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MACEDONIA FINANCIAL SECTOR STRENGTHENING PROJECT

Annual Report

USAID Contract No:
PCE-I-00-99-00008-00, Task Order No. 815

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Submitted to:
USAID / Skopje

Report for the Year Ended 2003

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EXECUTIVE SUMMARY

On 5 August 2002 Deloitte Touche Tohmatsu Emerging Markets, Ltd. (Emerging Markets Group) and the United States Agency for International Development (USAID), through its Regional Contracting Office (RCO), signed contract PCE-I-00-99-00008-00 for the implementation of the Macedonia Financial Sector Strengthening Project (“MFSSP” or “the Project”).

The purpose of the MFSSP is to provide:

- 1) Assistance to the commercial banking system;
- 2) Assistance in investment promotion and in the building of a viable capital market;
- 3) Assistance in accounting reform and strengthened financial reporting among enterprises;
- 4) Assistance in pension reform to include strengthening of the pillar one system and design and planning work for a pillar two system; and
- 5) Assistance in a range of other areas to include insurance supervision, legal reform, SME finance, and NBFIs development.

The Macedonia FSS Project supports USAID/Macedonia’s Strategic Objective 1.3 – Accelerated Development and Growth of the Private Sector. The SO 1.3 is linked to other initiatives currently occurring in the region, however, this activity’s Intermediate Results consists of: I.R. 1.3.1, Bank and Non-Bank Financial Institutional Strengthened.

This Annual Report is a summary of activities that includes the Project’s commencement and activities during 2003. It is provided in accordance with Section F.11 (C)(1), of the Contract for Services No. PCE-I-00-99-00008-00 (the “Contract”). The subsequent chapters of this Report will discuss in depth each technical area encompassed within the MFSSP.

During the 2003 fiscal year, the Macedonia Financial Sector Strengthening Project met a number of its key benchmarks and milestones. In addition to employing a number of local professionals and several short-term technical assistants, the Project has developed effective working relationships with the counterparts in the Macedonian Government. The Project has seen a number of changes since its original inception in August 2002: there was the addition of the Treasury Securities advisor and related activities, and although there was a slight decrease in the area of Banking activity, this will be supplemented by the addition of a Financial Regulatory specialist and an Investment Promotion advisor in 2004.

We have enhanced our cross-cutting activities within the MFSSP project, and with other USAID projects as well as other multilateral donor projects in Macedonia. Frequent communication and interaction with other projects is an essential element of the nature of the MFSSP project. The MFSSP was designed to achieve the overarching goal of establishing and promoting linkages and cross-cutting elements in the overall development of the financial sector. Each area of the project’s progress is highly dependent upon the other – making this a uniquely interdependent, systematic and all-inclusive development activity. Highlights from each of the technical areas that represent developments over the past year are summarized below:

- In the Accounting area, the Project administered the certification exam in Financial Accounting, Auditing and Managerial Cost Accounting. Nineteen of those taking the exam (25%) passed, bringing the number of certified auditors in Macedonia to 91. In addition, the Project made significant progress in developing the accounting and auditing SRO.
- In the Banking area, the Project assessed the level of interest in the establishment of a credit information bureau and identified a private sector counterpart to assist in the creation of a credit information center. We assisted in reviewing accounting practices for commercial banks and issued a report and training materials on the relevant international financial reporting standards.
- In the Pension area, we have made noteworthy progress in the establishment of the Pension Supervisory Agency in all aspects, such as development of the organizational structure, budgeting, by-laws, regulations, as well as a detailed critical path analysis. The Pensions Advisor has also worked closely with the World Bank in helping the Macedonian government establish the pensions reform program.
- In the area of Capital Markets, the Project has served as a close advisor to the SEC, and very often provides technical guidance to the SEC, the MSE and the CSD regarding a range of issues. The Project has also provided a review of the Macedonian Securities Legislation and compliance with IOSCO, among other legislative reviews.
- In addition, the Project has also hired a consultant to assist in the establishment of a Treasury Securities market.

