CENTRAL BANK OF MONTENEGRO

Financial Stability Report

2018

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ABBREVIATIONS USED IN THE REPORT

GDP	Gross Domestic Product
CBCG	Central Bank of Montenegro
CSDCC	Central Securities Depository and Clearing Company of Montenegro
CHF	Swiss Franc
DJIA	Dow Jones Industrial Average
DNS	Deferred Net settlement
ECB	European Central Bank
EONIA	Euro Overnight Index Average
EU	European Union
EUR	Euro
EURIBOR	Euro Interbank Offered Rate
FED	Federal Reserves
FTSE	Financial Times Stock Exchange
GBP	Pound Sterling
JPY	Japanese Yen
LIBOR	London Interbank Offered Rate
IMF	International Monetary Fund
MSCI	Morgan Stanley Capital International
PPP	Purchasing Power Parity
ROAA	Return on Average Assets
ROAE	Return On Average Equity
RTGS	Real Time Gross Settlement
USA	United States of America
FDI	Foreign Direct Investments
USD	United States Dollar

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INTRODUCTION

The Central Bank of Montenegro is the institution responsible for monetary and financial stability pursuant to the Constitution of Montenegro and the Central Bank of Montenegro Law (OGM 40/10, 46/10, 6/13, 70/17). Since instruments of the CBCG monetary policy are very limited, primarily because the CBCG is not an issuing central bank, its practice is largely aimed at fostering and preserving financial stability, i.e. stability of the banking system as the most important part of the financial system in Montenegro. The CBCG Law prescribes the obligation of publishing Financial Stability Report (Article 39).

The CBCG primarily uses microprudential regulation and supervision for fostering and maintaining financial stability. However, since this approach is primarily focused on stability of individual banks, the CBCG uses, if needed, macroprudential instruments which effects influence the entire system. With this orientation, in addition to individual business operations of banks, attention is paid to the complex relation between the bank and other economic entities in order to adequately understand potential vulnerabilities of the entire economy. The Financial Stability Report represents one of the ways the CBCG contributes to financial stability through raising awareness of other economic and financial policy makers, the financial sector, and the general public on sources of financial stability risk in the financial sector.

The Financial Stability Report analyses trends of those risks that are considered to have or may have systemic character - systemic risk. Basically, systemic risk may occur as the consequence of certain internal imbalances and vulnerabilities of the financial system/banking sector, and it may occur as the consequence of external shocks that may hit the economy in general or directly the financial system. Through the system of connected vessels and spillover of instability between economic entities, vulnerabilities may be intensified and increase system instability.

The Financial Stability Report comprises four sections. The first section gives an overview of systemic risk trends and assessments. The second section depicts trends and expectations in international economic and financial environment, which is very important considering the connectivity of the Montenegrin economy with the international economic and financial flows. The third section summarises generally accepted local macroeconomic trends and balance of payments developments as an overview of the relationship between Montenegro and foreign countries, as well as the risks and vulnerabilities in local private real sector and general government to which Montenegrin banks are exposed. The fourth and also the main analytical section of the report, displays trends and risks in the banking sector and in other relevant segments of the financial system. Using a spectrum of financial soundness and macroprudential indicators, it most directly reflects the banking sector stability as a result of activity of both factors discussed in the second and third section of the report and factors generated by the banking sector itself.

1. SYSTEMIC RISKS ANALYSIS AND ASSESSMENT

Generally, systemic risks were relatively moderate at end-2018 and the situation did not materially change relative to end-2017.

Seen through the economic growth rate, cyclical vulnerabilities of the non-financial sector have been mitigated, despite the fact that the debt of the non-financial sector towards banks increased in nominal terms, together with a slight increase in relation to GDP. The growth of indebtedness of the non-financial sector was driven by retail cash loans, with a higher share of long-term cash loans than in previous years. Real wages and salaries declined during the year. Finally, the public debt increased to over 70%, while the unemployment rate declined, but to a level of over 15%.

In 2018, the non-financial institutions' debt towards the Montenegrin banks rose by 57.6 million euros or 5.9%, while the share of this debt in GDP somewhat declined, from 22.7% to 22.3%. However minor, this was still a continuance of the non-financial institutions deleveraging in relation to the second half of 2009 when this sector's debt peaked (51% of GDP). In 2018, the amount frozen based on enforced debtors' debt in the process of enforced collection grew from 539.4 million euros to 635.4 million euros, settling at 13.8% of GDP.

Households debt to Montenegrin banks significantly increased over the past few years in nominal terms although in relation to GDP it was still lower compared to the leverage peak (32.5% at end-March 2009, 26% at end-2017, and 27.1% at end-2018). In 2018, real wages saw a minor average decline of 2.5% y-o-y. According to the Labour Force Survey, the unemployment rate additionally declined to 15.2% in 2018 compared to 16.1% in 2017, but it remains high with a strong structural component.

High level of public debt and government guarantees, significantly set off due to fiscal consolidation measures, represent a source of systemic risk in Montenegro. Following a decline in public debt in relation to GDP experienced in 2016 and 2017, the public debt rose from 64.2% to 70.8% of GDP in 2018. The previous mild public debt decline was the result of a vigorous growth of the nominal GDP in relation to the public debt growth and in relation to fiscal deficits, which averaged at 4.5% of GDP in this two-year period. Montenegro's 2018 credit rating according to Standard&Poors was B+, with the stable outlook, as confirmed in the March 2019 assessment. Even though fiscal consolidation measures are giving results, the main challenge for the public finance is imminent over the period 2019–2021 when 717.6 million euros debt arising from Eurobonds will mature[1], while the beginning of the 14-year repayment of loan for financing Bar-Boljare highway section is planned for 2021.

[1] The amount of debt was initially 1.08 billion euros, however, bond package valued at 362.4 million euros was redeemed in mid-April 2018.

When it comes to the banking sector, liquidity of banks remained to be very good, despite slight oscillations of liquidity ratios during the year. Structurally, very good capitalisation of the sector was maintained, and despite the fact that the solvency ratio decreased slightly during the year, it remained at a significantly higher level than stipulated. The banks continued to be mainly financed through deposits. In this regard, the loans to deposits ratio slightly increased during the year, even though it is almost two times lower in relation to the crisis period. In terms of the main structural vulnerabilities of banks, which are assessed as moderate, the most prominent continue to be the share of bad loans in total loans, the growth of exposure of banks to the government, the growth of banks' exposure to the households (especially through cash loans), as well as the increase in maturity mismatch between sources and assets (due to the growth in demand deposits on one hand and long-term loans on the other).

The level of non-performing loans, even though it is recording a significant decline, remains to be a systemic challenge for some banks, but not for the system as a whole. The situation additionally improved in 2018 as the share of non-performing loans declined from 7.3% to 6.7%. Nevertheless, this share, although it is not a reason for concern in terms of the level and is among the lowest in the region, exerts pressure on the bank's tendency toward risk, i.e. on the level of credit activity and lending conditions. In 2018, credit growth was satisfactory and amounted to 8.5%. It was predominantly caused by the increase in retail loans, while the increase of loans of non-financial institutions amounted to 5.9%. In 2018, the share of (net) loans in assets rose to 56.3%, whereby just above half of the banks' assets was directed to loans relative to 81.1% in 2008.[2]

As another part of the above processes, direct exposure of banks to the government (central government) increased from 527 million euros to 617.5 million euros in 2018, making up 14% of banks' assets. This tendency is under continuous supervision. This growth was due to the increased debt arising from loans as much as due to the increased government's debt towards the banks arising from securities.

In 2018, the leverage based on the so-called cash (all-purpose) loans was intensified, and this became an issue that will be carefully monitored by the CBCG, both from the micro and macroprudential aspect, where one of the key elements is their collateralisation, i.e. protection of banks against credit risk from these loans. To wit, new cash loans to natural persons amounted to 340.4 million euros (12.1% more than in 2017), while their share in total new loans increased to 68.9%, and their share has recorded an overall growth for seven years. Similarly, when it comes to the balance (unpaid principal) of loans to all entities, there has been a longstanding increase in the share of cash loans in total loans, as well as an increase in their maturity. Thus, at end-2018, cash loans accounted for 25.9% of total loans, while the share of cash loans with initial maturity over three years amounted to 92% of all cash loans, or 32.3% of all types of loans with initial maturity over three years. On the other hand, at end-2012, these shares amounted to 11.4%, 61% and 11.5%, respectively.

An important systemic challenge for banks was also the relationship between interest rates, spreads, competition, and profitability. Current concentration is lower than it was before. In 2018, the Herfindahl-Hirschman Index (HHI) changed, remaining below 1,000 points compared to the value of over 2,400 points in the pre-crisis period.

Further decline in interest rates spurred the spread to drop from 6.1 percentage points to 5.8 percentage points over the year. Moreover, the average interest rate on new loans (weighted amount in loans)

[2] The calculations do not account for other loan receivables.

declined from 6.9% in 2017 to 6.3% in 2018. On the other hand, interest rate spread on total earning assets, i.e. interest-bearing liabilities also declined from 4.3 percentage points to 4.1 percentage points, remaining substantially lower than the aforesaid standard spread. However, in addition to the profit of 24.8 million euros made at the system level, and primarily due to high allowances for impairment and provisioning, profitability indicators were less favourable than the spreads indicated, with the annual ROE averaging at mere 3% in the period 2013–2018.

Box 1 – Atlas banka AD Podgorica and Invest banka Montenegro AD Podgorica[3]

During 2018, the Central Bank of Montenegro carried out on-site examinations of Atlas banka and Invest banka Montenegro. The results of on-site examination disclosed that both banks were critically under-capitalised an insolvent, thus putting their further business operations under question. The determined solvency ratio for both banks was below one half of the statutory level, thus, in accordance with the imperative norms of the Banking Law, and based of the findings of on-site examinations, the Central Bank introduced an interim administration in Atlas bank and Invest banka Montenegro on 7 December 2018 and appointed interim administrators. On 10 December 2018, at the proposal of interim administrators, moratorium was introduced on all payments of liabilities of both banks, except for statutory exceptions, aimed at preserving bank's assets.

The report of interim administrator of Invest banka Montenegro, with the status as of 31 December 2018, states that the bank's solvency ratio, own funds, and bank's capital were negative, thus fulfilling the conditions to revoke the bank's licence in line with the Banking Law, while fulfilling the conditions to open insolvency procedure in line with the Law on Bank Bankruptcy and Liquidation. At the session held on 3rd and 4th of January 2019, the Council of the Central Bank issued a Decision on revoking the licence for operation of Invest bank Montenegro, as well the Decision to open bankruptcy proceeding.

In the Report of interim administrator on the financial position and business operating conditions of Atlas banka AD Podgorica, with the status as of 31 December 2018, it was stated that recapitalisation in the amount of 22 million euros would give the bank adequate capital position in line with its risk profile and improve its liquidity position. In addition, the realization of the part of the acquired assets would significantly improve the liquidity position of the Bank, regardless of the outcome of the temporary withdrawal of deposits by a number of depositors by the High Court, which resulted in the freezing of the bank's assets in the amount specified in the Decision of the High Court. Also, the collection of receivables from a person who has control over the Bank on the basis of a called guarantee granted to the legal entity Kaspia would additionally influence the improvement of the Bank's capital adequacy and its liquidity position. In addition to the above, the Bank was able to apply a more conservative exposure provisioning policy, which potentially has the highest risk. Therefore, the conclusion of the interim administrator on the basis of the available information, in the Report from December 2018, was that, with an adequate rationalisation of the Bank's costs, the functioning of the *e-commerce* service, and the capital increase of 22 million euros the Bank's business model is considered sustainable.

By the end of March 2019, the main activities of the interim administration were focused on preparing the documentation for the recapitalisation of the Bank - by issuing shares in a public offering in accordance with Article 126a of the Banking Law, as well as extensive activities on the reclassification of asset positions. The announcement on public offering was announced on 9 March 2019 and was open for 20 days, until 29 March 2019. In addition, liquidity management, collection of receivables, activities on

[3] Events following 31 December 2018.

the rationalisation of costs, as well as the management of acquired assets were one of the main tasks of interim administration.

After four months, that is, at end-March 2019, following two unsuccessful issues of shares, failure to operate the *e-commerce* service, and a significant impairment of the value of assets after reduction to fair value, the financial position of the Bank is such that its liabilities are greater than its assets, that their own funds are negative, that is, the solvency ratio is -7,01%, which according to the Banking Law, Article 129, items 7 and 9 imposes imperative norms for revoking a bank licence. On the session held on 5 April 2019, the Council of the Central Bank issued a Decision on revoking the licence for operation of Atlas bank, as well the Decision to open bankruptcy proceeding.

Generally speaking, banks are the most stable segment of economic system, which substantially reflects in the stability and growth in deposits in the banking sector. In 2018, these deposits grew to 3.46 billion euros (which was the all-time high) and they made up the largest portion of banks' liabilities and capital (78.5%). A more pronounced credit growth and increase investments in securities compared to the growth of deposits has somewhat lower liquidity position of banks. To wit, during 2018, total liquid assets of banks declined by 6.1% to 994.5 million euros, as well as their share in relation to assets and deposits. However, liquid assets remained to be high despite the decline in relation to 2017. In the context of structural limitations of Montenegro`s economic growth, these liquid assets, are currently banks' best safety reserve against the risk of asset quality deterioration and/or deposit outflow.

