BSCEE Review 2018

BSCEE

Albania
Croatia
Latvia
Russia
Armenia
Czech Republic
Lithuania
Serbia
North Macedonia
Austria
Estonia
Slovakia
Moldova
Belarus
Georgia
Slovenia
Montenegro
Bosnia and Herzegovina
Hungary
Poland
Turkey
Bulgaria
Kazakhstan
Romania
Ukraine

Introduction

the Group of Banking Supervisors from Central and Eastern Europe (the BSCEE Group) was established in 1991. The Agreement of the BSCEE Group was signed during the Stockholm International Conference of Banking Supervisors (ICBS) in 1996. The BSCEE Group operates according to its Agreement and Operational Bylaws that determine its organizational structure and the rules governing its operations. As of today it is signed by twenty six member institutions from twenty five 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, Kazakhstan, 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 2018 Mr Murtaz Kikoria, Vice-governor of the National Bank of Georgia chaired the Group. The permanent Secretariat of the Group since January 2006 has been located in Poland, with the KNF – Polish Financial Supervision Authority (PFSA). According to the previous years' practice, the Annual Review of the BSCEE Group summarizes the developments of the member countries in 2018. This publication gives an overview of the macroeconomic circumstances in the twenty five member states, and it describes the banking sector as well as the supervisory activities. It was prepared on the basis of the information given by the member countries. The Annual Review also summarises the main events of the BSCEE Group, including the workshops co-organized by the Financial Stability Institute (FSI) and other regional meetings. This Annual Report intends to provide in-depth information reflecting the mission of the BSCEE Group in a detailed and accurate manner regarding the banking sectors of the member countries. We hope that you will find this publication informative and useful. We are certain that this will help you become acquainted with our supervisory job in the Central and Eastern European region, the cooperation among the supervisory authorities of the member countries and with the Basel Committee.

BSCEE Secretariat

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2018 DEVELOPMENTS IN THE ALBANIAN BANKING SYSTEM

Macroeconomic environment

Albania's economic growth has trended upwards in recent years with GDP growth reaching 4.1% in 2018. GDP growth was broadly balanced across sectors and demand components though the rapid pace of growth was facilitated by the temporary spike in electricity production and exports. From an aggregate demand point of view, GDP growth was driven by higher household consumption, higher private sector investment and increased exports of goods and services. Finally, fiscal consolidation had a largely neutral impact on aggregate demand.

Strong domestic and external demand has reduced the negative output gap and brought the economy closer to its potential though not yet there. Reduced slack is reflected in higher employment, lower unemployment rates (12.3% in 2018), higher wages, as well as improved financial situation of the Albanian businesses. The other main economic and financial balances appear to be improving. Public debt is declining and both current account deficit and external debt are decreasing. The current account deficit dropped to an average level of 6.7% of GDP in 2018.

Although upward, domestic inflationary pressures were still insufficient to offset the low external inflationary pressures stemming from low inflation in our trading partners and pass-through of exchange rate appreciation. The exchange rate experienced a rapid appreciation in the beginning of 2018 posing deflationary risks to price stability in the medium term and prompting the reaction of the central bank. The monetary stimulus was further increased in June 2018 by lowering the policy rate to 1.00% and using foreign currency interventions as an unconventional monetary policy tool.

The monetary stimulus has helped reduce interest rates to their historical minima and has supported lending in domestic currency. The FX intervention program has been effective in cooling down the rapid exchange rate appreciation, managing market expectations and creating conditions for a more normal trading.

The economic outlook remains favorable, with solid growth in the near term to medium term. The economic growth is expected to be supported by favorable financing conditions, positive labor market outcome and improved confidence amongst businesses. The convergence of the economy to potential will exert upward pressure on wages and other output costs, thus contributing to the return of inflation to target in the medium-term.

Development in the banking sector (including assets total / GDP)

The banking sector remains the main component of the Albanian financial sector. Fourteen banks have operate during 2018 in the banking sector from sixteen banks that were active in 2017. The bank's number reduction during 2018 resulted due to some structural developments and ownership changes that took place, which led to consolidation of the structure of participants in the banking market.

During 2018, banking system assets grew by around ALL 7.6 billion or 0.5%, compared to the ALL 38.04 billion or 2.7% growth a year earlier. The loan portfolio fell by ALL 20.2 billion, or 3.4% during this year.

The banking system's share in the economy, measured by the ratio of total assets to the Gross Domestic Product (GDP), remains high. This ratio decreased by 3.15 percentage points this year, standing at 89.35%.

Meanwhile, the loan to Gross Domestic Product ratio fell by 2.75 percentage points, reaching at 35.71%, due to the growth of GDP against the decrease in the loan portfolio.

The most important indicator of supervision, the capital adequacy ratio (CAR), has been considerably upward and stable over 2018, reaching at around 18.2%, from 17% at the end of 2017. Also, the non-performing loans ratio (NPLR) dropped by 2.15 percentage points, at 11.08% at the end of year, notwithstanding the fall in loans portfolio by 3.36% during the year. Profitability indicators, although lower than in 2017, remain at good levels to provide support in capital. RoA stood at 1.32% at the end of 2018, from 1.56% at the end of 2017, while RoE stood at 12.96%, from 15.71% a year earlier.

The NPLR continued to trend downward recorded in recent years, standing at 11.8% in December 2018, from 13.23% a year earlier. This decrease was due to the 19% fall of NPLs, affected at almost the same degree by loans write offs and solutions provided by banks to borrowers, including restructuring forms combined with both total and partial payments by the borrowers. At the same time, the credit portfolio dropped by 3.36%, mainly due to the depreciation of the exchange rate of foreign currencies against the Albanian lek.

Following are banking system highlights for 2018:

1. Outstanding credit in the banking decreased by 3.36%, against the increase by around 0.15% in the previous year.
2. NPLR stood at 11.08%, down by 2.15 percentage points during 2018, from 13.23% at the end of 2017. The value of NPLs fell by 15,14 billion or 3.36% affected by write offs at ALL 8.4 billion and the rest by other solutions for loans in collaboration with borrowers.
3. Provisioning of NPLs was high, standing at 65,6%, albeit downward compared to 71,7% a year earlier;[1] as a result of this provisioning, net NPLR from these provisions was only 3.8% from 4,2% a year earlier;
4. Banking system's liquidity situation remains satisfactory. The liquidity indicator stood at 46,2%, from 40.79% at the end of 2017;
5. Deposits in the system grew by around ALL 1,18 billion in 2018, compared to the growth of around ALL 8,5 billion in 2017;
6. The CAR stood at 18,2% against the regulatory minimum of 12%, showing an annual growth of around 1.65 percentage points;
7. Banking system's profit was positive in 2018, at ALL 18.39 billion or ALL 3.68 billion lower than in 2017. RoA and RoE were positive, standing at 1.32% and 12.96%, respectively, down from the previous year.

[1] This fall is not a negative development, as it is due to the improvement of non-performing loans structure while the share of loan loss which is 100% provisioned has been down. This development is proportional to net non-performing loans ratio, which has been downward during the year.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in Albania

The drafting and review of the supervisory regulatory framework aims at supplementing and improving it, in order to carry out a more effective supervision, in compliance with legal requirements and aims approximation with the latest developments in the EU regulatory acts and Basel documents.

Banks or other institutions licensed and supervised by the Bank of Albania, played an important role in the process of drafting and reviewing regulatory supervision acts, contributing with their comments and suggestions on these regulatory changes.

During 2918, the Supervision Department contributed also to the working group for the draft-law "On payment services", in the framework of Bank of Albania's engagement to approximate the legal framework with the European Directive on Payment Services (PSD2).

In the regulatory aspect, special attention was paid to drafting new regulatory acts or revising existing ones, in the light of the approximation of the regulatory framework with the requirements of Basel III, namely the draft-regulation "On the Liquidity Coverage Ratio", which aims at introducing a new liquidity indicator in the regulatory framework of the Bank of Albania, the draft-guideline "On bank stress tests", reviewing the regulation" On regulatory capital of the bank" and drafting new acts on early interventions, in accordance with the provisions of the law on recovery and resolution in banks.

Also, during the 2018, several new regulatory acts were drafted and considered important for banking supervision and for banks, and some other regulations that are expected to be adopted in 2019 were partly revised. In more detail, the following regulatory acts were drafted and/or revised:

- drafting of the new draft regulation "On liquidity coverage ratio", in the framework of further approximation of Bank of Albania's requirements with the requirements of the Basel Committee and European regulations on liquidity risk management and fulfilment of strategic objectives of the Department of Supervision for the implementation of Basel III requirements. The liquidity coverage ratio (LCR), presented in the new draft-regulation, is a dynamic indicator that measures the bank's short-term liquidity over a 30-day forecasted time-horizon in liquidity stress situations. In order to be able to calculate the LCR, liquid assets ought to meet strict criteria, before they get qualified to be included in the banks' liquidity reserve, as well as calibrated rates for liquidity inflows or outflows, based on the European experience during the global financial crisis. The drafting of this regulatory act has also considered the important contribution of the banking system through the transmission of information and data in the support of the study / analysis of the impact for this indicator, as well as through the comments and suggestions, or through discussions with banks representatives during the meetings held by the Bank of Albania.
- Preparation of some draft-amendments to the regulation "On bank regulatory capital" aimed at approximating Bank of Albania's regulatory requirements for capital ratios, proportionally with Basel III requirements.
- Preparing the draft-guideline "On Bank's Stress Tests", which provides requirements and methodologies for conducting stress tests by banks as an important tool of the risk management process in general and the Internal Capital Adequacy Assessment Process, in order to unify the practices that banks need to pursue for carrying out stress tests.

Furthermore, the self-assessment of the Bank of Albania's regulatory framework pertaining to supervision vis-à-vis the CRD directive[2] and the European regulation on capital requirements CRR[3] for the activity of credit institutions were finalized. It is done in analogy with the "Assessment of the equivalence with the European regulatory and supervisory framework", carried out by the European Commission (EC) based on the questionnaire of the European Banking Authority (EBA). The self-assessment of the Supervision Department, as determined by the purpose of the process itself, aims to identify "gaps" in the regulatory framework of supervision, compared to the EU framework, and drafting a mid-term and long-term plan for drafting and reviewing legal and regulatory acts, which regulate the banking activity in order to ensure compliance with the Acquis Communautaire. The Bank of Albania's self-assessment showed that regulatory acts in force comply to a large extent with the CRD and the CRR. The self-assessment was accompanied by a mid-term roadmap on the plan for approximation of Bank of Albania's regulatory and supervisory framework with the EU regulatory framework.

Main strategic objectives of the Supervisory Authority in 2018

The main objectives set for 2018 by the Supervision Department of Bank of Albania were as follows:

- Banking system consolidation in view of the mergers or acquisition announced or expected to be attained.
- Credit risk monitoring focused on non-performing loans and the addressing of borrowers in financial difficulties maintaining a prudential approach on early addressing problems and the fulfilling the commitment in the framework of the national program on addressing non-performing loans.
- Approximation of regulatory framework with Basel III in view of regulatory changes provided for the management of unfavorable liquidity situations, with the introduction of a new indicator named Liquidity Coverage Ratio (LCR).
- Regulation and supervision of bank's governance with main focus on the revision of the examination manual providing tools for an adequate assessment of banks' structures and the preparation of an internal guideline to assess the Internal Capital Adequacy Assessment Process (ICAAP) document delivered by banks.
- Self-assessment of the equivalence with European regulatory and supervisory framework with the fulfillment of the appropriate Questionnaire of the European Banking Authority (EBA).
- Collaboration with the European Central Bank by signing a comprehensive agreement and participating in supervisory colleges for large banking groups already present in the Albanian market.
- Preparation of financial reporting according to the international accounting standards through monitoring its implementation by banks and assessing the outcome.

The activities of the Banking Supervisory Authority

In 2018, in the banking system, some structural developments and ownership changes took place, resulting from the **consolidation of the structure** of participants in the banking market, bringing the number of banks at 14 and potentially at 12 with the materialization of the absorption already in the process of finalization for a bank and the voluntary liquidation of another bank. These trends will be closely monitored in the period ahead. In this context, the following events have wither materialized or are in the process:

[2] *Capital Requirements Directive.*
[3] *Capital Requirements Regulation.*

- The merging by absorption for two banks of the system. The process was dictated by developments in the home country, rather than as a need arising in the domestic market. Consequently, the Intesa SanPaolo Bank acquired and merged with Veneto Bank, after the latter declared the bankruptcy and was purchased by Intesa SanPaolo Bank in Italy.
- The American Bank of Investment acquired and merged with the NBG Bank Albania. This event was supported by the banking system restructuring plan in Greece to reduce exposure outside Greece, in the framework of NBG Bank's Restructuring Plan, and in line with its commitments to the European Commission.
- Union Bank acquired the International Commercial Bank. This event was determined by the decision of its shareholders to leave the Albanian market, but also by the Union Bank's earlier ambition to expand in the domestic market through the absorption of an existing bank.
- Tirana Bank, formerly part of the Piraeus Group, for the same reasons as the NGB Bank, concluded the sale of its shares to Balfin Group shpk and Banka Commercijalna A.D. Skopje. This transaction was approved by the Supervisory Council of the Bank of Albania in February 2019.
- Societe Generale Albania Bank realized the sale to the Hungarian OTP Bank Nyrt Bank as part of the parent bank's strategy to withdraw in general from the Balkan region.
- Lastly, the shareholders of the Credit Bank of Albania decided on the voluntary liquidation of the bank, which is expected to be finalized during the first half of 2019.

The aforementioned events are materialization of the trends shown in recent years for the consolidation of the banking market; meanwhile, the most important expected changes have already occurred. As a result of these changes, the share of domestic capital has increased, and as such it is expected to boost banking activity. Supervision will hence be focused on preserving the quality of risk management and financial soundness indicators.

Despite the continuous reduction of the risk to this exposure, as part of its approach to address issues in a sustainable and inclusive manner-*identified as a supervisory priorities for 2018* – the Bank of Albania remains committed to providing a better solution in this regard and the realization of all its commitments under the national plan for the reduction of NPLs. For this purpose, the Bank of Albania prepared a draft-regulation on the **out-of-court addressing of borrowers**, which was discussed in several meetings with banks during the year and through written communication. Exchanging the opinions and reflecting them in the draft-regulation took some time for all the stakeholders due to the complex nature of establishing a viable and well-coordinated form of cooperation between banks. Meanwhile, important issues regarding the credit risk management were discussed during the meetings organized with the banks, such as the use of official financial statements of borrowers and a study of Deloitte on financial sustainability of the largest enterprises in the country. This study was funded by the World Bank FinSAC project.

In the first half of this year, the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) **completed the fifth round of the evaluation of Money Laundering and the Financing of Terrorism (MONEYVAL)**, a process that was launched and has been reported since 2017. The evaluation, where the Bank of Albania has played a special supporting role as the supervisor of most institutions in the financial market, was concluded in July 2018, with the adoption of the evaluation report in the Moneyval's plenary session. According to this report, financial institutions were assessed at the "substantial / significant" level of effectiveness, in particular when banks present a good understanding of the risks of money laundering and financing of terrorism, legal obligations, and generally have taken proper measures proportionate to the estimated risk level for the prevention of money laundering and the financing of terrorism.

The evaluation process was accompanied by several recommendations and a subsequent plan of measures to address the main issues identified in the report, whose fulfilment will continue throughout 2019. In this context, the Bank of Albania has drafted its own action plan, and is committed to achieving the necessary improvements in the regulatory framework and strengthen the effectiveness of the supervisory process by May 2019. Also, co-operation with the General Directorate for the Prevention of Money Laundering during the year continued intensively. This cooperation materialized in the framework of Moneyval's evaluation process, joint inspections as well as the contribution to reviewing the legal framework on anti-money laundering issues.

In support of its mission, the Bank of Albania, through the Supervision Department, continued its normal activity monitoring the financial system, mainly banks through on-site inspections and off-site analyses, assessing the measure of exposure against individual risks as well as the control environment for their management, as well as reviewing / improving the regulatory framework and licensing of entities, or additional activities.

During 2018, **full-scope and partial examinations** were conducted in 7 banks, 10 non-bank financial institutions and 31 foreign exchange bureaus during 2018. The main focus and sources are concentrated on the examination of banks, which have the main share in financial market activity. Special attention has been paid to banks that are in acquisition / merging processes, or banks with high growth rates.

Meanwhile, among the above-mentioned examinations for 5 banks, for 7 non-bank financial institutions and for 8 Foreign Exchange Bureaus, examinations were conducted in cooperation with the General Directorate of the Prevention of Money Laundering and examination at one bank was conducted in cooperation with Financial Supervisory Authority.

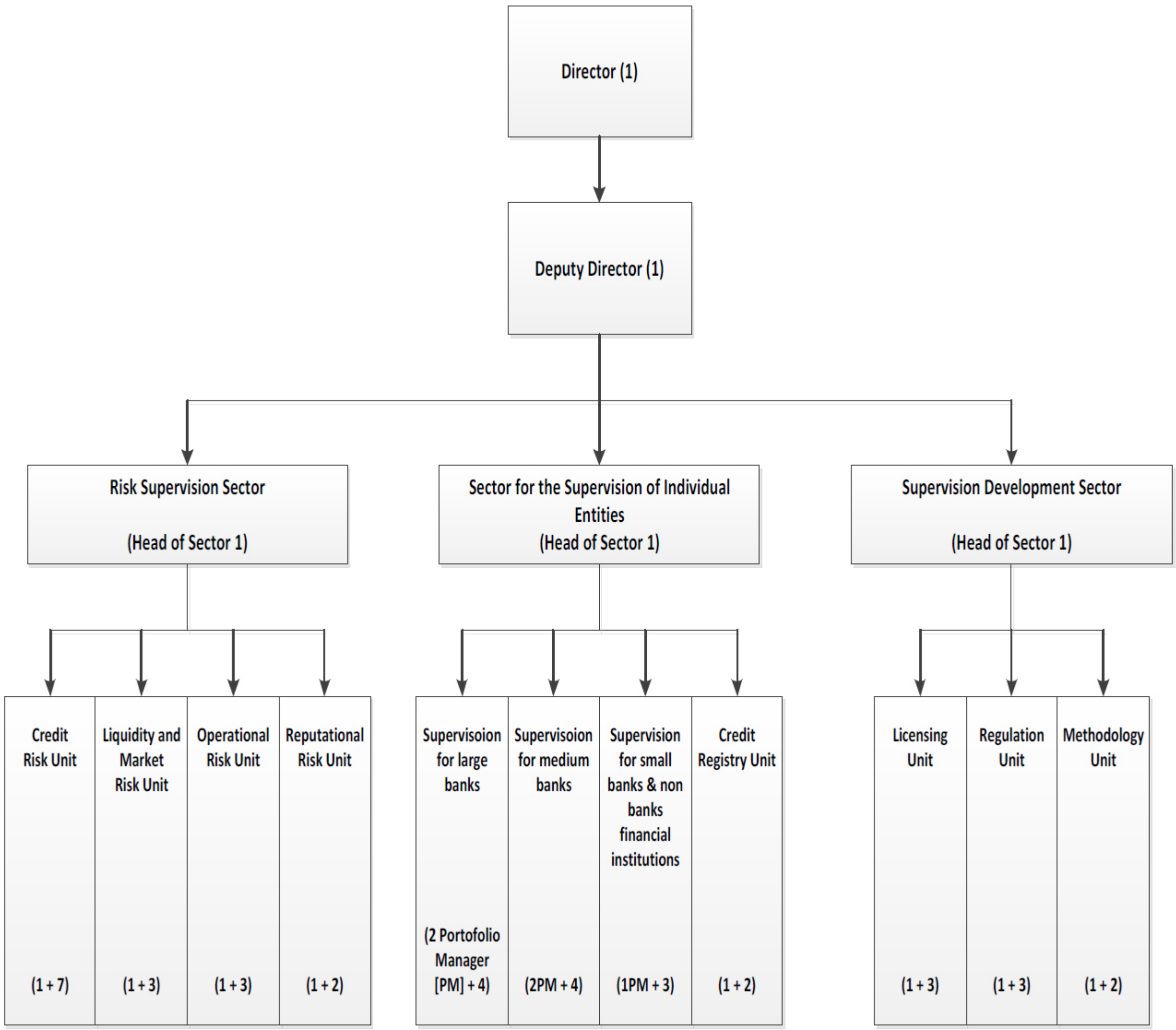
Table 1 Number of examinations by year of institution and topic

Examined institutions	Strategic Risk	Organisational Risk	Credit Risk	Liquidity Risk	Interest Rate Risk	Market Risk	ICT Risk	Operational Risk	Reputable Risk	Profitability Risk	Capital Risk
2016*	6	7	8	6	7	7	7	7	8	6	8
2017	9	12	13	10	10	9	11	8	11	10	11
2018	8	10	9	8	8	8	9	8	48	9	8

* In 2016, 14 joint inspections were carried out with the Deposit Insurance Agency (DIA) in the Savings and Loan Associations where the Bank of Albania was present to support the DIA.

Organizational chart of the Banking Supervisory Authority

The organizational structure of the Supervision Department hasn't had any changes during 2018. The last structural change was in 2016.



International activities of the authority

The signing of the memorandum of understanding between the Bank of Albania and the European Central Bank (ECB) on banking supervision, *deemed as a pivotal development among our priorities*, attaches importance to the Bank of Albania to establish a more structured and formalized cooperation relationship with the most important institution of the European Union (EU). It sets out the modalities of bilateral cooperation between the two institutions, providing for the exchange of information and conducting effective supervision.

In the framework of cooperation with counterpart authorities, we have participated in three supervisory colleges organized for the European-based banking groups that operate also in Albania. Even though Albania participates as an observer in the college, the assessments for the activity of subsidiaries in Albania have been considered and submitted in the framework of risk management at group level. Also, during 2018 there was a regular flow of information on the assessment of the group recovery plan as well as on the determination of capital requirements. In the framework of the coordination of supervisory activities, this year, a joint (targeted) examination was conducted with the ECB supervisors in one of the banks, whose group is based in the EU.

In terms of improving supervision processes, *a development process as defined in previous reports*, we are in the final phase of finalizing two projects assisted by EBRD and WB. More concretely:

- With the assistance of the European Bank for Reconstruction and Development (EBRD), an assessment of the internal supervisory of risk assessment procedures was carried out, mainly of organizational and credit risk. In addition, the relevant regulatory framework was assessed, accompanied by concrete proposals for change. Based on these assessments, a plan for their implementation was drafted, including training for employees of banks and of the Supervision Department.
- With the assistance of World Bank and Grant Thornton, a draft document for communication and exchange of information and evaluation of external auditors was prepared, for improving the quality of control for both banks and auditors. Defining a guideline and preparation for the implementation of international standards of reporting in the field of banking supervision and reporting is another objective of this project, which remains to be evaluated during 2019.

The Bank of Albania is part of the discussion process for establishing the **Credit Bureau,** part of which is the European Bank for Reconstruction and Development and the Albanian Association of Banks. Discussions between the parties began in 2016 and in the last year several meetings were held to discuss the main issues regarding the models that could be applied for the establishment of this bureau, its institutional positioning, the governing structure and the means of financing. The final stand regarding the issues under discussion is expected to be clarified in 2019.

Cooperation with other supervisory bodies in Albania

In 2018, Bank of Albania had the following activities in cooperation with other supervisory institutions:

- 20 examinations (5 banks, 7 NBFI and 8 foreign exchange bureaus) in collaboration with the General Directorate for the Prevention of Money Laundering consisting in opinions and expertise sharing, information exchange, coordination of administrative measures, coordination of reporting to international organizations.
- Ministry of Foreign Affairs through the distribution to licensed entities of the ONU Security Council resolutions and the decisions of the Council of Ministers on sanctions and update of the list of terrorism financiers.

Other relevant information and developments

One of the supervisory innovations, presented in the last year's report as well in 2018 the reporting was materialized for the first time, by banks of internal assessment of capital under the framework of **"Internal Capital Adequacy Assessment"** document. Consequently, their review and the concluding analysis of these reports, including **"Recovery Plans"**, have been a particular challenge, thus requiring a relatively long period of time and a comprehensive focus. These two documents represent a complete self-evaluation of the bank's capabilities, to control and cope with risk levels that arise during ordinary business, and to recover from a difficult financial situation. More concretely:

- The first assessment of this document evidenced the quantitative effects calculated by banks, compliance with regulatory requirements and some shortcomings for a wider and more qualitative inclusion of risks with potential effects on capital requirements. This assessment showed that the information contained in these documents was not sufficient for the Bank of Albania to agree on a minimum capital adequacy ratio for banks, which is expected to be the end result of this process. The identified issues were presented to banks in the framework of a formalized written communication at the beginning of 2019, which is expected to be ongoing in order to enhance the quality of preparation of this document in the future.

- During 2018, the recovery plans have been subject to enhanced regulatory requirements, while their assessment is conducted through close communication with banks, as well as with the World Bank's valuable assistance. While the quality of the drafted plans has increased, there are still elements that need to be improved for a more complete integration with the internal risk management framework as well as with the strategies and objectives at individual and group level.

During 2018, banks and financial institutions have made positive efforts in terms of prevention of money laundering and terrorism financing. Overall, on-site inspections carried out at banks during 2018, have shown that the level of compliance with obligations arising from legal and sub-legal acts is satisfactory and risk from money laundering/financing of terrorism have been managed effectively. In particular, banks have in place adequate structures and systems in this regard and have increased the effectiveness of preventive measures, which is reflected in the increase of the number and quality of reporting on doubtful activities.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	16	16	14
Branches of foreign credit institutions	0	0	0
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**16**	**16**	**14**

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	0	0	0
Other domestic ownership	11.50%	12.00%	16.55%
Domestic ownership total	11.50%	12.00%	16.55%
Foreign ownership	88.50%	88.00%	83.45%
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	58.41%	75.94%	0.16
Branches of foreign credit institutions	n/a	n/a	n/a
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	58.41%	75.94%	0.16

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	7.15%	15.71%	12.96%
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	7.15%	15.71%	12.96%

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
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 sector (%) (at year-end)

	2016	2017	2018
Claims from			
Financial sector	16.95	18.59	17.92
Nonfinancial sector	36.81	37.34	36.78
Government sector	42.08	39.55	41.23
Other assets	4.14	4.50	4.06
Claims due to			
Financial sector	2.29	2.66	2.88
Nonfinancial sector	81.14	79.73	80.28
Government sector	3.47	3.96	3.81
Other liabilities	3.41	3.51	2.88
Capital	9.69	10.14	10.17

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks	16.02**	17.03%**	18.24%**
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**16.02%****	**17.03%****	**18.24%****

(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	2016	2017	2018
Non-financial sector, including:	18.27	13.23	11.08
Households	10.18	7.64	6.44
Corporate	22.95	16.88	14.25

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

	Deposits	Loans
Non-financial sector, including:		
Households	82.81	31.81
Corporate	14.89	63.38
Government sector	2.30	4.81
Financial sector (exluding banks)	n/a	n/a
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	57,946.07	53,940.99	52,079.81
Interest expenses	10,794.42	9,058.8	8,547.29
Net interest income	47,151.66	44,882.19	**43,532.51**
Net fee and commission income	7,566.37	8,327.07	9,326.72
Other (not specified above) operating income (net)	10,235.87	22,177.77	17,036.78
Gross income	39,346.87	51,717.89	47,225.51
Administration costs	26,346.95	26,523.36	27,626.33
Depreciation	N/A	N/A	N/A
Provisions	18,439.50	2,449.77	6,265.06
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	11,671.88	23,972.22	21,067.44
Net profit (loss)	9,270.14	21,628.36	18,390.96

Total own funds in 2018 (in mln EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	1,175***	1,078***	1,077***	79***	n/a
Cooperative banks	n/a	n/a	n/a	n/a	n/a
Banking sector, total:	1,175	1,078	1,077	79	n/a

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

2018 DEVELOPMENTS IN THE ARMENIAN BANKING SYSTEM

Macroeconomic environment in the country

A higher-than-forecasted economic growth was observed in Armenia in 2018, mainly contributed by the expansionary monetary policy of the Central bank, the growth of lending and accelerating growth in private spending, on one hand, and by the moderate growth in foreign demand, on the other.

During the year, the growth rates of gross demand slowed down, caused by tighter fiscal policy, as compared to the previous year, and weaker currencies of partner countries.

The economic growth was 5.2% for the reporting year. The latter was mainly conditioned by the growth rates of service and trade sectors (9.4% year-on-year). These higher-than-anticipated growth rates of services and trade were due to high growth of trade volumes and significant activity in tourism, entertainment and recreation sectors.

Development in the banking sector (including assets total /GDP)

As of 31 December, 2018, 17 commercial banks operated in Armenia. The banking sector of Armenia accounts for 85.1% of the financial system assets.

The banking system assets to GDP ratio has increased by 4.9 pp. relative to the previous year and amounted 83.1%. The ratio of loans to economy to GDP has also increased, by 3.8 pp. and amounted 48.9 %.

During the year, total capital of the banking sector has grown by 9.2 % and amounted to AMD 749 billion. 4 banks made replenishment of their statutory capital by total AMD 41.4 billion. Non-resident participation in the statutory capital of the banking sector has increased by 0.3 p.p. to 62.1%.

Banking System Capital Adequacy

In 2018, commercial banks' total capital adequacy ratio continues to stay above the minimum required prudential threshold (12 %) amounting 17.7% at the year end.

Credit risk remains the most important risk to the financial stability. It stands for the largest share in the structure of risk weighted assets with 86.7 %. The share of market and operational risks in the structure of risk weighted assets was respectively 10.4% and 2.9% (as of 31.12.2017 the indicators were respectively 85.8%, 11.1% and 3.1%).

Banking System Liabilities

In 2018, total liabilities of the banking system increased by 15.2 % and amounted to AMD 4 trillion 238 billion. Both dram and foreign exchange liabilities increased by 20.4 % and 11.7% respectively. As a result, the share of foreign exchange liabilities decreased by 1.8 p.p. to 58.2 %.

Banking System Assets

At the end of 2018, total assets of the banking system increased by 14.3 % and amounted AMD 4 trillion 987 billion at the end of the year. Compared with the previous year the loans to economy increased by 16.5 % and amounted AMD 2 trillion 932 billion.

Financial Performance

In 2018, the net profit of the banking system amounted to AMD 38.6 billion. During the year, 15 banks reported profit and 2 banks incurred losses. Return on assets (RoA) and return on equity (RoE) of the banking system have decreased by 0.1 and 0.7 p.p amounting 0.9 % and 5.3%, respectively.

The legal and institutional framework of the operation and supervision of financial institutions, new developments

There were certain changes in the field of financial regulation in 2018. Specifically, amendments and additions were made to Armenian laws on “Asset Securitization and Assets-Backed Securities”, “Investment Funds”, “Foundations”, “Joint Stock Companies”, “Mortgage-Backed Bonds” and “Bankruptcy of Banks, Credit Organizations, Investment Firms, Investment Fund Managers and Insurance Companies”, and the Civil Code of the Republic of Armenia.

These amendments aim to:

1. Eliminate barriers to securitization processes that have existed so far,
2. Make sure existing legislation is aligned with current developments,
3. Achieve clearer and more effective regulatory solutions for investments,
4. Create incentives for the development of the mortgage market in Armenia,
5. Start the institute of a centralized issuer and participatory issuer,
6. Increase the attractiveness of secured mortgage bonds issued in Armenia to foreign investors.

The following amendments were made in the regulation of the banking sector:

1. The adoption of the new Regulation on “The CBA’s prior approval for outsourced banking activities provided by low”
2. Amendments and supplements have been made in Regulation 4 “Minimum Requirements for implementation of Internal Control of Banks”. Minimum requirements for the country risk of commercial banks, credit risk assessment for unhedged borrowers, as well as minimum requirements for model implementation process are set out.
3. Amendments and supplements have been made in Regulation 2 on “Regulation of banking, prudential standards for banking”. Improvements were made in the reserve requirements’ penalty regimes, as well as in reducing concentration risk and to adjust the risk weights of loans issued to exporting companies.

Legal competence of the Banking Supervisory Authority in the country

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

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

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

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

Main strategic objectives of the supervisory authority in 2018.

The Central Bank (mainly Financial Supervision Department, Financial Monitoring Centre, Financial Stability and Development Department) carries out supervisory analyzes continually based on the reports received from financial institutions.

In 2018, 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, information technologies, 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, quality control of rendered services.

In 2018, the Financial Supervision Department of the Central Bank performed 136 on-site inspections.

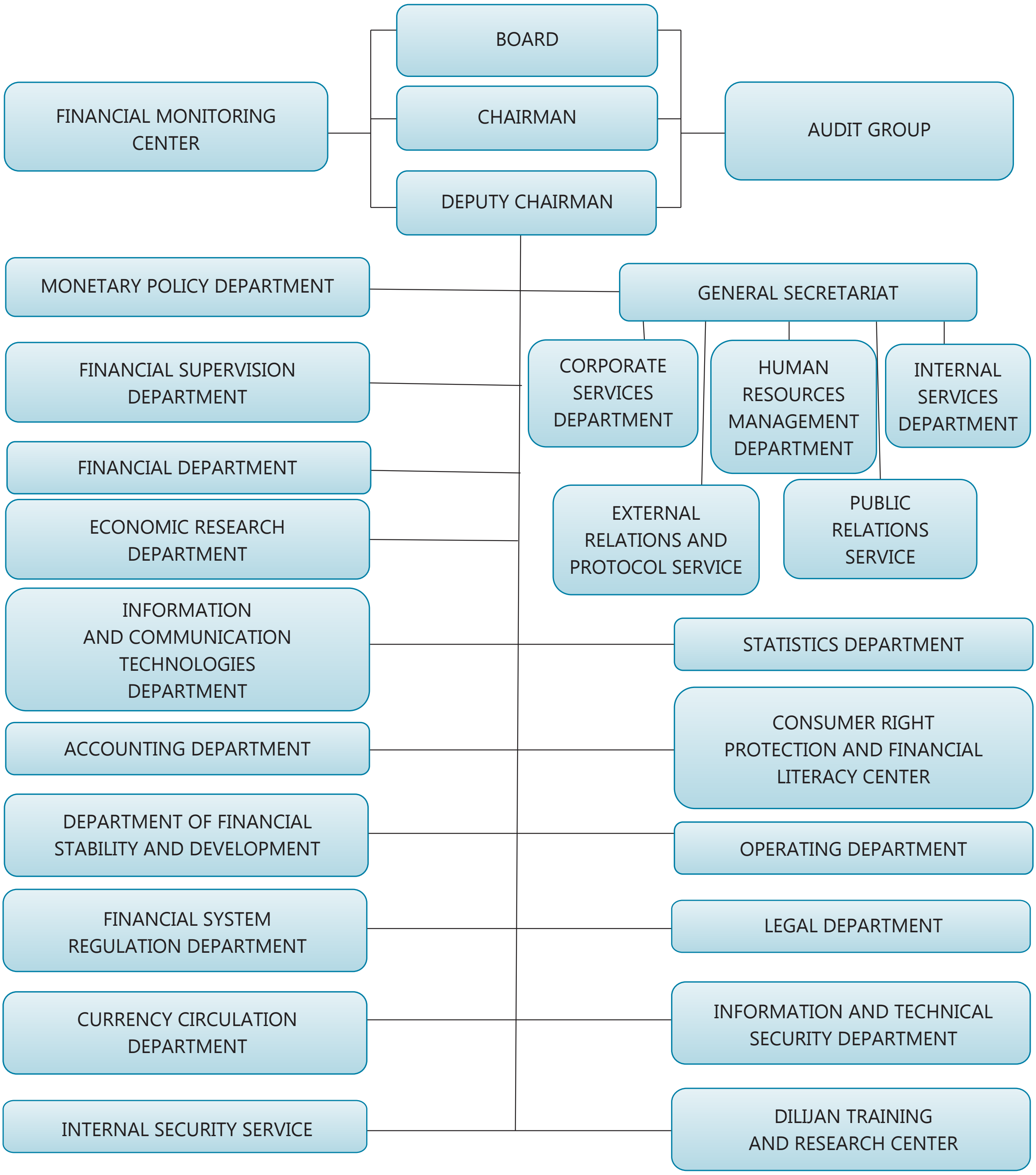
The activities of the Banking Supervisory Authority in 2018.

In 2018 the Central Bank continued taking on its supervisory functions to maintain the stability of the financial system, measure the financial organizations' risk exposure, compliance with the legal framework, while making 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.

The Central Bank monitors the activities of financial institutions, carries out analyses on their financial position, identifies and evaluates risks, measures the compliance of their activity with the legal framework and exercises other aspects of oversight under the law.

In 2018 supervisory inspections at financial institutions for risk disclosure, business conduct, reliability of reportable information and other aspects continued. During the year, the Central Bank conducted 136 inspections at financial institutions, including 33 inspections at banks, 1 target and 1 all-purpose inspection at credit organizations, 3 target inspections at insurance companies, 5 inspections at insurance agents, 2 all-purpose inspections at investment companies, and 91 inspections at other participants of the financial market (exchange offices, pawnshops, payment and settlement organizations, etc.).

Organizational chart of the Banking Supervisory Authority



International activities of the authority

The Central Bank sustained its multilateral and bilateral cooperation with international financial institutions during the year. This involved a handful of visits of partners and delegations, as follows:

In January of 2018, a group of experts from the International Monetary Fund (IMF) visited the Central Bank of Armenia for preparing an assessment of compliance of the Armenian banking system in April and June of 2018 as part of the Financial Sector Assessment Program (FSAP).

The Central Bank received the IMF/WB (Netherlands-Belgium) Constituency delegation headed by Anthony de Lannoy, IMF Executive Director for Armenia. Issues related to bilateral cooperation, current economic situation in Armenia, monetary and fiscal policy, strengthening of Armenia's international reserves, reducing public debt and maintaining stability of the banking system were the issues addressed during the visit.

To strengthen business ties, learn about the country's macroeconomic environment and negotiate on a variety of aspects in the financial and banking sectors, a delegation led by Black Sea Trade and Development Bank President Dmitry Pankin, an Asian Development Bank's delegation, as well as the representatives of Moody's and Fitch ratings paid visits to the Central Bank during the reporting period.

The Central Bank also received the delegations of the Asian Development Bank, of the UN Security Council's Executive Board of Anti-Terrorist Committee and of China's Banking and Insurance Sector Regulatory Commission.

The Bank continued collaboration in developing international standards in the field of AML/CFT with international organizations and partner countries involved in introducing and implementing those standards, including cooperation with the Council of Europe's MONEYVAL Committee, the Egmont Group, the Parties to the Warsaw Convention, the Eurasian Group, and the Board of Directors of CIS Financial Intelligence Units.

In the context of cooperation with international institutions, the Council of Europe's MONEYVAL approved in 2018 a status report on the national assessment of AML/CFT risks, which said that Armenia had made a good progress in implementing FATF Recommendation 1 (risk assessment and risk-based approach), Recommendation 7 (targeted financial sanctions imposed on proliferation of weapons of mass destruction) Recommendation 8 (non-profit organizations).

As part of cooperation with foreign financial intelligence units, the Bank received 29 requests and made 54 requests to FIUs during 2018. Most requests were made to the FIUs of the United States, Latvia, Russia, France, Great Britain, Cyprus, Germany and, consequently, most requests were received from those of Moldova, Russia, Uzbekistan, India, and Latvia.

The following business meetings, conferences, workshops organized by the Bank during the year are worth mentioning:

- A roundtable on innovative payment services, organized jointly with Master Card, with the participation of representatives of Armenian commercial banks.
- The Bank has actively engaged in the activities of all the committees that function in the framework of the Eurasian integration.
- A meet-up with the KfW Development Bank, Germany, to discuss the introduction of an insurance system in the agricultural sector.
- The Asian Regional Forum on "Investment Management of Foreign Exchange Reserves" was organized jointly with the Central Bank of Armenia and the Asian Development Bank.
- The regular (8th) meeting of regional advisory group on issues of financial stability of CIS countries.

In 2018 the Bank concluded agreements, contracts and memoranda of understanding with central banks of other countries as part of both bilateral cooperation and in the framework of intergovernmental committees. In particular, the following were concluded in Yerevan:

- The FATCA agreement between the Central Bank and the US Embassy.
- The agreement between the central banks of Armenia and Russia on cooperation in the fight against computer attacks.
- The agreement on harmonization of financial market legislation in EEU member states.
- The memorandum of understanding between the Central Bank and the Banking and Insurance Regulatory Commission of China.
- The € 50 million loan agreement between the Central Bank and the European Investment Bank to finance SME sector projects.

The Bank's enhanced cooperation with international partner financial institutions as well as respected scientific and educational establishments continued in the reporting period.

During the year, employees of the Bank attended a variety of training courses, workshops, consultations, symposiums conferences and roundtables, as well as made visits for sharing of experience, both in Armenia and abroad.

In 2018 the Bank hosted a dozen of regional and international symposiums, conferences, seminars, workshops, forums, etc. in its Yerevan Head Office and Dilijan Training and Research Center. In particular, in the framework of cooperation between central/national banks of the Eurasian Economic Union and the CIS Member-States, the Dilijan TRC hosted 4 trainings attended by about 90 representatives of banks from EEU and other countries. Furthermore, there were tailor-made workshops and work visits for sharing of experience, with 25 employees having presented the Central Bank's best experience.

Overall, 48 events/programs were organized by and in cooperation with the Central Bank in Armenia, with about 500 representatives from the Bank and about 800 representatives from central/national banks of other countries, international organizations, Armenian commercial banks and other government departments.

Cooperation with other supervisory bodies in the country

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

Other relevant information and developments in 2018

In reaction to the Basel III regulatory framework requirements developed by the Basel Committee on Banking Supervision, the Central Bank of Armenia has developed and adopted the Regulation on "The procedure for setting and calculating buffers higher than the Capital Adequacy Standard", which have entered into force since April 2019.

The Central Bank of Armenia has set three buffers exceeding the capital adequacy requirement: capital conservation buffer, counter-cyclical capital buffer, systemic risk buffer. Moreover, the first two buffers were set for all banks, while the systemic capital buffer was set for systemically important banks only. The introduction of the above-mentioned buffers is aimed at increasing the efficiency of the risk management in the banking sector, which in turn will strengthen the stability of the financial system.

In light of the global trends in information security, in 2018 the Central Bank emphasized the need to maximize the reliability of cybersecurity in the financial system and ensure its normal functioning in emergency situations. In the reporting period the Bank developed a concept of response center to incidents of cybersecurity in the financial sector. The center aims at raising overall level of cybersecurity in Armenia's financial system, cutting the number of unwanted incidents and reducing the response time.

In 2018 the International Monetary Fund and the World Bank jointly carried out Armenia's Financial System Assessment Program. According to round-up results, the financial system was estimated as stable and highly compliant (97%) with the Basel Principles of Banking Supervision. The stability of the financial system has strengthened, and the flexibility has increased, which is a safeguard for the continued functioning of the financial system. Armenia's banking system, the report said, had been able to withstand the consequences of the 2014 economic downturn, and a handful of macroprudential measures taken came to help the system endure the crisis.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	19	17	17
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	**19**	**17**	**17**

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	7,784,157	7,523,495	9,006,500
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:			
y/y change (in %)	19.30%	-3.35%	19.71%

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	3.67	2.39	
Domestic ownership total	37.96	38.22	
Foreign ownership	62.04	61.78	
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	42.91	55.70	0.09
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**100**	**100**	

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	7.01%	8.60%	7.63%
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**7.01%**	**8.60%**	**7.63%**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
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 sector (%) (at year-end)

	2016	2017	2018
Receivables			
Financial sector	30.94	27.45	26.62
Nonfinancial sector	53.53	57.76	59.50
Government sector	10.52	10.83	10.65
Other assets	5.98	5.55	5.04
Liabilites			
Financial sector	9.35	10.74	12.21
Nonfinancial sector	40.66	44.76	41.60
Government sector	1.07	0.81	0.67
Other liabilities	33.01	29.08	31.59
Capital	**16.15**	**15.58**	**14.74**

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks	19.95%	18.60%	17.66%
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	19.95%	18.60%	17.66%

(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	2016	2017	2018
Non-financial sector, including	6.70%	5.85%	4.89%
Households	7.32%	4.79%	5.83%
Corporate	7.75%	6.26%	4.46%

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	65.24	39.10
Corporate	27.07	57.05
Government sector	0.34	0.56
Financial sector (excluding banks)	7.34	3.29
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	609,209.36	586,386.64	634,726.08
Interest expenses	376,470.89	354,249.06	363,816.47
Net interest income	232,738.47	232,137.58	270,909.61
Net fee and commission income	66,734.78	68,115.06	93,237.81
Other (not specified above) operating income (net)	20,782	15,094	-20,703
Gross income	1,515,978.42	1,554,471.88	1,160,938.53
Administration costs	109,924.56	104,535.00	121,480.80
Depreciation	23,597.71	21,845.17	22,523.94
Provisions			
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	111,419.37	89,982.58	99,985.47
Profit (loss) before tax	75,313.71	89,133.77	99,454.13
Net profit (loss)	61,832.93	69,326.69	69,275.23

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	1,352,564	1,126,062	1,306,580	180,518	
Cooperative banks					
Banking sector, total:					

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

2018 DEVELOPMENTS IN THE AUSTRIAN BANKING SYSTEM

Macroeconomic environment in the country

At the beginning of 2016, the Austrian economy embarked on a recovery. Buoyed by lively investment activity and healthy private consumption growth as a result of an income tax reform, domestic demand was the major driver of growth at first. From the second half of 2016 onward, export activity picked up markedly as global trade was recovering. The combination of strong domestic and improving foreign demand resulted in the strongest economic momentum since the boom before the onset of the global financial and economic crisis. In 2017 the Austrian economy outpaced GDP growth in the euro area for the first time since 2013, also exceeding that of Germany, Austria's most important trading partner. Although the pace of growth gradually slowed in the course of 2018, the Austrian economy expanded by 2.7% in 2018 as a whole. Thus, Austria once again grew faster than the euro area and Germany. The deceleration was attributable to weaker external activity (weaker world trade growth in the second half of 2018): the slowdown of the Chinese economy, growing economic uncertainties as a result of increased global risks (trade war and Brexit) and negative domestic special effects in Germany and in Italy.

As the economy gathered momentum in 2016, employment growth accelerated, reaching 1.9% in 2017 and 2.3% in 2018 – the highest rate since 1991. Since mid-2016, the economic upswing has been robust enough to keep unemployment firmly on a downward path even though labor supply keeps rising strongly. The jobless rate dropped from 6.2% to 4.7% in the fourth quarter of 2018. In an EU-wide comparison, Austria ranked among the Member States with the lowest unemployment rates in 2018. The Austrian labor market is characterized by a high level of flexibility (in European terms) and a balancing of interests between employers and employees. Hence, Austria is also among the best performers worldwide in rankings of alternative indicators that measure, for instance, social stability (such as the frequency of strikes).

Recording an average inflation rate of 1.8% since the introduction of the euro in 1999, Austria has been among those countries that have successfully maintained price stability in line with the Eurosystem's definition (i.e. HICP inflation at a rate "below, but close to, 2% over the medium term").

In the past few years, Austria had recorded a markedly positive inflation gap with the euro area and Germany, which, however, steadily declined over the course of 2018, shrinking to +0.4 and +0.2 percentage points, respectively, for the year as a whole. In the period from 2011 to 2017, the inflation gap between Austria on the one hand and the euro area and Germany on the other averaged 0.7 and 0.6 percentage points, respectively. This gap has been attributable primarily to comparatively stronger price growth in the domestic service sector. The reduction observed in the inflation differential observed since last year was driven by all sub-components of the HICP and also, in particular, by the reduction of VAT on overnight stays.

Development in the banking sector (including assets total / GDP)

In 2008, banks still had a market share in the Austrian financial sector of well over 80%. However, in the wake of the financial crisis, banks have shrunk their balance sheets and embarked on a consolidation path. At the end of 2018, banks made up three-quarters of the Austrian financial sector. At the same time, mutual funds and insurance companies have become more important, increasing their net asset value and total assets. In 2018, consolidation among Austrian banks continued, but their balance sheets expanded. Compared to previous years, the pace of consolidation decelerated, with the number of banks declining by 5% to 597 at the end of the year. At the same time, banks' aggregate total assets increased by 4% to EUR 986 billion (255% of GDP).

Austrian banks continued to benefit from the macroeconomic tailwinds in 2018. Their consolidated profits reached another post-crisis high at EUR 6.9 billion, which implies a substantial year on year increase of 5% and a return on assets of 0.8%, with the latter being well above the average EU level of 0.4% (Source: EBA). Austrian banks' profits continued to be supported by falling risk provisions, which reached another historical low in 2018. Having declined substantially since the height of the financial crisis, provisioning for (mostly credit) risk was cut by more than half, as credit quality continued to improve. Cyclically-induced low risk costs have supported rising profits over the last years, while operating profitability remained burdened by a high CIR.

The loan quality of the Austrian banking sector continued to improve on the back of a reduction in nonperforming loans (NPLs) and an acceleration in credit growth. The consolidated NPL ratio went down to 2.6% as of end-2018, 80 basis points below the previous year's level. Austrian banks' CESEE subsidiaries have also further improved their loan quality. Compared to the previous year, the NPL ratio dropped from 4.5% to 3.2% in 2018. At the country level, the heterogeneity is still high.

Austrian banks' capital ratios declined in 2018 due to a rise in risk- weighted assets and in the dividend payout ratio. The Austrian banking system's profit reached a post-crisis high in 2018 amid strong loan growth in both Austria and CESEE, but this also led to higher risk-weighted assets. Furthermore, banks also chose to distribute a higher proportion of their profits to their shareholders in 2018: Compared to the previous year, Austrian banks doubled their dividend payout ratio to nearly one-third. As the increase in risk-weighted assets outpaced the increase in capital, the common equity tier 1 (CET1) ratio of Austrian banks declined and stood at 15.4% at the end of 2018. The slight deterioration in Austrian banks' capitalization was consistent with developments in other European banking sectors.

Foreign currency lending has continued to decline sharply in Austria. However, a new information leaflet on foreign currency loans informs borrowers about related risks. It has been published on the joint initiative of the OeNB, the FMA and the Austrian Economic Chamber with the aim of further increasing borrowers' awareness of the risks emanating from foreign currency loans.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

The 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) the Deposit Guarantee Schemes and Investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz – ESAEG – revised in 2019).

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.

In terms of legislative activities, the following can be reported: As of 01.06.2018 the Payment Services Act 2018 Act (Zahlungsdienstegesetz 2018 – ZaDiG 2018) entered into force which is the Austrian transposition of Directive (EU) 2015/2366 (PSD II). Additionally the Austrian Banking Act (Bankwesengesetz – BWG) was amended to comply with the Joint EBA and ESMA Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2017/12), as well as the EBA Guidelines on internal governance (EBA/GL/2017/11) and also to introduce new regulations regarding ousourcing of functions of credit institutions.

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. The SSM was launched on 4. November 2014 and as of today six Austrian banking groups in total have been classified as "significant institutions" (SIs), encompassing 91 individual credit institutions that thus fall 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) as well those national credit institutions thath are not part of the SSM (non-CRR CI) continue to be supervised directly by the FMA. This means that the FMA remains directly responsible for currently 453 of Austria's credit institutions as of 12/18. Regarding LSI, the ECB only carries out indirect supervision. When supervising LSIs, the FMA bases its supervisory approach on the harmonised rules developed by the EBA as well as guidance provided by the ECB to ensure consistent SI and LSI supervision. In case of common procedures (granting and withdrawal of authorisations, qualifying holdings procedures), the decision-making competence for both SIs and LSIs lies exclusively with 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 2018

The banking supervision department of the FMA has set the following strategic objectives for the year 2018:

- The operationalisation of the Payment Services Act 2018 (Zahlungsdienstegesetz 2018 ZaDiG 2018)
- Preparation for the uniform deposit guarantee scheme and IPS deposit guarantee schemes
- Further strenghtening of IT supervision
- Operationalisation of Conduct Supervision
- Assessing of the different interests between supervision and resolution
- Identification of possibilities for increasing efficiency of internal processes and data management
- Continuing improvement of the SREP – process
- Raising understanding of the FMA's role towards ECB (DG3) and external stakeholders.

The activities of the Banking Supervisory Authority in 2018

At the start of the financial year the FMA published its priorities for supervision and on-site inspections for the first time, in its annual facts and figures, trends and strategies publication. The six priorities set for 2018 were based on in-depth analysis of the key challenges and risks facing the Austrian financial market. Based on this analysis, specific targets and measures were formulated for each priority area. The FMA's transparent presentation and explanation of these priorities, targets and measures is designed to further improve the level of understanding and acceptance of its actions amongst the general public and on the financial market in general. At the end of the financial year the FMA subsequently evaluated the measures and reviewed how effective they were and to what extent the aims associated with the priorities for supervision and inspection were met.

Strengthening the capital base of supervised companies

Implementation of the new IFRS 9 accounting standard was accompanied by in-depth analysis and an impact assessment for banks' regulatory capital. Thematic reviews were used to raise banks' awareness of main issues and thus to contribute to highquality implementation. The FMA used far-reaching official and communicative measures to make the granting of real estate loans by banks more sustainable. At the same time, macroprudential tools were designed and implemented in the Banking Act to be in a position to cope with any potential bubble on the residential real estate market.

Long-term stability through sustainable real estate lending

The FMA uses regular reporting data on real estate lending to monitor growth rates and loan volumes. Additionally, the FMA, OeNB and the Austrian Financial Market Stability Board (FMSB) conduct targeted surveys to regularly assess lending standards in relation to new loans. To this end, regular reporting will also be adapted to include lending criteria such as loan-to-value ratios, debt service-to-income ratios, debt ratios and maturities of residential property loans in future. In 2018 the FMA clearly communicated its expectations to banks and the general public, stating that it would not accept lower lending standards, especially during periods when the economy is performing well. The FMA's priority for supervision proved its worth later in the year. Several banks that had experienced a very dynamic development in new lending business have taken heed of those expectations and changed their internal risk management accordingly, tightening up their lending standards once again. The FMA will continue to monitor developments in real estate financing. At its meeting on 21 September 2018, the FMSB asserted that there was currently no systemic risk associated with the financing of private residential property. Nevertheless the Board emphasised that any lending must be sustainable, ensuring appropriate amounts of own funds, an appropriate level of debt repayment in relation to net income, and appropriate loan terms. Should real estate risks increase, however, and pose a potential threat to financial market stability, the FMA could – based on a recommendation by the FMSB – set upper limits for those lending criteria in the form of a regulation. One of the FMA's priorities for supervision in 2019 (continuing in 2020) is the sustainable real estate lending. The Authority will conduct targeted on-site inspections, and also keep up its direct dialogue with credit institutions e.g., in the form of management talks.

Optimising internal control systems and governance structures

With a package of measures (comprising guidelines, increased on-site presence, and dedicated workshops and conferences) transparent and uniform supervisory requirements in relation to IT security were established, and their implementation has begun. The FMA governance focus has been implemented through circulars and also through consistent fit and proper tests of key function holders. With regard to banks, compliance with European standards and EBA rules in particular was achieved. Quality improvements can already be observec in the control bodies of credit institutions. The issue of outsourcing was focused on banking funtions on the basis of the new statutory rules. All existing outsourcing arrangements in banks were surveyed and the statutory requirements taken up in the SREP questionnaires, that form the basis of the annual SREP assesments.

Improving crisis management

The resolvability of banks was improved and will be further developed over the coming years as part of an integrated process of the FMA as supervisory and resolution authority. Banks' compliance with disclosure and information requirements when selling bail-in able securities to retail customers was the subject of an integrated analysis and review. Alongside investor protection, good conduct in relation to the sale of such instruments is a prerequisite for the practical viability of a bail-in should a crisis occur. The close involvement of the supervisors in the creation of the new deposit insurance scheme had a stabilising impact for the protection of savers while also boosting confidence in the financial market.

Enhancing collective consumer protection

The supervised entities' compliance with the rules of conduct on product transparency, customer information, complaints-handling and sales requirements was further improved. In particular, adherence by the supervised companies to the new provisions of the PRIIPs KID[1] was guaranteed by ongoing KID monitoring. Close cooperation with the supervised entities in this newly regulated area also helped to strengthen legal security. The increased density of information on the basis of new statutory rules and the setting of uniform product governance standards were implemented. By engaging in comprehensive communication measures, the FMA took part in dialogue forums and events to provide supervised entities with transparent information on its expectations and to ensure a strong preventive effect.

[1] Packaged Retail Insurance Investment Product; Key Information Document.

Increasing and broadening efforts for preventing money laundering

Focused on-site measures in Austria and abroad achieved specific improvements in group management in the supervised companies. On-site inspections were another key element as weaknesses in Austrian banks' existing video identification processes were eliminated and higher standards established, particularly in relation to the outsourcing of these services. With regard to the prevention of terrorist financing, both intensive dialogue with the sector as well as on-site inspections were used to raise awareness among the institutions concerned.

Using digitalisation opportunities and managing its risks

The FMAs FinTech point of contact has continued to make a name for itself as a one-stop shop for regulatory issues around innovative, digital business models on the Austrian market. The current state of digitalisation and business models on the Austrian financial market was reviewed and analysed as part of the digitalisation project, helping to identify the implications for the FMA's supervision strategy.

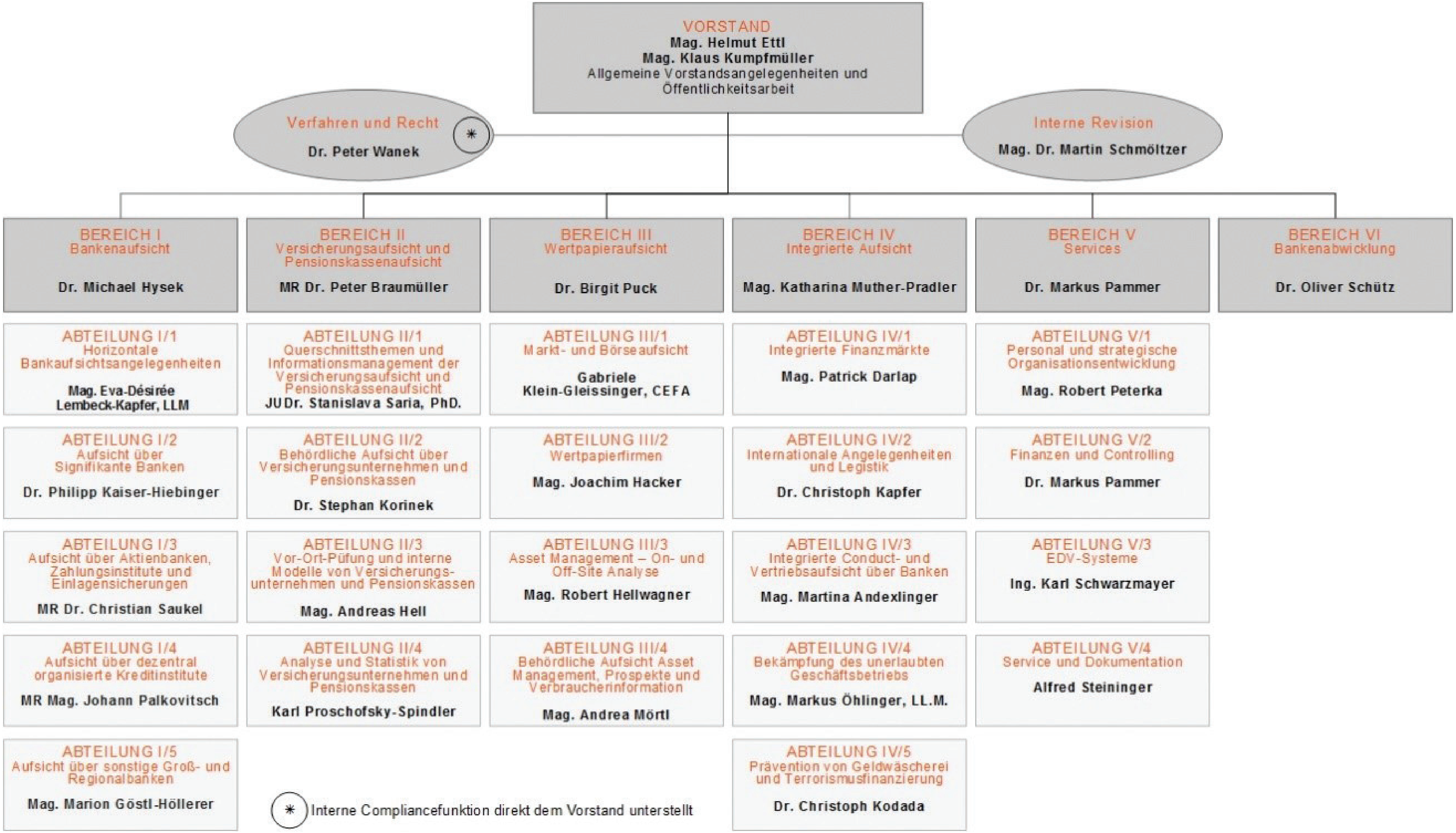
Transition of the new Austrian guarantee scheme

The Austrian deposit guarantee scheme was fundamentally restructured. With effect from 1 January 2019, Einlagensicherung AUSTRIA Ges.m.b.H. (ESA) replaces the four deposit guarantee schemes that had previously been provided by the relevant trade associations (Einlagensicherung der Banken & Bankiers Gesellschaft mbH, Österreichische Raiffeisen-Einlagensicherung eGen., Volksbank Einlagensicherung eG and Hypo-Haftungs Gesellschaft mbH) and forms one single DGS. In addition, the Sparkassen sector has its own DGS following recognition of its institutional protection scheme (IPS), Sparkassen-Haftungs GmbH, as a deposit guarantee and investor compensation scheme. There are therefore now two DGS in Austria. The changes were effected in accordance with the Deposit Guarantee Schemes and Investor Compensation Act (ESAEG; Einlagensicherungs- und Anlegerentschädigungsgesetz), which transposed the European DGS Directive of 2014 into Austrian law in 2015.

The transition period to establish the new deposit guarantee scheme started in mid-August 2015 and spanned nearly three and a half years. Throughout this period, the FMA, in the capacity of competent supervisory authority, worked closely with the deposit guarantee facilities, assisting them and monitoring the whole process of realignment. The year 2018 brought particular challenges, both for the deposit guarantee facilities and for the supervisor. Major focus areas were the operational merger of the four different sector-specific schemes into ESA as well as the recognition of the Sparkassen IPS as a DGS and the movement from an ex post financed system to an ex ante system. To ensure the proper functioning of the new deposit guarantee scheme, the FMA introduced several supervisory measures. These ranged from management talks to requiring the deposit guarantee facilities to regularly submit status and implementation reports to the FMA. The supervisory activities were supplemented by on-site inspections and analysis work carried out by the OeNB. In this way the FMA was at all times able to monitor that the merger was progressing as intended. During the merger process the FMA put particularl focus on data quality and the compatibility of internal systems and processes. High data quality, as well as robust and adequate processes and internal systems, guarantee that the DGS will function properly in the event of a pay-out becoming necessary. Through its measures, the FMA ensured that the transition from the old to the new DGS was smooth and successful. Depositors can rely on their deposits being covered in a pay-out event to the extent provided by law, and know that they will be reimbursed within the legally stipulated deadlines. The deposit guarantee facilities, in turn, have installed the necessary internal processes and systems to enable them to fulfil their legal remit of proper investor compensation.

