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Original scientific paper

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**EFFECTS OF THE FINANCIAL CRISIS ON THE LENDING
ACTIVITY OF BANKS IN THE REPUBLIC OF MACEDONIA**

Abstract

Macedonian banking is basically traditional banking, therefore loans are the main sources of the banks for provision of funds. Given that the analysis of lending is very complex, the paper makes reference only to certain aspects of the lending activity of banks in the past: structure of assets in the banking sector, dynamics of lending activity and lending structure by sectors (corporate and household sector).

The analysis based on all previously mentioned aspects is done for the period before and after the global financial crisis in order to see the effects of its impact on the credit activity of banks. There is an evident fact that slowing economic activity in the real sector, and tightening credit conditions by banks after 2008 conditions the existence of downward trend in the lending activity, which is evident through the reduction of the share of loans in the assets of the banking sector, the rate of growth of gross loans, and the rate of growth of loans in the corporate and household sector.

Keywords: lending activity, bank's assets, gross credit, credit growth rate, corporate sector, household sector.

JEL classification: G21

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Introduction

Credit activity is an important segment of the economy of a country, which significantly affects the country's economic development. Credit activities are the dominant banking activities in most banks and in the total portfolio of the bank. Thus banks expect from these activities to achieve the biggest income. However, on the other hand it depends on the the timely repayment of the credits. A bank's credit portfolio management is important and they tend to retain control over their claims and to avoid or reduce losses of workload that may have a direct impact on the prosperity and survival of the bank, as well as on the stability of the overall economy of the country .

The Macedonian banking sector, although indirectly exposed to the impact of the global financial crisis, set a new challenge - to maintain a high level of liquidity and to maintain the confidence of depositors. The deteriorating economic situation in the past, which resulted in reduced purchasing power, thus restrained consumption of the real sector and the citizens, affects the increase of credit exposure of banks at risk. This, in turn, contributed to reduction in the credit activity of banks after 2008. Credit activity and its dynamics before and after the financial crisis is studied in this paper.

1. Analysis of the structure f banks' assets

The banking system in Macedonia consists of seventeen banks and eight saving houses. In terms of credit activity¹, the general conclusion is that the concentration is in the group of large banks², because they participated with 48.3% of the total lending activity starting in 2003, and 66.3% in 2012.³ In the recent period the group of large banks have strengthened the position on the banking market and they are major drivers for annual growth of the gross loans (the share in 2007 rose

¹The paper focuses only on the credit activity of banks because savings account for an insignificant percentage, or 1% of total assets and 1.4% of total loans.

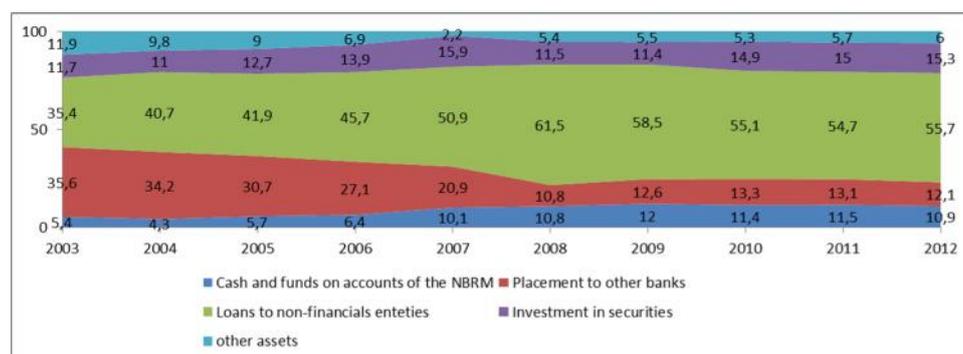
²In order to do more adequate analysis, NBRM divides banks into three groups (according to the size criterion of total assets). So, today, the group of large banks includes three banks, a number that has remained unchanged since 2003, while the number of banks in the group of medium-sized and small banks ranged from 6 to 8 medium-sized banks and from 7 to 13 small banks.

³Report on the banking system of the Republic of Macedonia in 2003, 2012, NBRM.

up to 70.3%⁴). In the period after 2006 and 2007, there is a significant trend of strengthening the position of the group of medium banks, first by increasing the deposit base and then by increasing and strengthening the market share in total assets.

