# BSCEE
# *Review*
# 2015

# INTRODUCTION

The Group of Banking Supervisors from Central and Eastern Europe (the BSCEE Group) was established in 1991. The Agreement of the BSCEE Group was signed during the Stockholm International Conference of Banking Supervisors (ICBS) in 1996. The BSCEE Group is operating according to its Agreement and Operational Bylaws that determine its organizational structure and the rules governing its operations. As of today it is signed by twenty five member institutions from twenty four member countries: Albania, Armenia, Austria, Republic of Belarus, Bosnia and Herzegovina (Banking Agency of the Federation of Bosnia and Herzegovina and Banking Agency of Republika Srpska of Bosnia and Herzegovina), Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey and Ukraine.

The Chairmanship of the BSCEE Group rotates on annual basis. In 2015 Mr. Vladimir Dvořáček, Member of the Bank Board and Executive Director of the Financial Market Supervision Unit of the National Bank of Slovakia chaired the Group.

The BSCEE Group Secretariat, as of January 2006, is located in Poland, at the Polish Financial Supervision Authority and its primary role is to provide technical assistance in organizing conferences, leaders' meetings, workshops and training seminars as well as facilitate cooperation among the member countries, the Basel Committee on Banking Supervision (BCBS) and other international institutions and organizations in the sphere of banking supervision.

According to the previous years' practice, the Annual Review of the BSCEE Group summarizes the developments of the member countries in 2015.

It was prepared on the basis of the information given by the member countries.

This publication gives an overview of the macroeconomic circumstances in the twenty four member states, and it describes the banking sector as well as the supervisory activities.

It should be stated that the combined banking sector of BSCEE Group consists of 2915 financial institutions (including banks and foreign credit institutions). The economies of the member countries are operating in global economic environment and are linked to it, what can be reflected inter alia by the ownership structure of banks – in 19 countries exceeding 50% of banks owned by foreign investors (of which in 6 exceeding 90%). It should also be highlighted that the banks are better capitalized than during previous years – in majority of countries capital adequacy ratios have been rising since 2013.

The Annual Review also summarizes the main events of the BSCEE Group, including the workshops co-organized by the Financial Stability Institute (FSI) and other regional meetings. The 28th Annual Members' Conference was organized by the National Bank of Slovakia in Bratislava on June 24 – 26, 2015.

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

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

*BSCEE Secretariat*

# CONTENTS

## 2015 DEVELOPMENTS IN THE BANKING SYSTEM OF THE MEMBER COUNTRIES

# 2015 DEVELOPMENTS IN THE ALBANIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Year 2015 was overall positive for the Albanian economy. Economic activity continued the upward cycle started in the previous year, employment recorded growth and internal and external economic balances improved. Annual inflation averaged 1.9%, rising 0.3 percentage point from the previous year. Despite the volatility throughout the year, financial markets were characterised by improved liquidity, downtrend in interest rates and stable exchange rates.

Economic growth for 2015 was higher than in the previous year. According to INSTAT data, the Gross Domestic Product rose 2.7% during the first three quarters of the year. The economy benefited from the improvement of the financing conditions, more liquid balances of firms due to the payment of arrears by the public sector, inflows of foreign direct investments, and improvement of businesses and consumers' confidence. On the other hand, economic growth continues to be decelerated by the high uncertainty and unfavourable external environment.

The monetary policy intensified its stimulating stance in 2015, in response to weak inflationary pressures. The key interest rate was lowered twice during 2015, to 1.75% at the end of the year, from 2.25% at the beginning of the year. To reinforce the transmission of the monetary stimulus, the Bank of Albania has increased the liquidity injection. During 2015, the injected liquidity has averaged around ALL 29.5 billion, up by around ALL 5 billion from a year earlier and around ALL 11 billion in the period 2011-2013.

The reduction of the budget deficit and the increasing control over the public debt were the indicating features of a consolidating trend in fiscal policy. In November 2015, the second Eurobond was issued in international markets.

Despite the economy not working in full employment, the economic growth was accompanied by an improvement in the utilisation of production capacities. Thus, pressures on the rise of wages, productions costs and profit margins were weak. Eventhough the level of core prices and inflation in the euro area was low, the inflationary pressures in Albania, lead to an upward trend of the inflation rate, still remaining below the targeted level[1].

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

The banking sector remains the main component of the Albanian financial sector. Sixteen banks continue to operate in the banking sector. As of December 2015, its assets consisted of 91.3% of the Gross Domestic Product (GDP), and compared to the previous year, rose to ALL 1.318 billion (1.9% annual growth from 4.8% a year earlier).

[1] *To read more go to https://www.bankofalbania.org/web/Annual_Report*

The expansion of inter-bank investments and the contraction of provisions, following the write off of loss loans from banks' balance sheets, provided the main contribution to the expansion of the sector's assets. The activity was financed through the increase in deposits of the public, which accounted for 83% of total banking sector assets. Aggregated, deposits in banks, as at the end of the year, increased 2.6%, from 4.5% in the previous year. In 2015, borrowing from parent banks fell at low historic levels.

A positive development is the considerable drop in the non-performing loans indicators of banking sector at the end of 2015 (at 18.2%, from 22.8% in 2014). The mandatory written off of loans which had been categorised for more than three years as loss loans contributed to this improvement as well as other policy initiatives taken.

The banking system had an increasing positive financial result with net profits reaching 15.7 billion ALL, compared with 11.2 billion ALL a year ago. By the end of 2015, the banking system’s capital adequacy ratio stood at 16 % that is notably higher than the 12% required minimum, foreseen in the regulatory framework. Good capitalisation remains a feature of the banking system and it has been maintained due to continued positive values in the net financial result. Banks maintained the required minimum even after the approval of the new rules on capital adequacy ratio, in line with the Basel II[2] approach. The core capital continues to account for 85% of system’s own funds.

## 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 main purpose for the compilation and review of the supervisory regulatory framework during 2015 was to adopt an effective and proactive banking supervision approach in introducing supervisory requirements for risk prevention and management, and implementing the recommendations by international institutions, such as the International Monetary Fund and the World Bank.

The regulatory acts that have been fully revised /approved during 2015:

- Regulation “On capital adequacy ratio” supplemented with the new guidelines “On the recognition of ECAIs” accepted by the Bank of Albania, which also contains the correspondence tables of credit quality degree with the relevant credit assessment realised by the ECAIs, which are known as accepted.
- Regulation “On consumer credit and mortgage credit” was revised to enrich the regulatory framework of the supervision authority in terms of consumer's protection, increase of competition and transparency on the consumer credit and mortgage credit products provided by banks and non-bank financial institutions. This was realised through the adoption of the best practices and alignment with Directive 2008/48EC “On credit

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

agreements for consumers" and Directive 2014/17/EU "On credit agreements for consumers relating to residential immovable property", and amendments to the Law "On consumers' protection".

- Regulation "On internal audit system", was reviewed triggered by the need to review the internal audit cycle and some principles as reviewed by Basel Committee on Internal Audit (2012). This review aimed at further strengthening the internal audit role in banks, by increasing the independence and professionalism, strengthening the relationships and communication between the supervision authority and internal audit unit of banks, and in particular between the business units, supporting units and the internal audit unit (the model of "three lines of defence").

Amendments to regulatory acts during 2015:

- Regulation "On the minimum requirements of disclosing information by banks and branches of foreign bank" was partially reviewed to further align the supervision authority's requirements in the field of market discipline with the European regulation on the credit institutions' activity, and increase the requirements on information disclosure, mainly of the banks remuneration's policies, as laid down in the recent document of the Basel Committee "Pillar 3 - Disclosure requirements for remuneration";
- Regulation "On capital adequacy ratio" was partially amended to extend the deadline into 2016 for the package of measures to improve lending climate in Albania.
- Regulation "On regulatory capital of the bank" was partially amended for the alignment of the regulatory capital with the revised provisions of the European Regulation on the activity of credit institutions, to gradually include in the commercial bank's regulatory capital the Tier 1 capital as a ratio to Tier 2 capital;
- In the light of the current liquidity situation in the system, and the cost materialisation that the entry into force of new requirements on risk concentration management would bring about, the Regulation "On the risk management from large exposures of banks" as amended. These amendments aimed to facilitate the treatment of banks' exposures against supervised institutions as well as Albanian government debt securities in foreign currency;
- Regulation "On the reporting to the Bank of Albania according to the Unified Reporting System", was amended aimed at completing one of the medium-term recommendations of the IMF and WB joint mission, FSAP (2013), for a more detailed information by banks about their direct and indirect shareholders;
- Regulation "On foreign exchange transactions" was amended, in accordance with IMF recommendations on the liberalisation of regulatory requirements on the foreign exchange transactions in the framework of the free capital movement.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

The main strategic directions of the supervisory authority in 2015 were:

- Further development and enhancement of risk-based supervision;
- The harmonization to a greater extend of regulatory and supervisory framework with EU Directives and international standards;
- Improvements of the interactions of the Supervision Department with Financial Stability Department and with other departments in Bank of Albania;
- Strengthening of relationships of Bank of Albania with other local and foreign supervisory authorities;
- Strengthening the banking sector self-regulation and consumer protection.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The attention of the Bank of Albania, during 2015, was focused on providing high standards of corporate governance, risk management and control, in order to maintain the level of banks capitalisation, liquidity and to improve credit portfolio. A positive development in terms of supervisory attention is the considerable drop in the non-performing loans indicators of banking sector at the end of 2015 (at 18.2%, from 22.8% in 2014). The mandatory written off of loans which had been categorised for more than three years as loss loans contributed to this improvement. This process was monitored on an on-going basis.

The assessment of the European Banking Authority for the Bank of Albania's confidentiality regime in 2015 was an important milestone in the work of the Bank of Albania in 2015. The European Banking Authority considered this regime in full compliance with the respective regime of the European Union (EU) and decided to include the Bank of Albania in the supervisory authorities list of non-EU countries, which participate in the banking supervisory colleges of the European Union.

In the framework of implementing the medium-term strategy of the Bank of Albania and the objectives laid down in this document, during 2015, work continued to develop supervisory methodologies, the regulatory framework and the human resources and skills to carry out the supervisory function. The review of the methodology aimed at further restructuring the supervisory procedures based on best international standards and practices. Also, the alignment of the Bank of Albania's regulatory framework with Basel II & III and with the European Union directives continued during 2015, taking into account developments in the domestic banking system. The development of human resources was focused not only in increasing its number, but also in intensifying the training of staff to enhance their knowledge and expertise, in parallel with the sophistication of the regulatory and methodological framework

The most important developments in the supervision activity during 2015 can be summarized as follows:

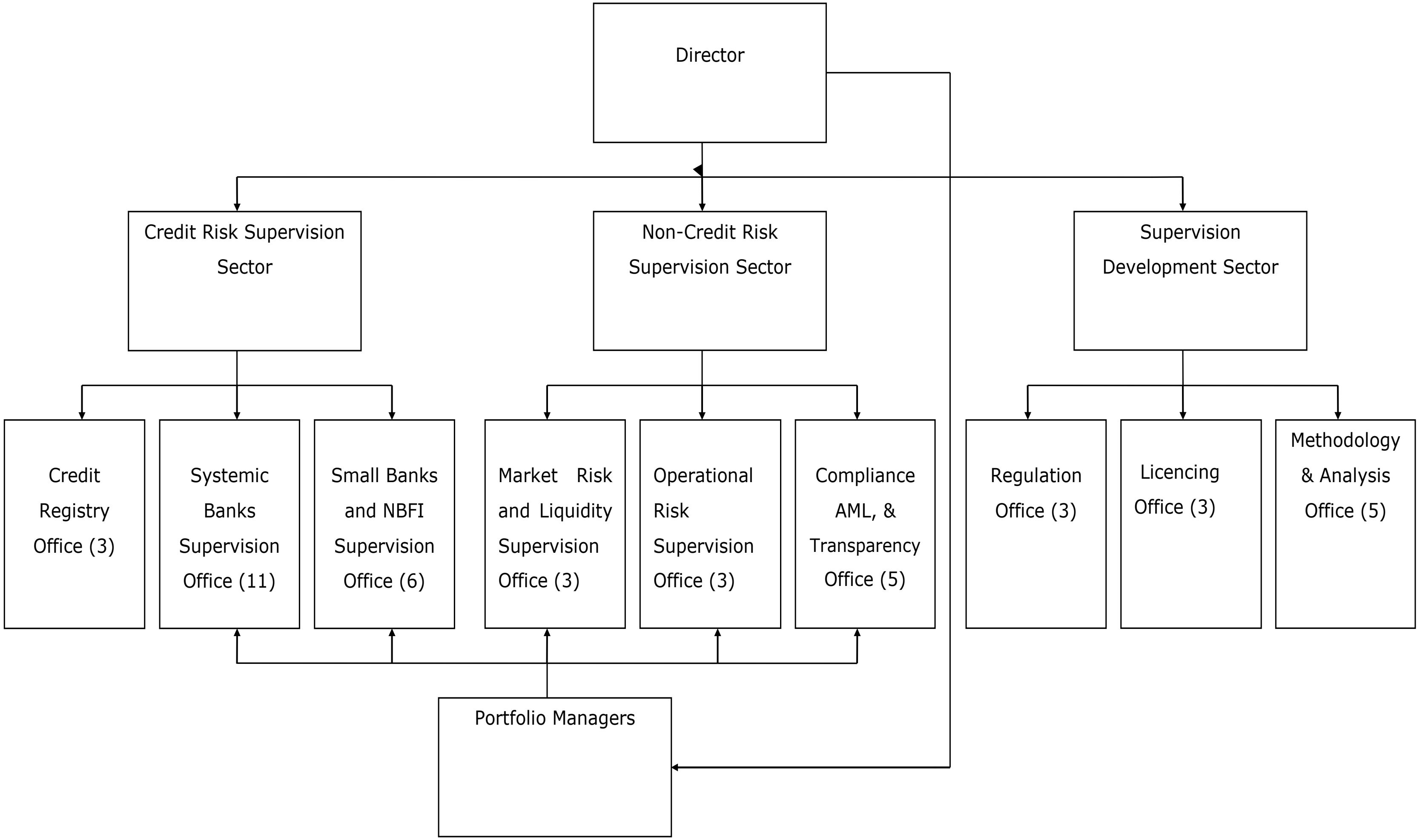
- Implementation of the risk-based supervisory policy which generally brought to a revision of supevisory cycles based on the separation of banks of systemic and non systemic, and a closer approach to the most concerning risks;

- Implementation of risk assessment manual and the new assessment system of banks which marked a qualitative increase of the conducted assessment, clearer identification of problems, and a supervisory practice in compliance with the assessment standards of EU homologous institutions;
- Implementation of the new regulation on calculating the capital adequacy ratio in compliance with Pillar I of Basel II. The impact was closely monitored through special analysis for possible fluctuations in the capital adequacy level of banks.

During 2015, a number of 20 full-scope and partial examinations were performed in banks and 44 examinations in other licensed entities, aiming to provide an overall assessment of banks (through full-scope examinations) as well as to assess the implementation of the regulatory framework (the new Regulation ''On capital adquacy").

BANK OF ALBANIA

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The Bank of Albania has periodically cooperated with the regulatory authorities of Italy, Greece, Austria, Kosovo, etc through the signing of several MoUs with the relevant counterparts. In this regard, during 2015, a joint inspection was organised with the Central Bank of the Republic of Kosovo. The visits and discussions provided for sharing experience and information and strengthening the relationships between both institutions.

The communication with the European Central Bank, the Bank of Greece and parent banks of Albanian banks with greek capital was also important. These communications aimed at sharing the information on the stress-test process, which was followed by the re-capitalisation process. Meanwhile, the comunication with the ECB has been higly intesified during summer 2015, after the negative development in Greece and the consequent effects in Albania.

Also, the Bank of Albania has cooperated with the delegation of the CoE Economic Crime and Cooperation Unit on the technical assessment of the situation in Albania on anti-corruption and money laundering issues. This collaboration took place in the framework of the Agreement between the European Union and the Council of Europe with Western Balkan countries and Turkey, named Horizontal Instrument of Financing, under IPA II.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN ALBANIA

During 2015, the BoA developped several activities, in close cooperation with various public institutions, such as:

- The Albanian Deposit Insurance Agency, through the regional workshops with banks' branches throughout the country, in the framework of the communication and training campaign on data maintaining and public information;
- Ministry of Foreign Affairs, regarding the United Nations SC resolution and the Decision of the Council of Ministers on introduction of sanctions and updating the list of terrorism financing;
- Tirana District Court and the Prosecution Office (in collaboration with judiciary police),
- Gambling Monitoring Unit on blocking the guarantee fund;
- General Directorate of Customs on the execution of guarantees on excises.
- The General Directorate for the Prevention of Money Laundering (GDPML) (a continuous close collaboration through the years), consisting in the share of opinions and expertise during the year.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS

***Platform for addressing non-performing loans***

This platform was initially introduced in October 2013 and was realised in collaboration with consultative companies ADASTRA and TPJ, supported by the World Bank FinSAC project. The purpose of this platform is to find out a sustainable solution for the difficult financial relationships of some large borrowers with the banks of the system. During 2015, many meetings were held with banks to discuss the possibilities to resolve the problems of these borrowers.

***National Plan for reducing non-performing loans in the banking system***

The special attention to reduce the non-performing loans in the system was materialised in drafting a strategy at the national level. This strategy and the plan of measures that followed was a result of the inter-institutional work to identify the legal, regulatory and administrative space for intervention with a view to reduce the non-performing loans in the banking system. The work was finalised upon approval of the plan by the Council of Ministers and the Bank of Albania. The scope of this plan is to review or draft some legal acts related to the bankruptcy, registration and execution processes of loans collaterals, review some Bank of Albania's regulation whose purpose is to improve the management, in particular, of non-performing loans, and in general, of the credit portfolio.

***Package of measures to support lending to economy***

This package of measures was introduced in 2013, and aimed at boosting bank lending to the economy through the incentives consisting in (i) easing of capital requirements upon the increase of credit; and (ii) increasing capital requirements upon the growth of investment in non-resident counterparties. The application of this package was initially decided for 2013-2015. Given its positive results, at the end of 2015, it was decided to extend the effects during 2016 as well.

***Drafting of the law on savings and loan associations***

Year 2015 marked the finalisation of the draft-law “On Savings and Loan Associations and their Unions" by the Bank of Albania, initiated in 2014. In this regard, round tables with savings and loans associations (SLAs) were held to present and consult developments in the new legal framework and respective expectations. These round tables were organised jointly with the World Bank.

***Recovery plans***

Seven banks in the Albanian banking system (systemically important banks), drafted for the first time the recovery plans in compliance with the Bank of Albania's guideline "On Recovery Plans". These plans are drafted to serve as a guideline in the event the institution is subject of financial stress. The submitted plans were assessed during the year, with the assistance of World Bank experts. This process aimed at not only analysing the compliance with the regulatory requirements laid down by the Bank of Albania, but also the drafting of some requirements for approximating the plan with the latest guidelines of the European Banking Authority, Financial Stability Bank of Albania and Directive 2014/59/EU “For the recovery and resolution of credit institutions and investment firms", and with the best practices.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 16 | 16 | 16 |
| Branches of foreign credit institutions | 0 | 0 | 0 |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | 16 | 16 | 16 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 0 | 0 | 0 |
| Other domestic ownership | 9.7 | 10.5 | 12.4 |
| Domestic ownership total | 9.7 | 10.5 | 12.4 |
| Foreign ownership | 90.3 | 89.5 | 87.6 |
| **Banking sector, total** | 100.0 | 100.0 | 100.0 |

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

| Type of financial institution | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 58.25 | 75.01 | 0.15 |
| Branches of foreign credit institutions | n/a | n/a | n/a |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | 58.25% | 75.01% | 0.15 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 6.43% | 10.53% | 13.16% |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | 6.43% | 10.53% | 13.16% |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 100 | 100 | 100 |
| Branches of foreign credit institutions | n/a | n/a | n/a |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 16.07 | 15.31 | 17.15 |
| Nonfinancial sector | 38.58 | 38.53 | 38.37 |
| Government sector | 40.86 | 41.67 | 40.23 |
| Other assets | 4.49 | 4.49 | 4.25 |
| **Claims due to** | | | |
| Financial sector | 3.35 | 3.43 | 2.62 |
| Nonfinancial sector | 82.11 | 82.3 | 82.37 |
| Government sector | 2.14 | 1.97 | 0.98 |
| Other liabilities | 4.03 | 3.72 | 0.71 |
| **Capital** | 8.37 | 8.58 | 9.53 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 17.91%* | 16.84%* | 16.04** |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | **17.91%*** | **16.84%*** | **16.04%**** |

(* - 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* | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector** | 23.49 | 22.80 | 18.22 |
| **- households** | 16.71 | 16.50 | 13.32 |
| **- corporate** | 27.69 | 26.70 | 21.43 |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | | |
| Households | 85.12 | 26.38 |
| Corporate | 12.48 | 68.60 |
| Government sector | 2.40 | 5.02 |
| Financial sector (excluding banks) | n/a | n/a |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 74,310.07 | 67,077.22 | 63,408.48 |
| Interest expenses | 34,778.01 | 22,455.99 | 14,424.79 |
| Net interest income | 39,532.06 | 44,621.22 | 48,983.69 |
| Net fee and commission income | 6,471.66 | 7,028.58 | 7,566.37 |
| Other (not specified above) operating income (net) | -1,029.38 | -1,086.13 | -1,054.93 |
| Gross income | **35,109.85** | **39,456.84** | **44,939.64** |
| Administration costs | 26,223.19 | 11,819.42 | 25,871.61 |
| Depreciation | N/A | N/A | N/A |
| Provisions | 14,797.33 | 11,819.42 | 11,644.08 |
| 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 | 7,900.25 | 13,992.98 | 18,028.32 |
| Net profit (loss) | 6,563.95 | 11,192.28 | 15,699.05 |

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 935.87*** | 800.65*** | 800.55*** | 135.32*** | n/a |
| Cooperative banks | n/a | n/a | n/a | n/a | n/a |
| **Banking sector, total:** | 935.87*** | 800.65*** | 800.55*** | 135.32*** | n/a |

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

*Note: As of April 30, 2015, the own funds have been calculated in accordance with Basel III requirements.*

# 2015 DEVELOPMENTS IN THE ARMENIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2015, the financial system of Armenia faced a number of emergent shocks transmitted from external economy. This has negatively affected the stability of financial markets and the growth pace of banking sector indicators. Due to mutually agreed actions of the Central bank of Armenia and Armenian government, the situation was quickly stabilized in the first quarter of the year and measures were taken in order to subsequently mitigate risks.

In 2015, the decline of base metals' prices in international markets, the dollar value of exports from Armenia, domestic consumption as well as foreign investments continued. Given the geopolitical developments, the economic growth of Russia weakened, which in turn negatively affected the volumes of inflow of private remittances to Armenia and exports to Russia.

Economic developments in Armenia's main trade partners, some countries of the European Union and Russia have been unfavorable, and their negative impact on the domestic economy persists.

In 2015, economic growth in Armenia was 3.0% (3.4% in 2014). The main contributors to the growth were higher-than-forecasted increases of agriculture and industry. The relatively expansionary fiscal policy of the Armenian government and considerable easing of monetary conditions by the Central bank of Armenia contributed to economic activity, thus mitigating the negative effect of the decline of private spending and private investments.

The lending to economy reduced caused by persistent risks to economic growth stabilization and fall in private remittances. In the period under review, the regulatory requirement of total capital adequacy and liquidity has grown, due to decline of risk weighted assets, capital growth and drop in lending.

Though on an upside track, risks in the financial system remain manageable in terms of financial stability.

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

As of 31 December, 2015, 21 commercial banks and one development bank (Panarmenian Bank OJSC) operated in Armenia. The banking sector of Armenia accounts for 89.2% of the financial system assets.

The banking system assets to GDP ratio has decreased by 6.0 pp. relative to the previous year and amounted 68.5%. The ratio of loans to economy to GDP has also decreased by 5.5 pp. and amounted 39.8 %. The deposits to GDP ratio has decreased by 0.2 pp., and reached 35.5 %.

During the year, total capital of the banking sector has grown by 9.6% (AMD[3] 44.9 billion) and amounted to AMD 514.0 billion. 9 banks made

[3] EUR/AMD exchange rate = 528.69

replenishment of their statutory capital in the amount of AMD 74.0 billion, AMD 68.4 of which was replenished from external sources.

Non-resident participation in the statutory capital of the banking sector has decreased by 1.2 p.p. to 67.7%.

### ***Banking System Capital Adequacy***

In 2015, commercial banks' total capital adequacy ratio increased by 1.7 p.p. to 16.2%, which was driven by the growth of total capital. All the banks maintained capital adequacy ratio within the required prudential threshold (12%).

The share of Tier 1 capital in total regulatory capital decreased by 1.3 p. p. to 86.2%.

The share of credit, market and operational risks in the structure of risk weighted assets was respectively 89.1%, 7.3% and 3.6% (as of 31.12.2014 the indicators were respectively 89.9%, 7.2% and 2.9%).

### ***Banking System Liabilities***

In 2015, total liabilities of the banking system remained almost at the same level and amounted to AMD 2 trillion 943 billion.

Dram liabilities decreased by 0.9 % and foreign exchange liabilities increased by 0.5 %. As a result, the share of foreign exchange liabilities increased by 0.3 p.p. to 65.7 %.

### ***Banking System Assets***

At the end of 2015, total assets of the banking system increased by 1.4 % and amounted AMD 3 trillion 457 billion at the end of the year. Growth of assets was mainly driven by the growth of claims against CBA.

Compared with the previous year the loans to economy decreased by 3.0 % and amounted AMD 2 trillion 11.1 billion.

Relative to the previous year, the share of non-performing loans and receivables in total loan and receivables portfolio grew by 1.0 p.p. to 7.4%.

### ***Financial Performance***

In 2015 the net loss of the banking system, calculated in accordance with the Central Bank supervisory reports, amounted to AMD 20.7 billion. During the year, 15 banks reported profit and 7 banks incurred losses. Return on assets (RoA) and return on equity (RoE) of the banking system amounted -0.6% and -4.3%, respectively.

The decrease in banking system profitability is mainly conditioned by the growth of net loss provisions to assets ratio owing to decrease of loans performability and the decline of net interest margin owing to interest rate spread decrease.

The banking system net profit, calculated in accordance with International Financial Reporting Standards (IFRS), amounted to AMD 17.7 billion, while the return on assets (RoA) was 0.5 % and return on equity (RoE) 3.5 %.

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

***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.

***New developments***

Along with differentiation of reserve requirements for short and long term funds in order to encourage attraction of long term funds, in 2015 the requirement rates of long term funds were decreased by CBA.

Measures taken in 2015 to protect depositor interests and enhance consumer confidence in the banking system included increasing the deposit guarantee limits from AMD 4 million to AMD 10 million for local currency deposits of individuals and from AMD 2 million to AMD 5 million for foreign currency deposits of individuals.

# MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

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

In 2015, the supervision of the financial institutions was focused on the following areas: asset quality assessment, internal control system, legal compliance, risk management system, integrity of corporate management principles, compliance with the requirements relating to security and sustainability of business operations, IT area, transparency,compliance of organizations to the changes of regulatory framework, level of reinsurance risk organization and supervision of registration procedures of the prospectus supervision of assuring the transparency, completeness and reliability of information to be published by the reporting issuers, supervision of compliance with the legislation of the operations of persons engaged in the public offering of securities, combat against money laundering and terrorism financing, consumer rights protection, prevention of operations by non-licensed entities, quality control of rendered services.

During 2015, the Central Bank has been working on the improvement of the supervision of financial institutions.The aim of such works is to complete the transition to risk-based supervision (RBS) model. CBA has already initiated works on implementation of RBS model, with support of specialists from Toronto Centre and the Central bank of the Netherlands. After preparing the manuals and guidelines describing the new supervisory model, during 2015, CBA developed RBS implementation plan for the next 3 years. Following ther plan, pilot testing has been done in 3 commercial banks.

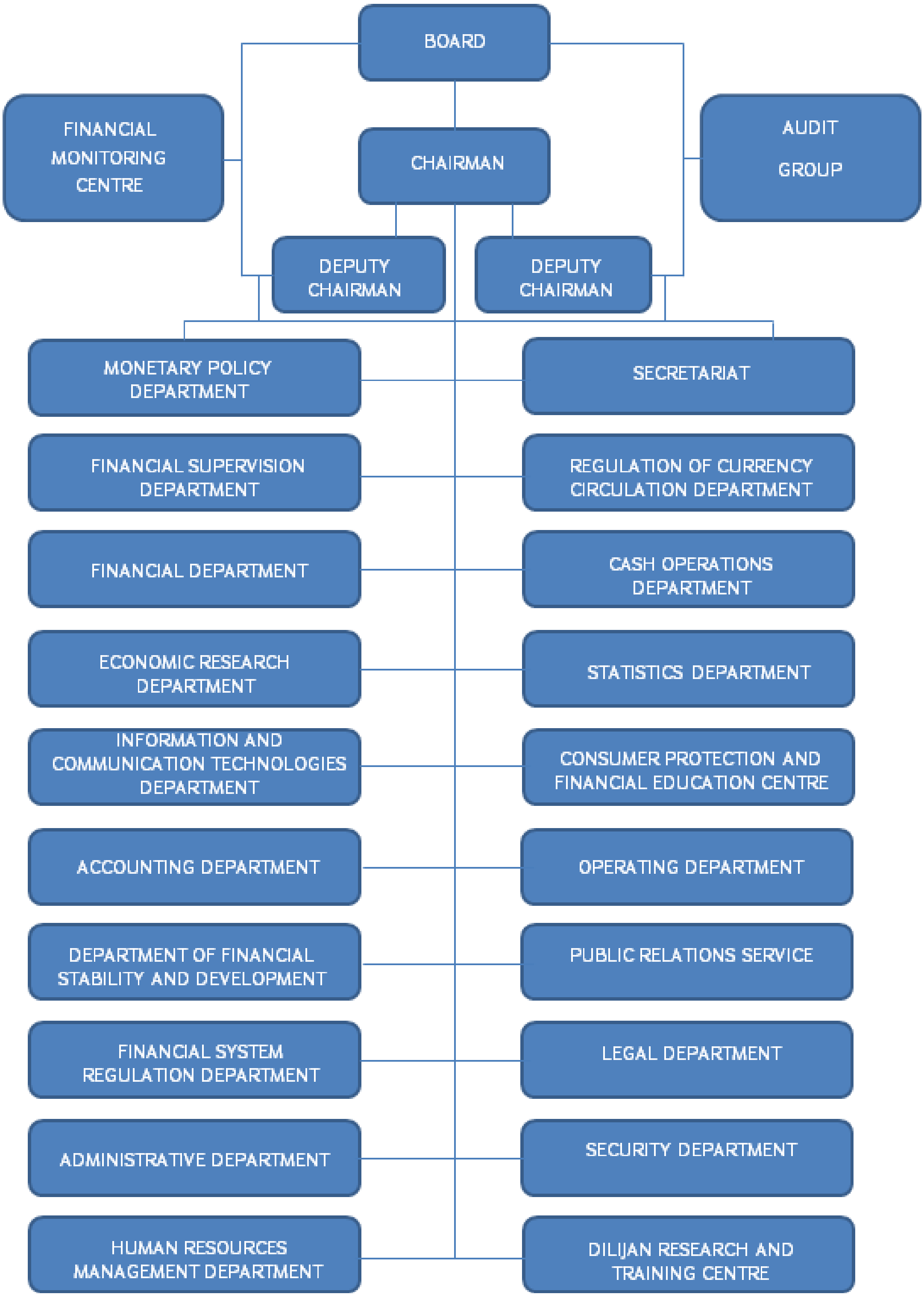
## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2015 the Bank continued supervision through off-site and on-site inspection over the activities of financial institutions with the aim to further maintain financial system stability, evaluate financial market participants' exposure to risks, make sure the legal and normative framework complies with international standards and an effective framework for combatting money laundering and terrorism financing is in place as well as interests of consumers in the financial market are duly protected.

In 2015, the Financial Supervision Department of the Central Bank performed both off-site and 129 on-site inspections.

Compared with the previous year, in 2015 the number of infringements of banks dropped in total number of infringements identified during on-site and off-site inspections performed by the Central Bank Financial Supervision Department. Conversely, compared to the previous year, the number of penalties increased.

# ORGANIZATIONAL CHART OF BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In 2015 the Bank sustained its multilateral and bilateral cooperation with international organizations and institutions elsewhere in the world.

In February 2015 an International Monetary Fund mission, headed by Mark Horton, visited the Bank. A number of issues relating to the bilateral cooperation, current economic situation in Armenia, fiscal and monetary policies were discussed during the visit. In the framework of cooperation with the IMF, the Bank received the delegation of Masood Ahmed, an IMF Regional Director. Enhancing Armenia's international reserves, reducing public debt, maintaining stability of the banking system were the coverage of this visit.

During the year the Bank received delegations and representatives from international financial institutions and agencies, including International Finance Corporation, European Investment Bank, Eurasian Development Bank, European Bank of Reconstruction and Development, Alliance for Financial Inclusion, as well as Head of the EU Delegation Office Traian Hristea, and experts from Moody's, an international rating agency, to expand business contacts, learn about the country's macroeconomic situation and negotiate with the Bank.

In 2015 the Bank organized a series of business meetings, sessions, roundtables and conferences. In particular, the meeting of Eurasian Economic Union's Member States and Eurasian Economic Commission's Consultative Committee for Financial Markets took place in capital Yerevan.

In 2015 the Dilijan TRC hosted the 11th Advisory Panel Meeting on Currency Policy of Central (National) Banks of EEU Member States. The other event taken place here was International Conference for Legal Counsels in the Framework of the Central Banks Governors' Club of Central Asia, Black Sea Region and Balkan Countries. The conference participants, a total of 24, were representing Albania, Belarus, Bulgaria, Croatia, Czech Republic, Kazakhstan, Kyrgyz Republic, Macedonia, Montenegro, Poland, Romania, Russia, Tajikistan, Serbia, and China.

In 2015 the Egmont Group convened the 23rd plenary meeting. The FMC representatives participated in the event for discussing a bunch of issues, including drafting a guideline along with FATF based on the national information accessibility program and information exchange with financial intelligence units of foreign countries, and preparing status reports on Turkmenistan and Islamic Republic of Iran in connection with their membership to the Egmont Group.

In 2015 the Bank inked more agreements and memoranda of understanding with central banks of other countries in the framework of bilateral and intergovernmental commissions.

Highlighting the importance of international cooperation in maintaining the development and reliability of Armenia's payment and settlement system, a cooperation agreement was signed in 2015 between the Bank and the Central Bank of the Russian Federation for joint oversight of payment systems.

In 2015 the Bank sustained its cooperation with the World Bank, KfW Bank, European Investment Bank, Asian Development Bank and other international organizations in the context of lending projects in a number of target sectors of the economy.

The "Bilateral Currency Swap Agreement between the Central Bank of Armenia and People's Bank of China" was signed by and between the Bank and the People's Bank of China in Beijing on March 25, 2015.

In March 2015 the Bank's Dilijan TRC hosted a course of qualification of evaluation experts in the field of AML/CFT, arranged by the Council of Europe's MONEYVAL Committee representatives.

The FMC continued enhancing ties with FIUs of other countries. For efficient cooperation, the FMC signed a memorandum of understanding with the FIU of Kazakhstan. On a basis of renewed version of the memorandum of understanding proposed by the Egmont Group, the FMC re-signed previous memoranda of understanding with FIUs of the Russian Federation and Croatia. As of 2015, the FMC has memoranda of understanding signed with FIUs of 31 countries.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN ARMENIA

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

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

In 2015, CBA proceeded with large scale of actions aimed at development of a methodology for regulation of systemically important banks, increase of financial inclusion, as well as the implementation of Basel III standards and principles, particularly the new approaches to liquidity risk management: the net stable funding ratio (NSFR) and theliquidity coverage ratio (LCR). To this effect, starting from August 2015, banks file monthly reports to the Central bank. This allows CBA to assess whether implementing one normative requirement or another is appropriate as well as to identify problems inherent in the domestic banking system and offer solution thereto.

Also, the continuing work is being done on the final implementation of risk-based supervision.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 22 | 22 | 22 |
| Branches of foreign credit institutions | 0 | 0 | 0 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total:** | **22** | **22** | **22** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 3.0 | 2.67 | 2.23 |
| Other domestic ownership | 22.4 | 30.81 | 30.10 |
| Domestic ownership total | 25.4 | 33.48 | 32.33 |
| Foreign ownership | 74.6 | 66.52 | 67.67 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

### Concentration of asset by the type of financial institutions

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 35.60 | 51.66 | 0.08 |
| Branches of foreign credit institutions | n/a | n/a | n/a |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | **100** | **100** | |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 9.07% | 4.6% | -4.35% |
| Cooperative banks | n/a | n/a | n/a |
| Banking sector, total: | 9.07% | 4.5% | -4.35% |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 100 | 100 | 100 |
| Branches of foreign credit institutions | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Claims from | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Financial sector** | 27.10 | 25.40 | 28.81 |
| Nonfinancial sector | 59.53 | 61.54 | 58.52 |
| Government sector | 7.56 | 6.82 | 7.16 |
| Other assets | 5.47 | 5.81 | 6.05 |
| **Claims due to** | **2013** | **2014** | **2015** |
| Financial sector | 10.99 | 15.55 | 12.55 |
| Nonfinancial sector | 37.18 | 36.34 | 40.47 |
| Government sector | 2.00 | 1.59 | 1.34 |
| Other liabilities | 35.10 | 34.83 | 32.38 |
| **Capital** | **15.41** | **13.49** | **14.35** |

### Capital adequacy ratio of banks

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 16.7% | 14.5% | 16.2% |
| Cooperative banks | n/a | n/a | n/a |
| **Banking sector, total:** | 16.7% | 14.5% | 16.2% |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 4.6% | 6.8% | 7.9% |
| **- households** | 5.5% | 6.4% | 8.1% |
| **- corporate** | 4.3% | 6.3% | 7.9% |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | | |
| Households | 66.98 | 38.90 |
| Corporate | 27.08 | 59.25 |
| Government sector | | |
| Financial sector (excluding banks) | 5.94 | 1.85 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 468 567 | 482 817 | 572,701.17 |
| Interest expenses | 248 327 | 259 488 | 355,583.55 |
| Net interest income | 220 240 | 223 330 | 217,117.62 |
| Net fee and commission income | 56 853 | (56 530) | (44,554.82) |
| Other (not specified above) operating income (net) | 535 556 | 323 205 | 593,807 |
| Gross income | 944 983 | 1 045 415 | 1,339,070.83 |
| Administration costs | 93 518 | 97 004 | 104,609.56 |
| Depreciation | 21 710 | 21 053 | 23,634.71 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 136 105 | 167 118 | 116 876 |
| Profit (loss) before tax | 90 676 | 51 263 | (30,564.68) |
| Net profit (loss) | 70 171 | 36 687 | (39,029.11) |

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total oun funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 972,309 | 897,575 | 773,739 | 123,835 | |
| Cooperative banks | | | | | |
| **Banking sector, total:** | | | | | |

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

# 2015 DEVELOPMENTS IN THE AUSTRIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

At annual real GDP growth rates of less than 1%, **economic activity** in Austria has been **very moderate** rate since 2012. While the economy had not dipped into a renewed recession in 2012–13 unlike several other euro area countries, it registered very moderate growth in 2014, and above all in 2015, compared with the euro area as a whole. Real GDP growth did not go beyond 0.7% in 2015 (trend-cycle component, adjusted for seasonal and working-day effects).

However, the weak annual growth rate for 2015 masks a **gradual rise in economic momentum during the year**. This increase has been driven mainly by the growth of gross capital formation, above all by the growth of investment in plant and equipment. Also, the decline in housing investment flattened in 2015. **Export growth** also **picked up considerably** between the fourth quarter of 2014 and the third quarter of 2015. Given the concomitant sharper rise of import growth, the contribution of net exports to GDP growth remained limited, though. **Real private consumption** was **dampened** by the decline in real disposable income and by pessimistic consumer sentiment. Private consumption demand has in fact been stagnating since the end of 2013.

Despite a weak economy, **employment continued to grow** at a surprisingly healthy pace in 2015, as in previous years. The number of employees rose by 0.7% on 2014. Given the rise in the total labor force, the jobless figures continued to rise as well, though, to levels that at the end of 2015 exceeded the peaks recorded during the economic crisis of 2009.

According to the OeNB's economic outlook of end 2015, the Austrian **general government deficit improved significantly** in 2015, to −1.6% of GDP, from −2.7% GDP in 2014. On the one hand, this improvement reflects a decline in capital transfers to HETA, the asset resolution vehicle created by the Austrian authorities for the failed Hypo Group Alpe Adria. On the other hand, higher-than-expected tax revenues more than offset additional spending for refugees.

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

The **consolidated net profit** of Austrian banks amounted to EUR 5.2 billion in 2015, **significantly higher** than the corresponding figure in 2014, which was compressed by write-downs and losses from restructuring. The return on average assets increased to 0.6%. This was to a large extent attributable to lower credit risk provisions and one-off effects that reduced operating expenses. The Austrian banking sector slightly improved its operating efficiency in 2015. The cost-to-income ratio strengthened from 69% in 2014 to 63% as of end-2015.

The **negative impact of the low interest rate environment** is getting visible only gradually (as higher-yielding assets and liabilities mature). The average interest margin in Austria decreased slightly in 2015 to 109 basis points.

The reduction in net interest income was mainly driven by reduced volumes rather than by lower yields.

The **asset quality** of Austrian banks' domestic **loan portfolio remained stable** in 2015, due to improvements in the second half of the year. Quality of retail loans increased markedly and the quality of domestic corporate loans only deteriorated slightly. Asset quality - on a consolidated level - improved due to a **mild reduction of NPLs at Austrian subsidiaries in CESEE**.

Stepped-up supervisory efforts aimed at curbing FX-lending have proven to be effective, as outstanding FX loan volumes in Austria continued their year-long downward trend. Between October 2008 and December 2015, **FX loans** to domestic nonfinancial borrowers **declined** by almost 42%. The associated exchange rate adjusted reduction amounted to 55%. In line with the ongoing downward trend of FX lending in Austria, Austrian banks have also continued to reduce their FX loans in CESEE.

Austria banks increased their CET1 capital in 2015 by 3.3%. At the same time RWAs have been falling. As a consequence, the **CET1 ratio** of the Austrian banking system **improved** to 12.7%

In 2015, **total assets** of the Austrian banking system (on a consolidated level) **decreased** by 2% yoy to 1,057 bn EUR. This was the fourth decline in a row. As a consequence, the size of the Austrian banking sector was reduced to 319% of the Austrian GDP.

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

The FMA is an independent, autonomous and **integrated supervisory authority** for the Austrian financial market, established as an institution under public law. It is responsible for supervising credit institutions (together with the European Central Bank – ECB), payment institutions, deposit guarantee schemes, insurance undertakings, pension companies, corporate provision funds, investment funds, licensed investment service providers, credit rating agencies and stock exchanges, as well as for prospectus supervision. The FMA is also responsible for monitoring trading in listed securities to ensure that this is carried out properly and for monitoring issuers' compliance with information and organization obligations. Further tasks include combating the unauthorised provision of financial services and taking preventive action against money laundering and terrorist financing. Thus, in its capacity as a cross-sectoral integrated supervisory body, the FMA is responsible for addressing the challenges created by a high degree of interweaving within the Austrian financial market due to ownership structures, sales cooperation agreements and financial transactions.

With the **Single Supervisory Mechanism (SSM)** in place, banks in the participating Member States are now supervised by means of a decentralized system involving close cooperation between the ECB and the National Supervisory Authorities (NCAs). The FMA is the NCA in Austria. Since the SSM was launched on 4. November 2014, eight Austrian banking groups in total have been classified as "significant institutions" (SIs), resulting in around 150 individual credit institutions being placed under the direct supervision of the ECB. SI supervision takes place in so-called Joint Supervisory Teams (JSTs), consisting of the relevant NCAs and chaired by the ECB. The remaining credit institutions based in Austria, classed as "less significant institutions" (LSIs) continue to be supervised directly by the FMA. This means that the FMA remains directly responsible for around 550 of Austria's credit institutions. For its part, the ECB only carries out indirect supervision in this regard. When supervising the LSIs, the FMA also bases its approach on the rules applicable throughout the SSM. In case of common procedures (granting and withdrawal of authorisations, qualifying holdings procedures), the decision-making competence for both SIs and LSIs lies exclusively within the ECB. However, the FMA is the entry point for notifications and prepares draft decisions for the ECB.

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 European Bank Recovery and Resolution Directive (BRRD) has been transposed into Austrian national law by the Austrian Bank Recovery and Resolution Act (*Bankensanierungs- und* Abwicklungsgesetz – *BaSAG*) and assigns the newly created role of National Resolution Authority (NRA) to the FMA. The main responsibilities of the NRA are resolution planning, the analysis and elimination of obstacles to resolution, and the conducting of resolution procedures in cases of credit institutions that have failed or are likely to fail. As the NRA for Austria, the FMA is an integral part of the SRM.

Lastly, the FMA is the National Designated Authority (NDA) for all **macro-prudential tasks and responsibilities**.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

The banking supervision department of the FMA has set the following goals for the year 2015:

- contributions towards the functioning of the SSM;
- particular attention to banking supervision activities in relation to less significant banks (LSIs) within the new institutional environment;
- fulfilment of additional duties conferred upon the FMA following the national implementation of the BRRD with regard to recovery plans;
- successful involvement in drawing-up and refining of Binding Technical Standards (BTS) and Guidelines (GL) on a European level;
- increased effectiveness of communications, cooperation and knowledge transfer (both internally and externally);
- competent and orderly handling of complex supervisory cases

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

### *Licensing processes*

The granting of licences to institutions subject to the Capital Requirements Regulation (CRR) now falls exclusively within the competence of the ECB. These CRR institutions are SIs or LSIs that are licensed to receive funds from the public and also to issue loans. Although it is the ECB that makes the final decision on whether to award a banking licence, applications for the process to be initiated must still be submitted to the FMA. The FMA is responsible for subsequently forwarding the application, along with a draft decision and the relevant documents, to the ECB for an official decision. The FMA continues to be the sole competent authority for the licensing of all credit institutions that are not subject to the CRR and of all payment and e-money institutions.

***Ownership provisions and approvals***

Any person intending to acquire or sell a qualifying holding in a credit institution must notify the FMA. Such a sale or acquisition can be prohibited within 60 working days. This applies where the new owners do not meet the requirements set in the interests of the sound and prudent management of a credit institution. A total of eleven notifications of a planned acquisition of holdings in an Austrian credit institution or payment institution were submitted to the FMA in 2015 and assessed in cooperation with the ECB. Eight resulted in the acquisition not being prohibited. There was one instance of an acquisition being prohibited. The proceedings in the remaining two cases had not yet been completed at the end of 2015. The FMA also approved ten mergers of credit institutions and three demerger during the reporting period.

***Obtaining of information for supervisory purposes***

To enable the FMA to duly fulfil their official tasks, credit institutions in Austria are subject to extensive ex lege reporting, notification and information obligations. Also, the FMA actively approaches the supervised banks. The FMA may request information at any time from the supervised credit and payment institutions. There were 445 instances of information being obtained or of documentation being inspected in this context in 2015.

The FMA holds regular discussions with all the bank auditors of Austrian credit institutions. Of particular relevance in this regard are the **meetings with the auditing associations of the decentralised sectors**, held at regular intervals, as well as the **meetings with the bank auditors**, held at least once every quarter, and ad-hoc meetings. The FMA further holds meetings, referred to as early recognition meetings, with representatives of the protection schemes for each of the sectors. Leaving aside ad-hoc meetings with the bank auditors, 41 bank auditor and early recognition meetings were held in total in 2015.

Other key sources of information are **on-site inspections** at credit institutions. Therefore the FMA issued a total of 32 inspection mandates to the OeNB in 2015, the main focuses of which were counterparty risk and overall risk management on the part of banks. The fall in the number of inspection mandates compared with earlier years can be attributed to the fact that, as a result of the setting-up of the SSM, significant institutions are now supervised by the ECB, which is therefore also responsible for planning and carrying out on-site inspections of SIs.

In view of the significance of the CESEE region for Austrian credit institutions, on-site inspections of credit institutions in that region have been conducted with greater frequency within the framework of consolidated supervision. Such inspections are held with the consent of the national competent authority in the particular case and of the ECB where required.

Additionally, the FMA conducts regular **structured talks with the management** of the credit institutions. Such talks represent a valuable source of supplementary information. Management talks held at major banks according to a set schedule play a significant role in routine analysis. One of the purposes of the meetings is to maintain contact with the management of credit institutions and to examine in greater detail their risk assessment and strategy. Depending on the issue being focused on, a distinction is made in this context between management talks and risk talks. During the period under review, 50 such talks were held in total.

***Supervisory Procedures***

In accordance with its statutory mandate, the FMA is responsible for monitoring compliance with statutory provisions pertaining to banking, for ascertaining facts in cases involving the endangering of creditors' interests and for introducing appropriate remedial measures where necessary. The relevant statutory provisions in this regard are Article 70 BWG and Article 64 ZaDiG, which provide the FMA with the means of implementing these objectives, including **powers to intervene and impose sanctions**.

If there is a **risk of a credit institution or payment institution being unable to fulfil its obligations to creditors and customers**, pursuant to Article 70 para. 2 BWG the FMA may prohibit distributions of capital or profits, appoint a government commissioner, relieve directors of their duties or prohibit the further pursuit of business activities. The FMA ordered such measures on two occasions in 2015.

One official power that is particularly relevant in practice is the one specified in Article 70 para. 4 BWG. In cases where **a licensing requirement is no longer met or where a credit institution violates provisions of the BWG** or another specific law, the FMA may introduce measures as described in the following. Firstly, the credit institution will be issued with a request to restore compliance with the statutory provisions or be subject to a coercive penalty. Should the institution fail to comply with this request, the FMA is required to completely or partially prohibit the directors from managing the business, except where such would be an inappropriate measure given the type and severity of the breach and it is expected that renewed imposition of the first measure will result in compliance with the statutory provisions. In such a case, the FMA is required to impose the threatened coercive penalty and to reissue the request under threat of a more severe penalty. If these measures are not sufficient to guarantee the ability of the credit institution to function, the institution's license is to be revoked as a last resort. On nine occasions during the period under review, the FMA ordered credit institutions, under threat of a coercive penalty, to establish compliance with statutory provisions within an appropriate period of time.

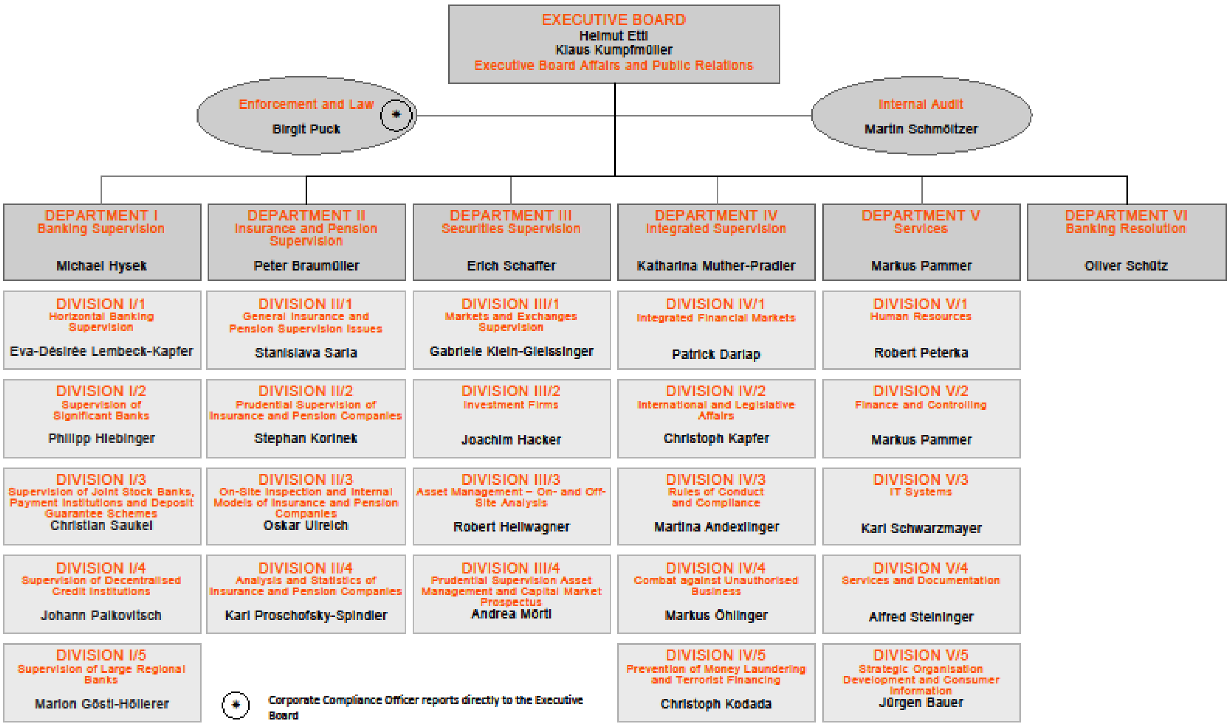
Further supervisory measures are contained in Article 70 para. 4a to 4c BWG. Where for a credit institution, affiliation of credit institutions or group of credit institutions the risks arising from banking transactions and banking operations are inadequately limited, and where such risks are not expected to become limited in the short term, the FMA must, irrespective of any other measures, impose a minimum capital requirement that is higher than the statutory minimum capital requirement ("**capital add-on**" measure). A capital add-on was required once during the year under review. Additionally, one measure pursuant to Article 70 para. 4a no. 9 BWG was imposed (**restriction of distribution of capital/profits**).

A further official measure intended to enforce compliance with the statutory provisions is specified in Article 97 BWG. Specifically, the FMA is required to charge **interest in the event of breaches of the law** involving failure to comply with thresholds, either by exceeding or falling below them. This occurs in cases where, for instance, limits for large exposures are exceeded or the minimum capital requirement is not met. One of the intentions here is to negate any competitive advantages that arise through disregarding provisions of law by skimming off economic gains. Interest was charged in 23 such cases (pursuant to Article 97 BWG) in 2015.

***Consolidated Supervision and Colleges***

Colleges of supervisors are a key instrument for the consolidated supervision of cross-border credit institutions. These colleges are where joint decisions are taken during model approval procedures, while also serving as a forum for discussing issues related to ongoing supervision in the context of overall risk management. The members of the college, specifically the home supervisor and all host supervisors, must arrive at a “joint risk assessment” for the particular group of credit institutions every year. Based on this assessment, a joint decision is made regarding capital adequacy. This is referred to as the Joint Risk Assessment and Decision Process (JRAD process). Based on this decision, the members of the college annually stipulate a supervisory action plan, defining the further procedures of the supervisory authorities in the case of the particular banking group. Colleges within the SSM are carried out by the JSTs and are therefore not included in the FMA statistics.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY.[4]




[4] Please note that the FMA is an integrated supervisory authority, therefore banking supervision is one of five departments in the FMA – see also answer to question 3. The new Department VI (Banking Resolution) is organised as a separate Department only as of 1. January 2016 due to the competences of the FMA as the National Resolution Authority.

## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The FMA attends the Integrated Financial Supervisors Conference (IFSC) on a regular basis as well as meetings of the Basel Consultative Group (BCG), a subgroup of the BCBS.

In addition, the FMA is part of the European cooperation within the European System of Financial Supervision (ESFS) as well as National Competent Authority within the Single Supervisory Mechanism (SSM) and National Resolution Authority within the Single Resolution Mechanism (SRM).

## COOPERATION WITH OTHER SUPERVISORY BODIES IN AUSTRIA

In handling official activities related to supervision, the FMA must, as far as possible, draw on analyses and inspection results as well as the results of the expert opinions prepared by the Oesterreichische Nationalbank (OeNB) during model approval procedures, in addition to using information from third parties or from the respective bank. The collaborative setup calls for intensive, timely coordination between the two institutions. This reconciliation process is supported by a database, the joint information system. Various reporting data, relevant information available from the FMA's supervisory activities as well as data and results of OeNB analyses are filed in this database. This close cooperation continues within the framework of the SSM and the SRM.

In line with the macro-prudential measures set out in the CRD IV the Financial Market Stability Board (Finanzmarktstabilitätsgremium) has been established. Its main tasks are to promote financial market stability, reduce the systemic threat and lower the systemic and procyclical risks. It consists of representatives of the Federal Ministry of Finance, the FMA, the OeNB as well as the Fiscal Council. In accordance with the European Systemic Risk Board (ESRB) warnings and recommendations, the Financial Market Stability Board should act on a possible threatening of the Austrian financial stability amongst others with warnings and recommendations.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

***Common Deposit Guarantee Scheme***

With the Deposit Guarantee Schemes and Investor Compensation Act (*Einlagensicherungs- und Anlegerentschädigungsgesetz – ESAEG*) entering into force on 15. August 2015 as the transposition of the Directive 2014/49/EU on Deposit Guarantee Schemes, the FMA has also been assigned supervision of Austrian deposit guarantee schemes (DGSs). Among others, the FMA has a right to inspect and request information, may arrange for on-site inspections to be carried out and order the restoration of legal compliance.

Until the single national deposit guarantee scheme becomes effective on 1. January 2019, the five existing sectorspecific protection schemes will continue to operate during the transition period.

### *FATF country evaluation*

The FATF country evaluation took place between May 2015 and June 2016. The methodology for evaluating effectiveness in implementing the FATF standards is based on a catalogue of objectives that encompasses three levels. At the highest level, the objective is that financial systems and the broader economy are protected from the threats of money laundering and the financing of terrorism and proliferation, thereby strengthening financial sector integrity and contributing to safety and security. In the context of the country evaluation, the FATF assessors made a two-week on-site visit to Austria in November 2015. Following a period of commenting lasting several months, the country report is being finalised in June 2016.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 190 | 183 | 180 |
| Branches of foreign credit institutions | 30 | 30 | 30 |
| Cooperative banks | 570 | 551 | 529 |
| **Banking sector, total:** | **790** | **764** | **739** |

Source: OeNB, unconsolidated data.

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 9.7 | 10.3 | 7.8 |
| Other domestic ownership | 66.7 | 63.1 | 67.4 |
| Domestic ownership total | 76.3 | 73.4 | 75.2 |
| Foreign ownership | 23.7 | 26.1 | 24.8 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

Source: OeNB, unconsolidated data.

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 39.7 | 48.9 | 769 |
| Branches of foreign credit institutions | 64.4 | 74.3 | 2,619 |
| Cooperative banks | 38.2 | 48.0 | 639 |
| **Banking sector, total:** | **27.8** | **35.3** | **386** |

Source: OeNB, unconsolidated data.

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | -5.3 | -17.8 | 7.5 |
| Cooperative banks | 4.7 | -0.8 | 3.7 |
| **Banking sector, total:** | -1.2 | -9.9 | 6.0 |

Source: OeNB, unconsolidated data.

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 62.5 | 62.8 | 63.2 |
| Branches of foreign credit institutions | 1.5 | 1.7 | 1.7 |
| Cooperative banks | 36.1 | 35.5 | 34.8 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

Source: OeNB, unconsolidated data.

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

| Assets | 2013 | 2014 | 2015 |
|---|---|---|---|
| Financial sector | n.a.* | n.a. | n.a. |
| Nonfinancial sector | | | |
| Government sector | | | |
| Other | | | |
| **Liabilities** | **2013** | **2014** | **2015** |
| Financial sector | n.a.* | n.a. | n.a. |
| Nonfinancial sector | | | |
| Government sector | | | |
| Capital | | | |
| Other | | | |

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

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks *** | 15.4 | 15.1 | 16.3 |
| Cooperative banks *** | 15.3 | 16.3 | 15.9 |
| **Banking sector, total:** | 15.4 | 15.6 | 16.2 |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 4.1% | 4.4% | 4.3% |
| **- households** | n.a. | 5.0% | 4.5% |
| **- corporate** | n.a. | 4.1% | 4.2% |

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

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | | |
| Households | 70.1% | 44.3% |
| Corporate | 17.0% | 41.0% |
| Government sector | 6.2% | 8.7% |
| Financial sector (excluding banks) | 6.7% | 6.0% |
| **Total** | **100.0** | **100.0** |

Source: OeNB, unconsolidated data; only domestic business

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 21.2 | 20.0 | 17.3 |
| Interest expenses | 12.4 | 10.7 | 8.4 |
| Net interest income | 8.8 | 9.3 | 9.0 |
| Net fee and commission income | 4.1 | 4.3 | 4.4 |
| Other (not specified above) operating income (net) | 6.1 | 6.4 | 7.4 |
| Gross income | **19.0** | **20.0** | **20.8** |
| Administration costs | 10.8 | 11.8 | 11.5 |
| Depreciation | 0.5 | 0.8 | 0.9 |
| Provisions | 6.6 | 6.0 | 2.1 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | n.a. | n.a. | n.a |
| Profit (loss) before tax | 0.2 | -5.6 | 4.8 |
| Net profit (loss) | -0.9 | -6.7 | 3.7 |

Source: OeNB, unconsolidated data in EUR bn.

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds (for CAR) | Tier 1 | Tier 2 | Tier 2 | ~~Tier 3~~ |
|---|---|---|---|---|---|
| Commercial banks *** | 56.0 | 42.3 | 42.5 | 13.5 | |
| Cooperative banks *** | 31.1 | 25.8 | 26.0 | 5.2 | |
| **Banking sector, total: *** ** | 87.2 | 68.1 | 68.5 | 18.6 | |

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

# 2015 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF BELARUS

## MACROECONOMIC ENVIRONMENT

In 2015, the economy of the Republic of Belarus was functioning under the conditions of unfavourable external economic conditions due to the changes of the macroeconomic situation in the countries which are main trade partners of the Republic of Belarus (the Russian Federation and Ukraine). As a result, the real GDP dropped in 2015 compared with 2014 by 3.9% (grew by 1.7% a year earlier) due to the decline in production, practically, in all sectors of the economy.

As at January 1, 2016, the assets (liabilities)/GDP ratio totaled 72.5% (61.9% as at January 1, 2015). Regulatory capital/GDP ratio was 9% as at January 1, 2016 (a year earlier – 8%).

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

As at January 1, 2016, the banking sector of the Republic of Belarus comprised 26 operating banks.

***For information:***

*In 2015, the banking licenses were revoked at four banks as a result of noncompliance with the licensing requirements and legislation. The owners of three banks took a decision on their liquidation. One bank was liquidated under the bankruptcy proceedings. One bank was reorganized by means of affiliating another bank thereto.*

In 2015, the number of branches fell from 65 to 41 owing to the streamlining by banks of their regional structures. 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 10.7% in 2015, amounting to 4,220 as at January 1, 2016. Foreign banks ran six representative offices in the territory of the country.

Foreign capital participated in the authorized capital of 21 banks. The share of foreign investors in the authorized capital exceeded 50% in sixteen of them and accounted for 100% in five of those. As at January 1, 2016, the share of foreign investments in the total volume of registered authorized capital of Belarusian banks stood at 15.0%, with the share of Russian capital in banks' authorized capital accounting for 10.0%. As at January 1, 2016, the share of the State Committee on Property of the Republic of Belarus in the authorized capital of nine banks was 76.9% of the banking sector's aggregate authorized capital.

The banking sector's aggregate registered authorized capital grew by 33.4% over 2015 and amounted to BYR44.8 trillion, or around USD2.4 billion in equivalent, as at January 1, 2016.

As at January 1, 2016, banks' regulatory capital totaled BYR78.6 trillion, or around USD4.2 billion in equivalent, a 26.3% increase in nominal terms in 2015. The banking sector's capital was concentrated in five core banks – 73.8%.

The banks' assets grew in 2015 by 30.3%, amounting to BYR627.5 trillion (around USD33.8 billion in equivalent) as at January 1, 2016.

Decline in the branches of the national economy, which are connected with the banking sector to the utmost by financial flows, as well as the slowing-down of economic activity made, on the whole, a negative impact on the efficiency of banks' activity.

Banks' profit dropped in 2015 by 32% in real terms, amounting to BYR5.9 trillion (USD315.5 million in equivalent). The banking sector's return on assets stood at 1.0% (1.7% as at January 1, 2015) and the return on regulatory capital – 8.38% (13.12% as at January 1, 2015).

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

In 2015, the National Bank continued to improve the regulatory legal framework in the area of regulating banks' activities and exercising banking supervision and bring it into line with international standards having regard to the practical application experience.

As part of the stage-by-stage implementation of the International Standards Basel III, since January 1, 2016, the capital and leverage ratios Basel III have been applied to banks as prudential norms; and the capital conservation buffer was introduced.

With a view to providing the banks with a possibility of technical reequipment and implementation of innovative banking technologies, a temporary gestation period was introduced, during which the banks are entitled not to reduce the core Tier I capital by the amount of intangible assets (less amortization) with respect to the software, data bases or their copies purchased in 2013-2018 under the license (copyright) agreements or on other grounds provided for by legislation. The above-mentioned decision made it also possible to reduce to a certain degree the pressure on the regulatory capital from the intangible assets.

With a view to determining the banks' readiness to implement the liquidity ratios Basel III as secure functioning requirements, the meeting by banks of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), as well as the analytical risk monitoring tools (including the following metrics: contractual maturity mismatch, concentration of funding, available unencumbered assets, and the LCR by significant currency) were monitored over 2015. Besides, the methodology of calculating the NSFR was improved.

For the purpose of improving the methodology of calculating prudential indicators characterizing the compliance by banks with secure functioning requirements, the assessment of risks in calculating capital adequacy, maximum amount of risk per debtor (a group of interrelated debtors) and liquidity under the banks' encumbered assets was toughened. As far as the encumbered assets are concerned, the approaches to the classification of assets and establishment of special provisions to cover potential losses were updated as well.

Within the development of the system of corporate governance at banks, the Banking Code of the Republic of Belarus was amended and modified on the

National Bank's initiative as to the presence of at least two independent directors in the Council of Directors (Supervisory Council) of a bank. At the same time, the work aimed at toughening requirements to the independent directors and efficiency of their activities, as well as avoiding the conflict of interests, was continuing.

## LEGAL FRAMEWORK FOR ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In the Republic of Belarus, the National Bank – the central bank of the country which incorporates a special unit the Banking Supervision Directorate – is entrusted with the supervisory functions.

In carrying out banking supervision in the Republic of Belarus, the National Bank performs the following functions:

- development of secure functioning requirements and other prudential requirements for banks to ensure the banking system's stability and soundness;
- state registration of banks and licensing of banks' activities;
- regulation of the foreign capital access to the banking system of the Republic of Belarus;
- off-site supervision of a bank's activities;
- on-site inspection of a bank's activities and assessment of risks posed by its activities;
- identification of violations of banking legislation;
- banking sector's risks monitoring;
- setting rules for publication of the information used to assess the degree of banks and non-bank financial institutions' reliability; and
- regulation of banks' reorganization and liquidation.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

In 2015, the main objective of the banking supervision development was determined by the need to ensure a stable functioning of the banking sector and protect the interests of depositors and other banks' creditors. Its implementation was associated with an improvement in prudential requirements and supervisory procedures and a raise in the level of all components of the supervisory process (prior supervision at the stage of state registration of banks and licensing of banks' activities; current supervision based on an individual and consolidated bases, including off-site supervision and inspections).

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The National Bank continued to supervise the banks with the application of risk-based approaches when assessing the stability of the banking sector functioning, monitored the banks' compliance with safe functioning requirements and other prudential norms and restrictions, as well as developed recommendations and exercised control over their implementation.

