BSCEE Review

2019

Albania

Croatia

Latvia

Russia

Armenia

Czech Republic

Lithuania

Serbia

North Macedonia

Austria

Estonia

Slovakia

Moldova

Belarus

Georgia

Slovenia

Montenegro

Bosnia and Herzegovina

Hungary

Poland

Turkey

Bulgaria

Kazakhstan

Romania

Ukraine

Introduction

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

In 2019 Mr Michael Hysek, Managing Director, Banking Supervision at the Austrian Financial Market Authority (FMA) chaired the Group. The permanent Secretariat of the Group since January 2006 has been located in Poland, with the Polish Financial Supervision Authority (PFSA). According to the previous years' practice, the Annual Review of the BSCEE Group summarizes the developments of the member countries in 2019. This publication gives an overview of the macroeconomic circumstances in the twenty five member states, and it describes the banking sector as well as the supervisory activities undertaken by the BSCEE Members. The Review was developed on the basis of the information provided by the member countries.

This Annual Report intends to provide in-depth information reflecting the mission of the BSCEE Group in a detailed and accurate manner regarding the banking sectors of the member countries. We hope that you will find this publication informative and useful. We are certain that this will help you become acquainted with our supervisory job in the Central and Eastern European region, the cooperation among the supervisory authorities of the member countries and with the Basel Committee.

BSCEE Secretariat

BSCEE

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Macroeconomic environment

According to INSTAT data, in the first three quarters of 2019, the economy grew 2.9%, from 4.1% growth recorded in the same period in 2018. The expansion of consumption and an increase in the export of services, due to a continuing positive trend in tourism, were the main sources of economic growth.

Strong domestic and external demand has reduced the negative output gap and brought the economy closer to its potential though not yet there. Reduced slack is reflected in higher employment, lower unemployment rates (11.2% in 2019 Q4) while the average wage indicator increased by 3.8%. The other main economic and financial balances appear to be improving. Also, enterprises reported a higher utilization rate of their production capacities, while their ability to service debt improved. Domestic inflationary pressures trended upwards, as shown by an increase in wages and production costs. Nevertheless, increase in costs remains slow and their transmission to consumer prices is still weak. The reduction of inflation reflected a more complete transmission of the exchange rate appreciation and a fall in the inflation of goods in international markets

The monetary stimulus drove to a decrease in credit price in lek and a reduction in financing costs to the private sector, which already appears at its historic minimum levels. The FX intervention program has been effective in cooling down the rapid exchange rate appreciation, managing market expectations and creating conditions for a more normal trading. The use of forward guidance on the monetary policy stance helped calm financial markets down, reflecting higher clarity on the trajectory of inflation and interest rates.

The economic outlook remains favorable, with solid growth in the near term. The economic growth is expected to be supported by favorable financing conditions, positive labor market outcome and improved confidence amongst businesses. The positive impact of monetary policy on the improvement of the cyclical position of the economy and on the acceleration of its growth pace has picked up, gradually, from 2017-2019. This performance reflects low interest rates in the financial market, reduction of risk premia and acceleration of lending to the economy. For the entire period, the positive effect on the average economic growth due to the accommodative monetary policy stance is assessed at 0.6 p.p. The monetary policy has an accumulative impact on the economic activity level, measured by the real GDP. The real economic activity is around 1.9 p.p. higher from an alternative GDP without the contribution of the monetary policy, up to 2019 Q3, due to the positive effect of the accommodative monetary policy implemented by the Bank of Albania.

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

The banking sector remains the main component of the Albanian financial sector. Twelve banks have operate during 2019 in the banking sector from fourteen banks that were active in 2018.

In 2019, the bank consolidation process, started years ago, was concluded, bringing the number of banks to 12. This process reformed the domestic banking market, which is now experiencing an increase in the presence of domestic capital, where 4 banks with a share of 29.3% in the market, are owned by this capital. In 2019, the process of ownership transfer for two banks was concluded, as well as the absorption of one bank and the self-liquidation of another.

During 2019, banking system assets grew by around ALL 22.1 billion or 1.52 %, compared to the ALL 8.12 billion or 0.56% fall of a year earlier. The loan portfolio fell by ALL 4.94 billion, or 0.85% during this year.

The banking system's share in the economy, measured by the ratio of total assets to the Gross Domestic Product (GDP), continues to stay at high levels. This ratio decreased by 1.43 percentage points this year, standing at 87.92%. Meanwhile, the loan to Gross Domestic Product ratio fell due to the growth of GDP against the decrease in the loan portfolio.

The most important indicator of supervision, the capital adequacy ratio (CAR), stood 6 percentage points above the minimum level and showed stability throughout 2019, above 18%.

For the first time in 10 years the non-performing loans ratio (NPLR) fell to a single digit level, reaching at 8.37% at the end of 2019. The value of non-performing loans reached ALL 48.2 billion, with an annual decline of ALL 16, 2 billion, or around 25, 14%, affected by the settlements, write-offs and partial restructuring of losses and non-performing loans. On the other hand, the annual developments in credit portfolio are summarised in an annual fall of ALL 4.9 billion or 0.9%. Hence, the dynamic of non-performing loans ratio was not supported by the performance of credit stock, which would have resulted upward of ALL 11.3 billion, or around 2% in annual level, in absence of the effect of NPLs reduction.

Profitability indicators, Return on Average Assets (RoAA) and Return on Average Equity (RoAE), respectively, increased compared with 2018. At the end of 2019, RoAA stood at 1.39% and RoAE at 13.45%, from 1.32% and 12.96%, respectively at the end of 2018.

Following are banking system highlights for 2019:

1. Net outstanding non-performing loans to total credit portfolio stood at 3.4%, downward by 0.41 percentage point compared with December 2018.

2. The non-performing loans ratio (NPLR) dropped by 2.72 percentage points in annual terms, to 8.37 % at the end of 2019.

3. Provisioning of NPLs was 59,4%, from 65,6% a year earlier8.

4. Liquidity indicators continuously appear significantly above the regulatory requirement set out in the Bank of Albania's regulatory acts. In December 2019, the ratio of liquid assets to short-term liabilities in the banking system was 49.40%9, up by 3.19 percentage points from the previous year.

5. In December 2019, the total value of deposits in the system amounted to ALL 1.193 billion, recording 1.1% annual growth from the previous year. The share of the domestic currency in total deposits increased to 48.51%, from 46.87% in December 2018.

6. As at the end of 2019, the Capital Adequacy Ratio - the main supervision indicator – was reported at 18.3%. This ratio decreased by 0.38 percentage point, compared with the same period in the previous year.

7. The banking system's profit was positive in 2019, at around ALL 19.89 billion, or ALL 1.5 billion higher than in 2018.

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

The drafting of new bylaws and the review of the supervisory regulatory framework in force aims at supplementing and improving it, in order to carry out more effective supervision, in compliance with legal requirements on banks and other financial entities being licensed and supervised by the Bank of Albania, through the approximation with the EU regulatory acts, the Core Principles for Effective Banking Supervision, and Basel Committee documents.

In 2019, the Bank of Albania dedicated special attention to the drafting of new regulatory acts, in the view of the commitments of the Bank of Albania for: fulfilling the recommendations of the experts of Moneyval regarding the prevention of money laundering and combating the financing of terrorism; approximating the regulatory framework with Basel III requirements; and reducing non-performing loans.

Following are listed the new approved and reviewed regulatory acts over 2019.

- *Amendments to the Regulation "On the regulatory capital of the bank", (adopted with Decision No. 2 dated 9.1.2019 of the Supervisory Council of the Bank of Albania).*

These amendments aim the further approximation of the Bank of Albania' requirements with Basel III requirements with the purpose the review of capital ratios laid down in this Regulation. Hence, the minimum ratio of Common Equity Tier 1 against the risk-weighted exposures, from 4.5% to 6.75%, and the minimum ratio of Tier 1 capital against risk-weighted exposures from 6% to 9%, by proportionally adapting these ratios to the required minimum capital adequacy ratio of 12%.

- *Approval of the new Regulation "On liquidity coverage ratio", (adopted with Decision No. 27, dated 28.3.2019 of the Supervisory Council of the Bank of Albania).*

The drafting of the Regulation "On liquidity coverage ratio" aims to further approximate the regulatory framework of the Bank of Albania to the requirements of the Basel Committee and the European regulations on liquidity risk management, in compliance with the strategic objectives of the Supervision Department for the implementation of Basel III requirements. This Regulation lays down the criteria and rules on the calculation of the liquidity coverage ratio (LCR) and the requirements of the Bank of Albania, as the supervisory authority on the minimum level of this ratio (in total for all currencies and in total for major foreign currencies).

This new regulatory act aims to complete the applicable regulatory framework on liquidity risk management, through the presentation of the liquidity hedging ratio (LRC), as a new indicator, as well as the definition of banks' requirements on the creation of a liquidity reserve that in conditions of liquidity stress hedges net outflows, within a time horizon of 30 calendar days. The regulation presents the composing elements of LCR, and the criteria on the adequacy that these elements should comply with, to be classified as liquid assets, inflows or outflows of liquidity. The liquidity coverage ratio (LCR) is a dynamic indicator, different from the current liquidity indicator which aims at being a static one.

The regulation set forth the supervisory requirements for the calculation of LCR on individual and consolidate basis; general requirements, operational requirements and eligibility criteria to be meet by liquid assets, for their classification to be included in the liquidity buffer, as well as requirements for the assessment of liquid assets through market value; the composition of the liquidity buffer according to assets levels, by defining the limits (minimum and maximum) for each level and the prediction on the haircuts applicable on each level of the liquid assets (level 1 assets, 2A assets and 2B, respectively); the calculation methodology of liquidity outflows and the criteria for the classification of balance sheet items or off-balance sheet items, in the category of outflows related with stable deposits and other retail deposits, with operational deposits, and of outflows which steam from liquidity and credit facilities and from products, services or other liabilities; the prediction of rates that banks shall apply to each category of outflows; the requirements on liquidity inflows and the rates applicable for their calculation; the definition of a cap for inflows; as well as the reporting and monitoring requirements.

This Regulation has entered into force on 1 March 2020.

- *Amendments to the following regulations, pursuant to the implementation of the recommendations of Moneyval experts, provided during Round V of the evaluation for Albania, regarding the prevention of money laundering and combating the financing of terrorism, approved by Decisions No. 46, 47, 48, 49 and 50, dated 03.07.2019, respectively, of the Supervisory Council of the Bank of Albania):*
  - Regulation "On licensing and carrying out the activity of banks and branches of foreign banks in the Republic of Albania";
  - Regulation "On licensing and activity of non-bank financial institutions";
  - Regulation "On licensing and activity of savings and loan associations and their unions";
  - Regulation "On licensing, organisation, activity and supervision of foreign exchange bureaus";
  - Regulation "On managing risk in the activity of non-bank financial institutions".

- *Approval of amendments to the following regulations (adopted with decisions No. 78, 79, and 80, dated 18.12.2019, respectively, of the Supervisory Council of the Bank of Albania):*
  - Regulation "On prevention of money laundering and terrorism financing";
  - Regulation "On consolidated supervision";
  - Regulation "On supervision of e-banking transactions".

In more concrete terms, amendments to the Regulation "On prevention of money laundering and terrorism financing" consists in further strengthening the requirements of the supervisory authority on entities, for a better risk management of money laundering and financing of terrorism, at both individual and group level. At the same time, part of regulatory amendments are some more tightened requirements on the integrity of entities' employees, and the requirements on the continuous training of the responsible persons and structure on the prevention of money laundering and financing of terrorism. Logically, in addition to the amendments in the regulation on the prevention of money laundering regarding the implementation of the enhanced due diligence, accordingly it is required the presence of the customers and their representatives before establishing a business relationship, the provision in the Regulation "On the supervision of e-banking transactions" on the physical presence of customers and their representatives to open an e-banking account, for every business relationship, including the opening of e-banking accounts, is repealed. Amendments to the Regulation " On consolidated supervision" aim at strengthening the requirements to banking/financial entities groups, subject to the consolidated supervision by the Bank of Albania, regarding the drafting of programmes at group level from the shareholding institutions, for a better management risk on money laundering and financing of terrorism.

- *Approval of the new Regulation "On out-of-court treatment of distressed borrowers by banks" (adopted with Decision No. 51, dated 3.7.2019 of the Supervisory Council of the Bank of Albania).*

The Regulation "On out-of-court treatment of distressed borrowers by banks", differently called "Tirana Approach", was drafted with the assistance of the World Bank Group experts (FinSAC project) and aims at fulfilling the commitments undertaken by the Bank of Albania in the framework of the National Plan on Addressing Non-performing Loans, and the completion of the continuous measures undertaken by the Bank of Albania to address non-performing loans in Albania.

The Regulation aims at encouraging the treatment of distressed borrowers, through structured and efficient cooperation between banks. This Regulation is expected to serve as a cooperation platform, where banks co-ordinate their attempts and find solutions that reflect the nature of the borrower's difficulties by creating facilities for generation of liquidity, to continue and to recover activity and to settle liabilities with banks. On the other hand, the solution takes into account also the exposure level and the position of each bank to the borrower. The Regulation, amid others, sets forth the requirement on signing an agreement which regulates the coordination way among banks with each other, the processes to be followed and the decision-making way on the identified solutions. Also, the Regulation sets forth a draft-agreement to be signed by all banks with the borrower and regulates the respective responsibilities and liabilities throughout the moratorium period. During the period, banks interrupt or do not undertake legal initiatives against the borrower and analyze the financial situation of the borrower and identify the appropriate solutions, with respect to the existing contractual obligations which are signed individually by each bank with the borrower. The Regulation sets forth the criteria a borrower may be included in the agreement with banks, while it does not exclude the possibility of addressing in the framework of this regulation, those exposures reaming outside of these stipulations. This Regulation is foreseen to remain into force up to December 2020, with the purpose to prompt banks to undertake all the possible initiatives to address the common borrowers at a rather short time.

- *Amendments to the Regulation "On credit risk management by banks and branches of foreign banks" (approved by Decision No. 52, dated 3.7.2019 of the Supervisory Council of the Bank of Albania).*

Amendments to the Regulation are in line with the new Regulation "On out-of-court treatment of distressed borrowers by banks". The regulatory amendments aim to strengthen the classification criteria and provision of restructured loans, after 1 January 2021, when these amendments enter into force. This period coincides with the re-appellation of the regulation "On out-of-court treatment of distressed borrowers by banks". In this way, to banks it is provided the possibility to use the existing regulatory ease to restructure the borrowers up to December 2020. Also, through the regulatory amendments the write-off limit of loss loans by banks is reduced from 3 years to 2 years, with the purpose to further reduce the non-performing loans in the system.

- *Approval of the new guideline "On banks stress testing" (adopted with Decision No. 60, dated 4.9.2019 of the Supervisory Council of the Bank of Albania).*

The new Guideline approximates to EBA guideline3, on the preparation of stress tests by banks, in compliance with the requirements of Basel III on risks management. The purpose of this guideline is to lay down the requirements and methodologies on banks carrying out stress tests, as part of their risk management process, particularly in the framework of the internal assessment process of capital adequacy.

Although the applicable legal framework of the Bank of Albania sets forth the requirements on the conduction of stress tests from banks on some type of risks4, the drafting of this special guideline, aimed at unifying the practices that banks should implement to conduct stress tests, by addressing in details various types of stress tests, according to the complexity and type of risks that banks face throughout their activity. The Guideline sets forth detailed requirements on stress tests programme, aspects of stress - tests management, data aggregation infrastructure, and the reporting process within the bank, for stress tests purposes; the establishment of role and responsibilities of the bank's management structures in drafting and approving stress tests programme, also the identification of actions and measures to be taken, based on stress tests results, purpose and scope of application of stress tests, and their various types; requirements from banks on the conduction of stress tests, requirements on banks' reporting of stress tests results, accompanied with the measures being undertaken by the steering bodies of the bank, in response to these results, etc.

This Guideline has entered into force on 1 March 2020.

- *Also, during 2019, several regulatory acts were drafted and revised, considered important for banking supervision and for banks. They are expected to be adopted during 2020. In more details, the following regulatory acts were drafted and/or revised:*
    - Drafting of the new regulation "On determining the conditions for granting the prior approval to the intra-banking group financial support agreement". This Regulation lays down the conditions for granting the prior approval to the financial support agreement, which may be granted only by banks that are part of a banking group that falls under the consolidated supervision of Bank of Albania, and the requirements for documentation and its content for acquiring this approval from the Bank of Albania.
    - Draft-amendments to the Regulation "On capital adequacy ratio", which aim at further approximation with the European Regulation (CRR) 575/2013/EU "On prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012" to present the method based on the assessment of credit quality of the counterparty, on determining the shares of credit risk to some exposures (against the supervised institutions, entities of public sector and guaranteed bonds). Also, amendments to this Regulation were drafted based on the needs for review, being identified from the implementation in practice of the above stated regulation or the problems identified by the supervisors.
    - Preparation of draft-amendments to the Regulation "On the risk management from large exposures of banks", which aim at approximation with the latest amendments in 2019 to Capital Requirements Regulation (CRR)5 and to Basel document on large exposures regime. In 2019, impact study, took place with banks, with the aim the prior measurement of the effect of changes foreseen in fulfilling the regulatory obligations by banks. Part of the regulatory changes was also the review of banks reporting forms, with the purpose the easing of data gathering and processing as reported by banks, and the addition of some new items for reporting.
    - Preparation of amendments to the Regulation "On risk management in the activity of Savings and Loan Associations and their Unions" which aim at adopting with their activity dynamisms and development in the last years.
    - There has started the work for the compilation of the new draft-regulation "On the reporting of leverage ratio of banks", while the respective work group was established the compilation of this Regulation aims at approximating Basel III requirements based on the revised CCR2. Also, at the end of 2019, there were conducted some calculations on the prior assessment of financial leverage ratio, based on the data reported by banks in Corep reporting form. These prior calculations of this ratio were deemed necessary serving at the same time, as an initial base to further continue with the drafting of the new regulation.

- *During 2019, the Supervision Department also continued to contribute to the working group for the draft-law "On payment services", in the framework of the Bank of Albania's commitment to approximate the legal framework of the European Directive on Payment Services (PSD2)6.*

- *Also the Supervision Department has contributed in the Inter-institutional Working Groups in the framework of the European Integration process for some important chapters.*

Main strategic objectives of the Supervisory Authority in 2020

In 2020, the work of supervision will focus in the fulfilment of the strategic objectives in line with the medium-term development strategy of the Bank of Albania and its development plans. Special attention will be paid on the development and impacts of Covid-19 spread on the banking activity and health of entities. The Bank of Albania has undertaken some regulatory facilities related with the classification and provisioning of loans to assist banks in dealing with the consequences of the pandemic and providing room for effectively restructuring the relationships of credit with borrowers. Depending on the pandemic spread and intensity, the supervisory approach and the orientation of available human resources will be adopted from a traditional approach to a targeted and prudential approach with a final objective that of maintaining the financial stability in Albania.

The activities of the Banking Supervisory Authority

In 2019, the bank consolidation process, started years ago, was concluded, bringing the number of banks to 12. This process reformed the domestic banking market, which is now experiencing an increase in the presence of domestic capital, where 4 banks with a share of 29.3% in the market, are owned by this capital. In 2019, the process of ownership transfer for two banks was concluded, as well as the absorption of one bank and the self-liquidation of another. Specifically:

- The majority of the shares of Tirana Bank were transferred from Piraeus Bank to new shareholders, Balfin Group. This transfer was approved by the Supervisory Council of the Bank of Albania. The transfer of the management of the bank to the new shareholder was also concluded, through this transfer.
- The qualifying holding of the shares of the Societe Generale Bank Albania was transferred to the ownership of the shareholder of OTP Bank Nyrt, Hungary. After this approval the bank changed its name to OTP Bank.
- The process of full absorption of the International Commercial Bank by Union Bank was completed during the year after the transfer of 100% of the shares was previously approved.
- The licence of Credit Bank Albania was revoked, after the decision of shareholders on its voluntary liquidation.

The map of the representation of banks with branches in various regions of the country also underwent downward changes. This trend was due mainly to the consolidation of the banking system and the reduction of the number of banks.

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

On-site examinations, the most important process for assessing banks, are performed at an increased attention for fulfilling the supervisory mission, and have been oriented towards main risks. In 2019, 17 full-scope and partial examinations were performed, covering almost all banks, three non-bank financial institutions, one SLA and 97 Foreign Exchange Bureaus. The examinations programme also took into account the development in the structure of the banking system as well as the commitments of the Bank of Albania in the framework of fulfilling the recommendations of the experts of Moneyval.

The examinations on banks have as an objective the on-site assessment of all risks, theme examination on the assessment of specific identified risks, and examinations on the follow-up of the recommendations left by previous examinations.

Theme examinations were mainly focused on the management process of non-performing loan portfolios, to continuously decrease them. They were also used to assess the internal methodologies of banks, reported at the Bank of Albania, on the calculation of capital requirements for internally identified risks, in accordance with the guideline "On the internal assessment process of capital adequacy".

Table 1 Number of examinations by year of institution and topic

Examined institutions	Strategic Risk	Organisational Risk	Credit Risk	Liquidity Risk	Interest Rate Risk	Market Risk	ICT Risk	Operational Risk	Reputable Risk	IProfitability Risk	Capital RiskRisk
2017	9	12	13	10	10	9	11	8	11	10	11
2018	8	10	9	8	8	8	9	8	48	9	8
2019	13	13	16	13	13	14	13	13	113	13	15

International activities of the authority

Cooperation with international financial institutions extended to several dimensions. During this year, participation in the supervision colleges organized by the European Central Bank was realized, in order to exchange information with some of the banks with EU origins that operate in the Albanian market. Also, in the first part of 2019, we benefited from the participation in training activities organized in the framework of a programme sponsored by the European Central Bank and led by the Deutsche Bundesbank for Strengthening the Central Bank Capacities in the Western Balkans with a view to the Integration to the European System of Central Banks. In more concrete terms, these activities were organized by the Bank of Poland, focusing in the acknowledgement and approximation with the European legislation in the field of transparency and consumer protection, and the Bank of Italy with a broad spectrum of themes in the field of supervision. This programme will also continue during 2020.

Also, in 2019 Q4, started the implementation of the twining project with Banka d' Italia and Deutche Bundesbank in the framework of the approximation to the regulatory and legal framework in the supervision field, the best practices originating from the European System of central Banks and the strengthening of technical capacities of staff of the Bank of Albania. This project consists in a set of intensive activities covering the review of capital requirements for various risks, the review of internal assessment process of capital, etc., to be mainly realized through experts' missions of Banka d'Italia and Deutche Bundesbank.

In the framework of the collaboration with international financial institution, we may mention also the communication with the National Bank of Hungary, with a focus on signing a cooperation agreement, mainly for information exchange.

Throughout 2019, it is worthy to mention the collaboration with international financial institutions, like the IMF and EBRD. Cooperation with the IMF has continued in the framework of the multi-year project for the development of supervisory and institutional capacities according to a risk-based approach, part of the strategy of the Bank of Albania, in capacity of the regulatory and supervisory authority of the banking market and more broadly. This collaboration has been materialized with the assistance of the IMF through a resident advisor at the Supervision Department. In this context, we particularly highlight the drafting of the internal methodology on the Supervision Review and Evaluation Process (known as SREP) as well as other regulations finalized and approved in 2019. The project will continue during the first part of 2020, which provides for the calibration of requirements for capital buffers of banks according to the second pillar of the Basel framework for capital adequacy, as well as the presentation in the banking industry of some revised, or new, regulations, according to best market practices. Also, cooperation with EBRD for the improvement project of the regulatory framework towards the sound governance of banks has continued, through the technical assistance and expertise of Deloitte London and Albania.

Cooperation with other supervisory bodies in Albania

Among local institutions, the Bank cooperated particularly with the General Directorate for the Prevention of Money Laundering (GDPML) for the implementation of the recommendations of Moneyval and providing relevant reports to the experts of Moneyval and FAG (Financial action group), conducting joint examinations and review of the legal and regulatory framework related to issues on the prevention of money laundering and terrorist financing. Also, BoA assisted the Albanian Financial Supervision Authority in various examinations in the banking sector, in order to fulfill the legal and regulatory obligations of this authority and continuous share of correspondences.

Eight on-site inspections were carried out within the framework of cooperation with the General Directorate for the prevention of Money laundering (GDPML), specifically in 5 banks and 3 foreign exchange bureaus.

Other relevant information and developments

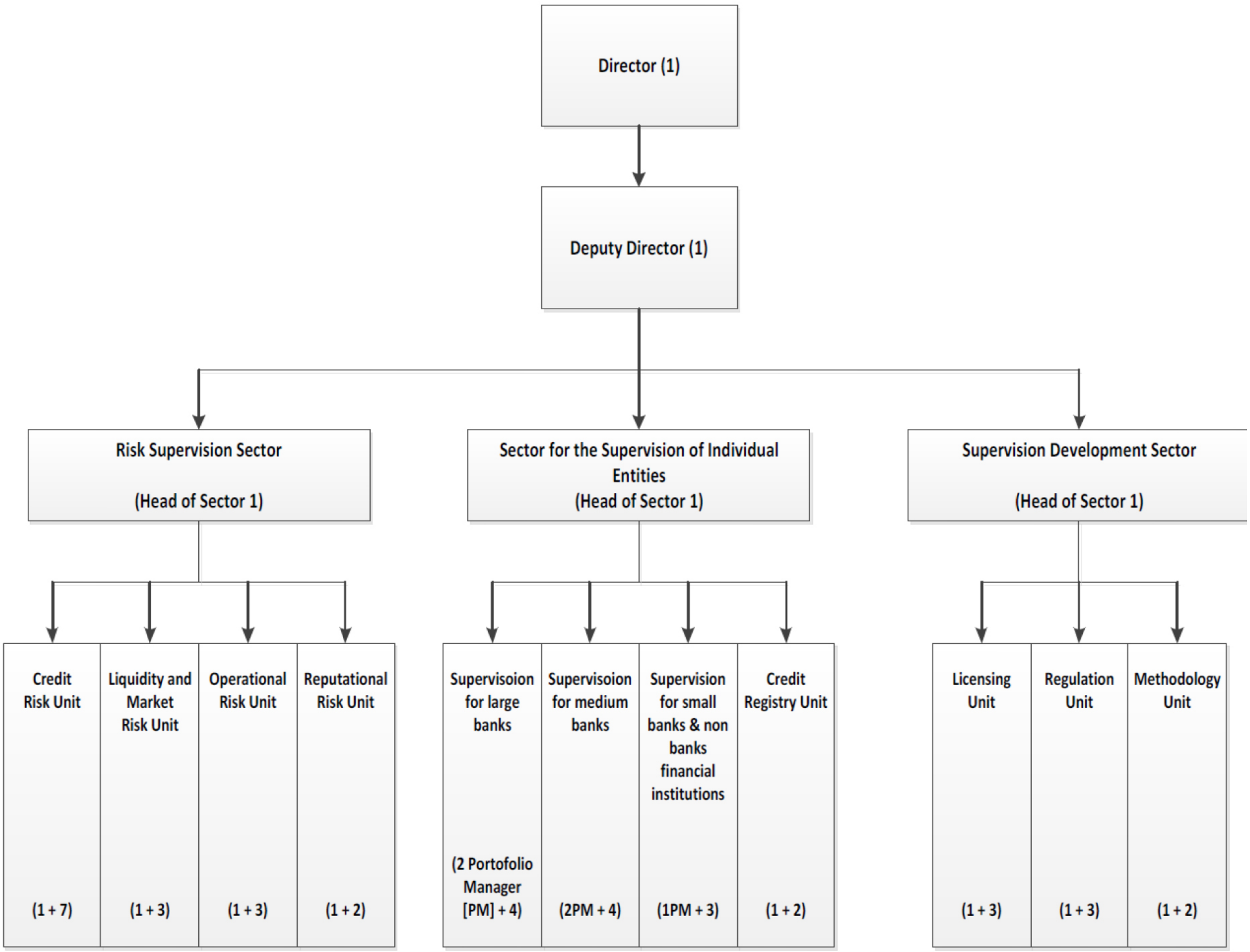
Tirana Approach[1] project, having gone through a phase of intensive discussions with stakeholders, including representatives of the FinSAC project and the IMF resident advisor to the Bank of Albania, was finalised in July 2019, with the approval of respective regulatory framework which will be implemented till the end of 2020. With the aim to encourage banking industry to maximally benefit from this framework, the Supervision Department has pursued a proactive approach through a simultaneous and symmetric communication with almost all banks, bringing into attention the exposures that may be subject to be addressed by this platform. Meanwhile, we remain attentive to all developments expected to be materialised in this regard, being ready to provide our support within the spirit of the regulatory framework.

In the framework of implementing the recommendations from the Committee of Experts of CoE on the Evaluation of Anti-Money Laundering Measures and counter Terrorist Financing (MONEYVAL), the Bank of Albania was included in the implementation of the national plan of measures, throughout 2019, regarding both technical and effectiveness issues, in order to improve the regulatory framework and strengthen the effectiveness of the supervisory process, with the purpose the addressing the main problems evidenced the report, whose fulfilment will continue also during 2020. Consequently, the assessment of the risk exposure of entities to the prevention of money laundering and combating the financing of terrorism has been a priority. The findings and recommendations from this process were factored in the drafting of supervisory plans for the more exposed entities, such as the Foreign Exchange Bureaus.

[1] Since the moment of drafting and presenting it up to its approval and implementation, this Regulation is called as "Tirana Approach", in the view of a parallelism with similar initiatives undertaken in other countries, but with specifics related to its objective and the economic and legal context to be implemented.

Organizational chart of the Banking Supervisory Authority

The organizational structure of the Supervision Department hasn't had any changes during 2019. The last structural change was in 2016.



Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	16	14	12
Branches of foreign credit institutions	0	0	0
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**16**	**14**	**12**

Total assets of banking sector (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	10,871.23*	11,772.21*	12,117.52*
Branches of foreign credit institutions	n/a	n/a	n/a
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	10,871.23*	11,772.21*	12,117.52*
y/y change (in %)		**8.29%**	**2.93%**

**The values are in thousand Euro*

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	0	0	0
Domestic ownership total	12%	16.55%	22.84%
Foreign ownership	88%	83.45%	77.16%
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	57.32%	75.52%	0.15
Branches of foreign credit institutions	n/a	n/a	n/a
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**57.32%**	**75.52%**	**0.15**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	15.71%	12.96%	13.45%
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**15.71%**	**12.96%**	**13.45%**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	100	100	100
Branches of foreign credit institutions	n/a	n/a	n/a
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector	18.59	17.92	17.98
Nonfinancial sector	37.34	36.78	36.92
Government sector	39.55	41.23	41.30
Other assets	4.50	4.06	3.80
Liabilites			
Financial sector	2.66	2.88	3.60
Nonfinancial sector	79.73	80.28	79.90
Government sector	3.96	3.81	3.26
Other liabilities	3.51	2.88	2.21
Capital	**10.14**	**10.17**	**10.45**

Capital adequacy ratio of banks

Type of financial institution	2017**	2018**	2019**
Commercial banks	17.03%	18.24%	18.28%
Cooperative banks	n/a	n/a	n/a
Banking sector, total:	**17.03%**	**18.24%**	**18.28%**

*(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	2017	2018	2019
Non-financial sector, including	13.23	11.08	8.37
- households	7.64	6.44	5.19
- corporate	16.88	14.25	10.73

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	84.06	32.45
Corporate	13.63	62.28
Government sector	2.30	5.27
Financial sector (excluding banks)	n/a	n/a
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	53.940.99	52.079.81	49.372.11
Interest expenses	9.058.8	8.547.29	8.158.59
Net interest income	44.882.19	43.532.51	41.213.52
Net fee and commission income	8.327.07	9.326.72	10.238.41
Other (not specified above) operating income (net)	22.177.77	17.036.78	21.688.95
Gross income	51.717.89	47.225.51	51.163.37
Administration costs	26.523.36	27.626.33	29.474.52
Depreciation	n/a	n/a	n/a
Provisions	2.449.77	6.265.06	288.56
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	23.972.22	21.067.44	22.158.14
Net profit (loss)	21.628.36	18.390.96	19.894.82

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds **	Core Tier 1**	Tier 1**	Tier 2**	Tier 3**
Commercial banks	1,178	1,100	1,100	78	n/a
Cooperative banks	n/a	n/a	n/a	n/a	n/a
Banking sector, total:	**1,178**	**1,100**	**1,100**	**78**	**n/a**

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

Macroeconomic environment in the country

A higher-than-forecasted economic growth was observed in Armenia in 2019 reaching to 7.6%, mainly contributed by the manufacturing industry and services, while agriculture has contributed negatively to the economic growth.

In the light of the developments in the international commodities markets and the decline in the foreign demand by partner countries, the contribution of the net exports of Armenia to the economic growth remained negative. However, in the first half of the year there was a decline in the export rates, conditioned by the economic growth rates of the partner countries, and consequently, by the decrease of foreign demand, the export rate recovered in the second half of the year, especially in terms of certain product groups. The annual growth rate of export was 12,2 %; on the contrary, the import rate's annual growth was 9.0%. In comparison with the last year's figures, the current account deficit improved to certain extent, inching to 8.2 % of GDP.

The year of 2019 can be characterized by the increased domestic demand, driven by the high level of private consumption, which was accompanied by a high rate of consumer lending. The lending expansion is a result of the increase in credit demand, the easing in lending conditions, and credit accessibility, conditioned by the positive expectations of economic growth.

Low inflation (0.7%) observed in the course of 2019 was attributable mainly to contractionary fiscal policy implementation during the year and to the inflation environment in the world's commodity markets weakened amid continued slowing of global economic growth. At the same time, some supply-side factors containing inflation, noticeable during the year, included increasingly competitive commodity markets, which has changed firms' approach to pricing and reduced their markups, and shifted demand from the market of non-durable consumer goods to that of durable goods.

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

As of 31 December 2019, 17 commercial banks operated in Armenia. The banking sector remains the largest participant of the financial system and accounts for 83.5% of the system's assets.

In 2019, the assets of the banking system increased by 16.9%, loans to the economy, by 16.4%, total capital, by 10.0%, and liabilities, by 18.1%. The indicators of the banking system assets to GDP and credits to GDP increased respectively by 5.9 and 3.2 percentage points, reaching 89.0% and 52.1%, respectively.

The banking system remains profitable, capitalized, and liquid. Credit, liquidity, and market risks are manageable. Due to the decline in dollarization, the financial system's vulnerability to foreign exchange risks significantly decreased. Due to the high growth of household lending, the possible risk developments are planned to be addressed by means of the execution of macroprudential tools.

The 16.47% increase in the credit portfolio mostly maintained the growth rate of the previous year, but unlike the previous year, the increase in lending was due to the growth of household lending by 32.0 % (consumer and mortgage loans). Lending to legal entities was moderate and the annual growth rate was around 6.1%. Easing in lending conditions and the increase in demand for loans by households have contributed to the advanced growth of household lending. The opportunity provided by the state programs (refund of the income tax contributions in the amount of mortgage interest expenses) significantly reduces the burden of credit service at least in the medium-term, has also contributed to the growth of demand for mortgage loans by households. Considering the possible signs of accumulating risks due to the high growth rate of consumer and mortgage loans, the CBA has undertaken and implemented efforts towards the more targeted and sectoral execution of the macroprudential tools (loan to value, debt to income).

As a result of the measures conducted by the CBA towards dedollarization, the decrease in inflation expectations, and the progressive growth of household lending, the share of foreign currency loans in the total credit portfolio decreased.

In comparison with the previous year, the share of non-performing loans, and receivables increased by 0.6 percentage points to 5.1% of total loans and receivables at the end of 2019.

The capital adequacy and liquidity ratios that describe the banking system stability continued running above the established thresholds. Specifically, the total capital adequacy ratio amounted to 17.6% (minimum threshold: 12.0%). On the back of expanding loan portfolio, the banking system liquidity persisted at the level almost twice as high as minimum thresholds, pointing to the sufficient liquidity in the banking system. As of the end of 2019, commercial banks' total and current liquidity ratios were 27.1% and 111.7% (minimum thresholds: 15.0% and 60.0%), respectively.

Profitability of the banking sector increased in 2019. Net income of banks increased by 61% from AMD 38.6 billion in 2018 to AMD 62.2 billion in 2019. The return on assets and return on equity ratios amounted to 1.2% and 7.9%, respectively (0.8% and 5.3% in 2018). The pretax RoE of the banking sector amounted to 10.3% in 2019 (7.61% in 2018).

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

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.

The following amendments were initiated during the year in the context of improvement of the financial system's regulatory framework:

- Capital conservation, countercyclical capital buffers and surcharge for systemically important banks were introduced.
- Changes were made to the reserve requirement ratio for banks.
- Measures were taken to improve risk management system of banks involved further requirements to stress testing and bank rehabilitation programs.

These changes have been made with the aim to:

- Contribute to maintaining the stability of the banking system and its ability to withstand shocks in various economic situations, increase the efficiency of the use of macroprudential instruments by the Central Bank, and align the capital requirement to international standards.
- Provide preconditions for the creation of foreign currency liquidity buffers.
- Improve the effectiveness of internal control and risk management systems in banks and the ability to respond quickly in emergencies.
- Implement the recommendations under the Financial Sector Assessment Program, FSAP, jointly carried out by the International Monetary Fund and the World Bank in 2018.

The law on "Non-Cash Transactions" drafted during the reporting period provides for limits in order to reduce the volume of cash transactions. The draft to the law is aimed to shorten the shadow economy, promote financial intermediation in the banking system. This, in turn, will add to the development of the entire financial system, including the expanding of infrastructure and services provided for payment services, thus ensuring fast, reliable and secure payment by non-cash instruments.

Main startegic objectives of the supervisory authority in 2019

Financial Supervision Department (FSD) is the main unit within the CBA in charge for supervision of all types of financial institutions in the Republic of Armenia. FSD accomplishes its tasks in close cooperation with the Financial Monitoring Centre (AML/CTF monitoring unit) and Financial Stability Department.

In 2019, FSD planned and performed its activities with the following main strategic objectives in mind:

- Further operationalization and advancement of Risk Based Supervision Framework;
- Improvement of governance practices with the current focus on strategic planning and strategic risk management processes;
- Improvement of risk management and consumer protection practices in the retail credit sector which shows relatively high growth in recent years;
- Control of emerging operational risk factors with the current focus on on-line banking;
- Improvement of AML/CTF risk identification and risk assessment toolkit for off-site and on-site supervision in the context of Risk Based Supervision;
- Enhancing bank resilience against cybercrime and IT risks.

The Central Bank of Armenia also assigned special significance to the protection of free and fair competition in the financial sector with a view to reducing barriers to entry and expansion that would lead to lower prices for consumers and greater variety of product/service offered in the market.

The activities of the Banking Supervisory Authorities in 2019

The Central Bank continually monitors the activities of financial institutions, carries out analyses of their financial position, identifies and assesses risks, evaluates the compliance of their activities with the legal framework and exercises other functions of oversight under the law. In 2019 the Central Bank continued performing its supervisory functions to maintain the stability of the financial system, while making sure an effective AML/CTF framework is in place and interests of consumers in the financial market are duly protected.

One of the focus areas within the Risk Based Supervision Framework was the assessment of risk management processes and practices through well-balanced off-site analyses and on-site validation.

During the year, FSD accomplished targeted on-site missions in 6 banks focused on the following areas: governance practices (corporate governance and internal audit, transactions with related parties), credit risk in the retail portfolio, quality of risk management, consumer protection structures and processes, AML/CTF compliance. Besides, FSD had on-site inspections in 6 insurance and 2 investment companies, as well as 162 more inspections with other market participants.

In addition, a notable step forward was made by fine-tuning the requirements for stress-testing and ICAAP, as well as by introducing requirements on recovery plans for banks.

In the first half of the year the Strategic plans of the banks were analyzed by the supervisors with the support from Corporate Governance team (expert team within the FSD) based on the principles mentioned in the Supervisory Expectations, a consultative document shared 2 years ago. The results were summarized and communicated to the industry revealing the areas for further improvements.

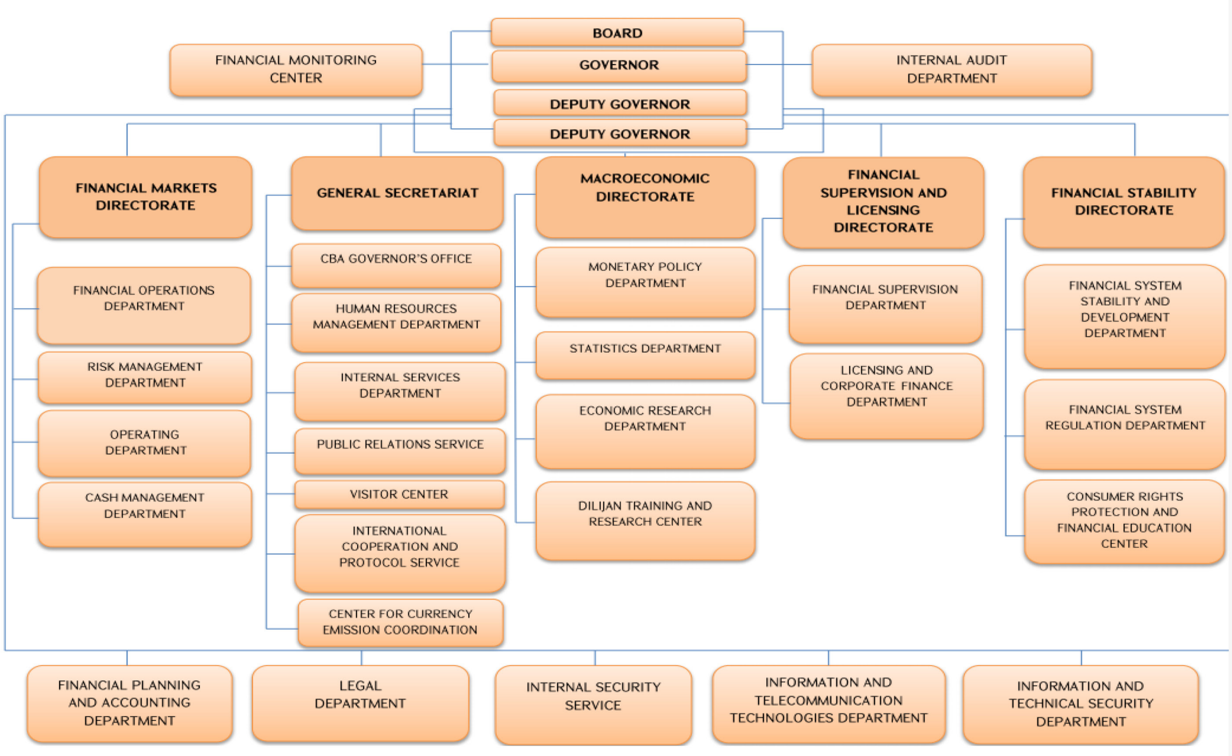
Taking into consideration the growth of on-line banking services the CBA started a review of on-line client identification practices and techniques used in commercial banks in order to calibrate its regulatory and supervisory policy. The review will be finalized in 2020 resulting in appropriate policy measures.

In the context of enhancing bank resilience against cybercrime, the FSD in cooperation with IT Security Department continued monitoring PEN testing results reported by the commercial banks (the formal regulation on PEN testing and reporting was introduced 2 years ago) and performing follow-ups for 2018 on-site inspections. Finally, further improvement of regulatory requirements and supervisory measures was sketched.

In the scope of enhancing competition in financial markets, the CBA expanded capacities and resources of the antitrust subdivision and delineated activities for the upcoming year in relation to legislative amendments and possible areas of research.

In 2019 the CBA continued evaluation of the competence, integrity and qualifications of proposed bank management in line with fit and proper principles and implemented measures to enhance the effectiveness of its licensing procedures.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

In 2019 the Central Bank sustained its ties with international partner institutions at multilateral and bilateral level by way of organizing a variety of workshops, posiums, courses, and mutual visits. A number of visits by representatives of partner organizations are noteworthy in this context.

The International Monetary Fund (IMF) made a regular visit to Armenia. Following an effective work with the Central Bank and the Government of the Republic of Armenia, the IMF Board approved a new program with Armenia in 2019. In the framework of the program approved by the IMF, the Central Bank has closely cooperated with the IMF Armenia mission, and the management of relevant department and the IMF/WB (Dutch-Belgian Subgroup) Constituency, ensuring the implementation of measures related to the monetary and financial sectors.

In April, the Central Bank received a delegation led by Christoph Tiskens, Chairman of the Board of Directors of the European Foundation for Southeast Europe (EFSE). The prospects of bilateral cooperation was the subject of discussion during the visit, followed by a roundtable on "SME Sustainable Finance" organized together with Finance in Motion.

In 2019 representatives of Moody's and Fitch Ratings, international rating agencies, arrived in Armenia on a regular visit. The visit was coordinated by the Central Bank. As a result, Moody's has raised Armenia's sovereign rating from B 1 to Ba 3, while changing the outlook for the country from 'stable' to 'positive'.

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

In the context of strengthening international cooperation, in 2019 the Central Bank hosted dozens of regional and international symposiums, conferences, seminars, workshops, forums, etc. in its Yerevan Head Office and Dilijan Training and Research Center.

In 2019 the Central Bank hosted the 2nd meeting of the Advisory Committee on financial markets of EEC, the meeting of the working group of specialists of national/central banks of the EEU member states in the field of developing national payment and settlement systems on the subject "Implementing the ISO 20022 standard", as well as a number of other events in the framework of its membership in international and regional institutions.

Agreements, contracts and memoranda of understanding signed between foreign central banks at a bilateral level and in the framework of intergovernmental commissions in 2019 included:

1. A memorandum of understanding signed between the Central Bank of Armenia and Abu Dhabi Global Market at the meeting of the Armenia-Emirates Committee in Yerevan on May 2nd.
2. An agreement on cooperation between the Central Bank of Armenia and the Central Bank of Russia in the field of financial market supervision, including the exchange of confidential information, signed in the framework of International Financial Congress in St. Petersburg on July 4th.
3. A memorandum of understanding between the Central Bank of Armenia and the Astana International Center on Financial Services Regulation signed in the framework of the regular meeting of the Advisory Committee on financial markets of EEC in Yerevan on October 2nd.
4. The Central Bank actively participated in developing the concept paper on Common Financial Market in EEU and has, together with partner central/national banks, finalized the concept paper, which was signed by the leaders of the EEU countries at the October 1st summit in Yerevan.

Cooperation with other supervisory bodies in the country

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

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	17	17	17
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	**17**	**17**	**17**

Total assets of banking sector (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	7,523,495	9,006,500	10,848,309
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	7,523,495	9,006,500	10,848,309
y/y change (in %)	-3.35%	19.71%	20.4%

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	2.39	2.22	2.22
Domestic ownership total	38.22	34.91	37.13
Foreign ownership	61.78	62.87	60.65
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	42.84%	56.38%	0.09
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**42.84%**	**56.38%**	**0.09**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	8.60%	7.61%	10.30%
Cooperative banks			
Banking sector, total:	**8.60%**	**7.61%**	**10.30%**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	100	100	100
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector	27.45	26.62	26.63
Nonfinancial sector	57.76	59.50	58.21
Government sector	10.83	10.65	10.30
Other assets	5.55	5.04	4.86
Liabilites			
Financial sector	10.74	12.21	21.50
Nonfinancial sector	44.76	41.60	59.96
Government sector	0.81	0.67	0.67
Other liabilities	29.08	31.59	3.74
Capital	**15.58**	**14.74**	**14.14**

Capital adequacy ratio of banks

Type of financial institution	2017	2018	2019
Commercial banks	18.60%	17.66%	17.58%
Cooperative banks			
Banking sector, total:	**18.60%**	**17.66%**	**17.58%**

*(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	2017	2018	2019
Non-financial sector, including	5.85%	4.89%	5.76%
- households	4.79%	5.83%	6.03%
- corporate	6.26%	4.46%	5.61%

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	44.61	44.78
Households	26.64	20.79
Corporate	17.97	23.99
Government sector	0.54	7.87
Financial sector (excluding banks)	10.24	3.57
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	586,386.64	634,726.08	734,741.94
Interest expenses	354,249.06	363,816.47	416,141.02
Net interest income	232,137.58	270,909.61	318,599.92
Net fee and commission income	68,115.06	93,237.81	123,006.52
Other (not specified above) operating income (net)	15,094	-20,703	8,984.82
Gross income	1,554,471.88	1,160,938.53	1,322,466.03
Administration costs	104,535.00	121,480.80	144,243.09
Depreciation	21,845.17	22,523.94	27,920.58
Provisions			
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	89,982.58	99,985.47	128,689.73
Profit (loss) before tax	89,133.77	99,454.13	149,737.87
Net profit (loss)	69,326.69	69,275.23	115,797.55

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	1,533,852	1,286,463	1,485,740	199,277	
Cooperative banks					
Banking sector, total:	**1,533,852**	**1,286,463**	**1,485,740**	**199,277**	

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

Macroeconomic environment in the country

The Austrian economy was already slowing when COVID-19 hit. In a weakening international environment, economic growth in Austria had decelerated in 2019, with the decline being most pronounced in the export-oriented sectors of the economy. Against this backdrop, nonfinancial corporations became increasingly cautious about their investments. Amidst the slowdown of economic growth, corporate profitability weakened in 2019. In the final quarter, the gross operating surplus of Austrian nonfinancial corporations decreased by 1.4% year on year in real terms (based on four-quarter moving sums), the first drop in six years. Profitability had already been on a downward trend for the past two years.

The debt sustainability of Austrian nonfinancial corporations deteriorated slightly in 2019. In the course of the year, the debt-to-income ratio of the corporate sector increased by 6 percentage points to 396%, as the growth of financial debt (measured in terms of total loans raised and bonds issued), despite being rather low at 1.8%, surpassed the expansion rate of gross operating surplus. Compared to 2008, i.e. the time before the onset of the financial crisis, the debt-to-income ratio of nonfinancial corporations was about 50 percentage points higher, pointing to comparatively weaker medium-term corporate debt sustainability.

However, the debt servicing capacity of the corporate sector was supported by the low interest rate environment. The interest burden of nonfinancial corporations remained at historically low levels in 2019.

With an average inflation rate of 1.8% since the euro's introduction in 1999, Austria has been among those countries that have managed to maintain price stability in line with the Eurosystem's definition (i.e. HICP inflation at a rate below, but close to, 2% over the medium term). In 2019, Austria recorded an HICP inflation rate of 1.5%.

The cyclical upturn that had started in early 2016 induced strong employment growth and a sustained decrease in unemployment. Between summer 2016 and the end of 2019, the unemployment rate (EU definition) dropped from 6.2% to 4.3% – thus reinforcing Austria's excellent record of social stability, which rests on high employment, low unemployment by international standards and a low frequency of strikes.

The outbreak of the COVID-19 pandemic led to a dramatic deterioration in the economic situation of the Austrian economy. Thus, macroeconomic conditions heavily worsened in the first half of 2020.

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

The Austrian banking sector increased in size in 2019, while the number of banks continued to decline. The consolidated total assets of the Austrian banking sector jumped over the EUR 1,000 billion mark in 2019 for the first time since 2016. Total assets to GDP reached nearly 260%. At the same time, the number of banks dropped further to 573.

Foreign claims of Austrian banks continued to climb in 2019, reaching EUR 401 billion at the end of 2019 (on an ultimate-risk basis). This corresponds to an increase of 7% compared to the previous year and 43% of consolidated total assets.

The Austrian banking sector earned a net profit of EUR 6.7 billion in 2019. This translates into a decline of 3% compared to 2018 and a return on average assets (RoA) of 0.7%, which was substantially higher than the average RoA for the EU banking sector (0.4%). The slight decline in profits can be attributed to rising operating and risk costs, which outweighed increases in the main sources of income (interest income and fees and commissions income).

Lending to nonfinancial corporations – especially the real estate sector – and mortgage loans were driving loan growth in Austria in 2019, with the former gaining further momentum in 2020. Loan quality at Austrian banks improved further in 2019, as NPLs were reduced and loan volumes grew. Coverage ratios continue to be comfortable, despite modest provisioning.

Austrian banks' common equity tier 1 (CET1) ratio reached 15.6 % at the end of 2019. This level represents a slight increase of 17 basis points year on year, but overall, it is fairly similar to the levels witnessed over the last two years and in line with developments in the EU banking sector.

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

The FMA is an independent, autonomous and integrated supervisory authority for the Austrian financial market, established as an institution under public law. It is responsible for supervising credit institutions together with the European Central Bank – ECB), payment institutions, deposit guarantee schemes, insurance undertakings, pension companies, corporate provision funds, investment funds, licensed investment service providers, credit rating agencies and stock exchanges, as well as for prospectus supervision. The FMA is also responsible for monitoring trading in listed securities to ensure that this is carried out properly and for monitoring issuers' compliance with information and organization obligations. Further tasks include combating the unauthorised provision of financial services and taking preventive action against money laundering and terrorist financing. Thus, in its capacity as a cross-sectoral integrated supervisory body, the FMA is responsible for addressing the challenges created by a high degree of interweaving within the Austrian financial market due to ownership structures, sales cooperation agreements and financial transactions. The legal framework in terms of banking supervision still comprises the Austrian Banking Act (Bankwesengesetz – BWG) as well as the Bank Recovery and Resolution Act (Bundesgesetz über die Sanierung und Abwicklung von Banken – BaSAG), transposing the European Bank Recovery and Resolution Directive (BRRD) the Deposit Guarantee Schemes and Investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz – ESAEG – revised in 2019).

With effect from 1. January 2015, the FMA also holds the function of the National Resolution Authority (NRA) for banks and forms part of the Single Resolution Mechanism (SRM). The main responsibilities of the NRA are resolution planning, the analysis and elimination of obstacles to resolution, and the conducting of resolution procedures in cases of credit institutions that have failed or are likely to fail. As the NRA for Austria, the FMA is an integral part of the SRM.

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

With the Single Supervisory Mechanism (SSM) in place, banks in the participating Member States are now supervised by means of a decentralized system involving close cooperation between the ECB and the National Supervisory Authorities (NCAs). The FMA is the NCA in Austria. The SSM was launched on 4. November 2014 and as of 31.12.2019 seven Austrian banking groups in total have been classified as "significant institutions" (SIs), encompassing 78 individual credit institutions that thus fall under the direct supervision of the ECB. SI supervision takes place in so-called Joint Supervisory Teams (JSTs), consisting of the relevant NCAs and chaired by the ECB. The remaining credit institutions based in Austria, classed as "less significant institutions" (LSIs) as well those national credit institutions thath are not part of the SSM (non-CRR CI) continue to be supervised directly by the FMA. This means that the FMA remains directly responsible for currently 471 of Austria's credit institutions as of 31.12.2019. Regarding LSI, the ECB only carries out indirect supervision. When supervising LSIs, the FMA bases its supervisory approach on the harmonised rules developed by the EBA as well as guidance provided by the ECB to ensure consistent SI and LSI supervision. In case of common procedures (granting and withdrawal of authorisations, qualifying holdings procedures), the decision-making competence for both SIs and LSIs lies exclusively with the ECB. However, the FMA is the entry point for notifications and prepares draft decisions for the ECB.

Main strategic objectives of the supervisory authority in 2019

Please see as well https://www.fma.gv.at/en/fma-publishes-its-priorities-for-supervision-and-inspections-for-2019-and-presents-its-publication-facts-and-figures-trends-and-strategies-2019/

Priorities for supervision and inspections 2019

The FMA has defined the following thematic areas as priorities for supervision and inspections in 2019:

- Financial market digitalisation: supporting digital change, managing risks.
- Sustainability of business models in the economic upturn: anticipatory thinking, acting anticyclically.
- Corporate governance: Strengthening resilience in a changing risk environment.
- A comprehensive examination of risk: increasing the stability of supervised entities by means of strong compliance and the strict prevention of money laundering.
- Collective consumer protection: Increased risk awareness thanks to targeted information, increased confidence due to product transparency, increased fairness as a result of the highest level of quality in distribution.
- Increasing operational readiness for future crises: improving the fitness of the FMA and the financial centre for more difficult times.

Operationalisation of the priorities for inspections

The FMA has defined a range of specific measures for each of these thematic areas, to operationalise the priorities for inspections. For example, the challenges presented by digitalisation are addressed among other ways by means of a "Cyber Incident Simulation" which stresses infrastructure and the organisation of IT and cyber security in supervised entities, to detect and rectify weaknesses. Furthermore a further priority is the compliance with conduct rules for protecting consumers where digital instruments and technologies such as robo-advice. In the area of outsourcing there is a priority for analysis and inspection placed on cloud-based computing.

In the priority for supervision for collective consumer protection there is a focus on the policy of sustainably granted consumer loans and mortgages. Furthermore an information offensive is planned for various target groups about the specific risks entailed in digital financial products, particular those in the cryptoeconomy. There will also be a particular focus on fairness and transparency in relation to the distribution of financial instruments, insurance and investment products.

Transparency and Clarity of Supervision

The aforementioned measures are only few outstanding examples. For clear and detailed presentation of all the measures for the Priorities for supervision and inspections 2019" has been published on the FMA website (In German) at (https://www.fma.gv.at/publikationen/fakten-trends-strategien/) as well as in the Publication "Fakten, Trends und Strategien 2019" (Facts and Figures, Trends and Strategies 2019).

The activities of the Banking Supervisory Authority in 2019

At the start of the financial year the FMA published its priorities for supervision and on-site inspections for the second time, in its annual facts and figures, trends and strategies publication.

The FMA set itself six medium-term strategic objectives in 2018, drawing on its medium-term risk analysis for the years from 2019 to 2023:

- Accompanying digitalisation on the financial market: supporting digital change, managing the risks
- Securing the sustainability of business models during a period of growth: looking ahead and pursuing a counter-cyclical approach
- Further improving corporate governance: strengthening resilience in a changing risk environment
- Further developing risk monitoring: using strong compliance and consistent antimony laundering measures to improve the stability of supervised entities
- Expanding collective consumer protection: targeted information to create greater risk awareness, product transparency to improve trust, top quality in sales for greater fairness
- Improving readiness for future crises: improving the ability of the FMA and Austria as a financial centre to withstand difficult periods.

Based on these medium-term strategic supervision objectives, the FMA defined specific priority areas for its supervision and inspection work in 2019, and communicated these to all financial market participants in its "Facts and figures, trends and strategies 2019" publication in line with its commitment to maximum transparency. The individual strategic objectives are explained in brief below, including a description of the derived specific priorities for supervision and inspections in 2019.

STRENGTHENING THE RESISTANCE OF THE SUPERVISED SECTORS AND COMPANIES TO CRISIS

The FMA not only works to improve its own ability to act when faced with a bank resolution process, however. It also added to the measures in place to make the banking sector more resistant to crisis in 2019.

- The FMA implemented binding MREL (minimum requirement for own funds and eligible liabilities) rules in 2019 for the first time.
- A further priority was ensuring the ability of banks to provide data in the event of their resolution.
- The deposit guarantee schemes provided by the individual associations were replaced, with effect from 1 January 2019, by the common deposit guarantee scheme or by institutional protection schemes (IPS) if the latter are recognised by the FMA as deposit guarantee schemes. The FMA and the OeNB together reviewed the systems and processes involved in the new scheme to ensure that they function properly.

The first international experience of the resolution regime for banks has shown that close and ongoing liaison between banking supervision and banking resolution provides the basis for and is a basic prerequisite of effective and successful resolution.

- Consequently, the FMA expanded the benefits of an integrated supervisory authority to an even broader and greater extent in the reporting year, making substantial efforts to streamline the processes between the banking supervision and resolution functions.

Although banking regulation is already more advanced than the regulation of other sectors, with its own resolution regime and institutions, action is also needed beyond the banking sector to improve how prepared the corporate sector is for potential crises.

- The FMA therefore reviewed whether companies in the insurance sector are sufficiently well prepared for crises in terms of their contingency planning and consideration of new risks.
- The FMA also reviewed whether capital market infrastructures are prepared for crises.
- Previous crises have shown that certain capital market infrastructures have a central role to play in the successful resolution of banks. With this in mind, the FMA entered into dialogue with these significant infrastructures in order to define the requirements on these infrastructures so that potential bank resolutions under the bank resolution regime can be implemented efficiently.

IMPROVING READINESS FOR FUTURE CRISES – IMPROVING THE ABILITY OF THE FMA AND AUSTRIA AS A FINANCIAL CENTRE TO WITHSTAND DIFFICULT PERIODS

Regulation and supervision aim to make companies on the financial market as resistant as possible to shocks and crises so that they can continue to provide their services to corporate and retail customers during difficult periods. Over recent years, however, the crises on the financial markets have highlighted the need for companies to prepare better for crisis situations. Companies are increasingly being required to prepare contingency or recovery plans setting out specific steps and measures that could be used to handle a crisis. Yet should these measures not suffice, companies must also be able to exit the market in an orderly fashion where necessary, without casting doubt on the stability of the market as a whole. This was the reason for the creation three years ago of the European resolution regime for the banking sector. The national bank resolution authorities and the Single Resolution Mechanism (SRM) in the eurozone have been expanded and given more staff. The first development phases in the resolution plans, preparing for a bank's orderly exit from the market, have been concluded.

Nevertheless, the first instances of the resolution regime being applied to banks in the eurozone have demonstrated that the banks themselves and the resolution authorities need to step up their preparatory work for future resolution cases in order to make a substantial contribution to financial market stability.

IT SECURITY AND CYBERSECURITY

In 2018 the FMA published guides on IT security for all sectors of the financial market. The aim of these is to provide the supervised companies with transparency regarding the FMA's requirements for their organisational structure and processes in relation to IT security and cybersecurity.

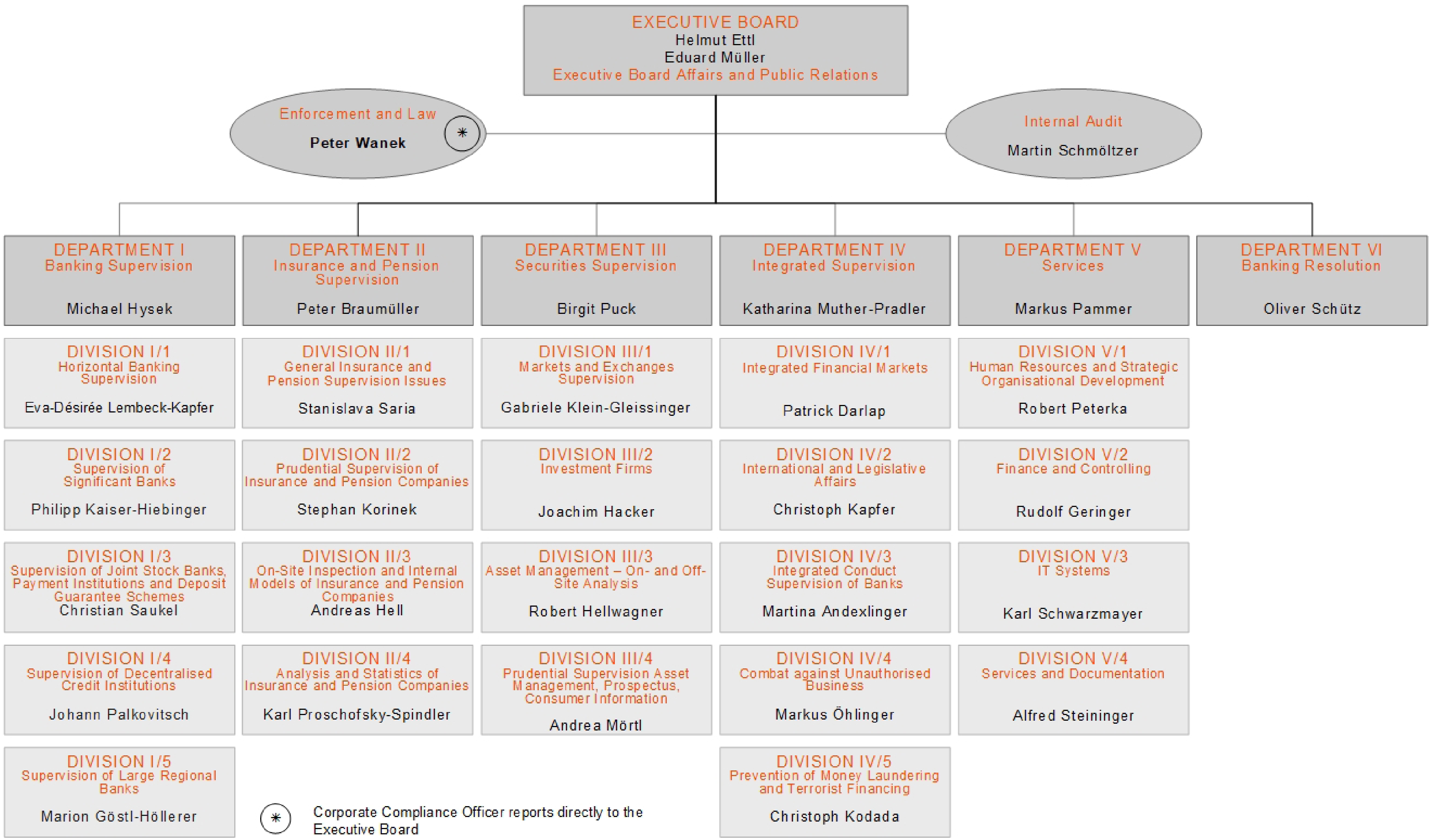
- In order to ensure that market participants and customers can rely on uniform standards of protection, a review of the practical implementation of the requirements set out in the FMA guides has been made a priority.
- IT risks and IT security were the main areas of focus during on-site inspections.
- The FMA focused particularly on outsourced functions and cloud computing, which is a special form of outsourcing. As with any type of outsourcing, cloud computing must take place within a clearly defined structure and not involve companies handing over business areas or applications to a black box, where there is no supervisory control, and failing to fulfil their overall responsibility.

In 2019 the FMA also made operational IT security and cybersecurity one of its priorities. To this end, it performed its first cybersecurity stress test together with the OeNB in the form of a cyber war game for the banking sector.

INTRODUCTION OF THE FOLLOWING GOVERNANCE MEASURES IN 2019

- Governance workshops were held with selected supervised companies in order to demonstrate best practice and to integrate findings into the companies' overall risk assessment.
- The compliance officer and internal audit functions, in the capacity of internal governance functions, are key contact points for the supervisory authority. Cooperation with these functions was stepped up.
- Good governance must be a daily reality in order to be effective. Consequently, the FMA focused specifically on insurance undertakings and reviewed whether their key functions were actually performing their role in practice. This involved checking whether the defined decision-making processes are being observed and whether all relevant key functions were being involved.
- With regard to asset management, a priority was governance in management companies, encompassing checks on the management of delegation processes (the outsourcing of services) and the overall integration of risk management into the investment process.
- The FMA tightened up its requirements of the new function of compliance officer in banks pursuant to Article 39 para. 6 of the Austrian Banking Act (BWG; Bankwesengesetz) and engaged in transparent market communication.
- With regard to the fit and proper nature of those in executive and key functions, the FMA focused on compliance with the new fit and proper guidelines used to assess the suitability of members of the executive body and holders of key functions.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

The Austrian FMA is part of the European cooperation within the European System of Financial Supervision (ESFS) and contributes actively to the activities of the European Supervisory Authorities (EBA, ESMA, EIOPA) as well as the ESRB. Furthermore, the FMA is National Competent Authority within the Single Supervisory Mechanism (SSM) and National Resolution Authority within the Single Resolution Mechanism (SRM).