Table 1.1

Key banking system ratios			
Banking system ratios (15 banks)	31 December 2018 (in thousand euros)	31 December 2017 (in thousand euros)	2018 / 2017 (%)
Assets	4,406,813	4,181,934	5.38
Loans	2,929,239	2,700,516	8.47
Deposits	3,459,220	3,267,149	5.88
Capital	513,016	514,019	-0.20
Net result	24,807	34,761	-28.64
Asset quality	31. 12. 2018. (%)	31 December 2017 (%)	2018 - 2017 (percentage points)
Non-performing loans / loans	6.72	7.29	-0.57
Past due loans over 30 days / loans	6.24	6.98	-0.74
Regulatory provisions / Non-performing loans	93.52	81.71	11.81
Value adjustment / Non-performing loans	75.76	60.16	15.60
Liquidity	%	%	percentage points
Liquid assets / Assets	22.57	25.32	-2.75
Loans / Deposits	84.68	82.66	2.02
Capital	%	%	percentage points
Solvency ratio	15.63	16.38	-0.75
Capital / Assets	11.64	12.30	-0.66

Source: CBCG

Table 1.2

Key banking system ratios without Invest Bank Montenegro and Atlas Bank			
Banking system ratios without IBM and Atlas Bank (13 banks)	31 December 2018 (in thousand euros)	31 December 2017 (in thousand euros)	2018 / 2017 (%)
Assets	4,134,420	3,880,256	6.55
Loans	2,741,000	2,524,224	8.59
Deposits	3,217,837	3,041,578	5.79
Capital	500,939	467,494	7.15
Net result	48,280	35,223	37.07
Asset quality	31 December 2018 (%)	31 December 2017 (%)	2018 - 2017 (percentage points)
Non-performing loans / loans	5.24	6.52	-1.28
Past due loans over 30 days / loans	4.58	6.38	-1.80
Regulatory provisions / Non-performing loans	90.59	87.45	3.14
Value adjustment / Non-performing loans	80.68	46.22	34.46
Liquidity	%	%	percentage points
Liquid assets / Assets	22.07	25.45	-3.38
Loans / Deposits	85.18	82.99	2.19
Capital	%	%	percentage points
Solvency ratio	17.29	16.83	0.46
Capital / Assets	12.12	12.05	0.07

Source: CBCG

By analysing data and key performance indicators for the banking system for 15, that is 13 banks in the system (without Atlas banka and Invest banka Montenegro), on 31 December 2018, it can be concluded that by eliminating the contaminated segment, key indicators of the banking system improved and their positive trend continued in 2019, which is particularly important. Improvement is primarily reflected through the asset quality indicators.

Other financial intermediaries - primarily due to their limited size and also the nature of activities they perform (not depository institutions), as well due to solid financial position of some of the more important among them (insurance companies) - do not represent sources of systemic risk.

With regard to real estate prices as key form of property (and collateral) in the situation of underdeveloped financial markets and instruments, at end-2018 it cannot be said that the prices were substantially above the „fundaments“ i.e. that the market was significantly „overheated“. This market had been experiencing a certain prices standstill over the past few years, with some movements in 2018.

Montenegro Stock Exchange turnover amounted to just 147.4 million euros (3.2% of GDP) compared to 47.5 million euros recorded in 2017. Such a prominent growth is attributed primarily to the two block trades of Electricity Company of Montenegro share. The Monex index grew by 6.5% relative to end-2017 and it was still several times lower relative to its maximum values from April 2007.

The CBCG`s payment system and the CSDCC`s securities settlement system, as the key financial infrastructure pillars in Montenegro, continued to work undisrupted in 2018.

Scheme 1.1

Key risks for financial stability	
High level of public debt and budget deficit, mildened significantly due to fiscal consolidation measures, considering limited growth prospects of the Montenegrin economy and the possibility of increase in Euro interest rates in international markets i.e. costs of debt (re)financing in the future.	→ (High systemic risk)
Negative feedback loop between the share of non-performing loans and credit growth in the context of uncertain economic growth.	↓ (Moderate systemic risk)
Growing exposure of banks to the government considering the challenges in government finances.	↑ (Low systemic risk)
Share of retail cash loans in total loans, with growing maturity of these loans	→ (Low systemic risk)

Explanation:

- High systemic risk
- Moderate systemic risk
- Low systemic risk

Colour represents the level of risk as a combination of probability of materialisation and potential impact in case of materialisation during the next two years based on the CBCG expert assessment. The arrow shows the direction of change in the level of risk relative to the previous Financial Stability Report.

2. INTERNATIONAL ECONOMIC AND FINANCIAL ENVIRONMENT

2.1. Global economic trends

The latest IMF assessments showed global economy growth of 3.6% in 2018 or a y-o-y decline of 0.2 percentage points. As in the previous years, growth in emerging and developing economies made the largest contribution of 4.5% to the global growth, while advanced economies reported a growth of 2.2%. The USA was the driver of growth among advanced economies, while the economies of the euro area and Japan with respective growths of 1.8% and 0.8% recorded lower results compared to 2017. On the other hand, with respective growth rates of 6.6% and 7.1%, China and India gave the main boost to growth in emerging and developing economies as well as on the global level. After a 1.6% growth in 2017, Russia experienced economic activity growth of 2.3%. Growth recorded in the group of Europe's emerging and developing economies[4], which includes Montenegro, was estimated to 3.6%, significantly below 6% from 2017, primarily due to abrupt slowing of growth in Turkey's economy.

Expectations for future periods focus on mild deceleration of global growth, with the estimated growth rate of 3.3% and 3.6% in 2019 and 2020, respectively. The slowdown in growth in 2019 will be driven by a slower growth of all leading economies, that is related groups of economies, while a slightly higher global growth rate is expected in 2020, largely due to the expected higher growth in Italy and Germany, as well as in some parts of India. European emerging and developing economies (including Montenegro), are expected to slowdown to 0.8% in 2019 and 2.8% in 2020, also due to strong decline in the growth of Turkey's economy[5].

The IMF's April forecasts also pointed to higher risks regarding the achievement of the aforesaid growth rates in the period 2019–2020, rather than the possibility of recording growth above expected. Possible introduction/increase of trade barriers, and further deterioration of trade relations, primarily between the US and China is seen as a key risk. At the same time, there is a risk of deterioration in financial markets (a decline in stock prices, a rise in yields on government bonds, a decline in ratings, etc.), not only in advanced economies, but also in developing and emerging economies. Triggers for the crisis could be the UK leaving the EU without an agreement, a deterioration of the fiscal and economic situation in Italy, and a slower growth of the Chinese economy than expected. The IMF sees additional risks in the uncertainty of economic policies by the newly elected governments of some countries, as well as in geopolitical tensions in the Middle East and East Asia.

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4 Albania, Bosnia and Herzegovina,Bulgaria, Montenegro, Croatia, Hungary, North Macedonia, Kosovo, Poland, Romania, Serbia and Turkey.

5 For the period 2019–2021, the IMF projected that Montenegro's economy will experience the respective annual growths of 2.8%, 2.5%, and 2.9%

Table 2.1

Overview of selected global indicators, %						
Indicator	2017	Estimate for 2018	Forecasts		Differences relative to October 2018 projections, percentage points	
			2019	2020	2019	2020
Real growth of GDP						
World	3.8	3.6	3.3	3.6	-0.4	-0.1
Advanced economies	2.4	2.2	1.8	1.7	-0.3	0.0
USA	2.2	2.9	2.3	1.9	-0.2	0.1
Euro area	2.4	1.8	1.3	1.5	-0.6	-0.2
Japan	1.9	0.8	1.0	0.5	0.1	0.2
Emerging and developing economies	4.8	4.5	4.4	4.8	-0.3	-0.1
China	6.8	6.6	6.3	6.1	0.1	-0.1
India	7.2	7.1	7.3	7.5	-0.1	-0.2
Russia	1.6	2.3	1.6	1.7	-0.2	-0.1
European emerging and developing economies	6.0	3.6	0.8	2.8	-1.2	0.0
Commodity prices, average rate						
OIL	23.3	29.4	-13.4	-0.2	-12.5	4.2
Non-energy products	6.4	1.6	-0.2	1.1	0.5	0.8
Consumer prices, average rate						
Advanced economies	1.7	2.0	1.6	2.1	-0.3	0.1
Emerging and developing economies	4.3	4.8	4.9	4.7	-0.3	0.1

Source: IMF, April 2019

The intensity of growth of commodity prices continued in 2018, primarily fuelled by a 29.4% increase in the prices of oil (average rate). The IMF forecasts suggest that oil prices will record average annual drop of 13.4% in 2019, while the non-energy products, as a heterogeneous group of commodities, will experience a less prominent price decline. In 2018, aluminium price averaged to 2,108 $/t relative to 1,968 $/t in 2017, continuing the price increase trend started at end-2015 when the price of this metal was below 1,500 $/t.

2.2. Global financial trends

Leading central banks, with some exception of the Fed, extended their extremely expansive monetary policies into 2018, maintaining their reference interest rates at record lows and continuing with the programme of purchasing government and corporate securities on the secondary market (quantitative easing). In 2018, the Fed made four hikes to their federal funds rate, pushing its year-end range to 2.25%-2.5% compared to 1.25%-1.5% from the beginning of the year. In addition to this, during 2018 the Fed intensified lowering of its securities portfolio formed as part of quantitative easing programme[6].

[6] In the beginning of 2018, on the monthly level, the Fed reinvested only the matured principal for treasury bonds exceeding 6 billion dollars, and 4 billion dollars for agency securities secured by mortgage loans. These limits stood at 30 and 20 billion dollars at the year-end, respectively.

The ECB made no changes to its reference interest rates in 2018, thus the interest rate on the main refinancing operations (MRO) stood at 0% during the entire year. However, the securities portfolio, established through the quantitative easing programme, had increased at monthly pace of 30 billion euros from January to September, which was followed by monthly increases of 15 billion euros until the year-end. Following this, new purchases of securities were abandoned, but reinvestments in matured principal continued.[7]

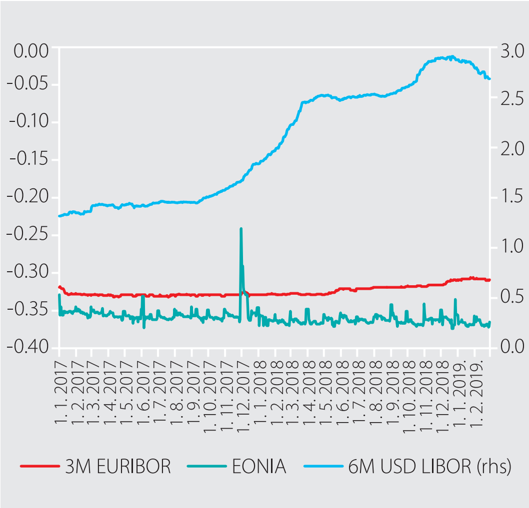
In August, the Bank of England raised its interest rate from 0.5% to 0.75%, while the Bank of Japan and the Swiss National Bank maintained their interest rates at the level of 0.1% and -0.75% throughout the year, respectively. In respect of quantitative easing - total assets of the FED declined by 8.4% over the year, while total assets of the Eurosystem and the Bank of Japan constantly grew over the year, increasing by 4.4% and 5.9% compared to end-2017, respectively.

Short-term reference interest rates "mirrored" the reference interest rates of the central banks. Thus, the six-month *USD LIBOR* grew by 1.04 percentage points over the year to 2.88% (recording a mild drop in early 2019), while the three-month *EURIBOR* increased by just 0.02 percentage points to -0.31%, and *EONIA* dropped by mere 0.01 percentage points to -0.36%.

US Dollar interest rates are expected to mildly increase over the upcoming period. The U.S. economy is in a far better situation compared to the 2007–2009 economic and financial crisis, as solid growth rates were established (they were notably higher than in the euro area in the post-crisis period) and the unemployment rate was below 4%. However, the share of those who were unemployed half a year or longer in the total number of unemployed persons was 20.5% in December 2018 compared to 16% before the subprime mortgage crisis, while the share of working age labour force amounted to some 63.1% relative to 66% in the pre-crisis period. At the same time, inflation in the USA was still within the Fed's 2% target, thus it is unreasonable to expect any upsurges thereof but some gradual changes can be expected instead. The participants at the meeting of the Federal Open Market Committee held in March 2019 estimated that the adequate levels of the Fed`s reference interest rate at end-2019, 2020, and 2021 will be 2.4%, 2.6%, and 2.6% respectively (median value of participants' expectations).

Graph 2.1

Short-term market interest rates, 2017–February 2019, %



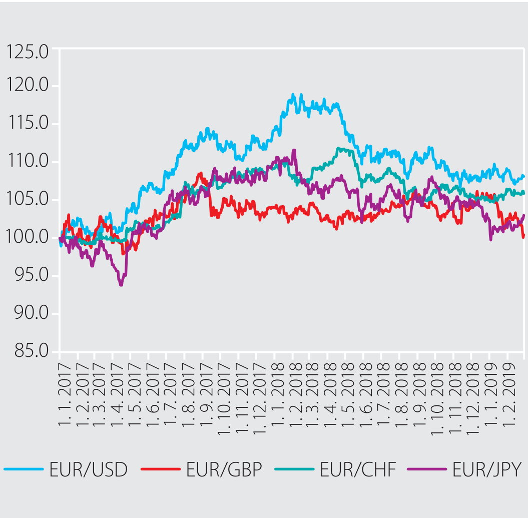
Source: Bloomberg

[7] In March 2019, a third series of quarterly "targeted long-term refinancing operations" was announced (*TLTRO III*), which will last from September 2019 to March 2021, with a maturity of two years. The applicants (banks) will be able to lend to the Eurosystem up to 30% of the balance of their loans at the end of February 2019.