With a view to improving the stability of the banking sector and achieving a sufficient capital cushion when the regulatory values reach a threshold level, activities aimed at increasing the banks' capitalization were undergone in cooperation with the management and owners of the banks.

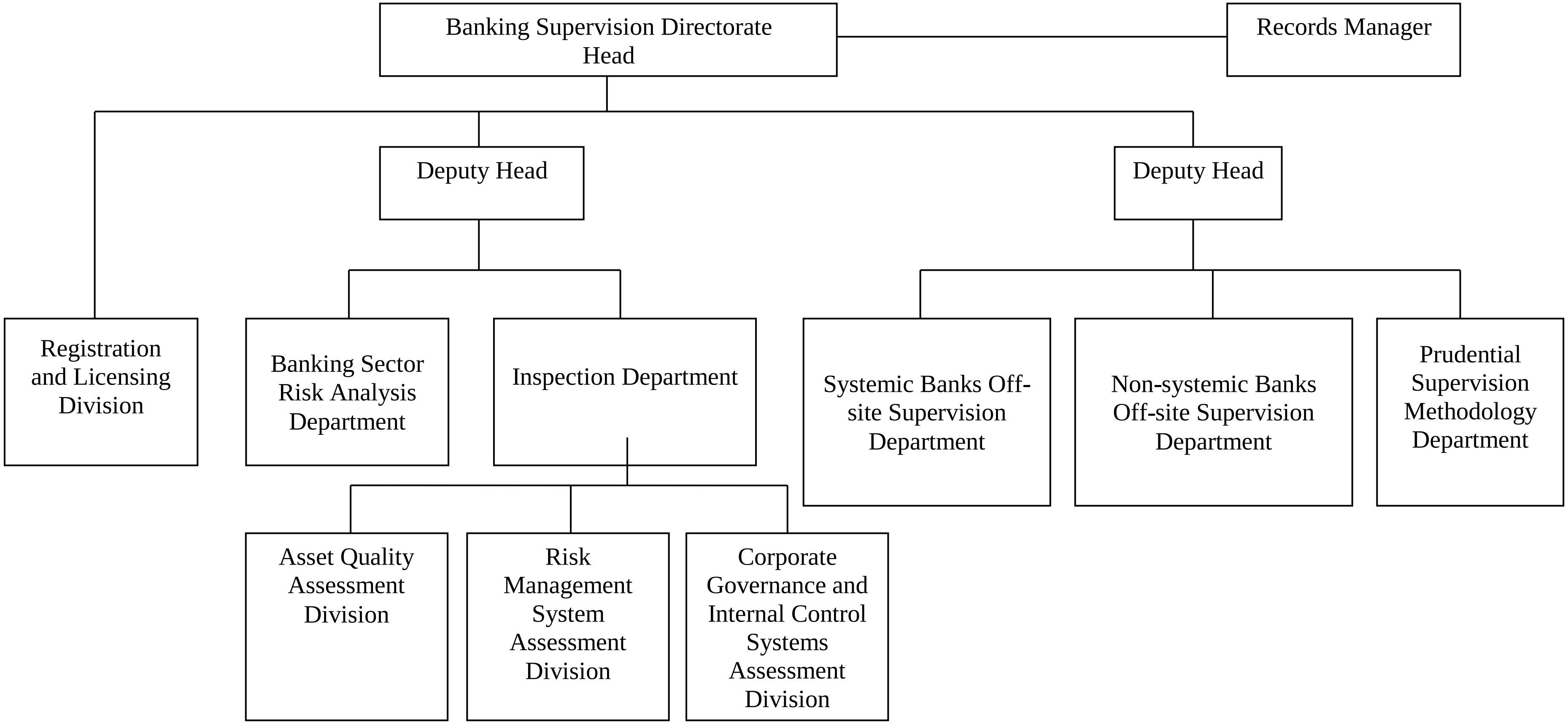
A work was underway to tighten the off-site supervision in terms of improving the analysis of banks' performance indicators and their compliance with safe functioning requirements and identifying negative trends and crisis developments at early stages. In case of identifying negative trends, the National Bank took appropriate supervisory response measures such as sending instructions to remedy identified violations, as well as holding meetings with banks' executive bodies and sending letters to them (to the boards of directors (supervisory boards) and executive bodies of the bank), and taking adequate enforcement actions, up to the revocation of banking license.

For the purpose of improving the quality of banks' corporate governance the National Bank took on an ongoing basis measures on assessing the compliance of the candidates for the positions of the head, chief accountant and deputies thereof, members of collective executive bodies, independent directors, of a bank or a non-bank financial institution with qualification and business reputation requirements, as well as other members of boards of directors (supervisory boards) of a bank or a non-bank financial institution with business reputation requirements.

In 2015, the National Bank conducted 25 audits of banks. In the course of inspections the attention was paid to credit risk assessment, the quality of banks' corporate governance, establishment of risk management systems, internal control systems, their compliance with the level of accepted risks and the functioning procedures. Additionally, the transparency of retail lending conditions and compliance with the requirements in the process of establishing a homogeneous loan portfolio was assessed.

In addition to interacting with banks, with a view to solving the tasks designed to ensure the banking sector's stability, the National Bank cooperated with audit organizations, the Association of Belarusian Banks, and supervisory authorities of other countries.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



## INTERNATIONAL COOPERATION

As of January 1, 2016, 17 bilateral agreements with foreign banking supervisory authorities were in force. Within the framework of these agreements cooperation in the area of banking supervision of credit institutions, namely, the exchange of information on the state and the development of the banking systems, current national banking legislation, regulations and requirements of banking supervision, all significant changes therein, as well as bilateral meetings, continued. A more close cooperation with those countries in which representative offices of Belarusian banks are located and with the countries the banks of which established subsidiaries and representative offices in the Republic of Belarus continued.

## COOPERATION WITH THE OTHER SUPERVISORY BODIES IN THE REPUBLIC OF BELARUS

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

## OTHER INFORMATION

More detailed information on the developments in 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 (*www.nbrb.by/engl/*).

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 31 | 31 | 26 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total** | **31** | **31** | **26** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 65.4 | 65.0 | 65.7 |
| Other domestic ownership | 1.1 | 1.2 | 2.0 |
| Domestic ownership total | 66.5 | 66.2 | 67.7 |
| Foreign ownership | 33.5 | 33.8 | 32.3 |
| **Banking sector, total** | **100.0** | **100.0** | **100.0** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 63.0 | 76.7 | 0.23 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **63.0** | **76.7** | **0.23** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 13.77 | 13.12 | 8.38 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **13.77** | **13.12** | **8.38** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 100.0 | 100.0 | 100.0 |
| Branches of foreign credit institutions | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | **100.0** | **100.0** | **100.0** |
| Financial sector | 1.9 | 2.3 | 2.7 |
| Nonfinancial sector | 71.7 | 72.0 | 66.0 |
| Government sector | 6.3 | 7.0 | 9.2 |
| Other assets, including | 20.1 | 18.6 | 22.1 |
| - non-resident | 3.5 | 2.9 | 5.2 |
| **Claims due to** | **100.0** | **100.0** | **100.0** |
| Financial sector | 2.0 | 2.8 | 2.7 |
| Nonfinancial sector | 48.7 | 49.0 | 50.3 |
| Government sector | 9.9 | 11.3 | 8.3 |
| Other liabilities, including | 25.3 | 23.3 | 26.0 |
| - non-resident | 19.7 | 18.1 | 18.9 |
| **Capital** | 14.1 | 13.5 | 12.7 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 15.5%** | 17.4%** | 18.7%** |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **15.5%**** | **17.4%**** | **18.7%**** |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 4.68% | 4.60% | 7.60% |
| **- households** | 0.93% | 1.36% | 1.01% |
| **- corporate** | 5.67% | 5.41% | 9.11% |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 89.5 | 51.8 |
| Households | 65.3 | 16.9 |
| Corporate | 24.2 | 34.9 |
| Government sector | 7.3 | 45.4 |
| Financial sector (excluding banks) | 3.2 | 2.8 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 3460.2 | 3618.0 | 3305.3 |
| Interest expenses | 2470.7 | 2492.2 | 2295.4 |
| **Net interest income** | **989.5** | **1125.8** | **1009.9** |
| **Net fee and commission income** | **560.8** | **585.8** | **433.7** |
| **Other operating income (net)** | **-829.7** | **-1049.0** | **-823.3** |
| **Net provision assignments** | **221.9** | **313.0** | **800.2** |
| **Net other income** | **124.4** | **278.1** | **468.5** |
| Gross income | 8813.2 | 11415.0 | 9532.4 |
| **Profit (loss) before tax** | **623.1** | **627.7** | **364.2** |
| Income tax | 101.5 | 99.6 | 75.6 |
| **Net profit (loss)** | **521.6** | **528.1** | **288.6** |

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 3856.6** | 3030.1** | - | 835.6** | 0.0** |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | **3856.6**** | **3030.1**** | **-** | **835.6**** | **0.0**** |

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

# 2015 DEVELOPMENTS IN THE BANKING SYSTEM OF THE FEDERATION OF BOSNIA AND HERZEGOVINA

## MACROECONOMIC ENVIRONMENT

Real GDP growth in the third quarter of 2015 in annual terms was 3.1%[5], down by 1.3 percentage points compared to the previous quarter.

The fourth quarter of 2015, in annual terms, is characterised by an increase in industrial production, although slightly lower than in the previous two quarters, when high growth rates were recorded due to the low basis. Moreover, a 3.1% increase in industrial production was recorded in 2015 compared to 2014. In 2015, the deflation rate is 1%, while the deflation rate in the previous year was 0.9%.

Banks were more active in terms of approving new loans, which is characteristic for the last quarter of the year. The upward trend of deposits was continued, caused by an increase in deposits of all sectors. Commercial banks are still focused on domestic sources of funding and continue to settle liabilities to non-residents. Interest rates on loans and deposits have not recorded significant deviations compared to the previous period. The increase in total lending was very modest since the beginning of the year and amounted to about 2%. Total loans amounted to KM 16.86 billion at the end of December 2015. The annual growth rate of total loans stood at 2.4% in December 2015. The annual growth rate of long-term retail loans was slightly higher compared to the one to private companies. The average annual growth rate of total retail loans was 5.5% in 2015 and quite stable during the year. The dynamics of new retail indebtedness and the quarterly growth rates of loans could indicate that a portion of the new debt is being used for the restructuring of existing liabilities.

Total deposits in the banking sector continued their upward trend and amounted to KM 16.53 billion at the end of 2015, up by 7.5% per annum. Deposit growth was recorded in most sectors on a quarterly basis. Retail deposits reached the amount of KM 9.86 billion at the end of December 2015, thus being up by 9.1% on an annual and 2.6% on a quarterly basis. The amount of deposit insurance, which is paid by the Deposit Insurance Agency of B&H per depositor per member bank (25 member banks), amounts up to KM 50 000. Data on average weighted interest rates for the fourth quarter of 2015 indicate that there were no significant oscillations in interest rate trends during the quarter.

[5] Preliminary data of the Central Bank of B&H – Newsletter IV quarter of 2015

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

Despite all negative influences, positive trends were recorded in 2015 and they are reflected in the increase in the balance sheet total, loans, deposits, especially retail savings, as well as the improved profitability of the entire banking sector. On the basis of everything, it can be concluded that the banking sector has remained stable, adequately capitalised, with liquidity still being satisfactory.

As of 31.12.2015, 17 banks in the FB&H had banking licences (16 banks in majority private ownership and 1 bank in state and majority state ownership), as was the case at the end of 2014. At the end of 2015, the number of employees was down by 4% compared to the end of 2014.

In 2015, the positive trend of balance sheet total growth continued and it is expected that the same trend will continue in the period to come. The balance sheet total of the banking sector as of 31.12.2015 amounted to KM 17.2 billion, up by KM 1 billion or 6.5% compared to the end of 2014. The balance sheet total growth with respect to sources (liabilities) is primarily the result of an increase in deposits and total capital, while the trend of reduced loan commitments continued in 2015 as well. Loans, as the largest assets item of banks, recorded an increase in the amount of 3.9% or KM 440 million in 2015, amounting to KM 11.6 billion at the end of the year. Retail loans amounted to KM 5.7 billion and are up by 5% or KM 257 million, reaching a share of 49.1% in total loans. Corporate loans amounted to KM 5.9 billion, up by 3.2% or KM 183 million, thus having a share of 50.9% in total loans at the end of 2015. The share of non-performing loans decreased compared to the previous period and amounted to 12.9%. Cash funds amounted to KM 4.86 billion or 28.3% of the balance sheet total of banks in the FB&H and recorded an increase in the amount of 6.5% or KM 297 million compared to the end of 2014.

In the structure of banks' sources of funding, deposits in the amount of KM 13.1 billion and with a share of 76.2% are still the most significant source of funding for banks in the FB&H, and they increased by 8% or KM 968 million in 2015. Savings deposits, as the most significant and largest segment of the deposit and financial potential of banks, maintained a positive trend of growth and amounted to KM 7.2 billion at the end of 2015, up by 8% or KM 543 million compared to the end of 2014. The total capital of banks as of 31.12.2015 amounted to KM 2.6 billion, up by 7.5% or KM 182 million compared to the end of 2014. As of 31.12.2015, the capital adequacy ratio of the banking system, as one of the most significant indicators of the capital strength and adequacy of banks, amounted to 15.3%, still significantly above the legal minimum (12%), which represents a satisfactory capitalisation of the overall system and a strong foundation and basis for preserving its security and stability. The liquidity of the banking system in the FB&H is still evaluated as good, with a satisfactory share of liquid assets in total assets as well as a good maturity adjustment of financial assets and liabilities.

According to final non-audited data from financial statements showing the success of banks' business operations in 2015, a positive financial result – profit in the amount of KM 149 million – was recorded at the level of the banking system in the FB&H, which is up by 29% or KM 34 million 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 BOSNIA AND HERZEGOVINA

## A) Prudential regulatory framework issued by the FBA (new changes in 2015):

- Decison on Bank's Handling of Dormant Accounts („Official Gazette of the FB&H", No. 30/15 and 98/15),
- Decision on Amending the Decision on Report Forms Banks Submit to the Banking Agency of the Federation of Bosnia and Herzegovina („Official Gazette of the FB&H", No. 26/16),
- Guidelines for Licencing and Other Approval of the Banking Agency of the Federation of Bosnia and Herzegovina („Official Gazette of the FB&H", No. 37/15 – consolidated text),
- Early Warning System – Methodology, Version 2, No. 03-3-1233-1/15 from 08.02.2016
- Early Warning System – Manual, Version 2, No. 03-3-1234-1/15 from 08.02.2016
- Code Amending the Code of Conduct of the Ombudsman for the Banking System ("Official Gazette of the FB&H", No. 93/15).

Legal competences of the Agency:

- issuance of licences for the establishment and operations of banks, microcredit organisations and leasing companies, issuance of licences for changing the organisational structure of banks and microcredit organisations and leasing companies, issuance of approvals for the appointment of their managerial staff,
- supervision of banks, microcredit organisations, leasing companies and supervision of authorised exchange offices as well as implementation of measures in accordance with laws and regulations,
- revocation of operating licences of banks, microcredit organisations and leasing companies in accordance with the law,
- appointment of provisional and liquidation administrators in banks, supervision of provisional administration and liquidation of banks, monitoring of liquidation proceedings of microcredit organisations and filing requests for insolvency proceedings against banks and microcredit companies;
- adoption of bylaws regulating the operations of banks, microcredit organisations, leasing companies and authorised exchange offices;
- collection, processing and recording of data banks, microcredit organisations, leasing companies and authorised exchange offices submit to the Agency in accordance with regulations;
- aiding anti-terrorist measures related to banks, microcredit organisations and leasing companies at the request of the competent authority, in accordance with the applicable law;
- taking all necessary actions, including freezing client accounts in any bank on the territory of the FB&H in order to prevent the financing of activities that obstruct or threaten to obstruct the peace implementation process as

pursued under the aegis of the General Framework Agreement for Peace in Bosnia and Herzegovina in accordance with special law;
- promotion and protection of the rights and interests of consumers, i.e. natural persons as users of financial services.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

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

- taking measures and activities within their competences for the purpose of implementing measures from the Reform Agenda and the Economic Reforms Programme that are related to the banking and financial sector;
- working on the implementation of the FSAP Mission's recommendations in order to improve the quality of banking sector supervision;
- continuing to improve secondary legislation, starting with EU Directives, the Basel principles and as part of the preparations for EU accession;
- maintaining continuous banking supervision by means of examinations via reports and on-site examinations with a focus on the examination of dominant risk segments of banking operations in order for supervision to be even more efficient in that respect:
  - insistence on capital strengthening of banks, especially those recording an above average increase in assets and decrease in the capital adequacy ratio,
  - continuing with the permanent monitoring of banks, primarily those of systemic importance to the development of lending activities in which a large amount of savings and other deposits is concentrated, in order to protect depositors,
  - reviewing and regularly updating the contingency plan as part of crisis preparedness,
  - the systematic monitoring of banks' activities in terms of preventing money laundering and terrorism financing has been continued, and cooperation with other supervisory and control institutions is to be improved,
  - monitoring the compliance of banks with laws and regulations and practices applied in banks in the segment of the protection of users of financial services and guarantors,
  - the establishment of and closer cooperation with supervisory authorities in countries whose investors are present in the banking sector of the FB&H, as well as with other countries in order to maintain effective supervision,
  - continuing cooperation with the ECB and EBA and information exchange in terms of banking supervision, as well as with the international financial institutions, the International Monetary Fund (IMF), the World Bank (WB), the European Bank for Reconstruction and Development (EBRD), etc.,

  - continuously improving the information system from an operational aspect, as an essential prerequisite for effective and proactive banking supervision, i.e. information technology support in the function of early warning and preventive action when it comes to eliminating weaknesses in banks' business operations;
- the accelerated completion of liquidation proceedings.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

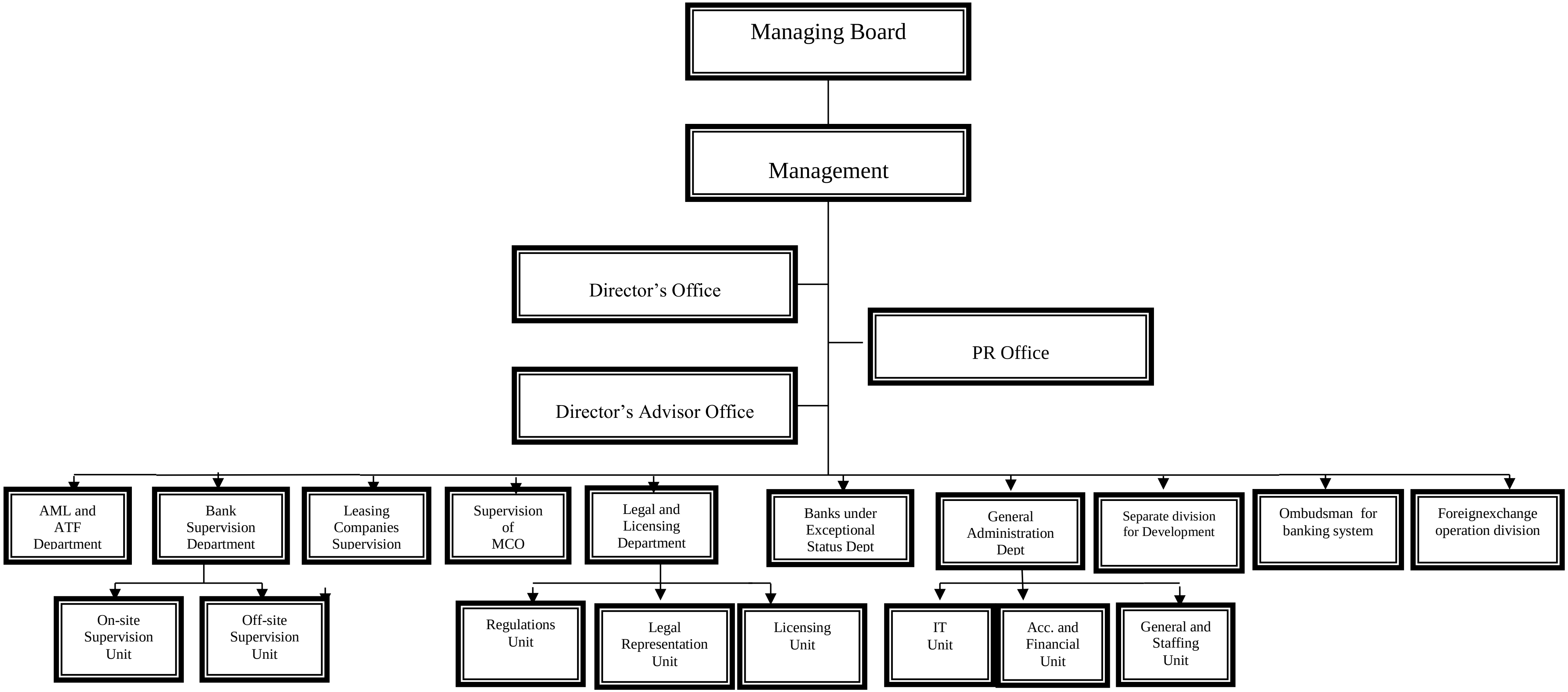
In 2015, the Banking Agency of the FB&H performed, among others, the following activities:

- maintaining the stability, security, liquidity and good capitalisation of the banking sector of the FB&H;
- continuous monitoring of the business operations of all banks, especially of banks that had significant business problems through a process of direct and indirect examinations and direct communication with representatives of the banks’ supervisory boards and management boards, the banks’ external auditors as well as regulators from countries in which the banking groups with banking subsidiaries in the FB&H are seated, in order to synchronise and coordinate activities within the framework of banking sector supervision;
- taking all measures in accordance with legal regulations, as well as continued examinations on the basis of regulations which came into force in previous years;
- continued improvement of the bank monitoring system by means of the development of additional supervisory tools: the Early Warning System (EWS) and the Risk Matrix, which further improves the consistency of methodologies for planning banking supervision and control;
- continued activities on the development of a regulatory framework by means of: providing technical assistance for drawing up a draft of the new Law on Banks, as well as draft by-laws within the competences of the Agency, in accordance with the Agency’s adopted Strategy and the annual plan for drafting regulations and in the interest of implementing EU Directives and Basel III;
- in cooperation with the Central Bank of B&H (CBBH) and the Banking Agency of Republika Srpska (BARS), the development of the methodology and use of stress tests for credit risk and the impact on capital was continued, based on macroeconomic assumptions, as well as the familiarisation of banks with the results of the conducted stress tests;
- the cooperation to improve the criteria and determining the list of systemically important banks was continued;
- the continuous information exchange within banking coordination and the Standing Committee for Financial Stability (SCFS) was realised;
- the information exchange and meetings with banking regulatory authorities of other countries in the context of supervising the business operations of their banking subsidiaries operating on the territory of the FB&H were continued;

- a Cooperation Agreement was signed with the banking regulators of Austria, and it is planned that one will soon be signed with the banking regulators from Germany and Italy as well;
- there has been significant cooperation with international financial institutions: the IMF, the WB, the European Central Bank (ECB), etc. in terms of information and analysis of trends in the banking system of the FB&H, as well as participation in various projects in order to strengthen the capacity for effective banking supervision;
- cooperation has been established and a Cooperation Agreement was signed with the European Banking Authority (EBA) in order to exchange information and strengthen the supervisory capacity in the signatory countries;
- the cooperation with the ECB was continued and it is planned that the Cooperation Agreement with the ECB be signed in 2016;
- activities regarding the implementation of the Strategy of the Banking Agency of the FB&H for the introduction of Basel III, i.e. the drawing up of the draft/preliminary draft regulatory framework under Pillar 1 and Pillar 2 were continued, along with the public debate within the banking sector through the Banks Association of B&H in accordance with the Agency's Operational Plan for 2015. This draft by-law framework is compliant with the EU regulatory framework to the extent to which that is possible, given the specificity of the market in B&H, i.e., with the regulations package the European Parliament and the Council of the European Union adopted CRD IV and CRR with;
- the activities regarding banks' supervisory reporting on capital and capital requirements were continued, as well as the Instructions for filling out the single reporting framework – COREP in accordance with the aforementioned implementing regulations, technical standards, instructions, i.e. guidelines prescribed by the EBA,
- the cooperation with the BARS and the Deposit Insurance Agency of B&H was continued.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

***Banking Agency of the Federation of BiH***



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In 2015, the Agency, in collaboration with the CBBH and the BARS, continued activities aimed at strengthening and improving international cooperation and, together with the CBBH and the BARS, signed a multilateral agreement with the supervisors of SEE countries: Albania, Greece, Macedonia, Romania, Bulgaria, Serbia, Montenegro and Cyprus, and a Memorandum of Understanding with the competent supervisory authorities of Austria, Slovenia, Croatia, Serbia, Montenegro and Turkey.

An MoU was also signed with the supervisory authorities of Austria (the Financial Market Authority in Austria – FMA, the Austrian National Bank and the Austrian Federal Ministry of Finance) on mutual cooperation in the area of supervision of credit institutions. Once cooperation with the EBA was established in October 2015, the Agency, together with the BARS, the National Bank of Macedonia, the Central Bank of Montenegro, the National Bank of Serbia and the Central Bank of Albania, signed a Cooperation Agreement with the EBA, by which the signatory countries acquire the status of equal participation in the information exchange with EU member states when it comes to business operations and banking system supervision.

With the establishment of the Single Supervisory Mechanism in the eurozone, special tasks in the supervision of credit institutions were transferred from national regulators to the ECB. Accordingly, in the first phase of information exchange with the ECB, the Agency, at the ECB's official request, gave its approval regarding national regulators that are members of the ECB, in the context of the supervision of credit institutions that have subsidiaries on the territory of the FB&H and are supervised by the ECB, being allowed to forward data they receive from the Agency to the ECB as well. Based on the positive assessment of compliance received from the EBA and the signed Agreement with the EBA, B&H was placed in the first group of third countries, with which the ECB is planning to sign joint cooperation agreements in 2016.

During 2015, the Agency, together with the BARS, actively participated in the work of the BSCEE.

The Agency also cooperated, with representatives of the WB in B&H, on regional projects of the WB pertaining to the banking and financial system, and certain issues related to the implementation of WB credit lines which are realised through banks in the FB&H, opportunities and areas in which the WB can provide technical assistance to the Agency were discussed.

In the context of bilateral cooperation, during 2015, the Agency cooperated with the banking regulatory authorities of Slovenia (regular information exchange with the Bank of Slovenia as part of the NLB group, regular exchange, drafting of an annual SREP, participation in colleges of the NLB Group in Slovenia), Austria (regular information exchange with the FMA on banking groups and their subsidiaries in the FB&H, an annual SREP for Hypo bank, participation in the supervisory colleges of Hypo Group, as well as several bilateral meetings in connection with the supervision of the Hypo Group and the restructuring process approved by the EC), Turkey (regular information exchange with Agency on banking regulation and supervision in the Republic of Turkey – BRSA, a bilateral meeting as part of the supervision of ZiraatBank BH dd Sarajevo, as well as the participation of BRSA supervisors in the Agency’s on-site examinations of ZiraatBank BH).

## COOPERATION WITH OTHER SUPERVISORY BODIES IN BOSNIA AND HERZEGOVINA

In 2015, the cooperation with the CBBH, the Deposit Insurance Agency, the Insurance Supervisory Agency, the Securities Commission of the FB&H, the Intelligence and Security Agency, the entity ministries of finance, the BARS, the Banks Association of B&H, the Association of Microfinance Organisations in B&H, the Association of Leasing Companies in B&H and other institutions was continued with respect to matters within the Agency’s competences.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

In 2015, the cooperation with the IMF Mission under the Stand-By Arrangement was continued. Also, the Agency participated in the work of the Moneyval Committee of the Council of Europe, during which an assessment of the compliance of B&H legislation and the compliance of the work of B&H institutions with Anti-Money Laundering and Counter-Terrorism Financing standards was made (IV round of assessment). With Bosnia and Herzegovina's adoption of the Law on Prevention of Money Laundering and Financing of Terrorist Activities in B&H, which eliminated the inconsistencies identified in the previous round of assessment, i.e. made the required corrections of the criminal code in the section defining money laundering and financing of terrorist activities, and with the adoption of the Report on the Compliance of B&H at the plenary session, the Moneyval Committee withdrew the Public Statement on B&H, i.e. wiped B&H from its list of non-cooperative countries.

Based on the submitted reports and recommendations of the FSAP Mission, in 2015, and given that the Agency is strategically commited to complying with the recommendations of the FSAP Mission, the Agency's Action Plan was drafted, with deadlines and principal bodies for the implementation of the aforementioned recommendations of the FSAP Mission. The Agency's Action Plan contains those recommendations with proposed measures the Agency will take in order to improve supervision.

In 2015, data or information that were included in the annual Progress Report for B&H were submitted to the European Commission, i.e. for the needs of joint bodies (subcommittees/working groups) regarding European integration. The meeting of European Commission representatives on behalf of the EU and B&H representatives in Brussels marked the beginning of the implementation of the Stabilisation and Association Agreement on a technical level, with a decision having been made on the establishment of seven permanent, instead of the previously temporary, subcommittees on subject areas, which will begin with the first cycle of meetings in February 2016.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 17 | 17 | 17 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **17** | **17** | **17** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 1,6 | 2,3 | 2,8 |
| Other domestic ownership | 7,4 | 7,0 | 6,8 |
| Domestic ownership total | 9,0 | 9,3 | 9,6 |
| Foreign ownership | 91,0 | 90,7 | 90,4 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI* |
|---|---|---|---|
| Commercial banks | 56,3 | 69,5 | 1.402 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 56,3 | 69,5 | 1.402 |

*Whole percentages are used.

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | -0,1 | 4,8 | 5,7 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | -0,1 | 4,8 | 5,7 |

*Return on average equity (ROAE).

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 100,0 | 100,0 | 100,0 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| Other | - | - | - |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | n/a | n/a | n/a |
| Nonfinancial sector | n/a | n/a | n/a |
| Government sector | n/a | n/a | n/a |
| Other assets | n/a | n/a | n/a |
| **Claims due to** | | | |
| Financial sector | n/a | n/a | n/a |
| Nonfinancial sector | n/a | n/a | n/a |
| Government sector | n/a | n/a | n/a |
| Other liabilities | n/a | n/a | n/a |
| **Capital** | n/a | n/a | n/a |

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

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 18,0* | 16,0* | 15,3* |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 18,0* | 16,0* | 15,3* |

(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 | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector* | 14,8 | 14,0 | 12,9 |
| **- households** | 10,0 | 9,7 | 9,0 |
| **- corporate** | 19,4 | 18,4 | 16,8 |

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

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 87,2 | 97,4 |
| Households | 60,5 | 45,9 |
| Corporate | 26,7* | 51,5* |
| Government sector | 8,1 | 2,2 |
| Financial sector (excluding banks) | **4,7** | **0,4** |
| **Total** | **100.0** | **100.0** |

*Including Non-profit organizations and other sectors.

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 781.045 | 770.716 | 766.124 |
| Interest expenses | 239.302 | 224.418 | 196.630 |
| Net interest income | 541.743 | 546.298 | 569.494 |
| 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* | 858.965 | 872.219 | 917.455 |
| Administration costs | 246.087 | 248.007 | 248.495 |
| Depreciation | n/a | n/a | n/a |
| Provisions | 232.804 | 148.251 | 130.018 |
| 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 | 15.025 | 138.386 | 172.426 |
| Net profit (loss) | -2.670 | 115.520 | 145.215 |

*Net interest income and gross operational income.

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 1.012.114* | - | 948.246* | 169.358* | - |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | 1.012.114* | - | 948.246* | 169.358* | - |

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

# 2015 DEVELOPMENTS IN THE BANKING SYSTEM OF REPUBLIKA SRPSKA OF BOSNIA AND HERZEGOVINA

## MACROECONOMIC ENVIRONMENT

In the course of 2015, the growth of overall economic activities in Republika Srpska (hereinafter: RS) at an inter-annual level was recorded. After the growth of 1.5% in Q1, the RS GDP in the course of Q2, Q3 and Q4 generated growth rates of 2.1, 2.4 and 2.6% y/y respectively. Positive macroeconomic trends in the neighboring countries and major domestic trade partners, a slight increase in domestic consumption, and the impact of base effect due to the 2014 floods, resulted in positive growth rates of RS GDP in 2015 at an inter-annual level.

Also, in 2015, a positive trend was evident in the RS industrial production which grew at a rate of 3% y/y, where the above represents the continuation of its growth from the previous period. The production growth was generated due to the growth in the area of mining and quarrying (10.2%) and the RS manufacturing industry (3.2%). However, despite increased production, the RS export activities saw a decrease of 6.6% within the observed period. On the other hand, the RS import activities recorded a significant decrease of 13.1%, which resulted in the decrease of the total foreign trade by 10.8%.

After the growth in 2014, in the course of 2015, the RS construction activity recorded a slight inter-annual production contraction of 0.5%. Inter-annual decline in the production of civil-engineering works, along with the weakening of the intensity of performed effective working hours in building construction, shaped the production results of this area. On the other hand, positive trends at the RS labor market were evident in 2015. In the period from January to December 2015, the average number of registered unemployed people at the RS Employment Institute amounted to 139 465, which is a decrease by 4.4% if compared to the average number in 2014.

In the following period, further positive trend developments in domestic economy will be to a great extent conditioned by the trends in the neighboring countries and EU, primarily the foreign trade partners of RS and Bosnia and Herzegovina (hereinafter: BiH). The RS Government estimates that domestic economy will have a growth rate of 2.4% in 2016, while the International Monetary Fund is slightly more optimistic and predicts the growth in BiH economy of 3% in this year.

*Source: Economic Monitor, The Republika Srpska Investment-Development Bank.*

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

Taking into account the banking sector results generated in 2015, it can be stated that the banking sector of RS, despite the challenges it encountered both in 2014 and 2015 (especially having in mind that one bank lost its license in 2014 and one bank was put under provisional administration in 2015), remained stable as a whole.

The slight increase of bank activities continued in 2015 as well. The increase, although a slower one, is important because the real sector, among other problems, still feels the negative impact of the floods that hit RS in 2014.

Total deposits retained their upward trend, and the increase was particularly evident in household deposits.

However, the share of non-performing loans and due receivables in total loans also increased in 2015, thus representing the highest treat and challenge for the banking system in future and requires broader engagement of all relevant institutions in RS and BiH.

As of 31/12/2015, the banking sector of RS had a total of 9 banks. One bank, the state-owned one, has been under provisional administration as of 16/11/2015, while other 8 banks have majority private capital dominated by foreign private capital.

Basic indicators of the banking sector operation as of 31/12/2015:

- total balance sheet amount was EUR 3.9 billion and remained approximately at the same level as of 31/12/2014.
- cash funds (EUR 0.7 billion) were 21% out of total balance sheet assets with a decrease rate of 6% when compared to the previous year. Out of total banks' cash funds, 30% was at accounts abroad (foreign currency current accounts and the funds termed up to 30 days).
- total gross loans (EUR 2.5 billion) increased by 2%, resulting from an increase of loans extended to private enterprises and households. At the same time, there was a decrease in loans extended to the Government and its institutions and public and state enterprises.
- share of non-performing loans in the total loan portfolio increased by 1.1 percentage points in comparison to the end of 2014 (from 14.4% to 15.4% as of 31/12/2015).
- total calculated reserves for the coverage of potential loan and other losses under regulatory requirement increased by 17% in comparison with the previous year, while the coverage rate of classified assets by reserves amounted to 12.5% (as of 2014, the coverage rate amounted to 11%).
- deficient amount of reserves under regulatory requirement, representing the difference between the reserves under regulatory requirement and value adjustment and reserves under the IAS, amounted to EUR 31.7 million and increased by 2% when compared to 2014.
- average coverage rate of classified assets by the value adjustments under IAS was 10.7% (as of 31/12/2014 amounted to 8.8%).
- deposits (EUR 2.5 billion), as a basic source of funding bank operations, had a share of 75% out of total bank liabilities and increased by 4% when compared to 2014. Since 2011, deposits have had a trend of increase.

- trend of growth in households' deposits continued also in 2015 and increased by 11% compared to 31/12/2014. Share of households' deposits in total deposits increased from 50% to 53%. Short-term and long-term deposits had a share of 55% and 45% in total deposits, respectively.
- banks' total capital (EUR 0.4 billion) and it decreased by 8% when compared to 2014, due to a significant impact of uncovered loss from previous years and loss from 2015.
- average capital adequacy ratio amounted to 14.2%, while as of 31/12/2014 it was 16.9% (legally required minimum is 12%).
- banking sector of RS liquid and able to meet all its obligations in due terms.
- at the level of total banking sector as of 31/12/2015, a net negative financial result was reported in the amount of EUR 40.5 million (as of 31/12/2014, the banking sector reported a profit amounting to EUR 14.4 million). Three banks operated with a loss amounting to EUR 70.9 million, while six banks generated a profit in the amount of EUR 30.4 million.

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

**Amendments to prudential regulation governing the operations of financial institutions issued by the Banking Agency of Republika Srpska (hereinafter: the BARS) in 2015:**

- Decision on amendments to the Decision on minimum standards for market risk management in banks ("Official Gazette of Republika Srpska", no. 107/15);
- Decision on amendments to the Decision on requirements and procedure for issuing an operating license to microcredit organizations, organizational units of microcredit organizations from the Federation of Bosnia and Herzegovina, District Brcko and foreign microcredit organizations in Republika Srpska ("Official Gazette of Republika Srpska", no. 104/15);
- Decision on amendments to the Decision on examination and supervision of microcredit organizations ("Official Gazette of Republika Srpska", no. 104/15);
- Decision on amendments to the Decision on procedure for revoking the operating license of microcredit organizations ("Official Gazette of Republika Srpska", no. 104/15);
- Decision on amendments to the Decision on requirements and procedure for issuing a permit for status change of microcredit organizations ("Official Gazette of Republika Srpska", no. 104/15);
- Decision on amendments to the Decision on conditions and procedure for revoking the operating license of saving-credit organizations ("Official Gazette of Republika Srpska", no. 104/15);

- Decision on amendments to the Decision on examination and supervision of leasing providers ("Official Gazette of Republika Srpska", no. 104/15);
- Decision on amendments to the Decision on conditions and procedure for granting a license for performing the activities of saving-credit organizations, an approval on founding acts and an approval for the appointment of external auditor in saving-credit organizations ("Official Gazette of Republika Srpska", no. 104/15);

**In 2015, in accordance with the Strategy for implementing the "International convergence for capital measurement and capital standards" – Basel II, the BARS continued to prepare draft decisions. The following drafts were disclosed on the Agency's website and public discussions were held at the end of 2015 and in the course of 2016:**

- Pillar I (Decision on bank capital calculation);
- Pillar II (Decision on risk management in banks, Decision on the management of interest rate risk in the banking book, Decision on large exposures, Decision on internal capital adequacy assessment process in banks – ICAAP and Reports on ICAAP).

**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 is authorized to:

- issue licenses for foundation and operation of banks, licenses for status changes and changes in both the organizational structure of banks and type of operation the banks perform;
- supervise safety and soundness and legality of banks' operations – through off-site and on-site examination of banks, and undertake appropriate supervisory measures;
- revoke banking licenses;
- introduce provisional administration in banks and appoint a provisional administrator, institute liquidation proceeding in banks and appoint a liquidation administrator, direct and supervise the proceeding of provisional administration and liquidation in banks, submit a request to institute bankruptcy proceeding in banks;
- adopt acts regulating banks' operation;
- evaluate whether the requirements have been met, and approve the following issuance of shares;
- supervise and undertake necessary activities regarding anti-money laundering and terrorism financing related to banks, microcredit organizations, saving-credit organizations and other financial organizations, all in cooperation with the competent institutions and in accordance with regulations governing this field;
- supervise and undertake other activities in accordance with regulations governing the introduction and implementation of certain interim measures for the purpose of effective enforcement of international restrictive measures;
- adopt adequate acts in the field of anti-money laundering and terrorism financing, and cooperate with the competent authorities and institutions within this field;
- adopt acts and undertake actions in order to ensure the protection of consumers' rights, i.e. of physical persons as beneficiaries of financial services in the banking system, supervise the implementation of

regulations governing this field and undertake other activities and adequate measures within the scope of its authority;
- perform other tasks in accordance with the law governing operation of banks;
- issue and revoke licenses and approvals to microcredit organizations, saving-credit organizations and leasing companies, control the legality of their operation, adopt general acts regulating operations of microcredit organizations, saving-credit organizations and leasing companies etc.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

The BARS main strategic objective is to safeguard and strengthen the banking system stability, as well as to improve its safe, good quality and lawful operations. In that sense, strategic objectives are:
- undertake activities and adopt measures within the scope of the BARS's authority with the aim to alleviate negative effects of global financial and economic crisis on the banking system of RS;
- continuous supervision of financial institutions, especially of systemically important banks due to the concentration of savings and other deposits in such banks;
- insist on capital strengthening, especially of banks which recorded an above-average assets growth and decrease of capital adequacy, but also of other financial organizations;
- asset quality review of banks which recorded an above-average asset growth;
- enhanced supervision of credit risk, primarily in the sense of adequacy of reserves for potential loan losses, and bank credit risk management adequacy;
- work on the regulations for dealing with problem banks;
- further development and improvement of supervision along with the technical assistance of international institutions;
- active role on the protection of rights of financial service consumers;
- improvement of the project for bank „Stress tests";
- professional training of employees and strengthening the capacities for efficient banking supervision, and continuous improvement of information system;
- monitoring of international banking and accounting standards (Basel Principles and EU Directives) and incorporating the same in our regulation;
- implementation of FSAP mission recommendations for banking supervision and cooperation with relevant international financial institutions;
- continue with enhanced (daily) off-site supervision of current bank liquidity;
- activities directed to further strengthening of transparency of the business activities of banks and other financial organizations, and maintaining the trust in the banking system;
- continue with the adequate monitoring of payment transactions and activities for the prevention of money laundering and terrorism financing,

and in that sense, improve the cooperation with other competent institutions;
- further improvement and establishment of cooperation with the banking supervisors, especially from the countries whose banks have equity shares in the banks from RS;
- continue and improve the cooperation with external auditors;
- actively participate in the work of Committee for Coordination of Financial Sector of RS.
- continue and improve the cooperation with the Banks Association of Bosnia and Herzegovina, Microcredit Organization Association of Bosnia and Herzegovina and Leasing Companies Association of Bosnia and Herzegovina.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2015, one bank was put under provisional administration, one microcredit organization lost its operating license, while one microcredit organization was issued an operating license. As to conclude, as of 31/12/2015, the banking system of RS consisted of 9 banks (one bank under provisional administration), 6 microcredit organizations and 1 leasing company.

In 2015, the BARS activities were aimed at maintaining the stability and improvement of the quality and legality of the RS banking system operations, on a basis of continuous supervision of banks, microcredit organizations and leasing companies.

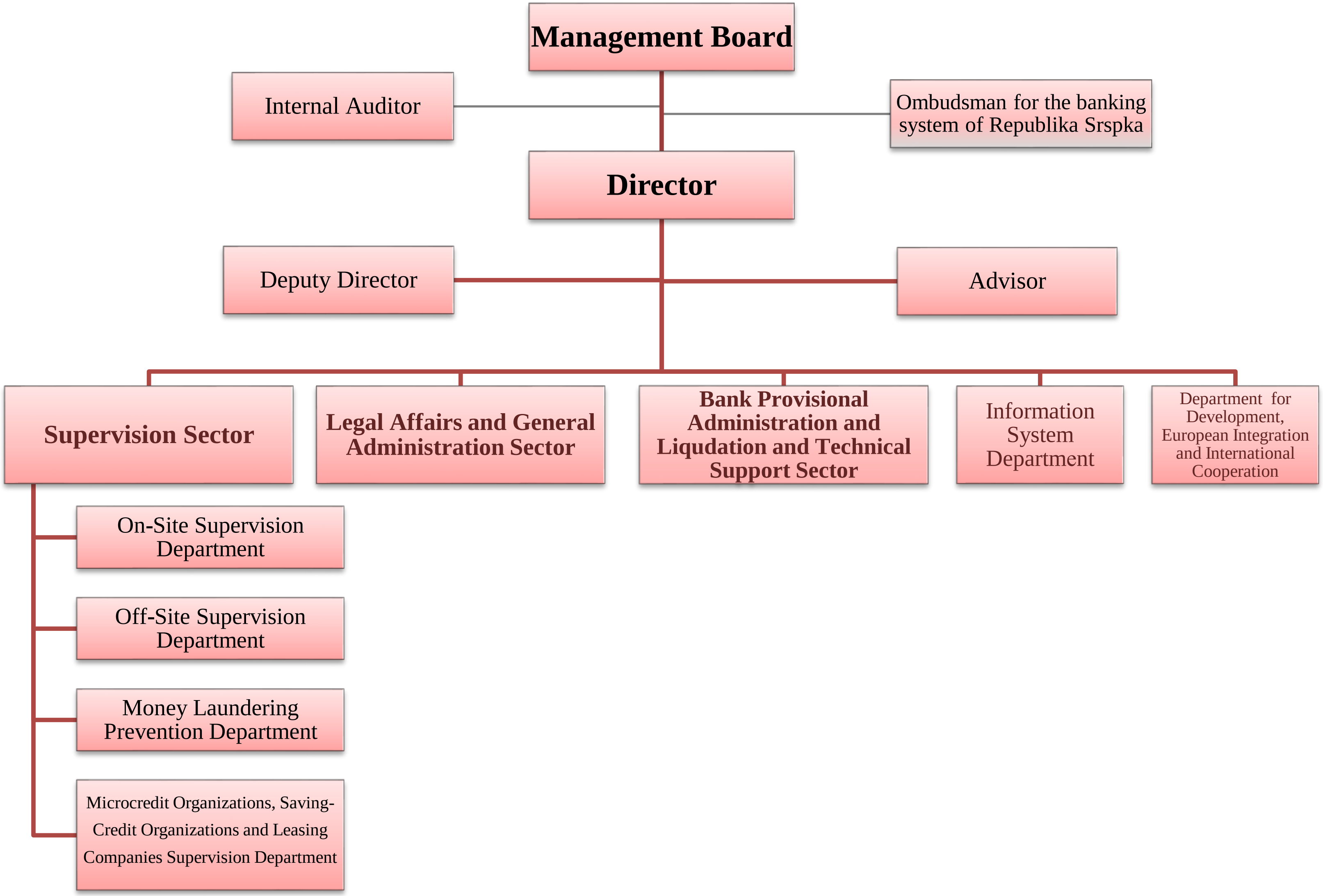
In 2015, the BARS continued with controlling the operations of financial organizations through the off-site and on-site supervision, primarily by means of monitoring the solvency, liquidity, capitalization and profitability of all individual financial organizations, as well as the system as a whole. The BARS orders were primarily aimed at the strengthening of capital, improving of loan policies and consistent application of the same, improving the management of credit and liquidity risk. In addition, a special attention was also dedicated to the control segments which were related to the assessment of harmonization of banks, microcredit organizations and leasing companies with the standards for the prevention of money laundering and terrorism financing, as well as ensuring and improving the protection of rights and interests of the banking service consumers.

In the reporting period, other activities of the BARS can be summarized as:
- 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 2015, the BARS signed a Memorandum of understanding and cooperation with the FMA, Austria);
- BARS signed a multilateral Memorandum of cooperation between the EBA and supervisory bodies from Serbia, Montenegro, Macedonia, Albania and Bosnia and Herzegovina. The Self-assessment on equivalence of confidentiality regime of the BARS with the CRD IV preceded the signing of the Memorandum;
- 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 was actively involved in the preparation of new, draft version of the law on banks of Republika Srpska and other regulations governing the operations of financial organizations;
- BARS continued to perform the activities in accordance with the BARS adopted Strategy for Introducing Basel II, primarily 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) as well as further development and improvement of the existing secondary regulatory framework. In accordance with the Strategy, 5 draft decisions were disclosed for public discussion;
- For the purpose of implementing the recommendations from the Financial Stability Assessment Program (FSAP) and for the continuation of already started activities on the alignment with EU regulations, the BARS prepared a Draft Strategy for introducing Basel III and a Draft Action plan for implementing the FSAP recommendations.
- 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 2015, 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 regural basis, to the inquiries, requests for data collection and questionnaires of international institutions and organizations (European Central Bank, European Banking Authority, International Monetary Fund, World Bank, EBRD, BSCEE, etc.).

# COOPERATION WITH OTHER SUPERVISORY BODIES IN BOSNIA AND HERZEGOVINA

In 2015, the BARS continued to actively cooperate with the Insurance Agency of Republika Srpska and Securities Commission of Republika Srpska in accordance with the Law on Committee for Coordination of Republika Srpska Financial Sector Supervision.

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

Furthermore, under the signed Memorandum of understanding, intensive bilateral cooperation with the Central Bank of Bosnia and Herzegovina, Banking Agency of the Federation of Bosnia and Herzegovina and Deposit Insurance Agency of Bosnia and Herzegovina was continued in 2015.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS

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

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 10 | 9 | 9 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **10** | **9** | **9** |

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

| Item | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 4.1 | 4.4 | 4.0 |
| Other domestic ownership | 7.2 | 26.2 | 27.1 |
| Domestic ownership total | 11.3 | 30.6 | 31.1 |
| Foreign ownership | 88.7 | 69.4 | 68.9 |
| **Financial institutions, total** | **100.0** | **100.0** | **100.0** |

### Concentration of asset by the type of financial institutions

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 60.2 | 85.5 | 1 663 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Financial institutions, total** | 60.2 | 85.5 | 1 663 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | -4.4 | 3.4 | -9.8 |
| Cooperative banks | - | - | - |
| **Financial institutions, total** | -4.4 | 3.4 | -9.8 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 100,0 | 100,0 | 100,0 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Financial institutions, total** | **100.0** | **100.0** | **100.0** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 17.4* | 16.9* | 14.2* |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 17.4* | 16.9* | 14.2* |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 16.2 | 14.4 | 15.4 |
| **- households** | **13.0** | **11.7** | **11.7** |
| **- corporate** | **18.2** | **16.2** | **18.1** |

**The structure of deposits and loans in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 93.7 | 99.6 |
| Households | 59.3 | 41.7 |
| Corporate | 24.8 | 43.4 |
| Government sector | 9.7 | 14.6 |
| Financial sector (excluding banks) | 6.3 | 0.4 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 176 735 | 169 654 | 168 770 |
| Interest expenses | 68 973 | 65 987 | 61 568 |
| Net interest income | 107 762 | 103 666 | 107 202 |
| Net fee and commission income | - | - | - |
| Other (not specified above) operating income (net) | - | - | - |
| Gross income | **178 486** | **175 883** | **172 980** |
| Administration costs | **120 831** | **110 952** | **119 702** |
| Depreciation | - | - | - |
| Provisions | - | - | - |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 63 200 | 36 965 | 76 848 |
| Profit (loss) before tax | -15 240 | 18 898 | -35 430 |
| Net profit (loss) | -18 351 | 14 380 | -40 465 |

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2* | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 339 519 | 304 413 | 304 413 | 66 771 | - |
| Cooperative banks | - | - | - | - | - |
| **Financial institutions, average** | 339 519 | 304 413 | 304 413 | 66 771 | - |

Note: *Additional regulatory deductions amounted to EUR 31 665 thousand

# 2015 DEVELOPMENTS IN THE BULGARIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2015 the real GDP growth rate accelerated to 3% (1.5% in 2014). A main contribution for the strengthening of economic activity had net export, while private consumption and fixed investment had a positive but small contribution to the growth. In the course of the year, the contribution of net exports to the increase of GDP gradually decreased, while that of final consumption and of fixed investment increased.

The improvement of labour market conditions continued, with a slight recovery in employment in most sectors of the economy and reduction of unemployment. Still, the lower growth rate in households’ labour income led to the slowdown in the rate of increase in consumption to 0.8%. Fixed investment rose by 2.5% in real terms, with a large input from public investment. Notwithstanding the better expectations of businesses for the future economic activity and the sizeable capacity utilisation of productive assets, economic uncertainty was perceived as a main deterring factor and the companies retained their conservative policy concerning investment outlays.

Gross value added in the economy slowed down in 2015, increasing in real terms by 1.5%, and contributed 1.3 p.p. to real GDP growth. Industry and services contributed 0.8 p.p. each to the growth in gross value added. In industry stronger growth was observed in value added in manufacture, which increased by 3.1% in real terms, while construction marked an annual increase of 1.4%. The value added in the sector "agriculture, forestry and fishing" fell by 1.4% in 2015 (compared to 5.2% growth in 2014) and had a negative contribution of 0.1 percentage points to the change in gross value added for the total economy.

In 2015 the deflation continued and consumer price index dropped by 0.9% at the end of the year[6]. The decrease in consumer prices was basically due to the influence of the deflationary impact of the external environment, reflecting the downward dynamics in international prices of commodities and raw materials. The internal environment, characterised by feebly increasing internal demand and lower production costs for firms, did not exert upward pressure on consumer prices.

Gross external debt declined to EUR 34.1 billion (77.2% of GDP), mainly due to decrease in intracompany loans[7] and in the external debt of the banking sector. There was also decrease in public and public-guaranteed external debt and in the external debt of other sectors.

[6] The analysis uses data by HICP.
[7] The main reason for the decrease was the unilateral derecognition of taking by foreign creditor.

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

In 2015 the banking system remained stable and reported an increase in balance sheet assets and deposits, as well as improved liquidity and capital position. The tendency towards funding becoming cheaper, marked mostly in household deposits, did not influence depositors' behaviour. The substantial increase in deposits by residents completely compensated for the decrease in deposits of non-residents (funding from credit institutions). The decrease in deposits of non-residents (funding from credit institutions) was mainly as a result of the measures taken by the BNB to prevent the transmission of risks to the Bulgarian banking system. Lending activity remained weak despite lower costs of offered credit products. In risk management, priority remained the management of credit risk in banks' balance sheets. Capital buffers were preserved. Most credit institutions preserved the ability to generate income and higher financial results led to the improvement in ROA and ROE in 2015.

Balance sheet structure was influenced by weak lending activity, limited choice of investment alternatives and rising amount of deposits. The share of cash and cash balances increased, investment in securities remained concentrated in Bulgarian government bonds.

Compared to end of 2014 the total assets of the banking system grew by EUR 1.2 billion to EUR 44.8 billion (BGN 87.5 billion). There was a slight decrease in the market share of domestic banks, to 23.6%, and a slight increase in the share of other EU-owned subsidiaries and branches, to 75.0%. The share of non-EU banks and branches remained at 1.4%.

**Market structure**

At the end of 2015 there were 28 credit institutions of which one was a state-owned bank. The five largest banks in the banking balance sheet accounted for 57.3% of total assets. The ratio of total banking assets to GDP was 101.3%.

**Asset quality**

Banks took measures to optimize their balances, mostly with relation to credit risk evaluation. Different methods were used like loan sales, write-offs against provisions, debt-ownership swaps using collateral. At the same time they started the refining of used methodologies for evaluation of credit risk and of received collateral. These resulted in some decline in the total size of the loan portfolio and rise in the sum of non-performing loans in the system. At the end of December 2015, the total sum of non-performing exposures[8] in the banking system stood at EUR 5.7 billion (BGN 11.2 billion), most of it loans and advances. Exposures past due more than 1 year amounted to EUR 3.5 billion (BGN 6.9 billion). At year-end, the net amount (after subtraction of impairment) of gross non-performing loans, EUR 2.9 billion (BGN 5.7 billion), was completely covered by the excess of capital over the 8% minimum requirement. The share of non-performing loans and debt securities in the total gross amount of all exposures in the banking system at the end of 2015 was 13.11%.

The accumulated impairment in the system at end-December was EUR 2.9 billion (BGN 5.7 billion), and the predominant amount was charged for exposures

[8] The amendment of 9 January 2015 of Implementing Regulation (EU) No 680/2014 introduced definitions, scope, frequency and formats for reporting in the area of asset quality and restructured exposures. Hence, juxtaposition of data for 2015 and data for previous years reported in older formats need not be sought.

past due more than 1 year. The total amount of impairment provided for a 51.3% coverage ratio of total non-performing exposures.

The quality of balance sheet items (other than loans) remained good. An influence had also the additional macro-prudential measures by the BNB, aimed at restricting the spreading into the banking system of risks stemming from the international environment.

**Profitability**

Limited possibilities for alternative investment, a low interest rate environment, and a need to maintain high liquidity were factors for a continuing, although slower, decline in income from interest-bearing assets. Expenditure management and changing price strategies, however, enabled most of the banks to improve their profitability indicators compared to those for 2014 and 2013. Compared to 2014, interest expenses decreased by an amount larger than the reduction in interest income, producing growth in net interest income. Rising profits from financial assets and liabilities and higher fee and commission income also contributed to the improved profitability. Impairment costs were by 1.9% lower than those for the previous year. Unaudited profit at year-end was EUR 433 million (BGN 847 million), marking a 19.2% increase vis-à-vis the one recorded for 2014. ROA improved to 0.97%, and ROE, to 7.35%.

**Solvency**

During the year the ratios of Total capital, of Tier 1 capital, and of CET 1, rose for the system, concluding the year respectively at 22.19%, 20.47%, and 19.99%. There were no significant changes in the structure of risk-weighted exposures. At end-December all banks reported capital adequacy above the required minimum of 8%. The capital exceeding the 8% minimum requirement amounted for the system to EUR 3.6 billion (BGN 7.0 billion), or 8.1% of GDP.

At end-December, the leverage ratio was 10.85%, continuing to reflect a low degree of indebtedness of the banking system[9].

**Liquidity**

The liquidity position of the banking system was further strengthened. Liquid assets grew by EUR 2.8 billion (BGN 5.5 billion) to EUR 14.2 billion (BGN 27.7 billion). For the end of the year the total amount of liquid assets accounted for 31.6% of the banking system's total assets.

Throughout the year the liquid assets ratio (liquid assets to liabilities) of the system remained high and reached 36.71% at the end of December. All credit institutions complied with the supervisory recommendation for a minimum of 20% coverage with liquid assets of deposits of households and legal entities.

**Products and distribution channels**

At the end of 2015 there were 52 points of sale (branches, offices, representative offices and remote workstations), 79 ATMs and 1289 POS terminals per 100 000 population.

[9] According to Art. 429 of Regulation (EU) № 575/2013 the leverage ratio is calculated by dividing tier one capital by the total exposure, expressed as a percentage. As of January 1, 2015, the credit institutions calculate this ratio to the reference date. Requirement for the leverage ratio is expected to be introduced from January 1, 2018.

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

In the first half of 2015 an internal analysis and assessment of the procedures and practices of the Banking Supervision Department was carried out. An independent and detailed assessment of the effectiveness of the banking supervision in Bulgaria by a joint IMF – World Bank team was taken into account too. Based on that, the BNB Governing Council adopted an opinion on the evaluation and provided guidance for strengthening specific areas of activity, and for certain changes in their organisation.

On October 5th the BNB Board adopted a plan for further development of banking supervision, which describes priority activities and deadlines for their implementation. The off-site function was re-established and was assigned to carry out the Supervisory Review and Evaluation, as well as to contribute to joint assessment and decision within international colleges of supervisors.

More regarding the development plan, it also provides for further overall increase of on-site resources. In order to enhance supervisory decision making power, a council to the Deputy Governor in charge of Banking Supervision was established to work for setting-up and implementation of supervisory measures. A new Division of market conduct was set up within the Specific Supervisory Activities Directorate, which is in charge of monitoring and analysing business practices in consumer and mortgage lending.

Organisational measures will be supported by amending the regulatory framework for implementation of risk-based supervisory activities with a view to expanding the powers of banking supervision, to defining more comprehensive requirements and improving supervisory practices in the areas of corporate management of banks, concentration risk management, compliance with the restrictions as regards large exposures and transactions with related parties.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015-2016

Besides the permanent long-term objective of maintaining the stability of the banking sector in the country and protection of depositors' savings, an important short-term objective of the Bank for 2015-2016 is a comprehensive evaluation of the assets in the banking system, and the ability of banks to withstand adverse market impacts.

Pursuant to § 9 of the Transitional Provisions of the Law on Recovery and Resolution of Credit Institutions and Investment Firms, and Article 80 of the Law on Credit Institutions (LCI), the Bulgarian National Bank is committed to conduct in late 2015 and 2016 a Comprehensive Assessment (CA) of the Bulgarian banks. The first stage comprises of carrying out an independent review of the quality of assets (AQR) in the banks.

This Comprehensive Assessment shall also include stress tests of the banking system using the outcomes of the AQR under Art. 80b of the LCI to establish the banks’ ability to absorb unexpected losses from hypothetical shocks.

The CA is being conducted under the lead of BNB as supervisor of banks with the assistance of Deloitte as external independent consultant. To ensure adherence to best practices in conducting similar exercises, the BNB is holding consultations with the EC and the European Banking Authority over the course of the review.

The underlying methodology for this exercise is the ECB AQR methodology as outlined in the Manual published 14th March 2014. The approach adopted takes into account some country-specific exercise where the BNB as supervisor has an inherent knowledge of the banking sector, i.e. size, the RW assets of the banks, existing risk management and lending practices, and supervisory reporting.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In November 2015 it was opened a procedure of prior approval for the transfer of the commercial enterprise of the Bulgarian branch of the Greek Alpha Bank over to Eurobank Bulgaria.

Over the year the focus of the on-going supervision was placed on preparing the annual ratings of credit institutions within the regular Supervisory Review and Evaluation Process (SREP). Where relevant, SREP assessments were exchanged within international colleges of supervisors. Apart from the risk profile, initial considerations were made on viability of banks taking into account the prevailing business model, i.e. the core-banking.

The results of off-site supervision serve as the basis for implementing risk-based approach for on-site inspections at credit institutions by applying the principle of proportionality in the planning, scope and frequency of inspections at the relevant credit institutions.

In 2015 thirteen supervisory inspections with varying scope were conducted. The most common supervisory recommendations were related to the need to improve lending, and more specifically the work of the relevant bank divisions or committees, like controls and management of credit risk, with special emphasis on loan portfolio concentrations and ICAAP. Inspections were also focused on the implementation of previous supervisory recommendations, e.g. on changes in group models. These recommendations were relating to banks that apply advanced approaches for measuring risks, i.e. to improving quality of data documentation and internal validation, carrying out further tests on risky areas, and others. Also a joint inspection with the Austrian National Bank was carried out concerning the application of capital requirements for operational risk at group level.

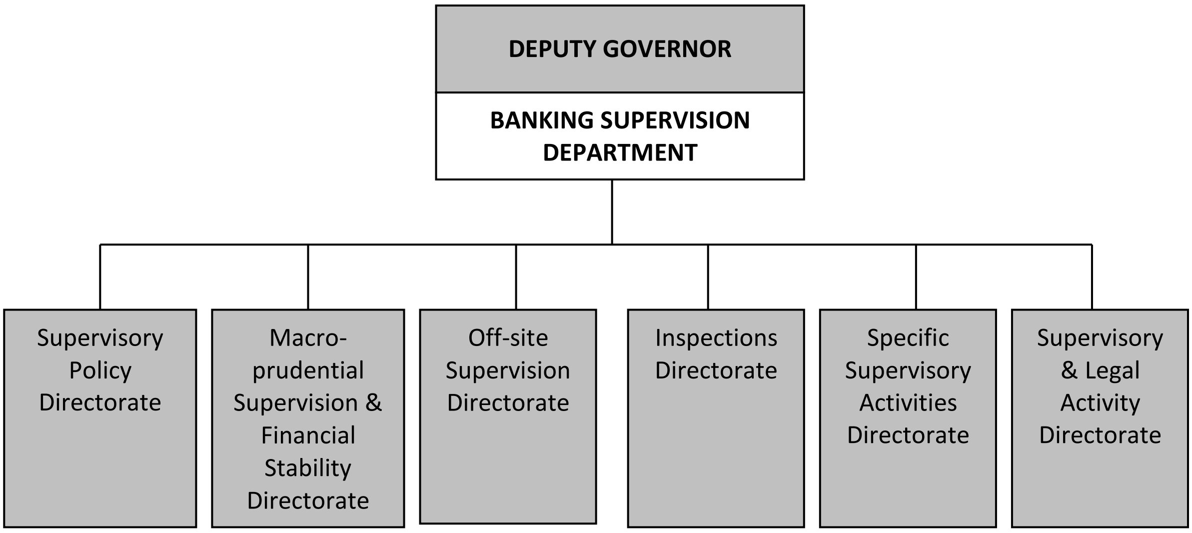
Over 2015 monitoring in the field of macro-prudential supervision was focused on areas with increased risk for the stability of the banking system, especially in the context of continued weak credit activity. Risks are associated mainly with excessive banking and financial interdependence. Harmonised financial information and analyses are exchanged within EBA, and it is aimed primarily at systemically important banking groups in the EU. Parallel to this, from BNB perspectives supplementary references were introduced, that account specifics and developments of the banking sector at national level. Outcomes from analyses are used also to BNB rationale for calibration of countercyclical buffer. In addition, distribution of dividends in the banking system could be subject to supervisory recommendations within the supervisory process.

As regards the special purposes supervision, the last year activity was conducted within an amended legal framework, and enhanced requirements for the internal procedures and documentation in the banks and in financial institutions subject of these requirements. As usual, they are aimed at increasing efficiency in combating money laundering, and at protecting the banking sector from funds of dubious origin. In the course of inspections carried out in 2015, recommendations made were mainly related to increase the capacity of banks and investment firms. In parallel to this, continue the joint inspections with the Specialised Administrative Directorate for Financial Intelligence within the State Agency of National Security, according to the established procedures under the Measures against Money Laundering.

Also within the function of specific supervisory activity, the newly set up unit for monitoring the market conduct by banks and financial firms continue to analyse received complaints of bank customers. The main groups of objections relate to misuse of personal data and initially not announced additional costs, but later made due. Where necessary, on-site inspections were carried out. The recommendations made to banks emphasise on improving and steadily keeping clear and transparent conditions on offered consumer products. In this regard, the BNB was holding up regular communication with the Commission for Consumer Protection and the Commission for Personal Data Protection and Law Enforcement Authorities.

As for the non-banking financial institutions under Article 3a of the Law on Credit Institutions, their number at the end of 2015 was reduced twice as compared to the previous year. This is due to the introduced stricter capital requirements, also to requirements for suitability of owners and managers of companies, and the reduced number of activities for which registration is required. As a consequence, there is a process of transformation of related companies aimed at ensuring adequate capacity according to the set criteria.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY




# COOPERATION WITH OTHER SUPERVISORY BODIES IN BULGARIA

In the plan adopted for development of the banking supervision it is provided for the need of further improving the coordination and information exchange in relation to supervisory cooperation with other domestic authorities, i.e. the Bulgarian Deposit Insurance Fund, the State Agency of National Security, the Ministry of Finance, the Financial Supervision Commission and the Commission of Public Oversight of Statutory Auditors. Steps made, and previous activities conducted in this direction will be further extended.

