INSTITUTE ALTERNATIVE

”The Case of the First Bank” Experiences for the supervisor and other decision makers

Podgorica, May 2009

Project:
”The Case of the First Bank”
Experiences for the supervisor and other decision makers

Publisher:
INSTITUTE ALTERNATIVE

For publisher:
Stevo Muk, President of the Managing Board

Author:
Mila Kasalica

Design and production:
Studio Mouse

Translation:
Maja Mugoša

Copies printed:
200

The preparation of this study was supported by the Friedrich Ebert Foundation

Content

Abbreviations

CG (MNE) – Montenegro
CBM- Central Bank of Montenegro (in text for this institution the following terms have been used as synonyms: national controller/national regulator/national supervisor)
FB MN 1901- First Bank of Montenegro, founded in 1901, ad Podgorica
CKB- Crnogorska komercijalna banka ad Podgorica
PDG SO GEN- Podgorička banka ad Podgorica, Societe Generale Group
ATM- AtlasMont banka ad Podgorica
OPPO- Opportunity banka ad Podgorica
HAAB CG- Hypo Alpe Adria banka ad Podgorica
FFB- First Financial banka ad Podgorica
Invest- Investbanka ad Podgorica
KOM BUD- Komercijalna banka ad Budva
HPDG- Hipotekarna banka ad Podgorica
NLB MNE- Montenegro banka ad Podgorica, NLB Group
MoF- Ministry of Finance
MMF (IMF)- International Monetary Fund
SB (WBG)- The World Bank
FSAP- Financial System Assessment Project
BIS- Basel Committee on Banking Supervision
DEM- German Mark
€/EUR- Euro

1. Executive Overview

Unilateral introduction of a foreign currency (1999-DEM; 2002-€) was the beginning of the new development period for national economy's banking sector and, consequently, establishment and implementation of innovative solutions and initiatives in the regulatory system of country's banking business. Period of reforms consisted of institutional consolidation, few bankruptcies and liquidations of banks, as well as establishing and strengthening of internal, administrative and institutional capacities within the Central Bank of Montenegro, CBM, the national banking supervisor. Since 2005, growth rates of deposits have significantly influenced the growth of banks' assets, especially credit portfolios, which had a positive impact on speeding up of overall reforms in the Montenegrin economic system.

The First Bank of Montenegro founded in 1901, the newly acquired name, was an insignificant bank, located in the workers town in the central part of the country until 2006. Next couple of years, this bank succeeded to increase its assets by 24 times, through supervisory non-approved investments in the bank's share capital from large number of local businessmen and high level political profiles, accompanied by aggressive and not always competitive-driven attraction of deposits from the clients. In less than two years it managed to replace the end of the banks' market share list with the second place among the reputable and strong competitors. Aggregately, this provincial bank suddenly received abundant funds for unsustainable expansion and implementation of business illusion that only with a strong marketing campaign and with a team of managers who had little or doubtful working experience in banking business could achieve, in very short time, strategically unfeasible ambition to take over the leading role in the banking system.

The first risk-bearing market signs about limited liquidity and solvency of FB MN 1901 were noted in the beginning of 2007; more transparently in the beginning of 2008, as the bank constantly was failing to execute domestic and foreign payments' orders from clients. Almost by the end of 2008, relevant institutions were too slow and passive to publicly acknowledge the crisis and to face with the system's disruption caused by the FB MN 1901 insolvency. Furthermore, the situation resulted in systemic risk of the country's banking sector, that recalled unpleasant memories from the '90s when savings "disappeared" from banking balance sheets leaving clients with nominal figures on the accounts, and had strong negative impact on reputation of the country's overall financial system with significant deposits' withdrawal.

The legislative solution regarding the protection of banking sector from negative effects of global financial crisis was adopted by the end of the previous year. It provided systemic and regulatory framework for monetary support to FB MN 1901's liquidity position at the amount of €44 million. The major goals of this facilitation mechanism were: to relax the market and prevent against the panic; to improve confidence and decrease sudden and strong mistrust of clients; to completely execute the domestic and foreign payment's orders that have been pilled up in the bank's documentations for several months.

To summarize, semi-decennial national economic reforms strengthened the neo-liberal standing that financial system's supervision is not necessary and has no market oriented benefits, provided that economic growth will be achieved through significant growth rates, and resulted in full pacification of the national banking sector supervisor from the end of 2006. Therefore, the CBM's failure of anticipating the roots of the liquidity crisis within the banking system, which originated in FB MN 1901 operations, it could be found surprising from professional point of view, but it had to be systemically and logically expected. Institutional weaknesses and policy limitations in the implementation of CBM competencies have to be subject of future adjustments and corrections, following that Montenegro's economic system is not yet viable to endure the collapse of the banking business accomplished reforms, which would help to regain and further improve citizens and clients confidence in the country's banking sector performance.

2. Genesis of Banking Market Disruption in Montenegro

2.1 Starting Position of the Banking sector in the Country, and the Position of the Small Regional Bank

Introduction of the systemic dollarization/euroization of monetary framework of Montenegro in November 1999 (and in January 2002) represents the new beginning for development of the banking sector of the national economy and, consequently, establishment amd implementsation of innovative solutions and initiatives in the regulatory system of banks within the country.

The Law on Central Bank of Montenegro ("Official Gazette of MNE" no. 52/00, 53/00, 47/01, 04/05) established the institution's banking supervisory competencies and responsibilities. It created the minimal legal framework within the wider state association (SR Yugoslavia, State Union of Serbia and Montenegro) necessary for establishing a strong and reliable banking controller in the process of redefining development of banking and financial sector, and overall economic system of the country. After 2002 when CBM started to work independently, by executing both administrative and organizational preconditions for overseeing of the overall changes of banking business, supervisory system has been established.

During the years of reform and stabilization ten banks[1], licensed for all banking operations, conducted business in Montenegro. The national regulator additionally was responsible to approve the securities operations' licenses for banks (custody, dealer-broker operations), too.

Banking assets (table no. 1) in initial three years period, slightly grew, because the inherited discrepancies from the previous managing system required time for reconciliation, in order to:

---

[1] Within the CBM official document, Supervision Department's Annual Report for 2003, it was specified that on 17/03/2003 according to the Ministry of Finance decision the procedure of termination and cessation of operation of so called off-shore banks and bank accounts which were kept under the register of the Ministry and were not been under the CBM, initiated. Based on strong pressure of accredited diplomatic body in Montenegro, the entire procedure was successfully completed by 24/07/2003, and from unofficial 500 licenses, the number of licenses decreased to only 15.

- To identify potentially sound and healthy banking subjects oriented towards market and further development,
- To capitally restructure the banks, in line with carefully defined schemes of Ministry of Finances,
- To start the process of privatization and further development of banking sector of the country.

Since 2005, significant growth rates of the banking assets, and especially loan portfolios' rates, initiated and marked overall positive changes in the economic system's reforms of Montenegro.[2]

"Trends at the financial market have been extremely encouraging. The amount of received credits increased for 124%, deposits increased for 120%, savings of citizens for 184%, and assets of banks increased for 105%. Banks have a high level of liquidity and therefore no funds from obligatory minimum reserves were used, or credits for liquidity were required. Process of privatization of banking system is almost fully completed and the state as a direct owner is not present in the balance sheet of any bank."[3]

Table no. 1 *Overview of Banking Assets Trends(individually and aggregately)* *(in 000 €)*

Bank/Period	2002	2003	2004	2005	2006	2007	2008
HBCG	79.005	60.233	31.827	18.571	48.160	69.079	74.759
POD SO GEN	70.246	53.263	59.015	86.105	133.795	177.723	222.421
NLB MONT	46.007	65.058	112.047	129.058	225.639	402.279	468.546
AMB	52.205	35.651	47.086	63.133	87.512	146.077	157.637
OPPORT	11.352	17.078	25.797	52.299	139.141	168.550	168.570
FB MN 1901	10.915	13.681	13.753	22.449	102.218	468.539	489.731
KB BUD	-	11.364	17.985	27.673	45.976	77.247	76.964
CKB	62.285	93.430	136.863	296.469	547.696	1.025.972	1.134.076
HAA B	-	-	-	-	87.153	414.993	482.283
INVEST	-	-	-	-	14.124	19.538	20.923
FFB	-	-	-	-	-	6.364	13.754
Total system	**332.015**	**349.758**	**444.373**	**695.757**	**1.431.414**	**2.976.361**	**3.309.664**

Source: Annual reports of CBM Chief Economist for the period 2002-2008; Annual reports on work of Supervision Department 2003-2006, as well as balance sheets and income statements of the banks published on the CBM web page;

Share of the state capital in the overall banking sector was reduced from a quarter (22.6%) in 2003 to insignificant percentage by the end of 2006 (3.6%). Swiftly and efficiently banking sector privatization, similar to many other countries in the region, contributed to creation of clear systemic signals for the foreign investors, interested in high profit margin that could be achieved on the local market.

Lending portfolios of the banks, in the beginning financed by domestic deposits, and later by additional foreign sources[4], respond to strong demand's pressures for

[2] CB CG Chief Economist Annual Report for 2006;

[3] CB CG Chief Economist Annual Report for 2006;

[4] "*Banks' Borrowings- Any shortfall in funds in banks caused by a mismatch of credit maturity structures and bank deposits is filled by foreign loans, mostly from their parent banks. Total borrowings amounted to*

achieving commercial and individual improvements in business and life style. Rapid economic boom and growth of economy, after the "dry" period of not having strong opportunities and sources to lend that lasted for over decade and a half, even though it was not consistent and supported by sustainable dynamics of individual incomes and other earnings in the system (real estate incomes, incomes from investments on capital market, incomes from tourism etc.), consequently led to the high growth rates of banking loans portfolios, which will be stopped by the end of 2007, when the necessity to administratively limit the lending growth within the banks' balance sheets, in line with levels defined by the CBM decision, aroused.

