BSCEE
Review
2017

INTRODUCTION

The Group of Banking Supervisors from Central and Eastern Europe (the BSCEE Group) was established in 1991. The Agreement of the BSCEE Group was signed during the Stockholm International Conference of Banking Supervisors (ICBS) in 1996.

The BSCEE Group operates according to its Agreement and Operational Bylaws that determine its organizational structure and the rules governing its operations. As of today it is signed by twenty five member institutions from twenty four member countries: Albania, Armenia, Austria, Republic of Belarus, Bosnia and Herzegovina (Banking Agency of the Federation of Bosnia and Herzegovina and Banking Agency of Republika Srpska of Bosnia and Herzegovina), Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey and Ukraine. The Chairmanship of the BSCEE Group rotates on annual basis. In 2017 Mr. Dmitry Lapko, Deputy Chairman of the Board of the National Bank of the Republic of Belarus chaired the Group.

The permanent Secretariat of the Group since January 2006 has been located in Poland, with the KNF – Polish Financial Supervision Authority (PFSA).

According to the previous years' practice, the Annual Review of the BSCEE Group summarizes the developments of the member countries in 2017. This publication gives an overview of the macroeconomic circumstances in the twenty four member states, and it describes the banking sector as well as the supervisory activities. It was prepared on the basis of the information given by the member countries. The Annual Review also summarises the main events of the BSCEE Group, including the workshops co-organized by the Financial Stability Institute (FSI) and other regional meetings.

This Annual Report intends to provide in-depth information reflecting the mission of the BSCEE Group in a detailed and accurate manner regarding the banking sectors of the member countries.

We hope that you will find this publication informative and useful. We are certain that this will help you become acquainted with our supervisory job in the Central and Eastern European region, the cooperation among the supervisory authorities of the member countries and with the Basel Committee.

BSCEE Secretariat

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2017 DEVELOPMENTS IN THE ALBANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

General macroeconomic situation has remained positive as GDP grew at higher rates and the current account deficit narrowed. Inflation rate increased, albeit it remained below the target of 3.0%. Unemployment rate dropped to 13.4% as end of year, compared to 14.2% a year ago The current account deficit narrowed for the third consecutive year in 2017 to 6.9 % of GDP (EUR 803 million) from 7.6 % in 2016. The average inflation rate rose to 2.0% during 2017, up from 1.3% in 2016. Although upward, domestic inflationary pressures were still insufficient to offset the low inflation rate in our trading partner countries, the effects of the exchange rate appreciation, and the growing inertia of the price formation process over the last years.

According to INSTAT data, the economy grew by 3.8% in 2017[1], up from 3.4 % in the preceding year and recording the highest annual growth rate since 2008. The expansion of the economic activity was supported by all the components of aggregate demand and helped increasing the output across all the main sectors of the economy.

The monetary policy stance of the Bank of Albania remained accommodative. The policy rate did not change and, at 1.25%, stands at its lowest historical level. Meanwhile, the Bank of Albania increased the liquidity injection and continued the forward guidance on monetary policy. The monetary policy pass-through to the financial markets has been complete, while its transmission to the economic activity and to prices is increasing.

The fiscal policy was less consolidating compared with the previous year. This policy supported economic growth mainly through the expansion of investments. The budget deficit was assessed at 2.0% of the GDP, while public debt reached 69.6% of GDP in 2017

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

The banking sector remains the main component of the Albanian financial sector. Sixteen banks continue to operate in the banking sector. Their activity has been improving: profitability indicators increased, capitalization and liquidity are at good levels and the non-performing loans ratio declined. The latter is at 13.2% from 18.2% in 2016 and reflects the implementation of the national plan of measures for reducing non-performing loans

The ratio of banking system assets to GDP fell at 92.5% as total of assets grew slightly less, at versus 2.7%, the GDP growth. The ratio of loans to GDP also fell by 2.1 pp at 38.65%. The balance sheet items were strongly impacted by the loans write-offs due to regulatory obligations.

[1] In the three first quarters of the year, economic growth resulted at 4.0%, 4.1% and 3.5%, respectively.

Assets growth was mainly driven by the expansion of interbank transactions and loans whereas a fall of securities transaction followed. The activity as principally financed by a large increase of interbank transactions of approximately 23%, whereas a light increase of customer deposit of 0.7% did pursue.

The loan portfolio grew by only 0.15% largely affected by loan write-offs. The portfolio composition by currency still shows a larger presence of foreign currency loans, mainly in euro, by 56.4% but with a continuous decrease of its weight, while the ALL denominated loans have showed a steady increase for some years.

The ratio of non-performing loans (NPLs) to total loans trended downward in 2017. It stood at 13.2 % at the end of the year, down from 18.3 % one year earlier and the lowest level in the last 7 years. In absolute terms the non-performing loans fell by 27.5% while its coverage ratio remained still high at 70.6%. In net terms the non-performing loan ratio reached the low level of 3.7%. The main factor for non-performing loans decrease consists of write-offs and the resolution of large borrowers that did gain a more significant ground during the year.

The profitability in absolute terms grew by 137% during 2017 reaching a net result of 22.1 billion ALL approximately. Respective profitability ratios improved significantly reaching the levels of 1.56% for RoAA and 15.7% for RoAE.

By the end of 2017, the banking system's capital adequacy ratio was at 16.6 %, up by 0.9 pps yoy., that is notably higher than required minimum2. The capital buffers created a good financial position coping with quite adequate levels of liquidity. Capital composition confirms its strong position as it relies in about 92% on tier-1 capital.

The most important developments in banking sector through 2017 are:

- Credit portfolio increased by 0,15%;
- NPL ratio reached a 13,23 %, with strong decrease from previous year;
- Coverage ratio of non-performing loans stands at 70,6%;
- Better liquidity position as measured by liquidity ratio, at the level of 40.8%;
- Deposits increased by 8,5 billion ALL, almost 0.7% of the last year;
- The capital adequacy ratio has increased at 16,6%, notably higher than the 12% required minimum;
- The financial result increased at satisfactory levels;
- Profitability ratios such as ROAA and ROAE are respectively 1.56% and 15.71%.

[2] Required minimum for capital adequacy ratio is 12%

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN ALBANIA

The drafting and the review of the supervision regulatory framework was aimed at supplementing and improving it, in order to ensure compliance with the applicable legal requirements and alignment with the directives and the regulations of the European Union (EU) and the standards of the Basel Committee, by continuously considering the identified problems and the suggestions of the supervised institutions, provided through an on-going communication with them. The main regulatory changes are as follows:

- The Bank of Albania, with the purpose to complete the regulation on the supervision of financial groups that operate in Albania, realised the complete review of the Regulation "On consolidated supervision". This initiative considered all the provisions stipulated in the Law "On banks in the Republic of Albania" on consolidated supervision, as well as the requirements and principles laid down in the directives and the regulations of the European Union (EU), and the standards of the Basel Committee. This Regulation lays down the conditions, rules and regulatory requirements of conducting consolidated supervision, for the purposes of risk management deriving from a banking group and a financial group.
- The Regulation "On capital adequacy ratio" was partially reviewed, with the aim to continue the implementation of the measures that penalises (in terms of capital requirement) the placements of the banking sector with non-residents.
- To fulfil the recommendations of the MoneyVal Experts Committee, provided in the last evaluation for Albania, and to resolve some issues concluded in the on-site supervision regarding the implementation of the requirements of the supervisory authority on the prevention of money laundering, the requirements set out in the Regulation "On the prevention of money laundering and terrorism financing" were reviewed and complemented.
- The Regulation "On the transparency for banking and financial products and services" was partially reviewed aimed at further strengthening transparency, addressing some problems manifested in banks regarding the transparency to customers, and further aligning it with the European Directive on consumer protection.
- The Regulation "On establishing the decision-making level in the supervision of banking and financial activities" was partially reviewed, with the aim to ensure the compliance with the decision-making process and its delegation, in particular the reflection of processes set out in the new supervision regulations on the savings and loan associations and their unions.
- The Regulation "On granting the license to non-bank financial institutions" and the Regulation "On risk management in the activity of savings and loan associations and their Unions", were simultaneously and interdependently reviewed. The amendments mainly consist in addressing some problems identified in the supervision process, also

aiming some facilities for the institutions while carrying out their financial activity.

- In compliance with the requirements laid down in the new Law 133/2016 "On the recovery and resolution of banks in the Republic of Albania", to complete the regulatory framework with regulatory acts, the existing guideline "On recovery plans" was completely reviewed. The new regulation "On recovery plans of banks", which replaces the applicable guideline, sets out the supervisory requirements on the recovery plans of banks and banking groups, mainly the content of these plans the way and term to present these plans and their updating, the inclusion of a list of qualitative and quantitative indicators, as a very important integral part, as well as the criteria stipulated by the supervisory authority to assess them.
- The important process of the effective governance of banks and the approval criteria of banks' administrators were strengthened through the new requirements set out in the partially reviewed Regulation "On the core management principles of banks and branches of foreign banks and the criteria on the approval of their administrators". The reviewed Regulation aims to align it with the recent requirements of the European Union regulatory acts on the good-governance and ensure compliance with the European Bank for Reconstruction and Development recommendations provided from the project on the assessment of the relevant legal and regulatory framework and supervisory practices applicable at the Bank of Albania. The amendments mainly consist in the new requirements of the supervisory authority regarding: the definition of risk appetite/tolerance and the capacity of banks' risk and the obligation to publish the appetite/tolerance statement as part of their annual report; the compilation of a special policy on the appointment of the Steering Council members of the bank; some additional requirements on the risk management unit/structure and the compliance structure/ unit; the requirements to realise an analysis and self-assessment of the bank for the administrators proposed for approval, on the adequacy of professional knowledge with the proposed position; as well as the regular re-assessment process of administrators and, whenever deemed necessary depending on the circumstances, throughout the conduct of their function in the bank, etc.
- The Regulation "On internal audit system" was partially reviewed, to be adapted to the amendments in the Regulation "On the core management principles of banks and branches of foreign banks and the criteria on the approval of their administrators", and aligned with the best practices on internal audit.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

Through setting priorities, the Supervision Department aim to address the main identified risks of the supervised entities and the challenges faced form supervision over a year's timeframe.

- Credit risk monitoring by following up banks' NPL strategies and solution of large non-performing borrowers, as well as preparing a regulatory framework addressing joint problematic borrowers (out-of-court workouts);
- Revision of the regulatory requirements and supervisory approaches for the assessment of banks corporate governance;
- Harmonization of supervision function with the resolution function within Bank of Albania. A new resolution unit has been recently established in Bank of Albania;
- Further alignment of regulatory requirements with those from EU directive (*acquis communautaire*) and Basel II & III standards;
- Greater co-operation with the European Central Bank and Single Supervisory Mechanism;

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The previous year was characterized by a number of developments related to the nature of supervisory work as well as to the developments in the banking and financial system supervised by the Bank of Albania. Supervisory practice has progressed towards improving banking supervision methodology, either by standards adoption by applying Basel principles to effective oversight, or by adapting best international practices, developments that are associated with ongoing review of regulatory framework. The consolidation trend within banking sector and exit strategies of some european group operating in Albania were carefully followed and monitored.

The self-assessment process of banks regarding internal capital requirements (ICAAP) is another important development that is expected to improve further banks' risk management and capital. With the assistance of the World Bank/FinSAC and the International Monetary Fund, a regulatory framework has been drafted to encourage banks to co-operate and to coordinate efforts to address common borrowers starting at an early stage of problem solving (out-of-court workouts). In addition, during 2017, a regulatory framework was drafted regarding the Liquidity Coverage Ratio (LCR) indicator. An impact study was initiated with the aim of early identification of the problems in its implementation and preliminary assessment of the bank's position towards this indicator.

In 2017, the Committee of Experts on the Assessment of Money Laundering and Financing Terrorism Measures (MONEYVAL) conducted the fifth round of Albania's assessment. The Bank of Albania as the supervisory authority played an important role in this process by providing information and through direct meetings with the experts. Currently, the fifth round of Albania's assessment is in the phase of drafting the evaluation report by experts and it is expected to be finalized by the committee within 2018.

During 2017, 14 full and partial examinations of banks, non-bank financial institutions and savings and loan associations were conducted. During this year the number of examinations in non-bank entities has increased, following the expansion of their number and relevance in the financial system. The main objective of the examinations remains the definition of a full risk profile for licensed subjects, taking into account quantitative and qualitative factors.

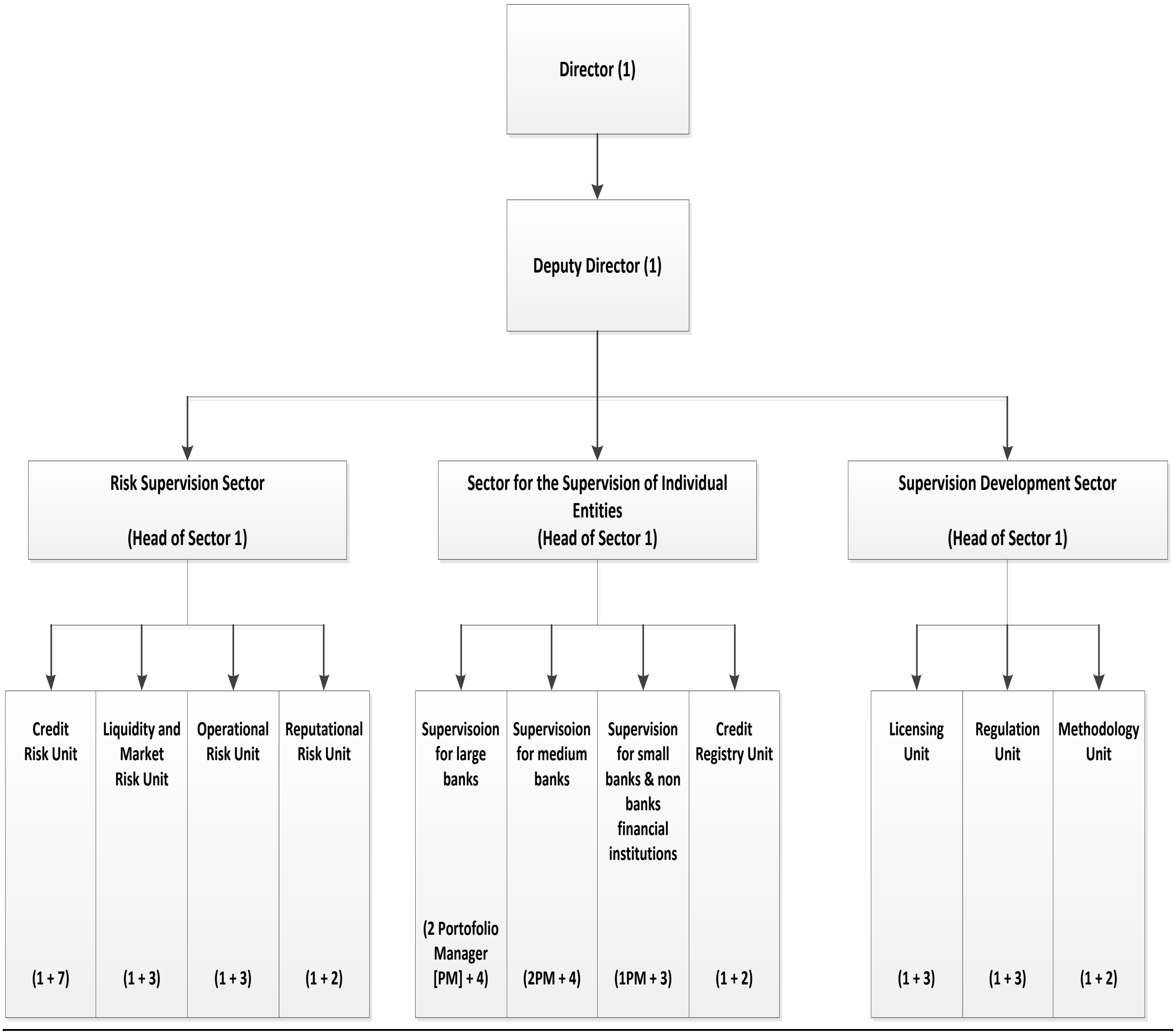
Table 1: Examinations number according to institutions and risks

Examined entities	Risks											Weight within the respective groups	Weight within the financial system
	Strategic	Organisational	Credit	Liquidity	IRRBB*	Market	IT	Operational	Reputational	Profitability	Capital		
Banks	*4*	*5*	*7*	*5*	*4*	*4*	*4*	*4*	*5*	*4*	*5*	71.22%	69.00%
Non-banks	*2*	*4*	*3*	*2*	*3*	*2*	*4*	*1*	*3*	*3*	*3*	29.33%	0.75%
Credit Unions	*3*	*3*	*3*	*3*	*3*	*3*	*3*	*3*	*3*	*3*	*3*	71.28%	0.39%
TOTAL	*9*	*12*	*13*	*10*	*10*	*9*	*11*	*8*	*11*	*10*	*11*	70.15%	70.15%

**Interest rate risk in banking book*

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

The organizational structure of the Supervision Department hasn't had any changes during 2017. The last structural change was in 2016.



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The cooperation with the international supervisory authorities is considerably intensified, notably, the cooperation agreement between the Bank of Albania and the European Central Bank. This agreement paves the way towards a stable collaboration through the share of common-interest information, of professional experiences and the decision-making coordination, as an important step in the integration process of the Albanian institutions in the European Union structures.

Meanwhile, Bank of Albania was invited to participate as observer in two supervisory colleges organised for Greek banking groups of international presence (including the Albanian presence) and in a targeted inspection in one bank of EU origin. The shared information and the meetings with the homologue authorities in other countries contributed in the coordination of actions and supervisory measures, and in the establishment of a more clear profile for banks in Albania and in the relevant group. This collaboration is expected to continue in 2018 and further.

There has been running a project in co-operation with the European Bank for Reconstruction and Development for the revision of regulatory and methodological supervisory framework in the qualitative assessment of bank governance structures. This project aimed at focusing on addressing and analyzing the elements of corporate governance for established structures, functioning and independence of bank committees, structures and functioning of internal control structures in risk assessment.

Cooperation with Bank of Italy have been tacken up in the previous year. The main issues were the revision of the Early Warning System and preparing a framework for borrower analsysis through setting financial ratios thresholds based on industry level. Meanwhile there was an intensive coordination on organizing an event consisting in electronic money institution supervision based upon based upon Bank of Italy and Bank of France practices. This event was materialized by the beginning of 2018.

In the course of 2017, Bank of Albania continued to cooperate with the European Banking Authority (EBA) and the central banks of Southeast Europe in the framework of the cooperation forum between the Supervisory Authorities of these countries, with a view to exchanging information on the latest regulatory changes as well as the update of developments in the field of supervision. Bank of Albania continued to contribute for the BSCEE review and Vienna Initiative platform.

COOPERATION WITH OTHER SUPERVISORY BODIES IN ALBANIA

In 2017, Bank of Albania had the following activities in cooperation with other supervisory institutions:

- 1 examinations in collaboration with Albanian Financial Supervisory Authority (AFSA)
- 6 examinations in collaboration with the General Directorate for the Prevention of Money Laundering ()/Albanian Financial Intelligence Unit (AFIU) consisting in opinions and expertise sharing.
- participation in the interinstitutional working group for the revision of law on Anti Money Laundering and Anti Terrorist Financing.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

The preparation and the approval of the regulatory framework for Internal Capital Adequacy Assessment Process has been one of the important supervisory developments during 2017. The document that regulates this process has been drafted in compliance with Basel II, Pillar II standards. The guidance identifies the basic requirements for the assessment of additional risks and the calculation of additional capital to cover these risks according to the methods set out in this guideline and those built by the Bank itself based on the risk profile and its strategy. According to the Guideline banks are required to commence submission of annual ICAAPs in April 2018.

It has been drawed a new assessement methodology for all supervised entities on Anti money laundering and a first round of assessment has been conducted. Bank of Albania has also been an important role player in the fifth round of Albania assessment by MONEYVAL through filling out the required information and participating in direct meetings.

A large number of customer complaints has been reckoned in the framework of transparency and protection of financial sector customers. During the year a total of 124 complaints / requests / letters were received from individuals, businesses, natural persons and state institutions which were analyzed and replied accordingly.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	16	16	16
Branches of foreign credit institutions	0	0	0
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**16**	**16**	**16**

Ownership structure of the financial institutions
on the basis of registered capital (%)
(at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	0	0	0
Other domestic ownership	12.4%	11.5%	12.0%
Domestic ownership total	12.4%	11.5%	12.0%
Foreign ownership	87.6%	88.5%	88.0%
Banking sector, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions
(at year-end)

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	57.63%	73.83%	0.15
Branches of foreign credit institutions	n/a	n/a	n/a
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	57.63%	73.83%	0.15

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	13.16%	7.15%	15.71%
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	13.16%	7.15%	15.71%

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	100	100	100
Branches of foreign credit institutions	n/a	n/a	n/a
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

	2015	2016	2017
Claims from			
Financial sector	17.15	16.95	18.58
Nonfinancial sector	38.38	36.81	37.33
Government sector	40.23	42.08	39.54
Other assets	4.24	4.14	4.54
Claims due to			
Financial sector	2.81	2.75	3.34
Nonfinancial sector	83.05	81.98	80.42
Government sector	0.98	2.13	2.55
Other liabilities	3.64	3.40	3.52
Capital	9.53	9.72	10.17

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks	16.04**	15.71%**	16.60%**
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**16.04%****	**15.71%****	**16.60%****

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification*	2015	2016	2017
Non financial sector**	18.22	18.27	13.23
- households	13.32	10.18	7.64
- corporate	21.43	22.95	16.88

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	83.25	29.62
Corporate	14.41	64.98
Government sector	2.34	5.40
Financial sector (excluding banks)	n/a	n/a
Total	**100.0**	**100.0**

P&L account of the banking sector (at year-ends)

P&L account	2015	2016	2017
Interest income	63,408.48	57,946.07	53,940.99
Interest expenses	14,424.79	10,794.42	9,058.8
Net interest income	48,983.69	47,151.66	44,882.19
Net fee and commission income	7,566.37	8,327.07	9,326.72
Other (not specified above) operating income (net)	-1,054.93	-982.60	-724.31
Gross income	44,939.64	39,360.31	51,790.24
Administration costs	25,871.61	26,346.95	26,513.95
Depreciation	N/A	N/A	N/A
Provisions	11,644.08	18,439.50	2,395.22
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	N/A	N/A	N/A
Profit (loss) before tax	18,028.32	11,671.88	24,162.81
Net profit (loss)	15,699.05	9,270.14	22,073.82

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	1,078***	981***	981***	96***	n/a
Cooperative banks	n/a	n/a	n/a	n/a	n/a
Banking sector, total:	1,078	981	981	96	n/a

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE ARMENIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

A higher-than-forecasted economic growth was observed in Armenia, mainly contributed by the recovery of foreign and domestic demand. The growth of domestic demand was contributed by the expansionary monetary policy which also had an impact on lending growth.

The recovery of demand in the main partner countries, a tourism growth, as well as Armenian Government's policy aimed at promoting export and investment positively contributed to the economic growth. The current trend of the recovery of the economic growth will continue during the next year as well, given the income growth and foreign positive developments, according to the CBA forecasts.

The economic growth was 7.5% for the reporting year. The latter was mainly conditioned by the growth rates of manufacturing and services. These positive trends were due to faster-than-anticipated recovery of both domestic and foreign demand.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

As of 31 December, 2017, 17 commercial banks operated in Armenia. The banking sector of Armenia accounts for 85.5% of the financial system assets.

The banking system assets to GDP ratio has decreased by 0.6 pp. relative to the previous year and amounted 78.2%. The ratio of loans to economy to GDP has also decreased, by 0.7 pp. and amounted 45.1 %.

During the year, total capital of the banking sector has grown by 4.9 % and amounted to AMD 685.5 billion. 2 banks made replenishment of their statutory capital.

Non-resident participation in the statutory capital of the banking sector has decreased by 0.2 p.p. to 61.8%.

Banking System Capital Adequacy

In 2017, commercial banks' total capital adequacy ratio continues to stay above the minimum required prudential threshold (12 %) amounting 18.6% at the year end.

The share of credit, market and operational risks in the structure of risk weighted assets was respectively 85.8%, 11.1% and 3.1% (as of 31.12.2016 the indicators were respectively 86.8%, 9.7% and 3.4%).

Banking System Liabilities

In 2017, total liabilities of the banking system increased by 10.1 p.p. and amounted to AMD 3 trillion 679 billion. Both dram and foreign exchange liabilities increased by 17.7 % and 5.6% respectively. As a result, the share of foreign exchange liabilities decreased by 3.1 p.p. to 60.0 %.

Banking System Assets

At the end of 2017, total assets of the banking system increased by 9.2 % and amounted AMD 4 trillion 364 billion at the end of the year. Compared with the previous year the loans to economy increased by 8.5 % and amounted AMD 2 trillion 517 billion.

Financial Performance

In 2017, the net profit of the banking system, calculated in accordance with the Central Bank supervisory reports, amounted to AMD 37.7 billion. During the year, 15 banks reported profit and 2 banks incurred losses. Return on assets (RoA) and return on equity (RoE) of the banking system amounted 1.0 % and 6.0%, respectively. Main indicators of profitability increased due to increase of profitability of the asset unit, but the decrease of leverage had a negative impact on capital.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS.
LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN ARMENIA

In 2017, the regulatory framework of the financial system incurred further changes and supplements with regard to several laws of the Republic of Armenia. The amendment to those laws pursued to:

1. Bring into compliance existing regulatory framework with the new Constitution,
2. Facilitate the exchange of information between supervisory bodies,
3. Fully secure protection of consumers' rights and legitimate interests in mortgage lending and improve the processes of issuance and further maintenance of mortgage loans,
4. Implement new standards set by Basel Committee of Banking Supervision.

Legal competence of the Banking Supervisory Authority in the country.

One of the main objectives of the Central Bank of Armenia is to ensure stability and normal activity of the financial system of the Republic of Armenia, including ensuring of necessary conditions for stability, liquidity, solvency and normal activities of the banking system of the Republic of Armenia.

According to the Law on the Central Bank of Armenia, in performing the underlying objectives stipulated in the Law, the Central Bank shall:

- license banks, as well as other entities, in case if envisaged by law, and regulate and supervise activities thereof,
- provide loans to the banks as a last-resort-lender,
- collect, coordinate and analyze information concerning legalization of criminal proceeds and financing of terrorism, exchange and deliver such information to intra-governmental competent authorities and international organizations, and competent authorities of other countries, if stipulated by international agreements of Armenia.

In implementation of its tasks, the Central Bank shall be independent from the state authorities.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

The Central Bank (mainly Financial Supervision Department, Financial Monitoring Centre, Financial Stability and Development Department) performs off-site and on-site inspections of the financial institutions aimed at the disclosure of potential risk, legal compliance, combating money laundering and terrorism financing, protection of financial system consumer rights and other.

In 2017, the supervision of the financial institutions was focused on the following areas: asset quality assessment, internal control system, legal compliance, risk management system, integrity of corporate management principles, compliance with the requirements relating to security and sustainability of business operations, IT area, transparency, compliance of organizations to the changes of regulatory framework, level of reinsurance risk organization and supervision of registration procedures of the prospectus supervision of assuring the transparency, completeness and reliability of information to be published by the reporting issuers, supervision of compliance with the legislation of the operations of persons engaged in the public offering of securities, combat against ML/TF, consumer rights protection, prevention of operations by non-licensed entities, quality control of rendered services.

The development of financial markets has led to the development and full implementation of risk-based supervision in banking sector. Currently, the implementation of risk-based supervision in insurance sector is in process.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2017 the Bank continued supervision through off-site and on-site inspection over the activities of financial institutions with the aim to maintain financial system stability, evaluate financial market participants' exposure to risks, legal and normative framework compliance and to make sure an effective framework to combat money laundering and terrorism financing is in place and interests of consumers in the financial market are duly protected.

In 2017 the Bank further spent efforts to identifying financial institutions' exposure to risks, evaluating business conduct and accuracy of reportable information and engaging in other supervisory activities of relevance. During the year the Bank completed 186 on-site inspections.

Infringements revealed through supervision were remedied and measures were taken to prevent the ones in the future.

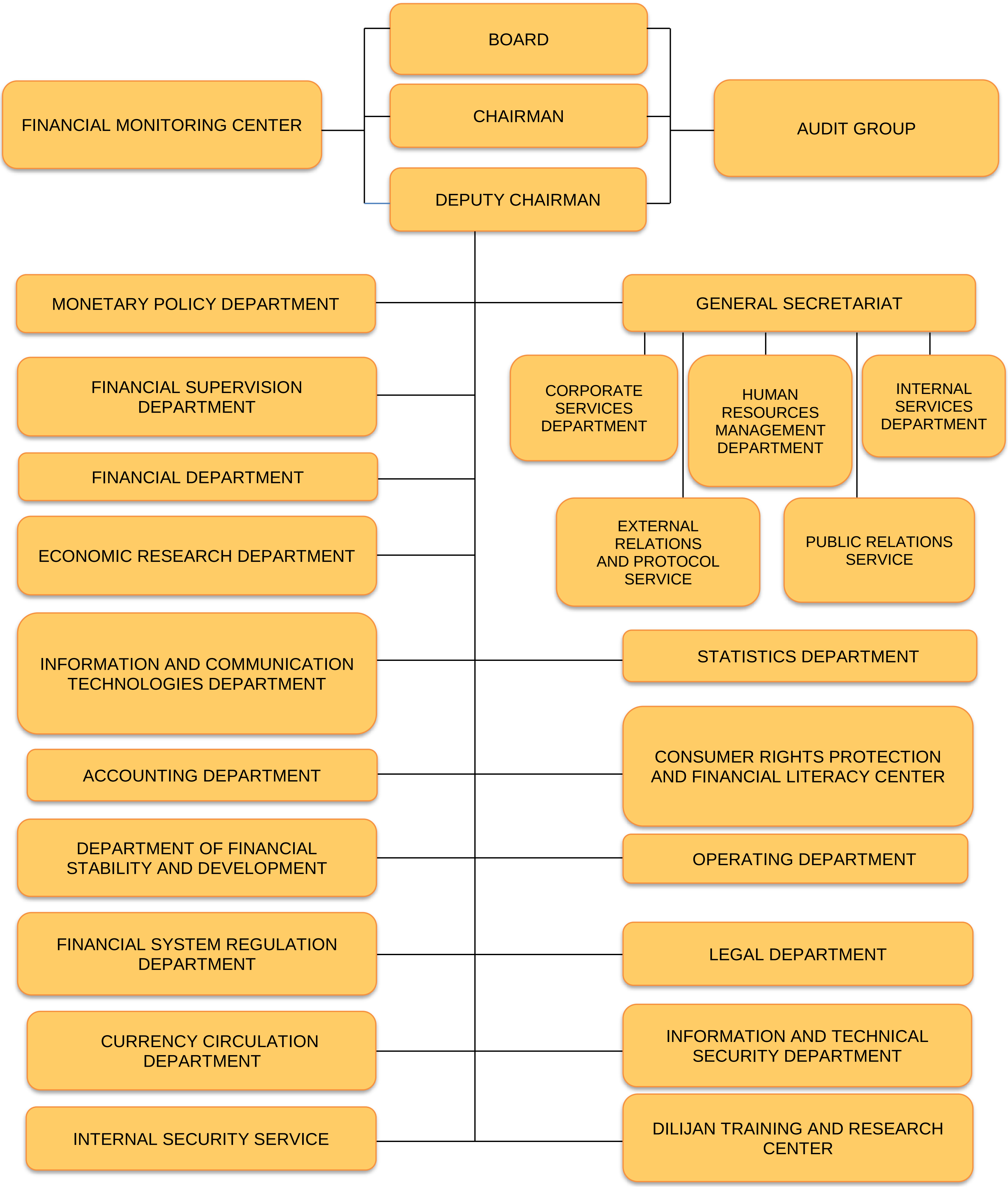
Activities as part of improvement of the financial system oversight during 2017 included:

- Transition from a rules-based supervision model to a risk-based and forward-looking supervision, driven by the developments in financial markets of the world. In the reporting period, the risk-based supervision approach was further developed and implemented at the Bank. The reforms are aimed at streamlining supervisory capacities in order to achieve increased effectiveness in carrying out supervision.

- In the context of financial stability and development, in 2017 the Bank designed and conducted another financial crisis management simulation exercise. The exercise participants were the Bank management, employees from different departments and the staff of the Deposit Guarantee Fund. The exercise was simulated around an alleged bankruptcy of the bank and subsequent remuneration of guaranteed deposits resulting therefrom, with a view to revealing possible problems with deposit remuneration, how to solve them, and identifying barriers to cooperation and communication between different institutions. Such exercises help participants get more prepared for emergency situations.

Central Bank of Armenia

ORGANIZATIONAL CHART OF BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In 2017, the Bank sustained its multilateral and bilateral cooperation with international financial institutions. The visits of the IMF Armenia mission and management of the Dutch and Belgium subgroup during the year contributed to closer ties. As the Bank continued coordinating the process of Armenia's sovereign rating in collaboration with international rating agencies, the representatives of "Moody's" and "Fitch", international rating agencies, paid visits.

There was further collaboration in developing international standards in the field of AML/CFT with international organizations and partner countries involved in introducing and implementing those standards, including cooperation with the Council of Europe's MONEYVAL Committee, the Egmont Group, the Parties to the Warsaw Convention, the Eurasian Group, the Board of Directors of CIS Financial Intelligence Units, as well as financial intelligence units of other partner countries.

During the year, the Bank has organized dozens of business meetings, conferences, workshops, round tables and forums. Of these events, the following are worth mentioning:

- The annual meeting of the IMF and WB (Belgium/Netherlands) Constituency, with participation of over 100 delegates from 14 countries, headed by central and national banks' chairmen.
- The regular meeting of the Board of Heads of Central/National Banks of Eurasian Economic Union.
- The roundtable on the development of new technologies for non-cash payments in payment systems, organized in collaboration with MasterCard, with participation of commercial banks of Armenia.
- The 12th meeting of the Interstate Coordinating Board of Heads of Insurance Supervisors of the CIS Member States.
- The regular meeting of the Supervisory Board of the KfW Development Bank, Germany.
- The annual meeting of the Federation of Eurasian Stock Exchange, organized with the support of the Bank.
- The National Payment and Settlement System Development Consultation, with the participation of Eurasian Economic Union central/national banks' chairmen.

In 2017, the Bank concluded agreements, contracts and memoranda of understanding with central banks of other countries as part of both bilateral cooperation and in the framework of intergovernmental committees, as follows:

- The Memorandum of Understanding and Cooperation between the Central Bank of the Republic of Armenia and the National Bank of the Kyrgyz Republic signed on January 25, 2017.
- The Memorandum of Understanding on Cooperation in the field of Insurance between the Central Bank of the Republic of Armenia and the Insurance Bureau of the Central Bank of the Islamic Republic of Iran signed on February 9, 2017.
- The Loan Agreement on SME Funding for Energy Efficiency (Phase 2) signed on December 18, 2017 between the Central Bank of the Republic of Armenia and the KfW Development Bank of Germany, within the framework of the German-Armenian Fund's program, for an amount of **EUR 15 million.**

COOPERATION WITH OTHER SUPERVISORY BODIES IN ARMENIA

CBA is the sole supervisory body of the financial system of Armenia.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

Changes were made in sub-legislative acts in order to facilitate the procedures of registartion of foreign branches of banks and their managers.

Taking into account international development, changes were made in chart of accounts aiming covergence with international accounting standards.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	22	19	17
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	**22**	19	17

Ownership structure of the financial institutions
on the basis of registered capital (%)
(at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	2.23	3.67	2.39
Other domestic ownership	30.10	96.33	97.61
Domestic ownership total	32.33	37.96	38.22
Foreign ownership	67.67	62.04	61.78
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	41.93	55.31	0.09
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:			

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	-4.35%	7.01%	8.60%
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	-4.35%	7.01%	8.60%

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	100	100	100
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

Claims from	2015	2016	2017
Financial sector	28.81	30.94	27.45
Nonfinancial sector	58.52	53.53	57.76
Government sector	7.16	10.52	10.83
Other assets	6.05	5.98	5.55
Claims due to	**2015**	**2016**	**2017**
Financial sector	12.55	9.35	10.74
Nonfinancial sector	40.47	40.66	44.76
Government sector	1.34	1.07	0.81
Other liabilities	32.38	33.01	29.08
Capital	**14.35**	**16.15**	**15.58**

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks	16.2%	19.95%	18.60%
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	16.2%	19.95%	18.60%

(* - for Basel I; ** - for Basel II; *** - for Basel III))

Asset portfolio quality of the banking sector*
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector	7.9%	6.70%	5.85%
- households	8.1%	7.32%	4.79%
- corporate	7.9%	7.75%	6.26%

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	64.34	35.30
Corporate	28.95	60.72
Government sector	0.36	0.73
Financial sector (excluding banks)	6.35	3.25
Total	**100.0**	**100.0**

P&L account of the banking sector (at year-ends)

P&L account	2015	2016	2017
Interest income	572,701.17	609,209.36	586,386.64
Interest expenses	355,583.55	376,470.89	354,249.06
Net interest income	217,117.62	232,738.47	232,137.58
Net fee and commission income	(44,554.82)	66,734.78	68,115.06
Other (not specified above) operating income (net)	593,807	20,782	15,094
Gross income	1,339,070.83	1,515,978.42	1,554,471.88
Administration costs	104,609.56	109,924.56	104,535.00
Depreciation	23,634.71	23,597.71	21,845.17
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	116 876	111,419.37	89,982.58
Profit (loss) before tax	(30,564.68)	75,313.71	89,133.77
Net profit (loss)	(39,029.11)	61,832.93	69,326.69

Total own funds in 2017 (in EUR)

Type of financial institution	Total oun funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	1,183,021	1,174,949	959,959	214,990	
Cooperative banks					
Banking sector, total:					

(* - for Basel I; ** - for Basel II; *** - for Basel III))

2017 DEVELOPMENTS IN THE AUSTRIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

Austria's economy grew by 3% in 2017 and will sustain its strong pace of growth at least until mid-2018, benefiting from the strong international economy and robust domestic demand. The expansion of the Austrian economy is broad-based. Overall household consumption increased by 1.5% against 2016. The need for expansion investments, particularly investment in machinery, remains high (+9% in 2017). This reflects the optimistic sentiment of businesses and thereby points to a continuation of the favorable economic developments in the first half of 2018. In 2017, Austrian exporters benefited from robust external conditions. The healthy growth of exports has also been a major stimulus to the domestic manufacturing industry. For the full year 2017, industrial production went up by 7%. Such buoyant industrial activity is typical of boom periods. Similarly steep growth rates were recorded in 2000, 2006–2007 and 2010–2011.

Modest productivity growth and low inflation in 2016 prompted relatively moderate wage settlements for 2017. Negotiated wages went up by 1.5% in 2017 – an increase that was lower than the HICP inflation rate of 2.2%. Wage growth is expected to accelerate significantly in 2018 in view of the economic boom. At the same time, employment has been growing particularly fast. In 2017, Austria's unemployment rate (national definition) decreased by 0.6 percentage points to 8.5% year on year.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

Ten years after the collapse of the US investment bank Lehman Brothers in 2008 and the ensuing height of the global financial crisis, the Austrian banking sector recorded its highest consolidated post-crisis profitability, both in absolute and relative terms. Austrian banks earned EUR 6.6 billion in 2017, which is nearly one third more than in the previous year.

Analyzing the aggregated profit and loss statement in more detail, operating income was only slightly higher than in 2016, as net interest income (NII) was flat and fees and commissions income (FCI) expanded by 5% year on year. These growth rates prolonged a multi-year trend in earnings' generation, where the importance of FCI continues to slowly expand at the expense of NII, which primarily reflects the fall in the net interest margin since 2015 as a consequence of the low interest rate environment. The interest margin of Austrian banks' consolidated operations stood at 1.5% in 2017, unchanged from 2016. On the cost side, both staff and administrative expenses fell in 2017 and combined with a strong fall in other operating expenses, this led to a noticeable reduction in operating expenses year on year. These positive cost-income trends improved the cost-income ratio (CIR) of the Austrian banking sector by 10 percentage points (to a still-elevated 65%) and lifted the operating profit to EUR 8.1 billion. Credit risk costs remained low, as the macroeconomic backdrop continues to be highly supportive and NPLs are being tackled, which lent further support to the strong profitability of Austrian banks in 2017.

Austrian banks have further reduced their total NPLs as of end-2017. Nearly two thirds of total NPLs were claims against nonfinancial corporates and approximately one third claims against households. The respective consolidated NPL ratio of the Austrian banking system came to 3.4%, while it stood at 2.5% for the domestic business.

In 2017, Austrian banks increased their CET1-capital by more than 4% to EUR 68 billion, which corresponds to 15.1% of their total consolidated risk-weighted assets. Despite profits at a post-crisis high and the substantially reduced banking levy, this slight improvement means a clear loss in momentum compared to previous years.

The measures taken by the Austrian supervisory authorities to curb foreign currency lending still have a positive impact, as the outstanding volume of foreign currency loans to domestic nonfinancial borrowers continued its downward trend in 2017. Just in the past year alone, it declined by 18.6% on an exchange rate adjusted basis.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN AUSTRIA

The FMA is an independent, autonomous and **integrated supervisory authority** for the Austrian financial market, established as an institution under public law. It is responsible for supervising credit institutions (together with the European Central Bank – ECB), payment institutions, deposit guarantee schemes, insurance undertakings, pension companies, corporate provision funds, investment funds, licensed investment service providers, credit rating agencies and stock exchanges, as well as for prospectus supervision. The FMA is also responsible for monitoring trading in listed securities to ensure that this is carried out properly and for monitoring issuers' compliance with information and organization obligations. Further tasks include combating the unauthorised provision of financial services and taking preventive action against money laundering and terrorist financing. Thus, in its capacity as a cross-sectoral integrated supervisory body, the FMA is responsible for addressing the challenges created by a high degree of interweaving within the Austrian financial market due to ownership structures, sales cooperation agreements and financial transactions. The legal framework in terms of banking supervision still comprises the Austrian Banking Act (Bankwesengesetz – BWG) as well as the Bank Recovery and Resolution Act (Bundesgesetz über die Sanierung und Abwicklung von Banken – BaSAG), transposing the European Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Schemes and Investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz – ESAEG). With effect from 1. January 2015, the FMA also holds the function of the National Resolution Authority (NRA) for banks and forms part of the **Single Resolution Mechanism (SRM)**. The main responsibilities of the NRA are resolution planning, the analysis and elimination of obstacles to resolution, and the conducting of resolution procedures in cases of credit institutions that have failed or are likely to fail. As the NRA for Austria, the FMA is an integral part of the SRM. Lastly, the FMA is the National Designated Authority (NDA) for all **macro-prudential tasks and responsibilities**. With the **Single Supervisory Mechanism (SSM)** in place, banks in the participating Member States are now supervised by means of a decentralized system involving close cooperation between the ECB and the National Supervisory Authorities (NCAs). The FMA is the NCA in Austria. Since the SSM was launched on 4. November 2014, eight Austrian banking groups in total have been classified as "significant institutions" (SIs), resulting in around 150 individual credit institutions being placed under the direct supervision of the ECB. At the end of 2017, there were still seven SI banking groups. SI supervision takes place in so-called Joint Supervisory Teams (JSTs), consisting of the relevant NCAs and chaired by the ECB. The remaining credit institutions based in Austria, classed as "less significant institutions" (LSIs) continue to be supervised directly by the FMA. This means that the FMA remains directly responsible for around 530 of Austria's credit institutions. For its part, the ECB only carries out indirect supervision in this regard. When supervising the LSIs, the FMA also bases its approach on the rules applicable throughout the SSM. In case of common procedures (granting and withdrawal of authorisations, qualifying holdings procedures), the decision-making competence for both SIs and LSIs lies exclusively within the ECB. However, the FMA is the entry point for notifications and prepares draft decisions for the ECB.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

The banking supervision department of the FMA has set the following strategic objectives for the year 2017:

- The principle of proportionality is applied to an adequate extent in the execution of banking supervision activities.
- Banks' business models are closely analysed against the background of the sustained low interest rate phase and - taking into account developments at European level - are addressed by means of suitable microprudential and macroprudential supervisory measures and any need for action with regard to legislation is pointed out.
- FMA interests are represented in international banking supervision committees based on clear thematic focuses and agreed positions.
- The effect of the supervisory work performed by banking supervision is made more apparent using structured information to link facts and figures and then clearly communicated externally.
- The Banking Supervision Department is up to speed with supervisory aspects of IT and digitalisation in the banking sector, and contributes towards forming a supervisory opinion both within the FMA and within the European supervision community.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Licensing process

The granting of licences to institutions subject to the Capital Requirements Regulation (CRR) now falls exclusively within the competence of the ECB. These CRR institutions are SIs or LSIs that are licensed to receive funds from the public and also to issue loans. Although it is the ECB that makes the final decision on whether to award a banking licence, applications for the process to be initiated must still be submitted to the FMA. One new licence pursuant to the ZaDiG was granted in 2017. There was also one licence extension. Overall, five licences awarded in accordance with Articles 6 and 7 BWG as well as Article 162 (3) BaSAG were declared lapsed, were revoked or relinquished during the reporting year. In the period under review, 135 credit institutions and 183 payment institutions from other Member States provided notification of taking up activities in Austria (passive notification). A total of 108 Austrian credit institutions provided notification via the FMA to the supervisory authorities in other Member States of their plans to make use of the freedom of establishment or the freedom to provide services (active notification). These figures include new notifications and changes to existing notifications in 2017.

Ownership provisions and approvals

Qualifying holdings exist where a party acquires more than 10% of the capital or the voting rights in a credit institution or payment institution. Any person intending to acquire such holdings or to increase an existing holding such that the thresholds of 20%, 30% or 50% of the capital or the voting rights will be exceeded must notify the FMA. This obligation to notify the FMA also applies to persons acting jointly who, when considered together, would be acquiring a qualifying holding or reaching one of the thresholds. Conversely, the same procedure applies in the event of holdings being sold and the total falling below such a threshold.

A transaction of this type may be prohibited by the FMA within 60 working days. This applies for instance where the new owners do not meet the requirements set in the interests of sound and prudent management of a credit institution. This is specified in Article 20 para. 2 in conjunction with Article 20b BWG.

A total of nine notifications of a planned acquisition of holdings in an Austrian credit institution or payment institution were submitted to the FMA in 2017. All of these resulted in the acquisition not being prohibited, with the ECB being the responsible authority for owner control procedures in the context of the common procedures and

thus also the body that issues the decision not to prohibit the acquisition.

In addition, the FMA approved 37 mergers of credit institutions during the reporting period (no demergers).

Sources of information for supervision purposes

Banking supervision in Austria is based on a system of control bodies at different levels. The first level involves the credit institution itself, and its internal control system. Here, the managing directors, the internal audit unit and the supervisory board function as an internal control body. The second level of control is that performed by the external bank auditors. It is only beyond this level that state supervision applies, performed by the FMA in the capacity of competent authority and the Oesterreichische Nationalbank (OeNB) as its partner responsible for data collection, analysis and on-site inspections. In keeping with the hierarchy of this supervisory structure, the primary and most important source of information for supervision purposes are the credit institutions themselves.

The reports from CRR institutions provide an overview on whether the credit institution is complying with essential provisions of supervisory law, particularly with regard to own funds requirements and the limits on large exposures. Further details such as information on any foreign currency risks, any real estate losses, etc. must also be reported.

In addition to the standardised and regular forms of reporting, certain events and developments must also be reported to the FMA. In 2017 the FMA received notification of a change in managing director in a total of 168 cases, with changes to the supervisory board chairperson being notified in 75 cases. In each of these cases, the competent authority (either the FMA or the ECB) is required to verify that the individual holding the new position is personally and professionally qualified (fit and proper) to meet the responsibilities. Apart from the information received as a result of reporting and notification obligations, the FMA may also actively request information at any time from the supervised credit institutions and payment institutions and inspect their business documents pursuant to Article 70 para. 1 no. 1 BWG or Article 63 para. 2 no. 2 ZaDiG as applicable. There were 310 instances of information being obtained or of documentation being inspected in this context in 2017.

In accordance with Article 70 para. 1 no. 2 BWG, the FMA may also request additional information from the respective institutions' bank auditors, auditing associations, protection schemes and government commissioners. The FMA issued seven such requests for information in 2017. Regular structured talks with the management of the credit institutions represent a valuable source of supplementary information. Management talks held at major banks according to a set schedule play a significant role in routine analysis. One of the purposes of the meetings is to maintain contact with the management of credit institutions and to examine in greater detail their risk assessment and strategy. Depending on the issue being focused on, a distinction is made in this context between management talks and risk talks. During the period under review, 107 such talks were held in total.

Supervisory procedures

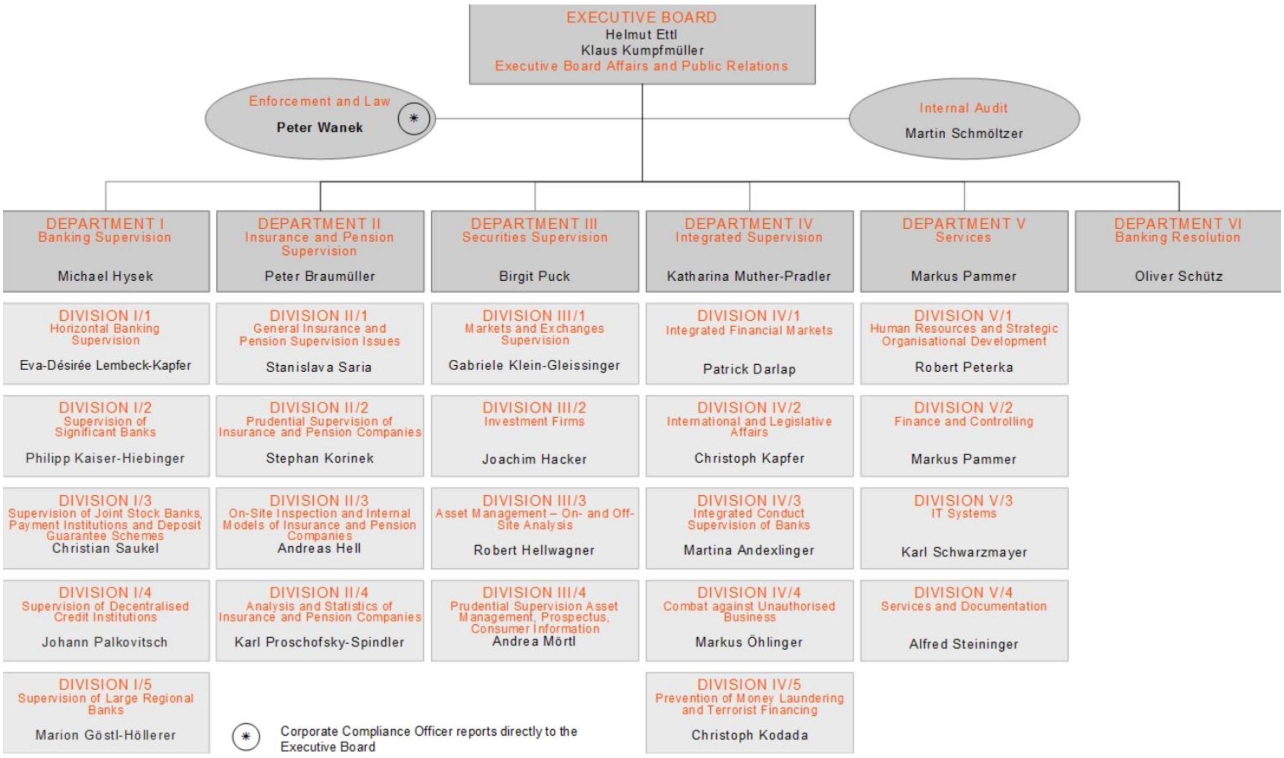
The relevant statutory provisions in regard of supervisory procedures are Articles 70 et seq. BWG and Article 64 ZaDiG. If there is a risk of a credit institution or payment institution being unable to fulfil its obligations to creditors and customers, pursuant to Article 70 para. 2 BWG the FMA may prohibit distributions of capital or profits, appoint a government commissioner, relieve directors of their duties or prohibit the further pursuit of business activities. The FMA did not order any such measures in 2017.

One official power held by the FMA that is particularly relevant in practice is that specified in Article 70 para. 4 BWG. In cases where a licensing requirement is no longer met or where a credit institution violates provisions of the BWG or another specific law, the FMA may introduce various measures. Firstly, the credit institution will be issued with a request to restore compliance with the statutory provisions or be subject to a coercive penalty. Should the institution fail to comply with this request, the FMA is required to completely or partially prohibit the directors from managing the business, except where such would be an inappropriate measure given the type and severity of the breach and it is expected that renewed imposition of the first measure will result in compliance with the statutory provisions. In such a case, the FMA is required to enforce the threatened coercive penalty and to re-issue the request under threat of a more severe penalty. If these measures are not sufficient to guarantee the ability of the credit institution to function, its licence is to be revoked as a last resort. On four occasions during the period under review, the FMA ordered credit institutions, under threat of a coercive penalty, to establish compliance with statutory provisions within an appropriate period of time. The orders were issued in the form of administrative decisions. Further supervisory measures are contained in Article 70 paras. 4a to 4c BWG. These serve as a means of effectively addressing any risk situations. For example, where the risks arising from banking transactions and banking operations for a credit institution, affiliation of credit institutions or group of credit institutions are inadequately limited, and where such risks are not expected to become limited in the short term, the FMA must, irrespective of any other measures, impose a minimum capital requirement that is higher than the statutory minimum capital requirement (capital add-on measure). Such a capital add-on was prescribed 25 times during the year under review.

Consolidated supervision and colleges

While collaborating in international organisations, in some cases in a leading capacity, the FMA is strongly concerned with maintaining bilateral and multilateral relations with other supervisory authorities. In line with the activities of Austrian credit institutions, the Central, Eastern and South-Eastern European (CESEE) region is a focus of such contacts. Colleges of supervisors are a key instrument for the consolidated supervision of cross-border credit institutions. These colleges are where joint decisions are taken during model approval procedures, while also serving as a forum for discussing issues related to ongoing supervision in the context of overall risk management. The members of the college, specifically the home supervisor and all host supervisors, must arrive at a "joint risk assessment" for the particular group of credit institutions every year. Based on this assessment, a joint decision is made regarding capital adequacy. This is referred to as the Joint Risk Assessment and Decision Process (JRAD process). Based on this decision, the members of the college annually stipulate a supervisory action plan, defining the further procedures of the supervisory authorities in the case of the particular banking group. Colleges within the SSM are carried out by the JSTs. Five such JRAD decisions were issued during the reporting year pursuant to Article 77c BWG.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY.



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

1) The FMA is part of the European cooperation within the European System of Financial Supervision (ESFS) and contributes actively to the activities of the European Banking Authority (EBA).
2) The FMA is the National Competent Authority for Austria within the Single Supervisory Mechanism (SSM) and National Resolution Authority within the Single Resolution Mechanism (SRM).
3) The FMA attends the Integrated Financial Supervisors Conference (IFSC) on a regular basis as well as meetings of the Basel Consultative Group (BCG), a subgroup of the BCBS.

COOPERATION WITH OTHER SUPERVISORY BODIES IN AUSTRIA

In handling official activities related to supervision, the FMA must, as far as possible, draw on analyses and inspection results as well as the results of the expert opinions prepared by the *Oesterreichische Nationalbank* (OeNB) during model approval procedures, in addition to using information from third parties or from the respective bank. The collaborative setup calls for intensive, timely coordination between the two institutions. This reconciliation process is supported by a database, the joint information system. Various reporting data, relevant information available from the FMA's supervisory activities as well as data and results of OeNB analyses are filed in this database. This close cooperation continues within the framework of the SSM and the SRM. In line with the macro-prudential measures set out in the CRD IV the Financial Market Stability Board (*Finanzmarktstabilitätsgremium*) has been established. Its main tasks are to promote financial market stability, reduce the systemic threat and lower the systemic and procyclical risks. It consists of representatives of the Federal Ministry of Finance, the FMA, the OeNB as well as the Fiscal Council. In accordance with the European Systemic Risk Board (ESRB) warnings and recommendations, the Financial Market Stability Board should act on a possible threatening of the Austrian financial stability amongst others with warnings and recommendations.

STATISTICAL TABLES

Number of financial institutions (head offices/branches) (at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	180	176	169
Branches of foreign credit institutions	30	28	26
Cooperative banks	529	468	433
Banking sector, total:	739	672	628

Source: OeNB, unconsolidated data.

Ownership structure of the financial institutions on the basis of registered capital (%) (at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	7.8	7.5	4.8
Other domestic ownership	67.4	66.3	69.2
Domestic ownership total	75.2	73.8	74.0
Foreign ownership	24.8	26.2	26.0
Banking sector, total:	**100.0**	**100.0**	**100.0**

Source: OeNB, unconsolidated data.

Concentration of asset by the type of financial institutions (at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	40	48	695
Branches of foreign credit institutions	62	73	1,813
Cooperative banks	40	47	647
Banking sector, total:	26	35	350

Source: OeNB, unconsolidated data.

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	7.5	9.4	7.3
Cooperative banks	3.7	3.9	7.7
Banking sector, total:	6.0	6.9	7.5

Source: OeNB, unconsolidated data.

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	63.2	63.1	62.2
Branches of foreign credit institutions	1.7	2.0	2.7
Cooperative banks	34.8	34.9	35.2
Banking sector, total:	100.0	100.0	100.0

Source: OeNB, unconsolidated data.

The structure of assets and liabilities of the banking system (%)
(at year-end)

Assets	2015	2016	2017
Financial sector	n.a.*	n.a.	n.a.
Nonfinancial sector			
Government sector			
Other			
Liabilities	**2015**	**2016**	**2017**
Financial sector	n.a.*	n.a.	n.a.
Nonfinancial sector			
Government sector			
Capital			
Other			

* a breakdown of the whole balance sheet into these categories is not possible because this structure is only given for loans and deposits

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks ***	16.4***	18.5***	18.7***
Cooperative banks ***	16.2***	17.9***	18.1***
Banking sector, total:	16.3***	18.2***	18.4***

Source: OeNB, unconsolidated data.
(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector	4.5%	3.6%	2.8%
- households	3.5%	3.1%	2.7%
- corporate	6.0%	4.7%	4.0%

Source: OeNB, unconsolidated data; NPL of domestic business.

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	70.1	45.8
Corporate	18.4	41.9
Government sector	5.8	7.2
Financial sector (excluding banks)	5.6	5.1
Total	**100.0**	**100.0**

Source: OeNB, unconsolidated data; only domestic business

P&L account of the banking sector (at year-ends)

P&L account	2015	2016	2017
Interest income	17.3	15.4	13.8
Interest expenses	8.4	6.9	5.6
Net interest income	9.0	8.5	8.2
Net fee and commission income	4.4	3.9	4.4
Other (not specified above) operating income (net)	7.4	6.6	6.9
Gross income	20.8	19.0	19.5
Administration costs	11.5	11.4	10.7
Depreciation	0.9	1.0	0.9
Provisions	2.1	0.1	0.9
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	n.a.	n.a.	n.a.
Profit (loss) before tax	4.8	5.1	5.7
Net profit (loss)	3.7	4.4	4.9

Source: OeNB, unconsolidated data in EUR bn.

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds (for CAR)	Tier 1	Tier 2	Tier 2	~~Tier 3~~
Commercial banks ***	47.5***	39.0***	39.8***	7.9***	n.a.
Cooperative banks ***	35.7***	29.1***	29.8***	5.6***	n.a.
Banking sector, total: * **	83.2***	68.1***	69.6***	13.5***	n.a.

Source: OeNB, consolidated data in EUR bn.
(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF BELARUS

MACROECONOMIC ENVIRONMENT

In 2017, the economy of the Republic of Belarus was functioning under the conditions of recovering external economic environment. The volume of GDP amounted in 2017 to BYN105.2 billion and increased in comparable prices versus 2016 by 2.4% (in 2016, a decrease by 2.6%).

As of January 1, 2018, the banks' assets (liabilities)/GDP ratio totaled 63.3% (68.3% as of January 1, 2017). Regulatory capital/GDP ratio stood at 9.4% as of January 1, 2018.

DEVELOPMENT OF THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

As of January 1, 2018, the banking sector of the Republic of Belarus comprised 24 banks and 3 non-bank financial institutions. 4 banks underwent liquidation.

The total number of banks' organizational units (branches, bank services centers, settlement and cash centers, and exchange offices) in the territory of the country dropped by 0.8% in 2017, amounting to 3,652 as of January 1, 2018. Foreign banks ran 5 representative offices in the territory of the country.

Foreign capital participated in the authorized capital of 19 banks. The share of foreign investors in the authorized capital exceeded 50% in fourteen of them and accounted for 100% in four of those.

As of January 1, 2018, the share of foreign investments in the total volume of registered authorized capital of Belarusian banks stood at 15.9%. As of January 1, 2018, the state share in the banks' authorized capital was 81.4% of the banking sector's aggregate authorized capital.

The total registered charter capital as of January 1, 2018 amounted to BYN5.2 billion, an increase by 9.8% in 2017.

In 2017, the National Bank of the Republic of Belarus carried out work aimed at improving the efficiency of the banking sector and ensuring its sustainability, as well as expanding the interaction between the banking sector and the real sector of the economy.

As of January 1, 2018, banks' regulatory capital totaled BYN9.9 billion, a 12.7% increase in nominal term over 2017. The banking sector's capital was concentrated in five core banks – 72.4%.

In 2017, assets (liabilities) of banks increased by BYN2.2 billion, or 3.4%, and as of January 1, 2018 reached BYN66.7 billion.

The profit received by banks in 2017 amounted to BYN886.7 million3 (in 2016 – BYN884.9 million). Such insignificant increase in the profit of operating banks is mainly due to the fact that in 2017 the banks continued to form special

[3] Data before confirmation by audit organizations.

reserves to cover possible losses on assets subject to credit risk and operations not reflected in the balance sheet (hereinafter – "special reserves").

The banking sector's return on assets totaled 1.4% (1.3% as of January 1, 2017); the return on regulatory capital was 9.55 % (10.8 % as of January 1, 2017).

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS

Throughout 2017, the work on improving the regulatory legal framework in the area of banking supervision and bringing it into line with international standards and practical experience continued.

As part of the implementation of the new Basel III capital, leverage and liquidity standards, as prudential requirements for the banks of the Republic of Belarus, liquidity ratios were set as secure functioning requirements with establishing minimum values of liquidity coverage (LCR) and net stable funding (NSFR) in the amount of 100 percent, as well as the requirements for reporting on implementation thereof and analytical information on the instruments of liquidity risk monitoring since January 1, 2018. In addition to Basel standard on the calculation of foreign currency LCR with a breakdown by significant foreign currencies, a requirement to the calculation of this indicator in the aggregate for all types of foreign exchange was specified with a view to improving foreign currency liquidity management.

Moreover, since January 1, 2018, a countercyclical buffer and a buffer of systemic significance, serving as supplements to the value of the Tier I regulatory capital ratio, as well as the procedures for classifying banks as systemically important with regard to taking measures to limit their risks, the growth of which may lead to the disruption of the banking sector's sustainable functioning, were introduced.

The National Bank's decision to classify banks and non-bank financial institutions as systemically important is based on an aggregated annual assessment of four indicators: the scope of the banks' activities, its interrelation with the resident banks, importance to the economy, and interrelation with non-residents. In the course of determining a bank as systemically important, based on the assessment results it refers to the group of systemic importance I or II with the subsequent use of a buffer of systemic significance in the amount of 1.5 or 1 percentage point, respectively. The value of the countercyclical capital buffer is established in line with resolution of the Board of the National Bank in the range from 0 to 2.5 percentage points.

For the purpose of stimulating the reduction in the foreign currency component in the Belarusian banks' assets and the foreign exchange risk accepted thereby, as well as the consistent implementation of the International Monetary Fund's recommendations, the approaches to assessing the adequacy of foreign exchange earnings for timely and full repayment of debt in foreign exchange were adjusted based on the results of the Financial Sector Assessment Program of the Republic of Belarus.

In the process of calculating a bank's regulatory capital adequacy, a higher level of risk under credit indebtedness and securities of systemically important borrowers (legal persons – the largest debtors of the banks of the Republic of

Belarus (except for the general government, the National Bank, banks, non-bank financial institutions, the Development Bank), which are assigned to credit risk group VIII with a risk level of 150%, was envisaged.

With a view to increasing the efficiency of corporate governance in banks, as well as further implementing international standards in the field of corporate governance and organizing risk management systems and internal control, minimum requirements for organizing a system of fees and compensation in banks, the Development Bank and non-bank financial institutions were established.

The second stage of a diagnostic study initiated by the National Bank for assessing the quality of Belarusian banks' assets (AQR), involving 15 banks that did not participate in the first phase of the study in 2016, was carried out. Based on the survey results, taking into account the aggregate share of assets of banks involved in the procedure, the adjustments based on the AQR results do not have a significant impact on the stability of the whole banking sector.

In 2017, as part of the improvement of the system for preventing the legalization of proceeds from crime, financing terrorist activities and financing the proliferation of weapons of mass destruction (hereinafter –"preventing the legalization of proceeds from crime"), the work on the implementation of FATF international standards[4] in the legislation of the Republic of Belarus was continued. Thus, the requirements for banks, non-bank financial institutions, and the Development Bank to submit reports on financial transactions subject to special control, which are used to remotely monitor the banks' activities in terms of their compliance with the legislation on preventing the legalization of proceeds from crime, analysis of the banks' involvement in conducting suspicious financial transactions and the selection of an object for conducting on-site inspections, were established.

LEGAL FRAMEWORK FOR ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In the Republic of Belarus, there is a system of banking supervision, which generally meets the world standards. It includes:

- registration and licensing of banks and non-bank financial institutions (banks);
- off-site supervision of banks and the JSC "Development Bank of the Republic of Belarus" (Development Bank) on the basis of reporting, on-site supervision in the form of inspections;
- application of appropriate supervisory response measures to banks and the Development Bank in case of violation of banking legislation thereby and deterioration of their financial condition;
- reorganization and liquidation of banks;
- systemic analysis of the banking sector's risks;
- regulation and control in the sphere of preventing the legalization of proceeds from crime, financing terrorist activities and financing the proliferation of weapons of mass destruction, and exercise foreign exchange control.

[4] FATF - Financial Action Task Force on Money Laundering is an intergovernmental organization that sets standards and develops policies to combat money laundering and financing of terrorism.

The National Bank is the banking supervision authority.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

In 2017, the activities of the National Bank in the framework of conducting off-site supervision of banks (banking holdings), non-bank financial institutions and the Development Bank were aimed at ensuring their sustainable and secure functioning, protecting the interests of depositors and other creditors, including by taking timely supervisory response measures, minimizing risks accepted by banks and increasing the efficiency of their activities, as well as preventing the bankruptcy of the banking sector's participants.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In the year under review, monitoring of banks' compliance with secure functioning requirements and other prudential norms was carried out, as well as the banks' financial stability was assessed on an ongoing basis. Measures to reduce problem assets and increase the share of coverage of assets exposed to credit risk with special reserves were taken in respect of separate banks.