The euro area economy is in a more fragile situation than the U.S. economy. The problem is largely structural and chronic, therefore it is expected that the ECB will continue to maintain a record low level of interest rates. It was also announced at a session of the Governing Council of the ECB in March 2019, where it was found that the rates would be at the same level at least by the end of 2019, while reinvestment within quantitative easing will continue until a longer period passes following interest rates increase.

Graph 2.2

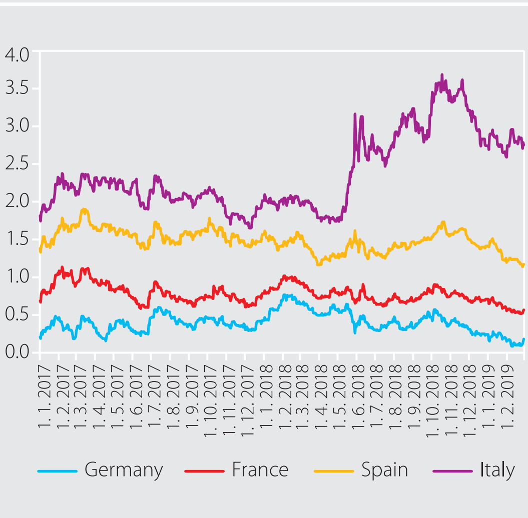
Nominal euro exchange rate, 2017–February 2019, 1 January 2017 = 100



Source: Bloomberg, CBCG calculations

Graph 2.3

10-Year Government debt Bond Yields in the euro area, 2017–February 2019, %



Source: Bloomberg

The euro depreciated nominally against the leading global currencies in 2018, specifically 4.5% against the US dollar, 7% against the Japanese yen, 3.8% against the Swiss franc, yet, it appreciated 1.2% against the British pound. Measured by variance ratio, the highest exchange rate fluctuation of the euro was in relation to the US dollar, followed by yen and franc, while the fluctuation in relation to the pound was the mildest. Euro depreciated to U.S. dollar from 1.2005 to 1.1467 USD per Euro, ranging on average at the level of 1.1808 U.S. dollars per Euro. Currently, the ECB's monetary policy is not expected to push for the euro appreciation, while the expected mild growth in U.S. dollar interest rates should go towards the dollar appreciation or the euro depreciation.

Generally, the situation of extremely low yields on government bonds deepened in 2018. The fact that the Swiss 10-Year Government Bond Yields continue to average below zero (at -0.0024%) serves as the most radical example of this. In reference to the euro area countries, 10-year government bond yields of Germany, Ireland, and particularly Italy increased, whereas those on German government debt declined during the last months of 2018, and were lower that as at 2017 year-end. The yield on the Italian debt, due to the fiscal and economic crisis in that country, rose to 3.7% and then stabilised at the end of the year. On the other hand, yields on French and Spanish debt fell, while yields on Greek and Portuguese debt dropped significantly. The yields on Japanese debt experienced no major changes, while yields on government bonds of the Great Britain, and particularly of the USA significantly exceeded those recorded in 2017.

The spreads, which are the differences between a country's bond yields and German government bond yields, except Italy, were even lower than in 2017, i.e. still very compressed. With regard to 10-year government bonds, yield on German debt amounted to 0.46% on average, while spreads on French, Italian, and Spanish debt averaged at 0.32 percentage points, 2.14 percentage points, and 0.97 percentage points, respectively. This is extremely low bearing in mind the problems Italian and Spanish banking sectors have been experiencing as well as vulnerabilities regarding the external debt of these countries. Secondly, it leads to delays of necessary fiscal and structural reforms in these countries and their absence will deteriorate the economic position of these countries once the normalisation period occurs, that is, when yields on government debt of these countries start to rise.

The analysis of stress and risk indicators suggests that the financial markets volatility saw further increase in relation to 2017. *TED*[8] spread and *LIBOR-OIS*[9] spread, recorded a number of major ups and downs, and were higher in terms of annual average as well as in relation to the end of the year. With somewhat similar trends, the index VIX, as a measure of the expected volatility of the prices of US stocks, reached the highest value at the beginning of February and at the end of 2018. Gold prices, as a specific indicator of stress and risk in global economy and in financial markets, were similar to those in 2017, growing by mere 0.9% observed through an average price, yet declining 1.6% in relation to end-2017. During 2018, the prices of gold experienced major oscillations, decreasing from 1.300 $/oz to nearly 1.175 $/oz early in mid-August, and dropping to nearly 1,300 $/oz towards the year-end.

There was rather „optimistic“ situation on the stock markets in developed countries, although with a lot of volatility, so that the leading indices largely achieved growth, compared to the average value during the year, and a decline relative to end-2017. In addition, some indexes such as the New York *DJIA* , the London *FTSE 100* or the Frankfurt *DAX*, reached their record highs in 2018. Moreover, the *MSCI* stock exchange index for developing and emerging markets declined by 16.6% in relation to end-2017, and recorded the year-on-year increase of 6.3% in terms of its mean value, nearing its all-time highs seen during the pre-crisis period.

The record SE indices were accompanied by the value of real estate peaking in many countries, e.g. in the USA where the nominal real estate prices exceeded those recorded prior to the subprime mortgage loans crisis. The policy of keeping the leading central banks' interest rates at historical nadirs was undoubtedly the factor that influenced the growth in prices of financial assets and real estate in the post-crisis period. Certain indicators showed that bubbles were not formed which was, inter alia, the position of the former Fed's Governor. However, it seems that there was unrealistic optimism to a certain extent and the expected gradual increase in the Fed interest rates will rein in the prices of financial assets and real estates, at least in the USA.

[8] TED spread is the difference between the three-month *LIBOR* and the interest rate on three-month U.S. treasury bills in percentage points.

[9] LIBOR-OIS spread is the difference between the three-month *LIBOR* and the three-month overnight indexed swap (*OIS*) in percentage points.

3. DOMESTIC ECONOMIC ENVIRONMENT

3.1. General macroeconomic developments

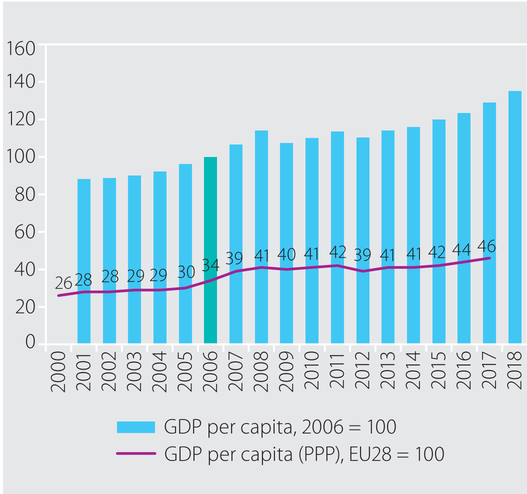
Preliminary Monstat data show real growth of 4.5%, 4.9%, 5%, and 4.8% for four consecutive quarters of 2018, which represents the real annual GDP growth of 4.9%. On the other hand, the latest European Commission`s estimates indicated a growth rate of 3.9%[10]. According to Monstat`s annual data by industries, overall growth was spurred by growths reported in the tourism, construction, retail trade sectors and industrial output registered a decline.

However, the preliminary growth rate of 4.9% significantly exceeded that of 3% estimated by the Ministry of Finance at the beginning of 2017, at the same time signalling the pick-up of economic activity after the growth rate of 4.7% recorded in 2017. This is mostly due to the almost triple growth rate of gross fixed capital formation in relation to the projected, due to the increase in investment activity. Also, in categories household consumption and government consumption, growth was higher than projected. The Ministry of Finance estimated growth rates of 2.8% and 2.3% for 2018 and 2019, while the EU estimated growth rates of 2.8% and 3.1% over the same periods. According to the worst-case scenario, based mainly on a decline in investment activity and tourism revenues, the Ministry of Finance estimated growth of 1.4% and 1.9% for the observed periods. As per the model-based CBCG projections for 2019, the GDP growth will range from 2.5% to 3.2%, with the central projection of about 2.9%.

Historically, real GDP *per capita* in 2018 was 35.1% higher than the one achieved in 2006, and 18.4% higher relative to real GDP *per capita* in 2008 due to low average growth rates in between 2009 and 2016 and partly due to an increase in the population in Montenegro over the same period[11]. Observed in terms of purchasing power parity, Montenegro's GDP *per capita* in 2017 amounted to 46% of the EU average compared to 42% in 2015 and 41% in 2008. Thus, convergence to the EU was practically stopped in the post-crisis period after the growth from 26% to 41% recorded between 2000 and 2008. However, Montenegro's growth recorded in 2016 and 2017 induced a substantial advance in regards to convergence, which will be further enhanced after Eurostat has processed data for 2018.

Graph 3.1

Montenegro's GDP per capita, 2000–2018



Source: MONSTAT, Eurostat, CBCG calculations

[10] *Autumn 2018 Economic Forecast*, November 2018

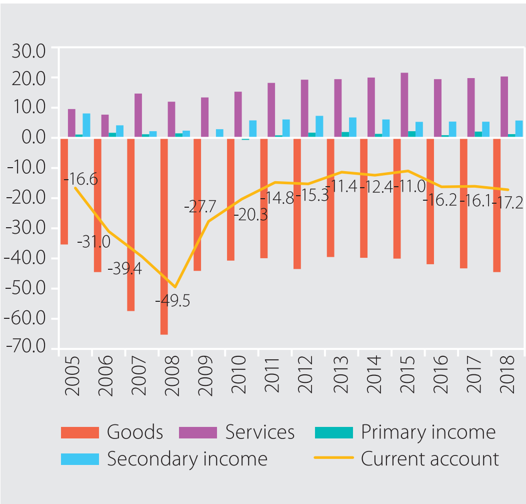
[11] CBCG assessment

Measured by consumer price index, prices increased y-o-y by 1.6% in December 2018, which was the slowing down of inflation compared to 1.9% from December 2017. In general, the December average of inflation rates for the period 2009–2018 amounted to 1.7%, currently showing no substantial inflation or deflation risks. Historically, price stability in Montenegro has been constant since the introduction of the euro as the legal tender, with minor oscillations over the years.

The current account balance amounted to -792.7 million euros in 2018 or 17.2% of GDP, which was an increase compared to a 691 million euros or 16.1% of GDP in 2017. With regard to the structure, this deficit was generated by a negative balance in the goods account that amounted to 2.05 billion euros (compared to 1.86 billion euros in 2017), which deepening could not be compensated by positive balances on other sub-accounts of the current account. The goods account deficit widening was driven by an increase in the visible imports from 2.24 billion euros to 2.49 billion euros. To an extent, such a rise in the goods deficit was to be expected in view of the implementation of significant infrastructure projects.

Graph 3.2

Current account components, % of GDP, 2005–2018



Source: IMF, CBCG calculations

As in the previous years, the 2018 deficit was primarily funded by foreign direct investments and their net inflow of 322.5 million euros or 7% of GDP. In addition to this, the deficit is financed by the new/net borrowing of the state in international markets, through securities (portfolio investment) in the amount of 137 million euros, and through loans (other investments) of 422.4 million euros. And historically speaking, the permanent current account deficit was to a large extent financed through foreign direct investments, but also through the contribution of portfolio investments and other foreign investments, so there is noticeable increase of financing of the current account deficit by the accumulation of external debt of Montenegro, of all resident sectors, not only the government, although the government external debt is the most characteristic.

3.2. Position of non-financial institutions[12]

In 2018, the debt of non-financial institutions to banks saw a rise[13] from 974.3 million euros to 1,031.8 million euros, thus stopping a general standstill of this debt initiated after 2011 and following the extensive deleveraging recorded between September 2008 and end-2011. In relation to GDP, deleveraging

[12] Since Montenegro does not have the financial account statistics. i.e. an overview of financial assets and liabilities by all institutional sectors of the economy, the position of non-financial institutions and households is primarily monitored through their relationship with Montenegrin banks through data the latter submit to the CBCG.

[13] Non-financial institutions cover resident business entities (private and state companies).

of non-financial institutions continued after 2011, albeit at slower pace, resulting in the debt balance of 22.3% of GDP at end-2018 (compared to 22.7% at end-2017, and 29.8% of GDP at end 2011). New debt of non-financial institutions based on new loans taken from banks in 2018 amounted to 527.5 million euros, which was an increase of 3.4% y-o-y. Observed by purpose, new debts mostly referred to loans granted for liquidity for working assets of 60% (56.7% in 2017), which has been the most presented type of loans granted to non-financial institutions for years[14].

Since deposits by non-financial institutions made a mild drop to 1.1 billion euros during 2018, non-financial institutions reduced their position as a net creditor in the banking system at end-2018 to the amount of 67.6 million euros or 1.5% of banks' total assets. This situation stands opposed to that observed in April 2009, when non-financial institutions represented the banking sector's net debtor with as much as 36.8% of banks' total assets.

However, it is worth mentioning that the actual balance of indebtedness of non-financial institutions cannot be viewed only through their debt to banks since the latter sold the major part of their assets to third parties - mostly parent banks, either through factoring companies founded by them or through other entities for purchase of receivables. Banks sold assets in the amount of 873.1 million euros between 2006–2018. A significant portion of the sold assets referred to non-performing loans (debt) of non-financial institutions, which is still present in debtors' balances.