Organizational chart of the Banking Supervisory Authority

The FMA is organized as follows:



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 the country

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*) was 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 is mandated to act on a possible threatening of the Austrian financial stability amongst others with warnings and recommendations.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	176	169	160
Branches of foreign credit institutions	28	26	25
Cooperative banks	468	433	412
Banking sector, total:	672	628	597

Source: OeNB, unconsolidated data

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	525.5	506.5	524.4
Branches of foreign credit institutions	16.8	21.7	22.8
Cooperative banks	290.0	287.1	307.2
Banking sector, total:	832.3	815.3	854.6
y/y change (in %)	-3.1%	-2.1%	+4.8%

Source: OeNB, unconsolidated data in EUR bn

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	7.5	4.8	4.8
Domestic ownership total	73.8	74.0	75.6
Foreign ownership	26.2	26.0	24.4
Banking sector, total:	**100.0**	**100.0**	**100.0**

Source: OeNB, unconsolidated data.

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	37.9	48.6	675
Branches of foreign credit institutions	58.0	71.8	1,628
Cooperative banks	41.0	49.1	711
Banking sector, total:	26.7	35.0	347

Source: OeNB, unconsolidated data.

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	9.4	7.3	7.2
Cooperative banks	3.9	7.7	9.0
Banking sector, total:	6.9	7.5	8.4

Source: OeNB, unconsolidated data.

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	63.1	62.2	61.4
Branches of foreign credit institutions	2.0	2.7	2.7
Cooperative banks	34.9	35.2	35.9
Banking sector, total:	**100.0**	**100.0**	**100.0**

Source: OeNB, unconsolidated data.

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks	18.5***	18.7***	18.7***
Cooperative banks	17.9***	18.1***	18.4***
Banking sector, total:	18.2***	18.4***	18.6***

(Please, mark for each item: * – for Basel I; ** – for Basel II; *** – for Basel III)
Source: OeNB, consolidated data.

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

Asset classification	2016	2017	2018
Non-financial sector, including			
Households	5.7	3.8	3.5
Corporate	7.2	5.3	3.7

Source: OeNB, consolidated data.

The structure of deposits and loans of the banking sector in 2018 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	69.6	45.4
Corporate	18.3	43.1
Government sector	5.9	7.3
Financial sector (excluding banks)	6.2	4.1
Total	**100.0**	**100.0**

Source: OeNB, unconsolidated data; only domestic business

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

P&L account	2016	2017	2018
Interest income	15.4	13.8	15.1
Interest expenses	6.9	5.6	6.5
Net interest income	8.5	8.2	8.6
Net fee and commission income	3.9	4.4	4.6
Other (not specified above) operating income (net)	6.6	6.9	6.9
Gross income	19.0	19.5	19.4
Administration costs	11.4	10.7	11.2
Depreciation	1.0	0.9	0.9
Provisions	0.1	0.9	0.3
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	5.1	5.7	6.6
Net profit (loss)	4.4	4.9	5.7

Source: OeNB, unconsolidated data in EUR bn.

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	(Add.) Tier 1	Tier 2	Tier 3
Commercial banks	48.8***	40.1***	1.6***	7.2***	n.a.
Cooperative banks	37.7***	31.6***	1.4***	4.7***	n.a.
Banking sector, total:	86.5***	71.7***	3.0***	11.9***	n.a.

(Please, mark for each item: * – for Basel I; ** – for Basel II; *** – for Basel III)
Source: OeNB, consolidated data in EUR bn.

2018 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF BELARUS

Macroeconomic conditions

In 2018, the economy of the Republic of Belarus was functioning under the conditions of recovering external economic environment. The volume of GDP amounted in 2018 to BYN121.6 billion and increased in comparable prices versus 2017 by 3.0% (in 2017, a decrease by 2.4%).

As of January 1, 2019, the banks' assets (liabilities)/GDP ratio totaled 60.6% (63.1% as of January 1, 2018). Regulatory capital/GDP ratio stood at 8.8% as of January 1, 2019.

Development of the banking sector

As of January 1, 2019, 24 banks and 3 non-bank financial institutions were carrying out the banking activities in the Republic of Belarus. 4 banks underwent bankruptcy or 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 4.1% in 2018, amounting to 3,467 as of January 1, 2019. Foreign banks ran 5 representative offices in the territory of the country.

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

As of January 1, 2019, the share of foreign investments in the total volume of registered authorized capital of Belarusian banks stood at 19.1%. As of January 1, 2019, the state share in the banks' authorized capital was 80.9% of the banking sector's aggregate authorized capital.

The total registered charter capital as of January 1, 2019 amounted to BYN5.5 billion, an increase by 5.2% in 2018.

In 2018, the National Bank of the Republic of Belarus focused its work on secure and sustainable functioning of the banking sector.

As of January 1, 2019, banks' regulatory capital totaled BYN10, 673.3 million, a 820, 2 million increase, or 8.3%, increase in nominal term over 2018. The main volume of the banking sector's capital was concentrated in five core banks – 71.5%.

Assets (liabilities) of banks reached BYN73, 661.5 million as at January 1, 2019, a 10.7% increase over January-December 2018.

The profit received by banks in 2018 amounted to BYN1096.3 million, a 23.6% increase in the nominal terms compared to 2017. Such increase in the profit of operating banks is mainly due to the decrease in net deductions to reserves in 2018 (in comparison with the 2017, the decrease in deductions amounted to 18.6%), which is associated with the slowing down of the tendency towards deterioration of the banks' assets quality.

The banking sector's return on assets totaled 1.6% (1.4% as of January 1, 2017); the return on regulatory capital was 10.7 % (9.6 % as of January 1, 2017).

The legal and institutional framework of the operation and supervision of financial institutions, new developments

Throughout 2018, 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.

Since January 2016, calculation of the regulatory capital of the banks, non-bank finance institutions (hereinafter – NBFI), and JSC "Development Bank of the Republic of Belarus", has been carried out according to the Basel III. Since January 1, 2018, a countercyclical buffer and a buffer of systemic significance were established, serving as supplements to the value of the Tier I regulatory capital ratio, as well as the procedures for classifying banks as systemically important were introduced.

Countercyclical buffer was established for the banks and the JSC "Development Bank of the Republic of Belarus", because they carry out credit operations. The value of the countercyclical buffer is established by the National Bank within the range of 0-2.5 percentage points depending on the value of the credit gap according to the methods of calculations based on the recommendations of the Basel committee. As at April 1, 2019, the value of the countercyclical buffer was established in the amount of 0 percentage points.

The value of the capital conservation buffer (was introduced stage by stage since January 1, 2016) totaled 2.5 percentage points.

The value of the systemic importance buffer amounted to:

- 1.5 percentage points – banks and NBFI classified as systemically important, NBFI of the systemic importance group I;
- 1 percentage point – banks and NBFI classified as systemically important, NBFI of the systemic importance group II.

With the purpose of improving the supervisory requirements and supervisory procedures, since April 1, 2018, the common requirements to the organization of the internal procedures for capital adequacy and risk-management review have been established for banks and JSC "Development Bank of the Republic of Belarus", that include the definition of aims and main principles of the internal procedures for capital adequacy organization.

Besides, the elements of the internal procedures for capital adequacy review were established, which include the identification of significant risks, procedures for calculation of the available and economic capital, establishment of the minimal requirements to the methods of conducting internal capital review, including definitions of the total value of risks assumed by banks, evaluation of the unexpected losses in case of non-standard (crisis) situation and calculation of the need in capital for their adequate coverage, usage of the economic capital, establishment and control of limits, generation of management accounting.

The concept of economic and available capital was introduced. The review of the capital adequacy is implemented by means of comparison of the economic and available capital values of a bank or JSC "Development Bank of the Republic of Belarus", which makes it possible to define the necessity to increase the amount of the available capital of a bank and (or) regulation of the amount of the assumed risks for ensuring secure activities of banks, JSC "Development Bank of the Republic of Belarus". The National bank defined the sources of generating available capital, approaches to the methods of the economic capital calculation that banks and JSC "Development Bank of the Republic of Belarus" can use in calculation of its amount. With that, the banks, JSC "Development Bank of the Republic of Belarus" are entitled to choosing on their own: whether to use the methods suggested by the National Bank for calculation of the economic capital, or to use their own qualitative models of the economic capital calculation (on condition that they meet the main requirements of the regulator). The requirements were set for planning of the capital amount and its allocation via the system of limits under the types of risks, business lines (structural units executing functions associated with assuming risks), as well as under implementation of control over the established limits compliance, establishment of the performance benchmarks and their thresholds.

In 2018, the possibility of application of a motivated judgment in the National Bank was enshrined with regards to assigning audits of banks, NBFI, JSC "Development Bank of the Republic of Belarus", carried out inter alia on the consolidated basis, when admitting persons connected to banks, admitting the influence of a bank and (or) the persons connected to it as a significant one for the purpose of defining the possibility of person's ability to have a position of an independent director. Also, the case of applying motivated judgment towards JSC "Development Bank of the Republic of Belarus" were specified.

Since January 1, 2018, the indicators of the Basel III liquidity have been introduced as secure functioning ratios, with establishing minimum values of liquidity coverage (LCR) and net stable funding (NSFR) in the amount of 100 percent, as well as requirements for reporting on implementation thereof and analytical information on the instruments of liquidity risk monitoring.

In addition to Basel standard on the calculation of foreign currency LCR with a breakdown by significant foreign currencies, a requirement to the calculation of this indicator in the aggregate for all types of foreign exchange was specified.

Since January 1, 2019, the method of calculating indicators characterizing the state of liquidity has been improved:

- on letters of credit and bank guarantees, the percentage of outflow of funds in the calculation of LCR is reduced, as well as the percentage of required funding in the calculation of NSFR;
- the composition of highly liquid assets in the calculation of LCR was clarified;
- accounting of requirements and obligations for repo transactions when calculating LCR were specified;
- accounting of pledged securities when calculating LCR was clarified;
- accounting of liabilities with a maturity of more than 30 days when calculating LCR was clarified;
- calculation of stable and unstable funds of individuals and independent entrepreneurs in the calculation of LCR was simplified;
- deduction of the special provision and amortization amounts from the required funding in calculating NSFR was envisaged.

Also, since January 1, 2019, the practice of providing subordinated loans (loans) has been improved:

- the maximum allowable rate was reduced with regard to subordinated loans (loans) in hard currency with LIBOR on 12-month interbank deposits in the relevant foreign currency plus 6% per annum to the similar LIBOR rate plus 4% per annum;
- the possibility of granting a subordinated loan (loan) exclusively in Belarusian rubles to a legal entity- resident of the Republic of Belarus (including banks);
- the possibility of termination of obligations on a subordinated loan (loan) as a result of the replacement of the currency of the loan (loan) is excluded.

Since March 1, 2019, approaches to determining credit risk have been changed in order to gradually bring them in line with the Basel III standard. In particular, the list of international financial organizations and development banks for which a zero risk level is established was expanded, risk levels for requirements to other international development banks were established, risk levels for requirements to banks were reduced, risk levels for requirements for SME were reduced, risk level on speculative shares not admitted to circulation at the stock exchange was increased up to 400%.

In addition, approaches to limiting the credit risk of loans issued at excessively high interest rates have been changed. Loans to legal entities (individuals), the rate for which is higher than the estimated standard risk on such loans determined by the National Bank, when forming special provisions for covering possible losses on assets and operations not reflected on the balance sheet, are included in the special portfolio of homogeneous loans (20% of provisions) and the amount of credit risk is taken into account to determine the adequacy of regulatory capital with the risk level of 500%.

Since July 1, 2019, when forming special provisions, of financial instability of the debtor or counterparty for contingent liabilities has to include data on whether the borrower has an overdue debt of more than 7 days to other banks of the Republic of Belarus, JSC "Development Bank of the Republic of Belarus", classified in IV-VI credit risk groups.

Besides, for the reason of the National Bank's special attention to the issues of the organization and improvement of banks', non-bank finance institutions' and JSC "Development Bank of the Republic of Belarus" work with non-performing loans, as well as indebtedness written off for the off-balance sheet, in the year under review the recommendations to work with the non-performing assets based on the best foreign practices with account of the Belarusian legislation peculiarities and expectations of the National Bank were submitted to the mentioned stakeholders.

The threshold value of the indicator of the share of non-performing assets of banks in assets subject to credit risk has been determined at the level of no more than 10 percent; monthly monitoring of the indicator value is envisaged. Exceeding the threshold value will indicate an increase in problems of banks and will give the National Bank a timely signal that immediate action should be taken.

With the aim of improving the risks management under the conditions of modern vectors and technologies development in the banking activities connected with digitalization, the cyber risk was added to the list of the main types of operational risks, its definition was given and the sources of occurrence were specified. All requirements applicable to the organization of the risk management system, including responsibility of the governing bodies of a bank, non-bank finance institutions and JSC "Development Bank of the Republic of Belarus", definition of tolerance for risk, development of the local legal acts, implementation of the risk management process, conduct of stress-testing, compilation and submission of the management reporting and other elements of the system are valid for the cyber risk.

The work aimed at introduction of international standards of corporate governance is continued.

Since April 1, 2018, requirements for organizing corporate governance were completed with the minimum requirements to organizing a system of fees and compensation in banks, the Development Bank and non-bank financial institutions, as well as approaches to their function, based on international standards.

The established minimum standard provides for:

- the establishment of the remunerations committee in banks, classified as systemically important according to the National Bank's requirements, and JSC "Development Bank of the Republic of Belarus";
- determination of the amount of remuneration and compensation based on the performance of the bank, NBFI, OJSC Development Bank of the Republic of Belarus, as well as risks assumed by the employee and (or) bank, NBFI, OJSC Development Bank of the Republic of Belarus;

- enshrining approaches to organizing the system of remuneration and compensation in the constituent documents and (or) local legal acts of the bank, the NBFI, OJSC Development Bank of the Republic of Belarus, approved by the board of directors and (or) the general meeting of shareholders, including all forms of remuneration used and types of payments to employees;
- establishing a list of employees who make decisions on the implementation of operations and other transactions, the results of which can significantly affect the level of risks taken by the bank, the NBFI, OJSC Development Bank of the Republic of Belarus, and the requirements for the procedure of paying remunerations and compensations to them;
- the main criteria for the effectiveness of the remuneration and compensation system.

Requirements are designed to ensure that banks, NBFI, Development Bank of Belarus JSC develop the rules for encouraging employees to work based on the effectiveness of their activities, taking into account the risks taken, and to ensure a uniform understanding of good practice in encouraging banking sector employees among the banking community and third parties.

In order to improve supervisory procedures in January 2019:

- the National Bank clarified the process of conducting a general supervisory review (Supervisory review and evaluation process – SREP), which includes an assessment of the business model, corporate governance, capital adequacy, bank liquidity, NBFI, Development Bank of Belarus, definition of a plan of supervisory actions based on general supervisory review;
- updated approaches to the implementation by the National Bank of banking supervision functions using the early warning system, which is a set of quantitative and qualitative indicators (early warning indicators) aimed at identifying problems in the bank's activities, the NBFI, Development Bank of Belarus at an early stage, and actions to prevent these problems at an early stage, were introduced.

In 2019, the following initiatives are planned:

- introduction of an updated standardized approach to calculating the value of operational risk;
- sending recommendations on cyber risk management;
- conducting an audit of information technologies and sending recommendations to banks following its results;
- updating the requirements for calculating the interest rate risk of the banking portfolio in accordance with the latest recommendations of the Basel Committee on Banking Supervision;
- determination of approaches to the internal procedure for assessing liquidity by the bank;
- improving the process of banking supervision, the adjustment of the supervisory cycle;
- improving the regulation of auditing activities;
- update the requirements for disclosure by banks of information about their activities;
- determination of the settlement of problem banks (Bank Resolution).

In 2018, as part of the improvement of the system for preventing the legalization of proceeds from crime, financing terrorist activities and financing the proliferation of weapons of mass destruction (hereinafter –"preventing the legalization of proceeds from crime"), the work on the implementation of FATF international standards[1] in the legislation of the Republic of Belarus was continued.

Resolution of the Board of the National Bank of the Republic of Belarus No. 62 "On Amending and Modifying Resolution of the Board of the National Bank of the Republic of Belarus No. 818 dated December 24, 2018" dated February 15, 2018 establishes requirements to banks, non-bank financial institutions, and the JSC

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

"Development Bank of the Republic of Belarus" with respect to organization of the system of internal control over financial transactions of the clients associated with the movement of funds on their accounts in connection with the purchase and (or) alienation of the digital units (tokens), as well as the obligation to conduct self-assessment of the risk to be involved into the clients' operations associated with money laundering and terrorism financing under the established main indicators (coefficients) of involvement. Resolution of the Board of the National Bank of the Republic of Belarus No.18 "On Amending and Modifying Resolution of the Board of the National Bank of the Republic of Belarus No. 24 dated January 18, 2017" dated January 19, 2018 made it necessary to submit the given indicators (coefficients) to the National Bank of the Republic of Belarus. The given indicators (coefficients) are used for exercising the off-site control over the activities of banks in terms of their compliance with legislation on combating money laundering and terrorism financing, and financing the proliferation of weapons of mass destruction, analyzing the banks' involvement into the conduct of suspicious financial operations, and choosing an object for the off-site inspections.

Legal competence 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;
- off-site supervision of banks, non-bank financial institutions 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, non-bank financial institutions;
- 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 2018

In 2018, the activities of the National Bank in the framework of conducting off-site supervision of banks (banking holdings), non-bank financial institutions and the Development Bank were aimed at ensuring their sustainable and secure functioning, protecting the interests of depositors and other creditors, including by taking timely supervisory response measures, minimizing risks accepted by banks and increasing the efficiency of their activities, as well as preventing the bankruptcy of the banking sector's participants.

The activities of the banking supervisory authority in 2018

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

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

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

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

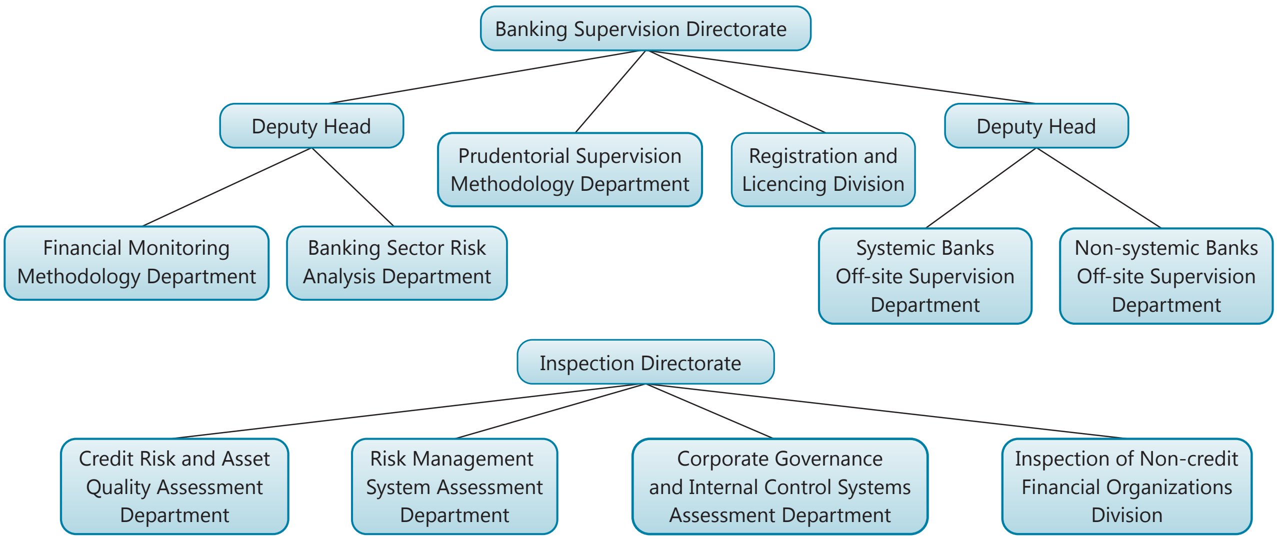
The National Bank issued permits for the participation of banks in the authorized funds of other legal persons, taking into account the assessment of the efficiency and expediency of such investments.

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

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

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

Organizational chart of the banking supervisory authority



International cooperation

As of January 1, 2019, 18 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 closer 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 2018, the meetings of the senior managers of the National Bank and the central (national) banks of neighboring countries, CIS member states, several states of Europe, Asia and the Middle East were held. A Memorandum of Understanding between the National Bank of the Republic of Belarus and the National Bank of Georgia in the Field of Banking Supervision and Memorandum of Understanding between the National Bank of the Republic of Belarus and the Central Bank of the United Arab Emirates were signed within the framework of the development of the legal framework for bilateral international cooperation.

Cooperation with other supervisory bodies

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 (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	24	24	24
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	24	24	24

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	100.0	100.0	100.0
y/y change (in %)	2.3	3.4	10.5

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	66.7	65.2	64.9
Domestic ownership total	69.3	68.1	67.8
Foreign ownership	30.7	31.9	32.2
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	63.2	75.3	0.22
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**0.22**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	10.78	9.55	10.72
Cooperative banks	-	-	-
Banking sector, total:	10.78	9.55	10.72

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
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 sector (%) (at year-end)

	2016	2017	2018
Receivables	100.0	100.0	100.0
Financial sector	2.1	2.6	1.9
Nonfinancial sector	62.5	64.9	67.2
Government sector	26.8	25.0	21.9
Other assets	8.7	7.5	9.0
Liabilities	100.0	100.0	100.0
Financial sector	2.7	2.6	2.0
Nonfinancial sector	50.5	56.4	54.4
Government sector	10.5	8.2	8.9
Other liabilities	36.3	32.8	34.7
Capital	13.4	14.4	14.4

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks	18.6%***	18.5%***	17.7***
Cooperative banks	-	-	-
Banking sector, total:	18.6%***	18.5%***	17.7***

(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	2016	2017	2018[2]
Non-financial sector, including	14.72%	14.54%	5.01%
Households	0.79%	0.53%	0.09%
Corporate	18.30%	18.91%	4.92%

[2] Since April 1, 2018, the classification of assets exposed to the credit risk has been implemented according to the six groups of risk. Also the concept "non-performing assets" was introduced. The non-performing assets of the acting banks are equal to the assets classified under V and VI risk groups, as well as the restructured indebtedness classified as IV-VI risk groups.

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	86.0	57.9
Households	59.1	26.3
Corporate	26.8	31,6
Government sector	9.8	37.4
Financial sector (excluding banks)	4.3	4.7
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	3,378.7	2,213.1	1,928.6
Interest expenses	1,856.5	933,8	761,6
Net interest income	1,522.2	1,279,3	1,167.0
Net fee and commission income	416.5	400.4	452.9
Other (not specified above) operating income (net)			
Gross income	12,213.7	7,570.9	6,740.9
Administration costs			
Depreciation			
Provisions	660.6	495.3	383.9
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)			
Profit (loss) before tax	505.1	460.9	536.1
Net profit (loss)	432.7	376.5	443.0

Total own funds in 2018 (in million EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	4315,2***	3308,4***	3309,7***	1005,6***	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**4315,2*** **	**3308,4*** **	**3309,7*** **	**1005,6*** **	-

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

2018 DEVELOPMENTS IN THE BANKING SYSTEM OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

Macroeconomic conditions

According to the official projections of the International Monetary Fund[1], nominal Gross Domestic Product (GDP) in BiH amounts to BAM 32,954 billion for 2018 which presents an increase of 5.0% compared to 2017. The projected rate of the real GDP growth for the previous year is 3.2%. According to data from the Agency for Statistics of BiH (BHAS)[2] the real GDP in the first three quarters of 2018 recorded a more excessive growth rates (3.5%) compared to the same period of 2017.

The rise of the real gross value added has generated due to the expansion of the most economic activities, wherein the bearer of growth is the service sector and downturn is recorded in production. In the fourth quarter of 2018, for the first time an annual decline in industrial production has recorded. With this quarterly development, the volume of industrial production in 2018 is up only by 1.6%, which is by 1.5 percentage points lower compared to 2017. Consumer prices continued rising, resulting in 2018 with the growth of annual inflation rate of 1.4%.[3]

In 2018 the banking sector of BiH is well-capitalised, liquid and profitable. The balance-sheet of the banking sector of the BiH recorded a continuous growth over the year and reached the amount of BAM 30.96 billion at the end of December 2018, which presents the greatest annual growth (9.7%) since 2007. As in previous year, the greatest impact on the growth of the bank's balance-sheet had a growth of domestic resident sector deposits, although non-resident deposits significantly increased. Due to the moderate growth of credit activities, an increase of liquid assets items was recorded, amount of funds at reserve account with the CBBH and deposits with foreign banks, while portion of funds has transferred to securities investment. Loans approved, as the most important assets item of the commercial banks increased by 5.8% at the annual level, where the most expressive increase (7.3%) has recorded with the retail sector. In 2018, the banking sector of BiH, whose operations are under jurisdiction of the entity's banking agencies, made a net profit in the amount of BAM 342.1 million. Over the last three years, the banking sector of BiH has rather stable return on assets and capital.[4]

Development in the banking sector (including the assets total / GDP)

As of 31.12.2018, 15 commercial banks operated in the FBiH, with 549 organisational units in which 6 739 persons were employed. The positive trends continued in the FBiH banking sector operations, reflected in the growth of assets, cash funds and deposits. The share of NPLs as the key credit quality indicator maintained a downward trend. The upward trend continued with the total deposits and savings deposits, which present the most significnat and the largest segment of the deposit and financial potential of the banks. As of 31.12.2018 the banks in the FBiH achieved positive financial results. Banking sector of the FBiH is stable, adequately capitalised, liquid and profitable.

The total net assets of the banking sector in the FBiH amount to BAM 22.1 billion, rising by BAM 1.9 billion or 9.3% compared to the end of 2017. The share of the total banking sector assets amounted to 1.04 of the projected FBiH's GDP.

[1] MMF, World Economic Outlook, October 2018
[2] Gross Domestic Product – quarterly data, January 2019
[3] Central Bank of BiH, Annual Report 2018, May 2019
[4] Central Bank of BiH, Annual Report 2018, May 2019

Loans in the banking sector of the FBiH, with a share of 64.8% in the structure of total assets, recorded an increase in the amount of BAM 1.1 billion or 8.7% compared to the end of the previous year, thus amount to BAM 14.3 billion as of 31.12.2018.

Loans approved to legal entities recorded an increase of BAM 651.5 million or 9.6%, amounting to BAM 7.5 billion as of 31.12.2018, with a share of 52.2% in the total loans. Over the same period, retail loans recorded an increase in the amount of BAM 495.3 million or 7.8% with a share of 47.8 in the total loans, and amount to BAM 6.8 billion as of 31.12.2018. The share of NPLs reduced from 9.7% to 8.5%, mainly as the result of credit growth and activities on collection. The share of corporate NPLs is 10.6% of the total corporate loans, and the share of retail NPLs is 6.2% of the total retail loans. Cash funds amount to BAM 6.6 billion or 29.8% of the total assets, rising by BAM 0.8 billion or 13.7% compared to the end of 2017.

Deposits of the banking sector of the FBiH reached the amount of BAM 17.6 billion, having recorded an increase in the amount of BAM 1.8 billion or 11.3% and they remain the most significant source of funding, with a 79.7% share in the total liabilities. Savings deposits, as the most significant and the largest segment of the deposit and financial potential of banks, increased by BAM 553.8 million or 6.7%, amounting to BAM 8.8 billion.

As of 31.12.2018, total capital amounts to BAM 3 billion (shareholders' equity amounts to BAM 1.3 billion) recording a growth of 6.0% compared to 2017. As of 31.12.2018 a regulatory capital ratio of the banking sector in the FBiH amounts to 17.5% and is higher than the minimum capital requirement of 12%. It is by 2.0 percentage points higher compared to the end of 2017, as a result of changed regulatory framework, business result of the banks and other adjustemnets related to IFRS application. At the level of the banking sector of the FBiH other capital ratios are also reported to be higher against minimum capital requirement (Common Equity Tier 1 Capital Ratio and Tier 1 capital). As of 31.12.2018, the financial leverage ratio of the FBiH banking sector amounts to 10.1% (statutory minimum 6%).

As of 31.12.2018, according to the final non-revised reporting data from banks, at the level of a banking sector in the FBiH a positive financial result – profit in the amount of BAM 255.4 million was recorded, which is rise by BAM 15.4 million or 6.4% compared to the end of the previous year.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

A Prudent Regulatory Framework issued by the FBA (changes in 2018):

In the process of the FBA regulatory activities related to preparation of regulations, the following decisions were adopted in 2018:

- FBA Decisions, Instructions and Guidelines related to the operations and supervision of the banks:
  - Decision on Reports Banks Submit to the Banking Agency of the Federation of BiH[5];
  - Decision on the Fee Tariff for banks[6];
  - Decision on criteria for inclusion of formed loan loss reserves into Common Equity Tier 1[7];

[5] Official Gazette of the FBiH", no. 103/17, 31/18 and 103/18
[6] Official Gazette of the FBiH", no. 46/18
[7] Official Gazette of the FBiH", no. 91/18

- Decision on Minimum Standards for Currency Exchange Operations[8];
- Instruction for completing reporting templates for liquidity coverage;
- Guidelines for external auditors of the information system;
- Instructions for completing reports on the volume of exchange operations, internal and external payment operations;

• FBA Decisions related to bank resolution[9]

- Decision on resolvability assessment of bank and banking group;
- Decision on business reorganisation plans for a bank;
- Decision on conditions and manner for conducting independent valuation of assets and liabilities of the bank before and during resolution proceedings of the bank
- Decision on sale of shares, assets, rights, and liabilities of bank in resolution;
- Decision on data and information bank submits to the banking agency of the federation of Bosnia and Herzegovina for the purpose of drawing and updating of the bank resolution plan;
- Decision on establishment, conditions, and manner of issuance consent for asset management company;
- Decision on procedure and manner of performing write down or conversion of capital instruments and liabilities of a bank;
- Decision on establishing a bridge bank;
- Decision on types of financial collateral arrangements and financial instruments to which protective measures for counterparties shall apply;
- Decision on minimum requirements for own funds and eligible liabilities of banks; as well as
- instruction on the manner of compiling reports bank submits for the purpose of drawing resolution plan;

• General FBA Decisions and Rulebook related to the work of the Ombudsmen for banking system of the FBiH

- Decision on conditions and manner of handling guarantor's claim to be released from in guarantor's obligation[10];
- Rulebook on Ombudsmen for banking system of the Federation of Bosnia and Herzegovina[11].

B Legal competences of the FBA:

Pursuant to the Law on the Banking Agency of the Federation of BiH, the competences of the FBA are the following:

- identifying and performing activities and measures to maintain and strengthen the banking system stability,
- establishing, enforcing and supervising a prudential rules regulating the operations of the banking system entities (banks, banking groups, development banks, microcredit organisations, leasing companies, factoring companies, exchange offices and other financial organisations which operates under FBA supervision according to the law),
- issuing and revoking licenses and other relevant acts to the banking system entities when authorized to do so by special regulations,
- supervising operations of the banking system entities when authorized to do so by special regulations,

[8] Official Gazette of the FBiH", no. 95/13, 99/13 and 103/18
[9] Official Gazette of the FBiH", no. 26/18
[10] Official Gazette of the FBiH", no. 31/18
[11] Official Gazette of the FBiH " no. 46/18

- supervising operations of the development bank, ordering supervision measures and other competences under regulation governing operations of the development bank and this Law,
- ordering supervision measures and other competences when authorized to do so by special regulations,
- adopting acts regulating operations of the FBA,
- adopting acts regulating operations of the banking system entities,
- adopting acts, supervising and undertaking the necessary measures related to anti-money laundering and terrorist financing that apply to the banking system entities in cooperation with the competent authorities and institutions in the field of anti-money laundering and terrorist financing under regulations governing anti-money laundering and terrorist financing,
- adopting acts and performing activities to protect the rights and interests of users of financial services in the banking system, performing supervision of implementation of regulations from this field and undertaking other activities and relevant measures within the scope of its authorities,
- Adopting and updating the resolution plan, establishing eligibility for initiation of bank resolution proceedings, conducting resolution proceedings, deciding on tools and measures to undertake in resolution and performing other activities relating to resolution under the law regulating banks.

Main strategic objectives of the supervisory authority in 2018.

The main strategic objectives of the FBA were focused on preserving the stability of the banking system entities and their further enhancement and develeopment through:

- Continuation of activities on creation of the regulatory framework in line with the EU's regulatory framework, as a step of the BiH preparations on the accession path to the European Union;
- Control of the dominant operational risks segments, control over the banks of systemically importance for development of credit activities, control of the applicable practices in the banks in the segment of protection of users of financial services and gurantors etc;
- Continuation of activities with the objective to implement recommendations of the FSAP mission related to improvement of the banking sector supervision, projects related to strenghetening banking supervision within the technical assistance provided by the international financial institutions;
- Strengthening bank capital;
- monitoring the application of IAS/IFRS with the objective to adequatly valuate financial assets and expected credit loss provisioning in order to maintain an adequate capitalization of banks in the FBiH;
- systemical monitoring of bank's activities on application of AML/CFT standards and enhancing cooperation with other competent institutions in this segment;
- building, expanding and improvement of the cooperation with the competent supervisory authorities for supervision of banking groups from the EU whose members having seat in the FBiH, as well from others countries, for the purpose of more efficient supervision and improvement of supervisory practices, cooperation and exchnage of information with the ECB and the EBA in terms of the supervision and banking regulations, and international financial institutions;
- improving cooperation by signing new memorandums on cooperation with relevant institutions in BiH included into the institutional supervisory framework, crisis managemnt and systemic risk, as well as protection of users of financial services.

The activities of the Banking Supervisory Authority in 2018.

The FBA activities in 2018 were characterised by the further strengthening of the institutional capacities connected with a challenging processes of the regulatory and supervisory reforms in the process of compliance with a new legislation, the FBA Statute and internal acts on internal organisation and staff establishment plan.

In the context of the FBA's regulatory activities, actions have been taken to create the regulatory framework for resolution bodies to exercise the resolution powers, so as to ensure regulatory requirements in regard to independence and organisational separation of the banking supervision operations and activities related to bank resolution. The activities continued to improve supervision over implementation of regulations on protection of rights and interests of the users of the financial services in the banking system of the FBiH.

In 2018, the key activities of banking supervision were directed on:

- Continues supervision of all banks in the FBiH, in particular of banks significant for the banking system of the FBiH;
- Further implementation of new supervisory approach – SREP, through a long-term project technically supported by the World Bank;
- Preparation drafts of new regulatory requirements for credit risk management in accordance with IFRS 9 implementation;
- Validation of the first bank's Reports on ICAAP application, with technical support provided by FINRA Project and submission of the supervisory letters to banks on review and assessment of the Reports;
- Commencement of the project to develop methodology for supervisory stress tests (FINRA Project);
- preparation of regulations for ILAAP and reporting on ILAAP, including public discussion with the banking sector via BA BiH (Banks Association of Bosnia and Herzegovina);
- validation of the first recovery plans submitted by the banks (FINRA Project);
- Improving cooperation with supervisors of the parent banks.

In 2018, the activities within the FBA field of competence, as a body responsible for bank resolution, were focused on:

- Finalising activities on drafting regulations, with the technical support from the World Bank;
- Collection and analysis of banks' data and information needed for drawing of the resolution plans for banks in the FBiH, as well as analyse and provision of opinion on submitted recovery plans of the banks.

Organizational chart of the Banking Supervisory Authority

In February 2018, the Rulebook on Internal organisation was adopted. A new organisational structure of the FBA was established, where inter-alia reorganisation was conducted for the supervision of the banking system entities in the FBiH. The organisational chart is presented in the Annex.

International activities of the authority

In 2018 the FBA oriented its activities on strengthening and fostering the cooperation with the international financial institutions, regional and other organisations, same as on strengthening of bilateral and multilateral cooperation with banking regulators from the country, region and abroad, which is based on the existing and new memorandums on cooperation and exchange of information.

In 2018, the MoU was signed with the ECB, with the aim of cooperating and exchanging information in the segment of the supervision of the entities supervised by the competent authorities, and the Cooperation Agreement signed with the IFC with the aim to support the Ombudsman in implementation of financial education activities.

In 2018, the FBA participated on supervisory colleges for the banks having the seat of the banking groups in Slovenia and Austria, and this type of supervisory cooperation has been extended on two additional banking groups which are considered significant and therefore under ECS's supervision (Raiffeisen group and Sberbank group).

In the context of bilateral cooperation, the cooperation and exchange of information has been continued with supervisory institutions of the countries where is the seat of the banking groups whose members are the banks having seat in the FBiH through the preparation of the supervisory reports and information for the Bank of Slovenia, the FMA and the ECB.

FBA participated in the work of the Vienna Initiative 2.0, as well as in work of the BSCEE. Significant activities of the FBA related to participation in missions/visits of the international financial organisations (IMF, WB, EBRD, USAID etc.), as well to International Rating Agency Standard & Poor's for the purpose of assessing sovereign credit rating of BiH.

Cooperation with other supervisory bodies in the country

In 2018, cooperation has continued with the competent institutions in BiH. Implementation of the stress tests for credit risk and capital impacts has continued in cooperation with the CBBH and BARS, based on macroeconomic assumptions, as well as sharing the results of stress tests with the banks.

Cooperation has continued with the BARS and DIA (Deposit Insurance Agency) in the form of regular exchange of information and joint actions, and also with the BARS in the part of creation new regulations, which includes cooperation with the entity's ministries of finance.

In 2018, a cooperation continued with the BA BiH (Banks Association of Bosnia and Herzegovina) both in terms of implementation of the existing regulatory framework and proposals for revision, and in the process of adoption a new regulatory framework for bank operations and supervision.

Other relevant information and developments in 2018

Significant cooperation has been achieved with the World Bank in relation to the Strengthening Banking Sector Project, same as with the USAID within FINRA Project and through the technical support in strengthening FBA capacities for more efficient banking supervision, as well as in preparation and implementation of the new banking regulation in the FBiH, plus a cooperation with domestic institutions and international financial organisations.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	15	15	15
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	15	15	15

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	18.382.034	20.209.851	22.094.135
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	18.382.034	20.209.851	22.094.135
y/y change (in %)	2016/2015 Index 107 (+7%)	2017/2016 Index 110 (+10%)	2018/2017 Index 109 (+9%)

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	2,8	3,2	3,5
Domestic ownership total	9,2	9,5	9,8
Foreign ownership	90,8	90,5	90,2
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	56,4	69,5	1.418
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	56,4	69,5	1.418

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	7,6	9,7	9,9
Cooperative banks			
Banking sector, total:	7,6	9,7	9,9

*Return on average equity (ROAE)

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	100,0	100,0	100,0
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	2016	2017	2018
Commercial banks	15,7*	15,5*	17,5***
Cooperative banks			
Banking sector, total:	15,7*	15,5*	17,5***

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

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

Asset classification	2016	2017	2018
Non-financial sector, including	11,6	9,7	8,5
Households	8,2	7,3	6,2
Corporate	15,0	12,1	10,6

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

The structure of deposits and loans of the banking sector in 2018 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	84,5	98,0
Households	55,3	48,6
Corporate	29,2	49,4
Government sector	10,9	1,5
Financial sector (excluding banks)	4,6	0,5
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	752.156	724.548	741.366
Interest expenses	165.147	149.985	130.053
Net interest income	587.009	604.563	611.313
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	969.238	1.026.103	1.051.108
Administration costs	243.892	248.113	256.662
Depreciation	n/a	n/a	n/a
Provisions	111.305	112.074	108.662
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	202.301	272.461	289.768
Net profit (loss)	173.248	239.973	256.239

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	1.267.485***	1.202.265***	1.202.265***	65.220***	
Cooperative banks					
Banking sector, total:	1.267.485***	1.202.265***	1.202.265***	65.220***	

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

2018 DEVELOPMENTS IN THE BANKING SYSTEM OF REPUBLIKA SRPSKA OF BOSNIA AND HERZEGOVINA

Macroeconomic environment in the country

In the course of 2018, the growth of overall economic activities in Republika Srpska (hereinafter: the RS) at an inter-annual level was been recorded. Thus, following the 3.1% growth in Q1, the RS GDP in the course of Q2, Q3 and Q4 generated growth rates of 3.6%, 3,8% and 3,7% y/y respectively.

Also, in 2018, a positive trend was evident in the RS industrial production which grew by 3.6% y/y, where the above represents the continuation of its growth from the previous period. Besides an increased production, the RS export increased by 12,8% in the observed period, while import registered an increase of 11,6%. Coverage of import with export was 71,7% and it is historically at the highest level.

In 2018, the average net salary in the RS amounted to EUR 438,3 and it has increased by 3% compared to 2017. An inter-annual inflation rate of 1.4% was registered in the period from January to December 2018.

According to the IMF's World Economic Outlook, economic growth rate of Bosnia and Herzegovina is projected to be 3.1% in 2019, while RS Government is slightly more optimistic and projects the growth rate of 3,7% in this year.

Development in the banking sector (including assets total / GDP)

The banking sector of RS at the end of 2018 consisted of eight banks, out of which six banks were with majority foreign private ownership, while two banks were in majority private domestic ownership.

Taking into account the banking sector results generated in 2018, it can be stated that the banking sector of RS 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 31/12/2018:

- total balance sheet amounted to EUR 4 billion and it is higher by 10% compared to 31/12/2017,
- cash funds (EUR 1 billion) accounted to 25% out of total balance sheet assets with an increase rate of 29% when compared to the previous year (significant increase of deposits),
- total gross loans (EUR 2.6 billion) increased by 3% compared to 31/12/2017,
- share of non-performing loans in the total loan portfolio decreased by 1.53 p.p. in comparison to the end of 2017 (from 11,07% to 9,54%),
- the rate of coverage of total non-performing loans with value adjustments amounted to 69.39% and recorded an increase compared to previous year.
- deposits (EUR 3,1 billion), as a basic source of funding bank operations, had a share of 78% out of total bank liabilities and increased by 12% when compared to 31/12/2017,
- trend of growth in households' deposits continued also in 2018 and they increased by 10% compared to 31/12/2017,
- regulatory capital of the banking sector of RS as of 31/12/2018 amounts to EUR 449.6 million which is an increase of 12% compared with previous year,

- the regulatory capital ratio of the banking sector of RS as of 31/12/2018 is 17.66% and is higher by 5.66 percentage points compared to the prescribed minimum regulatory capital rate of 12%,
- The financial leverage rate at the level of the banking sector of the RS is 10.03% and it is 4.03 p.p higher than the minimum prescribed rate (6%),
- at the level of total banking sector as of 31/12/2018, a net positive financial result was reported in the amount of EUR 37.9 million which is 22,8% lower than previous year. Seven banks generated profit amounted to EUR 43.4 million, while one bank operated with a loss amounting to EUR 5.5 million.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

Prudential regulation governing the operations of financial institutions issued by the BARS in 2018:

- Decision on liquidity risk management in banks,
- Decision on minimum standards for bank operations with persons related to bank,
- Decision on requirements and the manner of exercise of protection of clients' rights and response of banks to clients' complaints,
- Decision on amendments to Decision on performing external audit in banks,
- Decision on conditions for including formed reserves into the CET 1 capital,
- Decision on requirements and the procedure for issuance of licences, approvals and consents to banks operating in the RS,
- Decision on safeguard measures for counterparties,
- Decision on the procedure and the manner of write-off and conversion of capital instruments and liabilities of banks,
- Decision on sale of shares, assets, rights and liabilities of banks under resolution,
- Decision on special purpose banks,
- Decision on granting approvals and consents to asset management companies,
- Decision on data and information submitted to the RS Banking Agency for the purpose of developing and updating plans bank and banking group resolution plans,
- Decision on assessment of the possibility of bank and banking group resolution,
- Decision on plans of reorganization of banking operations,
- Decision on requirements and the manner of conduct of independent assessment of value of assets and liabilities of banks before and during the resolution procedure of banks,
- Decision on minimum requirements for capital and eligible liabilities of banks,
- Decision on conditions under which banks are considered insolvent,
- Decision on the unified tariff applied for collecting fees from banks for performance of tasks of the RS Banking Agency,
- Instruction for reporting on management of information systems in banks,
- Instruction for completing the reporting forms submitted to the RS Banking Agency for the purpose of developing restructuring plans,
- Instruction for electronic submission of data from the area of banking supervision.

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 providers 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 measures of supervision 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 measures of supervision 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 measures of supervision and other competencies in accordance with the law governing saving-credit organizations,
- issuance and revocation of leasing provider licenses and other corresponding by-laws in accordance with its competencies, indirect and direct supervision of leasing provider operations, imposing and ordering measures of supervision and other competencies in accordance with the law governing leasing providers,
- 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 measures of supervision 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 providers and other financial organizations of the banking system, in cooperation with competent authorities and institutions in the area of prevention of money laundering and financing of terrorist activities, and in accordance with regulations governing the prevention of money laundering and financing of terrorist activities,
- supervision and undertaking of necessary measures in accordance with regulations governing the introduction and implementation of specific interim measures in order to efficiently enforce international restrictive measures,
- adoption of by-laws and performing tasks from the area of protection of rights and interests of financial service beneficiaries in the banking system, supervision of implementation of regulations from this area and undertaking of other activities and appropriate measures within its competencies,
- determining the fulfillment of requirements for initiation of bank restructuring procedure, conducting the restructuring procedure, deciding on instruments and measures to be undertaken in restructuring procedure and performing other tasks related to restructuring, 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 measures of supervision 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 2018

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

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

The activities of the Banking Supervisory Authority in 2018

In 2018, 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.

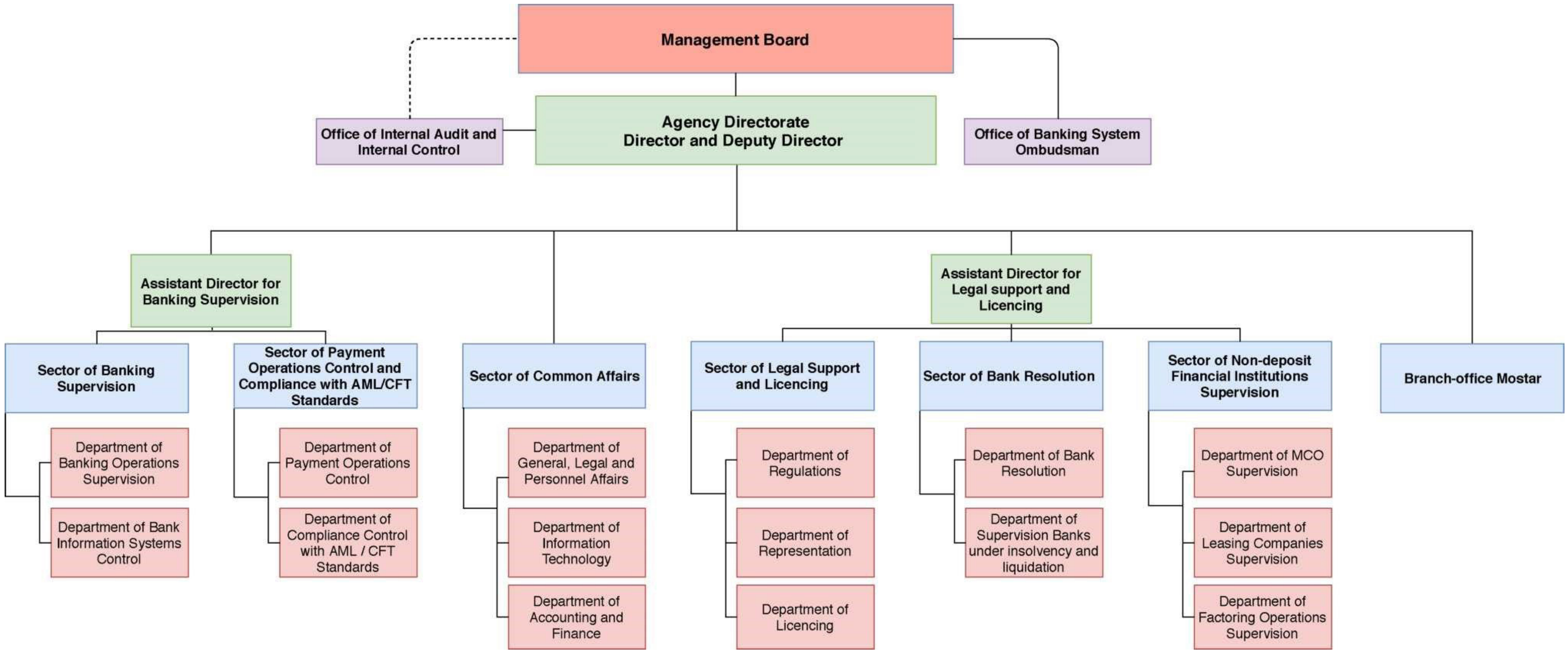
In addition, the BARS continued to control the operations of financial organizations through the off-site and on-site supervision, primarily by means of monitoring the solvency, liquidity, capitalization and profitability of all individual financial organizations, as well as the system as a whole. The 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 could be summarized as:

- 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 (in 2018, the BARS signed a Memorandum of understanding and cooperation with the European Central Bank);

- BARS, in cooperation with the Central Bank of Bosnia and Herzegovina and International Monetary Fund, 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).
- BARS continued to perform the activities aimed at the strengthening of institutional capacities of the BARS and gradual transition to the new regulatory framework (harmonization with the provisions of the EU directives and Basel principles), implementation of new risk based supervision process (SREP), as well as further development and improvement of the existing secondary regulatory framework.
- 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 2018, the BARS continued with the activities on strengthening and improving the cooperation with international financial institutions, regional and other organizations, as well as bilateral cooperation with regulators from other countries. Apart from attending the meetings, the BARS responded, on a regular basis, to the inquiries, requests for data collection and questionnaires of international institutions and organizations (European Central Bank, European Banking Authority, International Monetary Fund, World Bank, EBRD, BSCEE, etc.).

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

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

Cooperation with other supervisory bodies in the country

In 2018, the BARS continued to actively cooperate with the Insurance Agency of RS and Securities Commission of RS in accordance with the Law on Committee for Coordination of RS Financial Sector Supervision.

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 2018.

Other relevant information and developments in 2018

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-end)

Type of financial institution	2016	2017	2018
Commercial banks	8	8	8
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	8	8	8

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks*	3,629,936	3,833,568	4,207,661
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	3,629,936	3,833,568	4,207,661
y/y change (in %)	-1.1	+5.6	+10.0

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	0	0	0
Domestic ownership total	29.2	30.6	30.5
Foreign ownership	70.8	69.4	69.5
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	64.3	86.3	1.730
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	64.3	86.3	1.730

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	5.9	10.4	7.8
Cooperative banks	-	-	-
Banking sector, total:	5.9	10.4	7.8

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	100.0	100.0	100.0
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	2016	2017	2018
Commercial banks	16.3*	16.2***	17.7***
Cooperative banks	-	-	-
Banking sector, total:	16.3*	16.2***	17.7***

(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	2016	2017	2018
Non-financial sector, including	12.0	11.1	9.5
Households	9.7	8.3	7.4
Corporate	13.8	13.4	11.4

The structure of deposits and loans of the banking sector in 2018 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	93.8	99.1
Households	60.0	46.0
Corporate	23.5	42.3
Government sector	10.3	10.8
Financial sector (excluding banks)	6.2	0.9
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	159,495	155,948	154,011
Interest expenses	48,691	40,596	34,032
Net interest income	110,804	115,352	119,979
Net fee and commission income	-	-	-
Other (not specified above) operating income (net)	-	-	-
Gross income	184,770	203,294	197,819
Administration costs	122,748	112,109	114,607
Depreciation	-	-	-
Provisions	-	-	-
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans...)	22,395	22,370	24,085
Profit (loss) before tax	27,535	54,793	43,055
Net profit (loss)	23,180	49,179	37,943

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks***	449,617	411,416	412,657	36,960	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	449,617	411,416	412,657	36,960	-

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

2018 DEVELOPMENTS IN THE BULGARIAN BANKING SYSTEM

Macroeconomic environment

In 2018 Bulgaria's real GDP grew by 3.1% (3.8% in 2017), with private consumption having the highest contribution to the growth of economic activity, while fixed capital investments and government consumption had a lower contribution. The growth of private consumption was realized under the conditions of low interest rates and an increased demand for loans as well as a continuing favourable development in the labour market and continued tendency towards improvement of consumer confidence.

Total gross value added for the economy slowed its growth rate to 3.0% in real terms in 2018 (4.2% in 2017). Decrease in value added by 1.1% was recorded in agriculture, while in industry and services grew by 1.3% and 4.0%, respectively.

In 2018 the labour market trends remained favourable: a decrease in the level of unemployment and an increase in real wages was observed. According to NSI Labour Force Survey data, the level of unemployment decreased to 5.2% on average in 2018 (6.2% in 2017).

At the end of 2018, the annual consumer price inflation was 2.3% and it accelerated compared to December 2017 (1.8%)[1]. The increase in inflation during the year was largely determined by the group of services and energy products.

As of December 2018, the gross external debt decreased by EUR 509.4 million compared to the end of 2017 and amounted to EUR 33.3 billion (60.4% of GDP). External debt reduction was observed in all sectors except banks. Main contribution to the lower gross external debt of the country had the decrease of the intercompany loans and of the debt of "other sectors".

Development in the banking sector (including assets total /GDP)

In 2018 the banking sector's activity was realized during continuous improvement of asset quality and observance of adequate levels of credit institutions' liquidity and capital position.

Credit risk decreased as during the reporting period the tendency towards improvement of asset quality of banks continued. The residual credit risk in the banking system's balance sheet decreased due to the reduction of the amount of non-performing loans and advances. Despite that the reported share of non-performing loans was higher than the average for the European banking system, provisioning in the Bulgarian banking sector was also higher than the EU average[2].

The capital position of the banking system at the end of 2018 continued to be characterized by higher than the minimal regulatory and prudential requirements for capital adequacy ratios.

In 2018 the total assets of the banking system increased by 8.0% (BGN 7.8 billion) to BGN 105.6 billion. The annual growth of the banking system's assets was higher than that in 2017, which was due to higher growth in deposits and in balance sheet total equity as well as due to one-off factors. The ratio of the total assets to GDP was 97.8% as of end-2018.

[1] According to HICP data.

[2] With the entry into force of IFRS 9 the accrued impairment was increased and the level of coverage with impairment of non-performing loans and advances increased.

Market structure

At the end of 2018 there were 25 credit institutions and foreign branches of which one was a state-owned bank. The process of consolidation in the banking sector continued also in 2018. During the year Cibank was merged with United Bulgarian Bank. There was also a change in the ownership of Municipal Bank and also BNP Paribas Personal Finance was transformed from a financial institution into a branch of the credit institution BNP Paribas Personal Finance S.A., France. In the last quarter of 2018, Commercial Bank Victoria was transformed by merging into Investbank. At the end of the year the direct acquisition by DSK Bank of Société Générale Expressbank was approved and as a result the total balance sheet equity of the banking system increased.

At the end of December 2018 the share of the assets of the five largest banks increased to 59.4% (55.9% at the end of 2017). On an annual basis the market share of credit institutions with predominantly Bulgarian equity decreased (to 22.0%) at the expense of the increased market share of banks and branches outside the EU. The share of subsidiaries and branches of the EU amounted to 74.9% (compared to 75.2% at the end of 2017).

Asset quality

During the year the trend of improvement in asset quality indicators continued. At the end of December 2018 the gross amount of all non-performing exposures[3] was BGN 6.8 billion and their share decreased to 6.7% (8.9% at the end of 2017).

On an annual basis the gross amount of non-performing loans and advances decreased by BGN 1.5 billion (18.1%). At the same time total gross loans and advances increased by 9.2% (BGN 7.5 billion) and the share of gross non-performing loans and advances to total gross loans and advances decreased by 2.6 p. p. to 7.6% at the end of 2018.

The net amount of non-performing loans and advances[4], representing the potential credit risk in bank balances, decreased y-o-y by 21.4% to BGN 3.3 billion and remained fully covered by the excess of capital above the minimum regulatory requirement of 8%. The share of the net non-performing loans and advances in net loans and advances decreased from 5.4% to 3.9% at the end of 2018.

The coverage rate of gross non-performing loans and advances with the impairment inherent for that classification category at the end of 2018 increased to 51.4% (compared to 49.4% at the end of 2017).

The quality of the balance sheet assets, other than loans, remained good with a high share of liquid assets.

Profitability

The profit of the banking system at the end of 2018 amounted to BGN 1.7 billion or by BGN 514 million (44.7%) more than the realized profit during 2017. A contribution for the growth in profit of the banks had also single events. The ratios ROA and ROE increased compared to 2017 and at the end of 2018 were 1.58% and 11.97% respectively.

[3] Non-performing exposures are defined according to the broadest definition in EBA methodology, which includes gross loans and advances as well as debt securities, other than held for trading.

[4] The net amount of non-performing loans and advances is calculated according to EBA methodology and their gross amount is reduced with the accumulated impairment for that classification category. When calculating the share of net non-performing loans and advances their net value is used and also the net value of the total loans and advances.

Solvency

The levels of capital ratios of the banking system at the end of 2018 remained significantly above the regulatory minimum. Credit institutions observed capital buffer requirements (2.5% capital conservational buffer, 3% systemic risk buffer and 0% countercyclical capital buffer and buffer for other systemically important institution)[5].

With the increase in the amount of common equity tier one (by BGN 215 million, 2.0%) during the year, the tier one capital and total capital of the banking system also increased. At the end of 2018 total capital amounted to BGN 11.6 billion – by BGN 142 million (1.2%) more compared to end 2017.

Total risk exposures amount grew during the year due to the increase in loans and also regulatory changes[6]. As of 31 December 2018 the ratios of CET 1 capital, Tier 1 capital and total capital adequacy were 18.99%, 19.41% and 20.38%, respectively. The amount of capital, above the minimum requirement of 8%, at the end of 2018 amounted to BGN 7.1 billion.

The indicator of indebtedness – the leverage ratio (using a fully phased-in definition of tier one capital) – decreased to 10.11% at the end of 2018 (compared to 10.68% at the end of 2017) as a result of both the decrease in tier one capital and also the increase in the total exposure.

Liquidity

In 2018 the liquidity position of the banking system remained stable and the liquidity coverage ratio (reported according to the new requirements for liquidity) of the banking system was 294.1% and it continued to be above the average level in the EU banking system. The numerator of the ratio, the liquidity buffer of the banking system, reported a 14.9% y-o-y growth and amounted to BGN 29.6 billion. Net liquidity outflows increased by 34.7%.

Products and distribution channels

At the end of 2018 there were 44 points of sale (branches, offices, representative offices and remote workstations), 80 ATMs and 1362 POS terminals[7] 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

Regulation and supervision of credit institutions operating in the Republic of Bulgaria is one of the key functions of the BNB, which aims to maintain the stability of the banking system and to protect the interests of depositors.

The Bulgarian banking system is subject to the international regulatory framework for banks – Basel III in the European Union introduced by the Capital Requirements Regulation and Directive. Capital Requirements Regulation (Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms

[5] More information about the capital buffers is available on the BNB website:
http://www.bnb.bg/BankSupervision/BSCapitalBuffers/index.htm?toLang=_EN
[6] As of 1 January 2018 the possibilities of preferential treatment for some kinds of exposures, reported by banks until the end of 2017, with 0% risk weight and 0% capital requirements for currency pair 'BGN/EURO', are no longer into force.
[7] Data for ATMs and POS terminals refer to banks in Bulgaria.

is directly applicable to the member states, while the Capital Requirements Directive (Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms has been transposed into national legislation by the Law on Credit Institutions (LCI) and the legal acts for its implementation, which constitute the national legal framework governing the access to the activity, the supervisory framework and the prudential rules for credit institutions and investment firms. The activity of credit institutions is regulated also by Regulations adopted by the European Parliament and the Council, as well as delegated Regulations of the European Commission which are part from the European legislative framework, directly applicable to Bulgaria as EU member. Control over their implementation is carried out by the BNB and official European institutions (EBA, Commission etc.). The consistent application of the legally binding Union acts, the establishment of high quality common regulatory and supervisory standards and practices are provided also through guidelines and recommendations issued by the European Banking Authority.

In 2018 further improvements were carried out in the legislative framework for banking supervision. One of them is related to Article 45 of the Law on Credit Institutions (LCI), where draft amendments were initiated and proposed by the BNB to the Ministry of Finance. The amendments broadened the range of exposures to related parties. The new Ordinance No 37 adopted by the BNB on the Internal Exposures of Banks sets out the way banks have to calculate internal exposures, as well as reports and the notifications credit institutions have to submit to the BNB. Additionally, the Ordinance defines the requirements for internal rules and procedures the banks should adopt, in order to ensure they have identified all of their internal exposures and adequately consider risks related.

Amendments to Ordinance No 11 of the BNB for the management and supervision of banks' liquidity were adopted by the BNB Governing Council. They relate to the implementation of Regulation (EU) No 575/2013 and Implementing Regulation (EU) 2017/2114, which led to repeal of previous requirements of the Ordinance, e.g. the table for the maturity structure of assets, liabilities and off-balance sheet positions; the liquidity ratio and the liquidity ratio by maturity intervals. New requirements for the treatment of minimum required reserves for liquidity purposes were introduced in accordance with Delegated Regulation (EU) 2015/61. Notwithstanding the fore-mentioned amendments, most of the provisions of Ordinance No 11 of the BNB were preserved as they are basic transposed texts of Directive 2013/36/EU in Bulgarian legislation.

In 2018, the BNB adopted amendments to Ordinance No 30 on Calculation of the Amount and Collection of Premium Contributions Due by Banks under the Law on Bank Deposit Guarantee (LBDG). The term of identifying and collecting extraordinary contributions from banks was shortened from 45 to 7 days, which will allow synchronisation with the deadlines set by the LBDG (7 business days) for payment of deposits in a bank subject to the legal prerequisites for this.

Over the year, the BNB continued its work on convergence of supervisory practices in application of the prudential rules within the EU. For this purpose, the BNB Governing Council came to decisions for compliance with Guidelines of various fields adopted by the European Supervisory Authority (EBA).