In order to avoid negative trends, eliminate or prevent situations threatening the interests of depositors and other creditors, the activities aimed at increasing the banks' capitalization, improving corporate governance, preventing the execution of the non-core activities by banks, reducing the share of problem assets, eliminating liquidity shortages, and tackling other issues arising in the activities of banks were conducted. In some cases, measures of supervisory response based on a reasoned judgment were applied to the banks as well.

In the framework of the development of risk-oriented methods of banking supervision, attention was paid to the efficiency of risk management, especially credit, foreign exchange and liquidity risks, prospects for the continued operation of banks, as well as the identification of problems at banks at the early stages of their occurrence, including with the use of integrated indicators of the level of main banking risks in relation to banks (risk maps).

With a view to assessing the banks' ability to ensure financial reliability and sustainability in the long term, the work on reviewing strategic plans for the banks' development continued.

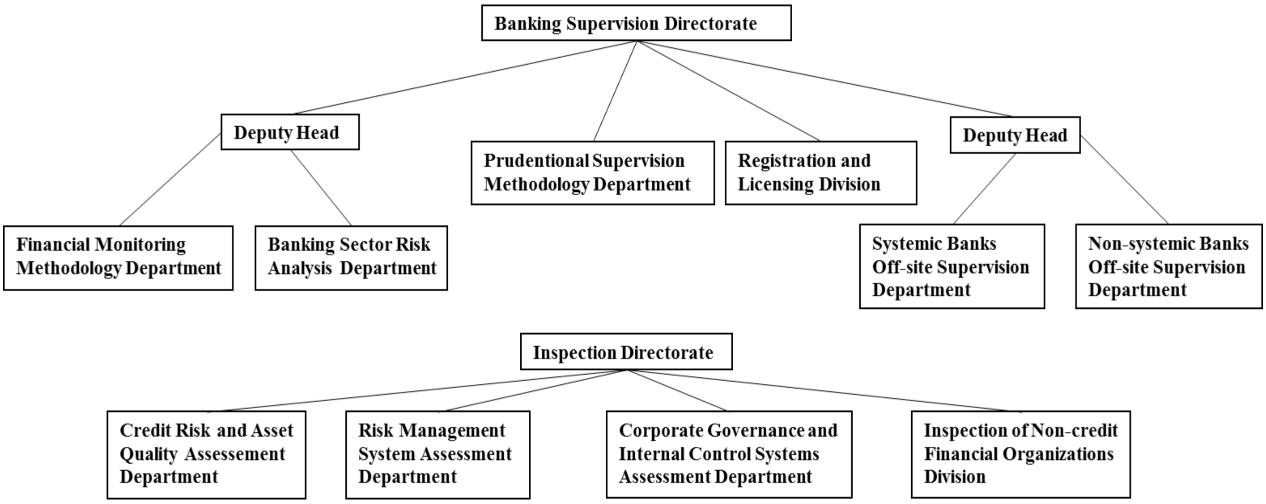
The National Bank issued permits for the participation of banks in the authorized funds of other legal persons, taking into account the assessment of the efficiency and expediency of such investments.

Based on the results of the conducted inspections of banks, the control over the completeness and timeliness of the banks' compliance with the National Bank's recommendations and instructions was exercised.

The practice of constructive interaction of the National Bank with international financial institutions, audit organizations, Association of Belarusian Banks, and supervisory authorities of other countries was continued.

For the purpose of improving the audit quality, as well as given the established practice of applying the legislation norms, meetings with external audit organizations of banks were held, at which the problematic issues of banks' activities and interaction of audit organizations with banks and the National Bank were discussed.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL COOPERATION

As of January 1, 2018, 17 bilateral agreements with foreign banking supervisory authorities were in force. Within the framework of these agreements cooperation in the area of banking supervision of credit institutions, namely, the exchange of information on the state and the development of the banking systems, current national banking legislation, regulations and requirements of banking supervision, all significant changes therein, as well as bilateral meetings, continued. A more close cooperation with those countries in which representative offices of Belarusian banks are located and with the countries the banks of which established subsidiaries and representative offices in the Republic of Belarus continued.

In order to develop bilateral ties in 2017, the meetings of the senior managers of the National Bank and the central (national) banks of neighboring countries, CIS member states, several states of Europe, Asia and the Middle East were held. A Memorandum of Understanding between the National Bank of the Republic of Belarus and the Central Bank of the Russian Federation in the Field of Banking Supervision was signed within the framework of the development of the legal framework for bilateral international cooperation.

COOPERATION WITH THE OTHER SUPERVISORY BODIES IN THE REPUBLIC OF BELARUS

In carrying out banking supervision functions, the National Bank of the Republic of Belarus cooperates on a regular basis with the Ministry of Finance of the Republic of Belarus, Ministry of Internal Affairs of the Republic of Belarus, General Prosecutor's Office of the Republic of Belarus, State Control Committee of the Republic of Belarus, State Customs Committee of the Republic of Belarus, financial intelligence units, and tax authorities.

OTHER INFORMATION

More detailed information about the development of the banking sector and banking supervision in the Republic of Belarus is available on the official website of the National Bank of the Republic of Belarus (*http://www.nbrb.by/engl/*).

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	26	24	24
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total	**26**	**24**	**24**

Ownership structure of the financial institutions
on the basis of registered capital (%)
(at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	65.7	66.7	65.2
Other domestic ownership	2.0	2.6	2.9
Domestic ownership total	67.7	69.3	68.1
Foreign ownership	32.3	30.7	31.9
Banking sector, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions
(at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	64.0	76.9	0.22
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**64.0**	**76.9**	**0.22**

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	8.38	10.78	9.55
Cooperative banks	-	-	-
Banking sector, total:	**8.38**	**10.78**	**9.55**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

	2015	2016	2017
Claims from	**100.0**	**100.0**	**100.0**
Financial sector	2.7	2.1	2.6
Nonfinancial sector	66.0	62.5	64.9
Government sector	23.7	26.8	25.0
Other assets, including	7.6	8.7	7.5
- non-resident	5.2	6.1	4.8
Claims due to	**100.0**	**100.0**	**100.0**
Financial sector	2.7	2.7	2.6
Nonfinancial sector	50.3	50.5	56.4
Government sector	10.8	10.5	8.2
Other liabilities, including	36.2	36.3	32.8
- non-resident	18.9	17.7	13.1
Capital	12.7	13.4	14.4

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks	18.7%**	18.6%***	18.5%***
Cooperative banks	-	-	-
Banking sector, total:	**18.7%****	**18.6%*****	**18.5%*****

(* - for Basel I; ** - for Basel II *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector	7.60%	14.72%	14.54%
- households	1.01%	0.79%	0.53%
- corporate	9.11%	18.30%	18.91%

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	85.0	55.8
Households	57.8	23.3
Corporate	27.2	32.5
Government sector	11.2	40.3
Financial sector (excluding banks)	3.8	3.9
Total	**100.0**	**100.0**

P&L account of the banking sector[5] (in EUR)
(at year-ends)

P&L account	2015	2016	2017
Interest income	3,305.3	3,378.7	2,215.4
Interest expenses	2,295.4	1,856.5	934.0
Net interest income	**1,009.9**	**1,522.2**	**1,281.4**
Net fee and commission income	**433.7**	**415.8**	**400.2**
Other operating income (net)	**823.3**	**1004.3**	**984.9**
Net provision assignments	**800.2**	**692.2**	**496.5**
Net other income	**544.1**	**34.6**	**40.4**
Gross income	9,532.4	12213.7	8,504.7
Profit (loss) before tax	**364.2**	**488.7**	**452.1**
Income tax	75.6	70.4	87.0
Net profit (loss)	**288.6**	**418.2**	**365.1**

[5] Data given the confirmation by audit organizations

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	4,183.4***	3,159.5***	3,160.7***	1,022.7***	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**4,183.4*** **	**3,159.5*** **	**3,160.7*** **	**1,022.7*** **	**-**

(* - for Basel I; ** - for Basel II *** - for Basel III)

2017 DEVELOPMENTS IN THE BANKING SYSTEM OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

MACROECONOMIC ENVIRONMENT

In the third quarter of 2017, real GDP growth, observed annually, amounted to 2.9%[6]. Compared to the same quarter of the previous year, real GDP growth was down by 0.8%. Significant increase in gross value added was recorded in service activities, wholesale and retail trade, the manufacturing industry and financial activities, with the high share of trade and industry in total gross value added mostly affecting overall GDP growth. The long-standing trend of decrease in prices was halted in early 2017, with annual inflation thus amounting to 1.3% at the end of 2017.

Regarding the activities of commercial banks, the recovery of credit growth continued in the last quarter of 2017, as did the trend of increase in deposits. Total loans in the banking sector amounted to KM 18.42 billion at the end of 2017, thus constituting a 1.7% increase on a quarterly basis and a 7.1% increase on an annual basis. The increase in total loans during the fourth quarter of 2017 was the result of an increase in long-term loans, primarily to non-financial companies that had a more intensive increase than retail loans. Total deposits of commercial banks amounted to KM 19.67 billion at the end of the fourth quarter of 2017, thus being up by 10.8% on an annual basis and by 2.8% on a quarterly basis. The increase in deposits was caused primarily by an increase in private sector deposits, with deposits of non-financial companies and retail deposits having made the largest contribution to the increase in total deposits.

The trend of decrease in interest rates on loans to non-financial companies continued. The average weighted interest rates on consumer loans and loans that are in the category of other loans, which are mostly cash loans, continued a slight downward trend during the fourth quarter of 2017 as well, amounting to 5.9% and 6.2%, respectively. The average weighted interest rate on housing loans stagnated at 4.4%.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

As of 31.12.2017, 15 commercial banks operated in the FBiH with 533 organisational units in which 6 655 persons were employed. Positive developments were recorded in the business operations of the banking system in 2017, reflected in the increase in assets, loans and deposits, as well as improvement of the profitability of the overall banking system. In the lending segment, higher lending to private companies than to the retail segment was recorded. The declrease in the share of non-performing loans as a key indicator of loan quality continued. Total deposits and savings deposits, as the most significant and largest segment

[6] Preliminary data of the Central Bank of BH used – Bulletin 4th quarter of 2017

of the deposit and financial potential of banks, continued to increase in 2017. Banks in the FBiH recorded a positive financial result and it is concluded that the banking system of the FBiH is stable, adequately capitalised, liquid and profitable.

Total net assets amount to KM 20.2 billion and are up by KM 1.8 billion or 9.9% compared to the end of 2016. The share of total assets of the banking sector in the FBiH in relation to the projected GDP of the FBiH7 is 0.98.

Loans, with a 65.2% share in the total assets structure, recorded an increase in the amount of 7.4% or KM 909 million and amounted to KM 13.2 billion at the end of the year. In 2017, positive trends in the segment of sectoral lending, i.e. higher lending to private companies than to the retail segment, were recorded. Loans granted to private companies recorded a growth rate in the amount of 9% or KM 539 million, thus reaching the amount of KM 6.3 billion and having a 47.8% share in total loans as of 31.12.2017. Retail loans recorded a growth rate in the amount of 6% or KM 387 million in the same period, while their share decreased slightly from 48.7% to 48.2%. As of 31.12.2017, they amounted to KM 6.4 billion. The share of non-performing loans in total assets decreased compared to the previous year. The larger increase in the loan portfolio, the decrease in the inflow of new non-performing loans, as well as permanent write-offs, had a positive effect on the ratio of the share of non-performing loans in total loans, which decreased from 11.7% at the end of 2016 to 9.7% as of 31.12.2017. The share of non-performing corporate loans in relation to total corporate loans amounted to 11.9%, and the share of non-performing retail loans in relation to total retail loans amounted to 7.3%. Cash funds amount to KM 5.8 billion or 28.7% of total assets and they are up by 11.3% or KM 590 million compared to the end of 2016.

Deposits reached KM 15.8 billion, having recorded an increase in the amount of 11.6% or KM 1.6 billion, and remain the most important source of funding, with a 78.3% share in the total liabilities. Savings deposits, as the most significant and largest segment of the deposit and financial potential of banks, increased by 4.5% or KM 357 million and amounted to KM 8.25 billion.

Total capital as of 31.12.2017 amounts to KM 2.9 billion (share capital KM 1.2 billion), which is up by 5.8% or KM 157 million compared to the end of 2016. The capital adequacy ratio of the banking system, as one of the most important indicators of the strength and adequacy of banks' capital, amounted to 15.5% as of 31.12.2017, which is significantly above the statutory minimum of 12% and represents satisfactory capitalisation of the overall system and a strong basis for preserving its security and stability. The financial leverage ratio at the level of the banking system was 9.6% (prescribed minimum 6%) as of 31.12.2017, as was the case at the end of 2016.

According to the final unaudited data from the income statement, profit in the amount of KM 240 million was recorded at the level of the banking system in the Federation of BiH in 2017, which is up by 39% or KM 67 million compared to the end of 2016.

[7] Federal Statistics Office IV quarter of 2017

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN BOSNIA AND HERZEGOVINA

A) Prudential regulatory framework issued by the FBA (changes in 2017):

In 2017, the FBA carried out significant, extensive and demanding activities in order to improve and develop the regulatory framework for the operations and supervision of the banking system entities of the FBiH. In the process of harmonisation of existing regulations with the new Banking Law (Official Gazette of the FBiH, No. 27/17) and the Law on the Banking Agency of the Federation of BiH (Official Gazette of the FBiH, No. 75/17), the following regulatory framework related to the work of banks in the FBiH was adopted:

- Decision on Calculation of Capital in Banks*
- Decision on Large Exposures in Banks*
- Decision on Interest Rate Risk Management in the Banking Book*
- Decision on Risk Management in Banks*
- Decision on Internal Capital Adequacy Assessment Process in Banks*
- Decision on Liquidity Risk Management in Banks*
- Decision on Disclosure of Bank Data and Information*
- Decision on Control Functions in Banks*
- Decision on External Audit and Content of Audit in Banks*
- Decision on Conditions for Issuance of Procuration in Banks*
- Decision on Purchase and Sale of Bank Investments*
- Decision on Recovery Plans of Bank and Banking Group*
- Decision on Requirements for Consolidated Banking Group*
- Decision on Outsourcing Management in Banks*
- Decision on Exceptions to Bank Secrecy*
- Decision on Records of Banks and Organisational Units of Banks Seated in Republika Srpska or the Brčko District and Representative Offices of Banks Opened in the Federation of Bosnia and Herzegovina*
- Decision on Obligation of Banks to Notify the Banking Agency of the Federation of Bosnia and Herzegovina*
- Decision on Bank Operations with Persons in a Special Relationship with Banks*
- Decision on Uniform Method of Calculation and Reporting of Effective Interest Rate on Loans and Deposits*
- Decision on Conditions in which Banks Are Considered Insolvent*
- Decision on Conscientious Behaviour of Members of Bank Bodies*
- Decision on Remuneration Policy and Practice for Bank Employees*
- Decision of Conditions and Manner of Customer Complaint Management in Banks, Microcredit Organisations and Leasing Companies*
- Decision on Information System Management in Banks*
- Decision on Statement of Assets*
- Decision on Foreign Exchange Risk Management in Banks*
- Decision on Internal Controls System in Banks*
- Decision on Inclusion of Special Conditions for Contracting Long-Term Non-Replacement and Replacement Loans to Natural Persons into Risk

Management System in Banks*
*** Official Gazette of the FBiH, No. 81/17**

- Decision on Conditions and Procedure for Issuing, Refusing to Issue and Revoking Operating Licences**
- Decision on Conditions and Procedure for Issuing and Refusing to Issue Approvals for the Selection or Appointment of Supervisory Board and Management Members of Banks and Revoking Issued Approvals**
- Decision on Conditions and Procedure for Issuing, Refusing to Issue and Revoking Other Approvals for Performing Banking Activities**
- Decision on Assessment of Fulfillment of Requirements for Supervisory Board and Management Members of Banks**
- Decision on Supervision of Banks and Procedures of the Banking Agency of the Federation of Bosnia and Herzegovina**
- Decision on Procedure for Determining Claims and Distribution of Assets and Liabilities in Bank Liquidation**
  ****Official Gazette of the FBiH, No. 90/17**
- Decision on Reports Banks Submit to the Banking Agency of the Federation of Bosnia and Herzegovina (Official Gazette of the FBiH, No. 103/17),
- Instructions for Completing Bank Reports on Regulatory Capital, Credit, Operational and Market Eisk and the Financial Leverage Ratio (No. 01-4914/17 of 22.12.2017)
- Instructions for Completing Reporting Forms for Large Exposures (No. 01-4915/17 of 22.12.2017)
- Instructions for Completing Reporting Forms for Interest Rate Risk in the Banking Book (No. 01-4916/17 of 22.12.2017)
- Guidelines on Reporting to the Banking Agency of the Federation of Bosnia and Herzegovina on Application of the ICAAP in Banks (No. 01-4917/17 of 22.12.2017)
- Instructions on Method of Application of the provisions of the Decision on Liquidity Risk Management in Banks Relating to LCR components (No. 01-4918/17 of 22.12.2017)
- Guidelines for Assessment of Recovery Plans (No. 01-4919/17 of 22.12.2017)
- Instructions for Reporting on Outsourcing Management (No. 01-4920/17 of 22.12.2017)
- Instructions for Calculation of Weighted Nominal and Effective Interest Rate (No. 01-4921/17 of 22.12.2017)
- Instructions for Applying and Drafting of Creditor Reports in Accordance with the Decision of Conditions and Manner of Customer Complaint Management in Banks, Microcredit Organisations and Leasing Companies (No. 01-4922/17 of 22.12.2017)
- Instructions for Reporting on Information System Management (No. 01-4923/17 of 22.12.2017)
- Instructions for Application of the Decision on Foreign Exchange Risk Management in Banks (No. 01-4924/17 of 22.12.2017).

B) <u>Legal competences of the FBA:</u>

The FBA's competences in accordance with the Law on the Banking Agency of the Federation of BiH:

- identifying and performing activities and measures to maintain and strengthen banking system stability,

- establishing, enforcing and supervising a system of rules for secure and prudent operations regulating the work of the banking system entities (banks, banking groups, development banks, microcredit organisations, leasing companies, factoring companies, exchange offices and other financial organisations for which it is prescribed by law that they operate under the supervision of the Agency),
- issuing and revoking licences and other relevant acts to the banking system entities when authorised to do so by special regulations,
- supervising operations of the banking system entities when authorised to do so by special regulations,
- supervising operations of the development bank, ordering supervision measures and other competences under regulation governing operations of the development bank and this Law,
- ordering supervision measures and other competences when authorised to do so by special regulations,
- enacting acts regulating the work of the Agency,
- enacting acts regulating the work of the banking system entities,
- enacting acts, supervising and undertaking the necessary measures relating to anti-money laundering and terrorist activity financing that apply to the banking system entities in cooperation with the competent authorities and institutions in the field of anti-money laundering and terrorist activity financing under regulations governing anti-money laundering and terrorist activity financing,
- enacting acts and performing activities to protect the rights and interests of users of financial services in the banking system, performing supervision of implementation of regulations from this field and undertaking other activities and relevant measures within the framework of its authorities,
- enacting and updating the resolution plan, establishing eligibility for initiation of bank resolution proceedings, conducting resolution proceedings, deciding on tools and measures to undertake in resolution and performing other activities relating to resolution under the law regulating banks.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

The main strategic objectives of the FBA were focused on preserving the stability of the system of the banking system entities and its further progress and development through:

- the continuation of activities aimed at the development of the regulatory framework in accordance with the EU regulatory framework as part of the preparations for BiH's accession to the European Union;
- the planned reorganisation of the FBA and the establishment of an internal organisational unit for carrying out bank resolution activities, the drafting of regulations relating to bank resolution;
- the launch of a SREP preparation and implementation project as a multi-year project to strengthen and improve supervision in accordance with the new regulatory framework, as well as the establishment of a regulatory

framework for the application of IFRS 9 in banks and the improvement of regulatory requirements in terms of asset classification;
- the realisation of the measures from the Reform Agenda and the Economic Reform Programme relating to the banking and financial sector, the continuation of the implementation of the recommendations of the FSAP Mission in order to improve the quality of banking sector supervision, as well as the obligations assumed by the Letter of Intent signed by the governments in BiH as part of the arrangement with the IMF, which are related to the entity banking agencies;
- the continuation of continuous supervision of banks, with a focus on inspections of dominant risk segments of banking operations, supervision of banks primarily of systemic importance for the development of lending activities, in which a large amount of savings and other deposits is concentrated, in order to protect depositors; the continuation of monitoring of bank activities to prevent money laundering and terrorism financing and improvement of cooperation with other supervisory and control institutions. The compliance of banks with laws and regulations as well as applied practices in banks in the segment of protection of users of financial services and guarantors will be monitored. The development and implementation of the „Early Warning System" (EWS) for the purpose of early identification of financial and operational inefficiencies and/or negative trends in bank operations will be continued;
- the further establishment, continuation and improvement of cooperation with supervisory authorities in the country and abroad, international financial and other institutions: the ECB and the EBA regarding the exchange of information in banking supervision, the IMF, the WB, the EBRD, etc.

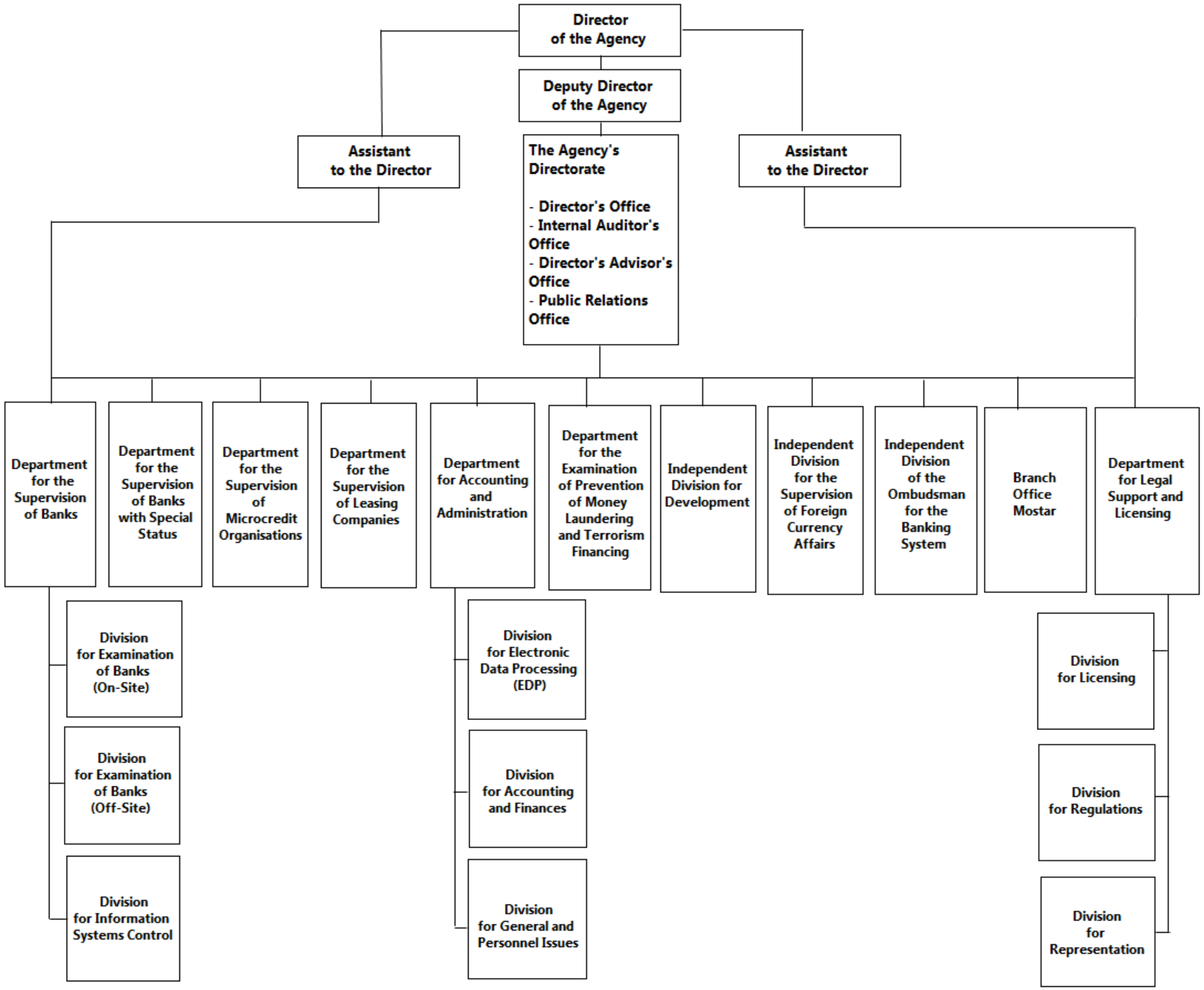
THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In addition to the regular implementation of planned FBA activities, 2017 was marked by significant, demanding and extensive processes related to: the reform of the regulatory framework for business operations and supervision of banks in order to harmonise it with the provisions of the new Banking Law, which entered into force in April 2017 (link item 3 A of the Questionnaire), the establishment of a new framework for bank resolution, the launch of a multi-year project of transition from the existing CAMELS-based supervisory methodology to a completely new supervisory framework – the SREP, the establishment of a new supervisory reporting framework with a gradual transition from existing reporting forms, in order to maintain the continuity of banking supervision and gradually adjust to the new method of assessing the risk profiles of banks, the harmonisation of the Statute of the FBA with the provisions of the new Law on the Banking Agency of the FBiH and the internal regulations of the FBA, as well as the harmonisation of the organisational structure with the new legal regulations regarding autonomy, organisational separation and separate management of tasks of supervising banks and development banks, tasks of bank resolution and other internal organisational units in accordance with the Law on the Banking Agency of the FBiH, the Statute of the FBA and the internal regulations of the FBA. Acts (decisions, instructions and guidelines) drafted as part of the project of implementing the FBA Strategy for the Introduction of Basel III have been finalised and harmonised with the provisions of the new Banking Law and published in the Official Gazette of the FBiH. In the first quarter of 2017, the new convocation of governing and managing bodies in the FBA was appointed, in accordance with the prescribed legal procedure.

FBA activities in the field of banking sector control and regulation in 2017 were aimed at preserving the stability, security, liquidity and adequate capitalisation of the banking sector in the FBiH. In 2017, the third round of the AQR was conducted, which included eight banks from the FBiH (over 70% share in the FBiH banking system),. The aforementioned activities were carried out in accordance with the obligations assumed by the Letter of Intent signed by the Governments of BiH as part of the arrangement with the IMF. The results of the AQR conducted in 2017 showed that the banking sector in the FBiH is adequately capitalised and that the identified individual deficiencies do not have a significant impact on the banking system. In cooperation with the CBBH and the BARS, stress testing for credit risk and impact on capital continued, based on macroeconomic assumptions, as did cooperation on improvement of criteria and establishment of the list of systemically important banks and drafting of the new Methodology for Determination of Systemically Important Banks. The continuous exchange of information within the framework of banking coordination and SCFS was also realised.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

As of 31.12.2017, the FBA had 118 employees. Significant changes in the organisational structure of the FBA took place in February 2018.



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In cooperation with the CBBH and the BARS, the FBA continued its activities to strengthen and enhance international cooperation with international financial institutions, regional and other organisations, as well as bilateral and multilateral cooperation with banking regulators from other countries.

Based on the Memorandum of Understanding with the FMA, a bilateral agreement on cooperation in the field of supervision of the Addiko Group was signed, and FBA representatives participated in the supervisory college of the Addiko Group in January 2017, which was organised by the Austrian supervisory authorities. In June 2017, FBA representatives also took part in the supervisory college of the NLB Group, organised by the ECB and the Bank of Slovenia. In September 2017, the FBA also held bilateral meetings in Sarajevo with representatives of the ECB regarding the supervision of Raiffeisen Bank d.d. Sarajevo and the Raiffeisen Group, after which the FBA was invited to join the supervisory college of the Raiffeisen Group in 2018 as an observer.

Within the framework of bilateral cooperation, the FBA continued its cooperation with the banking regulatory bodies of Slovenia and Austria in 2017 through:

- regular exchange of information with the Bank of Slovenia as part of the supervision of the NLB Group, regular exchange of the Newsletter on a quarterly basis, preparation of annual SREP reports, participation in the supervisory college of the NLB Group in Slovenia;
- regular quarterly exchange of the Newsletter with the FMA, information on banking groups and member banks of groups seated in the FBiH (Raiffeisen, Addiko, Sparkasse and Sberbank), the annual SREP report for Addiko Bank, and participation in supervisory college of the Addiko Group.

In 2017, on the basis of established bilateral cooperation, the FBA also cooperated with the supervisory teams of the ECB, which supervise the Raiffeisen Group, as part of which bilateral meetings were also held in Sarajevo, where issues related to the supervision of the Raiffeisen Group and its member bank in the FBiH were discussed. Significant FBA activities in the field of international cooperation were also related to the organisation of the Regional Conference of Supervisors, held in November 2017 in Sarajevo, attended by supervisors from countries in the region, as well as by representatives of the WB, the IMF and USAID. The conference focused on the supervisory approaches applied by regional supervisors, the situation in the banking sector in the region, the issue of non-performing loans, the application of IFRS 9, etc.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BOSNIA AND HERZEGOVINA

In 2017, cooperation with the competent institutions in BiH continued. Cooperation with the BARS and the Deposit Insurance Agency of BiH continued within the framework of regular exchange of information and joint activities, as well as within the framework of drafting new regulations in the case of the BARS. Continuous exchange of information within the framework of banking coordination and the Standing Committee on Financial Stability (SCFS) was realised. Cooperation with the Banks Association of BiH was realised both in terms of the application of the existing regulatory frameworks and proposals for their amendment and in the process of adoption of a new regulatory framework for banking operations and supervision.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

In 2017, cooperation was also realised as part of the IMF Mission for Technical Assistance, which visited the competent institutions in BiH in the field of strengthening cooperation in banking supervision and preparation for the drafting of a new MoU on financial stability, as well as the development of a new Methodology for Determination of Systemically Important Banks. Also, the World Bank provided significant technical assistance to the supervision in BiH regarding education in the field of consolidated supervision, IFRS, particularly IFRS 9, the drafting of a new regulatory framework, as well as the implementation of the QIS. In late 2017, the SREP project began (methodologies, manual, operating model, etc.), which will be realised as a long-term project with the technical assistance of the World Bank.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	17	15	15
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	17	15	15

Ownership structure of the financial institutions
(at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	2.8	2.8	3.2
Other domestic ownership	6.8	6.4	6.3
Domestic ownership total	9.6	9.2	9.5
Foreign ownership	90.4	90.8	90.5
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions
(at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI*
Commercial banks	55.9	69.1	1 391
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	55.9	69.1	1 391

*Whole percentages are used.

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	5.7	7.6	9.7
Cooperative banks			
Banking sector, total:	5.7	7.7	9.7

*Return on average equity (ROAE).

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	100,0	100,0	100,0
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Other	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking sector (%) (at year-end)

	2015	2016	2017
Claims from			
Financial sector	n/a	n/a	n/a
Nonfinancial sector	n/a	n/a	n/a
Government sector	n/a	n/a	n/a
Other assets	n/a	n/a	n/a
Claims due to			
Financial sector	n/a	n/a	n/a
Nonfinancial sector	n/a	n/a	n/a
Government sector	n/a	n/a	n/a
Other liabilities	n/a	n/a	n/a
Capital	n/a	n/a	n/a

*Breakdown of the total balance sheet not applicable. Loans and deposits structure is given in a table below.

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks	15.1*	15.7*	15.5*
Cooperative banks			
Banking sector, total:	15.1*	15.7*	15.5*

(Please, mark for each item: * - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector*	12.9	11.6	9.7
- households	9.0	8.2	7.3
- corporate	16.8	15.0	12.1

*Share of NPLs (past due 90 days) to total gross loans. Financial and governmentsectors are not included.

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	85.7	97.7
Households	56.8	48.2
Corporate	28.9	49.5
Government sector	9.9	1.9
Financial sector (excluding banks)	4.4	0.4
Total	**100.0**	**100.0**

*Including Non-profit organizations and other sectors.

P&L account of the banking sector (at year-ends)

P&L account	2015	2016	2017
Interest income	766 124	752 156	724 548
Interest expenses	196 630	165 147	149 985
Net interest income	569 494	587 009	604 563
Net fee and commission income	n/a	n/a	n/a
Other (not specified above) operating income (net)	n/a	n/a	n/a
Gross income	917 455	969 238	1 026 103
Administration costs	248 495	243 892	248 113
Depreciation	n/a	n/a	n/a
Provisions	157 747	111 305	112 074
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	n/a	n/a	n/a
Profit (loss) before tax	144 697	202 301	272 461
Net profit (loss)	117 486	173 248	239 973

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	1 186 792*		1 131 646*	156 576*	
Cooperative banks					
Banking sector, total:	1 186 792*		1 131 646*	156 576*	

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE BANKING SYSTEM OF REPUBLIKA SRPSKA OF BOSNIA AND HERZEGOVINA

MACROECONOMIC ENVIRONMENT

A growth in total economic activity in Republika Srpska (hereinafter: the RS) was seen in 2017 at an inter-annual level. Thus, following the 2.7% growth in Q1, the RS GDP grew at 2.8%, 3.3% and 3.1% in Q2, Q3 and Q4, respectively.

Also, in 2017 the RS industrial production grew by 1.4% which was a continuation of the growth from the previous period, although the growth was slower than in 2016. However, besides an increased production, the RS export increased by 21.2% in the observed period, while import registered an increase of 9.7%. Coverage of import with export was 71.6% and it is historically at the highest level.

In 2017, the average net salary in the RS amounted to EUR 424,8 and it is almost the same as in previous year. An inter-annual inflation rate of 0.5% was registered in the period from January to December 2017.

In the following period, further positive trend developments in domestic economy will be to a great extent conditioned by the trends in the neighboring countries and EU, primarily the foreign trade partners of RS and Bosnia and Herzegovina (hereinafter: BiH). According to the IMF's World Economic Outlook,8 economic growth of emerging and developing countries in Europe, including Bosnia and Herzegovina in 2018 is projected to 4.3%, which slightly above the RS Government projections.[9]

DEVELOPMENT IN THE BANKING SECTOR (INCLUDING THE ASSETS TOTAL / GDP)

The banking sector of RS at the end of 2017 consisted of eight banks, out of which six banks were with majority foreign private ownership, while two banks were in majority private domestic ownership.

Taking into account the banking sector results generated in 2017, it can be stated that the banking sector of RS, despite the challenges it encountered in previous years (especially having in mind that two small domestic banks lost their licenses over the last three years), is stable, adequately capitalized, with profitability and liquidity on satisfactory level and able to meet all its obligations in due terms.

Basic indicators of the banking sector operations as of 31/12/2017:

- total balance sheet amounted to EUR 4.2 billion an it is higher by 7% compared to 31/12/2016,

[8] *World Economic Outlook*, IMF, April 2018
[9] *Economic Reforms Program*, Government of Republika Srpska, December 2017

- cash funds (EUR 0.8 billion) accounted to 22% out of total balance sheet assets with an increase rate of 2% when compared to the previous year,
- total gross loans (EUR 2.5 billion) increased by 7% compared to 31/12/2016, mostly due to increase of loans to households and private enterprises,
- share of non-performing loans in the total loan portfolio decreased by 0.9 p.p. in comparison to the end of 2016 (from 12,0% to 11,1% as of 31/12/2017),
- avarage coverage rate of total loans by value udjustments under IAS was 8,4% and it by 1 p.p comapred to 31/12/2016,
- deposits (EUR 2.8 billion), as a basic source of funding bank operations, had a share of 76% out of total bank liabilities and increased by 7% when compared to 2016,
- trend of growth in households' deposits continued also in 2017 and they increased by 10% compared to 2016,
- regulatory capital amounts to EUR 0.4 billion with the regulatory capital rate of 16,2% (legally required minimum is 12%),
- CET 1 amounts to EUR 0.36 billion with the CET 1 ratio of 14,7% (legally required minimum is 6.75%),
- at the level of total banking sector as of 31/12/2017, a net positive financial result was reported in the amount of EUR 49.2 million (as of 31/12/2016, the banking sector reported a net positive financial result of EUR 23.2 million).

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY

Laws adopted concerning financial institutions:

- Law on banks (Official gazette of Republika Srpska no. 04/17),
- The amendments to the Law on Banking Agency of Republika Srpska (Official gazette of Republika Srpska no. 04/17).

The new Law on banks, which is aligned to the extent posisble with EU legal framework was adopted with aim, among others, to strengthen and improve internal governance in banks, capital requirements, liquidity framework, large exposure regime, licensing procedures, consolidated supervision, as well as to introduce resolution.

At the same time, the amendments to the Law on Banking Agency of Republika Srpska were adopted primarily with aim to improve Banking Agency of Republika Srpska (hereinafter: the BARS) legal competences and authorizations and also, among others, to provide BARS with powers of Resolution Authority.

Prudential regulation governing the operations of financial institutions issued by the BARS:

Subsequently, after the adoption of the mentioned laws, the BARS adopted or amended following by–laws:

- Decision on capital calculation,
- Decision on large exposures,
- Decision on risk management,
- Decision on amendments to the bank Decision on credit risk management and assets classification,
- Decision on documenting bank lending activities,
- Decision on inclusion of special conditions for contracting long-term non-purpose and substitute loans to natural persons in the bank risk management system,
- Decision on liquidity risk management,
- Decision on IRRBB management,
- Decision on amendments to the Decision on FX risk management,
- Decision on information system management in banks,
- Decision on ICAAP,
- Decision on bank internal control system,
- Decision on remuneration policy and practice in banks,
- Decision on bank and banking group recovery plans ,
- Decision on form and content of reports banks submit to the Banking Agency of RS,
- Decision on reporting on bank capital adequacy,
- Decision on due-diligence of members of the bank management body,
- Decision on suitability of members of the bank management body,
- Decision on conditions and procedure for issuing licenses, approvals and contents to banks operating in Republika Srpska,
- Decision on outsourcing,
- Decision on publishing bank data and information,

- Decision on conditions for the appointment and task performance of advisor in a bank,
- Decision on conditions for the introduction and execution of provisional administration in a bank,
- Decision on the procedure of determining receivables and allocation of property and determining and executing banks' obligations in the liquidation procedure,
- Decision on performing external audit in banks,
- Decision on minimum standards for bank operations with persons having special relation with a bank,
- Decision on purchase and sale of bank placements,
- Decision on consolidation requirements for a banking group,
- Decision on uniform method of calculating and disclosing the effective interest rate on loans and deposits,
- Decision on conditions for early repayment of natural person loans not intended for their business or other commercial activity,
- Decision on bank register,
- Decision on conditions and manner for realization protection of client rights and bank's acting upon client's complaint,
- Decision on Property Statement of the members of bank management and supervisory board,
- Decision on bank insolvency,
- Decision on the manner of performing supervision of banks and undertaking supervisory measures and
- Decision on the form and content of reports for organizational units of banks from FBiH and Brcko District.

In addition, more then ten additional guidelinces and instructions were adopted with aim to specify in more details requirements from adopted Decisions or reporting requirements.

It is also important to mention that the Resolution unit was established within the BARS in 2017 and more than then by-laws governing the resolution of banks were adopted in beginnig of 2018.

The BARS legal competences

The BARS has a mandate to regulate and supervise banks, microcredit organizations, leasing companies and saving-credit organizations.

Namely, the BARS competencies are as follows:

- identification and implementation of activities and measures in order to safeguard and strengthen the banking system stability, in accordance with the law,
- adoption of regulations governing the operations of banks, microcredit organizations, saving-credit organizations, leasing companies and other financial organizations of the banking system,
- issuance and revocation of bank licenses and other corresponding by-laws in accordance with its competencies, indirect and direct supervision of bank operations, imposing and ordering supervisory measures and other competencies in accordance with the law governing banks,
- issuance and revocation of microcredit organization licenses and other corresponding by-laws in accordance with its competencies, indirect and direct supervision of microcredit organization operations, imposing and

ordering supervisory measures and other competencies in accordance with the law governing microcredit organizations,

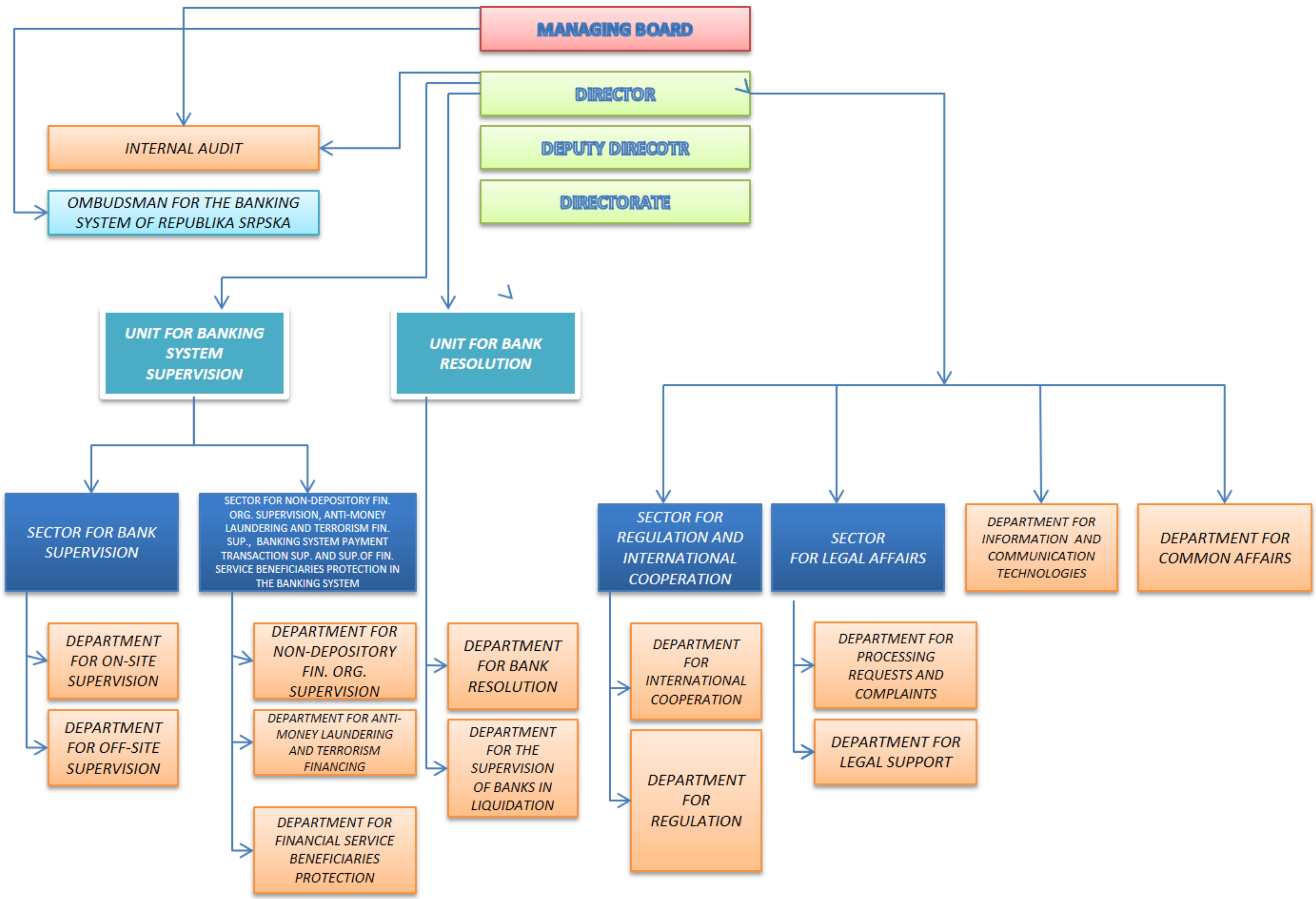
- issuance and revocation of saving-credit organization licenses and other corresponding by-laws in accordance with its competencies, indirect and direct supervision of saving-credit organization operations, imposing and ordering supervisory measures and other competencies in accordance with the law governing saving-credit organizations,
- issuance and revocation of leasing company licenses and other corresponding by-laws in accordance with its competencies, indirect and direct supervision of leasing company operations, imposing and ordering supervisory measures and other competencies in accordance with the law governing leasing companies,
- issuance and revocation of licenses for other financial organizations of the banking system and other corresponding by-laws when it is authorized for the above mentioned by this law or separate laws, indirect and direct supervision of operations of other financial organizations of the banking system, imposing and ordering supervisory measures and other competencies in accordance with this law and separate laws,
- adoption of corresponding legislation, supervision and undertaking of necessary measures regarding the prevention of money laundering and financing of terrorist activities related to banks, microcredit organizations, saving-credit organizations, leasing companies and other financial organizations of the banking system, in cooperation with competent authorities and institutions in the area of prevention of money laundering and financing of terrorist activities, and in accordance with regulations governing the prevention of money laundering and financing of terrorist activities,
- supervision and undertaking of necessary measures in accordance with regulations governing the introduction and implementation of specific interim measures in order to efficiently enforce international restrictive measures,
- adoption of by-laws and performing tasks from the area of protection of rights
- and interests of financial service beneficiaries in the banking system, supervision of implementation of regulations from this area and undertaking of other activities and appropriate measures within its competencies,
- determining the fulfillment of requirements for initiation of bank resolution, conducting the resolution, deciding on instruments and measures to be undertaken in resolution and performing other tasks related to resolution, in accordance with the law governing banks,
- issuance and revocation of consents and approvals for establishing representative offices, supervision of representative office operations, imposing and ordering supervisory measures and other competencies in accordance with the law governing banks,
- imposition of fines and issuance of misdemeanor warrant and other competencies in accordance with this law and other laws.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The BARS main strategic goal is to safeguard and strengthen the banking system stability, as well as to improve its safe, good quality and lawful operations. In that sense, main objectives are:

- continuous supervision of banks and other financial institutions through off- and on-site inspections,
- insistence on capital strengthening,
- enhanced supervision of credit risk, primarily in terms of adequacy of loan loss provisioning and the adequacy of credit risk management,
- detailed reviews of asset quality in banks that had a high rate of credit growth,
- further development and improvement of supervisory practices (implementation of the SREP methodology, supervisory stress testing, etc.),
- monitoring of international and EU banking and accounting standards and further development and improvement of the regulatory framework,
- professional training of staff and strengthening capacity for efficient supervision of banks, and further continuous development of information system,
- active role in supervision and protection of financial services consumers' rights,
- continue adequate monitoring of payment transactions and activities regarding the prevention of money laundering and financing of terrorism, and in this regard improve cooperation with other relevant institutions,
- continue to improve and establish cooperation with banking supervisors, particularly from countries whose banks have shares in banks in Republika Srpska,
- continue and improve cooperation with external auditors,
- actively participate in the work of the Committee for Coordination of the financial sector of Republika Srpska,
- continuation and improvement of cooperation with the Banks Association, the Association of microcredit organizations in BiH and the Association of Leasing Companies,

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

During 2017, the BARS continued with the activities on strengthening and improving the cooperation with international financial institutions, regional and other organizations, as well as bilateral cooperation with regulators from other countries. Apart from attending the meetings, the BARS responded, on a regular basis, to the inquiries, requests for data collection and questionnaires of international institutions and organizations (European Central Bank, European Banking Authority, International Monetary Fund, World Bank, EBRD, BSCEE, etc.).

The BARS submitted reports on progress regarding the implementation of legislation in the banking sector, which the European Commission uses for the needs of regular meetings of sub-committees between Bosnia and Herzegovina and the European Union.

The BARS continued to cooperate with home supervisory authorities through regular contacts and exchange of relevant information, sending SREP analysis and the participation of representatives of the BARS at the supervisory colleges organized by home supervisors.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BOSNIA AND HERZEGOVINA

In 2017, the BARS continued to actively cooperate with the Insurance Agency of Republika Srpska and Securities Commission of Republika Srpska in accordance with the Law on Committee for Coordination of Republika Srpska Financial Sector Supervision.

Also, the BARS participated in the work of the Standing Financial Stability Committee established by the Fiscal Council of Bosnia and Herzegovina, Central Bank of Bosnia and Herzegovina, Deposit Insurance Agency of Bosnia and Herzegovina, Banking Agency of the Federation of Bosnia and Herzegovina and the BARS.

Furthermore, under the signed Memorandum of understanding, intensive bilateral cooperation with the Central Bank of Bosnia and Herzegovina, Banking Agency of the Federation of Bosnia and Herzegovina and Deposit Insurance Agency of Bosnia and Herzegovina was continued in 2017.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

For further information on the BARS supervisory activities and regulations, please visit the BARS website at www.abrs.ba.

STATISTICAL TABLES

**Number of financial institutions
(at year-ends)**

Type of financial institution	2015	2016	2017
Commercial banks	9	8	8
Branches of foreign credit institutions	-	-	
Cooperative banks	-	-	
Banking sector, total:	**9**	**8**	**8**

Ownership structure of the financial institutions on the basis of assets total

Item	2015	2016	2017
Public sector ownership	4.0	0	0
Other domestic ownership	27.1	29.2	30,6
Domestic ownership total	31.1	29.2	30,6
Foreign ownership	68.9	70.8	69,4
Financial institutions, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	66.5	88.0	2,025
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Financial institutions, total	66.5	88.0	2,025

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	-9.8	5.9	10.4
Cooperative banks	-	-	-
Financial institutions, total	-9.8	5.9	10.4

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	100,0	100,0	100,0
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Financial institutions, total	**100.0**	**100.0**	**100.0**

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks	14.2*	16.3*	16.2***
Cooperative banks	-	-	-
Banking sector, total:	14.2*	16.3*	16.2***

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector	15.4	12.0	11.1
- households	11.7	9.7	8.3
- corporate	18.1	13.8	13.4

The structure of deposits and loans in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	83.0	87.6
Households	61.5	44.8
Corporate	21.5	42.8
Government sector	9.8	11.8
Financial sector (excluding banks)	7.2	0.6
Total	**100.0**	**100.0**

P&L account of the banking sector (at year-end)

P&L account	2015	2016	2017
Interest income	168,770	159,495	155,948
Interest expenses	61,568	48,691	40,596
Net interest income	107,202	110,804	115,352
Net fee and commission income	-	-	-
Other (not specified above) operating income (net)	-	-	-
Gross income	172,980	184,770	203,294
Administration costs	119,702	122,748	112,109
Depreciation	-	-	-
Provisions	-	-	-
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	76,848	22,395	22,370
Profit (loss) before tax	-35,430	27,535	54,793
Net profit (loss)	-40,465	23,180	49,179

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2*	Tier 3
Commercial banks***	400,439	363,425	363,425	37,014	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	400,439	363,425	363,425	37,014	-

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE BULGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

Bulgaria's real GDP rose by 3.6% in 2017 (3.9% in 2016). The main contribution to the growth of economic activity had private consumption, while fixed capital formation, government consumption and changes in inventories had a lower positive contribution. Exports of goods and services continued to grow in 2017 in conditions of favourable international environment.

Growth in gross fixed capital formation was due to private investment while government investments continued to decrease, albeit at a lower rate than in 2016.

The labour market continued to improve as an increase in the number of employed in the economy as a whole was observed, a continuing decrease in the unemployment rate and an increase in real wages. Under the influence of these factors and at high levels of confidence indicators of consumers, private consumption accelerated its growth rate to 4.8% in 2017 (3.6% in 2016).

In 2017 government consumption grew by 3.2% in real terms for which a main contribution had wage and salary costs of staff.

Investment in fixed capital increased by 3.8% in real terms in 2017, which was entirely due to private investments.

Gross value added for the economy increased its growth rate to 3.7% in real terms during 2017 (3.4% for 2016). An increase in gross value added was observed in almost all sectors.

Annual inflation in 2017 stood at 1.8% at the end of the year (-0.5% as of December 2016)[10].

As of December 2017, gross external debt decreased by EUR 1481.6 million compared to the end of 2016 and amounted to EUR 32.6 billion (64.3% of GDP). External debt reduction was observed in all sectors excluding banks. Main contribution to the lower gross external debt of the country had the "government" sector.

DEVELOPMENT IN THE BANKING SECTOR (INCLUDING THE ASSETS TOTAL / GDP)

In 2017 banking activity took place observing adequate levels of liquidity and capital positions of the credit institutions. The downward trend in the level of credit risk was maintained as a result of the actions towards improvement of asset quality.

The size and share of non-performing loans decreased, as well as residual (potential) credit risk in the balance sheet of the banking system

In 2017 the assets of the banking system increased by BGN 5.7 billion (6.2%) to BGN 97.8 billion. The ratio of the total banking assets to GDP was 99.1% as of end-2017. During the year there was an increase in deposits, loans and

[10] The analysis uses HICP data

advances and owned securities. Compared to the end of 2016 the market positions of credit institutions with predominantly Bulgarian participation were preserved (23.5%), also these of the subsidiaries and branches of the EU (75.2%) and banks and branches outside the EU (1.3%).

Market structure

At the end of 2017 there were 27 credit institutions and foreign branches, of which one is a state-owned bank. The consolidation process of banks continued during the year with the acquisition from a leading European banking group of one of the major credit institutions. At the end of 2017 the share of assets of the five largest banks represented 55.9% of the balance sheet total of the banking system.

Asset quality

At the end of 2017, the ratio of non-performing exposures, calculated according to the broadest definition of the methodology of the European Banking Authority (EBA) improved to 8.9%.

On an annual basis, the gross amount of non-performing loans and advances decreased. The share of gross non-performing loans and advances to total gross loans and advances decreased by 2.7 percentage points and was 10.2%.

The coverage rate of gross non-performing loans and advances with the impairment inherent for that classification category at the end of 2017 was 49.4%. The net amount of non-performing loans and advances representing the potential credit risk in bank balances[11] remained fully covered by the excess of the capital above the minimum regulatory requirement of 8%.

The quality of the balance sheet assets, other than loans, remained at good level considering the high share of liquid assets.

Profitability

The main indicators for profitability of the banking system at the end of 2017 remained at acceptable levels. Ratios for ROA and ROE slightly decreased in comparison to 2016 and at the end of 2017 amounted to 1.18% and 9.15%, respectively.

Solvency

The levels of capital ratios of the banking system at the end of 2017 were close to the ones reported a year earlier. Credit institutions observed capital buffer requirements (capital conservation buffer – 2.5%, system risk buffer – 3%, and countercyclical capital buffer – 0%).

As a result of the increase in CET1 during the year, the Tier 1 capital and own funds of the banking system grew. Total risk exposure amount increased on an annual basis mainly in risk-weighted exposures for credit risk, but the dynamics did not lead to a substantial change in the structure of total risk exposures.

As at 31 December 2017, the ratios of CET 1, of Tier 1 and of total capital adequacy were 20.41%, 20.86% and 22.08%, respectively. The amount of capital exceeding the minimum requirements of 8% increased and at the end of 2017 stood at BGN 7.3 billion.

The leverage ratio at the end of 2017 (10.68%) continued to show a low level of indebtedness of the banking system[12].

[11] Net non-performing loans and advances are calculated by reducing the gross amount of non-performing loans and advances with the impairment inherent for that classification category.
[12] Binding requirement for the leverage ratio is expected to be introduced in 2019.

Liquidity

In 2017 the liquidity position of the banking system was further strengthened upon the presence of increased deposits attracted mainly from non-financial corporations and households. The liquid assets ratio, calculated according to BNB Ordinance No 11 reached 38.97% (38.24% at the end of 2016).

During the year a certain change in the structure of liquid assets of the credit institutions was observed through which almost half of the liquidity resource of the banking system remained in the form of cash and cash balances with the BNB.

Products and distribution channels

At the end of 2017 there were 43 points of sale (branches, offices, representative offices and remote workstations), 81 ATMs and 1237 POS terminals[13] per 100 000 population.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN BULGARIA

The Banking Supervision Department is one of the three major departments in the Bulgarian National Bank (BNB). Its major objective is to maintain the stability of the banking system and to protect the interests of depositors.

Hence, its main function is to supervise the activities of banks and foreign bank branches in line with the international regulatory framework for credit institutions - Basel III in the European Union introduced by the Capital Directive and the Capital Requirements Regulation. The Capital Requirements Regulation (Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms is directly applicable to Bulgaria as EU member state, while Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms has been transposed into national legislation by the Law on Credit Institutions (LCI). Together with the legal acts for its implementation, the LCI constitutes the national legal framework governing the access to the activity, the supervisory framework and the prudential rules for credit institutions and investment firms. The activity of credit institutions is regulated also by Regulations adopted by the European Parliament and the Council, as well as delegated Regulations of the European Commission which are part from the European legislative framework, directly applicable to Bulgaria. These European legal acts are binding and must be applied in its entirety across the EU countries. Control over their implementation is carried out by the BNB and the EBA as European Supervisory Authority. The consistent application of the legally binding Union acts, the establishment of high quality common regulatory and supervisory standards and practices are provided also through guidelines and recommendations issued by the European Banking Authority.

More specific in 2017, for improving the regulatory regime for the risk arising from exposures to close related parties to a bank (e.g. administrators, qualified or

[13] Data for ATMs and POS terminals refer to banks in Bulgaria.

larger shareholders), the BNB prepared legislative changes to provide additional oversight capabilities in this respect.

At the end of the year, amendments to the Law on the Bulgarian National Bank and the LCI were promulgated according to which the individual administrative acts in the field of banking supervision are issued by the BNB Governing Council on the proposal of the Deputy Governor in charge of the Banking Supervision Department, and not by the Deputy Governor himself, like in the previous legal regime.

As regards the specific legal supervisory framework, representatives from the BNB actively took part in expert discussions and the drafting work on the new Law on measures against money laundering for achieving full compliance with the principles laid down in EU Directive 2015/849/EU[14].

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

One of the main strategic objectives of the supervisory authority in 2017 was to assess the current "state of readiness" of banks in implementing the new IFRS 9 in 2018. For its implementation, the BNB adopted the EBA Guidelines on the uniform disclosure of IFRS 9 transitional arrangements laid down in Regulation (EU) 2017/2395 on amending Regulation (EU) 575/2013.
In addition, the Bulgarian National Bank continued its efforts for further progress of the banking supervision by adopting a new update of the „Handbook on banking supervision process", also some legislative amendments to the LCI concerning banks' related entities, and implementing the relevant EBA guidelines concerning the convergence of supervisory practices.

In 2017 the supervisory authority took further steps for improving existing legislative framework for the recovery and resolution of credit institutions. In particular, the Bulgarian National Bank developed specific criteria and rules related to the practical issues on restructuring of credit institutions, including the methodology for determining the individual annual contributions of banks and branches from third countries to the Bank Resolution Fund.

Further to the changes in the prudential framework, the Bulgarian National Bank proposed amendments also to the legal framework in the field of payment services, systems and supervision in connection with the implementation of the Second Payment Services Directive (PSD 2). The central bank carried out significant work for preparation of the new Law on Payment Services and Payment Systems, which entered into force on 6 March 2018.

[14] Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2017, in the context of low interest rates on deposits and loans, a strong emphasis in the off-site supervision was placed on the identification of risks affecting the profitability of credit institutions.

As part of the Supervisory Review and Evaluation Process (SREP) the supervisors performed periodic assessments of the capital and liquidity adequacy, including daily monitoring of the liquidity position of credit institutions. The overall assessment of banks’ financial position and risk profile was also the result of the review and evaluation of banks' internal capital and liquidity adequacy assessment reports, as well as their funding plans.

In accordance with the Law on the Recovery and Resolution of Credit Institutions and Investment Firms (LRRCIIF) supervisors reviewed and assessed the revised and updated 2016 recovery plans of domestic banks which are subject to supervision on individual basis only, i.e. are not part of a banking group or a financial conglomerate.

The BNB also performed a review of all banks’ funding plans pursuant to the EBA Guidelines on harmonised definitions and templates for funding plans of credit institutions and the Recommendation of the European Systemic Risk Board.

During this period the inspections carried out were mainly focused on the current processes and systems for managing specific risks. Particular attention was paid to the organisation, rules and methodology applied by credit institutions, to identify their capital needs within the internal capital adequacy assessment process.

From macro-prudential perspectives, the supervisory activity in 2017 was focused on monitoring of the processes and the evaluation of inherent risks which have an impact on the stability of the banking system. In parallel to the trend analysis on the structure and the risk profile of financial intermediation, a top-down capital stress test was performed in accordance with Article 80b of the Law on Credit Institutions to assess the banks’ resilience to shocks from hypothetical negative macroeconomic and financial impacts. The results of the stress test showed an adequate capital level for the banking system.

During the year a review of the systemic risk buffer and the buffer for other systemically important institutions (O-SIIs) was carried out. The requirement to all banks to maintain a systemic risk buffer of 3% of their risk exposures in Bulgaria was confirmed. In setting the buffer for O-SIIs, was considered the change of systemic importance of each bank for the period since the introduction of this buffer and its annual review. The countercyclical capital buffer intended as a macro-prudential instrument protecting the banking system against potential losses from cyclical systemic risk accumulation in periods of excessive credit growth, remained at 0% as there was no cyclical systemic risk in the economy given the current negative deviation of the credit to GDP ratio from its long-term value.

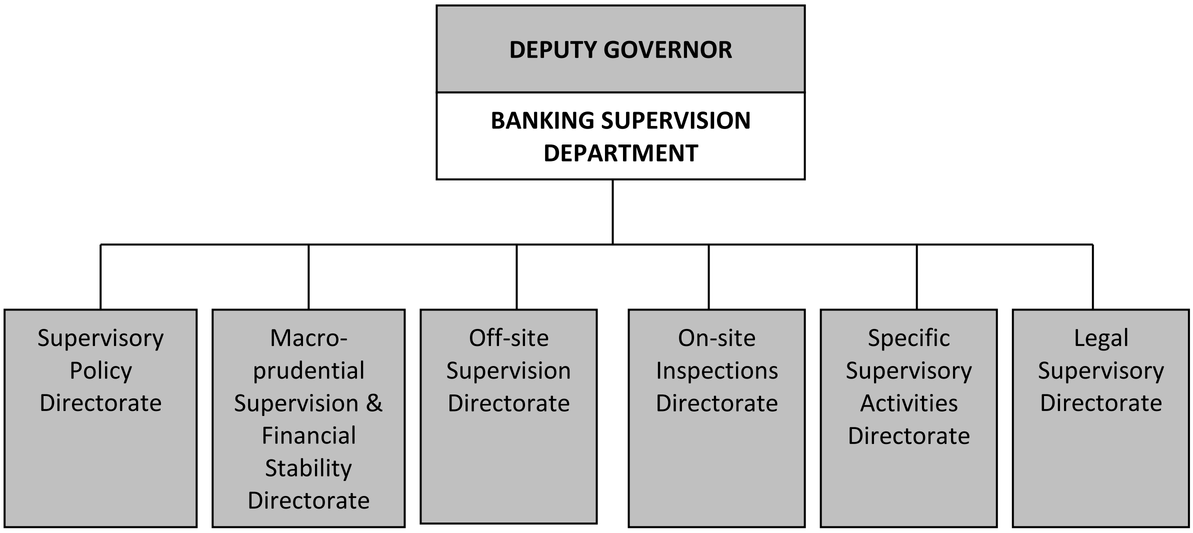
In the area of specialised supervision, efforts were typically directed at checks for preventing the system from attempts at money laundering and terrorist financing, especially to enhancing the internal administrative capacity and quality of control in banks. Besides, the BNB continued deploying its capacity in registration and verification of the origin of the capital of non-bank credit intermediaries granting loans under the Law on Consumer and Real Estate Loans. For this purpose a particular information system has been implemented. On-site verifications were also carried out in cases of suspicious credit intermediation without due registration or of undeclared fund origination.

As indicated concerning the consolidation process of banks, some institutional changes in the sector occurred in 2017. The direct acquisition of the majority stock of 99.91% of United Bulgarian Bank (previously an NBG group member) by the KBC Bank NV, Belgium was approved. This deal and the upcoming merger over 2018 with Cibank, the previous local KBC subsidiary, would produce the third in size credit institution in Bulgaria.

In August 2017, the İşbank AG, a German-quartered Turkish bank notified the BNB about its intention to close its branch in Bulgaria.

At the end of the year the BNB received an application from Novito Opportunities Fund AGmvK to acquire shares, representing 67.646407% of the registered share capital of the local Municipal Bank AD. In January 2018 the BNB Governing Council took the decision to issue a preliminary approval after an analysis of the conformity of the declared intent with the criteria under Article 28a, paragraph 3 of the Law on Credit Institutions.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



In exercising its supervisory powers, the BNB Deputy Governor in charge of the Banking Supervision Department appoints the directors of the six directorates therein – The On-site Inspections Directorate, The Off-site Supervision Directorate, The Macro-prudential Supervision and Financial Stability Directorate, The Specific Supervisory Activities Directorate, The Supervisory Policy Directorate and The Legal Supervisory Directorate.

INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In 2017, supervisory experts of the BNB continued their participation in the European Systemic Risk Board, and in various EBA working committees and groups, and contributed to the development of particular technical standards and guidelines.

In terms of international cooperation in the SREP, BNB supervisors took part in the work of various international supervisory colleges at the SSM/ECB, as well as in two more colleges, headed by the Hungarian Central Bank and by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), respectively. The supervisory risk assessments of the relevant banking groups and subsidiaries were discussed and joint supervisory decisions on the capital and liquidity taken. Where necessary, strategy plans of parent banks and individual subsidiary institutions will reckon with outcomes of the ECB stress tests carried out in 2017. As regards recovery plans of subsidiaries of eight EU banking groups presented in Bulgaria, these were updated, and accordingly joint decisions signed.

COOPERATION WITH OTHER SUPERVISORY BODIES IN BULGARIA

In 2017, the BNB was supporting other domestic competent authorities in the performance of their tasks. With the Financial Supervision Commission, joint inspections were carried out on trustees of supplementary pension insurance funds. With the Deposit Insurance Fund joint on-site visits were carried out in individual credit institutions in connection with the application of the provisions of the Law on Bank Deposit Guarantee, particularly of the way of calculating and reporting the amount of guaranteed deposits, etc.

In cooperation with the Consumer Protection Commission and for the needs of the customers of banking services, the BNB's 'Information on financial products and services' was updated. This was aimed at providing additional guidance and facilitation to customers in case of complaints against creditors, and in dealing with disputes on consumer and housing mortgage loans brought to the Arbitration.

STATISTICAL TABLES

Number of financial institutions
(at year-end)

Type of financial institution*	2015	2016	2017
Commercial banks	22	22	22
Branches of foreign credit institutions	6	5	5
Cooperative banks			
Banking sector, total:	**28**	**27**	**27**

* Data refer to credit institutions operating in Bulgaria (banks including branches of foreign credit institutions).