"Banking system proved to be, beside the tourism, probably the most significant driver of economic growth. Credit growth rate in previous year was too high and it led to the number of negative effects. Significant share of the loans were used to purchase imported goods which increased of current account deficit in the balance of payments. High credit expansion also led to the increase of overall demand, which additionally impacted inflation."[5]

*****

According to data from the table no.1, the First Bank of Montenegro, founded in 1901 (in further text FB MN 1901) was, until the end of 2005, a small bank located in central part of the country, in the workers town of Niksic, with the share in overall banking assets of only 3%, and the share in sector's equity less than 7%.

Consolidation of the bank's share capital held by the state as the major creditor, was conducted in the early 2005, which was the first step for further development of this bank, because from 7% in shares (€2.98 million) in 2003, state role increased to significant 72% (€4, 33 million), setting the basis for privatization towards interested investors.

The selling of the CKB, the leader in the banking sector by the end of 2006 to a very important international banking consortium, the OTP from Hungary, resulted in huge and profitable gains of a number of politically and business connected individuals in Montenegro. They decided to reinvest the funds in banking sector of Montenegro by buying a small, provincial bank, or more specifically, by buying the state owned shares of at the time Niksicka Bank ad Niksic, which soon changed the name to FB MN 1901.

The existing regulations[6] addressed the issues of integrity checks for banking investors, which consisted of conducting the "fit & proper" banks' shareholders tests. However, these rules were disregarded through uncompleted implementation by the national regulator, as the FB MN 1901 new investors were not able to meet the requirements even of the existing, relatively, weak rules for integrity checks, especially if the rules were to be applied to the major shareholders that had qualified participation of 10% and more of shares. Why? The funds of these new, potential investors could not be disputed as they were obtained through sale of CKB shares. However, overall business,

---

EUR 536.2 million at the end of 2007 (17.9% of total liabilities), out of which 95.7% referred to foreign borrowings." - CB CG Chief Economist Annual Report for 2007;

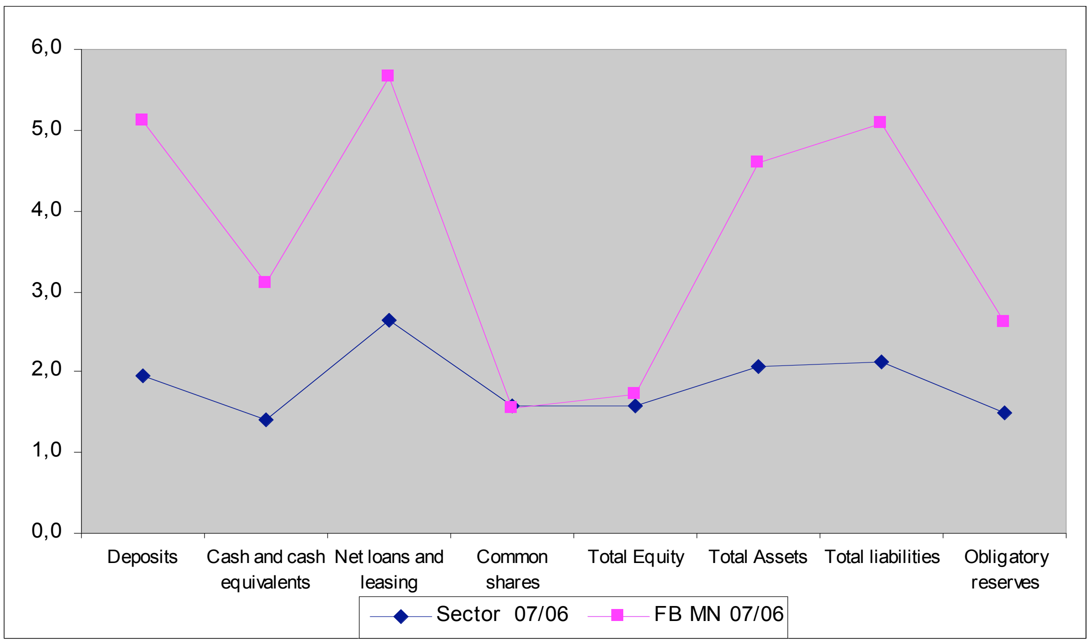
[5] CB CG Chief Economist Annual Report for 2007;
[6] List of all laws and regulations governing banking supervision could be found in Annex to this text;

professional and banking background of the FB MN 1901 new shareholders, especially of those that acquired qualified participation in shares, did not meet the minimal standards within their professional biographies which would prove strong financial knowledge and expertise, needed to receive supervisory approval for the acquisition of share capital.

Furthermore, FB MN 1901 new shareholders were successful in using the flows of the existing regulations' integrity tests, which allowed them to ignore professional rules, and to appoint the Managing Board of FB MN 1901 members with little or no banking experience and knowledge. The Managing Board of FB MN 1901 members consisted of theater and marketing professionals, diplomats and managers, owners of individual companies, as well as common representatives of two most important local companies: electro-energetic and insurance company. The newly appointed managing team was not ready to overview the complexity of everyday or strategic banking operations.

Graphics 1 and 2 show indexes of growth of the most important balance sheet indicators of FB MN 1901 and banking sector in comparative timeframes.

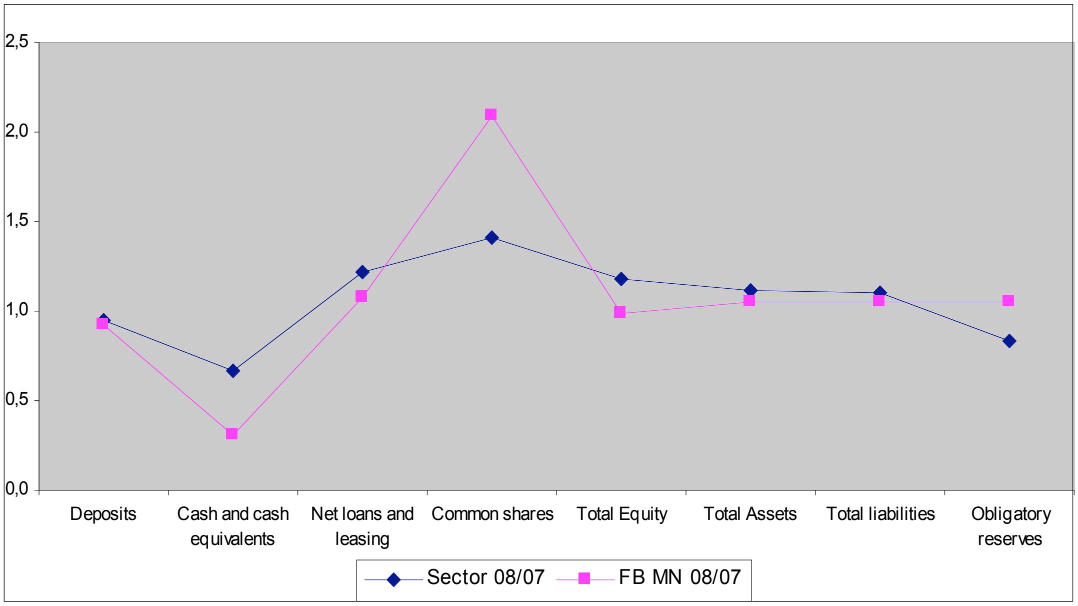
Graphic no. 1- Growth Trends of Basic Parameters FB MN 1901/Sector in t2006/2007



Source: Financial statements of banks published on CBM web page;

In 2006, which was the first year for "market conquest", the FB MN 1901 assets grew by 3.5 times; the same growth rate was repeated on the increased base for comparison in 2007. In less than three years the bank's assets increased by more than 24 times in comparison to a small initial capital in 2005, while improving its market position from the end of the market share list to the second place among the competitors, strategically progressing with its unfeasible ambition to take over the leading position in the system at as short period of time as possible.

Graphic no. 2 - Growth Trends of Basic Parameters FB MN 1901/Sector in 2007/2008



Source: Financial statements of banks published on CBM web page;

The FB MN 1901 2008 growth indicates that due to loans growth limits set by the CBM, the bank in majority of balance sheet indicators followed average bank's balance positions' changes. Above the average of the system was the share capital increase which was conducted at the end of 2008 and contributed to the significant common shares nominal growth (Note: explained in details in the following chapters). However, total bank's equity decreased below average levels for the system, as it was for the first time obliged to set aside specific reserves for potential losses of high-bearing risk loans.

In conclusion, following the comparison between growth trends of the banking sector and the FB MN 1901, it could be stated that bank's available cash was significantly below average level of the system, while loans portfolio limit measures set by the CBM in early 2008 managed to balance the growth rates of other bank's balance sheet parameters (graphic 2) in relation to the rest of the system.

Also, it is important to point out that the high deposits inflow was not met by adequate minimum reserves in the three years period. Problems regarding the bank's liquidity will be covered in details in chapter 2.5, but at this point it should be emphasized that this minimum reserves' low level indicated potentially controversial situation in the banking system, which was not addressed by the national supervisor's appropriate and corrective responses in regard to the change of size and the role of this bank in the system.