Memorandums with the relevant institutions will be amended or new ones will be developed and signed. Procedures for coordination of joint activity and information exchange will be updated in order to support the BNB’s supervisory function in a more efficient way. In this regard, in August 2015 a joint instruction was signed for cooperation between the BNB and the State Agency of National Security.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS

With entry into force of the Law on Recovery and Resolution of Credit Institutions and Investment Firms on 14 August 2015, a regulatory framework governing such processes was established. The relevant directorate is subordinated to the Governor of the BNB and is committed with the resolution activities and drawing up of operational procedures for interaction with the Banking Supervision Department.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 24 | 22 | 22 |
| Branches of foreign credit institutions | 6 | 6 | 6 |
| Cooperative banks | | | |
| **Banking sector, total:** | **30** | **28** | **28** |

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

| Item | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 2.08 | 2.25 | 1.84 |
| Other domestic ownership | 28.15 | 21.45 | 21.75 |
| Domestic ownership total | 30.23 | 23.70 | 23.59 |
| Foreign ownership | 69.77 | 76.30 | 76.41 |
| **Banking sector, total** | **100.0** | **100.0** | **100.0** |

### Concentration of asset by the type of financial institutions

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 42.45 | 57.30 | |
| Branches of foreign credit institutions | 3.07 | 3.84 | |
| Cooperative banks | n.a. | n.a. | |
| **Banking sector, total:** | **100.00** | **100.00** | 919.69 |

***Note:** Shares in the sum total for the banking sector.

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | 4.90 | 7.15 | 7.35[10] |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 93.66 | 92.94 | 96.15 |
| Branches of foreign credit institutions | 6.34 | 7.06 | 3.85 |
| Cooperative banks | | | |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

**The structure of assets and liabilities of the banking system (%) [11]**
**(at year-end)**

| Assets | 2015 |
|---|---|
| Cash, cash balances at central banks and other demand deposits | 21.01 |
| Financial assets held for trading | 1.62 |
| Financial assets designated at fair value through profit or loss | 0.30 |
| Available-for-sale financial assets | 8.23 |
| Loans and receivables | 61.78 |
| Held-to-maturity investments | 2.61 |
| Derivatives – Hedge accounting | 0.02 |
| Fair value changes of the hedged items in portfolio hedge of interest rate risk | 0.00 |
| Investments in subsidiaries, joint ventures and associates | 0.39 |
| Tangible assets | 2.98 |
| Intangible assets | 0.20 |
| Tax assets | 0.03 |
| Other assets | 0.48 |
| Non-current assets and disposal groups classified as held for sale | 0.37 |
| **TOTAL ASSETS** | **100.00** |
| **Liabilities** | **2015** |
| Financial liabilities held for trading | 0.18 |
| Financial liabilities designated at fair value through profit or loss | 0.00 |
| Financial liabilities measured at amortised cost | 85.92 |
| Derivatives – Hedge accounting | 0.04 |
| Fair value changes of the hedged items in portfolio hedge of interest rate risk | 0.00 |
| Provisions | 0.14 |
| Tax liabilities | 0.05 |
| Share capital repayable on demand | 0.00 |
| Other liabilities | 0.49 |
| Liabilities included in disposal groups classified as held for sale | 0.00 |
| **TOTAL EQUITY** | 13.17 |

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

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | 16.97** | 21.95*** | 22.19*** |

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

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

| Asset classification | 2015[12] |
|---|---|
| Net Non-performing loans (excl. those to credit institutions and central banks) as a % of net loans (excl. those to credit institutions and central banks) | 11.03 |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits[13] | Loans[14] |
|---|---|---|
| **Non-financial sector, including:** | **92.7 %** | **95.9%** |
| Households[15] | 64.9% | 35.7% |
| Corporate[16] | 27.8% | 60.2% |
| **Government sector[17]** | **2.8%** | **1.6%** |
| **Financial sector (excluding banks)[18]** | **4.5%** | **2.5%** |
| **Total** | **100.0** | **100.0** |

Source: Other monetary financial institutions (S.122 in accordance with ESA'95).

[12] As a result of the harmonisation of concepts and definitions, no match should be sought between the manner and scope of reporting of these items in the old and new reports (to the end of 2014 and from January 2015, respectively). Before 2015, non-performing exposures are the risk exposures where principal or interest arrears payments have been past-due over 90 days. From 2015, due to the new reporting requirements there is a change in definitions and scope of the new Standard Form 18 Information on performing and non-performing exposures.
[13] In accordance with the requirements of Regulation ECB/2008/32, in the liability side, instrument deposits also includes loans and repurchase agreements.
[14] In accordance with the requirements of Regulation ECB/2008/32, in the asset side, instrument loans includes also claims on deposits and repurchase agreements.
[15] Data refer to resident sectors S.14 Households and S.15 Non-profit institutions serving households in accordance with ESA'95.
[16] Data refer to resident sector S.11 Non-financial corporations in accordance with ESA'95.
[17] Data refer to resident sector S.13 General government (S.1311 Central government, S.1313 Local government and S.1314 Social security funds) in accordance with ESA'95.
[18] Data refer to resident sectors S.123 Other financial intermediaries, S.124 Financial auxiliaries and S. 125 Insurance corporations and pension funds in accordance with ESA'95.

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 2,360,922 | 2,025,199 | 1,866,721 |
| Interest expenses | 1,063,130 | 681,043 | 449,790 |
| Net interest income | 1,297,792 | 1,344,156 | 1,416,930 |
| Net fee and commission income | 418,797 | 423,967 | 455,138 |
| Other (not specified above) operating income (net) | 178,864 | 226,810 | 272,941 |
| Gross income | **1,895,453** | **1,994,933** | **2,145,009** |
| Administration costs | **912,301** | **888,921** | **947,269** |
| Depreciation | 103,602 | 98,249 | 87,642 |
| Provisions | 7,328 | 7,754 | 9,355 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans) | 576,011 | 591,002 | 588,820 |
| Profit (loss) before tax | 287,531 | 409,429 | 488,509 |
| Net profit (loss) | 257,702 | 363,355 | 432,967 |

**Total own funds in 2015 (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: (*** for all items)** | 5,606,382 | 5,049,480 | 5,171,185 | 435,197 | |

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

# 2015 DEVELOPMENTS IN THE CROATIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

After six consecutive years of decline, economic activity in Croatia picked up in 2015, boosted by the rise in foreign and, to a lesser extent, in domestic demand. As a result, employment increased and the unemployment rate decreased. A decrease in the prices of crude oil and food raw materials in the world market aided the domestic economic activity and contributed to further decline in inflation. Exceptionally good results in tourism, better absorption of EU funds and one-off bank losses sustained under the influence of the implementation of regulatory provisions regarding the conversion of loans in Swiss francs contributed to the considerable improvement in the current account surplus. The CNB's expansive monetary policy continued to favourably affect domestic lending conditions, thus ensuring the preconditions for the recovery of lending.

## DEVELOPMENTS IN THE BANKING SYSTEM

The assets of credit institutions stood at HRK 401.2bn at the end of 2015[19] (120.0% of GDP), down marginally from the end of 2014 (-0.5%). Bank assets declined (-0.5%), while the assets of housing savings banks remained the same, still accounting for a very small share of total assets of credit institutions (only 1.9%). There were no changes in the number of credit institutions and their ownership structure. At the end of 2015 there were 33 credit institutions (of which five were housing savings banks) with the dominant role of a few institutions owned by foreign bank groups.

Bank assets decreased for the fourth consecutive year due to the absence of credit growth and further deleveraging, as well as due to the sale of non-performing claims and the implementation of regulatory provisions on the conversion of loans in Swiss francs and loans indexed to the Swiss franc into loans in euros and loans indexed to the euro. Under the influence of these regulations banks reported losses and started the conversion and partial write-off of loans at the end of the year. In 2015, banks recorded HRK 6.8bn of expenses on provisions for loan conversion and reported losses (before taxes) totalling HRK 5.0bn. Operating profitability remained at a very good level, although it stagnated primarily due to the decision to fix the exchange rate of the Swiss franc for loan repayments which was adopted in January 2015. In addition, bank operating income was affected by other costs related to the conversion of loans (such as costs spurred by the adjustment of currency position) and other administrative measures like increased costs of deposit insurance premiums and of the first contribution to the resolution fund, as well as stricter restrictions of the level of default interest rates and thus indirectly of effective loan rates.

Bank lending decreased in 2015, even if the effects of the sale of claims and of the write-off of the principal of converted loans and exchange rate developments

[19] The 2015 data, as well as data for the previous years, are based on the audited reports of credit institutions.

are excluded. Loans to corporates went down the most, to almost all activities within the sector. A noticeable increase was registered only in lending to the activities associated with tourism and agriculture. Household loans decreased for the seventh consecutive year, with a noticeable currency restructuring. Kuna loans to households went up noticeably, especially general-purpose cash loans and home loans, reflecting a change in household preferences. However, the overall home financing decreased, as did all other significant types of household loans. The only exception, as in the year before, were general-purpose cash loans which mildly increased.

The growth of partly recoverable and fully irrecoverable bank loans (classified into risk categories B and C) that had started in 2008 was interrupted. The share of said risk categories decreased from 17.1% at the end of 2014 to 16.7% at the end of 2015. The sale of claims, especially relating to the corporate sector, had a key influence on the trend observed by loan quality indicators. Apart from sales, the fall in the amount of B and C category loans was also under the influence of other activities relating to the resolution of non-performing claims (such as bankruptcy and pre-bankruptcy proceedings and stronger debt write-off), as well as bank estimates on the improvement of the creditworthiness of individual borrowers. The ageing of the portfolio, strengthened by the influence of regulatory rules on the gradual value adjustment increase for placements with long history of non-payment contributed to the noticeable growth in the coverage of B and C category loans by value adjustments (from 51.3% to 56.9%).

Repayment of funds to foreign owners continued in 2015 even more intensively than the year before, with the key impact of the decrease in sources denominated in the Swiss franc. Preparations for conversion, that is, adjustments of bank currency positions created pressure on the money and the foreign exchange market, which was alleviated by a series of CNB measures. The kuna liquidity coefficient that was temporarily disrupted thus recovered by the end of the year and reached its usual, relatively high, level. The deposit base increased stronger than in the year before, primarily thanks to the growth of household and corporate deposits. The growth in corporate deposits was under the predominant influence of the extraordinary events in two enterprises, while in relation to the household sector it came to the growth of less stable sources, such as deposits on transaction accounts, which can be associated with the decline in interest rates but also with the introduction of the tax on savings interest in 2015.

The total capital ratio went down in 2015, but remained very high at 20.9%. The decrease was a result of the implementation of regulatory provisions on the conversion of loans, on one side through the reduction of own funds due to current year losses and on the other through the increase in exposure of banks to currency risk, as a consequence of the adjustment of currency position. The fall in own funds was also under the influence of dividend payments from retained earnings. A total of HRK 2.5bn in kuna dividend payments were made in 2015, as compared to the HRK 1.8bn paid the year before.

The operations of housing savings banks slowed down in 2015 under the impact of changes in the system of state incentives for housing savings[20]. Deposits of housing savings banks savers decreased, as well as the amount of granted home loans. Their quality remained very good – the share of risk category B and C loans totalled 1.6%. Profit (before tax) was noticeably lower than the year before (17.0%), primarily due to lower profit from financial assets classified in the

[20] Government incentives for 2014 were repealed. They were reintroduced in 2015 and 2016 but in significantly lower amounts.

portfolio held for trading (exclusively T-bills and bonds of the domestic central government), while the already high total capital ratio additionally increased to 25.8%.

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

The Credit Institutions Act was amended two times in 2015. The first reason for amendments was to transpose the provisions of Directive 2014/59/EU (BRRD)[21], published in 2014 with a view to set up a system that provides a set of instruments enabling early and swift intervention in failing institutions or those likely to fail, in order to ensure the continuation of key functions and concurrently limit the impact of the failure on the economic and financial system. The existing regulatory framework was thus expanded by provisions regulating the actions of credit institutions and competent authorities in resolution proceedings. In 2015, the provisions of the said Directive were transposed into the Act on the Resolution of Credit Institutions and Investment Firms[22] and simultaneously into amendments to the Credit Institutions Act[23] and the Capital Market Act. Additionally, the Credit Institutions Act needed to be harmonised with the relevant directive regulating the area of deposit guarantee schemes. Apart from alignment with the acquis communautaire, the said amendments additionally regulated individual segments of operation of credit institutions based on the experiences acquired in the implementation of the existing Act and introduced the first of the two measures adopted in 2015 whose aim was to alleviate the position of debtors who borrowed in Swiss francs. The first measure fixed the exchange rate to HRK 6.39 for one franc for instalments/annuities in that currency maturing within the period of one year. In September 2015, the Credit Institutions Act was amended for the second time[24] by incorporating provisions governing the procedure of conversion of loans denominated in or indexed to the Swiss franc into loans denominated in or indexed to the euro. This regulated the conversion of loans to persons other than consumers, while the conversion of loans granted to consumers was at the same time regulated by amendments to the Consumer Credit Act.[25]

Supervision of credit institutions consists of several coordinated activities aimed at verifying compliance of credit institutions with risk management rules, provisions of the Credit Institutions Act and regulations adopted under that Act, other laws and regulations governing the conduct of financial activities, their own rules, and professional standards and rules. In addition to supervision, the CNB

[21] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 of the European Parliament and of the Council (Official Journal L 173); the so-called *Bank Recovery and Resolution Directive*, *BRRD*.
[22] OG 19/2015.
[23] OG 19/2015.
[24] The Act on Amendments to the Credit Institutions Act (102/2015).
[25] The Act on Amendments to the Consumer Credit Act (OG 102/2015).

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

The CNB exercises supervision of credit institutions by:

- collecting and analysing reports and information, ongoing monitoring of credit institutions' operations;
- carrying out on-site examinations of credit institutions' operations;
- imposing supervisory measures in order to take actions at an early stage to improve the safety and stability of credit institutions' operations and to eliminate any illegalities established;
- issuing opinions, authorisations, approvals and assessment of credit institutions.

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

Other supervisory authorities in the Republic of Croatia that are competent for financial system supervision are the Ministry of Finance and the Croatian Financial Services Supervisory Agency. Their competence pertains to the regulation and supervision of non-banking financial services.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

As over the previous years, the main objectives of supervision exercised by the CNB 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 continued in 2015, as well as the improvement of other segments of the domestic legislation regulating the operation of credit institutions. The focus of on-site examinations in 2015, in addition to the analysis of asset quality and credit risk management, and determining capital adequacy, was the on-site examination of credit institutions categorised in the group of large institutions by their asset size, with the scope of supervision, to the greatest extent, encompassing risk modelling.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

As regards banking regulations, 2015 was marked by continued efforts relating to amendments of laws and regulations, predominantly as a consequence of harmonisation with the legal framework of the EU. CNB employees actively participated in the work of the committees and sub-committees of the European Banking Authority where drafts of technical standards in various fields were prepared.

In 2015, Supervisory resources were to a great degree focused on the continuous monitoring of credit institutions' operations through regular communication with credit institutions or the analysis of specific operating areas assessed to carry an increased degree of risk.

In 2015, the CNB carried out the supervisory cycle of assessment of the risk profile of credit institutions in relation to all the risks to which credit institutions are or might be exposed in their operations, an assessment of adequacy of the process of assessment and maintenance of the internal capital of a credit institution and continuous cooperation based on a dialogue between the supervisors and the credit institution. In addition, supervision includes the imposition and monitoring of supervisory measures aimed at taking actions to improve the operation of a credit institution, improve the safety of its operation and eliminate any illegalities.

In 2015, the CNB prepared written off-site examination analyses of credit institutions' operations, analyses of internal capital adequacy assessment reports, reports on the risk assessment of credit institutions (including reports for credit institutions for which cross-border colleges of supervisors were set up) and gave opinions on the assessment of recovery plans for all credit institutions.

The CNB carried out on-site examinations in 2015 in accordance with the adopted methodology for supervision, based on an on-site examination plan adopted at the end of each year for the following year. The on-site examination plan for 2015 was based on the established cycle of conducting regular on-site examinations of credit institutions, while extraordinary activities included engagement in operations of the trustee and special administration.

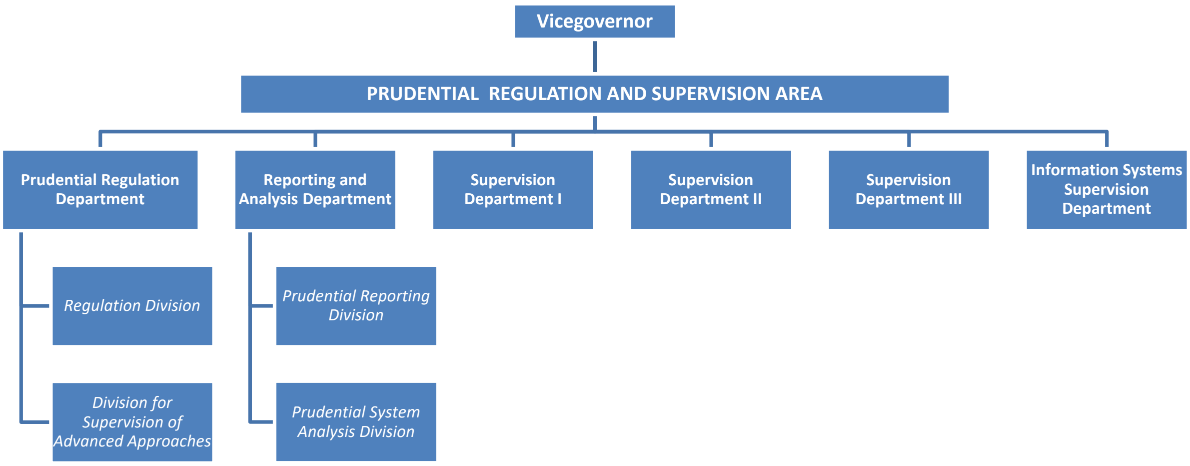
On the basis of continued monitoring of credit institutions and conducted on-site examinations in 2015, the CNB imposed a series of measures for the elimination of established illegalities and irregularities in their operation, as well as measures for improvement of the situation and recommendations for the improvement of business processes.

The table below lists supervisory activities carried out in 2015:

| Activities | Number of activities | Number of credit institutions |
|---|---|---|
| Reports issued on the basis of ongoing supervision (regular risk assessment) | 28 | 24 |
| Reports issued on the basis of ongoing supervision due to established irregularities | 8 | 6 |
| Conducted on-site examinations | 21 | 14 |
| Decisions issued to eliminate irregularities | 56 | 27 |
| Technical decisions issued (authorisations and approvals) as a result of implementing Regulation (EU) No 575/2013 | 24 | 15 |
| Decisions issued for the use of advanced risk measurement approaches | 2 | 2 |
| Warnings issued | 3 | 2 |
| Trustees appointed | 4 | 4 |
| Joint decisions adopted | 12 | 12 |
| Early interventions | 2 | 2 |

# ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

Supervisory activities are organised within the Prudential Regulation and Supervision Area. At the end of 2015, the Area had 109 employees, and the organisational chart was as follows:




# THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2015

In 2015, the CNB continued to cooperate with foreign supervisors, particularly as regards joint assessment 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 supervision of IT systems.

Based on the memoranda of understanding in effect, in 2015 CNB representatives participated in colleges of supervisors relating to the supervision of banking groups that include domestic credit institutions (12 credit institutions).

Within the framework of cooperation with foreign supervisors, the CNB is responsible for the creation of the Supervisory Risk Report, i.e. the annual assessment of the domestic credit institution's risk profile, which serves as an element for making the final Joint Risk Assessment Decision in relation to a banking group by the consolidating (home) supervisor. In 2015, the CNB drafted supervisory reports for 2014 and agreed on joint decisions on capital adequacy of a banking group. In addition, in the first quarter of 2015 joint decisions for 2013 were reached for institutions for which proceedings were not closed in 2014.

As of 2015, the CNB participates in the process of reaching a joint decision on the review and assessment of the recovery plan for groups of credit institutions. The proceedings were started in the middle of the year, while the agreement on joint decisions is expected to be reached in the first half of 2016.

The CNB continued to cooperate and provided technical assistance to supervisors from the region as regards the implementation of prudential regulation (CRD IV and CRR).

## COOPERATION WITH OTHER SUPERVISORY BODIES IN CROATIA

In 2015, the CNB continued to cooperate with the Croatian Financial Services Supervisory Agency (HANFA) by participating in the work of the joint Working Committee. At the Committee meetings, the institutions exchange information on current topics in the banking sector and the sector supervised by HANFA, resolve open issues on the exchange of data and arrange the coordination of supervisory activities. A regular meeting of the Committee was held in 2015, as well as a number of meetings of working groups and several bilateral meetings at which specific issues were discussed.

Regular meetings of the Working Committee for cooperation with the State Agency for Deposit Insurance and Bank Rehabilitation (DAB) were also held in 2015. At the Committee meetings, the institutions exchange information and data on institutions subject to supervision within their scope of competence.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

More information on the supervisory activities of the CNB, the regulations based on which supervision is exercised by the CNB and other regulatory texts are available on the CNB's website (www.hnb.hr).

# STATISTICAL TABLES

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

| Type of financial institution* | 2013 | 2014 | 2015 |
|---|---|---|---|
| Banks | 29 | 27 | 27 |
| Savings banks | 1 | 1 | 1 |
| Housing savings banks | 5 | 5 | 5 |
| **Banking sector, total:** | **35** | **33** | **33** |

*Data reffer to credit institutions operating in Republic of Croatia (RoC): banks, savings banks and housing savings banks. There are no branches of foreign credit institutions operating in RoC.

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 5,2 | 5,1 | 5,3 |
| Other domestic ownership | 5,0 | 4,6 | 4,3 |
| Domestic ownership total | 10,2 | 9,7 | 9,6 |
| Foreign ownership | 89,8 | 90,3 | 90,4 |
| **Banking sector, total:** | **100,0** | **100,0** | **100,0** |

### Concentration of asset by the type of financial institutions (end-2015)

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Banks* | 59,7 | 74,5 | 1 464,8 |
| Housing savings banks | 57,9 | 100,0 | 2 482,3 |
| **Banking sector, total:** | **58,5** | **73,0** | **1 409,5** |

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

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Banks | 0,8 | 2,8 | -8,8 |
| Housing savings banks | 5,1 | 8,9 | 6,4 |
| **Banking sector, total:** | **0,9** | **2,8** | **-8,5** |

*ROAE

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Banks | 98,1 | 98,1 | 98,1 |
| Housing savings banks | 1,9 | 1,9 | 1,9 |
| **Banking sector, total:** | **100,0** | **100,0** | **100,0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 17,8 | 17,0 | 17,0 |
| Nonfinancial sector* | 55,1 | 53,2 | 51,5 |
| Government sector | 18,5 | 19,3 | 19,7 |
| Other assets** | 8,6 | 10,5 | 11,9 |
| **Claims due to** | | | |
| Financial sector | 9,0 | 8,8 | 9,7 |
| Nonfinancial sector* | 57,3 | 59,1 | 63,0 |
| Government sector | 2,0 | 2,4 | 2,8 |
| Other liabilities** | 17,7 | 15,7 | 11,8 |
| Capital | **13,8** | **14,0** | **12,7** |

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

**Capital adequacy ratio of banks**

| Type of financial institution | 2013** | 2014*** | 2015*** |
|---|---|---|---|
| Banks | 21,0 | 21,8 | 20,9 |
| Housing savings banks | 20,5 | 23,5 | 25,8 |
| **Banking sector, total:** | **21,0** | **21,8** | **20,9** |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector, including: | 19,1 | 20,7 | 20,0 |
| **- households** | 11,1 | 12,0 | 11,8 |
| **- corporate** | 28,3 | 30,8 | 30,1 |

*share of partly recoverable (risk category B) and fully irrecoverable (risk category C) loans
Note: Up to 2013 bank loans were classified into risk categories A, B and C pursuant to the Decision on the classification of placements and off-balance sheet liabilities of credit institutions (OG 1/2009, 75/2009, 2/2010 and 89/2013). As of 2014, bank loans are classified into risk categories A, B and C pursuant to the Decision on the classification of placements and off-balance sheet liabilities of credit institutions (OG 41A/2014).

**The structure of deposits and loans of the banking sector in 2015 (%)***
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 83,5 | 78,9 |
| Households | 65,2 | 45,7 |
| Corporate | 18,3 | 33,2 |
| Government sector | 2,5 | 17,2 |
| Financial sector (excluding banks) | 3,2 | 2,2 |
| Other** | 10,8 | 1,8 |
| **Total:** | **100,0** | **100,0** |

*excluding deposits from/loans to banks
**non-residents

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 2 636,4 | 2 505,9 | 2 421,0 |
| Interest expenses | 1 288,4 | 1 146,1 | 1 020,5 |
| Net interest income | 1 348,0 | 1 359,7 | 1 400,4 |
| Net fee and commission income | 394,3 | 410,1 | 403,4 |
| Other (not specified above) operating income (net) | 165,0 | 195,8 | 101,7 |
| Gross income | 1 907,2 | 1 965,6 | 1 905,5 |
| Administration costs | 899,6 | 893,9 | 899,6 |
| Depreciation | 97,1 | 90,9 | 89,2 |
| Provisions | 11,9 | -2,4 | 911,6 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 801,8 | 704,1 | 656,4 |
| Profit (loss) before tax | 96,8 | 279,2 | -651,3 |
| Net profit (loss) | 66,4 | 208,0 | -598,3 |

**Total own funds in 2015 (in million EUR)**

| Type of financial institution | Total own funds*** | Core Tier 1 | Tier 1*** | Tier 2*** | Tier 3 |
|---|---|---|---|---|---|
| Banks | 6 668,9 | - | 6 101,6 | 567,2 | - |
| Housing savings banks | 96,4 | - | 86,9 | 9,5 | - |
| **Banking sector, total:** | **6 765,3** | **-** | **6 188,6** | **576,7** | **-** |

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

# 2015 DEVELOPMENTS IN THE CZECH BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

The annual growth of the Czech economy, which had started already in 2013 Q4, accelerated substantially in 2015. Real GDP picked up by 4.3% in 2015 as a whole. All domestic demand components, in particular gross capital formation and household consumption, contributed to the economic growth. The rise in household consumption was aided by relatively strong growth in real wages and salaries. The economic growth was also supported by a marked increase in government investment financed in particular from EU funds, a rise in external demand, low oil prices and – last but not least – still easy monetary conditions. Net exports recorded a slightly negative contribution to economic growth despite growing external demand, as imports of consumer and investment goods continued to increase.

Inflation remained at exceptionally low levels, averaging 0.3% in 2015. Both annual headline and monetary policy-relevant inflation were well below the lower boundary of the tolerance band around the CNB's target in 2015. The low inflation was also due to subdued developments in food prices and administered prices and a deepening of the annual decline in fuel prices. By contrast, "core" inflation accelerated to more than 1%.

The CNB Bank Board repeatedly decided to continue using the exchange rate as an additional instrument for easing the monetary conditions. At all its monetary policy meetings in 2015, it confirmed the CNB's commitment to intervene on the foreign exchange market if needed to weaken the koruna against the euro so that the exchange rate of the koruna is kept close to CZK 27 to the euro. It stated that a need to maintain expansionary monetary conditions at least to the current extent persisted.

The average CZK/EUR exchange rate appreciated slightly from 27.5 in 2014 to 27.3 in 2015. Conversely, the average CZK/USD rate weakened in year-on-year terms: in 2014 it was 20.7, but in 2015 it reached 24.6.

The current account ended 2015 in a surplus of 0.9% of GDP. In absolute terms the surplus amounted to CZK 41.4 billion.

Average unemployment, as measured by the share of unemployed persons, decreased to 6.6% in 2015. Total employment and the number of employees converted into full-time equivalents picked up year on year. The average gross nominal wage in the national economy continued to grow in 2015, up by 3.4% year on year. Given the considerably lower inflation rate compared to the rise in the nominal wage, the average real wage rose for the second consecutive year in 2015, up by 3.1%. Overall, the good macroeconomic results of the domestic economy were also reflected in a year-on-year increase in total labour productivity of 3.0% in 2015.

Measures to reduce the public finance deficit continued to be taken in 2015, leading to a further decline in the state budget deficit to 0.4% of GDP under ESA 95 methodology. The government debt-to-GDP ratio also decreased as a result of these measures, down to 41.1% in 2015.

In 2015 the Czech National Bank left key interest rates unchanged at technical zero. The two-week repo rate thus stayed at 0.05% in 2015 (since the

Bank Board's decision of 2 November 2012) and the discount and Lombard rates remained unchanged at 0.05% and 0.25% respectively.

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

The Czech banking sector was sound and well capitalised in 2015 and continued to generate profit. It has sufficient funds and no liquidity problems.

As of 31 December 2015, the Czech banking sector consisted of 46 banks and foreign bank branches. The structure of the banking sector has long been stable.

The shareholder structure of the Czech banking sector is stable, too. Foreign capital has long dominated banks' capital.

The banking sector continued to grow in 2015. Total assets increased by 3.0% to CZK 5,469.6 billion. The total receivables of the banking sector grew slightly throughout 2015. The sector's receivables make up a large part of its balance-sheet assets. Domestic banks' total loans to clients rose by 5.3% year on year, to CZK 2,832.9 billion at the end of 2015. Loans provided to households (individuals and trades) and non-financial corporations accounted for the largest share of the rise in lending.

The Czech banking sector recorded good financial results in 2015. It generated net profit of CZK 66.6 billion, which represents an increase of 5.5% compared to the previous year. The main source of net profit was again profit from financial activities (of more than CZK 174 billion), in particular interest profit accounting for almost 64% of profit from financial activities. Profit from fees and commissions accounted for CZK 34.3 billion, down by 4.8% in 2015. However, total administrative expenses increased slightly by 0.9% year on year, to CZK 70.9 billion. The banking sector paid aggregate income tax of CZK 14.1 billion, CZK 1.0 billion higher than in 2014.

The quality of the loan portfolio improved slightly in 2015. Non-default loans made up a large majority of the investment portfolio (94.6%). The total value of default receivables decreased by CZK 2.8 billion to CZK 172.4 billion. The share of default receivables in total investment portfolio receivables was relatively low, 5.5% at the end of 2015, down by 0.2 percentage point year on year.

Domestic banks are mostly local in nature and non-resident and foreign currency activities are relatively small. Operations in foreign markets are usually executed by other units from the financial group to which the domestic bank belongs. Transactions with non-residents are significant mainly in the interbank market.

The liquidity of the Czech banking sector remains very good and liquidity indicators remained stable during 2015. Sufficient primary funds are available to finance the loans of the banking sector.

The capitalisation of the Czech banking sector remains solid. The CET1 capital ratio stood at 17.40% at the end of 2015. The Tier 1 capital ratio increased by 0.4 percentage point year on year and reached 17.91%. The total capital ratio was 18.37% at the end of 2015. Total capital rose by 5.9% during the year to more than CZK 420 billion. The value of Tier 1 increased by more than 6.0% to more than CZK 410 billion, accounting for 97.5% of total capital.

All banks were compliant with the set minimum total capital ratio of 8%, the Tier 1 capital ratio of 6% and the Tier 1 (CET1) capital ratio of 4.5% during the whole of 2015.

The depth of banking intermediation as measured by the ratio of total bank assets to GDP decreased in the Czech Republic during 2015. It stood at 122.3% at the end of 2015, 2.2 percentage points lower than in the same period of 2014.

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

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

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

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

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

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

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

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

- to contribute systematically to ensuring and maintaining the financial stability of financial market entities, with an emphasis on timely identification of potential risks (especially in the area of prudential supervision),

- to contribute systematically to increasing the transparency of the financial market and the quality of conduct towards clients in the overall governance and management of financial market entities, leading to increased confidence of clients in the financial market (especially in the area of conduct of business supervision),
- to act in systematic coordination to ensure a unified and hence also effective approach to supervision in meeting these objectives.

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

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

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

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

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

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

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

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

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

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

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

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Banking supervision was performed under the standard regime in 2015. Owing to persisting uncertainties in the European economy, attention was devoted primarily to credit portfolios (particularly categorisation of claims, sufficient provisioning, collateral amount, etc.), sufficient capital to cover potential losses, liquidity and overall performance of banks and their consolidated units. In 2015, attention continued to be paid to the implementation of revised prudential rules associated with CRD IV and CRR. In line with the requirements of the BRRD directive, banks submitted to CNB supervision the amended versions of their recovery plans for assessment on an ongoing basis. At the same time, a number of consultations took place during which these amendments were discussed with banks.

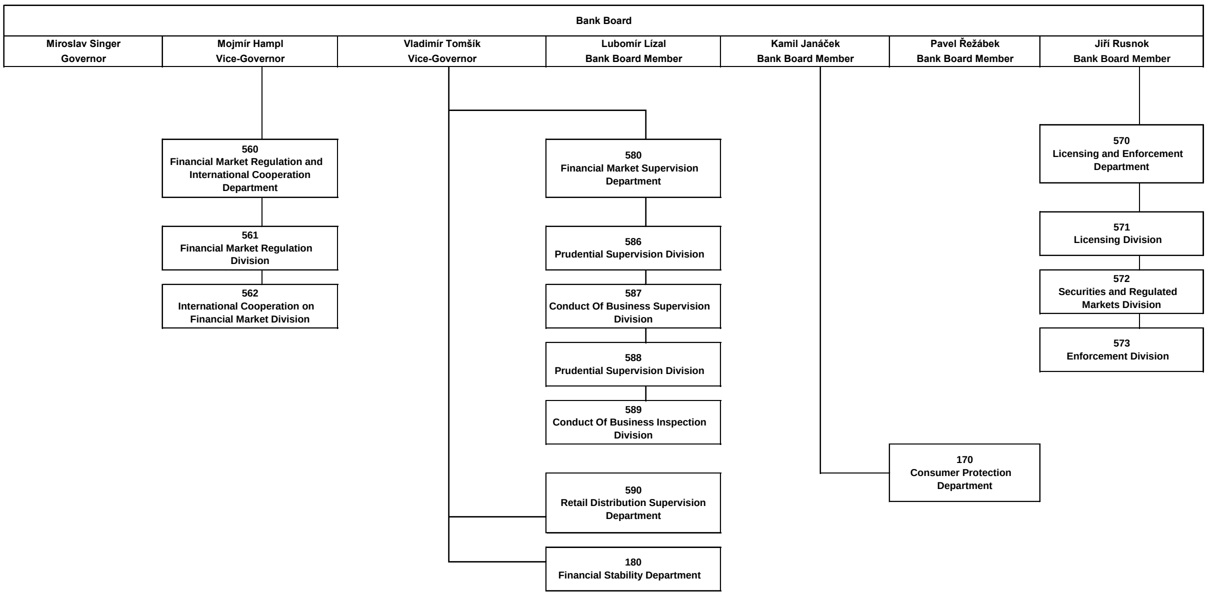
The CNB, in cooperation with selected banks, continued to implement the joint project of stress testing of banks in 2015. The frequency of the joint stress tests was unchanged from 2014, i.e. annual testing using year-end data. As in 2014, banks' interest rate risk was also tested in addition to credit risk. The nine largest domestic banks, most of which have received approval to use the special IRB approach for calculating the capital requirement for credit risk, took part in the testing using data as of 31 December 2014. These banks represent almost 90% of the assets of the Czech banking sector. The aggregated results of the two rounds of stress tests confirmed the good resilience of domestic banks. Their capital adequacy ratio stayed above the regulatory minimum by a sufficient margin even in an adverse scenario. In addition to these bottom-up tests, the CNB conducts half-yearly stress tests of the entire banking sector (top-down tests) whose results are regularly published on the CNB website.

Despite its relatively small market share, the credit union sector is subject to more intensive on-site inspection and continuous off-site surveillance owing to a higher degree of uncertainty with regard to its future evolution. In 2015, CNB off-site surveillance concentrated in particular on assessing the current situation and developments in individual credit unions and on resolving their problems, mainly with respect to specific risks undertaken by individual entities. An extraordinary information duty was introduced, aimed at detailed monitoring of the developments in individual credit unions (in the areas of liquidity, credit portfolio, operating costs, outsourcing, ceding of receivables etc.). Increased attention will continue to be paid to the relatively heterogeneous credit union sector.

## ORGANIZATIONAL CHART OF BANKING AUTHORITY

**Organisational structure of CNB financial market supervision**

as of 31 December 2015




## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The Czech National Bank cooperates actively with other (foreign) supervisors to ensure effective supervision within its area of competence and coordinated handling of crisis situations.

Where the Czech National Bank is the home supervisor, it establishes a supervisory college and manages the work of the college, which is the basic platform for cooperation. In doing so, it takes into account the risk profile and systemic importance of the supervised group and of the individual institutions that make up the group.

Where the Czech National Bank is the host supervisor, it coordinates and plans its activities in cooperation with the home supervisor, identifying areas of common interest. It aims for open communication and close cooperation with the home supervisor in order to cover its area of competence effectively. Such communication mainly concerns material risks relating to the supervised group or to the institution subject to supervision by the Czech National Bank. The Czech National Bank participates in on-site inspections organised by the home supervisor and allows the home supervisor to participate in inspections conducted by the Czech National Bank.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN THE CZECH REPUBLIC

The CNB's activities include cooperation with the Czech Ministry of Finance and other state administration bodies. The CNB works in close cooperation with the Czech Ministry of Finance, which has primary responsibility for preparing laws in the financial market area. It thus acts in accordance with the agreement on cooperation in the preparation of draft national legislation concerning the financial market and other regulations concluded between the Czech National Bank and the Ministry of Finance.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

The Central Credit Register (CCR) is an information system administered by the Czech National Bank since 2002 which enables banks and foreign bank branches operating in the Czech Republic (banks) to share information on the credit commitments and payment discipline of businesses and to create aggregated reports for the banking sector as a whole or for the main groups of banks. The data are used mainly by users from banks to assess potential and existing clients, but selected users from the CNB also have access for the purposes of banking supervision and financial stability.

During 2015, a plan to extend collection of individual loan data beyond the scope of the CCR in connection with the ECB's AnaCredit (Analytical Credit Datasets) initiative was considered in cooperation with banks. The function of the CCR will not be affected by the planned launch of extended data collection as from 2018 and the register will continue to serve as a platform for interbank exchange of information on the credit commitments of clients.

As in the previous period, the CCR continued to be involved in international data exchange with eight countries participating in the joint project on the basis of the MoU. The data obtained from this exchange are available to CCR users under the same conditions as the data collected from banks operating in the Czech Republic. Anonymised data for 2015 H1 and H2 were transferred to the ECB as part of the preparatory stage of AnaCredit.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 23 | 23 | 23 |
| Branches of foreign credit institutions | 21 | 22 | 23 |
| Credit unions | 12 | 11 | 11 |
| **Banking sector, total:** | **56** | **56** | **57** |

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

| Type of bank | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 3.8 | 4.3 | 2.2 |
| Other domestic ownership | 0.5 | 3.1 | 3.7 |
| Domestic ownership total | 4.3 | 7.4 | 5.9 |
| Foreign ownership | 95.7 | 92.6 | 94.1 |
| **Banking sector, total** | **100.0** | **100.0** | **100.0** |

### Concentration of asset by the type of financial institutions (2015 year-end)

| Type of financial institution | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 53.9 | 70.0 | 0.119 |
| Branches of foreign credit institutions | 56.1 | 68.1 | 0.134 |
| Credit unions | 74.8 | 91.4 | 0.234 |
| **Banking sector, total:** | 48.5 | 62.9 | 0.098 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 18.4 | 16.8 | 16.7 |
| Credit unions | n.a. i) | 0.6 | 0.8 |
| **Banking sector, total:** | n.a. ii) | 16.2 | 16.1 |

i) Indicators don't have information content due to the different accounting periods in the credit unions sub-sector.
ii) Within the CNB we have only banking sector data due to the different accounting periods in the credit unions sub-sector.

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 90.2 | 89.7 | 89.9 |
| Branches of foreign credit institutions | 9.2 | 9.7 | 9.5 |
| Credit unions | 0.6 | 0.6 | 0.6 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 8.8 | 14.9 | 12.1 |
| Nonfinancial sector | 48.4 | 30.7 | 29.7 |
| Government sector | 1.6 | 2.3 | 2.1 |
| Other assets | 41.2 | 52.1 | 56.1 |
| **Claims due to** | | | |
| Financial sector | 11.3 | 14.5 | 11.3 |
| Nonfinancial sector | 58.8 | 17.7 | 19.1 |
| Government sector | 8.4 | 6.5 | 4.1 |
| Other liabilities | 12.5 | 51.7 | 55.9 |
| **Capital** | **9.0** | **9.6** | **9.6** |

*Note: Banking sector = commercial banks + bank foreign branches.*
*Note: Different reporting of households in 2013.*

**Capital adequacy ratio of banks**

| Type of financial institution | 2013** | 2014 | | | 2015 | | |
|---|---|---|---|---|---|---|---|
| | | Total capital | Tier 1 capital | CET 1 capital | Total capital | Tier 1 capital | CET 1 capital |
| Commercial banks | 17.08 | 18.00 | 17.54 | 17.41 | 18.38 | 17.92 | 17.41 |
| Credit unions | 14.34 | 13.51 | 12.45 | 12.45 | 15.80 | 15.45 | 15.45 |
| **Banking sector, total:** | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector. | 6.2 | 6.4 | 6.1 |
| **- households** | 5.0 | 4.7 | 4.1 |
| **- corporate** | 7.2 | 6.6 | 5.7 |

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

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 95.5 | 93.6 |
| Households | 61.6 | 53.7 |
| Corporate | 27.5 | 37.4 |
| Government sector | 6.4 | 2.4 |
| Financial sector (excluding banks) | 4.5 | 6.4 |
| **Total** | **100.0** | **100.0** |

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

**Income statement of the banking sector**
**Absolute indicators**
(data as of the given date; in CZK millions)

| | 31.12.2013 | 31.12.2014 | 31.12.2015 |
|---|---|---|---|
| Financial & operating income and expenses | 168 171 | 167 905 | 174 781 |
| 1. Interest income | 154 787 | 158 865 | 150 847 |
| 2. Interest expenses | 49 315 | 48 445 | 39 926 |
| 3. Expenses on share capital repayable on demand | 0 | 0 | 0 |
| 4. Dividend income | 8 823 | 6 728 | 8 117 |
| 5. Fee and commission income | 49 868 | 48 965 | 47 587 |
| 6. Fee and commission expenses | 12 817 | 12 935 | 13 283 |
| 7. Gains or (-) losses on derecognition of financial asset and liabilities not measured at fair value throught profit or loss, net | 5 737 | 1 856 | 5 405 |
| 8. Gains or (-) losses on financial assets and liabilities held for trading, net | -9 554 | 4 080 | 9 526 |
| 9. Gains or (-) losses on financial assets and liabilities designated at fair value through profit or loss, net | -636 | -205 | 94 |
| 10. Gains or (-) losses from hedge accounting, net | -1 098 | -277 | 405 |
| 11. Exchange differences (gain or (-) loss) net | 23 053 | 8 328 | 4 562 |
| 12. Gains or (-) losses on derecognition of non financial assets, net | 88 | 276 | 766 |
| 13. Other operating income | 5 306 | 2 958 | 2 914 |
| 14. Other operating expenses | 6 071 | 2 289 | 2 234 |
| 15. Administrative expenses | 65 825 | 70 248 | 70 821 |
| 16. Depreciation | 6 496 | 6 413 | 6 569 |
| 17. Provisions or (-) reversal of provisions | 1 558 | 1 284 | 903 |
| 18. Impairment | 21 018 | 13 828 | 15 619 |
| 19.Negative goodwill recognised in profit or loss | 0 | 0 | 0 |
| 20. Share of the profit (-) or loss of investments in subsidiaries, joint ventures and associates | 21 | -1 | 2 |
| 21. Profit or (-) loss from non-current assets and disposal groups classified as held for sale not qualifying as discontinued operations | 4 | -8 | 62 |
| 22. Tax expense or (-) income related to profit or loss from continuing operations | 12 253 | 13 068 | 14 046 |
| 23. Profit or (-) loss after tax from disccontinued operations | 0 | 37 | 41 |
| PROFIT OR (-) LOSS FOR THE YEAR (1.-23.) | 61 048 | 63 092 | 66 928 |

**Total own funds in 2015 (in EUR millions)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 15 561.9 | 15 174.4 | 14 738.4 | 387.5 | x |
| Credit unions | 154.5 | 151.1 | 151.1 | 3.4 | x |
| **Banking sector, total:** | 15 716.4 | 15 325.5 | 14 889.5 | 390.9 | x |

*Note: Banking sector = commercial banks + credit unions.*
*Note: EUR = 27.025 CZK as at 31 December 2015.*

# 2015 DEVELOPMENTS IN THE ESTONIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

The state of the Estonian financial sector in 2015 was sound. The level of systemic risk perceived by financial markets was low. In the European Union, the focus shifted from legislative drafting to its implementation stage. The Financial Supervision Authority (FSA) took steps for the prevention of risks and for the elimination of adverse effects. We began to licence small creditors, launched the crisis resolution function and adopted a new strategy for years to come.

In 2015, the systemic risk perceived by markets was low across the entire European Union. Major risks included national debt burdens, the low profitability of banks, heterogeneity of the credit market, rapidly increasing prices of housing property and the effect of the low interest rate environment. From Estonia's perspective, the risk concerned the potential revaluation of risks arising from the economies and banks of Nordic countries by financial markets, which, if realised, would have increased the funding and liquidity risks of banks. Due to increased income and low interest rates, the risk of the acceleration of the rise of property prices in Estonia persisted. A tense situation in foreign policy also left its mark.

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

The Estonian bank-centred financial market was as concentrated as before and the market share of branches was high. The ratio of banking sector's total assets to GDP was 113%. In 2015, an increased intention to enter into the Estonian regulated financial market either through the application of an authorisation or the acquisition of a company or a qualifying holding was notable. Some financial intermediaries changed their strategy of operating in the Estonian market. The volume of loans granted by credit institutions increased and the quality of the loan portfolio maintained its sound level, whereas the volume of deposits grew. The relative importance of non-resident customers in the entire customer base indicated a decrease. Investment funds grew mainly due to the growth of mandatory pension funds. The indicators in the insurance sector were generally good.

The Financial Supervision Authority as a supervisory body took steps for the prevention of risks and elimination of adverse effects. Under the guidance of the FSA, regulated financial intermediaries maintained sufficient capital buffers and in general, the sector adhered to the requirements of laws in the administration of their organisation and delivery of services. Some single risks in these areas were realised, but the FSA prevented or eliminated a wider adverse effect of these situations either in cooperation with market participants or by taking necessary measures.

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

On 18 February 2015, the Riigikogu passed the Financial Crisis Prevention and Resolution Act, which governs the application of crisis prevention and resolution tools and powers to credit institutions and investment firms. In addition to acting as a supervision authority, the FSA is also a resolution authority pursuant to the Act. The Financial Crisis Prevention and Resolution Act entered into force on 29 March 2015.

On 18 February 2015, the Riigikogu passed the Creditors and Credit Intermediaries Act, which sets out that creditors and credit intermediaries have to apply to the Financial Supervision Authority for authorisation and bring their activities into conformity with the provisions of the Act by 21 March 2016. As a rule, supervision covers all creditors and credit intermediaries who grant or mediate consumer credit.

As of 1 January 2016, insurance activities are governed by the new Insurance Activities Act that was passed in 2015 and with which the risk-sensitive norms of the European Union or Solvency II are transposed into Estonian law. Solvency II established common requirement for the assets and liabilities and management systems of insurance intermediaries in all Member States. In addition to this Act, insurers will be governed by the directly applicable resolution of the European Union and implementation standards and guidelines that describes the principles of Solvency II written into the Insurance Activities Act in greater detail. These rules will have a significant effect on insurers and their activities.

Other important changes included the enforcement of provisions governing the infrastructure of the securities market, new provisions on investment funds, new legal acts for the prevention of market abuse, the harmonisation of provisions governing the intermediation of financial services, initatives and reforms concerning the security net of the financial sector, the enforcement of a new framework of payment services, the Creditors and Credit Intermediaries Act, etc.

In the harmonised legal environment, the following agencies of the European Union play an increasing role: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). They substantiate the framework acts of the European Union with implementation acts and guidelines. In cooperation with the European Commission, these agencies define the harmonised plan of legislative drafting and legislative practices at the technical level for the forthcoming period.

In terms of legislative drafting, 2015 was very labour intensive for the FSA. Several draft Acts and the materials based on which they were developed needed to be commented on and coordinated. Throughout the year, the specialists of the FSA worked on almost all special acts that govern the financial sector, including the Law of Obligations Act, the Guarantee Fund Act, the Emergency Act, the Act that amends the Accounting Act, the draft Act of Investment Funds, the Ratification Act of the Intergovernmental Agreement on the Transfer and Mutualisation of Contributions to Single Resolution Fund, and other draft Acts.

# MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

In prudential supervision we will focus on integration with the European Single Supervisory Mechanism, with emphasis on cooperation with Eesti Pank. In addition we will also focus on corporate governance, with emphasis on the suitability of managers, the internal control system, business continuity and outsourcing, and accuracy of reporting.

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

In crisis resolution, we will focus on the integration with the European Single Resolution Mechanism and the Single Resolution Board and also on the preparation of resolution plans.

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

We will contribute to the analysis and optimisation of the institutional framework of financial crises resolution in Estonia, to the analysis of potential new supervision areas and to monitoring of financial innovation.

# THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

**Supervisory and crisis resolution activities of the Financial Supervision Authority**

In 2015, the FSA granted one credit institution authorisation, one payment institution authorisation, one money remittance service licence and two authorisations for granting consumer credit. In addition, the FSA granted a supplementary activity licence to one management company for the provision of an investment service and one supplementary payment institution authorisation. During the year, the FSA also revoked one investment firm authorisation, one management company authorisation and one payment institution authorisation.

The FSA refused to grant authorisations to two companies. Applications of six companies applying for authorisation were not reviewed, as there were material shortcomings in the documents submitted to the FSA.

In 2015, the FSA reviewed the suitability of more than 180 persons and during the process, the person's conformity to legal requirements and their suitability to the financial sector was verified. The persons operating in the financial sector must conform to legal requirements and have an impeccable reputation.

In 2015, the Management Board of the FSA registered the rules of two new contractual investment funds and coordinated the establishment of one investment fund set up as a public limited company. During the year, the FSA also registered the amendments in the rules of ten funds; the amendments in the articles of association of investment funds established as public limited companies were coordinated on three occasions, one authorisation was granted for funds' merger and one authorisation also for a cross-border merger. In 2015, one investment fund was dissolved.

Pursuant to § 81 of the Investment Funds Act, the FSA also registered one management company of a fund, which was established outside the scope of the Investment Funds Act: AS Etalon Varahaldus.

Insurance intermediaries in Estonia are insurance brokers and insurance agents. An insurance broker represents the interests of the insured person. An insurance agent represents the interests of an insurance company by intermediating the services of an insurer. An insurance agent is entered on the list of insurance agents by the insurance company whom they represent. In 2015, the FSA entered three new insurance brokers on the list of insurance intermediaries and deleted three insurance brokers from the list.

In 2015, the FSA granted authorisations to two payment institutions for operating in the countries of destination through respective agents. One payment institution was authorised to provide cross-border services in four member states of the European Union. In addition, authorisations for the provision of cross-border services were granted to two insurance intermediaries and one credit institution.

In 2015, the FSA issued licences for the establishment of branches to two non-life insurance companies, AB Lietuvos Draudimas and Compensa Vienna Insurance Group UADB. An authorisation was also granted for the establishment of a payment institution, Kortaccept Nordic AB Estonia Branch. LHV Pank AS obtained authorisation for the establishment of a branch in the Republic of Latvia.

Financial institutions that have obtained authorisations subject to EU law in other EU Member States do not have to apply for a license from the Financial Supervision Authority for the provision of financial services in Estonia. They may commence the provision of cross-border services after the competent supervision agency of the respective EU member state has informed the Financial Supervision Authority of the financial institution’s wish to provide its services in Estonia and has forwarded the information required by law to the FSA. The number of cross-border service providers in Estonia increased in 2015.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

**Supervisory Board**

**Management Board**



**Andres Kurgpõld**
Member of the Management Board

**Kilvar Kessler**
Chairman of the Management Board

**Andre Nõmm**
Member of the Management Board

Prudential Supervision Division

Prudential Policy and Financial Reporting Division

Legal Department

Resolution Department

International Cooperation

Public Relations and Consumenr Education

Head of Human Resources

Internal Audit

Business Conduct Supervision Division

Market Supervision and Enforcement Division

Administrative Services Department

# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

Representatives of EU national supervision authorities participate in the Board of Supervision of each European Supervision Authority (ESA) founded in 2010 – the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

All three supervision authorities are connected by the Joint Committee of the European Supervision Authorities. In 2015, the Joint Committee, among other topics, dealt with the budgets and strategies of the European supervision authorities, and consumer protection and anti-money laundering issues, as well as prepared surveys on financial market development and risks. Experts of the FSA acted as members in two Joint Committee working groups and participated in five meetings of these working groups.

In 2015, the representatives of the FSA acted as members in 32 different committees or working groups of the European supervision authorities and attended 95 meetings.

The year 2015 was the first full year of working for the Single Supervisory Mechanism (SSM), which was launched on 4 November 2014. Alongside the Single Resolution Mechanism, the SSM is the other pillar of the European Banking Union, which incorporates the European Central Bank and the supervision agencies of the euro area countries. Within the Single Supervisory Mechanism, supervision is exercised over 123 significant banking groups of the euro area. Of the banks operating in Estonia, the European Central Bank exercises direct supervision over Swedbank AS and AS SEB Pank. The FSA exercises supervision over other, smaller credit institutions, but if applicable, the FSA has to follow the guidelines and standards of the European Central Bank, if issued on specific matters.

The Single Resolution Board became functional in March 2015. The Single Resolution Mechanism together with the SSM are the two main pillars of the European Banking Union and the SSM incorporates the Single Resolution Board and the national resolution authorities of the euro area countries. As of the spring of 2015, the national resolution authority in Estonia is the FSA. The objective of the SRB is to ensure the orderly resolution of failing banks, with minimum impact on the real economy and the public finances in the euro area countries and elsewhere.

Together with Eesti Pank, the FSA participated in the work of the European Systemic Risk Board (ESRB) under the auspices of the European Central Bank in 2015. The FSA participated in the sessions of the highest decision-making body, the General Board of the ESRB, as a member without voting rights and as a full member of the Advisory Technical Committee established at the ESRB. In 2015, the FSA participated in four meetings of the General Board and two meetings of the Advisory Technical Committee, where the issues of ensuring financial stability were discussed.

In addition, the FSA participated in the work of the following global organisations in 2015: the International Association of Insurance Supervisors (IAIS); the Bank for International Settlements (BIS), including its Group of Banking Supervisors from Central and Eastern Europe (BSCEE); the International Organisation of Securities Commissions (IOSCO); and the Organisation for Economic Cooperation and Development (OECD).

Meetings were also held within traditional annual visits of rating agencies to Estonia: Fitch Ratings in April, Standard & Poor’s in May and Moody’s in July. In the course of the evaluation visits of rating agencies, the FSA presented a traditional overview of the developments and risks in the financial sector.

In October, the representatives of the FSA met with the delegation of the IMF within the IMF's Article IV Mission. In November, the FSA met with the delegation of the European Commission in connection with the Macroeconomic Imbalance Procedure.

In the framework of activities concerning the supervision and resolution of cross-border financial groups, the FSA participated in the work of 14 supervisory colleges in 2015.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

The Supervisory Board of the Financial Supervision Authority approved the new strategy for 2016–2018. The strategy was developed based on the experiences gained from the development and implementation of previous strategies as well as the fact that the strategy has to take into consideration the tasks resulting from the legislation of the European Union and Estonia and the strategies of its main partners.

In developing the strategy, the risks central to the financial sector were screened: the avalanche of regulations and the capability of financial intermediaries to adapt their organisation to new requirements; the implementation of the updated architecture of banking prudential supervision; business interruptions and their connection with the business continuity of IT, telecommunications and electricity supply and the dependence of operations on outsourcing; the quality of the management and organisations of new players, the origin of their capital, the law-abiding behaviour of certain subjects and the riskiness of their business models; mis-sale of certain widespread products, compliance with the requirements for understanding customers and related organisational solutions; and conflicts of interests in the activities of financial intermediaries.

In line with strategic choices we have to make sure that financial intermediaries have integral managers, transparent management practices and sustainable operations. We will see to it that the regulated financial market has carefully designed transparent and responsibly sold products and that financial intermediaries have sufficient controls in place which minimize the options of terrorists and other criminals to misuse the financial system. For every bank, the FSA will prepare a plan that will contribute to the solution of any serious crisis at the bank. If applicable, we will analyse potential supervision areas, provide advice for the improvement of the efficiency of a financial safety net and address the opportunities and risks of financial innovation. The FSA will integrate with the banking supervision and resolution system of the euro area.

In the performance of our tasks, we act based on risks, we stand for proportionality and uniformity, and we pursue a common conservative streak and deliver results.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 8 | 8 | 9 |
| Branches of foreign credit institutions | 7 | 7 | 7 |
| **Banking sector, total:** | **15** | **15** | **16** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 0.0 | 0.0 | 0.0 |
| Other domestic ownership | 5.2 | 5.3 | 5.9 |
| Domestic ownership total | 5.2 | 5.3 | 5.9 |
| Foreign ownership | 94.8 | 94.7 | 94.1 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

**Concentration of asset by the type of financial institutions**

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 64.8 | 69.7 | 0,208 |
| Branches of foreign credit institutions | 24.5 | 26.2 | 0,030 |
| **Banking sector, total:** | 89.3 | 95.9 | 0,238 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Banks | 11.7 | 10.2 | 6.6 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 71.2 | 73.1 | 73.6 |
| Branches of foreign credit institutions | 28.8 | 26.9 | 26.4 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 20.0** | 35.7*** | 28.0*** |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 2.0 | 1.8 | 1.3 |
| **- households** | 2.6 | 2.2 | 1.5 |
| **- corporate** | 1.8 | 1.9 | 1.6 |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 81,8 | 87.3 |
| Households | 41.1 | 45.6 |
| Corporate | 40.7 | 41.7 |
| Government sector | 7.1 | 3.0 |
| Financial sector (excluding banks) | 11.1 | 9.7 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 480 | 492 | 498 |
| Interest expenses | 101 | 87 | 77 |
| Net interest income | 379 | 405 | 421 |
| Net fee and commission income | 132 | 148 | 156 |
| Other (not specified above) operating income (net) | 247 | 134 | 383 |
| **Gross income** | **920** | **823** | **817** |
| Administration costs | **268** | **266** | **273** |
| Depreciation | 12 | 15 | 14 |
| Provisions | 9 | 0 | 0 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 23 | 19 | 27 |
| Profit (loss) before tax | 462 | 344 | 673 |
| Net profit (loss) | 445 | 334 | 610 |

**Total own funds in 2015 (in EUR millions)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 |
|---|---|---|---|---|
| Commercial banks | 2012 | 1984 | 1989 | 23 |

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

# 2015 DEVELOPMENTS IN THE GEORGIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2015 economic growth in Georgia reached 2.8%. Major contributors to the growth in 2015 were construction (15.2%), and operation with real estate (6.9%). High growth rates were recorded in construction-mining and financial sectors.

Growth rate of private consumption was under 9%, and it accounted for more than 50% of nominal growth of GDP in 2015. Other source of growth, namely, export of goods and services, has increased by 14%. Tourism sector has also supported the growth of export revenues in 2015. Gross capital formation made up 32% of GDP, nominally increased by 17%.

Gross national savings rate increased to 21.7% of GDP in 2015. Unemployment rate remained high; however, it decreased slightly to 12.0% in 2015 compared to the previous year (12.4%).

Inflation rate was increasing in 2015, and it had reached - 4.9% by December. As a response to increased inflation expectations, the National Bank of Georgia (NBG) gradually increased the monetary policy rate from 4.0% to 8.0% in 2015.

Consolidated budget deficit has reached 3.7% of GDP compared with 3.2% in 2014. Tax revenues of consolidated budget have increased significantly by 10.6% compared to 8.7% in 2014, while budget current expenditures increased by 5.5% compared to 15.0% in 2014. Tax burden made up 25.3% of GDP, which is more than 24.8% in 2014. Public debt to GDP increased and amounted to 41.4% in 2015, while in 2014 it was 35.4%.

Current account deficit reached 11.8% of GDP in 2015, which is 1.2 percentage points higher than in 2014. The imports decreased by 15.3%[26], but exports decreased by 23%, which is higher than its decline of 1.7% in 2014. Trade deficit made up 30.8% of GDP in 2015. Revenues from tourism, as well as transfers and remittances were significant sources of financing trading goods deficit. Other sources of financing of current account deficit were FDIs, which made up about 1.351 billion USD in 2015, which is 23% less than in 2014. At the same time, the outflow of portfolio investments made up 156 mln USD in 2015, unlike the previous year, when it was 207 mln USD inflow. As the result, total external debt increased by 1.2 billion USD up to the 15 billion USD, which is 107% of GDP. In the same period, external public debt increased to 33% of GDP. Large portion of the state borrowing consisted of low interest bearing loans from donor organizations.

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

Banking is the main financial intermediary in Georgian economy. Foreign investments dominate banking sector and account for more than 80% percent of

[26] Without imports of hepatitis C treatments which are provided to Georgia as a grant.

total equity. Banking sector assets grew by 22% in 2015. Credit portfolio increased by 23.5% YoY at the end of 2015, compared to 23.7% in 2014, mainly due to exchange rate effect. In total, credit portfolio accounted for 50.5% of GDP which is 6% higher than in 2014. As for the total assets of banking sector, they accounted for 79.5% of GDP that is 9 percentage points higher than in 2014.

In 2015, the highest growth rate was recorded in SME (33% annually), followed by corporate and retail sectors. Banking sector loan portfolio break-down by products is the following: 38% accounts for corporate sector, 41% - retail sector, and 21% - SMEs.

Throughout the year, loan portfolio quality remained the same. According to NBG's more forward-looking methodology and taking into account restructured loans with no evidence of being able to repay them under the new schedule, NPL ratio decreased by 0.1 percentage points and made up 7.5% of total portfolio. At the same time, NPL ratio calculated with widely accepted methodology - loans with more than 90 days overdue to total portfolio - decreased to 2.8% in 2015, 0.3 percentage points less than in 2014.

In 2015, banking sector accumulated liquidity ratio above the prudential minimum. The share of liquid assets to total assets and non-bank deposits made up 23% and 41%, respectively.

Banking system still remained highly dollarized, contributing to currency induced credit risk. In 2015, the dollarization of loans increased by 3.9 percentage points, up to 64.3%, and dollarization of deposits also increased, making up 69.4%. To mitigate this risk, NBG applies additional risk weights for foreign currency exposures and higher reserve requirement for foreign currency deposits.

Georgian banking system is well capitalized, mainly driven by aforementioned risk weighting. At the end of 2015, CAR for Tier I capital and regulatory capital were 11% and 17.5%, respectively, which are significantly higher than the required prudential minimum. The same indicators, calculated based on Basel II/III methodology, were 12% and 16.7%, respectively.

Profitability of banks increased in 2015. Net income of the system jumped from 475 million GEL in 2014 to 537 million GEL in 2015. At the end of 2015 RoA made up 2.3% and RoE made up 15.4%. Nominal growth of the credit portfolio and increase of liquid asset yield led to higher profitability in banking system. In addition, the efficiency of banking system continued to improve with the increase of scales of operations. Cost to income ratio declined from 49.6 % in 2014 to 46.6% in 2015.

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

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

The legal framework of the operation and supervision of financial institutions is primarily defined by the Constitution of Georgia (Articles 95 and 96); Organic Law of Georgia on the 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.

Throughout 2015, NBG continued to further improve and develop supervisory framework in line with risk-based supervision principles. This included, but was not limited to, implementation of Pillar 2, improvement of normative acts and development new legislative initiatives for the purpose of strengthening effective supervision.

In the process of developing Pillar 2 capital adequacy framework based on Basel II/III, "Instruction on Capital Buffer for Credit Concentration Risk for Commercial Banks" was approved (Decree N125/04 of December 30, 2015). The instruction contains certain definitions and guidelines for calculating Pillar 2 concentration charges for capital add-ons.

The new edition of "Regulation on Management of Conflicts of Interests" was approved (Decree N26/04 of March 10, 2015). The regulation enhances adequate supervision and control of commercial banks' transactions with related parties for the purpose of avoiding conflict of interests as much as possible. The regulation is based on IAS 24 and is compliant with the principles of effective banking supervision defined by Basel Committee on Banking Supervision.

Furthermore, the updated version of "Regulation on Internal Audit Requirements for Commercial Banks" (Decree N25/04 of March 10, 2015) was approved. The regulation enhances cooperation between supervisors and internal auditors according to the best international practice.

Based on the recommendations from International Monetary Fund and World Bank, NBG worked on legislative initiatives that should strengthen effective banking supervision.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

In 2015, the main strategic objective of the National Bank of Georgia was to continue improving and developing the supervisory framework, including the implementation of Pillar 2 framework.

In 2015, credit portfolio monitoring became a priority of the supervisory process due to the local currency devaluation, severe competition, and increased share of unregulated financial intermediaries. Enhanced monitoring included updating critically important indicators on an ongoing basis to evaluate the quality of credit portfolio in a timely manner.

Transparency of the financial sector remained one of the most important priorities for NBG in 2015. In that regard, NBG continues conducting reforms for enhancing transparency.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2015, throughout the supervisory review and evaluation process (SREP), commercial banks' Internal Capital Adequacy Assessment Process (ICAAP) results were evaluated. In particular, feedback and recommendations on the submitted ICAAP results were provided to the largest banks of the Georgian banking sector. Banks were required to renew their ICAAP according to the provided comments.

Within pillar 2 of Basel II/III, all material risks of a bank should be reflected in the capital add-ons. In that regard, NBG successively developed an approach that ensures the integration of supervisory stress tests with pillar 2 framework.

Enterprise-level stress-tests entail systemic shocks of economic nature, shocks of sectorial importance and idiosyncratic events. They also play an important role in the assessment of internal capital adequacy during the supervisory review in accordance with Basel II/III. Alongside the integration of supervisory stress-tests with pillar 2 framework[27], it is important to avoid double requirement of capital for similar risks. Accordingly, capital buffer under supervisory stress-tests is effective if it is greater than the sum of Countercyclical and Conservation buffers of Basel III.

In 2015, NBG continued working on fully replacing current reporting system of commercial banks with the IFRS system. As a result, continuous supervisory reporting by commercial banks in line with IFRS will be based on the reporting system established by the European Union (FINREP). This will contribute to enhancing transparency and efficiency, and will avoid any double reporting burden. However, NBG will also maintain prudential filters to ensure that the conservative and risk-based supervision process continues uninterrupted.