Main strategic objectives of the Supervisory Authority in 2018

The processes in the local banking sector and developments in the supervisory framework at EU level predetermine the objectives and tasks for BNB in the field of banking supervision. They are set in the program and the decisions of the Governing Council for the development of banking supervision. The main ones, the implementation of which falls in 2018 and 2019, include:

- Conduct written consultations with the ECB on the national legislation with a view to establish close cooperation between the ECB and the BNB; the implementation of the recommendations of the Convergence Report by amending the Law on the BNB; macro-prudential powers of the BNB and the management of credit institutions;
- Interaction with JST/SSM and non-SSM supervisory colleges – stressing the importance of subsidiaries on local market, not considered material within group context;
- M&A in the banking sector – recent trends show the need to further assess financial stability, prudential positions and competition concerns stemming from consolidation of the banking sector.

The activities of the Banking Supervisory Authority

In 2018, the focus of the *Supervisory Review and Evaluation Process* (SREP) of credit institutions was placed on their business model and profitability, the corporate governance, the capital and liquidity adequacy. The assessments are based mainly on the risks prevailing in their activity, i.e. the credit risk, the operational risk, the market risk, the IRRBB and the liquidity risk. The ongoing supervision included also evaluation of banks' internal capital adequacy assessment and liquidity adequacy assessment process (ICAAP, resp. ILAAP), and particularly to what extent and how they are incorporated in the capital planning, in the asset-liability management and budgeting.

Another important supervisory activity in 2018 was related to review and assessment of updated recovery plans of the credit institutions, mainly with regard to how they took into account the BNB recommendations on their initial plans. In general, the assessments indicate progress in terms of feasibility of measures for restoring institutions' viability under stressed conditions.

The ongoing supervision of credit institutions was supported in 2018 by *nine inspections*, the main objective of which was to verify the risk management and control systems. In some cases, underrated credit risk and credit concentrations have been identified. In this regard, supervisory recommendations have been made to the relevant banks to improve the analysis of borrowers' solvency and to address gaps in the ICAAP.

Depending on the results of the checks concerning the business model and the relatively low profitability of some banks, supervisory recommendations have been issued for changes in their business strategy and risk appetite, resp. to reconsider risk limits. Supervisory measures were also imposed for breaches of the regulatory framework.

Another important subject of verifications within the on-site activity was the implementation of supervisory measures imposed following previous inspections and after the asset quality review, which was carried out in 2016-2017. In general, there has been a number of improvements in internal risk management systems, as well as in specific areas where institutions have identified deviations from particular standards, e.g. for recognition and reporting of eligible collaterals for the purpose of provisioning.

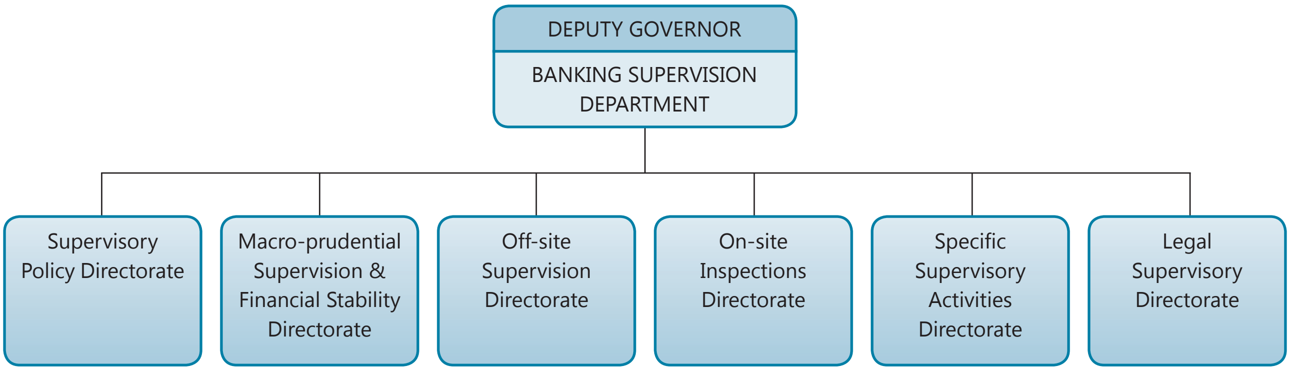
As part of its macro prudential mandate and policy of transparency, the BNB continued publishing risks and main banking trends in the country. It continued close monitoring of processes in the Bulgarian economy which affect the sector. The analyses were focused on dynamics in non-performing loans, the credit standards applied in mortgage lending, dynamics in sovereign debts and in banks' portfolios in foreign government bonds.

The observed favourable domestic economic trends, and increased credit activity in 2018 give reason to believe that the country is in the ascending phase of the economic and financial cycle. At the same time, accelerated credit growth is a potential source of cyclical systemic risk, which could materialise in the next weakening of economic activity and/or a future rise in interest rates, although the latter for now seems unlikely. In view of this, on September 25, 2018, the Governing Board of BNB decided to increase the countercyclical capital buffer applicable to credit risk exposures in Bulgaria in the amount of 0.5%, in force as of October 1, 2019. This aims at the favourable economic conditions be used to preserve and further reinforce the capital position of the banking system, resp. the resilience of credit institutions to future credit risk.

An annual review of the identified as other systemically important institutions (O-SIIS) and the applicable capital buffers for O-SII has also been carried out. According to validated methodology, they shall be phased in by the full attainment of the levels of capital buffer assigned to each credit institution as from 1st January 2020.

Maintaining a business environment precluding the use of the banking sector for money laundering and terrorist financing requires exerting continuous efforts, which is also a top priority for BNB. By applying the risk based approach, target supervisory inspections were carried out in a range of banks and credit intermediaries. Partially, they covered also follow-ups on the implementation of previous recommendations and supervisory measures. The main findings were associated to insufficient administrative capacity, availability and quality of a specialised software, and necessary improvements to KYC-controls. The verifications and follow-ups had a generally favourable effect in terms of prevention at banks and credit intermediaries.

Organizational chart of the Banking Supervisory Authority



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

International activities of the Authority

Between 1st January and 30th June 2018, within the Bulgarian Presidency of the EU Council, a Deputy Governor of the BNB was member of the Coordination Board of the Council of Ministers. Representatives of the BNB also participated in interdepartmental thematic teams on legislative proposals of the EU Commission in the field of financial services, assisting with their expertise the Ministry of Finance. The issues and proposals discussed under Bulgarian coordination covered risk reduction in the banking sector (the so-called Banking Package, continued during the Austrian and Romanian rotating terms, adopted by the EC in April 2019), issues in strengthening the Banking Union, technical discussions on shaping the future European Deposit Guarantee Scheme. Among the topics covered during the Bulgarian mandate were also the review of the European System of Financial Supervisors, the legislative package for issuing covered bonds, as well as legislative proposals within the package of measures to deal with non-performing loans.

Cooperation with other supervisory bodies in Bulgaria

In 2018, the BNB continued its cooperation with other national competent authorities as usual. With the Financial Supervision Commission joint inspections were carried out on trustees of supplementary pension insurance funds. On-site verifications in individual credit institutions were focused on application of the provisions of the Law on Bank Deposit Guarantee, particularly of the way of calculating and reporting the amount of guaranteed deposits, etc.

As regards practices in housing lending, BNB in cooperation with the Commission for consumer protection, strives to be clear about the process, and control seller party to complying with the requirements of the Law on Mortgage Lending to Consumers. When verifying the consumer complaints both authorities place the focus on observing the requirements and applying good practices by creditors for a *bona fide* assessment of consumer creditworthiness, training and staff remuneration policies. The results of the checks in this direction show that, at both credit institutions and credit intermediaries, rules and practices applied are broadly consistent with the requirements of the law, without neglecting the cases of identified weaknesses and breaches.

Other relevant information and developments in 2018

In 2018 the BNB started preparing for the amendment of the legislative framework following the request made by Bulgaria on 18th July 2018 to establish close cooperation between the ECB and the BNB, and to perform the requirements joining the SSM. In connection with the procedure for establishing close cooperation with the ECB, the National Assembly amended the Law on Credit Institutions and the Law on the BNB. The amendments were mainly related to the preconditions for establishing close cooperation between the ECB and the BNB, including the conferral of powers on the ECB, and complementing the powers of the BNB related to macro-prudential supervision of credit institutions.

The BNB also assisted the ECB in the preparation and performance of a comprehensive assessment of six Bulgarian banks. The exercise, comprising an asset quality review and a stress test is required as part of the process of establishing close cooperation between the ECB and the BNB. The exercise started in November 2018 and its aggregate and bank-by-bank results (as of 31st Dec 2018) are expected to be published in July 2019.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	22	22	20
Branches of foreign credit institutions	5	5	5
Cooperative banks			
Banking sector, total:	27	27	25

Total assets of banking sector (at year-end) (EUR'000)

Type of financial institution	2016	2017	2018
Commercial banks	45 956 464	48 779 343	52 400 040
Branches of foreign credit institutions	1 131 816	1 214 894	1 569 873
Cooperative banks			
Banking sector, total:	47 088 280	49 994 237	53 969 913
y/y change (in %)	5.2%	6.2%	8.0%

Ownership structure of banks on the basis of assets total (%)

Item	2016	2017	2018
Public sector ownership	2.1	2.5	2.9
Domestic ownership total	23.5	23.5	22.0
Foreign ownership	76.5	76.5	78.0
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 (%)
Commercial banks	42.76	59.36
Branches of foreign credit institutions	2.22	2.91
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	2016	2017	2018
Commercial banks			
Cooperative banks			
Banking sector, total:	**10.41**	**9.15**	**11.97**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	97.6	97.6	97.1
Branches of foreign credit institutions	2.4	2.4	2.9
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

Assets	2018
Cash, cash balances at central banks and other demand deposits	19.3
Financial assets held for trading	0.4
Non-trading financial assets mandatorily at fair value through profit or loss	0.3
Financial assets designated at fair value through profit or loss	0.0
Financial assets at fair value through other comprehensive income	9.8
Financial assets at amortised cost	65.9
Derivatives – Hedge accounting	0.0
Fair value changes of the hedged items in portfolio hedge of interest rate risk	0.0
Investments in subsidiaries, joint ventures and associates	0.4
Tangible assets	1.8
Intangible assets	0.2
Tax assets	0.0
Other assets	1.8
Non-current assets and disposal groups classified as held for sale	0.1
TOTAL ASSETS	100.0
Liabilities	**2018**
Financial liabilities held for trading	0.1
Financial liabilities designated at fair value through profit or loss	0.0
Financial liabilities measured at amortised cost	85.8
Derivatives – Hedge accounting	0.1
Fair value changes of the hedged items in portfolio hedge of interest rate risk	0.0
Provisions	0.2
Tax liabilities	0.0
Share capital repayable on demand	0.0
Other liabilities	0.6
Liabilities included in disposal groups classified as held for sale	0.0
TOTAL EQUITY	13.2
TOTAL EQUITY AND TOTAL LIABILITIES	**100.0**

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks			
Cooperative banks			
Banking sector, total*:**	22.15	22.08	20.38

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

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

Asset classification	2018
Gross non-performing loans and advances to total gross loans and advances (%)	7.6
Net non-performing loans and advances to total net loans and advances (%)	3.9

The structure of deposits and loans and advances of the banking sector in 2018 (%) (at year-end)[8]

	2017		2018	
	Deposits	Loans and advances	Deposits	Loans and advances
Central banks	0.0	17.2	0.0	17.2
General governments	2.4	0.7	3.0	0.8
Credit institutions	6.3	14.0	5.7	14.3
Other financial corporations	3.3	3.1	3.6	3.6
Non-financial corporations	28.9	40.7	28.2	39.2
Households	59.1	24.3	59.5	24.8
Total	**100.0**	**100.0**	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	1,695,123	1,555,804	1,553,737
Interest expenses	254,738	188,154	152,005
Net interest income	1,440,385	1,367,650	1,401,733
Net fee and commission income	470,921	509,141	545,247
Other (not specified above) operating income (net)	173,295	109,483	209,207
Total operating income, net	2,084,600	1,986,274	2,156,187
Administrative expenses	808,361	825,605	878,061
Depreciation	89,437	89,872	89,634
Provisions or (-) reversal of provisions	32,997	10,637	11,542
Impairment or (-) reversal of impairment on financial assets not measured at fair value through profit or loss	415,181	394,092	244,096
Profit or (-) loss before tax from continuing operations	722,115	654,009	923,216
Profit or (-) loss for the year	645,754	588,206	850,962

Total own funds in 2018 (in 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:	5,954,843	5,546,902	5,671,435	283,409	

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

[8] Source: Macroprudential reporting form MPF1.

2018 DEVELOPMENTS IN THE CROATIAN BANKING SYSTEM

Macroeconomic environment in the country

Economic growth decelerated to 2.6% in 2018, from 2.9% in 2017, mostly due to slower growth in the exports of goods and services. The growth in real GDP was mostly attributable to personal consumption, which continued to grow at a similar pace as in 2017. Consumer price inflation picked up slightly, mainly as a result of a rise in the prices of energy products (primarily electricity). The continued increase in tourism revenues and the more vigorous uptake of EU funds provided positive contributions to the results seen in the current and capital account in 2018. The CNB's expansionary monetary policy coupled with the maintenance of a stable nominal exchange rate of the kuna against the euro continued to support economic recovery. This resulted in an all-time high in surplus kuna liquidity of the monetary system and contributed to further improvement of the financing conditions in the domestic market, and, ultimately, to the continued growth in the banks' lending activity to households and corporates.

Development in the banking sector (including assets total / GDP)

The banking system continued to be dominated by credit institution in foreign ownership, which accounted for 90.2% of total assets of credit institutions. The number of credit institutions went down by five, so that 21 banks and four housing savings banks operated in the Republic of Croatia at the end of 2018. In addition, there was one branch of an EU credit institution operating in the country, while around 160 EU (and EEA) institutions notified the CNB of the direct provision of mutually recognised services in the territory of the Republic of Croatia. The assets of credit institutions reached a total of HRK 414.1bn (108% of GDP).

Following six years of decline or stagnation, in 2018 bank assets increased noticeably (by 4.4%), reaching record levels. The significance of liquid items increased in its structure, as evident from the high liquidity coverage ratio (LCR), which was 161.0% at the end of 2018. The share of loans granted also increased considerably. The four-year downward trend in loans thus ended, primarily owing to the more vigorous lending to households, but also the rise in general-purpose cash loans to that sector. In order to cover potential increased risks, the CNB issued recommendations related to non-housing consumer loans, while banks were instructed to pay particular attention to this type of loans when performing their internal risk assessments. Over the past years, the largest part of credit growth has been concentrated in tourism, i.e. in accommodation and food services. Lending at fixed interest rates continued at a faster pace, as did kuna lending.

The stable structure of sources of funds arises from strong reliance on household deposits, whose increase picked up considerably, especially at mid-year, under the seasonal influences of tourist activity. Kuna deposits continued to rise, as did transaction account deposits, which exceeded one half of total bank deposits. This is attributable to an environment characterised by low interest rates and to the continued decline in interest rates on time deposits. In addition, the introduction of the taxation of interest payments on savings in 2015 certainly contributed to the trend.

Loan quality improved under the strong influence of the sale of claims. The share of non-performing loans (B and C risk category loans) dropped from 11.3% to 9.8%. The decline in losses arising from non-performing loans (i.e. the coverage of non-performing loans by value impairments), which began in the preceding year, continued. The coverage indicator went down to 59.5% under the influence of the sale of above-average covered claims, but also the inflow of new non-performing loans. Bank activity aimed at addressing the issue of bad loans, especially through the sale of claims, continued; the bulk of the amount again involved claims on corporations and professional acquirers.

In 2018, bank profit grew by 43.4% thanks to lower credit risk expenses. As these expenses dropped in 2018, banks' ROAA and ROAE recovered and grew to 1.4% and 8.5% respectively. However, operating profitability, i.e. profitability before expenses on value adjustments and provisions decreased due to the decrease in all components of net operating income, in particular, the key source of bank income, net interest income. The effects of savings on interest expenses weakened, causing the effect of the drop in interest income, resulting from the decrease in interest rates, to prevail. The effect of the decline in interest income from the domestic government, caused by refinancing of the road sector, was particularly strong.

Total capital ratio went down under the influence of stronger business activities of banks and growing credit risk exposure. At the end of 2018, it stood at 23.1%. The average credit risk weight was slightly lower than in 2017, standing at 49.3%, primarily as a result of the sale of claims and despite the changes in the weighting of exposures to the domestic central government and central bank in currencies other than kuna. As of 2018, such exposures are no longer weighted by a preferential risk weight of 0% and a risk weight of 20% is applied to them instead. Own funds stagnated.

Under the influence of a merger of one housing savings bank with its parent bank, the assets of housing savings banks dropped by one third to only 1.3% of the total assets of credit institutions.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

The CNB's tasks regulated by the Act on the Croatian National Bank include the issuance and withdrawal of authorisations and approvals, and supervision and oversight in accordance with acts governing the operations of credit institutions and credit unions. The exercise of supervision and oversight of credit institutions and credit unions is governed by the Credit Institutions Act and the Credit Unions Act. The rules and requirements pertaining to the operations of credit institutions are governed by Croatian regulations, as well as EU regulations. This is primarily Regulation (EU) No 575/2013 of the European Parliament and of the Council with corresponding technical standards, i.e. regulations that are directly applied in EU member states.

In addition to supervision, the CNB oversees the implementation of the Act on the Croatian National Bank, regulations adopted under that Act, and the implementation of other laws and regulations subject to which it is competent to exercise supervision. The CNB also supervises the operation of credit unions.

Main strategic objectives of the supervisory authority in 2018

As over the previous year, the main objectives of the supervision exercised by the CNB under law were to maintain confidence in the Croatian banking system, and to promote and safeguard its safety and stability. The process of harmonising the domestic regulatory framework with EU regulations was continued in 2018, aiming to improve domestic legislation regulating the operation of credit institutions. As a result of the relatively high level of bad placements, the strategic objective for 2018 was connected with the procedure of monitoring of the management and resolving of the issue of credit institutions' bad placements.

The activities of the Banking Supervisory Authority in 2018

In 2018, the CNB carried out the regular supervisory cycle of assessing credit institutions. This includes assessing the risk profile of credit institutions, examining the adequacy of procedures in place for assessing and maintaining the internal capital of credit institutions and continuous cooperation based on a dialogue. In 2018, the CNB compiled 16 reports on risk assessments of credit institutions, of which nine had to do with credit institutions for which cross-border colleges of supervisors were established and for which joint decisions are reached on specific prudential requirements. Since the European Central Bank carried out stress testing in 2018, the results of which are used to determine the required capital of banks, the majority of joint decisions were reached in the first quarter of 2019 as the results were disclosed in November 2018. Analyses of the banks' internal capital adequacy assessment reports were performed in the segment of supervising advanced approaches to measuring risks and risk management with a special focus on internal models.

The CNB awarded special attention to the area of IT risk and cyber security by continuously monitoring cyber threats that could affect the banking system in Croatia. The CNB participated in the activities of relevant committees and coordinations at country level and systematically communicated with credit institutions in order to maintain and enhance the level of cyber security and the capability of reacting to cyber threats. Additional efforts were put in the harmonisation of banking operation with the Act on the Cybersecurity of Essential Service Operators and Digital Service Providers.

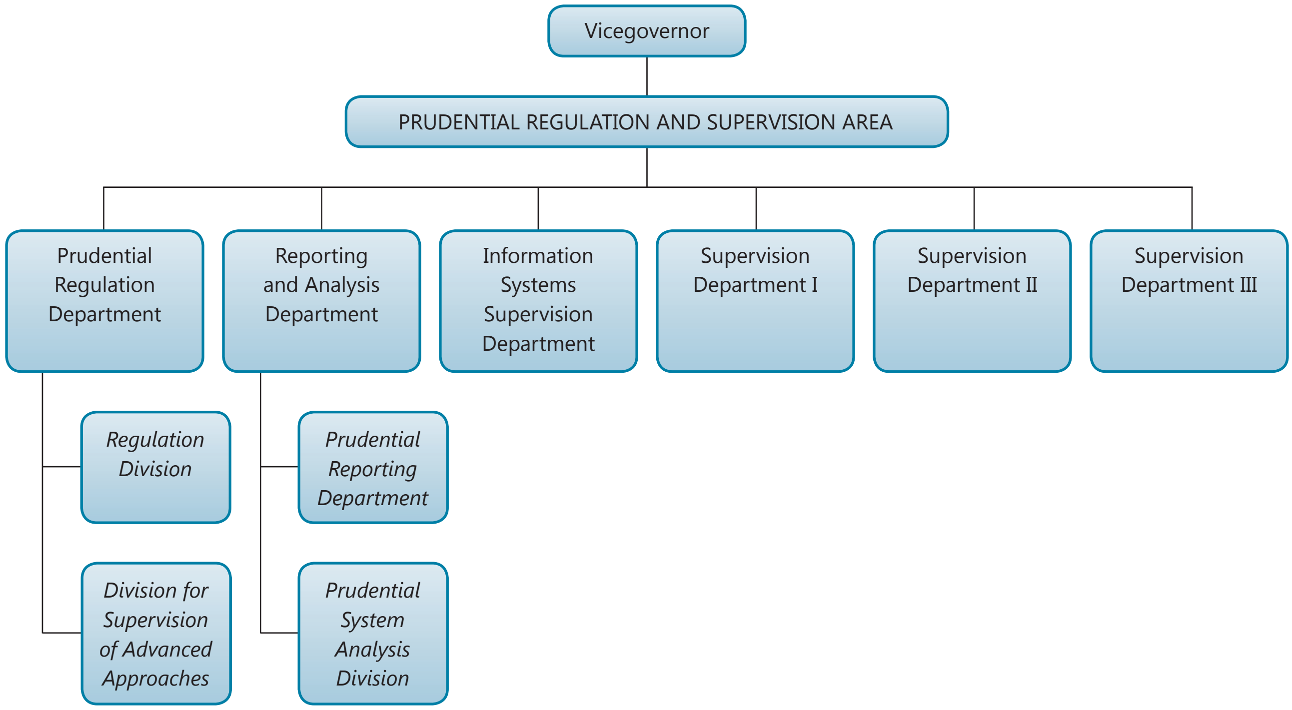
The total number of on-site examinations in 2018 equally included banks categorised as large and those categorised as small according to the size of their assets. As regards examination areas, special focus was placed on the analysis of asset quality and credit risk management, analysis of market and interest rate risk, own funds adequacy and the supervision of the implementation of legal provisions pertaining to the prevention of money laundering and terrorist financing. The CNB carried out trustee and special administration activities in two credit institutions, which were related to detailed assessment and monitoring of the credit institutions' financial positions and operating conditions.

The CNB performed the stress testing of systemically important credit institutions in the Republic of Croatia for supervisory purposes. The testing was performed based on adjusted EBA methodology for the purpose of the supervisory review and assessment process.

The CNB actively cooperated with the State Agency for Deposit Insurance and Bank Resolution (DAB), with the aim of exchanging data and information on the subjects of supervision and oversight. The CNB regularly monitored the methodology for the calculation of individual credit institutions' degree of risk prescribed by DAB for the purpose of calculating insurance premiums.

The CNB continued to participate actively in the national system of the prevention of money laundering and terrorist financing in 2018. To coordinate and engage in joint activities aimed at attaining strategic and operational objectives in this field, the CNB continued to cooperate with other competent authorities, particularly within the Supervision Subgroup of the Inter-Institutional Working Group for Preventing Money Laundering and Terrorist Financing.

Organizational chart of the Banking Supervisory Authority*



* In the first half of 2019, the CNB reorganised its bank supervision operations, aiming to ensure conditions for achieving its long-term objectives. The key objectives are related to the participation and work within the framework of the Single Supervisory Mechanism, to ensuring of methodology, procedures and activities for adequate monitoring of the risks associated with digitalisation of banking operations, improvement of monitoring and management of interest rate risk in the banking book, as well as bad placements and improvement of the supervision of prevention of money laundering and terrorism financing.

International activities of the authority

As EBA member, the CNB participates in the European System of Financial Supervision. Over the course of 2018, the Bank allocated considerable resources to participation in EBA and ECB working groups.

In 2018, the CNB continued to cooperate with foreign supervisors, particularly as regards joint assessments of the risk of business operations of banking groups and the adequacy of allocated amounts of capital for members of individual groups, as well as in the segment of IT system supervision. Based on the memoranda of understanding in effect, in 2018 the CNB representatives participated in numerous colleges of supervisors relating to the supervision of banking groups that include domestic banks.

The cooperation with international institutions continued in 2018 in terms of interactive participation in the work of committees of European supervisory bodies dealing with the problem of money laundering and terrorist financing, including the work on the adoption and application of guidelines issued by European supervisory bodies and preparation of materials for the special committee of the Council of Europe – MONEYVAL.

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

Cooperation with other supervisory bodies in the country

Other supervisory bodies in the Republic of Croatia operating in the area of financial system oversight include the Ministry of Finance and the Croatian Financial Services Supervisory Authority (HANFA). They are competent for the regulation and oversight of non-banking financial services.

In 2018, the CNB continued to cooperate with 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 HANFA, resolve open issues on the exchange of data and arrange the coordination of supervisory activities.

Other relevant information and developments in 2018

More information on the CNB's supervision, regulation on which the CNB's oversight is based and the texts of regulations themselves may be found on the CNB's website (www.hnb.hr).

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	31	30	25
Branches of foreign credit institutions	1	1	1
Cooperative banks	-	-	-
Banking sector, total:	32	31	26

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	52 466,8	53 136,8	55 829,7
Branches of foreign credit institutions	228,1	252,3	351,1
Cooperative banks	-	-	-
Banking sector, total:	52 694,9	53 389,1	56 180,8
y/y change (in %)	0,3	1,3	5,2

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	6,2	6,1	6,2
Domestic ownership total	10,2	9,7	9,8
Foreign ownership	89,8	90,3	90,2
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	62,2	80,3	1 591,3
Branches of foreign credit institutions	100,0	100,0	10 000,0
Cooperative banks	-	-	-
Banking sector, total:	62,2	80,3	1 571,9

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	9,5	5,9	8,4
Cooperative banks	-	-	-
Banking sector, total:	9,5	5,9	8,4

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	99,6	99,5	99,4
Branches of foreign credit institutions	0,4	0,5	0,6
Cooperative banks	-	-	-
Banking sector, total:	**100,0**	**100,0**	**100,0**

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

	2016	2017	2018
Receivables			
Financial sector	25,5	28,0	28,4
Nonfinancial sector	47,2	47,5	47,2
Government sector	24,7	21,9	21,9
Other assets	2,7	2,6	2,4
Liabilites			
Financial sector	11,1	10,5	11,2
Nonfinancial sector	67,9	68,0	68,2
Government sector	6,2	6,0	6,1
Other liabilities	0,8	0,8	0,7
Capital	14,0	14,8	13,9

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks	23,0	23,8	23,1
Cooperative banks	-	-	-
Banking sector, total:	23,0	23,8	23,1

(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	2016	2017	2018
Non-financial sector, including	17,6	13,7	12,1
Households	10,0	7,8	6,4
Corporate	28,3	22,2	20,4

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	81,1	90,1
Households	49,9	68,2
Corporate	31,2	21,9
Government sector	17,3	4,2
Financial sector (excluding banks)	1,6	5,7
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	2 232,6	2 004,3	1 607,0
Interest expenses	781,2	527,7	258,1
Net interest income	1 451,4	1 476,5	1 348,8
Net fee and commission income	431,8	454,9	444,2
Other (not specified above) operating income (net)	289,2	200,9	202,6
Gross income	2 172,4	2 132,3	1 995,6
Administration costs	881,8	901,2	863,0
Depreciation	86,8	95,3	90,6
Provisions	90,7	137,1	55,0
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	288,3	468,7	222,4
Profit (loss) before tax	824,9	530,0	760,4
Net profit (loss)	672,6	454,3	663,6

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	7 343	-	7 002	341	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	7 343	-	7 002	341	-

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

2018 DEVELOPMENTS IN THE CZECH BANKING SYSTEM

Macroeconomic environment in the country

In 2018, the growth dynamics of the Czech economy decreased. According to the latest estimate, real GDP grew by 2.9%, a deceleration of 1.6 percentage points as compared to the annual growth rate of 4.5% recorded in the previous year.

The GDP growth in 2018 was driven by household consumption, which increased by 3.1%, due mainly to significant growth in real wages and salaries of 6% (the highest figure recorded since 2002). Government final consumption expenditure, which went up by 3.7% y-o-y, contributed significantly to economic growth as well. Gross capital formation rose by 10.4% y-o-y due to higher investment activity across sectors. Also, net exports on an annual basis have been contributing positively to GDP formation since 2004, and 2018 was no exception.

In 2018, the average annual inflation rate as expressed by the consumer price index amounted to 2.1%, down by 0.4 percentage point y-o-y. During the entire year, it fluctuated in the tolerance band around the 2% inflation target. The most significant inflationary factors in 2018 were growth in housing-related costs and energy costs.

The Czech koruna appreciated on average both against the euro (2.6% y-o-y) and the US dollar (7.0% y-o-y). The average nominal exchange rate of the Czech koruna to the euro stood at CZK 25.64/EUR in 2018, and the exchange rate of the Czech koruna to the US dollar reached CZK 21.73/USD on average.

In 2018, the CNB continued to tighten its monetary policy by increasing its monetary policy rates. During the year, the two-week repo rate gradually increased by 1.25 percentage point to 1.75% (the increase in the two-week repo rate was accompanied by an increase in the CNB's discount and Lombard rates).

The downward trend in unemployment observed since 2013 continued, but more slowly than in previous years. The annual average of the general unemployment rate decreased by 0.6 percentage point y-o-y to 2.3%, representing the lowest figure among all EU Member States in 2018. The record-low unemployment rate, accompanied by excess demand for labour, created conditions for high growth in wages, which grew in nominal terms by 8.1% on average y-o-y, significantly influenced by a rise in public sector pay.

Development in the banking sector (including assets total / GDP)

At the end of 2018, the Czech banking sector comprised 23 domestic banks (including five building societies), 10 credit unions and 27 branches of foreign banks. The group of the four largest domestic banks held 60.1% of total assets in the banking sector.

In the Czech Republic, the relative size of the domestic banking sector expressed by the ratio of total bank assets to GDP went down slightly in 2018. The ratio stood at 137.5% at the end of 2018, i.e. 1.6 percentage points lower than in the same period of 2017.

The total assets of the Czech banking sector rose by 3.9% to CZK 7,301.3 billion, whereas the volume of client loans, the main component of assets, grew at a faster rate of 7.1%. In 2018, the quality of the loan portfolio improved due to a downward trend in the category of non-performing loans. As of the end of the year, the NPL ratio calculated on the basis of total client loans stood at 3.3%, i.e. 0.7 percentage point lower than in 2017.

In terms of liquidity, the domestic banking sector enjoys long-term favourable characteristics. This can be illustrated, for example, by the fact that the share of quick liquid assets in total assets stayed at solid level of 41.2% in 2018.

Banking entities generated a total net profit of CZK 81.4 billion in 2018, which corresponds to y-o-y growth of 8.1%. Due to their traditional business model, the main component of the total net profit of domestic banks was interest income (CZK 129.8 billion in 2018). Return on equity, as expressed by the ratio of total net profit to Tier 1 capital, grew by 0.6 percentage point to 17.2%.

The capitalisation of the Czech banking sector has long been satisfactory. At the end of 2018, the Tier 1 capital ratio for commercial banks stood at 19.1%, i.e. 0.4 percentage point higher than a year earlier. The total capital ratio also increased, reaching 19.6%. Domestic banks safely fulfilled the capital requirements defined by CRD IV / CRR throughout 2018.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

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

Main strategic objectives of the supervisory authority in 2018

Act No. 6/1993 Coll., on the Czech National Bank, tasks the CNB with supervising the financial market in the Czech Republic. The CNB's supervision of credit institutions is an integral part of maintaining the stability of the financial sector in the Czech Republic and promoting its sound and smooth development.

This broadly defined objective means, in particular, supporting the market discipline and competitiveness of credit institutions, preventing systemic crises and strengthening public confidence in the banking system. This corresponds with the areas of competence as regards supervision of compliance with prudential rules (hereinafter also "prudential supervision") and supervision of compliance with the rules of business conduct.

In 2018 the CNB focused on the following strategic objectives:

- enhancing the Supervisory Review and Evaluation Process (SREP) of credit institutions especially in the field of credit risk, information systems risk and IT risks;
- in the prudential supervision of credit institutions, investigating the conditions for providing loans to households, both mortgage and consumer, with a particular focus on the procedures for the assessment of clients' creditworthiness and collateral valuation;
- assessing risks related to cyber security and risk stemming from the use of cloud services;

- in the area of professional care related to credit institutions, focusing on investment services, payment services and also on exchange services;
- in the area of payment services, focusing on monitoring of compliance with PSD2 requirements;
- in the area of professional care, contributing to the clarification of interpretative uncertainties and to the unification of practices.

The activities of the Banking Supervisory Authority in 2018

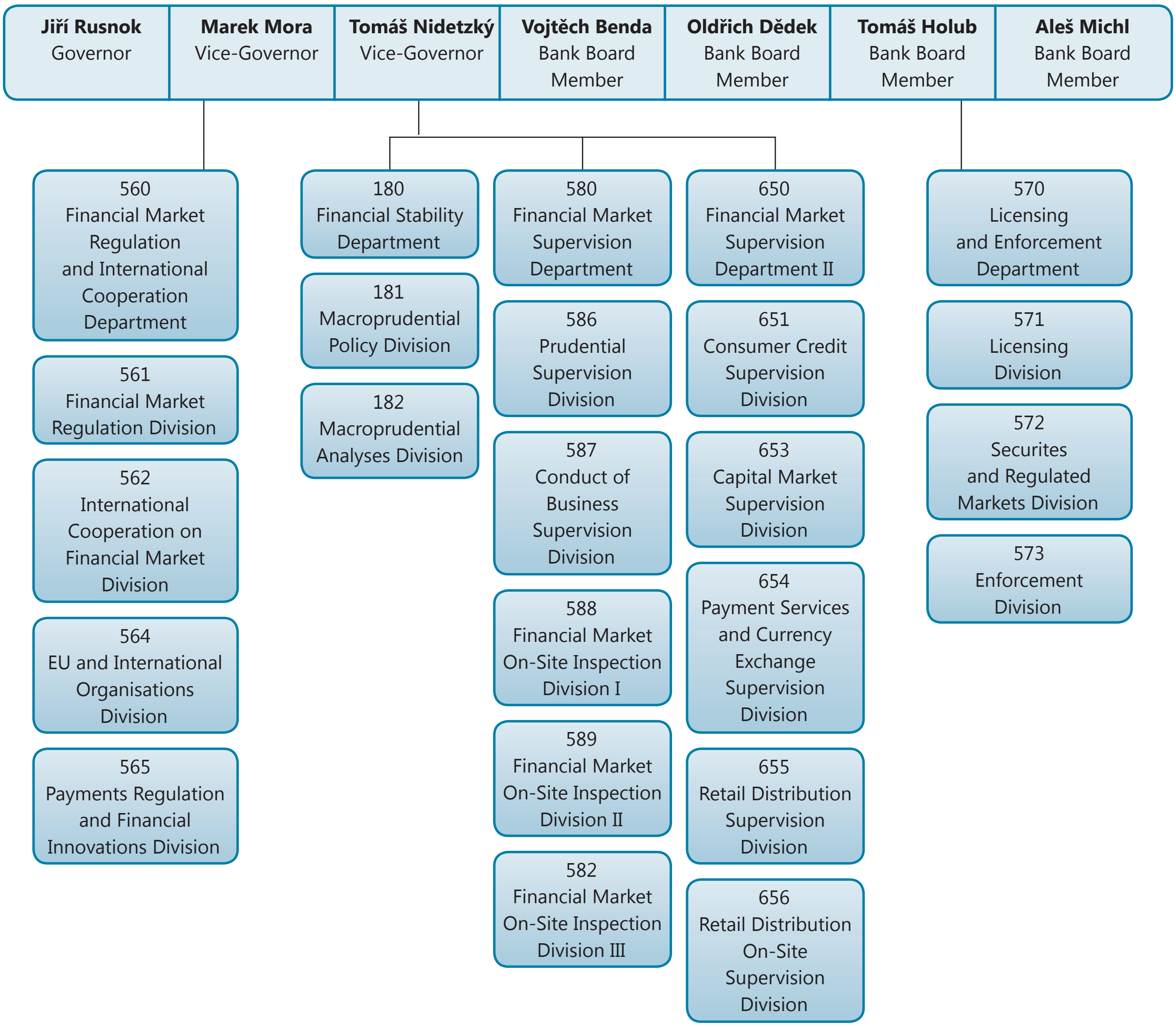
In 2018, the core activities of supervision were also focused on regular assessment of the financial situation, checking compliance with prudential requirements and monitoring qualitative information about the banking sector of the Czech Republic. Within the SREP, as in the previous years, the CNB prepared a comprehensive assessment of the risk profiles of the individual credit institutions.

Last year, the CNB's off-site surveillance of credit institutions was supplemented by 12 examinations carried out directly in banks, two of which were comprehensive. Despite the small market share of credit unions, this sector was subject to intensive CNB supervision. Four examinations were conducted in credit unions, one of which was comprehensive.

In cooperation with selected banks, the CNB conducted stress tests to assess the impacts of highly adverse future economic scenarios on the domestic banking sector. The six largest domestic banks, together accounting for 76% of the assets of the Czech banking sector, took part. The aggregated results of the stress tests confirmed good resilience of domestic banks.

In 2018, the CNB also evaluated the quality of the recovery plans prepared by credit institutions and their compliance with the requirements of the EU Bank Recovery and Resolution Directive (BRRD) and the Act on Recovery and Resolution in the Financial Market.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

The Czech National Bank cooperates actively with other (foreign) supervisors to ensure effective supervision within its area of competence as well as to coordinate a supervisory response to crisis situations. Where the CNB is the home supervisor, it establishes a supervisory college and manages the work of the college, which is the basic platform for cross-border supervisory cooperation. Where the CNB is the host supervisor, it coordinates and plans its activities in cooperation with the home supervisor.

At the international level, the CNB focuses on integration and cooperation within European structures. In 2018 the CNB cooperated with the European Banking Authority (EBA), the European Systemic Risk Board (ESRB) and the European Central Bank (ECB). The CNB also closely followed the discussions in the EU Council and its structures.

Cooperation with other supervisory bodies in the country

The CNB's activities include cooperation with the Czech Ministry of Finance and other state administration bodies. The CNB works in close cooperation with the Czech Ministry of Finance, which has primary responsibility for preparing laws in the financial market area. The basis for such cooperation is laid down in the Agreement on cooperation on the preparation of draft national legislation concerning the financial market in the Czech Republic. The CNB and the Czech Ministry of Finance cooperate under the Agreement in the preparation of laws, statements of intent for laws and implementing legislation regarding (i.) the foreign exchange system and regulation of electronic money issuance; (ii.) payments and accounting in the financial market; (iii.) banking, AML, the capital market, consumer protection in the financial market, insurance and pension schemes.

Other relevant information and developments in 2018

In 2018, work started on an amendment to Act No. 6/1993, on the Czech National Bank. The amendment should govern several issues regarding the CNB's issuance function and implementation of monetary and macroprudential policy. In this regard, the amendment should authorise the CNB to set mandatory indicators relevant for consumer lending, i.e. LTV (ratio of loan to property value), DTI (ratio of total debt to the debtor's annual net income) and DSTI (ratio of total monthly payment of all loans to the debtor's annual net income), in case of increased systemic risk. The legislative process will continue in 2019.

Further, work started on the resubmission of an amendment to the Act on Banks and the Act on Credit Unions. The amendment was expanded to include a number of new topics and submitted to the government at the close of 2018. The legislative process of preparing an amendment to the Act will continue in 2019.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	22	23	23
Branches of foreign credit institutions	23	24	27
Cooperative banks	11	10	10
Banking sector, total:	56	57	60

Total assets of banking sector (in billions CZK) (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	5393.2	6275.2	6603.0
Branches of foreign credit institutions	567.2	726.8	678.0
Cooperative banks	34.2	23.1	20.2
Banking sector, total:	5994.6	7025.0	7301.3
y/y change (in %)	9.0	17.2	3.9

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	1.8	1.2	1.1
Domestic ownership total	6.9	7.9	8.2
Foreign ownership	93.1	92.1	91.8
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	56.3	71.8	1,313.1
Branches of foreign credit institutions	53.1	71.9	1,505.9
Cooperative banks	79.0	94.4	2,833.6
Banking sector, total:	50.9	64.9	1,054.4

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	17.6	16.8	17.4
Cooperative banks	-1.0	-2.4	0.0
Banking sector, total:	17.5	16.6	17.2

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

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	90.0	89.3	90.4
Branches of foreign credit institutions	9.5	10.3	9.3
Cooperative banks	0.6	0.3	0.3
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2016	2017	2018
Receivables			
Financial sector	7.6	7.0	7.0
Nonfinancial sector	45.2	40.6	41.7
Government sector	1.1	0.9	0.8
Other assets	46.0	51.5	50.5
Liabilites			
Financial sector	14.0	21.0	20.0
Nonfinancial sector	57.4	52.6	53.9
Government sector	4.1	4.0	4.0
Other liabilities	17.1	15.8	15.3
Capital	7.4	6.7	6.8

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

Capital adequacy ratio of banks***

Type of financial institution	2016	2017	2018
Commercial banks	18.45	19.26	19.63
Cooperative banks	15.91	18.61	21.07
Banking sector, total:	n.a.	n.a.	n.a

(* – 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	2017	2018
Non-financial sector, including	4.0	3.2	2.7
Households	3.2	2.5	2.1
Corporate	5.2	4.2	3.6

Note: Banking sector = commercial banks + bank foreign branches; share of non-performing loans by sector.

The structure of deposits and loans of the banking sector in 2018 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	85.7	89.2
Households	60.1	50.1
Corporate	25.6	39.1
Government sector	6.4	1.8
Financial sector (excluding banks)	7.9	9.0
Total	**100.0**	**100.0**

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

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

P&L account	2016	2017	2018
Interest income	143,420.1	146,657.1	179,170.6
Interest expenses	33,561.1	34,561.4	49,416.8
Net interest income	109,859.0	112,095.7	129,753.8
Net fee and commission income	32,434.4	32,057.4	33,646.4
Other (not specified above) operating income (net)	1,429.3	2,504.2	2,935.7
Gross income	228,353.3	228,020.7	254,167.7
Administration costs	71,670.8	73,568.1	76,798.6
Depreciation	6,989.5	7,380.7	8,133.3
Provisions	2,810.3	2,613.3	2,047.6
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	10,564.8	4,989.0	4,594.3
Profit (loss) before tax	87,928.8	90,309.9	97,974.1
Net profit (loss)	73,897.6	75,354.3	81,426.0

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

Total own funds in 2018 (in millions EUR)***

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	19,181.1	18,147.3	18,664.9	516.1	n.a.
Cooperative banks	138.3	136.3	136.3	2.1	n.a.
Banking sector, total:	19,319.4	18,283.5	18,801.2	518.2	n.a.

(* – for Basel I; ** – for Basel II; *** – for Basel III)
Note: EUR = 25.73 CZK as at 31 December 2018.

2018 DEVELOPMENTS IN THE ESTONIAN BANKING SYSTEM

Macroeconomic environment in the country

In 2018, the gross domestic product of Estonia increased 3.9% compared to 2017. For the third consecutive year the economic growth in Estonia was faster than 3%. Main contributors to a growth covering the majority of economic activities were construction, manufacturing, professional, scientific and technical activities. A significant contribution to growth came also from transportation and storage, information and communication. All the above-mentioned economic activities showed good results in 2018. The only significant negative impacts on the economic growth were exerted by agriculture, forestry and fishing. This was largely due to their poor performance in the second half of the year.

In 2018, the exports of goods and services increased 4.3%, mainly due to the growth of the services exports. Although the growth was slightly lower than in 2017, the export of services increased by 5.6%. This was mostly due to the exports of computer and transportation services. The export of goods increased 3.6%. Main contributors to that growth were the exports of computers, electronic and optical equipment, motor vehicles, trailers and semi-trailers. Imports of goods and services increased 6.1%, which was the fastest growth in the last 6 years. This was mostly influenced by the imports of machinery and equipment not elsewhere classified, basic and pharmaceutical products and pharmaceutical preparations. The imports of services increased 11.6%, thanks to the imports of travel and transportation services. Net exports reached 904 million euros in 2018, which is 3.5% of the GDP.

Domestic demand also produced the best results in the last 6 years, growing 5.3%. This was mostly due to final consumption of households, which increased 4.6% in 2018. Last time the household consumption grew that fast was at the peak of the previous boom in 2007. Investments that declined in the first half of the year started to grow again in the second half. The investments increased 3.3% in 2018, which is a very good result compared to previous years. Biggest contributions to growth came from investments into buildings and structures by nonfinancial enterprises and from investments into dwellings by households. The investments by nonfinancial enterprises and government sector into transport equipment declined. The final consumption expenditure of the government sector grew by 0.3 in 2018.

In 2018 the unemployment rate was 5.4%. The number of longterm unemployed was the lowest of the last 20 years. Further growth in the employment of Estonian residents will be restricted because labour force participation and the employment rate are already very high.

Central bank forecasts Estonian economy growth 3.3% this year and 2.1% next. Growth in the economy will slow as export markets are weaker than before and there are still shortages of labour in Estonia. Wages will continue to rise despite the slower economic growth, but they will do so at a lower rate.

Development in the banking sector (including assets total / GDP)

At the end of the year there were 16 banks operating in Estonia, of which eight were branches of foreign banks. The authorisation was withdrawn from one bank by the European Central Bank working with Finantsinspektsioon. Changes in the structure of the banking sector with the creation of Luminor Bank AS mean there are additional risks that come from the economic environment in Latvia and Lithuania.

The yearly growth in the loan portfolio of the banks slowed from 6.8% to 5.7%. Although the growth in credit slowed, it was still relatively fast. Credit growth has been supported by the economic environment, low unemployment, rising incomes, and low base interest rates. There was growth of 1.2% in loans issued to non-financial companies, and of 6.2% in loans to households. The banking sector assets ratio to GDP was 102% in the end of 2018. The growth in lending by the banks has been supported by a favourable economic climate. Slower growth in the economy could worsen the quality of the loans, and this makes it important for the banks to maintain their conservative approach to lending and to keep sufficient capital buffers.

The share of the loan portfolio that was long-term overdue by more than 90 days fell further to 0.5% at the end of the year. This was helped by a decline in overdue loans and by the growth in the loan portfolio. Overdue loans have declined broadly at most of the banks and in most sectors of the economy.

Deposits increased by 4% over the year and the loan-to-deposit ratio rose to 109%. There were no significant changes in the structure of deposits, as the largest share continues to be in demand deposits, which account for 82% of all deposits. The share of non-resident client deposits fell from 11.8% to 7.9%. The share of non-resident deposits that are at greater risk of money laundering has fallen. The share of deposits held by clients from low-tax regions has fallen below 1% of all deposits.

The banks are profitable. The banks have managed to maintain their interest income and profitability even with interest rates low. The return on equity of the banks increased from 10.3% to 11%. The return on assets was 1.5% at the end of the year. Both these indicators are above the average for the European Union.

The liquidity and capitalisation of the banking sector have remained strong. Around a quarter of the assets of the banks are liquid and the liquidity requirements are met with sufficient margin. The figures for capitalisation are among the strongest in Europe.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

Finantsinspektsioon is a financial supervision and resolution authority with autonomous responsibilities and budget. The goal of financial supervision is to increase the stability, reliability, transparency and effectiveness of the financial sector, to reduce systemic risks, and to help prevent criminal activity in the financial sector. By doing this, Finantsinspektsioon supports the stability of the Estonian monetary system. The goal of resolution is to avoid any negative impacts on financial stability from any insolvency occurring at any bank. Finantsinspektsioon works on behalf of the state of Estonia and is independent in its decision-making. In carrying out financial supervision and in resolving financial crises, Finantsinspektsioon works only for the benefit of the public interest. Its work is funded by the supervision and procedural fees that are paid by the market participants that

Finantsinspektsioon supervises. Finantsinspektsioon carries out state supervision of licensed banks, insurance companies, insurance intermediaries, investment firms, fund management companies, investment and pension funds, payment institutions, e-money institutions, creditors and credit intermediaries, and the securities market. Finantsinspektsioon is part of the European Single Supervisory Mechanism (SSM), which carries out capital supervision for the most important banks and banking groups in Europe. Finantsinspektsioon is also part of the Single Resolution Board. The activities of Finantsinspektsioon are planned and controlled by the Supervisory Board. Its work is managed by a three-member management board, which takes decisions by majority vote.

Main strategic objectives of the supervisory authority in 2018

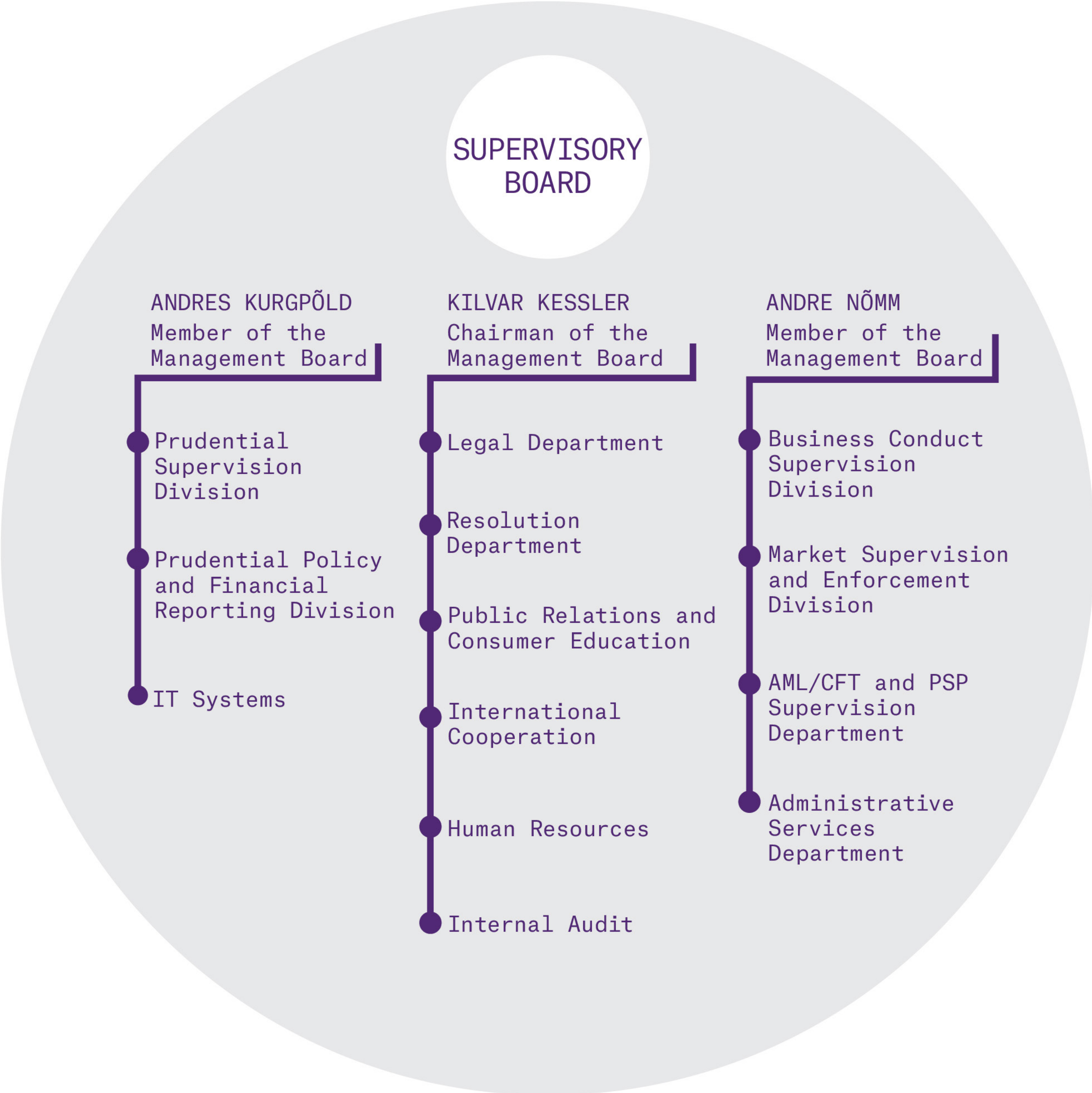
The Finantsinspektsioon strategy for 2016–2018 for supervision focused separately on priority activities in capital and service supervision and in resolution. In capital supervision Finantsinspektsioon focused on integrating with the single supervisory mechanism, with the emphasis on work with Eesti Pank in this. Finantsinspektsioon also worked hard on the supervision of corporate management, focusing on the suitability of managers, internal control systems, sustainability of business and continuity of operations, and reporting rights. In supervising services, Finantsinspektsioon focused on the life-cycle of financial services and products. Particular attention was paid to preventing money laundering and terrorist financing. As part of this Finantsinspektsioon has developed analyses and methodologies for financial supervision and has substantially raised the number of on-site inspections. The focus in resolution was on integrating with the Single Resolution Mechanism and the Single Resolution Board, and on drawing up resolution plans for the banks. In promoting public awareness, Finantsinspektsioon focused on supporting the supervision and resolution functions by giving consumers information on topical issues and setting a good example for professional participants in the financial market.

The activities of the Banking Supervisory Authority in 2018

Finantsinspektsioon issued six authorisations in 2018 and accepted six others as withdrawn or partially withdrawn. One authorisation was issued to a creditor and one to a credit intermediary under the Creditors and Credit Intermediaries Act. Licences were withdrawn from two creditors at their own application and two creditors withdrew their applications for authorisations during the application proceedings. Two authorisations for investment firms were also issued and two authorisations for payment institutions, one of which was issued with an exception for providing account information services. Two payment institutions had their authorisations withdrawn at their own application. An authorisation as an investment fund was issued to one fund manager, from whom the fund management authorisation was then withdrawn. The authorisation from one Eurofund manager was partly withdrawn at the application of the fund manager. Applicants for authorisations withdrew their application during the proceedings on six occasions, and on eight occasions the application for an authorisation remained unprocessed.

The European Central Bank withdrew the authorisation from one Estonian bank at the proposal of Finantsinspektsioon. On one occasion the European Central Bank granted permission for a cross-border merger of banks operating in the Baltic states. The new wording of the Payment Institutions and E-money Institutions Act that came into force at the start of the year was taken from PSD2, the new version of the payment services directive (PSD), that created authorisations for two new payment services in the Estonian market, which were payment initiation and account information services. For payment initiation and account information services to be provided, the payment account managers must ensure access to client payment accounts for those that have the right to provide such services.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

The Estonian financial sector is a part of the single European market for financial services. Finantsinspektsioon can contribute to designing the single financial supervisory policy of the European Union through the European supervisory authorities.

There are three European supervisory authorities, which are the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities Market Authority (ESMA). The European Systemic Risk Board (ESRB) is also part of the European system of financial supervisors, and handles macro risks. Staff from Finantsinspektsioon are involved in the work of all these supervisory bodies, and in 2018 they attended a total of 110 meetings of 38 committees or working groups of European supervisory authorities.

In autumn 2017 the European Commission proposed changes to the management and funding of the European supervisory authorities and a review of their mandates, roles and jurisdictions. Work was done on the proposal and the responses from member states throughout 2018 and continues in 2019. Finantsinspektsioon is in favour of making the European supervisory authorities more cost-effective, moving towards more efficient decision-making processes, and finding a balance between responsibility and duties.

As Estonia is a member of the Eurozone, the everyday work of Finantsinspektsioon is affected by the Single Supervisory Mechanism. This is a banking supervision system for the Eurozone that takes in the European Central Bank and the supervisory authorities of the Eurozone countries.The main role of the SSM is to ensure the security of the banking system and confidence in it, to increase financial integration and stability, and to ensure supervisory continuity. The European Central Bank conducts direct capital supervision through the SSM over systemically important banks in the Eurozone, of which there were 119 in 2018. Systemically important banks in Estonia are AS SEB Pank, Swedbank AS, and from 2018 Luminor bank AS.

Finantsinspektsioon is a main partner to the Single Resolution Mechanism, which is a central resolution institution for important banks in the Eurozone. The Single Resolution Mechanism consists of the Single Resolution Board together with the resolution authorities of the Eurozone countries. The Single Resolution Mechanism is responsible for ensuring that banks that have fallen into difficulties can be wound up with as little impact as possible on the economy and the whole financial system. One of the main strategic goals of Finantsinspektsioon is to integrate with the work of the Single Resolution Mechanism and the Single Resolution Board.

Finantsinspektsioon is also a member of a number of other global financial supervisory organisations. These are the International Association of Insurance Supervisors (IAIS), the International Organisation of Securities Commissions (IOSCO), the International Network on Financial Education of the Organisation for Economic Co-operation and Development (OECD), and the Group of Banking Supervisors from Central and Eastern Europe (BSCEE Group).

Strengthened cooperation is also very important because the Estonian financial system is tightly connected with those of the other Nordic and Baltic countries. Finantsinspektsioon is part of Nordic and Baltic groups such as the Nordic-Baltic Stability Group (NBSP) and the Nordic-Baltic Macroprudential Forum (NBMF).

In 2018 Finantsinspektsioon received visits from several rating agencies as part of their regular assessments, and it met representatives of the International Monetary Fund (IMF) in their annual Article IV assessment visit.

Other relevant information and developments in 2018

One of the goals of Finantsinspektsioon is to promote public understanding of financial services and financial products.

Financial intermediaries are constantly bringing new products and services to the market or adding new options to their current offers. Finding the best and most appropriate product from among all those on offer frequently requires detailed research in advance. For more than a decade now, Finantsinspektsioon has had a consumer website www.minuraha.ee that has helped to encourage financial literacy among the Estonian public. It offers independent advice on the financial services and products that are on the market. Finantsinspektsioon started updating the technical platform of the consumer website in 2018, and plans to transition to the full version of the site in the first half of 2019. It will offer independent information on the nature of financial services and it is planned that new calculators will gradually be introduced.

Alongside administering the consumer website, Finantsinspektsioon works on financial education together with the Ministry of Finance, Eesti Pank, the Estonian Banking Association, the Estonian Insurance Association, and the Tallinn stock exchange. Family days held to explain about money were organised jointly with Eesti Pank in the Eesti Pank Museum in 2018, and lectures were given on subjects ranging from consumer credit to cryptocurrencies.

Statistical tables

Number of financial institutions
(at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	9	9	8
Branches of foreign credit institutions	7	8	8
Banking sector, total:	16	17	16

Total assets of banking sector (mln €)
(at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	18208	22665	23925
Branches of foreign credit institutions	6302	2616	2194
Banking sector, total:	24511	25281	26119
y/y change (in %)	5,9	3,1	3,3

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	0	0	0
Domestic ownership total	7,3	11	7,9
Foreign ownership	92,7	89	92,1
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	79,7	83,4	2502
Branches of foreign credit institutions	7,6	8,2	27
Banking sector, total:	79,7	90,5	2529

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Banking sector, total:	11,9	10,3	11,0

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	74,3	89,7	91,6
Branches of foreign credit institutions	25,7	10,7	8,4
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2016	2017	2018
Receivables			
Financial sector	27,9	25,5	31,4
Nonfinancial sector	56,9	48,0	60,9
Government sector	2,5	2,8	4,2
Other assets	12,6	23,7	3,5
Liabilites			
Financial sector	25,7	23,3	21,2
Nonfinancial sector	54,3	54,2	57,2
Government sector	6,7	7,1	5,4
Capital	13,3	15,4	16,1

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks* **	35,1	30,6	30,1

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

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

Asset classification	2016	2017	2018
Non-financial sector, including	1,9	2,6	1,8
households	1,3	1,7	1,4
corporate	2,7	3,6	2,3

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	83	82
Households	47	47
Corporate	36	35
Government sector	6	3
Financial sector (excluding banks)	8	12
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	511	483	551
Interest expenses	65	61	72
Net interest income	446	421	479
Net fee and commission income	150	144	150
Other (not specified above) operating income (net)	138	47	169
Gross income	889	770	967
Administration costs	290	279	332
Depreciation	11	12	13
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	47	14	-8
Profit (loss) before tax	387	347	459
Net profit (loss)	360	316	370

Total own funds in 2018 (in mln EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2
Commercial banks* **	3308	3238	3241	67

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

2018 DEVELOPMENTS IN THE GEORGIAN BANKING SYSTEM

Macroeconomic environment in the country

In 2018, economy of Georgia grew by 4.7 percent. The largest share of the growth, 4.5 percentage points, came from the services, 0.2 pp – from industry. The year 2018 was notable in terms of growth in revenues from exports and tourism, as well as growth in money transfers. The increased number of foreign visitors had particularly positive effect on the real estate operations, hotels, restaurants and transports. In the real estate operations the growth surged to 12.1% and its contribution to growth equaled 0.7 pp. A large contribution to the growth came from transport sector as well, which leaped by 9.4% to make a contribution of 0.6 pp. A substantial share of that growth came from travel agencies, tour operators and air transport – all of which further underlines the significance of the enlargement of the tourism industry. Tourists' participation is also important for the output of hotels and restaurants, which grew by 9.7%, contributing 0.2 pp to total growth. In line with the significant improvements in the external sector, the main driver of economic growth in 2018 was net exports, the contribution of investment and domestic demand was weak compared to net exports.

Gross national savings rate was 26% of GDP in 2018. Unemployment rate remained high; however, it decreased to 12.7% in 2018 compared to the 13.9% in the previous year.

During the 2018, inflation stood close to, but slightly under, the target level of 3%. This was in spite of the increase in tobacco and fuel prices and the growth of water and electricity fees from the beginning of the year. Additionally, in December, there was a hike in bread prices, but inflation nevertheless declined to its lowest point of 1.5%. Overall, throughout the year average inflation equaled 2.6%.

Consolidated budget deficit was 2.3% of GDP compared with 2.9% in 2017. Tax burden made up around 26% of GDP, almost the same as in 2017. Public debt to GDP decreased and amounted to 45.8% in 2018, while in 2017 it was 48.5%.

The current account deficit in the balance of payments was at 7.7% of GDP, which is the lowest level during the last 5 years. The current account deficit was positively affected by the improvement in the trade balance in services, which increased by 220 USD in 2018. It is worth mentioning that tourism export inflows increased by 518 USD (by 27%). Trade balance remains the most negative component of the current account. In 2018, the ratio of trade deficit in goods to GDP worsened by 0.2 percentage points and was at 25.4% of GDP.

Development in the banking sector (including assets total / GDP)

Banking is the main financial intermediary in Georgian economy. Foreign investments dominate banking sector and account for more than 85% percent of total equity. Banking sector assets grew by 15% in 2018. Credit portfolio increased by 19% YoY at the end of 2018, more than in 2017. In total, credit portfolio accounted for 65% of GDP which is 6% higher than in 2017. As for the total assets of banking sector, they accounted for 97% of GDP that is 5 percentage points higher than in 2017.

