustable rate declined from 71.5% in 2015 to 53.8% in 2018, the interest rate risk remains quite significant and points to remaining vulnerabilities to upside shocks in interest rates.

16. Credit to households has been expanding significantly over the last decade (around 10% year on year), supported by improved household expectations, favourable labour market developments and low indebtedness. Mortgage loans account for approximately one third of total loans to households and are characterised by a low level of NPLs (0.9%) and a conservative LTV (around 60%). On the other hand, consumer loans have been increasing significantly over the last years. Therefore, the NBRNM started applying higher capital requirements (RW of 150% to new consumer loans with original maturity equal to or longer than 8 years). The measure contributed to a significant slowdown in the growth of long-term consumer loans from about 40% at the end of 2015 to 11-12% in 2019. While the share of NPLs in this category is still low (2.7% as of June 2019), its fast growth rate (17.2% year on year in June 2019) calls for further monitoring.

17. Despite the rapid increase in the ratio of household debt-to-disposable income over the past five years, indicators for solvency and liquidity point to a limited vulnerability of households to shocks and to a limited risk to the financial stability from this sector (see Figure 4). Moreover, the level of household debt to GDP (25.4% in 2018) remains relatively modest, while the growth of household disposable income has accelerated thanks to the rapid employment and wage growth. Similarly to loans to corporate sector, some risks come from the significant presence of

loans with a foreign currency component (44.6% of total loans) and loans with adjustable (30% of total loans) and/or variable (17.7% of total) interest rates.

Figure 4. Household indebtedness and vulnerability indicators (in %)



Source: Central Registry and National Bank's calculations, based on data from State Statistical Office, Ministry of Finance and Central Securities Depository.

B. Detailed Assessment of North Macedonia

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Largely Equivalent</td></tr>
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Tasks and responsibilities of the authorities

The National Bank of the Republic of North Macedonia (NBRNM) is the sole banking regulator and supervisor of the banks and saving houses incorporated in the Republic of North Macedonia. The NBRNM is also the central bank of the Republic of North Macedonia, and its organisation, roles and responsibilities are prescribed in the Law on the National Bank of the Republic of North Macedonia (Law of NBRNM).

Along with its supervisory functions (i.e. licensing, supervising and issuing corrective measures), NBRNM is empowered by the Banking Law to issue relevant prudential regulation (by-laws). While responsibility of Level 1 regulation (i.e. laws) resides with the Ministry of Finance and the Parliament, the NBRNM adopts two types of binding regulations i.e. Decisions and Instructions.

In addition to laws and by-laws, banks are also expected to follow the guidance provided by NBRNM in its Circulars, i.e. non-binding acts that provide additional clarification or interpretation of the regulation. Although not binding, these Circulars are considered by NBRNM as best practices and non-compliance is usually followed with a regular measure issued by NBRNM Governor requiring the bank to correct certain deficiencies and improve risk management practices. In addition, the NBRNM publishes "Question and Answers" regularly on its website, with the aim of enabling a harmonized understanding and implementation of the banking regulation by the banks and saving houses.

Licensing of credit institutions

NBRNM has the power to issue and withdraw banking licenses. The Banking Law regulates the licensing procedure and prescribes the criteria that needs to be met for issuing license for founding and operating a bank. Similarly to Articles 10-11 of the CRD, Article 17 of the Banking Law requires the applicant to submit a strategic and operational plan of the bank including projection of the financial statements for the following five years. The content of the strategic and operational plan is defined in details in the Decision on Issuing Licenses and includes information about the organisational structure of the bank, the scope of financial activities, the review of the market, and the projections of the balance sheets. Further documentation must prove the qualifications, reputation and professional experience of Supervisory and Management Board members *(see below section on Fit and Proper).*

Pursuant to Article 14 of the Banking Law, a bank shall be established with initial capital of 310,000,000 denars (approx. EUR 5 million), i.e. the same amount required by the CRD. However, if a bank is willing to perform certain type of activities (e.g. trade in foreign assets, trade in precious metals, trade in securities, trade in financial derivatives, custody services for property of investment and pension funds, purchasing and selling, underwriting or placement of securities issue), the initial required capital is increased to the amount of 560,000,000 denars (EUR 9 million).

Once the license for founding and operating a bank has been granted by NBRNM, it can be withdrawn with a Decision of the Governor on the back of a number of reasons that are prescribed in Art. 154 of the Banking Law and are broadly in line with those envisaged by Art. 18 CRD:

1. The license was obtained on the basis of false data;
2. The bank failed to adopt a statute within 30 days upon receipt of the license;
3. The bank failed to commence operating within 90 days following the issuance of the founding and operating license;
4. The bank performs financial activities for which it did not obtain a license;
5. The bank fails to meet the technical, organizational, personnel or other requirements for conducting banking activities;

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	6. The bank performs no financial activities for more than six months; 7. The bank has been involved in money laundering and other felonies; 8. The terms for introducing a bankruptcy or liquidation procedure in the bank have been fulfilled. **<u>Qualifying shareholder participations</u>** The provisions for the notification and assessment of increases in participation (qualifying shareholdings) are more conservative than the framework defined in the EU with respect to the definition of qualifying shareholding and the relevant thresholds: • **<u>Definition</u>**: According to Art. 2 of the Banking Law, "Qualified holding in a bank" is defined as direct or indirect ownership of <u>at least 5%</u> of the total number of shares or issued voting shares in a bank or which makes it possible to exercise a significant influence over the management of that bank; • **<u>Threshold</u>**: Article 59 of the Banking Law stipulates that any person who intends to acquire, directly or indirectly, gradually or immediately, shares in the total cumulative nominal amount of and over <u>5%, 10%, 20%, 33%, 50% or 75%</u> of the total number of shares (either alone or together with other connected persons) shall obtain the relevant prior approval from NBRNM. Item 51 of the Decision on Issuing Approvals provides that the assessment on whether the person who intends to acquire shares in the bank fulfils the same criteria prescribed in the Banking Law to grant an authorisation to commence activities. These criteria are largely in line with the ones envisaged by Art. 23 of the CRD, to ensure that the bank is organised and able to operate in accordance with the regulations and the prescribed supervisory standards. **<u>Fit and Proper</u>** The legal basis for fitness and propriety assessments are set out in the Banking Law (Articles 83-92). The regime is quite prescriptive and mirrors most of the requirements set out in the CRR/CRD. The criteria for the appointment to Management or Supervisor Board are similar: the nominee must have a good reputation, adequate qualifications and experience, ability to devote sufficient time to carry out the obligations, and avoid conflict of interests. The following requirements are also considered and are largely in line with the CRD provisions: • <u>Good reputation</u>: In addition to moral and professional integrity, NBRNM requires that there is no proof of: involvement in activities implying noncompliance with regulations; disruption or jeopardy of the interests of the legal entity where this person has worked; inadequate cooperation or refusal to cooperate with competent authorities. • <u>Independence of mind</u>: In addition to the requirement that at least one quarter of bank's supervisory board members need to be independent, all members of Supervisory and Management Board need to avoid conflicts of interest. According to the Banking Law, members of the Supervisory and Management Boards are required to operate solely in the interest of the bank and its depositors, and to act with attention and diligence. • <u>Adequate qualifications</u>: All members of Management and Supervisory Board need to have university degree and knowledge in finance and knowledge of banking business in general and of that specific bank. This knowledge can be confirmed based on previous experience. • <u>Collective knowledge</u>: The assessment of the adequacy of the person proposed as a member of the Supervisory Board is considered together with the other Board members – the Supervisory Board as a whole needs to have the knowledge and experience in areas important for understanding the bank's activities, the material risks it is exposed to and for conducting efficient supervision of the bank's operations. • <u>Time Commitment</u>: Time commitment for the members of the Management Board of a bank is stipulated in the Banking Law with the requirement that they shall be full-time (permanent) employees of the bank. In addition, the bank needs to make sure that the