Institutional, administrative and professional capacities of national regulator identified on time these potentially disturbing signals, but the occasional liquidity[7]

[7] Unofficial information gathered during contacts with various actors from financial and banking sector have confirmed appointment of several controllers' teams to check and monitor liquidity of FB MN 1901 already in early 2007. However, official records of conducted controls were not subject to CBM Council discussion. Since the Council is the only accountable body which should take decisions on corrective measures towards banks in Montenegro, on-site controls' findings of FB MN 1901 liquidity position remained at the operational levels within CBM;

controls had not resulted in any type of corrective measures, which could have been already in 2007 useful to stabilize the FB MN 1901 "overheated" growth, as the bank did not have either internal qualities or external possibilities for ambitious strategy of achieving country's leading position in the banking sector.

Realistically speaking, leader in the sector, the CKB was ten times larger than FB MN 1901 at the beginning of non-competitive "conquest" of the market. Based on the data from the end of 2008, to catch up with leader it would mean that FB MN 1901 should have doubled its size (over half a billion EUR) during a year, and it still would not surpass the CKB balance parameters. Additionally, it was professionally disturbing to identify that the FB MN 1901 strategic assumption was based on the fact that none of the rivals in the sector will continue to grow within the period in which the FB MN 1901 should eventually overtake the "leading position".

For summarizing, it is worth to mention that the FB MN 1901 from one bank branch in the original establishment town developed strong network of offices, branches and bureaus across the country that included 37 organizational units, while the 2007 bank's profitability still nominally justified the expansion of the business network. Nonetheless, without the analytical approach regarding clientele, analysis of deposits, credits and other business indicators which would document and support the branch expansion, investments into network had shown to be unclear and unsustainable.

2.2 Advertising Campaign as a Basis for FB MN 1901 Uncontrolled Growth

New local banking market approach to the competitors and clients was clearly identifiable at the end of 2006. The FB MN 1901 initiated in the last quarter uncontrolled, strategically unfeasible growth of on and off balance sheet positions, except those related to risk coverage and to liquidity reserves. Pleasantly diversified, but professionally unfounded advertising campaign's two aspects, which aimed at the "conquest" of the entire market, are important for this analysis:

First, public, transparent, expensive, that took place through media and other advertising platforms, sending aggressive "message" about FB MN 1901 formally invented one hundred years of tradition, quality, innovation, market significance, leadership;

Second, informal, away from public, that took place among local businessmen and stakeholders, which aimed at taking over the clients from competitors, but disregarding respect for business projects and initiatives' perspectives; in a shell, the most important for FB MN 1901 managers was to get clients at all costs[8].

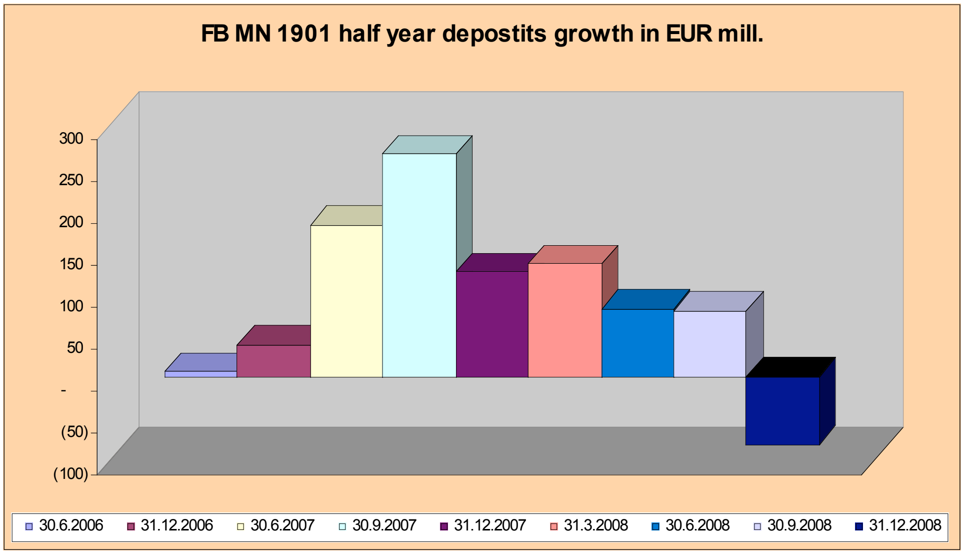
First aspect of the campaign had some success. Re-branding initiated with the name's change, from the one that focused the role of the provincial bank (Niksicka bank) to the name that would indicate the link with Montenegrin banking history dates (First Bank of Montenegro founded in 1901 ad Podgorica).[9]

---

[8] IA would like to emphasize that official sources which could profound details of this issue were extremely limited, because market situation in relation to FB MN 1901's almost hostile takeover of the clients has not been discussed in a professional way, by both banking sector's clients or experts in Montenegro;

[9] *New Business on 107th Birthday*, daily newspaper "Republika", March 2008;

Graphic no. 3: Growth of Interest-Bearing Deposits;



Source Financial statements of banks published on CBM web page

"Assault on market", "conquest of the clients", or taking over the legal entities' deposits in a small national economy such as Montenegrin requires less expenses than "assault" on citizens' deposits, especially when individuals were much more careful to place deposits with the banks due to the savings scandals from 90's. Despite the fact that decade passed, they were reluctant to change the banks with which they do business, open account for income transfers or borrow funds to buy house goods and other households' necessities. However, small savings from a number of pensioners and state employees were attracted to the "honey" offered in a form of consumer loans, which were easily disbursed by the FB MN 1901 almost over night.

These funds were not unlimited, so they could not succeed in boosting bank's market share position and complete its leadership ambitions. Therefore bank's plans were fully focused on the investing time and resources to fulfill second campaign's aspect, which demanded FB MN 1901 managerial teams strong and dedicated efforts (graphic no 3). To understand better the actual moment on the banking market, it is valuable to point out that the second aspect of the advertising campaign was conducted in the period which matched the successful and huge real estates sales in coastal municipalities. The pressures from local and central government officials, closely involved in bank's business plans, influenced that the funds, which were obtained through municipal or private land sale, should only be directed to the FB MN 1901's accounts. [10]

Even though the FB MN 1901 strong inflow of interest-bearing deposits from wide range of clients, who reached 75 thousand [11] in 2007, to some extent continued in 2008, it did not have either dynamics or the growth rate as in the first "onset", due to the following main reasons:

[10] *Russians are Building a Hotel, Villa Suites and a Marina on Maljevik* – daily newspaper "Vijesti", 11/09/2007;
[11] M*arch 2008,* daily newspaper "Vijesti"*;*

- Local managers and investors learned, during period of three years of strong growth of Montenegrin economy, and followed the rule “it is necessary to work with the bank that will help our business and would respects contracts”;
- Be careful with giving or signing for collaterals;
- Stay away from public and media, as main business profiles in Montenegro have been the products of the given opportunity to be chosen participants in lucrative inside deals;
- Be careful when presenting performance data and when dealing with employees;

Despite the fact that local business rules reminded of rudimental development definitions, a small number of important Montenegrin employers took decision to transfer their business accounts to the FB MN 1901. Top managers of major companies in Montenegro decided to follow silent tactics to transfer insignificant a vista deposits amounts, and to sign contracts for new foreign-exchange accounts with the FB MN 1901 in order to balance the pressure of dealing with “our bank” and to avoid risks of potential tax and other controls.

Furthermore, large state system such as customs, IRS (tax authority) and state funds also transferred their deposit accounts to the FB MN 1901, accompanied by shareholders decisions to join the bank’s accounts. In majority of cases, these are the companies with limited capital base and weak development potentials, but with strong informal, political and other public contacts.

Overview of press headlines that most comprehensively illustrate the market “game” of FB MN 1901

Abolished decree to receive salaries through First Bank

“*Workers of Steel Mill have, until recently, received salary in Montenegrin Commercial Bank (CKB). After the arrival of new owners, Niksic Bank, renamed into First Bank of Montenegro, has been chosen to handle the payment of salaries. Vučinic says that Niksic Bank was practically imposed to workers by decree, but that this decision was changed yesterday.*
- Demands of workers have been met and now they can choose a bank in which they wish to receive salary – said the leader of union of the factory in Niksic, and added that the number of workers insisted that the payments should be handled by CKB, as it was the case until recently. CKB is since recently owned by Hungarian OTP Bank, while the owner of Niksic, and now First Bank is businessman Aco Djukanovic”; Daily newspaper Vijesti, 23/03/2007

Opposition suspects that the First bank is privileged

Representatives of Ministry of Finances agreed yesterday to modify proposed amendments of the Law on Budget, in order to clear the suspicions of MPs from opposition that the Government plans transfer of competencies of Central Bank to the “hands” of private First Bank.
Suspicions of opposition that this is “indirectly, and unscrupulously announced”, are based on article seven of the proposed draft, which says that “Ministry can sign a contract … with a residential bank to conduct banking operations on behalf of the state”.
Representative of Ministry Nikola Vukicevic at first said that it could happen that the state deposit could be transferred to another bank, but after the harsh reactions of opposition agreed to “seek for compromise”.
- We are ready to make a compromise. We can find a solution which would settle this issue… We can say that it must be international bank with interest ratings... – said Vukicevic. He added that the Ministry does everything publicly, and that this, possible solution would be “under the public eye” – Daily newspaper Vijesti 25/10/2007.

MBA breached business code of conduct

Association of Banks and Financial Institutions of Montenegro Managing Board deemed as unprofessional and incorrect the action of Montenegro Business Alliance, which recently signed an agreement with Hypo Alpe Adria Bank and First Bank of Montenegro to obtain more favorable lending terms for it s members. “This act where the invitation was not given to other banks also members of the MBA, which has directly favored two of banks and by doing so, it breached the code of conduct of banking professional business behavior.” announced the Association. It is added in the announcement, signed by Secretary of Association Mirko Radonjic, that Montenegrin banks will reexamine their membership in the MBA.
Montenegro Business Alliance is, after Commerce of Employers, practically the largest association of private companies in Montenegro. It was founded by supporters of neo-liberal economic school, among them Petar Ivanovic, Ivanovic was, since recently, in the top management of Hypo Alpe Adria Bank. Daily Vijesti, 24/04/2007.