In 2017, the highest growth rate was recorded in SME (28% annually), followed by corporate and retail sectors. Banking sector loan portfolio break-down by products is the following: 30% accounts for corporate sector, 45% – retail sector, and 25% – SMEs.

Throughout the year, loan portfolio quality has slightly improved. According to NBG's more forward-looking methodology and taking into account restructured loans with no evidence of being able to repay them under the new schedule, NPL ratio decreased by 0.4 percentage points and made up 5.6% of total portfolio. At the same time, NPL ratio calculated with widely accepted methodology – loans with more than 90 days overdue to total portfolio – decreased to 2.7% in 2018, 0.1 percentage points less than in 2017.

In 2018, banking sector accumulated liquidity ratio above the prudential minimum. The share of liquid assets to total assets and non-bank deposits made up 22% and 37%, respectively.

Banking system still remained highly dollarized, contributing to currency induced credit risk. In 2018, the dollarization of loans is same on 57.1%, and dollarization of deposits decreased, making 63.1%. To mitigate this risk, NBG applies additional capital requirements for currency induced risk under Pillar 2.

Georgian banking system is adequately capitalized, mainly driven by aforementioned risk weighting. At the end of 2018, core Tier 1, Tier 1 capital and regulatory capital ratios calculated based on Basel III framework were 13.3, 13.5% and 18.4%, respectively (minimum requirements are 7.0%, 8.5% and 10.5%). It is noteworthy, that starting from 2018, Basel I framework is fully phased-out.

Profitability of banks increased in 2018. Net income of the system jumped from 870 million GEL in 2017 to 915 million GEL in 2018. At the end of 2018 RoA made up 2.5% and RoE made up 19.5%. Nominal growth of the credit portfolio and improvement of efficiency led to higher profitability in banking system. Cost to income ratio decreased from 47.1 % in 2017 to 44.8% in 2018.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

The 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.

According to the amendments in the organic law on the National Bank of Georgia, made by Georgian Parliament in the end of 2017, the National Bank of Georgia was authorized to supervise loan issuing entities (entities which issues loan more than 20 individuals). In addition, NBG has the right to regulate and supervise the activities of the Credit Information Bureau from September 1, 2018. Accordingly, in 2018 the orders of the governor of the National Bank of Georgia entered into force, "On Approving the Rule of Registering, Cancelling Registration and Regulation of the Credit Information Bureau in the National Bank of Georgia" and "On Submitting Information to the Credit Information Bureau on the Territory of Georgia, Recording Information in the Database of the Credit Information Bureau and Its Accessibility".

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 2018 NBG continued development of regulatory framework and approximation of current standards with international practices and principles.

In 2018, the NBG approved the "Code of Ethics and Professional Conduct Standards for Commercial Banks" that aims to establish internationally recognized ethical and professional standards of banking profession for the Georgian banking sector. These will facilitate an enhancement of public trust, including amongst investors, towards the banking sector. It will also significantly support the banking sector in operating in a stable and efficient manner. The principles and standards established by the latter document are based on the framework of ethical principles and standards of professional conduct developed by the Certified Financial Analysts (CFA) Institute – one of the most commonly recognized and respected manuals in the financial market.

The Code of Ethics is a component of the Corporate Governance framework. In 2018, the National Bank of Georgia made significant changes in this direction. In particular, in order to approximate with the principles of corporate governance best practice, the National Bank of Georgia elaborated and approved the "Corporate Governance Code for Commercial Banks". Abovmentioned code contains internationally accepted requirements and standards, including composition of supervisory board regarding inclusion of independent members and maintaining gender balance.

The National Bank of Georgia implemented the Basel III leverage ratio. The leverage ratio is a simple and transparent figure that acts as a supplementary measure of risk-based capital adequacy requirements. The ratio is defined as Tier 1 capital divided by a bank's total risk exposures. Regulation on the "Leverage Ratio Requirements for Commercial Banks" came into force in September, 2018 and established the requirement of minimum leverage ratio of 5%. Ratios calculated under this regulation are published by commercial banks in quarterly Pillar 3 reports.

On May 14, 2018, the Governor of the National Bank of Georgia approved the "Instructions on Real Estate Appraisal for Commercial Banks", which was enacted on June 1, 2018. The main purpose of the instruction is to improve the quality of real estate valuation in the banking sector and to ensure greater transparency of the valuation principles and processes, that will contribute to the stable and efficient functioning of the banking sector.

During 2018, the National Bank of Georgia, in cooperation with financial sector, actively worked on the framework of responsible lending. Accordingly, on December 24, 2018, the Governor of the National Bank of Georgia approved the "Regulation on Lending Standards for Natural Persons" (decree N 281/04). The regulation aims to strengthen stable functioning of financial sector and encourage sound lending standards, which will favor sustainable development of country's economy.

Main strategic objectives of the supervisory authority in 2018

In 2018, 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 framework, capital buffers and approximating banking legislation to the EU legislation according to the EU-Georgia Association Agreement.

The NBG finalized the formalization process of the Pillar 2 elements of the Basel III capital adequacy framework. Changes were also made to the existing Pillar 1 framework so that minimum requirements for capital adequacy are thus in line with the capital framework set by the Basel Committee for Banking Supervision. Apart from the abovementioned changes and the Common Equity Tier 1 capital ratio, banks are also obliged to comply with an additional, so-called combined buffer that includes conservation, countercyclical and systemic buffers. Systemic buffer rates and compliance timeframes were set for systemically important banks that were defined by the NBG.

During 2018, the National Bank of Georgia has actively worked on the calibration of stress test buffer, which is part of Pillar 2. during 2019, NBG plans to formalize and standardize stress testing framework with cooperation with banks in order to fully integrate stress test buffer in Pillar 2 requirements. Enterprise-level stress test helps to assess the effect of systemic and sectoral economic shocks and idiosyncratic events on banks and determine the relevant capital requirements. Alongside with the integration of net stress testing buffer in Pillar 2 requirements, it is important to avoid double requirements of capital. Accordingly, stress-testing buffer requires capital in an amount that exceeds the sum of conservation and countercyclical buffers.

During 2018, net GRAPE buffer became effective. It is determined within the risk-based supervision framework, which aims to assess the risk profile of commercial banks. According to GRAPE, the risk profile of each commercial bank is evaluated. In 2018, individual GRAPE buffer became effective, which ranges from 1.4% to 14.4%.

During 2018, the National Bank of Georgia, in cooperation with the State Insurance Supervision Service, continued working on the development and implementation of a supplementary supervision framework for financial conglomerates. This, in accordance with the EU-Georgia Association Agreement, is to approximate the legislation to the EU acquis within a stipulated timeframe. The supplementary supervision framework implies prudential supervision with respect to capital adequacy, risk concentration, intra-group transactions and the internal control mechanisms of entities within a financial conglomerate.

The activities of the Banking Supervisory Authority in 2018

In 2018, the NBG approved the "Code of Ethics and Professional Conduct Standards for Commercial Banks" that aims to establish internationally recognized ethical and professional standards of banking profession for the Georgian banking sector. These will facilitate an enhancement of public trust. The principles and standards established by the latter document are based on the framework of ethical principles and standards of professional conduct developed by the Certified Financial Analysts (CFA) Institute – one of the most commonly recognized and respected manuals in the financial market. The document defines principles of ethics in detail and regulates standards of professional conduct, including professionalism, integrity of financial markets, the integrity of the banking sector, duties to clients, duties to employers, principles of professional behavior, conflicts of interests, and the responsibilities of subjects in the scope of the code. In addition, the code establishes the obligations of commercial banks for the purpose of complying with the standards and requirements of the code as well as the issues concerning identification of violations of the code, decision making and appeal procedures.

In order to approximate with the principles of corporate governance best practice, the National Bank of Georgia elaborated and approved the "Corporate Governance Code for Commercial Banks". Abovementioned code contains internationally accepted requirements and standards, including composition of supervisory board regarding inclusion of independent members and maintaining gender balance. The regulation concerns the following issues regarding the supervisory board and its committee(s): the number of members, independence, qualifications, responsibilities and delegation of authority. In addition, the regulation defines issues related to the composition and qualifications of the management board, risk management and internal control functions, and the remuneration principles for senior management and material risk takers. The code aims to introduce international best practice of corporate governance of commercial banks, which supports the banking sector in operating in a stable and efficient manner.

Regulation on the "Leverage Ratio Requirements for Commercial Banks" came into force in September, 2018 and established the requirement of minimum leverage ratio of 5%. Ratios calculated under this regulation are published by commercial banks in quarterly Pillar 3 reports.

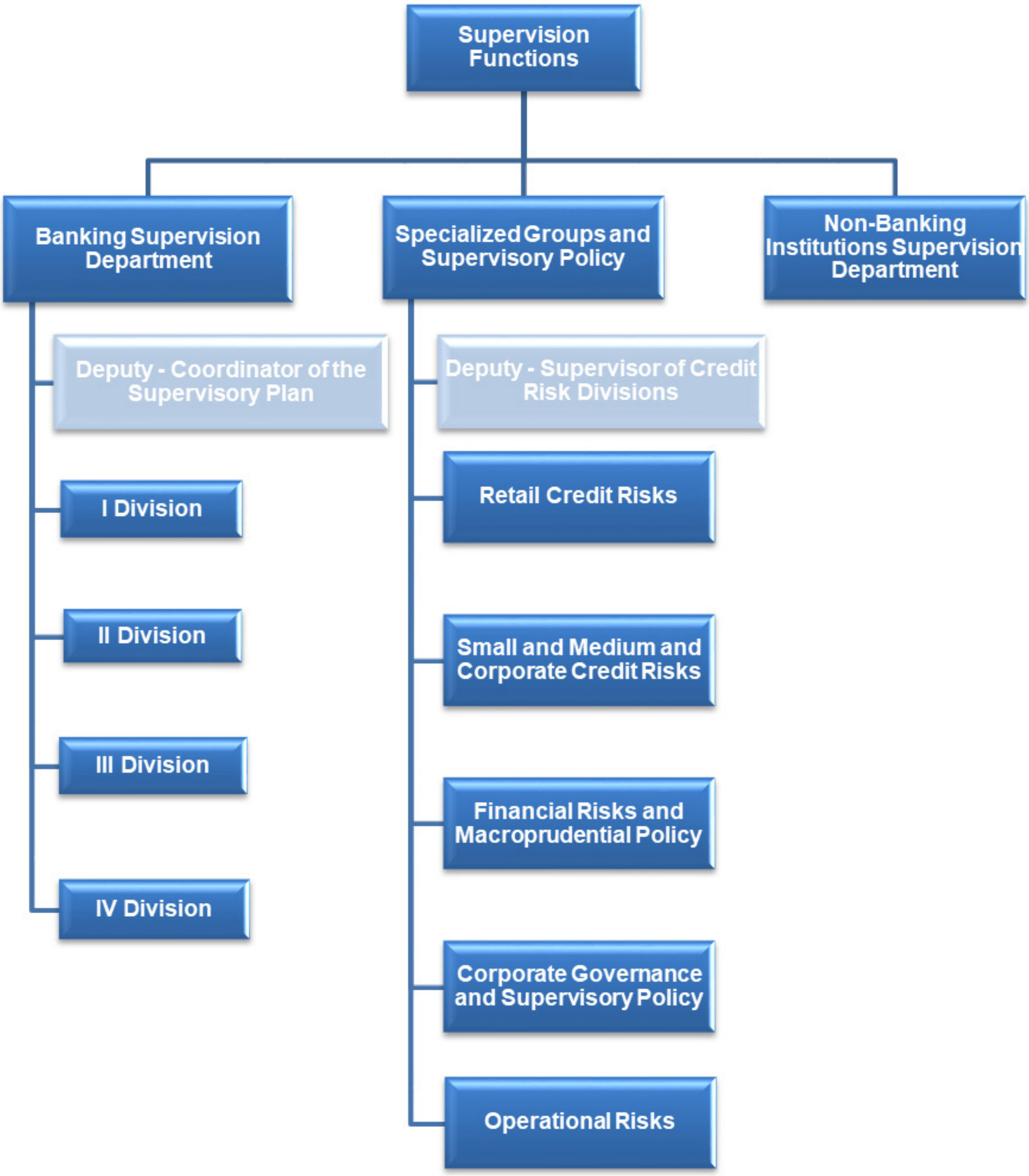
On May 14, 2018, the Governor of the National Bank of Georgia approved the "Instructions on Real Estate Appraisal for Commercial Banks", which was enacted on June 1, 2018. The main purpose of the instruction is to improve the quality of real estate valuation in the banking sector. According to the instruction, ethical standards, qualification requirements for the appraiser and commercial bank's Liabilities regarding the real estate valuation process conducted by a professional internal/external appraisers and the rights of the National Bank of Georgia relating to above-mentioned liabilities were determined and regulated.

During 2018, the National Bank of Georgia, in cooperation with financial sector, actively worked on the framework of responsible lending. Accordingly, on December 24, 2018, the Governor of the National Bank of Georgia approved the "Regulation on Lending Standards for Natural Persons" (decree N 281/04). The regulation aims to strengthen stable functioning of financial sector and encourage sound lending standards, which will favor sustainable development of country's economy. According to the regulation, a financial institution shall not grant the loan or other liability (e.g. guarantee) without prior analyses of client's solvency. The regulation covers all the lending institutions under the supervision of the National Bank of Georgia and it was enacted on January 1, 2019. The lenders will be obliged to analyse the income of the client, the value of the collateral and draft the loan, if the Payment-to-Income (PTI) and Loan-to-Value (LTV) ratios do not exceed the limits defined in this regulation. Abovementioned ratios differ for local and foreign currency loans, which aims to protect the borrowers and the financial system from the foreign exchange volatility induced risk.

It is important that the National Bank of Georgia is working on Bank recovery and resolution framework, which will be based on respective international best practice and EU directive.

Since September, 2018 according to the changes in the Georgian legislation, two orders of the governor of the National Bank of Georgia entered into force: "On Approving the Rule of Registering, Cancelling Registration and Regulation of the Credit Information Bureau in the National Bank of Georgia" (№193/04) and "On Submitting Information to the Credit Information Bureau on the Territory of Georgia, Recording Information in the Database of the Credit Information Bureau and Its Accessibility"

Organizational chart of the Banking Supervisory Authority



International activities of the authority

In 2018 the National Bank of Georgia was a chairman of the BSCEE (Banking Supervisors from Central and Eastern Europe) Group. The National Bank of Georgia became a member of BSCEE in 2013 and has been actively involved in a Group activities. BSCEE combines 24 countries of Eastern and Central Europe. According to the Group's rules, the chairperson of the group is elected from member states, annualy. The National Bank of Georgia hosted the BSCEE Group annual conference in 2018.

The conference, held in Tbilisi, was dedicated to the Basel III reform, stress-test methodology and to the solvency analysis issues with respect to reduce excess debt risks. Participants were able to share their experience on topics presented in the conference and to listen to the experience of member states.

It is noteworthy that Toshio Tsuik, representative of the General Secretary of the Basel Committee of Bank Supervision, attended the conference. In his speech, he introduced Basel III's final framework and future priorities to the participants.

In 2018, the National Bank of Georgia continued cooperation with supervisory bodies of different countries. The National Bank of Georgia signed memorandums with Astana Financial Services Authority and China Banking and Insurance Regulatory Commission. According to the memorandums the parties agreed that within a mutual cooperation they will exchange information and closely cooperate with each other in the banking supervision and security markets supervision fields in order to improve functioning of financial institutions, commercial banks and capital markets.

In October 2018, representatives of Azerbaijan Financial Market Supervision Agency (FIMSA) visited the National Bank of Georgia on a study mission. Within the visit, meetings were held on the following issues: NBG risk-based Basel III supervision framework, stress tests, liquidity and market risks, corporate and retail credit risks, corporate governance and group structure risks, financial stability analysis.

The National Bank of Georgia has deepened cooperation with the Basel Committee on Banking Supervision within the framework of the RCAP (Regulatory Consistency Assessment Program). Employees of the National Bank of Georgia are invited to the team of this program as experts. Within the program, employees of the National Bank of Georgia conduct monitoring and assessment of the process of implementation of Basel III's large exposures and NSFR.

Cooperation with other supervisory bodies in the country

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

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

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

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	15	16	15
Branches of foreign credit institutions	1	0	0
Cooperative banks			
Banking sector, total:	16	16	15

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	30,149,324,340	34,593,509,966	39,682,984,387
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	30,149,324,340	34,593,509,966	39,682,984,387
y/y change (in %)	19.80%	14.74%	14.71%

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership			
Domestic ownership total	14%	14%	13.1%
Foreign ownership	86%	86%	86.9%
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	77.50%	85.36%	27.45%
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	77.50%	85.36%	27.45%

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	18.22%	20.73%	19.38%
Cooperative banks			
Banking sector, total:	18.22%	20.73%	19.38%

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	99.73%	100%	100%
Branches of foreign credit institutions	0.27%	0%	0%
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2016	2017	2018
Receivables			
Financial sector	1.49%	0.77%	1.08%
Nonfinancial sector	57.07%	60.17%	62.34%
Government sector	4.24%	3.52%	3.63%
Other assets	37.20%	35.54%	32.96%
Liabilites			
Financial sector	4.34%	3.09%	2.20%
Nonfinancial sector	52.97%	54.36%	56.02%
Government sector	3.31%	2.82%	1.96%
Other liabilities	26.19%	26.91%	26.90%
Capital	13.20%	12.82%	12.93%

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks	15%* 15.06%***	16.4%* 19.13%***	18.4%***
Cooperative banks			
Banking sector, total:	15%* 15.06%***	16.4* 19.13%***	18.4%***

(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	2016	2017	2018
Non-financial sector, including	3.67%	2.81%	2.71%
Households	2.04%	1.93%	1.92%
Corporate	4.98%	3.56%	3.34%

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	96.62%	98.40%
Households	54.13%	41.40%
Corporate	42.49%	57.01%
Government sector	3.38%	0.01%
Financial sector (excluding banks)	0.00%	1.59%
Total	**100.00%**	**100.00%**

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

P&L account	2016	2017	2018
Interest income	2,453,795,614	2,842,579,309	3,375,387,165
Interest expenses	1,017,733,187	1,249,073,368	1,468,274,598
Net interest income	1,436,062,427	1,593,505,941	1,907,112,566
Net fee and commission income	315,213,697	409,942,825	429,385,296
Other (not specified above) operating income (net)	390,841,578	357,224,599	387,766,389
Gross income	3,159,850,888	3,609,746,733	4,192,538,850
Administration costs	522,636,060	629,127,409	671,956,367
Depreciation	108,677,550	120,372,400	126,364,198
Provisions	337,830,397	274,394,894	396,448,870
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	337,830,397	274,394,894	396,448,870
Profit (loss) before tax	819,327,557	973,466,867	1,106,409,941
Net profit (loss)	679,101,417	869,798,258	914,718,058

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds ***	Core Tier 1***	Tier 1***	Tier 2***	Tier 3
Commercial banks	2,078,600,904	1,505,968,315	1,527,226,054	551,374,850	
Cooperative banks					
Banking sector, total:	2,078,600,904	1,505,968,315	1,527,226,054	551,374,850	

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

2018 DEVELOPMENTS IN THE HUNGARIAN BANKING SYSTEM

Macroeconomic environment in the country

Hungarian GDP increased by 4.9 percent, while inflation rate reached 2.8 over the course of 2018. The budget deficit was 2.2 percent. The economy's overall external position remained positive, the current account balance was 0.5 as a percentage of GDP.

Hungarian economic growth accelerated in 2018. On the expenditure side, domestic demand items – consumption and investment – continued to contribute to growth to the greatest degree. The contribution of net exports was negative, as the expansion of goods imports exceeded export growth in parallel with the increase in domestic demand items.

The increase in household consumption expenditures is strongly supported by the favourable underlying income trends related to the continued robust increase in wages and growth in employment. Growth was also supported by robust consumer confidence, willingness to borrow and net financial wealth.

Gross fixed capital formation continued to increase in 2018, a rise in the investment activity in all three sectors contributed to the expansion. Corporate investments were up significantly in parallel with dynamic lending activity and huge investments by the manufacturing subsector. The buoyant expansion in government investment was primarily a result of developments implemented from EU funds. Households' investment activity also improved in accordance with the upswing of the housing market.

In 2018, inflation fluctuated around the 3 percent inflation target. Volatile items (fuels and unprocessed food), sensitive to movements in global commodity prices, led to a greater-than-usual volatility of inflation. Core inflation excluding indirect tax effects rose gradually. Underlying inflation indicators also increased throughout 2018.

The increase in total employment continued in 2018, however, the rise slowed down somewhat compared to the previous year. Public sector employment decreased due to a drop in Public Work Scheme, whereas private sector employment grew supported by the manufacturing and construction sectors. The unemployment rate dropped to 3.7 percent in 2018.

Hungary's net lending and the current account balance were 2.2 percent and 0.5 percent of the GDP in 2018, respectively. Both net lending and current account balance decreased somewhat compared to the previous year. The decline is attributable to a decrease in the balance of goods, which is primarily related to the strong domestic demand mainly due to investments, but temporary factors and a deterioration in the terms of trade also played a role in the decline. The deficit of the income balance did not change significantly: the decline in foreign interest expenditures was offset by the change in the compensation of employees. The surplus of the transfer balance increased as a result of a higher absorption of EU transfers.

Development in the banking sector (including assets total / GDP)

In the continuing benign economic environment, Hungarian banks have extended further their balance sheet total via sustainable lending growth. The expanding balance sheet total continues to help the banking sector to outgrow the legacy of the global financial crisis. Namely, the rising balance sheet total, the expansion in lending and improving macroeconomic fundamentals have a positive impact on the non-performing loan ratio, the size of loan losses and the operating expense-to-assets ratio. In 2018, the Hungarian banking system's overall shock absorbing capacity remained robust both in terms of liquidity and capital adequacy. Banks' capital adequacy ratios indicate strong solvency, while the liquidity coverage ratio (LCR) is also well above the regulatory requirements. Based on the results of our solvency stress test, the institutions in the Hungarian banking sector would be able to meet the regulatory requirements even in the case of a severely adverse macroeconomic scenario.

Corporate loans outstanding of credit institutions rose by 14 per cent during the year, while their household loans increased by over 7 per cent. The expansion in corporate lending was the strongest seen since the crisis and was broad-based across sectors, although one-off items (financing of large investment projects as well as corporate acquisitions and purchases of commercial real estates) also played a significant role. Annual growth in lending to SMEs amounted to 10.1 percent including the transactions of the self-employed, while the annual growth rate was nearly 11 percent excluding lending to the latter. As regards household lending, the nominal value of newly contracted housing loans reached the pre-crisis level, but total household lending remained below the volume from 10 years ago, both in nominal and real terms. As a proportion of households' disposable income, borrowing in 2018 was only a half of the level recorded in 2008. The favourable economic environment and the wide range of regulatory instruments ensure that credit growth continues in a balanced and sustainable way.

In 2018, banks faced rising demand both for housing loans and consumer loans, accompanied by a significant increase in average loan amounts and a moderate one in maturities in both segments. The interest rate spread on new disbursements declined, while the interest rate spread on fixed-rate housing loans decreased to below the spread on variable-rate loans. The amendment of the payment-to-income (PTI) ratio, effective from 1 October 2018, did not have a material impact on the volume of housing loan disbursements, but the tightening is diverting demand towards loans with longer interest rate fixation periods, thereby reducing the interest rate risk borne by households. The ratio of certified consumer-friendly housing loans (CCHL) within monthly new disbursements of loans with an interest period longer than five years rose to 68 percent by the end of the year, while the share of housing loans with interest fixed for more than one year increased to 95 percent. Compared to the previous year, the volume of newly issued housing loans expanded by 31 percent, amounting to 52 percent of total annual disbursements. The level of lending for housing purposes as a percentage of GDP is low in Hungary both in European and regional comparisons, hence there is still ample room for an expansion in lending. At the end of 2018, – as a result of dynamic nominal GDP growth of 9.7 per cent – the total assets-to-GDP ratio of the banking sector decreased 1 percentage point to 85 per cent relative to the end of 2017.

Property prices in the capital continued to increase during the year, achieving a 22.9 per cent annual growth rate by the end of 2018. The effect exerted by the potential overvaluation of the housing market on the banking system is mitigated by the fact that the price increases were not coupled with a considerable rise in the share of risky loans with a high loan-to-value (LTV) ratio. The proportion of mortgage loans with an LTV of over 70 per cent relative to banks' own funds is a fraction of pre-crisis levels, both in terms of outstanding loans and new contracts. This suggests that a potential housing market shock would be less likely to create a negative, self-reinforcing spiral between the banking system and the housing market. While house prices in the capital have skyrocketed in recent years, the property market has hardly recovered in certain parts of the country.

Delinquent mortgage debtors in these areas are in an especially difficult situation, since selling their property does not typically offer them a way out of the default status. This problem may be alleviated by a government programme aiming to support the property market in areas suffering from population loss. However, the issue of overdue loans is nowadays concentrated in the balance sheets of workout companies, which poses a limited risk to banks.

Hungarian banks realised high profits last year, but a relevant part of their high profitability originated from one-off effects. Releasing write-downs has significantly boosted profits in recent years, but this process seems to have lost momentum by the end of 2018. Write-backs of earlier reserves concealed the fact that banks' structural profits (which can be maintained in the long run) are considerably lower than in the past two years. Improving cost effectiveness is still considered to be crucial to boost sustainable profitability, and it may be greatly facilitated by cost-cutting measures (e.g. digitalisation, consolidation) as well as the expansion in credit.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

The Central Bank of Hungary (Magyar Nemzeti Bank, hereinafter: "MNB") performs its supervisory and consumer protection tasks according to the Act CXXXIX of 2013 on the Magyar Nemzeti Bank.

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

Regarding the legislative developments in 2018, we would highlight the following laws:

1. Act CXXVI of 2018 on harmonizing the laws governing the operation of financial intermediary system provided the fine tuning of the Hungarian legislation especially due to the corrigendum of PSD2 [Directive (EU) 2015/2366 of the European Parliament and of the Council], Strong customer authentication ITS [Commission Delegated Regulation (EU) 2018/389], Deposit guarantee schemes Directive [Directive 2014/49/EU of the European Parliament and of the Council].

2. MNB Decree No. 45/2018. (XII.17.) on the detailed rules concerning the implementation of the Act on the Prevention and Combating of Money Laundering and Terrorist Financing – for details see Chapter 10.

3. MNB Decree No. 44/2018 (XII.5.) on taking into account of the qualifying holdings in non-financial sector and the materiality threshold for late credit obligations – laying down the provisions necessary for the implementation of CRR [Regulation (EU) No 575/2013 of the European Parliament and of the Council], and of Commission Delegated Regulation (EU) 2018/171 of 19 October 2017 on supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for the materiality threshold for credit obligations past due.

Main strategic objectives of the supervisory authority in 2018

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

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

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

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

The activities of the Banking Supervisory Authority in 2018

In 2018 the directorate of MNB responsible for credit institutions supervision launched 67 inspections and concluded 12 comprehensive, 28 targeted, 1 special thematic, 5 follow-up and 2 other inspections. Concerning the internal capital adequacy of the institutions 10 complex (on-site) Internal Capital Adequacy Assessment Process ("ICAAP") inspections and concerning the internal liquidity adequacy of the institutions 10 complex (on-site) Internal Liquidity Adequacy Assessment Process ("ILAAP") inspections were completed. As a result of the completed inspections 508.1 million HUF prudential fine was imposed on credit institutions, emphasizing that the MNB is taking a stand firmly against infringements and the institutions that had failed to comply with the former resolutions.

Similarly to our activities in 2017, in 2018 we continued to carry out our analyses in accordance with the business model-based approach. As the international trends and recommendation of the European Banking Authority ("EBA") show this approach is gaining ground in the domestic supervisors' activities. The MNB is attending to acquaint the business model analyses based on a continuously developing framework and the disclosed risks to the supervised institutions, which dialogue effectively supports the strategy planning and the risk management processes of the banks. The early warning system of MNB with differential indicators supports the forward-looking supervision to take actions against the risks emerging in the future.

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

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

During the comprehensive inspections there were multiple findings regarding the work of the supervisory board, the internal control and in general with the average quality of the control points implemented in the different processes. Regarding the credit risk we have found that in multiple cases the credit risk processes were not supported properly with efficient controls.

In 2018 PTI and LTV were focuses for the targeted inspections. The PTI and LTV limits were bridged in multiple cases. There were problems with the client documentation and the control points too. In other cases, the credit institutions tried to find exemption from the regulation to be able to give higher limits to the clients.

In 2018, another focus for the MNB was the introduction of International Financial Reporting Standards.. Within the scope of IFRS implementation, the first-time application of IFRS 9 has been emphasized because of its new impairment calculation requirements. The MNB has carried out a survey about the impacts on financial institutions of IAS 39 standard which was effective in 2017, and IFRS 9 standard which has been implemented in 2018. Based on the result of the survey, the 2-step implementation of IFRS does not have a relevant impact on the capital ratios of financial institutions, however the MNB will closely monitor the IFRS implementation because of the enhanced operational risk resulted by the first-time application and the methodological differences between financial institutions. During the supervisory audits the MNB reviews if the credit institution's impairment models and individual provision methodology comply with the IFRS 9 standard.

Reliable regulatory data service and appropriate data quality remained the supervisory preferences in 2018. As the first step of the zero-tolerance concept, the MNB held a conference in order to communicate its requirements and answer financial institutions' questions. On-site and off-site investigations were carried out to review data quality, data service and reporting processes. In case of inadequate data servicing, data correction was prescribed and considered as aggravating circumstance during penalty calculation.

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

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

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

Table 1: Number of inspections at credit institutions

Number of on-site inspections	2017		2018	
	comprehensive	other*	comprehensive	other*
Large banks	3	33	3	31
Small and medium sized banks	5	7	4	11
Integration	0	4	21	4
Specialized credit institution	0	8	1	8
Bank branch	1	2	1	0
Financial enterprises	0	4	0	2
Payment institution	0	2	3	0
Insurance corporations	1	0	3	0
Insurance associations	9	0	5	3
Intermediaries	7	1	5	0
Pension funds	0	7	0	4
Capital market participants	13	3	13	0
Occupational pensions	19	12	25	0
Total	**58**	**83**	**67**	**36**

Organizational chart of the Banking Supervisory Authority

The organizational chart of the Magyar Nemzeti Bank is available under the following link:
https://www.mnb.hu/en/the-central-bank/organisation/organisation-chart

International activities of the authority

ESRB

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

FSB Regional Consultative Group for Europe

The MNB and the Ministry of Finance both are members of the FSB's regional substructure. The MNB was represented at managerial level at the meetings of the FSB European Regional Consultative Group in June and in October 2018.

EBA

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

Memorandum of Understanding

The MNB and the Central Bank of Turkey (CBRT) signed a Memorandum of Understanding in Turkey, on 14 May 2018, in order to deepen relations and strengthen the exchange of information in the field of central banking business. The Parties agreed to undertake a business dialogue at expert level at a frequent basis, to strengthen exchanges of knowledge and expertise through visits by officials at working level.

The MNB, the Fudan University and the Corvinus University of Budapest signed a Memorandum of Understanding in 2018 on the establishment of a double degree programme. The Parties also agreed to exchange information and to promote extensive cooperation in the field of financial education and research.

Supervisory colleges

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

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

As home supervisor the MNB leads the banking supervisory college of the OTP Group. In 2018 the MNB organized two supervisory college meetings and a bilateral telephone conference in home role, coordinated the college work which resulted among others in the joint decision on capital and liquidity adequacy and on group recovery plan assessment. The supervisory college established for the OTP Group has made its WCCA and updates it annually.

Cooperation with other supervisory bodies in the country

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[1] and the Financial Consumer Protection Center.[2]

The MNB and the Ministry for National Economy – the Ministry of Finance ("Ministry") from 18 May, 2018 – are the most important Hungarian organizations responsible for the establishment and maintenance of financial stability hence the MNB cooperates closely with the Ministry, first and foremost, in the area of legislation.

Furthermore, the MNB collaborates with other competent Hungarian authorities as well, such as the Ministry of National Development – the Ministry for Innovation and Technology from 18 May, 2018 – in charge of General Consumer Protection Activities.

1 a professionally independent alternative forum for resolving disputes

2 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[3]

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	37	35	35
Branches of foreign credit institutions	10	9	9
Cooperative banks	59	22	13
Banking sector, total:	106	66	57

Total assets of banking sector (at year-end in HUF million)

Type of financial institution	2016	2017	2018
Commercial banks	27 260 918	29 102 077	32 041 608
Branches of foreign credit institutions	3 276 859	3 684 610	3 731 478
Cooperative banks	1 280 866	1 322 920	1 278 624
Banking sector, total:	31 818 643	34 109 607	37 051 710
y/y change (in %)	4.2%	7.2%	8.6%

Ownership structure of banks on the basis of assets total*

Item	2016	2017	2018
Public sector ownership	3.1%	3.0%	3.3%
Domestic ownership total	20.3%	19.9%**	19.6%
Foreign ownership	79.7%	80.1%**	80.4%
Banking sector, total:	**100.0%**	**100.0%**	**100.0%**

* Ownership structure based on the ultimate majority owners
** Data correction due to the availability of audited data

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	46.1%	61.3%	0.114
Branches of foreign credit institutions	82.5%	94.2%	0.324
Cooperative banks	34.8%	54.4%	0.090
Banking sector, total:	39.9%	53.0%	0.089

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

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	14.4%*	17.4%	13.7%
Cooperative banks	-1.5%	-4.8%**	-1.4%
Banking sector, total:	13.8%	16.9%	13.4%

* Modification due to data correction from bank
** Data correction due to the availability of audited data

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	85.7%	85.3%	86.5%
Branches of foreign credit institutions	10.3%	10.8%	10.1%
Cooperative banks	4.0%	3.9%	3.5%
Banking sector, total:	**100.0%**	**100.0%**	**100.0%**

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

	2016	2017	2018
Receivables			
Financial sector	32.4%	31.2%	32.2%
Nonfinancial sector	34.7%	40.6%	41.5%
Government sector	22.8%	25.6%	23.5%
Other assets*	10.1%	2.6%	2.8%
Liabilites			
Financial sector	30.6%	30.9%	29.1%
Nonfinancial sector	47.2%	49.5%	51.9%
Government sector	3.7%	4.1%	3.1%
Other liabilities	8.4%**	4.7%	5.2%
Capital	10.1%	10.8%	10.7%

*Other assets and liabilities decreased due to extended counterparty classification in 2017 compared to 2016.

Capital adequacy ratio of banks***

Type of financial institution	2016	2017 2	2018
Commercial banks	21.0% [1]	23.2%	21.3%
Cooperative banks	15.8%	14.5%	13.9%
Banking sector, total:	20.8% [1]	22.9%	21.1%

(Please, mark for each item: * – for Basel I; ** – for Basel II; *** – for Basel III)
[1] data correction due to switch of data
[2] Data correction due to the availability of audited data

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

Asset classification	2016	2017	2018
Non-financial sector, including*	14.3%	8.6%	5.5%
Households	16.8%	11.1%	7.2%
Corporate	11.6%	6.3%	4.1%

* Domestic loans

The structure of deposits and loans* of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	84.5%	90.9%
Households	42.7%	41.8%
Corporate	41.8%	49.1%
Government sector	5.0%	2.2%
Financial sector (excluding banks)	10.5%	6.9%
Total	**100.0**	**100.0**

* Domestic loans and deposits

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

P&L account	2016	2017*	2018
Interest income	1 155 869	1 027 440	1 120 679
Interest expenses	354 740	285 024	353 798
Net interest income	801 129	742 416	766 881
Net fee and commission income	463 543	507 137	537 559
Other (not specified above) operating income (net)	-193 520	75 894	230 941
Gross income	1 071 152	1 325 447	1 535 380
Administration costs	617 779	776 216	943 120
Depreciation	62 755	63 155	69 672
Provisions	120 897	184 068	43 905
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	511 515	670 144	566 493
Net profit (loss)	440 499	608 057	519 629

* Data correction due to the availability of audited data

Total own funds in 2018 (in EUR)***

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	11 724 288 964	10 692 196 732	10 701 266 994	1 023 021 970	
Cooperative banks	222 505 377	217 244 723	217 718 527	4 786 850	
Banking sector, total:	11 946 794 341	10 909 441 454	10 918 985 521	1 027 808 820	

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

2018 DEVELOPMENTS IN THE KAZAKH BANKING SYSTEM

Development in the banking sector

Given that the AFSA officially started in January 2018 all efforts were focused on development of legal base in order to enable development of banking services.

As of end of 2018 existing AIFC regulations enabled broad range of financial services activities, covering conventional and Islamic banking, and offered robust environment for development of financial services markets of the AIFC.

Established regulatory framework on banking business comprised following regulated activities:

Conventional banking business:

- accepting deposits;
- dealing in investments as principal;
- providing credit;

Islamic banking services:

- raising, accepting and managing funds or money placements;
- managing Unrestricted Profit Sharing Investment Accounts;
- providing financing or making Investments by entering as principal or agent into any Islamic Financial Contract.

Rules adopted in 2018 as part of AIFC legal and regulatory framework include:

1. **Banking Business Prudential Rules,** which establishes the prudential framework for Authorised Firms carrying out Banking Business. These rules are based on the Basel Accords and on the Basel Core Principles for Effective Banking Supervision, issued by the Basel Committee on Banking Supervision.

2. **Islamic Banking Business Prudential Rules,** which establishes the prudential framework for Authorised Firms carrying out Islamic Banking Business, Providing Islamic Financing or carrying out other Regulated Activities which involve assuming prudential risks by way of employing Islamic Financial Contracts. These rules are based on the standards and guidelines issued by the Islamic Financial Services Board on Capital adequacy, the Basel Accords; and the Basel Core Principles for Effective Banking Supervision.

Overall, as of 31 December 2018 the AIFC financial services framework included:

- 25 types of regulated activities;
- 3 types of market activities;
- 5 types of ancillary services.

On 16 February 2018 the AFSA registered first bank in the AIFC, the China Development Bank Astana, operating a Representative Office, organisation-legal form: Recognised Company.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority

The AFSA is a legal entity and statutory body of the Republic of Kazakhstan, which is established in accordance with the Constitutional Statute of the Republic of Kazakhstan "On the Astana International Financial Centre" for the purposes of regulating financial services and operations related to financial services in the AIFC.

The AIFC pursuant to Article 2 of the Constitutional Statute has the objective of developing banking services, insurance markets, Islamic finance, financial technologies, electronic commerce and innovative projects in Kazakhstan on the territory of the AIFC; further to the Article 2 of the Constitutional Statute, Article 12 empowers the AFSA for regulation of financial services in the AIFC.

Following legal acts provide basis for the AFSA to regulate and supervise banking activities in the territory of the AIFC:

1. Constitutional Statute of the Republic of Kazakhstan "On the Astana International Financial Centre" (7 December 2015);
2. AIFC Financial Services Framework Regulations (20 December 2017);
3. AIFC General Rules (17 October 2017);
4. AIFC Conduct of Business Rules (1 January 2018);
5. AIFC Banking Business Prudential Rules (30 July 2018);
6. AIFC Islamic Banking Business Prudential Rules (1 January 2018).

According to subsection 1.1.1. of the AIFC General Rules, the AFSA Regulated Activities[1] that may be carried on by an Authorised Firm, subject to the terms of its Licence.

AIFC Banking Business Prudential Rules and Islamic Banking Business Prudential Rules complement the AIFC General Rules and establish the prudential framework for Authorised Firms carrying out Banking Business and Islamic Banking Business.

Main strategic objectives of the supervisory authority in 2018

AFSA Strategy 2019-2020 has been prepared in 2018 within the context of Kazakhstan's 100 Concrete Steps to Implement Five Institutional Reforms and is consistent with the "Strategy for the Development of the Astana International Financial Centre". The strategic goals were set in the following areas:

Regulation: the AFSA continues to develop and strengthen its legal and regulatory framework that complies with international best practices.

Prudential supervision: the AFSA establishes a risk-based supervision framework and a continual supervision cycle to monitor financial activities by AIFC Participants thereby fostering and maintaining confidence in the AIFC's financial system and regulatory regime.

[1] Regulated Activity – an activity specified of Schedule 1 of the AIFC General Rules (http://afsa.kz/storage/files/28fd13b1c2fa4223/GEN%20_v8_FR0001_02.07.2019.pdf).

Business conduct: the AFSA strives to protect customers from activities not permitted in the AIFC and from financial products that are high risk, through the strict enforcement of rules, and will resolve disputes between customers and AIFC Participants in a fair and timely manner.

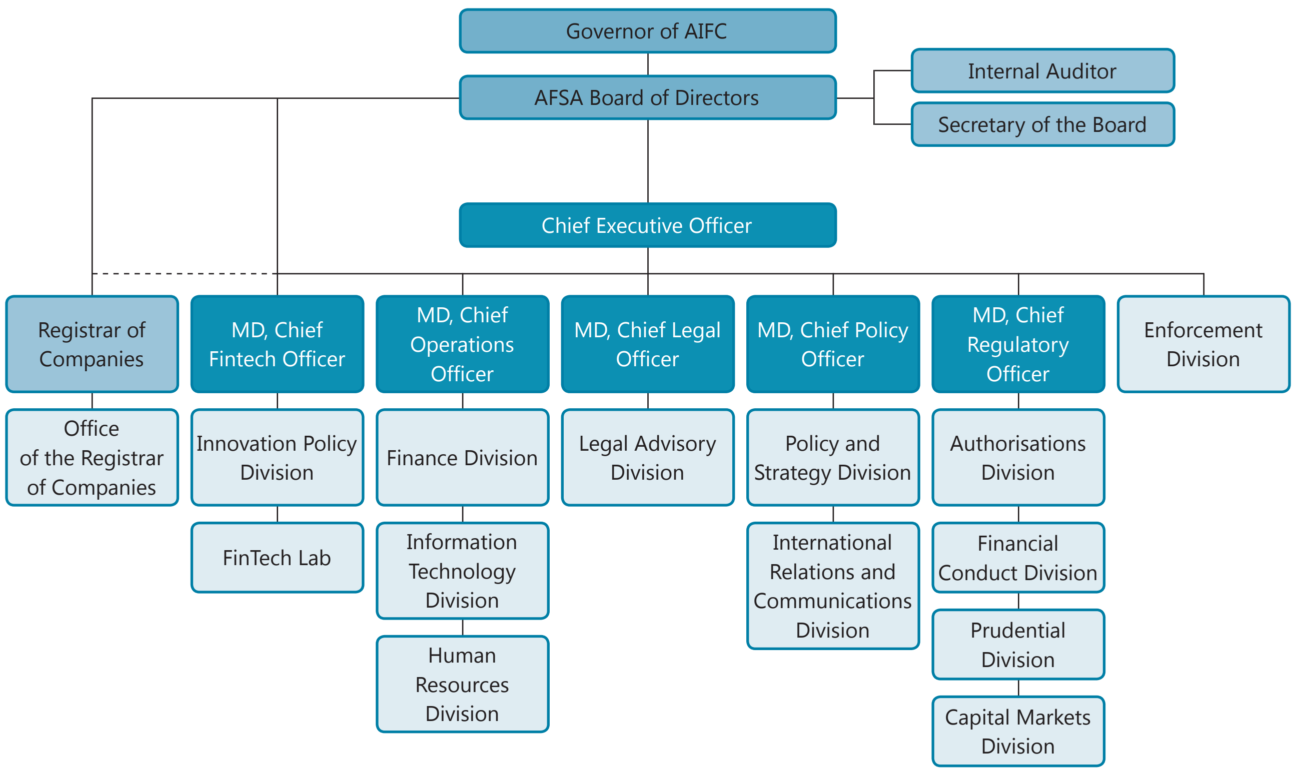
National and international cooperation: the AFSA creates awareness and build strategic partnerships and memberships with local, regional and international stakeholders such as standard setting bodies, other international financial regulators, ministries and state agencies in Kazakhstan.

The activities of the Banking Supervisory Authority in 2018

Since its opening for business on 1 January 2018, the AFSA has been adopting and implementing regulations, rules, policies and procedures within a regulatory regime that complies with international best practices:

- All legislative base created to ensure functioning of the conventional and Islamic banking sector.
- Existing AIFC regulations enabled broad range of financial services, covering conventional and Islamic banking, and offer robust environment for development of financial services markets of the AIFC.
- On 16 February 2018 the AFSA welcomed first tenants in banking, the China Development Bank Astana.
- In 2018 the AFSA has worked towards integration of following international standards of the Organisation of Economic Cooperation and Development into regulatory framework of the AIFC: Exchange of Information on Request (Exchange of Information Standard); Automatic Exchange of Information regarding bank accounts (Common Reporting Standard, CRS).

Organizational chart of the Banking Supervisory Authority



International activities of the authority

The AFSA has become a member of key global standard setting international organizations, such as the International Organization of Securities Commissions (IOSCO), International Association of Insurance Supervisors (IAIS), Banking Supervisors from Central and Eastern Europe (BSCEE), Islamic Financial Services Board (IFSB) and Accounting and Auditing Organization for Islamic Finance Institution (AAOIFI).

Multilateral relations of AFSA have continued focusing on establishing and developing cooperation with global standard setting organizations, international development finance institutions and other international organizations:

- 20 April 2018 – Astana Financial Services Authority becomes Member of International Organisation of Securities Commissions;
- 26 November 2018 – AFSA becomes a member of the Group of Banking Supervisors from Central and Eastern Europe.

The AFSA has continued its efforts on establishing bilateral cooperation with peer regulators from other countries on banking supervision:

- 9 May 2018 – MoU was signed with Abu Dhabi Global Markets Regulatory Authority (ADGM) regarding Banking;
- 21 June 2018 – MoU was signed with Dubai Financial Services Authority on cooperation in financial services regulation;
- 3 July 2018 – MoU was signed with Qatar Financial Centre Regulatory Authority on cooperation in financial services regulation;
- 13 September 2018 – MoU was signed with China Banking and Insurance Regulatory Commission;
- 18 October 2018 – MoU was signed with National Bank of Georgia.

Cooperation with other supervisory bodies in the country

The AFSA maintained a permanent dialogue with the National Bank of the Republic of Kazakhstan through formal cooperation mechanisms like a bilateral working group, consultations and joint meetings.

2018 DEVELOPMENTS IN THE LATVIAN BANKING SYSTEM

Macroeconomic environment in the country

In 2018, Latvia reported strong **economic growth** with its real GDP increasing by 5.0% (s.a. data) for the second year in a row. It was stimulated by the **investment** activity, with gain on both private and EU funds related investments, and by an increase in private consumption. Despite the deterioration of external demand in 2018, **goods and service exports** grew by 2.3%. Latvia's economic growth momentum is expected to moderate, with the growth rate projected to stand at around 3% in medium term.

Acceleration of the economic activity caused a steady increase in labour demand, with participation and employment rates keeping to reach their historical highs. **Unemployment** continued to decrease gradually, reaching the lowest level in the last eleven years: in 2018, job seekers accounted for 7.4% of the economically active population, representing an annual decrease of 1.3 percentage points.

Favourable labour market conditions for employees supported **private consumption** and will increase role of private consumption as a growth driver in the future. The average **inflation** was 2.5% in 2018. The path of inflation over the year primarily reflected the global trends observed for the supply-side factors, i.e. the development of food and energy prices. Continuing economic growth will increase the demand side factor on inflation.

Although export growth helped to achieve a current account surplus in the first half of the year, in 2018 the **current account** ran a deficit (1% of GDP) due to the increase in imports as well as weakening external demand and exports. The **foreign direct investment** inflows in Latvia were close to their historical average in 2018, reaching 2.5% of GDP with the largest flows in trade, real estate and manufacturing sectors. Latvia's **net external debt** to GDP continued its declining path and stood at 22.7% of GDP in 2018.

Development in the banking sector[1] (including assets total / GDP)

The banks account for about 79 per cent of the total assets of the Latvian financial sector or about 78 per cent of GDP. At the end of 2018, there were 15 licensed banks operating in Latvia as well as five EU banks branches. Of total Latvian banking share capital, 82 per cent is owned by foreign investors. All of the Latvian-licensed banks have been licensed as universal banks and may provide a full range of financial and investment services.

During the reporting year, a stable growth of the loan portfolio of domestic non-bank customers was observed – this was determined not only by non-financial corporations (by 3%), but also by the increase in the lending amount to households (by 1.5%). More active lending was observed in the construction, energy and wholesale sectors, as well as in consumer and housing loan segments, where the state support programme for house purchase continued to play a major role. In turn, the balance of the loan portfolio of foreign non-bank customers dropped by 5.1% over the year, thus reducing the annual growth rate of the total non-bank loan portfolio to 1.8%.

[1] As of 2018, in the publications by the FCMC the FINREP and COREP data provided by the banking sector are mainly used – the consolidated data of the banks under the consolidated supervision (i.e., the data on banks and their financial subsidiaries), as well as the data on other banks and foreign bank branches on an individual level.

NPL[2] ratio in the non-bank credit portfolio decreased overall, reaching 7.5% at the end of the year. Improvement in the quality of the credit portfolio was observed in both the domestic non-financial corporation segment and the household segment, reaching 6.3% in the domestic non-financial corporation loan portfolio and 4.5% in the household loan portfolio at the end of the year (8.0% and 4.9% at the end of 2017, respectively). In turn, in the segment of foreign customers, representing 14.1% of the total credit portfolio, the credit quality indicators slightly deteriorated (mainly due to the decrease of this portfolio), NPL ratio reaching 20% at the end of the year.

Coverage ratio of non-performing loans did not change significantly during the year and at the end of the reporting year it was 32.6%. Coverage ratio of non-performing loans still remained at the level appropriate for the region, confirmed by the banks' internal provisioning models (based on historical loss rates) and the availability of credit collateral and constant rise in the housing price index over recent years, as well as banking practices for the taking over of collateral. At the end of the reporting year, the aggregate amount of accumulated loan loss provisions for non-performing loans and collateral value in fact fully covered the amount of such loans.

Structural changes in the banking sector[3] and the de-risking measures implemented to reduce reputational risk, determined the direction towards further narrowing of the banking sector – the amount of non-bank deposits and thereby also the amount of the banking sector assets decreased by approximately 20% (or by 8.5%)[4] over the reporting year. Banks, previously focused on servicing foreign customers, were able to meet the outflow of foreign deposits with sufficient liquidity buffers.

Despite a significant outflow of foreign deposits, liquidity risk in the Latvian banking sector remains limited. Average liquidity coverage ratio (LCR) at the end of reporting year amounted to 266% – almost three times exceeding the minimum requirement (as of 1 January 2018 the minimum requirement for the LCR was100%).

As a result of the banking sector assets decrease, the total amount of the risk-weighted assets reduced in 2018 and it had a positive impact on the capital ratios of the banking sector, the total capital ratio (TCR) increasing from 21% to 22.3%, but the Common Equity Tier 1 (CET1) capital ratio – from 19% to 20.3%.That was fully determined by the decrease in the risk-weighted assets of the banks previously focused on the servicing of foreign customers. The capital ratios of the domestically active banks remained practically unchanged. Overall, the capital ratios of the Latvian banking sector were still higher than in the EU on average and ensuring the sufficient buffer for the coverage of unexpected losses.

Despite a rapid drop in the business activity of banks previously focused on servicing foreign clients, the development of overall profitability was positive in the banking sector in 2018. The profits of the banking sector[5] amounted to EUR 274 million, moreover, 12 banks and three branches of foreign banks (the market share whereof made up 94% of the total assets of the banking sector) recorded a profit. As the profitability of the banking sector improved, at the end of the reporting period the ROE reached 9.3%, thus exceeding the average EU level (6.5%); in turn, the ROE of individual banks ranged from –37.6% to 18.7%.

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[2] Loans overdue by more than 90 days and loans that are not overdue or are overdue by 90 days or less, but have an indication that the borrower will not be able to cover its liabilities (i.e., doubtful loans).

[3] During the reporting year the following structural changes in the banking sector took place: (1) after the USA FinCEN report and based on the ECB decision a licence for a credit institution's operations was withdrawn for ABLV Bank; (2) AS Citadele banka took the final decision to change the legal status of AB Citadele bankas (Lithuania) from the subsidiary to the branch, thus improving the efficiency of the banking group performance and developing the services of Citadele for customers throughout the BalticSstates; (3) finalisation of the merger project of DNB Bank AS and Nordea Bank AB, as a result two mutually competing banks were merged, further on operating under the name Luminor Bank AS (as of 2019, the Bank is continuing to operate as branch of Estonian Luminor Bank AS).

[4] Excluding the impact of the structural changes of the banking sector.

[5] Unaudited.

The total amount of non-bank customer deposits decreased by EUR 1.3 billion, or 7.2%, in 2018. The drop in foreign customer deposits in the Latvian banking sector had already been observed since 2015, however, as a result of the measures implemented by banks the process of declining speeded up significantly in 2018 and overall during the year the balance of foreign customer deposits decreased by 37.4% or EUR 2.4 billion (including from the EU member states – by EUR 0.7 billion, but from non-EU countries – by EUR 1.7 billion). The drop in foreign deposits was partly compensated by the stable increase of domestic customer deposits (during the year by EUR 869 million or 7.2%), which was observed along with the positive economic developments in Latvia. In the second half of the year, the amount of foreign customer deposits stabilised as well, mainly as a result of the increase in the EU countries customers' deposits, while the deposits from customers from other countries continued to decline. Thus, the radical change in the strategies implemented by individual banks was observed, foreseeing reorientation of business towards domestic and EU markets.

As a result of the opposite trends in domestic and foreign deposits, the geographic structure of deposits (according to the customer's country of registration) also changed significantly, and the share of domestic deposits at the end of the reporting year reached 76.4%, while the share of the EU member states' deposits – 13.7% and other countries 9.9% (at the end of 2017, 57.3%, 17.9% and 24.8%, respectively).

During 2018 the Financial and Capital Market Commission (FCMC) continued intensive dialogue with all banks specializing in servicing foreign customers regarding their business model viability and changes to business strategy in order to decrease substantially the share of high AML/CTF risk clients and related services in the banking business.

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

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

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

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

Since introduction of the Single Supervisory Mechanism (SSM) the FCMC has been sharing banking supervision powers with the European Central Bank (ECB). During 2018, the ECB in close cooperation with the FCMC directly supervised four banks in Latvia (A/S Swedbank, A/S SEB banka, A/S ABLV Bank[6] and A/S Luminor Bank), while other banks are under indirect SSM supervision. However, monitoring of anti-money laundering and combating terrorist financing still remain within the FCMC competence.

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

Resolution and Guarantee Funds Division of the FCMC operates in a capacity of a national resolution authority, whose activities and functions are separated from the supervision functions. In addition, the Division is responsible for administering the Latvian Deposit Guarantee Fund, the Fund for the Protection of the Insured and the Investor Protection Scheme.

Main strategic objectives of the supervisory authority in 2018

The FCMC defined priorities for carrying out the supervision of the credit institutions in 2018 were as follows:

- To assess the strategies, business models, and the profitability of banks, with a focus on ML/TF risk reduction, sustainability and the balancing of the earning capacity;
- To strengthen the compliance and other risk management functions by paying particular attention to the processes and effectiveness of stress testing; to improve recovery planning and the application thereof in practice; to improve quality of reporting , as well as to address weaknesses detected in horizontal reviews;
- To assess credit risk levels and the adequacy of provisions, mainly focusing on problem (overdue, restructured) loans, and the credit recovery process, as well as the implementation of IFRS 9.

The activities of the Banking Supervisory Authority in 2018

During 2018, the FCMC continued to regulate and carry out oversight of the financial and capital market in close cooperation with the ECB within the scope of the SSM and with the European Supervisory Authorities, and pursuant to the best international credit institution supervisory practices and operational frameworks. With a view to promoting the protection of the interests of investors, depositors and the insured, as well as the stability of the financial and capital market, the FCMC has been exercising continuous and comprehensive supervision over market participants by:

- determining the priorities of the supervision of each financial sector, based on risk assessment and trends in the financial market and developing supervisory programmes for each sector and market participant, based on the defined priorities;
- maintaining a constant dialogue with market participants and professional associations regarding the new regulations, requirements, sectoral trends, and the risks and problem issues pertaining thereto;
- ensuring that new market participants with a sound capital base and clear and viable strategy enter the market;
- carrying out on-site inspections and off-site analysis of the indicators characterising the activities of market participants, risks and risk management systems, continuously focusing on the qualitative and quantitative changes of the financial indicators as well as compliance with regulatory requirements and the effectiveness of corporate governance;

[6] Until 12.07.2018 when its credit institution licence has been withdrawn

- ensuring, within the scope of its competence, the disclosure of true and fair information about the activity of market participants;
- assessing the quality of financial services and ensuring consumer protection within the scope of its competence;
- in cases of non-compliance with regulatory requirements, imposing preventive and corrective measures on the market participants in a timely manner.

The global financial crisis demonstrated that microprudential supervision, which mostly focused on ensuring stability at the level of an individual financial institution, was not sufficient to preserve the stability of the financial system as a whole. Therefore, in addition to the traditional supervisory approach, macro-prudential supervision was introduced, which requires taking appropriate measures in cases, when cyclical (e.g. an excessive increase in lending) or structural – systemic risks, for example, in relation to systemically important credit institutions, increase. In such cases, appropriate instruments may be applied, i.e., specified capital buffer requirements, increased minimum capital and liquidity requirements, and more stringent restrictions on large exposures.

Licensing and supervision

As for the banking sector, the structural changes observed in 2018 were related to the merger project at the Baltic level which resulted in a revoked licence of Luminor Bank AS, after which the bank continues its activities in the Latvian banking sector as a branch of Estonian Luminor Bank AS. Also, in 2018, the ECB took a decision to withdraw authorisation of ABLV Bank, given that the bank had started a self-liquidation process. The FCMC, being part of SSM ,continued to play an active role in the process of approval of qualifying holdings and key position holders in banks , remaining the responsible authority for examining the documents submitted and preparing the draft decisions which were subsequently submitted to the ECB for final approval.

The FCMC, ensuring continuous monitoring of market participants, in 2018, carried out the following supervisory measures:

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

Regulatory developments

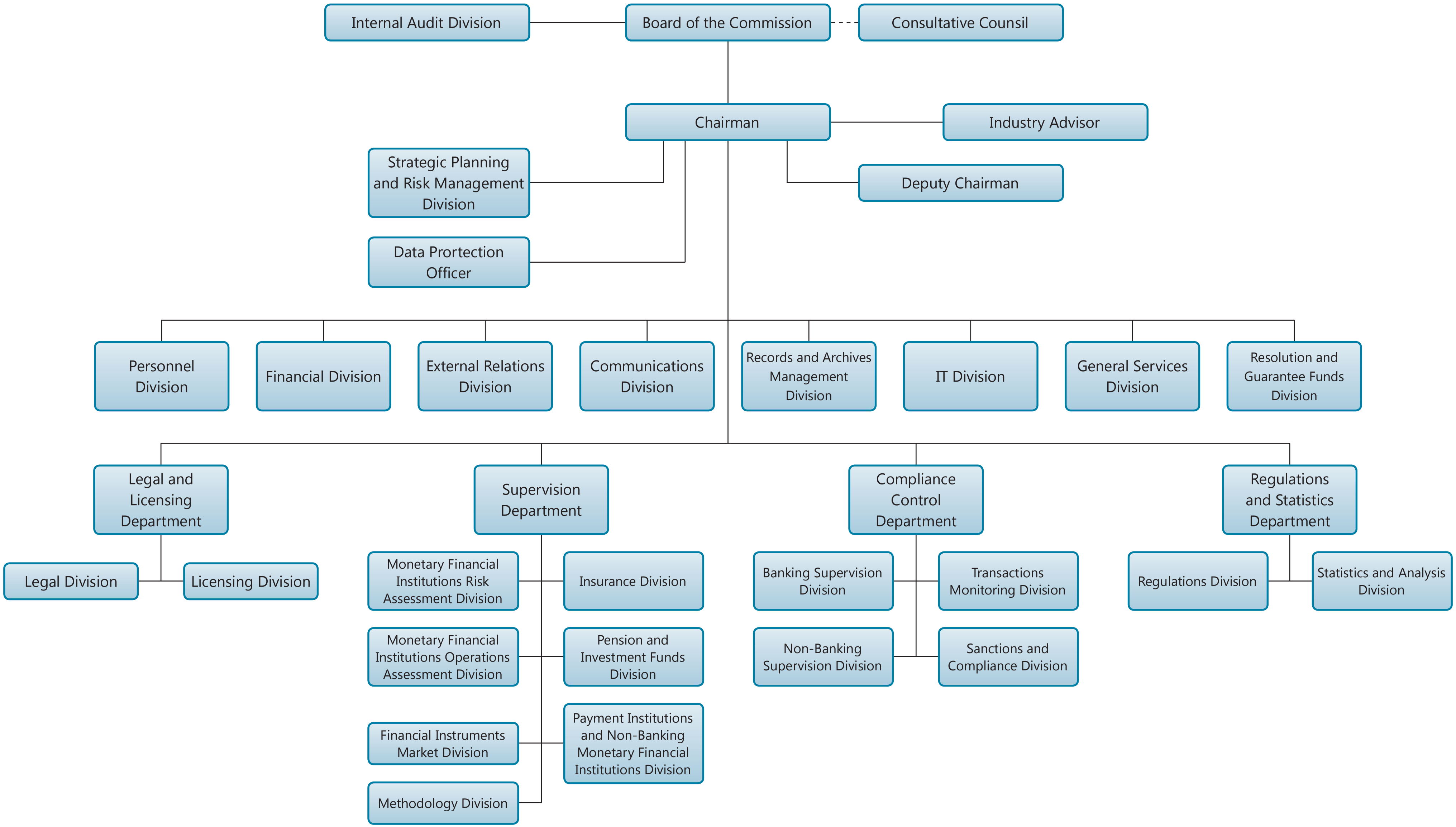
In 2018, the FCMC continued to improve the legal framework for financial and capital market participants, within the scope of the powers conferred on it. Changes in the regulatory framework were mainly based on legislative acts issued by the EU institutions to provide a harmonized framework for the single EU financial market. Overall, in 2018, no substantial changes were made to the prudential banking regulatory requirements.

During 2018, Latvia continued its active work in improving AML/CFT regulatory base. In 2018, amendments to the Law on the Prevention of Money Laundering and Terrorist Financing (the AML/CTF Law) where adopted stipulating that credit institutions, payment institutions, electronic money institutions, investment brokerage companies, and – in relation to the management of individual portfolios of customers and the distribution of certificates of open investment funds – also investment management companies are prohibited to establish business relationship or to execute an occasional transaction with a shell arrangement, if following indications are met:

- it has no affiliation of a legal person to an actual economic activity or the operation of a legal person forms a minor economic value or no economic value at all, and the subject of the AML/CTF Law has no documentary information at its disposal that would prove the contrary;
- laws and regulations of the country where the legal person is registered do not provide for an obligation to prepare and submit financial statements for its activities to the supervisory institutions of the relevant state, including the annual financial statements.