On the Budgeting and Contractual issues, there have been some periods over the last year of significant activity, mainly attributed to increased short-term consultant utilization. In addition, Other Direct Costs (ODCs) have remained fairly consistent throughout the year. The use of funds for MSFFP has not exceeded the budget projections.

Overall, in 2003, the MFSSP has made successful inroads in establishing close links to the Government of Macedonia's counterparts. This Project is truly a next generation economic reform program that was designed to leverage the combined components and create synergies within the development of the financial sector – we have indeed seen significant advancement in this regard. The MFSSP is optimistic that it will continue to meet and exceed its targets for the following year.

1. KEY HIGHLIGHTS OF THIS YEAR'S ACTIVITIES

1.1 Major Accomplishments from the past year

During this year, the MFSSP team achieved a number of results in the overall Activity. Below we present the major accomplishments that show significant progress for each technical area of the MFSSP.

Overall Project

Although not required under the terms of the Task Order, the Project prepared and delivered an 81 page Inception Report detailing updated status in each sector, comments and adjustments proposed, related efforts by other projects and donors, possible obstacles and priorities and itemization of the work in each sector. The report also identified crosscutting issues within the project, linkages to other USAID projects and linkages to other donor programs. This Inception Report formed the basis of the Project's discussions with USAID on start-up and planning.

We gave numerous presentations in support of the Project's work:

- *The Pension Reform Roundtable* sponsored by the World Bank –COP presentation concerning the intersection between pension reform and the capital markets, insurance, accounting and banking sectors.
- *NBFI Forum* sponsored by FULM Savings House – COP presentation in support of the development of the NBFI sector in Macedonia describing the current status of the financial sector and near-term efforts underway. The presentation was covered by the newspapers.
- *MSE 7th Anniversary Roundtable* sponsored by the MSE – COP presentation on the future of the Macedonian securities markets. The comments were carried on television news and the newspapers.
- *Listed Company Conference* sponsored by the Project – COP keynote address outlining the structure of the Macedonian securities markets.
- *Broker's Certification Review Course* sponsored by the SEC – COP presentation on "Ethics and Professionalism", the first time this subject has been taught as part of the review course.
- *Mission Director Briefing* for USAID – 3 ½ hour briefing for the Mission Director by the Project

We supported the US Embassy's Economics Office by

- *Helping draft a cable on Macedonian banking system:* At the request of the embassy we prepared an extensive memorandum detailing the status of the banking system which was used as background material for an official State department cable.

- *Briefing Material for Ambassador:* At the request of the embassy we prepared background material entitled “Recent Developments in the Macedonian Banking System” for the US Ambassador’s visit to the IMF in Washington.
- *Performing an Inquiry into Auction of State-owned shares:* At the request of the Embassy, the Project performed an inquiry into one of the auctions of State-owned shares during which the bid of an American company was rejected by the MSE as late. After receiving the electronic audit trail, other supporting documents and interviewing the MSE’s Director and IT staff, the Project concluded that the US company’s offer was rejected for proper reasons.

The Project also provided input to the Ministry of Finance as it prepared its policies to be presented to the Council of Ministers. This input concerned the role of financial system reform in promoting economic growth.