Ownership structure of banks on the basis of assets total (%)
(at year-end)

Item	2015	2016	2017
Public sector ownership	1.8	2.1	2.5
Other domestic ownership	21.8	21.5	20.9
Domestic ownership total	23.6	23.5	23.5
Foreign ownership	76.4	76.5	76.5
Banking sector, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	40.79	55.90	97.57**
Branches of foreign credit institutions	2.31	2.43	2.43**
Cooperative banks			
Banking sector, total:			

** **Note:** The reported data is market share in the sum of total assets for the banking sector and not HHI.

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks			
Cooperative banks			
Banking sector, total:	**7.35**	**10.41**	**9.15**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	96.2	97.6	97.6
Branches of foreign credit institutions	3.9	2.4	2.4
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

Assets	2017
Cash, cash balances at central banks and other demand deposits	20.0
Financial assets held for trading	1.4
Financial assets designated at fair value through profit or loss	0.1
Available-for-sale financial assets	11.0
Loans and receivables	61.0
Held-to-maturity investments	1.8
Derivatives – Hedge accounting	0.0
Fair value changes of the hedged items in portfolio hedge of interest rate risk	0.0
Investments in subsidiaries, joint ventures and associates	0.4
Tangible assets	1.9
Intangible assets	0.2
Tax assets	0.0
Other assets	1.6
Non-current assets and disposal groups classified as held for sale	0.4
TOTAL ASSETS	**100.0**
Liabilities	**2017**
Financial liabilities held for trading	0.2
Financial liabilities designated at fair value through profit or loss	0.0
Financial liabilities measured at amortised cost	86.1
Derivatives – Hedge accounting	0.1
Fair value changes of the hedged items in portfolio hedge of interest rate risk	0.0
Provisions	0.2
Tax liabilities	0.0
Share capital repayable on demand	0.0
Other liabilities	0.6
Liabilities included in disposal groups classified as held for sale	0.0
Total equity	**12.9**
Total equity and total liabilities	**100.0**

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks			
Cooperative banks			
Banking sector, total* **	**22.19**	**22.15**	**22.08**

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2017
Non-performing loans and advances to total gross loans and advances[15] (%)	10.18

The structure of deposits and loans and advances[16] of the banking sector in 2017 (%)
(at year-end)

	2016		2017	
	Deposits	Loans and advances	Deposits	Loans and advances
Central banks	0.0	18.7	0.0	17.2
General governments	2.1	0.9	2.4	0.7
Credit institutions	5.7	11.1	6.3	14.0
Other financial corporations	5.0	2.6	3.3	3.1
Non-financial corporations	27.2	42.8	28.9	40.7
Households	60.1	24.0	59.1	24.3
Total	**100.0**	**100.0**	**100.0**	**100.0**

[15] The definitions and the scope of non-performing loans and advances are in line with the Implementing Technical Standards regarding the non-performing exposures adopted by the European Banking Authority (EBA) and Commission Implementing Regulation (EU) 2015/1278 of 09 July 2015 amending Implementing Regulation (EU) 680/2014 published in the Official Journal of the EU on 31 July 2015. The Non-performing loans to total gross loans indicator is calculated according to the EBA methodology for AQT_3.2 Level of non-performing loans and advances (NPL ratio) published in the EBA Methodological guide (http://www.eba.europa.eu/documents/10180/1380571/EBA+Methodological+Guide+-+Risk+Indicators+and+DRAT.pdf/02c01596-5122-4d45-ac3e-23eb2f79f032)

[16] Source: Macroprudential reporting form MPF1

P&L account of the banking sector (at year-end) (EUR'000)

P&L account	2015	2016	2017
Interest income	1,866,721	1,695,123	1,555,804
Interest expenses	449,790	254,738	188,154
Net interest income	1,416,930	1,440,385	1,367,650
Net fee and commission income	455,138	470,921	509,141
Other (not specified above) operating income (net)	272,940	173,295	109,483
Total operating income, net	2,145,009	2,084,600	1,986,274
Administrative expenses	947,269	808,361	825,605
Depreciation	87,642	89,437	89,872
Provisions or (-) reversal of provisions	9,355	32,997	10,637
Impairment or (-) reversal of impairment on financial assets not measured at fair value through profit or loss	588,820	415,181	394,092
Profit or (-) loss before tax from continuing operations	488,509	722,115	654,009
Profit or (-) loss for the year	432,967	645,754	588,206

Total own funds in 2017 (EUR'000)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks					
Cooperative banks					
Banking sector, total*:**	**5 882 278**	**5 437 175**	**5 559 236**	**323 042**	

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE CROATIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The broad-based economic growth continued in 2017, with the annual growth rate of real GDP slowing to 2.8%, down from 3.2% in 2016. Consumer price inflation gained momentum, largely driven by stronger imported inflationary pressures, which raised domestic prices of food and refined petroleum products. The pick-up in inflation was in part fuelled by stronger domestic demand. The surplus in the current and capital account increased in 2017 due to the effect of provisions for loans associated with the Agrokor Group[17] on bank profits, coupled with the steady increase in net exports of services and stronger inflows from EU funds. At the same time, external indebtedness of domestic sectors continued to shrink noticeably. The monetary policy of the CNB remained expansionary, which resulted in the all-time high surplus kuna liquidity of the monetary system. This contributed to the steady decline in interest rates for all sectors, improvement of other financing conditions and heightened bank lending to corporates and households. The strong fiscal adjustment continued in 2017, accompanied with a surplus in the general government balance and the ongoing downturn in public debt.

DEVELOPMENTS IN THE BANKING SYSTEM

The several-year moderate downward trend in the number of credit institutions continued in 2017. Since voluntary winding-up proceedings were initiated in one bank in December, there were 30 credit institutions operating in Croatia at the end of the year – 25 banks (one savings bank included) and five housing savings banks. In addition, there was one branch of an EU credit institution operating in the country, while almost 150 institutions from the EU (and the EEA) notified the CNB of the direct provision of mutually recognised services in the territory of the Republic of Croatia. Credit institutions' assets stood at HRK 399.3bn[18] (110% of GDP) rising by 0.7% from the end of 2016.

After a five-year decline, the assets of banks saw a slight increase (0.7%) in 2017. The most significant contribution to such trends came from the recapitalisation of OTP banka Hrvatska d.d. enabling the acquisition of Splitska banka d.d., which resulted in the strengthened capital of banks and investments in subsidiaries. This exceeded the effects that the losses associated with difficulties in the operation of the Agrokor Group, exchange rate developments, the sale of irrecoverable claims and the exit of one bank from the system had on the assets of banks. In the composition of bank assets, the share of loans granted dropped to the relatively low 57.9% under the influence of the central government's strong deleveraging with respect to domestic banks and a fall in the lending of foreign parent banks. On the other hand, surplus liquidity was high, as reflected in the

[17] Refers to a systemically important enterprise and its affiliated entities pursuant to a special act.
[18] Data for 2017, as for the previous years, are based on the audited reports of credit institutions.

unusually large amounts deposited in the banks' giro accounts with the CNB and the high liquidity coverage ratio (LCR)

The banks' lending to corporations and households increased noticeably (excluding the impact of exchange rate adjustments and write-offs on loan movements) in 2017. Broken down by activities, loans to corporations providing accommodation and food services saw the sharpest rise, ranking third in terms of the amount of loans granted to corporations, following manufacturing and trade. Observed by loan type, investment loans recovered noticeably. As regards loans to households, general-purpose cash loans increased the most, in line with long-standing trends. A moderate increase in the amount of housing loans granted put an end to the several-year downward trend, which is certainly largely attributable to the housing loans subsidies. Only the kuna component recorded a rise among both general-purpose cash loans and housing loans to households. Loans granted at fixed interested rates continued to grow in importance, spurred by, among other things, the CNB's recommendations related to risks associated with a possible change in interest rates.

The quality of loans improved – the share of non-performing loans dropped from 13.8% to 11.3%, mainly as a result of the sale of claims. The financial difficulties of the Agrokor Group and the related increased recognition of losses marred the effect of positive changes in the economic environment and slowed down the recovery of loan quality. In the non-financial corporate sector, the share of non-performing loans dropped, but still remained relatively high (22.2%), with loans in construction still constituting the largest share of non-performing loans. The improvement of the quality of household loans, where the share of non-performing loans fell to 8.1%, was mainly driven by the developments in housing loans.

The upward trend registered in the coverage of non-performing loans by value adjustments, observed since 2011, ended. The coverage fell to 61.5% as a result of the sale of well covered claims and the inflow of new non-performing loans. The sale of claims continued to trend sharply upwards in 2017, with three quarters of their amount accounted for by non-financial corporations. The past few years witnessed a surge in the coverage of non-performing loans in the sector on account of the rules on the gradual increase in value adjustments for long-term delinquent placements that motivated banks to pursue a more active approach in resolving non-performing loans, including their sale in the secondary market.

As regards the banks' sources of financing, the trend of substituting domestic funds for foreign funds continued, with the rise in domestic sources of financing greatly due to the effects of the good tourist season. As for the structure of deposits, which increased slightly, sight deposits continued to increase in importance. They accounted for almost one half of total deposits, with the dominant effect of their growth recorded in the household sector. Reduced attractiveness of time deposits in banks, most likely due to low interest rates and the taxation of interest payments on savings, contributed to the trend, causing households to turn to other forms of investment. The sources from majority foreign owners went down by a quarter, further reducing their modest contribution to 2.9% of total sources.

Bank profits and profitability indicators fell strongly, by one third, on account of increasing costs arising from value adjustments and provisions associated with the Agrokor Group. The return on average assets (ROAA) and the return on average equity (ROAE) stood at 1.0% and 5.9% respectively. The decline in earnings in 2017 was also partly a result of the disappearance of the base period effects, particularly the effects stemming from the sale of equity holdings in 2016

(Visa[19], etc.). Excluding the Visa effect from 2016, the operating profitability of banks reached a record level in 2017, while its increase from 2016 primarily resulted from stronger income from commissions and fees. Effects of income from dividends of subsidiaries were positive as well, while cost efficiency had an unfavourable effect. Interest income continued to decline, but the net interest margin held steady under the influence of significant savings on interest expenses.

The total capital ratio grew, reaching a record high of 23.8%. In the unlikely unfavourable scenario of complete irrecoverability of non-performing loans, the total capital ratio of banks would amount to 19.1%, indicating a healthy capital base that can withstand additional losses without significant difficulties.

The assets of housing savings banks grew by 1.3% in 2017, with the deposits with financial institutions rising at the highest rate, followed by housing loans to households. Profit increased by 4.0% in the observed year, primarily as a result of lower interest expenses and a resulting increase in net interest income. The return on average assets (ROAA) and the return on average equity (ROAE) remained at almost the same level, standing at 0.7% and 5.8% respectively. The total capital ratio increased considerably, to 28.5%.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN CROATIA

The CNB’s tasks regulated by the Act on the Croatian National Bank include the issuance and withdrawal of authorisations and approvals, and supervision and oversight in accordance with acts governing the operations of credit institutions and credit unions. The main objectives of the supervision exercised by the CNB are to maintain confidence in the Croatian banking system, and to promote and safeguard its safety and stability. The exercise of supervision and oversight of credit institutions and credit unions is governed by the Credit Institutions Act and Credit Unions Act.

The rules and requirements pertaining to the operations of credit institutions are governed by Croatian regulations (the Credit Institutions Act and accompanying subordinate legislation), as well as EU regulations. This primarily refers to Regulation (EU) No 575/2013, with corresponding technical standards.

In the course of supervision, the Croatian National Bank verifies the legality of the credit institution's operation, including the organisational structure, strategies, policies, processes and procedures adopted by the credit institution to comply with regulations and evaluates risks arising from the credit institution's operation. In addition to supervision, the CNB oversees the implementation of the Act on the Croatian National Bank, regulations adopted under that act, and the implementation of other laws and regulations under for which it is competent.

The CNB exercises supervision of credit institutions by:

- collecting and analysing reports and information and by ongoing
- monitoring of credit institutions' operations;
- carrying out on-site examinations of credit institutions' operations;

[19] In the first half of 2016, banks sold their holdings in Visa Europe Ltd to its parent company from the USA, generating an estimated income of HRK 650m.

- imposing supervisory measures in order to take actions at an early stage
- to improve the safety and stability of credit institutions' operations and to eliminate any illegalities established;
- issuing opinions, authorisations and approvals and by assessing credit
- institutions.

The CNB exercises supervision of credit unions in a similar manner.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

Like in the previous years, the main legal objectives of the supervision exercised by the CNB were to maintain confidence in the Croatian banking system, and to promote and safeguard its safety and stability. In 2017, the CNB continued the harmonisation of the domestic regulatory framework with EU regulations in order to improve the domestic legislation on the operation of credit institutions.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In the course of 2017, in the highly harmonised regulatory environment governing the operations of credit institutions, the CNB continued the normative harmonisation with EU regulations by applying guidelines issued by the European Banking Authority (hereinafter referred to as: 'EBA') and adopting new subordinate legislation as well as by amending existing regulations. In 2017, the CNB actively cooperated with credit institutions in the preparations for the application of the International Financial Reporting Standard 9 – Financial instruments (IFRS 9), in application since 1 January 2018. At the same time as working on regulations governing reporting, the CNB continued to develop the software for data receipt, processing and integrity. In order to promote the consistent application of regulations, the CNB held numerous seminars and workshops in 2017, and in order to maintain the transparency of the banking system it continued to publish important data and publications on the system.

All credit institutions operating in 2017 were included in at least one supervisory activity as part of the regular supervisory cycle of assessing credit institutions.

The ongoing supervision of credit institutions' operation in 2017 included the analyses of credit institutions' internal capital adequacy assessment reports, which provide a basis for determining minimum capital requirements and the planning of the next supervisory cycle for an individual credit institution. Furthermore, the CNB compiled reports containing risk assessments of credit institutions, including credit institutions for which cross-border colleges of supervisors were established and adopted measures stipulating the minimum requirement for own funds. In cases where indicated by the risk profile analysis, the CNB adopted additional measures to improve the operations of a credit institution. Analyses of credit institutions' internal capital adequacy assessment reports were performed in the segment of supervising advanced approaches to measuring risks and risk management with a special focus on internal models.

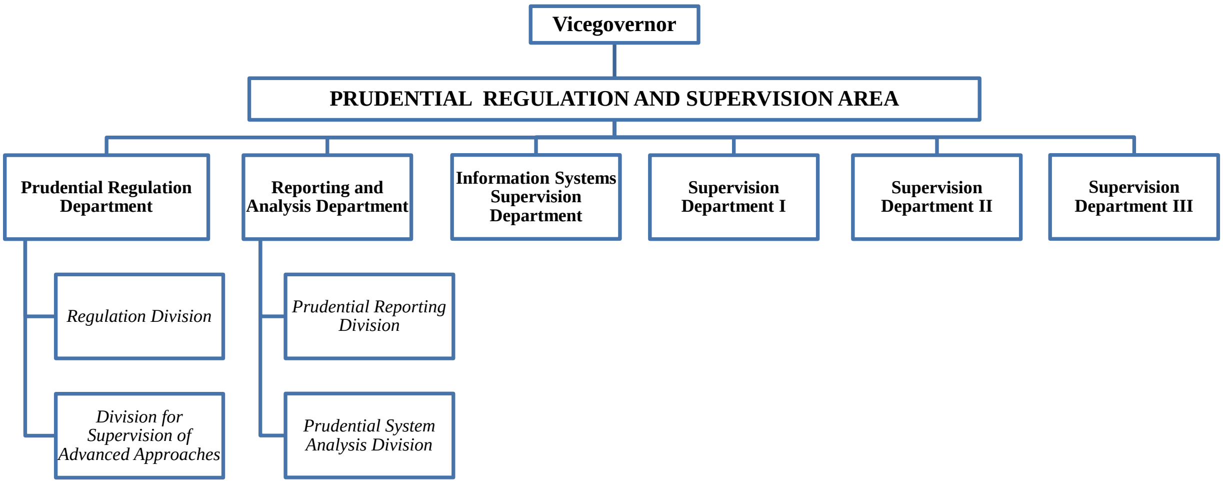
The supervisory cycle of the CNB also entailed assessing IT risks of credit institutions and monitoring the situation related to various incidents of the IT system and cyber threats that could affect the banking system in Croatia. As part of the regular annual stress testing in 2017, the CNB performed supervisory stress testing of other systemically important credit institutions in the Republic of Croatia, designed for the purpose of providing information on the supervisory review and assessment process.

On-site examinations were in 2017 focused on the analysis of asset quality and credit risk management, establishing own funds adequacy and the supervision of the implementation of legal provisions pertaining to the prevention of money laundering and terrorist financing. In addition, CNB resources were also dedicated to the operations of trustees in two credit institutions.

In addition, the CNB's supervision involved the licensing process of deciding on a large number of applications for approval, mostly related to the performance of the function of a member of the supervisory board of a credit institution, but also to other stipulated areas of bank operations (authorisations, provision of services, acquisition of holdings, etc.)

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

The CNB's supervisory activities are organised within the Prudential Regulation and Supervision Area, with the organisational scheme presented below:



THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2017, the CNB continued to cooperate with foreign supervisors, particularly as regards joint assessments of the risk of business operations of banking groups and the adequacy of allocated amounts of capital for members of individual groups, as well as in the segment of IT system supervision. Based on the memoranda of understanding in effect, in 2017 the CNB representatives participated in numerous colleges of supervisors relating to the supervision of banking groups that include 10 domestic credit institutions.

As part of its cooperation with foreign supervisors, the CNB is responsible for drawing up the Supervisory Risk Report, i.e. the annual assessment of the risk profile of a domestic credit institution, serving as the element for adopting the final Joint Risk Assessment Decision and the joint decision on the required amount of capital of a banking group. Since 2015, the CNB has participated in the adoption of the joint decision on the verification and assessment of recovery plans for groups of credit institutions.

As EBA member, the CNB participates in the European System of Financial Supervision. Over the course of 2017, the Bank allocated considerable resources to the participation in EBA and ECB working groups. In the area of prevention of money laundering and terrorist financing, cooperation with international institutions continued in 2017 in terms of interactive participation in the work of committees of European supervisory bodies, including the work on the adoption and application of guidelines issued by European supervisory bodies. In 2017, the CNB continuously cooperated with other European bodies competent for the prevention of money laundering and prepared materials for the Committee of the Council of Europe – MONEYVAL.

The CNB continued to cooperate and provide technical assistance to supervisory authorities in the region as regards the application of prudential regulations and technical aspects of supervision.

COOPERATION WITH OTHER SUPERVISORY BODIES IN COUNTRY

In 2017, the CNB continued to cooperate with the Croatian Financial Services Supervisory Agency (HANFA) with a view to exchanging information on current topics in the banking sector and the sector supervised by HANFA, resolving open issues on the exchange of data and arranging the coordination of supervisory activities.

In 2017, the CNB continued to actively participate in the national system of the prevention of money laundering and terrorist financing and to work on the monitoring and application of the acquis in the field of prevention of money laundering and terrorist financing. The CNB continued to participate in the work of relevant committees and coordinations at the level of the RC in the area of cyber security.

The CNB continued its cooperation with the State Agency for Deposit Insurance and Bank Resolution (DAB) in 2017, where institutions exchanged data and information on the subjects of supervision and oversight within their scope of activity and competence. The CNB regularly monitors the methodology for the calculation of individual credit institutions' degree of risk prescribed by DAB for the purpose of calculating deposit insurance premiums.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

For more information on the activities of the CNB exercise of supervision, regulations forming the basis for the CNB supervision and the texts of these regulations, please refer to the CNB website at (www.hnb.hr).

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution*	2015	2016	2017
Banks	27	25	24
Savings banks	1	1	1
Housing savings banks	5	5	5
Branches of foreign credit institutions	0	1	1
Banking sector, total:	**33**	**32**	**31**

Note: The following tables do not contain data on branches of foreign credit institutions.

Ownership structure of the financial institutions
on the basis of assets total (%)
(at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	5.3	6.2	6.1
Other domestic ownership	4.3	3.9	3.6
Domestic ownership total	9.6	10.2	9.7
Foreign ownership	90.4	89.8	90.3
Banking sector, total:	**100,0**	**100,0**	**100,0**

Concentration of asset by the type of financial institutions
(end-2016)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Banks*	60.1	75.0	1 472.7
Housing savings banks	60.9	100.0	2 470.0
Banking sector, total:	**58.9**	**73.5**	**1 415.8**

*From this table onwards, data for savings banks are included in line Banks.

Return on Equity (ROE) by type of financial institutions* (%)

Type of financial institution	2015	2016	2017
Banks	-8.8	9.6	5.9
Housing savings banks	6.4	5.8	5.8
Banking sector, total:	**-8.5**	**9.5**	**5.9**

*ROAE

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Banks	98.1	98.0	98.0
Housing savings banks	1.9	2.0	2.0
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

	2015	2016	2017
Claims from			
Financial sector	16.8	18.6	22.6
Nonfinancial sector*	48.0	46.9	47.2
Government sector	23.3	23.5	20.9
Other assets**	11.9	11.0	9.4
Claims due to			
Financial sector	6.5	5.9	6.4
Nonfinancial sector*	62.8	65.1	65.8
Government sector	6.3	6.4	6.1
Other liabilities**	11.8	8.6	7.0
Capital	**12.7**	**14.0**	**14.8**

* households and corporates
**Includes claims from/due to non-residents.

Capital adequacy ratio of banks

Type of financial institution	2015***	2016***	2017***
Banks	20.9	22.9	23.8
Housing savings banks	25.8	25.9	28.6
Banking sector, total:	20.9	23.0	23.8

* Basel I, ** Basel II, *** Basel III

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)*

Asset classification	2015	2016	2017
Non financial sector, including:	20.0	17.6	13.7
- households	11.8	10.0	7.8
- corporate	30.1	28.3	22.2

*share of partly recoverable (risk category B) and fully irrecoverable (risk category C) loans in line with the Decision on the classification of placements and off-balance sheet liabilities of credit institutions (OG 41A/2014 and 28/2017).

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	85.0	78.9
Households*	64.2	48.7
Corporate	20.8	30.2
Government sector	3.7	17.3
Financial sector (excluding banks)	5.0	1.3
Other**	6.3	2.5
Total:	**100,0**	**100,0**

*Includes non-profit institutions serving households.
**non-residents

P&L account of the banking sector (at year-end)
(in million EUR)

P&L account	2015	2016	2017
Interest income	2 421.0	2 230.3	1 994.7
Interest expenses	1 020.5	780.6	526.0
Net interest income	1 400.4	1 449.6	1 468.7
Net fee and commission income	403.4	431.6	454.4
Other (not specified above) operating income (net)	101.7	289.0	200.7
Gross income	1 905.5	2 170.2	2 123.8
Administration costs	899.6	880.9	897.5
Depreciation	89.2	86.7	95.0
Provisions	967.1	103.7	147.2
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	600.9	275.0	456.6
Profit (loss) before tax	-651.3	823.9	527.4
Net profit (loss)	-598.3	671.9	452.2

Total own funds in 2017 (in million EUR)

Type of financial institution	Total own funds***	Core Tier 1	Tier 1***	Tier 2***	Tier 3
Banks	7 140	-	6 714	426	-
Housing savings banks	103	-	94	9	-
Banking sector, total:	7 243	**-**	6 808	435	**-**

* Basel I, ** Basel II, *** Basel III

2017 DEVELOPMENTS IN THE CZECH BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2017, the Czech economy increased its growth dynamics. According to the latest estimate, real GDP grew by 4.6%, representing acceleration by 2.1 percentage points when compared to annual growth rate of 2.5% recorded in 2016.

GDP growth in 2017 was driven by household consumption that went up by 4.0%, representing the largest positive y-o-y change observed since 2007 and caused mainly by growth in real wages and salaries. Investment activity at macro level accelerated as gross fixed capital formation rose y-o-y by 5.9% mainly due to increased investment activities by non-financial corporations sector. Government final consumption expenditure rose, albeit (in comparison with previous years) by a smaller relative increase of 1.5%. In 2017, exports of goods and services to the domestic economy grew by 6.9%, while volume of imported goods and services increased by 6.2%.

In 2017, annual average rate of inflation amounted to 2.5%. During the entire year, rate of inflation fluctuated in the upper half of the tolerance band defined around the 2% inflation target. Food prices, housing related costs, including imputed rent and fuel and transport costs were the most significant inflationary factors in 2017.

In April 2017, the CNB decided to end its exchange rate commitment maintained at the level of 27 CZK / EUR since November 2013.[20] In addition, the CNB increased its key rates in August after almost nine years. On an aggregated basis for 2017 the two-week repo rate increased by 45 basis points to 0.50%, the Lombard rate increased by 95 basis points to 1.00%. Tightening of monetary conditions necessarily affected the exchange rate. The Czech koruna on average basis appreciated both in relation to the euro (2.6% y/y) and the US dollar (4.3% y/y). The average nominal exchange rate of the Czech koruna to the euro stood at 26.3 CZK/EUR in 2017 while the exchange rate of the Czech koruna to the US dollar on average reached 23.4 CZK/USD.

The current account ended the year in a surplus of CZK 54.2 billion in 2017, decreasing its surplus by CZK 20 billion. The reported surplus was primarily due to the CZK 362.9 billion positive balance of goods and services.

In the labour market, increasing labour shortages led to a surge in wage growth. The annual average unemployment rate for 2017 was 2.9%, representing the lowest figure recorded among all EU Member States in 2017. The unemployment rate was falling throughout the year almost continuously decreasing by 1.1 percentage point when compared to the previous year. Nominal wages grew by 7% y-o-y while real wages increased by 3.5%, the largest increase in real wages since 2003.

[20] For more details see https://www.cnb.cz/en/monetary_policy/exit_exchange_rate_commit/index.html

DEVELOPMENT IN THE BANKING SECTOR (INCLUDING THE ASSETS TOTAL / GDP)

As of the end of 2017, the banking sector of the Czech Republic was represented by 23 domestic banks (including five building societies), 10 credit unions and 24 branches of foreign banks. All but one branch of foreign banks were domiciled in the EU. The group of four largest domestic banks held 59.3% of total assets in the banking sector.

Banks operating in the Czech Republic mostly follow a traditional business model where client deposits are used as the primary source to cover loans provided. This prevailing orientation is reflected in the structure of their balance sheets, with loans and receivables being the biggest asset category.

The structure and size of the banking sector balance sheet was affected by CNB's exit from its exchange rate commitment. At the beginning of 2017, expectations that there will be an exit from the commitment led to a high inflow of deposits, particularly from non-resident credit institutions. Also, both sharp increase in receivables of the banking sector vis-á-vis the central bank and corresponding significant increase in the CNB's foreign reserve assets were related to the above-mentioned events.

At the end of 2017, the banking sector reported total assets of CZK 7,008.7 billion, which corresponded to a y-o-y increase of 17.6%. Nevertheless, the volume of client loans grew at a slower rate of 4.9% (y-o-y), i.e. two percentage points lower than in 2016.

In 2017, the loan portfolio quality improved due to an improving trend in the category of non-performing loans. As of the end of the year, NPL ratio calculated on the total client loans basis, stood at 4.0%. The share of clients' receivables in default (in total banking sector receivables) declined by 0.9 percentage point (y-o-y).

In terms of liquidity, the domestic banking sector enjoys long-term favourable characteristics in the context of a permanent surplus of client deposits over client loans.

Banking entities generated total net profit of CZK 75.5 billion in 2017, an increase of CZK 1.6 billion relative to 2016. Due to their traditional business model, the main component of the total net profit of the domestic banks was represented by interest profit (CZK 112.1 billion in 2017). Return on equity, expressed by the ratio of total net profit to Tier 1 capital, declined by 0.8 percentage point to 16.8%.

The capitalisation of the banking sector in the Czech Republic has long been satisfactory. The sector’s regulatory capital amounted to CZK 471.8 billion at the end of 2017, a rise of CZK 31.1 billion on a year earlier. The total capital ratio of banks operating in the Czech Republic was 19.3% at the end of 2017, i.e. 0.8 percentage point higher compared to previous year. Domestic banks met the capital requirements defined by CRDIV / CRR throughout 2017.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN THE CZECH REPUBLIC

In accordance with Act No. 6/1993 Coll., on the Czech National Bank, the Czech National Bank is the supervisor of the financial market in the Czech Republic. The CNB supervises the banking sector, the capital market, the insurance industry, pension funds, credit unions, bureaux-de-change, payment system institutions and non-bank consumer credit providers. The CNB lays down rules safeguarding the stability of the banking sector, the capital market, the insurance industry and the pension scheme industry. It systematically regulates, supervises and, where appropriate, issues penalties for non-compliance with these rules.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

The CNB endeavours to supervise the financial market and its institutions in accordance with international standards. It actively monitors developments in this area and prudently implements new requirements or, where applicable, initiates steps to implement them.

The CNB's general objective in the area of supervision, as defined by law, is to ensure financial stability and safe and sound operation of the financial system in the Czech Republic, thereby contributing to achieving its primary objective, namely to maintain price stability. This objective defines the CNB's area of competence as regards supervision of compliance with prudential rules (hereinafter also "prudential supervision") and supervision of compliance with the rules of business conduct.

In 2017 the CNB focused on the following strategic objectives:

- To enhance the Supervisory Review and Evaluation Process (SREP) of credit institutions especially in the field of credit risk, information systems risk and IT risks;
- In the prudential supervision of credit institutions the aim was to investigate the conditions for providing loans to households (both mortgage loans and consumer loans), with a particular focus on the procedures for the assessment of clients' creditworthiness and collateral valuation, including e.g. whether the CNB's recommendation on risk management related to retail loans secured by residential property was respected;
- In line with new technology trends the CNB assessed risks related to financial services called FinTech and risks stemming from the use of cloud services;
- In the area of professional care related to credit institutions the focus was on investment services, information obligations attached to payment services and also on exchange services provided by banks;
- The CNB ensured the implementation of the PSD II directive and related legal norms and continuously adjusted its supervisory practices. It also made sure that new requirements provided for in the directive, in the

new Act on payment system and other related legal norms were complied with;
- The CNB also did off-site supervision of bank consumer credit providers and assumed supervisory competences over non-bank providers and intermediaries of consumer credit, that received an authorisation in 2017 according to the consumer credit Act.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Also in 2017, the core activities of the supervision were focused on regular assessment of the financial situation, control of compliance with prudential requirements and monitoring of other relevant qualitative information about the Czech banking sector. The CNB’s supervisory activities concentrated primarily on quality of banks' credit portfolios (on solo and consolidated basis), their overall performance and sufficient level of capitalisation and liquidity. The CNB also engaged in financial situation of parent companies of the domestic subsidiaries and intra-group transactions monitoring.

Within the supervisory review and evaluation process (SREP), as in the previous years, the CNB prepared comprehensive assessment of the risk profiles of individual credit institutions. The SREP was based on monitoring of the institution’s key financial indicators, analysis of its business model, assessment of management and control mechanisms in credit institutions, and evaluation of the capital, liquidity and funding risks.

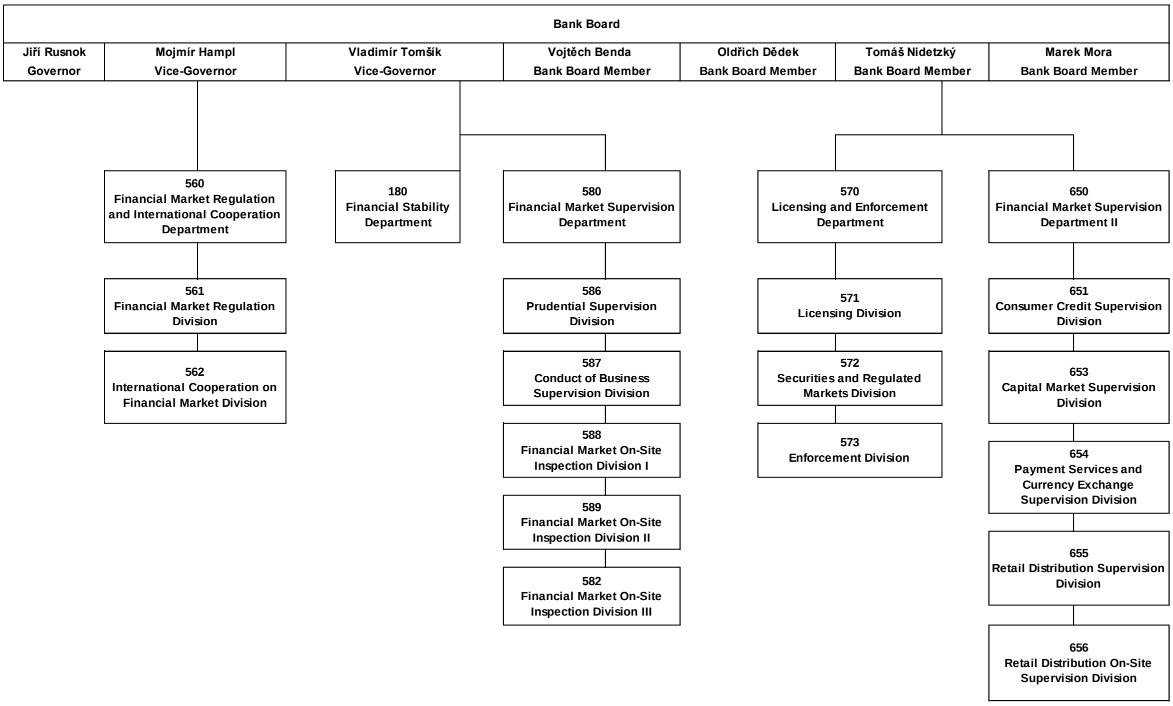
The CNB’s off-site surveillance of credit institutions was combined with on-site examinations. Both comprehensive and partial examinations were conducted in the credit institutions sector. In 2017, a total of 13 examinations were conducted or commenced in banks, four of these were comprehensive. Three examinations were carried out in credit unions in 2017 (despite its small market share, the credit unions sector was subject to intensive CNB supervision; a substantial proportion of supervisory capacity was devoted to this sector).

In 2017, the Czech National Bank, in cooperation with selected banks, conducted stress tests[21] to assess the impacts of highly adverse future economic scenarios on the domestic banking sector. The results of stress tests using data available as of the end of 2017 Q3 confirm that the banking sector is sufficiently resilient to potential adverse shocks. The capitalisation of the sector as a whole would remain well above the regulatory minimum of 8% even in a stress scenario assuming a sizeable decline in economic activity in the Czech Republic and abroad. The sector’s resilience was based mainly on its high capital ratio and on its current profitability.

Last year, the CNB also assessed the quality of the recovery plans and their compliance with the requirements of the EU Bank Recovery and Resolution Directive (BRRD), respectively the Act on Recovery and Resolution in the Financial Market. As of the end of 2017, most of the recovery plans met the legislative requirements. Within colleges of supervisors, the CNB strove for a group recovery plan structure to take sufficient account of recovery planning at the level of individual domestic institutions.

[21] The CNB applies both a top-down macro/aggregate approach and a bottom-up individual/micro approach to stress testing. The scenarios for the individual stress tests are prepared by the CNB, the stress testing methodology is regularly revised and published in the CNB’s Financial Stability Reports.

ORGANIZATIONAL CHART OF BANKING AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The Czech National Bank cooperates actively with other (foreign) supervisors to ensure effective supervision within its area of competence as well as to coordinate supervisory response to crisis situations.

Where the Czech National Bank is the home supervisor, it establishes a supervisory college and manages the work of the college, which is the basic platform for cross-border supervisory cooperation. In doing so, it takes into account the risk profile and systemic importance of the supervised group and of the individual institutions that make up the group. Where the Czech National Bank is the host supervisor, it coordinates and plans its activities in cooperation with the home supervisor, identifying areas of common interest. The Czech National Bank participates in on-site inspections organised by the home supervisor and allows the home supervisor to participate in inspections conducted by the Czech National Bank.

In 2017 the CNB also cooperated with European supervisory authorities, i.e. the European Banking Authority (EBA), European Securities and Markets Authority (ESMA), and European Insurance and Occupational Pensions Authority (EIOPA) in the area of regulation and supervisory convergence in the EU. Besides, the CNB participated in the activities of the European Systemic Risk Board (ESRB), which focused on risks related to rapid growth of loans. From the perspective of the CNB, one of the key themes was the drafting of the ESRB position to upcoming legislative changes concerning bank's structural capital reserves provided for in the CRD directive.

The CNB also closely followed the discussions in the EU Council and its structures, especially regarding further work aiming to enhance the Banking Union (e.g. strategies to reduce risks in the banking sector, establish European deposit insurance scheme and common backstop) and the Capital Markets Union (review of the European System of Financial Supervision).

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE CZECH REPUBLIC

The CNB's activities include cooperation with the Czech Ministry of Finance and other state administration bodies. The CNB works in close cooperation with the Czech Ministry of Finance, which has primary responsibility for preparing laws in the financial market area. The basis for such cooperation is laid down in the agreement on cooperation on the preparation of draft national legislation concerning the financial market in the Czech Republic.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

The new Consumer Credit Act, that took effect on 1 December 2016, applies to consumer credit provided by businesses to consumers and entrusts the CNB with supervision of all consumer credit providers and intermediaries, including the competence to conduct licensing proceedings, during which the CNB examines if the respective entities comply with the conditions for granting a licence. The Act also specifies in detail the information duties towards consumers and some other rights and duties in the area of consumer credit which improve the consumer's position (e.g. the possibility of early loan repayment). In 2017, the first five authorizations to non-bank consumer credit providers and 258 authorizations to independent consumer credit intermediaries were granted.

In 2017, the CNB considered residential property in the Czech Republic to be moderately overvalued and lending standards for the provision of mortgage loans to be highly relaxed. Therefore, the CNB recommended that loan providers should ensure that the loan to value (LTV) ratio for individual retail loans secured by residential property do not exceed 90%, and new retail loans secured by residential property with an LTV of 80%–90% do not exceed 15% of the total amount of retail loans secured by residential property provided in any given quarter.[22]

Given the positive output gap of domestic economy, the CNB decided to increase the countercyclical capital buffer rate to 1.0% in June 2017 effective from 1 July 2018. Subsequently, in December 2017, the CNB raised the rate further to 1.25% (the decision will be effective from 1 January 2019)[23].

[22] For more information see https://www.cnb.cz/en/financial_stability/macroprudential_policy/

[23] The CNB had increased the rate from zero for the first time in December 2015, with effect from 1 January 2017.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	23	22	23
Branches of foreign credit institutions	23	23	24
Credit unions	11	11	10
Banking sector, total:	**57**	**56**	**57**

Ownership structure of banks on the basis of assets total (%)
(at year-ends)

Type of bank	2015	2016	2017
Public sector ownership	2.2	1.8	1.2
Other domestic ownership	4.3	5.1	6.7
Domestic ownership total	6.5	6.9	7.9
Foreign ownership	93.5	93.1	92.1
Banking sector, total	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions
(2017 year-end)

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	55.7	71.6	1262.4
Branches of foreign credit institutions	55.2	71.3	1490.9
Credit unions	44.4	93.6	2682.9
Banking sector, total:	**49.7**	**63.9**	**1021.4**

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	16.6	17.6	16.8
Credit unions	0.2	-0.7	-1.7
Banking sector, total:	**16.4**	**17.4**	**16.7**

Note: RoE is calculated as a ratio of (sub)sector's net profit to annual average of (sub)sector's Tier 1 capital.
Note: Indicators don't have information content due to the different accounting periods in the credit unions sub-sector.

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	89.9	90.0	89.2
Branches of foreign credit institutions	9.5	9.5	10.4
Credit unions	0.6	0.6	0.3
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking sector (%)
(at year-end)

	2015	2016	2017
Claims from			
Financial sector	7.9	7.6	7.0
Nonfinancial sector	46.1	45.2	40.6
Government sector	1.5	1.1	0.9
Other assets	44.5	46.0	51.5
Claims due to			
Financial sector	11.3	13.9	20.9
Nonfinancial sector	58.7	57.4	52.5
Government sector	4.0	4.1	4.0
Other liabilities	18.3	17.2	15.9
Capital	7.7	7.4	6.7

Note: Banking sector = commercial banks + bank foreign branches.

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks	18.38	18.45	19.25
Credit unions	15.44	16.17	19.00
Banking sector, total:	n.a.	n.a.	n.a

Asset portfolio quality of the banking sector (%)
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector.	4.7	4.0	3.2
- households	4.1	3.2	2.5
- corporate	5.7	5.2	4.2

Note: Banking sector = commercial banks + bank foreign branches; share of receivables in default (substandard, doubtful and loss) by sector.

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	85.8	89.6
Households	59.2	49.9
Corporate	26.6	39.7
Government sector	6.5	1.9
Financial sector (excluding banks)	7.7	8.5
Total	**100.0**	**100.0**

Note: Banking sector = commercial banks + bank foreign branches;

P&L account of the banking sector (at year-end, mil. CZK)

	2015	2016	2017
Interest income	150, 903.6	143,439.1	146,672.3
Interest expenses	39,973.6	33,579.9	34,586.1
Net interest income	110,930.0	109,859.2	112,086.2
Net fee and commission income	34,618.7	32,436.1	32,052
Other (not specified above) operating income (net)	123.5	1,439.4	2,507.3
Gross income	229,814.7	228,355.9	228,037.3
Administration costs	70,722.5	71,648.3	73,537.4
Depreciation	6,568.9	6,985.5	7,380.7
Provisions	799.9	2,809.5	2,613.3
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	14,800.9	10,595.1	4,898.5
Profit (loss) before tax	80,515.1	87,920.8	90,432.3
Net profit (loss)	66,372.9	73,926.6	75,517.7

Note: Banking sector = commercial banks + bank foreign branches.

Total own funds in 2017 (in EUR millions)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	18,471.4	17,401.2	17,922.8	548.7	n.a.
Credit unions	136.0	133.7	133.7	2.3	n.a.
Banking sector, total:	18,607.4	17,534.9	18,056.5	550.9	n.a.

Note: Cooperative banks = credit unions.
Note: EUR = 25.540 CZK as at 29 December 2017.

2017 DEVELOPMENTS IN THE ESTONIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The year 2017 was a successful one for the Estonian economy. Growth climbed to almost 5%, having been stalled in previous years, and this is one of the fastest rates seen since the financial crisis. A marked recovery in destination markets for exports and higher inflation there gave a lift to the growth in the economy. The economy also benefited from the rapid growth in the incomes of residents of Estonia, which allowed consumption to rise and companies to increase their turnover and, for the first time in several years, their profits. The general improvement in the economic climate and increased confidence led companies to invest more last year in fixed assets, which is the foundation for future economic growth. Companies still invested a smaller share of their revenues than the average for the other countries in the euro area, and so the investment was not sufficient for the income level of Estonia to catch up quickly with those of richer countries.

An increase in employment rather than in investment has led the labour market very close to overheating. Low unemployment, a rise in the number of unfilled vacancies, worsening labour shortages, strong wage growth, and rising consumer price inflation all indicate that the economic cycle in Estonia has reached a point where growth is being driven mainly by demand, not by increases in the production capacity of companies or in labour productivity. Productivity grew a little faster last year, but the rate of growth was still lower than in the previous decade. However, success in exporting and competitiveness and the overall development of the economy depend on productivity. There is no sign at the moment that the competitiveness of exports would have suffered had wages and production costs not risen, though it is possible that success in exporting last year was mainly due to the favourable foreign environment and problems will only appear if demand weakens in Estonia's trading partners.

The success of the economy was also reflected in public finances. More was taken in VAT and labour taxes than was planned, but the budget for the year as a whole was in deficit even though it was forecast to be in balance. Expenditures exceeding income meant that the state contributed to boosting growth in the economy alongside the private sector. Fiscal policy is an important tool for keeping the economy in balance in countries in the euro area, though its scope is limited. Forecasts indicate slower growth ahead in the Estonian economy as the boost from foreign markets fades and production capacities approach their limits.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

The financial position of the banking sector and its resilience to risks remain strong. Seventeen credit institutions operated in Estonia as at the end of the year, eight of which were branches of foreign credit institutions. Bank loans and leases grew robustly in the second half of 2017 and the quality of the loan portfolio of the banks remained good and loan losses were small. The annual growth in loans issued by credit institutions operating in Estonia was 2.1% and growth in loans without one-off adjustments in the consolidation groups of market participants would have been 6.8% and the share of long-term or over 90 days overdue loans dropped to 0.8%; the last time this indicator amounted to less than one per cent was 10 years ago. The decrease in overdue loans has been broad-based, covering most economic sectors and banks. Volume of non-residents' deposits decreased from 12.7% to 11.7% over the year. Credit institutions have coped well and managed to maintain their interest income and profitability irrespective of the low interest rates and the negative Euribor. Although the return on equity of banks decreased from 11.9% to 10.3% over the year, it was mainly due to the increased equity and profitability remains high.

The banking sector is mainly funded through the deposits of resident clients, though financing from Nordic parent companies plays an important role in the funding of some banks. The banking sector assets ratio to GDP was 110% in 2017. The profitability of the banks was a little lower in 2017 than a year before, but was still relatively good. The return was affected most by dividend income and income tax expenses. The net profit of the banks has been affected greatly in recent years by the dividends received from subsidiaries and the cost of income tax paid. Without this the profit of the banks would have been higher in 2017 than in the previous year as base was higher earlier. Income was boosted by a rise in net interest income and total net fee income did not change substantially in 2017. The profitability of the banking sector is very likely to remain stable in future. It will be maintained by growth in the loan portfolio and an increase in loan margins. Upwards pressure on the expenses of the banks will also continue. The capitalization of the banks operating in Estonia is mainly strong. The ratio of own funds of the banks to risk assets remained one of the highest in Europe.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN ESTONIA

Finantsinspektsioon has three areas of activity: prudential supervision, market and services supervision, and resolution. These areas are supported by supportive and control functions, such as public relations, consumer education, law, personnel and training activities, coordination of international cooperation, internal control, IT, accounting and secretariat.

Prudential supervision is centred on analysing the risks of financial institutions and business continuity. The objective of market and services supervision is to ensure the transparency, reliability and efficiency of financial services. Resolution is the responsibility of the Resolution Department of Finantsinspektsioon, which is independent of supervision functions. To avoid possible conflict of interest, the Resolution Department reports to the member of the Management Board who is not directly responsible for the prudential supervision of credit institutions.

In the opinion of Finantsinspektsioon, the Estonian financial market will be affected in the years ahead by the increasing complexity and scope of the legal framework, the geopolitical situation and digitalisation. The expansion and deepening of the laws surrounding the financial market sets new tasks for the market and the state's supervisory mechanism. These tasks bring costs which result in the consolidation of the financial market and a trend towards consolidation can be seen in Estonia as well. However, this may not be suitable, as it can lead to excessive risk concentration and reduced competition and the transfer of actual supervision under the present European Union norms to another country, even when a subject has a significant market share in Estonia. The emergence of large market participants in Estonia in its turn requires analysis and testing of the security network.

STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

In prudential supervision, we focus on integration with the European Single Supervisory Mechanism with an emphasis on cooperation with Eesti Pank. In addition to this, we focus on corporate governance with emphasis on the suitability of managers, the internal control system, business continuity and outsourcing, and the accuracy of reporting. In market and business conduct supervision, we focus on the life cycle of financial services and financial products, with emphasis on the prevention of money laundering and terrorist financing, oversight of the development of products and services and accuracy of disclosed information. In crisis resolution, we focus on the integration with the European Single Resolution Mechanism and the Single Resolution Board and also on the preparation of resolution plans. In promoting public awareness, we focus on supporting the supervision and resolution functions by providing information on relevant issues to consumers (better understanding of financial services) and thereby represent good practice in the financial market to professional market participants (more responsible delivery of services). We contribute to the analysis and optimisation of the institutional framework for financial crisis resolution in Estonia, to the analysis of potential new supervision areas and to monitoring of financial innovation.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2017 the supervision of credit institutions focused on the operation of the internal control systems of the subjects of supervision, the conduct of strength analyses in several areas of risk, the operational and financial risks associated with the implementation of business strategy and the management of capital, and the operational risks related to information and communications technology and business continuity.

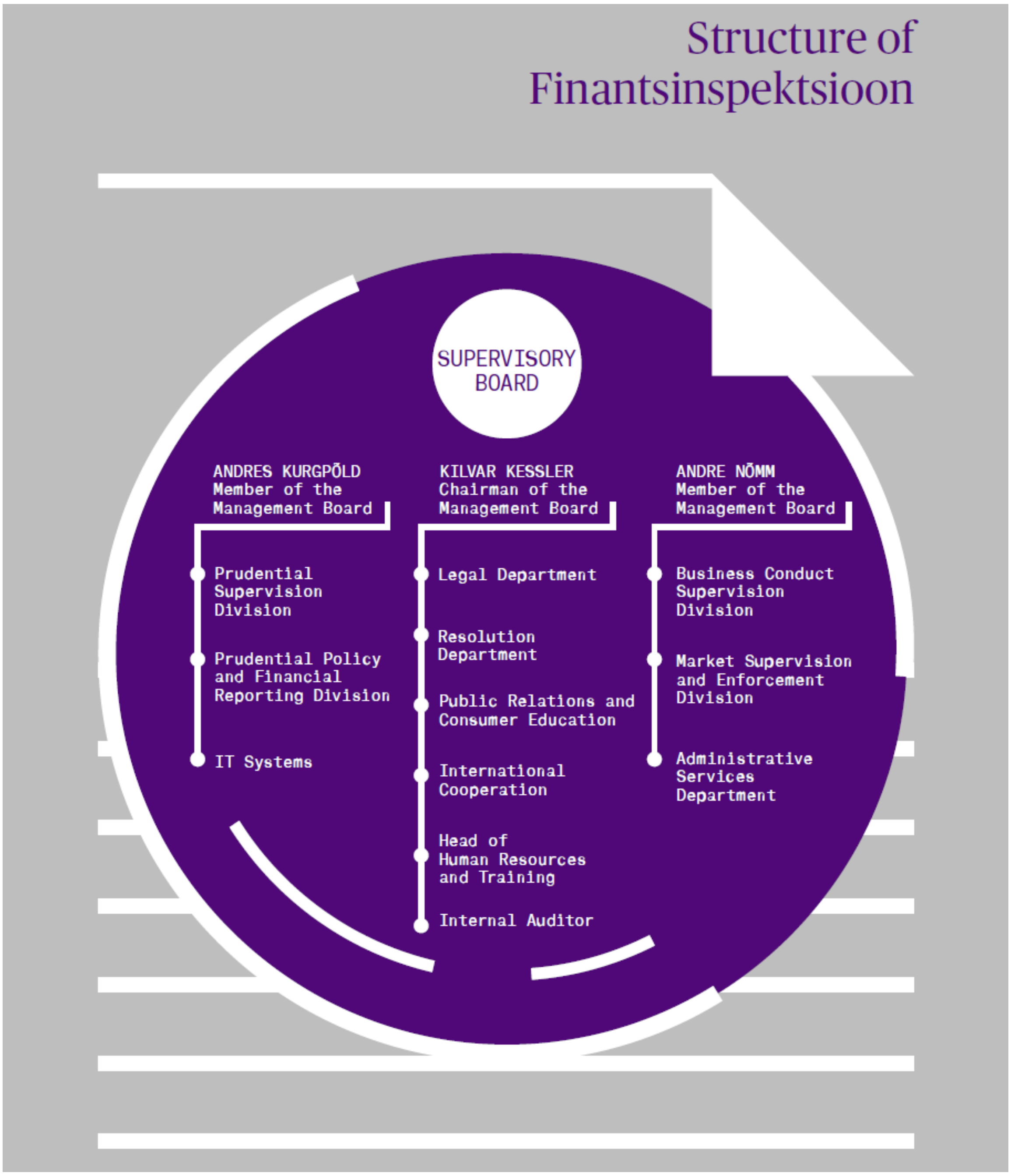
The joint supervisory teams prepared a supervisory opinion for significant credit institutions in 2017 and analysed the plans for recovering their financial status. Swedbank AS and AS SEB Bank were deemed significant credit institutions in Estonia in 2017. An application to list Luminor Bank AS as a significant bank was filed late in the year. The business models and sources of profit of credit institutions and their preparations for the implementation of IFRS 9 were also exceptionally assessed. Two procedures for the internal models of credit risk for significant banks were carried out in cooperation with the European Central Bank. As a result of the merger of AS DNB Pank and Nordea Bank AB Estonia branch in the Baltic states and the establishment of Luminor Bank AS, a procedure for evaluating a majority holding was carried out at AS DNB Pank in cooperation with the European Central Bank, as the ownership structure of the bank changed in the course of the business transfer.

Finantsinspektsioon is responsible for supervising credit institutions that are less significant for the purposes of the Single Supervisory Mechanism. Finantsinspektsioon drew attention to the risks that may be associated with the rapid increase in loans granted by less significant banks and the resulting need to strengthen risk management and internal control systems. Finantsinspektsioon also set additional capital requirements to cover the risks arising from the increase in loans as part of its annual supervisory review. The European Central Bank is developing standards for supervising less significant credit institutions in order to ensure that credit institutions in Europe are supervised in the same manner. Finantsinspektsioon has started using these standards in its everyday work to ensure that Estonia integrates with the European Single Supervisory Mechanism as much as possible. The less significant credit institutions in Estonia continued improving their simplified recovery plans in 2017 and submitted the updated plans to Finantsinspektsioon for assessment. Although the quality of the plans has improved considerably, Finantsinspektsioon still found some deficiencies in them. The biggest of these was the inadequacy of the description of the escalation process for implementing the plans. The credit institutions must submit the amended plans in 2018.

In 2017 Finantsinspektsioon carried out a credit risk stress test within the scope of the SREP, in the course of which it assessed how the loan portfolios of all the credit institutions operating in Estonia and two branches of credit institutions operating in foreign countries would react to a negative shock in the economic environment. The payment discipline of the credit institutions and the potential loan losses arising from a fall in the value of collateral was assessed. Stress tests of interest rate risk, liquidity risk and market risks were also carried out within the scope of the SREP, and the results were used in setting the additional capital requirement under the SREP. Finantsinspektsioon also prepared risk assessments for branches of significant foreign credit institutions operating in Estonia. This assessment was submitted to the supervisory authorities of the home countries of the credit institutions, which will use it in the SREP of the banking group. The supplementary capital requirement for less significant credit institutions in 2017 was 65 million euros, which is 46% more than the regulatory requirement. The supplementary capital requirement for significant credit institutions was 145.7 million euros or 29% more than the regulatory requirement.

In 2017 Finantsinspektsioon carried out five onsite inspections in 30 risk areas in credit institutions. The focus during the inspections was on internal control systems and the organisation of risk management and control. The management and control of single risk areas was also assessed. As a result of the onsite inspections, Finantsinspektsioon identified 171 circumstances for which credit institutions had to submit explanations and plans for eliminating deficiencies. The observations mostly concerned ensuring that internal rules of procedure are up to date and adequate. There were also problems in the functioning of the second line of defence, risk control. There were deficiencies in how risk appetite and tolerance were defined, making it impossible to compare how actual risks correspond to the risk level desired for the future. In 2017 Finantsinspektsioon and the Guarantee Fund started stress tests of the capacity of the guarantee scheme. One part of the test is to assess the capability of credit institutions to submit data about the deposits that are subject to compensation to the Guarantee Fund and the capability of the Guarantee Fund to receive and process these data.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The Estonian financial sector is a part of the European single financial services market. The financial stability of Estonia also depends on cooperation with other Member States. Finantsinspektsioon has a say in shaping the financial supervision policy of the European Union through European supervisory authorities. Since Estonia is also a member of the euro area, the daily work of Finantsinspektsioon is related to the Single Supervisory Mechanism. This is the banking supervision system of the euro area, which includes the European Central Bank and the banking supervisory agencies of the euro area countries. Finantsinspektsioon is also the main partner in Estonia of the Single Resolution Board, which is the central resolution authority of the significant credit institutions of the euro area. The Single Resolution Board and the resolution authorities of the euro area countries form the Single Resolution Mechanism. There are three European supervisory authorities: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). Staff from Finantsinspektsioon participate in the work of the supervisory boards of all of these authorities and in 2017 they participated in the work of 37 different committees or working groups of the European supervisory authorities and attended 99 meetings in total. All three European supervisory authorities belong to the Joint Committee of the European Supervisory Authorities, where they discuss topics that concern the entire financial sector, including the budgets and strategies of financial supervision authorities, consumer protection, AML and preparation of overviews about the developments and risks in the financial market. In 2017 experts from Finantsinspektsioon participated in the working groups of two joint committees and attended eight meetings in total. Finantsinspektsioon transposed two guidelines of the Joint Committee. In autumn, the European Commission made a proposal to change the management and funding of the European financial supervision authorities and review their mandates, functions and authority. Work on the proposal and the feedback received from Member States will continue in 2018. Finantsinspektsioon and Eesti Pank participate in the work of the European Systemic Risk Board (ESRB), which operates at the European Central Bank. Finantsinspektsioon participates in sessions of the highest decision-making body of the ESRB, the Administrative Board, as a voting member and in the work of the Advisory Technical Committee (ATC) established by the ESRB as a full member. In 2017 a representative from Finantsinspektsioon attended four administrative board meetings and one Advisory Technical Board meeting, where issues of ensuring financial stability were discussed. Finantsinspektsioon is also a member of the following global financial supervisory organisations: the International Association of Insurance Supervisors (IAIS), the Group of Banking Supervisors from Central and Eastern Europe (BSCEE Group), the International Organisation of Securities Commissions (IOSCO), and the International Network on Financial Education of the Organisation for Economic Co-operation and Development (OECD) Finantsinspektsioon met with the representatives of the International Monetary Fund (IMF) within the scope of their annual consultation under Article IV of the Articles of Agreement.

STATISTICAL TABLES

**Number of financial institutions (head offices/branches)
(at year-ends)**

Type of financial institution	2015	2016	2017
Commercial banks	9	9	9
Branches of foreign credit institutions	7	7	8
Banking sector, total:	16	16	17

Ownership structure of banks on the basis of assets total

Type of financial institution	2015	2016	2017
Public sector ownership	0,0	0,0	0
Other domestic ownership	5,9	7,3	11
Domestic ownership total	5,9	7,3	11
Foreign ownership	94,1	92,7	89
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	76,9	86,6	2360
Branches of foreign credit institutions	9,4	10,2	45,4
Banking sector, total:	86,4	95,8	2400

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Banks	21,6	11,9	10,3

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	73,6	74,3	89,7
Branches of foreign credit institutions	26,4	25,7	10,3
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking sector (%)
(at year-end)

	2015	2016	2017
Claims from			
Financial sector	29,5	27,9	25,5
Nonfinancial sector	56,9	56,9	48,0
Government sector	2,6	2,5	2,8
Other	11,1	12,6	23,7
Claims due to			
Financial sector	24,4	25,7	23,3
Nonfinancial sector	56,4	54,3	54,2
Government sector	6,0	6,7	7,1
Capital	13,3	13,3	15,4

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks***	36,0	34,6	30,1

(* - for Basel I; ** - for Basel II; *** - for Basel III

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector	1,3	1,3	1
- households	1,5	1,0	0,7
- corporate	1,6	1,7	1,4

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	78,8	65,2
Households	43,7	36,5
Corporate	35,2	28,7
Government sector	10,4	3,8
Financial sector (excluding banks)	10,8	30,9
Total	**100.0**	**100.0**

P&L account of the banking sector (at year-ends)
mln EUR

P&L account	2015	2016	2017
Interest income	498	511	483
Interest expenses	77	64	61
Net interest income	421	446	421
Net fee and commission income	156	150	144
Other (not specified above) operating income (net)	412	168	47
Gross income	1160	889	770
Administration costs	274	290	279
Depreciation	14	11	12
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	0	0	0
Profit (loss) before tax	671	387	347
Net profit (loss)	610	360	316

Total own funds in 2017 (in EUR millions)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2
Commercial banks***	3169	3121	3121	47

(* - for Basel I; ** - for Basel II; *** - for Basel III

2017 DEVELOPMENTS IN THE GEORGIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2017, economic growth in Georgia reached 5%. Major contributors to the growth in 2017 were trade (0.9 pp), construction (0.7 pp), Transport (0.5 pp) and manufacturing sectors (0.4 pp).

Growth rate of export of goods and services amounted to 29% accounted for most of nominal growth of GDP in 2017. Tourism sector has also supported the growth of export revenues in 2017. Other source of growth, namely, households' consumption has increased by 9% in nominal terms.

Gross national savings rate was 23.2% of GDP in 2017. Unemployment rate remained high; however, it decreased slightly to 13.9% in 2017 compared to the previous year (14.0%).

Inflation rate was above NBG's target of 4% mostly due to one off factors such as increase of excise taxes on fuel and tobacco and rise of international price of oil. Headline inflation reached 6.7% by December 2017 while inflation excluding effects from excise taxes and oil price increase was under 4% for the most of the year. Monetary policy stance was moderately tightened in 2017. As a response to increased inflation expectations, the National Bank of Georgia (NBG) gradually increased the monetary policy rate from 6.5% to 7.25% in 2017.

Consolidated budget deficit has reached 2.9% of GDP compared with 3.0% in 2016. Tax revenues of consolidated budget have increased by 11.3% compared to 9.7% in 2016, while budget current expenditures increased by 5.9% compared to 11.6% in 2016. Tax burden made up 25.7% of GDP, which is slightly less than 25.8% in 2016. Public debt to GDP increased and amounted to 44.6% in 2017, while in 2016 it was 44.4%.

Current account deficit[24] reached 8.9% of GDP in 2017, which is 4.3 percentage points smaller than in 2016. The goods imports increased by 9.9%, while goods exports increased by 24.5% (in 2016, imports and exports decreased by 3.2% and 5.2% correspondingly). Trade deficit made up 25.4 % of GDP in 2017. Revenues from tourism, as well as transfers and remittances were significant sources of financing trading goods deficit.

Main sources of financing of current account deficit were FDIs, which made up about 1812.9 million USD in 2017, which is 14.3% more than in 2016. At the same time, the outflow of portfolio investments made up 71 mln USD in 2017, unlike the previous year, when it was inflow of 41 mln USD. As the result, total external debt increased by 1.4 billion USD up to the 17.3 billion USD, which is 114% of GDP. In the same period, external public debt increased to 48.2% of GDP. Large portion of the state borrowing consisted of low interest bearing loans from donor organizations.

[24] According BPM6 methodology

DEVELOPMENTS IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL/GDP)

Banking is the main financial intermediary in Georgian economy. Foreign investments dominate banking sector and account for more than 84% percent of total equity. Banking sector assets grew by 15% in 2017. Credit portfolio increased by 18% YoY at the end of 2017, the same as in 2016. In total, credit portfolio accounted for 59% of GDP which is 3% higher than in 2016. As for the total assets of banking sector, they accounted for 91% of GDP that is 2 percentage points higher than in 2016.

In 2016, the highest growth rate was recorded in SME (30% annually), followed by retail and corporate sectors. Banking sector loan portfolio break-down by products is the following: 31% accounts for corporate sector, 46% - retail sector, and 23% - SMEs.

Throughout the year, loan portfolio quality has slightly improved. According to NBG's more forward-looking methodology and taking into account restructured loans with no evidence of being able to repay them under the new schedule, NPL ratio decreased by 1.3 percentage points and made up 6% of total portfolio. At the same time, NPL ratio calculated with widely accepted methodology - loans with more than 90 days overdue to total portfolio - decreased to 2.8% in 2017, 0.9 percentage points less than in 2016.

In 2017, banking sector accumulated liquidity ratio above the prudential minimum. The share of liquid assets to total assets and non-bank deposits made up 21% and 37%, respectively.

Banking system still remained highly dollarized, contributing to currency induced credit risk. In 2017, the dollarization of loans decreased by 8.4 percentage points, to 57.1%, and dollarization of deposits also decreased, making up 65.6%. To mitigate this risk, NBG applies additional risk weights for foreign currency exposures and higher reserve requirement for foreign currency deposits.

Georgian banking system is adequately capitalized, mainly driven by aforementioned risk weighting. At the end of 2017, core Tier 1, Tier 1 capital and regulatory capital ratios calculated based on Basel III framework were 13.6, 13.8% and 18.9%, respectively (minimum requirements are 7.0%, 8.5% and 10.5%). It is noteworthy, that starting from 2018, Basel I framework will be fully phased-out.

Profitability of banks increased in 2017. Net income of the system jumped from 679 million GEL in 2016 to 870 million GEL in 2017. At the end of 2017 RoA made up 2.8% and RoE made up 20.7%. Nominal growth of the credit portfolio and improvement of asset quality led to higher profitability in banking system. In addition, the efficiency of banking system continued to improve with the increase of scales of operations. Cost to income ratio increased from 46.0 % in 2016 to 47.1% in 2017.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN GEORGIA

The authority to supervise and regulate the financial services sector in Georgia (except insurance) including commercial banks, non-bank financial institutions - securities market, credit unions, microfinance organizations, money remittance units, currency exchange bureaus and qualified credit institutions, is vested with the National Bank of Georgia. NBG is the central bank of Georgia and an independent public body.

The legal framework of the operation and supervision of financial institutions is primarily defined by the Constitution of Georgia (Articles 95 and 96). In addition, Organic Law on Georgia on National Bank of Georgia, Law on the Activities of Commercial Banks, Law of Georgia on the Securities Market, Law of Georgia on Microfinance Organizations, Law of Georgia on Non-Bank Depository Institutions - Credit Unions and relevant by-laws issued on specific prudential areas support the legislative framework of the financial institutions' supervision in Georgia.

Throughout 2017 NBG continued development of regulatory framework and approximation of current standards with international practices and principles.

During 2017 the parliament reviewed package of legislative amendments ("Organic Law on the National Bank of Georgia" and the "Law on the Activities of Commercial Banks"), initiated in order to execute recommendations made through the "Financial Sector Assessment Program" (FSAP), which was undertaken by a joint International Monetary Fund and World Bank mission in 2014, and to satisfy the directives under the EU-Georgia Association Agreement. Package of legislative initiatives was approved at the end of the year 2017 and became effective on January 11, 2018. Qualitative amendments made in various legislative acts significantly improved the supervisory framework of NBG, and aligned it with international practice.

During 2017, the National Bank of Georgia has launched the initiative of publishing draft versions of supervision-related normative acts on NBG's web-site for the purpose of enhancement the transparency of the financial sector. The initiative enables all the interested parties to be familiarized with the draft normative acts before adoption and submit recommendations and comments to the NBG. "Code of Ethics and Professional Conduct Standards for Commercial Banks" has been the first published draft version in the course of the mentioned initiative that is currently implemented.

In 2017 the "Regulation on Disclosure Requirements for Commercial Banks within Pillar 3" was approved and became effective, requiring commercial banks to publish qualitative and quantitative information regarding to capital elements, risk weighted assets, remuneration of senior management and other material issues. Abovementioned regulation replaced the "Regulation on Transparency of Financial Conditions of Commercial Banks" approved in 2006. Its noteworthy that requirement of abovementioned regulation are in line with updated Pillar 3 framework of Basel Committee (which was finalized in 2017) and principles of corresponding European directives. Quarterly reports published by commercial banks within pillar 3 framework, containing quantitative information, are available on web-sites of NBG and corresponding commercial bank. Respective annual reports, containing qualitative information in addition to quantitative information, were published in May of current year.

