BSCEE

# BSCEE
# *Review*
# 2016

# 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 is operating 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 2016 Mr. Gergely Gabler, Director of the Special Competencies Directorate of the Central Bank of Hungary chaired the Group.

The permanent Secretariat of the Group, as of January 2006, is located in Poland, at 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 2016. 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 summarizes 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 sector of the member countries.

We hope that you will find this publication informative and useful. We are sure 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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## 2016 DEVELOPMENTS IN THE BANKING SYSTEM OF THE MEMBER COUNTRIES

BSCEE

# 2016 DEVELOPMENTS IN THE ALBANIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Year 2016 was overall positive for the Albanian economy. Economic activity continued the upward cycle started in the previous year, employment recorded growth and internal and external economic balances improved. The current account deficit narrowed from 9% at the end of 2015 to 8 % of the GDP at the end of 2016, the smallest deficit since 2006. Annual inflation averaged 1.3%, decreasing 0.6 percentage point from the previous year. Despite the volatility throughout the year, financial markets were characterized by improved liquidity, downtrend in interest rates and stable exchange rates.

Economic growth for 2016 was higher than the previous year. According to INSTAT[1] data, the Gross Domestic Product rose to 3.4% at the end of the year, reaching the highest annual growth rate since 2010. The economy benefited from the improvement of the financing conditions, surging exports, inflows of foreign direct investments and improvement of businesses and consumer's confidence.

The monetary policy intensified its accommodative stance in 2016, in response to weak inflationary pressures. The key interest rate was lowered twice during 2016, to 1.25% at the end of the year, from 1.75% at the beginning of the year.

To reinforce the transmission of the monetary stimulus, the Bank of Albania has increased the liquidity injection.

## 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. As of December 2016, its assets consisted of 95% of the Gross Domestic Product (GDP), and compared to the previous year, rose to ALL 1.407 billion (6.8% annual growth from 1.9% a year earlier).

The expansion of investments in treasury bills and bonds, credit portfolio and of less importance in deposits with other banks and financial institutions provided the main contribution to the expansion of the sector's assets. The activity was financed through the increase in deposits of the public, which accounted for 82% of total banking sector assets. Aggregated, deposits in banks, as at the end of the year, increased 5.2%, from 2.8% in the previous year.

By the end of 2016 the non-performing loans indicator of the banking sector have been to some extent volatile, even though on yoy basis there is no any significant development with the indicator staying at 18.3% from 18.2% one year before. However, non-performing loans reached the maximum level of 21.4% to improve later on due to written off loans (mainly loans that had been categorized

[1] Statistics Institute

for more than three years as loss loans) and credit restructuring and recovering efforts of the the banks across the board.

The banking system had a positive financial result with net profits reaching 9.3 billion ALL and obviously less than a year ago (15.7 billion ALL). The decrease was mostly indicated by the increase of the accumulated provisions for non-performing loans. By the end of 2016, the banking system's capital adequacy ratio was at 16 % that is notably higher than required minimum[2]. A good solvency and liquidity positions remain a stable positive feature of the banking system. It is to be mentioned that banks maintained the required minimum, even after the approval of the new rules on capital adequacy ratio, in line with the Basel II[3] approach. The core capital makes for the biggest chunk of the regulatory capital, which continues at higher levels and accounted for 88%.

The most important developments in banking sector through 2016 are:

- Credit portfolio increased by 2.5%;
- A relatively stable loan portfolio quality on yoy basis;
- Coverage ratio of non-performing loans portfolio remains high, around 71%;
- Better liquidity position as measured by liquidity ratio, at the level of 40.6%;
- Deposits increased by 59 billion ALL, almost double of the last year;
- The capital adequacy ratio despite the slightly decrease continues to stay notably higher than the 12% required minimum;
- The financial result despite the decrease, remains at satisfactory levels;
- Profitability ratios such as ROAA and ROAE are respectively 0.69% and 7.15%.

## 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 process of drafting and reviewing of the supervisory regulatory framework over 2016 was broadly based on the Basel Committee standards, the directives and regulation of the European Union (EU) on credit institutions, also taking into account the best practices in the field of banking supervision and the actual developments in the Albanian banking system.

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

[3] Starting from January 2015, banks have shifted to a new standard of calculating the capital requirements for monitoring main risks, in accordance with Basel II.

**The Laws approved by the Albanian Parliament**

- The Law "On savings and loan associations and their Unions" was approved in May 2016. The dynamics of this typology of institutions and the problems faced during the implementation of the previous law were the motivation behind the drafting of the new Law. The main purpose of drafting this Law was to consolidate the savings and loan associations market and strengthen the oversight of this sector in the conditions when these entities are already obliged to be part of the deposit insurance scheme. This law rearranged the conditions and rules for the establishment, licensing, organization, management, custody, liquidation and supervision of the SLAs and their Unions in the Republic of Albania with many changes in the number and size, as well as in the structure and organization of the activity of these entities following suit. To the other side, it triggered the need for a complete revision of the regulatory framework of licensing and supervision of these entities.
- The Law "On recovery and resolution of banks in the Republic of Albania" was approved in December 2016. It aligns partially the Albanian legislation with the Directive 2014/59/EU of the European Parliament and of the Council. Subjects of this Law are the banks licensed by the Bank of Albania that conduct their activity in the territory of the Republic of Albania. The provisions laid down in this Law define the Bank of Albania as the Resolution Authority, with a set of legal instruments to early and rapidly intervene in case of adverse development in the position of a bank, in order to ensure the continuity of its critical functions and minimize the negative effect in the economy and in the whole financial system. The Law provides four main resolution tools: ***the bridge bank, the sale of business, the asset separation and the bail-in***. In order to implement the instruments laid down in the Law, it makes provisions for the creation, use and management of the resolution fund, which would be financed mainly by the annual contribution, as well as extraordinary contributions by the banks and managed by the Deposit Insurance Agency.

**The regulatory acts fully revised /approved**

- Regulation "On minimum safety requirements on premises where banking and financial activities are carried out and on the transport of monetary values" was revised entirely. The new regulation sets out the minimum security requirements regarding the premises where banking and/or financial activities are conducted and the transportation of monetary values, for the normal and safe performance of these activities. The revision of the existing regulation was drafted in cooperation with the Safety and Security Department, and aimed to provide solutions to the various issues encountered by inspections, carried out in bank branches and agencies, in non-bank financial institutions, as well as in the foreign exchange bureaus.
- Regulation "On licensing and activity of savings and loans associations and their Unions" was revised entirely, mainly in accordance with the provisions of the new law no. 52/2016, dated 19.05.2016 "On savings and loan associations and their Unions". The new regulation lays down the conditions, requirements, time frame, documentation and procedures on: licensing of savings and loan associations (SLAs) and their Unions to perform financial activities in the Republic of Albania; granting prior approval during the exercise of the activity; obligation to notify the Bank of Albania during the

execution of the activity of SLAs and their Unions; defining the criteria for the bodies of these entities; their legal reorganization, etc.

- Regulation "On risk management in the activity of savings and loan associations and their Unions" was revised entirely, mainly in accordance with the provisions of the new law no. 52/2016, dated 19.05.2016 "On savings and loan associations and their Unions". The new regulation sets out the rules for the risk management in the activities of the savings and loan associations and their Unions.
- The "Reporting system of the savings and loan associations and their Unions" was revised entirely, mainly in accordance with the provisions of the new law no. 52/2016. The purpose of the review of the reporting system for savings and loan associations and their Unions is the fulfillment of a complete package with new forms, for the data of each individual SLA, for total SLAs, members of a Union and also for the Union itself.

**Amendments of the regulatory acts**

- Regulation "On granting the license and the exercise of banking activity of banks and branches of foreign banks in the Republic of Albania" was partially revised, to ensure compliance and consistency with the concepts used to assess the bank's financial position with other applicable documents, such as the "Supervision Policy" document and the "Risk Assessment Manual";
- Regulation "On licensing and activity of non-bank financial institutions" was partially amended to implement the action plan for the reduction of the Non-Performing Loans (NPL), and also to address some of the issues identified during the licensing practices. These amendments mainly define requests for the non-bank financial institutions (undertaking the payment services and money transfers) and the electronic money institutions, related to their agents that carry out activities on their behalf, aiming to strengthening the role and responsibility of the above-mentioned institutions to ensure the complementarity of qualifying criteria for agents, and define a subcategory of non-bank financial entities that purchase non-performing loans with the respective level of capital requirements for this type of institutions.
- Regulation "On licensing, organization, activity and supervision of foreign exchange bureaus" was partially amended to be aligned with and reflect the amendments to the Regulation "On licensing and activity of non-bank financial institutions".
- Regulation "On credit risk management from banks and branches of foreign banks" was amended for addressing the concern over the accumulation in bank balances sheet during the recent years, of assets acquired against credits' settlement, and consisted in the clarification of the writing-off process from the banks' balance sheet, and consequently recording and keeping them off-balance, the prolongation of the term for keeping these assets in the balance sheet up to seven years, applying a higher risk weight to these assets, as well as the creation of provisions for possible losses from these assets. The amendments were carried out in the framework of the Bank of Albania's commitments undertaken in the inter-institutional plan of the measures "On the reduction of non-performing loans in the banking system".
- Regulation "On Capital Adequacy Ratio", was revised at the same time and in alignment with the amendments to the Regulation "On credit risk management from banks and branches of foreign banks", and added a

requirement for applying a higher risk weight to the assets acquired against credits' settlement.

- Regulation "On the reports at the Bank of Albania accordingly to the Unified Reporting System" was partially amended regarding the implementation of the new system, ERRS (Electronic Regulatory Reporting System), where banks shall submit their reports electronically.
- Regulation "On minimum safety requirements on premises where banking and financial activities are carried out and on the transport of monetary values" was partially amended in accordance with the requirements set out in the Regulation "On licencing and activity of savings and loans associations and their Unions", for carrying out additional financial activities, including SLAs and Unions, as subjects to the requirements of this Regulation regarding the technical and security conditions, when these activities are carried out through counters.
- Regulation "On licensing and activity of non-bank financial institutions" was partially amended to comply and in accordance with the provisions of the Directive2015/2366 "On Payment Services in the Internal Market" and Directive 2009/110/EC "On electronic money institutions" as well as taking into consideration the continuous development and consolidation of electronic money institutions in the Albanian financial market, at a time when market demand for obtaining a range and variety of financial products and services is increasing. The amendments provided some exceptions regarding licensing requirements for entities or persons that provide payment's services via mobile phones or other electronic equipment only for the purchase of electronic tickets, as well as the increase of the minimum initial capital required for electronic money institutions.
- Regulation "On electronic payment instruments" was partially amended in alignment with the amendments to Regulation "On licensing and activity of non-bank financial institutions". According to the amendments, the maximum limits of the electronic money issuance were removed; both for rechargeable and non-rechargeable instruments, while it is required that the minimum and maximum limits of issuance should now be clearly stated in the contract between the issuer and the holder of electronic money.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

The main strategic directions of the supervisory authority in 2016 were in line with the medium term target of building up further risk based supervision capacities and closing further the gap of regulatory framework as opposed to best international rules and standarts:

- Building a framework to addressing non-performing loans;
- Review of the legal framework and supervisory practices related to corporate governance;
- Reshaping the organizational structure of the Supervision department and enhancement of supervisory capacities;
- Designing a formal framework of the Early Warning System;
- Further development and enhancement of the legal and regulatory framework with European standards.

# THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The fulfillment of the supervisory function is carried out in parallel with the development of internal capacities, the review and improvement of the supervisory structure, roles and responsibilities, as well as co-operation and coordination with other regulatory authorities, both within and outside the country. In addition to the usual activity for the supervision of licensed entities, the department's resources have been focused on the implementation of the Bank of Albania's mid-term strategy objectives.

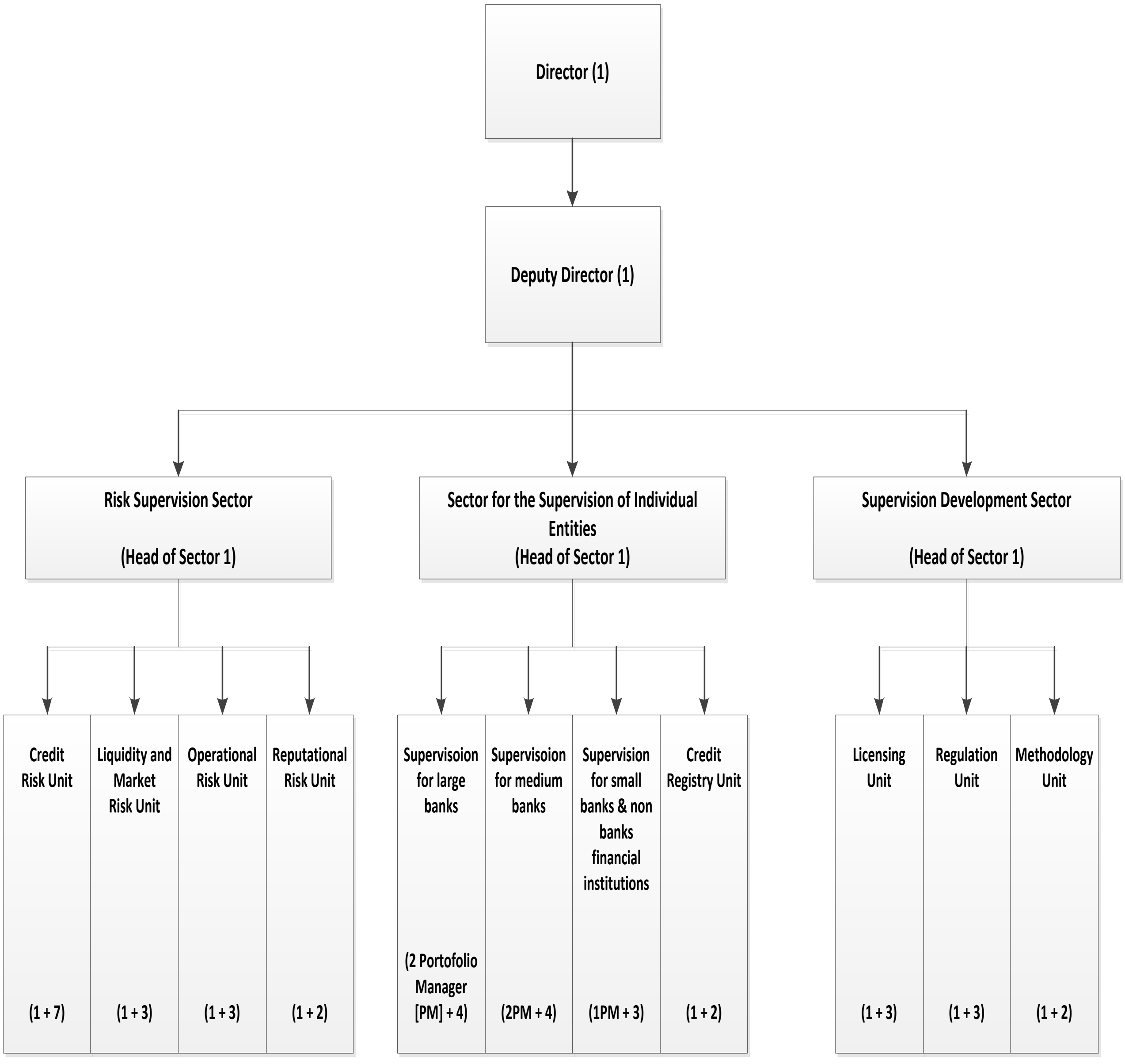
The attention of the Bank of Albania in the supervisory function has been the fulfillment of the objectives for ongoing monitoring, through on-site inspections and off-site analyzes, the level of risk of the banks and the maintenance of their management. Special attention has been paid to monitoring the risks to which financial institutions are most exposed, as well as to financial institutions which are of particular importance for the smooth functioning of the financial system in Albania. As such, close attention was paid to credit risk exposure by intensifying communication with the banking industry and pushing banks to better coordinate and address big nonperforming debtors, formulating clear strategies for debt resolution and reduction, as well as following a formal process of NPL performance monitoring through realistic budgeting and reporting to Supervision Department. To the other side, close supervision through on site supervision process following the supervisory strategy of each bank and supervisory policy, was another realm of supervision which required quite a lot of human resources allocation, to be manifested in 10 on-site inspections of banks (full and partial scope) and 19 of other licensed entities.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

The new organizational structure of the Supervision Department was effective as of May 2016. This is the first structural change since 2009. The new format was designed with aim of addressing a couple of concerns spotted out with the old organization structure, as following:

- Improving the flow of the work process and decisions making;
- Providing a better approximation with the best international practices of supervisory functions providing the limitations of local specifics;
- Providing coverage for the new work and future to come processes/commitments and the necessary flexibility to deal with them;
- Fine tuning the mix of human resources skills and numbers and creating more incentives and motivations towards a better performance.

The implementation of this structure brought as a novelty (i) a better division of duties and responsibilities; (ii) reinforcing the role of off-site analysis and (iii) enhancing the role of the Portfolio Manager.




# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

### *Cooperation with Bank of Kosovo*

During the summer of 2016 at the Bank of Albania were held several technical meetings and presentations with the supervisory staff of the Central Bank of Kosovo. These meetings aimed to exchange experiences and informing colleagues of the CBK on the main issues and challenges faced by the Albanian Supervision Department during implementation of Basel II (standard method) and transition period from Basel I to Basel II.

### *Cooperation with EBRD*

- *Credit Bureau establishment in Albania*

The European Bank for Reconstruction and Development (EBRD) has signed a Memorandum of Understanding with the Albanian Government to undertake reforms to support the investment climate and good governance. An important part of this project would be the reshaping of Credit Registry of Bank of Albania. The establishment of the Credit Bureau will be addressing the lack of a Credit Scoring System in Albania as an added value to the banking and financial system to create a complete borrowers risk profile. The Score system is foreseen as a measure to be undertaken for the reduction of non-performing loans in Albania, based on the Inter-Institutional Plan of measures designed for this purpose.

- *Review of supervisory practices on corporate governance*

Regarding its objectives on the approximation of supervisory practices with applicable practices in European Union countries as well as the drafting of regulatory framework and methodologies reflecting the latest developments, the Bank of Albania has cooperated with the European Bank for Reconstruction and Development for enabling a project that will review issues of banking risk management. The main purpose is to review the governance structures, the Steering Council and committees' composition, responsibilities and the role they should play to promote an efficient and transparent control environment; Governance with a focus on risk management, especially credit risk; Evaluation and regulation of remuneration policies; Evaluation and regulation of compliance and internal control functions.

To analyze the adequacy and potential needs for review and reassessment of the above elements, the EBRD will focus on assessing the extent of their implementation in the legal, regulatory, and internal documents that support this process. The project started in 2016 and is expected to extend even during 2017.

### *Cooperation with World Bank*

- *Law on The activity of Savings and Loan Associations*

During 2016 Supervision Department in cooperation with the World Bank have revised the legal and regulatory framework with the aim of continuously improving with EU directives and regulations and best practices. In this co-operation including stakeholders, was drafted a law on 'The activity of savings and loan associations", which was approved by the Albanian Parliament in May 2016. It consists of the regulation on the licensing process, the regulation on the risk management criteria in the activity of these entities as well as the regulation on reporting system which includes periodic information on their financial activities.

- *Law on Banking Recovery and Resolution Directive*

The law main objective is the establishment of a legal basis for emergency recovery and intervention in banks, in cases where the latter face financial crisis. Also it aims to partially approximate Albanian legislation with the Directive 2014/59 / EU of 15 May 2014 (Banking Recovery and Resolution Directive) of European Parliament and Council.

- *Platform for addressing non-performing loans*

This platform was initially introduced in October 2013 and was realised in collaboration with consultative companies ADASTRA and TPJ, supported by the World Bank FinSAC project. The purpose of this platform was to find out a sustainable solution for the difficult financial relationships of some large borrowers with the banks of the system. During 2016, some changes were made regarding the issue as below :

1. Definition of the concept of writte off loans from the balance sheet,
2. Reviewing the supervisory aproach of real estate property acquired as a result of judicial processes for the execution of non-performing loans collateral,
3. Reviewing the regulatory framework in order to facilitate the sale of non-performing loans,
4. Necessary improvements in the credit registry.

Bank of Albania in close colaboration with World Bank/FinSAC representatives have worked on 2 important issues such as co-ordination between banks regarding the solution of the 35 largest borrowers as well as the out of court restructuring debt in order to benefit from similar international practices.

### Cooperation with Bank of Italy

In order to to accomplish some recommendations of the FSAP mission, a co-operation project with the Bank of Italy was arranged for some important aspects of supervision area, as below:

- Implementation of supervisory requirements according to BAZEL III, consisting in reviewing the regulatory framework for liquidity risk.
- Revision of the regulation on "Capital Adequacy" in order to further align with the revised European directive and Basel requirements.
- Develope internal departmental capacities to provide a better estimate on the criteria used by banks for lending decision making quality, by selecting a range of most important financial indicators and setting thresholds on them, in order to assess various sectors of the economy.
- Review of Early Warning System Indicators to improve external analysis to give a fuller dimension of a risk-based approach.-
- Review of supervisory requirements on electronic money institutions related to the further development of regulatory licensing and supervisory framework of these institutions.

### Cooperation with the European Central Bank

Considering the active presence of large subsidiaries European banking groups in Albania as well as considering the establishment by the European Central Bank on November 2014, of a Single Supervisory Mechanism (SSM), the Bank of Albania and the European Central Bank were in contact through the process of drafting a comprehensive agreement that following this agreement in the coming year (2017), the Supervision Department intends to participate in some of the Supervisory Colleges for European banking groups. This is considered an important step, not only towards the strengthening cooperation with EU supervisory authorities and alignment with the most advanced supervisory practices, but also towards having a more comprehensive oversight of European banking goups operating in Albania.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN ALBANIA

During 2016, the BoA developed several activities, in cooperation with other public institutions, such as:

- 13 examinations in collaboration with Albanian Deposit Insurance Agency (ADIA)
- 3 examinations in collaboration with the General Directorate for the Prevention of Money Laundering Albanian Financial Intelligence Unit (AFIU) consisting in opinions and expertise sharing.
- 1 examination with the Albanian Financial Supervisory Authority (AFSA)
- 1 joint seminar in cooperation with GDPML and participation of all nonbank licensed entities on antimonely laundring and terrorism finance prevention law and bylaw requirements and best practices.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

In the course of the last year, in compliance with the objective of meeting Pillar II requirements, supervision function was involved in the process of laying the ground to support the banks assessment of their internal capital. As such, the development of regulatory frame and in a spirit of a guideline containing the qualitative and quantitative technical requirements was agreed to be challenged with the best practices of the field. This was a work in process which is actually finalized in the first couple of months of 2017.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 0 | 0 | 0 |
| Other domestic ownership | 10.5% | 12.4% | 11.5% |
| Domestic ownership total | 10.5% | 12.4% | 11.5% |
| Foreign ownership | 89.5% | 87.6% | 88.5% |
| **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 | 58.1% | 74.4% | 0.15 |
| Branches of foreign credit institutions | n/a | n/a | n/a |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | 58.1% | 74.4% | 0.15 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 10.53% | 13.16% | 7.15% |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | 10.53% | 13.16% | 7.15% |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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)**

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 15.31 | 17.15 | 16.95 |
| Nonfinancial sector | 38.53 | 38.38 | 36.81 |
| Government sector | 41.67 | 40.23 | 42.08 |
| Other assets | 4.49 | 4.24 | 4.14 |
| **Claims due to** | | | |
| Financial sector | 3.43 | 2.81 | 2.75 |
| Nonfinancial sector | 82.3 | 83.05 | 81.98 |
| Government sector | 1.97 | 0.98 | 2.13 |
| Other liabilities | 3.72 | 3.64 | 3.40 |
| **Capital** | 8.58 | 9.53 | 9.72 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 16.84%* | 16.04** | 15.71%** |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | **16.84%*** | **16.04%**** | **15.71%**** |

(* - 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* | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector** | 22.80 | 18.22 | 18.27 |
| **- households** | 16.50 | 13.32 | 10.18 |
| **- corporate** | 26.70 | 21.43 | 22.95 |

**The structure of deposits and loans of the banking sector in 2016 (%)
(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | | |
| Households | 14.05% | 28.09% |
| Corporate | 83.43% | 67.13% |
| Government sector | 2.52% | 4.77% |
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 67,077.22 | 63,408.48 | 57,946.07 |
| Interest expenses | 22,455.99 | 14,424.79 | 10,794.42 |
| Net interest income | 44,621.22 | 48,983.69 | 47,151.66 |
| Net fee and commission income | 7,028.58 | 7,566.37 | 8,327.07 |
| Other (not specified above) operating income (net) | -1,086.13 | -1,054.93 | -982.60 |
| Gross income | 39,456.84 | 44,939.64 | 39,360.31 |
| Administration costs | 11,819.42 | 25,871.61 | 26,346.95 |
| Depreciation | N/A | N/A | N/A |
| Provisions | 11,819.42 | 11,644.08 | 18,439.50 |
| 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 | 13,992.98 | 18,028.32 | 11,671.88 |
| Net profit (loss) | 11,192.28 | 15,699.05 | 9,720.14 |

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 1,036*** | 910*** | 910*** | 126*** | n/a |
| Cooperative banks | n/a | n/a | n/a | n/a | n/a |
| **Banking sector, total:** | 1,036*** | 910*** | 910*** | 126*** | n/a |

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

# 2016 DEVELOPMENTS IN THE ARMENIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

During 2016, the lower-than-expected economic recovery of the main partner countries of Armenia, the geopolitical tensions and the ongoing low-level of commodity prices continue to negatively impact the domestic economic activity. Meanwhile, these macroeconomic risks were mitigated due to both the continuous improvement of external demand and the easing of monetary policy by the CBA and accommodative fiscal policy of the Armenian Government. As a result, risks hindering the financial system stability were partly offset. The lackluster world economic growth in Armenia’s partner countries and shortening of remittances remain the key endogenous risks, negatively affecting the business climate and disposable income of Armenian population. Under such conditions, the economic activity slowed down to 0.2% in 2016, while a -1.1% deflation was registered.

Despite the shortening of private transfers and outbound workers’ compensation, the current account deficit-to-GDP ratio improved continually to 2.7%. However, amidst declining macroeconomic uncertainties in the region and strengthening external sector income levels, all macroeconomic risks were absorbed by the financial system due to the easing of monetary policy by the CBA and the imposed macroprudential instruments.

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

As of 31 December, 2016, 17 commercial banks and one development bank (Panarmenian Bank OJSC) operated in Armenia. The banking sector of Armenia accounts for 88.4% of the financial system assets.

The banking system assets to GDP ratio has increased by 10.3 pp. relative to the previous year and amounted 78.8%. The ratio of loans to economy to GDP has also increased, by 6.0 pp. and amounted 45.8 %.

During the year, total capital of the banking sector has grown by 27.1 % (AMD[4] 139.5 billion) and amounted to AMD 653.6 billion. 10 banks made replenishment of their statutory capital in the amount of AMD 115.0 billion, AMD 86.0 of which was replenished from external sources.

Non-resident participation in the statutory capital of the banking sector has decreased by 5.7 p.p. to 62.0%.

### *Banking System Capital Adequacy*

In 2016, commercial banks' total capital adequacy ratio increased by 3.8 p.p. to 20.0%, which was driven by the growth of total capital. All the banks maintained capital adequacy ratio within the required prudential threshold (12%).

[4] EUR/AMD exchange rate = 512.20 end of December, 2016

The share of Tier 1 capital in total regulatory capital decreased by 3.9 p. p. to 82.3%.

The share of credit, market and operational risks in the structure of risk weighted assets was respectively 86.8%, 9.7% and 3.4% (as of 31.12.2015 the indicators were respectively 89.1%, 7.3% and 3.6%).

***Banking System Liabilities***

In 2016, total liabilities of the banking system increased by 13.5 p.p. (by AMD 397.9 billion) and amounted to AMD 3 trillion 341 billion.

Both dram and foreign exchange liabilities increased by 23.8 % and 8.2% respectively. As a result, the share of foreign exchange liabilities decreased by 3.1 p.p. to 62.6 %.

***Banking System Assets***

At the end of 2016, total assets of the banking system increased by 15.5 % and amounted AMD 3 trillion 995 billion at the end of the year. Growth of assets was mainly driven by the loans granted to economy, growth of claims against CBA and government bonds. Compared with the previous year the loans to economy increased by 15.4 % and amounted AMD 2 trillion 320 billion.

Relative to the previous year, the share of non-performing loans and receivables in total loan and receivables portfolio decreased by 1.2 p.p. to 6.2%.

***Financial Performance***

In 2016, the net profit of the banking system, calculated in accordance with the Central Bank supervisory reports, amounted to AMD 31.7 billion. During the year, 15 banks reported profit and 3 banks incurred losses. Return on assets (RoA) and return on equity (RoE) of the banking system amounted 0.9 % and 5.7%, respectively. Main indicators of profitability increased due to increase of profitability of the asset unit, as well as due to improvement of quality of loan portfolio compared to last year.

The banking system net profit, calculated in accordance with International Financial Reporting Standards (IFRS), amounted to AMD 18.4 billion, while the return on assets (RoA) was 0.5 % and return on equity (RoE) 3.0 %.

# 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 2016, 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. Tackle the problems associated with collateral, which may be impediment to financial institutions and customers,
2. Promote the development of the market of derivatives and other financial instruments in Armenia,
3. Develop legislation on securities market abuse in order to make the market more transparent and protected, make it in line with the expectations of foreign investors, establish adequate sanctions for abuses and make sure an effective international cooperation is in place,
4. Prevent the organizing and administration of, and the involvement of individuals with, financial pyramids.

Changes were made to a number of sub-legislative acts, including the Republic of Armenia Law on Banks and Banking, after the Bank appeared with a legislative initiative to introduce a variety of Basel 3 requirements in consideration of buffers, a leverage standard under Basel 3 as well as certain tools of macro-prudential policy proposed by the Bank, particularly the possibility to establish the debt-to-income and loan-to-value ratios.

***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.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

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 2016, 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.

In 2016, Armenia continued efforts aimed at finalizing the implementation of risk-based supervision. It will enable, through an optimal distribution of scarce resources, to improve the effectiveness of the supervision of financial organizations. In comparison with the previous year when only 3 banks where included in the RBS project as pilot banks, during 2016, supervision of all the banks in the system was based on risk-based rules and RBS guidance manuals.

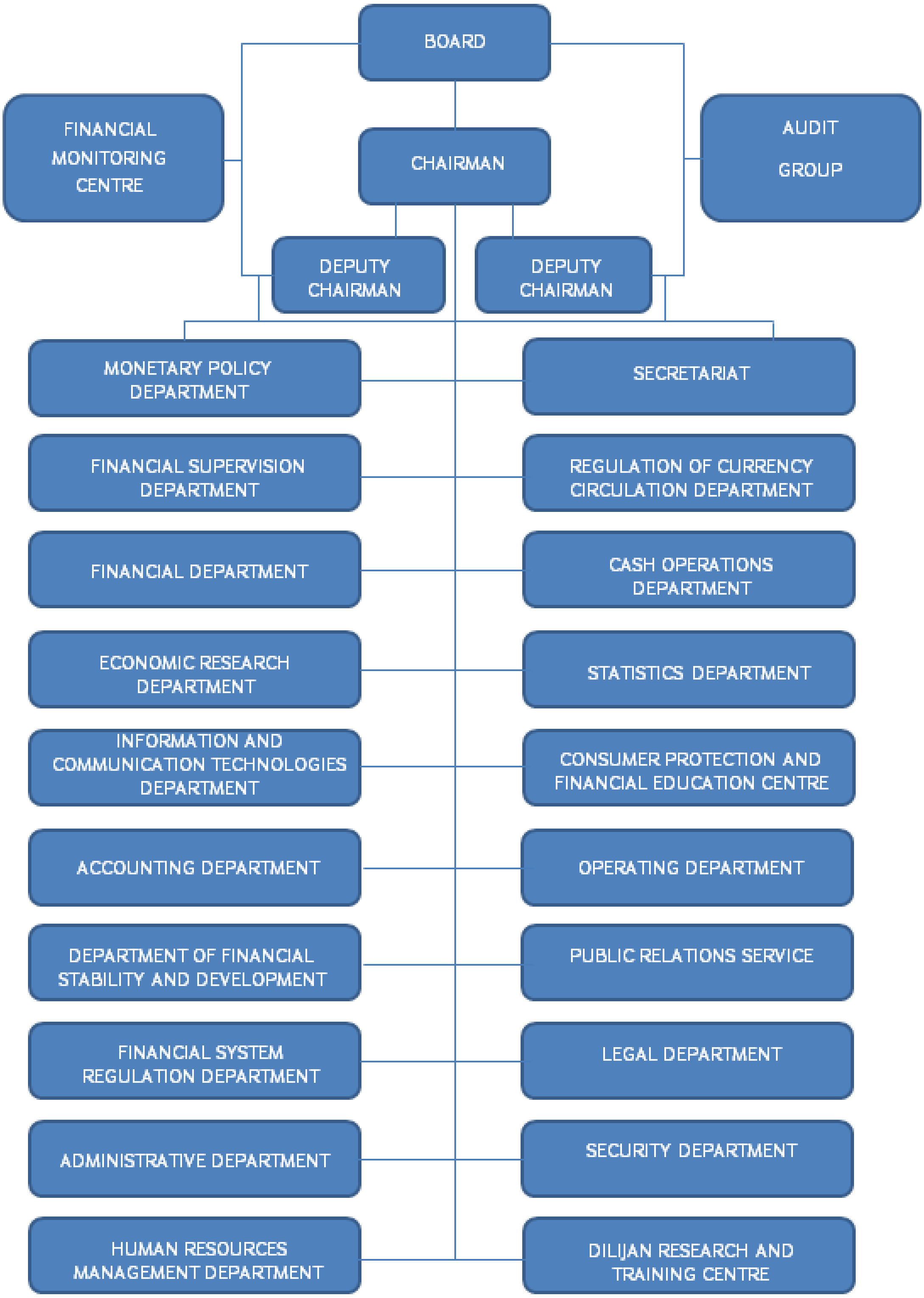
## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2016, 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.

On-site inspections are provided for both comprehensive (all-purpose) and target (specific-area) examinations. In 2016 the supervisory arm of the Bank further spent efforts to identify and evaluate the financial institutions' exposure to risks, business conduct, accuracy of reportable information, and so on. During 2016, the Bank completed 190 on-site inspections

Compared with the previous year, in 2016 the number of infringements of banks dropped in absolute value as well as in total number of infringements identified during on-site and off-site inspections performed by the Central Bank Financial Supervision Department. Compared to the previous year, the number of penalties decreased to 1.

# ORGANIZATIONAL CHART OF BANKING SUPERVISORY AUTHORITY



## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In 2016, the Bank sustained its multilateral and bilateral cooperation with international organizations and institutions elsewhere in the world.

During the year, the Bank received delegations of the International Monetary Fund, the World Bank, other international financial organizations and partner banks. The following activities are worth mentioning:

- the Memorandum of Understanding under the EBRD Early Transition Country Local Currency Lending Programme was signed between the Bank and Ministry of Finance of Armenia and the European Bank for Reconstruction and Development (March 15th, venue: Yerevan),
- the lending program "Development of sustainable housing market, phase IV " for the amount of EUR 20 million was signed between the Bank and the German KfW Development Bank (March 31st, venue: Yerevan),
- the lending program "Financing of SMEs" for the amount of EUR 50 million was signed between the Bank and the European Investment Bank (November 18th, venue: Yerevan).

In 2016, the Bank organized a series of business meetings, forums, sessions, roundtables and conferences, which were held in Yerevan, as well as other regional educational complexes of the Bank.

During the year, nearly 250 employees of the Bank attended a variety of events, including annual meetings, forums, international conferences on banking and finance, symposiums, roundtable meetings, consultations, exhibitions and workshops, in the framework of both technical assistance and bilateral and multilateral cooperation.

Highlighting the importance of stronger consumer protection and the need for further financial education, the Bank enhanced its cooperation with Organization of Economic Co-operation and Development, International Network on Financial Education, Alliance for Financial Inclusion, Eurasian Economic Community, and Child & Youth Finance International.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN ARMENIA

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

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

In pursuit of increasing the effectiveness of risk management at banks, further work was done to implement Basel 3, and the introduction of Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), which are new Basel approaches to liquidity risk management, was part of the work. Based on the LCR and NSFR reports being introduced by banks, supervisory authority made analyses in order to assess whether implementing one normative requirement or another is appropriate as well as to identify problems inherent in the domestic banking system and offer solution thereto.

In 2016, in implementation of consolidated supervision, the Bank developed and adopted policies and regulations which established procedures for recognition and de-recognition of financial groups, regulatory requirements applicable with regard to such groups, including the minimum requirements to internal control and reporting by the financial groups.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 22 | 22 | 19 |
| Branches of foreign credit institutions | 0 | 0 | 0 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total:** | **22** | **22** | **19** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 2.67 | 0.51 | 3.67 |
| Other domestic ownership | 30.81 | 99.50 | 96.33 |
| Domestic ownership total | 33.48 | 42.4 | 37.96 |
| Foreign ownership | 66.52 | 57.6 | 62.04 |
| **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 | 40.6 | 53.6 | 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 4.6% | -4.4% | 7.01 |
| Cooperative banks | n/a | n/a | n/a |
| Banking sector, total: | 4.5% | -4.4% | 7.01 |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Financial sector** | 25.40 | 28.81 | 30.94 |
| Nonfinancial sector | 61.54 | 58.52 | 53.53 |
| Government sector | 6.82 | 7.16 | 10.52 |
| Other assets | 5.81 | 6.05 | 5.98 |
| **Claims due to** | **2014** | **2015** | **2016** |
| Financial sector | 15.55 | 12.55 | 9.35 |
| Nonfinancial sector | 36.34 | 40.47 | 40.66 |
| Government sector | 1.59 | 1.34 | 1.07 |
| Other liabilities | 34.83 | 32.38 | 33.01 |
| **Capital** | **13.49** | **14.35** | **16.15** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 14.5% | 16.2% | 19.95 |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | 14.5% | 16.2% | 19.95 |

( * - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 6.8% | 7.8% | 6.7 |
| **- households** | 6.4% | **n/a** | **7.32** |
| **- corporate** | 6.3% | **n/a** | **7.75** |

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | | |
| Households | 65.61 | 36.83 |
| Corporate | 25.72 | 59.78 |
| Government sector | 1.99 | 1.06 |
| Financial sector (excluding banks) | **6.7** | **2.33** |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 482 817 | 572,701.17 | 609209.36 |
| Interest expenses | 259 488 | 355,583.55 | 376470.89 |
| Net interest income | 223 330 | 217,117.62 | 232738.47 |
| Net fee and commission income | (56 530) | (44,554.82) | 66734.78 |
| Other (not specified above) operating income (net) | 323 205 | | 20782.0 |
| Gross income | 1 045 415 | 1,339,070.83 | **1515978.42** |
| Administration costs | 97 004 | 104,609.56 | **109924.56** |
| Depreciation | 21 053 | 23,634.71 | 23597.71 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 115 537 | 203,127.47 | |
| Profit (loss) before tax | 50 239 | | 111419.37 |
| Net profit (loss) | 51 263 | (30,564.68) | 75313.71 |

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total oun funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 1261412 | 1224391 | 1008165 | 216226 | |
| Cooperative banks | | | | | |
| **Banking sector, total:** | | | | | |

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

# 2016 DEVELOPMENTS IN THE AUSTRIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

- Austria's economy is recovering, with both domestic and foreign demand driving the rebound. Having accelerated by 1.4% in 2016, real GDP is projected to grow by 2.2% in 2017, 1.7% in 2018 and 1.6% in 2019.
- At 1.7% of GDP, Austria's current account balance in 2016 had deteriorated by 0.2 percentage points against the previous year. This was due to a special effect related to company car purchases, which significantly boosted car imports and weighed on the goods balance. The balance of goods contracted from 0.4% of GDP in 2015 to −0.1% of GDP in 2016. The balance on income, by contrast, improved slightly in 2016.
- In the past few years, both the number of employed individuals and the number of registered unemployed individuals increased in tandem. Payroll employment grew at an annual 1.1% between 2012 and 2016, subdued economic activity notwithstanding. 2016 saw a turnaround in seasonally adjusted unemployment, which has declined since the closing quarter of that year. The national unemployment rate shrunk to 9.1% in 2016.
- Austrian HICP inflation increased in 2016 and stood at 1% at year-end. This increase further accelerate in the first months of 2017. The price growth was driven by energy, unprocessed food and industrial goods excluding energy. Moreover, unexpected one-off effects (e.g. weather-linked price hikes of unprocessed food) came into play.

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

- For the Austrian banking system, the adjustment process gathered pace in 2016, as reflected in a number of indicators. The total number of credit institutions in Austria declined to 672 (from 739 at end-2015, or down 22% against 2008 figures), driven by the consolidation in the cooperative banking sectors. The total number of branches decreased by 4% to 3,926 (i.e. to their 1995 level), which marks an acceleration in the downsizing of the branch network.
- In 2016, the Austrian banking sector generated a consolidated net profit of EUR 5 billion. This corresponds to a 5% decline year on year, which was, however, driven by the restructuring of UniCredit Bank Austria AG. Adjusted for this effect, profits increased by nearly 13% year on year. The return on average assets came to 0.6% and the return on average equity was around 8%. Results had been propelled by significantly lower risk provisioning.
- The profitability of Austrian banks' subsidiaries in CESEE improved in 2016 as their aggregated net profit increased to EUR 2.4 billion – this is the highest reading since 2008 despite the fact that results no longer include those of subsidiaries of UniCredit Bank Austria AG. This rise in aggregated net profit mainly resulted from a further decline in loan loss provisions.

- The (domestic) loan quality in Austria improved in 2016, as the unconsolidated NPL ratio declined to 3.5% by end-2016 due to NPL reductions. The consolidated NPL ratio declined to 4.9%.
- In the Austrian banking system, the restructuring of UniCredit Bank Austria AG significantly reduced the volume of banks' risk-weighted assets in 2016, while capital declined by less. At the same time, and adjusted for this one-off effect, Austrian banks increased their common equity tier 1 (CET1) capital via the retention of profits, which substantially improved the consolidated CET1 ratio to 14.8%.
- In 2016, total assets of the Austrian banking system (on a consolidated level) decreased by 9% yoy to 969 bn EUR. This was the fifth decline in a row. As a consequence, the size of the Austrian banking sector was reduced to 271% of the Austrian GDP.

## 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. As of 18.09.2016 the Consumer Payment Account Act (Verbraucherzahlungskontogesetz - VZKG) entered into force which is the Austrian transposition of Directive 2014/92/EU.

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. 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 490 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 2016

The banking supervision department of the FMA has set the following strategic objectives for the year 2016:

- Implementation of the Deposit Guarantee Schemes and Investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz – ESAEG)
- Strengthened attention to banking supervision activities in relation to less significant banks (LSIs) within the SSM
- Supervisory response to economic and structural changes within the banking sector in view of the current low-interest environment
- Further implementation of European standards and regulations
- Increased awareness of the impact of prudential supervision
- Promoting the transfer of information and knowledge
- Implementation of measures to enhance efficiency

## 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. Four new licences pursuant to the BWG were granted in 2016. There were no licence extensions. Overall, six licences awarded in accordance with Articles 6 and 7 BWG were declared lapsed, were revoked or relinquished during the reporting year. In the period under review, 111 credit institutions and 247 payment institutions from other Member States provided notification of taking up activities in Austria (passive notification). A total of 163 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 2016.

***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 27 notifications of a planned acquisition of holdings in an Austrian credit institution or payment institution were submitted to the FMA in 2016. 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 54 mergers of credit institutions and two demergers during the reporting period.

***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 2016 the FMA received notification of a change in managing director in a total of 214 cases, with changes to the supervisory board chairperson being notified in 89 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 279 instances of information being obtained or of documentation being inspected in this context in 2016.

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 twelve such requests for information in 2016. 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, 68 such talks were held in total.

### ***Supervisory procedures***

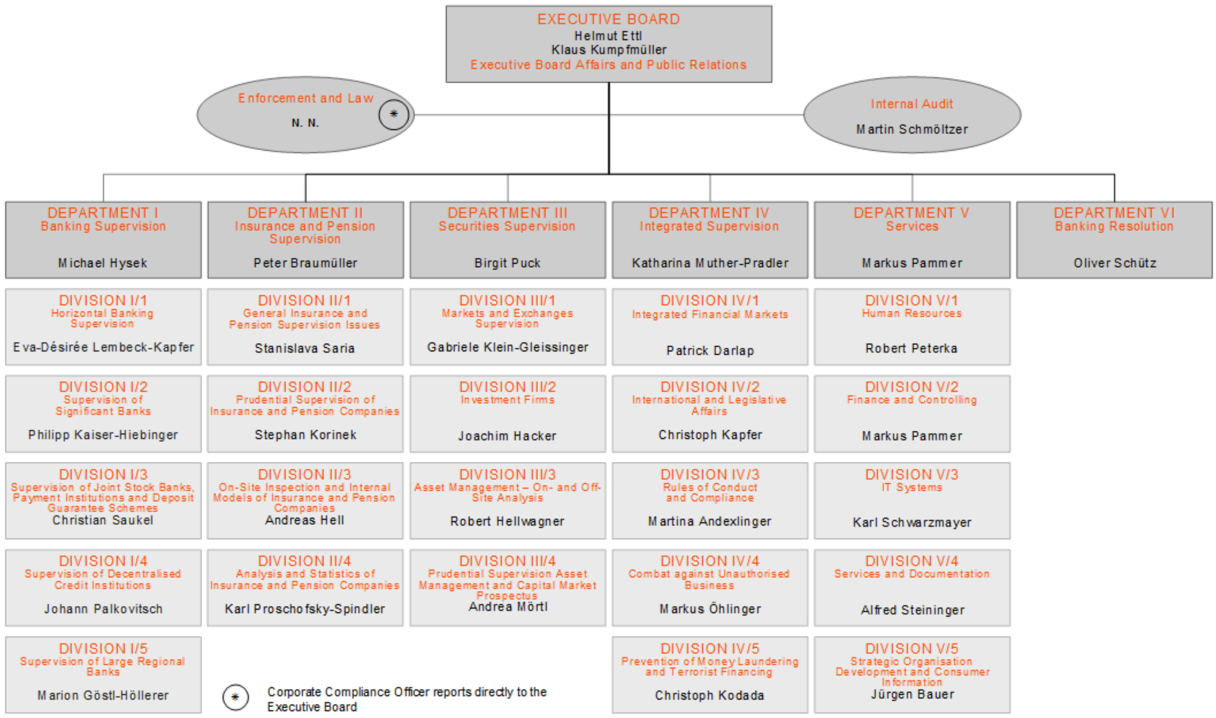
The relevant statutory provisions in regard of supervisory procedures are Articles 70 et seq. BWG and Article 64 ZaDiG. If there is a risk of a credit institution or payment institution being unable to fulfil its obligations to creditors and customers, pursuant to Article 70 para. 2 BWG the FMA may prohibit 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 2016.

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 16 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 once during the year under review. Additionally, one measure pursuant to Article 70 para. 4a no. 6 BWG was imposed (obligation to reduce risk).

***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. Four 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

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. In addition, the FMA is part of the European cooperation within 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).

## 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 183 | 180 | 176 |
| Branches of foreign credit institutions | 30 | 30 | 28 |
| Cooperative banks | 551 | 529 | 468 |
| **Banking sector, total:** | **764** | **739** | **672** |

Source: OeNB, unconsolidated data.

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 10.3 | 7.8 | 7.5 |
| Other domestic ownership | 63.1 | 67.4 | 66.3 |
| Domestic ownership total | 73.4 | 75.2 | 73.8 |
| Foreign ownership | 26.1 | 24.8 | 26.2 |
| **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 | 33.7 | 47.0 | 671 |
| Branches of foreign credit institutions | 61.5 | 70.9 | 2,511 |
| Cooperative banks | 35.2 | 45.4 | 539 |
| **Banking sector, total:** | 25.1 | 33.2 | 334 |

Source: OeNB, unconsolidated data.

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | -17.8 | 7.5 | 9.4 |
| Cooperative banks | -0.8 | 3.7 | 3.9 |
| **Banking sector, total:** | -9.9 | 6.0 | 6.9 |

Source: OeNB, unconsolidated data.

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 62.8 | 63.2 | 63.1 |
| Branches of foreign credit institutions | 1.7 | 1.7 | 2.0 |
| Cooperative banks | 35.5 | 34.8 | 34.9 |
| **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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Financial sector | n.a.* | n.a. | n.a. |
| Nonfinancial sector | | | |
| Government sector | | | |
| Other | | | |
| **Liabilities** | **2014** | **2015** | **2016** |
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks *** | 15.4*** | 16.4*** | 18.5*** |
| Cooperative banks *** | 15.3*** | 16.2*** | 17.9*** |
| **Banking sector, total:** | 15.4*** | 16.3*** | 18.2*** |

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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 4.4% | 4.3% | 3.5% |
| **- households** | 5.0% | 4.5% | 4.2% |
| **- corporate** | 4.1% | 4.2% | 3.0% |

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

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | | |
| Households | 69.9 | 44.9 |
| Corporate | 18.3 | 40.7 |
| Government sector | 6.1 | 8.5 |
| Financial sector (excluding banks) | 5.6 | 5.9 |
| **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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 20.0 | 17.3 | 15.4 |
| Interest expenses | 10.7 | 8.4 | 6.9 |
| Net interest income | 9.3 | 9.0 | 8.5 |
| Net fee and commission income | 4.3 | 4.4 | 3.9 |
| Other (not specified above) operating income (net) | 6.4 | 7.4 | 6.6 |
| Gross income | **20.0** | **20.8** | **19.0** |
| Administration costs | 11.8 | 11.5 | 11.4 |
| Depreciation | 0.8 | 0.9 | 1.0 |
| Provisions | 6.0 | 2.1 | 0.1 |
| 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 | -5.6 | 4.8 | 5.1 |
| Net profit (loss) | -6.7 | 3.7 | 4.4 |

Source: OeNB, unconsolidated data in EUR bn.

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds (for CAR) | Tier 1 | Tier 2 | Tier 2 | ~~Tier 3~~ |
|---|---|---|---|---|---|
| Commercial banks *** | 46.9*** | 38.0*** | 38.1*** | 5.6*** | n.a. |
| Cooperative banks *** | 33.8*** | 27.9*** | 28.5*** | 8.7*** | n.a. |
| **Banking sector, total: *** ** | 80.7*** | 65.8*** | 66.1*** | 14.6*** | n.a. |

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

# 2016 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF BELARUS

## MACROECONOMIC ENVIRONMENT

In 2016, the economy of the Republic of Belarus was functioning under the unfavorable external economic conditions: a fall in oil prices, a recession. The volume of GDP amounted in 2016 to BYN94.3 billion and decreased in comparable prices versus 2015 by 2.6% (in 2015 – by 3.8%).

As of January 1, 2017, the assets (liabilities)/GDP ratio totaled 68.3% (70.1% as of January 1, 2016). Regulatory capital/GDP ratio was 9.3% as at January 1, 2017.

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

As at January 1, 2017, banking sector of the Republic of Belarus comprised 24 banks and 3 non-bank financial institutions. 5 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 12.7% in 2016, amounting to 3.682 as at January 1, 2017. 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 at January 1, 2017, the share of foreign investments in the total volume of registered authorized capital of Belarusian banks stood at 16.7%, with the share of the Russian capital in banks' authorized capital accounting for 10.3%. As at January 1, 2017, the share of the State Committee on Property of the Republic of Belarus in the authorized capital of banks was 80.3% of the banking sector's aggregate authorized capital.

The total registered charter capital as at January 1, 2017 amounted to BYN4.7 billion, an increase by 5.2% in 2016.

In 2016, 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 at January 1, 2017, banks regulatory capital totaled BYN8.7 billion, a 11.4% increase in nominal term over 2016. The banking sector's capital was concentrated in five core banks – 72.0%.

In 2016, assets (liabilities) of banks increased by BYN1.420.7 million, or 2.3%, and as at January 1, 2017 reached BYN64.467 million.

The profit received by banks in 2016 amounted to BYN884.9 million (in 2015 – BYN585.9 million). The increase in profit is mainly due to the growth of net interest income as a result of reduction of interest expenses. The profit earned made it possible for banks to retain capital and maintain their resilience to possible shocks. The banking sector's return on assets totaled 1.3% (1.0% as at January

1, 2016); the return on regulatory capital was 10.8 % (8.38 % as at January 1, 2016).

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

Throughout 2016, 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.

In April 2016, the IMF and World Bank mission assessed the compliance with the updated Core Principles for Effective Banking Supervision developed by the Basel Committee on Banking Supervision during the assessment of the financial sector of the Republic of Belarus (FSAP). In general, based on the results of the assessment, the experts noted the achievement of significant progress in the development of the banking supervision system in the Republic of Belarus. Recommendations were received under 11 principles, which, in accordance with the updated assessment methodology, focus more on the practical implementation of the principles than on the availability of legal and regulatory frameworks. A plan of measures designed to implement the recommendations was developed.

To determine the banks readiness to implement Basel III liquidity indicators from January 1, 2018 as standards for safe operation, during 2016 the monitoring of banks' compliance with net stable funding and liquidity coverage ratios continued.

In order to improve the management of foreign exchange liquidity, the calculation of the liquidity coverage ratio in foreign exchange is provided for not only in the context of significant foreign currencies, but also in total for all types of foreign exchange.

The work, which commenced in 2015 and was aimed at limiting credit risk under loans granted to legal entities and individuals in Belarusian rubles at high interest rates by gradual reduction of the size of the coefficient used to determine the maximum level of the annual interest rate, at which banks are required to include a loan, granted to a legal entity, into a special portfolio of homogeneous loans, with the formation of a special reserve for such portfolios at a rate of 30% of the balance owed under credit, continued.

To improve the effectiveness of corporate governance at banks, taking into account the IMF’s and World Bank’s recommendations, as well as to further implement the updated international standards in the field of corporate governance, organization of risk management systems and internal control, additional requirements were established with regard to the composition, procedures and functions of the supervisory board (board of directors) and committees established under it, as well as requirements for the activities of external auditors and disclosure of information in this field.

In order to improve the effectiveness of interaction of the National Bank’s units participating in the inspections and the level of control over compliance with the requirements of the legislation regulating the procedures for organizing and conducting inspections, the inspection procedure is established, the stages of this process related to the planning and preparation of inspections, their conduct and preparation of materials and consideration of results are detailed. For each stage, deadlines and responsible units are defined.

# 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);
- remote 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.

The National Bank is the banking supervision authority.

# MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

In 2016, the main objective of the banking supervision development was ensuring of the stable functioning of the banking sector and protecting the interests of depositors and other creditors. Its implementation was associated with an improvement in prudential requirements and supervisory procedures and a raise in the level of all components of the supervisory process (prior supervision at the stage of state registration of banks and licensing of banks' activities; current supervision based on an individual and consolidated bases, including off-site supervision and inspections).

# THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

During 2016, the National Bank carried out control over compliance by banks with secure functioning requirements and other prudential norms and restrictions. The work designed to create equal conditions for functioning of banks and ensure fair competition was continued. The main attention was paid to ensuring the stable functioning of banks, primarily the state-owned ones, which were involved to the utmost in lending to the real sector of the economy of the Republic of Belarus. The issues of ensuring the stable and safe functioning of banks were regularly considered by the Board of the National Bank.

The work on a constant basis was carried out with the management and owners of banks with a view to increasing the capitalization of banks (primarily, to eliminate the violation of the minimum regulatory capital requirement), improving corporate governance and preventing the execution of the non-core activities by banks, as well as tackling other issues arising in the activities of banks. Implementation by banks of the measures designed to prevent the reduction of regulatory capital in real terms (adjusted for inflation) and to maintain regulatory capital adequacy at a level of at least 12 % was monitored on a constant basis.

In the framework of remote supervision, the National Bank constantly assessed the financial soundness of banks and their performance, monitored the effectiveness of risk management, especially that of the credit risk, paid attention to the prospects for the continued operation of banks, as well as the identification of problems at banks at the early stages of their occurrence.

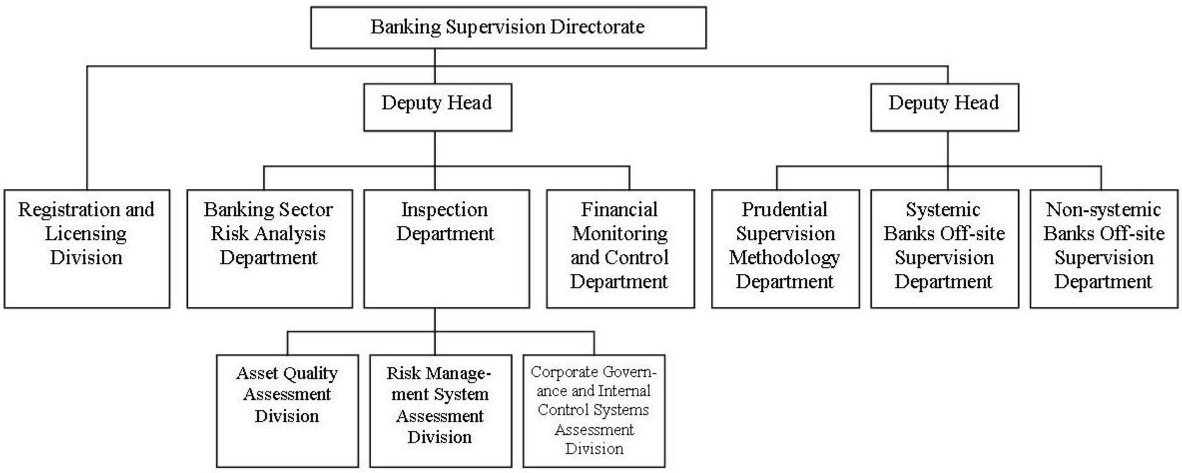
Also considerable attention was paid to the monitoring of the liquidity situation and liquidity management at banks, as well as the issues of foreign exchange risk management.