	majority of the members of the Supervisory Board and the Management Board are available upon request of NBRNM. Fitness and Propriety criteria are assessed on an on-going basis through on-site and off-site inspections to make sure that governance and management bodies are established in accordance with the law and regulations. **<u>Prudential Supervision</u>** **Supervisory scope** According to the Banking Law, the prudential supervision is performed on an individual as well as on a consolidated level. According to the Banking Law, a bank subject to consolidated supervision is a bank having its head office in the Republic of North Macedonia which is: a parent entity of the banking group, or a subsidiary of financial holding company having its head office in the North Macedonia, which is a parent entity of the banking group. Item 20 of the Decision on consolidated supervision lists the reasons to exclude entities from the perimeter of consolidation. These reasons are in line with Art. 19 of the CRR, i.e. a subordinated entity shall not be included in the consolidated financial statements for the purposes of consolidated supervision in the following cases: - when its head office is outside the Republic of North Macedonia, in a country where there are legal impediments to the transfer of information needed for consolidated supervision; - when the parent entity acquires equity holding in the subordinated entity with the intention to be disposed within the next 12 months; - when the inclusion in the consolidation might produce misleading or inappropriate conclusions with regard to the purposes of consolidated supervision; - when its inclusion has no significant influence on the financial standing of the banking group, and when the total assets of such subordinated entity do not exceed 1% of the parent entity's assets. To this extent, there is only a slight difference with the last condition above, as in Art. 19 CRR the quantitative criterion and the significant influence are separate conditions, and the quantitative criterion is coupled with a threshold of 10 million in the total amount of assets. The Decision on consolidated supervision states that – as a general rule – consolidated financial statements should be compiled by applying the method of full consolidation. Similarly to Art. 18 of the CRR, the proportional method of consolidation may be used in the process of compilation of the consolidated financial statements of banks when the responsibility of the parent entity is clearly defined and restricted to its share in the equity of the subordinated entity, i.e. when the liability of other shareholders or members may be clearly determined. In some selected cases, similarly to the ones envisaged by Art. 19(5) of the CRR, item 19 of the Decision on consolidated supervision allows the equity method to be applied for the consolidation purposes. **Audit activities** According to article 107 of the Banking Law, the auditing company shall immediately notify the NBRNM Governor in writing if, during the audit, it finds out that i) the solvency or liquidity situation of the bank is compromised; ii) the bank is insolvent or illiquid; iii) the bank operates and/or has operated contrary to the regulations and/or a condition for revoking a license for founding and operating a bank has been fulfilled; iv) there are significant discrepancies and shortcomings in the functioning of the internal control systems or in the financial reporting process. The auditing company must simultaneously also submit the Audit report to the Supervisory Board and to the NBRNM no later than on 30 April of the current year. The Supervisory Board of a bank is responsible for submitting the annual report of the Internal Audit Department to NBRNM, which enables the National Bank to receive information on all findings of bank's internal audit, including findings of material breaches of laws and regulations. The Internal Audit Department is also required to immediately notify the Supervisory Board and the Management

	Board if it identifies i) violation of the risk management standards that is likely to deteriorate the bank's liquidity and solvency, and ii) violations of bank's regulations and internal procedures. Since Art. 84 of the Banking Law requires members of a bank's Supervisory and Management Board to inform NBRNM in case a decision of the bank's bodies violates the law or other regulations. This allows NBRNM to be timely notified for any material breaches of laws or regulations. **Supervisory powers** In accordance with Art. 131 of the Banking Law, in case a bank fails to comply with the regulations that govern the bank's operations or its internal procedures, the NBRNM's Governor may undertake different types of supervisory measures, according to the severity of non-compliance: - regular measures, - additional measures, - introduction of administration, - withdrawal of an approval, and - revocation of a license. If non-compliance does not seriously compromise the safety and soundness of the bank, the Governor will undertake "regular" measures as defined in Article 132 of the Banking Law. These regular measures often require the banks to reach a certain level of supervisory standards and notify NBRNM of the time when the prescribed level will reasonably be fulfilled. In the event of serious violation of the regulations and noncompliance with the supervisory standards, recurrent irregularities or non-compliance with previously issued measures, the Governor shall adopt a decision on imposing "additional" measures as defined in Article 133 of the Banking Law, including the following: achieving and maintaining a higher amount of own funds and/or a higher capital adequacy ratio than legally required under Pillar 1; stricter supervisory standards, implementation of a bank improvement plan, recapitalisation of the bank, introduction of temporary administration and finally the initiation of a bankruptcy or liquidation procedure. **<u>Supervisory Review Process</u>** **ICAAP/ILAAP** According to the Decision on Risk Management, banks are required to establish a process for Internal Capital Adequacy Assessment (ICAAP), which is largely in in line with the expectations set forth by the CRD. The ICAAP needs to be conducted every year, or more often if there are significant changes in the risk profile of the bank. The internal capital of the bank shall be at least equal to the regulatory capital for risk coverage, or higher if the bank determines that higher level of internal capital is needed for covering individual material risks. The bank reports at least yearly to the NBRNM on the results of the process of determining the internal capital through a relevant document (ICAAP Report). The ICAAP report must contain at least the following information and data: - A description of the approaches used to determine internal capital and the differences in the approaches prescribed by NBRNM regulations on the methodology for determining capital adequacy; - A description of the stress test that the bank takes into consideration in the ICAAP and a description of its results; - The amount of internal capital to cover individual risk and total internal capital and current and future needs of own funds; - Activities that are taken for reaching/maintaining the required level of own funds and/or capital adequacy. The results of the ICAAP are also integrated in the assessment of risks to capital within the SREP. In May 2019, a new Decision on Risk Management was adopted (implemented in December 2019). The new Decision introduces the obligation for institutions to carry out their own Internal Liquidity Adequacy Assessment Process (ILAAP). The ILAAP shall determine the internal liquidity needs at least