In 2017, the NBG updated the "Law Defining Minimum Capital Requirements for Commercial Banks" of May 23, 2006 (decree N144). According to the updated version of the law, legal persons seeking a banking license and existing commercial banks must comply with a minimum capital requirement of 50 million GEL. Furthermore, existing banks that do not comply with this requirement are given a transitional period of three stages. According to this, the minimum regulatory capital must amount to at least 30 million GEL by 31 December 2017, rising to no less than 40 million GEL by 30 June 2018 and to no less than 50 million GEL by 31 December 2018.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

In 2017, the main strategic objective of the National Bank of Georgia was to continue improving and developing the supervisory framework, including the implementation of Basel III Pillar 2 and Pillar 3 frameworks, capital buffers and approximating banking legislation to the EU legislation according to the EU-Georgia Association Agreement.

For this purpose of improving the quality of regulatory capital of banks and achieving better compliance with Basel III framework and international standards, amendments have been introduced in the regulations relating to capital adequacy requirements. Abovementioned changes include amendments to "the Regulation on Capital Adequacy Requirements for Commercial Banks" and introduction of new requirements through following normative acts: "Additional Capital Buffer Requirements for Commercial Banks within Pillar 2", "Determination of the Countercyclical Buffer Rate" and "Identification of Systematically Important Banks and Determining Systemic Buffer Requirements".

According to the amendments to "the Regulation on Capital Adequacy Requirements for Commercial Banks" Pillar 1 minimum requirements have become compatible with the framework established by Basel Committee of Banking Supervision. In particular, conservation buffer in the amount of 2.5% which used to be merged with minimum requirements, has been separated from the minimum capital requirements (Common Equity Tier 1, Tier 1 and Total Regulatory Capital respectively being 7%, 8.5% and 10.5 %). Therefore, updated minimum capital requirements are: 4.5%, 6% and 8% for Common Equity Tier 1, Tier 1 and Total Regulatory Capital respectively.

Furthermore, besides abovementioned changes, combined buffer requirements (the conservation, the countercyclical and the systemic buffers) have been introduced. The rate for the conservation buffer has been set at 2.5% of risk weighted assets, while 0% rate has been set for countercyclical buffer. For systematically important commercial banks the systemic buffer has been introduced. In particular, the Financial Stability Committee of the National Bank of Georgia discussed the methodology of identification of systematically important banks and determining additional capital requirements for them. Therefore, based on the Decree of the Governor of the National Bank of Georgia the normative act has been approved on "Identification of Systematically Important Banks and Determining Systemic Buffers". As a result, the systemic buffer rates and compliance timeframes were set for systemically important banks defined by NBG.

The National Bank of Georgia also plans to implement the Basel III leverage ratio. The leverage ratio is a simple and transparent figure that is a supplementary measure of risk-based capital adequacy requirements. The ratio is defined as Tier 1 capital divided by a bank's total risk exposures.

In order to fully comply with the Basel III Tier 2 capital quality standards, the NBG plans to work on defining the requirements for additional Tier 1 and Tier 2 capital instruments. This implies creating write-off or conversion requirements for additional Tier 1 and Tier 2 capital instruments into common Tier 1 equity, either upon the occurrence of predetermined trigger events or at the NBG's request.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

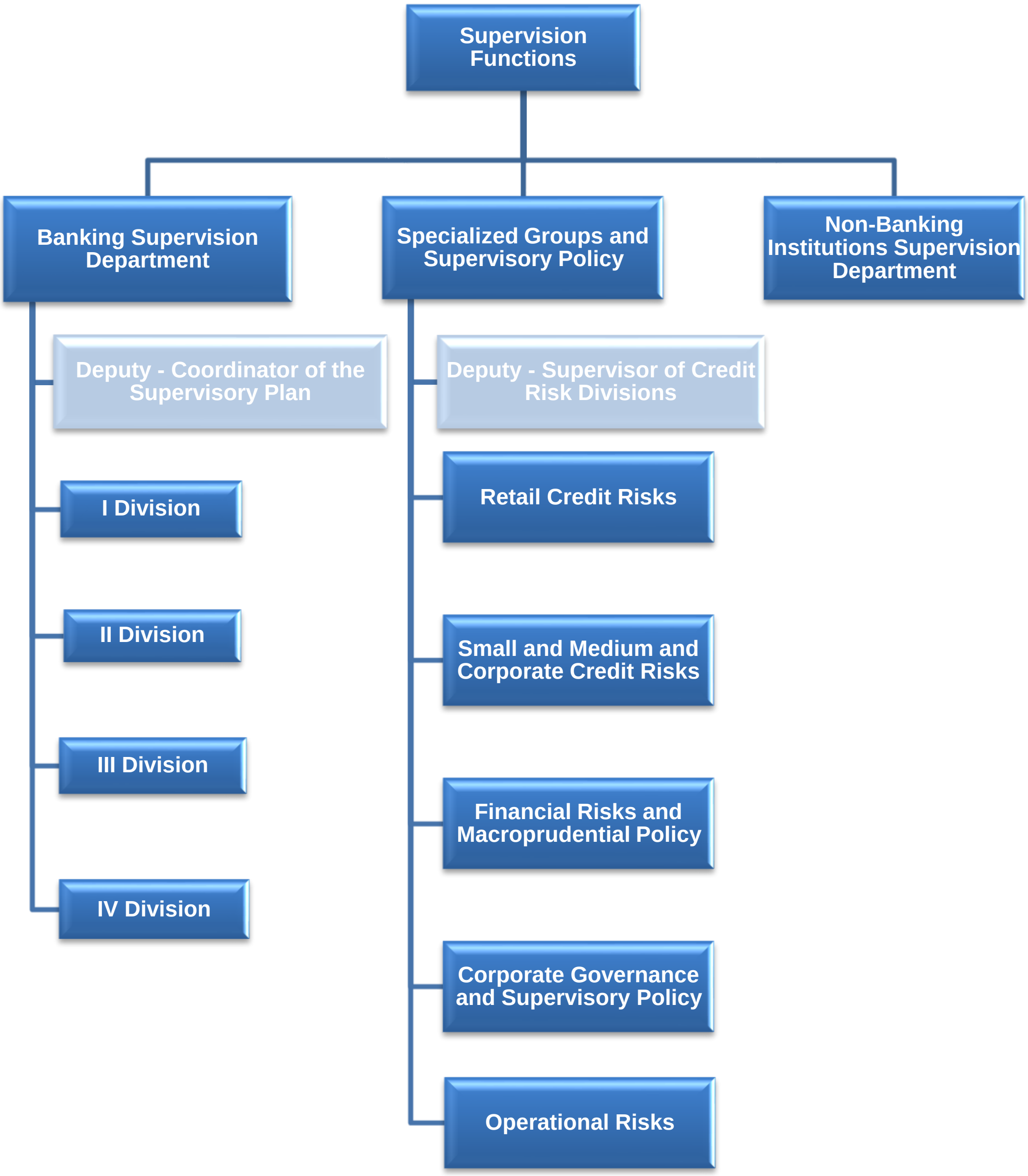
Throughout 2017, NBG continued working on alignment with capital standards of Basel III which implied amendments in legal acts related to capital adequacy requirements. In particular amendments were made in the "Regulation on capital adequacy Requirements for Commercial Banks" and new regulations were introduced on "Additional Capital Buffer Requirements within Pillar 2 for Commercial Banks", "Rule of defining Countercyclical Capital Buffer Rate", and "Rule on defining systemically important commercial Banks and Imposing Systemic Risk Buffer". These updates aim to enhance Basel III framework and comply with international standards through improvement the quality of regulatory capital.

Within the framework of Pillar 2, additional capital requirements are imposed on commercial banks according to General Risk Assessment Program (GRAPE). NBG drafted special guideline regarding to GRAPE, which aims to provide information about the supervisory approaches of NBG to commercial banks, investors, depositors and other stakeholders in order to support formation of accurate expectations towards the financial sector and prevention of procyclical behavior in the sector. The document sets out supervisory actions and principles that are observed by each employee involved in carrying out the supervisory function. The document describes the risk categories and their assessment criteria that shall be assessed within GRAPE, as well as resource allocation during the assessment process and organizational structure of NBG.

Within the development of risk based supervision framework and encouragement of sound lending standards, NBG amended the "Regulation on Capital Adequacy Requirements for Commercial Banks" which is based on Basel III framework. In addition, the "Regulation on Asset Classification and the Creation and Use of Reserves for Losses for Commercial Banks" was updated. On the one hand these changes implies growth of the exposure limits for group of connected counterparties from GEL 350 000 to GEL 2 million for assigning to the retail exposure class, that will allow banks to include loans given to micro, small and medium businesses in the retail class (which implies easing of supervisory burden on these types of loans), on the other hand the "Regulation on Asset Classification and the Creation and Use of Reserves for Losses for Commercial Banks" defined minimum requirements for loans to be classified in standard category distributed to natural persons Payment to Income (PTI) and Loan to Value (LTV) coefficients. In case of breaching limits defined within updated regulation the regulatory burden harshly/significantly increases with regard to capital adequacy requirements. Abovementioned updates will encourage improvement of lending standards in the banking sector, decrease the motivation to distribute retail loans without checking of borrowers' income, and, consequently, improve the quality of commercial banks' credit portfolios and encourage socially responsible credit relationships.

Since September 1, 2017 minimum requirements of Basel III based Liquidity Coverage Ratio (LCR) became effective, which is a modern and effective approach for short-term (up to 30 days) liquidity management and provides a comprehensive tool for identifying, assessing, monitoring and controlling these types of risks. Furthermore, in order to improve the management of long-term liquidity, implementation of the Net Stable Funding Ratio (NSFR) is planned. Following the introduction of the latter ratio, the existing liquidity requirement (of 30% of short-term liabilities) will be void. Once this has happened, the liquidity risk supervisory framework will come into full compliance with Basel III standards.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



The supervisory process of NBG is directly managed by one of the two Vice-Governors. Supervisory functions are performed by two closely related groups – bank supervisors and specialized groups. Bank supervisors (Banking Supervision Department) are responsible for all risk areas across each bank, while specialist risk teams (Specialized Groups and Supervisory Policy Department) are responsible for the system-wide monitoring and assessment of their particular risks across all banks and maintaining systemic stance of the risk. They elaborate risk assessment methodologies, set system-wide benchmarks and are involved in all risk–related tasks. Non-Banking institutions supervision department is charged with monitoring non-banking financial sector, regulating and assisting entities that are registered at NBG. Registering money exchange and money transfer companies.

Normally, the assessment of each risk (inherent risk and risk mitigants) at each bank will be prepared and/or reviewed by these two departments. The separation of the tasks of reviewing/preparing depends on resource availability and task complication level. This approach contributes to more appropriate and consistent benchmarked assessments, while also meeting the "four eyes" principle. It also ensures that a strong peer group review element and consistency of treatment across banks is introduced at an early stage in the risk assessment process, in contrast to other systems where the risk assessment process is driven entirely by the bank supervisor, and any peer group or "panel review" procedures are introduced towards the end of the process. Supervisors are not separated into on-site and off-site supervisors. Both the supervisors and the specialist risk teams undertake on-site and off-site work and perform all necessary steps to identify and assess banks' risks and elaborate relevant supervisory actions[25].

INTERNATIONAL ACTIVITY OF THE AUTHORITY

In 2017 the National Bank of Georgia participated in the project of transition towards risk-based supervision at the National Bank of Kyrgyz Republic (NBKR). Within the frames of the abovementioned project, the NBG held meetings and consultations with representatives of the NBKR on the formation and implementation of an operational risk supervisory framework. The project is a joint technical assistance initiative of the World Bank, the International Monetary Fund and the State Secretariat for Economic Affairs of Switzerland. The technical assistance will continue into 2018.

COOPERATION WITH OTHER SUPERVISORY BODIES IN THE COUNTRY

Until April 2013, NBG was the sole regulator for the financial sector in Georgia. In April 2013 the insurance supervision function was separated from the National Bank of Georgia and a separate public body – State Insurance Supervision Service of Georgia – was established for performing insurance supervision. A Memorandum of Understanding (MOU) between NBG and State Insurance Supervision Agency of Georgia Regarding the Enhancement of the Effectiveness of Inter-Agency Cooperation was signed on June 25, 2014. In accordance with EU-Georgia Association Agreement, the National Bank of Georgia, in cooperation with the supervisor of Insurance Sector, is working on drafting and implementing the framework for supervision of Financial Conglomerates, thus active cooperation with Insurance sector supervisory authority is expected in the future.

[25] For further information, see the presentation „The use of horizontal reviews for micro as well as macro prudential supervision"

In addition, NBG and Financial Monitoring Service have a formal memorandum of understanding on sharing information regarding money laundering and illicit income issues.

NBG is planning to sign memorandum with Deposit Insuarence Agency, which was established in 2017, in accordance with the "Law of Georgia on Deposit Insurance System". Main function of the Agency is to insure deposits of resident and non-resident individuals in all commercial banks operating in Georgia. In the event of commencement of liquidation, insolvency or bankruptcy proceedings in any of the banks (according to the Law of Georgia on Activities of Commercial Bank), the Deposit Insurance Agency will ensure reimbursement of deposits to depositors in the amount of the set limit within 20 calendar days. The Supervisory Board comprised of the Minister of Finance, the Minister of Economy and Sustainable Development, the President of the National Bank of Georgia and two independent members selected by commercial banks, supervises the Agency. Deposit Insurance Agency administers deposit insurance system in the country and ensures its proper and effective operation. Deposit insurance system, together with the prudential regulation, liquidity support and effective supervision represents an important component of financial stability and safety and protects depositors from incurring losses (within the set limit).

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

During 2017, the NBG has been continuing its activities to implement new statistical products. After implementing a new statistical information system – SebStat - data quality and timeliness increased significantly. In 2017, up to 12 million records had been entered the database, that is almost 10 times more than the amount of records received annually before the implementation of the new statistical information system. Consequently, there had been processed more than 10 thousand time series every month. A significant part of these time series is published on the NBG website, while the other parts is provided to the international organizations, representatives of academia and business sector, and other data users.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	**18**	15	16
Branches of foreign credit institutions	**1**	1	0
Cooperative banks			
Banking sector, total:	**19**	**16**	**16**

Ownership structure of banks on the basis of assets total

Type of financial institution	2015	2016	2017
Public sector ownership			
Other domestic ownership			
Domestic ownership total	15%	14%	14%
Foreign ownership	85%	86%	86%
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions (at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	76.06%	84.49%	26.11%
Branches of foreign credit institutions	0%	0%	
Cooperative banks	0%	0%	
Banking sector, total:	76.06%	84.49%	

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	15.37%	18.22%	24,64%
Cooperative banks			
Banking sector, total:	15.37%	18.22%	24,64%

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	99.75%	99.73%	100%
Branches of foreign credit institutions	0.25%	0.27%	0%
Cooperative banks			
Banking sector, total:	**100%**	**100%**	**100%**

The structure of assets and liabilities of the banking system (%)
(at year-end)

	2015	2016	2017
Claims from	**100.00%**	**100.00%**	**100%**
Financial sector	1.51%	1.49%	0.77%
Nonfinancial sector	57.67%	57.07%	60.17%
Government sector	4.75%	4.24%	3.52%
Other assets	36.08%	37.20%	35.54%
Claims due to	**86.04%**	**86.80%**	**87.18%**
Financial sector	4.59%	4.34%	3.09%
Nonfinancial sector	53.54%	52.97%	54.36%
Government sector	3.39%	3.31%	2.82%
Other liabilities	24.52%	26.19%	26.91%
Capital	**13.96%**	**13.20%**	**12.82%**
Claims from	**100.00%**	**100.00%**	**100%**

Capital adequacy ratio of banks

Type of financial institution	2015		2016		2017	
	Basel I	Basel III	Basel I	Basel III	Basel I	Basel III
Commercial banks*	17.49%	16.66%	15.00%	15.06%	16.40%[26]	19.13%
Cooperative banks						
Banking sector, total*:	17.49%	16.66%	15.00%	15.06%	16.40%	19.13%

(* - for Basel I;   ** - for Basel II;   *** - for Basel III)

[26] This indicator shows the capital adequacy ratio of commercial banks at the end of third quarter of 2017.

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector	2.75%	3.67%	2.81%
- households	2.24%	2.04%	1.93%
- corporate	3.10%	4.98%	3.56%

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	97.07%	98.89%
Households	53.74%	42.48%
Corporate	41.33%	56.41%
Government sector	4.93%	0.01%
Financial sector (excluding banks)	0.00%	1.11%
Total	100.00%	100.00%

P&L account of the banking sector (at year-ends)
(EUR thousands)

P&L account	2015	2016	2017
Interest income	2,268,414,646	2,453,795,614	2,842,679,309
Interest expenses	938,953,525	1,017,733,187	1,249,073,368
Net interest income	1,329,461,121	1,436,062,427	1,593,505,941
Net fee and commission income	257,363,295	315,213,697	409,942,825
Other (not specified above) operating income (net)	333,986,239	390,841,578	357,244,599
Gross income	2,859,764,181	3,159,850,888	3,609,746,733
Administration costs	466,101,066	522,636,060	629,127,409
Depreciation	102,433,244	108,677,550	120,372,400
Provisions	406,525,577	337,830,397	274,394,894
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ..)	406,525,577	337,830,397	274,394,894
Profit (loss) before tax	620,147,062	819,327,557	973,466,867
Net profit (loss)	537,394,050	679,101,417	869,798,258

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds		Core Tier 1	Tier 1		Tier 2		Tier 3
Commercial banks		1,765,243,460***	1,266,675,438		1,288,995,359***		476,248,101***	
Cooperative banks								
Banking sector, total:		1,765,243,460***	1,266,675,438		1,288,995,359***		476,248,101***	

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE HUNGARIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

Hungarian GDP increased by 4.0 percent, while inflation rate reached 2.4 over the course of 2017. The budget deficit was 1.9 percent. The economy's overall external position remained positive with the current account balance decreasing to 2.9 as a percentage of GDP.

Hungarian economic growth accelerated in 2017. The acceleration in growth was primarily attributable to strong domestic demand (the continued expansion of household consumption and a bounce-back of investments). Government consumption also had a positive impact on growth, while net exports decelerated the economy as a result of dynamic import growth, stemming from the strong domestic demand.

Household consumption expenditures rose due to several factors. Strong underlying income trends, favorable labor market developments and the historically high consumer confidence all contributed to household consumption growth.

Gross fixed capital formation rebounded in 2017 thanks to the simultaneous expansion of household, corporate and government investments. Corporate investments increased in parallel with accelerating corporate loan disbursement. Along with SME investments there are several capacity-expanding projects. Households' investment activity also improved in accordance with the upswing of the housing market. Government investments rose significantly thanks to the upturn of EU fund absorption and the weak base of 2016.

Inflation stayed below the 3 percent inflation target. After the pick-up at the beginning of the year, inflation stayed in the lower half of the tolerance band. Core inflation rose steadily throughout 2017 because of increasing processed food prices. Underlying inflation indicators remained stable throughout the year and fall short of core inflation.

Total employment increased, while the unemployment rate decreased in 2017 primarily due to increasing private sector employment. Private sector employment growth was supported by manufacturing and construction. The unemployment rate dropped to 4.2 percent in 2017.

Hungary's net lending decreased to 4.1 percent of the GDP in 2017, while the current account balance amounted to 2.9 percent. The trade surplus diminished significantly because of the expanding imports related to stronger domestic absorption, and temporarily subdued exports due to the factory shutdowns in the summer. Along with the balance of goods and services, the income balance also contributed to the drop in current account balance as a result of expanding profits of foreign-owned companies. Interest payed to non-residents continued falling. The transfer balance rose significantly due to the increasing utilization of funds from the EU's new programming period.

DEVELOPMENT IN THE BANKING SECTOR (INCLUDING THE ASSETS TOTAL / GDP)

In 2017 the Hungarian banking system's overall shock absorbing capacity remained robust both in terms of liquidity and capital adequacy. Several favourable developments happened during 2017, among others the ratio of non-performing loans at Hungarian banks declined significantly. Continued improvement in banks' portfolio quality is one of the key pillars of the improving resilience of the Hungarian banking sector. Moreover, SME lending expanded at a rate of 12 per cent, and lending to the corporate sector as a whole also reached double-digit growth in annual terms. The continuous improvement in banks' profitability enhances their resilience, but – over the cycle – this profitability needs to be underpinned with increased business activity and cost efficiency.

Corporate lending grew at a rate of 10 per cent in annual terms in 2017, owing to the continued, significant (12 per cent) growth in SME lending and expansion in the large companies' segment. In addition to stronger demand, lending growth was also facilitated by the Market-based Lending Scheme of the Central Bank of Hungary (Magyar Nemzeti Bank, MNB). Increasing competition in the banking sector was coupled with the steady easing of credit conditions, while corporates' credit demand also increased. In this favourable market environment, lending is expected to continue to expand. Corporate indebtedness cannot be considered high in an international comparison; therefore, further growth in lending may be in line with the equilibrium path.

In 2017, considerable growth was registered in household loans outstanding compared to the previous year, amounting to a total of 2 per cent in annual terms. This was mainly attributable to the growth in housing loans, although a pick-up in consumer lending was also seen during the year. The volume of new contracts reached the level observed before the crisis, but – as a result of the debt cap rules effective since 2015 – new lending is occurring in a sound structure, with lower risks. Within new housing loans, the proportion of loans with longer-term interest rate fixation is growing, and within these longer-fixed-rate loans more than 40 per cent were Certified Consumer-Friendly Housing Loans[27] in December 2017. Banks expect rising demand for both housing loans and consumer loans, and further growth in household lending. Accordingly, household indebtedness may approach its equilibrium level in the coming years, while the negative credit gap may gradually close.

The pick-up in the Hungarian housing market continued in 2017. House prices rose by 13.8 per cent in nominal terms compared to the previous year, while the number of market transactions expanded by nearly 2 per cent in 2017. Domestic housing market developments continue to be characterised by strong geographical heterogeneity, although the relationship between developments in the capital and the countryside seems to be reversing. The underlying developments point to further increases in housing market demand, and therefore a healthy upswing in the supply of new homes is of key importance. All in all, the market cannot be considered overheated, and according to the relevant condition indicators, housing prices are at the level justified by the fundamentals.

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[27] In order to increase the transparency and comparability of credit products, in mid-2017 the MNB has introduced the "Certified Consumer Friendly Housing Loan" qualification that can only be obtained by HUF-based housing loan products that comply with the strict conditions set out in the Call for Proposals [e.g. annuity repayment, fixed interest rate period or fixed-rate interest, short deadline for credit assessment and disbursement, maximized cap on spreads (350 bp) and fees related to disbursement and early repayment].

Following a significant decline in previous years, the stock of non-performing loans shrank considerably in 2017, although further steps still need to be taken. The decline in the corporate segment is primarily attributable to the improvement of the portfolio and reclassifications, while in the household segment it is mostly the result of banks' active portfolio cleaning. Overall, the ratio of non-performing corporate loans declined by 6.3 percentage points in 2017, to reach 7.2 per cent at the end of the year. Following a decline of EUR 1 billion, non-performing household loans in the credit institutions sector amounted to EUR 2 billion at the end of December 2017, corresponding to an NPL ratio of 10.9 per cent of total household loans outstanding. The active portfolio cleaning of non-performing mortgage loans may continue in 2018 as well, and thus further portfolio sales to asset management companies are expected. The acquisition of non-performing mortgage loans by asset management companies may, in addition to financial stability aspects, also facilitate a more efficient search for a solution if debtors cooperate.

In 2017, with a total after-tax profit of nearly EUR 2 billion, the profitability of the credit institution sector exceeded even the record profit of the previous year. In line with that, at the end of the year, return on equity rose to a historically high level of 17.5 per cent from previous year's 14.4 per cent. Although the profit is still related to one-off items and ones that cannot be sustained over the long term, also as a result of the stability of core items, the return on equity considerably exceeds the risk-free yield. Over the short run, institutions can ensure a sustainable level of bank profitability by expanding lending activity, improving operational efficiency and implementing digitalisation solutions. In addition, significant potential is also seen in the cost-efficiency of the Hungarian banking sector in an international comparison. The capital adequacy of the credit institutions sector is still high, as the total consolidated capital adequacy ratio amounted to 16.8 per cent at end of 2017. All credit institutions meet the minimum requirement of 9.25 per cent valid for 2017 together with the capital conservation buffer.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN HUNGARY

The MNB performs its supervisory and consumer protection tasks according to the Act CXXXIX of 2013 on the Magyar Nemzeti Bank.

In order to give information and guidance for the supervised institutions in connection with the supervisory interpretation of the sector-specific legislation and the expectations of MNB, the MNB issues binding MNB decrees and non-binding recommendations, documents with information purposes and CEO letters.

Regarding the legislative developments in 2017, we would highlight the following laws:

1. Act LXIX of 2017 on harmonizing the laws governing the operation of financial markets and the trading of financial instruments transposed legislation of MiFID II. [Directive (EU) 2014/65 of the European Parliament and of the Council] to the Hungarian legal system. This act

also provided the fine tuning of the Hungarian legislation due to MiFIR (600/2014/EU Regulation).
2. Act CXLV of 2017 on harmonizing the laws on insurance and payment services implemented legislation of PSD2 [Directive (EU) 2015/2366 of the European Parliament and of the Council] and IDD [Directive (EU) 2015/849 of the European Parliament and of the Council] to the Hungarian legal system.
3. Act LIII of 2017 on the Prevention and Combating of Money Laundering and Terrorist Financing transposed legislation of the new AML Directive [Directive (EU) 2015/849 of the European Parliament and of the Council] to the Hungarian legal system.
4. MNB Decree No. 37/2017. (XII.27.) on the detailed provisions relating to the professional qualifications and competences prescribed for natural persons providing investment advice and information to clients on financial instruments, investment service activities or ancillary services also serves as a transposition of MiFID II. provisions regarding the governance rules related to investment activities.

MAIN STRATEGIC OBJECTIVES OF THE MNB IN 2017

MNB’s supervisory strategy for the period covering 2014–2019 was approved by the Financial Stability Board in July 2014. The strategy determines the mission of the MNB, according to which it aims at maintaining and even strengthening the stability of the financial system and at deepening the participants’ confidence both in the system as a whole and individually in each other. This is supposed to be enhanced by the integrated supervisory instruments. The management of the MNB defined confidence and stability as priority values for the supervisory area for the aforementioned period.

The strategy also contains clearly set objectives for the forthcoming years regarding the supervised markets. Moreover, the MNB has internal, organizational goals as well that it endeavors to achieve with the assistance of the instruments at its disposal. Every supervised sector and supervisory area has its own tasks to be fulfilled in order to be able to achieve the long-term objectives.

Currently, in each sector the focus of the supervisory area is on the following issues:

- examining the authorizations within the supervised entities,
- checking and assessing the internal and external control mechanisms that help detect abuses and frauds,
- and ensuring the high quality of the data supplied.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2017 the directorate of MNB responsible for credit institutions supervision launched 46 inspections and concluded 6 comprehensive, 15 targeted, 1 special thematic, and 7 follow-up inspections. Concerning the internal capital adequacy of the institutions 7 complex (on-site) Internal Capital Adequacy Assessment Process (“ICAAP”) inspections and concerning the internal liquidity adequacy of the institutions 5 complex (on-site) Internal Liquidity Adequacy Assessment Process ("ILAAP") inspections were completed. As a result of the completed inspections 322 million HUF prudential fine was imposed on credit institutions, emphasizing that the MNB is taking a stand firmly against infringements and the institutions that had failed to comply with the former resolutions.

In accordance with the international trends and recommendation of the European Banking Authority ("EBA") the business model-based approach is gaining ground in the domestic supervisors' activities. The MNB is attending to acquaint the business model analyses based on a continuously developing framework and the disclosed risks to the supervised institutions, which dialogue effectively supports the strategy planning and the risk management processes of the banks. The early warning system of MNB with differential indicators supports the forward-looking supervision to take actions against the risks emerging in the future.

During the year the MNB conducted ICAAP and ILAAP review proceedings for all systemically important banks and initiated several validation procedures for risk models at the request of the banks. In order to supplement and aid the efficiency of PHP (program to encourage market-based SME lending) supporting the economic growth, the MNB as a supervisory authority provided preferential capital requirements for the credit institutions in proportion of their growth commitments in SME lending.

High volatility in real estate project finance, depending on the economic cycles and specialties of the regulatory environment, stimulated the MNB to define recommendations for real estate project finance. On one hand, the MNB elaborated its key methodological statements as best practice related to appraisals, appraisals' aspects and framework in order to improve the quality and reliability of real estate valuation. On the other hand, the MNB expects financial institutions for special monitoring, assessment and treatment of real estate projects to enhance risk-consciousness and to incite related risk management developments. In the spirit of the NPL guidance of ECB, the MNB is implementing its recommendation for reduction high NPL portfolios. The recommendation defines the materiality threshold of non-performing loans and sets out supervisory expectations for banks with high NPL related to NPL strategy and adequate organizational framework to manage high NPL portfolios.

In 2017, another focus for the MNB was the introduction of International Financial Reporting Standards, including the first-time application impacts of IFRS in 2017 and follow-up of credit institutions' preparations in those cases where IFRS 9 implementation has been carried out in 2018. During the project, the MNB has had continuous dialogue both with external auditors and financial institutions. Within the scope of IFRS implementation, the first-time application of IFRS 9 has been emphasized because of its new impairment calculation requirements. The MNB has carried out a survey about the impacts on financial institutions of IAS 39 standard which was effective in 2017, and IFRS 9 standard which has been implemented in 2018. Based on the result of the survey, the 2-step implementation of IFRS does not have a relevant impact on the capital ratios of financial institutions, however the MNB will closely monitor the IFRS implementation because of the enhanced operational risk resulted by the first-time application and the methodological differences between financial institutions.

Reliable regulatory data service and appropriate data quality were other supervisory preferences in 2017. As the first step of the zero-tolerance concept, the MNB held a conference in order to communicate its requirements and answer financial institutions' questions. On-site and off-site investigations were carried out to review data quality, data service and reporting processes. In case of inadequate data servicing, data correction was prescribed and considered as aggravating circumstance during penalty calculation.

From 2018 onwards, new IFRS data reporting sheets have been involved into the scope of zero-tolerance concept and in addition to further consultation and investigations, repeating shortcomings in data servicing are expected to entail stricter punishment.

Besides, the MNB targeted to take accurate effective supervisory actions when finding issues. Therefore, in the case of receiving consumer complaints with suspected systemic issue behind or when finding suspected fraudulent events, the MNB launches immediate targeted examinations.

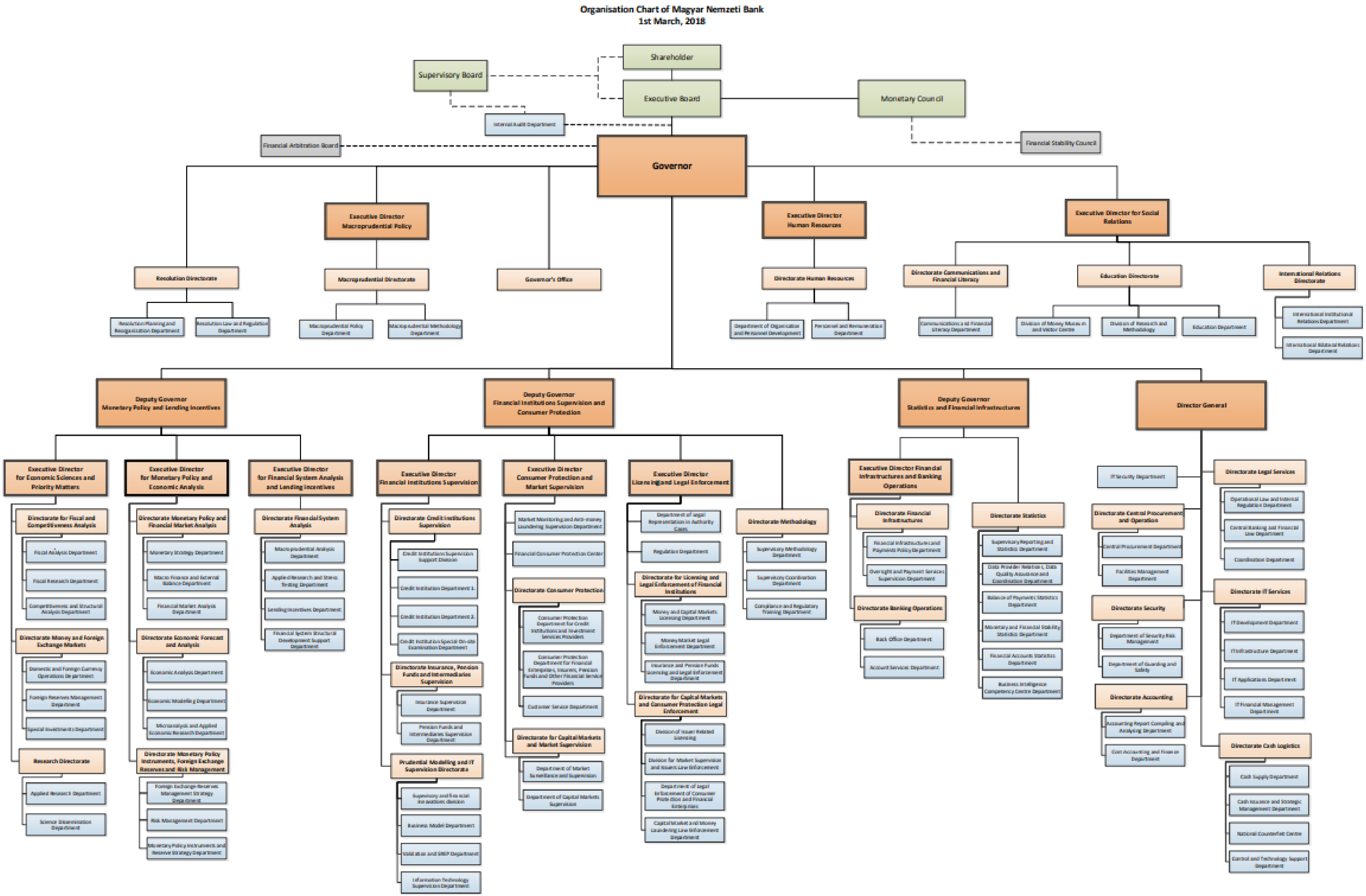
During the reporting period the MNB actively participated in the risk assessment of the international banking groups as home and as host authority. In course of the college activity, under the joint decision the MNB urged requirements for the institutions, active in Hungary that ensure the risk-awareness and effective functioning of these banks from a micro-prudential aspect. As result of the intensive cooperation the recovery plans have been adopted, which ensure that an institution hit by crisis to be capable of operating and restoring the course of business without any state aid.

Table 1: Number of inspections at credit institutions

Number of on-site inspections	2017		2018 plan	
	comprehensive	other*	comprehensive	other*
Large banks	3	33	7	19
Small and medium sized banks	5	7	6	3
Integration	0	4	2	2
Specialized credit institution	0	8	1	5
Bank branch	1	2	0	0
Financial enterprises	0	4	0	0
Payment institution	0	2	0	0
Insurance corporations	1	0	3	0
Insurance associations	9	0	5	3
Intermediaries	7	1	5	0
Pension funds	0	7	0	4
Capital market participants	13	3	13	0
Occupational pensions	19	12	25	0
Total	**58**	**83**	**67**	**36**

* including ICAAP reviews and validations

ORGANIZATIONAL CHART OF THE MNB



INTERNATIONAL ACTIVITY OF THE AUTHORITY

ESRB

The MNB actively participates in the workstream of the ESRB both at managerial and expert levels through several working groups and expert groups. The leaders of national supervisory authorities and central banks meet four times per year in General Board ("GB") sessions, while members of the Advisory Technical Committee meet with the same frequency preceding the GB meetings. Regular discussion topics at these sessions include risks and vulnerabilities, the capital and liquidity position of banks, the ratio of non-performing and restructured loans, the cross-border effects of macro-prudential policy, countercyclical capital buffers, shadow banking and other key issues related to financial stability.

The annual offsite meeting of the European Systemic Risk Board's (ESRB) Instruments Working Group and the European Central Bank's (ECB) Macroprudential Policy Group was hosted by the MNB in July 2017. The three-day event was attended by, in addition to representatives of the ESRB, ECB and the MNB, the senior executives in charge of macroprudential policy from 27 European central banks and/or supervisory authorities. Further to the meetings, a researcher workshop was also organised, where participants discussed – in addition to the costs and benefits of the macroprudential policy – the challenges posed by the residential property housing market and the low interest rate environment.

FSB Regional Consultative Group for Europe

The MNB and the Ministry for National Economy both are members of the FSB's regional substructure. The MNB was represented at managerial level at the meetings of the FSB European Regional Consultative Group in June and in November 2017.

EBA

The experts of MNB actively participated in the professional work of the EBA, mainly in the framework of EBA's various working groups. There is a constant effective communication between the MNB and the EBA, as well as since last year the Hungarian BoS Member has been a substitute member of the EBA Mediation and Breach of Union Law (BUL) Panels.

Memorandum of Understanding

The MNB and the **Bank of China** signed a Memorandum of Understanding in Budapest on 23 January, 2017 in order to assess how the MNB would carry out its renminbi settlements in a more efficient way and to cooperate in order to strengthen the role of Budapest as the Central and Eastern European clearing hub for renminbi.

The MNB and the **Bank of Mongolia** signed a Memorandum of Understanding in Budapest on 12 January, 2017 in order to create a mechanism for long-term cooperation by developing channels of communication to foster the continuing relationship between the parties for the benefit of the respective banking sectors in both Mongolia and Hungary as well as to promote the development of the parties.

Supervisory colleges

The supervisory colleges of financial groups operating in multiple countries are forums of supervisory cooperation. Under the framework of cooperation in supervisory colleges, regular and significant exchange of information takes place among national supervisory authorities.

Since European Central Bank ("ECB") is the consolidating (home) supervisor in case of parent institution of the financial group in SSM-countries, colleges are organized and led by the joint supervisory team (JST) representing ECB and national supervisory authority supervising the parent institution (former home supervisor). College members (home and host supervisors) regularly exchange information on the group concerned, assess risks of the group, parent company and subsidiaries, evaluate the appropriateness of the group's and subsidiaries' recovery plan and may request each other to carry out supervisory procedures. The framework of this cooperation is stated in Written Coordination and Cooperation Arrangements. As a result of colleges' work college members made joint decision on capital and liquidity adequacy and group recovery plan assessment. In total, the MNB participates in 14 banking colleges as host supervisor authority.

As home supervisor the MNB leads the banking supervisory college of the OTP Group. In 2017 the MNB organized two supervisory college meetings and a telephone conference in home role, coordinated the college work which resulted among others in the joint decision on capital and liquidity adequacy and on group recovery plan assessment. The supervisory college established for the OTP Group has made its WCCA and updates it annually.

COOPERATION WITH OTHER SUPERVISORY BODIES IN HUNGARY

The MNB performs supervisory and consumer protection tasks as well. The MNB monitors and supervises the activities of financial and capital market institutions, funds, insurance companies and institutions of the financial infrastructure as well, furthermore, it carries out investor protection tasks and it operates the Financial Arbitration Board[28] and the Financial Consumer Protection Center.[29]

The MNB and the Ministry for National Economy ("MNE") are the most important Hungarian organizations responsible for the establishment and maintenance of financial stability hence the MNB cooperates closely with the MNE, first and foremost, in the area of legislation.

Furthermore, the MNB collaborates with other competent Hungarian authorities as well, such as the Ministry of National Development in charge of General Consumer Protection Activities

[28] a professionally independent alternative forum for resolving disputes
[29] it supplies consumers with comprehensive and easy to understand information about the products and processes in the financial sector and handles consumer claims

STATISTICAL TABLES [30]

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	35	37	35
Branches of foreign credit institutions	10	10	9
Cooperative banks	87	59	22
Banking sector, total:	**132**	**106**	**66**

Ownership structure of banks
on the basis of assets total (%)
(at year-ends)*

Type of financial institution	2015	2016	2017
Public sector ownership	9.6%	3.1%	3.0%
Other domestic ownership	11.6%	17.2%	18.0%
Domestic ownership total	21.2%	20.3%	21.0%
Foreign ownership	78.8%	79.7%	79.0%
Banking sector, total:	100.0%	100.0%	100.0%

* Ownership structure based on the ultimate majority owners.

Concentration of asset by the type of financial institutions
(at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	46.9%	61.9%	0.116
Branches of foreign credit institutions	84.4%	95.3%	0.358
Cooperative banks	33.9%	51.1%	0.075
Banking sector, total:	**40.0%**	**52.8%**	**0.089**

[30] Without 3 Special Financial Institutions (MFB, EXIM, KELER)
Based on individual data

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	0.2%	14.3%	17.4%
Cooperative banks	-1.0%	-1.5%	-3.0%
Banking sector, total:	**0.1%**	**13.8%**	**16.9%**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	86.9%	85.7%	85.3%
Branches of foreign credit institutions	8.8%	10.3%	10.8%
Cooperative banks	4.4%	4.0%	3.9%
Banking sector, total:	**100.0%**	**100.0%**	**100.0%**

The structure of assets and liabilities of the banking system (%)
(at year-end)*

	2015	2016	2017
Claims from			
Financial sector	35.7%	32.4%	31.2%
Nonfinancial sector	35.0%	34.7%	40.6%
Government sector	21.0%	22.8%	25.6%
Other assets*	8.3%	10.1%	2.6%
Claims due to			
Financial sector	31.6%**	30.6%**	30.9%
Nonfinancial sector	45.6%**	47.2%	49.5%
Government sector	3.0%**	3.7%	4.1%
Other liabilities	11.4%**	8.4%**	4.7%
Capital	**8.4%****	**10.1%**	**10.8%**

* Other assets and liabilities decreased due to extended counterparty classification
** Correction in calculation method due to higher data preciseness

Capital adequacy ratio of banks***

Type of financial institution	2015	2016	2017
Commercial banks	20.2%	20.8%****	20.4%
Cooperative banks	16.6%	15.8%	15.4%
Banking sector, total:	**20.0%**	**21.1%**	**20.2%**

(* - for Basel I; ** - for Basel II; *** - for Basel III)
**** Modification due to data correction from bank

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015*	2016**	2017**
Non-financial sector, including***	13.7%	14.3%****	8.6%
- households	17.6%	16.8%	11.1%
- corporate	9.6%	11.6%****	6.3%

* Loans overdue more than 90 days
** Non-performing loans
*** Domestic loans
**** Modification due to data correction from bank

The structure of deposits and loans* of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	80.59%	91.16%
Households	40.31%	41.77%
Corporate	40.28%	49.39%
Government sector	6.62%	1.93%
Financial sector (excluding banks)	12.79%	6.91%
Total	**100.00%**	**100.00%**

* Domestic loans and deposits

P&L account of the banking sector (at year-end, in HUF million)

P&L account	2015	2016	2017
Interest income	1 306 550	1 155 869	1 027 893
Interest expenses	545 007	354 740	284 357
Net interest income	761 543	801 129	743 536
Net fee and commission income	461 953	463 543	508 095
Other (not specified above) operating income (net)*	-988 350	-193 520	70 255
Gross income	235 147	1 071 152	1 321 886
Administration costs	634 292	617 779	773 683
Depreciation	58 027	62 755	63 072
Provisions*	483 779	120 897	184 777
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	0	0	0
Profit (loss) before tax	26 607	511 515	669 909
Net profit (loss)	-34 266	440 499	610 759

***** Change of value is the effect of the Act XL of 2014 on the rules of financial settlement and certain other issues set out in Act XXXVIII of 2014 on the settlement of certain issues concerning the uniformity decision by the Supreme Court related to loan agreements between financial institutions and households. Credit institutions used provisions set aside in 2014 for expected losses. Actual losses caused by settlements are recorded under extraordinary expenditure and the change in credit risk provisions had a positive effect on financial results in 2015.

Total own funds in 2017 (in EUR)***

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	10 002 811 051	8 953 268 542	8 963 389 494	1 039 421 557	-
Cooperative banks	254 319 175	248 071 309	248 597 521	5 721 654	-
Banking sector, total:	**10 257 130 226**	**9 201 339 851**	**9 211 987 015**	**1 045 143 211**	-

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE LATVIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2017, Latvia reported the strongest **economic growth** in the last six years, with its GDP increasing by 5.0%. It was triggered by the recovering **investment** activity, with both private and EU funds related investment on the rise, and by improving export opportunities. The growth of the global economy coupled with economic development in the euro area and Latvia's major trade partner countries triggered an upswing of Latvia's external demand in 2017. Real volumes of **goods and service exports** expanded by 4.7%. Latvian exporters managed to increase their world market share, yet further investment in both physical and human capital will be required to sustain competitiveness. Favourable labour market conditions for employees supported **private consumption.**

Acceleration of the economic activity caused a steady increase in labour demand, with participation and employment rates reaching their historical highs. **Unemployment** continued to decrease gradually, reaching the lowest level in the last nine years: in 2017 job seekers accounted for 8.7% of the economically active population, representing an annual decrease of 0.9 percentage points. Following a four-year period of exceptionally low inflation, average **inflation** rose to 2.9% in 2017. The path of inflation over the year primarily reflected the global trends observed for the supply-side factors, i.e. the development of food and oil prices. Against the background of accelerating economic growth, the effect of demand-side factors on inflation slightly increased.

Although Latvian exporters benefited considerably from the strengthening of the global economy, the **current account** ran a deficit (0.8% of GDP) in 2017 due to the rising global prices and the recovery of the domestic economic activity. The **foreign direct investment** inflows in Latvia were close to their historical average in 2017, reaching 2.4% of GDP. Latvia's **net external debt** to GDP continued its declining path and stood at 24.4% of GDP in 2017.

DEVELOPMENT IN BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

The banks account for about 84 per cent of the total assets of the Latvian financial sector or 105.7 per cent of GDP. On 31 December 2017, there were 16 licensed banks operating in Latvia as well as five EU banks branches. 81 per cent of the Latvian banking share capital is owned by foreign investors. All of the Latvian-licensed banks have been licensed as universal banks and can provide a full range of financial and investment services.

Total loan portfolio in 2017 declined by 4.6%, which was mainly driven by the banking consolidation process. Since mid-2010, the quality of the banking sector's total loan portfolio has been gradually improving in line with improvements in the domestic economic environment. After peaking at 19.4 per cent in July 2010, the share of loans overdue for more than 90 days in the total loan portfolio decreased to 4.1 per cent as at 31 December 2017. The domestic corporate sector contributed the most to this improvement in loan quality, with the proportion of loans overdue for more than 90 days in that sector falling to 2.5 per cent as at 31 December 2017 from a peak of 22.3 per cent in May 2010.

The share of restructured loans in the total banking sector loan portfolio was 5.4 per cent and loans in a work-out process comprised 3.1 per cent of the total banking sector loan portfolio as at 31 December 2017 (compared to 7.9 per cent. and 3.7 per cent as at 31 December 2016).

The total amount of loan loss provisions has gradually decreased since July 2010 as banks have released previously created provisions as their loan quality improves as well as due to the write-offs of the loan portfolio. Loan loss provisions were 3.8 per cent of the total banking sector loan portfolio and the coverage ratio for the loans overdue for more than 90 days improved to 93.2 per cent as at 31 December 2017.

In 2017, total banking sector profit amounted to 236.1 million euro and that was 48% less than in 2016. There were several factors that negatively influenced the banking profits in the reporting year, including the base effect determined by one-off income from the sale of Visa Europe Limited shares (that ensured high profits in 2016), as well as a reduction in the banking business servicing foreign customers and the merger of banks. The above factors had an adverse impact on the amount of total net operating income – compared to the previous year operating income shrank by ~22%, while the key expenditure item – administrative expenditure slightly grew (~1%). At the end of 2017, the return on equity (ROE) of banks reached 7.6% (10.4% at the end of 2016). Earning capacity of banks' focused on providing services to foreign customers continued to decline and ROE in 2017 shrank to 5.7% (11.6%2 at the end of 2016), whereas ROE of the banks focused on domestic customers remained stable at 9.5% (9.2% at the end of 2016).

Despite the significant decrease in deposits received from foreign customers the liquidity risk of credit institutions has not increased and remains limited as the amount of liquid assets maintained by credit institutions is relatively large and more than sufficient to meet both the LCR and the FCMC's liquidity ratio. The FCMC's liquidity ratio was 59.5 per cent as at 31 December 2017 (well above 30% set by the FCMC). LCR was 313 % on 31 December 2017. As of 2018 the LCR requirement of 100% took effect and thus the liquidity ratio requirement set by the FCMC was revoked. Specific liquidity requirements for credit institutions with a sizeable share of foreign customers' deposits in their funding were set individually under Pillar 2.

The banking sector is well capitalised. Following ongoing capital strengthening and reduction in risk weighted assets, the total capital adequacy ratio of the Latvian banking sector reached 21.6 per cent as at 31 December 2017, while the CET I ratio was 19.3 per cent.

Volume of foreign deposits in the Latvian banking sector has been declining since the end of 2015 when they comprised 53.4% of the total deposits. The total volume of deposits decreased by €1.1 billion, or 5.2 per cent, to €20.3 billion as at 31 December 2017 (as compared to €21.4 billion as at 31 December 2016). Deposits of foreign clients decreased by 1.1 billion or 12% during the 2017 and stood at 8.1 billion at the year-end 2017. The decrease in the amount of foreign deposits was mainly due to the stricter AML/CTF requirements and deteriorating macroeconomic conditions in the CIS countries from where the bulk of foreign deposits had been sourced. Deposits of domestic households increased significantly (by EUR 479 million), which almost completely compensated the decline in deposits of local governments and financial institutions. As a result, the total deposits of domestic clients at the year-end remained almost unchanged at €12.2 billion, while the proportion of deposits of domestic clients to total deposits increased up to 60.3 per cent (57.2 per cent at the end of 2016).

The FCMC has started an intensive dialogue with all banks specializing in servicing foreign customers regarding their business model viability and changes to business strategy in order to decrease substantially the share of high AML/CTF risk clients and services in the banking business. Currently undergoing de-risking and change of banks business models is closely monitored and is the focus of 2018 supervisory activities.

Due to previously set strong additional capital and liquidity requirements the banks servicing foreign clients show ability to adjust to the new environment, even with significant decrease in their customer base.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN LATVIA

The Financial and Capital Market Commission (FCMC) is an autonomous public institution and has been performing in this capacity since 1 July 2001. It carries out the supervision of Latvian banks, credit unions, insurance companies and insurance brokerage companies, investment management companies, participants of financial instruments market, electronic money institutions, payment services providers as well as private pension funds. The FCMC ensures supervision and the regulatory framework for the Latvian financial and capital market as well as protects the interests of customers of market participants and promotes soundness, competitiveness and development of the sector in general.

The scope of the FCMC competence is set forth in the Law on the Financial and Capital Market Commission and other relevant laws (e.g., Credit Institution Law). As regards the banking sector, the FCMC has authority to issue regulations and guidelines governing activities of banks, to request and receive information from banks necessary for the execution of its functions, to impose restrictions on the activities of banks, to examine compliance of the activities with the legislation and the FCMC regulations, and to apply sanctions set forth by the regulatory requirement on banks and their officials in case of any violations of regulatory requirements.

Since introduction of the Single Supervisory Mechanism (SSM) the FCMC has been sharing banking supervision powers with the European Central Bank (ECB), namely, the ECB in close cooperation with the FCMC directly supervises three largest banks in Latvia (i.e. Swedbank, SEB banka and ABLV Bank), while other banks are under indirect SSM supervision. However, monitoring of anti-money laundering and combating terrorist financing still remain within the FCMC competence.

The FCMC is also a designated authority for implementation of macro-prudential instruments according to the CRD IV/CRR.

Resolution and Guarantee Funds Division of the FCMC operates in a capacity of a national resolution authority, whose activities and functions are separated from the supervision functions, and a manager of the Deposit Guarantee Fund.

MAIN STRATEGIC OBJECTIVES OF FCMC IN 2017

The FCMC strategic priorities for 2015-2017:

- To improve a regulatory framework for the Latvian financial sector within the context of the EU single market;
- To establish efficiently functioning macro-supervisory mechanism in cooperation with the Bank of Latvia and the Ministry of Finance;
- To develop and make more efficient methods, instruments and practice of financial and capital market supervision;
- To support the implementation of business models of the market participants that are appropriate to the local circumstances, sustainable, safe and reliable for financial service consumers;
- To introduce the efficiently functioning resolution mechanism, integrated into the EU system and appropriate for the Latvian financial sector, including improvements in crisis prevention tools;
- To pro-actively raise public awareness and raise its financial literacy level.

The key supervision-related tasks for carrying out the supervision of the credit institutions in 2017 were as follows:

- To assess the strategies, business models, and the earning capacity of banks, with a focus on risk-taking, sustainability and the balancing of the earning capacity;
- To consolidate the compliance and risk management functions by paying attention to the processes and effectiveness of the carrying out of the stress tests of banks, to improve the ORP and the application thereof in practice, and the quality of reports;
- To assess credit risk and the adequacy of provisions, mainly focusing on problem (overdue, restructured) loans, and the credit recovery process;
- To monitor how successfully the credit institutions that focus on providing services to foreign customers carry out the corrective measures set by the FCMC and how the necessary measures are being taken to eliminate the deficiencies identified by the specialists of the US consultancy companies in 2016.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

During 2017, the FCMC continued to regulate and carry out oversight of the financial and capital market in close cooperation with the ECB within the scope of the SSM and with the European Supervisory Authorities, and pursuant to the best international credit institution supervisory practices and operational frameworks. With a view to promoting the protection of the interests of investors, depositors and the insured, as well as the stability of the financial and capital market, the FCMC has been exercising continuous and comprehensive supervision over market participants by:

- determining the priorities of the supervision of each financial sector, based on risk assessment and trends in the financial market and developing supervisory programmes for each sector and market participant, based on the defined priorities;

- maintaining a constant dialogue with market participants and professional associations regarding the new regulations, requirements, sectoral trends, and the risks and problem issues pertaining thereto;
- ensuring that new market participants with a sound capital base and clear and viable strategy enter the market;
- carrying out on-site inspections and off-site analysis of the indicators characterising the activities of market participants, risks and risk management systems, continuously focusing on the qualitative and quantitative changes of the financial indicators as well as compliance with regulatory requirements and the effectiveness of corporate governance;
- ensuring, within the scope of its competence, the disclosure of true and fair information about the activity of market participants;
- assessing the quality of financial services and ensuring consumer protection within the scope of its competence;
- in cases of non-compliance with regulatory requirements, imposing preventive and corrective measures on the market participants in a timely manner.

Licensing and supervision

In 2017, minor changes in the field of licensing were observed in all segments of the Latvian financial market. As for banking sector, the changes observed were related to the discontinuity of banking activities for two branches of the EU Member States banks and a change in the name of three banks.

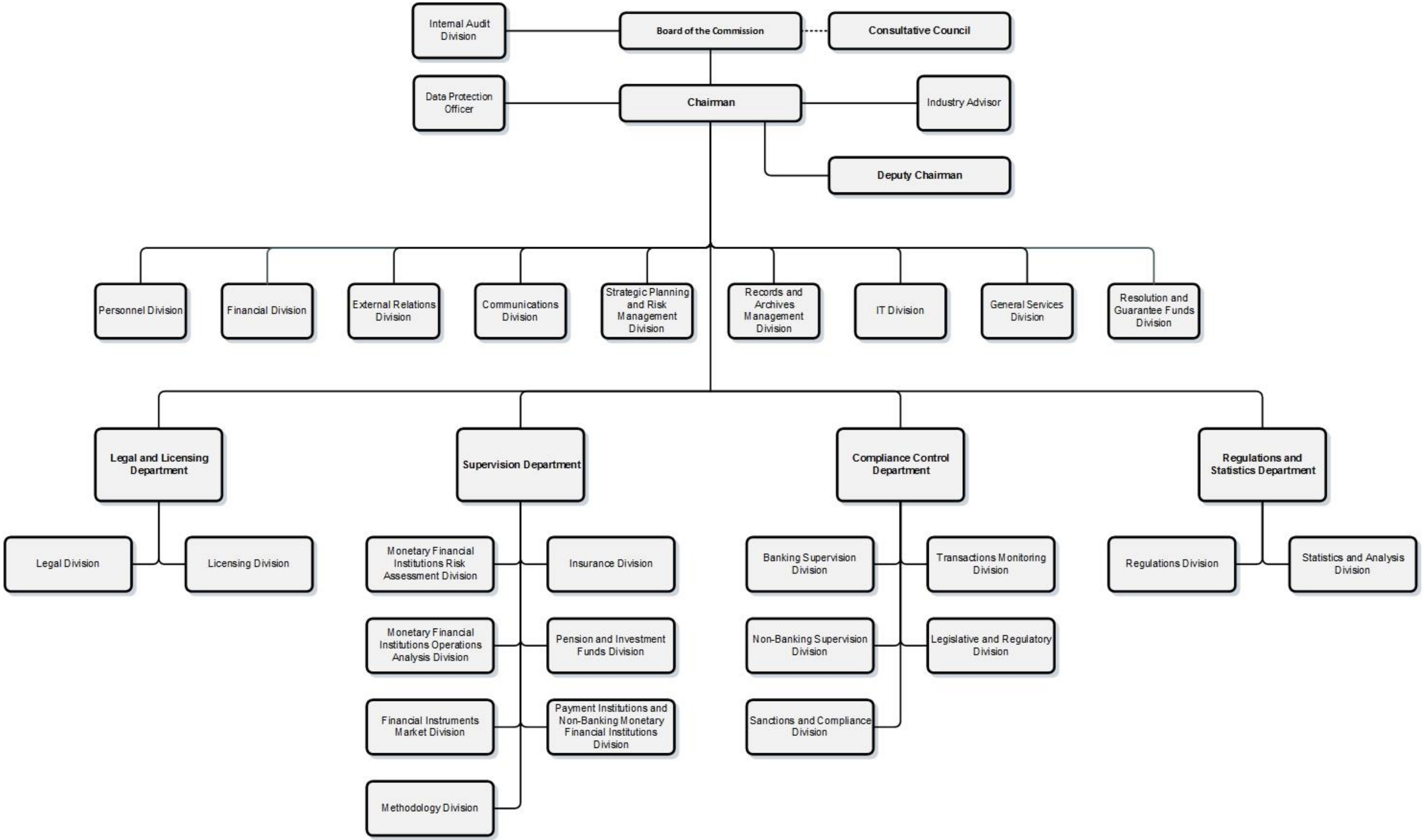
The FCMC, ensuring continuous monitoring of market participants, in 2017, carried out the following supervisory measures:

- monitoring of the performance of market participants after completing the analysis of the financial statements thereof;
- on-site inspections in a credit institution, paying particular attention to the lending process, risk management functions as well as compliance with the AML/CTF regulations;
- follow-up monitoring within the scope of off-site supervision by controlling the progress of the implementation of the action plan to eliminate deficiencies;
- horizontal off-site inspections comprising such matters as asset recovery process and legacy asset management, calculation of risk weighted exposure for credit risk and readiness of banks to apply IFRS 9 requirements;
- the ECB inspections (together with the FCMC experts) in significant credit institutions assessing the quality and adequacy of the calculation of the bank's internal models for credit risk capital requirements.

Regulatory developments

Aimed at ensuring the stable growth of the Latvian financial and capital markets, and based on the regulatory enactments issued by the EU institutions, as well as taking into account the nature and dynamic environment of the Latvian financial sector, the FCMC continued to improve the legal framework of financial and capital market participants, within the scope of the powers conferred on it. Overall, a broad scope of changes was made to the regulatory framework. The most important amendments developed and approved during 2017 referred to the following areas: assessment of asset quality and provisioning, application of IFRS 9, implementation of Solvency II, remuneration policy and establishment of management systems, as well as in the AML/CTF area.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In the area of international cooperation, the FCMC's priority is to take part in the events held in the European region. The FCMC is a part of the European System of Financial Supervision (ESFS) as well as National Competent Authority within the Single Supervisory Mechanism (SSM) and National Resolution Authority within the Single Resolution Mechanism (SRM). The FCMC experts take active part also in the work of the EU Council working parties and participate in the European Commission's Expert Groups.

In addition, the FCMC participates as a member also in the work of several global organizations, such as the Organization for Economic Cooperation and Development (OECD), International Organization of Securities Commission (IOSCO), European Forum of Deposit Insurers (EFDI), International Association of Insurance Supervisors (IAIS) and Group of Banking Supervisors from Central and Eastern Europe (BSCEE).

Like previous years, in 2017, the FCMC continued to maintain close contacts with supervisory authorities from other countries. Bilateral cooperation is facilitated by cross-border agreements on cooperation and exchange of information. An essential part of the banking supervision constitutes the cooperation with home supervisor authorities and the FCMC participates in the work of supervisory colleges for cross-border banking groups.

As key legal acts determining the framework for the functioning of the financial markets in Europe are drafted on the EU level, active participation of the FCMC in negotiations on an international stage is necessary to safeguard the interests of the domestic financial system. Therefore also during 2017 the FCMC continued to intensively participate in the SSM and ESFS working groups and bodies, as well as in the EU Council expressing the opinion that is in line with Latvia's interests and ensuring that its opinion is taken into account. For Latvia, being a small country, it is important to express its opinion on the impact of the legislation under development on small financial markets and seek to achieve that it is balanced so that it would benefit and develop not only large but also small countries.

COOPERATION WITH OTHER SUPERVISORY BODIES IN LATVIA

The FCMC is a unified financial sector supervisory authority in the Republic of Latvia. Nevertheless, the FCMC works in a close cooperation with different national public authorities and institutions, i.e. the Bank of Latvia (macroeconomic, macro-prudential and financial stability issues), the Ministry of Finance (preparation of national legislation), the Office for Prevention of Laundering of Proceeds Derived from Criminal Activity (FIU) (AML/CTF issues), Ministry of Justice, Consumer Rights Protection Centre and other government bodies.

The FCMC cooperates and consults also with all the relevant sector associations, especially within the processes of preparation of regulation, recommendations and guidelines.

STATISTICAL TABLES

Number of financial institutions (head offices/branches) (at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	17	16	16
Branches of foreign credit institutions	9	7	5
Cooperative banks	0	0	0
Banking sector, total:	26	23	21

Ownership structure of the financial institutions on the basis of registered capital (%) (at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	0	0	0
Other domestic ownership	22.8	21.5	21.4
Domestic ownership total	22.8	21.5	21.4
Foreign ownership	77.2	78.5	78.6
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions (at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	51.4	76.5	0.134
Branches of foreign credit institutions	91.4	100.0	0.368
Cooperative banks	-	-	-
Banking sector, total:	49.3	73.3	0.124

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	12.5	14.3	7.6
Cooperative banks	-	-	-
Banking sector, total:	12.5	14.3	7.6

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	89.4	86.3	95.9
Branches of foreign credit institutions	10.6	13.7	4.1
Cooperative banks	0	0	0
Banking sector, total:	**100**	**100**	**100**

The structure of assets and liabilities of the banking system (%)
(at year-end)

	2015	2016	2017
Claims from			
Financial sector	32.1	30.5	34.1
Nonfinancial sector	51.2	55.7	51.5
Government sector	10.9	7.7	8.5
Other assets	5.8	6.1	5.9
Claims due to			
Financial sector	14.7	14.9	15.3
Nonfinancial sector	66.4	64.1	64.0
Government sector	1.7	3.8	2.9
Other liabilities	6.8	7.1	6.7
Capital	10.4	10.1	11.1

Capital adequacy ratio of banks

Type of financial institution	2016***	2017***	2018***
Commercial banks	22.79	21.46	21.37
Cooperative banks	-	-	-
Banking sector, total:	22.79	21.46	21.37

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector	6.3	4.8	4.5
- households	8.0	5.4	4.0
- corporate	5.3	4.5	4.9

(*above 90 days overdue)

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	89.6	88.1
Households	41.6	38.7
Corporate	48.0	49.4
Government sector	4.1	0.5
Financial sector (excluding banks)	6.3	11.4
Total	**100.0**	**100.0**

P&L account of the banking sector (in thousands of EUR at year-ends)

P&L account	2015	2016	2017
Interest income	654 124	638 404	566 396
Interest expenses	131 205	135 755	125 682
Net interest income	522 919	502 649	440 714
Net fee and commission income	333 973	324 587	289 557
Other (not specified above) operating income (net)	156 142	277 705	133 375
Gross income	1 013 034	1 104 941	863 646
Administration costs	462 646	463 288	467 664
Depreciation	26 442	26 909	31 948
Provisions	53 355	117 862	63 164
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	53 355	117 862	63 164
Profit (loss) before tax	470 591	496 882	300 869
Net profit (loss)	415 901	453 754	236 101

Total own funds in 2017* (thousand of EUR)**

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	3 042 500	2 708 340	2 708 340	334 160	0
Cooperative banks	-	-	-	-	-
Banking sector, total:	3 042 500	2 708 340	2 708 340	334 160	0

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE LITHUANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2017 Lithuania's economy recorded the strongest growth in the last 6 years, expanding by 3.8% (adjusted for seasonal and workday effects). The largest contribution stemmed from favourable developments in international trade, which enabled a significant pickup of activity in Lithuania's tradeable sector.

Export growth was stimulated by both an upsurge in foreign demand and the recovery in investment, which, in turn, boosted corporate production capacity. Investment covered not only machinery and equipment, but also buildings and structures. Hence construction was one of the sectors to propel Lithuania's economic growth in 2017. Such investment developments largely stemmed from private sector investment projects that were not financed using EU funds.

Household consumption remained one of the main drivers of economic growth in 2017. Rising prices limited household purchasing power and consumption. Having recorded low rates in the last few years, inflation picked up and stood at above 4.0% in the second half of 2017. Household consumption was also dampened by another significant factor – a declining number of persons employed.

DEVELOPMENT OF THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

Banks continued to operate in a stable manner, while their business models remained unchanged: as before, the main share of their assets was comprised of loans, while deposits accounted for the bulk of their liabilities. Housing loans have posted strong growth within the loan segment in recent years. The level of non-performing loans remained broadly unchanged and continues to be well below the EU average. Deposits with banks have recently been growing on account of corporate funds. The banking sector's capital continued on a sustainable path, whereas its liquidity level was still high.

The banking sector underwent considerable consolidation in 2017: the largest banks in the country continued to optimise their functions, distributing them among the centres of excellence within the group. The merger between AB DNB and Nordea Bank, AB was completed: the new bank called Luminor started its operation on 1 October 2017. It is the third largest bank in Lithuania with a market share of 16% in deposits and 23% in lending, and a wide customer base of around 1.3 million.

In 2017 crediting in Lithuania remained active. Over the year the portfolio of loans issued to the private non-financial sector posted a 6.4% increase, to a similar extent stimulated by both loans to enterprises and households. The portfolio of loans to non-financial corporations expanded by 5.2% year on year. The housing loan portfolio was expanding rapidly as well: over the year it increased by 8.1%. This was mostly influenced by the historically-high activity in the RE market.

The expanding domestic economy, still accelerating crediting and RE markets, as well as adequate bank profitability indicators show that now is the best time for accumulating an additional capital buffer, which would increase the resilience of the financial system to both potential cyclical risks and external economic shocks that may occur even when the financial situation in the country is sustainable. As a result, at the end of 2017 the Bank of Lithuania took a decision to set a positive (0.5%) countercyclical capital buffer rate.