The work on improving the information and analytical system of the National Bank in order to strengthen and expand the possibilities of remote supervision continued.

Based on the results of the analysis of reports and other information in order to prevent negative trends, eliminate or prevent situations that threaten the interests of depositors and other creditors, the National Bank applied measures of supervisory response based on a reasoned judgment to banks.

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.

## ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



## INTERNATIONAL COOPERATION

As at January 1, 2017, 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 2016, 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 Cooperation between the National Bank of the Republic of Belarus and the Bank of Latvia and a Memorandum of Understanding between the National Bank of the Republic of Belarus and the State Bank of Pakistan were 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 31 | 26 | 24 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total** | **31** | **26** | **24** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 65.0 | 65.7 | 66.7 |
| Other domestic ownership | 1.2 | 2.0 | 2.6 |
| Domestic ownership total | 66.2 | 67.7 | 69.3 |
| Foreign ownership | 33.8 | 32.3 | 30.7 |
| **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 | 67.1 | 79.1 | 0.24 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **67.1** | **79.1** | **0.24** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 13.12 | 8.38 | 10.78 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **13.12** | **8.38** | **10.78** |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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)**

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | **100.0** | **100.0** | **100.0** |
| Financial sector | 2.3 | 2.7 | 2.1 |
| Nonfinancial sector | 72.0 | 66.0 | 62.5 |
| Government sector | 7.0 | 9.2 | 13.0 |
| Other assets, including | 18.6 | 22.1 | 22.4 |
| - non-resident | 2.9 | 5.2 | 6.1 |
| **Claims due to** | **100.0** | **100.0** | **100.0** |
| Financial sector | 2.8 | 2.7 | 2.9 |
| Nonfinancial sector | 49.0 | 50.3 | 52.3 |
| Government sector | 11.3 | 8.3 | 9.8 |
| Other liabilities, including | 23.3 | 26.0 | 21.6 |
| - non-resident | 18.1 | 18.9 | 18.0 |
| **Capital** | 13.5 | 12.7 | 13.4 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 17.4%** | 18.7%** | 18.6%*** |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **17.4%**** | **18.7%**** | **18.6%***** |

(* - 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)**

| Asset classification | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 4.60% | 7.60% | 14.72% |
| **- households** | 1.36% | 1.01% | 0.79% |
| **- corporate** | 5.41% | 9.11% | 18.30% |

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 88.1 | 53.0 |
| Households | 63.7 | 20.0 |
| Corporate | 24.4 | 33.0 |
| Government sector | 8.5 | 44.0 |
| Financial sector (excluding banks) | 3.4 | 3.0 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 3618.0 | 3305.3 | 3378.7 |
| Interest expenses | 2492.2 | 2295.4 | 1856.4 |
| **Net interest income** | **1125.8** | **1009.9** | **1522.3** |
| **Net fee and commission income** | **585.8** | **433.7** | **416.5** |
| **Other operating income (net)** | **-1049.0** | **-823.3** | **-974.7** |
| **Net provision assignments** | **313.0** | **800.2** | **690.6** |
| **Net other income** | **278.1** | **544.1** | **231.6** |
| Gross income | 11415.0 | 9532.4 | 12213.7 |
| **Profit (loss) before tax** | **627.7** | **364.2** | **505.1** |
| Income tax | 99.6 | 75.6 | 72.4 |
| **Net profit (loss)** | **528.1** | **288.6** | **432.7** |

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 4274.4*** | 3253.0*** | 3254.3*** | 1020.1*** | - |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | **4274.4*** ** | **3253.0*** ** | **3254.3*** ** | **1020.1*** ** | **-** |

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

# 2016 DEVELOPMENTS IN THE BANKING SYSTEM OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

## MACROECONOMIC ENVIRONMENT

In the third quarter of 2016, real GDP growth was 2.4%[5] in annual terms, which is already the eighth consecutive quarter to record positive GDP growth. Growth in the aforementioned quarter was faster by 1.2 percentage points compared to the second quarter.

The fourth quarter of 2016, in annual terms, is characterised by an increase in industrial production, which was recorded in all three months of the observed quarter. The annual deflation rate, present since mid-2013, significantly decreased in the fourth quarter, amounting to 0.3% at the end of 2016.

Commercial banks service receivables due on the basis of loans taken from non-residents and generally do not have significant additional debt. The trend of increase in deposits continued. Data on average weighted interest rates for the fourth quarter of 2016 indicate that the trend of decrease in interest rates on loans and deposits continued.

Total loans in the banking sector amounted to KM 17.02 billion at the end of 2016, constituting an increase in the amount of 2.0% on annual basis and 1.0% on a quarterly basis. In the case of short-term loans, an annual increase was recorded with non-financial companies. The retail sector retained a larger share in the total loan portfolio over the last quarter. During the fourth quarter, banks primarily directed credit activity towards the private sector via facilities in the amount of KM 1.84 billion, 61.6% of which accounts for loans to non-financial companies and 38.4% for the retail segment.

Total deposits of commercial banks amounted to KM 17.75 billion at the end of 2016, constituting an increase in the amount of 7.4% on an annual basis and 3.1% on a quarterly basis. An increase in deposits at the quarterly level was recorded with both the government and non-government sector. Government sector deposits, with a share of 9.6% in total deposits, recorded an increase on an annual basis since October 2015. Retail deposits made the largest contribution to the increase total deposits in the last quarter of 2016. The average weighted interest rates on consumer loans and loans that are in the category of other loans, which mostly consist of cash loans, were equal to 7.1% in the last quarter of 2016, while the average weighted interest rate on housing loans is lower than the aforementioned by 1.8 percentage points. The category of other loans makes up about 90% of the total new contracted loans.

[5] Preliminary data used by the Central Bank of BiH – Newsletter, 4th quarter of 2016

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

In 2016, positive trends were recorded and they are reflected in the increase in the balance sheet total, loans, deposits, especially retail savings, as well as the improved profitability of the entire banking sector. On the basis of everything, it can be concluded that the banking sector has remained stable, adequately capitalised, with liquidity still being satisfactory.

As of 31.12.2016, 15 banks in the Federation of BiH had a banking licence. The number of banks is lower by two banks compared to the end of 2015 (17 banks) due to status changes of mergers. As of 31.12.2016, the number of employees was 6 615, down by 1% or 68 employees compared to the end of 2015.

In 2016, the positive trend of balance sheet total growth continued (for the fourth consecutive year) and it is expected that the same trend will continue in the period to come as well. The balance sheet total of the banking sector as of 31.12.2016 amounted to KM 18.4 billion, up by KM 1.2 billion or 7.1% compared to the end of 2015. The balance sheet total growth with respect to sources (liabilities) is primarily the result of an increase in deposits and total capital, while the trend of reduced loan commitments continued in 2016 as well.

Loans, as the largest assets item of banks, increased by 5.7% or KM 659 million in 2016, amounting to KM 12.3 billion at the end of the year. In 2016, positive trends were also recorded in the segment of sectoral lending, i.e. greater lending to private companies compared to the retail segment. Loans to private companies recorded a growth rate of 8% or KM 428 million in 2016, so that loans to this sector amounted to KM 5.8 billion and had a share of 46.9% as of 31.12.2016. Retail loans recorded a growth rate of 5% or KM 266 million in the same period, while their share slightly decreased from 49.1% to 48.7%. As of 31.12.2016, they amounted to KM 6 billion.

Loan quality indicators improved in 2016 as well, as was the case in the previous year, which particularly impacted the corporate sector. A somewhat higher increase in the loan portfolio, a lower 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 is down from 12.9%, to which it amounted at the end of 2015, to 11.7% as of 31.12.2016.

Cash funds amounted to KM 5.2 billion or 28.3% of the balance sheet total of banks in the FBiH and recorded an increase of 7.1% or KM 347 million in 2016.

In the structure of banks' sources of funding, deposits in the amount of KM 14.2 billion are the most significant source of funding for banks in the FBiH, with their share increasing to 77.1% (at the end of 2015: 76.3%) in 2016. In 2016, deposits recorded an increase in the amount of 8% or KM 1.1 billion. Savings deposits, as the most important and largest segment of the deposit and financial potential of banks, maintained a positive trend of growth and amounted to KM 7.9 billion at the end of 2016, which is up by 9.1% or KM 662 million compared to the end of 2015.

As of 31.12.2016, the total capital of banks amounted to KM 2.7 billion (share capital: KM 1.2 billion), up by 5.4% or KM 138 million compared to the end of 2015. The capital adequacy ratio of the banking system, as one of the most important indicators of the strength and capital adequacy of banks, was 15.7% as of 31.12.2016, which is up by 0.6% compared to the end of 2015, when it amounted to 15.1%, but still significantly above the legal minimum (12%), which represents a satisfactory capitalisation of the overall system and a strong foundation and basis for preserving its security and stability. The financial leverage ratio at the level of the banking system amounted to 9.7% as of 31.12.2016 (prescribed minimum: 6%).

Banks in the Federation of BiH have recorded the best financial result since 1996, i.e. profit in the amount of KM 173 million.

# 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 (new changes in 2016):

- Decison on Minimum Standards for the Content of Factoring Agreements („Official Gazette of the FBiH, No. 70/16),
- Decision on Minimum Standards for the Requirements and Manner of Performing the Business Activities of Factoring Companies („Official Gazette of the FBiH, No. 70/16),
- Decision on Minimum Standards for the Criteria, Rules and Additional Requirements for Capital in Factoring Companies („Official Gazette of the FBiH, No. 70/16),
- Decision on Minimum Standards for the Criteria and Decision-Making Procedure on Issuing Approvals for Acquiring or Increasing Qualifying Shares in Factoring Companies and of Factoring Companies in Another Legal Entity („Official Gazette of the FBiH, No. 70/16),
- Decision on Minimum Standards for Detailed Requirements and the Manner of Issuing Operating Licences to Factoring Companies in Domestic Factoring („Official Gazette of the FBiH, No. 70/16),
- Decision on Minimum Standards for the Requirements to be Met by Members of the Factoring Company Supervisory Board and Management („Official Gazette of the FBiH, No. 70/16),
- Decison on Minimum Standards for the Criteria and Manner of Risk Management in Factoring Companies („Official Gazette of the FBiH, No. 70/16),
- Decison on Minimum Standards for the Manner of Conducting Internal Audits in Factoring Companies („Official Gazette of the FBiH, No. 70/16),
- Decision on Minimum Standards for the Structure, Content, Manner and Deadlines for Submitting Factoring Company Information and Reports to the Banking Agency of the Federation of Bosnia and Herzegovina („Official Gazette of the FBiH, No. 70/16, 85/16-corr., 104/16),
- Instructions for Filling out Financial and Other Reports Factoring Companies Are Obliged to Draft for the Purposes of the Banking Agency of the Federation of BiH, No. 4203/16 from 24.10.2016,

- Instructions for Drafting Reports on the Calculation of Capital of Factoring Companies, No. 4204/16 from 24.10.2016;

**B) <u>Legal competences of the Agency:</u>**

- issuance of licences for the establishment and operations of banks, microcredit organisations, leasing companies, factoring companies, issuance of licences for changing the organisational structure of banks and microcredit organisations and leasing companies, issuance of approvals for the appointment of their managerial staff,
- supervision of banks, microcredit organisations, leasing companies, factoring companies and supervision of authorised exchange offices as well as implementation of measures in accordance with laws and regulations,
- revocation of operating licences of banks, microcredit organisations, leasing companies, factoring companies in accordance with the law,
- appointment of provisional and liquidation administrators in banks, supervision of provisional administration and liquidation of banks, monitoring of liquidation proceedings of microcredit organisations and filing requests for insolvency proceedings against banks and microcredit companies;
- adoption of by-laws regulating the operations of banks, microcredit organisations, leasing companies, factoring companies and authorised exchange offices;
- collection, processing and recording of data banks, microcredit organisations, leasing companies, factoring companies and authorised exchange offices submit to the Agency in accordance with regulations;
- aiding anti-terrorist measures related to banks, microcredit organisations and leasing companies at the request of the competent authority, in accordance with the applicable law;
- taking all necessary actions, including freezing client accounts in any bank on the territory of the FB&H in order to prevent the financing of activities that obstruct or threaten to obstruct the peace implementation process as pursued under the aegis of the General Framework Agreement for Peace in Bosnia and Herzegovina in accordance with special law;
- promotion and protection of the rights and interests of consumers, i.e. natural persons as users of financial services.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

As was the case in previous years, the Agency's activities are aimed at maintaining a strong and stable banking, microcredit and leasing system, market-oriented and based on international standards of business operations and supervision of banks, microcredit organisations, leasing companies, authorised exchange offices as well as factoring companies, and thus activities are planned with respect to:

- taking measures and activities within its competences for the purpose of implementing measures from the Reform Agenda and the Economic Reforms Programme that are related to the banking and financial sector;

- continuing the implementation of the FSAP Mission's recommendations for the purpose of improving the quality of supervision;
- continuing the drafting of the regulatory framework, preparing and adopting a significant number of new by-laws in accordance with the new Law on Banks and the Law on the Banking Agency of the FBiH and the adopted Strategy for the Implementation of Basel III and the annual plan for drafting regulations, for the purpose of implementing Basel III and EU Directives and as part of the preparations for the accession of BiH to the European Union;
- reorganising the Banking Agency and establishing an internal organisational unit for conducting bank restructuring operations, preparing and adopting by-laws related to bank restructuring following the adoption of the new Law on the Banking Agency of the FBiH;
- launching the SREP preparation and implementation project as a long-term (three-year) project of strengthening and improving supervision in accordance with the new regulatory framework;
- taking measures and activities within its competencies in the interest of safer and more stable business operations of banks and the banking system as a whole;
- continuing ongoing banking supervision by means of inspections via reports and on-site inspections with a focus on the inspection of dominant risk segments of banking operations for the purpose of more efficient supervision and in that sense:
    - continuing to insist on the capital strengthening of banks, especially those recording an above average increase in assets and decrease in the capital adequacy ratio,
    - continuing with the permanent monitoring of banks, primarily those of systemic importance to the development of lending activities in which a large amount of savings and other deposits is concentrated, in order to protect depositors,
    - continuing to systematically monitor banks' activities in terms of preventing money laundering and terrorism financing and improving cooperation with other supervisory and control institutions,
    - reviewing and regularly updating the contingency plan as part of crisis preparedness,
    - continuing to develop and implement the „Early Warning System" (EWS) for the purpose of early identification of financial and operational inefficiencies and/or negative trends in banks' operations,
    - monitoring the compliance of banks with laws and regulations and practices applied in banks in the segment of the protection of users of financial services and guarantors,
    - continuing cooperation with the ECB and EBA and information exchanges in terms of banking supervision, as well as with the international financial institutions, the IMF, the WB, the EBRD, etc.,
- conducting the new AQR cycle in 2017, which includes 8 banks and approximately 75% of the banking system of the FBiH;
- accelerating the completion of liquidation proceedings.

# THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2016, the Agency's activities regarding banking supervision were aimed at preserving the stability and security of the banking sector by continuously analysing the situation in banks in the FBiH, planning and conducting inspections and taking corrective and other measures in accordance with legal powers. Joint on-site inspections with the BARS were carried out, as well as joint on-site inspections with the ECB and the regulator from Turkey in individual banks. The Agency actively participated in the implementation of the obligations from the Letter of Intent signed by the governments in BiH in relation to the arrangement with the IMF, where the Agency was designated as the bearer of the activities (drafting a new regulatory framework, conducting the AQR, strengthening banking supervision, etc.) In 2016, the second round of the AQR continued, in which five banks from the FBiH participated in accordance with the approved criteria. Activities on improving the bank monitoring system through the development of additional off-site supervision tools continued: the EWS and the „Risk Matrix", which additionally improves the consistency of the methodology for planning banking supervision and control.

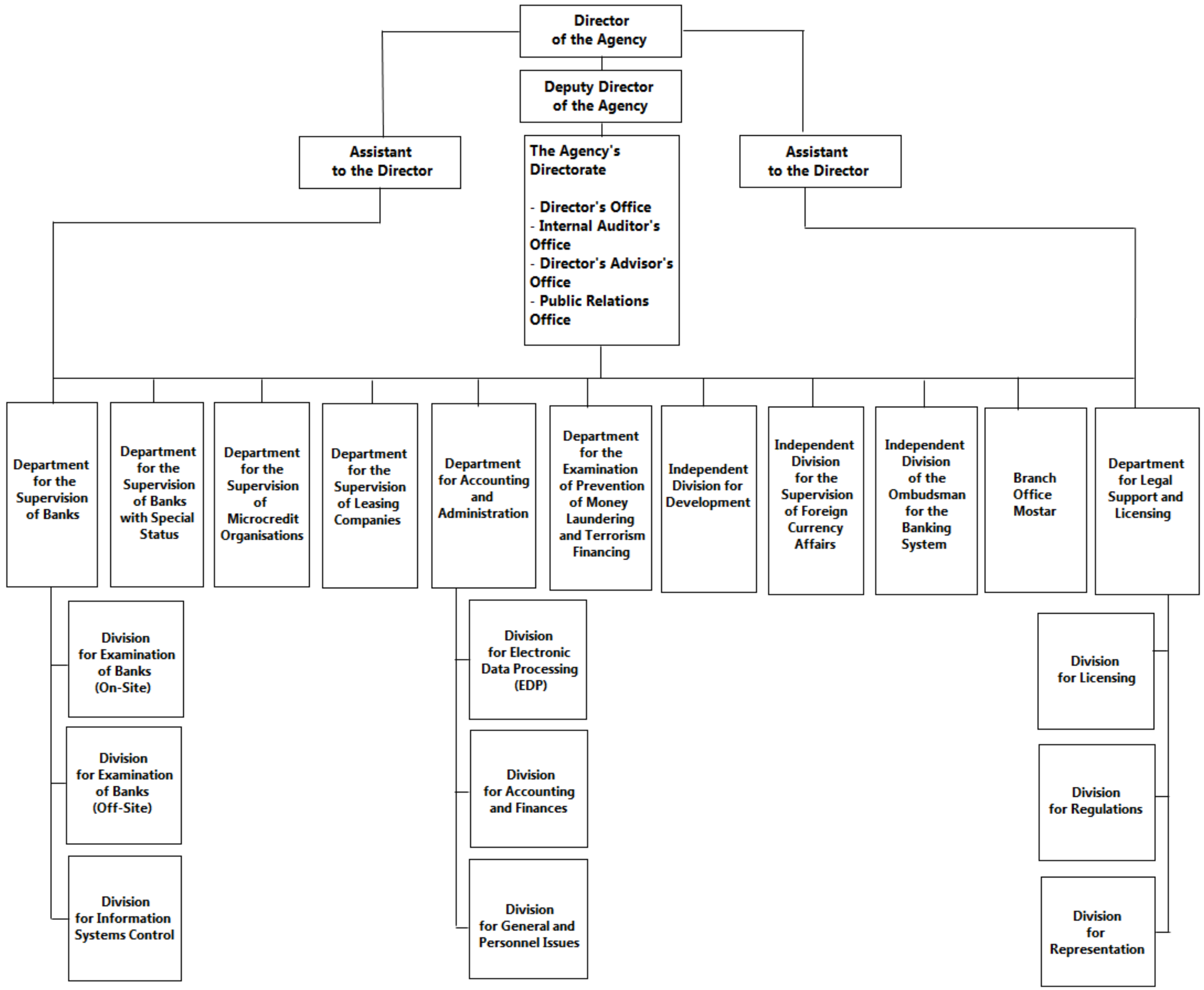
In cooperation with the CBBH and the BARS, the development of the methodology and use of stress tests for credit risk and the impact on capital continued, based on macroeconomic assumptions, as well as the familiarisation of banks with the results of the conducted stress tests. In 2016, cooperation on improving the Criteria and establishing a list of systemically important banks continued.

Together with representatives of the IMF Mission, the Agency regularly quarterly reviewed and analysed the impact of the consequences of the global economic and debt crisis on the domestic banking and financial sector, trends in the banking sector, the capitalisation of banks in the FBH, the results of stress tests for the banking system and for individual banks, the current regulatory and banking legislative framework, the fulfillment of the recommendations from previous IMF Missions, as well as the planned changes in the regulatory framework. The IMF also provided technical assistance in drafting the proposals of the Law on Banks and the Law on the Banking Agencies, and the World Bank in conducting the QIS study, improving the AQR framework and education in the area of recovery plans.

Activities aimed at implementing the Agency's Strategy for the Introduction of Basel III continued. In coordination with a team from the BARS, the process of holding a public hearing within the banking sector in BiH through the Banks Association of BiH was completed with regard to the regulatory framework from the Pillar 1 and Pillar 1 segments. All activities related to conducting two Quantitative Impact Studies (QIS) of the introduction of new regulatory requirements were completed. The objective of the QIS was to examine the effects of the new regulatory requirements of the EU on the banking system in terms of regulatory capital, the calculation of capital requirements for credit, operational and market risk when using a standardised approach, the financial leverage ratio, liquidity coverage requirements (LCR), risk management, the ICAAP, large exposures and interest rate risk in the banking book. The QIS results showed that new regulatory requirements in line with the EU regulatory framework would not have a negative impact on the banking system in the FBiH.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

**Organisational Structure of the Banking Agency of the Federation of Bosnia and Herzegovina as of 31.12.2016**



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In 2016, the Agency, in cooperation with the CBBH and the BARS, continued activities to strengthen and improve 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 signed with Austria, a bilateral agreement on cooperation in the area of supervision of the Addiko Group (formerly the Hypo Alpe Adria Group) was signed, and Agency representatives participated in the college of banking supervisors of the Addiko Group in January and December 2016, which was organised by Austrian supervisory authorities. Also, in June 2016, Agency representatives participated in the college of banking supervisors of the NLB Group organised by the ECB and the Bank of Slovenia.

In the context of bilateral cooperation, the Agency established cooperation with the following banking regulatory authorities in 2016: Slovenia – regular information exchange with the Bank of Slovenia as part of the supervision of the NLB Group (quarterly newsletter, drafting of an annual SREP, participation in the college of the NLB Group in Slovenia), Austria – regular information exchange (quarterly newsletters) with the FMA on banking groups and their subsidiaries in the FBiH (Raiffeisen, Addiko, Sparkasse and Sberbank), an annual SREP for Addiko Bank, participation in the supervisory college of the Addiko Group, as well as several bilateral meetings regarding the supervision of the Addiko Group and the restructuring process approved by the EC, and Turkey – regular information exchange with the BRSA (bilateral meeting as part of the supervision of ZiraatBank BH dd Sarajevo, as well as the participation of BRSA supervisors in the Agency's on-site inspection of ZiraatBank BH).

In December 2016, an MoU on mutual cooperation in the area of supervision of credit institutions was signed with the Federal Financial Supervisory Authority of Germany („BaFin"), and the signing of one with the Central Bank of Russia is in progress.

In early July 2017, negotiations about signing a Memorandum of Understanding with the European Central Bank began.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN BOSNIA AND HERZEGOVINA

In 2016, cooperation with competent institutions in BiH continued. Cooperation with the BARS and the Deposit Insurance Agency of BiH continued within the framework of regular information exchange and joint activities, and also within the framework of drafting new regulations with the BARS. There was also a continuous exchange of information within the framework of banking coordination and the Standing Committee for Financial Stability (SCFS) was realized. Cooperation was established with the Banks Association of BiH, both regarding the application of existing regulatory solutions and proposals for their modification, and in the process of adopting new regulatory solutions.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS

Activities of the Banking Agency of the FBiH regarding the process of harmonisation with the provisions of the new Law on Banks, which was adopted in April 2017, are in progress. A set of draft regulations has been prepared in the Banking Agency of the FBiH, which will be in force within 6 months following the entry into force of the new Law on Banks, with the exception of the regulatory framework in the segment of bank restructuring, for which the deadline for harmonisation is 9 months following the entry into force of the new Law on Banks.

The regulations that are in the process of being drafted include the following: the harmonisation of the existing regulatory framework with the provisions of the new Law on Banks, a new regulatory framework that will be the subject of a public hearing, as well as draft decisions within the framework of the activities of the Banking Agency of the FBiH regarding the preparations for the introduction of Basel III, with these having gone through the public hearing process.

The draft regulatory framework that is in the process of being prepared constitutes, among other things, a harmonisation with European directives in the area of capital, risk management, corporate governance, prescribes minimum requirements for the disclosure of data and information of banks, control functions in banks, the conditions and manner of buying and selling banks' facilities, recovery plans for banks and banking groups, consolidated requirements for the banking group, etc. The aforementioned regulatory framework will be published in the Official Gazette of the FBiH.

The Agency actively participated in the process of answering the EC Questionnaire submitted to BiH.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 17 | 17 | 15 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **17** | **17** | **15** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 2,3 | 2,8 | 2,8 |
| Other domestic ownership | 7,0 | 6,8 | 6,4 |
| Domestic ownership total | 9,3 | 9,6 | 9,2 |
| Foreign ownership | 90,7 | 90,4 | 90,8 |
| **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 | 56,9 | 69,8 | 1416 |
| Branches of foreign credit institutions | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | 56,9 | 69,8 | 1416 |

*Whole percentages are used.

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 4,8 | 5,7 | 7,6 |
| Cooperative banks | | | |
| **Banking sector, total:** | 4,8 | 5,7 | 7,6 |

*Return on average equity (ROAE).

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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)**

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 16,0* | 15,1* | 15,7* |
| Cooperative banks | | | |
| **Banking sector, total:** | 16,0* | 15,1* | 15,7* |

(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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector* | 14,0 | 12,9 | 11,6 |
| **- households** | **9,7** | **9,0** | **8,2** |
| **- corporate** | **18,4** | **16,8** | **15,0** |

*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 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 86,4 | 97,5 |
| Households | 60,3 | 48,7 |
| Corporate | 26,1* | 48,8 |
| Government sector | 8,9 | 2,2 |
| Financial sector (excluding banks) | **4,7** | **0,3** |
| **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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 770.716 | 766.124 | 752.156 |
| Interest expenses | 224.418 | 196.630 | 165.147 |
| Net interest income | 546.298 | 569.494 | 587.009 |
| 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* | **872.219** | **917.455** | **969.238** |
| Administration costs | **248.007** | **248.495** | **243.892** |
| Depreciation | n/a | n/a | n/a |
| Provisions | 148.251 | 157.747 | 111.305 |
| 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 | 138.386 | 144.697 | 202.301 |
| Net profit (loss) | 115.520 | 117.486 | 173.248 |

*Net interest income and gross operational income.

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 1.094.369* | | 1.050.969* | 145.676* | |
| Cooperative banks | | | | | |
| **Banking sector, total:** | 1.094.369* | | 1.050.969* | 145.676* | |

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

# 2016 DEVELOPMENTS IN THE BANKING SYSTEM OF REPUBLIKA SRPSKA OF BOSNIA AND HERZEGOVINA

## MACROECONOMIC ENVIRONMENT

A growth in total economic activity in Republika Srpska (hereinafter: RS) was seen in 2016 at an inter-annual level. Thus, following the 2.5% growth in Q1, RS GDP grew at 2.0%, 3.4% and 3.6% in Q2, Q3 and Q4, respectively, that equals average growth of 2.9% in 2016.

Also, in 2016 the RS industrial production grew by 8.2%, (2016/2015), which was a continuation of the growth from the previous period. The production growth was achieved due to a rise in the sector of electricity, gas, steam and air condition supply (25.3%) and manufacturing (3.5%). However, besides an increased production, the RS export increased by 9.6% in the observed period, while import registered only a slight increase by 0.8%. Coverage of import with export was 65.0%.

In 2016, the average net salary in RS amounted to EUR 427.4 and it is nominally higher by 1.8% if compared to the previous year. An inter-annual deflation rate of -1.2% was registered in the period from January to December 2016.

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*,[6] economic growth of emerging and developing countries in Europe and Bosnia and Herzegovina in 2017 is projected to 3.0%, which correspondents to RS Government projections.[7]

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

The banking sector of RS at the end of 2016 consisted of eight banks, out of which six banks were with majority foreign private ownership, while two banks were in majority private domestic ownership.

Difficulties in real sector over previous years and in 2016 influenced the situation and prospects of the banking sector, which led to increase of credit risk and increased importance of liquidity risk management.

Taking into account the banking sector results generated in 2016, 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

[6] *World Economic Outlook*; IMF, April 2017
[7] *Economic Reforms Program*, Government of Republika Srpska, December 2016

licenses over the last two 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 31/12/2016:

- total balance sheet amounted to EUR 3.9 billion and remained approximately at the same level as of 31/12/2015.
- cash funds (EUR 0.8 billion) accounted to 23% out of total balance sheet assets with an increase rate of 10% when compared to the previous year. Out of total banks' cash funds, 35% was cash funds at accounts abroad (foreign currency current accounts and the funds termed up to 30 days).
- total gross loans (EUR 2.3 billion) decreased by 6%, mostly resulting from a decrease of loans to the Government and its institutions (-18%), public and state enterprises (-10%) and private enterprises (-7%). At the same time, loans to households remained the same as they were in the previous year.
- share of non-performing loans in the total loan portfolio decreased by 3.6 percentage points in comparison to the end of 2015 (from 15.6% to 12.0% as of 31/12/2016).
- average coverage rate of total loans by the value adjustments under IAS was 9.3% (as of 31/12/2015 amounted to 11.3%).
- deposits (EUR 2.6 billion), as a basic source of funding bank operations, had a share of 75% out of total bank liabilities and increased by 1% when compared to 2015. Since 2011, deposits have had a trend of increase.
- trend of growth in households' deposits continued also in 2016 and increased by 6% compared to 31/12/2015. Share of households' deposits in total deposits increased from 53% to 56%. Total short-term and long-term deposits had a share of 59% and 41% in total deposits, respectively.
- banks' total capital (EUR 0.45 billion) accounted to 13% of total liabilities and increased by 14% when compared to 2015, due to the recapitalization of three banks, increase of capital reserves by 11% and significant drop in the negative item "other capital" by 49% relating to uncovered losses from previous years and current period (three banks).
- average capital adequacy ratio amounted to 16.3%, while as of 31/12/2015 it was 14.1% (legally required minimum is 12%).
- at the level of total banking sector as of 31/12/2016, a net positive financial result was reported in the amount of EUR 23.2 million (as of 31/12/2015, the banking sector reported a negative financial result of EUR 43.9 million). Two banks operated with a loss amounting to EUR 13.4 million, while six banks generated a profit in the amount of EUR 36.6 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:**

- Amendments to the Law on Anti Money Laundering and Terrorism Financing ("Official Gazette of Bosnia and Herzegovina", no. 46/16);

It is important to mention that at the beginning of 2017, the new Banking Law 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, 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.

**Amendments to prudential regulation governing the operations of financial institutions issued by the BARS:**

- Decision on amendments to the Decision on minimum standards for market risk management in banks ("Official Gazette of Republika Srpska", no. 115/16);
- Decision on Amendments to the Decision on minimum standards for bank capital management and capital buffers ("Official Gazette of Republika Srpska", no. 21/17).

The prudential regulation aligned with new Banking Law is under preparation.

**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 rightsand 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.

# MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

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;
- continuous monitoring primarily of systemically important banks;
- 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;
- undertaking activities and adopting measures within the competence of the BARS in order to increase the overall credit activity, with focus on support to the economy during financial instability in Republika Srpska and environment;
- detailed reviews of asset quality in banks that had a high rate of credit growth;
- work on regulations addressing the problematic banks;
- further development and improvement of supervision with technical assistance provided by international institutions;
- active role in supervision and protection of financial services consumers' rights;
- professional training of staff and strengthening capacity for efficient supervision of banks, and further continuous development of information system;
- implementation of FSAP mission recommendations (Financial Sector Assessment Program) for banking supervision and continued cooperation with the relevant international financial institutions;
- 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;
- together with other competent institutions, members of the Standing Committee for Financial Stability in BiH - SOFS, continue to work on improving the framework for crisis management and updating of contingency plans;
- continuation and improvement of cooperation with the Banks Association, the Association of microcredit organizations in BiH and the Association of Leasing Companies;
- monitoring of international and EU banking and accounting standards and development of own supervisor capacities for creation, incorporation and enforcement of new regulatory framework in our regulation in accordance with the Strategy for implementation of Basel III and new

Banking Law, in cooperation and coordination with relevant home and foreign institutions.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2016, operating license was revoked for one bank, while one microcredit organization was issued an operating license. As of 31/12/2016, the banking system of RS consisted of 8 banks, 9 microcredit organizations and 1 leasing company.

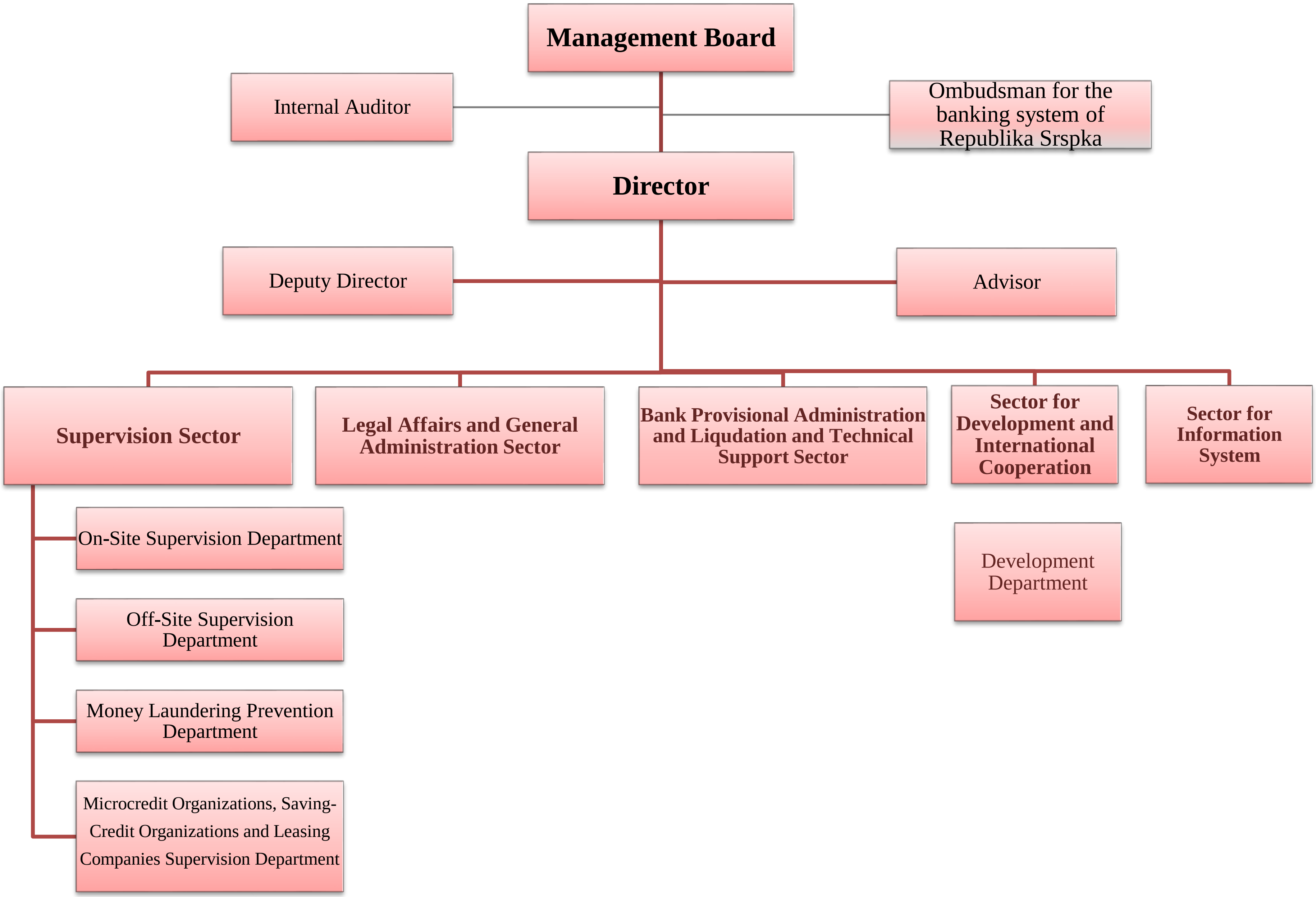
In 2016, the BARS activities were aimed at maintaining the stability and improvement of the quality and legality of the RS banking system operations, on the basis of continuous supervision of banks, microcredit organizations and leasing companies.

In addition, the BARS continued to control the operations of financial organizations through the off-site and on-site supervision, primarily by means of monitoring the solvency, liquidity, capitalization and profitability of all individual financial organizations, as well as the system as a whole. The BARS orders were primarily aimed at the strengthening of capital, improving of loan policies and consistent application of the same, improving the management of credit and liquidity risk. In addition, a special attention was also dedicated to the control segments which were related to the assessment of harmonization of banks, microcredit organizations and leasing companies with the standards for the prevention of money laundering and terrorism financing, as well as ensuring and improving the protection of rights and interests of the banking service consumers.

In the reporting period, other activities of the BARS can be summarized as:

- the BARS continued with the activities on strengthening and improving the cooperation with international and domestic institutions, regional and other organizations, as well as bilateral cooperation with regulators from other countries;
- The new Strategy for Implementing Basel III was adopted and the BARS continued to perform the activities on preparation of new by-laws in accordance with this Strategy;
- In cooperation with the Central Bank of Bosnia and Herzegovina and International Monetary Fund, the BARS continued to develop the methodology for collecting and analyzing the FSIs indicators, as well as the methodology for banks' stress tests based on the macroeconomic assumptions (credit risk and impact on capital adequacy);
- Ombudsman for the banking system of RS, who acts within the BARS, continued to perform the function of protection of rights of financial service consumers.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

During 2016, 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 (in 2016, the BARS signed a Memorandum of understanding and cooperation with the BaFin, Germany). Apart from attending the meetings, the BARS responded, on a regural 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 newsletters, 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 2016, 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 2016.

## 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 9 | 9 | 8 |
| Branches of foreign credit institutions | - | - | |
| Cooperative banks | - | - | |
| **Banking sector, total:** | **9** | **9** | **8** |

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

| Item | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 4.4 | 4.0 | 0 |
| Other domestic ownership | 26.2 | 27.1 | 29.2 |
| Domestic ownership total | 30.6 | 31.1 | 29.2 |
| Foreign ownership | 69.4 | 68.9 | 70.8 |
| **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 | 64.9 | 88.8 | 1,778 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Financial institutions, total** | 64.9 | 88.8 | 1,778 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 3.4 | -9.8 | 5.9 |
| Cooperative banks | - | - | - |
| **Financial institutions, total** | 3.4 | -9.8 | 5.9 |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 16.9* | 14.2* | 16.3* |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 16.9* | 14.2* | 16.3* |

(* - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 16.2 | 14.4 | 15.4 |
| **- households** | **13.0** | **11.7** | **11.7** |
| **- corporate** | **18.2** | **16.2** | **18.1** |

**The structure of deposits and loans in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 83.8 | 87.1 |
| Households | 61.8 | 44.6 |
| Corporate | 22.0 | 42.5 |
| Government sector | 8.6 | 12.6 |
| Financial sector (excluding banks) | 7.6 | 0.3 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 169,654 | 168,770 | 159,495 |
| Interest expenses | 65,987 | 61,568 | 48,691 |
| Net interest income | 103,666 | 107,202 | 110,804 |
| Net fee and commission income | - | - | - |
| Other (not specified above) operating income (net) | - | - | - |
| Gross income | **175,883** | **172,980** | **184,770** |
| Administration costs | **110,952** | **119,702** | **122,748** |
| Depreciation | - | - | - |
| Provisions | - | - | - |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 36,965 | 76,848 | 22,395 |
| Profit (loss) before tax | 169,654 | 168,770 | 159,495 |
| Net profit (loss) | 65,987 | 61,568 | 48,691 |

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2* | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 382,559 | 351,699 | 351,699 | 54,926 | - |
| Cooperative banks | - | - | - | - | - |
| **Financial institutions, average** | 382,559 | 351,699 | 351,699 | 54,926 | - |

Note: *Additional regulatory deductions amounted to EUR 24,065 thousand

# 2016 DEVELOPMENTS IN THE BULGARIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2016 the real GDP of Bulgaria rose by 3.4% (compared to 3.6% for 2015) as a main contribution to the growth were the net exports and to a lesser extent the private consumption and changes in inventories. The lower gross fixed capital formation was due to the smaller volume in government investments while private investments increased[8].

The labour market continued to improve gradually as a smooth recovery of employment in most sectors of the economy was observed and decrease of unemployment. Nevertheless the weaker growth of labour income of households influenced the slowdown of growth of private consumption from 4.5% in 2015 to 2.1% in 2016.

The government consumption increased by 0.6% in real terms during 2016 with the contribution of the moderate growth of wage expenditures, operating expenditures and healthcare spending.

Real fixed capital investment decreased by 4.0% in 2016 with a decrease in government investments conditioned by the low level of absorption of EU funds for the programming period 2014 – 2020. Along with improvement in expectations of companies for the future economic activity and with the high load factor of their production capacities, private investments grew. Nonetheless economic uncertainty continued to be stated as a major factor restricting the business activity.

Gross value added in the economy increased by 2.9% in real terms (3.0% for 2015) and contributed by 2.5 p.p. to the growth of the real GDP[9]. An increase in the activity was observed in all economic sectors and industry and services contributed by 0.6 and 2.1 p.p. respectively to the growth of value added.

The annual inflation in consumer prices remained negative in 2016 and at the end of the year was -0.5% (-0.9% as of December 2015) reflecting the deflationary impact of external and internal factors.[10]

As of December 2016 the amount of gross external debt increased by EUR 695.2 million compared to end of 2015 and amounted to EUR 34.6 billion (73.1% of GDP). The growth in debt was due to the increase in general government sector (by EUR 1204.0 million). The external debt for "other sectors" and to a smaller extent intercompany loans decreased, while the banks' external debt grew slightly compared to end of 2015.

[8] The assessment of private and government investments is made using the published data from national accounts for the total investments in the economy and also data from quarterly non-financial accounts of the general government sector and the implementation reports of Consolidated fiscal programme.
[9] The contribution of the corrections to GDP growth is 1 pp.
[10] The analysis uses data by HICP.

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

In 2016 due to the growth in deposits, the assets of the banking system increased at a higher rate compared to that for the previous year. During the year the dynamics in the structure of the balance sheet of the banking system showed no change in the model of financial intermediation. Deposits were invested mainly in debt securities and in balances on current accounts with other banks and interbank deposits with a term of up to seven days with group entities. The growth in the credit portfolio was weak, but credit institutions were able to generate in 2016 higher income from organic sources in a setting of declining interest rates on loans and deposits. Profitability indicators increased. The growth of the banking system's profit also contributed to the strengthening of the balance sheet equity.

For the period January - December 2016, the assets of the banking system increased by EUR 2.4 billion (5.2%) to EUR 47.1 billion. The market share of credit institutions with predominantly Bulgarian participation, as well as that of banks and branches outside the EU, remained almost unchanged and by the end of 2016 were 23.5% and 1.3%, respectively. The market position of the subsidiaries and branches of the EU continued to exceed ¾ of the total assets of the banking system (75.2%).

**Market structure**

At the end of 2016 there were 27 credit institutions of which one is a state-owned bank. With the acquisition by Eurobank Bulgaria of Alpha Bank Bulgaria Branch during the year there was a change in the composition of the five largest credit institutions, but the total share of the group compared to end of 2015 remained unchanged (57.3%). The ratio of the total banking assets to GDP[11] was 99.4% as of end-2016.

**Asset quality**

The actions towards management and reduction of credit risk in the balance sheet of banks determined the favourable tendency in the asset quality. During the year the total gross non-performing loans and advances[12] decreased by EUR 611 million (10.7%) to EUR 5.1 billion at the end of the period. An improvement was monitored in all claims according to institutional sectors. The share of gross non-performing loans and advances to total gross loans and advances decreased to 12.85%.

Net non-performing loans and advances[13] declined and their amount (EUR 2.5 billion or BGN 5.0 billion) remained entirely covered by capital exceeding the minimum regulatory requirement of 8% (EUR 3.6 billion or BGN 7.1 billion). The accumulated impairment on non-performing loans and advances decreased

[11] According to preliminary data on GDP for 2016.
[12] 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)
[13] Net non-performing loans and advances are calculated by subtracting the accumulated impairment for gross non-performing loans and advances from the total amount of gross non-performing loans and advances.

compared to 2015 due to write-offs of fully impaired loans in 2016, but its amount continued to cover more than half of the gross non-performing loans.

The quality of balance sheet items (other than loans) remained at good level. In the total assets of the banking system the share of debt and equity instruments increased (from 12.8% to 14.6%). The share of balance sheet item "cash, cash balances at central banks and other demand deposits" decreased but remained high – 19.8%.

**Profitability**

In 2016 the profit of the banking system amounted to EUR 646 million (BGN 1263 million) or by EUR 213 million (49.1%) more than the one reported for 2015. The significant growth rate of profit compared to the reported at end-of December 2015 influenced the improvement of both indicators on an annual basis. ROA increased to 1.37% (0.97% for 2015) and ROE – to 10.41% (7.35% for 2015).

The net interest income realized at the end of 2016 amounted to EUR 1.4 billion and was by EUR 24 million (1.7%) higher than that for the previous year. The tendency towards an outpacing decrease in interest expenses continued and compared to 2015 they were by EUR 195 million (43.4%) less. Net fee and commission income increased by EUR 16 million (3.5%) and net income from financial instruments – by EUR 41 million (24.2%)[14].

In 2016 the credit institutions had made impairment costs on loans and receivables amounting to EUR 412 million (BGN 805 million) or by EUR 172 million (29.5%) less than the ones reported for 2015.

**Solvency**

The high levels of capital ratios were maintained during 2016. The credit institutions observed the requirements for capital buffers (capital conservation buffer – 2.5%, systemic risk buffer[15] – 3% and countercyclical capital buffer – 0%)[16]. During the year the ratios of CET1 and of Tier 1 capital rose for the system, concluding the year at 20.41% and 20.88% respectively. Despite the decrease in Tier 2 capital, Total capital adequacy remained high — 22.15%. There were no significant changes in the structure of total risk exposures. The amount of capital, exceeding the minimum requirement of 8%, continued to grow and at the end of the year 2016 amounted to EUR 3.6 billion (BGN 7.1 billion) for the banking system.

At end-December 2016, the leverage ratio was 10.89%, continuing to reflect a low degree of indebtedness of the banking system[17].

**Liquidity**

In 2016 the liquidity of the banking system continued to increase. Liquid assets grew by EUR 1.4 billion (BGN 2.7 billion) to EUR 15.5 billion (BGN 30.3 billion), and their share in the total amount of the banking system's assets reached 32.9% (compared to 31.6% at the end of December 2015).

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[14] Due to the increase in profits from available for sale financial assets with the effect of the deal for the acquisition of Visa Europe by Visa Inc.

[15] Systemic risk buffer – 3% of risk-weighted exposures in Bulgaria.

[16] On 10 November 2016 the BNB Governing Council identified ten banks as other systemically important institutions (O-SIIs). The BNB Governing Council set a buffer for O-SIIs in accordance with art. 11, paragraph 1 of the BNB Ordinance No. 8 on an individual and on consolidated basis, applicable to the total risk exposure amount from 1 Jan. 2017 at the level 0% reaching 1.00% from 1 Jan. 2020. http://www.bnb.bg/PressOffice/POPressReleases/POPRDate/PR_20161212_EN

[17] According to article 429 Regulation (EU) No. 575/2013 the leverage ratio is calculated as an institution's capital measure (Tier 1 capital) divided by that institution's total exposure measure and expressed as a percentage. As of January 1, 2015 the institutions calculate that ratio as of the reference reporting date. Mandatory requirement for the leverage ratio is expected to be introduced from January 1, 2018.

The liquid assets ratio as calculated under BNB Ordinance No.11 reached 38.24% at the end of the period (against 36.71% at the end of 2015). The increase was influenced by the higher growth rate of the liquid assets throughout the year (9.6%) compared to that of the amount of liabilities (5.2%). All credit institutions complied with the supervisory recommendation for a minimum of 20% coverage with liquid assets of deposits of households and legal entities.

**Products and distribution channels**

At the end of 2016 there were 41 points of sale (branches, offices, representative offices and remote workstations), 80 ATMs and 1157 POS terminals[18] 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

In 2016, a year after the slowly fading collapse of the Corporate Commercial Bank, as a step of support to restoring public confidence in the banking system and the BNB as its supervisory body, a joint mission of the IMF and the WB was conducted in Bulgaria. In the last October, their team assessed the stability of the financial sector in Bulgaria under the Financial Sector Assessment Program (FSAP). During its mission, the IMF and the WB examined the overall activity of the BNB, with special attention paid to the way the BNB carries out banking supervision. The team also made a stocktaking of the current state of the implementation of the key recommendations made by the IMF and the WB in their 2015 assessment report on the observance of Basel Core Principles for effective banking supervision in Bulgaria. The IMF and the WB also carried out a comprehensive review of the process, documentation, approach and results of the recently completed AQR and ST.

Parallel to the FSAP assessment of the BNB supervisory framework and practice, new elements were added to it. In 2016, the Law on Consumer Real Estate Loans was adopted and assigned new tasks to the Banking Supervision Department related to the registration of credit intermediaries and exercising control over compliance with the competence and knowledge requirements of creditor's employees and credit intermediaries, the assessment of the consumers' creditworthiness, and the review of the remuneration policies. By its decision, the Governing Council of the BNB adopted Ordinance No 19 on Credit Intermediaries, which lays down the procedure for entering into and deleting from the Register of Credit Intermediaries as well as the documents and information required for the entry.

In the past year, supervisory experts from BNB took part in the work of an inter-ministerial working group on the transposition into national law of the Fourth Anti-Money Laundering Directive[19]. As a result, a new bill was drafted. Experts

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

[19] 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

from the BNB continued to provide assistance to develop a methodology for risk assessment in this area.

The BNB together with the Bulgarian Deposit Insurance Fund developed a project related to the determination of the specific parameters of the data according to Ordinance No 30 of BNB on Calculation of the Premium Contributions Due by Banks under the Law on Bank Deposit Guarantee.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

The major priority of the Banking Supervision Department in 2016 was to conduct an Asset Quality Review and Stress Test for all 22 banks in order to restore credibility.

In response to the recommendation of the 2015 Basel Core Principles (BCP) Assessment, the BNB endorsed and was implementing a plan through a series of multiyear actions that aimed to address the issues identified by the 2015 BCP report. The prioritisation of the AQR and the Stress Test exercise exerted heavy pressure on supervisory resources, which led to rescheduling the implementation of some planned BCP recommendations. Nevertheless, a set of new policies, manuals, and ordinances are expected to be adopted later in 2017-early 2018.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In the first half of 2016 the BNB conducted an Asset Quality Review (AQR) and Stress Test (ST) of all 22 banks licensed by BNB excluding the 6 foreign bank branches operating in Bulgaria. The AQR and ST were carried out in collaboration with an independent external consultant, selected under a public procurement tender procedure, and independent consultants and appraisers employed by the banks after a uniform selection procedure approved by the BNB. Overall, more than 900 experts across the BNB and the external independent parties were involved in the AQR and ST.

Total assets of BGN 84.2 billion as at 31 December 2015, or 96% of the banking system were subject to asset quality review. Over 3,400 individual credit files were reviewed, equivalent to BGN 23.2 billion or 71% of the banks' corporate and large SME loan books. The AQR resulted in aggregate adjustments of BGN 665 million, or 1.3% of risk-weighted assets, to be reflected in the banks' 2016 financial statements. The AQR-adjusted CET1 capital ratio for the banking system was 18.9% as at 31 December 2015. Although results varied across individual banks, after the AQR, the overall result from AQR showed that the Bulgarian banking system is stable. The main indicator of a bank's financial resilience, the ratio of bank common equity tier one capital to its risk-weighted assets, or the CET 1 ratio, remains significantly above the required minimum regulatory requirements. On a system level it is above the EU average as announced in the latest European stress test.

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Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC.

The ST was conducted in July 2016 with a purpose to assess the resilience of the banks in Bulgaria to absorb shocks from hypothetical negative financial and macroeconomic developments. The ST was based on the AQR-adjusted capital and risk-weighted assets and applied two macroeconomic scenarios over a three-year horizon until 2018: a baseline and an adverse scenario. Under both scenarios, banks' capital positions remained strong and indicated resilience to absorb the tested shocks, although results varied across individual banks. Where necessary, follow-up plans have been developed in line with individual results and include measures aimed at maintaining existing capital buffers for some banks or increasing capital buffers and decreasing risk-weighted assets for others. The results do not necessitate any public support to the banks with state budget funds.

Within the regular supervisory activity, in the past year, the off-site supervision focused on the ongoing monitoring of the financial condition of banks and the rating on CAEL rating system. The supervisory reviews and assessments involved monitoring of key risk indicators, evaluation of risks to capital and liquidity, ICAAP and ILAAP reports, and funding plans. Work continued on improving the quality of regular supervisory reporting and the tools used to verify the data.

Priority was also given to following up the implementation of supervisory measures prescribed by orders following supervisory inspections, participation in the work of supervisory colleges and reviewing and evaluating banks' recovery plans. In accordance with the requirements of the applicable European and national framework and using a standardised template were assessed the recovery plans of domestic banks which were not group subsidiaries and were subject to consolidated supervision under the Law on the Recovery and Resolution of Credit Institutions and Investment Firms. Where necessary, recasting the plans was requested.

The frequency and efficiency of on-site inspections increased in 2016. Alongside the AQR process, planned supervisory inspections were carried out at several banks to check the extent of implementation and the effect of recommendations from previous inspections, aimed at improving the quality of risk management. Following the inspections were drafted reports containing recommendations to banks such as: improving the quality of management and monitoring of credit exposures, their assessment and classification in accordance with the regulatory framework; achieving the required quality in the ICAAP; development of long-term strategies and goals, as well as ways to achieve them; improving market risk management and related internal policies; taking measures to reduce operational risks as a prerequisite for minimising losses stemming from operational events, etc.

The factors influencing banking system stability continued to be monitored in line with macro-prudential supervision commitments. A set of various macro-prudential instruments were employed for early identification of increased risk to system's stability. Analyses and assessments continued giving rise to precautionary measures and macro-prudential recommendations to counteracting external risks and avoid spillovers of instability from outward circumstances. The liquidity position of all credit institutions continued to be subject to day-to-day monitoring. The supervisory information service facilitated reliable information exchange between the BNB and credit and financial institutions, and provided data to external users and institutions with which the BNB liaised at agreed formats. Over the period, the practice continued to perform expert analysis and assessment to regularly calibrate the countercyclical capital buffer.

At the end of 2016, a buffer for other systemically important institutions (O-SIIs) was introduced as a macro-prudential measure with preventive character aimed at banks with systemic importance. Its purpose is to strengthen the capacity of O-SIIs to absorb losses thus limiting the contagion risks stemming from potential stress event at a systemically important bank to other credit institutions or to the banking system as a whole.

In the area of specific supervisory activities, the thematic reviews carried out to assess the degree of transparency of the offered deposit products reflected the improvement of the information provided to depositors. An assessment of several banks' customer dispute procedures and practice showed that specialised units handle claims in line with internal rules applying best European practice. A joint inspection with the Financial Supervision Commission at two banks acting as supplementary pension insurance fund custodian showed legal observance.

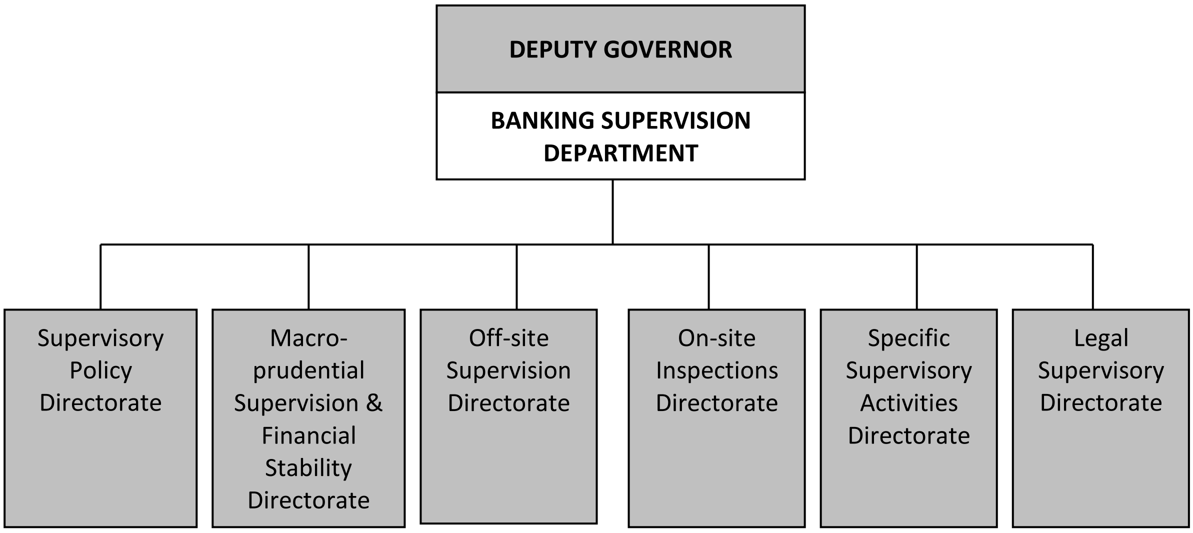
Supervisory inspections to review the systems in place to prevent money laundering and terrorist financing were carried out under a changing European legal framework aimed at a coordinated approach to the implementation of unified practices to counteract the flow of funds of a criminal nature and the use of opaque corporate structures. The inspections carried out ascertained some violations, and where necessary recommendations were made to improve resource strengthening and quality control when applying due diligence to higher risk customers. The joint inspections with the State Agency of National Security confirmed the overall assessments of business lines in the banking system.

The recently observed tendency of reduction of complaints from financial institutions' customers continued in 2016. Main contribution to the reported decline had the consistent work of the relevant authorities and actions taken to improve the awareness of the population, as well as the promoted communication between the BNB and the Commission for Consumer Protection.