On an international level, the FMA is an active member of the IAIS, IOPS and IOSCO and 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 to active cooperation with international organisations, the fostering of bilateral relations with other supervisory authorities is of particular importance. Bilateral cooperation is facilitated by memoranda of understanding on cooperation and exchange of information, which the FMA has already signed with supervisory authorities from 44 jurisdictions. Furthermore, the FMA has signed multilateral memoranda of understanding under ESMA, IOSCO, IAIS and the ECB.

Cooperation with other supervisory bodies in the country

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

Other relevant information and developments in 2019

One of the most important and uppermost tasks of regulators and supervisors should be to work hard during the good times so that the financial market is always prepared for the difficult times. While the upturn lost some of its momentum during 2019, any slowdown during the reporting year ultimately proved to be relatively moderate in nature: global growth was +2.9%, with the eurozone countries expanding by +1.1% in real terms and Austria's gross domestic product (GDP) up by +1.5%.

We used the good years to ensure that our supervised entities are more robust and resistant to crisis across all of the supervised sectors. We have done this, firstly, by insisting on consistently tackling the damage left behind by the global financial crisis. Secondly, we have prioritised improving the sustainability of business models, which has been successful. Austrian banks have doubled the size of their capital buffer compared with pre-crisis levels, from around 8% to approximately 16% currently, while at the same time dramatically improving the quality of their capital resources, more than 90% of which now comprises CET1 capital with full loss-absorbing capacity.

The banks have also slashed their portfolios of non-performing loans to around two per cent of their total volume of outstanding credit. The capital buffer that has been built up during the upturn in order to help cushion and smooth out the effects of any economic dips, or even slumps, totalled approximately € 21 billion by the end of 2019. This means that, should the need arise, banks would be able to mobilise capital of € 38 billion while still complying with the statutory requirements. They could do so to cushion any losses or in order to provide the real economy with financial and active support in both good and bad times. This also means that banks as a whole could initiate a credit volume of close to € 400 billion.

Government and supervisors are also playing their part. We learned the lessons of the global financial crisis more than ten years ago, taking the appropriate regulatory and institutional steps. We have consistently made our systems of regulation and supervision more European, working on the basis of harmonised rules within the European Economic Area, and, together with our European partners, lending the supervised entities our close support as they operate across borders and on foreign markets, be this through the European Systemic Risk Board (ESBR), the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) or the European Securities and Markets Authority (ESMA). Within the euro countries, we also cooperate fully in the operational supervision and resolution of banks within the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) headed by the European Central Bank (ECB) and the Single Resolution Board (SRB).

We have made the sustainability of business models a priority for the supervised entities, ensuring that financial operators do not get carried away when the economy is doing well, taking their eye of the ball or neglecting their risk management systems. It is also important that they face up to the challenges of technological change even when markets are booming, embracing the opportunities and addressing the risks.

We have always adhered to and driven forward the principle of integrated supervision through which the FMA supervises all of the financial market. After all, it is this approach that proved its worth during the global financial crisis as a contemporary, efficient and effective way of dealing with a small, open and closely linked national economy such as ours. It is also the ideal basis for embedding supervision in the wider European system of regulation and supervision. The integrated approach to supervision is also conducive to the creation of a level playing field for all, ensuring fair competition across all product, sector and technological borders. Our approach has also proven successful in protecting consumers, savers, investors and borrowers. With our concept of collective consumer protection, we ensure that these groups are provided with accurate, fair and comparable information on the products and financial services on offer to them, enabling them to make well-informed decisions in line with their financial needs.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	169	160	162
Branches of foreign credit institutions	26	25	22
Cooperative banks	433	412	389
Banking sector, total:	**628**	**597**	**573**

Source: OeNB, unconsolidated data

Total assets of banking sector (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	506.5	524.4	536.4
Branches of foreign credit institutions	21.7	22.8	23.0
Cooperative banks	287.1	307.2	325.6
Banking sector, total:	815.3	854.6	885.0
y/y change (in %)	-2.1%	+4.8%	+6.0%

Source: OeNB, unconsolidated data in EUR bn

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	4.8	4.8	4.7
Domestic ownership total	74.0	75.6	81.1
Foreign ownership	26.0	24.4	18.9
Banking sector, total:	**100.0**	**100.0**	**100.0**

Source: OeNB, unconsolidated data.

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	37	48	660
Branches of foreign credit institutions	57	72	1,160
Cooperative banks	41	49	721
Banking sector, total:	**26**	**35**	**341**

Source: OeNB, unconsolidated data.

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	7.3	7.2	6.9
Cooperative banks	7.7	9.0	5.8
Banking sector, total:	**7.5**	**8.4**	**6.4**

Source: OeNB, unconsolidated data

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	62.2	61.4	60.6
Branches of foreign credit institutions	2.7	2.7	2.6
Cooperative banks	35.2	35.9	36.8
Banking sector, total:	**100.0**	**100.0**	**100.0**

Source: OeNB, unconsolidated data.

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

	2017	2018	2019
Receivables	n.a.*	n.a.*	n.a.*
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.*
Liabilites	n.a.*	n.a.*	n.a.*
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.***

** 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	2017	2018	2019
Commercial banks	18.7***	18.7***	19.0***
Cooperative banks	18.1***	18.4***	18.3***
Banking sector, total:	**18.4*** **	**18.6*** **	**18.7*** **

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

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

Asset classification	2017	2018	2019
Non-financial sector, including			
- households	3.8	3.5	3.0
- corporate	5.3	3.7	3.1

Source: OeNB, consolidated data.

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	70	45
Corporate	18	44
Government sector	6	7
Financial sector (excluding banks)	6	4
Total	**100.0**	**100.0**

Source: OeNB, unconsolidated data; only domestic

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

P&L account	2017	2018	2019
Interest income	13.8	15.1	15.1
Interest expenses	5.6	6.5	6.5
Net interest income	8.2	8.6	8.6
Net fee and commission income	4.4	4.6	4.6
Other (not specified above) operating income (net)	6.9	6.9	6.5
Gross income	19.5	19.4	19.7
Administration costs	10.7	11.2	11.6
Depreciation	0.9	0.9	1.0
Provisions	0.9	0.3	0.2
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	n.a.	n.a.	n.a.
Profit (loss) before tax	5.1	6.6	5.7
Net profit (loss)	4.4	5.7	4.8

Source: OeNB, unconsolidated data in EUR bn.

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	50.8	41.4	43.4	7.4	n.a.
Cooperative banks	40.1	34.4	35.9	4.2	n.a.
Banking sector, total:	**90.9**	**75.8**	**79.3**	**11.6**	**n.a.**

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

Macroeconomic conditions

In 2019, the volume of GDP amounted to BYN 132.0 billion and increased in comparable prices versus 2018 by 1.2% (in 2018, an increase by 3.0%).

As of January 1, 2020, the banks' assets (liabilities)/GDP ratio totaled 59.3% (60.6% as of January 1, 2019). Regulatory capital/GDP ratio stood at 8.5% as of January 1, 2020.

Development of the banking sector

As of January 1, 2020, 24 banks and 3 non-bank financial institutions were carrying out the banking activities in the Republic of Belarus. Three banks were in the process of liquidation.

The total number of banks' organizational units (branches, bank services centers, settlement and cash centers, and exchange offices) in the territory of the country dropped by 7.8% in 2019, amounting to 3,208 as of January 1, 2020. Foreign banks ran 5 representative offices in the territory of the country.

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

As of January 1, 2020, the share of foreign investments in the total volume of registered authorized capital of Belarusian banks stood at 19.7%. As of January 1, 2020, the state share in the banks' authorized capital was 77.1% of the banking sector's aggregate authorized capital.

The total registered authorized capital as of January 1, 2020 amounted to BYN 5.5 billion, an increase by 1.6% in 2019.

In 2019, the National Bank of the Republic of Belarus focused its work on secure and sustainable functioning of the banking sector.

As of January 1, 2020, banks' regulatory capital totaled BYN 11,161.8 million, having increased by BYN 488.6 million or by 4.6% in nominal terms since the beginning of 2019. The main volume of the banking sector's capital was concentrated in five core banks – 70.6%.

Assets (liabilities) of banks reached BYN 78,314.6 million as at January 1, 2020, a 6.3% increase over January-December 2019.

The profit received by banks in 2019 amounted to BYN 1,175.2 million, a 7.2% increase in nominal terms compared to 2018.

The banking sector's return on assets totaled 1.5% (1.6% as of January 1, 2019); the return on regulatory capital was 10.9 % (10.7 % as of January 1, 2019).

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

Throughout 2019, the work on improving the regulatory legal framework in the area of banking supervision and bringing it into line with international standards and practical experience continued.

As part of the implementation of Basel III international standards, the approaches to determining the amount of credit risk have been changed for the purpose of calculating the regulatory capital adequacy of banks and JSC "Development Bank of the Republic of Belarus".

Approaches to limiting credit risk for loans issued at excessively high interest rates were changed, and the composition of signs of the debtor's financial instability, taken into account when creating special reserves to cover possible losses on assets and operations not reflected in the balance sheet, was clarified.

In order to improve supervisory procedures, enhanced approaches have been introduced to the implementation of banking supervision functions by the National Bank using an early warning system designed to identify problems in the activities of the bank, JSC "Development Bank of the Republic of Belarus", a non-bank financial institution and prevent them at an early stage.

The requirements for state registration of banks and non-bank financial institutions and licensing of banking activities, as well as qualification requirements and requirements for the business reputation of officials of banks, JSC "Development Bank of the Republic of Belarus" and non-bank financial institutions were updated given the established practice of their application.

The requirements for business plans (strategic development plans) of banks, JSC "Development Bank of the Republic of Belarus" and non-bank financial institutions were optimized.

For the purpose of improving risk management in the context of the digital economy development, banks, JSC "Development Bank of the Republic of Belarus", and non-bank financial institutions were sent recommendations on improving cyber risk management, defining approaches to organizing the management of this risk and specific features of its management, taking into account the current requirements for organizing the system risk management at banks, JSC "Development Bank of the Republic of Belarus", non-bank financial institutions, banking groups and bank holding companies.

The National Bank also initiated an audit of information technologies by banks classified as systemically important banks of Group of Importance I, for which a technical task was submitted, defining the minimum requirements for such an audit, the content of the report on its results, as well as an audit organization and consultants.

In 2019, the work on introducing FATF[1] international standards into the legislation of the Republic of Belarus continued: procedures and internal control measures were established for members of a banking, financial group (holding).

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

Legal competence of the Banking Supervisory Authority

The National Bank is the banking supervision authority.

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

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

Main strategic objectives of the supervisory authority in 2019

In 2019, the main tasks of the National Bank in the framework of off-site supervision of banks (bank holding companies), non-bank financial institutions and JSC "Development Bank of the Republic of Belarus" (hereinafter for the purposes of this section – "banks") were to ensure their stable and safe functioning, to protect interests of depositors and other creditors, including by minimizing and limiting risks assumed by banks, as well as preventing the bankruptcy of the banking sector's participants.

The activities of the Banking Supervisory Authority in 2019

During the reporting year, monitoring of the banks' performance, the levels of risks assumed thereby (by analyzing the quality of assets and the state of liquidity), as well as the banks' compliance with secure functioning requirements and other prudential requirements was carried out on an ongoing basis, including within the framework of an early warning system.

When violations or shortcomings in the activities of banks were detected, in order to avoid the development of negative trends, measures of early and (or) supervisory response were applied to them, in particular, those aimed at increasing capitalization, eliminating liquidity shortages, improving corporate governance and excluding the participation in non-core activities. Subsequently, the implementation of these measures was assessed and, if necessary, additional supervisory actions were carried out.

The activities aimed at reviewing strategic development plans in order to assess the banks' ability to ensure financial reliability and sustainability in the long term within the implementation of the presented strategic plans were carried out. The issues of issuing permits for participation of banks in the authorized capital of other legal entities, given the assessment of the efficiency and feasibility of such investments, were considered as well.

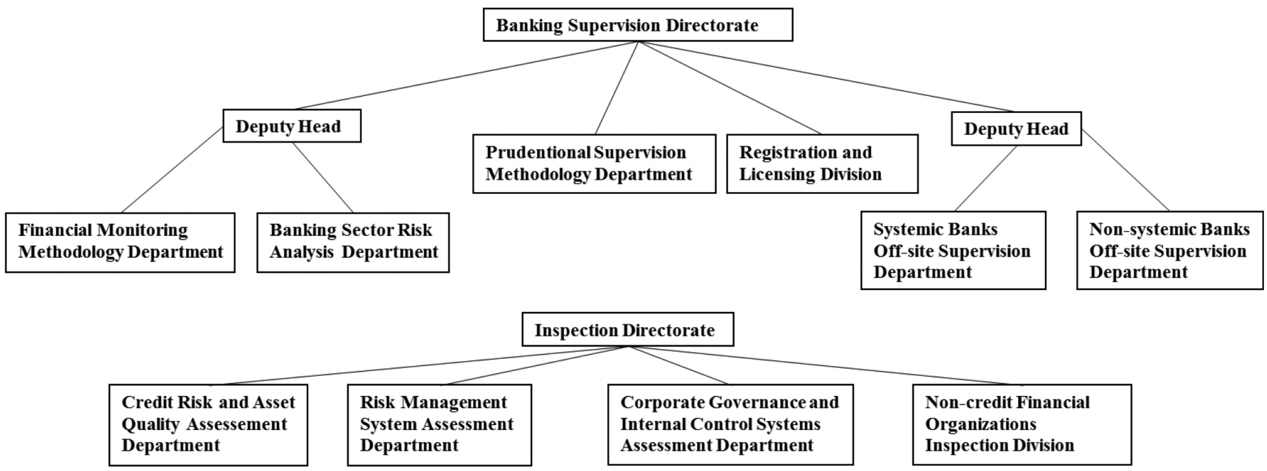
In order to strengthen and expand the capabilities of off-site supervision, the work on improving the information and analytical system of the National Bank continued.

As part of interaction with external audit organizations, work continued to improve the quality of the audit, as well as the practice of holding meetings to discuss problematic issues in the process of auditing banks.

In November 2019, the plenary meeting of the Eurasian Group on Combating Money Laundering and Financing of Terrorism approved the report on the international assessment of the Belarusian system for preventing money laundering, financing terrorist activities and financing the proliferation of weapons of mass destruction for compliance with the FATF requirements. The National Bank took an active part in the preparation and defense of this report. The system of combating money laundering and terrorist financing of our country was highly appreciated by international experts: the banking and financial sector's deep understanding of the risks in this area, the effectiveness of strategies and legislative acts aimed at eliminating these risks, significant efficiency in the prevention of illegal activities, as well as international cooperation implementation were noted.

It is expected that the positive results of the international assessment will have a favorable impact on the credit, investment and other ratings of the country, as well as contribute to expanding opportunities and increasing the availability of financial resources for Belarus in the international financial market.

Organizational chart of the Banking Supervisory Authority



International cooperation

As of January 1, 2020, 18 bilateral agreements with foreign banking supervisory authorities were in force. Within the framework of these agreements cooperation in the area of banking supervision of credit institutions, namely, the exchange of information on the state and the development of the banking systems, current national banking legislation, regulations and requirements of banking supervision, all significant changes therein, as well as bilateral meetings, continued. A closer cooperation with those countries in which representative offices of Belarusian banks are located and with the countries the banks of which established subsidiaries and representative offices in the Republic of Belarus continued.

In order to develop bilateral ties in 2019, the meetings of the senior managers of the National Bank and the central (national) banks of neighboring countries, CIS member states, several states of Europe and Asia were held.

Cooperation with other supervisory bodies

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

Other information

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

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	24	24	24
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**24**	**24**	**24**

Total assets of banking sector (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**
y/y change (in %)	**3.4**	**10.5**	**6.3**

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	65.2	64.9	63.0
Domestic ownership total	68.1	67.8	66.3
Foreign ownership	31.9	32.2	33.7
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	61.4	73.6	0.2
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**0.2**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	9.55	10.72	10.92
Cooperative banks	-	-	-
Banking sector, total:	**9.55**	**10.72**	**10.92**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables	**100.0**	**100.0**	**100.0**
Financial sector	2.6	1.9	1.4
Nonfinancial sector	64.9	67.2	70.0
Government sector	25.0	21.9	21.7
Other assets	7.5	9.0	6.9
Liabilites	**100.0**	**100.0**	**100.0**
Financial sector	2.6	2.0	1.4
Nonfinancial sector	56.4	54.4	56.9
Government sector	8.2	8.9	7.8
Other liabilities	32.8	34.7	34.0
Capital	**14.4**	**14.4**	**14.8**

Capital adequacy ratio of banks

Type of financial institution	2017	2018	2019
Commercial banks	18.5%***	17.7***	17.8***
Cooperative banks	-	-	-
Banking sector, total:	**18.5%*** **	**17.7*** **	**17.8*** **

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

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

Asset classification	2017	2018[2]	2019
Non-financial sector, including	14.54%	5.01%	4.63%
- households	0.53%	0.09%	0.12%
- corporate	18.91%	4.92%	4.51%

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

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	85.3%	59.9%
Households	56.8%	29.0%
Corporate	28.5%	30.8%
Government sector	10.3%	35.2%
Financial sector (excluding banks)	4.4%	4.9%
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	2213.1	1928.6	2166.8
Interest expenses	933,8	761,6	957.6
Net interest income	1279.3	1167.0	1209.2
Net fee and commission income	400.4	452.9	545.8
Other (not specified above) operating income (net)			
Gross income	7570.9	6740.9	7126.4
Administration costs			
Depreciation			
Provisions	495.3	383.9	358.4
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)			
Profit (loss) before tax	460.9	536.1	587.6
Net profit (loss)	376.5	443.0	499.6

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	4744.9***	3729.6***	3730.9***	1013.9***	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**4744.9*** **	**3729.6*** **	**3730.9*** **	**1013.9*** **	**-**

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

Macroeconomic environment in the country

According to the information of the BIH Agency for Statistics[1] , the nominal gross domestic product (GDP) in BIH in 2019 stood at BAM 35.2 billion, up by 5.3% against 2018. If observed by industry branches, the most significant increase of the gross added value was seen with administrative and auxiliary services, construction, as well as wholesale and retail sale. The nominal increase of the gross added value was noted with ore and stone mining, production and electricity and gas supply. The real growth rate of GDP in 2019 vs. the year before was 2.7% and GDP per capita in 2019 was 10,108 BAM/5,785 USD[2] which is higher by 5.7% compared to 2018. Average trend of the production price index in BIH in 2019 went up by a total of 4.6%[3] compared to the base average. The average annual inflation in BIH in 2019 vs. 2018 stood at 0.6%.[4]

The banking system in BIH is liquid, well capitalised and profitable. The balance sheet total of the BIH banking sector has been posting a continuous increase over the course of 2019, thus reaching a value of BAM 32.5 billion at the end of 2019. this represents an increase of 8.9% compared to the same period the year before. During 2019, the trend of increase of deposits and loans continued in 2019 in the environment of economic growth and high liquidity, as well as the trend of interest rate reduction and assets quality in banks. Total loans in 2019 stood at BAM 20.7 billion and this total loan growth of the BIH banking system of 7% vs. the year before was mostly affected by the increase of loans approved to the households segment and segment of non-financial private companies. Total deposits of the BIH banking system in 2019 amounted to BAM 23 billion, whereas the biggest contribution to the total deposit increase of 10% vs. the previous year came from household deposits. The BIH banking system, whose operations falls under competency of the two state entity level banking agencies, posted a net profit of BAM 370.5 million. In late 2019, return on average assets (ROAA) equaled 1.4% and return on average equity (ROAE) at 10.4%.[5]

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

As of 31.12.2019, there were 15 commercial banks operating in the FBIH with 533 organisational parts and a total of 6,659 employees. Positive trend in the FBIH banking sector have continued, reflecting in growth of assets, loans, cash funds and deposits. The share of NPLs, as a key indicator of loan quality, still displays a downward trend. What has also continued is the increase of total deposits and savings representing the most significant and the biggest segment of the deposit and financial potential of banks. As of 31.12.2019, banks in the FBIH have generated positive financial result. The FBIH banking sector is stable, adequately capitalised, liquid and profitable.

Total net assets of the FBIH banking sector amounted to BAM 24.2 billion, up by BAM 2.1 billion or 9.6% vs. YE2018. The share of total assets of the FBIH banking sector vs. the GDB in FBIH[6] was 1.05.

[1] BIH Agency for Statistics, Press release regarding gross domestic product in BIH – initial results, July 2020
[2] BIH Agency for Statistics, Press release regarding gross domestic product in BIH – initial results, July 2020
[3] BIH Agency for Statistics, industrial production price index in BIH in 2019, special blleting No.12
[4] BIH Agency for Statistics, consumer price index in BIH in 2019, special bulleting No. 09
[5] Central Bank of BIH, statistical web portal, Financial soundness indicators of the banking sector and Basic information on the banking sector
[6] FBIH Statistics Bureau, Press release regarding the annual gross domestivc product for the Federation of BIH, 2019 – initial results, July 2020

Total capital as of 31.12.2019 equaled BAM 3.1 billion (shareholder capital amounting to BAM 1.3 billion), thus going up by 5.4% vs. 2018. regulatory capital was BAM 2.7 billion and saw an increase by BAM 211.3 million or 8.5% compared to the end of 2018. the own funds rate of the FBIH banking sector as of 31.12.2019 was 17.9%, which is by 0.4 percentage points higher than as at YE2018, i.e. by 5.9 percentage points above the legal minimum of 12%. At the FBIH banking sector level, other capital rates (common equity Tier 1 rate and common equity rate, i.e. CET1 and T1) also exceeded the prescribed minimum. The financial leverage rate (the ratio of common equity and total bank exposure) at the FBIH banking sector level as of 31.12.2019 was 10.5%, which is by 0,4 percentage points higher than at YE2018 (prescribed minimum being 6%).

Loans, holding a share of 62.8% in total assets, posted a rise against the end of 2018 of BAM 895.1 million or 6.2%, thus arriving to the figure of BAM 15.2 billion as of 31.12.2019. Corporate loans went up by 348.8 million or 4.7%, reaching BAM 7.8 billion of 31.12.2019 and holding 51.4% share in total loans. Over the same period, household loans grew by BAM 546.3 million or 8%, thus holding a share in total loans of 48.6%. their amount as of 31.12.2019 was BAM 7.4 billion. The share of NPLs dropped from 8.5% to 7.6% as a result of the loan growth, collection activities and performed write offs. The share of corporate NPLs in total corporate loans was 9.4%, while the share of household NPLs in total household loans was 5.7%.

Cash funds amounted to BAM 7.6 billion and represented 31.6% of total assets, thus being by BAM 1 billion or 15.9% higher than at the end of 2018.

The FBIH banking sector's deposits reached a value of BAM 19.4 billion, thus going up by BAM 1.8 billion or 10.3% and represented 80.2% of total liabilities. Savings deposits, as the most significant and the biggest segment of the deposit and financial potential of banks, rose by BAM 769.3 million or 8.7% to BAM 9.6 billion.

As of 31.12.2019 (based on final unaudited reporting data), the FBIH banking sector posted a positive financial result – profit of BAM 273.9 million, which is by BAM 17.7 million or 6.9% higher than in the same period in 2018.

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

A) Prudent Regulatory Framework issued by the FBA (changes in 2019):

In the process of the FBA regulatory activities related to preparation of regulations, the following decisions were adopted in 2019:

- FBA Decisions, Instructions and Guidelines related to the operations and supervision of the banks:
  - Decision on Internal Capital Adequacy Assessment Process and Internal Liquidity Adequacy Assessment Process in Banks;[7]
  - Decision on Amendments to the Decision on Reports Banks Deliver to the Banking Agency of the Federation of Bosnia and Herzegovina;[8]
  - Decision on Credit Risk Management and Determination of Expected Credit Losses;[9]
  - Decision on Amending and Supplementing the Decision on Calculation of Bank Capital;[10]
  - Decision on Amendments to the Decision on Fees Tariff for Banks;[11]
  - Guidelines for Reporting to the Banking Agency of the Federation of Bosnia and Herzegovina on Implementation of ICAAP and ILAAP in Banks (16.04.2019);
  - Instructions for Classification and Valuation of Financial Assets (05.07.2019);
- FBA Decisions, Instructions related to bank resolution:
  - Decision on Data and Information Delivered to the Banking Agency of the Federation of Bosnia and Herzegovina for Purpose of Developing and Updating Resolution Plans of Banks and Banking Groups;[12]
  - Correction of the Decision on Data and Information Delivered to the Banking Agency of the Federation of Bosnia and Herzegovina for Purpose of Developing and Updating Resolution Plans of Banks and Banking Groups;[13]
  - Instructions for Preparation of Reports Banks Deliver for Purpose of Developing and Updating Resolution Plans (FBA - 05.07.2019).

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7 FBIH Official Gazette No. 16/19
8 FBIH Official Gazette No. 44/19
9 FBIH Official Gazette No. 44/19
10 FBIH Official Gazette No. 50/19
11 FBIH Official Gazette No. 69/19
12 FBIH Official Gazette No. 44/19
13 FBIH Official Gazette No. 48/19

B) Legal competences of the FBA:

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

- identifying and performing activities and measures to maintain and strengthen the banking system stability,
- establishing, enforcing and supervising prudential rules regulating the operations of the banking system entities (banks, banking groups, development banks, microcredit organisations, leasing companies, factoring companies, exchange offices and other financial organisations which operates under FBA supervision according to the law),
- issuing and revoking licenses and other relevant acts to the banking system entities when authorized to do so by special regulations,
- supervising operations of the banking system entities when authorized to do so by special regulations,
- supervising operations of the development bank, ordering supervision measures and other competences under regulation governing operations of the development bank and this Law,
- ordering supervision measures and other competences when authorized to do so by special regulations,
- adopting acts regulating operations of the FBA,
- adopting acts regulating operations of the banking system entities,
- adopting acts, supervising and undertaking the necessary measures related to anti-money laundering and terrorist financing that apply to the banking system entities in cooperation with the competent authorities and institutions in the field of anti-money laundering and terrorist financing under regulations governing anti-money laundering and terrorist financing,
- adopting acts and performing activities to protect the rights and interests of users of financial services in the banking system, performing supervision of implementation of regulations from this field and undertaking other activities and relevant measures within the scope of its authorities,
- Adopting and updating the resolution plan, establishing eligibility for initiation of bank resolution proceedings, conducting resolution proceedings, deciding on tools and measures to undertake in resolution and performing other activities relating to resolution under the law regulating banks.

Main strategic objectives of the supervisory authority in 2019

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

- Continuation of activities on creation of the regulatory framework in line with the EU's regulatory framework, as a step of the BiH preparations on the accession path to the European Union;
- Control of the dominant operational risks segments, control over the banks of systemically importance for development of credit activities, control of the applicable practices in the banks in the segment of protection of users of financial services and guarantors, etc;
- Continuation of activities with the objective to implement recommendations of the FSAP mission related to improvement of the banking sector supervision, projects related to strengthening banking supervision within the technical assistance provided by the international financial institutions;
- Strengthening bank capital;
- monitoring the application of IAS/IFRS with the objective to adequately valuate financial assets and expected credit loss provisioning in order to maintain an adequate capitalization of banks in the FBiH;
- systemic monitoring of bank's activities on application of AML/CFT standards and enhancing cooperation with other competent institutions in this segment;

- building, expanding and improvement of the cooperation with the competent supervisory authorities for supervision of banking groups from the EU whose members having seat in the FBiH, as well from others countries, for the purpose of more efficient supervision and improvement of supervisory practices, cooperation and exchange of information with the ECB and the EBA in terms of the supervision and banking regulations, and international financial institutions;
- improving cooperation by signing new memorandums on cooperation with relevant institutions in BiH included into the institutional supervisory framework, crisis management and systemic risk, as well as protection of users of financial services.

The activities of the Banking Supervisory Authority in 2019

FBA operations in 2019 were marked by further strengthening of institutional capacities related to demanding processes of regulatory and supervisory reforms in the process of alignment with the new regulatory framework and its own documents defining internal organisation and job classification. Activities have continued on improvement of supervision over implementation of regulations related to protection of rights and interests of financial service users in the FBIH banking system.

Key activities related to banking supervision in 2019 were aimed towards the following:

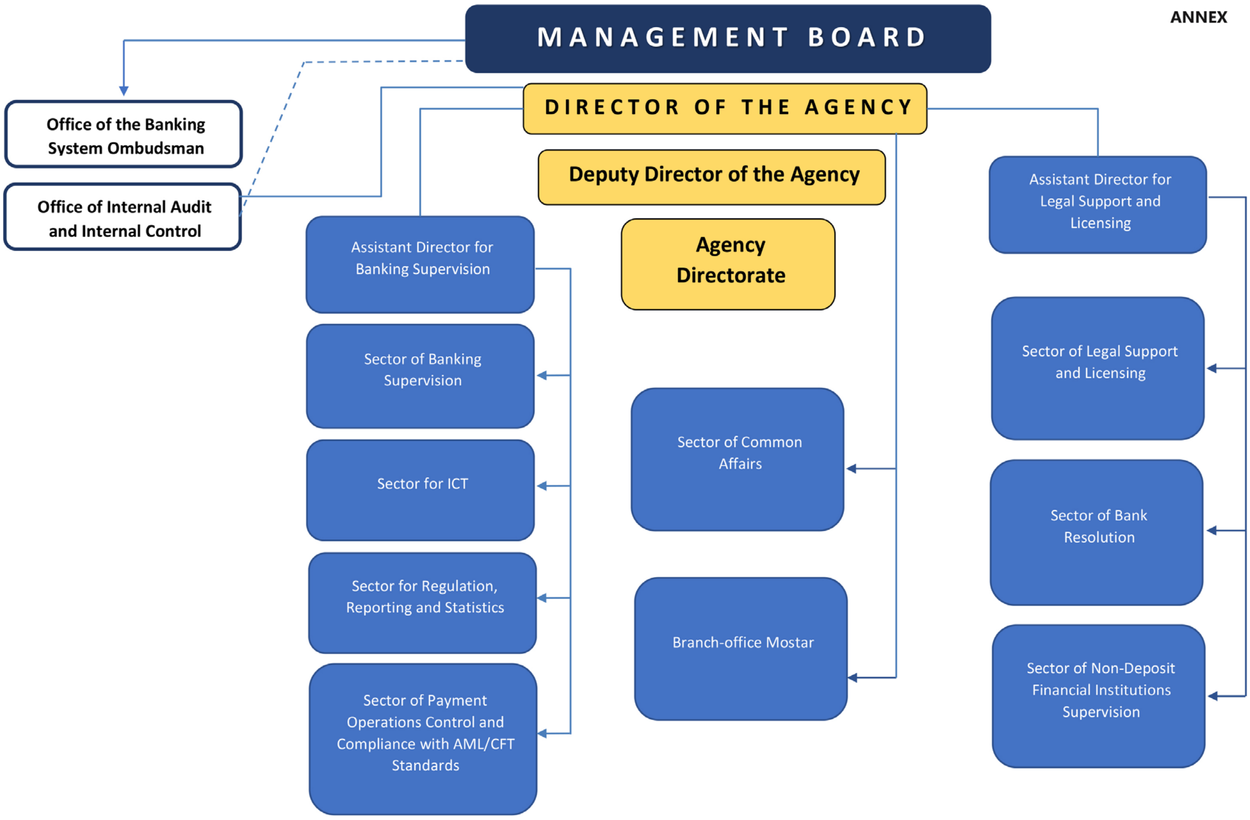
- continuous monitoring of operations of all banks in the FBIH, especially banks of systemic importance for the FBIH banking system;
- intensified activities regarding introduction of a new supervisory approach - SREP, through a long term project technically supported by the World Bank that resulted in adoption of the SREP methodology; also, a pilot project of testing the SREP methodology components on selected banks has been finalised;
- finalised activities related to development of new regulations aimed at ensuring implementation of IFRS 9 (Decision, Instructions and reporting forms);
- assessment of reports on ICAAP delivered by all commercial banks and providing banks in return with supervisory review and assessment letters concerning these reports;
- continued project of establishment of supervisory stress testing of banks with technical assistance of USAID FINRA, i.e. preparation of a methodological framework (methodology, instructions and forms) and implementation of supervisory stress tests;
- validation of initial recovery plans provided by banks (FINRA project), where a new round of recovery plan assessments has started in late 2019;
- performance of planned examinations of bank operations and management of risks stemming IT systems and outsourcing of certain bank activities;
- improvement of cooperation with supervisory authorities of parent banks.

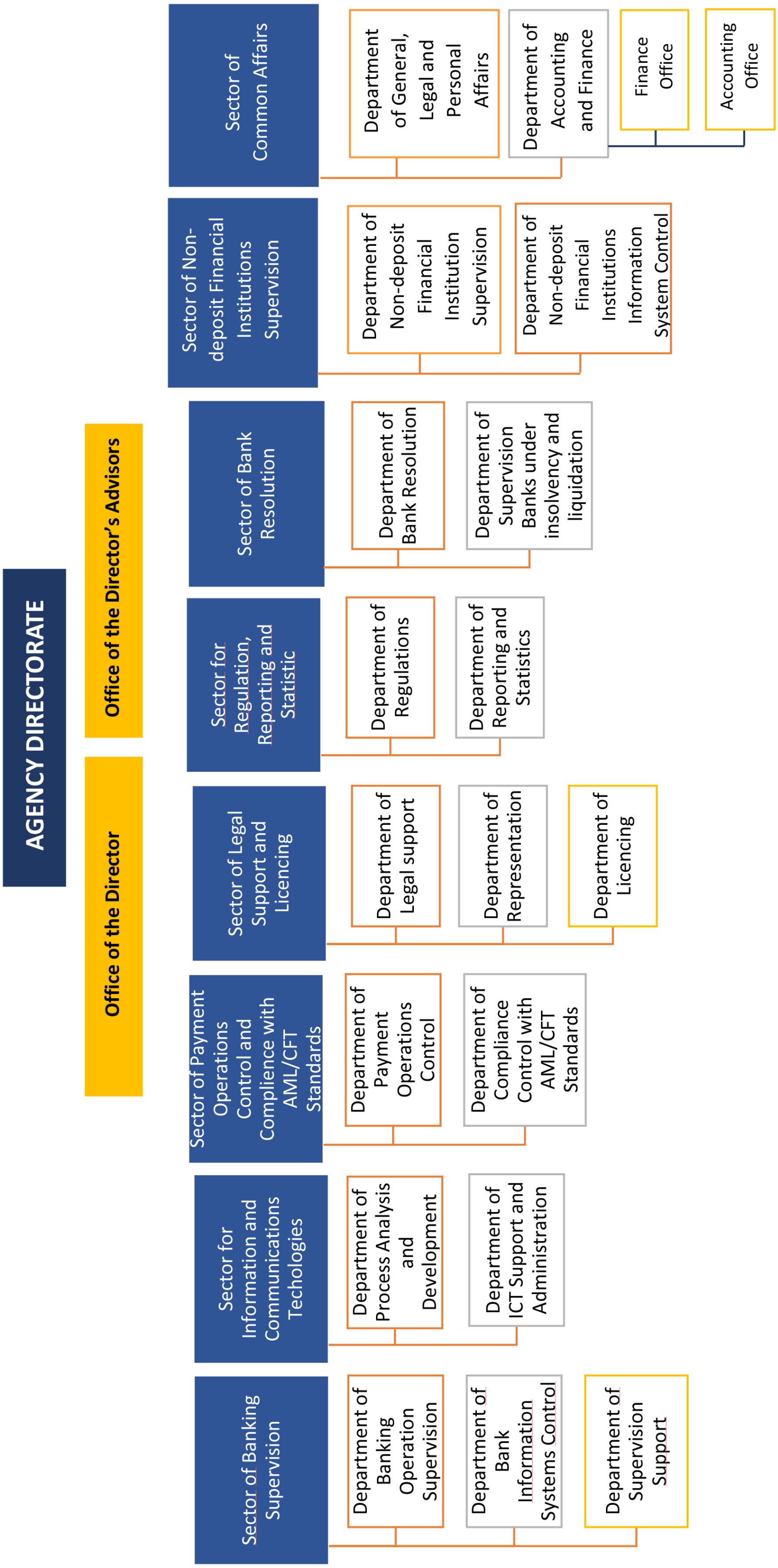
In 2019, activities falling within the competence of FBA that refer to bank resolutions were aimed towards:

- development and adoption of resolution plans for banks in the FBIH;
- development and adoption of regulations related to FBA reporting for purposes of developing and updating resolution plans of banks and banking groups in order to ensure alignment with the new EU regulations,
- development of the Methodology for Determination of Key Functions in Banks for purpose of preparation and adoption of resolution plans.

Organizational chart of the Banking Supervisory Authority

In November 2019, the Rulebook on Internal organization was adopted. A new organizational structure of the FBA was established with significant changes compared to previous organization.




AGENCY DIRECTORATE
Office of the Director
Office of the Director's Advisors
Sector of Banking Supervision
Department of Banking Operation Supervision
Department of Bank Information Systems Control
Department of Supervision Support
Sector for Information and Communications Techologies
Department of Process Analysis and Development
Department of ICT Support and Administration
Sector of Payment Operations Control and Complience with AML/CFT Standards
Department of Payment Operations Control
Department of Compliance Control with AML/CFT Standards
Sector of Legal Support and Licencing
Department of Legal support
Department of Representation
Department of Licencing
Sector for Regulation, Reporting and Statistic
Department of Regulations
Department of Reporting and Statistics
Sector of Bank Resolution
Department of Bank Resolution
Department of Supervision Banks under insolvency and liquidation
Sector of Non-deposit Financial Institutions Supervision
Department of Non-deposit Financial Institution Supervision
Department of Non-deposit Financial Institutions Information System Control
Sector of Common Affairs
Department of General, Legal and Personal Affairs
Department of Accounting and Finance
Finance Office
Accounting Office

International activities of the authority

In 2019, FBA also continued with activities to strengthen and improve cooperation with both, local and international financial institutions, as well as with regional and other organisations. It has also strengthened bilateral and multilateral cooperation with ban regulatory from the country, the region and beyond subject to existing and new agreements of cooperation and information exchange.

In 2019, subject to the MoU signed with ECB, FBA exchanged information and participated in colleges related to ECB-supervised banks, as well as in regular annual meetings and meetings with EBA.

The cooperation with ECB is of relevance for improvement of stability and efficient supervision of BSEs, as well as the process of alignment of bank regulations with the EU regulations. FBA is in process of an equivalence assessment of the regulatory framework and supervisory practices in BIH related to EU directives and implementation of supervisory practices in the EU (being performed by EBA).

FBA exchanges information and participates in supervisory colleges for banks whose banking groups are seated in Slovenia, Austria and Germany. Improvement of cooperation with supervisory authorities of banking groups in terms of information exchange, joint actions, interaction with banking groups and better readiness to crisis situations will be in focus of the supervisory activities in the forthcoming period as well.

Other significant activities of the FBA include participation in missions/visits of international financial organisations (IMF, World Bank, EBRD, USAID, etc.) related to information and analysis of trends in the FBiH banking system and strengthening of supervisory capacities, as well as with the international rating agency Standard&Poor's for purposes of an assessment of the sovereign credit rating of BIH.

Cooperation with other supervisory bodies in the country

Cooperation with the competent institutions in BiH has continued. Cooperation with the CBBH is carried out in the domain of top down test tests conducted by the Financial Stability Department. FBA participates in this process by providing data for conducting top down stress tests, participating in the analysis of projections related to credit growth, and providing comments on testing methodology, while the results of top down stress tests are used in supervisory assessments. In addition to the above, FBA submit to the CBBH the data necessary for the calculation of financial stability indicators (FSI) at the level of BiH, and regularly exchange other relevant data and information with the CBBH (reports and information related to regulatory framework effects, network analysis of systemic risk spillovers, etc).

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

In 2019, a cooperation continued with the BA BiH (Banks Association of Bosnia and Herzegovina) both in terms of implementation of the existing regulatory framework and proposals for revision, and in the process of adoption a new regulatory framework for bank operations and supervision.

Other relevant information and developments in 2019

The Banking Agency of Federation of BiH actively participates in various projects aimed at strengthening the capacity for effective supervision of banks, of which key one is the World Bank Project - Strengthening the Banking Sector and the USAID FINRA Project. In 2019 FBA continued with activities on the implementation of a new supervisory approach - SREP within the WB Projects - Strengthening the Banking Sector in BiH. The World Bank Project "Strengthening the Banking Sector in BiH" entails technical assistance to FBA in a part of enhancing the capacities for the supervision and resolution of banks.

USAID FINRA technical assistance include assistance in developing regulatory framework, training in the supervision segment, as well as providing support for the bank restructuring segment.

In 2019, the Programme for strengthening the central banks capacities in the Western Balkans began with the aim of integration into the European System of Central Banks. The goal of the program is to strengthen monetary and financial stability in the region and improve the harmonization of national regulatory frameworks with European and international standards. The beneficiaries of the program are BiH, Serbia, Montenegro, Northern Macedonia, Albania and Kosovo. The CBBH and entity banking agencies are participating in this project. The Deutsche Bundesbank is a signatory to the Grant Agreement with the European Commission and the coordinator of this regional program. The project is implemented in cooperation with the European System of Central Banks, which refers to the education of employees from institutions that use technical assistance and bilateral technical assistance from an EU national regulator. The FBA uses technical assistance in the segment of bank restructuring by Austrian regulators.

Questionnaire tables for the 2019 review

Number of financial institutions
(at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	15	15	15
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**15**	**15**	**15**

Total assets of banking sector
(at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	20.209.851	22.094.135	24.210.567
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**20.209.851**	**22.094.135**	**24.210.567**
y/y change (in %)	**2017/2016 Index 110(+10%)**	**2018/2017 Index 109(+9%)**	**2019/2018 Index 110(+10%)**

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	3.2	3.5	3.3
Domestic ownership total	9.5	9.8	9.6
Foreign ownership	90.5	90.2	90.4
Banking sector. total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	56.5	69.2	1.419
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector. total:	**56.5**	**69.2**	**1.419**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	9.7	9.9	11.06
Cooperative banks	_	_	_
Banking sector. total:	**9.7**	**9.9**	**11.06**

**Return on average equity (ROAE)*

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	100.0	100.0	100
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector. total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables	**n/a**	**n/a**	**n/a**
Financial sector	n/a	n/a	n/a
Non-financial sector	n/a	n/a	n/a
Government sector	n/a	n/a	n/a
Other assets	n/a	n/a	n/a
Liabilities	**n/a**	**n/a**	**n/a**
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	2017	2018	2019
Commercial banks	15.5*	17.5***	17.9***
Cooperative banks			-
Banking sector. total:	**15.5***	**17.5*****	**17.9*****

*(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	2017	2018[2]	2019
Non-financial sector. including	9.7	8.5	7.6
- households	7.3	6.2	5.7
- corporate	12.1	10.6	9.4

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

**The structure of deposits and loans of the banking sector in 2019 (%)
(at year-end)**

	Deposits	Loans
Non-financial sector. including:	83.8	98.1
Households	54.3	49.4
Corporate	29.5	48.7
Government sector	11.8	1.3
Financial sector (excluding banks)	4.4	0.6
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	724.548	741.366	733.732
Interest expenses	149.985	130.053	130.668
Net interest income	604.563	611.313	603.064
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	1.026.103	1.051.108	1.070.879
Administration costs	248.113	256.407	260.389
Depreciation	n/a	n/a	n/a
Provisions	112.074	108.662	77.315
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	272.461	289.768	318.814
Net profit (loss)	239.973	256.236	273.889

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	2.690.298***	2.656.534***	2.656.534***	33.764***	-
Cooperative banks	-	-	-	-	-
Banking sector. total:	**2.690.298***	**2.656.534***	**2.656.534***	**33.764***	**-**

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

Macroeconomic environment in the country

In the course of 2019, the slowdown of growth of overall economic activities in Republika Srpska (hereinafter: the RS) was recorded.

The RS GDP in the course of 2019 generated growth rate of 2.5%, while in 2018 the growth of 3.9% was recorded, which is primarily the result of decrease of the RS industrial production in comparison to previous year. The industrial production decreased primarily as a result of decrease of electricity production, as well as production of other products (refined petroleum products, furniture, leather and leather products, processing of wood and wood products) due to lower external demand.

The RS import decreased by 8.5% in the observed period, while export registered a slightly lower decrease of 3.8%. This led to the increase of coverage of import with export which was 75.3% and it is historically at the highest level.

In 2019, the average net salary in the RS amounted to EUR 463.2 and it has increased by 5.8% compared to 2018. The unemployment ratio decreased significantly in 2019 due to the increase of number of employees and the decrease in the number of unemployed, as a result of higher employment and negative demographic trends.

An inter-annual inflation rate of 0.5% was registered in the period from January to December 2019, and it is lower than in 2018, when it was 1.2%.

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

The banking sector of RS at the end of 2019 consisted of eight banks, out of which six banks were with majority foreign private ownership, while two banks were with majority private domestic ownership.

Taking into account the banking sector results generated in 2019, it can be stated that the banking sector of RS is stable, adequately capitalized, with profitability and liquidity at satisfactory level and able to meet all its obligations in due terms.

Basic indicators of the banking sector operations as of 31/12/2019:

- total gross balance sheet amounted to EUR 4.4 billion and it is higher by 6% compared to 31/12/2018,
- cash funds (EUR 1 billion) accounted to 22% of total balance sheet assets with a decrease rate of 7% when compared to the previous year,
- share of non-performing loans in the total loan portfolio decreased by 2.6 pp in comparison to the end of 2018 (from 9,5% to 6.9%),
- coverage ratio of total non-performing loans with impairments amounted to 77% and recorded an increase compared to previous year of 7.6 pp,
- deposits (EUR 3,3 billion), as a basic source of funding bank operations, had a share of 77% out of total bank liabilities and increased by 6% when compared to 31/12/2018,
- trend of growth in households' deposits continued also in 2019 and they increased by 9% if compared to 31/12/2018,
- regulatory capital of the RS banking sector as of 31/12/2019 amounted to EUR 499 million which is an increase of 11% if compared with previous year,
- the regulatory capital ratio of the RS banking sector as of 31/12/2019 was 18,3% and was higher by 6.3 pp if compared to the stipulated minimum regulatory capital rate of 12%,
- the leverage ratio at the level of the RS banking sector was 10,4% and it was 4.4 pp higher than the minimum stipulated rate (6%),
- at the level of total banking sector as of 31/12/2019, a net positive financial result was reported in all banks in total amount of EUR 49.4 million which is 14% higher than the previous year.

The ratio of banks' total assets (balance and off-balance) to GDP amounted to 85%.

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

Prudential regulation governing the operations of banks issued by the BARS in 2019:

- Decision on Internal Liquidity Adequacy Assessment Process (ILAAP),
- Decision on Credit Risk Management and Accounting of Expected Credit Losses,
- Decision on amendments to Decision on Calculation of Capital in Banks,
- Decision on amendments to Decision on Reporting on Bank Capital Adequacy,
- Decision on amendments to Decision on form and content of reports banks submit to the Banking Agency of RS,
- Instruction on fulfilling reporting forms for liquidity coverage ratio (LCR),
- Instructions for the application of the provisions of the decision pertaining to the calculation of the LCR,
- Instructions for filling out the reporting forms on the disclosure of bank data and information,
- Instruction for the classification and valuation of financial assets,
- Instruction for IT external audit in banks.

Prudential regulation issued by the BARS in the field of bank resolution in 2019:

- Decision on data and information submitted to the Banking Agency of RS for the purpose of developing and updating bank and banking group resolution plans,
- Instruction for fulfilment of reporting forms to be submitted to the Banking Agency of RS needed for drafting and updating bank and banking group resolution plans.

Prudential regulation governing the operations of microcredit organizations (MCO) issued by the BARS in 2019:

- Decision on microcredit organizations supervision and supervisory measures implementation,
- Instruction for implementation of Decision on uniformed method of calculating and disclosing effective interest rate for micro loans.

The BARS legal competences

The BARS has a mandate to regulate and supervise operations of banks, microcredit organizations, leasing providers and saving-credit organizations, as well as for bank resolution.

Namely, the BARS competencies are as follows:

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

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

Main strategic objectives of the supervisory authority in 2019

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

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

The activities of the Banking Supervisory Authority in 2019

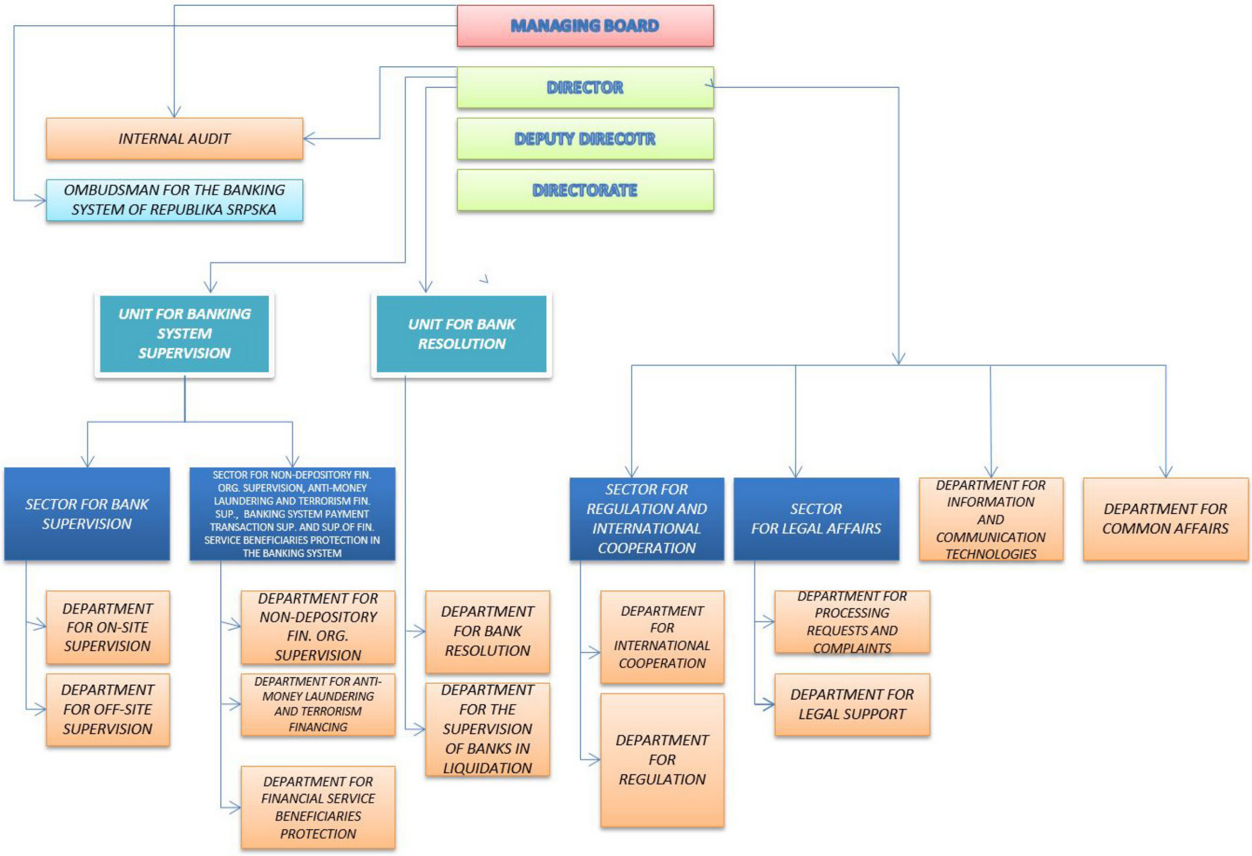
In 2019, the BARS activities were aimed at maintaining the stability and improvement of the quality and legality of the RS banking system operations, based on continuous supervision of banks, microcredit organizations and leasing providers.

In addition, the BARS continued to supervise 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 lending 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 supervision segments which were related to the assessment of harmonization of banks, microcredit organizations and leasing companies with the standards for the prevention of money laundering and terrorism financing, as well as ensuring and improving the protection of rights and interests of the banking service consumers.

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

- The BARS continued with the activities on strengthening and improving the cooperation with international and domestic institutions, regional and other organizations, as well as bilateral cooperation with regulators from other countries,
- The BARS continued to perform activities aimed at the strengthening of institutional capacities of the BARS and gradual transition to the new regulatory framework, implementation of new risk based supervision process (SREP), including methodologies for the assessment of ICAAP, ILAAP and recovery plans, as well as further development and improvement of the existing secondary regulatory framework,
- The BARS continued to perform activities aimed at the strengthening of institutional capacities for resolution of banks, further development and improvement of the existing secondary regulatory framework in the field of resolution. In 2019, the BARS finished the preparation of the first resolution plans for all banks,
- The BARS, together with the Banking Agency of the Federation of BiH, took part in equivalence assessment process, which was conducted by the representatives of the European Banking Authority, in order to asses equivalence of regulatory and supervisory framework in RS and FBIH with the one applied in the European Union,
- 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 2019, the BARS continued with activities on strengthening and improving the cooperation with international financial institutions, regional and other organizations, as well as bilateral cooperation with regulators from other countries. Apart from attending the meetings, the BARS responded, on a regular basis, to the inquiries, requests for data collection and questionnaires of international institutions and organizations (European Central Bank, European Banking Authority, International Monetary Fund, World Bank, EBRD, BSCEE, etc.).

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

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

The BARS continues cooperation within the World Bank Banking Sector Strengthening Project, USAID FINRA Project and in 2019 BARS signed Agreement in order to participate in the EU-funded programme to support central banks and banking supervisory agencies in the EU candidate countries and potential candidates from the Western Balkans.

Cooperation with other supervisory bodies in the country

In 2019, the BARS continued to actively cooperate with the Insurance Agency of RS and Securities Commission of RS in accordance with the Law on Committee for Coordination of RS Financial Sector Supervision.

Furthermore, under the signed Memorandum of understanding, intensive bilateral cooperation with the Central Bank of Bosnia and Herzegovina, Banking Agency of the Federation of Bosnia and Herzegovina and the Deposit Insurance Agency of Bosnia and Herzegovina was continued in 2019.

Other relevant information and developments in 2019

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

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	8	8	8
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**8**	**8**	**8**

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

Type of financial institution	2017	2018	2019
Commercial banks	3,833,568	4,207,661	4,470,804
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**3,833,568**	**4,207,661**	**4,470,804**
y/y change (in %)	**+5.6**	**+10.0**	**+6.9**

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

Item	2017	2018	2019
Public sector ownership	0	0	0
Domestic ownership total	30.6	30.5	34.8
Foreign ownership	69.4	69.5	65.2
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	64.3	86.0	1,731
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**64.3**	**86.0**	**1,731**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	10.4	7.8	9.7
Cooperative banks	-	-	-
Banking sector, total:	**10.4**	**7.8**	**9.7**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

Capital adequacy ratio of banks

Type of financial institution	2017	2018	2019
Commercial banks***	16.2	17.7	18,3
Cooperative banks	-	-	-
Banking sector, total:	**16.2**	**17.7**	**18,3**

*(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	2017	2018[2]	2019
Non-financial sector, including	11.1	9.5	6.9
- households	8.3	7.4	6.6
- corporate	13.4	11.4	7.2

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	83.8	87.0
Households	62.1	45.8
Corporate	21.7	41.2
Government sector	11.0	12.0
Financial sector (excluding banks)	5.2	1.0
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	155,948	154,011	150,945
Interest expenses	40,596	34,032	31,946
Net interest income	115,352	119,979	118,999
Net fee and commission income	-	-	-
Other (not specified above) operating income (net)	-	-	-
Gross income	203,294	197,819	204,933
Administration costs	112,109	114,607	114,940
Depreciation	-	-	-
Provisions	-	-	-
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	22,370	24,085	16,582
Profit (loss) before tax	54,793	43,055	54,884
Net profit (loss)	49,179	37,943	49,397

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks***	499,237	459,187	459,978	39,259	-
Cooperative banks					-
Banking sector, total:	**499,237**	**459,187**	**459,978**	**39,259**	**-**

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

Macroeconomic environment in the country

In 2019 Bulgaria's real GDP grew by 3.4% (3.1% in 2018), with private consumption having the highest contribution for expansion in economic activity, followed by government consumption and gross fixed capital formation. Private consumption grew by 5.8% (4.4% in 2018) in an environment of low interest rates and increased credit demand and supply, continuing favourable developments in the labour market and strong consumer confidence. Government consumption grew by 5.5% (5.3% in 2018), driven by compensation, healthcare and maintenance expenditures. Gross fixed capital formation increased by 2.2% in real terms (5.4% in 2018) mainly on account of government investment while the amount of private investment stood close to its level in 2018 amid prospects of weaker foreign demand and expectations for slowdown of economic activity. Despite the weaker foreign demand in Bulgaria's main trading partners, exports of goods and services increased by 1.9% (1.7% growth in 2018) backed by increased competitiveness of the export sector and expiry of temporary supply side factors present in 2018. Driven by strong consumer demand, imports increased by 2.4%, with net exports having a contribution of -0.3 p.p. in real GDP growth (-2.4 p.p. in 2018).

Total gross value added for the economy slowed its growth to 3.0% in real terms in 2019 (3.5% in 2018), as a result of weaker expansion in the services sector, amounting to 3.0% (5.8% in 2018). The agricultural and industrial sectors grew by 3.6% and 2.8%, respectively.

In 2019, developments in the labour market remained favourable. Nominal and real wages increased respectively by 5.8% and 3.3%, while unemployment decreased to 4.2% from 5.2% in 2018, according to NSI Labour Force Survey data. Strong labour productivity growth contributed to decelerating real unit labour cost growth in the economy.

At the end of 2019, HICP inflation accelerated to 3.1% from 2.3% in 2018, driven mainly by food products and services.

As of December 2019, the gross external debt increased by EUR 956.2 million compared to the end of 2018, amounting to EUR 34.1 billion (56.2% of GDP). This increase was mainly the result of intercompany loans, as well as higher debt in the banking sector.

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

In 2019, the banking sector's activity was realized in observance of credit institutions' capital and liquidity requirements, and with sufficient profitability to allow a continued improvement of their capital position. While credit growth accelerated and total assets in the banking system increased, the residual credit risk continued to decrease due to a reduction in the amount of net non-performing loans and advances.

The capital position of the banking system remained stable and the capital ratios continued to exceed minimal regulatory and prudential requirements. Additional capital requirements were introduced during the period, while all credit institutions reported Common Equity Tier 1 capital above the minimal requirements and met the requirements of all capital buffers.

The liquidity position of the banking system remained solid, with all credit institutions having a liquidity coverage ratio above the 100% requirement.

In 2019 the total assets of the banking system increased by 8.3% (BGN 8.8 billion) to BGN 114.3 billion. The annual growth of the banking system's assets was higher than that in 2018. The share of loans and advances also grew and reached 65.7% of total assets. The share of cash, cash balances at central banks and other demand deposits – the most liquid item in the balance sheet – was relatively high at 15.9%. The ratio of the banking system's total assets to GDP was 96.3% as of end-2019.

Loans and Deposits

Gross loans and advances[1] in 2019 increased by BGN 5.4 billion (6.1%), totalling BGN 94.4 billion. Loans and advances denominated in BGN increased to 59.4% of the total amount, while claims in EUR and claims in other currencies were 35.4% and 5.2%, respectively.

The gross loan portfolio (excluding loans and advances to central banks and to credit institutions) increased by BGN 5.4 billion (8.8%), amounting to BGN 66.3 billion. Loans to households increased by BGN 2.1 billion (9.6%), those to financial corporations increased by BGN 1.4 billion (42.7%), and those to the general governments sector increased by BGN 191 million (25.8%). Loans to non-financial corporations, which have the highest share of total loans and advances, increased by BGN 1.7 billion (4.9%).

In 2019, the deposits in the banking system increased by BGN 7.5 billion (8.4%), totalling BGN 97.2 billion. Household deposits, which have the highest share in the total amount, increased by BGN 4.2 billion (7.9%). Deposits from non-financial corporations increased by BGN 2.9 billion (11.4%), while those from credit institutions and from other financial corporations increased respectively by BGN 226 million (4.4%) and BGN 209 million (6.5%). Deposits from the general governments sector, the only sector to register a reduction, decreased by BGN 32 million (1.2%).

Market structure

At the end of 2019, there were 24 credit institutions and foreign branches, of which one was a state-owned bank. The process of consolidation in the banking sector continued in 2019. DSK Bank acquired Société Générale Expressbank, while Eurobank Bulgaria acquired Piraeus Bank Bulgaria. These operations contributed to one-off changes to the balance sheet dynamics and regulatory capital in the banking system.

At the end of December 2019, the share of the assets of the five largest banks increased to 62.2% (59.4% at the end of 2018). On an annual basis, the market share of credit institutions with predominantly Bulgarian equity decreased to 21.8% from 22.0% in 2018. The share of EU subsidiaries and branches increased to 75.0% (74.9% at the end of 2018), and the share of non- EU banks and branches increased to 3.2% (3.1% at the end of 2018).

Asset quality

Asset quality indicators continued to improve. At the end of December 2019, the gross amount of all non-performing exposures[2] was BGN 6.1 billion and their share decreased to 5.7% of all exposures (6.7% at the end of 2018).

On an annual basis the gross amount of non-performing loans and advances decreased by BGN 663 million (9.8%), while total gross loans and advances increased by 6.1% (BGN 5.4 billion). The share of gross non-performing loans and advances in the total amount of gross loans and advances decreased by 1.1 p. p. to 6.5% at the end of 2019.

The net amount of non-performing loans and advances , representing the potential credit risk in bank balances, decreased by 4.5% to BGN 3.2 billion on an annual basis and remained fully covered by the capital surplus above the minimum regulatory requirement of 8%. The share of net non-performing loans and advances in the total net loans and advances decreased from 3.9% to 3.5% at the end of 2019.

The coverage rate of gross non-performing loans and advances[3] with the impairment inherent for that classification category decreased to 48.6% at the end of 2019 (51.4% at the end of 2018).

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

[1] Gross loans, advances and deposits as reported in Macroprudential Reporting Form 1 (MPF1).

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

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

Profitability

The level of profitability of the banking system was influenced by the low interest rates retained for a prolonged period. The profit of the banking system at the end of 2019 amounted to BGN 1.7 billion and was comparable to the profit realized in 2018, having risen by BGN 11 million (0.7%). As a result, of the higher growth rate in total assets and total balance sheet equity, the ratios ROA and ROE decreased slightly in 2019, and at the end of the year they were 1.47% and 11.67% respectively.

Net operating income for 2019 increased by BGN 21 million (0.5%), while its main component, net interest income, registered a slight decline and its share was 64.3% of total net operating income (65.0% in end-2018). Net income from fees and commissions increased, its share in the total net operating income reaching 26.1% (25.3% in end-2018).

Impairment costs for 2019 were lower by 6.6% compared to end-2018, amounting to BGN 0.4 billion.

The cost to income ratio, calculated as a ratio of administrative expenses and depreciation to total net operating income, increased to 45.6% in 2019 (44.9% in 2018).The dynamics were driven by higher depreciation expenditure, which registered an increase of 53.1% compared to end-2018, mainly a result of changes to accounting reporting standards of financial leasing according to IFRS 16. Administrative expenditure decreased by 3.2% compared to end-2018.

Solvency

The reported capital ratios in the banking system at the end of 2019 remained significantly above the regulatory minimum. All credit institutions observed the capital buffer requirements (2.5% capital conservation buffer, 3% systemic risk buffer, 0.5% countercyclical capital buffer introduced in October 2019, and higher O-SII buffer rates for other systemically important institutions)[4]. Additional capital requirements under Pillar 2 were introduced during the reporting year.[5]

At the end of the year, the total capital in the banking system was BGN 1.6 billion (13.8%) higher than in end-2018, amounting to BGN 13.3 billion. Both Tier 1 capital and Common Equity Tier 1 capital increased by BGN 1.7 billion to BGN 12.8 billion and BGN 12.5 billion, respectively.

The total risk exposures amount increased, due to credit growth and regulatory changes (higher risk weights[6]). As of 31 December 2019 the ratios of CET 1 capital, Tier 1 capital and total capital adequacy were 19.09%, 19.55% and 20.21%, respectively. At the end of 2019, the amount of capital above the minimum requirement of 8%, amounted to BGN 8.0 billion, BGN 0.9 billion higher than in end-2018.

The indicator of indebtedness – the leverage ratio (using a fully phased-in definition of Tier 1 capital) – increased to 10.55% at the end of 2019 (compared to 10.11% at the end of 2018) as a result of the higher growth of Tier 1 capital.

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[4] More information about the capital buffers is available on the BNB website: http://www.bnb.bg/BankSupervision/BSCapitalBuffers/index.htm?toLang=_EN

[5] In March 2019 based on the completed supervisory review and evaluation process (SREP) and according to the EBA methodology, the BNB Governing Council set an additional capital requirement under Pillar 2 of the regulatory framework (in force from the second quarter of 2019).

[6] As of early 2019 a higher risk weight to exposures to Member States' central governments and central banks should apply where exposures are denominated in a currency other than the domestic one (under Articles 114, 136 and 138 of Regulation (EU) 575/2013), and a 4 per cent capital requirement for foreign exchange risk (Article 354 of the same Regulation).

Liquidity

The liquidity position of the banking system remained stable in 2019, and all credit institutions exceeded the minimal regulatory requirement for liquidity coverage of 100%. The liquidity coverage ratio (LCR) of the banking system decreased to 269.9%, compared to 294.1% at the end of 2018, but remained above the average level reported in the EU banking system.

The liquidity buffer, the numerator of the liquidity coverage ratio, registered an annual growth of BGN 1.3 billion (4.3%) and amounted to BGN 30.9 billion. Net liquidity outflows, the denominator of the ratio, increased by BGN 1.4 billion (13.6%) to BGN 11.5 billion, thus lowering the liquidity coverage ratio reported at the end of the year.

The loan-to-deposit ratio (LTD)[7] for the banking system was almost at the same level (72.2% at end-2019 compared to 72% at end-2018).

Products and distribution channels

At the end of 2019 there were 49 points of sale (branches, offices, representative offices and remote workstations), 80 ATMs and 1463 POS terminals[8] per 100 000 population.

The legal and institutional framework of the operation and supervision of financial institutions, new developments. Legal competence of the banking supervisory authority in Bulgaria

In general, the activity of banking supervision in Bulgaria is based on the European regulatory framework for credit institutions (CRD/CRR, BRRD, AMLD, etc.), including the EC delegated acts in relevant areas, the EBA guidelines and the ESRB recommendations. Depending on the needs in practice, as well as the changes made at EU level, individual policies and measures within the national framework are subject to amendments.

In April 2019, the BNB Governing Council adopted the new Ordinance No 10 on the Organisation, Governance and Internal Control of Banks. The Ordinance builds on the current regulations concerning the internal control of banks, extending the requirements to banks' internal organisation in accordance with the provisions of the Law on Credit Institutions (LCI) and the Guidelines on Internal Governance issued by the EBA. The Ordinance provides for banks to organise their structures/divisions and develop internal policies, rules and procedures according to the size, nature, scale and complexity of banks' activities and the risks inherent. In addition, specific criteria shall apply to ensure the bank's governance is compatible with risk profile and business model.

