

Analytical review on activities of the banking system for six months of 2012

1. About the condition and development of the banking system.

1.1. Basic indicators of credit institutions

Table 1

Indicators of the activities of credit institutions for six months of 2012

(thousand rubles)

| SN | Indicators | As July 1 | | Growth rate (%) |
|----|--|------------------|------------------|-----------------|
| | | 2012 | 2011 | |
| 1. | Number of operating credit institutions | 11 | 15 | 73,3 |
| 2. | Equity capital* | 1 108 607 | 884 912 | 125,3 |
| | including: | | | |
| | - authorized capital | 454 749 | 531 854 | 85,5 |
| 3. | Currency of the summary balance sheet (gross) | 7 466 225 | 6 349 445 | 117,6 |
| 4. | Credit investments**, total: of which | 3 165 152 | 2 863 889 | 110,5 |
| | - share of total (balance sheet assets), % | 42,4 | 45,1 | 94,0 |
| | a) Prolonged loans | 575 061 | 491 446 | 117,0 |
| | - share of total (credit exposure), % | 18,2 | 12,9 | 141,1 |
| | a) Loan arrears | 502 025 | 288 992 | 173,7 |
| | - share of total (credit exposure), % | 15,9 | 10,1 | 157,4 |
| 5. | Loan loss provisions | 609 418 | 366 573 | 166,2 |
| 6. | Deposits of private individuals | 504 050 | 501 451 | 100,5 |
| | - share of total (Russian ruble), % | 83 | 78 | 106,4 |
| | - share of total (foreign currency: US dollar and Euro), % | 17 | 22 | 77,3 |
| 7. | Deposits of legal entities | 13 150 | 38 025 | 34,6 |
| 8. | Financial results | -69 481 | -18 026 | |
| | a) profit*** | 24 560 | 38 757 | 63,4 |
| | -number of profitable credit institutions | 5 | 9 | 55,6 |
| | б) loss | 94 041 | 56 783 | 165,6 |
| | - number of unprofitable credit institutions | 6 | 6 | 100,0 |

*) The sum of equity capital is shown taking into account the updated corrections in the procedure of calculation, according to statutory acts of the Bank of Abkhazia, and reduction of negative value.

**) The Credit exposure is shown taking into account guarantees and deposits.

***) The profit sum is shown without consideration of corrections for losses.

The data displayed in Table 1 testify to the significant growth rate of individuals indicators. In particular the equity capital of credit institutions as at July 1, 2012 has increased by 25.3 % in compar-

ison with the similar date of 2011 due to revaluation of fixed assets and as well as a consequence of the extension of the subordinate loans to five credit institutions in the amount of 181.3 million rbl as at July 1, 2012. The total sum of equity capital has increased by 83.9 million rubles as a result of the exclusion of the negative value of the equity capital of the three out of four credit institutions, in connection with the revocation of the license for banking operations.

The currency of the summary balance sheet of credit institutions has increased by 17.6%, including increased assets: at the expense of increased credit investments – by 10.5%; at the expense of increased sum of equity capital – by 16.2 %.

On the contrary as at July 1, 2012 in comparison with July 1, 2011 there was a significant decrease of the following indicators: the authorised capital – by 14.5%, the monetary funds - by 12.3 %; the funds on correspondent accounts – by 51.8 %; the required reserves deposited in the Bank of Abkhazia – by 14.2 %. This decrease first of all is caused by the revocation of the license for banking operations of four credit institutions.

At the same time, the negative factor in the increasing assets (in credit investments) is the increase of prolonged loans – by 17.0%, which exceeded the general increase of credit investments by 6.5 percentage points, while the loan arrears have increased by 73.7 % and exceeded the general increase of credit investments by 63.2 %. These increases testify to a deterioration in the asset quality as a result of the unsecured return of credits by borrowers which have caused an increase in expenses for loan loss provisions by 242.8 million rubles or by 66.2 % and had a negative impact on the financial results of credit institutions' activity. According to their summary balance sheet as at July 1, 2012 the total loss amounted 69.5 million rubles (51.5 million rubles more than as at July 1, 2011). Among 11 credit institutions the loss has been made by 6 institutions in total amount of 94.0 million rubles and in comparison with the first six months of 2011 the loss increased by 65.6 %. The activity was profitable in 5 banks which realized a profit in the amount of 24.6 million rubles or 36.6% less than in the first six months of 2011.