In connection with the deal for Alpha Bank Bulgaria Branch, the procedure for issuing a preliminary approval for the transfer of the commercial enterprise to Eurobank Bulgaria AD was finalised in March 2016, under the terms of full legal succession of the latter.

Within the announced intra-group restructuring of UniCredit Group S.p.A a prior approval was issued to UniCredit Italy for the direct acquisition of a shareholding (representing the share held by UniCredit Bank Austria AG, Austria) amounting to 99.45% of the capital of UniCredit Bulbank AD, Bulgaria.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY




# COOPERATION WITH OTHER SUPERVISORY BODIES IN BULGARIA

In 2016, supervisory experts of the BNB continued their participation 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 experts in charge of off-site banking supervision took part in the work of various international supervisory colleges at the SSM/ECB, as well as in two particular colleges of the Hungarian Central Bank, and of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), respectively. The supervisory risk assessments of the relevant banking groups and subsidiaries were discussed and the joint supervisory decisions on their capital and liquidity taken. Where necessary, strategies of parent banks and individual subsidiary institutions were updated to reduce the level of non-performing loans.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS

After updating cooperation agreements with other authorities in the country, i.e. with the Bulgarian Deposit Insurance Fund, the State Agency of National Security, the Ministry of Finance, the Financial Supervision Commission and the Commission of Public Oversight of Statutory Auditors, the interaction plans among them were also updated. This has made it possible to improve the exchange of information, and enabling already-identified or new emerging issues to be addressed in a timely manner. Procedures for coordination of joint activity and information exchange will continue to be further updated in order to support the BNB’s supervisory function in a more efficient way.

# STATISTICAL TABLES

### Number of financial institutions (at year-end)

| Type of financial institution* | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 22 | 22 | 22 |
| Branches of foreign credit institutions | 6 | 6 | 5 |
| Cooperative banks | | | |
| **Banking sector, total:** | **28** | **28** | **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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 2.3 | 1.8 | 2.1 |
| Other domestic ownership | 21.5 | 21.8 | 21.5 |
| Domestic ownership total | 23.7 | 23.6 | 23.5 |
| Foreign ownership | 76.3 | 76.4 | 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 | 42.48 | 57.30 | 97.60** |
| Branches of foreign credit institutions | 2.30 | 2.40 | 2.40** |
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | **7.15** | **7.35**[20] | **10.41** |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 92.9 | 96.2 | 97.6 |
| Branches of foreign credit institutions | 7.1 | 3.9 | 2.4 |
| Cooperative banks | | | |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

[20] As of 2015 the ratios are calculated on the basis of assets and total equity at the end of the reporting period according to the requirements of EBA for key risk indicators. For the previous periods (until the entry into force of the harmonized criteria on EU level) the calculations are on the basis of averaged values of assets and total equity.

**The structure of assets and liabilities of the banking system (%) [21]**
**(at year-end)**

| Assets | 2016 |
|---|---|
| Cash, cash balances at central banks and other demand deposits | 19.8 |
| Financial assets held for trading | 2.0 |
| Financial assets designated at fair value through profit or loss | 0.2 |
| Available-for-sale financial assets | 10.3 |
| Loans and receivables | 60.9 |
| Held-to-maturity investments | 2.1 |
| 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 | 2.0 |
| 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** | **100.00** |
| **Liabilities** | **2016** |
| 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 | 85.9 |
| 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 | 0.1 |
| Share capital repayable on demand | 0.0 |
| Other liabilities | 0.5 |
| Liabilities included in disposal groups classified as held for sale | 0.00 |
| **Total equity** | **13.2** |
| **Total equity and total liabilities** | **100.0** |

[21] As of 1.01.2015 the BNB started publishing balance sheet and income statement data in accordance with the reporting templates implemented under Implementing Regulation (EU) No. 680/2014.

**Capital adequacy ratio of banks**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | **21.95*** ** | **22.19*** ** | **22.15*** ** |

(* - 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 | 2016 |
|---|---|
| Non-performing loans and advances to total gross loans and advances[22] (%) | 12.85 |

**The structure of deposits and loans and advances[23] of the banking sector in 2016 (%) (at year-end)**

| | 2015 | | 2016 | |
|---|---|---|---|---|
| | Deposits | Loans and advances | Deposits | Loans and advances |
| Central banks | 0.0 | 17.8 | 0.0 | 18.7 |
| General governments | 2.5 | 0.9 | 2.1 | 0.9 |
| Credit institutions | 6.8 | 9.5 | 5.7 | 11.1 |
| Other financial corporations | 4.4 | 2.5 | 5.0 | 2.6 |
| Non-financial corporations | 26.5 | 44.7 | 27.2 | 42.8 |
| Households | 59.7 | 24.6 | 60.1 | 24.0 |
| **Total** | **100.0** | **100.0** | **100.0** | **100.0** |

[22] See footnote №12.

[23] Macro-prudential form 1 (MPF 1) was introduced during the first quarter of 2015. The form provides timely, additional, statistical information that allows for key groups of assets and liabilities' dynamics to be monitored by counterparties and by types of currency. The definitions and the positions' breakdown in it correspond to those applied in the FinRep forms.
The data submitted by banks and branches of foreign banks are on an individual (non-consolidated) basis. The information is not subject to validation rules, developed by the European banking authority and initiated with the Implementing Technical Standards (ITS) according to Regulation (EU) №680/2014.
Additional notes for MPF 1 data in section "Loans and advances":
The scope of MPF 1 data in section "Loans and advances" changes from 1 June 2015 as "Cash balances at central banks and other demand deposits" should be included in loans and advances.

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 2,025,199 | 1,866,721 | 1,695,123 |
| Interest expenses | 681,043 | 449,790 | 254,738 |
| Net interest income | 1,344,156 | 1,416,930 | 1,440,385 |
| Net fee and commission income | 423,967 | 455,138 | 470,921 |
| Other (not specified above) operating income (net) | 226,810 | 272,940 | 173,295 |
| Total operating income, net | 1,994,933 | 2,145,009 | 2,084,600 |
| Administrative expenses | 888,921 | 947,269 | 808,361 |
| Depreciation | 98,249 | 87,642 | 89,437 |
| Provisions or (-) reversal of provisions | 7,754 | 9,355 | 32,997 |
| Impairment or (-) reversal of impairment on financial assets not measured at fair value through profit or loss | 591,002 | 588,820 | 415,181 |
| Profit or (-) loss before tax from continuing operations | 409,429 | 488,509 | 722,115 |
| Profit or (-) loss for the year | 363,355 | 432,967 | 645,754 |

**Total own funds in 2016 (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***:** | **5,670,284** | **5,224,079** | **5,344,456** | **325,828** | |

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

# 2016 DEVELOPMENTS IN THE CROATIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Economic recovery and favourable labour market developments picked up considerably in 2016. Annual real GDP growth rate accelerated to 2.9% in 2016 from 1.6% in 2015, reflecting a significant increase in all components of domestic demand. Household consumption rose and, along with the exports of goods and services, contributed the most to the growth in economic activity. The recovery of capital investments intensified noticeably, and the production and imports of capital goods continued to grow at high rates, indicating that the private sector's investment cycle gained pace. The rise in total investment was strongly supported by the increased withdrawal of EU funds. The growth in exports of goods and services continued in 2016, mainly as a result of an increase in the exports of tourist services. The Croatian National Bank continued its extremely expansionary and countercyclical monetary policy in 2016, supporting the economic recovery.

## DEVELOPMENTS IN THE BANKING SYSTEM

There were 31 credit institutions or 26 banks (one savings bank included) and five housing savings banks operating in the Republic of Croatia at the end of 2016. The number has decreased by two from the end of 2015: bankruptcy proceedings were opened against one bank, while one bank merged with its foreign parent bank, which continued operating in the Republic of Croatia through a branch. Assets of credit institutions stood at HRK 396.5bn[24] (116% of GDP), trending down by 1.2% from the end of 2015. The drop in assets was affected by the decrease in bank assets (1.2%), which continued for the fifth consecutive year. Assets of housing savings bank increased slightly (0.5%), still constituting a very small share of total assets of credit institutions, only 2.0%.

The decrease in bank assets in 2016 was greatly influenced by the effects of the conversion of loans in Swiss franc into loans in euros, exchange rate developments, the sale of irrecoverable claims and the exit of two banks from the system. Developments that started in 2015 continued, as reflected in poor lending and sustained bank deleveraging.

Loans granted decreased by 1.1% (based on transactions[25]). In addition to greater lending to financial institutions, especially foreign parents, a slight increase in lending was observed in the household sector as well, primarily in the form of non-purpose loans (cash loans and overdraft facilities), thus interrupting a years-long downward trend in lending to this sector. Loans to other sectors decreased. New lending was primarily realised in kuna, with loans granted at fixed interest

[24] Data for 2016, as well as for other periods, are based on audited reports from credit institutions.

[25] Rates of change calculated on the basis of transaction data exclude the impact of exchange rate adjustments and write-offs on loan movements, whereby write-offs include partial write-off of the principal in the process of conversion from loans in the Swiss franc to loans in euros. The effect of the sale of claims is excluded in the amount of value adjustments.

rates gaining in importance. Kuna lending increased substantially in the segment of housing loans, partly attributable to the refinancing of converted loans.

The share of partly recoverable and fully irrecoverable loans (the share of B and C risk category loans) decreased for the second year in a row, from 16.7% at the end of 2015 to 13.8% at the end of 2016. This was a result of improvements in the economic environment, as reflected in the better collection of claims and improved creditworthiness of clients, and in the resolution of non-performing loans, especially through the sale of claims. The CNB's progressive rules on the allocation of additional value adjustments provided a strong impetus to such selling. In the household sector, improvement in credit quality was also affected by the conversion of loans in Swiss francs into loans in euros. Portfolio ageing, strengthened by the mentioned regulatory rules on the gradual increase in value adjustments for long-term delinquent claims, was responsible for the noticeable growth in the coverage of B and C risk category loans by value adjustments, from 56.9% at the end of 2015 to 63.7% at the end of 2016.

Bank deleveraging, especially to majority foreign owners, continued, and a large portion of foreign sources was substituted with domestic sources of finance. The growth of the share of deposits on transaction accounts and kuna deposits continued. The overall liquidity position was quite good – liquidity indicators showed that banks had significant surpluses for the coverage of liquidity needs during a 30-day stress period.

After the losses of 2015, caused by loan conversion expenses, bank profitability improved in 2016 and the return on average assets (ROAA) and the return on average equity (ROAE) reached their highest level since 2008, totalling 1.6% and 9.6% respectively. All components but interest income contributed to these improved results. The key influence came from lower expenses on value adjustments and provisions, both for conversion expenses and for expenses on loan portfolio losses (partly affected by conversions). A great impact on the result came from one-off revenues from the sale of equity holdings (especially the sale of shares of Visa Europe Ltd. to its US parent company[26]), sale of irrecoverable claims, and dividends received. The slow, but stable years-long trend of improvement in the cost efficiency continued.

The sale of claims and conversion of loans reduced the exposure to credit and currency risks, which had the greatest influence on the rise in the total capital ratio. It increased from 20.9% at the end of 2015 to its all-time high of 22.5% at the end of 2016. A portion of the reduction in exposure to credit risk arose from the improvement in the creditworthiness of individual clients, which resulted in the reduction of the riskiness of claims and consequently a lower capital requirement.

The assets of housing savings banks continued to increase, causing their small share in the assets of all credit institutions to increase slightly to 2.0%. Almost the entire increase in the balance sheets of housing savings banks was based on the growth of the kuna component, with the key influence of increasing deposits of housing savings bank savers and housing loans. In 2016, housing savings banks reported 5.5% less profit from continuing operations (before tax) than in 2015. ROAA and ROAE decreased slightly as a result of lower net interest income and a rise in expenses on value adjustments and provisions, totalling 0.7% and 5.8% respectively. The total capital ratio of housing savings banks stood at 25.9%.

[26] Banks' receipts in 2016 arising from this transaction were estimated at some HRK 650m.

# 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 the supervision and oversight in accordance with acts governing the operation of credit institutions and credit unions. The exercise of supervision and oversight of credit institutions and credit unions is governed by the Credit Institutions Act and the Credit Unions Act. Rules and requirements related to the operations of credit institutions are governed by Croatian regulations (the Credit Institutions Act and relevant subordinate legislation) and EU regulations, primarily Regulation (EU) No 575/2013 and relevant technical standards, which are regulations directly applied in all EU member states.

Supervision of credit institutions encompasses a series of coordinated activities directed at verifying the compliance of operations of credit institutions (banks, savings banks and housing savings banks) with:

- risk management rules;
- the provisions of the Credit Institutions Act and Regulation (EU) No 575/2013 and regulations adopted under that Act and Regulation;
- other laws governing the provision of banking and financial services provided by credit institutions and regulations adopted under these laws; and
- internal bylaws and professional standards and rules.

In addition to supervision, the CNB exercises oversight of the implementation of the Act on the Croatian National Bank, regulations adopted under that act, and the implementation of other laws and regulations for which it is competent.

The CNB exercises supervision of credit institutions by:

- collecting and analysing reports and information, ongoing monitoring of credit institutions' operations;
- carrying out on-site examinations of credit institutions by imposing supervisory measures aimed at taking 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.

Other supervisory bodies in the Republic of Croatia responsible for the oversight of the financial system are the Ministry of Finance and the Croatian Financial Services Supervisory Agency. They are competent for the regulation and supervision of non-banking financial services.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

As in the previous years, the main objectives of supervision exercised by the CNB are to maintain confidence in the Croatian banking system, and to promote and safeguard its safety and stability. The process of harmonisation of the domestic regulatory framework with EU regulations continued in 2016 with the aim of improving domestic legislation governing the operation of credit institutions.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

As previously, supervisory resources in 2016 were predominantly focused on the continuous monitoring of credit institutions' operations through regular communication with credit institutions or the analysis of specific operating areas assessed to carry an increased degree of risk for a credit institution. The CNB carried out the supervisory cycle of the assessment of the risk profile of credit institutions in relation to all the risks to which credit institutions are exposed or might be exposed in their business operations, an assessment of the adequacy of the process of assessment and the maintenance of the internal capital of a credit institution, as well as continuous cooperation based on a dialogue between the supervisors and the credit institution.

The supervisory cycle of the assessment of credit institutions in 2016 also included the analyses of credit institutions' internal capital adequacy assessment reports. The analysis of the submitted internal reports and self-assessments by credit institutions enables the supervisor to assess the adequacy of procedures prescribed and implemented by a credit institution with a view to the timely identification, measurement, control and management of risks and the adequacy of the determined required internal capital. Combined, all these factors, together with the risk profile assessment, provide the basis for determining minimum capital requirements and planning the next supervisory cycle for an individual credit institution.

In line with the supervisory cycle, the CNB performed an assessment of IT risks in credit institutions in 2016. The assessment was based on an analysis of reports made by external auditors on the audits of IT systems of credit institutions, self-assessment results and direct information gathered from individual credit institutions' organisational units in charge of the functionality, safety and internal audit of IT systems. The CNB communicated actively with credit institutions and analysed and monitored the situation related to various IT system incidents: potential information disclosure, disruptions in Internet banking services and cyberattack attempts.

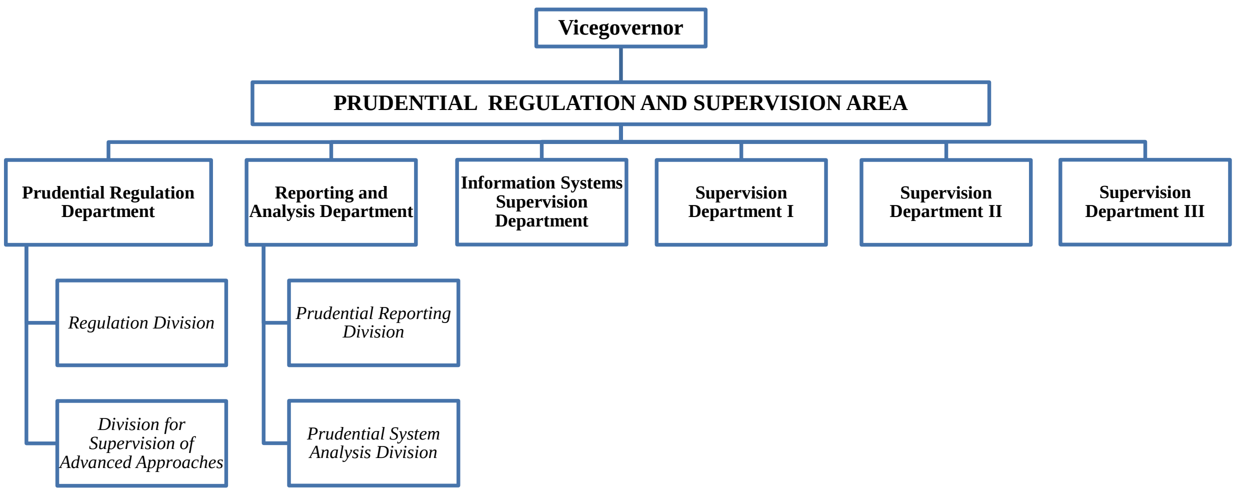
A comprehensive methodology to implement a study of supervisory solvency stress testing in other systemically important credit institutions in Croatia was developed in 2016. The study was designed for the purposes of informing about the supervisory review and evaluation process and will be implemented in 2017.

In addition to the analysis of asset quality and credit risk management and the determination of adequacy of own funds, priorities in the course of on-site examinations in 2016 included on-site examinations of credit institutions categorised as large according to the size of their assets, particularly in the areas of supervising advanced approaches in risk measurement and management, supervising IT systems and the prevention of money laundering and terrorist financing. Considerable resources were allocated to operations of trustee and special administration.

Banking regulations in 2016 were marked by the continuous work on the amendments to laws and regulations, primarily as a result of harmonisation with the EU legal framework. CNB employees were actively involved in the work of EBA committees and subcommittees drafting technical standards for particular areas.

## ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

Supervisory activities are organised within the Prudential Regulation and Supervision Area. The organisational chart is provided below:




## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2016

In the course of 2016, 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 area of IT system supervision. Based on the memoranda of understanding in effect, CNB representatives participated in several colleges of supervisors relating to the supervision of banking groups that include domestic credit institutions. Within the framework of cooperation with foreign supervisors, the CNB is responsible for the drafting of a Supervisory Risk Report, i.e. an annual assessment of the risk profile of a domestic credit institution, which serves as an element for making the final joint risk assessment decision and for a joint decision on the required amount of capital of a banking group. Since 2015, the CNB has participated in the process of reaching joint decisions on the review and assessment of recovery plans for groups of credit institutions.

The CNB continued to cooperate and provide technical support to supervisors in the region with regard to the application of prudential regulations (CRD IV and CRR) and technical aspects of supervision.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN CROATIA

In 2016, the CNB continued to cooperate with the Croatian Financial Services Supervisory Agency (HANFA) by participating in the work of the joint Working Committee. At the Committee meetings, the institutions exchange information on current topics in the banking sector and the sector supervised by the Agency, resolve open issues on the exchange of data and arrange the coordination of supervisory activities.

Regular meetings of the Working Committee with the State Agency for Deposit Insurance and Bank Resolution (DAB), during which institutions exchange data and information on entities subject to supervision and oversight from their scope of activities and competences, continued in 2016.

Furthermore, in 2016, the Croatian National Bank participated in the work of the National Cyber Security Council and in the implementation of measures included in the Action Plan for the Implementation of the National Cyber Security Strategy. In addition, the CNB participated in the activities of the Ministry of Finance working group in charge of carrying out the tasks referred to in the Act on Critical Infrastructures in the finance sector.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

More information on CNB's supervisory activities, regulations under which the CNB performs oversight, as well as the texts of regulations are available on the CNB's website (*www.hnb.hr*).

# STATISTICAL TABLES

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

| Type of financial institution* | 2014 | 2015 | 2016 |
|---|---|---|---|
| Banks | 27 | 27 | 25 |
| Savings banks | 1 | 1 | 1 |
| Housing savings banks | 5 | 5 | 5 |
| Branches of foreign credit institutions | 0 | 0 | 1 |
| **Banking sector, total:** | 33 | 33 | 32 |

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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 5,1 | 5,3 | 6,2 |
| Other domestic ownership | 4,6 | 4,3 | 3,9 |
| Domestic ownership total | 9,7 | 9,6 | 10,2 |
| Foreign ownership | 90,3 | 90,4 | 89,8 |
| **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 | 75,2 | 1 482,2 |
| Housing savings banks | 59,6 | 100,0 | 2 455,4 |
| **Banking sector, total:** | **58,9** | **73,7** | **1 425,4** |

*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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Banks | 2,8 | -8,8 | 9,6 |
| Housing savings banks | 8,9 | 6,4 | 5,8 |
| **Banking sector, total:** | **2,8** | **-8,5** | **9,5** |

*ROAE

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Banks | 98,1 | 98,1 | 98,0 |
| Housing savings banks | 1,9 | 1,9 | 2,0 |
| **Banking sector, total:** | **100,0** | **100,0** | **100,0** |

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

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 16,9 | 16,8 | 18,6 |
| Nonfinancial sector* | 50,0 | 48,0 | 46,9 |
| Government sector | 22,7 | 23,3 | 23,5 |
| Other assets** | 10,5 | 11,9 | 11,0 |
| **Claims due to** | | | |
| Financial sector | 5,2 | 6,5 | 5,9 |
| Nonfinancial sector* | 58,8 | 62,8 | 65,1 |
| Government sector | 6,3 | 6,3 | 6,4 |
| Other liabilities** | 15,7 | 11,8 | 8,6 |
| Capital | **14,0** | **12,7** | **14,0** |

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

**Capital adequacy ratio of banks**

| Type of financial institution | 2014*** | 2015*** | 2016*** |
|---|---|---|---|
| Banks | 21,8 | 20,9 | 22,9 |
| Housing savings banks | 23,5 | 25,8 | 25,9 |
| **Banking sector, total:** | 21,8 | 20,9 | 23,0 |

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

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

| Asset classification | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector, including: | 20,7 | 20,0 | 17,6 |
| **- households** | 12,0 | 11,8 | 10,0 |
| **- corporate** | 30,8 | 30,1 | 28,3 |

*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)

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 83,6 | 73,5 |
| Households | 64,3 | 45,3 |
| Corporate | 19,3 | 28,2 |
| Government sector | 3,2 | 21,3 |
| Financial sector (excluding banks) | 5,1 | 1,9 |
| Other* | 8,1 | 3,3 |
| **Total:** | **100,0** | **100,0** |

*non-residents

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 2 505,9 | 2 421,0 | 2 230,3 |
| Interest expenses | 1 146,1 | 1 020,5 | 780,6 |
| Net interest income | 1 359,7 | 1 400,4 | 1 449,6 |
| Net fee and commission income | 410,1 | 403,4 | 431,6 |
| Other (not specified above) operating income (net) | 195,8 | 101,7 | 289,0 |
| Gross income | 1 914,2 | 1 905,6 | 2 141,7 |
| Administration costs | 893,9 | 899,6 | 880,9 |
| Depreciation | 90,9 | 89,2 | 86,7 |
| Provisions | 46,3 | 967,1 | 103,7 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 655,3 | 600,9 | 275,0 |
| Profit (loss) before tax | 279,2 | -651,3 | 823,9 |
| Net profit (loss) | 208,0 | -598,3 | 671,9 |

**Total own funds in 2016 (in million EUR)**

| Type of financial institution | Total own funds*** | Core Tier 1 | Tier 1*** | Tier 2*** | Tier 3 |
|---|---|---|---|---|---|
| Banks | 6 956 | - | 6 465 | 491 | - |
| Housing savings banks | 100 | - | 91 | 9 | - |
| **Banking sector, total:** | 7 056 | **-** | 6 556 | 500 | **-** |

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

# 2016 DEVELOPMENTS IN THE CZECH BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2016, the Czech economy continued to grow, nevertheless the annual GDP growth slowed down compared to 2015. According to latest information, the real GDP went up by 2.6% in 2016, which was 2.7 percentage points less than in the previous year. The economic growth was mainly driven by household consumption, which increased by 3.6% y-o-y (particularly due to rising real wages and households' positive expectations), and exports of goods and services (increased by 4.5% y-o-y). On the contrary, expenditure on gross fixed capital formation decreased by 2.3% y-o-y. The decline in investment activity can be explained by a lower draw on EU funds compared to 2015. The impact of government spending on GDP growth was not significant in 2016.

Inflation in the Czech economy remained at low levels, averaging 0.7% in 2016 (0.4 percentage points more than in 2015). During the first three quarters of 2016, the inflation stayed below the lower boundary of the tolerance band around the CNB's inflation target.[27] Nevertheless, in the last quarter the level of prices began to increase and in December 2016 the inflation rate reached 2.0% y-o-y, i.e. it got to the inflation target. During the year, the price level development was influenced mainly by food and fuel prices. In 2016, the Czech National Bank left key interest rates unchanged at technical zero. The two-week repo rate thus stayed at 0.05% (since the Bank Board's decision of 2 November 2012) and the discount and Lombard rates remained unchanged at 0.05% and 0.25% respectively.

Moreover, the CNB Bank Board repeatedly decided to continue using the exchange rate as an additional instrument for easing the monetary conditions. At all its monetary policy meetings in 2016, it confirmed the CNB's commitment to intervene on the foreign exchange market if needed to weaken the koruna against the euro so that the exchange rate of the koruna was kept close to CZK 27 to the euro.[28]

The average CZK/EUR exchange rate appreciated slightly from 27.28 in 2015 to 27.02 in 2016. Equally, the average CZK/USD rate appreciated subtly in year-on-year terms: in 2015 it came to 24.6, but in 2016 it reached 24.43.

The current account of balance of payments ended in a surplus of 1.1% of GDP in 2016. In absolute terms the surplus amounted to 52.6 billion CZK.

Average unemployment, as measured by the share of unemployed persons, decreased from 5.0% in 2015 to 4.0% in 2016. The average gross nominal wage in the Czech economy continued to grow in 2016, up by 3.7% year on year, while the average real wage rose for the third consecutive year in 2016, up by 3.0%.

In 2016, the state budget of the Czech Republic ended in surplus of 61.8 billion CZK (it was the first surplus since 1995). The government debt-to-GDP ratio decreased from 40.3% in 2015 to 36.8% in the previous year.

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[27] The current tolerance band is from one to three percent.

[28] The Bank Board of the CNB decided to discontinue the use of the exchange rate as an additional instrument for easing the monetary conditions at its extraordinary monetary policy meeting on 6 April 2017. By taking this step, the CNB returned to the conventional monetary policy regime, in which interest rates are the main instrument.

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

The Czech banking sector was characterised by favourable development in 2016. The sector continued to generate profit, had no problems with liquidity and was well capitalised.

At the end of 2016, the Czech banking sector was composed of 45 banks (including 23 foreign bank branches). The structure of the sector has been stable in the long-term.

Further long-term stable feature of the sector is a shareholder structure for which is typical a domination of foreign capital (72.1% of total sector capital was concentrated to foreign owners).

The total assets of the Czech banking sector rose by 9.0% to CZK 5,960.8 billion at the end of the 2016. The asset structure reflects the business model of Czech banks that is based on traditional banking intermediation, i.e. on deposit-taking and lending. In 2016, the total loans and receivables grew (year on year) by 14.2% to CZK 3,990.9 billion. The main share of this total amount was represented by clients' loans and receivables that went up by 6.9% to CZK 3,027.3 billion at the end of the 2016.

The Czech banking sector continued to generate net profit in 2016. In this year, domestic banking sector recorded net profit of CZK 73.9 billion, which corresponds to year on year growth by 11.4 %. The main component of net profit is a profit from financial activities (CZK 180.2 billion in 2016) that is primarily based on interest profit (109.9 billion CZK). In 2016, banks paid a total of CZK 14.4 billion in corporate taxes.

The quality of loan portfolio of the Czech banking sector improved relatively significantly in 2016. Default receivables (from clients and credit institutions in total) dropped by 11.5% year on year to CZK 152.9 billion. The share of clients' receivables in default in total banking sector receivables fell by 1.0 percentage point year on year to 4.9%.

Non-resident and foreign currency activities correspond with ownership structure of the Czech banking sector. These activities are traditionally realized via transactions within financial groups between parent companies and other members of the financial group on the one side, and Czech subsidiaries on the other side.

For the Czech banking sector, in 2016, the positive liquidity characteristics remained, which stems from a long-term surplus of aggregated clients' deposits that consistently exceed the cumulative value of clients' loans in the Czech Republic.

The capitalization of the Czech banking sector has long been satisfactory. At the end of 2016, the Tier 1 capital ratio stood at 17.9% (zero change in comparison to 2015), the total capital ratio was 18.4%. The amount of Tier 1 capital reached CZK 440.7 billion, which meant year on year growth by CZK 20.1 billion (relatively +4.3%). The capital of domestic banks is made up largely (97.1%) of high quality Tier 1 capital. The domestic banks safely fulfilled the capital requirements defined by CRD IV / CRR during 2016.

In the Czech Republic, the relative size of the domestic banking sector expressed by ratio of total bank assets to GDP went up during 2016. The ratio stood at 124.9% at the end of 2016, i.e. 6.1 percentage points higher than in the same period of 2015.

# 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 and payment system institutions. 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 2016

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 key strategic framework for the CNB's supervisory work is the Core Principles for Effective Banking Supervision published by the Basel Committee.

The CNB develops a system of financial market supervision that is based on a clear articulation of responsibilities and objectives.

The CNB's objective in the area of supervision, as defined by law, is to ensure financial stability and the 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 conduct of business.

In the CNB's routine supervisory work, the said objective consists of several sub-objectives:

- to contribute systematically to ensuring and maintaining the financial stability of financial market entities, with an emphasis on timely identification of potential risks (especially in the area of prudential supervision),
- to contribute systematically to increasing the transparency of the financial market and the quality of conduct towards clients in the overall governance and management of financial market entities, leading to increased confidence of clients in the financial market (especially in the area of conduct of business supervision),
- to act in systematic coordination to ensure a unified and hence also effective approach to supervision in meeting these objectives.

The CNB seeks to apply a single approach to individual financial market entities. To this end, it organises its supervisory activities not on a sectoral but on a functional basis. It separates the creation of regulations, decision-making in licensing and enforcement proceedings and activities relating to resolution and macroprudential policy (financial stability) from the direct performance of supervision.

The main components of the functional organisation of supervision are prudential supervision and conduct of business supervision. Their activities must be coordinated to prevent conflicts arising between their different approaches and to ensure that they support each other's activities and thereby contribute to meeting the CNB's supervisory objectives.

Supervision is further broken down according to whether it takes the form of on-site inspections or off-site surveillance. These activities are also closely interrelated. With continuous supervision, the main emphasis is placed on off-site activities. Given continuous access to an extensive set of information, the job of off-site surveillance is to systematically identify relevant risks (in both prudential and conduct of business supervision), to assess those risks and to propose appropriate measures.

Supervisory procedures are based on the regulations in force, especially Czech and EU legislation, the decisions, opinions and recommendations issued by the Commission and the ESFS institutions and the standards and recommendations of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), as well as on international accounting standards (IFRS), auditing standards and so on. The long-term objective of supervision is to ensure convergence of supervisory approaches in the EU.

The CNB effectively exercises the supervisory powers conferred on it by legislation, its primary objective being to ensure the stability of the Czech financial system. Supervisory actions are taken in a timely manner in a form that is appropriate to the situation to which they respond.

The CNB applies its legally defined independence in the area of supervision. This independence gives it full discretion to take action against supervised institutions.

To ensure that supervision is transparent to the public, the CNB issues reports on supervisory activities and communicates major supervisory actions and selected findings and approaches in a prompt and flexible manner.

Supervision is organised so that information flows smoothly and appropriate decisions are taken at every level of management. When allocating its capacity, the CNB takes into account the risk profiles and systemic importance of supervised institutions.

The core part of the CNB's supervisory work is supervision of groups of financial institutions on a consolidated basis. The aim of this activity is to understand how risks arising at group level can affect the stability of the supervised institution, usually a bank or insurance company. When conducting consolidated supervision, the CNB requires effective management of these risks. Also, the CNB works in cooperation with foreign supervisory authorities and regularly communicates with the management of important subsidiaries and branches that belong to the consolidated group and examines their risk profile and systemic importance. Where the CNB detects significant risks in the activities of these subsidiaries and branches with an impact on the consolidated group, it initiates corrective action.

The CNB has a framework – based on legislation or specific agreements and arrangements – for cooperation with other (foreign) supervisors. Among other things, the framework provides for protection of confidential information shared by supervisory authorities.

The CNB cooperates European supervisory authorities EBA, ESMA, EIOPA in the area of regulation and supervisory convergence in the EU and facilitates a proper cooperation between home and host supervisors.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

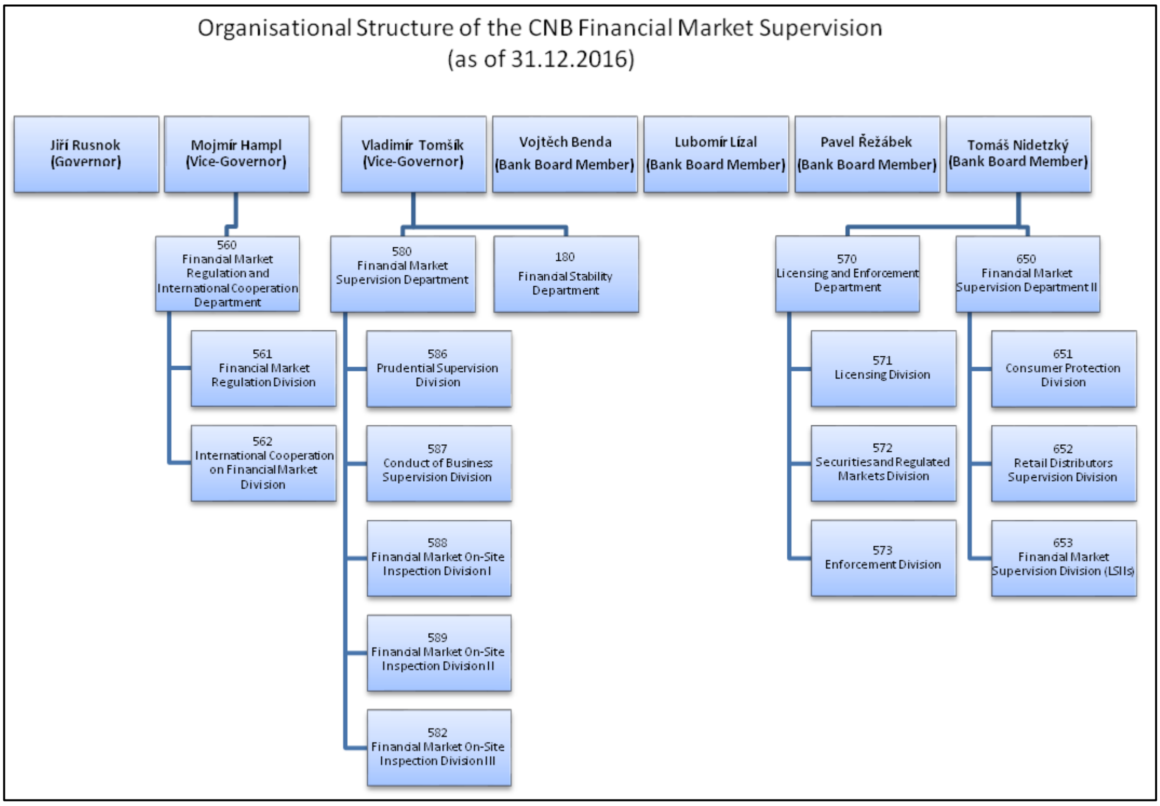
Banking supervision was performed under the standard regime in 2016. Owing to persisting uncertainties in the European economy, attention was devoted primarily to credit portfolios (particularly categorisation of claims, sufficient provisioning, collateral amount, etc.), sufficient capital to cover potential losses, liquidity and overall performance of banks and their consolidated units. The CNB had also been analysing financial situation of parent companies of the Czech subsidiaries including the monitoring of intra-group transactions.

The CNB, in cooperation with selected banks, continued to implement the joint project of stress testing of banks in 2016. The frequency of the joint stress tests was unchanged from 2015, i.e. annual testing using year-end data. As in 2015, banks' interest rate risk was also tested in addition to credit risk. The nine largest domestic banks, most of which have received approval to use the special IRB approach for calculating the capital requirement for credit risk, took part in the testing using data as of 31 December 2015. These banks represent almost 75% of the assets of the Czech banking sector. The aggregated results of the stress tests confirmed the good resilience of domestic banks. Their capital adequacy ratio stayed above the regulatory minimum by a sufficient margin even in an adverse scenario. In addition to these bottom-up tests, the CNB conducts half-yearly stress tests of the entire banking sector (top-down tests) whose results are regularly published on the CNB website.

In 2016, the CNB also dealt with the evaluation of the quality of the recovery plans prepared by credit institutions and their compliance with the requirements of the Act No. 374/2015 Coll., the Act on Recovery and Resolution in the Financial Market (Act), the resolution authority for banks, credit unions and certain investment firms which has transposed the EU Bank Recovery and Resolution Directive (BRRD). During the year 2016, for the first time, some colleges of supervisors adopted joint decisions on group recovery plans.

The supervision of the credit union sector has been concentrated in particular on assessing the current situation and developments in individual credit unions and on resolving their problems, mainly with respect to specific risks undertaken by individual entities. The CNB focused its supervisory activities on categorization of the credit portfolio, sufficient provisioning, financing of economically-linked groups, compliance with regulatory limits, the origin of the capital and usage of the outsourcing services. An extraordinary information duty, established in 2015, was maintained introduced, aimed at detailed monitoring of the developments in individual credit unions (in the areas of liquidity, credit portfolio, operating costs, outsourcing, ceding of receivables etc.).

# 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 and coordinated handling of 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 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. It aims for open communication and close cooperation with the home supervisor in order to cover its area of competence effectively. Such communication mainly concerns material risks relating to the supervised group or to the institution subject to supervision by the Czech National Bank. 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.

## 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. It thus acts in accordance with the agreement on cooperation in the preparation of draft national legislation concerning the financial market and other regulations concluded between the Czech National Bank and the Ministry of Finance.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

As regards financial stability, the banking sector's already high resilience to potential adverse shocks strengthened further in 2016. This was repeatedly confirmed by the results of stress tests. The growing resilience was due mainly to an increase in capital adequacy, favourable liquidity developments and positive changes in risk management by financial institutions. On the other hand, the cyclical risks in the sector increased, especially due to growth in property prices, higher demand for loans and easing of credit standards. In reaction on identification of the risk of a price spiral between property prices and house purchase loans, the CNB decided to tighten the loan-to-value ratio to 95% in October 2016 (and 90% in April 2017). Further, in 2016, on the basis of the regular review of systemically important banks, an altered systemic risk buffer of 1%–3% of common equity was set for five banks (in force from 1st January 2017).

After the new Consumer Credit Act took effect on 1 December 2016, the CNB gradually started supervising the entire consumer credit market, including non-bank companies, which are now required to obtain authorisation (a licence) from the CNB to carry on their business. In this context, the CNB started the process of licensing non-bank providers, which must meet certain conditions relating, for example, to trustworthiness, professional qualifications and initial capital, and comply with other business requirements to obtain a licence. Within this context, a new Supervision Department II was established on 1 July. The department is responsible for carrying out the CNB's new activities under the Consumer Credit Act and other work previously performed by stand-alone departments – the Consumer Protection Department and the Retail Distribution Supervision Department – and by the Financial Market Supervision Division (LSIIs) of the Financial Market Supervision Department. These were abolished on 30 June.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 23 | 23 | 22 |
| Branches of foreign credit institutions | 22 | 23 | 23 |
| Credit unions | 11 | 11 | 11 |
| **Banking sector, total:** | **56** | **57** | **56** |

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

| Type of bank | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 4.2 | 2.2 | 1.8 |
| Other domestic ownership | 4.0 | 4.3 | 5.1 |
| Domestic ownership total | 8.2 | 6.5 | 6.9 |
| Foreign ownership | 91.8 | 93.5 | 93.1 |
| **Banking sector, total** | **100.0** | **100.0** | **100.0** |

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

| Type of financial institution | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 54.2 | 70.4 | 1216.8 |
| Branches of foreign credit institutions | 58.7 | 72.4 | 1475.7 |
| Credit unions | 76.6 | 90.6 | 2405.6 |
| **Banking sector, total:** | 48.7 | 63.4 | 998.2 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 16.6 | 16.6 | 17.7 |
| Credit unions | 0.6 | 0.2 | -0.7 |
| **Banking sector, total:** | 16.4 | 16.5 | 17.5 |

*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.*
*Note: The CNB has available only banking sector data due to the different accounting periods in the credit unions sub-sector.*

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 89.7 | 89.9 | 90.0 |
| Branches of foreign credit institutions | 9.7 | 9.5 | 9.5 |
| Credit unions | 0.6 | 0.6 | 0.6 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 9.6 | 7.9 | 7.6 |
| Nonfinancial sector | 45.1 | 46.1 | 45.2 |
| Government sector | 1.6 | 1.5 | 1.1 |
| Other assets | 43.7 | 44.5 | 46.0 |
| **Claims due to** | | | |
| Financial sector | 14.5 | 11.3 | 13.9 |
| Nonfinancial sector | 56.4 | 58.8 | 57.4 |
| Government sector | 6.5 | 4.0 | 4.1 |
| Other liabilities | 12.9 | 16.3 | 15.5 |
| **Capital** | **9.6** | **9.6** | **9.1** |

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

**Capital adequacy ratio of banks**

| Type of financial institution | 2013** | 2015 | | | 2016 | | |
|---|---|---|---|---|---|---|---|
| | | Total capital | Tier 1 capital | CET 1 capital | Total capital | Tier 1 capital | CET 1 capital |
| Commercial banks | 18.00 | 18.38 | 17.92 | 17.41 | 18.45 | 17.90 | 17.37 |
| Credit unions | 13.51 | 15.44 | 15.09 | 15.09 | 16.18 | 15.92 | 15.92 |
| **Banking sector, total:** | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

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

| Asset classification | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector. | 5.6 | 4.7 | 4.0 |
| **- households** | 4.7 | 4.1 | 3.2 |
| **- corporate** | 6.7 | 5.7 | 5.2 |

*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 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 94.2 | 91.3 |
| Households | 60.8 | 48.4 |
| Corporate | 27.1 | 40.7 |
| Government sector | 6.3 | 2.3 |
| Financial sector (excluding banks) | 5.8 | 8.7 |
| **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)**

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 158 865.5 | 150 903.6 | 143 439.1 |
| Interest expenses | 48 444.9 | 39 973.6 | 33 579.9 |
| Net interest income | 110 420.6 | 110 930.0 | 109 859.2 |
| Net fee and commission income | 36 029.8 | 34 618.7 | 32 436.1 |
| Other (not specified above) operating income (net) | 669.6 | 123.5 | 1 439.4 |
| Gross income | 231 572.9 | 229 814.7 | 228 355.9 |
| Administration costs | 70 248.1 | 70 722.5 | 71 648.3 |
| Depreciation | 6 412.9 | 6 568.9 | 6 985.5 |
| Provisions | 1 284.1 | 799.9 | 2 809.5 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 14 139.7 | 14 800.9 | 10 595.1 |
| Profit (loss) before tax | 76 122.6 | 80 515.1 | 87 920.8 |
| Net profit (loss) | 63 092.2 | 66 372.9 | 73 926.6 |

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

**Total own funds in 2016 (in EUR millions)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 16 310.9 | 15 828.5 | 15 360.7 | 482.5 | n.a. |
| Credit unions | 171.5 | 168.8 | 168.8 | 2.8 | n.a. |
| **Banking sector, total:** | 16 482.4 | 15 997.2 | 15 529.5 | 485.2 | n.a. |

*Note: Cooperative banks = credit unions.*
*Note: EUR = 27.020 CZK as at 30 December 2016.*

# 2016 DEVELOPMENTS IN THE ESTONIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

The Estonian economy grew in 2016 at one of its slowest rates since the crisis. This was mainly because of problems in some branches of the economy, notably oil shale production, energy, agriculture and real estate activities, and economic difficulties in some important trading partners. An increase in the rate of growth was evident in the second half of the year, and the situation improved in most sectors. Confidence indicators for the private sector show greater optimism about the near future and the increase in output volumes indicates that companies will be looking to recruit additional staff.

There remain some contradictions in the Estonian economy, as growth has been slow but demand for employees has been high, leading wages to rise rapidly. The unemployment rate has fallen and was 6,8% in 2016. Eesti Pank considers that the most likely scenario is that the burst of economic growth driven by rising employment after the crisis is coming to an end, and wage rises will start to depend more and more on increased productivity, giving grounds for some optimism.

Pressure on wage costs has already increased, as taxes started to rise again in autumn 2016. Driven mainly by higher energy prices and rises in excise, inflation climbed above 2%, having been negative for two years. The slower growth in purchasing power that resulted from the rise in inflation will increase the pressure on wage demands from employees, and labour shortages will give them a stronger position in wage negotiations. The key issue for further development in the economy is how much companies want and are able to reorganise their production to meet the ever higher wage demands of employees.

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

Estonia has a strong financial sector that creates good conditions for economic growth. The structure of the financial markets of the European Union and Estonia are different enough, as are the risks in these markets. In the opinion of the European Systemic Risk Board, the main risk to the financial stability of the European Union is the revaluation of risks in the global financial market and the weak balance sheets of financial institutions. In the opinion of Eesti Pank, the financial stability of Estonia is influenced by the decreasing profitability of companies, which reduces solvency, and the evaluation of the risks of the Scandinavian economy or banking groups as higher by the financial market, which increases the liquidity risk of the Scandinavian banks operating in Estonia and the risk of financing the economy. The accelerating price increase in real estate driven by the growth of income and low interest rates further influences financial stability that leads to higher vulnerability of the banks to the risks of the real estate sector.

The balance sheets of significant financial intermediaries in Estonia cannot be considered weak. The indicators of our financial sector, especially in banking, show much higher sector quality compared to the European average. Total banking sector assets ratio to GDP was 120% in 2016. There is no burden of the past in the form of bad assets, low capitalisation and poor profitability in Estonia that would unreasonably limit the financial intermediaries to play their role in the society well.

Finantsinspektsioon continues to contribute to maintaining financial stability, also working together with the European Central Bank, by requiring financial intermediaries to have sufficient capital buffers, develop transparent and functioning liquidity resolutions, but also supporting Eesti Pank in adopting supplementary macroeconomic measures to control risks. Further, we make sure that our financial intermediaries are managed by people of integrity; that internal control systems function better and business continuity procedures are thought through and tested. In order to reduce IT-related incidents, we have encouraged credit institutions to apply legal remedies if their partners that deliver information technological solutions violate the agreed service standards. We focus strongly on checking the suitability of persons that participate in the financial sector, which, in some cases, leads to litigation, but is necessary to maintain integrity and transparency of the financial sector. All the above builds trust in a regulated financial market.

## 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.

As the areas of IT and reporting are closely intertwined, it was decided to combine the management of both areas under the Prudential Supervision Division since January 2016.

A need arose to create an independent quality control function because of the participation of Finantsinspektsioon in the Single Supervisory Mechanism and further development of the organisation. The main objective of quality control is to assess the activities and processes of Finantsinspektsioon based on the effective legal and methodological framework. To meet this requirement, one position in the Legal Department was reorganised into a position of a quality control specialist-lawyer in 2016.

In 2016, a special working group was established to ensure that the supervisory activities in a merger of large credit institutions was seamless and well-coordinated in cooperation with other supervision authorities of the Baltic States and the European Central Bank. The Chairman of the Management Board coordinated supervision-related work between the areas of responsibility to resolve management issues in an Estonian credit institution and to ensure that Estonian entrepreneur(s) gained control therein. The Management Board of Finantsinspektsioon decided to contribute greatly to the Estonian presidency of the Council of the European Union and assigned some employees to support the activities of the Ministry of Finance. In February 2016, the Management Board established a special working group with the aim of further examining financial innovation topics.

The Management Board decided to plan tasks and assess the performance thereof in 2016 in a way that the progress of fulfilling the extensive work schedules approved at the beginning of the financial year is assessed twice a year, i.e. in the middle of the year and at the end of the year. At the starting point of preparing a draft budget the general risks of the market and Finantsinspektsioon are identified. Based on these and within the strategic framework, general directions for the activities of the following financial year are developed or amendment of the strategy is initiated, if necessary.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

In capital supervision, we focus on integration into the Single Supervisory Mechanism, with emphasis on cooperation with Eesti Pank. We will further focus on corporate governance, with emphasis on the suitability of managers, the internal control system, business continuity and outsourcing, as well as the accuracy of reporting.

In service supervision, we focus on the life cycle of financial services and products, with emphasis on the prevention of money laundering and terrorist financing, oversight of the development of products and services and the accuracy of disclosed information.

In resolution, we focus on the integration with the Single Resolution Mechanism and its Board and preparing resolution plans.

In promoting public awareness, we focus on supporting the supervision and resolution functions by providing consumers with information about relevant issues (better understanding of financial services) and thereby showing good practice in the financial market to professional market participants (more responsible provision of services).

We contribute to the analysis and optimisation of the institutional framework of 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

The previous reporting period confirmed that certain and clear decisions of Finantsinspektsioon and open discussions and readiness to cooperate bring good results. The stalemate at Eesti Krediidipank, a source of threat, was resolved under the active monitoring of Finantsinspektsioon in an entrepreneurial way: the Russian credit institution exited the circle of owners and a large Estonian business conglomerate acquired control in the bank. This process required all parties to trust each other and clear unambiguous signals from the supervision authority.

The large banks Nordea and DNB announced their plan to merge their Baltic businesses with headquarters in Tallinn. Estonia was chosen because of its good legal environment and activities of the supervision authority. Such decisions are not born overnight but relay on opinions on the environment and institutions formed over time.

The level of digitalisation and information technological literacy are the competitive edge of the Estonian market participants in the common market of the European Union. Noteworthy is the enthusiasm and readiness of the Estonian people to implement new solutions. This is why we opened the doors of Finantsinspektsioon for a discussion with companies involved in financial innovation. We have studied the local environment, gathered ideas to develop legal norms and our activities. To provide better protection for consumers, some innovative financial services must be regulated minimally; however, in our opinion, they have to be harmonised across the European Union, which would break down the barriers between the Member States and open up these countries as a common market for our entrepreneurs.

Finantsinspektsioon takes an active part in the activities of the European banking union. We are probably one of the authorities in Estonia most integrated, in law and in fact, with the partner authorities of the European Union. Clearly specified supervision methodology and close regional cooperation offer added value: our contribution is a reasonably conservative approach to capital in the banking sector and resolution of weak credit institutions. Finantsinspektsioon believes that it is worth analysing whether the common market requires strong European institutions in other segments, e.g. in the prevention of money laundering and terrorist financing to ensure uniform standards and equivalent implementation.

In the reporting year, we have been working hard to reduce risks attributable to high-risk non-resident clients in our financial intermediaries. The share of such clients has significantly decreased, which is a sign of reduced money laundering and terrorist financing risk. We distinguish non-transparent grey or even criminal business conducted by non-residents from regular foreign trade. For Finantsinspektsioon, the most important aspect is whether and how efficient the financial intermediaries' systems to identify unsuitable clients are. As for regulations and implementation, we maintain a reasonable balance between technological progress and risks.

A financial market should not only be a common market that offers opportunities for entrepreneurs but also a functioning market that protects consumers honestly and transparently because these values support trust in the financial sector. In cooperation with the Estonian law enforcement authorities, we have dealt with stock exchange misuse and detecting pyramid schemes. The criminals have been convicted by the court.

Last year, the creditors and credit intermediaries had to apply for an authorisation from Finantsinspektsioon to continue their business operations. We have made great efforts within the new supervision area entrusted to us to ensure that the procedures of the creditors entering the market in assessing the solvency of borrowers are of a higher quality and that such companies are owned and managed by suitable persons. Now we continue with our regular supervision activities. The consumer credit market is gradually shifting to more orderly organisation compared to the time before the requirement of an authorisation was imposed.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

Estonia's financial stability thus depends, among other things, on its cooperation with other Member States and organisations.

Finantsinspektsioon can take part in shaping the financial supervision policy of the European Union through European Supervisory Authorities. All financial supervision authorities of the European Union participate in the work of these authorities. The objective of the European Supervisory Authorities is to develop proposals for the European Commission for adopting regulations.

As Estonia is a member of the euro area, the daily work of Finantsinspektsioon is related to the Single Supervisory Mechanism. This is a system of the European banking supervision that includes the European Central Bank and the supervisory authorities of euro zone countries.

Finantsinspektsioon is also a partner of the Single Resolution Board, which is the central resolution authority of euro area credit institutions. The Single Resolution Board together with the resolution authorities of euro area countries form the Single Resolution Mechanism.

Finantsinspektsioon is a member of the following global financial supervision organisations: the International Association of Insurance Supervisors (IAIS), the Group of Banking Supervisors from Central and Eastern Europe (BSCEE Group) of the Bank for International Settlements (BIS), the International Organisation of Securities Commissions (IOSCO) and the International Network on Financial Education of the Organisation for Economic Co-operation and Development (OECD). In addition, the authority promotes financial stability of Nordic and Baltic countries in the cooperation body and stability group of macroprudential supervision.

In spring 2016, Finantsinspektsioon met with the ratings agencies Fitch Ratings, Standard & Poor's and Moody's during their regular evaluation visits. Finantsinspektsioon gave an overview of the trends and risks of the financial sector in Estonia.

In October, Finantsinspektsioon met with the representatives of the International Monetary Fund (IMF) during their annual evaluation visit that is performed pursuant to the Article IV consultations.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 8 | 9 | 9 |
| Branches of foreign credit institutions | 7 | 7 | 7 |
| **Banking sector, total:** | **15** | **16** | **16** |

### Ownership structure of banks on the basis of assets total

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 0.0 | 0.0 | 0.0 |
| Other domestic ownership | 5.3 | 5.9 | 7.3 |
| Domestic ownership total | 5.3 | 5.9 | 7.3 |
| Foreign ownership | 94.7 | 94.1 | 92.7 |
| **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 | 66,1 | 71,1 | 0.212 |
| Branches of foreign credit institutions | 23.9 | 25.5 | 0.027 |
| **Banking sector, total:** | 90.0 | 96.6 | 0.239 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Banks | 10.2 | 6.6 | 11.5 |

### Distribution of market shares in balance sheet total (%)

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 73.1 | 73.6 | 74.3 |
| Branches of foreign credit institutions | 26.9 | 26.4 | 25.7 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 25 | 28 | 29 |
| Nonfinancial sector | 66 | 63 | 61 |
| Government sector | 6 | 4 | 4 |
| Other assets | 4 | 5 | 6 |
| **Claims due to** | | | |
| Financial sector | 12 | 15 | 16 |
| Nonfinancial sector | 68 | 64 | 64 |
| Government sector | 2 | 2 | 2 |
| Other liabilities | 18 | 19 | 18 |
| **Capital** | **13** | **23** | **22** |

### Capital adequacy ratio of banks

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 35,7*** | 28,0*** | 31,8*** |

(* - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 1.8 | 1.3 | 1.3 |
| **- households** | 2.2 | 1.5 | 1.0 |
| **- corporate** | 1.9 | 1.6 | 1.7 |

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 89 | 88 |
| Households | 44 | 46 |
| Corporate | 43 | 40 |
| Government sector | 6 | 3 |
| Financial sector (excluding banks) | 5 | 9 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 492 | 498 | 511 |
| Interest expenses | 87 | 77 | 65 |
| Net interest income | 405 | 421 | 446 |
| Net fee and commission income | 148 | 156 | 150 |
| Other (not specified above) operating income (net) | 134 | 383 | 66 |
| **Gross income** | **823** | **817** | **887** |
| Administration costs | **266** | **273** | **289** |
| Depreciation | 15 | 14 | 11 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 211 | 190 | 194 |
| Profit (loss) before tax | 344 | 673 | 387 |
| Net profit (loss) | 334 | 610 | 360 |
| Interest income | 492 | 498 | 511 |

**Total own funds in 2016 (in EUR millions)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 |
|---|---|---|---|---|
| Commercial banks | 2466 | 2427 | 2432 | 34 |

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

# 2016 DEVELOPMENTS IN THE GEORGIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2016, economic growth in Georgia reached 2.7%. Major contributors to the growth in 2016 were construction (0.5 pp), manufacturing (0.4 pp) and real estate sectors (0.4%).

Growth rate of fixed capital was under 15%, and it accounted for more than 50% of nominal growth of GDP in 2016. Other source of growth, namely, export of goods and services, has increased by 4% in nominal terms. Tourism sector has also supported the growth of export revenues in 2016.

Gross national savings rate was 19.1% of GDP in 2016. Unemployment rate remained high; however, it decreased slightly to 11.8% in 2016 compared to the previous year (12.0%).

Inflation rate was decreasing in 2016, and it had sunk to 1.8% by December. As a response to decreased inflation expectations, the National Bank of Georgia (NBG) gradually decreased the monetary policy rate from 8.0% to 6.5% in 2016.

Consolidated budget deficit has reached 4.1% of GDP compared with 3.7% in 2015. Tax revenues of consolidated budget have increased by 9.7% compared to 10.6% in 2015, while budget current expenditures increased by 11.6% compared to 5.5% in 2015. Tax burden made up 26.4% of GDP, which is more than 25.3% in 2015. Public debt to GDP increased and amounted to 44.6% in 2016, while in 2015 it was 41.4%.

Current account deficit reached 13.3% of GDP in 2016, which is 1.3 percentage points higher than in 2015. The imports decreased by -4.8%, while exports decreased by -6.3%, which is less than its decline of 24% in 2015. Trade deficit made up 26.6 % of GDP in 2016. 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 16640.1 billion USD in 2016, which is 5.2% more than in 2015. At the same time, the outflow of portfolio investments made up 329 mln USD in 2016, unlike the previous year, when it was 154 mln USD outflow. As the result, total external debt increased by 0.4 billion USD up to the 15.5 billion USD, which is 108% of GDP. In the same period, external public debt increased to 34% of GDP. Large portion of the state borrowing consisted of low interest bearing loans from donor organizations.