In the same time, the BNB Governing Council adopted also a new edition of Ordinance No 20 on the Issuance of Approvals to the Members of the Management Board (Board of Directors) and Supervisory Board of a Credit Institution and Requirements for Performing their Duties. The Ordinance improves the existing rules by aligning them with the latest amendments in the LCI, and the requirements of the Guidelines on the assessment of the suitability of members of the management body and key function holders issued by the EBA and the European Securities and Markets Authority.

[7] The ratio is calculated on the basis of data from Macroprudential Reporting Form 1 (MPF1) excluding sectors central banks and credit institutions.
[8] Data for ATMs and POS terminals refer to banks in Bulgaria.

Furthermore, amendments adopted to Ordinance No 4 of 2010 on the Requirements for Remunerations in Banks provide that the obligation to set up a remuneration committee particularly to significant banks, since the number of their board members is in general higher, and it allows for efficient distribution of committees' functions between its members.

Consistent to the above changes, updates done to Ordinance No 7 of 2014 on Organisation and Risk Management of Banks lay down the requirements on the repute, qualification and professional experience to the head of risk management function. Establishing a risk committee is compulsory to significant banks. Committees shall consist of supervisory board members and/or non-executive board members, the majority of them independent.

Along with the amendments to ordinances, the BNB Governing Council adopted resolutions to implement a number of guidelines issued by the EBA, and respectively the Banking supervision Department notified it of the decisions taken.

Main strategic objectives of the supervisory authority in 2019

The main priority of the BNB is establishing close cooperation with the European Central Bank (ECB) in view of exchanging information, joint assessments and decisions, etc. with the Single Supervisory Mechanism (SSM).

In the context of close cooperation, work continued on the convergence in supervisory practices of BNB with practices of the ECB, e.g. the internal supervisory processes and information flows between the two competent authorities.

The activities of the Banking Supervisory Authority in 2019

In 2019, the focus in the work program and activity of the banking supervision continued to be the supervisory review and evaluation of credit institutions with particular emphasize on credit risk, risk of concentrations, market and operational risk, as well as liquidity risk.

Within the 2019 Supervisory review and evaluation process, all of the four elements, i.e. business model and profitability, corporate governance, capital adequacy and liquidity adequacy were thoroughly reported and considered both, for individual domestic credit institutions and within supervisory colleges of EU banking groups. The BNB governing council adopted the relevant decisions.

The EBA criteria on banks' ICAAP and ILAAP have been taken into account in assessing their integrity with the internal corporate governance framework, and to what extent the targets defined are based on the capital planning, on liquidity forecasting and budgeting.

In addition to the 2019 SREP, the BNB reviewed also banks' funding plans to ensure their feasibility in terms of the short and long-term objectives set, and to assess their compliance with the EBA Guidelines on harmonized definitions and templates for funding plans of credit institutions. The review of the funding plans took into account forecasts of dynamics in assets, liabilities and capital over a three-year period (2019-2021). In addition, evaluations of updated recovery plans took place, especially of local banks, which are not parts of banking groups (Article 6, paragraph 1 of the Law on the Recovery and Resolution of Credit Institutions and Investment Firms).

The scope of the on-site inspections carried out in 2019, mainly covered the management process and the mechanism for the control of individual bank risks, in particular credit and concentration risks. The management of operational risk and its incorporation in ICAAP, as well as the liquidity position from the point of view of the intragroup bank transactions, were also assessed. Due attention was placed on the organisation, rules and methodology of the ICAAP, which are essential in determining internal capital needs. The process and timeliness of supervisory reporting have been considered. Subject of assessments also was the implementation of supervisory measures imposed under previous supervisory on-site inspections, e.g. recommendations and measures to address deficiencies in operational activities and internal control mechanisms.

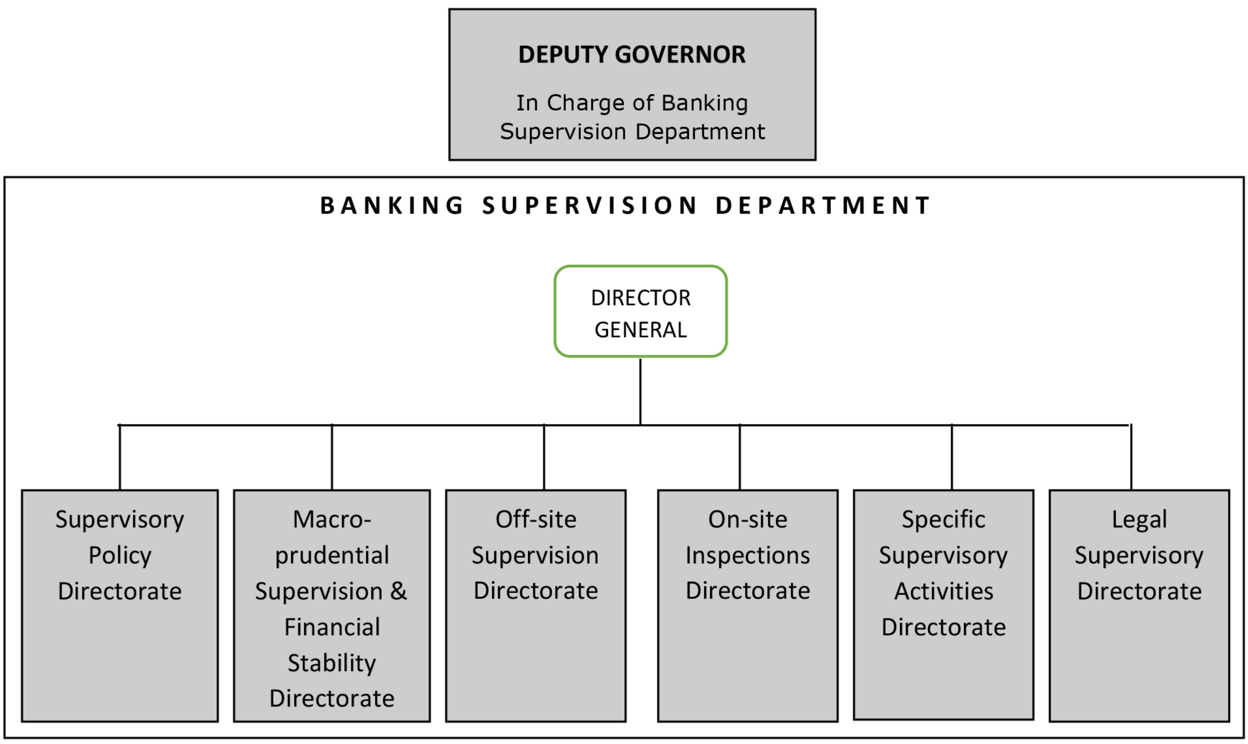
Estimates have shown the extent to which banks' internal systems are comprehensive and the extent to which strategies and processes are consistent the nature, scale and complexity of the activity.

In 2019, draft changes were prepared to the On-Site Inspection Manual with relevance to the cooperation with the SSM/ECB. The amendments would serve to update of some internal approaches or procedures for the purposes of coordination in joint assessments and decisions within the SREP, for participation in joint supervisory teams, etc.

Within its macro-prudential mandate, the BNB continued to prepare trend analyses on the banking sector, its interconnection with the financial system, with the development of the Bulgarian economy and the impact of the international environment. In line with the assessment of structural risks in the banking sector, the systemic risk capital buffer was set at 3%. From October 2019, a 0.5% countercyclical capital buffer applies to local credit risk exposures. In the context of the macro-prudential policy, various thematic studies and analyses were subject of reviews, e.g. mortgage lending to households, the annual survey "Aspects of banking activity", etc.

As it regards the specific supervisory activity, as usual, the main priority belongs to periodically checking the internal control rules, and the prevention of money laundering and terrorist financing. The focus in this area is placed on the continuous and consistent application of the requirements for thorough customer verification ("know your customer"), and respectively, to continuously enhancing training and administrative capacity of the respective services and departments in credit and financial institutions.

Organisational chart of the Banking Supervisory Authority



International activities of the authority

In 2019, supervisory experts of BNB have cooperated in the exercise within the EBA Subgroup on Own Funds in assessing equity instruments of three Bulgarian banks, issued before the entry into force of Regulation (EU) № 575/2013 (CRR) and included in Common Equity Tier 1 capital (CET1). The aim of the assessment was to verify and analyse the extent to which the equity instruments of banks included in CET1 capital meet the prudential requirements. The outcome of the review confirmed that both, the national legislation and the statutes of the banks are compatible with the requirements of Article 28 of the CRR, the Commission Delegated Regulation (EU) № 241/2014 of 7 January 2014, the EBA Report on CET1 instruments, and all published EBA questions and answers relating to CET1 instruments.

For the sake of close cooperation with the SSM, BNB experts provided to the ECB definitions concerning Bulgarian banking system specificities in relation to the asset quality review (AQR) and stress test of six selected Bulgarian banks, performed by the ECB based on its methodology and macroeconomic scenarios. The submitted information covered main risk assessments, financial position data and specific information on each bank. The AQR process included both on-site visits to banks, and data verification and confirmation, as requested by the ECB. A communication of the results was released on 26 July 2019 on the ECB's website.

Cooperation with other supervisory bodies in Bulgaria

In accordance with their powers, in the performance of dedicated verifications in the prevention of money laundering and financing terrorism, experts of the BNB conducted joint inspections with representatives of the Financial Intelligence Directorate of the National Security Agency (DANS).

In connection with the bank deposit guarantee, the BNB interacts with the Bank Deposit Insurance Fund. Credit institutions' reporting in respect of deposits protected by law are subject of regular checks.

The BNB interacts also with the Commission of Consumer Protection in cases of complaints and alerts received from consumers of banking and financial services. Supervisory experts drew opinions and replies to the complainants and the Commission, which has a mandate of protecting consumers in case of infringed rights and interests.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	22	20	19
Branches of foreign credit institutions	5	5	5
Banking sector, total:	**27**	**25**	**24**

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

Type of financial institution	2017	2018	2019
Commercial banks	48 779 343	52 400 040	56 612 527
Branches of foreign credit institutions	1 214 894	1 569 873	1 845 379
Banking sector, total:	**49 994 237**	**53 969 913**	**58 457 906**
y/y change (in %)	**6.2%**	**8.0%**	**8.3%**

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

Item	2017	2018	2019
Public sector ownership	2.5	2.9	2.8
Domestic ownership total	23.5	22.0	21.8
Foreign ownership	76.5	78.0	78.2
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset based on market share in terms of total assets

Type of financial institution	The first three largest (%)	The first five largest (%)
Banking sector, total:	**43.5%**	**62.2%**

Return on Equity (ROE) (%)

	2017	2018	2019
Banking sector, total:	**9.15**	**11.97**	**11.64**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	97.6	97.1	96.8
Branches of foreign credit institutions	2.4	2.9	3.2
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

Assets	2019
Cash, cash balances at central banks and other demand deposits	15.9
Financial assets held for trading	0.5
Non-trading financial assets mandatorily at fair value through profit or loss	0.6
Financial assets designated at fair value through profit or loss	0.0
Financial assets at fair value through other comprehensive income	8.6
Financial assets at amortised cost	68.9
Derivatives – Hedge accounting	0.0
Fair value changes of the hedged items in portfolio hedge of interest rate risk	0.0
Investments in subsidiaries, joint ventures and associates	1.3
Tangible assets	2.2
Intangible assets	0.3
Tax assets	0.0
Other assets	1.5
Non-current assets and disposal groups classified as held for sale	0.1
TOTAL ASSETS	**100.0**
Liabilities	**2019**
Financial liabilities held for trading	0.1
Financial liabilities designated at fair value through profit or loss	0.0
Financial liabilities measured at amortised cost	86.1
Derivatives – Hedge accounting	0.1
Fair value changes of the hedged items in portfolio hedge of interest rate risk	0.0
Provisions	0.3
Tax liabilities	0.0
Share capital repayable on demand	0.0
Other liabilities	0.8
Liabilities included in disposal groups classified as held for sale	0.0
TOTAL EQUITY	**12.6**
TOTAL EQUITY AND TOTAL LIABILITIES	**100.0**

Capital adequacy ratio of banks

	2017	2018	2019
Banking sector, total***:	**22.08**	**20.38**	**20.21**

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

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

Asset classification	2019
Gross non-performing loans and advances to total gross loans and advances (%)	6.5
Net non-performing loans and advances to total net loans and advances (%)	3.5

The structure of deposits and loans and advances of the banking sector in 2019 (%) (at year-end)[9]

	2018		2019	
	Deposits	Loans and advances	Deposits	Loans and advances
Central banks	0.0	17.2	0.0	14.3
General governments	3.0	0.8	2.7	1.0
Credit institutions	5.7	14.3	5.5	15.6
Other financial corporations	3.6	3.6	3.5	4.9
Non-financial corporations	28.2	39.2	29.0	38.7
Households	59.5	24.8	59.3	25.6
Total	**100.0**	**100.0**	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	1,555,804	1,553,737	1,547,425
Interest expenses	188,154	152,005	153,401
Net interest income	1,367,650	1,401,733	1,394,024
Net fee and commission income	509,141	545,247	565,559
Other (not specified above) operating income (net)	109,483	209,207	207,206
Total operating income, net	1,986,274	2,156,187	2,166,789
Administrative expenses	825,605	878,061	849,893
Depreciation	89,872	89,634	137,216
Provisions or (-) reversal of provisions	10,637	11,542	35,933
Impairment or (-) reversal of impairment on financial assets not measured at fair value through profit or loss	394,092	244,096	227,964
Profit or (-) loss before tax from continuing operations	654,009	923,216	942,656
Profit or (-) loss for the year	588,206	850,962	856,515

Total own funds in 2019 (in EUR)

	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Banking sector, total:	**6,777,725**	**6,401,407**	**6,555,905**	**221,819**	

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

[9] Source: Macroprudential Reporting Form 1 (MPF1).

Macroeconomic environment

The growth in gross domestic product accelerated to 2.9% in 2019 from 2.7% in the year before. Such developments are the result of accelerated growth in foreign and domestic demand. Economic growth was mostly fuelled by the growth in total goods and services exports. Consumer price inflation slowed down in 2019, primarily due to a reduction in the rate of VAT on certain food and pharmaceutical products. The current and capital account surplus rose from 3.3% of GDP in 2018 to 5.0% of GDP in 2019.

This was spurred by a further fast growth in tourism and more intensive use of EU funds. By contrast, the foreign trade deficit widened additionally. At the same time, external indebtedness of domestic sectors continued to shrink. The expansionary monetary policy of the CNB supported economic recovery in the conditions of a stable nominal exchange rate of the kuna against the euro maintained by the CNB. As a result, bank liquidity in 2019 was at the highest levels ever recorded, which led to a further fall in interest rates on loans and lending growth. The budget balance was maintained and the public debt to GDP ratio continued to trend downwards.

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

The banking system in 2019 was profitable, highly-liquid and well-capitalised.

The number of credit institutions went down by two, so that 20 banks and three housing savings banks operated in the Republic of Croatia at the end of 2019. In addition, there was one branch of an EU credit institution operating in the country, while around 200 EU (and EEA) institutions notified the HNB of the direct provision of mutually recognised services in the territory of the Republic of Croatia.

The banking system continued to be dominated by credit institution in foreign ownership and OSIIs. The assets of credit institutions reached a total of HRK 425.8 bn (105.8% of GDP), as the result of second consecutive year of asset growth, mainly financed by increase of domestic deposits with strong reliance on domestic household deposits.

Household and corporate loans grew sharply amid stimulating private and government sector financing conditions; interest rates were historically low and liquidity was high. HNB monitored the acceleration in the growth of general-purpose cash loans that account for approximately 12% of the banking system assets. Although they did not pose a threat to system stability since bank capital is greater than the amount of these loans, we issued a recommendation to banks in regard to granting of these loans.

Namely, we estimated that further growth in consumer lending, coupled with very lax credit standards, might hinder debt repayment or even bring it to a halt in the case of deterioration in economic activities. A small slowdown in the growth of cash loans is exclusively the result of compliance with HNB recommendation, which was equally effective for system stability and consumer welfare.

In 2019 the loan quality improvement trend, which began several years ago continued under the strong influence of the sale of claims and Agrokor case settlement. The share of non-performing loans (NPL) as a result of positive trend, reached the lowest level of 5.5%, compared to previous years and was accompanied with high NPL coverage ratio of 68%.

Main characteristic of banking system is good bank capitalisation and high short-term liquidity. Total capital ratio of 23.2% was among highest of EU member state. The increase in highly-liquid assets was reflected in the high Liquidity Coverage Ratio (LCR) of 172.7%. Bank profitability indicators in 2019. went up significantly. As profit increased, ROAA and ROAE increased to 1.6% and 9.9%, respectively.

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

The main objective of HNB supervision is to maintain confidence in the banking system, promote and safeguard its safety and stability and remove institutions that operate contrary to these principles from the market. This reduces the risk from loss for depositors and other creditors of a bank and the society as a whole.

The HNB's tasks regulated by the Act on the Croatian National Bank include the issuance and withdrawal of authorisations and approvals, and supervision and oversight in accordance with acts governing the operations of credit institutions and credit unions. The exercise of supervision and oversight of credit institutions and credit unions is governed by the Credit Institutions Act and the Credit Unions Act. The rules and requirements pertaining to the operations of credit institutions are governed by Croatian regulations, as well as EU regulations.

One of the main new development in banking supervision area in 2019. include further strengthening of banking system supervision through the establishment of Close cooperation framework between the HNB and ECB that we applied for in May 2019.

In the context of Croatia's request to establish Close cooperation, ECB started in September 2019 Comprehensive assessment of five Croatian banks on the basis of data as at 30 June 2019 with results expected to be finalised in May 2020.

A comprehensive assessment is required as part of the process of establishing close cooperation between the ECB and the national competent authority of an EU Member State whose currency is not the euro and is comprised of asset quality review (AQR) and a stress test. The ECB will also assess relevant Croatian legislation, ensuring that HNB will be obliged to adopt all measures requested by the ECB in relation to Croatian credit institutions. As part of that assessment, the ECB will also take account of the practical implementation of such legislation.

Main strategic objectives of the supervisory authority in 2019

In 2019, HNB supervision fulfilled its main objectives of preserving safety and stability of the Croatian banking system. The banking system in 2019 was profitable, highly-liquid and well-capitalised. The Republic of Croatia applied to the European Central Bank (ECB) for the establishment of close cooperation in the framework of the Single Supervisory Mechanism in line with the requirements for joining the ERM II.

In addition, HNB developed the EDINA supervisory priorities for 2019/2020 that include:

E – convergence to the euro area: the adjustment of the regulatory framework to establish a close cooperation between the HNB and the ECB, the adjustment of the organisation of the HNB's supervisory function for entry into the mechanism of close cooperation and the provision of support to the comprehensive assessment (CA) of credit institutions by the ECB;

D – digitalisation of credit institution operations: the overview of initiatives to digitalise operations, the assessment of their impact on business models and risk profile and the assessment of the preparedness of internal management and risk management for changes brought about by digitalisation;

I – interest rate risk in the banking book (IRRBB): the assessment of models used by credit institutions to manage the IRRBB and monitoring of its level due to the transformation of maturities in credit institution balance sheets;

N – non-performing exposures: the credit institutions' compliance with new regulatory requirements on management of non-performing exposures and monitoring of their levels, especially in the context of a rise in unsecured general-purpose cash loans to households;

A – anti-money laundering and countering the financing of terrorism, (AML/CFT): the improvement of supervisory mechanisms in order to prevent the misuse of the financial system for money laundering and financing of terrorism and the continued awareness raising in the system on risks of money laundering and financing of terrorism.

The activities of the Banking Supervisory Authority in 2019

In 2019, the HNB carried out the regular supervisory cycle of assessing credit institutions. This includes assessing the risk profile of credit institutions, examining the adequacy of procedures in place for assessing and maintaining the internal capital of credit institutions and continuous cooperation based on a dialogue.

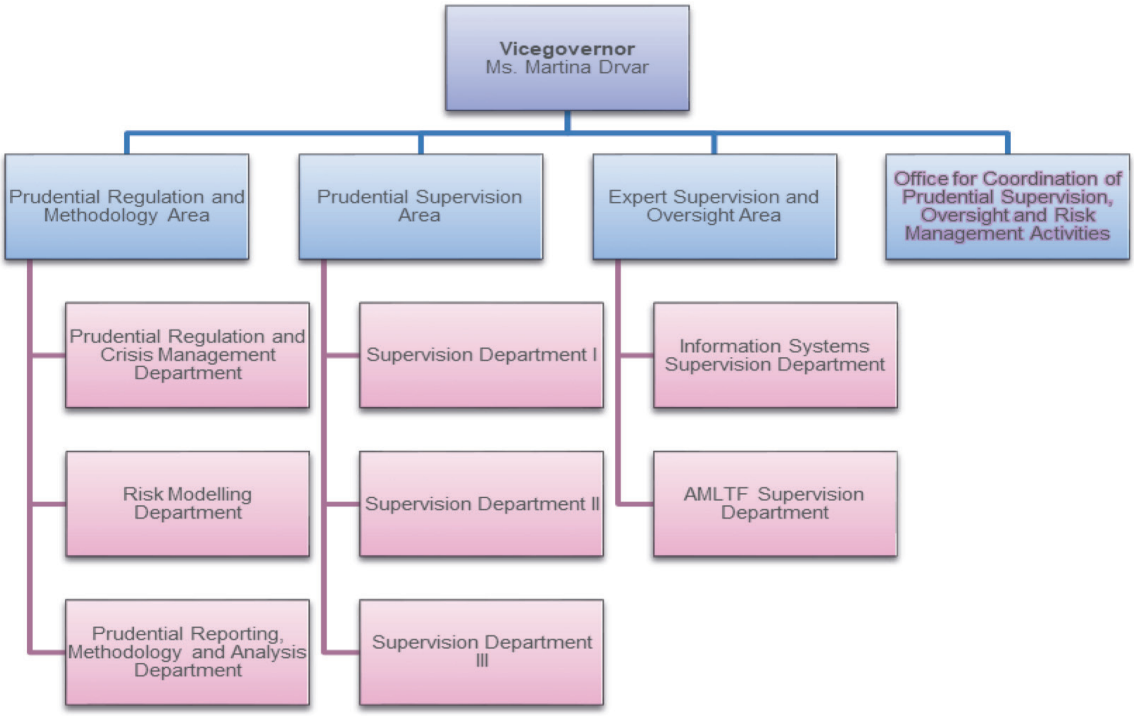
In 2019, the HNB compiled 14 reports on risk assessments of credit institutions, of which nine had to do with credit institutions for which cross-border colleges of supervisors were established and for which joint decisions are reached on specific prudential requirements.

The HNB performed 10 on-site examinations in 2019, with 14 risk-areas in focus with coverage of 88% of total banking system assets. As regards examination areas, special focus was placed on AML related risk, credit model risk (IRB) and the analysis of market and interest rate risk. The on-site examination plan take into account comprehensive assessment carried by ECB in 2019 in 5 important credit institutions in Croatia. In 2019, HNB recevied 55 notifications in authorisations area, majority in FAP, based on which overall 72 HNB Decisions were issued.

The HNB awarded also attention to the area of IT risk and cyber security by continuously monitoring cyber threats that could affect the banking system in Croatia. Additional efforts were put in the analysis of trend in banking system in the area of the digitalisation with focus on business model viability and transformation and new risk and products that could emerge from that change.

Organizational chart of the Banking Supervisory Authority

The CNB's supervision is reorganised in June 2019 in accordance with requirements which arise from Croatia's joining the ERM II and the Banking union through close cooperation within the Single Supervisory Mechanism (SSM), challenges in the macroeconomic environment, changes in bank business models and need to optimise decision-making processes by establishing organisational units with higher-level responsibility.



We have created four areas, to match the organisation of the ECB and to reduce hierarchy:

- Prudential Regulation and Methodology Area (Reporting, Methodology, Model Supervision, Regulation, Crisis Management),
- Prudential Supervision Area (JST Sub-Coordinators and teams, LSI Supervision and Licensing),
- Expert Supervision and Oversight Area (IT Supervision, AML Oversight) and
- Office for Coordination (supports participation and decision making in the ECB and EBA and coordinates external cooperation of supervision).

In addition to the above, we have two permanent committees established to support senior management in decision-making, reporting and policy designing as well as benchmarking for credit risk and business models. The Credit Risk Committee, comprised of regulatory experts, JST credit risk team leaders and internal modelling experts, follows up on the implementation of the recent credit risk regulations, and also compares and reports how credit risks evolve under the pandemic. The Business Model Committee is composed of internal governance experts, JST business model team leaders and IT supervision experts. It follows up on the digitalisation processes, outsourcing policies and the appropriateness of recovery plans in banks. In this way, we defined annual work plans for horizontal support and the committees' contribution to the decision-making at the highest management level, as well as at the JSTs functioning level.

International activities of the authority

As EBA member, the HNB participates in the European System of Financial Supervision. Over the course of 2019, we allocated considerable resources to participation in EBA and ECB working groups.

In 2019, the HNB 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 of IT system supervision. Based on the memoranda of understanding in effect, in 2019 the HNB representatives participated in numerous colleges of supervisors relating to the supervision of banking groups that include domestic banks.

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

In parallel, we stepped up our efforts to establish close cooperation between the HNB and the ECB, primarily in the area of human resources, legal and organization adjustment as well as policies and procedures. Significant resources participated in intense dialog and cooperation with ECB in various areas of supervisory preparedness in view of HNBs potential future role as NCA within SSM.

Cooperation with other supervisory bodies in the country

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

In 2019, the HNB continued to cooperate with HANFA by participating in the work of the joint Working Committee. At the Committee meetings, the institutions exchange information on current topics in the banking sector and the sector supervised by HANFA, resolve open issues on the exchange of data and arrange the coordination of supervisory activities.

Other relevant information and developments in 2019

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

Questionnaire tables for the 2019 review

Number of financial institutions*
(at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	30	25	23
Branches of foreign credit institutions	1	1	1
Cooperative banks			
Banking sector, total:	**31**	**26**	**24**

**Data on housing savings banks is included in line Commercial banks.*

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

Type of financial institution	2017	2018	2019
Commercial banks	53 136.8	55 829.7	57 919.9
Branches of foreign credit institutions	252.3	351.1	370.9
Cooperative banks			
Banking sector, total:	**53 389.1**	**56 180.8**	**58 290.8**
y/y change (in %)	**1.3**	**5.2**	**3.8**

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	6.1	6.2	6.0
Domestic ownership total	9.7	9.8	9.5
Foreign ownership	90.3	90.2	90.5
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	62.4	80.5	1 602.3
Branches of foreign credit institutions	100.0	100.0	10 000.0
Cooperative banks			
Banking sector, total:	**62.0**	**80.0**	**1 582.3**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	5.9	8.4	9.8
Cooperative banks			
Banking sector, total:	**5.9**	**8.4**	**9.8**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	99.5	99.4	99.4
Branches of foreign credit institutions	0.5	0.6	0.6
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector	28.0	28.4	27.1
Nonfinancial sector	47.5	47.2	47.6
Government sector	21.9	21.9	22.8
Other assets	2.6	2.4	2.5
Liabilites			
Financial sector	10.5	11.2	9.6
Nonfinancial sector	68.0	68.2	68.7
Government sector	6.0	6.1	6.9
Other liabilities	0.8	0.7	0.9
Capital	**14.8**	**13.9**	**13.9**

Capital adequacy ratio of banks

Type of financial institution	2017	2018	2019
Commercial banks	23.8	23.1	24.8
Cooperative banks			
Banking sector. total:	**23.8**	**23.1**	**24.8**

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

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

Asset classification	2017	2018	2019
Non-financial sector. including	11.7	10.3	7.4
- households	8.0	6.8	5.8
- corporate	22.1	20.4	13.6

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector. including:	90.4	81.7
Households	68.1	51.4
Corporate	22.3	30.3
Government sector	5.4	17.0
Financial sector (excluding banks)	4.2	1.3
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	2 004.3	1 607.0	1 641.1
Interest expenses	527.7	258.1	206.8
Net interest income	1 476.5	1 348.8	1 434.3
Net fee and commission income	454.9	444.2	484.5
Other (not specified above) operating income (net)	200.9	198.4	268.7
Gross income	2 132.3	1 991.4	2 187.5
Administration costs	901.2	863.0	878.7
Depreciation	95.3	90.6	135.6
Provisions	137.1	55.0	174.5
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans. ...)	468.7	222.4	103.9
Profit (loss) before tax	530.0	760.4	894.7
Net profit (loss)	454.3	663.6	779.5

Total own funds in 2019 (in EUR million)

Type of financial institution	Total own funds ***	Core Tier 1	Tier 1***	Tier 2***	Tier 3
Commercial banks	8 030	7 720	7 759	270	
Cooperative banks					
Banking sector. total:	**8 030**	**7 720**	**7 759**	**270**	

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

Macroeconomic environment in the country

As compared to the annual growth rate of 2.9% recorded in the previous year, in 2019 the real GDP growth decelerated by 0.4 percentage points to 2.5%. The growth dynamics of the Czech economy decreased notably at the end of the year.

The GDP growth was driven mainly by the domestic consumption which contributed 1.8 percentage points to the yearly addition to GDP. Dynamics of household consumption (3.0%) was moderately higher compared to government consumption (2.6%). On the contrary, the contribution of foreign trade balance to the GDP growth was the worst since 2010 (-1.9 percentage points), mainly due to the slump in the balance of trade in services. In 2019, expenditures on gross capital formation grew by 3.3%.

The average annual inflation rate (expressed by the consumer price index) amounted to 2.8% in 2019. The inflation was 0.7 percentage points higher than in the previous year and it was the highest value for the last seven years. Relatively high core inflation coupled with growth in administered prices and food prices kept inflation in the upper half of the tolerance band around the CNB's target for most of the year. The CNB responded by raising its monetary policy rates in May by 0.25 percentage points, so the two-week repo rate was 2.0% for the rest of 2019.

The Czech koruna was stable against the euro in 2019, it marginally appreciated on average (0.03% y-o-y), without any significant movements. On the contrary, the Czech koruna depreciated on average against the US dollar by 5.5% y-o-y, which corresponds to the movement of the EUR/USD rate. The average nominal exchange rate of the Czech koruna to the euro stood at 25.65 CZK/EUR in 2019 while the exchange rate of the Czech koruna to the US dollar on average reached 22.93 CZK/USD.

The unemployment rate slightly slowed down the decreasing trend when it reached 2.0% at the end of 2019 (0.2 percentage point y-o-y change). This was the lowest figure among all EU Member States in 2019. The growth of average nominal wage slowed down when it reached 7.1% in 2019.

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

As of the end of 2019, the banking sector of the Czech Republic was represented by 24 domestic banks (five building societies included), 9 credit unions and 25 branches of foreign banks. The group of four largest domestic banks held 60.3% of total assets in the banking sector.

At the end of 2019, the Czech banking sector reported total assets of CZK 7,557.4 billion, which corresponded to a y-o-y increase of 3.5%. The volume of the main component of assets, client loans, rose by 4.6%. The ratio of total assets of the banking sector to GDP stood at 133.7% level at the end of 2019.

The loan portfolio quality improved due to an improving trend in the category of non-performing loans. As of the end of 2019, NPL ratio calculated on the total client loans basis declined y-o-y by 0.8 percentage points to 2.6%.

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

A total net profit generated by banking entities in 2019 was CZK 91.1 billion, i.e. 11.9% more than in the previous year. Due to the prevailing traditional business model, the main component of the profit was net interest income which amounted to CZK 145.7 billion. Net fee and commission income remained largely stable at the level of CZK 33,1 billion while administration costs increased slightly to CZK 77,7 billion. Return on equity expressed by the ratio of total net profit to Tier 1 capital rose by 0.5 percentage point y-o-y to 17.8%.

The capitalisation of the banking sector in the Czech Republic has long been satisfactory. Tier 1 capital, the main component of capital in the banking sector, rose by 8.1% during 2019. The total capital ratio of banks operating in the Czech Republic was 21.3% at the end of 2019, i.e. 1.7 percentage points higher compared to the previous year. Domestic banks safely fulfilled the capital requirements defined by CRD IV/CRR throughout 2019.

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

In accordance with Act No. 6/1993 Coll., on the Czech National Bank, the CNB is the supervisor of the financial market in the Czech Republic. It supervises the banking sector, the capital market, the insurance industry, pension funds, credit unions, bureaux-de-change, payment system institutions, non-bank consumer credit providers and other institutions operating on the Czech financial market. 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 2019

As defined by Act No. 6/1993 Coll., on the Czech National Bank, the CNB's general objective in the area of supervision is to ensure financial stability and safe and sound operation of the financial system in the Czech Republic. This objective defines the CNB's area of competence as regards supervision of compliance with prudential rules (hereinafter "prudential supervision") and supervision of compliance with the rules of business conduct.

In 2019, the CNB focused on the following strategic objectives:

- to enhance Supervisory Review and Evaluation Process (SREP) of credit institutions, especially in the field of IT risks and information systems risk;
- in the area of prudential supervision, to continue with investigation of conditions for providing mortgage and consumer loans to households;
- in line with new technology trends, to focus on resilience of credit institutions to cyber risks;
- based on the risk oriented approach to the supervision, to form risk profiles of individual credit institutions in the context of AML risk;
- in the area of professional care, to supervise providing information to clients, communication with clients, procedures for concluding and terminating contractual relationships with clients, processes for requesting information from clients and last but not least, on proactively detecting unfair business practices of credit institutions;
- to monitor compliance with PSD II requirements;
- to monitor the credit institutions compliance with obligations for an investment funds depositories arising mainly from MiFID II and MiFIR.

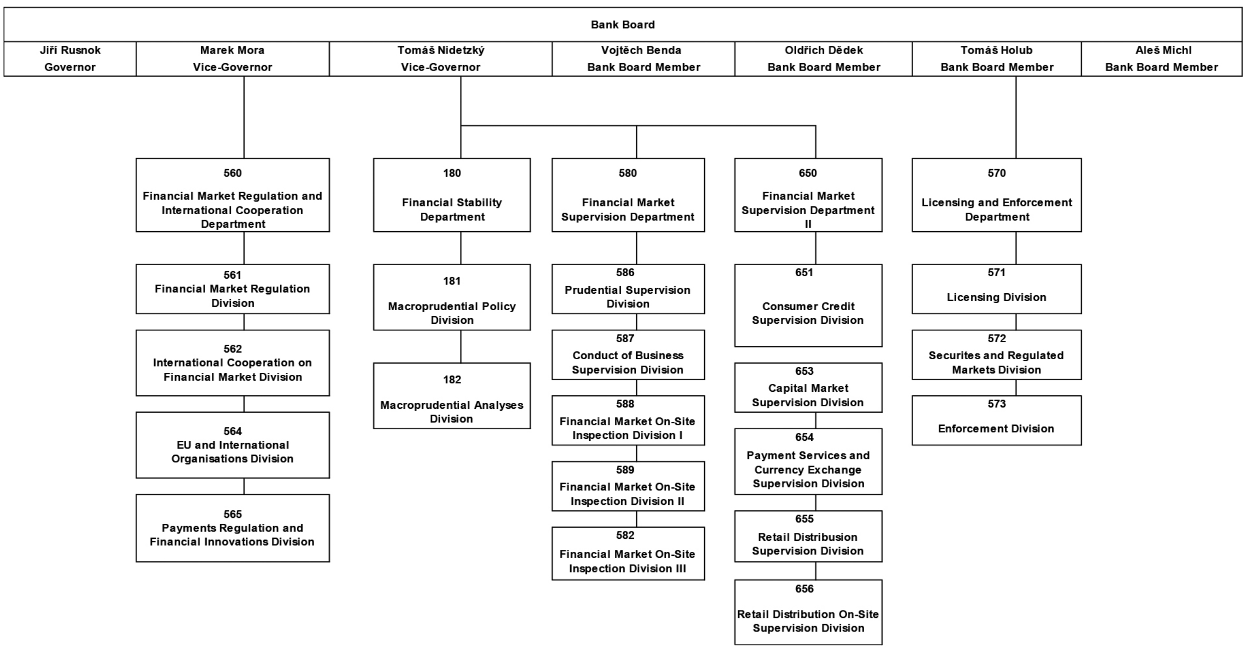
The activities of the Banking Supervisory Authority in 2019

As in previous years, the core activities of the supervision in 2019 were focused on regular assessment of the financial situation, control of compliance with prudential requirements and monitoring of other relevant qualitative information about the institutions operating on the Czech banking market. Supervisory activities of the CNB were concentrated primarily on the quality of bank's credit portfolios (both on solo and consolidated basis), their overall performance and a sufficient level of capitalisation and liquidity. As in previous years, within the SREP, the CNB prepared a comprehensive assessment of the risk profiles of the individual credit institutions.

The CNB's off-site surveillance of credit institutions was combined with on-site examinations. In 2019, a total of 21 examinations were conducted or commenced in banks, one was carried out in a credit union.

In 2019, the CNB conducted stress tests to assess the impact of highly adverse future economic scenarios on the domestic banking sector. Compared to 2018, the sample of banks in stress tests was extended to the whole of the banking sector in the Czech Republic. The aggregate results of stress tests confirmed the relatively good resilience of domestic banks to possible unfavourable economic developments.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

The Czech National Bank actively cooperates with foreign supervisors to ensure effective supervision within its area of competence as well as to coordinate supervisory response to crisis situations. Where the CNB is the home supervisor, it manages the work of the college taking into account the risk profile and systemic importance of the supervised group and of the individual institutions that make up the group. Where the CNB is the host supervisor, it coordinates and plans its activities in cooperation with the home supervisor.

At international level, the CNB focuses on integration and cooperation within European structures. In 2019, the CNB cooperated with the European Banking Authority (EBA), the European Systemic Risk Board (ESRB) and the European Central Bank (ECB). The CNB also closely followed the discussions in the EU Council and its structures. Last but not least, the CNB is actively involved in the work of Basel Committee on Banking Supervision (BCBS).

Cooperation with other supervisory bodies in the country

The CNB is an integrated supervisory authority which oversees the subjects on the Czech financial market however the CNB works in close cooperation with the Czech Ministry of Finance, which has primary responsibility for preparing laws in the financial market area. The basis for such cooperation is laid down in the Agreement on cooperation on the preparation of draft national legislation concerning the financial market in the Czech Republic. Under the Agreement, the CNB and the Czech Ministry of Finance cooperate in the preparation of laws, statements of intent for laws and implementing legislation regarding: (i) the foreign exchange system and regulation of electronic money issuance; (ii) payments and accounting in the financial market; (iii) banking, AML, the capital market, consumer protection in the financial market, insurance and pension schemes.

Other relevant information and developments in 2019

In 2019, the CNB actively cooperated with the Ministry of Finance on an amendment to the Act on Banks and the Act on Credit Unions. An important material change included in the amendment is strengthening protection of bank customers and enhanced financial stability in the event of conversion or disposal of a bank's business or part thereof. It should also contribute to the stability of deposit guarantee scheme and reduce the administrative burden for banks.

In the second half of 2019, the CNB participated on implementation of the European regulation CRR II / CRD V to the Czech legislation. Following the requirements of CRD V, the amendment of affected laws adjusts some provisions concerning the capital requirements of credit institutions and the conditions under which the CNB may impose an additional capital requirement on an institution.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	23	23	24
Branches of foreign credit institutions	24	27	25
Cooperative banks	10	10	9
Banking sector, total:	**57**	**60**	**58**

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

Type of financial institution	2017	2018	2019
Commercial banks	6274.1	6596.1	6874.0
Branches of foreign credit institutions	727.8	683.1	673.2
Cooperative banks	23.1	20.2	10.2
Banking sector, total:	7025.0	7299.4	7557.4
y/y change (in %)	17.2	3.9	3.5

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	1.2	1.1	0.9
Domestic ownership total	6.7	7.1	7.7
Foreign ownership	92.1	91.8	91.4
Banking sector, total:	**100.0**	**100.0**	**100.0**

Note: Banking sector=commercial banks + bank foreign branches

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	56.4	71.6	1277.8
Branches of foreign credit institutions	52.4	75.2	1329.6
Cooperative banks	86.4	96.3	2615.9
Banking sector, total:	**51.3**	**65.1**	**1067.7**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	16.0	16.6	17.3
Cooperative banks	-2.4	-1.0	-2.1
Banking sector, total:	**15.9**	**16.5**	**17.2**

Note: RoE is calculated as a ratio of (sub)sector's net profit to annual average of (sub)sector's Tier 1 capital.

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	89.3	90.4	91.0
Branches of foreign credit institutions	10.4	9.4	8.9
Cooperative banks	0.3	0.3	0.1
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector	7.0	7.0	6.7
Nonfinancial sector	40.6	41.7	42.1
Government sector	0.9	0.8	0.8
Other assets	51.5	50.5	50.4
Liabilites			
Financial sector	21.0	20.0	18.2
Nonfinancial sector	52.6	53.9	54.8
Government sector	4.0	4.0	4.2
Other liabilities	14.6	14.2	14.5
Capital	**7.9**	**7.9**	**8.2**

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

Capital adequacy ratio of banks***

Type of financial institution	2017	2018	2019
Commercial banks	19.26	19.63	21.28
Cooperative banks	18.61	21.07	29.14
Banking sector, total:	**n.a.**	**n.a.**	**n.a.**

*(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	2017	2018	2019
Non-financial sector, including	3.2	2.7	2.3
- households	2.5	2.1	1.7
- corporate	4.2	3.6	3.2

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	85.0	89.3
Households	60.1	51.1
Corporate	24.9	38.2
Government sector	6.5	1.8
Financial sector (excluding banks)	8.5	8.9
Total	**100.0**	**100.0**

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

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

P&L account	2017	2018	2019
Interest income	146,657.1	179,170.6	225,926.6
Interest expenses	34,561.4	49,416.8	80,179.0
Net interest income	112,095.7	129,753.8	145,747.7
Net fee and commission income	32,057.4	33,646.4	33,050.7
Other (not specified above) operating income (net)	2,504.2	2,935.7	2,681.4
Gross income	228,020.7	254,167.7	295,572.5
Administration costs	73,568.1	76,744.6	77,717.1
Depreciation	7,380.7	8,133.3	12,366.7
Provisions	2,613.3	2,045.9	- 707.0
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	4,989.0	4,594.3	3,197.7
Profit (loss) before tax	90,309.9	98,032.1	109,210.4
Net profit (loss)	75,354.3	81,439.8	91,105.3

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

Total own funds in 2019 (in millions EUR)***

Type of financial institution	Total own funds **	Core Tier 1**	Tier 1**	Tier 2**	Tier 3**
Commercial banks	21,247.9	19,837.6	20,747.7	500.1	n.a.
Cooperative banks	71.6	68.0	68.0	3.6	n.a.
Banking sector, total:	**21,319.5**	**19,905.6**	**20,815.7**	**503.8**	**n.a.**

*(Please, mark for each item: * - for Basel I; ** - for Basel II; *** - for Basel III)*
Note: EUR= 25.41 CZK as at 31 December 2019.

Macroeconomic environment in the country

The gross domestic product (GDP) of Estonia grew 4.3% in 2019, reaching to 28 billion euros at current prices, according to Statistics Estonia. The high economic growth persisted from quarter to quarter, exceeding 4% for the third year in a row. The main contributor to the growth was information and communication sector, followed by wholesale and retail trade, and professional, scientific and technical activities. Manufacturing had a positive impact on the economic growth in the middle of the year, and the second half of the year saw a strong contribution from the previously modest agricultural sector. The only notable negative impact came from the energy sector.

Information and communication, finance and insurance, and professional, scientific and technical activities experienced the fastest growth in value added in a decade. Value added in information and communication grew as much as 29%. Value added dropped in mining and quarrying and in the energy sector.

Domestic demand grew at the fastest rate in seven years. The growth was led by investments that grew 13.1% mostly in the first half of the year. The growth of investments was broad-based and supported by all economic activities and sectors, except for the government sector. The biggest positive impact came from the investments of non-financial corporations into buildings and structures and transportation equipment. Households' investments into dwellings were also notable. Household consumption grew 3.1%.

The exports of goods and services grew by 5.2% compared to 2018. The main contributors were the sale of computer services and the export of motor vehicles and wood products. Imports grew 3.9%, mainly on account of the purchase of construction and transportation services.

The number of persons employed continued to grow, pushing unemployment rate from 5.4% in 2018 down to 4.5% by the end of 2019. The productivity per person employed increased by 3%. Productivity per hour worked increased by 3.7%. The labour unit cost grew by 4.6%.

Driven by the COVID-19 related economic crisis, Estonian central bank forecasts Estonian economy to decline by 10% this year (2020), but return to growth next year (+8.5%). GDP decline in 2020 is expected to be caused mainly by weaker export markets, but also lower domestic consumption and investment activity. Unemployment rate is forecasted to increase to 9.5% in 2020, while wages should decrease modestly, by 1.0% compared to 2019. As a result of government's efforts to support the economy Estonian central banks sees government budget's deficit to reach to 10% of GDP in 2020 and 4.3% in 2021.

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

At the end of the year there were 15 banks operating in Estonia, of which 6 were branches of foreign banks. Due to the violation of anti-money laundering regulations, the authorization was withdrawn from Danske Bank Eesti. On the other hand, new banking license was issued to the Holm Bank AS. Formation of Luminor Bank AS included the bank's Latvian and Lithuanian branches to the Estonian banking sector, which significantly increased the size of the sector, when measured for example by assets or loan portfolio. In addition, this also means that since 2019 there are additional risks in the Estonian banking sector arising from the economic environment in Latvia and Lithuania.

While changes related to the Luminor Bank increased sector's loan portfolio from 19,4 billion euros seen in 2018 to the 27,7 billion euros, the comparable growth (excluding Luminor branches) reached 7,3% (vs 5,7% in 2018). Credit growth was still supported by the economic environment, low unemployment, rising incomes, and low base interest rates. The loan growth for non-financial companies was 6.2% y/y in 2019, while amount of household loans increased by 7.8% compared to the end of 2018. Fast loan growth increases the importance of assessment of credit quality and related processes and control systems. In addition, banks need to maintain their conservative approach to lending and to keep sufficient capital buffers also in economic upturn as clearly emphasized by the economic developments in 2020. The Estonian banking sector assets ratio to GDP was 133% at the end of 2019.

The share of the loan portfolio overdue by more than 90 days fell further from 0,5% in 2018 to 0.4% at the end of 2019. This was achieved as amount of overdue loans increased at the lower pace than the loan portfolio. Overdue loans have declined broadly at most of the banks and in most sectors of the economy. However, including Luminor branches, the 90 days overdue loans to the loan portfolio stood at 0.75% at the end of 2019, indicating lower credit quality in Luminor branches.

Deposits increased by 12% over the year and as this figure is higher than the growth of sector's loan amount, this pushed the loan-to-deposit ratio down to 101% from 109% in 2018. There were no significant changes in the structure of deposits, as the largest share continues to be in demand deposits. The share of non-resident client deposits increased from 7.9% to 10.0%. This is mainly explained by the increase of the deposits gathered from the EU households through deposit platforms. At the same time, the share of non-resident deposits that are at greater risk of money laundering fell further in 2019. In other words, the share of deposits held by clients from lowtax regions fell below 0.5% of all deposits.

Estonian banks (including Luminor branches) continued to operate efficiency, achieving return of equity of 7.7% in 2019. This is comparable of EU average of 5.7%. This indicates that Estonian banks have managed to maintain their interest income and profitability even in the environment of low interest rates. Estonian banking sector return on assets was 1.0% in 2019.

The liquidity and capitalization of the Estonian banking sector remained strong in 2019. Around a quarter of the assets of the banks are liquid and the liquidity requirements are met with sufficient margin. The figures for capitalization remain among the strongest in Europe.

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

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

Finantsinspektsioon is part of the European Single Supervisory Mechanism (SSM), which carries out capital supervision for the most important banks and banking groups in Europe. Finantsinspektsioon is also part of the Single Resolution Board. The activities of Finantsinspektsioon are planned and controlled by the Supervisory Board. Its work is managed by a three-member management board, which takes decisions by majority vote.

Main strategic objectives of the supervisory authority in 2019

Finantsinspektsioon strategy for 2019-2021 focuses on preventing money laundering and terrorist financing, making preparations for better risk management, and promoting cyber security. In setting its strategy, Finantsinspektsioon started from the experience of drafting and implementing the previous strategies, and from market and legislative trends. The need to carry out tasks set by European Union and the Estonian law was considered, as were the strategies of Finantsinspektsioon's main partners.

The activities of the Banking Supervisory Authority in 2019

The Management Board held 56 meetings in 2019 at which 86 management decisions and 99 administrative rulings were made, of which 9 were written precepts. Supervised entities were fined on three occasions for breach of regulations, the Management Board issued three authorisations and withdrew three authorisations because of infractions, and it prohibited one branch from operating in Estonia.

Finantsinspektsioon carried out four on-site inspections of 13 risk areas at banks last year. The organization and operation of internal control systems, general management, risk management and control, and compliance controls were inspected. During its standard quarterly analysis, Finantsinspektsioon analyzed incidents and loss events connected to interruptions to the business operations of banks and system failures. The analyses show the level of business interruptions and IT incidents have generally been quite stable at the majority of banks.

Finantsinspektsioon created a separate department to make anti-money laundering supervision more effective, and it hired new staff for the department so that it had seven members at the end of 2019. This was an increase of almost half in the number of staff dealing with supervision over money laundering and terrorist financing.

Finantsinspektsioon made six on-site anti-money laundering inspections, 15 extraordinary enquiries, and 146 remote inspections in 2019. It also organised five information days to discuss prevention of money laundering, met market participants on some 60 occasions, and attended ten meetings of the Estonian Banking Association on preventing money laundering.

Finantsinspektsioon developed its international cooperation in anti-money laundering work a great deal in 2019. Finantsinspektsioon was one of the instigators in creating a cooperation network between the financial supervision authorities of the Nordic and Baltic countries.

On top of the thorough regular supervision, at the start of the reporting period, the complicated process of merging different banks was completed under the supervision of Finantsinspektsioon, and the result was that Luminior Bank, large by Estonian standards was founded with its head office in Estonia and activities in Latvia and Lithuania. Additionally, the US investment fund Blackstone applied for permission to acquire a significant holding in the Luminor Bank together with other investors. The application was processed by Finantsinspektsioon and the European Central Bank. Finantsinspektsioon also coordinated work at the Baltic level with the Latvian and Lithuanian supervision authorities, who carried out similar procedures for the subsidiaries of Luminor Bank AS in those countries.

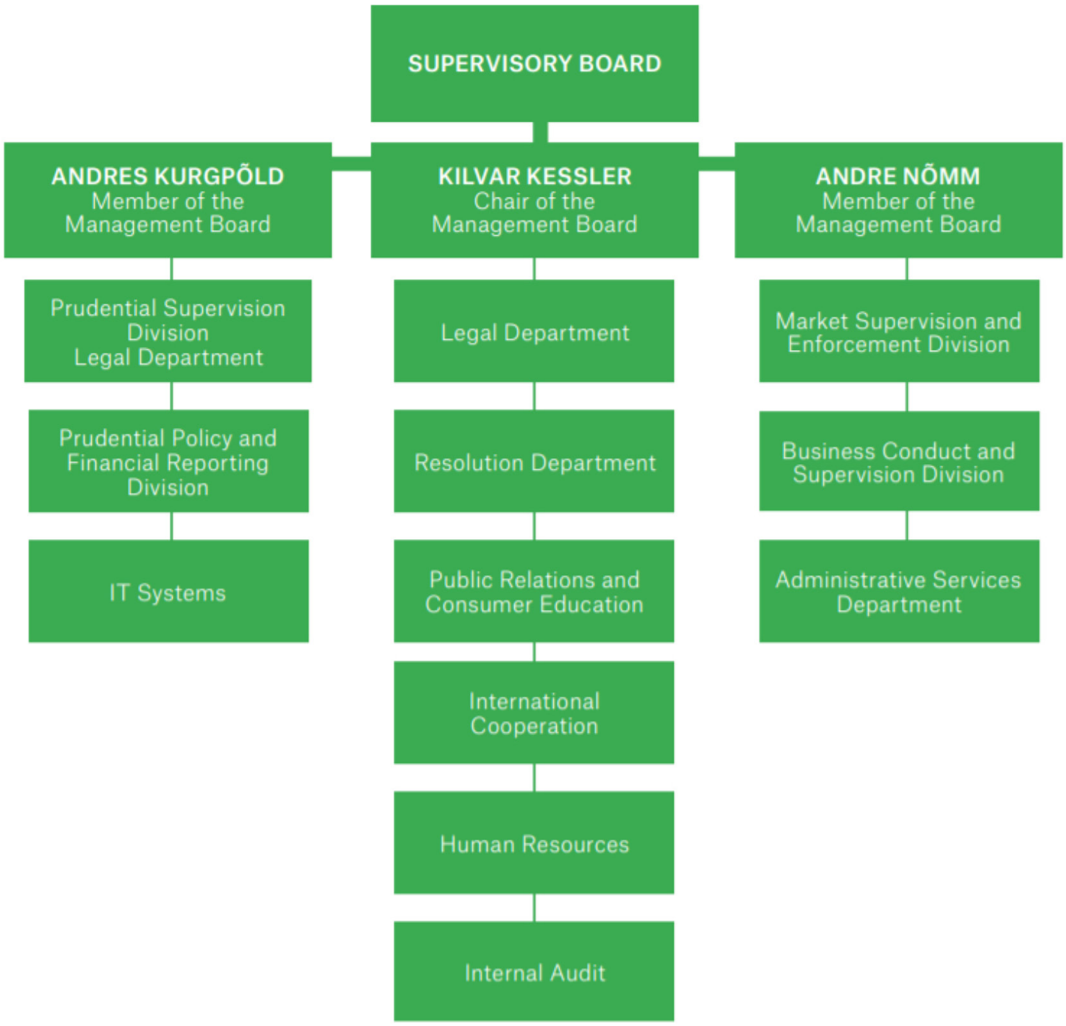
Another important event was that Luminor Bank AS was given an additional authorisation to issue covered bonds. The Covered Bonds Act came into force in early 2019, and Luminor Bank AS was the first to apply to Finantsinspektsioon under it. This was the first time the Covered Bonds Act was applied. Finantsinspektsioon worked with the European Central Bank on this, and had the lead role in it. It was decided at the end of 2019 to issue Luminor Bank AS an additional authorisation to issue covered bonds. This was the first such authorisation issued to an Estonian bank.

Finantsinspektsioon signed an agreement with the Guarantee Fund in 2019. Finantsinspektsioon will provide services under this agreement to the Guarantee Fund that will help the fund achieve its goals better, especially outside of crises. Merging the activities of the two organisations will create scale effects that will help save on costs.

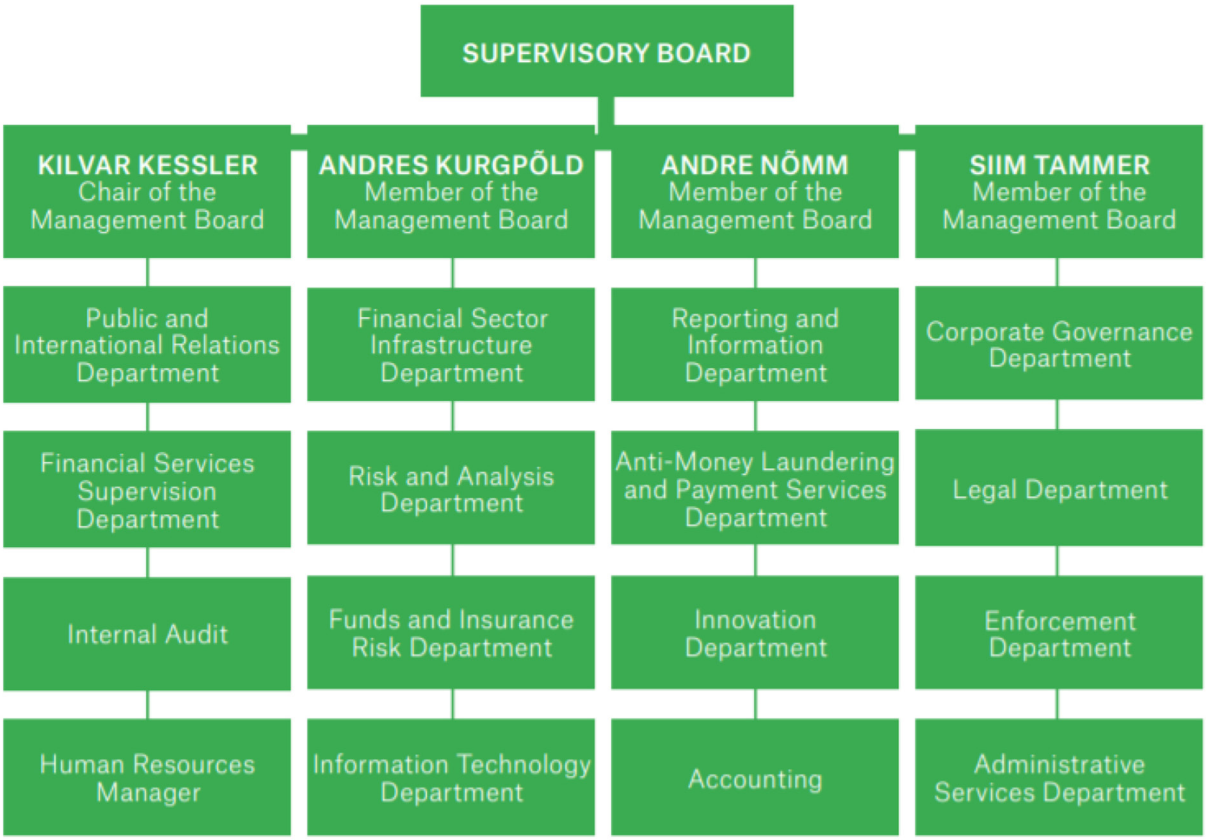
One important joint project between the European Central Bank and Finantsinspektsioon in 2019 was the issue of a banking licence to Holm Bank AS. During this process Finantsinspektsioon exchanged numerous opinions with the European Central Bank and held telephone conferences.

Organizational chart of the Banking Supervisory Authority

The Finantsinspektsioon Management Board in 2019 comprised Chair Kilvar Kessler and members Andre Nõmm and Andres Kurgpõld. The structure in 2019:



There have been substantial changes in recent years to the structure of the Estonian financial market and the dynamics of risk in it, and also to the content, complexity and amount of the regulation of it. The structural changes that Finantsinspektsioon has made will help it to achieve its strategic goals better and to take supervisory steps in the interests of an honest financial market. The new structure in 2020:



International activities of the authority

Finantsinspektsioon can contribute to designing the financial supervisory policy of the European Union through the European supervisory authorities, which are the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities Market Authority (ESMA). The European Systemic Risk Board (ESRB) is also part of the European system of financial supervisors, and handles macro supervision. Staff from Finantsinspektsioon are involved in the work of all these supervisory bodies and their working groups, and attended a total of 105 meetings of 41 working groups and committees in 2019.

Changes to the statutes of the European supervisory institutions were approved in 2019 that concerned the management of institutions, their duties and their mandates. Efforts were focused on the financial sector being ready for the departure of the United Kingdom from the European Union.

EBA sets effective single standards for credibility, and supervises compliance with them. Finantsinspektsioon adopted 11 EBA guidelines and one recommendation in 2019. Finantsinspektsioon representatives attended seven meetings and one teleconference of the Board of Supervisors and participated in 14 working groups of the EBA.

The role of EIOPA is to promote a strong legal framework and single supervisory culture in insurance and occupational pensions. Finantsinspektsioon adopted one EIOPA recommendation in 2019. Finantsinspektsioon representatives attended six meetings of the Board of Supervisors and participated in 10 working groups in the EIOPA network.

The role of ESMA is to make investor protection more effective and promote stability and efficient functioning in financial markets. Finantsinspektsioon adopted six ESMA guidelines in 2019. Finantsinspektsioon representatives attended six meetings of the Board of Supervisors and five teleconferences, and its experts participated in 15 ESMA working groups and committees.

Finantsinspektsioon works together with Eesti Pank also at the ESRB, which operates at the European Central Bank. The ESRB is responsible for supervision of the financial system at the macro level, and for preventing and minimising systemic risks. Finantsinspektsioon is a non-voting member of the General Board of the ESRB, which is its highest decision-making body, and is a full member of the Advisory Technical Committee (ATC) of the ESRB. Representatives of Finantsinspektsioon attended four meetings of the General Board in 2019, one meeting of the Advisory Technical Committee and two meetings of working groups.

In addition, Finantsinspektsioon is a member of the International Association of Insurance Supervisors (IAIS), the Group of Banking Supervisors from Central and Eastern Europe (BSCEE), the International Organization of Securities Commissions (IOSCO), and the international financial education network of the Organisation for Economic Co-operation and Development (OECD). It also promotes cooperation between Nordic and Baltic countries in the Nordic-Baltic Macroprudential Forum (NBMF) and the Nordic-Baltic Stability Group (NBSG). The Nordic-Baltic Stability Group carried out a crisis simulation exercise in early 2019, which was attended by 31 institutions from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden, and from the European Union.

In 2019 Finantsinspektsioon received visits from several rating agencies as part of their regular assessments, and it met representatives of the International Monetary Fund (IMF) in their annual Article IV assessment visit.

Finally, Finantsinspektsioon participates in supervisory colleges for banking and insurance and in resolution colleges to make supervision over banks and insurers and over resolution of them as efficient as possible, and to make cooperation between the institutions responsible in different countries as effective as possible.

Other relevant information and developments in 2019

Finantsinspektsioon updated the consumer website minuraha.ee in 2019. Financial intermediaries are constantly bringing new products and services to the market or adding new options to their current offers. To help improve the financial literacy of the Estonian public, Finantsinspektsioon set up the consumer website minuraha.ee 10 years ago. It introduced a more user-friendly and easier to use version of the website in 2019. Minuraha.ee offers independent advice on the financial services and products that are on the market. The main information website is grouped by subject area under banking, insurance, investment, and pensions. The latest news and most popular information can be found on the front page.

Alongside administering the consumer website, Finantsinspektsioon works on financial education together with the Ministry of Finance, Eesti Pank, the Estonian Banking Association, the Estonian Insurance Association, and the Tallinn stock exchange. Family days held to explain about money were organised jointly with Eesti Pank in the Eesti Pank Museum in 2019, and lectures were given in various subjects.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	9	8	9
Branches of foreign credit institutions	8	8	6
Cooperative banks	0	0	0
Banking sector, total:	**17**	**16**	**15**

Total assets of banking sector (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	22 665	23 925	36 294
Branches of foreign credit institutions	2 616	2 194	1 066
Banking sector, total:	25 281	26 119	37 360
y/y change (in %)	3.1	3.3	43*
y/y change (in %)		8.29%	2.93%

**fast growth is mainly a result of Luminor's structural change in 2019*

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	0	0	0
Domestic ownership total	11	7.9	8.5
Foreign ownership	89	92	91.5
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	84	94	2 614
Branches of foreign credit institutions	2.7	2.8	4
Banking sector, total:	**84**	**94**	**2 617**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	10.6	11.1	7.7
Banking sector, total:	**10.6**	**11.1**	**7.7**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	90	92	97
Branches of foreign credit institutions	10	8.4	2.9
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector	26	31	31
Nonfinancial sector	48	63	63
Government sector	2.8	2.2	1.6
Other assets	24	3.5	4.2
Liabilites			
Financial sector	27	25	16
Nonfinancial sector	67	70	75
Government sector	5.6	4.7	8.7
Other liabilities	0.5	0.3	0.0
Capital	**16**	**15**	**14**

Capital adequacy ratio of banks

Type of financial institution	2017**	2018**	2019**
Commercial banks***	30.6	30.1	26.3
Banking sector*, total:**	**30.6**	**30.1**	**26.3**

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

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

Asset classification	2017	2018	2019
Non-financial sector, including	2.6	1.8	2.2
- households	1.7	1.4	1.8
- corporate	3.6	2.3	2.9

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	83	85
Households	46	50
Corporate	37	35
Government sector	10	2
Financial sector (excluding banks)	7	13
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	483	551	814
Interest expenses	61	72	140
Net interest income	421	479	674
Net fee and commission income	144	150	206
Other (not specified above) operating income (net)	47	169	195
Gross income	770	967	1 329
Administration costs	279	332	533
Depreciation	12	13	38
Provisions			
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	14	-8	61
Profit (loss) before tax	347	459	440
Net profit (loss)	316	370	370

Total own funds in 2019 (in mln EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2
Commercial banks***	4582	4478	4501	82
Banking sector, total*:**	**4582**	**4478**	**4501**	**82**

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

Macroeconomic environment in the country

In 2019, economy of Georgia grew by 5.1 percent. The largest share of the growth, 4.2 percentage points, came from the services, 0.9 pp – from industry. The year 2019 was notable in terms of growth in revenues from exports and tourism, as well as growth in money transfers. The increased number of foreign visitors had particularly positive effect on the real estate operations, hotels, restaurants and transports. In the real estate operations the growth surged to 6.1% and its contribution to growth equaled 0.6pp. A large contribution to the growth came from transport sector as well, which leaped by 8.3% to make a contribution of 1.4 pp. A substantial share of that growth came from travel agencies, tour operators and air transport – all of which further underlines the significance of the enlargement of the tourism industry. Tourists' participation is also important for the output of hotels and restaurants, which grew by 36.3%, contributing 0.6 pp to total growth of nominal GDP. In line with the significant improvements in the external sector, the main driver of economic growth in 2019 was net exports, the contribution of investment and domestic demand was weak compared to net exports.

Gross national savings rate was 25.1% of GDP in 2019. Unemployment rate remained high; however, it decreased to 11.6% in 2019 compared to the 12.7% in the previous year.

Inflation rate was above the target (3%) in 2019. This was mainly driven by increase in prices food and non-alcoholic beverages. In the beginning of the year prices of tobacco and alcohol were also increased. Therefore, inflation rate reached 7%, highest level since 2011. Overall, throughout the year average inflation equaled 4.9%.

Consolidated budget deficit was 2.7% of GDP compared with 0.7% in 2018. Tax burden made up around 22.8% of GDP, which decreased by 0.8 percentage points. Public debt to GDP increased and amounted to 41.2% in 2019, while in 2018 it was 39.9%.

The current account deficit in the balance of payments was at 5.1% of GDP, which is the lowest level during the last 5 years. The current account deficit was negatively affected by the deterioration in the trade balance in services, which decreased by 75 mln USD in 2019. It is worth mentioning that tourism export inflows increased by 46 mln USD. Trade balance remains the most negative component of the current account. In 2019, the ratio of trade deficit in goods to GDP improved by 2.3 percentage points and was at 21.1% of GDP.

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 86.7% percent of total equity. Banking sector assets grew by 19% in 2019. Credit portfolio increased by 20% YoY at the end of 2019, more than in 2018. In total, credit portfolio accounted for 64% of GDP which is 4 percentage points higher than in 2018. As for the total assets of banking sector, they accounted for 94% of GDP that is 5 percentage points higher than in 2018.

In 2019, the highest growth rate was recorded in corporate segment (36% annually), followed by SME (23%) and retail segments (8%). Banking sector loan portfolio break-down by segments is the following: 34% accounts for corporate, 40% - retail, and 26% - SME segment.

Throughout the year, loan portfolio quality has slightly improved. According to NBG's more forward-looking methodology and taking into account restructured loans with no evidence of being able to repay them under the new schedule, NPL ratio decreased by 1.2 percentage points and made up 4.4% 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 1.9% in 2019, 0.8 percentage points less than in 2018.