Within the scope of the project of transferring supervisory reporting to IFRS, NBG drafted a local FINREP reporting form, which is a modification of the European FINREP and incorporates specificities of the Georgian banking sector. To hear the feedback from the industry, NBG organized meetings with commercial banks. Leading representatives of the banking sector were required to report financial

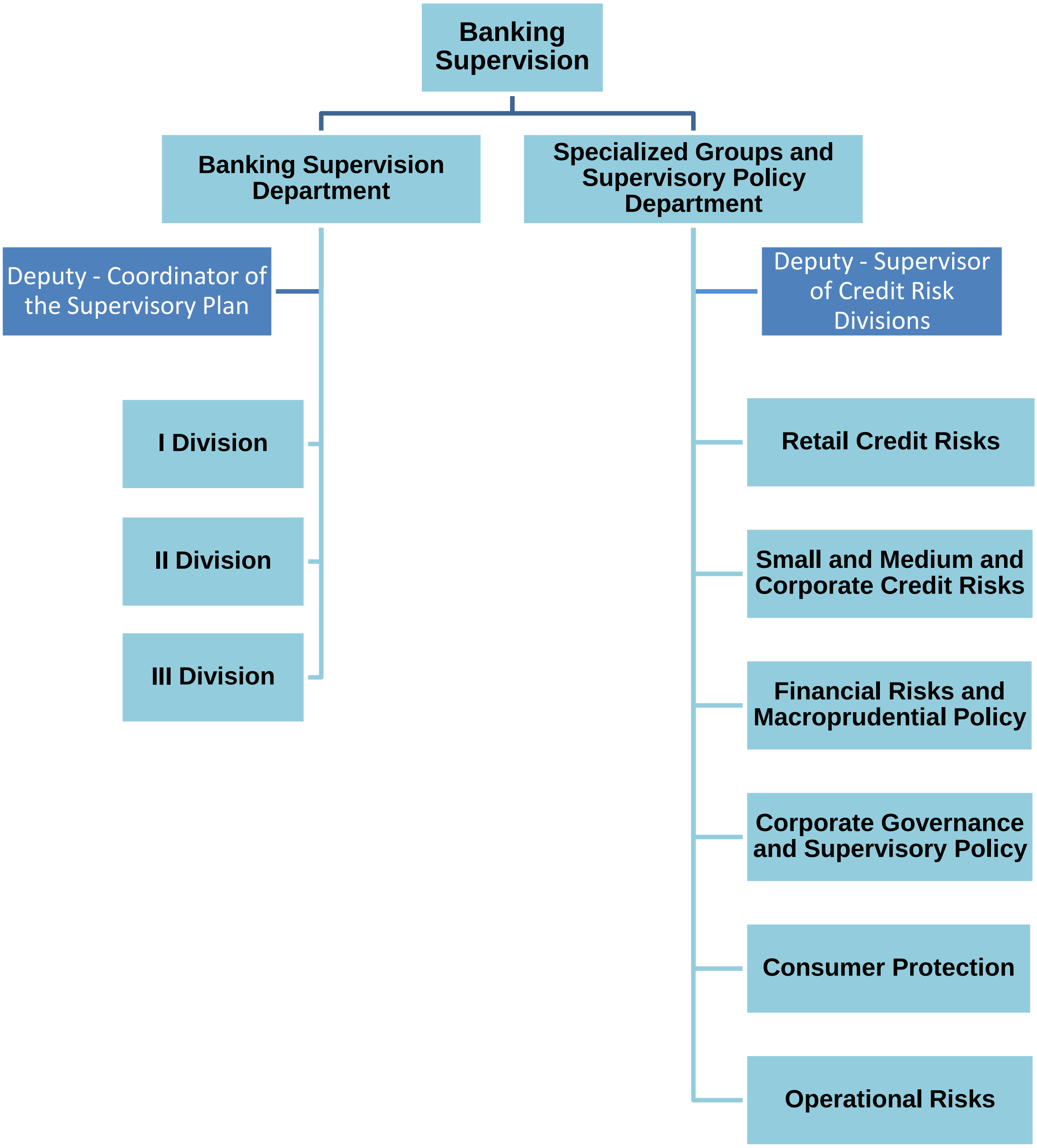
[27] For further information, see the presentation „Building Supervisory Pillar 2 under GRAPE using Simplicity, Comparability and Risk Sensitivity Principles"

statements according to the draft FINREP form. The goal of this process is to identify technical difficulties of filling out the form in order to design more appropriate and understandable version of the form.

Further, throughout 2015 NBG continued the cooperation with external auditors of commercial banks to improve transparency and quality of annual financial reporting. With the increase of banking sector’s assets and complexity, the process of sharing information between supervisors and external auditors is highly important, as both sides have the same objectives.

In 2015, NBG became a member of an inter-agency group working on accounting and auditing reform in Georgia. The goal of the working group is to propose legislative amendments related to accounting, financial reporting and audit in order to gradually approximate respective local legislation to the EU requirements. Together with other members of the working group, NBG participated in consultations with professional unions of accountants and auditors, and in the process of drafting new legislative acts. Drafting these regulations is an important step with respect to enhancing transparency and corporate governance in real sector, which ensures promotion of spheres of credit issuance, foreign direct investments, private capital and capital markets.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY




The supervisory pillar of NBG is directly managed by one of the two Vice-Governors. Supervisory functions are performed by two closely related groups – bank supervisors and specialized groups. Bank supervisors (Banking Supervision Department) are responsible for all risk areas across each bank, while specialist risk teams (Specialized Groups and Supervisory Policy Department) are responsible for the system-wide monitoring and assessment of their particular risks across all banks and maintaining systemic stance of the risk. They elaborate risk assessment methodologies, set system-wide benchmarks and are involved in all risk–related tasks.

Normally, the assessment of each risk (inherent risk and risk mitigants) at each bank will be prepared and/or reviewed by these two departments. The separation of the tasks of reviewing/preparing depends on resource availability and task complication level. This approach contributes to more appropriate and consistent benchmarked assessments, while also meeting the "four eyes" principle. It also ensures that a strong peer group review element and consistency of treatment across banks is introduced at an early stage in the risk assessment process, in contrast to other systems where the risk assessment process is driven entirely by the bank supervisor, and any peer group or "panel review" procedures are introduced towards the end of the process. Supervisors are not separated into on-site and off-site supervisors. Both the supervisors and the specialist risk teams undertake on-site and off-site work and perform all necessary steps to identify and assess banks' risks and elaborate relevant supervisory actions[28].

## INTERNATIONAL ACTIVITY OF THE AUTHORITY

In 2015, the National Bank of Georgia was actively engaged in the activities of Basel Consultative Group (BCG) of the Basel Committee on Banking Supervision (BCBS). NBG became the member of BCG in 2014. Within the framework of the membership, NBG representatives participated in meetings devoted to developing and implementing advanced approaches of international supervisory policy. NBG supervisors also shared their knowledge and experience with other group members.

NBG further enhanced its cooperation with BCBS within the framework of Regulatory Consistency Assessment Program (RCAP), and NBG representatives were invited as experts in RCAP working group. Within the frames of the program, NBG representatives monitor and evaluate the consistency of the Basel III implementation process in the member countries of the Basel Committee. In addition, throughout 2015, NBG was actively engaged in the main activities of the BCBS's Supervision and Implementation Group, in particular focusing on international standards and prudential approaches regarding asset classification.

In 2015 NBG enhanced the export of its reforms in the direction of banking supervision. For the purpose of sharing experience and studying the reforms related to banking supervision, delegations of different countries' central banks visited NBG. In addition, NBG representatives conducted international seminars regarding banking supervision issues in different countries.

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

## COOPERATION WITH OTHER SUPERVISORY BODIES IN GEORGIA

Until April 2013, NBG was the sole regulator for the financial sector in Georgia. In April 2013 the insurance supervision function was separated from the National Bank of Georgia and a separate public body – State Insurance Supervision Service of Georgia – was established for performing insurance supervision. A Memorandum of Understanding (MOU) between the 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 addition, NBG and Financial Monitoring Service have a formal memorandum of understanding on sharing information regarding money laundering and illicit income issues.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

Financial sector consumer protection is a very important question for the National Bank of Georgia. In 2015, in cooperation with SBFIC, NBG conducted a Mystery Shopper study at commercial banks.. To respond to some of the shortcomings identified by the study above, NBG conducted a workshop for commercial banks, dedicated to thoroughly discussing existing challenges in consumer protection in the country, ways of mitigating deficiencies, and future prospects. Banks were also required to amend their training materials for the employees responsible for consumer service and protection, closely monitor relevant staff performance, and analyze risks related to their products. In addition, in 2016 NBG is planning to introduce amendments to the regulatory framework for consumer protection, extending NBG’s authority over non-bank lending institutions, and addressing such important questions as risk disclosure, remote banking, marketing activities, and inactive accounts.

Financial consumer protection is closely linked with financial education. Financially literate consumers can make better informed choices and avoid financial distress. Therefore, NBG, with the involvement of international experts, is actively working on developing National Financial Education Strategy, which entails synthesizing and streamlining the efforts of different public and private stakeholders with a common goal of enhancing financial literacy levels in the country.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 19 | 18 | 18 |
| Branches of foreign credit institutions | 2 | 2 | 1 |
| Cooperative banks | | | |
| **Banking sector, total:** | 21 | 20 | 19 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | | | |
| Other domestic ownership | | | |
| Domestic ownership total | 15% | 13% | 15% |
| Foreign ownership | 85% | 87% | 85% |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 65.21% | 77.33% | 18.52% |
| Branches of foreign credit institutions | 0.43% | 0.43% | 0.003% |
| Cooperative banks | | | |
| **Banking sector, total:** | 65.21% | 77.33% | 18.52% |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 14.62% | 14.79% | 15.37% |
| Cooperative banks | | | |
| **Banking sector, total:** | 14.62% | 14.79% | 15.37% |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 99.57% | 99.23% | 99.75% |
| Branches of foreign credit institutions | 0.43% | 0.77% | 0.25% |
| Cooperative banks | | | |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | 100.0% | 100.0% | 100.0% |
| Financial sector | 1.3% | 1.3% | 1.5% |
| Nonfinancial sector | 54.0% | 56.9% | 57.7% |
| Government sector | 5.9% | 5.2% | 4.7% |
| Other assets | 38.8% | 36.6% | 36.1% |
| **Claims due to** | 83.2% | 82.6% | 86.0% |
| Financial sector | 3.4% | 3.9% | 4.6% |
| Nonfinancial sector | 52.8% | 53.6% | 53.5% |
| Government sector | 3.2% | 2.7% | 3.4% |
| Other liabilities | 23.8% | 22.4% | 24.5% |
| **Capital** | 16.8% | 17.4% | 14.0% |
| **Claims from** | 100.0% | 100.0% | 100.0% |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | | 2015 | |
|---|---|---|---|---|---|
| | | Basel I | Basel III | Basel I | Basel III |
| Commercial banks* | 17.16% | 17.35% | 16.52% | 17.49% | 16.66% |
| Cooperative banks | | | | | |
| **Banking sector, total*:** | 17.16% | 17.35% | 16.52% | 17.49% | 16.66% |

(* - 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 | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 7.55% | 3.09% | 2.75% |
| **- households** | **1.63%** | **2.36%** | **2.24%** |
| **- corporate** | **5.91%** | **3.66%** | **3.10%** |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 94.0% | 97.8% |
| Households | 51.5% | 37.0% |
| Corporate | 42.6% | 60.8% |
| Government sector | 6.0% | 0.3% |
| Financial sector (excluding banks) | 0.0% | 1.9% |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 1,714,135,144 | 1,844,152,039 | 2,268,414,646 |
| Interest expenses | 751,904,241 | 737,254,352 | 938,953,525 |
| Net interest income | 962,230,903 | 1,106,897,687 | 1,329,461,121 |
| Net fee and commission income | 205,045,098 | 243,564,520 | 257,363,295 |
| Other (not specified above) operating income (net) | 210,984,311 | 250,291,581 | 333,986,239 |
| Gross income | 2,130,164,552 | 2,338,008,140 | 2,859,764,181 |
| Administration costs | 396,187,437 | 438,598,953 | 466,101,066 |
| Depreciation | 80,384,355 | 89,912,278 | 102,433,244 |
| Provisions | 218,239,688 | 245,200,932 | 406,525,577 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 218,239,688 | 245,200,932 | 406,525,577 |
| Profit (loss) before tax | 436,958,594 | 561,416,989 | 620,147,062 |
| Net profit (loss) | 389,131,586 | 474,807,717 | 537,394,050 |

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds | | Core Tier 1 | Tier 1 | | Tier 2 | | Tier 3 |
|---|---|---|---|---|---|---|---|---|
| Commercial banks | 1,638,926,171* | 1,686,786,409*** | 1,213,967,760 | 1,033,871,744* | 1,213,313,690*** | 605,054,426* | 470,472,719*** | |
| Cooperative banks | | | | | | | | |
| **Banking sector, total:** | 1,638,926,171* | 1,686,786,409*** | 1,213,967,760 | 1,033 ,871,744* | 1,213,313,690*** | 605,054,426* | 470,472,719*** | |

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

# 2015 DEVELOPMENTS IN THE HUNGARIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Gross domestic product (GDP) increased by 2.9 while inflation rate was -0.1 per cent in 2015. Meanwhile, the budget deficit remained well below 3 per cent. As seen in previous periods, the economy’s external position continued to be high both in international and in historical comparison.

In the past period, the Hungarian economy continued to expand in a balanced structure, while inflation remained steadily far below the 3 per cent inflation target. The substantial fall in commodity prices, weak imported inflationary pressure and softening of inflation expectations contributed to low inflation.

The real economy continued to increase in 2015. Growth was primarily led by domestic demand; however net exports contributed materially to growth as well. Household consumption expenditures rose in 2015, mainly on the back of the improving labour market conditions and dynamically increasing real wages – supported by low inflation environment. Investments increased further and the investment ratio reached 21.3 per cent.

Economy-wide investments were primarily fueled by recovering demand and the rise of EU fund absorption, while the Funding for Growth Scheme (FGS) launched by Magyar Nemzeti Bank (hereinafter referred to as MNB) substantially eased the financing constraints on small and medium-sized enterprises, thus boosting investment activity in the private sector. Investment activity of households increased further in 2015 in line with gradual recovery of the housing market, however in terms of its level it is still considerably below its pre-crisis average. In parallel with the Central Bank base rate cuts, interest rates continued its downward trend seen in recent quarters. Banks reported an easing of price and non-price conditions on corporate loans in the Lending Survey. Respondents anticipate further easing in the first half of 2016. In the housing loan segment, conditions remained broadly unchanged, while in the case of consumer loans there was some easing. According to the banks, no major change may be expected in the next half year.

Total employment increased significantly in 2015 owing to the increase in the number of private sector employees and the extension of public work programs. The unemployment rate decreased to 6.8 per cent in 2015. The tightness indicators indicate the continual tightening of the labour market in 2015.

The net lending rose close to 9 per cent of GDP in 2015, reflecting the decrease of the net borrowing of the state while the net financial saving of the private sector increased further. The decline in general government net borrowing is due to the fact that economic growth, high wage dynamics and the increasing employment boosted the government tax revenues, which may have been further enhanced by the improved efficiency of VAT collection stemming from the installation of tax authority cash registers. Interest payment of the government has also decreased as well in recent years, which decreased the expenditures of the government.

Net lending of the real economy was stable in Q4 as well, at close to 9 per cent of GDP. The trade surplus increased, primarily due to increasing capacity utilization of vehicle manufacturers, and preferable terms of trade. The increase in the transfer balance surplus was mainly due to the fact that the annual value of the absorption of EU transfers was over 6 per cent of GDP. There was no material change in the income balance; however the deficit slightly decreased mostly due to the decreasing interest payments, and is close to 5 per cent of GDP.

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

In 2015 the Hungarian banking sector was characterized by strong shock-absorbing capacity, along with high capitalization, while the liquidity situation remained abundant. The external vulnerability of the financial system continued to decline along with the vulnerability of the whole economy, and the resulting positive effects have been appreciated considerably in the light of the mounting global financial stability risks. Settlements of mortgage loans and the conversion of FX loans into local currency loans carried out in two steps were able to mitigate the most important systemic risk stemming from households' FX loans. The central bank's self-financing programme also significantly reduced the country's external vulnerability. The Funding for Growth Scheme (FGS) effectively stabilized lending to non-financial corporates, however, market based lending remained remarkably subdued, which is attributable to high risk aversion of Hungarian banks. Last year the Hungarian financial system was facing three major challenges: restoring market-based corporate lending, reducing the high rates of non-performing loans (NPL rates) and improving the persistently weak profitability of the sector.

At the end of 2015 the total assets to GDP ratio of the banking sector decreased 5 percentage points to 90.5 per cent related to the end of 2014. Corporate loans outstanding excluding one-off items shrank by 2.1 per cent last year. However, the focus should be on SME lending, as it proves to be a more reliable indicator on trends in lending. SME sector plays a pivot role in terms of sustainable and inclusive growth, while large corporations can easily substitute domestic bank loans and given large loan sizes and subsequently high concentration, one-off cases can distort figures to a great extent. Outstanding loans to small and medium-sized enterprises further increased in 2015, by 3.6 per cent year on year. In the coming years, the recovery of market-based corporate lending poses the greatest challenge to the financial intermediary system, as the dynamics of corporate lending still fall significantly short of the 6–7 per cent mark conducive to sustainable growth. Sustainable and dynamic economic growth requires a strong pick-up in the lending activity of the banking sector. This is why, in an effort to encourage banks' return to market-based lending activity, the MNB decided to launch the Growth Supporting Programme (GSP) in 2015.

The high percentage of non-performing loans represents another major risk in the household mortgage and commercial real estate loan segments. The settlement and the conversion of FX mortgage loans to forint (HUF) loans mitigated the risk of new defaults regarding the loans outstanding. In the case of new loans, in turn, debt brake rules contribute to containing such risks. At the same time, the high ratio of problematic household mortgage loans continue to represent a key risk to the financial intermediary system, which may be mitigated, through the clean-up of the portfolio, by fine-tuning the institution of personal bankruptcy and the expansion of the National Asset Management Agency (NAMA). Nevertheless, existing government programmes need to be supplemented by further measures to address the problem of non-performing mortgage loans under market conditions as well. The in-depth analysis of loans and debtors' position indicates that in many cases, the root of the problem is not the lack of income but excessive indebtedness; thus improving the quality of the loan portfolio appears achievable through restructuring. In order to boost sustainable restructuring, the MNB issued a recommendation for credit institutions, determining in detail the expected minimum framework of the cooperation between debtors and banks, focusing on sustainable solutions.

In the case of corporate non-performing loans the resolution of a large bank reduced the banking sector exposure markedly; however substantial problematic commercial real estate exposure remained in the balance sheets of the banks with a restrained cleaning rate in the past years. Looking ahead, improving commercial property market and of distressed assets may support the cleaning of banks' balance sheets. Incentives announced by MNB play a significant role in the pick-up of the market of impaired assets both on the demand and the supply side. The activity of MARK Ltd.. may boost the further cleaning of the corporate non-performing loan portfolio.

The profitability of the banking sector remarkably improved in 2015, but still remains low by international standards. While the aggregate effect of recent regulatory measures is almost neutral over the medium term, banks' profitability outlook should improve over the next two years on the whole, due to the lower provisioning requirements for loan losses and the reduction of the bank levy. Through weak capital accumulation capacity, profitability – which is permanently below the expected return on equity – has a negative impact on the growth possibilities of the banking sector and thus on the ability to adequately support sustainable economic growth. There is room for further improvement in profitability by improving cost efficiency. The cost saving of the banking sector may not only be increased at the level of individual banks; leveraging synergies through the merger of institutions may also boost the profitability of the sector. Cleaning up large, non-performing portfolios and an increase in cost efficiency are both needed for the restoration of structural profitability, after which it could become possible to ensure that the Hungarian financial system fulfils its role in supporting sustainable economic growth over the long term as well.

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

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

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

Regarding the legislative developments in 2015, we would highlight the following Acts:

1. The Act CV of 2015 on the debt settlement of natural persons was published in order to settle the debts of natural persons in an appropriate regulatory framework by using their regular income and assets. Several related government decrees were published defining the details of the debt settlement procedure.
2. The Act CXLV of 2015 on arranging questions regarding certain loan contracts derived from consumer claims converted to forint (HUF) was promulgated. The MNB published a related recommendation on information requirements to be provided for consumers as well.

# MAIN STRATEGIC OBJECTIVES OF THE HFSA IN 2015

Following the integration of the HFSA and the MNB, the MNB had to develop a new strategy for the integrated authority. In July 2014 the Financial Stability Board approved the new supervisory strategy for the period of 2014–2019. According to the strategy, the mission of the MNB is to maintain and support the stability of the financial system and to strengthen the confidence of participants both in the system and in one another with the assistance of the integrated supervisory instruments. The management of the MNB designated confidence and stability as priority values for the supervisory area.

The strategy also determines clearly defined objectives for the next years that the MNB wishes to achieve in the supervised markets and with respect to itself as an institution, by taking advantage of the opportunities provided by the instruments at its disposal. The tasks required for the achievement of the long-term objectives have been designated for each supervised sector and supervisory area.

# THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Microprudential supervision is intended to facilitate the prudent operation of credit institutions, supervise the careful exercise of owners' rights, identify and assess the risks associated with individual institutions, mitigate or eliminate risks, and take preventive measures in order to ensure prudent operations. In order to make these preventive measures more efficient and could control the identified risks, the MNB has made its inspection framework more flexible and modified the scheduled inspection timetable to examine the institutions where the risks are building up quickly. Both in on-site and off-site microprudential supervision, priority inspection areas included the management and mitigation of high accumulated credit risk at credit institutions and the examination of the inspected institution's capital position, profitability and the sustainability of its business model. In addition, special focus was given to the evaluation of liquidity and the adequate calculation of capital position according to the EU new regulation.

In 2015 banking supervisory instruments were modified and widened. Emphasized focus was on targeted, special thematic and follow-up examinations; the scope of IT supervision was renewed and enhanced. Moreover sanctioning policy, stronger personal accountability became stronger. Business Model Analysis was integrated into the comprehensive examination. AQR method was introduced regarding evaluation of provision adequacy in connection with NPL project portfolio.

In the year of 2015 purifying was continued in the Hungarian financial sector. The license of 4 small commercial banks belongs to one group were revoked because their biggest owner, the brokerage firm was involved in the brokerage scandal in 2015.

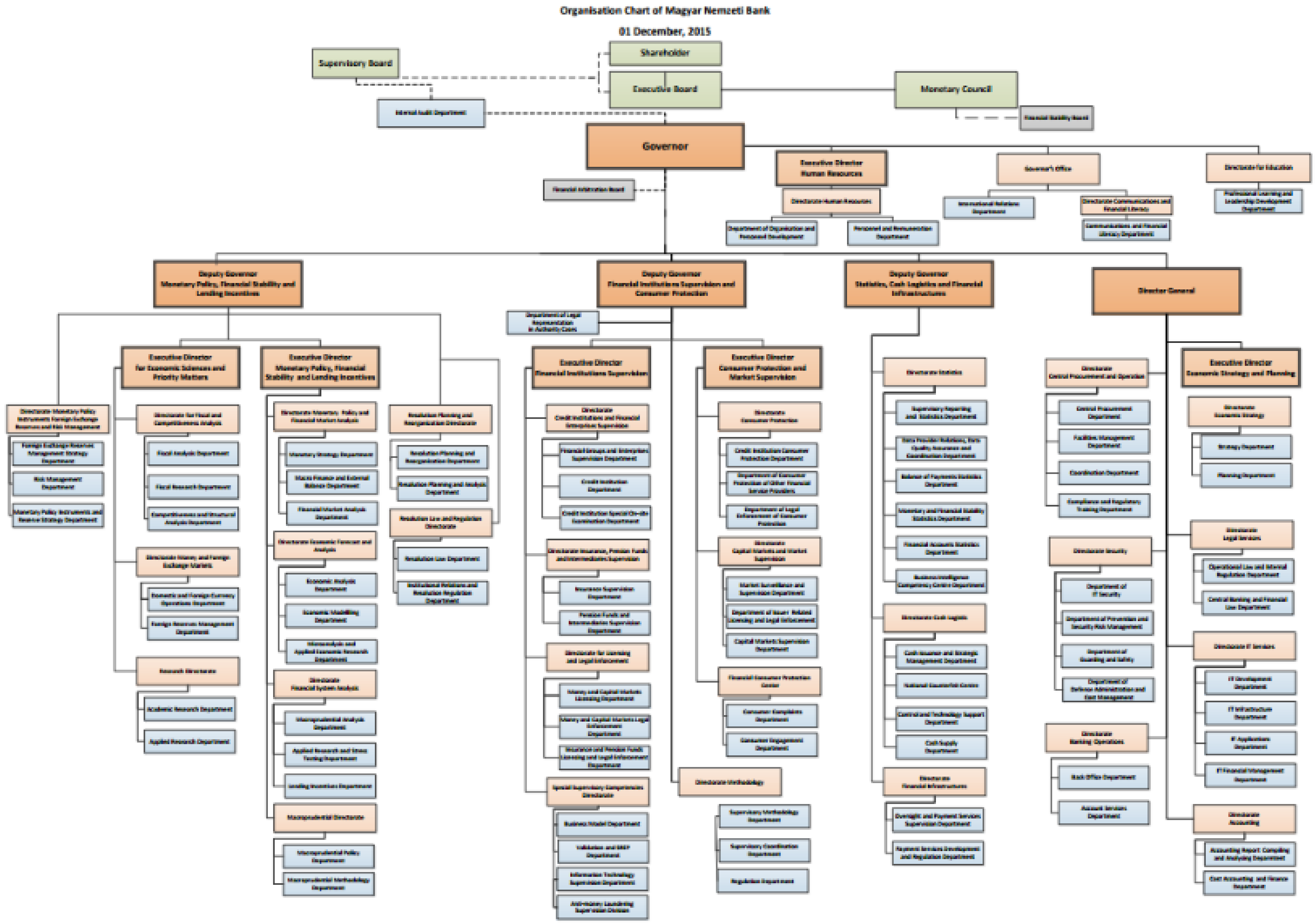
Regarding the cooperative credit institutions there wasn't any license withdrawal due to the special Integration Regulations. The Integration operates under 'guarantee community' (joint responsibility for liabilities) and integrated regulations such as: risk management, business policy, marketing policy, IT system. The integration is going through structural changes; number of the cooperative societies is decreasing continuously, because of mergers. Due to low interest rate environment most of cooperative credit institutions have profitability problems, which speed up the mergers.

Table 1: Number of inspections at credit institutions

| Number of on-site inspections | 2015 actual | |
|---|---|---|
| | comprehensive | other |
| Large banks | 4 | 21* |
| Small and medium banks | 8 | 4 |
| Credit cooperatives | 7 | 4 |
| Financial intermediaries | 2 | 6 |

*including ICAAP-reviews

# ORGANIZATIONAL CHART OF THE HFSA BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITY OF THE AUTHORITY

### *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 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 supervisory 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 10 banking colleges as host supervisor authority.

As home supervisor MNB leads the banking supervisory college of the OTP Group. In Central and Eastern Europe, the MNB is the only supervisory authority to perform home supervisor functions, regularly holding meetings with the participation of the supervisors of foreign OTP group member institutions and EBA representatives. In 2015 MNB organized two supervisory college meeting in home role, coordinated the college work which resulted among others the joint decision on capital and liquidity adequacy and on recovery plan assessment. The supervisory college established for the OTP Group has made its WCCA.

### *ESRB*

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

### *FSB Regional Consultative Group for Europe*

The MNB and the Ministry for National Economy are both members of the FSB's regional substructure. The MNB were represented at managerial level at the meeting of the FSB European Regional Consultative Group in May 2015.

### *EBA*

MNB staff members actively contributed to the professional efforts of the EBA and participated in the elaboration and assessment of professional materials on a regular basis. MNB cooperates with EBA in the framework of EBA's various working groups. Beside this in 2015 the EBA' representative has participated in every supervisory college meeting of the OTP Group and has also checked and commented on the draft documents of the OTP, such as the joint decision on capital, liquidity adequacy and group recovery plan assessment, and the WCCA. There is a constant effective communication between the MNB and the EBA. MNB cooperates with the EBA in EBA's various working groups as well.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN HUNGARY

The MNB performs supervisory and consumer protection tasks as well. The MNB monitors and supervises the activities of financial and capital market institutions, funds, insurance companies and institutions of the financial infrastructure as well. Furthermore, it carries out investor protection tasks and it operates the Financial Arbitration Board[29] and the Financial Consumer Protection Center.[30]

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

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

[29] a professionally independent alternative forum for resolving disputes

[30] 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[31]

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 37 | 39 | 35 |
| Branches of foreign credit institutions | 9 | 10 | 10 |
| Cooperative banks | 122 | 110 | 87 |
| **Banking sector, total:** | **173** | **168** | **132** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | - | 6.6% | 10.1% |
| Other domestic ownership | 14.5% | 15.8% | 14.0% |
| Domestic ownership total | 14.5% | 22.4% | 24.1% |
| Foreign ownership | 85.5% | 77.6% | 75.9% |
| **Banking sector, total:** | **100** | **100** | **100.0** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 46.5% | 61.4% | 0.114 |
| Branches of foreign credit institutions | 69.4% | 90.6% | 0.193 |
| Cooperative banks | 16.6% | 24.0% | 0.023 |
| **Banking sector, total:** | **40.4%** | **53.4%** | **0.088** |

[31] Without 3 Special Financial Institutions (MFB, EXIM, KELER)

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 0.8% | -19.2% | -0.6% |
| Cooperative banks | -2.4% | -6.2% | -0.8% |
| **Banking sector, total:** | **0.6%** | **-18.7%** | **-0.6%** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 86.6% | 87.6% | 86.9% |
| Branches of foreign credit institutions | 7.7% | 7.7% | 8.7% |
| Cooperative banks | 5.8% | 4.7% | 4.4% |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 28.4% | 30.7% | 27.1% |
| Nonfinancial sector | 40.8% | 38.4% | 34.4% |
| Government sector | 15.7% | 16.3% | 21.0% |
| Other assets | 15.1% | 14.6% | 17.6% |
| **Claims due to** | | | |
| Financial sector | 18.9% | 21.3% | 22.1% |
| Nonfinancial sector | 42.2% | 41.0% | 44.6% |
| Government sector | 2.4% | 2.9% | 2.9% |
| Other liabilities | 26.9% | 26.4% | 21.6% |
| **Capital** | **9.7%** | **8.4%** | **8.8%** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013** | 2014** | 2015*** |
|---|---|---|---|
| Commercial banks | 17.4 | 19.2 | 19.9 |
| Cooperative banks | 16.7 | 19.0 | 16.2 |
| **Banking sector, total:** | **17.4** | **19.2** | **19.8** |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non-financial sector, including** | 17.2% | 16.4% | 13.7% |
| - households | 18.5% | 19.0% | 17.6% |
| - corporate | 15.8% | 13.6% | 9.7% |

*Loans overdue more than 90 days
**Domestic loans

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 80.9% | 83.2% |
| Households | 42.1% | 40.8% |
| Corporate | 38.8% | 42.4% |
| Government sector | 4.8% | 1.6% |
| Financial sector (excluding banks) | 14.3% | 15.2% |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 1 977 038 | 1 569 215 | 1 308 895 |
| Interest expenses | 1 056 025 | 650 330 | 545 119 |
| Net interest income | 921 013 | 918 885 | 763 775 |
| Net fee and commission income | 412 641 | 447 327 | 462 014 |
| Other (not specified above) operating income (net) | -265 550 | -322 028 | -1 011 285 |
| Gross income | 1 068 105 | 1 044 185 | 214 504 |
| Administration costs | 618 367 | 611 538 | 633 646 |
| Depreciation | 60 116 | 59 702 | 58 035 |
| Provisions* | -278 758 | -862 325 | 502 231 |
| 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 | 110 864 | -489 380 | 25 055 |
| Net profit (loss) | 25 959 | -542 628 | -15 850 |

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

**Total own funds in 2015 (in EUR)*****

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 8 564 699 962 | 6 978 420 903 | 7 079 875 658 | 1 484 824 305 | - |
| Cooperative banks | 294 659 374 | 287 333 859 | 287 725 271 | 6 934 103 | - |
| **Banking sector, total:** | 8 859 359 336 | 7 265 754 763 | 7 367 600 929 | 1 491 758 407 | - |

*** - for Basel III)

# 2015 DEVELOPMENTS IN THE LATVIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Latvia's economic **growth remained moderate** in 2015: according to seasonally and calendar adjusted data, GDP increased by 2.6%. The fourth quarter of 2015 and first quarter of 2016 saw a notable slowdown in economic growth suggesting high uncertainty and risks on account of external factors and EU funding cycle disruption.

Continuing the previous year's trend, **private consumption** was the key growth engine also in 2015; it increased by 3.1% over the year and contributed 2.0 percentage points to GDP growth. Throughout the year, private consumption was supported by a rather steep acceleration of real net wages. Amid ongoing strengthening of purchasing power of the working population and stable consumer sentiment, private consumption is expected to be the driver of growth also in 2016.

**Investment increased** by 2.1% in 2015 and contributed 0.6 percentage point to GDP growth. By sector, transportation and storage as well as real estate activities secured the largest positive share of non-financial investment growth. Despite a boost in investment over 2015 overall, its volume was unsteady, and uncertainties about the future outlook along with existing external risks were an obstacle to faster inflows of investment.

Despite the weak external demand and Russia-related sanctions, **exports grew somewhat in 2015**. In real terms, the export volume picked up 1.3%, with expansion recorded for both exports of goods and exports of services (0.9 percentage point contribution to GDP growth). The largest contributors to the annual export growth were industries of wood and products of wood, computer and optical products, and fishing products. Along with rising exports and strengthening consumption, import volumes also grew in 2015 (in real terms; by 1.8%).

In general, the economic growth in 2015 relied on strong private consumption, which offset, to a certain extent, the weak external demand and absence of steadiness in investment growth. At the current junction, external factors do not support export and investment acceleration; hence measures leading to improvements in Latvia's business environment and other areas of activity via structural reforms aimed at boosting economy's competitiveness are gaining in importance.

In 2015, **unemployment rate** continued to moderate, albeit at a decelerating pace. Cyclical unemployment remained close to zero. The gradual decline in unemployment rate depended on the structural component which remained high vis-à-vis the EU average, while its further decrease will be determined by active labour market policy measures. Employment rose slowly. On the one hand, impetus to it came from a higher participation rate and dropping unemployment, while, on the other hand, such negative demographic developments as contracting population and decreases in the share of working age population hindered it. Labour remuneration kept rising steadily (annual rise by 6.8%), albeit its pace still exceeded that of labour productivity growth. Nevertheless, amid the environment of declining energy and commodity prices, businesses managed to boost wages and, at the same time, to retain stable profit margins.

In 2015, **average inflation (HICP) stood at 0.2%**, and its year-on-year decline primarily was on account of commodity (e.g. oil and agricultural and food products) price falls on a global scale. At the same time, positive upward price level shifts were mainly triggered by the domestic factors – liberalisation of the electricity market for households (in connection with the transition from administered to market electricity prices), somewhat rising indirect tax rates, more expensive public transport services in Riga, and a gradual increase in income.

The **deficit of the consolidated general government budget** estimated on an accrual basis decreased from 1.6% of GDP in 2014 to 1.3% of GDP in 2015. This improvement of the budget balance was supported by an increase in tax revenue supported by the economic and labour market developments as well as measures combating the shadow economy. At the same time, weaker absorption of the EU funds and lower capital spending of local governments resulted in deceleration of expenditure growth in comparison with 2014.

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

At the end of 2015, there were 17 banks and nine Member State bank branches operating in Latvia. The Latvian banking sector's development is in line with the global trend in the banking industry and still banks dominate the financial sector in Latvia, accounting 88.9% of total financial sector assets or approximately 131% of GDP.

In 2015, the banks in Latvia had to consider a number of factors that impacted their external and internal financial environment. A moderate growth rate was observed in the overall national economy in 2015 and it provided for positive progress also in the banking sector, continuing improvements in the total banking profits, efficiency of operations and capital return. The banks still maintained high capitalization and liquidity levels. Positive dynamics in domestic borrowers' solvency ensured gradual improvements in the quality of bank loan portfolios. Though new credit growth rate remained slow, failing to cover amortization of existing loan portfolio, generally there was a gradual increase observed in demand for loans.

The most essential sources of uncertainty and risks were still associated with the developments in the external macro-financial environment. An impact of such external factors as global growth risks, constant geopolitical tensions and related uncertainty might affect the probability of increasing credit risk level although the debt burden on borrowers is declining in Latvia.

Despite some uncertainty in the external environment, the key indicators of banking activity as a whole continued to stabilize and move towards the moderate development during 2015, shock absorption capacity remained high, in particular with the high levels of capitalization and liquidity in the banking sector.

Currently, approximately 85.2 per cent of the Latvian banking share capital is owned by foreign investors. Three subsidiaries of EEA banks and nine branches of EU banks accounted for ~49 per cent of total banking sector assets and ~81 per cent of the total resident loan portfolio at 31 December 2015. At the end of 2015, all banks in Latvia were privately owned.

The bank capitalization level remained high and at the end of 2015 the total capital adequacy ratio (CAR) stood at 22.7%, whereas the Common Equity Tier 1 (CET1) capital ratio was 19.7%. The high quality of banking sector capital was ensured by the main component of equity, CET1 capital, which in the case of Latvian banks coincided with the Tier 1 capital. The leverage ratio was maintained by the banks at an adequate level, and by the end of 2015 it was 9.5%, whereas for individual banks it ranged from 3.6% to 17.6% (3%, according to a minimum threshold set by the Basel Committee on Banking Supervision for the period until 01.01.2017).

With liquid assets growing faster than current liabilities, the banking sector's liquidity ratio also grew and at the end of 2015 it was 66.7% (minimum liquidity ratio requirement – 30%). As from October 2015, the banks have to comply with the requirements for liquidity coverage ratio, which was set at 60% for 2015. The liquidity coverage ratio requirement has been met by all banks, and at the end of December 2015 the above ratio in the overall banking sector reached 306%, well above the minimum threshold.

With growing deposit amounts, the total loan-to-deposit ratio slightly improved in the banking sector and at the end of 2015 reached 63.1% (compared to 66% at the end of 2014), including the proportion of the loans granted to residents/ deposits attracted from residents of 115% at the end of December (compared to 118% at the end of 2014), indicating that lending in the domestic market has been almost entirely financed by resident deposits.

The bank performance improved in the reporting year, and non-audited profit amounted to ~416 million euro (compared to ~311 million euro in 2014). Moreover, all the 15 banks operating in Latvia and five branches of foreign banks posted profits (their market share in the total banking sector assets made up ~ 96%). During 2015, profitability improved and return on equity (ROE) of the banking sector reached 12.5% at the end of December (compared to 11.1% at the end of 2014). An increase in profits for the banks focusing on servicing non-residents was mainly due to the net interest income growth (increasing interest income from crediting and investment in securities), as well as an increase in income from transactions in financial instruments. Whereas an increase in profits for the banks focusing on the domestic market still was due to a reduction in expenditures (mainly shrinking expenses for loan loss provisions and interest expenses).

The amount of deposits attracted during 2015 continued growing (by 1.1 billion euro, or 4.8%) and by the end of the year reached 23.3 billion euro, including resident deposits about 47%. Though a stable growth in deposits of private sector continued, i.e. deposits of private non-financial undertakings rose by 317 million euro, or 10.3%, household deposits by 323 million euro, or 6.4%, and deposits of financial companies by 240 million euro, or 31%, the total increase in resident deposits over the year was not significant (by 110 million euro, or 1.0%), because of a significant decrease in the government deposits (by 745 million euro, or 59%).

An increase in non-resident deposits (by 954 million euro, or 8.3%) was mainly the result of a significant appreciation of the US dollar (following the adjustments to the value of US dollar, the amount of non-resident deposits increased only by 0.9%).

In 2015, the loan portfolio became stable and its volume almost had not changed over the year (rose by ~0.1%). A decline rate in resident non-financial undertaking portfolio essentially slowed down (-1.6% during 2015), whereas amortization/depreciation of resident household loans boosted the further reduction in loan portfolio (by ~4%). At the same time appreciation of the US dollar over the euro to the great extent impacted an increase in non-resident loan portfolio by 9.9%, while adjustments to the value of US dollar resulted only in a 3% increase in loan portfolio.

The new lending amounts grew as credit institutions financed both the purchase of resident households and resident non-financial undertakings, i.e. by 11.5% and ~8% more than the previous year.

During 2015, improvements in the quality of loan portfolio continued and the share of the loans more than 90 days overdue in the loan portfolio shrank from 6.9% to 6.0%. Improvement was observed both in the resident household and corporate portfolios, whereas the share of the non-resident loans more than 90 days overdue (from 5.3% to 8.8%) was affected by the unfavourable economic situation in their home countries. The total share of past due loans in the portfolio had decreased over the year from 12.3% to 10.9%.

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

## LEGAL COMPETENCE OF THE BANKING SUPERVISORY AUTHORITY IN LATVIA

The Financial and Capital Market Commission (FCMC) is an autonomous public institution and has been performing in this capacity for 15 years as of its establishment on 1 July 2001. It carries out the supervision of Latvian banks, credit unions, insurance companies and insurance brokerage companies, investment management companies, participants of financial instruments market, electronic money institutions, payment services providers as well as private pension funds. The FCMC ensures supervision and the regulatory framework for the Latvian financial and capital market as well as protects the interests of customers of market participants and promotes soundness, competitiveness and development of the sector in general.

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

Since transposition of CRD IV/CRR the FCMC has been designated authority for implementation of macro-prudential instruments.

In 2015, the FCMC in its capacity as a resolution authority set up a separate division, the Resolution and Guarantee Funds Division, whose activities and functions are separated from monitoring functions. The resolution authority is responsible for drawing up resolution plans, applying resolution action (or bailing out) to institutions where it is necessary in the interests of  the public, or taking decisions on not applying resolution measures, as well as accumulating the funds in the Single Resolution Fund.

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

## MAIN STRATEGIC OBJECTIVES OF FCMC IN 2015

In order to fulfil its functions as efficiently as possible in boosting the development and stability of financial and capital markets as well as the protection of the interests of investors, depositors and insured persons, in 2015 the FCMC approved the Strategy for Regulating and Monitoring of the Financial and Capital Market 2015–2017, indicating six strategic priorities for the next three years.

FCMC strategic priorities for 2015-2017:

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

In 2015, the FCMC continued to strengthen the framework of intensive monitoring, aimed at applying risk-focused and result-oriented monitoring measures. Monitoring of the prevention of money laundering and terrorist financing was strengthened as well.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

### Regulatory developments

In 2015, the FCMC continued enhancing the regulatory framework governing the activities of financial and capital markets. Intensive regulatory framework reforms continued based on the experience and lessons learned during the financial crisis. To ensure a stable development of Latvia's financial and capital market, based on the rules and regulations issued by the EU institutions and taking into account specifics of national financial sector and dynamic financial environment, the FCMC in 2015 improved national legislation, thus not only regulating activities of participants of the Latvian market but also enhancing the protection of interests of investors, depositors and the insured persons.

The results of lessons learned in the area of credit institutions during the financial crisis are the Basel III standards, implementation of which was intensively continued also in 2015. Overall, to supplement the regulatory framework 4 new draft amendments to regulations and 4 draft regulations were prepared and approved that would be binding on credit institutions, credit unions, investment firms as well as alternative investment fund managers.

Also amendments to the Credit Institution Law were drawn up to specify the supervisory authority regarding decision-taking on authorizing or forbidding the issuing of a licence (permission) to a credit institution or acquisition of a qualifying holding within the Single Supervisory Mechanism.

The financial crisis demonstrated the presence of systemically important financial institutions that in the event of facing problems may have an impact also on other financial market participants and the actual economy. Systemically important institutions are determined based on the following criteria: size, substitutability, significance in the financial system infra-structure, complexity, and cross-jurisdiction activity, as well as interconnectedness. In view of activity of systemically important financial institutions and their material role in the financial sector, there is a need to introduce additional requirements, for example, increased capital buffer rates in accordance with the importance of institution. Application of macro-prudential tools enables the most significant financial market participants to become more resistant to unforeseen circumstances. In accordance with the Credit Institution Law, the FCMC shall identify credit institutions that are O-SIIs (other systemically important institutions) once a year, as well as it may set the capital buffer rate of other systemically important institution of up to 2 per cent of risk weighted assets. In 2015, the FCMC identified six systemically important credit institutions in the local financial sector, placing the list of them on the FCMC website, as well as determined that no advantages shall be applicable to them in ensuring compliance with certain corporate governance requirements. The decision on setting the O-SII capital buffer is to be taken in 2016.

The FCMC adopted the regulations on the calculation of credit institution specific countercyclical capital buffer rate, specifying credit exposures to which countercyclical capital buffer rate is applicable, procedure for determining countercyclical capital buffer rate applicable to exposures to the Latvian, Member State or foreign residents, as well as date of the application of the relevant countercyclical capital buffer rate and algorithm according to which the relevant countercyclical capital buffer rate shall be calculated. The FCMC shall set and publish quarterly the countercyclical capital buffer rate for the exposures to the Latvian residents that is to be used for the calculation of institution specific countercyclical capital buffer rate for 12 months after its setting. Based on April 2016 estimates, the countercyclical capital buffer rate for exposures to the Latvian residents was set at 0 per cent until the year 2018.

The FCMC continued to implement changes arising from directly applicable EU regulation, particularly in relation to CRDIV/CRR, BRRD and DGSD. This included the ongoing implementation of a number of technical standards developed by EBA and introduction of single reporting framework (COREP, FINREP). Many of these changes to EU regulatory framework have been implemented through consultations, supervisory statements, and incorporated into internal procedures. Harmonised liquidity coverage ratio has been introduced as from 1 October 2015 with phasing in of the minimum requirement until 2018, while preserving parallel application of liquidity requirements set by the FCMC

(30% minimum liquidity ratio and Pillar 2 individual liquidity ratio). Also annual public disclosure of leverage ratio by banks has been set to begin with 2015 Pillar 3 disclosures.

**Supervision**

In 2015, the FCMC continued enhancing the intense supervision framework aimed at the risk-focused and result-oriented supervisory measures enabling the FCMC to timely interfere in the activities of banks and take the necessary measures for resolving potential and existing problems or reducing losses.

In the reporting year, priorities for the supervision of the Latvian banking sector were as follows:

- assessment of bank capital base adequacy;
- assessment of bank business models and identification of factors impacting their sustainability;
- assessment of potential impact of bank strategy on the risk structure and size;
- assessment of adequacy of liquidity maintenance and management, and quality assessment taking into account the business model;
- assessment of adequacy regarding recognition of operational quality of banks in dealing with problem loans and credit impairment losses in the bank statements and accounts;
- evaluation of bank recovery plans regarding the necessary improvements through a dialogue with banks.

In 2015, the banking supervision was invariably based on the related methods: off-site monitoring of banking performance based on the financial statements and analysis of other operational information available to the FCMC, and on-site inspections.

The past year was a first full-fledged year within the Single Supervisory Mechanism (SSM) that brought changes to the previous supervision model of Latvian credit institutions. The ECB in cooperation with the relevant EU national supervisory authorities, including the FCMC, is responsible for efficient and harmonious operation of the SSM for implementation of main goals:

- to ensure security and stability of the European banking system;
- to increase financial integration and stability;
- to ensure coordinated supervision.

In order to facilitate the achievement of above objectives and ensure implementation of supervisory principles set by the SSM, the FCMC in 2015 continued revising and enhancing supervision methods, taking into account other national supervisory practices and supervision quality standards set by the ECB.

In 2015, the FCMC carried out intensive off-site supervision and monitoring of bank performance based on the analysis of regular reporting and the following additional operational statements, information and reports on the bank performance:

- daily reports on the dynamics of deposits;
- reports on liabilities to affiliated financial institutions;
- minutes of the meetings of bank credit committees, executive and supervisory boards, as well as reports of bank internal audit on examinations performed,
- credit risk, liquidity and market risk reports and stress testing results.

The FCMC in cooperation with the Bank of Latvia continued conducting the regular credit risk and liquidity risk stress tests. Credit risk stress tests were performed taking into account the macro-economic forecast, and stress test results were used to determine potential loan portfolio losses under various economic development scenarios and based on different assumptions in order to evaluate the banks' loss absorption capacity. Liquidity risk stress tests also were conducted. Under above stress tests a number of bank customer conduct scenarios were analyzed and the ability of banks to ensure timely fulfilment of legitimate claims of customers.

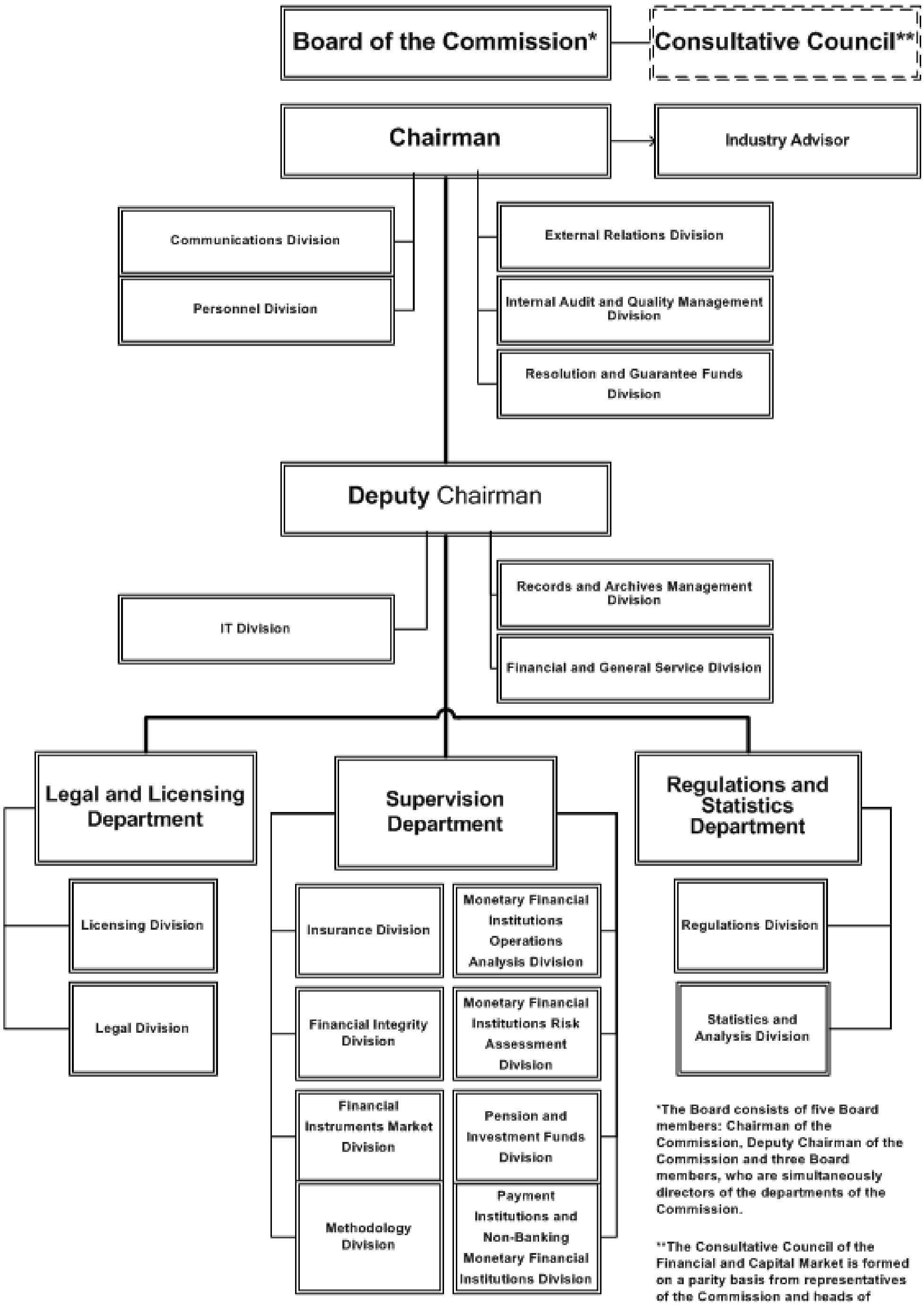
In the reporting year, the FCMC performed 30 inspections of banks particularly focused on the assessment of capital adequacy, lending process, as well as risk management functions, i.e. management of credit risk, operational risk, liquidity risk, strategic risk and business risk, and compliance control function (including 4 on-site inspections of most important banks).

In 2015, the FCMC cooperated with supervisory authorities of Member States implementing the credit institution supervision under the regulatory requirements. The FCMC experts participated in five colleges of Member States' credit institution supervisors in 2015; moreover, headed the college of supervisory authorities as the competent authority. In supervision of two Latvia's important banks, the ECB has been taking part as a participant in the colleges of supervisors since the introduction of the SSM, while the FCMC participates as an observer in above colleges of supervisors, enabling the FCMC to take part in the work of college of supervisors and to access information necessary for carrying out supervisory functions.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

There have been changes introduced in the structure of the FCMC. To ensure communication among the competent authorities of the Republic of Latvia, the European Union (EU) and the United States on the issues regarding anti-money laundering and combating terrorism financing (AML/CTF) and to foster awareness of the requirements set by the U.S. competent authorities and their implementation in practice, the post of compliance adviser, attaché, was temporary opened in the FCMC and other competent authorities of the Republic of Latvia. Upon granting a diplomatic rank, the attaché performs his duties in the United States.

For the purposes of strengthening of the AML supervision, in 2016 the Compliance Control Department was set up on the basis of Financial Integrity Division and the number of employees has been increased.




*The Board consists of five Board members: Chairman of the Commission, Deputy Chairman of the Commission and three Board members, who are simultaneously directors of the departments of the Commission.

**The Consultative Council of the Financial and Capital Market is formed on a parity basis from representatives of the Commission and heads of professional organizations of financial and capital market participants.

# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

Within international cooperation area the priority of FCMC is to contribute in the regional developments on a European scale. The FCMC has been engaged in the discussion on draft regulations during the meetings of the Council of the EU and the European Commission committees, as well as in the work of the European financial supervision authorities. Participation in the Single Supervisory Mechanism established in the euro area and loading capacity in 2015, takes an increasing importance in the activities of the FCMC.

The year 2015 was a unique one because of the FCMC's participation in the implementation of two prior tasks for the Republic of Latvia – Latvia's presidency of the Council of European Union and negotiations on the accession to the Organization for Economic Cooperation and Development (OECD).

As in previous years, the FCMC continued to maintain good cooperation with supervisors of the countries where cross-border cooperation with Latvia has been established.

In performing financial sector supervision cooperation with supervisory authorities of other countries plays an important role. Priority is given to the cooperation with Baltic and Nordic financial supervisors, as well as the European Central Bank. After establishing the Single Supervisory Mechanism there have been changes also in the cooperation with the Nordic supervisory authorities, because in the future the heads of the ECB joint supervisory teams will participate in the colleges of supervisors regarding the important banks "SEB" and "Swedbanka", as well as Nordea. Cooperation between the central banks and financial supervisory authorities of the Nordic and Baltic States usually was implemented at the Macro-prudential Forum where the leaders of supervisory authorities and heads of central banks discussed developments in the macro-prudential policy.

Bilateral cooperation and exchange of information among the supervisory authorities are based on the information exchange and cooperation agreements.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN LATVIA

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

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 19 | 17 | 17 |
| Branches of foreign credit institutions | 9 | 9 | 9 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total:** | **28** | **26** | **26** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 8.9 | 8.0 | 0 |
| Other domestic ownership | 26.6 | 35.7 | 22.8 |
| Domestic ownership total | 35.6 | 43.7 | 22.8 |
| Foreign ownership | 64.5 | 56.3 | 77.2 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 50.1 | 71.6 | 0.120 |
| Branches of foreign credit institutions | 95.0 | 98.3 | 0.656 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 44.8 | 64.5 | 0.104 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 8.7 | 11.1 | 12.5 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 8.7 | 1.1 | 12.5 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 88.2 | 87.2 | 89.4 |
| Branches of foreign credit institutions | 11.8 | 12.8 | 10.6 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total:** | **100** | **100** | **100** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 33.1 | 34.6 | 32.1 |
| Nonfinancial sector | 56.1 | 52.8 | 51.2 |
| Government sector | 5.3 | 7.5 | 10.9 |
| Other assets | 5.5 | 5.1 | 5.8 |
| **Claims due to** | | | |
| Financial sector | 18.1 | 14.5 | 14.7 |
| Nonfinancial sector | 60.3 | 65.0 | 66.4 |
| Government sector | 3.9 | 4.1 | 1.7 |
| Other liabilities | 7.8 | 6.5 | 6.8 |
| **Capital** | **9.9** | **9.9** | **10.4** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013** | 2014*** | 2015*** |
|---|---|---|---|
| Commercial banks | 18.94 | 21.07 | 22.65 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 18.94 | 21.07 | 22.65 |

(* - 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 | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 8.8 | 7.3 | 6.3 |
| **- households** | 11.9 | 9.6 | 8.0 |
| **- corporate** | 6.6 | 5.7 | 5.3 |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 91.2 | 92.2 |
| Households | 34.9 | 38.6 |
| Corporate | 56.3 | 53.6 |
| Government sector | 2.3 | 0.6 |
| Financial sector (excluding banks) | 6.5 | 7.2 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 674 877 | 625 859 | 654 124 |
| Interest expenses | 180 429 | 141 322 | 131 205 |
| Net interest income | 494 447 | 484 537 | 522 919 |
| Net fee and commission income | 306 425 | 331 939 | 333 973 |
| Other (not specified above) operating income (net) | 178 810 | 110 432 | 156 142 |
| Gross income | 979 683 | 926 908 | 1 013 034 |
| Administration costs | 476 147 | 443 679 | 462 646 |
| Depreciation | 28 973 | 26 462 | 26 442 |
| Provisions | 177 666 | 96 431 | 53 355 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 177 666 | 96 431 | 53 355 |
| Profit (loss) before tax | 296 897 | 360 336 | 470 591 |
| Net profit (loss) | 246 201 | 311 407 | 415 901 |

**Total own funds in 2015*** (thousand of EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 3 186 662 | 2 777 452 | 2 777 452 | 409 210 | 0 |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | 3 186 662 | 2 777 452 | 2 777 452 | 409 210 | 0 |

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

# 2015 DEVELOPMENTS IN THE LITHUANIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2015 Lithuania's economy grew by 1.6 per cent. Household consumption was the main driver of economic growth. The favourable labour market situation (both wages and employment grew), price declines, which enhanced the purchasing power of households, and the interest rates on loans, which fell to record lows and eased the burden of financial liabilities, were among the major contributions that have formed significantly elevated consumer expectations.

The number of persons employed grew at a slower pace. Consumer prices fell markedly in 2015: average annual HICP inflation stood at −0.7 per cent. Already in previous years inflation was very low, much lower than the long-term average: in 2013 it was 1.2 per cent, in 2014 — 0.2 per cent. Low inflation in those few years was related to consumer-favourable developments in commodity, import and producer prices. Consumer prices fell markedly in 2015: average annual HICP inflation stood at −0.7 per cent.

In 2015, the general government balance to GDP ratio was −0.2 per cent. The deficit narrowed by 0.5 p.p. over the year, mainly due to the increased general government revenue-to-GDP ratio.

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

As of 1 January 2016, six banks and seven foreign bank branches operated in Lithuania. All banks operating in Lithuania complied with both the minimum capital adequacy requirement and the new capital conservation buffer requirement with a margin. The overall capital adequacy ratio of banks, as of 1 January 2016, was 24.8 per cent, resulting in a year-on-year increase (21.3%). In 2015, banks held sufficient liquid assets reserves, their liquidity level remained high. As of 2015, the national liquidity ratio (requirement — 30%) was replaced with the liquidity coverage ratio (LCR). Banks must ensure that this ratio is not lower than 100 per cent. All banks operating in the country complied with the liquidity coverage ratio requirement with a large margin.

In 2015, the Lithuanian banking system was profitable; however, income from main asset positions continued to decrease. In 2015, profit of banks and foreign bank branches was EUR 215.3 million, a year-on-year increase of EUR 1.9 million (0.9%).

Total bank assets as of 1 January 2016 amounted to EUR 23.4 billion, and over the year decreased by EUR 693 million (−2.9%). Year on year, there were less funds held on the central bank's accounts at the end of 2015 — they decreased by EUR 1,428 million (−33.8%). Such a change was driven by the adoption of the euro: prior to it, more funds were held at the central bank, as banks had to pledge them for euro.

As of 1 January 2016, customers held with banks EUR 17.1 billion in deposits, which was a hike of EUR 783 million (4.8%) year on year. As expected, at the beginning of 2015, when the euro was adopted, customers withdrew part of deposits from the banking system. The amount of customer deposits grew, even though interest rates were low.

The portfolio of loans and leases of the banking system increased by 3.9 per cent, to reach EUR 16.3 billion as at 1 January 2016. The growth in the loan portfolio was mostly driven by household loans, which increased by 6.9 per cent, and loans to non-financial corporations, which grew by 4.5 per cent. Growth in household borrowing was led by an increase in activity in the housing market. In 2015, the amount of housing loans granted by banks increased by 5.2 per cent; the amount of consumer loans increased as well. As of 1 January 2016, the housing loan portfolio amounted to EUR 6 billion, the consumer loan portfolio — EUR 0.6 billion, while all household loans — EUR 7.5 billion.

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

Together with the ECB, the Bank of Lithuania, as a participant of the SSM, supervised the banking sector during 2015. Representatives of the Bank of Lithuania participated in the ECB's working groups developing uniform supervisory techniques and standards according to international standards and best practice. On-site inspection, current supervision, supervisory review and evaluation as well as licensing processes were harmonised with the SSM requirements. Supervision of the three largest banks registered in Lithuania was performed together with the ECB on the basis of the uniform SSM methodology.

In observance of CRD IV, implemented in Lithuania, a Supervisory Review and Evaluation Process in relation to all banks operating in the country was carried out in 2015. During this process, banking activities in terms of types of risks, financial standing and compliance with prudential requirements were assessed in detail; the requirement of additional capital, necessary for covering Pillar II risks (i.e. risks which are not covered by the minimum capital adequacy requirements) was also estimated. It will be in force until the next Supervisory Review and Evaluation Process.

In 2015, the Bank of Lithuania set capital buffers in accordance with CRD IV. The capital conservation buffer (2.5%) is applied to all banks operating in the country. The countercyclical capital buffer is set at 0 per cent after the state of the Lithuanian economic cycle was assessed; the Bank of Lithuania reviews its value on a quarterly basis.

After the transposition of the provisions of the Bank Recovery and Resolution Directive into Lithuanian legislation at the end of 2015, banks will have to submit recovery plans to the Bank of Lithuania for assessment. In addition, banks will have to pay contributions (intended for providing financial aid to banks in crisis, if necessary) to the resolution fund, administrated by the Deposit Insurance Fund, annually.

Growing IT system security and cyber threats remain one of the most significant types of operational risks. Even though banks did not incur any direct losses due to IT incidents, indirect losses and a negative impact on reputation were seen. According to data on cases of operational risk losses provided by banks, in 2015 banks incurred EUR 3.94 million in losses, or three times more than in 2014.

## MAIN STRATEGIC OBJECTIVES OF THE BANKING SUPERVISORY AUTHORITY IN 2015

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

## THE ACTIVITIES OF BANKING SUPERVISORY AUTHORITY

In the area of bank supervision, changes were implemented to adapt the supervisory model to the SSM requirements in 2015. At the same time, an effective supervisory process was maintained.

The Bank of Lithuania is improving the licensing process with the objective of ensuring that only transparent and financially sound market participants enter the market. To ensure that managers of the supervised institutions and other responsible persons are competent and have an irreproachable reputation, the suitability of managers to perform these duties is assessed. The Bank of Lithuania website publishes the Licensing Guide, which provides comprehensive information on the legislative requirements for financial market participants. The Guide helps persons intending to obtain a business license or permission to promptly get comprehensive information on the legislative requirements, whereas already operating entities can find in it the most important information provided in a clear and comprehensive manner.

In recent years, much attention was devoted to the transposition of the EU directives and preparation of the legislation implementing them. CRD IV and CRR implementation was completed. The draft resolutions of the Board of the Bank of Lithuania implementing CRD IV were adopted, a new package of financial statements and supervisory reports of banks was successfully introduced and the capital conservation buffer of 2.5 per cent was established to banks. The Bank Recovery and Resolution Directive establishing a framework for the recovery and resolution of credit institutions and investment firms, which came into force on 1 January 2015, was implemented: the Law on Financial Sustainability and related laws were amended substantially; the Board of the Bank of Lithuania adopted the provisions for the preparation of recovery plans, which establish the requirements for the information provided and the terms of provision of recovery plans updated once per year to the supervisory authority; the supervisory process will follow the guidelines of the European Banking Authority related to the application of the provisions of the aforementioned directive as well as Directive 2014/49/EU of the European Parliament and of the Council on deposit guarantee schemes.

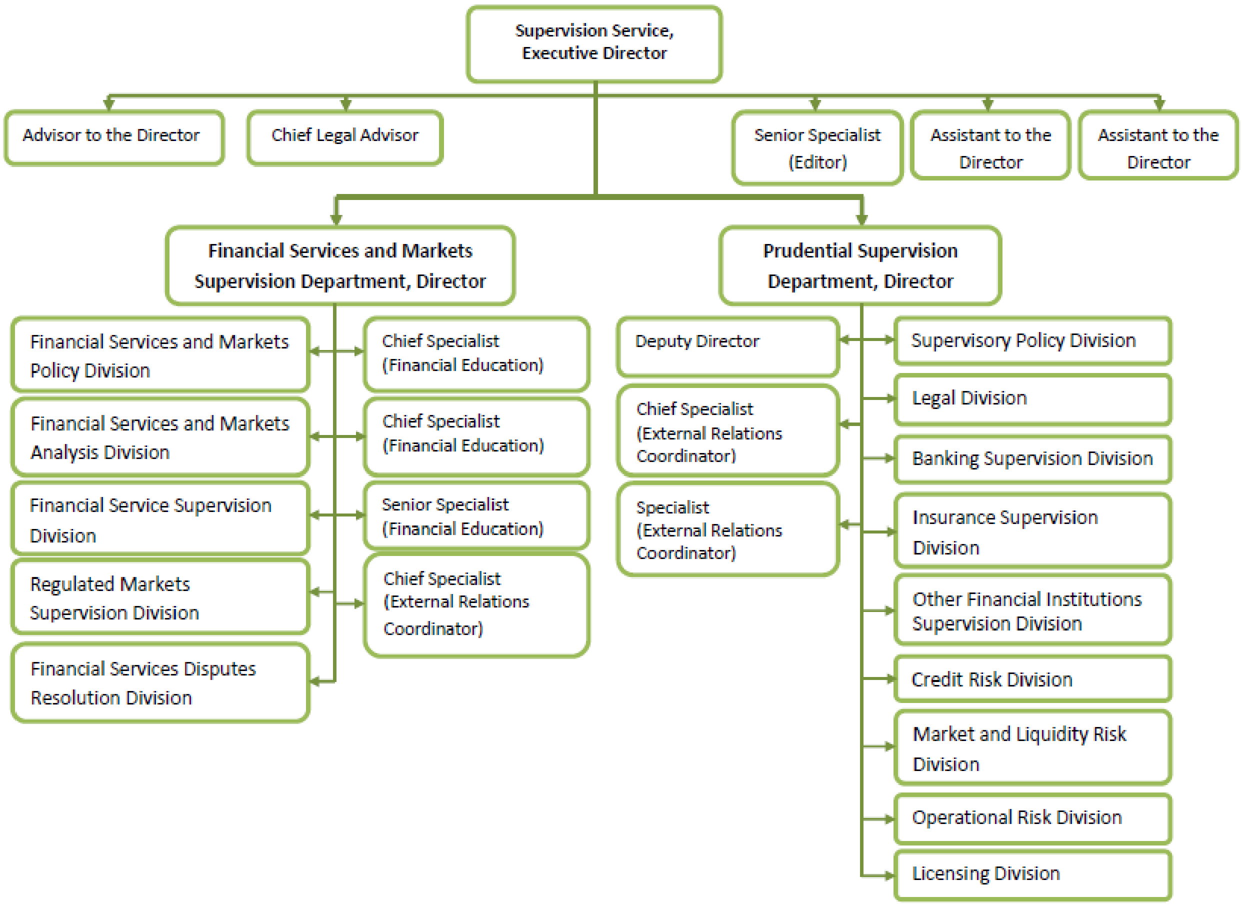
The tightening of the credit union supervision continued. After the Budget and Finance Committee of the Seimas of the Republic of Lithuania approved the Concept of the Sustainable Operation of Credit Unions, the draft laws amending the Law on Credit Unions and the Law on the Central Credit Union were drawn up and submitted to the Ministry of Finance. To ensure the sustainability of the operation of this financial sector segment, the legal acts regulating the operation of credit unions and the management of the risk assumed were improved. To assess credit risk more accurately, Resolutions of the Board of the Bank of Lithuania on prudential requirements for credit unions and on the calculation of prudential requirements for credit unions were amended: the differentiated capital adequacy ratio was abandoned and a uniform ratio of 13 per cent was set for all credit unions from 30 September 2015. Credit unions that have significant portfolios of loans granted to associated members will be required to calculate an additional capital requirement to cover this risk by applying respective risk weights. To reduce interest rate risk assumed by credit unions, the Rules of Credit Union Investment in Non-Equity Securities were adopted; they establish the requirements on investment portfolio size (no more than 35% of the on-balance-sheet assets of a credit union) and on the average modified financial duration of the securities portfolio (it should be no longer than 2 years from 31 December 2017). The new requirements are used to ensure that credit union investment does not have a negative impact on the primary objective of credit unions — satisfaction of borrowing requirements of members, i.e. credit unions must maintain the traditional business model, whereas investment in securities should be made only for the purposes of liquidity management.