Loaning bank activities could be considered from more aspects. One aspect of the analysis is the recognition of the share of loans in the total assets of the banking sector. The change in the share of individual assets in the assets in the period of ten years indicates the activity of banks performed in that period. The structure of the assets of the entire banking system is shown in the Figure 1, where you can clearly see that the situation stems from 31.12.2003, when the banks had a strategy of targeting deposit placements in the first-class banks in the world, instead of lending in the country itself. The share of the placements to other banks and the category of loans to non-financial entities of over 70% by 2010 indicates prevailing exposure of the banking system to credit risk.

Figure 1: Asset structure of the banking system for 2003-2012



Source: Own calculations according to Annual reports of NBRM for period 2003- 2012 year

The displayed graph 1 shows that since 2009, there is slowdown of credit activity and reduction of its share in the total assets (under 60% compared to 2008, when participation is the highest - 61.5%) as a result of the stricter conditions of lending by banks due to deteriorating economic conditions. The expense of this slowdown has increased the share of placements in banks and the share of funds in the accounts with

⁴Report on the banking system of the Republic of Macedonia in 2007, NBRM.

NBRM⁵, as well as increased investments of banks in securities (from 11,7% in 2003 to 15.3% in 2012), primarily due to the positive assessment of the connection between return and risk of that investments, but also due to improving the liquidity of banks. In this period there was increased participation of investment of banks in low-risk securities, which also shows that banks are still wary of increasing lending activity.⁶

Generally speaking, that conditions largely increase the activities of banks, and thus the bank's assets are the deposits, because all these years they have a role of the dominant source of funding for the banking activities. Deposits show continued growth starting from 2003 to 2007, which led to an increase in the assets of banks and credit growth and their share in assets. But starting from 2008, when there was stagnation of deposits as well as tightening of the conditions for external borrowing, until 2012, deposit growth was slowing down due to slowing economic growth and uncertainty from the debt crisis. What is remarkable in this period is greater reduction of deposits in the corporate sector, primarily due to reduced liquidity of operations and need for cash.

2. Analysis of the dynamics of credit market

Under the impact of the global financial crisis, banks in the country have felt the slowdown in total assets. The reasons for this were multiple: psychological pressure created by domestic entities, reduced propensity for saving because of future uncertainty about the effects of the financial crisis, and declining trust in the banking system (which had the most reaction by household sector). This in turn affects the tightening of credit conditions for approval of loans by the banks.

Also, slowing the dynamics of lending is a result of certain legislative measures brought forth by NBRM. In June 2008 the Decision for mandatory deposit⁷ was brought, which conditioned banks to allocate required deposits to the NBRM accounts monthly, if they exceed the maximum limit for approval of loans to the household sector, in order to discourage and slowdown the rapid growth of loading activities in the

⁵This change is due because of tight monetary policy of the NBRM, namely made increasing rates of reserve requirements for liabilities denominated in the currency.

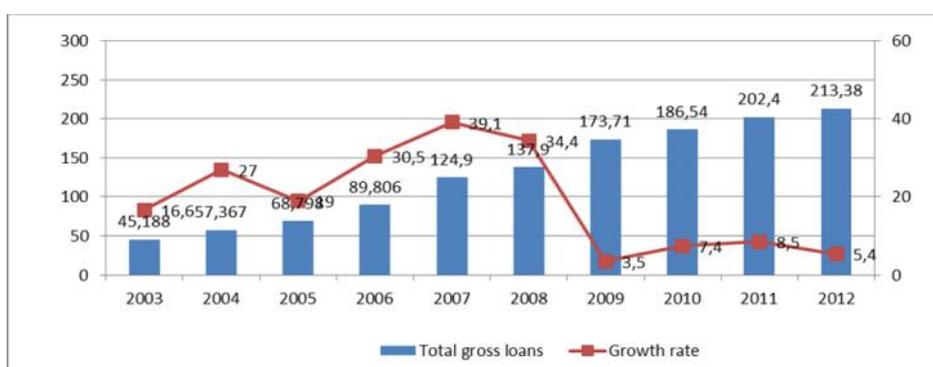
⁶Report on the banking system and banking supervision in the Republic of Macedonia in 2009, NBRM, p. 25.