	once a year, as well as in cases of a significant change in the risk profile or in cases of significant change due to the presence of new markets, or introduction of new products and services. Internal liquidity shall enable the bank to fulfil its obligations regarding their maturity and cover the liquidity needs in normal and stressed conditions. The first ILAAP report was submitted to the NBRNM by the end of May 2020. This assessment will be adequately integrated into the SREP assessment of the liquidity positions of institutions. **SREP** All 15 banks operating in North Macedonia are subject to a supervisory risk assessment process based on a Supervisory Review and Evaluation Process (SREP), which has been designed mirroring the EBA SREP guidelines. At a more operational level, the Methodology for the Process of Supervisory Risk Assessment has been largely inspired by the European Central Bank's (ECB) supervisory practice. While the SREP methodology is the same for all the banks in North Macedonia, supervisors recognize the importance of the size and complexity of the activities of individual institutions and take them into consideration in the assessment. In line with the EBA SREP Guidelines, the four main elements of the supervisory assessment are: 1. Analysis of the bank's business model (BMA); 2. Assessment of the bank's corporate governance; 3. Risks to capital and assessment of the bank's capital position; 4. Assessment of the bank's liquidity position. The supervisory review is conducted through a mix of off-site and onsite activities. BMA includes analysis in the short and long term: the former refers to an assessment of the viability of the existing business model, while the latter refers to an assessment of the soundness of the bank's strategic objectives. After determining the summary assessments of the individual risks to capital, the supervisor establishes an overall assessment of the risks to capital. The assessment of the risks to liquidity focuses on inherent liquidity risk, i.e. the actual risk of the funding sources, and the quality of management of these risks. A number of indicators are monitored and aggregated in one composite measure, which indicates the overall quantitative liquidity risk level. Based on the assessment of each element, the overall SREP assessment (i.e. the assessment of the overall risk profile) of the bank is performed taking into account the significance of each element for the risk profile. The results of the supervisory review will be the basis for NBRNM to undertake the appropriate supervisory measures (*see below*). **Supervisory powers to levy higher requirements (Pillar 2)** Based on the assessment of the overall risk profile of each bank, the NBRNM reassess the required minimum level of own funds, which is communicated to the bank, at least annually. The report on the capital requirement to be maintained by the bank in the following year also considers possible differences with the bank's internal capital and includes the overall SREP score as well as scores for individual risks. More importantly, it includes information on the risks for which Pillar 2 capital add-ons are determined. The report on the capital requirements is sent to the Board of Directors of the bank who can submit their observations about the report to the NBRNM within 8-10 days. The Pillar 2 capital surcharge is based on the grades of the SREP ratings and is expressed in percentage points above the legally prescribed minimum Capital Adequacy Ratio of 8%. Banks are required to fulfil Pillar 2 capital add-ons on top of the minimum Total Capital Ratio and before fulfilling capital buffers. Pillar 2 add-ons may be met with any "quality" of capital (CET1, AT1 or T2 capital), as opposed to capital buffers that need to be met only with CET1 instruments. Yet, CET1 capital used to fulfil Pillar2 capital add-ons cannot be used for fulfilling capital buffers requirement.	
Section 3	**Own Funds**	Section Assessment Largely Equivalent
Rationale for section assessment	The framework for Own Funds can be regarded as Largely Equivalent.	

	<u>Own funds requirements</u> The own funds requirements are the same as in the EU framework, and are structured as follows: • CET1 ratio: 4.5%; • T1 ratio: 6%; • Total Capital ratio: 8%. In terms of capital composition and eligibility criteria, the conditions for CET1 capital that are included in Item 14 of the Decision on methodology for determining capital adequacy mirror the ones established in Art. 28 CRR (minor differences only). Similarly, the conditions in Item 19.a and Item 19.f are largely in line with the ones established in Art. 52 and Art. 63 of the CRR for AT1 and T2 capital respectively. There are two differences, which however do not impair substantially the quality of own funds: - There is no explicit mention to funds for general banking risks within CET1 capital as in the CRR. However, to this extent, it was explained that the mandatory general reserve is fully and immediately available to cover risks and losses from the banks' operations. - There are no references, as in CRR Art. 28(1)(f)(i) and Art. 28(2), to resolution as triggering the reduction of capital as – at the time of assessment – the Law on banks' resolution was still under finalisation, and there is no resolution framework in place yet. **<u>Prudential filters and deductions</u>** With regard to prudential filters, most of the adjustments prescribed by Art. 32-35 of the CRR are present in the local framework. According to item 19-h of the Decision on methodology for determining capital adequacy, it is prescribed that banks should not include in any element of their own funds any increase arising from securitisation positions. Due to the absence of these type of positions on the domestic market, as well as the lack of banks' interest for investing in such positions abroad, there is no mention on future margin income and securitisation where the institution is the originator. The same provision also establishes the need of excluding from own funds cash flow hedges and changes in the value of own liabilities (as in Art. 33 CRR) and unrealised gains and losses measured at fair value (as Art. 35 CRR). The filter for Additional Value Adjustments (AVAs) is not prescribed due to the limited presence of Trading book positions on banks' balance sheet. Concerning deductions, while Art. 16 of the Decision on methodology for determining capital adequacy prescribes to deduct most of the item listed in Art. 36(1) of CRR (i.e. intangibles, goodwill, DTAs, significant investments, tax charges), there are some differences, due to the specific characteristic of the local market, but the overall effect does not materially impair the degree of conservativeness of the framework. In particular, no deduction is prescribed for Defined Benefit Obligation (DBO) related to pension funds, but this reflect the fact that this type of instrument is not present in the local market. Securitisations and free deliveries are not listed as deductibles due to their absence on the domestic market as well as the lack of banks' interest for investing in such positions abroad. Similar to the requirement established in Art. 78 CRR, item 19-l of the Decision on methodology for determining capital adequacy prescribes that institutions must obtain the permission to supervisors in order to reduce own funds, and must ensure an adequate level of capital after the reduction. However, it is envisaged the possibility that a bank may redeem instruments that are part of the CET 1 capital without the approval of the National Bank if the amount of the total instruments redeemed does not exceed 1% of the total amount of such kind of instruments issued by the bank. **<u>Minority Interests</u>** Minority interests can be recognised in Own Funds only up to a certain threshold, according to the same calculation/methodology as in CRR/Basel III. Share premium accounts, retained earnings and