## 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 20% in 2016. Credit portfolio increased by 18% YoY at the end of 2016, compared to 23% in 2015, mainly due to exchange rate effect. In total, credit portfolio accounted for 55.8% of GDP which is 5% higher than in 2015. As for the total assets of banking sector, they accounted for 88.9% of GDP that is 9 percentage points higher than in 2015.

In 2016, the highest growth rate was recorded in retail (31% annually), followed by SME and corporate sectors. Banking sector loan portfolio break-down by products is the following: 34% accounts for corporate sector, 45% - retail sector, and 21% - SMEs.

Throughout the year, loan portfolio quality remained the same. 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 0.2 percentage points and made up 7.3% of total portfolio. At the same time, NPL ratio calculated with widely accepted methodology - loans with more than 90 days overdue to total portfolio - increased to 3.7% in 2015, 0.9 percentage points more than in 2015.

In 2016, banking sector accumulated liquidity ratio above the prudential minimum. The share of liquid assets to total assets and non-bank deposits made up 23% and 41%, respectively.

Banking system still remained highly dollarized, contributing to currency induced credit risk. In 2016, the dollarization of loans increased by 1.1 percentage points, up to 65.4%, and dollarization of deposits also increased, making up 71.3%. 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 2016, Tier 1 capital and regulatory capital ratios based on Basel I framework were 9.9% and 15%, respectively, which are significantly higher than the required prudential minimum. It is noteworthy, that starting from 2018, Basel I framework will be fully phased-out. Tier 1 capital and regulatory capital ratios calculated based on Basel III framework were 10.5% and 15.1%, respectively (minimum requirements are 8.5% and 10.5%).

Profitability of banks increased in 2016. Net income of the system jumped from 537 million GEL in 2015 to 679 million GEL in 2016. At the end of 2016 RoA made up 2.6% and RoE made up 18.2%. 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 declined from 46.6 % in 2015 to 46% 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 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 2016, based on the recommendations of International Monetary Fund and World Bank, NBG worked on legislative initiatives that must support the strengthening of the effective banking supervision. Legal initiatives include amendments to the "Law of Georgia on Activities of Commercial Banks" and „Organic Law on the National Bank of Georgia". The amendment project that are fully in compliance with best international practices as well as EU Directives among others expands NBG's authority to regulate and supervise banking groups on the consolidated basis, including authority to set prudential limits on a consolidated basis. In addition, based on amendments, triggers and grounds for temporary administration regime will be expanded in a way that gives NBG the authority to resolve a bank through a temporary administration process under a more defined range of grounds, and at an early stage of a bank's financial difficulty, before reaching insolvency. Amendments related to corporate governance issues include strengthening effectiveness of supervisory board and audit committee by requiring majority of audit committee members to be independent members of supervisory board.

Based on EU-Georgia Association Agreement Georgia should gradually approximate its legislation to the EU legislation and instruments within the stipulated timeframes. In this term, NBG is working on a consolidated supervision framework in accordance with CRD IV package (Regulation 575/2013 on prudential requirements for credit institutions and investment firms and Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms) and supplementary supervision framework for financial conglomerates in line with the Directive 2002/87/EC of The European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate that is one of the EU directives.

In the beginning of 2017, certain amendments were implemented in relation to normative acts issued by the National Bank of Georgia, which were prepared in 2016. Specifically amendments concerned the „Regulation on Fit and Proper Criteria for Administrators of Commercial Banks" and "Regulation on Licensing of Commercial Banks", which closely approximated existing standards with best international practices. Furthermore, updated version of "Regulation for Establishing a Branch, a Division (Service Centre) and a Representative Office by Commercial Banks" was put into force, which will ensure that establishment of braches, divisions and representative offices is carried out according to international best practice.

NBG updated the "law defining minimum capital requirements for commercial banks". According to an updated version, legal persons seeking banking license and existing commercial banks shall comply with minimum capital requirement of GEL 50 million.

In 2016, NBG drafted the regulation on disclosure requirements for commercial banks under Pillar 3, which is based on latest Pillar 3 guidelines by Basel Committees on Banking Supervision. In addition, Liquidity Coverage Ratio

(LCR) calibration and integration process in the banking sector was finalized last year.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

In 2016, 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 and approximating banking legislation to the EU legislation according to the EU-Georgia Association Agreement.

In line with NBG's main strategic objectives, in 2016, NBG drafted and in 2017 approved the regulation on disclosure requirement for commercial banks under Pillar 3. According to these requirements, commercial banks are obliged to publish quantitative and qualitative information about supervisory capital elements, risk weighted assets, top management's remuneration and other material issues. Information disclosed by commercial banks within this framework shall promote market discipline through regulatory disclosure requirements and enable market participants to access key information relating to a bank's regulatory capital and risk exposures in order to increase transparency and confidence about a bank's exposure to risk and the overall adequacy of its regulatory capital. Commercial banks will publish their first quarterly Pillar 3 disclosure reports in July 2017.

In addition, NBG finalized Basel III Liquidity Coverage Ratio (LCR) calibration and integration process in the banking sector. LCR is a modern and effective approach for short-term (up to 30 days) liquidity management and provides more comprehensive tool for identifying, assessing, monitoring and controlling these types of risks. Adhering to minimum requirements is planned to be obligatory for banks starting from September 2017. Furthermore, in order to improve management of long-term liquidity, NBG plans to introduce Basel III Net Stable Funding Ratio (NSFR). Following the introduction of the latter ratio, existing liquidity requirement will be void (30% of short-term liabilities). Thus, liquidity risk supervisory framework will come in full compliance with Basel III standards.

In order to fully comply with Basel III framework, National Bank of Georgia plans to implement Basel III leverage ratio and improve additional tier 1 and tier 2 capital quality standards by requiring write off or conversion into common equity tier 1 upon occurrence of predefined trigger events.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

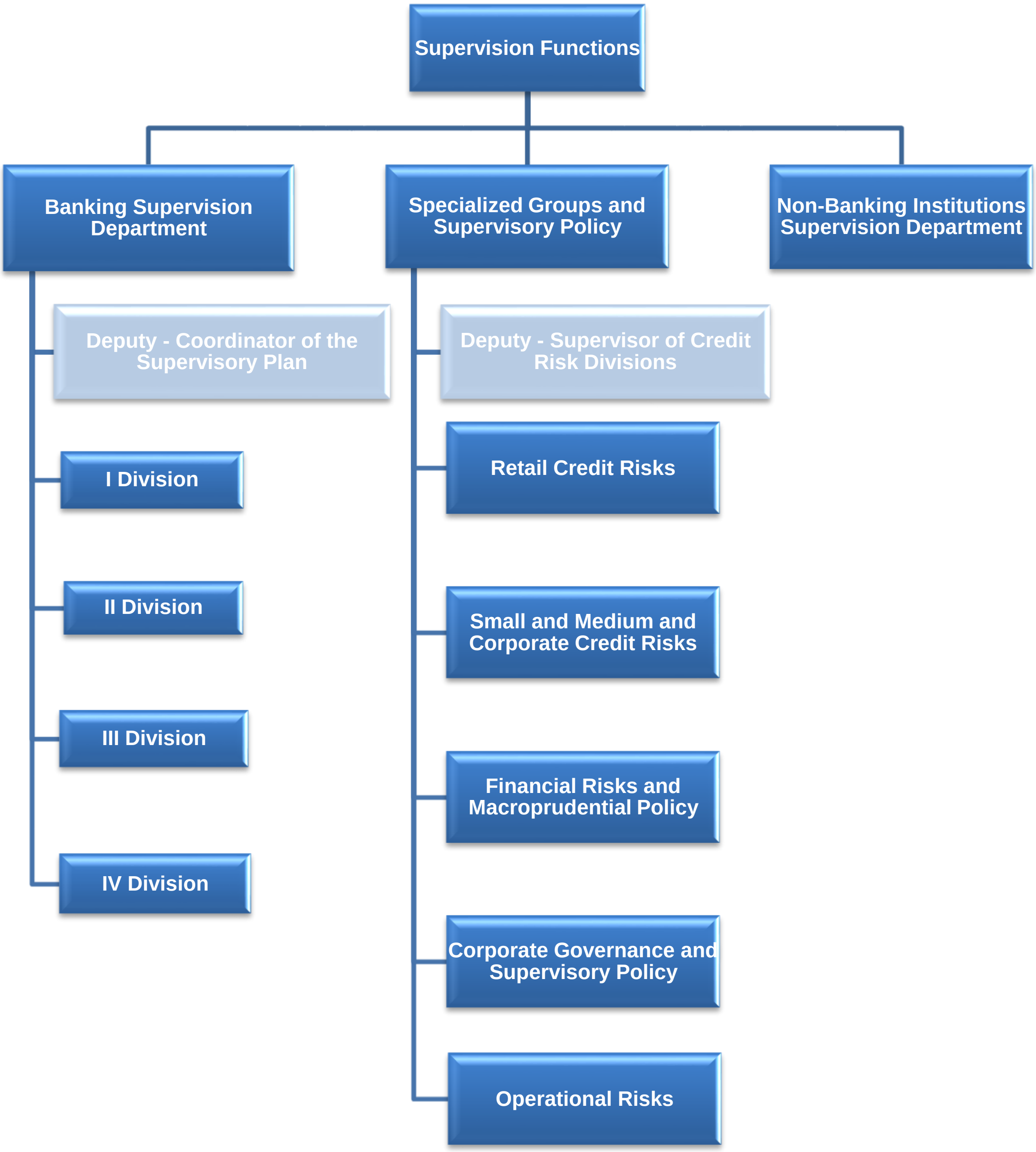
Throughout 2016, the National Bank of Georgia was actively working on the legislative initiatives recommended by the International Monetary Fund and World Bank within FSAP (Financial Stability Assessment Program) mission. Aforementioned legal initiatives are prescribed in detail in the third chapter (the legal and institutional framework of the operation and supervision of financial institutions, new developments, legal competence of the banking supervisory authority) of this document.

In addition, NBG was working on implementing capital and liquidity standards according to Basel III framework. To this end, LCR and Pillar 3 disclosure requirements were adopted (see details in fourth chapter on main strategic objectives of the supervisory authority of this document).

Development of pillar 2 framework within Basel III is still one of the priorities for NBG. To this end, throughout 2016, the process of calibration and implementation of concentration risk buffer within Basel III Pillar 2 framework was continued. According to the "Instruction on Capital Buffer for Credit Concentration Risk for Commercial Banks" commercial banks started calculating the necessary capital for single name and sectoral concentration risks, which is based on the Herfindahl-Hirschman Index.

In 2017, NBG plans to determine additional guidelines within pillar 2 for orientation purposes, in order to ensure banks calculate capital for those risks that are not included in Pillar 1.

# 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[29].

## INTERNATIONAL ACTIVITY OF THE AUTHORITY

The National Bank of Georgia further enhanced its cooperation with the BCBS within the framework of the Regulatory Consistency Assessment Program (RCAP). Within the frames of RCAP, representatives of the NBG evaluated the consistency of the Basel III implementation process in Basel Committee member countries. Furthermore during 2016 NBG was actively involved in the activities of Basel Core Committee's Supervision and Implementation Group. In particular, representative from NBG is actively engaged in the process of renewing stress test principles.

In 2016 export of regulatory reforms increased. The NBG hosted delegation from Central Bank of the Republic of Uganda in order to present its reforms and share its experiences in macroprudential supervision. The visit was organized by International Monetary Fund East African Technical Assistance Center (IMF East AFRITAC) within regional development program. Georgian experts shared with Ugandan colleagues their analytical framework and experience on macroprudential supervision, including monitoring of Loan to Value ratio (LTV), development of a framework for countercyclical capital buffer, risk weighting of foreign currency denominated loans, analyzing financial ratios for the assessment of the (system wide) development of credit risk, stress-testing framework etc. What really stands out is integration of micro and macro prudential supervision.

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

# COOPERATION WITH OTHER SUPERVISORY BODIES IN GEORGIA

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.

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

In 2016 new agency - Service for Accounting, Reporting and Auditing supervision (SARAS) - was established under ministry of finance of Georgia. The purpose of the agency is to supervise accounting, reporting and audit professions and promote transparency of financial information in the country. SARAS was established based on a new law of accounting, reporting and auditing adopted in June 2016. NBG was a member of interagency group working on development of the law. NBG actively cooperates with SARAS with respect to issues of reporting and transparency of financial institutions. A Memorandum of Understanding (MOU) between NBG and SARAS was signed in June 2017 for the purpose of promoting transparency and publicity of financial statements of the entities supervised by NBG.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS

Financial sector consumer protection and financial education are some of the priority areas for the National Bank of Georgia. Throughout 2016, NBG introduced significant changes to the consumer protection legal framework in order to better respond to existing challenges, improve the transparency and the stability of the financial system, and strengthen NBG's authority in consumer protection issues. In December 2016, NBG introduced a new "Rule on Consumer Protection for Financial Organizations", which will enter into force on June 1, 2017. The new Rule extends the scope and coverage of the previous consumer protection rule and applies not only to commercial banks, but also to microfinance institutions and non-bank deposit-taking institutions - credit unions and "qualified" credit institutions; the new Rule also covers not only private individuals, but also legal entities, extends the thresholds of applicability for loans and deposits up to 200,000 GEL, and regulates pre-contractual relations, as well as other key aspects of consumers' relations with financial organizations.

In 2016, with the support from the European Fund for Southeast Europe Development Facility (EFSE DF), NBG conducted the country-wide study of Financial Literacy and Financial Inclusion, results of which helped establish the baseline for the National Strategy for Financial Education. The Strategy was developed by NBG with the support from the Savings Banks Foundation for International Cooperation (SBFIC) and signed into force in December 2016. Within the frames of the strategy, the Steering Committee was established, which is comprised of key stakeholders from public, private and civil sectors, and which will have an important role in the process of implementing the Strategy.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 18 | 18 | 15 |
| Branches of foreign credit institutions | 2 | 1 | 1 |
| Cooperative banks | | | |
| **Banking sector, total:** | **20** | **19** | **16** |

### Ownership structure of banks on the basis of assets total

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | | | |
| Other domestic ownership | | | |
| Domestic ownership total | 13% | 15% | 14% |
| Foreign ownership | 87% | 85% | 86% |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

*The share of non-resident beneficiaries (foreign ownership) in banks' assets is calculated according to final ownership.

### 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 | 68.90% | 78.57% | 21.79% |
| Branches of foreign credit institutions | 0.22% | 0.25% | 0.001% |
| Cooperative banks | | | |
| **Banking sector, total:** | | | |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 14.79% | 15.37% | 18.22% |
| Cooperative banks | | | |
| **Banking sector, total:** | 14.79% | 15.37% | 18.22% |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 99.68% | 99.75% | 99.73% |
| Branches of foreign credit institutions | 0.32% | 0.25% | 0.27% |
| Cooperative banks | | | |
| **Banking sector, total:** | **100%** | **100%** | **100%** |

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

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | **100.00%** | **100.00%** | **100.00%** |
| Financial sector | 1.31% | 1.51% | 1.49% |
| Nonfinancial sector | 56.88% | 57.67% | 57.07% |
| Government sector | 5.20% | 4.75% | 4.24% |
| Other assets | 36.61% | 36.08% | 37.20% |
| **Claims due to** | **82.61%** | **86.04%** | **86.80%** |
| Financial sector | 3.89% | 4.59% | 4.34% |
| Nonfinancial sector | 53.57% | 53.54% | 52.97% |
| Government sector | 2.72% | 3.39% | 3.31% |
| Other liabilities | 22.43% | 24.52% | 26.19% |
| **Capital** | **17.39%** | **13.96%** | **13.20%** |
| **Claims from** | **100.00%** | **100.00%** | **100.00%** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014 | | 2015 | | 2016 | |
|---|---|---|---|---|---|---|
| | Basel I | Basel III | Basel I | Basel III | Basel I | Basel III |
| Commercial banks* | 17.35% | 16.52% | 17.49% | 16.66% | 15.00% | 15.06% |
| Cooperative banks | | | | | | |
| **Banking sector, total*:** | 17.35% | 16.52% | 17.49% | 16.66% | 15.00% | 15.06% |

(* - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 3.09% | 2.75% | 3.67% |
| **- households** | 2.36% | 2.24% | 2.04% |
| **- corporate** | 3.66% | 3.10% | 4.98% |

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 94.12% | 97.65% |
| Households | 54.08% | 41.11% |
| Corporate | 40.04% | 56.54% |
| Government sector | 5.88% | 0.15% |
| Financial sector (excluding banks) | 0.00% | 2.20% |
| **Total** | 100.00% | 100.00% |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 1,844,152,039 | 2,268,414,646 | 2,453,795,614 |
| Interest expenses | 737,254,352 | 938,953,525 | 1,017,733,187 |
| Net interest income | 1,106,897,687 | 1,329,461,121 | 1,436,062,427 |
| Net fee and commission income | 243,564,520 | 257,363,295 | 315,213,697 |
| Other (not specified above) operating income (net) | 250,291,581 | 333,986,239 | 390,841,578 |
| Gross income | 2,338,008,140 | 2,859,764,181 | 3,159,850,888 |
| Administration costs | 438,598,953 | 466,101,066 | 522,636,060 |
| Depreciation | 89,912,278 | 102,433,244 | 108,677,550 |
| Provisions | 245,200,932 | 406,525,577 | 337,830,397 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ..) | 245,200,932 | 406,525,577 | 337,830,397 |
| Profit (loss) before tax | 561,416,989 | 620,147,062 | 819,327,557 |
| Net profit (loss) | 474,807,717 | 537,394,050 | 679,101,417 |

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds | | Core Tier 1 | Tier 1 | | Tier 2 | | Tier 3 |
|---|---|---|---|---|---|---|---|---|
| Commercial banks | 1,579,153,710* | 1,714,876,864*** | 1,171,184,760 | 1,039,575,872* | 1,193,998,920*** | 790,859,673* | 520,877,943*** | |
| Cooperative banks | | | | | | | | |
| **Banking sector, total:** | 1,579,153,710* | 1,714,876,864*** | 1,171,184,760 | 1,039,575,872* | 1,193,998,920*** | 790,859,673* | 520,877,943*** | |

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

# 2016 DEVELOPMENTS IN THE HUNGARIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Hungarian GDP increased by 2.2[30] (2.0) percent, while inflation rate reached 0.4 over the course of 2016. The budget deficit was 1.8 percent. The economy's overall external position remained positive with the current account balance reaching 5.5 as a percentage of GDP.

In 2016, the Hungarian economy has continued to expand, but temporarily at a slower pace than in the years before. The slowdown in growth was attributable to the weaker-than-expected fiscal impulse, the downturn in investment implemented from EU funds and the subdued performance of industrial production due to temporary effects (model change, not full-shift production).

Growth was still mainly supported by the significant expansion in household consumption. Net exports and government consumption also had a positive impact on growth, while gross fixed capital formation decelerated economic growth in the previous year.

Household consumption expenditures rose due to several factors. Strong real wage dynamics, increasing employment, low inflation environment and an increase in the overall propensity to consume all contributed to household consumption growth. Improving consumer confidence and recovering loan disbursement also fostered household consumption.

Gross fixed capital formation fell in 2016 due to a sharp decrease in government investments, related to the transition from the 2007-2013 EU budget cycle to the 2014-2020. The sudden fall in EU fund absorption, with the strong base of 2015 led to shrinking investments despite the healthy underlying trends experienced in the private sector. Corporate investments picked up in 2016 in line with increasing corporate loans supported by the Funding for Growth Scheme. Along with accelerating SME investments, significant capacity expanding projects in the vehicle industry also contributed to the rise in private investments. Households' investment activity also improved in accordance with sharply increasing home completions and recovering household loan disbursement.

Inflation stayed far below the 3 percent inflation target. Low inflation is mainly attributable to weak imported inflationary pressure, and low inflation expectations. By the end of the year we experienced a pick-up in headline inflation, partially due to increasing oil prices and base effect. Core inflation was steady throughout 2016.

Total employment increased significantly and the unemployment rate decreased in 2016, due to a growing number of employees in both the private and the public sector. Private sector employment increased both in manufacturing and private services. The expansion in employment other than public work programs was a key factor regarding public employment growth. Unemployment rate decreased to 5.1 percent in 2016.

[30] For monetary policy, it is important to make decisions with the lowest possible uncertainty and relying upon the widest information base; therefore, expected routine revisions (excluding the effect of methodological changes) have been taken into account related to year 2016. The values in parentheses shows official data published on 7 June 2017 by Hungarian Central Statistical Office (HCSO).

After decreasing in the second half of the year, net lending fell to close to 5.5 percent of GDP by the end of 2016, reflecting the low absorption of EU transfers. The impact of falling EU funds was dampened by a high trade surplus and the decline in the income balance deficit. The current account balance amounted to 5.5 percent of Hungarian GDP in 2016. By the end of 2016, terms of trade started deteriorating – negatively affecting the trade surplus – after long years of supporting it. Slowing industrial production also decreased the dynamics of trade in goods. The transfer balance fell sharply in accordance with subdued EU fund inflows, while major other current transfer payments (e.g. taxes paid in relation to the wages of employees temporarily working abroad) were made. The further decline in the income balance deficit was mainly caused by the declining interest expense resulting from the low interest rate environment.

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

In 2016 the Hungarian banking system's shock-absorbing capacity remained robust both in terms of liquidity and capital stock. During 2016 the banks' lending activity intensified; the annual SME credit growth reached the level of 5-10 percent, necessary for sustainable growth. The formerly very strong procyclical operation of the Hungarian financial system substantially eased, which was greatly supported by the lending incentives programs (Funding for Growth Scheme, "FGS"; Market-Based Lending Scheme, "MLS"). However, external risks rose in 2016. In addition to the severe legacies of the crisis, geopolitical developments and challenges posed by the persistently low interest rate environment represent the main risks in the European banking sector.

At the end of 2016 the total assets to GDP ratio of the banking sector increased by 2 percentage points to 88 percent related to the end of 2015. As regards the operating environment for the domestic banking sector is concerned, a significant improvement has been seen compared to the previous years. A complete turnaround has occurred in lending developments. Rising consumption and investment demand is generating steadily increasing credit demand in both the corporate and household sectors. In terms of net disbursements and repayments, domestic corporate lending grew by a total 4 percent, expanding a rate not recorded since the crisis. The credit growth seen in the SME sector is in the 5–10 percent band which is deemed sustainable by Magyar Nemzeti Bank (Central Bank of Hungary, "MNB"): an 8 percent expansion was observed in the case of non-financial corporate SMEs, while the rate of growth including sole proprietors amounted to 12 percent in 2016. Looking ahead, developments in corporate lending will be driven by rising credit demand, easing credit conditions, the low interest rate environment and continued support from the MLS; consequently, further growth in lending is expected after the FGS is phased out.

The segmented recovery of the property market continued in 2016. Compared to end-2015, housing prices in Budapest increased by 22.5 percent by end-2016, while in the case of rural towns and villages the rise observed in the same period was only 13.8 and 9.8 percent, respectively. Housing market developments are closely related not only to the financial stability dilemmas, but also fundamentally determine the short- and long-term prospects of economic activity. Housing market developments and – in particular – the volatility of housing prices influence the sector's savings and consumption decisions through the households' wealth, while through the mortgage loan collaterals it influences the portfolio, profitability and lending activity of credit institutions. In order to monitor the property price developments and the impacts of those on financial stability, MNB developed its own housing price index, which is able to capture the changes in domestic housing prices more accurately, particularly the heterogeneity in prices and their development compared to the fundamentally justified level. The regular analysis of housing price development highlights the fact that even though there was a substantial rise in the housing prices in Budapest, housing prices still cannot be deemed exaggerated. On the other hand, price increase is not so typical in less frequented areas or smaller settlements.

In parallel with the housing market developments, a turn took place in household lending as well. Disbursements – for the first time since 2008 – already exceed repayments from June 2016, which is primarily attributable to the almost 50 percent increase in housing loans. To date the central bank's debt cap rules kept new lending at a sound level; nevertheless, a shift to fixed rate loans would be desirable, particularly on the longer maturities, in the case of the customers with higher payment-to-income ("PTI") ratio. However, this requires the strengthening of the price competition among the Hungarian banks, as the spread of the domestic fixed-rate loans is extremely high by international standards.

Additional challenge is the legacy of the previous crisis in the form of non-performing loans ("NPL"). 2016 represented a turn in several respects, as the foreclosure and eviction moratorium ended on 1 March, thus it once again became possible for the lenders to enforce the collaterals. It was foreseeable at the start of the year that the number of properties offered to the National Asset Management Agency ("NAMA") would reach the permitted limit and that the property market boom and the low yield environment together make the sales of the receivables attractive for the lenders. Following an in-depth research, in March 2016 MNB issued a recommendation on stimulating the permanent restoration of the solvency of defaulting household mortgage loan debtors. The lenders falling within the scope of the recommendation contacted the debtors from May 2016 at a predefined schedule: by the end of the year the first contact was established with roughly 72,000 debtors. However, for the time being the number of compositions falls short of MNB's expectations, thus further work is needed here and challenges lie ahead. It would be desirable to improve the volume and efficiency of the arrangements, bearing in mind the common interests of both the debtors and the creditors, while taking also in account the social aspect of the problem. All in all, it is essential to ensure that in case of loan defaults there is a continuous cleaning and portfolios are not stuck.

Compared to the previous years, the banking sector realized an outstanding profit in 2016. Partly due to one-off effects, such as the release of impairments, the return on equity rose to 17 percent. At the same time, in the persistently low interest rate environment, banks' structural profitability will be under pressure in the medium term due to the narrowing interest margins. Despite the streamlining efforts of the past years, there was no substantial improvement in the sector's cost effectiveness and the management of the non-performing portfolio continues to take up significant capacities.

The domestic credit institution sector functions with a relatively high level of operating expenses in proportion to total assets. The high level of operating expenses (operating costs to total assets: 3.2 percent) is coupled with a high level of net interest income (net interest income to total assets: 3.1 percent), and thus the high operating expenses are covered by the available interest income. Improved cost efficiency is key to managing the challenges posed by the persistently low interest environment and the technological progress. This could be fostered by the consolidation of the banking sector, the exploitation of the opportunities inherent in digitalization and the reduction of the NPL portfolio. The improvement in cost efficiency could be boosted by competition within the banking sector, particularly the price competition in lending to households, which would force banks to take the necessary steps.

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

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, MNB issues binding MNB decrees and non-binding recommendations, documents with information purposes and CEO letters.

Regarding the legislative developments in 2016, we would highlight the following laws:

1. Act XV of 2016 on national housing communities was published to promote the growth of housing opportunities and the growth of housing stock, to encourage the purchase of new residential real estate, to promote community saving of resources from own resources of the population, and to conduct housing in a closed and separate system, with state support and supervision, also to promote the strengthening of construction industry indirectly. Related government decree was published defining the details of authorization, registration and operation of housing communities.
2. Act CIII of 2016 on the legal harmonization of laws regulating criminal cooperation with the European Union and international organizations, and of certain criminal laws. The act transposed legislation of MAD and MAR to the Hungarian legal system.

## MAIN STRATEGIC OBJECTIVES OF THE HFSA IN 2016

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 to maintain and even strengthen the stability of the financial system and to deepen 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 2016 the directorate of MNB responsible for credit institutions supervision launched 42 inspections and concluded 28 comprehensive, 11 targeted, 1 special thematic and 8 follow-up inspections. Concerning the internal capital adequacy of the institutions 11 complex (on-site) Internal Capital Adequacy Assessment Process ("ICAAP") inspections were completed. As a result of the completed inspections 709 million HUF prudential fine was imposed on credit institutions emphasizing that 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 central bank 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.

During the year MNB conducted the ICAAP-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 SME lending) supporting the economic growth, MNB as a supervisory authority provided preferential capital requirements for the credit institutions in proportion of their growth commitments in SME lending.

In April 2016, a prudential thematic inspection was launched to assess the efficiency of the retail mortgage recovery processes covering the organizational structure of the recovery department and the adequacy of the risk methods used in the classification of the overdue transactions. The procedure of analyzing the efficiency of the NPL resolution strategy catalyzed the cleaning of the portfolios, and also encouraged the banks to widen the scale of the restructuring solutions by reviewing and streamlining their own processes. MNB also conducted quick on-site inspections for credit institutions, typically without prior notice, in which MNB made conclusions concerning data disclosure and the compliance with the rules set for prudential and sustainable consumer lending (LTV and PTI limits).

During the reporting period 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 central bank 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 | 2016 | | 2017 plan | |
|---|---|---|---|---|
| | comprehensive | other* | comprehensive | other* |
| Large banks | 3 | 14 | 3 | 27 |
| Small and medium sized banks | 2 | 5 | 5 | 2 |
| Integration | 10 | 7 | 0 | 16 |
| Specialized credit institution | 5 | 4 | 0 | 5 |
| Bank branch | 0 | 1 | 0 | 0 |
| Financial enterprises | 0 | 3 | 0 | 1 |
| Payment institution | 2 | 0 | 2 | 0 |
| Insurance corporations | 6 | 2 | 9 | 0 |
| Insurance associations | 1 | 0 | 8 | 0 |
| Intermediaries | 0 | 4 | 0 | 3 |
| Pension funds | 13 | 2 | 13 | 2 |
| Capital market participants | 30 | 9 | 24 | 0 |
| Occupational pensions | 1 | 0 | 0 | 0 |
| **Total** | **73** | **51** | **64** | **56** |

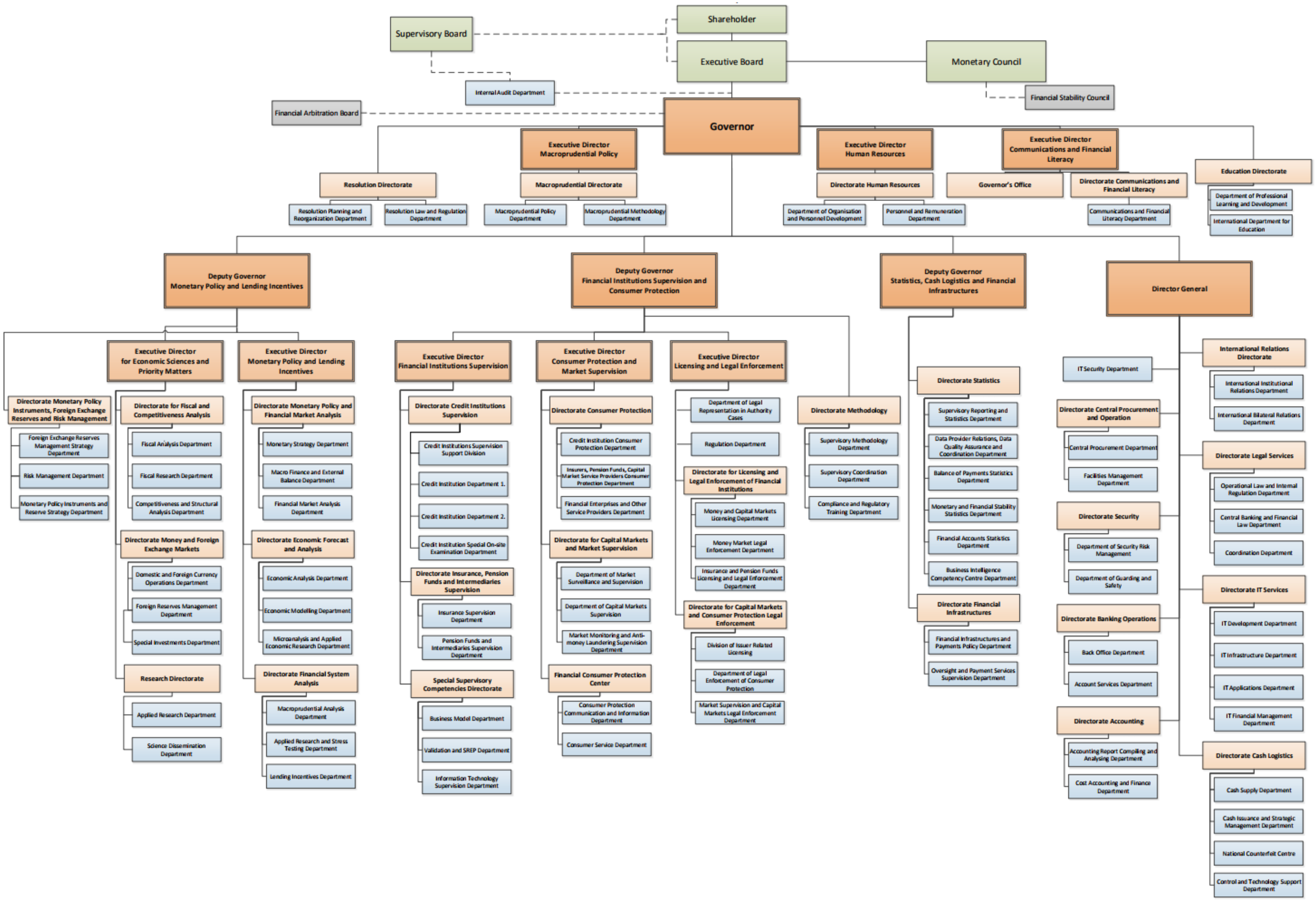
* including ICAAP reviews and validations

Table 1: Number of inspections at credit institutions

| Number of on-site inspections | 2016 | |
|---|---|---|
| | comprehensive | other* |
| Credit institutions (included bank branch) | 25 | 31 |
| Financial enterprises | 0 | 6 |
| Payment institution | 3 | 0 |
| **Total** | **28** | **37** |

* including ICAAP reviews and validations

# ORGANIZATIONAL CHART OF THE HFSA BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITY OF THE AUTHORITY

### *ESRB*

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.

### *FSB Regional Consultative Group for Europe*

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 May and in October 2016.

### *Memorandum of Understanding*

The MNB and the China Banking Regulatory Commission ("CBRC") signed a Memorandum of Understanding in Budapest on March 31, 2016, in order to establish a formal arrangement for the sharing of supervisory information and for the enhancing of cooperation in the area of banking supervision.

# 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[31] and the Financial Consumer Protection Center.[32]

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

Furthermore, MNB collaborates with other competent Hungarian authorities as well, such as the Hungarian Authority for Consumer Protection Authority and the National Tax and Customs Administration of Hungary.

[31] a professionally independent alternative forum for resolving disputes

[32] 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[33]

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 39 | 35 | 37 |
| Branches of foreign credit institutions | 10 | 10 | 10 |
| Cooperative banks | 110 | 87 | 59 |
| **Banking sector, total:** | **168** | **132** | **106** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 6,3% | 9,6% | 3,1% |
| Other domestic ownership | 13,4% | 11,6% | 17,2% |
| Domestic ownership total | 19,7% | 21,2% | 20,3% |
| Foreign ownership | 80,3% | 78,8% | 79,7% |
| **Banking sector, total:** | **100,0%** | **100,0%** | **100,0%** |

* Ownership structure based on the ultimate majority owners instead of direct majority owner in last year.

**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 | 47,0% | 62,2% | 0,115 |
| Branches of foreign credit institutions | 83,6% | 95,7% | 0,275 |
| Cooperative banks | 17,5% | 25,6% | 0,030 |
| **Banking sector, total:** | **40,2%** | **53,3%** | **0,088** |

[33] Without 3 Special Financial Institutions (MFB, EXIM, KELER)
Based on individual data
Data correction of 2015 due to the arrival of audited data after the data collection deadline of last year's BSCEE Annual Review.

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | -19,2% | 0,2% | 14,3% |
| Cooperative banks | -6,2% | -1,0% | -1,5% |
| **Banking sector, total:** | **-18,7%** | **0,1%** | **13,8%** |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 87,6% | 86,9% | 85,7% |
| Branches of foreign credit institutions | 7,7% | 8,8% | 10,3% |
| Cooperative banks | 4,7% | 4,4% | 4,0% |
| **Banking sector, total:** | **100,0%** | **100,0%** | **100,0%** |

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

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 35,8% | 35,7% | 32,4% |
| Nonfinancial sector | 39,4% | 35,0% | 34,7% |
| Government sector | 16,6% | 21,0% | 22,8% |
| Other assets | 8,2% | 8,3% | 10,1% |
| **Claims due to** | | | |
| Financial sector | 21,3% | 22,1% | 23,2% |
| Nonfinancial sector | 41,0% | 44,6% | 47,2% |
| Government sector | 2,9% | 2,9% | 3,7% |
| Other liabilities | 26,4% | 21,6% | 15,8% |
| **Capital** | **8,4%** | **8,8%** | **10,1%** |

* Data correction for 2014 and 2015 due to the insertion of data regarding foreign assets into each category.

**Capital adequacy ratio of banks*****

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 19,2% | 20,2% | 21,3% |
| Cooperative banks | 19,0% | 16,6% | 15,8% |
| **Banking sector, total:** | **19,2%** | **20,0%** | **21,1%** |

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

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

| Asset classification | 2014* | 2015* | 2016** |
|---|---|---|---|
| Non-financial sector, including*** | 16,4% | 13,7% | 14,1% |
| - households | 19,0% | 17,6% | 16,8% |
| - corporate | 13,6% | 9,6% | 11,4% |

* Loans overdue more than 90 days
** Non-performing loans
***Domestic loans

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 80,3% | 87,8% |
| Households | 40,0% | 41,6% |
| Corporate | 40,3% | 46,2% |
| Government sector | 5,7% | 0,9% |
| Financial sector (excluding banks) | 14,0% | 11,3% |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 1 569 215 | 1 306 550 | 1 155 869 |
| Interest expenses | 650 330 | 545 007 | 354 740 |
| Net interest income | 918 885 | 761 543 | 801 129 |
| Net fee and commission income | 447 327 | 461 953 | 463 543 |
| Other (not specified above) operating income (net)* | -322 028 | -988 350 | -193 520 |
| Gross income | 1 044 185 | 235 147 | 1 071 152 |
| Administration costs | 611 538 | 634 292 | 617 779 |
| Depreciation | 59 702 | 58 027 | 62 755 |
| Provisions* | -862 325 | 483 779 | 120 897 |
| 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 | -489 380 | 26 607 | 511 515 |
| Net profit (loss) | -542 628 | -34 266 | 440 499 |

***** 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 2016 (in EUR)*****

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 9 879 617 346 | 8 874 546 554 | 8 874 546 554 | 1 005 070 792 | - |
| Cooperative banks | 291 506 998 | 284 079 526 | 284 733 264 | 6 773 734 | - |
| **Banking sector, total:** | 10 171 124 344 | 9 158 626 080 | 9 159 279 818 | 1 011 844 526 | - |

*** - for Basel III)

# 2016 DEVELOPMENTS IN THE LATVIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Latvian economy grew by 1.3% in 2016 (2.0% n.s.a.) – a temporary slowdown in GDP growth due to falling **investment**. The hindered implementation of investment projects was caused by delayed adoption of the relevant legislative acts of the new EU structural funds planning period. As expected, investment is recovering lately – its strong growth in Q1 2017 contributed to the overall rise in GDP in Q1 by 4.0%.

Despite the unfavourable external environment and the resulting weak foreign demand, coupled with elevated geopolitical uncertainty and increasingly protectionist rhetoric on global trade, Latvian real **exports** grew by 2.8% in 2016. The start of 2017 was characterized by improving international environment which resulted in a 7.6% growth in real exports. The economy of Latvia has recently become less sensitive to external shocks – the structure of exports has become more diversified and Latvia has seen its market share in world imports increase in 2016.

The **rate of unemployment** continues to decrease slowly (9.3% of the economically active population in Q4 2016) and is below the euro zone average. Latvia's flexible labour market is characterized by decentralized wage bargaining and elastic labour force movement across sectors. The improving labour market and the recent robust increase in wages and salaries is reflected in growing **private consumption**. In real terms private consumption in 2016 was supported also by close-to-zero **inflation**. In 2017 inflation picked up (3.4% in April Y-o-Y), largely due to higher global energy and food prices.

The **current account** in 2016 recorded a surplus (1.5% of GDP). Improvement in goods deficit was driven by the dropping imports resulting both from lower prices of raw materials and a decrease in capital goods. Current account is likely to slip back into a small deficit due to the increase in global prices and the recovery of domestic investment activity. Net external debt of Latvia remains at a low level (27% at the end of 2016) and is considerably lower than gross external debt (147%) as large part of MFI's gross external liabilities is counterbalanced by foreign assets.

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

Banks account for about 87.5 per cent. of the total assets of the Latvian financial sector or approximately 118 per cent. of GDP . At 31 December 2016, there were 16 Latvian licensed banks operating in Latvia as well as seven additional banks licensed in other EU Member States which only have a branch presence in Latvia. All of the Latvian-licensed banks have been licensed as universal banks and can provide a full range of financial and investment services.

The Latvian banking sector’s development is in line with the global trend in the banking industry. In 2016, the annual growth rate of the total loan portfolio of the Latvian banking sector increased to 3.1 per cent., which was the first increase in the annual growth rate since the global financial crisis

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 more than 90 days in the total loan portfolio decreased to 4.4 per cent. at 31 December 2016. The domestic corporate sector contributed the most to this improvement in loan quality, with the proportion of loans overdue more than 90 days in that sector falling to 2.3 per cent. at 31 December 2016 from a peak of 22.3 per cent. in May 2010.

Loan restructuring declined in 2016 as compared to 2015. At 31 December 2016, the share of restructured loans in the total banking sector loan portfolio was 7.9 per cent. (compared to 8.7 per cent. at 31 December 2015). Loans in a work-out process are declining and comprised 3.7 per cent. of the total banking sector loan portfolio at 31 December 2016 (compared to 5.3 per cent. at 31 December 2015). At 31 December 2016, the total amount of restructured loans and loans in a work-out process was €1.8 billion, 14.7 per cent. less than at 31 December 2015.

The total amount of loan loss provisions has gradually decreased since July 2010 as banks have released previous provisions as their loan quality improves. Loan loss provisions were 4.0 per cent. of the total banking sector loan portfolio, at 31 December 2016. The provisioning level for loans overdue more than 90 days improved to 89.3 per cent. at 31 December 2016.

After experiencing large losses from 2009 to 2011, the Latvian banking sector has been profitable, driven principally by improved fee income, significantly reduced charges for loan loss provisions and a decrease in administrative expenses. In 2016, total profit of banking sector grew by 9% y-o-y and was €453.8 million. Profits have been mainly increased by the sale of Visa Europe Limited shares and excluding this one-off effect, the profit of banking sector declined by ~20% (y-o-y). In 2016 profit levelled off due to decline in business activities on servicing foreign clients and increased administrative expenses, which were largely caused by implementing enhanced AML/CFT requirements.

Despite a significant share of demand deposits, liquidity risk in the Latvian banking sector remains limited due to a high volume of liquid assets (predominantly claims on central bank and debt securities). The liquidity ratio of the banking sector remains high; it was 61.9 per cent. at 31 December 2016 and is well above the minimum requirements. Banks are required to maintain liquid assets in amounts of not less than 30 per cent. of liabilities with a maturity of up to 30 days.

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 21.5 per cent. at 31 December 2016 compared to the regulatory minimum of 8 per cent. at that date. Since 28 May 2014, a 2.5 per cent. capital conservation buffer has been applied in addition to the 8 per cent. minimum regulatory capital requirement, bringing the total capital adequacy requirement to 10.5 per cent. The Tier I ratio, which predominantly consists of top quality own funds (common equity tier 1), was at 18.2 per cent. as at 31 December 2016. At 31 December 2016, the banking sector's total capital and reserves was €3.0 billion.

After strong clients deposit growth in previous years, total deposit amount in the Latvian banking sector has been declining since the end of 2015. In 2016, total volume of deposits decreased by €1.9 billion or 8.2 per cent. and at the end of the year was €21.4 billion. Nevertheless, trends differ between domestic and foreign deposits. In line with economic and income growth and labour market improvements, amount of domestic deposits in 2016 increased by €1.9 billion or by 12.6 per cent. At the same time, sharp growth rate of foreign deposits observed in previous years became negative. Due to deteriorating macroeconomic conditions in CIS countries, withdrawal of license of JSK TRASTA KOMERCBANKA and stricter AML/CTF requirements, amount of foreign deposits decreased by €3.3 billion or 26.3 per cent. As a result, the share of foreign deposits has decreased from 53.4 per cent. at the end of 2015 at to 42.8 per cent. at the end of 2016.

Risks stemming from significant share of foreign deposits in the Latvian banking system are mitigated by appropriate structure of assets and maintaining high liquidity ratios. Liquid assets are mostly comprised of claims to central bank, foreign banks (predominantly EU banks) and debt securities issued by central governments). In line with decrease of foreign deposits, banks reduced liquid assets by the same amount preserving high liquidity ratios.

In addition, banks focused servicing foreign clients in compliance with their business model and the structure are required to maintain higher capital and liquidity ratios based on pre-defined quantitative criteria taking into account both the share of foreign deposits and loans to foreign clients within bank's balance sheets as well as their growth rate.

The FCMC reviews the additional prudential requirements relating to banks which service foreign clients on a regular basis in order to ensure that any increase in risks is adequately reflected in the relevant capital and liquidity requirements.

## 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 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 the 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 CRD IV/CRR.,

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

## MAIN STRATEGIC OBJECTIVES OF FCMC IN 2016

<u>FCMC strategic priorities for 2015-2017:</u>

- 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 ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2016, the FCMC **continued to improve the regulatory framework** governing the activities of the participants of the financial and capital market. In continuing the transposition of the requirements of the AML/CTF directive and the FATF (*Financial Action Task Force*), the FCMC developed **amendments to the Law on Anti-Money Laundering and Combating Terrorist Financing**, imposing a duty on banks to carry out an assessment of the aptness of the person or the board member responsible for compliance with the requirements of the AMT/CTF law, as well as provide for the powers and the breakdown of the duties of the persons in charge of the AMT/CTF, as well as the procedure under which the supervision of the responsible persons is ensured. These requirements were provided for to ensure that the person responsible for AML/CTF has appropriate professional experience and education in order to fulfil their responsibilities and to ensure that the institution is compliant with the requirements of the AML/CTF law. Furthermore, a clearly defined list of competencies facilitates the possibility of identifying the responsible person at the bank to which sanctions are to be applied for the identified non-compliance. Concurrently, with a view to ensuring the implementation of uniform standards in credit institutions and financial institutions regarding the measures to be taken to comply with the requirements of the AML/CTF law, and to enable the FCMC to impose sanctions and corrective measures in cases where the relevant credit institution or financial institution fails to fulfil the specified requirements, a number of areas has been provided for entitling the FCMC with the right to issue laws and regulations. The FCMC also drafted necessary amendments to the *Credit Institution* Law, according to which the penalties applicable to banks for violations of the AML/CTF compliance have been increased.

There was also a number of regulations enacted to enhance AML/CTF requirements. The overview of legal acts applied in AML/CTF sector are available at http://www.fktk.lv/en/law/general/legal-acts-in-the-aml-cft-area/6246-legal-acts-in-the-aml-cft-area.html.

**Amendments to the Law on Payment Services and Electronic Money**, which came into force on 28 March 2017, have been made to implement the requirements of the Payment Accounts Directive (2014/92/EU) regarding the comparability, exchange, and disclosure of information and access to accounts for consumer payment accounts. Additional amendments provide for a change in the calculation of the fees chargeable for the supervision of payment and electronic money institutions.

**Regulatory Provisions for Establishing the Capital and Liquidity Adequacy Assessment Process** refine the existing requirements as well as introduce new requirements that credit institutions must comply with in defining the amount of capital required to cover the risks inherent in the activity thereof as well as potential risks, as well as requirements for the assessment of liquidity adequacy. The key changes are related to the requirements regarding the need to carry out a regular assessment of the identification of liquidity risk, and the assessment of the identification and management processes, and the determination of the amount of the liquidity buffer. Based on the new regulatory provisions, credit institutions need to focus on measuring the viability of their business model when determining the amount of capital needed, which is a particularly important consideration in the case of extremely low market rates. In addition to the above, the new requirements also change the general procedure for calculating the amount of necessary capital, lays down the capital structure for addressing Tier 2 risks, which corresponds to the covering of the capital structure for addressing Tier 1 risks, and provides for covering the recommended capital buffer with Tier 1 base capital, thus promoting the ability of credit institutions to absorb the potential losses under stress conditions.

**The Regulatory Provisions for the Preparation of Supervisory Financial Statements.** In accordance with Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards for the prudential oversight of the institutions pursuant to Regulation (EU) No 575 / 2013 of the European Parliament and of the Council, the FCMC receives financial reports of credit institutions (FINREP) at a consolidated level. However, FCMC experience suggests that for carrying out the supervisory functions, information is also required at the individual level. Therefore, regulatory provisions have been developed, laying down a requirement for credit institutions and the branches of the credit institutions registered in other Member States and the branches of foreign credit institutions to also provide financial information at an individual level.

Information regarding other regulatory development is available in Annual Report 2-16 of the FCMC http://www.fktk.lv/en/media-room/annual-reports/2016.html.

As regards **macroprudential supervision** the FCMC, starting from 2015, has been determining and publishing, once a quarter, the **countercyclical capital buffer requirement** for transactions with domestic customers. The counter-cyclical capital buffer is intended as a kind of a buffer for credit institutions to enable them to continue lending also under adverse economic circumstances. For the assessment of cyclical risks in the Latvian national economy, the FCMC applies a counter-cyclical capital reference point, which takes account of lending trends as well as GDP trends. During 2016, as well as at the beginning of 2017, due to weak lending and economic growth, the FCMC maintained the counter-cyclical capital buffer rate for transactions with Latvian domestic customers at 0%.

In 2016, the FCMC identified and published a list of six systemically important credit institutions in the domestic financial sector, for which a systemic capital buffer rate and more stringent corporate governance requirements have been defined. Compared to 2015, the list of other systemically important institutions remained unchanged in 2016. A transitional period ending 30 June 2018 has been set to give time for the identified institutions to be able to get prepared for compliance with the capital buffer rate.

In 2016, the FCMC continued to consolidate the framework of **intensive supervision**, the purpose of which is to take risk-based and result-orientated supervisory measures and enable the FCMC to get involved in the activities of the banks and take the necessary measures to resolve potential and existing problems or reduce losses in a timely manner.

At the beginning of 2016, based on the assessment of the operational risks of credit institutions and of the trends of the financial system, the FCMC set banking supervision priorities.

**Banking supervisory priorities set in 2016:**

- Assessing the sustainability and earning capacity of the relevant business models and maintaining dialogue with market participants;
- Assessing and reducing compliance risk;
- Assessing credit risk and early identification of potential problems, with an emphasis on problem loans and concentration risk;
- Assessing management risk strategies, risk appetite and governance.

**Assessing the sustainability and earning capacity of the relevant business models and maintaining dialogue with market participants** For the implementation of this priority, a number of off-site measures was taken in accordance with the approved supervisory measures plan:

- The reports submitted by banks, performance indicators and other information at the disposal of the supervisors were analysed, the risks significant for banks were assessed, and quarterly reports were prepared for the FCMC Board. The bank's capital adequacy assessment process was evaluated and minimum capital adequacy and liquidity requirements were established in accordance with the banking business models. Credit risk, liquidity risk and payment stress tests were also carried out. The results of stress tests were used, maintaining and identifying new corrective measures;
- In 2016, the process for reviewing the strategies of all banks was launched aimed at assessing the sustainability and earning capacity of banks. One of the key elements in this process is the independent review carried out by US consultants in the AML/CTF area in 2016 and the

measures developed by banks aimed at improving the internal control system. These factors can have a significant impact on the overall strategy and business models of banks.
- In 2016, the assessment of the recovery activity planning (RAP) of banks was launched in a new quality, i.e., in line with the methodology developed by the EBA and the ECB.
- In 2016, pursuant to the documents submitted by banks, applications for new financial services were examined. The submitted applications, as well as the banks seeking advice from the FCMC on the possibility of launching new financial services, demonstrates a trend to adapt to the modern requirements in the banking business and focus on new services, which have been developed as an alternative to the conventional term deposit and which are related to various innovations (such as e-commerce, the use of FinTech elements) and the remote identification of customers.

**Assessing and reducing compliance risk.** Two horizontal inspections were carried out to implement this priority:
- The horizontal inspection of the internal governance of banks, paying greater attention to risk assessment and the independence and operational efficiency of internal control functions (including risk director functions, operational compliance functions and internal audit functions);
- The horizontal inspection of the processes of launching new products and services.

Concurrently, in 2016, within the scope of off-site supervision, regular meetings were held with the members of the board of directors of each bank (on average, four meetings per year) and with risk managers (on average two meetings per year) with a view to maintaining and developing a dialogue with banks, to better understand banking strategies and business models, as well as strengthening the internal control functions of banks. In the scheduled meetings with the members of the boards of directors of banks, the performance, earning capacity and the capital situation of the relevant bank was discussed as well as the ability to implement the bank's strategy.

**Assessing credit risk and early identification of potential problems, with an emphasis on problem loans (overdue and restructured loans) and concentration risk.** In order to implement this priority, in 2016, a horizontal inspection was carried out to assess the control measures of large exposures and the loan restructuring processes in banks.

At the same time, in 2016, monitoring of the off-site supervision of the loan portfolio continued, corrective measures regarding the structure and amount of the loan portfolio were identified for six banks, and, if necessary, based on supervisory ratings, adjusting of capital or creating additional provisions to problem assets was required.

**Assessing management risk strategies, risk appetite and governance.** This priority was taken into account when setting objectives for the horizontal inspection of the internal governance of banks, assessing the role of risk managers and how the bank's board of directors and council:
- discharge their duties, especially on matters relating to the definition of the bank’s and group’s strategy, supervision and governance arrangements;
- in performing their supervisory and management functions, have established appropriately composed committees and ensure that they effectively support the board of directors and council in decision-making, the bank committees are adequately managed and effectively monitored;

- receive and review reports on key risks, the course of the implementation of the strategy and the key information that ensures appropriate decision-making.

Within the scope of off-site supervisions, in assessing the capital adequacy process evaluated by banks, the results thereof and the RAP of banks, attention was paid to the development plans of banks, risk assessment processes and whether the required capital level set by the bank conformed to its risk.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In the area of international cooperation-, the FCMC’s priority is to continue to take part in the events held in the European region. Considering that participation in the work carried out by the Single Supervision Mechanism (SSM) and the European financial supervisory authorities is gaining importance, the FCMC got actively involved in the committees of the EU Council and the European Commission only in regard of the projects with significance to the Latvian financial market (RRM proposal, EDIS, etc.).

Just as in previous years, the FCMC continued to cooperate successfully with supervisory authorities in those countries which have engaged in cross-border cooperation with Latvia.

Because Latvia is a member of the European Union and part of the European financial and capital market, the FCMC also participates in the work of all European supervisory authorities. Only by actively participating and expressing an opinion that is in line with Latvia's interests can it be possible to ensure that Latvia's opinion is heard. Moreover, an opportunity arises to influence the shaping of European supervisory policies and practices. For Latvia, being a small country, it is key 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.

In 2016, the FCMC continued to participate in the SSM. Intensive work was carried out in the working groups set up by the ECB in order to identify existing supervisory practices, identify and adopt best supervisory practices, harmonizing, as far as practicable, the supervisory approach, including by ensuring the principle of proportionality. Within the scope of these processes, the FCMC exchanged experience with their peers from other countries and participated in the development of the SSM of the ECB, which in future will form the basis for establishing a single supervisory mechanism and developing best supervisory practices and the implementation thereof across the eurozone.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN LATVIA

The FCMC is a unified financial sector supervisory authority in the Republic of Latvia.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 17 | 17 | 16 |
| Branches of foreign credit institutions | 9 | 9 | 7 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total:** | **26** | **26** | **23** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 8.0 | 0 | 0 |
| Other domestic ownership | 35.7 | 22.8 | 21.5 |
| Domestic ownership total | 43.7 | 22.8 | 21.5 |
| Foreign ownership | 56.3 | 77.2 | 78.5 |
| **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 | 50.2 | 75.1 | 0.129 |
| Branches of foreign credit institutions | 95.3 | 98.9 | 0.648 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 43.3 | 66.4 | 0.108 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 11.1 | 12.5 | 14.3 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 11.1 | 12.5 | 14.3 |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 87.2 | 89.4 | 86.3 |
| Branches of foreign credit institutions | 12.8 | 10.6 | 13.7 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total:** | **100** | **100** | **100** |

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

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 34.6 | 32.1 | 30.5 |
| Nonfinancial sector | 52.8 | 51.2 | 55.7 |
| Government sector | 7.5 | 10.9 | 7.7 |
| Other assets | 5.1 | 5.8 | 6.1 |
| **Claims due to** | | | |
| Financial sector | 14.5 | 14.7 | 14.9 |
| Nonfinancial sector | 65.0 | 66.4 | 64.1 |
| Government sector | 4.1 | 1.7 | 3.8 |
| Other liabilities | 6.5 | 6.8 | 7.1 |
| **Capital** | **9.9** | **10.4** | **10.1** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014*** | 2015*** | 2016*** |
|---|---|---|---|
| Commercial banks | 21.07 | 22.65 | 21.46 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 21.07 | 22.65 | 21.46 |

(* - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 7.3 | 6.3 | 4.8 |
| **- households** | 9.6 | 8.0 | 5.4 |
| **- corporate** | 5.7 | 5.3 | 4.5 |

(*above 90 days overdue)

**The structure of deposits and loans of the banking sector in 2016 (%) (at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 88.5 | 89.8 |
| Households | 37.7 | 37.3 |
| Corporate | 50.8 | 52.5 |
| Government sector | 5.2 | 0.7 |
| Financial sector (excluding banks) | 6.3 | 9.5 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 625 859 | 654 124 | 638 404 |
| Interest expenses | 141 322 | 131 205 | 135 755 |
| Net interest income | 484 537 | 522 919 | 502 649 |
| Net fee and commission income | 331 939 | 333 973 | 324 587 |
| Other (not specified above) operating income (net) | 110 432 | 156 142 | 277 705 |
| Gross income | 926 908 | 1 013 034 | 1 104 941 |
| Administration costs | 443 679 | 462 646 | 463 288 |
| Depreciation | 26 462 | 26 442 | 26 909 |
| Provisions | 96 431 | 53 355 | 117 862 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 96 431 | 53 355 | 117 862 |
| Profit (loss) before tax | 360 336 | 470 591 | 496 882 |
| Net profit (loss) | 311 407 | 415 901 | 453 754 |

**Total own funds in 2016*** (thousand of EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 2 908 706 | 2 467 108 | 2 467 108 | 441 599 | 0 |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | 2 908 706 | 2 467 108 | 2 467 108 | 441 599 | 0 |

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

# 2016 DEVELOPMENTS IN THE LITHUANIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2016 global economic growth decelerated. This was underpinned by decreasing growth in advanced economies, especially the US and the euro area, as well as moderately slowing China's economic growth. The UK's decision to leave the EU did not have a significant impact on the growth of the region in 2016. Expectations about global economic growth prospects began improving at the end of 2016.