Furthermore, the legislative framework on international and national sanctions have been amended governing explicit responsibilities of the FCMC in relation to the supervision of compliance with the sanctions regulations. In line with amendments in the Law on International and National Sanctions of the Republic of Latvia the FCMC is entitled to enact administrative liability and to impose corrective measures for violation of legal provisions in the area of international or national sanctions.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

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

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

Like previous years, in 2018, the FCMC continued to maintain close contacts with supervisory authorities from other countries. Bilateral cooperation is facilitated by cross-border agreements on cooperation and exchange of information. An essential part of the banking supervision constitutes the cooperation with home supervisor authorities and the FCMC participates in the work of supervisory colleges for cross-border banking groups.

As key legal acts determining the framework for the functioning of the financial markets in Europe are drafted on the EU level, active participation of the FCMC in negotiations on an international stage is necessary to safeguard the interests of the domestic financial system. Therefore also during 2018 the FCMC continued to intensively participate in the SSM and ESFS working groups and bodies, as well as in the EU Council expressing the opinion that is in line with Latvia's interests and ensuring that its opinion is taken into account. For Latvia, being a small country, it is important to express its opinion on the impact of the legislation under development on small financial markets and seek to achieve that it is balanced so that it would benefit and develop not only large but also small countries.

Cooperation with other supervisory bodies in the country

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

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

Other relevant information and developments in 2018

No additional information to be provided.

Statistical tables

Number of financial institutions
(at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	16	16	15
Branches of foreign credit institutions	7	5	5
Cooperative banks	0	0	0
Banking sector, total:	23	21	20

Total assets of banking sector[1]
(at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	25 455 621	27 217 001	21 662 620
Branches of foreign credit institutions	4 040 473	1 170 739	917 441
Cooperative banks	0	0	0
Banking sector, total:	29 496 094	28 387 740	22 580 061
y/y change (in %)	-7.6	-3.8	-20.7

[1] Here and below as from 2018 the data source is FINREP and COREP (on consolidated level).

Ownership structure of banks on the basis of assets[1] total

Item	2016	2017	2018
Public sector ownership	0	0	0
Domestic ownership total	21.5	21.4	8.2
Foreign ownership	78.5	78.6	91.8
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions[1]

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	65.7	86.8	0.175
Branches of foreign credit institutions	88.3	100.0	0.319
Cooperative banks	-	-	-
Banking sector, total:	63.0	83.3	0.162

Return on Equity (ROE) by type of financial institutions[1]

Type of financial institution	2016	2017	2018
Commercial banks	14.3	7.6	9.3
Cooperative banks	-	-	-
Banking sector, total:	14.3	7.6	9.3

Distribution of market shares in balance sheet total[1] (%)

Type of financial institution	2016	2017	2018
Commercial banks	86.3	95.9	95.9
Branches of foreign credit institutions	13.7	4.1	4.1
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

The structure of assets and liabilities of the banking sector[1] (%) (at year-end)

	2016	2017	2018
Receivables			
Financial sector	30.5	34.1	28.6
Nonfinancial sector	55.7	51.5	57.5
Government sector	7.7	8.5	0.4
Other assets	6.1	5.9	13.5
Liabilities			
Financial sector	14.9	15.3	13.3
Nonfinancial sector	64.1	64.0	67.8
Government sector	3.8	2.9	4.0
Other liabilities	7.1	6.7	2.1
Capital	10.1	11.1	12.8

Capital adequacy ratio of banks[1]

Type of financial institution	2016***	2017***	2018***
Commercial banks	21.46	21.37	22.28
Cooperative banks	-	-	-
Banking sector, total:	21.46	21.37	22.28

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

Asset portfolio quality of the banking sector[1] (share of impaired receivables / share of non-performing loans*)

Asset classification	2016	2017	2018
Non-financial sector, including	4.8	4.5	4.5
Households	5.4	4.0	2.6
Corporate	4.5	4.9	6.0

*above 90 days overdue (incl. "unlikely to pay" as from 2018)

The structure of deposits and loans of the banking sector in 2018[1] (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	90.2	96.6
Households	52.8	41.4
Corporate	37.4	55.2
Government sector	5.3	0.6
Financial sector (excluding banks)	4.5	2.8
Total	**100.0**	**100.0**

P&L account of the banking sector[1] (at year-end)

P&L account	2016	2017	2018
Interest income	638 404	566 396	554 299
Interest expenses	135 755	125 682	102 530
Net interest income	502 649	440 714	451 769
Net fee and commission income	324 587	289 557	282 170
Other (not specified above) operating income (net)	277 705	133 375	74 099
Gross income	1 104 941	863 646	808 038
Administration costs	463 288	467 664	461 412
Depreciation	26 909	31 948	34 617
Provisions	117 862	63 164	31 783
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	117 862	63 164	31 783
Profit (loss) before tax	496 882	300 869	281 408
Net profit (loss)	453 754	236 101	273 635

Total own funds*** in 2018[1] (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	2 701 458	2 458 488	2 458 488	242 970	0
Cooperative banks	-	-	-	-	-
Banking sector, total:	2 701 458	2 458 488	2 458 488	242 970	0

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

2018 DEVELOPMENTS IN THE LITHUANIAN BANKING SYSTEM

Macroeconomic environment in the country

Economic growth in Lithuania remained robust, reaching 3.4%. If not for the poor grain harvest caused by drought, which took out several percentage points, economic growth in 2018 could have been even stronger. As a result, the value added generated in agriculture in the second half of 2018 was almost 15% lower than the year before. The value added in other sectors increased at a rather rapid and steady pace, close to 4%.

Strong growth was mainly fuelled by domestic demand, particularly household consumption. The main driver of household consumption was the rapid growth in household disposable income, which is likely to have hit its ten-year peak in 2018. Such evolution was largely attributable to labour market tensions and government decisions. According to the Bank of Lithuania estimates, in 2018 these decisions could have increased household disposable income by up to €635 million and added 2.3 percentage points to disposable income growth.

In 2018, investment growth almost reached its five-year peak. This was mainly driven by the upswing in construction of engineering buildings, which to a large extent came from recovering EU capital flows – in 2018, they increased by almost a third. The most prominent engineering construction projects include the cogeneration power plant, the modernisation and expansion of water supply and sewage networks as well as transport infrastructure.

Development in the banking sector

The banking and credit union sector was stable. Robust lending had a positive impact on banks' profitability – almost twothirds of their operating income stemmed from the increase in corporate and household loan volumes. The restructured credit union sector recorded gains for the second consecutive year, while the number of sustainable shares continued growing. The landscape of the banking sector has changed – in order to reduce costs, two banks have reorganised into foreign bank branches. Following the assessment and proposal of the Bank of Lithuania, at the end of 2018 the ECB granted the first three specialised bank licences; one of the banks has already commenced its activities and is in operation. We expect that over time new market participants will boost competition and provide consumers with wider choice of financial services.

Following the completion of the consolidation process of Luminor Bank AB, its Lithuanian licence was revoked with effect from January 2019. Starting from 2019, its activities have been carried out via the Lithuanian branch of Luminor Bank AS, headquartered in Estonia. The licence of AB Citadele bankas was also revoked with effect from January 2019. The bank will carry out its activities as the Lithuanian branch of the Latvian company AS Citadele banka.

In 2018, the Bank of Lithuania received 1 application for a banking licence and 4 applications for a specialised bank licence. It is important to note that licences for specialised banks are issued by the ECB.

FinTech companies were issued 28 licences in 2018 – almost as much as in 2017 (29 licences). Having met with more than 160 potential market participants to discuss the possibilities of setting up in Lithuania, currently the Bank of Lithuania is assessing more than 60 applications.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

In 2018, market participants continued to show avid interest in Lithuanian licences. These were mainly foreign FinTech businesses (companies from the UK and other EU countries, Israel, Asia) as such licences granted authorisation to provide payment services across the EU.

With a view to making Lithuania a FinTech hub in the NordicBaltic region, the Bank of Lithuania aims at creating a FinTech-friendly environment that would attract new companies and encourage them to incubate new products in the country. The Bank of Lithuania has already developed a onestop shop, set up a dedicated email for all queries on setting up in Lithuania, allowed foreign citizens to submit documents necessary for obtaining a licence in English, and updated the Lithuanian and English versions of its Licensing Guide. The Bank of Lithuania website has a section dubbed the Newcomer Programme, which in a concise and clear manner presents key information for new market entrants.

In 2018, the central bank developed and launched a regulatory sandbox that will allow companies developing innovative financial products to test their business solutions in a live environment under the guidance and supervision of the Bank of Lithuania. Selection of eligible participants will be based on **certain criteria**.

Main strategic objectives of the supervisory authority in 2018

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

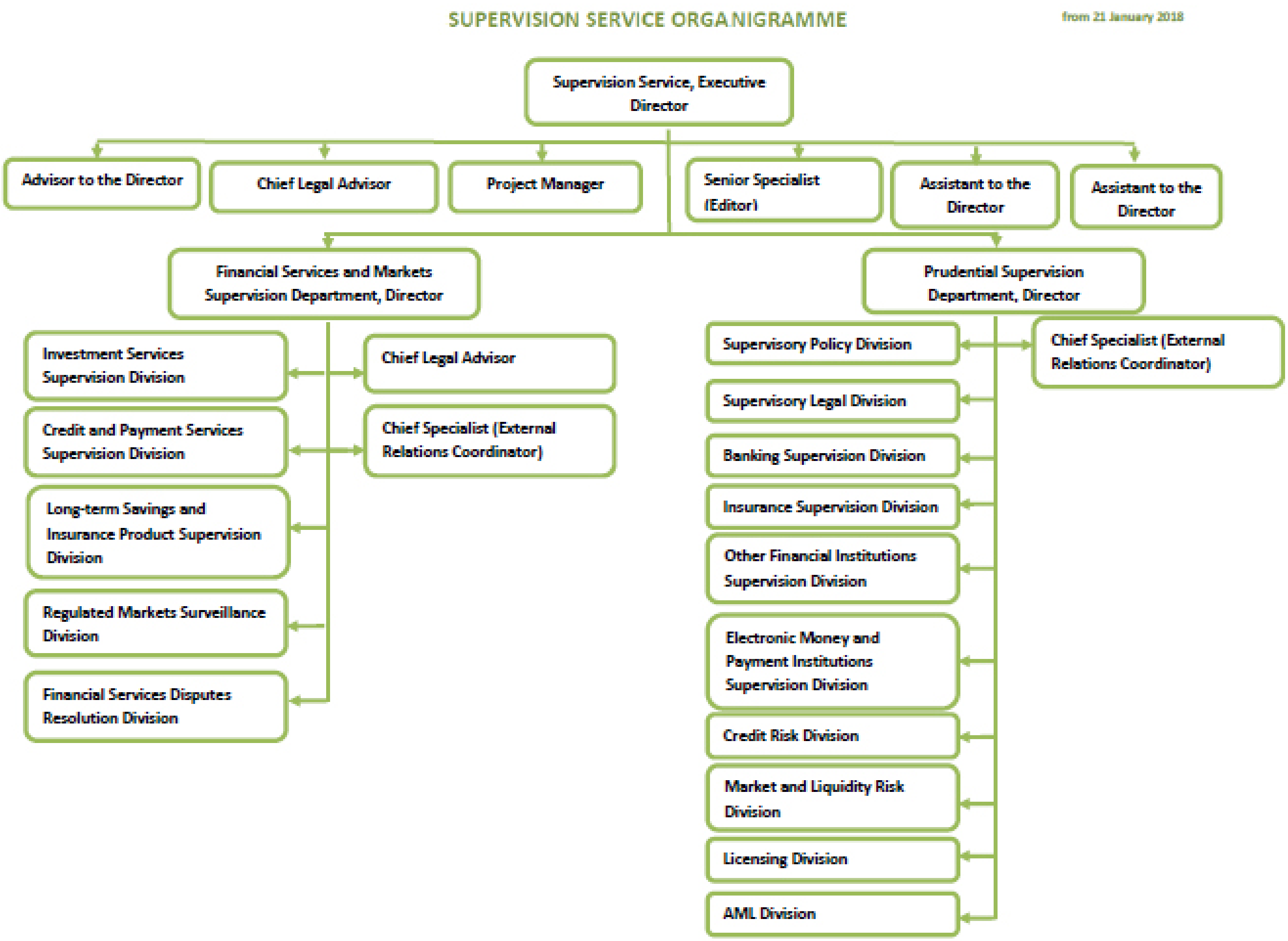
The activities of the Banking Supervisory Authority in 2018

One the main goal of the Supervisory Authority in 2018 was to strengthening partnership with financial market participants. Seeking to maintain regulatory hygiene, the central bank is gradually abandoning excessive and outdated solutions. The Bank of Lithuania took the initiative to review relevant legislative acts: in collaboration with market participants, it identified provisions to be amended and is dedicated to focusing on the implementation of the necessary changes. It also seeks to ensure that its actions are predictable and communicated to market participants in advance. Therefore, the Bank of Lithuania started announcing its plans of on-site inspections and regulatory amendments as well as organising periodic meetings with market participants. It also took up new ways of fulfilling its supervisory mandate (on-site visits, etc.).

In a joint effort with other public sector institutions, the Bank of Lithuania has been lowering barriers to market entry and operation therein, at the same time ensuring financial market resilience and its sustainable development. Therefore, the central bank improved remote customer identification processes, introduced the possibility to obtain a specialised bank licence, granted payment and e-money institutions access to its retail payment system, and allowed potential financial market participants to apply for a licence remotely – all these are just a few examples reaffirming Lithuania's position as an attractive jurisdiction for foreign capital.

The Bank of Lithuania introduced its electronic licensing tool: now all companies are able to take care of the necessary paperwork and procedures electronically.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

The central bank continued its involvement in international cooperation initiatives. In addition to providing technical assistance, the Bank of Lithuania has also been participating in the EU Twinning Project. The project aims to enhance the capacity of the National Bank of Belarus to effectively pursue its core responsibilities in several key areas. Two of the Bank of Lithuania staff members coordinate the consortium experts' work in the fields of financial stability and banking supervision, while 12 more experts share their experience with the Belarusian counterparts in such areas as payment systems, banking supervision, financial stability, consumer protection and communication policy.

In January 2018, a consortium of the national central banks of Germany, Lithuania and Poland started implementing the EU Twinning project 'Strengthening the National Bank of Belarus'. The project aims to enhance the capacity of the National Bank of the Republic of Belarus to effectively pursue its core responsibilities in the field of financial stability, banking supervision, payment systems, consumer protection and communication policy. The project was set to run for 18 months, counting on the expertise of the Bundesbank as the main partner and the central banks of Poland and Lithuania as junior partners. First of its kind in Belarus, it is also the first EU Twinning Project to the implementation of which the Bank of Lithuania contributes.

Cooperation with other supervisory bodies in the country

The Bank of Lithuania has been creating a business-friendly regulatory environment. Together with other public sector institutions, we have lowered the barriers to market entry and operation therein. The Bank of Lithuania has been providing consultations to potential financial market participants on business opportunities in Lithuania. FinTech companies can now test their innovative financial products in the Bank of Lithuania's regulatory sandbox. As a result, Lithuania has grabbed the attention of world-renowned companies and was ranked first in continental Europe in terms of licensed electronic money institutions in 2018. Yet the doors to the Lithuanian, and, in turn, the EU, market is not open to everyone. The Bank of Lithuania grants licences only to carefully selected companies seeking to enter Lithuania's financial sector. To strengthen its international relations, the Bank of Lithuania signed FinTech cooperation agreements with the Monetary Authority of Singapore, the National Bank of Ukraine and the Astana Financial Services Authority (Kazakhstan).

Other relevant information and developments in 2018

At the beginning of 2019, the Bank of Lithuania helped to organise and took part in the joint Nordic-Baltic Crisis Simulation exercise. The exercise involved representatives from 31 competent national authorities from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, Sweden and competent EU authorities – the European Commission and the Single Resolution Board. The exercise assessed respective Nordic-Baltic authorities' capacities to manage crises and ensure regional cooperation. Lessons learned during the exercise will allow improving interinstitutional cooperation and decision-making processes at the domestic and Nordic-Baltic level.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	6	6	6
Branches of foreign credit institutions	8	7	7
Cooperative banks	74	70	67
Banking sector, total:	88	83	80

Total assets of banking sector (at year-end, EUR million)

Type of financial institution	2016	2017	2018
Commercial banks	21 429,7	25 213,2	27 034,9
Branches of foreign credit institutions	4 323,5	2 110,7	1 585,3
Cooperative banks	658,5	684,8	741,1
Banking sector, total:	26 411,7	28 008,6	29 361,4
y/y change (in %)	9,6	6,0	4,8

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership			
Domestic ownership total	10,9	11,1	11,7
Foreign ownership	89,1	88,9	88,3
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	88,7	98,8	2743,0
Branches of foreign credit institutions	92,0	98,7	3538,9
Cooperative banks	16,4	25,1	289,31
Banking sector, total:	2263,8	2326,9	2336,1

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	9,86	9,42	12,8
Cooperative banks	-11,67	3,08	4,99
Banking sector, total:	-	-	-

Distribution of market shares in balance sheet total (%)

Type of financial institution	**2016**	**2017**	**2018**
Commercial banks	81,1	89,6	92,1
Branches of foreign credit institutions	16,4	7,5	5,4
Cooperative banks	2,5	2,9	2,5
Banking sector, total:	**100.0**	**100.0**	**100.0**

Capital adequacy ratio of banks

Type of financial institution	**2016**	**2017**	**2018**
Commercial banks***	19,10	18,79	18,58
Cooperative banks	15,98*	18,49*	13,97**
Banking sector, total:	19,01	18,78	18,46

(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	**2016**	**2017**	**2018**
Non-financial sector, including	3,77	2,97	2,37
Households	4,81	3,71	3,03
Corporate	6,52	5,47	4,33

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	**Loans**
Non-financial sector, including:	88,8	96,7
Households	60,3	48,0
Corporate	28,5	48,8
Government sector	8,2	2,0
Financial sector (excluding banks)	3,0	1,3
Total	**100,0**	**100,0**

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

P&L account	2016	2017	2018
Interest income	472,4	456,2	505,9
Interest expenses	89,5	73,9	66,2
Net interest income	382,9	382,3	439,7
Net fee and commission income	174,0	196,9	218,1
Other (not specified above) operating income (net)	80,8	35,3	64,5
Gross income	637,8	614,5	730,6
Administration costs	294,3	266,4	313,3
Depreciation	14,9	21,2	19,5
Provisions	5,1	42,7	-0,3
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	16,7	-10,5	5,2
Profit (loss) before tax	274,7	275,4	385,0
Net profit (loss)	239,1	225,4	334,5

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	2325,2		2309,0	16,2	
Cooperative banks**	52,9		46,9	6,0	
Banking sector, total:	2378,1		2355,9	22,2	

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

2018 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF NORTH MACEDONIA

Macroeconomic environment in the country

After the stagnation in 2017, in conditions of stable domestic environment, with sound economic bases and absence of imbalances, in 2018 the domestic economy returned to the path of solid growth, whereby real GDP increased by 2.7%. The favorable performances were particularly evident starting from the second quarter, in circumstances of stable expectations and enhanced confidence of economic entities, as well as sustainable dynamics of the export activity, in a solid external position of the economy. Most of the economic activities increased their positive contribution to the economic growth. The main driver of economic growth throughout the year is the group of activities "trade, transport, accommodation and food service activities", which simultaneously represents a structural feature of the domestic economy, present in the past two years. Acceleration of activity and higher value added to the total growth compared to 2017 is also observed in the industry, while the construction activity registered recovery and returned to the zone of positive performances in the last quarter of 2018, after six quarters of unfavorable achievements and continuous negative contribution to the economic growth. Observed from the aspect of aggregate demand, the export shows significant growth and highest individual contribution, which is the main factor for the high positive contribution of the net-export in the total economic growth. The achievements in the export sector were mainly a reflection of the strengthened activity and further increase in the level of capacity utilization of export-oriented production facilities with foreign capital, while simultaneously the export activity of the traditional exporters from the metal processing industry also has a significant positive contribution. The export growth is also associated with the favorable external environment, despite the generally more pronounced political instability in global terms, increased trade tensions and volatility of financial markets.

In circumstances of moderate growth in consumer prices during 2018, the average annual inflation rate remained at the level of 1.5% (1.4% in the previous year). Two key components of the consumer price index (food component and the energy component) registered an accelerated annual growth in 2018. On the other hand, the core inflation component noted slight slowdown in the annual growth. Nevertheless, the core inflation remains with the highest positive contribution (due to increased excises on tobacco products and air transport) to the annual growth in domestic consumer prices. Additionally, the domestic inflation performance reflects the changes in world prices of primary products, their indirect effects on other prices and the effect of certain domestic factors.

In accordance with the positive developments in the real economy, most of the labor market indicators indicate persistence of the favorable labor market trends in 2018. The continuous implementation of active labor market measures supported the increase in number of employed persons by 2.5% (similar to the growth in 2017), which led to 1 p.p. increase in the employment rate (45.1%). Industry registered the most prominent increase in the employment, largely reflecting the positive shifts in the manufacturing industry, but also there is a significant contribution coming from the service sector. The positive developments, both on the demand and the supply side of the labor market contributed to reduction in the unemployment rate to the historically lowest level of 20.7% (annual decrease by 1.6 p.p.). The reduction of the total unemployment rate is defined by the lower unemployment in all age groups, with particularly significant decrease observed in the population aged between 15 to 24 and 25 to 49 years. The upward trend in average wages continued in 2018, with their growth noting particular acceleration, which is partly due to the legal provision for increasing the minimum wage level as of September 2017 and the additional growth of 1.4% in July 2018, but it is also a result of the raised public sector wages. Thus, nominal net- and gross-wages registered an annual growth of 5.9% and 5.7%, respectively (as opposed to the moderate growth of 2.6% respectively in 2017). Employees from mining, information and communication, manufacturing, accommodation and food service activities and real estate activities received the highest raises in wages.

The public debt in North Macedonia grew by 8.7% in 2018, which caused an increase in its share in GDP to 48.5% (47.8% at the end of the previous year). In terms of the debt structure, the annual growth in total public debt is mostly due to increased government debt, as a consequence of the growth in central government's external debt. According to the resident, the public debt structure observed divergent movements in its main components, with the share of external debt in GDP increasing up to 33.0% of GDP, while the share of domestic debt in GDP decreased to 15.5%. The changes in the direction of fiscal consolidation were more pronounced in 2018, demonstrated by the further reduction of the budget deficit share in GDP to the level of 1.8%, which is lower compared to last year's (2.7% of GDP in 2017), but also in relation to the initially projected plan and the revised budget for 2018. In conditions of more stable domestic environment, stabilization of economic entities' expectations, as well as positive changes in domestic exports' structure, favorable trends in the balance of payment continued during 2018, enabling persistence of North Macedonian favorable external position. The current account deficit was reduced second year in a row, reaching historically lowest level of 0.3% of GDP (by 0.7 p.p. lower compared to the previous year), mainly reflecting the improved balance of goods and services, as a result of stronger export activity of new production facilities in foreign ownership. At the end of 2018, gross external debt was almost unchanged compared to the previous year (73.7% of GDP), with public debt increase (by 0.4 p.p. of GDP) that is offset by almost equal decrease in private sector debt. The growth in public external debt is a consequence of higher state liabilities on debt securities as well as public non-financial companies in the form of long-term loans. The analyses on the indicators of external indebtedness of the domestic economy indicate that the gross external debt is in the safe zone. Namely, the solvency and liquidity indicators demonstrate relatively moderate external indebtedness of the Republic of North Macedonia. However, according to the indicator of the share of gross external debt in GDP, which marks certain deterioration on annual basis, the economy is ranked in the group of highly indebted countries. However, it should be noted that the structure of total gross external debt was predominated by liabilities on intercompany debt (debt between connected entities) and trade credits, indicating more stable and less vulnerable sources of financing, thereby reducing the vulnerability of the economy to potentially exceptionally high external indebtedness.

During 2018 the National bank continued loosening the monetary policy, which started in December 2016. The policy rate was reduced on three occasions, in March, August and December, for a total of 0.75 p.p., reaching the level of 2.5%. Additionally, in March, the interest rate on deposit facility with maturity of 7 days and overnight deposit facility was reduced by 0.2 and 0.1 p.p., respectively, at the level of 0.3% and 0.15%. The monetary policy loosening was reflection of the solid external position of the economy and gradual stabilization of economic entities' expectations. In such conditions, the movements on the FX market were favorable throughout the year and enabled continuous intervention of the National Bank on the FX market for purchase of foreign currencies surplus, which also resulted in foreign reserves growth. Positive movements were also detected in the dynamics and structure of banks' deposit base.

According to the macroeconomic forecast for the upcoming two years, the growth of the economy is expected to accelerate further, due to domestic demand and expectations for revival of investment activity and accelerated growth of personal consumption in surrounding of stable prices and lack of significant inflationary pressures. In the fiscal sphere, with further consolidation of the budget deficit and relatively stable level of public debt, the implementation of prudent fiscal policy is expected to continue. Adequate coordination of fiscal and monetary policy is a key factor for attaining sustainable external position of the country and maintaining macroeconomic stability.

Development in the banking sector (including the assets total / GDP)

As it was pointed in the previous chapter, with the absence of imbalances in the economy and favorable external position and stable expectations of the economic agents, the domestic banking assets were significantly increased (9% in 2018), banks improved their profitability while still pertaining prudent risk management, which led to improvement of the banks' risk profile. Given the growth of the sources of funds (both on deposits and capital positions), the lending activity was mainly directed towards the households, although solid annual growth rates of credit support to the corporate sector were registered (total loans to non-financial clients grew by 7.6%). De-euroization process continued in 2018, perceived through the reduced share of loans and deposits with currency component in total loans and deposits (denar loans grew by 9.7%, while denar deposits grew by 10.5%). De-euroization was more pronounced on the side of the loans, but is somewhat slower compared to 2017.

Financial intermediation indicators registered certain upward developments in 2018. The assets-to-GDP ratio equaled 76.2%, which is an increase of 1.3 percentage points relative to 2017. The gross credits and the deposits reached 48.5%, i.e. 56.2% of the gross domestic product, respectively (incline of 0.2 percentage points, i.e. 1.2 percentage points, compared to 2017)[1].

The share of the non-performing loans in the total loans of the non-financial entities went down to the level of 5.2% (6.3% as of 31 December 2017). The decrease in non-performing loans was fully concentrated in non-financial companies, where these loans decreased by 16.1%, mostly due to the sale of a significant amount of non-performing claims from one client (in the first quarter of 2018), and the effects of the compulsory write-offs of non-performing loans to this sector. Thus at the end of 2018 after a longer period, the share of non-performing loans to total corporate loans was reduced to a one-digit level of 8% (10% at the end of 2017). The non-performing loans in the household credit portfolio grew faster compared to the preceding year (7.4% in 2018 and 1.4% in 2017), due to the increase in the non-performing consumer loans. However, in conditions of accelerated and solid growth of the households' lending activity, the share of the non-performing loans in the total household loans decreased and reached 2.3% at the end of 2018 (2.4% on 31 December 2017). The high coverage of the non-performing loans with provisions was also preserved in 2018, which, accompanied with the solid volume and quality of own funds, limits the negative effects on the banks' solvency, from risk of defaults of these loans.

Most indicators of the liquidity of the banking system registered improvement, in conditions of solid annual growth of the banks' liquid assets, of 12.7% (0.8% in 2017), which accounted slightly over 40% of the total assets growth of the banking system. The liquid assets make up roughly one third of banks' total assets, covering more than half of the short-term liabilities and nearly 60% of the total household deposits. Positive trends in the deposit base of the banking system provide stable sources of funding the credit growth, which is evidenced by the level of loan to total deposit ratio (around 86% on aggregate).

The profitability of the banking system improved in 2018. ROAA and ROAE reached solid levels of 1.7% and 16.0%, respectively (in 2017, these indicators equaled 1.4% and 13.5%, respectively). In an environment of annual decrease of the net interest income, the main generator of the improved profitability were the lower impairment losses signaling the banks' activities for collection of nonperforming loans, primarily in the first and the second quarter of 2018. In addition, the capital gain from the sale of a capital investment in another financial institution, as well as the intensified sale of previously foreclosed property, had a positive impact on banks'

[1] Financial intermediation indicators are calculated according to the last available data on GDP. Data on GDP were last revised as of June 2019.

higher profitability. The operational efficiency of the banking system has been improving for several years now, evident through the downward trend of the share of operating expenses in total operating revenues, which reached 46.2% at the end of 2018 (48.7% in 2017).

The solvency of the banking system also improved in 2018. The reinvestment of profits in the banks' own funds, the new issues of shares and subordinated instruments contributed to the annual growth of the capital positions. The capital adequacy ratio of the banking system equals 16.5% (15.7% as of 31 December 2017), while the common equity Tier 1 capital ratio equals 15.0% (14.2% at the end of 2017). On aggregate, the banking system has "free" own funds above the regulatory and supervisory requirements of 8.6% of the total own funds (6.8% as of 31 December 2017).

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

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

These competences of the National Bank are regulated with the Law on the National Bank of the Republic of Macedonia and the Banking Law.

In order to harmonize the domestic regulations with the Basel standards and principles, as well as with relevant EU directives and regulations, the National Bank has issued several decisions as a replacement or amendment of the existing banking regulation:

- The Decision on good corporate governance rules for banks introduces several novelties: increasing the significance and role of the supervisory board and its members; introducing regular internal assessments of the members of the supervisory board, the board of directors and other persons with special rights and responsibilities, in terms of fulfillment of the prescribed criteria and the quality of their work; strengthening of the remuneration requirements by defining the content of the remuneration policy and adopting more precise remuneration principles that should be followed by the banks; strengthening the role and significance of the control functions i.e. risk management, compliance and internal audit, which ultimately led to more efficient internal control systems;
- Amendments to the regulations on issuing licenses and approvals, which aim at further harmonization with the Core Principles for Effective Banking Supervision, which should enable better efficiency of the licensing procedures implemented the National Bank;
- The Decision on the methodology for managing the risk of money laundering and financing terrorism defines the manner for determining the level of inherent risk and establishing adequate internal control systems for its management. This decision is in line with the relevant EU directive;
- The Decision on the Methodology for bank's information system security allows for further enhancement of banks' information security by incorporating the best practices established by the European regulatory bodies in the period from 2008 to 2017, as well as by incorporating the findings of the on-site IT examinations carried out in the past nine years;

- The Decision on the methodology for credit risk management is aimed at implementing the International Financial Reporting Standard IFRS 9 and the EU guidelines on the treatment of forbearance and non-performing credit exposures, adopted by the European Banking Authority and the European Central Bank;
- The Decision on the manner of conducting supervision and inspection aligns the supervisory practices of the National Bank with those implemented by the SSM;
- Amendments to the Decision on the methodology for determining the capital adequacy, which provide clarification of certain provisions related to the possibility of early repayment or purchase of capital instruments which are part of the banks' own funds.

Main strategic objectives of the supervisory authority in 2018

The National Bank continued its efforts for further enhancement of the regulatory and supervisory framework. After a period when bulk of the regulatory and supervisory efforts were dedicated to smooth implementation of Basel 3 capital requirements through introducing the capital buffers, strengthening own funds requirements and widening the Pillar 2 risks captured under SREP during the past few years, National Bank's activities were focused on improving the corporate governance and risk management requirements. In long run, the enriched corporate governance and risk management practices should foster the public trust and confidence and promote the safety and soundness of the entire banking system.

The recent unblocking of the Euro-Atlantic integration processes for our country gives a new positive impetus to the domestic economic activity and the financial system, which would have lasting, positive effects on the overall economic flows. One of the initial effects of the revival of these integrative processes is the transition in the second stage of the Stabilization and Association Agreement concluded between the Republic of North Macedonia and the European Union and its member states (just before the end of 2018). The transition in the second stage of this agreement brings changes in the business environment of domestic banks, which should increase the degree of integration of the domestic with the global financial system and strengthen the competitive pressure on the domestic financial institutions, to which they should respond with an enriched offer of products and services for their customers. The surge of FinTech activities and the announced adoption of the Law on Payment Services and Payment Systems are challenges domestic banks will cope with in the forthcoming period. Although these risk does not currently pose treat to the financial stability in the country, the National Bank has established an Innovation Hub as a platform for supporting the FinTech innovations and raising the FinTech awareness of the National Bank, other supervisory and regulatory bodies and the public, as well as for building internal capacities for adequate implementation of the new technologies and monitoring of the associated risks.

In addition to this, NBRM continued its activities for improvement of the financial stability monitoring instruments and development of macroprudential tools and practices, as well as strengthening of the existing supervisory capacity.

The activities of the Banking Supervisory Authority last year

Activities of the Off-Site Supervision Department last year

As part of its regular off-site analysis of banks' operation, the National Bank has continued with its activities for determining banks' risk profiles and Pillar 2 capital requirements. Within the Supervisory Review and Evaluation Process (SREP), in order to further increase the transparency of the supervisory function and align it with the EBA guidelines and methodology and ECB practices, a formal supervisory dialogue with the banks was carried out for the first time. Prior to the final announcement of the minimum capital requirement (Pillar 2 capital requirement) for 2019, the supervisory assessment of the banks' risk profiles and the preliminary assessment of the required capital were communicated to the banks. In doing so, the banks were given the opportunity to comment, i.e. submit to the National Bank any comments regarding these assessments. On the basis of this process, in December 2018, the National Bank informed the banks of the minimum required level of capital to be maintained during 2019.

In addition to this, during 2018 systemically important banks were required to develop and submit to the National Bank, the first version of their recovery plans. Supervisors assessed the plans and gave recommendations for their further enhancements, which should be taken into account during the next revision of the recovery plans (October 2019).

The other two pillars of the off-site supervisory function of the National Bank refer to issuing licenses and approvals to banks and savings houses and undertaking corrective actions. During 2018, the National Bank has finished 60 licensing procedures, which were mainly related to issuing: approvals for appointment of members of the Boards of Directors and members of the Supervisory Boards, amending and/or supplementing the Statute of the banks, approvals for commencement of new financial activities by banks, approvals for including current profit or year-and profit and other capital instruments in the calculation of CET1. Within its legal authorization, and in order to maintain the stability and the safety of certain banking institutions and the whole banking system, the National Bank undertook corrective actions towards banks and saving houses where irregularities, noncompliance and illegitimacies in their operation were found. The aim of the majority of the undertaken measures was the improvement of certain elements of the risk management systems of banks.

Activities of the On-Site Supervision Department last year

During 2018, pursuant to the Annual Supervision Plan, the National Bank carried out 12 regular examinations (on-site risk-based supervision) in 10 banks and 2 savings houses, as well as inspections (on-site compliance examinations) in 13 banks, 2 savings houses, 3 money transfer services, 5 subagents and 167 examinations of licensed exchange offices.

In 2018, the National Bank also performed horizontal review of the exposure to the interest rate risk in the banking group and the quality of the risk management across the banking sector. For this purpose, a questionnaire was prepared and submitted to all banks.

On-site risk controls

Banks in the Republic of Macedonia usually perform traditional banking activities, with the credit risk mainly defining their risk profile. Hence, the exposure to this risk, as well as its management quality, with special emphasis on the adequacy of estimating impairment losses are the most often subject to on-site supervision. In the past year, this risk was examined in 10 banks and 2 savings houses.

In the reporting period, 5 banks were subject to examination of the suitability of the anti-money laundering systems, 7 banks were examined for operational risk management, and 7 banks for corporate governance. Additionally, in the reporting period, information security adequacy was also examined in 4 banks. The accuracy of capital adequacy reports was examined in 7 banks, while the accuracy of reports on transactions with persons related to banks was examined in 10 banks.

The examinations showed that banks' risk management was adequate and they were largely responsive to the corrective measures imposed by the National Bank in the previous periods.

In order to improve the banks' credit risk management rules and practices, the National Bank made several recommendations. They mainly focus on the promotion of the credit risk exposure classification process in terms of greater impact on the client's creditworthiness, inclusion of early warning indicators, and increase in the percentage of impairment for exposures classified within the same risk category. Recommendations were also made for improving the existing credit risk identification processes by strengthening the criteria for approving exposure to non-financial legal entities and monitoring their credit exposure.

Some banks were given recommendations for improving internal controls of the appropriateness of the use of loans, the accounting records, management of exposures approved as an exception, as well as for improving the process for identifying connected parties. In the household segment, recommendations were given first of all to tighten banks' criteria for approving credit risk exposures and their internal controls.

As for the actions and measures for anti-money laundering and financing of terrorism, recommendations were also given to increase their effectiveness in risk management. The recommendations refer to strengthening the measures for determining and confirming the identity of the rightful owner of the clients, expanding the analyzes and controls when establishing a business relationship and in transactions with non-residents, strengthening the analyses of clients that establish a business relationship without a physical presence or clients that are non-profit organizations, associations or foundations. Some banks were given a recommendation to provide additional documentation to determine consistency of clients' transactions with their activity, to extend the list of offshore countries for the purpose of adequate determination of the geographical risk, to extend the inherent risk assessment analyses and to revise suspicious transactions indicators. During this period, some banks were given a recommendation for improving the management information system regarding this risk and expanding the controls carried out by the internal audit.

Banks' corporate governance was found to be satisfactory. Almost all banks' bodies comply with the law and bylaws and are involved in the strategic and operational risk management. There were findings for appropriate organizational structure, satisfactory remuneration system and satisfactory implementation of the three control functions: risk management, compliance and internal audit. For further improvement of corporate governance, recommendations were given for adoption and annual review of risk management policies by the supervisory board, strengthening the compliance activities, improving the process of introducing new products/services, improving the process and internal acts that regulate the selection and dismissal of persons with special rights and responsibilities, extending the content of the reports on meetings of the bank's bodies and implementing and reviewing internal acts that regulate remuneration in the Bank. Part of the banks was given a recommendation for improving the internal audit activities, through changes to the audit cycle, scope of audits, staffing and internal work methodologies. Most of the banks were given a recommendation to enhance the role of independent members of the supervisory board and the audit committee in carrying out the activities set out in the law and the rules of procedure.

In terms of operational risk management, recommendations were given for improving the process of risk identification, measurement and monitoring. The recommendations refer to defining limits on key risk indicators, revising the manner of monitoring harmful events, and appropriately defining key risk indicators, centralized risk monitoring and reporting, and employee training to determine and report on operational risk exposures. Also, recommendations were given for enhancing the internal audit activities, revising the operational risk management framework regarding the use of outsourcing, improving the business continuity plan and improving the risk identification process by establishing a process of operational risk exposure self-assessment.

In assessing banks' IT or information security risk, recommendations were given for proper segregation of duties of IT system administrators, for strengthening the established audit trail system, for improving system configurations, improving the protection of IT system confidentiality, improving the business continuity plan, improving the process of testing the existing functionalities in case of changes to applications and drafting an IT system development strategy. The other recommendations refer to: increasing the rate of implementation of IT projects deriving from the business plan and operations, expanding the analyzes resulting from the annual IT risk assessments, as well as greater commitment and information IT infrastructure-based risks, as well as expanding internal audit activities. Also, a recommendation was given for reviewing the configuration files and establishing a user identifier and password management process, proper procurement and resources planning, and establishing an independent audit trail system of card operations.

The examinations mainly found that banks are in compliance with the regulations that pertain to the accuracy of information in the capital adequacy reports. Some banks were given a recommendation to strengthen internal controls.

Examinations targeted to accuracy of reporting on transactions with related parties found no material failure. For some of the banks, the recommendations refer to strengthening of internal controls for the purpose of proper identification of persons related to persons with special rights and responsibilities, as well as the extension of information contained in the reports to the supervisory board for adequate coverage of all transactions with these persons.

On-site compliance examinations

The on-site compliance examinations are focused on assessment of the compliance of banks and savings houses with the Law on the National Bank of the Republic of Macedonia, the Law on Foreign Exchange Operations, the Law on Consumer Protection in Case of Consumer Loan Agreements, the Law on Providing Fast Money Transfer Services and the Law on Payment Operations. All supervised entities are mainly complied with the regulations.

On-site examination of non-banking financial institutions or licensed exchange offices, money transfer services and their subagents aimed to assess their compliance with the Law on Foreign Exchange Operations, the Law on Providing Fast Money Transfer Services and the Law on Prevention of Money Laundering and Financing of Terrorism. Overall, these institutions were found to be complied with the regulations.

Organizational chart of the Banking Supervisory Authority

The organizational chart of the Supervision, Banking Regulations and Financial Stability Division is enclosed in Appendix No. 1. Please be informed that organizational changes with regard to this Division occurred in June 2019.

International activities of the authority

In 2018, the National Bank signed a Memorandum of Understanding with the European Central Bank. This Memorandum represents a willingness for cooperation based on a mutual trust for performing supervisory tasks in respect to cross border credit institutions that fall under their supervisory responsibilities. It ensures effective exchange of supervisory information between Authorities respective to their supervisory powers over the supervised entities, to the extent permitted by a law and in accordance with the Basel Principles for effective banking supervision. The Memorandum focuses on the exchange of information in relation to the on-going supervision matters, cooperation in relation to authorization process/qualified holdings assessments/assessment of directors, breach reporting mechanism and cooperation in relation to enforcement and sanctions. It also prescribes cooperation in relation to on-site inspections, to internal models or advanced approaches and to emergencies.

The other previously signed bilateral and multilateral Memorandums of Understandings continued to be implemented in accordance with the needs and the planned activities of the signatories. Within this cooperation, National Bank's supervisory staff attended two supervisory colleges (for one Greek and one Slovenian subsidiary).

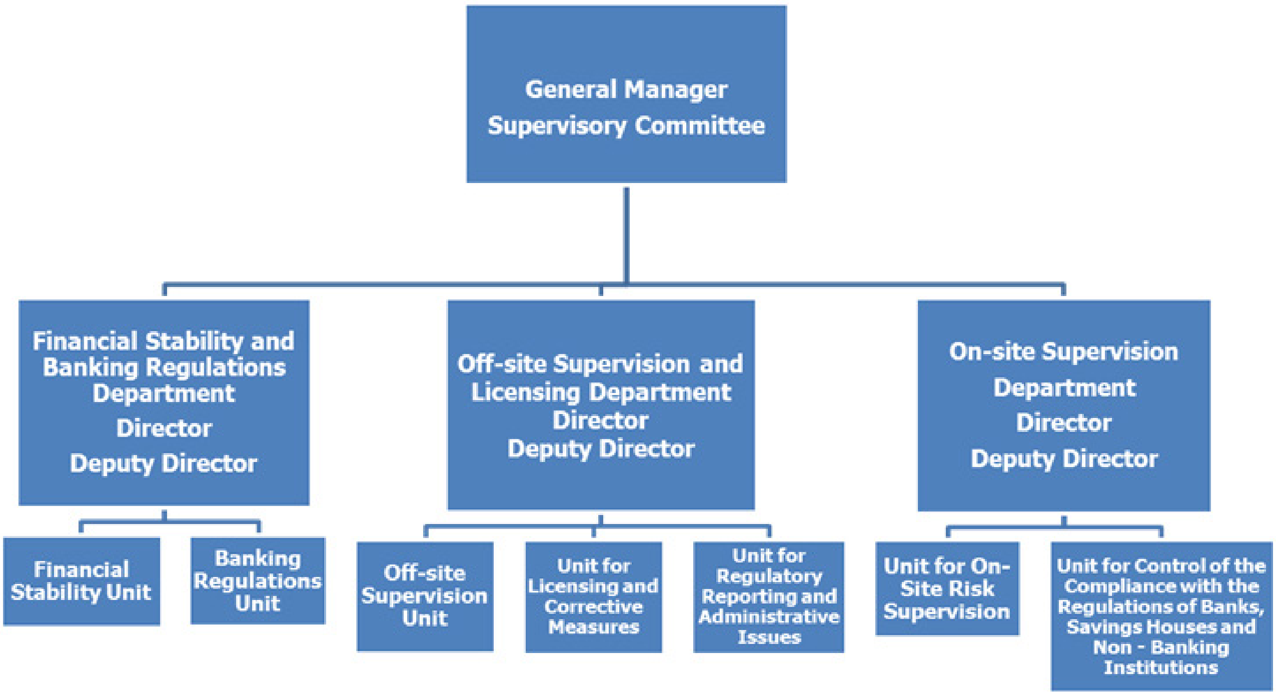
Cooperation with other supervisory bodies in the country

The collaboration of the domestic supervisory authorities in 2018 continued on a regular basis. The Memorandum signed with the Financial Intelligence Office was updated. Also, National Bank initiate signing of an agreement with the Public Revenue Office for receiving data on personal net income of each individual tax payer recorded in the National Bank's Credit Registry. The obtained information will be used for assessing and monitoring of the creditworthiness of individuals in the context of maintaining the stability of the banking system and the overall financial system.

Other relevant information and developments in the course of last year

The supervision and regulation of the domestic financial and, in particular, the banking system, were subject to detailed examinations conducted by IMF and World Bank staff, as part of the last year's FSAP mission. The examinations did not find any major non-compliance of domestic supervisory and regulatory standards with respect to the internationally accepted, sound standards in this domain. On the contrary, the assessment of the compliance with the Basel Core Principles resulted in receiving only two grades: compliant for 21 BCPs and largely compliant for 8 BCPs. Moreover, a macro stress test was conducted that indicated to a relatively satisfactory resilience of domestic banking system.

Based on the received recommendations, National Bank has started with activities that should led to further enhancement of its supervisory policies and practices. A new Decision on the risk management methodology was prepared during 2018 and adopted in May 2019, which promotes improvement of the banks' risk management systems and introduction of formal internal liquidity adequacy assessment process (ILAAP), established by the banks not later than the end of 2019. In addition, in accordance with one of the recommendations, the National Bank has started with performing full scope examinations of systemically important banks on a regular frequency.



Appendix No. 1

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	15	15	15
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	15	15	15

Total assets of banking sector (in millions of Macedonian Denar) (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	444,680	461,992	503,469
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	444,680	461,992	503,469
y/y change (in %)	5.0%	3.9%	9.0%

* 1 EUR = 61.4950 MKD, as of 31.12.2018

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	3.3%	2.7%	2.0%
Other domestic ownership	26.7%	26.8%	26.4%
Domestic ownership total	30.1%	29.5%	28.4%
Foreign ownership	69.9%	70.5%	71.6%
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	57.3%	74.5%	1,352
Branches of foreign credit institutions	/	/	/
Cooperative banks	/	/	/
Banking sector, total:	57.3%	74.5%	1,352

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	13.6%	13.5%	16.0%
Cooperative banks	/	/	/
Banking sector, total:	13.6%	13.5%	16.0%

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
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 sector (%) (at year-end)

Assets	2016	2017	2018
Cash, balances and deposits with central bank (National Bank)	13.3%	12.2%	14.2%
Placements in securities	12.7%	13.0%	12.2%
– issued by domestic government sector	7.2%	7.2%	7.0%
– issued by central bank (National Bank)	5.2%	5.4%	5.0%
– other (including non residents)	0.4%	0.4%	0.3%
Loans, deposits and accounts with financial institutions (excluding central bank, including non residents)	11.4%	10.7%	10.1%
Loans with non-financial sector (including non residents)	58.3%	59.8%	59.6%
– loans with domestic government sector	0.5%	0.5%	0.4%
Other assets	4.3%	4.3%	3.9%
Total	**100.0%**	**100.0%**	**100.0%**
Liabilities	**2016**	**2017**	**2018**
Deposits of financial institutions (including non residents)	4.4%	4.8%	5.5%
Deposits of non financial sector (including non residents)	72.6%	73.4%	73.8%
– deposits of domestic government sector	0.1%	0.1%	0.2%
Borrowings, issued securities and liabilities on the basis of subordinated and hybrid instruments (including non residents)	9.3%	7.9%	6.6%
– domestic financial sector	3.2%	2.7%	5.5%
– domestic government sector	0.1%	0.1%	0.1%
– other	5.9%	5.1%	4.5%
Other liabilities	3.1%	1.6%	3.4%
Equity and reserves (including loss in current year)	10.6%	10.8%	10.8%
Profit after tax in current year	1.4%	1.5%	1.7%
Total liabilities	**100.0%**	**100.0%**	**100.0%**

Capital adequacy ratio of banks

Type of financial institution	2016**	2017***	2018***
Commercial banks	15.2%	15.7%	16.5%
Cooperative banks	/	/	/
Banking sector, total:	15.2%	15.7%	16.5%

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

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

Asset classification	2016	2017	2018
Non-financial sector, including	6.6%	6.3%	5.2%
Households	2.6%	2.4%	2.3%
Corporate	9.9%	10.0%	8.0%

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	93.7%	99.8%
Households	64.8%	47.9%
Corporate	25.5%	50.9%
Government sector	0.2%	0.7%
Financial sector (excluding banks)	6.3%	0.2%
Total	**100.0%**	**100.0%**

P&L account of the banking sector, in millions of Macedonian Denar (at year-end)

P&L account	2016	2017	2018
Interest income	20,169	19,940	19,605
Interest expenses	-4,780	-4,308	-4,225
Net interest income	15,389	15,632	15,380
Net fee and commission income	4,247	4,365	4,639
Other (not specified above) operating income (net)	2,750	3,243	4,244
Gross income	22,383	23,239	24,262
Administration costs**	-9,732	-9,758	-2,909
Depreciation	-1,002	-1,065	-1,078
Provisions***	-835	-107	-426
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)****	-3,765	-4,998	-3,362
Profit (loss) before tax	7,048	7,326	9,341
Net profit (loss)	6,325	6,555	8,353

* 1 EUR = 61.4950 MKD, as of 31.12.2018
** Administration costs include all operating expenses.
*** Provision items include: impairment losses of non-financial assets, provisions for off-balance sheet items and other provisions.
**** Presented on net basis.

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds***	Core Tier 1***	Tier 1***	Tier 2***	Tier 3
Commercial banks	987,633,941	896,027,639	897,003,328	90,630,614	/
Cooperative banks	/	/	/	/	/
Banking sector, total:	987,633,941	896,027,639	897,003,328	90,630,614	/

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

2018 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MOLDOVA

Macroeconomic environment in the country

Economic activity

In 2018, GDP of the Republic of Moldova recorded a growth of 4.0%, this annual dynamics being lower by 0.7 percentage points compared to 2017. The positive evolution of the economic activity in 2018 was mainly determined by the pronounced contribution of the investment component. In this regard, gross fixed capital formation increased by 14.0 % compared to the 2017, supported by the implementation of the good roads program for Moldova. The inventories sub-component of the national accounts generated a 1.0 p.p. impact on GDP growth. At the same time, the economic growth in 2018 was mainly determined by the final household consumption growth by 3.8% compared to 2017, as a result of the increase in the disposable income of the population. In the first nine months of the year, population consumption experienced a more modest evolution. Subsequently, in the fourth quarter, the dynamics of private consumption increased, being favored by the effects of fiscal reforms. In 2018, the final consumption of public administration in 2018 contracted by 0.1 % compared the previous year. The dynamics of economic activity in 2018 was significantly lowered by the increase of imports by 8.9% as compared to 2017, mainly as a result of both the domestic demand growth and the appreciation trend of the national currency. Within the national economy sectors, in 2018 the gross added value of construction was by 16.0% higher than in 2017. The commercial sector registered an increase of 5.7%. Positive but lower magnitude contributions were generated by developments in industry, agriculture, the information and communications sector, financial and insurance, and real estate transactions. At the same time, net product taxes in 2018 increased by 2.7 percent compared to 2017.

Inflation

In 2018, the average annual inflation rate (CPI) recorded 3.0%, being 3.6 percentage points lower than in 2017. During 2018, the annual inflation rate recorded a significant downward trajectory. It declined from 7.3% in December 2017 to 0.9% in December 2018. At the beginning of 2018, the downward trend in the annual inflation rate was mainly driven by the missing of the impact adjustment in the first quarter of 2017 of medical services tariffs, as well as the recalculation of inflation for the first two months of 2018 as a result of the fall in the price of gas in the grid. Subsequently, this trend was supported by the effect of a high base period from April to May 2017 on food prices, but also by a rich harvest of fruit in 2018. At the same time, in the second half of the year an impact of a sharp decline in the CPI's annual rate was determined by the fall in the electricity tariff in July. The downward trajectory of inflation in 2018 was also supported by the appreciation trend of the national currency against the currencies of the main trading partners. During 2018, domestic demand has had a modest impact on the annual inflation rate. The excise taxes adjustment and the setting of the minimum retail price for cigarettes triggered some inflationary pressures. At the same time, pressures from the rise in oil prices on the international market in 2018 were partly mitigated by the exchange rate dynamics, as well as the freezing of fuel prices – limit in the second half of the year.

In 2018, the exchange rate of the national currency has depreciated slightly in nominal terms by 0.2% against the USD, while strengthening against the euro by 4.4%. At the same time, the Moldovan Leu has appreciated in real terms by 3.5% against main trading partners' currencies.

Foreign currency inflows continued to exceed outflows, creating a foreign currency market surplus. However, the volume of the surplus decreased compared to the previous years, as the deterioration of the trade balance resulted in a 24.8% rise in the net FX demand from companies. At the same time, a 5.6% increase in net transfers from abroad has maintained the steady growth of the net FX supply from individuals (7.3% YoY). Under these conditions, the coverage ratio of the net demand by the net supply dropped from 120% in 2017 to about 103%.

The NBM reduced its FX market presence by lowering the net FX purchases to USD 262.7 million, 39.4% down from the previous year. The international reserves continued to ensure a sufficient coverage of the imports of goods and services (around 5.6 months of imports).

External sector

According to preliminary data, in 2018, the current account balance of the Republic of Moldova recorded a deficit of US$ 1 186,71 million, two times larger as compared to the deficit recorded in 2017. The CAB to GDP ratio was 10,5% (5,8% in 2017). The source of the CA deficit was traditionally the external trade in goods deficit, while other components recorded growing surpluses.

In 2018, the exports of goods and services amounted to US$ 3 430,18 million, up by 10,6% as against 2017. Exports, on the one hand, were positively influenced by the demand from the main trading partners who recorded economic growth. On the other hand, in the second half of 2018, exports had a negative evolution, which was manifested both in falling exports prices (in the last quarter of the year) and in declining physical volumes.

The imports of goods and services amounted to US$ 6 365,63 million, increasing by 18,9% as compared to 2017. The increase in imports was mainly due to the revival of investment activity, which resulted in growing imports of capital and intermediate goods, and of business services. Another driver of imports was the growth in households' disposable income, determined by the increase in remittances and wages, as well as by the relaxation of fiscal policy starting from October 2018.

The primary income surplus grew by 6,0% in 2018 as against 2017 and amounted to US$ 590,24 million. The compensation of resident employees by nonresident employers went up by 12,2%. At the same time, primary income outflow increased by 25,8%, mainly as a result of growth in investment income payable to nonresidents.

The secondary income surplus amounted to US$ 1 158,50 million, up by 2,2% as compared to 2017 due to the increase in personal transfers received by Moldovan residents from abroad (+12,1%). Simultaneously, however, the total amount of technical assistance and grants received by all sectors within current international cooperation decreased by 27,5% as against 2017.

Personal remittances (the sum of net compensation of employees (excluding the expenditures of workers in host countries and some fees and taxes paid by residents abroad), of personal transfers and of capital transfers between households) received by Moldovan residents in 2018 were estimated at US$ 1 742,50 million (+11,9% as against 2017), which represents 15,4% as a ratio to GDP.

The capital account recorded a negative balance amounting to US$ 39,38 million, driven by capital outflows recorded by the private sector (US$ 60,72 million), as well as by external assistance inflows received by the general government for the financing of investment projects (US$ 21,24 million).

The financial account recorded net capital inflows of US$ 1 132,16 million in 2018, resulting from the net increase in residents' liabilities to nonresidents by US$ 595,05 million, while the residents' foreign financial assets decreased by US$ 537,11 million in net value.

Liabilities increased, in particular, as a result of residents' receipts of trade credits and advances from nonresident partners in the net amount of US$ 304,04 million.

Likewise, total liabilities grew due to the net increase in liabilities in the form of direct investment by US$ 231,96 million, which constituted 2,1% relative to GDP. Net equity inflows (other than reinvestment of earnings) during 2018 amounted to US$ 107,42 million, the reinvestment of earnings was evaluated at US$ 25,24 million, and the net incurrence of debt from foreign direct investors – at US$ 99,30 million. At the end of 2018, the stock of external liabilities in the form of direct investment amounted to US$ 4 087,40 million.

External liabilities in the form of loans recorded net drawings amounting to US$ 87,82 million (drawings – US$ 515,05 million, repayments – US$ 427,23 million). In 2018, the general government (including local) made drawings on new loans amounting to US$ 144,83 million from the following main creditors: EIB – US$ 63,42 million, IDA – US$ 36,18 million, EBRD – US$ 19,77 million, IMF – US$ 13,36 million, IBRD – US$ 7,27 million, IFAD – US$ 3,20 million, CEB – US$ 1,24 million etc. The repayments made by the general government in the same year amounted to US$ 115,07 million. The NBM received a tranche of US$ 20,37 million from the IMF and repaid US$ 61,86 million on previously contracted loans. Commercial banks made net repayments on external loans amounting to US$ 4,07 million, and other sectors – net drawings amounting to US$ 103,62 million.

Liabilities in the form of currency and deposits recorded a net decrease amounting to US$ 22,34 million (mainly driven by the withdrawals of money from nonresident banks' loro accounts open with resident banks).

The net decrease in financial assets was determined by the net reduction in currency and deposits assets amounting to US$ 730,04 million (of which the assets of commercial banks diminished by US$ 3,00 million and the assets of other sectors – by US$ 727,04 million). At the same time, the NBM's official reserve assets increased by US$ 235,53 million and amounted to US$ 2 995,18 million as of 31.12.2018, which is sufficient by all adequacy criteria.

Another factor contributing to the decrease in total financial assets were the net repayments amounting to US$ 81,53 million made by nonresidents on trade credits and advances previously received by them from resident trading partners.

Development in the banking sector (including assets total / GDP)

Total assets to GDP: The share of bank assets to GDP has declined during 2018 by 9,1 percentage points, registering a value of 43,8 percent as of the end of December 2018. The above-mentioned evolution is due to the higher growth pace of the economic activity at the national level compared to the growth pace of the banking activity. The share of big bank's assets has accounted for ¾ of the total system assets registered during 2018.

Total own funds amounted to 10,881.5 million lei and during the year 2018 it recorded an increase of 2.8% (295.2 million lei). The increase in own funds was determined by the inclusion in the calculation of the own funds of profits earned until the new regulation. At the same time, the positive difference between asset write-downs and contingent liabilities (prudential discounts) and impairment losses for impairment assets and provisions (IFRS cuts) decreased by 600.7 million lei. Also, net intangible assets decreased by 29.0 million lei. At the same time, two banks distributed capital in a total amount of 354.9 million lei.

The total own funds rate on the banking sector according to the data presented by the licensed banks recorded the value of 26.6%, decreasing by 4.7 pp. compared to the end of the previous year.

Assets on the banking sector according to the data presented by the licensed banks constituted 83,076.6 million lei, increasing by the end of the previous year by 3,611.7 million lei (4.5%).

At 31.12.2018, the gross loan portfolio constituted 42.7% of the total assets or 35,452.8 million lei, increasing by 5.9% (1,979.5 million lei) during 2018.

During 2018, the share of non-performing loans (substandard, doubtful and compromised) in total credits decreased by 5.8 pp. compared to the end of the previous year, constituting 12.5 percent as of 31.12.2018.

In the context of risk distribution, the largest share in the total loan portfolio was held by credits granted to commerce – 25.6% or 9,059.9 million lei, followed by the share of consumer credits – 14.5% (5,126.8 million lei) and the weight of loans for the purchase / construction of the real estate – 11.1% (3,944.0 million lei).

As of December 31, 2018, the profit for the year amounted to 1,451.6 bln. lei. Compared to the same period of the previous year, profit decreased by 5.0 percent, largely due to a decrease in interest income of 8.8 percent.

Return on assets and return on capital at 31.12.2018 constituted 1.9 percent and 11.6 percent respectively (basically at the same level as last year).

Banks maintained liquidity ratios at a high level. Thus, the value of the long-term liquidity indicator (principle I of liquidity) constituted 0.7, being practically at the same level as the end of the previous year. Current liquidity by sector (principle II of liquidity) decreased by 0.9 pp, constituting 54.6%. It should be noted that the largest decrease in the structure of liquid assets during the year 2018 was recorded in liquid securities by 16.1%.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

The banking system in the Republic of Moldova consists of two levels: the National Bank of Moldova and 11 licensed banks. The National Bank of Moldova regulates and supervises the banks in accordance with the Law on the National Bank of Moldova and the Law on banking activity, which provide the competence, main objective, basic attributions of the National Bank, its relationship with banks and other Competent Authorities, in the process of performing the supervisory function.

According to the Law on the National Bank of Moldova, the National Bank is exclusively responsible for the licensing, supervision and regulation of the banks and foreign banks' branches' 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 banks 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 banks, and to examine theirs books, documents and accounts, conditions in which the business is carried out and the compliance with the legislation;

c) to require any employee of the bank to provide the National Bank with the information necessary for the purpose of supervision and regulation of the banks' activity;

d) to prescribe to any bank, to its shareholders, to the members of the bank's management body, to the persons holding key positions within the bank, supervisory measures or to apply the sanctions and sanctioning measures foreseen in the Law on banking activity, if they have violated the provisions of the mentioned law, of the normative acts or other acts issued for its application:

e) act as a resolution authority for the banks in accordance with the Law no.232/2016 on banks' recovery and resolution.

The new Law no.202/2017 on banking activity, in force since January 01, 2018, provides the main requirements related to the banking activity and aims to improve the national banking legislation, taking into account the best international standards and practices related to licensing process, banking regulation and supervision.

The law determines the conditions of access to and conduct of banking activity in the territory of the Republic of Moldova, the prudential requirements, the competences, the instruments and procedures of prudential supervision of banks, as well as requirements of disclosure to the National Bank of Moldova of information on the prudential supervision and regulation of banks.

At the same time, for the purpose of prudential supervision of banks, the provisions of the new law on banking activity shall apply to financial holding companies, mixed financial holding companies, and mixed activity holding companies, which are legal entities of the Republic of Moldova.

It's to be noted that, the Law no.202/2017 on banking activity transposes the provisions of Directive 2013/36/EU of 26 June 2013 on the access to credit institutions and the prudential supervision of credit institutions and investment firms and of the Regulation 575/2013 of 26 June 2013 on the prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.