<table>
<tr><td></td><td colspan="2">other reserves are part of the CET 1 capital, thus are captured in the calculation of the minority interest.</td></tr>
<tr><td rowspan="2">Section 5</td><td rowspan="2">Credit Risk (Standardised Approach)</td><td>Section Assessment</td></tr>
<tr><td>Equivalent</td></tr>
<tr><td>Rationale for section assessment</td><td colspan="2">
The framework for credit risk requirements in North Macedonia can be considered equivalent to the ones in the CRR for the Standardised Approach, which is the only method authorised by NBRNM. No bank is authorised to use IRB approach.
The framework for Standardised Approach to Credit Risk in North Macedonia includes the same exposure classes as in the CRR. The risk-weights for all the exposures classes are the largely the same as in the CRR, with some exceptions where the approach is slightly more conservative:

<u>Exposures to regional governments and local authorities</u>: as in Art. 115 (1) CRR, they are treated as exposures to institutions. However, Item 49 of the Decision does not allow the exception provided in CRR Art. 115(2), i.e. exposures to regional governments and local authorities cannot be treated as exposures to the central government in whose jurisdictions they are established.
<u>Exposure to institutions</u>: in case of short-term exposure to an unrated institution, it is not possible to use a 20% risk weight as in Art. 121(3) CRR.
<u>Exposure to residential properties secured by mortgages</u>: same risk weights as CRR Art. 125 (35%), but a slightly lower loan to value is needed for this treatment (75% v. 80% in CRR).
<u>Exposures to commercial real estate secured by mortgages</u>: higher risk weights than CRR Art. 126 (100-75% vs. 50% in CRR).
<u>Exposures to Retail</u>: same risk weights as in the CRR, but consumer loans with a maturity equal or higher than 8 years are considered as high-risk exposures and thus are assigned a 150% risk-weight.
<u>Covered Bonds</u>: Due to non-existence of these type of securities on the domestic market, there is no special treatment regarding the applied risk weights. The exposures to covered bonds will be treated as any other investment in the banking book, i.e. in accordance with its credit rating. If credit rating is not available, than the risk weight will depend on the credit rating of the issuer (item 181 of the Decision). If neither the covered bond CB, nor its issuer have a credit rating, the investment is treated as unrated exposure.

- <u>Public Sector Entities</u> are defined similarly to the CRR, entities for which the competent authority of their domicile countries determined a treatment of public sector entities (PSEs) or are incorporated in their domicile country as administrative authorities responsible to the central government, regional and local government; non-profit legal entities established by the central government and whose liabilities are guaranteed by the central government, including the local government bodies established by a special law and are under government scrutiny.
- <u>Retail exposures</u> are defined as in the CRR, with the only difference that the limit of 1mn/EUR has been lowered to the equivalent of 100.000 EUR, to reflect the different conditions of the local market.
- <u>Defaulted exposures (definition)</u>: defined as in the CRR, i.e. i) credit exposure which on any basis (principal, interest, other non-interest claims) has not been collected in a period longer than 90 days from the maturity date; ii) credit exposure for which the client will not be able to meet his/her liabilities to the bank (unlikeness to pay). Unlikeness to pay is prescribed in more detail in item 44 of the Decision on the Methodology for credit risk management.
- <u>Defaulted exposures (risk weights)</u>: same treatment as in the CRR (i.e. 150%/100 %, where credit risk adjustments are less/no less than 20% of the unsecured part of the exposure value if these credit risk adjustments were not applied).
- Items 71 (for residential property) and 72 (for commercial property) of the Decision define the conditions for cross dependence between the value of property and credit quality of the
</td></tr>
</table>

<table>
<tr><td></td><td colspan="2">borrower i.e. a condition under which the value of residential/commercial property does not depend significantly on the debtor's creditworthiness. Additionally, the credit risk of the debtor should not materially depend on the cash inflows arising from the performance of the underlying residential property.</td></tr>
<tr><td rowspan="2">Section 7</td><td rowspan="2">Credit Risk Mitigation</td><td>Section Assessment</td></tr>
<tr><td>Largely Equivalent</td></tr>
<tr><td>Rationale for section assessment</td><td colspan="2">In general terms, the applicable framework in North Macedonia can be seen as more conservative than the CRR, as a narrower set of collateral and guarantors is allowed for the recognition of the effect of credit risk mitigation. There are however a few deviations with respect to the treatment of collateral expressed in a different currency.

<u>Funded credit protection</u>

- <u>Allowed methods</u>: only Financial Collateral Simple Method (FCSM) is allowed; Financial Collateral Comprehensive Method (FCCM) is not allowed. On-Balance Sheet Netting (OBSN) is limited to netting the loans and deposits, under conditions that are in line with the ones defined in Art. 205 of the CRR. However, Master Netting Agreements (MNAs) are not recognised as a mitigation technique.
- <u>Allowed collateral</u>: All types of collateral included in Art. 197 of the CRR However, Credit Linked Notes (CLN) and Securitisation positions cannot be used as CRM instrument. Cash deposits and life insurance policies are also allowed and are subject to the same requirements of Art. 212 of the CRR.
- <u>Eligibility criteria</u>: The Decision on the methodology for determining the capital adequacy provides for criteria that are in line with those defined in Art. 207 of the CRR in terms of legal certainty and recognition.
- <u>Volatility adjustments</u>: Not allowed, as only FCSM is recognized.
- <u>Effects of FCP</u>: As in the CRR, for the claims covered with appropriate financial collateral banks shall apply the risk weight that would be applied in case of direct exposure to that collateral (with a 20% floor). The risk weight of the collateral is applied only to the collateralised part of the exposure.
<u>Collateral held in another country and currency mismatch</u>

Item 88 (for Financial collateral) and Items 92 and 93 (for On Balance Sheet Netting) of the Decision on the methodology for determining the capital adequacy prescribe that, in case the agreements require the implementation of regulations of another country, banks must obtain legal opinion from a lawyer in that country, confirming the possibility of execution of the agreement according to the relevant regulations.

While the Financial Collateral Comprehensive Method (FCCM) is not allowed North Macedonia, there is a possibility to adjust for a currency mismatch using the supervisory volatility formula that under the CRR is allowed only within the FCCM (Art. 223 CRR). This approach has been explained with the need to account for the existing practice, where banks' claims and the collaterals associated to those claims have a different currency denomination. For this reason, NBRNM has allowed currency mismatching even within the FCSM by using the supervisory volatility formula in case of currency mismatch between: (1) the claim and financial collateral; (2) the loans and deposits subject to netting and (3) the claim and the cash deposit/cash equivalent/ life insurance policy.