Having opened the doors for establishing specialised banks, the Bank of Lithuania received numerous applications for such licences (including the world famous startup Revolut). It should be noted, however, that the last banking licence in Lithuania was issued only in 2007. Some credit unions also started restructuring into specialised banks; hence, they will add to the range of financial services available to consumers and increase market competition.

The year 2017 saw a growing interest in licences required for payment service provision. Those keen on obtaining such licences were mostly foreign FinTech businesses (companies from the UK and other EU countries, Israel, Asia) as they granted authorisation to provide services across the EU.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN LITHUANIA

The Bank of Lithuania takes active measures to ensure that the road towards positive innovation and market competition remains open. To this end, it works in several directions:

- Strengthening the partnership with financial market participants. With its goal to maintain regulatory hygiene, the central bank is gradually abandoning excessive and outdated solutions. It took the initiative to review relevant legislative provisions: in collaboration with market participants, it identified provisions that should be amended and is dedicated to devoting much attention to implement necessary changes. The Bank of Lithuania also seeks to ensure that its actions are predictable and communicated to market participants in advance. Thus the central bank started announcing its on-site inspection plans and has been organising periodic meetings with market participants. It also took to new ways of fulfilling its supervisory mandate (on-site visits, etc.).
- Encouraging competition in the financial market by lifting the barriers to market entry. Together with other public authorities, the Bank of Lithuania has been searching for ways to attract investors and foreign capital to Lithuania. For example, it improved remote customer identification processes, introduced the possibility to obtain a specialised bank licence, granted payment and e-money institutions access to its retail payment system, and reduced the fee for the licensing of credit institutions 10 times.
- Promotion of innovation in the financial market. The Bank of Lithuania not only seeks to create an environment that would be favourable for providing financial services, but also encourages innovation in the

financial market. It also aims at ensuring that businesses are willing and able to set up in Lithuania, consequently unlocking the full potential of Lithuania's skilled labour pool and infrastructure.

- The Bank of Lithuania also developed a tool for submitting applications for an electronic licence, which will be made available to all market participants following the adoption of the legislative package transposing the revised Payment Services Directive (PSD2). Foreign capital and innovation inevitably entail certain risks (money laundering, terrorist financing, cybersecurity, etc.). The Bank of Lithuania took effective measures to mitigate them: it has been developing the competences of its Supervision Service, increasing internal resources, maintaining close cooperation with law enforcement authorities to evaluate the shareholders and management of licensed undertakings, as well as establishing connections with foreign supervisory authorities.

MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISORY AUTHORITY IN 2017

1. Develop an innovative, attractive and competitive regulatory and supervisory environment for the financial sector:
   - Improve regulatory and supervisory environment, remove barriers to entry and barriers to operate;
   - Develop strong and trust-based relationships with supervised financial market participants;
   - Switch from function to service delivery concept.
2. Lithuania - a financial technology center in the Nordic-Baltic region:
   - Concentrate on research and application of innovations in the financial sector at the Bank of Lithuania;
   - Implement sandbox regime in Lithuania.
3. Increase the level of maturity of business processes.
4. Improve cyber security of financial market participants.

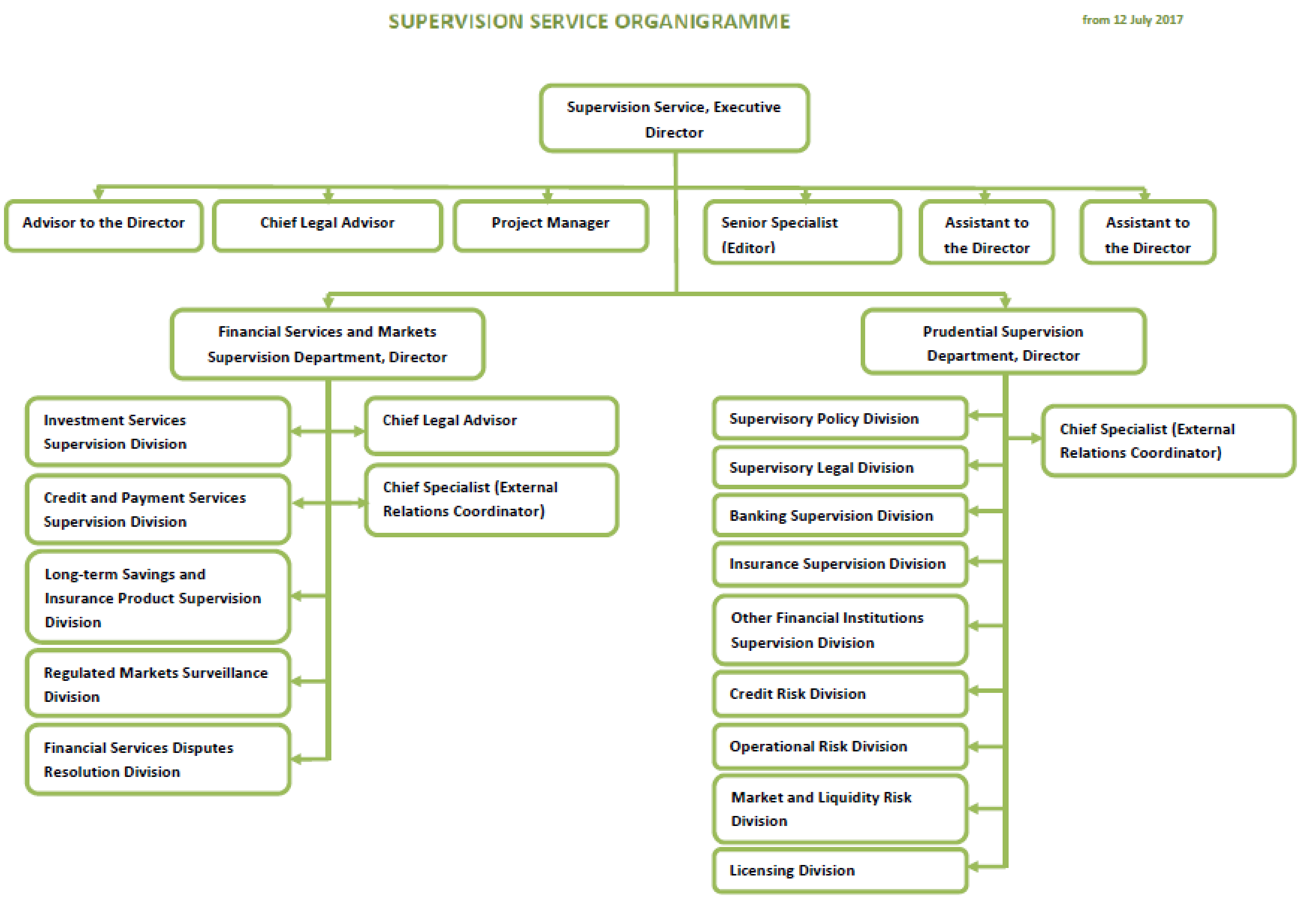
THE ACTIVITIES OF BANKING SUPERVISORY AUTHORITY

The Supervision Service, while becoming a financial sector partner, promoting innovation and sustainable growth:

- Reviewed various legislative provisions and made a list of necessary amendments;
- Started announcing inspection plans;
- Reduced the licensing fee for banks, payment and e-money institutions;
- Launched the Newcomer Programme – a one-stop shop for new market participants interested in obtaining licences in Lithuania;
- Introduced the concept of regulatory sandbox and drafted amendments to relevant legislation;
- Launched the blockchain-based platform dubbed LBChain
- Issued 32 licences (e-money, payment institution and P2P lending platform)

- Increased the visibility of Lithuania on a global scale through presentations, interviews and target events held in the UK, Israel, Singapore and Japan

THE ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In September 2017, the proposal for the EU Twinning Project "Strengthening the National Bank of Belarus", submitted by a consortium of national central banks of Germany, Lithuania and Poland, was selected and a Consortium Agreement was signed later in the year, on 22 December. With a budget of €1.15 million, the project aims to enhance the capacity of the National Bank of Belarus to effectively pursue its core responsibilities in the field of financial stability, banking supervision, payment systems, financial consumer protection, and communication policy. Set to run for 18 months, the project counts on the expertise of the Bundesbank as the main partner and the central banks of Poland and Lithuania as junior partners.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

The credit union sector reform, which was implemented throughout 2017, was successfully completed. Since the beginning of 2018, 2 central credit unions have been in operation: the Lithuanian Central Credit Union, whose membership includes 50 credit unions and the Government of the Republic of Lithuania, and the newly-established United Central Credit Union, comprising 11 credit unions. In 2017 the Bank of Lithuania completed the valuation of the quality of credit union assets.

In 2017 the Bank of Lithuania received 3 applications for a specialised bank licence. According to the most recent data, in addition to the 3 already submitted applications, market participants intend to submit another 19 in 2018. These include applications from 5 credit unions that have been authorised to restructure into a specialised bank. It is important to note that licences for specialised banks, like others, are issued by the ECB.

In 2017 FinTech companies were issued 29 licences – nearly twice as many as in 2016 (17 licences granted). Having met with more than 100 companies to discuss the possibilities to set up in Lithuania, currently the Bank of Lithuania is investigating nearly 20 applications.

In 2018 the Bank of Lithuania is also planning to launch an electronic licensing facility – all companies will be able to get the necessary paperwork done electronically thus saving time and resources.

Amid a rise in the number of cyber attacks, challenges related to cybersecurity are not subsiding. This is of particular relevance to participants of the Lithuanian financial system as they are more and more keen on providing services online so as to make their activities more efficient. Challenges related to cybersecurity will continue to remain relevant to financial system participants, yet potential adverse effects should be reduced by security-increasing initiatives.

STATISTICAL TABLES

**Number of financial institutions (head offices/branches)
(at year-ends)**

Type of financial institution	2015	2016	2017
Commercial banks	6	6	6
Branches of foreign credit institutions	7	8	7
Cooperative banks*	75	74	70
Banking sector, total:	**88**	**88**	**83**

**Ownership structure of the financial institutions
(at year-ends)**

Type of financial institution	2015	2016	2017
Public sector ownership	-	-	-
Other domestic ownership	-	-	-
Domestic ownership total	10.7	10.9	11.1
Foreign ownership	89.3	89.1	88.9
Banking sector, total:	**100.0**	**100.0**	**100.0**

**Concentration of asset by the type of financial institutions
(at year-end)**

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	88.8	98.9	2705.2
Branches of foreign credit institutions	94.9	99.4	4096.63
Cooperative banks	16.5	24.8	280.76
Banking sector, total:	79.9	90.6	2215.51

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	9.58	9.86	9.42
Branches of foreign credit institutions	-6.74	-11.67	3.08
Banking sector, total:	-	-	-

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	81.9	81.1	89.6
Branches of foreign credit institutions	15.3	16.4	7.5
Cooperative banks	2.8	2.5	2.9
Banking sector, total:	**100.0**	**100.0**	**100.0**

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks***	24.30	19.10	18.79
Cooperative banks*	17.59	15.98	18.49
Banking sector, total:	24.36	19.01	18.78

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non-financial sector	5.11	3.77	2.97
- households	6.62	4.81	3.71
- corporate*	8.64	6.52	5.47

The structure of deposits and loans in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	89.5	91.3
Households	59.8	46.6
Corporate	29.7	44.7
Government sector	7.8	2.6
Financial sector (excluding banks)	2.7	6.1
Total	**100.0**	**100.0**

P&L account of the banking sector (at year-ends)

P&L account	2015	2016	2017
Interest income	462.0	472.4	456.2
Interest expenses	116.2	89.5	73.9
Net interest income	345.8	382.9	382.3
Net fee and commission income	170.2	174.0	196.9
Other (not specified above) operating income (net)	47.2	80.8	35.3
Gross income	563.2	637.8	614.5
Administration costs	287.1	294.3	266.4
Depreciation	15.4	14.9	21.2
Provisions	-1.6	5.1	42.7
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	30.6	16.7	-10.5
Profit (loss) before tax	274.6	274.7	275.4
Net profit (loss)	244.0	239.1	225.4

Total own funds in 2017 (in mln EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks***	2240.5	2209.5	2209.5	31.0	
Cooperative banks*	55.1		50.0	5.1	
Banking sector, total:	2295.6	2259.5	2259.5	36.1	

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MACEDONIA

MACROECONOMIC ENVIRONMENT

After a four-year period of continuous solid growth of Macedonian economy, in 2017, economic activity noted stagnation (the real GDP growth equaled 0.0%). Despite the stable growth of private consumption and the strengthening of the export sector, the prolonged political uncertainty had a negative impact on investment cycle and was the main reason for the economic stagnation of the country. Thus, the positive contribution of domestic demand in GDP change registered a considerable decline, which was mainly due to the decreased investment demand, mirrored by the fall in gross investments for the first time in the last six years. In 2017, most of the economic activities had a negative contribution in GDP change, with the construction activity noting the largest fall. The first half of 2017 was especially unfavorable, when real GDP noted a fall, while in the second half of the year it rebounded a little and registered a growth of 0.7% (y-o-y).

After a three-year period of continuous fall, in 2017, consumer prices noted an increase of 1.4%. All three components of inflation contributed towards the upward trend of consumer prices. Namely, the changes in international prices of primary products in 2017 had a corresponding impact on domestic prices of food and energy, where a certain narrowing of negative contributions was registered. Moreover, core inflation growth (excluding prices of food and energy) accelerated as a reflection of certain one-time effects (enlarged excises on tobacco products), increased prices for the phone services, etc.

Despite the weaker impulses coming from the real economy, the positive trends in the labor market were maintained in 2017. The number of employed persons was increased by 2.4% in 2017, which led to 1 p.p. increase in the employment rate (44.1%). The most prominent increase in the employment was registered in the services sector and in the industry. The upward trend in average wages continued in 2017, with their growth noting slight acceleration, mainly due to the introduced raise in the minimum wage (according to the Law on minimum wage in Macedonia). Thus, nominal gross- and net-wages registered an annual growth of 2.6% (compared to 2.0% in 2016). Employees from mining, manufacturing and information and communication activities received the highest raises in wages.

The public debt in Macedonia grew by 1.6% in 2017, while public debt to GDP ratio noted a fall from 48.5% to 47.6%. The budget deficit share in GDP remained unchanged and equaled 2.7% in 2017. The share of gross external debt in GDP declined by 0.7 p.p. and equaled 73.6% at end-2017. The decrease of gross-external debt was mainly due to the lower public external debt.

At the beginning of 2017 the Central bank continued with monetary policy normalization, which started in December 2016. Namely, in January and February 2017, the Central bank lowered the main interest rate by 0.5 p.p. to a level of 3.25%. Thus, the main interest rate reached the level before May 2016, when the Central bank started with tightening of the monetary policy as a consequence of the pressures on the FX market and on the deposit market in the country, which were mainly due to the domestic political crisis. By the end of the year, the Central bank did not make any additional changes in the setting of the monetary policy, in environment of solid economy fundamentals, absence of significant imbalances in the economy, but still present risks in particular segments of the economy.

According to the macroeconomic forecast for the years 2018 and 2019, the conduct of the monetary policy is expected to be in a more favorable environment, although with further presence of external and domestic risks. An acceleration of the economic growth is expected, primarily due to strengthening exports and investments. In addition, the lending activity as provided by the banking sector is expected to further support the economic activity. The Central bank will mainly focus its activities on maintaining the projected level of foreign reserves and monitoring the developments on the foreign exchange market, along with other potential risks and adjusting the monetary policy, accordingly.

DEVELOPMENT OF THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL/GDP)

In 2017, domestic banks operated in environment of unstable political situation and zero economic growth, which were especially emphasized in the first half of the year. The uncertain domestic environment had a corresponding impact on the perceptions of our economic agents, who restrained from investment activities, and it also had a reflection on banking system assets, which grew by only 3.9% (5.0% in 2016). Decelerated growth of banking system assets was due to not so favorable dynamics of deposits from non-financial sector, as banks' dominant source of finance, which remained unchanged in first half of 2017, although renewed its growth in the second half of the year. Thus, at the end of 2017, total deposits noted an annual increase of 5.1% (compared to 5.4% in 2016), with the household deposits contributing the most in total deposits growth. Denar deposits noted somewhat stronger growth compared to FX deposits, while sight deposits, according to deposits' maturity structure, continued to contribute the most in total deposit growth.

Despite weak demand for credits in 2017, due to higher caution of economic agents when making consumer and investment decisions, banks managed to achieve satisfactory annual credit growth of 5.9%. Credits were extended mostly to households, for financing their consumption needs, although real estate loans have been solidly growing for several years now. Credit support to corporate sector was weaker (compared to households), but corporate credit growth accelerated compared to 2016. Banks' credit portfolio has been undergoing currency transformation for a longer time period, with denar credits registering growth in 2017, contrary to FX credits which declined.

Financial intermediation indicators registered certain upward developments in 2017. The assets-to-GDP ratio equaled 74.5%, which is an increase of 0.3 percentage points relative to 2016. The gross credits and the deposits reached 48.0%, i.e. 54.7% of the gross domestic product, respectively (incline of 1.1 percentage points, i.e. 0.8 percentage points, compared to 2016)[31].

In 2017, total non-performing loans grew by 2%, mainly due to the accelerated annual growth of non-performing corporate loans, which was however

[31] Financial intermediation indicators are calculated according to the last available data on GDP. Data on GDP were last revised as of 8.3.2018.

concentrated at several larger customers that were not able to service its debt to banks. Non-performing household loans also grew in 2017, but far more slowly compared to corporate NPLs, and mainly as a consequence of a certain materialization of credit risk seen at consumer loans. The NPL ratio in the credit portfolio of non-financial sector customers equaled 6.3% at end-2017, whereas in the corporate and household credit portfolio amounted to 10% and 2.4%, respectively. The part of the non-performing loans which is not covered with loan loss provisions equaled 7.9% of banking system own funds, pointing out to sound provisioning of non-performing loans.

Banking system liquid assets noted an increase of only 0.8%, which caused an annual decline in the "liquid assets / total assets" ratio of 1 percentage point to a level of 29.8%. The coverage of banks' different categories of liabilities with liquid assets decreased as well, but it is still at satisfactory level, assuring smooth operating of our banks (liquid assets / household deposits equaled 57.0%, while the coverage of short-term liabilities with liquid assets amounted to 51.8%).

Our banking system continued its profitable operating, constantly noting relatively high ROAA and ROAE, which amounted to 1.4% and 13.5% as of the end of 2017. However, after a several year period of strong profit growth of around 40% per annum, in 2017 banking system total profit increased by only 3.6%. Decelerated profit growth was mainly due to the weaker net interest income growth as a consequence of the fall in the interest income earned from the non-financial companies. The solid increase of the net impairment losses in 2017 was another reason for the slowdown in banks profit growth.

Solvency and capitalization indicators registered certain increase in 2017, which, in largest extent, derived from the faster growth of capital positions (mainly due to the retention of profit and issuance of new subordinated instruments by banks). At the end of 2017, the capital adequacy ratio was 15.7%, compared to 15.2% at end-2016.

In 2017, Macedonian banks successfully faced the challenge for complying with the new regulatory requirements pertaining to the capital component of Basel 3. Thus, besides requirements on maintaining banks' capital adequacy ratio to a level of at least 8%, two additional solvency ratios are prescribed in our Banking Law – the common equity tier 1 ratio and the tier 1 ratio, which may not decline below 4.5 and 6% level, accordingly. The leverage ratio is also in play – taking into consideration the coverage of total banks' activities with capital positions. The conservation capital buffer of 2.5% is currently activated, together with the capital buffer for systemically important banks (ranging from 1- 2%). Seven banks (out of 15) are determined as systemically important, in a procedure prescribed in a written Methodology, which is in compliance with EBA and Basel Committee Guidelines in this area. The counter-cyclical and the systemic risk capital buffer are two additional macro-prudential tools at disposal according to regulation - however still are not activated. Finally, according to Basel 2's Pillar 2, our banking supervisors (through SREP) determine particular capital add-ons for individual banks, according to each bank risk profile (for 2017, this capital add-on ranged from 1.6-9.5% by individual bank).

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN MACEDONIA

The National Bank of the Republic of Macedonia (NBRM) is Banking Supervisory Authority responsible for licensing and supervision of banks and savings houses in the Republic of Macedonia. The Supervision, Banking Regulations and Financial Stability Division, through its three departments: Off-site Supervision and Licensing Department, On-site Supervision Department and Financial Stability and Banking Regulations Department, performs the supervisory function.

These competences of the NBRM are regulated with the Law on the National Bank of the Republic of Macedonia and the Banking Law.

During 2017, the NBRM continued its activities for further compliance of the domestic regulation with Basel Capital Accord, the so-called Basel 3, and with the European regulation package for operation and prudential requirements for banks.

With the amendments of the Banking law from October 2016, among other things, the banks are required to maintain adequate amount of capital to cover the so-called capital buffers. The Law prescribes four capital buffers: (1) capital conservation buffer maintained at 2.5% of the risk weighted assets; (2) countercyclical capital buffer which can be up to 2.5% of the risk weighted assets, or higher, depending on other systemic factors/indicators (3) capital buffer for systemically important banks which can range from 1% to 3.5% of the risk weighted assets, and (4) systemic risk buffer which can range from 1% to 3% of the risk weighted assets. Pursuant to the provisions of the Banking Law on that basis, the following decisions were adopted:

- The Decision on the methodology for determining the rate of the countercyclical capital buffer for exposure in the Republic of Macedonia, which prescribes the methodology for determining the rate of the countercyclical capital buffer for exposures to residents in the Republic of Macedonia and manner of calculation of the specific rate of the countercyclical capital buffer. This capital buffer is aimed at limiting the risk arising from high credit growth, so it is introduced in case of high credit growth, on the basis of prescribed criteria;
- The Decision on the methodology for determining systemically important banks, which prescribes the manner of identifying the systemically important banks in the Republic of Macedonia, i.e. the banks the operations of which are important for the stability of the entire banking system. The amount of the capital buffer that the systemically important banks should meet depends on the level of their systemic importance;
- The Decision on the methodology for developing a recovery plan for systemically important banks that requires systemically important banks to submit a recovery plan to the NBRM. This plan contains preparatory activities that the bank would undertake in case of possible deterioration of its financial standing;
- The Decision on the methodology for determining maximum distributable amount of earnings which prescribes the manner of determining the maximum distributable amount, reporting to the NBRM and the contents of the capital conservation plan. This Decision envisages restriction of the

bank's earnings distribution if it fails to maintain adequate amount of capital buffers. The capital buffers can be covered only by the highest quality capital positions, i.e. common equity tier 1 capital (CET1).

Also, in order to achieve further enhancement of the banking regulatory framework, in 2017 the following acts were prepared and adopted:

- The Decision on the methodology for managing leverage risk, which prescribes the manner of determining and monitoring the leverage ratio. As a standard of the Basel Capital Accord Basel 3 and the European banking regulations, the leverage ratio represents the ratio between the capital value and the exposure value i.e. activities of the bank;
- The Decision amending the Decision on exposure limits and the Decision for amending the Decision on the accounting and regulatory treatment of foreclosed assets, which ensure compliance with other bylaws of the NBRM, were adopted as a result of the amendments to the Banking Law in 2016.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

There were several activities performed by the NBRM in 2017 which with a prime aim of achieving its main strategic objective of maintaining the stability of the banking system as a basic prerequisite for financial stability and sustainable economic growth. The most important activities were related to the implementation of the ammended capital adequacy framework and the itroduction of the capital buffers (capital conservation buffer and capital buffer for sistemically important banks are introduced as of March 2017), as well as to changes in the supervisory approach for assessing the adequacy of banks' capital positions. This has allowed for further harmonization of the NBRM's banking regulation and supervision with the international standards and best practices, especially with those implemented by the EU authorities.

In addition to this, NBRM continued its activities for improvement of the financial stability monitoring instruments and development of macroprudential tools and practices, strengthening of the supervisory capacity for contingency planning and crisis management and participation in supervisory colleges, amid the creation of the Single Supervisory Mechanism.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

During 2017, the overall SREP methodology as well as the internal methodology for assessing particular types of risk was revised in line with the latest Basel principles and ECB manual. Also, the methodology for preparing examination report was improved.

Activities of the Off-Site Supervision Department last year

The off-site supervisory function of the National Bank of the Republic of Macedonia is carried out through 3 cornerstone activities: licensing (issuing licenses and approvals to banks and savings houses), regular off-site supervision of the operations of the banks and the savings houses and undertaking corrective actions. Within this framework, during 2017 the National Bank has performed the following activities:

- 52 licensing procedures were realized, which were mainly related to issuing: approvals for appointment of members of the Boards of Directors and members of the Supervisory Boards, amending and/or supplementing the Statute of the banks and approvals for commencement of new financial activities by banks. Among these procedures, three refer to savings houses – two for appointment of manager and one for the transformation of a savings house into a financial company.
- Regular off-site analysis of the operations and the risk profiles of banks.

Within its legal authorization, and in order to maintain the stability and the safety of certain banking institutions and the whole banking system, the National Bank undertook corrective actions towards banks and saving houses where irregularities, noncompliance and illegitimacies in their operation were found. The aim of the majority of the undertaken measures was the improvement of certain elements of the risk management systems of banks.

Performing supervision and oversight

During 2017, pursuant to the annual on-site control plan, NBRM performed regular supervisory controls (on-site risk controls) in 14 banks and 1 ancillary IT system banking service and inspection controls (on-site controls of compliance with the provisions) in all 15 banks, 2 savings houses, 3 fast money transfer, 22 subagents and controls in 156 exchange offices.

On-site risk examinations

Banks in the Republic of Macedonia are oriented towards traditional banking activities and credit risk is the main risk that determines their risk profile. Hence, this risk, especially the quality of its management, with main focus on the appropriateness of the impairment assessment as well as the level of credit risk exposure, are most often subject to on-site control assessments. Also, the adequacy of money laundering prevention systems was assessed in individual banks, managing the operational risk and the adequacy of the statements for transactions with connected parties. In the reporting period, the adequacy of the informational security in six commercial banks was assessed. Also, during the on-site risk controls, in 3 banks the statements for the adequacy of the capital was reviewed.

The conducted controls have shown that banks adequately manage the risks they are exposed to and they are mostly responsive to the corrective measures undertaken by the NBRM.

In order to improve the existing rules and practices for credit risk management in banks, NBRM has given several recommendations which mainly refer to: improving the process of classification of credit exposure through increasing the impact of the creditworthiness and consumers' credit history, promoting early warning criteria in the process of monitoring of the approved loans, decreasing the credit risk exposure towards individual consumers within prudent exposure limits and improvement of the management of concentration risk, more frequent monitoring of the problem loans, improving the system for identifying and monitoring of related parties and improving the process for management of the credit risk exposures approved with an exception. Also by sampling and analysis of the credit files in 9 banks was identified improper risk category according to the criteria prescribed in the regulation for credit risk management and for those banks additional impairments for credit risk losses were determined. Furthermore, recommendations are given for improving the process established for non-performing loans management that includes establishment of a strategy for decreasing of this portfolio, timely identification and promptly taking actions for restructuring of this exposures as well as enhancement of the activities for their monitoring. For retail segment recommendations refer to: improvement of the approval criteria and internal controls, internal limits and improvement of the credit risk policies and recordings of the exceptions.

For preventing money laundering and financing terrorism, during the on-site risk controls the recommendations referred to: strengthening of the methods for identification and verification of the identity of the legal beneficial owner, improvement of the customer due diligence and the consistency of their transactions with it's financial condition and business activity, enchantment and strengthening of the indicators for identifying potential suspicious transactions and strengthening of internal controls and enhancement of the scope and controls that are in place by the Internal audit department.

For the operational risk management, recommendations are given for improvement of the process for identification, measurement and monitoring of the risk. The recommendations are given for establishing of internal limits for KRI, definition and establishment of the amount for minimal loss, improvement of the recording of the loss events and improvement of the RSCA (risk self-control assessment). Also recommendations were given for improvement of the internal procedures for physical security and additional personnel involved for management of the operational risk.

In order to increase the informational security, recommendations are given in terms of strengthening the internal controls and limit the access to the database, strengthening of the system for audit trail, improvement of the IT system configuration, improvement of the confidentiality IT security, improvement of the continuity plan and the process for testing application solutions of the existing functionalities before updating the old software systems and establishment of the strategy for IT development.

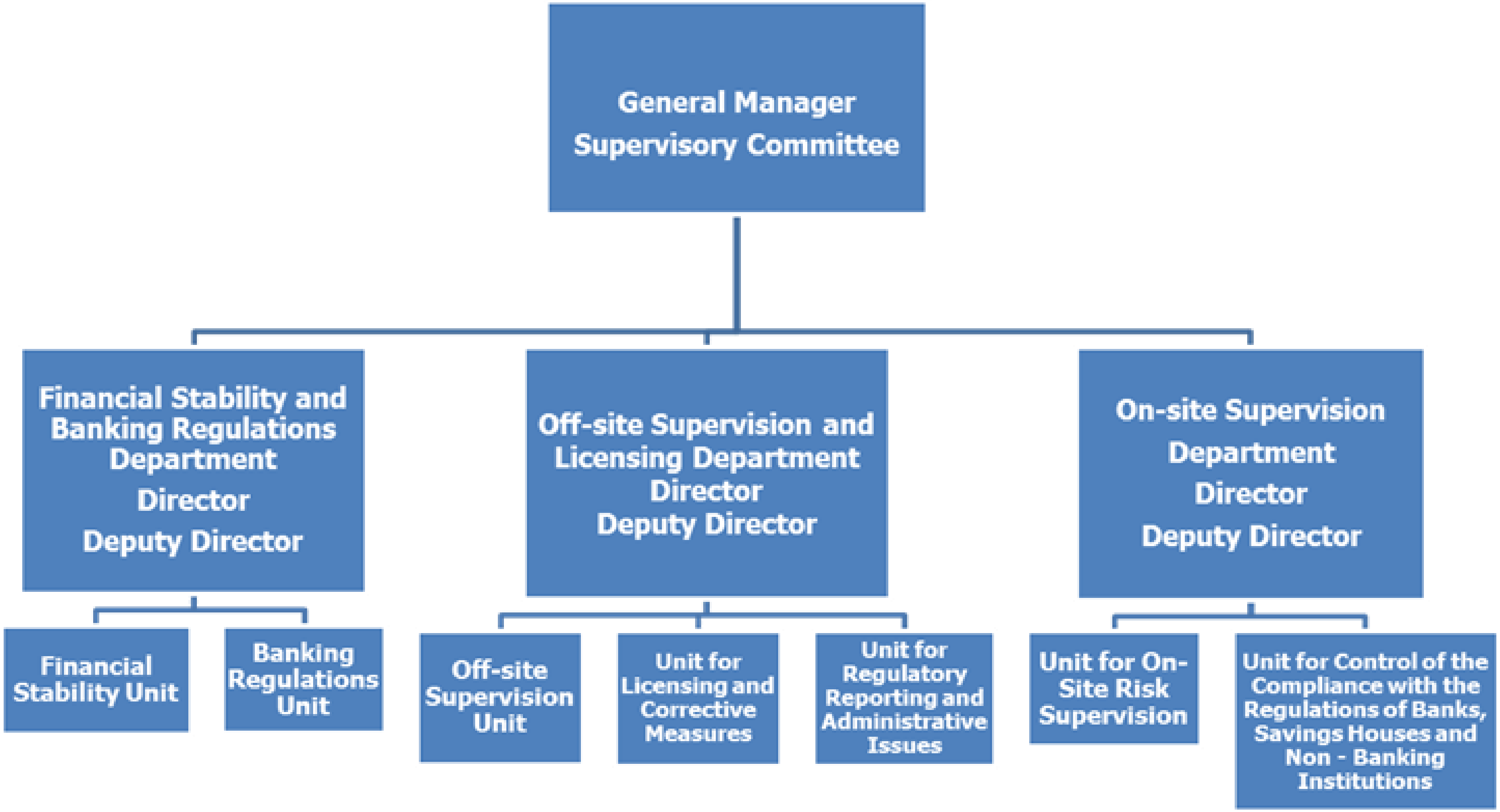
On-site controls of compliance with regulations

On-site control of compliance with the provisions or so-called inspection controls, mainly in assessing the operation of banks and savings houses pursuant to the Law on the National Bank of the Republic of Macedonia, the Law on Foreign Exchange Operations, the Law on Consumer Protection in Consumer Loan

Agreements, the Law on Fast Money Transfer and Payment Operations Law. All controlled subjects operated in accordance with the regulations. In some banks, there were identified irregularities in foreign payment operation, non-resident operation, and weakness identified in the loan contracts that are not in accordance with the Law on Consumer Protection in Consumer Loan Agreements.

On-site controls of non-banking financial institutions, i.e. licensed exchange offices, providers of fast money transfer services and their subagents aimed to assess the compliance of their operations with the Law on Foreign Exchange Operations, the Law on Fast Money Transfer and the Law on Prevention of Money Laundering and Financing Terrorism.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The international activities of the NBRM in 2017 established through the signed MoU's with other supervisory bodies continued on a regular basis. Among other activities, within this cooperation NBRM supervisory staff attendend two supervisory colleges (for one Greek and one Slovenian subsidiary). No new MoU's were signed. However, the process of signing a MoU with the ECB, that is expected to ease the exchange of relevant supervisory information, has started.

COOPERATION WITH OTHER SUPERVISORY BODIES IN MACEDONIA

The cooperation with domestic supervisory bodies and agencies in 2017 continued without any obstacles. There was a regular flow of information sharing among NBRM any the other counter parties, which helped for achieving the goals arising on the basis of the signed bilateral agreements and MoU's. There were neither newly signed agreements nor MoU's. The efforts for signing formal agreements with the Agency for real estate cadaster and the Deposit Insurance Fund continued.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	16	15	15
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	**16**	**15**	**15**

Ownership structure of banks on the basis of assets total
(at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	4.0%	3.3%	2.7%
Other domestic ownership	26.9%	26.7%	26.8%
Domestic ownership total	30.9%	30.1%	29.5%
Foreign ownership	69.1%	69.9%	70.5%
Banking sector, total:	**100.0%**	**100.0%**	**100.0%**

Concentration of asset by the type of financial institutions
(at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	57.8%	74.6%	1,357
Branches of foreign credit institutions	/	/	/
Cooperative banks	/	/	/
Banking sector, total:	**57.8%**	**74.6%**	**1,357**

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	10.4%	13.6%	13.5%
Cooperative banks	/	/	/
Banking sector, total:	**10.4%**	**13.6%**	**13.5%**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions	/	/	/
Cooperative banks	/	/	/
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

Assets	2015	2016	2017
Cash, balances and deposits with central bank (NBRM)	11.1%	13.3%	12.2%
Placements in securities	14.8%	12.7%	13.0%
- issued by domestic government sector	8.5%	7.2%	7.2%
- issued by central bank (NBRM)	5.9%	5.2%	5.4%
- other (including non residents)	0.4%	0.4%	0.4%
Loans, deposits and accounts with financial institutions (excluding central bank, including non residents)	12.0%	11.4%	10.7%
Loans with non-financial sector (including non residents)	57.7%	58.3%	59.8%
- loans with domestic government sector	0.5%	0.5%	0.5%
Other assets	4.4%	4.3%	4.3%
Total	**100.0%**	**100.0%**	**100.0%**
Liabilities	**2015**	**2016**	**2017**
Deposits of financial institutions (including non residents)	4.0%	4.4%	4.8%
Deposits of non financial sector (including non residents)	72.3%	72.6%	73.4%
- deposits of domestic government sector	0.1%	0.1%	0.1%
Borrowings, issued securities and liabilities on the basis of subordinated and hybrid instuments (including non residents)	10.1%	9.3%	7.9%
- domestic financial sector	3.5%	3.2%	2.7%
- domestic government sector	0.2%	0.1%	0.1%
- other	6.4%	5.9%	5.1%
Other liabilities	2.8%	3.1%	1.6%
Equity and reserves (including loss in current year)	10.8%	10.6%	10.8%
Profit after tax in current year	1.1%	1.4%	1.5%
Total liabilities	**100.0%**	**100.0%**	**100.0%**

Capital adequacy ratio of banks

Type of financial institution	2015**	2016**	2017***
Commercial banks*	15.5%	15.2%	15.7%
Cooperative banks	/	/	/
Banking sector, total:	**15.5%**	**15.2%**	**15.7%**

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector

Asset classification	2015	2016	2017
Non financial sector	10.8%	6.6%	6.3%
- households	5.2%	2.6%	2.4%
- corporate	15.2%	9.9%	10.0%

The structure of deposits and loans of the banking sector in 2017 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	94.3%	99.0%
Households	65.3%	46.6%
Corporate	25.7%	52.2%
Government sector	0.1%	0.8%
Financial sector (excluding banks)	5.6%	0.1%
Total	**100.0%**	**100.0**

P&L account of the banking sector
(at year-end)

Type of financial institution	2015	2016	2017
Interest income	19,954	20,169	19,940
Interest expenses	-5,602	-4,780	-4,308
Net interest income	14,352	15,389	15,632
Net fee and commission income	4,234	4,247	4,365
Other (not specified above) operating income (net)	2,350	2,750	3,243
Gross income	20,935	22,383	23,239
Administration costs**	-9,672	-9,732	-9,758
Depreciation	-996	-1,002	-1,065
Provisions***	-1,164	-835	-107
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)****	-3,921	-3,765	-4,998
Profit (loss) before tax	5,184	7,048	7,326
Net profit (loss)	4,640	6,325	6,555

* 1 EUR = 61.4907 MKD, as of 31.12.2017
** Administration costs include all operating expenses.
*** Provision items include: impairment losses of non-financial assets, provisions for off-balance sheet items and other provisions.
**** Presented on net basis.

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds***	Core Tier 1***	Tier 1***	Tier 2***
Commercial banks	882,867,458	795,573,782	797,574,086	85,293,372
Cooperative banks	/	/	/	/
Banking sector, total:	**882,867,458**	**795,573,782**	**797,574,086**	**85,293,372**

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MOLDOVA

MACROECONOMIC ENVIRONMENT

In 2017, the exchange rate of the national currency has strengthened in nominal terms by 14.4% against the USD and by 2.3% against the euro. At the same time, the Moldovan Leu has appreciated in real terms by 13.4% against main trading partners' currencies.

The local FX market in 2017 was characterized by a surplus, as the FX supply from individuals excessively covered the net FX demand from businesses to a level similar to 2016 (around 120%).

The growth of net transfers from abroad to individuals remained strong (+11.2% YoY), thus fueling the increase of the net FX supply from individuals by 4.8% as compared to 2016. At the same time, the deterioration of the trade balance has caused the rise of the net FX demand from businesses by 5.2%.

Given the persistence of a FX surplus on the domestic market, in 2017 the NBM has intervened by purchasing USD 433.8 million, thus softening the appreciation pressures on the domestic currency. Consequently, the FX reserves adequacy improved, up to around 5.5 months of imports. The developments in the international accounts of the Republic of Moldova in 2017 were influenced by several factors:

- The economic growth trend continued, so the GDP of Moldova increased 4.5% in real terms as against 2016. This growth was particularly due to trade and agriculture (even though in the first half of 2017 there was a dramatic fall in crop production because of unfavorable weather conditions, in the second half it recovered, growing by 13.1% as compared to the previous year).
- Total exports of goods and services increased by 19.9% as against 2016 due to the demand from the main partner countries, who recorded economic growth (both CIS and EU countries). At the same time, the appreciation of the national currency against the US dollar and the Euro had a negative impact on exports;
- Following the growth in wages and in personal remittances, the final consumption of households increased (by 4.9% in comparable prices as against 2016), which contributed to the growth in imports of goods and services (by 20.2% compared to previous year). Another factor behind the growth in imports was the resumption of electric power imports from Ukraine.
- Personal remittances received by residents of the Republic of Moldova represented 19.2% as ratio to GDP in 2017 (decreasing as a ratio to GDP as against 2016, but increasing in absolute value by 13.2%, especially due to the growth in inflows from EU countries by 24.9%);

In 2017, the CAB recorded a deficit of US$ 616.94 million, 2.2 times larger as compared to the deficit recorded in 2016. The CAB to GDP ratio was 7.6% and worsened by 3.4 percentage points as against the previous year. The deterioration of CAB was caused entirely by the increase in external trade in goods deficit, while other components recorded growing surpluses.

Exports of goods amounted to US$ 1,857.74 million, and imports – to US$ 4,426.74 million. Thus, the trade deficit in goods totaled US$ 2,569.00 million, growing by 23.0%, because the increase in imports (+21.8%) was larger than the growth in exports (+20.1%), as compared to 2016.

Exports of agri-food products increased by 19.4% as against 2016 and traditionally predominated in total exports of goods with a 59.7% share. In the structure of imports, the largest share (17.5%) belonged to mineral products, the imports of which increased by 22.9% as compared to the previous year.

The increase in services surplus by 44.5% to US$ 315.29 million was due to the 19.7% growth in exports as against 2016, while services imports increased by 13.2%. A significant growth was recorded in the exports of travel services (+28.2%), transport services (+16.9%), particularly air transport (+27.9%, which can be partially attributed to the operations of two new airline carriers). A considerable growth was also recorded in the exports of manufacturing services on physical inputs owned by others (+27.8%), which can be attributed, to a large extent, to new FDI made in the automotive sector. The increase in services imports was also mainly due to the growth in travel services (+20.0%) and in transport services imports (+15.9%).

The primary income surplus went up by 10.9% in 2017 as compared to the previous year and reached US$ 510.80 million. The compensation of resident employees received from non- resident employers increased by 17.6% and amounted to US$ 839.56 million. The impact of this increase was partly mitigated by the simultaneous growth in investment income outflows (+36.2%), especially income in the form of dividends payable to direct investors, that grew 2.3 times, amounting to US$ 134.58 million.

The positive balance of secondary income increased insignificantly (+0.2%) as against 2016 and amounted to US$ 1,125.97 million. While personal transfers received by Moldovan residents from abroad went up by 6.6%, reaching US$ 800.10 million, the total amount of technical assistance and grants received by all sectors within current international cooperation decreased by 15.3% as compared to 2016, amounting to US$ 183.73 million.

The capital account recorded a negative balance amounting to US$ 30.41 million, driven by capital outflows recorded by the private sector (US$ 44.46 million), as well as by external assistance inflows received by the general government for the financing of investment projects (US$ 14.05 million).

The financial account recorded net capital inflows of US$ 569.77 million (which is 7.0% as a ratio to GDP) in 2017, due to the net increase in the national economy's liabilities to the rest of the world by US$ 622.38 million, while the residents' foreign financial assets increased by US$ 52.61 million in net value.

The net increase in financial assets was determined by the US$ 531.20 million growth in the

NBM's official reserve assets and by the increase in the assets of licensed banks in the form of currency and deposits by US$ 168.18 million. At the same time, currency and deposits assets of households decreased by US$ 552.96 million and the assets of economic agents of other sectors in the form of trade credits and advances previously granted to non-resident partners went down by US$ 92.77 million in net value.

Liabilities increased, in particular, as a result of residents' receipts of trade credits and advances from non-resident partners in the net amount of US$ 288.92 million.

After the setback recorded in 2016, the net FDI inflow in domestic economy rebounded (2.3 times as against 2016) and amounted to US$ 208.46 million (2.6%

as a ratio to GDP). The increase in FDI inflow was due not so much to the creation of new companies with foreign capital (net equity inflows only amounted to US$ 39.23 million), but rather to the reinvestment of earnings by existing enterprises (US$ 86.81 million) and to the incurrence of debt from foreign investors (US$ 82.42 million, in net value).

Loans from abroad were contracted in the net amount of US$ 107.24 million (drawings – US$ 423.06 million, repayments – US$ 315.82 million). The general government (including local) made drawings on new loans amounting to US$ 200.97 million from the following creditors: the government of Romania – US$ 100.90 million, IMF- US$ 26.47 million, IDA – US$ 20.70 million, IBRD – US$ 19.43 million, EIB – US$ 17.51 million, EBRD – US$ 9.53 million, IFAD – US$ 3.33 million, CEB – US$ 2.90 million and the government of Poland – US$ 0.21 million.

The NBM contracted loans amounting to US$ 17.27 million from the IMF. Commercial banks made new drawings on external loans amounting to US$ 47.38 million, and other sectors – to US$ 157.44 million.

The official reserve assets recovered to the pre-crisis level (2013), thus, by 31.12.2017, their

stock amounted to US$ 2,803.26 (+27.1% as against 31.12.2016), which is sufficient by all adequacy measurements.

In the first half of 2017, the economy of the Republic of Moldova grew only by 2.8 percent. The GDP growth rate has accelerated in the second half of the year, recording 5.4 % and 6.4 %, respectively, in the third and fourth quarters of 2017, largely due to favorable weather conditions that determined a high performance in the agricultural sector. Thus, in 2017, the gross value added in agriculture increased by 7.9 % compared to 2016. It also supported positive developments in related sectors such as food processing industry, trade and transportation. At the same time, the construction sector experienced a positive dynamics after the decline in 2016. In 2017, the positive evolution of the agricultural sector, as well as, the favorable external environment, supported the increase of exports by 12.7%. At the same time, the increase of the disposable income of the population, as well as the rich harvest in the second half of the year, favored household consumption growth by 4.9% compared to 2016. In 2017, the final consumption of the public administration contracted by 0.1% compared to the previous year. At the same time, in 2017, gross fixed capital formation increased by 5.3 percent compared to 2016. The inventories sub-component generated a 1.7 p.p. impact on GDP growth. In 2017, the dynamics of the economic activity was significantly lowered by the increase of imports by 11.4%, mainly as a result of both the domestic demand growth and the appreciation trend of the national currency.

Inflation

In 2017, the average annual inflation rate recorded 6.6 %, being 0.2 p.p. higher than in 2016. During 2017, the annual inflation rate denoted a significant upward trajectory, increasing from 2.4 % in December 2016 to 7.9 % in October 2017. Subsequently, by the end of 2017, it moderated slightly to 7.3 %, exceeding the upper limit of the 5.0 % ± 1.5 p.p. interval stipulated in Medium-Term Monetary Policy Strategy. The upward trajectory of the annual inflation rate in 2017 was mainly determined by higher tariffs for some regulated services and atypical weather conditions that led to higher prices for fruit and vegetables. At the same time, this trajectory was also supported by the impact of the excise taxes adjustment on some product categories, as well as, by a low base period effect from 2016. The inflationary pressures associated with the aforementioned factors were partly offset by the appreciation trend of the national currency from 2017, but also by a still modest aggregate demand.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

Tier I capital amounted to 10,183.8 million lei and during the year 2017 it grew by 9.6% (889.7 million lei). The increase of the first grade capital was mainly generated by obtaining a profit of 1,528.1 million lei.

The average risk-weighted capital adequacy ratio was 31.3 percent, up 1.6 percentage points. compared to the end of the previous year, an indicator followed by all banks (the limit for each bank ≥16 percent), ranging from 24.7 percent to 98.1 percent.

Total assets amounted to 79,464.8 million lei, increasing by 9.1% (MDL 6,634.4 million) compared to the end of the previous year. The share of assets in GDP constituted 52.9%, decreasing by 1.3% compared to the end of the previous year. The evolution in question is due to the higher growth rate of economic activity at national level compared to the growth rate of banking activity. Large bank assets concentrated ¾ of total bank assets.

At 31.12.2017, the gross loan portfolio constituted 42.1% of the total assets or 33,473.3 million lei, decreasing by 3.7% in the course of 2017. The decrease is mainly due to the lack of demand for loans, as well as to the more cautious approach applied by banks to potential debtors. Thus, banks increased investments in securities (certificates of the National Bank and State Securities) by 35.6% compared to the previous year, accounting for 19.0% of the total assets.

During 2017, the share of non-performing loans (substandard, doubtful and compromised) in total loans increased by 2.0 pp. compared to the end of the previous year, constituting 18.4 percent as of 31.12.2017.

In the context of the distribution of risks, the largest share in the total loan portfolio was held by credits granted to commerce - 29.1%, followed by consumer credit - 12.4%, loans to the food industry - 10.5%, credits for purchasing / building construction - 7.9%, loans to agriculture - 7.4%, credits to productive industry - 6.9%, credits in the field of services rendered - 5.9% and other credits - 5.0%.

As of December 31, 2017, the profit for the year amounted to 1,528.1 bln. lei. Compared with the same period of the previous year, profit increased by 12.0%, mostly due to the increase in non-interest income by 6.8%.

Return on assets and return on capital as at 31 December 2017 amounted to 1.9 percent and 11.4 percent respectively (being at the same level as last year).

Banks have maintained liquidity ratios at a high level. Thus, the value of the long-term liquidity indicator (principle I of liquidity) was 0.6, being practically at the same level as the end of the previous year. Current liquidity by sector (principle II of liquidity) increased by 6.2 pp, constituting 55.5%. It is worth mentioning that the largest increase in the structure of liquid assets during the year 2017 was recorded in liquid securities by 35.7%.

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*The information was prepared according to the data reported by the licensed banks on 05.06.2018

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN MOLDOVA

The banking system in the Republic of Moldova consists of two levels: the National Bank of Moldova and 11 licensed banks (financial institutions). The National Bank of Moldova regulates and supervises the financial institutions in accordance with the Law on the National Bank of Moldova and the Law on Financial institutions, which provide the competence, main objective, basic attributions of the National Bank and its relationship with financial institutions.

According to the Law on the National Bank of Moldova, The National Bank is exclusively responsible for the licensing, supervision and regulation of the financial institutions activity. To that end, the National Bank shall be empowered:

a) to issue the necessary regulations and to take the proper actions in order to perform its powers and duties under this law, by way of licensing financial institutions and elaborating supervision standards and establishing the way of implementing the regulations and measures mentioned above;
b) to perform, through its staff or other qualified professionals involved for this purpose, inspections over all financial institutions, and to examine these institutions' books, documents and accounts, conditions in which the business is carried out and financial institutions' compliance with the legislation;
c) to require any employee of the financial institution to provide the National Bank with the information necessary for the purpose of supervision of the and regulating the activity of financial institutions;
d) to prescribe to any financial institution remedial measures or to apply the sanctions foreseen in the Law on Financial Institutions, if the financial institution or its employees:
   - have violated the provisions of the Law on Financial Institutions or a regulation of the National Bank;
   - have violated a fiduciary duty;
   - have engaged in unsafe or unsound operations of the financial institution or any of its branches.

The Law on financial institutions stipulates the main requirements related to the banking activity. Thus, the respective law determines: general provisions, licensing of banks, organization and administration of banks, conduct of banking operations, banking reporting, violations, remedial measures and sanctions, withdrawal of license and liquidation process of the bank at which the license was withdrawn.

During 2017, the Law on financial institutions has been amended with provisions that aim to strengthening of corporate governance, to create premises for application of the new and more complex framework and enhance risk management and licensing.

Concurrently, banks are guided in their activity by normative acts issued by the National Bank of Moldova under the Law on financial institutions that establishes requirements for the licensing process, holding equity interest in the capital of banks, requirements to bank administrators, as well as requirements regarding capital of the banks, liquidity, bank's exposures, foreign exchange position, prudential assessment of assets and conditional commitments, equity investments of banks in other legal entities, reporting to the National Bank of Moldova, disclosure of information on the financial activity of the banks, internal control systems, etc.

Therefore, through a number of requirements provided through the normative acts, the National Bank maintains the mechanism of supervision and regulation of banks' activity in the Republic of Moldova, based on international accepted principles, including the Basel Committee' principles.

MAIN STRATEGIC OBJECTIVES OF THE BANKING AUTHORITY IN 2017

The development of banking supervision function remains an objective of strategic importance to the National Bank of Moldova. In order to strengthen the capacity in banking regulation and supervision field, the National Bank of Moldova undertakes a number of activities directed towards achieving the implementation of the requirements of Basel III through the EU's instrument of support and cooperation - Twinning.

During 2017, continued the activities within Twinning project, launched on 30 June 2015 for a 24-month period.

In order to perform the above mentioned objective, has been approved a new banking law, Law on banks' activity no.202 of October 6, 2017 (in force January 1, 2018) which represents the general framework applicable to the banks and has been concluded the drafts of secondary acts for the implementation of the new law. The respective secondary acts will be promoted after the entering in to force of the new banking law.

The Law on banks' activity aims to improve national banking legislation, taking into account the best international standards and practices related to banking regulation and supervision and to licensing process, provided by the Supervision Authority. Thus, the law transposes the provisions of Directive 2013/36 / EU of 26 June 2013 on the access to credit institutions and the prudential supervision of credit institutions and investment firms and of the Regulation 575/2013 of 26 June 2013 on the prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.

ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY LAST YEAR.

During the 2017 year, a number of actions have been taken to maintain banking system stability and to ensure its further development. To this end, the National Bank of Moldova has refined the prudential regulations and supervisory methods taking into consideration the existing regulatory framework and the generally accepted standards in this field.

In order to strengthens of banks' corporate governance by improving the provisions related to bank's risk management and internal governance has been approved the Regulation on the banks' internal governance. Also, the regulation provides reporting requirements for banks related to fraud detected cases that may affect the bank's safety, soundness and reputation. Thus, the implementation of the provisions of the **Regulation on the banks' internal governance** will contribute to the efficiency of the banks' activity and preventing excessive risks, respectively, to the maintenance of the financial stability in order to protect the interests of the depositors.

The Regulation on the banks' internal governance provide requirements related to bank's risk management and internal governance, requirements for risk management policies and set limits according to the bank' risk appetite and risk profile.

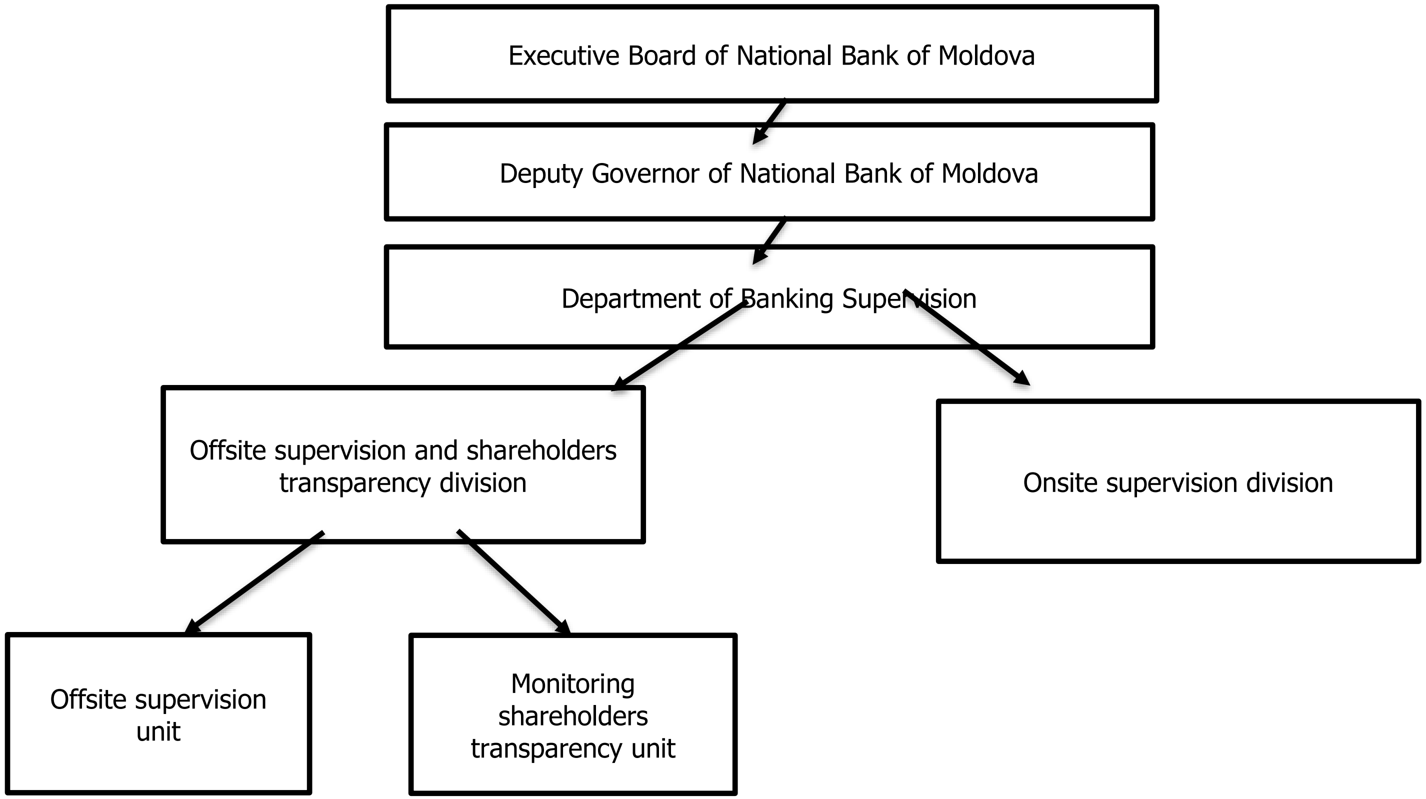
In order to improve the system of promotion in the positions of bank's administrator the persons who correspond to fit and proper principle and, respectively, to ensure the efficient management of the bank, has been approved in a new version the **Regulation on requirements to bank administrators**. The amendments, based on the recommendations of the European Banking Authority Guidelines and those of the International Monetary Fund experts, improve the ways of applying the qualification and experience criteria of the person proposed for the administrator position.

The amendments to the **Regulation on holding equity interest in the capital of banks** aim to improve the regulatory framework by establishing mechanisms to allow the entry to the banking market only for the persons who meet the legal requirements regarding the quality of the bank's shareholders. At the same time, the process of granting permissions to hold allowances in the bank's share capital has been improved, where the potential acquirer is an international organization, a multilateral development bank, a bank from the Republic of Moldova or a foreign bank. In this case, a set of reduced number of documents is required for the entities mentioned, taking in to account their status and the fact that the banks concerned are supervised by the competent authorities.

In order to create the normative framework for the establishment of branches of foreign banks on the territory of the Republic of Moldova, the **Regulation on licensing of banks** was improved by establishing the mechanism for setting up the branch of the foreign bank, which provides requirements related to licensing, endowment capital and conditions for carrying out the activity. Therefore, in order to ensure a fair and equal treatment for all banking market' participants, the endowment capital of a foreign bank' branch have to be the same as the capital that a bank must maintain.

In this context has been amended the **Regulation on risk-weighted capital adequacy**. The amendments provide the endowment capital (the capital of a foreign bank' branch) as a component of the total regulatory capital. At the same time, in order to maintain the banks' financial stability and from the perspective of the banks' capital consolidation, the regulation has been amended with conditions for capital distribution by banks, which are related to evolution of banks' financial performance indicators and to impact of economic and social nature on bank's prudential indicators, assessed including by evaluating the stress test results carried out by the bank and/or the National Bank.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In order to further strengthen the regulatory and supervisory framework of the Moldovan financial and banking system, the National Bank of Moldova (NBM) has continued to increase its level of cooperation with the international financial institutions, foreign central banks and other development partners (International Monetary Fund (IMF), European Union (EU), The Group of Banking Supervisors from Central and Eastern Europe (BSCEE), etc.).

Therefore, during the year 2017, the Republic of Moldova has advanced its relations with the IMF, based on the comprehensive program on economic and financial reforms, which was approved by the IMF Executive Board on 7 November 2016, for a period of three years.

In the financial and banking field, the main objective of the IMF supported program in 2017 was to strengthen the governance and financial situation of banks, through: increasing shareholders' transparency; ensuring compliance with fit and proper criteria of bank shareholders; identification of loans to related parties; and ensuring compliance with regulatory and capital requirements.

At the same time, in order to ensure continuity in the implementation of the Association Agreement, the Republic of Moldova and the European Union have agreed upon a new EU-Republic of Moldova Association Agenda for the period 2017-2019, published in the Official Journal of the EU on 19 August 2017. The new document aims to support and strengthen the resilience and stability of the Republic of Moldova, while pursuing a closer political association and deeper economic integration. The Association Agenda 2017-2019 provides a list of short and medium-term priorities, including NBM's areas, such as: financial services, current payments and capital movements, right of establishment and trade in services, economic development and market opportunities.

Moreover, cooperation with the European partners was marked in 2017 by the signing in Brussels, on 23 November, of the package of documents regarding the granting of macro-financial assistance to the Republic of Moldova by the European Union. The Memorandum of Understanding was signed by the European Commissioner for Economic and Financial Affairs, Taxation and Customs, Pierre Moscovici, the Governor of the National Bank of Moldova, Sergiu Cioclea, and the Minister of Finance, Octavian Armasu, in the presence of the Prime Minister, Pavel Filip.

Another major event that marked the dialogue between the NBM and the EU in 2017, was the successful conclusion of the Twinning project for strengthening the NBM’s capacity in the field of banking regulation and supervision in the context of EU requirements. The project was launched on the 30 June 2015, and was implemented for a period of two years by the NBM with the technical assistance offered by the National Bank of Romania and De Nederlandsche Bank.

As a member of the Group of Banking Supervisors from Central and Eastern Europe (BSCEE), the NBM has continued to cooperate with BSCEE members, including on information and best practices exchange in the areas of banking regulation and supervision. In this regard, the NBM representatives took part at the regional seminar on applying the EU’s legislation with respect to Basel III, which was organized by the BSCEE. The participation of the NBM representatives at this seminar served as an important step towards reaching the strategical objectives of the NBM, including the already initiated process of EU’s CRD IV package (Capital Requirements Directive) transposition into the national legislation through the Twinning project mentioned above.

Additionally, on 3 July 2017, the Memorandum of Understanding between the National Bank of Moldova and the Black Sea Trade Development Bank was signed within the regional Business Forum “Moldova: Working Together to Support Growth”, held in Chisinau on the occasion of the Annual Meeting of the Board of Governors of the Black Sea Trade Development Bank (BSTDB). The document signed by the Governor of the NBM, Sergiu Cioclea, and the President of the BSTDB, Ihsan Ugur Delikanli, provides for the creation of the necessary framework to facilitate the collaboration between the parties and to extend the technical assistance in banking sector. At the same time, the memorandum offers new opportunities to attract international expertise from the Black Sea countries in fields of major interest for the NBM.

In the context of strengthening cooperation with the Bank of Lithuania, a Memorandum of Understanding between the National Bank of Moldova and the Bank of Lithuania (Lietuvos bankas) was signed on 22 August 2017, during a working visit of NBM delegation to Vilnius. The agreement stipulates the establishment of a broad framework for cooperation and information exchange between the institutions, offering new opportunities to expand technical assistance in banking sector and to attract expertise from EU central banks.

Also, in order to fulfill its function on banks licensing, the NBM has cooperated and has carried out a mutual exchange of information, necessary in the process of assessing the quality of stakeholders ("Fit & Proper") with banking supervisory authorities from other countries (Belarus, Czech Republic, Georgia, Italy, Kyrgyzstan, Romania, Russia and Ukraine).

In order to carry out the banking authorization function in accordance with the Law on Financial Institutions and normative acts of the National Bank in force in 2017, the NBM has provided the exchange of information with the following supervisory authorities: the National Bank of Belarus, the National Bank of Georgia, the National Bank the Bank of Italy, the National Bank of the Russian Federation, the Bank of Lithuania, the Central Bank of the Czech Republic, the National Bank of Ukraine.

COOPERATION WITH OTHER SUPERVISORY BODIES IN MOLDOVA

According to the legal framework in force and the bilateral agreements, the National Bank of Moldova cooperates with other supervising authorities and competent authorities from the Republic of Moldova. Thus, during 2017, in order to efficiently perform its functions, the National Bank of Moldova collaborated on the basis of bilateral agreements signed with the National Anticorruption Center, the Intelligence and Security Service and the National Commission for the Financial Market.

STATISTICAL TABLES

Number of financial institutions (at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	10	7	7
Branches of foreign credit institutions	4	4	4
Cooperative banks	-	-	-
Banking sector, total:	**14**	**11**	**11**

Ownership structure of banks on the basis of assets total (at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	0.0	0.0	0.0
Other domestic ownership	41.42	49.2	50.33
Domestic ownership total	41.42	49.2	50.33
Foreign ownership	58.58	50.8	49.67
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions (at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	65.3	84.0	0.151
Branches of foreign credit institutions	23.1	24.9	0.022
Cooperative banks	-	-	-
Banking sector, total:	88.4	108.9	0.173

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	10.2	11.1	11.4
Cooperative banks	-	-	-
Banking sector, total:	10.2	11.1	11.4

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	75.69	74.0	75.11
Branches of foreign credit institutions	24.31	26.0	24.89
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

* Only branches of foreign banks.

The structure of assets and liabilities of the banking system (%) (at year-end)

Assets	2015	2016	2017
Cash	4.39	5.09	5.23
Due from banks and NBM, net	29.44	28.74	31.30
Net loans and financial leasing	53.21*	44.11*	38.12*
Government securities, net	6.21	7.09	7.69
Other, net	6.72	14.94	17.66
Total assets	100.00	100.00	100.00
Liabilities	**2015**	**2016**	**2017**
Deposits of households	50.64	51.72	49.86
Deposits of corporates (nonfinancial)	19.71	23.33	25.31
Other	12.57	7.62	7.66
Shareholder capital	17.05	17.31	17.18
Total liabilities and shareholder capital	100.0	100.0	100.0

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks	26.22*	29.8*	31.3*
Cooperative banks	-	-	-
Banking sector, total	26.22*	29.8*	31.3*

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking system (%)

Loan classification	2015	2016	2017
Standard	51.27	51.10	54.58
Supervised	38.78	32.50	26.67
Substandard	4.12	5.98	5.72
Doubtful	2.57	2.88	4.23
Losses	3.26	7.55	8.43
Total	**100.0**	**100.0**	**100.0**
Specific reserves	8.5	13.42	14.81

The structure of deposits and loans in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	97.42	96.03
Households	66.15	22.47
Corporate	31.27	73.56
Government sector	0.12	0.09
Financial sector (excluding banks)	2.18	3.88
Total*	**100.0**	**100.0**

*Bank deposits and loans were excluded from the total

P&L account of the banking sector (at year-end, in mln. EUR)

P&L account	2015	2016	2017
Interest income	254.17	297.55	231.31
Interest expenses	113.07	141.67	91.12
Net interest income	141.11	155.88	140.19
Net fee and commission income	40.84	47.94	53.02
Other (not specified above) operating income (net)	-33.79	-42.64	-12.30
Gross income	508.35	595.10	462.61
Administration costs	65.47	77.42	87.14
Depreciation	9.80	11.47	12.53
Provisions	97.20	144.15	156.36
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	78.74%	40.39%	14.58%
Profit (loss) before tax	62.40	69.01	83.35
Net profit (loss)	66.47	65.30	74.87

As of December 31.12.2017, 1 EUR=20.4099 MDL.

Total own funds in 2017 (in mln. EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	518.7*	-	499.0*	19.7*	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	518.7*	-	499.0*	19.7*	-

(* - for Basel I; ** - for Basel II; *** - for Basel III)
As of December 31.12.2017, 1 EUR=20.4099 MDL.