As a whole it should be noted that along with the total increase of the balance sheet assets as at July 1, 2012 in comparison with the similar date of 2011 the share of working profitable assets has decreased by 2.3 percentage points since the assets of the summary balance sheet increased as well at the expense of the unprofitable assets (fixed assets, free monetary funds, presence of losses and other assets).

For information purposes and for use upon determination of credit relationships with economic entities that act in the appropriate economic fields of the region there are data on basic socio-economic indicators of regions of Abkhazia for the first six months of 2012 (Annex 1)

1.2. The structure of credit investments in borrowers and the categories of quality of the loan arrears accrued by them.

1.2.1. The presence of arrears for the extended credits in a list of borrowers is shown in Table 2.

Table 2

**The structure of credit investments by the credit institutions in borrowers
as at July 1, 2012**

(thousand rbl)

| № SN | Borrowers | as at July 1, 2012 | | as at July 1, 2011 | | Growth rate (%) |
|-----------|--|--------------------|--------------------|--------------------|--------------------|-----------------|
| | | sum | share of total (%) | sum | share of total (%) | |
| 1. | Government enterprises | 116 638 | 3,7 | 92 433 | 3,2 | 126,2 |
| | of which: | | | | | |
| | prolonged loans | 37 954 | 6,6 | 37 850 | 7,7 | 100,3 |
| | arrears | 15 915 | 3,2 | 5 971 | 2,1 | 266,5 |
| 2. | Non-government sector of the economy (legal entities) | 1 844 568 | 58,3 | 1 626 309 | 56,9 | 113,4 |
| | of which: | | | | | |
| | prolonged loans | 366 634 | 63,8 | 272 093 | 55,4 | 134,7 |
| | arrears | 226 140 | 45,2 | 112 000 | 38,8 | 201,9 |
| 3. | Other banks | 15 098 | 0,5 | 17 798 | 0,6 | 84,8 |
| | of which: | | | | | |
| | prolonged loans | | | 15 190 | 3,1 | |
| | arrears | 15 098 | 3,0 | 208 | 0,1 | 99,4 |
| | Total: legal entities | 1 976 304 | 62,5 | 1 736 540 | 60,7 | 113,8 |
| | of which: | | | | | |
| | prolonged loans | 404 588 | 70,4 | 325 133 | 66,2 | 124,4 |
| | arrears | 257 153 | 51,4 | 118 179 | 40,9 | 217,6 |
| 4. | Private entrepreneurs | 216 931 | 6,8 | 120 977 | 4,2 | 179,3 |
| | of which: | | | | | |
| | prolonged loans | 15 425 | 2,6 | 18 612 | 3,7 | 82,9 |
| | arrears | 6 162 | 1,2 | 1 356 | 0,5 | 454,4 |
| 5. | Private individuals | 970 148 | 30,7 | 1 006 372 | 35,1 | 96,4 |
| | of which: | | | | | |

| № SN | Borrowers | as at July 1, 2012 | | as at July 1, 2011 | | Growth rate (%) |
|---------|-----------------|--------------------|--------------------------|--------------------|--------------------------|-----------------------|
| | | sum | share of total (%) | sum | share of total (%) | |
| | prolonged loans | 155 048 | 27.0 | 147 701 | 30.1 | 105.0 |
| | arrears | 237 011 | 47.4 | 169 387 | 58.6 | 139.9 |
| | Total: | 3 163 383 | 100.0 | 2 863 889 | 100.0 | 110.5 |
| | of which: | | | | | |
| | prolonged loans | 575 061 | 18.2 | 491 446 | 17.2 | 117,0 |
| | arrears | 500 326 | 15.8 | 288 922 | 10.0 | 173.2 |

According to the balance sheet of the credit institutions the total assets as at July 1, 2012 amounted 7 466.2 million rubles and increased by 17.6% in comparison with July 1, 2011.

A considerable proportion of 42.4% in total assets is taken by credit investments, the total sum of which amounted 3163.3 million rubles and compared to July 1, 2011 increased by 299.4 million rubles or by 10.5%. Meanwhile, the credit extension to legal entities increased by 13.8%, their proportion in the total sum of extended loans amounted 62.5%.