<u>Unfunded credit protection</u>

- <u>Eligible protection providers</u>: All the providers allowed as per Art. 201 CRR are admitted as guarantors. However, the set of protection providers is narrower than n the CRR, as central counterparties and credit derivatives are not allowed.
- <u>Eligibility criteria</u>: the requirements that protection providers need to fulfill to be recognised for UFCP are largely in line with those defined by Art. 213-215 CRR.</td></tr>
</table>

	- Effects of the protection: The substitution approach is used to calculate the effects of unfunded credit protection i.e. the risk weight of the secured part of the exposure is replaced with the risk weight associated with the protection provider as determined under the Standardised Approach, while, for the unsecured part of the exposure, the risk weight of the original obligor is used. Maturity mismatches: When determining the weighted value of the claim, the bank shall be required to take into consideration the influence of the maturity mismatch resulting from the shorter residual maturity or validity period of the credit risk mitigation instrument than the residual maturity of the claim it refers to, according to the methodology that is in line with Art. 237-239 CRR.		
Section 8	**Securitisation**	Section Assessment Not Equivalent	
Rationale for section assessment	North Macedonia has not implemented a regulation on securitisation explaining it with a non-existent market and low level of development compared to the EU, which the assessment team took note of. North Macedonia's domestic banks perform traditional banking activities where deposits are the main source of funds and banks have not shown any interest to invest in securitisation products abroad. However, should banks decide to invest in these transactions, either by investing in positions issued by other domestic or foreign issuers, or by retaining certain portion of their own issues, the positions would be treated as part of the capital requirements for market risk if the positions are part of a bank's trading book (they will be treated as positions in debt securities), or they would be part of the capital requirements for credit risk if the positions are part of a bank's banking book. The implementation of the securitisation framework in North Macedonia is planned for 2021. At the time of assessment, the North Macedonia's framework on Securitisation is therefore not equivalent to the one in the CRR.		
Section 9	**Operational Risk**	Section Assessment Largely Equivalent	
Rationale for section assessment	**Definition** Operational risk is defined in North Macedonian legislation as the risk of loss resulting from inadequate or failed internal processes, inadequate personnel and inadequate or failed systems of a bank, or from external events, and includes legal risk, risk of ML/TF and IT risk. It does not include reputational and strategic risk. **Regulation** According to the law, a bank may calculate the capital requirement for operational risk by using one of the indicator based approaches: 1) Basic Indicator Approach (BIA), 2) Standardised Approach (SA), subject to prior consent of the NBRNM. Alternative SA and Advanced Measurement Approach (AMA) have not been implemented. Both approaches allowed in the legislation are generally in line with the CRR quantitative requirements (same indicator definition and calculation methods) and qualitative criteria, which are checked during onsite inspections. However, there are no provisions for cases when there are less than three years of available data and for M&A or exceptional circumstances. The combination of the two approaches is not allowed to calculate the capital requirement for operational risk. Banks also need to report regularly (on an annual basis) their material losses. Banks are obliged to internally define material risk events but supervisors expect that these threshold is not higher than 1,000 EUR.		

<table>
<tr><td></td><td colspan="2">A bank using the Standardised Approach may revert to BIA only if they get a prior consent of the NBRNM and prove that there is no regulatory arbitrage.

North Macedonia's Decision on Methodology for Risk includes also requirements for management, reporting and ICAAP that are largely in line with the CRR requirements.

Pillar 2

Banks are obliged to establish a methodology for the measurement of operational risk under ICAAP and internally define material risk events (no higher than EUR 1000) based on their previous experience and risk tolerance. The definition of material losses needs to be submitted to NBRNM on a yearly basis (for the previous year). These are all used for the SREP purposes.

Capital add-ons are determined for operational risk as a risk to capital if Pillar 1 for operational risk is more than 5% in the total Pillar 1 capital. If the overall grade for operational risk is 3, then + 1-2ppts will be added to minimum CAD (8%); if the grade is 4, then +3 to 4ppts.

Capital requirements for operational risk are 9.7% of total capital requirements and 4.4% of total own funds.

North Macedonia's framework of operational risk is largely equivalent to the one in the CRR.</td></tr>
<tr><td rowspan="2">Section 10</td><td rowspan="2">Market Risk</td><td>Section Assessment</td></tr>
<tr><td>Partially Equivalent</td></tr>
<tr><td>Rationale for overall topic assessment</td><td colspan="2">North Macedonia's capital adequacy regulation considers counterparty credit risk and all risks under market risk. There are provisions in place also for settlement risk.

In general, the legal provisions are based on the same ideas and principles (building block approach) as the CRR provisions for these types of risks but there are some deviations compared to the CRR, which stem from the fact that North Macedonian market is not developed and market risk is not an important risk there. Market risk framework is partially equivalent; however, settlement risk and counterparty credit risk frameworks are both equivalent to the CRR.

<u>Own funds requirement for market risk</u>

North Macedonia has trading book concept in place, which is similar to CRR's trading book concept both with regard to the instruments assigned to it and the conditions for the small trading book derogation are slightly lower thresholds than in the CRR. They have also the principles of prudent valuation in place. However, the requirements for the management of trading book have not been set out.

The lower absolute values for 'small trading book' than those in the CRR correspond to the smaller size of banks' activities, especially those of the trading positions. A bank needs to calculate capital requirements for market risk if the amount of the positions in the trading book of a bank does not exceed 0.1% of the total assets and at the same time does not exceed EUR 4 mn. This is why none of the banks determines capital requirements for market risk in practice.

Market risk provisions are based on a building block approach taking into account the position risk for trading book activities, foreign exchange risk and commodities risk for all business activities. Regarding the approaches to calculate own funds requirements, their regulation allows only for the application of the standardised approach (SA). The calculations of capital requirements are largely aligned with the CRR, however lower risk weights for specific risk of equity positions are applied (this will be revised in 2021). Offsetting between entities is allowed on sub-consolidated and consolidated basis.

FX risk is the only risk that exists in practice and the provisions are identical to the CRR – risk weighted with 8% and they have also implemented the 2% de minimis rule. North Macedonia has capital requirements for commodities risk and risk of options (simplified methods in both cases).

Internal Model Method has not been implemented because the markets are very small and simple.</td></tr>
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<tr><td></td><td colspan="2">North Macedonia has not implemented requirements for CVA risk because the derivative market is much less developed compared to the EU.

Considering the fact that regulation in North Macedonia on own funds requirements for market and related risks comprises of all the elements that are part of the CRR but with some deviations, the provisions are considered partially equivalent to those of the CRR.

<u>Settlement risk</u>

The scope and calculations for the settlement risk are identical to the CRR in North Macedonia and capital requirements are required for all activities (banking book and trading book) from January 2020. 1250% for free delivery exposures until the extension of the contract is the same as in the CRR.