Aggregately, the bank received the funds for further expansion on the local market which strongly influenced unsustainable illusion that advertising campaign is a single tool for achieving ambition of taking over the leading position on the country's banking market.

At the end, it should be emphasized that FB MN 1901 has partially conducted its marketing campaign by conventional means, such were: support to sport teams, sport associations and national organizations, Olympic association, theatrical and other manifestations; support to projects which addressed corporative responsibility for health and educational institutions in Montenegro. Although it was necessary to set conventional marketing campaign, objectively it had limited results, which did not have the potential to provide for deposits inflow with which the bank would invest in ambitious growth of main balance sheet positions.

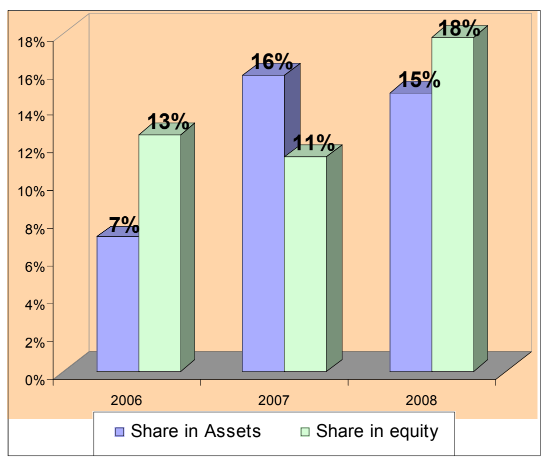
2.3 The Bank's Ownership Structure /Managing Board

Banking sector internal systemic reforms until 2005 were focused to establish national regulator's competencies and responsibilities; to improve quality of banking services and products; and to reduce and avoid systemic risks immanent to negative experiences from centralized decision making system. Therefore, the reforms consisted of implementing prompt and efficient model of full privatization of banking equity, recommended by IMF and USAID. By the end of 2006 only insignificant portion of shares remained within state portfolio (4%), which did not provided for any kind of direct influence or informal control (table 2, graphic no 4).

Table no 2: FB MN 1901 Positions of Equity after Privatization

Shareholders share in equity		
31.12.2005	Sector	FB MN 1901
State capital	13.20%	67.38%
Private capital	18.93%	25.30%
Foreign-capital	67.87%	7.32%
31.12.2006	Sector	FB MN 1901
State capital	3.57%	14.01%
Private capital	17.61%	77.26%
Foreign-capital	78.81%	8.73%

Graphic no. 4: FB MN 1901 Share in Sector's Aggregates



Source Financial statements of banks published on CBM web page;

However, the first significant test in consistency of implemented rules regarding banks' equity acquisition was being conducted during privatization of FB MN 1901state owned shares. The decision has been made among local businessmen with important and transparent contact in state and political administration to "establish" a bank with "originally ours/ local" capital. This legitimate business plan was finalized in late 2006, when funds from selling CKB majority ownership to Hungarian financial group was transferred to a number of local investors who were interested to find areas where their capital would grow with similar rates. Decision to reinvest the funds into banking sector was logical, as growth of the sector was strong and viable at the moment; also, local individual fascination with external definitions of the banking profession were do strong, that many believed that “being a banker” counted a lot and was more important than to learn about who/how/when/with what assets/why could invest in banking equity above limited percentages of qualified participation.

In short, proceedings and acquisition of qualified participation of the bank’s equity became the biggest professional and regulatory controversy in the financial system of the country. Phases that marked the entire process were as following steps show:

- During 2005 A. Djukanović became the owner of 14 percent of the bank’s shares, through private company (“Monte Nova”); this huge acquisition was organized without supervisory approval;
- Next year, at the Ministry of Finances tender the same shareholder acquired additional 42 percent of bank’s shares;[12]
- In the first half of 2007 participation in the ownership of the most shareholders decreased after additional recapitalization which nominally increased the company capital[13], first at €14 million, and than nearly €22 million; because of the bankruptcy of private company[14], after three years the single largest shareholder received the national regulator approval to be a full time shareholder and to be able to perform all duties in line with legislative framework (see text in the box); it remained unclear upon which data the regulator refused to give official approval to the legal entity (Monte Nova) which had limited business reputation, but found some new arguments to support its approval to an individual whose business and banking background was not in line with minimum regulatory standards at all;

Overview of text in the newspapers that fully explains acquisition of equity in FB MN 1901

[12] *Knezevic Signed an Agreement with Aco for 23Percent of Shares*– daily newspaper “Dan”, 21/11/2006;

[13] *Aco Turned over Shares to Friends of the Bank* – daily newspaper “Vijesti”, 10/08/2007;

[14] *Monte Nova Goes to History*- daily newspaper “Vijesti”, 11/09/2008;

Central Bank approved the qualified participation's acquisition of the First Bank's shares by Aco Djukanovic, who acquired shares as a legal successor of the legal entity's assets and investemnts. The license pertains to acquisition of 27.9 percent of regular voting shares, said yesterday to "Dan" director of Supervision Department of Central Bank Zdenka Rakocevic. CB MNE issued this license by the end of the last week after Djukanovic submitted his request by the end of September. According to the Law on Banks, license of Council of CB MNE, presided by Ljubisa Krgovic, is necessary for acquisition of more than five percent of shares of a bank. After being a major shareholder for three years, Djukanovic asked and received an approval of CB MNE to formally take over the managing over the First Bank. The bank was recapitalized last week with the amount of EUR 20 million by Aco Djukanovic and Elektroprivreda. Its equity increased at 44 million, and the share of Djukanovic to 46.47percent. Share of Elektroprivreda, which has through numerous recapitalizations been reduced from 25 to nine percent, increased after new recapitalization to 18.24 percent. Approval for this recapitalization was given by Securities Commission. Rakocevic said to "Dan" that CB MNE does not issue approvals to banks to increase their capital through issuing of new shares", daily Dan, 03/12/2008

- Until the 2008third quarter nominal value of equity capital only slightly changed through partially and internally conducted sales of shares;
- Without CBM approval, in the 2008 last quarter, within few weeks prior to credit line which would be used to help bank's illiquidity (30/11/2008), formal recapitalization by single largest shareholder A. Djukanovic (€14 mil) and state owned company EP CG (€6 mil.) of nominal €20 million was conducted which was approved by Securities Commission, the regulator which is not responsible for overseeing of banking business or follow on investment in the equity of banks;
- For the further development of the country's financial market, the fact that the Security Commission consented recapitalization was not too disturbing, since the influence and the role of this regulator in minor. The market disruption lies in the fact that systemically, if the Basel rules of banking supervision are to be followed, only paid share capital could be accepted in the bank's equity capital, while it is highly likely that swap of debts to capital was organized, which makes already complex situation even more regulatory disputable;

Shareholders as abovementioned described, furthermore, internally being limited to understand necessity to have huge market experience in banking, consequently proposed and appointed Managing Board members who had no or little experience in their professional carriers in running complex financial institutions such are banks.

Overview of headlines that most comprehensively illustrate election of members of FB MN Managing Board

Aco's – First Bank of Montenegro

Niksic – Niksic Bank is to be renamed into the First Bank of Montenegro – it was decided yesterday at the bank's Assembly of Shareholders.
Shareholders appointed the new Managing Board in which, among others, are elected Goran Rakocevic, Radmila Vojvodic and Vuk Rajkovic. They will represent the company Monte Nova of Aco Djukanovic, which is in control of Niksic Bank since last year. Rajkovic was in the managing team already, while Rakocevic, advisor to the President of Montenegro for foreign policy and future ambassador in Spain, and Vojvodić, theater director and director of Mapa agency, are for the first time engaged in banking. Rakocevic, Vojvodic and Rajkovic are appointed thanks to the long friendship with Đukanović which was the recommendation for management of the bank. Velimir Bogdanovic, Jelica Petricevic, Srdjan Kovacevic and Ardenko Puric were appointed in the managing board as well. Kovacevic and Puric are appointed by EPCG and Lovcen Insurance as significant shareholders of the bank, and Bogdanovic, director of the bank, and Petricevic as employees – daily newspaper Vijesti 06/03/2007;

In conclusion, unsubstantiated decisions to acquire majority ownership of the bank, followed by unprincipled professional selection of the Managing Board members, it resulted in concentration of executive and operational FB MN 1901 managerial "power" within the hands of individuals who, also, were not professionally strong and reliable and were not capable, in a long run, to manage growth of the bank's lending portfolio.