In 2019, banking sector accumulated liquidity ratio above the prudential minimum. The share of liquid assets to total assets and non-bank deposits made up 21% and 38%, respectively.

Banking system still remained highly dollarized, contributing to currency induced credit risk. In 2019, the dollarization of loans decreased to 55.4%, while dollarization of deposits increased slightly, making 64.1%. To mitigate this risk, NBG applies additional capital requirements for currency induced risk under Pillar 2.

Georgian banking system is adequately capitalized, mainly driven by aforementioned risk weighting. At the end of 2019, core Tier 1, Tier 1 capital and regulatory capital ratios calculated based on Basel III framework were 12.8%, 14.6% and 19.4%, respectively (minimum requirements are 9.9%, 12% and 17.3%)[1].

Profitability of banks increased in 2019. Net income of the system jumped from 915 million GEL in 2018 to 953 million GEL in 2019. At the end of 2019 RoA made up 2.2% and RoE made up 17.7%. Nominal growth of the credit portfolio, improvement of efficiency and the quality of assets led to higher profitability in banking system. Overhead costs to assets ratio decreased from 3.4% in 2018 to 3.1% in 2019.

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

The National Bank of Georgia (NBG), which is the central bank of Georgia and an independent public entity, is authorized to supervise and regulate the financial services sector in Georgia (except insurance[2]) including commercial banks, non-bank financial institutions - securities market, credit unions, microfinance organizations, money remittance units, currency exchange bureaus and qualified credit institutions. Since 2018 NBG also supervises loan issuing entities

Over the course of 2019, various steps were taken to improve the supervisory framework and for the approximation of domestic rules with international best practices.

At the end of the year, the Parliament of Georgia adopted amendments to the Organic Law on the National Bank of Georgia and the Law on the Commercial Banking Activities. These changes equip the NBG with resolution powers and set out a preliminary basis for the recovery and resolution framework. Moreover, based on the relevant EU law, early intervention and supervisory measure frameworks have been improved. These frameworks were developed in line with international best practices reflected in the Bank Recovery and Resolution Directive (BRRD)[3] and the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions".[4]

The resolution framework and relevant legislation were made on the basis of World Bank and IMF recommendations under the financial sector assessment program (FSAP). IMF experts were directly engaged in the work on the legislative package.

The amendments authorize the NBG to exercise early intervention measures when a commercial bank is faced with financial difficulties or to apply resolution tools; while whenever early intervention measures are ineffective, the NBG can restructure a problem bank in a manner that does not threaten financial stability.

[1] This minimum requirements includes Pillar 1 minimum requirements 4.5%, 6%, 8%, Conservation buffer 2.5%, Systemic buffer for D-SIBs and Pillar 2 capital requirements. The latter differs across the banks.

[2] Since 2013, 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.

[3] 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.

[4] FSB "Key Attributes of Effective Resolution Regimes for Financial Institutions". Available at: https://www.fsb.org/work-of-the-fsb/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/.

Within the framework of the amendments package, the NBG has introduced amendments in the framework for being a lender-of-last-resort, which authorizes the NBG, under exceptional circumstances when the sustainability of the financial system is threatened, to issue a loan to a bank with uncertain solvency. However, in these cases, it is necessary for the collateral to be an unconditional and non-revocable guarantee by the Ministry of Finance.

The NBG also continues to process of approximating domestic supervisory legislation with the EU legislation, as prescribed under the Association Agreement between the EU and Georgia. The NBG is actively working on the implementation of the standards and requirements of the supervisory framework on capital adequacy (CRD IV Package)[5] that is applicable in the EU and is based on Basel III standards. In order to fully comply with the Basel III Tier 2 capital quality standards, the NBG plans to work on defining the requirements for additional Tier 1 and Tier 2 capital instruments. This implies creating write-off or conversion requirements for additional Tier 1 and Tier 2 capital instruments into common Tier 1 equity, either upon the occurrence of predetermined trigger events or at the NBG's request.

In 2019, the NBG prepared and approved the "Rule on the Net Stable Funding Ratio (NSFR)", which is fully aligned with Basel III standards. The NSFR came into force in September and its implementation will substantially improve the long-term liquidity regulation process.

In 2019, based on Basel III and relevant EU legislation, the NBG adopted a rule on exposures concentration and large exposures in commercial banks, which should have come into effect in June 2020; however, as a result of the supervisory actions taken as a response to COVID-19, the enforcement of this rule has been suspended until 2021.

Furthermore, the NBG is empowered[6] to enforce competition policy in the banking system and determine acceptable activity parameters, assessment criteria, and supervisory measures to foster a competitive market environment.[7] Considering globally emerging trends, the NBG is in the process of examining and analyzing best practices regarding competition, the elements that promote competition and new regulatory requirements in the field of competition.

Main strategic objectives of the supervisory authority in 2019

In 2019, to improve and develop the supervisory framework was one of the main strategic objectives of the National Bank of Georgia. This implied the implementation of Basel III framework, capital buffers and approximation of banking legislation to the EU legislation and standards according to the EU-Georgia Association Agreement.

At the end of 2019, the Parliament of Georgia adopted amendments to the Organic Law on the National Bank of Georgia (NBG) and the Law on the Commercial Banking Activities. These changes equip the NBG with resolution powers and set out a preliminary basis for the recovery and resolution framework. Moreover, based on the relevant EU law, early intervention and supervisory measure frameworks have been improved.

The National Bank actively continues to work on the consolidated supervision framework, which will be finalized by the end of 2020. As a result of amendments made to the Organic Law on the National Bank of Georgia at the end of 2017, the National Bank of Georgia has been empowered with a mandate to execute supervision of banking groups (so-called consolidated supervision).

[5] Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.
[6] The Law on Commercial Bank Activities, Article 22.
[7] The Organic Law of Georgia on the National Bank of Georgia, Article 47

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

Furthermore, the National Bank of Georgia continues to develop its stress testing framework. It is expected that the scenarios employed within the framework will include all the risks and relevant capital requirements of Pillar 2. As a result, the net GRAPE buffer can be equal to zero after implementing the net stress test buffer.

In addition, during 2020, the National Bank of Georgia will continue to align its capital adequacy standards with the European Union's regulations.

From October 2020, a net stress test buffer will be implemented based on supervisory stress testing. During 2019, the National Bank of Georgia actively worked on the calibration of this buffer. In addition, during 2020, the NBG plans to formalize and standardize the stress testing framework in cooperation with commercial banks in order to fully integrate the stress test buffer in the Pillar 2 requirements.

The National Bank is constantly striving for excellence in the introduction and development of modern technologies, which is recognized as one of the most important factors for achieving the main goals and objectives of the bank.

Last but not least, enhancing the transparency of the financial sector is one of the main objectives of the NBG. Enhancing transparency reduces information asymmetry, increases trust in the financial sector and protects the rights of investors and users. The NBG continues to implement relevant reforms towards that end.

The activities of the Banking Supervisory Authority in 2019

Over the course of 2019, various steps were taken to improve the supervisory framework and for the approximation of domestic rules with international best practices.

At the end of the year, the Parliament of Georgia adopted amendments to the Organic Law on the National Bank of Georgia (NBG) and the Law on the Commercial Banking Activities. These changes equip the NBG with resolution powers and set out a preliminary basis for the recovery and resolution framework. Moreover, based on the relevant EU law, early intervention and supervisory measure frameworks have been improved.

The recovery and resolution frameworks were developed in line with international best practices reflected in the Bank Recovery and Resolution Directive (BRRD) and the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions". The amendments authorize the NBG to exercise early intervention measures when a commercial bank is faced with financial difficulties or to apply resolution tools; while whenever early intervention measures are ineffective, the NBG can restructure a problem bank in a manner that does not threaten financial stability.

In 2019, the NBG prepared and approved the "Rule on the Net Stable Funding Ratio (NSFR)", which is fully aligned with Basel III standards. The NSFR came into force in September and its implementation will substantially improve the long-term liquidity regulation process.

In 2019, based on Basel III and relevant EU legislation, the NBG adopted a rule on exposures concentration and large exposures in commercial banks, which should have come into effect in June 2020; however, as a result of the supervisory actions taken as a response to COVID-19, the enforcement of this rule has been suspended until 2021.

Proactive measures have been taken to improve the criteria and requirements for shareholder and administrator suitability and the bank licensing process. These improvements will be based on the standards and requirements enshrined in the EU directive.

Further actions included the amendments in the framework for being a lender-of-last-resort, which authorizes the NBG, under exceptional circumstances when the sustainability of the financial system is threatened, to issue a loan to a bank with uncertain solvency. However, in these cases, it is necessary for the collateral to be an unconditional and non-revocable guarantee by the Ministry of Finance.

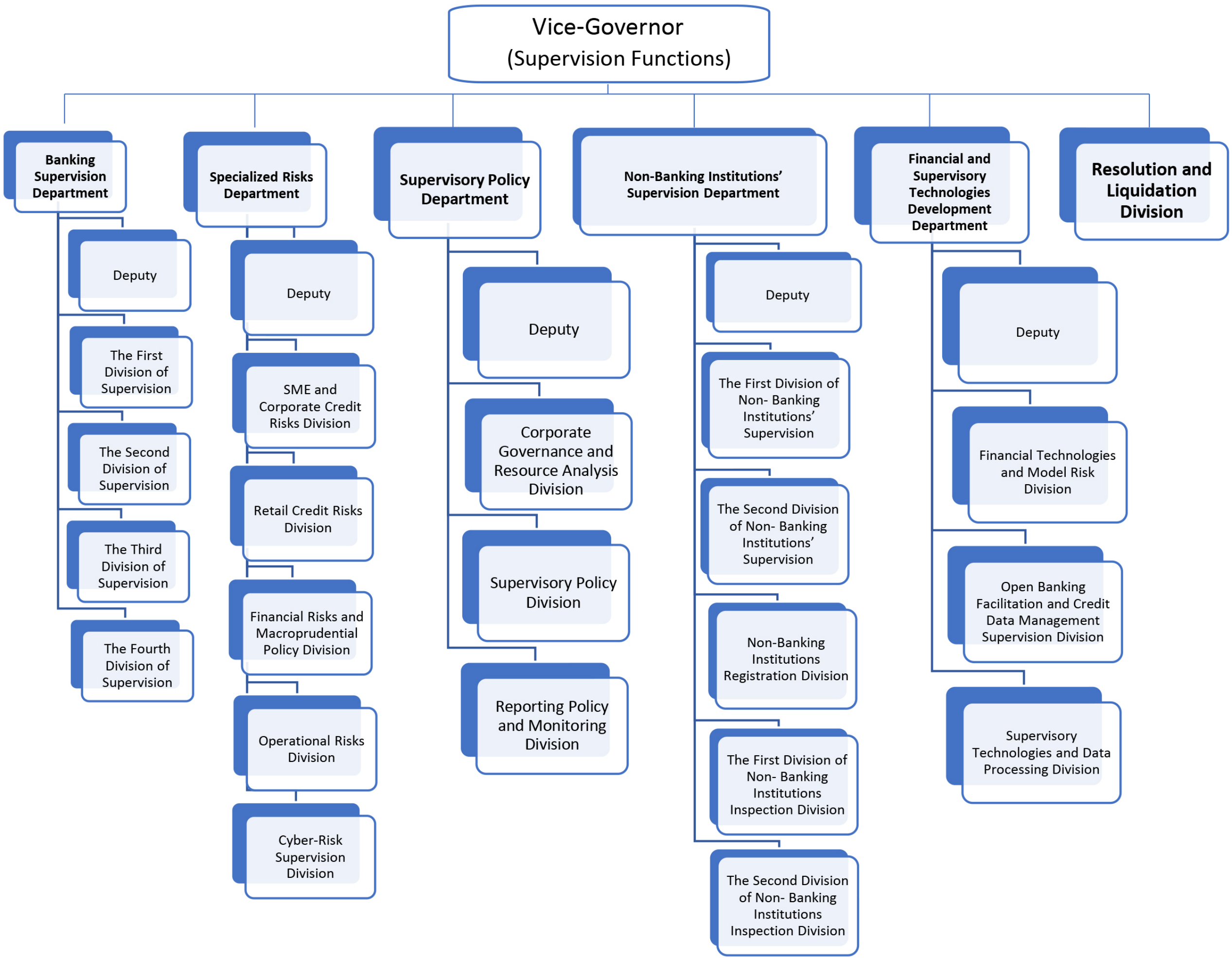
It should be stressed that the NBG is actively working on the implementation of the standards and requirements of the supervisory framework on capital adequacy (CRD IV Package) that is applicable in the EU and is based on Basel III standards. In order to fully comply with the Basel III Tier 2 capital quality standards, the NBG plans to work on defining the requirements for additional Tier 1 and Tier 2 capital instruments.

Considering globally emerging trends, the NBG is in the process of examining and analyzing best practices regarding competition, the elements that promote competition and new regulatory requirements in the field of competition.

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

It is worth noting that the NBG has begun publication of an annual supervisory strategy document. The first publication is intended for the years 2020-2022. The document establishes the vision, goals, supervisory principles and values, strategic priorities and upcoming reforms, and offers a timeline for their implementation. The purpose of the document is to provide information to investors, international financial institutions, rating companies, the public and other stakeholders regarding the supervisory priorities, plans and upcoming arrangements of the National Bank of Georgia.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

The year 2019 was a significant year with regard to international cooperation since the National Bank of Georgia hosted several high-level international meetings.

During 19-21 May, the Managing Director of International Monetary Fund (IMF), Christine Lagarde, visited Georgia. Throughout the visit, the IMF Managing Director met with the President of Georgia, the Prime Minister of Georgia, the Governor of the National Bank of Georgia and representatives of the economic group. Christine Lagarde discussed inclusive growth and positively assessed the reforms implemented in the financial sector.

As had been the case in 2018, the world's leading financial editorial, Global Finance, named Koba Gvenetadze among the Best Central Bankers of 2019 for the second consecutive time. In 2018, influential international financial magazine Global Finance first entered the Governor of the National Bank of Georgia in its "Central Banker Report Cards" and under their criteria he received the grade of "A-". This year, the Governor once again received an "A-" grade and thus cemented his membership in the elite club of central bankers whose ratings are "A" and "A-". The Global Finance awards are acknowledged worldwide and the Central Banker Report Cards are published annually. In total, 98 central bankers were graded in 2019's Global Finance's Central Banker Report Cards, and the final report was published in October.

In April 2019, the Governor of the National Bank of Georgia participated in the Governor Talks organized by the IMF. Such discussions are held with representatives of five regions of the world during the annual and spring meetings of the International Monetary Fund and the World Bank Group in order to share successful experiences in specific economic directions. IMF Regional Directors serve as moderators of these meetings. The 2019 discussions were held with the Minister of Finance of the Netherlands (representing the euro area), the Governor of Central Bank of Paraguay (representing the Western Hemisphere), with the Governor of Reserve Bank of India (representing Asia and the Pacific) and with the Minister of Economy and Finance of Benin (representing Africa).

The Governor Talks of 2019 were opened with the speech of Koba Gvenetadze. The main topic of discussion was "The NBG's experience with implementing inflation targeting". Mr. Jihad Azour, Director of Middle East and Central Asia Department of the IMF, served as the moderator of the discussion. Mr. Azour stressed the successful practice and experience of the National Bank of Georgia in the implementation of an inflation-targeting regime with a floating exchange rate. The impressive progress in larization was also mentioned as an important factor for reducing the vulnerability of the financial sector.

In October 2019, the National Bank of Georgia, in cooperation with the International Finance Corporation (IFC), a member of the World Bank Group, and the IFC-supported Sustainable Banking Network (SBN), hosted the Sustainable Finance Conference in Tbilisi. The conference brought together IFC experts, representatives from SBN member countries and regional central banks, senior representatives from relevant ministries, Presidents/CEOs and senior leadership representatives of financial institutions, international organizations and other stakeholders.

The conference was the second event hosted by the NBG in cooperation with the IFC on sustainable finance. Since the first workshop in September 2018, the NBG has made significant progress towards the development of a sustainable finance framework in Georgia. A key achievement was the launch of the NBG's Roadmap for Sustainable Finance in Georgia in April 2019.

In November 2019, the National Bank of Georgia, along with the Central Bank of Netherlands, organized an international workshop on "Cyber-risk and Cyber-flexibility for Financial Regulators". During the meeting, attendees discussed the EU Cyber Security Framework (TIBER-EU), cyber-risk focused approaches to financial supervision in the United States, and cybersecurity in Georgia. Financial supervisory bodies and representatives of 11 countries from Europe and the Caucasus region participated in the meeting: the Netherlands, Poland, Israel, Northern Macedonia, Bosnia and Herzegovina, Croatia, Bulgaria, Romania, Azerbaijan, Armenia, and Montenegro.

The National Bank of Georgia also hosted a high-level international meeting on Financial Education in cooperation with the Ministry of Finance of the Kingdom of the Netherlands and the Organization for Economic Co-operation and Development (OECD / INFE). The event was organized within the framework of a 5-year (2018-2022) project of technical support for education, organized by OECD / INFE, in which, along with Georgia, six Eastern European countries – Bulgaria, Northern Macedonia, Moldova, Montenegro, Romania and Croatia – participated. The aim of the meeting was to increase financial education and to provide support to central banks and other stakeholders. The conference "Financial Education and Literacy: Promoting Financial Education in Southeast Europe" was opened by the Governor of the National Bank of Georgia, Koba Gvenetadze. The conference participants discussed conceptual and institutional issues related to the process of introducing the National Financial Education Strategy.

It should be noted that during the year, the National Bank of Georgia, including the Money Laundering Inspection and Supervision Department, carried out extensive work to prepare for the assessment mission of the Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (Moneyval).

Cooperation with other supervisory bodies in the country

As part of the obligations stipulated by the EU-Georgia Association Agreement, the National Bank, in cooperation with the State Insurance Supervision Service, continues to work on elaboration and implementation of a supplementary supervision framework for financial conglomerates, with a focus on approximating the legislation to the agreed acts and international legal instruments within a specific timeframe. This supervisory framework implies supplementary prudential supervision with respect to capital adequacy, risk concentration, intra-group transactions, internal control mechanisms and risk management processes for entities within financial conglomerates.

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

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

Other relevant information and developments in 2019

Financial Education

In 2019, the National Bank of Georgia took significant steps towards improving the financial literacy of the population. Projects that had started in previous years were scaled up and new projects commenced, the latter included a new financial education website that will bring together all educational resources and topics concerning financial literacy. An action plan for implementing the National Strategy for Financial Education was developed, which determines priority activities and programs to be initiated both immediately and in the medium term, and sets out the actions to implement them. The action plan was approved by the steering committee on the National Strategy for Financial Education. Within the frames of the action plan, numerous financial education activities were conducted during the year. Training sessions, workshops, competitions, and games were held for priority target groups, including entrepreneurs, children and the youth. International and local partner organizations focusing on financial education were also involved in the events.

Within the frames of the financial education program for micro and small entrepreneurs, the National Bank of Georgia has started trainings of trainers from interested public, private and civil sector organizations. These trainers subsequently distributed the program among 1,200 beneficiaries. Furthermore, the National Bank of Georgia has started the development of a brochure and training module specifically for micro and small entrepreneurs working in the agricultural sector.

Starting from the 2019-2020 school year, in cooperation with the Ministry of Education, Science, Sports and Culture of Georgia, the teaching of financial literacy topics started in all schools in the country. Financial literacy topics have been integrated into the "Citizenship" subject. Moreover, to scale up the SchoolBank project developed for schoolchildren of 7th-9th grades, the National Bank of Georgia continued conducting trainings for schoolteachers.

In 2019, the Governor of the National Bank of Georgia, Koba Gvenetadze, and the Chairman of the Association of Rural Development for Future Georgia (RDFG), Ivane Grigolashvili, signed a memorandum of understanding aimed at raising awareness about financial literacy among the youth.

The first project supported by the National Bank of Georgia within the frames of the Memorandum of Understanding was a joint Regional Youth Entrepreneurship Project conducted by RDFG and USAID that aims at empowering youth living in rural areas in Georgia.

Open Banking

In 2019, with the active participation of the National Bank of Georgia, a working group was set up to promote the introduction of open banking in Georgia. Open banking involves the instantaneous exchange of information and services between different financial organizations using electronic technologies. At the same time, the NBG discusses and evaluates those factors contributing to the emergence of healthy entities on the market, thereby supporting the global trend of the fintech market and financial innovation to create healthy competitive incentives in the market.

In December 2019, the NBG hosted a two-day workshop on open banking, which was held within the framework of a joint European Union-World Bank project on financial involvement and accountability. The workshop was led by the representatives of the World Bank together with invited experts who were directly involved in the process of the implementation of open banking in different countries. The event allowed Georgian banks to learn more regarding the open banking implementation process, particularly through examining the experiences of the UK, the EU and Australia.

It should be noted that the work on the implementation of open banking in Georgia within a private-public partnership framework has actively continued. From 2020, commercial banks plan to establish Open API standards and take effective steps to develop a common infrastructure.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	16	15	15
Branches of foreign credit institutions	0	0	0
Cooperative banks			
Banking sector, total:	**16**	**15**	**15**

Total assets of banking sector (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	34,593,509,966	39,682,984,387	47,183,026,804
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	34,593,509,966	39,682,984,387	47,183,026,804
y/y change (in %)	14.74%	14.71%	18.89%

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership			
Domestic ownership total	14%	13.1%	11.6%
Foreign ownership	86%	86.9%	88.3%
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	79%	86%	28.5%
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**79%**	**86%**	**28.5%**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	20.73%	19.38%	17.8%
Cooperative banks			
Banking sector, total:	**20.73%**	**19.38%**	**17.8%**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	100%	100%	100%
Branches of foreign credit institutions	0%	0%	0%
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector	0.77%	1.08%	1.37%
Nonfinancial sector	60.17%	62.34%	62.44%
Government sector	3.52%	3.63%	3.91%
Other assets	35.54%	32.96%	32.27%
Liabilites			
Financial sector	3.09%	2.20%	2.10%
Nonfinancial sector	54.36%	56.02%	53.93%
Government sector	2.82%	1.96%	1.65%
Other liabilities	26.91%	26.90%	30.15%
Capital	**12.82%**	**12.93%**	**12.18%**

Capital adequacy ratio of banks

Type of financial institution	2017	2018	2019
Commercial banks	16.4%*; 19.13%***	18.4%***	19.4%***
Cooperative banks			
Banking sector, total:	**16.4*** **19.13%*****	**18.4%*****	**19.4%*****

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

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

Asset classification	2017	2018	2019
Non-financial sector, including	2.81%	2.71%	1.96%
- households	1.93%	1.92%	1.41%
- corporate	3.56%	3.34%	2.32%

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	97.04%	97.86%
Households	57.23%	37.52%
Corporate	39.81%	60.34%
Government sector	2.96%	0.24%
Financial sector (excluding banks)	0.00%	1.89%
Total	**100.00%**	**100.00%**

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

P&L account	2017	2018	2019
Interest income	2,842,579,309	3,375,387,165	3,663,335,867
Interest expenses	1,249,073,368	1,468,274,598	1,732,915,557
Net interest income	1,593,505,941	1,907,112,566	1,930,420,310
Net fee and commission income	409,942,825	429,385,296	421,851,708
Other (not specified above) operating income (net)	357,224,599	387,766,389	455,331,337
Gross income	3,609,746,733	4,192,538,850	4,540,518,913
Administration costs	629,127,409	671,956,367	730,245,358
Depreciation	120,372,400	126,364,198	189,325,528
Provisions	274,394,894	396,448,870	385,261,724
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	274,394,894	396,448,870	385,261,724
Profit (loss) before tax	973,466,867	1,106,409,941	1,067,114,438
Net profit (loss)	869,798,258	914,718,058	953,294,854

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	2,460,622,538	1,619,795,149	1,849,529,738	611,092,800	
Cooperative banks					
Banking sector, total:	**2,460,622,538**	**1,619,795,149**	**1,849,529,738**	**611,092,800**	

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

Macroeconomic environment in the country

Hungarian GDP increased by 4.9 percent, while inflation was 3.4 percent in 2019. The budget deficit amounted to 2.0 percent, current account deficit to 0.8 percent as a percentage of GDP.

Hungarian economic growth maintained its already high pace in 2019. Domestic demand components – consumption and investment – continued to contribute to growth to the greatest degree, while the contribution of net exports was slightly negative, as the expansion of imports exceeded exports growth in parallel with the expansion of domestic demand.

The strong increase in household consumption expenditures was supported by the double-digit increase in average earnings and the growth in employment. Growth was also supported by the robust rise of household loans and the CEE region's highest net financial wealth of households.

Gross fixed capital formation continued to expand in 2019. All three sectors (corporations, households, government) contribute to the rise in investment activity. Corporate investments were up significantly in parallel with the dynamic lending activity and huge capacity expansion projects in the manufacturing subsector. The increase in government investment slowed down to some extent, resulted by the fading out of EU funds, but still amounted to double digits. Households' investment activity also increased significantly in line with increasing housing.

The consumer price index remained within the tolerance band throughout 2019. Inflation developments were characterized by a dichotomy: buoyant domestic demand boosted the pace of inflation, while moderate GDP growth of Hungary's main trading partners restrained imported inflation. Average annual core inflation excluding indirect taxes was 3.4 percent in 2019. The cost-side inflationary effect of the dynamic, double-digit growth in wages was mitigated by a further reduction of the social contribution tax in July 2019 and the rising labour productivity.

The increase in total employment continued in 2019 for the ninth year in a row, however, the growth rate slowed down compared to last year. Public sector employment continued to decrease due to the narrowing Public Work Scheme, whereas private sector employment grew. Within the private sector, employment in manufacturing fell, while the number of employees in the market services sector increased. The unemployment rate dropped to 3.4 percent in 2019.

Hungary's net lending and the current account deficit were 1 percent and 0.8 percent of GDP in 2019, respectively. The trade balance was reduced by rising imports as result of dynamic investment growth and the expansion in consumption, which was partly offset by the impact of the absorption of inventories and favourable changes in the terms of trade.

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

Prolonged benign economic conditions helped keep the banking system's balance sheet total on a growth trajectory and Hungarian banks continued to expand their balance sheet total via dynamic lending growth. Reflecting strong credit growth, the total assets-to-GDP ratio of the banking sector (without state-owned specialized banks) increased by 1 percentage point to 86 percent at the end of 2019 relative to the end of 2018. Hungarian banks' high capital adequacy ratios indicate strong solvency, while the liquidity coverage ratio (LCR) is also well above the regulatory requirements. Favourable economic conditions and a wide range of regulatory instruments ensure that credit growth continued in a balanced and sustainable way. Based on the results of our solvency stress tests, Hungarian credit institutions would be able to meet the regulatory requirements even under a severely adverse macroeconomic scenario; therefore, the Hungarian financial system is prepared for the risks arising from a deterioration in the external environment.

Double-digit growth in corporate lending continued in 2019: outstanding borrowings of the corporate sector increased by 14 percent and by almost 15 percent in the SME segment. This growth was broad-based both in the entire sector and at individual banks. The structure of corporate credit growth was also influenced by the new phase of the Central Bank of Hungary's (Magyar Nemzeti Bank, hereinafter: "MNB") Funding for Growth Scheme (FGS). The primary objective of the FGS fix launched in early 2019 was designated to improve the structure of SME lending, in other words, to boost the share of long-term, fixed-rate loans. Until the end of 2019, credit institutions concluded contracts with Hungarian SMEs to the tune of HUF 400 billion. Investment loans accounted for 55 percent of transactions and leasing deals for 45 percent.

In 2019, outstanding loans of households also expanded considerably, by 17 percent. In this segment, lending developments were enormously influenced by prenatal baby support loans launched by the Hungarian government in the middle of the year as part of its Family Protection Action Plan. Corresponding borrowing amounted to HUF 470 billion until the end of 2019. During the first six months of the programme, 48.000 contracts were concluded and most credit applicants signed for the maximum loan amount of HUF 10 million, which may be linked to the fact that at present customers who borrow are typically higher earners. Prenatal baby support loans are mostly taken out for housing purposes. Thanks to the introduction of prenatal baby support loans, banks continued to experience a pick-up in demand in the consumer credit segment; however, demand for housing loans was somewhat more muted in the second half of the year 2019 than earlier. Based on disbursement volumes and on survey results, the additional impact of the prenatal baby support is significant, exceeding the crowding-out effect.

Following the trend of recent years, the non-performing loan portfolio of the banking sector continued to decrease in 2019, although there are still several credit institutions with substantial non-performing portfolios. Cleaning these loan portfolios requires further actions by the banks. By the end of 2019, the non-performing household loan portfolio dropped to HUF 300 billion, with over 60 percent comprising loans over 90 days past due. During the year, the share of non-performing household loans dropped by approximately 3 percentage points to 4.2 percent, mainly owing to credit institutions' portfolio cleaning activities, but the dynamic expansion of credit also contributed to the fall in the ratio – via the denominator effect – as well. The ratio of non-performing corporate loans (NPL ratio), calculated in line with the broader definition of non-performing loans, was 3.9 percent. For total (household and corporate) outstanding loans, this ratio amounted to 4.0 percent, in contrast to 6.1 percent at the end of 2018.

Credit institutions' after-tax profit amounted to HUF 499 billion at the end of 2019, HUF 29 billion lower than in 2018. The after-tax 12-month rolling ROE reached 11.6 percent in December 2019, one of the highest figures among EU banking sectors. While margins were continuously under pressure earnings were positively influenced mostly by the increase in net commission and fee income and dividends received, while the profit-improving effect of the reversal of impairment losses seen earlier faded. Despite growth in nominal terms, operating costs as a proportion of assets slightly declined. Based on international examples, increasing the balance sheet total and the wide-ranging application of digital solutions may play a crucial role in improving cost-efficiency in the years to come. The capital adequacy of the credit institutions sector remained high; the total consolidated capital adequacy ratio reached 18.1 percent at the end of 2019. All credit institutions meet the 10.5 percent statutory capital adequacy valid for 2020, together with the capital conservation buffer. The sector has a high free capital buffer, although around two-thirds of it is still concentrated at three banks.

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

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

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

Regarding the legislative developments in 2019, we would highlight the Act CXVIII of 2019 on modifying the laws governing the operation of financial intermediary system, public finances and financial stability, the main purpose of which was the implementation of the Prospectus Regulation [Regulation (EU) 2017/1129 of the European Parliament and of the Council], nevertheless it included further amendments of the financial regulation e.g. the amount of the initial capital applicable to financial institutions has increased.

Main strategic objectives of the supervisory authority in 2019

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

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

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

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

** Please also note that MNB's supervisory strategy for 2020–2025 was approved by the Financial Stability Board in December 2019. The mission of MNB, determined in the strategy, continues to aim to maintain and even strengthen the stability of the financial system and to deepen participants' confidence both in the system as a whole and individually in each other. The vision of the MNB has also been updated, and the long-term objective is to have a developing, competitive and sound financial sector, supported, shaped and efficiently overseen by the MNB. To achieve this, it is necessary to support and deepen the stability of the financial system, with special focus on consumer protection, digitalisation and sustainability. Confidence and stability remain priority values for the supervisory area for the mentioned period.*

Healthy competition for customers could be strengthened by expanding the range of certified consumer-friendly products under the new strategy. Consumers should be able to compare products of the same type, with the development of MNB's consumer-friendly comparison sites and consistent supervisory expectations for market calculators. Furthermore, as part of strengthening its consumer protection activities, the MNB pays special attention to cross-border financial activities.

Financial institutions need to incorporate environmental sustainability considerations into their corporate governance and risk management systems. The MNB establishes a cooperation network with the involvement of market participants, governmental, civil, interest representation and university organizations in order to develop green financial and capital market services and promote sustainable investments.

Supervisory and regulatory systems must also be prepared for the digital future, as more and more information technology systems supporting the business process come to the attention of consumers and the MNB. Thus, the basic goal is to modernize the regulatory environment related to IT technologies, also to develop supervisory methodologies and new IT supervision methods.

The activities of the Banking Supervisory Authority in 2019

In 2019 the directorate of MNB responsible for credit institutions supervision launched 43 inspections and concluded 5 comprehensive, 8 targeted, 2 follow-up and 9 other inspections. Concerning the internal capital adequacy of the institutions 16 complex (on-site) Internal Capital Adequacy Assessment Process ("ICAAP") inspections and concerning the internal liquidity adequacy of the institutions 8 complex (on-site) Internal Liquidity Adequacy Assessment Process ("ILAAP") inspections were completed. As a result of the completed inspections 508.1 million HUF prudential fine was imposed on credit institutions, emphasizing that the MNB is taking a stand firmly against infringements and the institutions that had failed to comply with the former resolutions.

Similarly to activities in 2018, in 2019 the MNB continued to carry out analyses in accordance with the business model-based approach. As the international trends and recommendation of the European Banking Authority ("EBA") show this approach is gaining ground in the domestic supervisors' activities. The MNB is attending to acquaint the business model analyses based on a continuously developing framework and the disclosed risks to the supervised institutions, which dialogue effectively supports the strategy planning and the risk management processes of the banks. The early warning system of MNB with differential indicators together with the viability scoring (implemented according to the SREP Guidelines) supports the forward-looking supervision to take actions against the risks emerging in the future.

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

As included in the 575/2013/EU regulation, special care is required when an institution has an exposure to its own parent institution or to another subsidiary of its own parent institution, and such exposures shall be managed in a fully autonomous manner, without taking into account other considerations. In order to comply with the above principles, MNB's earlier published recommendation on the credit risk management was amended by adding a new point, which sets out MNB's expectations regarding the management, registration and control of exposures and internal loans outstanding towards enterprises under the influence of the owners of credit institutions.

The MNB also defined recommendations regarding the application of the default definition as included in Article 178 of the 575/2013/EU regulation and the EBA's related guidelines (EBA/GL/2016/07).

Retail mortgage loans in Hungary are outstanding in local currency, thus they are not affected by FX risk, but the instalments may change due to the interest rate risk. In order to mitigate such risks, the MNB defined recommendations for financial institutions to inform their borrowers regarding the interest rate risk of their outstanding loan facilities, and about the possibility to re-contract their floating interest rates to fixed interest rates.

During the comprehensive inspections there were multiple findings regarding the work of the supervisory board, the internal control and in general with the average quality of the control points implemented in the different processes. Regarding the credit risk the MNB has found that in multiple cases the credit risk processes were not supported properly with efficient controls, there were problems with the evaluation of collaterals, with client and transaction rating procedures.

The MNB also applied short-term procedures for credit institutions, in which the MNB made conclusions concerning data reporting and PTI limits.

Besides the IFRS/IFRS9 implementation remaining a key priority, the most important focus topics for 2019 regarding to the credit institutions' supervision were the adequacy of the collateral assessment processes; the compliance with the macroprudential requirements; the sector level NPL reduction; the adequacy of the lending processes and the risk monitoring of the project finance; the operational and independency issues of the internal governance; the IT strategy and Fintech preparedness; the AML and CFT issues.

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

Table 1: Number of inspections at credit institutions

Number of on-site inspections	2018		2019	
	comprehensive	other*	comprehensive	other*
Large banks Small and medium sized banks	5	16	1	18
Specialized credit institution	1	5	4	1
Bank branch	0	0	0	0
Financial enterprises	0	2	2	6
Payment institutions	2	0	3	0
Insurance corporations	7	2	13	8
Insurance associations	0	6	0	4
Intermediaries	0	3	0	2
Pension funds	6	0	15	4
Capital market participants	30	5	30	11
Occupational pensions	0	0	0	0
Total	**51**	**39**	**68**	**54**

**targeted, follow-up, thematic inspections*

Organizational chart of the Banking Supervisory Authority

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

International activities of the authority

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

FSB Regional Consultative Group for Europe
The MNB and the Ministry of Finance both are members of the FSB's regional substructure. The MNB was represented at managerial level at the meetings of the FSB European Regional Consultative Group in May and in November 2019.

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

Memorandum of Understanding
On 21 January 2019 the MNB signed the Multilateral Agreement between the ECB and Competent Authorities under the Article 57a(2) of Directive (EU) 2015/849 of the European Parliament and of the Council on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (AMLD).

The MNB and the UK Financial Conduct Authority (FCA) signed a Memorandum of Understanding (MoU) on 25 February 2019 to consult, cooperate and exchange of information in connection with the discharge of responsibilities entrusted to the Authorities under the Laws and Regulation, in a manner consistent with, and permitted by the laws and requirements that govern the Authorities.

The MNB, the Bank of England and the FCA signed a Multilateral Memorandum of Understanding (MMoU) on 27 March 2019 in order to establish cooperation arrangements between the UK authorities, on the one hand, and each single EEA Authority.

The MNB and the Eurasian Development Bank signed an MoU on 30 October 2019. The purpose of the MoU is to establish and formalize a framework for cooperation between the Parties, with a view to enhance further fruitful collaboration in areas of common interest.

The MNB, the Bank of England and the FCA signed an MMoU on 21 November 2019 to formalize supervisory cooperation and information sharing arrangements between the parties due to the withdrawal of the UK from the European Union. The MMoU focuses on information exchange and supervisory cooperation between the UK authorities and the MNB.

Due to the new acquisitions of OTP Group in Moldova and Albania, the MNB was engaged in concluding MoUs with the supervisory entities of these countries. The conclusion of the MoUs with the National Bank of Moldova (NBM) and with the National Bank of Albania is on-going.

Supervisory colleges

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

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

As home supervisor the MNB leads the banking supervisory college of the OTP Group. In 2019 the MNB organized two supervisory college meetings and a bilateral telephone conference in home role, coordinated the college work which resulted among others in the joint decision on capital and liquidity adequacy and on group recovery plan assessment. The supervisory college established for the OTP Group has made its WCCA and updates it annually.

Cooperation with other supervisory bodies in the country

The MNB performs supervisory and consumer protection tasks as well. The MNB monitors and supervises the activities of financial and capital market institutions, funds, insurance companies and institutions of the financial infrastructure as well, furthermore, it carries out investor protection tasks and it operates the Financial Arbitration Board[1] and the Financial Consumer Protection Center.[2]

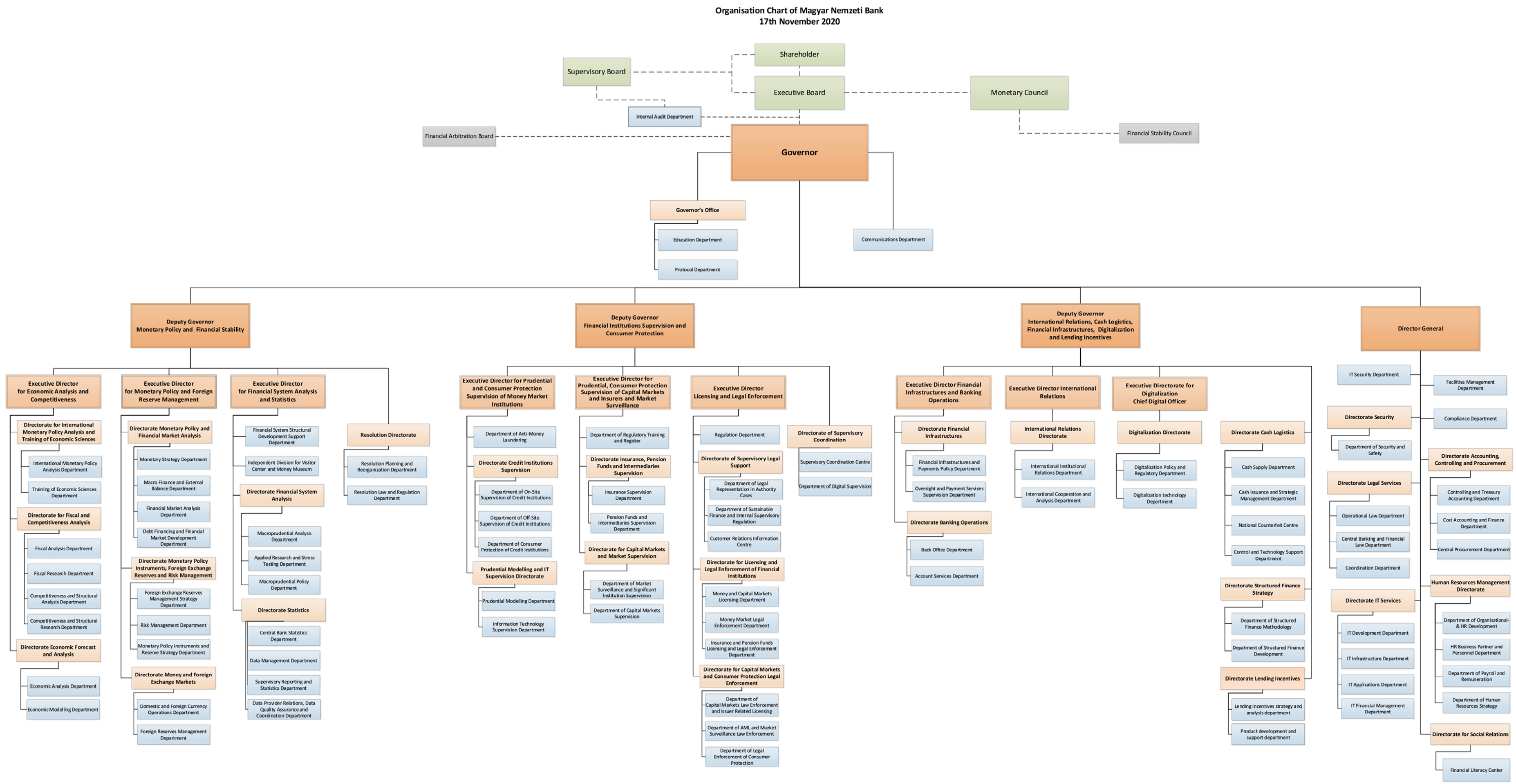
The MNB and the Ministry of Finance ("Ministry") are the most important Hungarian organizations responsible for the establishment and maintenance of financial stability hence the MNB cooperates closely with the Ministry, first and foremost, in the area of legislation.

Furthermore, the MNB collaborates with other competent Hungarian authorities as well, such as the Ministry for Innovation and Technology in charge of General Consumer Protection Activities.

[1] A professionally independent alternative forum for resolving disputes

[2] It supplies consumers with comprehensive and easy to understand information about the products and processes in the financial sector and handles consumer claims

Other relevant information and developments in 2019



Questionnaire tables for the 2019 review[3]

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	35	35	30
Branches of foreign credit institutions	9	9	8
Cooperative banks	22	13	0
Banking sector, total:	**66**	**57**	**38**

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

Type of financial institution	2017	2018	2019
Commercial banks	29 102 077	32 041 608	37 066 732
Branches of foreign credit institutions	3 684 610	3 731 478	3 464 243
Cooperative banks	1 322 920	1 278 624	-
Banking sector, total:	34 109 607	37 051 710	40 530 975
y/y change (in %)	7.2%	8.6%	9.4%

Ownership structure of banks on the basis of assets total*

Item	2017	2018	2019
Public sector ownership	3.0%	3.3%	3.7%
Domestic ownership total	19.9%	19.6%	18.0%
Foreign ownership	80.1%	80.4%	82.0%
Banking sector, total:	**100.0%**	**100.0%**	**100.0%**

** Ownership structure based on the ultimate majority owners*

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	46.2%	60.9%	0.117
Branches of foreign credit institutions	79.8%	93.5%	0.312
Cooperative banks	-	-	-
Banking sector, total:	**42.2%**	**55.7%**	**0.100**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	17.4%	13.7%	12.6%
Cooperative banks	-4.8%	-1.4%	-
Banking sector, total:	**16.9%**	**13.4%**	**12.6%**

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

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	85.3%	86.5%	91.5%
Branches of foreign credit institutions	10.8%	10.1%	8.5%
Cooperative banks	3.9%	3.4%	-
Banking sector, total:	**100.0%**	**100.0%**	**100.0%**

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

	2017	2018	2019
Receivables			
Financial sector	31.7%*	32.2%	33.0%
Nonfinancial sector	40.3%*	41.5%	42.5%
Government sector	25.6%	23.5%	21.5%
Other assets	2.4%*	2.8%	3.0%
Liabilites			
Financial sector	30.8%*	29.1%	29.3%
Nonfinancial sector	49.3%*	51.9%	51.2%
Government sector	4.1%	3.1%	3.3%
Other liabilities	4.7%	5.2%	5.5%
Capital	**11.1%***	**10.7%**	**10.7%**

**Changed due to data correction.*

Capital adequacy ratio of banks***

Type of financial institution	2017**	2018**	2019**
Commercial banks	23.2%	21.3%	22.1%
Cooperative banks	14.5%	13.9%	-
Banking sector, total:	**22.9%**	**21.1%**	**22.1%**

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

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

Asset classification	2017	2018	2019
Non-financial sector, including*	8.6%	5.5%	3.7%
- households	11.1%	7.2%	4.2%
- corporate	6.3%	4.1%	3.2%

** Domestic loans*

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	83.6%	90.1%
Households	42.0%	42.9%
Corporate	41.6%	47.2%
Government sector	5.4%	3.2%
Financial sector (excluding banks)	11.0%	6.7%
Total	**100.0%**	**100.0%**

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

P&L account	2017	2018	2019
Interest income	1 027 440	1 120 679	1 143 605
Interest expenses	285 024	353 798	404 608
Net interest income	742 416	766 881	738 997
Net fee and commission income	507 137	541 973*	569 276
Other (not specified above) operating income (net)	75 887*	231 240*	295 036
Gross income	1 325 440*	1 540 093*	1 603 309
Administration costs	779 409*	947 534*	938 372
Depreciation	63 155	69 672	95 237
Provisions	184 060*	43 905	-26 549
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	666 935*	566 792*	543 150
Net profit (loss)	608 057	519 928*	499 305

** Data correction due to the availability of audited data*

Total own funds in 2019 (in EUR)***

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	13 627 201 323	11 976 418 926	12 089 679 848	1 537 521 474	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**13 627 201 323**	**11 976 418 926**	**12 089 679 848**	**1 537 521 474**	**-**

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

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

Given that the AFSA opened for business in 2018, the 2019 has be a crucial year for the development of the banking sector in AIFC and its customer base. In 2019, 2 branches of foreign credit institutions were authorised by the AFSA and became AIFC participants, with the total amount of assets constituting 212,510 thousand of USD. More data on the banking sector is displayed in the questionnaire tables below.

By 2019 the following banks became the Participants of the AIFC:

- China Development Bank (Operating a Representative Office);
- China Construction Bank Corporation;
- JSC Altyn Bank;
- Hungarian Export-Import Bank (Operating a Representative Office).

In 2019 AFSA developed the following rules related to the banking sector as part of AIFC legal and regulatory framework:

1) AIFC Banking Prudential Guideline (BPG), the purpose of which is to supplement the AIFC Banking Business Rules (BBR) in establishing the regulatory framework for Authorised Firms carrying out Banking Business. The BPG as well as the BBR Rules are based on the Basel Accords and on the Basel Core Principles for Effective Banking Supervision, issued by the Basel Committee on Banking Supervision.
2) AIFC Preferential Creditor Rules, which were adopted to supplement the existing regulatory framework on insolvency law to protect the employees of any company at the AIFC that becomes insolvent by ensuring that they receive a preferential right to payment upon the company's bankruptcy.
3) AIFC Common Reporting Standard Regulations and Rules, which are based on the model OECD Common Reporting Standard (2014) and provide a regulatory framework for the reporting and exchange of tax information between global regulators in order to ensure a cohesive regime for worldwide enforcement against tax evasion.
4) AIFC Trust Regulations, which provide a robust framework for the establishment, redomiciliation, operation and termination of trusts in the AIFC. The regulations have been drafted to provide a detailed and modern regime that is in line with international best practice. Care has been taken to ensure that the Trust Regulations do not give preferential treatment to that available under the law of Kazakhstan (for example, in relation to settlements of community property into a trust and in relation to the consequences of fraudulent conveyances).
5) AIFC Foundation Regulations, which provide the AIFC with a framework for a new type of legal entity, the foundation. Foundations share some characteristics with companies and with the common law concept of a trust. However, unlike a trust, a foundation has legal personality and can hold assets. Unlike a company, a foundation does not have shareholders and cannot carry out commercial activities.

As of the end of 2019, the AIFC financial services framework included:

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

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

The AFSA is established in accordance with the Constitutional Statute of the Republic of Kazakhstan "On the Astana International Financial Centre" for the purposes of regulating financial services and related activities in the AIFC.

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

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

1. Constitutional Statute of the Republic of Kazakhstan "On the Astana International Financial Centre" (7 December 2015), provides the legal basis for the establishment of the AIFC;
2. AIFC Financial Services Framework Regulations (20 December 2017), enacted by the Governor in exercise of the powers conferred on the AIFC Bodies, including the Governor by the Constitutional Statute, and specifically by Article 4(3) of the Constitutional Statute;
3. AIFC General Rules (17 October 2017), complement the regulatory framework established by the Financial Services Framework Regulations;
4. AIFC Conduct of Business Rules (1 January 2018), ensures that financial services firms operating in the AIFC meet the standards of conduct with regard to the treatment of their clients and other market participants;
5. AIFC Banking Business Prudential Rules (30 July 2018), establish the prudential framework for Authorised Firms carrying out Banking Business;
6. AIFC Islamic Banking Business Prudential Rules (1 January 2018), establish the prudential framework for Authorised Firms carrying out Islamic Banking Business;
7. AIFC Banking Prudential Guideline (28 January 2019), supplement the AIFC Banking Business Rules in establishing the regulatory framework for Authorised Firms carrying out Banking Business.

Main strategic objectives of the supervisory authority in 2019

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

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

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

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

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

The activities of the Banking Supervisory Authority in 2019

The activities of AFSA in 2019 were guided by the overarching goals of its midterm strategy for 2019-2020.

1) AFSA developed and adopted the following Regulations and Rules:

  - AIFC Foundations Regulations;
  - AIFC Preferential Creditor Rules;
  - AIFC Common Reporting Standard Regulations;
  - AIFC Common Reporting Standard Rules;
  - AIFC Trust Regulations Framework.

2) AFSA enhanced the following legislative frameworks:

  - AIFC Funds Framework;
  - AIFC Legal Entities Framework.

3) Commitment to International Standards and International Cooperation:

  - AFSA became a signatory to IOSCO's Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information and IOSCO's administrative arrangement on personal data sharing between EU and Non-EU members;
  - Integrated three OECD standards into the AIFC's regulatory framework: Standard on Exchange of Information on Request and Common Reporting Standard.

4) AFSA took the following actions to enhance consumer protection:

  - Joined International Financial Consumer Protection Organisation (FinCoNet);
  - In cooperation with the UK Financial Conduct Authority, World Bank Group and IMF, AFSA launched the Global Financial Services Network, dedicated to advancing consumer wellbeing and protection through innovation.

5) Combating money laundering, AFSA:

  - Conducted Anti-Money Laundering Thematic Review;
  - Implemented of AML/CFT supervisory programme.

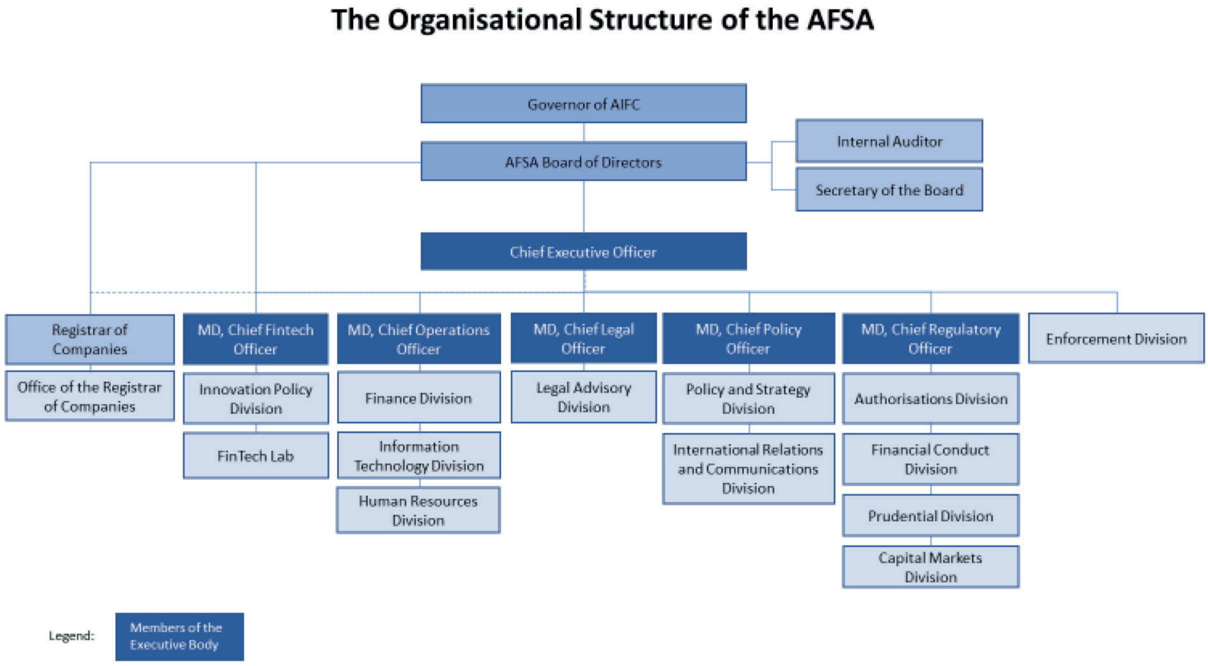
6) Supervision of firms:

  - In 2019 AFSA supervised 10 prudentially regulated firms (including 3 banks), while 85 firms and 71 key individuals were under conduct supervision.

7) Promotion of FinTech and Innovations in the AIFC and beyond:

  - AFSA supported innovations through its regulatory sandbox regime ("FinTech Lab") and wider policy initiatives. In 2019 AFSA saw an expansion of the FinTech Lab programme: 56 applications have been received and processed, with 13 firms accepted to the FinTech Lab.
  - Total number of firms engaged in FinTech related services reached 25, offering 7 types of innovative financial services in the areas of money services/banking, digital assets, robo-advisory, Islamic finance, crowdfunding and factoring.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

AFSA maintained active cooperation with the BSCEE Group in 2019 and was elected to serve as Chair of BSCEE in 2020.

Multilateral relations of AFSA have continued focusing on establishing and developing cooperation with global standard setting organizations:

- 5 July 2019 – Astana Financial Services Authority has become a signatory to the IOSCO Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information (IOSCO MMoU).
- 23 July 2019 – AFSA signed the Administrative Arrangement of IOSCO, which is a mechanism that sets the appropriate safeguards for transferring personal data outside the European Union.

The AFSA signed Bilateral Memorandum of Understanding and Agreements on banking supervision with the following peer regulators:

- Banking Regulation and Supervision Agency of Turkey;
- The Financial Services Commission of Republic of Korea and the Financial Supervisory Service of Republic of Korea;
- Central Bank of Armenia;
- Polish Financial Supervisory Authority;
- National Bank of the Republic of Kazakhstan.

Cooperation with other supervisory bodies in the country

The AFSA maintained active cooperation with the National Bank of the Republic of Kazakhstan through formal cooperation mechanisms like a bilateral working group, consultations and joint meetings. In 2019 AFSA has entered into the Agreement with the National Bank of the Republic of Kazakhstan in relation to mutual co-operation.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2019
Commercial banks	
Branches of foreign credit institutions	2
Cooperative banks	
Banking sector, total:	**2**

Total assets of banking sector (at year-end)

Type of financial institution	2019
Commercial banks	
Branches of foreign credit institutions	212,5 million USD
Cooperative banks	
Banking sector, total:	212,5 million USD
y/y change (in %)	-

Ownership structure of banks on the basis of assets total

Item	2019
Public sector ownership	
Domestic ownership total	
Foreign ownership	100
Banking sector, total:	**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			
Branches of foreign credit institutions	100%	100%	
Cooperative banks			
Banking sector, total:	**100%**		

Distribution of market shares in balance sheet total (%)

Type of financial institution	2019
Commercial banks	
Branches of foreign credit institutions	100.0
Cooperative banks	
Banking sector, total:	**100.0**

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

	2019
Receivables	
Financial sector	
Nonfinancial sector	100%
Government sector	
Other assets	
Liabilites	
Financial sector	100%
Nonfinancial sector	
Government sector	
Other liabilities	
Capital	

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households		
Corporate		100.0
Government sector		
Financial sector (excluding banks)		
Total	**0.0**	**100.0**

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

P&L account	2019
Interest income	304 000 USD
Interest expenses	181 000 USD
Net interest income	123 000 USD
Net fee and commission income	-106 000 USD
Other (not specified above) operating income (net)	0 USD
Gross income	15 000 USD
Administration costs	928 000 USD
Depreciation	67 000 USD
Provisions	527 000 USD
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	527 000 USD
Profit (loss) before tax	-1 506 000 USD
Net profit (loss)	-1 506 000 USD

Macroeconomic environment in the country

In 2019, **economic growth** moderated notably in Latvia with real GDP picking up by 2.2% (s.a. data). Deceleration was to a large extent determined by more cautious investment as well as uncertainty prevailing in global trade relations and major trading partners' economies loosing growth momentum, resulting in slow-down of Latvian exports.

Deceleration of economic activity was reflected in the labour market indicators. While the level of **unemployment** still decreased and reached 6.3% (the lowest level since GFC), the labour shortage as a factor limiting further growth gradually became a somewhat less often received answer in business surveys. The wage level grew more steadily (by 7.2%) than suggested by overall economic developments, partially reflecting some labour shortage, mostly prevailing in H1 2019, as well as the obligation to disclose the expected remuneration in job advertisements allowing for employee's migration to better-payed jobs. As the annual average **inflation** rate remained moderate (2.7%), the robust wage growth supported an increase of purchasing power and consumption. The factors influencing the inflation rate, however, shifted more to the demand side.

A number of factors weighed on exports: external uncertainties, unfavourable wood price dynamics (in the circumstances of weaker demand) triggered by ample regional supply because of damage caused by bark beetles, as well as restructuring of Latvia's credit institution sector. The moderation of imports at the same time could be partially explained by businesses holding back on their investments as the capacity utilization decreased gradually (due to weaker exports). As a result the **balance of trade** remained relatively unchanged and the **current account deficit** remained small (0.6% of GDP).

The foreign direct investment inflows in Latvia remained close to their long-term average in 2019, reaching 2.6% of GDP with the largest increase of accumulated FDI stock in real estate activities, financial services, agriculture and forestry as well as manufacturing sector. Latvia's **net external debt** to GDP maintained its declining path and stood at 18.9% of GDP in 2019.

Development in the banking sector

The banking sector also in 2019 remains the main component of the national financial system accounting about 76 per cent of the total assets of the Latvian financial sector or about 73,8 per cent of GDP. At the end of 2019, there were 13 banks and five branches of banks from the EU Member States operating in Latvia. There were minor changes observed in bank number comparing with the previous year, namely, at the beginning of the year, after the completion of reorganisation, *Luminor Bank AS Latvia Branch* started its activity, however *Scania Finans Aktiebolag Latvia Branch*, in its turn, terminated its activities. Additionally, in the third quarter of 2019, the operation of *AS PNB Banka* was suspended, in September of 2019, the court declared the insolvency of the bank, and, even though the process of withdrawing the banking licence on the part of the European Central Bank had not yet been completed by the end of the year, the referred-to bank was not actually operating[1].

All of the Latvian-licensed banks have been licensed as universal banks and may provide a full range of financial and investment services. Of total Latvian banking share capital, 82 per cent is owned by foreign investors.

In 2019, the total amount of the Latvian banking sector assets did not significantly change (decreased by 0.2%). Excluding the impact from termination of the operation of separate credit institutions, as well as the strategic decisions implemented by two credit institutions oriented towards servicing domestic clients by consistently reducing domestic market operations exposures and liabilities towards affiliated and associated credit institutions over the period of the reporting year (namely, by EUR 849 million or 55%), the amount of assets of other banks grew by 5.6%.

[1] *AS PNB Banka* indicators are excluded from the total banking sector indicators in the overview, in order to assess the operation of active banks

Capital and liquidity ratios of active banks remained at a high level. At the end of the reporting year, the total amount of own funds of active banks was by EUR 117.5 million, or by 5.5%, smaller than the year before. This was determined by the drop in the amount of both Tier 1 and Tier 2 capital instruments (correspondingly, by EUR 19.2 million, or 1.0%, and by EUR 98.4 million, or 44.8%). In general, the changes had a positive effect on the capital structure of the banking sector – during the reporting year, the share of Tier 2 capital reduced from 10% to 6%.

Without significant changes in the amount of structure of the assets of the sector, the changes in the risk weighted assets were also insignificant (increasing by 0.9% over the year). Even under the impact of changes in the capital and its structure, capital ratios as a whole decreased over the year (CET1 ratio – from 21.8% to 21.3%, total capital ratio – from 24.6% to 22.7%); overall they remained at a high level, ensuring sufficient reserves for shock absorption capacity and exceeding the average EU ratios (CET1 – 14.6%, total capital ratio – 18.9%). Average EU harmonised liquidity coverage ratio of the banking sector did not change significantly and remained high (304.6%); for individual banks it ranged from 157% to 753% (as of 1 January 2018, the minimum requirement of the LCR is determined in the amount of 100%).

Profitability of the banking sector, in general, deteriorated. In 2019, overall, the Latvian banking sector performance involved a profit in the amount of EUR 228.9 million, which is by 20.2% less than the year before.

Following the reduction for several years, the total amount of non-bank client deposits stabilised, showing moderate growth (by EUR 477 million, or 2.8%). The balance of domestic deposits significantly increased, namely, by EUR 983 million, or 7.6% (incl. of non-financial corporations – by EUR 284 million, or 6.3%, of households – by EUR 521 million, or 7.4%, of general governments – by EUR 5 million, or 0.6% and, of other financial corporations – by EUR 172 million, or 29.5%). Along with the stable wage growth, the main driver in domestic deposits over the period of the last five years has been the rise in household deposits by 8% per year on average. At the same time, the amount of foreign client deposits continued reducing to decline (by 12.6%, or EUR 505 million), incl. in the main drop observed in the deposits of non-financial corporations, while the amount of deposits of households from the EU countries increased.

Over the year, the total amount of loans issued in Latvian banking sector to non-bank clients decreased by EUR 279 million, or 2.0%, incl. domestic clients - by 1.0%. Decrease in the total amount of loans issued to non-bank clients was mainly affected by the structural changes in the Latvian banking sector - termination of activities of separate credit institutions, as well as implementation of strategic decisions of two foreign bank branches, by consistently reducing the amount of their loan portfolio.

The quality of loans issued to non-bank clients continued to improve, with the share of the NPL reducing to 5.6% at the end of December. In the reporting year, changes were observed in the NPL structure, especially in the last quarter of the year, when some banks carried out the write off of the long past-due and bad (uncollectable) loans, while separate large-scale loans migrated from the category of doubtful loans (unlikely to pay) to the group of loans past-due more than 90 days. Therewith, the share of long past-due (more than one year) loans in the NPL structure decreased, while the share of loans past-due more than 90 days increased, amounting to, correspondingly, 2% and 0.9% at the end of December. Overall, the referred-to processes had a positive impact on the loan portfolio quality indicators and, in the last quarter of the year, the NPL share reduced considerably for loans issued both to domestic non-financial corporations and foreign clients, amounting to, correspondingly, 5.5% and 14.8% at the end of December. Domestic household loan portfolio quality indicators also continued to demonstrate a steady positive trend over the entire year, with the NPL share therein reducing to 3.5% at the end of December (3.4% in housing loan portfolio; 3.8% in other household loans). Overall, in the banking sector the provisions to the NPL ratio decreased to 30.0% at the end of December; a steeper drop was observed in the last quarter of the reporting year (from 31.6% to 30.0%), when several credit institutions implemented the write off of the long past-due and bad (uncollectable) loans. Considering that the coverage of such loans with the formed provisions is traditionally considerably higher, their write-off reduced the average provisions to the NPL ratio in the sector.

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

The Financial and Capital Market Commission (FCMC) has been operating as an autonomous public institution since 1 July 2001, regulating and monitoring the Latvian financial and capital market, ensuring the protection of the interests of the customers of market participants and promoting the stability, competitiveness and development of the whole sector. The scope of the FCMC competence is set forth in the Law on the Financial and Capital Market Commission and other relevant sectoral laws (e.g., Credit Institution Law, Insurance and Reinsurance Law, Law on the Financial Instruments Market etc.).

The activities of the FCMC are managed by the Board, which up until 15 July 2019, consisted of five members: Chairman of the FCMC, his deputy, and three members of the Board, who concurrently were the directors of the departments. On 13 June 2019, the *Saeima* (Parliament) of the Republic of Latvia adopted in the final reading the amendments to the Law on the Financial and Capital Market Commission, providing for gradual replacement of the management and change of the governance model of the FCMC. Changes to the law provide that, instead of the previous five Board members, the FCMC Board will henceforth consist of three members – the Chairperson and two Board members. The Chairperson, upon the proposal of the Cabinet, and the Board members, upon the proposal of the Chairperson, are approved in the office by the *Saeima* of the Republic of Latvia.

As regards the banking sector, the FCMC has authority to issue regulations and guidelines governing activities of banks, to request and receive information from banks necessary for the execution of its functions, to impose restrictions on the activities of banks, to examine compliance of the activities with the legislation and the FCMC regulations, and to apply sanctions set forth by the regulatory requirement on banks and their officials in case of any violations of regulatory requirements.

Since introduction of the Single Supervisory Mechanism (SSM) in November 2014 the FCMC has been sharing banking supervision powers with the European Central Bank (ECB). During 2019, the ECB in close cooperation with the FCMC directly supervised three banks in Latvia (*A/S Swedbank, A/S SEB banka, AS PNB Banka*[2]), while other banks are subject to direct FCMC and indirect SSM supervision. However, monitoring of anti-money laundering and combating terrorist financing (AML/CTF) still remain within the FCMC competence.

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

Resolution and Guarantee Funds Division of the FCMC operates in a capacity of a national resolution authority and forms a part of the Single Resolution Mechanism (SRM), and its activities and functions are separated from the supervision functions. In addition, the Division is also responsible for administering the Latvian Deposit Guarantee Fund, the Fund for the Protection of the Insured and the Investor Protection Scheme.

Legislative developments in 2019.

By developing the regulatory environment corresponding and appropriate to the Latvian financial sector, in 2019, the FCMC continued to improve the legal framework governing the activities of the participants of the financial and capital market. The changes in the framework of regulatory requirements were mainly based on the legal acts issued by EU institutions in order to ensure a harmonised framework in the EU single financial market, considering the risks and development trends of the Latvian financial sector and concurrently seeking solutions fostering the reduction of administrative burden.

[2] *On 12 September 2019, the court declared PNB Banka insolvent and on 17 February 2020, the ECB have adopted decision to withdraw PNB Banka licence, the decision came into force on 18 February 2020.*

To enhance credit risk management, in light of the changes in the EU regulations and supervisory practice, in 2019 the FCMC put considerable effort in enhancing the laws and regulations in the field of credit risk.