At end-2018, the number of blocked business entities in the CBCG's enforced collection system was 14,197, which is annual increase of 11.6%. Out of 43,104 active business entities, a total of 32.9% was blocked, which is 3.3 percentage points more in relation to end-2017. Total debt based on which business entities were blocked amounted to 635.4 million euros, or 17.8% more compared to the previous year. Due to high debt concentration, the debt of the top ten debtors stood at 94.9 million euros (14.9% of debt), and that of the top 50 borrowers was 235.2 million euros (37% of debt).

A total of 2,311 economic entities were under uninterrupted account blockage up to 365 days with the frozen amount of 30.6 million euros, whereas a total of 11,886 business entities were blocked over 365 days, with the frozen amount of 604.8 million euros, accounting for 95.2% of debt, thus this debt will remain uncollectable for the most part. However, sound non-financial institutions increased their deposits over the last couple of years, which is indicative of the improved liquidity.

When it comes to the maturity of non-financial institutions' debt to banks, debts maturing after three years accounted for the main share of 56.4% at end-2018 (55.4% at end-2017)[15]. Debt with the agreed maturity of over one-year made up 76% of debt. In reference to the debt's currency structure at end-2018, debts in euros accounted for 99.5%, while a mere 0.5% referred to debt in other currencies, which was a situation that has not changed essentially over the last years.

Although still relatively poor, the quality of debt of non-financial institutions to banks additionally improved during 2018. According to the banks' classification, non-performing debt amounted to 107.2 million euros at end-2018 compared to 141.1 million euros at end-2017. Thus, the share of non-performing debt in total non-financial institutions' debt declined from 14.6% to 10.4% (35.6% at end-Q1 2013).

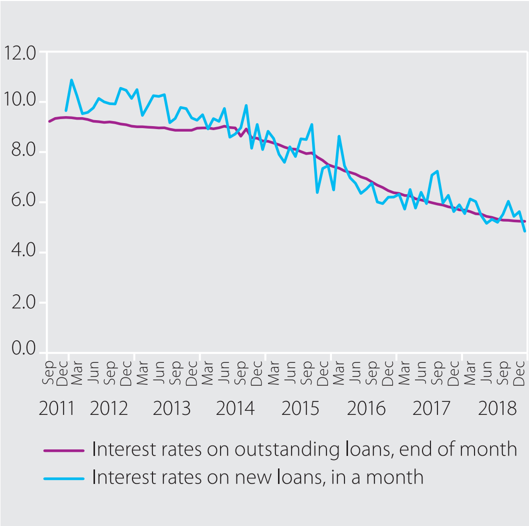
[14] These data refer to all legal entities but they are sufficiently representative, since 77.3% of total debt arising from loans to legal persons in 2018 referred to non-financial institutions.

[15] Data are given according to the initially agreed maturity.

However, at least two important factors influenced a decline in this share over the last several years: 1) transfer of significant amounts of non-performing debt outside the balance sheet of banks, and 2) write-offs of non-performing debt from the balance sheet of banks.

Graph 3.3

Interest rates on debt of non-financial institutions, %, 2012–2018



Source: CBCG

In 2018, the average interest rate on total non-financial institutions' debt based on loans further declined, from 5.7% to 5.2%, signalling a continuance of the rate's downtrend. Similarly, this year, the average interest rate on new loans declined from 6.1% to 5.5% (compared to 10% in 2012)[16]. Regardless of its significant decline recorded over the past four years, the non-financial institutions' price of borrowing remains high. Moreover, this decline in the price of borrowing was not enough to substantially change the non-financial institutions' position, which serves as a confirmation that lower borrowing price is just one of the prerequisites for achieving profitability and international competitiveness of these institutions. When it comes to non-financial institutions, structural factors, i.e. the overall business environment play a more significant role.

3.3. Households' position

In 2018, the households' leverage towards banks additionally increased[17] from 1.12 to 1.25 billion euros, strongly fuelling this debt's growth initiated in 2013 after a period of deleverage between September 2008 and end-2012. The level of households' debt reached its record high. However, in relation to GDP, households' debt recorded a mild increase yet in 2018 to 27.1% of GDP, while it was generally on standstill in the period 2013-2017 (26.6% of GDP at end-March 2013 and 26% of GDP at end-2017). Households' leverage to banks exceeded that of non-financial institutions for the first time in 2016, with this trend deepening in 2017 and 2018.

In 2018, households' debt based on new loans amounted to 493.9 million euros, which was an increase of 3.6% y-o-y. In reference to purpose, as much as 68.9% (63.7% in 2017) of the new debt referred to cash loans (non-earmarked), which has been the most represented type of loans to the households' sector for years. In addition, new leverage based on loans for the apartment purchase and refurbishing declined in both absolute terms from 63.7 million euros to 71.7 million euros and as a share in total new households' leverage from 13.4% to 14.5%.

[16] The rate is obtained by weighting monthly interest rates on new debt with monthly amounts of new debt.

[17] Households also include resident natural persons.

Apart from the retail loans reaching their all-time high, the position of the retail sector as a net creditor somewhat declined on the back of a slower growth of retail deposits, which also reached their historical high of as much as 1.33 billion euros at end-2018. Thus at end-2018, households' net creditor position accounted for 1.8% of total assets of banks compared to 2.7% at end-2017, while at end-April 2009, households were a net debtor in the banking sector in the amount of 12.9% of total assets of banks.

With regard to the maturity of the households' debt to banks, the debt with maturity of over three years accounted for the main share of 92% of debt at end-2018 (90.4% at end-2017)[18], mainly due to the cash loans-based leverage. Debt with the agreed maturity of over one-year made up 97.5% of debt. In reference to the debt's currency structure, the debt in euros accounted for 99.6% at end-2018, while just 0.4% referred to debt in other currencies, thus showing a continued downtrend in the share of debt in other currencies, primarily in the Swiss Francs.

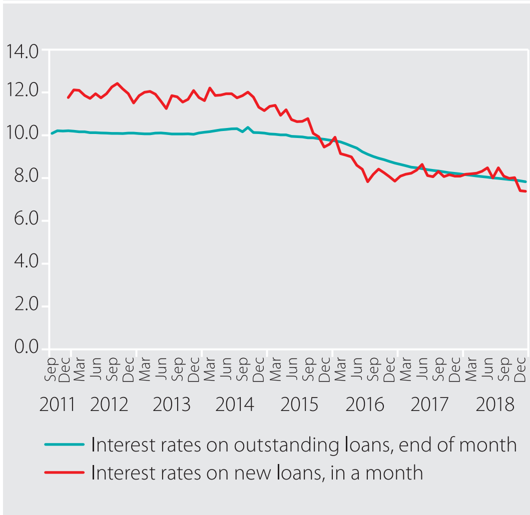
The quality of households' debt to banks additionally improved during 2018. According to the banking classification, non-performing debt of households amounted to 53.4 million euros at end-2018 compared to 57.9 million euros at end-2017. Thus, the share of non-performing debt to total debt of households declined from 5.2% to 4.3% (compared to 12.6% at end-Q1 2013).

An average interest rate on total households' debt based on loans additionally declined during 2018 from 8.2% to 7.8%, continuing the rate's downtrend initiated after 2014. On the other hand, the average interest rate on new leverage based on loans declined slightly from 8.2% to 8.1% in 2016 (compared to 12% in 2012)[19]. However, the price of households' indebtedness is obviously still high despite its substantial decline in the last four years.

According to the Labour Force Survey, the 2018 unemployment rate was 15.2% or 0.9 percentage points below the 2017 rate (16.1%). After a substantial decline in unemployment during the last boom (2006-2008), when it dropped from 30.3% in 2005 to 16.8% in 2008, the rate saw a mild downtrend followed by oscillations in some of the subsequent years, clearly indicating a prominently structural character of unemployment in Montenegro.

Graph 3.4

Interest rates on households' debt, %, 2012–2018



Source: CBCG

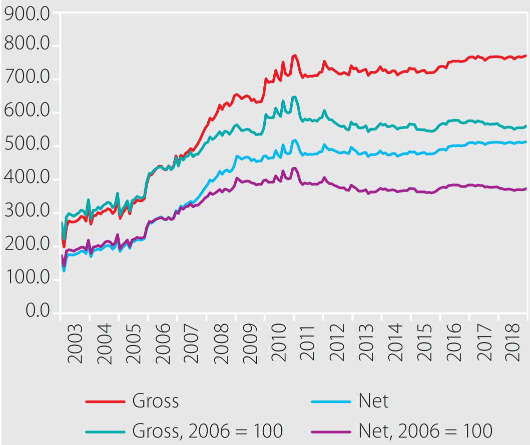
Domestic Economic Environment

[18] Data are given according to the initially agreed maturity.

[19] The rate is obtained by weighting monthly interest rates on new debt with monthly amounts of new debt.

Graph 3.5

Nominal and real wages in Montenegro, in euros, 2003–2018



Source: Monstat; CBCG calculations

Observed through the average 12-month data, nominal net wages and salaries rose by slight 0.1% in 2018, from 510.3 euros to 510.8 euros (mostly resulting from fiscal consolidation), which was their highest annual level since the introduction of euro as the legal tender in Montenegro. On the other hand, real net wages and salaries saw an average decline of 2.5% in 2018[20]. If we observe net earnings only in December 2017 and 2018 and the annual inflation rate in December 2018, then the decline in real net wages and salaries was milder, amounting to 1.4%. However, real net wages and salaries remain below the historical maximum recorded in 2010. Compared to 2006, both nominal and real wages and salaries increased, by 80.5% and 31.1%, respectively.

3.4. Government finances

The 2018 government budget recorded a deficit of 159.2 million euros (3.5% of GDP) or by 16.4 million euros above 142.8 million euros planned. The above-planned deficit was mainly due to the expenditure arising from the repayment of debt from the previous period in the amount of 22.9 million euros, which are not included in the deficit calculation, as a rule. When it comes to other major deviations from the plan, the expenditure for services exceeded the plan by 16.5 million euros, while the expenditure for social welfare transfers were 14.4 million euros below planned. On the other hand, source revenues were 10.6 million euros bellow plan. The budget deficit has been recorded for the tenth consecutive year, whereas the average deficit in the period 2009–2018 amounted to some 5% of GDP.

According to the latest Ministry of Finance report on debt, as at 31 December 2018, public debt amounted to 3.27 billion euros or 70.8% of GDP, of which the external debt made up 2.76 billion euros, internal debt was 393 million euros and debt of local self-governments accounted for 115.6 million euros. In this way, public debt increased by 6.6 percentage points in 2018, following two years when it declined by an average of one percentage point of GDP per year. In this two-year period, the debt growth in absolute terms was at an average rate of 6.8% per annum, but declined through a relationship with GDP, due to a stronger rise in nominal GDP in relation to the public debt growth.

[20] The calculations were made by deflating nominal wages and salaries by the consumer price index, i.e. the cost of living index using 2006 as basis year.

Table 3.1

Main categories of Montenegro's budget, 2017–2019						
	2017 (statement of accounts)		2018 (estimate)		2019 (Plan)	
	million euros	% of GDP	million euros	% of GDP	million euros	% of GDP
Budget revenues	**1,566.3**	**36.4**	**1,746.4**	**37.9**	**1,828.0**	**38.2**
direct taxes	656.2	15.3	717.5	15.6	715.4	14.9
indirect taxes	809.9	18.8	875.9	19.0	931.2	19.4
non-taxable income	100.2	2.3	153.0	3.3	181.3	3.8
Budget expenditure	**1,803.1**	**41.9**	**1,905.6**	**41.4**	**1,970.2**	**41.1**
Current expenditures	1,529.1	35.6	1,640.9	35.6	1,630.7	34.1
Wages, gross	445.4	10.4	459.8	10.0	472.1	9.9
Transfers for social welfare	538.1	12.5	544.5	11.8	554.5	11.6
Capital expenditures	274.1	6.4	264.7	5.7	320.9	6.7
Surplus/deficit, cash	**-236.9**	**-5.5**	**-159.2**	**-3.5**	**-142.2**	**-3.0**
Net increase/decrease in liabilities	14.0	0.3	-	-	-	
Surplus/deficit, adjusted	**-250.9**	**-5.8**	-	-	-	

Source: Ministry of Finance

Debt arising from Eurobonds takes a significant place within the external public debt. Montenegro entered the international bond market for the first time in September 2010 and there have been seven Eurobond issues since that time. Three of them were repaid, and currently outstanding issues are those from 2014, 2015, 2016, and 2018[21]. Government budget realised a portion of its funding needs through two issues of bonds in the Montenegro Stock Exchange, bearing in mind surpluses of liquid assets of banks and their conservatism in lending to non-financial institutions and households. The March 2014 issue was repaid in full at the beginning of March 2018, leaving the 2016 issue as the only outstanding one.

Apart from the 2018 issue, the remaining three groups of current Eurobonds are of five-year maturity and they will be due in the period 2019–2021. Total amount that matures based on these three issues is 717.6 million euros of the remaining principal. The year 2020 will be particularly demanding when 321.1 million euros of principal on the March 2015 issue will become due. The amount of 80 million euros for the repayment of four-year bonds issued on the Montenegro Stock Exchange in November 2016 should be added to this amount. Also, the repayment of the loan for funding highway will begin in 2021, which will additionally pressure the government finances. Namely, the subject of the loan arrangement for highway signed in October 2014 with the Chinese Exim Bank is a loan of 944 million U.S. dollars with a 6-year grace period and a 14-year repayment period after the expiry of the grace period. As at end-2018, the debt towards Exim Bank stood at 516.6 million euros (translated into euros), and every new withdrawal will increase the public debt arising from that loan.