2.4 How the Bank Caused High Systemic Risk on the Market

In order to more comprehensively analyze the disruption in relatively well run banking and financial market of Montenegro from 2006 to mid 2008, it is necessary to describe two basic aspects of FB MN 1901 illiquidity, which publicly culminated in the second half of 2008:

- One internally created by the bank, which was conducted in hostile takeovers of deposits from other banks;
- One where the informal and business "power" of the bank's certain shareholders "pacified" national banking sector regulator, which prevented from timely supervisory reaction which would be in line with current regulations;

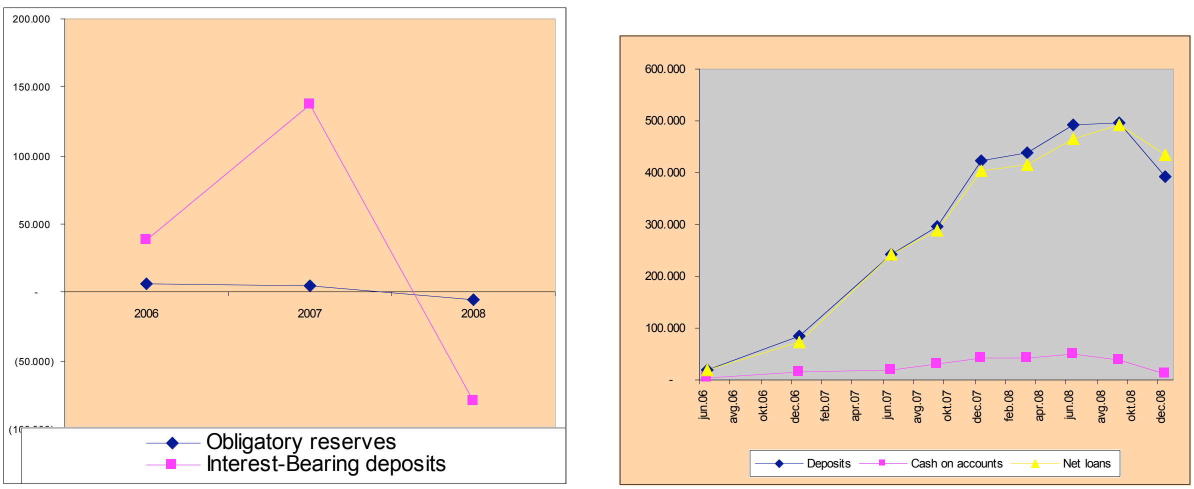
First aspect has emphasized the importance of negative and hidden impact aroused from bank's professional mistakes and its inadequate organizational capacities to handle the ambitious growth. Additionally, the bank's managers proved to be incapable to identify factors of where is/what is doing the competition, and what are the rules that should be respected by all banks in the system, regardless of size and shareholders. In the later stage of the bank's growth, major liquidity discrepancy to daily organization of payments operations was linked to the fact that a number of chosen companies received huge loans which were not supported by adequate risk assessments and evaluation of business and development capacities of these companies. In granting credit lines the prudent control's rules were fully disregarded, because:

- *Firstly*, loans were granted to individuals connected between themselves or connected with the bank, which automatically meant that these were high risk placements;
- *Secondly*, granted loan amounts surpassed by far the quarter of regulatory capital (less than €5 million), margin that was set in regulations;
- *Thirdly*, loans were granted in short periods of time, without necessary risk assessment. The bank's top managers and Managing Board members believed that this was the bank's competitive advantage, which would make the bank presentable as an efficient in decision making, and would draw in many new clients.

This facilitated disbursement of loans, on one hand, disregarded the rules of careful granting, and, at the same time, stimulated high risk transfers towards clients that were already heavily indebted or that did not applied with measurable business development projects.

Additionally, the bank unilaterally, without the accompanying documentation, artificially drawn in new clients, legal entities or individuals, performing prompt but random accounts opening without necessary clients' consent, trying to maintain the majority of payment operations within the transactions between the clients of the bank. [15] Again, the professional rules that do not recommend this kind of professional shortsightedness, have been disregarded, despite the fact that this works only in a short run and results with sudden serious disturbance regarding the main liquidity parameters, through effect of "self creation" of money, or facing with the daily average where commitments are larger than funds available.

Graphics 5a/b: FB MN 1901 Curves of Main Liquidity Indicators in the period end 2006 – 2008



Source Financial statements of banks published on CBM web page; CBM Statistic report for 2008 – monetary statistics;

Graphics 5 a/b simply show the curves of interest bearing deposits, disbursed net loans and minimal cash reserves of the bank, which indicated already in the middle of 2007 that strategic steps regarding "growth of a bank at any cost" should be stopped and changed. It means that 2007 was marked by the first public signals of irregular liquidity situation as the non-fulfillment of payment operations orders in the country and towards foreign banks were noted.[16]

---

[15] Daily newspaper Vijesti 23/2/2007

[16] *According to information "Dan" received from Association of Banks of Montenegro, the First Bank from Niksic is on the verge of illiquidity. Since new management tried to develop the bank swiftly, the sum of money placed in loans is larger than the deposits. At the same time, these are mostly short-term deposits. In deposit potential of the bank there are almost no one year deposits, and there is not even a single long term deposit, which additionally impacts bank's illiquidity. According to information "Dan" obtained, Central Bank of Montenegro has already prepared a set of measures for revitalization of the First Bank of Montenegro.* – Daily newspaper "Dan", 24/05/2007; this issue was covered in detail by weekly magazine "Monitor" in a story "At the tip of the pen" published in August 2008";

Graphic ***a*** presents the movement of the growth of interest-bearing deposits and minimal obligatory reserve, where the difference of the lines and discrepancies between trends regarding speed and strength gave anticipative signs to national supervisor. Curves of total deposits and net credits (loans after risk) are by speed and trend the same as graphic ***b*** presents, which would pose logical question – if all deposits went to the loans disbursements, which funds were used by the bank to finance its own and current payments of its numerous clients.

Second aspect of systemic disturbance relates to the behavior of national banking regulator. It was noticeable and additionally confirmed by international evaluations (IMF-FSSA, 2007), that the strong presence of CBM in the public from 2002 to 2006 sent comforting signals to the entire financial market. This, together with consolidation of banks' balances sheets and relatively acceptable privatization until then, contributed to the strong investors' interest for the sector and economy's development.

However, after receiving first disturbing data and warning trends that meant the potential risks (IMF definition "weak disclosure regime") in the 2007 first half, the national banking regulator did not find the strength to apply institutional and systemic mechanisms and transform its realistically strong informal power into activities that would provide for consistent role of preserving stability and soundness on the market. The CBM public appearances consisted of either short bureaucratic reports that did not represent reliable information in relation to noted irregularities, or senior mangers' weak interviews in which CBM acted as the FB MN 1901 "lawyer" accusing other banks for disloyal competition and for dissemination of negative information on FB MN 1901 because of the political reasons.[17]

In 2008first quarter, failures to meet domestic payment operations orders increased concerns that the situation with the FB MN 1901 liquidity is not sustainable. Escalation of non fulfillment of client's payment orders happened during the summer, when the SWIFT system of international payments was not systematically operational as FB MN 1901 responsible employees were trying to execute orders on behalf of its clients without pledged funds at the correspondent banks abroad, completely negating the achieved level of reforms and smooth foreign payment operations' functioning.

The bank's unsuccessful marketing "defenses" that only all concerning information were "fabrications of ignorant journalists" followed by weak explanations of the regulator, which called it "professional envy of other bankers", announced the heavier crisis on the horizon than the one that dealt with common imbalance between sources and placements. Therefore, the acknowledgment of the market disruption and FB MN 1901 illiquidity, which publicly begun in October of 2008[18], subsequently brought the entire

---

[17] Interview with Mr. Krgovic, CBM Council President, daily newspaper "Vijesti", 03/11/2008;

[18] *Putting the First Bank in order – Monetary authorities have, according to the reliable source of "Vijesti", temporarily frozen all credit activities of the First Bank and forbade further growth of assets, except in parts that can improve liquidity (acceptance of deposits etc.). The First Bank is, among other restrictions, denied the right to invest into securities. "Vijesti" find out that CBM recently ordered change of entire management of the First Bank, including Deputy Director Jelica Petricevic. General Director of the bank Velimir Bogdanovic was disregarded by this measure which is within competencies of the Central Bank, because he was the only one willing to co-operate with monetary authorities. "Central bank, in line with the law, is not authorized to announce measures which it takes in the process of supervision over any*

banking sector in the state of systemic risks which reminded local population of 90's. This whole situation had a negative impact on reputation of the country's financial system.

How the state solved illiquidity of second largest bank in the country?

By the end of October 2008, the Parliament of Montenegro adopted the "Law on Measures for the Protection of the Banking Sector" (Off. Gazette no 64/08), because the global crisis at world's financial markets had certain effects that reduced the trust in banking sector of the country. Global crisis was used as ideal systemic, aggregated justification to create a mechanism for potential state influence on the banking sector.

Besides the measures aiming to protect the deposits of citizens and legal entities, art. 4 of the aforementioned law prescribes that "Government can provide a monetary support to a bank which needs additional funds for liquidity upon the request … only after it settles the state debt towards the bank prior to monetary support". It meant that adopted legal mechanism automatically provided two ways to help banks: reduction of state debt and granting of credit line for liquidity.