2017 DEVELOPMENTS IN THE MONTENEGRIN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

According to the available indicators, the Montenegrin economy recorded significant growth in 2017 compared to the previous year. The basic indicators point to positive trends in most sectors, followed by significant results primarily in the construction and tourism sectors. Growth was also recorded in all components of GDP consumption, including personal and public consumption, visible exports and imports, and it was particularly evident in gross fixed capital formation and changes in inventories.

Preliminary data on quarterly GDP trends show positive rates in all four quarters of 2017 (3.1% in Q1, 5.2% in Q2, 4.7% in Q3, and 4% in Q4), while the annual growth amounted to 4.4%.

The annual CPI inflation was 1.9% in December 2017, while inflation measured by the HICP (Harmonized Index of Consumer Price) was 2.9%. The average annual growth rate was 2.4%.

Preliminary data of the Ministry of Finance show that total budget revenues with the government funds amounted to 2.19 billion euro or 51.6% of the estimated GDP in 2017. Compared to the 2017 plan, the source revenues were 0.9% lower, and compared to 2016, they were higher by 5.3%. The budget deficit of Montenegro is estimated at 237.6 million euros or 5.6% of GDP and it is 102.6 million euros higher than in 2016.

The Ministry of Finance registered a net public debt of Montenegro amounted to 2,687.9 million euro or 63.5% of the estimated GDP for 2017. Compared to the end of 2016, the net public debt recorded an increase of 7.6%. There is a concern both regarding the total amount of public debt and the expectation that the public debt will increase in the coming period due to a more intensive implementation of planned infrastructure projects.

The average number of employees in 2017 was 182,368 and it was 2.5% higher than the average in the previous year. According to the Employment Agency of Montenegro, the average number of registered unemployed persons was 50,510, which is 17.9% more than in the previous year. The strong growth of unemployment in 2017 was largely due to the enforcement of the Constitutional Court`s decision on cancelling the amendments to the Law on Social and Child Protection which had granted mothers with three or more children the social welfare right on the basis of years of being on the unemployment records and their reregistering in the Employment Agency records. In December 2017, the unemployment rate published by the Employment Agency amounted to 22.09% or 0.76 percentage points more than a year ago.

According to MONSTAT data, the average gross salary in Montenegro in 2017 amounted to 765 euros and it was 1.9% higher than the average salary in 2016. The average salary without taxes and contributions amounted to 510 euros and was 2.2% higher than in the previous year.

According to 2017 preliminary data, the current account deficit amounted to 799.3 million euros and it was 11.8% higher than in the previous year. This increase is the result of an increase in the deficit in the account of goods. The deficit was mostly financed from the inflow of FDIs (59.3%) and other investments

(31.7%). The service account generated a surplus of 836.4 million euros, which is 8.8% more year-on-year. Total revenues from services amounted to 1.4 billion euros or 8.6% more than in 2016.

Net foreign direct investments in the financial account amounted to 474.3 million euro or 27.6% more than in the same period of the previous year, accounting for 11.2% of GDP.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

The banking system in Montenegro is profitable, properly capitalized, and highly liquid. There were 15 banks operating in Montenegro as at 31 December 2017.

The key balance positions recorded growth year-on-year. Total assets of banks rose 10.34%, loans (gross loans and receivables from banks and customers) increased by 11.78%, total bank deposits (including funds in escrow accounts, excluding interest and accruals and prepayments) increased by 13.77%, while total capital increased by 5.87%. Liquid assets of banks recorded the annual increase of 13.92%. All asset quality parameters improved in 2017.

Although lending activity improved in 2017, banks continue to pursue a prudential credit policy. Deposits exceeded the level of loans, with the loans to deposits ratio amounting to 0.83. Liquidity of banks was satisfactory. Daily and ten-day liquidity indicators of banks were above the prescribed minimum. Total liquid assets of banks amounted to 1,059 million euros, while the share of liquid assets in total assets amounted to 25.32%.

Financial result on the aggregate level was positive and banks made a profit in the total amount of 35.1 million euros. Individually, twelve banks in the system recorded profit, while three banks recorded negative financial result.

At the end of the reporting year, total capital of banks in Montenegro amounted to 514.2 million euros or 28.5 million euros or 5.87% more than in 2016. The aggregate capital adequacy ratio was 16.37%, which is significantly above the prescribed minimum of 10%. Total own funds of banks amounted to 394.6 million euros, while the total amount of risk weighted assets amounted to 2,410.4 million euros.

Total loans (gross loans and receivables from banks and customers) amounted to 2,700.5 million euros and they rose 11.78% compared to the previous year. In the maturity structure of total loans, long-term loans accounted for 75.87% and short-term loans made up 24.13%. The most important loan beneficiaries (90.15%) were the corporate sector, households, and non-resident banks. At the end of 2017, corporate loans amounted to 979.4 million euros (36.27% of total loans), household loans 1,123.1 million euros (41.59% of total loans), and loans of non-resident banks were 332 million euros (12.29%).

Non-performing loans (excluding interest and accruals and prepayments) amounted to 197 million euros and they accounted for 7.29% of total loans at end-2017. Compared to December 2016, non-performing loans were 20.77% lower.

Total deposits in banks (including funds in escrow accounts, excluding interest and accruals and prepayments) amounted to 3,267.1 million euro or 13.77% more compared to the previous year.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN MONTENEGRO

The Central Bank had participated in drafting the Law amending the Law on Voluntary Financial Restructuring of Debts towards Financial Institutions that was adopted in June 2017. These changes were made in order to create the conditions for encouraging voluntary debt restructuring, and in this sense the deadline for the implementation of the Law was extended for a year, the volume of loans that can be subject to voluntary restructuring was extended, the restructuring procedure was improved, and additional tax reliefs were provided for debtors.

In connection with the implementation of this Law and with the aim of strengthening new regulatory solutions in the area of loan restructuring, in July 2017, the Central Bank adopted the Decision amending the Decision on Minimum Standards for Credit Risk Management in Banks. These amendments oblige banks to submit detailed information on all initiated restructuring procedures, as well as on results of implemented restructurings. They also prescribe certain measures that the Central Bank may impose on banks that do not consider all possible restructuring instruments with due diligence when considering the initiative.

Significant activities were also take with a view to establishing a regulatory framework for licensing, operating and controlling the operations of non-banking financial institutions, resulting in the Central Bank drafting the Law on Financial Leasing, Factoring, Purchase of Receivables, Micro-Lending and Credit-Guarantee Operations, which was adopted in October 2017 (the application started on 11 May 2018). In addition to financial services that are already regulated (micro-lending and credit-guarantee operations), this Law regulates other financial services that were performed by unregulated entities in the country (leasing, factoring and purchase of receivables) to cover their establishment, operation and supervision. This created normative conditions for further development of this segment of financial services with the aim of creating a comprehensive database on the operations of financial service providers that will be used for statistical and other purposes, the improvement of the Credit Registry maintained by the Central Bank, and the improvement of consumer protection who are users of services provided by these financial institutions.

The implementation of the International Financial Reporting Standard 9 (IFRS 9) necessitated amendments to the secondary legislation of the Central Bank. In this respect, the following decisions were prepared:

- Decision Supplementing the Decision on Capital Adequacy of Banks (adopted in November 2017);
- Decision Amending the Decision on Minimum Standards for Credit Risk Management in Banks (adopted in November 2017);
- a new Decision on Chart of Accounts for Banks (adopted in December 2017);
- Decision Amending the Decision on Bank Reporting to the Central Bank of Montenegro (adopted in December 2017).

Along with these changes, in order to further improve the current regulations, Decision on minimum standards for bank investment in immovable property and fixed assets has been amended.

In July 2017, draft versions of the Bank Resolution Law and the Law amending the Banking Law were adopted and submitted to the competent authority for further procedure.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

Activities of the Central Bank were focused on several important projects during 2017, primarily on harmonization with the legislation of the European Union and international standards, but also on the improvement of current solutions in order to overcome the problems and achieve positive effects for the economy as a whole.

In the framework of aligning the domestic regulations with EU regulations, the Central Bank continued to work on the preparation of laws implementing the Directive 2014/59 EU on establishing a framework for the recovery and resolution of credit institutions and investment firms. To that end, in July 2017, draft versions of the Bank Resolution Law and the Law amending the Banking Law were adopted and submitted to the competent authority for further procedure. The adoption of these laws will create conditions for the strengthening of the financial system stability in order to deal with problem banks.

Significant activities were taken with a view to implementing the IFRS 9 standard that would provide for the harmonization of preparation of financial statements by banks (full implementation as of 1 January 2018). It replaced the International Accounting Standard 39 (IAS 39), which implied the introduction of new requirements regarding the classification and valuation of financial instruments in the banking system and the related reporting, and created the need to make appropriate amendments to the secondary legislation of the Central Bank.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

During 2017, in accordance with the Supervision Plan, 12 regular on-site inspections were carried out, which included 11 banks in the system. In addition, 6 extraordinary targeted on-site inspections were carried out and they covered four banks.

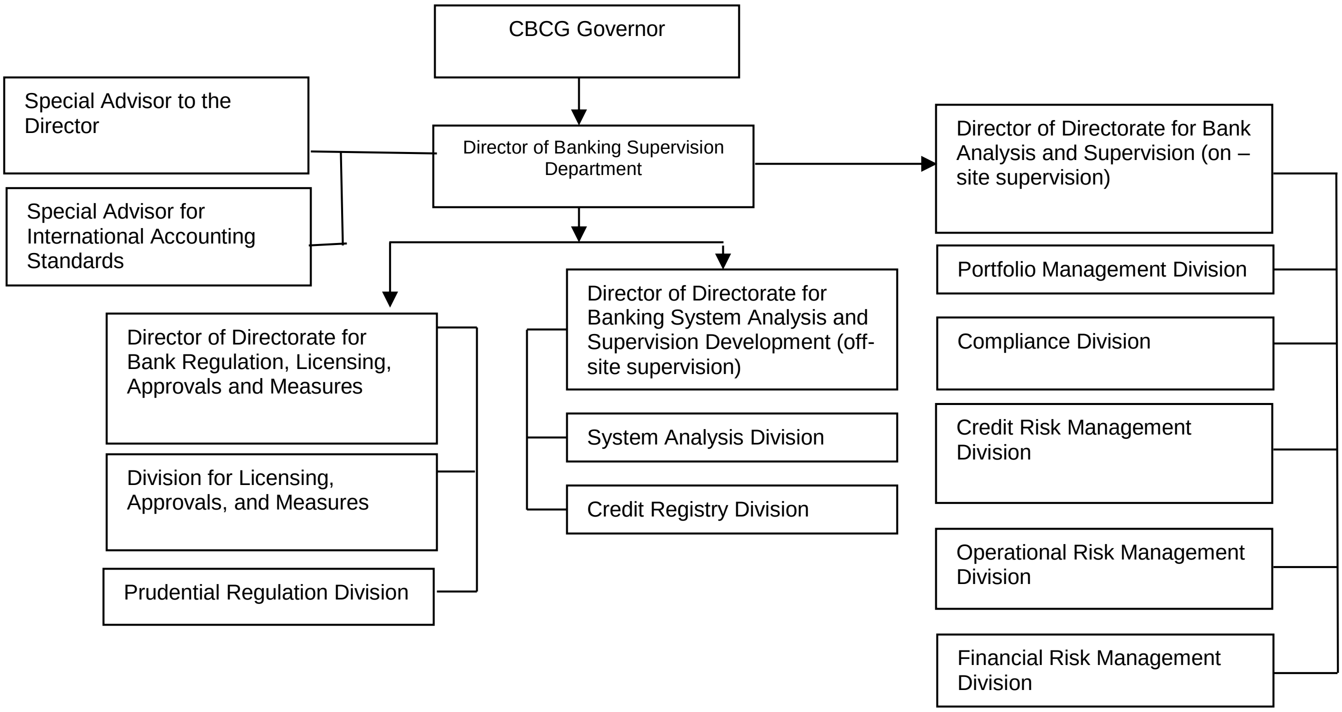
With a view to preserving and improving the banking sector’s stability in accordance with the risk-based supervision, two full-scope inspections were conducted in 2016, while targeted inspections focused on the supervision of capital adequacy, credit risk, income, liquidity, and compliance with regulations on the prevention of money laundering and terrorist financing. Conducting of target inspections continued the improving of supervision’s efficiency, and the development of the risk-based supervision, with the dominant role of portfolio management access in the supervisory process. Banking sector supervision primarily focused on banking supervision from the perspective of risk assessment areas.

In 2017, due to identified irregularities in operations of six banks, the Central Bank took measures against these banks to eliminate irregularities in their work (one bank was given a decision and a written warning, and four banks signed agreements with the Central Bank).

Additionally, requests for initiation of misdemeanour proceedings against two banks and one legal entity and responsible persons in these legal entities were filed with the competent Misdemeanour Court.

In addition to its off-site and on-site supervisory activities, the Supervision Department also carried out two targeted on-site supervisions of microfinance institutions.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

During the reporting year, the Central Bank continued with active participation in the process of Montenegro's EU accession. Within the working groups for the preparation of negotiations it leads (Chapter 4 Free movement of capital, Chapter 9 Financial services, and Chapter 17 Economic and monetary union) and in which it has an active role (Chapter 18 Statistics and Chapter 32 Financial control), together with other competent institutions, the Central Bank worked intensively on the preparation of documents and materials that are important for successful membership negotiations.

Cooperation with representatives of central banks of the EU Member States and EU institutions and bodies continued through regular visits and ongoing communication, especially with representatives of the European Commission and the European Central Bank who made several visits to the Central Bank during 2017.

Intensive activities were carried out on preparations for the Twinning project "Support to Financial Services Regulation" funded by the European Commission, which is expected to be launched in 2018. The project deliverable will be a completely innovated regulatory framework for the financial services sector in Montenegro, in line with the latest Basel III standards.

Work on the improvement and strengthening of administrative capacities continued also through various types of technical bilateral cooperation in 2017 and the Central Bank representatives paid 15 bilateral visits to the partner central banks.

As for the cooperation with the IMF, regular consultations were held from 15 February to 1 March (concluded on 8 September in Washington, D.C.). The Central Bank representatives attended the IMF/World Bank Spring Meetings held from 21 to 23 April, as well as the Annual Meetings from 13 to 15 October in Washington, D.C. In both cases, the Montenegrin delegation had a series of bilateral meetings with the IMF and the World Bank officials whereat they discussed the results and prospects of the Montenegrin economy.

The main activities in the area of cooperation between the Central Bank and the World Bank Group in 2017 related to the preparation and approval of the first Policy based guarantee in the area of fiscal and financial resistance (PBG1).

COOPERATION WITH OTHER SUPERVISORY BODIES IN MONTENEGRO

In 2017, the Central Bank continued successful cooperation with other regulators in the country, which is based on the regular exchange of information in accordance with the objectives defined in the concluded bilateral agreements and MoUs, and which largely relate to the exchange of information regarding the acquisition of qualified participation with financial market participants and AML/TF information.

STATISTICAL TABLES

Number of financial institutions (head offices/branches) (at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	14	15	15
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Financial institutions, total	**14**	**15**	**15**

Ownership structure of banks on the basis of assets total

Type of financial institution	2015	2016	2017
Public sector ownership	-	-	-
Other domestic ownership	-	-	-
Domestic ownership total	22.4	24.5	26.99
Foreign ownership	77.6	75.5	73.01
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	38.27	60.82	991
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total	**38.27**	**60.82**	**991**

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	-0.91	1.21	6.98
Cooperative banks	-	-	-
Banking sector, total:	-0.91	1.21	6.98

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	100	100	100
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total	**100.0**	**100.0**	**100.0**

Capital adequacy ratio of banks

Type of financial institution	2015**	2016**	2017**
Commercial banks	15.48	16.01	16.37
Cooperative banks	-	-	-
Banking sector, total:	**15.48**	**16.01**	**16.37**

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector*	98.8	98.4	96.6
- households	25.11	26.2	28.8
- corporate**	71.56	71.7	67.6

*excluding government sector and financial institutions; share of total NPL
**state companies, private companies and entrepreneurs; share of total NPL

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	93.5	80.2
Households	52.0	41.6
Corporate	39.4	37.4
Government sector	5.3	7.0
Financial sector	1.0	0.4
Total	**100.0**	**100.0**

P&L account of the banking sector (at year-ends)

P&L account	2015	2016	2017
Interest income	165,102	161,010	159,759
Interest expenses	48,086	39,141	34,907
Net interest income	117,018	121,868	124,849
Net fee and commission income	36,126	36,874	41,813
Other (not specified above) operating income (net)	18,170	15,635	21,743
Gross income	171,371	174,474	188,844
Administration costs	106,429	108,288	114,341
Depreciation	9,740	9,710	9,656
Provisions	54,194	45,089	21,939
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)			
Profit (loss) before tax	-2,503	9,342	37,089
Net profit (loss)	**-4,148**	**7,317**	**35,077**

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds**	Core Tier 1	Tier 1**	Tier 2**	Tier 3
Commercial banks	394,625	-	360,765	37,299	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**394,625**	**-**	**360,765**	**37,299**	**-**

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE POLISH BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2017 Polish economy grew by 4.6%. Poland maintained its high economic growth from the previous years and remained one of the fastest growing countries in the EU. Between 2008 and 2017 the average annual real growth rate amounted to 3.32%. During this period the only EU countries to record such a rapid growth were Ireland and Malta. GDP growth for the whole EU28 amounted to 0.83% and for the Eurozone only to a mere 0.59%. Polish GDP growth in 2017 was, as in the previous year, based on household consumption expenditure. The balance of payments improved significantly and amounted to PLN 1.85 billion (compared to PLN -5.37 billion in December 2016). On the labor market the positive trend from the recent years persisted and the unemployment rate fell to 6.6% at the end of December 2017. The inflation rate stayed above zero during the year and amounted to -2.0% on a yearly basis. The central bank interest rates were kept at their historically low levels: the reference rate at 1.5% and the deposit rate at 0.5%.

On the FX market a significant appreciation of the Polish zloty against the main global currencies was observed. At the end of the year, the zloty's exchange rate against the euro amounted to 4.17 (a decrease from 4.42 at the start of the year), the Swiss franc was valued at 4.57 (down from 4.12 at the start of the year) and the US dollar was valued at 3.48 (a fall from 4.21).

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

In 2017 the situation of the banking sector remained stable. Total balance sheet of the banks grew by around 6% amounting to PLN 1.78 trillion (around 90% of GDP). Commercial banks accounted for over 90% of the banking sector's assets. Net profit at the end of the year amounted to PLN 13.7 billion – a slight fall of 1.2% in comparison to the previous year.

The situation with respect to the capital base remained strong and at the end of 2017 capital adequacy ratios were at considerably high levels. Banks are still expected to maintain or even further strengthen their capital base. The level of non-performing loans decreased slightly for the fifth consecutive year in a row.

Fast GDP growth allows further development of the Polish banking sector. However, record low central bank and interbank interest rates force the banks to adjust their business profiles and to search profits in fees rather than in margins and to also reduce administrative costs substantially.

In 2017 there was a significant rise (to 54.5%) in public sector ownership of banks (from 43.4% in 2016). The change was mainly caused by the acquisition of 32.8% of Bank Pekao SA by PZU and the Polish Development Fund. It was one of the largest transactions in the European banking industry in recent years (amounting to around EUR 2.5 bn). The acquisition is in line with PZU's strategy by the year 2020, which aims at creating a banking group with assets of at least PLN 140 bn (or EUR 33 bn).

In February 2016 Poland introduced a tax on banks and insurance companies. The Banking Tax Act applies to: domestic banks, consumer lending institutions and insurance companies, as well as the branches of foreign banks and insurance companies operating in Poland. The Banking Tax Act imposes a tax on the assets of financial institutions. In particular, the taxable amount will be the excess of total assets over PLN 4 billion for domestic banks, branches of foreign banks, branches of credit institutions and credit unions funds. The rate of tax applied to the taxable base is 0.0366 percent per month (0.44 percent annually). The new tax is generally designed to finance governmental spending. In 2017 tax outlays paid by commercial banks reached PLN 4.34 billion and constituted around 1.3% of state revenues.

One of the issues that raise concerns about the Polish banking sector remains also a potential source of risk - significant share of FX loans in banks' portfolios. It is worth stressing that from the economic point of view the portfolio does not pose a systemic risk: the income buffers of FX borrowers are still higher that the zloty ones. Over time the exposure of banks to FX will gradually decrease as no new loans are granted. There is still a potential legal risk given various initiatives aimed at imposing a forced conversion of FX loans into zloty which could pose a threat to financial stability. Fortunately, almost all of loans were granted with an adjustable interest rate and the depreciation of the zloty was over the past two years partially off-set by lower, even negative interest rates - so that the monthly instalments did not change significantly. As long as FX lending risk is not eliminated, both borrowers and banks will be under constant pressure related to exchange rates and will be exposed to a number of risks.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN THE COUNTRY

The organization, scope and purpose of supervision over the financial market are regulated by the Act of 21 July 2006 on *Financial Market Supervision*. According to the above, the supervision over the financial market comprises of:

1) banking supervision,
2) pension supervision,
3) insurance supervision,
4) capital market supervision,
5) supervision over electronic money institutions,
6) supervision of payment institutions and payment service offices,
7) supplementary supervision,
8) supervision over credit unions and their national association.

Supervision over the financial market, in the above mentioned scope, is exercised by **the Polish Financial Supervision Authority (KNF)**. As far as the banking sector is concerned, the KNF is in charge of microprudential supervision since 2008. Regulatory powers of the KNF have been narrowed to powers strictly specified in the Banking Act. It shares its regulatory powers with the Ministry of Finance and the National Bank of Poland.

The **objective of the supervision** is to ensure:

1) the safety of funds held on bank accounts,
2) compliance by the banks with the provisions of the Banking Act, the Act on the National Bank of Poland, their articles of association, and the acts granting the authorization to establish those banks.
3) that the banks' activities are carried out in accordance with Art. 70 para. 2 of the Act on Trading in Financial Instruments of July 29, 2005 with provisions of that Act, the Banking Act and the articles of association.

Moreover, the tasks of the KNF include:

a) undertaking measures aimed at ensuring stable operation of the financial market,
b) undertaking measures aimed at the development of the financial market and its competitiveness,
c) undertaking educational and information measures related to financial market operation,
d) participation in the drafting of legal acts related to financial market supervision,
e) creation of opportunities for amicable and conciliatory settlement of disputes which may arise between financial market participants, in particular disputes resulting from contractual relations between entities supervised by the KNF and recipients of services provided by those entities,
f) carrying out other activities imposed for by acts of law.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

In 2017 the activities of the KNF focused primarily on the objectives set out by the Act of 21 July 2006 on Financial Market Supervision: ensuring the proper functioning of the financial market, its stability, security and transparency.

The process of modifying the organizational structure of the Authority began. It is aimed at streamlining licensing and inspections in all of the supervised sectors of the financial system.

Also the KNF undertook activities in the Fintech area. This will allow the dynamically developing Polish financial innovation sector to gain additional support from the supervisory side.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The supervisory activities taken by the KNF in 2017 involved ongoing monitoring and quarterly analysis of banks' economic and financial standing (rating given for Q4 2016 and 3 quarters of 2017). Based on the results of the analysis, the banks were given a rating according to the KOBRA rating system. In 2017 all commercial banks were rated. 132 quarterly analyses of branches of credit institutions, 2227 quarterly analyses of cooperative banks and 8 quarterly analyses of associating banks were prepared. In 2017 the cyclical evaluation process of cooperative and associating banks continued.

Also 120 quarterly analyses of branches of credit institutions were prepared (rating given for Q4 2016 and 3 quarters of 2017). Apart from the quarterly rating, banks are covered by the SREP process, i.e. Supervisory Review and Evaluation Process.

In the area of consolidated supervision the KNF reviewed consolidated financial statements of banks, economic and financial standing of holdings, banks' parent companies and banks included in conglomerates. Direct off-site supervision involved the selection of banks for comprehensive and problem-oriented inspections, and the results of the selection process were passed to the KNF Office's organizational units responsible for inspection.

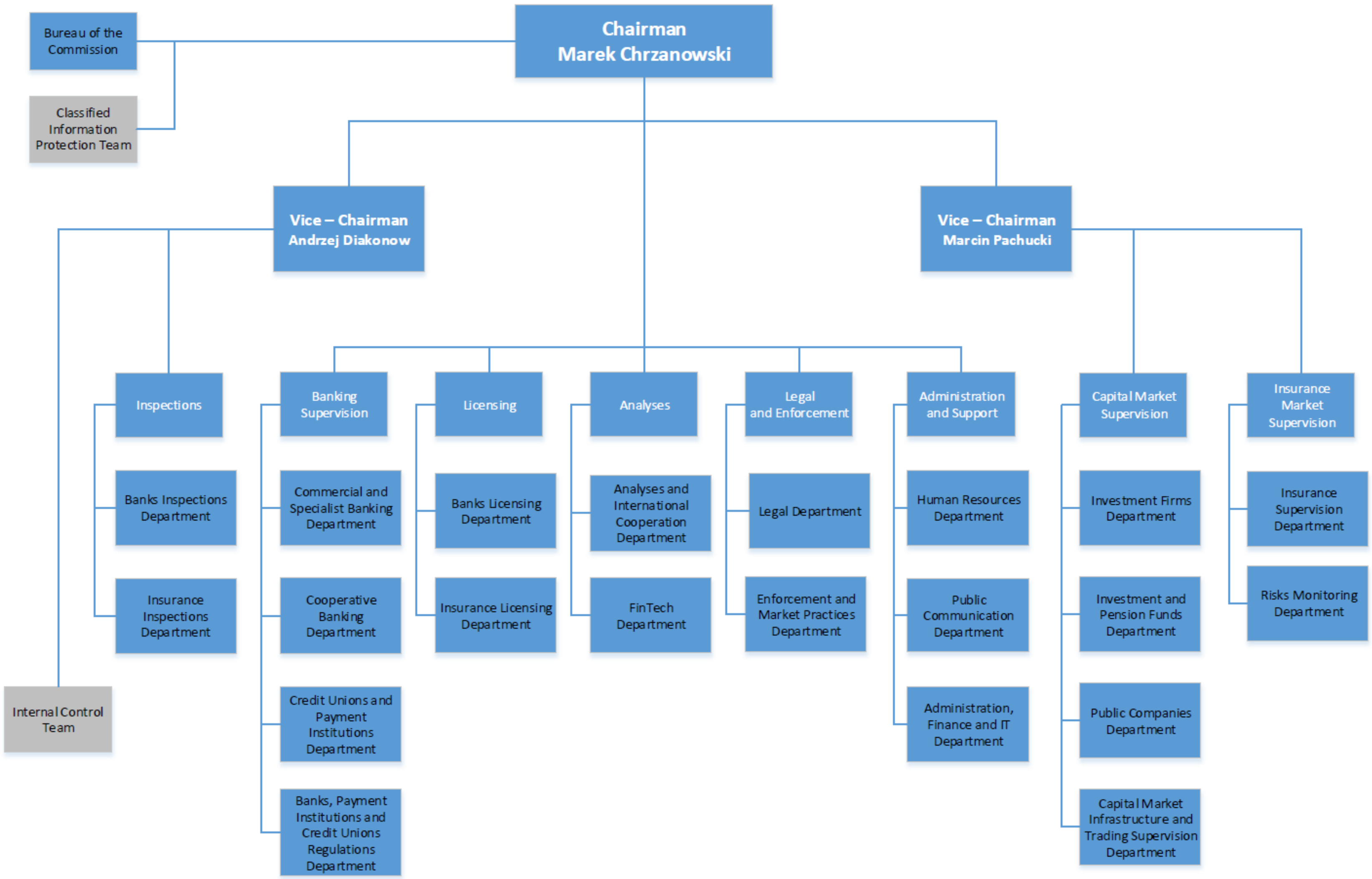
Comparative (quarterly) analyses were conducted to examine the manner in which debt owned by the same borrower is classified by different banks. Whenever any discrepancies were identified, relevant steps were taken with respect to the regulated entities involved.

Supervision activities were conducted in the following areas:

- reinforcement the capital base, including rules on dividend payment,
- bancassurance,
- transforming processes,
- administrative procedures, including applications for recognising subordinated liabilities, interim profits under funds, appointment of forced administration,
- liquidity,
- recovery procedures plans including the assessment of their implementation, completion or imposition of the recovery procedures plan,
- implementation of recommendations issued in the course of inspections, the SREP process and other recommendations issued under the off-site supervision.

In 2017 7 commercial banks were covered by recovery procedures. At the end of 2016 34 cooperative banks and one associating bank were subject to the recovery procedures.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The KNF is an active member of international supervisory bodies on the EU as well as on an international level including EBA, ESMA, EIOPA, ESRB, IOSCO, IAIS and IOPS. With the considerable involvement of foreign capital groups in the ownership structure of financial institutions in Poland, the international supervisory cooperation remains a vital element of the efficient supervision. In 2017 the KNF participated in 30 supervisory colleges, including banking and insurance groups.

On the European level the KNF representatives took part in pre-application and review processes of the appropriateness of the internal models of foreign insurance groups.

The KNF maintains close contact with supervisors from other countries. Bilateral cooperation is facilitated by memoranda on cooperation and exchange of information, which the KNF has already signed with supervision authorities from 58 jurisdictions (excluding multilateral agreements under ESMA, IOSCO and IAIS). In 2017, such memorandum has been signed with the Monetary Authority of Singapore, Financial Supervisory Commission from Taiwan and the China Banking Regulatory Commission.

COOPERATION WITH OTHER SUPERVISORY BODIES IN POLAND

The KNF is responsible for the supervision of the Polish financial sector. Besides credit institutions (commercial banks, cooperative banks, credit unions) the KNF supervises insurance and reinsurance companies, pension funds, the Warsaw Stock Exchange, the clearing house, investment firms, investment funds, payment institutions, electronic money institutions and other types of entities.

The KNF also takes part in the works of the Financial Stability Committee (KSF) – a body responsible for: (1) macroprudential authority (the legal framework of macroprudential oversight in Poland has been established by the Act of 5 August 2015 on Macroprudential Supervision over the Financial System and on the Crisis Management in the Financial System), and (2) crisis management in the financial system.

Acting as a macroprudential authority, the Financial Stability Committee (KSF) is chaired by the Governor of the National Bank of Poland and comprises also: Chairman of the KNF, Minister of Finance, and Chairman of the Bank Guarantee Fund. The Committee is entitled to issue: (1) statements - aimed at highlighting potential sources of systemic risk (the statements may be addressed to: participants of the financial system or its part / sector, member institutions of the Financial Stability Committee); and (2) recommendations – aimed at initiating some actions to address systemic risk (recommendations might be addressed only to member institutions of the Financial Stability Committee). The Committee is empowered to discuss, assess and monitor potential systemic risks that might disturb functioning of the financial system. It is also the Committee to discuss and provide opinions on whether, and in which form, the macroprudential instruments should be activated. Throughout 2017, the Committee adopted resolutions on recommending the countercyclical buffer rate at a level of 0%. This meant lack of changes in relation to the level set in 2016. At the beginning of 2018 the Committee recommended imposing the systemic risk buffer of 3% applicable to all credit institutions and to all exposures on the territory of the Republic of Poland. This capital buffer was set in January 2018. The main reason of imposing systemic risk buffer is an unstable international macroeconomic environment.

The statutory tasks of the KNF include also participation in the process of drafting laws regulating supervision over the financial market. The KNF acts as an advisor and gives opinions to authorities and agencies which, under separate legal regulations, initiate and conduct legislative work (however the KNF does not have legislative initiative).

OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

In 2017 the KNF identified 12 banks as O-SII (Other Systemically Important Institutions). An O-SII buffer was imposed, ranging from 0% to 0.75%. The list of the identified entities will be review on a yearly basis and if necessary the buffer will be adjusted accordingly.

Poland is among the jurisdictions whose financial sectors are deemed to be systemically important by the International Monetary Fund. In 2017 the IMF and the World Bank decided that in 2018 Poland will undergo assessments under the Financial Sector Assessment Program (FSAP) which are mandatory every five years. FSAP is a comprehensive and in-depth analysis of a country’s financial sector with two main goals: to gauge the stability and soundness of the financial sector and to assess its potential contribution to growth and development. In 2017 a scoping mission took place. Its aim was to discuss the precise scope of the upcoming FSAP.

STATISTICAL TABLES

Number of financial institutions (at year-end)

Type of financial institution	2015	2016	2017
Commercial banks	38	36	35
Branches of foreign credit institutions	27	27	28
Cooperative banks	561	558	553
Banking sector, total:	626	621	616

Ownership structure of banks on the basis of assets total

Type of financial institution	2015	2016	2017
Public sector ownership	23.9	28.8	39.8
Other domestic ownership	14.6	14.6	14.7
Domestic ownership total	38.5	43.4	54.5
Foreign ownership	61.5	56.6	45.5
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	37.0	53.0	795
Branches of foreign credit institutions	41.1	58.0	919
Cooperative banks	5.9	8.3	43
Banking sector, total:	33.4	47.8	648

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2015	2016	2017
Commercial banks	7.58	7.74	6.99
Cooperative banks	-11.38	3.86	5.79
Banking sector, total:	6.40	7.50	6.91

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	91.2	90.8	90.2
Branches of foreign credit institutions	2.0	2.1	2.5
Cooperative banks	6.9	7.1	7.3
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

Assets	2015	2016	2017
Claims from			
Financial sector	8.2	8.1	8.5
Nonfinancial sector	60.1	59.1	58.6
Government sector	6.0	5.7	5.6
Other assets	25.7	27.0	27.3
Claims due to			
Financial sector	22.1	21.0	20.3
Nonfinancial sector	58.7	60.1	60.1
Government sector	3.0	3.7	3.9
Other liabilities	5.3	4.5	4.3
Capital	10.9	10.7	11.5

Capital adequacy ratio of banks

Type of financial institution	2015***	2016***	2017***
Commercial banks	16.5	17.8	19.1
Cooperative banks	13.7	17.1	17.2
Banking sector, total:	16.3	17.7	19.0

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector	7.6	7.1	6.8
- households	6.2	6.0	6.1
- corporate	10.3	9.2	8.3

The structure of deposits and loans of the banking sector in 2017 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	89.2	86.0
Households	63.4	55.3
Corporate	23.7	30.1
Government sector	5.7	8.2
Financial sector (excluding banks)	5.1	5.8
Total	100.0	100.0

P&L account of the banking sector (at year-ends)

P&L account	2015	2016	2017
Interest income	52 873	53 903	58 172
Interest expenses	17 496	15 879	15 551
Net interest income	35 377	38 021	42 621
Net fee and commission income	13 317	12 592	13 728
Other (not specified above) operating income (net)	5 902	7 390	4 410
Gross income	55 958	59 315	61 927
Administration costs	30 665	31 663	33 014
Depreciation	2 854	2 913	2 949
Provisions	1 047	1 134	735
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	8 545	7 665	8 293
Profit (loss) before tax	14 175	18 326	18 503
Net profit (loss)	11 189	13 914	13 746

Total own funds* in 2017 (in EUR m)**

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	44 742	40 533	40 536	4 207	-
Cooperative banks	2 750	2 588	2 599	151	-
Banking sector, total:	47 492	43 121	43 135	4 357	-

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE ROMANIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2017, Romania recorded the fastest growth rate since the start of the global financial crisis (6.9 percent), placing itself among the most dynamic economies from the European Union. The main driver of the economic growth continued to be represented by the consumption demand, boosted by factors from the labor market, from the perspective of salaries and employment, and fiscal-budgetary relaxation measures.

As a significant part of domestic absorption is covered by imports, their increase exceeded the advance of exports, so that the economic growth was accompanied by a deepening of the current account deficit up to 3.4 percent of GDP. Although was fully funded by stable capital flows, the trajectory followed by this macroeconomic variable in recent years is worrying, given that most EU countries have recorded over the same period either current account surpluses or declining deficits. The budget deficit stood at 2.9 percent of GDP, continuing to evolve in the proximity of the threshold set by the Stability and Growth Pact (3 percent of GDP), against the background of an expansionary tax policy. In December 2017, the public debt-to-GDP ratio declined to 35 percent from 37.6 percent at end of 2016 (standard European methodology) and below the threshold of the European Commission's assessment procedure, of 60 percent of GDP. From public debt, on December 2017, domestic debt accounted for 18 percent of GDP, and external debt was 17 percent of GDP.

The annual inflation rate stayed on an upward trend over the entire year and reached 3.3 percent at December-end 2017. The evolution was mainly attributed to the influence of excess aggregate demand, accumulated cost pressures (utilities, labor force) and deterioration of the inflations expectations.

Romania's international reserves reached 37.1 billion euros in December 2017 against 37.9 billion euros in December 2016.

DEVELOPMENT IN THE BANKING SYSTEM

During the year 2017, in the context of acquisitions and mergers on the local market, the banking system narrowed from 37 to 35 banks as a result of the merger of two locally incorporated banks, as well as the closure of a foreign credit institutions branch. Thereby, at the end of 2017, the Romanian banking system comprised 28 banks, Romanian legal entities and 7 branches of foreign banks. At the same time, on the background of the changes registered in the credit institutions shareholder structure, the market share held by banks with majority private domestic capital increased from 0.5 percent at 31 December 2016 to 14.3 percent on 31 December 2017.

Although the share of banking system assets in GDP continued its downward trend, representing 49.8% at the end of 2017, with 1.8 percentage points less than in December 2016, the banking sector remains the main player in Romania’s financial system in terms of assets held. Aggregated banking assets totaled lei

427.8 billion at the end of December 2017, exceeding by 8.7 percent the level recorded in December 2016. This was mainly due to lending, on the assets side, and to the significant contribution of domestic deposits, on the liabilities side, respectively.

The main indicators for assessing the performance of the banking system indicate continuous positive trends, both in terms of meeting prudential requirements and improving the balance sheet structure and financial position. In this respect, it is noteworthy that it has been maintained the downward trend in the non-performing loans ratio, reaching 6 percent in December 2017, with 3.2 percentage points less than December 2016, both as a result of the significant reduction in non-performing exposures (-28 percent) and growth of total exposures (+7.5 percent). The NPL coverage ratio provides a comfortable counterbalance to NPL ratio (57.1 percent, December 2017).

The banking sector remained profitable throughout the year 2017, bringing a net profit in the amount of ROL 5,335.4 million at the end of the year, higher than in the previous year, about 80 percent of credit institutions having positive financial results at the end of 2017. The main profitability indicators of the banking sector, i.e. return on assets (ROA) and return on equity (ROE), increased to 1.3% and 12.5% respectively, from 1.1 percent and 10.4 percent last year respectively.

The solvency level shows an adequate capitalization, in line with the applicable regulatory prudential requirements. The total capital ratio indicated a slight improvement from end-2016, by 0.3 percentage points, from 19.7 percent in 2016 to 20.0 percent in 2017, due to a more rapid increase of own funds than that of risk-weighted assets. In the structure of total capital, Tier 1 capital and Common Equity Tier 1 account for around 90 percent. At the end of 2017, the leverage ratio, determined based on transitional definition of Tier 1 own funds, was 8.9 percent for the credit institutions, Romanian legal persons, roughly at the same level as in December 2016.

The liquidity of the banking sector stands at comfortable levels, posting higher indicator values than the minimum requirements. As of 31 December 2017 the average liquidity coverage ratio (LCR) across the banking system was 239.2 percent, pointing to sufficient high-quality liquid assets in a 30-day stress scenario. For 2017, according to the schedule for the gradual phase-in, the minimum required threshold was 80 percent, all banks reporting levels above this threshold.

In terms of founding structure, Romanian banking system financing relied on funds raised from local market, while the resources attracted from parent banks, continued to decline. If the stock of deposits taken from non-bank clients expanded by 11 percent compared to the previous year (from lei 295,530.5 million to lei 328,280.1 million), funds raised from parent banks dropped by approximately 20 percent versus end-2016 (from lei 34,761.5 million to lei 28,009.1 million).

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE ROMANIAN BANKING SUPERVISORY AUTHORITY

According with Law no.312/2004 on the statute of the National Bank of Romania, the NBR shall have exclusive competence to authorise credit institutions and shall be responsible for the prudential supervision of the credit institutions authorised to operate in Romania according to the provisions of the Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy, as subsequently amended and supplemented (Banking Law). The National Bank of Romania is the competent authority for the regulation, licensing, prudential supervision and resolution of credit institutions, and shall monitor the activities of credit institutions, as well as, where it is the authority responsible for supervision on a consolidated basis, the activities of financial holding companies and mixed financial holding companies, for the provisions applicable to them, so as to assess compliance with the prudential requirements of the Banking Law, of Regulation (EU) no.575/2013 and of the applicable regulations.

Credit institutions are mainly regulated by the Banking Law and by Regulation No. 575 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 and, among others, by the Law No. 85/2014 regarding the procedures for the prevention of insolvency and the insolvency procedures.

Moreover, beginning with the CRD IV/CRR and BRRD implementation, credit institutions are required to observe the EC's implementing regulations laying down technical standards, directly applicable in all Member States, including also those related to the reporting field. In 2017, following the changes in the International Financial Reporting Standards, both the accounting framework and the FINREP individual reporting framework applicable to Romanian credit institutions, as well as the reporting framework applicable to Romanian branches of credit institutions having their head offices in other Member States, were updated accordingly. Thus, starting in 2018, the new standard, IFRS 9 – Financial Instruments, fundamentally changed the way financial instruments are accounted for, introducing the new concept of expected credit losses in the accounting and reporting framework.

From the macro-prudential perspective, as of 28 February 2017, the Parliament adopted Law no. 12/2017 for the macro-prudential supervision of the national financial system. The law establishes the National Committee for Macro-prudential Supervision (NCMS), as an inter-institutional structure of co-operation between the National Bank of Romania, the Financial Supervisory Authority and the Government. The law implements at national level the relevant recommendations of the European Systemic Risk Board by establishing NCMS as a macro-prudential authority, and also entitles the NCMS to issue recommendations addressed to NBR and FSA in order to impose the capital buffers regulated by CRD IV. Finally, the NCMS shall act as the designated authority for the activation of macro-prudential measures which can be taken under CRR.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

Regulatory framework developments led to substantial changes in the supervisory practices. One key objective for 2017 was to continue the harmonization process with the guidelines and standards issued by EBA. The NBR focused on enhancing the quality of supervision throughout the SREP process. The supervisors assess the risk profile of the institutions in order to determine the adequacy of their own funds and of their liquidity resources, the appropriateness of their governance, strategy, etc. The reviews and assessments are updated at least on an annual basis.

On the regulatory side, NBR updated, among others, the regulation in place on the FINREP reporting framework at solo level by including the amendments made by the EBA to the consolidated FINREP reporting framework and incorporating the proposals following the implementation of the FINREP reporting framework. Also, the NBR has actively participated in the negotiation process of the RRM package, in which context it has developed several positions. On 23 November 2016, in the context of risk reduction measures in the banking sector, the European Commission published a package of reforms, including changes to Directive 2013/36/EU (CRD IV), changes of Regulation (EU) No. 575/2013 (CRR) and changes to the BRRD.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2017

Under the 2017 annual examination programme, approved by the NBR’s Supervisory Committee, 29 inspections were conducted, out of which 28 at the head-offices of credit institutions, Romanian legal entities, and one at the branch in Romania of a credit institution having its head office in another Member State.

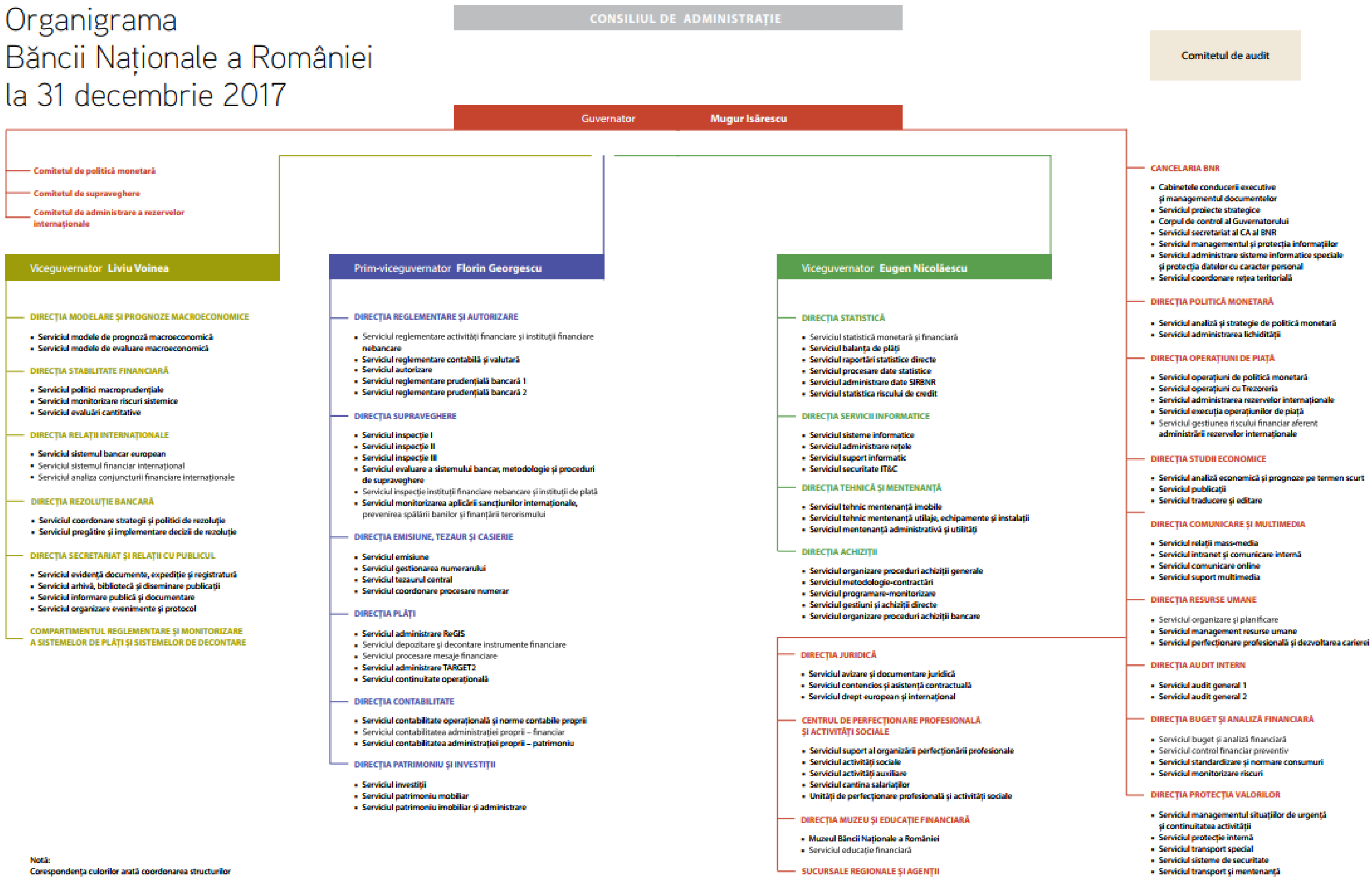
Supervision activities are carried out in accordance with the methodology for supervisory review and evaluation process (SREP), which has been implemented into national supervisory practices since 1 January 2016. The supervisory activities focused on the viability and sustainability of the business model, internal governance and internal control system, assessment of risks to capital and adequacy of capital to cover these risks, assessment of risks to liquidity and adequacy of liquidity resources to cover these risks, verifying the implementation of the measures imposed by the NBR and of the set of measures prepared by the credit institution.

In addition to the scheduled inspections, 10 target inspections were also conducted, with a specific control objective, mainly focused on: total SREP capital requirement and TSCR ratio; reporting of own funds and own funds requirements; assessing additional risks that could result in inadequate risk management systems and in internal governance weaknesses; operational risk, internal governance and internal control system; reporting on employee remuneration; compliance with the regulatory framework on reporting Shareholders' structure.

After conducting the SREP, overall scores of 2, 3 and 4 were assigned to 25 percent, 68 percent and 7 percent respectively of the 28 credit institutions, Romanian legal entities. At system level, average and median of total SREP capital requirements (TSCR) were of about 12 percent.

In 2017, the Supervisory Committee passed decisions in 25 meetings, while 8 meetings were held January through March 2018, the topics focusing mainly on: (i) the notification of the intention to acquire a qualifying holding in the share capital of a credit institution and/or to increase such participations; (ii) applications submitted by credit institutions, Romanian legal entities, pursuant to prudential regulations, referring to changes in their standing as concerns the Board members and/or executives, broadening their scope of activity, the financial auditor, operations on preferential terms set forth in the employee benefits and incentive packages, mergers, etc.; iii) draft pieces of legislation to be issued by the central bank or other authorities concerning the activity of credit institutions and non-bank financial institutions; (iv) implementing EBA Guidelines in the national legal framework and/or in supervisory practices; v) proposals to transpose the EU acquis in the area of payment institutions and electronic money institutions; (vi) proposals for positions in the negotiation process of draft amendments to the EU regulatory framework for credit institutions; (vii) monitoring developments in terms of financial stability, identifying, monitoring and assessing systemic risks and those related to systemically-important credit institutions, specific analyses (monitoring the lending terms and conditions, the periodical stress testing of the solvency and liquidity of the banking sector), proposals for measures on macro-prudential policy, cross-border exchange of information;(viii)analyses on the activity of the Central Credit Register and of the Payment Incidents Register; (ix)other matters related to banking system functioning.

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF NBR

As regards the responsibilities of the National Bank of Romania concerning the alignment to the European regulatory and supervisory framework, the NBR have been pursued the harmonization efforts with regard to the supervision of credit institutions through the participation of Romania in a number of working groups set up at the EBA level. At the same time, the oversight activity continued through JSTs (Joint Supervisory Teams). In the supervision of cross-border banking groups, the NBR has maintained its cooperation with the other supervisory authorities through the Supervisory Colleges, structures that ensure both optimal dissemination of information and joint decisions on capital adequacy and liquidity or recovery plans of supervised credit institutions. In addition, during 2017, the National Bank of Romania participated as an observer at the resolutions of the Resolution Colleges, governed by the Single Resolution Committee, and set up for the adoption of joint decisions on the resolution plans at group level.

Regarding the structures and substructures of the EBA, the NBR participated in the Board of Supervisors; in the Standing Committee on Oversight and Practices, the Standing Committee on Regulation and Policy, the Standing Committee on Accounting, Reporting and Auditing, the Subcommittee on Anti-Money Laundering of the Joint Committee of the European Supervisory Authorities, the Subgroup on Own Funds, the Subgroup on Governance and Remuneration, the Subgroup on Liquidity, the special Working Group on Stress Testing, the special Working Group on Impact Study; and in supervisory colleges.

COOPERATION WITH OTHER SUPERVISORY BODIES IN ROMANIA

National Bank of Romania cooperates with Financial Supervisory Authority (FSA), the authority that has the role to ensure the stability, competitiveness and proper operation of the financial instruments markets and the efficient operation of the private pension system, as well as the promoting of the stability of the insurance activity. Meetings were held between representatives of the National Bank of Romania (NBR), the Financial Supervisory Authority (FSA) and the Government within the National Committee for Macroprudential Oversight (NCMO). This committee was established pursuant to Law No.12/2017 on the macroprudential oversight of the national financial system, as an inter-institutional cooperation structure without legal personality.

Once the NCMO became operational (11 April 2017), the tasks of the National Committee for Financial Stability (NCFS) in the field of financial stability and macroprudential policies, as well as those related to financial crisis management, were taken over by the newly-established entity. Specifically, the tasks concerning the adoption of recommendations and advisory opinions for the implementation of the macroprudential policy were transferred to the NCMO. All recommendations on implementing the macroprudential measures adopted by the NCFS, as an inter-institutional cooperation entity, prior to the NCMO establishment, remain valid if they are not contrary to the recommendations subsequently issued by the NCMO. The fundamental objective of the National

Committee for Macroprudential Oversight (NCMO) is to contribute to safeguarding financial stability, also by strengthening the financial system's resilience and by containing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial system to economic growth.

In 2017, the NCMO recommended the National Bank of Romania, in its capacity as competent authority, to take the following actions in relation to credit institutions:

- to maintain the countercyclical capital buffer at 0 (zero) percent, a level which has been implemented starting with 1 January 2016 and monitor developments in household indebtedness;
- to assess on a regular basis material third countries for the banking sector in Romania in terms of recognising and setting countercyclical buffer rates and to propose the necessary measures should these exposures become material. The exposures to third countries of the banking sector in Romania are further low, and the assessments carried out have not found any material third country in terms of recognising and setting countercyclical buffer rates for the banking sector in Romania;
- to require, starting 1 January 2018, a capital buffer for other systemically important institutions (O-SII buffer), on an individual or consolidated basis, as applicable, equal to 1 percent of the total risk exposure amount for all the credit institutions identified as having a systemic nature in accordance with the methodology of the assessment of O-SIIs, based on the data reported as at 31 March 2017;
- to implement a systemic risk buffer applicable to all exposures, starting 30 June 2018, in the context of the structural vulnerabilities identified, currently noticed or possibly emerging in the future, which may lead to a larger stock of non-performing loans;
- to assess on a regular basis the impact of credit institutions' funding plans on the flow of credit to the real economy, as these data could provide forward-looking information on the developments in lending or the identification of vulnerabilities at an early stage or the build-up of potential risks to financial stability.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	28	28	27
Branches of foreign credit institutions	7	8	7
Cooperative banks	1	1	1
Banking sector, total:	**36**	**37**	**35**

Ownership structure of banks on the basis of assets total (%)
(at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	8.3	8.2	8.7
Other domestic ownership	1.3	0.5	14.3
Domestic ownership total	9.6	8.7	23.0
Foreign ownership	90.4	91.3	77.0
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions
(at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	47.5	66.9	1071
Branches of foreign credit institutions	94.8	98.6	5449
Cooperative banks	-	-	-
Banking sector, total:	**42.2**	**59.4**	**909**

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	11.64	10.18	11.92
Cooperative banks	1.35	0.42	1.24
Banking sector, total:	**11.77**	**10.42**	**12.51**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	88.9	88.8	88.8
Branches of foreign credit institutions	10.8	10.9	11.0
Cooperative banks	0.3	0.3	0.2
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

	2015	2016	2017
Claims from	**100.0**	**100.0**	**100.0**
Financial sector	20.1	20.6	21.7
Nonfinancial sector	54.6	54.4	54.0
Government sector	-	-	-
Other assets	25.3	25.0	24.3
Claims due to	**100.0**	**100.0**	**100.0**
Financial sector	15.2	12.0	9.9
Nonfinancial sector	71.4	74.5	76.1
Government sector	-	-	-
Other liabilities	3.1	3.2	3.5
Capital	10.3	10.3	10.5

Capital adequacy ratio of banks (%)

Type of financial institution	2015***	2016***	2017***
Commercial banks	19.1	19.6	19.9
Cooperative banks	30.0	30.6	30.6
Banking sector, total:	**19.2**	**19.7**	**20.0**

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans - %)

Asset classification	2015	2016	2017
Non financial sector	18.1	12.9	8.7
- households	9.6	7.3	5.8
- corporate	27.1	19.3	12.2

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	80.1	66.5
Households	50.1	35.8
Corporate	30.0	30.7
Government sector	15.0	28.8
Financial sector (excluding banks)	4.9	4.7
Total	**100.0**	**100.0**

P&L account of the banking sector (at year-ends)
(in million RON)

P&L account	2015	2016	2017
Interest income	14,557.2	13,484.3	13,363.1
Interest expenses	3,931.2	2,579.1	2,083.4
Net interest income	10,626.0	10,905.2	11,279.7
Net fee and commission income	3,805.0	3,839.5	3,911.7
Other (not specified above) operating income (net)	3,734.6	4,610.8	4,000.5
Gross income	**18,165.6**	**19,355.5**	**19,191.9**
Administration costs	9,767.7	9,444.6	9,741.7
Depreciation	836.5	819.6	825.6
Provisions	445.2	270.3	301.5
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	3,956.3	4,288.5	1,838.6
Profit (loss) before tax	**4,813.8**	**4,496.2**	**6,472.5**
Net profit (loss)	**4,474.7**	**4,153.2**	**5,335.4**

Total own funds in 2017 (in million EUR)

Type of financial institution	Total own funds***	Core Tier 1***	Tier 1***	Tier 2***	Tier 3***
Commercial banks	8,548.7	7,680.0	7,680.0	868.7	-
Cooperative banks	63.5	62.0	62.0	1.5	-
Banking sector, total:	8,612.2	7,742.0	7,742.0	870.2	-

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE RUSSIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT IN THE COUNTRY

In 2017, Russia's economy continued to recover. GDP grew by 1.5% (in 2016, it declined by 0.2%). The external economic environment was favorable, whereas the oil production cut agreement restrained growth of Russian oil exports. Positive supply movements were largely determined by the internal economic structure and, to a lesser degree, by external factors. The labor market remained stable. Unemployment held low, below its natural level. Domestic consumer demand recovered at a moderate pace without hindering inflation slowdown. Annual inflation declined close to 4% as early as the first half of 2017, and continued to slow in the second half of the year, driven, among other things, by temporary factors associated primarily with certain food markets. In December, annualized inflation stood at 2.5%.

DEVELOPMENT IN THE BANKING SECTOR (INCLUDING THE ASSETS TOTAL / GDP)

As of the end of 2017, the banking sectors' total assets increased from ₽80 trillion to ₽85 trillion thanks to growth in ruble assets from ₽58 trillion to ₽66 trillion, whereas FX assets reduced slightly (from ₽22 trillion to ₽19 trillion). FX assets decreased in ruble terms both because of the nominal shrinkage of FX assets (from $367 billion to $330 billion) and as a result of the ruble's strengthening.

As a result, the banking sector's total assets increased by 9.0%. Nevertheless, outpacing growth of nominal GDP reduced the bank assets to GDP ratio from 92.9% to 92.6%[32].

The ratio of the banking sector's capital to GDP also dropped by 0.7 pp over the year and reached 10.2% as of 1 January 2018. That said, capital increased by 1.3% to ₽9.4 trillion. A considerable impact on capital movements was exerted by a one-off loss provisioning for bad loans of banks undergoing financial resolution under the new mechanism using the resources of the Banking Sector Consolidation Fund.

The value of loans to the economy (non-financial organisations and households) increased overall by 6.2% as of year-end. On the backdrop of economic recovery, the ratio of loans to the economy to GDP shrank from 47.5% to 46.0%.

[32] The banking sector's relative indicators were affected by the ruble exchange rate movements, as well as licence revocations and cancelling of some credit institutions (except for reorganisation-related licence cancelling). Consequently, to enable a more accurate presentation of key banking sector performance indicators, this analytical material reflects the growth rate (adjusted for currency effects) for credit institutions in operation as of 1 January 2018 (including banks reorganised throughout the year).

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN THE COUNTRY

In 2017, Federal Law No. 395-1, dated 2 December 1990, 'On Banks and Banking Activities' was amended to divide banks by equity into banks with a universal licence and banks with a basic licence. The type of the banking licence determines a bank's regulatory burden. Banks with a basic licence enjoy a simplified regulation that provides for a restricted number of required ratios and the specifics of their calculation, as well as non-application of new and technically advanced international regulation standards, including those related to risk assessment for calculating required ratios.

In September 2017, amendments to Federal Law No. 86-FZ, dated 10 July 2002, 'On the Central Bank of the Russian Federation (Bank of Russia)' became effective. They empower the Bank of Russia to cooperate with credit institutions through personal accounts on the Bank of Russia website. The amendments allowed harmonising requirements for the Bank of Russia's cooperation with all participants of information exchange, including banks, through personal accounts.

In order to ensure transparency of operations of credit institutions and banking groups, amendments were introduced in 2017 to Article 57 of Federal Law No. 86-FZ, dated 10 July 2002, 'On the Central Bank of the Russian Federation (Bank of Russia)'. They are aimed at entitling the Bank of Russia to disclose on its website individual reporting forms of credit institutions and banking groups submitted to the Bank of Russia in accordance with Article 43 of the Federal Law On Banks and Banking Activities' and currently subject to voluntary disclosure by credit institutions on the Bank of Russia website, and statements of credit institutions and banking groups for publication purposes.

In 2017, the following federal laws were adopted:

1. Federal Law No. 281-FZ, dated 29 July 2017, 'On Amending Certain Laws of the Russian Federation with Regard to Improvement of Mandatory Requirements for Founders (Participants), Governing Bodies and Officials of Financial Institutions'. The main amendments introduced into this law are as follows:
   - introducing a cross-sectoral approach to the control over business reputation of the management and owners of a number of financial organisations (credit institutions, insurance companies, management companies, non-governmental pension funds and microfinance companies);
   - tightening the criteria for assessment of business reputation of members of governing bodies, managers and owners of financial organisations;
   - expanding the list of financial organisation officials to whom business reputation requirements are applied with an official responsible for the implementation of internal control rules for the purpose of countering the legalisation (laundering) of criminally obtained income and the financing of terrorism (AML/CFT);
   - expanding the list of persons subject to assessment for compliance with requirements for financial standing and (or) business reputation, with a controller of the acquirer (owner) of more than

10% shares (stakes) of a financial organisation, and persons acquiring less than 10% within a group of persons acquiring (holding) more than 10% of shares (stakes) of a financial organisation, their controllers, and sole executive bodies of the said legal entities.

2. Federal Law No. 212-FZ, dated 26 July 2017, 'On Amending Parts One and Two of the Civil Code of the Russian Federation and Certain Laws of the Russian Federation' (hereinafter referred to as Law No. 212-FZ) effective since 1 June 2018:
   - introduces new types of agreements (precious metals account agreement and precious metals deposit agreement);
   - expands the list of bank operations with precious metals;
   - removes the need for credit institutions to undergo Bank of Russia licensing for operations with precious metals other than bank operations; this equals the legal position of credit institutions and other legal entities as regards the procedure for conducting such operations.

In 2017, the Bank of Russia issued an ordinance that provided for a six-month planning horizon for bank inspections; revised the procedure and timeframes for the development, filling and agreeing a Consolidated Plan of Bank (Branch) Inspections, including in cases when they are carried out simultaneously with inspections of other credit institutions, non-bank financial institutions (NCIs) and national payment system agents; and clarified the reasons for mandatory unscheduled inspections of credit institutions.

Also, the Bank of Russia issued an ordinance that provided for a deadline for a comprehensive inspection of credit institutions and targeted inspections of systemically important banks.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

In 2017, supervision prioritised early problem recognition in banks' operations and effective supervisory response to ensure stability of the banking sector and protect creditors' and depositors' interests.

A special attention was paid to credit institutions with high concentration of non-core assets, such as real estate, land plots and collateral, in their balance sheet. Credit institutions usually recorded such property in their balance sheets at an elevated value; this allowed them to replace assets to comply with regulatory requirements and absorb risk undervaluation previously revealed by the supervisor.

One of supervision priorities was the analysis of non-transparent capital sources, including accrued commissions and interest income without their actual payment or payment from the funds with elevated value or provided by the credit institution.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The Bank of Russia continued consolidated supervision over financial groups (including informal ones) which included non-bank financial institutions. Group members were assessed for their mutual influence on their financial standing. Proposals were made to align inspections of related credit institutions and insurance companies.

Also, supervision was focused on credit institutions which aggressively expanded their internal structural divisions to carry out shadow foreign exchange transactions, among other thing. The Bank of Russia revealed individual credit institutions which raised household funds without recording them in accounting books.

In 2017, as part of advisory supervision, the Bank of Russia took further measures aimed at improving the supervisory environment of systemically important credit institutions. In particular, the regulator discussed with senior management and beneficiaries of systemically important credit institutions their risk profiles and operating business model, deficiencies in the operations of their credit institutions and recommendations on their elimination.

In the course of early response procedures, senior management and (or) the board of directors (supervisory board) of 601 credit institutions received written notifications of deficiencies in their operations and recommendations on their elimination.

Supervisory meetings were held with representatives of 443 credit institutions in order to communicate the problems revealed and the need for their independent elimination to the management and owners of the credit institutions.

Where required, the following enforcement measures were imposed on banks:

- fines: 247 credit institutions;
- restrictions on individual transactions: 135 credit institutions;
- bans on individual bank transactions: 28 credit institutions;
- prescriptive orders[33]: 484 credit institutions;
- bans to open branches: on 41 credit institutions;
- appointment of provisional administration to manage a credit institution without licence revocation (including provisional administrations the functions of which are entrusted with the State Corporation Deposit Insurance Agency and LLC Fund of Banking Sector Consolidation Asset Management Company: 12 credit institutions.

In compliance with Article 74 of Federal Law No. 86-FZ, dated 10 July 2002, ‘On the Central Bank of the Russian Federation (Bank of Russia)’ (hereinafter referred to as Federal Law No. 86-FZ) and Article 20 of Federal Law No. 395-1, dated 2 December 1990, ‘On Banks and Banking Activities’ (hereinafter referred to as Federal Law No. 395-1), the Bank of Russia revoked licences from 51 credit institutions in 2017, half the 2015 and 2016 reading.

[33] Orders to comply with Bank of Russia required ratios, orders to replace persons whose positions are indicated in Article 60 of Federal Law No. 86-FZ, dated 10 July 2002, orders to replace persons holding positions indicated in Parts 4, 6 and 10 of Article 111 of Federal Law No. 395-1, dated 2 December 1990, orders to reclassify receivables, orders to build up loan loss provisions.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

In 2017, the Supervisory Authority of the Bank of Russia head office includes Banking Supervision Department, Banking Regulation Department, Department for Market Access and Activity Termination of Financial Institutions, Financial Resolution Department, Systematically Important Banks Supervision Department, Financial Monitoring and Foreign Exchange Control Department, Service for Ongoing Banking Supervision, Risk Analysis Service and Bank of Russia Chief Inspection.

The major tasks of these divisions are to provide methodological and organizational support to the Bank of Russia statutory functions of banking supervision within the framework of the entire supervisory cycle: from the licensing of credit institutions, establishment of regulatory requirements, the exercise of on-going supervision of their activities and the conduct of on-site inspections to financial rehabilitation of credit institutions and implementation of measures, if necessary, to liquidate financially unviable credit institutions.

The supervisory divisions are managed by the Bank of Russia Banking Supervision Committee, which is headed by the Bank of Russia First Deputy Chairman in charge of this area. The Committee is responsible for decision-making on banking supervision policies.

INTERNATIONAL ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The Bank of Russia continued its cooperation with foreign central (national) banks and other agencies responsible for banking supervision.

On 24 September 2017 the Bank of Russia and the National Bank of the Republic of Belarus signed a memorandum of understanding in the field of banking supervision. Compared with the superseded memorandum signed in 2005, this document has expanded the fields of cooperation. In particular, it determined the issues of supervision over banking groups; updated the procedure for inspections of banking group member banks by the supervisory authority of the home country of the parent bank; supplemented the list of information subject to exchange with data constituting bank secrecy; expanded the list of persons the information of non-compliance of which with business reputation requirements and financial standing of legal entities owning cross-border establishments or controlling shareholders (stakeholders) of such institutions is subject to exchange; and introduced a new section 'Cooperation in Financial Resolution of Parent Companies of Organisations and Cross-border Establishments, and the Procedure of Insolvency (Bankruptcy) of Supervised Institutions'.