[21] In mid-April 2018, a Eurobond issue in the amount of 500 million euros was executed under a 7-year maturity and at the interest rate of 3.375%. The issue will, inter alia, be used to redeem portions of bonds issued in 2014, 2015 and 2016, in the respective amounts of 110.9 million euros, 178.9 million euros and 72.6 million euros.

In the medium term, it is expected that the withdrawal of funds based on loan with Exim Bank will contribute to further increase in Montenegro's debt in other foreign currencies to about 23% from the current 18%. This exposes the country to the risk of depreciation of the euro against the dollar, thus the so-called hedging arrangement is planned to be concluded before the beginning of the repayment as a protection against the exchange rate change, which is still the current issue and the subject of intensive activities of the Ministry of Finance.

According to its baseline scenario, the Ministry of Finance projected a public debt growth to drop notably to 60.4% of GDP in 2021, while the lower-growth scenario projection for the same year is 63.6% of GDP.

At end-2018, the balance of debt arising from government guarantees stood at 287.5 million euros or 6.2% of GDP. Moreover, the balance of debt arising from external guarantees amounted to 247.8 million euros (5.4% of GDP), while the balance of debt on domestic guarantees was 39.7 million euros (0.9% of GDP). At end-2017, the debt arising from government guarantees stood at 312.8 million euros or 7.3% of GDP. When it comes to issuing guarantees, the government has been pursuing a notably more moderate and prudent policy compared to the previous period. There were no guarantees issued in 2016, while two guarantees were issued in 2017, specifically for loans granted to the Railway Infrastructure of Montenegro (for the reconstruction of the railway infrastructure) and the PC "Regional Water Supply of the Montenegrin Coast", Budva (for the purposes of refinancing the Abu Dhabi Fund for Development loan). In 2018, one guarantee was issued and it was for the loan granted to the Electric Transmission System of Montenegro, for the construction of electricity infrastructure on the Luštica peninsula.

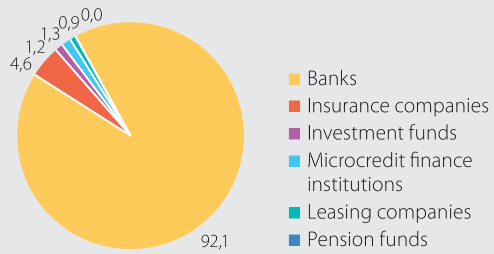
4. FINANCIAL SYSTEM

In the structure of the financial sector of Montenegro, banks have a key share, i.e. about 92% of total assets of the financial system[22]. In addition to banks, insurance companies have the second most important share and are dominated by those dealing in non-life insurance. In the total assets of the financial system, insurance companies accounted for 4.5%.

The remaining part of the financial sector (pension funds, investment funds, microcredit financial institutions and lease companies) is small or relatively underdeveloped. Microcredit financial institutions, as a structure supplementing the banking sector, continued their uptrend into 2018, with their assets growing at an average rate of 5.8%, and with the other key operating ratios. The share of microcredit financial institutions in total assets of the financial sector was a mere 1.3% at end-2017. Over the past years, the activities of lease companies have contracted, resulting in a drastic decline in their assets. In the euro area, investment and pension funds and other parts of the financial intermediation sector usually account for a much more developed and bigger share of the financial system than is the case in Montenegro.

Graph 4.1

Montenegro's financial sector structure, %, end–2017



Source: Competent national supervisors

A total of 15 banks operated in Montenegro in 2018. Most capital is foreign owned, which is also typical for countries in the Southeastern Europe, as well as a large number of the EU member states from Central and Eastern Europe. The share of foreign capital of banks in total capital averaged at 82.1% in 2018. In respect to the country of origin of the foreign capital, five main proprietary interests originate from Austria, France, Hungary, Slovenia and Serbia. Observed by assets, banks with the majority foreign capital control 79.6% of Montenegro's banking market.

Box 2 – Deposit Protection Fund

All banks with registered office in Montenegro are obliged to participate in the deposit protection scheme as provided for by the Deposit Protection Law[23]. Banks are obliged to pay the regular premium amounting to 0.5% of total deposits (annual premium).

[22] Latest available data.

[23] OGM 44/10 of 30 July 2010, 40/11 of 8 August 2011, 47/15 of 18 August 2015.

The Fund's resources are provided from:

1. revenues from collected initial premiums;
2. revenues from collected regular premiums;
3. revenues from invested funds;
4. revenues from the indemnification of the Fund in bank bankruptcy proceedings;
5. donations, and
6. other revenues in accordance with the law.

In case the abovementioned resources are insufficient for the Fund's liabilities arising from the deposit protection scheme, the Managing Board may decide to provide the lacking funds by:

1. charging an extraordinary premium;
2. borrowing from the Budget of Montenegro;
3. taking loans from foreign banks and financial institutions,
4. issuing securities.

In case of bankruptcy, pursuant to the Law on Bank Bankruptcy and Liquidation[24], Article 48, the Fund is ranked third in terms of the order of priority in the division of the bankruptcy pool of assets, right behind the Central Bank of Montenegro. When it comes to the current cases in Montenegro, CBCG receivables from banks arising from loans given to banks or other liabilities incurred during the interim administration or bankruptcy proceedings are negligible, which significantly increases the possibilities for collection of receivables by the Fund.

As at 31 December 2018, the Fund had a total of 111,489,223 euros for indemnification. In November 2018, the Fund extended the use of Stand-By Arrangements with the European Bank for Reconstruction and Development for one year, which can be used for the payment of additional 30 million euros of guaranteed deposits[25].

At end-2018, the coverage of the number of depositors was 98.9% (the total number of depositors whose deposits did not exceed 50.000 euros), and the ratio of the Fund's assets to total guaranteed deposits (coverage ratio) was 7.6%. Together with the funds from the stand by arrangement with the European Bank for Reconstruction and Development, the coverage ratio was 9.6%.

In accordance with the Law, the target level of coverage is 10% of the guaranteed deposits. When the funds of the Fund (without donations) reach 10% of guaranteed deposits, the Managing Board of the Fund may decide to reduce the rate of regular premium, namely to temporarily suspend the payment of regular premium.

In the European Union, Directive 2014/49/EU prescribes the minimum coverage of 0.8% of guaranteed deposits, which must be reached by 3 July 2024. The target levels are determined depending on the structure of the banking system (number and type of banks) and the number of deposit protection funds existing in a particular country within the EU.

The Fund has sufficient funds from regular premiums to pay off all guaranteed deposits in Atlas Bank and Invest Bank Montenegro. As at 31 March 2019, the guaranteed deposits at Atlas banka amounted to 89,161,914 euros (the bankruptcy was introduced on 5 April 2019). On the day the bankruptcy was introduced, on 4 April 2019, the guaranteed deposits of Invest banka Montenegro amounted to 22,333,240 euros.

In case the amount of the deposit is higher than the guaranteed (50,000 euros), the amount of the deposit exceeding the guaranteed sum can be collected by the depositor from the Bank's bankruptcy pool of assets.

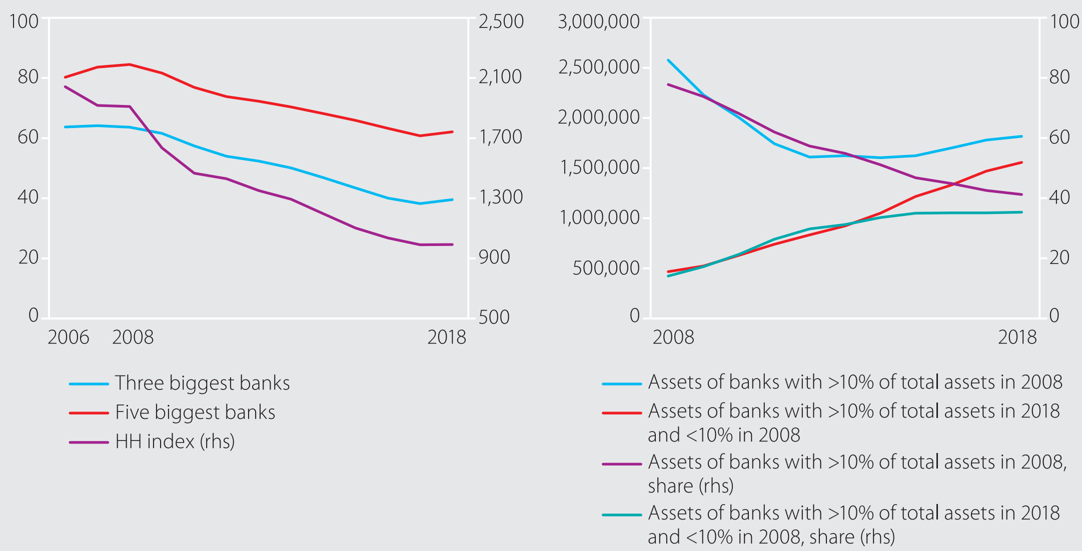
[24] OGRM 47/01, and OGM 62/08, 44/10

[25] The arrangement was initially concluded in 2010. It is used only in case of insolvency in one of the banks.

The concentration of the Montenegrin banking market has significantly changed over the last ten years. As per the HHI, from the highly concentrated market in the pre-crisis period Montenegro's market turned into a low-concentrated market, which has remained its distinctive feature over the past years. In reference to assets, the market share of three and five largest banks grew for the first time over the last ten years, respectively amounting to 39.5% and 62.1% at end-2018.

Graph 4.2

HHI, market shares (%) banks' assets (thousand euros), 2006–2018



Source: CBCG

4.1. Banks' balance sheet structure

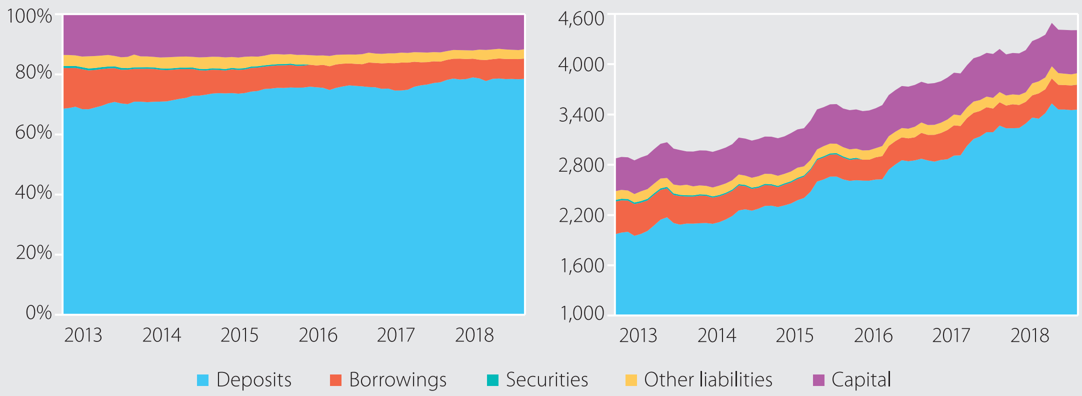
The increase in the banks' balance sheet, which was characteristic in recent years, continued in 2018 (annual growth of 5.4%, while the balance sheet amounted to 4.41 billion euros). Over the past three year, total assets and liabilities of banks rose at an average rate of 10.1%, with a substantial increase in the amount of liquid assets acting as the key component of the growth.

Funding of banking activities from deposits prevailed for many years back, continuing and mildly increasing this year. Total deposits have been hitting all-time highs over the few past years. At end-2018 they rose to 3.46 billion euros, accounting for the year-on-year increase of 5.9%. Deposits of total loans of non-financial institutions also reached record levels in Q3 2018, yet recording the negative annual growth rate of 1.8%. Retail deposits ended this year at the peak level, growing by 7.8% in 2018. Non-resident deposits, both corporate and retail, accounted for a significant portion of total deposits, as much as 21.3% at end-2018, with a significant 12% rise in relation to end-2018. In relation to GDP, at end-2018, total deposits were at the slightly lower level of 74.9% as at end-2018 compared to 2017 (76%). The share of deposits in liabilities and capital increased by 0.4 percentage points, up to 78.5%.

Financing of banks from borrowings was at the same level as in 2017. In 2018, borrowings slightly increased, but their share in total liabilities remained unchanged (7.6%), so there is no source of vulnerability (according to amounts, maturity and currency structure) on this basis.

Graph 4.3

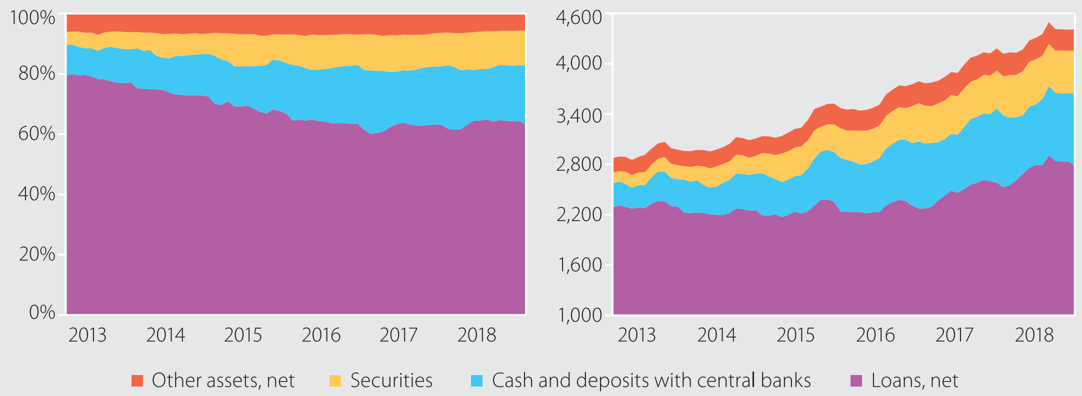
Liabilities and capital: structure (lhs) and amount in million euros (rhs), 2013–2018



Source: CBCG

Graph 4.4

Assets: structure (lhs) and amount in million euros (rhs), 2013–2018



Source: CBCG

Given the business profile of Montenegrin banks, loans still account for the main share in assets. However, this share has been on a downturn for years now, primarily on the back of a more prudential lending, as well as the adverse effects of the crisis, large scope of purchase of receivables, and partly due to growth recorded in other assets segments. In recent years, banks have intensified their lending activity, which has been significantly reflected in assets over the last two years, so overall loans „gain importance", with an annual growth of 12% (gross loans) at the end of this year. Compared y-o-y, the share of net loans in assets rose by 1.4 percentage points to 63.1% of assets at end-2018.