Concurrently, banks are guided in their activity by normative acts issued by the National Bank of Moldova under the Law on banking activity that establishes requirements for the licensing process, holding equity interest in the capital of banks, requirements to members of the management body and persons who hold key positions, as well as requirements regarding to own funds of the banks, the treatment of the credit/settlement/operational and market risks, liquidity, bank's exposures, foreign exchange position, prudential assessment of assets and conditional commitments, reporting to the National Bank of Moldova (FINREP, COREP and other prudential reports), disclosure of information on the financial activity of the banks, banking activity management framework, etc.

Therefore, in order to implement the provision of the Law no.202/2017 on banking activity, in the context of transposing the requirements of the Base III capital agreement, during the 2018 year has been approved a number of normative acts applied to banks:

Regulation on banks' own fund and capital requirements (effective July 30, 2018) – regulates the calculation methodology of own funds and sets out requirements for own funds and elements that are included in the calculation of own funds, deductions from own fund items, own funds reductions and other requirements for determining them;

Regulation on banks' capital buffers (effective July 30, 2018) – provides requirements on own funds that banks have to hold for the purpose of establishing capital buffers (capital conservation buffer, bank specific countercyclical capital buffer, O-SII buffer, system risk buffer, combined buffer);

Aiming to establish the methodology for determining credit risk-weighted exposure amounts and minimum requirements for eligible form of credit protection for the purposes of calculating banks' own funds requirement has been approved the Regulation on treatment of credit risk for banks according to standardized approach and Regulation on credit risk mitigation techniques used by banks (effective July 30, 2018);

Regulation on treatment of operational risk for banks according to basic indicator approach and standardized approach – lays down the rules on own funds requirements relating to entirely quantifiable, uniform and standardised elements of operational risk according to standardised approach and Basic Indicator Approach and establish own funds requirements for operational risk based on standardised or alternative standardised approach and Basic Indicator Approach;

Regulation on the treatment of market risk according to standardized approach – provides the rules on own funds requirements for market risk according to standardized approach for trading book and all bank's exposures. Thus, for determining own fund requirements for market risk on all bank exposures (including trading book) banks shall set up own funds requirements for foreign-exchange risk and commodities risk. At the same time, additional for the trading book, banks shall calculate own funds requirements for position risk;

Regulation on the treatment of settlement/delivery risk – lays down rules on the treatment of settlement/delivery risk for the purposes of calculating own funds requirements related to transactions that are unsettled after their due delivery dates. When the transaction is unsettled after their due delivery date, the bank shall calculate the price difference to which it is exposed;

Regulation on external audit of banks – establishes normative framework for performing external audit in banks from the Republic of Moldova, requirements for approving the audit company by the National Bank of Moldova, for documentation between the audit company and the bank, etc.;

The Instruction on COREP reporting for banks has been approved and provides the reporting rules for prudential purposes related to own funds requirements, credit/ market/ operational and settlement risks.

At the same time, the NBM amended a number of normative acts, based on improvement of supervisory practice.

Thus, the amendments to the Regulation on holdings in bank equity provides the improvement of the access to the banking market mechanism of persons, including those from the country which apply prudential supervision and regulation requirements at least equivalent to those applicable in the Republic of Moldova and which meet the legal requirements regarding the quality of the bank's shareholder;

Aiming to promote an efficient and prudent banks' management and to ensure that the managers are persons with an appropriate experience and reputation, in line with the requirements of the legislation, has been approved the Regulation on requirements to members of the management body of the bank, of the financial holding or mixed holding companies, senior management of the foreign banks' branches, persons holding key positions and to liquidator of a bank in the liquidation process. The Regulation provides the requirements on adequacy assessment, by banks and by the National Bank of Moldova, of the members of the management body and of the persons holding key positions, as well as criteria for assessment of members of the management body on a collective basis.

In order to strengthens of banks' corporate governance, has been approved in new editing, the Regulation on banking activity management framework, which brings in line with European Union standards the requirements for internal governance and risk management. The regulation covers provisions related to corporate governance in banks, the tasks of the management body and its committees, organizational framework and organizational structure of the bank, remuneration, internal control, risk management, Internal capital adequacy assessment process, etc.

Thus, through a number of requirements provided through the normative acts, the National Bank of Moldova maintains the mechanism of supervision and regulation of banks' activity in the Republic of Moldova, based on international accepted principles.

In view of developing and consolidating the macro-prudential supervision, in 2018 Law no. 209/2018 on National Financial Stability Committee (NCFS) was approved and entered in force, which established the assigned national macro-prudential authority responsible for coordinating the implementation of macro-prudential policy and actions to be taken in order to prevent and remediate systemic financial crisis. In line with its mandate, the NCFS is entitled to issue recommendations for the implementation of certain macro-prudential actions, measures and tools to contribute to the maintenance of the financial stability.

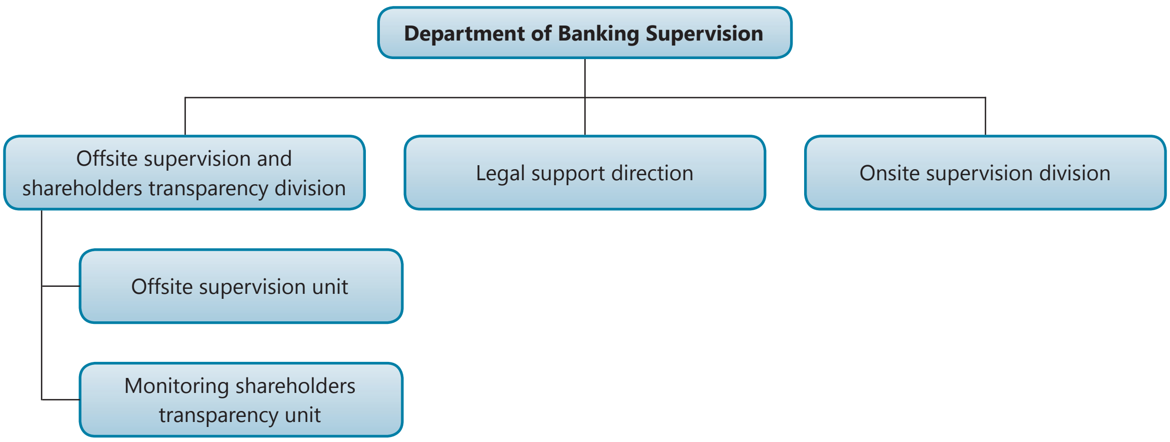
Main strategic objectives of the supervisory authority in 2018

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. The National Bank of Moldova continues the drafting process of the normative acts (related to counterparty risk, CVA, LCR, Internal rating based approach on credit and market risk) in order to implement the provisions of the new Law on banking activity, in the context of harmonization of the national banking legislation with the international standards.

The activities of the Banking Supervisory Authority in 2018

During the 2018 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 approved a number of normative acts, by transposing the provisions of the Directive 2013/36/EU and Regulation 575/2013, which implement the provisions of the international regulation framework Basel III.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

In order to carry out the banking authorization function in accordance with the Law no.202/2017 on banking activity and normative acts of the National Bank in force in 2018, the NBM has provided the exchange of information with the following supervisory authorities: the National Bank of Romania, , the Central Bank of the Russian Federation, the Bank of Lithuania, the National Bank of Ukraine, National Bank of the Kyrgyz Republic, Central Bank of Hungary, Banking Regulation and Supervision Agency, Banking Agency of the Federation of Bosnia and Herzegovina, Central Bank of Armenia, Financial and Capital Market Commission of Latvia.

In order to further strengthen the regulatory and supervisory framework of the Moldovan financial and banking system, the National Bank of Moldova (NBM) cooperates with international financial institutions, foreign central banks and other development partners (International Monetary Fund (IMF), European Union (EU), European Bank for Reconstruction and Development (EBRD), Group of Banking Supervisors from Central and Eastern Europe (BSCEE), etc.).

During the year 2018, cooperation relation between the Republic of Moldova and the IMF has mainly developed in the context of the implementation of the IMF supported Program through the EFF (Extended Fund Facilities) and ECF (Extended Credit Facilities) funding mechanisms, which was approved by the IMF Executive Board on 7 November 2016, in order to support the state's economic and financial reform agenda.

Therefore, in the financial and banking sector, the Program aims at strengthening corporate governance, increasing shareholders' transparency, improving risk management frameworks, identification of loans landed to related parties and streamlining the activity of the Central Securities Depositary.

In order to ensure further implementation of the Association Agreement (AA) between the Republic of Moldova and the European Union, authorities from the Republic of Moldova have advanced in the implementation of the actions reflected in the National Action Plan for the Implementation of the AA for 2017-2019, approved by the Government Decision no. 1472 as of December 30, 2016. This complex document is the basic instrument for monitoring, at the national level, the progress made in achieving the public commitments under the Association Agreement.

At the same time, during 2018, the NBM initiated dialogue with the European Central Bank (ECB) in order to evaluate the possibility of concluding a cooperation agreement between institutions. In this context, the NBM received from the ECB a model of an ad-hoc agreement that is used in order to exchange information in individual cases between both institutions.

In addition, after the positive assessment of the confidentiality regime applied in the Republic of Moldova by the European Banking Authority (EBA), the EBA added the NBM to the list of non-EU country supervisory authorities, whose confidentiality regimes can be regarded as equivalent to those included in the EU Capital Requirements Directive (CRD IV).

Thus, the EBA's positive assessment facilitated the initiation of the exchange of information between the NBM and EU supervisory authorities and opened the possibility to the NBM to participate in the colleges of supervisors overseeing the EU bank groups. Furthermore, in 2018, the NBM has started the process of joining the Memorandum of Cooperation, signed in 2015 between EBA and supervisory authorities of the South-Eastern European (SEE) countries.

For the implementation of the EBRD Country Strategy for the Republic of Moldova (2017-2022), the NBM cooperates with the EBRD to improve governance and strengthen resilience of the banking sector by implementing sound practices and ensuring sustainable funding. In this respect, in 2018, the EBRD facilitated the entry on the local market of several foreign investors and together with them acquired the majority capital shares of two licensed banks from the Republic of Moldova.

As a member of the BSCEE, the NBM has continued to cooperate with BSCEE members, including on information and best practices exchange in the areas of banking regulation and supervision. In this regard, during July 4-7, 2018, the NBM representatives participated at the BSCEE annual Conference "Capital adequacy requirements including finalization of Basel III: challenges of implementation and the role of stress tests in defining capital requirements."

Additionally, on May 13, 2018, a *Memorandum of Understanding on Cooperation between the National Bank of Moldova and the Central Bank of the Republic of Turkey* was signed within the 39th Meeting of The Central Banks Governors' Club of the Central Asia, Black Sea Region and Balkan Countries, which took place in the Republic of Turkey on May 13-15, 2018. The purpose of the Memorandum is to develop cooperation and exchange of information and knowledge in the areas of activity of the central banks.

In order to fulfill its function on banking licensing, in 2018, the NBM has cooperated and has carried out a mutual exchange of information, necessary in the process of assessing the quality of stakeholders ("Fit & Proper") with banking supervisory authorities from other countries (Latvia, Lithuania, Romania, Turkey, Bosnia and Herzegovina, Hungary and the Russian Federation).

Cooperation with other supervisory bodies in the country

According to the legal framework in force and the bilateral agreements, the National Bank of Moldova cooperates with other supervising competent authorities from the Republic of Moldova. Thus, during 2018, in order to efficiently perform its functions, the National Bank of Moldova collaborated with the Office for Prevention and Fight against Money Laundering, the Intelligence and Security Service and the Office of the prosecutor general.

Other relevant information and developments in 2018

In addition to the minimum own funds requirement, banks were obliged to maintain additional capital buffers. For the end of 2018, capital conservation buffer rate equaled 2,5%, countercyclical capital buffer rate for Republic of Moldova was established at 0% and systemic risk buffer rate for all banks was set at the level of 1% (depending on banks' shareholders structure systemic risk buffer rate of 3% applies for several banks). At the same time, buffer for other systemically important institutions (O-SIIs) was established for 4 largest banks (ranging from 0,25% to 0,75%).

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	7	7	6
*Branches of foreign credit institutions	4	4	5
Cooperative banks	-	-	-
Banking sector, total:	11	11	11

**Subsidiary – a legal entity that is owned or controlled by a parent undertaking in a way as defined under the concept of 'parent undertaking'. Branch offices of a subsidiary are considered to be subsidiaries of the parent undertaking (Law On Banks Activity no. 202 of 06 October 2017).*

Total assets of banking sector (mil. lei) (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	53,851.0	59,685.3	48,459.0
Branches of foreign credit institutions	18,979.4	19,779.5	34,617.6
Cooperative banks	-	-	-
Banking sector, total:	72,830.4	79,464.8	83,076.6
y/y change (in %)	5.9	9.1	4.5

Ownership structure of banks on the basis of assets total (%)

Item	2016	2017	2018
Public sector ownership	0.0	0.0	0.0
Domestic ownership total	49.2	50.33	47.02
Foreign ownership	50.8	49.67	52.98
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	52.0	57.1	0.123
*Branches of foreign credit institutions	35.1	41.7	0.051
Cooperative banks	-	-	-
Banking sector, total:	87.1	98.8	0.175

**Subsidiary – a legal entity that is owned or controlled by a parent undertaking in a way as defined under the concept of 'parent undertaking'. Branch offices of a subsidiary are considered to be subsidiaries of the parent undertaking (Law On Banks Activity no. 202 of 06 October 2017).*

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

Type of financial institution	2016	2017	2018
*Commercial banks	11.1	11.4	10.3
Cooperative banks	-	-	-
Banking sector, total:	11.1	11.4	10.3

*The information is presented for the banking sector (11 banks)

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	74.0	75.11	58.33
*Branches of foreign credit institutions	26.0	24.89	41.67
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

**Subsidiary – a legal entity that is owned or controlled by a parent undertaking in a way as defined under the concept of 'parent undertaking'. Branch offices of a subsidiary are considered to be subsidiaries of the parent undertaking (Law On Banks Activity no. 202 of 06 October 2017).*

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

	2016	2017	2018
Receivables	5.09	5.23	6.05
Financial sector	28.74	31.30	33.20
Nonfinancial sector	44.11	38.12	41.40
Government sector	7.09	7.69	7.87
Other assets	14.94	17.66	11.48
Liabilites			
Financial sector	6.17	5.61	4.59
Nonfinancial sector	51.72	49.86	50.17
Government sector	23.34	25.31	26.11
Other liabilities	1.46	2.05	2.00
Capital	17.31	17.18	17.13

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
*Commercial banks	29.8*	31.3*	26.6***
Cooperative banks	-	-	-
Banking sector, total:	29.8*	31.3*	26.6***

**The information is presented for the banking sector (11 banks)*
(Please, mark for each item: * – for Basel I; ** – for Basel II; *** – for Basel III)

Asset portfolio quality of the banking sector (%)
(Share of credits by category)

Loan classification	2016	2017	2018
Standard	51.10	54.58	62.27
Supervised	32.50	26.67	25.14
Substandard	5.98	5.72	4.22
Doubtful	2.88	4.23	2.81
Losses	7.55	8.43	5.56
Total	100.0	100.0	100.0
Specific reserves	13.42	14.81	10.90

The structure of deposits and loans of the banking sector in 2018 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	98.26	96.15
Households	65.77	27.66
Corporate	32.49	68.39
Government sector	0.13	0.11
Financial sector (excluding banks)	1.61	3.85
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	297.55	231.31	220.46
Interest expenses	141.67	91.12	74.62
Net interest income	155.88	140.19	145.85
Net fee and commission income	47.94	53.02	54.39
Other (not specified above) operating income (net)	-42.64	-12.30	-17.09
Gross income	595.10	462.61	440.93
Administration costs	77.42	87.14	108.44
Depreciation	11.47	12.53	14.19
Provisions	144.15	156.36	143.09
Profit (loss) before tax	69.01	83.35	84.32
Net profit (loss)	65.30	74.87	74.36

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	557.4***	-	552.0***	5.4***	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	557.4***	-	552.0***	5.4***	-

**The information is presented for the banking sector (11 banks)*
(Please, mark for each item: * – for Basel I; ** – for Basel II; *** – for Basel III)
As of December 31.12.2018, 1 EUR=19.5212 MDL.

2018 DEVELOPMENTS IN THE MONTENEGRIN BANKING SYSTEM

Macroeconomic environment

According to available indicators, Montenegrin economy recorded significant growth in 2018 in relation to the previous year. After the growth in GDP of 4.7% recorded in 2017, the preliminary MONSTAT data showed that Montenegrin economy grew at a rate of 4.9% in 2018. The main indicators show positive trends in most sectors, and they are primarily followed by significant results in construction, industry and tourism. All components of GDP consumption, including personal and government spending, visible exports and imports also recorded the year-on-year growth, which was particularly pronounced with gross fixed capital formation and changes in supplies. Only the component referred to changes in inventories declined.

Preliminary Monstat data on quarterly GDP trends showed positive rates in 2018 for all four quarters, with growth of 4.5%, 4.9%, 5.0%, and 4.8% being recorded in Q1, Q2, Q3, and Q4, respectively.

The annual inflation in December 2018 in Montenegro, as measured by the CPI, was 1.6%, while the HICP inflation stood at 1.5%. The average inflation was 2.6%

In 2018, according to the Ministry of Finance`s preliminary data, total budget revenues with state funds amounted to 2.88 billion euros or 62.3% of estimated GDP. Concerning the plan, source revenues decreased by 0.6%, but these were higher by 11.5% compared to 2017. Budget deficit of Montenegro was estimated at 159.2 million euro or 3.4% of GDP and it fell by 77.6 million euro compared to deficit from 2017.

At end-2018, the net public debt of Montenegro, as per the Ministry of Finance data, amounted to 2.99 billion euro or 64.8% of estimated GDP for 2018. Compared to end-2017, net public debt increased by 11.3%. However, the potential risk was largely mitigated by the fiscal consolidation measures. Total amount of public debt as well as the expected future growth, due to more intensive implementation of the planned infrastructural projects, indicate the need to endure with fiscal consolidation measures that will ensure the sustainability of public debt in the medium term.

The average number of employed persons in 2018 amounted to 190,132, thus being 4.3% higher than the average number of employees in the previous year. According to the Employment Agency's records, the average number of registered unemployed persons totalled 43,612 in 2018, which was 13.7% less than in the same period last year. In 2018, the highest number of unemployed persons was registered in January (48,580), while the lowest was in September (39,902). The unemployment rate published by Montenegro's Employment Agency amounted to 17.83% in December 2018, recording the year-on-year decrease of 4.26 percentage points.

Monstat data showed that an average gross salary in Montenegro was 766 euros in 2018 and it increased by 0.1% in relation to the average salary in 2017. An average salary without taxes and contributions amounted to 511 euros, showing the increase of 0.2% y-o-y.

According to preliminary data, in 2018, the current account deficit amounted to 793 million euro, being 17.2% higher than in the previous year when it was 691.2 million euro or 16.1 of 2017 GDP. The increase in the current account deficit is largely the result of an accelerated growth in domestic demand due to the increase in the economy and implementation of significant development projects in the infrastructure, energy and tourism sectors.

The 2018 financial account showed net foreign direct investments in the amount of 327.6 million euros or 32.4% less than in the previous year, accounting for 7.1% of GDP.

Banking system

Fifteen banks operated in Montenegro at end-2018. In December 2018, interim administration was introduced in two non-systemic banks, and during 2019, the bankruptcy proceedings were opened in these two banks. Other banks were adequately capitalised and their liquidity is satisfactory. The banking system is stable and recorded positive trends.

In the one-year comparative period, the key balance sheet positions increased. Banks' total assets grew at a rate of 5.38%, loans (gross loans and receivables from banks and customers) increased by 8.47%, total deposits of banks (with funds at escrow accounts) increased by 5.88%, while total capital slightly declined by 0.20%. All asset quality indicators improved during 2018.

Although the lending activity improved in 2018, banks continued to pursue a prudential lending policy. Banks' deposits exceeded the level of loans, which resulted in the loans to deposits ratio of 0.85. In 2018, the liquidity of banks was satisfactory, although liquid assets of banks reported an annual decline of 6.09%. Daily and ten-day liquidity indicators of banks were above the statutory minimum, except in one bank in which interim administration was introduced. Total liquid assets of banks amounted to 994.5 million euros, while the share of liquid assets in total assets amounted to 22.57%.

Financial result on the aggregate level was positive, and the banks recorded profit in the total amount of 24.8 million euros in 2018. At end-2018, eleven banks in the system operated with profit, while four banks recorded negative financial result. Two banks under interim administration reported loss of 23 million euros.

Banks' total capital in Montenegro amounted to 513 million euros at end-2018, recording the year-on-year decrease of 1 million euro or 0.20%. Implementation of the IFRS 9 from January 2018 largely affected the decline in total capital, primarily due to the increase in value adjustments for loan losses. The capital adequacy ratio at the aggregate level amounted to 15.63% at end-2018, being significantly above the statutory minimum of 10%. Total own funds of banks amounted to 405.2 million euros.

Total loans (gross loans and receivables from banks and customers) amounted to 2,929.2 million euros and showed growth in relation to the previous year. In the maturity structure of total loans, long-term loans took the main share of 78.11%, while short-term loans accounted for 21.89%. The most significant loan beneficiaries (88.05%) were corporate sector, household sector and non-resident banks. At end-2018, loans to corporate sector amounted to 1,029.6 million euro or 35.15% of total loans, loans of household sector amounted to 1,277.9 million euros (43.63% of total loans), and non-resident banks with 271.7 million euros or 9.28%.

As at end-2018, non-performing loans amounted to 178 million euro and accounted for 7.75% of total loans. However, the share of non-performing loans in total loans was 6.8% and it declined by 1.5 percentage points, thus representing an improvement of the quality of loan portfolio in one-year period.

Total deposits of banks at end-2018 (with funds at escrow accounts) amounted to 3,459.2 million euros or 5.88% more in relation to the previous year. Deposits by natural persons increased 7.59%.

Change in regulatory framework

During 2018, the Central Bank has continued with the regulatory framework reform, which referred to the alignment of the current regulation with the new acquis of the European Union and the international standards in the financial services area.

With a view to further encouraging of the financial restructuring of the sustainable legal persons and further maintaining of the declining trend of the NPLs in the country, the Law amending the Law on Voluntary Financial Restructuring of Debts towards Financial Institutions was adopted, which extended its application for another year (by May 2019).

In the connection with the activities on the implementation of the IFRS 9, which full application started on 1 January 2018, the Council of the Central Bank adopted, in April 2018, the Decision amending the Decision on the Content, Deadlines and the Manner of Compiling and Submitting Bank's Financial Statements.

With regard to the further harmonisation of the regulatory framework governing the activities of institutions engaged in the financial lease operations, factoring, purchase of receivables, micro-lending and credit and guarantee operations, in June 2018, the Council of the Central Bank adopted new Decision on Credit Registry which will be applied from 1 January 2019. This decision is also aimed at improving the work of the Credit Registry by providing additional, individual and aggregate data from the Credit Registry that will become available to the users.

In addition, the Central Bank has, in line with the obligation arising from the adoption of the amendments to the Law on Investment and Development Fund of Montenegro ("Official Gazette of Montenegro", No. 088/09, 040/10, 080/17) – adopted in December 2017, prepared a set of secondary legislation regulating manner of calculating capital adequacy ratio of the Fund and minimum standards for risk management in the Fund.

As for the alignment of domestic regulations with the EU regulations, the Central Bank adopted in December 2018 draft Law on Credit Institutions, draft Law on the Resolution of Credit Institutions and draft Law amending the Bank Bankruptcy and Liquidation Law. The adoption of these laws, which is envisaged by the Programme of Accession of Montenegro to European Union 2019-2010 for end of September 2019, will align these laws with the directives 2013/36/EU (CRD, together with CRR) and 2014/49/EU (BRRD) and improve the current framework for the supervision of credit institutions as well as timely action in a credit institutions experiencing problems.

In December 2018, the Council of the Central Bank adopted the Decision amending the Decision on Minimum Standards for Credit Risk Management in Banks, which improves current solutions in relation to the valuation of collateral when classifying assets and provisioning for loan losses, the treatment of restructured loans in the loan classification, further adjustment of the NPL definition. These amendments were prepared in accordance with the relevant guidelines of the European Banking Authority.

Main strategic objectives of the Supervisory Authority in 2018

In 2018, the activities of the Central Bank were focused on several important project that primarily referred to the alignment with the EU acquis and international standards.

Several activities have been accomplished with regard to the Twinning Project "Support to Regulation of Financial Services". The Law on Credit Institutions was drafted within this project in cooperation with the EU experts. In period from April through November 2018, six expert missions were held for drafting regulations that will align regulatory framework with the Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, as well as with the Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, which implement Basel standards on capital and liquidity in the EU (Basel III).

The activities of the Banking Supervisory Authority last year

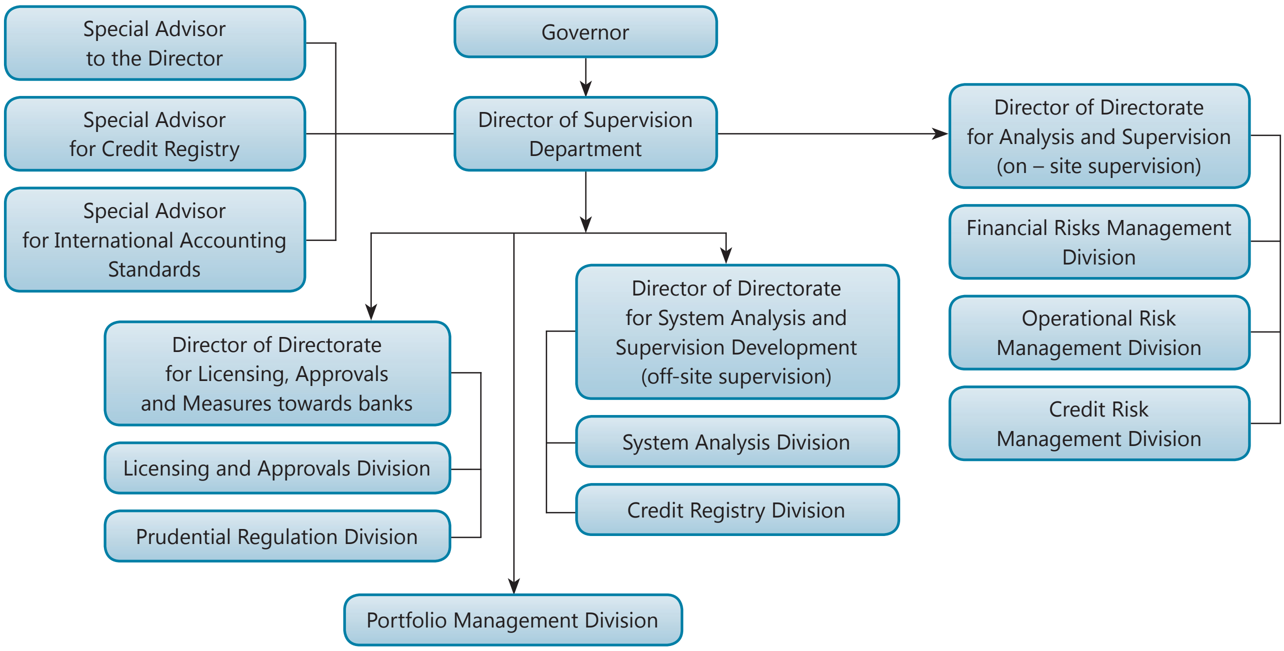
In 2018, the Central Bank completed 10 examinations of banks and one examination of a payment institution in order to assess risk management of money laundering and terrorist financing. In addition, in the area of compliance with regulations and compliance of the operations in the AML/FT area, three extraordinary targeted examinations were carried out, whereby one of them was the examination of a payment institution.

During 2018, due to the irregularities disclosed in operations, the Central Bank imposed measures against six banks to remove irregularities, five banks were imposed measures in the form of decision and one bank in the form of a warning. Also, as a necessary activity due to recognised vulnerabilities in some banks, the Central Bank requested their daily reporting and supervised their further operations.

In 2018, the Central Bank carried out on-site examinations in two banks and the results of these examinations showed critical undercapitalisation and insolvency in both banks, thereby questioning the continuance of their further activities. The determined solvency ratio for both banks was below one half of the statutory minimum. Therefore, at the end of 2018, the Central Bank introduced interim administration in both banks and appointed interim administrators. The reports of interim administrators stated that the solvency ratio in both banks, own funds and capital of banks were negative, which created conditions, in accordance with the prevailing regulation, to revoke license and open bankruptcy proceedings in these banks.

Contrary to two banks in which interim administration was introduced, the third, "sensitive" bank increased capital through its own potential and improved performance indicators relative to the previous year. In doing so, the bank maintained stable operating profile. The reports of external auditors suggest that this bank improved its operations, i.e. they contain small number of recommendations as compared to the prior year's recommendations.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

During 2018, further progress has been achieved in the negotiating process for Montenegro's EU accession process. All chapters concerning the functions of the Central Bank and those in which the Central Bank's employees are in charge are opened (4 Free movement of capital, 9 Financial services and 17 Economic and monetary union) and chapters in which it has an active role (18 Statistics and 32 Financial control).

A significant progress has been achieved in negotiations related to Chapter 17 Economic and Monetary Union. Within the fulfilment of the obligations related to this negotiating chapter, the Central Bank continued with the activities to further align its legislation with the regulations and standards of the European central banks and strengthen the administrative capacities for their efficient and qualitative application.

During 2018, a project funded from IPA 2014, titled "Support to Regulation of Financial Services" started. The project will last 24 months and it is aimed at further harmonisation of legislation from the financial services area with the EU regulation and strengthening of the supervisory and regulatory capacities.

In addition, in 2018, the Central Bank finalised in cooperation with the Deutsche Bundesbank the activities concerning the drafting of the new regional project, titled "Programme for Strengthening the Central Bank Capacities in the Western Balkans with a view to the Integration to the European System of Central Banks". This project is aimed at strengthening monetary and financial stability in the region and preparation of beneficiary countries for future membership to the ESCB.

During 2018, the Central Bank continued to improve and strengthen its administrative capacities through various forms of technical bilateral cooperation. To that end, 9 bilateral visits of the Central Bank's representatives in partner central banks were performed (these being: Deutsche Bundesbank, De Nederlandsche Bank, Czech National Bank, Bank of France, National Bank of Serbia, Central Bank of Bosnia and Herzegovina, National Bank of Macedonia), as well as expert missions of the Bank of Slovenia representatives to Central Bank of Montenegro.

In the part that refers to the cooperation with the International Monetary Fund, regular IMF Article IV Consultation missions to Montenegro are held from 21 February to 7 March, and were concluded on 18 May 2018, when the IMF Executive Board published Consultation report with supporting documents. There is also a two-year programme of the IMF technical assistance to improve the capacities of the banking supervision and implement prudential limits of the CBCG and guidelines for managing risk for transactions with related parties and large exposures. Technical assistance for the implementation of the IFRS 9 has been implemented in 2017 within this programme.

Cooperation with other supervisory bodies in the country

In addition to aforementioned Twinning project "Strengthening the Regulatory and Supervisory Capacities of the Financial Regulators", the project itself reinforced the collaboration among the financial sector supervision authorities through the signing of MoU on Cooperation and the Exchange of Information in the area of the Prevention on Money Laundering and Terrorist Financing between CBCG, Ministry of Finance, Administration for the Prevention of Money Laundering and Terrorist Financing, Securities and Exchange Commission and the Insurance Supervision Agency.

Oher relevant information and developments in 2018

Within the framework of the twinning project "Support to Financial Services Regulators", which began in April 2018, the Central Bank actively worked on the preparation of the set of regulations envisaged by the contract. During 2018, 7 missions were held with the aim of providing expertise necessary for transposing the relevant EU regulations, and in this respect a working version of the Law on Credit Institutions was drafted as well as a number of working versions of secondary legislation in order to fully align with Directive 2013/36/EU and Regulation (EU) 575/2013. Within this project, the preparations of a decision on the capital adequacy of credit institutions, liquidity and LCR indicator, large exposures, remuneration, conditions for acquiring qualified participation and conditions to be fulfilled by members of the management bodies are being prepared.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	15	15	15
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	15	15	15

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	3790255	4182130	4406813
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	3790255	4182130	4406813
y/y change (in %)	9.17	10.34	5.37

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	-	-	-
Domestic ownership total	24.5	26.99	20.43
Foreign ownership	75.5	73.01	79.57
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	39.5	62.1	993
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	39.5	62.1	993

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	1.21	6.98	5.36
Cooperative banks	-	-	-
Banking sector, total:	1.21	6.98	5.36

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
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	2016**	2017**	2018**
Commercial banks	16.01	16.37	15.63
Cooperative banks	-	-	-
Banking sector, total:	16.01	16.37	15.63

(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	2016	2017	2018
Non-financial sector, including	98.4	96.6	98.4
Households	26.2	28.8	35.7
Corporate	71.7	67.6	59.2

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	92.8	82.67
Households	52.96	43.51
Corporate	38.18	38.82
Government sector	6.18	7.47
Financial sector (excluding banks)	1.02	9.86
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	161010	159759	168297
Interest expenses	39141	34907	29216
Net interest income	121868	124849	139081
Net fee and commission income	36874	41813	40197
Other (not specified above) operating income (net)	15635	21743	19854
Gross income	174474	188844	276337
Administration costs	108288	114341	116201
Depreciation	9710	9656	10199
Provisions	45089	21939	16951
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)			
Profit (loss) before tax	9342	37089	31238
Net profit (loss)	7317	35077	27270

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds**	Core Tier 1	Tier 1**	Tier 2**	Tier 3
Commercial banks	405232	-	372214	34330	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	405232	-	372214	34330	-

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

2018 DEVELOPMENTS IN THE POLISH BANKING SYSTEM

Macroeconomic environment in the country

Poland's GDP growth throughout 2018 amounted to 5.1%. Thus, the positive trend from previous years was maintained (an increase of 4.8% in 2017 and 3% in 2016), and the growth rate was still high compared with other European countries. Between 2008 and 2017, the average annual growth rate of our economy was 3.35% and it was the second result among the EU countries in that period. The average annual growth over the same period was 0.83% for the entire EU-28 and 0.62% for the euro area. The key factor for growth was the increasing consumer demand, driven by the growing employment and salaries, and a very high consumer sentiment index. Growth was also driven by public investments, co-financed with EU funds. In the second quarter of 2018, GDP was also helped by the positive balance of net exports.

The cumulative balance of the current account from the previous twelve months amounted to PLN – 6 billion in December 2018 (compared with PLN –5.7 billion in December 2017). The labour market continued its positive trend from 2013, with the officially recorded unemployment rate declining to 5.8% at the end of 2018 (from 6.6% at the end of 2017). Similarly, the seasonally-adjusted unemployment rate measured according to the BAEL (Polish Labour Force Survey) fell from 4.3% at the end of 2017 to 3.5% at the end of 2018. The average annual inflation measured by consumer price index (CPI) in 2018 was 1.65%. No year-on-year deflation was recorded in any of the months of the year.

The Monetary Policy Council (MPC) maintained the NBP interest rates at the level of March 2015 (reference rate of 1.5%). According to the MPC, such level of interest rates is conducive to maintaining the Polish economy on a sustainable growth path and allows to maintain macroeconomic balance.

In 2018, the currency market saw a depreciation of the exchange rate of the Polish Zloty (PLN) against the main currencies. The depreciation of the Polish currency was particularly severe in April/May. At the end of the year, the average PLN/EUR exchange rate was 4.3 against 4.17 at the beginning of the year, the average PLN/CHF exchange rate was 3.82 (against 3.56) and the average PLN/USD exchange rate was 3.76 (against 3.45).

At the end of 2018, the interest rate on 10-year Treasury bonds amounted to 2.81% and was lower than the year before (3.29%). In 2018, the budget deficit was under-implemented (25.1% of the annual plan) and the deficit reached PLN 10.4 billion. The budget revenues were implemented in 107% and amounted to PLN 380.1 billion. The expenses were implemented in 98.3% and amounted to PLN 390.5 billion. Whereas, according to the data as at the end of the third quarter of 2018, the general government gross debt (part of the government finance Maastricht criterion) was PLN 1 024 trillion, i.e. 49.4% of GDP.

The balance sheet total of the banking sector at the end of December 2018 amounted to PLN 1 896.2 billion and was higher than in the previous year by 6.7% (PLN 1 776.8 billion). In the period concerned, banks generated a profit of PLN 14.7 billion, which was approx. 7.5% lower than in the previous year (PLN 13.7 billion). At the end of the fourth quarter of 2018, the assets of credit unions amounted to over PLN 9.6 billion.

According to the reporting data, in 2018 the credit unions sector recorded a net loss of PLN 2.7 million. It should be noted that the credit unions sector—excluding the credit union SKOK Jaworzno, in relation to which proceedings were conducted in respect of the acquisition of the credit union by a domestic bank—would generate a net profit of PLN 30.75 million. As at the end of 2018, the amount of own funds of the unions (calculated in accordance with the Act on credit unions) was PLN 387.18 million. The balance sheet total of the insurance sector decreased by 4.6% during the year and amounted to PLN 192.1 billion at the end of December 2018, of which PLN 95 billion was allocated to life insurance undertakings, and PLN 97.1 billion to non-life insurance undertakings—other personal insurance and property insurance.

In 2018, the Warsaw Stock Exchange recorded a decrease in indices. During the year, WIG lost 9.5% and WIG20 7.5%. The value of trading in shares amounted to PLN 212 billion and was approx. 20% lower than in the previous year, whereas the value of trading in bonds fell as compared with 2017 and reached PLN 1.3 billion. At the end of the year, the capitalisation of domestic companies amounted to PLN 615 billion (a 8% decrease compared with the previous year), and of foreign companies to PLN 550 billion (a 22% increase).

Development in the banking sector (including assets total / GDP)

One of the main challenges that Polish banking sector faces is the **environment of historically low interest rates**. On one hand it may lead to an increase in portfolios' quality, on the other hand it may deterioratingly affect other issues, including:

- Underlying interest rate risk which could have been underestimated by both banks and customers;
- Risk of an overestimating investments' profitability;
- Both households and NFC search for yield what may lead to disturbances at some markets (e.g. RRE).

In spite of relatively favourable economic environment, **diminishing returns on banking activity** could be observed. It may negatively affect a few banks and have to be addressed accordingly in order to maintain profitability.

The portfolio of **consumer loans** pose **a challenge in terms of its quality**, especially when considering **high volume loans** (exceeding PLN 50 th.) **with long maturity** (over 5 years).

On one hand, **ongoing integration process** poses a challenge for both domestic and global banking sectors. On the other hand, it creates an opportunity for large entities to increase their activity and expand to new markets. However, **the process would constitute a considerable challenge for small entities**, especially for cooperative banks **which** already **struggle to maintain** (or even reach) **satisfactory level of profitability**, as they incur relatively high fixed costs with limited resources – both capital and human – due to their local character. Simultaneously, the rapid development of mobile access to banking services put coops at risk of not catching-up with the ongoing process of banking digitalization that can further discourage customers to cooperative banking. It seems that it is then desirable to further integrate smaller entities in order to truly compete.

Polish banking sector undergoes the same process observed both in EU and globally, i.e. not only ongoing consolidation of the sector and a consistent decrease in employment and branches but also fast development of digital access to banking services and necessity of adjusting business models due to the introduction of new technologies and new types of customers.

Banking sector assets hardly exceeds 90% of Polish GDP, while loans to non-financial sector equals 55% of GDP.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

The Board of the Polish Financial Supervision Authority (hereinafter: 'KNF Board' or 'supervisor') operates under the Act of 21 July 2006 on financial market supervision (Journal of Laws 2019, items 298 and 326), hereinafter referred to as 'Act on financial market supervision'. Under the Act on financial market supervision, the KNF Board exercises supervision of the financial market, which as at 31 December 2018 included: banking supervision, pension supervision, insurance supervision, capital market supervision, supervision of payment institutions, payment service offices, electronic money institutions, branches of foreign electronic money institutions, supervision of rating agencies, supplementary supervision of credit institutions, insurance undertakings, reinsurance undertakings and investment firms in a financial conglomerate, supervision of credit unions and the National Association of Credit Unions (PL: Krajowa Spółdzielcza Kasa Oszczędnościowo-Kredytowa) as well as mortgage credit intermediaries and their agents. The purpose of supervision of the financial market is to ensure its proper functioning, stability, security and transparency, confidence in the financial market, and protection of the interests of market participants.

In 2018, the Act of 9 November 2018 amending certain laws to strengthen financial market supervision and investor protection (Journal of Laws, item 2243) was passed and, in consequence, the former KNF was abolished and the former KNF Office was replaced by the new Polish Financial Supervision Authority as a state legal person responsible for providing support and assistance to the KNF Board and the Chair of the KNF Board. The KNF Board and the Chair of the KNF Board have become the bodies of the newly established KNF. The changes have become effective as of 1 January 2019, which means that until 31 December 2018 the KNF operated in its previous structural form.

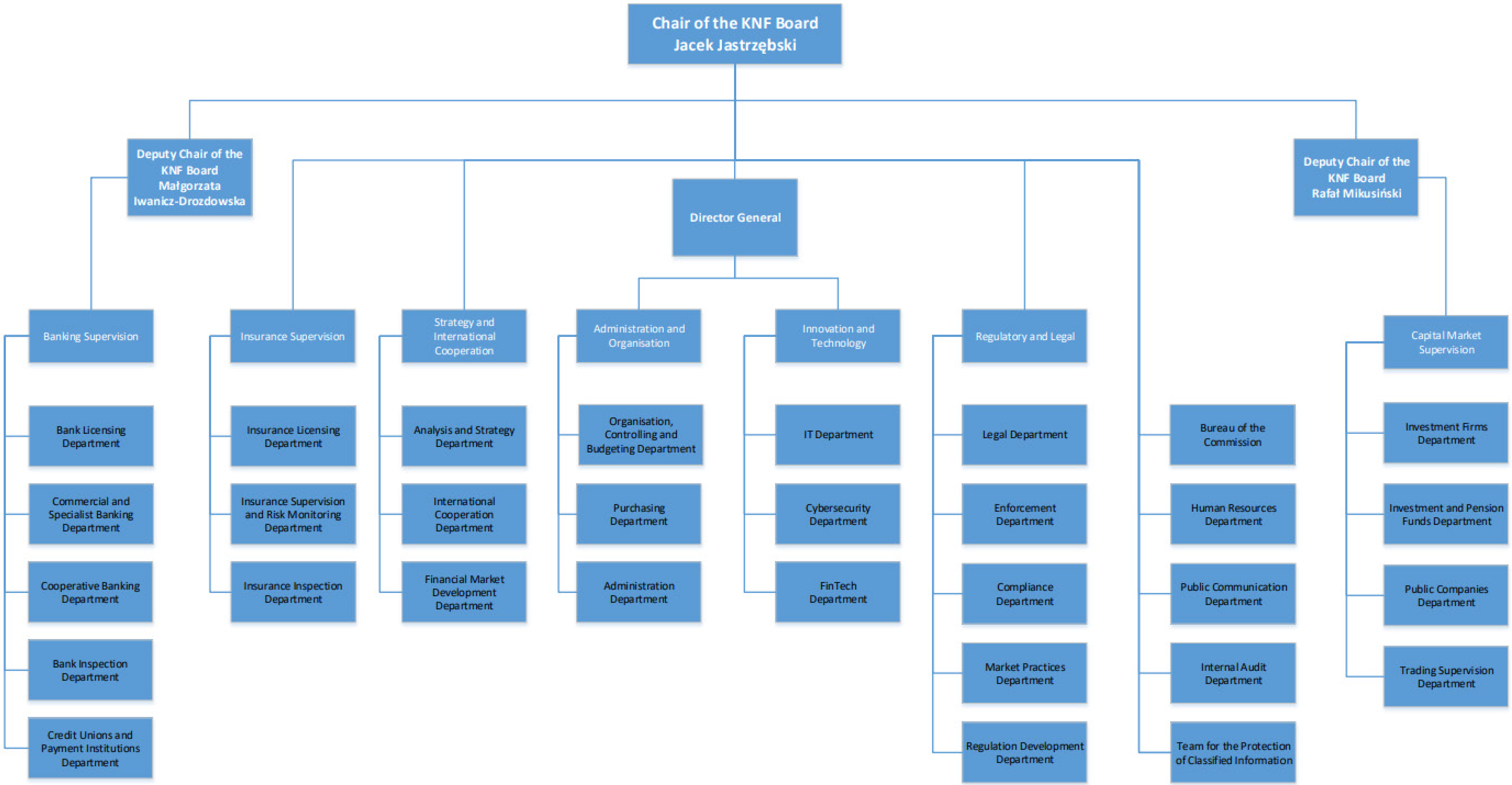
Main strategic objectives of the supervisory authority in 2018

In 2018 the activities of the KNF focused primarily on the objectives set out by the Act of 21 July 2006 on Financial Market Supervision i.e.: ensuring the proper functioning of the financial market, its stability, security and transparency. The process of modifying the organizational structure of the Authority, which began in 2017, had been continued within 2018 with the aim to streamline processes in all of the supervised sectors of the financial system. Additionally, it has to be emphasized that KNF continued to undertake the activities in the Fintech area with the aim to sustainable development and growth of Polish financial innovation sector to gain additional support from the supervisory side.

The activities of the Banking Supervisory Authority in 2018

The supervisory activities taken by the KNF in 2018 involved ongoing monitoring and quarterly analysis of banks' economic and financial standing (rating given for Q4 2017 and 3 quarters of 2018). Based on the results of the analysis, the banks were given a rating according to the KOBRA rating system. In 2018 all commercial banks were rated. In 2018 the cyclical evaluation process of cooperative and associating banks continued. Also quarterly analyses of branches of credit institutions were prepared (rating given for Q4 2017 and 3 quarters of 2018). Apart from the quarterly rating, banks are covered by the SREP process, i.e. Supervisory Review and Evaluation Process. The process covered 31 commercial banks. The results of SREP process allow for the conclusion that the general condition of supervised entities shall be considered as satisfactory. In the area of consolidated supervision the KNF reviewed consolidated financial statements of banks, economic and financial standing of holdings, banks' parent companies and banks included in conglomerates. Direct off-site supervision involved the selection of banks for comprehensive and problem-oriented inspections, and the results of the selection process were passed to the KNF Office's organizational units responsible for inspection. Supervision activities were conducted in the following areas: reinforcement the capital base, bank assurance, processes of transformation, administrative procedures, liquidity, recovery procedures plans including the assessment of their implementation, completion or imposition of the recovery procedures plan, as well as implementation of recommendations issued in the course of inspections, the SREP process and other recommendations issued under the off-site supervision.

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 2018 the KNF participated in 29 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 61 jurisdictions (excluding multilateral agreements under ESMA, IOSCO and IAIS). In 2018, agreements on Fintech were signed with the Taiwan's Financial Supervisory Commission and the Hong Kong Monetary Authority. An agreement with the National Bank of Pakistan was signed and negotiations were launched with the Central Bank of Brazil. As a result of the activities initiated in 2018, the KNF will be one of the signatories to the Multilateral Agreement on the practical modalities for exchange of information between the European Central Bank (ECB) and all competent authorities (CAs) responsible for supervising compliance of credit and financial institutions. The Agreement, to be concluded in early 2019, will establish a framework for the exchange of operation for the purpose of prevention of money laundering and terrorist financing.

Cooperation with other supervisory bodies in the country

The KNF is responsible for the supervision of the Polish financial sector. Besides credit institutions (commercial banks, cooperative banks, credit unions) the KNF supervises insurance and reinsurance companies, pension funds, the Warsaw Stock Exchange, the clearing house, investment firms, investment funds, payment institutions, electronic money institutions and other types of entities. The KNF also takes part in the works of the Financial Stability Committee (KSF) – a body responsible for: (1) macroprudential authority (the legal framework of macroprudential oversight in Poland has been established by the Act of 5 August 2015 on Macroprudential Supervision over the Financial System and on the Crisis Management in the Financial System), and (2) crisis management in the financial system.

The statutory tasks of the KNF include also participation in the process of drafting laws regulating supervision over the financial market. The KNF acts as an advisor and gives opinions to authorities and agencies which, under separate legal regulations, initiate and conduct legislative work (however the KNF does not have legislative initiative).

Other relevant information and developments in 2018

In 2018 the KNF revised the list of O-SII (Other Systemically Important Institutions). As a result of the review, 11 banks were identified as O-SII, with buffers imposed on them, ranging from 0% to 1.0%. The list of the identified entities is subject to annual review and, if necessary, the buffer rate will be adjusted accordingly.

Poland remains among the jurisdictions whose financial sectors are deemed to be systemically important by the International Monetary Fund, thus should undergo mandatory Financial Sector Assessment Program (FSAP) every five years. The 2018 FSAP Mission to Poland, carried out by the IMF and World Bank assessors, comprised all the sectors of the Polish financial market. During the mission, a comprehensive and in-depth analysis of a country's financial sector has been carried out, with two main goals: to gauge the stability and soundness of the financial sector and to assess its potential contribution to growth and development.

Representatives of the KNF took part in more than 120 meetings with the FSAP team (including the scoping mission in September 2017, and main missions in January, February and May 2018). These meetings constituted a valuable platform of discussions and contributed to numerous reports / technical notes drafted by the FSAP Mission.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	36	35	32
Branches of foreign credit institutions	27	28	31
Cooperative banks	558	553	549
Banking sector, total:	621	616	612

Total assets of banking sector (PLN bn) (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	1 549 481,9	1 601 975,0	1 689 674,7
Branches of foreign credit institutions	36 570,5	44 822,8	65 832,9
Cooperative banks	120 488,7	129 987,6	138 287,0
Banking sector, total:	1 706 541,2	1 776 785,5	1 893 794,7
y/y change (in %)	6,9%	4,1%	6,6%

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	28,8%	39,9%	39,5%
Domestic ownership total	43,4%	54,5%	53,0%
Foreign ownership	56,6%	45,5%	47,0%
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	39,5%	56,0%	868
Branches of foreign credit institutions	44,4%	59,5%	1006
Cooperative banks	5,7%	7,9%	42
Banking sector, total:	35,3%	49,9%	692

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	7,72%	7,02%	6,64%
Cooperative banks	5,27%	5,20%	5,07%
Banking sector, total:	7,57%	6,91%	6,55%

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	90,8%	90,2%	89,2%
Branches of foreign credit institutions	2,1%	2,5%	3,5%
Cooperative banks	7,1%	7,3%	7,3%
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2016	2017	2018
Total assets	100%	100%	100%
Financial sector	8,2%	8,5%	9,2%
Nonfinancial sector	59,3%	58,8%	58,3%
Government sector	5,8%	5,6%	8,4%
Other assets	26,8%	27,1%	24,1%
Liabilities	89,3%	88,5%	89,2%
Financial sector	21,0%	20,3%	19,2%
Nonfinancial sector	60,2%	60,2%	61,2%
Government sector	3,7%	3,9%	4,4%
Other liabilities	4,3%	4,0%	4,4%
Capital	10,7%	11,5%	10,8%

Capital adequacy ratio of banks***

Type of financial institution	2016	2017	2018
Commercial banks	17,77%	19,08%	19,14%
Cooperative banks	17,09%	17,11%	17,62%
Banking sector, total:	17,72%	18,96%	19,05%

(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	2016	2017	2018
Non-financial sector, including	7,1%	6,8%	6,9%
Households	6,0%	6,1%	5,9%
Corporate	9,2%	8,3%	8,7%

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	88,8%	87,2%
Households	64,3%	55,9%
Corporate	22,5%	30,7%
Government sector	6,4%	6,9%
Financial sector (excluding banks)	4,8%	5,9%
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	53 903,1	58 166,7	60 470,9
Interest expenses	15 878,9	15 547,8	15 650,4
Net interest income	38 024,1	42 618,9	44 820,6
Net fee and commission income	12 591,8	13 764,3	12 287,7
Other (not specified above) operating income (net)	9 847,7	6 462,2	5 972,4
Gross income	61 771,8	64 013,9	64 586,4
Administration costs	31 662,8	33 061,4	33 446,2
Depreciation	2 912,6	2 948,8	2 905,1
Provisions	1 133,5	728,4	649,7
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	7 977,9	8 860,3	9 444,2
Profit (loss) before tax	18 306,3	18 423,1	18 224,0
Net profit (loss)	13 897,7	13 686,6	13 071,6

Total own funds in 2018 (in PLN m)***

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	191 609,9	171 732,4	171 743,8	19 866,1	
Cooperative banks	12 027,6	11 410,0	11 445,3	582,3	
Banking sector, total:	203 637,5	183 142,4	183 189,1	20 448,4	

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

2018 DEVELOPMENTS IN THE ROMANIAN BANKING SYSTEM

Macroeconomic environment in the country

Romania recorded a 4.1% economic growth in 2018, down from almost 7% in 2017, in the context of investments contraction, the slowdown in private consumption growth, which has remained robust amid measures to relax income policy, and accelerate structural shortage of labor. Together with the deterioration of the primary income balance, the net export trend led to a substantial widening of the current account deficit to 4.5% of GDP in 2018, from 3.2% in the previous year.

In December 2018, the public debt-to-GDP ratio remained at 35% (standard European methodology) below the threshold of the European Commission's assessment procedure of 60% of GDP, domestic debt accounted for 18% of GDP, and external debt was 17% of GDP.

Similar to the previous year, 2018 ended with an annual inflation rate of 3.3%, in the context of the persistence of the significant excess of aggregate demand, the rising dynamics of unit labor costs and the increasing electricity and natural gas prices in specific competition markets.

Romania's international reserves reached 36.8 billion euros in December 2018, against 37.1 billion euros in December 2017.

Development in the banking sector (including assets total / GDP)

In 2018, the banking sector remained the main component of the financial system. The aggregated banking system assets amounted to lei 451.2 billion at the end of December 2018, up by 5.5% against the previous year level, and held a share of 47.8% in GDP.

During the year 2018, the banking sector preserved the consolidation tendency, with the number of credit institutions declining from 35 to 34 banks, as of the merger between two local banks. Thereby, at the end of 2018, the Romanian banking system comprised 27 banks, Romanian legal entities and 7 branches of foreign banks.

Prudential indicators have stood at adequate levels in 2018 and capital reserves have strengthened, providing a good capacity to absorb unexpected losses and resources to ensure lending to the real sector. In this respect, the total capital ratio indicated an improvement from end-2017, by 0.7 percentage points, from 20.0% in 2017 to 20.7% in 2018, due to a more rapid increase of total own funds than that of risk-weighted assets. In the structure of total capital, Tier 1 capital and Common Equity Tier 1 accounted for 90%. At the end of 2018, the leverage ratio, increased to 9.3% (both on transitional and fully phased-in definition of Tier 1 capital), with 0.4 percentage points, respectively 0.2 percentage points above the level of December 2017.

The liquidity of the banking sector stands at comfortable levels, posting higher indicator values than the minimum requirements. As of 31 December 2018 the liquidity coverage ratio (LCR) in all currencies across the banking system was 237.8%, pointing to sufficient high-quality liquid assets in a 30-day stress scenario. Starting 1 January 2018, according to the schedule for the gradual phase-in, the minimum liquidity requirements has risen from 80% to 100%, all banks reporting levels above this threshold. Banking sector liquidity has been underpinned by increasing funding from domestic deposits and by liquid asset holdings.

The quality of bank assets continued to improve. In this vein, it is worth mentioning the downtrend – for the fifth consecutive year – in the NPL ratio, which reached 5% in December 2018, both as a result of the significant reduction in non-performing exposures (-20.4%) and growth of total exposures (+2.9%). Moreover, NPL coverage ratio for the banking sector, calculated based on the EBA definition, further followed an upward trend, rising by 0.8 percentage points, from 57.7% in December 2017 to 58.5% in December 2018.

Banking sector recorded positive financial results in 2018, mainly due to the further cut in net impairment losses and favorable domestic macroeconomic environment. Thereby, the banking system reported a net profit of lei 6,827.5 million, with lei 1,492.1 million more than the previous year. The main profitability indicators of the banking sector, i.e. return on assets (ROA) and return on equity (ROE), increased to 1.6% and 14.6% respectively, from 1.3% and 12.5% last year respectively.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

According with Law no.312/2004 on the statute of the National Bank of Romania, the NBR shall have exclusive competence to authorise credit institutions and shall be responsible for the prudential supervision of the credit institutions authorised to operate in Romania according to the provisions of the Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy, as subsequently amended and supplemented ("Banking Law"). The National Bank of Romania is the competent authority for the regulation, licensing, prudential supervision and resolution of credit institutions, and shall monitor the activities of credit institutions, as well as, where it is the authority responsible for supervision on a consolidated basis, the activities of financial holding companies and mixed financial holding companies, for the provisions applicable to them, so as to assess compliance with the prudential requirements of the Banking Law, of Regulation (EU) no.575/2013 and of the applicable regulations.

Credit institutions are mainly regulated by the Banking Law and by Regulation No. 575 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 and, among others, by the Law No. 85/2014 regarding the procedures for the prevention of insolvency and the insolvency procedures. The NBR Regulation No. 5/2013 on prudential requirements for credit institutions, as amended and supplemented, ensures the transposition of the provisions of Directive 2013/36/EU and specifies the manner in which the national options included in the CRD IV package have been exercised. Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms ("BRRD") was transposed into Romanian legislation by Law No. 312/2015, which establishes the domestic grounds for the recovery and resolution of credit institutions. Moreover, beginning with the CRD IV/CRR and BRRD implementation, credit institutions are required to observe the EC's implementing regulations laying down technical standards, directly applicable in all Member States, including also those related to the reporting field.

In January 2018, the NBR issued Regulation No. 1/2018 which (i) amended the Regulation No. 5/2013 on prudential requirements for credit institutions, by requiring banks to take the necessary steps in order to avoid keeping the beneficial terms granted under remuneration packages for clients who are no longer employees and (ii) repealed the NBR Regulation No. 16/2012 on classification of loans and investments and the establishment and use of prudential value adjustments. In October 2018, the NBR issued Regulation No. 5/2018 amending and supplementing NBR Regulation No. 5/2013 on prudential requirements for credit institutions, which establishes the level of materiality thresholds used by credit institutions in the context of the definition of default, and the deadline for compliance with those thresholds, and the obligation for credit institutions to draw and communicate to the NBR a list of their bank agents.

The financial reporting framework FINREP, approved by the EBA, is governed by the (EU) Regulation No 680/2014, as subsequently amended and supplemented, being directly applicable to the EU credit institutions. 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, this framework was adapted in 2014 for solo reporting purposes and NBR Order No. 6/2014 was issued. For ensuring the continuity of the financial and accounting statistical information, reported by the Romanian branches of credit institutions having their head offices in other Member States, needed for performing analyses and studies at the NBR level, the NBR also issued the Order No. 5/2014.

Following the changes in the International Financial Reporting Standards, effective from 1 January 2018 (the adoption at EU level of the new standard IFRS 9 – Financial Instruments which fundamentally changes the way financial instruments are accounted for, introducing the new concept of expected credit losses), the accounting framework was amended by issuing the NBR Order No. 8/2017 and the financial reporting framework was updated accordingly, by issuing the NBR Order No. 9/2017 (repealing NBR Order No. 6/2014) and the NBR Order No. 10/2017 (repealing NBR Order No. 5/2014).

From the macro-prudential perspective, as of 28 February 2017, the Parliament adopted Law no. 12/2017 for the macro-prudential supervision of the national financial system. The law establishes the National Committee for Macro-prudential Supervision (NCMS), as an inter-institutional structure of co-operation between the National Bank of Romania, the Financial Supervisory Authority and the Government.

Main strategic objectives of the supervisory authority in 2018

In 2018, the key objectives in the field of regulation and supervisory activities were to fulfill the annual assessment and verification programme; to carry out and enhance the quality of supervision throughout the SREP process; to participate in the Supervisory Colleges, Resolution Colleges and the working groups of the EU Council, the European Commission and the European Banking Authority; to analyse and include in the regulatory framework the EBA Guidelines applicable to the competent authority and/or the institutions within the National Bank of Romania's regulatory scope, as applicable, in the fields of prudential banking, payment services, anti-money laundering and countering the financing of terrorism, deposit guarantee and bank resolution, as well as to update the accounting and financial reporting regulations; to analyse EU (delegated and implementing) regulations and prepare the regulatory framework for the appropriate implementation of their provisions into national law; to implement the recommendations of the 2017-2018 Financial Sector Assessment Program for Romania conducted by the International Monetary Fund and the World Bank.

The activities of the Banking Supervisory Authority in 2018

During 2018, in line with the inspection programme, 30 inspections were conducted, of which 27 at the head-offices of credit institutions, Romanian legal entities, and 3 at the branch in Romania of a foreign credit institution having its head office in another Member State.

The supervisory activities conducted under the annual assessment and verification programme focused on the viability and sustainability of the business model, internal governance and institution-wide controls, the assessment of risks to capital, the assessment of capital adequacy, the assessment of risks to liquidity, the assessment of liquidity adequacy, as well as verifying the implementation of the measures imposed by the NBR and of the set of measures prepared by the credit institution.

In addition to the scheduled inspections, 11 target inspections were also conducted, with a specific control objectives, related to: financial statement and key prudential banking indicators assessment; compliance with the reporting requirements in case of individual and consolidated FINREP statements; assessment of the operational risk management framework; reporting of own funds and own funds requirements, large exposures, additional liquidity monitoring metrics; compliance with reserve requirements; systemic risk buffer and capital conservation plan; monitoring and managing of significant risks; internal control framework and measures imposed by the NBR.

After conducting the SREP, overall scores of 2, 3 and 4 were assigned to 30%, 63% and 7% respectively of the 27 credit institutions, Romanian legal entities. At system level, average and median of total SREP capital requirements (TSCR) were of about 11.7%.

In 2018, the Supervisory Committee passed decisions in 34 meetings, while 6 meetings were held January through May 2019, the topics focusing mainly on: (i) the notification of the intention to acquire a qualifying holding in the share capital of a credit institution and/or to increase such participations; (ii) applications submitted by credit institutions, Romanian legal entities, pursuant to prudential regulations, referring to changes in their standing as concerns the Board members and/or executives, broadening their scope of activity, the financial auditor, operations on preferential terms set forth in the employee benefits and incentive packages, mergers, etc.; iii) draft pieces of legislation to be issued by the central bank or other authorities concerning the activity of credit institutions and non-bank financial institutions; (iv) implementing EBA Guidelines in the national legal framework and/or in supervisory practices; v) proposals to transpose the EU acquis in the area of payment institutions and electronic money institutions; (vi) proposals for positions in the negotiation process of draft amendments to the EU regulatory framework for credit institutions or in other areas where the central bank has competence;(vii) monitoring developments in terms of financial stability, identifying, monitoring and assessing systemic risks and those related to systemically-important credit institutions, specific analyses (monitoring the lending terms and conditions, the periodical stress testing of the solvency and liquidity of the banking sector), cross-border exchange of information;(viii)analyses on the activity of the Central Credit Register and of the Payment Incidents Register; (ix)other matters related to banking system functioning.