New FCMC *Regulations for Calculating Credit Risk Capital Requirement* were approved prescribing the threshold of materiality of delay in obligations for determination of default and providing for more extensive explanations on several rules for calculating credit risk, voluminous amendments were introduced to the *Regulations on Credit Risk Management*, inter alia, in order to reduce the amount of non-performing loans and to prevent repeated accumulation thereof in the future, the content of the credit risk strategy was adjusted, more detailed requirements were set for application of forbearance measures, additional requirements were set for the institution with high NPL share in the field of management of such loans. In addition, fostering the implementation of better corporate governance standards, in 2019 the amendments to *Regulations on Establishment of the Internal Control System* were approved, introducing EBA guidelines on internal governance, as well as taking into consideration the core principles of Basel Committee on Banking Supervision in the field of corporate governance. Also the *Regulations on the Assessment of the Suitability of the Executive and Supervisory Board Members and Key Function Holders* were developed, introducing the Joint EBA and ESMA Guidelines on the assessment of the suitability of members of the management body and key function holders.

The FCMC continued aslo the work started in the previous years to improve the regulatory framework in the field of AML/CFT. Voluminous amendments were introduced to the *Law on the Prevention of Money Laundering and Terrorism and Proliferation Financing* (AML/CTPF Law) in order to ensure the transposition of the requirements of 5th AML Directive, to prevent the deficiencies of the AML/CTPF Law detected in Moneyval Report on the Effectiveness of the AML/CTPF System of Latvia, and to implement the sub-objectives to be achieved set by Action Plan for the Prevention of Money Laundering and Terrorist Financing for the Time Period until 31 December 2019 approved by the Cabinet of Ministers. Considering the delegation prescribed by the AML/CTPF Law, the FCMC issued *Regulations on the Establishment of Customer Due Diligence, Enhanced Customer Due Diligence, and Risk Scoring System* as well as *issued Regulations on Conducting an Independent Assessment of the Internal Control System for the Prevention of Money Laundering and Terrorism and Proliferation Financing and Regulations on Information Accompanying Transfers of Funds*. Additionaly, considering the delegation prescribed by the Law on International Sanctions and National Sanctions of the Republic of Latvia, in 2019 the FCMC issued also *Regulations on Sanctions Risk Management*.

Main strategic objectives of the supervisory authority in 2019

In 2019, the FCMC Board approved a new FCMC Operational Strategy for 2019 - 2023, setting five priority areas:

- to ensure consistent and professional supervision of the financial sector by developing an appropriate and proportionate regulatory environment of the financial sector, promoting a high level of compliance of the financial sector, and mitigating the risks, inter alia, in the AML/CFT field, as well as by raising effectiveness of the financial sector supervisory and control measures and facilitating deeper integration in the SSM;
- to continue developing as a professional and responsible organisation with effective corporate management and processes by improving corporate culture and developing professional knowledge and skills of the staff, as well as the IT used on an everyday basis, in light of the development trends thereof and the needs of the users;
- to actively involve in the dialogue with the representatives of the financial sector, implement clear and understandable strategic communication with the public, and to continue enhancing financial literacy of the population;
- to facilitate a business environment favourable for innovative and reliable financial services and to proactively follow up the development of financial innovations, to actively be involved in the dialogue with the participants of the financial sector regarding risks caused by innovations, and to ensure the timely response and adaptation of the supervisory approach;

- to continue stronger integration in the Single Resolution Mechanism and the Single Deposit Insurance Mechanism, to improve the effectiveness of the crisis management mechanism of Latvian financial sector, and to ensure the resolution solution corresponding to the public interest.

The activities of the Banking Supervisory Authority in 2019

In 2019, the FCMC continued to consolidate the framework of intensive banking supervision, the purpose of which is to take risk-based and result-orientated supervisory measures and enable the FCMC to get involved in the activities of the banks and take the necessary measures to resolve potential and existing problems or reduce losses in a timely manner. At the beginning of 2019, based on the assessment of the operational risks of credit institutions and of the trends of the financial system, the FCMC set the following supervisory priorities in 2019:

- supervision of the process of successful implementation of strategies and new business models and the result thereof, as well as the assessment of the earning capacity, focussing on further viability and sustainability of the business models of the banks;
- evaluation of internal governance, operational compliance, and reputational risk, focussing on effective operation of internal control systems of the banks and evaluation of the risk appetite of the banks, as well as the changes in the risk tolerance of the banks, especially, considering the aspect of the change of business models of the banks;
- credit risk supervision, concentrating on the NPL and ensuring the development of the NPL strategies, as well as risk management as a whole. In parallel, the supervisors still focus on introduction of IFRS 9.

Prudential supervision.
For the purposes of evaluating the strategy, business model, and earning capacity, the supervisory focus in 2019 was on active following up on how the new bank strategies and business models are introduced. Both the information obtained during regular meetings with the banks and the data from the reports submitted by the banks were used in the SREP, determining the personal funds requirements for covering risks inherent to the activities of the banks and probable risks and special liquidity requirements, as well as applying other supervisory measures.

Special emphasis was still put also on constant improvement of the ICAAP, ILAAP, and recovery plans, as well as the quality of data of such reports as COREP and FINREP. Besides, the supervisory process of successful elimination of drawbacks discovered during the previous horizontal inspections continued in 2019.

When assessing the credit risk and adequacy of provisionst, the FCMC focussed on the credit risk both in the context of the change of banking business models and in regular supervisory activities of the FCMC, namely, within the scope of on-site inspections and continuing the supervisory process of elimination of drawbacks discovered during the previous horizontal inspections also in 2019.

In 2019, the FCMC continued the SREP according to the SREP guidelines developed by the EBA, as well as the ECB guidelines regarding the SREP of less-important banks, with the process taking place within the scope of supervisory dialogues on the SREP results. Also in 2020, a significant focus of the SREP is pointed towards the revised banking business models and assessment thereof, paying special attention to the earning capacity, viability, and sustainability of banks, as well as the risks connected with the change of the business model.

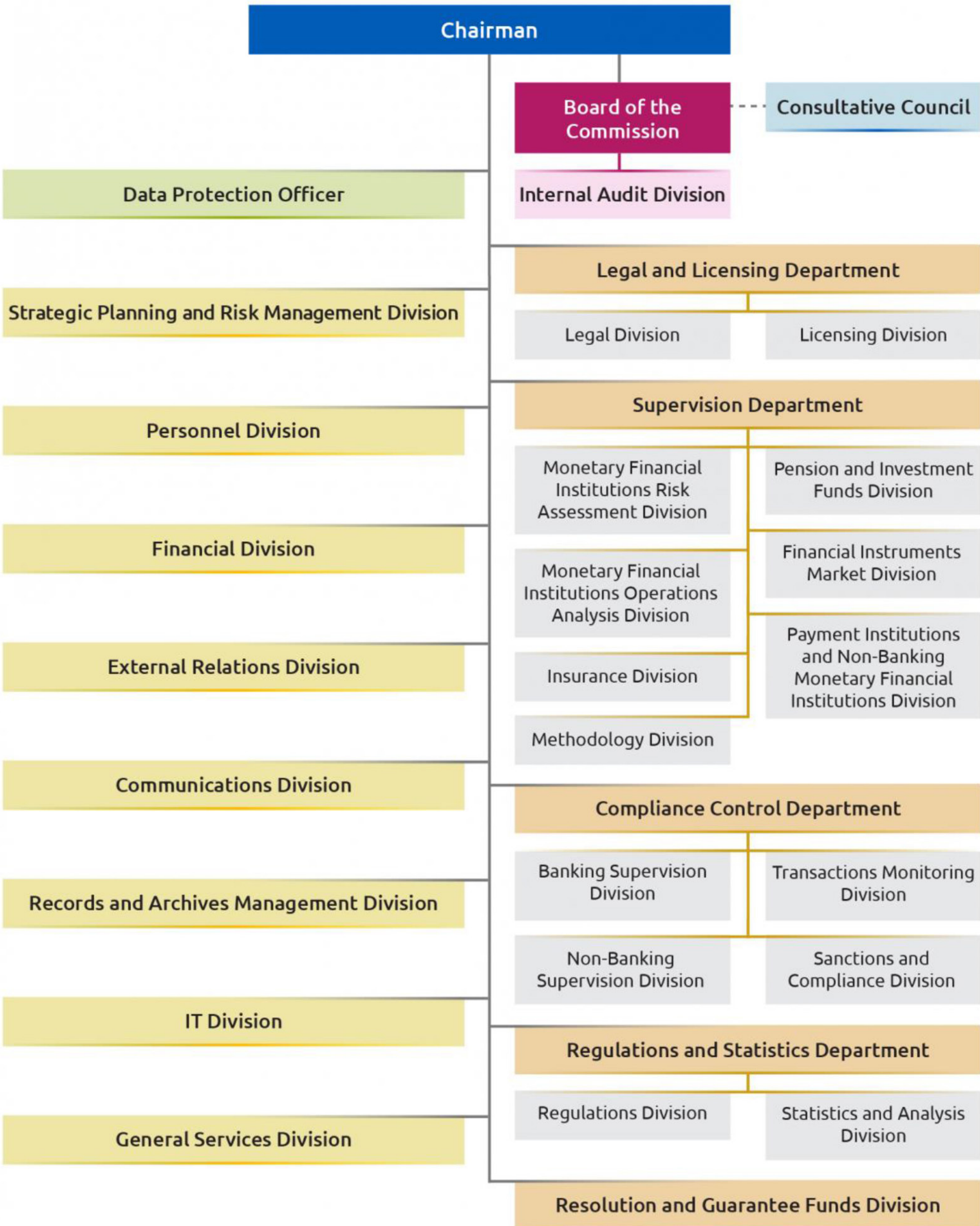
During the reporting year, the FCMC carried out six on-site inspections in banks, paying particular attention to the lending process, including work with problematic assets, as well as risk management functions – management of credit risk, strategy, and business risk. Also on-site inspections of information systems in three banks were performed.

AML/CFT *supervision.*

In the field of AML/CFT in 2019, the work started in the previous years to improve the supervisory processes of compliance with AML/CFT requirements for banks and non-bank financial institutions, as well as in the strengthening of the AML/CFT supervisory function carried out by the FCMC, was actively continued. The FCMC continued its regular monitoring in the AML/CFT area, the number of on-site inspections in banks was increased by 20% as compared to 2018.

As a result in 2019, a fine was imposed on four credit institutions for failure to comply with the requirements laid down in the AML/CTPF Law, restrictive measures were set, and a set of duties was imposed that should be carried out in order to fine-tune and improve the internal control systems of the banks.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

On an international scale, likewise as in previous years, the activities of the FCMC were mainly focussed on co-operation and information exchange with national supervisory authorities of other countries and participation in the SSM and SRM as well as cooperation with the European authorities – European Central Bank, European Supervisory Authorities (EBA, ESMA, EIOPA), European Systemic Risk Board and Single Resolution Board. The FCMC experts took active part also in the work of the EU Council working parties and participated in the European Commission's Expert Groups.

In 2019, the FCMC continued to maintain close contacts with national supervisory authorities from other countries. An essential part of the banking supervision constitutes the cooperation with home supervisor authorities and the FCMC participates in the work of the four supervisory colleges for cross-border banking groups.

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

In 2019, the FCMC has signed several agreements for cooperation and exchange of information with financial sector supervisory authorities from the United Kingdom, so called BREXIT agreements, to ensure cooperation with the UK authorities if it would withdraw from the EU without agreement.

The year 2019, was highly important for Latvia in preventing the deficiencies referred to in *Moneyval* Fifth Round Evaluation Report, because, in light of the enhanced follow-up status that *Moneyval* had granted to Latvia, it was possible that also FATF would set the enhanced follow-up or add Latvia to the so-called "grey list". The FCMC, within the scope of its competence, put forth considerable effort in consolidating the financial sector supervision, enhancing the regulation, and explaining these changes to the representatives of *Moneyval* Member States. As a result, Latvia was assessed as compliant or largely compliant with all FATF 40 Recommendations and it was concluded that Latvia has established a strong and resilient financial system for protection against money laundering, terrorist financing, and proliferation of weapons of mass destruction, and will not be made subject to enhanced follow-up.

Additionally, in autumn of 2019, the IMF Financial Sector Assessment Program for Latvia was launched with the aim to conclude it by mid-2020, however the assessment process is terminated now for an indefinite time period due to COVID-19 restrictions.

Cooperation with other supervisory bodies in the country

The FCMC is a unified financial sector supervisory authority in the Republic of Latvia. Nevertheless, the FCMC works in a close cooperation with different national public authorities and institutions, i.e. the Bank of Latvia (macroeconomic, macro-prudential and financial stability issues), the Ministry of Finance (preparation of national legislation and collaboration in development of financial policy issues), the Financial Intelligence Unit (FIU) of Latvia (AML/CTF issues), Ministry of Justice, Consumer Rights Protection Centre and other government bodies.

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

Other relevant information

More detailed information about the developments in the banking sector and banking supervision in Latvia is available on the FCMC website: https://www.fktk.lv/en/.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	16	15	14
Branches of foreign credit institutions	5	5	5
Cooperative banks	0	0	0
Banking sector, total:	**21**	**20**	**19**

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

Type of financial institution	2017	2018	2019
Commercial banks	27 217 001	21 651 497	17 652 267
Branches of foreign credit institutions	1 170 739	917 441	4 853 172
Cooperative banks	0	0	0
Banking sector, total:	28 387 740	22 568 937	22 505 439
y/y change (in %)	-3.8	-20.7	-0.3

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

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	0	0	0
Domestic ownership total	21.4	8.2	14.7
Foreign ownership	78.6	91.8	85.3
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	76.3	89.0	0.214
Branches of foreign credit institutions	97.6	100.0	0.009
Cooperative banks	-	-	-
Banking sector, total:	**61.8**	**85.7**	**0.198**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	7.6	9.7	4.4
Cooperative banks	-	-	-
Banking sector, total:	**7.6**	**9.7**	**4.4**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	95.9	96.1	78.6
Branches of foreign credit institutions	4.1	3.9	21.4
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector	34.1	31.7	32.5
Nonfinancial sector	51.5	58.8	56.2
Government sector	8.5	4.0	4.4
Other assets	5.9	5.5	6.9
Liabilities			
Financial sector	15.3	12.1	7.1
Nonfinancial sector	64.0	69.8	73.1
Government sector	2.9	2.5	2.1
Other liabilities	6.7	2.4	5.5
Capital	**11.1**	**13.2**	**12.2**

Capital adequacy ratio of banks

Type of financial institution	2017***	2018***	2019***
Commercial banks	21.37	22.31	21.04
Cooperative banks	-	-	-
Banking sector, total:	**21.37**	**22.31**	**21.04**

*(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	2017	2018	2019
Non-financial sector, including	4.5	7.4	7.1
- households	4.0	5.2	4.9
- corporate	4.9	9.1	8.9

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

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	89.4	94.3
Households	55.1	41.8
Corporate	34.3	52.5
Government sector	5.2	0.8
Financial sector (excluding banks)	5.5	4.9
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	566 396	554 305	543 611
Interest expenses	125 682	102 532	103 703
Net interest income	440 714	451 773	439 908
Net fee and commission income	289 557	282 142	228 769
Other (not specified above) operating income (net)	133 375	99 266	115 810
Gross income	863 646	833 181	784 486
Administration costs	467 664	464 712	471 977
Depreciation	31 948	34 621	38 129
Impairment and Provisions	63 164	41 973	153 892
Profit (loss) before tax	300 869	291 874	120 489
Net profit (loss)	236 101	283 983	113 647

Total own funds in 2019 (at year-end, in thousand of EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	1 932 890	1 798 684	1 798 684	134 206	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**1 932 890**	**1 798 684**	**1 798 684**	**134 206**	**-**

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

Macroeconomic environment

Whilst global growth has been hampered by international trade conflicts and prolonged uncertainty over Brexit, the recent outbreak of the coronavirus (COVID-19) has generated an unprecedented economic shock, adding yet another layer of uncertainty. Against this background, the Eurosystem central banks, including the Bank of Lithuania, have undertaken to maintain interest rates at low levels, preserve favourable lending conditions and ensure consistent implementation of other economic stimulus measures.

In 2019 Lithuania's economy grew by 3.9% in 2019. Domestic demand was the main driver of strong economic growth.

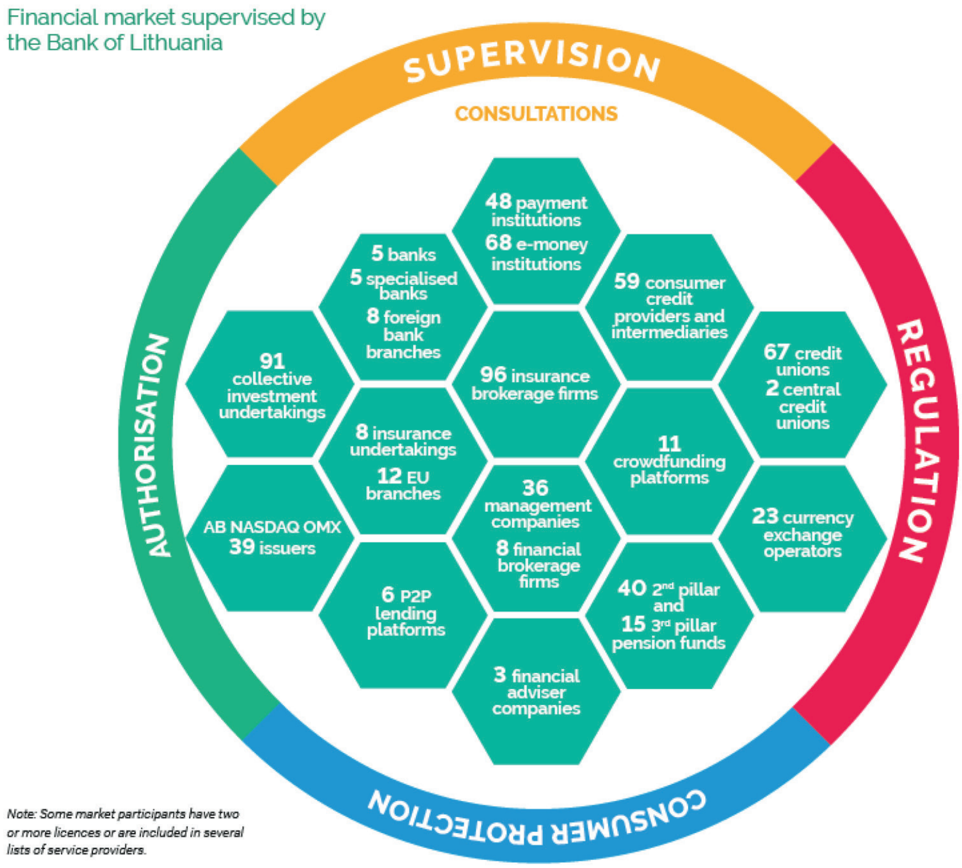
Foreign trade, which was faltering due to trade wars, the still unrecovered EU industry and challenges to the transportation sector did not significantly dampen Lithuania's economic growth, which was supported by household consumption and investments. Meanwhile, exports of goods and services, which saw rapid growth in the first half of 2019, started to slow down – in the last quarter, their growth was nearly twice below the levels recorded in the first half-year.

Household consumption was mostly underpinned by favourable labour market developments. Increasing number of jobs and rising wages were still among the most important factors contributing to the increase in household income. Weaker inflation for goods and services provided an even stronger boost to the purchasing power of households.

In 2019, investments were still increasing quite rapidly despite the unfavourable international economic climate. Growth in material investments was mainly stimulated by companies engaged in manufacturing, real estate activities, general government-related activities, energy, and transportation, as they invested more in both machinery and equipment and buildings and structures. Investments in non-residential buildings and structures were largely influenced by increasing EU funding for investment projects, which in 2019 grew by almost 25%. In the second half of 2019, investments in information and communication technology facilities significantly increased, with their respective share in total investments being the highest over the last seven years. At the same time, however, investments in vehicles dropped.

Development in the banking sector

The Bank of Lithuania supervises more than 650 market participants whose assets exceed €47.5 billion. At the end of 2019, four banks and three foreign bank branches were active in Lithuania. In the meanwhile, three foreign bank branches ceased their activities in Lithuania.



For the first time in history, the assets of banks operating in Lithuania exceeded €30 billion. Such robust growth was underpinned by a record increase in resident deposits. In 2019, banks enhanced their resilience to potential losses by strengthening their capital positions. Soon after the outbreak of the pandemic, the Bank of Lithuania carried out a stress test which showed that the Lithuanian banking system is fully equipped to withstand even severe economic shocks. The largest share of banks' income was earned from their main activities, namely – lending. Their willingness to lend varied, however: although banks remained generous in providing housing loans to residents, lending to businesses, especially small ones, has considerably tightened. Given the importance of small and medium-sized enterprises to the country's economy, the Bank of Lithuania, together with the Competition Council of the Republic of Lithuania, has launched a joint study in order to analyse the reasons behind such trends and find ways to facilitate access to financing for smaller businesses.

In carrying out financial market supervision, the Bank of Lithuania mainly focused on areas exposed to highest risk.

In 2019, Lithuania's banking sector remained stable: the composition of assets and liabilities of banks were still broadly unchanged, with loans and deposits accounting for the largest share of assets and liabilities respectively. The overall profit of the banking sector somewhat decreased due to reorganisations; however, incumbent banks not undergoing any major changes continued to increase their profit from credit activities. All banks complied with their minimum capital adequacy requirements, while resident and corporate deposits – the main financing source for banks – continued to grow, thus ensuring their strong liquidity position.

Despite weakening links with parent banks, the Lithuanian banking sector remains sensitive to a potential correction of imbalances in the Nordic countries. While banks operating in the country have become less likely to use foreign credit institutions' deposits as a source of funding, they still remain dependent on group-level decisions. Amid high concentration in the Lithuanian banking sector, the importance of individual banks has been increasing. The COVID-19 pandemic has shaken global financial markets, thus weakening investor confidence which has already been shattered by money laundering scandals. This in turn is making funding for Nordic banks more expensive.

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

Seeking to create an advanced and attractive regulatory and supervisory environment, for the fourth consecutive year the Bank of Lithuania published the schedule and scope of its routine inspections and investigations, thus allowing financial market participants to make necessary preparations. In 2020, stronger focus will be directed to compliance with AML requirements. The Bank of Lithuania also made public announcements regarding the intended regulatory changes within the financial market in order to inform and enable relevant stakeholders to prepare for consultations.

Within the framework of its consulting activities, the Bank of Lithuania continued publishing guidelines and recommendations on relevant regulatory issues, thus aiming to enhance clarity with regard to the content of existing legal requirements and supervisory expectations as well as to formulate best practices.

The Bank of Lithuania's RegTech solution is set to streamline reporting procedures. In order to ensure that higher regulatory standards and reporting requirements do not hinder the sustainable development of the financial system, the Bank of Lithuania seeks to employ new technologies to reduce compliance costs. Discussions with financial market participants, particularly fintech companies, on ways to abandon outdated reporting solutions are already bearing fruit. In 2019, the GovTech Lab challenge drew the attention of private IT companies which provided numerous ideas on new reporting solutions to reduce the administrative burden for market participants and enhance cost efficiency. The two selected companies joined forces to create a smart solution prototype using API software – a key element of Open Banking. As a result, all financial reports will be generated automatically, thus avoiding conflicting interpretations of legislation, delays and any inaccuracies. The application limits and implementation deadlines of this solution will be assessed in the course of 2020.

Main strategic objectives of the supervisory authority in 2019

The Bank of Lithuania in its 2017-2020 strategic plan dedicated for the supervisory authority the following strategic objective and tasks:

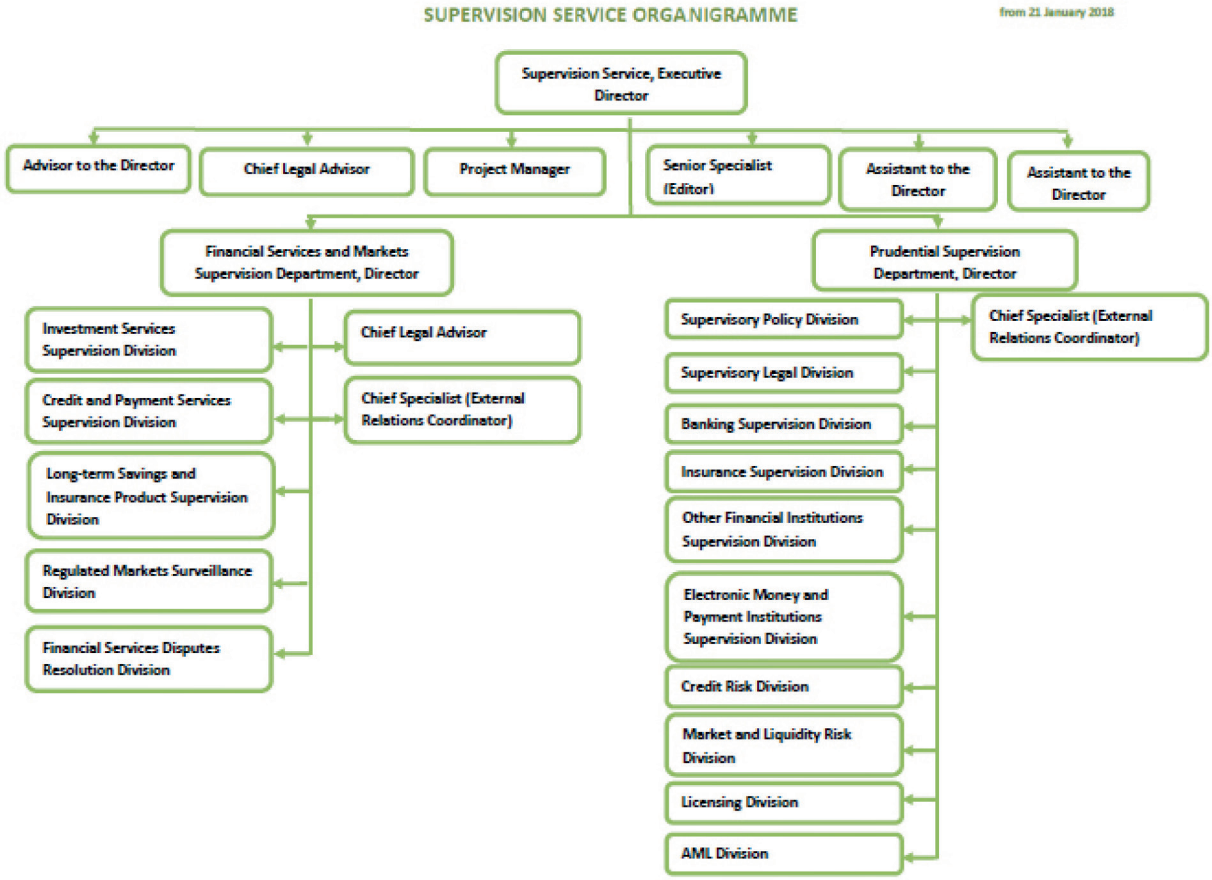
1. Develop an innovative, attractive and competitive regulatory and supervisory environment for the financial sector:
   - Improve regulatory and supervisory environment, remove barriers to entry and barriers to operate;
   - Develop strong and trust-based relationships with supervised financial market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

The activities of the Banking Supervisory Authority in 2019

The Bank of Lithuania held annual meetings with the supervised financial market participants so as to discuss annual results and present plans for the next year, including intended regulatory changes. In cooperation with associations of financial market participants, the Bank of Lithuania inquired about the need for consultations and their topics. The most frequently requested topics included money laundering risk management, compliance with the requirements of payment and insurance legislation, as well as reporting. In the light of the information received, the Bank of Lithuania plans to organise training events, conferences and consultations in order to address the most relevant issues.

The Bank of Lithuania has been strengthening partnership with financial market participants. With a goal to maintaining regulatory hygiene, the Bank of Lithuania has been gradually abandoning excessive and outdated solutions. In collaboration with market participants, the Bank of Lithuania identified legislative acts to be amended and is dedicated to implementing the necessary changes. Seeking to ensure that its actions are predictable and communicated in advance, the Bank of Lithuania has made its plans for inspections and regulatory amendments publicly available as well as been organising periodic meetings with market participants. It also took up new ways of fulfilling its supervisory mandate (e.g. on-site visits).

Organizational chart of the Banking Supervisory Authority



International activities of the authority

In July 2019, the implementation of the EU Twinning Project "Strengthening the National Bank of Belarus", which was set to run for 18 months, was completed by a consortium of the national central banks of Germany, Lithuania and Poland. The project aimed to enhance the capacity of the National Bank of the Republic of Belarus to effectively pursue its core responsibilities in the field of financial stability, banking

supervision, payment systems, consumer protection, and communication policy. First of its kind in Belarus, it was also the first EU Twinning Project that the Bank of Lithuania contributed to implementing. In spring 2019, the Bank of Lithuania, together with the ECB and other national central banks from the ESCB, launched the EU-funded "Programme for Strengthening the Central Bank Capacities in the Western Balkans with a view to the Integration to the ESCB", which is set to run for two years.

Other relevant information and developments in 2019

Fintech companies were issued 28 licences in the course of 2019 (exactly the same as in 2018). The said fintech companies included banks, specialised banks, e-money and payment institutions (except for institutions holding a licence for restricted activity) as well as crowdfunding platform and P2P lending platform operators. Having met with more than 160 potential market participants to discuss the possibilities of setting up in Lithuania, currently the Bank of Lithuania is assessing more than 58 applications.

With a view to making Lithuania the fintech hub in the Nordic-Baltic region, the Bank of Lithuania created a fintech-conducive environment that attracts new market players and encourages product development in the country. The Bank of Lithuania has already created a one-stop shop, set up a dedicated email for all queries on setting up in Lithuania, allowed foreign citizens to submit documents necessary for obtaining a licence in English, and provided both the Lithuanian and English versions of its Licensing Guide. The Bank of Lithuania's website has a section dubbed the Newcomer Programme, which presents key information for new market entrants in a concise and clear manner.

The Bank of Lithuania launched an e-licensing tool, allowing all companies to take care of the necessary paperwork and procedure electronically.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	6	6	10
Branches of foreign credit institutions	7	7	8
Cooperative banks	70	67	65
Banking sector, total:	**83**	**80**	**83**

Total assets of banking sector (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	25 213.2	27 034.9	21 978.2
Branches of foreign credit institutions	2 110.7	1 585.3	8 707.4
Cooperative banks	684.8	741.1	791.3
Banking sector, total:	28 008.6	29 361.4	31 477
y/y change (in %)	6.0	4.8	7.2

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	-	-	-
Domestic ownership total	11.1	11.7	10.0
Foreign ownership	88.9	88.3	90.0
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	98.1	99.9	3937.6
Branches of foreign credit institutions	91.3	98.1	5653.3
Cooperative banks	16.5	25.4	292.8
Banking sector, total:	**82.7**	**93.4**	**2448.3**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	9.42	12.8	10.8
Cooperative banks	3.08	4.99	6.27
Banking sector, total:	**-**	**-**	**-**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	89.6	92.1	69.8
Branches of foreign credit institutions	7.5	5.4	27.7
Cooperative banks	2.9	2.5	2.5
Banking sector, total:	**100.0**	**100.0**	**100.0**

Capital adequacy ratio of banks

Type of financial institution	2017	2018	2019
Commercial banks	18.79***	18.58***	19.49***
Cooperative banks	18.49*	13.97**	14.5**
Banking sector, total:	**18.78**	**18.46**	**19.45**

*(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	2017	2018	2019
Non-financial sector, including	2.97	2.37	1.63
- households	3.71	3.03	2.14
- corporate	5.47	4.33	3.11

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	87.5	91.4
Households	59.8	48.6
Corporate	27.6	42.9
Government sector	9.8	2.5
Financial sector (excluding banks)	2.7	6.0
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	456.2	505.9	558.8
Interest expenses	73.9	66.2	80.2
Net interest income	382.3	439.7	478.6
Net fee and commission income	196.9	218.1	232.2
Other (not specified above) operating income (net)	35.3	64.5	74.8
Gross income	614.5	730.6	796.3
Administration costs	266.4	313.3	348.5
Depreciation	21.2	19.5	30.5
Provisions	42.7	-0.3	-4.2
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	-10.5	5.2	21.9
Profit (loss) before tax	275.4	385.0	386.7
Net profit (loss)	225.4	334.5	324.7

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks***	1685.6	-	1651.4	34.2	-
Cooperative banks**	58.4	-	49.3	9.1	-
Banking sector, total:	**1744.0**	**-**	**1700.7**	**43.3**	**-**

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

Macroeconomic environment in the country

Economic growth in North Macedonia has been strengthening in recent years with real GDP growth reaching 3.6% in 2019. The pickup in growth in 2019 was broad-based across all sectors, with the exception of information and technology sector, and gained from increases in wholesale and retail trade, transport and hospitality sector, construction as well as industry. On the expenditure side, domestic demand has provided strong impetus to growth in 2019 after a period of stagnation in the previous two years. Investment rebounded, following two years of decline, supported by fiscal stimulus and private investment growth amid favorable financing conditions. Households' spending has continued to grow, boosted by higher wages, pensions and social transfers, solid remittances from abroad and strengthened credit growth. Export growth remained strong, but decelerated on annual basis, amid growing global uncertainty and slowing growth of the main trading partners of the domestic economy.

As the economy gathered momentum in 2019, favorable trends on the labor market continued with unemployment rate falling further and nominal wages continuing to grow. Supported by active employment and vocational training measures, unemployment rate has hit a new record low of 17.3%. Most of the new jobs where in the service sector and industry, especially the manufacturing. Youth unemployment (15-24) decreased sharply from 45.4% in 2018 to 35.6% in 2019, but remains elevated, calling for further efforts to address labor market weaknesses. Gross wages increased by 5.1% on average boosted by rises in minimum wages and in public sector wages and government subsidies for private sector wages increase.

During 2019, inflation moderated to 0.8% from 1.5% in 2018. The slowdown in inflation primarily reflects the impact of lower world energy prices, while food prices increased contributing to rise in CPI. Core inflation stood at 0.5%.

External sector vulnerabilities remain contained with gross foreign reserves continuing to increase, thus providing a strong support to the fixed exchange rate regime. Current account deficit widened, but remained moderate at 2.8% of GDP in 2019 from 0.2% of GDP in 2018. This was driven mostly by the widening trade deficit amid weaker export demand from abroad. The current account deficit was fully covered by net inflows of FDI, which amounted to 2.6% of GDP and external borrowing from the Government and the private sector. Gross foreign reserves increased standing at 3.3 EUR billion or 29% of GDP at year-end that covers 4.6 months of import. Gross external debt remains sustainable at 72.2% of GDP, which is the only indicator that ranks the country as moderately indebted, while all the other indicators point to a low level of external debt.

The background of low inflation and continued foreign exchange inflows enabled the National Bank of the Republic of North Macedonia to continue with the accommodative monetary policy stance. Policy rate was further reduced from 2.5% to 2.25% that contributed to further loosening of financial conditions and continued growth of banks' lending to households and non-financial corporations. Total loans granted by banks increased by 6.1% year-on-year supported by growth in total deposits of 9.2%.

Fiscal sector developments in 2019 have continued to support macro-financial stability in the country by maintaining a moderate budget deficit and a stable level of public debt. The realized budget deficit of 2.0% of GDP in 2019 (1.8% of GDP in 2018) was below its target for the year (2.5% of GDP) and was mostly financed through government borrowing on the domestic market and to a lesser extent through external borrowing and the use of government deposits within the National Bank. The primary budget balance in 2019 was 0.8% of GDP, compared to 0.6% in 2018. Such developments, complemented by the growth of economic activity, contributed to maintaining public debt at a relatively stable level of 48.9% of GDP in 2019 (48.6% of GDP in 2018). The structure of public debt continues to be dominated by external debt, whose share in GDP decreased on an annual basis, at the expense of growth of domestic debt through new issues of continuous securities. Slightly more than 80% of the public debt refers to central government debt (including public funds and municipalities), while the rest falls on the debt of public enterprises.

All in all, economic prospects of North Macedonia were quite encouraging before the COVID-19 outbreak hit the country since early 2020. Economic growth was strengthening, thus improving the conditions on the labor market and stable macro environment supported further development of the financial sector. Important steps were also made towards securing the political stability, with North Macedonia recently receiving positive decision by the European Council on opening accession talks for EU membership and joining NATO as its 30th member state. The outlook for the domestic economy deteriorated sharply as the coronavirus developed into global pandemic. As a consequence, economic activity is expected to decline in 2020, and early indicators point to a strong impact in almost all economic segments. Spill-over effects on the domestic economy are also expected from the deteriorating global environment and the disruption of global production chains, lowering the export demand and narrowing inflows form private transfers, as a traditional source of additional financing to households' income. The measures taken by the National Bank in response to the pandemic, along with the economic measures of the Government, are expected to contain risks and reduce the economic damage of the crisis. However, the risks remain high, given the high uncertainty around the duration and intensity of the health crisis. Despite the deteriorating environment, gross foreign reserves are expected to remain at appropriate level to support the exchange rate stability as important pillar of the macro-financial stability in the country. Public debt remains sustainable, despite the expected increase in the short run due to the considerable fiscal impact of the corona crisis.

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

The banking sector makes the main component of the Macedonian financial sector with banks' assets accounting 81.4% of total financial sector's assets in 2019. The number of banks operating in the country remained unchanged in 2019 standing at total 15 banks. The system has moderate market concentration with the top three banks holding 56.6% of total banking sector assets, while the share of the top five banks accounts 74.7%.

During 2019, the banking system assets to GDP ratio has increased by 2.3 percentage points relative to the previous year and amounted 78.8%. The share of total credit to GDP was broadly stable at 48.7% in 2019 with credit and GDP growing at approximately the same pace. Such developments point to sustainable lending cycle contributing to maintain sound and healthy balance sheets of domestic banks. Asset quality of the banking sector continued to improve overall with NPL ratio reaching its record low of 4.8% in 2019. The decline in NPL ratio was mainly driven by the mandatory write-off of NPLs that are fully provisioned for longer than 2 years (since 2016) i.e. one year (since 2019). In addition, is the improved collection of NPLs by domestic banks. Provisioning coverage ratio (total provisions to NPLs ratio) is high at over 100% giving banks cushion to absorb losses.

Domestic banking sector is resilient with sound buffers to withstand shocks. The system is well-capitalized with banks comfortably meeting capital adequacy requirements and maintaining high quality of own funds. Capital adequacy ratio amounts 16.3% in 2019, while CET1 ratio stands at 14.7%.The resilience of the banking sector to shocks is further confirmed by National Bank's stress tests that show sufficient capacity of banks to absorb credit losses, even in the event of extreme shocks that are very unlikely to happen. The banking system traditionally maintains high liquidity buffers, and in 2019, it further strengthened the already sound liquidity positions. Nearly one third of banks' assets are liquid assets that cover more than half of short - term liabilities and around 60% of total households' deposits.

Year-end profit is the main source of banks capital support. Total after tax profit for 2019 equals to 6.6 billion denars and is by 1.7 billion denars or 20% lower compared to 2018 profit. The decline in 2019 profit is a result of the higher profit in 2018 due to large non-recurring items i.e. collection of large non-performing claim from one bigger client, by several banks. ROAA and ROAE equal to 1.3% and 11.7% respectively (1.7% and 16% for 2018). The net interest income as relevant determinant of profitability has been declining in the last period due to declining interest rates and weaker lending activity to the corporate sector. Over the past several years, lending and deposit interest rates of banks, as well as the spread of interest rates registered a continuous decline.

The funding model of domestic banks is another factor that contributes to reduced vulnerability to shocks. Domestic banks have limited cross-border linkages and dependence on parent banks funding is negligible. The share of debt instruments issued by parent entities is only 3% of total liabilities. Non-financial sector deposits are the main source of funding of banks' activities, where, household deposits prevail with a share of around 70%. Over the past several years, banks have been more oriented towards lending to households given the still low level of indebtedness of the households sector and higher possibilities for risk diversification associated with households' lending. These trends continued in 2019 as well with households' loans increasing by 10.6% year-on-year compared to 2.4% growth rate of corporate loans. Household and corporate loans hold almost equal shares in total banks' loans of around 50% and 49% respectively.

Thanks to the sound capital and liquidity buffers, domestic banking sector is well prepared to cope with adverse shocks including the ongoing corona crisis. In response to the COVID-19 pandemic, National Bank has undertaken several measures, including regulatory flexibility that allowed banks to temporarily restructure debts of the high-quality borrowers affected by the pandemic, thus providing for more favorable credit terms and easing of financial strains. Banks have massively engaged in loans restructuring. As of May 2020, around 60% of households have accepted banks offers for deferred payment of credit liabilities up to six months. Liquidity positions of banks have remained strong, despite the credit prolongation, while robust capital positions allow banks to withstand the crisis and continue supporting the economy by expanding lending to the private sector.

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

The National Bank of the Republic of North Macedonia is the Banking Supervisory Authority responsible for licensing and supervision of banks and savings houses in the Republic of North Macedonia. The Supervision Sector, through its two departments, Off-site Supervision and Licensing Department and On-site Supervision Department, performs the supervisory function. The Financial Stability, Banking Regulations and Bank Resolution Department is responsible for analysis of the financial system and the financial stability in the country and for development of the relevant banking regulation in line with international standards and best practices. This Department will also be responsible for performing bank resolution function, upon the adoption of the relevant regulation entrusting the National Bank with this role and upon facilitating it with appropriate tools and capacities.

These competences of the National Bank are regulated with the Law on the National Bank of the Republic of Macedonia and the Banking Law.

In order to harmonize the domestic regulations with the Basel standards and principles, as well as with relevant EU directives and regulations, during 2019 National Bank has enhanced the existing banking regulation by adopting the following regulations:

- amendments of the licensing regulation providing for harmonization with the amendments of the Banking Law from January 2019 which enabled a (non)conviction of a shareholders with qualified holding in a bank and for persons with special rights and responsibilities to be regarded as a criterion for assessing the reputation of these persons. In addition, the reputation of a natural person who intends to become a shareholder with qualified holding in a bank and of the person proposed for a member of the Management Board of a bank depends also on the reputation of his associate (a natural person with whom together, directly or indirectly and/or through a contract, a control over a domestic or foreign trade company is performed).
- New regulation on risk management which provides for further improvement of the banks' risk management systems, taking into account the provisions of the regulation on good corporate governance adopted in 2018, the guidelines of the European Banking Authority, Basel Standards and corporate governance principles, as well as the recommendations of the FSAP mission. The most significant novelties of this regulations refer to strengthening of the requirements for efficient risk management, introducing a requirement for developing and maintaining adequate Internal Liquidity Adequacy Assessment Process and strengthening the reporting requirements of the National Bank.
- Strengthening the corporate governance requirements regarding the competencies of the bank's supervisory board in the process of determination of the internal liquidity (in line with the new requirement arising from the regulation on risk management). It also limits the possibility for the chairman of one of the legally prescribed committees (Risk Management Committee and Auditing Committee), to be a chairman of another committee established by the supervisory board.
- Amendments of the methodology for calculating the annual percentage rate of total costs, which should provide greater transparency and protection of consumers regarding the prices of consumer loans.
- Amendments of the capital adequacy regulation which clarifies in more details the manner for determining capital requirements for counterparty risk and settlement/delivery risk. More specifically, in addition to the existing requirement for determining adequate capital for the trading book positions, banks are required to allocate capital for these risks rising from the banking book positions. This amendment enables further harmonization with the Basel Capital Standards, as well as with the relevant European regulation.

In line with National Bank's efforts for harmonization with the relevant EU regulation, a new regulation on liquidity risk management was developed in 2019, which was adopted in 2020. The most important novelty of this regulation is the introduction of the liquidity coverage ratio. In addition, in the first half of 2020, the National Bank has undertaken serious efforts to adequately address the adverse effects of the COVID-19 pandemic on the financial system and the real economy.

Main strategic objectives of the supervisory authority in 2019

As over the previous year, the main objectives of the supervision were to maintain stable and reliable banking system as the main prerequisite for financial stability and sustainable economic growth of the country. In 2019, the supervision of banks was focused on regular assessment of the risk profile ,the required level of capital of individual banks and timely taking of appropriate supervisory action. The traditional types of risks in the banks' operations, primarily the credit risk, continues to be in the focus of supervisory activities. Also, corporate governance and operational risk, and within its framework, especially the risk arising from the information system security and the risk of money laundering and financing of terrorism, were primarily subject of assessment this year.

In addition, the National Bank continued to strengthen the existing supervisory capacity and continued its activities to follow and harmonize the regulatory framework with the international standards and the European legislation in the field of banking operation.

The activities of the Banking Supervisory Authority in 2019

Activities of the Off-Site Supervision Department last year

The activities of the Off-site Supervision and Licensing Department continued on regular basis. As part of its regular off-site analysis of banks' operation, the National Bank has continued with its activities for determining banks' risk profiles and minimum capital requirement (Pillar 2 capital requirements). Within the Supervisory Review and Evaluation Process (SREP), the National bank carried out a formal supervisory dialogue with the banks in order to smooth any differences in National Bank's and the bank's views. As in 2018, prior to the final announcement of the Pillar 2 capital requirement for 2020, the National Bank communicated to the banks the supervisory assessment of the banks' risk profiles and the preliminary assessment of the required capital . The banks were given the opportunity to comment, i.e. to submit comments to the National Bank regarding these assessments. On the basis of this process, in December 2019, the National Bank informed the banks of the minimum required level of capital to be maintained during 2020.

In 2019 all systemically important banks submited to the National Bank their recovery plans, for the second time. Within the cooperation with the World bank Financial Sector Advisory Centre (FinSac), supervisors carried out an assessment of the recovery plans. In 2020, the National bank gave the banks recommendations for further enhancements of the recovery plans. In this course, Off-site Supervision and Licensing Department also developed the internal methodology for recovery plans assessment.

Furthermore, in order to enhance its supervisory activities, the National bank has used technical assistance in the area of assessment of the banks' business models and strategies and development of a so called "BMA tool" that should empower the supervisors to assess viability of bank's existing business model and sustainability of bank strategy over a forward - looking period. Also, the Off-site Supervision and Licensing Department was engaged in the EU Twinning Project for Strengthening the institutional capacity of the National Bank in the process of its accession to the ESCB in the area of assessment of Internal Liquidity Adequacy Assessment Process (ILAAP) and its integration in the SREP. In accordance with the local regulation on risk management methodology, all banks are required to submit their first ILAAP reports to the National bank by the end of September 2020.

Regularly as in previous years, the off-site supervisory function of the National bank was involved in issuing licenses and approvals to banks and savings houses and undertaking corrective measures. During 2019, The Governor of the National bank has issued 80 licenses which were related to: approvals for appointment of members of Supervisory Board and Management Board of banks, amending and/or supplementing the Statutes of banks, approvals for commencement of new financial activities by banks, approvals for acquiring ownership in banks and approvals for including current profit or end-of-year profit and other capital instruments in the calculation of CET1. Within its legal authorisation, and in order to maintain the stability and safety of the banking institutions and banking system, the National bank undertook corrective measures towards banks and saving houses where illegitimacies, irregularities and non-compliance with Law on Banks and by-laws were determined during on-site inspections.

Activities of the On-Site Supervision Department in 2019

In 2019, the by-laws were harmonized with the Law on Anti Money Laundering and Combating the Financing of Terrorism, and the National Bank also took part in the preparation of the National assessment of the risk of money laundering and terrorist financing. In terms of the supervisory function, the National Bank improved the risk assessment methodology, especially the process of supervisory assessment of IT risk and banks' business models.

Within the regular supervisory controls, according to the annual plan, the National Bank performed regular supervisory controls (onsite risk controls) within 10 banks, out of which 6 banks were also subject to control of compliance of the operations with the regulations. Also, the National Bank conducted controls of the compliance of the operations with the regulations with other 4 banks, as well as with 2 savings houses, 1 subagent (of fast money transfer provider) and 209 authorized currency exchange offices.

Regarding the activities for strengthening the framework for anti-money laundering and combating the financing of terrorism, in 2019 the National Bank adopted the Instructions for assessing the risk of money laundering and financing of terrorism with banks, savings houses, fast money transfer providers and licensed currency exchange offices. Representatives of the National Bank participated in working groups to assess the risk of money laundering and financing of terrorism with banks and non-bank financial institutions.

On-site risk controls

Banks in the Republic of Macedonia usually perform traditional banking activities, with the credit risk mainly defining their risk profile. Hence, the exposure to this risk, as well as its management quality, with special emphasis on the adequacy of estimating impairment losses are the most often subject of on-site supervision. In the past year, this risk was examined in 6 banks.

In the reporting period, 4 banks were subject to examination of the suitability of the anti-money laundering systems, 6 banks were examined for IT risk, 2 banks were examined for operational risk management, 2 banks were examined for liquidity risk and 5 banks for corporate governance.

The examinations generally showed that banks' risk management was adequate and they were largely responsive to the corrective measures imposed by the National Bank in the previous periods. They mainly focus on improvement of the credit risk exposure classification process in terms of greater impact of the client's creditworthiness, inclusion of early warning indicators and adequacy of credit exposure.

As for the actions and measures for anti-money laundering and financing of terrorism, recommendations were also given to increase bank's effectiveness in risk management. The recommendations refer to strengthening the measures for determining and confirming the identity of the beneficial owner of clients, adequate monitoring of business relationship and transactions, AML software updates etc.

Banks' corporate governance was found to be satisfactory. Almost all banks' bodies comply with the law and bylaws. Focal points were: activities of the bank bodies and following of the corporate culture and values, remuneration system, risk management function, compliance function and internal audit function.

In the area of liquidity risk, focal points were: rules for liquidity risk management, organizational structure, management information systems, internal audit and internal control systems.

In the area of operational risk, focal points were: policies and procedures, operational risk profile, risk identification, risk measurement and decrement, management information system, business continuity plan, outsourcing and internal audit.

In assessing banks' IT or information security risk, focal points were: implementation of the new Decision on IT risk, substitution of the IT system (in one bank) and preparations for merger of two banks.

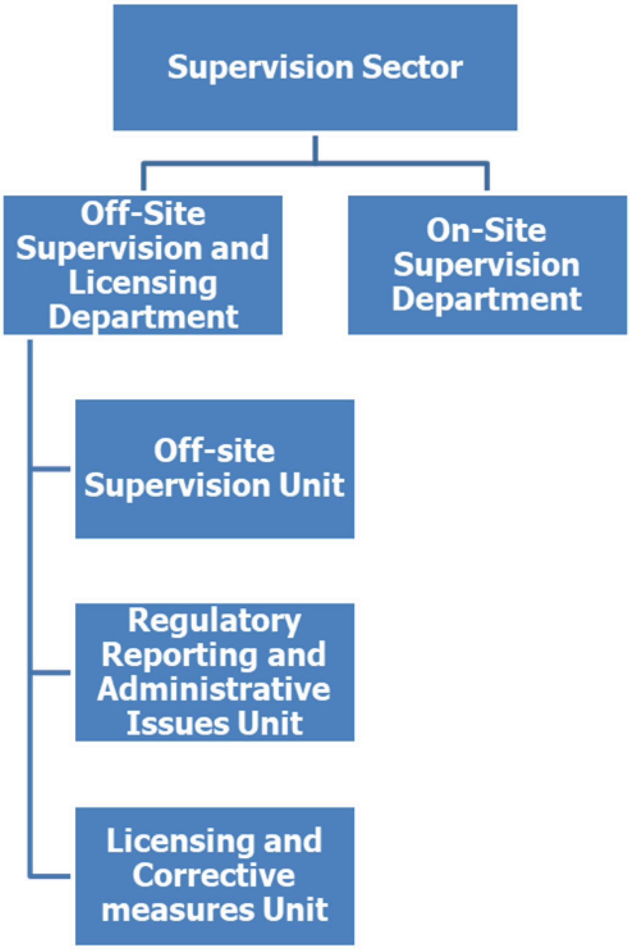
On-site compliance examinations

The on-site compliance examinations were focused on assessment of the compliance of banks and savings houses with the Law on the National Bank of the Republic of Macedonia, the Law on Foreign Exchange Operations, the Law on Consumer Protection in Case of Consumer Loan Agreements, the Law on Providing Fast Money Transfer Services and the Law on Payment Operations. All supervised entities are mainly in compliance with the regulations.

On-site examination of non-banking financial institutions or licensed exchange offices, money transfer services and their subagents aimed to assess their compliance with the Law on Foreign Exchange Operations, the Law on Providing Fast Money Transfer Services and the Law on Prevention of Money Laundering and Financing of Terrorism. Overall, these institutions were found to be in compliance with the regulations.

Organizational chart of the Banking Supervisory Authority

According to the organizational chart of the National Bank, the supervisory function is performed by a separate organizational part (Supervision Sector) consisted of two departments: Off-site Supervision and Licensing Department and On-site Supervision Department. This Sector is headed by a General Manager, appointed by the governor of the National Bank.



In addition, the Financial Stability, Banking Regulations and Resolution Department is responsible for development of the secondary banking regulations (by-laws), as well as for the monitoring of the financial stability in the country and proposing adequate macro-prudential measures, if needed. After the adoption of the relevant law, this Department will also be responsible for bank resolution (currently, the Department undertakes preparatory activities for introduction and implementation of this new function, such as preparation of the relevant law and by-laws, capacity building, etc.).

The organizational structure of the National Bank provides for a division of the activities of the Supervision Sector and the Financial Stability, Banking Regulations and Resolution Department, especially in terms of performing the supervisory and resolution functions. However, having in mind the close connection and interconnectedness of the activities of these two organizational parts, their cooperation is channelled through a separate Committee for supervision, financial stability and resolution. The Committee serves as a platform for exchanging relevant information and data between the Supervision Sector and the Financial Stability, Banking Regulations and Resolution Department, and it is an integral part of the whole decision-making process within the National Bank.

International activities of the authority

Within the cooperation based on bilateral and multilateral Memorandums of Understandings and Written Coordination and Cooperation Agreement, the National Bank's supervisory staff attended two supervisory colleges for a Greek and one Slovenian subsidiary. In early 2020, the Written Agreement for the Greek banking group was terminated, based on the ECB's notice that after the sale of a significant subsidiary, there were no longer significant subsidiaries in the group.

Cooperation with other supervisory bodies in the country

The cooperation of the domestic supervisory authorities in 2019 continued on a regular basis. During 2019, National Bank has undertaken several activities for revising the provisions of the existing Memorandums of understanding with several domestic financial regulators. Prior to the onset of the COVID-19 crisis, a new Memorandum with the Security and Exchange Commission was developed and finalized for signing, while new Memorandums with the Insurance Supervision Agency and the Agency for Supervision of Fully Funded Pension Insurance were in an initial stage of revision.

Following the general post-crisis trends and in line with the recommendations of the 2018 FSAP mission, important steps were taken recently, to further strengthen financial stability framework in the country. By signing a Memorandum of Understanding in the first quarter of 2020, Financial Stability Committee (FSC) was reconstituted to serve as principal domestic coordination body for macro prudential policy and crisis management. FCS now comprises of all the regulatory and supervisory authorities in the country (National Bank of the Republic of North Macedonia, Ministry of Finance, Agency for Insurance Supervision, Securities and Exchange Commission and Agency for Supervision of Fully Funded Pension Insurance) and Deposit Insurance Fund providing a platform for joint risks assessment and policy coordination among different authorities. In support to the FSC, two sub-committees will be operationalized – Sub-Committee for monitoring systemic risk and recommendation of macro prudential measures and Sub-Committee for preparing financial crises management, both working under the guidelines of FSC. The tasks of the FSC are to: 1) guide the work of the sub-committees; 2) review analyses, information and recommendations submitted by sub-committees and draw conclusions upon them; 3) make conclusions regarding the state of the financial system; 4) issue recommendations and warnings with respect to systemic risks and financial stability and monitor their implementation; 5) discuss macro prudential measures implemented by different supervisory authorities; 6) assess institutional preparedness for coping with financial crisis and other tasks enhancing cooperation and institutional coordination.

In 2019, National bank submitted two semi-annual reports to the Financial Intelligence Office with information concerning examinations performed and findings. Also, National bank sent separate information to the Financial Intelligence Office concerning the findings seriousness.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	15	15	15
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	**15**	**15**	**15**

Total assets of banking sector (in millions of Macedonian Denar) (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	461,992	503,469	549,969
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	461,992	503,469	549,969
y/y change (in %)	3.9%	9.0%	9.2%

** 1 EUR = 61.4856 MKD, as of 31.12.2019*

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	2.7%	2.0%	1.9%
Other domestic ownership	26.8%	26.4%	26.3%
Domestic ownership total	29.5%	28.4%	28.2%
Foreign ownership	70.5%	71.6%	71.8%
Banking sector, total:	**100.0%**	**100.0%**	**100.0%**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	56.6%	74.7%	1,343
Branches of foreign credit institutions	/	/	/
Cooperative banks	/	/	/
Banking sector, total:	**56.6%**	**74.7%**	**1,343**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	13.5%	16.0%	11.7%
Cooperative banks	/	/	/
Banking sector, total:	**13.5%**	**16.0%**	**11.7%**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	100.0%	100.0%	100.0%
Branches of foreign credit institutions	/	/	/
Cooperative banks	/	/	/
Banking sector, total:	**100.0%**	**100.0%**	**100.0%**

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

Assets	2017	2018	2019
Cash, balances and deposits with central bank (National Bank)	12.2%	14.2%	17.1%
Placements in securities	13.0%	12.2%	12.7%
- issued by domestic government sector	7.2%	7.0%	7.7%
- issued by central bank (National Bank)	5.4%	5.0%	4.5%
- other (including non residents)	0.4%	0.3%	0.5%
Loans, deposits and accounts with financial institutions (excluding central bank, including non residents)	10.7%	10.1%	7.7%
Loans with non-financial sector (including non residents)	59.8%	59.6%	58.5%
- loans with domestic government sector	0.5%	0.4%	0.3%
Other assets	4.3%	3.9%	3.9%
Total	**100.0%**	**100.0%**	**100.0%**
Liabilities	**2017**	**2018**	**2019**
Deposits of financial institutions (including non residents)	4.8%	5.5%	5.5%
Deposits of non financial sector (including non residents)	73.4%	73.8%	73.7%
- deposits of domestic government sector	0.1%	0.2%	0.2%
Borrowings, issued securities and liabilities on the basis of subordinated and hybrid instruments (including non residents)	7.9%	6.6%	6.7%
- domestic financial sector	2.7%	5.5%	1.8%
- domestic government sector	0.1%	0.1%	0.1%
- other	5.1%	4.5%	4.8%
Other liabilities	1.6%	3.4%	1.7%
Equity and reserves (including loss in current year)	10.8%	10.8%	11.0%
Profit after tax in current year	1.5%	1.7%	1.4%
Total liabilities	**100.0%**	**100.0%**	**100.0%**

Capital adequacy ratio of banks

Type of financial institution	2017***	2018***	2019***
Commercial banks	15.7%	16.5%	16.3%
Cooperative banks	/	/	/
Banking sector, total:	**15.7%**	**16.5%**	**16.3%**

*(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	2017	2018	2019
Non-financial sector, including	6.3%	5.2%	4.8%
- households	2.4%	2.3%	2.0%
- corporate	10.0%	8.0%	7.6%

The structure of deposits and loans of the banking sector in 2019 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	**93.4%**	**99.8%**
Households	63.7%	49.8%
Corporate	26.4%	49.0%
Government sector	0.2%	0.6%
Financial sector (excluding banks)	**6.6%**	**0.2%**
Total	**100.0%**	**100.0%**

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

P&L account	2017	2018	2019
Interest income	19,940	19,605	19,247
Interest expenses	-4,308	-4,225	-4,232
Net interest income	15,632	15,380	15,015
Net fee and commission income	4,365	4,639	5,075
Other (not specified above) operating income (net)	3,257	4,217	3,004
Gross income	23,254	24,236	23,093
Administration costs**	-9,758	-10,029	-10,427
Depreciation	-1,065	-1,078	-1,050
Provisions***	-107	-717	392
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)****	-4,998	-3,071	-4,496
Profit (loss) before tax	7,326	9,341	7,514
Net profit (loss)	6,555	8,353	6,685

** 1 EUR = 61.4856 MKD, as of 31.12.2019*
*** Administration costs include all operating expenses, except for depreciation.*
**** 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 2019 (in EUR)

Type of financial institution	Total own funds ***	Core Tier 1***	Tier 1***	Tier 2***	Tier 3
Commercial banks	1,071,277,524	966,870,723	972,736,962	98,540,562	/
Cooperative banks	/	/	/	/	/
Banking sector, total:	**1,071,277,524**	**966,870,723**	**972,736,962**	**98,540,562**	**/**

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

Macroeconomic environment in the country

Economic activity

In 2019, the GDP recorded an increase of 3.6%, lower than in 2018. The evolution of economic activity in 2019 was largely determined by domestic demand, both for consumption and investment. In this respect, household consumption was 3.0% higher than the previous year, and the gross fixed capital increased by 12.9%. Both the evolution of private consumption and that of investments were mainly supported by the increase in disposable income of the population during 2019. At the same time, economic growth is due to the 7.3% increase in exports compared to 2018. Final consumption of public administration contracted by 0.5% compared to the previous year. Imports in 2019 increased by 6.7% compared to 2018. In the sectors of the national economy, the gross added value in construction was 15.9% higher than in 2018. The commercial sector recorded an increase of 5.7%. Positive contributions to GDP dynamics were also generated by the increase in gross added value in industry and in information and communication sector. The evolution of the financial and insurance sector, as well as that of real estate transactions, has had a positive but modest impact on GDP growth. At the same time, net product taxes increased by 1.4% as compared to 2018. A negative impact on economic growth in 2019 was exercised by the dynamics of the agricultural sector.

Inflation

In 2019, the average annual inflation rate was 4.8%, being higher than in 2018. During 2019, the annual inflation rate had a pronounced upward trajectory. It increased from 0.9% in December 2018 to 7.5% in December 2019. The upward trajectory of the annual inflation rate was supported, according to estimates, by a positive aggregate demand. At the same time, at the beginning of 2019 the upward trajectory of the annual inflation rate was determined by some fiscal policy adjustments that accelerated core inflation, as well as the effect of a short base period in the first quarter of 2018 for regulated prices. Subsequently, this trend was supported by the depreciation of the national currency, as well as the effects of adverse weather conditions for some crops, which exerted inflationary pressures on food prices and a growing contribution by the end of the year from this subcomponent. In the third quarter of 2019, regulated prices generated additional pressures as a result of the adjustment of the electricity tariff. At the same time, towards the end of 2019, the above-mentioned inflationary pressures were partially mitigated by the atypical hot weather which delayed and diminished the impact of the positive seasonal effect characteristic of that period on food and fuel prices.

In 2019, the exchange rate of the Moldovan Leu has depreciated, on average, against the US dollar and the euro by 4.6% and 0.9% respectively. This dynamic was mostly driven by market sentiment amid the uncertainty related to parliamentary election cycle in the first part of the year and was temporary in nature - depreciation pressures have subsequently abated and the exchange rate has followed an appreciation path by the end of the year. In real terms, the Moldovan Leu has slightly appreciated, by 3.7%, against main trading partners' currencies.

In 2019, the central bank has intervened with insignificant net sales (USD 5 million). Meanwhile, the international reserves, already at robust levels according to commonly known reserve adequacy metrics, have increased by 2.2% up to USD 3.06 billion.

External sector

According to preliminary data, in 2019, the current account balance of the Republic of Moldova recorded a deficit of US$ 1 159,30 million, 4,3% lower as against 2018. The CAB to GDP ratio was -9,7% (-10,6 % in 2018). The source of the CA deficit was the external trade in goods, while other items recorded growing surpluses.

The trade deficit in goods and services totaled US$ 2 959,94 million, which is 0,9% larger than in 2018. The exports of goods and services amounted to US$ 3 650,85 million, up by 5,8%. Despite unfavorable developments in the prices of exported goods, their value increased due to the growth in physical volumes. The imports of goods and services amounted to US$ 6 610,79 million, increasing by 3,6%. The growth in imports was driven by increasing investment and households' final consumption, although in the second half of the year the growth rates of wages and retirement benefits decelerated. The prices of imported goods fell, however, the value of imports increased as a result of growing physical volumes.

The primary income surplus grew by 5,1% in 2019 as against 2018 and amounted to US$ 576,31 million. The compensation of resident employees by nonresident employers went up by 3,6%. At the same time, payments of dividends to nonresident direct investors increased by 29,4%, which had a downward impact on the primary income surplus.

The secondary income surplus amounted to US$ 1 224,33 million, up by 4,4% as compared to 2018. Personal transfers from abroad received by residents increased by 4,2%. The total amount of technical assistance and grants received by all sectors within current international cooperation grew by 22,7 % as against 2018.

Personal remittances (the sum of net compensation of employees, of personal transfers and of capital transfers between households) received by Moldovan residents in 2019 were estimated at US$ 1 812,44 million (+4,0% as against 2018), which represents 15,1% as a ratio to GDP (approximately the same as in 2018).

The capital account recorded a negative balance amounting to US$ 52,08 million, driven by capital outflows recorded by the private sector (US$ 73,01 million), while external assistance inflows received by the general government for the financing of investment projects totaled US$ 20,95 million).

The financial account recorded a net capital inflow of US$ 1 205,94 million in 2019, resulting from the net increase in residents' liabilities to nonresidents by US$ 694,37 million, along with the net decrease in residents' foreign financial assets by US$ 511,57 million.

Liabilities grew, in particular, as a result of the net increase in liabilities in the form of direct investment by US$ 593,01 million, which constituted 5,0% relative to GDP. Net equity inflows during 2019 amounted to US$ 426,93 million, the reinvestment of earnings was evaluated at US$ 76,00 million, and the net incurrence of debt from foreign direct investors – at US$ 90,08 million. At the end of 2019, the stock of external liabilities in the form of direct investment amounted to US$ 4 836,36 million.

External liabilities in the form of loans recorded net drawings amounting to US$ 58,90 million (drawings – US$ 518,57 million, repayments – US$ 459,67 million). In 2019, the general government (including local) made drawings on new loans amounting to US$ 149,26 million from the following main creditors: EIB – US$ 56,46 million, IMF – US$ 27,51 million, the European Commission – US$ 22,22 million, IDA – US$ 14,98 million, EBRD – US$ 13,55 million, IBRD – US$ 8,86 million, IFAD – US$ 3,59 million, CEB – US$ 2,10 million. The repayments made by the general government in the same year amounted to US$ 125,50 million. The NBM received US$ 18,48 million from the IMF and repaid US$ 55,38 million on previously contracted loans. Commercial banks made net repayments on external loans amounting to US$ 21,54 million, and other sectors – net drawings amounting to US$ 93,58 million.

Liabilities have also increased as a result of residents' net receipts of trade credits and advances from nonresident partners amounting to US$ 50,66 million.

The net decrease in financial assets was driven by the net reduction in currency and deposits assets by US$ 537,56 million (of which the assets of commercial banks increased by US$ 46,33 million and the assets of other sectors decreased by US$ 583,89 million). Another factor contributing to the decrease in total financial assets were the net repayments amounting to US$ 97,51 million made by nonresidents on trade credits and advances previously received from residents.

At the same time, the NBM's official reserve assets increased by US$ 60,49 million during 2019, which had an upward impact on total assets. At the end of 2019, the stock of reserve assets amounted to US$ 3 059,63 million and was sufficient by all adequacy criteria.

Residents' foreign assets in the form of direct investment increased by US$ 46,94 million, and in the form of loans extended to nonresidents – by US$ 11,52 million, in net value.

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

The share of bank assets to GDP has increased during 2019 by 3,5 percentage points, registering a value of 43,1 percent as of the end of December 2019. The above-mentioned evolution is due to the accelerated growth pace of the mortgage portfolio and the portfolio of loans granted to individuals. The share of big bank's assets has accounted for a little more than ¾ of the total system assets registered at the end of 2019.