Banks' receivables from non-residents increased mostly based on cash and deposits in 2018. Banks' deposits held abroad referred mainly to demand deposits with prominently seasonal effect, through the summer tourist season influence, which was particularly noticeable this year. Total receivables from non-residents stood at 649.8 million euros or 14.7% of assets at end-2017. On the other hand, banks' payables to non-residents also increased, primarily those arising from deposits. Liabilities based on foreign loans also increased (5.7% of total liabilities). Payables to non-residents amounted to 965.9 million euros or 21.9% of total assets and liabilities. Thus, net foreign assets of banks stood at -7.2% of their total assets and liabilities at end-2018.

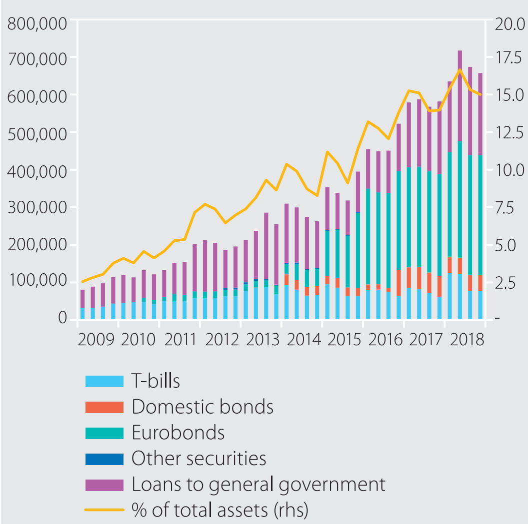
In the first half of 2018, banks significantly increased their investments into securities, but this portfolio was decreasing in the second half of the year, amounting to 508.1 million euros at end-December (annual growth of 11.9%). The main portion of new investment into securities referred to securities issued by the Government of Montenegro, the value of which amounted to 438.9 million euros. At end-December, the total exposure of banks to the general government amounted to 661.1 million euros or 15% of assets. At end-Q2 2019, exposure reached the highest level (16.7%).

During 2018, the exposure of banks to the state also increased through lending. The state borrowed a total of 82.6 million euros of new loans. In terms of the balance, the central government loans rose by 28.8% to 175 million euros at the end of this year. In contrast, local self-government loans declined by 24.2%.

For bank, all this represents investments with a favourable interest rate compared to the risks they bear, which was particularly „attractive" to banks in recent years. In addition, regulatory risk weight for this type of investment is 0%, whereby banks make profit for this type of portfolio and do not have any related regulatory capital requirements.

Graph 4.5

Banks' exposure toward the General Government, in thousand euros and % of assets, 2009–2018

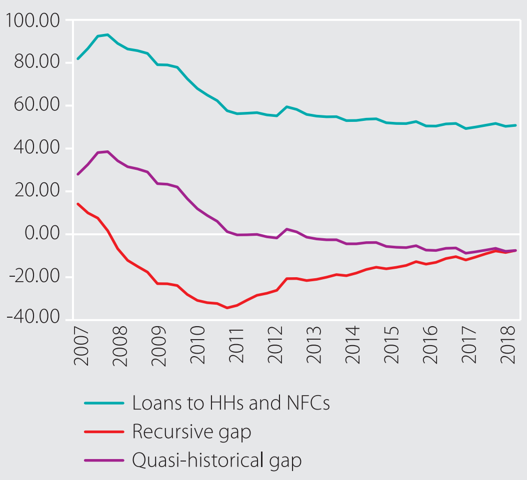


Source: CBCG

4.2. Credit growth and non-performing loans[26]

Graph 4.6

Credit-to-GDP gap, 31 December 2018, in percentage points



Source: CBCG

Total loans had been increasing for the third consecutive year, yet particularly increasing during the last two years, when their annual growth rates amounted to 11.8% and 8.5 in 2017 and 2018, respectively. If new loans are considered, there was also an evident increase in the lending activity. Total loans in the post-crisis period fell to their record low in 2012, followed by a clear upward trend in new loans. During the last seven years, the value of new loans was at its record high in 2018 (1.18 billion euros). As a result of stronger growth of new loans in the last period, the long-term decline in the share of net loans in assets was stopped and recorded a slight increase in 2018.

The gap between the loans of the non-financial sector[27] to GDP ratio and the long-term trend of this ratio has remained negative (-7.6%), which is a tendency since the fourth quarter of 2011. Looking at this analytical tool, it can be said that credit growth, at this moment, does not generate risks to the stability of the financial system[28].

Total retail loans (outstanding principal balance) exceeded total loans of non-financial institutions back in mid-2016[29]. The banks continued to lend to the household sector to a considerable extent, especially considering that new retail loans were approximately at the same level as new loans of non-financial institutions. Similarly, as in the previous two years, retail loans had the largest contribution to the growth of total loans[30] (1.25 billion euros at end-2018). Retail loans have experienced positive growth rates over the past six years, rising at two-digit growth rates over the last three years, as much as 11.9% in 2018. Moreover, for the third consecutive year, retail loans grew at a pace faster than that of nominal growth of economic activity. Loans from domestic non-financial institutions experienced a significant growth for the second year in a row (5.9%), primarily referring to privately owned companies.

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[26] Unless otherwise stated, the loan information presented in this chapter as well as in the rest of the report relates to loans and other receivables of the credit type by gross principle (with the related impairment allowances), excluding related interest and prepayments and accruals of interests/fees.

[27] The gap measures the difference between the current credit to GDP ratio and the long-term credit to GDP ratio. In addition, the recursive gap refers only to data available up to and including this quarter, and is calculated only for the given quarter (while "disregarding" the data relating to the following quarters), while the quasi-historical gap is calculated for the last and for all previous quarters, taking into account all historical data available on 31 December 2018.

[28] Natural persons residents (households and entrepreneurs) and non-financial institutions residents (state-owned and private-owned companies).

[29] Privately owned companies (residents) and state owned companies.

[30] Residents

In 2018, new loans reached their record high (1.18 billion euros) in the post-crisis period, with the focus still being on non-financial institutions (527.5 million euros) and the household sector (493.9 million euros). As in the previous years, the main share of new loans of non-financial institutions referred to loans for liquidity (working capital), with the amounts with maturity up to one year and over one year were approximately similar. In contrast, total loans to the household sector recorded stronger growth, and 97.2% of new loans to this sector had a maturity of over one year.

In respect to industries, the main portion of loans were granted for trade activities, construction, and service activities.

According to the available results of the credit activity survey[31], there was easing of standards for retail loans, and according to bank reports, the demand consistently increased (net percentage higher than 5%)[32]. In terms of in non-financial institutions, credit standards have been generally eased (in the survey - „corporate“), with some oscillations depending on the maturity of loans and the size of the company, while the demand also increased. The easing of standards for lending of non-financial institutions and the household sector is perceived by the banks as a result of increased competition in the market, as well as a better overall economic situation and a greater willingness to take risks. The demand of non-financial institutions was driven by the need to finance capital investments, working capital and the restructuring of existing debt, while the main factors of increased demand in the households sector were the need for refinancing existing debt, as well as the purchase of real estate and durable consumer goods.

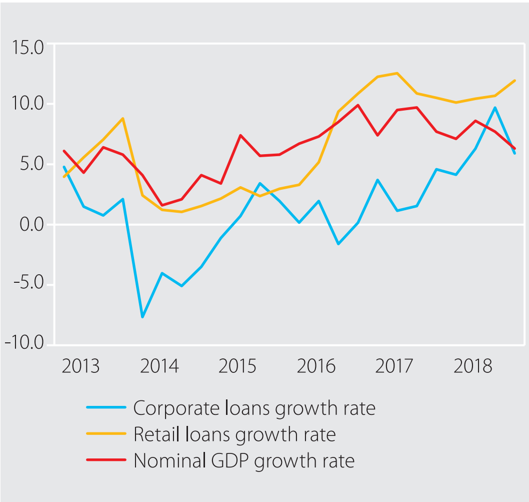
During the year, the banks intensified their lending activity towards non-resident corporate entities (44.3 million euros).

In terms of FX risk, i.e. currency induced credit risk, the loans' currency structure is favourable. A marginal portion of the loan (0.5%) refers to loans in other foreign currencies, which has been typical for the banks' loan portfolio for a longer period.

In reference to the maturity structure of loans as per initially agreed maturity, long-term loans accounted for 87.3% (not including credit-type receivables) at end-2018. However, observed in terms of remaining loan maturity, the share of long-term loans appears to have been significantly lower, 66.6%.

Graph 4.7

Annual growth rate of retail loans, loans of non-financial institutions and nominal GDP, %, 2013–2018



Source: CBCG

[31] Since April 2018, the Central Bank of Montenegro has begun to conduct a credit activity survey, which is in line with the survey conducted by the central banks in the euro area, but also adapted specifically to the specifics of the Montenegrin market. The aim of this survey is to provide the Central Bank with an insight into the key determinants of supply and demand for corporate and retail loans.

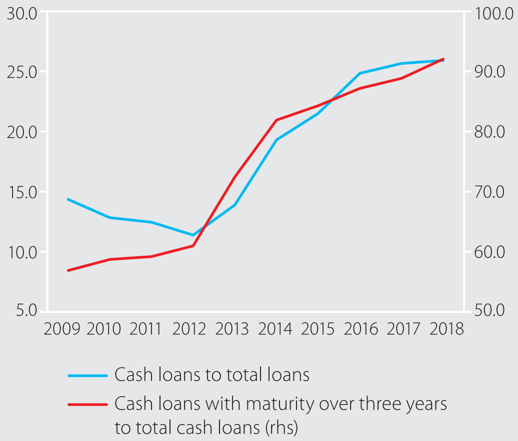
[32] During the preparation of the report, two surveys were available - for the second and third quarters, with expectations for the fourth quarter of 2018.

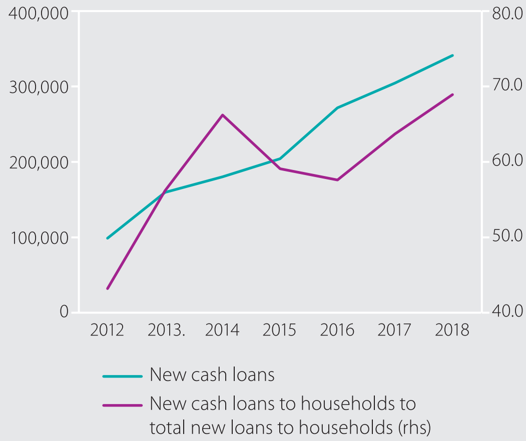
Box 3 – Cash (all-purpose) loans

One of the key drivers of credit growth in recent years was cash (all-purpose) loans, which accounted for 25.9% of total loans or 676.8 million euros at end-2018. In comparison to this, at end-2012, cash loans accounted for 11.4% of loans or 212 million euros. Since that period, cash loans have grown at an average annual rate of 22.8%, which amounted to 13.1% or 78.2 million euros.

Graph 1

Cash (all-purpose) loans, total and newly approved, selected indicators, % and thousand euros

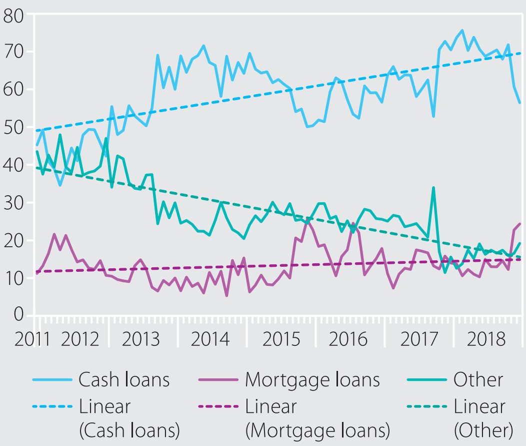




Source: CBCG

Graph 2

Monthly trend of the share of new loans to natural persons by purpose and linear share trends, %, 2012-2018



Source: CBCG

Cash (all-purpose) loans are essentially loans intended for natural persons, since in the last seven years, 99.1% of all new cash (all-purpose) loans referred to natural persons. The amount of new cash loans has been increasing in recent years, and in 2018 it reached 341.1 million euros.

This type of loan has become dominant in new loans to the household sector. Over two thirds (68.9%) of new loans to natural persons in 2018 were cash loans.

According to the bank lending survey, the demand for these loans increased significantly during the year. Banks believe that higher demand was driven by financial needs in the household sector rather than by the improved economic situation in the country.