In 2016 economic development accelerated in Lithuania, growing by 2.2 per cent. The major contributions to economic recovery were once again increasing real exports of goods and services and household consumption, whose growth has been the fastest since the beginning of economic recovery.

Household consumption was the main driver behind economic growth. One of the major reasons for the increase in household consumption was the rather favourable situation in the labour market, particularly robust wage growth.

In terms of the production approach, it should be noted that more intensive economic activity in 2016 was driven by trade and transport activities. It has offset the impact of declining activity within the construction sector. In many other economic activities, the value added grew as well. Their impact on GDP growth was close to their development in 2015.

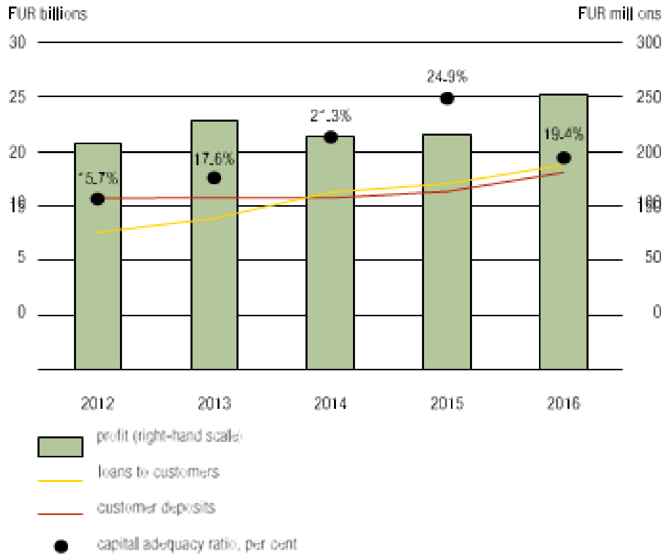
The recovery in export growth, following the 2015 shocks, is similar to the growth patterns observed prior to the trade restrictions imposed by Russia. In addition to some exporters' quite successful reorientation to other markets, accelerating foreign demand in Lithuania contributed to higher export performance as well. The current account is still close to balanced; however, a deficit in it is still likely in the future due to import, which is necessary for investment.

Job growth was two times slower than in recent years. This is mainly related to manufacturing activities and the decline in the volume of construction works. However, the number of companies facing a shortage of employees increased markedly. Such a shortage as well as the rising minimum wage underpinned rapid wage growth.

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

In 2016, 6 banks and 8 foreign bank branches operated in Lithuania; they did not change in number over the year, but consolidation processes were observed within the sector. In June 2016, Swedbank, AB took over the retail customer portfolio of Danske Bank A/S Lithuania branch; in August, DNB ASA and Nordea Bank AB announced their intention to combine forces and establish a common bank in the Baltic countries. Amendments to the Law on Banks came into force in 2017; they provide for the establishment of a specialised bank under simplified conditions. Such a bank would be subject to the minimum authorised capital requirement (EUR 1 million); it would not be able to provide investment services, but would be subject to all other supervisory requirements applicable to banks.

Key performance indicators of the banking system




*Source: Bank of Lithuania*

Bank assets amounted to EUR 25.8 billion in 2016, a year-on-year increase of 9.9 per cent. The ratio of total bank asset to GDP stood at 66.70 per cent. Asset growth was mainly driven by an increase in the net value of the loan portfolio, which grew by 10.6 per cent over the year, to EUR 18.1 billion. Both household and corporate loan portfolios posted growth in net value. The value of the household loan portfolio was driven mainly by loans for house purchase, of the corporate loan portfolio – by individual large corporate loans. It seems that the credit market, including housing loans, has been so far rapidly expanding; hence, it needs to be further monitored. The banks' loan portfolio quality continues to improve: the share of non-performing debt instruments contracted by 1.7 p.p. over the year, to 3.8 per cent of the banks' loan portfolio. Banks' liabilities amounted to EUR 23.5 billion at the end of 2016, an increase of 12.9 per cent. The main driver behind this change was customer deposits, which accounted for 80 per cent of banks' total liabilities. Deposits within the banking sector continue to grow despite low interest rates; the amount of customer deposits rose by 10.0 per cent over the year, to EUR 18.8 billion.

In 2016, the operations of the banking sector were profitable – according to unaudited data, EUR 252 million were earned in profits, an increase of 17.1 per cent over the year. Most banks (10) operated at a profit, whereas 3 banks operated at a loss. Profit growth was driven mainly by net interest income; a decrease in deposit insurance costs due to a lower deposit insurance fee as well as new loans contributed to net interest income growth.

The general quality of the banking sector's capital was good, the total capital adequacy ratio stood at 19.4 per cent as at 31 December 2016. The liquidity level of banks continued to be high, the liquid asset reserves – sufficient. The liquidity coverage ratio of the banking system was 266 per cent (the ratio is 100%).

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

Since 2015, supervision of banks in Lithuania has been carried out jointly with the ECB Single Supervisory Mechanism, which is responsible for direct supervision of the three largest banks; however, Bank of Lithuania experts work as members of joint supervisory teams. Following an annual supervisory review and evaluation process, banks have been set new capital requirements, which will be effective until a new process is carried out in 2017.

The Bank of Lithuania, as the supervisory authority of the financial sector, actively implemented the National Plan for the Mitigation of the Risk of Money Laundering and Terrorist Financing for 2016–2018: it conducts ongoing supervision of financial market participants with regard to proper implementation of measures for the prevention of money laundering and terrorist financing, carried out some important investigations in the field of the prevention of money laundering and terrorist financing. To enhance supervision in this field, the importance of information technology security is emphasised. In 2016, issues of commercial banks' cyber security were analysed: a survey of the control measures applicable by banks to manage cyber risk was conducted; testing of cyber risk is also taking place, to be completed at the end of the first half of 2017.

# MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISORY AUTHORITY IN 2016

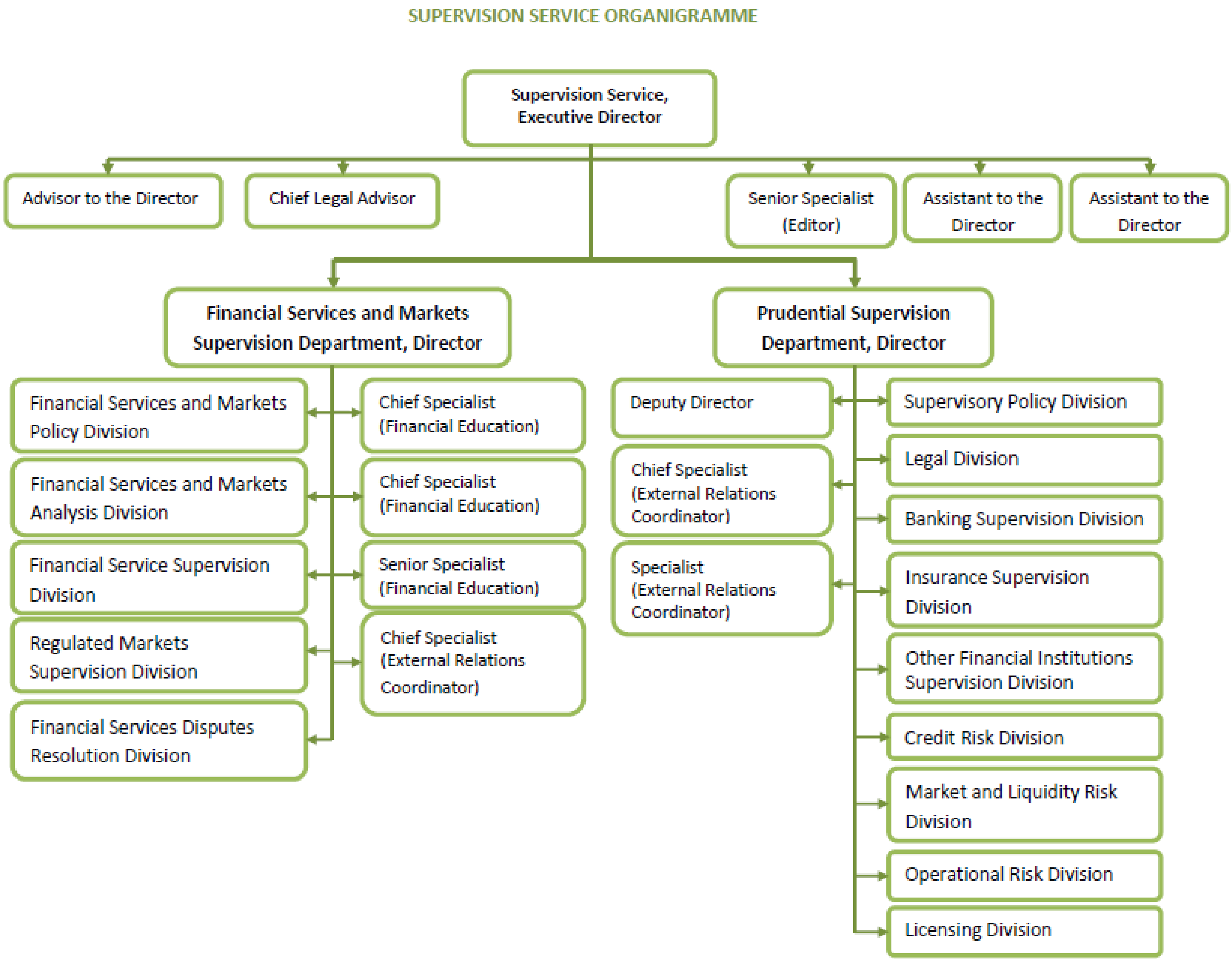
- Adjust banking supervision model to SSM requirements, so that the supervisory model remains effective and the dialogue with the ECB constructive.
- Reduce the risk of credit union operations, together with Financial Stability Service create a legal framework under the new credit union operations concept.
- In cooperation with financial market participants implement the EU directives and other direct application documents.
- Prepare for testing Cyber Risk in banks in 2016-2017.
- Improve communication with the stakeholders.

# THE ACTIVITIES OF BANKING SUPERVISORY AUTHORITY

The Bank of Lithuania was further improving the regulatory and supervisory environment in supervising the financial market with more than 450 participants and aiming to ensure its sustainable development. The credit union sector reform, aiming at strengthening the sector and encouraging financing of small and medium-sized business, continues to be pushed through. With competition in the banking sector enhancing, credit unions not willing to join central credit unions will be able to seek restructuring into a specialised bank, catching the attention of financial technology companies. Active efforts are devoted to attracting new market participants and increasing competition in the field of financial services.

The Bank of Lithuania carried out active supervision of consumer credit providers to help the general public to secure against excessive and irresponsible borrowing, providing a new service STOP: Consumer Credits.

## THE ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In supervising the financial market, the Bank of Lithuania actively participates in the activities of the EU institutions responsible for microprudential supervision (European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA)), making decisions on issues relevant to the EU financial market and presenting the position of the Bank of Lithuania in a due manner.

In 2016, the Bank of Lithuania played an active role in the process of Lithuania’s accession to the OECD. With the OECD assessing the compliance of Lithuania’s legal regulation of policy and economics with OECD requirements, the Bank of Lithuania cooperated with the Financial Markets Committee, the Insurance and Private Pensions Committee, the Investment Committee, the Statistics Committee, and the Economic and Development Review Committee.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

One particularly important achievement is the initiation and implementation of the credit union sector reform. Financial performance of a significant share of credit unions has been disappointing for a long period of time, thus, aiming at sustainable development, it was decided to restructure the sector. Discussions were held with its participants, concluding in a consensus among all parties concerned on future development of the sector. Cooperation between public institutions and corporates produced fruitful results in terms of the onward path for credit unions which were cemented by laws. Currently we are in a transitional phase, during which credit unions have to make necessary preparations for the launch of the new system in 2018.

The Bank of Lithuania took action to increase accessibility of payment services and promote competition in this market as there are still impediments to its more robust growth. Our initiatives in the payments market attract new market participants from the non-bank sectors in China, Great Britain and other countries, i.e. electronic money and payment institutions. We notice particularly strong interest in Lithuania among potential market participants, thus we hope that they and other FinTech companies will play an increasingly important role in our financial sector.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 7 | 6 | 6 |
| Branches of foreign credit institutions | 8 | 7 | 8 |
| Cooperative banks* | 75 | 75 | 74 |
| **Banking sector, total:** | **90** | **88** | **88** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | - | - | - |
| Other domestic ownership | - | - | - |
| Domestic ownership total | 10.3 | 10.7 | 8.1 |
| Foreign ownership | 89.7 | 89.3 | 91.9 |
| **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 | 87.9 | 98.8 | 2826.7 |
| Branches of foreign credit institutions | 95.8 | 99.1 | 4078.0 |
| Cooperative banks | 14.8 | 22.8 | 253.7 |
| **Banking sector, total:** | 71.3 | 87.7 | 1970.2 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 8.77 | 9.58 | 9.89 |
| Branches of foreign credit institutions | 1.11 | - 6.74 | -11.67 |
| **Banking sector, total:** | - | - | - |

### Distribution of market shares in balance sheet total (%)

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 77.4 | 81.9 | 16.4 |
| Branches of foreign credit institutions | 20.1 | 15.3 | 81.1 |
| Cooperative banks | 2.5 | 2.8 | 2.5 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

### Capital adequacy ratio of banks

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 21.12 | 24.55 | 19.09 |
| Cooperative banks | 22.65 | 17.59 | 15.98 |
| **Banking sector, total:** | 21.17 | 24.36 | |

(* - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non-financial sector | 6.32 | 5.11 | 3.77 |
| **- households** | **x** | **x** | **x** |
| **- corporate*** | **x** | **x** | **x** |

### The structure of deposits and loans in 2016 (%)
### (at year-end)

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 90.0 | 89.4 |
| Households | 59.4 | 44.3 |
| Corporate | 30.6 | 45.1 |
| Government sector | 7.3 | 4.6 |
| Financial sector (excluding banks) | 2.6 | 6.0 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 561.8 | 462.0 | 472.4 |
| Interest expenses | 206.3 | 116.2 | 89.5 |
| Net interest income | 355.5 | 345.8 | 382.9 |
| Net fee and commission income | 190.6 | 170.2 | 174.0 |
| Other (not specified above) operating income (net) | 81.6 | 47.2 | 80.8 |
| Gross income | 627.7 | 563.2 | 637.8 |
| Administration costs | 328.4 | 287.1 | 294.3 |
| Depreciation | 15.2 | 15.4 | 14.9 |
| Provisions | -3.7 | -1.6 | 5.1 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 35.5 | 30.6 | 16.7 |
| Profit (loss) before tax | 255.4 | 274.6 | 274.7 |
| Net profit (loss) | 211.2 | 244.0 | 239.1 |

**Total own funds in 2016 (in mln EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks*** | 1917.8 | | 1889.2 | 28.6 | |
| Cooperative banks* | 53.7 | | 49.5 | 4.2 | |
| **Banking sector, total:** | 1971.5 | | 1938.7 | 32.8 | |

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

# 2016 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MACEDONIA

## MACROECONOMIC ENVIRONMENT

Despite solid economy fundamentals, the deceleration of the economic growth has been affected by the uncertain political situation in the country which lasted almost two years. It is considered to be the main risk factor, affecting the growth rate of the economy which decreased to 2,4% in 2016, compared to 3,8% in 2015. Economic activity was driven by exports and private consumption. The export was supported by the new export oriented capacities and by the increase in foreign demand, while the private consumption was fueled by the favorable trends in the labor market, the increase of real wages and pensions as well as increase in lending activities to households. On the other hand, the private investments were restrained due to the political crisis.

The inflation in the Republic of Macedonia remained negative for three consecutive years. In the absence of significant pressures on the demand side, the negative inflation rate reflected the global environment of generally low import prices of food and energy, where the general price level in the domestic economy registered an annual decrease of 0.2%, which represented a slight slowdown in the fall in the price level compared to the previous two years (average decrease in the general price level of 0.3%).

The positive trends in the labor market as suggested by various indicators were partial reflection of the sound performance of the real sector and to some extent supported by the active employment measures. Consequently, the number of employed persons increased by 2.5% in 2016, which led to 1pp increase in the employment rate (43,1%). The most prominent increase in the employment was registered in the service sector, followed by the public sector and finally in the industry sector. To the contrary, the number of persons employed in agriculture declined during 2016.

In the recent years, the public debt in Macedonia has grown steadily, reaching EUR 4,711 million in 2016, representing 47.8% of GDP and an increase of 1.1 percentage points compared to 2015. The government debt accounts for the largest share in the public debt, but in the last few years it has decreased and reached 82% of the public debt (2002: 94%), while at the same time the guaranteed debt of enterprises in full or partial ownership of the state is continuously increasing in the last several years, accounting for 18% of public debt (2002: 6% of public debt). In the last two years, a fiscal consolidation process has begun which has led to a reduction of the budget deficit from 3.5% to 2.6% of GDP in 2016 compared to the previous year. The main reason for the reduced deficit was political instability which led to slower economic activity and restrained capital investment, giving support the countercyclical fiscal policy conducted in 2016. The gross external debt increased further, that is by EUR 962,6 millions (or by 4.1 percentage points), mainly on account of foreign borrowing by the government and by public sector companies and by the end of the year amounted 73.5% of GDP.

Monetary policy is appropriate in the light of the challenges faced. In April, due to the unfavorable political situation, banks were faced with a real stress scenario. The losing confidence of the population in the financial system led to a withdrawal of a substantial amount of household deposits and increased demand for foreign currency. Unfavorable movements in the FX and deposit market required appropriate reaction of the National Bank, which had intervened in the FX market and also increased its key interest rate (i.e. Central Bank bills interest rate) and reserve requirements rate for FX-indexed banks' liabilities. Additionally, auctions with FX deposits were reactivated by the National Bank, offering some more favorable conditions, i.e. attractive interest rates for banks, which encouraged them to place their FX liquid assets with the Central bank, instead of abroad. As the situation was stabilized, the NBRM lowered the interest rate to 3.75% by December, and during the first quarter of 2017 the interest rate was returned on the initial level of 3.25%.

According to the macroeconomic forecast for the years 2017 and 2018, the conduct of the monetary policy is expected to be in a relatively stable 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 NBRM 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)

As explained above, in 2016, and especially in the first half of the year, activities of the domestic banking system were heavily influenced by the unstable political situation in the country, accompanied by speculations about stability of domestic currency exchange rate, domestic banks and deposits placed with them. Consequently, public confidence was shaken and withdrawals of deposits took place in April and May, 2016. The measures taken by the National Bank as well as the prudential liquidity management performed by banks, which fulfilled instantly all client requests for deposits withdrawals, gave the expected positive spillover effects in the second half of the year. Hence, economic agents have stabilized expectations and unfavorable developments in the markets have been overcome, which enabled domestic banking system to register a solid increase in total assets of 5% (compared to 5.8% in 2015). However financial intermediation indicators registered certain downward developments in 2016. The assets-to-GDP ratio equaled 73.2%, which is a decrease of 2.7 percentage points relative to 2015. The gross credits and the deposits reached 46.3%, i.e. 53.1% of the gross domestic product, respectively (decline of 3.5 percentage points, i.e. 1.7 percentage points, compared to 2015)[34].

Deposits withdrawal from the banking system had a huge impact on banks' liquid assets, which declined by more than 10% in just one quarter. However, the higher amount of previously accumulated liquid assets and the National bank instruments for creating liquidity successfully offset this crisis episode in our banking system. By the end of 2016, the gradual recovery of the deposit activity, combined with the given opportunity for placement of FX deposits with the National

[34] Financial intermediation indicators are calculated according to the last available data on GDP. Data on GDP were last revised as of 8.6.2017.

Bank at higher interest rates compared to rates offered abroad contributed to higher amount of liquid assets. Thus, banking system liquid assets grew by 3.5% in 2016, which enabled solid levels of liquidity indicators, similar to those registered at the end of 2015, with FX liquidity indicators registering even some improvements.

Developments in loans were largely influenced by the change in the existing regulation of the National Bank (applied since 1/1/2016), according to which banks are continuously required to "clean up" credit portfolios of all claims which are entirely reserved for a period longer than two years. These mandatory write offs of old and entirely reserved non-performing loans has improved indicators for credit portfolio quality (the share of non-performing to total loans descended to 6.4% in 31.12.2016, from a level of 10.8% at the end of 2015) and it should also encourage better management with new and less reserved non-performing loans, which can, potentially create losses in the future. If effects of this measure are excluded, the overall quality of credit portfolio remained unchanged in 2016 (the quality of corporate credit portfolio registered deterioration while loans to households improved their quality).

Solvency and capitalization indicators registered certain decrease, which mostly derives from the faster growth of risk-weighted assets (mainly due to credit growth), but it was also influenced by the undertaken regulatory measures (applied since 01/01/2016) to contain excessive growth of banks credit exposure to household, established for financing of household consumption (credit cards, overdrafts and consumer credits with maturity equal to or longer than eight years). At the end of 2016, the capital adequacy ratio was 15.2% (15.5% on 31.12.2015) which currently provides enough room to absorb any unexpected losses for banks. New changes to the Banking Law (brought in October 2016), that began to be applied from March 2017, represent an important modernization of the regulatory framework, through the introduction of the new rules of the Basel Committee and the European legislation for capital buffers, whose fulfillment will be an additional support for the banks' solvency.

Towards the end of 2016 and the beginning of 2017, in environment of gradual stabilization of expectations of economic agents and maintained stability of economic fundamentals, the National Bank decreased the CB bills interest rate, which has returned to the "starting" level (3.25%), from the beginning of 2016. Also, starting from October 2016, the National Bank has ceased to hold FX auctions.

## 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 the Banking Supervisory Authority responsible for licensing and supervision of banks and savings houses in the Republic of Macedonia. The Division for Supervision, Banking Regulations and Financial Stability, performs the supervisory function through its three departments: Off-site Supervision and Licensing Department, On-site

Supervision Department and Financial Stability and Banking Regulations Department.

These competences of the NBRM are regulated with the Law on the National Bank of the Republic of Macedonia and the Banking Law. During 2016, the NBRM continued its activities for further harmonization of the domestic regulation with the revised international capital requirements (so-called Basel III) and with the European legislation package (CRD IV and CRR) on the operation and prudential requirements for credit institutions.

In October 2016, amendments to the Banking Law were adopted, which enabled introduction of capital buffers, strengthening of the capital requirements, definition of the leverage ratio, strengthening of banks' corporate governance and strengthening of corrective measures that can be undertaken by the National Bank. Thus, in addition to the minimum capital adequacy ratio of at least 8% of the risk weighted assets, minimum requirements were introduced for the Common Equity Tier 1 (4.5% of risk weighted assets) and for the Tier 1 capital (6% of risk weighed assets).

The most important amendment to the Banking Law refers to the introduction of four capital buffers: capital conversation buffer, countercyclical capital buffer, capital buffer for systemically important banks and systemic risk buffer. Starting from March 2017, all banks are required to fully comply with the capital conversation buffer (2,5% of the RWA). Based on the methodology issued by the National Bank, seven banks were identified as systemically important, and are required to fulfill adequate capital buffer rates, no later than March 31, 2018. In addition to this, National Bank has issued rules for countercyclical capital buffer, and for reporting of the level of leverage ratio, in accordance with the provisions of the EU Capital Requirements Directive and Regulation.

In December 2016 the Decision on the methodology for determining capital adequacy was amended, in order to allow for further strengthening of the banks' own funds, by changing its structure, especially the structure of Tier 1 capital, and by emphasizing the importance of the Common Equity Tier 1 capital, as capital positions with highest quality.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

There were several activities performed by the NBRM in 2016 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 establishment and implementation of a more stringent capital adequacy framework, not just by changes in the relevant legal framework, but also with 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

**Activities of the Off-Site Supervision Department last year**

The off-site supervisory function of the NBRM is carried out through three 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 2016 the National Bank has performed the following activities:

- 87 licensing procedures, which were related to issuing: approvals for (re)appointment of members of the Management Body and members of the Supervisory Board of banks, amending and/or supplementing the Statute, approvals for commencement of new financial activities by banks, approvals for acquiring a qualified share in banks and approvals for change in the name and headquarters of banks,
- 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 against banks and saving houses where irregularities, noncompliance or illegitimacies in their operation were found. The aim of the majority of the undertaken measures was to improve certain aspects of the banks' risk management systems.

**Activities of the On-Site Supervision Department last year**

*Performing supervision and oversight*

Pursuant to the annual plan of examinations for 2016, NBRM performed on-site risk examinations in 13 banks and 1 saving house and inspection controls (on-site controls of compliance with the laws and regulations) in all 15 banks and 3 savings houses. In the reporting period, a thematic examination was also conducted in all three savings houses in terms of the IT-systems set-up and compliance with the regulation on information systems security. In light of the increasing volume and sophistication of cyber threats, the National Bank developed a Cybersecurity Assessment Tool which should help banks identify their risks and determine their cybersecurity preparedness. During 2016, the National bank performed assessments of several banks in order to determine their cybersecurity preparedness. This type of assessments will continue in the future.

In the reporting period, regular supervisory activities were conducted over three providers of fast money transfer services, 35 subagents, as well as 33 licensed exchange offices.

*On-site risk examinations*

Banks in the Republic of Macedonia perform traditional banking activities and the credit risk largely determines their risk profile. Hence, this risk, especially the quality of its management, as well as the level of exposure to it, are most often subject to the on-site assessments performed by the National Bank. In addition, on-site examinations were also focused on the adequacy of the systems for money laundering prevention, management of the legal and operational risk and banks' corporate governance.

The conducted examinations have shown that banks adequately manage the risks they are exposed to and they are largely responsive to the corrective measures undertaken by the NBRM.

In order to improve the existing credit risk management practices in banks, NBRM has issued several recommendations which mainly refer to: strengthening the underwriting standards and credit analysis of customers, strengthening of the monitoring of the quality of banks' loan portfolio, especially the corporate loans and mortgage loans, improving the system for identifying and monitoring related parties and management of concentration risk and increasing the role of the risk management organizational units in the lending process. Furthermore, some of the banks were recommended to improve the credit classification process, to enhance the early warning criteria used for monitoring of the extended loans, to improve the manner of identifying and managing restructured loans, to strengthen bank's records and monitoring of loans extended with exceptions, as well as to improve the operation of the internal audit and to strengthen the internal controls in the "household" segment.

In terms of measures and actions undertaken by banks for preventing money laundering and financing of terrorism, the recommendations pertained to the following: improvement of internal policies, strengthening of the measures for identifying and verifying the identity of the legal entities' ultimate owners, enhancement of customer and transaction analysis in order to adequately asses the client’s risk level, encroachment of reports submitted to the managing bodies, strengthening of the indicators for identifying potential suspicious transactions and widening of the scope of controls which are conducted by the banks' Internal audit Unit.

Related to legal and reputational risk management, main recommendations refer to the improvement of the operation of the banks’ compliance units, as well as greater involvement of these units in the process of monitoring consumer complaints and drafting loan contracts. In addition, banks involved in court cases were required to have adequate reserves for potential losses. In general, corporate governance of the examined banks was determined as adequate, having in mind the organizational structure, the risk management processes and the internal control mechanisms.

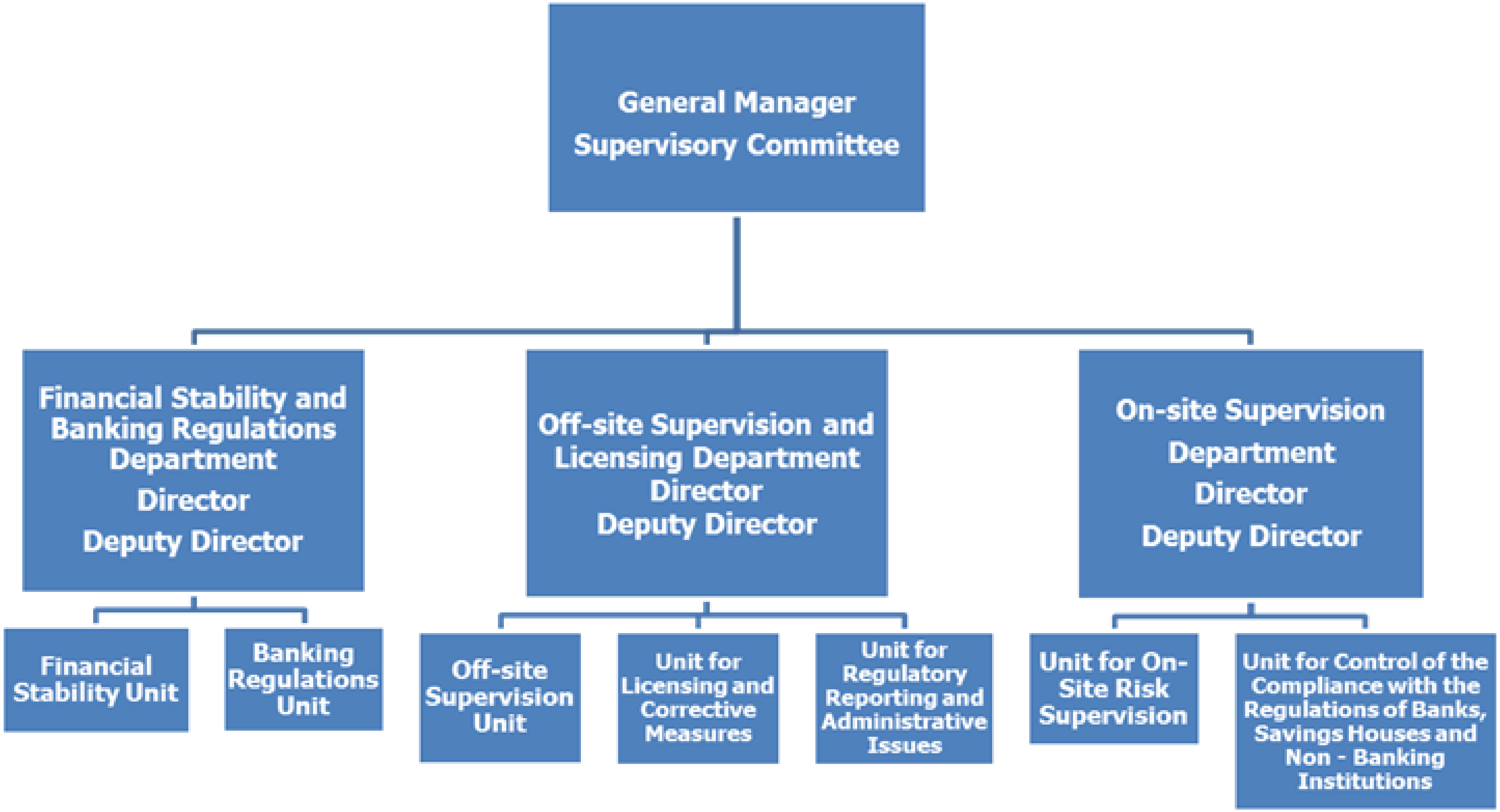
In order to increase information security systems, examined banks and saving houses were required to strengthen their internal controls and limits to access databases, to improve the testing process of IT solutions, to complete the audit trail systems, to replace or update certain software systems (for example the electronic banking) and to perform IT-audit by the internal audit. In order to improve the existing practices for operational risk management, banks were recommended to increase their operational risk awareness and to enhance their internal procedures and processes for identifying, reporting and assessing this risk.

*On-site controls of compliance with regulations*

On-site control of compliance with the laws and regulations, or so-called inspection controls, are mainly related to 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 the Law on Payment Operations. Certain weaknesses were determined in some banks in terms of the method of calculation and allocation of the compulsory reserve.

On-site controls of non-banking financial institutions, i.e. licensed exchange offices, providers of fast money transfer services and their subagents, were 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 cooperation with foriegn supervisory bodies continued in 2016 under the signed MoUs. Among other activities, within this cooperation NBRM supervisory staff attendend two supervisory colleges (for one Greek and one Slovenian subsidiary).

No new MoUs were signed. However, since the first quarter of 2017 there is an ongoing initiative to draft a new written coordination and cooperation agreement (WCCA) for the supervisory college of a banking group that has presence in the banking system of the Republic of Macedonia through its subsidiary. The obligation to deliver a new Cooperation and Coordination agreement derives from specific provisions of Directive 2013/36/EU (CRD) further developed in two Commissions delegated regulations.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN MACEDONIA

The cooperation with domestic supervisory bodies and agencies in 2016 continued without any obstacles. There was a regular flow of information sharing between NBRM and the relevant counter parties, which helped for achieving the goals expected by signing the bilateral agreements and MoUs.

In 2016 the NBRM enhanced its efforts to set up formal agreements with the Agency for real estate cadastre and the Deposit Insurance Fund. The undertaken activities will result in signing information sharing agreements in future, thus deepening the close cooperation that NBRM has with this two designated authorities.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 3.8% | 4.0% | 3.3% |
| Other domestic ownership | 27.1% | 26.9% | 26.7% |
| Domestic ownership total | 30.9% | 30.9% | 30.1% |
| Foreign ownership | 69.1% | 69.1% | 69.9% |
| **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 | 58.2% | 74.3% | 1,361 |
| Branches of foreign credit institutions | / | / | / |
| Cooperative banks | / | / | / |
| **Banking sector, total:** | **58.2%** | **74.3%** | **1,361** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 7.4% | 10.4% | 13.6% |
| Cooperative banks | / | / | / |
| **Banking sector, total:** | 7.4% | 10.4% | 13.6% |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Cash, balances and deposits with central bank (NBRM) | 12.5% | 11.1% | 13.3% |
| Placements in securities | 14.5% | 14.8% | 12.7% |
| - issued by domestic government sector | 7.9% | 8.5% | 7.2% |
| - issued by central bank (NBRM) | 6.4% | 5.9% | 5.2% |
| - other (including non residents) | 0.3% | 0.4% | 0.4% |
| Loans, deposits and accounts with financial institutions (excluding central bank, including non residents) | 12.5% | 12.0% | 11.4% |
| Loans with non-financial sector (including non residents) | 55.5% | 57.7% | 58.3% |
| - loans with domestic government sector | 0.5% | 0.5% | 0.5% |
| Other assets | 5.0% | 4.4% | 4.3% |
| **Total** | **100.0%** | **100.0%** | **100.0%** |
| **Liabilities** | **2014** | **2015** | **2016** |
| Deposits of financial institutions (including non residents) | 4.1% | 4.0% | 4.4% |
| Deposits of non financial sector (including non residents) | 71.7% | 72.3% | 72.6% |
| - 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) | 10.8% | 10.1% | 9.3% |
| - domestic financial sector | 3.4% | 3.5% | 3.2% |
| - domestic government sector | 0.2% | 0.2% | 0.1% |
| - other | 7.2% | 6.4% | 5.9% |
| Other liabilities | 1.8% | 2.8% | 3.1% |
| Equity and reserves (including loss in current year) | 10.8% | 10.8% | 10.6% |
| Profit after tax in current year | 0.8% | 1.1% | 1.4% |
| **Total liabilities** | **100.0%** | **100.0%** | **100.0%** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014** | 2015** | 2016** |
|---|---|---|---|
| Commercial banks* | 15.66% | 15.49% | 15.22% |
| Cooperative banks | / | / | / |
| **Banking sector, total:** | 15.66% | 15.49% | 15.22% |

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

**Asset portfolio quality of the banking sector**

| Asset classification | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 11.3% | 10.8% | 6.6% |
| **- households** | 5.9% | 5.2% | 2.6% |
| **- corporate** | 15.3% | 15.2% | 9.9% |

**The structure of deposits and loans of the banking sector in 2016 (%) (at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 94.2% | 99.9% |
| Households | 64.5% | 45.0% |
| Corporate | 26.4% | 53.7% |
| Government sector | 0.1% | 0.9% |
| Financial sector (excluding banks) | 5.8% | 0.1% |
| **Total** | **100.0%** | **100.0** |

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

in millions of Denars*

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 20,216 | 19,954 | 20,169 |
| Interest expenses | -7,133 | -5,602 | -4,780 |
| Net interest income | 13,083 | 14,352 | 15,389 |
| Net fee and commission income | 4,118 | 4,234 | 4,247 |
| Other (not specified above) operating income (net) | 1,677 | 2,350 | 2,750 |
| Gross income | 18,878 | 20,935 | 22,383 |
| Administration costs** | -9,383 | -9,672 | -9,732 |
| Depreciation | -953 | -996 | -1,002 |
| Provisions*** | -785 | -1,164 | -835 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)**** | -4,200 | -3,921 | -3,765 |
| Profit (loss) before tax | 3,557 | 5,184 | 7,048 |
| Net profit (loss) | 3,149 | 4,640 | 6,325 |

* 1 EUR = 61.4812 MKD, as of 31.12.2016
** Administration costs include all operating expenses.
*** Provision items include: impairment losses of non-financial assets, provisions for off-balance sheet items and other provisions.

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds** | Core Tier 1** | Tier 1** | Tier 2** |
|---|---|---|---|---|
| Commercial banks | 808,908,915 | 736,685,456 | 736,685,456 | 72,223,459 |
| Cooperative banks | / | / | / | / |
| **Banking sector, total:** | 808,908,915 | 736,685,456 | 736,685,456 | 72,223,459 |

# 2016 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MOLDOVA

## MACROECONOMIC ENVIRONMENT

At the end of 2016 as compared to end-2015, the exchange rate of the national currency was slightly weaker against the US dollar, by 1.6%, while strengthening against the euro by 2.7%. At the same time, the Moldovan Leu has appreciated in real terms by 1.5% against main trading partners’ currencies.

During 2016, external sector developments had a favorable impact on the domestic FX market conditions. Particularly, the trade deficit has lowered under a higher growth of exports, of 4.8%, amid an insignificant increase in imports (by 0.2%). In this context, the net FX demand from businesses has dropped by 12% as compared to 2015. Given the trade balance improvement and a recovery of the net FX supply from individuals, following a de-dollarization process, the National Bank of Moldova was able to restore reserves in 2016 by 26% up to USD 2,205.9 million (considering a loss of more than a third in the previous two years). Consequently, the FX reserves adequacy strengthened, up to around 5.2[35] months of imports.

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

During 2016, the National Bank of Moldova carried out quality assessments of the banks' shareholding and applied some remedial measures on large banks to ensure a transparent ownership structure. Thus, the assets recorded an increase and the banks became more resistant, being capitalised with a high liquidity level, which provides for the possibility to finance more actively the country's economy. At the same time, the banking sector has faced certain issues related to the high level of non-performing loans, maintaining the downward trend of the lending activity. In this regard, the banks continued to enhance their corporate governance and risk management framework to which they are subject.

Tier I capital was MDL 9,296.9 million, increasing by 3.2 percent (MDL 288.7 million) during 2016. The increase of Tier I capital was driven mainly by the profit in the amount of MDL 1,363.9 million obtained during 2016. At the same time, the capital was influenced negatively by the loan reclassification (increase in provisions by 41.7 percent or MDL 723.0 million).

The average risk-weighted capital adequacy was 30.3 percent, increasing by 4.0 percentage points compared to the end of last year, this indicator has been complied with by all banks (limit for each bank ≥ 16.0 percent), varying between 22.6 percent and 121.3 percent.

The total assets of the sector were MDL 72,830.4 million, increasing by 5.9 percent (MDL 4,040.2 million) compared with the end of the previous year. The share of assets in GDP constituted 54.2%, decreasing by 1.9% compared to the end of the previous year.

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[35] calculated based on the updated imports forecast for 2017

As of 31 December 2016, gross loan portfolio amounted to 47.7 percent in total assets or MDL 34,761.3 million, decreasing by 9.0 percent during 2016. Total volume of new loans decreased also by 12.8 percent than the similar period of last year. The decrease was determined mainly by the lack of loan demand and a more prudential approach applied by banks against potential debtors. Thus, the banks increased the investments in securities (certificates of the National Bank of Moldova and state securities) by 2.2 time, amounting to 15.3 percent of total assets.

During 2016, the share of non-performing loans (substandard, doubtful and compromised) in total loans increased by 6.5 percentage points compared to the end of last year, accounting for 16.4 percent per sector as of 31 December 2016.

In the context of the distribution of risks, the largest share in the total loan portfolio was held by credits granted to commerce - 30.0%, followed by loans granted to the food industry - 10.0%, consumer credit - 10.0%, loans to agriculture - 7.0%, loans granted in the field of service provision - 7.0%, credits for transport, telecommunications and network development - 6.0%, other credits granted - 5.0%, loans granted to the non-banking financial environment - 4.0%, loans granted in the field of construction industry - 3.0%, loans to individuals performing business - 3.0%, loans to the energy industry - 2.0%.

As of 30 December 2016, the profit of the banking sector accounted for MDL 1,363.9 million. Compared to the same period of the previous year, the profit increased by 19.2 percent due mainly to the increase in interest related income by 13.9 percent.

Return on assets and return on equity represented 1.8 percent and 11.1 percent as on 30 December 2016 (increasing by 0.2 percentage points and 1.0 percentage points, respectively).

Banks have maintained the liquidity indicators at a high level. Thus, the long-term liquidity ratio (liquidity principle I) accounted for 0.6, reaching practically the same level as at the end of previous year. Current liquidity on the system (liquidity principle II) accounted for 49.3 percent, increasing by 7.6 percentage points. It should be mentioned that the liquid securities recorded during 2016 the highest increase of 129.8 percent in the structure of liquid assets.

# 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 2016, 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, external audit activity and transparency of the bank's shareholders. The amendments provide additional requirements for bank administrators whose confirmation as administrators has been withdrawn, including that they shall not be allowed to hold any other positions within the banking and non-banking financial sector of the Republic of Moldova for a period of 10 years from the date such confirmation was withdrawn.

In order to improve discipline of the banking system, has been increased the limit of sanctions that supervisory authority may apply to banks, administrators and shareholders and has been established provisions related to the prosecution of individuals who contributed directly to the occurrence of insolvency of the bank. Also, in the context of improving the regulatory framework related to the banks relationship with its related persons and considering their possibility to influence the governance in the bank, it has been extended the list of persons considered related to the bank, as well, has been provided the supervision authority' right to presume, until proven otherwise, as the persons affiliated to the bank, if these persons meet one or more of the characteristics specified in the NBM's regulations.

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.

During 2016, the National Bank, in order to ensure a transparent ownership structure, carried out assessments of the quality of shareholding in banks and applied some remedial measures to large banks.

## MAIN STRATEGIC OBJECTIVES OF THE BANKING AUTHORITY IN 2016

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.

The Twinning project launched on 30 June 2015 for a period of 24 months has been continued during 2016 through a lot of activities aimed to perform the above mentioned objective.

So, there have been organized a number of work missions and trainings of NBM personnel in order to improve the knowledge in the prudential supervision of banks and to assimilate the European legal provisions which are similar to Basel II Capital Agreement provisions.

As a consequence of work missions, a new banking law was drafted, which represents the general framework applicable to the banks. Also, it was drafted secondary acts for the implementation of the new law and has been organized practical exercises concerning application of new requirements involving the banks from Republic of Moldova. At the end of the year, the draft of the new baking law was subject to public consultation. As a result, there has been received comments and suggestions on the content of the draft law from the interested authorities and, especially, form licensed banks. Also, the drafting activity of the secondary acts was continued in accordance with action plan of the NBM, these drafts will be promoted after entering into force of the new banking law at the beginning of 2018.

In 2016 has been initiated improvements to the regulatory framework regarding the prudential regulations for banks related to banks' internal governance, including risk management, taking into consideration the best international practices in order to develop regulatory framework on corporate governance in the banking system.

## ACTIVITY OF THE BANKING SUPERVISORY AUTHORITY

During the 2016 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 increase the transparency of bank’ shareholders, has been amended the Regulation on holding equity interest in the capital of banks. The respective amendments provide the reductions from 5% to 1% of significant equity interest in the bank’ capital. Also, has been amended the level of participation in the share capital of banks that need National Bank permission, by including two new levels, 5% and respectively 10%. Simultaneously, has been introduced prohibitions aimed to organize the formation of bank ownership according to legal procedures and to involve stakeholders to effectively manage their investments.

The Regulation on licensing of banks has been amended. The provisions established the requirements related to the specification of the information to be provided by the bank when the general meeting of shareholders adopted the decision to increase the bank's share capital by issuing additional shares.

The amendments to the Regulation on banks' transactions with their related parties provide the development of the mechanism related to the NBM’ right to presume, in the course of supervision functions based on identifying characteristics, certain parties as bank’s related parties, until the bank provides to the NBM evidence of lack of affiliation.

In order to reduce the concentration risk on bank’ exposures, has been amended the Regulation on „large” exposures. The amendments provide the new requirement for bank's exposure to the shareholders holding less than substantial quotas, namely the aggregate amount of net debt on loan granted and contracted with the bank by the shareholders holding, directly or indirectly, or controlling less than 1 percent of the bank’s equity capital, including their related parties, shall not exceed 20% of the total regulatory capital of this bank. In case that maximum allowed limits for large exposure and related parties are exceeded, the NBM has the power to require decrease the bank’ regulated capital by the amounts exceeding the limits set in the NBM regulations.

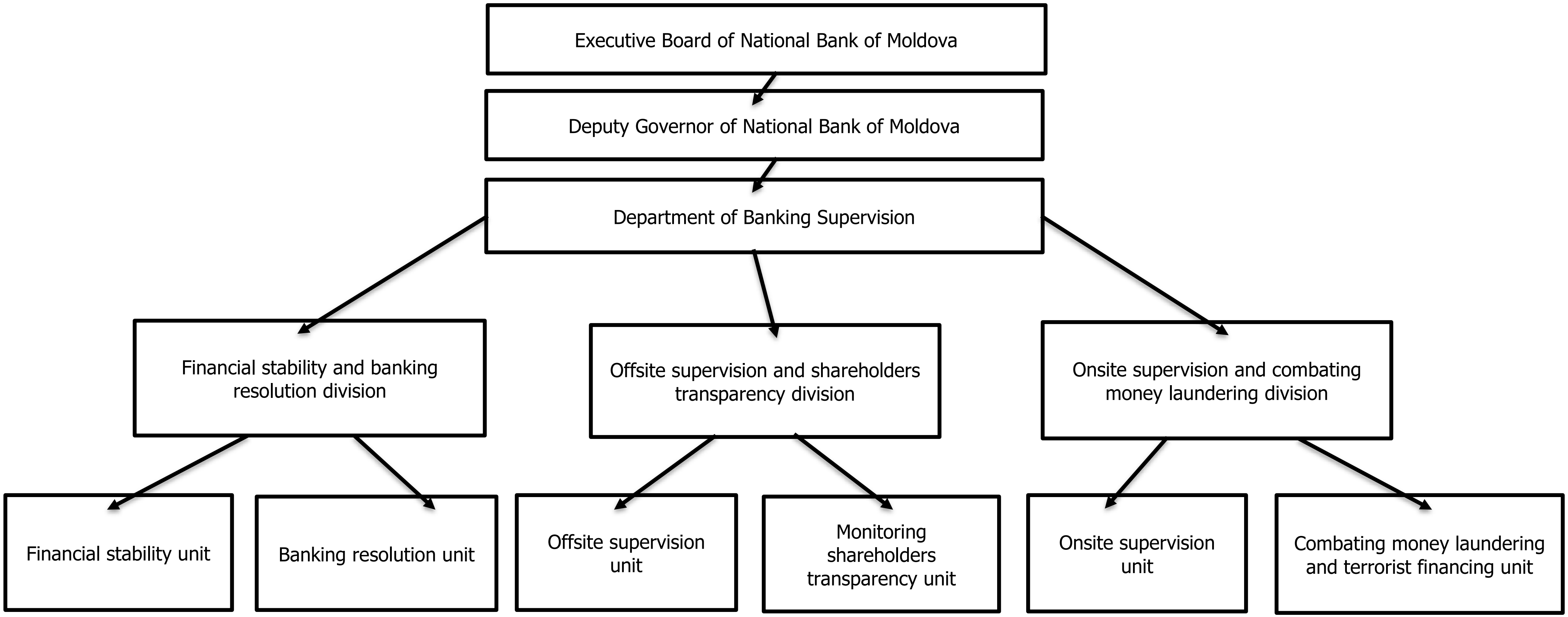
At the same time, the amendments to the Regulation on banks holding shares in the equity of legal entities provide the process for obtaining the NBM’ written permission by the bank, alone or within the group of persons acting in concert, to hold in the capital of a legal entity a quota which represents 20% or more of the equity of legal entity, exceeds, according to its accounting value, 5% of the regulatory capital of the bank or, the total accounting value of the aggregate holding quotas exceed 50% of the regulatory capital of the bank.

Consequently, in order to obtain information from banks and to refine the methods of banking supervision, the Instruction on the preparation and submission of reports by banks for prudential purposes has been completed. In this respect, the report of banks' related parties has been expanded. Also, has been included the reporting related to the aggregate amount of net debt on loan granted and contracted with the bank by the shareholders, including their related parties.

As a result of the finding in March and October in two large banks of groups of shareholders acting concerted against the respective banks and having acquired a substantial share in the bank's share capital, without the prior written permission of the National Bank. NBM on the basis of Art.15 par. (2) of the Law of Financial Institutions, suspended the rights attaching to the shares held by the above mentioned shareholders.

At the same time, following the establishment of indicators on the non-transparent structure of shareholders and engaging in high-risk lending operations, in October 2016, the National Bank of Moldova instituted the early intervention regime at a large bank.

# ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In order to fulfill the banks' authorization function, in accordance with the Law on financial institutions and National Bank' normative acts, NBM has provided the exchange of information with the fallowing supervision authorities: National Bank of Romania, National Bank of Kazakhstan, Bank of Italy, Bank of Lithuania, Banking Agency of the Federation of Bosnia and Herzegovina, National Bank of Serbia. In 2016, in order to further consolidate the regulatory and supervising framework of the Moldovan financial and banking system, the National Bank of Moldova (NBM) increased 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.).

One of the biggest achievement of the 2016 was the agreement reached between the Moldovan authorities and the IMF on a new comprehensive program on economic and financial reforms to be implemented in the Republic of Moldova during the next three years. As a result, on the 7th of November 2016, IMF Executive Board adopted a decision on offering financial assistance to the Republic of Moldova through two loan instruments – the Extended Fund Facility and the Extended Credit Facility.

As well, during the year of 2016, the NBM continued to benefit from the technical assistance offered by the National Bank of Romania and De Nederlandsche Bank, in the framework of the Twinning project financed by the European Union. The project was launched on the 30th of June 2015, for a period of two years, aiming to assist the National Bank of Moldova in strengthening the framework of prudential regulation and supervision of banks through approximation with the standards applied by the central banks of the EU countries. During this project, the experts from both partner banks assisted the NBM in the process of drafting a new Law on banking activity and secondary regulations, which will ensure the transposition of the relevant EU legal framework (CRD IV) into the national legislation and will contribute to the assertion of a solid and competitive banking sector.

Starting with the 15th of February 2016, the NBM is assisted by a High Level Adviser for the banking sector. This support is provided by the European Union through a project on counseling the Moldovan authorities on public policies, which offers a great opportunity to increase the capacities of the NBM in the field of banking supervision.

As a member of the Group of Banking Supervisors from Central and Eastern Europe (BSCEE), NBM has continued its cooperation in 2016 with other members of the BSCEE, including on information and best practices exchange in the areas of banking regulation and supervision. In this regard, the NBM representatives participated at the regional seminar on applying the EU's legislation with respect to Basel III, which was organized by the BSCEE in cooperation with the Financial Stability Institute and European Supervisor Education Initiative. The participation of the NBM representatives at this seminar served as an important step forward 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.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN MOLDOVA

According to the legal framework in force and the existent agreements, the National Bank of Moldova cooperates with other supervision authorities from the Republic of Moldova. Thus, in 2016, in order to fulfill efficiently its functions, the National Bank of Moldova has worked based on the concluded agreement with the National Anticorruption Center, National Commission of Financial Market and State Registration Chamber.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 4.94 | 0.0 | 0.0 |
| Other domestic ownership | 44.55 | 41.42 | 49.2 |
| Domestic ownership total | 49.49 | 41.42 | 49.2 |
| Foreign ownership | 50.51 | 58.58 | 50.8 |
| **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 | 64.2 | 83.4 | 0.145 |
| Branches of foreign credit institutions | 24.1 | 26.0 | 0.023 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 88.3 | 109.4 | 0.168 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 9.3 | 10.2 | 11.1 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 9.3 | 10.2 | 11.1 |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 85.27 | 75.69 | 74.0 |
| Branches of foreign credit institutions | 14.73 | 24.31 | 26.0 |
| 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Cash | 3.58 | 4.39 | 5.09 |
| Due from banks and NBM, net | 15.11 | 29.44 | 28.74 |
| Net loans and financial leasing | 55.84* | 53.21* | 44.11* |
| Government securities, net | 4.72 | 6.21 | 7.09 |
| Other, net | 20.75 | 6.72 | 14.94 |
| Total assets | 100.00 | 100.00 | 100.00 |
| **Liabilities** | **2014** | **2015** | **2016** |
| Deposits of households | 36.83 | 50.64 | 51.72 |
| Deposits of corporates (nonfinancial) | 15.86 | 19.71 | 23.33 |
| Other | 34.14 | 12.57 | 7.62 |
| Shareholder capital | 13.17 | 17.05 | 17.31 |
| Total liabilities and shareholder capital | 100.0 | 100.0 | 100.0 |

* Calculated according to IFRS.

**Capital adequacy ratio of banks**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 13.93* | 26.22* | 29.8* |
| Cooperative banks | - | - | - |
| **Banking sector, total** | 13.93* | 26.22* | 29.8* |

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

**Asset portfolio quality of the banking system (%)**

| Loan classification | 2014 | 2015 | 2016 |
|---|---|---|---|
| Standard | 55.18 | 51.27 | 51.10 |
| Supervised | 33.09 | 38.78 | 32.50 |
| Substandard | 3.04 | 4.12 | 5.98 |
| Doubtful | 3.22 | 2.57 | 2.88 |
| Losses | 5.47 | 3.26 | 7.55 |
| **Total** | **100.0** | **100.0** | **100.0** |
| **Specific reserves** | **10.37** | **8.5** | **13.42** |

**The structure of deposits and loans in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 97.07 | 95.58 |
| Households | 68.69 | 18.79 |
| Corporate | 28.38 | 76.80 |
| Government sector | 0.19 | 0.22 |
| Financial sector (excluding banks) | 2.43 | 4.20 |
| **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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 292.73 | 254.17 | 297.55 |
| Interest expenses | 153.90 | 113.07 | 141.67 |
| Net interest income | 138.84 | 141.11 | 155.88 |
| Net fee and commission income | 49.90 | 40.84 | 47.94 |
| Other (not specified above) operating income (net) | -51.93 | -33.79 | -42.64 |
| Gross income | 406.51 | 374.16* | 411.99 |
| Administration costs | 85.90 | 65.47 | 77.42 |
| Depreciation | 45.86* | 76.53* | 58.22 |
| Provisions | 112.00 | 97.20 | 144.15 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 40.95% | 78.74% | 40.39% |
| Profit (loss) before tax | 48.59 | 62.40 | 69.01 |
| Net profit (loss) | 37.91 | 66.47 | 65.30 |

As of December 31.12.2016, 1 EUR=20.8895 MDL.
***** Data has been recalculated

**Total own funds in 2016 (in mln. EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 462.0* | - | 445.0* | 17.0* | - |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | 462.0* | - | 445.0* | 17.0* | - |

( * - for Basel I; ** - for Basel II; *** - for Basel III)
As of December 31.12.2016, 1 EUR=20.8895 MDL.

# 2016 DEVELOPMENTS IN THE MONTENEGRIN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

The basic indicators for 2016, observed by production methods, indicate positive trends in most sectors, primarily construction and tourism, while there was a decline in the area of industrial output. When it comes to all components of GDP consumption, including personal and public spending, visible exports and imports, growth was also recorded, which was particularly significant in gross investments in fixed assets that increased by 26.4%, while in 2015 the annual growth amounted to 12.5%.

Preliminary MONSTAT data on quarterly **GDP** trends show positive rates in 2016 for all four quarters, with growth of 1.1%, 2.7%, 2.4% and 3.4% recorded in Q1, Q2, Q3 and Q4, respectively. Based on quarterly estimates, the annual growth amounted to 2.5%.

In December 2016, the annual **CPI** inflation amounted to 1%, while the average annual rate was negative and amounted to -0.3%. In 2016, the monthly rate of core inflation was below the level of total monthly inflation during five months (April, May, June, October, and December), while during the remaining seven months it was above the total monthly inflation.

In 2016, as per the Ministry of Finance`s preliminary data, total **budget revenues** with state funds amounted to 2.13 billion euros or 56.6% of the estimated GDP, with 69.7% (1.49 billion euros) referring to source revenues. Relative to the plan and the previous year, source revenues increased by 1.9% and 12%, respectively. The fiscal deficit of Montenegro is estimated at 129.4 million euros or 3.4% of GDP.

At end-2016, the net **public debt** of Montenegro, as per the Ministry of Finance data, amounted to 2,499.2 million euros or 66.2% of the estimated GDP for 2016. Compared to end-2015, net public debt increased by 5.8%. There is a concern regarding the total amount of the government debt as well as the expectation of its future growth due to a more intensive implementation of the planned infrastructural projects.