Accounting

- **Certification Exam:** The certification exam in Financial Accounting, Auditing and Managerial Cost Accounting was given during the month of May. The exam was updated to be fully compliant with IAS, ISA and IFAC, and also to reflect advanced theories designed to raise the standard of the examination. The Project has established credibility through the implementation of higher security and internal controls. Recent results of the certification exam reflect an average 30% pass rate (19 successful candidates) from 5% a year ago. The number of certified auditors in Macedonia now totals 91. In addition to the exams being IFRS compliant, the technical standards have been improved to an ACCA Level 3.
- **SRO Development:** The development of the SRO has been a challenging one over the last year. IFAC suspended SOYUZ membership and the Ministry gave tacit approval to begin formation of a new SRO. After several months of slow developments, however, the Project called for a special meeting with the Deputy Minister to emphasize the lack of progress on the Accounting SRO. The Project drafted the required modifications of the Accounting SRO’s by-laws and charter. The modified existing by-laws are now compliant with IFAC standards and these have gained virtual universal acceptance by the Ministry of Finance and the World Bank, including a majority of potential members.
- **University Participation.** The Project has established new IFRS compliant curricula in 2 universities, and actively lectures in 3 universities. This is significant progress, as in the previous years, the universities were not willing to consider outside educational assistance. Of particular note is the concurrence on the part of the schools to adopt the project’s idea to offer courses, in addition to the standard offerings, that would be accelerated and be commensurate with ACCA standards. These courses are for students who intend to be professional accountants or auditors and prepare for the certification examination. Short term consultants have been retained to contribute to Continuing Professional Education

- (CPE) and adult education and to some extent participate in the development of the SRO. These CPE courses are being held now.
- **Translation of Accounting/Auditing Texts and Materials.** As part of the CPE program, the Project translated a compilation of accounting textbooks into a 450 page manual. It has received wide acceptance. Similar translations were done on a smaller scale for the review of courses.
 - **Modification of Current Law(s).** The Project has been active in the Profit Tax, Leasing, Audit and Trade Company Law companies. Participation on the Company Trade Law committee has now been completed and the law is now in parliament. Further project involvement is contingent on the outcome of any proposed amendments. The Audit Law is in the process of review and further discussions will be held before the law is submitted to parliament. The project also had very intensive involvement with the Leasing law. The project has been asked to conduct courses to enterprises and ministries to assist in the accounting implementation of the technical rudiments of the law.

Banking

- **Seminar on Credit Information in the Commercial Banking System:** Organized and presented a seminar for representatives of banks and other government officials. The seminar also presented the findings of a number of meetings and interviews held with commercial bankers, government officials and other interested parties in order to assess the concept of a credit information agency in Macedonia.
- **Credit Information Center:** The Project has identified a private sector counterpart for the creation of a credit information center. The counterpart, the Interbank Clearinghouse (KIBS), has requested technical assistance and talks are in progress.
- **Briefing Paper:** Prepared a briefing paper and estimates of NPL losses in the commercial banking system for MOF officials. This was based on available, system-wide data from the Central Bank. The Project also prepared a number of other papers on bank accounting and auditing, deposit insurance and risk-based assessments, and state deposits in commercial banks for the Ministry of Finance.
- **Accounting Practices for Banks:** The Project completed STTA regarding accounting practices for banks for the NBRM and issued a report on current accounting practices of the banks, training material on IAS 30 and 39 and a draft directive requiring banks to use IFRS.
- **Market Risk Assessment Assignment:** The Project completed a 5 stage short-term assistance effort designed to help the NBRM understand the level and the nature of market risk within the banking system. This assistance included tutorials and other working sessions with NBRM staff, on-site examination assistance and creation of bank risk and product risk profile templates. In

addition, the Project delivered a 26 page final “Report on Market Risk and its Supervision”.

Capital Markets

- **The Securities and Exchange Commission.** The Project serves as confidential advisor to the SEC and attends all of its closed-door meetings. In this role we provide guidance on a wide range of sensitive issues. In one particular situation we rendered advice that helped diffuse a demonstration at the Commission’s offices concerning shareholder lists of a large company.
- **Technical guidance and opinions.** We delivered detailed technical opinions to the SEC, MSE and CSD regarding:
 - Trading, clearing and settling shares that are encumbered by voting right proxies (the Project was mentioned in the Macedonian press in this regard);
 - The application of the Law on Takeovers to a specific transaction under review;
 - Disclosures required by listed companies regarding the setting of dividends. (This material was subsequently distributed to all listed companies and used at a seminar sponsored by the MSE.)
 - On several occasions we provided comments to proposed technical amendments to the Law on Securities sponsored by the Ministry of Finance
- **Broker Certification Examination.** We assisted the SEC in reinstating the Broker Certification Examination and a two-week Review Course. This is the first time in two years that the Course and Examination will be conducted. The COP has been designated as one of only three persons who will select the questions for the examination.
- **Stock Exchange Listing.** The Project organized and conducted a seminar for all companies listed on the Stock Exchange. Over 70 persons attended. There were presentations from 6 guest speakers and handout materials for all attendees. Feedback from the Exchange and the attendees was that the seminar was highly informative.
- **Working Group on Voting Rights Abuse.** The Project organized a working group, including the principals of the MSE, MSEC and CSD and representatives from the corporate governance and financial projects, to address the abuse of the voting rights agreements. As a result of the effort amendments were passed in July 2003 removing the legal basis for entering into these contracts. As a result the previous practice has now been banned.
- **Grey Market Securities Trading.** The Project prepared and delivered a report on “Grey Market Securities Trading in Macedonia”, containing a detailed review