The largest proportion in the total sum of extended credits falls on non-government sector of the economy - 58.3%, the proportion of government enterprises is 3.7% of the total sum of extended credits.

The credit extension to private individuals decreased by 3.6%, amounted 970 million rubles, and its proportion respectively decreased by 4.4 percentage points. The credit extension to private entrepreneurs increased by 79.3% and compared to July 1, 2011 its proportion increased by 2.6 percentage points.

As a whole the condition of credit relations with borrowers (economic entities) is characterized by indicators displayed in Annex 2 in the list of the objects for crediting.

In essence these figures testify to the quality of loan portfolios in the context of the objects for crediting, to the availability of prolonged and past-due loans (whose proportion in the total amount of loan arrears is respectively 20.6% and 12.3%) and to the availability of debt on overdue interest.

However, the provided data reflect as well the difference in the quality of the loan portfolios between the objects for crediting, for example, credits extended for the purchase of inventory holdings with their proportion in the total amount of loan arrears being 10.7%, at the same time the proportions of the prolonged and past-due loans in their total sum are larger and amounted respectively 15.8% and 16.5%. The share of overdue interest is also significant - 22.9%. Similarly there is a large proportion of arrears on the loans that were extended for the purchase of equipment - 27.7% and on overdue interest - 12.1%.

All this testify to a varied effectiveness in the use of credits by borrowers and therefore the credit institutions should determine the most profitable objects for crediting in terms of secured return of credits and payment of interests.

1.2.2. Data on the categories of quality of the extended credits.

Table 3

Quality of the credit portfolio of credit institutions with consideration of arrears on guarantees and interbank deposits

(thousand rubles)

| INDICATOR | as at July 1, 2012 | | as at July 1, 2011 | | Growth rate, % |
|-----------------------------|--------------------|--------------------|--------------------|--------------------|----------------|
| | Sum (thousand rbl) | Share of total (%) | Sum (thousand rbl) | Share of total (%) | |
| Standard loans | 1 780 012 | 56.2 | 1 803 533 | 63.0 | 98.7 |
| Non-standard loans | 537 460 | 17.0 | 580 042 | 20.3 | 92.7 |
| Doubtful loans | 317 666 | 10.0 | 128 086 | 4.5 | 248.0 |
| Non-performing loans | 56 883 | 1.9 | 63 097 | 2.2 | 90.2 |
| Uncollectible loans | 473 131 | 14,9 | 289 131 | 10,0 | 163,6 |
| Total: | 3 165 152 | 100 | 2 863 889 | 100 | 110,5 |

The quality of the loan portfolio of credit institutions in the first half of 2012 in comparison with the same period in 2011 has worsened - the share of depreciated loans (II-V category) increased by 43.8%, or by 6.8 percentage points and their sum reached 1 385.1 million rubles. Thereby the accretion process of the credit portfolio was accompanied by significant risks.

The figures in Table 3 testify to a decline in the share of "standard" loans to 56.2% compared to 63% - in 2011. The share of arrears on "doubtful" loans increased by 5.5 percentage points and uncollectible loans - by 4.9 percentage points, while the share of uncollectible loans in the total amount of depreciated loans amounted 34.2%, and compared to July 1, 2011 has increased by 6.9 percentage points. This is a consequence of insufficient analysis of creditworthness (i.e. unsecure return of extended credits) of borrowers before granting them credits.

Decrease in credit portfolio quality is caused by the presence of the prolonged and past-due loans of borrowers and by the deterioration of their financial condition. As a result, the expenses of credit institutions for loan loss provisions are increased and the sum of incomes from credit operations is decreased due to non-payment of interest . In connection with this, in whole the financial condition of credit institutions is going down, and the activities of most of them in the first half of 2012. were unprofitable (in 6 out of 11).

The untimely return of loans to credit institutions reduces the resources to extend loans to other business entities that effectively carry out its activities creating new value with the involvement of bank credits, rather than using the loan as a source for cover of losses and for solving of various financial problems that not contribute to the development of its economy and the economy in the region and the country as a whole.

2. About the financial results of activities of the credit institutions

The financial condition of the credit institutions directly depends upon received incomes and the expenses incurred.

According to the data as at July 1, 2012 on form f-102, in comparison with a similar date last year the increase in the sum of incomes is 68,2%.