The supervision of the implementation of requirements for the prevention of money laundering and terrorist financing is strengthened further. The National Money Laundering and Terrorist Financing Risk Assessment of the Republic of Lithuania was performed in 2015, which identified the factors that pose risk, whereas the Bank of Lithuania, as the financial sector supervisory authority, is actively involved in plans for the reduction of various risks identified in the National Money Laundering and Terrorist Financing Risk Assessment Report. In 2015, the Council of Europe expert committee on measures against money laundering and terrorist financing (*Moneyval*), acknowledged Lithuania's progress in the area of money laundering and terrorist financing — the tighter supervision procedures were abandoned for Lithuania in April 2015.

The Bank of Lithuania emphasises the importance of information technology security and strengthens supervision in this area. The Minimum Security Requirements for Online Payments, which have the objective of enhancing the security of these payments, came into effect on 1 November 2015.

# THE ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

SUPERVISION SERVICE ORGANIGRAMME



## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The Bank of Lithuania actively participated in the activities of the ESCB, the SSM, the Single Resolution Mechanism and other EU institutions and international organisations, closely cooperated with the IMF and other international organisations, rating agencies, national central banks and supervisory authorities. After Lithuania became a member of the euro area, representatives of the Bank of Lithuania participate in the meetings of the ECB's Governing Council and the ECB's Supervisory Board as well as Eurosystem-composition ESCB committees and deal with important issues together with other NCBs of euro area countries.

By ensuring the supervision of the financial market, the Bank of Lithuania actively participates in the work of European institutions responsible for micro-prudential oversight such as the European Supervisory Authorities (ESA) by addressing the issues relevant to the EU market and expressing properly the position of the Bank of Lithuania.

The major banks and branches of foreign banks in Lithuania's financial sector belong to large financial groups, therefore the cooperation between Nordic-Baltic supervisors remained the priority.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

The process of reducing the administrative burden of the supervised market participants, which began in 2014, is being continued. Bank and credit union licensing procedures were simplified and the amount of information that has to be collected and submitted was reduced. It is planned to create a possibility for financial market participants to submit to the Supervision Service of the Bank of Lithuania the documents signed by a certified electronic signature. This would allow to save not only costs, but also time, and accelerate information exchange procedures. It is planned to abandon a part of the regularly collected information and to join some reports in the future. In order to help businesses avoid the double reporting burden, the information already collected in state registers will be used for supervisory purposes.

Much attention was devoted to communication with market participants and their consulting. The Supervision Service of the Bank of Lithuania organises the annual meetings with all supervised market participants and their associations. During these meetings, it presents already-implemented and future business regulation innovations and expected EU supervisory regulation trends as well as discusses the current state of the market. Individual meetings of representatives of banks, audit companies that conduct their audit and the Supervision Service to discuss the results of annual financial statements as well as individual discussions of performance results and prospects with each insurance undertaking are organised each year.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 7 | 7 | 6 |
| Branches of foreign credit institutions | 8 | 8 | 7 |
| Cooperative banks* | 77 | 75 | 75 |
| **Banking sector, total:** | **92** | **90** | **88** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | - | - | - |
| Other domestic ownership | - | - | - |
| Domestic ownership total | 10.9 | 10.3 | 10.7 |
| Foreign ownership | 89.1 | 89.7 | 89.3 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 85.0 | 95.4 | 2814.6 |
| Branches of foreign credit institutions | 95.8 | 98.7 | 4028.7 |
| Cooperative banks | 12.4 | 18.9 | 257.7 |
| **Banking sector, total:** | 72.3 | 87.5 | 1984.5 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 11.67 | 7.96 | 10.36 |
| Branches of foreign credit institutions | -19.70 | 1.11 | - 6.74 |
| **Banking sector, total:** | - | - | - |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 78.7 | 77.4 | 81.9 |
| Branches of foreign credit institutions | 18.6 | 20.1 | 15.3 |
| Cooperative banks | 2.7 | 2.5 | 2.8 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 15.41 | 21.12 | 24.55 |
| Cooperative banks | 18.44 | 22.65 | 17.59 |
| **Banking sector, total:** | 15.51 | 21.17 | 24.36 |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non-financial sector | 10.70 | 6.32 | 5.11 |
| **- households** | **x** | **x** | **x** |
| **- corporate*** | **x** | **x** | **x** |

**The structure of deposits and loans in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 91.4 | 90.1 |
| Households | 60.7 | 43. 9 |
| Corporate | 30.7 | 46.3 |
| Government sector | 6.4 | 5.7 |
| Financial sector (excluding banks) | 2.3 | 4.2 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 568.8 | 561.8 | 462.0 |
| Interest expenses | 234.0 | 206.3 | 116.2 |
| Net interest income | 334.8 | 355.5 | 345.8 |
| Net fee and commission income | 186.0 | 190.6 | 170.2 |
| Other (not specified above) operating income (net) | 47.5 | 81.6 | 47.2 |
| Gross income | 568.3 | 627.7 | 563.2 |
| Administration costs | 313.3 | 328.4 | 287.1 |
| Depreciation | 15.0 | 15.2 | 15.4 |
| Provisions | -1.2 | -3.7 | -1.6 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | -0.9 | 35.5 | 30.6 |
| Profit (loss) before tax | 307.1 | 255.4 | 274.6 |
| Net profit (loss) | 277.4 | 211.2 | 244.0 |

**Total own funds in 2015 (in mln EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 2325.1 | | 2273.5 | 51.6 | |
| Cooperative banks | 55.1 | | 49.6 | 5.5 | |
| **Banking sector, total:** | 2380.2 | | 2323.1 | 57.1 | |

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

# 2015 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MACEDONIA

## MACROECONOMIC ENVIRONMENT

In 2015, the Macedonian economy registered solid macroeconomic performance, despite the present risks and uncertainty throughout the year. Against the backdrop of exogenous risks present during the times of global crisis and post-crisis recovery of the global economy, and pronounced geopolitical risks, this year the stable foundations of the Macedonian economy based on structural changes, again came to the fore and enabled constant solid economic growth. On the other hand, 2015 was marked by specific risks associated with the internal political situation, which despite bringing an extra dose of uncertainty, are estimated to have had limited impact on the economy. However, this situation posed additional challenges to the monetary policy that have been addressed by appropriate changes aimed at achieving the legislative objectives.

In 2015, the Macedonian economy preserved the solid growth (3.7%), proving its vitality, despite the exogenous and endogenous risks. The growth mainly resulted from domestic consumption and exports. In this light, one should note the contribution of new facilities with foreign capital to the exports, the robust infrastructure projects of the public sector and the further decline in unemployment that positively affect consumer spending. The number of employees increased by 2.3% in 2015, which is a faster growth compared to last year. In 2015, the average unemployment rate fell by 2 percentage points and reduced to 26.1%. Inflation was slightly negative (-0.3%) in 2015, influenced by supply factors, mainly lower fuel prices on world markets, which also had major effects on the inflation globally. However, average core inflation was moderately positive (0.5%), indicating solid domestic demand. The current account deficit, albeit slightly expanded, has been ranging around 2% of GDP for six years in a row. More importantly, 2015 witnessed narrowing of the trade deficit, mainly due to the contribution of new facilities in the free economic zones, as well as the positive price effect on energy imports, with relatively stable private transfers. The financial account registered specific movements such as moderate inflow of foreign direct investment, outflow from the repayment of external government liabilities, and outflows from the private sector, partly reflecting the complex global environment. Against such backdrop, foreign reserves registered a moderate decline, but remained at an adequate level (Euro 2.262 million).

At the end of 2015, the gross external debt stood at Euro 6,353.7 million, or 69.9% of GDP, which is a decrease of 0.4 percentage points of GDP, compared with the end of 2014. The fall in gross external debt is mainly a result of the decline in public debt, despite the higher level of private sector debt. The reduction of the public debt is due to the reduction in long-term liabilities of the central government on the basis of long-term loans, primarily due to the repayment of the PCL to the IMF in February 2015, in the amount of Euro 153.4 million.In 2015, public finances were characterized by moderate fiscal consolidation, which reduced the central government debt, while public debt to GDP ratio recorded a slight growth. In 2015, the budget deficit was 3.5% of GDP which is by 0.7 percentage points lower compared with the previous year. Deficit narrowed partly due to the improvement of the cyclical component, but a significant portion of the downward correction is due to the improvement of the structural component.

Amidst low inflation, solid balance of payments position and consequently, stable foreign exchange market developments, the interest rate on the main monetary instrument in 2015 remained unchanged. Additional easing of monetary policy in the euro area, as anchor economy, during the year has contributed to retaining unchanged setup of domestic monetary policy, given the implicitly increased attractiveness of domestic interest rates. On the other hand, as early as in the first quarter of the year there were indication for retaining accommodative monetary policy by further reducing the interest rates on deposit facilities and creating prerequisites for greater allocation of banks' funds to lending to the private sector. Also, in 2015, a non-standard measure for release from reserve requirement continued to be applied to loans to the export and energy sectors.

Although the economy in general, soundly overcame the exogenous challenges, still, the present uncertainty clouding the domestic political situation and the outburst of the Greek crisis mostly spilled over through the expectations channel, particularly affecting the propensity of households to save. Consequently, given the uncertainty and declining interest rate spread between the denar and foreign currency deposits, total deposits growth slowed down moderately and the multiyear trend of denarization of savings stabilized in 2015. In such circumstances, banks were released from the reserve requirement on denar deposits over one year, in order to support long-term savings in domestic currency.

In light of the escalation of Greek crisis, and taking into account the developed trade and financial ties with this neighboring economy, in the second half of the year, temporary measures were applied to limit capital outflows to Greek non-residents. The measure was in force until the end of the year (six months in total).

In 2015, "Fitch" Credit Rating Agency announced that it affirmed the previously awarded BB+ foreign and local currency sovereign credit rating of the Republic of Macedonia, revising the country's outlook to negative from stable. Also, "Standard & Poor's" Credit Rating Agency affirmed the previously awarded BB- foreign and local currency sovereign credit rating of the Republic of Macedonia, at the same time affirming the stable outlook of the country. Affirmed credit rating is based upon the moderate level of both public and government debt, low inflation and table and well-capitalized banking sector. Stable credit rating of the Republic of Macedonia is a strong signal to foreign investors and it has positive impact on the interest rate at which the country borrows on the international capital market, as well as the overall economic and political image of the Republic of Macedonia.

According to macroeconomic forecasts, in 2016, solid macroeconomic performance can be expected, yet again, these expectations are significantly encumbered by constant threats from the external and the domestic environment. National bank of the Republic of Macedonia remains ready to respond flexibly to all challenges in order to accomplish the monetary policy objectives of price stability and stable exchange rate, financial stability and macroeconomic stability in the domestic economy.

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

Despite all the challenges, Macedonian banking system maintained its stability in 2015 and has confirmed its resilience to domestic and external environment shocks. Given the solid domestic economy growth, banking system activities continued to rise although with a slower pace. On annual basis, banks assets, loans and deposits have been increased by 5.8%, 9.7% and 6.7%, respectively (compared to previous year growth of 8.3%, 9.9% and 10.7%, respectively). The assets-to-GDP ratio equaled 75.6%, which is a decrease of 0.5 percentage points relative to 2014. The gross credits and the deposits reached 49.5%, i.e. 54.7% of the gross domestic product, respectively (growth of 1.4 percentage points, i.e. 0.1 percentage points, compared to 2014)[32].

In 2015, banks operations have been significantly influenced by several non-economic factors that were primarily reflected through the intensified domestic political turmoil and the uncertainty caused by the Greek debt crisis. These unfavorable factors coupled with the considerably low interest rates environment have limited banks opportunities for faster growth. Namely, in mid-2015, under the apparent influence of factors from a mainly non-economic nature, the banking system faced a moderate withdrawal of deposits. Banks liquidity risk management proved to be very sound and prudential, which, coupled with the increased monitoring and the several measures undertaken by the National Bank of the Republic of Macedonia (NBRM), contributed to fast stabilization and normalizing of the unfavorable movements in banks' deposit base. However, the several years long trend of denarization in banks balance sheets has lost momentum and deposits maturities were considerably shortened. Furthermore, the increase in total deposits was mainly due to the growth of corporate deposits, amid the slower growth rate of households deposits, which however remain main traditional source of banks' funds.

Despite the lack of solid deposit growth, banks managed to achieve significant credit growth rate, almost similar to the growth rate registered in 2014. Banks continued to lend more cautiously to corporate sector entities, so that the upward movement in banks lending activity has been more evident in the households segment, unlike the credit support given to corporate clients, whose annual growth has slowed down. NBRM adopted a package of measures which are aimed to reduce the high growth of long-term consumer loans to households and in that manner to reduce the potential risks originating from certain segments of banks credit portfolio. At the same time, a new measure was adopted and existing one was extended, with both aimed to facilitate the access of domestic corporate sector to banks financial services.

Credit risk is the most significant risk in banks' balance sheets, although it did not cause any significant concern in 2015. The growth of non-performing loans (NPLs) has slowed down significantly (4.7% in 2015 versus 8.3% in 2014), which contributed in reduced share of NPLs in total loans of 10.8%, at the end of 2015. The possible negative impact from existing NPLs on banks own funds is limited, considering the already prudentially high level of impairments allocated by the banks. NBRM adopted a new measure that will obligate banks, starting from mid-2016 to write-off NPLs that are fully covered with impairment losses for more than

[32] Financial intermediation indicators are calculated according to the last available data on GDP. Data on GDP were last revised as on 10.03.2016.

two years. In reference with this measure, one could expect a significant reduction of banks NPLs in the forthcoming period.

Banks exposure to other risks is not significant. The significance of FX risk is minimized given the strategy of maintaining stable exchange rate of the denar against the euro and the dominance of this currency in the banks' FX positions. Furthermore, the ratio between the aggregate FX position and own funds, remains within the prescribed limit for all banks (30% of banks' own funds).

Banks liquidity is satisfactory (besides the certain liquid assets reduction in 2015), due to their propensity to maintain stable level of liquidity, whose share constantly accounts for about one third of total assets. Liquid assets cover approximately 60% of short-term liabilities and more than 80% of the contractual obligations with residual maturity up to 30 days, which confirms the satisfactory liquidity position of domestic banks as one of the main pillars of the overall banking system stability.

Banking system has maintained its high solvency position. Capital adequacy ratio equaled 15.5% at the end of 2015 which is a slight reduction compared to 2014 due to increased banks lending activity. Reinvested profit is the main source of banks own funds enlargement. The increase of own funds equaled 5.8% in 2015 and is expected to continue in 2016 as well, after banks shareholders decide on the amount of reinvested profit in banks capital positions. Banks profitability is considerable and improving for several consecutive years. The total amount of profit earned in 2015 is by almost 50% larger compared to 2014, generating relatively high returns on average asset and on average equity and reserves of 1.1% and 10.4%, respectively.

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

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

These competences of the NBRM are regulated with the Law on the National Bank of the Republic of Macedonia and the Banking Law. The Banking Law and the relevant by-laws follow the provisions of the European directives and regulations in order to provide a higher degree of compliance with the European legislation and with the principles and standards developed by the Basel Committee on Banking Supervision.

In order to achieve further enhancement of the banking regulatory framework, in 2015 the following acts were prepared and adopted:

- The Decision amending the Decision on the terms and the manner of operating of the savings houses is aimed at strengthening the standards for the operation of savings houses. The main amendments are related to the higher capital adequacy ratio requirement of 20%, the implementation of currency risk management system and the manner of conducting internal audit;

- The Decision on information security of saving houses prescribes standards for information system security for saving houses, by defining criteria for establishing information security management process and ensuring business continuity, which brought them closer to the standards that apply to banks' operations in the Republic of Macedonia;
- The Decision amending the Decision on the contents and the manner of functioning of the Credit Registry is aimed to ensure compliance with the provisions of the Law on Personal Data Protection, by prescribing the access of natural persons to their personal data and information in the Credit Registry, as well as the manner and terms of correcting incomplete, incorrect and inaccurate personal data;
- The Decision amending the Decision on the method of determining connected persons/entities was made to comply with the recommendations contained in Supervisory framework for measuring and controlling large exposures published by the Basel Committee on Banking Supervision in April 2014. The amendments define more precisely the economic interdependence i.e. the existence of a single risk between two or more persons/entities taking into account their business relationship, collateral arrangement, the sources of supply, financing or the repayment of debts. In determining the existence of economic interdependence the exemption is made for the bank's exposure to individual person which is less than 2% of its own funds;
- The Decision amending the Decision on the methodology for determining the capital adequacy is aimed to prevent the potential risks of rapid growth of long-term consumer loans (with contractual maturities equal to or longer than eight years), by increasing their risk weight to 150%. This requirement applies to all new long-term consumer loans extended after January 1, 2016, including restructured and refinanced loans that will have longer maturities after the restructuring/refinancing. The Decision stipulates an additional obligation for banks to apply 75% risk weight to the positive difference between (1) the total exposure from overdrafts and credit cards on the reporting date and (2) the total exposure from overdrafts and credit cards on December 31, 2015. Also, lower capital requirement for banks' claims collateralized by commercial real estate is allowed if certain criteria are fulfilled;
- The Decision amending the Decision on credit risk management requires banks to explicitly inform their clients on the risks arising from FX loans, prior to the extension of such loans. Also it prescribes an obligation for banks to write-off credit exposure if two years have passed from the date as of which the bank was required to make impairment or allocate special reserve in the amount of 100%. Namely, almost 70% of all NPLs are fully impaired and some of them are in banks' balance sheets for more than two years. This measure will enable more accurate presentation of banks' credit risk exposure.

During 2015, the NBRM continued its activities for further harmonization of domestic regulation with Basel III, European Directive 2013/36/EU and Regulation (EU) No 575/2013, regarding: (1) Liquidity Coverage Ratio (LCR) as a minimum liquidity standard, (2) structure and characteristics of the Own Funds and (3) implementation of capital buffers.

# MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

Maintaining of the stability of the banking system as a basic prerequisite for financial stability and sustainable economic growth is the main strategic objective of the National Bank as the Macedonian banking supervisory body. This objective is achieved by:

1. Enhancement of financial stability by improvement of the financial stability monitoring instruments, development of macroprudential tools and practices, performing regular stress-test analyzes, including macro-stress analysis and further capacity building for application of econometric techniques.
2. Strengthening of the supervisory capacity for contingency planning and crisis management.
3. Continuous improvement of banking regulations by undertaking activities for adequate implementation of the new Basel III requirements and CRDIV/CRR.
4. Harmonization of banking supervision and regulatory framework with the new Basel Principles for Effective Banking Supervision (issued in September 2012).
5. Participation in supervisory colleges, amid the creation of the Single Supervisory Mechanism
6. Participation in regional initiatives for development of adequate information sharing framework and dealing with joint supervisory issues and challenges.

# THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

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

The off-site supervisory function of the National Bank of the Republic of Macedonia is carried out through 3 cornerstone activities: licensing (issuing licenses and approvals to banks and savings houses), regular off-site supervision of the operations of the banks and the savings houses and undertaking corrective actions. Within this framework, during 2015 the National Bank has performed the following activities:

- 69 licensing procedures were performed, which were mainly related to issuing: approvals for appointment of members of the Boards of Directors and members of the Supervisory Boards, amending and/or supplementing the Statute of the banks and approvals for commencement of new financial activities by banks;
- Regular off-site analysis of the banks' operations and their risk profiles.

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

*Performing supervision and oversight*

During 2015, the supervisory and inspection controls were largely synchronized. In comparison with 2014, the number of on-site controls decreased. Assessment of the risk profile, as well as compliance of the operations with the regulations was performed in 6 banks and one savings house. Five banks were subject of assessment of exposure to certain risks, while seven banks and two savings houses were subject of oversight of the compliance of their operations with the regulations. Control activities were conducted over two providers of fast money transfer, 40 subagents, as well as 64 exchange offices.

*On-site supervision of risks*

Banks in the Republic of Macedonia perform traditional banking activities and credit risk largely determines their risk profile. Hence, this risk, especially the quality of its management, is mostly assessed with on-site controls. In 2015, special attention was paid to the risks of the household segment, given the banks' orientation for greater credit support to this segment. Also, certain banks were subject of assessment of the adequacy of the systems for preventing money laundering, liquidity risk, operational risk, their profitability, information security, as well as corporate governance.

Controls have shown that banks adequately manage the risks they are exposed to and they are largely responsive to the corrective measures given by the National Bank. Banks have established adequate organizational structure and processes for risk management, as well as internal control mechanisms, that were constantly strengthened.

Based on the on-site findings, appropriate recommendations were given for further improvement of the existing credit risk management rules and practices, that relate to: strengthening of credit analyses of customers, strengthening of the monitoring in relation to proper usage of extended loans, improving the systems for identifying and monitoring of the related parties, improving of the monitoring of the households' creditworthiness by monitoring their total indebtedness at the system level, improving the process of classification of credit exposures in terms of the impact of the creditworthiness and the credit history, promoting early warning criteria in the process of monitoring of the extended loans, strengthening the monitoring of loans approved with the exception, as well as recommendations for improving the internal audit in respect of this risk.

The recommendations for enhancing the prevention of money laundering and financing of terrorism pertained to the following: strengthening the measures for identifying and verifying the identity of the beneficial owner of clients, improving the structure and contents of the analyses for clients and transactions due to more adequate determination of the level of risk of clients, i.e. the recognition of suspicious transactions, strengthening the indicators for detecting possible suspicious transactions, improving the dynamic profiling of the risk of clients, aligning the scope of the measures and actions that were taken with the level of risk and strengthening the internal audit activities.

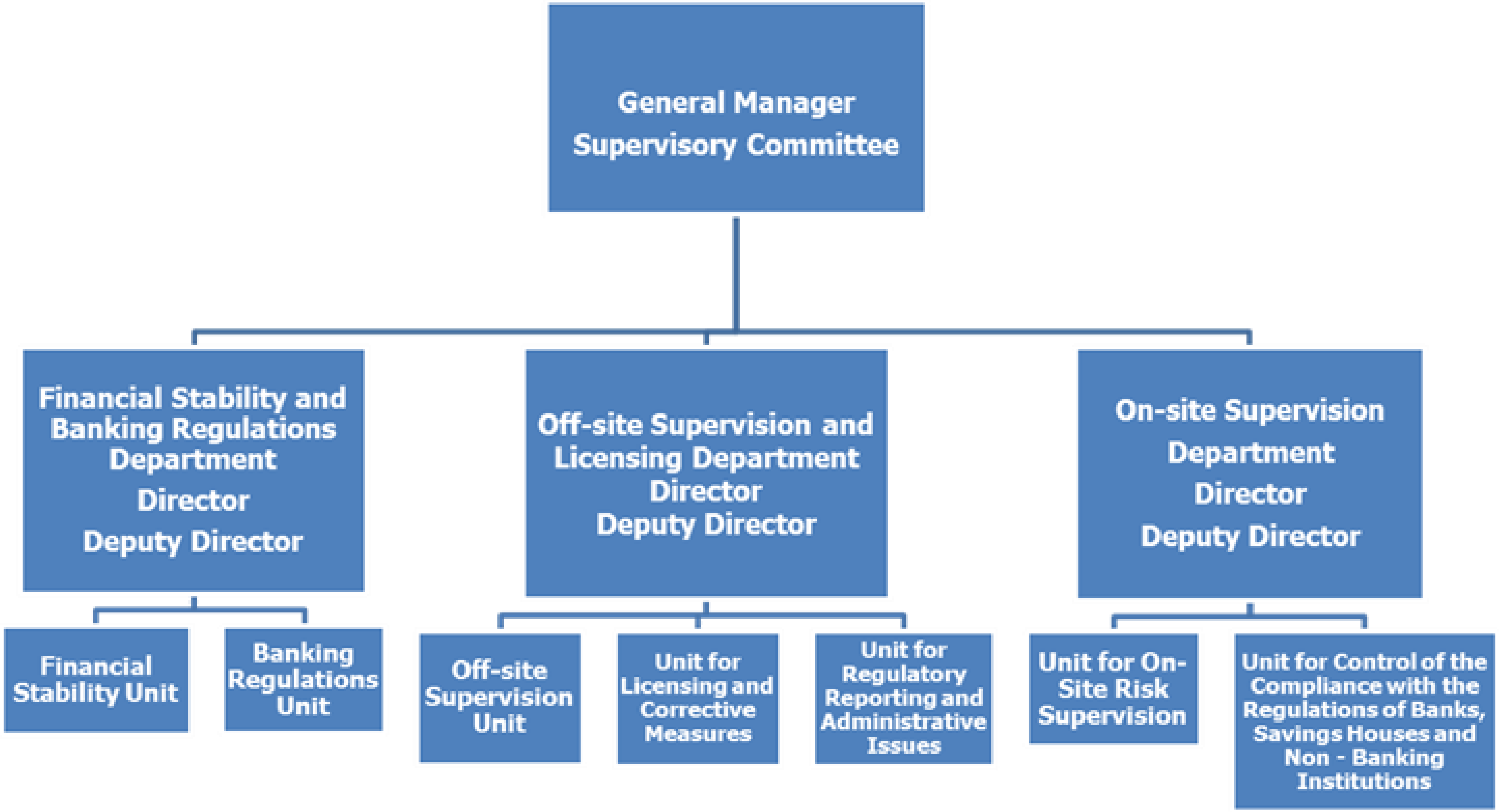
In order to improve the liquidity risk management, recommendations were given regarding the appropriate projections of loan collections, reviewing of the stress-test scenarios and further development of plans for contingency liquidity management. The operational risk management should be improved by: improving the process of risk determination, improving the use of databases of adverse events, timely updating of the plans for continuity of operations in accordance with the business processes and systems in banks and increasing the scope of their testing through greater involvement of the business side, improvement of controls in treasury premises, strengthening the role of the Risk Management Department in relation to this risk. In order to increase the information security, recommendations were made to: improve the process of risk analysis, reinforce the control measures, improve the systems of audit trail, improve the activities in the development and upgrade and improve the protection of communication with users of e-banking.

*On-site controls of compliance with regulations*

On-site control activities, through which the operations of banks and savings houses was controlled in terms of implementation of the regulations, included verification of compliance with: the Law on the National Bank of the Republic of Macedonia, the Law on Foreign Exchange Operations, the Law on Consumer Protection in Consumer Loan Agreements, the Law on Fast Money Transfer and Payment Operations Law. It was determined that all controlled subjects mainly operated in accordance with the regulations.

On-site controls of non-banking financial institutions, i.e. licensed exchange offices, providers of fast money transfer and their subagents, were aimed at assessment of the compliance of their operations with the Law on Foreign Exchange Operations, the Law on Fast Money Transfer and the Law on Prevention of Money Laundering and Terrorist Financing. The controls determined certain irregularities in the licensed exchange offices regarding the manner of conducting currency exchange operations.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

On October 23, 2015, a Memorandum of Cooperation was signed between the European Banking Authority and the supervisory authorities of six countries in South-Eastern Europe: Albania, Macedonia, Montenegro, Serbia, Bosnia and Herzegovina and Republika Srpska. The Memorandum was signed under the auspices of the Vienna Initiative - a public-private network established in 2009 to protect the financial stability in Central and Eastern Europe countries. The signing of this Memorandum recognizes the efforts of these countries to promote and strengthen banking supervision and regulation and brings them closer to the standards and practices within the European Union. At the same time, the Memorandum establishes a framework for cooperation and exchange of information with the European Banking Authority facilitates the participation of supervisory authorities in the supervision of banking groups from the European Union present in these countries and increases the opportunities for further strengthening of the capacity of supervision.

The cooperation with foriegn supervisory bodies continued in 2015 under the signed MoUs. Among other activities, within this cooperation NBRM supervisory staff attended three supervisory colleges (for two Greek and one Slovenian subsidiary).

# COOPERATION WITH OTHER SUPERVISORY BODIES IN MACEDONIA

The cooperation with other domestic supervisory authorities regarding the regular flaw of information relevant for the performance of their tasks and responsibilities continued in 2015 on the basis of the previously signed Memorandums of understanding.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS

The methodology for generating financial stability indexes (FSIs) has been considerably extended in 2015. Namely, several new methods for generating FSIs were established: modified portfolio method with decomposition of variance, modified portfolio method with dynamic variances, modified portfolio method with signals and method of VaR (Value at risk). Additionally, several new features of the FSIs were introduced: index threshold, obtained by employment of Threshold VAR models and probability of stress occurrence, obtained while estimating of Markov Switching VaR models. The final version of the FSI is calculated as an average of the indexes generated with different methods, as this proved to be more reliable than using an individual financial stability index.

NBRM representatives participated in the preparation and assembly of the "Moneyval" report on the progress of the Republic of Macedonia in the field of anti-money laundering and finacing of terrorism. The acquired knowledge from the meetings will be appropriately incorporated into the by-law for prevention of money laundering and terrorist financing. At the same time, working meetings with representatives from regulatory bodies, banks and non-bank financial institutions were realized for establishment of the national risk of money laundering in banks and non-bank financial institutions.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 16 | 15 | 15 |
| Branches of foreign credit institutions | 0 | 0 | 0 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total:** | **16** | **15** | **15** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 3.8% | 3.8% | 4.0% |
| Other domestic ownership | 27.9% | 27.1% | 26.9% |
| Domestic ownership total | 31.7% | 30.9% | 30.9% |
| Foreign ownership | 68.3% | 69.1% | 69.1% |
| **Banking sector, total:** | **100.0%** | **100.0%** | **100.0%** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 59.4% | 74.3% | 1.390 |
| Branches of foreign credit institutions | / | / | / |
| Cooperative banks | / | / | / |
| **Banking sector, total:** | 59.4% | 74.3% | 1.390 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 5.7% | 7.4% | 10.4% |
| Cooperative banks | / | / | / |
| **Banking sector, total:** | 5.7% | 7.4% | 10.4% |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 100.0 | 100.0 | 100.0 |
| Branches of foreign credit institutions | / | / | / |
| Cooperative banks | / | / | / |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Assets | 2013 | 2014 | 2015 |
|---|---|---|---|
| Cash, balances and deposits with central bank (NBRM) | 10.5% | 12.5% | 11.1% |
| Placements in securities | 17.1% | 14.5% | 14.8% |
| - issued by domestic government sector | 10.0% | 7.9% | 8.5% |
| - issued by central bank (NBRM) | 6.9% | 6.4% | 5.9% |
| - other (including non residents) | 0.2% | 0.3% | 0.4% |
| Loans, deposits and accounts with financial institutions (excluding central bank, including non residents) | 12.0% | 12.5% | 12.0% |
| Loans with non-financial sector (including non residents) | 54.7% | 55.5% | 57.7% |
| - loans with domestic government sector | 0.6% | 0.5% | 0.5% |
| Other assets | 5.7% | 5.0% | 4.4% |
| **Total** | **100.0%** | **100.0%** | **100.0%** |
| **Liabilities** | **2013** | **2014** | **2015** |
| Deposits of financial institutions (including non residents) | 4.6% | 4.1% | 4.0% |
| Deposits of non financial sector (including non residents) | 70.1% | 71.7% | 72.3% |
| - deposits of domestic government sector | 0.2% | 0.1% | 0.1% |
| Borrowings, issued securities and liabilities on the basis of subordinated and hybrid instuments (including non residents) | 11.6% | 10.8% | 10.1% |
| - domestic financial sector | 4.0% | 3.4% | 3.5% |
| - domestic government sector | 0.3% | 0.2% | 0.2% |
| - other | 7.3% | 7.2% | 6.4% |
| Other liabilities | 1.7% | 1.8% | 2.8% |
| Equity and reserves (including loss in current year) | 11.3% | 10.8% | 10.8% |
| Profit after tax in current year | 0.7% | 0.8% | 1.1% |
| **Total liabilities** | **100.0%** | **100.0%** | **100.0%** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks* | 16.85%** | 15.66%** | 15,49%** |
| Cooperative banks | / | / | / |
| **Banking sector, total:** | 16.85%** | 15.66%** | 15,49%** |

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

**Asset portfolio quality of the banking sector**

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 11.5% | 11.3% | 10.8% |
| **- households** | 6.4% | 5.9% | 5.2% |
| **- corporate** | 15.2% | 15.3% | 15.2% |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 95.4% | 99.8% |
| Households | 67.1% | 42.0% |
| Corporate | 25.0% | 56.6% |
| Government sector | 0.1% | 0.9% |
| Financial sector (excluding banks) | 4.6% | 0.2% |
| **Total** | **100.0%** | **100.0** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 20,100 | 20,216 | 19,954 |
| Interest expenses | -7,942 | -7,133 | -5,602 |
| Net interest income | 12,158 | 13,083 | 14,352 |
| Net fee and commission income | 3,918 | 4,118 | 4,234 |
| Other (not specified above) operating income (net) | 1,767 | 1,677 | 2,350 |
| Gross income | 17,843 | 18,878 | 20,935 |
| Administration costs** | -9,645 | -9,383 | -9,672 |
| Depreciation | -1,013 | -953 | -996 |
| Provisions*** | -1,007 | -785 | -1,164 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)**** | -3,828 | -4,200 | -3,921 |
| Profit (loss) before tax | 2,350 | 3,557 | 5,184 |
| Net profit (loss) | 2,311 | 3,149 | 4,640 |

* 1 EUR = 61.5947 MKD, as of 31.12.2015
** 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 2015 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 |
|---|---|---|---|---|
| Commercial banks | 778,298,903 | 700,335,629 | 700,335,629 | 77,963,273 |
| Cooperative banks | / | / | / | / |
| **Banking sector, total:** | 778,298,903 | 700,335,629 | 700,335,629 | 77,963,273 |

# 2015 DEVELOPMENTS IN THE BANKING SYSTEM OF THE REPUBLIC OF MOLDOVA

## MACROECONOMIC ENVIRONMENT

During 2015, Moldova's economy declined 0.5 percent this dynamic is 5.1 percentage less than in 2014. The negative evolution of economic activity was driven largely by the drought in 2015 which reduced substantially the performance of agriculture, but also damaged the regional economic climate, in the same time persistent domestic economic and political uncertainty, resulted domestic demand decline from population and investment contracting. Household final consumption and gross fixed capital formation decreased with 2.3 and 1.2 percent in comparison with 2014.

The negative impact associated with changes in inventories to GDP dynamics was even more pronounced one. Government consumption, similar to previous years, not essentially influenced the dynamics of economic activity, registering a decrease of 0.4 percent. The negative impact of the above factors was partially offset by the depreciation of the national currency against the US dollar which offset the contraction of foreign inflows and at the same time, improved the competitiveness of local products. Consequently, the decrease in domestic demand and currency depreciation led to significant contraction in imports (4.3 percent). At the same time, exports of goods and services grew by 2.3 percent in 2015. Gross added value from agriculture recorded a decline of 13.4 percent after two years of sustained economic activity as a result of adverse weather conditions. A negative evolution, but which generated a less significant impact in 2015 was recorded in the trade. Negative contribution of mentioned above components was mitigated by the positive dynamics of the financial sector, industrial and communications.

In 2015, average annual inflation rate was 9.7 percent, with 4.6 p. p. higher than in 2014. During 2015, the annual inflation rate has outlined a pronounced upward trajectory. This increased from 4.7 percent in January to 7.1 percent in March under pressure from currency depreciation, exceeding thus the upper limit of ± 1.5 percentage points to the inflation target of 5.0 percent stipulated in the policy strategy monetary medium term. Thereafter, annual inflation rate was increased gradually to 8.6 percent in July 2015 was influenced by the effects of depreciation, but also unfavorable agro-meteorological conditions put pressure on food prices. Increase in electricity tariff and gas from network caused a pronounced acceleration of inflation to 12.2 percent in August and by the end of 2015 the inflation rate was 13.6 percent. Inflationary pressures during the year were partially mitigated by modest domestic demand, the embargoes on some product categories, and the trend of lower prices for food and oil internationally.

During 2015, as compared to the end of 2014, the nominal official exchange rate of the national currency has weakened by 25.9% against the U.S. dollar and by 13.1% against the euro. Meanwhile, the real effective exchange rate of the national currency[33] has depreciated insignificantly, by 0.3%, as compared to December 2014. The main trading partners, which contributed to this dynamic were Ukraine – with 1.09 p.p. and Russia – with 0.51 p.p.

[33] December 2000=100

The nominal depreciation of the national currency was due to lower net foreign exchange inflows (as remittances, exports, foreign loans and investments declined), but also came as an outcome of increasing vulnerabilities in the domestic banking sector. In 2015 three banks were liquidated and another three major banks were placed under special supervision. In the first two months of the year, the Moldovan Leu faced stronger depreciation pressures, as the deteriorating conditions of the banking sector have triggered individuals to shift savings from local to foreign currency. Subsequently, in this period, the local FX market has registered a significant deficit, that was partially covered by NBM sales of FX reserves. Additionally, some measures have been taken to tighten monetary policy.

Since the second quarter and by the end of the year, the pace of currency depreciation has tempered amid a moderate net demand from businesses, given a decrease in trade deficit by 33.8 percent over the previous year.

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

The development of aggregate indicators per banking sector in 2015 was heavily distorted by initiating on 16.10.2015 process of forced liquidation of three banks.

Simultaneously, National Bank was determined to establish special administration on other three systemic banks by the decisions of the Council of Administration.

At the end of 2015, Tier I capital amounted to 418.8 million EUR, increasing during 2015 by 64.4 million EUR (18.2 percent). As of 31.12.2015 all banks reported Tier I capital corresponding to the minimum required capital (≥9.3 million EUR).

Tier I capital increase was determined by the profit equal to 57.6 million EUR obtained during 2015 and decrease of the calculated but unreserved amount of the allowances for impairment losses on assets and conditional commitments by 12.0 million EUR or 12.1 percent.

Also ordinary shares increased by 0.1 million EUR and capital surplus by 2.5 million EUR due to share buyback in January 2015. The share buyback amount for „FinComBank" was to 0.5 million EUR, with the price per share equal to 13.4 EUR. Additionally, BC „MOLDOVA - AGROINDBANK" S.A. performed treasury share sale amounting for EUR 0.6 million in April 2015. At the same time, 5 banks have distributed dividends in the total amount of 7.6 million EUR (at the year-end exchange rate).

Average risk-weighted capital adequacy ratio on the system was 26.2 percent, increasing by 4.5 percentage points compared to the end of the previous year.

The total assets of the sector (according to IFRS) constituted 3,209.9 million EUR, increasing by 417.3 million EUR (14.9 percent) compared to the end of 2014, due to increase of liabilities by 360.2 million EUR (15.6 percent) and increase of capital by 57.1 million EUR (11.8 percent). Also, the share of assets in GDP increased from 53.5 percent up to 56.6 percent. Gross loan portfolio amounted to 1,779.9 million EUR as of December 31, 2015, increasing during 2015 by 73.0 million EUR (4.3 percent).

During the year 2015, the balance of non-performing loans (substandard, doubtful and loss) increased in absolute value by 33.7 million EUR (23.5 percent), representing 176.9 million EUR, while the share of non-performing loans in total loans increased by 1.5 percentage points compared to the end of the previous year, amounting to 9.9 percent at 31.12.2015. The share of net non-performing loans in total regulatory capital increased by 3.4 percentage points, amounting to 15.0 percent as of 31.12.2015.

In the context of risk distribution the largest share in the total loan portfolio was held by credits granted to trade – 30.5 percent, followed by credits to food industry – 9.3 percent, consumer credits – 8.0 percent, credits to agriculture – 7.8 percent, credits to service delivery sector – 7.2 percent, credits to production industry – 7.1 percent, credits for purchase/building real estate – 6.1 percent, credits for transport, telecommunications and network development – 5.8 percent, credits to nonbanking financial sector – 3.8 percent, other credits – 3.7 percent, credits to constructions – 3.5 percent, credits to individual practicing activity – 3.1 percent, credits to the energy industry - 2.9 percent.

As of 31.12.2015, the profit of the banking sector for the period accounted for 57.6 million EUR. Compared to the same period of the previous year, the profit increased by 14.2 million EUR (32.9 percent) due to increase of interest related incomes by 62.0 million EUR (32.2 percent) and non-interest related incomes by 45.7 million EUR (61.2 percent). Simultaneously, non-interest expenses increased by 70.4 million EUR (52.7) and interest related expenses by 23.1 million EUR (25.6 percent).

Return on assets and return on equity represented 1.8 percent and 11.0 percent as of December 31, 2015, increasing by 0.2 percentage points and respectively by 1.6 percentage points compared to 31.12.2015.

Long-term liquidity ratio of the banking system (assets with terms more than two years/financial resources with potential withdrawal term of over two years) recorded a level of 0.7 (average per system). This indicator is respected by all banks (maximum allowable level ≤1).

Current liquidity on the system (liquid assets, expressed in cash, deposits at NBM, liquid securities, and net interbank credits with maturity up to one month / total assets ×100%) accounted for 41.6 percent (average per system). The requirement for this indicator is respected by all banks (minimum allowable limit equals to 20 percent).

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

The banking system in the Republic of Moldova consists of two levels: the National Bank of Moldova and 11 licensed banks. The National Bank of Moldova regulates and supervises the financial institutions in accordance with the Law on the National Bank of Moldova and the Law on Financial institutions, which provide the competence, main objective, basic attributions of the National Bank and its relationship with financial institutions.

According to the Law on the National Bank of Moldova, The National Bank is exclusively responsible for the licensing, supervision and regulation of the financial institutions activity. To that end, the National Bank shall be empowered:

a) to issue the necessary regulations and to take the proper actions in order to perform its powers and duties under this law, by way of licensing financial institutions and elaborating supervision standards and establishing the way of implementing the regulations and measures mentioned above;
b) to perform, through its staff or other qualified professionals involved for this purpose, inspections over all financial institutions, and to examine these institutions' books, documents and accounts, conditions in which the business is carried out and financial institutions' compliance with the legislation;
c) to require any employee of the financial institution to provide the National Bank with the information necessary for the purpose of supervision of the and regulating the activity of financial institutions;
d) to prescribe to any financial institution remedial measures or to apply the sanctions foreseen in the Law on Financial Institutions, if the financial institution or its employees:
   - have violated the provisions of the Law on Financial Institutions or a regulation of the National Bank;
   - have violated a fiduciary duty;
   - have engaged in unsafe or unsound operations of the financial institution or any of its branches.

The Law on financial institutions stipulates the main requirements related to the activity of financial institutions, including banking activity. Thus, the respective law determines: general provisions, licensing of banks, organization and administration of banks, conduct of banking operations, banking reporting, violations, remedial measures and sanctions, withdrawal of license.

During 2015, the Law on financial institutions has been amended with provisions related to information providing, in order to facilitate the tax compliance on foreign accounts FATCA and monitoring of public sector debt.

At the same time, in order to strengthen the organization and administration of the National Bank, during 2015, the Law on National Bank of Moldova has been amended and republished. The respective amendments provide peculiarities related to composition and activities of the decision-making bodies of the National Bank.

Concurrently, banks are guided in their activity by normative acts issued by the National Bank of Moldova under the Law on financial institutions that establishes requirements for the licensing process, holding equity interest in the capital of banks, regarding capital of the banks, liquidity, bank's exposures, foreign exchange position, valuation of assets and conditional commitments, equity investments of banks in other legal entities, reporting to the National Bank of Moldova, disclosure of information on the financial activity of the banks, internal control systems, etc.

Therefore, through a number of requirements provided through the normative acts, the National Bank maintains the mechanism of supervision and regulation of banks' activity in the Republic of Moldova.

## MAIN STRATEGIC OBJECTIVES OF THE BANKING AUTHORITY IN 2015

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 has undertaken a number of activities directed towards achieving the implementation of the requirements of Basel II / III through the EU's instrument of support and cooperation - Twinning. Thus, on 30th of June, 2015 was launched the Twinning project on "Strengthening the National Bank of Moldova's capacity in the field of banking regulation and supervision in the context of EU requirements", planned to finish in June, 2017. The NBM benefits from assistance provided by experts from the Central Banks of Romania and Netherlands.

During 2015, within the Twinning project, a legal gap analysis was performed, in order to assess the alignment of the bank legislation to the the acquis and best practices of the EU. Also, the assessment of the impact of Basel III implementation on the banking sector in RM has started.

At the same time, a number of trainings have been provided for the NBMs staff and for the banking sector, in order to familiarize them with banking regulation and supervision principles provided by EU legal framework.

In 2015 the legal and regulatory framework was improved regarding the prudential regulations for banks related to risk management, taking into consideration the best international practices in order to develop regulatory framework on corporate governance in the banking system.

## ACTIVITY OF THE BANKING SUPERVISORY AUTHORITY

During 2015, a number of actions have been taken to maintain banking system stability and to ensure its further development. To this end, the National Bank of Moldova has refined the prudential regulations and supervisory methods taking into consideration the existing regulatory framework and the generally accepted standards in this field.

Thus, in order to refine the methods of banking supervision, the Instruction on the preparation and submission of reports by banks for prudential purposes has been amended. There have been made changes in the calculation of risk-weighted capital adequacy by including a new category of 50% risk for the loans totally secured with a residential mortgage, which is the propriety of the debtor who is an individual.

In order to minimize the risk from the credit activity it has been amended the Regulation on assets and conditional commitments classification. The respective amendments provide that banks exposed to the credit risk, shall monthly classify and calculate the required amount of allowance for assets and conditional commitments' losses.

At the same time, new principles have been included on assets / conditional commitments' classification, which are based on counterparty rating established by one of the internationally recognized agencies, such as Standard & Poor's, Moody's and Fitch-IBCA.

Also, certain requirements have been added in order to assess the person who may be a personal guarantee (surety) for the debtor bank.

As well, in order to minimize the credit risk, it has been provided that bank's assets shall be classified above the "substandard" category, in case if, according to the debtor's financial position, liabilities exceed 30 times the own funds. This requirement shall not be applied if the cumulative value of credits and conditional commitments is lower than 1 million lei and those secured at least 50 percent of the exposure to the debtor- owner of the real guarantee.

According to the amendments to the Regulation on „large" exposures, when calculating the net exposure amount - only pledged irrevocable deposits shall be recognized as eligible guarantee and only in those cases when holders are domestic debtors or international organizations, multilateral development banks and/or banks which are rated not lower than BBB-/Baa3 at least by one of the internationally recognized agencies (such as Standard & Poor's, Moody's and Fitch-IBCA), and are also residents of a country with the above mentioned rating.

During 2015, has been amended the Regulation on the requirements to bank administrators. In order to ensure that only individuals who correspond to "fit and proper" principles are proposed as banks' administrators, there have been set forth certain requirements for them to confirm their professional knowledge and obligation to comply with the legal provisions in force when acting as an administrator.

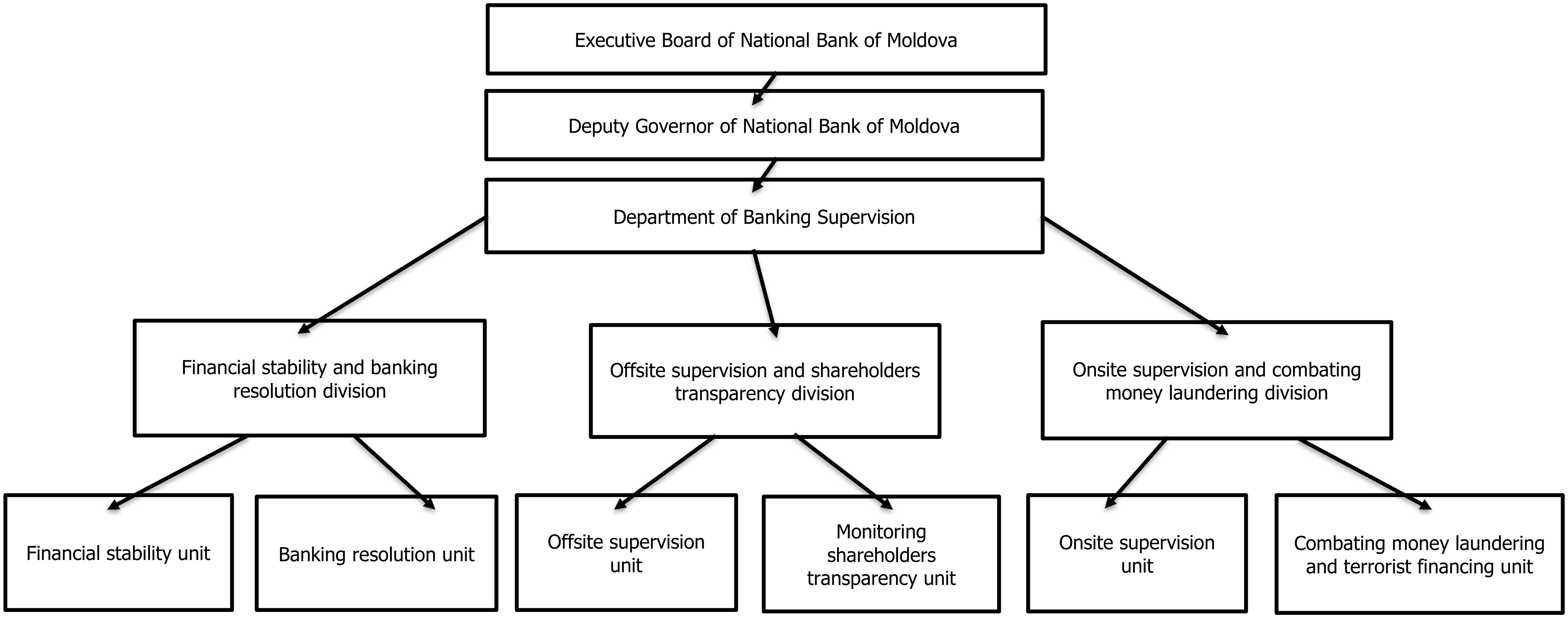
Also, there have been established the requirements related to theoretical expertise of candidates to an administrator function, as well as requirements related to qualification of practical experience. In particular, there has been set a condition that the majority of Board of Directors members shall have experience as administrators in the banking or non-banking financial market.

Taking into account the bank's number reduction in October 2015 and aiming at creating conditions as to exclude any limitation for an expansion and development of banks' financial activity, has been amended the Regulation on mergers and absorptions of banks in the Republic of Moldova. In this respect, the maximum allowed limit of the dominant position on the banking market has been changed from 30% to 35 % of total bank's assets in relation to total assets of the banking sector, and bank's deposits of individuals in relation to total deposits of individuals of the banking sector.

During 2015, in order to ensure a prudent management of assets and liabilities with different maturities, and therefore preventing the risk of excessive liquidity in the banking sector there have been amended the Regulation on bank's liquidity. The respective amendments will be applied effective June 30, 2016 and provide peculiarities aiming to complete the existing requirements related to term liquidity higher than 2 years by the liquidity maturity band, using the following maturity bands: up to 1 month; 1-3 months; 3-6 months; 6-12 months and over

12 months. Also, in calculating the liquidity maturity band will be also included the off-balance sheet commitments.

# ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISORY AUTHORITY



## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

During 2015, in order to further develop the domestic banking system, including improvement of the prudential regulations and of the banking supervision mechanism, the National Bank of Moldova (NBM) has collaborated with a number of international organizations, such as: IMF, World Bank, European Commission, European Bank for Reconstruction and Development, U.S. Department of the Treasury and the Group of Banking Supervisors from Central and Eastern Europe.

Strengthening the regulatory and supervisory capacity of a central bank has a key role in developing a strong and competitive banking sector. In this regard, on 30 June 2015, the National Bank of Moldova along with the National Bank of Romania and De Nederlandsche Bank launched the Twinning project for strengthening the NBM's capacity in the field of banking regulation and supervision in the context of EU requirements. The project is funded by the European Union and will run for a period of two years with the support of experts from the two partner banks.

In order to promote the global financial stability and to ensure an effective cooperation between the banking supervision authorities it is important to establish a procedure for interaction between these authorities. Thus, in November 2015 the National Bank of Moldova and the Latvian banking supervision authority (Financial and Capital Market Commission of Latvia) have signed a Memorandum of Understanding on the exchange of information in the field of banking supervision and combating money laundering. Also, the National Bank of Moldova has cooperation agreements in the field of banking supervision with foreign authorities from Belarus, Germany, Kazakhstan, Romania and Russia. Currently, cooperation agreements are negotiated with supervision authorities from other countries.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN MOLDOVA

According to the legal framework in force and the existent agreements, the National Bank of Moldova cooperates with other supervision authorities from the Republic of Moldova. Thus, in 2015, in order to fulfill efficiently its functions, the National Bank of Moldova has worked based on the concluded agreement with the National Anticorruption Center, National Commission of Financial Market, the State Chamber of Registration, the State Enterprise „Cadastru", and Office of the General Prosecutor.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

On June 15, 2015, NBM has initiated the project of implementing the Credit Risk Register. This is a modern system for collection, storage, processing and systematic analysis of detailed information on all loans extended by licensed banks from Moldova.

Implementation of Credit Risk Register will allow NBM to more effectively monitor credit quality in the banking system and banks require timely implementation of the measures required to mitigate potential losses from lending. IT solution will be implemented until the third quarter of 2016 by an international consortium.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 10 | 10 | 7 |
| Branches of foreign credit institutions | 4 | 4 | 4 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 14 | 14 | 11 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 3.82 | 4.94 | 0.0 |
| Other domestic ownership | 48.97 | 44.55 | 41.42 |
| Domestic ownership total | 52.79 | 49.49 | 41.42 |
| Foreign ownership | 47.21 | 50.51 | 58.58 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 66.71 | 83.98 | 0.155 |
| Branches of foreign credit institutions | 22.68 | 24.31 | 0.019 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 89.38 | 108.29 | 0.173 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 9.39 | 5.92 | 12.78 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 9.39 | 5.92 | 12.78 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 82.99 | 85.27 | 75.69 |
| Branches of foreign credit institutions | 17.01 | 14.73 | 24.31 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

* Only branches of foreign banks.

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

| Assets | 2013 | 2014 | 2015 |
|---|---|---|---|
| Cash | 3.69 | 3.58 | 4.39 |
| Due from banks and NBM, net | 21.43 | 15.11 | 29.44 |
| Net loans and financial leasing | 53.86* | 55.84* | 53.21* |
| Government securities, net | 5.36 | 4.72 | 6.21 |
| Other, net | 15.66 | 20.75 | 6.72 |
| Total assets | 100.00 | 100.00 | 100.00 |
| **Liabilities** | **2013** | **2014** | **2015** |
| Deposits of households | 41.15 | 36.83 | 50.64 |
| Deposits of corporates (nonfinancial) | 18.37 | 15.86 | 19.71 |
| Other | 25.48 | 34.14 | 12.57 |
| Shareholder capital | 15.00 | 13.17 | 17.05 |
| Total liabilities and shareholder capital | 100.0 | 100.0 | 100.0 |

* Calculated according to IFRS.

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 23.38* | 13.93* | 26.22 |
| Cooperative banks | - | - | - |
| **Banking sector, total** | 23.38* | 13.93* | 26.22 |

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

**Asset portfolio quality of the banking system (%)**

| Loan classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Standard | 47.22 | 55.18 | 51.27 |
| Supervised | 41.20 | 33.09 | 38.78 |
| Substandard | 3.70 | 3.04 | 4.12 |
| Doubtful | 2.96 | 3.22 | 2.57 |
| Losses | 4.92 | 5.47 | 3.26 |
| **Total** | **100.0** | **100.0** | **100.0** |
| **Specific reserves** | 10.65 | 9.68 | 10.37 |

**The structure of deposits and loans in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 97.22 | 95.16 |
| Households | 69.98 | 17.23 |
| Corporate | 27.24 | 77.93 |
| Government sector | 0.03 | 1.03 |
| Financial sector (excluding banks) | 2.75 | 3.81 |
| **Total*** | **100.0** | **100.0** |

*Bank deposits and loans were excluded from the total

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 265.24 | 292.73 | 254.17 |
| Interest expenses | 149.35 | 153.90 | 113.07 |
| Net interest income | 115.89 | 138.84 | 141.11 |
| Net fee and commission income | 47.53 | 49.90 | 40.84 |
| Other (not specified above) operating income (net) | -11.63 | -51.93 | -33.79 |
| Gross income | 367.38 | 406.51 | 508.35 |
| Administration costs | 87.07 | 85.90 | 65.47 |
| Depreciation | 12.29 | 11.53 | 9.80 |
| Provisions | 133.17 | 111.37 | 97.20 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 13.14% | 40.61% | 78.74% |
| Profit (loss) before tax | 64.04 | 48.59 | 62.40 |
| Net profit (loss) | 56.73 | 37.91 | 66.47 |

As of December 31, 2015, 1 EUR=21.4779MDL.

**Total own funds in 2015 (in mln. EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 433.5* | - | 418.4* | 15.7* | - |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | 433.5* | - | 418.4* | 15.7* | - |

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

# 2015 DEVELOPMENTS IN THE MONTENEGRIN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Although there were some challenging effects arising from both domestic and international environment the growth in Montenegrin economic activity in 2015 was 3,2%. FDI recorded a significant increase. The banking system was stable and highly liquid, and the asset quality improved.

In 2015, total industrial output increased by 7,90%, mostly due to increase in the manufacturing industry in the amount 19,96%. The decline was recorded in the production in electricity supply, gas and steam in the amount of 5.84% and in the mining and quarrying sector of 8,06%.

The fiscal deficit of Montenegro amounted to EUR 291.25 million or 8,10% of GDP, while in 2014 it amounted EUR 102.6 million or 3,10% of GDP.

In 2015, the FDI recorded a significant increase. Net inflow of foreign direct investments amounted to EUR 619,3 mil showing a y-o-y increase of 74,97%.

The average number of employed persons amounted to 175.617 in 2015, which was 1,16% more in relation to the average number of employed persons in 2014, while in December 2015 it reached 172.517 and was higher 0,79% higher in relation to the number of employees in December 2014.

At end-2015, there were 39.991 unemployed people on the records of the Employment Agency, which is 15,29% more than in a corresponding month in 2014. In 2015, the average number of registered unemployed persons amounted to 34,587 or 3,91% more in relation to the corresponding period of the previous year.

In 2015, according to the MONSTAT data, the average salary in Montenegro amounted to EUR 725 and it was higher by 0,28% in comparison to the average salary in the previous year. The average salary without taxes and contributions amounted to EUR 480, showing a y-o-o increase of 0,63%.

According to preliminary MONSTAT data, the growth in economic activity in 2015 was 3,2%. Ministry of finance projections indicate that the economic growth in 2016 will be 4,1%. However, somewhat slower recovery and negative impact on the projections is possible due to political risks in a number of foreign trade partners of Montenegro.

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

In 2015. year, total bank assets increased at a rate of 10.72%, total deposits growing by 13.49%, loans and receivables (net) growth of 1.99%, total capital increases by 4.15%. Liquid assets of the banks increased by 23.38%. All banks in 2015 continued with the policy of prudent lending and rely mainly on their liquid funds. Deposits from banks exceed the level of lending activity, resulting in a coefficient of loan to deposit ratio of 85.44%. All parameters of the quality of assets during 2015 recorded an improvement. Bank liquidity is good. Total liquid assets of banks amounted to 860.2 mil. EUR, while the coefficient of liquid assets to total assets was 24.77%. Daily and ten-day liquidity ratios of banks were above the prescribed minimum.

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

In line with article 28 of the Central bank Law, Central Bank shall, in line with the law, issue licenses and approvals to banks and financial institutions, supervise banks and financial institutions, perform other activities granted to its authority under the law, and pass regulations and other acts regulating the operation of banks and financial institutions and establishing the standards of sound and safe operations for banks and financial institutions. Regarding this, we prepared a new Central Bank law which is now in the parlament procedure, based on the main objective of the Central Bank, it shall be to foster and maintain the financial system stability, including fostering and mintaining a sound banking system and safe and efficient payment systems.

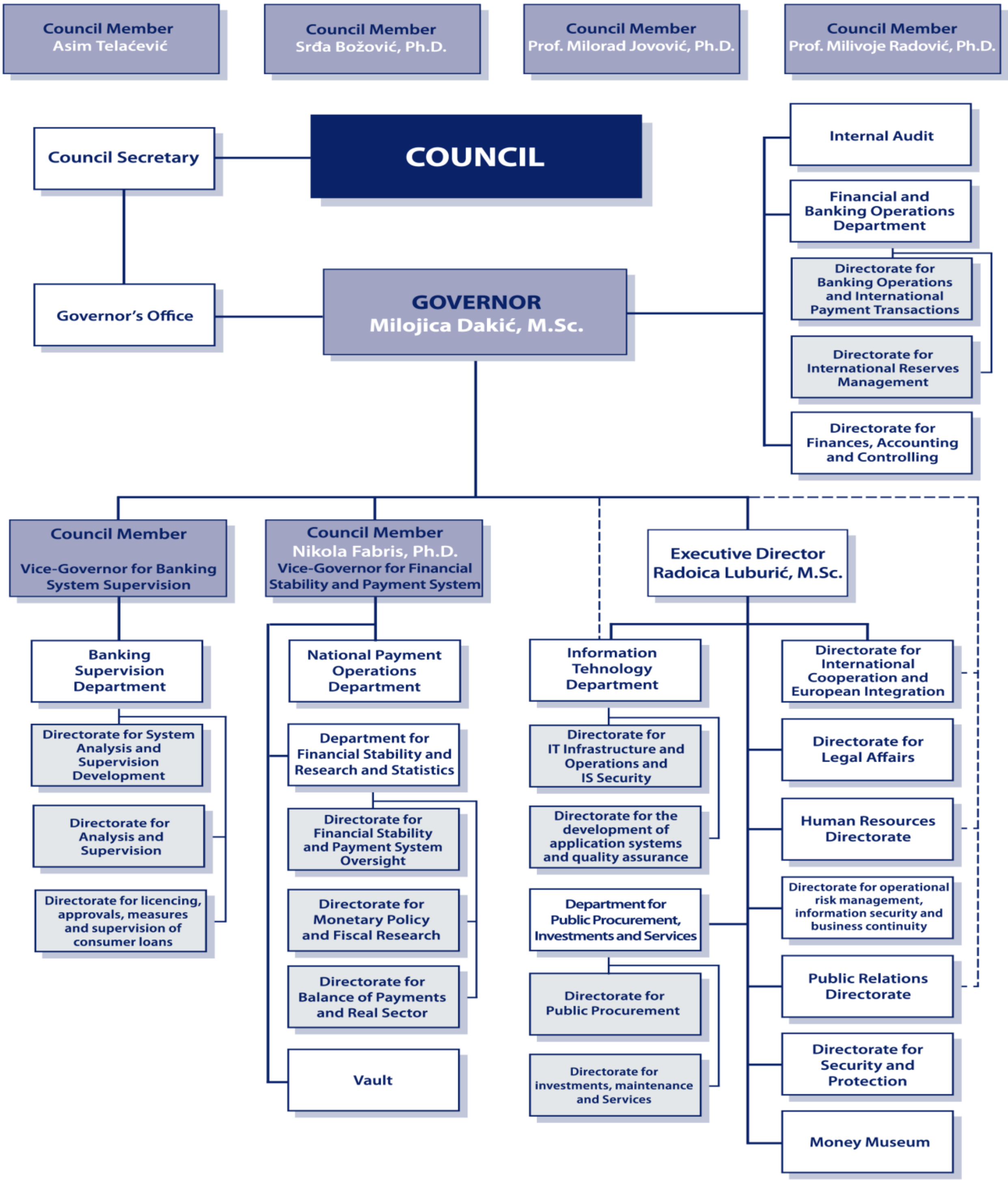
## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

Activities of the Central Bank regarding the modification of the existing regulatory framework also in 2015 largely committed to the negotiation position of Montenegro in the EU accession process. In this sense, the position for Chapter 9 Financial services, established by the Government of Montenegro in October 2014, defined, among other things, a set of laws and bylaws which the Central Bank is obliged to prepare and adopt the period until the end of 2017. year. In order to comply with the new EU legislation (Basel III), among other things, the plan is the adoption of the new Law on Banks by the end of 2016, and a number of by-laws for the implementation of the law. The central bank during 2015 established a working group to prepare a new law that will implement into national law Directive 2013/36 on EU accession the business of credit institutions and the prudential supervision of credit institutions and investment firms and Act and Regulation no. EU 575/2013 on prudential requirements for credit institutions and investment firms. Adoption of this law is planned by the end of 2016, which will create the legal basis for the adoption of a set of bylaws for the execution of the law, whose adoption is planned during 2017. Also, we are preparing a new Resolution Law which will be in compliance with Bank Recovery and Resolution Directive. In addition, we started to prepare a law that will regulate the establishment, operation and control of the business of certain financial institutions (leasing companies, factoring companies, micro-credit financial institutions and legal persons involved in the credit and guarantee operations). With supervision of these institutions we will create conditions for further development of this segment of financial services, providing comprehensive database of business entities that provide financial services, which will be used for statistical and other purposes, the improvement of the Credit Registry maintained by the Central Bank, as well as improve the protection of consumers-users of services provided by these financial institutions.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Banking system in Montenegro is stable and continuously supervised by the Central bank of Montenegro. In 2015, in Montenegro has been operating 14 banks. During 2015, in accordance with the Plan of supervision we completed 11 regular, direct control of which 9 target and two comprehensive. Controls included 11 banks in the system. In addition, we completed also 12 extraordinary direct controls of the banks, which included 7 banks.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

Central Bank of Montenegro with other authorities in five Soth-Eastern Countries signed with European Banking Authority a Memorandum of Cooperation, establishing a framework for cooperation and information exchange.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN MONTENEGRO

Central Bank of Montenegro very often has very important and useful cooperation with Insurance Supervision Agency and Security and Exchange Commission.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 11 | 12 | 14 |
| Branches of foreign credit institutions | 0 | 0 | 0 |
| Cooperative banks | 0 | 0 | 0 |
| **Financial institutions, total** | **11** | **12** | **14** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | - | - | - |
| Other domestic ownership | - | - | - |
| Domestic ownership total | 10 | 20.5 | 22.4 |
| Foreign ownership | 90 | 79.5 | 77.6 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

**Concentration of asset by the type of financial institutions**

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 43,44 | 65,91 | 1,102 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total** | 43,44 | 65,91 | 1,102 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 0.49 | 5.35 | -0,74 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 0.49 | 5.35 | -0,74 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| 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 | 2013** | 2014** | 2015** |
|---|---|---|---|
| Commercial banks | 14.44 | 16.18 | 15.49 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **14.44** | **16.18** | **15.49** |

( * - 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 | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector* | 98.42 | 97.49 | 98.85 |
| **- households** | 23.26 | 24.29 | 25.11 |
| **- corporate**** | 74.35 | 71.32 | 71.56 |

*excluding government sector and financial institutions; share of total NPL
**state companies, private companies and entrepreneurs; share of total NPL

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 94.42 | 79.5 |
| Households | 54.5 | 38.7 |
| Corporate | 39.92 | 40.8 |
| Government sector | 5.35 | 4.6 |
| Financial sector | 0.23 | 15.9 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 179149 | 173072 | 165102 |
| Interest expenses | 74895 | 61983 | 48086 |
| Net interest income | 104253 | 111091 | 117018 |
| Net fee and commission income | 33863 | 34969 | 36126 |
| Other (not specified above) operating income (net) | 17652 | 12083 | 18170 |
| Gross income | 252119 | 242127 | 244374 |
| Administration costs | 96091 | 99593 | 106429 |
| Depreciation | 9640 | 9471 | 9742 |
| Provisions | 44036 | 21117 | 53361 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | | | |
| Profit (loss) before tax | 3555 | 25222 | -1670 |
| Net profit (loss) | **2049** | **23787** | **-3390** |

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1** | Tier 2** | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 328478 | - | 302023 | 31413 | - |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | 328478 | - | 302023 | 31413 | - |

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

# 2015 DEVELOPMENTS IN THE POLISH BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2015 the Polish economy grew by 3.6%. Poland maintained its high economic growth from the previous years and remained one of the fastest growing countries in the UE. Between 2005 and 2014 the average annual growth rate amounted to 3.8%. During this period the only EU country to record such a rapid growth was Slovakia. GDP growth for the whole UE28 amounted to 0.9% and for the Eurozone only to a mere 0.7%. Polish GDP growth in 2015 was, as in the previous year, based on household consumption expenditure and – to a lesser extent – on gross fixed capital formation. The balance of payments improved significantly and amounted to PLN -0.9 billion (compared to PLN -11 billion in 2014).