⁷Decision for mandatory deposit Official gazette, Republic of Macedonia, no. 163, 26 december 2008 year, Skopje.

population sector, which in the years before 2008 reached up to 56%. Also, with the adoption of the Decision to amend the Decision for methodology for determining the adequacy of capital⁸ and the introduction of higher risk weight for claims arising from approved and used overdrafts on transaction accounts and credit cards, there is certain contribution to the reduction in the credit activity of banks in the household sector. Then, the change in the Decision for mandatory reserve increased the rates of reserve for liabilities with currency component (increased rates for foreign currency liabilities from 10% to 13% and liabilities in foreign currency clause from 10% to 20%). This increase in the reserve was intended to increase the liquidity of banks, but also meant reducing the amount of available funds that banks can use for lending.

The impact of all these factors led to a slowdown of credit activity after 2008. In Figure 2 the movement of the rate of growth of loans starting in 2003 until 2012 can be observed through the movement of the rate of growth of gross loans.

Figure 2: Total amount of gross credits and the growth rate for period 2003-2012 year



Source: Own calculations according to Annual reports of NBRM for period 2003- 2012 year

From the data shown, it can be seen that the growth rate in 2009 was only 3.5%, while in previous years it is over 30%.

But, as it can be seen from Figure 2, since 2010 there has been a revival of credit activity and the growth rate of gross loans is increased.

⁸Decision to amend the Decision for methodology for determining the adequacy of capital, Official gazette, Republic of Macedonia, no. 32, 7 march 2008 year, Skopje.

The revival of credit activity is due to the more stable environment and the gradual recovery and revival of the domestic economy and expanding deposit base, most in the household sector (growth rate of deposits is three times higher than the previous year⁹). The growth in this period is a result of the increased lending to the corporate sector, the export sector, and growing consumption of population. This moderate increased growth in loans is followed by a continuous downward trend in interest rates (and largely influenced by changes in the Law on Obligations in 2010¹⁰ when the maximum contractual interest is prescribed).

But the general impression is that in the period after 2008 there has seen great caution on banks and their focus on maintaining a quality loan portfolio, primarily due to the risks of the environment, and the difficult recovery of existing loans.

3. Analysis of the credit portfolio of non-financial sectors

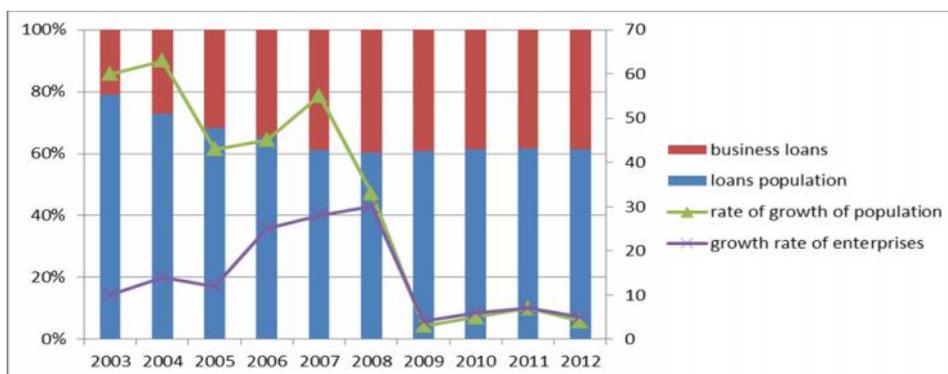
When analyzing the sectoral structure of the credit portfolio, the fact that loans in the corporate sector are dominant in comparison with loans to the household sector is quite evident. Lending to the population sectors almost did not exist before 2003. However, 2003 witnessed significant growth and interest in banks because of the fact that these loans carried high rates of return and were less risky since there was a possibility for diversification of risk.

The participation of the corporate and household sector in the credit portfolio and the dynamics of lending activity of these two sectors is shown in Figure 3. For the entire analyzed period there was greater participation of the corporate sector in the structure of the credit portfolio in relation to the household sector.

⁹Report on the banking system and banking supervision in the Republic of Macedonia in 2010, NBRM, p.3.

¹⁰Law for change the Law of obligations, Official gazette no. 81, 30 june2009, Skopje.

Figure 3: The participation of the corporate and the household sector and growth rate for period 2003-2012 year



Source: Own calculations according to Annual reports of NBRM for period 2003- 2012

The data in Figure 3 shows that the decline in lending from 2008 until 2012 was present in both sectors. The impact of the financial crisis on banks' credit activity led to a reduction in the credit growth rate in both sectors.