During the year, the Bank of Russia continued to draft memoranda of understanding (cooperation agreements) with banking supervisory agencies of a number of countries as well as negotiating updates to the effective ones.

Representatives of the National Bank of Kazakhstan paid a visit to the Bank of Russia to share best practices in banking supervision. The Bank of Russia representatives participated in risk assessment of OTP Group (Hungary).

COOPERATION WITH OTHER SUPERVISORY BODIES IN RUSSIA

The Bank of Russia developed cooperation with agencies, regulators and supervisors of financial markets within the framework of inter-agency agreements and arrangements that were reached with the Ministry of Finance, the Federal Anti-Monopoly Service, the Federal Tax Service, the Federal Customs Service, Federal Treasury, Pension Fund of the Russian Federation and other federal agencies.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

Banking sector assets increased by 9.0% to ₽85.2 trillion over the year (in 2016, by 3.4%).

Just like liabilities, assets registered dedollarisation. Credit institutions' FX assets (in US dollar terms) shrank by 9.0% in 2017, and their share in total assets dropped to 22.3% (as of 1 January 2017, 27.8%).

Systemic efforts aimed at banking sector resolution resulted in improvement of qualitative aspects of Russian banks' operations and withdrawal of unscrupulous players from the banking market. The number of operating credit institutions declined by 62 banks to 561 credit institutions in 2017.

In 2017, Russian banks still faced complications in accessing foreign funding sources. This motivated banks to incentivize the use of internal sources. As of 1 January 2018, households' deposits accounted for 30.5% and corporate deposits and accounts (other than credit institutions) - for 29.2% of bank liabilities34 (a year earlier, 30.4% and 30.2% respectively).

Amid the transition to a stable structural liquidity surplus, credit institutions reduced their borrowing from the Bank of Russia considerably (by 25.7%). The share of these funds in banking sector liabilities dropped from 3.4% to 2.4%. At the same time, funds placed by the Federal Treasury on deposits with banks tripled in 2017 with their share in banking sector liabilities increasing from 0.4% to 1.2%.

2017 witnessed tangible positive developments both in retail and corporate lending. The total value of loans to the economy (non-financial organisations and individuals) rose by 6.2% to ₽42.4 trillion in 2017 (in 2016, shrank by 0.8%). At the same time, the share of loans to the economy in banks' assets declined (from 51.1% to 50.8%).

Outstanding loans to individuals increased by 13.2% to ₽12.2 trillion in 2017 (in 2016, by 2.5%); this segment accounted for 14.3% of banking sector assets as of 1 January 2018. As the Bank of Russia took measures to mitigate credit risk in the FX retail lending market, the share of FX loans in the retail loan portfolio declined considerably in the reporting period (from 1.5% to 0.9%).

Non-financial organisations' outstanding loans increase by 3.7% to ₽30.2 trillion in the overall banking sector in 2017 (in 2016, dropped by 0.8%).

In 2017, credit institutions gained profit in the amount of ₽790 billion (in 2016, ₽930 billion). The decline in profits resulted from net creation of additional loss provisions that increased by ₽769 billion or 39% in 2017 compared with 2016. Additional provisioning was largely created by a number of large banks undergoing financial resolution, including that with the Bank of Russia's involvement.

[34] Here «liabilities» stand for «bank funds and profits (capital items in the balance sheet) plus liabilities» or right side of accounting equation (total resources); this value is traditionally used in economic analysis in Russia as well as «pure liabilities».

As of the end of 2017, capital adequacy of the banking sector held at a comfortable level: N1.0 dropped by 1.0 pp from 13.1% to 12.1%. Common equity Tier 1 capital adequacy (N1.1) also decreased by 0.7 pp from 8.9% to 8.2%, while Tier 1 capital adequacy (N1.2) declined by 0.7 pp from 9.2% to 8.5%.

STATISTICAL TABLES

Number of financial institutions
(at year-ends)

Type of financial institution	2015	2016	2017
Banks	681	575	517
Non-bank credit institutions	52	48	44
Banking sector total	733	623	561

Ownership structure of banks on the basis of assets total (%)
(at year-ends)

Type of financial institution	2015	2016	2017
State-controlled banks	58.8	59.2	60.6
Other banks controlled by residents	32.3	33.1	31.4
Banks controlled by residents, total	91.1	92.2	92.0
Foreign-controlled banks (banks with non-resident interest in excess of 50%)	8.9	7.8	8.0
Banking sector (excluding non-bank credit institutions), total	100.0	100.0	100.0

Concentration of asset by the type of financial institutions
(at year-end)

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Banks	49.2	57.8	0.118
Non-bank credit institutions	98.7	99.3	0.858
Banking sector, total	47.4	55.8	0.111

Return on Equity (ROE) by type of financial institutions*

Type of financial institution	2015	2016	2017
Banks	2.2	10.4	8.1
Non-bank credit institutions	44.0	36.8	40.6
Banking sector total	2.3	10.3	8.3

Distribution of market shares in balance sheet total*
(at year-ends, %)

Type of financial institution	2015	2016	2017
Banks	99.7	99.8	96.5
Non-bank credit institutions	0.3	0.2	3.5
Banking sector total	100.0	100.0	100.0

The structure of assets and liabilities of the banking sector (%)
(at year-ends, %)

Assets	2015	2016	2017
Financial sector	17.9	18.9	19.1
Nonfinancial sector	53.0	51.1	49.7
Government sector (including the Bank of Russia)	7.8	9.8	11.7
Other	21.3	20.1	19.4
Liabilities	**2015**	**2016**	**2017**
Financial sector (including credit institutions)	12.4	15.1	15.0
Nonfinancial sector	56.2	55.7	54.9
Government sector (including the Bank of Russia)	7.6	4.4	4.9
Capital (profits, funds)	9.1	10.8	10.5
Other	14.7	14.0	14.6

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Banks	12.7	13.1	12.0
Non-bank credit institutions	29.3	30.8	22.2
Banking sector, total	12.7	13.1	12.7

Asset portfolio quality of the banking sector
(share of non-performing loans, %)

Asset classification	2015	2016	2017
Non financial sector	10.0	11.0	11.4
households	12.9	11.8	9.8
corporate (including individual entrepreneurs)	9.1	10.7	12.0

The structure of deposits and loans of the banking sector in 2017
(at year-end, %)

	Deposits and other funds raised by credit institutions	Loans, deposits and other funds provided by credit institutions
Non financial sector, including:	90.7	90.6
Households	59.2	25.3
Non financial institutions	31.5	65.3
Government financial authorities and off-budget funds	4.9	1.9
Financial sector (excluding banks)	4.4	7.5
Total	100.0	100.0

P&L account of the banking sector (at year-ends)
(in thousands of EUR)

P&L account	2015	2016	2017
Interest income	81 925 814	101 627 505	83 956 791
Interest expenses	55 471 251	60 048 956	46 306 972
Net interest income	26 454 563	41 578 549	37 649 819
Net commission income	9 692 733	14 001 679	13 450 382
Other (not specified above) income (net)	8 095 143	-3 479 679	7 558 903
Gross income	44 242 439	52 100 549	58 659 104
Administration costs	20 287 614	27 126 367	-26 446 533
Depreciation	n/a	n/a	n/a
Loan loss provisions	21 538 435	10 414 205	-20 812 105
Impairement on financial assets not measured at fair value through profit and loss| Provisions on financial assets (loans, …)	n/a	n/a	n/a
Profit (loss) before tax	2 416 390	14 559 977	11 400 466
Profit (loss) after tax	1 437 633	10 856 748	7 767 913

Total Own Funds in 2017 (in thousands of EUR)

Type of financial institution	Total own funds (capital)	Core capital	Additional capital
Banks	135 409 622	95 480 166	39 929 456
Non-bank credit institutions	1 046 632	687 021	359 611
Banking sector, total	136 456 255	96 167 187	40 289 067

2017 DEVELOPMENTS IN THE SERBIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2017 average inflation stood at 3.0% y-o-y and fifth year in a row remained low. After temporary picking up at the beginning of the year, led by energy and food prices growth, inflation stabilized in the following months moving around the midpoint of target tolerance band. Core inflation moved around the lower bound of the target tolerance band, ending the year at 1.3% y-o-y. National Bank of Serbia continued with monetary policy relaxation in 2017 and reduced key policy rate twice by 25 basis points to 3.5%.

After picking up in 2016, growth temporary slowed down in 2017 to 1.9% y-o-y. This slowdown was due to shocks in agriculture, where we experienced severe drought, and shocks in mining and energy sector where in several occasions hydro potential issues occurred. Outside of these shocks, Serbian economy grew at rate of around 3.0%.

There was faster growth in manufacturing, employment, private consumption and private investment, as well as in exports. Private investment grew by over 8.0% y-o-y, as a result of a more vigorous FDI inflow and increased profitability of the Serbian economy.

Positive trends in real economy reflected on labour market as well. Unemployment rate decreased from 15.3% (2016) to 13.5% on average for 2017, while participation rate rose to 66.5% on average. Private sector employment growth was around 4.4% y-o-y (around 60 thousand persons of which 1/3 were recorded in manufacturing, where productivity continued to grow). Average salary increased by 0.8% in real terms led by salary growth in the private sector by 1.4% in real terms, while public sector salary slightly decreased in real terms (-0.6%).

In 2017 CAD amounted 5.7% of GDP and was more than fully covered by FDI (115.6%). The deficit increase in 2017 was, on one side, the consequence of one-off factors – a slowdown in agricultural exports due to adverse weather conditions and the rise in energy imports which was partly related to the economy's increased demand for energy and partly to the rise in oil prices (around 60% is price effect, while 40% goes to quantity). On the other hand, strong investment cycle resulted in imports of equipment and raw materials for industry needs, and higher expenditures on FDIs within primary income. Exports of goods continued to record double digit growth (10.0%) keeping its diversification. Exports were led by manufacturing exports (13.6%) where 22 of 23 branches recorded growth. Negative contribution to exports came from agriculture and electricity exports due to already mentioned shocks. Higher services surplus was recorded as well, since exports of services grew faster than imports. Positive contribution to CAD came from secondary income where remittances inflow increased by 9.9% y-o-y. Net FDI inflow amounted EUR 2.4 bn and was project and geographically diversified.

In 2017 the general government surplus was 1.2% of GDP. Share of revenues in GDP increased by 1.0 pp (7.1% annual growth in RSD nominal terms) as a result of increase in corporate income tax revenue and social security contributions. On the other hand, expenditures share declined by 1.5 pp (1.3% in RSD nominal growth), which was achieved by interest reduction payments and decreased share of pensions, wages and called guaranties. Share of public debt (central government) in GDP continued to decline and at the end-2017 amounted to 61.5% (reduced by 10.4 pp compared to 2016). Compared to the end-2016 debt decreased by EUR 1.6 bn (form EUR 24.8 bn to 23.2 bn) whereas internal debt increased by EUR 148 mln, while external debt decreased by EUR 1.760 mln.

Key Macroeconomic Indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Q1 2018
Real GDP growth (in %)[1]	5,5	4,9	5,9	5,4	-3,1	0,6	1,4	-1,0	2,6	-1,8	0,8	2,8	1,9	4,5
Consumer prices (in %, relative to the same month a year earlier)[2]	17,7	6,6	11,0	8,6	6,6	10,3	7,0	12,2	2,2	1,7	1,5	1,6	3,0	1,4
NBS foreign exchange reserves (in EUR million)	4.922	9.020	9.634	8.162	10.602	10.002	12.058	10.915	11.189	9.907	10.378	10.205	9.962	10.235
Exports (in EUR million)[3]	5.329	6.948	8.110	9.583	8.043	9.515	11.145	11.469	13.937	14.451	15.728	17.385	19.330	4,845[6]
- growth rate in % compared to a year earlier	19,1	30,4	-	18,2	-16,1	18,3	17,1	2,9	21,5	3,7	8,8	10,5	11,2	10.5[6]
Imports (in EUR million)[3]	9.612	11.970	15.468	18.267	13.099	14.244	16.487	16.992	17.782	18.096	18.643	19.597	22.365	5,751[6]
- growth rate in % compared to a year earlier	0,7	24,5	-	18,1	-28,3	8,7	15,7	3,1	4,7	1,8	3,0	5,1	14,1	13.0[6]
Current account balance[3]														
(in EUR million)	-1.778	-2.356	-5.474	-7.125	-2.032	-2.037	-3.656	-3.671	-2.098	-1.985	-1.234	-1.075	-2.090	-650[6]
as % of GDP	-8,4	-9,6	-18,6	-21,2	-6,6	-6,8	-10,9	-11,6	-6,1	-6,0	-3,7	-3,1	-5,7	-7.3[6]
Unemployment according to the Survey (in %)[7]	20,8	20,9	18,1	13,6	16,1	19,2	23,0	23,9	22,1	19.2[7]	17,7	15,3	13,5	
Wages (average for the period, in EUR)[8]	210,4	257,8	347,1	402,0	337,8	331,8	372,5	366,1	388,5	379,8	367,9	374,5	383,9	412,9
RS budget deficit / surplus (in % of GDP)[4]	0,5	-1,7	-1,6	-1,7	-3,2	-3,4	-4,0	-5,9	-5,2	-6,3	-2,8	-0,2	0,8	0,6
Consolidated fiscal result (in % of GDP)[4]	1,2	-1,5	-1,9	-2,6	-4,4	-4,6	-4,8	-6,8	-5,5	-6,6	-3,7	-1,3	1,2	0,4
RS public debt, (central government, in % of GDP)	50,2	35,9	29,9	28,3	32,8	41,8	45,4	56,2	59,6	70,4	74,7	71,9	61,5	59,0
RSD/USD exchange rate (period average)	66,87	67,03	58,39	55,76	67,47	77,91	73,34	88,12	85,17	88,54	108,85	111,29	107,50	96,34
RSD/USD exchange rate (end of period)	72,22	59,98	53,73	62,90	66,73	79,28	80,87	86,18	83,13	99,46	111,25	117,14	99,12	96,08
RSD/EUR exchange rate (period average)	82,99	84,11	79,96	81,44	93,95	103,04	101,95	113,13	113,14	117,31	120,73	123,12	121,34	118,43
RSD/EUR exchange rate (end of period)	85,50	79,00	79,24	88,60	95,89	105,50	104,64	113,72	114,64	120,96	121,63	123,47	118,47	118,39
MEMORANDUM:														
GDP (in EUR million)[5]	21.103	24.435	29.452	33.705	30.655	29.766	33.424	31.683	34.263	33.319	33.491	34.617	36.795	8.883[2]

[1] At constant prices of previous year.

[2] Retail prices until 2006.

3) Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5. Due to the break in the series for 2007, exports and imports growth rates are not shown. As of 1 January 2010, the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. The Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

4) Includes below-the-line items (payment of called guarantees, bank recapitalisations and debt takeover) in line with IMF methodology, as of 2008 on RS budget level and as of 2005 on consolidated level.

[5] According to ESA 2010.

[6] NBS estimate.

[7] New methodology of Labour Force Survey since 2014.

[8] By 2017, wages according to the old methodology. Since 2017, wages are published according to the new methodology and data are based on Tax administration evidence. Wages for the first quarter of 2018 are average of two available months. For conversion of wages from RSD to Euros used exchange rate RSD/EUR average of the period.

Notes:
1. Data are subject to corrections in line with official data sources.
2. Source for the data on unemployment: Labour Force Survey, Statistical Office.
3. Source for public debt: MoF.

DEVELOPMENT IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

Serbian banking sector, with the largest portion in the financial system of Serbia (91%), could be assessed as well capitalized and highly liquid. In the environment of macroeconomic stability and economy expansion, during 2017 the banking sector was attractive for reputable investors, the lending activity was accelerated, and quality of bank's portfolios was significantly improved. Also, banking sector profitability is notably increased in 2017, mostly due to lower impairment losses and one-off transactions derived from banking sector consolidation. Total net pre-tax profit at the end of 2017 amounted to EUR 579.8

million (compared to EUR 172.5 million in 2016), with return on assets (ROA) of 2.08% and return on equity (ROE) of 10.57% (compared to 0.68% and 3.4% in 2016, respectively).

At the end of December 2017, there were 29 banks operating in Serbia (21 in majority foreign ownership, 2 in majority ownership of domestic entities, while 6 banks were in majority ownership of the Republic of Serbia). All banks in Republic of Serbia are operating as independent legal entities, no branching is allowed. Foreign-owned banks are members of banking groups from 13 countries and regarding the total assets the most significant foreign banks are from Italy and Austria (27.5% and 12.7%, respectively), followed by banks from France (11.1%), Greece (6.2%) and other countries (19.4%). In Serbia, overall financial intermediation by banks is still on relatively low level in comparison to more developed markets. The share of banking sector assets to GDP amounted to 75.5% at the end of December 2017.

Total balance sheet assets of the banking sector in Serbia reached EUR 28.4 billion at the end of 2017 which is an increase of 8.3% since the end of 2016.

Taking into account dispersion of the core banking activities (HHIs of assets, lending and deposits are below 1,000), the level of competition in the Serbian banking sector is at a satisfactory level. The market share of the top five banks in Serbia is 54.9% for assets, 53.6% for lending and 55.6% for deposits. In addition, strategic decision of some banking groups to recall their operations from Republic of Serbia, entrance of new investors, as well as mergers and acquisitions, have influenced banking sector structure changes in direction of consolidation. During 2017, two mergers were realized, while another two mergers are expected. Low interconnectedness in the banking system indicates low risk of contagion.

In 2017, lending activity was significantly improved with almost doubled growth rate in comparison to previous year (from 6.9% to 13.7%, excluding the effects of NPLs write-offs and sales and dinar appreciation during 2017). The main drivers for lending activity growth were working capital loans (growth by 18%) in corporate segment, as well as, cash loans (growth by 27%) in retail segments. At the end of December 2017, total gross loan portfolio[35] was at the level of EUR 17.3 billion. Loans to companies (private and public) made 49.7% of total loans with EUR 8.6 billion, while retail loans (including households, entrepreneurs and registered agricultural producers) amounted to EUR 7.6 billion, making 43.8% of total loans at the end of 2017.

As the consequence of NPL Strategy implementation followed by additional measures for NPL resolution, gross NPL ratio has accelerated the downward trend to 9.85% at the end of December 2017 which is 7.2 p.p. lower than in December 2016 and simultaneously the lowest ever recorded level of NPL ratio.

The total stock of gross NPLs at the end of December 2017 amounted EUR 1.7 billion which is a decrease by EUR 1.1 billion on yearly level. Such a decrease in NPLs was primarily the result of direct write-offs and NPLs assignment/sale to other legal entities outside of the banking sector.

The largest reduction of NPLs in absolute terms was recorded in private corporate sector, where NPLs were decreased by EUR 413 million year-on-year. Above mentioned reduction was accompanied by NPL ratio declining which is lower by 6.8 p.p. comparing to previous year (drop from 17.6% to 10.8%).

NPLs of households (citizens, farmers and entrepreneurships) are lower for EUR 230.3 million on yearly level and amounts EUR 447.5 million at the end of

[35] without loans under repo transactions

December 2017. Gross NPL ratio for households also has downward trend – it dropped from 10.0% at the end of 2016 to 5.9% at the end of 2017.

Despite a significant reduction in NPLs, we are emphasizing that NPLs coverage is maintained on relatively high level by both, IFRS provisions (58%) and regulatory reserves (133%). Owing to the high coverage by reserves for estimated losses, the current level of NPLs poses neither threat to banking sector operations nor to overall financial stability.

By observing funding structure, it is based on stability of retail and corporate deposits, which accounted 48% and 25% of total liabilities, respectively at the end of 2017. At the end of December 2017, total banking sector deposits stood at the level of EUR 19.9 billion with an increase of 9.2% in 2017. Household deposits made 51.8% of total deposits with increase of 5.4% in 2017. Savings deposits in foreign currency are the most prominent in both segments (household deposits and total deposits) with EUR 9.4 billion at the end of December 2017 and increase of 4.3% in 2017. Approximately, one fifth of all deposits were related to corporate sector with a EUR 4.7 billion at the end of 2017 which is an increase of 12.1% compared to the end of the previous year. The growth rate of own funding sources was sufficient to maintain the proportion of own funds to total liabilities of 19.8% as of 31 December 2017.

As a result of the prudential measures taken by the National Bank of Serbia in the previous period, banks in Serbia have built significant capital buffers and liquidity reserves, making them capable to cope successfully with the risks inherent in the system and provide stability in case of serious disturbances.

The capital adequacy ratio was 22.6% at the end of December 2017, which is significantly above the regulatory minimum of 8%. In addition to the high capital adequacy ratio, the banking sector of Republic of Serbia is characterized by an optimal capital structure, with CET1 over 95% of total regulatory capital. The high solvency of the banking sector is also indicated by the leverage ratio, introduced in regulatory framework of the Republic of Serbia with Basel III implementation, which amounted 11.1% at the end of 2017.

The average regulatory liquidity ratio for the Serbian banking sector in December 2017 was 2.0, indicating that liquid assets (core and receivables maturing in the next 30 days) were twice as large as liabilities without maturity and liability maturity within 30 days. Liquid assets comprised 36.7% of total assets and 53.1% of total short-term liabilities.

In order to further strengthen the resilience of the banking sector, the liquidity coverage ratio was introduced since June 30, 2017. This indicator is the ratio of the liquidity buffer (made up by high-quality liquid assets) and net outflow of a bank's liquid assets that would occur in the 30 days after the calculation of this ratio in assumed stress conditions. Until 31 December 2017, banks were required to maintain this ratio at a level not lower than 80% while from January 1, 2018 at a level which is not lower than 100% (prescribed floors are the same as in the European Union). At the end of 2017, the liquidity coverage ratio at the level of the banking sector amounted 239.5%. Having in mind that gross lending activity is fully covered with stable domestic deposits (loan to deposit ratio stood at 93.2% at the end of 2017), funding structure of the banking sector of Republic of Serbia is assessed as adequate.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN SERBIA

In June 2017 Executive Board of the National Bank of Serbia adopted ***the Decision Amending the Decision on Consolidated Supervision of a Banking Group*** (RS Official Gazette, No 58/2017) which enabled introduction of Basel III standards on consolidated basis with simultaneous harmonization with Basel III standards implemented on individual level. The minimum prescribed level of capital adequacy ratio of the banking group is reduced from 12% to 8%, which is equal to the requirement for individual banks. Capital requirement for other risks has been introduced (capital requirement for CVA risk and a capital requirement for large exposures for each member of the banking group). Obligations for the ultimate parent company to establish a system for liquidity risk management at the level of the banking group is stipulated, as well as the obligation to calculate the liquidity coverage ratio and accordingly apply the appropriate restrictions relating to a bank's exposure to liquidity risk.

With the aim of further harmonisation with EU legislation, Executive Board of the National Bank of Serbia adopted ***Guidelines for the identification of default*** (RS Official Gazette, No 69/2017) in July 2017. The maturity of the exposures is specified in such a way that, for the purposes of determining that status, the bank considers the exposure to be past due if any amount of the principal amount, interest or fees was not paid at due date, and that the counting of days past due for exposures with changed terms of repayment are based on the changed repayment schedule. Guidelines also prescribe the manner of calculating a materially significant amount, indications of unlikeliness to pay, conditions for return to a non-defaulted status and the new occurrence of default, application of the definition of default, monitoring the fulfilment of conditions for classification into non-defaulted status, the risk management process as well as requirements regarding the principles of management for banks applying the IRB Approach. Those Guidelines are based on Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013 and Draft Regulatory Technical Standards on the materiality threshold for credit obligations past due under Article 178 of Regulation (EU) No 575/2013.

In August 2017 Executive Board of the National Bank of Serbia adopted ***Decision on the accounting write-off of bank balance sheet assets*** (RS Official Gazette, No 77/2017) which applies as of September 30, 2017. In accordance with this decision, banks are obliged on direct write-off of NPLs which are fully impaired if the calculated amount of loan impairment recorded by the bank in favor of allowances equals 100% of its gross book value. The Decision was adopted to encourage banks to continue their efforts on resolving NPLs by introducing mandatory transfer of the worst part of NPLs to off-balance sheet records, additionally cleaning bad assets from banks' balance sheets, freeing up their resources for new lending and further growth in credit and economic activity.

In September 2017 Executive Board of the National Bank of Serbia adopted **Guidelines for Implementation of the Provisions of the Decision on Capital Adequacy of Banks Related to the Capital of the Bank** (RS Official Gazette, No 82/2017). In order to create additional regulatory requirements for increasing the resilience of the banking sector through increasing the quality of regulatory capital of banks. Guidelines introduced more detailed conditions for inclusion of certain items of capital in the calculation and closer regulation of the method of calculating deductibles, including the calculation of certain regulatory adjustments. Those Guidelines are in line with Commission Delegated Regulation (EU) No 241/2014 of 7 January 2014 supplementing Regulation (EU) No 575/2013, Commission Delegated Regulation (EU) No 523/2014 of 12 March 2014 supplementing Regulation (EU) No 575/2013 and Commission Delegated Regulation (EU) 2015/850 of 30 January 2015 amending Delegated Regulation (EU) No 241/2014.

Banks are enabled to apply IFRS 9 in banks from 1st of January 2018. In accordance with domestic regulations, when compiling annual financial statements, a bank shall apply the international financial reporting standards as of the date which the competent authority has designated as the date of the application of these standards. In this respect, in November 2017 the following set of regulation aiming to enable the application of IFRS 9 in banks from 1st of January 2018 is adopted:

- **The Decision Amending the Decision on the Chart of Accounts and Contents of Accounts in the Chart of Accounts for Banks;**
- **New Decision on Forms and Content of Items in Financial Statement Forms to Be Completed by Banks;**
- **New Decision on collection, processing and submission of the data on state and structure of Accounts in Chart of Accounts for Banks;**
- **The Decision Amending the Decision on the Classification of Bank Balance Sheet Assets and Off-balance Sheet Items;**
- **The Decision Amending the Decision on Reporting Requirements for Banks.**

All mentioned by-laws are published in ***RS Official Gazette, No 101/2017*** from 10th November 2017.

The Decision Amending the Decision on the Classification of Bank Balance Sheet Assets and Off-balance Sheet Items (RS Official Gazette, No 114/2017) was adopted in December 2017 with the aim to prevent the risk of "returning" of the non-performing loans (NPLs) which previously came out from the banking sector to the banking sector i.e. to prevent the illusive reduction of NPLs participation in banks' total loans. The aim was achieved by introducing destimulative "sanctions" for cases of financing the purchase of NPLs from the assets of that bank i.e. bank approving loan by which the borrower indirectly or directly settled a part or the entire amount of NPL approved by that same bank. Destimulative "sanctions" mean that the bank has to increase the calculated reduced amount of required reserves for estimated losses (in accordance with the model for reduction of the required reserves), i.e. the classification of all exposures from that borrower in the most unfavorable category of classification. The adoption of this by-law represent the NBS`s approach to reduce NPLs but in a manner which grant safeguarding and strengthening of the banking and financial system.

The Decision Amending the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, 114/2017) was adopted in December 2017 in order to relax the conditions for granting housing loans by relaxation of the LTV ratio from 80% to 90% if the loan is approved as a government-support measure for certain groups of natural persons.

Decision Amending the Decision on Risk Management by Banks (RS Official Gazette, No. 119/2017) adopted by NBS`s Executive board in December 2017 with the aim of improving the process of internal capital adequacy assessment (ICAAP), as well as the supervision of that process. Stress testing is systematically regulated and reverse stress testing is introduced. New regulatory requirements are contributing to additional caution regarding the management of the risks arising from the introduction of new products, as well as on the basis of outsourced activities.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

Implementation of regulation aiming to enable the application of IFRS 9 in banks followed coordination and monitoring banks' preparations to implement the International Accounting Standard 9 – financial instruments. NBS worked intensely in 2017 to identify the necessary amendments to the regulations so as to enable the application of IFRS 9 in banks since the day of the commencement of its application. In addition, bearing in mind the changes in banks' operations and financial reporting due to the beginning of application of the new standard, in 2017 the NBS monitored the process of banks' preparation for the onset of application of IFRS 9, in line with its jurisdiction.

Continuing the process of NPL resolving – Following the Strategy for NPL Resolution that was adopted by the Government of the Republic of Serbia in August 2015 the reduction of the NPL portfolio in the banks has been largely contributed by the National bank of Serbia`s Action Plan for implementation of the NPL Resolution Strategy, which has been fully conducted within the envisaged deadlines. But also during the 2017 year, National bank of Serbia continues to enhance the banks' capacities to resolve NPLs. In this regard, National Bank of Serbia adopted ***the Decision on the accounting write-off of bank balance sheet assets*** which applies as of September 30, 2017***.***

Implementation of the recommendations from the Moneyval Evaluation Report, as well as aligning with **AML/TF regulations**, as well as further strengthening of cooperation with relevant government bodies and supervised obligors in the field of AML/TF.

Further improvement of the legal framework in line with the EU regulations, international standards and best practice in a manner which ensures the preservation and strengthening of the banking and financial systems' stability, and honouring the specific features of the domestic regulations and market.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

AML

The National Bank of Serbia, as supervisory body in the field of Prevention of Money Laundering and Financing of Terrorism (for banks, insurance sector, financial leasing providers, voluntary pension funds, payment institutions and electronic money institutions) has taken part in the improvement of AML / CFT system in the Republic of Serbia. Having in mind that the 5th Round Mutual Evaluation Report of the Serbian AML / CFT system, published by MoneyVal Committee in June 2016, identified deficiencies in the AML / CFT system of the Republic of Serbia, the National Bank of Serbia took a part in the development of an Action plan for the implementation of MoneyVal recommendations. The National Bank of Serbia also cooperates with MoneyVal Committee as well as with International Cooperation Review Group (ICRG) are regularly informed them about improvements in AML/CFT system.

NPL

During Q4 2017, as a part of its continuous efforts aimed at reducing NPL levels, the NBS issued recommendations regarding management of NPLs based on the comprehensive assessments which were done on single-bank level concerning both - risk levels and risk controls as well as horizontal peer and sectorial analyses.

Further steps towards resolving NPL issue in the banking sector of the Republic of Serbia can be observed from the aspect of the competent institutions and from the aspect of the banks. The relevant institutions, in accordance with their competencies, undertake activities planned by the NPL Resolution Strategy whose effects have not yet been fully exhausted, while the banks are directed by the NBS to further resolving of this issue, through instruments and mechanisms for monitoring banks operations.

Measures Against Banks

During 2017, National Bank of Serbia – Administration for Supervision of Financial Institutions took following measures against banks: 13 letters of warning, 6 decisions on orders and measures and 32 decisions on temporary measures. Further, National Bank of Serbia – Administration for Supervision of Financial Institutions filed 8 requests for initiation of the proceeding for misdemeanors and 6 economic offences against banks and responsible persons (17 conclusions on termination of the supervision procedure).

Licensing and Approvals regarding Banks

In 2017, the National Bank of Serbia – Administration for Supervision of Financial Institutions: granted 5 prior consents for acquisition of ownership in banks, approved 35 requests for amendments of banks' founding acts and their articles of association. Also, 93 procedures regarding appointment of managing and executive board members were initiated (91 requests were approved, 1 procedure was terminated and 1 request was rejected).

Also, the National Bank of Serbia – Administration for Supervision of Financial Institutions granted 1consent to change conditions under which the subordinated obligations were created.

Furthermore, 3 requests for prior approval for distributing bank's profit through payment of dividends to its shareholders were submitted (2 request for distributing bank's profit through payment of dividends to its shareholders was approved and 1 request for distributing bank's profit through payment of dividends to its shareholders was denied), 4 requests for granting consent for acquisition of subordinated company in financial sector were approved, 2 banks were permitted not to include a subsidiary in consolidated financial statements.

The National Bank of Serbia – Administration for Supervision of Financial Institutions granted 1 consent for changing the elements that are included in the calculation of the basic share capital and granted 1 consent for bank acquisition of own shares.

Also, the National Bank of Serbia – Administration for Supervision of Financial Institutions granted 3 prior consents for inclusion in the calculation of the basic share capital of the elements of the capital referred to in item 7, paragraph 1, provision under 1) of the Adequate Decision Capital banks by increasing the basic share capital same value reduction instrument additional capital. Furthermore, the National bank of Serbia- Administration for Supervision of Financial Institutions granted 2 consents for the merging by acquisition of the banks and granted 3 prior consents for reducing the value of the elements of the Common Equity Tier 1 from point 8. Decision on adequacy of capital and 1 procedure was terminated.

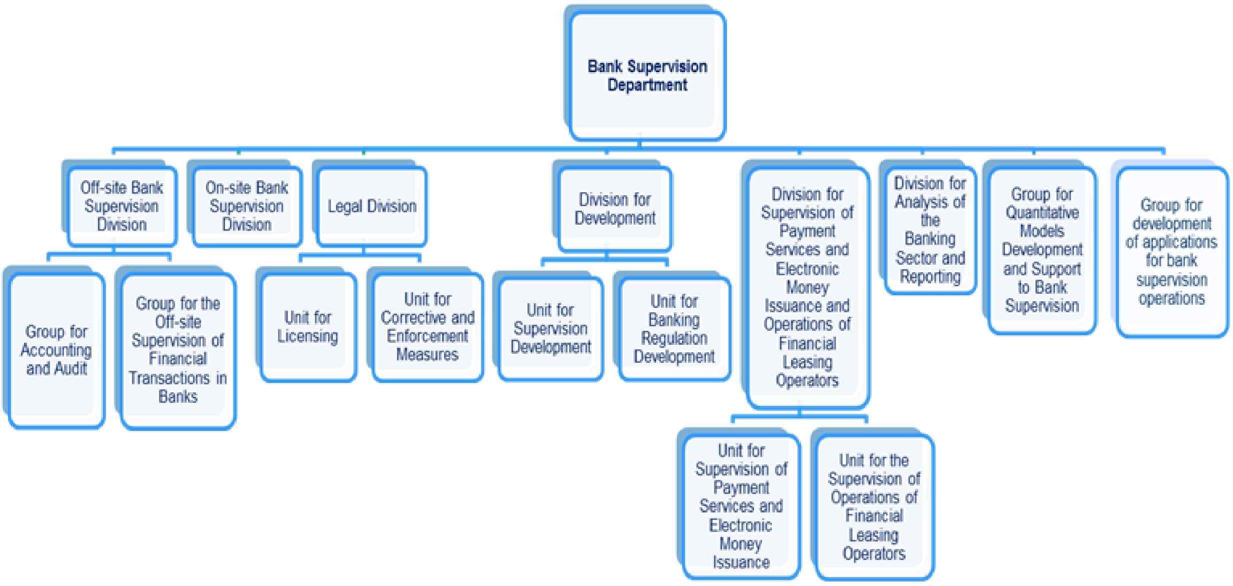
The National Bank of Serbia – Administration for Supervision of Financial Institutions processed 235 notifications from banks regarding outsourcing of their business activities.

Regarding activities of prudential on-site supervision of bank operations in 2017, 21 on-site inspections were conducted with different types of risks within their scope: 8 targeted inspections, 2 diagnostic examinations and 11 follow-up inspections related to corrective measures that have been undertaken. In addition to the mentioned inspections, in 2017 National bank of Serbia has conducted 12 on-site examinations related to the risks of money laundering and financing of terrorism (7 targeted and 5 follow-up inspections), as well as 3 inspections regarding protection of financial service consumers and 8 inspections regarding payment services.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

The Bank Supervision Department is one of the four basic organisational units within the Supervision Administration which consists of lower-level organisational units as shown below:

Organizational chart of the Bank Supervision Department:



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

NBS has signed Memorandums of Understanding (MoU) with banking supervision authorities of following countries: Austria, Belgium, Bosnia and Herzegovina and Republika Srpska, Cyprus, France, Germany, Greece, Hungary, Italy, Macedonia, Montenegro, Russia, Slovenia, Turkey and Memorandum of cooperation between the European Banking Authority (EBA) and the banking supervisory authorities of: Bosnia and Herzegovina, Republic of Srpska, Macedonia, Montenegro and Serbia and Abu Dhabi United Arab Emirates in 2017, as well as several multilateral MoUs related to supervisory colleges of banking groups including implementation of Written coordination and cooperation arrangements (WCCAs) for colleges in accordance with EBA's recommendations. For all the banking groups which are under the supervision of ECB these previously signed MoUs continue to apply until the finalization of the general MoU with the ECB. In addition, update phase of the WCCAs had been finished in 2017, but still they are periodically revised. NBS participates in the supervisory colleges as observer in accordance with WCCA established for banking groups.

Co-operation regarding MOUs includes contact during the authorisation and licensing process of a cross-border establishment, relating to supervision of on-going cross-border activities and handling of problem situations.

The NBS has very successful cooperation with all of the home supervisors of the banks whose subsidiaries are conducting its business in Serbia, through the Supervisory colleges, conference calls, joint on-site review etc

COOPERATION WITH OTHER SUPERVISORY BODIES IN SERBIA

In that respect and regarding its supervisory task NBS has signed Memorandums of Understanding with following domestic bodies and authorities:

- Deposit Insurance Agency,
- Securities Commission,
- Administration for the Prevention of Money Laundering,
- Tax Administration,
- Commission for Protection of Competition,
- Association of Serbian Banks and
- the Belgrade Stock Exchange.

The NBS successfully cooperates with all before mentioned supervisory authorities whenever there is a need for sharing information in accordance with MoUs signed. The cooperation with domestic regulatory authorities has been additionally enhanced by conclusion of the multilateral Agreement on cooperation and data exchange between the NBS, Ministry of Finance, Serbian Business Registers Agency, Central Securities Depository and Clearing House and Securities Commission in 2013.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

During the second part of the year, the NBS took additional regulatory steps aimed at encouraging banks to more efficiently resolve NPL issue and to establish a system that will prevent their accumulation. Additionally, as a part of its continuous efforts aimed at reducing NPL levels, the NBS issued during Q4 2017 recommendations regarding NPLs management based on the comprehensive assessments which were done on single-bank level concerning both - risk levels and risk controls as well as horizontal peer and sectorial analyses. Taking into account the specificity of the domestic market and carefully considering the activities of the European Union in this field, the NBS will continue regulatory efforts aimed at further solving the complex issue of NPLs in the banking sector of Serbia, in accordance with its competencies, with the aim of preserving and strengthening the stability of the financial system.

Regarding the application of IFRS 9 standards, all banks in Serbia have timely completed the implementation process, whereby the activities of monitoring the preparation of banks for the application of IFRS 9 and determining the necessary amendments to regulations were carried out under the established working group, which, in addition to employees of the National Bank of Serbia also had representatives of banks, the Association of Serbian Banks and external auditors. After the public debate, a set of regulations was adopted that allowed the application of IFRS 9 in banks as of January 1, 2018. The activities of the National Bank of Serbia regarding the application of the new standard are continuing after first application and implementation of the new standard. The National Bank of Serbia will closely monitor further improvements of local banks in this field and also activieties of supervisory and regulatory bodies in other countries.

Before implementation of Basel III, NBS did not set additional capital requirement to banks due to the fact that regulatory minimum for capital adequacy ratio was 12% (that was above the additional capital requirements recalculated on 8%) and banks were obliged to maintain additional form of buffer of 2.5% that actually prevented dividend distribution if total capital ratio was under 14.5%, which all together lead to significantly higher capital requirements. Moreover, prudential reserve, as a deduction from own funds additionally increased supervisory requirements. After Basel III was put into force on 30 June 2017 and new capital ratios were introduced, NBS decided to request banks to hold additional capital requirements in excess of the minimum own funds requirement and these quantitative requirements for each bank for 2018 are set as recomendations.

The Law on the Prevention of Money Laundering and Terrorism Financing (RS Official Gazette, No 113/2017 – hereinafter: Law), entered into force as of 25 December 2017, and its application started as of 1st April 2018.

After the Law has entered into force the NBS is empowered with more efficient and more strict sanctioning regime, with powers to impose significantly higher fines than the ones prescribed in the previous Law on Prevention of Money Laundering and the Financing of Terrorism ("RS Official Gazette", Nos 20/2009, 72/2009, 91/2010 and 139/2014) and it can impose those fines directly, without need to charge for the economic offence in the commercial courts. In addition, the new law provides NBS with powers to sanction members of managerial or supervisory boards within the obliged entity and impose higher fines, which is a additionally dissuasive action for breaching the Law, as well as stronger incentive to the top management to fully implement the Law and further improve the system for its implementation.

STATISTICAL TABLES

Number of financial institutions (head offices/branches) (at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	30	31*	29
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**30**	**31***	**29**

* One bank has obtained operating licence by NBS as of 20.12.2016. but data didn't include in this information.

Ownership structure of the financial institutions on the basis of registered capital (%) (at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	18.0	17.3	16.1
Other domestic ownership	5.9	6.0	7.0
Domestic ownership total	23.9	23.3	23.1
Foreign ownership	76.1	76.7	76.9
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions (at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	38.5	54.9	813
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**38.5**	**54.9**	**813**

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	1.6	3.4	10.6
Cooperative banks			
Banking sector, total:	**1.6**	**3.4**	**10.6**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%)
(at year-end)

	2015	2016	2017
Claims from			
Financial sector	15.9	13.8	12.1
Nonfinancial sector	49.2	50.8	54.3
Government sector	24.0	24.0	22.2
Other assets	10.9	11.4	11.4
Claims due to			
Financial sector	9.6	8.2	9.2
Nonfinancial sector	61.7	63.7	63.3
Government sector	7.3	7.5	6.5
Other liabilities	1.1	1.1	1.2
Capital	**20.3**	**19.5**	**19.8**

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks	20.9	21.8	22.6
Cooperative banks			
Banking sector, total:	**20.9**	**21.8**	**22.6**

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Type of financial institution	2015	2016	2017
Non financial sector			
- households	10.87	9.28	5.63
- corporate	23.56	17.58	10.80

The structure of deposits and loans of the banking sector in 2017 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	90.1	93.6
Households	55.3	39.4
Corporate	25.1	45.9
Government sector	7.8	5.5
Financial sector (excluding banks)	2.1	0.9
Total	**100.0**	**100.0**

P&L account of the banking sector (at year-ends)

P&L account	2015	2016	2017
Interest income	1,410,588	1,232,293	1,210,989
Interest expenses	343,505	229,255	190,299
Net interest income	1,067,083	1,003,038	1,020,690
Net fee and commission income	287,144	285,666	317,686
Other (not specified above) operating income (net)	154,476	135,638	263,133
Gross income	1,508,702	1,424,342	1,601,509
Administration costs	876,629	863,977	900,604
Depreciation	62,050	59,039	58,297
Provisions	0	0	0
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	490,092	328,800	62,809
Profit (loss) before tax	79,931	172,526	579,799
Net profit (loss)	61,239	148,629	536,608

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds	Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	4,088,583		3,909,813	178,770	
Cooperative banks					
Banking sector, total:	**4,088,583**		**3,909,813**	**178,770**	

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE SLOVAKIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2017 Slovakia was experiencing an expansionary phase of the financial cycle when Slovak GDP recorded 3.4% annual growth. The GDP growth was driven by domestic demand. Household consumption growth accounted for more than a half of overall GDP growth in 2017. Slovak households were able to increase their demand for goods and services last year owing to the buoyant labour market and rising nominal wages. Another contributor to Slovak GDP growth was investment, particularly as a result of the acceleration of private sector investment in the second half of the year. Net foreign trade had the largest negative impact contribution to economic growth in 2017, with exports increasing more slowly than foreign demand fundamentals would imply. Favorable economic development especially mirrors in positive development at labour market, when registered unemployment rate fell below 6% at the end of 2017 and almost 2.4 million people (historical maximum) had their job. The labour market is beginning to show signs of overheating in the form of skilled labour shortages and acceleration of nominal wages. Corporate sector also recorded a successful year in 2017 with corporate sales rising by more than 6% year on year. Going forward, it is expected that current trends in Slovak economy will continue and that the economy will gradually overheat.

DEVELOPMENT IN THE BANKING SECTOR (INCLUDING THE ASSETS TOTAL / GDP)

The favourable economic situation was reflected also in the financial market that is in the expansionary phase of its cycle. The banking sector's asset growth in 2017 stood at around 6% on year on year basis, approximately double its post-crisis average. The banking sector assets increased to 96.9 % of GDP level. In response to currently compressed interest margins, banks are seeking to increase their lending activity. Since loans make up more than two-thirds of banks' total assets, they had the largest impact on the banking sector's asset growth in 2017. The economic upswing had a positive impact on the banking sector's results in 2017, however the low interest rate environment weighed on its profitability. The aggregate return on equity (ROE) of banking sector fell year on year to 9.2%, but its level net of one-off effects36, remained largely unchanged despite the increase in banks' lending activity. Looking ahead, however, the prolonged compression of interest margins is expected to put increasing pressure on the banking sector's current business model.

[36] One-off income from the sale of holdings in VISA company in 2016.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN SLOVAKIA

The National Bank of Slovakia (NBS) was established as the independent central bank of Slovakia on 1 January 1993, under Act no. 566/1992 Coll. on Národná banka Slovenska.

NBS is a member of the Eurosystem, which comprises the European Central Bank (ECB) and the national central banks (NCBs) of those countries that have adopted the euro. NBS joined the Eurosystem on 1 January 2009, the date on which Slovakia adopted the euro. The NBS Governor is a member of the ECB's Governing Council, the Eurosystem's highest decision-making body. Thus NBS, together with other NCBs and the ECB, contributes to achieving the common goals of the Eurosystem. NBS contributes to the activities of the Eurosystem and the ESCB through its involvement in the Eurosystem/ESCB committee.

As the national supervisory authority in Slovakia, NBS has been part of the EU's Single Supervisory Mechanism (SSM) – a mechanism for exercising supervision over credit institutions in participating EU Member States – since the SSM came into operation on 4 November 2014.

The NBS participates in specific supervisory tasks of the ECB through the direct involvement of staff members of the NBS Financial Market Supervision Unit in Joint Supervisory Teams and through cooperation in the drafting of ECB decisions. As regards the supervision of significant banks, NBS exercised supervision over the banks' activities on a daily basis and continuously monitored quantitative data and oversaw risk management processes.

Slovakia's Resolution Council was established in January 2015 as part of the EU's Single Resolution Mechanism – the second of the Banking Union's three pillars – with NBS assigned the role of providing expertise to the Council and organising its functioning. In 2017, NBS worked in internal resolution teams for all major Slovak banks and contributed to the successful completion of the third version of the crisis resolution plans.

Since 1 January 2015 NBS has been the financial consumer protection authority in Slovakia. As such, the central bank supervises the protection of financial consumers' and other clients' rights in order to support the secure and sound functioning of the financial market.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

Role and objectives of the NBS´s Financial Market Supervision Unit is defined by relevant legal rules. The objective of the integrated financial market supervision is to contribute to the stability of the financial market as a whole, as well as to the secure and sound operation of the financial market in the interest of maintaining credibility of the financial market, protecting clients, and respecting the competition rules.

There were no detailed strategic objectives in a formalised form defined for 2017.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

As at 31 December 2017 there were 12 banks and 14 branches of foreign banks operating in the Slovak banking sector.

Under the Single Supervision Mechanism (SSM), consisting of the ECB and the national competent authorities of participating Member States, all banks and their branches operating in Slovakia are categorised into:

- significant banks – supervised directly by the ECB (Tatra banka, a.s., belonging to the Raiffeisen Bank International A.G.; Všeobecná úverová banka, a.s., belonging to the Intesa Sanpaolo; Slovenská sporiteľňa, a.s., belonging to the Erste Group Bank; Československá obchodná banka, a.s. and ČSOB stavebná sporiteľňa, a.s., both belonging to the KBC Group; UniCredit Bank Czech Republic and Slovakia, a.s., pobočka zahraničnej banky, belonging to the UniCredit Bank banking group); and
- less significant banks (other banks with a registered office in Slovakia) – supervised directly by NBS. Within the scope of the SSM, the ECB has exclusive power to issue or revoke banking authorisations to/from credit institutions, as well as to assess notifications of the acquisition or transfer of qualifying holdings in credit institutions, with the exceptions related to resolution and Article 15 of Regulation (EU) No 1024/2013. Authorisation proceedings relating to credit institutions established in Slovakia are conducted with close cooperation between the ECB and NBS. ECB may also evaluate the suitability of members of the board of directors or supervisory board, but only for significant banks.

All applications for an authorisation to conduct business or for the assessment of qualifying holdings are submitted to NBS. In such cases, NBS assesses the applications according to Slovak law, while the ECB does so according to EU law. In the period under review NBS initiated 54 proceedings falling within the competence of the ECB, which mainly concerned the assessment of suitability of new members of the boards of directors and supervisory boards of significant banks.

Within its area of competence NBS issued a total of 41 decisions relating to authorisation proceedings in the banking sector, mostly concerning the granting of prior approval to appoint members to the boards of directors or supervisory boards of banks, and managerial employees, general proxies, and heads of the internal control and internal audit units of banks.

For the most important decisions issued in 2017 can be mentioned the prior approval of Prima banka Slovensko, a. s. and Sberbank Slovensko, a. s. to the merger of companies with the legal successor Prima banka Slovensko, a.s. with effect from 1 August 2017.

In 2017 a total of nine thematic on-site inspections were conducted in banks and branches of foreign banks. The on-site inspections focused mainly on the effectiveness of banks' risk management systems with particular attention paid to credit risk, market risk and interest rate risk in the banking book, as well as on operational risk management systems, liquidity risk management systems, banks' internal governance and their level of protection against money laundering and terrorist financing.

As the national supervisory authority NBS participated in the conduct of the ECB's supervisory tasks through its employees' direct participation in the work of Joint Supervisory Teams (JSTs) and by drafting decisions within the ECB's decision-making processes. All on-site inspections at significant banks under the ECB's direct supervision were conducted by NBS staff acting under ECB authorisation.

In addition to the regular examination of statements and reports, monitoring of prudential business indicators, analytical activities, communication with the supervised entities and their domestic supervision, the conduct of off-site supervision of banks and branches of foreign banks also includes joint activities under the ECB's direct and indirect supervision and work in supervisory colleges for individual banks.

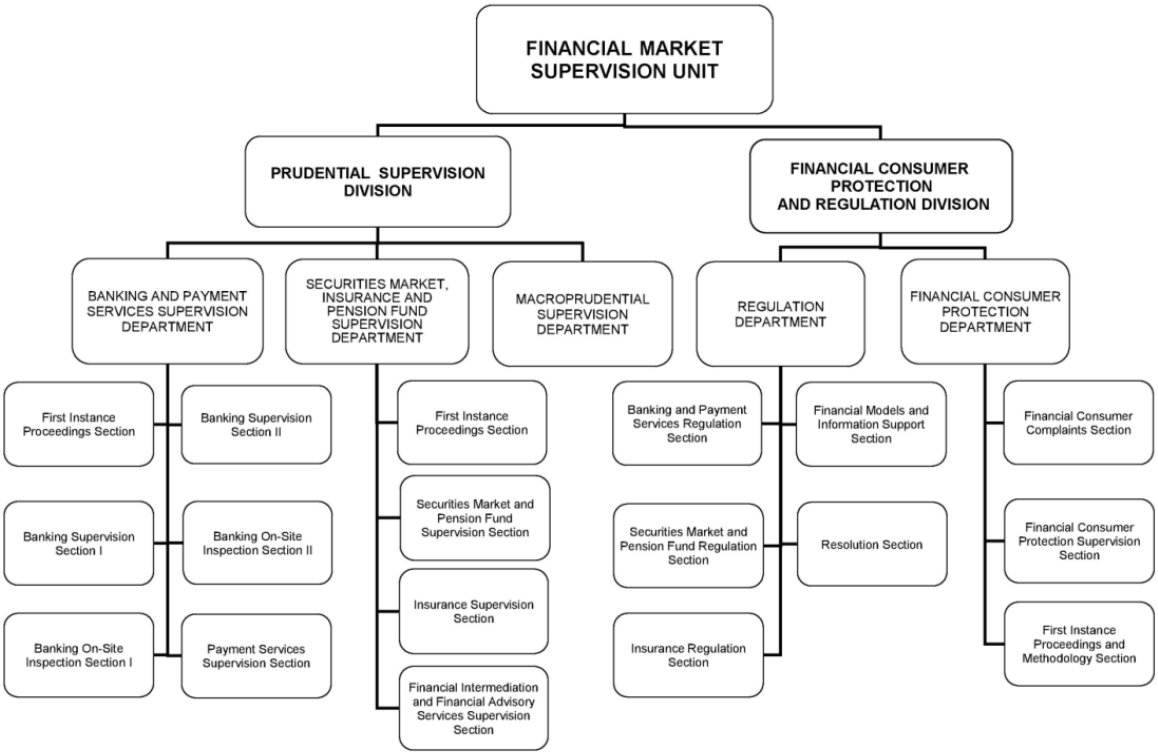
In regard to the banks under the ECB's direct supervision, the annual assessment of banks was conducted in accordance with the SSM processes thanks to the continuing cooperation in JSTs, whose members included employees of NBS. Off-site supervision was used to review the assessment of ex ante and ex post notifications in accordance with Commission Delegated Regulation (EU) No 529/2014. Next, the validation reports on banks' internal models and internal audits were reviewed and compliance with requirements and recommendations stemming from decisions on the use of internal models was evaluated.

Banking regulation

In 2017, NBS continued in the implementation of legislative and approximation competences which are arising from the Act NR SR no. 566/1992 Coll. on Národná banka Slovenska. NBS in the cooperation with the Ministries of the Slovak Republic prepared some of draft laws and other generally binding financial market legislation, issued generally binding regulations for the implementation of financial market laws, elaborated and published methodological guidelines, recommendations explaining the application of laws and other generally binding legislation relating to supervised entities.

In co-operation with the Ministry of Finance of the Slovak Republic, NBS prepared an amendment to the Act on Banks with a view to creating a new regulatory framework regulating the area of mortgage banking and cover bonds; other relevant activities concerned topics of consumer credits, housing loans, national elections under CRR as well as reporting due to implementation of IFRS 9 and changes in FINREP/COREP.

ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



The organizational chart of the National Bank of Slovakia valid until 31 December 2017.

INTERNATIONAL ACTIVITIES OF THE AUTHORITY

At the international level, NBS focuses on integration and cooperation within European structures. Increasing international cooperation in financial markets requires the respective supervisory authorities to work more closely together. Thus through the European System of Financial Supervision (ESFS), the activities of NBS as supervisor of the domestic financial market are closely coordinated with those of other supervisory authorities in the EU.

The single supervisory regime works on the basis of continual cooperation between the ECB and the national supervisory authorities. NBS participated in particular supervisory tasks of the ECB through its involvement of NBS staff in Joint Supervisory Teams and in the drafting of ECB decisions during 2017.

For supervision at the level of the European financial system, NBS continued in co-operation with the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

During 2017, four meetings of the General Council of the ESRB were held. In addition to regular discussions on the development of factors and the intensity of systemic risks, the negotiations focused on various areas, such as stress testing conducted by EIOPA and EBA, providing both institutions with an unfavorable scenario for stress testing. Other areas included the impact assessment of IFRS 9 on financial stability and pro-cyclicality, the assessment of trends and risks arising from the commercial real estate market. Part of the discussion was about the structural macroprudential pillow.

In 2017, NBS continued to be involved in the work of the EBA committees and working groups and submitted comments on the documents prepared by the EBA on the regulation and functioning of the financial market for banking, consumer protection and AML. Also in 2017, NBS cooperated with EBA in the development of ITS and RTS resulting from the CRR and the CRD IV.

COOPERATION WITH OTHER SUPERVISORY BODIES IN SLOVAKIA

NBS is the only national supervisory body supervising regulated entities of the Slovak financial market. Slovak Ministry of Finance has only certain minor supervisory tasks in this area, such as oversight over state subsidies for mortgage banks.

Nevertheless, the Banking and Payment Services Supervision Department communicates with all relevant sector associations, especially within the processes of preparation of regulation, recommendations and guidelines. In addition to that, there is a close cooperation among the NBS, the Ministry of Interior and the Police Headquarters.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

As regards the area of bank recovery and resolution, the Resolution Council held its sixth meeting in April 2016 to discuss the 2017 contributions to the Single Resolution Fund, changes to its Statutes and Rules of Procedure and the proposals for simplified crisis management plans and criteria for the application of simplified obligations in the elaboration of resolution plans. In November 2017, at its seventh meeting, the Resolution Council discussed the development of resolutions plans and related methodologies in 2017 and familiarized with the development of an resolution international insurance framework.

In the summer of 2017, EIOPA and the ESRB independently published documents in which they publicly express their views on the possible benefits and form of a harmonized framework for the recovery and resolution of insurance crisis situations in the EU. These are the first steps towards creating a European legal framework that should direct impact also on insurance companies in Slovakia. The objective of the framework should be to protect insurance undertakings and to ensure financial stability, while the framework should apply to all insurance and reinsurance undertakings covered by the Solvency II regime.

As regards the area of financial consumer protection, NBS addressed several important topics. Regards to the judgement of Court of Justice of the European Union in the case of Home Credit Slovakia, a.s. v Klára Bíróová, NBS issued an opinion on the effects of this judgment on the area of consumer loan, particularly the mandatory acts of the consumer loan agreement. On the basis of the results of ad campaign tracking and promotional activities, an opinion was issued on some issues of promotion the price of loan products. The opinion has the preventive objective of raising awareness of the obligations of supervised entities and the practices that NBS considered as examples of good and bad practice.

The supervisory findings for 2016 and 2017 lead to the initiation of 44 procedures for imposing sanctions to remedy the services provided by supervised entities to financial consumers. NBS does not only use the option of imposing financial penalties, but also other powers serving to protect financial consumers effectively - prohibiting unfair commercial practices or using an unacceptable contractual conditions and measures to eliminate and remedy any identified deficiencies.

In 2017, 5 decisions imposing a sanction became valid and in 39 cases a sanction order was issued. Consumer protection supervision in 2017 focused on the provision of consumer loan in the banking and non-banking sectors and on the sale of long-term investment products, including investment life insurance, mainly through independent financial agents.

An important priority of supervision was to monitor the advertising of financial services in traditional media, on the internet and through social media. In the framework of consumer protection supervision, the continuous control of financial service providers without authorization is also carried out. In 2017, 2 field surveys, 21 investigations of unauthorized businesses, 50 off-site inspections from field surveys and analysis of the Section of supervision on financial consumer protection were carried out. Also 6 new on-site inspections were launched, focusing on the provision of consumer loans, as well as housing loans by banks and the provision of consumer loans, other loans and loans by non-bank creditors.

In 2017 NBS received 2,364 complaints against supervised entities from financial consumers and other customers, which was almost the same as in 2016. Of those complaints that were justified, 60% were resolved by the entity voluntarily addressing the deficiencies identified, without NBS having to compel them to do so through the issuance of a decision and initiation of proceedings. The complaints received about banks concerned mostly consumer loans provided by non-bank creditors (353 submissions, 15% of total submissions).

In these submissions, consumers complained of shortcomings in the consumer loan agreement, which could result in the free of charge and payment of consumer loans. The high number of submissions concerned the non-payment of the insurance benefit from damage to the windscreen on the motor vehicle (260 submissions, 11% of the total number of submissions). In 2017 was also a high number of submissions against compulsory contractual insurance (237 submissions, 10% of the total).

6% of all submissions related to life insurance products, which have confirmed that financial consumers are still confused about investment life insurance with savings and don´t recognize this product as long-term. The number of submissions on financial intermediation has not changed significantly, while the scope and quality of information provided to consumers by intermediaries is long term subject of consumer dissatisfaction.

Submissions of supervised entities' clients were also a source of information in 2017, which was used by the NBS to perform on-site inspections, off-site inspections and conducting proceedings against supervised entities.

In 2017 NBS continued of increasing the financial literacy of consumers and held 44 training sessions - modules for primary and secondary school students and seniors. Training took place at the NBS and under the European Money Week project, also at schools in different regions of Slovakia. A total of 1,500 participants participated in the training events. In cooperation with Junior Achievement

Slovensko, n. o., NBS issued two further workbooks on financial literacy topics for secondary school students. Several lectures and workshops on the provision and promotion of credit and insurance products in connection with breaches of obligations in the area of financial consumer protection were held within the framework of the training of the professional public.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	13	13	12
Branches of foreign credit institutions	14	15	14
Cooperative banks	0	0	0
Banking sector, total:	**27**	**28**	**26**

Ownership structure of banks on the basis of assets total

Type of financial institution	2015	2016	2017
Public sector ownership	0,8	0,8	0,7
Other domestic ownership	0,4	0,3	0,3
Domestic ownership total	1,2	1,1	1,0
Foreign ownership	98,8	98,8	98,9
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	66.0	84.8	1723
Branches of foreign credit institutions	70.7	82.9	2994
Cooperative banks	-	-	-
Banking sector, total:	**56.8**	**74.6**	**1333**

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	10.9	13.22	9.16
Cooperative banks	-	-	-
Banking sector, total:	**10.9**	**13.22**	**9.16**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	85.4	85.4	86.0
Branches of foreign credit institutions	14.6	14.6	14.0
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking sector (%)
(at year-end)

	2015	2016	2017
Claims from			
Financial sector	12.1	12.4	13.6
Nonfinancial sector	64.2	66.6	68.9
Government sector	18.7	16.3	12.8
Other assets	5.0	4.7	4.8
Claims due to			
Financial sector	10.4	10.9	11.2
Nonfinancial sector	64.9	64.9	64.0
Government sector	2.8	2.4	2.5
Other liabilities	8.6	8.7	9.4
Capital	**13.4**	**13.2**	**12.9**

Capital adequacy ratio of banks (%)

Type of financial institution	2015	2016	2017
Commercial banks	17.75***	18.15***	18.81***
Cooperative banks	-	-	-
Banking sector, total:	**17.75*** **	**18.15*** **	**18.81*** **

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans) (%)

Asset Classification	2015	2016	2017
Non financial sector	4.97	4.52	3.75
- households	**3.89**	**3.69**	**3.18**
- corporate	**7.30**	**6.52**	**5.20**

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	88.9	95.9
Households	**62.2**	**59.4**
Corporate	**26.7**	**36.4**
Government sector	3.4	1.5
Financial sector (excluding banks)	7.7	2.6
Total	**100.0**	**100.0**

P&L account of the banking sector (at year-ends in EUR thousands)

P&L account	2015	2016	2017
Interest income	2 275 894	2 137 186	1 984 185
Interest expenses	417 293	358 560	273 240
Net interest income	1 858 601	1 778 626	1 710 945
Net fee and commission income	521 453	519 029	528 748
Other (not specified above) operating income (net)	-159 412	187 517	-94 353
Gross income	2 229 049	2 493 096	2 150 076
Administration costs	1 082 506	1 135 189	1 114 160
Depreciation	134 193	142 601	127 199
Provisions	170 303	239 392	109 465
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	1 478 411	1 664 977	1 685 890
Profit (loss) before tax	833 640	967 990	794 516
Net profit (loss)	626 032	742 259	611 781

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds	Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	6 343 207 600***	5 527 178 146***	5 677 178 146***	666 029 454***	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**6 343 207 600*** **	**5 527 178 146*** **	**5 677 178 146*** **	**666 029 454*** **	**-**

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE SLOVENIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

The Slovenian economy moved from the recovery phase to the rapid expansion phase last year. GDP growth recorded one of the highest rates in the euro area, reaching 5.0%, up 1.9 percentage points on 2016. At the end of the year real GDP was nevertheless up only 4.5% on its pre-crisis peak. The structure of growth last year differed from the period of strongest overheating in 2007: the contribution to growth made by net trade was strongly positive, while the sharp growth in private-sector investment was mostly financed by retained earnings in the corporate sector, and not via borrowing. Private consumption also strengthened, in line with the rapid growth in employment. It also began to be supported in the second half of the year by higher wage growth, which remained at levels that did not endanger external competitiveness, as growth in unit labour costs remained lower than the euro area average. Economic growth was also promoted by the government sector via increased expenditure, although within boundaries that allowed for a significant improvement in the fiscal position.

Imbalances on the labour market increased in 2017 in the wake of high growth in employment. The workforce in employment increased by 3.5% last year, the highest rise since 2007. It was largely attributable to manufacturing and to administrative and support service activities, which includes staffing agency work. The employment growth was based on a rapid fall in unemployment, a rise in the labour force participation rate and increased hiring of foreign workers. The harmonised unemployment rate stood at 6.8%, 2.3 percentage points less than the average unemployment rate across the euro area. The increased employment growth nevertheless did not meet the demand for labour in the economy, as the proportion of firms facing a shortage of workers increased. Despite faster hiring in sectors with below-average pay, the shortage of workers has already begun to be reflected in moderate upward pressure on wages, although growth remains low compared with the pre-crisis period, at 2.7%.

The structure of economic growth and the reduced burden of interest payments on the public debt were reflected last year in an increase in the current account surplus. It reached EUR 2.8 billion, or 6.4% of GDP.

The general government position was balanced in 2017, a significant improvement on the government forecasts, which were predicting a deficit in the amount of 0.8% of GDP. The improvement in the position was attributable to the favourable economic situation, as there was a significant decline in the interest burden, while the government also retained certain austerity measures.

Price developments underwent a reversal in 2017. Headline inflation in Slovenia as measured by the HICP averaged 1.6% last year, comparable to the average across the euro area, and 1.8 percentage points more than in the previous year.

DEVELOPMENTS IN THE BANKING SYSTEM (INCLUDING THE ASSETS TOTAL / GDP)

At the end of 2017 there were 12 banks, three savings banks and three branches of foreign banks operating in Slovenia. There was one fewer bank compared with the previous year, the trend of a fall in the number of banking institutions in Slovenia seen over several years thereby continuing.

The banking system's total assets amounted to EUR 37.9 billion at the end of 2017, up 2.4% or EUR 897 million on the end of 2016, the year-onyear rate of growth having turned positive late in the first quarter of 2017. On the funding side the increase in the balance sheet total was largely attributable to deposits by the non-banking sector, household deposits in particular, while the banks continued to pay down their liabilities on wholesale markets. On the investment side the increase was primarily attributable to

loans to the non-banking sector, while the banks and savings banks maintained a large proportion of the most liquid assets and safe assets. The faster growth in GDP meant that the ratio of the banking system's total assets to GDP declined in 2017, to below 87%.

The Slovenian banking system was well-capitalised in 2017, although there remained significant variation from institution to institution. The quality of the capital structure remained high. The small domestic banks and savings banks remained the weakest in capital terms in 2017.

The banking system recorded solid lending growth in 2017. Growth in loans to the non-banking sector turned positive in December 2016. The increase in lending activity was mainly attributable to faster growth in lending to households and corporates. SMEs were primarily responsible for the growth in corporate loans. The increased growth in lending was primarily seen in consumer loans, as a result of increased demand from households on account of favourable lending terms and the good economic situation, the improvement in the situation on the labour market, and increased consumer confidence. The solid growth in housing loans was the result of certain favourable factors, such as low interest rates, low household indebtedness and the revival of the real estate market.

The quality of the banks' credit portfolio further improved in 2017. The banking system's liquidity position remained favourable: the stock of secondary market liquidity increased, the first-bucket liquidity ratio remained high, and the proportion of the pool of eligible collateral that is free also remained sufficient, which allows banks to access additional funding at the Eurosystem in the event of increased liquidity needs.