<u>Counterparty Credit Risk</u>

In general, North Macedonia's rules for the treatment of counterparty credit risk (CCR) are identical to the respective rules of the CRR. Only the Mark-to-Market Method and the Original Exposure Method (OEM) have been implemented in the regulation. Similarly to the CRR, OEM cannot be used if the institution is not eligible for the small trading book derogation.

Both methods eligible to calculate own funds requirements are identical to the CRR with regard to the calculation methodology. A bank is obliged to apply the same method for all positions belonging to the same group of transactions when calculating CCR (no combinations). Only a bank applying the OEM can switch towards use of the mark to market method.

Only non-material differences were noted. There is no specific requirement for contracts that are structured to settle outstanding exposure following specified payment dates and NM regulation does not allow banks to use other percentages for contracts relating to commodities other than gold (more conservative). Unlike the CRR, contractual netting agreements are not allowed.

Due to the degree of development of derivatives markets NBRBN does not consider counter-party credit risk as threat to the financial system.

Regulations on settlement risk and counterparty credit risk are both equivalent to the CRR.</td></tr>
<tr><td>Section 11</td><td>Liquidity</td><td>Section Assessment

Equivalent</td></tr>
<tr><td>Rationale for section assessment</td><td colspan="2">The framework for liquidity in North Macedonia can be assessed equivalent to the EU one, the new NBRNM Decision on the methodology for liquidity risk management (D. No. 02-15/VIII-2/2020) approved on 29 May 2020 substantially reflects the provisions on the Liquidity Coverage Ratio (LCR) included in the CRR and Delegated Regulation 2015/61 (DR).

Banks and savings houses must respect a 100% threshold for the LCR, while the introduction of the Net Stable Funding Ratio (NSFR) will be a medium-term activity of the National Bank and will follow the latest amendments of the CRR regarding calculation of NSFR.

<u>Short-term liquidity</u>

According to the NBRNM's Decision on the methodology for liquidity risk management, banks are required to maintain a LCR of 100%. The LCR is defined as the ratio of liquidity buffer and net liquidity outflows over a 30-day stress period; the regulation also prescribes the same type of stress scenarios as in the EU.

The liquidity buffer is the sum of level 1, level 2A and level 2B assets, with the same limits applied in the CRR (Level 1 assets should equal 60% minimum, Level 2B assets should equal 15% maximum). The composition of assets is the same as defined in Commission Delegated Regulation (EU) 2015/61, Art. 10-12, however, in North Macedonia there is no possibility for non-interest bearing assets to be</td></tr>
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<tr><td></td><td colspan="2">included in Level 2B assets due to religious observance while the operational requirements are the same as defined in Art. 8 of the same DR.

The local law prescribes the same conditions for eligibility for LCR purposes (low risk, certainty of valuation, low correlation with risky assets, being listed in an exchange, having an active market, type of issuer) and the same haircuts to be applied when valuating HQLA. The rules on calculating liquidity inflows and outflows for the purposes of LCR are identical to the ones in the DR, with a few (conservative) differences: i) for investment in CIUs, the bank can outsource the calculation of market value of the CIUs only under condition that this market value is verified and confirmed by an auditing company, ii) in case of insufficient liquid assets in a given currency, no derogation or alternative approaches are allowed and iii) the application of the 3% outflow rate for retail deposits – as in Art. 24(4-6) DR) - is not allowed.

Banks are required to submit regular reports for 1) LCR (liquid assets, outflows, inflows, collateral swaps and calculations), 2) additional liquidity monitoring metrics (maturity ladder template, concentration of funding by large depositors and by product type, prices for various lengths of funding and roll-over of funding, 3) unencumbered assets and 4) internal liquidity indicators.

<u>Long-term liquidity</u>

According to the Decision on managing banks' liquidity risk in place since 2009, banks are required to maintain a liquidity ratio (LR180) for assets and liabilities maturing in the following 180 days at least equal to 1 (before the introduction of the LCR, banks had also to comply with a similar liquidity ratio with a reference period of 30 days). In the monitoring of long term liquidity, LR 180 is considered by NBRNM as a form of quasi-stable funding ratio. In case the bank fails to maintain the minimum level of LR180, it shall submit to NBRNM a written explanation of the reasons behind the noncompliance with the limit, and indicate measures to achieve the minimum level.

At the time of assessment, the NSFR had not been included in the local regulation yet but it was regarded as a medium-term activity that would have followed the latest amendments of the CRR regarding the calculation of NSFR.

<u>Supervision</u>

The assessment of risks to liquidity is part of the supervisory review process based on SREP. To this extent, NBRNM assesses the risks to liquidity first analysing the inherent liquidity risk and the inherent risk of the funding sources and then comparing it with the quality of management of these risks.

Inherent risk is assessed first through a number of indicators (e.g. liquid assets/total assets, liquid assets/short term liabilities, liquid assets/household deposits, etc.), which are then aggregated into a synthetic indicator measuring the overall assessment of the bank exposure to liquidity risk. The assessment of liquidity risk is also supplemented by additional knowledge acquired through analysis of the Bank's reports, communication with the Bank and the Bank's strategy. Other factors that are considered are, for instance: the concentration of sources of funding; the structure and trends of highly liquid assets and liquid assets; the structure and terms of borrowings (creditor, maturity, interest, currency, changes) and their share in the total sources of funding; the analysis of the share of the secondary sources of funds. After establishing an assessment of the level of exposure to liquidity risk and the quality of liquidity risk management, the supervisor establishes a summary assessment of liquidity risk, which ultimately feeds into the SREP assessment.</td></tr>
<tr><td rowspan="2">Section 12-13</td><td rowspan="2">Macroprudential framework and capital buffers</td><td>Section Assessment</td></tr>
<tr><td>Equivalent</td></tr>
<tr><td>Rationale for overall topic assessment</td><td colspan="2">The framework for macroprudential framework/tools and capital buffers in North Macedonia be regarded as equivalent to the EU one.</td></tr>
</table>

Macroprudential framework

Although it is not currently designated explicitly as a macroprudential authority, according to the Art. 6 of the Law on the National Bank, besides its primary objective to achieve and maintain price stability, the NBRNM has an objective to contribute to the maintenance of a stable, competitive and market-based financial system. Moreover, the Banking Law explicitly (Art. 65) empowers the NBRNM to decide on setting and releasing of capital buffers as one of the most relevant macroprudential tools.

In October 2009, the NBRNM and the Ministry of Finance signed a Memorandum of Understanding (MoU) for maintaining financial stability and managing financial crisis. With this MoU, the Financial Stability Committee (FSC) was established with a purpose to provide timely, efficient and flexible approach when coping with potential financial crisis. The FSC (meets quarterly) operates in normal times with the purpose to prepare the members in coping with potential financial crisis, and in conditions of potential or actual financial crisis may jeopardise the stability of the financial system. The main principles of the MoU in case of a financial crisis are to protect the stability and confidence in the financial system, to protect interests of depositors and to minimise potential adverse economic consequences.