On the labor market the positive trend from the years 2013 and 2014 persisted and the unemployment rate fell to 9.8% at the end of December 2015. The one-digit unemployment rate was previously registered in Poland in December 2008. Historically low levels were also reached by the inflation rate, which was below zero during the whole 2015 and amounted to -0.9% on a yearly basis. The fact of deflation determined the decisions of the Monetary Policy Council: in March the central bank interest rates were reduced to their historically low levels: the reference rate to 1.5% and the deposit rate to 0.5%.

Polish currency, the Zloty, experienced a major depreciation against the Swiss Franc – the exchange rate changed during the year from around CHF/PLN = 3.6 to around 3.9. A similar depreciation of the Zloty against the US Dollar was observed. Despite large fluctuations during the 12 month period, the exchange rate against the Euro at the end of the year remained close to the levels from January.

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

In 2015 the situation of the banking sector remained stable.

The situation with respect to the capital base remained strong and at the end of 2015 capital adequacy ratios were at considerably high levels, however, a little lower than European Union average. Thus, banks are expected to maintain or even further strengthen their capital base. The situation as regards the liquidity was stable, too. Only 3 small banks (out of 626) did not fulfill one or more liquidity measures. The level of non-performing loans decreased slightly third year in a row.

Polish economy develops sustainably – GDP growth rate exceeds 3 per cent (in 4Q2015 it reached even 4.3 per cent), which ensures favourable environment for further development of the Polish banking sector. However, record low central bank and interbank interest rates stressed banks in year 2015 to adjust their business profiles and to search profits in fees rather than in margins and to reduce administrative costs substantially. In 2016 there are new challenges for Polish banking sector – banking tax, additional fees for banking guarantee scheme or Borrowers' Support Fund

One of the issues that raise concerns about Polish banking sector remains, as it in 2015 did, quite high share of FX loans in banks' portfolios, especially after rapid increase in CHF exchange rate in January 2015 – the decision of Swiss National Bank to stop keeping the EUR/CHF peg at the level of 1.20 resulted in sharp rise in CHF/PLN rate. Such a decision incurred a discussion in Poland what to do with CHF borrowers. Fortunately, almost all of loans were (and are) granted by Polish banks at flexible interest rate and any depreciation of PLN is partially traded off by change in currency parity so that the instalments of such loans remain relatively moderate. As long as FX lending risk is not eliminated, both borrowers and banks will be under constant pressure related to exchange rates and will be exposed to a number of risks. However, according to the KNF recommendations there are no new FX loans granted by banks to clients (except for FX earners), so the problem of FX loans should dwindle successively.

The importance of banking sector in Polish economy slightly grew compared with that in year 2014 – in year 2015 relation of banking sector assets to GDP amounted to 89.4% compared with 89.1% in 2014, and 84.9% in 2013.

**Credit Unions (SKOKs)**

In the end of 2015 there were 48 credit unions operating in Poland with the number of members equal to 2.09 mln (decrease of 1.3% yoy). With total assets at the level of 12.4 bn PLN (2.9 bn EUR, (-) 6.59% yoy), the credit unions' sector is still 7 times smaller than the sector of co-operative banks. Throughout last year SKOKs were characterized by high interest rate margin (5.7%), ROA was negative (-0.74%), cost effectiveness was poor (C/I equal to 123.4%). Moreover, as a majority of credit unions faces capital problems, recovery plans were implemented in 96.4% of them (in terms of deposits). The average capital adequacy ratio totaled 2.71% in the end of 2015, but after inspections it declined significantly to (-)1.83%.

From 2013 to 2016 six credit unions went bankrupt, 5 credit unions were taken over by commercial banks, one credit union was taken over by other credit union and one merger took place.

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

The organization, scope and purpose of supervision over the financial market are regulated by the Act of 21 July 2006 *on Financial Market Supervision*. According to the above, the supervision over the financial market comprises of the:

1) banking supervision,
2) pension supervision,
3) insurance supervision,
4) capital market supervision,
5) supervision over electronic money institutions,

6) supervision of payment institutions and payment service offices,
7) supplementary supervision,
8) supervision over credit unions and their national association.

The supervision over the financial market, in the scope mentioned above, is exercised by **the Polish Financial Supervision Authority (KNF)**. As far as the banking sector is concerned, KNF is in charge of microprudential supervision since 2008. Regulatory powers of KNF have been narrowed to powers strictly specified in the Banking Act. It shares its regulatory powers with the Ministry of Finance and the National Bank of Poland.

The **objective of the supervision** is to ensure:

1) the safety of funds held on bank accounts,
2) compliance by the banks with the provisions of the present Banking Act, the Act on the National Bank of Poland, their articles of association, and the decision on granting authorization to establish those banks.
3) compliance of banks' activity carried out in accordance with Art. 70 para. 2 of the Act on Trading in Financial Instruments of July 29, 2005 with provisions of that Act, this Act and the articles of association.

Moreover, the tasks of the KNF includes the:

a) undertaking measures aimed at ensuring regular operation of the financial market,
b) undertaking measures aimed at development of financial market and its competitiveness,
c) undertaking educational and information measures related to financial market operation,
d) participation in the drafting of legal acts related to financial market supervision,
e) creation the opportunities for amicable and conciliatory settlement of disputes which may arise between financial market actors, in particular disputes resulting from contractual relations between entities covered by the KNF supervision and recipients of services provided by those entities,
f) carrying out other activities provided for by acts of law.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

In 2015 the KNF – taking into account the national law – continued work on adoption of the requirements for supervisory review and evaluation process (SREP) specified in the Directive 2013/36/EU to the KNF's internal standards concerning off-site and on-site banking supervision. The amendments aimed at adjusting the KNF's "BION Methodology" ("BION" stands for "Supervisory Review And Assessment") to the required framework of supervisory examination program and rules on micro-prudential systemic risk identification.

In 2015 in total 596 BION analyses were carried out, including 560 in cooperative banks, 2 in associating banks and 34 in commercial banks.

In 2015 the KNF carried out 7 complex inspections and 35 targeted inspections both in commercial and cooperative banks. Targeted inspections were focused on the areas of bank's activity considered to generate the highest risk.

Responding to the FX loans situation the KNF offered a solution, which could solve the CHF loans problem, also members of the parliament prepared several legislative proposals. However, no final law and no systemic solution has been adopted yet. The KNF imposed additional capital requirements for banks involved in granting such loans, calculated individually for each bank.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The supervisory activities taken by the KNF in 2015 involved ongoing monitoring and quarterly analysis of banks' economic and financial standing (rating awarded for Q4 2014 and 3 quarters of 2015). Based on the analysis results, the banks were awarded rating according to the KOBRA rating system. In 2015, all commercial and cooperative banks were rated. 151 quarterly analyses of commercial banks, 2253 quarterly analyses of cooperative banks and 8 quarterly analyses of associating banks were prepared. In 2015, the cyclical evaluation process of cooperative and associating banks was continued. The result of the analytic works was formulation of 507 supervisory recommendations and 12 supervisory reminders for cooperative and associating banks.

Also 112 quarterly analyses of branches of credit institutions were prepared (rating awarded for Q4 2014 and 3 quarters of 2015). Apart from the quarterly rating, banks are covered by the BION process, i.e. Supervisory Review and Evaluation Process. Detailed information on BION process in banking sector is presented in section Supervisory Review and Evaluation Process (BION) section.

In the area of consolidated supervision the supervision authority 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 organisational units responsible for inspection. Data were developed for inspections carried out in banks.

Comparative (quarterly) analyses were conducted to examine the manner in which debt owned by the same borrower is classified by different banks and in which the shareholder structures of some major bank clients are presented, if any discrepancies were identified, relevant steps were taken with respect to the regulated entities involved.

Supervision activities were conducted in the following areas:

- reinforcement the capital base, including rules on dividend payment,
- bancassurance,
- transforming processes,
- administrative procedures, including applications for recognising subordinated liabilities, interim profits under funds, appointment of forced administration,
- liquidity,
- recovery procedures plans (PPN) including the assessment of their implementation, completion or imposition of the recovery procedures plan,
- implementation of recommendations issued in the course of inspections, the BION process and other recommendations issued under the off-site supervision.

In 2015, 6 commercial banks were covered by recovery procedures. As far as the cooperative banks are concerned at the beginning of 2015, 31 cooperative banks and one associating bank were subject to the recovery procedures. At the end of 2015, in 36 cooperative banks and one associating bank recovery procedures were covered by recovery procedures. In March 2015, the KNF appointed a trustee to supervise execution of recovery procedures of the associating bank.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The KNF is an active member of relevant international supervisory bodies on the EU as well as on an global level including among others 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 2015 the KNF participated in: (1) 16 supervisory colleges for cross-border banking groups (these colleges coordinate supervisory actions taken towards given banking groups, prepare the potential anti-crisis measures, hold consultations concerning joint assessment of risk and capital adequacy), (2) 18 supervisory colleges for international insurance groups.

The supervisory cooperation between European Central Bank has intensified in 2015, with the ECB (in the framework of Single Supervisory Mechanism - SSM) being responsible for the direct supervision over the largest banks in the Eurozone as of November 2014.

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 concluded with supervision authorities from 36 jurisdictions (excluding multilateral agreements under ESMA, IOSCO and IAIS). In 2015, such memorandum has been signed with the China Securities Regulatory Commission.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN POLAND

The KNF is responsible for supervision of the Polish financial sector. Besides credit institutions (commercial banks, cooperative banks, credit unions), the KNF supervises insurance and reinsurance undertakings, publicly-mandated pension funds, the Warsaw Stock Exchange, the clearing houses, investment firms, investment funds, payment institutions, electronic money institutions and some other types of entities. Division of tasks within KNF is mostly sectorwise, with common support functions.

The KNF also takes part in the works of the Financial Stability Committee – a body with a dual function of: (1) macroprudential authority (the legal framework reg. macroprudential supervision in Poland has been established by the Act of 5 August 2015 on Macroprudential Supervision over the Financial System and on the Crisis Management in the Financial System), and (2) authority responsible for the crisis management in the financial system.

Acting as a macroprudential authority, the Financial Stability Committee is chaired by the Governor of the National Bank of Poland and comprises also: Chairman of the KNF, Minister of Finance, and Chairman of the Bank Guarantee Fund. The Commitee is entitled to issue: (1) statements - aimed at highliting potential sources of systemic risk (the statements may be addressed to: participants of the financial system or its part / sector, member institutions of the Financial Stability Committee); and (2) recommendations – aimed at initiating some actions to address systemic risk (recommendations might be addressed only to member institutions of the Financial Stability Committee). The Committee is empowered to discuss, assess and monitor potential systemic risks that might disturb functioning of the financial system. It is also the Committee to discuss and provide opinions on whether, and in which form, the macroprudential instruments should be activated.

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).

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 41 | 38 | 38 |
| Branches of foreign credit institutions | 28 | 28 | 27 |
| Cooperative banks | 571 | 565 | 561 |
| **Banking sector, total:** | **640** | **631** | **626** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 22.3 | 24.1 | 23.9 |
| Other domestic ownership | 14.4 | 14.4 | 17.1 |
| Domestic ownership total | 36.8 | 38.5 | 41.0 |
| Foreign ownership | 63.2 | 61.5 | 59.0 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

### Concentration of asset by the type of financial institutions

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 38.0 | 53.5 | 808 |
| Branches of foreign credit institutions | 60.0 | 70.8 | 1550 |
| Cooperative banks | 6.3 | 9.0 | 46 |
| **Banking sector, total:** | 34.7 | 48.8 | 672 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 10.13 | 10.12 | 7.72 |
| Cooperative banks | 7.84 | 7.39 | -10.30 |
| **Banking sector, total:** | 9.99 | 9.94 | 6.60 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 90.9 | 91.0 | 91.1 |
| Branches of foreign credit institutions | 2.3 | 2.1 | 2.0 |
| Cooperative banks | 6.9 | 6.8 | 6.9 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Assets | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 8.4 | 8.5 | 8.2 |
| Nonfinancial sector | 59.6 | 58.4 | 60.1 |
| Government sector | 6.6 | 6.1 | 6.0 |
| Other assets | 25.4 | 27.0 | 25.7 |
| **Claims due to** | | | |
| Financial sector | 24.7 | 23.4 | 23.1 |
| Nonfinancial sector | 55.2 | 55.7 | 58.7 |
| Government sector | 3.9 | 4.0 | 3.0 |
| Other liabilities | 5.3 | 6.1 | 4.3 |
| **Capital** | 10.9 | 10.8 | **10.9** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013** | 2014** | 2015*** |
|---|---|---|---|
| Commercial banks | 14.2 | 14.6 | 16.5 |
| Cooperative banks | 13.4 | 15.7 | 13.7 |
| **Banking sector, total:** | 14.1 | 14.7 | 16.3 |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 8.5 | 8.1 | 7.5 |
| - households | 7.1 | 6.5 | 6.2 |
| - corporate | 11.6 | 11.2 | 10.2 |

**The structure of deposits and loans of the banking sector in 2015 (%)
(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 89.6 | 86.0 |
| Households | 63.6 | 56.2 |
| Corporate | 24.2 | 29.3 |
| Government sector | 4.6 | 8.5 |
| Financial sector (excluding banks) | 5.8 | 5.5 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 61 896 | 58 835 | 52 860 |
| Interest expenses | 27 196 | 21 678 | 17 496 |
| Net interest income | 34 699 | 37 157 | 35 364 |
| Net fee and commission income | 13 434 | 13 789 | 13 338 |
| Other (not specified above) operating income (net) | 6 576 | 5 573 | 5 900 |
| Gross income | 55 469 | 57 688 | 55 965 |
| Administration costs | 27 587 | 27 198 | 30 673 |
| Depreciation | 2 654 | 2 727 | 2 853 |
| Provisions | 458 | 715 | 1 028 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 7 790 | 8 333 | 8 510 |
| Profit (loss) before tax | 18 510 | 20 032 | 14 283 |
| Net profit (loss) | 15 175 | 15 877 | 11 335 |

**Total own funds*** in 2015 (in EUR m)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 35 150 | 32 293 | 32 296 | 2 854 | - |
| Cooperative banks | 2 188 | 1 989 | 2 006 | 182 | - |
| **Banking sector, total:** | 37 338 | 34 282 | 34 302 | 3 036 | - |

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

# 2015 DEVELOPMENTS IN THE ROMANIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Domestic macroeconomic developments have remained robust in 2015. Romania's economic expansion was substantial, yet it was due particularly to the increase in consumption, on the back of higher wages. The stronger domestic demand may translate into import growth outpacing export growth. The general government deficit in Romania stood at 1.5 percent of GDP, down from 1.9 percent of GDP in 2014 (national methodology). Consolidation of fiscal policy responsibility by securing enhanced predictability in the regulatory field and the preclusion of a pro-cyclical behavior of the macroeconomic policy mix are of the essence in preserving economic equilibria and supporting financial stability in the period ahead. In the latter half of 2015, important steps were taken to improve the payment discipline of the general government in relation to the real sector. Thus, general government arrears fell to lei 86 million, down from lei 262 million in June 2015 and lei 126 million at end-2014 respectively. In December 2015, the public debt-to-GDP ratio declined to 38.6 percent from 39.8 percent at end-2014 (standard European methodology). The largest contribution to the decline in public debt stock came from the external debt component, which dropped from 20.7 percent of GDP to 19.1 percent of GDP in December 2014 – December 2015, whereas the domestic debt rose slightly in the said period (up 0.3 percentage points, to 19.4 percent of GDP). Nevertheless, the domestic banking sector's capacity to grant additional loans to the public sector is further contained, given that credit institutions have a substantial exposure to the general government, i.e. 21.5 percent of the total bank assets in December 2015. Foreign investors maintained a steady interest in government securities, amid a low sovereign risk, underpinned by stronger economic fundamentals.

## DEVELOPMENT IN THE BANKING SYSTEM

The number of credit institutions decreased in 2015, the Romanian banking system comprising 29 banks, Romanian legal entities and 7 branches of foreign banks at the end of year, after the consolidation of the banking system through two merger processes of local banks and closing of two branches of foreign banks.

The NBR closely monitors banking system developments taking measures for an appropriate supervision and adequate management of risks faced by the banks. Risks to the banking sector were also countered by efforts of credit institutions such as consolidation of solvency, provisioning and liquidity levels. The total capital ratio (former solvency ratio) stood at 19.2% in December 2015, considerably above the minimum regulated level of 8%, and consisted overwhelmingly of high loss-absorbency capacity components. Thus, both Tier 1 capital ratio and Core Tier 1 ratio were nearly 17%. Also, the use of such macroprudential instruments is not expected to imply any capital contribution, at this point in time, for credit institutions in Romania, considering the high level of capital reserves in place, as revealed by the reported capital adequacy indicators.

The current capital requirements for credit institutions concerning the minimum required Core Tier 1 capital ratio of 4.5 percent of the credit institution's total risk exposure amount will change following the implementation of these buffers, as follows: as of 1 January 2016 – 5.125 percent; as of 1 January 2017 – 5.75 percent; as of 1 January 2018 – 6.375 percent; as of 1 January 2019 – 7 percent.

The degree of NPL coverage with IFRS provisions remained at a comfortable level while the NPL had a steadily decline by 7.2 percentage points (from 20.7% to 13.5%). The NPL ratio is based on EBA definition of non-performing exposure, implemented in the national financial reporting framework, and is calculated as share of non-performing loans and advances in total gross loans and advances. Parent banks continued to provide capital to support their subsidiaries in the local market, and capital contributions have been made by shareholders without any recourse to public funds. In 2015, the deleveraging process has continued at a relatively similar rate; steadily increase of domestic liabilities replaced the external sources that recorded a decline over the last years. The loan-to-deposits ratio fell further to around 85% in December 2015 from 91% in December 2014, reflecting mainly the increase of deposits at a faster pace than loans granted clients.

The banking sector returned in positive territory in 2015 (total profit for the banking system of RON 4.5 billion) after the losses at the end of 2014 (RON -4.7 billion) due to the banks' effort to address the nonperforming loans issue. Among banks, 22 registered positive financial results at the end of 2015 (RON 5.2 billion) while other 14 reported negative financial results (RON-0.7 billion).

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

Credit institutions are mainly regulated by the Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy ("Banking Law"), as subsequently amended and supplemented 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 ("CRR") and, among others, by the Law No. 85/2014 regarding the procedures for the prevention of insolvency and the insolvency procedures. In 2015, the Romanian Parliament adopted the Law No. 304/2015 on the issuances of covered bonds. The new legislation was developed according to the best practices set out in the EBA Report on EU Covered Bonds Frameworks and Capital Treatment (2013). Directive 2014/59/EU was transposed into Romanian legislation by Law No. 312 as of 4 December 2015, which establishes the domestic grounds for the recovery and resolution of credit institutions, and which repealed certain provisions of GEO No. 99/2006 on credit institutions and capital adequacy regarding the stabilisation measures.

The current prudential regulatory framework ensures: (i) harmonisation with CRD IV and adequate measures to facilitate the implementation of CRR. As regards the transposition of CRD IV, Romania observed the implementation timetable set at EU level by adopting Government Emergency Ordinance No. 113/2013 on some budgetary measures and on amending and supplementing

Government Emergency Ordinance No. 99/2006, as amended and supplemented, which contains provisions envisaging the strengthening of the legal framework on credit institutions and investment firms in areas such as corporate governance, prudential supervision and sanctions; (ii) harmonisation with guidelines issued by the European Banking Authority ("EBA"). Areas in which the EBA guidelines were transposed into Romanian regulations refer to governance arrangements, remuneration policies, internal capital adequacy assessment process and management of significant risks, liquidity cost benefit allocation, conditions for outsourcing of activities, assessment and validation of using advanced approaches for calculating capital requirements for credit and operational risks, retention requirements in securitisation transactions, clarifications regarding the revised large exposures regime and clarifications regarding the exemption of some short-term exposures from the application of the large exposures regime, the eligibility criteria for capital instruments to be recognised as original own funds.

Moreover, starting with the CRD IV/CRR implementation, credit institutions are required to observe the EC's implementing regulations laying down technical standards, directly applicable in all Member States, including also those related to the reporting field.

The financial reporting framework for prudential supervision purposes ("FINREP"), were updated in order to ensure the optimal conditions for the unitary application of the FINREP individual reporting framework by the Romanian credit institutions, as well as the correlation thereof with the new FINREP consolidated reporting framework set up at european level by ITS 680/2014. In this regard, NBR Order no.6/2014 applicable to Romanian credit institutions 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, NBR also issued Order no.5/2014.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

In 2014 and further in 2015, NBR set up a strategy for the reduction of fully provisioned uncollectible NPLs on commercial banks' balance sheets. Thus, several decisions were taken in order to decrease NPLs stock and strengthen the supervision of NPL developments in the context of critical volume of NPL mainly representing non-performing loans overdue more than 360 days and without initiation of legal proceeding (actually uncollected loans), and low banks interest in addressing NPL and poor recovery level. The action plan focused on regulatory and supervisory measures consisting in drawing-up of a regulation to establish the distinct book-keeping records for the operations of direct decreasing of the gross carrying amount of fully uncollectible loans and NBR recommendations for certain actions to be performed by banks, such as: i) a recommendation addressed to credit institutions to remove from on balance sheet of all the exposures representing uncollectible loans fully covered by provisions; ii) a recommendation to fully cover with provisions the exposure from debt service over 360 days without initiation of legal proceedings to recover debts, followed by their removal once provisioned for; iii) a recommendation to establish provisions in order to cover exposures against borrowers in insolvency and followed by their removal from the balance sheet; iv) carrying out of an external audit on the IFRS provisions established by banks to cover losses for the existing loans.

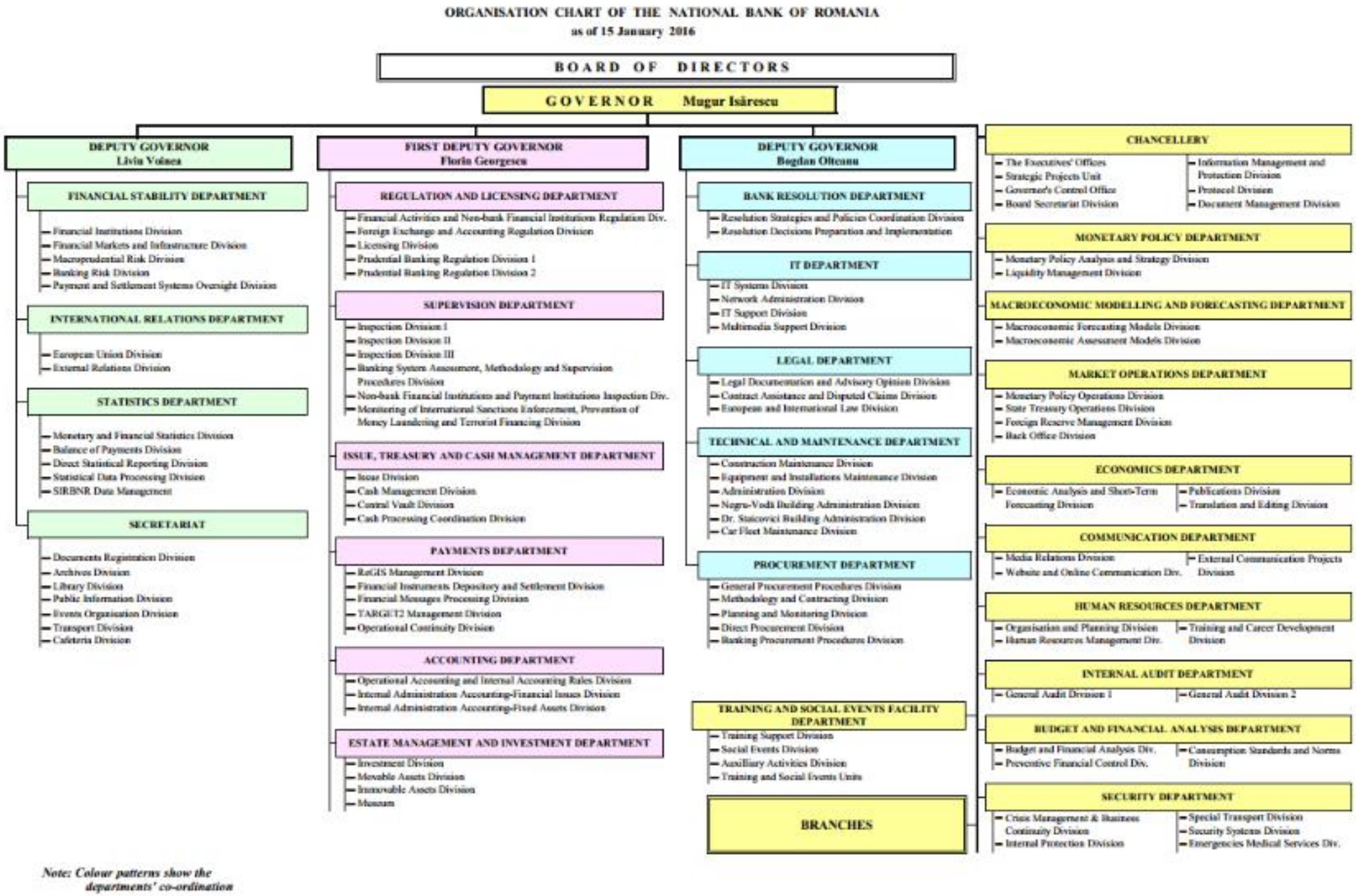
## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY IN 2015

During 2015, according to the annual supervision program, NBR carried out 29 on-site inspections at credit institutions (Romanian legal persons).

These addressed mainly issues regarding: the business model (viability and sustainability), the internal governance (organizational structure and management body, remuneration policies and practices, internal control system), the risk assessment associated to capital adequacy and the risk assessment associated to liquidity, the systemic risk, the review of the internal capital adequacy assessment process (ICAAP), the inter-risk diversification effects and the results of stress tests.

Other 25 additional actions on specific topics were performed at credit institutions and were focused mainly on: financial statement and key prudential indicators, management of non-performing exposures risk, management of exposures with forbearance measures, internal governance, lending, collateral obtained by taking possession by banks, adjustments for depreciation, credit risk, liquidity risk, operational risk, organizational structure and management body, remuneration policy, governance of independent internal control functions, operations carried out under consultancy contracts with external service providers, financial reporting (FINREP) on an individual and consolidated basis, the internal capital adequacy assessment process (ICAAP) and the measures taken by the NBR.

# ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



## INTERNATIONAL ACTIVITIES OF NBR

Throughout 2015, the NBR was involved in the twinning project dedicated to the National Bank of Moldova for strengthening the latter's capacity in the field of banking regulation and supervision. For the implementation of this project, over a period of two years, the NBR entered a consortium with De Nederlandsche Bank (DNB).

The overall objective of the project is to assist the National Bank of Moldova (NBM) in consolidating the framework for prudential supervision in the process of adjustment to the tasks and the standards required for the Central Banks of the European Union, increasing the NBM's institutional and administrative capacity in this area and ensuring the proper functioning and operation of a sustainable and competitive banking sector. The specific objectives are: i) gradual implementation of the EU Capital Requirements Directive (CRD-IV) and amending the prudential regulations of the NBM in the context of Basel II/III; ii) defining requirements and calculating methods for risks under Pillar1 of Basel II/III; iii) providing knowledge on the implementation of Pillars 2 and 3 risk oriented management policy reinforced in banks; iv) delivering a comprehensive training programme with regard to Basel II/III implementation.

In regard to the supervision of cross-border banking groups, the NBR cooperates with other supervisors through supervisory colleges, a structure that ensures both optimum dissemination of information and the adoption of joint decisions on capital adequacy and liquidity, and since 2015 on the recovery plans of credit institutions. So far, the NBR signed multilateral cooperation agreements with 19 international bank groups. Apart from participating in the meetings of the supervisory colleges, the NBR, in its capacity as supervisory authority, also had representatives in certain EBA groups and sub-groups such as: Standing Committee on Oversight and Practices, Joint Committee on Financial Conglomerates (JCFC), Task Force on the Impact of the New Capital Framework (TFICF), Subgroup on Operational Risk (SGOR), Sub-committee on Accounting, Reports and Auditing (SCARA), Standing Committee on Regulation and Policy and Board of Supervisors.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN ROMANIA

National Bank of Romania cooperates with Financial Supervisory Authority (FSA), the authority that is overseeing the capital markets and the insurance and private pension markets. At 30 April 2013, the FSA took over the responsibilities of the National Securities Commission (NSC), the Insurance Supervisory Commission (ISC) and the Private Pension System Supervisory Commission (PPSSC).

Meetings were held between representatives of NBR and FSA within the National Committee for Financial Stability (NCFS), a committee that was set up according to the provisions of multilateral agreement signed between Ministry of Public Finance, National Bank of Romania and Financial Supervisory Authority. In 2015, according to its prerogatives to adopt recommendations and advisory opinions respectively, during the transitional period until the interinstitutional structure coordinating macroprudential supervision of the national financial system becomes operational, the NCFS assessed the macroprudential objectives and instruments previously assumed by the NBR and the FSA. Particular attention was attached to capital buffers that may be imposed on credit institutions, apart from the own funds requirements, in order to strengthen financial system resilience and mitigate any negative effects on financial system stability and economic stability.

To this end, the NCFS members adopted NCFS Recommendation No. 1/26.11.2015 whereby the NBR, in its capacity as competent authority, is recommended to require credit institutions to implement capital buffers as of 1 January 2016, as follows: 0 (zero) percent for the countercyclical capital buffer, 0.625 percent for the capital conservation buffer, whereas for the other buffers the procedures will be followed in line with regulations in force.

The capital conservation buffer will be phased in between 1 January 2016 and 1 January 2019 in equal increments of 0.625 percent per annum of the credit institution’s total risk exposure amount, until it reaches the required 2.5 percent level, as follows: as of 1 January 2016 – 0.625%; as of 1 January 2017 – 1.25%; as of 1 January 2018 – 1.875%; as of 1 January 2019%.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 30 | 30 | 28 |
| Branches of foreign credit institutions | 9 | 9 | 7 |
| Cooperative banks | 1 | 1 | 1 |
| **Banking sector, total:** | **40** | **40** | **36** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 8.5 | 8.7 | 8.3 |
| Other domestic ownership | 1.5 | 1.4 | 1.3 |
| Domestic ownership total | 10.0 | 10.1 | 9.6 |
| Foreign ownership | 90.0 | 89.9 | 90.4 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 46.5 | 65.0 | 1030 |
| Branches of foreign credit institutions | 91.1 | 97.3 | 3945 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 41.4 | 57.8 | 861 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | -0.66 | -14.15 | 11.64 |
| Cooperative banks | 1.33 | 1.05 | 1.35 |
| **Banking sector, total:** | **0.13** | **-12.45** | 11.77 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 90.4 | 89.9 | 88.9 |
| Branches of foreign credit institutions | 9.4 | 9.8 | 10.8 |
| Cooperative banks | 0.2 | 0.3 | 0.3 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | **100.0** | **100.0** | **100.0** |
| Financial sector | 20.5 | 20.1 | 20.1 |
| Nonfinancial sector | 55.9 | 54.3 | 54.6 |
| Government sector | - | - | - |
| Other assets | 23.6 | 25.6 | 25.3 |
| **Claims due to** | **100.0** | **100.0** | **100.0** |
| Financial sector | 23.3 | 18.7 | 15.2 |
| Nonfinancial sector | 63.2 | 67.9 | 71.4 |
| Government sector | - | - | - |
| Other liabilities | 3.1 | 3.8 | 3.1 |
| **Capital** | 10.4 | 9.6 | 10.3 |

**Capital adequacy ratio of banks (%)**

| Type of financial institution | 2013** | 2014*** | 2015*** |
|---|---|---|---|
| Commercial banks | 15.4 | 17.5 | 19.1 |
| Cooperative banks | 31.7 | 30.7 | 30.0 |
| **Banking sector, total:** | **15.5** | **17.6** | **19.2** |

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

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

| Asset classification | 2013 | 2014* | 2015** |
|---|---|---|---|
| Non financial sector | 21.9 | 14.0 | 18.1 |
| **- households** | 13.5 | 7.9 | 9.6 |
| **- corporate** | 29.2 | 20.0 | 27.1 |

*from FINREP- F18.00 – Non-performing loans includes all loans more than 90 days past due and/or in which case legal proceedings were initiated
**from FINREP- F18.00 – Starting with December 2015, NBR introduced the EBA definition of non-performing loans (NPL are those that satisfy any of the following criteria: i) material exposures which are more than 90 days past due; ii) the debtor is assessed as unlikely to pay its credit obligations in full without realization of collateral, regardless of the existence of any past due amount or of the number of days past due).

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 80.1 | 67.2 |
| Households | 49.3 | 34.0 |
| Corporate | 30.8 | 33.2 |
| Government sector | 14.9 | 28.3 |
| Financial sector (excluding banks) | 5.0 | 4.5 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 20,193.7 | 17,381.5 | 14,557.2 |
| Interest expenses | 8,854.0 | 6,311.9 | 3,931.2 |
| Net interest income | 11,339.7 | 11,069.6 | 10,626.0 |
| Net fee and commission income | 3,957.6 | 3,938.2 | 3,805.0 |
| Other (not specified above) operating income (net) | 3,976.8 | 3,895.0 | 3,734.6 |
| Gross income | **19,274.1** | **18,902.8** | **18,165.6** |
| Administration costs | 9,943.6 | 9,627.8 | 9,767.7 |
| Depreciation | 955.0 | 862.6 | 836.5 |
| Provisions | 688.8 | 2,744.2 | 445.2 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 8,174.0 | 10,275.7 | 3,956.3 |
| Profit (loss) before tax | **-489.2** | **-4,641.4** | **4,813.8** |
| Net profit (loss) | **48.6** | **-4,667.1** | **4,474.7** |

**Total own funds in 2015 (in million EUR)**

| Type of financial institution | Total own funds*** | Core Tier 1*** | Tier 1*** | Tier 2*** | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 7,636.4 | 6,658.1 | 6,658.1 | 978.3 | - |
| Cooperative banks | 55.9 | 54.5 | 54.5 | 1.4 | - |
| **Banking sector, total:** | 7,692.3 | 6,712.6 | 6,712.6 | 979.7 | - |

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

# 2015 DEVELOPMENTS IN THE RUSSIAN BANKING SYSTEM

## MACROECONOMIC SITUATION

During 2015 the average crude oil price dropped to 51,4 dollars per barrel and that had a negative influence on the economic situation. At the same time a degree of influence of external economic situation on Russian economy faded out while agents adjusted to external shocks. In comparison with 2014 outflow of the private capital from Russia essentially reduced (up to 57,5 bln USD), while the Russian private sector repaid its external debt.

Early 2016, the external debt of the Russian Federation stood at 515.8 billion US dollars, reducing by 14% over 2015 (the year before– by 18%).

The international reserves of the Russian Federation amounted to 368.4 billion US dollars as of 1 January 2016. The sufficiency of international reserves, measured according to international standards in months of goods and services imported was 15.7 months (in 2014 – 10.8 months).

The GDP decreased by 3.7% in 2015. The unemployment rate went up from 5.2% in January 2015 to 5.7% in December 2015. The annual consumer price growth in December 2015 reached 12.9%.

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

In 2015, most of the key indicators that reflected the banking sector's role in the economy exhibited positive dynamics.

The assets-to-GDP ratio rose from 99.6% to 102.7% and capital to GDP measured 11.1%, representing a rise of 0.9 p.p. during the year.

The ratio of individual deposits to GDP during the reporting year was 28,7%, up 4,9 p.p.; the ratio of funds raised from organizations to GDP was 35.2% (a yearly increase of 3.1 p.p.).

The ratio of total volume of loans to the economy (non-financial institutions and households) to GDP rose by 2.0 p.p. to 54.4%.

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

In March 2016 Basel Committee on Banking Supervision proved full compliance of Russian banking regulation with standards of Basel II, Basel 2,5 and Basel III.

The Bank of Russia pays special attention to the balance of regulatory changes, the influence of these changes on capital adequacy of credit organizations and on the ability to continue lending to the economy.

The Bank of Russia is currently working on the possibility to introduce regulation commensurate with complexity of a bank's operations (in addition to existing differentiation in credit organizations regulation).

An implementation of proportional regulation assumes a transition period up to 2 years during which banks will be able to define how they see their future business model.

The activities of the Bank of Russia concerning consolidated supervision improved significantly. Still the Bank of Russia needs additional powers to regulate and supervise bank holding companies.

To improve the efficiency of consolidated supervision it is essential to establish mandatory ratios and requirements for risk and capital control systems, requirements for goodwill of Board of Directors members and for heads of the main organization of banking holdings. It is also important to allow the Bank of Russia to apply enforcement measures concerning the head organization or participants of banking holdings in case of violation of regulation on banking holdings activities.

Moreover, banking supervision has been seriously reorganized. The main changes cover further centralization of the banking supervision on the one hand and functional specialization on the other. The integrated supervisory IT system and central data base will accumulate data about all transactions of credit institutions. The banking transactions will be analyzed by supervisors on-line but not post factum. The transition to this system will be gradual but the supervisors can review much more assets of banks on permanent basis already today.

Segregation of supervision decision making from risk assessment will become the key element of the new system.

# MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

In 2015, the Bank of Russia continued to implement the risk-based approach to the banking supervision which is based on following main principles:

- substance over form approach;
- early detection of problems in credit institutions' operations, adequate assessment of risks;
- regular dialogue with banks concerning the organization of their activities and risk-management;

- supervisory measures adequate to a situation in the credit organization and applying equal measures to different banks for identical violations.

With due account of these approaches the Bank of Russia continued the policy of the banking sector rehabilitation for protecting the interests of depositors and creditors of the credit organizations.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

In 2015, the Bank of Russia continued the policy of rehabilitation and strengthening of the banking sector, carrying out measures to further intensify the banking supervision. When organizing this activity, the Bank of Russia proceeds from the need to ensure maximum transparency of bank operations to the regulator, understand the bank business model and the economics of operations conducted by banks.

In the reporting year, off-site supervision departments focused on improving response to negative developments in certain banks, more conservative assessment of bank risks and selecting efficient supervisory measures adequate to revealed violations. To this end, the practice of daily submission of the main reporting forms by banks to the Bank of Russia was applied selectively.

Substantial attention was given to banks engaged in dubious transactions; they were promptly subjected to restrictive measures, and if they failed to eliminate considerable and repeated violations of the law their banking licenses were revoked.

In this area, the Bank of Russia paid additional attention to the quality of internal controls in credit institutions and the compliance of banks' rules of internal controls with regulatory requirements.

In the reporting period, the supervision over banks of federal and regional importance was enhanced. The Bank of Russia additionally analyzed all aspects of their activities both at the level of regional divisions and at the level of the Bank of Russia's Head Office.

Within the supervision the Bank of Russia applied methods of consolidated supervision over banking groups, including those presuming a limit on the credit institution risk exposure to the owners' business. The entire range of supervisory response tools was used to reduce the concentration of bank risks on the owners' business. Banks actively developed and implemented action plans to reduce the concentration of risks on the owners' business.

Among the bank risks, the credit risk traditionally calls for special supervisory attention. Amid vigorous build-up of loan portfolios by banks in 2015 more attention was paid to the actual business performance of the borrower as the source of funds to service loans and to the quality and adequacy of collateral used to adjust the value of provisions made. To improve the quality of supervision in 2015 the Bank of Russia continued to collect and assess information on real sector companies borrowing from credit institutions. The analysis of activity of especially economically important borrowing enterprises was given special attention.

In 2015, within banking supervision the Bank of Russia continued to analyze credibility of banks' assessment of certain types of assets, in particular closed-end unit investment funds and real estate both being a separate asset on the bank's balance sheet and a part of property of a closed-end unit investment fund, or used as collateral (including the case of mortgage participation certificates).

In 2015, preventive measures were actively applied to credit institutions: written notices were sent to the management of 813 supervised banks; 494 meetings with banks were held. Compulsory measures in the form of orders to eliminate violations were applied: fines were imposed on 212 banks, restrictions on certain transactions were imposed on 243 credit institutions.

Banks in unsatisfactory financial condition continued to be removed from the banking market. Strategically, these actions are aimed at enhancing confidence in the banking sector, terminating disguising poor quality of assets by misreporting, preventing transfers by unscrupulous owners of high-quality assets from credit institutions to other organizations under their control, further countering withdrawal of funds from the banking system through shell companies. Individual stability of credit institutions is decisive for systemic stability.

## ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

In 2015, the Supervisory Authority of the Bank of Russia head office includes the Banking Supervision Department, the Banking Regulation Department, the Credit Institution Licensing and Financial Rehabilitation Department, the Systematically Important Banks Supervision Department, the Financial Monitoring and Foreign Exchange Control Department and the Chief Inspectorate of the Bank of Russia. The major tasks of these divisions are to provide methodological and organizational support to the Bank of Russia statutory functions of banking supervision within the framework of the entire supervisory cycle: from the licensing of credit institutions, establishment of regulatory requirements, the exercise of on-going supervision of their activities and the conduct of on-site inspections to financial rehabilitation of credit institutions and implementation of measures, if necessary, to liquidate financially unviable credit institutions.

The supervisory divisions are managed by the Bank of Russia Banking Supervision Committee, which is headed by the Bank of Russia First Deputy Chairman in charge of this area. The Committee is responsible for making decisions on banking supervision policies.

The Bank of Russia carries out its banking supervision policies through its regional offices in the constituent entities of the Russian Federation.

The Bank of Russia supervisory divisions employ 5253 executives and specialists, of whom 41.6% work at the head office, and 58.4% are engaged in the regional branches. The vast majority of specialists (98.3%) have higher education, are aged between 30 and 50 years (62.9%), and have worked in the banking system for more than three years (85.5%).

# INTERNATIONAL ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The Bank of Russia's continued to take part in the activities of the Basel Committee on Banking Supervision (BCBS) and its working groups and subgroups.

In 2015 the BCBS evaluated the banking regulation of the Russian Federation (Regulatory Consistency Assessment Program) in respect of its compliance with the standards of Basel II, Basel 2.5, and Basel III.

The Bank of Russia issued a number of regulative documents amending the regulation of bank risks aiming at the implementation of BCBS framework in the Russian Federation.

During the year, the Bank of Russia also prepared information and other materials at the request of the Secretariat of the BCBS Group of Bank Supervisors form Central and Eastern Europe (BSCEE).

In the course of preparation to the Financial Sector Assessment Program (FSAP) of the Russian Federation by the IMF and World Bank experts planned for 2016, the self-assessment was made with regard to conformity with the BCBS Core Principles for Effective Banking Supervision.

The Bank of Russia pays much attention to cooperation and exchange of information with banking supervisory authorities of foreign countries. It has signed 38 cooperation agreements (memoranda of understanding, MoUs) with foreign bank supervisors. In 2015 the Bank of Russia continued discussion on draft agreements (MoUs) with banking supervisory authorities of several foreign countries taking into account of the latest amendments in the Russian legislation.

Besides, aiming at enhancing cross-border cooperation the Bank of Russia continued to inform foreign supervisory authorities about the latest legislative amendments concerning its powers to share supervisory information, to conduct on-site inspections of cross-border establishments of bank groups and banking holdings, as well as about the guarantee of a higher level of information protection provided by the Bank of Russia to foreign supervisors.

To coordinate the activities of the authorities responsible for the supervision of cross-border establishments of banking groups, the Bank of Russia participates in supervisory colleges, organized by foreign supervisory authorities. In 2015 the Bank of Russia's representatives took part in supervisory colleges organized by the Central Bank of Hungary and the National Bank of the Republic of Kazakhstan.

The Bank of Russia also held bilateral meetings on the actual issues of banking supervision with the representatives of the National Bank of the Republic of Kazakhstan and the supervisory bodies of China.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN RUSSIA

The Bank of Russia developed cooperation with agencies, regulators and supervisors of financial markets within the framework of inter-agency agreements and arrangements that were reached with the Ministry of Finance, the Federal Anti-Monopoly Service, the Federal Tax Service, the Federal Customs Service, Federal Treasury, Pension Fund of the Russian Federation and other federal agencies.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS

Despite slowing economy, the Russian banking sector continued to develop, though at a slower pace: over the year assets of credit institutions increased by 6.9% (adjusted for exchange rate dynamics – reduced by 1.6%) to 83 trillion rubles.

The downward trend in the number of credit institutions continued in 2015: it decreased by 101 to 733 during the reporting year.

In the reporting period, the funds in customer accounts increased by 18.5% (in 2014 - by 25.4%) to 51.9 trillion rubles; the share of these funds in banking sector liabilities increased over the year from 56.4% to 62.5%.

Borrowing from the Bank of Russia decreased over the year by 42.3% to 5.4 trillion rubles; deposits placed with banks by the Federal Treasury also decreased – by 28.4% to 0.4 trillion rubles. As a result, the share of funds raised from the Bank of Russia in banks' liabilities dropped over the year from 12.0% to 6.5%, and of funds raised from the Federal Treasury - from 0.7% to 0.5%.

The total value of loans to the economy (non-financial enterprises and households) increased over 2015 by 7.6% (in 2014 - by 25.9%) and reached 44.0 trillion rubles; excluding foreign exchange revaluation the growth in these loans over the year was 0.1%.

The value of loans and other placed funds provided by banks to non-financial organisations increased by 12.7% in the reporting period (in 2014 - by 31.3%); excluding the foreign exchange factor the increase was 2.5%. The corporate loan portfolio reached 33.3 trillion rubles, and its share in the banking sector assets as of 1 January 2016 amounted to 40.1% (in early 2015 – 38.0%).

Household lending decreased over the year by 5.7% (in 2014 – increased by 13.8%) and as of end of 2015 the portfolio reached 10.7 trillion rubles. During 2015, the household loans declined mainly because of reduction in the unsecured consumer lending segment.

In 2015, bank profits amounted to 192 billion rubles (in 2014 - 589 billion rubles.). Credit institutions’ return on assets amounted to 0.3%, return on equity – to 2.3% (in 2014 – 0.9% and 7.9% respectively).

Over the year the capital adequacy ratio increased across the entire banking sector from 12.5% to 12.7%. At the same time the core capital adequacy ratio (N1.1) decreased from 8.9 to 8.2%, while the Tier 1capital adequacy ratio (N1.2) decreased from 9.0 to 8.5%.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Banks | 859 | 783 | 681 |
| Non-bank credit institutions | 64 | 51 | 52 |
| **Banking sector total** | 923 | 834 | 733 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| State-controlled banks | 51,5 | 58,6 | 58,8 |
| Other banks controlled by residents | 33,2 | 31,7 | 32,3 |
| Banks controlled by residents, total | 84,7 | 90,3 | 91,1 |
| Foreign-controlled banks (banks with non-resident interest in excess of 50%) | 15,3 | 9,7 | 8,9 |
| **Banking sector (excluding non-bank credit institutions), total** | 100,0 | 100,0 | 100 |

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

| Type of financial institution | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Banks | 46,8 | 54,2 | 0,107 |
| Non-bank credit institutions | 82,9 | 88,0 | 0,422 |
| **Banking sector, total** | 46,7 | 54,1 | 0,107 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Banks | 15,1 | 7,8 | 2,2 |
| Non-bank credit institutions | 48,1 | 21,8 | 19,2 |
| **Banking sector total** | 15,2 | 7,9 | 2,3 |

**Distribution of market shares in balance sheet total***
**(at year-ends, %)**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Banks | 99,7 | 99,6 | 99,7 |
| Non-bank credit institutions | 0,3 | 0,4 | 0,3 |
| **Banking sector total** | 100,0 | 100,0 | 100,0 |

* Share in aggregate banking sector assets

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

| Assets | 2013 | 2014 | 2015 |
|---|---|---|---|
| Financial sector | 15,7 | 16,3 | 17,9 |
| Nonfinancial sector | 56,5 | 52,6 | 53,0 |
| Government sector (including the Bank of Russia) | 7,0 | 7,4 | 7,8 |
| Other | 20,7 | 23,7 | 21,3 |
| **Liabilities** | **2013** | **2014** | **2015** |
| Financial sector (including credit institutions) | 12,6 | 12,4 | 12,4 |
| Nonfinancial sector | 50,1 | 50,1 | 56,2 |
| Government sector (including the Bank of Russia) | 8,6 | 13,4 | 7,6 |
| Capital (profits, funds) | 11,5 | 8,9 | 9,1 |
| Other | 17,2 | 15,3 | 14,7 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Banks | 13,4 | 12,4 | 12,7 |
| Non-bank credit institutions | 34,8 | 63,4 | 29,3 |
| **Banking sector, total** | 13,5 | 12,5 | 12,7 |

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 6,8 | 7,9 | 10,0 |
| households | 7,5 | 9,9 | 12,9 |
| corporate (including individual entrepreneurs) | 6,5 | 7,2 | 9,1 |

**The structure of deposits and loans of the banking sector in 2015**
**(at year-end, %)**

| | Deposits and other funds raised by credit institutions | Loans, deposits and other funds provided by credit institutions |
|---|---|---|
| Non financial sector, including: | 98,3 | 94,0 |
| Households | 45,4 | 22,8 |
| Non financial institutions | 52,9 | 71,2 |
| Government financial authorities and off-budget funds* | 1,7 | 2,4 |
| Financial sector (excluding banks) | | 3,5 |
| **Total** | 100,0 | 100,0 |

* Deposits and other funds raised by credit institutions from financial sector are included in deposits and other funds raised from non financial corporate sector

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 98 091 365 | 77 426 441 | 81 925 814 |
| Interest expenses | 48 595 053 | 40 352 148 | 55 471 251 |
| Net interest income | 49 496 312 | 37 074 293 | 26 454 563 |
| Net commission income | 14 546 949 | 10 610 076 | 9 692 733 |
| Other (not specified above) income (net) | 9 475 488 | 10 981 474 | 8 095 143 |
| Gross income | 73 518 749 | 58 665 843 | 44 242 439 |
| Administration costs | 37 779 667 | 27 994 920 | 20 287 614 |
| Depreciation | 1 858 695 | 1 315 166 | 1 099 085 |
| Loan loss provisions | 13 635 682 | 22 027 437 | 21 538 435 |
| Impairement on financial assets not measured at fair value through profit and loss\| Provisions on financial assets (loans, …) | n/a | n/a | n/a |
| Profit (loss) before tax | 22 103 401 | 8 643 486 | 2 416 390 |
| Profit (loss) after tax | 17 906 761 | 7 553 571 | 1 437 633 |

**Total Own Funds in 2015 (in EUR)**

| Type of financial institution | Total own funds (capital) | Core capital | Additional capital |
|---|---|---|---|
| Banks | 112 733 249 | 75 107 596 | 37 625 653 |
| Non-bank credit institutions | 301 506 | 208 742 | 92 764 |
| **Banking sector, total** | 113 034 755 | 75 316 338 | 37 718 417 |

# 2015 DEVELOPMENTS IN THE SERBIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

In 2015, economic activity was marked by a recovery in industrial production and a strong growth of construction industry. These two sectors were the main drivers of GDP growth, which in annual terms equaled 0.74%. On the other hand, a contraction was recorded in agricultural production, as well as in some service sectors.

On the expenditure side, 2015 GDP growth was mostly driven by fixed investments. Positive, though lesser, contribution came from net exports as well, since exports grew faster than imports. Final consumption gave a negative contribution to GDP, though less so than in 2014.

External imbalances narrowed further in 2015, owing largely to the implementation of fiscal consolidation and structural reforms, falling global oil prices and the gradual recovery of external demand. The current account deficit (4.8% of GDP) was lower by a fifth and was fully covered by FDIs. The current account structure improved as the deficit on the trade in goods declined (by EUR 117 mln), whereas the surplus on the trade in services and the surplus on the secondary income account widened (by EUR 260 mln and EUR 345 mln respectively). Expectedly, it was only the deficit on the primary income account that went up (by EUR 315 mln).

Exports expanded 6.7% y-o-y, led mainly by a rebound in exports in the manufacturing sector (base metals, metal products, other machinery and equipment, and tobacco products) and agricultural products. Imports of goods were up 4.1% in 2015. The sharpest increase was observed for machinery, telecommunications equipment and metal ores, while nominal imports of oil and natural gas were suppressed by the crash in global oil prices. In contrast to 2014, thanks to a more robust net FDI inflow (EUR 1.8 bn) and lower net foreign debt repayment under financial loans (EUR 198 mln), the capital and financial account showed a net capital inflow, thus boosting NBS FX reserves (EUR 166 mln).

Despite external uncertainties, relative stability of the dinar against the euro has been preserved (the dinar weakened against the euro by 0.5% in 2015), due to the reduced internal and external imbalances. Appreciation pressures prevailed for most of the year, while depreciation pressures built up in late 2015, when foreign investors, anticipating the onset of the FED monetary tightening, started reducing their exposure to emerging markets, including Serbia. These pressurs were moderated by an upturn of FDIs and positive assessment of the Serbia’s precautionary SBA and revised Serbia’s rating outlook by Fitch in December.

Inflationary pressures remained subdued in 2015, reflecting the impact of the majority of domestic factors, as well as falling global prices of primary commodities (oil and primary agricultural commodities) and generally low inflation abroad. Like in other European countries, under the overwhelming sway of the drop in global prices of oil and primary agricultural commodities, year-on-year inflation continued below the lower bound of the target tolerance band and settled at 1.5% in December.

The undershooting of the target tolerance band is largely attributable to the drop in global prices of primary commodities, notably oil, and administered price growth that remained low for the greater part of the year. The absence of major inflationary pressures was indicated also by the fact that both short- and medium-term inflation expectations were well-anchored within the target band, this being a key prerequisite for stabilising inflation and increasing the effectiveness of monetary policy measures.

In making the decision to cut the key policy rate, the Executive Board of the NBS took into account that disinflationary pressures were reinforced by tight fiscal policy. The pace of key policy rate cuts in 2015 was largely determined by developments in the international environment. The key policy rate was kept unchanged in the first two and last two months of the year and in July, whereas in each of the other months, it was trimmed down by 50 bp.

Late 2014 saw the launching of a major fiscal consolidation program, supported by the conclusion of a three-year precautionary stand-by arrangement with the IMF in February 2015. In the first year of program implementation, general government deficit narrowed to 3.8% of GDP (a 2.8 pp reduction y-o-y), while primary deficit measured only 0.5% of GDP (down by 3.2 pp y-o-y). Quantitative targets under the IMF arrangement were exceeded by a comfortable margin, as the original program headline deficit cap was set at 5.9% of GDP for 2015.

Fiscal over performance in 2015 relative to the program was mainly driven by higher-than-expected revenues collection, which grew by 3.0% in real terms despite the ongoing consolidation measures.

Expenditures were successfully kept in check by consolidation measures, and dropped by 3.3% in real terms from the year before. The main driver of the decline was the cut in public sector wages and pensions. General government debt reached 77.3% of GDP at year-end, and is expected to peak during 2016 and gradually decline thereafter.

**Key macroeconomic indicators**

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Q1 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP growth (in %)[1] | 5,5 | 4,9 | 5,9 | 5,4 | -3,1 | 0,6 | 1,4 | -1,0 | 2,6 | -1,8 | 0,74 | 3,5 |
| Consumer prices (in %, relative to the same month a year earlier)[2] | 17,7 | 6,6 | 11,0 | 8,6 | 6,6 | 10,3 | 7,0 | 12,2 | 2,2 | 1,7 | 1,5 | 0,6 |
| NBS foreign exchange reserves (in EUR million) | 4.922 | 9.020 | 9.634 | 8.162 | 10.602 | 10.002 | 12.058 | 10.915 | 11.189 | 9.907 | 10.378 | 9.501 |
| Exports (in EUR million)[3] | 5.329 | 6.948 | 8.110 | 9.583 | 8.043 | 9.515 | 11.145 | 11.469 | 13.937 | 14.451 | 15.618 | 3,942[6] |
| - growth rate in % compared to a year earlier | 19,1 | 30,4 | - | 18,2 | -16,1 | 18,3 | 17,1 | 2,9 | 21,5 | 3,7 | 8,1 | 11,7 |
| Imports (in EUR million)[3] | 9.612 | 11.970 | 15.468 | 18.267 | 13.099 | 14.244 | 16.487 | 16.992 | 17.782 | 18.096 | 18.899 | 4,513[6] |
| - growth rate in % compared to a year earlier | 0,7 | 24,5 | - | 18,1 | -28,3 | 8,7 | 15,7 | 3,1 | 4,7 | 1,8 | 4,4 | 1,7 |
| Current account balance[3] (in EUR million) | -1.778 | -2.356 | -5.474 | -7.125 | -2.032 | -2.037 | -3.656 | -3.671 | -2.098 | -1.985 | -1577 | -249[6] |
| as % of GDP | -8,4 | -9,6 | -18,6 | -21,1 | -6,6 | -6,8 | -10,9 | -11,6 | -6,1 | -6,0 | -4,8 | -3,3 |
| Unemployment according to the Survey (in %) | 20,8 | 20,9 | 18,1 | 13,6 | 16,1 | 19,2 | 23,0 | 23,9 | 22,1 | 19,2[7] | 17,7 | |
| Wages (average for the period, in EUR) | 209,7 | 260,0 | 347,1 | 400,5 | 337,4 | 330,1 | 372,5 | 364,5 | 388,6 | 379,3 | 368,0 | 353,7 |
| RS budget deficit/surplus (in % of GDP)[4] | 0,5 | -1,7 | -1,6 | -1,7 | -3,2 | -3,4 | -4,0 | -5,9 | -5,2 | -6,3 | -2,9 | -1,0 |
| Consolidated fiscal result (in % of GDP)[4] | 1,2 | -1,5 | -1,9 | -2,6 | -4,4 | -4,6 | -4,8 | -6,8 | -5,5 | -6,6 | -3,8 | -1,7 |
| RS public debt, (central government, in % of GDP) | 50,2 | 35,9 | 29,9 | 28,3 | 32,8 | 41,8 | 45,4 | 56,2 | 59,6 | 70,4 | 75,9 | 74,8 |
| RSD/USD exchange rate (period average) | 66,87 | 67,03 | 58,39 | 55,76 | 67,47 | 77,91 | 73,34 | 88,12 | 85,17 | 88,54 | 108,85 | 111,37 |
| RSD/USD exchange rate (end of period) | 72,22 | 59,98 | 53,73 | 62,90 | 66,73 | 79,28 | 80,87 | 86,18 | 83,13 | 99,46 | 111,25 | 108,60 |
| RSD/EUR exchange rate (period average) | 82,99 | 84,11 | 79,96 | 81,44 | 93,95 | 103,04 | 101,95 | 113,13 | 113,14 | 117,31 | 120,73 | 122,87 |
| RSD/EUR exchange rate (end of period) | 85,50 | 79,00 | 79,24 | 88,60 | 95,89 | 105,50 | 104,64 | 113,72 | 114,64 | 120,96 | 121,63 | 122,92 |
| MEMORANDUM: | | | | | | | | | | | | |
| GDP (in EUR million)[5] | 21.103 | 24.435 | 29.452 | 33.705 | 30.655 | 29.766 | 33.424 | 31.683 | 34.263 | 33.319 | 32.908 | 7.522[6] |

[1] At constant prices of previous year.

[2] Retail prices until 2006.

[3] Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5. Due to the break in the series for 2007, exports and imports growth rates are not shown. As of 1 January 2010, the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. The Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

[4] Includes below-the-line items (payment of called guarantees, bank recapitalisations and debt takeover) in line with IMF methodology, as of 2008 on RS budget level and as of 2005 on consolidated level.

[5] According to ESA 2010.

[6] NBS estimate.

[7] Revised data for 2014 and 2015 according to the new methodology of Labour Force Survey

Notes:

1. Data are subject to corrections in line with official data sources.
2. Source for the data on unemployment: Labour Force Survey, Statistical Office.
3. Source: MoF for public debt and NBS for estimated GDP.

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

The banking sector, as the largest portion of the financial system of Serbia (92%), has been relatively successful in overcoming the negative spill-over effects of the global financial crisis. Reasons lie in the previously accumulated liquidity and solvency buffers, timely support of parent banks and measures taken by the NBS and Government of the RS for alleviating negative effects of the global financial crisis on Serbia. Banking sector is adequately capitalized and liquid, still, non-performing loans are still the main issue in Serbian banking sector.

At the end of December 2015, there were 30 banks operating in Serbia (23 in majority foreign ownership, one in majority ownership of domestic entities, while six banks were in majority ownership of the Republic of Serbia). All banks in Serbia are operating as independent legal entities, no branching is allowed. Foreign-owned banks are members of banking groups from 13 countries and the most significant foreign banks are from Italy and Austria (26.1% and 14.9%, respectively), followed by banks from Greece (12.9%), France (10.4%) and other countries (11.8% share in total). 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 76.7% at the end of December 2015.

Total balance sheet assets of the banking sector in Serbia reached EUR 25.1 billion at the end of 2015 which is an increase of 2.1% since the end of 2014.

With a large number of banks holding small shares in total assets, lending, deposits and income, the Serbian banking sector is fragmented. The market share of the top five banks in Serbia is 54.2% for assets, 52.7% for lending and 53.6% for deposits.

At the end of December 2015, total gross value of loan portfolio[34] was at the level of EUR 15.5 billion which is an increase of 0.8% compared to the end of 2014. Loans to (private and public) companies made 51.8% of total loans with EUR 8 billion, at the end of 2015. During 2015 loans to corporate sector have decreased by 0.6%. The growth rate of total household loans was 4.8% during 2015 and at the end of December 2015 they amounted to EUR 5.5 billion and made 35.6% out of total loans.

At the end of December 2015, the share of NPL's in total loans granted was 21.6% gross (9.5% net), while in absolute terms, their level reached EUR 3.5 billion gross. Despite the relative size of the non-performing share of lending portfolios in Serbia's banking sector, significant provisioning has been established both by means of International Financial Reporting Standards ("IFRS") rules (62.3% of NPL's was provisioned) and local asset classification rules (114.2%).

Total banking sector deposits at the end of December 2015 stood at the level of EUR 16.5 billion with an increase of 5.7% in 2015. Household deposits made 56.3% of total deposits with increase of 2.7% in 2015. Savings deposits are the most prominent in both segments (household deposits and total deposits) with EUR 8.6 billion at the end of December 2015. Approximately, one fifth of all deposits were related to corporate sector with a EUR 3.5 billion at the end of 2015 which is an increase of 11.2% compared to the end of the previous year.

The growth rate of own funding sources was sufficient to maintain the proportion of own funds to total liabilities of 20.3% as of 31 December 2015. The capital adequacy ratio was 20.89% at the end of December 2015, which is significantly above the regulatory minimum of 12%.

The average regulatory liquidity ratio for the Serbian banking sector in December 2015 was 2.09, 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 34.3% of total assets and 52.0% of total short-term liabilities.

[34] without loans under repo transactions

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

**In February 2015**, Serbian banking legislation has been significantly reformed, primarily through the amendments and supplements to the **Law on the National Bank of Serbia and the Law on Banks**, with the aim of improving bank recovery and resolution framework in line with principles and rules set out in the Directive 2014/59/EU (so called Bank Recovery and Resolution Directive, BRRD).

The National Bank of Serbia was given a central role as the resolution authority, and as envisaged in the new rules, which started to apply on April 1st 2015, the NBS Executive Board is in charge of initiation of resolution proceedings, the selection of resolution strategies and tools, and the determination of the least cost test.

Organizational separation between supervision activities and bank resolution activities is a requirement of the BRRD, hence, an organizational unit, separate from Administration for Supervision of financial institutions (hereinafter: Administration) is created. The division of responsibilities under the new framework is such that the Administration is in charge of recovery planning, intra group financial support, early intervention, determination of „failing or likely to fail", while activities regarding the development of resolution plans, resolvability assessments and orders directed towards removal of impediments, application of resolution tools and powers are the responsibility of the resolution unit.

The main objectives of bank resolution, incorporated in the Law on Banks, include: avoiding an adverse effect on financial stability, protecting budgetary and other public funds, protecting depositors and investors, ensuring the continuity of critical functions. The way these objectives will be achieved is defined through resolution plans that are developed and updated for each bank by the NBS as the authority in charge of bank resolution. The bank shall provide to the NBS, at the NBS's request, all necessary assistance, information and data in the process of developing and updating the resolution plan, and the NBS shall prescribe that information in detail.

Further the Law on Banks introduces, a number of pre-emption mechanisms are introduced, such as recovery plans and early intervention measures, to enable both the pre-emptive action of banks and an early response of the NBS as the supervisor, with a view to preserving financial stability by preventing any aggravation of problems and precluding government costs.

Recovery plans imply concrete measures to be taken by banks facing problems in operation, enabling them to swiftly continue with regular operation. At the same time, early intervention powers enable the NBS to order banks to take measures or decisions (restructuring of debt with bank creditors, removal of members of managing or executive boards, appointment of a temporary administrator etc.), for cases where the NBS establishes that a bank has acted contrary to the provisions of the Law on Banks, regulations of the NBS or other regulations or that it is likely to do so due, inter alia, to a rapidly deteriorating financial condition, including deteriorating liquidity situation, increasing level of leverage, non-performing loans or concentration of exposures in order to ensure that a bank continues as a going concern. These measures are introduced in addition to regular supervisory measures prescribed by the Law on Banks, and besides them, the NBS can remove a member of a bank's management body or another person holding a managing position, as well as to introduce one or more temporary managers to the bank, if prescribed conditions are met.

NBS is also in charge of giving or refusing to give consent to bank or an ultimate parent company/member of a banking group subject to consolidated supervision, to enter into an agreement with other members of the group to provide financial support to any other party to the agreement that meets the conditions for early intervention measures.

Before providing intra-group financial support, the management body of the entity that intends to provide that support shall notify the NBS of its intention and shall deliver details of the proposed financial support, including a copy of the intra-group financial support agreement. Within five business days from the receipt of a complete notification, the NBS may prohibit or restrict the provision of financial support if it assesses that the conditions for providing intra group financial support are not met.

According to new amendments in order for the resolution procedure to be initiated, the following conditions must be met:

- the bank is failing or likely to fail,
- having regard to all circumstances of an individual case, it is not probable that any other measure by the bank or a private sector entity, a supervisory measure taken pursuant to this Law or write down and conversion of capital instruments – could in a reasonable period remove impediments to the continuation of the bank's operation,
- the bank's resolution is in the public interest.

The Law on Banks provides the power for NBS to appoint one or more special managers for a term not longer than a year, if it assesses that a change to the governance and management of a bank under resolution would contribute to the achievement of resolution objectives. Special manager assumes functions of members of the bank's managing and executive boards necessary for achieving resolution objectives, and is supervised and controlled by the NBS.