The average number of **employed persons** in 2016 amounted to 177,908, thus being 1.3% higher than the average number of employees in the previous year. As per the Employment Agency’s records, the number of registered unemployed persons averaged at 42,844 in 2016, which is 23.9% more than in the same period previous year. Significant growth of unemployment in the reporting year mostly came as a result of implementation of the Law Amending the Law on Social and Child Protection. The unemployment rate published by Montenegro’s Employment Agency amounted to 21.33% in December 2016, recording the year-on-year increase of 4.09 percentage points.

MONSTAT data shows that an average gross **salary** in Montenegro in 2016 amounted to 751 euros, being 3.6% higher than in the previous year. An average salary without taxes and contributions amounted to 499 euros, showing the year-on-year increase of 4%.

As per preliminary data, the **current account deficit** of the balance of payments amounted to 711.9 million euros or 18.9% of GDP, which is 5.6% more than in 2015. The current account deficit was mostly financed by FDI (52.2%) and other investments (41.9%) inflows. The share of net FDI in GDP amounted to 9.8% while other investments accounted for 7.9%. The current account deficit was mostly financed by FDI (52.2%) and other investments (41.9%) inflows. The share of net FDI in GDP amounted to 9.8% while other investments accounted for 7.9%.

There was a decline of a net inflow of **foreign direct investments**. According to preliminary data, net foreign direct investments amounted to 371.6 million euros, or 9.8% of GDP, which is 7.2 percentage points less compared to 2015.

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

The banking system in Montenegro was stable and liquid. As at 31 December 2016, there were 15 banks that operated in Montenegro, one more than in the previous year.

Over the one-year comparative period, the key balance sheet positions increased. Banks' total assets grew at the annual rate of 9.2%, loans increased by 1.3%, total deposits by 9.4%, while banks' total capital grew at a rate of 5.52%. Banks' liquid assets recorded the annual increase of 8.1%. All asset quality parameters improved during the reporting year.

In 2016, banks continued pursuing restrictive lending policies and relied mainly on their own liquid funds. Banks' deposits exceeded the level of loans, which resulted in the loans to deposits ratio of 0.84. During 2016, banks were liquid and the total liquid assets of banks amounted to 929.6 million euros, while the share of liquid assets in total assets amounted to 24.5%.

Financial result on the aggregate level was positive and banks recorded a profit at the system level in the total amount of 7.3 million euros. At end-2016, ten banks in the system operated with profit, while five banks reported negative financial results.

Banks had sufficient capital for operational activities and its level corresponded to the level of operational risk. At end-2016, banks' total capital amounted to 487.2 million euros, recording the year-on-year increase of 25.5 million euros or 5.5%. At end-2016, the capital adequacy ratio at the aggregate level amounted to 16.1%, being significantly above the statutory minimum of 10%. Total own funds of banks amounted to 358 million euros, while the total risk weighted assets for all risks the banks are exposed to in their operations amounted to 2,226.8 million euros.

Total (gross) loans of banks amounted to 2,416 million euros and recorded an increase of 1.3% compared to the previous year, while new loans increased by 18.9%, which represents the continuation of its two-figure growth that started in the previous year.

In the maturity structure of total loans, long-term loans accounted for the main share of 76.3%, while short-term loans made up 23.7%. The most significant beneficiaries of loans (90.7%) were the corporate and household sectors and non-resident banks. At end-2016, loans to the corporate sector amounted to 930.6 million euros or 38.8% of total loans, loans to the household sector amounted to 1.018 million euros (42.5% of total loans), and 224.5 million euros or 9.4% to non-resident banks.

Total deposits of banks at end-2016, amounted to 2,871.7 million euros or 9.4% more in relation to the previous year. Retail deposits increased by 6.5% as a continued trend from the previous years, which indicates a stable and good trust of the household sector in the banking system.

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

Activities of the Central Bank regarding amendments to the existing regulatory framework were mostly determined by the negotiation position of Montenegro in the EU accession process. In this regard, the position for Chapter 9 - Financial services established by the Government of Montenegro in October 2014, defined, inter alia, a set of laws and by-laws which the Central Bank is obliged to prepare and adopt in the period until the end of 2017.

During 2016, the Central Bank implemented a part of these activities with minor deviations from the deadlines stipulated by the plan of the Government of Montenegro, which was determined by the 2017-2018 Programme of Accession of Montenegro to the EU. The deviation from the deadlines was conditioned by the delay in the implementation of the Twining project "Support to Regulation of Financial Services", foreseen by the IPA Annual Action Program for Montenegro, through which the implementation of the set of said laws and implementing legislation is envisaged. This resulted in changes to the envisaged dynamics of the drafting and adoption of the new Banking Law, and consequently a number of pertinent implementing legislation, which would transpose the Directive 2013/36 EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and Regulation no. 575/2013 EU on prudential requirements for credit institutions and investment firms.

Due to these circumstances, activities of the Central Bank in 2016 focused primarily on the harmonization of domestic regulations with the regulations of the European Union, which drafting was not covered by the aforementioned Twining project. To this end, activities on the preparation of the Bank Resolution Law and the Law Amending the Banking Law have been intensified, which will implement the Directive 2014/59 establishing a framework for the recovery and resolution of credit institutions and investment firms. The amendments of these laws will provide the regulation of conditions and methods of recovering banks of systemic importance (rules, procedures and tools for the resolution of banks, powers and duties of the resolution authorities, the establishment, financing and use of funds of the resolution fund and the management thereof) and provide conditions for strengthening financial system stability in cases of problems appearing in these banks.

In addition, preparatory activities for the preparation of the Law on Financial Leasing, Factoring, Micro-Crediting and Credit-Guarantee activities were carried out, which adoption will create conditions for further development of this segment of financial services, as well as to improve the protection of users of services provided by these financial institutions.

In 2016, the CBCG participated in drafting the Law Amending the Law on Voluntary Financial Restructuring of Debts to Financial Institutions. With a view to improving applicable solutions and overcoming the problems identified during the implementation phase of the Law, the proposed amendments are aimed at extending the deadline for the implementation of the law for a year. Increased coverage included loans that can be subject to mutual restructuring (in addition to loans classified into groups “B” and “C”, loans from group “D” are included), introduction of a new restructuring measure - exemption from mortgage, fiduciary or stock proportionately to the debt reduction, allowing more favourable tax and other incentives for participants in restructuring, simplification of procedure, etc.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

Strategic objectives of the Central Bank are largely determined by the position of Montenegro in the negotiation process for the EU accession.

In the reporting year, the CBCG continued improving the regulatory framework which aims to harmonize laws and regulations in the banking sector with relevant EU directives and the Basel capital and liquidity standards (Basel III). It intensified activities on the preparation of legislation which implements the Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms and which involve the drafting of the Bank Recovery and Resolution Law and the Law Amending the Banking Law. Moreover, the draft Law on Financial Leasing, Factoring, Micro-crediting and Credit-Guarantee Operations was also prepared. The adoption of this Law will create conditions for further developing of this segment of financial services and for improving the protection of consumers of services provided by these financial institutions. In 2016, the CBCG participated in the drafting of the Law Amending the Law on Voluntary Financial Restructuring of Debts to Financial Institutions. The purpose of the Law was to improve the applicable solutions and overcome problems in the implementation of the Law.

In 2016, the Central Bank exercised supervision over the implementation of the Law on the Conversion of Swiss Franc (CHF)-denominated loans into Euro (EUR)-Denominated Loans.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In accordance with the Inspection plan, a total of 12 bank inspections were carried out in 2016 (10 targeted on-site inspections and 2 full-scope on-site inspections). In addition, 2 targeted extraordinary examinations of banks were carried out in 2 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.

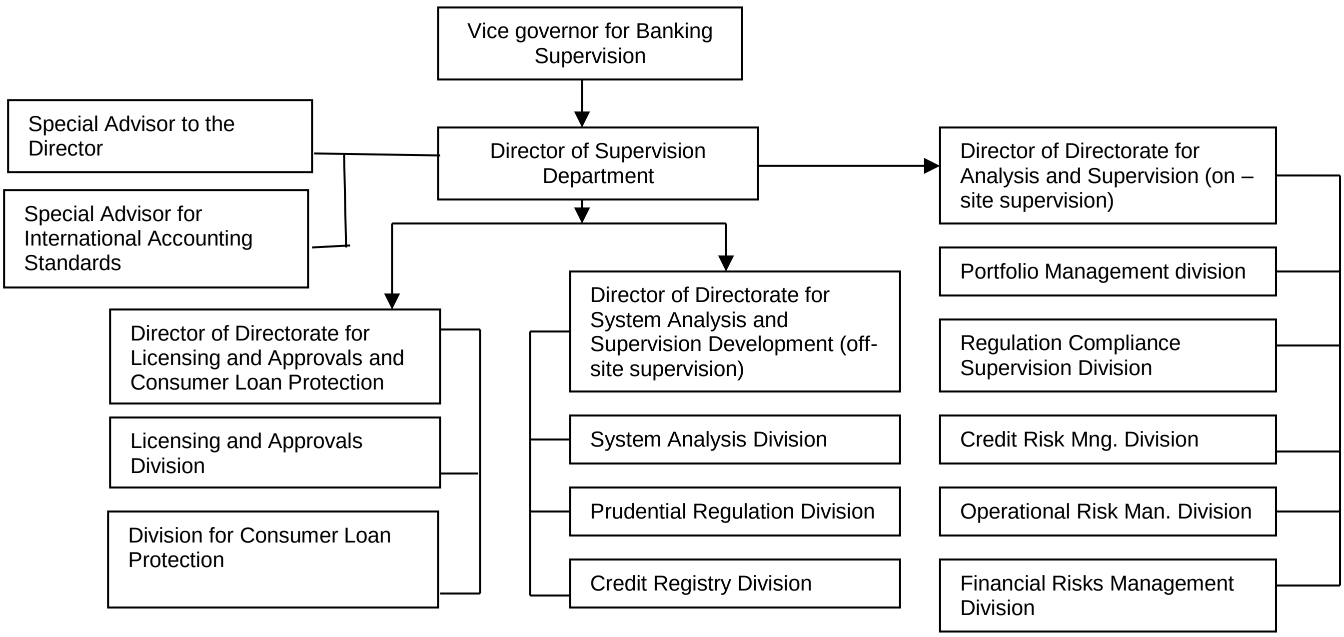
To that end, due to irregularities in the operations, the Central Bank imposed measures against six banks to eliminate irregularities in their work, whereby two banks received a decision imposing the measures and two banks received written warnings.

In addition to the activities on the on-site and off-site supervision of banks, the Supervision Department performed one targeted on-site inspection of a micro-financial institution. An extraordinary targeted on-site inspection of one payment institution was also performed.

During the regular on-site inspection in banks, supervisors examined the compliance of banks' operations in the payment system area. The inspections included 9 banks in the system. In addition, two extraordinary targeted on-site inspections of two banks were performed. In some of the aforesaid cases, the supervisors disclosed minor irregularities that were removed during the inspection.

Great interest of foreign investors into the banking sector was also present in 2016. The CBCG issued licence to one bank, thus the total number of banks in the system increased to 15.

## ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In the field of cooperation between the Central Bank with international institutions and organizations, 2016 was very significant. Cooperation was, as usual, the most intense with the International Monetary Fund and the World Bank Group. In the context of finalizing the Financial Sector Assessment Program (FSAP 2015) for Montenegro, realized during the previous year, final versions of the Financial Sector Assessment (FSA) and the Financial System Stability Assessment (FSSA) were prepared and published.

As a member of the regional group which signed the Memorandum with the European Banking Authority (EBA) in 2015, the Central Bank has been included in various educational processes organized by this institution. Different trainings began in September 2016 in Sarajevo, with the seminar "Common European SREP Framework and Supervisory assessment of recovery plans."

In the area of administrative and institutional support that the EU provides to Montenegro, the Central Bank continued activities on the preparation of a Twinning project to be financed from IPA 2014 project entitled "Support to the regulation of financial services." Its implementation will start in 2017 in cooperation with relevant institutions and other financial regulators in Montenegro.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN MONTENEGRO

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# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 12 | 14 | 15 |
| Branches of foreign credit institutions | 0 | 0 | 0 |
| Cooperative banks | 0 | 0 | 0 |
| **Financial institutions, total** | **12** | **14** | **15** |

### Ownership structure of banks on the basis of assets total

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | - | - | - |
| Other domestic ownership | - | - | - |
| Domestic ownership total | 20.5 | 22.4 | 24.5 |
| Foreign ownership | 79.5 | 77.6 | 75.5 |
| **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 | 39.53 | 63.29 | 1036 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total** | **39.53** | **63.29** | **1036** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 5.35 | -0.91 | 1.51 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 5.35 | -0.91 | 1.51 |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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 | 2014** | 2015** | 2016** |
|---|---|---|---|
| Commercial banks | 16.18 | 15.48 | 16.07 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **16.18** | **15.48** | **16.07** |

( * - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector* | 97.5 | 98.8 | 98.4 |
| **- households** | 24.29 | 25.11 | 25.7 |
| **- corporate**** | 71.32 | 71.56 | 71.7 |

*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 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 93.2 | 84.3 |
| Households | 53.2 | 42.2 |
| Corporate | 38.3 | 40.7 |
| Government sector | 5.2 | 5.1 |
| Financial sector | 1.0 | 0.5 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 173072 | 165102 | 161010 |
| Interest expenses | 61983 | 48086 | 39141 |
| Net interest income | 111091 | 117018 | 121868 |
| Net fee and commission income | 34969 | 36126 | 36874 |
| Other (not specified above) operating income (net) | 12083 | 18170 | 15635 |
| Gross income | 158254 | 171371 | 171474 |
| Administration costs | 99593 | 106429 | 108288 |
| Depreciation | 9471 | 9740 | 9710 |
| Provisions | 21117 | 54194 | 43619 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | | | |
| Profit (loss) before tax | 25222 | -2503 | 9342 |
| Net profit (loss) | **23787** | **-4148** | **7317** |

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1** | Tier 2** | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 357859 | - | 329675 | 32876 | - |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | 357859 | - | 329675 | 32876 | - |

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

# 2016 DEVELOPMENTS IN THE POLISH BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2016 Polish economy grew by 2.7%. Poland maintained its high economic growth from the previous years and remained one of the fastest growing countries in the EU. Between 2007 and 2016 the average annual real growth rate amounted to 3.5%. During this period the only EU countries to record such a rapid growth were Ireland and Malta. GDP growth for the EU28 amounted to 0.83% and for the Eurozone only to a mere 0.63%. Polish GDP growth in 2016 was, as in the previous year, based on household consumption expenditure. The balance of payments improved significantly and amounted to PLN -9.8 billion (compared to PLN -11.2 billion in 2015).

On the labor market the positive trend from the years 2013 and 2014 persisted and the unemployment rate fell to 8.3% at the end of December 2016. The one-digit unemployment rate was previously registered in Poland in December 2008. Historically low levels were also reached by the inflation rate, which stayed below zero during the first eleven months of the year and amounted to -0.8% on a yearly basis. The fact of deflation determined the decisions of the Monetary Policy Council: 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%.

In 2016 there were no significant changes in the FX market. A slight depreciation of the zloty against the main global currencies was observed. At the end of the year, the zloty’s exchange rate against the euro amounted to 4.42 (a slight increase from 4.26 at the start of the year), the Swiss franc was valued at 4.17 (up from 3.90 at the start of the year) and the US dollar was valued 4.11 (a slight rise from 3.93).

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

In 2016 the situation of the banking sector remained stable. Total balance of the banks grew by 7% amounting to PLN 1.7 trillion (around 92% 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 13.9 billion – a significant increase of 24% in comparison to the previous year.

The situation with respect to the capital base remained strong and at the end of 2016 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 four 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 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 2016 tax outlays paid by commercial banks reached PLN 3.2 billion.

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. 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.

**Credit Unions (SKOKs)**

At the end of 2016 there were 40 credit unions operating in Poland. Their assets amounted to PLN 11.4 billion (down from PLN 12.4 billion at the end of 2015). In 2016 they recorded a loss of PLN 77.8 million.

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

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.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

In 2016 the KNF focused on development and amendment of prudential regulations, including a review of the existing regulations. Six recommendations have been adopted by the KNF in 2016, and works on the other three will be continued in 2017.

In particular, two recommendations aimed at credit unions were adopted in 2016 - D-SKOK and E-SKOK. Together with the previously issued recommendations for the sector of cooperative savings and credit institutions they create a comprehensive framework for stable and safe functioning of the unions (SKOKs).

In 2016 a new and important regulatory element came into force - the acts regulating the recovery and resolution of banks. From the banking supervision point of view, recovery plans are particularly important to prevent the escalation risks resulting from defaulting banks. The KNF also monitors the preparation of resolution plans, especially by systemically important banks.

The discussion on foreign currency loans was continued. This topic was in the scope of interest of the Financial Stability Committee (KSF), which prepared a set of recommendations to mobilize banks to work more closely with the clients to mitigate the risks associated with currency exposures. As part of its mandate, the KNF has reiterated its individualized impact on banks with significant portfolios of foreign currency loans granted to unsecured borrowers.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The supervisory activities taken by the KNF in 2016 involved ongoing monitoring and quarterly analysis of banks' economic and financial standing (rating given for Q4 2015 and 3 quarters of 2016). Based on the results of the analysis, the banks were given a rating according to the KOBRA rating system. In 2016 all commercial and cooperative banks were rated. 136 quarterly analyses of commercial banks, 2241 quarterly analyses of cooperative banks and 8 quarterly analyses of associating banks were prepared. In 2016 the cyclical evaluation process of cooperative and associating banks continued.

Also 104 quarterly analyses of branches of credit institutions were prepared (rating given for Q4 2015 and 3 quarters of 2016). 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 organisational units responsible for inspection.

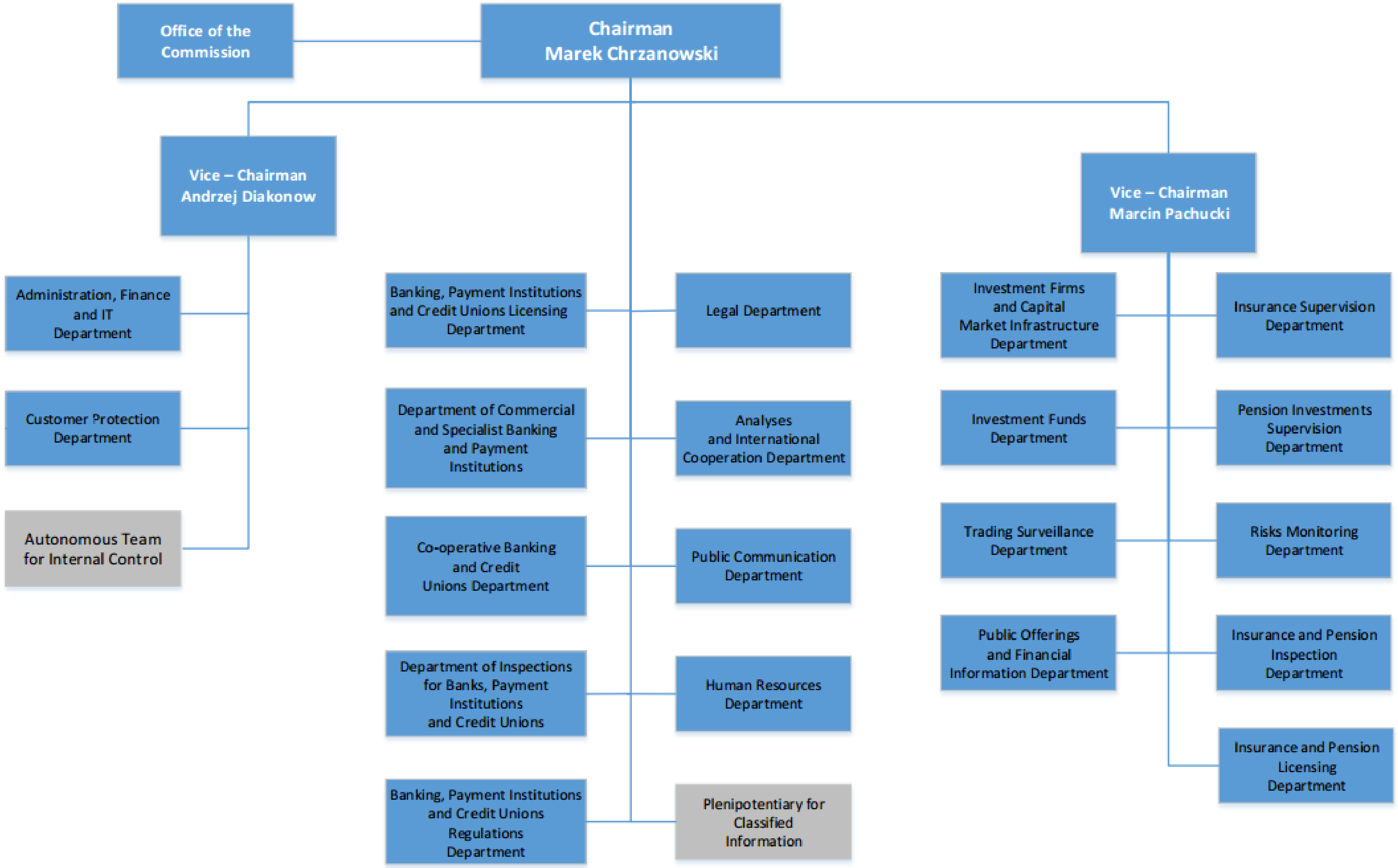
Comparative (quarterly) analyses were conducted to examine the manner in which debt owned by the same borrower is classified by different banks. Whenever any discrepancies were identified, relevant steps were taken with respect to the regulated entities involved.

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 2016, 8 commercial banks were covered by recovery procedures. At the end of 2016 42 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 2016 KNF participated in 38 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 36 jurisdictions (excluding multilateral agreements under ESMA, IOSCO and IAIS). In 2016, such memorandum has been signed with the National Bank of Kazakhstan.

# 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 reg. macroprudential supervision 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. In 2016 the KSF decided to maintain the countercyclical buffer rate at 0%.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS IN THE COURSE OF LAST YEAR

In 2016 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.

At the end of 2016 the KNF authorised the creation of two IPS (Institutional Protection Scheme). The IPS allow the participating cooperative banks to pay lower fees to the Bank Guarantee Fund (BFG), have lower capital requirements – through lower risk weights, a benefit from liquidity requirements. In effect the risk of a cooperative bank default will have less impact on the sector as a whole.

# STATISTICAL TABLES

### Number of financial institutions (at year-end)

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 38 | 38 | 36 |
| Branches of foreign credit institutions | 28 | 27 | 27 |
| Cooperative banks | 565 | 561 | 558 |
| **Banking sector, total:** | **631** | **626** | **621** |

### Ownership structure of banks on the basis of assets total

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 24.1 | 23.9 | 25.2 |
| Other domestic ownership | 14.4 | 17.1 | 18.2 |
| Domestic ownership total | 38.5 | 41.0 | 43.4 |
| Foreign ownership | 61.5 | 59.0 | 56.6 |
| **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 | 37.1 | 53.2 | 909 |
| Branches of foreign credit institutions | 46.7 | 60.7 | 1423 |
| Cooperative banks | 6.1 | 8.5 | 44 |
| **Banking sector, total:** | **33.7** | **48.3** | **756** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 9.97 | 7.57 | 7.87 |
| Cooperative banks | 7.38 | -11.21 | 5.20 |
| **Banking sector, total:** | 9.80 | 6.40 | 7.71 |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 91.0 | 91.1 | 90.8 |
| Branches of foreign credit institutions | 2.1 | 2.0 | 2.1 |
| Cooperative banks | 6.8 | 6.9 | 7.1 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Assets | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 8.5 | 8.2 | 8.1 |
| Nonfinancial sector | 58.4 | 60.1 | 59.1 |
| Government sector | 6.1 | 6.0 | 5.7 |
| Other assets | 27.0 | 25.7 | 27.1 |
| **Claims due to** | | | |
| Financial sector | 23.4 | 22.1 | 21.0 |
| Nonfinancial sector | 55.7 | 58.7 | 60.1 |
| Government sector | 4.0 | 3.0 | 3.7 |
| Other liabilities | 6.1 | 5.3 | 4.4 |
| **Capital** | 10.8 | 10.9 | 10.8 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014*** | 2015*** | 2016*** |
|---|---|---|---|
| Commercial banks | 14.6 | 16.5 | 17.8 |
| Cooperative banks | 15.8 | 13.7 | 17.1 |
| **Banking sector, total:** | 14.7 | 16.3 | 17.7 |

(* - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 8.1 | 7.6 | 7.0 |
| - households | 6.5 | 6.2 | 6.0 |
| - corporate | 11.3 | 10.3 | 9.0 |

**The structure of deposits and loans of the banking sector in 2016 (%)
(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 89.4 | 86.3 |
| Households | 63.6 | 56.3 |
| Corporate | 23.9 | 29.4 |
| Government sector | 5.5 | 8.4 |
| Financial sector (excluding banks) | 5.0 | 5.3 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 58 835 | 52 873 | 53 904 |
| Interest expenses | 21 678 | 17 496 | 15 876 |
| Net interest income | 37 157 | 35 377 | 38 028 |
| Net fee and commission income | 13 789 | 13 317 | 12 592 |
| Other (not specified above) operating income (net) | 5 573 | 5 902 | 7 388 |
| Gross income | 57 688 | 55 958 | 59 317 |
| Administration costs | 27 198 | 30 665 | 31 657 |
| Depreciation | 2 727 | 2 854 | 2 913 |
| Provisions | 715 | 1 047 | 1 067 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 8 333 | 8 545 | 7 455 |
| Profit (loss) before tax | 20 032 | 14 126 | 18 441 |
| Net profit (loss) | 15 877 | 11 189 | 14 158 |

**Total own funds*** in 2016 (in EUR m)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 37 218 | 33 832 | 33 834 | 3 384 | - |
| Cooperative banks | 2 455 | 2 289 | 2 302 | 153 | - |
| **Banking sector, total:** | 39 672 | 36 120 | 36 136 | 3 536 | - |

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

# 2016 DEVELOPMENTS IN THE ROMANIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

The Romanian's economic expansion was substantial in 2016, with the highest growth rate (4.8 percent) in the period after the global crisis. The key contribution to this result was the demand for consumption, boosted by the improvement of labor market conditions and, in addition, the fiscal-budgetary relaxation measures approved in the second half of 2015. However, the acceleration of economic growth was accompanied by a strain on the balance macroeconomic developments, reflected in the deepening of the budget and external deficits. Thus, the budget deficit at the end of the year reached the 3.0 percent of GDP set by the Stability and Growth Pact, while the current account deficit widened to 2.3 percent of GDP - a sustainable level, entirely financed through foreign direct investments and non-reimbursable European funds. In December 2016, the public debt-to-GDP ratio declined to 37.6 percent from around 38 percent at end of 2015 (standard European methodology). From public debt, on December 2016, domestic debt accounted for 19.4 percent of GDP, and external debt was 18.2 percent of GDP.

The annual dynamics of industrial producer prices on the domestic market reverted to positive territory at end-2016, i.e. 0.1 percent, for the first time in the past two years. This evolution was correlated with the increase in prices of some commodities (oil, metals) on international markets and the stronger depreciation of the domestic currency versus the US dollar. In this context, the annual rate of decline of energy prices slowed down to -1.6 percent, whereas the prices of intermediate goods reverted to positive annual dynamics, i.e. 0.2 percent. At the same time, the annual change in prices of capital goods narrowed to 0.3 percent, solely on the back of a base effect, while that in prices of consumer goods stabilized at around 2.0 percent.

Romania's international reserves strengthened in 2016, reaching 37.9 billion euros in December. The year 2016 also the end of reimbursement process of the IMF contracted loan in 2009 (within the multilateral financing agreement signed by the Romanian state with the international financial institutions).

## DEVELOPMENT IN THE BANKING SYSTEM

At the end of 2016, the Romanian banking system comprised 29 banks, Romanian legal entities and 8 branches of foreign banks, the total number of banks increasing by one after the opening a new branch of a foreign bank.

In general terms, the trend of the main indicators continues to characterize the Romanian banking system as a profitable one with adequate capitalization and liquidity. The quality of banking assets further improved during 2016. The notable performance of 2016 was the decline of the non–performing loan ratio (as defined by the EBA) by 3.9 percentage points to 9.6 percent mainly as a result of the banks' balance sheet clean–up. The resolution of NPLs and appropriate provisioning in the context of successive collateral revaluations were boosted by the prudential measures that the NBR has taken since 2013. The NPL coverage ratio provides a comfortable counterbalance to the still high NPL ratio (56.3 percent, December 2016). Although slightly lower than 2015-end (57.7 percent), this ratio was above the 44.7 percent EU average.

The banking system ended the year 2016 with a net profit of lei 4 153.2 million, over two thirds of the total number of credit institutions in the local market showing positive financial results at the end of the year. Although the 2016 cumulative net profit narrowed with lei 322 million compared with the previous year, the financial performance improved from the operational point of view. The main profitability indicators of the banking sector, i.e. return on assets (ROA) and return on equity (ROE), fared well and stood at 1.1 percent and 10.4 percent respectively.

Capital adequacy indicators have improved since the previous year, their high level providing a substantial reserve for the absorption of unexpected losses. Thus, the total capital ratio was 19.7 percent in December 2016, while the Tier 1 capital ratio and Common Equity Tier 1 capital ratio stood at 17.5 percent. The high loss absorption capacity of banks in Romania is attributable to the prevailing share of Tier 1 capital in total own funds, i.e. 89.2 percent.

Liquidity remained adequate, as shown by relevant indicators and stress testing results. Banks have significant resources for both financing the economy and countering potential negative liquidity shocks. In December 2016, the system-wide average liquidity coverage ratio (LCR) stood at around 230 percent. For 2016, according to the schedule for the gradual phase-in, the minimum required threshold was 70 percent, all banks reporting levels above this threshold. Across the banking sector there are enough liquidity reserves to withstand strong shocks over the short term (less than 30 days).

Deposits from non-bank clients (households and non-financial companies) increased by 9.8 percent in December 2016 versus December 2015, continuing to support the comfortable liquidity position of banks. Foreign financing from parent banks continued to decline in an orderly manner (down by around 21 percent versus December 2015), being fully offset by the increase in deposits raised on the local market.

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

Against the background of the entry into force of the CRD IV/CRR legislative package as of 1 January 2014, new provisions were transposed into national legislation via amending and supplementing Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy, as subsequently amended and supplemented and via issuing NBR Regulation No. 5/2013 on prudential requirements for credit institutions, as subsequently amended. The provisions of Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms were directly implemented into national legislation by credit institutions, in organizing and conducting their activity and by the National Bank of Romania in its supervision activity. The Directive 2014/59/EU was also transposed into Romanian legislation by Law No. 312 as of 4 December 2015, which establishes the domestic grounds for the recovery and resolution of credit institutions, and which repealed certain provisions of GEO No. 99/2006 on credit institutions and capital adequacy regarding the stabilization measures.

The current prudential regulatory framework ensures: (i) harmonization with CRD IV and adequate measures to facilitate the implementation of CRR (ii) harmonization with guidelines issued by the EBA. Moreover, starting with the CRD IV/CRR 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. The financial reporting framework for prudential supervision purposes were being updated in order to ensure the optimal conditions for the unitary application of the FINREP individual reporting framework by the Romanian credit institutions, as well as the correlation thereof with the new FINREP consolidated reporting framework set up at European level by ITS 680/2014.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

Prior 2016, several decisions were taken in order to decrease NPLs stock and strengthen the supervision of NPL ratio developments in the context of critical volume of NPL mainly representing loans overdue more than 360 days and without initiation of legal proceeding (actually uncollected loans). The result was notable as the level declined from around 21 percent (2014) to 9.6 percent at (2016). In the previous year, NBR continued to monitor the developments at each bank level and a new measure was taken consisting in the recommendation for fully coverage with IFRS provisions for unsecured NPLs for which repayment of principal and/or interest was overdue by more than 180 days, followed by the removal of exposure from on-balance sheet.

With the view of strengthening the supervisory practices, the supervisory authority implemented the SREP Guidelines as of 1 January 2016. The main components of SREP methodology are the following: the categorization of credit institutions and periodic review of this categorization based on their size, structure, internal organization and scope, and on the nature and complexity of their activities; the constant assessment of risks to which credit institutions are or may be exposed, in line with proportionality criteria (depending on the classification category where they are included), by means of the following activities: (i) monitoring of key indicators; (ii) business model assessment; (iii) assessment of internal governance and institution-wide control; (iv) assessment of risks to capital (credit and counterparty risk, market risk, interest rate risk from non-trading activities, operational risk, other risks); (v) assessment of risks to liquidity.

On the regulatory side, we briefly mention the following key objectives for 2016 in the field of prudential regulation: to prepare secondary regulation concerning deposit guarantee schemes; to analyze EBA guidelines and prepare the regulatory framework for their implementation into national law; to prepare secondary regulations concerning covered bonds; to review the regulatory framework applicable to macroprudential instruments, so as to ensure compliance with the legal framework governing the macroprudential oversight of the national financial system; to contribute, via participation in EBA working groups, to the drawing up of draft regulatory and implementing technical standards, as well as of guidelines to prudential banking; to supplement/review the regulatory framework applicable to credit institutions in areas such as licensing and business management framework. Objectives in the field of accounting regulation focused on the update of the IFRS-compliant accounting regulations applicable to credit institutions, and update of the regulation in place on the FINREP reporting framework at solo level, by including the amendments to be made by the EBA to the consolidated FINREP reporting framework and incorporating the proposals following the actual implementation of the FINREP reporting framework.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2016

In 2016, under the annual assessment and verification programme, 30 on-site inspections were conducted at 29 credit institutions, Romanian legal entities, and one foreign bank branch. The inspections carried out under the annual assessment and verification programme targeted particularly: the viability and sustainability of business model, internal governance and the internal control system, capital adequacy and the associated risks, liquidity adequacy and associated risks, the manner of implementation of recommendations and measures imposed by the NBR. Apart from the scheduled inspections, 24 targeted thematic inspections, with a specific control objective, were conducted at credit institutions as well. The inspections focused mainly on aspects concerning the way in which the own funds provide an appropriate coverage of the risks according to the credit institution's risk profile, the compliance with the prudential regulatory framework with regard to the limits of large exposures, the setting up of depreciation adjustments for restructured loans, the restructuring management framework, as well as the implementation of the measures imposed by the NBR.

In order to ensure the effectiveness of the decision-making process in the field of supervision, the NBR has an operational body namely Supervisory Committee that is responsible for the performance of the supervisory tasks. Over 2016, the Supervisory Committee passed decisions in 24 meetings, the topics relating primarily to: (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, for approval of changes in their standing; (iii) draft pieces of legislation to be issued by the central bank or other authorities; (iv) implementation of EBA Guidelines into national legislation; (v) monitoring developments in terms of financial stability, identifying, monitoring and assessing systemic risks and those related to systemically-important credit institutions, specific analyses, analyses on the activity of the Central Credit Register and of the Payment Incidents Register (the use of information in databases, submitting the information in the CCR database to the ECB in line with Recommendation ECB/2014/7), reviews and proposals on payment and settlement systems, including the transposition of European payment legislation; and (vi) other matters related to banking system functioning.

Starting January 1, 2016, the National Bank of Romania Board approved the implementation of the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) into national supervisory practices. Following the overall SREP 2016, 21 percent of the 29 credit institutions were ranked in score 2, 69 percent in score 3 and 10 percent in score 4. In the

Romanian banking system, average and median of overall SREP 2016 TSCR demand were around 12 percent.

# ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

ORGANISATION CHART OF THE NATIONAL BANK OF ROMANIA
1 August 2017

**BOARD OF DIRECTORS**

**GOVERNOR** Mugur Isărescu

**DEPUTY GOVERNOR** Liviu Voinea

- MACROECONOMIC MODELLING AND FORECASTING DEPARTMENT
  - Macroeconomic Forecasting Models Division
  - Macroeconomic Assessment Models Division
- FINANCIAL STABILITY DEPARTMENT
  - Macroprudential Policies Division
  - Systemic Risk Monitoring Division
  - Quantitative Assessment Division
- INTERNATIONAL RELATIONS DEPARTMENT
  - European Banking System Division
  - International Financial System Division
  - International Financial Conditions Analysis Division
- BANK RESOLUTION DEPARTMENT
  - Resolution Strategies and Policies Coordination Division
  - Resolution Decisions Preparation and Implementation Div.
- SECRETARIAT AND PUBLIC RELATIONS DEPARTMENT
  - Documents Registration, Dispatching and Check-in Desk Div.
  - Archives, Library and Publications Dissemination Div.
  - Public Relations and Documentation Division
  - Events Organisation and Protocol Division
- PAYMENT AND SETTLEMENT SYSTEMS REGULATION AND OVERSIGHT UNIT

**FIRST DEPUTY GOVERNOR** Florin Georgescu

- REGULATION AND LICENSING DEPARTMENT
  - Financial Activities and Non-bank Financial Institutions Regulation Div.
  - Foreign Exchange and Accounting Regulation Division
  - Licensing Division
  - Prudential Banking Regulation Division 1
  - Prudential Banking Regulation Division 2
- SUPERVISION DEPARTMENT
  - Inspection Division I
  - Inspection Division II
  - Inspection Division III
  - Banking System Assessment, Methodology and Supervision Procedures Division
  - Non-bank Financial Institutions and Payment Institutions Inspection Div.
  - Monitoring of International Sanctions Enforcement, Prevention of Money Laundering and Terrorist Financing Division
- ISSUE, TREASURY AND CASH MANAGEMENT DEPARTMENT
  - Issue Division
  - Cash Management Division
  - Central Vault Division
  - Cash Processing Coordination Division
- PAYMENTS DEPARTMENT
  - ReGIS Division
  - Financial Instruments Depository and Settlement Division
  - Financial Messages Processing Division
  - TARGET2 Division
  - Business Continuity Division
- ACCOUNTING DEPARTMENT
  - Operational Accounting and Internal Accounting Rules Division
  - Internal Administration Accounting-Financial Issues Division
  - Internal Administration Accounting-Fixed Assets Division
- ESTATE MANAGEMENT AND INVESTMENT DEPARTMENT
  - Investment Division
  - Movable Assets Division
  - Immovable Assets and Management Division

**DEPUTY GOVERNOR** Eugen Nicolăescu

- STATISTICS DEPARTMENT
  - Monetary and Financial Statistics Division
  - Balance of Payments Division
  - Direct Statistical Reporting Division
  - Statistical Data Processing Division
  - SIRBNR Data Management Division
  - Credit Risk Statistics Division
- IT DEPARTMENT
  - IT Systems Division
  - Network Administration Division
  - IT Support Division
- TECHNICAL AND MAINTENANCE DEPARTMENT
  - Buildings Maintenance Division
  - Equipment and Installations Maintenance Division
  - Administrative Maintenance and Utilities Division
- PROCUREMENT DEPARTMENT
  - General Procurement Procedures Division
  - Methodology and Contracting Division
  - Planning and Monitoring Division
  - Direct Procurement Division
  - Banking Procurement Procedures Division

**GOVERNOR**

- TRAINING AND SOCIAL EVENTS FACILITY DEPARTMENT
  - Training Support Division
  - Social Events Division
  - Auxilliary Activities Division
  - Cafeteria Division
  - Training and Social Events Units
- MUSEUM AND FINANCIAL EDUCATION DEPARTMENT
  - Museum
  - Financial Education Division
- REGIONAL BRANCHES AND AGENCIES
- CHANCELLERY
  - The Executives' Offices and Document Management
  - Strategic Projects Division
  - Governor's Control Office
  - Board Secretariat Division
  - Information Management and Protection Division
  - IT&C Information Management and Security
  - Territorial Network Coordination Division
- MONETARY POLICY DEPARTMENT
  - Monetary Policy Analysis and Strategy Division
  - Liquidity Management Division
- MARKET OPERATIONS DEPARTMENT
  - Monetary Policy Operations Division
  - State Treasury Operations Division
  - Foreign Reserve Management Division
  - Back Office Division
  - Foreign Reserves Risk Management Division
- ECONOMICS DEPARTMENT
  - Economic Analysis and Short-Term Forecasting
  - Publications Division
  - Translation and Editing Division
- COMMUNICATION AND MULTIMEDIA DEPARTMENT
  - Media Relations Division
  - Intranet and Internal Communication D.
  - Online Communication Div.
  - Multimedia Support Div.
- HUMAN RESOURCES DEPARTMENT
  - Organisation and Planning Division
  - Human Resources Management Div.
  - Training and Career Development Division
- INTERNAL AUDIT DEPARTMENT
  - General Audit Division 1
  - General Audit Division 2
- BUDGET AND FINANCIAL ANALYSIS DEPARTMENT
  - Budget and Financial Analysis Div.
  - Preventive Financial Control Div.
  - Consumption Standards and Norms Div.
  - Risk Monitoring Division
- SECURITY DEPARTMENT
  - Crisis Management & Business Continuity Division
  - Internal Protection Division
  - Special Transport Division
  - Security Systems Division
  - Transport and Maintenance Div.
- LEGAL DEPARTMENT
  - Legal Documentation and Advisory Opinion Division
  - Contract Assistance and Disputed Claims Division
  - European and International Law Division

*Note: Colour patterns show the departments' coordination.*

# INTERNATIONAL ACTIVITIES OF NBR

In 2015 and 2016, the NBR was mainly involved in the twinning project dedicated to the National Bank of Moldova (NBM), titled "Strengthening the NBM's capacity in the field of banking regulation and supervision in the context of EU requirements". The assistance was granted by a consortium formed by the NBR and De Nederlandsche Bank, with the NBR as Lead Partner. The overall objective of the project was to assist the NBM in strengthening the framework for prudential supervision in the process of adjustment to the EU tasks and standards for the banking supervision authorities and increasing the NBM's institutional and administrative capacity in this area, with a view to ensure a proper functioning of the banking sector.

The assistance covered the following areas: (i) legal framework, institutional capacity and CRD IV additional requirements; (ii) supervisory framework for the three risk categories of Pillar 1; (iii) Implementation of banks' risk management self-appraisal Internal Capital Adequacy Assessment Process (ICAAP) and evaluation by NBM of banks' ICAAPs; (iv) publication of information enabling market participants to assess the risk management process and capital adequacy of each particular bank.

Regarding the structures and substructures of the EBA, the NBR participated in: the Board of Supervisors and the Resolution Committee; 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 NBR and FSA within the National Committee for Financial Stability (NCFS), a committee that was set up according to the provisions of multilateral agreement signed between Ministry of Public Finance, National Bank of Romania and Financial Supervisory Authority. In 2016, according to its prerogatives to adopt recommendations and advisory opinions respectively, during the transitional period until the interinstitutional structure coordinating macroprudential oversight of the national financial system becomes operational, the NCFS reviewed the capital buffers that may be applied to credit institutions. Thus, NCFS 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 implemented starting 1 January 2016, to apply a buffer of 1 percent of the total risk exposure amount for all credit institutions identified as systemically important and to deactivate the 1 percent systemic risk buffer starting 1 March 2017. These recommendations had in view the fact that developments in private sector credit and leverage in 2016 revealed no significant pressures in terms of private sector indebtedness, the favorable macroeconomic and financial conditions, as well as the reduction in contagion risks via the external channel.

In March 2017, the National Committee for Macroprudential Oversight (NCMO) was set up under the Law no. 12/2017 on macroprudential oversight of national financial system. NCMO comprises representatives of National Bank of Romania, Authority for Financial Supervision and Romanian Government. It operates as an inter-institutional cooperation structure, without legal personality, with the role to ensure the coordination to the macroprudential supervision at national level.

The main tasks of the NCMO aims at: developing the macroprudential policy strategy; collecting and analyzing information and identifying, monitoring and analysis of systemic risks to financial stability; identifying financial system institutions and structures relevant systemically; issuing recommendations and warnings to prevent or reduce systemic risks to the stability of the national financial system and monitoring their implementation; issuing recommendations or warnings to ensure implementation of the recommendations or warnings of the European Systemic Risk Board; monitoring implementation of the recommendations of the European Systemic Risk Board (ESRB) and the national measures taken in response to recommendations and warnings issued by the ESRB; issuing recommendations for ensuring implementation at national level, of regulations, decisions, recommendations, guidelines, guidelines issued in macro-prudential supervision, adopted at EU level and issuing advisory opinions in its field of competence.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 30 | 28 | 28 |
| Branches of foreign credit institutions | 9 | 7 | 8 |
| Cooperative banks | 1 | 1 | 1 |
| **Banking sector, total:** | **40** | **36** | **37** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 8.7 | 8.3 | 8.2 |
| Other domestic ownership | 1.4 | 1.3 | 0.5 |
| Domestic ownership total | 10.1 | 9.6 | 8.7 |
| Foreign ownership | 89.9 | 90.4 | 91.3 |
| **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 | 47.6 | 66.5 | 1064 |
| Branches of foreign credit institutions | 90.4 | 96.7 | 4590 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **42.3** | **59.1** | **894** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | -14.15 | 11.64 | 10.18 |
| Cooperative banks | 1.05 | 1.35 | 0.42 |
| **Banking sector, total:** | **-12.45** | **11.77** | **10.42** |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 89.9 | 88.9 | 88.8 |
| Branches of foreign credit institutions | 9.8 | 10.8 | 10.9 |
| Cooperative banks | 0.3 | 0.3 | 0.3 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | **100.0** | **100.0** | **100.0** |
| Financial sector | 20.1 | 20.1 | 20.6 |
| Nonfinancial sector | 54.3 | 54.6 | 54.4 |
| Government sector | - | - | - |
| Other assets | 25.6 | 25.3 | 25.0 |
| **Claims due to** | **100.0** | **100.0** | **100.0** |
| Financial sector | 18.7 | 15.2 | 12.0 |
| Nonfinancial sector | 67.9 | 71.4 | 74.5 |
| Government sector | - | - | - |
| Other liabilities | 3.8 | 3.1 | 3.2 |
| **Capital** | 9.6 | 10.3 | 10.3 |

**Capital adequacy ratio of banks (%)**

| Type of financial institution | 2014** | 2015*** | 2016*** |
|---|---|---|---|
| Commercial banks | 17.5 | 19.1 | 19.6 |
| Cooperative banks | 30.7 | 30.0 | 30.6 |
| **Banking sector, total:** | **17.6** | **19.2** | 19.7 |

(* - 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 | 2014* | 2015** | 2016** |
|---|---|---|---|
| Non financial sector | 14.0 | 18.1 | 12.9 |
| **- households** | 7.9 | 9.6 | 7.3 |
| **- corporate** | 20.0 | 27.1 | 19.3 |

*from FINREP- F18.00 – Non-performing loans includes all loans more than 90 days past due and/or in which case legal proceedings were initiated
**from FINREP- F18.00 – Starting with December 2015, NBR introduced the EBA definition of non-performing loans ( NPL are those that satisfy any of the following criteria: i) material exposures which are more than 90 days past due; ii) the debtor is assessed as unlikely to pay its credit obligations in full without realization of collateral, regardless of the existence of any past due amount or of the number of days past due).

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 77.7 | 66.3 |
| Households | 49.1 | 34.9 |
| Corporate | 28.6 | 31.4 |
| Government sector | 17.6 | 28.8 |
| Financial sector (excluding banks) | 4.7 | 4.9 |
| **Total** | **100.0** | **100.0** |

**P&L account of the banking sector (at year-ends)**
**(in million RON)**

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 17,381.5 | 14,557.2 | 13,484.3 |
| Interest expenses | 6,311.9 | 3,931.2 | 2,579.1 |
| Net interest income | 11,069.6 | 10,626.0 | 10,905.2 |
| Net fee and commission income | 3,938.2 | 3,805.0 | 3,839.5 |
| Other (not specified above) operating income (net) | 3,895.0 | 3,734.6 | 4,610.8 |
| Gross income | **18,902.8** | **18,165.6** | **19,355.5** |
| Administration costs | 9,627.8 | 9,767.7 | 9,444.6 |
| Depreciation | 862.6 | 836.5 | 819.6 |
| Provisions | 2,744.2 | 445.2 | 270.3 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 10,275.7 | 3,956.3 | 4,288.5 |
| Profit (loss) before tax | **-4,641.4** | **4,813.8** | **4,496.2** |
| Net profit (loss) | **-4,667.1** | **4,474.7** | **4,153.2** |

**Total own funds in 2016 (in million EUR)**

| Type of financial institution | Total own funds*** | Core Tier 1*** | Tier 1*** | Tier 2*** | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 8,219.9 | 7,324.7 | 7,324.7 | 895.2 | - |
| Cooperative banks | 59.1 | 57.5 | 57.5 | 1.6 | - |
| **Banking sector, total:** | **8,279.0** | **7,382.2** | **7,382.2** | **896.8** | - |

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

# 2016 DEVELOPMENTS IN THE RUSSIAN BANKING SYSTEM

## MACROECONOMIC SITUATION

During 2016 the Russian economy continued to adapt to external conditions, which were still relatively unfavorable. The moods and expectations of the subjects of the economy have stabilized, the sensitivity to external shocks has decreased. The indicators of industrial activity improved, and individual growth zones developed in industry, including manufacturing industries. In the conditions of restrained growth of the world economy and preservation of relatively stable domestic financial conditions, the decline of the Russian economy slowed, and in the second half of the year, a transition to recovery growth was designated.

In general, following the results of 2016 compared with the previous year, the decline in GDP slowed to 0.2% from 2.8% in 2015. At the same time, structural factors, as well as economic uncertainty, had a deterrent effect on the development of the economy.

Inflation in 2016 was 5.4% compared to 12.9% in 2015. Basic inflation in 2016 was 6.0%.

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

At the end of 2016, total assets of the banking sector declined from 83 to 80 trillion rubles, which is due to the reduction in assets in foreign currency (from 28.8 to 22.2 trillion rubles), while ruble assets increased from 54 to 58 trillion rubles.

The reduction in assets in foreign currency occurred both because of a nominal reduction in assets in foreign currency (from 395 to 367 billion US dollars) and because of the strengthening of the ruble. As a result, the aggregate value of the assets of the banking sector decreased by 3.5% (excluding currency revaluation there was an increase of 1.9%). The ratio of assets of the banking sector to GDP decreased from 99.7% to 93.0%.

The ratio of the capital of the banking sector to GDP for the year increased by 0.1 pp and as of 01.01.2017 it was 10.9%.

In the sources of the formation of the resource base of credit institutions, the share of household deposits increased from 28% to 30% of the total liabilities, and the ratio of household deposits to GDP increased from 27.9% to 28.1% by the end of the year.

During the year, the ratio of the volume of loans extended to the economy to GDP declined from 52.8% to 47.6%.

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

In 2016, Federal Law No. 262-FZ of 03.07.2016 was adopted. This law establishes the responsibility of the head credit institutions of banking groups and parent organizations of bank holdings, whose securities are admitted to organized trading by including them in the quotation list, credit institutions that do not form a banking group, to audit the interim financial statements prepared in accordance with the International Financial Reporting Standards and to disclose to the wide audience of users an audit opinion on the reliability of these financial statements.

In 2016, the Bank of Russia continued to implement internationally recognized approaches to banking regulation, including the Basel Committee on Banking Supervision recomendations, as well as on clarifying approaches to banking regulation. In particular, the following measures were taken:

1. On the score of the entry into force on 01.01.2017 of the legislative requirement to calculate and comply with the maximum risk limit for the person associated with the bank (N25) the development of the necessary regulatory acts has been completed.
2. In 2016, work was initiated to introduce into the Russian practice the Basel Committee on Banking Supervision document "Updated requirements for the disclosure of information of Component 3 “Market discipline” of Basel II, 2015", providing for disclosure of information on the calculation of capital requirements for the most significant risks and procedures for managing these risks to a wide range of users in the form of tables of the established format, accompanied by textual explanations.
3. In order to increase the availability of information on the risks of credit institutions for investors and customers, as well as other interested parties, since 2017, a list of information disclosed by credit institutions as part of the annual (interim) accounting (financial) statements has been supplemented with information on transactions of credit institutions with non-resident counterparties, on encumbered and unencumbered assets of credit institutions and on the volume of the most risky part of the loan portfolio, the reserves for possible losses on which are formed in the amount less than it follows from the formalized criteria of the Bank of Russia and on securities held by depositories that meet the criteria of the Bank of Russia in order to form an increased reserve for possible losses.
4. In order to control the concentration risk arising from the exposure of the credit institution to major risks, the implementation of which could lead to significant losses that could pose a threat to the creditworthiness of the credit institution, a new reporting form "Data on the risk of concentration" was introduced.
5. With the view of additional covering the currency risks of the banking sector with capital and reduction the dependence of its performance on currency volatility in the framework of calculating the capital adequacy ratios of banks, the requirements for the application of increased risk

factors for loans to legal entities and transactions with securities in foreign currency entered into force from 01.05.2016.

6. In July 2016, Instruction No. 139-I of 03.12.2012 "On Mandatory Banking Standards" restored an increased risk ratio of 110% for unsecured consumer loans issued after 01.08.2016 in Russian rubles, with the value of the full cost of the loan from 25% to 35%.
7. For the purpose of calculating the risk limit for a single borrower (N6), a reduced risk factor of 50%, regardless of the Russian Federation's country assessment for claims in foreign currency to certain categories of borrowers, and a 100% risk ratio for investments in bonds of the junior tranche securitization were set.
8. Changes in the procedure for forming reserves for possible losses entered into force from 01.10.2016.
9. On December 9, 2016, amendments to Regulation No. 254-P came into force. The amendments concern the increase from 180 to 270 calendar days of the term for the sale of collateral and, respectively, the increase in the time during which provision can be taken into account for the purpose of forming reserves subject to discounting.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

In 2016, the Bank of Russia embarked on the implementation of a banking supervision reform based on its centralization. The objectives of the reform are the optimization of business processes and the strengthening of the pro-active nature of supervisory process as well as the identification of risks of credit institutions in the early stages and the adoption of preventive measures to minimize risks.

The banking supervision of the Bank of Russia in 2016 was focused primarily on identifying of negative trends in the activities of credit institutions in the early stages and the application of adequate measures to prevent the development of these trends.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The establishment in 2016 of the Risk Analysis Service, which builds up the competence to analyze the credit and market risks of credit institutions on a regular, on-going basis, will allow to identify the emerging risks quickly in the long term.

The Board of Directors of the Bank of Russia on December 16, 2016 decided to establish the Service for Ongoing Banking Supervision.

The Bank of Russia proceeded to apply the practice of consolidated supervision of banks and banking groups, which allowed to identify and to take measures to reduce the systemic risks. Improving the information exchange between the structural divisions of the Bank of Russia, as well as between the Bank of Russia and other agencies and organizations (including the Federal Tax Service, stock exchanges, depositories) has expanded the tools for identifying of schemes aimed at camouflaging individual banking risks.

In cooperation with the financial markets supervision divisions of the Bank of Russia, the practice of consolidated supervision of financial groups (including informal ones) which include non-credit financial organizations continued to be used.

In order to assess the risks of the activities of credit organizations that are part of the international groups, the representatives of the Bank of Russia participated in international supervisory colleges.

In 2016, certain banks allowed the acceptance of the household's funds into deposits without drawing up relevant documents and reports (so-called "off-balance-sheet deposits"). The Bank of Russia has developed guidelines for the identification and prevention of such activities.

The Bank of Russia took measures aimed at preventing schemes for the withdrawal of assets before the revocation of banking licenses, including schemes related to the issuance of "technical" loans, bank guarantees and the withdrawal of liquid real estate from the balance sheet.

Significant supervisory efforts focused on analysis of sources of capital that were not transparent, in particular income generated according to the scheme, implying entering the property in the capital at an inflated cost. Within the framework of the Bank of Russia agreements with foreign supervisory authorities, the work was carried out to investigate sources of own funds received from non-residents.

In 2016, Bank of Russia evaluated the fair value of collateral items, as well as property on the balance sheet of credit institutions. The results of this evaluation were used to assess the adequacy of the formed reserves and sources of formation of own funds (capital) of credit institutions.

In terms of the implementation of the procedures for early response, information regarding the shortcomings in the activities of the organization and recommendations for its correction was sent in written form to the management and (or) the board of directors (supervisory board) of 713 credit organizations.

The Bank of Russia held supervisory meetings with the representatives of 580 credit institutions to indicate to the managers and owners of credit institutions the identified problems and the need for their self-elimination.

In 57 cases, recommendations were sent on the development of an action plan to eliminate the identified shortcomings, strengthening control over reporting to the Bank of Russia, an adequate assessment of credit risks.

In 2016, the Bank of Russia sent the requests to credit institutions for the replacement of 42 heads, heads of branches, members of the board of directors (supervisory board) on the score of their inconsistency with established requirements for business reputation.

If the owners of the credit institutions did not apply effective measures to eliminate identified violations and to restore financial stability, the Bank of Russia on the legal grounds has taken an extreme penalty – revocation of a banking license.

## ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

By the end of 2016, the supervisory function 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 Rehabilitation Department, Systemic Important Banks Supervision Department, Financial Monitoring and Foreign Exchange Control Department, Service for Ongoing Banking Supervision, Risk Analysis Service and Chief Inspectorate of the Bank of Russia. 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.

The Bank of Russia carries out its banking supervision policies through its regional offices in the constituent entities of the Russian Federation.

The Bank of Russia supervisory function employs 5387 managers and specialists, 43.1% of them in the central office, 56.9% in the territorial offices of the Bank of Russia. The majority of specialists have a higher professional education (98.2%), age – from 30 to 50 years (63.4%) and work experience in the banking system - more than three years (81.9%).

## INTERNATIONAL ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2016 under the Financial Sector Assessment Program (FSAP) the World Bank and the IMF assessed compliance of the Russian banking supervisory framework with the Basel Core Principles for Effective Banking Supervision, developed by the Basel Committee on Banking Supervision (BCBS). Consultations on the modules 'Stress Testing' and 'State-owned Banks' also took place.

The FSAP findings highlighted significant progress made by the Bank of Russia in fulfilling the previous 2011 FSAP's recommendations, including those on improving the regulatory system and implementing up-to-date supervisory practices.

In March 2016 the BCBS published the report of the Regulatory Consistency Assessment Programme (RCAP) for the Russian Federation. The results confirmed that the Bank of Russia regulatory framework complies with Basel II, Basel 2.5 and Basel III standards.