In addition to lending, it is the maturity of these loans that could pose vulnerability in the forthcoming period, given that 92% (gross) cash loans has a maturity over three years. Loan processing fees for cash loans are lower with less security requirements, making these loans attractive. On the other hand, interest rates at which these loans are granted are an important source of revenues for banks. Also, it is important to note that banks are sufficiently liquid to finance this category of clients, who are otherwise significantly better than legal entities in terms of portfolio quality. The higher growth of loans granted to natural persons over the one-year period (February 2019 / February 2018) of 12.2%, compared to legal entities of 7.5%, is not worrying as natural persons are traditionally good clients to commercial banks. According to the latest quarterly data, the percentage of NPLs in the portfolio of natural persons is 5.5% and it is lower in relation to legal entities (9.2%), as well as in relation to the ratio at the system level which was 6.1% on 28 February 2019.

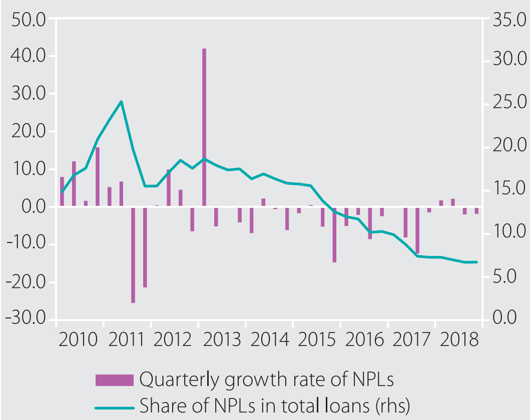
The decline in credit risk, seen through the share of non-performing loans, continued in 2018, although the decline in non-performing loans did not have the same dynamics as during the last four years. The annual decline in the share of non-performing loans amounted to 0.6 percentage points, which was 6.7% at end-2018.

The amount of non-performing loans at the end of this year was approximately at the same level as at the end of the previous year (196.9 million euros), with a slight increase in the first part of the year. The sum of non-performing loans in relation to GDP also continued to decline, amounting 4.3% at end-2018 compared to 4.7% and 6.3% at end-2017 and end-2016.

At end-2018, the amount of over 30 days past due loans (182.9 million euros, or 6.2% of total loans) recorded the year-on-year decrease of 2.9%.

Graph 4.8

Quarterly growth rate of NPLs and share of NPLs in total loans, %, 2010–2018

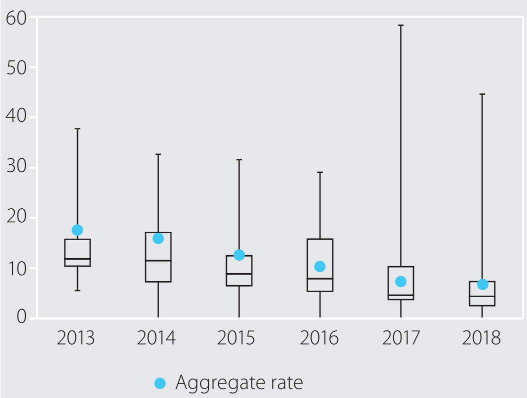


Source: CBCG

Judging by the dispersion of the share of non-performing loans in the system, the credit risk decreased at the aggregate level. The graph below shows that the gap between the minimum and the maximum is lower than last year, as well as the gap between the first and the third quarter. The share of non-performing loans at the system level was around the value from the third quarter, to wit approximately three quarters of banks in the system had the share of non-performing loans below the one at the system level. If we exclude two banks in which an interim administration was introduced in December, then only one bank would have the share of non-performing loans exceeding 10% (which is lower than at the end of 2017), while the second largest share would be very close to the share at the system level.

Graph 4.9

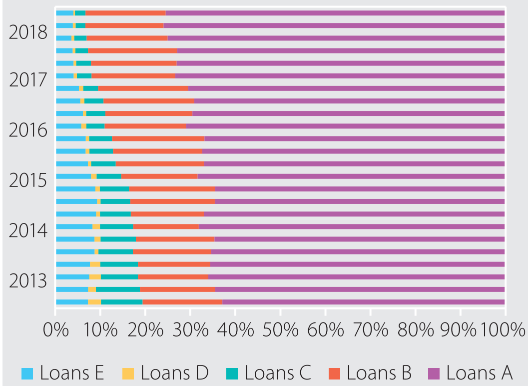
Distribution of the share of bad loans and the share at the system level,%, 2013–2018[33]



Source: CBCG

Graph 4.10

Trends of classified loans, 2013–2018



Source: CBCG

Loans in category „A“ recorded the highest annual growth (11.5% in 2018, 16.9% in 2017), which is an expected trend having in mind the enormous „influx“ of new loans in the past two years and the growth of total loans. Category „B“ loans, unlike the previous year (growth of 9.5%), failed to record a significant increase (1%) in 2018. On the other hand, loans from categories „C“ and „D“ declined by 23.4% and 36.6%, respectively (last year's decline was 14% and 6.5%, respectively). During this year, category „E“ loans increased by 7%.

In line with the IFRS 9, the banks have placed most of their financial assets (87%) in Stage I, which includes financial instruments with low credit risk. Stage II contains 5% of financial instruments whose quality is significantly worse than initially recognised, while Stage III, which includes financial instruments with objective evidence of the occurrence of credit losses, comprises 8% of total financial assets at the system level. During the year, loans from Stage I and II increased, while loans from Stage III declined.

Restructured loans declined in 2018, and recorded a decline of 15.6% compared to end-2017. Restructured loans amounted to 186 million euros accounting for 6.3% of total loans. The decrease in restructured loans mostly related to loans from non-financial institutions, primarily to loans from trade and construction companies.

[33] Reading from the bottom up, the graph's horizontal lines for each year mark the minimum, first quartile, second quartile (median), third quartile and maximum.

Credit risk arising from the part of the portfolio related to non-financial institutions, judging by the sum of non-performing loans, also decreased this year. At end-2018, the annual decline in the amount of these loans was 24%, while their share in total loans of non-financial institutions fell from 14.5% to 10.4% (19.8% at end-2016). The highest non-performing loans concentration remained in the trade and construction sectors, whereby banks' receivables from the trade sector and manufacturing industry were lower than in the previous year (29.1% and 22.5%, respectively).

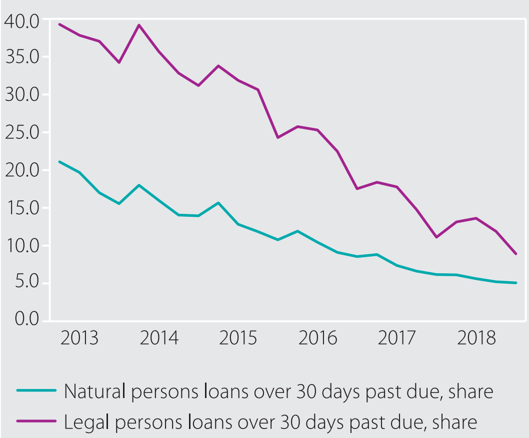
As it was the case in the previous period, credit risk was far less pronounced in the retail sector. At end-2018, the share of non-performing loans of the retail sector was 4.3%.

In 2018, credit risk, measured as over 30 days past due loans, continued the downward trend. This was especially the case with non-financial institutions, where the share of this category at end-2018 was one-digit (8.9%, from 11.1% at end-2017) for the first time since the crisis. In the retail sector, this share amounted to 5.1% at end-2018.

The coverage of non-performing loans by value adjustments amounted to 50.3% at end-2018.[34] The net non-performing loans to capital ratio amounted to 21.5% at end-2018. This ratio has been trending downwards for several years, signalling a decline in the amount of capital exposed to credit risk.

Graph 4.11

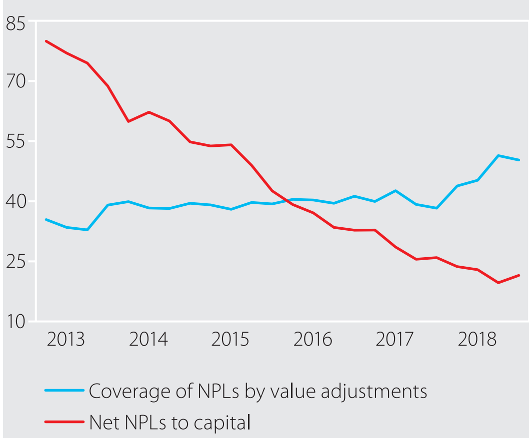
Natural and legal persons loans over 30 days past due, 2013–2018



Source: CBCG

Graph 4.12

Capital resilience to credit risk indicators, %, 2013–2018



Source: CBCG

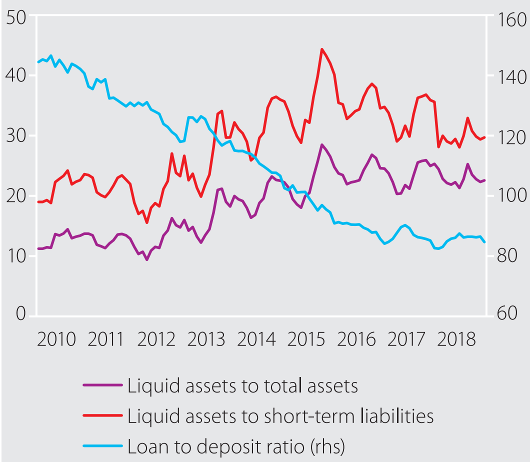
[34] Value adjustments for losses on non-performing loans to non-performing loans ratio. It refers to loans covering interest receivables and interest/fees prepayments and accruals.

4.3. Liquidity

The banking sector continued to boast high level of liquidity in 2018. Thus, liquid assets accounted for 22.6% of the total assets. In absolute terms, liquid assets decreased by 6.1% y-o-y.

Graph 4.13

Liquid assets and loans to deposits ratio (rhs), %, 2010–2018



Source: CBCG

The loans to deposits ratio (84.7%) recorded a slight annual increase, for the first time after 2009 stopping the decline. In 2018, there was also a significant growth in deposits as well as in credit activity. Both non-financial institutions sector and retail sector continued to be net creditors in the system.

The ratio of liquid assets and short-term financial liabilities to remaining contractual maturity amounted to 29.7%, which is less than at end-2017. Short-term liabilities also increased in 2018 (by 373.5 million euros). In terms of maturity of deposits, for the fourth consecutive year, demand deposits have continued to have a higher share than time deposits. At end-2018, they accounted for 64.2% of total deposits, compared to end-2013 when they accounted for 42%. Maturity match of financial assets and financial liabilities per the remaining contractual maturity points to a negative cumulative gap in the period from one to 365 days, and from one to 5 years (0.2% of the total sources of funds).

For liquidity needs, significant funds are available to banks at short notice, primarily deposits held by banks with foreign financial institutions, largely in the form of demand deposits. At end-2018, those deposits amounted to 189.4 million euros, and accounted for 20.2% of liquid assets. Also, at settlement accounts with the CBCG the banks had 416.3 million euros. In addition to this, banks kept a total of 201.8 million euros of cash in their vaults.

4.4. Solvency

Total capital of banks amounted to 513 million euros at end-2018 and it made up 11.6% of total assets and liabilities, which is an annual decline of 0.2%. The share of total capital, in addition to growth in absolute value, is slightly reduced in total assets and liabilities, as a result of higher growth of the total assets and liabilities. However, if we compare the core capital (*Tier 1*) and total assets and liabilities, this ratio has been balanced in recent years, and at end-2018 it amounted to 8.4%.

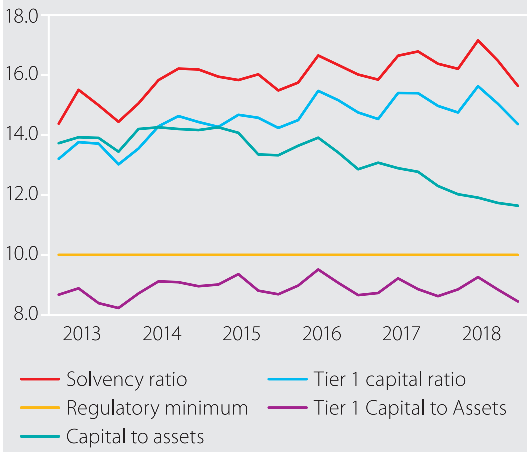
Regulatory capital to risk weighted assets ratio (solvency ratio) recorded the highest value at end-Q2 2018 since Q1 2008, yet it declined at end-2018 compared to 2017 and stood at 15.6%.

The solvency ratio was below the statutory minimum in two smaller banks, whose market share at the end of the year amounted to 6.2% in terms of assets, with the interim administration being introduced in these banks at the beginning of December 2018, and in the first months of 2019 their licences have been revoked. In other banks, the solvency ratio was well above the statutory minimum, and the annual increase in this ratio was recorded in five largest banks. At end-2018, „first-class“ capital ratio was 14.4%, and was also lower than at the end of the previous year.

During 2018, the capital increase was carried out by three banks in the total value of 17.4 million euros.