Overview of texts in press that most comprehensively illustrate the opinions of state officials regarding the credit line for FB MN

Minister Luksic added that in the case of the First Bank the state is obligated to intervene and support its liquidity – "In a case of the First Bank, which is national and does not have at the moment the possibility to obtain support from foreign banks, as it is the case with other banks whose "mother" banks grant them loans, in accordance with the Law on Measures for the Protection of the Banking Sector, the state is obligated to intervene", said Luksic. He added that it is a task of every responsible government in a period when an economic crisis hits large number of world's economies, to be responsible and proposes laws and measures that would reduce the consequences of the crisis, which gradually spreads to Montenegrin economy. News Agency BETA, 11/11/2008;

The one who doesn't have investors, has the state – *"First Bank is the first also by the fact that it is the only one that decided to use the benefits offered in the new Law on protection of the banking system, which was urgently adopted in the Parliament by the end of November. It has sent the request to the government for grant of liquidity credit. 94 percent of shares of the bank were offered as a collateral for the 44 million EUR loan. This request, however, is still not approved. Law on Measures for the Protection of the Banking Sector prescribes that the Government can, at the request of the bank, approve the grant of liquidity credit for a period of a year. The request has to be submitted to the Ministry of Finances and the permission of CBM is not required. Central Bank, however, provides the Ministry with and opinion regarding the liquidity of the bank in question, but so far it did not receive documentation from the Ministry for any bank", said Rakocevic (director of Supervision Department of CB CG, IA)* daily Dan 03/12/2008

Even though the public was bombarded with unsubstantiated explanations that the state support to FB MN 1901 for sustainability of liquidity is not needed (see the previous box), within next month and a half after the adoption of the law, in December of 2008 the First Bank CG 1901 submitted the credit line request to the MoF. The bank promptly received the monetary support at the amount of €44 million, which was used: to calm the market and stop the panic; to reduce the mistrust of clients; to meet and execute orders of domestic and foreign payment operations that were being pilled up in the bank's documentations for several months.[19]

---

bank", said in the reply of PR service of CBM the question of "Vijesti" about measures taken regarding the First Bank – daily newspaper Vijesti, 22/10/2008;

[19] REPORT on assets employed for support of banking system for 2008, the document which Ministry of Finance conveyed to Parliamentary Board for economy, finances and budget, at the end of 2008;

3. Public Policy Measures

3.1 Previous Law on Banks Legal Framework

Based on the established responsibilities of CBM, Law on Banks (Official Gazette of MNE", no. 52/00 and 32/02) with accompanying bylaws, established grounds for setting up the national regulation of banking sector system with the main goal to define the rules that would apply to everyone and be implemented equally towards all of the participants on the banking market. Legal discrepancies caused by the fact that laws on CBM and banks have been adopted while Montenegro was a part of a larger state system, were handled with relatively good results of supervision and consolidation of banks' balances in the early stage of the banking market's reforms.

Rules for acquiring bank's equity qualified participation were upheld by shareholders of all other participants in banking business, until FB MN 1901 single largest shareholders in equity capital decided to enter the banking market with independent investments.

FB MN 1901 failure to meet regulatory rules and submit proper application for acquisition of qualified participation, as well as discrepancy between business careers and professional profiles of shareholders and Managing Board members, with supervisory bylaws, from the end of 2006 until the III quarter of 2008, caused the reputation risk to both, national regulator and all other participants on the market.

For this analysis is important to point out the awkwardness of the period when the national banking regulator was targeted by unconstructive criticisms and non-market oriented frustrations from sector, and partly from Montenegrin businesses, which happened at the IV quarter of 2007. CBM decided to apply the measures which consisted of bank loans' growth restrictions, heavily implemented on two largest banks by assets in 2008 (CKB and FB MN 1901). Text from the following box shows the pressure performed upon the national banking regulator. This was the period prior to the adoption of the new Law on Banks.

Overview of texts in press that most comprehensively illustrate public pressures on CBM

Selective decision of CB CG regarding lending activities restrictions, believes Association of Banks

Association of Banks believes that yesterday's decision of Central Bank regarding limiting of credit growth is selective and that it would influence the profit of banks, especially the largest ones. Association of Banks claims that they were not officially notified, and that Central Bank did not ask beforehand for their opinion. Association of banks claims that the decision of the Council of Central bank regarding limiting credit growth is selective, and that this would influence banking operations.

Mirko Radonjic, Secretary General of the Association of Banks of Montenegro: "It happens for the first time, in my opinion, that the Central Bank of Montenegro adopts a selective decision because all of the banks are equal in the market, and this is a selective decision which will be implemented selectively."

According to new measures bank whose credit balance is larger than 200 million can increase loan portfolio next year by only 30 percent. In this group are CKB, NLB, Montenegro bank, Hypo Alpe Adria and the First Bank of Montenegro. Growth of banks with 100 to 200 million net credits is limited to 40 percent and the rest of the banks to 60 percent. Newly founded banks in the first year of business are excluded from lending restrictions.

Mirko Radonjic: "This will for sure influence especially the profit of leaders. The banks with the placement of over 200 millions will least be able to influence the percentage, and this will affect the result. Association of banks found out about the new rules from media", said Radonjic. Official position will be taken when they are officially notified. Set of measures for slowing of credit growth will be implemented after New Year (transcript of daily news)

IN TELEVISION, INPULS 2 NOVEMBER 14, 2007

Institutional, political and systemic strengthening of neo-liberal school of thinking which believed that financial system's supervision is unnecessary, because the markets are able to perform for self-regulation, was especially reinforced from 2005, when first signals of stronger economic growth were noticeable. This strong trend produced the passive role of national commercial banking regulator from the middle of 2007. So, the process of forced pacification of banks' supervisor will fully escalate in the following period, when the new Law on Banks is about to be adopted.

3.2 *Events during the Adoption of the New Law on Banks and Conduct of the Parliament of Montenegro*

Joint mission of IMF and World Bank conducted in IV quarter of 2006 FSAP (Financial System Assessment Project), the project of assessment of financial market development and of defining the further steps for the next period. Key recommendations from the final document were addressing the issue of drafting and adopting the new Law on Banks, which would provide for wider supervisory competencies.

Overview of most important recommendations of FSAP, project implemented in Montenegro from July to October 2006.

IMF and WBG "FSSA- Financial System Stability Assessment", document approved by IMF Board of Directors in December 2007 *"**Main findings of the FSAP are**: Montenegro is experiencing a credit boom that is primarily funded by local deposit growth. Until recently, lending growth was concentrated in the largest bank, recently sold to a rated foreign banking group. However, other banks are now engaged in rapid expansion, posing supervisory challenges and increasing macroeconomic risk. There is scope for further reducing the role of the public sector in the financial system. This includes gradually moving public deposits from commercial banks to the Central Bank of Montenegro (CBM), limiting the growth in funding for further credit expansion and reducing governance issues. It is important to strengthen the legal framework, including the adoption of the draft Law on Banks and enhancing enforcement powers. Although the overall quality of banking supervision was found to be robust, enforcement powers are insufficient. A correction of the stock market may pose a reputational risk to the young financial system; the authorities are encouraged to increase disclosure requirements, commence investigations into suspicious transactions, and strengthen enforcement."*
***The results of the liquidity stress tests indicate that some banks experience tight liquidity conditions, and have a relatively high degree of deposit concentration**. This is partly owing to the starting liquidity position at the date of the stress test, where one bank does not have free liquidity. Two large banks cannot meet the first three hypothetical withdrawal shocks from free liquidity, and must tap into their required reserves, which is permitted. If all public sector deposits were withdrawn, one bank would run out of free liquidity. Other banks also have significant public sector deposit concentration: in four banks, public sector deposits account for more than 13 percent of total deposits; in two banks the share is greater than 20 percent.* ***Assessment of the Basel Core Principles for Effective Banking Supervision undertaken in the context of the FSAP found overall compliance satisfactory**. Areas in need of improvement included: (i) internal controls of banks; (ii) insufficient legal protection of CBM supervisors; and (iii) relatively weak enforcement powers.* *B**anking supervision in Montenegro has been effective**. Individual banks are overseen through a process of periodic offsite analysis and a system of onsite inspections. The CBM has operational independence in performing its supervisory functions, and there is no evidence of governmental or industry interference in supervisory decision-making. The CBM also enjoys financial independence from government. It directly levies fees for its bank regulatory and examination activities. Senior staff and inspectors have made progress in effectively incorporating best international practices, especially by promoting stronger risk management in key areas including the operations and internal controls of the banks. They are knowledgeable about the risks facing both the banking sector as a whole and individual bank. The CBM employs the corrective measures available to it in the laws. Its examiners have also been proactive in ensuring that banks comply with the legal requirements for antimoney laundering processes and procedures.* ***It is important to swiftly adopt the draft Law on Banking (LOB) to strengthen the legal framework for banking supervision, in a rapidly changing environment of extremely high credit growth**.*

In the last two quarters of 2007, based on improved communication and co-operation of many decision makers, with most important were CBM and Ministry of Finances, prepared the draft of new Banking Law, which addressed majority of FSSA guidelines for banking supervision enhancement. This document, adopted by the Government of Montenegro, was sent to the Parliament for further amendments and final approval.

Twelfth session of Committee for Economy, Finances and Budget, was held in many sessions on 19th, 26th and 27th of December 2007 and 12th February 2008, and represented a precedent in the proceedings for the preparation law adoptions, because before that the submitted texts of the laws from the Government, were never disputed by MPs of Parliament's majority. Four MPs from the biggest political party in the Parliament, (Zarija Franovic, Djordje Pinjatic, Veljko Zarubica, Milorad Vuletic, DPS, document dated 24/12/2007), proposed the amendments which fully derogated the role and significance of national banking regulator and diminished the quality of proposed solutions for new developments of the banking sector.

The "crippled" version of the Law on Banks was then, with smaller number of amendments than originally proposed, adopted by the responsible Committee and submitted to the General Assembly of the Parliament for final approval.