In 2016 the Bank of Russia representatives proceeded their activities in the BCBS, its working groups and subgroups, as well as in the Regional Group of Banking Supervisors from Central and Eastern Europe (BSCEE).

During the year the Bank of Russia prepared informational and other types of materials on requests from the BSCEE secretariat.

The Bank of Russia pays close attention to the exchange of information with foreign banking supervisors. It has signed 38 cooperation agreements (memoranda of understanding, MoUs) with foreign supervisory authorities. In 2016 the Bank of Russia continued discussion on draft agreements (MoUs) with banking supervisory authorities of several foreign nations / jurisdictions taking into account the latest amendments in the Russian legislation.

The Bank of Russia representatives took part in the work of supervisory colleges set up by the Hungarian National Bank, along with bilateral high-level meetings on topical issues of banking supervision with representatives of the Czech National Bank and the National Bank of the Republic of Belarus.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN RUSSIA

In 2016 the Bank of Russia continued cooperation with domestic agencies, regulators and financial markets supervisors 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, the Federal Treasury, the Federal State Statistics Service, the Deposit Insurance Agency, the Federal Registration Service, the Pension Fund of the Russian Federation and other federal authorities.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

The main indicators of active operations of banking sector in 2016 were significantly influenced by the exchange rate dynamics: for the year the assets of the banking sector decreased by 3.5%, to 80.1 trillion rubles.

As a result of the withdrawal from the market of banking services unsustainable organizations that violate the requirements of the Bank of Russia legislation and regulations, in 2016 the number of operating credit institutions declined by 110, to 623.

With the elimination of the effect of foreign exchange revaluation, there was an increase in funds on customer accounts by 2.6%, but due to the strengthening of the ruble in nominal terms, the volume of these funds decreased by 3.7% in the reporting period (in 2015 – increased by 18.5%), up to 50.0 trillion rubles. The aggregate share of clients' funds in the liabilities of the banking sector has not changed for the year (62.5%).

Borrowing from the Bank of Russia decreased over the year by 49.2% to 2.7 trillion rubles the debt on deposits placed in banks by the Federal Treasury also decreased – by 28.5% to 0.3 trillion rubles. As a result, the share of funds raised from the Bank of Russia in banks' liabilities decreased over the year from 6.5% to 3.4%, and of funds raised from the Federal Treasury – from 0.5% to 0.4%.

Against the background of weak demand for loans from the corporate sector, the total volume of loans to the economy (non-financial organizations and individuals) decreased by 6.9% in 2016 and amounted to 40.9 trillion rubles as of 01.01.2017; without taking into account the foreign exchange revaluation, the decline in these loans was less noticeable – 2.4%.

The value of loans and other placed funds provided by banks to non-financial organizations decreased by 9.5% (for the year 2015 there was an increase of 12.7%), to 30.1 trillion rubles; if adjusted for the exchange rate – by 3.6%. The share of corporate loans in the assets of the banking sector decreased from 40.1% to 37.6% during the year.

In the first half of 2016, retail lending declined, but in general, loans to households (primarily due to growth in mortgages) increased by 1.1% in the year, and with the exception of the impact of the foreign exchange – by 1.4% (in 2015 there was a decrease of these loans by 5.7%, excluding the impact of the foreign exchange rate – by 6.3%). At the end of the reporting year, the volume of the retail portfolio reached 10.8 trillion rubles.

In 2016, the net profit of credit institutions increased sharply compared with the previous year and amounted to 930 billion rubles (in 2015, 192 billion rubles). The profitability of the assets of credit institutions reached 1.2% in 2016, the return on equity was 10.3% (a year earlier, 0.3% and 2.3%, respectively).

Over the year the capital adequacy of the banking sector N1.0 increased by 40 basis points (bp) – from 12.7% to 13.1%. The common equity adequacy N1.1 also increased by 70 bp – from 8.2% to 8.9% – and the Tier 1 capital adequacy N1.2 – by 70 bp, from 8.5% to 9.2%.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Banks | 783 | 681 | 575 |
| Non-bank credit institutions | 51 | 52 | 48 |
| **Banking sector total** | 834 | 733 | 623 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| State-controlled banks | 58.6 | 58.8 | 59.2 |
| Other banks controlled by residents | 31.7 | 32.3 | 33.1 |
| Banks controlled by residents, total | 90.3 | 91.1 | 92.2 |
| Foreign-controlled banks (banks with non-resident interest in excess of 50%) | 9.7 | 8.9 | 7.8 |
| **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 | 47.8 | 55.4 | 0.111 |
| Non-bank credit institutions | 84.7 | 90.0 | 0.435 |
| **Banking sector, total** | 47.7 | 55.2 | 0.111 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Banks | 7.8 | 2.2 | 10.2 |
| Non-bank credit institutions | 21.8 | 19.2 | 36.6 |
| **Banking sector total** | 7.9 | 2.3 | 10.3 |

**Distribution of market shares in balance sheet total***
**(at year-ends, %)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Banks | 99.6 | 99.7 | 99.8 |
| Non-bank credit institutions | 0.4 | 0.3 | 0.2 |
| **Banking sector total** | 100.0 | 100.0 | 100.0 |

* Share in aggregate banking sector assets

**The structure of assets and liabilities of the banking sector (%)**
**(at year-ends, %)**

| Assets | 2014 | 2015 | 2016 |
|---|---|---|---|
| Financial sector | 16.3 | 17.9 | 18.9 |
| Nonfinancial sector | 52.6 | 53.0 | 51.1 |
| Government sector (including the Bank of Russia) | 7.4 | 7.8 | 9.8 |
| Other | 23.7 | 21.3 | 20.1 |
| **Liabilities** | **2014** | **2015** | **2016** |
| Financial sector (including credit institutions) | 12.4 | 12.4 | 15.1 |
| Nonfinancial sector | 50.1 | 56.2 | 55.7 |
| Government sector (including the Bank of Russia) | 13.4 | 7.6 | 4.4 |
| Capital (profits, funds) | 8.9 | 9.1 | 10.8 |
| Other | 15.3 | 14.7 | 14.0 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Banks | 12.4 | 12.7 | 13.1 |
| Non-bank credit institutions | 63.4 | 29.3 | 30.8 |
| **Banking sector, total** | 12.5 | 12.7 | 13.1 |

**Asset portfolio quality of the banking sector**
**(share of non-performing loans, %)**

| Asset classification | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 7.9 | 10.0 | 11.0 |
| households | 9.9 | 12.9 | 11.8 |
| corporate (including individual entrepreneurs) | 7.2 | 9.1 | 10.7 |

**The structure of deposits and loans of the banking sector in 2016**
**(at year-end, %)**

| | Deposits and other funds raised by credit institutions | Loans, deposits and other funds provided by credit institutions |
|---|---|---|
| Non financial sector, including: | 93.3 | 91.8 |
| Households | 59.6 | 23.3 |
| Non financial institutions | 33.7 | 68.5 |
| Government financial authorities and off-budget funds | 2.0 | 2.2 |
| Financial sector (excluding banks) | 4.6 | 6.0 |
| **Total** | 100.0 | 100.0 |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 77 426 441 | 81 925 814 | 101 627 505 |
| Interest expenses | 40 352 148 | 55 471 251 | 60 048 956 |
| Net interest income | 37 074 293 | 26 454 563 | 41 578 549 |
| Net commission income | 10 610 076 | 9 692 733 | 14 001 679 |
| Other (not specified above) income (net) | 10 981 474 | 8 095 143 | -3 479 679 |
| Gross income | 58 665 843 | 44 242 439 | 52 100 549 |
| Administration costs | 27 994 920 | 20 287 614 | 27 126 367 |
| Depreciation | n/a | n/a | n/a |
| Loan loss provisions | 22 027 437 | 21 538 435 | 10 414 205 |
| 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 | 8 643 486 | 2 416 390 | 14 559 977 |
| Profit (loss) after tax | 7 553 571 | 1 437 633 | 10 856 748 |

**Total Own Funds in 2016 (in thousands of EUR)**

| Type of financial institution | Total own funds (capital) | Core capital | Additional capital |
|---|---|---|---|
| Banks | 146 734 014 | 102 971 194 | 43 762 820 |
| Non-bank credit institutions | 373 273 | 250 859 | 122 414 |
| **Banking sector, total** | 147 107 287 | 103 222 053 | 43 885 234 |

# 2016 DEVELOPMENTS IN THE SERBIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2016 economic growth picked up and amounted to by 2.8% y-o-y. GDP growth was led by agriculture, industry, construction sectors and private sector services. The main driver on the expenditure side was net exports due to faster exports of goods and services growth. None the less, investments and recovery of final consumption gave positive contributions as well. Favourable trends in the real sector had a positive effect on the labour market – the unemployment rate was reduced significantly (to 15.3%) and formal employment growth in the private sector (2.6% on average) more than compensated public sector rightsizing (-1.8% on average). Average salary increased by 2.6% in real terms led by salary growth in the private sector by 3.5% in real terms.

Following a significant reduction in external imbalances in 2015 (CAD was reduced from 6% to 4.7% of GDP), positive trends have continued during 2016 and CAD at end-2016 amounted 4.0% of GDP and was fully covered by FDI (135.8%). Narrowing of CAD (-13,1% y-o-y) was achieved as a result of much faster growth in exports of goods and services (10.8% y-o-y) relative to imports (5.3% y-o-y). External demand recovery, fiscal consolidation and low oil prices have contributed to this improvement.

Exports were led by exports of agriculture (12.7% y-o-y) and manufacturing exports (11.5% y-o-y). Within manufacturing, the highest contributions came from exports of electrical equipment, chemical products, motor vehicles, food, rubber and plastic products.

Primary income deficit was higher due to higher expenses on FDIs, while secondary income surplus was somewhat lower.

In 2016, net FDI inflow amounted EUR 1.9 bln and was diversified by country and sector. Although the financial account recorded inflow, it wasn't enough to cover CAD, so NBS FX reserves were decreased.

In 2016 inflation remained low and stable and at end-2016 stood at 1.6%. On November Executive Board meeting, decision was made to reduce the inflation target from 2017 to 3%±1.5%. Furthermore, there was a substantial decline and then stabilization of inflation expectations to the level which is in line with the new target.

NBS lowered the key policy rate in February and July by 0.25 pp each (from 4.5% to 4.0%).

The steady improvement in fiscal balances since 2014 (when the deficit reached 6.6% of GDP) continued further in 2016, with an overall fiscal deficit posted at 1.3% of GDP, mainly on account of better collection of all revenue categories (by 2pp of GDP) but also a further decline in expenses (by 0.4pp of GDP), compared to 2015 which already saw expenses drop by 2.5pp of GDP (cut in wages and pensions) in that year. Public debt amounted to 72.9% at year-end (after a peak of 74.7% in 2015), starting its decline a year earlier than envisioned by the IMF program.

**Key Macroeconomic Indicators**

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | Q1 2017 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 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 | 1,2 |
| 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 | 3,6 |
| 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 | 9.730 |
| 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 | 15.631 | 17.314 | 4.351 |
| - 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 | 8,2 | 10,8 | 10,2 |
| 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 | 18.899 | 19.895 | 5.158 |
| - 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 | 4,4 | 5,3 | 14,3 |
| 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 | -1577 | -1.370 | -746 |
| as % of GDP | -8,4 | -9,6 | -18,6 | -21,1 | -6,6 | -6,8 | -10,9 | -11,6 | -6,1 | -6,0 | -4,7 | -4,0 | -9,5 |
| Unemployment according to the Survey (in %) | 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 | 14,6 |
| Wages (average for the period, in EUR) | 209,7 | 260,0 | 347,1 | 400,5 | 337,4 | 330,1 | 372,5 | 364,5 | 388,6 | 379,3 | 368,0 | 374,1 | 366,6 |
| 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 | 0,7 |
| 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 |
| 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 | 72,9 | 69,2 |
| 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 | 116,18 |
| 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 | 116,13 |
| 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 | 123,88 |
| 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 | 123,97 |
| 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 | 34.115 | 7.859 |

[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] Revised data for 2014 and 2015 according to the new methodology of Labour Force Survey

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, as the largest portion of the financial system of Serbia (91%), could be assessed as well capitalized and highly liquid, which is confirmed from the perspective of past results as well as from results related to actual time frame. Due to its strong performance, banking sector in 2016 was attractive, both for foreign direct investments, and for the investments from reputable domestic investors.

At the end of December 2016, there were 30[36] banks operating in Serbia (22 in majority foreign ownership, two in majority ownership of domestic entities,

[36] At the end of December 2016 were 31 banks with operating licence, but one bank has obtained operating licence by NBS as of 20.12.2016. and it's data didn't include in this information.

while six banks were in majority ownership of the Republic of Serbia). All banks in Serbia are operating as independent legal entities, no branching is allowed. Foreign-owned banks are members of banking groups from 13 countries and the most significant foreign banks are from Italy and Austria (27.3% and 15.2%, respectively), followed by banks from Greece (12.4%), France (10.1%) and other countries (11.7% share in total). Despite a modest growth reported in 2016, overall financial intermediation by banks is still on relatively low level in Serbia in comparison to more developed markets. The share of banking sector assets to GDP amounted to 83% at the end of December 2016.

Total balance sheet assets of the banking sector in Serbia reached EUR 26.3 billion at the end of 2016 which is an increase of 4.8% since the end of 2015.

The level of competition in market is at a satisfactory level, without concentration in any field of activities. The market share of the top five banks in Serbia is 54.7% for assets, 51.2% for lending and 54.3% for deposits.

At the end of December 2016, total gross value of loan portfolio [37] was at the level of EUR 16.0 billion which is an increase of 3.1% compared to the end of 2015. Loans to (private and public) companies made 49.9% of total loans with EUR 8 billion, at the end of 2016. During 2016, loans to corporate sector slightly decreased by 0.6%, mainly as a result of sale and write-offs of non-performing loans due to successful implementation of NPL Resolution Strategy. The growth rate of total household loans was 8.8% during 2016 and at the end of December 2016 they amounted to EUR 6.0 billion and made 37.5% out of total loans.

Gross NPL ratio stood at 17.03% at the end of December 2016 that is 4.6 p.p. lower than in December 2015 and simultaneously the lowest recorded level of NPL ratio since January 2011. Data show that systemic, inter-institutional and coordinated approach which is envisaged by the NPL Resolution Strategy, has positive impact on relevant players regarding the NPL resolution.

The total stock of gross NPLs at the end of December 2016 totaled 2.8 bln EUR which is a decrease by 19.8% on yearly level. Such a decrease in NPLs was primarily the result of direct write-offs and their sale to other legal entities outside of the banking sector.

The largest reduction of NPLs in absolute terms was recorded in corporate sector, where NPLs were decreased to 1.3 bln EUR at the end of December 2016. Above mentioned reduction was accompanied by NPL ratio declining which is lower by 6.0 p.p. comparing to previous year (drop from 23.6% to 17.6%).

NPLs of households (citizens, farmers and entrepreneurships) are lower for 47.1 mln EUR on yearly level and amounts 677,8 mln EUR at the end of December 2016. Gross NPL ratio for households also has downward trend – it dropped from 11.7% at the end of 2015 to 10% at the end of 2016.

We are emphasizing that NPLs are completely covered with regulatory loan-loss reserves and IFRS provisions and all coverage ratios showed increasing trend. At the end of December 2016, regulatory loan loss reserves covered ca. 119% of gross NPLs, while allowances for loan impairment (under IFRS) covered ca. 68% of gross NPLs.

Total banking sector deposits at the end of December 2016 stood at the level of EUR 18.2 billion with an increase of 10.4% in 2016. Household deposits made 53.7% of total deposits with increase of 5.3% in 2016. Savings deposits in foreign currency are the most prominent in both segments (household deposits and total deposits) with EUR 9.0 billion at the end of December 2016 and an increase of 4.2% in 2016. Approximately, one fifth of all deposits were related to

[37] without loans under repo transactions

corporate sector with a EUR 4.2 billion at the end of 2016 which is an increase of 17.9% 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 19.5% as of 31 December 2016. The capital adequacy ratio was 21.8% at the end of December 2016, which is significantly above the regulatory minimum of 12%.

The average regulatory liquidity ratio for the Serbian banking sector in December 2016 was 2.05, 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 36.9% of total assets and 53.6% of total short-term liabilities.

Bank's profitability significantly improved in 2016, by most due to lower impairment losses. Total net pre-tax profit at the end of December 2016 amounted to EUR 172.5 million.

## 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 2016, the National bank of Serbia (hereinafter: NBS) Executive Board adopted **the Decision Amending the Decision on Risk management by banks (RS Official Gazette, No 61/2016)** in order to regulate money laundering and the financing of terrorism risk, as well as to implement Action Plan for Implementation of the NPL Resolution Strategy, by introducing the concept of bad assets and regulation of risk management relating to the management of bad assets, and with the aim of complying with Law on Payment Services.

For the same purpose of implementing the Action Plan for Implementation of the NPL Resolution Strategy, in June 2016, the NBS Executive Board **adopted the Decision Amending the Decision on the classification of bank balance sheet assets and off-balance sheet items („RS Official Gazette", No. 61/2016)** which has changed the definition and treatment of the restructured receivables, taking into account definitions and treatment of the forborne receivables as envisaged by the EBA's Implementing technical standard on supervisory reporting on forbearance and non-performing exposures. The Decision envisages introduction of new definitions of non-performing (NPE), performing and forborne exposure ( in line with technical standards published by the European banking authority (EBA)), prescribes additional requirements for classification for the purpose of additional monitoring of asset quality, so that banks would be obliged in addition to assigning exposures into categories (A, B, C, D, E), to mark the exposures as non-performing, performing and forborne exposure, with no impact on the calculation of the amount of required reserves for estimated losses, and defines the conditions and the time required for the transition of receivables from one category to another.

In June 2016, the NBS Executive Board adopted **the Decision Amending the Decision on Reporting Requirements for Banks** („RS Official Gazette", No. 61/2016). Those amendments of the Decision on Reporting Requirements for

Banks introduce appropriate changes of the reporting system, as well as new reports on NPE and forborne exposure in line with the EBA technical standard.

In August 2016, the NBS Executive Board **adopted the Decision Amending the Decision on the classification of bank balance sheet assets and off-balance sheet items** („RS Official Gazette‟, No. 69/2016). Those amendments have introduced the model of reducing the amount of required reserve, which is conditional on the level of NPL ratio earlier than Basel III standards implementation date (decision has been made to start implementing this model on 30. September 2016 and it will be applied until 1 January 2019) in order to have longer implementation period for this model and thus to give banks stronger incentive to reduce the level of NPLs and/or increase lending activity. Given that the adopted amendments to the Decision on the Classification of Bank Balance Sheet Assets and Off-balance Sheet Items, amongst others, envisage that banks, which had NPL ratio of non-state and non-financial sector equal to or lower than 10% on 30 June 2016 and they still have this ratio equal to or lower than 10% on reporting date, can calculate their required reserve, treated as deductible from regulatory capital and credit risk weighted assets, to the level of zero. With additional aim to stimulate banks to increase lending activity, the adopted amendments to the Decision on the Classification of Bank Balance Sheet Assets and Off-balance Sheet Items prescribe possibility for the banks to change the percentage from 2% to 0% applicable to the base for the calculation of reserves for estimated losses for the receivables classified in category B which were created on the basis of contracts signed after 30 September 2016, provided that their aim is not refinancing or restructuring.

In August 2016, the NBS Executive Board adopted **the Decision Amending the Decision on Reporting Requirements for Banks** (RS Official Gazette, No. 69/2016) in order to adjust existing regulatory reporting system with mentioned amendments to the treatment of the required reserve and to ensure verification of fulfillment of conditions for the reduction or abolishing of the required reserve for estimated losses, by introducing a new report on the largest debtors from non-financial and non-government sector with NPLs in banks, as well as to enable conducting detailed analysis about the reasons for the high level and share of non-performing loans in total loans.

In October 2016, the NBS Executive Board adopted **the Decision Amending the Decision on capital adequacy of banks** (RS Official Gazette, No. 85/2016) in order to ensure long-term stability of the amount and quality of banks' capital required to cover all the risks to which banks are exposed or may be exposed to in its business, and, consequently, the stability of the financial system. The NBS has assessed that prescribing conditions for the exclusion from the calculation of regulatory capital by way of reducing the value of elements of Tier 1 capital, are adequate instrument for attaining those objectives.

In November 2016, NBS Executive Board adopted the Decision Amending **the Decision on the classification of bank balance sheet assets and off-balance sheet items** („RS Official Gazette‟, No. 91/2016) in order to equalize the treatment of bank refinanced exposure to borrower (forborne exposure upon earlier valid solution), and the treatment of "refinancing" exposure of another legal entity other than a bank to whom the receivable from that borrower was assigned to (which was not treated as forborne exposure upon earlier valid solution). Consequently, the definition of refinancing of exposures has been changed.

In December 2016, the NBS Executive Board adopted the following decisions (published in the RS Official Gazette, No 103/2016) which introduce Basel III standards in the Republic of Serbia:

- **Decision on Capital Adequacy of Banks,**
- **Decision on Disclosure of Data and Information by Banks,**
- **Decision on Reporting on Capital Adequacy of Banks,**
- **Decision Amending the Decision on Reporting Requirements for Banks,**
- **Decision on Liquidity Risk Management by Banks,**
- **Decision Amending the Decision on Risk Management by Banks.**

Implementation of by-laws introducing Basel III standards is set to start as of 30 June 2017.

These regulations lay down the reduction of the prescribed minimum capital adequacy ratio from 12% to 8% and the simultaneous setting of capital buffers (capital conservation buffer, countercyclical capital buffer, systemic risk buffer, capital buffer for systemically important banks) as of the starting date of implementation of Basel III standards (30 June 2017). The new regulations ensure compliance with the requirements of Regulation (EU) No 575/2013, introduce all three capital adequacy ratios (the Common Equity Tier 1 capital ratio, the Tier 1 capital ratio, the total capital ratio), new standards for the calculation of capital requirements for credit, market, operational risk and credit risk arising from securitisation, a more favourable risk weight for exposures secured by commercial immovable property and the new capital requirement for the correlation trading portfolio. They also prescribe the mandatory use of the stressed VaR parameter in the calculation of capital requirements for market risks, introduce the capital requirement for the breach of exposure limits in the bank’s trading book, and prescribe the leverage ratio and the liquidity coverage ratio.

These regulations also lay down that the treatment of the required reserve for estimated losses as a deductible from capital and credit risk-weighted assets, as a specificity of the regulatory framework for banks in Serbia, will cease as of 1 January 2019, whereas banks will be in position to reduce additionally the amount of the required reserve for estimated losses by reducing the level of non-performing loans in their portfolios by that date.

In addition, the new regulations prescribe that until the date of the Republic of Serbia’s accession to the European Union, the risk weight assigned to exposures to the Republic of Serbia and the National Bank of Serbia, as well as to exposures to EU Member States and their central banks that are denominated and settled in the currency of any member state is the same as the risk weight assigned to exposures to these persons that are denominated and settled in their national currencies.

Decision on Liquidity Risk Management by Banks introduced liquidity coverage ratio (LCR). In accordance with this decision the bank shall maintain the LCR at a level of at least 80%, aggregately in all currencies, until 31 December 2017, after which it shall maintain the ratio at a level of at least 100%.

Decision Amending the Decision on Reporting Requirements for Banks introduced reports on the LCR ratio. Also, reports on the leverage ratio are introduced. The leverage ratio is only reporting category and is defined as ratio of Tier 1 capital – sum of Common Equity Tier 1 capital and Additional Tier 1 capital in accordance with the decision governing capital adequacy of banks – to the bank's exposure measure and is expressed as a percentage.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

As part of its efforts to continuously, enhance regulatory framework for banking supervision in line with international standards and EU regulation, the NBS adopted in December 2013 **the Strategy for implementation of Basel III standards** in Serbia which envisaged to be conducted through three phases. After all of these three phases have been conducted (preparatory phase – conducting analysis of (non)compliance (gap analysis) between Basel 2.5 and Basel III standards on the one hand, and the existing regulatory framework for banks in Serbia, on the other; impact assessment and determination of the dynamics for implementation phase; and legislation drafting phase), at its meeting in December 2016, the NBS Executive Board adopted set of bylaws introducing Basel III standards in the Republic of Serbia.

**The Strategy for NPL Resolution**, adopted by the Government of the Republic of Serbia in August 2015, has been developed in cooperation of relevant authorities and the NBS. The Strategy aims to provide incentives and to eliminate barriers identified in the system preventing timely resolution of NPLs and to establish a system, which will prevent the accumulation of non-performing loans to the level, which might have a material adverse effect on credit activity jeopardizing potential economic growth. In line with the Strategy, the NBS Executive Board reached a decision to adopt the Action plan of the NBS for implementation of the Strategy.

The NBS has conducted all activities in line with its Action Plan for implementation of the NPL Resolution Strategy during 2016, aiming to enhance the banks' capacities to resolve NPLs through improvement of NPL management in banks and enhancement of restructuring practices and accounting practices, to improve transparency of banks regarding assets quality, to enhance collateral management in banks and reporting to regulator on NPL structure.

Data show that systemic, inter-institutional and coordinated approach envisaged by the Strategy has positive impact on relevant players regarding the NPL resolution.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

34 on-site supervisions were conducted in 2016: 6 target control (3 ICAAP, 1 credit risk and capital adequacy, 1 credit risk, capital adequacy and corporate management and 1 corporate management), 4 supervisions related to AML/CFT issues and payment transactions, 1 supervision of opening and manner of maintaining accounts of clients- natural persons Non-Residents, 1 supervision of consumer protection and 22 follow up-on site supervisions (14 follow-ups on safety and soundness examinations from the aspect of risk management, 7 supervisions related to AML/CFT issues and payment transactions and 1 supervision of consumer protection).

***AML***

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 companies and voluntary pension funds) is actively participating in the work of Money Val Committee, which brings together experts from member states who perform AML/CFT tasks within their parent institutions (FIU, Central Bank, Ministry of Interior, Ministry of Justice). The Committee works on the principle of mutual evaluations-assessment of measures and actions undertaken by Member States, in the field of anti-money laundering and combating the financing of terrorism. MoneyVal evaluation reports contain recommendations for improving the effectiveness of AML/CFT national system, as well as for strengthening capacity for international cooperation.

MoneyVal published the Fth Round Mutual Evaluation Report of Serbia's AML/CFT system on its website in June 2016, providing summary on measures put in place in Serbia as well as recommendations on how the AML/CFT system could be strengtened.

***Measures Against Banks***

During 2016, National Bank of Serbia – Banking Supervision Department took following measures against banks: 10 letters of warning, 9 resolutions with orders for banks to undertake certain measures, 4 resolutions on temporary measures and 1 resolution on imposing early intervention measures. Further, National Bank of Serbia – Banking Supervision Department filed 1 request for initiation of the proceeding for commercial misdemeanors against banks and responsible persons.

***Licensing and Approvals regarding Banks***

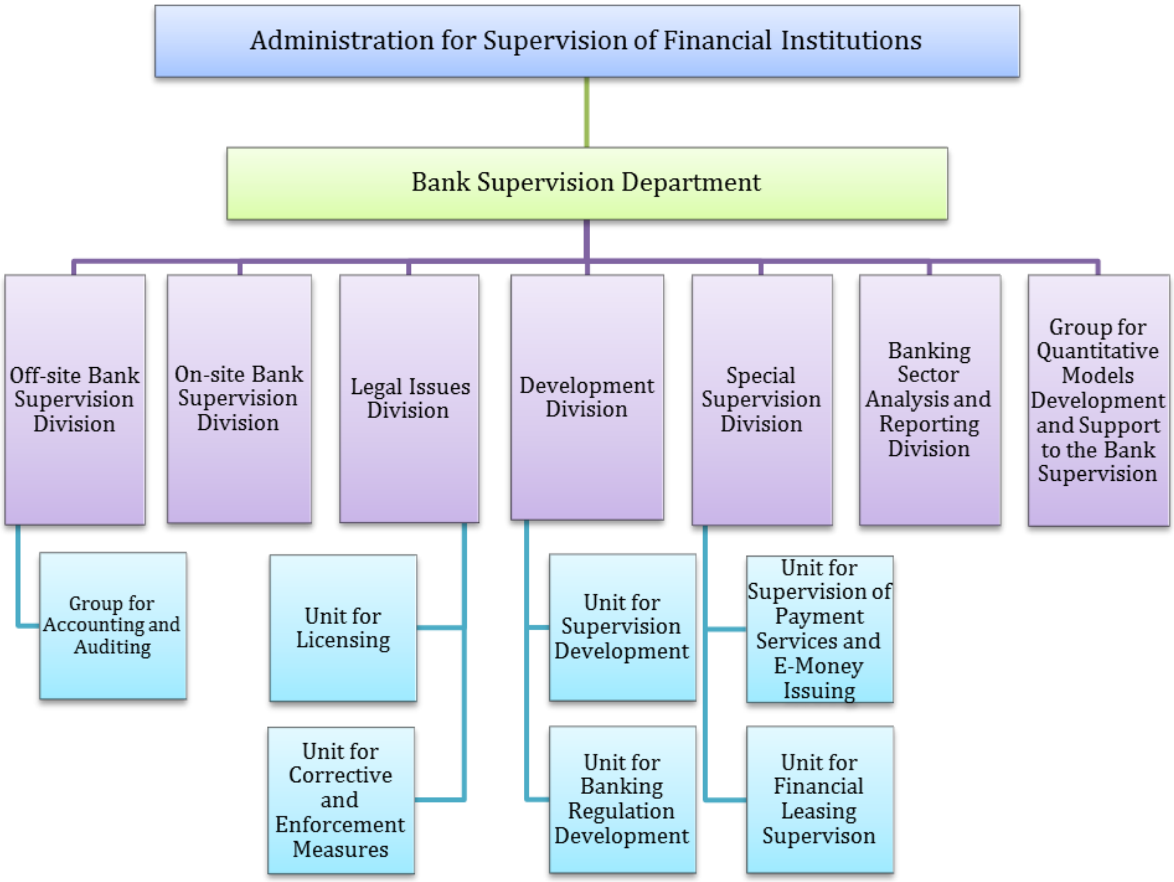
In 2016, National Bank of Serbia – Banking Supervision Department granted 1 preliminary bank founding permit and 1 operating licence for the same bank, granted consent for the acts of a Bank's founding assembly, approved 27 requests for amendments of banks' founding acts and their articles of association. Also, 99 procedures regarding appointment of managing and executive board members (92 requests were approved, 7 procedures were terminated) and 3 procedures of direct acquisition of ownership in banks in Serbia (2 requests for acquisiton of an ownership in banks in Serbia were approved, 1 was dennied) were initiated.

Furthermore, 2 requests for distributing bank's profit through payment of dividends to its shareholders were submitted (1 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), 1 application for approval for acquisition of subordinated company in financial sector was approved, 1 bank was permitted not to include a subsidiary in consolidated financial statements.

The National Bank of Serbia – Banking Supervision Department granted 1 consent on putting on the List of external auditors.

The National Bank of Serbia – Banking Supervision Department processed 170 notifications from banks regarding outsourcing of their business activities and processed 8 notifications from banks about their intent to include subordinated obligations into the supplementary capital.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

NBS has signed Memorandums of Understanding (MoU) with banking supervision authorities of following countries: Austria, Belgium, Bosnia & 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, 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, the WCCAs are currently in the update phase which is scheduled to be finished until end of June.

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

In the second half of 2016 the NBS intensify its activities regarding the implementation of IFRS9 in the banks i.e. the preparations in the banks regarding this process and communication with the banks on this topic.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 29 | 30 | 31* |
| Branches of foreign credit institutions | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | **29** | **30** | **31*** |

* 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 19.2 | 18.0 | 17.3 |
| Other domestic ownership | 6.3 | 5.9 | 6.0 |
| Domestic ownership total | 25.5 | 23.9 | 23.3 |
| Foreign ownership | 74.5 | 76.1 | 76.7 |
| **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 | 39.6 | 54.7 | 813 |
| Branches of foreign credit institutions | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | **39.6** | **54.7** | **813** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 0.6 | 1.6 | 3.4 |
| Cooperative banks | | | |
| **Banking sector, total:** | **0.6** | **1.6** | **3.4** |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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)**

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 17.0 | 15.9 | 13.8 |
| Nonfinancial sector | 49.3 | 49.2 | 50.8 |
| Government sector | 21.9 | 24.0 | 24.0 |
| Other assets | 11.8 | 10.9 | 11.4 |
| **Claims due to** | | | |
| Financial sector | 11.0 | 9.6 | 8.2 |
| Nonfinancial sector | 60.4 | 61.7 | 63.7 |
| Government sector | 6.3 | 7.3 | 7.5 |
| Other liabilities | 1.6 | 1.1 | 1.1 |
| **Capital** | 20.7 | 20.3 | 19.5 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 20.0 | 20.9 | 21.8 |
| Cooperative banks | | | |
| **Banking sector, total:** | **20.0** | **20.9** | **21.8** |

(* - 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)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | | | |
| **- households** | 10.30 | 10.87 | 9.28 |
| **- corporate** | 26.70 | 23.56 | 17.58 |

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 89.6 | 92.3 |
| Households | 56.3 | 38.0 |
| Corporate | 24.0 | 45.2 |
| Government sector | 8.3 | 6.9 |
| Financial sector (excluding banks) | 2.1 | 0.8 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 1,513,152 | 1,410,588 | 1,232,293 |
| Interest expenses | 482,061 | 343,505 | 229,255 |
| Net interest income | 1,031,092 | 1,067,083 | 1,003,038 |
| Net fee and commission income | 287,913 | 287,144 | 285,666 |
| Other (not specified above) operating income (net) | 125,235 | 154,476 | 135,638 |
| Gross income | 1,444,239 | 1,508,702 | 1,424,342 |
| Administration costs | 867,739 | 876,629 | 863,977 |
| Depreciation | 63,931 | 62,050 | 59,039 |
| Provisions | 0 | 0 | 0 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 483,505 | 490,092 | 328,800 |
| Profit (loss) before tax | 29,065 | 79,931 | 172,526 |
| Net profit (loss) | 18,870 | 61,239 | 148,629 |

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds | Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 3,324,649 | | 3,043,432 | 281,218 | |
| Cooperative banks | | | | | |
| **Banking sector, total:** | **3,324,649** | | **3,043,432** | **281,218** | |

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

# 2016 DEVELOPMENTS IN THE SLOVAKIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Slovak economy grew by 3.3% in 2016, with 0.5 pp lower dynamics in comparison with the previous year. The deceleration of the GDP growth was result of strong EU fund withdrawals in 2015 due to expiration of previous programming period in 2015 and only gradual absorption of EU funds in 2016 from new EU budgetary period. Government investment thus negatively contributed to economic growth last year. The economic development in 2016 was generally balanced, when both domestic and external demand contributed to its growth. Favorable development on labor market, manifested by historically high levels of employed people and low level of unemployment rate, has also mirrored in stable increase of the household consumption. Nominal wage increase at the background of negative inflation resulted in real wage increase and increase of real disposable income. Favorable economic development has also reflected in increase of sales of nonfinancial corporations (NFCs). After two years of negative contributions, the net exports positively affected economic growth. Persisting low level interest rate environment, favorable economic outlook and sentiment, together with steadily increase of wealth of households and NFCs promoted the increase of demand for new loans. Generally, macroeconomic development has contributed to strengthening of the expansionary phase of the financial cycle.

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

Ongoing strong credit growth in retail, both housing and consumer loans, is the most significant factor in domestic banking sector. On the demand side, the growth was mainly driven by strong decline in interest rates and improving situation on labor market. Supply side was formed by bank completion amplified by new cap on prepayment penalty and by mortgage brokers. The annual rate of growth of the volume of retail loans reached 14% at end-December 2016. The growth rate kept to be the highest dynamic among EU countries. The upward trend in retail lending in recent years has led to rising growth in household debt. Credit to disposable income has doubled since 2010 and is 2nd highest among CEE peers. The rapid growth in housing loans has also contributed to a build-up of imbalances in the real estate market. The Národná banka Slovenska (NBS) have reacted to these trends in financial sector by imposing measures with the aim of strengthening resilience of banks (setting a non-zero countercyclical capital buffer (CCyB) rate, identification of O-SII, capital conservation buffer) and at the same time forcing banks to responsible lending (NBS Decree No 10/2016 entered into force that implemented principles concerning the provision of housing loans, set out in NBS Recommendation No 1/2014).

Economic growth coupled with improving sentiment in corporate sector influenced the firms' demand for loans as well as their debt servicing capacity. Corporate lending experienced stable dynamics in 2016 at the level close to 6 %.

Growth in corporate lending was driven by private firms in domestic or foreign ownership. Relatively robust lending upturn could be observed, as most of economic sectors as well as segment of small and medium sized firms have experienced growth in lending.

The total volume of investment in debt securities continued to fall in 2016 (by 5.5% year on year), as did the volume of investment in Slovak government bonds (by almost 9% year on year).

Favorable credit development stayed beyond the increase of the Total assets-to-GDP ratio from 90% at the end of 2015 to 92% at the end of 2016.

NPL ratio of both, retail and corporate sector experienced an improvement under the influence of positive economic situation and decreasing interest rates. However, increase in the NPL ratio for consumer loans was in contrast with the favorable economic conditions.

Domestic banking sector is further characterized by sound funding structure, owing to customer's deposits, that are dominant and stable form of financing. Customer's deposits continued to growing at the pace of 5% at the end of 2016. As a result of strong loan growth, Loan-to-Deposit ratio increased close to 100% and reached EU average.

Sustainability of bank's business models is one of main risks to financial stability. Profitability of the banking sector after adjustment for one-off effects declined in the 2016 (annual increase of 19.8% before adjustment and decline 11% after adjustment). Drop in profitability was driven by prolonged environment of low interest rates, which coupled with strong banking competition, decreased net interest income. On the other hand, overall drop in NPL ratio was positive factor for profitability in terms of decrease of credit risk costs. Regulatory contributions and levies significantly weighted on profitability.

Resistance of domestic banking sector to potential risks remained relatively high, as capital adequacy ratio slightly increased to 18.16% at the end of 2016 and average leverage ratio stayed at satisfactory level slightly above 8%. Performance of the banking sector in the stress test suggests it is relatively resilient to potential headwinds from the real economy and financial markets.

## 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 most extensive of the central bank's activities is supervision of the financial market, which includes supervision of the banking sector, capital market, insurance sector, pension sector, and financial intermediation and financial advisory services. NBS also exercises supervision over the provision of financial services in the private pension sector. As of 2015, NBS assumed responsibility for the protection of financial consumers, a task previously entrusted to the Slovak Trade Inspectorate. Its supervision in the area of consumer protection extends to foreign institutions operating in Slovakia under the 'single passport' regime established by EU Directives, notwithstanding that such institutions are supervised by the competent authority in their home country.

NBS supervises all entities that it has registered or issued with an authorisation. In addition to checking supervised entities for their compliance with consumer rules and imposing sanctions in cases where the rules are breached, it also handles allegations and complaints made by financial consumers and other customers against supervised entities.

Each of these supervisory areas is given an adequate attention by regulation. The regulatory activity is influenced by the preparation and implementation of regulation at European level in addition to the preparation of regulation at national level.

In the banking sector, the regulatory activity of NBS in 2016 was focused on the preparation of several laws and subordinate legislation, e.g. the Housing Loan Act, the amendment to the Consumer Credit Act and the Decree on Housing Loans.

In 2016 was also published a preliminary information on the preparation of an amendment to the Act on Payment Services aimed at transposing the PSD 2 Directive. This Directive was adopted in line with the Europe 2020 Strategy and the digital agenda, with the aim of contributing to the creation of a harmonized electronic payment market throughout the European Union.

During the year 2016, NBS was also involved in the preparation of the ECB draft regulation on the exercise of national elections and authorizations for significant institutions (SIs). In the same year, the preparation of regulation of national elections and authorizations against less significant institutions (LSIs) continued, and it was decided to implement the policy towards LSIs, similar to the SIs.

Furthermore, NBS participated in drafting a new Act on the implementation of international sanction concerning the freezing of terrorists´ financial resources and assets with the Ministry of Finance in 2016.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

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 2016.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

As at 31 December 2016 there were 13 banks and 15 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.; Všeobecná úverová banka, a.s.; Slovenská sporiteľňa, a.s.; 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 22 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 73 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.

In one case in 2016, sanction proceedings were initiated against a banking institution.

In 2016 BNP Paribas Personal Finance S.A., pobočka zahraničnej banky began operating in Slovakia. Following a cross-border merger of the French credit institution COFIDIS SA and the Portuguese credit institution BANCO COFIDIS,SA, the foreign bank BANCO COFIDIS, SA, operating in Slovakia through its organizational unit BANCO COFIDIS, SA, pobočka zahraničnej banky (previous name: Banco Banif Mais, S.A., pobočka zahraničnej banky), ceased to exist as of 1 December 2016. As of 1 December 2016 the successor foreign credit institution COFIDIS SA began carrying out banking activities in Slovakia through its organisational unit COFIDS SA, pobočka zahraničnej banky.

NBS registered 21 foreign credit institutions that started to provide banking services in Slovakia without establishing a branch. NBS notified a foreign supervisory authority about the intention of Poštová banka, a.s. to provide banking services in Germany without establishing a branch.

In 2016 a total of eleven 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 and interest rate risk in the banking book, as well as on operational risk management systems, the provision of payment services, 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

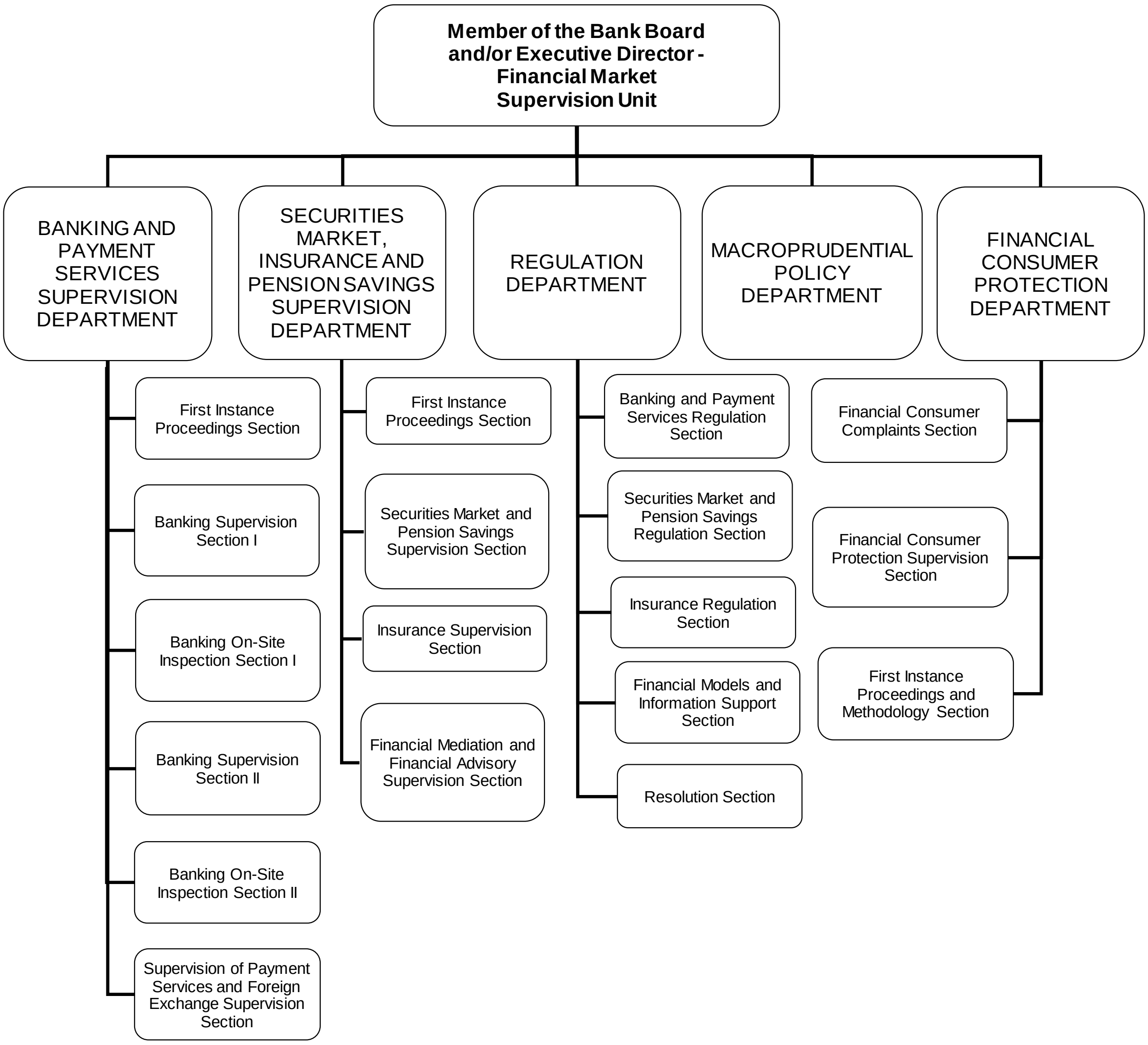
Joint Supervisory Teams (JSTs) and by drafting decisions within the ECB's decision-making processes. All on-site inspections at significant banks under the ECB's direct supervision were conducted by NBS staff acting under ECB authorisation.

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.

Communication with the ECB concerning banks under direct NBS supervision included topics such as the gradual harmonisation of supervisory practices, assessment of these banks and exchange of information between NBS and the ECB.

# ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY




# 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 2016.

For supervision at the level of the European financial system, NBS continued in cooperation 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).

In 2016, NBS is ongoing cooperation with the EBA focused on the drafting of regulatory technical standards required under the EU´s Capital Requirements Regulation and Directive (CRR/ CRD IV). NBS cooperated with EBA at all levels of competence, from working groups to the highest approval bodies.

## 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 fourth meeting in April 2016, to discuss the 2016 contributions to the Single Resolution Fund, changes to its Statutes and Rules of Procedure, and the election of the Council's Executive Member. Director of the NBS Regulation Department and Council member, Júlia Čillíková, was elected as the Council's Executive Member. In November2016, at its fifth meeting, the Resolution Council approved a proposal for the implementation of provisions on proportionality in bank resolution and preliminary simplified resolution plans for smaller banks. The Council also approved the Underlying Methodology for determining MREL for selected institutions within the Council's remit with bankruptcy as the preferred resolution strategy.

With a view to promoting cooperation and preventing different national responses, resolution colleges are being established in line with Article 88 of the BRRD Directive, under which resolution authorities are obliged to cooperate in the resolution of group entities. In 2016 the staff members of the NBS Resolution Section participated in a college established by the Hungarian resolution authority.

In the year under review the Resolution Section continued to monitor the resolution of financial corporations other than credit institutions and investment firms on both global and European level.

As regards the area financial consumer protection, two preliminary measures entered into force and six sanction proceedings were initiated in 2016. In the event of a breach of obligations in the area of financial consumer protection it is possible to impose financial sanctions, prohibit the use of unfair market practices or unacceptable contractual conditions disadvantageous to the financial consumer, prohibit the provision of financial services that infringe rules for financial consumer protection, and also revoke the creditor's license or other authorisation.

Last year saw a significant rise in the number of broad-based analyses, off-site examinations and on-site inspections. A total of 25 off-site examinations and broad-based surveys/analyses, and 21 on-site inspections, were conducted in 2016. NBS continued to exercise its right to initiate an on-site inspection by procuring financial services under an assumed identity, conducting a total of 95 such "mystery shopping exercises" during the year.

Supervision of consumer credit provision focused mainly on the disclosure of credit information prior to the conclusion of the loan agreement, the use of unacceptable contractual conditions, contracts' statutory elements, and the use of unfair market practices.

In 2016 NBS received 2,376 complaints against supervised entities from financial consumers and other customers, which was 702 more than it received in 2015 (the year-on-year increase of 40% was the highest to date). 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 corresponding share in 2015 was 45%). The complaints received about banks concerned mostly mortgage and housing loan fees and consumer loans.

In 2016 NBS continued to promote financial literacy through various activities, focusing mainly on youth (primary and secondary school students). he FMS Unit contributed to the work of the Financial Literacy Inter-Ministerial Expert Group at the Ministry of Education, Science, Research and Sport of the Slovak Republic, resulting in an updated version of the National Standard for Financial Literacy reflecting the changes in the financial market, and feedback received on the standard's current version.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 13 | 13 | 13 |
| Branches of foreign credit institutions | 15 | 14 | 15 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total:** | **28** | **27** | **28** |

### Ownership structure of banks on the basis of assets total

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 0.9 | 0.8 | 0.8 |
| Other domestic ownership | 0.4 | 0.4 | 0.3 |
| Domestic ownership total | 1.3 | 1.2 | 1.1 |
| Foreign ownership | 98.7 | 98.8 | 98.8 |
| **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 | 64.6 | 83.8 | 1659 |
| Branches of foreign credit institutions | 69.4 | 82.9 | 2824 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **55.2** | **73.0** | **1271** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 10.30 | 11.05 | 13.25 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **10.30** | **11.05** | **13.25** |

### Distribution of market shares in balance sheet total (%)

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 85.8 | 85.4 | 85.4 |
| Branches of foreign credit institutions | 14.2 | 14.6 | 14.6 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 11.9 | 12.1 | 12.4 |
| Nonfinancial sector | 63.4 | 64.2 | 66.6 |
| Government sector | 19.2 | 18.7 | 16.3 |
| Other assets | 5.6 | 5.0 | 4.7 |
| **Claims due to** | | | |
| Financial sector | 10.9 | 10.4 | 10.9 |
| Nonfinancial sector | 64.0 | 64.9 | 64.9 |
| Government sector | 2.0 | 2.8 | 2.4 |
| Other liabilities | 8.9 | 8.6 | 8.7 |
| **Capital** | **14.2** | **13.4** | **13.2** |

### Capital adequacy ratio of banks (%)

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 17.35*** | 17.75*** | 18.16*** |
| Cooperative banks | - | - | - |
| Banking sector, total: | **17.35*** ** | **17.75*** ** | **18.16*** ** |

(* - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 5.50 | 4.97 | 4.52 |
| **- households** | **4.32** | **3.89** | **3.69** |
| **- corporate** | **8.61** | **7.30** | **6.52** |

**The structure of deposits and loans of the banking sector in 2016 (%)
(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 89.3 | 95.8 |
| Households | **62.7** | **58.2** |
| Corporate | **26.6** | **37.6** |
| Government sector | 3.2 | 1.7 |
| Financial sector (excluding banks) | 7.5 | 2.5 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 2 396 875 | 2 275 894 | 2 137 186 |
| Interest expenses | 494 502 | 417 293 | 358 560 |
| Net interest income | 1 902 373 | 1 858 601 | 1 778 626 |
| Net fee and commission income | 469 860 | 521 453 | 519 029 |
| Other (not specified above) operating income (net) | -219 458 | -159 412 | 187 517 |
| Gross income | 2 175 500 | 2 229 049 | 2 493 096 |
| Administration costs | 1 073 520 | 1 082 506 | 1 135 189 |
| Depreciation | 134 285 | 134 193 | 142 601 |
| Provisions | 198 032 | 170 303 | 239 392 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 1 544 198 | 1 478 411 | 1 664 977 |
| Profit (loss) before tax | 746 938 | 833 640 | 967 990 |
| Net profit (loss) | 560 224 | 626 032 | 742 259 |

# 2016 DEVELOPMENTS IN THE SLOVENIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Economic Economic growth strengthened to 2.5% in 2016, with particular impetus in the second half of the year. The seasonally adjusted year-on-year rate of growth increased to 3.6% in the final quarter. Domestic final consumption, household consumption in particular, was the main engine of growth for the first time since 2008. This was attributable to a significant rise in wages in the government sector, and even more so to employment growth of more than 2%. By contrast gross fixed capital formation actually contracted in 2016, having previously recorded weak growth. Investment in machinery and equipment increased, but there was simultaneously a sharp decline in construction investment owing to a freeze in the government investment cycle after the end of the old programme of European financing and before the rise of the new programme. Net exports accounted for a very small proportion of overall economic growth on this occasion, the lowest since 2008. Exports of merchandise and services actually increased slightly more than in the two previous years, but strengthening domestic consumption meant that imports increased even more.

The situation on the labour market was even better in 2016 than in the previous year. The workforce in employment increased by 1.6%, the highest figure since the outbreak of the crisis. The largest contributions to the increase came from manufacturing, human health and social work activities, and administrative and support service activities. The proportion of new hires accounted for by temporary employment last year remained at a comparable level to the previous year at 75%, while the contribution to overall employment growth made by self-employment and employment activities declined, an indication of increased direct hiring by firms. The number of registered unemployed stood at 103,152, down 8.5% on a year earlier. The largest factor in the fall in unemployment was a fall in inflows into unemployment, the largest fall in which was in the number of those newly registering as unemployed as a result of their temporary employment ending. The registered unemployment rate fell from 12.3% in 2015 to 11.2%. The average nominal gross wage was up 1.8% on the previous year. There was high wage growth in public services of 3.3% as a result of the relaxation of certain austerity measures, while wage growth in the private sector was lower at just 1.3%.

Deflation eased towards the end of 2016. The fall in prices averaged 0.2%, 0.6 percentage points less than in the previous year. Slovenia saw one of the sharpest overall falls in prices in the euro area in 2016. The deflation was primarily attributable to foreign factors, in particular developments in oil prices and commodity prices on global markets, which reduced energy prices more sharply than in the euro area overall. This is because the share of energy in domestic consumption is higher than the euro area average. The contributions to inflation made by prices of industrial goods were also more negative than in the euro area overall. By contrast growth in services prices was higher in Slovenia, which in the second half of the year was probably also attributable to the domestic economic growth, which was much stronger than in the euro area overall predominantly as a result of increased private consumption.

The current account surplus widened considerably in 2016. It reached almost 7% of GDP, or EUR 2.7 billion, exceeding the surplus in 2015 by more than EUR 700 million. The current account surplus is an indicator of the competitiveness of Slovenia's export sector, whose exports of merchandise and services increased by 4.6% in value terms in 2016, despite the economic, political and security risks in the international environment. Another factor in the size of the surplus was the favourable terms of trade, import prices having fallen more sharply than export prices.

Slovenia was a net financer of the rest of the world in the amount of EUR 1.1 billion in 2016, compared with EUR 2 billion in the previous year. Slovenia's net external debt declined by EUR 2 billion in 2016 to end the year at EUR 10 billion.

The reduction in the general government deficit continued in 2016. It amounted to 1.5% of GDP, the government having estimated a deficit of 2.2% of GDP in its draft budget plans of October 2016. The reduction in the deficit was attributable to the improved economic situation, particularly on the labour market, the introduction of fiscal cash registers at the beginning of the year, and a significant decline relative to the previous year in the contribution made to the deficit by the Bank Asset Management Company (BAMC).

The general government debt declined in 2016 after a long period of rapid growth. It amounted to 79.7% of GDP, and remains below the EU average. The decline was attributable to the rise in GDP, a primary surplus and a decline in the government's cash reserves. The government continued its issues of euro-denominated bonds and treasury bills in 2016, the latter at negative interest rates. Some of the bonds issued in US dollars were replaced with euro-denominated bonds in 2016, the government thereby extending the maturity of the debt and reducing the cost of future interest payments. The required yield on 10-year government bonds averaged 1.13% during the year, down on the previous year.

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

At the end of 2016 there were 13 banks, three savings banks and three branches of foreign (European Economic Area member state) banks operating in Slovenia. The banks including savings banks held a market share of 96% of the banking system in terms of total assets. There were three fewer banks and one fewer branch 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 contraction in the Slovenian banking system's total assets slowed significantly in 2016. Total assets amounted to EUR 37 billion, down 0.9% or EUR 333 million. The main factors in the contraction in total assets on the funding side were the continuing repayment of liabilities to foreign banks and a decline in the stock of issued debt securities. Claims against banks and investments in securities were down on the investment side. Total assets were down for the seventh consecutive year, and declined to 93% as a ratio to GDP.

The capital position of the Slovenian banking system improved slightly in 2016, although significant differences between the bank groups remain. The large domestic banks have maintained their good capital position, while the small domestic banks remain the most vulnerable bank group in capital terms. The Slovenian banking system's total capital ratio on a solo level reached 20,8% and on a consolidated basis 19.1% in December, maintaining its position above the average across the euro area. The improvement in capital adequacy was primarily attributable to a decline in capital requirements, which was the result of better optimisation of operations, an improvement in the quality of the credit portfolio, and further consolidation of the banking system. There was an additional improvement in the quality of the capital structure in 2016, as a result of a decline in the stock of subordinated instruments at certain banks. The banks primarily increased the stock of the highest-quality common equity Tier 1 capital via earnings, increased reserves and minor recapitalisations.

The contraction in lending to the non-banking sector slowed throughout the year. Growth in loans to the non-banking sector turned positive at the end of the year reaching 1.3%, although growth in corporate loans remained negative, in the amount of 1%. Last year's contraction in corporate lending was attributable to both supply-side and demand-side factors. Household loans gradually increased last year, the rate of growth reaching 4.6% by the end of the year. The gradual increase in growth is attributable to low household indebtedness, low interest rates on loans and relatively favourable real estate prices, and the fact that the banks are increasingly focusing on households as corporate lending contracts.

The Slovenian banking system's liquidity position remains good, although funding stability is declining as average maturity shortens. The favourable liquidity position is reflected in a high first-bucket liquidity ratio, a stable stock of secondary liquidity, and the high proportion of the pool of eligible collateral that is free, which allows banks to obtain additional liquidity at the Eurosystem if necessary.

Deposits by the non-banking sector increased in importance as the most important source of funding in the banking system. The proportion of total funding that they account for had reached almost 71% by the end of 2016. This was partly attributable to the banks' ongoing repayments of debt on the wholesale markets and at the Eurosystem. Household deposits have maintained their leading role in deposits by the non-banking sector. Despite extremely low interest rates, the stock of household deposits increased by 6.7% in 2016. Low interest rates are deterring savers from committing funds for fixed terms, for which reason the proportion of sight deposits is continuing to strengthen as short-term and long-term deposits decline. The proportion of total deposits by the non-banking sector accounted for by sight deposits increased by 8 percentage points in 2016, to stand at 63%.