Total own funds amounted to 11,363.0 million lei and during the year 2019 it recorded an increase of 5.7 % (612.2 million lei). The increase in equity was mainly due to the reflection by banks of the eligible profit.

The total own funds rate on the banking sector according to the data presented by the licensed banks recorded the value of 24.8%, decreasing by 1.2 pp. compared to the end of the previous year.

Assets on the banking sector according to the data presented by the licensed banks constituted 90,678.2 million lei, increasing by the end of the previous year by 7,463.2 million lei (9.0%).

At 31.12.2019, the gross loan portfolio constituted 44.5% of the total assets or 40,375.5 million lei, increasing by 13.9% (4,922.7 million lei) during 2019.

During 2019, the share of non-performing loans (substandard, doubtful and compromised) in total credits decreased by 4.0 pp. compared to the end of the previous year, constituting 8.5 percent as of 31.12.2019.

In the context of risk distribution, the largest share in the total loan portfolio was held by credits granted to commerce - 23.9% or 9,624.8 million lei, followed by the share of consumer credits - 16.9% (6,824.8 million lei) and the weight of loans for the purchase / construction of the real estate - 15.5% (6,239.1 million lei).

As of December 31, 2019, the profit for the year amounted to 2,259.9 bln. lei. Compared to the same period of the previous year, profit increased by 55.7 percent (808.3 million lei), largely due to the increase of non-interest income by 330.4 million lei (12.6%) and interest income by 204.3 million lei (4.7%). At the same time, non-interest expenses decreased by 211,3 million lei (5.3%) and interest expenses by 62,2 million lei (4.3%).

Return on assets and return on capital at 31.12.2019 constituted 2.5 percent and 14.6 percent respectively, increasing by the end of the previous year by 0.8 pp and 4.3 pp respectively.

Banks maintained liquidity ratios at a high level. Thus, the value of the long-term liquidity indicator (principle I of liquidity) constituted 0.7, being at the same level as the end of the previous year. Current liquidity by sector (principle II of liquidity) decreased by 4.0 pp, constituting 50.6%. It should be noted that the largest decrease in the structure of liquid assets during the year 2019 was recorded in liquid securities by 6.9%.

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

The banking system in the Republic of Moldova consists of two levels: the National Bank of Moldova and 11 licensed banks. The National Bank of Moldova regulates and supervises the banks in accordance with the Law on the National Bank of Moldova and the Law on banking activity, which provide the competence, main objective, basic attributions of the National Bank, its relationship with banks and other Competent Authorities, in the process of performing the supervisory function.

According to the Law on the National Bank of Moldova, the National Bank is exclusively responsible for the licensing, supervision and regulation of the banks and foreign banks' branches' activity. To that end, the National Bank is empowered:

a) to issue the necessary regulations and to take the proper actions in order to perform its powers and duties under this law, by way of licensing banks and elaborating supervision standards and establishing the way of implementing the regulations and measures mentioned above;

b) to perform, through its staff or other qualified professionals involved for this purpose, inspections over all banks, and to examine theirs books, documents and accounts, conditions in which the business is carried out and the compliance with the legislation;

c) to require any employee of the bank to provide the National Bank with the information necessary for the purpose of supervision and regulation of the banks' activity;

d) to prescribe to any bank, to its shareholders, to the members of the bank's management body, to the persons holding key positions within the bank, supervisory measures or to apply the sanctions and sanctioning measures foreseen in the Law on banking activity, if they have violated the provisions of the mentioned law, of the normative acts or other acts issued for its application;

e) to act as a resolution authority for the banks in accordance with the Law no.232/2016 on banks' recovery and resolution.

Therefore, in order to implement the provision of the Law no.202/2017 on banking activity, in the context of transposing the requirements of the Basel III capital agreement, during the 2019 year has been approved a number of normative acts applied to banks:

Regulation on large exposures (effective June 19, 2019) - sets the requirements for the calculation of the exposure value, the maximum allowable limits on the risk of concentration of the bank's exposures to a client or a group of connected clients, the concentrations in the portfolio of exposures, as well as requirements related to monitoring, managing and reporting on large exposures. The new requirements for large exposures have led to the need to make amendments to the Instruction on COREP reporting for banks, which contributes to the uniform and timely reporting by banks of information on exposures to a client or a group of connected clients and, respectively, to improve the supervision of the concentration risk of the bank's exposures.

Regulation on branches and secondary offices of banks (effective June 24, 2019) - provides the secondary regulatory framework related to opening branches in other states and simplifies the process of opening and closing branches and secondary offices in the country, which positively influences the expansion of banks in the territory.

Regulation on the licensing of the bank and the branch of a bank from another state (effective February 17, 2020) - imposes requirements on access to the activity of banks, including the licensing of banks and the regime of branches of banks from other states.

Thus, through a number of requirements provided through the normative acts, the National Bank of Moldova maintains the mechanism of supervision and regulation of banks' activity in the Republic of Moldova, based on international accepted principles.

Main strategic objectives of the supervisory authority in 2019

The development of banking supervision function remains an objective of strategic importance to the National Bank of Moldova. In order to strengthen the capacity in banking regulation and supervision field, the National Bank of Moldova undertakes a number of activities directed towards achieving the implementation of the requirements of Basel III. The National Bank of Moldova continues the drafting process of the normative acts (related to counterparty risk, CVA, LCR, leverage, consolidated supervision of banks, publishing information on the adequacy of own funds, Internal rating based approach on credit and market risk) in order to implement the provisions of the new Law on banking activity, in the context of harmonization of the national banking legislation with the international standards.

Additionally for 2019, supervisory priorities set by NBM are based on review of: shareholder transparency, corporate governance arrangements and, credit risk and large exposures and related parties framework, IT and AML risks.

The activities of the Banking Supervisory Authority in 2019

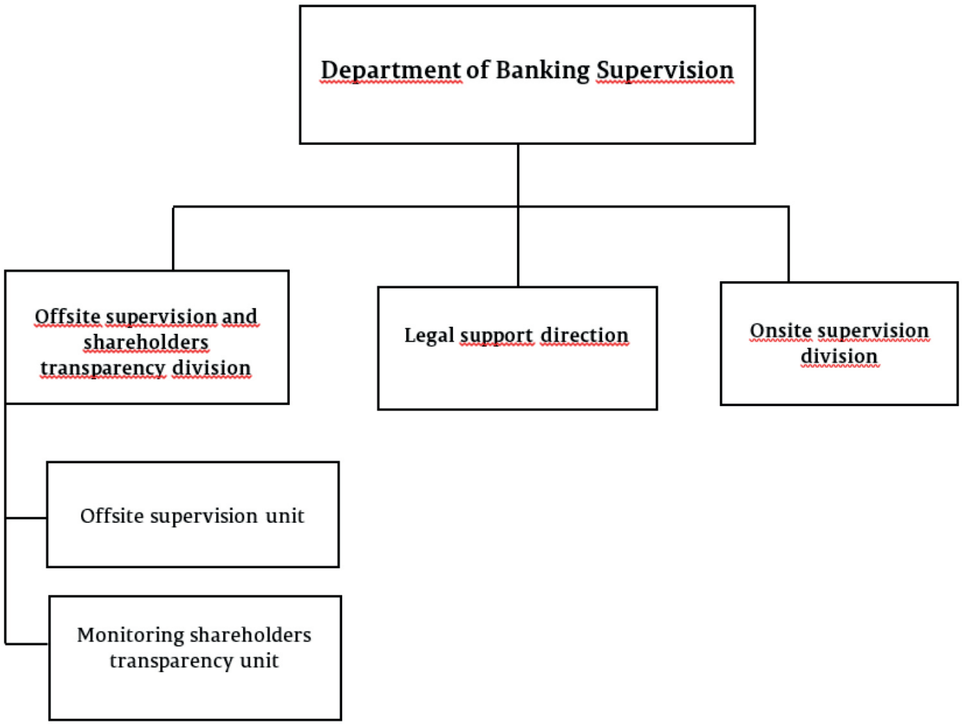
During 2019, the National Bank of Moldova (NBM) continued its efforts to ensure sound corporate governance and make the shareholding of the banking sector transparent in order to maintain a stable banking sector and reduce the risks to which banks are exposed.

During the 2019 year, a number of actions have been taken to maintain banking system stability and to ensure its further development. To this end, the National Bank of Moldova approved a number of normative acts, by transposing the provisions of the Directive 2013/36/EU and Regulation 575/2013, which implement the provisions of the international regulation framework Basel III.

In 2019, the NBM performed for the first time the supervisory review and evaluation process (SREP) for each bank, in order to determine the extent to which the bank's management framework, strategies, processes and mechanisms, own funds, and its liquidity ensures prudent management and adequate risk coverage in rapport with the bank's risk profile.

At the same time, the National Bank assessed all significant risks of the bank; reviewed and evaluated ICAAPs and stress tests; reviewed and evaluate compliance with the prudential requirements provided by Law no. 202/2017 and the provisions of normative acts issued by the National Bank; identified the current and potential problems, bank vulnerabilities and shortcomings in the bank's activity management and risk management framework. For the first time banks were obliged to maintain higher capital ratios (Pillar II).

Organizational chart of the Banking Supervisory Authority



International activities of the authority

In order to further strengthen the regulatory and supervisory framework of the Moldovan financial and banking system, the National Bank of Moldova (NBM) cooperates with international financial institutions, foreign central banks and other development partners (International Monetary Fund (IMF), European Union (EU), European Bank for Reconstruction and Development (EBRD), Group of Banking Supervisors from Central and Eastern Europe (BSCEE), etc.).

During the year 2019, cooperation relation between the Republic of Moldova and the IMF has mainly developed in the context of the implementation of the IMF supported Program through the EFF (Extended Fund Facilities) and ECF (Extended Credit Facilities) funding mechanisms, which was approved by the IMF Executive Board on 7 November 2016, in order to support the state's economic and financial reform agenda.

Thus, in the financial and banking sector, the Program aims at strengthening corporate governance, increasing shareholders' transparency, improving risk management frameworks, settling the issues originated from the related parties lending and streamlining the activity of the Central Securities Depositary.

In order to ensure further implementation of the Association Agreement (AA) between the Republic of Moldova and the European Union, authorities from the Republic of Moldova have advanced in the implementation of the actions reflected in the National Action Plan for the Implementation of the AA for 2017-2019, approved by the Government Decision no. 1472 as of December 30, 2016. This complex document is the basic instrument for monitoring, at the national level, the progress made in achieving the public commitments under the Association Agreement.

For the implementation of the EBRD Country Strategy for the Republic of Moldova (2017-2022), the NBM co-operates with the EBRD in order to improve governance and strengthen resilience of the banking sector by implementing sound practices and ensuring sustainable funding. In this respect, in 2019, the NBM collaborated with EBRD representatives by ensuring a continuous dialogue on the macroeconomic situation and the evolution of the banking system as a whole.

In 2019, the NBM maintained the dialogue with the World Bank, during which the NBM presented all the necessary information for the correct and objective assessment of the situation in the internal financial system, in order to make decisions to continue providing financing in various priority areas for the Republic of Moldova.

Following the positive assessment of the confidentiality regime applied by the Republic of Moldova in the field of banking supervision by the European Banking Authority (EBA) in 2018, in January 2019, the NBM acceded to the Memorandum of Cooperation concluded between EBA and banking supervisors in some countries of Southeast Europe. Thus, the Republic of Moldova is the first country in the Eastern Partnership to accede to this memorandum.

In addition, in 2019 the NBM initiated and conducted negotiations with the European Central Bank, the National Bank of Romania and the Central Bank of Hungary in order to conclude bilateral cooperation agreements.

As a member of the BSCEE, the NBM has continued to cooperate with BSCEE members, including on information and best practices exchange in the areas of banking regulation and supervision In this regard, during 21 - 24 May 2019, the NBM representatives participated at the BSCEE annual Conference on "Challenges of banking supervision in the digital age" and "An integral vision on prudential risks and money laundering".

In order to carry out the banking authorization function in accordance with the Law no.202/2017 on banking activity and normative acts of the National Bank in force in 2019, the NBM has provided the exchange of information with the following supervisory authorities: the Croatian National Bank, the National Bank of Romania, the Central Bank of the Russian Federation, the National Bank of Ukraine, Autorité de Contrôle Prudentiel et de Résolution France, Bulgarian National Bank, Bulgarian Financial Supervision Commission, Bank of Slovenia, the Bank of Albania, the Banking Agency of Republika Srpska, Central Bank of Hungary, the Magyar Nemzeti Bank, Banking Agency of the Federation of Bosnia and Herzegovina, Central Bank of Armenia, Banking Regulation and Supervision Agency of Turkey, the Bank of Lithuania, Financial and Capital Market Commission of Latvia.

In 2019, the NBM continued to receive the assistance of a high-level adviser for the financial sector in the context of the new EU High Level Adviser's Mission (EUHLAM) for the Republic of Moldova for the years 2019 - 2021. The High-Level Adviser provides policy advice to NBM in the field of banking supervision and the implementation of risk-based supervision, effective communication, as well as in order to facilitate cooperation of the NBM with various national and international authorities.

At the same time, in order to strengthen the knowledge of banking supervisors on the effective application of risk-based supervision and professional judgment, using the Supervisory Review and Evaluation Process (SREP), during the period of October 2019 – April 2020, the NBM was assisted by an EU medium-term expert for banking supervision assigned under the EUHLAM. Due to the support provided by the expert, the structure and content of the SREP reports of all banks in the Republic of Moldova was improved.

Through the European Commission's Technical Assistance and Information Exchange Instrument (TAIEX), in 2019, the NBM benefited from four short term expert missions on different components of SREP, aiming at strengthening the knowledge of the NBM staff in understanding, applying and complying with the EU legislation, as well as at exchanging best practices with institutions with similar responsibilities from the EU countries. This assistance was provided by the experts from the National Bank of Romania and the Bank of Lithuania.

Additionally, in the process of implementing the new micro-prudential banking supervision framework based on EU standards and Basel III standards, during the period 13-16 May 2019, the NBM hosted an expert mission from the central bank of the Netherlands (De Nederlandsche Bank). The knowledge gained in this mission contributed to the development of supervisors 'analytical and practical skills for identifying and assessment internal governance taking into account the appropriate and transparent corporate structure of banks and the banks' business models in terms of their viability and sustainability.

During the year 2019, the NBM hosted study visits by representatives of the Bank of Botswana and the National Bank of the Republic of Belarus in the field of Balance of Payments compilation and, respectively, in the transition to / and implementation of International Financial Reporting Standards in the banking sector and the central bank.

Cooperation with other supervisory bodies in the country

According to the legal framework in force and the bilateral agreements, the National Bank of Moldova cooperates with other supervising authorities from the Republic of Moldova. Thus, during 2019, in order to efficiently perform its functions, the National Bank of Moldova collaborated with the National Commission of the Financial Market of the Republic of Moldova.

In addition, the National Bank, for banking authorization, cooperates with other competent authorities, such as Office for Prevention and Combating of Money Laundering, National Anticorruption Center, Security and Intelligence Service, Office the Prosecutor General of the Republic of Moldova, and other.

Other relevant information and developments in 2019

In addition to the minimum own funds requirement, banks are obliged to maintain additional capital buffers. For the end of 2019, capital conservation buffer rate equaled 2,5%, countercyclical capital buffer rate for Republic of Moldova was established at 0% and systemic risk buffer rate for all banks was set at the level of 1% (depending on banks' shareholders structure systemic risk buffer rate of 3% applies for several banks). At the same time, buffer for other systemically important institutions (O-SIIs) was established for 4 largest banks (ranging from 0,5% to 1,5%).

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	7	6	6
Branches of foreign credit institutions	4	5	5
Cooperative banks	-	-	-
Banking sector, total:	**11**	**11**	**11**

Total assets of banking sector (mil. lei) (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	45,193.9	48,459.0	53,009.6
Branches of foreign credit institutions	34,270.9	34,756.0	37,668.6
Cooperative banks	-	-	-
Banking sector, total:	79,464.8	82,215.0	90,678.2
y/y change (in %)	9.1	4.7	9.0

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

Item	2017	2018	2019
Public sector ownership	0.0	0.0	0.0
Domestic ownership total	50.33	46.99	31.95
Foreign ownership	49.67	53.01	68.05
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	52.57	57.13	0.125
Branches of foreign credit institutions	34.56	41.54	0.050
Cooperative banks	-	-	-
Banking sector, total:	**87.13**	**98.67**	**0.175**

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

Type of financial institution	2017	2018	2019
Commercial banks	11.4	10.3	14.6
Cooperative banks	-	-	-
Banking sector, total:	**11.4**	**10.3**	**14.6**

**The information is presented for the banking sector (11 banks)*

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	75.11	58.23	58.46
Branches of foreign credit institutions	24.89	41.77	41.54
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables	5.23	6.05	5.79
Financial sector	31.30	33.20	31.78
Nonfinancial sector	38.12	41.40	45.18
Government sector	7.69	7.87	7.06
Other assets	17.66	11.48	10.19
Liabilites			
Financial sector	5.61	4.59	4.33
Nonfinancial sector	49.86	50.17	50.29
Government sector	25.31	26.11	24.99
Other liabilities	2.05	2.00	2.31
Capital	**17.18**	**17.13**	**18.08**

Capital adequacy ratio of banks (%)

Type of financial institution	2017**	2018**	2019**
[1]Commercial banks	31.3*	26.0***	24.8***
Cooperative banks	-	-	-
Banking sector, total:	**31.3***	**26.0*****	**24.8*****

1The information is presented for the banking sector (11 banks)

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

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

Asset classification	2017	2018	2019
Non-financial sector, including	18.38	12.54	8.49
- households	1.15	1.17	1.27
- corporate	17.23	11.37	7.22

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	98.54	96.1
Households	66.80	34.34
Corporate	31.74	61.75
Government sector	0.14	0.11
Financial sector (excluding banks)	1.32	3.80
Total	**100.0**	**100.0**

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

P&L account	**2017**	**2018**	**2019**
Interest income	231.31	220.46	234.06
Interest expenses	91.12	74.62	72.40
Net interest income	140.19	145.85	161.66
Net fee and commission income	53.02	54.39	59.58
Other (not specified above) operating income (net)	-12.30	-17.09	15.25
Gross income	462.61	440.93	468.12
Administration costs	87.14	108.44	117.45
Depreciation	12.53	14.19	22.36
Provisions	156.36	143.09	105.91
Profit (loss) before tax	83.35	84.32	131.38
Net profit (loss)	74.87	74.36	117.33

Total own funds in 2019 (in EUR)

Type of financial institution	**Total own funds**	**Core Tier 1**	**Tier 1**	**Tier 2**	**Tier 3**
Commercial banks	557.4***	-	552.0***	5.4***	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**557.4*** **	**-**	**552.0*** **	**5.4*** **	**-**

**The information is presented for the banking sector (11 banks)*
*(Please, mark for each item: * - for Basel I; ** - for Basel II; *** - for Basel III)*
As of December 31.12.2019, 1 EUR=19.2605 MDL.

Macroeconomic environment

Following a significant GDP growth of 5.1% in 2018, Monstat data show that Montenegrin economy recorded a growth of 3.6% in 2019. Preliminary Monstat data on quarterly GDP trends show positive rates in 2019 for all four quarters, with respective growths of 3%, 3.2%, 4.7% and 3.1% being recorded in Q1, Q2, Q3 and Q4.

After an average annual inflation of 2.6% in the previous year, consumer prices recorded significantly lower rates in 2019. Annual inflation in December in Montenegro, measured by CPI was 1% or 1.2% measured by the HICP (Harmonized Index of Consumer Prices) while the average annual growth rate was 0.4%

In 2019, according to Ministry of Finance`s preliminary data, total budget revenues with state funds amounted to 2.90 billion euros i.e. 59.2% of estimated GDP, with 64.9% (1.89 billion euros) referring to source revenues. Budget deficit of Montenegro was estimated at 143.6 million euros or 2.9% of GDP and it fell by 25.3 million euros compared to deficit from 2018 and by 53.4 million euros compared to the adjusted deficit from 2018 .

At end-2019, the net public debt of Montenegro, as per the Ministry of Finance data, amounted to 3.19 billion euros or 65% of estimated GDP for 2019. Compared to the end-2018, net public debt recorded an increase of 6.7%, but the potential risk was significantly reduced by fiscal consolidation measures.

The average number of employed persons amounted to 203,545 in 2019, thus being 7.1% higher than the average number of employees in the previous year. As per the Employment Agency's records, the number of registered unemployed persons averaged at 36,693 in 2019, which was 15.9% less than in the same period last year. The unemployment rate published by Employment Agency of Montenegro amounted to 16.21% in December 2019, recording a y-o-y decrease of 1.62 percentage points. The Labour Force Survey, published by Monstat on quarterly basis, shows that the highest unemployment rate in 2019 (15%) was recorded in the first quarter, while the unemployment rate amounted to 14.3% and 15.2% in the second and third quarter, respectively.

Monstat data showed that an average gross salary in Montenegro was 773 euros in 2019 and it increased by 0.9% in relation to the average salary in 2018. An average salary without taxes and contributions amounted to 515 euros, showing the year-on-year increase of 0.8%.

In 2019, current account deficit recorded a decline. Preliminary data indicate that the current account deficit amounted to 743.6 million euros or 15.2% of GDP, which is a decrease in relation to 792.8 million euros or 17% of GDP in 2018. The deterioration of the deficit predominantly came as a result of an increase in the surplus on the services account and secondary income account, which was not followed by a significant increase in the foreign trade deficit.

In 2019, net foreign direct investments in the financial account amounted to 344.7 million euros, recording the year-on-year increase of 6.9%, and accounting for 7% of GDP. These trends came as a result of a smaller outflow based on withdrawal of equity investments, as well as the repayment of intercompany debt, when compared to 2018. The total FDI inflow amounted to 769.9 million euros (or 10.3% less than in 2018), of which equity investments amounted to 412.3 million euros, while the inflow in the form of intercompany debt amounted to 321.7 million euros or 7.2% more than in 2018.

Banking system

At end-2019, there were 13 banks operating in Montenegro. During the year, bankruptcy was initiated in two non-systemic banks. Other banks in the system were adequately capitalized and highly liquid. The banking system is stable, profitable and has been recording positive trends.

In the one-year comparative period, key balance sheet items recorded growth: total bank assets 4.47%, loans (gross loans and receivables from banks and customers) 4.52%, total bank deposits (with funds on escrow accounts) 0.48%, while total capital increased by 16.95%. All asset quality parameters improved during 2019.

If we exclude the data referring to the two banks in bankruptcy from the aggregate data, for the sake of comparability, the key balance sheet positions of all 13 banks recorded growth in relation to end-2018. Thus, the total assets of banks increased by 11.35%, loans by 11.70%, total deposits by 8.02%, while total capital increased by 19.77%. The capital adequacy ratio at the aggregate level amounted to 17.73%, while in the same period last year it equalled 17.29%. At end-December 2019, the share of non-performing loans in total loans was 4.72%, while in the same period last year, their share was 5.24%. Past due loans decreased in the reporting one-year period.

During 2019, a total of 1.2 billion euros of new loans were approved, which is 4.95% more than in 2018. Banks' deposits exceeded the level of loans significantly, which resulted in the loans to deposits ratio of 0.88. The liquidity of banks during 2019 was satisfactory, although the liquid assets of banks decreased by 3.76% on an annual level. As at 31 December 2019, the share of liquid assets in total assets amounted to 20.79%.

Financial result on the aggregate level was positive. The banks recorded profit in the total amount of 50.6 million euros in 2019. At end-2019, twelve banks in the system operated with profit, while one bank reported negative financial result.

Banks' total capital amounted to 600 million euros at end-2019, recording the year-on-year increase of 87 million euros or 16.95%. The capital adequacy ratio at the aggregate level amounted to 17.73%, being significantly above the statutory minimum of 10%.

Total loans (gross loans and receivables from banks and clients) amounted to 3,061.8 million euros and show growth in relation to the previous year. In the maturity structure of total loans, long-term loans took the main share of 82.28%, while short-term loans accounted for 17.72%. The most significant loan beneficiaries (87.30%) were the nonfinancial sector, retail sector, and non-resident banks.

At end-2019, total deposits with banks (including funds in escrow accounts) amounted to 3,475.8 million euros or 0.48% more in relation to the previous year. Deposits by natural persons and entrepreneurs decreased by 4.03%, while corporate deposits increased by 5.65%.

Non-performing loans (excluding interest and accruals and prepayments) amounted to 142 million euros and they accounted for 5.05% of total loans at end-2019 (annual decline of 20.85%).

Change in regulatory framework

In March 2019, the Central Bank passed a Decision amending the Decision on Credit Registry, which provides the preconditions for a bank subject to bankruptcy or liquidation proceedings to fulfil the obligation to report to the Central Bank on its credit portfolio and its condition during the bankruptcy or liquidation proceedings.

After the Law on Voluntary Financial Restructuring of Debts towards Financial Institutions ceased to be valid at end-May 2019, in July 2019, the Central Bank passed a Decision amending the Decision on Minimum Standards for Credit Risk Management in Banks. These amendments ensured the alignment with the EU Regulation no. 680/2014 and the EBA Guidelines on management of non-performing and forborne exposures, which introduced new rules for determining and reporting NPLs, as well as for treating restructured loans, which will ensure full comparability of data on non-performing loans in the Montenegrin banking system with data of the EU member states.

In order to further maintain the stability of the financial system and sustainable financing of individuals, on 14 October 2019, the Central Bank adopted a Decision on macroprudential measures related to retail banking loans . This decision entered into force on 1 January 2020.

The new Law on Credit Institutions provided for the strengthening of capital requirements for banks, as well as the creation of a framework for new regulatory requirements related to liquidity and additional capital requirements for credit institutions of systemic importance. The Law on Credit Institutions was prepared during the year within the twinning project "Support to regulation of financial services" which also included the drafting of a set of bylaws that will provide for a full compliance with the Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and the Regulation (EU) 575/2013/EU on prudential requirements for credit institutions and investment firms, including most of its latest amendments. The project also covered the work on regulations governing capital adequacy, liquidity coverage ratios (LCRs), large exposures, bank reporting obligations, methodologies for ICAAP and SREP procedures, remuneration of bank employees, eligibility of governance body members and qualified shareholders, as well as the necessary documentation for the establishment of banks.

Law on Resolution of Credit Institutions ensured necessary compliance with the Directive 2014/59/EU (BRRD). This solution provides instruments for timely intervention in a troubled credit institution in order to ensure the continuation of its key functions whilst limiting the impact of the credit institution's failure on the economic and financial system to a minimum.

Law Amending the Bank Bankruptcy and Liquidation provided for necessary alignment with the BRRD and certain adjustments to the new Law on Credit Institutions. In this way, the new regulatory framework has been completed.

With a view to complying with the international accounting standard IFRS 16 Leasing, in December 2019, the Central Bank passed a Decision Amending the Decision on Chart of Accounts for Banks to be applied as of 1 January 2020.

Main strategic objectives of the supervisory authority in 2019

Activities of the Central Bank were focused on several important projects during 2019, primarily on harmonization with the legislation of the European Union and international standards, but also on the improvement of current solutions in order to overcome the problems and achieve positive effects for the economy as a whole.

In the framework of aligning the domestic regulations with EU regulations, the Central Bank continued to work on drafting of a set of bylaws that will provide full compliance with the Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and the Regulation (EU) 575/2013/EU on prudential requirements for credit institutions and investment firms, including most of its latest amendments. Emphasis has been placed on work on regulations governing capital adequacy, liquidity coverage ratios (LCRs) and large exposures.

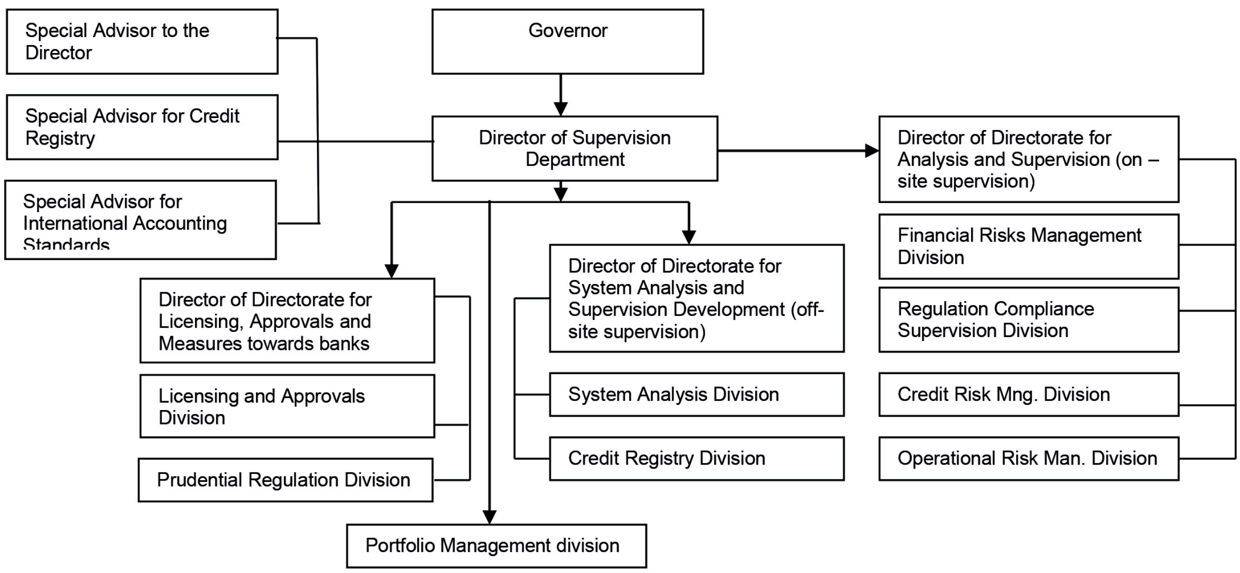
Activities of the Banking Supervisory Authority last year

During the reporting year, the CBCG continuously worked on the identification of potential risks and directed actions at maintaining stability of the banking sector.

Banking supervision in the reporting year focused on increasing the number of targeted over comprehensive inspections aimed at integrating the two in order to ensure continuous monitoring of risks in banks. In accordance with the risk-based supervision, the focus of targeted inspections was on capital adequacy, credit risk, income, liquidity, operational risk, and IT regulations, as well as acting on the CBCG`s supervisory measures. Targeted inspections ensured continued improvement of supervisory efficiency and the development of risk-based supervision, with the prevailing role of portfolio management access in the supervisory process. During 2019, seven regular targeted on-site inspections were carried out.

In 2019, due to irregularities in the operations, the Central Bank imposed measures against five banks to eliminate irregularities in their work, whereby two banks received a decision imposing the measures, two banks received written warnings, and one bank signed an agreement with the CBCG. Based on the findings of on-site inspections of two banks that revealed that both banks had been critically undercapitalized and insolvent, their licenses were revoked in the reporting year. The process of revoking the banks` licenses did not have any negative effects on the rest of the banking system.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

During 2019, the Central Bank continued its active participation in the process of Montenegro's accession to the European Union. As members of the working groups for negotiations for the chapters chaired by the Central Bank (4 - Free movement of capital, 9 - Financial services and 17 - Economic and Monetary Union), and in which it has a significant role (18 - Statistics and 32 - Financial Supervision), the representatives of the Central Bank participated actively in the work and preparation of documents and materials that are important for the successful continuation of the EU membership negotiations process.

The Central Bank continued to actively participate in the preparation of national strategic documents such as the Economic Reform Program for the period 2020–2022, the Programme of Accession of Montenegro to the EU 2019-2020, and contributions to the European Commission's Annual Report on Montenegro.

Representatives of the Central Bank participated in the meetings of the bodies established to monitor the implementation of contractual obligations under the Stabilization and Association (SAA) Agreement. Thereby, during 2019, experts of the Central Bank participated in the preparation of materials for the meetings of Sub-committee for Internal Market and Competition, Sub-committee for Economic and Financial Issues and Statistics, and of the Stabilisation and Association Board. Moreover, the representatives of the Central Bank participated in the ministerial conference within the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey held in May 2019.

The representatives of the ECB and the EC visited the Central Bank during 2019. Also, senior management of the Central Bank continued the High Level Dialogue with the ECB conducted annually with central banks of the EU candidate countries that started the negotiation process.

It continued activities within the twinning project titled "Support to Regulation of Financial Services", to be financed from IPA 2014. The Project is implemented in cooperation with the consortium consisting of Bundesbank, Croatian National Bank, De Nederlandsche Bank, German Federal Financial Supervisory Authority (BaFin), and Croatian Financial Services Supervisory Agency (HANFA).

Moreover, the regional project titled "Programme for Strengthening the Central Bank Capacities in the Western Balkans with a view to the Integration to the European System of Central Banks", managed by the Deutsche Bundesbank with the ECB support and including 17 national central banks, started in 2019. The programme aims at strengthening monetary and financial stability in the region, and the preparation of beneficiary institutions to the future membership in the ESCB.

The Central Bank's cooperation with the World Bank group in 2019 was marked by many activities of the Central Bank in meeting the conditions for the approval of the second policy-based guarantee in the area of fiscal and financial resilience (PBG2).

Cooperation with other supervisory authorities in the country

In 2019, the Central Bank continued successful cooperation with other regulators in the country, which is based on the regular exchange of information in accordance with the objectives defined in the concluded bilateral agreements and MoUs, and which largely relate to the exchange of information regarding the acquisition of qualified participation with financial market participants and AML/TF information.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	15	15	15
Branches of foreign credit institutions	0	0	0
Cooperative banks	0	0	0
Banking sector, total:	**15**	**15**	**15**

Total assets of banking sector (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	4182130	4406813	4603931
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	4182130	4406813	4603931
y/y change (in %)	10.34	5.37	6.61

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	-	-	-
Domestic ownership total	26.99	20.43	19.73
Foreign ownership	73.01	79.57	80.27
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	42.4	66.08	1091
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**42.4**	**66.08**	**1091**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	6.98	4.87	8.66
Cooperative banks	-	-	-
Banking sector, total:	**6.98**	**4.87**	**8.66**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
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	2017**	2018**	2019**
Commercial banks	16.37	15.63	17.73
Cooperative banks	-	-	-
Banking sector, total:	**16.37**	**15.63**	**17.73**

*(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	2017	2018	2019
Non-financial sector, including	96.6	98.4	99.8
- households	28.8	35.7	37.7
- corporate	67.6	59.2	62.0

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	91.73	83.29
Households	50.24	44.74
Corporate	39.67	38.22
Government sector	5.23	8.41
Financial sector (excluding banks)	1.51 (0.84)	8.30 (0.48)
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	159759	168297	173390
Interest expenses	34907	29216	22247
Net interest income	124849	139081	151140
Net fee and commission income	41813	40197	35339
Other (not specified above) operating income (net)	21743	19854	18509
Gross income	188844	276337	278286
Administration costs	114341	116201	121785
Depreciation	9656	10199	10700
Provisions	21939	16561	10582
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)			
Profit (loss) before tax	37089	31238	53574
Net profit (loss)	35077	27270	48652

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	456262	-	466031	32821	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**456262**	**-**	**466031**	**32821**	**-**

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

Macroeconomic environment in the country

Poland's GDP growth throughout 2019 amounted to 4.0% (according to Statistics Poland[1], compared to 5.1 % in 2018 and 4.8% in 2017). Thus, despite the slight weakening of the economic growth rate recorded in previous years, it was still high compared to other European countries, which indicates the resilience of the Polish economy to the global slowdown (in particular in the first half of the year). In 2019, similarly as in previous years, the main drivers of the national GDP growth were private consumption supported by the favourable labour market situation and increasing household incomes, as well as investments in tangible assets related to the implementation of infrastructure projects co-financed by EU funds. The payment of social benefits was also a factor in boosting consumer demand over 2019.

The domestic labour market continued its positive trend, with the officially recorded unemployment rate declining to 5.2% at the end of 2019 (from 5.8% at the end of 2018). Similarly, the seasonally-adjusted unemployment rate measured according to the BAEL method (Polish Labour Force Survey) fell from 3.7% at the end of 2018 to 2.9 % at the end of 2019.

The average annual inflation measured by consumer price index (CPI) in 2019 was 2.3% compared to 1.6% in 2018. The increase in inflationary pressures over 2019 was influenced by both supply factors (an increase in food prices) and the base component, i.e. the rising labour costs. The Monetary Policy Council (MPC) maintained in 2019 the NBP interest rates at the unchanged level of March 2015 (the reference rate of 1.5%). According to the MPC, such level of interest rates was conducive to maintaining the Polish economy on a sustainable growth path and allowed to maintain macroeconomic balance.

The cumulative balance of the current account from the previous twelve months amounted to PLN 25.4 billion in December 2019 (compared with PLN 21.7 billion in December 2018). Differences compared to the previous year were noticed mostly in the area of commodity trade, whose balance was higher by PLN 30.9 billion than in the same period of the previous year.

According to data for January and December 2019, the budget deficit was under-implemented (47.9% of the annual plan) and the deficit reached PLN 13.7 billion. The budget revenues were implemented in 103.3% and amounted to PLN 400.6 billion. The expenses were implemented in 99.5% and amounted to PLN 414.2 billion.

Compared with the previous year, no major changes in the value of the Polish Zloty (PLN) against main currencies were seen in 2019. At the end of the year, the average PLN/EUR exchange rate was 4.26 compared to 4.3 at the beginning of the year, the average PLN/CHF exchange rate was 3.92 (compared to 3.82) and the average PLN/USD exchange rate was 3.8 (compared to 3.76). At the end of 2019, the interest rate on 10-year Treasury bonds amounted to 2.1% and was lower than the year before (2.81%).

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

At end of 2019, the PFSA supervised 30 commercial banks (including 1 state development bank and 2 affiliating banks), 2 institutional protection systems, 538 cooperative banks, and 32 branches of credit institutions. In 2019, the Board approved the merger processes for ten cooperative banks.

The balance sheet total of the banking sector at the end of December 2019 amounted to PLN 2 000.1 billion and was higher than in the previous year (December 2018) by approx. 5.6% (PLN 1 893.7 billion). Domestic commercial banks (with foreign branches) account for 89.0% of the sector's assets, branches of credit institutions account for 3.5% and cooperative banks account for 7.5%.

[1] https://stat.gov.pl/en/topics/national-accounts/annual-national-accounts/gross-domestic-product-in-2019-preliminary-estimate,1,9.html

In the structure of assets, 67.0% (PLN 1 340.7 billion) were loans and other receivables, 17.1% (PLN 341 billion) were available-for-sale financial assets, 1.3% (PLN 26 billion) were held-for-trading financial assets and 5.8% (PLN 116 billion) were cash, cash at central banks and other demand deposits. As for liabilities, deposits accounted for 74.4% of total liabilities (PLN 1 487.4 billion), and equity for 10.5% (PLN 209.8 billion).

An important component of the banking sector's assets is housing loans, including loans denominated in Swiss franc (CHF) or indexed to this currency. In 2019, for another year, there was a clear decrease in the volume of loans in CHF; their sum decreased from CHF 27.5 billion at the end of December 2018 to CHF 25.0 billion at the end of December 2019, i.e. a decrease of 8.9% and 33.2% over the next five years (from CHF 37.4 billion at the end of December 2014). At the same time, the quality of housing loans, including those denominated in CHF, remains good: in 2019 it was at a level similar to 2018, and the share of non-performing loans in the portfolio of housing loans was the lowest of all loan portfolios.

The net financial result of the banking sector in 2019 amounted to PLN 13.8 billion and was higher than in 2018. In 2019, 16 commercial banks and 8 branches of credit institutions paid a total of PLN 4.1 billion on account of the banking tax.

The structure of the banking sector in terms of the origin of capital has not changed in comparison to 2018. Polish capital controls over half of the sector's assets, of which the share of private investors is approx. 14%.

The Polish banking sector assets in relation to the Polish GDP is at level close to 90%. Whereas the domestic financial system's assets to GDP ratio at the end of 2019 was 124%.

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

The Board of the Polish Financial Supervision Authority (hereinafter: 'the Board') operates under the *Act of 21 July 2006 on financial market supervision*[2], (hereinafter 'the Act'). Under the Act, the Board is competent for supervision of the financial market, which under the legal framework as at 31 December 2019 included: banking supervision, pension supervision, insurance supervision, capital market supervision, supervision of payment institutions, payment service offices, electronic money institutions, branches of foreign electronic money institutions, supervision of credit rating agencies, supplementary supervision of credit institutions, insurance undertakings, reinsurance undertakings and investment firms in a financial conglomerate, supervision of credit unions and the National Association of Credit Unions, mortgage credit intermediaries and their agents, as well as supervision to the extent specified in the *'BMR Regulation' (EU Regulation 2016/1011)* and supervision to the extent specified in the *'STS Regulation' (EU Regulation 2017/2402)*. The purpose of supervision of the financial market is to ensure its proper functioning, stability, security and transparency, confidence in the financial market, and to ensure that the interests of market participants are protected. Under the Act, that purpose is also to be achieved through reliable information concerning the functioning of the market, through the pursuit of objectives stated, in certain legal acts.

[2] On 15 February 2019, the consolidated text of the Act was announced (Journal of Laws, item 298), which included, inter alia, amendments that became effective on 1 January 2019, announced in the Journal of Laws 2018, items 2215 and 2243. The amendments to the consolidated text in 2019 were announced in the Journal of Laws, items 326, 730, 875, 1571 and 2217.

Since 1 January 2019, the supervisor has been functioning in a new legal form - as of 1 January 2019 the Polish Financial Supervision Authority (Polish: Urząd Komisji Nadzoru Finansowego) has been established as a state legal entity composed of the following bodies:

(I) the Board ('Komisja Nadzoru Finansowego'), competent for matters relating to supervision over the financial market; and
(II) the Chair of the Board (Polish: 'Przewodniczący Komisji'), who shall manage the activities of the Polish Financial Supervision Authority and represent the Authority externally.

Thus, in line with the provisions of the Act, the supervision over the financial market is formally entrusted to the Board. However, as the Board is a body of the Polish Financial Supervision Authority, please note that – in a broader sense and in line with further legal arrangements - the day-to-day supervisory activities are conducted by the Polish Financial Supervision Authority (under the management of the Chair of the Board), whereas the Board is a decision-making body, with full competencies for matters relating to supervision over the financial market.

Since 15 December 2018 the Board has operated as an expanded team of twelve members (the Board had the following composition: Chair, two Deputy Chairs, and nine members). Another amendment to the Act, which took place in October 2019, made it possible to extend the composition of the Board to include a third Deputy Chair of the Board.

In 2019, the structure of the PFSA changed substantially. On 1 April 2019, new Statutes of the PFSA entered into force. The idea behind the creation of the new structure was a more efficient distribution of existing responsibilities as well as the efficient fulfilment of new tasks within the newly created organisational units. The new structure introduced a function of Director-General, who is responsible for ensuring the operation and continuity of the PFSA's activities as well as organising work, in particular by preparing the draft PFSA's financial plan and by supervising the implementation of that plan. Departments were structured into Divisions, led by the managing directors – i.a. the Banking Supervision Division has been created - which allows for a better coordination and more comprehensive approach to the day-to-day supervisory challenges.

Changes have been made to the way the PFSA is financed, which may manage its funds more efficiently and independently. From 2019, the PFSA is financed directly from the fees paid by supervised financial market entities.

New departments have been created: the Compliance Department and the Internal Audit Department. The key task of the former is to strengthen, develop and maintain the confidence in the PFSA by building the organisational culture based on the rule of law and compliance with internal rules and ethical principles. The Compliance Department performs its tasks by providing advice on the management of potential conflicts of interest among staff members, ensuring the right education and communication in the area of compliance, and tackling the risk of corruption. The tasks of that department also include the effective management of the risk of non-compliance of the PFSA's activities with the law, the standards for supervisory authorities and the internal rules, and the performance of the Board's tasks arising from the Act on the prevention of money laundering and terrorist financing. The Internal Audit Department is tasked with internal control at the PFSA, in particular by reviewing the tasks falling within the remit of the organisational units under its control, the committees, councils and teams, according to the subject of the audit, and by reviewing the efficiency of the existing control mechanisms.

The PFSA's activities in the area of cybersecurity are also worthy of note: the newly established Cybersecurity Department has significantly strengthened and expanded supervisory powers.

Main strategic objectives of the supervisory authority in 2019

In 2019 the activities of the Board (and subsequently - the PFSA) focused primarily on the objectives set out by the Act i.e.: ensuring the proper functioning of the financial market, its stability, security and transparency, confidence in the financial market, and ensuring that the interests of market participants are protected. Despite the changes in the supervisory structure implemented in 2019, no changes have been made to the principles of supervision of the financial market. As under the law effective before 1 January 2019, the Board continues to exercise all powers relating to the supervision of the financial market and the transitional provisions have maintained in force all supervisory activities, administrative decisions, recommendations and guidelines issued by the Board before 1 January 2019.

The activities of the Banking Supervisory Authority in 2019

In 2019, the supervisory activities in the banking sector covered the full supervisory process, including the licensing process, the off-site supervision and the inspection activities carried out on-site (which comprised: i. targeted inspections, ii. comprehensive inspections and iii. preliminary investigations).

The intensive monitoring of the economic and financial situation of commercial and cooperative banks has been carried out, as well as the tasks related to analytical and day-to-day supervision in relation to the activities of credit unions, payment institutions, electronic money institutions, payment service offices, account information service providers, and mortgage intermediaries.

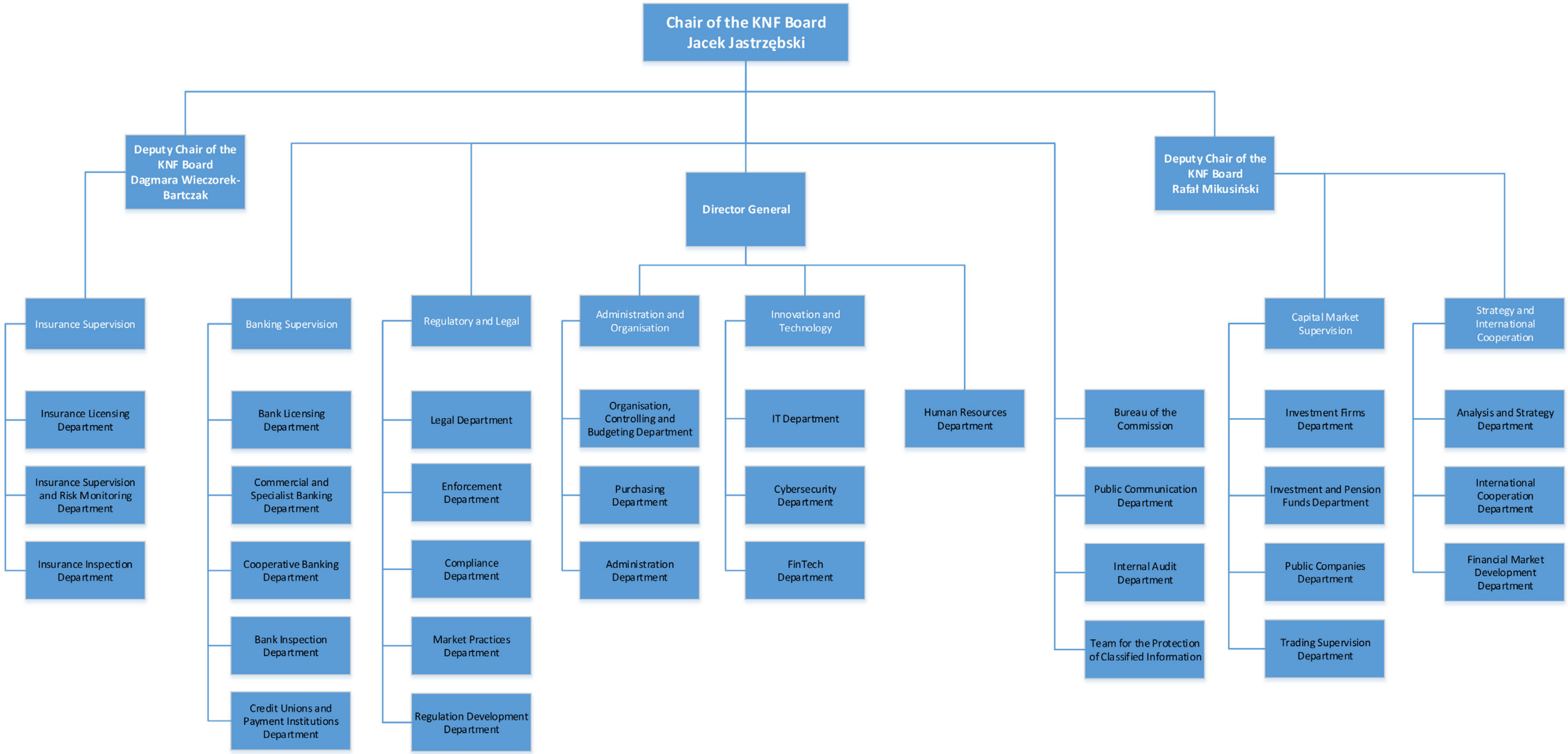
On the basis of in day-to-day monitoring and quarterly review of the economic and financial standing of banks, quarterly bank ratings were assigned in the KOBRA system. In 2019, all commercial banks were assessed. 194 quarterly analyses of commercial banks were drawn up. In 2019, the process of cyclical review and supervisory assessment of cooperative and affiliating banks continued. 2 182 quarterly analyses of cooperative banks and 8 quarterly analyses of affiliating banks were drawn up. In addition to the quarterly assessment, banks were subject to a review as part of the SREP (Supervisory Review and Evaluation Process). The SREP conducted by the PFSA takes into account, in a complementary and consistent manner, the findings from on-site analyses and on-site inspections carried out by the supervisory authority at the banks. The intensity of the SREP at individual banks depends primarily on the overall SREP score assigned in the previous SREP cycle and the results of categorisation process. The SREP methodology involves periodic updates of the SREP score as part of quarterly off-site analyses, and a dialogue between the supervisory authority and banks. Similarly as in previous years, the SREP also took into account the results of ad hoc reviews conducted by the supervisory authority, e.g. in the form of surveys. In 2019, commercial banks were given 27 final SREP ratings, while cooperative banks were given 538 final SREP ratings.

The consolidated financial statements of banks, the economic and financial situation of holding companies and parent undertakings of banks were analysed as part of the consolidated supervision. As part of day-to-day analytical supervision, banks were selected for comprehensive and targeted inspections, and then the information was passed to the organisational units of the UKNF responsible for inspection activities.

In 2019, for the tenth time, the PFSA conducted stress tests for the banking sector. The purpose of the tests was to determine the potential impact of changes in the macroeconomic environment on the financial and capital situation of the Polish banking sector institutions and to assess the sector's resilience to shock. Commercial banks accounting for 86% of the sector's assets participated in the stress test exercise. The published results indicate high resistance of the banking sector to hypothetical market shocks as well as its good capitalisation. The PFSA also conducted the first edition of supervisory liquidity stress testing. The purpose of the liquidity stress testing was to analyse the sensitivity of banks' short-term liquidity position, to verify the banks' liquidity buffers, and to estimate possible shortages of liquid assets to the levels required under the LCR standard.

Organizational chart of the Banking Supervisory Authority

the Polish Financial Supervision Authority



International activities of the authority

In 2019, the PFSA continued its active participation in the international supervisory bodies, both on the EU as well as on the international level, including EBA, ESMA, EIOPA, ESRB, IOSCO, IAIS and IOPS. With the considerable involvement of foreign capital groups in the ownership structure of financial institutions in Poland, the international supervisory cooperation remains a vital element of the efficient supervision, and serves – in a broader perspective - the implementation of the PFSA's supervisory objectives.

The European System of Financial Supervision (ESFS) remains particularly important field of international activities – as the key laws setting the framework for the functioning of financial institutions are adopted at the EU fora. In 2019 the day-to day involvement of the PFSA employees in the activities of the European Banking Authority (EBA) remained crucial from the banking supervision perspective.

In 2019 the PFSA employees participated in numerous supervisory colleges, including banking and insurance groups. The PFSA maintains close contact with supervisors from other countries. The bilateral cooperation is facilitated by the memoranda of understanding that the KNF signed with 62 foreign supervisory authorities (beside multilateral agreements within ESMA, IOSCO and IAIS). In 2019, a memorandum was signed with the Astana Financial Services Authority (AFSA) — the financial supervisory authority in the Republic of Kazakhstan, competent for the Astana International Financial Centre (AIFC).

The PFSA's international activities also take the form of deepening cooperation within Central and Eastern Europe, whose supervisors, due to the characteristics of emerging markets, often identify convergent interests and therefore present similar positions.

Cooperation with other supervisory bodies in the country

The Board takes part in the works of the Financial Stability Committee (KSF) – a body comprising: (i) The Board, (ii) the National Bank of Poland, (iii) the Ministry of Finance and (iv) the Bank Guarantee Fund. The KSF is responsible for both: (1) macroprudential supervision and (operating under the chairmanship of the President of the NBP), and (2) crisis management in the financial system (operating under the chairmanship of the Minister of Finance).

In 2019, the UKNF continued its cooperation – in the area of prevention of money laundering and terrorist financing - with the General Inspector of Financial Information (GIFI). The cooperation covered in particular: (i) notification of transactions that might be related to money laundering or terrorist financing, (ii) reporting irregularities identified at supervised institutions in the course of ongoing analysis, and (iii) exchange of information on the plans and results of inspections at obliged institutions.

The statutory tasks of the KNF included also participation in the process of drafting laws regulating supervision over the financial market.

Other relevant information and developments in 2019

In 2019 the Board revised the list of O-SIIs (Other Systemically Important Institutions) and the buffer rates imposed on identified O-SIIs. Following the review, the Board confirmed the identification of nine banks as O-SIIs and ceased to recognise two banks as O-SIIs. On that basis, the Board also decided to set appropriate buffer rates, ranging from 0.1% to 1.0%. The list of the identified entities is subject to annual review (under the Act of 5 August 2015 on macroprudential supervision) and, if necessary, the buffer rates are adjusted accordingly.

In 2019, the Financial Sector Assessment Program (FSAP), initiated in 2017 by the IMF and the World Bank was completed. The Polish supervisor was strongly involved in the process. The FSAP measurable outcome is the elaboration, by the IMF and World Bank, of a series of reports on regulatory and supervisory issues and the situation of financial markets in Poland. In 2019 selected reports summarising the FSAP mission were published.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	35	32	30
Branches of foreign credit institutions	28	31	32
Cooperative banks	553	549	538
Banking sector, total:	**616**	**612**	**600**

Total assets of banking sector (at year-end, in PLN)

Type of financial institution	2017	2018	2019
Commercial banks	1,601,975,006,108.0	1,689,645,807,178.0	1,780,157,094,516.0
Branches of foreign credit institutions	44,822,832,110.0	65,844,638,264.0	69,290,186,151.0
Cooperative banks	129,987,617,816.0	138,252,091,690.0	150,683,982,905.0
Banking sector, total:	**1,776,785,456,034.0**	**1,893,742,537,132.0**	**2,000,131,263,572.0**
y/y change (in %)	4.1%	6.6%	5.6%

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	39.9%	39.5%	40.0%
Domestic ownership total	14.6%	13.6%	13.7%
Foreign ownership	45.5%	46.9%	46.3%
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	38.9%	56.3%	879
Branches of foreign credit institutions	42.2%	53.8%	874
Cooperative banks	5.6%	7.9%	41
Banking sector, total:	**34.7%**	**50.1%**	**778**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	7.0%	6.6%	6.9%
Cooperative banks	5.3%	5.2%	5.3%
Banking sector, total:	**6.9%**	**6.5%**	**6.7%**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	90.2%	89.2%	89.0%
Branches of foreign credit institutions	2.5%	3.5%	3.5%
Cooperative banks	7.3%	7.3%	7.5%
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables	73.0%	76.0%	76.1%
Financial sector	8.5%	9.3%	9.4%
Nonfinancial sector	58.8%	58.3%	57.4%
Government sector	5.6%	8.4%	9.3%
Other assets	27.0%	24.0%	23.9%
Liabilites	88.5%	89.2%	89.5%
Financial sector	20.3%	19.2%	17.5%
Nonfinancial sector	60.2%	61.2%	63.5%
Government sector	3.9%	4.4%	4.3%
Other liabilities	4.1%	4.4%	4.3%
Capital	**11.5%**	**10.8%**	**10.5%**

Capital adequacy ratio of banks ***

Type of financial institution	2017**	2018**	2019**
Commercial banks	19.1%	19.1%	19.2%
Cooperative banks	17.1%	17.6%	17.7%
Banking sector, total:	**19.0%**	**19.0%**	**19.1%**

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

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

Asset classification	2017	2018	2019
Non-financial sector, including	6.8%	6.9%	6.6%
- households	6.1%	5.9%	5.7%
- corporate	8.3%	8.7%	8.5%

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	89.7%	80.8%
Households	66.4%	52.8%
Corporate	23.3%	28.0%
Government sector	6.1%	13.2%
Financial sector (excluding banks)	4.2%	5.9%
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	58,166,712,522.0	60,469,041,317.0	66,022,968,849.0
Interest expenses	15,547,805,784.0	15,648,748,941.0	16,907,276,786.0
Net interest income	42,618,906,738.0	44,820,292,376.0	49,115,692,063.0
Net fee and commission income	13,764,340,455.0	12,306,064,352.0	13,363,382,715.0
Other (not specified above) operating income (net)	6,462,237,688.0	5,932,969,509.0	6,018,257,058.0
Gross income	64,013,936,822.0	64,565,071,939.0	70,626,941,555.0
Administration costs	33,061,446,870.0	33,460,788,440.0	34,817,944,012.0
Depreciation	2,948,772,868.0	2,905,062,296.0	4,429,097,988.0
Provisions	728,351,247.0	628,854,192.0	2,406,030,624.0
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	8,860,257,961.0	9,430,478,468.0	9,565,562,761.0
Profit (loss) before tax	18,423,093,524.0	18,222,628,307.0	19,324,285,511.0
Net profit (loss)	13,686,623,999.0	13,046,230,072.0	13,806,338,524.0

Total own funds in 2019 (in PLN)***

Type of financial institution	Total own funds	Core Tier 1	Tier 1***	Tier 2***	Tier 3
Commercial banks	49,255,649,236.12	44,050,077,722.20	44,056,787,390.63	5,198,861,845.49	-
Cooperative banks	41,403,420,614.07	41,272,171,785.14	41,273,886,878.01	129,533,736.06	-
Banking sector, total:	**90,659,069,850.18**	**85,322,249,507.34**	**85,330,674,268.64**	**5,328,395,581.54**	**-**

Macroeconomic environment

In a global environment marked by the slowing expansion of economic activity, Romania's economic growth stood at 4.1 percent in 2019. In the context of the loose income policy and persistent structural labor shortage, the further above-potential increase in domestic absorption was chiefly ascribable to private consumption. However, investment also made a positive contribution in 2019, supported primarily by the private sector.

The growth of imports at a faster pace than exports, which were depressed by the flagging external demand, had a strong impact on Romania's industrial production, which contracted in 2019 for the first time in a decade. Against this background, the current account deficit widened to 4.6 percent of GDP.

In December 2019, the public debt-to-GDP ratio was 35.2% (standard European methodology) below the threshold of the European Commission's assessment procedure of 60% of GDP, domestic debt accounted for 18.9% of GDP, and external debt was 16.3% of GDP.

The annual inflation rate stood at 4 percent at end-2019 (versus 3.3% at the end of 2018). Ever since early 2019, the annual inflation rate followed an upward path, as a result of developments in exogenous components (products with highly volatile prices, tobacco) and of the impact of the new tax levied on telecom companies, to which added thereafter the effects of higher international prices of some agri-food commodities. At the same time, given the more expansionary fiscal and income policies, combined with labor market tensions, inflationary pressures continued to come from the persistence of excess aggregate demand and developments in wage costs.

As at 31 December 2019, Romania's international reserves amounted to EUR 37,45 billion, up by EUR 650 million from end-2018 (amid the increase in the value of gold reserves by EUR 789 million, following the upswing in the gold price on the international market, and the decline in the foreign currency reserve by EUR 139 million).

Development in the banking sector

During 2019, the number of credit institutions operating in Romania remained unchanged (27 banks, Romanian legal entities and 7 branches of foreign banks). Against the background of the changes registered in the credit institutions shareholder structure, the market share held by credit institutions with domestic capital reached 33.2% on December 31, 2019, while credit institutions with majority foreign capital, including branches of foreign credit institutions continued to decline up to 66.8%.

Prudential indicators continue to post adequate levels in 2019 as well, that point out the banking sector's capacity to withstand adverse developments. In this respect, the total capital ratio indicated an improvement from end-2018, by 1.3 percentage points, from 20.7% in 2018 to 22.0% in 2019. The structure of own funds entails a good loss absorption capacity of banks, considering that total own funds consist primarily of Tier 1 capital and Common Equity Tier 1 (both around 91 percent as of December 2019).

The liquidity of the banking sector stands at comfortable levels. The balance sheet composition helps improve credit institutions' liquidity position. The loan-to-deposit ratio for the private sector is below one, and bank funding is dispersed and stems chiefly from retail deposits taken from households in particular. As of 31 December 2019 the average liquidity coverage ratio across the banking system was 242.6 percent, significantly above the minimum requirements, pointing to sufficient high-quality liquid assets in a 30-day stress scenario.

The quality of bank assets continued to improve in 2019 as well. The NPL ratio, reached 4.1% in December 2019, both because of the significant reduction in non-performing exposures (-11%) and growth of total exposures (+8%). Moreover, NPL coverage ratio for the banking sector further followed an upward trend, rising by 2.2 percentage points, from 58.5% in December 2018 to 60.7% in December 2019.

As for banks' profitability, return on assets (1.3 percent) and return on equity (12.2 percent) decreased slightly over the previous year (due also to expenses related to the introduction of the tax on bank assets), their levels remaining adequate, albeit not excessive.

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

The National Bank of Romania is the competent authority for the regulation, licensing, prudential supervision and resolution of credit institutions, and shall monitor the activities of credit institutions, as well as, where it is the authority responsible for supervision on a consolidated basis, the activities of financial holding companies and mixed financial holding companies, for the provisions applicable to them, so as to assess compliance with the prudential requirements of the Banking Law, of Regulation (EU) no.575/2013 and of the applicable regulations. Credit institutions are mainly regulated by the Banking Law and by Regulation No. 575 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 and, among others, by the Law No. 85/2014 regarding the procedures for the prevention of insolvency and the insolvency procedures. The NBR Regulation No. 5/2013 on prudential requirements for credit institutions, as amended and supplemented, ensures the transposition of the provisions of Directive 2013/36/EU and specifies the manner in which the national options included in the CRD IV package have been exercised. Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms ("BRRD") was transposed into Romanian legislation by Law No. 312/2015, which establishes the domestic grounds for the recovery and resolution of credit institutions. Moreover, beginning with the CRD IV/CRR and BRRD implementation, credit institutions are required to observe the EC's implementing regulations laying down technical standards, directly applicable in all Member States, including also those related to the reporting field.

During 2019 the European regulatory framework for resolution (Directive 2014/59/EU and Regulation (EU) No 806/2014) was supplemented with the publication in the Official Journal of the European Union of 7 June 2019 of the RRM Package (the Risk Reduction Measures Package), which also includes changes to two other essential legal acts on risk reduction (Directive 2013/36/EU and Regulation (EU) No 575/2013). The implementation of the RRM Package is an important step forward towards completing the Economic and Monetary Union, which will also ensure, apart from risk reduction, the strengthening of banks' ability to withstand potential shocks, through better capitalization and by holding much more adequate tools to this end. The resolution-related provisions of the package entered into force within 20 days from publication, namely on 27 June 2019, and there is an 18-month transposition and implementation deadline from their entry into force (as regards Directive 2014/59/EU) and an implementation deadline starting with 28 December 2020 (as regards Regulation (EU) No 806/2014).

In respect of AML/CFT framework, national Law 29/2019 on preventing and combating money laundering and terrorist financing, as well as on amending and supplementing some legal acts, had been adopted by Romanian Parliament and had been implemented at national level. Following this, the National Bank of Romania issued the Regulation 2/2019 on preventing and combating money laundering and terrorist financing. The new regulation includes the necessary details how to be performed the risk assessment, how to implement internal policies and procedures based on the requirements, some new provisions related to KYC (know your customer) measures, new requirements in respect of the institutions 'staff adjustment, provisions for the related risk organization and management framework, as well as supervisory measures.

During 2019, based on the Law 225/2018, National Bank of Romania was nominated the public authority responsible for protection of the critical national infrastructures within the financial-banking sector, “banks” and “payment systems” subsectors. As a consequence, according to the specific legal provisions, NBR issued the Order 11/2019 on setting the sectorial criteria and critical threshold, in order to identify potential critical national infrastructures within the banking and payment systems sectors, in their competency area. The owners of these critical national infrastructures are going to implement and test on a year basis the special plans of operational security, verified by NBR, in accordance with the legal requirements.

Following the changes in the International Financial Reporting Standards, effective from 1 January 2018 (the adoption at EU level of the new standard IFRS 9 – Financial Instruments), improvements had also been done in 2019 within the reporting and accounting areas by amending and supplementing the existing framework of NBR, such as Order No. 1 of 18 January 2019 amending and supplementing NBR Order 9/2017 approving the Methodological Norms on the FINREP reporting framework at solo level, in compliance with the International Financial Reporting Standards, applicable to credit institutions for prudential purposes and NBR Order 10/2017 approving the Methodological Norms on preparing regular reports containing financial and accounting statistical information, applicable to the branches in Romania of credit institutions from other Member States, Order No. 3 of 22 March 2019 amending and supplementing NBR Order No 6/2015 on approving the accounting regulations compliant with EU Directives, Order No. 5 of 29 May 2019 amending and supplementing NBR Order No. 1/2013 on approving the Methodological Norms on preparing the annual accounting reports designed to meet the information requirements of the Ministry of Public Finance applicable to credit institutions, Order No. 8 of 30 October 2019 on the application of International Financial Reporting Standards by non-bank financial institutions.

Main strategic objectives of the supervisory authority in 2019

In 2019, the key objectives in the field of regulation and supervisory activities were to i) fulfill the annual assessment and verification programme through off- and on-site inspections, to take timely supervisory response measures and to enhance the quality of supervision throughout continuous improvement of the SREP process; ii) continue to implement the recommendations of the 2017-2018 Financial Sector Assessment Program for Romania conducted by the International Monetary Fund and the World Bank; iii) complete / revise the regulatory framework applicable to credit institutions in areas such as authorization, changes in the situation of credit institutions, merger / division, establishment of the credit-bridge institution, corporate governance, outsourcing, risk management; iv) analyze and include in the regulatory framework the EBA Guidelines applicable to the competent authority and/or the institutions within the National Bank of Romania’s regulatory scope, as applicable, in the fields of prudential banking, payment services, anti-money laundering and countering the financing of terrorism, deposit guarantee and bank resolution, as well as to update the accounting and financial reporting regulations; v) further strengthen of the institutional and supervisory capacities in the field of prevention of money laundering and financing of terrorism and continuing to participate, in accordance with the legal powers of the central bank, in the review of the national regulatory framework in the field of of prevention of money laundering and financing of terrorism to increase the efficiency of internal processes and to develop and improve supervisory practices.