Before initiating the resolution process, the NBS may write down or convert relevant capital instruments of a bank into shares or other instruments of ownership of the bank, whereas after initiating the resolution process it shall write down or convert capital before the application of an appropriate resolution tool. The write down and/or conversion is carried out in the following order of sequence:

1) core capital is reduced first, in proportion to the losses and to the extent of its capacity;
2) supplementary capital items are written down and/or converted into the bank's shares which may be included in the bank's core capital to the extent required to achieve the resolution objectives or to the extent of the capacity of the relevant capital items, whichever is lower.

In accordance with rules prescribed by BRRD, the Law on Banks envisages the following resolution tools:

- transfer of bank's shares and/or assets and liabilities to a private sector purchaser under market conditions, which ensures preservation of bank's critical functions while retaining unrestricted access to the insured deposits;
- transfer of bank's shares and/or assets and liabilities to a bridge bank established by the state, which will be applied in cases where there is no market interest to purchase the failing bank, until such purchaser is found;

- asset separation, which implies taking over of bad assets. The application of this tool should enable the management of transferred assets by a special purpose public entity (such as the Deposit Insurance Agency), which should ensure higher proceeds from those assets in comparison to the proceeds obtained in an insolvency procedure;
- the bail-in tool, which ensures that the losses are first distributed among shareholders of the bank, and unsecured creditors after them, thereby achieving protection of public funds. The mechanism of this tool consists of cancellation/dilution of bank's shares, and write down and conversion of receivables of unsecured creditors.

Prior to adopting the decision on resolving a bank, the NBS carries out the least cost test, indicating which solution is the cheapest and most effective for the bank in light of resolution objectives. To protect shareholders and creditors, before the decision is made, an audit firm conducts an independent valuation of the bank's assets and liabilities, which should give an objective and fair picture of the bank's financial situation.

Besides changes relating to the recovery and resolution framework, certain amendments were also introduced in the bank prudential framework, which include:

- abolishment of (individual and aggregate) limits on exposures to persons related to the bank, with the aim of further harmonization with international standards;
- changes in the definition of "related parties" – instead of the previous threshold of a 5% holding or more, new provisions set the threshold to 20% or more for the purpose of establishing interconnectedness between clients. Additionally, a bigger scrutiny is expected of banks when determining economic interconnectedness;
- investment property of a bank is included in the indicator (limit) of bank's investments, which is up to 60% of bank capital;
- provisions that established competences of the NBS in the field of protection of competition were removed – consequently, Commission for the Protection of Competition is now the sole competent authority for banks in the area of competition control;
- measures that the NBS can take against banks were simplified (ordering letter has been removed), along with the expansion of the list of possible actions which the NBS can order to the bank. Also, provisions on pecuniary administrative penalties to the bank and its management bodies have been improved.

Besides major changes to the Law on Banks in February 2015, during 2015, the NBS adopted several by-laws.

**In February 2015**, the NBS adopted the **Decision on Measures for Preserving Stability of the Financial System in the Context of Foreign Currency-Indexed Loans**. The decision was rendered with a view to preserving and strengthening the stability of the financial system of the Republic of Serbia, ensuring more adequate risk management by banks and better protection of financial services consumers who bear the brunt of the negative consequences triggered by current developments in international foreign exchange markets.

This decision deals with a complex problem of currency-indexed housing loans from the systemic point of view, fully respecting freedom of contract on the one hand, and mandatory nature of regulations on the other. In its capacity of a banking market regulator, the NBS adopted a solution which helps the citizens overcome the difficulties in repaying CHF-indexed loans, as well as the difficulties caused by banks' unilateral raising of interest margins.

The first part applies to all loan repayment agreements concluded before the start of implementation of the Law on the Protection of Financial Services Consumers, regardless of the currency of indexation. NBS decided to mandate the manner in which funds overcharged on account of unilateral raising of variable indefinable elements of interest rate should be treated by banks. Hence, banks are required to treat the amount overcharged as early loan repayment and send the notification to each borrower with the modified loan repayment schedule within 30 days from the effective date of the NBS's Decision. Implementation of this part of the Decision is mandatory and precedes the implementation of any other provision contained in the second part.

The second part of the Decision concerns solely the CHF-indexed housing loans. Banks are required to offer to their client borrowers, not later than 30 days from the effective date of the NBS's Decision, four models of annex proposals containing modified terms of loan repayment, while keeping the existing loan collaterals. Borrowers must be given no less than 3 months to decide on the offer and may accept it at any time before this deadline expires.

In order to further relieve the burden of debt servicing of CHF-indexed housing loans and to provide a more comprehensive protection to their client borrowers, banks will not be allowed to offer conversion, under any of the modalities envisaging such an option, on the terms applied in the extension of EUR-indexed loans if such terms are less favourable than the terms applied on 31 December 2014. In order to minimise the costs of annexing loan agreements that might discourage the borrowers from accepting bank offers, and to optimise the effects of the Decision, banks will not be allowed to charge any fees for undertaking these measures and carrying out these activities nor to obtain any compensation for any related costs in regard to such measures and activities.

On its meeting held **on 26 March 2015**, the Executive Board of the NBS adopted the following decisions in the field of bank supervision and resolution, which entered into application on 1 April:

- Decision on intra-group financial support,
- Decision on detailed terms and manner of performing bank supervision and special bank audit,
- Decision on detailed terms of conversion of supplementary capital items of a bank, and/or bank under resolution and detailed terms and manner of write-down and conversion of liabilities of a bank under resolution,
- Decision on detailed requirements and manner of independent valuation of assets and liabilities of a bank in order to determine whether the conditions for bank resolution are met,
- Decision on content of documents and evidence submitted with the application for operating licence and application for specific consents and approvals of the National bank of Serbia to a bridge bank and detailed conditions and manner of giving specific consents and approvals to an asset management company,
- Decision on detailed terms and conditions of temporary administration in a bank,
- Decision on detailed terms and manner of inviting and selecting bids for the acquisition and/or sale of shares, assets and liabilities of a bank under resolution,

- Decision on the minimum requirement for capital and eligible liabilities for banks.

At its meeting held **in April 2015**, the NBS Executive Board adopted **Decision on Amendments and Supplements to the Decision on Risk Management by Banks** (RS Official Gazette, No 33/2015) in the part which regulates limits of exposure, removed the limit on total exposure of a bank to a single related entity and the limit on the bank's total exposure to related entities, thus aligning the Decision with the amendments to the Law on Banks. In addition, investment property was included in the definition of investment risk. Amendments and supplements to this Decision came into force on 17 April 2015.

**Decision on Supplements to the Decision on the Classification of Bank Balance Sheet Assets and Off-balance Sheet Items** (RS Official Gazette, No 38/2015) came into force **on 7 May 2015** and amended one of the exceptions from the conditions under which delay in the collection of receivables is calculated as of the subsequently agreed maturity date. According to the supplement to the Decision, delay in the collection of receivables shall be calculated as of the subsequently agreed maturity date if it is agreed at the time of the extension of the repayment period that interest or interest and a part of the principal will be calculated and collected on a monthly basis, or if the original repayment schedule envisages the calculation and collection of interest and a part of the principal on less than a monthly basis – under the condition that the frequency of the repayment agreed on the extension of the repayment terms is not lower than the one originally agreed, except in case of receivables secured with prime collateral.

The decision to extend the deadline for the application of a more favorable credit risk weight was made after careful consideration of the regulatory treatment of exposures to governments and central banks under the EU regulations that implement Basel III standards and envisage the same type of a more favorable treatment until 31 December 2017.

**The Decision on Bank Reporting Requirements** was adopted to harmonize the reports prescribed by the Decision with a set of accounting regulations published in the RS Official Gazette, No 71/2014, as well as to upgrade individual reports that banks submit to the NBS.

**The Decision on Disclosure of Data and Information by Banks** introduces four standard forms for banks to disclose data on their capital and main features of financial instruments which are included in capital calculation, data on the reconciliation of regulatory capital items with capital items from bank balance sheets, and data on capital adequacy. The Decision aims to ensure greater transparency in bank operation and to provide the broadest public with a set of simple, comparable and easily accessible data and information on bank capital, which should facilitate business decision making and assessment of banks' risk profile.

**Decision on Amendments and Supplements to the Decision on Measures for Preserving Stability of the Financial System in the Context of Foreign Currency- Indexed Loans** (RS Official Gazette, No 51/2015) was adopted **in June 2015** by the Executive Board of the National Bank of Serbia, amended the reporting requirements of banks concerning the results of measures and activities carried out in accordance with this Decision as well as data on those activities, particularly as regards the number of borrowers who were given the information and borrowers who declined the offer, including all other data of significance for monitoring the efficiency of the procedure. Pursuant to the amendments to the Decision, the bank is obliged to submit the reports to the

National Bank of Serbia on a monthly basis, with balance as at the last calendar day of the previous month, by no later than the 25th day in the month. In Annex 1, the National Bank of Serbia prescribed the specific form and content of the reports, not set out in the original text of the Decision. The bank's obligation to submit reports to the National Bank of Serbia within the meaning of this Decision shall cease after the bank submits the report for the month in which the deadline for accepting the offer has expired for all loan beneficiaries. The amendments to the above Decision came into force on 20 June 2015.

**In July 2015** Executive Board of the National Bank of Serbia adopted **Decision amending Decision on Risk Management by Banks** (RS Official Gazette, No 61/2015), which prescribes that exceptionally in the event of urgency, when the assignment of receivables is necessary for improving a bank's financial position, the bank may request from the National Bank of Serbia the approval that it submits to it the notification and documentation hereof within the deadline shorter than 30 days, but not later than five business days before conclusion of the assignment agreement.

On its meeting held **on 13 August 2015** Executive Board of the National Bank of Serbia adopted **Decision on recovery plans of banks and banking groups** (RS Official Gazette, No 71/2015) implementing provisions regarding to recovery plans of banks and banking groups. This Decision sets forth the contents of the recovery plan of a bank or a banking group subject to consolidated supervision of the National Bank of Serbia, the manner and deadlines for submission of the recovery plan and updated recovery plan, as well as the drawing up and assessment of the banking group's recovery plan. This Decision sets forth the contents of the recovery plan of a bank or a banking group subject to consolidated supervision of the National Bank of Serbia (NBS), the manner and deadlines for submission of the recovery plan and updated recovery plan, as well as the drawing up and assessment of the banking group's recovery plan.

**In September 2015** NBS adopted **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**. This Decision sets forth detailed conditions and manner of implementing the provisions of the Law on Banks based on which the National Bank of Serbia grants a preliminary bank founding permit and a bank operating licence, consents to acts adopted by the founding assembly, prior consent to acquisition of own shares, consent to the bank's articles of association and/or amendments and supplements to the bank's articles of association and founding act, prior consent to the appointment of members of the bank's managing and executive board, prior consent to acquisition of ownership in a bank, operating license for a bank which is established through merger by acquisition and prior consent for merger by acquisition, as well as the criteria for defining a first-class bank in the procedure of voluntary termination of bank's operations. Regulatory framework for banks was improved in accordance with the needs that have been identified by applying the applicable regulations, European guidelines and best comparative practice.

In order to improve reporting on non-performing loans, **in December 2015** the **Decision amending the Decision on Reporting Requirements for Banks**, was adopted. The existing forms were amended and new forms were introduced in order to obtain information from banks related to the monitoring of accrued interest on non-performing loans, as well as the coverage of non-performing loans by collateral.

The National Bank of Serbia has invested significant efforts to harmonize national regulations in the field of payment services with those of the EU. As a result of these efforts, on 18 December 2014 the National Assembly of the Republic of Serbia adopted the new Law on Payment Services. The start of implementation of the Law – as of October 1, 2015 (and secondary legislation enacted pursuant to it) marks the completion of NBS's efforts to set up a comprehensive regulatory framework relating to the provision of payment services and electronic money issuance. In addition to developing payment services and defining rules for their provision, the Law has also established legal grounds for setting up and operation of payment and electronic money institutions, as new types of payment service providers. The Law sets out that the NBS will be in charge of supervision of all payment service providers and electronic money issuers, in the part of their operations relating to provision of payment services or/and electronic money issuance.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

Regarding Strategy for Implementation of Basel III Standards in Serbia (which covers relevant issues under the new set of standards and envisages three phases of Basel III implementation: a preparatory phase to conduct a gap analysis between domestic regulatory framework and Basel 2.5 and Basel III standards, and a comparative analysis of the dynamics of the introduction and implementation of Basel III standards by EU member states and neighboring countries, and to draw up an operational plan for Basel III implementation, an impact assessment phase which includes setting of the timeframe for implementation of particular elements of Basel III; and a legislation drafting phase, i.e. drafting of regulations implementing Basel 2.5 and Basel III standards), it should be noted that First (preparatory) and second phases were successfully conducted (the completion of the gap analysis and quantitative impact phase). Currently, NBS is in the third phase of Strategy for Implementation of Basel III Standards in Serbia (drafting legislation).

On the meeting held on 13 of August 2015, NBS Executive Board reached a decision to adopt the action plan of NBS for implementation of NPL resolution Strategy, entering into force on the day of adoption of the Strategy by the Government. NBS action plan envisages goals, activities regarding realization of those goals, expected results as well as defined deadlines. Action plan specifies activities which relate to banking supervision with the focus on the regulatory framework for the treatment of restructured loans and on the enhancement of distressed asset management. Beside this, focus is on the enhancement of IAS 39 implementation by banks, enhancement of disclosure by banks regarding information on asset quality and on the activities aimed at supporting adequate collateral valuation through development of a database on real estate collateral valuations and loans approved based on reported collateral. In addition, the action plan envisages activities with the aim of analyzing possibilities and obstacles for liberalization of retail NPLs and identification of obstacles in relation to NPL market, which are under the competence of NBS.

# THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

22 on-site supervisions were conducted in 2015: 2 supervisions of safety and soundness and legality of bank's operations from the aspect of risk management, 1 target control (Inspection of Classification of Bank Balance Sheet Assets and Off-balance Sheet Items and Inspection of Capital Adequacy Ratio), 2 target control related to AML/CTF issues and 17 follow-up on-site supervisions of bank's operations.

***AML***

National Bank of Serbia, as supervisory body in the field of Prevention of Money Laundering and Financing of Terrorism (for banks, insurance sector, financial leasing companies and voluntary pension funds) is actively participating in the work of Money Val Committee, which brings together experts from the member states, who perform AML/CFT tasks within parent institutions (FIU, Central Bank, Ministry of Interior, Ministry of Justice). The Committee works on the principle of mutual evaluations-assessment of measures and actions undertaken by Member States, in the field of anti-money laundering and combating the financing of terrorism. Money Val evaluation reports contain recommendations for improving the effectiveness of AML/CFT national system, as well as strengthening capacity for international cooperation.

Republic of Serbia is the second member of Money Val that has passed the fifth evaluation round, that take place according to the new FATF Methodology and complex rules. As part of evaluation process state authorities were given two questionnaires (technical and effectiveness) and National Bank of Serbia-Banking Supervision Department, after gathering information from the private sector, filled parts related to the operations of banks. The evaluation included the visit of team of experts, who were in visit to Republic of Serbia, from 28th September to 9th October 2015. During the two-week visit a number of meetings had been held, with participation of representatives of National Bank of Serbia-Banking Supervision Department. The evaluators had the opportunity to visit the National Bank of Serbia.

Representatives of Banking Supervision Department participate in the work of the Standing Coordination Group, a body of the Government of Republic of Serbia, responsible for monitoring the implementation of the National AML/CFT Strategy, as well as proposing and coordinating activities in the field of combating money laundering and terrorist financing, which held a number of meetings during 2015.

***Measures Against Banks***

During 2015, National Bank of Serbia – Banking Supervision Department took following measures against banks: 9 letters of warning, 5 resolutions with orders for banks to undertake certain measures, 4 resolutions on temporary measures and 1 resolution on imposing early intervention measures. Further, National Bank of Serbia – Banking Supervision Department rendered 1 resolution on imposing a fine to a bank, and filed 8 reports against banks and responsible persons for commercial offences and 7 requests for initiation of the proceedings for commercial misdemeanors against banks and responsible persons.

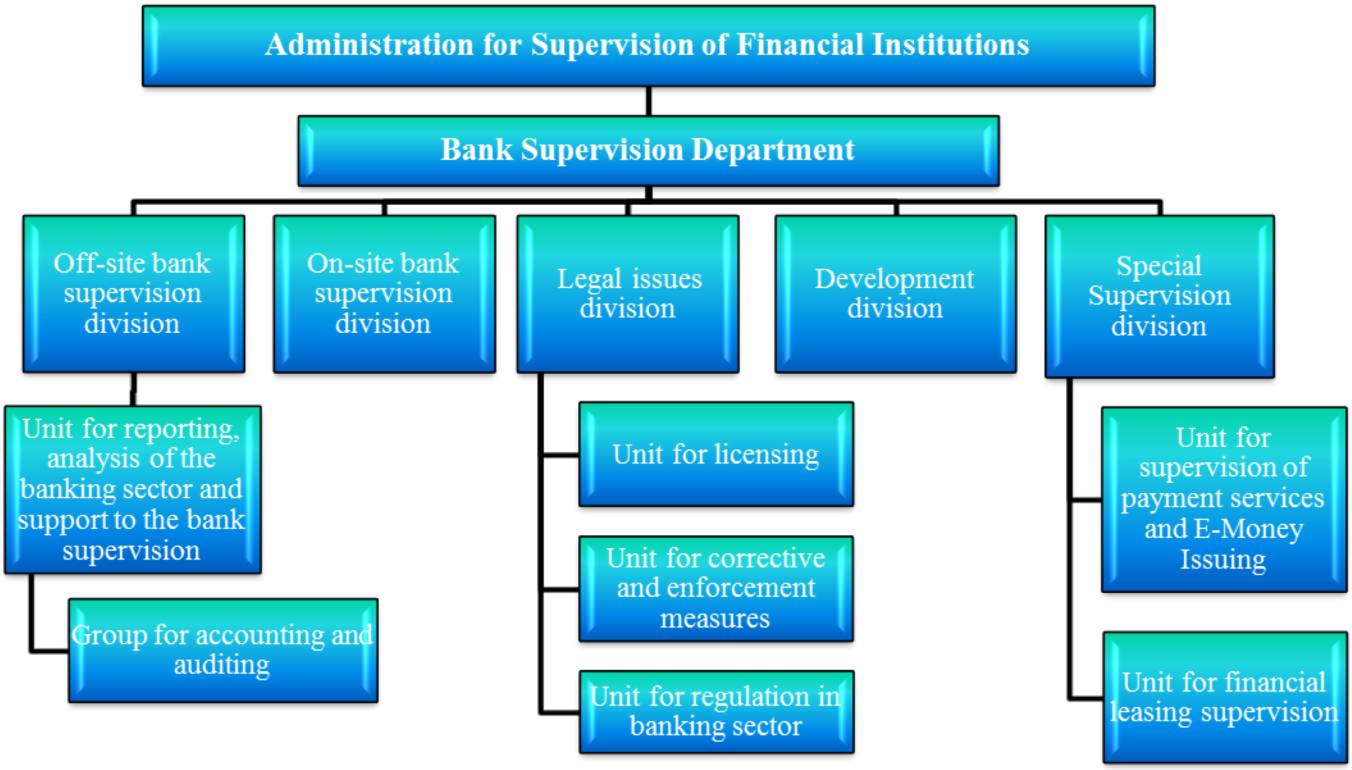
***Licensing and Approvals regarding Banks***

In 2015, National Bank of Serbia – Banking Supervision Department granted consent for the acts of a Bank's founding assembly, approved 43 requests for amendments of banks' founding acts and their articles of association. Also, 79 procedures regarding appointment of managing and executive board members (72 requests were approved, 7 procedures were terminated) and 8 procedures of direct acquisition of ownership in banks in Serbia (4 requests for acquisiton of an ownership in banks in Serbia were approved, 2 were dismissed and 2 procedures were terminated) were initiated.

Furthermore, 2 requests for acquisition of own shares were approved, 1 request for distributing bank's profit through payment of dividends to its shareholders was approved, 2 applications for approval for acquisition of subordinated company in financial sector was approved, 2 banks were permitted not to include a subsidiary in consolidated financial statements.

The National Bank of Serbia – Banking Supervision Department processed 171 notifications from banks regarding outsourcing of their business activities and processed 3 notifications from banks about their intent to include subordinated obligations into the supplementary capital.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



## INTERNATIONAL ACTIVITIES OF THE AUTHORITY

NBS has signed Memorandums of Understanding with banking supervision authorities of following countries: Austria, Belgium, Bosnia & Herzegovina and Republika Srpska, Cyprus, France, Germany, Greece, Hungary, Italy, Macedonia, Montenegro, Russia, Slovenia, Turkey and Memorandum of cooperation between the European Banking Authority (EBA) and the banking supervisory authorities of: Bosnia and Herzegovina, Republic of Srpska, Macedonia, Montenegro and Serbia, as well as several multilateral Memorandums of Understanding relating to supervisory colleges of banking groups including implementation of Written coordination and cooperation arrangements for colleges in accordance with EBA's recommendations.

However, even before the conclusion of mentioned memorandums and agreements, the NBS has already established very successful practical cooperation with all of the home supervisors of banks with subsidiaries in Serbia. Beyond signing formal agreements on understanding, cooperation and coordination, cooperation is extended through active participation of the NBS' representatives at Supervisory Colleges.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN SERBIA

In that respect and regarding its supervisory task NBS has signed Memorandums of Understanding with following domestic bodies and authorities:

- Deposit Insurance Agency,
- Securities Commission,
- Administration for the Prevention of Money Laundering,
- Tax Administration,
- Commission for Protection of Competition,
- Association of Serbian Banks and
- the Belgrade Stock Exchange.

The NBS successfully cooperates with all before mentioned supervisory authorities whenever there is a need for sharing information in accordance with MoUs signed. The cooperation with domestic regulatory authorities has been additionally enhanced by conclusion of the multilateral Agreement on cooperation and data exchange between the NBS, Ministry of Finance, Serbian Business Registers Agency, Central Securities Depository and Clearing House and Securities Commission in 2013.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

Within the context of Republic of Serbia and International Monetary Fund stand-by arrangement concluded on 23 February 2015 the NBS conducted the Special Diagnostic Studies (SDS) in cooperation with external auditors engaged as consultants.

The National bank of Serbia has undertaken a program of SDS of 14 banks operating in the Republic of Serbia (with total assets that account for 88% of total banking assets as of 31 March 2015) in line with similar initiatives in many EU countries. The key stated objectives of this exercise were to:

a) verify the health of the banking system by focusing on largest institutions and covering significant share of system assets;
b) dispel uncertainties about banks' asset quality by introducing uniform, conservatively calibrated methodology backed by mandatory collateral (re)valuations in line with internationally recognized valuation standards;
c) guide the regulatory and supervisory policies to follow, in particular in the domain of IFRS (such as enhancement of IAS 39 implementation in the form IAS 39 supervisory guidelines16).

In total, the exercise has not identified any capital shortfalls for 14 banks in scope. For that matter overall net SDS capital impact has confirmed the robustness and resilience of the Serbian banking system capital adequacy and resulted in relatively minor aggregate decrease of SDS adjusted CAR ratio by 176 bps (decrease from 20.21% CAR ratio to 18.45% SDS adjusted CAR ratio3).

NBS will use the studies to foster conservative implementation of IFRS accounting standards and disclosure practices and in addition diagnostics will be guided, to the extent possible, by strengthened collateral valuation standards and minimum requirements for appraisers. Moreover, NBS will use the experiences obtained thorough this exercise to strengthen its prudential framework and supervisory approach.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 32 | 30 | 30 |
| Branches of foreign credit institutions | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | **32** | **30** | **30** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 18.7 | 19.2 | 18.0 |
| Other domestic ownership | 6.9 | 6.3 | 5.9 |
| Domestic ownership total | 25.6 | 25.5 | 23.9 |
| Foreign ownership | 74.4 | 74.5 | 76.1 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 39.0 | 54.2 | 796 |
| Branches of foreign credit institutions | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | **39.0** | **54.2** | **796** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | -0.4 | 0.6 | 1.6 |
| Cooperative banks | | | |
| **Banking sector, total:** | **-0.4** | **0.6** | **1.6** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 100.0 | 100.0 | 100.0 |
| Branches of foreign credit institutions | | | |
| Cooperative banks | | | |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 10.0 | 17.0 | 15.9 |
| Nonfinancial sector | 51.9 | 49.3 | 49.2 |
| Government sector | 16.4 | 21.9 | 24.0 |
| Other assets | 21.7 | 11.8 | 10.9 |
| **Claims due to** | | | |
| Financial sector | 10.4 | 11.0 | 9.6 |
| Nonfinancial sector | 62.7 | 60.4 | 61.7 |
| Government sector | 4.1 | 6.3 | 7.3 |
| Other liabilities | 1.9 | 1.6 | 1.1 |
| **Capital** | 20.9 | 20.7 | 20.3 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013** | 2014** | 2015** |
|---|---|---|---|
| Commercial banks | 20.9 | 20.0 | 20.9 |
| Cooperative banks | | | |
| **Banking sector, total:** | **20.9** | **20.0** | **20.9** |

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

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | | | |
| **- households** | 9.43 | 10.30 | 10.87 |
| **- corporate** | 27.10 | 26.70 | 23.56 |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 89.7 | 89.5 |
| Households | 58.5 | 35.7 |
| Corporate | 22.2 | 43.8 |
| Government sector | 7.8 | 9.9 |
| Financial sector (excluding banks) | 2.5 | 0.6 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 1,709,141 | 1,513,152 | 1,410,588 |
| Interest expenses | 671,911 | 482,061 | 343,505 |
| Net interest income | 1,037,230 | 1,031,092 | 1,067,083 |
| Net fee and commission income | 303,525 | 287,913 | 287,144 |
| Other (not specified above) operating income (net) | 78,747 | 125,235 | 154,476 |
| Gross income | 1,419,502 | 1,444,239 | 1,508,702 |
| Administration costs | 839,573 | 867,739 | 876,629 |
| Depreciation | 70,646 | 63,931 | 62,050 |
| Provisions | 0 | 0 | 0 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 527,760 | 483,505 | 490,092 |
| Profit (loss) before tax | -18,477 | 29,065 | 79,931 |
| Net profit (loss) | -30,470 | 18,870 | 61,239 |

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds | Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 2,990,746** | N.A. | 2,685,483** | 305,263** | |
| Cooperative banks | | | | | |
| **Banking sector, total:** | **2,990,746**** | **N.A.** | **2,685,483**** | **305,263**** | |

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

# 2015 DEVELOPMENTS IN THE SLOVAKIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Slovak economy continued at growing trend, when increased by 3.6% in 2015. However structure of its growth has changed, when domestic demand became the main driver of economic growth in last two years, driven by EU funds´ drawing and household consumption. Favorable development at labor market that mirrored in an increase of employment back to pre-crisis levels, together with real wage increase has reflected in improved economic sentiment and stronger household consumption. Slovak economy is expected to growth also in 2016, however the growth dynamics are expected to decelerate due to lower expenditures from EU budget after termination of previous EU budget programming period and only slow onset of new programming period. Favorable development at labor market is expected to continue also in 2016 with positive impact on decrease of unemployment rate. Prices have declined in 2016 by -0.3% and will probably continue to decrease, although by moderate pace, also during this year. Main driver of price decrease are energy prices, while inflation excluding the energy and food prices remained positive. Nonfinancial corporation revenues accelerated in 2015, driven by favorable economic development and positive sentiment. From the macroprudential policy perspective actual economic development has positive effect on financial system, however mirrors also in increase appetite for new loans and in an increase of private debt.

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

The annual rate of growth of the volume of retail loans have stabilized during 2015 at relatively high level exceeding 12% at end-December. The growth rate kept to belong between the highest dynamics among EU countries. Significant growth rate was driven by development in both main categories of loans, housing loans and consumer loans. Demand and supply side of the retail loans market was mainly influenced by increasing bank's competition, decreasing interest rates together with growing average salaries and positive prospects in the real estate market. Lending standards have rather tightened, to a large extent, due to NBS Recommendation No 1/2014, which have contributed to the more prudent lending.

Year 2015 saw a gradual upturn in lending activity in the corporate sector, which led to the fastest loans growth in the post-crises period. Growth in corporate lending was driven by private firms in domestic or foreign ownership, while development in the segment of state-owned firm contributed negatively. Relatively robust lending upturn could be observed, as most of economic sectors as well as segment of small and medium sized firms have experienced growth in lending. Demand was mainly fueled by favorable economic prospects, while supply side was driven by decreasing interest rates and easing of some lending conditions.

The total volume of bond investments remained without significant changes in 2015, however the declining trend in investments in domestic government bonds continued. Nevertheless, share of these bonds as a percentage of total assets of the banking sector remained one of the highest in EU.

Looking at above mentioned trends, the total assets-to-GDP ratio increased from 87% at the end of 2014 to 90% at the end of 2015.

The credit quality of both, retail and corporate sector experienced an improvement.

Domestic banking sector is further characterized by sound funding structure, owing to customer's deposits, that are dominant and stable form of financing. Customer's deposits continued to growing at the pace of 9% at the end of 2015. Loan-to-Deposit ratio stayed well below level of 100% and remained below average in comparison with EU countries.

Net profit in the Slovak banking sector achieved €626 milion, representing an increase of 11.7% on year-on-year basis. As in the previous year, the main drivers of increasing profit were growth in retail lending, accompanied by a fall in the price of financing and a fall in credit risk costs. Declining rate of return on loans had main negative impact on bank's profit. Fall in expenses on the payment of bank levy and contributions to the Deposit Protection Fund were one-off factors that contributed positively to the profitability of the banking sector.

Resistance of domestic banking sector to potential risks remained high, as capital adequacy ratio reached 17.7% at the end of 2015 and average leverage ratio stayed at satisfactory level slightly below 8%.

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

The National Bank of Slovakia performs supervision of the financial market.

As part of its supervision of the financial market, the National Bank of Slovakia shall perform supervision of banks, branch offices of foreign banks, securities dealers, branch offices of foreign securities dealers, stock exchanges, central depositories, asset management companies, branch offices of foreign asset management companies, mutual funds, foreign collective investment undertakings, insurance companies, reinsurance companies, branch offices of foreign insurance companies, branch offices of foreign reinsurance companies, branch offices of insurance companies from another state, branch offices of reinsurance companies from another state, pension asset management companies, pension funds, supplementary pension insurance companies, supplementary pension companies, supplementary pension funds, payment institutions, branch offices of foreign payment institutions, rating agencies, electronic money institutions, branch offices of foreign electronic money institutions, independent financial agents, financial advisers, the Deposit Protection Fund, the Investment Guarantee Fund, the Slovak Bureau of Insurers, consolidated groups, sub consolidated groups, financial holding institutions, mixed financial holding companies, financial conglomerates, also over other persons, other property associations with a designated purpose and over groups of persons and property associations with a designated purpose.

The Single Supervisory Mechanism (SSM) is a new system of financial supervision that officially entered into operation on 4 November 2014. It comprises the European Central Bank and the national competent authorities (NCAs) of mainly euro area countries, including Slovakia. The basis of the SSM is cooperation between the ECB and NCAs, with Národná banka Slovenska operating as the NCA in Slovakia. For the purposes of the SSM, banks (credit institutions) are categorised into "significant" and "less significant" institutions, with the ECB directly supervising significant banks, while NCAs are in charge of the supervision of less significant banks. The criteria used to assess whether a credit institution falls within the significant or less significant institution category are set out in the respective EU legislation.

Throughout year 2015, the financial market supervision unit began to execute a new activity - regulation of non-banking consumer credit providers. This type of loans can provide only subjects with license from National Bank of Slovakia. Entity with National Bank of Slovakia license becomes supervised entity, whose activity is supervised by off-site supervision and on-site supervision.

The second new area, which the financial market supervision unit began to execute, was the protection of consumers in the financial market. National Bank of Slovakia has been authorized as the body of consumer protection for the Slovak financial market effective from 1 January 2015. The aim of the National Bank of Slovakia is contribute to prevent breaches in consumer law, in order to remedy the situation as soon as possible and not to repeat the practices which in the past led to significant consumer dissatisfaction. In this context a particular challenge is consumer protection in the field of non-bank consumer credit, which National Bank of Slovakia took during 2015. There was also monitored the situation in performance of the obligations and the rules of supervised entities, there were created several legislative changes responding to damage the rights and consumer interests, there were carried out the first on-site supervisions and there were launched several penalty proceedings. Attention was also concentrated upon financial education and awareness of the general consumer public.

In cooperation with the Ministry of Finance, NBS prepared an amendment to the Resolution Act, in order to improve the legal framework for the prevention and resolution of crisis situations in the Slovak financial market. The amendment was designed to better align the transposition of the Bank Recovery and Resolution Directive (BRRD)with the Slovak law.

NBS, working closely with the Ministry of Finance, also prepared a law on housing loans, designed to implement the Mortgage Credit Directive and to create a legal framework for the effective functioning of the housing loan market within the harmonised internal market of the EU. This law stipulates conditions for the provision of housing loans and other services, procedures for the conclusion of housing loan agreements, the due form of such loan agreements and other particulars needed for the provision of housing loans.

In connection with the implementation of the new single European regulatory framework for banks, i.e. the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV), NBS continued to prepare further legal regulations in 2015, especially NBS decrees.

NBS prepared a decree stipulating the details of additional types of risks, the details of the risk management systems of banks and branches of foreign banks, and the details of what is meant by a ‘sudden and unexpected change in market interest rates.’

The risks related to asset encumbrance and their management were taken into account in the drafting of a decree amending the decree on information disclosure by banks and branches of foreign banks. In compliance with the EBA Guideline, the new decree was designed to extend the list of financial indicators to include a new item to be published, i.e. information about encumbered and unencumbered assets.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

Role and objectives of the NBS´s Financial Market Supervision Unit is defined by relevant legal rules. The objective of the integrated financial market supervision is to contribute to the stability of the financial market as a whole, as well as to the secure and sound operation of the financial market in the interest of maintaining credibility of the financial market, protecting clients, and respecting the competition rules.

There were no detailed strategic objectives in a formalised form defined for 2015.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

As at 31 December 2015, there were 13 banks and 14 branches of foreign banks operating in the banking sector of Slovakia. Under the Single Supervision Mechanism (SSM, a framework for cooperation between the ECB and the competent national authorities), banks (credit institutions) are categorised into:

- significant banks – supervised directly by the ECB (Tatra banka, a.s.; Všeobecná úverová banka, a.s.; Slovenská sporiteľňa, a.s.; Československá obchodná banka, a.s., and ČSOB stavebná sporiteľňa, a.s., both belonging to the KBC Group; and Sberbank Slovensko, a.s., belonging to Sberbank Europe AG); and
- less significant banks – supervised directly by NBS (other banks with a registered office in Slovakia).

Within the scope of the SSM, the ECB has assumed certain powers in the area of authorisation, too. It conducts authorisation proceedings in close cooperation with NBS. The ECB issues decisions concerning the granting or revocation of authorisations and the acquisition of qualifying holdings in relation to both significant banks and less significant banks. It also assesses the eligibility of board members and supervisory board members, but only for significant banks.

Proceedings in matters falling within the ECB's competence are also commenced before NBS. In such cases, NBS assesses the relevant application according to Slovak law, and the ECB does so according to the EU law. In total, 108 proceedings were commenced in the year under review: 82 within the competence of NBS and 26 within the competence of the ECB.

In regard to the banking sector, NBS conducted 94 authorisation proceedings during the year: 12 were instituted in 2014 and 82 were completed in 2015 with the issuance of a final decision. Most of the decisions concerned the granting of prior approval to appoint new members of the statutory body, members of the supervisory board, managerial employees or company secretaries.

The ECB conducted a total of 29 authorisation proceedings in 2015. Three of these proceedings were instituted in 2014 and 22 were completed in 2015 with the issuance of a final decision. Most of the decisions concerned the eligibility of members of the statutory body and members of the supervisory board of banks.

In 2015 no sanction proceedings were initiated in regard to the banking sector. One of the two proceedings brought in 2014 was completed in 2015 with the issuance of a final decision.

In 2015 NBS received one notification from a foreign bank (BNP Paribas Personal Finance S.A.) that intended to establish a branch in Slovakia and registered 14 foreign credit institutions that reported their intention to provide cross-border banking services in Slovakia, without establishing a branch. The branch of The Royal Bank of Scotland plc ended its activities in Slovakia in 2015.

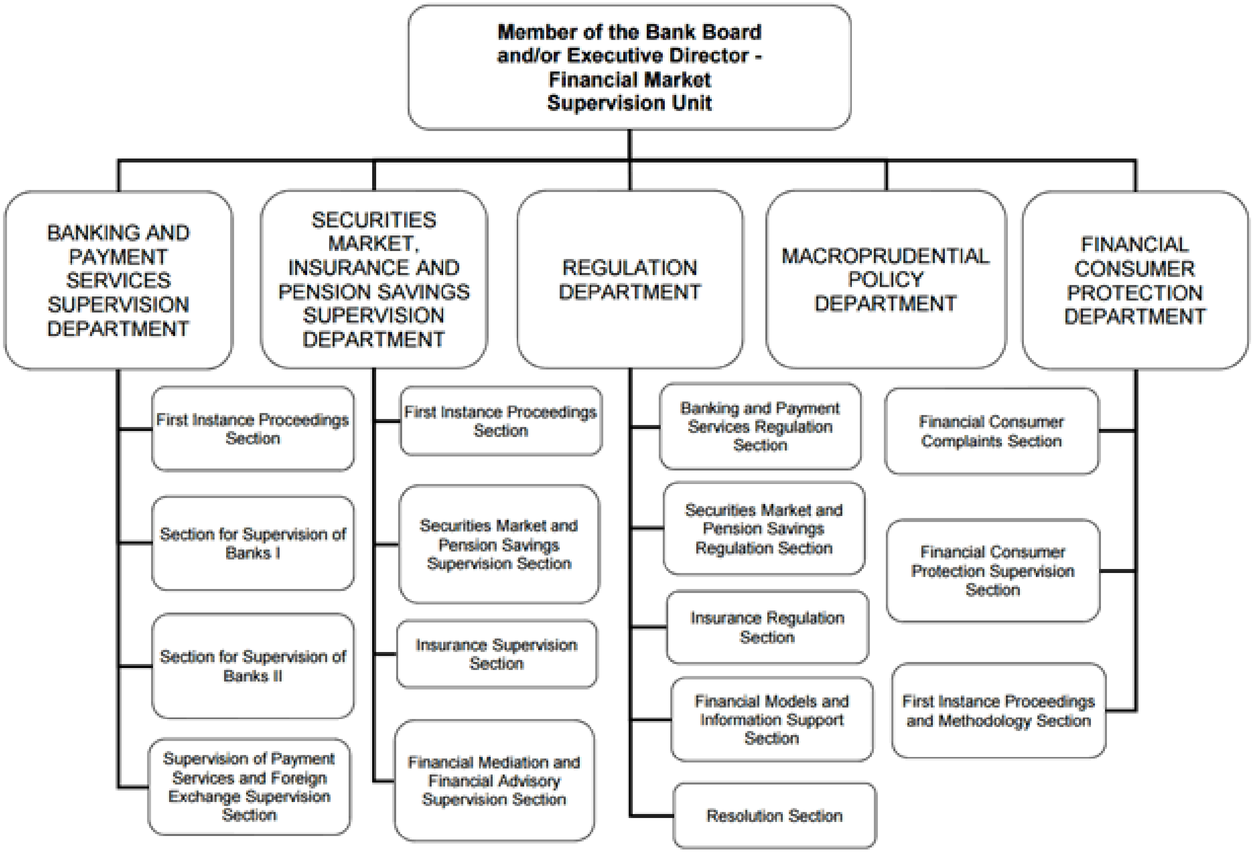
In 2015 eight thematic on-site inspections were carried out in banks and branches of foreign banks. Within the scope of these inspections, the supervisors examined seven applications for the use of, or for a change in, an internal risk measurement model for capital requirement calculation for credit risk and one application for the use of an internal model for capital requirement calculation for operational risk. One of the top priorities of on-site inspections was to assess the effectiveness of banks' risk management systems, the provision of investment and payment services, and the protection of banks against money laundering and terrorist financing.

The performance of on-site inspections in significant banks (falling within the ECB's competence) was brought into line with the principles of the SSM during 2015. Inspections in such banks were carried out by the staff members of NBS on the basis of the ECB's authorisation.

In exercising off-site supervision, the supervisors examined the regular statements and reports of banks and branches of foreign banks, analysed the risk profiles of individual banks, performed tasks in the ECB's joint supervisory teams and supervisory colleges for individual banks, and carried out comprehensive evaluations, including an evaluation of banks' risk profile, internal capital adequacy, own-funds adequacy and liquidity. This was followed by a joint assessment of the risk profile and ownfunds adequacy of bank groups, which also include banks from the Slovak banking sector. The joint assessment led to the adoption of joint decisions by the participating supervisors. For the needs of a joint assessment of bank groups in terms of risk and capital, the supervisors also compiled detailed risk profile reports for the consolidating supervisors of banks that are the subsidiaries of banks established in other EU countries.

Banks that are subject to direct supervision by the ECB have set up joint supervisory teams to exercise supervision over banks on a continuous basis. These supervisory teams are responsible for the supervision of banks established in Slovakia. They perform this function in close cooperation with the Financial Market Supervision Unit of NBS. The most important task of these teams in 2015 was to carry out an annual evaluation of banks in accordance with the principles of the SSM. The results of this annual evaluation were taken into account in the joint decisions.

# ORGANISATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY




# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The representatives of the Banking and Payment Services Supervision Department are members of the EBA Board of Supervisors. Several employees have been nominated as members of all working groups across the four Standing Committees and the EBA Review Panel.

An essential part of the banking supervision constitutes the cooperation with supervisory bodies which supervise parent institutions of subsidiaries based in Slovakia. This cooperation is realized mainly through the colleges of supervisors for the respective banking group.

Throughout the year 2015, National Bank of Slovakia continues in activities in cooperation with the EBA focus within its various committees particularly on the development of technical and regulatory standards arising from the provisions adopted by the European legislation - Regulation CRR and CRD IV.

Also, throughout the year 2015, National Bank of Slovakia has taken active participation in the negotiations and teleconferences in the preparation of the Regulation of European Central Bank in area of options and national discretions under the provisions of CRR / CRD IV. This Regulation concerns significant banks in the euro area and in Slovakia will be directly applied to the six significant banks.

Other entities, including less significant banks, will be further underlined to national options and discretions, thus regulating by National Bank of Slovakia. In connection with the initiative of European Central Bank (recommendation) in area of options and national discretions, also for less significant banks will be challenge for National bank of Slovakia to deal with the possible recommendation from European Central Bank.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN SLOVAKIA

NBS is the only national supervisory body supervising regulated entities of the Slovak financial market. Slovak Ministry of Finance has only certain minor supervisory tasks in this area, such as oversight over state subsidies for mortgage banks.

Nevertheless, the Banking and Payment Services Supervision Department communicates with all relevant sector associations, especially within the processes of preparation of regulation, recommendations and guidelines. In addition to that, there is a close cooperation among the NBS, the Ministry of Interior and the Police Headquarters.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

In January 2015 the Resolution Council (‘the Council’) was established as the national resolution authority for institutions in Slovakia’s financial sector, as part of the Single Resolution Mechanism (the second of the banking union’s three pillars). Resolution in the financial sector means the restructuring of a financial institution or group which is in difficulties. NBS provides expertise to the Council and organises its functioning. These tasks are carried out by the bank’s Resolution Section, a part of the Regulation Department.

As from 1 January 2015 NBS assumed responsibility for financial consumer protection in Slovakia. In this role, the bank supervises the protection of financial consumers’ and other clients’ rights in order to support the secure and sound functioning of the financial market.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 13 | 13 | 13 |
| Branches of foreign credit institutions | 15 | 15 | 14 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total:** | **28** | **28** | **27** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 0.8% | 0.9% | 0.8% |
| Other domestic ownership | 0.4% | 0.4% | 0.4% |
| Domestic ownership total | 1.2% | 1.3% | 1.2% |
| Foreign ownership | 98.8% | 98.7% | 98.8% |
| **Banking sector, total** | **100.0** | **100.0** | **100.0** |

### Concentration of asset by the type of financial institutions

| Type of financial institution | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 64.0 | 82.9 | 1623 |
| Branches of foreign credit institutions | 72.6 | 84.9 | 3072 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **54.7** | **72.3** | **1250** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 11.69 | 10.30 | 11.05 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **11.69** | **10.30** | **11.05** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 85.9 | 85.8 | 85.4 |
| Branches of foreign credit institutions | 14.1 | 14.2 | 14.6 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 11.4 | 11.9 | 12.1 |
| Nonfinancial sector | 62.2 | 63.4 | 64.2 |
| Government sector | 20.9 | 19.2 | 18.7 |
| Other assets | 5.5 | 5.6 | 5.0 |
| **Claims due to** | | | |
| Financial sector | 10.4 | 10.9 | 10.4 |
| Nonfinancial sector | 64.8 | 64.0 | 64.9 |
| Government sector | 1.7 | 2.0 | 2.8 |
| Other liabilities | 8.5 | 8.9 | 8.6 |
| **Capital** | **14.6** | **14.2** | **13.4** |

**Capital adequacy ratio of banks (%)**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 17.23** | 17.35*** | 17.75*** |
| Cooperative banks | - | - | - |
| Banking sector, total: | **17.23**** | **17.35***** | **17.75***** |

(* - 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 | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 5.28 | 5.50 | 4.97 |
| **- households** | **4.16** | **4.32** | **3.89** |
| **- corporate** | **8.13** | **8.61** | **7.30** |

**The structure of deposits and loans of the banking sector in 2015 (%) (at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 88.6 | 95.2 |
| Households | **60.6** | **56.5** |
| Corporate | **28.0** | **38.7** |
| Government sector | 3.3 | 2.2 |
| Financial sector (excluding banks) | 8.1 | 2.6 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 2 399 937 | 2 396 875 | 2 275 894 |
| Interest expenses | 586 234 | 494 502 | 417 293 |
| Net interest income | 1 813 703 | 1 902 373 | 1 858 601 |
| Net fee and commission income | 439 043 | 469 860 | 521 453 |
| Other (not specified above) operating income (net) | -136 697 | -219 458 | -159 412 |
| Gross income | 2 156 786 | 2 175 500 | 2 229 049 |
| Administration costs | 1 027 764 | 1 073 520 | 1 082 506 |
| Depreciation | 138 722 | 134 285 | 134 193 |
| Provisions | 219 041 | 198 032 | 170 303 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 1 593 930 | 1 544 198 | 1 478 411 |
| Profit (loss) before tax | 730 522 | 746 938 | 833 640 |
| Net profit (loss) | 549 369 | 560 224 | 626 032 |

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 5 580 405 031*** | 5 035 663 031*** | 5 185 663 031*** | 394 742 000*** | -*** |
| Cooperative banks | | | | | |
| **Banking sector, total:** | **5 580 405 031*** ** | **5 035 663 031*** ** | **5 185 663 031*** ** | **394 742 000*** ** | **-*** ** |

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

# 2015 DEVELOPMENTS IN THE SLOVENIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

Economic growth remained relatively high in 2015. The gradual recovery in domestic consumption continued, and contributed two thirds to overall GDP growth of 2.9%. Growth in household consumption has strengthened, but continues to be curbed by low wage growth, in part due to the increased employment of low-income workers, and by growth in precarious forms of employment. Growth in gross fixed capital formation was down sharply last year due to the fall in construction investment. This was the result of the end of a strong government investment cycle prompted by the uneven disbursement of EU funds. After years of rapid corporate deleveraging, growth in investment in machinery and equipment began to strengthen and exceeded 8% in year-on-year terms. Domestic demand has also recovered, in part due to more growth-friendly fiscal consolidation, which facilitates weak growth (of 0.7%) in final government consumption. Net exports contributed close to one third or 1 percentage point to last year's GDP growth, as real export growth exceeded 5%.

For the second year in a row employment continued to rise. Employment was 1.4% higher on average, with employment in the sectors of wholesale and retail trade, accommodation and food service activities, and manufacturing contributing most to that rise. Uncertain forms of employment remained prevalent, as self-employment accounted for more than a third of the rise in employment. The number of registered unemployed was down more than 6% last year to stand at 113,000 at the end of the year. The registered and surveyed unemployment rates were both down. The latter had fallen to 8.4% by the end of the year, which is well below the euro area average. The largest factor in the fall in unemployment was a decline in the number of people newly registering as unemployed, while the number of deregistrations caused by a decline in subsidised jobs also fell. The labour market reforms of 2013 are no longer having the desired effects, as the proportion of temporary new hires is rising again and the proportion of those registering as unemployed because their temporary employment has ended its increasing. Nominal wage growth lagged behind economic activity last year and fell to just 0.7%, partly as a result of the increased employment of low-wage workers.

Annual inflation as measured by the HICP averaged -0.8% in Slovenia in 2015, the lowest figure to date, down 1.2 percentage points on the previous year. Slovenia thus recorded deflation in 2015 for the first time since price growth began to be measured by the HICP. Most notably there was a sharp fall in energy prices due to the fall in oil prices on global markets. Core inflation as measured by the HICP excluding energy and food was thus down 0.4 percentage points on the previous year.

Slovenia ranked as one of the euro area countries with the highest deflation rates in 2015.

The increase in the current account surplus slowed in 2015. The surplus stood at 7.3% of GDP at the end the year, compared with of 7.0% of GDP at the end of 2014. Growth in nominal merchandise exports remained solid, despite the expected slowdown due the specific cycle of Slovenia's automotive industry, while a positive season in the tourism sector contributed to growth in exports of services.

Slovenia was a net financer of the rest of the world in 2015 in the amount of EUR 2.0 billion, compared with EUR 2.3 billion in 2014. External debt was down in 2015 due to debt repayments by all sectors, except the general government.

Slovenia's main objective in the fiscal realm in 2015 was to sustainably eliminate the excessive general government deficit, which is a condition for exiting the excessive deficit procedure. With a reduction in the general government deficit to 2.2% of GDP, that objective has been achieved. Contributing to the reduction in the general government deficit by 2.7 percentage points were the more favourable economic situation and measures to raise general government revenues (e.g. the introduction of contributions for student health and pension insurance, and a higher tax rate on financial services and insurance transactions), while the effect of one-off factors was considerably less.

The general government debt increased to 83.0% of GDP. Other factors contributed to the rise in debt beside the deficit, in particular an increase in deposits for hedging against currency risk for bond issues in US dollars. The required yield on Slovenian government bonds averaged 1.66% during the year, a decrease on the previous year. Guarantees and sureties amounted to 18.3% of GDP at the end of 2015, a decrease relative to 2014, due to the maturity of certain bank bonds and loans to non-financial and financial corporations that were secured by government guarantees.

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

At the end of 2015 there were 16 banks, three savings banks and four branches of foreign banks operating in Slovenia. The banks held a market share of 95% of the banking system in terms of total assets. The number of credit institutions was down one on the previous year. Following the recapitalisations carried out by the Slovenian government based on decisions regarding state aid in 2013 and 2014, the level of government ownership exceeded 60% for the second consecutive year. The proportion of equity held by non-residents amounted to around 30% in December, while other domestic entities accounted for the remaining ownership stake.

The contraction in the banking system's total assets continued last year, but at a slower pace than previous years. The banking system's total assets declined by EUR 1.3 billion last year to EUR 37.4 billion, a decrease of 3.4% in year-on-year terms. The main factors in the decline in total assets were the banks' repayment of debt on the wholesale markets, and the continuing contraction in lending activity on the asset side. Total assets were down in 2015 for the sixth year in succession, while the ratio of the total assets of banks and savings banks to GDP fell to 97%, a decrease of 49 percentage points relative to the situation in the middle of 2010, when that ratio reached its highest value since independence.

The capital position of the Slovenian banking system improved in 2015, but significant differences between bank groups remain. The small domestic banks are more exposed than the other banks. The more notable improvement in 2014, when capital adequacy exceeded the euro area average, was the result of stabilisation measures imposed on certain state-owned banks. The banks further improved their capital position in 2015 by generating positive operating results and through minor recapitalisations. A further reduction in lending activity also contributed to the improvement in capital adequacy. An additional factor that affects growth in lending is the commitment given by banks receiving state aid to the European Commission (EC) regarding a contraction in operations.

Lending to the non-banking sector continued to contract, but at a slower pace. The year-on-year decline in loans to the non-banking sector stood at 5.5% at the end of the year. The improved economic environment and reduced corporate debt are resulting in gradual growth in demand for corporate loans. Credit standards for corporate loans are high in the context of a persistently high proportion of non-performing claims, but have not tightened further. The supply of bank loans was not limited by the banks’ access to funding sources. After a three-year decline, loans to households began to record growth again in May 2015. Year-on-year growth in housing loans stood at 2.9% in December, while the decline is consumer loans eased.

The quality of the banks’ credit portfolio improved in 2015. The proportion of claims more than 90 days in arrears[35] had declined to 9.9% by December compared with 11.9% at the end of 2014. The trend of declining credit risk declined as a result of forbearance and write-offs, and as a result of the favourable impact of economic growth. Coverage of claims more than 90 days in arrears by impairments, bank capital and collateral improved.

The banks’ deleveraging process on the wholesale markets has slowed, while the banking system maintains a good liquidity position. The banks have reduced their dependence on foreign funding significantly in recent years. At 12.4%, the proportion of total funding accounted for by foreign sources is merely a third of the proportion of foreign funding during the pre-crisis period when it stood at 36%. The favourable liquidity position is reflected in a high first-bucket liquidity ratio, a high proportion of the pool of eligible collateral at the Eurosystem that is free, and in a stable stock of secondary liquidity.

The importance of funding accounted for by deposits by the non-banking sector has risen further, but the shortening of the maturity of the aforementioned source makes it less stable. Deposits by the non-banking sector (the most important being household deposits) accounted for more than two thirds of bank funding at the end of 2015. Growth in household deposits reached 3.1% in 2015, despite low interest rates. The overall maturity of deposits by the non-banking sector is shortening due to low interests rates, making the aforementioned source less stable due to the possible shift of a portion of deposits to alternative investments, or to consumption and investment.

The banks generated a pre-tax profit of EUR 158 million in 2015. Net interest was down by 10% due to falling interest rates and the continuing contraction in bank balance sheets, with both, interest expense and interest income falling sharply, the former by 42% and the latter by 22%. The banking system’s gross income was down 9% on the previous year. The improved quality of the portfolio is having a decisive impact on the banks’ profitability via lower impairment and provisioning costs. After generating a loss for five years, the banking system generated a pre-tax profit of EUR 158.3 million in 2015.

[35] The proportion of claims according to this definition (more than 90 days in arrears) is used for reporting to the IMF

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

The Financial Stability Board (FSB) is a macro-prudential authority that comprises representatives from supervisory authorities, such as the Bank of Slovenia (principally represented by banks and branches of foreign banks), the Insurance Supervision Agency and the Securities Market Agency, as well as the Ministry of Finance.

The FSB was established with the entry into force of the Macro-prudential Supervision of the Financial System Act (hereinafter: the ZMbNFS; Official Gazette of the Republic of Slovenia, No. 100/13). On the basis of the aforementioned act, the board is responsible for formulating and implementing macro-prudential policy in the Republic of Slovenia with the objective of helping protect the stability of the entire financial system by the strengthening its resilience and reducing accumulated systemic risks, thereby ensuring that the financial sector is able to make a sustainable contribution to economic growth.

The ZMbNFS assigns the lead role within the FSB to the Bank of Slovenia by appointing the Governor of the Bank of Slovenia as the president of the FSB with the power to convene and chair sessions, while the Bank of Slovenia is given the power to ensure the functioning of the FSB's secretariat.

The FSB reports to the National Assembly of the Republic of Slovenia once a year with regard to its work and to EU authorities and the ESRB as necessary.

According to the Bank of Slovenia Act the central bank carries out supervision of credit institutions in order to maintain the stability and security of their operations and for the creation of confidence in the banking system, particularly among savers and depositors. In accordance with the statutory mandate the tasks of the Banking Supervision Department of the Bank of Slovenia include in particular the performance of licensing, authorisation and notification procedures for the work of these institutions, giving consent for members of boards of management to hold their offices in banks, and other authorisations and consents prescribed by The Banking Act, the performance of on-site inspection in banks, collecting and analysing quantitative and qualitative information from supervised entities and other sources, cooperate with other supervisors in the country and outside, participate actively at international supervisory forums, working groups and colleges.

With the aim of operationalising macro-prudential policy the Bank of Slovenia set out a strategic framework for macro-prudential policy for the banking sector, which builds on the Bank of Slovenia's Macro-Prudential Policy Guidelines published in early 2015. The strategic framework has provided a basis for conducting macro-prudential policy using instruments under the Bank of Slovenia's direct control.

The Bank of Slovenia developed two more macro-prudential instruments in 2015: the countercyclical capital buffer and the capital buffer for other systemically important institutions (O-SIIs). The purpose of the countercyclical capital buffer is to protect the banking system against potential losses when excessive growth in lending is linked to an increase in risks in the system as a whole. The reason for the special regulation of systemically important banks (O-SIIs) is that their collapse could endanger financial stability and could lead to significantly larger adverse effects on the financial system and the entire economy than could the collapse of a systemically unimportant institution.

Looking ahead, the financial sector is faced with new challenges associated with regulatory and institutional changes and the prevailing macroeconomic environment. Regulation and supervision is being strengthened to make the future of the banking system more stable and less crisis-prone. Hence, prudential rules have been established that requires putting in place new requirements on, among other things, quality and quantity of capital (in the form of several layers of capital buffers). In Slovenia, these requirements have been incorporated in the new Banking Act. The requirements of the new regulatory framework will impose higher costs on banks. In addition, the business models of banks have to adapt to the low-interest environment. The outlook is therefore of low bank profitability.

Among the more important matters discussed by the Governing Board of the Bank of Slovenia in 2015 were the guidelines adopted for the Bank of Slovenia's macro-prudential policy, the strategic framework of macro-prudential policy for the banking sector, two macro-prudential measures (the countercyclical capital buffer and the capital buffer for other systemically important banks) and a comprehensive package of secondary legislation on the basis of the ZBan-2, the Bank of Slovenia Act, the Bank Resolution Authority and Fund Act and the Commemorative Coins Act. A total of 58 regulations were adopted in the area of banking supervision, while three regulations were adopted in the area of payment and settlement systems and cash operations. A total of 112 decisions on individual matters in the area of banking supervision and 28 decisions in the area of payment and settlement systems and cash operations were also adopted.

In addition, the Bank of Slovenia issued three guidelines for the area of credit risk management last year, namely the Guidelines for monitoring customers and early warning systems (EWSs) for increased credit risk, the Guidelines for the management of doubtful claims and the Guidelines for calculating default rate and loss rate. The aforementioned guidelines provide a detailed definition of individual elements of credit risk management that are of particular importance in situations when banks face a relatively large proportion of non-performing and forborne exposures in their portfolios.

A significant number of regulations on the application of guidelines and recommendations were adopted in connection with guidelines and recommendations adopted by the EBA. This is a new regulatory instrument pursuant to Article 13 of the ZBan-2, by which the Bank of Slovenia decides on the compliance with individual EBA guidelines or recommendations as required by the Regulation establishing the EBA[36] in a transparent, standardised and consistent manner. The regulatory framework was supplemented by numerous interpretations of European and domestic legislation and clarifications in connection with its implementation submitted to banks and other interested parties. In this way the Bank of Slovenia is contributing to the enforcement of the Single Rulebook as the first pillar of the banking union in the Slovenian banking environment.

In its regulatory activities last year the Bank of Slovenia also focused on banks' internal governance and corporate governance arrangements. In addition to the significant upgrade of content in this area in the ZBan-2, a new Regulation on internal governance arrangements, the management body and the internal

23Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

capital adequacy assessment process for banks and savings banks was adopted, which fundamentally upgraded the two regulations that had governed this area until the entry into force of the new regulation.

Within the framework of its supervisory activities last year, the Bank of Slovenia overhauled reporting by banks in the area in question, issued a series of guidelines encouraging banks to take a more structured approach to the restructuring of non-performing exposures (Guidelines for creating impairments and provisions for exposures to restructured customers, Guidelines for monitoring customers and early warning systems for increased credit risk, Guidelines for managing problem claims), required the preparation and submission of plans to reduce non-performing exposures and put in place a structured process for monitoring corporate master restructuring agreements.

In 2015 the Bank of Slovenia encouraged the creation of and participated in the drafting of the Guidelines for managing the non-performing claims of SMEs, which introduce detailed guidance for the actions of banks into banking practice. The guidelines will aid the senior management of banks in making faster decisions, which will lead to the comprehensive restructuring of firms, and not merely to the continuation of the existing (often inviable) situation, and require good and fair conduct of the owners and senior management of these firms, including the disclosure of all material information, the observation of the banks' requirements, and additional financial investment by owners in the form of personal guarantees or recapitalisation.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

The Bank of Slovenia will devote most attention to supervisory activities, through which it aims to encourage better management of non-performing exposures. These notably include:

- **Preparation of individual plans to reduce non-performing exposures.** The Bank of Slovenia is planning to resolve issue within the framework of monitoring individual plans to reduce non-performing exposures drawn up by the individual banks.
- **Optimisation of restructuring processes at the banks with eliminating** collective and individual deficiencies in the organisation of the restructuring processes at the banks, and to apply standardised best practice in the organisation of the restructuring processes.
- **Creation of EWSs for monitoring exposures** In light of the importance of the EWS as a preventive tool, the Bank of Slovenia will issue guidelines on the minimum requirements for the creation of an EWS on the basis of best banking practice and the results of the analysis.
- **Overhaul of reporting to the Bank of Slovenia on progress in restructuring.** To reduce the reporting workload on the banks and to improve the quality and usefulness of existing reports on progress in restructuring, the Bank of Slovenia will overhaul the reporting methods used to date.
- **Establishment of guidelines for fundamental restructuring that is sustainable in the long term.** The financial restructuring of a large number of firms that are over-leveraged yet have good long-term prospects has stabilised the situation to a considerable extent. Now the

need is for operational and ownership restructuring, for firms to be able to invest more significantly in their development and in expanding turnover. Given that a large number of stakeholders are involved in these processes, the guidelines will help to make the process faster and more effective.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

Following the introduction of the Single Supervisory Mechanism (SSM) under the aegis of the ECB in 2014, there were extensive adaptations in 2015 to the new supervisory regime. This has had a significant impact on the powers, procedures, workload and organisation of the supervisory institutions in each country. The establishment of the SSM brought significant European banks under the direct supervision of the ECB. In operational terms supervision of these banks is conducted by Joint Supervisory Teams (JSTs), which consist of ECB coordinators and members of the national supervisory authorities. The national supervisory authorities participate in all the supervisory activities, while the supervisory decisions with regard to these banks are made by the ECB. The supervision of less significant banks, which is the responsibility of national supervisors, is conducted in accordance with the rules and methodology of the ECB and the SSM. National supervisors regularly submit supervisory data for less significant banks to the ECB, and inform it of the findings of their supervision. The national supervisory authorities may consult the ECB on the issue of measures, but the final decision is their responsibility, other than in exceptional cases when serious breaches have been found in supervision. The new arrangements also allow the ECB to directly take over the supervision of less significant banks 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.

The supervision and monitoring of significant banks is undertaken via ongoing supervision, which is conducted by the members of the JST[37], and via on-site inspections at the banks. Inspections are coordinated for significant banks by the ECB, whereby all the inspections at significant banks in 2015 were conducted in full by Bank of Slovenia examiners. Post-inspection measures are proposed and prepared by the JST, and are issued by the ECB.

Within the framework of banking supervision, in early 2015 the ECB adopted priorities and set out the minimum scope of supervisory activities for all significant banks.

One of the more important regular tasks within the framework of the supervision and monitoring of banks is the Supervisory Review and Evaluation Process (SREP). The SREP is based on the review and evaluation of:

- the internal capital adequacy assessment process (ICAAP) put in place by the bank;
- the bank’s risk exposure and the control environment that the bank has put in place for the management and mitigation of the risks taken up.

[37] A JST is appointed for each systemically important bank, headed by an ECB coordinator, while at the national level the work of the JST is coordinated by a sub-coordinator from the Bank of Slovenia.

As part of the annual SREP, in accordance with the process implementation methodology and the internal risk assessment methodology, in 2015 the Bank of Slovenia assessed individual risks and the adequacy of the control environment for managing the individual risks, and set out individual requirements for the maintenance of capital adequacy at individual less significant banks. There was particularly detailed monitoring of the banks that failed to fully meet the capital adequacy requirements determined in the SREP. These banks had to submit plans to meet and maintain the required capital adequacy. The Bank of Slovenia imposed a capital increase measure on two banks in 2015.

Four supervisory reviews were conducted at less significant banks in 2015, in which the areas of credit risk, liquidity risk, interest rate risk, profitability risk, the business model and corporate governance were reviewed. One supervisory review was conducted in conjunction with ECB inspectors.

Within the framework of the SREP and on the basis of the ICAAP and the bank's risk profile, a determination is made of the level of capital adequacy that the bank must maintain until the next SREP. The other supervisory activities in the significant banks segment focused primarily on the following in 2015:

- credit risk,
- corporate governance and risk management,
- operational risk,
- liquidity risk, and
- interest rate risk.

Credit risk is by far the most important risk in the banking system, for which reason it was a major focus of the ongoing supervision of banks and the inspections at banks. The following activities were carried out in the area of credit risk:

- within the framework of ongoing supervision, much attention was focused on the formulation of credit risk analysis, developments in non-performing claims, bank strategies for reducing non-performing claims, analysis of forborne exposures and foreclosed real estate, analysis of Swiss franc loans.
- The JST conducted a limited review of the credit process at two banks. The objective of the reviews was to investigate the entire procedure for carrying out the credit process (preparation of credit analysis, credit approval process, process of creating impairments, credit portfolio monitoring process) and to identify any deficiencies.
- A review of credit risk was conducted at two banks, and encompassed a follow-up of the requirements from the AQR of 2014, a review of forbearance and the assessment of impairments on forborne loans, the early warning system and a review of individual credit files. A follow-up review of the implementation of measures in the area of credit risk issued in 2014 was conducted at one bank.

A thematic review of risk governance and appetite was conducted for all significant banks within the framework of the SSM in 2015. The purpose of the review was to obtain a horizontal overview of various internal governance practices, and of risk management and risk take-up, and to order the banks to take corrective measures in the event of deficiencies being identified. As part of the review an assessment was made of the composition of the governing bodies, their knowledge and diversity, the quality of the risk appetite framework, and the quality of information and reports on risks.

In the area of operational risk the supervisory activities at the significant banks focused on the regular monitoring of the banks' exposure to operational risk, on the management of IT risks and on legal risk. A review of operational risk was conducted at two banks. The reviews focused on the area of the measurement and management of operational risk and IT risk (organisational framework, strategies, policies, procedures and system architecture, IT organisation and outsourcing, management of IT security, and IT operations management).

The area of liquidity risk was reviewed at one bank in 2015. The review targeted funding risk and the bank's liquidity position, and liquidity management over the medium term. A follow-up review of the implementation of measures in the area of liquidity risk issued in 2014 was conducted at one bank.

A review of interest rate risk was also conducted at one of the significant banks. The level and identification of risks, the interest rate risk measurement system and the control functions that the bank has put in place to manage and mitigate interest rate risk were all reviewed. The review process had not been completed by the end of 2015.

In the area of the use of advanced IRB approaches to the calculation of capital requirements, a regular review of the use of the IRB approach was conducted at one bank, and a review of the introduction of the IRB approach to the calculation of capital requirements for the corporate segment was conducted at one bank.

Pursuant to Article 396 of the ZBan-2, the banks prepared and submitted recovery plans in 2015. JST members reviewed two recovery plans in 2015.