of the level of off-exchange trading and 9 recommendations to curb this activity. The SEC, MSE and CSD have each agreed to implement the Study's recommendations.

- **Macedonian Stock Exchange.** The Project provided a short-term adviser for the MSE who focused on: (1) improving the Exchange's business arrangements with Reuters and Bloomberg; (2) reviewing the coverage by the local media; (3) advising on further memberships in associations of stock exchanges; (4) changes to the trading system to make it more transparent. The MSE has agreed with the recommendations of the Report and begun to adopt its recommendations.

The Project also provided short-term technical assistance with regard to the ownership structure, governance and block trading practices of the MSE. During an intensive 3-week process, the Project completely reviewed the MSE's practices in these areas and then issued a 90-page report containing specific recommendations for a substantial reorganization of the MSE. The Exchange's management has concurred with the far-reaching changes and intends to submit them to the Board of Directors for approval in November.

- **Legislative Reviews.** The Project completed an extensive review of the "Macedonian Securities Legislation and its Compliance with the IOSCO Principles of Securities Regulation" including a review of the G-30 Recommendations on Clearance and Settlement. All interested institutions have agreed that a comprehensive, integrated package of amendments to the Securities Legislation is necessary and the Minister of Finance has agreed with the Project's proposal to form a working group for this purpose with the SEC as lead.

Treasury Securities

- The Project completed Phase I of the technical assistance regarding the creation of a treasury securities market. A 40-page report was furnished to the Mission.

Pensions

- **Pension Supervision Agency.** The Project has been instrumental in its role as the donor coordinator in the establishment, budgeting and design of the organizational structure of the Agency. The Project has provided assistance in drafting by-laws and the secondary legislation, preparing job descriptions and also assisting in equipment purchases. Additionally, the Project has drafted tender documents for Pension Fund Company, and has held a road show to promote pension reform tenders. A Pension Agency Development Plan Report was drafted to assist in identifying the needs for staffing, budgeting requirements, business processes, IT needs, etc.
- **Critical path analysis.** The Project finalized the critical path analysis for the Pension Agency. Working with Rhoda Davis, a World Bank consultant all required tasks for the PSA between now and January 1, 2004 were identified.

This identified all the detailed steps required to establish the Agency, issue required regulations, run a public education campaign to help workers decide whether to join the new system, run a public tender to hire two Pension Companies, develop Agency business processes and IT systems, and enroll all workers in Pension Funds.

- **Data Collection and Allocation.** The Project assisted the Pension Supervision Agency and Pension and Disability Fund with design of contribution and data collection and allocation procedures, and employee registration and affiliation procedures
- **Public Education Campaign:** The Project prepared a draft of the public education assessment, and outlined the primary goals for this campaign and the guidelines for hiring a local polling firm.
- **Financial Model Analysis:** The Project estimated transition costs, estimated cash flows to a fully funded pension system, and created a model to assist workers with the decision to join the new pension system.
- **Training.** The Project has been involved in a number of training initiatives, including sponsoring a number of Macedonians to attend regional pension conferences, in addition to various computer training seminars such as Microsoft Project, Visual Basic for Applications, Microsoft Access, etc.