In addition, as NBRNM is the regulator and supervisor only for the banking sector, an informal Inter-institutional body for financial stability was established between individual supervisory authorities for other sectors of the financial system, upon NBRNM's initiative. The main purpose of this body is to enhance the cooperation among various supervisory authorities through reviewing the movements in individual segments of the financial system.

In order to further improve the legal provisions for adequate macroprudential supervision, the NBRNM and the Ministry of Finance are preparing changes of the current legislation which will enable explicit designation of the macroprudential mandate.

Macroprudential tools

In addition to the possibility of setting capital buffers, NBRNM can impose other measures of a systemic or macroprudential nature. Article 65 of the Law on the National Bank empowers the Governor to prescribe higher than stipulated capital adequacy ratios for one or more banks, in consideration of the risks it is exposed, including risks arising from the macroeconomic environment. Art 133 of the same envisages the possibility of states that the Governor may impose stricter supervisory requirements against bank or bank shareholder when identified that there is a risk to the maintenance of the safety and soundness of the bank or the banking system as a whole. To this extent, the following measures have been undertaken in the last few years:

i. **High credit growth to household , 2008**
   - Higher risk weight for credit cards and overdrafts (125%),
   - Marginal deposit with NBRM for higher than 1% credit growth to households.

ii. **Rapid long term consumer credit growth, 2015**
   - Higher RW on new consumer loans with contractual maturity 8+ years (to 150%),
   - Additional 75% RW for the growth in overdrafts and credit cards compared to 31.12.2015.

Capital buffers

Values

All the four capital buffers envisaged in the EU framework are currently implemented in North Macedonia:

- Capital Conservation Buffer, set at 2.5%;
- Countercyclical Capital Buffer (CCyB), between 0 and 2.5%;
- Capital buffer for systemically important banks (O-SII) 1% to 3,5% The National Bank sets the buffer based on its methodology, at least once a year;
- Systemic risk buffer (SysB), between 1 and 3%.

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Methodologies

- <u>CCyB</u>: The methodology follows the Basel III approach, i.e. it is based on the credit-to-GDP deviation from its long-term trend. Similar to Art. 140 CRD, NBRNM may impose a countercyclical buffer at the level of single institution. The institution-specific CCyB rate is determined based on the rates for different jurisdictions, i.e. the Institution specific CCyB is weighted average of the CCyB for the bank's exposures to private sector from all jurisdictions.
- <u>O-SII</u>: The Methodology for identifying SIIs and setting the capital buffer is prescribed by the National Bank's Council, based on the international standards in this area published by the Basel Committee. The quantitative approach for identifying systemically important banks relies on four criteria of systemic importance: size, substitutability, interconnectedness and complexity.
- SysB: Article 65-g of the Law on National Bank determines that the governor of the NBRNM may prescribe a systemic risk capital buffer for all, or one or several banks in the country, if necessary for limiting the risk of disruption to the financial system or the national economy, due to activities of one or more banks or risks they are exposed to. SyRB rate may range from 1% to 3% of risk-weighted assets and may be different for various banks or groups of banks.

All the buffers consist only of CET1 capital and cannot be used to maintain other capital adequacy ratios.

Capital conservation measures-MDA

Art. 65h of the Banking Law and the Decision on the Methodology for determining maximum distributable amount of earnings design a framework that is in line with the one envisaged by Art. 141-142 CRD. A bank that fails to fulfil the total amount of capital buffers (combined buffer) shall prepare a capital conservation plan and deliver it to the National Bank within 10 days after the date determined that it no longer meets the total amount of capital buffers. The content of the capital conservation plan prescribed by the law is substantially the same as the one prescribed by Art. 142 CRD. Similarly, banks are limited in the distribution of payments in case this will imply a breach of the combined buffer threshold. Before making any distribution, banks need to calculate the Maximum Distributable Amount (MDA), whose amount and percentages are in line with Art. 142 CRD.

Pillar 2 stacking order

Capital buffers can only be met with positions of the CET1, which are not used for P1 and P2 additional capital requirements. If the excess CET1 (above the minimum and additional capital requirements) is not enough to cover capital buffers, that bank is limited in terms of distribution of earnings *(see above)* and need to present an adequate Capital Conservation Plan.

</td></tr>
<tr><td rowspan="3"></td><td rowspan="2">Section 14</td><td rowspan="2">Large Exposures</td><td>Section Assessment</td></tr>
<tr><td>Equivalent</td></tr>
<tr><td>Rationale for section assessment</td><td colspan="2">

Definitions and limits

- <u>Exposure Value</u>: The total exposure to individual person/entity is the sum of the bank's exposure to individual person/entity arising from the banking book and bank's exposure to individual person/entity arising from the trading book. The calculation of the exposure value is aligned with the methodology and includes the same exceptions of Art. 390 CRR.
- <u>Large Exposure definition</u>: According to Article 72(1) of the Banking Law, large exposure to an entity and entities connected is an exposure equal to or higher than 10% of the bank's own funds provided in the FBA and BARS legislation is the same as in the EU, i.e. exposure exceeding 10% of the bank's capital.
- <u>Eligible capital</u>: While there is no difference between eligible and regulatory capital, CET1 capital alone represents more than 90% of banks' own funds, as AT1 and T2 capital instruments have only a small share.
- <u>Connected clients</u> are defined in the same way as in the CRR, i.e. two or more persons, which represent a single risk, because i) one of them directly or indirectly exercises control over other person/entity or other persons/entities; ii) although they are not control-related, they are