Another regular task for the JST is the review of disclosures under Regulation (EU) No 575/2013. A review of disclosures was conducted for four significant banks.

Within the framework of the ongoing supervision, which is based primarily on regular reports by the banks and additional requests for information and clarifications, analysis of operations is conducted at all the banks, and is used as the basis for organising thematic meetings on the performance of individual banks at various managerial levels and for subsequent supervisory activities (including reviews and inspections at the banks).

The Bank of Slovenia continually monitored the process of the merger of two banks and banking groups in 2015. The merger of the two banks was the result of a decision by the European Commission on the allowable amount of state aid, and the commitments issued by the government in the procedure for issuing the aforementioned decision. The banks merged on 5 October 2015. The Bank of Slovenia is responsible for the procedure for the merger of two less significant banks. The newly merged bank is one of the three largest banks in the country in terms of total assets, and as a result in 2016 will come under the direct supervision of the ECB, which has already issued the bank with a decision on its classification as a significant bank.

Examiners specialising in individual risks conducted reviews of various risk areas at 11 banks last year. The majority of the reviews were conducted in the area of credit risk, followed by liquidity risk, governance, and operational risk. Four reviews of the eligibility of collateral for monetary operations at the ECB were also conducted.

<u>Prevention of money laundering and terrorist financing as part of the supervision of bank compliance</u>

The only activities within the framework of compliance supervision carried out in 2015 related to the prevention of money laundering and terrorist financing (PMLTF), and the implementation of restrictive measures. Other major activities within the framework of compliance supervision in the area of fraud, misuse of inside information and breaches of law and regulations were carried out as part of the work of the Special Inspection Group (SIG) and in conjunction with other Bank of Slovenia departments. There were six inspections conducted in 2015, of which one was a comprehensive inspection of PMLTF, three were targeted inspections, and two were follow-up inspections of the implementation of measures.

Special Inspection Group

The Special Inspection Group (SIG) was established by the Bank of Slovenia by order of the Governor in April 2014 for the purpose of cooperating more actively with the judicial authorities and the prosecution authorities, and for the needs of faster responsiveness, analysis and interpretation of bank data and supervisory analysis. The SIG provides extra support for banking supervision; the key is that it ensures continuity of action and represents a constituent part of integral banking supervision, in light of the current situation and the public's sensitivity to the problem of holes in bank finances, and in light of Article 146 of the ZBan-2 and the guidelines of the Basel Committee on Banking Supervision.

The SIG's activities in 2015 focused on supporting the police, the Special State Prosecutor and, as necessary, the banks in compiling high-quality criminal indictments against responsible persons in connection with bad loans approved under non-standard terms and without consideration of the underlying economic indicators of creditworthiness in the event of breaches of laws and regulations in the area of banking. In this connection the SIG formulated extensive analysis of the actions of holding companies in Slovenia via the actual course of the development of holding companies in Slovenia, their governance and ownership consolidation, and analysis of their performance between 2000 and 2014 from the perspective of lending at the macro level.

Stress tests

In accordance with established practice, the Bank of Slovenia again conducted stress tests of the entire banking system in 2015. All banks and savings banks were included in the stress tests, with the exception of UniCredit Banka Slovenija, which conducted the stress tests as part of the comprehensive assessment of the bank under the supervision of the ECB.

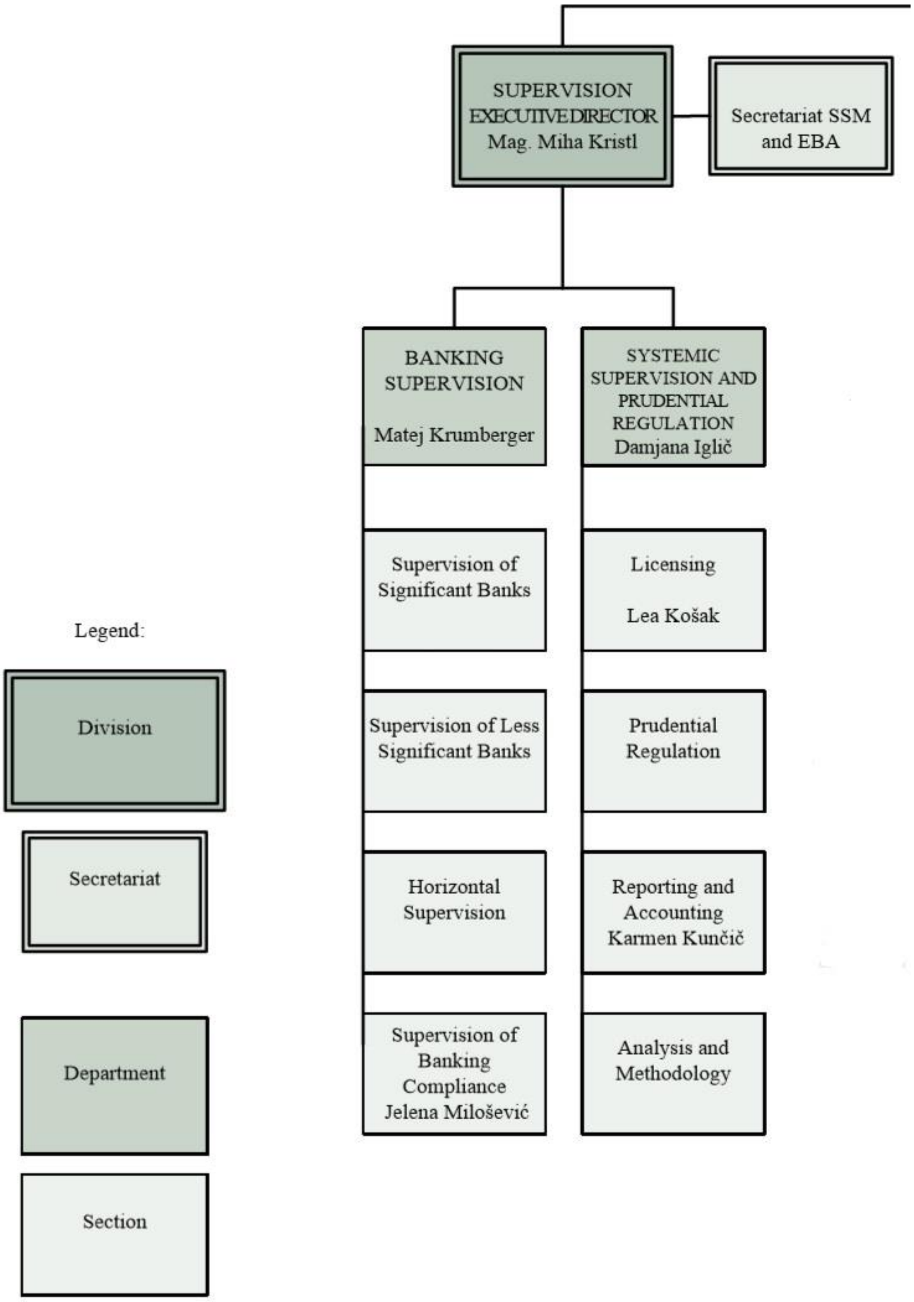
The general assumptions and methodology drawn up by the EBA for the pan-European stress tests in 2014 were taken into account in the stress tests. Given the assumed changes in the macroeconomic environment on the basis of the baseline scenario and the adverse scenario, the banks assessed the increase in credit risk, country risk and market risk, the increase in funding costs, and the impact on net interest income and net non-interest income.

Nonperforming exposures

The Bank of Slovenia focused a significant part of its efforts in 2015 on the management of banks' non-performing exposures. Action to promote and manage processes is organised within the framework of a special project and is directed at direct supervisory activities, and also at active cooperation with other stakeholders in Slovenia. This should ensure the requisite reduction in and permanent management of the banks' stock of non-performing claims. In addition Bank of Slovenia representatives are actively involved in the ECB's work in the area in question.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY

One of the bank's strategic objectives is to be an effective institution in terms of development, organisation and cost, committed to prudent asset management and to the quest for effective and cost efficient solutions. In accordance with these guidelines there were certain changes in the bank's organisational structure in 2015.



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

In 2015 Bank of Slovenia representatives attended sessions of committees, working groups and other bodies that are active within the institutions of the EU with a focus on financial and monetary matters. These include sessions of the Economic and Financial Committee (EFC) and its subcommittees, meetings of the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB) and other working groups from the relevant areas that are active within the European Commission and the European Council.

The Eurosystem and ESCB are headed by the ECB's decision-making bodies: the Governing Council and Executive Board. The functioning of decision-making bodies is defined in the Treaty on the Functioning of the European Union, the Statute of the ECB, and the Rules of Procedure of the ECB's Governing Council and Executive Board. The Governing Council is the main decision making body of the ECB. It comprises the members of the Executive Board and the governors of national central banks.

The Governor of the Bank of Slovenia attends the meetings of the Governing Council and participates equally in the decision-making process. Since January 2015 the Governing Council meets every six weeks to make decisions regarding monetary policy.

The national supervisory authorities may consult the ECB on the issue of measures, but the final decision is their responsibility, other than in exceptional cases when serious breaches have been found in supervision. The new arrangements also allow the ECB to directly take over the supervision of less significant banks 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.

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. IMF representatives made two visits to Slovenia as part of the Article IV consultations in 2015.

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 Bank of Slovenia is a shareholder in the BIS, and the Governor attended the annual general meeting of the BIS in Basel in June 2015.

Bank of Slovenia representatives attended sessions of committees and working groups of the OECD. They participated in meetings of the Economic Policy Committee, the Committee on Financial Markets, the Working Group on International Investment Statistics, the Working Party on Financial Statistics and the Working Party on National Accounts, and in the informal steering committee of 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.

In accordance with Article 152 of the Constitution of the Republic of Slovenia, the Bank of Slovenia is answerable to the National Assembly. Although its entry into the European System of Central Banks and its related obligations mean that the Bank of Slovenia also reports to EU institutions, the Bank of Slovenia's reporting to the National Assembly remains one of the important elements in ensuring oversight of its functioning.

In accordance with Article 26 of the Bank of Slovenia Act, without prejudice to other laws, the Bank of Slovenia reports on its work exclusively to the National Assembly. The Bank of Slovenia thus submits annual reports to the National Assembly, and publishes interim information on its activities on its website.

The Bank of Slovenia has a presence in two supervisory authorities, and is involved in numerous supervisory activities and forms of collaboration at EU level via its participation in sub-groups and networks. As part of the SSM, the Bank of Slovenia has a presence at the ECB in the form of the Supervisory Board, which meets twice a month. The Supervisory Board discusses, plans and carries out the ECB’s supervisory tasks, and proposes draft decisions to the Governing Council under the non-objection procedure. Bank of Slovenia representatives also actively participate in more than 30 different SSM sub-groups and networks.

At the European Banking Authority (EBA) Bank of Slovenia representatives sit on the Board of Supervisors, which is the authority’s main decision-making body and is responsible for all decisions in connection with EBA policy, such as adopting draft technical standards, guidelines, opinions and reports. Bank of Slovenia representatives also have a presence on 34 working groups, where they actively participate in promoting the convergence of supervisory practices and the preparation of binding technical standards and guidelines that provide for a single set of coordinated prudential rules for financial institutions across the entire EU, which will contribute to the establishment of a level playing field and ensure a high level of protections for depositors, investors and consumers.

## COOPERATION WITH OTHER DOMESTIC SUPERVISORY AUTHORITIES

The committee for cooperation between supervisory authorities (the Bank of Slovenia, the SMA and the ISA) met at four ordinary sessions in 2015, to discuss new developments with the Ministry of Finance in connection with financial legislation and activities related to the meetings of the Financial Stability Committee, to define joint activities and joint on-site inspections, and to exchange information on the functioning of the board of supervisors at EU level.

Cooperation between representatives of the Bank of Slovenia and the Bank Association of Slovenia (BAS) has continued in line with established practice, with the participation of Bank of Slovenia representatives in various committees at the BAS (the risk committee, the accounting committee, the treasury committee, etc.), in the drafting of secondary legislation and within the framework of training programmes under the aegis of the BAS. The Bank of Slovenia collaborated particularly intensively with the BAS in the restructuring of non-performing exposures, the establishment of the single credit register, and internal governance and corporate governance arrangements. At the invitation of the BAS training centre Bank of Slovenia representatives participated in a number of expert conferences and panels, and gave a presentation to the internal control functions (most notably compliance, internal audit and risk management) on the new banking act and various elements of the internal governance arrangements deriving from various regulations and guidelines. Particular mention should be made of the all-day seminar on corporate governance that the Bank of Slovenia organised for the banks in conjunction with the EBRD. Last year the Bank of Slovenia also organised a comprehensive consultation process in connection with the new regulation on internal governance, the governing body and the ICAAP, where a detailed and lengthy debate was held at the BAS over the summer months with regard to individual regulatory requirements that banks have to meet in the areas in question.

The Bank of Slovenia participated in two important projects in 2015 under the aegis of the Office for Money Laundering Prevention, on the preparation of a national risk assessment and the drafting of a new law. Various institutions were included in the national risk assessment project, where an active role was also played by the Bank of Slovenia, when it assessed the risk from the perspective of PMLTF in the banking sector. The close cooperation established with banks and savings banks in the past continued in 2015. The Bank of Slovenia participated in various activities organised at the level of the BAS (participation in various forms of training, participation in the annual conference of PMLTF officers, joint preparation of a PMLTF booklet). The Bank of Slovenia also acted within the framework of the standing steering group for restrictive measures, which operates under the aegis of the Ministry of Foreign Affairs.

The Bank of Slovenia established the National Payments Council (NPC) at the end of 2013 with the aim of supporting the balanced and sustainable development of the market for safe and efficient payment services in Slovenia, and ensuring that the market adapts to changes in the international environment. The NPC is essentially a strategic, consultative and communications body whose decisions provide a basis for the work of its participants in the area of payment services. The platform provided by the NPC is a place where the supply and demand sides of the payment services market can meet to coordinate their interests, set their priorities and resolve any misunderstandings. Cooperation between stakeholders within the NPC strengthened in 2015, and the Bank of Slovenia organised two sessions at which current topics in the area of payment services were discussed. The Bank of Slovenia also acted in its role as a catalyst for the payment services market by releasing an NPC e-bulletin aimed at providing information to members of the NPC and the wider public about new developments in the area of payments in Slovenia and the EU.

The key activities in the oversight of securities settlement systems in 2015 related to the establishment of a legal basis for the Bank of Slovenia's potential new role as a competent authority under Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories, and to the definition of the requisite adaptations at the Bank of Slovenia. The activities encompassed coordination between the Bank of Slovenia, the SMA and the Ministry of Finance.

# OTHER RELEVANT INFORMATION AND DEVELOPMENTS

In 2015 there were three banks in Slovenia classed as significant banks under the direct supervision of the ECB: NLB d.d., NKBM d.d. and UniCredit Banka d.d. The significant banks included banks that are members of banking groups established in euro area countries and that constitute a significant banking group. Two-thirds of the Slovenian banking system in terms of total assets thus came under the direct supervision of the ECB, while a third remained under Bank of Slovenia supervision.

In 2015 the Bank of Slovenia regularly monitored the operation and functioning of seven payment systems that operate under Slovenian law. It conducted one on-site inspection of the functioning and operation of a payment system. In its oversight of securities settlement systems in Slovenia, where the sole system is operated by KDD, the Bank of Slovenia monitored the adequacy of the measures taken by KDD on the basis of Bank of Slovenia recommendations issued after an assessment of the compliance of the KDD system versus the Eurosystem oversight standards. The Bank of Slovenia also supervised the operations of authorised payment institutions (non-bank payment service providers) and granted an authorisation to a first electronic money institution in Slovenia.

The structure of eligible collateral was similar to the previous year. Government securities accounted for the highest proportion of assets eligible as collateral (24%), followed by bank loans (22%), covered bank bonds (19%) and asset-backed securities (18%).

Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (the BRRD) defined a new task of resolution. It required Member States to establish a national resolution authority. The Bank Resolution Fund and Authority Act (ZOSRB) designated the Bank of Slovenia as the resolution authority in Slovenia. A bank resolution fund was also established pursuant to the ZOSRB, which is to be financed by the banks with their own funds and operated by the Bank of Slovenia. Together with the resolution fund, the aforementioned measures entail a shift from bank resolution via bail-out to resolution via bail-in, i.e. the assets of the banks and bank creditors. All activities related to the new task at the Bank of Slovenia as the national resolution authority are carried out by the resolution unit, which was established in April 2015. The department also took over all tasks related to the deposit guarantee scheme.

In accordance with the ZOSRB, the Governing Board of the Bank of Slovenia set out an investment policy, via the Regulation on the investment policy and management fees of the bank resolution fund, to ensure that the fund is secure, is low risk and has high liquid assets.

<u>Autorisation – licesing</u>

The Bank of Slovenia conducted 16 procedures for assessing the suitability of members of bank supervisory boards in 2015, completing nine of the procedures. Of these, the final suitability assessment was provided by the ECB in the case of four members of a bank’s supervisory board. Of the seven remaining procedures, two concluded with the resignation of the member of the supervisory board in question, while five are still in progress.

The most common authorisations granted in 2015 were to perform the function of a member of a bank’s management board (six in all), followed by three authorisations to merge a bank with another bank or another legal person, and one authorisation each to acquire a qualifying holding and to provide financial services.

The Bank of Slovenia conducted 16 procedures for assessing the suitability of members of bank supervisory boards in 2015, completing nine of the procedures. Of these, the final suitability assessment was provided by the ECB for four members of bank supervisory boards.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks[38] | 20 | 20 | 19 |
| Branches of foreign credit institutions | 3 | 4 | 4 |
| Cooperative banks | 0 | 0 | 0 |
| **Banking sector, total** | **23** | **24** | **23** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 54.9 | 55.6 | 54.3 |
| Other domestic ownership | 12.6 | 10.3 | 11.3 |
| Domestic ownership total | 67.5 | 65.9 | 65.6 |
| Foreign ownership | 32.5 | 33.8 | 34.4 |
| **Banking sector, total** | **100,0** | **100,0** | **100,0** |

### Concentration of asset by the type of financial institutions

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 44.3 | 60.2 | 0.0782 |
| Branches of foreign credit institutions | 99.9 | 100 | 0.8235 |
| Cooperative banks | | | |
| **Banking sector, total** | 43.1 | 58.5 | 0.1030 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | -97.4 | -2.56 | 3.54 |
| Cooperative banks | / | / | |
| **Banking sector, total** | -97.3 | -2.69 | 3.63 |

[38] Including 3 savings banks

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 98.3 | 97.8 | 97.3 |
| Branches of foreign credit institutions | 1.7 | 2.2 | 2.7 |
| Cooperative banks | / | / | / |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | | | |
| Financial sector | 11,3 | 11,4 | 11,6 |
| Nonfinancial sector | 56,2 | 51,0 | 49,1 |
| Government sector | 20,8 | 24,9 | 25,3 |
| Other assets | 11,7 | 12,8 | 14,0 |
| **Claims due to** | | | |
| Financial sector | 19.2 | 16.1 | 12.7 |
| Nonfinancial sector | 51.8 | 57.0 | 61.6 |
| Government sector | 4.1 | 6.0 | 5.6 |
| Other liabilities | 15.8 | 10.0 | 8.3 |
| **Capital** | **9.1** | **10.8** | **11.8** |

### Capital adequacy ratio of banks

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks** | 14.3 | 19.28 | 20.84 |
| Cooperative banks | / | / | / |
| **Banking sector, total**** | 14.3 | 19.28 | 20.84 |

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

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 13.3 | 11.9 | 9.9 |
| **- households** | 4.1 | 5.3 | 4.7 |
| **- corporate** | 20.4 | 17.7 | 15.4 |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | 83.0 | 82.0 |
| Households | 61.9 | 41.6 |
| Corporate | 21.1 | 40.4 |
| Government sector | 8.4 | 9.4 |
| Financial sector (excluding banks) | 8.6 | 8.6 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 1,504,051 | 1,327,869 | 1,031,590 |
| Interest expenses | 792,983 | 495,703 | 285,956 |
| Net interest income | 711,070 | 832,165 | 745,632 |
| Net fee and commission income | 339,486 | 346,281 | 335,722 |
| Other (not specified above) operating income (net) | 39,494 | 55,807 | 76,205 |
| Gross income | 1,090,051 | 1,230,900 | 1,157,559 |
| Administration costs | 640,262 | 611,890 | 614,410 |
| Depreciation | 79,644 | 74,972 | 71,560 |
| Provisions | 123,057 | 104,966 | -47,860 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 3,600,558 | 545,157 | 361,117 |
| Profit (loss) before tax | -3,353,475 | -106,087 | 158,332 |
| Net profit (loss) | -3,490,414 | -114,058 | 115,304 |

**Total own funds in 2015 (in EUR)**

| Type of financial institution | Total own funds | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 4,078,821 | 3,923,633 | 3,928,648 | 150,172 | \ |
| Cooperative banks | \ | \ | | \ | \ |
| **Banking sector, total:** | 4,078,821 | 3,923,633 | 3,928,648 | 150,172 | \ |

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

# 2015 DEVELOPMENTS IN THE TURKISH BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

While the global risk appetite has improved, volatility in global markets continues. Accordingly, portfolio flows to developing countries remain volatile. Macroprudential measures taken in recent years as well as improvements in fiscal discipline have increased the economy's resilience to global shocks. As such, despite high levels of volatility in global capital flows, the Turkish economy has continued grow at a stable pace.

Recent macroeconomic developments in the Turkish economy provide a generally supportive background for financial stability. Following a growth performance that exceeded expectations in 2015, current domestic production and consumption dynamics suggest that a similar performance will continue in 2016 as well. Inflation developments follow the path predicted in official end-of-the-year forecasts. Fiscal discipline in the public sector is maintained. In tandem with favorable conditions in the terms of trade as well as the moderate growth rate seen in consumer loans supported by macroprudential policies, the recovery in the current account balance continues. At present, the current account deficit is financed mainly through foreign direct investment and other long term sources.

Non-financial corporate sector indebtedness saw a limited upswing due to exchange rate movements. Nevertheless, the probability of exchange rate related risk in the non-financial corporate sector remains low since the maturities on foreign currency denominated loans have increased in this period and these loans continue to be concentrated in larger firms that are relatively better at risk management. As with the household sector, prudent borrowing by the corporate sector will increase the resilience of the Turkish economy in the face of global fluctuations.

Credit continues to grow at moderate rates. New regulations on consumer loan risk weightings, wage developments, and improvements in financial conditions may support credit growth in the upcoming period. However, due to the tight monetary policy stance and the framework of macroprudential policies, annual credit growth is expected to continue at modest levels.

The upward trend in non-performing loan (NPL) ratios of banks has recently flattened due to developments in consumer loans and loans to SMEs. It is expected that as the economic activity continues along its steady course, the credit risk outlook will improve.

For the past six months, marked by a high level of global financial volatility, banks continued securing external funding smoothly. While external borrowing has declined, favorable borrowing costs and longer maturities signal that banks have a positive outlook accessing external funding sources. Macroprudential policies that encourage longer term external funding reduce the banking sector's susceptibility to adverse developments in global markets by lengthening maturities.

Capital adequacy ratios in the banking sector have improved since the last quarter of 2015. According to the Regulatory Consistency Assessment Programme (RCAP) coordinated by the Basel Committee, Turkey is assessed as compliant in risk-based capital standards and liquidity coverage ratio regulations.

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

As of March 2016, there are 53 banks operating in Turkish banking sector (TBS). The total asset size of TBS is nearly 2.4 trillion TL which overpassed GDP. As of year end 2015, the total asset/GDP ratio is 120,7%.

The main investment item in assets is loan portfolio which has a 62.8% share in total assets. As of March 2016, the loan portfolio has reached to 1.5 trillion TL. As of year end 2015, annual increase in loan portfolio is 19.1%. The share of FX loans in loan portfolio is around 36%. In terms of segmentation, credit portfolio of the sector is granular. The share of corporate loans, retail loans and SME loans are 48%, 25.6% and 26.4% respectively. Also, in terms of sub-sectors, there is no substantial domination. NPL ratio is at 3.3% which is comparatively low when compared to other emerging markets.

Securities are the other important investment item. Total share of securities in the balance sheet is 13.7% and the amount of securities is nearly 331 billion TL. 73.9% of securities are classified in available for sale portfolio.

The main funding source is deposit (53% of total liabilities). As of March 2016, total deposit in TBS has reached to 1.3 trillion TL. FX deposit constitutes 42.7% of total deposits. As of March 2016, funds from abroad item is around 137 billion USD. Foreign borrowing includes repos, deposit, loans and syndication and securitization loans.

TBS's capital base is strong. CAR is 15.5% which is quite higher than 12% target CAR. Tier I CAR is nearly 13.1%. TBS has high and sustained profitability ratios. As of March 2016, annualized NIM is 3.6%, ROA is 1.4% and ROE is 13%. As of March 2016, the profit of banking sector increased is 22,6%.

The FX position of banking sector is very limited. There is a short position in the balance sheet but banks balance their short position by using off-balance sheet instruments such as derivatives which yields a fully hedged fx positions.

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

In Turkey, Capital Markets Board of Turkey (CMB) is the regulatory and supervisory authority in charge of the securities markets. General Directorate of Insurance (GDI) and the Insurance Supervisory Board under Secretariat of Treasury is responsible for insurance sector. Banking Regulation and Supervision Agency (BRSA) with the authority given by Banking Law Nr. 5411 regulates and supervises banks (commercial-deposit banks, investment and development banks and participation banks and the branches in Turkey of such institutions established abroad), financial holding companies, financial leasing companies, factoring companies, consumer financing companies and asset management companies, payment institutions and e-money institutions. Moreover, BRSA authorizes independent audit, rating, valuation and outsourcing firms that give service to supervised institutions.

Within the scope of the Law on Bank Cards and Credit Cards, the institutions willing to establish card systems, issue bank cards and credit cards, exchange information on card holders, and engage in clearing and settlement activities are also regulated by BRSA. In addition, BRSA is empowered to authorize and terminate the activities, temporarily or permanently, of institutions that performs the independent audit, valuation, rating and outsourcing activities for banks.

BRSA is a public legal entity with administrative and financial autonomy. The independence of the BRSA gives autonomy in three main areas: i) autonomy in regulation and supervision, ii) autonomy in Agency administration, iii) autonomy in using financial resources.

With the enactment of the Banking Law Nr. 5411, regulatory and supervisory framework of the banking system has been reshaped in a more systematic way in the light of international best practices. Banking Law in force gives the BRSA all the powers to regulate, enforce and ensure the implementation of the establishment, activities, management and organizational structure, merger, disintegration, change of shares and liquidation of banks and monitor and supervises enforcement of them. BRSA uses its powers through regulatory transactions and specific decisions taken by its Board. Banking Regulation and Supervision Board is authorized to revoke the operating permissions of failing banks or to transfer the shareholder rights except dividends and the management and supervision of the banks to the Savings Deposit Insurance Fund (SDIF), for the purposes of transferring, selling or merging them partially or fully. The banks whose operating permissions have been revoked are liquidated as subject to the provisions of Banking Law by SDIF.

Besides, according to the Bank Cards and Credit Cards Law Nr. 5464, BRSA is also responsible for authorization, regulation and supervision of card system organizations, card issuing organizations, organizations entering into merchant agreements, information exchange and clearing/settlement organizations. Furthermore, with the Law Nr. 6493 enacted in 2013, authorization, regulation and supervision of payment institutions and electronic money institutions were also incorporated into the scope of authority.

## MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

“Strategic Plan 2013-2015” adopted in 2013 includes four main strategic objectives: (1) enhancing corporate structure; (2) strengthening the efficiency of regulation, supervision and enforcement framework; (3) boosting confidence, stability and competitiveness in financial markets; and (4) raising awareness among financial consumers, protecting them at the maximum level and improving financial inclusion.

## THE ACTIVITIES OF THE BANKING SUPERVISORY AUTHORITY

The regulation and supervision of banks and other financial institutions comprises two fundamental functions of the BRSA. BRSA has continued these activities in 2015. On the other hand, the activities coming to the forefront are as follows:

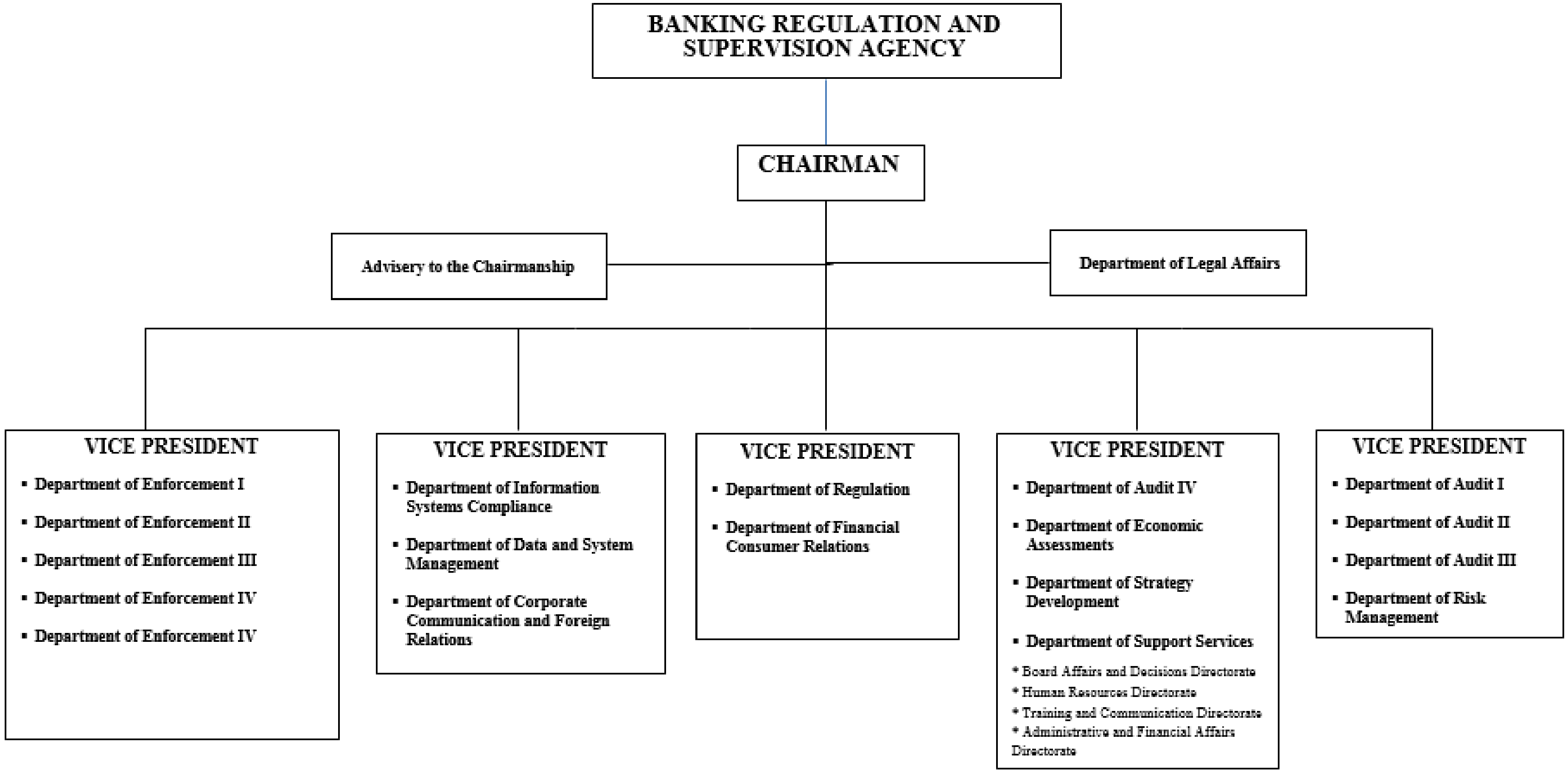
In 2015, Turkey was conducted peer review processes both under RCAP and FSB country review processes. In these processes, the banking regulations are evaluated by the assessment teams. In preparation for the RCAP assessment, the BRSA made a comprehensive self-assessment of the consistency of its domestic regulations with the Basel standards. Based on this self-assessment, the BRSA has issued a set of amendments in August 2015 to align its domestic regulations. BRSA has also prepared a further regulation set based on RCAP Assessment Team's feedback which were passed in January 2016.

Within the framework of Pillar II (Supervisory Review Process), BRSA has continued to form its own Supervisory Guidelines compatible with the Basel standards. In this respect, 11 new Supervisory Guidelines were issued last year.

BRSA has also worked on Islamic banking issues to enhance product variety and increase the number of players in the sector. It is aimed to deepen the financial sector and increase financial inclusion this way.

BRSA started to evaluate and issue operating license applications from electronic money institutions and payment institutions. In 2015, the Board of BRSA has authorized 4 electronic money institutions and 5 payment institutions.

# ORGANIZATIONAL CHART OF THE BANKING SUPERVISORY AUTHORITY



# INTERNATIONAL ACTIVITIES OF THE AUTHORITY

The Banking Regulation and Supervision Agency's (BRSA) international relations have four dimensions.

- BRSA ***have collaboration with foreign supervisory authorities related to consolidated supervision,***

Efficient and timely exchange of information among supervisory bodies is essential for effective supervision, and is particularly critical for a strong financial market. In order to improve the effectiveness of the consolidated supervision, BRSA collaborates with foreign supervisory authorities. Accordingly, BRSA signs Memorandum of Understanding (MoU) with foreign counterparts on the consistency of policies and regulations pursuant to Article 98 of the Banking Law Nr. 5411. Memorandums of understanding aim at developing cooperation among supervisory and regulatory authorities that are parties to agreement for developing financial stability and ensuring the sustainable growth. Pursuant to the memorandums signed between the Agency and The Foreign Equivalent Supervisory Authorities, parties give importance to cooperation on sharing experiences and organizing training programmes to ensure the development of financial sector by means of collaborating for strengthening the legal, regulatory and organizational structure to ensure sustainability of financial stability and for identifying and generalizing of international best practices. The number of Memorandums of Understanding has reached to 34 as mid of 2016.

- ***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.

- ***relations with other international and foreign institutions.***

Pursuant to the provisions of Banking Law Nr 5411, the BRSA has worked in close cooperation with international institutions, has carried out necessary adaptation studies by monitoring closely the regulation and standards developed by these institutions and has actively participated in studies performed by the institutions.

# COOPERATION WITH OTHER SUPERVISORY BODIES IN TURKEY

Based on Article 98 of Banking Law, views were exchanged and information was shared with Undersecretariat of Treasury, Capital Market Board (CMA), Savings Deposit Insurance Fund (SDIF) and Central Bank of Republic of Turkey (CBRT) in order to ensure coordination and cooperation among authorities in executing monetary, credit and banking policies.

**Financial Sector Commission,** consisting of the representatives of Agency, Ministry of Finance, the Treasury Undersecretariat, Central Bank, Capital Market Board, Fund, Competition Board, Undersecretariat of State Planning Organization, Istanbul Gold Exchange, securities stock exchanges, Futures and Options Markets and the associations of institutions, is responsible for ensuring coordination, cooperation and exchange of information among the related authorities and associations, raising joint policy recommendations and conveying comments on matters concerning the future of the sector, in order to improve confidence and stability in the financial markets pursuant to Banking Law.

**The Coordination Committee** consisting of the presidents and vice presidents of BRSA and SDIF, pursuant to Banking Law Nr. 5411, is in charge of ensuring the maximum cooperation be established between the BRSA and the SDIF when it is necessary to carry out transactions in the competency of the SDIF, and exchange of information.

**Financial Stability Committee,** established through Decree-Law no. 637 published in 2011 is chaired by the Minister for Undersecretariat of Treasury and consists of Undersecretary of Treasury, CMB, BRSA and SDIF Presidents. While the primary function of the Committee is to develop proposals for measures and policies to identify, monitor and mitigate systemic risks that may involve financial system as a whole, the Committee is also responsible for planning, policy development, monitoring and coordination of systemic risk management activities.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks[39] | 31 | 32 | 33 |
| Branches of foreign credit institutions | 5 | 6 | 6 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 49 | 51 | 52 |

**Ownership structure of banks on the basis of assets total[40]**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 30,8 | 31,3 | 32,0 |
| Other domestic ownership | 50,7 | 49,5 | 37,7 |
| Domestic ownership total | 81,5 | 80,8 | 69,7 |
| Foreign ownership | 18,5 | 19,2 | 30,3 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

**Concentration of asset by the type of financial institutions[41]**

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 37,03 | 57,26 | 782,61 |
| Branches of foreign credit institutions | 0,25 | 0,29 | 0,03 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 100,00 | 100,00 | 788 |

[39] There are no cooperative banks in Turkey. Commercial banks are defined as deposit taking instutions, therefore investment & development banks are excluded. We have, as of year end 2015, investment & development banks (13), private, public and participation (5) banks.
[40] Turkish Banking Sector General Outlook, 2013, 2014,2015.
[41] Commercial bank shares inclued branches of foreign credit instutions excluding only investment &development banks.

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 15,0 | 12,7 | 11,6 |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | 14,2 | 12,3 | 11,3 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 95,7 | 95,5 | 95,2 |
| Branches of foreign credit institutions | 0,3 | 0,3 | 0,3 |
| Cooperative banks | - | - | - |
| Banking sector, total: [42] | **100.0** | **100.0** | **100.0** |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013** | 2014** | 2015** |
|---|---|---|---|
| Commercial banks | 14,5 | 15,6 | 15,0 |
| Cooperative banks | - | - | - |
| Banking sector, total: | 15,3 | 16,3 | 15,6 |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non-financial sector, including | | | |
| - households | 2,9 | 3,4 | 4,3 |
| - corporate | 2,4 | 2,2 | 2,0 |
| -SME[43] | 3,1 | 3,3 | 3,9 |

[42] Remaing shares belong to investment &development banks.
[43] Current data classification of loans ecludes SME loans from corporate loans.

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Non-financial sector, including: | | |
| Households | 59,7 | 25,9 |
| Corporate[44] | 35,4 | 72,5 |
| Government sector | 4,8 | 1,6 |
| Financial sector (excluding banks) | - | - |
| Total | 100.0 | 100.0 |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 110,6 | 138,7 | 164,1 |
| Interest expenses | 53,3 | 73,1 | 86,8 |
| Net interest income | 57,3 | 65,6 | 77,3 |
| Net fee and commission income | 18,8 | 20,7 | 22,4 |
| Other (not specified above) operating income (net) | -17,9 | -20,9 | -23,6 |
| Gross income | 144,9 | 173,7 | 200,0 |
| Administration costs | 32,8 | 36,3 | 41,0 |
| Depreciation | 2,1 | 2,6 | 3,0 |
| Provisions | 5,0 | 4,1 | 5,3 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | 3,4 | 3,2 | 3,6 |
| Profit (loss) before tax | 31,1 | 31,5 | 33,1 |
| Net profit (loss) | 24,7 | 24,6 | 26,1 |

[44] Including SME loans.

**Total own funds in 2015 (in EUR)**

| Type of financial institution (million EUR) | Total own funds *** | Core Tier 1*** | Tier 1*** | Tier 2*** | Tier 3*** |
|---|---|---|---|---|---|
| Commercial banks | 88,1 | 73,9 | 73,5 | 15,2 | - |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | 96,2 | 81,9 | 81,5 | 15,3 | - |

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

# 2015 DEVELOPMENTS IN THE UKRAINIAN BANKING SYSTEM

## MACROECONOMIC ENVIRONMENT

The economy of Ukraine bottoming out in the first half of 2015 demonstrated gradual recovery in Q3 and Q4 (in seasonally adjusted terms GDP grew by 1.1% and 1.4% respectively compared to the previous quarter). In annual terms, real GDP decline in Q4 slowed to 1.4% while the whole year decline was 9.9%. In addition to the low comparison base, improvements in the real sector performance were also due to following factors:

the de-escalation of military conflict, that led to the restoration of raw materials supply chain, and finished product sales by select industrial enterprises in the East;

slowing decline in real household income and improved consumer confidence, which somewhat supported domestic consumer demand;

the signs of investment demand recovery (gross fixed capital formation in Q4 increased by 1.4% y-o-y).

At the same time, substantial negative results were observed in the financial sector due to continuing banking system clean-up.

Nominal GDP in the reporting period made UAH 1 979 billion (USD 90.5 billion). By IMF estimate GDP per capita based on PPP fell to USD 7 519 compared with USD 8 242 in 2014.

In 2015, the nominal household income increased as compared with the previous year by 15% and made UAH 1 744 billion. At the same time, the real disposable income decreased by 22.2%.

After peaking in April 2015 (at 61% y-o-y), annual headline inflation has been on a steady descending trend, slowing down to 43.3% at the end of 2015. Core inflation declined to 34.7% y-o-y in December 2015. A firm disinflation trend was also observed in industry – producer inflation decreased to 25.4% y-o-y at the end of 2015.

In 2015, net inflow of foreign direct investment increased to USD 3.0 billion (USD 0.3 billion in 2014). Most of these investments were directed to the banking sector as a result of debt-to-equity operations between subsidiaries and parent banks.

## DEVELOPMENT IN THE BANKING SYSTEM

As of 1 January 2016, 117 banks worked in a regular mode, 3 banks were declared insolvent and 67 banks were under the liquidation process[45].

Number of banks with foreign capital – 41 (35% of the total number of licensed banks), 17 of which with 100% foreign capital (15% of the total number).

In 2015 the NBU:

- declared 29 banks insolvent (including one bank that was sold to a foreign investor and now operates in a regular mode).

[45]Including 5 banks under liquidation since 1 January 2014.

- launched liquidation procedures for 45 banks (including for 16 banks declared insolvent in 2014, for 2 banks due to annexation of Crimea, for 1 bank because of its breach of the banking law, and for 1 bank due to military operations in the east of the country).

Removing inviable banks from the banking system led to considerable growth of the shares of state-owned and foreign-owned banks. Thus, as of 1 January 2016, the share of state-owned banks within the authorized capital of the banking system was 24.6% compared with 19.5% as of 1 January 2015, the share of foreign capital within the banking system rose to 42.5% as of 1 January 2016 from 32.5% as of 1 January 2015.

In 2015, total assets of banks increased by UAH 78 billion (by 5%) to UAH 1.6 trillion.

The share of assets of the largest five banks grew to 52.9% as of 1 January 2016 from 43.5% as of 1 January 2015.

Lending operations remain the main type of asset-side operations. As of 1 January 2016, the loans extended made 62% of the total assets of banks. However, banks were not very active in lending last year.

In 2015, the amount of loans extended decreased by UAH 19 billion (2%) to UAH 987 billion.

The shares of loans extended to legal entites46 and individuals were 82% and 15% of the total loan portfolio.

In 2015, quality of assets deteriorated. Non-performing loans under lending transactions of operating banks grew by UAH 119 billion (by 48%) in a year reaching UAH 370 billion, which was 28% of the outstanding amounts under lending operations (versus 19% as of 1 January 2015). The quality of FX loans deteriorated the most - NPLs grew by UAH 3.8 billion or by 45.1%.

In 2015, liabilities increased by UAH 2 billion (by 0.2%) to UAH 1.2 trillion. Funds of customers remained the main source of financing the asset-side transactions in 2015.

As of 1 January 2016, customer deposit portfolio made 64% of the liabilities, including funds of individuals - 34% (UAH 394 billion) and funds of legal entities - 30% (UAH 349 billion). The high shares of the funds of legal entities and individuals were due to limited access of banks to other funding sources, in particular to external debt markets.

At that, total customer funds adjusted through revaluation of FX funds fell by 11.2% in 2015. Household FX deposits also decreased in 2015. Generally, deposit run on banks made USD 5.4 billion in equivalent.

Loan-to-Deposit Ratio decreased from 139.4% to 129.1%.

In 2015, the total regulatory capital decreased by UAH 59 billion (2%) to UAH 130 billion. Regulatory capital adequacy ratio fell to 12.31% from 15.60%

Banks' authorized capital increased by UAH 30 billion (by 17%) to UAH 210 billion. Authorized capital growth was mainly owing to additional capitalization of banks.

In 2015 the banking system received income of UAH 203.3 billion. The main source of income (68.2%) remained interest income. On the backdrop of low lending activity in 2015, banks effected more transactions generating fee revenues. In 2015, the share of fee revenues within the total income was 14.1%. Return on trade operations grew by 40.0% compared with 2014 and made UAH 21.7 billion, at the expense of the profits from financial derivatives trading.

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[46]Loans granted to business entities and nonbank financial institutions.

2015 financial result of the banking system of Ukraine was a loss of UAH 72.5 billion, primarily due to much higher provisions made, which grew 1.2 rimes since 2014 and made UAH 122.1 billion (44.3% of the total expenses). On the other hand, 2015 net operational income of banks was a profit of UAH 83.3 billion, which shows potential ability of most banks to generate a positive net cashflow.

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

Banking in Ukraine is regulated by the following fundamental laws:

- Constitution of Ukraine;
- The Civil Code of Ukraine;
- The Economic Code of Ukraine;
- Law of Ukraine *On the National Bank of Ukraine*;
- Law of Ukraine *On Banks and Banking*;
- Law of Ukraine *On Households Deposit Guarantee System*;
- Law of Ukraine *On Financial Services and State Regulation of Financial Markets;*
- Law of Ukraine *On Joint Stock Companies*;
- Law of Ukraine *On Prevention and Counteraction of Legalization (Laundering) of the Proceeds from Crime or Terrorism Financing.*

Under the Laws of Ukraine On the National Bank of Ukraine and On Banks and Banking the National Bank of Ukraine NBU (NBU) is responsible for banking and supervision in Ukraine.

In 2015 by the NBU initiative the Law of Ukraine On amendments to some legislative acts of Ukraine concerning liability of related parties to the bank was approved. This Law was developed with the aim of approximation to international standards of prudential regulation and supervision of banks namely to implement Principle 20 of the BCBS Core Principles for Effective Banking Supervision on control over transactions with related parties.

So, this Law strengthened the responsibility of bank managers, ultimate beneficial owners of the bank, and other qualifying shareholders in the bank during making decisions that affect the financial condition of the bank. Also, the effectiveness of banking supervision was increased to ensure the stability of the banking system and protect the interests of depositors and creditors of the bank. In addition, according to the Law, the range of the bank's related parties is not limited to formal signs of labor or corporate relations: any legal or natural person who actually controls the bank, regardless of the legal registration of such control is a bank's related party.

# MAIN STRATEGIC OBJECTIVES OF THE SUPERVISORY AUTHORITY IN 2015

During 2015 the NBU actively participated in implementation of the measures used as the basis of 2020 Comprehensive Program of the Ukrainian Financial Sector Development. This program was carried out in close cooperation with the IMF, World Bank, EU, EBRD and other IFIs and financial donors.

The goal of such measures was to support stability and appropriate functioning of the domestic banking system, improvement of its ability to counteract existing challenges.

The measures were implemented in the areas of banks capitalization, introduction of requirements to activities of systemically important banks, improvement of transparency requirements for the structure of the banks (disclosure of the owners by the banks), and strengthening control over the banks' operations with related parties.

# BANKING SUPERVISORY AUTHORITY ACTIVITIES IN 2015

In order to bring the regulatory requirements of the NBU closer to modern European approaches to and Basel III standards of capital management, as well as EU Directive No. 2013/36 and EU Regulation No. 2013/575 (CRR/CRD IV), the NBU has started gradual introduction of new requirements for banks' capital, buffer stock (conservation) and a countercyclical capital buffer for all banks, and a systemic importance buffer for systemically important banks.

Such requirements are approved by the NBU Board Resolution No. 312 of 12 May 2015 On approval of the changes to the instructions about the order of regulation of banks in Ukraine.

Adequacy of fixed capital for banks will be set at 7% starting from 1 January 2019. Capital buffers are planned for introduction on 1 January 2020. For systemically important banks the buffer of systemic importance will be set on 1 January 2020. Its size will be set on a case-by-case basis from 1% to 2% depending on the category of systemic importance of a bank.

According to the measures provided for by the Memorandum of Economic and Financial Policies in the framework of the IMF Extended Fund Facility (EFF), a diagnostic study of the 20 largest banks by their assets has been conducted.

To conduct the above-mentioned diagnostic study the NBU Board Resolution No. 260 of 15 April 2015 On the implementation of diagnostic study of banks approved the following:

Terms of Reference which provides for an assessment of asset quality, adequacy of regulatory capital, fixed capital, necessary volume of additional capitalization of banks up to the end of 2017;

Regulation on the Coordination Committee for monitoring and control over the diagnostic inspections of banks;

Schedule for bringing the NBU regulations in compliance with the requirements of the regulatory capital adequacy ratio and the core capital adequacy indicator;

Requirements for preparing a capitalization program or a restructuring plan for banks (standardized format).

In March 2015, Verkhovna Rada of Ukraine adopted the Law of Ukraine On amendments to some legislative acts of Ukraine concerning liability associated with the related parties.

In order to implement the provisions of this law, the NBU approved:

Regulation on identification of a bank's related parties (the NBU Resolution No. 315 of 12 May 2015), which set forms and timeframes for a bank's submission of related parties list to the NBU, and also the features that can be used by the NBU while exercising its banking supervision to identify individuals or legal entities related to the bank;

Regulation on procedures for submitting information on the ownership structure of a bank (the NBU Resolution No. 328 of 21 May 2015) contains new requirements for the disclosure of ownership structure of banks;

Changes to the Regulation on registration and licensing of banks, opening of separated units (the NBU Resolution No. 357 of 04 June 2015), which improved approaches to approval by the NBU of acquiring a qualifying holding in a bank by legal entities and individuals, business reputation and financial standing of these persons, as well as the final qualifying holders in the ownership structure of the bank.

In view of the increased risks of banks' transactions with related parties and considering the obligations undertaken by Ukraine in accordance with the Memorandum of Economic and Financial Policies, the NBU carries out the procedure for identification and monitoring of asset-side transactions with a bank's related parties.

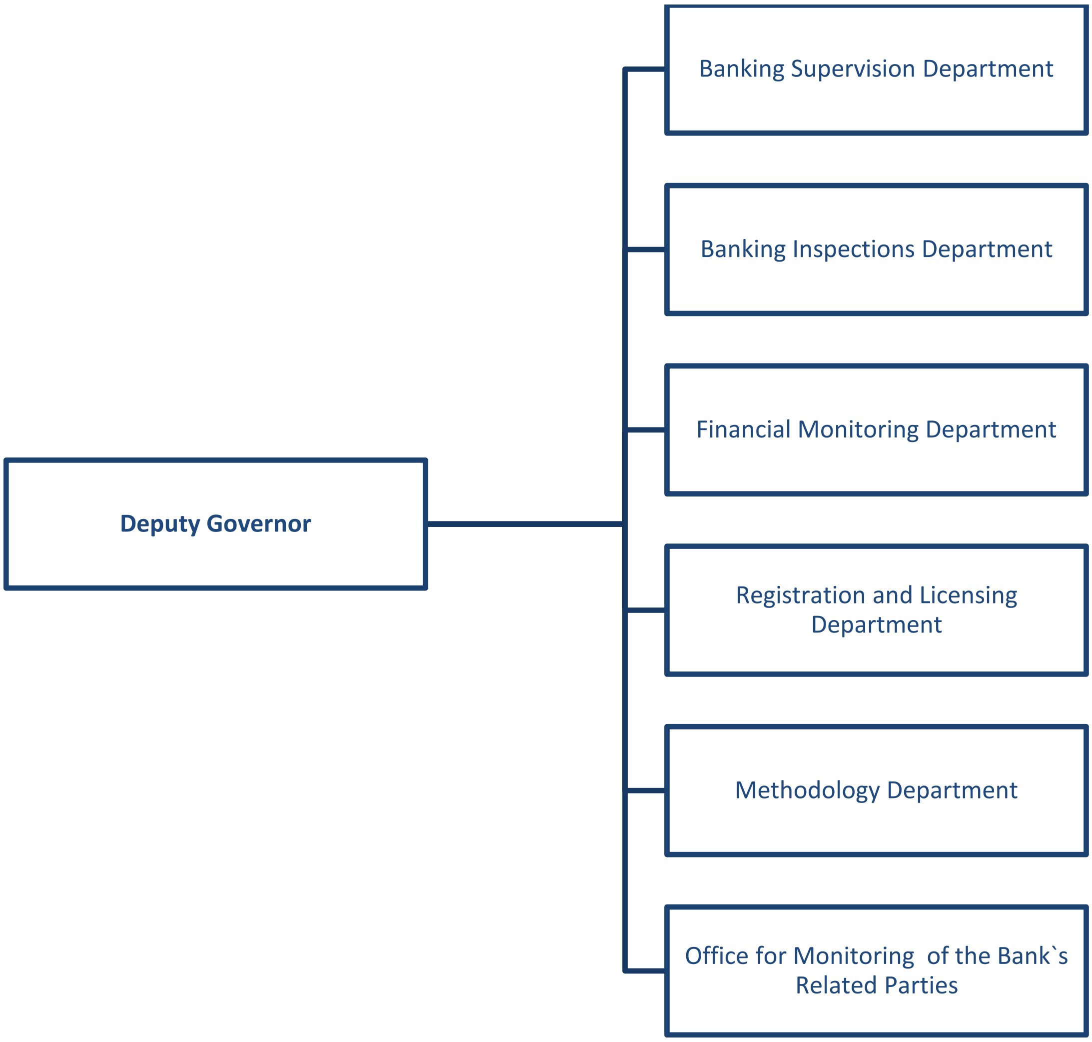
For this purpose, on 12 May 2015 the NBU Board adopted Resolution No. 314 On measures to bring the volume of banks' asset-side transactions with related parties in compliance with regulatory requirements, pursuant where to banks are required to ensure the proper identification of a bank's related parties in accordance with Article 52 of the Law On Banks and Banking and submit reports to the NBU on asset-side transactions with the bank's related parties.

Pursuant to the Law of Ukraine On Banks and Banking, as amended, banks are forbidden to carry out risky activities that threaten the interests of depositors or other creditors of the bank, and the NBU is empowered to set the list of features in its regulations which is the basis for the NBU's conclusion on whether a bank is engaged in such risky activities.

The NBU Resolution No. 778 of 10 November 2015 On amendments to some regulations of the NBU amended the Regulation on application of the NBU measures, approved by the NBU Board Resolution No. 346 of 17 August 2012, sets the list of features of banks' risky activities, including in the area of prevention and counteraction to legalization (laundering) of proceeds from crime, combatting terrorist financing and financing of proliferation of weapons of mass destruction, and sets the list of enforcement measures to be applied by the NBU to banks for engagement in risky activities.

Also, the NBU Board Resolution No.788 of 16 November 2015 On Approving Amendments to the Regulation on Peculiarities of Bank's Reorganization upon Decision of the Bank Owners simplifies the procedure for reorganization of the banks that need additional capitalization.

## ORGANIZATIONAL STRUCTURE OF THE BANKING SUPERVISORY AUTHORITY




## INTERNATIONAL ACTIVITIES

In 2015 the NBU continued its cooperation with International Financial Institutions including in the Banking Supervision.

In particular, new four-year EFF Program for Ukraine was approved by the IMF Executive Board on 11 March 2015. It, inter alia, includes measures directed at strengthening Ukrainian banking sector and improvement of banking supervision regulatory framework.

In September 2015 the NBU has competed implementation of the World Bank project "Programmatic Financial Sector Development Policy Loan". This project covered such areas as DGF capacity strengthening, improving the Ukrainian banking system solvency, strengthening legal and institutional framework for banking system resiliency and efficiency.

The NBU continued the work on ensuring bilateral international cooperation with foreign supervisory authorities under Memoranda of Understanding on

Cooperation in the Area of Credit Institutions Supervision and Multilateral Cooperation and Coordination Agreements on the Supervision.

The NBU took part in the EBA Assessment of equivalence of confidentially/professional secrecy regime of non-EU countries.

Besides, the NBU was very active in TA field. During 2015 the volumes of TA received by the NBU have increased drastically. Its main supporters and TA donors are the EU, IMF, World Bank, USAID, EBRD and others.

Moreover, in November 2015 the NBU participated in the European Bank Co-ordination (Vienna) Initiative Full Forum.

## COOPERATION WITH OTHER SUPERVISORY BODIES IN UKRAINE

As a banking supervisor, the NBU has been cooperating with other supervisory authorities of the country, in particular: The National Commission for State Regulation of Financial Service Markets and the National Securities and Stock Market Commission, with whom the NBU has signed the respective agreements on exchange of information.

## OTHER RELEVANT INFORMATION AND DEVELOPMENTS

The Comprehensive Program of the Ukrainian Financial Sector Development up to 2020 has been approved by the Board of the NBU on 18 June 2015.

The main objective of the Comprehensive Program is to build a fully-fledged, efficient and effective financial market in Ukraine, develop all the market segments, build its infrastructure, and strengthen its resilience to external threats.

The measures set out in the Comprehensive Program address three key areas: ensuring financial stability, development of institutional capacity of financial market regulators, and protection of consumer and financial market investors' rights.

# STATISTICAL TABLES

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 180 | 163 | 120 |
| Branches of foreign credit institutions | – | – | |
| Cooperative banks | – | – | |
| **Banking sector, total:** | 180 | 163 | 120 |

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

| Type of bank | 2013 | 2014 | 2015 |
|---|---|---|---|
| Public sector ownership | 15.5 | 22.1 | 24.7 |
| Other domestic ownership | 51.7 | 20.3 | 16.9 |
| Domestic ownership total | 67.2 | 42.4 | 41.6 |
| Foreign ownership | 32.8 | 57.6 | 58.4 |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| Type of the financial institutions | The first three largest (%) | The first five largest (%) | HHI |
|---|---|---|---|
| Commercial banks | 43,0 | 52,9 | 0,08469 |
| Branches of foreign credit institutions | – | – | – |
| Cooperative banks | – | – | – |
| **Banking sector, total:** | **43,0** | **52,9** | **0,08469** |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 0.81 | -30.46 | -69.95 |
| Cooperative banks | – | – | – |
| **Banking sector, total:** | 0.81 | -30.46 | -69.95 |

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

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 100.0 | 100.0 | 100.0 |
| Branches of foreign credit institutions | - | - | - |
| Cooperative banks | - | - | - |
| **Banking sector, total:** | **100.0** | **100.0** | **100.0** |

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

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| **Claims from** | **100** | **100** | **100** |
| Financial sector | 20.21 | 15.73 | 18.00 |
| Nonfinancial sector | 51.53 | 53.68 | 52.95 |
| Government sector | 7.65 | 8.43 | 7.11 |
| Other assets | 20.61 | 22.16 | 21.94 |
| **Claims due to** | **100** | **100** | **100** |
| Financial sector | 24.18 | 26.77 | 29.78 |
| Nonfinancial sector | 14.53 | 15.23 | 17.26 |
| Government sector | 0.39 | 0.44 | 0.59 |
| Other liabilities | 44.46 | 43.47 | 42.17 |
| **Capital** | 16.44 | 14.09 | 10.20 |

**Capital adequacy ratio of banks**

| Type of financial institution | 2013 | 2014 | 2015 |
|---|---|---|---|
| Commercial banks | 18.26* | 15.60* | 12.31** |
| Cooperative banks | – | – | – |
| **Banking sector, total:** | **18.26*** | **15.60*** | **12.31**** |

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

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

| Asset classification | 2013 | 2014 | 2015 |
|---|---|---|---|
| Non financial sector | 12.9* | 19.0* | 28.0 |
| **- households** | 4.6 | 7.1 | 7.9 |
| **- corporate** | 8.3 | 11.9 | 20.0 |

**The structure of deposits and loans of the banking sector in 2015 (%)**
**(at year-end)**

| | Deposits | Loans |
|---|---|---|
| Households | 95.1 | 98.1 |
| Government sector | 58.1 | 17.8 |
| Corporate | 37.0 | 80.3 |
| Other (excluding banks) | 0.8 | 0.3 |
| **Total** | **100.0** | **100.0** |

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

| P&L account | 2013 | 2014 | 2015 |
|---|---|---|---|
| Interest income | 11.767 | 7.864 | 5.288 |
| Interest expenses | 7.325 | 5.052 | 3.743 |
| Net interest income | 4.442 | 2.812 | 1.545 |
| Net fee and commission income | 1.901 | 1.216 | 866 |
| Other (not specified above) operating income (net) | -653 | -285 | -61 |
| Gross income | 15.295 | 10.929 | 7.753 |
| Administration costs | 3.683 | 2.320 | 1.482 |
| Depreciation | 370 | 214 | 143 |
| Provisions | 2.533 | 5.371 | 4.657 |
| Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...) | – | – | – |
| Profit (loss) before tax | 278 | -2.878 | -2.782 |
| Net profit (loss) | 130 | -2.754 | -2.767 |

**Total own funds in 2015 (in EUR billions)**

| Type of financial institution | Total own funds (for CAR) | Core Tier 1 | Tier 1 | Tier 2 | Tier 3 |
|---|---|---|---|---|---|
| Commercial banks | 4.95** | - | 3.33** | 1.68** | - |
| Cooperative banks | - | - | - | - | - |
| **Banking sector, total:** | **4.95**** | **-** | **3.33**** | **1.68**** | **-** |

# MAIN GROUP EVENTS OF THE YEAR 2015

## 28th Annual BSCEE Members' Conference

## Bratislava, Slovakia, June 24 – 26, 2015

The Chairmanship of the BSCEE Group in 2015 was held by National Bank of Slovakia and Mr. Vladimir Dvořáček, Member of the Bank Board and Executive Director of the Financial Market Supervision Unit of the National Bank of Slovakia was entrusted the position of the Chairman. Therefore, the 28th Annual BSCEE Members' Conference together with the High Level meeting were hosted by the National Bank of Slovakia on June 24 - 26, 2015 in Bratislava.

The Fourth High-Level Meeting on *Strengthening Financial Sector Supervision and Current Regulatory Priorities* was jointly organized by the Basel Committee on Banking Supervision (BCBS), the Financial Stability Institute (FSI), the Group of Banking Supervisors from Central and Eastern Europe (BSCEE) and the National Bank of Slovakia and was held on June 24, 2015 in Bratislava.

The meeting was organized as a joint forum for heads of supervisory authorities from Central and Eastern Europe. The objective was to discuss the latest developments in banking and banking supervision, and promote an active and productive dialogue on the challenges the banking supervisors face.

The specific topics that were discussed during the meeting included:

- Total loss-absorbing capacity, revision to the Basel III standards, capital requirements for banks using the standardised approaches, interest rate in the banking book
- Implementation of macroprudential buffers
- Supervisory challenges from recent changes in bank provisioning rules
- Payment system, central counterparties and systemic risk
- Cybercrime and its potential impact on banks' operations

The BSCEE Conference focused on the topics of the Single Supervisory Mechanism - exchange of views and Macroprudential Policy - National Framework

The event was attended by around sixty representatives of the central banks and supervisory institutions from thirty one countries from Central and Eastern Europe, and other world institutions for banking supervision. International experiences, among others, were presented by the representative of the Bank for International Settlements (BIS) from Basel and the representatives of the European Central Bank and Federal Reserve Bank.

## FSI – BSCEE Regional Seminar

## Prague, Czech Republic, May 5 – 7, 2015

The Czech National Bank in cooperation with the Financial Stability Institute and the BSCEE Secretariat organized a regional seminar for BSCEE member countries on Basel III and the New Standardised Approaches, Risk-Weighted Asset (RWA) Calculation and Liquidity Standards. The emphasis of the seminar was to provide a forum for supervisors to hear from experts on the latest regulatory reforms and to share experiences and issues in implementing Basel III and policies relating to systemic stability. The programme for the seminar covered the topics of:

- Basel III framework
- Liquidity ratios
- Standardised approaches for credit, operational and market risk
- A practical exercise

# BSCEE CONTACT LIST

| Supervisory Authorities of the Member Countries | Address | Web-site address |
|---|---|---|
| ***Bank of Albania*** | *Sheshi Skënderbej No. 1*<br>*Tirana, Albania* | www.bankofalbania.org |
| ***Central Bank of Armenia*** | *6, Vazgen Sargsyan str.*<br>*PO Box 0010, Yerevan*<br>*Republic of Armenia* | *www.cba.am* |
| ***Austrian Financial Market Authority*** | *Otto-Wagner-Platz 5*<br>*1090 Wien*<br>*Austria* | www.fma.gv.at |
| ***National Bank of the Republic of Belarus*** | *Nezavisimosty Ave. 20*<br>*Minsk 220008*<br>*Republic of Belarus* | www.nbrb.by |
| ***Banking Agency of Federation of Bosnia and Herzegovina*** | *Kosevo 3, Sarajevo 4000*<br>*Bosnia and Herzegovina* | www.fba.ba |
| ***Banking Agency of Republika Srpska, Bosnia and Herzegovina*** | *Vase Pelagića 11 A*<br>*78000 Banja Luka*<br>*Republika Srpska* | www.abrs.ba |
| ***Bulgarian National Bank*** | *1 Knyaz Alexander I Square*<br>*Sofia 1000, Bulgaria* | www.bnbank.org |
| ***Croatian National Bank*** | *TRG Hrvatskih velikana 3*<br>*Zagreb 10002, Croatia* | www.hnb.hr |
| ***Czech National Bank*** | *Prague 1,Na Prikope 28*<br>*115 03 Czech Republic* | www.cnb.cz |
| ***Estonian Financial Supervision Authority*** | *Sakala 4*<br>*Tallinn 15030, Estonia* | www.fi.ee |
| ***National Bank of Georgia*** | *2 Sanapiro Street*<br>*0114 Tbilisi, Georgia* | www.nbg.gov.ge |
| ***Central Bank of Hungary*** | *Krisztina krt. 39*<br>*1013 Budapest, Hungary* | www.mnb.hu |
| ***Financial and Capital Market Commission*** | *Kungu iela 1*<br>*Riga, LV-1050, Latvia* | www.fktk.lv |
| ***Bank of Lithuania*** | *Zirmunu St 151*<br>*Vilnius, LT-09128 Lithuania* | www.lbank.lt |

| | | |
|---|---|---|
| ***National Bank of Macedonia*** | *Kuzman Josifovski Pitu Blvd 1<br>Skopje, 1000 Macedonia* | www.nbrm.mk |
| ***National Bank of Moldova*** | *1 Grigore Vieru Ave.<br>Chisinau, MD-2005 Moldova* | www.bnm.org |
| ***Central Bank of Montenegro*** | *Bulevar Svetog Petra Cetinjskog 7<br>Podgorica, Montenegro* | www.cb-cg.org |
| ***Polish Financial Supervision Authority*** | *Plac Powstańców Warszawy 1<br>00-950 Warsaw, Poland* | www.knf.gov.pl |
| ***National Bank of Romania*** | *25, Lipscani str.<br>Bucharest 1, Romania* | www.bnro.ro |
| ***Central Bank of the Russian Federation (Bank of Russia)*** | *12 Neglinnaya str.<br>103016 Moscow, Russia* | www.cbr.ru |
| ***National Bank of Serbia*** | *Kralja Petra 12<br>11000 Belgrade, Serbia* | www.nbs.rs |
| ***National Bank of Slovakia*** | *Imricha Karvasa 1<br>813 25 Bratislava, Slovakia* | www.nbs.sk |
| ***Bank of Slovenia*** | *Slovenska 35<br>1505 Ljubljana , Slovenia* | www.bsi.si |
| ***Turkish Banking Regulation and Supervision Agency*** | *Atatürk Bulvarı 191 B Blok<br>06680 Kavaklidere<br>Ankara, Turkey* | www.bddk.org.tr |
| ***National Bank of Ukraine*** | *Institutska str. 9.<br>01601 Kiev, Ukraine* | www.bank.gov.ua |
| ***BSCEE Secretariat*** | *Plac Powstańców Warszawy 1<br>00-950 Warsaw, Poland* | www.bscee.org |