2. OBJECTIVES FOR THE NEXT FISCAL YEAR

2.1 Major Goals for Fiscal 2004

We have identified a series of specific tasks that must be achieved in order to accomplish the Project's objectives for this quarter. Key tasks to be started or completed during the next quarter include the following:

Accounting

- Certification Examination will see continual upgrades in the standards to meet the goal of being on par with ACCA level 4 CAT (certified accounting technician).
- Increase the number of at the university level lectures ; initiate a special professional track in addition to the regular academic courses. Initiate meetings with ACCA to coordinate their required standards and develop their participation; continued training of professors in both content and technique. Expanded CPE program to include Managerial Cost Accounting, Auditing and Financial Management.
- SRO Development : Adoption and ratification of by-laws by the assembly of the association; attain associate membership in IFAC; and, prepare a business plan that includes activities that will make the SRO self sustaining and professionally responsive to the financial community.
- Translation of Accounting Texts and IFRS Standards by March, as well as further translations of other accounting material.
- The accounting component of the MFFSP will maintain its availability to participate in other programs of the MFSSP and on the various committees in place that are relevant to the goals of the project.

Banking

- Obtain commitment by the NBRM to address the NPL problem.
- Participate in the amendments to the Savings House Law.
- Participate in the amendments to the Bankruptcy Law
- Participate in the creation of a Law on Finance Companies.
- Participate, as requested, in the creation of a Law on Credit Unions.
- Institute full compliance by the banks with the requirement to present financial statements in accordance with IFRS.

Capital Markets:

- Continue serving as confidential advisor to the SEC and attend all of its closed-door meetings.
- Continue providing detailed technical opinions as requested
- Conduct the Broker Certification Examination.
- Complete 8 regulations called for by the securities legislation but not yet adopted.
- Extend the mandatory listing program one more year
- Implement recommendations of the study “Grey Market Securities Trading in Macedonia.”
- Implement the recommendations of the report on the MSE’s ownership structure, governance and block trading practices and institute the far-reaching changes to board structure and trading operations.
- Prepare a comprehensive, integrated package of amendments to the Securities Legislation as recommended by the IOSCO Report.
- Prepare the MSE’s top listed companies for marketing to portfolio investors and perform outreach to mutual funds specializing in transition economies.
- Reach out to companies seeking to conduct offerings of alternative securities
- Support the Ministry of Economy’s FDI Promotion Program.

Treasury Securities

- Complete all preparations, commence auctions for treasury securities and create secondary market for trading.

Pensions

- Complete Pension Company accounting regulation.
- Complete custody, marketing, sales agent, and fee regulations.
- Identify IT and Pension Company administration experts; agree to the dates for their initial visits.
- Identify pension reform leader for the Ministry of Labor.

- Finish computer procurement and deliver equipment to the Agency.
- Hire 4 recent university graduates to work for the Agency.
- Resolve problems with Civil Service Agency so MAPAS can hire senior people from other government agencies.
- Select Macedonian polling and public education firms to support the public education campaign.

2.2 Potential Problems and Needs for Assistance

At this stage, we foresee no major or unusual impediments to our ability to achieve the objectives outlined above during the next year. We anticipate having the support of our local counterparts in all of the initiatives we intend to undertake, as well as the support of the Mission.

2.3 Expected Staffing Requirements

In order to accomplish these tasks, during the next quarter we tentatively plan to request USAID approval to assign short and long-term experts in the areas of:

Banking: Credit Information Bureau Expert

Banking: Bank IAS / IFRS Expert

Banking: NPL Expert

Capital Markets: Stock Exchange External Operations Specialist

Accounting: Accounting Professor

Accounting: Accounting Instructor

Pension: Pension Company Administration Expert

Pension: Public Education Expert

Pension: IT Expert

Government Securities: Government Securities Expert

Cross-cutting: Financial Regulatory Specialist

Cross-cutting: Investment Promotion Specialist