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		interconnected such that the financial problems in one of them are likely to make other person(s)/entity(s) in default. The recent Decision on exposure limits and connected clients clarifies in more details the manner of determining control relationship and economic dependency, aligning closely with the EBA Guidelines on connected clients. - Large exposure limit: as in the CRR, the limit (for a client or group of connected clients) is set at 25% of the bank capital. The limit is defined only in percentage, as the absolute limit set out in EU legislation (150 mn EUR) at the moment, is too high for the local financial market. - Breach of Large Exposure limit: The Decision on exposure limits and connected clients defines the following two events as exceptional cases of exceeding the limits: (1) the exceeding results from merger and acquisition of two legal entities or (2) the exceeding results from reasons beyond control of the bank. In case the limit is exceeded, the bank shall immediately notify NBRNM stating the person or the group of connected clients concerned, the amount of the excess, the reasons for the excess, and the deadline for achieving the set limits. **Level of application** Large exposure limits are applied both at consolidated and solo level. **Large exposures in the trading book** The provisions are very much in line with the EU framework: - Trading book exposures are included in the relevant exposures of the Large Exposure calculation and the items are the same as the ones in Art. 390(3)(a); - A bank may exceed the exposure limits only in extraordinary cases for exposures in the trading book and if some specific conditions, aligned with Art. 395(5) CRR, are fulfilled. **Exemptions** The list of exposures that are exempted from the limits reflect the items listed in Art. 400 CRR, although in the EU some exposures may be exempted at the discretion of national authorities. However, the approach is slightly more conservative in that i) exposures secured with cash deposit with the bank, its parent entity or its subsidiary can be exempted only if they fulfil some conditions; ii) exposures to a bank's subsidiary are not exempted, but are subject to a 10% limit; iii) some other exposures that can be exempted according to Art. 400 CRR cannot be excluded from the limits. Exposures arising from mortgage lending secured by residential property are exempted from exposure limits, if the residential property fulfils the criteria for acquiring a 35% risk weight, but by no more than 50% of the market value of the property or 60% of the exposure secured with the residential property. However, a conservative approach is taken in the sense that the exemption from limits is not allowed for the exposures secured with commercial real estate properties. Moreover, it is established that banks may apply only one of the exceptions to the same exposure to a person/entity or to the same portion of the exposure to a person/entity. **Reporting and monitoring** Large exposures are constantly monitored through regular reporting on a monthly basis. In addition, banks are required to submit the following reports to the NBRNM: - on each large exposure, including exposures exempted from exposure limits, - on the largest 10 exposures to other banks on consolidated basis, - on exposures that do not represent large exposures, but are greater than 10 EUR/mn in denar equivalent, on consolidated basis, - on exposures to clients connected to the bank, - on the amount that exceeds the exposure limits, - on exposures arising from reverse repo-agreements under which the bank has purchased mortgages liens on immovable property of third parties.

		For the first two type of the exposures above, NBRNM requires banks to provide a more detailed reporting. The framework for Large Exposures can thus be considered equivalent to the EU one.	
	Section 15	Leverage Ratio	Section Assessment Equivalent
	Rationale for section assessment	**Definition** According to the Item 2 of the Decision on the methodology for managing leverage risk, the leverage ratio shall represent the ratio between the capital value, equal to the Tier 1 capital as determined with the capital adequacy regulation, and the exposure value, as a measure of the total on-balance sheet and off-balance sheet assets of the bank. While the regulation does not prescribe any limits for the leverage ratio, there is an obligation for credit institutions to calculate the leverage ratio and to report it to the NBRNM. At the level of banking sector, the leverage ratio as of June 2019 stood at 10.9%. **Exposures** The total exposure measure includes same items as CRR and it is the sum of the following values: - on-balance sheet positions included in the determination of credit risk weighted assets, - derivatives, - exposure value of repurchase transactions, securities lending or borrowing transactions, long settlement transactions and margin lending transactions, - off balance sheet items. The principles for calculation of on-balance sheet exposures are similar to the ones prescribed by the CRR: - the exposure value of the assets is its' accounting value remaining after credit risk adjustments (IFRS 9 provisions), - banks cannot reduce the assets exposure value by taking account of any collateral regardless of its form (physical or financial collateral, guarantees or other credit risk mitigation techniques), - loans cannot be netted with deposits, - repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions cannot be netted as well. The exposure value of the derivative contracts is determined according to the mark-to-market method as prescribed in the Decision on the Methodology for Determining Capital Adequacy. Since contractual netting is not allowed as a risk reduction under the capital adequacy regulation, it is also not allowed for the purposes of calculating the leverage ratio. **Netting and add-ons** Banks may net positions (on a transaction basis) only in the case of securities, which meet the conditions of financial collateral, according to the methodology for capital adequacy. This straightforward approach (vs. the detailed requirements of Art. 429(8) CRR) was adopted in consideration of the simplicity of instruments on banks' balance sheets, as it is easier to implement by the banks and to monitor by the supervisors. There are no provisions for a CCR add-on for SFT; this reflects the fact that banks do not have exposures based on repos, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions. **Reporting** Banks are required to report to NBRNM the leverage ratio on semi-annual basis using a uniform reporting template prescribed by the Instructions for enforcing the Decision on the Methodology for Managing Leverage Risk.	

		The framework for Leverage Ratio can thus be considered equivalent to the EU one.	
	Section 16	**Disclosure**	Section Assessment Largely Equivalent
	Rationale for section assessment	NBRNM apply qualitative and quantitative disclosure elements that are largely comparable to the EU requirements. The principles underlying the scope and objective of disclosure are in line with Art. 431 of the CRR. Also, in line with Art. 432 of the CRR, exceptions to disclosure are based on confidentiality and materiality of data. The current disclosure regulation was enacted in 2007 and at the time of the assessment the NBRNM was preparing a new Decision on Market Disclosure that would be in line with the latest international standards. Banks are required to adopt disclosure policy which should contain the type of data to be disclosed, the disclosure frequency and the control systems in the disclosure process. The data the bank is required to disclose should be accurate and timely. **Frequency**. The banks are required to disclose the data on the bank, on bank's shareholders structure and on the bank's own funds, including on the capital adequacy, at least on a **semi-annual basis**, while the data on the risk management process should be disclose at least once a year. The NBRNM may require from the bank to disclose part or all the data for shorter periods, depending on the volume and the type of its activities, in case of significant changes in the shareholders structure of the bank, the level and the structure of the bank risk exposure and the amount and the structure of the bank's own funds. The frequency is more stringent than foreseen by the CRR (annual). The **scope** of information to be disclosed is fully in line with the CRR art 436. Banks need to disclose the strategies and the processes of management of each risk, the structure and the organisation of the risk management function, the structure of risk measurement and internal reporting systems, and the policies on hedging and risk mitigation, as well as the procedures for monitoring the efficiency of the policy implementation. In addition the banks are required to prepare a corporate governance report on an annual basis and to disclose it as an integral part of the annual report on the bank's operations. There is no requirement yet to disclose information on risk appetite (foreseen in the new regulation that is under preparation). Disclosure requirements on own funds are in line with the CRR, except on prudential filters which is not a requirement yet. All capital requirements are well represented/disclosed, there is more transparency in disclosing ICAAP results and possible Pillar 2 requirements stemming from SREP than foreseen in the CRR. The current Decision does not require banks to disclose information in relation to capital buffers but this will be introduced with the new regulation in 2020. The requirements on each risk are in line with the requirements of the CRR; except for the counterparty credit risk where only the amount needs to be disclosed but there is no CCR exposure in North Macedonian market, and there are no disclosure requirements on securitisation (there is no securitisation framework or market). Regarding **supervisory disclosure**, NBRNM publish all the relevant laws and regulations on their website and is in line with the CRR requirements. Given that some requirements were planned to be introduced after this assessment in 2020-21, the current disclosure framework is largely equivalent to the CRR.	