Deposits by the non-banking sector became the most important source of funding for Slovenian banks in 2017, although the increase in sight deposits saw average maturity continue to shorten. The lengthening maturities of loans and the simultaneous growth in sight deposits by the non-banking sector increased the maturity mismatch between investments and funding.

The banking system on solo level generated a pre-tax profit of EUR 424 million in 2017. The decline in net interest income continued. There was a decline in both interest income and interest expenses, the year-on-year contraction in both slowing during the year. Net non-interest income declined last year, as certain beneficial one-off factors that were seen in the previous year were not present. Net fees and commission, which accounts for the largest proportion of non-interest income, increased last year. The improvement in the quality of the credit portfolio, which is most often the result of economic growth and the resolution of non-performing loans, had a favourable impact on impairments and provisioning, which recorded a net release overall in the banking system. After several years of decline, operating costs increased minimally in 2017.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS. LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN SLOVENIA

The Single Supervisory Mechanism (SSM) is one of the three pillars of the EU banking union, created in response to the financial crisis with the aim of restoring and maintaining confidence in the European banking system. The banking union complements the economic and monetary union (EMU) and the single market by coordinating the responsibility for bank supervision, resolution and funding at the EU level, and ensuring a level playing field for banks across the euro area. Alongside the SSM, which has been in operation since 4 November 2014, the other two pillars of the banking union consists of the Single Resolution Mechanism (SRM), which has been in operation since 1 January 2015, and the European Deposit Insurance Scheme (EDIS), which is still being established.

The establishment of the SSM saw supervision of significant institutions (SIs) in the EU transferred to the ECB in 2014, although this supervision is conducted in operational terms via joint supervisory teams (JSTs). The JST for each bank consists of a coordinator from the ECB, and members from the national supervisory authority and the ECB. The national supervisory authorities (the Bank of Slovenia in Slovenia’s case) participate in all the supervisory activities, while the supervisory decisions with regard to these banks are made by the ECB.

The supervision of banks and savings banks that do not meet the criteria for being classed as significant institutions, i.e. less significant institutions (LSIs), is conducted by national supervisors, i.e. the Bank of Slovenia in Slovenia’s case, in accordance with the rules and methodology of the ECB and the SSM. National supervisors regularly submit supervisory data for less significant institutions to the ECB, and inform it of the material findings of their supervision. The national supervisory authorities may consult the ECB on the imposition of measures, but the final decision is their responsibility, other than in exceptional cases. The new arrangements allow the ECB to directly take over the supervision of less significant institutions at the proposal of the national supervisor, at its own initiative in the event of the potential occurrence of a systemic crisis, or if the national supervisor is failing to conduct adequate supervision.

According to the Bank of Slovenia Act (ZBan-2) the central bank carries out supervision of credit institutions in order to maintain the stability and security of their operations and for the creation of confidence in the banking system, particularly among savers and depositors. In accordance with the statutory mandate the tasks of the Banking Supervision Department of the Bank of Slovenia include in particular the performance of licensing, authorisation and notification procedures for the work of these institutions, giving consent for members of boards of management to hold their offices in banks, and other authorisations and consents prescribed by The Banking Act, the performance of on-site inspection in banks, collecting and analysing quantitative and qualitative information from supervised entities and other sources, cooperate with other supervisors in the country and outside, participate actively at international supervisory forums, working groups and colleges.

The main developments in banking regulations in 2017 were the changes in regulations brought by the implementation of the new IFRS 9, an overhaul of regulations in the area of credit risk, and the adoption of a package of secondary legislation on the basis of the new Consumer Credit Act (the ZPotK-2).

In the overhaul of regulations in the area of credit risk, the starting point was the applicable regulatory framework (Bank of Slovenia, EU, EBA and ECB documents) and the Basel standards for credit risk management, whereby account was taken of the changes envisaged in the area of the assessment of credit risk losses as a result of the changeover to IFRS 9 and the desire to optimise and streamline regulations.

The Bank of Slovenia also participates in the activities of the EBA within the scope of its competences. With the aim of putting in place consistent, effective and efficient supervisory practices and ensuring the harmonised application of European legislation in all EU Member States, the EBA issues guidelines and recommendations addressed to competent supervisory authorities and banks. It is the duty of supervisory authorities and banks to endeavour to uphold these guidelines and recommendations to the greatest possible extent. The guidelines and recommendations relate to the areas of banking supervision, bank recovery and early intervention, AML/CFT, payment services and systems, consumer protection and financial innovations. Pursuant to the ZBan-2 the Bank of Slovenia also decides on the application of individual guidelines or recommendations issued by other European supervisory authorities (ESMA, EIOPA) in the form of regulations on the application of guidelines or recommendations.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

The objective of the Bank of Slovenia's supervisory activities is identifying risks in all areas of the operations of banks and savings banks (credit risk, liquidity risk, operational risk, capital risk, interest rate risk, profitability risk, internal controls, corporate governance, reputation, anti money laundering, etc.) in timely fashion, and ensuring the stability of the banking system and the financial system through effective action.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The ECB defined preparations for the introduction of IFRS 9, the new accounting standard effective as of 1 January 2018, as one of its priority tasks of supervision in 2017. To this end a thematic review of banks' readiness for the introduction of IFRS 9 was conducted within the framework of the SSM. Three of Slovenia's significant banks participated in the review.

A thematic review of profitability drivers was conducted within the framework of the SSM in 2017 with the aim of assessing the sustainability of banks' business models and profitability. The JSTs conduced in-depth analysis and review of individual elements of profitability drivers, such as the bank's strategy, the sustainability of interest income and non-interest income, the evolution of operating costs and the model for setting the price of credit.

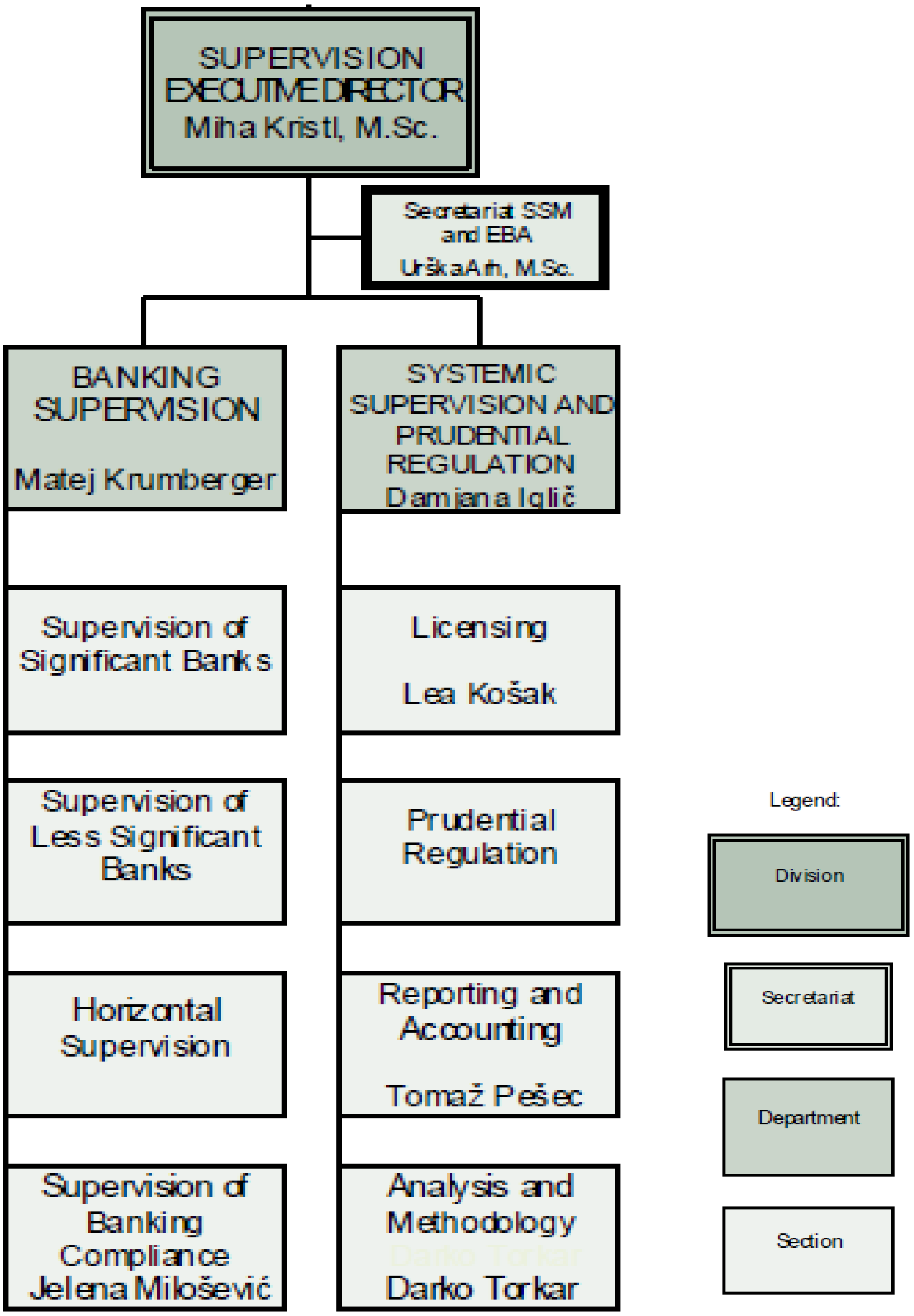
Activities in connection with the thematic review on risk governance and appetite, which the ECB conducted at all significant institutions in 2015, continued in 2017. The purpose of the review was to obtain a horizontal overview of various internal governance practices, and of risk governance and appetite, and to identify deficiencies and bring them to the attention of the banks.

Within the framework of the SREP, in 2017 the Bank of Slovenia assessed individual risks and the adequacy of the control environment for managing the individual risks, and set out individual requirements for the maintenance of capital adequacy.

The EBA did not conduct EU-wide stress tests in 2017, in line with its approach and timetable. The SSM therefore decided to focus on interest rate risk in the banking book (IRRBB) in 2017 for the purposes of SREP stress tests. The Bank of Slovenia also modelled its approach to stress tests on the ECB, and included less significant banks (LSIs) and subsidiary banks under majority foreign ownership in the stress tests.

Within the framework of the IFRS 9 project, in 2017 all of the relevant secondary legislation and guidelines in the areas of books of account, annual reports, credit risk management and reporting were overhauled.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

European Union;

Representatives of the Bank of Slovenia participated in informal meetings of the ECOFIN (the EU's council of economics and finance ministers and central bank governors) in 2017. The first meeting in 2017 was held in April in Malta, where discussions included the future of the economic and monetary union, the issue of non-performing loans, the promotion of private-sector investment in north Africa and elsewhere, and international taxation issues. The second meeting was held in September in Tallinn, and discussed the deepening of the economic and monetary union, the capital markets union from the perspective of technological innovations, and financial regulations.

In 2017 Bank of Slovenia representatives again attended sessions of committees, working groups and other bodies that are active within the institutions of the EU with a focus on financial and monetary matters.

In November 2017 representatives of the European Commission and the ECB met with representatives of the Bank of Slovenia within the framework of the European Semester (the annual cycle of economic policy coordination). The agenda included an in-depth review of the economic situation in Slovenia and the fulfilment of specific recommendations in accordance with the procedure for preventing and eliminating macroeconomic imbalances.

International Monetary Fund;

The Bank of Slovenia is responsible for Slovenia's cooperation within the IMF, and the Governor of the Bank of Slovenia is a member of the IMF Board of Governors.

An Article IV mission took place in Slovenia in March 2017, and IMF representatives conducted a brief visit to Slovenia in late November and early December. During the March mission IMF representatives were briefed on the macroeconomic situation and conditions in the financial sector, issues in the management of public finances, and the institutional and legal framework for administering economic policy.

Bank for International Settlements;

The Governor of the Bank of Slovenia attends meetings of central bank governors of BIS members, which are held every two months. The meetings discuss developments in the global economy and on the financial markets. The governors' meetings are also an opportunity to exchange views on various central banking issues, in 2017 most notably global value chains, central bank profitability, the role of the US dollar in the global financial system, the responsibilities of central banks, central bank reporting to parliament, the central banking challenges presented by big data, and key areas of research for the BIS and central banks.

Bank of Slovenia representatives attended sessions of committees and working groups of the OECD. The Bank of Slovenia maintained regular contacts with multilateral and private international financial institutions and with rating agencies.

COOPERATION WITH OTHER SUPERVISORY AUTHORITIES IN SLOVENIA

The Bank of Slovenia works with a range of institutions in Slovenia. Its cooperation with the Bank Association of Slovenia (BAS), the Securities Market Agency (SMA), the Insurance Supervision Agency (ISA), National Payments Council and the Office for Money Laundering Prevention is examined in detail below.

Financial Stability board:

The Financial Stability Board (FSB) is a national macroprudential authority that formulates macroprudential policy and implements it in conjunction with supervisors of the financial system. The purpose of the FSB is to help protect the entire financial system, including strengthening its resilience and reducing the build-up of systemic risks, thereby ensuring that the financial sector is able to make a sustained contribution to economic growth. The FSB is chaired by the Governor of the Bank of Slovenia.

The FSB met in four ordinary sessions in 2017, on the basis of the Macro-prudential Supervision of the Financial System Act. The FSB reports on its work to the National Assembly of the Republic of Slovenia. At its sessions the FSB identified, monitored and assessed risks in the Slovenian financial system in accordance with law. There was no significant change in risks in 2017, and they did not significantly endanger financial stability.

Office for Money Laundering Prevention:

In the area of AML, the Bank of Slovenia again carried out several activities in 2017 in conjunction with the Office for Money Laundering Prevention (OMLP). A memorandum of understanding was signed between the Bank of Slovenia and the OMLP early in the year to define their collaboration when conducting supervisory activities from the perspective of AML/CFT at banks and other entities under Bank of Slovenia supervision. Joint activities were also conducted in the area of virtual currencies.

Committee for cooperation between supervisory authorities:

The committee for cooperation between supervisory authorities (the Bank of Slovenia, the SMA and the ISA) met at four ordinary sessions in 2017, to discuss new developments with the Ministry of Finance in connection with financial legislation and activities related to the meetings of the Financial Stability Board, to define joint activities and joint on-site inspections, to exchange information on the functioning of the board of supervisors at EU level, and to discuss other subjects of mutual interest.

National Payments Council:

The Bank of Slovenia again chaired the National Payments Council (NPC) in 2017. This platform provides for consultation and dialogue on content related to payment services and payments in general between stakeholders in the payments market in Slovenia. With the aim of ensuring the ongoing balanced, sustainable development of the payments market in Slovenia, the NPC involves representatives of public bodies, organisations representing the interests of payment service providers and users, and payment infrastructures.

Bank Association of Slovenia:

Close cooperation with the Bank Association of Slovenia (BAS) continued at all levels in 2017, most notably through support for the BAS's various expert committees, and regular participation in various technical workshops and expert conferences organised by the BAS for control, support and managerial functions at banks.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

Under the Resolution and Compulsory Winding Up of Banks Act (the ZRPPB), which entered into force on 25 June 2016, the Bank of Slovenia acquired the role of the national resolution authority.

In 2017 the Bank of Slovenia put in place resolution plans for all banks and savings banks (hereinafter: banks) whose resolution is its responsibility. At the same time it participated in updating the plans of the banking groups with members in Slovenia via internal groups within the framework of the Single Resolution Board (SRB), the central authority of the Single Resolution Mechanism in the European banking union. The approach to drawing up the resolution plans is coordinated at the level of the SRB and is standardised for all banks.

The Bank of Slovenia is responsible for drawing up the resolution plans for all banks that do not fall under the competence of the SRB, the SRB is responsible for drawing up resolution plans for banks and banking groups that are under the direct supervision of the ECB, and for all banks that pursue cross-border activities.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks[37]	19	16	15
Branches of foreign credit institutions	4	3	3
Cooperative banks	0	0	0
Banking sector, total	**23**	**19**	**18**

Ownership structure of the financial institutions
on the basis of registered capital (%)
(at year-ends)

Type of financial institution	2015	2016	2017
Public sector ownership	54,3	42	40,4
Other domestic ownership	11,3	9,2	10,4
Domestic ownership total	65,6	51,2	50,8
Foreign ownership	34,4	48,8	49,2
Banking sector, total	**100,0**	**100,0**	**100,0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	47,2%	62,7%	0,0845
Branches of foreign credit institutions	100,0%	/	0,7327
Cooperative banks	/	/	/
Banking sector, total	**45,5%**	**60,6%**	**0,1079**

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	**2,6%**	**7,3%**	**9,2%**
Cooperative banks	/	/	/
Banking sector, total	**2,6%**	**7,3%**	**9,2%**

[37] Including 3 savings banks

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	97,2%	96,0%	96,6%
Branches of foreign credit institutions	2,8%	4,0%	3,4%
Cooperative banks	/	/	/
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking system (%) (at year-end)

	2015	2016	2017
Claims from			
Financial sector	11,6	11,1	11,5
Nonfinancial sector	49,1	49,8	51,5
Government sector	25,3	23,7	21,5
Other assets	14,0	15,3	15,5
Claims due to			
Financial sector	12,7	10,5	8,6
Nonfinancial sector	61,6	66,4	69,6
Government sector	5,6	4,2	3,0
Other liabilities	8,3	6,6	6,4
Capital	11,8	12,4	12,5

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks**	20,8	20,8	**19,8**
Cooperative banks	/	/	/
Banking sector, total**	**20,8**	**20,8**	**19,8**

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector (share of impaired receivables / share of non-preforming loans)

Type of financial institution	2015	2016	2017
Non financial sector	13,7	6,6	4,6
- households	4,0	2,6	2,4
- corporate	15,2	7,6	5,4

The structure of deposits and loans of the banking sector in 2017 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	63,70	43,76
Corporate	23,14	38,51
Government sector	**4,07**	**9,20**
Financial sector (excluding banks)	**9,09**	**8,53**
Total	100.0	100.0

P&L account of the banking sector (at year-ends in EUR thousands)

P&L account	2015	2016	2017
Interest income	1.031.590	828.328	767.180
Interest expenses	285.956	158.379	115.232
Net interest income	745.632	669.954	651.948
Net fee and commission income	335.722	307.394	313.479
Other (not specified above) operating income (net)	76.205	149.799	108.744
Gross income	1.157.559	1.127.144	1.074.175
Administration costs	614.410	603.604	614.622
Depreciation	71.560	63.518	59.066
Provisions	-47.860	-11.824	19.528
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	361.117	108.171	-62.273
Profit (loss) before tax	158.332	363.674	443.227
Net profit (loss)	115.304	332.439	424.785

Total own funds in 2017 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	4.117.555	4.019.643	4.019.643	97.912	/
Cooperative banks	/	/	/	/	/
Banking sector, total:	**4.117.555**	**4.019.643**	**4.019.643**	**97.912**	/

Comment: There is no Tier 3 capital applied in Slovenian banking system
(Please, mark for each item: * - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE TURKISH BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

Turkey's economy has performed remarkably well with its steady growth over the past 14 years. A sound macroeconomic strategy, prudent fiscal policies, and major structural reforms have all contributed to the integration of Turkey's economy into the globalized world while also transforming the country into one of the major recipients of FDI in its region.

According to the OECD, Turkey is expected to be one of the fastest growing economies among OECD members during 2015-2025, with an annual average growth rate of 4.9 percent. Also, as stated by the targets of the Medium-Term Programme (MTP) 2018-2020, Turkey aims to grow 5.5% for successive three years. Accordingly, in 2017 the Gross Domestic Product has extended to 851 billion USD, supported by the intense domestic private demand as the economic activity remained strong throughout the year with robust enlargement in industry, services and construction, with the help of measures introduced inland along with exports glowed through reviving global trade and demand from Europe on the external front. A provisional decrease in tax for white durable goods and furniture, facilitation of companies' access to new financing by an enhanced and Treasury-backed Credit Guarantee System and deferral of insurance premiums to be paid to social security institutions played a key role for the country to post a 7.4% growth performance, the largest increase in GDP since 2013. Turkey's economic boost have also encouraged foreign trade. Exports reached USD 157 billion by the end of 2017, up from USD 36 billion in 2002.

During this period, the unemployment rate hovers around 10.9% maintaining the same level as in the previous year.

Regarding the monetary policy, it should be noted that given the high level of inflation the tight monetary stance was maintained to contain risks to the pricing behavior. In 2017, Consumer Price Index (CPI) was realized at 11.92%. The Central Bank of Turkey continue to use all available instruments in the pursuit of the price stability objective. Policy stance is such that further tightening will be delivered if needed.

Robust economic growth, prudent fiscal discipline, well-regulated and effectively supervised strong financial system with high capital adequacy levels and sound risk management practices, resilient to external shocks are the main characteristics of Turkey's economy in 2017. These characteristics carried Turkey to the 17th largest economy in the world ranking based on GDP figures.

DEVELOPMENT IN THE BANKING SECTOR (INCLUDING THE ASSETS TOTAL / GDP)

The Turkish financial system is dominated by the banking sector, which represents about 89 percent of total financial sector assets. By the end of March 2018 there are 51 banks operating in the Turkish Banking Sector (TBS) of which 33 are deposit taking banks (90 percent market share), 5 are participation banks and 13 are development and investment banks. All banks are under the supervision of the BRSA. The total asset size of TBS is nearly 3.2 trillion TL. As of year-end 2017, the total assets to GDP ratio is at 105%.

According to the Regulatory Consistency Assessment Program (RCAP), undertaken by the Basel Committee on Banking Supervision in 2016, Turkey's banking regulatory and supervisory framework is fully compliant with Basel standards.

As of March 2018, the volume of loans has reached to 2.2 trillion TL which constitutes 65.1% of total assets. The foreign currency and parity effect eliminated annual loan growth is 18.4%. Following a strong growth mainly driven by the Credit Guarantee Fund in 2017, loan growth has slowed down in 2018. The share of FX loans in loan portfolio is around 36.7% (including FX indexed loans). The share of corporate loans, retail loans and SME loans are 53.2%, 22.7% and 24.1%, respectively.

NPL ratio (at 2.8%), which is an important indicator of asset quality, is low compared to other emerging markets. Loan loss provisioning rate is at 75%. The share of second group loans (watch list) has increased to 7.3% from 4.4% as compared to year end 2017, mainly due to the implementation of IFRS9 starting from January 2018. Also, in terms of sub-sectors, concentration is at manageable levels.

As of March 2018, Credit Guarantee Fund (CGF) cash loans reached 172.8 billion TL (non-cash loans 10.2 billion TL). 93.9% of CGF loans are classified as 1st group loans and 5.3% as 2nd group loans. These ratios are 89.8% and 7.4% respectively for the total loans (excluding retail portfolio). Findings reveal that Credit Guarantee Fund guarantee has had significant implications in terms of cost of credit and maturity extension.

Securities are the other important investment item in the balance sheet of Turkish banks. Total share of securities in the balance sheet is 12.1% and the amount of securities is nearly 407 billion TL.

For Turkish banks, the main funding source is deposits (52.7% of total liabilities). Total deposits in TBS has reached to 1.8 trillion TL. FX deposit constitutes 44.7% of total deposits. As another source, total funds from abroad is around 134 billion USD and constitutes 15.6% of total liabilities. Foreign borrowing includes repos, deposit, loans and syndication and securitization loans. The current rollover rate of syndication loans is 110%.

Starting by the year 2010, banks are able to issue debt instruments both in local and international markets as a long term source of funding compared to deposits. Currently, the amount of bond issuances has reached to 162 billion TL with a share of 4.8% in total liabilities.

The TBS's performance indicators reflect a healthy and sound banking system. TBS's capital base is strong. CAR is at 16.6% which is higher than 12% target CAR regime that is being implemented in Turkey. Common Equity Tier I CAR is nearly 13.9%. Despite downgrade of Turkey's sovereign debt rating to below investment grade, Turkish banks preserves their high profitability ratios. As of March 2018, annualized NIM is 3.9%, ROA is 1.7% and ROE is 16.1%.

The FX position of banking sector is long. There is a short position in the balance sheet but banks balance their short positions by using off-balance sheet instruments such as derivatives which yields fully hedged FX positions.

Turkey has been implementing Liquidity Coverage Ratio (LCR) since 2015 and will complete its transition period with gradual increases each year until 2019. Currently, for 2018, deposit banks are required to achieve at least 90% total LCR and 70% FX LCR. Currently, all banks are complying with these limits and sector

LCR Ratios are 123.4% for total and 189.3% for FX which are significantly above the regulatory limits. Turkish banking system preserves its strong liquidity position against possible shocks with high liquidity coverage ratios.

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS.

LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN TURKEY

In Turkey, Banking Regulation and Supervision Agency (BRSA) with the authority given by Banking Law Nr. 5411 regulates and supervises banks (commercial-deposit banks, investment and development banks and participation banks and the branches in Turkey of such institutions established abroad), financial holding companies, financial leasing companies, factoring companies, consumer financing companies and asset management companies, payment institutions and e-money institutions. Moreover, BRSA authorizes independent audit, rating, valuation and outsourcing firms that give service to supervised institutions. Capital Markets Board of Turkey (CMB) is the regulatory and supervisory authority in charge of the securities markets. General Directorate of Insurance (GDI) and the Insurance Supervisory Board under Secretariat of Treasury are responsible for insurance sector.

Within the scope of the Law on Bank Cards and Credit Cards, the institutions willing to establish card systems, issue bank cards and credit cards, exchange information on card holders, and engage in clearing and settlement activities are also regulated by BRSA. In addition, BRSA is empowered to authorize and terminate the activities, temporarily or permanently, of institutions that performs the independent audit, valuation, rating and outsourcing activities for banks.

BRSA is a public legal entity with administrative and financial autonomy. The independence of the BRSA gives autonomy in three main areas: i) autonomy in regulation and supervision, ii) autonomy in BRSA’s administration, iii) autonomy in using financial resources.

With the enactment of the Banking Law Nr. 5411, regulatory and supervisory framework of the banking system has been reshaped in a more systematic way in the light of international best practices. Banking Law in force gives the BRSA all the powers to regulate, enforce and ensure the implementation of the establishment, activities, management and organizational structure, merger, disintegration, change of shares and liquidation of banks and monitor and supervises enforcement of them. BRSA uses its powers through regulatory transactions and specific decisions taken by its Board. Banking Regulation and Supervision Board is authorized to revoke the operating permissions of failing banks or to transfer the shareholder rights except dividends and the management and supervision of the banks to the Savings Deposit Insurance Fund (SDIF), for the purposes of transferring, selling or merging them partially or fully. The banks whose operating permissions have been revoked are liquidated as subject to the provisions of Banking Law by SDIF.

Besides, according to the Bank Cards and Credit Cards Law Nr. 5464, BRSA is also responsible for authorization, regulation and supervision of card system organizations, card issuing organizations, organizations entering into merchant agreements, information exchange and clearing/settlement organizations. Furthermore, with the Law Nr. 6493 enacted in 2013, authorization, regulation and supervision of payment institutions and electronic money institutions were also incorporated into the scope of authority.

With its Implementing Decision no. 2016/2358 dated 20.12.2016, the European Commission acknowledged that the regulatory and supervisory framework of the Turkey's banking sector is equivalent to the European Union (EU) legislation in terms of the EU Regulation 575/2013 on Prudential Requirements for Credit Institutions and Investment Firms. Similar to the results of the Regulatory Consistency Assessment Program (RCAP), which was previously held by the Basel Committee on Banking Supervision, this Implementation Decision also confirmed that the Turkey's banking regulatory and supervisory framework is fully in line with international standards.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

Ongoing impact of the global crisis reveals the importance of public sectors' strategic moves about policy-making and preventive measures. In this context, strategies of national institutions that are established with a visionary perspective and broad participation of stakeholders have increasingly become more important. In this context, strategies of the BRSA focuses on reinforcement of the efficiency of regulation, supervision and implementation framework with the aim of protecting rights and interests of depositors and safeguarding an efficient functioning of the credit system. These objectives are in turn add to uplifting confidence, stability and competitiveness in financial markets. In addition, the protection of financial consumers by improving financial education and rising awareness are considered as important means to enlarge financial inclusion.

Throughout the year 2017, BRSA continued to use these strategies to enhance confidence in financial markets with micro and macro prudential tools employed effectively to maintain soundness in the banking sector with due consideration to the requirements of economic development.

THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The BRSA is mainly responsible for the regulation and supervision of banks, non-bank financial companies, asset management companies and payment/electronic money companies. In this regard, the BRSA has continued to regulate and supervise these financial institutions throughout 2017. To that end, the activities coming to the forefront are as follows:

From the BRSA's perspective the year 2017 was a fruitful period for accomplishing a significant number of amendments to the existing regulations and communiques along with new regulations with the purpose of adjusting to the international best practices and regulatory standards. In this regard, 2 new regulations and 2 additional communiques have been issued while 21 amendments to the existing regulations and 5 changes to the present communiques have been realized.

In 2017, the Board of BRSA approved the establishment of 1 finance company and 4 asset management companies while 1 bank, 12 electronic money institutions and payment institutions and 3 asset management companies were issued with operating license. In addition, the Board of BRSA has authorized 6 rating companies. However, license and authorization of 1 bank, 1 financial leasing company, 1 factoring company, 2 asset management companies, 1 payment institution and 4 rating company were revoked during the same period due to various reasons.

The BRSA supervises the institutions under its responsibility with a risk based dynamic approach to ensure adequate, effective and sustainable supervision while using institutional capacity effectively. Supervision groups have been closely following the developments in financial markets from up-to-date sources and accomplishing supervision in line with the manuals prepared according to the international best practices, and risk based supervision principles.

As a result of supervision activities carried out in 2017, 278 audits reports including financial soundness evaluation and rating reports, regulatory compliance reports, denunciation and compliance reports, domestic branch audit reports along with 19 risk assessment reports and 363 assessment commentary were prepared. In addition, 86 audit reports within the scope of IT supervision and 156 audit reports for financial customers' issues were delivered.

In order to share country experiences on resolution of financial institutions which are considered by standard setting bodies as part of the prudential regulations and strong supervision in the wake of 2008 global financial crisis, the BRSA hosted an international workshop in 2017, supported by the sponsorship of the European Bank of Restructuring and Development (EBRD).

The BRSA has continued to contribute to the further development of Islamic banking following the 10th Country Development Plan's vision of 'Interest-free Finance Strategy'. With the implementation of this Strategy throughout the last four years, public awareness has been grown to serve more people, state-owned Islamic banks have been established, regulation covering tax and capital markets issues has been regulatedl, more of an Islamic financial product, namely 'sukuk' has been issued by private and public institutions, new academic departments in faculties are founded and new research centers are opened while preparatory studies has been organized for introduction of new Islamic money and capital markets in the near future. Probably one of the most important development in this field was the establishment of an Islamic Consultative Board under the

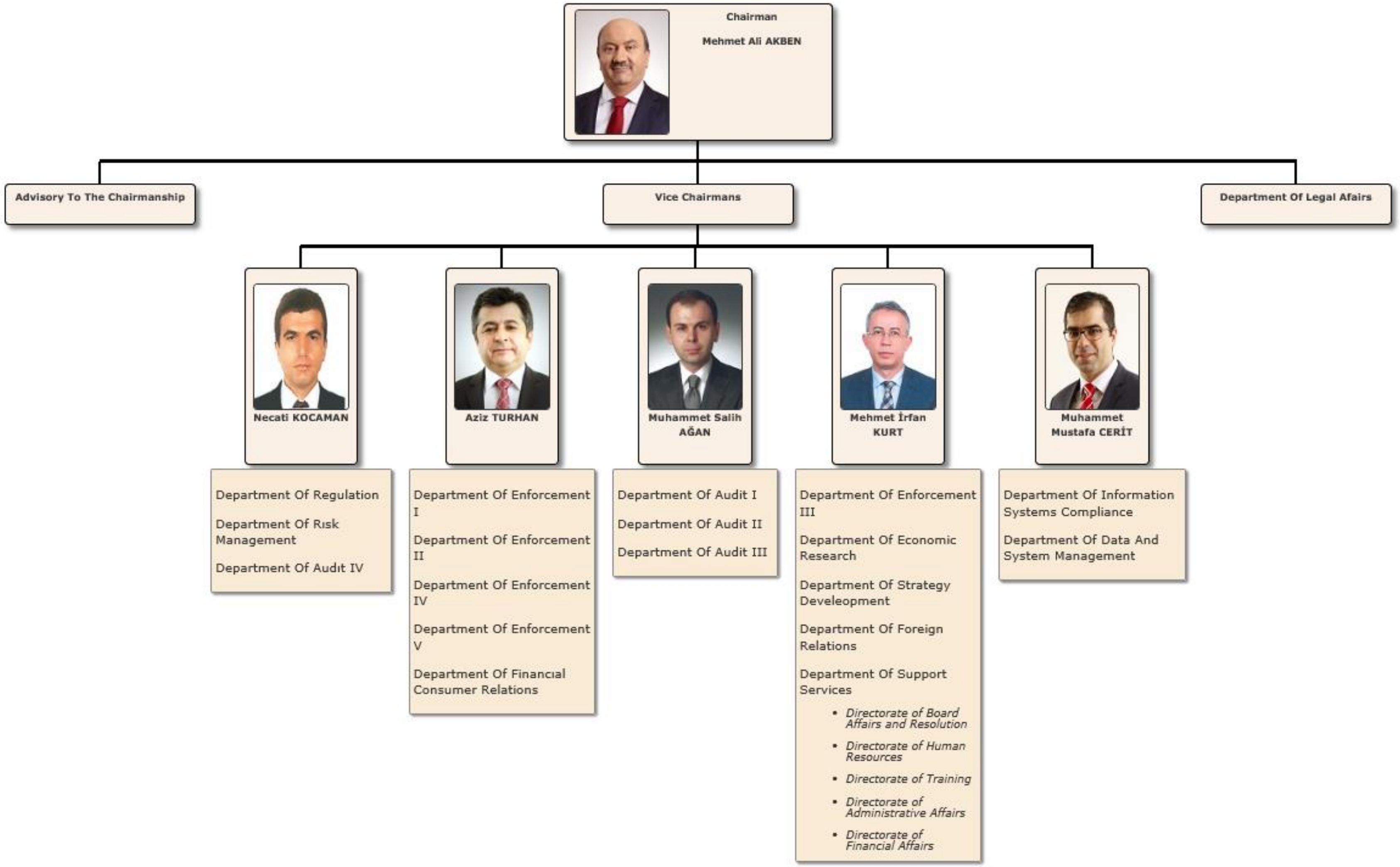
Association of Islamic Banks of Turkey with the purpose of ensuring Islamic finance institutions to operate in line with Islamic requirements and principles. The Board is anticipated to improve the perception of Islamic finance sector and thus contribute to the development of the sector itself.

In order to facilitate access to banking services without difficulty and increase financial inclusion of citizens with disabilities, the studies continued in 2017 to ensure banks to comply with the standards set in the Regulation issued in 2016 by taking into account the needs of these persons while planning their services.

Istanbul Financial Center Project has been on the agenda in year 2017 as well. The studies mainly in the field of taxation, banking and capitals markets has been accelerated.

Last but not the least, the progress in financial technologies and cyber security were also under the BRSA’s radar.

ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES OF THE AUTHORITY

BRSA's international relations have four dimensions.

- **Collaboration with foreign supervisory authorities related to consolidated supervision,**

Efficient and timely exchange of information among supervisory bodies is essential for effective supervision, and is particularly critical for a strong financial market. In order to improve the effectiveness of the consolidated supervision, BRSA collaborates with foreign supervisory authorities. Accordingly, BRSA signs Memorandum of Understandings (MoU) with foreign counterparts on the consistency of policies and regulations pursuant to Article 98 of the Banking Law Nr. 5411. MoUs aim at developing cooperation among supervisory and regulatory authorities that are parties to agreement for developing financial stability and ensuring the sustainable growth. Pursuant to the memorandums signed between the BRSA and the foreign equivalent supervisory authorities, parties give importance to cooperation on sharing experiences and organizing training programmes to ensure the development of financial sector by means of collaborating for strengthening the legal, regulatory and organizational structure to ensure sustainability of financial stability and for identifying and generalizing of international best practices. The number of Memorandums of Understanding has reached to 37 as mid of 2018.

- **Close cooperation with European Union as a candidate country,**

Since Turkey is a candidate country to European Union (EU), there exists an extensive effort to align national legislation with EU acquis and to improve the administrative capacity for an effective implementation of new regulations.

Within this context, the BRSA participates in the negotiations with EU and responsible for an effective harmonization of the regulations. In recent years, the BRSA has made amendments in banking regulations in order to incorporate EU laws. As a result banking sector is now one of the most prepared sectors for EU accession.

- **Strong links with multinational institutions**

The BRSA has close relations with multinational institutions such as International Monetary Fund (IMF), World Bank (WB), Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS), European Central Bank (ECB), Organization for Economic Cooperation and Development (OECD), World Trade Organization (WTO) and Financial Action Task Force (FATF). The Authority also established membership in Islamic Financial Services Authority (IFSB) which conducts studies on ensuring standardization in Islamic financial services and also became a member of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) on June 2016, which conducts studies for the standardization of finance practices, governance, auditing, accounting standards and financial reporting for non-interest financial institutions.

- **Relations with other international and foreign institutions.**

Pursuant to the provisions of Banking Law Nr 5411, the BRSA has worked in close cooperation with international institutions, has carried out necessary adaptation studies by monitoring closely the regulation and standards developed by these institutions and has actively participated in studies performed by the institutions.

COOPERATION WITH OTHER SUPERVISORY BODIES IN TURKEY

Based on Article 98 of Banking Law, views were exchanged and information was shared with Undersecretariat of Treasury, Capital Markets Board (CMB), Savings Deposit Insurance Fund (SDIF) and Central Bank of Republic of Turkey (CBRT) in order to ensure coordination and cooperation among authorities in executing monetary, credit and banking policies.

Financial Sector Commission, consisting of the representatives of the BRSA, Ministry of Finance, the Treasury Undersecretariat, Central Bank, Capital Market Board, SDIF, Competition Board, Undersecretariat of State Planning Organization, Istanbul Gold Exchange, securities stock exchanges, Futures and Options Markets and the associations of institutions, is responsible for ensuring coordination, cooperation and exchange of information among the related authorities and associations, raising joint policy recommendations and conveying comments on matters concerning the future of the sector, in order to improve confidence and stability in the financial markets pursuant to Banking Law.

The Coordination Committee consisting of the presidents and vice presidents of BRSA and SDIF, pursuant to Banking Law Nr. 5411, is in charge of ensuring the maximum cooperation be established between the BRSA and the SDIF when it is necessary to carry out transactions in the competency of the SDIF, and exchange of information.

Financial Stability Committee, established through Decree-Law no. 637 published in 2011 is chaired by the Minister for Undersecretariat of Treasury and consists of Undersecretary of Treasury, CMB, BRSA and SDIF Presidents. While the primary function of the Committee is to develop proposals for measures and policies to identify, monitor and mitigate systemic risks that may involve financial system as a whole, the Committee is also responsible for planning, policy development, monitoring and coordination of systemic risk management activities.

STATISTICAL TABLES

Number of financial institutions (head offices/branches) (at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks[38]	34	34	33
Branches of foreign credit institutions	6	6	5
Cooperative banks	0	0	0
Banking sector, total:	52	52	51

Ownership structure of banks on the basis of assets total

Type of financial institution	2015	2016	2017
Public sector ownership	31,98	33,82	35,96
Other domestic ownership	37,68	36,78	36,00
Domestic ownership total	69,66	70,60	71,96
Foreign ownership	30,34	29,40	28,04
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	34,46	53,55	779,25
Branches of foreign credit institutions	0,37	0,39	0,11
Cooperative banks	-	-	-
Banking sector, total:	100,00	100,00	788

[38] There are no cooperative banks in Turkey. Commercial banks are defined as deposit taking institutions, therefore investment & development banks are excluded. We have, as of year-end 2017, 13 investment & development banks and 5 private and public participation banks

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	11,96	14,95	16,52
Cooperative banks	-	-	-
Banking sector, total:	11,28	14,28	15,88

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	95,2	94,8	94,6
Branches of foreign credit institutions	0,3	0,3	0,4
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

[2] Remaining shares belong to investment &development banks.

Capital adequacy ratio of banks

Type of financial institution	2015***	2016***	2017***
Commercial banks	15,0	15,1	16,5
Cooperative banks	-	-	-
Banking sector, total:	15,6	15,6	16,8

(* - for Basel I; ** - for Basel II; *** - for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification[3]	2015	2016	2017
Non-financial sector, including			
- households	4,3	4,3	3,5
- corporate	2,0	1,9	2,8

[3] NPL Ratio

The structure of deposits and loans of the banking sector in 2017 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	59,3	23,3
Corporate[4]	36,2	74,9
Government sector	4,5	1,8
Financial sector (excluding banks)	-	-
Total	100.0	100.0

[4] Including SME Loans

P&L account of the banking sector (at year-ends)

P&L account	2015	2016	2017
Interest income	164,1	194,7	247,4
Interest expenses	86,8	103,4	134,1
Net interest income	77,3	91,3	113,4
Net fee and commission income	22,4	24,1	28,8
Other (not specified above) operating income (net)	-23,6	-14,2	-20,7
Gross income	**200,0**	**239,8**	**303,1**
Administration costs[5]	**41,0**	**43,4**	**25,0**
Depreciation	3,0	3,2	3,8
Provisions	5,3	5,0	4,0
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	3,6	4,1	8,0
Profit (loss) before tax	33,1	47,3	60,9
Net profit (loss)	26,1	37,5	48,6

[5] Administration Costs includes only personnel costs and provisions for termination indemnities.

Total own funds in 2017 (in EUR)

Type of financial institution (million EUR)	Total own funds ***	Core Tier 1***	Tier 1***	Tier 2***	Tier 3***
Commercial banks	86,4	72,4	72,0	14,7	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	93,6	79,5	79,0	14,9	-

(* - for Basel I; ** - for Basel II; *** - for Basel III)

2017 DEVELOPMENTS IN THE UKRAINIAN BANKING SYSTEM

MACROECONOMIC ENVIRONMENT

In 2017, the Ukrainian economy maintained its growth momentum, with real GDP growth at 2.5% (compared to 2.4% in 2016, driven by stronger consumer demand and high investment activity.

Consumer demand was the main driver of the real GDP growth in 2017, propelled by robust household income growth. While early in the year this was due to the doubling of the minimum wage, later on, wage growth was bolstered by robust labor demand amid a continued pickup in labor migration. In addition, Q4 2017 saw a substantial rise in average pension payments due to a pension reform.

Consumer inflation reached 13.7% yoy as of end-2017, exceeding the target of 8% ± 2 pp set by the National Bank of Ukraine (NBU) in the Monetary Policy Guidelines for 2017 and Medium Term. Inflation accelerated from 12.4% yoy in 2016, mainly driven by factors on which monetary policy tools have only a limited effect. These factors include a decrease in the supply of some fruit and vegetables resulting from unfavorable weather conditions in the first half of 2017, unstable situation in the animal breeding sector, higher global prices and stronger demand for Ukrainian food items, especially for meat and dairy products as well as rising global crude oil prices. Growth in the Producer Price Index (PPI) slowed substantially to 16.5% yoy from 35.7% in 2016.

Ukraine's balance of payments reported a surplus of USD 2.6 billion in 2017, up from USD 1.3 billion in 2016. The current account deficit amounted to USD 2.1 billion in 2017 (compared to USD 1.3 billion in 2016). A slight widening from the previous year was the result of robust growth in domestic demand and higher energy imports needs. On the financial account, foreign direct investments to Ukraine amounted to USD 2.2 billion. Owing to the balance of payments surplus and the disbursement of the next loan tranche under the EFF program with the IMF, international reserves increased by 21% to USD 18.8 billion as of the end of 2017.

DEVELOPMENT IN THE BANKING SYSTEM

In 2017, 14 banks left the market, of which four became financial companies and one merged with another one. In early 2017, these banks accounted for 1.7% of net sector assets. The percentage of state-owned banks in net assets rose by 3.6 pp, to 54.9%. The growth in the share of private banks was driven by active lending and the purchase of several foreign-owned banks. Concentration increased noticeably, with the 20 largest banks accounting for 90.7% of the banking sector's net assets (+1.3 pp yoy).

Assets. The banking sector's net assets grew by 6.4%, to UAH 1,336 billion in 2017, and most pronouncedly in Q4 (4.3%). The recapitalization of state-owned banks increased the domestic government bond portfolio of the sector by UAH 107 billion1. At the same time, interbank loans and deposits at the NBU dropped by UAH 27 billion. Net loans adjusted for provisions were practically unchanged when calculated at a fixed rate. The foreign currency loan portfolio shrunk pronouncedly, on the back of written-off and restructured loans, which was offset by a rise in hryvnia lending. In 2017, foreign and state-owned banks generated the largest increases in net hryvnia corporate loans (17.5% and 12.8% respectively). PrivatBank's net hryvnia loans dropped by 79.5% yoy, as the bank made provisions for loans to companies related to its former shareholders. State monopolies, trading, and agricultural companies were mainly responsible for corporate lending growth. The restructuring of foreign currency loans increased the hryvnia loan portfolio by one fourth.

Retail lending grew rapidly, contributing 42% to the net hryvnia loan growth. Loans by PrivatBank and private banks increased at the highest pace (by over 60% yoy), driven by consumer loans. Despite a rebound in mortgage lending, the writing-off of legacy loans reduced the percentage of mortgage loans in the retail loan portfolio.

New lending improved the quality of the loan portfolios of all the banks (apart from PrivatBank) due to statistical effects. The NPL rate declined by 3.2 pp, to 54.5%39 in H2. The percentage of these loans, excluding state- and Russian-owned banks, was 28.4%.

Funding. In 2017, hryvnia household deposits grew by 22.4%[40], while foreign currency ones stayed unchanged. Q2 and December saw the largest deposit inflows. PrivatBank and Oschadbank generated the largest growth in hryvnia and foreign currency household deposits respectively. Foreign-owned banks reported the biggest drops in foreign currency household deposits.

Hryvnia corporate deposits grew by 13.6% in 2017 (by 11.1% in December), driven by increased budgetary spending at the end of the year. Foreign currency corporate deposits declined by 10% in the US dollar equivalent.

Interest Rates. Interest rates on retail hryvnia loans decreased by 3.2 pp, to 14.3% per annum in 2017[41]. However, recent decisions by the NBU to raise its key policy rate pushed up rates on short-term (up to six months) hryvnia deposits – by 0.2-0.4 pp since the first rate hike. Rates on retail foreign currency deposits have remained at a historically low level of 3.7% per annum. Rates on corporate and retail hryvnia loans remained largely unchanged.

Financials and Capital. The banking sector's operating income increased 10% yoy, but administrative costs grew faster, resulting in an increase in operating profit before provisioning by 8% to UAH 40.7 billion. Due to significant provisioning, the banking sector booked losses of UAH 24.4 billion in 2017. The losses were mostly generated by four banks, in particular by PrivatBank and two banks with Russian capital. The number of loss-making banks decreased from 33 in 2016 to 18 in 2017, while the number of banks that posted an operating loss before provisioning was down, from 23 to 14. The final indicators in the financial statements of the banks for 2017 may still change by the end of April, following the results of their annual audits.

[39] Held by all reporting banks.
[40] Solvent banks as of the end of 2017.
[41] Based on the Ukrainian Index of Household Deposit Rates.

Item	2015	2016	2017
Gross corporate loans*/ GDP	41.8%	35.5%	29.7%
Net corporate loans*/GDP	30.9%	20.0%	15.6%
Gross retail loans/GDP	8.8%	6.6%	5.8%
Net retail loans/GDP	4.8%	3.2%	3.1%
Corporate deposits*/ GDP	17.6%	17.3%	14.6%

*Including nonbank financial institutions

THE LEGAL AND INSTITUTIONAL FRAMEWORK OF THE OPERATION AND SUPERVISION OF FINANCIAL INSTITUTIONS, NEW DEVELOPMENTS.
LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN UKRAINE

Banking in Ukraine is regulated by the following laws:

- Constitution of Ukraine
- Civil Code of Ukraine
- Economic Code of Ukraine
- Law of Ukraine *On the National Bank of Ukraine*
- Law of Ukraine *On Banks and Banking*
- Law of Ukraine *On Households Deposit Guarantee System*
- Law of Ukraine *On Financial Services and State Regulation of Financial Markets*
- Law of Ukraine *On Joint Stock Companies*
- Law of Ukraine *On Prevention and Counteraction to Legalization (Laundering) of Proceeds from Crime, Financing of Terrorism and Financing the Proliferation of Weapons of Mass Destruction*.

Under the Laws of Ukraine *On the National Bank of Ukraine* and *On Banks and Banking*, the National Bank of Ukraine (NBU) is responsible for banking supervision and regulation in Ukraine.

On 23 March 2017, the Law *On Simplification of Procedures for the Reorganization and Capitalization of Banks* was adopted. The Law provides simplified procedures for capitalization of banks - at the expense of additional contributions and through the procedure of joining one bank to another. Moreover, the Law provisions provide a possibility of termination of banking activity without the liquidation of a legal entity. The law is temporary and valid until 1 August 2020.

MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2017

To achieve the key objective of the Comprehensive Program of Ukrainian Financial Sector Development Until 2020, which is to strengthen resilience of the banking system of Ukraine and to protect the rights of depositors and creditors, the banking supervision focused on:

- monitoring the credit risk recognition by banks under Resolution 351 (Regulation on Measuring Credit Risk Generated by Banks' Exposures, approved by NBU Board Resolution No. 351 of 30 June 2016)
- IFRS 9 introduction
- NPLs treatment
- SREP implementation
- introduction of annual diagnostics and business model assessment
- launching Credit Register.

BANKING SUPERVISORY AUTHORITY ACTIVITIES IN 2017

In 2017, the NBU enhanced the risk-based supervision approaches to improve banking supervision. For this purpose in line with adopted Comprehensive Program of Ukrainian Financial Sector Development Until 2020, in 2017, the NBU drafted new instruments regulating banks' assessment and ongoing monitoring of banks' financial standing as part of off-site risk-based supervision. These instruments are based on the *Guidelines for Common Procedures and Methodologies for the Supervisory Review and Evaluation Process* (Supervisory Review and Evaluation, SREP) (Guidelines – EBA/GL/2014/13 of 19 December 2014), having regard to principles and recommendations of the Basel Committee on Banking Supervision.

Bank assessment during off-site banking supervision under the SREP methodology is implemented to create a uniform bank evaluation system in the NBU based on the appraisal of their risks and viability, as well as to allocate proportionally supervisory resources and outline the banking supervision strategy using the risk-based approach. The aforesaid bank assessment comprises as follows:

- the bank assessment procedure during off-site supervision under the SREP methodology
- approaches to categorizing banks in order to implement the principle of proportionality when deciding on the scope, frequency, and application of supervisory actions to banks
- identification of banks' business models to define peer groups according to lines of business
- supervisory actions with regard to the bank's systemic significance and data on the bank's risk level, including the comprehensive bank assessment (SREP) while drafting the schedule of banks' inspections
- involving the NBU units in the assessment process
- an ongoing dialogue with Ukrainian banks on the findings based on SREP and assessment of their viability.
- Furthermore, in 2017, the Banking Supervision Department initiated testing of new approaches to the assessment of:

- bank funds, based on the economic capital concept
- bank's liquidity based on forecasting liquidity of an individual bank considering its behavior features.

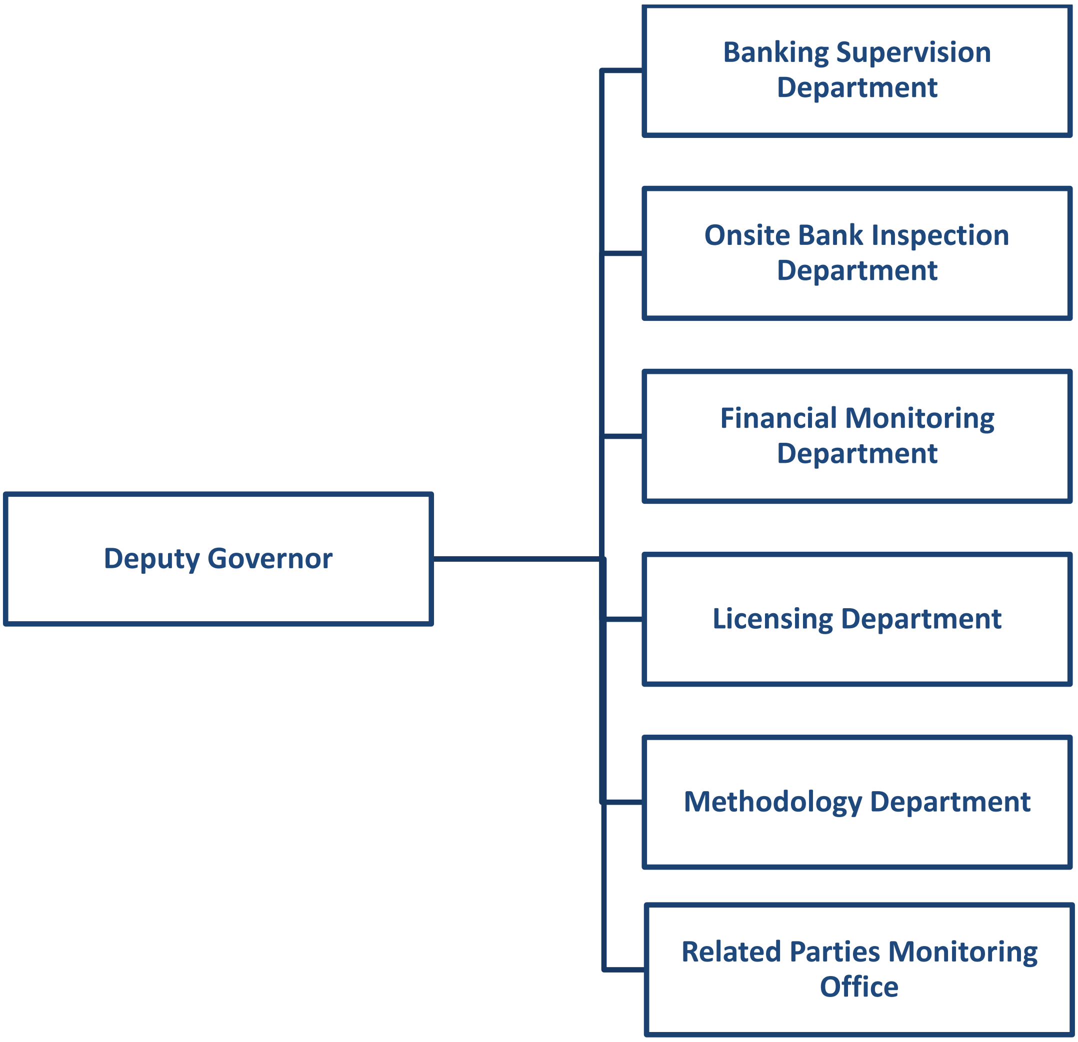
In 2017, preparatory actions were taken for adoption of the Law of Ukraine introducing the Credit Register of the National Bank of Ukraine. The NBU Credit Register will become an additional efficient banking supervision instrument, and introduction hereof will have a positive effect on the macrofinancial stability of the country. Creating and keeping records of the public credit register will enable the NBU to monitor credit risk concentrations and consequently improve protection of interests of depositors and other bank creditors, ensure independent risk assessment carried out by banks in the course of lending and a decrease in the NPLs share. The Verkhovna Rada of Ukraine adopted the Law of Ukraine *On Amendments to Certain Laws of Ukraine on Establishing and Maintaining the Credit Register of the National Bank of Ukraine and Improving Credit Risk Management of Banks* on 6 February 2018.

In 2017, the diagnostic study of 37 small banks was completed. According to the diagnostic study findings, four banks (out of 37 banks) were found as needing additional capital in the amount of UAH 143 million.

On 22 December 2017, the NBU Board approved the Regulation O*n Assessing Resilience of Banks and Banking System of Ukraine* (NBU Board Resolution No. 141 dated 22 December 2017).

Seven financial restructuring procedures were held in 2017 in accordance with the Law *On Financial Restructuring* No.1414-19 dated 14 June 2016.

ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISORY AUTHORITY



INTERNATIONAL ACTIVITIES

In 2017, the NBU continued its cooperation with international financial institutions including in the field of banking supervision.

In particular, the NBU continued cooperation with the International Monetary Fund under the EFF program that includes measures aimed at strengthening the Ukrainian banking sector and improvement of banking supervision regulatory framework, namely in the area of corporate governance, establishing a credit register and monitoring of related parties etc.

Together with the World Bank the NBU worked on assessment of the compliance of Ukraine’s legal framework on banking supervision with the BCBS Core Principles for Effective Banking Supervision and EU legislative acts concerning capital requirements (CRD IV). In addition, a roadmap to improve the quality of banking supervision in Ukraine was developed.

The NBU continued to develop its bilateral relations with foreign supervisory authorities under the Memoranda of Understanding and Cooperation in the Area of

Credit Institutions Supervision and Multilateral Cooperation and Coordination Agreements on the Supervision.

It is also worth mentioning that the NBU was very active in the TA field. The constant increase of the TA volumes received by the NBU was observed during 2017. The key TA donors of the NBU are the EU, IMF, World Bank, USAID, KNF (Poland) and EBRD.

In November, the NBU also held the 5-th joint event with the ECB on SREP Methodology, the next in a series of bilateral meetings.

COOPERATION WITH OTHER SUPERVISORY BODIES IN UKRAINE

As a banking supervisor, the NBU works in cooperation with the other Ukrainian supervisory authorities. In particular, the NBU has signed the agreements on exchange of information with the National Commission for State Regulation of Financial Service Markets and the National Securities and Stock Market Commission.

OTHER RELEVANT INFORMATION AND DEVELOPMENTS

As part of the Action Plan on Enhancing Banking Supervision, as well as the NBU plans on implementing EU laws in line with the EU-Ukraine Association Agreement, the regulator drafted laws and regulations for the implementation of Directive 2013/36/EU and EU Regulation No. 575/2013 based on Basel III provisions for:

- introducing new requirements to capital (new capital structure, capital adequacy ratios)
- introducing the new liquidity ratio, LCR i.e. Liquidity Coverage Ratio.

STATISTICAL TABLES

Number of financial institutions (head offices/branches)
(at year-ends)

Type of financial institution	2015	2016	2017
Commercial banks	120	96	82
Branches of foreign credit institutions	–	–	–
Cooperative banks	–	–	–
Banking sector, total:	**120**	**96**	**82**

Ownership structure of banks
on the basis of assets total (%)
(at year-ends)

Type of bank	2015	2016	2017
Public sector ownership	24.7	52.5	58.25
Other domestic ownership	16.9	12.84	12.59
Domestic ownership total	41.6	65.34	70.84
Foreign ownership	58.4	34.66	29.16
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions
(at year-end)

Type of the financial institutions	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	53.8	62.3	0.118
Branches of foreign credit institutions	–	–	–
Cooperative banks	–	–	–
Banking sector, total:	**53.8**	**62.3**	**0.118**

Return on Equity (ROE) by type of financial institutions (%)

Type of financial institution	2015	2016	2017
Commercial banks	-69.95	-116.05	-15.96
Cooperative banks	–	–	–
Banking sector, total:	**-69.95**	**-116.05**	**-15.96**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2015	2016	2017
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure[42] of assets and liabilities of the banking system (%) (at year-end)

	2015	2016	2017
Claims from	**100**	**100**	**100**
Financial sector[43]	18.00	16.45	14.91
Nonfinancial sector	52.95	47.44	45.15
Government sector	7.11	17.29	22.50
Other assets	21.94	18.82	17.44
Claims due to	**100**	**100**	**100**
Financial sector	29.78	34.15	33.52
Nonfinancial sector	17.26	17.99	18.86
Government sector	0.59	0.47	1.41
Other liabilities[44]	42.17	38.29	36.12
Capital	10.20	9.10	10.09

[42] NBU: monetary and financial statistics data
[43] NBU: non-financial corporations sector (S.11)
[44] NBU: households sector (S.14), non-profit institutions serving households sector (S.15) and rest of the world sector (S.2)

Capital adequacy ratio of banks

Type of financial institution	2015	2016	2017
Commercial banks	12.31**	12.69**	16.16**
Cooperative banks	–	–	–
Banking sector, total:	**12.31****	**12.69****	**16.16****

(* - for Basel I; ** - for Basel II; ***- for Basel III)

Asset portfolio quality of the banking sector
(share of impaired receivables / share of non-performing loans)

Asset classification	2015	2016	2017
Non financial sector	19.0	28.0	33.6
- households	7.1	7.9	5.4
- corporate	11.9	20.0	28.2

The structure of deposits and loans of the banking sector in 2017 (%)
(at year-end)

	Deposits	Loans
Households	94.3	98.8
Government sector	56.0	17.2
Corporate	38.3	81.6
Other (excluding banks)	2.5	0.1
Total	3.2	1.1

P&L account of the banking sector (at year-ends)
(in EUR million)

P&L account	2015	2016	2017
Interest income	5.288	4.778	3.704
Interest expenses	3.743	3.224	2.119
Net interest income	1.545	1.554	1.585
Net fee and commission income	866	866	820
Other (not specified above) operating income (net)	-61	30	-411
Gross income	7.753	6.709	5.318
Administration costs	1.485	1.385	1.320
Depreciation	143	–	–
Provisions	4.657	6.977	1.471
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	–	–	–
Profit (loss) before tax	-2.782	-5.623	-680
Net profit (loss)	-2.767	-5.608	-790

Total own funds in 2017 (in EUR billions)

Type of financial institution	Total own funds (for CAR)	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	3.68**	–	2.83**	0.88**	–
Cooperative banks	–	–	–	–	–
Banking sector, total:	3.68**	–	2.83**	0.88**	–

(* - for Basel I; ** - for Basel II; *** - for Basel III)

MAIN GROUP EVENTS OF THE YEAR 2017

30th Annual BSCEE Members' Conference

Minsk, Belarus, May 31-June 2, 2017

The Chairmanship of the BSCEE Group in 2017 was held by Mr. Dmitry Lapko from the National Bank of the Republic of Belarus (NBRB). Therefore, the 30th Annual BSCEE Members' Conference was hosted in Minsk between 31 May and 2 June 2017 by the NBRB.

The National Bank of Georgia volunteered to hold the 2018 BSCEE Chairmanship as well as host the 31st Annual Conference and the Member countries accepted this candidature by acclamation.

Fifth BSCEE-BCBS-FSI high-level meeting on global and regional supervisory priorities

The high-level meeting organised organized jointly by the Group of Banking Supervisors from Central and Eastern Europe (BSCEE), the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Institute (FSI) of the Bank for International Settlements (BIS). During the 2017 meeting usual discussions related to then current supervisory challenges were held and facilitated by keynote speeches delivered by Ms Danièle Nouy, Chair of the Supervisory Board of European Central Bank, and Mr Andrea Enria, the Chairperson of European Banking Authority. Moreover the topics of NPL measurement, proportionality and cyber risks in banking activity were elaborated on at length.

FSI – ESE - BSCEE Regional Seminar

Berlin, Germany, 5-7 December 2017

Deutsche Bundesbank in cooperation with the Financial Stability Institute, the European Supervisor Education Initiative (ESE) and the Group of Banking Supervisors from Central and Eastern Europe (BSCEE) organized a regional seminar on "on the interaction of forward looking supervision and recovery and resolution of banks". The programme for the seminar covered topics related mainly to supervisory early intervention and actual resolution cases that happened in EU. A noteworthy input from the representatives of the Single Resolution Board brought a much appreciated element of recent practical experience in dealing with resolution processes in Spain and Italy.

BSCEE CONTACT LIST

Supervisory Authorities of the Member Countries	Address	Web-site address
Bank of Albania	*Sheshi Skënderbej No. 1* *Tirana, Albania*	www.bankofalbania.org
Central Bank of Armenia	*6, Vazgen Sargsyan str.* *PO Box 0010, Yerevan* *Republic of Armenia*	*www.cba.am*
Austrian Financial Market Authority	*Otto-Wagner-Platz 5* *1090 Wien* *Austria*	www.fma.gv.at
National Bank of the Republic of Belarus	*Nezavisimosty Ave. 20* *Minsk 220008* *Republic of Belarus*	www.nbrb.by
Banking Agency of Federation of Bosnia and Herzegovina	*Kosevo 3, Sarajevo 4000* *Bosnia and Herzegovina*	www.fba.ba
Banking Agency of Republika Srpska, Bosnia and Herzegovina	*Vase Pelagića 11 A* *78000 Banja Luka* *Republika Srpska*	www.abrs.ba
Bulgarian National Bank	*1 Knyaz Alexander I Square* *Sofia 1000, Bulgaria*	www.bnbank.org
Croatian National Bank	*TRG Hrvatskih velikana 3* *Zagreb 10002, Croatia*	www.hnb.hr
Czech National Bank	*Prague 1,Na Prikope 28* *115 03 Czech Republic*	www.cnb.cz
Estonian Financial Supervision Authority	*Sakala 4* *Tallinn 15030, Estonia*	www.fi.ee
National Bank of Georgia	*2 Sanapiro Street* *0114 Tbilisi, Georgia*	www.nbg.gov.ge
Central Bank of Hungary	*Krisztina krt. 39* *1013 Budapest, Hungary*	www.mnb.hu
Financial and Capital Market Commission	*Kungu iela 1* *Riga, LV-1050, Latvia*	www.fktk.lv
Bank of Lithuania	*Zirmunu St 151* *Vilnius, LT-09128 Lithuania*	www.lbank.lt

National Bank of Macedonia	*Kuzman Josifovski Pitu Blvd 1 Skopje, 1000 Macedonia*	www.nbrm.mk
National Bank of Moldova	*1 Grigore Vieru Ave. Chisinau, MD-2005 Moldova*	www.bnm.org
Central Bank of Montenegro	*Bulevar Svetog Petra Cetinjskog 7 Podgorica, Montenegro*	www.cb-cg.org
Polish Financial Supervision Authority	*Plac Powstańców Warszawy 1 00-950 Warsaw, Poland*	www.knf.gov.pl
National Bank of Romania	*25, Lipscani str. Bucharest 1, Romania*	www.bnro.ro
Central Bank of the Russian Federation (Bank of Russia)	*12 Neglinnaya str. 103016 Moscow, Russia*	www.cbr.ru
National Bank of Serbia	*Kralja Petra 12 11000 Belgrade, Serbia*	www.nbs.rs
National Bank of Slovakia	*Imricha Karvasa 1 813 25 Bratislava, Slovakia*	www.nbs.sk
Bank of Slovenia	*Slovenska 35 1505 Ljubljana , Slovenia*	www.bsi.si
Banking Regulation and Supervision Agency of Turkey	*Buyukdere Cad. No 106 34394 Esentepe Sisli Istanbul, Turkey*	www.bddk.org.tr
National Bank of Ukraine	*9 Instytutska Str. 01601 Kyiv, Ukraine*	www.bank.gov.ua
BSCEE Secretariat	*Plac Powstańców Warszawy 1 00-950 Warsaw, Poland*	www.bscee.org