Starting in 2008 the population sector appeared significantly reduced credit growth over the previous year (from 56.2% in 2007 to 37.4% in 2008) because of the effect of the previously mentioned measures taken by NBRM and the strained terms of banks for loan approval. From 2009 to 2011 the population sector realized lower growth rate than the corporate sector. This significant slowdown of credit activity as previously stated is due to increased fear and risk of banks' inability to realize the security and perceptions of worsening for this kind of credit¹¹. Credit growth of the population sector in 2010 had even lower rate than the corporate sector. It was due to "slower growth in disposable income, and lower demand for loans in order to achieve greater caution with the population and the slow adjustment of expectations to the uncertainty"¹². It means that in terms of the uncertainty on the labor market, the population still refrains from consumption and is more inclined towards saving.

In 2011, banks gradually changed their views on the riskiness of this sector according to the perception of future favorable expectations in

¹¹Survey of credit activity, april 2009, NBRM.

¹²Report for financial stability of Republic of Macedonia for 2010, NBRM, p. 87.

the improved economic environment and thus increase the growth rate of this portfolio. During this year for the first time there was bigger growth in the household sector than in the corporate sector, thereby increasing their share in the absolute increase in gross loans. This change occurred after three years of constant reduction of the household sector in the growth of gross loans, which happened because of the greater caution of this sector in lending and the banks' perception of increased risk of this loan portfolio due to less conservative approach of the banks in their lending in pre-crisis period.

In the corporate sector from 2003 to 2008 there was a permanent decline in gross loans, but despite this dynamic this sector had a dominant share in the total gross loans (from 60% in 2008, with greater contribution to the increase of total credits, 57.9%, see Figure 3).

In 2009 under the impact of the financial crisis there were noticeable changes in credit growth. The low growth rate of loans to this sector by 4.4% (compared to 32.8% in 2008) due to reduced demand for loans because of restraint in consumption and reduced tendency for new borrowing in an unpredictable future income. Certain impact on slowing demand for loans decreased foreign trade in this period, which is direct result of the world economic and financial crisis. However, in 2010 the number of approved applications, according to the Survey of lending activity of banks in 2010¹³ increased in this sector due to the adaptation of the bank to the new economic conditions caused by the crisis, interruption of the "restraint" of lending and beginning of the phase of supporting lending in terms of stable domestic and global economic environment. These positive trends in the economy also suggest that there is a connection between the growth of credit activity among enterprises and the economic cycle of the country. In 2011 and 2012 the demand for loans in the corporate sector increased, but with less intensity due to a moderate tightening of conditions for lending to this sector by requesting to provide collateral of possible credit risk (risk of non-payment of credit claims).

¹³Survey of credit activity, February 2010, NBRM.

Conclusion

Credits play an important role in the bank, because they make up 50% to 80% of the total assets in bank assets.

From the analysis in the paper it can be concluded that unlike the pre-crisis period when banks were the main goal-increasing market share and increased the loan portfolio, the orientation of the banks in the last four years has been more with restraint of the bank lending, retention stability of banks and keeping quality of the loan portfolio.

The positive trend of growth of gross loans in the period 2003 to 2007 was due to: the dynamic role of the banks to increase lending activity particularly in the household sector, increased lending in foreign currency, targeting to long-term lending and reducing exposure to credit risk or improving the quality of its credit portfolio. The credit portfolio during this period is of high quality because of its “immaturity”; a portfolio which should be carefully followed in the later stage of its “payback”.

The financial crisis in 2008 led to the restraint of the corporate and household sector from investing and spending, and abstinence from lending because of the tightening of credit conditions by banks, which resulted in a decline in credit growth. The decline was felt in both sectors. The trend of improvement in the loan portfolio was discontinued in 2008 due to “payback” portfolio of population and the appearance of the first signs of deterioration from world financial crises, which resulted in reducing the export of enterprises, restructuring of loans in recent years, write-offs of outstanding loans and taking over the outstanding claims by banks.

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5. Report for financial stability of Republic of Macedonia for 2010, NBRM.
6. Report for banking system and banking supervision in Republic of Macedonia in 2003, 2007, 2010, 2012, NBRM.
7. Survey of lending activity, 2009, 2010, NBRM.