To summarize, the negative impacts in adoption of the new Law on Banks were as follows:

- Amendments were proposed by MPs who had not have experience in banking sector, therefore proposed amendments they signed and submitted to the committee were not professionally backed by sound arguments at all;
- Weak explanations of amendments indicated the strong lobbyists pressures, as the responsibility and competencies of national regulator were decreased, especially in the area of approving main shareholders, as well as approving the professional backgrounds of Managing Board members and executive managers, and all of this was defended with simple argument that it cannot be stopped "larger liberties at the market and unlimited flow of capital" ;
- The Deputy of General Director of CBM for supervision over banks was representative on behalf of the state until the last session of the Committee, when this role was taken over by the Minister of Finances, who at the end signed most of the proposed amendments;
- Proposed amendments were not dealing with intentionally left systemic uncertainty about who is responsible for registration and supervision over investments in equity capital of banks;
- CBM defines its role in the process of preparation and adoption of the key legal text [20] in the area of supervision over banks with following statement:"Neither

[20] **Excessive freedom for bank shareholders**- KRGOVIĆ REGRETS THAT LAW ON BANKS LIMITS CERTAIN COMPETENCES OF CBM, *Podgorica (MINA-BUSINESS) – Adopted amendments of the Law on banks have decreased competences of the Central Bank (CBCG) in some vital segments of its*

the Parliament of Montenegro nor its working bodies ever asked for an opinion of CBM regarding the amendments that were submitted by MPs, and Central Bank was not authorized to directly deliver its opinions regarding the specific legal solutions in the procedure of adoption of the law. In line with the Law on Central Bank of Montenegro ("Official Gazette of MNE", no. 52/00, 52/00, 47/01, 04/05) Central Bank is authorized to "prepare and participate in the preparation of the laws and other regulations in the area of monetary, foreign currencies and banking system", but not to participate in the in the procedure of adoption of the law in the Parliament" (transcript of electronically sent response, IA);

- The final consequence within CBM was the resignation of the Deputy General Director for Supervision over banking sector, who was a member of political party a part of ruling Parliament's coalition that decided, after this resignation, not to vote for the crippled solution of the banking law.

---

supervisory function and in some parts have led to unnecessary lack of harmonization with EU directives and international standards, this institution considers. President of the CBM Council Mr. Ljubiša Krgović said that the amendments directly promote principle of priority protection and excessive freedom of banks shareholders regarding investment of capital in the banking system and decrease of competences of the Central Bank regarding limitation of the rights of stakeholders through interim management and similar. "This largely increases the risks for depositors and creditors of the bank, but increases the protection of the shareholders. This solutions did not produce good reactions of relevant European Commission bodies and we should wait to hear their official position, but this was also mentioned in the newest assessment of Standard end Poor's in connection of credit rating of Montenegro.", stated Krgovic for the first issue of magazine "Banker". He also said than reasons for decrease of competence of Central Bank could be found in interest of the investors to have the lower degree of control and thus higher liberty in managing capital. "In banking system this approach leads to increased risk for deponents and creditors, because stakeholders dispose of and make decisions about other people's financial means, unlike freedom of entrepreneurship in other sectors, where owners of the capital are only risking they own financial means", stated Krgovic. Law on banks has been adopted in mid February by votes of ruling party, Democratic Party of Socialists (DPS), while opposition, which vigorously criticized this document, provided quorum for voting. 24 amendments of DPS have been enlisted in the Law, which have been adopted by the Government on its regular session prior to parliamentary debate. Amendments of DPS, which have been integrated in the Law, have limited, by the words of some MPs from oppositional parties, some competencies of CBCG in the field of owner an managerial prerogatives, since it was considered that they allow for too strong influence of the state., daily newspaper "Vijesti" 12/05/2008;

Controversial events regarding the resignation of Deputy General Director of CBM for Supervision over banking sector

Information- letter of Deputy General Director of CBM for supervision over banking was posted at the CBM web site in February 2008: *"Reason for my resignation is the culmination of misbalance between competencies and responsibilities, given to me with the Article 20 of the Law on Central Bank, and impossibility for me to be responsible for proper supervision over banks in this legislative-institutional framework. (Signed, Mr. G. Knezevic, 08/02/2008)."*

At the beginning of this project, Institute Alternative contacted CBM and asked specific questionsThe answer for one was as in the following transcript:

IA: Did former Deputy General Director submited his resignation because of the adoption of legislation that was contradictory to the role and quality of supervision or was there any other institutional reason for it?

Response of CBM (sent by email 06/05/2009): "Resignation of Deputy General Director of CBM for Supervision over banking is his personal decision directed at the Parliament of Montenegro, and the Central Bank was notified about this without the mentioning of specific reason."

Unethical institutional events linked to the adoption of the new Law on Banks will soon result with a number of negative disruptions on banking market of the country as early described, in late 2008.

In the meantime, the CBM Council approved new bylaws based on new Law on Banks, which clearly identified the CBM's intention to try to compensate for limitations imposed by the "crippled" law and despite of it to try to provide suitable framework for the sound and strong banking supervision in the country which would consequently enable the CBM to safeguard the stability and safety of the banking sector and the entire financial system.

4. Lessons learned and recommendations

Overall positive effects of Montenegrin banking market development from 2006-2008 reaffirmed the traditional banking practice that states that the strong and feasible liquidity is a basis of business, growth and profit gains of each banking subject which aims to be successful in a long term. Consequently, the liquidity proved to be the most important professional rule of the financial system globally.

At the beginning of the economic and financial reforms, the CBM managed to achieve reputable degree of supervision that should have led to the new directions in development and further growth of the sector with quality products and strong banking subjects. Discreet institutional position of CBM, taken particularly after the events related to the adoption of the new Law on Banks, indicated the professional intent of avoiding to send disturbing signals to the market, especially if main tasks of the institution were assessed to be achieved through current legislation.

Nonetheless, clear passive role of the regulator, especially recognized in 2008, was continually accompanied with brief public reports that were supposed to offer some bureaucratic justifications, and resulted in the CBM's systemic impotence to control unsustainable growth of the FB MN 1901. Therefore it is necessary to organize national supervisor's future activities towards a number of important steps, such as:

First, it is systemically important that integrity tests, i.e. proving of business and professional reputation, are fully applied and implemented without limitations to all large shareholders, Boards' members and executive management, and without posing structurally inexistent "dilemmas" of overregulation on the banking market. Montenegrin market is small, so the banking sector regulator could turn out to be exposed to pressures in the time of low liquidity, and that the small size of the market would be used as an argument for pressures or justification that regulation is a discrimination of investors. Banking supervisor must not accept this argumentation, because banking investors are the most controlled investors in any country in the world. Political participants in Montenegro should fully support the necessary procedures that would allow the new Law on Banks to be modernized with solutions that would strengthen the role of banking supervisor. The law should be amended in those areas where it has been "crippled". CBM has tried through bylaws to discretely introduce "fit & proper" tests for shareholders, management and executives, as not to upset the so called extreme "neoliberal" advocates. However, this solution leaves it in a position of high susceptibility to exterior and informal influences, especially since the large part of bylaws can be disputed in front of the Administrative Court.

Second, CBM must find a transparent means within the current legislation to educate participants on the financial market and prove to them, that investment in banking can take place only through this institution for all qualified participations (5% of equity capital) and increments of qualified participations in line with the rules that are applied for connected persons and persons connected to the bank, since this is a common practice in modern supervision to treat such persons as one shareholder of the bank. Issue of acquisition of equity capital of the bank is not an issue of liberalization of a market, it relates to the strengthening of banking system, and consequently to stronger development of the entire financial system of the country.

Third, it is particularly important that the institutions such as Securities Commission and CDA (Central Depository Agency), if professional standards are followed, cannot announce data regarding the acquisition of shares of a bank and give consent for it, without fully respecting the procedure of expert correspondence on institutional level with CBM. All the laws and bylaws that regulate financial market should be complementary amended in order to respect the demands of banking supervisor regarding the acquisition of qualified participation in bank's equity capital.

Fourth, in order to secure future development of the country's banking sector, it is important that FB MN 1901 fully reimburses state for €44 million. There should be no doubts regarding the approved sum, because it is very likely that the entire sum was used only to fulfill the payment operations orders. On the other hand, an argument that the credit support is not adequate could not be the proper approach to the issues of low liquidity of significant banking subject.

Although false information that were coming from the FB MN 1901 in relations to the achievement of the leading position in the sector, and alleged positive effects of these results, were not accepted by Montenegrin professional and, partially, political public, it could not justify the disturbance of the banking market caused by many public figures, as the ownership structure of the bank could be interesting topic of many political debates, until the situation of the current FB MN 1901 limited liquidity is not harmonized with regulations.

How would the scenarion in which CBM has taken all necessary measures look like?

This professional dilemma can be solved if one could imagine the situation in which CBM has formally implemented regulations that were in power during 2006/2007 and part of 2008, which would lead to denial of request for acquisition of shares to the largest shareholders of FB MN 1901, as well as raising an issue of unsustainable liquidity already in 2007. However, having in mind that the economy of Montenegro has strongly grown in those three years after decades of economic decline, it was to some extent expectable that the most important financial institution of the country would accept internal estimation that banking system is resistant enough and that the sudden and disproportional growth of FB MN 1901 would likely have additional positive effects on national economy.

When a similar estimation showed soon after negative effects for the entire market and economic system of the country, there was no professional justification for regulator's failure to take anticipative activities, because it was clear already in the middle of 2007 that measures of strict supervision are necessary in the case of FB MN 1901.

Gathering of information is not just a matter that concerns public; it should also be a tool of national controller, especially when necessary results could not be achieved through official channels. Regarding the informal power and usage of informal information, CBM completely remained in the limits of bureaucracy, which contributed to the escalation of internal crisis of banking sector, and increased necessity for credit support to save the liquidity of FB MN 1901.

In short, what would happen if optimal scenario was realized, if everything was done "by the book", in line with competencies of national regulator, is a fruitless professional and public dilemma, because the complex problems in banking sector have been additionally complicated with global financial collapse. However, it would be institutionally justified to encourage wide range of organizations for discussion about all events that led to internal disruptions in FB MN 1901, since such professional discussion can contribute to the return of confidence in banking sector of the country

Also, it should be remembered that the prolongation for the monetary support, after payment of quarterly installment in the amount of €11 million (end of the first quarter of 2009), is a discretional competency of Ministry of Finances. It is not recommended for sustainable recovery of banking sector and financial system, to artificially create panic in the system linked to the bank's shareholders conflict of interests, because that could create risk of drastic slowing of economic activities in the country in the long run.