The banks generated a pre-tax profit of EUR 364 million in 2016. The trend of decline in net interest continued as a result of the fall in interest rates and the ongoing contraction in turnover. Net interest was down 10% last year. The banks faced a decline in interest income on the asset side, while the fall in interest rates and the increase in the proportion of sight deposits mean that the banks have diminishing room for additional cuts in interest expenses. The banks' gross income in 2016 was down 2.6% on the previous year, while net non-interest income was up 11% on the previous year. The banks reduced operating costs again in 2016. Impairment and provisioning costs in 2016 were down 69% on the previous year, and were the decisive factor in the increase in profit, which was up EUR 205 million on the previous year at EUR 364 million.

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

With the establishment of the Single Supervisory Mechanism (SSM) in 2014, the ECB assumed responsibility for the oversight of significant European banks, including three Slovenian banks. Operational supervision is conducted via joint supervisory teams (JSTs), the members of which are national supervisors, including the Bank of Slovenia. The Bank of Slovenia conducts direct supervision over the banks officially classed as less significant institutions.

The Bank of Slovenia co-designs, implements and oversees a system of rules for the secure and prudent operations of banks and savings banks, and ensures financial stability through the regular monitoring and analysis of banks. Together with the Securities Market Agency (SMA) and the Insurance Supervision Agency (ISA), the Bank of Slovenia attends to macroprudential supervision and addresses identified risks by means of macroprudential instruments.

According to the Bank of Slovenia Act 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 national microprudential regulatory framework did not change significantly in 2016. Regulations adopted in the area of banking supervision for banks and savings banks mostly relate to the streamlining of bank reporting, thereby reducing the reporting burden faced by banks. Some other changes were made to the existing regulations also due to the SSM developments as well as based on practical experience gained through the conduct of supervision.

# MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

The first part of banking supervision in 2016 was conducted via established practices of collaboration with the ECB on systemically important banks and banks owned by large foreign banks. The collaboration is the responsibility of the JSTs, which conduct on-site inspections, and via which the constant exchange of information, opinions, reports and other documentation proceeds.

The following are additionally envisaged within the framework of supervisory activities: (i) a comprehensive assessment within the framework of the SSM for a new systemically important bank; (ii) monitoring of the fulfilment of the commitments to the European Commission deriving from state aid procedures at banks under government ownership; (iii) a review of the first recovery plans at banks.

The second part of supervision covers the non-systemic credit institutions, with full supervisory powers and slightly less collaboration with the ECB. With back-office support, the focus in 2016 was on the development of knowledge and tools for enhanced risk identification (RAS, ICAAP, SREP, IMAS), an overhaul of regulations in prevention of money laundering and terrorist financing (PMLTF) and the strengthening of collaboration with competent authorities inside and outside Slovenia.

Within the framework of systemic supervision and regulations, the focus was subsequently: (i) on the establishment of high-quality supervisory databases and (ii) the development of effective and transparent methodologies, techniques and standards of supervision.

The major challenges within the framework of the first task (i) include the upgrade of reporting and the preparation for introduction of the new IFRS 9, while those within the framework of the second task (ii) include the NPE forbearance project (progress in the reduction of non-performing exposures), the establishment of infrastructure for conducting bottom-up stress tests and the implementation of the methodology for ensuring quality of supervision.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Joint Supervisory Teams (JSTs), via which the ECB and the Bank of Slovenia conduct operational supervision of significant institutions (SIs), carried out their key planned supervisory activities in 2016.

Among the most important tasks was the comprehensive assessment of Abanka conducted as a result of its reclassification as an SI within the framework of the Single Supervisory Mechanism (SSM) as of 1 January 2016. The comprehensive assessment consisted of an asset quality review (AQR) and a stress test. The results revealed Abanka's capital position to be adequate.

Regular monitoring was conducted of compliance with the commitments to the European Commission deriving from state aid procedures at banks under government ownership, and the first review was conducted of the recovery plans submitted by banks.

In the supervision of less significant institutions (LSIs), in accordance with the joint supervisory standards, guidelines and recommendations issued by the ECB for the purpose of harmonising the supervision of LSIs, the Supervisory Examination Programme (SEP) for individual institutions was drawn up for the first time for 2016, and was mostly implemented. The recovery plans of all LSIs in accordance with the joint supervisory standard were also reviewed for the first time.

The Bank of Slovenia also began using the IMAS supervisory tool (Information Management for the SSM) in the area of LSIs in 2016. This is used for SIs by the SSM, and has been adjusted slightly for LSIs. It is a particularly important aid to regular supervisory activities, and provides for a harmonised supervisory approach in all euro area countries.

In 2016 the Bank of Slovenia again conducted bottom-up stress tests of the banking system, which have become part of its regular supervisory activities. They covered all the less significant Slovenian banks, SID banka and the subsidiaries of banks under majority foreign ownership (NLB, NKBM and Abanka were included in the ECB tests). The general assumptions and methodology drawn up by the EBA for the pan-European stress tests in 2016 were taken into account in the stress tests. The stress tests were aimed at detecting key risks, and were used as one of the input parameters in the supervisory review and evaluation process (SREP). To put in place an effective and transparent stress testing process, in 2016 the Bank of Slovenia simplified the forms for submitting stress test results, organised workshops for banks with a presentation of the methodology and set up a help desk system for communicating with banks, prepared expanded controls of input data and model forecasts, and conducted bilateral presentation of the stress test results.

The Bank of Slovenia continued its efforts in the reduction of non-performing loans (NPLs) in 2016. Action was organised via a special NPLs restructuring project, within the framework of which individual supervisory interviews were conducted with the eight most-exposed banks. The Bank of Slovenia required the banks to submit plans for reducing non-performing loans over the upcoming three-year period (2017-2019). There was successful participation in the ECB's NPL Task Force, while a detailed handbook for managing NPLs made to micro, small and medium-size enterprises (MSMEs) was drawn up in conjunction with the World Bank. Case studies and sample legal documents (contracts) form an integral part of the handbook, which was published in March 2017.

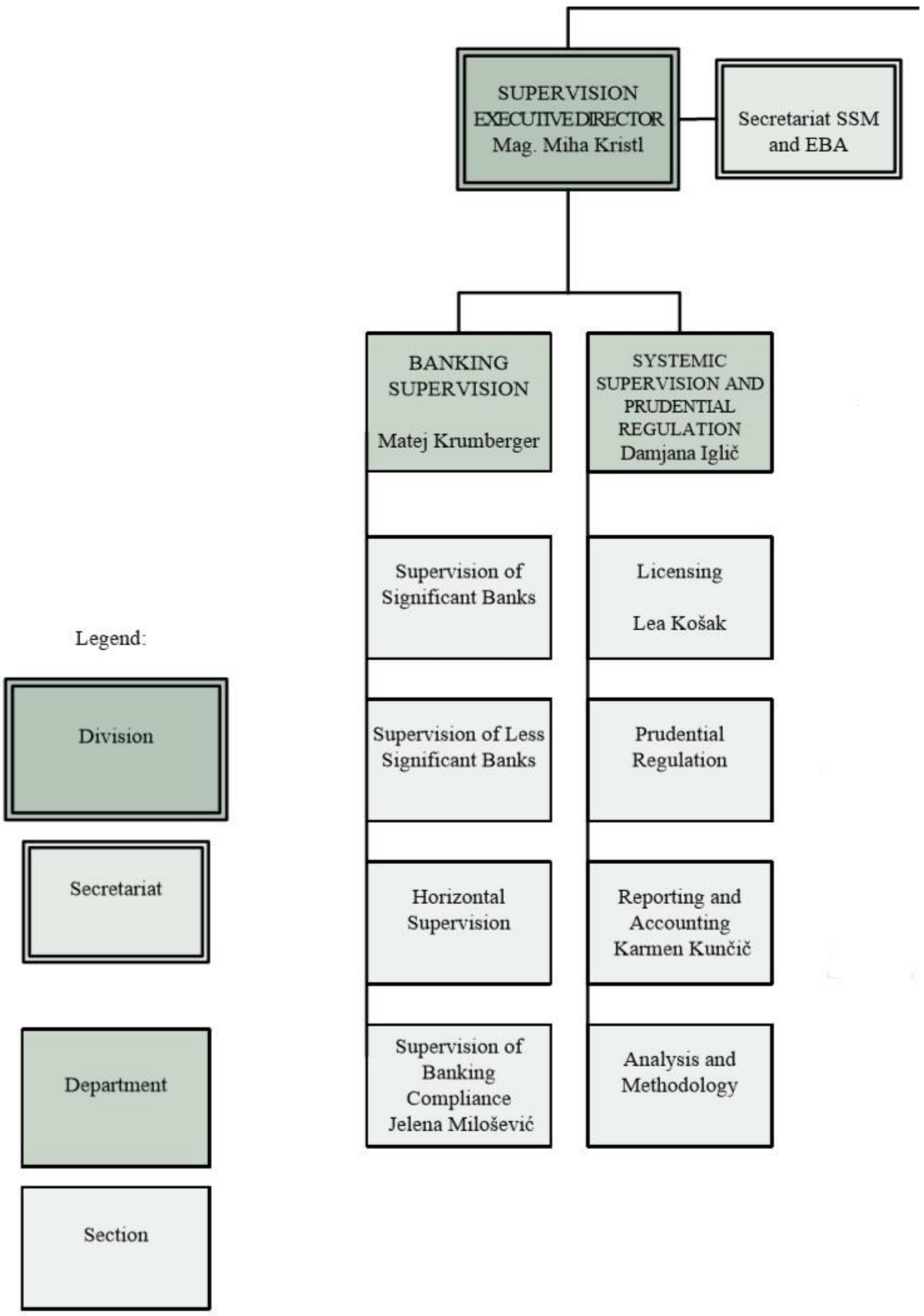
At the level of the European Commission a special task force to address the problem of the high NPL ratio at banks in the EU, where Slovenia is represented by the Bank of Slovenia, began its work in mid-2016 (under the aegis of the Financial Services Committee). The task force has already drawn up an interim report on the burden placed on EU banking systems by non-performing loans, on their impact on financial stability and economic activity, and on examples of best practice for their resolution. The report cites Slovenia as one of the countries that has successfully reduced its NPL ratio. Later the task force will draw up proposals of possible measures and policies for reducing the NPL ratio.

Partly as a result of all of the aforementioned work, the stock of NPLs at the banks declined significantly last year. The ratio of claims more than 90 days in arrears to total classified claims at the banks declined from 9.9% to 5.8% in 2016. Taking account of the EBA's broader definition, the ratio of non-performing exposures to total exposures in the banking system declined from 11.4% to 8.2% last year.

The Bank of Slovenia achieved the majority of its objectives in the area of prevention of money laundering and terrorist financing (AML/CFT) in 2016. A risk assessment from the perspective of AML/CFT was conducted at the level of individual institutions and the banking sector in 2016, and supervisory activities were conducted on this basis. There was also a successful realisation of activities within the framework of the Moneyval assessment (conducted by the relevant committee at the Council of Europe for the purpose of determining whether Slovenia is consistently complying with the FATF recommendations in this area). The following themes were to the fore in cooperation with the banking industry in 2016: the impact of the requirements of the new Prevention of Money Laundering and Terrorist Financing Act (the ZPPDFT-1) on the implementation of existing procedures, the implementation of restrictive measures and the establishment of transactions with Iran after the withdrawal of financial sanctions, and the requirement for asylum seekers to open a basic payment account.

Within the framework of the preparations for the introduction of the new IFRS 9, which will replace the existing IAS 39 on 1 January 2018, in 2016 the Bank of Slovenia primarily monitored the banks' activities in the preparations for the new standard, and received their initial assessments of the impact of the introduction of IFRS 9 on financial statements and own funds. On the basis of the initial data the Bank of Slovenia assessed that in general the greatest impact of the introduction of IFRS 9 could be expected to be an increase in impairments and provisions as a result of the changeover to the new model of expected losses, although a more detailed assessment at this stage of the preparations cannot be made yet.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

***European Union;***

In 2016 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. These include sessions of the Economic and Financial Committee (EFC) and its subcommittees, meetings of the Committee on Monetary, Financial and Balance of Payments Statistics, the European Statistical Forum and other working groups from the relevant areas that are active within the European Commission and the Council of the EU.

Representatives of the European Commission and the ECB met representatives of the Bank of Slovenia within the framework of the European Semester (the annual cycle of economic policy coordination) in January, September and December 2016. 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 correcting macroeconomic imbalances. The European Commission presented the findings of the in-depth review in March 2016, and concluded that there are macroeconomic imbalances in Slovenia. The vulnerabilities that need to be addressed are weaknesses in the banking sector, corporate indebtedness, lack of investment, and risks to long-term fiscal sustainability. In July 2016 the Council of the EU adopted specific recommendations for Slovenia within the framework of the 2016 European Semester. These recommendations relate to the sustainability of public finances and the national fiscal framework, the pension and healthcare systems, the labour market, the restructuring of the banking sector, management of state-owned enterprises, a better business environment and more effective public administration.

***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 2016, and IMF representatives conducted a Staff visit to Slovenia in November. The mission took place between 16 and 29 March, within the framework of which 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. Under the new mission chief for Slovenia, Nikolay Gueorguiev, IMF representatives made another Staff visit to Slovenia between 15 and 21 November 2016 for briefings on the situation in the economy.

***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: the main issues in 2016 were liquidity support of central banks, interventions on the foreign exchange markets, recent regulatory changes, cyber risks and promotion of economic resilience. The Bank of Slovenia is a shareholder in the BIS, and a representative of the Governing Board of the Bank of Slovenia attended the annual general meeting of the BIS in Basel in June 2016.

In September 2016 the Governor of the Bank of Slovenia became a member of the Central Bank Governance Group, which operates under the aegis of the BIS. The group was established in response to the increasing interest in issues in connection with the governance of central banks as public institutions. It focuses on the institutional and organisational setting in which central banks pursue monetary and financial policies.

***Organisation for Economic Co-operation and Development;***

Bank of Slovenia representatives attended sessions of certain committees and working groups of the OECD. They participated in meetings of the Committee on Financial Markets, the Working Group on International Investment Statistics, the Working Party on Financial Statistics and the Working Party on International Trade in Goods and Trade in Services Statistics. In December 2016 a Bank of Slovenia representative became a member of the working group for the Code of Liberalisation of Capital Movements.

As part of the preparations for the Economic Review of Slovenia, which is published by the OECD every two years, Bank of Slovenia representatives met a delegation of OECD experts in September 2016.

## 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) and the Office for Money Laundering Prevention is examined in detail below.

***Cooperation with the SMA and ISA***

In accordance with the Rulebook on mutual cooperation by supervisory authorities in the area of macroprudential supervision of 1 January 2016, the Bank of Slovenia assumed responsibility for organising meetings of the Commission for Mutual Cooperation (CMC), which consists of the vice-governor of the Bank of Slovenia, the director or deputy-director of the ISA, and the director or deputy-director of the SMA. Meetings of the CMC were also attended by the general director of the financial system directorate at the Ministry of Finance, where there was discussion of legislation relating to the financial system and other systemically important issues relating to the financial sector. The CMC met three times in 2016. In addition to amendments to legislation in the financial area, the CMC discussed joint activities and major individual activities and inspections by the supervisory authorities, and gave briefings on activities deriving from the work of the boards of supervisors of the EBA, the ESMA and the EIOPA. The CMC also discussed the conclusions of coordinating meetings, particularly in relation to the project for the potential merger of financial supervisors.

In addition to cooperation within the framework of the CMC, the Bank of Slovenia also held meetings with the SMA and ISA on the subject of joint inspections. Alongside the operational disclosure of the inspection plans of individual institutions, other tasks in the current year and potential methodological changes in supervisory procedure were also examined at the meetings. The Bank of Slovenia conducted two joint inspections with the ISA in 2016.

***Cooperation with the Office for Money Laundering Prevention***

In the area of AML, the Bank of Slovenia again carried out several activities in 2016 in conjunction with the Office for Money Laundering Prevention, primarily in connection with the Moneyval assessment, an update of the national risk assessment and the drafting of the new Prevention of Money Laundering and Terrorist Financing Act (ZPPDFT-1).

***Cooperation with the BAS***

Intensive cooperation with the BAS continued at all levels in 2016, including the Bank of Slovenia's regular participation in various technical workshops and expert conferences organised by the BAS for control, support and managerial functions at banks.

The majority of the cooperation related to the banks' activities in connection with the creation and implementation of EBA regulations and guidelines in the area of risk management and internal governance arrangements at banks, and activities in connection with the implementation of the new IFRS 9. The Bank of Slovenia held three comprehensive multi-day workshops in the area of the creation and implementation of the EBA guidelines on sound remuneration policy and reporting on remuneration to the Bank of Slovenia, while two workshops were devoted to the inclusion of Slovenian banks in the EBA consultation process for drafting new guidelines with regard to assessment of the suitability of members of the governing body and guidelines on internal governance arrangements.

In the area of banking supervision, the Bank of Slovenia also participated, via papers and discussions, in all of the BAS's most important conferences for banks, of which 12 were aimed at the most senior staff and management. The Bank of Slovenia's contributions discussed the latest themes in the area of risk management, assessment of liquidity and internal capital, new financial reporting standards, important aspects of the activities of the HR department, the internal audit department and the compliance department, remuneration policy, assessment of the suitability of members of the governing body, and the general regulatory framework for banks. In numerous discussions with representatives of the banks, at these conferences the Bank of Slovenia responded directly to a number of issues and questions raised by the banks, defining its position regarding the issues raised.

# 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.

Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (the BRRD) was fully transposed into Slovenian law by the ZRPPB. The ZRPPB gives the Bank of Slovenia a key role in the event of bank resolution and the resolution process, and entails a shift from bank resolution via bail-out to resolution via bail-in, i.e. the assets of the banks and bank creditors.

The Single Resolution Board (SRB) began functioning in Brussels in 2016, and acts as an independent EU agency. The Bank of Slovenia is a member. The SRB is responsible for the preparation and update of the resolution plans of significant banks and groups, the implementation of resolution at individual significant banks and groups, where necessary, and also decides on the use of the Single Resolution Fund (SRF), to which credit institutions and certain investment firms from the 19 countries of the banking union contribute.

The Deposit Guarantee Scheme Act (ZSJV) entered into force in April 2016, thereby fully transposing Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (DGSD) into Slovenian law. The ZSJV stipulates that the Bank of Slovenia shall establish and operate a deposit guarantee scheme to guarantee a depositor's deposits in the event of the unavailability of deposits at a bank by means of the payment of coverage of guaranteed deposits to depositors, or through other measures by which depositors' access to guaranteed deposits is maintained in the event of the bank's resolution or compulsory wind-up.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks[38] | 20 | 19 | 16 |
| Branches of foreign credit institutions | 4 | 4 | 3 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total** | **24** | **23** | **19** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 55,6 | 54,3 | 42,0 |
| Other domestic ownership | 10,3 | 11,3 | 9,2 |
| Domestic ownership total | 65,9 | 65,6 | 51,2 |
| Foreign ownership | 34,1 | 34,4 | 48,8 |
| **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 | 46,9% | 62,0% | 0,0857 |
| Branches of foreign credit institutions | 100,0% | / | 0,7992 |
| Cooperative banks | / | / | / |
| **Banking sector, total** | **45,0%** | **59,5%** | **0,1076** |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | -2,7% | 2,6% | 7,2% |
| Cooperative banks | / | / | / |
| **Banking sector, total** | **-2,7%** | **2,6%** | **7,2%** |

[38] Including 3 savings banks

### Distribution of market shares in balance sheet total (%)

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 97,3% | 97,2% | 96,0% |
| Branches of foreign credit institutions | 2,7% | 2,8% | 4,0% |
| Cooperative banks | / | / | / |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 11,4 | 11,6 | 11,1 |
| Nonfinancial sector | 51,0 | 49,1 | 49,8 |
| Government sector | 24,9 | 25,3 | 23,7 |
| Other assets | 12,8 | 14,0 | 15,3 |
| **Claims due to** | | | |
| Financial sector | 16,1 | 12,7 | 10,5 |
| Nonfinancial sector | 57,0 | 61,6 | 66,4 |
| Government sector | 6,0 | 5,6 | 4,2 |
| Other liabilities | 10,0 | 8,3 | 6,6 |
| **Capital** | **10,8** | **11,8** | **12,4** |

### Capital adequacy ratio of banks

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks** | 19,3 | 20,8 | 20,8 |
| Cooperative banks | / | / | / |
| **Banking sector, total**** | **19,3** | **20,8** | **20,8** |

(* - 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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 11,9 | 9,9 | 5,8 |
| **- households** | 5,3 | 4,7 | 3,5 |
| **- corporate** | 17,7 | 15,3 | 7,6 |

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | **85,54** | **82,44** |
| Households | 63,51 | 42,95 |
| Corporate | 22,03 | 39,49 |
| Government sector | **5,90** | **10,09** |
| Financial sector (excluding banks) | **8,56** | **7,47** |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 1.327.869 | 1.031.590 | 828.328 |
| Interest expenses | 495.703 | 285.956 | 158.379 |
| Net interest income | 832.165 | 745.632 | 669.954 |
| Net fee and commission income | 346.281 | 335.722 | 307.394 |
| Other (not specified above) operating income (net) | 55.807 | 76.205 | 149.798 |
| Gross income | 1.230.900 | 1.157.559 | 1.127.144 |
| Administration costs | 611.890 | 614.410 | 603.604 |
| Depreciation | 74.972 | 71.560 | 63.518 |
| Provisions | 104.966 | -47.860 | -11.824 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 545.157 | 352.941 | 93.147 |
| Profit (loss) before tax | -106.087 | 158.332 | 363.674 |
| Net profit (loss) | -114.058 | 115.304 | 332.439 |

**Total own funds in 2016 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 4.061.119 | 3.946.897 | 3.946.897 | 114.223 | / |
| Cooperative banks | / | / | / | / | / |
| **Banking sector, total:** | **4.061.119** | **3.946.897** | **3.946.897** | **114.223** | **/** |

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

# 2016 DEVELOPMENTS IN THE TURKISH BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

After confronting unfortunate coup attempt, Turkish economy started to regain its ex-coup momentum, while restoring its institutional structure and continuing to employ macroprudential measures to restrain potential externalities. Improvement in global economic conditions, especially in EU countries and Russia, and diminishing oil prices support better prospect for Turkish Economy.

Current macroeconomic environment provides a generally supportive background for financial stability. Soaring economic growth performance, current domestic production and consumption dynamics, and the government's incentives to fuel economy suggest that Turkish economy has ability to back financial markets. Despite short term deterioration, inflation has decreased as foreign exchange rate volatility started to stabilize and oil prices has declined. Fiscal discipline in the public sector is maintained, although fiscal deficit increased because of stimulus packages employed in the first half of 2017. Because election is not expected before 2019, budget balance can become positive as momentum in economy helps to increase tax revenues, while expenditures falling. The recovery in the current account balance continues, resulting from weakening TRY and improving global macroeconomic environment. At present, the current account deficit is financed mainly through foreign direct investment and other long term sources.

The ratio of the non-financial corporate sector's total financial indebtedness to GDP has been flat since 2015, which is well below the average of emerging countries. The probability of exchange rate related risk in the real corporate sector remains low, as rate of increase in the FX open position tends to decline due to the market awareness regarding the management of the foreign exchange risk and the effect of the firms' recent tendency towards TL credits instead of FX credits. Increasing maturities and decreasing NPL level of FX dominated loans also limit foreign exchange risk of real sector firms.

Though rising interest rates are limiting credit growth, BRSA's extensive measures and government incentives to stimulate economy maintain yearly credit growth rate at 19.5% as of April 2017. Under the tight monetary policy stance and the framework of macroprudential policies, annual credit growth is expected to continue at modest levels.

Because of government incentives to support SMEs and regulation adjustments by BRSA to revive economy, the upward trend in non-performing loan (NPL) ratios of banks has recently flattened. As the economic activity continues along its steady course, the credit risk outlook is expected to improve.

Assessed as compliant in risk-based capital and liquidity standards by the Regulatory Consistency Assessment Programme (RCAP), Turkey has a sound banking sector, which has capital adequacy ratio of 16.38% as of April 2017, the highest level since November 2014.

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

As of April 2017, there are 52 banks operating in Turkish banking sector (TBS). The total asset size of TBS is nearly 2.9 trillion TL which overpassed GDP. As of year-end 2016, the total asset/GDP ratio is 105.4%.

The main investment item is the loan portfolio which has a 64.3% share in total assets. As of April 2017, the loan portfolio has reached to 1.9 trillion TL FX and parity effect eliminated annual loan growth is 19.5% as of April 2017. The share of FX loans in loan portfolio is around 36.7% (FX indexed loans included). In terms of segmentation, credit portfolio of the sector is granular. The share of corporate loans, retail loans and SME loans are 51%, 24% and 25% respectively. As of April 2017, NPL ratio is at 3.2% which is comparatively low when compared to other emerging markets.

Securities are the other important investment item. Total share of securities in the balance sheet is 12.6% and the amount of securities is nearly 365 billion TL. 70% of securities are classified in available for sale portfolio.

The main funding source is deposit (53.2% of total liabilities). As of April 2017, total deposits in TBS has reached to 1.5 trillion TL. FX deposit constitutes 44.7% of total deposits. Another important source, total funds from abroad is around 127.8 billion USD Foreign borrowing includes repos, deposit, loans and syndication and securitization loans.

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 as compared to deposits. Currently, the amount of bond issuances has reached to 120.8 billion TL with a share of 4.2% in total liabilities.

TBS's capital base is strong. CAR is 16.38% which is significantly higher than 12% target CAR. Tier I CAR is nearly 13.9%. TBS has high and sustained profitability ratios. As of April 2017, annualized NIM is 3.9%, ROA is 1.8% and ROE is 18.2%. As of April 2017 banking sector's net profit has increased by 59.2% as compared to previous year.

The FX position of banking sector is very limited. 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.

## 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, 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. 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.

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 Agency 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.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

With slight revisions, the Strategic Plan of 2013-2015 is still under implementation due to the relevance of the main objectives. However, the preparation of a new strategic plan will start soon that is aimed at covering the 2018-2020 period.  In this context, current strategies of BRSA focuses on four main strategic objectives: (1) enhancing corporate structure; (2) strengthening the efficiency of regulation, supervision and enforcement framework; (3) boosting confidence, stability and competitiveness in financial markets; and (4) raising awareness among financial consumers, protecting them at the maximum level and improving financial inclusion. Moreover, starting from the last quarter of 2016, BRSA used various strategic tools to enhance confidence in financial markets. Micro and macro prudential tools are employed effectively to maintain soundness in the banking sector.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

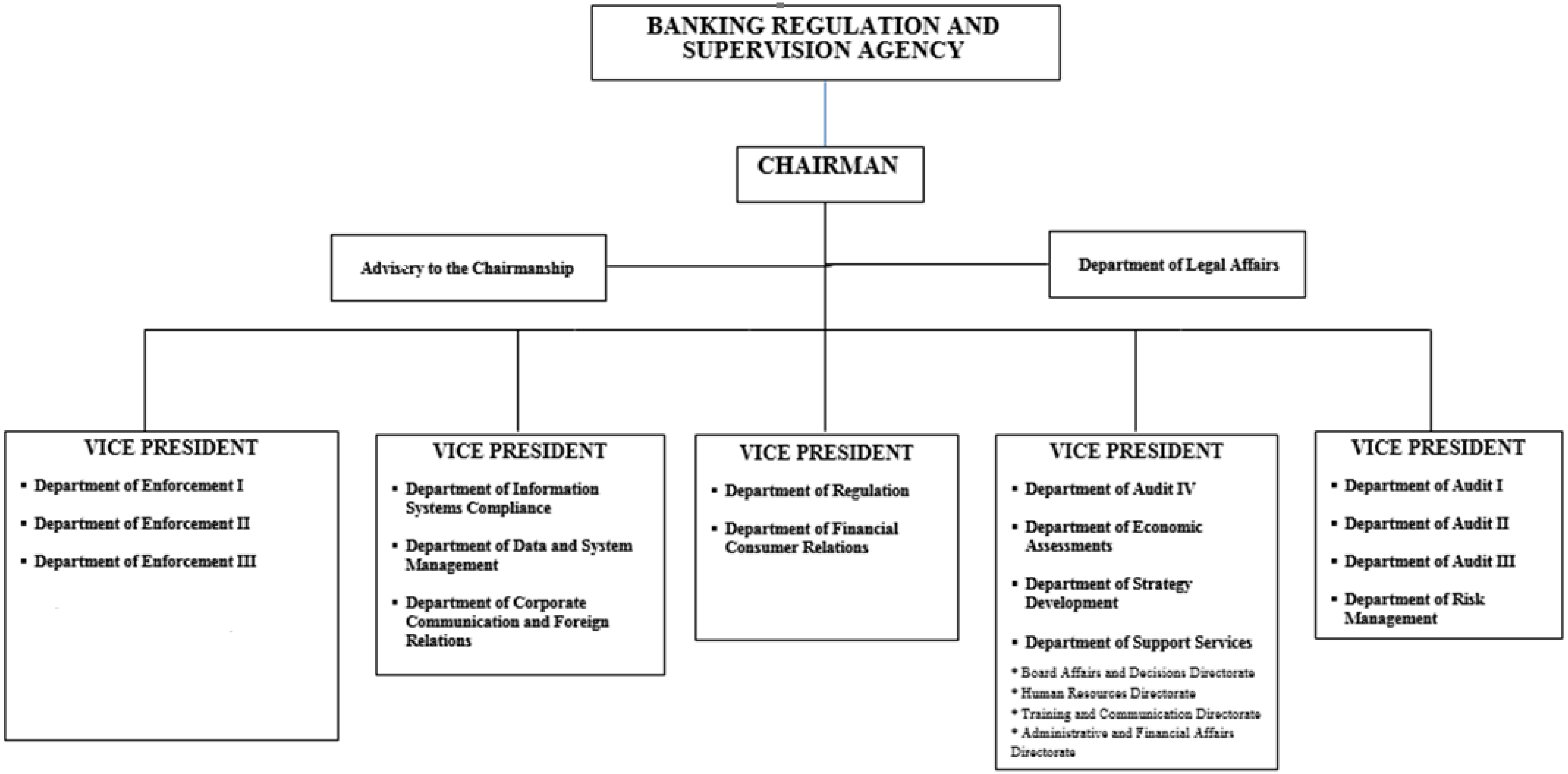
The BRSA is mainly responsible for the regulation and supervision of banks, non-bank financial companies, asset management companies and payment/electronic money companies. In 2016 the BRSA has continued to supervise these activities. On the other hand, the activities coming to the forefront are as follows:

In the first half of 2016, Financial Sector Assessment Program (FSAP) was one of the important items on BRSA's agenda. According to this assessment, BRSA's supervision activities have been identified in full compliance with respect to 15 principles. On the other hand, the RCAP Assessment of Basel Committee on Banking Supervision which started in 2015, has been accomplished with the announcement of the assessment on Turkey in March 2016. Accordingly Turkish banking legislation has been found in full compliance with Basel standards. In conjunction with the mentioned RCAP assessment, 14 new best practice guidelines have been published. In addition to this, the European Commission decided in December 2016 that the regulatory and supervisory framework of Turkey is in equivalence with EU regulations. It is clear that Turkish financial sector will benefit from this decision, and at the same time it is a confirmation that Turkish financial regulatory environment is in line with international best standards.

In 2016 BRSA has continued to contribute to the further development of Islamic banking and Istanbul Financial Center Project. Development of new Islamic banking products, Islamic banking and entrepreneurship, Islamic banking backed by savings, corporate governance and accounting standards of Islamic banks are areas to be stressed at first place. In relation with these efforts, in July 2016 BRSA became a member of The Accounting and Auditing Organization for Islamic Financial Institutions-AAOIFI.

In 2016, the Board of BRSA has authorized 1 bank, 1 financial leasing company, 4 asset management companies. Moreover, 1 bank, 2 finance companies, 19 payment institutions and 3 electronic money institutions has been issued with operating license.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The Banking Regulation and Supervision Agency's (BRSA) 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 Understanding (MoU) with foreign counterparts on the consistency of policies and regulations pursuant to Article 98 of the Banking Law Nr. 5411. Memorandums of understanding 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 Agency 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 2017.

- ***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 Market Board (CMA), 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 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.

**Financial Sector Commission,** consisting of the representatives of Agency, Ministry of Finance, the Treasury Undersecretariat, Central Bank, Capital Market Board, Fund, 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.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks[39] | 32 | 33 | 34 |
| Branches of foreign credit institutions | 6 | 6 | 6 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **51** | **52** | **52** |

**Ownership structure of banks on the basis of assets total**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 31,3 | 32,0 | 33,8 |
| Other domestic ownership | 49,5 | 37,7 | 36,8 |
| Domestic ownership total | ***80,8*** | ***69,7*** | ***70,6*** |
| Foreign ownership | 19,2 | 30,3 | 29,4 |
| **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 | 35,06 | 54,30 | 780,1 |
| Branches of foreign credit institutions | 0,26 | 0,28 | 0,05 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 100,00 | 100,00 | 788 |

[39] There are no cooperative banks in Turkey. Commercial banks are defined as deposit taking instutions, therefore investment & development banks are excluded. We have, as of year end 2015, investment & development banks (13), private, public and participation (5) banks.

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks[40] | 12,7 | 11,6 | 15,0 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 12,3 | 11,3 | 14,3 |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution[41] | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 95,5 | 95,2 | 94,8 |
| Branches of foreign credit institutions | 0,3 | 0,3 | 0,3 |
| Cooperative banks | - | - | - |
| Banking sector, total: [42] | **100.0** | **100.0** | **100.0** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014** | 2015*** | 2016*** |
|---|---|---|---|
| Commercial banks | 15,6 | 15,0 | 15,1 |
| Cooperative banks | - | - | - |
| Banking sector, total: | 16,3 | 15,6 | 15,6 |

(* - 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[43])**

| Asset classification | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non-financial sector, including | | | |
| - households | 3,4 | 4,3 | 4,3 |
| - corporate | 2,2 | 2,0 | 1,9 |

[40] There are no cooperative banks in Turkey. Commercial banks are defined as deposit taking instutions, therefore investment & development banks are excluded.
[41] Remaing shares belong to investment &development banks.
[42] Remaing shares belong to investment &development banks.
[43] NPL Ratios.

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | | |
| Households | 59,4 | 24,2 |
| Corporate[44] | 36,3 | 73,9 |
| Government sector | 4,3 | 1,9 |
| Financial sector (excluding banks) | - | - |
| Total | 100.0 | 100.0 |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 138,7 | 164,1 | 194,7 |
| Interest expenses | 73,1 | 86,8 | 103,4 |
| Net interest income | 65,6 | 77,3 | 91,3 |
| Net fee and commission income | 20,7 | 22,4 | 24,1 |
| Other (not specified above) operating income (net) | -20,9 | -23,6 | -14,2 |
| Gross income | **173,7** | **200,0** | **239,8** |
| Administration costs | **36,3** | **41,0** | **43,4** |
| Depreciation | 2,6 | 3,0 | 3,2 |
| Provisions | 4,1 | 5,3 | 5,0 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 3,2 | 3,6 | 4,1 |
| Profit (loss) before tax | 31,5 | 33,1 | 47,3 |
| Net profit (loss) | 24,6 | 26,1 | 37,5 |

[44] Including SME loans.

**Total own funds in 2016 (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)

# 2016 DEVELOPMENTS IN THE UKRAINIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

The economy of Ukraine continued to recover, growing by 2.3% yoy in 2016. GDP growth accelerated over the course of the year underpinned by robust investment (fixed investment was up by 20.1% yoy) as well as inventory build-up amid record crop harvest.

The following factors contributed to improvements in the real sector performance:

- relatively calm situation in the east
- improved business confidence
- record high crop yields
- growth in budget capital expenditures.

Private consumption remained subdued, while consumer sentiments somewhat improved.

Nominal GDP for the period under review totaled UAH 2,383 billion (USD 83.6 billion). According to IMF estimates, GDP per capita (PPP based) increased to USD 8,185 compared to USD 7,971 in 2015.

In 2016, nominal household income increased by 15.4% compared to the previous year. At the same time, real disposable income grew by 0.3%.

Annual headline inflation, slowed down to 12.4% in December 2016, fully in line with the NBU target of 12% ± 3 percentage points for the end of 2016. The rapid inflation slowdown in 2016 was primarily driven by subsiding underlying inflation pressure. This was evidenced by a sharp decline in core inflation to 5.8% yoy facilitated by appropriately tight monetary and fiscal policies. However, in 2016, the producer price index accelerated to 35.7% yoy mainly tracking price trends in global commodity markets.

In 2016, net FDI inflows increased to USD 3.3 billion (USD 3.0 billion in 2015). As in the previous year, the bulk of these investments were directed to the banking sector in the form of debt-to-equity operations between subsidiaries and parent banks.

## DEVELOPMENT IN THE BANKING SYSTEM

As of 1 January 2017, 96 banks operated in a regular mode and 4 banks were declared insolvent.

The number of banks with foreign capital was 38 (40% of the total number of licensed banks), including 17 banks (18%) with 100% foreign capital. In 2016, the number of operating banks reduced by 21 banks, including:

- 17 banks declared insolvent by the NBU decision
- 4 banks liquidated by the shareholders’ decision.

Nationalization of Privanbank and removing unviable banks from the banking system led to considerable growth of the shares of state-owned and foreign-owned banks. Thus, as of 1 January 2017, the share of state-owned banks within the authorized capital of the banking system was 41.7% compared with

24.6% as of 1 January 2016, the share of foreign capital within the banking system rose to 53.6% as of 1 January 2017 from 42.5% as of 1 January 2016.

In 2016, total assets of banks increased by UAH 165.9 billion (by 10.6%) to UAH 1.7 trillion.

The share of assets of the largest five banks grew to 56.1% as of 1 January 2017 from 52.9% as of 1 January 2016.

Cash grew by UAH 2.2 billion (by 6.5%) to UAH 36.2 billion.

Amounts in the correspondent account with the NBU increased by UAH 13.4 billion (by 49%) to UAH 40.8 billion.

The balances on correspondent accounts in other banks went down by UAH 7.8 billion (6%) and became UAH 121.8 billion.

Lending operations remain the main type of asset-side operations. As of 1 January 2017, the loans extended made 58% of the total assets of banks. However, banks were not very active in lending last year.

In 2016, loans granted to clients declined by UAH 3.8 billion (0.4%) and amounted to UAH 1,006 billion. Due to hryvnia depreciation, the share of FX loans within the loan portfolio jumped to 62.6% (as of 1 January 2017) from 58% (as of 1 January 2016).

Retail loans went down by UAH 18.3 billion (10.4%) to UAH 157.5 billion.

Faced with the high credit risks and a credit squeeze, the banks channeled their excess liquidity to the government securities market.

During 2016, liabilities of banks fell by UAH 18 billion (1.6%) to UAH 1.1 trillion.

The liabilities primarily decreased due to the fall in deposits of other banks and loans due to other banks (by UAH 48.7 billion or 39.7% to UAH 73.9 billion).

Funds of customers remained the main source of financing the asset-side transactions in 2016.

The high liquidity observed in the banking system in 2016 was due to the inflow of  households' and businesses' funds to the banks. Removal of restrictions on cash withdrawals from hryvnia deposits and significantly higher limits on FX cash withdrawals had no adverse impact on deposit dynamics.

During 2016, the businesses' funds grew by 16.1% (by UAH 51.3 billion) and the households' funds by 8.7% (by UAH 35 billion). (8,7%).

As of 1 January 2017, customer deposit portfolio made 75% of the liabilities, including funds of households - 38.6% (UAH 437.2 billion) and funds of legal entities - 36.4% (UAH 412.7 billion). The high shares of the funds of legal entities and households were due to limited access of banks to other funding sources, in particular to external debt markets.

In 2016, the total regulatory capital decreased by UAH 20.2 billion (15.5%) to UAH 109.7 billion. At the same time, the regulatory capital adequacy remain almost unchanged at 12.69%.

Banks' authorized capital increased by UAH 192.5 billion (by 86.6%) to UAH 414.7 billion. Authorized capital growth was mainly owing to additional capitalization of banks.

In 2016, the banking system received a revenue of UAH 190.7 billion. The interest income remained its main source of revenue (71.2%). On the backdrop of low lending activity in 2016, the banks effected more transactions generating fee income. In 2016, the share of fee income within the total income was 16.4%. Other operational income was UAH 9.6 billion (5.0%). Trading income was UAH 8.2 billion (4.3%).

2016 financial result of the banking system of Ukraine was a loss of UAH 159.4 billion, primarily due to much higher provisions made, which grew 1.7 rimes since 2015 and made UAH 198.3 billion (56.6% of the total expenses).

## 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 and supervision in Ukraine.

On 15 November 2016, the Law of Ukraine On Amendments to Certain Laws of Ukraine Concerning the Compensation through the Deposit Guarantee System of Harm to Individuals Caused by the Banking and Financial Systems Abuse was adopted. The Law aims to protect the rights of individuals who were deceived by the banks and resolving the issue of reimbursing their money. The Law also poses a number of restrictions that should prevent the misuse of investors' funds by banks and other financial institutions through the shadow schemes from happening in future.

The Law On Consumer Rights Protection was also adopted on 15 November 2016. The Law regulates relations between a creditor and a client during the consumer lending process. Pursuant to the Law the NBU shall set the requirements to the banks concerning:

- calculation of an interest rate per annum
- activities of credit agents and brokers
- identification and verification of clients by the third parties.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2016

The NBU's priority for 2016 was to ensure stability of the banking system and to complete the banking sector clean-up, removing from the market those market players that do not act in good faith and increasing the bank ownership transparency.

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:

- increasing capitalization of the banks
- strengthening control over banks' lending to related parties
- introducing and implementing modern risk assessment techniques in accordance with the international standards
- improving governance and supervision based on banks' business model analysis.

The regulator also took steps to shift from compliance based supervision to risk based supervision and principles of ongoing preemptive monitoring.

## BANKING SUPERVISORY AUTHORITY ACTIVITIES IN 2016

In 2016, it was decided to reorganize the supervisory process in accordance with the recommendations of the European Banking Authority. The New Supervision concept is based on the Supervisory Review and Evaluation Process (SREP). Within the SREP framework, the NBU made the first steps towards new approaches to supervisory review and assessment, in particular: the banks were classified in accordance with their business models; the format of the UBPR to be used for the regular analysis of the banks' indicators and comparison with the peer groups was developed.

The NBU upgraded its early warning system aimed at early identification of risks and banks whose activities may lead to future problems.

Additionally, the NBU improved the comprehensive risk assessment system used for the general assessment of bank's level of risk. Now the system includes quantitative and qualitative indicators. For example, when assessing the total, the transparency of the ownership structure, as well as viability of the business model and other indicators are taken into account.

The NBU Board has approved decisions on the outcomes of the diagnostic study of the 20 largest banks. 7 banks out of these 20 do not need capital increase, and for 12 banks the capital increase was required. As to the latter 12 banks, the Board decisions approve the capital increase measures taken by 1 bank, the capital increase plans submitted by 8 banks and declare insolvent 3 banks. In accordance with the results of the diagnostic study of the next 21 largest banks, the Board decided that 10 banks do not need capital increase, and for 11 banks the capital increase was required. One bank out of the 11 banks in need of capital increase was declared insolvent.

The NBU worked on finding out real volumes of related-party loans.

By the end of 2016, the regulator had approved three-year reduction plans to unwind related-party exposures submitted by eight banks. 15 more plans submitted by the banks that belong to the second and third groups (each consists of 20 banks) are currently under review by the NBU.

In 2016, the NBU has also laid the foundation for establishing a credit registry. It has prepared the respective amendments to the laws, the draft regulation on the credit registry operation, and terms and conditions for submitting data on credit transactions by the banks to the NBU.

The full and timely assessment by the banks of their credit risks is essential for the correct evaluation of their capital adequacy and ultimately for the banking sector resilience. Therefore, the NBU issued the Regulation *On Measuring Credit Risk Generated by Banks' Asset Operations*.

Under the Memorandum of Economic and Financial Policies between the IMF and Ukraine under the EFF Arrangement, Ukraine has conducted a diagnostic study of the next 40 largest banks (following the diagnostics of the top 20 banks).

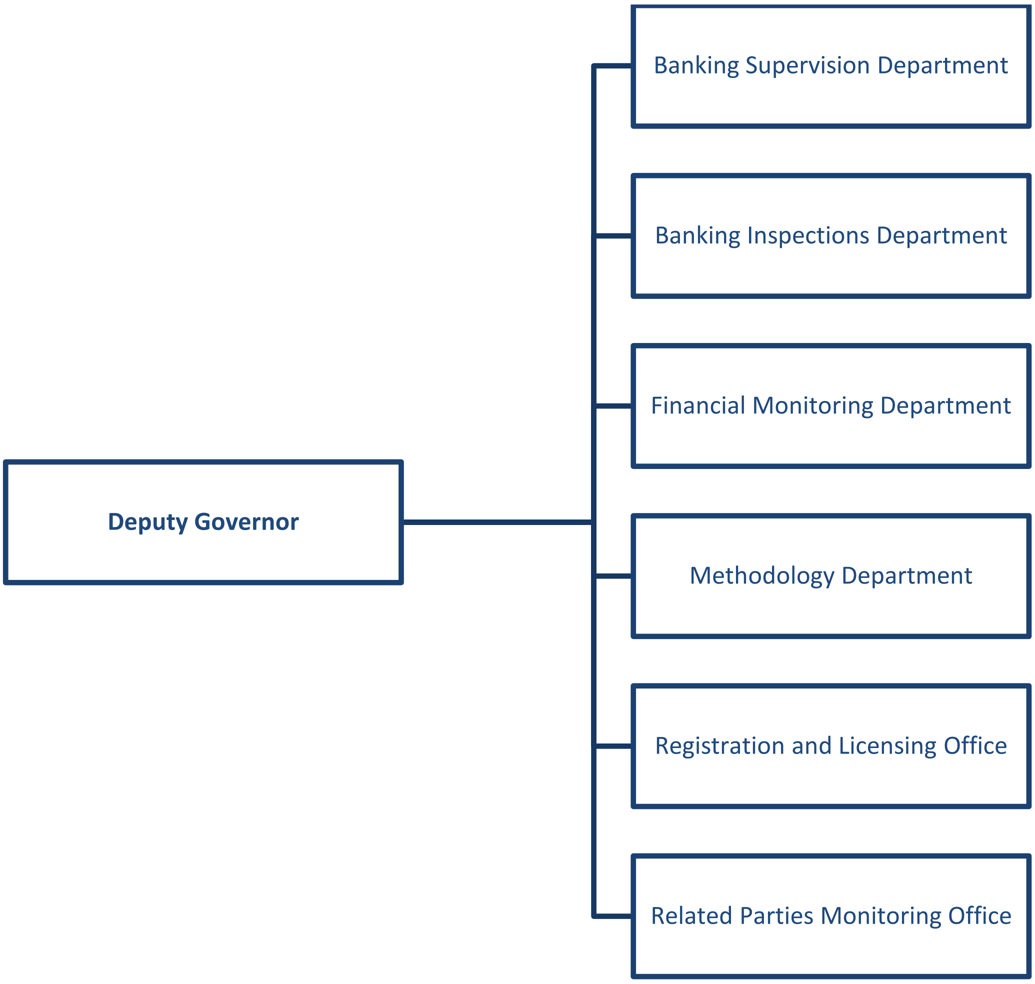
The Board of the National Bank of Ukraine issued the Resolution *On Approval of the Regulation on Internal Audit Guidelines for Ukrainian Banks* that aims to improve the corporate governance in banks and strengthen their control over the internal audit function.

In 2016, as part of its efforts to implement the Comprehensive Program of the Ukrainian Financial Sector Development Until 2020 as regards further strengthening of banking regulation and supervision, the NBU amended its Regulation *On Application by the National Bank of Ukraine of Corrective Measures*. It extended the list and clarified the wording of certain signs of risky activity by banks in the compliance field and improved the procedure for the application of certain enforcement measures, in particular the methodology for calculating selected penalties (failure to submit/failure to submit in a timely manner, misreporting of statistics, non-compliance with reserve requirements, failure to submit credible information/failure to submit information on the ownership structure in a timely manner). Also the list of criteria for qualifying a bank as problematic was expanded, and with a view to enhancing the efficiency of a special monitoring regime of the activities of the bank, provisions regulating the activities of the curator appointed by the NBU have been streamlined.

The work on identification of bank's related parties and monitoring of asset-side operations with them.

To improve the procedure for appointing banks managers and streamline the registration and licensing procedures the NBU Board approved the Resolution *On Approval of Amendments to the Regulation on the Rules Governing Registration and Licensing of Banks, Opening the Standalone Units*.

## ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISORY AUTHORITY




## INTERNATIONAL ACTIVITIES

In 2016, 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 of Ukrainian banking sector and improvement of banking supervision regulatory framework, namely in the area of corporate governance, establishing a credit registry 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.

The 3rd Ukrainian Financial Forum under the auspices of the Vienna Initiative 2.0 was held in March with the participation of representatives from IFIs, the European Commission and banks. During the event, participants discussed issues related to problem loans and their restructuring, banking sector consolidation, and ways of boosting confidence in the banking system.

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 2016. The key TA donors of the NBU are the EU, IMF, World Bank, USAID and EBRD.

In December, the NBU also held the third joint event with the ECB on Transition Processes in Monetary Policy, Macroprudential Analysis, and Banking Supervision, 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

The Comprehensive Program of Ukrainian Financial Sector Development Until 2020 was being implemented in accordance with the plan. Over the reporting year, the NBU completed Stage I Resolving Past Problems and Cleaning Up the Financial Sector and launched Stage II Establishing Conditions for the Long-Term Sustainable Development of the Financial Sector.

# STATISTICAL TABLES

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 163 | 120 | 96 |
| Branches of foreign credit institutions | – | – | – |
| Cooperative banks | – | – | – |
| **Banking sector, total:** | **163** | **120** | **96** |

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

| Type of bank | 2014 | 2015 | 2016 |
|---|---|---|---|
| Public sector ownership | 22.1 | 24.7 | 52.5 |
| Other domestic ownership | 20.3 | 16.9 | 12.84 |
| Domestic ownership total | 42.4 | 41.6 | 65.34 |
| Foreign ownership | 57.6 | 58.4 | 34.66 |
| **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 | 47.0 | 56.1 | 0.0886 |
| Branches of foreign credit institutions | – | – | – |
| Cooperative banks | – | – | – |
| **Banking sector, total:** | 47.0 | 56.1 | 0.0886 |

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

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | -30.46 | -69.95 | -116.05 |
| Cooperative banks | – | – | – |
| **Banking sector, total:** | -30.46 | -69.95 | -116.05 |

**Distribution of market shares in balance sheet total (%)**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| 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)**

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Claims from** | **100** | **100** | **100** |
| Financial sector | 15.73 | 18.00 | 16.45 |
| Nonfinancial sector | 53.68 | 52.95 | 47.44 |
| Government sector | 8.43 | 7.11 | 17.29 |
| Other assets | 22.16 | 21.94 | 18.82 |
| **Claims due to** | **100** | **100** | **100** |
| Financial sector | 26.77 | 29.78 | 34.15 |
| Nonfinancial sector | 15.23 | 17.26 | 17.99 |
| Government sector | 0.44 | 0.59 | 0.47 |
| Other liabilities | 43.47 | 42.17 | 38.29 |
| **Capital** | **14.09** | **10.20** | **9.10** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2014 | 2015 | 2016 |
|---|---|---|---|
| Commercial banks | 15.60* | 12.31** | 12.69** |
| Cooperative banks | – | – | – |
| **Banking sector, total:** | **15.60*** | **12.31**** | **12.69**** |

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

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

| Asset classification | 2014 | 2015 | 2016 |
|---|---|---|---|
| Non financial sector | 12.9 | 19.0 | 28.0 |
| **- households** | 4.6 | 7.1 | 7.9 |
| **- corporate** | 8.3 | 11.9 | 20.0 |

**The structure of deposits and loans of the banking sector in 2016 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Households | 95.9 | 98.7 |
| Government sector | 56.8 | 16.4 |
| Corporate | 39.1 | 82.3 |
| Other (excluding banks) | 0.7 | 0.1 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2014 | 2015 | 2016 |
|---|---|---|---|
| Interest income | 7.864 | 5.288 | 4.778 |
| Interest expenses | 5.052 | 3.743 | 3.224 |
| Net interest income | 2.812 | 1.545 | 1.554 |
| Net fee and commission income | 1.216 | 866 | 866 |
| Other (not specified above) operating income (net) | -285 | -61 | 30 |
| Gross income | 10.929 | 7.753 | 6.709 |
| Administration costs | 2.320 | 1.485 | 1.385 |
| Depreciation | 214 | 143 | – |
| Provisions | 5.371 | 4.657 | 6.977 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | – | – | – |
| Profit (loss) before tax | -2.878 | -2.782 | -5.623 |
| Net profit (loss) | -2.754 | -2.767 | -5.608 |

**Total own funds in 2016 (in EUR billions)**

| Type of financial institution | Total own funds (for CAR) | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 4.03** | – | 2.85** | 1.22** | – |
| Cooperative banks | – | – | – | – | – |
| **Banking sector, total:** | 4.03** | – | 2.85** | 1.22** | – |

# MAIN GROUP EVENTS OF THE YEAR 2016

## 29th Annual BSCEE Members' Conference

## Budapest, Hungary, June 15 – 17, 2016

The Chairmanship of the BSCEE Group in 2016 was held by Central Bank of Hungary and Mr. Gergely Gabler, Director of the Special Competencies Directorate of the Central Bank of Hungary was entrusted the position of the Chairman. Therefore, the 29th Annual BSCEE Members' Conference was hosted by the Central Bank of the Republic of Hungary on June 15 - 17, 2016 in Budapest.

The two day conference focused on two topics, mainly different approaches of the BSCEE member countries on the Supervisory Review and Evaluation Process and the practice of the cooperation between micro and macro prudential regulators, resolution authority, national bank and deposit insurance.

It was attended by around forty representatives of the central banks and supervisory institutions from twenty two countries from Central and Eastern Europe, and other institutions for banking supervision. International experiences, among others, were presented by the representative of the Bank for International settlements (BIS) from Basel and the representative of the Banca D'Italia.

The National Bank of the Republic of Belarus volunteered to hold the 2017 BSCEE Chairmanship as well as host the 30th Annual Conference and the Member countries accepted this candidature by acclamation.

## FSI – ESE - BSCEE Regional Seminar

## Prague, Czech Republic, April 12 – 14, 2016

The Czech National Bank 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 "The Leverage Ratio and Interest Rate Risk in the Banking Book". The programme for the seminar covered the topics of:

- Basel III leverage ratio framework and disclosure requirements
- Work by the BCBS on the regulation of interest rate in the banking book
- Basel III Simulation Engine

## XIX ICBS, Santiago, Chile, September 28 – December 1, 2016

## BSCEE Regional Meeting, September 28, 2016

The XIX International Conference of Banking Supervisors was hosted by the Superintendency of Banks and Financial Institutions of Chile and coorganized by the Basel Committee on Banking Supervision. The panel discussions focused The Basel global standards – the regulatory framework for the coming years and Sustainable/Prudential banking for financial stability. The participants were able to engage in a thorough exchange of views through a series of workshops on topics related to the post-Basel III agenda for the Basel Committee, as well as on the broader issue of how a safe financial system can support economic growth.

It has provided an excellent opportunity for supervisors worldwide to deepen the supervisory dialogue on measures to strengthen the long-term resilience of the global financial system.

During the event, on September 28, the BSCEE Regional Meeting took place and focused on one of the topics of the: *The Basel global standards – the regulatory framework for the coming years and Recovery and resolution in the banking sector in CEE countries.*

# BSCEE CONTACT LIST

| Supervisory Authorities of the Member Countries | Address | Web-site address |
|---|---|---|
| ***Bank of Albania*** | *Sheshi Skënderbej No. 1<br>Tirana, Albania* | www.bankofalbania.org |
| ***Central Bank of Armenia*** | *6, Vazgen Sargsyan str.<br>PO Box 0010, Yerevan<br>Republic of Armenia* | *www.cba.am* |
| ***Austrian Financial Market Authority*** | *Otto-Wagner-Platz 5<br>1090 Wien<br>Austria* | www.fma.gv.at |
| ***National Bank of the Republic of Belarus*** | *Nezavisimosty Ave. 20<br>Minsk 220008<br>Republic of Belarus* | www.nbrb.by |
| ***Banking Agency of Federation of Bosnia and Herzegovina*** | *Kosevo 3, Sarajevo 4000<br>Bosnia and Herzegovina* | www.fba.ba |
| ***Banking Agency of Republika Srpska, Bosnia and Herzegovina*** | *Vase Pelagića 11 A<br>78000 Banja Luka<br>Republika Srpska* | www.abrs.ba |
| ***Bulgarian National Bank*** | *1 Knyaz Alexander I Square<br>Sofia 1000, Bulgaria* | www.bnbank.org |
| ***Croatian National Bank*** | *TRG Hrvatskih velikana 3<br>Zagreb 10002, Croatia* | www.hnb.hr |
| ***Czech National Bank*** | *Prague 1,Na Prikope 28<br>115 03 Czech Republic* | www.cnb.cz |
| ***Estonian Financial Supervision Authority*** | *Sakala 4<br>Tallinn 15030, Estonia* | www.fi.ee |
| ***National Bank of Georgia*** | *2 Sanapiro Street<br>0114 Tbilisi, Georgia* | www.nbg.gov.ge |
| ***Central Bank of Hungary*** | *Krisztina krt. 39<br>1013 Budapest, Hungary* | www.mnb.hu |
| ***Financial and Capital Market Commission*** | *Kungu iela 1<br>Riga, LV-1050, Latvia* | www.fktk.lv |
| ***Bank of Lithuania*** | *Zirmunu St 151<br>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 |
| ***Turkish Banking Regulation and Supervision Agency*** | *Atatürk Bulvarı 191 B Blok 06680 Kavaklidere Ankara, 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 |