The activities of the Banking Supervisory Authority in 2019

During 2019, 30 supervisory actions were conducted, of which 27 at the head offices of credit institutions, Romanian legal entities, and 3 at the branches in Romania of credit institutions having their head offices in other Member States. The objectives of the supervisory actions were established based on the risk profile of each credit institution as shown in the latest assessment. The thematic objectives focused on the viability and sustainability of the business model, the internal governance, the assessment of capital risks, the assessment of capital adequacy, the assessment of liquidity risks, the assessment of liquidity adequacy, as well as verifying the implementation of the measures imposed by the NBR and of the action plan prepared by the credit institution.

After conducting the SREP, overall scores of 2, 3 and 4 were assigned to 33%, 56% and 11% respectively of the 27 credit institutions, Romanian legal entities. At system level, average and median of total SREP capital requirements (TSCR) were of about 11.1% and 11.7%.

In 2019, the Supervisory Committee passed decisions in 19 meetings, while eight other meetings were held January through March 2020, the analysed materials relating primarily to: (i) the notification of the intention to acquire a qualifying holding in the share capital of a credit institution and/or to increase such participations; (ii) applications submitted by credit institutions, Romanian legal entities, pursuant to prudential regulations, for approval of changes in their standing as concerns the Board members and/or executives, expansion of their scope of business, the financial auditor, operations on preferential terms set forth in the employee benefits and incentive packages, exemption from the assignment of risk weights to subsidiaries, mergers, etc.; (iii) proposal for the authorisation of a payment institution; (iv) draft legal acts to be issued by the central bank or other authorities concerning the activity of credit institutions, of payment institutions, of account information service providers, of electronic money institutions and of non-bank financial institutions, as well as in the fields of anti-money laundering and countering the financing of terrorism; (v) the implementation of EBA Guidelines in the national legal framework and/or in supervisory practices, from the perspective of the central bank's powers; (vi) legislative proposals for transposing the EU acquis and European regulations in the field of credit institutions and non-bank financial institutions; (vii) proposals for positions in the other areas of competence of the central bank; (viii) the monitoring of developments in terms of financial stability, identifying, monitoring and assessing systemic risks and those related to systemically-important credit institutions, specific analyses (monitoring the lending terms and conditions, systemic risks survey, periodical stress tests of the banking sector's liquidity, analyses regarding macroprudential instruments - capital buffers, etc.), proposals for measures regarding macroprudential policy, the cross-border exchange of information, the assessment of a potential materialisation of the systemic risk of misconduct in the banking sector, the assessment of concentration risk across the banking sector, clarification of the manner in which banks and NBFIs in Romania should apply the regulations in force in the context of the COVID-19 pandemic; (ix) analyses on the activity of the Central Credit Register and of the Payment Incidents Register; (x) other matters in connection to the banking system functioning.

Organisational chart of the Banking Supervisory Authority

Organisation Chart of the National Bank of Romania

BOARD OF DIRECTORS

The Audit Committee

Governor **Mugur Isărescu**

- The Monetary Policy Committee
- The Supervisory Committee
- The Foreign Reserve Management Committee

First Deputy Governor **Florin Georgescu**

FINANCIAL STABILITY DEPARTMENT
- Macroprudential Policies Division
- Systemic Risk Monitoring Division
- Quantitative Assessment Division

REGULATION AND LICENSING DEPARTMENT
- Financial Activities and Non-bank Financial Institutions Regulation Division
- Foreign Exchange and Accounting Regulation Division
- Licensing Division
- Prudential Banking Regulation Division 1
- Prudential Banking Regulation Division 2

SUPERVISION DEPARTMENT
- Inspection Division I
- Inspection Division II
- Inspection Division III
- Banking System Assessment, Methodology and Supervision Procedures Division
- Non-bank Financial Institutions and Payment Institutions Inspection Division
- Monitoring of International Sanctions Enforcement, Prevention of Money Laundering and Terrorist Financing Division
- Legal Advice on Supervisory Acts Office

ISSUE, TREASURY AND CASH MANAGEMENT DEPARTMENT
- Issue Division
- Cash Management Division
- Central Vault Division
- Cash Processing Coordination Division

ACCOUNTING DEPARTMENT
- Operational Accounting and Internal Accounting Rules Division
- Internal Administration Accounting-Financial Issues Division
- Internal Administration Accounting-Fixed Assets Division

ESTATE MANAGEMENT AND INVESTMENT DEPARTMENT
- Investment Division
- Movable Assets Division
- Immovable Assets and Management Division

Deputy Governor **Eugen Nicolăescu**

STATISTICS DEPARTMENT
- Monetary and Financial Statistics Division
- Balance of Payments Division
- Direct Statistical Reporting Division
- Statistical Data Processing Division
- SIRBNR Data Management Division
- Credit Risk Statistics Division

BANK RESOLUTION DEPARTMENT
- Resolution Strategies and Policies Coordination Division
- Resolution Decisions Preparation and Implementation Division
- Monitoring of the Implementation of Measures for Resolvability Enhancement Division
- Resolution Planning and Decisions Implementation Division

IT DEPARTMENT
- IT Systems Division
- Network Administration Division
- IT Support Division
- IT&C Security Division

PROCUREMENT DEPARTMENT
- Procurement Contracts Award Division
- Contracting Division
- Planning and Monitoring Division
- Purchase Order Division
- Procurement Methodology, Standardisation and Norming Division

FINANCIAL EDUCATION AND MUSEUM DEPARTMENT
- Museum
- Financial Education Division

PAYMENT AND SETTLEMENT SYSTEMS REGULATION AND OVERSIGHT UNIT
- Financial Market Infrastructures Oversight Division
- Payments and Payment Instruments Oversight Division

Deputy Governor **Leonardo Badea**

MACROECONOMIC MODELLING AND FORECASTING DEPARTMENT
- Macroeconomic Forecasting Models Division
- Macroeconomic Assessment Models Division

PAYMENTS DEPARTMENT
- ReGIS Division
- Financial Instruments Depository and Settlement Division
- Financial Messages Processing Division
- TARGET2 Division
- Business Continuity Division

INTERNATIONAL RELATIONS DEPARTMENT
- European Banking System Division
- International Financial System Division
- International Financial Conditions Analysis Division

SECRETARIAT
- Documents Registration, Dispatching and Check-in Desk Division
- Archives, Library and Publications Dissemination Division
- Events Organisation and Protocol Division

TECHNICAL AND MAINTENANCE DEPARTMENT
- Buildings Maintenance Division
- Equipment and Installations Maintenance Division
- Administrative Maintenance and Utilities Division

LEGAL DEPARTMENT
- Legal Advice and Assistance Division
- Contract Assistance and Disputed Claims Division
- European and International Law Division

TRAINING AND SOCIAL EVENTS FACILITY DEPARTMENT
- Training Support Division
- Social Events Division
- Auxiliary Activities Division
- Cafeteria Division
- Training and Social Events Units

COMPLIANCE DIVISION

REGIONAL BRANCHES AND AGENCIES

Governor

INTERNAL AUDIT DEPARTMENT*
- General Audit Division 1
- General Audit Division 2

CHANCELLERY
- The Executives' Offices and Document Management
- Strategic Projects Division
- Governor's Control Office
- Board Secretariat Division
- Information Management and Protection Division
- Administration of Special Computer Systems and Personal Data Protection Division
- Territorial Network Coordination Division

MONETARY POLICY DEPARTMENT
- Monetary Policy Analysis and Strategy Division
- Liquidity Management Division

MARKET OPERATIONS DEPARTMENT
- Monetary Policy Operations Division
- State Treasury Operations Division
- Foreign Reserves Management Division
- Back Office Division
- Foreign Reserves Risk Management Division

ECONOMICS DEPARTMENT
- Economic Analysis and Short-Term Forecasting Division
- Publications Division
- Translation and Editing Division

COMMUNICATION AND PUBLIC RELATIONS DEPARTMENT
- Media Relations Division
- Intranet and Internal Communication Division
- Online Communication Division
- Multimedia Support Division
- Public Relations and Documentation Division

HUMAN RESOURCES DEPARTMENT
- Organisation and Planning Division
- Human Resources Management Division
- Training and Career Development Division

BUDGET AND FINANCIAL ANALYSIS DEPARTMENT
- Budget and Financial Analysis Division
- Preventive Financial Control Division
- Consumption Standards and Norms Division
- Risk Monitoring Division

SECURITY DEPARTMENT
- Crisis Management & Business Continuity Division
- Internal Protection Division
- Special Transport Division
- Security Systems Division
- Transport and Maintenance Division

Note:
Colour patterns show the departments' coordination.
*The Internal Audit Department reports functionally to the Audit Committee and administratively to the Governor of the National Bank of Romania.

International activities of NBR

As regards the responsibilities of the National Bank of Romania concerning the alignment to the European regulatory and supervisory framework, the NBR have been pursued the harmonization efforts with regard to the supervision of credit institutions through the participation of Romania in a number of working groups set up at the EBA level. At the same time, the oversight activity continued through JSTs (Joint Supervisory Teams). In the supervision of cross-border banking groups, the NBR has maintained its cooperation with the other supervisory authorities through the Supervisory Colleges, structures that ensure both optimal dissemination of information and joint decisions on capital adequacy and liquidity or recovery plans of supervised credit institutions.

Regarding the structures and substructures of the EBA, the NBR, as the regulatory and supervisory authority of the banking sector in Romania, is a member of the European Banking Authority, an independent authority of the EU that aims to ensure an efficient and consistent level of regulation and prudential supervision throughout the EU banking sector. In this capacity, the NBR participates in the decision-making process of the authority, as well as in the working parties constituted at its level. Thus, during the reference period, the NBR participated in a series of EBA working structures and substructures, namely:

- the Board of Supervisors and the Resolution Committee;
- other structures and substructures, such as: Standing Committee on Regulations and Policy; Standing Committee on Accounting, Reporting and Auditing, Subcommittee on Anti-Money Laundering of the Joint Committee of the European Supervisory Authorities; Standing Committee on Payment Services; Review Working Group; Committee on prevention of money laundering and terrorist financing; Subgroup on continuous surveillance; Sub-Group on Securitization and Covered Bonds; Sub-Group on governance and remuneration; Subgroup for liquidity; Subgroup for preparing resolution planning; Working Group on the operational aspects of the evaluation process for resolution; Special Working Group on Stress Testing; Special Working Group on Impact Assessment; Special Working Group on surveillance of the information & technology risk, and in supervisory colleges.

Cooperation with other supervisory bodies in Romania

The cooperation and coordination in the field of macroprudential oversight of the national financial system is ensured by the National Committee for Macroprudential Oversight (NCMO). This committee was established by virtue of Law No. 12/2017 on the macroprudential oversight of the national financial system, as an inter-institutional cooperation structure without legal personality.

The NCMO's mission is to ensure coordination in the field of macroprudential oversight of the national financial system by setting the macroprudential policy and the appropriate instruments for its implementation.

Five meetings were held in 2019 between representatives of the National Bank of Romania (NBR), the Financial Supervisory Authority (FSA) and the Government within NCMO. Thus, in 2019, the NCMO recommended the NBR, in its capacity as competent authority, to take among others the following actions in relation to credit institutions/non-bank financial institutions:

- to maintain the countercyclical buffer rate at 0 (zero) percent and to closely monitor developments in structural imbalances and indebtedness at aggregate and sectoral levels. In the current context of uncertainty generated by the COVID-19 pandemic, the NCMO recommendation on the countercyclical capital buffer was that such an additional capital requirement is not warranted, considering that total indebtedness currently remains below the signaling threshold;
- the implementation of the International Financial Reporting Standards (IFRS) by non-bank financial institutions(NBFIs), by issuing the regulations necessary for the full implementation of IFRS by NBFIs entered in General Register (in compliance with the related legal provisions), as a basis of accounting and preparing individual financial statements.

Amid the COVID-19 pandemic crisis, the NCMO recommendation on this issue was that the plan to implement the IFRS by these entities to be postponed by one year, with a view to supporting non-bank financial institutions to use the existing resources for the proper functioning of operational activities;

Also, in 2020, in the current context of COVID-19 pandemic, it was recommended to the NBR to request financial institutions under their supervision to refrain, at least until 1 January 2021, from undertaking any of the following actions: (i) make a dividend distribution or give an irrevocable commitment to make a dividend distribution; (ii) buy-back ordinary shares, (iii) create an obligation to pay variable remuneration to a member of a category of staff whose professional activities have a material impact on the financial institution's risk profile, which has the effect of reducing the quantity or quality of own funds at the consolidated and/or individual level.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	27	26	26
Branches of foreign credit institutions	7	7	7
Cooperative banks	1	1	1
Banking sector, total:	**35**	**34**	**34**

Total assets of banking sector (mill.RON) (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	379,721.2	398,622.3	433,282.3
Branches of foreign credit institutions	46,855.7	51,232.2	60,457.8
Cooperative banks	1,215.7	1,315.2	1,474.1
Banking sector, total:	**427,792.6**	**451,169.7**	**495,214.2**
y/y change (in %)	**+8.7%**	**+5.5%**	**+9.8%**

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

Item	2017	2018	2019
Public sector ownership	8.7	8.1	8.2
Domestic ownership total	23.0	25.0	26.3
Foreign ownership	77.0	75.0	73.7
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	49.6	69.8	1156
Branches of foreign credit institutions	94.5	98.7	5756
Cooperative banks	-	-	-
Banking sector, total:	**43.4**	**61.4**	**971**

Return on Equity (ROE) by type of financial institutions (%) (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	11.92	13.87	11.13
Cooperative banks	1.24	1.28	1.41
Banking sector, total:	**12.51**	**14.59**	**12.21**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	88.8	88.3	87.5
Branches of foreign credit institutions	11.0	11.4	12.2
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 sector (%) (at year-end)

	2017	2018	2019
Receivables	**100.0**	**100.0**	**100.0**
Financial sector	21.7	19.6	19.9
Nonfinancial sector	54.0	55.0	53.9
Government sector	-	-	-
Other assets	24.3	25.4	26.2
Liabilities	**89.5**	**89.2**	**88.9**
Financial sector	9.9	7.8	6.0
Nonfinancial sector	76.1	78.1	78.9
Government sector	-	-	-
Other liabilities	3.5	3.3	4.0
Capital	**10.5**	**10.8**	**11.1**

Capital adequacy ratio of banks (%) (at year-end)

Type of financial institution	2017***	2018***	2019***
Commercial banks	19.9	20.7	22.0
Cooperative banks	30.6	30.1	28.4
Banking sector, total:	**20.0**	**20.7**	**22.0**

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

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

Asset classification	2017	2018	2019
Non-financial sector, including	8.7	6.6	5.4
- households	5.8	4.8	4.0
- corporate	12.2	8.6	7.1

The structure of deposits and loans of the banking sector in 2019 (%)
(at year-end)

	Deposits	Loans
Non-financial sector, including:	86.8	66.3
Households	55.1	36.4
Corporate	31.7	29.9
Government sector	8.9	29.5
Financial sector (excluding banks)	4.3	4.2
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	13,363.1	16,767.7	18,831.7
Interest expenses	2,083.4	2,943.3	3,581.8
Net interest income	11,279.7	13,824.4	15,249.9
Net fee and commission income	3,911.7	4,134.2	4,152.7
Other (not specified above) operating income (net)	4,000.5	3,172.1	3,561.1
Gross income	**19,191.9**	**21,130.7**	**22,963.7**
Administration costs	9,741.7	10,323.2	10,758.1
Depreciation	825.6	912.1	1,716.2
Provisions	301.5	468.8	1,613.8
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	1,838.6	1,030.6	1,164.9
Profit (loss) before tax	**6,472.5**	**8,463.9**	**7,817.2**
Net profit (loss)	**5,335.4**	**6,827.5**	**6,334.3**

Total own funds in 2019 (in mill.EUR)

Type of financial institution	Total own funds ***	Core Tier 1***	Tier 1***	Tier 2***	Tier 3***
Commercial banks	10,830.2	9,814.3	9,864.3	965.9	-
Cooperative banks	66.5	65.4	65.4	1.1	-
Banking sector, total:	**10,896.7**	**9,879.7**	**9,929.7**	**967.0**	**-**

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

Macroeconomic environment in the country

In 2019, the Russia's economy growth rates slowed down. GDP grew by 1.3% in 2019 (in 2018: 2.5%). Annual inflation declined to 3.0% from 4.3% in 2018. The labour market was stable, average unemployment rate declined to 4.6% in 2019 from 4.8% in 2018.

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

In 2019, the Russian banking sector total assets increased by 5.2% (hereinafter adjusted for currency movements). However, the assets to GDP ratio decreased to 87.8% from 89.9% due to outpacing growth of nominal GDP.

Loans to customers (corporates[1] and households) grew by 9.4% in 2019. Corporate loans increased by 5.8%, while household loans (retail book) – by 18.6%. In retail book, unsecured consumer loans increased by 21%, while mortgages – by 17.2% (about 20% if adjusted by loans transferred to securitisation pool). The slowdown of retail lending growth was due to the Bank of Russia's macroprudential regulation aimed to constrain an overheating of unsecured consumer lending and high-risk mortgages (those with high LTV ratios).

In 2019, problem corporate loans (those of IV and V quality categories) contracted to 11.1% from 12.0% of total corporate book, mainly due to problem debts' workouts. The total provision coverage of problem corporate loans improved to 88.8% from 81.9%. At the same time, problem retail loans also decreased to 6.6% from 7.6%, with total provision coverage remained high (over 110% at end-2019).

Household accounts (including term deposits) increased by 10% in 2019, while corporate accounts – by 4.4%.

In 2019, banks's net profit was equal to 1.7 trillion rubles (1.3 trn rubles excluding the impact of IFRS 9 implementation) compared to 1.0 trillion rubles in 2018 (1.3 trillion rubles if adjusted for the financial result of the banks under FBSC[2] resolution).

In 2019, the banking sector's total regulatory capital grew by 7.2%. Capital adequacy remained at comfortable level of 12.3% as of 1 January 2020.

[1] The corporate lending indicator includes loans to non-financial and financial organizations (except of credit organizations).

[2] Fund of Banking Sector Consolidation.

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

Article 75 of the Constitution of the Russian Federation establishes the special legal status of the Central Bank of the Russian Federation (Bank of Russia). The status, goals, functions and powers of the Bank of Russia are defined by Federal Law No. 86-FZ, dated 10 July 2002, 'On the Central Bank of the Russian Federation (Bank of Russia)' and by other federal laws.

The Bank of Russia continued to improve banking regulation and banking supervision aimed at identifying risks at the earliest stages to ensure stability of the banking sector and protect creditors' and depositors' interests.

In 2019, an important area of activity was the participation of the Bank of Russia in the transition to project financing of shared housing construction. The new financing scheme for shared construction covers a set of regulatory changes, supervisory and communication measures.

In 2019, the Bank of Russia continued to work:

- on the gradually introduction of regulatory standards of the Basel Committee on Banking Supervision;
- on the development of proportional regulation for banks with a basic licence;
- on the implementation of the incentive banking regulation concept in order to support the growth of lending;
- as well as on the improvement of the Russian deposit insurance system.

Main strategic objectives of the supervisory authority in 2019

The main priorities for banking regulation and banking supervision are the stable functioning of the banking sector, stability and reliability of its institutions. The systemic risks' identification system is based on a constant analysis of the banking activities and accepted risks, taking into account external factors.

In 2019, the supervision was carried out in proportion to the specifics of credit organizations' activities in accordance with the type of licence, taking into account:

- in relation to banks with basic licence – their compliance with regulatory restrictions in terms of operations[3] and activities with "core" and "non-core" customers[4]; significant impacts of changes in economic conditions on banks with basic licence due to their limited capital and less competitiveness;
- in relation to banks with universal licence – increased regulatory requirements in terms of risk management systems, capital and internal control;
- in relation of non-bank credit institutions (NCIs) – risks in payment systems, since the NCIs' business models are often based on money transfers (including e-money transfers).

[3] These banks have a more limited range of operations compared to other banks.

[4] "Core" customers are determined in accordance with the Bank of Russia Instruction No 183-I, dated 6 December 2017, "On the Required Ratios of Banks with Basic Licence".

The activities of the Banking Supervisory Authority

As of the year-end of 2019, as a part of consolidated supervision 23 financial groups were supervised by the Bank of Russia. As a result of the group supervision the key risks of the financial groups were identified, information on group companies is consolidated and updated in the electronic dossier.

An important component of supervision was the assessment of the quality of the internal capital adequacy assessment process (ICAAP) and capital adequacy in credit institutions and banking groups. In 2019, the Bank of Russia completed the first supervisory assessment of the ICAAP quality in banking groups as well as it made such an assessment for banks with a universal license that are not participants of the banking group.

In 2019, the Bank of Russia also conducted the first supervisory assessment of financial stability recovery plans for systemically important credit institutions.

Organizational chart of the Banking Supervisory Authority

As of the year-end of 2018, the Supervisory Authority of the Bank of Russia head office includes Banking Supervision Support Department, Banking Regulation Department, Department for Market Access and Activity Termination of Financial Institutions, Financial Resolution Department, Systematically Important Banks Supervision Department, Financial Monitoring and Foreign Exchange Control Department, Service for Ongoing Banking Supervision, Risk Analysis Service and Bank of Russia Chief Inspection.

The major tasks of these divisions are to provide methodological and organizational support to the Bank of Russia statutory functions of banking supervision within the framework of the entire supervisory cycle: from the licensing of credit institutions, establishment of regulatory requirements, the exercise of on-going supervision of their activities and the conduct of on-site inspections to financial rehabilitation of credit institutions and implementation of measures, if necessary, to liquidate financially unviable credit institutions.

The supervisory divisions are managed by the Bank of Russia Banking Supervision Committee, which is headed by the Bank of Russia First Deputy Chairman in charge of this area. The Committee is responsible for decision-making on banking supervision policies.

Other relevant information and developments

More detailed information about the development of the banking sector and banking supervision in the Russian Federation is available on the official website of the Bank of Russia *(http://www.cbr.ru/eng)*.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Banks	517	440	402
Non-bank credit institutions	44	44	40
Banking sector, total	**561**	**484**	**442**

Total assets of banking sector (at year-end, trln rub)

Type of financial institution	2017	2018	2019
Banks	82,2	90,0	92,4
Non-bank credit institutions	3,0	4,1	4,2
Banking sector, total	85,2	94,1	96,6
y/y change (in %, nominal)	6,4	10,4	2,7

Ownership structure of banks on the basis of assets total, %

Item	2017	2018	2019
Public sector ownership	65,4	70,4	71,7
Domestic ownership total (public + residents)	92,0	87,8	88,0
Foreighn ownership	8,0	12,2	12,0
Banking sector (excluding non-bank credit institutions), 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
Banks	54,7	62,7	0,138
Non-bank credit institutions	98,5	99,1	0,859
Banking sector, total	**52,3**	**60,3**	**0,128**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Banks	8,1	13,4	19,4
Non-bank credit institutions	40,6	42,6	53,1
Banking sector, total	**8,3**	**13,8**	**19,7**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Banks	96,5	95,6	95,6
Non-bank credit institutions	3,5	4,4	4,4
Banking sector, total	**100,0**	**100,0**	**100,0**

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

Assets	2017	2018	2019
Financial sector (including credit institutions)	19,1	18,1	17,5
Nonfiancial sector (including households)	49,7	51,3	53,2
Government sector (including the Bank of Russia)	11,7	10,9	9,7
Other assets	19,4	19,7	19,5
Liabilities	**2017**	**2018**	**2019**
Financial sector (including credit institutions)	15,0	13,8	12,5
Nonfiancial sector (including households)	54,9	55,7	56,2
Government sector (including the Bank of Russia)	4,9	6,4	6,4
Capital (profit, funds...)	10,5	9,9	10,4
Other liabilities	**14,6**	**14,2**	**14,6**

Capital adequacy ratio of banks (N1), %

Type of financial institution	2017	2018	2019
Banks	12,0	12,0	12,2
Non-bank credit institutions	33,3	34,3	40,5
Banking sector, total	**12,1**	**12,2**	**12,3**

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

Asset classification	2017	2018	2019
Non-financial sector, including:	11,4	10,8	9,6
- households	9,8	7,6	6,6
- corporate (including individual entrepreneurs)	12,0	12,2	11,0

The structure of deposits and loans of the banking sector in 2019 (at year-end, %)

	Deposits	Loans
Non-financial sector, including:	87,9	89,6
- households	58,5	30,4
- corporate	29,4	59,2
Government sector*	7,0	1,4
Financial sector*	5,1	9,0
Total*	**100,0**	**100,0**

** Excluding transactions with credit institutions and the bank of Russia*

P&L account of the banking sector* (at year-end, thous. EUR)

	2017	2018	2019
Interest income	84 664 748	77 762 608	97 028 619
Interest expences	45 748 203	37 956 020	51 879 614
Net interest income (1-2)	38 916 546	39 806 588	45 149 005
Net fee and comission income	12 183 656	13 096 853	16 919 487
Other (not specified above) operating income (net)	7 576 437	4 469 468	18 094 272
Gross income (3+4+5)	58 676 638	57 372 909	80 162 764
Administration costs	27 254 128	26 583 123	32 643 204
Depreciation**	1 539 022	1 463 871	1 922 522
Provisions	20 930 294	15 285 144	18 130 823
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial asets (loans,...)	n/a	n/a	n/a
Profit (loss) before tax	10 492 216	15 504 642	29 388 736
Net profit (loss)	7 761 739	12 558 299	24 748 604

Total own funds in 2019 (thous. EUR)

Type of financial institution	Total capital	Tier 1 capital	Tier 2 capital
Banks	156 771 271	117 454 121	39 317 150
Non-bank credit institutions	1 593 859	1 156 974	436 885
Banking sector, total	**158 365 130**	**118 611 095**	**39 754 035**

Macroeconomic environment in the country

Even in conditions of faster than expected growth in domestic demand and positive labour market trends, inflation remained low and stable in 2019, averaging 1.9%, which was also end of year figure and close to its average in the last six years. Low inflationary pressures were also indicated by core inflation, which moved in 2019 in the range of 1.1–1.5% y-o-y, and short- and medium-term inflation expectations of the financial and corporate sectors which were anchored close to, but below the NBS target midpoint. The easing of monetary policies of the Fed and ECB, coupled with continued low inflationary pressures at home, enabled further monetary policy easing by the NBS in 2019. The key policy rate was cut in July, August and November by 75 bp in total, to 2.25%, which was its lowest level in the inflation targeting regime in that moment. The lower costs of borrowing in the domestic market sustained further credit growth at an almost two-digit rate, led to the larger extend by the corporate lending.

Economic growth exceeded 4% for the second year in a row as domestic factors compensated for the slowdown in external demand. According to the Statistical Office data, real GDP growth was 4.2% in 2019. The main boost came from investment owing to accelerated implementation of infrastructure projects, the upgrade of the business environment, as testified by Serbia's improved score on the World Bank's Doing Business list, and favourable financing sources. Sustainable consumption growth also continued, most notably thanks to favourable labour market trends and lower borrowing costs. In contrast, as external demand slowed and the investment cycle at home continued, net exports were a negative contributor, though to a lesser extent than in 2018. On the production side, the major contribution to growth came from the overperformance in the construction sector and the growth in most service sectors. Industrial production gave a moderate positive impulse, despite the effects of the external demand slowdown, 100% taxes on products delivered to Kosovo, and the overhauls in the oil and chemical industries in H1.

Despite the slowdown in external demand, the implementation of past investment helped maintain a high growth rate of goods and services exports in 2019 (10.5%). Investment largely determined the pace and structure of goods and services imports, which were up by 10.7%, led by increased corporate needs for intermediate goods and equipment, and, to a lesser extent, by rising consumer demand. Although the current account deficit increased on these grounds in 2019 (accounting for 6.9% of GDP), the imported equipment will boost the export capacities of the Serbian economy, which will most likely help reduce the deficit share in GDP in the medium run. For the fifth consecutive year, the current account deficit was fully covered by the net FDI inflow. Non-residents' stepped-up investment in Serbia fuelled further appreciation pressures in the FX market. To mitigate excessive short-term volatility of the dinar against the euro, in 2019 the NBS intervened in the interbank FX market, thus boosting the gross NBS FX reserves, which rose to EUR 13.3 bn at end-2019 and were at their highest end-year level since 2000, when records began.

The fiscal result was better than planned in 2019 as well – the general government deficit stood at 0.2% of GDP, with primary surplus at 1.8% of GDP. Continued positive fiscal trends in 2019 were supported primarily by economic growth and the resulting higher corporate profitability, positive labour market trends, and lower government borrowing costs, achieved owing to the effects of NBS monetary policy easing, a more favourable country risk premium and credit rating. The narrowing in fiscal imbalances and reduced currency and refinancing risks helped bring public finances within sustainable bounds – at end-2019, central government public debt was 52.0% of GDP.

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

Serbian banking sector, which makes the largest portion of the Serbian financial sector (over 90%), was adequately capitalized and highly liquid throughout 2019. In the environment of macroeconomic stability and economy expansion, during 2019 the banking sector was attractive for reputable investors, the lending activity was accelerated, and quality of banks' portfolios was significantly improved. Total net pre-tax profit at the end of 2019 amounted to EUR 575.6 million (compared to EUR 640.6 million in 2018), with return on assets (ROA) of 1.72% and return on equity (ROE) of 9.79% (compared to 2.12% and 11.27% in 2018, respectively).

At the end of December 2019, there were 26 banks operating in Serbia (19 banks in majority foreign ownership with 75.7% share in total banking sector assets, 4 banks in majority ownership of the Republic of Serbia with 16.8% share, and 3 banks in majority ownership of domestic entities with 7.5% share). All banks in the Republic of Serbia are operating as independent legal entities, no branching is allowed. Majority foreign-owned banks are members of banking groups from 13 countries. At the end of 2019, the banks from Italy had the largest share in total banking sector assets (26.8%), followed by the banks from Austria and Hungary, whose share was per 13.5%, while all other foreign countries accounted for 21.9% of total banking sector assets. The share of banking sector assets to GDP amounted to 75.5% at the end of December 2019.

Total net balance sheet assets of the banking sector in Serbia reached EUR 34.7 billion at the end of 2019 which is an increase of 8.8% compared to the end of 2018.

Considering the dispersion of the core banking activities (HHIs of assets, lending and deposits are below 1,000), the level of competition in the Serbian banking sector is at a satisfactory level. The market share of the top five banks in Serbia is 53.4% of assets, 52.0% of lending and 54.9% of deposits.

At the end of 2019, total gross loan portfolio amounted EUR 20.9 billion, which is 9.0% higher in comparison to the end of 2018. The main lending activity generators were investment loans to corporates[1] (by 25.7% higher than end-2018) and retail[2] cash loans (by 19.0% higher than end-2018). Loans to corporates made 50.7% of total loans with EUR 10.6 billion, while retail loans accounted for 45.0% of total loans with EUR 9.4 billion.

The *Strategy for NPL resolution* adopted by the NBS in August 2015, followed by additional measures aimed at NPL resolution (notably *The Decision on the accounting write-off of bank balance sheet assets*, effective since September 2017), resulted in continuous decline of gross NPL ratio, down to 4.09% at the end of 2019, which is by 1.61 p.p. lower than in 2018 and at the same time, the lowest level since the NBS started to record this indicator. The total stock of gross NPLs at the end of 2019 amounted EUR 862.4 million which is a decrease by EUR 243.0 million on a yearly level. The NPLs were reduced primarily through direct write-offs and assignments/sales to other legal entities outside of the banking sector.

The largest portion of NPLs (54.2% of total NPLs) refers to corporate sector whose total gross NPLs amounted EUR 467.8 million at the end of 2019. However, corporate sector also recorded the largest reduction in NPLs, by EUR 232.8 million compared to the end of 2018. As a result, the NPL ratio for corporates was reduced from 7.15% to 4.37%.

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[1] Public enterprises, private companies, legal persons and institutions in the areas of education and health protection not financed from the budget, public enterprises in bankruptcy and private companies in bankruptcy.

[2] Households, entrepreneurs, entrepreneurs in bankruptcy, private households with employed persons, registered agricultural producers.

Retail NPLs (43.0% of total NPLs) amounted EUR 371.2 million at the end of 2019, a reduction by EUR 8.8 million compared to the end of 2018. As a result, the gross NPL ratio dropped from 4.44% to 3.94%.

Despite a significant reduction in NPLs, it should be emphasized that NPLs coverage by IFRS provisions is maintained on a relatively high level (84.2%).

At the end of 2019, total banking sector deposits were at the level of EUR 25.2 billion, which is an increase by 9.0% compared to the end of 2018. Retail deposits, which account for 52.5% of total deposits, increased by 12.5% compared to the end of 2018. Retail foreign currency deposits amounted to EUR 10.5 billion at the end of 2019, which is an increase of 9.4% compared to the end of 2018. Corporate deposits (31.1% of total deposits) amounted EUR 7.8 billion at the end of 2019. Deposits of private companies, which account for 86.1% of total corporate deposits, reached the amount of EUR 6.8 billion - an increase by 16.8% compared to the end of 2018.

Prudential measures taken by the NBS in the previous period have provided an incentive for banks to build significant capital buffers and liquidity reserves, making them capable to cope successfully with the risks inherent in the system and maintain stability in case of serious disturbances. The capital adequacy ratio was 23.4% at the end of 2019, which is significantly above the regulatory minimum of 8%. In addition to the high capital adequacy ratio, Serbian banking sector is characterized by favorable capital structure, bearing in mind that CET1 capital makes up more than 95% of total regulatory capital. The high solvency of the banking sector is also indicated by the (Basel III) leverage ratio, which amounted 13.55% at the end of 2019. The proportion of balance sheet capital to total liabilities stood at 17.28% at the end of 2019.

The average regulatory liquidity ratio for the Serbian banking sector in December 2019 was 2.18, indicating that liquid assets (core liquid assets and receivables maturing within the next 30 days) were more than twice as large as liabilities without maturity and liability maturing within 30 days. Liquid assets comprised 37.27% of total assets and 52.31% of total short-term liabilities at the end of 2019. Liquidity coverage ratio of 199.30% also confirmed high liquidity of Serbian banking sector. The funding of the banks' lending activity is adequate, having in mind that gross loans to nonfinancial sector are fully covered with nonfinancial sector's deposits (loan to deposit ratio was 91.16% at the end of 2019).

In the aim of taking proactive action regarding unsecured retail lending under unjustified long tenors, *The Decision on Managing Concentration Risk Arising from Bank Exposure to Specific Products* was adopted by the NBS at the end of December 2019. Through this Decision, a new indicator - Concentration Risk Indicator was introduced. The numerator of this indicator comprises the existing portfolio of cash, consumer and other loans (that are not mortgage loan nor overdrafts) with contractual maturity above eight years. The denominator is the sum of regulatory capital (minus regulatory adjustment, current and previous years losses and unrealized losses) and dinar liabilities whose remaining maturity is more than 5 years. Newly introduced indicator represents additional regulatory and supervisory instrument bearing in mind that it defines the "cap" of the bank's exposure to certain unsecured long-term retail loans. The effects of measures taken by the NBS are already visible through reduction of Concentration Risk Indicator by 9.52 p.p. (from 25.19% in January to 15.67% in December 2019).

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

In the observed period, exercising its regulatory competences in the area of bank supervision the NBS issued the following regulation:

In February 2019, continuing activities commenced in 2018, the NBS Executive Board adopted by-laws aimed at adjusting the reporting system with the adopted set of regulations for addressing the issue of unsecured long-term non-purpose household loans. The reason for adopting ***the Decision Amending the Decision on Reporting on Capital Adequacy of Banks*** was to adjust the Report on Capital (KAP Form) in order to enable reporting to the NBS on the new introduced deductibles from Common Equity Tier 1 items – starting from the first reporting date (31 March 2019). This Decision was published in the RS Official Gazette, No 8/2019, and applied as of 31 March 2019. ***The Decision Amending the Decision on Reporting Requirements for Banks*** introduced a new Report on debt-to-income ratio (DTI Form) with a aim to verifying whether receivables in D category have been classified properly on the basis of exceeding the debt-to-income ratio prescribed by the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items (60%), but also to obtain detailed data for the needs of future calibration of this percentage which is a threshold for the application of the corresponding deductible from Common Equity Tier 1 prescribed by the current Decision on Capital Adequacy of Banks. This Decision was published in the RS Official Gazette, No 8/2019, and applied as of 31 March 2019.

Also in February 2019, the following regulations were published in RS Official Gazette No 13/2019 of 28 February 2019.

- ***Decision Amending the Decision on the Chart of Accounts and Contents of Accounts in the Chart of Accounts for Banks, and***
- ***Decision Amending the Decision on Collection, Processing and Submission of Data on the Balance and Structure of Accounts in the Chart of Accounts.***

The decisions were adopted in order to ensure the collection of data required for monitoring the application and effects of new regulations for banks adopted in December 2018 aimed at promoting the practice of sustainable household lending, in order to improve certain solutions based on the needs identified in practice as well as the quality of reports for monetary and financial statistics.

In August 2019, NBS Executive board adopted ***Decision Amending the Decision on Risk Management by Banks***. This Decision further improved the regulatory framework in the field of bank supervision - in the context of calculating large exposures, monitoring operational risk management in banks, as well as simplifying the control of forms submitted to the NBS in connection with risk management. This Decision was published in the RS Official Gazette, No 57/2019, and entered into force on August 17, 2019.

In December 2019, the NBS Executive Board adopted by-laws for the purpose of reducing the use of the foreign exchange rate as an indexation mechanism and stimulating RSD lending. In this respect, the following decisions that were published in the RS Official Gazette No 88/2019:

- ***Decision Amending the Decision on Capital Adequacy of Banks and***
- ***Decision Amending the Decision on Risk Management by Banks.***

The novelty introduced by the ***Decision Amending the Decision on Capital Adequacy by Banks*** is the incentive to banks for dinar lending (without a foreign currency clause) and all other dinar exposures to micro, small and medium-sized enterprises, entrepreneurs and farmers. As soon as 1 January 2020, banks may utilise this incentive for dinar lending and all other exposures to micro, small and medium-sized enterprises, entrepreneurs and farmers which implies that the amount of credit risk-weighted assets under dinar exposure to an SME, an entrepreneur or a farmer, is multiplied by a deduction factor of 0.7619 if the prescribed conditions have been met (as opposed to the current solution according to which all exposures to micro, small and medium-sized enterprises, entrepreneurs and farmers are treated in the same way, regardless of currency).

An additional novelty introduced by these amendments aims to encourage dinar lending by introducing measures to discourage the approval of new non-purpose and non-investment FX-indexed and FX loans to companies, entrepreneurs and farmers. Namely, the maximum percentages of these loans have been introduced, and if a bank exceeds these maximum levels, it will be subject to capital reduction. Apart from gradualness, this measure is also characterised by the absence of any form of lending prohibition, given that there are still no obstacles for a bank to approve a non-purpose and non-investment loan with the agreed foreign currency clause or a loan in foreign currency to any client, provided that it maintains an appropriate level of capital after that, i.e. that at any point it has sufficient own funds to meet all regulatory requirements.

The Decision Amending the Decision on Risk Management by Banks specifies the supervisor's requirements from banks in the context of the management of risks arising from a bank's exposure in dinars with a foreign currency clause and exposure in a foreign currency, starting from the level of the risk management strategy, through risk management policies to the procedure level. Among other, the amendments envisage a bank's obligation to have a strategy defining acceptable and target levels of these exposures in terms of both total exposures and segmented by exposure type. They also defined hedging against exchange rate risk resulting from the currency mismatch between the currency of the borrower's income and the currency of his obligations under the loan, and introduced provisions whose implementation would obligate banks to continually undertake activities towards lowering the share of exposures without the natural and financial hedge. Additionally, provisions have been introduced regarding conducting control of the usage of funds approved for the contractually specified purposes.

AML

The basis for supervising financial institutions in the area of prevention of money laundering and financing of terrorism (hereinafter: ML/FT) is regulated by the Law on the Prevention of Money Laundering and Financing of Terrorism ("Official Gazette of RS", Nos. 113/2017 and 91/2019; hereinafter: The AML/CFT Law) and sectoral laws. By the AML/CFT Law is defined that the National Bank of Serbia (hereinafter: NBS) supervises the implementation of this law in banks in accordance with The Law on Banks ("Official Gazette of RS", No. 107/2005, 91/2010 and 14/2015). It is also defined that the NBS imposes measures and sanctions to the banks for violating the AML/CFT Law in accordance with The Law on Banks.

The NBS, as a central bank in the Republic of Serbia (hereinafter: RS), is the national competent authority for the supervision of the largest part of the financial institutions in RS. It's in charge for supervision of banks, insurance companies, voluntary pension fund management companies, financial leasing providers, payment institutions, electronic money institutions, a public postal operator, and persons engaged in the provision of services related to virtual currencies, as well as authorised exchange dealers.

Within the NBS supervision of the prevention of ML/FT, among others, in banks is performed in a special organizational unit AML Supervision Centre.

With the aim to further harmonization with the Fifth Directive (EU) 2018/ 843 (hereinafter: Fifth Directive), in December 2019, RS adopted the Law on Amendments to the Law on Prevention of Money Laundering and Financing of Terrorism (hereinafter: The amendments to the Law), which has become effective as of January 1, 2020.

The amendments to the Law follow the provisions of the Fifth Directive, among others, on CDD, risk analysis and international cooperation among AML/CFT supervisors. The amendments to the Law also define the term of financial group and extends the AML/CFT requirements to the obliged entities which are part of such group. New terms and new obliged entities are also being introduced, such as wallet custodian providers. The amendments align the amounts in relation to wire transfers, and set out which data the obliged entities must obtain about wire transfer beneficiaries.

The provisions not covered in the AML/CFT Law, such as those on the beneficial ownership register, are covered in the Law on Centralised Records of Beneficial Owners. In December 2019, RS adopted the Law on Amendments to the Law on Central Records of Beneficial Owner, which governing matters relating to supervision over recording, accuracy and updating of the recorded data of registered entities and supervision over the application of the law.

In March 2019, the NBS adopted the Decision on Conditions and Manner of Establishing and Verifying Identity of a Natural Person through Means of Electronic Communication, which regulates conditions and manner of establishing and verifying identity of a customer – natural person and a legal representative of that customer in the video identification procedure, namely via real time streaming of image and sound (live streaming) and without mandatory physical presence of the person who is being identified at the obliged entity's premises. The video identification procedure may be carried out by obliged entity supervised by the NBS when establishing a business relationship or carrying out a transaction of that person in accordance with AML/CFT Law. Numerous safeguards for carrying out this procedure are prescribed by this Decision, including the fact that the procedure can be implemented by the obliged entity only after the notification to the NBS that all prescribed conditions have been met.

Furthermore, in August 2019 the NBS adopted new amendments to the Decision on Guidelines for the Application of the Provisions of the Law on the Prevention of Money Laundering and Terrorism Financing for Obligors Supervised by the National Bank of Serbia, transposing provisions of the Fifth Directive regarding group-wide policies, with focus on provisions on information sharing, prohibition of disclosure and confidentiality, improvement of compliance functions, internal audit, standards for employees' hiring procedures and their continuous training, while fully implementing the FATF Recommendation 18 at the same time. Namely, the Decision prescribes more explicitly the obligations of the obligor who is a member of a financial group, such as the implementation of group-wide programmes against ML/TF, adoption of the internal act governing the procedure and manner of implementation of the AML/CFT regulations in all his branches and majority-owned subsidiaries, no matter where those branches and subsidiaries are located (whether in the RS or in a foreign country) etc.

In December 2019, RS commenced drafting of the new National Strategy for the Fight against Money Laundering and the Financing of Terrorism, and the Action Plan for the implementation of this Strategy (2020-2024).

Main strategic objectives of the supervisory authority in 2019

Further improvement of the legal framework in line with the EU regulations, international standards and best practice in a manner which ensures the preservation and strengthening of the banking and financial systems' stability, and honouring the specific features of the domestic regulations and market.

Main strategic objectives of the supervisory authority in RS in the field of prevention of ML/FT are further improvement of the legal framework to align with the Fifth Directive and with updated the FATF recommendations in a manner which ensures the strengthening of the AML/CFT system in RS, and to ensure implementation of that improved legal framework by conducting supervisions activities.

The activities of the Banking Supervisory Authority in 2019

Measures Against Banks

During 2019, National Bank of Serbia took following measures against banks: 11 letters of warning, 6 decisions on orders and measures and 7 fines to the bank/member of board of directors. Decisions on fines imposed toward to 7 banks and members of their board of directors. Also, National Bank of Serbia was terminated six control procedure.

Licensing and Approvals regarding Banks

In 2019, the National Bank of Serbia received 6 requests for giving prior consent for acquisition of ownership in banks and: granted 5 prior consents for acquisition of ownership in banks (1 requests was terminated), approved 25 requests for amendments of banks' founding acts and their articles of association. Also, 101 procedures regarding appointment of managing and executive board members were initiated (99 requests were approved, 1 procedure was terminated, 1 request was rejected).

Also, the National Bank of Serbia: granted 2 prior consents for inclusion in calculation of the common equity tier 2 of element of the capital – subordinated obligation and granted 1 prior consent for early repayment subordinated obligation.

Furthermore, 4 requests for prior approval for distributing bank's profit through payment of dividends to its shareholders were submitted (all 4 requests for distributing bank's profit through payment of dividends to its shareholders were approved), 1 request for granting consent for acquisition of subordinated company in financial sector was approved and, 4 banks were permitted not to include a subordinated company in financial sector in revision of consolidated financial statements and 1 bank was rejected for consent own shares.

Also, the National Bank of Serbia granted 6 prior consents for inclusion in the calculation of the common equity tier 1 - of the elements of that capital referred to in item 7, paragraph 1, provision under 1) of the Adequate Decision Capital banks by increasing the basic share capital. Furthermore, the National bank of Serbia granted 1 consent for the merging by acquisition of the banks and granted 1 prior consent for reducing the value of the elements of the tier 1 capital.

Also, the National Bank of Serbia granted 5 prior consents for inclusion interim profit in common equity tier 1 capital (4 requests were approved, 1 request was terminated). The National Bank of Serbia processed 382 notifications from banks regarding outsourcing of their business activities.

Off-site controls

In order to identify the main risks in the operations of banks and to examine their risk profile, the NBS prepares regular information that include the analysis of the business model of banks, the quality of corporate governance and internal control systems, the risks that affect the solvency and liquidity of the banks, as well as the assessment of the adequacy of capital and liquid assets of the banks. The conclusions of these supervisory assessments, as well as quantitative and qualitative supervisory recommendations, were submitted to the banks.

In addition to the above information, annual estimates of banks recovery plans, as well as recovery plans of banking groups were also carried out. According these estimates, the NBS sent recommendations to the banks regarding identified irregularities or deviation from best practices.

In 2019, NBS monitored the implementation of banks' plans to reduce bad assets.

In addition, notifications on the introduction of new products, outsourcing activities and notifications on the transfer of receivables were analyzed on the on-going basis.

From the previous questionnaire, two new off-site controls were conducted related to: control of the cash flow management activities and control of the accounting for business changes.

Based on all the above analyzes and information, the on-site plan for 2020 was prepared, as well as a plan of supervisory activities for this year.

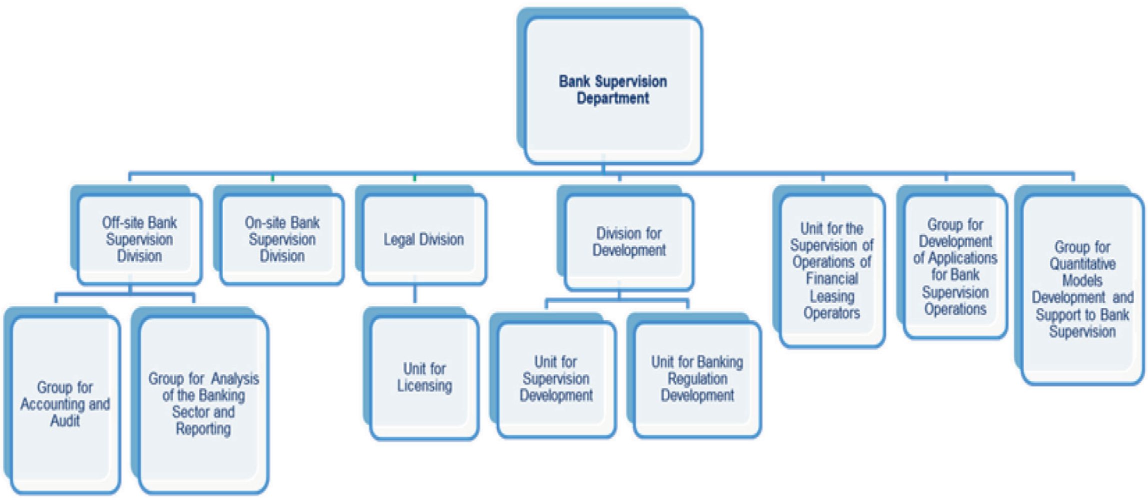
On-site inspections

Regarding activities of prudential on-site supervision of bank operations in 2019, 22 on-site inspections were conducted with different types of risks within their scope: 12 targeted inspections and 10 follow-up inspections related to corrective measures that have been undertaken.

AML

In the area of AML/CFT in banks, in 2019 the NBS conducted regular off-site supervisions activities by analyzing bank's responses to submitted quarterly questionnaires on their operations in the area of ML/CFT risk management, monitoring of compliance submitted internal acts with AML/CFT regulations, monitoring of internal controls finding etc. Also, in 2019, NBS's, on the basis of estimated plan of supervision activities, performed targeted AML/CFT on-site controls in 9 banks, and in case of irregularity imposed corrective measures and fines.

Organizational chart of the Banking Supervisory Authority



The Bank Supervision Department consists of seven lower-level organizational units: Off-site supervision division (with two lower-level organizational units: Unit for banking sector analyses and supervisory reporting and Unit for accounting and auditing), On-site supervision division, Legal division (with lower-level organizational unit: Unit for licensing), Division for development (with two lower-level organizational units: Unit for supervision development and Unit for banking regulation development), Unit for the supervision of operations of financial leasing operators, Group for development of quantitative models and support to bank supervision and Group for development of applications for bank supervision operations.

International activities of the authority

The NBS cooperates with foreign regulatory authorities, for the purposes of cooperation and exchange of data (information) with a view to exercising and promoting its supervisory function.

In that respect in 2019, the NBS continued to implement the Memorandums of Understanding (hereinafter: the MoUs) signed with foreign regulatory authorities in the field of banking and insurance supervision.

The NBS has very successful cooperation with all of the home supervisors of the banks whose subsidiaries are conducting its business in Serbia, through the Supervisory colleges, conference calls, joint on-site review etc.

Regarding the competencies of the NBS, which is the central bank in the Republic of Serbia, and the supervisory authority of the largest part of the financial system in RS, its general empowerment for the cooperation with foreign central banks and regulatory authorities is defined by the Law on NBS and sectoral laws (such as the Law on Banks).

Despite the possibility of exchanging information without concluded MOUs, the NBS has numerous bilateral and multilateral agreements with supervisory authorities from foreign countries.

The NBS most frequently exchanges information with its counterparts about the main findings on performed controls, as well as the information needed in the licensing process.

AML

The Delegation of the RS (consisting of representatives from the Administration for the Prevention of Money Laundering, the NBS, the Ministry of Internal Affairs and the Ministry of Justice) is actively participating in the work of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and Financing of Terrorism of the Council of Europe (Moneyval), which brings together experts assessing the compliance of Member States with all relevant international standards to combat money laundering and terrorist financing in the area of legal practice, financial system and internal affairs, through the process of mutual evaluation of equal members.

Regarding the competencies of the NBS, which is the central bank in the RS, and the supervisory authority of the largest part of the financial system in RS, its general empowerment for the cooperation with foreign central banks and regulatory authorities is defined by the Law on NBS and sectoral laws (such as the Law on Banks), and in the AML/CFT area is defined by The AML/CFT Law.

Despite the possibility of exchanging information without concluded MOUs, the NBS has numerous bilateral and multilateral agreements with supervisory authorities from foreign countries.

The NBS most frequently exchanges information with its counterparts about the main findings on performed controls, as well as the information needed in the licensing process.

After the FATF Plenary meeting, in June 2019, it's published at FATF's website information that Serbia made significant progress in terms of improving its system for combating money laundering and terrorism financing and the proliferation of weapons of mass destruction, thus affirming that the mechanisms in this domain have been greatly reinforced. It was assessed that there is the highest-level political commitment, as well as institutional capacities for sustaining reforms of the system for AML/CFT.

Further progress made by Serbia and its commitment to implementing the MoneyVal recommendations was acknowledged at the December 2019 Plenary meeting, which discussed the Third Enhanced Follow-Up Report when MoneyVal upgraded the 2016 compliance ratings for three more FATF recommendations: 6 (Targeted financial sanctions related to terrorism and terrorist financing), 8 (Non-profit organisations) and 18 (Internal controls and foreign branches and subsidiaries).

Cooperation with other supervisory bodies in the country

The NBS successfully cooperates with all supervisory authorities in the country whenever there is a need for sharing information in accordance with signed MoUs.

Regarding its supervisory task, National bank of Serbia has signed MoUs with following domestic bodies and authorities: Deposit Insurance Agency, Securities Commission Administration for the Prevention of Money Laundering, Tax Administration of the Republic of Serbia, Commission for Protection of Competition, Association of Serbian Banks and the Belgrade Stock Exchange. In that respect in 2019, the NBS has signed a Memorandum of understanding and mutual exchange of information and data with the Deposit Insurance Agency. Cooperation includes, in particular, the exchange of data and opinions regarding the possibility of initiating a restructuring procedure against a certain bank or revoking its operating license in accordance with the Law on Banks, and in particular the exchange of data needed to assess the possibility of bank restructuring and to draft a minimum cost test report.

The cooperation also includes joint activities on the development of a Methodology for the calculation of deposit insurance premiums based on the level of risk in the operations of banks (hereinafter: the Methodology) and the exchange of data in accordance with the Methodology.

The NBS successfully cooperates with all before mentioned domestic supervisory authorities whenever there is a need for sharing information in accordance with provisions of MoUs signed.

AML

Cooperation with other supervisory bodies in the RS in the field of prevention of ML/FT is regulated by the AML/CFT Law and MoU between relevant institutions. The NBS successfully cooperates with other supervisory bodies in the RS by participating in the drafting of regulations, in exchanging of information regarding identified irregularities in the control process in accordance with the AML/CFT Law, also the NBS informs other supervisory authorities about irregularities in their competence and conduct other activities.

Aiming to improve coordination and effectiveness of cooperation of all stakeholders in the AML/CFT system, in RS is established a Coordination body for prevention of ML/FT authorized, besides to monitor the implementation of the National AML/CFT Strategy and its Action Plan, for coordination of all AML/CFT activities in preventing ML/TF on a permanent basis.

Other relevant information and developments in 2019

Other relevant developments were mainly related to analysis regarding European Union regulations and their potential implementation in domestic regulatory framework (prudential reserve, NSFR…) in line with characteristics of domestic market and defined priorities.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	29	27	26
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**29**	**27**	**26**

Total assets of banking sector in thousand EUR (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	28,440,240	31,931,225	34,731,173
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	28,440,240	31,931,225	34,731,173
y/y change (in %)	8.33	12.27	8.77

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	16.1	17.5	16.8
Domestic (private and public) ownership total	23.1	24.6	24.3
Foreign ownership	76.9	75.4	75.7
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	37.4	53.4	800
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**37.4**	**53.4**	**800**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	10.6	11.3	9.8
Cooperative banks			
Banking sector, total:	**10.6**	**11.3**	**9.8**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions			
Cooperative banks			
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector[3]	12.1	14.7	13.1
Nonfinancial sector[4]	56.9	57.2	58.2
Government sector[5]	19.6	17.8	17.4
Other assets	11.4	10.2	11.3
Liabilites			
Financial sector	9.2	10.7	9.9
Nonfinancial sector	67.5	68.4	68.9
Government sector	2.2	2.0	2.7
Other liabilities	1.2	1.0	1.3
Capital	**19.8**	**17.9**	**17.3**

Capital adequacy ratio of banks ***

Type of financial institution	2017	2018	2019
Commercial banks	22.6	22.3	23.4
Cooperative banks			
Banking sector, total:	**22.6**	**22.3**	**23.4**

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

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

Asset classification	2017	2018	2019
Non-financial sector, including			
- retail	5.90	4.44	3.94
- corporates	13.64	7.15	4.37

[3] Domestic finance and insurance sector, plus foreign banks
[4] Public nonfinancial entities, private companies, entrepreneurs, households, private households with employed persons, registered agricultural producers, foreign persons (except banks) and other legal entities.
[5] General government sector.

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	94.5	97.6
Retail	56.8	45.2
Corporate	33.6	50.9
Government sector	2.6	1.6
Financial sector (excluding banks)	2.8	0.8
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	1,210,989	1,254,773	1,293,036
Interest expenses	190,299	180,610	197,855
Net interest income	1,020,690	1,074,162	1,095,181
Net fee and commission income	317,686	341,594	357,878
Other (not specified above) operating income[6] (net)	263,819	249,509	196,002
Gross income	1,602,195	1,665,265	1,649,061
Administration costs[7]	882,500	887,859	909,026
Depreciation[8]	58,297	59,963	104,448
Net income/expenses from impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	81,598	76,836	60,011
Profit (loss) before tax	579,799	640,608	575,576
Net profit (loss)	536,608	595,839	543,545

Total own funds in 2019 (in EUR) ***

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	5,244,195	5,003,597	5,016,978	227,217	n.a.
Cooperative banks					
Banking sector, total:	**5,244,195**	**5,003,597**	**5,016,978**	**227,217**	**n.a.**

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

[6] Comprises net gain/loss on change in fair value of financial instruments, net gain/loss from reclassification of financial instruments, net gain/loss from derecognition of financial instruments measured at fair value, net gain/loss from hedging, net gains/losses on exchange rate differences and gains/losses from agreed currency clause, net gains/losses from derecognition of the financial instruments measured at amortised cost, net gains/losses from derecognition of investments in associated companies and joint ventures, other operating income, other income.

[7] Salaries, salary compensations and other personal expenses, other expenses.

[8] In accordance with the official „Income Statement" form, under the item Depreciation costs, the banks disclose the costs of depreciation of intangible investments, fixed assets and investment property.

Macroeconomic environment in the country[1]

The economic growth faded in 2019. Slovak GDP recorded 2.4% annual growth in 2019, notably lower than more than 3% growth rates in the two previous years. The deceleration was result of the cooling of global demand which stemmed from the implementation of protectionist trade measures and the climate of heightened uncertainty. While domestic demand remained relatively stable, net exports recorded negative contribution to Slovakia´s GDP growth. The domestic labour market proved resilient to the cooling trends in 2019. After six years of falling, the unemployment rate ended the year at 5.7%. The relatively low labour supply was reflected in the average wage, which increased by 5.5% in nominal terms and by more than 2.7% in real terms. The economic slowdown was fully reflected in corporate sales in 2019, as their annual growth rate slumped to 2.1%. Given the ongoing decline in interest rates and the acceleration of headline inflation that attained 2.8% levels, an increasing share of loans secured by residential real estate was being provided at a negative real interest rate. While macroeconomic development has mirrored in the demand for corporate loans in 2019 that decelerated in line with its fundamentals, the labour market development has stimulated the household demand for new loans. Macroeconomic development however has significantly reversed during the first quarter 2020 after COVID-19 pandemics onset.

Development in the banking sector (including assets total / GDP)[2]

The expansionary phase of the financial cycle was in its advanced stage in 2019, mirroring the fading GDP growth. However, economic slowdown in 2019 was not yet having a notable impact on the domestic financial sector. Compared with the end of 2018, the financial sector's total assets were higher by 6.8%, or more than €8 billion, at the end of 2019, at €126.3 billion. All significant segments of the financial sector recorded asset growth, while the banking sector´s asset growth by 5.5% accounted for more than half of the overall asset growth in the financial sector. An environment of strong competition and ongoing compression of interest margins (among the lowest in the euro area) was compelling banks to step up lending activity in order to maintain their profitability. The banking sector's business model is coming under substantial pressure, as the persisting decline in interest margins is forcing banks to provide large volumes of new loans, thereby increasing their exposure to risks of a cyclical nature. As result the banking sector's ROE, declined by 0.7 percentage point year on year and is now approaching 8.5% levels. In terms of profitability, the Slovak banking sector was one of the highest ranked among CEE banking sectors in 2016 but now lies on the edge of the lower quartile.

[1, 2] Source: Financial Stability Report

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

National Bank of Slovakia (NBS) was established as an independent central bank of Slovakia on 1 January 1993, under Act no. 566/1992 Coll. on Národná banka Slovenska.

In 2019, NBS continued to be a member of the Eurosystem, which includes the European Central Bank (ECB) and the national central banks (NCBs) of those countries that adopted the euro. NBS joined the Eurosystem on 1 January 2009, the date on which Slovakia adopted the euro. NBS Governor continued to be a member of the ECB's Governing Council, the Eurosystem's highest decision-making body. Thus NBS, together with other NCBs and ECB, contributes to achieving the common goals of the Eurosystem. NBS has been participating in activities of the Eurosystem and the ESCB through its involvement in the Eurosystem and ESCB committees.

As the national supervisory authority in Slovakia, NBS has been part of the EU's Single Supervisory Mechanism (SSM) – a mechanism for exercising supervision of credit institutions in participating EU Member States – since the SSM came into operation on 4 November 2014.

The NBS participated in specific supervisory tasks of the ECB through the direct involvement of staff members of the NBS Financial Market Supervision Unit in Joint Supervisory Teams and through cooperation in the drafting of ECB decisions. As regards the supervision of significant banks, NBS exercised supervision over the banks' activities on daily basis and continuously monitored quantitative data and oversaw risk management processes.

Slovakia's Resolution Council was established in January 2015 as part of the EU's Single Resolution Mechanism – the second of the Banking Union's three pillars – with NBS assigned the role of providing expertise to the Council and organising its functioning.

Since 1 January 2015, NBS has been the financial consumer protection authority in Slovakia. As such, the central bank supervises the protection of financial consumers' and other clients' rights in order to support the secure and sound functioning of the financial market.

Main strategic objectives of the supervisory authority in 2019

Roles and objectives of the NBS' Financial Market Supervision Unit ("FMS") are defined by legal rules as set forth by the Act No. 747/2004 Coll. On Supervision in the Financial Market as amended. The objective of the integrated financial market supervision is to contribute to the stability of the financial market as a whole, as well as to the secure and sound operation of the financial market in the interest of maintaining credibility of the financial market, protecting financial market consumers, and respecting the competition rules.

One of the key priorities for all the Bank's supervisory activities in 2019 was credit risk. Supervision focused mainly on analysing the quality of banks' portfolios in close connection with the approval of a new definition of "default" and with the continuing long-term SSM project focused on reviewing banks' internal models used for the capital requirement calculation.[3]

[3] Annual Report 2019 - http://www.nbs.sk/en/publications-issued-by-the-nbs/annual-report/ar-2019-chapters

The activities of the Banking Supervisory Authority in 2019[4]

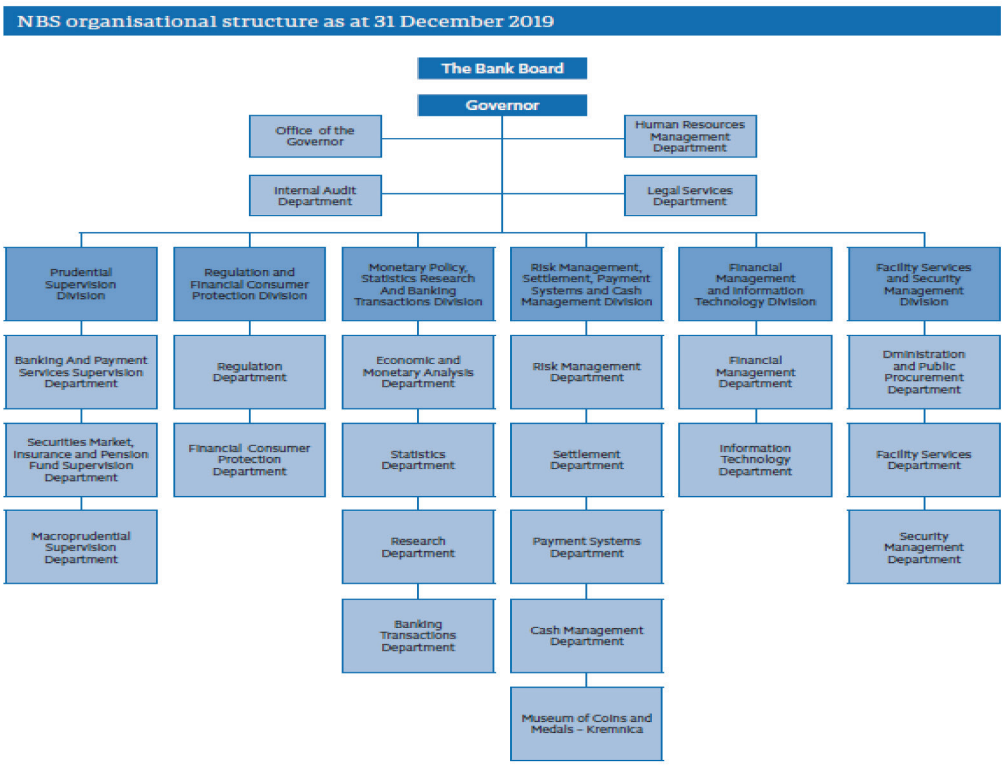
As at 31 December 2019 a total of 12 banks and 15 foreign bank branches were operating in Slovakia. Under the Single Supervision Mechanism (SSM), consisting of the European Central Bank (ECB) and the national competent authorities of participating Member States, all banks and foreign bank branches in Slovakia are categorised as either:

- significant institutions (SIs), supervised directly by the ECB in cooperation with NBS;
- less significant institutions (LSIs), supervised directly by NBS; three of these institutions are classified as high-priority LSIs.

In 2019 a total of 24 proceedings were initiated in which the ECB exercises decision-making power in cooperation with NBS. The majority of these proceedings concerned fit and proper assessments of persons nominated to be a member of a significant bank's management board or supervisory board.

In 2019 NBS issued a total of 73 decisions under supervisory proceedings concerning this sector; most of them were grants of prior approval for appointments to one or more of the following positions: member of a management board or supervisory board, senior manager, and chief internal control/audit officer.

Organizational chart of the Banking Supervisory Authority



[4] Annual Report 2019 - http://www.nbs.sk/en/publications-issued-by-the-nbs/annual-report/ar-2019-chapters; Further details are provided in a Slovak-language report entitled "Správa o činnosti útvaru dohľadu nad finančným trhom NBS za rok 2019" (Report on the Activities of the Financial Market Supervision Unit of NBS in 2019), which is published on the NBS website at http:// www.nbs.sk/sk/publikacie/publikacie-dohladu/sprava-o-cinnosti-udf

International activities of the authority

At the international level, NBS focused on integration and cooperation within European structures. Increasing international cooperation in financial markets requires the respective supervisory authorities to work more closely together. Thus, through the European System of Financial Supervision (ESFS), the activities of NBS as supervisor of the domestic financial market were closely coordinated with those of other supervisory authorities in the EU.

The single supervisory regime works on basis of continual cooperation between the ECB and the national supervisory authorities. NBS participated especially in supervisory tasks of the ECB through its involvement of NBS staff in Joint Supervisory Teams and in the drafting of ECB decisions during 2019.