The most important and significant in the process of evaluation of credit activities of the credit institutions are interest yields. Over credit institutions as a whole, the proportion of the interest yield amounted 33,9%, while the proportion of loan arrears and other arrears equated to them in the assets of the banking system amounted 42,4 %. The absolute growth of the interest yields in the first half-year of 2012 relative to the similar period of 2011 amounted 16,9 million rubles.

The high proportion of the interest yields in the general structure of incomes is observed just in three banks.

- CB «Gagra-Bank» – 79,0%
- CB «Sukhum-Bank» – 58,7%
- CB «KIBIT-Bank» – 54,0%

The proportion of the interest yields in the total sum of incomes in other credit institutions is not more than 50%.

The financial result as a whole according to form f-102 is negative, and the total excess of expenses over incomes has reached 69 481 thousand rubles.

Data analysis of the form f-102 also testifies to that even with the positive value of the pure interest margin the profitability of working assets in 4 commercial banks out of 9 banks(44,4%) is lower than the cost of the attracted funds that are to be paid (SPRED). This is connected with the fact that commercial banks receive less interest income on extended loans. This fact decreases the profitability of working assets, due to the poor quality of the debt service by the borrowers of banks, despite the fact that banks have to make timely payments of interests on attracted funds that are to be paid.

Unprofitable activities of credit institutions are explained by the unsecured return of loans by borrowers and non-payment of interest by them which testifies to the absence of an accurate estimation of creditworthiness (trustworthiness) of borrowers in the course of granting them credit and, as a consequence, inefficient use of bank credit, growth of prolonged and delayed loans and non-payment of interest. This all leads to the depreciation of bank loans and a high growth of allowance for loan loss provisions, and testifies to inefficiency in the active operations. The pure interest margin for credit institutions as a whole, taking into account the risk as at July 1, 2012, gave a negative showing of 1,9%. The credit institutions: “Fininvest Bank” (–38,1%) and “Amra-bank” (–8%) have a high level of negative showing.

The financial result of the activities of a credit institution in many respects depends on the quality of condition of its credit portfolio, and consequently in order to make a decision on granting credit to a borrower his creditworthiness should be taken into consideration. In es-

sence, according to the requirements of article 1 of the Law of the Republic of Abkhazia "On banks and banking", credit granting should be made subject to conditions of redemption, payment and promptness.

At the same time, the factors reflecting sums of the generated loan loss provisions testify to a tendency of their growth, and, hence, to the growth of the depreciated loans.

As at July 1, 2012 the total sum of reserves amounted 609,4 million rubles and in comparison with the similar date last year increased by 242,8 million rubles, while the income and the profit of the credit institutions decreased by the same sum. It should be noted that the restorable amounts from the reserve accounts and credited to income are much less than re-credited amounts to reserves and the amounts reflected in the costs. For example, during the first half of 2012 according to reports on f.102 the credit institutions restored from the reserve accounts 249.4 million rubles (i.e. enrolled in income), and re-credited to the reserves (enrolled in cost) the amount of 397.3 million rubles or more by 1.6 times, and the excess of some credit institutions is from 2 to 6 or more times. As a result, the share of allocations to reserves in the total amount of expenditure as a whole in credit institutions reached 62.2%, and some - from 65% to 88%.

This all testifies that for earlier allotted loans (as well as for newly allotted loans) the category of quality has decreased, which is in essence caused by an absence of the due analysis of the financial condition of borrowers and of their creditworthiness.

The National Bank suggests an enhancement of the responsibility of corresponding office workers of credit institutions who are engaged in drawing up a professional judgment on borrowers, taking into account conditions for the granting of credits, as defined by article 1 of the Law of the Republic of Abkhazia "On banks and banking" and corresponding statutory acts of the Bank of Abkhazia (in particular Regulations 12-P and 20-P, etc.).

In view of the fact that, according to banking legislation, the purpose of the activity of credit institution is profit-making, it is necessary to apply all possible measures for the recovery of borrowers' arrears in overdue loans and interests, and not to allow the prolongation of terms of credit payment without careful study of the reasons which have caused a delay in its return according to the terms defined in the credit contract. All of this will encourage a decrease in the sums which are registered to accounts of loan loss provisions, and, accordingly, to increase the income and profit of credit institutions.