Fifth, in the process of preparation of the "Law on the Protection of the Banking Sector", as well as during the approval of saving the FB MN 1901 liquidity, it was encouraging to notice that better co-operation between Ministry of Finances and CBM was performed. If the national regulator has failed by itself to anticipate disturbances at the banking market, this innovated institutional unity regarding preparing and implementing important decisions in the area of the protection of financial system, should send positive signals that would additionally influence the return of the confidence in the banking sector of the country.

Sixth, identified CBM professional inconsistencies, mainly focused in the failure to anticipate autochthon liquidity crisis within the banking sector is surprising, but it could and has to be corrected, since the economic system of Montenegro does not have capacities to endure the collapse of achieved levels of banking sector reforms, which would only additionally endanger the trust that citizens still have in the banking system.

LITERATURE

- CBM Chief Economist Report (Third quarter 2008)
- CBM Chief Economist Annual Report – 2007
- CBM Chief Economist Annual Report – 2006
- CBM Chief Economist Annual Report – 2005
- CBM Chief Economist Annual Report – 2004
- CBM Chief Economist Annual Report – 2003
- CBM Chief Economist Annual Report (January - December 2002)
- CBM Bank Supervision 2006- six years later
- CBM Bank Supervision Department Annual Report for 2005
- CBM Bank Supervision Department Annual Report for 2004
- CBM Bank Supervision Department Annual Report for 2003
- 2008 International Monetary, IMF Country Report No. 08/50 Republic of Montenegro: Financial System Stability Assessment
- Texts from print and electronic media:
  - Vijesti
  - Dan
  - Republika
  - Pobjeda
  - Monitor
  - TV IN
  - Mina Business
  - RFE RL
  - Beta
  - B92
  - CG Bankar
  - CG Ekonomist

OLD REGULATIONS

Guidelines for Appliance of the System of Bank Ranking Based on CAMELS Methodologies ("Official Gazette of MNE", no. 53/01)

Law on Banks ("Official Gazette of MNE", no.52/00, 53/00, 47/01, 032/02)

Law on Bank bankruptcy and liquidation ("Official Gazette of MNE", no. 47/01)

Law on Protection of Deposit

Law on Settlement of Obligations and Claims in respect of Foreign Debt and Foreign Currency Savings of Citizens

Law on Commercial entities ("Official Gazette of MNE", no. 06/02)

Law on General Administrative Procedure

Law on Securities ("Official Gazette of MNE", no. 59/00, 10/01)

Law on Prevention of Money Laundering ("Official Gazette of MNE", no. 55/03 from 01.10.2003, 58/03 from 20.10.2003)

Decision on Procedure and Manner of Issuing Operating Permits, Other Approvals and the Amount of Fees ("Official Gazette of MNE", no. 68/02)

Decision on Procedure and Manner of Control of Banks and Amount of Fees ("Official Gazette of MNE", no. 37/01)
Decision on Liquidity Risk Management ("Official Gazette of MNE", no. 37/01)
Decision on Minimal Standards for Bank Capital ("Official Gazette of MNE", no. 44/02)
Decision on minimum Standards of Credit Risk Management and Operations with Bank Related Parties ("Official Gazette of MNE", no.44/02)
Decision on Chart of Accounts for the Central Bank of Montenegro ("Official Gazette of MNE", no. 11/02)
Decision on Chart of Accounts for the Banks and Financial Institutions
Decision on Conditions for Acquiring and Operation of Banks with their Shares
Decision on Bank Control on a Consolidated Basis
Decision on Interim Bank Management
Decision on Content and Manner of Maintaining the Register of Foreign Bank Representative Offices ("Official Gazette of MNE", no.67/02)
Decision on the Basics of the Internal Control System in Banks ("Official Gazette of MNE", no. 37/01)
Decision on Internal Audits in Banks
Decision on Financial Remedy Measures for Insolvent Banks (published in "Official Gazette of MNE", no. 16/01)
Decision on Criteria and Classification Procedures of Assets and Establishment of Reserves for Potential Loses per Asset Item ("Official Gazette of MNE", no. 44/02)
Decision on Deposition of Foreign Currency on Foreign Currency Account at Authorised Bank (published in "Official Gazette of MNE", no. 8/01)
Decision on More Detailed Conditions and Manner of Using Bank Liquidity Loans Extended by the Central Bank of Montenegro ("Official Gazette of MNE", no. 02/02)
Decision on External Audit of Financial Reports of the Bank ("Official Gazette of MNE", no. 37/01)
Decision on Content and Manner of Maintaining the Register of Foreign Bank Representative Offices ("Official Gazette of MNE", no. 67/02)
Decision on Content and Manner of Maintaining the Register of Banks and Foreign Affiliates ("Official Gazette of MNE", no. 67/02)
Decision on Credit Unions ("Official Gazette of MNE", no. 01/03)
Decision on Direct Appliance of International Accounting Standards ("Official Gazette of MNE", no. 69, from 24.12.2002)
Decision on Terms and Conditions of Currency Exchange Affairs (published in "Official Gazette of MNE", no. 50/99)
Decree on External Trade (published in "Official Gazette of MNE", no. 33/00, 44/00)
Decision on Micro-credit Financial Institutions ("Official Gazette of MNE", no. 01/03)
Decision on Bank Reserve Requirements of the Banks held at the Central Bank of Montenegro ("Official Gazette of MNE", no. 20/03, 72/03)
Decision on the Uniform Manner of Calculating and Disclosing the Effective Interest Rate on Loans and Deposits

Decision on Reports Banks Submit to Central Bank of Montenegro

NEW REGULATIONS

Law on Banks ("Official Gazette of MNE", no. 17/08)

Law on Bank Bankruptcy and Liquidation ("Official Gazette of MNE", no. 47/01, "Official Gazette of MNE", no. 62/08)

Law on Measures for the Protection of the Banking System ("Official Gazette of MNE", no. 64/08)

Decision on Reports submitted to Central Bank of Montenegro in line with the Law on Banks http://www.cb-mn.org/slike_i_fajlovi/fajlovi/fajlovi_kontrola_banaka/odluke/novo/odluka_o_izvjestajima.pdf ("Official Gazette of MNE", no. 68/08); Annex to decision

Decision on Chart of Accounts for Banks ("Official Gazette of MNE", no. 68/08); Annex to the Decision on Chart of Accounts ("Official Gazette of MNE", no. 57/08); Guidelines for Estimation of Meeting the Criteria for the Candidates for Membership in Board of Directors of the Bank

Decision on Conditions for Performing Credit Guarantee Operations ("Official Gazette of MNE", no. 42/08)

Decision on Capital Adequacy of Banks ("Official Gazette of MNE", no. 60/08)
Decision on Internal Audits in Banks ("Official Gazette of MNE", no. 60/08)
Decision on Methodology for Country Risk Measurement in Banks ("Official Gazette of MNE", no. 60/08)

Decision on Minimum Standards for Business Affairs of the Bank with the Persons Connected to the Bank ("Official Gazette of MNE", no. 60/08)

Decision on Minimum Standards for Interest Rate Risk Management Not Originating from Bank's Trading Activities ("Official Gazette of MNE", no. 60/08)

Decision on Minimum Standards for Liquidity Risk Management in Banks ("Official Gazette of MNE", no. 60/08)

Decision on Minimum Standards for Market Risk Management in Banks ("Official Gazette of MNE", no. 60/08)

Decision on the Basics of Internal Control System in Banks ("Official Gazette of MNE", no. 60/08)

Decision on the Content and Manner of Maintaining Registries of Banks, Foreign Bank Branches, Micro-credit Financial Institutions, Credit Unions, and Foreign Bank Representative Offices ("Official Gazette of MNE", no. 60/08)

Decision on the Central Bank Fee for Performing the Supervisory Function ("Official Gazette of MNE", no. 48/08)

Guidelines for Appliance of the System of Bank Ranking Based on CAMELS Methodology ("Official Gazette of MNE", no. 53/01)

INSTITUTE ALTERNATIVE

Institute Alternative was founded in September 2007. Founders are prominent individuals with civil society, public administration and business sector background.

Mission of Institute is to strengthen democratic processes in Montenegro by identifying and analyzing policy options.

IA Strategic objectives are to increase quality of public policy development, to contribute to human rights protection in Montenegro, to contribute to development of democracy and rule of law.

The values we share are commitment, independence, learning, networking, team work.

Institute has implemented project "Public administration in Montenegro- salary schemes, rewarding mechanisms and opportunities for professional advancement in legislation and practice (January 2008 – June 2008)".

Institute prepared short information with recommendations on Parliament of Montenegro - Transparency of financial activities (June 2008).

Institute prepares and distributes on daily bases to over 200 recipients in Montenegro and worldwide "Daily Brief" containing political, social, economic, regional issues, with weekly commentaries.

Institute was coeditor/co publisher of the Publication "Political criteria for EU Accession".

Representative of IA participated in session of the Parliamentary Committee for budget and finances where IA opinion on procedural and substantial budgetary issues was presented (December 2008).

IA implements, in cooperation with Center for Monitoring CEMI and European Movement in Montenegro, project "EU Matrix – Monitoring European integration process – Monitoring implementation of National Program for Integration of Montenegro into EU – preparatory phase"

Research report on Public Companies in Montenegro is in drafting process. (IA voluntary activity)

Foundation Friedrich Ebert finances three IA research reports on Case "Lipci"; Case of "First Bank"; Public private partnerships – Montenegrin Experience.

IA has been supported by Open Society Institute Foundation and Friedrich Ebert Foundation.

IA is member of NGO Self regulatory body and has provided full financial information in accordance with NGO Code of Conduct.