Organizational chart of the Banking Supervisory Authority

Organisation Chart of the National Bank of Romania

BOARD OF DIRECTORS

The Audit Committee

Governor Mugur Isărescu

- The Monetary Policy Committee
- The Supervisory Committee
- The Foreign Reserve Management Committee

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 Division

SECRETARIAT
- Documents Registration, Dispatching and Check-in Desk Division
- Archives, Library and Publications Dissemination 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 Division
- 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 Division
- 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
- IT&C Security 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

LEGAL DEPARTMENT
- Legal Advice and Assistance Division
- Contract Assistance and Disputed Claims Division
- European and International Law Division

TRAINING AND SOCIAL EVENTS FACILITY DEPARTMENT
- Training Support Division
- Social Events Division
- Auxiliary Activities Division
- Cafeteria Division
- Training and Social Events Units

FINANCIAL EDUCATION AND MUSEUM DEPARTMENT
- Museum
- Financial Education Division

REGIONAL BRANCHES AND AGENCIES

INTERNAL AUDIT DEPARTMENT*
- General Audit Division 1
- General Audit Division 2

CHANCELLERY
- The Executives' Offices and Document Management
- Strategic Projects Division
- Governor's Control Office
- Board Secretariat Division
- Information Management and Protection Division
- Administration of Special Computer Systems and Personal Data Protection Division
- 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 Reserves Management Division
- Back Office Division
- Foreign Reserves Risk Management Division

ECONOMICS DEPARTMENT
- Economic Analysis and Short-Term Forecasting Division
- Publications Division
- Translation and Editing Division

COMMUNICATION AND PUBLIC RELATIONS DEPARTMENT
- Media Relations Division
- Intranet and Internal Communication Division
- Online Communication Division
- Multimedia Support Division
- Public Relations and Documentation Division

HUMAN RESOURCES DEPARTMENT
- Organisation and Planning Division
- Human Resources Management Division
- Training and Career Development Division

BUDGET AND FINANCIAL ANALYSIS DEPARTMENT
- Budget and Financial Analysis Division
- Preventive Financial Control Division
- Consumption Standards and Norms Division
- Risk Monitoring Division

SECURITY DEPARTMENT
- Crisis Management & Business Continuity Division
- Internal Protection Division
- Special Transport Division
- Security Systems Division
- Transport and Maintenance Division

Note:
Colour patterns show the departments' coordination.
*The Internal Audit Department reports functionally to the Audit Committee and administratively to the Governor of the National Bank of Romania.

International activities of the authority

As regards the responsibilities of the National Bank of Romania concerning the alignment to the European regulatory and supervisory framework, the NBR have been pursued the harmonization efforts with regard to the supervision of credit institutions through the participation of Romania in a number of working groups set up at the EBA level. At the same time, the oversight activity continued through JSTs (Joint Supervisory Teams). In the supervision of cross-border banking groups, the NBR has maintained its cooperation with the other supervisory authorities through the Supervisory Colleges, structures that ensure both optimal dissemination of information and joint decisions on capital adequacy and liquidity or recovery plans of supervised credit institutions.

Regarding the structures and substructures of the EBA, the NBR participated in the Board of Supervisors; in the Standing Committee on Oversight and Practices, the Standing Committee on Regulation and Policy, the Standing Committee on Accounting, Reporting and Auditing, the Subcommittee on Anti-Money Laundering of the Joint Committee of the European Supervisory Authorities, the Subgroup on Own Funds, the Subgroup on Governance and Remuneration, the Subgroup on Liquidity, the special Working Group on Stress Testing, the special Working Group on Impact Study; and in supervisory colleges.

Cooperation with other supervisory bodies in the country

The cooperation and coordination in the field of macroprudential oversight of the national financial system is ensured by the National Committee for Macroprudential Oversight (NCMO). This committee was established by virtue of Law No. 12/2017 on the macroprudential oversight of the national financial system, as an inter-institutional cooperation structure without legal personality. Its fundamental objective is to contribute to safeguarding financial stability, also by enhancing financial system resilience to shocks and by containing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth.

Four meetings were held in 2018 between representatives of the National Bank of Romania (NBR), the Financial Supervisory Authority (FSA) and the Government within NCMO.

Thus, in 2018, the NCMO recommended the NBR, in its capacity as competent authority, to take among others the following actions in relation to credit institutions: (i) to maintain the countercyclical capital buffer at 0 (zero) percent, a level which has been implemented starting with 1 January 2016 and monitor developments in household indebtedness; (ii) to impose, starting 1 January 2019, a capital buffer for other systemically important institutions (O-SII buffer), on an individual or consolidated basis, as applicable, calculated based on the total risk exposure amount for all the credit institutions identified as having a systemic nature based on the data reported as at 30 June 2018; (iii) to make the semi-annual re-assessment and set the 12-month reference interval for the average values of the indicators based on which the systemic risk buffer is determined, as well as the level at which credit institutions apply this buffer, namely on individual and/or consolidated level.

Actions taken in order to implement the recommendations issued by the NCMO are to be found on the NCMO web site (http://www.cnsmro.ro/en/politica-macroprudentiala/modul-de-implementare-de-catre-destinatari-a-recomandarilor-emise-de-cnsm/)

Statistical tables

Number of financial institutions
(at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	28	27	26
Branches of foreign credit institutions	8	7	7
Cooperative banks	1	1	1
Banking sector, total:	37	35	34

Total assets of banking sector (mill.RON)
(at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	349,634.3	379,721.2	398,622.3
Branches of foreign credit institutions	42,901.7	46,855.7	51,232.2
Cooperative banks	1,111.9	1,215.7	1,315.2
Banking sector, total:	393,647.9	427,792.6	451,169.7
y/y change (in %)	+4.4%	+8.7%	+5.5%

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

Item	2016	2017	2018
Public sector ownership	8.2	8.7	8.1
Domestic ownership total	8.7	23.0	25.0
Foreign ownership	91.3	77.0	75.0
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	49.3	69.7	1134
Branches of foreign credit institutions	94.5	98.8	5882
Cooperative banks	-	-	-
Banking sector, total:	43.5	61.6	962

Return on Equity (ROE) by type of financial institutions (%)
(at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	10.18	11.92	13.87
Cooperative banks	0.42	1.24	1.28
Banking sector, total:	10.42	12.51	14.59

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	88.8	88.8	88.3
Branches of foreign credit institutions	10.9	11.0	11.4
Cooperative banks	0.3	0.2	0.3
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2016	2017	2018
Receivables	**100.0**	**100.0**	**100.0**
Financial sector	20.6	21.7	19.6
Nonfinancial sector	54.4	54.0	55.0
Government sector	-	-	-
Other assets	25.0	24.3	25.4
Liabilites	89.7	89.5	89.2
Financial sector	12.0	9.9	7.8
Nonfinancial sector	74.5	76.1	78.1
Government sector	-	-	-
Other liabilities	3.2	3.5	3.3
Capital	10.3	10.5	10.8

Capital adequacy ratio of banks (%)
(at year-end)

Type of financial institution	2016***	2017***	2018***
Commercial banks	19.6	19.9	20.7
Cooperative banks	30.6	30.6	30.1
Banking sector, total:	19.7	20.0	20.7

(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) (%)
(at year-end)

Asset classification	2016	2017	2018
Non-financial sector, including	12.9	8.7	6.6
Households	7.3	5.8	4.8
Corporate	19.3	12.2	8.6

The structure of deposits and loans of the banking sector in 2018 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	81.8	66.7
Households	52.3	36.4
Corporate	29.5	30.3
Government sector	13.3	28.8
Financial sector (excluding banks)	4.9	4.5
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	13,484.3	13,363.1	16,767.7
Interest expenses	2,579.1	2,083.4	2,943.3
Net interest income	10,905.2	11,279.7	13,824.4
Net fee and commission income	3,839.5	3,911.7	4,134.2
Other (not specified above) operating income (net)	4,610.8	4,000.5	3,172.1
Gross income	19,355.5	19,191.9	21,130.7
Administration costs	9,444.6	9,741.7	10,323.2
Depreciation	819.6	825.6	912.1
Provisions	270.3	301.5	468.8
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	4,288.5	1,838.6	1,030.6
Profit (loss) before tax	4,496.2	6,472.5	8,463.9
Net profit (loss)	4,153.2	5,335.4	6,827.5

Total own funds in 2018 (in mill.EUR)

Type of financial institution	Total own funds***	Core Tier 1***	Tier 1***	Tier 2***	Tier 3***
Commercial banks	9,475.5	8,523.4	8,523.4	952.1	-
Cooperative banks	67.1	65.7	65.7	1.4	-
Banking sector, total:	9,542.6	8,589.1	8,589.1	953.5	-

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

2018 DEVELOPMENTS IN THE RUSSIAN BANKING SYSTEM

Macroeconomic environment in the country

In 2018, Russian economy growth rates accelerated. GDP grew by 2.3% (in 2017, it increased by 1.6%). Annual inflation increased to 4.3%, this level corresponds with the goal of maintaining inflation close to 4%. The labor market remained stable, unemployment held near its natural level (4.8%).

Development in the banking sector (including the assets total / gdp)

In 2018, the Russian banking sector total assets increased by 6.9%[1]. Nevertheless, outpacing growth of nominal GDP reduced the assets to GDP ratio from 92.5% to 90.6%.

Total outstanding loans to non-financial organizations and households grew by 10.7% in 2018. Loans to non-financial organizations increased by 5.8% and household lending – by 22.8%. Segment-wise, mortgages kept growing (23.1% in 2018) and unsecured consumer lending picks up quickly as well (growth rates were 22.8%). In order to prevent excessive risk-taking, the Bank of Russia tightened macroprudential regulations of unsecured consumer loans and mortgages.

The level of overdue debt in retail lending in 2018 has been declining: the share of overdue loans fell from 7.0% to 5.1%. In corporate lending, the share of overdue loans decreased insignificantly, from 6.4% to 6.3% as of the year.

Household deposits increased by 6.5% in 2018. The total amount of corporate deposits and accounts grew by 6.0%. Borrowing from the Bank of Russia in 2018 increased by 29.4%.

Over 2018 credit institutions earned a net profit of ₽[2] 1.3 trillion (*vs* ₽0.8 trillion in 2017).

In 2018, the banking sector's capital grew by 9.9% to ₽10.3 trillion. Capital adequacy remains at comfortable level of 12.2% as of 1 January 2019.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the banking supervisory authority in the country

The Bank of Russia continued to improve banking regulation and banking supervision aimed at identifying risks at the earliest stages. The completion in 2018 of work on the implementation of a number of regulatory standards of the Basel Committee on Banking Supervision was important. Proportional regulation was introduced gradually for banks with a basic license. In 2018, they were released from preparing IFRS financial statements on

[1] The banking sector's relative indicators were affected by the ruble exchange rate movements, as well as licence revocations and cancelling of some credit institutions. Consequently, to enable a more accurate presentation of key banking sector performance indicators, this material reflects the growth rate (adjusted for currency effects) for credit institutions in operation as of 1 January 2019.

[2] On 11 December 2013, the Bank of Russia approved the graphic symbol of the ruble in the form of a capital cyrillic letter 'P' with a horizontal line in the lower part (₽).

an individual basis. The Bank of Russia also made important steps to develop the concept of incentive banking regulation. It will promote dynamic development of market segments that are of high priority for the economy.

Main strategic objectives of the supervisory authority in 2018

In 2018, supervision prioritised early problem recognition in banks' operations and effective supervisory response to ensure stability of the banking sector and protect creditors' and depositors' interests. The systemic risks' identification system was built based on a constant analysis of the banking activities and accepted risks, taking into account external factors. A special attention was paid to credit institutions with high concentration of owners' business, branch, region, non-core assets in their balance sheet.

The activities of the banking supervisory authority

To increase the effectiveness of banking supervision, the Bank of Russia worked to unify supervisory procedures and improve the methodological framework of supervision and supervisory technology. In development of the Core Banking Supervision Standard, the Bank of Russia introduced both evaluation and procedural standards.

In 2018, the Bank of Russia completed the first assessment of the quality of the internal capital adequacy assessment process (ICAAP) and capital adequacy in a number of credit institutions with assets exceeding ₽500 billion. During the year, the Bank of Russia also started making such an assessment for credit institutions with assets less than ₽500 billion and for banking groups the assets of the parent credit institutions of which exceed ₽500 billion.

The Bank of Russia continued consolidated supervision over financial groups (including informal ones) which included non-bank financial institutions. Group members were assessed for their mutual influence on their financial standing. Further development of consolidated supervision implies the preparation of a concept for cross-sectoral regulation of financial associations.

Organizational chart of the banking supervisory authority

As of the year-end of 2018, the Supervisory Authority of the Bank of Russia head office includes Banking Supervision Support Department, Banking Regulation Department, Department for Market Access and Activity Termination of Financial Institutions, Financial Resolution Department, Systemically Important Banks Supervision Department, Financial Monitoring and Foreign Exchange Control Department, Service for Ongoing Banking Supervision, Risk Analysis Service and Bank of Russia Chief Inspection.

The major tasks of these divisions are to provide methodological and organizational support to the Bank of Russia statutory functions of banking supervision within the framework of the entire supervisory cycle: from the licensing of credit institutions, establishment of regulatory requirements, the exercise of on-going supervision of their activities and the conduct of on-site inspections to financial rehabilitation of credit institutions and implementation of measures, if necessary, to liquidate financially unviable credit institutions.

The supervisory divisions are managed by the Bank of Russia Banking Supervision Committee, which is headed by the Bank of Russia First Deputy Chairman in charge of this area. The Committee is responsible for decision-making on banking supervision policies.

International activities of the banking supervisory authority

The Bank of Russia cooperates with foreign central (national) banks and other agencies responsible for banking supervision on the basis of Article 51 of the Federal Law No. 86-FZ dated 10 July 2002 “On the Central Bank of the Russian Federation (Bank of Russia)”.

Aiming at streamlining cooperation and information sharing, the Bank of Russia signed 40 bilateral agreements (memoranda of understanding – MoUs) for cooperation in banking supervision and information exchange.

On 7 June 2018 the Bank of Russia and the National Bank of Kazakhstan signed a new Agreement on Cooperation and Information Exchange in the field of financial market supervision. This overwhelming Agreement covers key sectors of the financial market. In August of 2018 the Bank of Russia also entered into a Memorandum of Understanding (MoU) with the Dubai Financial Services Authority (DFSA). The document establishes arrangements for sharing supervisory information and enhancing cooperation in the area of banking supervision, anti-money laundering (AML) and counter-terrorist financing (CTF).

During the year, the Bank of Russia continued exchanging supervisory information with banking supervisory agencies of a number of states (jurisdictions).

Cooperation with other supervisory bodies in Russia

The Bank of Russia developed cooperation with agencies, regulators and supervisors of financial markets within the framework of inter-agency agreements and arrangements that were earlier reached with the Ministry of Finance, the Federal Anti-Monopoly Service, the Federal Tax Service, the Federal Customs Service, Federal Treasury, Pension Fund of the Russian Federation and other federal agencies.

Other relevant information and developments

More detailed information about the development of the banking sector and banking supervision in the Russian Federation is available on the official website of the Bank of Russia (*http://www.cbr.ru/eng*).

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	575	517	440
Non-banking credit institutions	48	44	44
Branches of foreign credit institutions	n/a	n/a	n/a
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	623	561	484

Total assets of banking sector (at year-end, trln rub)

Type of financial institution	2016	2017	2018
Commercial banks	79,9	82,2	90,0
Non-banking credit institutions	0,2	3,0	4,1
Branches of foreign credit institutions	n/a	n/a	n/a
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	80,1	85,2	94,1
y/y change (in %, nominal)	-3,5	6,4	10,4

Ownership structure of banks on the basis of assets total (%)

Item	2016	2017	2018
Public sector ownership	59,2	60,6	62,2
Domestic ownership total (public+residents)	92,2	92,0	87,8
Foreign ownership	7,8	8,0	12,2
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	55,0	62,7	0,138
Non-banking credit institutions	98,8	99,3	0,887
Branches of foreign credit institutions	n/a	n/a	n/a
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	52,6	60,4	0,128

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	10,4	8,1	13,4
Non-banking credit institutions	36,8	40,6	42,6
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	10,3	8,3	13,8

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	99,8	96,5	95,6
Non-banking credit institutions	0,2	3,5	4,4
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 sector (at year-end, %),

	2016	2017	2018
Receivables			
Financial sector	18,9	19,1	18,1
Nonfinancial sector	51,1	49,7	51,3
Government sector	9,8	11,7	10,9
Other assets	20,1	19,4	19,7
Liabilites			
Financial sector	15,1	15,0	13,8
Nonfinancial sector	55,7	54,9	55,7
Government sector	4,4	4,9	6,4
Other liabilities	14,0	14,6	14,2
Capital	10,8	10,5	9,9

Capital adequacy ratio of banks (%)

Type of financial institution	2016	2017	2018
Commercial banks	13,1	12,0	12,0
Non-banking credit institutions	30,8	22,2	107,4
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	13,1	12,1	12,2

(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	2016	2017	2018
Non-financial sector, including	11,0	11,4	10,8
Households	11,8	9,8	7,6
Corporate	10,7	12,0	12,2

The structure of deposits and loans of the banking sector in 2018 (at year-end, %)

	Deposits	Loans
Non-financial sector, including:	88,6	90,1
Households	56,8	26,8
Corporate	31,8	63,3
Government sector*	6,8	1,6
Financial sector (excluding banks)*	4,6	8,3
Total*	**100.0**	**100.0**

* Excluding credit institutions and The Bank of Russia

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

P&L account	2016	2017	2018
Interest income	101 627 505	83 956 791	77 247 781
Interest expenses	60 048 956	46 306 972	38 503 399
Net interest income	41 578 549	37 649 819	38 744 382
Net fee and commission income	14 001 679	13 450 382	14 159 059
Other (not specified above) operating income (net)	-3 479 679	7 558 903	4 930 510
Gross income	52 100 549	58 659 104	57 833 951
Administration costs	27 126 367	26 446 533	25 728 463
Depreciation	n/a	n/a	n/a
Provisions	10 414 205	20 812 105	15 180 997
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	14 559 977	11 400 466	16 924 490
Net profit (loss)	10 856 748	7 767 913	12 557 918

Total own funds in 2018 (in thous. EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	127 998 626	87 295 655	93 429 914	34 573 052	n/a
Non-banking credit institutions	1 239 016	953 239	953 239	285 777	n/a
Cooperative banks	n/a	n/a	n/a	n/a	n/a
Banking sector, total:	129 237 642	88 248 894	94 383 153	34 858 828	n/a

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

2018 DEVELOPMENTS IN THE SERBIAN BANKING SYSTEM

Macroeconomic environment in the country

In 2018, inflation moved at a lower level than in 2017. With the exception of two months (March and April), when the base effect pushed it temporarily below the lower bound of the target tolerance band, for the rest of the year inflation moved within the target band (3±1.5%). It measured 2% in December and this was also its annual average. Subdued inflationary pressures were confirmed by core inflation of around 1.0% y-o-y and inflation expectations of the financial and corporate sectors which were anchored within the NBS target tolerance band. National Bank of Serbia continued with monetary policy easing at a cautious pace into 2018 and lowered the key policy rate in two occasions – in March and April, by 25 basis points each, to current level of 3.0%.

According to the Statistical Office data, real GDP growth in 2018 measured 4.3% (calculated as the sum of quarterly figures), which is the highest growth in the last ten years. The greatest impetus came from the above-average output in agriculture and construction, as well as from the expansion in the majority of service sectors. Another positive contribution came from the rising industrial production, despite the slowdown in external demand in the second half of the year. On the expenditure side, GDP growth was led by domestic demand. Investment increased on the back of the preserved macroeconomic stability, continued improvement of the business environment (as evidenced by Serbia's progress on the World Economic Forum global competitiveness list to the 65th position out of 140 countries), implementation of infrastructure projects and low costs of financing. Concurrently, favorable labor market trends continued to impact positively on the recovery of household consumption. Exports extended their high and dispersed growth. However, due to a faster rise in imports, primarily of equipment and intermediate goods for industrial purposes, which is linked with the investment cycle, the contribution of net exports to GDP was negative.

Despite the production- and investment-driven import growth and the rise in global oil prices, the share of CAD in GDP in 2018 remained unchanged from 2017 – at 5.2%. Relative to 2017, more favorable movements were seen in trade in services and secondary income account, which posted higher surpluses, as well as in the primary income account, whose deficit narrowed, and this is what largely compensated for the higher trade in goods deficit. Despite slowdown of external demand, manufacturing export growth remained solid, at 9% in nominal terms. Compared to 2017, the financial account also saw more favourable trends, mainly in terms of FDI whose net inflow rose to EUR 3.2 bn, as a result of the improved business environment. This ensured more than full coverage of the current account deficit (143.4%) for the fourth consecutive year. Since FDI also boosts export capacities of the Serbian economy, it will help narrow the current account deficit in the medium term. These movements at the annual level pushed the FX reserves up by EUR 1.1 bn (according to the balance of payments methodology) which in nominal terms at the end of 2018 stood at EUR11.3 bn, underscoring the economy's increased resilience to external shocks.

Fiscal overperformance extended into 2018 and public finance recorded a surplus for the second year in a row. The consolidated budget recorded a surplus of 0.6% of GDP (or RSD 32.2 bn). The continuation of positive fiscal trends was to a large extent due to the vibrant economic activity and positive trends in the labour market, which resulted in better than expected public revenue performance. A significant growth in government capital expenditures, as well as the rise in public sector wages and pensions boosted investment and consumption, while not causing any major inflationary pressures. The favourable fiscal result and the maturing of the eurobond issued in 2013 in the amount of USD 1 bn drove the public debt of central government further down, extending the downward trajectory of the share of public debt in GDP to 53.8% at year-end. The government's decision to rely more on domestic borrowing in dinars also helped mitigate the currency risk.

Development in the banking sector (including assets total / GDP)

Serbian banking sector, with the largest portion in the financial system of Serbia (90.3%), could be assessed as well capitalized and highly liquid. In the environment of macroeconomic stability and economy expansion, during 2018 the banking sector was attractive for reputable investors, the lending activity was accelerated, and quality of bank's portfolios was significantly improved. As a result of asset quality improvements as well as significant rose in net interest income, profitability was notably increased in 2018. Total net pre-tax profit at the end of 2018 amounted to EUR 640.6 million (compared to EUR 579.8 million in 2017), with return on assets (ROA) of 2.12% and return on equity (ROE) of 11.27% (compared to 2.08% and 10.57% in 2017, respectively).

At the end of December 2018, there were 27 banks operating in Serbia (20 in majority foreign ownership, 2 in majority ownership of domestic entities, while 5 banks were in majority ownership of the Republic of Serbia). All banks in Republic of Serbia are operating as independent legal entities, no branching is allowed. Foreign-owned banks are members of banking groups from 13 countries and regarding the total assets the most significant foreign banks are from Italy and Austria (26.7% and 13.1%, respectively), followed by banks from France (11.0%), Hungary (5.9%) and other countries (18.8%). In Serbia, overall financial intermediation by banks is still on relatively low level in comparison to more developed markets. The share of banking sector assets to GDP amounted to 74.6% at the end of December 2018.

Total balance sheet assets of the banking sector in Serbia reached EUR 31.9 billion at the end of 2018 which is an increase of 12.3% since the end of 2017.

Taking into account dispersion of the core banking activities (HHIs of assets, lending and deposits are below 1,000), the level of competition in the Serbian banking sector is at a satisfactory level. The market share of the top five banks in Serbia is 53.5% for assets, 53.3% for lending and 54.1% for deposits. In addition, favorable macroeconomic environment together with interest of foreign direct investors for Serbian banking sector, have influenced further changes in direction of consolidation. At the same time, privatization of state-owned banks (especially the largest state-owned bank i.e. Komercijalna banka) is ongoing activity, which should be done till the end of 2019. Furthermore, low interconnectedness in the banking system indicates low risk of contagion.

At the end of December 2018, total gross loan portfolio was at the level of EUR 19.2 billion. In 2018, lending activity was significantly improved in comparison to previous year (from growth rate of 8.5% to 10.7%. The main drivers for lending activity growth were cash loans (growth by 18.7%) in retail segments and working capital loans (growth by 15.9%) in private corporate segment, as well as. Loans to companies (private and public) made 49.2% of total loans with EUR 9.4 billion, while retail loans (including households, entrepreneurs and registered agricultural producers) amounted to EUR 8.6 billion, making 44.6% of total loans at the end of 2018.

As the consequence of NPL Strategy implementation followed by additional measures for NPL resolution, gross NPL ratio has continued the downward trend to 5.70% at the end of December 2018 which is 4.15 p.p. lower than in December 2017 and simultaneously the lowest ever recorded level of NPL ratio.

The total stock of gross NPLs at the end of December 2018 amounted EUR 1.1 billion which is a decrease by EUR 0.6 billion on yearly level. Such a decrease in NPLs was primarily the result of direct write-offs practice and NPLs assignment/sale to other legal entities outside of the banking sector. In that sense, the effects of Strategy for NPL Resolution (since August 2015) and the Decision on the accounting write-off of bank balance sheet assets (since September 2017) are reflected into historically the lowest level of NPL ratio.

The largest reduction of NPLs in absolute terms was recorded in private corporate sector, where NPLs were decreased by EUR 413 million year-on-year and amounts EUR 451.5 million at the end of December 2018. Above mentioned reduction was accompanied by NPL ratio declining which is lower by 5.6 p.p. comparing to previous year (drop from 10.8% to 5.2%).

NPLs of households (citizens, farmers and entrepreneurships) are lower for EUR 67.5 million on yearly level and amounts EUR 380.0 million at the end of December 2018. Gross NPL ratio for households also has downward trend – it dropped from 5.9% at the end of 2017 to 4.4% at the end of 2018.

Despite a significant reduction in NPLs, we are emphasizing that NPLs coverage by IFRS provisions is maintained on relatively high level (60.2%). Owing to the high coverage by reserves for estimated losses, the current level of NPLs poses neither threat to banking sector operations nor to overall financial stability.

At the end of December 2018, total banking sector deposits stood at the level of EUR 23.1 billion with an increase of 16.0% in 2018. Household deposits (only citizens) made 48.6% of total deposits with increase of 8.9% in 2018. Savings deposits in foreign currency are the most prominent in both segments (household deposits and total deposits) with EUR 10.0 billion at the end of December 2018 and increase of 6.2% in 2018. Approximately, one quarter of all deposits were related to private corporate sector with a EUR 5.8 billion at the end of 2018 which is an increase of 23.7% compared to the end of the previous year.

As a result of the prudential measures taken by the National Bank of Serbia in the previous period, banks in Serbia have built significant capital buffers and liquidity reserves, making them capable to cope successfully with the risks inherent in the system and provide stability in case of serious disturbances.

The capital adequacy ratio was 22.3% at the end of December 2018, which is significantly above the regulatory minimum of 8%. In addition to the high capital adequacy ratio, the banking sector of Republic of Serbia is characterized by an optimal capital structure, with CET1 over 95% of total regulatory capital. The high solvency of the banking sector is also indicated by the leverage ratio, introduced in regulatory framework of the Republic of Serbia with Basel III implementation, which amounted 12.64% at the end of 2018. The growth rate of own funding sources was sufficient to maintain the proportion of own funds to total liabilities of 17.9% as of 31 December 2018.

The average regulatory liquidity ratio for the Serbian banking sector in December 2018 was 2.04, 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 37.4% of total assets and 52.8% of total short-term liabilities. Most recently introduced liquidity coverage ratio (LCR) with its value of 213.32% also confirms high liquidity of Serbian banking sector.

Having in mind that gross lending activity is fully covered with stable domestic deposits (loan to deposit ratio stood at 90.0% at the end of 2018), funding structure of the banking sector of Republic of Serbia is assessed as adequate.

For the aim of taking proactive action regarding unsecured retail lending under unjustified long tenors, at the end of December 2018, the Decision on Managing Concentration Risk Arising from Bank Exposure to Specific Products, was introduced. Through this Decision, new indicator – Concentration Risk Indicator was introduced in order to comprise the existing portfolio of cash, consumer and other loans (that are not classified as mortgage loan or overdrafts) with contractual maturity above eight years. Newly introduced indicator represents additional regulatory and supervisory instrument of National bank of Serbia bearing in mind that it define the "cap" of bank's exposure to the concentration risk (50% of the capital increased for all liabilities in dinars with the residual maturity above five years).

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

In the observed period, exercising its regulatory competences in the area of bank supervision the NBS issued the following regulation:

In July 2018, the NBS Executive Board adopted the **Decision Amending the Decision on Consolidated Supervision of a Banking Group** (RS Official Gazette No 54/2018). The Decision aims to regulate the manner of calculation and conditions for inclusion of minority interests and Additional Tier 1 capital instruments and Tier 2 capital instruments issued by subsidiary companies in the capital of the banking group and to allow for offsetting of positions between members of the banking group for the purpose of calculating net positions and the capital requirement for market risks on a consolidated basis. The Decision is applied as of 21 July 2018.

In October 2018, the NBS adopted the **Decision Amending the Decision on Risk Management by Banks** (RS Official Gazette No 76/2018). The main goals of these amandments were to improve risk management by banks related to outsourced activities, as well as the introduction of new products/services while at the same time improving the supervisory process over the application of the relevant provisions of the Decision. The most important novelties relate to the more detailed regulation of the content of the banks internal regulations regarding the process of introduction of new products, specifying the activities that the bank undertakes before introducing the new product, as well as the supplementary documentation that the bank is obliged to submit to the NBS before the introduction of new product. In addition, the obligation to establish and keep single records of the introduction of new products is prescribed, as well as to submit the excerpt from the records semi-annually. Further, the scope of the activities that the bank is obliged to carry out prior to outsorsing activities to a third party, as well as the supplementary documentation bank is obliged to submit to the NBS before outsorcing. In addition, the obligation to establish and keep single records of activities outsourced to a service provideris is prescribed, as well as the minimum content of the excerpt from that record, which is submitted to the NBS.

Aiming to **Promote Sustainable Household Lending Practices** NBS Executive Board adopted the following decisions:

- Decision on Managing Concentration Risk Arising from Bank Exposure to Specific Products,
- Decision Amending the Decision on Bank Capital Adequacy, and
- Decision Amending the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items.

The adopted set of regulations comes as a response to the recognised need for the NBS's proactive approach to the increasingly recurrent approval of unsecured non-purpose loans to households at unreasonably long maturities. The NBS has therefore expanded its supervisory toolkit and adjusted prudential requirements for banks in order to bring the described practice within acceptable bounds.

In this context, the key novel solutions envisaged by the above regulations and relating to lending to natural persons (which within the meaning of these regulations exclude farmers and entrepreneurs) are as follows:

- a new indicator of concentration risk has been introduced, which primarily includes a bank's current portfolio of cash, consumer and other loans (other than housing loans and current account overdrafts) with the agreed maturity of 8 years or more;

- a 60% credit indebtedness limit has been prescribed – if this limit is exceeded as a result of approval of any loan to a natural person after the entry into force of the new regulations, a bank is required to disclose its exposure to that particular borrower separately when reporting to the NBS on its asset quality, while the exceeding of those limit as the result of the approvement of cash, consumer and other loans (other than housing loans and current account overdrafts) will be the trigger for the new deductible from CET1;
- another new deductible from CET1 was introduced, if a bank, in the course of 2019, approves a consumer loan, cash or other loan (other than a housing loan or a current account overdraft), with a repayment term of 8 years or more. (in 2020 seven years or more in 2021 six years or more – for other than for purchase of motor vihacles).

In February 2019, the NBS Executive Board adopted by-laws for the purpose of adjusting the reporting system with the adopted set of regulations for addressing the issue of unsecured non-purpose loans to households at unreasonably long maturities.

In February 2019, the NBS Executive Board adopted by-laws for the purpose of adjusting the reporting system with the adopted set of regulations for addressing the issue of unsecured non-purpose loans to households at unreasonably long maturities. The main reason for the adoption of **Decision Amending the Decision on Reporting on Capital Adequacy of Banks** („RS Official Gazette" No 8/2019) is the adjustment of the report prescribed by the Decision – KAP Form, in order to enable the reporting of the National Bank of Serbia in accordance with the requirements of the aforementioned Decision Amending the Decision on Capital Adequacy of Banks by introducing new deductable from Common Equity Tier 1 capital – with the data on the first reporting date (March 31, 2019). By the **Decision Amending the Decision on Reporting Requirements for Banks**, a new report on the level of credit indebtedness was introduced with a view to conducting a control of the correctness of classifying receivables in category D on the basis of exceeding the percentage of credit indebtedness prescribed by the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items but also for obtaining more detailed data for the purpose of future calibration of this percentage representing the limit value for the application of the corresponding deductable from the capital prescribed by the Decision on the Capital Adequacy of Banks.

The basis for supervising financial institutions in the area of prevention of money laundering and financing of terrorism is regulated by the Law on the Prevention of Money Laundering and Financing of Terrorism ("Official Gazette of RS", No. 113/2017; hereinafter: The AML/CFT Law) and sectoral laws. By the AML/CFT Law, which is adopted in December 2017, and is effective as of 1 April 2018, is defined that the National Bank of Serbia supervises the implementation of this law in banks in accordance with The Law on Banks ("Official Gazette of RS", No. 107/2005, 91/2010 and 14/2015).

The National Bank of Serbia (NBS), as a central bank in the Republic of Serbia (RS), is the national competent autority for the supervision of the largest part of the financial institutions in RS. It's in charge for supervision of banks, insurance companies, voluntary pension fund management companies, financial leasing providers, payment institutions, electronic money institutions, a public postal operator, and persons engaged in the provision of services related to virtual currencies, as well as authorised exchange dealers.

In November 2018. within the NBS is set up a special organizational unit – the Center for Special Control – AML, which is in charge of supervision of the prevention of money laundering and terrorist financing (hereinafter: ML/FT) in banks. In the previous period, these jobs were carried out within the Banking Supervison Department.

On Februar 12, 2018. the NBS`s Executive board adopted The Decision on guidelines for the application of the provisions of the Law on Prevention of Money Laundering and Terrorism Financing for the obliged entities supervised by the National Bank of Serbia („RS Official Gazette", No 13/2018), with the aim to regulate the manner in which an obligor supervised by the NBS carries out an analysis of the money laundering and terrorism financing risk, the procedure to determine whether the customer or the beneficial owner of the customer is an official, as well as the manner of applying other provisions of the AML/CFT law.

On May 31, 2018. the Government of the RS adopted the National Money Laundering and Terrorist Financing Risk Assessment (NRA). The assessment is a result of cooperation among relevant state authorities and representatives of the private sector (financial and non-financial), and was carried out in line with the World Bank methodology.

On December 21, 2018 the Executive Board of the NBS adopted amendments to the Decision on guidelines for the implementation of the provisions of the AML/CFT Law for Obligors Supervised by the NBS („RS Official Gazette", No 103/2018) which, inter alia, further prescribes, more explicitly, findings of the NRA as mandatory risk factors to be taken into consideration by the obligers while conducting risk assessments (referral to ways and manners of ML presented in the NRA, criminal offences posing high or medium level of threat for ML/FT etc).

In addition, the NBS has upgraded bylaws to fulfil the requirements of a clean criminal records with regard to persons holding a managerial positions or owners of a significant share in financial institutions, as well as their beneficial owners of shareholders and persons associated with them (FATF Recommendation No. 26). On April 12, 2018, the Executive Board of the NBS adopted The Decision on Amendments to the Decision on implementing the provisions of the Law on banks relating to granting of a preliminary bank founding permit, bank operating licence and consents and approvals by the National bank of Serbia.

Main strategic objectives of the supervisory authority in 2018

Adoption of the above-mentioned set of regulations in December 2018 in order to promote sustainable household lending practices was a response to the recognized need for the NBS's proactive approach to the increasingly recurrent approval of unsecured non-purpose loans to households at unreasonably long maturities. These regulations aim to contribute preventing the emergence of non-performing loans in the banking sector and encourage cautious risk-taking by banks by directing them to sustainable lending and avoiding excessive exposure to certain types of credit products, without undermining the trend of lending growth and taking into account the rights and interests of the bank services consumers in order to maintain and strengthen financial stability in the Republic of Serbia.

Further improvement of the legal framework in line with the EU regulations, international standards and best practice in a manner which ensures the preservation and strengthening of the banking and financial systems' stability, and honouring the specific features of the domestic regulations and market.

AML

Main strategic objectives of the supervisory authority in RS in the field of prevention of money laundering and financing of terrorism are related to further strengthening of institutional and supervisory capacities (except the NBS), better understanding of AML risks posed by individual licenced entities to ensure that the frequency and intensity of supervision is based on risk, improve the sanctioning regime for non-compliance with regulations and standards in the AML/CFT area to ensure that sanctions are dissuasive, proportionate, and issued in a timely manner.

The activities of the Banking Supervisory Authority in 2018

Measures Against Banks

During 2018, National Bank of Serbia took following measures against banks: 16 letters of warning, 4 decisions on orders and measures and 4 fines to the bank/member of board of directors. Decisions on fines imposed toward to 2 banks (in amount of 25 million rsd and 5 million rsd respectively) and members of their board of directors (in amount of minimum 633 546 rsd to the maximum 2 954 833 rsd). Also, National Bank of Serbia filed 2 requests for initiation of the proceeding for misdemeanors and 2 economic offences against banks and responsible persons (16 conclusions/decisions on termination of the supervision procedure and revoked 1 licence).

Licensing and Approvals regarding Banks

In 2018, the National Bank of Serbia received 4 requests for giving prior consent for acquisition of ownership in banks and: granted 2 prior consents for acquisition of ownership in banks (2 requests were rejected), approved 24 requests for amendments of banks' founding acts and their articles of association. Also, 120 procedures regarding appointment of managing and executive board members were initiated (114 requests were approved, 4 procedure was terminated, 1 request was rejected and 1 request was refused).

Also, the National Bank of Serbia: granted 2 prior consents for inclusion in calculation of the common equity tier 2 of element of the capital – subordinated obligation.

Furthermore, 3 requests for prior approval for distributing bank's profit through payment of dividends to its shareholders were submitted (all 3 requests for distributing bank's profit through payment of dividends to its shareholders were approved), 2 requests for granting consent for acquisition of subordinated company in financial sector were approved and 2 requests for granting consent for acquisition of subordinated company in financial sector were rejected, 2 banks were permitted not to include a subsidiary in consolidated financial statements and 1 bank was rejected not to include a subsidiary in consolidated financial statements.

Also, the National Bank of Serbia granted 4 prior consents for inclusion in the calculation of the common equity tier 1 – of the elements of that capital referred to in item 7, paragraph 1, provision under 1) of the Adequate Decision Capital banks by increasing the basic share capital. Furthermore, the National bank of Serbia granted 1 consent for the merging by acquisition of the banks and granted 1 prior consent for reducing the value of the elements of the tier 1 capital.

In 2018, the National Bank of Serbia: granted 1 prior consent for correct capital requirement for operational risk and 1 prior consent bank to correct capital requirement for operational risk applying basic indicator approach, due to merger by acquisition.

Also, the National Bank of Serbia granted 3 prior consents for inclusion interim profit in common equity tier 1 capital and granted 1 consent to set out to the list of external bank audit.

The National Bank of Serbia processed 282 notifications from banks regarding outsourcing of their business activities.

On-site supervision

Regarding activities of prudential on-site supervision of bank operations in 2018, 21 on-site inspections were conducted with different types of risks within their scope: 10 targeted inspections, 1 diagnostic examinations and 10 follow-up inspections related to corrective measures that have been undertaken.

Off-site controls

In order to identify the main risks in the operations of banks and to examine their risk profile, the NBS prepares regular information that include the analysis of the business model of banks, the quality of corporate governance and internal control systems, the risks that affect the solvency and liquidity of the banks, as well as the assessment of the adequacy of capital and liquid assets of the banks. The conclusions of these supervisory assessments, as well as quantitative and qualitative supervisory recommendations, were submitted to the banks.

In addition to the above information, annual estimates of banks recovery plans, as well as recovery plans of banking groups were also carried out. According these estimates, the NBS sent recommendations to the banks regarding identified irregularities or deviation from best practices.

In 2018, NBS monitored the implementation of banks' plans to reduce bad assets. Also, an analysis of the recording and monitoring of interest and fee income, as well as analysis of the banks` internal acts that regulated by this area, has been carried out. Concerning the conclusions of this analysis, a letter was sent to all banks and external auditors.

In addition, notifications on the introduction of new products, outsourcing activities and notifications on the transfer of receivables were analyzed on the on-going basis.

During 2018 four off-site controls were conducted related to: adequacy and reliability of reports submitted by the bank to the NBS (Foreign currency risk report and Daily liquidity indicator report), control of the bank's management in the part of informing the NBS about holding meetings of the Board of Directors, control of the cash flow management activities. In addition, NBS performed an assessment whether the bank shall be considered as failing or likely to fail, on the basis of which a proposal for revoking the operating license was drafted.

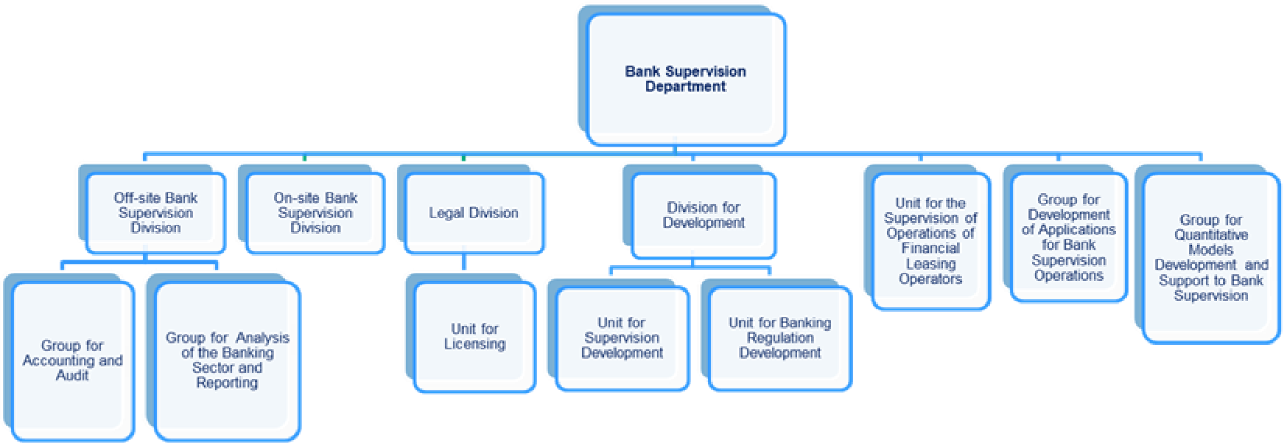
Based on all the above analyzes and information, the on-site plan for 2019 was prepared, as well as a plan of supervisory activities for this year.

During the 2018, the NBS developed and adopted a set of regulations responding to the increasingly recurrent approval of unsecured non-purpose loans to households at unreasonably long maturities. The NBS has expanded its supervisory toolkit and adjusted prudential requirements for banks in order to bring the described practice within acceptable bounds aiming to provide further economic prosperity.

AML

Taking into account that new legislation which regulates measures and actions for preventing and detecting money laundering and terrorism financing, took effects as of 1 April 2018 (specifically the AML/CFT Law and the Decision on Guidelines for the Application of the Provisions of the Law on the Prevention of Money Laundering and Terrorism Financing for Obligors Supervised by the National Bank of Serbia), targeted on-site AML/CFT inspections have been conducted aiming to verify whether the internal acts of banks in line with the new provisions of the aforementioned regulation (such as PEPs, correspondent banking, information accompanying wire transfers, beneficial ownership etc), and whether banks practices are in accordance with those internal acts and regulation. Moreover, the subject of control was organization of the process related to the AML/CFT risk management in banks and adequacy of the actions and measures that bank uses in order to prevent ML/FT, taking into account banks' size and it's exposure to that risk.

Organizational chart of the Banking Supervisory Authority



The Bank Supervision Department consists of seven lower-level organizational units: Off-site supervision division (with two lower-level organizational units: Unit for banking sector analyses and supervisory reporting and Unit for accounting and auditing), On-site supervision division, Legal division (with lower-level organizational unit: Unit for licensing), Division for development (with two lower-level organizational units: Unit for supervision development and Unit for banking regulation development), Unit for the supervision of operations of financial leasing operators, Group for development of quantitative models and support to bank supervision and Group for development of applications for bank supervision operations.

The NBS recognized the importance of supervision in the banking sector, and carried out internal organizational changes – it singled out money laundering and terrorism financing management activities from the organizational part dealing with banking supervision – the Banking Supervision Department, in a special organizational unit – the Center for Special Control – AML.

International activities of the authority

The National bank of Serbia cooperates with foreign regulatory authorities, for the purposes of cooperation and exchange of data (information) with a view to exercising and promoting its supervisory function.

In that respect in 2018, NBS has signed Memorandum of Understanding (MOU) with China Banking and Insurance Regulatory Commission (CBIRC) in the field of supervision of banks and insurance, including bank/insurance resolution, on September 18, 2018. Also, NBS has signed MOU with the SSM – European Central Bank (ECB) in a field of supervision of significant credit institutions and less significant credit institutions in euro zone at individual and consolidated level, on December 13, 2018. Co-operation regarding MOUs includes contact during the authorisation and licensing process of a cross-border establishment, relating to supervision of on-going cross-border activities and handling of problem situations.

The NBS has very successful cooperation with all of the home supervisors of the banks whose subsidiaries are conducting its business in Serbia, through the Supervisory colleges, conference calls, joint on-site review etc.

The Delegation of the Republic of Serbia (consisting of representatives from the Administration for the Prevention of Money Laundering, the National Bank of Serbia, the Ministry of Internal Affairs and the Ministry of Justice) is actively participating in the work of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and Financing of Terrorism of the Council of Europe (Moneyval), which brings together experts assessing the compliance of Member States with all relevant international standards to combat money laundering and terrorist financing in the area of legal practice, financial system and internal affairs, through the process of mutual evaluation of equal members.

Regarding the competencies of the NBS, which is the central bank in the Republic of Serbia, and the supervisory authority of the largest part of the financial system in RS, its general empowerment for the cooperation with foreign central banks and regulatory authorities is defined by the Law on NBS and sectoral laws (such as the Law on Banks).

Despite the possibility of exchanging information without concluded MOUs, the NBS has numerous bilateral and multilateral agreements with supervisory authorities from foreign countries.

The NBS most frequently exchanges information whit its counterparts about the main findings on performed controls, as well as the information needed in the licensing process.

The APML is a member of the Egmont Group of financial-intelligence units (EG), joining it in July 2003. Since June 2010, the APML has participated in the work of the Eurasian Group on Combating Money Laundering and Terrorist Financing (EAG) as an observer.

Cooperation with other supervisory bodies in the country

The NBS successfully cooperates with all supervisory authorities in the country whenever there is a need for sharing information in accordance with signed MoUs.

Regarding its supervisory task, National bank of Serbia 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 of the Republic of Serbia, Commission for Protection of Competition, Association of Serbian Banks and the Belgrade Stock Exchange. The NBS successfully cooperates with all before mentioned domestic supervisory authorities whenever there is a need for sharing information in accordance with provisions of MoUs signed.

Cooperation with other supervisory bodies in the RS in the field of prevention of money laundering and terrorist financing is regulated by the AML/CFT Law and MoU between relevant institutions. The NBS successfully cooperates with other supervisory bodies in the RS by participating in the drafting of regulations, in exchanging of information regarding identified irregularities in the control process in accordance with the AML/CFT Law, also the NBS informs other supervisory authorities about irregularities in their competence and conduct other activities.

Aiming to improve coordination and effectiveness of cooperation of all stakeholders in the AML/CFT system, the Government of the RS established a new Coordination body for prevention of money laundering and the financing of terrorism on 12 July 2018 (RS Official Gazette, No 54/2018) authorized, besides to monitor the implementation of the National AML/CFT Strategy and its Action Plan, for coordination of all AML/CFT activities in preventing ML/TF on a permanent basis.

Other relevant information and developments in 2018

Having in mind the risks identified regarding dinar loans indexed to foreign currency clause (hereinafter: FX-indexed loans), the NBS in October 2018, announced to the banks existing and possible course of action in the field of restriction of foreign exchange indexed lending. As the regulatory activities related to the limitation of cash and consumer loans to household at unreasonably long maturities have been priority, elaboration and calibration of this matter is planned for the next phase.

Also, the comparative analyses of domestic and regulations at the European Union level were intensified, particularly in the field of minimum loss coverage for non-performing exposures and recently changed European capital requirement legislation was tracked.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	31*	29	27
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	31*	29	27

* One bank has obtained operating licence by NBS as of 20.12.2016 but data didn't include in this information.

Total assets of banking sector (at year-end in EUR thousand)

Type of financial institution	2016	2017	2018
Commercial banks	26,252,890	28,440,240	31,930,862
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	26,252,890	28,440,240	31,930,862
y/y change (in %)	4.76	8.33	12.27

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	17.3	16.1	17.5
Domestic ownership total	23.3	23.1	24.6
Foreign ownership	76.7	76.9	75.4
Banking sector, total*:	**100.0**	**100.0**	**100.0**

* Banking sector total represents the sum of "domestic ownership total" and "foreign ownership", whilst the figure for "public sector ownership" is the part of figure in "domestic ownership total".

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	37.4	53.5	779
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	37.4	53.5	779

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	3.4	10.6	11.3
Cooperative banks			
Banking sector, total:	3.4	10.6	11.3

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
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 sector (%) (at year-end)

	2016	2017	2018
Receivables from			
Financial sector	13.8	12.1	14.7
Nonfinancial sector	50.8	54.3	54.5
Government sector	24.0	22.2	20.6
Other assets	11.4	11.4	10.2
Receivables due to			
Financial sector	8.2	9.2	10.7
Nonfinancial sector	63.7	63.3	63.3
Government sector	7.5	6.5	7.1
Other liabilities	1.1	1.2	1.0
Capital	19.5	19.8	17.9

Capital adequacy ratio of banks ***

Type of financial institution	2016	2017	2018
Commercial banks	21.8	22.6	22.3
Cooperative banks			
Banking sector, total:	21.8	22.6	22.3

(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	2016	2017	2018
Non-financial sector, including			
Households	9.28	5.63	4.36
Corporate	17.58	10.80	5.20

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	88.4	93.7
Households	52.5	40.3
Corporate	27.0	45.5
Government sector	9.1	5.5
Financial sector (excluding banks)	2.5	0.8
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	1,232,293	1,210,989	1,254,773
Interest expenses	229,255	190,299	180,610
Net interest income	1,003,038	1,020,690	1,074,163
Net fee and commission income	285,666	317,686	341,594
Other (not specified above) operating income (net)	135,638	263,133	199,680
Gross income	1,424,342	1,601,509	1,615,437
Administration costs	863,977	900,604	887,859
Depreciation	59,039	58,297	59,963
Provisions	0	0	0
Profit (loss) before tax	172,526	579,799	640,608
Net profit (loss)	148,629	536,608	596,035

Total own funds in 2018 (in EUR thousand) ***

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	4,544,358	4,301,010	4,314,323	230,035	
Cooperative banks					
Banking sector, total:	4,544,358	4,301,010	4,314,323	230,035	

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

2018 DEVELOPMENTS IN THE SLOVAKIAN BANKING SYSTEM

Macroeconomic environment in the country

Slovakia recorded a slowdown in economic growth in the second half of 2018 owing to weaker impetus from external demand. The growth typical for the upswing of the business cycle reached its peak in the summer and autumn months of 2018. Despite losing some momentum, Slovakia's annual GDP growth maintained a rate of around 4%. The deceleration in Slovakia's GDP growth was largely attributable to net exports, which amid softening demand in the country's export partners, actually made a negative contribution to overall GDP growth. Domestic demand provided a counterweight to that impact, remaining as a source of economic growth. This included household consumption expenditure, which maintained its upward trend underpinned by wage growth and favourable labour market developments. The unemployment rate continued to decrease in the second half of 2018. After continuously setting new lows over the previous two years, the rate by the end of 2018 was under 6%. Firms therefore faced with labour shortages. Labour shortages are also putting upward pressure on year-on-year wage growth, which in the second half of 2018 averaged 6.1%. The business cycle's ongoing expansionary phase is evident in NFC income, which was almost 8% higher in the last quarter of 2018 than in the same period of previous year. The risks to economic growth are mainly cyclical in nature and mostly exposed to external shocks as further slowdown of external demand.

Development in the banking sector (including assets total / GDP)

The slowdown in retail loan growth has been a key change. Year-on-year growth in total retail loans has fallen for the first time in five years. The slowdown has been most pronounced in the consumer loan segment (from 11.4% in March 2018 to 3.5% in March 2019). Housing loan growth began to ease from September 2018, though its slowdown has been far more moderate than that of consumer loans (from 12.0% in March 2018 to 10.9% in March 2019). Year-on-year growth in loans to non-financial corporations (NFCs) has been stable at around 5%, slightly above the EU median.

The exposure to European sovereign debt consists mainly of Slovak government bonds which amount is gradually decreasing. The share of foreign sovereign debt is kept on low levels (less than 2% of total assets).

The size of the banking sector's assets as a percentage of GDP stayed around 93% as at the end of 2018.

NPL ratio of both, retail and corporate sector experienced an improvement under the influence of positive economic situation and low interest rate environment. The share of non-performing loans as a percentage of total loans decreased to 3.45% as at 31 December 2018 from 4.09 % as at 31 December 2017. The level of loan-loss provisions as a percentage of the total amount of non-performing loans increased from 66% as at 31 December 2017 to 70.7% as at 31 December 2018.

The Slovak banking sector ended up the year 2018 with a net income after tax at the level of EUR 640 million. In relative terms, the profitability of the banking sector increased on an annual basis by 6.9%. The main factor behind improvement of banking sector's profitability was increase in returns on NFC loans. Decreasing credit risk costs also continued to have positive impact on profitability of the banking sector. On the other side, net interest income as well as income from fees and commissions in retail sector stayed at decreasing trend within the year under review.

Total capital adequacy ratio decreased to 18.2% as at 31 December 2018 from 18.6% as at the end of 2017. This resulted mainly from an increase of capital requirements due to strong loan growth. The banking sector also reported decrease in its leverage ratio, which fell from 8.2% at the end of 2017 to 8.0% at the end of 2018.

In spite of the relatively high resilience of Slovak banking sector there are some potential risks which might affect assets of the Slovak banking institutions. These are mainly global macroeconomic and the political development and the low interest rate environment (which is affecting multiple areas, including business model of the banking sector, real estate market prices and the level of indebtedness of retail and corporate sectors).

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

The National Bank of Slovakia (NBS) celebrated its 25th anniversary in 2018. NBS was established as the independent central bank of Slovakia on 1 January 1993, under Act no. 566/1992 Coll. on Národná banka Slovenska.

In 2018 NBS continued to be a member of the Eurosystem, which included the European Central Bank (ECB) and the national central banks (NCBs) of those countries that have adopted the euro. NBS had joined the Eurosystem on 1 January 2009, the date on which Slovakia adopted the euro. The NBS Governor continued to be a member of the ECB's Governing Council, the Eurosystem's highest decision-making body. Thus NBS, together with other NCBs and ECB, contributed to achieving the common goals of the Eurosystem. NBS participated in activities of the Eurosystem and the ESCB through its involvement in the Eurosystem and ESCB committees.

As the national supervisory authority in Slovakia, NBS has been part of the EU's Single Supervisory Mechanism (SSM) – a mechanism for exercising supervision over credit institutions in participating EU Member States – since the SSM came into operation on 4 November 2014.

The NBS participated in specific supervisory tasks of the ECB through the direct involvement of staff members of the NBS Financial Market Supervision Unit in Joint Supervisory Teams and through cooperation in the drafting of ECB decisions. As regards the supervision of significant banks, NBS exercised supervision over the banks' activities on a daily basis and continuously monitored quantitative data and oversaw risk management processes.

Slovakia's Resolution Council was established in January 2015 as part of the EU's Single Resolution Mechanism – the second of the Banking Union's three pillars – with NBS assigned the role of providing expertise to the Council and organising its functioning.

Since 1 January 2015 NBS has been the financial consumer protection authority in Slovakia. As such, the central bank supervises the protection of financial consumers' and other clients' rights in order to support the secure and sound functioning of the financial market.

Main strategic objectives of the supervisory authority in 2018

Roles and objectives of the NBS' Financial Market Supervision Unit ("FMS") is defined by legal rules as set forth by the Act No. 747/2004 Coll. On Supervision in the Financial Market as amended. 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 formalised detailed strategic objectives defined for 2018.

The activities of the Banking Supervisory Authority in 2018

As at 31 December 2018 a total of 12 banks and 15 foreign bank branches were operating in Slovakia.

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 were categorized into significant banks, supervised directly by the ECB, and less significant banks, supervised directly by NBS.

In 2018 a total of 29 proceedings were initiated in which the ECB exercises decision-making power in cooperation with NBS. The majority of these proceedings concerned fit and proper assessments of persons nominated to be a member of a significant bank's statutory board or supervisory board.

In 2018 NBS issued a total of 27 decisions under approval proceedings in this area; most of them concerned the grant of prior approval for appointments to one or more of the following positions: member of a statutory body or supervisory board, senior manager, authorized representative, and chief internal control/audit officer.

Three of the most important decisions issued by NBS in 2018 were related to the new legislative framework for mortgage banking in force since 1 January 2018; they were decisions to grant approval for the conduct of business related to the covered bond program.

In 2018 a total of nine thematic on-site inspections were conducted in banks and foreign bank branches in Slovakia. These inspections focused mainly on the quality of the institution's risk management system, paying particular attention to credit risk, market risk, operational risk, interest rate risk in the banking book, the corporate governance system, and the level of protection against money laundering and terrorist financing.

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 included joint activities under the ECB's direct and indirect supervision and work in supervisory colleges for individual banks.

As regards banks in Slovakia that fall under the ECB's direct supervision, the ECB conducted the supervision through joint supervisory teams (JSTs) that include NBS supervisory staff. An annual assessment of each bank was produced by its respective JST in accordance with SSM processes. Under off-site supervision, assessments of ex ante and ex post notifications were reviewed in accordance with Commission Delegated Regulation (EU) No 529/2014. In addition, validation reports on banks' internal models and internal audits were reviewed, and banks were evaluated for compliance with requirements and recommendations arising from decisions on the use of internal models.

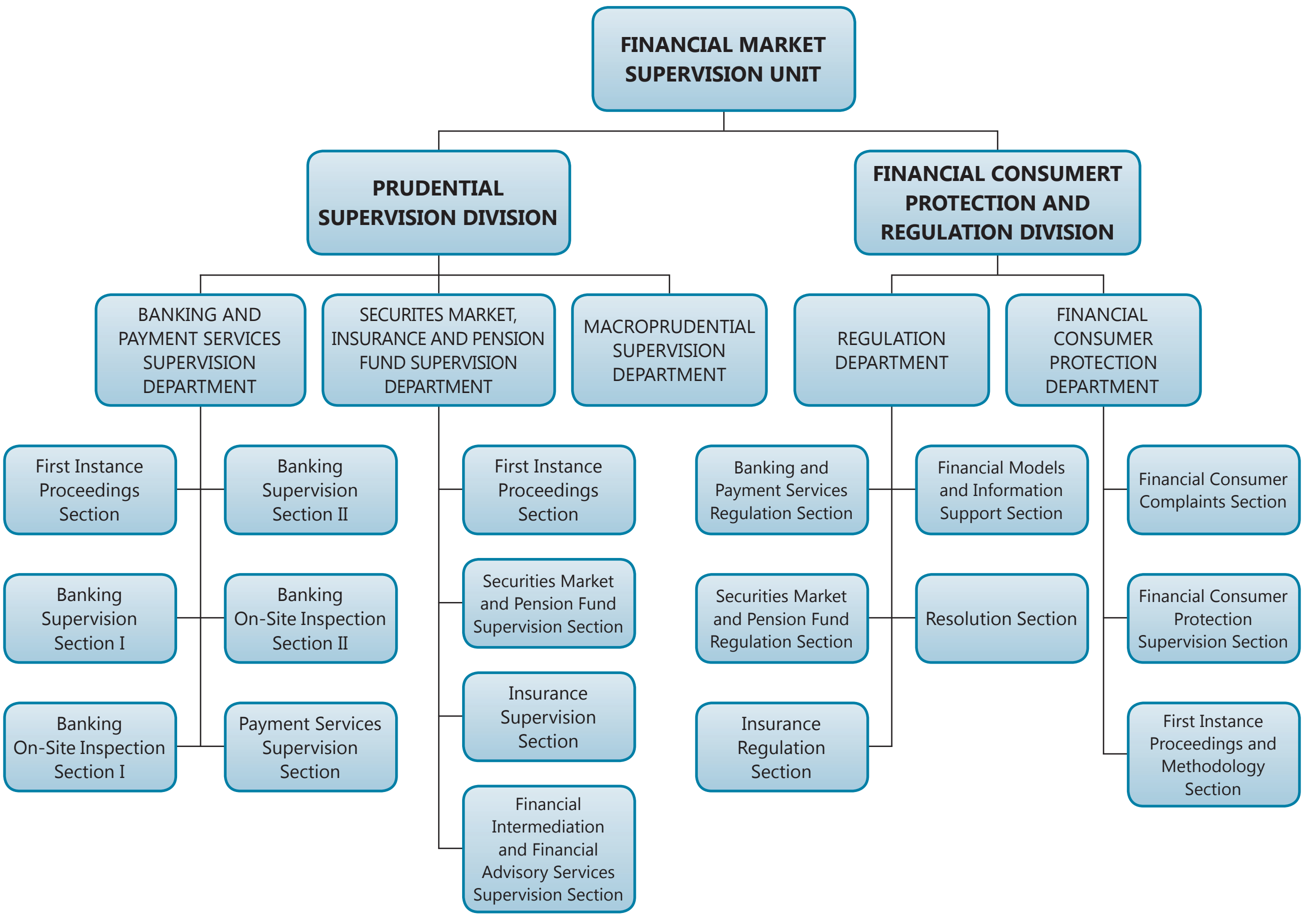
Financial market regulation

During 2018 FMS Unit staff cooperated actively with the Ministry of Finance of the Slovak Republic (MF SR) on the drafting of an amendment to the Resolution in the Financial Market Act. The amending law includes amendments to several other laws that are substantively interrelated and represent a comprehensive legislative framework governing various legal relations in the financial market.