For supervision at the level of the European financial system, NBS continued in co-operation with the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

NBS's ongoing cooperation with the EBA focused, in 2019, on the drafting of implementing technical standards (ITSs), regulatory technical standards (RTSs) and guidelines required under the EU's Capital Requirements Regulation and Directive (CRR/CRD IV) and related legal acts. NBS cooperated with the EBA at all levels of competence, from working groups to the highest approval bodies.

Cooperation with other supervisory bodies in the country

NBS is the only national supervisory body supervising regulated entities of the Slovak financial market. Slovak Ministry of Finance has only certain minor supervisory tasks in this area, such as oversight over state subsidies for mortgage banks. Nevertheless, the Banking 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 2019[5]

In an environment of low interest rates, high non-performing loan ratios in several European countries, discussions about loan pricing, and downward pressure on banks' profitability, the ECB and the European Banking Authority responded with a number of initiatives in 2019. Among them was a review of credit underwriting standards conducted at EU and national levels. In Slovakia, the review was conducted by NBS through ongoing supervision of the country's three largest banks.

In 2019 NBS banking supervision actively participated in the work of the ECB's joint supervisory teams (JSTs) and supervisory colleges for individual European banks, which includes the production of annual assessments of the supervised banks. Compared with the 2019 assessments of other EU banks, the assessment results for Slovak banks were among the best.

The fastest-growing sector of the Slovak financial market in 2019 was payment services. As at 31 December 2019 a total of 13 payment service providers were authorised to operate in the Slovak financial market; nine of them were authorised to provide payment services to an unlimited extent, and four of them to a limited extent. One electronic money institution was active in the Slovak financial market in 2019.

The Commission Delegated Regulation on strong customer authentication and secure standards of communication ('the SCA regulation'), in force from 14 September 2019, supports new security requirements introduced into the payment services market by the EU's second Payment Service Directive (PSD 2) and does so partly by regulating third-party access. In this case, 'third party' means account information service providers and payment initiation service providers in regard to payment accounts accessible online which are held with account servicing payment service providers, in particular with banks. The operational testing of these bank interfaces was already available for functional testing by third parties from 14 March 2019.

[5] Annual Report 2019 - http://www.nbs.sk/en/publications-issued-by-the-nbs/annual-report/ar-2019-chapters

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	12	12	12
Branches of foreign credit institutions	15	15	15
Cooperative banks	0	0	0
Banking sector, total:	**27**	**27**	**27**

Source: NBS

Total assets of banking sector (in EUR thousands) (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	65 209 896	69 544 067	73 968 089
Branches of foreign credit institutions	10 609 400	10 463 396	10 697 315
Cooperative banks	-	-	-
Banking sector, total:	75 819 296	80 007 463	84 665 404
y/y change (in %)	6.3%	5.5%	5.8%

Source: NBS

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	0.85	0.79	0.66
Domestic ownership total	0.38	0.36	0.32
Foreign ownership	98.77	98.85	99.02
Banking sector, total:	**100.0**	**100.0**	**100.0**

Source: NBS

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	68.0%	85.7%	1786
Branches of foreign credit institutions	66.5%	79.3%	2600
Cooperative banks	-	-	-
Banking sector, total:	**59.4%**	**75.7%**	**1405**

Source: NBS

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	9.16%	9.17%	8.73%
Cooperative banks	-	-	-
Banking sector, total:	**9.16%**	**9.17%**	**8.73%**

Source: NBS

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	86.0%	86.9%	87.4%
Branches of foreign credit institutions	14.0%	13.1%	12.6%
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

Source: NBS

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

	2017	2018	2019
Receivables			
Financial sector	13.6%	11.5%	10.8%
Nonfinancial sector	68.9%	71.6%	72.2%
Government sector	12.8%	12.1%	11.8%
Other assets	4.8%	4.8%	5.2%
Liabilites			
Financial sector	11.2%	10.6%	9.5%
Nonfinancial sector	64.0%	64.9%	65.3%
Government sector	2.5%	3.4%	2.5%
Other liabilities	9.4%	8.4%	10.3%
Capital	**12.9%**	**12.8%**	**12.3%**

Source: NBS

Capital adequacy ratio of banks (%)

Type of financial institution	2017	2018	2019
Commercial banks	18.81% ***	18.43% ***	18.21% ***
Cooperative banks	-	-	-
Banking sector, total:	**18.81% *** **	**18.43% *** **	**18.21% *** **

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

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

Asset classification	2017	2018	2019
Non-financial sector, including	3.75%	3.12%	2.91%
- households	3.18%	2.94%	2.85%
- corporate	5.20%	3.88%	3.46%

Source: NBS

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	89.9%	96.7%
Households	63.2%	61.8%
Corporate	26.6%	34.9%
Government sector	3.4%	1.6%
Financial sector (excluding banks)	6.7%	1.7%
Total	**100.0**	**100.0**

Source: NBS

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

P&L account	2017	2018	2019
Interest income	1 984 185	2 044 707	1 986 132
Interest expenses	273 240	272 340	264 094
Net interest income	1 710 945	1 772 367	1 722 038
Net fee and commission income	528 748	592 487	616 777
Other (not specified above) operating income (net)	-94 353	-121 826	-112 669
Gross income	2 150 076	2 248 418	2 231 211
Administration costs	1 114 160	1 165 939	1 151 047
Depreciation	127 199	120 718	165 520
Provisions	109 465	132 632	105 186
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	126 273*	148 332*	148 516*
Profit (loss) before tax	794 516	823 739	804 393
Net profit (loss)	611 781	640 329	636 027

*Note: * - Data for Commercial banks only, according to FinRep Profit and Loss Account, for years 2017-2019*

Source: NBS

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	6 750 354 425 ***	5 928 049 921 ***	6 178 049 921 ***	572 304 504 ***	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**6 750 354 425 *** **	**5 928 049 921 *** **	**6 178 049 921 *** **	**572 304 504 *** **	**-**

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

Source: NBS

Macroeconomic environment in the country

Developments last year were shaped above all by the reversal in the economic cycle, although the economy itself remained relatively strong. The Slovenian banking system also followed this path, with a renewed improvement in the majority of performance indicators. However, the economic slowdown had already indicated that the period of improving performance is coming to an end for banks. The reversal in the economic cycle picked up great pace in the early part of this year with the outbreak of the pandemic, to which the Eurosystem responded with immediate, wide-ranging measures, thereby reiterating our commitment to the inflation target and the maintenance of financial stability in the euro area.

The economic cycle underwent a reversal in 2019: as GDP growth slowed, while inflation remained below 2%. Economic growth slowed in 2019 in the euro area overall, and also in Slovenia. The key factors related to the deterioration in the international environment. International trade continued to slow, as trade disputes worsened, and growth also slowed in emerging countries. Despite slowing, economic growth in Slovenia remained among the highest rates in the euro area, at 2.4%. Inflation meanwhile was subdued: it was below 2% for the majority of the year in Slovenia and in the euro area overall.

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

The number of credit institutions in Slovenia has fallen over recent years, primarily as a result of consolidation, but was unchanged over the course of last year. At the end of 2019 there were 12 banks, three savings banks and two branches of foreign banks operating in Slovenia. The banks held a market share of 91.4% of the banking system in terms of the balance sheet total, while the savings banks held a share of less than 5% and the branches a share of less than 4%. The trend of decline in the number of banking institutions is nevertheless continuing, thanks to the consolidation process. An agreement was signed in the middle of last year for the sale of Abanka d.d. to NKBM d.d. In January 2020 the ECB issued an authorisation to NKBM for the takeover of Abanka, and the transaction was executed on 5 February 2020. The merger is expected to be completed in the second half of 2020.

The banking system's balance sheet total increased by 6.3% in 2019 to EUR 41.2 billion. On the funding side, the largest factor in the increase was deposits by the non-banking sector, household deposits in particular. On the investment side, the main increases were in loans to the non-banking sector and in highly liquid assets. Investments in securities remained almost unchanged in absolute terms, but the expansion of the balance sheet meant that the proportion of the balance sheet total that they account for had declined to 21.4% by the end of the year. The ratio of the banking system's balance sheet total to GDP has declined slightly in recent years as GDP has recorded relatively high nominal growth; the figure stood at 83.5% at the end of 2019. Slovenia has one of the lowest figures for the ratio of the banks' balance sheet total to GDP among all EU Member States.

The banking system remained well-capitalised in 2019, although there are considerable variations from bank to bank. The sound capital position of the banks has a favourable impact on their capacity to cover losses under any stress scenarios. The banking system's common equity Tier 1 capital ratio stood at 17.8% on a consolidated basis, and remained above the euro area average. The banks increased their regulatory capital not only via retained earnings and other reserves, as was the case in previous years, but also via issuance of subordinated debt securities. Growth in risk-weighted assets strengthened, primarily as a result of an increase in corporate and household lending, but did not outpace year-on-year growth in regulatory capital. The small domestic banks and savings banks, which are weaker in capital terms, improved their capital adequacy via recapitalisations. Despite the increase in regulatory capital, their leverage ratio remained a half lower than the average in the Slovenian banking system.

The quality of bank investments improved again in 2019. The stock of NPEs had declined to EUR 1 billion by the end of 2019, taking the NPE ratio across the banking system to 2.2%, down 1.8 percentage points on the end of 2018. The largest stock of NPEs and highest NPE ratio remained in the non-financial corporations portfolio, although portfolio quality in this segment was significantly better at the end of 2019 than in previous years. Despite high growth in household loans, the NPE ratio remains low for now in both the consumer and housing segments. One potential source of increased risk is consumer loans concluded under laxer credit standards before the introduction of the binding macroprudential instrument in the area of household lending.

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

The Single Supervisory Mechanism (SSM) is one of the three pillars of the EU banking union, created in response to the financial crisis with the aim of restoring and maintaining confidence in the European banking system. The banking union complements the economic and monetary union (EMU) and the single market by coordinating the responsibility for bank supervision, resolution and funding at the EU level, and ensuring a level playing field for banks across the euro area. Alongside the SSM, which has been in operation since 4 November 2014, the other two pillars of the banking union consists of the Single Resolution Mechanism (SRM), which has been in operation since 1 January 2015, and the European Deposit Insurance Scheme (EDIS), which is still being established.

The establishment of the SSM saw supervision of significant institutions (SIs) in the EU transferred to the ECB in 2014, although this supervision is conducted in operational terms via joint supervisory teams (JSTs). The JST for each bank consists of a coordinator from the ECB, and members from the national supervisory authority and the ECB. The national supervisory authorities (the Bank of Slovenia in Slovenia's case) participate in all the supervisory activities, while the supervisory decisions with regard to these banks are made by the ECB.

The supervision of banks and savings banks that do not meet the criteria for being classed as significant institutions, i.e. less significant institutions (LSIs), is conducted by national supervisors, i.e. the Bank of Slovenia in Slovenia's case, in accordance with the rules and methodology of the ECB and the SSM. National supervisors regularly submit supervisory data for less significant institutions to the ECB, and inform it of the material findings of their supervision. The national supervisory authorities may consult the ECB on the imposition of measures, but the final decision is their responsibility, other than in exceptional cases. The new arrangements allow the ECB to directly take over the supervision of less significant institutions at the proposal of the national supervisor, at its own initiative in the event of the potential occurrence of a systemic crisis, or if the national supervisor is failing to conduct adequate supervision.

According to the Bank of Slovenia Act (ZBan-2) the central bank carries out supervision of credit institutions in order to maintain the stability and security of their operations and for the creation of confidence in the banking system, particularly among savers and depositors. In accordance with the statutory mandate the tasks of the Banking Supervision of the Bank of Slovenia include in particular the performance of licensing, authorisation and notification procedures for the work of these institutions, giving consent for members of boards of management to hold their offices in banks, and other authorisations and consents prescribed by The Banking Act, the performance of on-site inspection in banks, collecting and analysing quantitative and qualitative information from supervised entities and other sources, cooperate with other supervisors in the country and outside, participate actively at international supervisory forums, working groups and colleges.

In 2019 several secondary regulations were implemented (New Regulation on credit risk management at banks and savings banks, Guidelines for implementing the Regulation on reporting by monetary financial institutions, New Regulation on the books of account and annual reports of banks and savings banks, with implementing guidelines, Regulations on the application of EBA guidelines).

The Bank of Slovenia also participates in the activities of the EBA within the scope of its competences. With the aim of putting in place consistent, effective and efficient supervisory practices and ensuring the harmonised application of European legislation in all EU Member States, the EBA is¬sues guidelines and recommendations addressed to competent supervisory authorities and banks. It is the duty of supervisory authorities and banks to endeavour to uphold these guidelines and recommendations to the greatest possible extent. The guidelines and recommendations relate to the areas of banking supervision, bank recovery and early intervention, AML/CFT, pay¬ment services and systems, consumer protection and financial innovations. Pursuant to the ZBan-2 the Bank of Slovenia also decides on the applica¬tion of individual guidelines or recommendations issued by other European supervisory authorities (ESMA, EIOPA) in the form of regulations on the application of guidelines or recommendations.

Main strategic objectives of the supervisory authority in 2019

The ECB set the following supervisory priorities within the framework of the SSM in 2019, which also formed the starting point for the supervision of Slovenia's significant banks:

a) credit risk, with a focus on NPL guidance, loan approval procedures and the quality of specific asset-class exposures (e.g. real estate, leverage finance);

b) risk management, with an emphasis on:

  - validation and approval of internal models to calculate capital requirements;
  - the internal capital adequacy assessment process (ICAAP) and the internal liquidity adequacy assessment process (ILAAP), and their inclusion in the SREP;
  - cyber risk and IT risk;
  - liquidity stress test;

c) multiple risk dimensions, such as Brexit preparations, and trading risks and asset valuations.

Within the framework of the annual SREP, in 2019 an assessment of individual risks and internal controls was conducted for all banks, individual capital requirements that must be maintained in excess of the minimum capital requirements were stipulated for them, and qualitative measures were imposed. These primarily related to the management of NPLs, internal governance and operational risk.

Banka Slovenije is independently and directly responsible for **supervising less significant banks**. The supervision is conducted in the form of ongoing supervision, i.e. monitoring and review of reports, data and information that the banks are required to submit to Banka Slovenije periodically or at its explicit request, and in the form of on-site inspections in connection with the identification, measurement and management of various risks.

We set out our principal supervisory activities for each less significant bank in the upcoming calendar year on the basis of a comprehensive annual risk assessment at the bank.

As at significant banks, the most important part of the supervisory process at less significant banks consists of the supervisory review and evaluation process, based on which we define individual requirements for the maintenance of capital adequacy and also qualitative measures for risk management.

For 2019 we identified the following risks as the most material in the operations of less significant banks:

a) credit risk with a focus on consumer and housing lending, and on further reduction of NPLs;
b) risk management with a focus on the ICAAP and the risk inherent in the large holdings of sight deposits;
c) operational risk with a focus on IT and cyber security;
d) internal governance with a focus on changes in bank ownership structures, and the related changes in management bodies, and proper prudential consolidation.

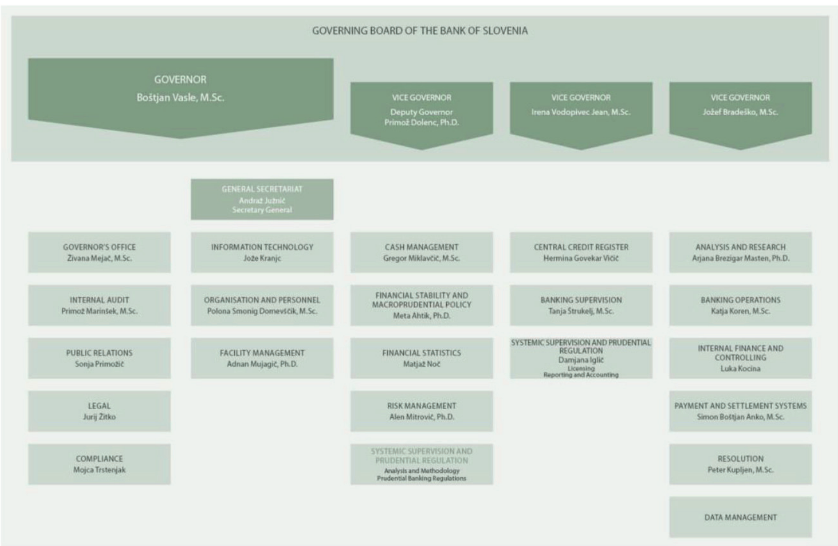
The activities of the Banking Supervisory Authority in 2019

Within the framework of the annual SREP, in 2019 an assessment of individual risks and internal controls was conducted for all banks, individual capital requirements that must be maintained in excess of the minimum capital requirements were stipulated for them, and qualitative measures were imposed. These primarily related to the management of NPLs, internal governance and operational risk.

Given the specific risks at individual banks, the JSTs conducted six deep-dive inspections for signifacnt banks in 2019, which were confined to a narrow segment of banking: credit standards in selected portfolios, credit protection management, operational risk management and internal governance. For less significant banks five on-site supervisory inspections in the areas of credit risk, with a focus on consumer lending and internal controls, operational risk from the perspective of cyber security, bank governance and the ICAAP.

In contrast to prudential supervision, which is conducted by the ECB in conjunction with Banka Slovenije, non-prudential supervision is the exclusive responsibility of Banka Slovenije. The central focus of this supervision is prevention of money laundering and terrorist financing (AML/ CFT), which in addition to banks and savings banks covers other institutions that are supervised by Banka Slovenije in accordance with the ZPPDFT-1 (payment institutions, electronic money institutions, currency exchange offices, and entities engaged in virtual currency activities).

Organizational chart of the Banking Supervisory Authority



International activities of the authority.

European Union;

Representatives of Banka Slovenije participated in informal meetings of the ECOFIN (the EU's council of economics and finance ministers and central bank governors) in 2019. Last year's first meeting was held in April in Bucharest, and discussed the priorities for the next institutional cycle in ensuring growth and convergence in the EU, the way forward for the capital markets union, and taxation and challenges in public finances. The second meeting was held in September in Helsinki, and discussed the resilience of financial markets infrastructure and the role of the financial sector in combatting hybrid threats. It also discussed ideas for rebooting the capital markets union, EU fiscal rules and energy taxation.

International Monetary Fund;

Banka Slovenije is responsible for Slovenia's cooperation within the IMF, and the Governor of Banka Slovenije is a member of the IMF Board of Governors.Slovenia's quota at the IMF stood at SDR 586.5 million61 at the end of 2019, or 0.12% of the total IMF quota. A Banka Slovenije delegation attended the annual and spring meetings of the IMF and the World Bank in 2019. The main topics of the meetings were current developments in the global economy and on international financial markets, the outlook and the potential policy responses.

Bank for International Settlements;

The Governor of Banka Slovenije attends meetings of central bank governors of BIS members, which are held every two months. The meetings discuss developments in the global economy and on the financial markets. The governors' meetings are also an opportunity to exchange views on various central banking issues, most notably in 2019 on innovations in financial inclusion and the role of central banks, digitalisation in central banking, and the macroeconomic consequences of weak bank profitability. Banka Slovenije is a shareholder in the BIS, and the Governor of Banka Slovenije attended the annual general meeting of the BIS in Basel in June 2019.

Organisation for Economic Co-operation and Development;

Banka Slovenije representatives attended sessions of committees and working groups of the OECD. They participated in meetings of the Committee on Financial Markets, the Working Group on International Investment Statistics, the Working Party on Financial Statistics, and the Working Party on International Trade in Goods and Services, and provided information for the Working Party on SMEs and Entrepreneurship.

Technical assistance

Banka Slovenije staff are also involved in programmes of technical assistance to other central banks and supervisory institutions.In 2019 we provided assistance to the central banks and supervisory authorities of Bosnia and Herzegovina, Montenegro, Serbia and Turkey, in the following areas: banking supervision, banking regulations, accounting and internal auditing. Three workshops, two expert missions and one study visit were held within the framework of this technical assistance. The assistance in the area of accounting took place under the aegis of interinstitutional cooperation funded by the EU.

Cooperation with other supervisory bodies in the country

Banka Slovenije actively works with the Ministry of Finance on drafting legislative proposals in connection with banking and finance. Banka Slovenije again worked intensively in 2019 on technical coordination and the preparation of positions on drafts of new legislation and amendments (including the Companies Act, the Act on Judicial Relief Granted to Holders of Qualified Bank Credit, the Prevention of Money Laundering and Terrorist Financing Act, the Central Credit Register Act and the Decree on the provision of data for the activities of SID).

As part of our legislative work at EU level, we took part in negotiations on the revision of the European System of Financial Accounts (in the part relating to the EBA and the ESRB), sustainable finance (taxonomy regulation, disclosure of information and reference values), prudential requirements for investment firms (regulation and directive), the European deposit insurance scheme (EDIS), and certain other legislative proposals that will be debated in 2020. These proposals notably include the legislative proposal for transposing Basel III into EU legislation, which represents the completion of the post-crisis reforms to prudential banking regulation.

Financial Stability Board:

The Financial Stability Board (FSB) is the macroprudential body responsible for formulating macroprudential policy in Slovenia.Banka Slovenije, the Securities Market Agency and the Insurance Supervision Agency exercise macroprudential policy, as members of the FSB. The Ministry of Finance also sits on the FSB, but has no right to vote in its decision-making. The purpose of the FSB is to contribute to the stability of the Slovenian financial system, including strengthening its resilience and reducing the build-up of systemic risks. The FSB is chaired by the Governor of Banka Slovenije, while Banka Slovenije also provides administrative and expert support.

At its four meetings in 2019 the FSB discussed systemic risks, and was briefed on supervisors' macroprudential measures, actions taken to meet the ESRB's recommendations, and the work of the FSB's fintech and cyber security taskforce. Other issues of relevance to financial stability discussed at meetings of the FSB included the methodologies for identifying critical functions and the public interest in resolution, the simplification of obligations in the preparation of resolution plans, the macro stress tests for the Slovenian banking system and insurance system, and Brexit. The FSB also discussed a report on negative interest rates on household deposits (custody fees). The FSB reported on its work to the National Assembly in accordance with the Macroprudential Supervision of the Financial System Act.

Committee for Cooperation between Supervisory Authorities:

Banka Slovenije representatives took part in two ordinary meetings of the Committee for Cooperation between Supervisory Authorities (Banka Slovenije, Ministry of Finance, Securities Market Agency, Insurance Supervision Agency) in 2019. In these meetings the committee discussed new developments in connection with financial legislation, and activities related to the meetings of the Financial Stability Board. It set out joint activities including cooperation on on-site inspections, exchanged information on the functioning of the board of supervisors at EU level, and discussed other subjects of mutual interest.

Office for Money Laundering Prevention

Banka Slovenije works with the Office for Money Laundering Prevention (OMLP) on AML/CFT activities. In keeping with customary practice, meetings are organised before the kick-off of on-site inspections for the purpose of exchanging relevant information that might have a significant impact on the content and scope of the inspection. After completing an inspection, we regularly brief the OMLP on the findings and any measures imposed, as set out by the ZPPDFT-1.

Questionnaire tables for the 2019 review

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	15	15	15
Branches of foreign credit institutions	3	2	2
Cooperative banks	0	0	0
Banking sector, total:	**18**	**17**	**17**

Total assets of banking sector (at year-end) in thousand EUR

Type of financial institution	2017	2018	2019
Commercial banks	36.639.326	37.286.775	39.593.306
Branches of foreign credit institutions	1.307.007	1.490.186	1.619.485
Cooperative banks	0	0	0
Banking sector, total:	37.946.333	38.776.961	41.212.791
y/y change (in %)	2,4	2,2	6,3

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	40,4	25,2	21,9
Domestic ownership total	50,8	35,1	29,9
Foreign ownership	49,2	64,9	70,1
Banking sector, total:	**100.0**	**100.0**	**100.0**

Concentration of asset by the type of financial institutions

Type of financial institution	The first three largest (%)	The first five largest (%)	HHI
Commercial banks	47,3%	62,7%	0,0872
Branches of foreign credit institutions	/	/	0,7206
Cooperative banks	/	/	/
Banking sector, total:	**45,4%**	**60,3%**	**0,1092**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	9,2%	10,3%	10,9%
Cooperative banks	/	/	/
Banking sector, total:	**9,2%**	**10,3%**	**10,9%**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	96,6%	96,2%	96,1%
Branches of foreign credit institutions	3,4%	3,8%	3,9%
Cooperative banks	/	/	/
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector	11,5	12,6	12,1
Nonfinancial sector	51,5	52,9	53,1
Government sector	21,5	20,7	19,1
Other assets	15,5	13,8	15,7
Liabilites			
Financial sector	8,6	8,2	6,8
Nonfinancial sector	69,6	72,1	72,9
Government sector	3,0	2,7	2,5
Other liabilities	6,4	4,9	5,7
Capital	**12,5**	**12,2**	**12,0**

Capital adequacy ratio of banks

Type of financial institution	2017**	2018**	2019**
Commercial banks	19,8	19,8	20,1
Cooperative banks	/	/	/
Banking sector, total:	**19,8**	**19,8**	**20,1**

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

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

Asset classification	2017	2018	2019
Non-financial sector, including	4,6	3,1	2,2
- households	2,4	1,9	1,8
- corporate	5,4	3,4	1,4

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	92,7	87,7
Households	65,5	45,5
Corporate	27,1	42,2
Government sector	3,3	6,9
Financial sector (excluding banks)	4,0	5,3
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	767.180	775.339	789.969
Interest expenses	115.232	103.618	107.256
Net interest income	651.948	671.719	682.708
Net fee and commission income	313.479	315.405	333.821
Other (not specified above) operating income (net)	108.744	166.392	239.574
Gross income	1.074.175	1.153.292	1.256.077
Administration costs	614.622	614.411	639.681
Depreciation	59.066	55.067	69.618
Provisions	19.528	4.707	-4.282
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	-62.273	-57.730	-55.522
Profit (loss) before tax	443.227	530.865	592.509
Net profit (loss)	424.785	495.198	530.501

Total own funds in 2019 (in EUR)

Type of financial institution	Total own funds	Core Tier 1	Tier 1	Tier 2	Tier 3
Commercial banks	4.545.816	4.344.258	4.344.258	201.558	/
Cooperative banks	/	/	/	/	/
Banking sector, total:	**4.545.816**	**4.344.258**	**4.344.258**	**201.558**	**/**

** There is no Tier 3 capital applied in our banking system.*

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

Macroeconomic environment in the country

Turkey is the 19th-largest economy in the world with a GDP around USD 754 billion. From 2000 to 2019, per capita GDP in Turkey more than doubled from USD 4,200 to USD 9,127. The growth pace of Turkish economy has been noteworthy in the past three years despite adverse shocks. This performance has been driven by policy stimulus and a dynamic, well-diversified business sector.

In 2018, GDP growth rate was 2.8%. Turkey started the year 2019 within the impacts of slowdown in global economic activity, the negative impact of protectionist tendencies in global trade, the uncertainty in the macroeconomic conditions of the country and the rising geopolitical risks. On the other hand, although the effects of the financial shocks in August 2018 were replaced by normalization since September, the lagged effects on the real economy became more pronounced as of the last quarter of 2018. The macro financial outlook improved with the start of 2019, and this trend became more evident after June 2019. Particularly in the third quarter of 2019, mild course of global financial conditions and the fall in domestic inflation and inflation expectations helped bring Turkey's risk premium and exchange rate volatility down. Regarding to these developments in 2019, GDP grew by 0.9%, albeit limited.

The moderate and gradual recovery observed in domestic economic activity was mostly driven by net exports in the first half and by consumer spending in the third quarter of 2019. The fall in interest rates and improvement in financial conditions, which came on the back of the downward trend in inflation and the improvement in inflation expectations, support credit demand and economic activity.

The contraction in current account deficit during the rebalancing process reduced the need for additional FX borrowing. The ratio of the corporate sector's domestic and external FX financial debt to GDP decreased due to a contraction in FX loan balances given the limitations on the issuance of FX-indexed and FX loans introduced in May 2018 with amendments made to the Law No.32 Regarding the Protection of the Value of Turkish Currency, decline in investment demand, and the enhanced awareness of FX risk management. Moreover with the contraction in GDP in 2019, current account deficit turned into a surplus. The current account surplus is USD 8 billion as of 2019.

Household indebtedness remains stable at low levels. The average ratio of household indebtedness to GDP, which was 42 percent in EMEs in the first half of 2019, is 14% in Turkey.

[1] BRSA 2019 Annual Report

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

The Turkish financial system is dominated by the banking sector, which represents about 86.5[1] percent of total financial sector assets. As of December 2019, there are 53 banks operating in the Turkish Banking Sector (TBS) of which 34 are deposit taking banks (86,9 percent market share), 6 are participation banks and 13 are development and investment banks. All banks are under the supervision of the BRSA. Turkish banking sector operates with 11,376 branches and 204,884 employees. The total asset size of TBS is nearly TL 4.5 trillion. As of year-end 2019, the total assets to GDP ratio is at 104.9%.

As of December 2019, the volume of loans has reached to TL 2.7 trillion, which constitutes 59.1% of total assets. The Turkish banking sector had a cumulative average growth rate of 20% since 2002. Despite this outstanding performance, sustainable credit growth is considered around 15%, given the population dynamics and the banking penetration levels. However, below-potential growth rates emerged because of the decelerated economic activity particularly in the second half of 2018. On the other hand, with the second half of 2019, credit growth started to pick up with the normalization in inflation outlook leading to an easing in interest rates, which has eventually supported the loan demand. As a result, the annual loan growth[2] is 6.7% as of December 2019.

The share of FX loans in loan portfolio is around 38.8% (including FX indexed loans). The share of corporate loans, retail loans and SME loans are 54.8%, 22.0%, and 23.2% respectively.

The economic rebalancing was remarkable and a 'V' shaped economic recovery was gaining momentum before COVID-19 outbreak. Global COVID-19 pandemic is currently causing significant market disruptions. As a result, to minimize the impact of the virus, Turkish authorities have launched fiscal and monetary packages. Besides, BRSA made a series of new decisions to support the banking sector and the economy. One of the most important measures taken by BRSA is the Asset Ratio. Asset Ratio was introduced in order to minimize the negative impact of the COVID-19 pandemic on the economy, markets, production, and employment, as well as to ensure the most effective use of banks' funds. The most obvious intention is to encourage banks to lend more, preferably to retail and commercial clients.

NPL ratio, which is an important indicator of asset quality, is 5.4% as of December 2019. Due to the significant depreciation of the Turkish lira and the rising interest rates after the 2018 August turmoil asset quality of the sector deteriorated during the slowdown in the economic growth. The rise in NPL ratio of SME loans and the restructuring demands of large corporates raised concerns about the health of asset quality. In this period, BRSA conducted a comprehensive asset quality review process for banks to implement relevant actions for reclassification of loans and to enhance their financial soundness. The NPL ratio of loans, which was 2,9% at the end of 2017, increased to 3,9% and 5,4% in December 2018 and December 2019 respectively. However, NPL ratio started to decrease with the beginning of 2020 mainly because of the recovery in the economy before the pandemic and the recent rise in loans. There is no expectation about any significant increase in NPL's, but the development of NPL's are closely monitored.

Securities are the second biggest item in the balance sheet of Turkish banks. Total share of securities in the balance sheet is 14.7% and the amount of securities is nearly TL 661 billion.

For Turkish banks, the main funding source is deposits (57.1% of total liabilities). Total deposits has reached to TL 2.6 trillion. FX deposit constitutes 51% of total deposits. Wholesale funding, is around USD 88.4 billion and constitutes 11.7% of total liabilities. Foreign borrowing includes repos, deposit, loans and syndication and securitization loans. As of year-end 2019, the rollover rate of syndication loans is at 77.7%. Bond issuances with a share of 4.3% in total liabilities has reached to TL 200 billion.

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[2] Foreign currency and parity effect eliminated

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

In Turkey, Banking Regulation and Supervision Agency (hereinafter: '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. 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. Furthermore Turkish Banking Law is codexed in accordance with the "Core Principles for Effective Banking Supervision" document published by BCBS. Banking Law in force gives the BRSA all the powers to regulate, enforce and ensure the implementation of the establishment, activities, management and organizational structure, merger, disintegration, change of shares and liquidation of banks and monitor and supervise enforcement. BRSA uses its powers through regulatory transactions and specific decisions taken by its Board. Banking Regulation and Supervision Board is authorized to revoke the operating permissions of failing banks or to transfer the shareholder rights except dividends and the management and supervision of the banks to the Savings Deposit Insurance Fund (SDIF), for the purposes of transferring, selling or merging them partially or fully. The banks whose operating permissions have been revoked are liquidated as subject to the provisions of Banking Law by SDIF.

The supervisory approach of the BRSA is a dynamic risk-focused one that aims to ensure efficiency, continue adequacy of supervision and efficient allocation of supervisory resources. The approach proposes to shape supervision form, scope, time, content and intensity based on the risk profile and adequacy of internal controls and risk management systems of each institution.

The BRSA's methodology for ongoing supervision of banks, established in the Supervisory Manual on Banking Supervision Process is organized in supervisory cycles that last one year.

Supervision and risk management departments are responsible for on-site examinations. That includes regular annual on-site supervision, which includes risk assessment, credit model evaluation, CAMELS rating, targeted inspections, complementary and compliance inspections.

Main strategic objectives of the supervisory authority in 2019

Bank and non-bank financial institutions under the regulation and supervision of the BRSA constitute 86.5% of total assets of the financial sector in Turkey.

BRSA's main strategic objective is to ensure market efficiency, with aiming full functioning credit system, protecting depositor's rights and improving financial markets.

BRSA set the following strategic objectives in 2019:

- Improving the administrative efficiency for achieving the institutional goals.
- Incrementing human, fiscal and physical resources and strengthening the institutional culture.
- Expanding the content and shortening the period of data disclosed to the public via developing structures intending the effective and secure use of the information.
- Strengthening flexible, effective and extensive regulation infrastructure based on the financial stability and the safety within the scope of new financial architecture.
- Improving supervision in terms of extent and efficiency, and using forward-looking approaches and tools in consistent with risk-focused point of view.
- Ensuring the effectiveness and continuity of enforcement function.
- Developing the participation banking and interest-free finance.
- Improving the capacity to analyze systemic fragilities.
- Increasing the effectiveness of risk management policies.
- Strengthening the administrative capacity and regulatory framework intending the protection of the financial consumers, and working on improvement of financial awareness.

The activities of the Banking Supervisory Authority in 2019

In 2019, Banking Regulation and Supervision Agency (BRSA) put 1 new regulation and 1 new communiqué into effect, and amended 22 regulations and 5 communiqués.

BRSA also prepared a draft law amending Banking Law No. 5411. The amendment aimed to achieve compliance with the changes in international standards and principles, particularly the standards published by the Basel Committee on Banking Supervision. The draft law entered into force in February 2020 as Law No. 7222.

BRSA performed a special comprehensive on-site audit within the scope of IFRS 9 policies throughout the banking industry in 2019. With the audit, financial structure and rating reports were prepared, and rating scores regarding asset quality, capital and liquidity adequacy for banks were calculated. Based on the results, BRSA instructed banks to take the respective measures and actions, and classify loans extended to troubled debtors as non-performing loans.

Besides its regulation and supervision activities, BRSA also took macro prudential measures as required by the conjuncture to ease or tighten both credit and currency markets. The measures taken in 2019 particularly focused on limitations on credit card installments and consumer loan terms, loan-to-value ratios, and minimum payment ratio for credit cards.

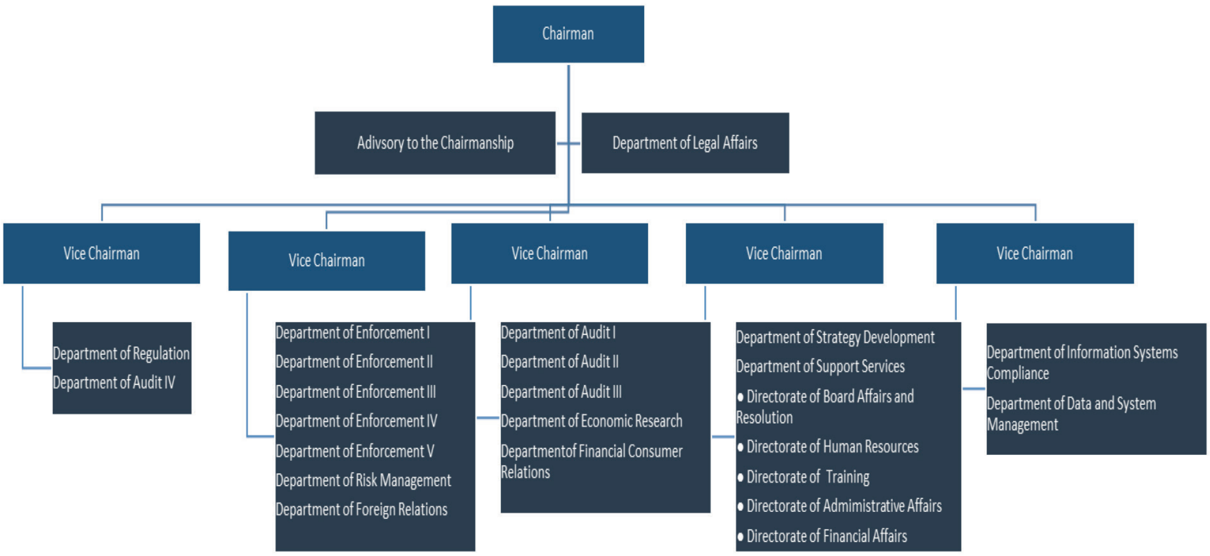
BRSA continued licensing activities based on its "fit-and-proper" standards and meticulous assessment process. Within this scope, BRSA granted 1 investment bank and 2 asset management companies establishment licenses. BRSA also granted 1 participation bank, 1 factoring company, 1 financing company, 3 asset management companies, 3 payment institutions and 3 electronic money institutions operating licenses. Furthermore, 6 valuation companies and 1 independent audit institution were authorized to perform valuation and audit, respectively.

Participation-banking segment, which BRSA pays particular importance for the development of financial system, was another work area in 2019. For this segment to be promoted, fund utilization methods of participation banks were diversified; development and investment banks were allowed to operate also based on participation banking methods; and flexibilities were provided in donation and aid limits with respect to revenues acquired compulsorily due to the legislation and which do not comply with the professional principles and standards of participation banking.

Aiming to improve international cooperation and information exchange in banking regulation and supervision field, BRSA signed two memorandums of understanding with the Kazakhstan Financial Market Supervision Authority and the Central Bank of Republic of Uzbekistan in 2019. Thus, as of the end of 2019, the number of memorandums of understanding signed with foreign counterpart authorities reached to 40 from 36 countries.

The Fourth Strategic Plan of the BRSA (2019-2021), specifying the critical steps for the effective fulfillment of the duties of the Agency, was adopted by the Banking Regulation and Supervision Board in March 2019. The Plan aims to boost confidence and stability in the financial markets, to ensure that the credit system operates effectively, to protect the rights and interests of the savings owners and to improve the financial sector.

Organizational chart of the Banking Supervisory Authority



International activities of the authority

Efficient and timely exchange of information among supervisory bodies is essential for effective supervision, and is particularly critical for a strong financial market. In order to improve the effectiveness of the consolidated supervision, BRSA collaborates with foreign supervisory authorities. Accordingly, BRSA signs Memorandum of Understanding (MoU) with foreign counterparts on the consistency of policies and regulations pursuant to Article 98 of the Banking Law Nr. 5411. Memorandums of understanding aim at developing cooperation among supervisory and regulatory authorities that are parties to agreement for developing financial stability and ensuring the sustainable growth. Pursuant to the memorandums signed between the Agency and The Foreign Equivalent Supervisory Authorities, parties give importance to cooperation on sharing experiences and organizing training programs 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 40 as mid of 2020.

Close cooperation with European Union as a candidate country

Since Turkey is a candidate country to European Union (EU), there exists an extensive effort to align national legislation with EU acquis and to improve the administrative capacity for an effective implementation of new regulations.

Within this context the BRSA participates in the negotiations with EU and responsible for an effective harmonization of the regulations. In recent years, the BRSA has made amendments in banking regulations in order to incorporate EU laws. As a result banking sector is now one of the most prepared sectors for EU accession.

Strong links with multinational institutions

The BRSA has close relations with multinational institutions such as International Monetary Fund (IMF), World Bank (WB), Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS), European Central Bank (ECB), Organization for Economic Cooperation and Development (OECD), World Trade Organization (WTO) and Financial Action Task Force (FATF). The Authority also established membership in Islamic Financial Services Authority (IFSB), which conducts studies on ensuring standardization in Islamic financial services, and also became a member of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in June 2016, which conducts studies for the standardization of finance practices, governance, auditing, accounting standards and financial reporting for non-interest financial institutions.

Relations with other international and foreign institutions

Pursuant to the provisions of Banking Law Nr. 5411, the BRSA has worked in close cooperation with international institutions, has carried out necessary adaptation studies by monitoring closely the regulation and standards developed by these institutions and has actively participated in studies performed by the institutions.

Cooperation with other supervisory bodies in the country

Based on Article 98 of Banking Law, views were exchanged and information was shared with, Ministry of Treasury and Finance, Capital Markets Board (CMB), Savings Deposit Insurance Fund (SDIF) and Central Bank of Republic of Turkey (CBRT) in order to ensure coordination and cooperation among authorities in executing monetary, credit and banking policies.

Financial Sector Commission (FSC) consists of the representatives of BRSA, Turkish Republic Presidency of Strategy and Budget Administration, Ministry of Treasury and Finance, Revenue Administration, CBRT, SDIF, Borsa Istanbul, CMB, Competition Board, Banks Association and Participation Banks Association. FSC is responsible for ensuring coordination, cooperation and exchange of information among the related authorities and associations, raising joint policy recommendations and conveying comments on matters concerning the future of the sector, in order to improve confidence and stability in the financial markets pursuant to Banking Law. The Commission convenes at least twice a year, and the secretariat of the Commission is carried out by the BRSA.

The Coordination Committee (CC) consists of the presidents and vice presidents of BRSA and SDIF. Pursuant to Banking Law Nr. 5411, the CC is in charge of ensuring the maximum cooperation be established between the BRSA and the SDIF when it is necessary to carry out transactions in the competency of the SDIF, and exchange of information.

At the quarterly meetings of the Committee in 2019, evaluations and information exchange were made on the general outlook of the banking industry, measures to be taken as a result of credit institution audits, calculation of risk-based insurance premiums and situations which require procedures by SDIF.

Financial Stability and Development Committee (FİKKO) consists of the presidents of CRBT, BRSA, CMB, SDIF, Borsa Istanbul and the Banks Association (TBB) and chaired by Treasury and Finance Minister. FİKKO is in charge of sustainable development and financial stability.

The Committee was established with the aim of managing systemic risks, ensuring harmonization in financial regulations and practices, and increasing coordination with the real sector in order to ensure that the financial system supports economic growth in a healthy way and maintaining confidence in the markets. The working mechanism of the Committee is being regulated and carried out by the Ministry of Treasury and Finance.

Questionnaire tables for the 2019 review

Number of financial institutions
(at year-end)

Type of financial institution	2017	2018	2019
Commercial banks[3]	38	39	40
Branches of foreign credit institutions	5	5	5
Cooperative banks	0	0	0
Banking sector, total:	**51**	**52**	**53**

Total assets of banking sector (billion TL)
(at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	3082,8	3610,2	4188,5
Branches of foreign credit institutions	12,8	14,6	16,4
Cooperative banks	-	-	-
Banking sector, total:	3257,8	3867,4	4490,8
y/y change (in %)	19,29	18,71	16,12

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	35,96	38,61	41,03
Domestic ownership total[4]	71,96	72,56	73,53
Foreign ownership	28,04	27,44	26,47
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	35.09	53.18	763.84
Branches of foreign credit institutions	0.36	0.37	0.10
Cooperative banks	-	-	-
Banking sector, total:	**35.09**	**53.18**	**788.26**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	16.39	14.95	11.16
Cooperative banks	-	-	-
Banking sector, total:	**15.88**	**14.83**	**11.48**

[3] There are no cooperative banks in Turkey. Commercial banks are defined as deposit taking institutions, therefore investment & development banks are excluded. We have, as of year-end 2019, 13 investment & development banks. Also there are 6 participation banks and 2 SDIF operated banks.

[4] Public and private

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks[5]	94.6	93.3	93.3
Branches of foreign credit institutions	0.4	0.4	0.4
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables			
Financial sector[6]	3.8%	5.6%	5.4%
Nonfinancial sector	68.3%	66.2%	65%
Government sector[7]	22.8%	21.8%	23.2%
Other assets	5.1%	6.4%	6,4%
Liabilites			
Financial sector[8]	20.8%	20.9%	16.3%
Nonfinancial sector	58.6%	60.6%	64.2%
Government sector	4.1%	5.0%	4.1%
Other liabilities	5.5%	2.6%	4.4%
Capital	**11.0%**	**10.9%**	**11.0%**

Capital adequacy ratio of banks

Type of financial institution	2017	2018	2019
Commercial banks***	16.5	16.9	18.0
Cooperative banks	-	-	-
Banking sector, total:	**16.8**	**17.3**	**18.4**

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

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

Asset classification	2017	2018	2019
Non-financial sector, including			
- households	3.5	3.4	3.3
- corporate[10]	2.8	4.0	6.0

[5] Remaining shares belong to investment &development banks.
[6] Consists of receivables from banks and money markets, reverse repo
[7] Consists of required reserves in CB,receivables from CB, government securities and credit loans.
[8] Consists of debts to banks, debt to money markets and banks deposits.
[9] NPL Ratio
[10] Including SME Loans

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:		
Households	61.8	22.0
Corporate	35.1	75.6
Government sector	3.1	2.0
Financial sector (excluding banks)	NA	0.4
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	247.4	368.4	420.5
Interest expenses	134.1	222.3	258.2
Net interest income	113.4	146.2	162.4
Net fee and commission income	28.8	37.0	49.2
Other (not specified above) operating income (net)	-21.0	-19.5	-24.5
Gross income	303.1	446.0	526.9
Administration costs	24.5	27.9	34.1
Depreciation	3.5	3.6	6.8
Provisions	4.0	21.0	21.2
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	8.0	8.9	7.0
Profit (loss) before tax	60.9	66.4	60.6
Net profit (loss)	48.6	54.1	49.0

Total own funds in 2019 (billion EUR)

Type of financial institution	Total own funds ***	Core Tier 1***	Tier 1***	Tier 2***	Tier 3
Commercial banks	81,7	66,8	72,3	14,9	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**95,1**	**73,4**	**79,2**	**15,9**	

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

Macroeconomic environment in Ukraine

In 2019, real GDP grew by 3.2% yoy, a virtually flat rate compared to 2018. Major drivers of this growth were a pickup in private consumption on the back of higher wages and pensions, improved consumer sentiment, and rapid growth in investment. These, in turn, fueled growth in trade, transportation, construction, and in a number of services sectors. Another record harvest of grains and oilseeds also contributed to the growth in GDP and exports. At the same time, the performance of industrial production was weak for the year as a whole due to the unfavorable external price environment, a decrease in price competitiveness driven by the stronger real effective exchange rate, and warm weather that adversely effected energy production. Economic growth in 2019 spurred the demand for labor, which led to a decline in the unemployment rate.

Consumer inflation fell to a six-year low of 4.1% yoy in December (versus 9.8% yoy in December 2018). The NBU thus achieved its medium-term inflation target of 5% ± 1 pp. This was made possible by lower underlying inflationary pressures, as reflected in the slowdown of core inflation (to 3.9% yoy). The fall in inflation to its target in 2019 was mainly the result of the NBU's consistent monetary policy, which aims to deliver price stability, and prudent fiscal policy. The key factor behind the rapid disinflation was the appreciation of the hryvnia, fueled by the surplus of foreign currency in the market that persisted throughout most of last year. The increase in foreign currency supply was in turn caused by exporters selling large amounts of their foreign currency revenues and foreign investors showing a strong appetite for hryvnia-denominated government securities. Apart from the exchange rate factor, the decline in inflation was also driven by an improvement in inflation expectations, lower fuel prices, and weaker pressure from the food supply and administered prices. However, consumer demand and rapid wage growth continued to put upward pressure on prices. That was reflected in a moderate slowdown in the growth of services prices. In line with the global price trends for energy and goods that Ukraine exports, producer prices dropped by 7.4%, held back also by the strengthening of the hryvnia.

The current account deficit narrowed significantly, to USD 4.2 billion (compared to USD 6.5 billion in 2018) due to both fundamental and one-off factors. In particular, the narrowing of the deficit in late 2019 reflected the compensation paid by Gazprom under a ruling made by the Stockholm Arbitration Court. Excluding this transaction, the CA balance remained almost flat from last year: further growth in remittances, lower repatriation of dividends, and a rise in the trade in services surplus offset the widening of the merchandise trade deficit and higher reinvested earnings. The merchandise trade deficit widened moderately (to USD 14.3 billion from USD 12.7 billion in 2018). Exports of goods rose by 6.4%, fueled by a bumper harvest of cereals and oilseeds in 2018–2019. The growth in imports decelerated (to 7.8%), in part due to a plunge in energy prices.

The financial account saw an increase in capital inflows (to USD 10.2 billion) thanks to the public and real sectors. Public sector capital inflows were generated by purchases of hryvnia domestic government debt securities by nonresidents, the issuance of sovereign Eurobonds, and disbursement of a loan guaranteed by the World Bank. The role of the real sector also has strengthened: some corporations placed Eurobonds successfully, net FDI inflows amounted to USD 4.6 billion. The banking sector recorded capital outflows mainly due to debt redemptions by some banks and the government's repayment of FX-denominated domestic government debt securities. A USD 0.6 billion inflow of net FDIs helped stem the outflows. Overall, the balance of payments has recorded the highest surplus since 2007 – USD 6 billion. As a result, reserves increased significantly and reached a seven-year high of USD 25.3 billion as of the end of the year. This level of reserves was sufficient to cover 4.8 months of future imports and exceeded 80% of the IMF reserves adequacy metrics.

Developments in the banking sector

The number of solvent banks decreased to 75 in Q4 2019, as Ukrsotsbank merged into Alfa Bank. In Ukraine, there are 34 banks with foreign capital, including 23 with 100% foreign capital.

The state-owned banks (including PrivatBank) saw their share of total net assets inch up by 1.0 pp, to 55.2%, while their share of retail deposits dropped by 1.0 pp, to 61.6%. The privately and foreign-owned banks each increased their share in retail deposits by 0.5 pp.

Assets

Sector assets grew noticeably in Q4, with total assets up 5.7% and net assets up 8.8%. Banks' investments in NBU certificates of deposit increased the most, up by UAH 92.2 billion over the quarter (including UAH 75.0 billion in December), to UAH 152.2 billion as of end-2019. This was due to record inflows into corporate accounts in December (+UAH 70.7 billion), mainly to Naftogaz. In addition, cash in circulation, funds in correspondent accounts with the NBU, and interbank loans all increased.

Net hryvnia corporate loans dropped by 6.1% qoq and 6.2% yoy. The largest decreases were reported by the state-owned banks (apart from PrivatBank) and foreign-owned banks, down 10.6% qoq and 5.5% qoq, respectively, as state monopolies and local subsidiaries of multinational groups repaid their loans. Despite increasing by 1.3% qoq in the dollar equivalent, net foreign currency loans declined by 4.1% yoy.

Net hryvnia retail loans grew by 6.6% qoq and 29.8% yoy. The private banks generated the bulk of the growth: +13.3% qoq and +54.0% yoy.

The non-performing loans ratio shrank by 0.6 pp qoq and 4.5 pp yoy, to 48.4% as of end-2019. The main reasons for this were the issuance of new retail loans and write-offs of nonperforming loans against provisions. This decreased the ratio of non-performing retail loans by 4.0 pp qoq, to 34.1% as of end-2019. The quality of the corporate portfolio changed little in Q4.

The dollarization rate for gross loans decreased by 0.5 pp, to 40.7%, due to the issuance of new hryvnia retail loans and hryvnia appreciation. The dollarization rate for net loans remained practically flat, totaling 35.4% as of end-2019.

Funding

The sector's total liabilities increased by 8.9% in Q4. Customer deposit inflows pushed retail and corporate deposits as a share of total liabilities up by 1.5 pp, to 83.3%, a new historical high. The end of 2019 saw a seasonal drop in budgetary funds, while foreign banks repaid a portion of interbank liabilities.

Hryvnia household deposits rose by 16.2% qoq and 19.5% yoy. The highest growth was generated by the state-owned banks, up 23.1% qoq and 28.3% yoy. FX corporate deposits surged by 48.4% yoy due to an increase in FX deposits with the state-owned banks (up 43.8% in Q4 or up 109.5% yoy). This growth was mainly driven by a USD 2.9 billion award paid to Naftogaz under a ruling by the Stockholm Arbitration Court.

Following a decline in Q3, hryvnia retail deposits rose across all bank groups, up 8.4% qoq and 17.5% yoy. This increase is explained by weaker depreciation expectations and very low interest rates on foreign currency deposits. Foreign currency retail deposits (in the U.S. dollar equivalent) increased by 6.4% qoq and 15.4% yoy.

In Q4, the share of customers' FX deposits shrank by 0.7 pp, to 39.8%. Factoring out the FX payment to Naftogaz, the decrease would be more substantial.

Interest Rates

In 2019, the NBU has entered an easing cycle of its monetary policy. It cut its key policy rate five times – cumulatively – from 18% to 13.5%. This has led to a decline in the monthly weighted average rates on hryvnia corporate loans and deposits from 20.8% to 15.7% and from 14.5% to 10.3%, respectively, between December 2018 and December 2019.

At the same time, bank interest rates on retail loans and deposits moved sluggishly due to market-related and structural factors. In December 2019, weighted average rates on hryvnia retail term deposits stood at 14.7%, close to the level of December 2018. This was mainly a result of tight competition for resources among some financial institutions and insufficiently flexible price strategies pursued by state-owned banks, the dominant players in the retail segment. In the meantime, the weighted average interest rate on hryvnia loans even increased on the back of sustained high demand for consumer loans.

Profit or Loss and Capital

The banking sector generated net income of UAH 58.4 billion in 2019, up 2.6 times yoy. PrivatBank accounted for over half of the total profit. Out of the 75 operating banks, only eight banks were loss-making, reporting a combined loss of UAH 0.4 billion.

In Q4, total operating income fell by 4.9% qoq, while operating expenses rose by 15.2% qoq. Growth in operating profit before provisioning thus decelerated, from 70.1% to 46.9% yoy. The operating performance worsened, with the sector's CIR growing to 57.4% from 47.4% in the previous quarter. That said, the operating performance indicator for the full year was better than in 2018, at 49.8% compared to 58.1%. The drop in operating income in Q4 stemmed from a decrease in revaluation results of the state-owned banks and slowing growth in net interest income (to +9.9% yoy). Net fee and commission income rose by 16.3% yoy, driven by an increase in cashless transactions and robust retail lending.

Provisioning in the sector dropped by 54.9% over the year, to UAH 10.7 billion, the lowest level in a decade. The banks with significant provisioning included two state-owned banks and one bank with Russian capital. Although 29 out of the 75 banks released their provisions in 2019, the total amount of the released provisions was only UAH 700 million.

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

- The Constitution of UkraineThe Civil Code of Ukraine
- The Economic *Code of Ukraine*
- The Law of Ukraine *On the National Bank of Ukraine*
- The Law of Ukraine *On Banks and Banking*
- The Law of Ukraine *On Households Deposit Guarantee System*
- The Law of Ukraine *On Financial Services and State Regulation of Financial Markets*
- The Law of Ukraine *On Joint Stock Companies*
- The Law of Ukraine *On Preventing and Counteracting to Legalization (Laundering) of the Proceeds of Crime, Terrorist Financing, and Financing Proliferation of Weapons of Mass Destruction*[1]
- The Law of Ukraine *On Consumer Lending*
- The Law of Ukraine *On Payment Systems and Money Transfers in Ukraine*
- The Law of Ukraine *On Simplifying Bank Reorganization and Capitalization Procedures*

[1] new version adopted on 6 December 2019, registered as No. 361–IX

In 2019, Ukrainian lawmakers passed a number of important laws:

1) The Law of Ukraine No. 79–IX *On Amending Some Laws That Improve State Regulation of Financial Services Markets*, dated 12 September 2019 (hereinafter – the Law). The Law empowered the NBU to regulate insurance activities, the system of credit cooperation, and all other types of nonbank financial services, as well as the protection of the rights of consumers of these financial services.
2) The Law of Ukraine No. 122–IX *On Amendments to Certain Laws of Ukraine Regarding Protection of Consumer Rights in Financial Services*, dated 20 September 2019. This law granted the NBU the mandate to safeguard the rights of consumers of banking and other financial services rendered by banks.
3) The Law of Ukraine *On Amendments to Some Laws of Ukraine on Improving the Financial Restructuring Procedure*, dated 19 September 2019. This law optimized the financial restructuring procedures by taking into account the previous application of these procedures, and extended the financial restructuring mechanism to enable its use in the coming years.

Main strategic objectives of the supervisory authority in 2019

In 2019, the NBU completed the implementation of the Comprehensive Program of Ukrainian Financial Sector Development until 2020 (hereinafter – CP 2020). Taking into account the measures outlined in CP 2020, the NBU drafted a 2019 Action Plan, through which the central bank aimed to achieve the goals of the NBU Strategy, the main of which are:

- to maintain a stable, transparent, and efficient banking system
- to resume lending and to introduce effective regulation of the financial sector
- to develop the NBU as a modern, open, and effective supervisory authority.

The activities of the Banking Supervisory Authority in 2019

During 2019, the NBU implemented a risk-based approach to banking supervision by following the guidelines of the European Banking Authority (EBA) on common procedures and methodologies for the Supervisory Review and Evaluation Process (SREP) and recommendations of the Basel Committee on Banking Supervision (BCBS), while taking the proportionality approach to supervision. Within the framework of risk-based banking supervision, the NBU implemented offsite banking supervision on an individual and consolidated basis by:

(1) evaluating banks under the SREP methodology
(2) conducting the ongoing monitoring of financial standing of banks and banking groups
(3) identifying banks' related parties, ensuring control over banks' transactions with their related parties, and analyzing the terms of banks' transactions with their customers to identify episodes of collaboration that is not market-driven.

The NBU monitored the implementation of the action plans developed by individual banks based on the results of a diagnostic study of banks in 2015–2016.

As part of the annual bank resilience assessment, the NBU stress-tested the top 29 Ukrainian banks. The results of the bank resilience assessment for each bank were published on the NBU's official website.

Pursuant to the provisions of European legislation, in particular Directive 2013/36/EU, Directive 2014/59/EU, EU Regulation 575/2013, recommendations of the BCBS, and the documents of the EBA, the NBU in 2019 adopted a number of regulations to introduce/improve:

- Minimum capital requirements to cover operational risk.

With the support of World Bank experts, the NBU completed drawing up the Methodology for calculating the regulatory capital of banks (according to the new structure), which is based on the rules of EU Regulation No. 575/2013. For the new requirements to be imposed, the Parliament needs to pass amendments to the Law of Ukraine *On Banks and Banking.*

The central bank introduced a procedure for Ukrainian banks to determine the minimum amount of operational risk and to consider it when calculating capital adequacy ratios. Banks' capital needs to cover this risk will be determined in accordance with the new standardized approach of the BCBS – Basel III: Finalizing Post-Crisis Reforms, dated 7 December 2017 – while taking into account the specificity of the Ukrainian banking system.

- Net stable funding ratio (NSFR).

EU regulations set the value of the NSFR for banks at 100%.

- Requirements for drafting recovery plans for banks and banking groups, according to which banks and banking groups must develop realistic options for restoring financial stability in the event of a significant deterioration in financial standing or an emergency. The requirements are mandatory for systemically important banks and recommended for other banks.

- Revisions of the procedure for identifying systemically important banks.

In June 2019, the NBU identified 14 systemically important banks out of Ukraine's 75 operating banks.

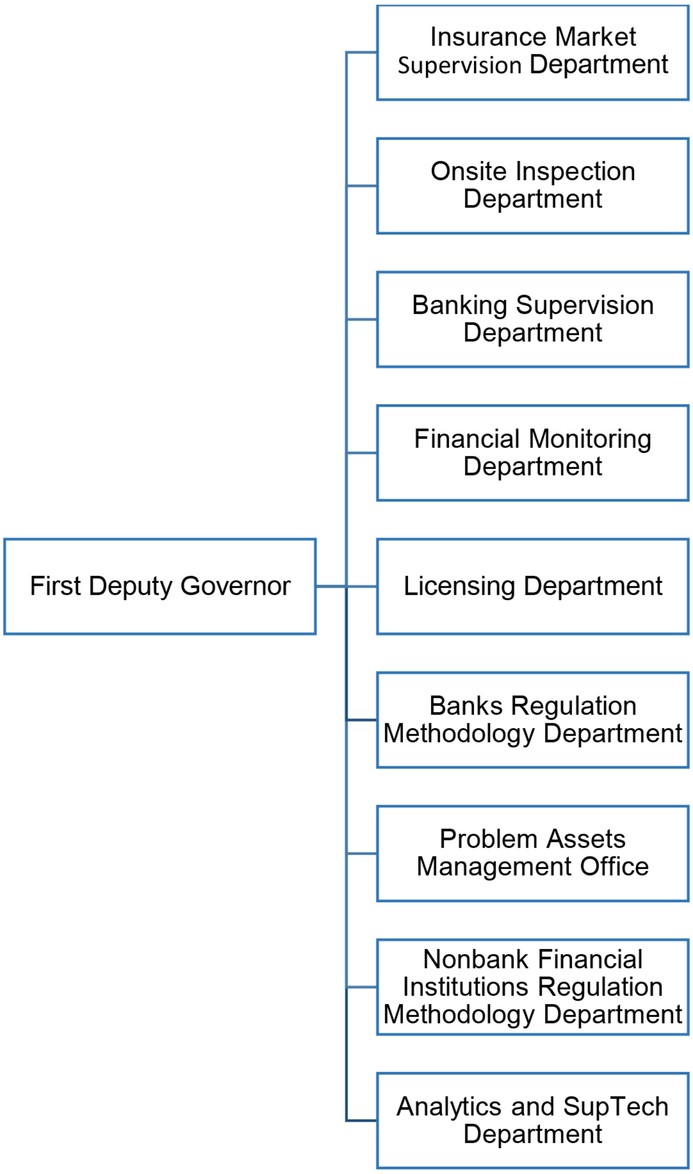
- Requirements for organizing the management of nonperforming assets in banks.

The requirements were approved by the Regulation *On Organizing the Management of Nonperforming Assets In Ukrainian Banks.*

- Approaches to organizing corporate governance at banks.

To increase the efficiency of corporate governance, the NBU approved the Regulation *On Establishing Internal Control Systems in Ukrainian Banks and Banking Groups.*

Organizational chart of the Banking Supervisory Authority



International activities of the authority

The National Bank of Ukraine has continued to develop its bilateral relations with foreign supervisory authorities.

Within the framework of cooperation with the Bank for International Settlements, the NBU has taken part in the meetings of the Basel Consultative Group of the BCBS.

In addition, the NBU has been involved in implementing the EU-Ukraine Association Agreement, focusing on the harmonization of national laws with EU acquis in the areas of banking regulation and supervision, AML/CFT, capital market liberalization, and the operation of payment systems.

Together with the World Bank the NBU worked on improving the quality of banking regulation in accordance with the EU framework.

The NBU was active in technical cooperation with IFIs, other central banks and financial sector regulators. In banking supervision area TA was provided on combating money laundering and terrorist financing to the National Bank of Montenegro.

In 2019, the NBU signed the Memorandum of Understanding on Cooperation between the National Bank of Ukraine and Central Bank of Montenegro on Banking Supervision (dated 12 April 2019).

Cooperation with other supervisory bodies in Ukraine

As a banking supervisor, the National Bank of Ukraine has cooperated with other Ukrainian supervisory authorities. In particular, it has concluded information exchange agreement with the National Securities and Stock Market Commission. The NBU also cooperates with the Deposit Guarantee Fund and the Audit Chamber of Ukraine.

Other relevant information and developments

For further information on the NBU's supervisory activities and regulations, please visit the NBU's website at www.bank.gov.ua

Statistical tables

Number of financial institutions (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	82	77	75
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**82**	**77**	**75**

Total assets of banking sector (at year-end)

Type of financial institution	2017	2018	2019
Commercial banks	1 839 958	1 910 614	1 981 594
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	1 839 958	1 910 614	1 981 594
y/y change (in %)	5.9	3.8	3.7

Ownership structure of banks on the basis of assets total

Item	2017	2018	2019
Public sector ownership	59.00	59.71	60.39
Domestic ownership total	29.69	28.47	27.19
Foreign ownership	11.31	11.82	12.42
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	53.94	65.18	0.120
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**53.94**	**65.18**	**0.120**

Return on Equity (ROE) by type of financial institutions

Type of financial institution	2017	2018	2019
Commercial banks	-15.84	14.67	33.45
Cooperative banks	-	-	-
Banking sector, total:	**-15.84**	**14.67**	**33.45**

Distribution of market shares in balance sheet total (%)

Type of financial institution	2017	2018	2019
Commercial banks	100.0	100.0	100.0
Branches of foreign credit institutions	-	-	-
Cooperative banks	-	-	-
Banking sector, total:	**100.0**	**100.0**	**100.0**

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

	2017	2018	2019
Receivables	**100**	**100**	**100**
Financial sector	14.91	14.42	21.42
Nonfinancial sector	45.15	45.39	38.35
Government sector	22.50	21.91	19.31
Other assets	17.44	18.28	20.92
Liabilites	**100**	**100**	**100**
Financial sector	33.52	34.70	28.99
Nonfinancial sector	18.86	18.24	22.43
Government sector	1.41	1.37	1.28
Other liabilities	36.12	36.36	35.71
Capital	**10.09**	**9.33**	**11.59**

Capital adequacy ratio of banks

Type of financial institution	2017	2018	2019
Commercial banks	16.16**	17.69**	19.66**
Cooperative banks	-	-	-
Banking sector, total:	**16.16****	**17.69****	**19.66****

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

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

Asset classification	2017	2018	2019
Non-financial sector, including	33.6	27.9	37.9
- households	5.4	4.1	9.81
- corporate	28.2	23.8	28.07

The structure of deposits and loans of the banking sector in 2019 (%) (at year-end)

	Deposits	Loans
Non-financial sector, including:	95.1	98.5
Households	54.6	21.9
Corporate	40.5	76.6
Government sector	2.0	0.5
Financial sector (excluding banks)	2.9	1.0
Total	**100.0**	**100.0**

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

P&L account	2017	2018	2019
Interest income	124 009	140 803	152 954
Interest expenses	70 971	67 760	74 062
Net interest income	53 039	73 043	78 892
Net fee and commission income	27 489	37 809	43 961
Other (not specified above) operating income (net)	7 264	8 589	8 147
Gross income	178 054	204 554	243 102
Administration costs	44 202	53 670	62 936
Depreciation	4 616	5 417	6 149
Provisions	49 206	23 758	10 714
Impairment on financial assets not measured at fair value through profit and loss / Provisions on financial assets (loans, ...)	-	-	-
Profit (loss) before tax	26 397	51 153	73 838
Net profit (loss)	-26 491	22 339	58 356

Total own funds in 2019 (in EUR)

Type of financial institution	Total ** own funds	Core Tier 1	Tier 1**	Tier 2**	Tier 3
Commercial banks	5 689	-	3 906	1 805	-
Cooperative banks	-	-	-	-	-
Banking sector, total:	**5 689**	**-**	**3 906**	**1 805**	**-**

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