In regard to the new regulatory framework under which the mortgage banking sector has been governed and supervised since 2017, NBS drafted several related decrees in 2018. These included a Decree on the covered bonds register, Decree on the submission for supervisory purposes of reports from the covered bonds register and mortgages register, an amendment to the Decree on the disclosure of information by banks and branches of foreign banks.

Credit growth remained robust in 2018, particularly in the household sector, and for an extended period it has been outpacing growth in GDP, employment and wages. In this context, NBS adopted several measures in 2018 with the aim of ensuring that borrowers do not become overindebted. Especially important in this regard was the issuance of two amending Decrees, one amending the Housing Loan Decree and the other amending the Consumer Loan Decree.

Organizational chart of the Banking Supervisory Authority



The organizational chart of the National Bank of Slovakia valid until 31 December 2018.

International activities of the authority

At the international level, NBS focused 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 were closely coordinated with those of other supervisory authorities in the EU.

The single supervisory regime works on basis of continual cooperation between the ECB and the national supervisory authorities. NBS participated especially in supervisory tasks of the ECB through its involvement of NBS staff in Joint Supervisory Teams and in the drafting of ECB decisions during 2018.

For supervision at the level of the European financial system, NBS continued in co-operation with the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

NBS's ongoing cooperation with the EBA focused, in 2018, on the drafting of implementing technical standards (ITSs) and regulatory technical standards (RTSs) required under the EU's Capital Requirements Regulation and Directive (CRR/CRD IV) and related legal acts. NBS cooperated with the EBA at all levels of competence, from working groups to the highest approval bodies.

Cooperation with other supervisory bodies in the country

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 in 2018

Regarding area of bank recovery and resolution, in 2018 Slovakia's Resolution Council addressed the issue of contributions to the Single Resolution Fund. The Council issued decisions on collecting contributions from individual banks and approved the draft financial statements of the national resolution fund for 2017. It also dealt with draft simplified resolution plans and with criteria for application of simplified obligations in regard to the preparation of resolution plans. The Council also discussed the current situation regarding resolution plans and related policies in 2018, and discussed legislative amendments related to the resolution regime.

At the end of 2018 the Slovak Parliament passed an Act amending the Resolution in the Financial Market Act. The amending Act entered into force on 1 January 2019, with the exception of certain points that will enter into force on 21 July 2019. The amending Act also included amendments to other laws. These amendments related not only to the issue of resolution, but also to many other areas. There were important changes concerning the resolution regime and insolvency, in particular the transposition of the EU's Directive amending Directive 2014/59/EU pertaining to ranking of unsecured debt instruments in insolvency hierarchy. Its enactment in Slovak law introduced a new class of claims in bank insolvency – non-preferred senior debt. Among the other changes were the following: the introduction of another new class of claims in bank insolvency – claims related to securities which have the attributes of additional Tier 1 (AT1) instruments; the defining of the term 'subordinated debt' for resolution purposes; and the simplifying and expediting of the write- down and conversion of capital instruments and of capitalisation measures.

In 2018 the FMS Unit (Financial Market Supervision Unit of NBS) was monitoring also the issue of the resolution of financial institutions other than credit institutions and investment firms. Its discussions in this regard focused on insurers. In summer 2018, EIOPA published a document on potential sources of resolution funding for (re) insurers, which followed up on EIOPA Opinion on the harmonisation of recovery and resolution frameworks for (re)insurers. The FMS Unit participated on drafting process of the Opinion.

In 2018 NBS's educational activities aimed at professionals included organising several workshop-style lectures and technical conferences on the topics of credit product promotion, information obligations when amending a contract, and the assessing of unfair contract terms and unfair commercial practices in consumer relationships. As part of its efforts to increase consumer financial literacy, NBS published a number of warnings on its website, including, for example, one entitled "What is a pyramid scheme, airplane game or Ponzi scheme?". It also produced a Slovak-language financial guide for senior citizens, called "Všetko, čo by ste mali vedieť o peniazoch" (Everything you should know about money).

Also, in 2018 NBS organised interactive lectures for primary and secondary schoolchildren, which were based on the National Standard for Financial Literacy and focused on information gained from practice. There was a total of 39 lectures and 1,180 students participated in them. During school holidays, NBS supported the Children's University project of Comenius University by organising two talks for 60 children.

NBS realises that one of the key tasks of central banks is to support financial literacy amongst the general public, so that people gain a better understanding of their personal finances and know how to approach the financial market. This is why, in 2018, the NBS Bank Board approved the establishment of a Financial Literacy Committee, which will prepare a draft NBS strategy for supporting financial literacy among the public.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	13	12	12
Branches of foreign credit institutions	15	14	15
Cooperative banks	0	0	0
Banking sector, total:	28	26	27

Total assets of banking sector (in EUR thousands) (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	60 944 879	65 209 896	69 544 067
Branches of foreign credit institutions	10 403 143	10 609 400	10 463 396
Cooperative banks	-	-	-
Banking sector, total:	71 348 022	75 819 296	80 007 463
y/y change (in %)	5.9%	6.3%	5.5%

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	0,95	0,85	0,79
Domestic ownership total	0,41	0,39	0,36
Foreign ownership	98,64	98,77	98,85
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	67.2	85.5	1766
Branches of foreign credit institutions	69.9	82.8	2837
Cooperative banks	-	-	-
Banking sector, total:	58.4	75.6	1383

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

Type of financial institution	2016	2017	2018
Commercial banks	13.22	9.16	9.17
Cooperative banks	-	-	
Banking sector, total:	13.22	9.16	9.17

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	85.4	86.0	86.9
Branches of foreign credit institutions	14.6	14.0	13.1
Cooperative banks	-	-	
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2016	2017	2018
Receivables			
Financial sector	12.4	13.6	11.5
Nonfinancial sector	66.6	68.9	71.6
Government sector	16.3	12.8	12.1
Other assets	4.7	4.8	4.8
Liabilites			
Financial sector	10.9	11.2	10.6
Nonfinancial sector	64.9	64.0	64.9
Government sector	2.4	2.5	3.4
Other liabilities	8.7	9.4	8.4
Capital	13.2	12.9	12.8

Capital adequacy ratio of banks (%)

Type of financial institution	2016	2017	2018
Commercial banks	18.15***	18.81***	18.43***
Cooperative banks	-	-	-
Banking sector, total:	18.15***	18.81***	18.43***

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

2018 DEVELOPMENTS IN THE SLOVENIAN BANKING SYSTEM

Macroeconomic environment in the country

Slovenia's economy was again significantly stronger than the overall euro area economy in 2018. Economic growth has outpaced overall euro area growth since the end of 2013. It stood at 4.5% in 2018. Annual inflation approached 2%, as its rise on 2017 was driven by energy prices and stronger domestic demand, which was reflected in higher service price inflation. It was nevertheless not far off the euro area average, which helped to maintain domestic exporters' price competitiveness on euro area markets. Despite the structural imbalances on the labour market, and slightly higher wage growth, the cost competitiveness of the domestic export sector also remained favourable. The balance of payments surplus remained large, external indebtedness continued to decline, firms and banks saw a further improvement in the quality of their balance sheets, and the fiscal position strengthened.

As a small, open economy, Slovenia is deeply affected by the international situation, particularly in the euro area, which has begun to deteriorate. The uncertainties in the international environment increased significantly: trade disputes and political tensions worsened, having slowed growth in global trade and industrial production even last year. This was reflected in the structure of domestic economic growth, as growth in industrial production and merchandise exports slowed. Because the Slovenian economy is highly integrated into the euro area, its business cycle is also aligned, and it is thus particularly vulnerable to potential shocks in foreign demand.

Development in the banking sector (including assets total / GDP)

At the end of 2018 there were 12 banks, three savings banks and two branches of foreign banks (credit institutions) operating in Slovenia. The banks held a market share of 93.6% of the banking system in terms of the balance sheet total. There was one branch fewer than in the previous year. This continued the trend seen over several years of a fall in the number of credit institutions in Slovenia. There was also a major ownership change in the banking system: the process of privatising a 65% holding in Nova Ljubljanska banka d.d. was carried out in the second half of the year.

The Slovenian banking system's balance sheet total increased to EUR 38.8 billion in 2018, equivalent to almost 85% of GDP. On the funding side, last year's increase was largely attributable to deposits by the non-banking sector, household deposits in particular, while the banks continued to pay down their liabilities on wholesale markets. On the investment side, the main increase was in loans to the non-banking sector and in highly liquid assets, with a lesser increase in investments in securities, which remained almost unchanged from the end of 2017 as a proportion of the balance sheet total. The banks held more than a third of their assets in safe, highly liquid forms.

The banking system remained well-capitalised in 2018, although there are considerable variations from bank to bank. The total capital ratio of the banking system on a consolidated basis stood at just over 18% as at the end of the third quarter of 2018, and thus remained above the average total capital ratio in the euro area. The banks mainly increased their regulatory capital via retained earnings, and less via recapitalisations. There was an increase in risk-weighted assets, driven primarily by increased lending activity to households and corporates. The small domestic banks and savings banks have the weakest capital position, despite recapitalisations in 2018. Capital adequacy is also gradually declining at banks that are more active in lending, but are failing to adjust their regulatory capital to keep pace with the credit portfolio.

The quality of the balance sheet is improving, although the process of cleaning up legacy non-performing assets is not yet complete: non-performing claims amounted to EUR 1.7 billion at the end of 2018, or 4% of the banks' total exposure. The Slovenian banking system's pre-tax profit exceeded EUR 500 million last year, while ROE stood at 11.1%. Here it should be noted that the profit was mostly the result of the net release of impairments and provisions, and would have been significantly lower had impairment and provisioning costs been at their long-term average. Lending risk is low, but there are indications of increased income risk and risk inherent in high real estate prices. Macroeconomic risks are now also being transmitted from the international environment. At the same time we are seeing lasting changes in firms' behaviour, as in the wake of high profits they are decreasingly turning to banks for financing, while the banks are increasingly looking to finance households.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

The Single Supervisory Mechanism (SSM) is one of the three pillars of the EU banking union, created in response to the financial crisis with the aim of restoring and maintaining confidence in the European banking system. The banking union complements the economic and monetary union (EMU) and the single market by coordinating the responsibility for bank supervision, resolution and funding at the EU level, and ensuring a level playing field for banks across the euro area. Alongside the SSM, which has been in operation since 4 November 2014, the other two pillars of the banking union consists of the Single Resolution Mechanism (SRM), which has been in operation since 1 January 2015, and the European Deposit Insurance Scheme (EDIS), which is still being established.

The establishment of the SSM saw supervision of significant institutions (SIs) in the EU transferred to the ECB in 2014, although this supervision is conducted in operational terms via joint supervisory teams (JSTs). The JST for each bank consists of a coordinator from the ECB, and members from the national supervisory authority and the ECB. The national supervisory authorities (the Bank of Slovenia in Slovenia's case) participate in all the supervisory activities, while the supervisory decisions with regard to these banks are made by the ECB.

The supervision of banks and savings banks that do not meet the criteria for being classed as significant institutions, i.e. less significant institutions (LSIs), is conducted by national supervisors, i.e. the Bank of Slovenia in Slovenia's case, in accordance with the rules and methodology of the ECB and the SSM. National supervisors regularly submit supervisory data for less significant institutions to the ECB, and inform it of the material findings of their supervision. The national supervisory authorities may consult the ECB on the imposition of measures, but the final decision is their responsibility, other than in exceptional cases. The new arrangements allow the ECB to directly take over the supervision of less significant institutions at the proposal of the national supervisor, at its own initiative in the event of the potential occurrence of a systemic crisis, or if the national supervisor is failing to conduct adequate supervision.

According to the Bank of Slovenia Act (ZBan-2) the central bank carries out supervision of credit institutions in order to maintain the stability and security of their operations and for the creation of confidence in the banking system, particularly among savers and depositors. In accordance with the statutory mandate the tasks of the Banking Supervision 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.

In 2018 several secondary regulations were implemented (criteria for designating significant banks, updated internal governance regulation, changes in the reporting framework). Changes in EU legislation meant that it was necessary to amend the Regulation on the exercise of options and discretions under European Union law, the Regulation on reporting by monetary financial institutions, their implementing guidelines, and the Guidelines for compiling the statement of financial position, income statement and statement of comprehensive income, and calculating the performance indicators of banks and savings banks. In addition a new Payment Services, Electronic Money Issuance Services and Payment Systems Act was entered into force.

The Bank of Slovenia also participates in the activities of the EBA within the scope of its competences. With the aim of putting in place consistent, effective and efficient supervisory practices and ensuring the harmonised application of European legislation in all EU Member States, the EBA issues guidelines and recommendations addressed to competent supervisory authorities and banks. It is the duty of supervisory authorities and banks to endeavour to uphold these guidelines and recommendations to the greatest possible extent. The guidelines and recommendations relate to the areas of banking supervision, bank recovery and early intervention, AML/CFT, payment services and systems, consumer protection and financial innovations. Pursuant to the ZBan-2 the Bank of Slovenia also decides on the application of individual guidelines or recommendations issued by other European supervisory authorities (ESMA, EIOPA) in the form of regulations on the application of guidelines or recommendations.

Main strategic objectives of the supervisory authority in 2018

The ECB set the following supervisory priorities within the framework of the SSM in 2018, which also formed the starting point for the supervision of Slovenia's significant banks:

a) business models and profitability;

b) credit risk, with a focus on non-performing loans, concentration and collateral management;

c) risk management, with an emphasis on:
   - validation and approval of internal models to calculate capital requirements
   - the internal capital adequacy assessment process (ICAAP) and the internal liquidity adequacy assessment process (ILAAP),
   - preparations and implementation of IFRS 9;

d) multiple risk dimensions, such as Brexit preparations and stress tests.

Within the framework of the annual supervisory review and evaluation process (SREP), in 2018 an assessment of individual risks and internal controls was conducted for all banks, individual capital requirements that must be maintained in excess of the minimum capital requirements were stipulated for them, and qualitative measures were imposed. These primarily related to the management of NPLs, internal governance and operational risk.

The Bank of Slovenia is independently and directly responsible for supervising less significant banks. The supervision is conducted in the form of ongoing supervision, i.e. monitoring and review of reports, data and information that the banks are required to submit to the Bank of Slovenia periodically or at its explicit request, and in the form of on-site inspections in connection with the identification, measurement and management of various risks.

The Bank of Slovenia sets out its principal supervisory activities for each less significant bank in the upcoming calendar year on the basis of a comprehensive annual risk assessment at the bank.

As at significant banks, the most important part of the supervisory process at less significant banks consists of the supervisory review and evaluation process, based on which the Bank of Slovenia defines individual requirements for the maintenance of capital adequacy and also qualitative measures for risk management.

The activities of the Banking Supervisory Authority in 2018

For significant banks the JSTs conducted nine deep-dive inspections in 2018, which were confined to a narrow segment of banking:

- internal governance;
- retail lending;
- collateral management;
- viability of business strategy and business plan;
- compliance of remuneration policy and remuneration system with the EBA Guidelines on sound remuneration policies (GL/2015/22);
- calculation of capital requirements for market risks.

The thematic review of profitability and business models, which aimed to assess the viability of business models and bank profitability, was completed in 2018. The findings were reported to banks in early 2018, and supervisory recommendations were issued. The review revealed that profitability and business models were still under pressure, despite the general improvement in the banks' economic position.

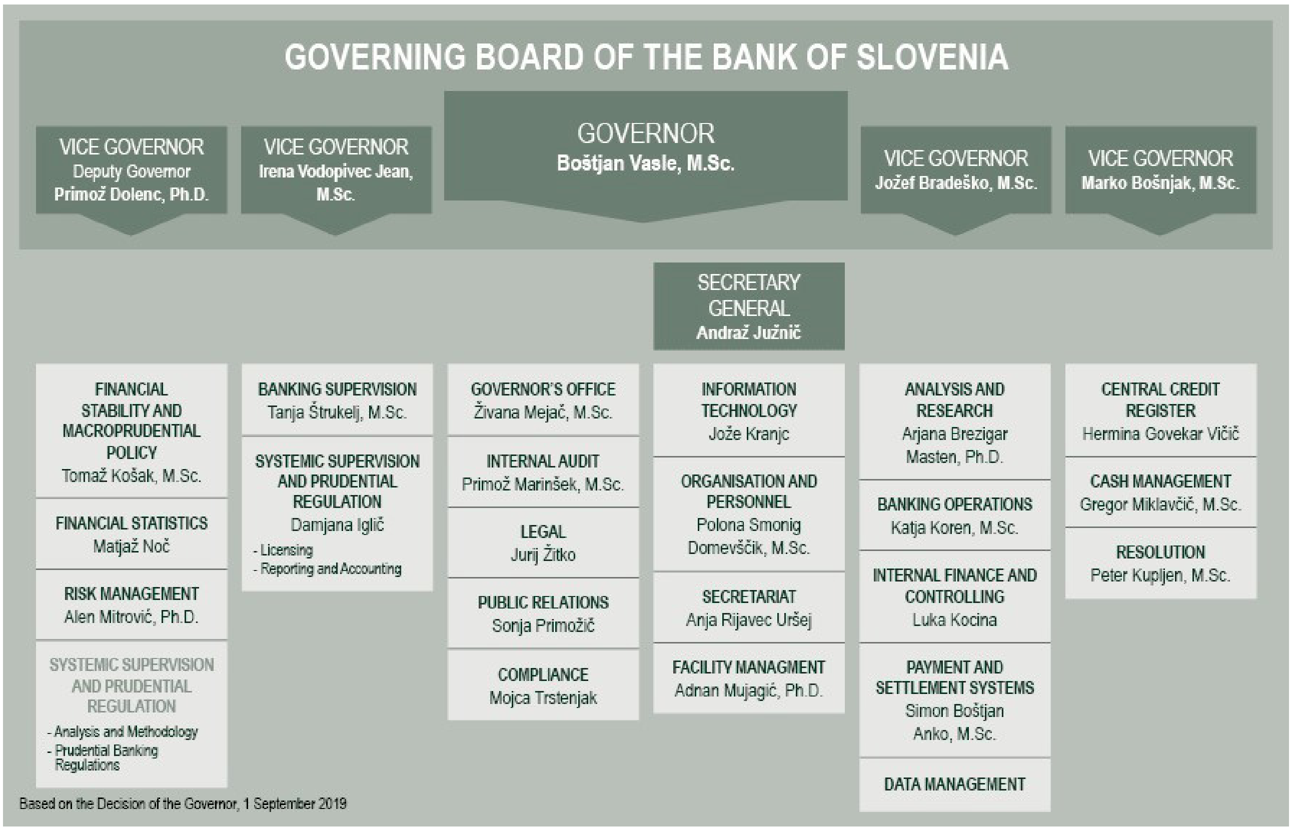
The new IFRS 9 became effective as of January 2018. The ECB therefore decided in 2016 to embark on a thematic review of IFRS 9 as part of its supervisory priorities. The objective was to assess the banks' preparedness and to encourage high quality and consistent implementation of the new standard. Supervisory recommendations to rectify the deficiencies identified in the thematic review issued to banks in 2017 and 2018. The thematic review revealed considerable deviations in impairment creation practices, as a result of which the JSTs devoted particular attention to this area in 2018. Impairment creation practices will also be the subject of review in the future. Supervision in 2018 also focused on the impact of the changeover to IFRS 9, including changes in the classification of exposures, the allocation of allowances, and migration of exposures between pools.

In the area of less-significant banks the Bank of Slovenia conducted particularly detailed monitoring of the banks that failed to fully meet the capital adequacy requirements determined in the SREP, or whose capital adequacy was very close to the SREP requirements. In addition, the Bank of Slovenia focused a substantial part of its supervisory activities on changes in the shareholder structure at certain institutions where major ownership changes were either taking place or were upcoming, and were generally associated with changes in the composition of management bodies, whether management boards or supervisory boards. The Bank of Slovenia therefore issued shareholders in one bank with two orders to dispose of shares during its supervisory activities.

The following risks were identified as the most material in the operations of less significant banks:

- profitability and business model;
- credit risk;
- risk management with an emphasis on funding maturity structure;
- operational risk;
- internal governance.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

European Union

Representatives of the Bank of Slovenia participated in informal meetings of the ECOFIN (the EU's council of economics and finance ministers and central bank governors) in 2018. The first meeting in 2018 was held in April in Sofia, where discussions included the deepening of the economic and monetary union, convergence with the EU, the capital markets union, and taxation issues. The second meeting was held in Vienna in September, and discussed challenges facing the European Investment Bank, financial stability, the economic potential and risks associated with cryptoassets, and programmes to promote investment and to finance structural reforms in the EU.

In 2018 Bank of Slovenia representatives again attended meetings 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 included meetings of the Economic and Financial Committee (EFC) and its subcommittees. The EFC discussed the economic and financial situation in the EU, economic governance, the free movement of capital, the banking union, the deepening of the economic and monetary union, the capital markets union, financial stability in the EU, the European system of financial supervision, sustainable financing, the issue of non-performing loans, AML issues, and issues related to the IMF.

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. A Bank of Slovenia delegation attended the annual and spring meetings of the IMF and the World Bank in 2018. The main topics of the meetings were current developments in the global economy and on international financial markets, the outlook and the potential policy responses.

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 themes in 2018 were the final implementation of the Basel III capital standards, macroprudential measures in the housing market, AI and machine learning in the financial services sector, risks related to counterfeiting and banknote orders, and the future of the LEI.

Organisation for Economic Co-operation and Development

Bank of Slovenia representatives attended meetings 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 Services, and provided information for the Working Party on SMEs and Entrepreneurship.

The Bank of Slovenia maintained regular contacts with multilateral and private international financial institutions and with rating agencies.

Cooperation with other supervisory bodies in the country

The Bank of Slovenia actively works with the Ministry of Finance on drafting legislative proposals in connection with banking and finance. This was again the case in 2018, when the Bank of Slovenia's main cooperation with the ministry involved the expert coordination and preparation of positions with regard to proposed new regulations and amendments to regulations.

Within the framework of the adoption of legislation at EU level, the Bank of Slovenia took part in negotiations with regard to revisions to the Capital Requirements Regulation (CRR), the Capital Requirements Directive (CRD IV), the European Market Infrastructure Regulation (EMIR), the NPLs package, covered bonds, the audit of the European system of financial supervision, and certain other legislative proposals discussion of which will be completed in 2019 or the following years.

Financial Stability board:

The Financial Stability Board (FSB) is a national macroprudential authority that formulates macroprudential policy and implements it in conjunction with supervisors of the financial system (alongside the Bank of Slovenia, the Securities Market Agency [SMA] and the Insurance Supervision Agency [ISA]). The purpose of the FSB is helping to protect the entire financial system, strengthening its resilience and reducing the build-up of systemic risks, thereby ensuring that the financial sector is able to make a sustained contribution to economic growth. The FSB is chaired by the Governor of the Bank of Slovenia.

The FSB met at four ordinary sessions in 2018, and reported on its work to the National Assembly in accordance with the Macroprudential Supervision of the Financial System Act. The FSB carefully monitored systemic risks in 2018, was briefed on the actions taken by national supervisors with regard to the implementation of recommendations by the European Systemic Risk Board (ESRB), and discussed other issues of importance to financial stability. The major risks in the financial system were assessed as medium during the observation period.

The Bank of Slovenia works with a range of institutions in Slovenia. Its cooperation with the Bank Association of Slovenia (BAS), the Securities Market Agency (SMA), the Insurance Supervision Agency (ISA), National Payments Council and the Office for Money Laundering Prevention.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	16	15	15
Branches of foreign credit institutions	4	3	2
Cooperative banks	0	0	0
Banking sector. total:	20	18	17

Total assets of banking sector (at year-end in 000 EUR)

Type of financial institution	2016	2017	2018
Commercial banks	35,571,616	36,639,326	37,286,775
Branches of foreign credit institutions	1,478,035	1,307,007	1,490,186
Cooperative banks	0	0	0
Banking sector. total:	37,049,651	37,946,333	38,776,961
y/y change (in %)	-0.9	2.4	2.2

Ownership structure of banks on the basis of assets total (in %)

Item	2016	2017	2018
Public sector ownership	42	40.4	25.2
Domestic ownership total	51.2	50.8	35.1
Foreign ownership	48.8	49.2	64.9
Banking sector. total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	47.0%	62.4%	0.0837
Branches of foreign credit institutions	/	/	/
Cooperative banks	/	/	/
Banking sector. total:	45.2%	60.0%	0.1064

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	7.3%	9.2%	10.3%
Cooperative banks	/	/	/
Banking sector. total:	7.3%	9.2%	10.3%

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	96.0%	96.6%	96.2%
Branches of foreign credit institutions	4.0%	3.4%	3.8%
Cooperative banks	/	/	/
Banking sector. total:	**100.0**	**100.0**	**100.0**

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

	2016	2017	2018
Receivables			
Financial sector	11.1	11.5	12.6
Nonfinancial sector	49.8	51.5	52.9
Government sector	23.7	21.5	20.7
Other assets	15.3	15.5	13.8
Liabilites			
Financial sector	10.5	8.6	8.2
Nonfinancial sector	66.4	69.6	72.1
Government sector	4.2	3.0	2.7
Other liabilities	6.6	6.4	4.8
Capital	12.4	12.5	12.2

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks	20.8	19.8	19.8
Cooperative banks	/	/	/
Banking sector. total:	20.8	19.8	19.8

(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	2016	2017	2018
Non-financial sector. including	6.6	4.6	3.1
Households	2.6	2.4	1.9
Corporate	7.6	5.4	3.4

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector. including:	92.54	87.42
Households	64.64	45.32
Corporate	27.89	42.09
Government sector	3.59	7.83
Financial sector (excluding banks)	3.87	4.76
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	828,328	767,180	775,339
Interest expenses	158,379	115,232	103,618
Net interest income	669,954	651,948	671,719
Net fee and commission income	307,394	313,479	315,405
Other (not specified above) operating income (net)	149,799	108,744	166,392
Gross income	1,127,144	1,074,175	1,153,292
Administration costs	603,604	614,622	614,411
Depreciation	63,518	59,066	55,067
Provisions	-11,824	19,528	4,707
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans. ...)	108,171	-62,273	-57,730
Profit (loss) before tax	363,674	443,227	530,865
Net profit (loss)	332,439	424,785	495,198

Total own funds in 2018 (in 000 EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	4,256,074	4,174,095	4,174,095	81,979	/
Cooperative banks	/	/	/	/	/
Banking sector. total:	4,256,074	4,174,095	4,174,095	81,979	/

(Please. mark for each item: * – for Basel I; ** – for Basel II; *** – for Basel III)

2018 DEVELOPMENTS IN THE TURKISH BANKING SYSTEM

Macroeconomic environment in the country

Turkey is the 18th-largest economy in the world with a GDP around USD 770 billion. From 2000 to 2018, per capita GDP in Turkey more than doubled from USD 4,200 to USD 9,445.[1] The Turkish economy has grown very fast in the past two years despite adverse shocks. This performance has been driven by policy stimulus and a dynamic, well-diversified business sector.[2]

In 2017 GDP growth rate was 7.4%. This high growth rate kept to continue in the first half of 2018 as well. GDP growth rate reached to 6.2% in the first half of the year. On the other hand in the second half of the year speculative attacks in financial markets effected Turkey. However, speculative attacks on Turkish Lira was eliminated as a result of the measures taken by the government. Nevertheless, growth rate have declined in the second half of the year and GDP growth declined to 2.6% increase in the whole year. GDP per capita reached to USD 9,632 and inflation rate increased to 20.3% by the end of 2018.

After August 2018, aiming to support sustainable growth and to ensure effective credit mechanism government took some measures to stop the turbulence in the financial markets. Thanks to macro prudential tools used by the government, pressure on banking sector balance sheet has eased.

With the help of measures taken by Central Bank of the Republic of Turkey (CBRT), BRSA and other financial institutions, the pressure on the value of the TL was eased, and volatility of exchange rates declined together with the inflation rate. Because of the depreciation of the Turkish Lira, imports has diminished faster than exports, thus the current account balance has improved considerably in recent years.

Development in the banking sector (including assets total / GDP)

The Turkish financial system is dominated by the banking sector, which represents about 87[3] percent of total financial sector assets. As of March 2019, there are 53 banks operating in the Turkish Banking Sector (TBS) of which 34 are deposit taking banks (87,5 percent market share), 6 are participation banks and 13 are development and investment banks. All banks are under the supervision of the BRSA. Turkish banking sector operates with 11542 branches and 206615 employees. The total asset size of TBS is nearly 4.1 trillion TL. As of year-end 2018, the total assets to GDP ratio is at 104.5%.

According to the Regulatory Consistency Assessment Program (RCAP), undertaken by the Basel Committee on Banking Supervision in 2016, Turkey's banking regulatory framework is fully compliant with Basel standards.

As of March 2019, the volume of loans has reached to 2.5 trillion TL which constitutes 60.8% of total assets. The foreign currency and parity effect eliminated annual loan growth is 2.2%. Loan growth is below the historical averages. Loan growth declined in 2018 due to slowdown in economic activity, especially in the second half, and high base effect generated by Credit Guarantee Fund loans in 2017 . In the first quarter of 2019, annual

* Please return by June 28, 2019
1 The World Bank Country Snapshots; http://pubdocs.worldbank.org/en/188761555342422504/Turkey-Snapshot-Spring-2019.pdf
2 OECD Economic Survey- Turkey: http://www.oecd.org/eco/surveys/Turkey-2018-OECD-economic-survey-overview.pdf
3 BRSA 2018 Annual Report

loan growth recovered moderately. The share of FX loans in loan portfolio is around 41.4% (including FX indexed loans). The share of corporate loans, retail loans and SME loans are 54.6%, 20.2%, and 25.2% respectively.

NPL ratio (at 4.1%), which is an important indicator of asset quality, is low compared to other emerging markets. Loan loss provisioning rate is at 68.8%. The share of second group loans (watch list) has increased to 11.6% from 4.4% as compared to year end 2017, mainly due to the implementation of IFRS9 starting from January 2018.

Securities are the other important investment item in the balance sheet of Turkish banks. Total share of securities in the balance sheet is 12.8% and the amount of securities is nearly 531 billion TL.

For Turkish banks, the main funding source is deposits (53.3% of total liabilities). Total deposits in TBS has reached to 2.2 trillion TL. FX deposit constitutes 53.7% of total deposits. As another source, total funds from abroad is around 103.5 billion USD and constitutes 14.1% of total liabilities. Foreign borrowing includes repos, deposit, loans and syndication and securitization loans. The current rollover rate of syndication loans is at 87%.

Starting from the year 2010, banks are able to issue debt instruments both in local and international markets as a long term source of funding compared to deposits. Currently, the amount of bond issuances has reached to 208 billion TL with a share of 5% in total liabilities.

The TBS's performance indicators reflect a healthy and sound banking system. TBS's capital base is strong. CAR is at 16.4%, which is higher than 12% target CAR regime that is being implemented in Turkey. Common Equity Tier I CAR is nearly 13%. Despite downgrade of Turkey's sovereign debt rating to below investment grade, Turkish banks preserves their high profitability ratios. As of March 2019, annualized NIM is 3.5%, ROA is 1.2% and ROE is 12.2%.

The FX position of banking sector is long. There is a short position in the balance sheet but banks balance their short positions using off-balance sheet instruments such as derivatives which yield fully hedged FX positions.

Turkey has been implementing Liquidity Coverage Ratio (LCR) since 2015 and has completed its transition period with gradual increases each year until 2019. Currently, deposit banks are required to achieve at least 100% total LCR and 80% FX LCR. All banks are complying with these limits and sector LCR Ratios are 146% for total and 262% for FX, which are significantly above the regulatory limits. Turkish banking system preserves its strong liquidity position against possible shocks with high liquidity coverage ratios.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the Banking Supervisory Authority in the country

In Turkey, Banking Regulation and Supervision Agency (BRSA) with the authority given by Banking Law Nr. 5411 regulates and supervises banks (commercial-deposit banks, investment and development banks and participation banks and the branches in Turkey of such institutions established abroad), financial holding companies, financial leasing companies, factoring companies, consumer financing companies and asset management companies, payment institutions and e-money institutions. Moreover, BRSA authorizes independent audit, rating, valuation and outsourcing firms that give service to supervised institutions. Capital Markets Board of Turkey (CMB) is the regulatory and supervisory authority in charge of the securities markets. General Directorate of Insurance (GDI) and the Insurance Supervisory Board under Secretariat of Treasury are responsible for insurance sector.

Within the scope of the Law on Bank Cards and Credit Cards, the institutions willing to establish card systems, issue bank cards and credit cards, exchange information on card holders, and engage in clearing and settlement activities are also regulated by BRSA. In addition, BRSA is empowered to authorize and terminate the activities, temporarily or permanently, of institutions that performs the independent audit, valuation, rating and outsourcing activities for banks.

BRSA is a public legal entity with administrative and financial autonomy. The independence of the BRSA gives autonomy in three main areas: i) autonomy in regulation and supervision, ii) autonomy in 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 supervise enforcement. 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.

The supervisory approach of the BRSA is a dynamic risk-focused one that aims to ensure efficiency, continue adequacy of supervision and efficient allocation of supervisory resources. The approach proposes to shape supervision form, scope, time, content and intensity based on the risk profile and adequacy of internal controls and risk management systems of each institution.

The BRSA's methodology for ongoing supervision of banks, established in the Supervisory Manual on Banking Supervision Process is organized in supervisory cycles that last one year.

Supervision departments are responsible for on-site examinations. That includes regular annual on-site supervision, which includes risk assessment and CAMELS rating, targeted inspections, complementary and compliance inspections.

Risk assessment and the CAMELS rating phase of the supervisory cycle is conducted by analyses of the financial soundness of the bank and the assessment of the efficiency of the bank's general risk profile, risk management and internal control and internal audit systems. The results of this phase are a financial structure and rating report, risk matrix, risk profile and their view of the ICAAP report submitted by banks.

With its Implementing Decision no. 2016/2358 dated 20.12.2016, the European Commission acknowledged that the regulatory and supervisory framework of the Turkey's banking sector is equivalent to the European Union (EU) legislation in terms of the EU Regulation 575/2013 on Prudential Requirements for Credit Institutions and Investment Firms. Similar to the results of the Regulatory Consistency Assessment Program (RCAP), which was previously held by the Basel Committee on Banking Supervision, this Implementation Decision also confirmed that the Turkey's banking regulatory and supervisory framework is fully in line with international standards.

Main strategic objectives of the supervisory authority in 2018

Bank and non-bank financial institutions under the regulation and supervision of the BRSA constitute 90% of total assets of the financial sector in Turkey.

BRSA's main strategic objective is to ensure market efficiency, with aiming full functioning credit system, protecting depositor's rights and improving financial markets.

BRSA has set the following strategic objectives in 2018;

- Improving efficiency of regulation and supervision activities via performing Agency's operations in line with international standards.
- Achieving flexible, effective and extensive regulatory and supervisory framework to sustain stability.
- Enhancing information management and call report framework by efficient data collecting process and releasing data more comprehensively to the public.
- Increasing volume and comprehension of bank and non-bank financial institution's audit on both risk management and banking system management side.
- Strengthening participation bank's legislation framework and enlarging usage of Islamic banking tools in the both financial markets and in the economy.
- Continuing to protect financial consumer rights.

The activities of the Banking Supervisory Authority in 2018

In 2018, while continuing its regulation and supervision activities, Agency have used some micro and macro prudential tools to ease turbulence both in credit and currency markets.

During financial turbulence, BRSA has issued several regulations, which eased the pressure on banks and helped them smoothly continue to their activities.

BRSA also set some restrictions on instalments of consumer loans. With these regulations BRSA had the opportunity to regulate consumer expenditures in the economy.

BRSA also issued several regulations about restriction of swap transactions aiming at Turkish Lira to gain (TRY) stability in currency market. Regulations on swap transactions led the TRY fluctuations decrease in currency market and helped TRY to gain its value again.

BRSA also continued its efforts to harmonize its legislation framework with the EU and international standards. Within this framework 1 new regulation, 1 new communique and 1 new circular were issued. During 2018, 21 regulations and 4 communiques have been amended in parallel to the international standards.

As a member of National Risk Evaluation Committee, Agency has contributed to the anti-money laundering audits and contributed to the legislation improvement process in the scope of anti-money laundering.

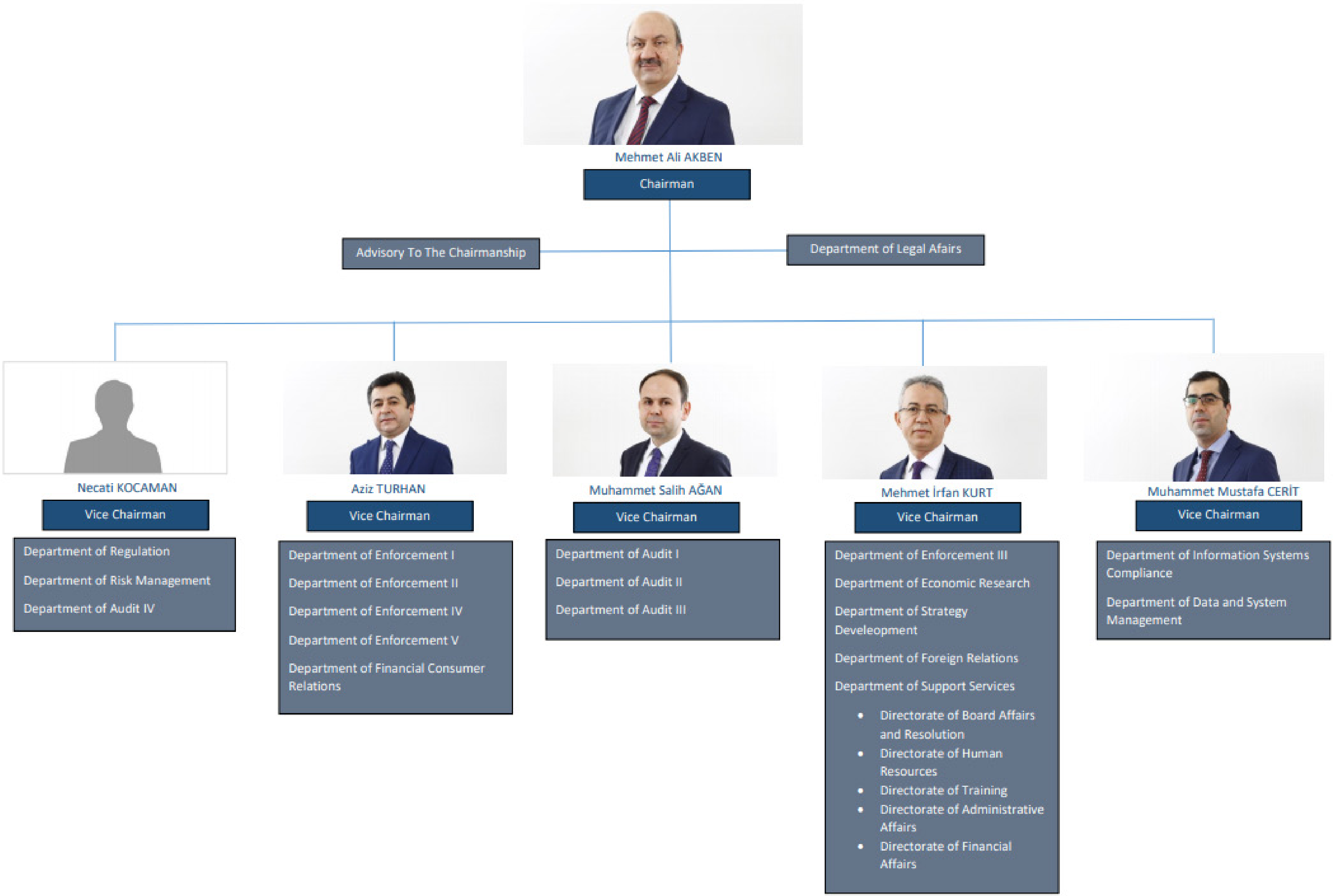
Volume and scope of both banking system and risk management audits have increased in the 2018 for both bank and non-bank financial institutions including electronic money and payment system institutions.

Protection of financial consumer rights was one of the other focus areas of the Agency. BRSA have continued to evaluate consumer appeals about claim of "consumer right violation" and applied audit activities for these consumer appeals.

Strengthening participating bank's legislation framework was one of the other main working topic of the BRSA in 2018. BRSA continued its efforts to enlarge Islamic banking tools usage in the economy and continued its activities to harmonise legislative framework on Islamic banking with international standards.

BANKACILIK DÜZENLEME VE DENETLEME KURUMU

Organizational chart of the Banking Supervisory Authority



International activities of the authority

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 39 as mid of 2019.

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) in 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 the country

Based on Article 98 of Banking Law, views were exchanged and information was shared with, Ministry of Treasury and Finance, Capital Market Board (CMB), Savings Deposit Insurance Fund (SDIF) and Central Bank of Republic of Turkey (CBRT) in order to ensure coordination and cooperation among authorities in executing monetary, credit and banking policies.

Financial Sector Commission (FSC) consists of the representatives of BRSA, Turkish Republic Presidency of Strategy and Budget Administration, Ministry of Treasury and Finance, Revenue Administration, CBRT, SDIF, Borsa Istanbul, CMB, Competition Board, Banks Association and Participation Banks Association. FSC 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 (CC) consists of the presidents and vice presidents of BRSA and SDIF. Pursuant to Banking Law Nr. 5411, the CC is in charge of ensuring the maximum cooperation be established between the BRSA and the SDIF when it is necessary to carry out transactions in the competency of the SDIF, and exchange of information.

Financial Stability and Development Committee (FİKKO) consists of the presidents of CRBT, BRSA, CMB, SDIF, Borsa Istanbul and the Banks Association (TBB) and chaired by Treasury and Finance Minister. FİKKO is in charge of sustainable development and financial stability.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks[1]	34	33	34
Branches of foreign credit institutions	6	5	5
Cooperative banks	0	0	0
Banking sector, total:	52	51	52

[1] There are no cooperative banks in Turkey. Commercial banks are defined as deposit taking institutions, therefore investment & development banks are excluded. We have, as of year-end 2018, 13 investment & development banks and 5 private and public participation banks

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	2455.4	2922.7	3403.3
Branches of foreign credit institutions	7.9	12.8	14.6
Cooperative banks	-	-	-
Banking sector, total:	2731.0	3257.8	3867.4
y/y change (in %)	15.85	19.29	18.71

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	33.82	35.96	38.61
Domestic ownership total	70.60	71.96	72.56
Foreign ownership	29.40	28.04	27.44
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	34.46	52.80	760.23
Branches of foreign credit institutions	0.36	0.38	0.10
Cooperative banks	-	-	-
Banking sector, total:	34.46	52.80	782.30

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	14.95	16.52	14.94
Cooperative banks	-	-	-
Banking sector, total:	14.28	15.88	14.75

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
Commercial banks	94.8	94.6	94.3
Branches of foreign credit institutions	0.3	0.4	0.4
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

[2] Remaining shares belong to investment &development banks.

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

	2016	2017	2018
Receivables			
Financial sector	4.2%	4.0%	4.8%
Nonfinancial sector	73.9%	73.1%	70.5%
Government sector	16.7%	15.9%	18.0%
Other assets	5.2%	5.3%	6.7%
Liabilites			
Financial sector	19.4%	20.8%	18.6%
Nonfinancial sector	60.4%	58.6%	60.9%
Government sector	3.6%	4.1%	4.1%
Other liabilities	5.6%	5.4%	5.5%
Capital	11.0%	11.0%	10.9%

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks ***	15.1	16.5	16.9
Cooperative banks	-	-	-
Banking sector, total:	15.6	16.8	17.3

(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	2016	2017	2018
Non-financial sector, including			
Households	4.3	3.5	3.4
Corporate	1.9	2.8	4.0

[3] NPL Ratio

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	62.2	21.1
Corporate	34.1	76.8
Government sector	3.7	2.1
Financial sector (excluding banks)	NA	NA
Total	**100.0**	**100.0**

[4] Including SME Loans

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

P&L account	2016	2017	2018
Interest income	194.7	247.4	368.4
Interest expenses	103.4	134.1	222.3
Net interest income	91.3	113.4	146.2
Net fee and commission income	24.1	28.8	37.0
Other (not specified above) operating income (net)	-14.2	-20.7	-19.7
Gross income	239.8	303.1	446.6
Administration costs	43.4	25.0	28.5
Depreciation	3.2	3.8	3.8
Provisions	5.0	4.0	21.0
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	4.1	8.0	8.9
Profit (loss) before tax	47.3	60.9	66.1
Net profit (loss)	37.5	48.6	53.8

[5] Administration Costs includes only personnel costs and provisions for termination indemnities.

Total own funds in 2018 (in EUR)

Type of financial institution	Total own funds ***	Core Tier 1 ***	Tier 1 ***	Tier 2 ***	Tier 3
Commercial banks	74.8	59.5	60.3	14.5	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	85.4	68.1	69.1	16.4	-

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

2018 DEVELOPMENTS IN THE UKRAINIAN BANKING SYSTEM

Macroeconomic Environment in Ukraine

Ukrainian economy has been recovering at a solid pace. In 2018, Ukraine's real GDP growth accelerated to 3.3% yoy (up from 2.5% yoy in 2017) owing to favorable terms of trade and domestic demand. Across sectors, agriculture made a strong contribution to growth owing to record high harvest of corn and sunflower seeds. In 2019, the growth is forecast to temporarily decelerate to 2.5% due to less benign external conditions and tight monetary and fiscal policies.

Robust growth of consumer demand was largely supported by a strong increase in wages (up by 12.5% yoy in real terms in 2018), rising remittances (up by 17.5% yoy in US dollar terms), social transfers and improving consumer confidence. Investment growth remained solid (at 14.3% yoy), although slowed somewhat from the previous year on the back of the waning effect of the pent-up investment seen during the post-crisis period.

Consumer price inflation declined to a five-year low of 9.8% in 2018, from 13.7% in 2017. The progress in disinflation was achieved due to the NBU's tight monetary policy. The expansion in the domestic supply of some foods (fruit, milk, meat, etc.) and lower global food prices contributed to the decrease in inflation, causing the growth in raw food prices to slow sharply. Despite the decrease, inflation had exceeded the NBU's target of 6% ± 2 pp by the end of 2018, as specified in the Monetary Policy Guidelines for 2018 and the Medium Term. This was largely due to factors over which monetary policy has only a limited effect. These were mainly administered price increases, higher production costs on the back of strong wage growth, rising global oil prices seen throughout most of the year, and the narrowing supply of some vegetables on the back of unfavorable weather conditions. In 2018, the growth in the producer price index (PPI) decelerated to 14.2% yoy, but remained high throughout the year, mainly driven by high energy prices.

The current account deficit has widened moderately to USD 4.3 billion (compared to USD 2.4 billion in 2017). The widening was mainly attributed to an increase in the merchandise trade deficit (to USD 12.6 billion compared to USD 9.7 billion in 2017) on the back of robust domestic demand. Exports was supported by a record high harvest. However, repair works at some metallurgical plants and transportation difficulties, in particular through the Sea of Azov, weighed on exports growth in 2018.

FA inflows (USD 7.1 bn) were generated by both public and private sectors, exceeding the CA deficit. Net FDI inflows amounted to USD 2.4 billion. The surplus in the overall balance of payments (USD 2.9 billion) coupled with a tranche disbursement under the IMF program led to an increase in international reserves to a 5-year maximum of USD 20.8 billion as of end-2018. This amount was sufficient to cover 3.4 months of future imports.

Developments in the Banking Sector

Ukraine had 77 operating banks in late 2018, 4 less than a quarter earlier: two banks merged with other banks, one transformed into a financial institution, and VTB Bank was declared insolvent. The market share of state-owned financial institutions did not change: 54.7% by net assets and 63.4% by retail deposits. Retail lending was on the rise in 2018, boosting PrivatBank's share of net assets by 1.3 pp to 20.7%, and the share of private banks by 0.9 pp to 14.8%. Asset concentration in the sector has remained unchanged over the past two years, with the top-20 banks accounting for 91% of net assets in late 2018.

Assets

The banking sector's net assets increased by 1.1% in Q4, primarily driven by the expansion of loan portfolios. Interbank loans declined and were partially replaced by the purchase of NBU certificates of deposit in the final days of the year.

Net hryvnia retail loans grew 6.7% in October–December, and 34.1% over the whole of 2018. The highest growth rates were reported by private (+54.2% yoy) and state-owned banks (+49.0% yoy). Hryvnia mortgage lending increased at a significant pace of 6% yoy.

Net hryvnia corporate loans grew 2.0% qoq and 8.1% yoy. Net hryvnia corporate loans to borrowers that had never defaulted on their debt increased 25.8% yoy. PrivatBank reported the sharpest increase (+ 70% yoy) on the back of a low comparison base, as nearly the entire pre-nationalization loan portfolio had been covered with provisions. Among other groups of financial institutions, the highest lending rates were reported by private and foreign banks: 17.6% and 7.6% yoy, respectively. At the same time, hryvnia lending stopped growing at state-owned banks: these banks issued 1.5% fewer hryvnia loans last year, following a 12.7% increase in 2017.

Net FX corporate loans increased 6.0% qoq and 2.6% yoy. Alternative energy companies, trading companies, and agricultural exporters took out most of the FX loans.

Over the course of 2018, lending portfolios improved in quality. In Q4, the NPL ratio declined 1.7 pp, to 52.8%. The improvement in loan quality came after the surge in retail lending statistically diminished the NPL ratio.

Funding

Throughout 2018, hryvnia deposits of households and businesses increased 14.8% and 6.8%, respectively. In Q4 2018, hryvnia retail deposits grew 3.9%, mainly due to improved depreciation and inflation expectations. Private and foreign banks accounted for the larger part of the deposit increase in Q4: up 7.8% and 6.7%, respectively. FX retail deposits shrank 1.7% (+1.4% yoy) after increasing a quarter earlier.

The inflow of corporate deposits was primarily driven by substantial government spending in the final days of 2018. As a result, hryvnia corporate deposits grew 15.7% in December. In particular, PrivatBank showed an increase of 19.7%. This seasonal liquidity inflow boosted banks' demand for the NBU's certificates of deposit in late 2018.

The dollarization of retail deposits declined by 2.0 pp in Q4, including due to the strengthening of the hryvnia. This indicator reached 47.3% by the end of the year. The dedollarization trend thus resumed, after slowing in Q3 on the back of the weaker hryvnia exchange rate.

The breakdown of bank liabilities by instrument was little changed over the course of the year. In Q4, the share of corporate deposits increased to 35.7%. In state-owned banks, liabilities to IFIs accounted for a significant 23.6% of total liabilities. In other banks, this indicator stood at 1.2%.

Interest Rates

In 2018, the NBU raised its key policy rate four times – overall, from 14.5% to 18% – with the last rate hike occurring in late Q3. Despite the higher key policy rate, interest rates on deposits were practically unchanged and started rising only in Q3 as deposit growth slowed. In Q4, the average interest rate on 12-month hryvnia retail deposits edged 0.6 pp higher, to 15.7% per annum, while the average rate on 12-month US dollar deposits grew 0.1 pp, to 3.6% per annum. The gap between rates on 6-month and 12-month deposits widened somewhat. Stronger competition for corporate deposits took interest rates on these deposits higher, to 14.5% per annum (+5.3 pp in 2018, +1.5 pp in Q4).

The growth in retail deposit rates in Q4 occurred at the same time as rates on new hryvnia loans increased 1.4 pp, to 31.5% per annum. Interest rates on hryvnia corporate loans rose 1.1 pp, to 20.8%.

Profit or Loss and Capital

In 2018, the banking sector generated a record UAH 21.7 billion in earnings, including UAH 10.8 billion in Q4 alone. Net profits of profitable banks amounted to UAH 34.4 billion, while loss-making banks incurred UAH 12.7 billion of losses. Operating income was up by 27.5% yoy, driven primarily by an increase in net interest and fee and commission income, with expenditures rising by 27.6% yoy. Operating income before provisioning grew by 25.4% yoy. Meanwhile, operating performance remained unchanged, with the cost-to-income ratio at 58.9%. PrivatBank and foreign-owned banks (except banks with Russian capital) improved their performance. At the same time, two state-owned banks incurred operating losses due to negative results of a revaluation of certain financial instruments and because of operating costs. However, these banks were able to turn a moderate profit by reversing their provisions. In 2018, banks made UAH 23.7 billion in provisions, down by half from a year earlier. In Q4, banks with Russian capital accounted for most of the provisions.

Legal and Institutional Framework of Operation and Supervision of Financial Institutions, New Developments, and Legal Competence of the Banking Supervisory Authority in Ukraine

- The Constitution of Ukraine
- The Civil Code of Ukraine
- The Economic Code of Ukraine
- The Law of Ukraine *On the National Bank of Ukraine*
- The Law of Ukraine *On Banks and Banking*
- The Law of Ukraine *On Households Deposit Guarantee System*
- The Law of Ukraine *On Financial Services and State Regulation of Financial Markets*
- The Law of Ukraine *On Joint Stock Companies*
- The Law of Ukraine *On Preventing and Counteracting to Legalization (Laundering) of the Proceeds of Crime, Terrorist Financing, and Financing Proliferation of Weapons of Mass Destruction*
- The Law of Ukraine *On Consumer Lending*
- The Law of Ukraine *On Payment Systems and Money Transfers in Ukraine*
- The Law of Ukraine *On Simplifying Bank Reorganization and Capitalization Procedures*[1]

On 6 February 2018, the Verkhovna Rada of Ukraine adopted the Law of Ukraine *On Amendments to Certain Laws of Ukraine on Establishing and Maintaining the Credit Register of the National Bank of Ukraine and Improving Credit Risk Management of Banks*, which stipulates, among other things, the implementation of the centralized Credit Register of the National Bank of Ukraine – an information system for collecting, storing, changing, using, and disseminating (providing) information on banks' lending transactions and the status of discharge

[1] adopted by the VRU on 23 March 2017. The law has introduced the streamlined procedures for increasing banks' capital (with the additional contributions to authorized capital) and the procedure for bank merges. The law provides for a legal innovation – an option to terminate banking activities of a legal entity without liquidation. The law is provisional and will remain effective until 1 August 2020.

of liabilities under such transactions, as well as analysis and classification of loans. In line with the said law, the NBU Board has approved the Regulation on the Credit Register of the National Bank of Ukraine (Resolution No. 50 dated 4 May 2018), which establishes the organizational and legal framework for operation of the Credit Register. In addition, the specifications have been developed on banks' submission to the NBU of a report on lending transactions with an individual/corporate debtor and administration of the NBU Credit Register.

On 5 July 2018, the Verkhovna Rada of Ukraine adopted the Law of Ukraine *On Amendments to Certain Laws of Ukraine on Improving the Financial Sector of Ukraine*, which aims at improving the corporate governance at state-owned banks. The said law establishes the new wording of Article 7 of the Law of Ukraine *On Banks and Banking*, which stipulates, in particular, that the management bodies of a state-owned bank are the Cabinet of Ministers of Ukraine, the supervisory board, and the board. The supervisory board of a state-owned bank comprises nine members, whereof six members are independent, and the remaining three members are the state representatives of the President, the Cabinet of Ministers, and the Verkhovna Rada of Ukraine. In addition, a provision of the aforementioned law defines a list of criteria to be met by the independent members and the state representatives in the supervisory board.

Main Strategic Objectives of the Supervisory Authority

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:

- improving the system of financial sector regulation and supervision
- the gradual transition to risk-based supervision.

Activities of the Banking Supervisory Authority

To harmonize bank regulation with the provisions of Directive 2013/36/EU, Directive 2014/56/EU, EU Regulation 575/2013, and the recommendations of the Basel Committee on Banking Supervision, and to improve the efficiency and sustainability of the Ukrainian banking system, the NBU adopted a number of regulations in 2018 on introducing/improving:

- the Liquidity Coverage Ratio (LCR)
- the annual resilience assessment of banks and the banking system of Ukraine
- the risk-based approach to bank licensing
- minimum requirements to organization of the risk management system in Ukrainian banks and banking groups
- the NBU Credit Register.

To implement the updated Strategy for the Development of the Public Banking Sector, approved by the Cabinet of Ministers of Ukraine on 21 February 2018, the efforts have been taken to tackle the NPL issue. In particular, the Ministry of Finance of Ukraine had initiated the establishment of the Financial Stability Council's committee on resolution of nonperforming loans of state-owned banks, which has developed the recommendations on resolution of NPLs. According to paragraph 7 of the said recommendations, the Ministry of Finance of Ukraine has to make sure that the information on the resolution of problem debt by state-owned banks is publicized semiannually.

In line with the Law of Ukraine *On Financial Restructuring*, the state-owned banks implemented measures under the financial restructuring procedure.

In addition, in line with the obligations to the IMF pertaining to the financial sector policies that Ukraine has accepted under the Memorandum on Economic and Financial Policies of 5 December 2018, the NBU, with the technical assistance of the World Bank, has developed the draft regulation on the organization of the process of NPL management at Ukrainian banks on the basis of approaches set out in the ECB's Guidance to Banks on Non-Performing Loans.

Also, given the significant changes in the accounting of banks' transactions with financial instruments after the conversion to IFRS 9: Financial Instruments, the NBU has updated/adapted the supervisory reporting indicators and improved the assessment of risks related to financial instruments when calculating capital ratios, credit risk, and liquidity.

The NBU has initiated the implementation of the provisions of Directive 2014/59/EU, which establishes a framework for the recovery and resolution of credit institutions and investment firms (the BRRD), namely:

- the white paper on strategic development of a better resolution mechanism for insolvent banks has been drafted jointly with the World Bank
- the BRRD Implementation Framework has been presented for further work on the corresponding draft law.

To further increase the effectiveness of risk-based supervision, the NBU has developed the *Regulation on the Offsite Banking Supervision Conducted by the National Bank of Ukraine* approved by NBU Board Resolution No. 135 dated 6 December 2018, which took effect on 12 February 2019.

The regulation introduced the following:

- the procedure for the offsite supervision by the risk-based approach taking into account the provisions of Directive 2013/36/EU, the Core Principles for Effective Banking Supervision, and the recommendations of the Basel Committee on Banking Supervision. Pursuant to the new regulation, the NBU will perform the ongoing monitoring of the financial position of banks and will assess banks based on their inherent risks level and the quality of their inherent risks management.
- a new instrument of offsite banking supervision – the desk (offsite) inspections, as well as the grounds and the procedure for them.

To improve the legal regulation of bank licensing processes and to harmonize the relevant provisions with the European legislation, the NBU has adopted the *Regulation on Bank Licensing*. The key novelties in the legal regulation of bank licensing set out in the *Regulation on Bank Licensing* are as follows:

- additional suitability requirements to banks' top managers and independent directors
- liberalization of requirements to opening of standalone units and launching of new business lines
- safeguarding the rights of the persons with reduced mobility.

International Activities of the Authority

The NBU continued to develop its bilateral relations with foreign supervisory authorities.

Within the framework of cooperation with the Bank for International Settlements, the NBU took part in the meetings of the Basel Consultative Group of the Basel Committee on Banking Supervision.

In addition, the NBU was involved in the process of implementation the EU-Ukraine Association Agreement focusing on approximation of national laws to acquis EU in the areas of banking regulation and supervision, AML/CFT, capital market liberalization and the operation of payment systems.

The NBU started new 14-month Stand-By Arrangement (SBA) program with the International Monetary Fund that includes measures aimed at further strengthening the Ukrainian banking sector and further developing the financial markets.

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.

Jointly with the European Central Bank the NBU held the 5-th joint event on SREP Methodology, the next in a series of bilateral meetings.

At the end of the year, the NBU and the National Bank of the Republic of Kazakhstan signed an Agreement on Banking Supervision Cooperation.

Cooperation with Other Supervisory Bodies in the Country

As a banking supervisor, the NBU cooperates with other Ukrainian supervisory authorities. In particular, the NBU has agreements on exchange of information with the National Commission for State Regulation of Financial Services Markets and the National Securities and Stock Market Commission.

Other Relevant Information and Developments

For further information on the NBU's supervisory activities and regulations, please visit the NBU's website at www.bank.gov.ua.

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	96	82	77
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	96	82	77

Total assets of banking sector (at year-end)

Type of financial institution	2016	2017	2018
Commercial banks	1 711 579	1 815 991	1 911 093
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	1 711 579	1 815 991	1 911 093
y/y change (in %)	8.9	6.1	5.2

Ownership structure of banks on the basis of assets total

Item	2016	2017	2018
Public sector ownership	52.5	58.25	53.11
Domestic ownership total	65.34	70.84	66.07
Foreign ownership	34.66	29.16	33.93
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	47.97	58.34	0.118
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	47.97	58.34	0.118

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2016	2017	2018
Commercial banks	-116.05	-15.96	14.54
Cooperative banks	-	-	-
Banking sector, total:	-116.05	-15.96	14.54

Distribution of market shares in balance sheet total (%)

Type of financial institution	2016	2017	2018
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 sector (%) (at year-end)

	2016	2017	2018
Receivables	**100**	**100**	**100**
Financial sector	16.45	14.91	14.42
Nonfinancial sector	47.44	45.15	45.39
Government sector	17.29	22.50	21.91
Other assets	18.82	17.44	18.28
Liabilites	**100**	**100**	**100**
Financial sector	34.15	33.52	34.70
Nonfinancial sector	17.99	18.86	18.24
Government sector	0.47	1.41	1.37
Other liabilities	38.29	36.12	36.36
Capital	9.10	10.09	9.33

Capital adequacy ratio of banks

Type of financial institution	2016	2017	2018
Commercial banks	12.69**	16.16**	17.69**
Cooperative banks	-	-	-
Banking sector, total:	12.69**	16.16**	17.69**

(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	2016	2017	2018
Non-financial sector, including	28.0	33.6	27.9
Households	7.9	5.4	4.1
Corporate	20.0	28.2	23.8

The structure of deposits and loans of the banking sector in 2018 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	94.5	98.8
Households	57.8	18.7
Corporate	36.7	80.1
Government sector	2.5	0.3
Financial sector (excluding banks)	3.0	0.9
Total	**100.0**	**100.0**

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

P&L account	2016	2017	2018
Interest income	133 143	122 977	140 859
Interest expenses	89 142	70 079	67 759
Net interest income	44 001	52 898	73 100
Net fee and commission income	23 777	27 217	37 810
Other (not specified above) operating income (net)	9 364	6 925	8 424
Gross income	186 728	175 509	204 459
Administration costs	38 099	43 158	53 490
Depreciation	3 993	4 630	5 418
Provisions	196 613	44 348	23 705
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	8 951	7 336	5 812
Profit (loss) before tax	38 551	27 376	50 220
Net profit (loss)	-157 534	- 20 194	21 726

Total own funds in 2018 (in EUR)

Type of financial institution	Total** own funds	Core Tier 1	Tier 1**	Tier 2**	Tier 3
Commercial banks	4 298	-	2 906	1 419	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	4 298	-	2 906	1 419	-

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