Graph 4.14

Selected capital ratios, %, 2013–2018



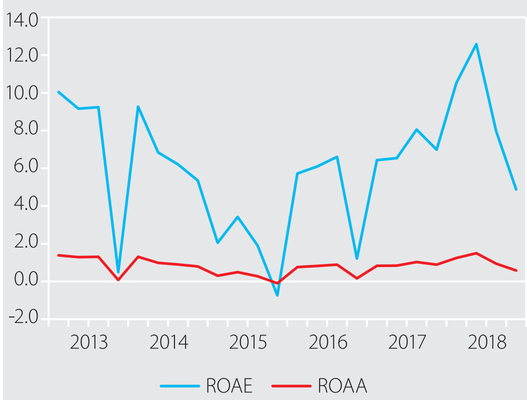
Source: CBCG

4.5. Profitability, interest rates, and competition

In 2018, profitability at the system level was satisfactory with an upward trend for the past three years. Banks' net profit amounted to 24.8 million euros in 2018, declining 28.6% compared to 2017. The lower net profit at the system level is mainly the result of losses in banks where interim administration was introduced at the beginning of December and was followed by the revoking of their licenses. In the rest of the system, most banks recorded a profit. The five largest banks, which individually exceed 10% of the market share in terms of assets, were doing much better than in the previous year, with their profit increasing by 24.7%. Looking at the system excluding banks where interim administration was introduced, the net profit amounted to 48.3 million euros, which is 37.1% more than in the previous year.

Graph 4.15

Selected profitability ratios, %, 2013–2018[35]



Source: CBCG

[35] Quarterly data for the first three quarters refer to cumulative amounts - first three months, first six months, and first nine months of the year, respectively, and for annual period they were transferred by multiplying by 4, 2, and 4/3.

Given negative trends in the above-mentioned banks, return on average assets (ROAA) (0.6%) and return on average equity (ROAE) (4.9%) recorded the year-on-year decreases. If we observe the rest of the system without the two banks mentioned, then the return on average assets was 1.2%, and return to the average equity was 10%.

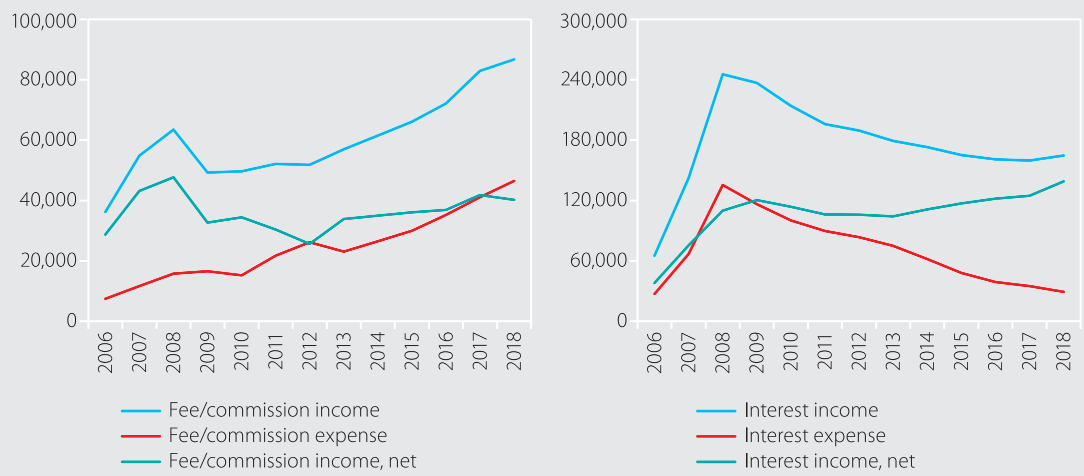
Significant lending activity in 2018 influenced an increase of banks' income from interest, for the first time since the onset of the crisis in 2008. Banks continued to „diversify" interest income, as securities portfolio increased by 12% in 2018. The banks mostly based their investments in securities on those issued by the state of Montenegro (86.2%). The share of these revenues in total interest income was 9.7%.

Interest expenditure continued to decline during this year. Banks currently finance themselves mostly from domestic deposits, with the deposit interest rates that fell considerably, although at lower pace than in the previous period. As a result of an increase in revenues and a decline in interest expense, net interest income recorded a significant increase in 2018, which is a continuation of their growth over several years.

Net fee and commission income was at a slightly lower level than in 2017. In general, fee and commission income in the post-crisis period were becoming more and more significant in the total income of banks, so the ratio of this income and interest income in 2009 was 20.8%, while reaching the level of 52.6% in 2018.

Graph 4.16

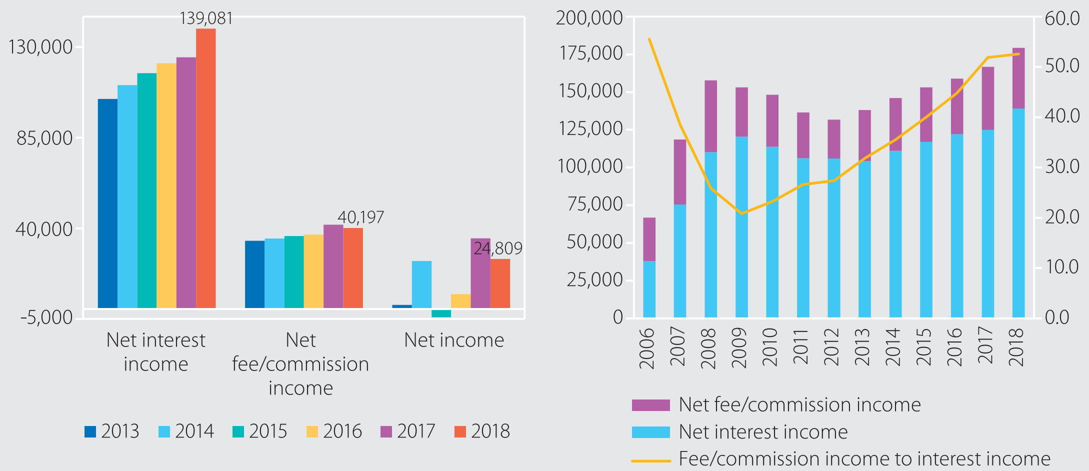
Interest income/expenses, and fees and commissions income/expenses, thousand euros, 2006–2018



Source: CBCG

Graph 4.17

Interest income/expenses, fee and commission income/expenses: interrelation and comparison to total result, thousand euros, 2006–2018



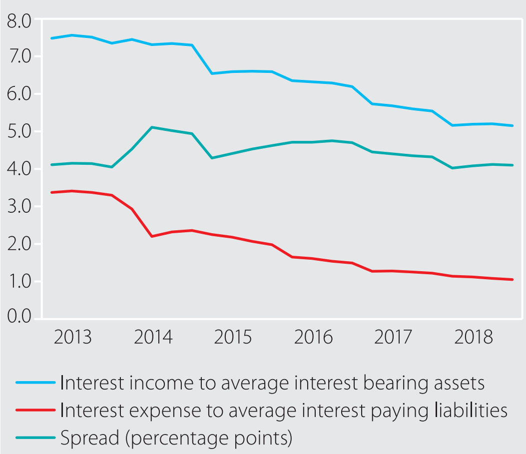
Source: CBCG

In addition to interest income, the earning assets also increased during the year. At end-2018, the average earning assets accounted for 76.3% of average assets. The increase in net interest income can be also seen through the revenue-expense spread[36], as banks continued to reduce interest expense. At end-2018, the spread was generally at the level from the previous year and stayed above four percentage points, and it significantly differed from one bank to another, ranging from 0.02 to 5.3 percentage points. Lower interest rate spread could strain banks' profitability in the medium term, bearing in mind the size and current status of Montenegro's economy.

The decomposition of the return on average assets also shows that net interest income has the highest contribution. Although the allowances for impairment were nominally lower than in 2017,

Graph 4.18

Income/expenses spread (percentage points) and its components (%), 2013–2018[37]



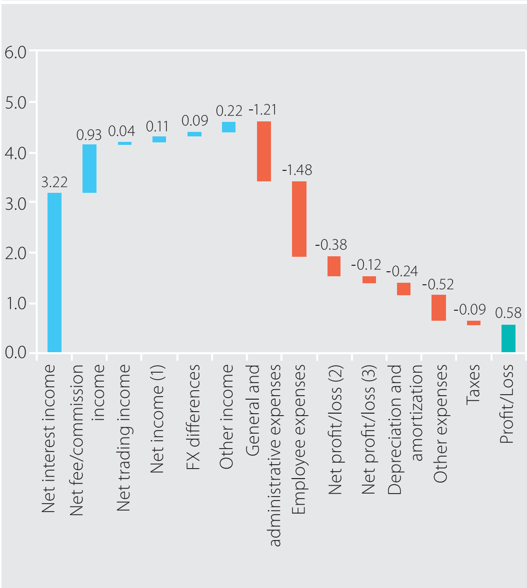
Source: CBCG

[36] Interest rate spread is calculated as the difference between the interest income to average earning assets ratio and the interest expenses to average interest-bearing liabilities ratio.

[37] Quarterly data for the first three quarters referred to a cumulative amount - first three months, first six months and first nine months of the year, respectively, and for annual period they were transferred by multiplying by 4, 2, and 4/3.

Graph 4.19

Components of the banks' statement of financial result in 2018, share in the return on average assets, percentage points[38]



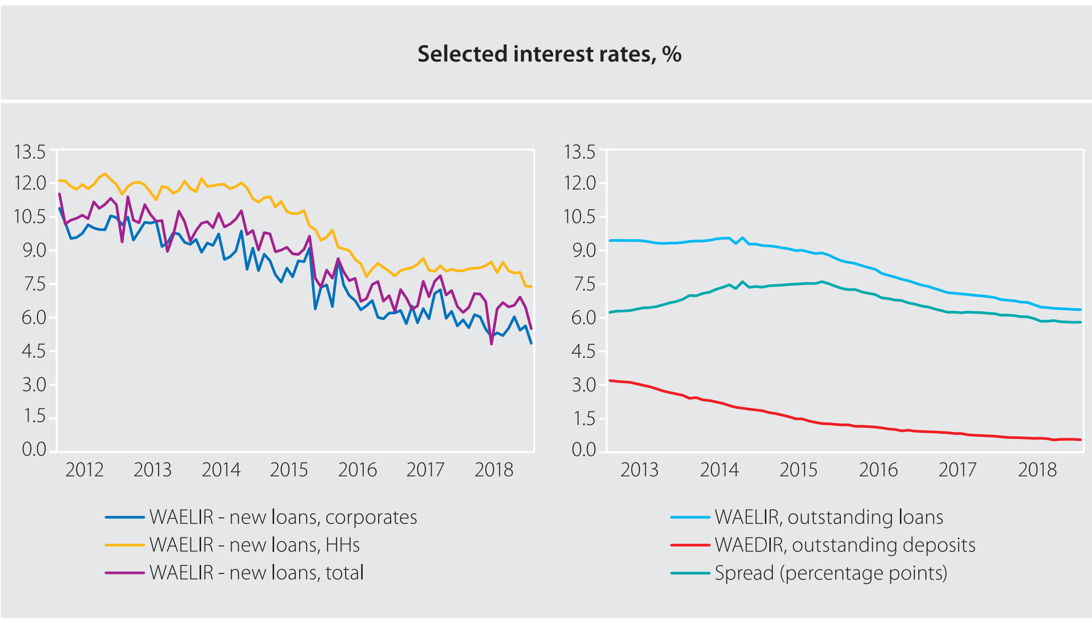
Source: CBCG

their contribution to *ROAA* was -0.38 percentage points. Employee expenses and overhead and administrative expenses represent the highest costs, and they chowed an annual growth, while depreciation expenses were also higher.

The downtrend in the weighted average lending interest rate (for the entire loan portfolio of banks i.e. on unpaid principal/debt) continued in 2018, amounting to 0.4 percentage points. The weighted average deposit interest rate declined by a mere 0.1 percentage points. At end-December, the weighted average lending interest rate was 6.36%, while the weighted average deposit interest rate was 0.56%. In the middle of the year, the interest rate spread dropped to below 6 percentage points, and it was 5.8 percentage points at end-2018.

Similar trends were recorded by the interest rates on new loans in 2018. The weighted lending interest rates on new loans amounted to 6.28% at end-2018, decreasing by 0.57 percentage points y-o-y.

Graph 4.20



Source: CBCG

[38] (1) due to the discontinuance of operations of financial instruments that are not valued at fair value through statement of financial result; (2) based on impairment of financial instruments that are not valued at fair value through profit and loss; (3) from financial instruments at fair value through profit and loss, which are not held for trading.

The decrease was „dragged“ by the sector of non-financial institutions, whose interest rates were 0.66 pp. lower than in 2017, and the weighted rate for this sector was 5.46%. In general, borrowing of the retail sector is „more expensive“ compared to the sector of non-financial institutions. The weighted rate of the retail sector was 0.15 percentage points lower in 2018 compared to 2017 and amounted to 8.06%.

4.6. Sensitivity analysis

The sensitivity analysis of credit risk revealed that some banks showed significant sensitivity levels, primarily after the application of the first and the fourth tests, while banks showed a large level of resilience to the second and third tests. The first test was not passed by three banks with total amount of lacking capital of 48.8 million euros, while the fourth test was not passed by six banks whereby total amount of lacking capital was 65.8 million euros. However, the solvency ratio at the sector level did not fall below the statutory minimum after any of the tests applied.[39]

Table 4.1

Sensitivity analysis of credit and market risks, 31 December 2018

No.	Test	Solvency ratio after the test, %					Lacking capital at the sector level, thousand euros	Number of banks that failed the test
		Min.	Q1	Q3	Max.	System		
		Solvency ratio before the test, %						
		-20.8	12.8	24.4	45.6	15.6		
	Credit risk test							
1.	Negative reclassification of classified loans' structure[40]	-40.1	10.7	21.1	45.5	13.9	48,835	3
2.	Increase in non-performing loans by 30% and value adjustments by 40%	-27.0	11.5	23.3	45.5	14.7	31,367	2
3.	Large debtor bankruptcy[41]	-21.9	11.1	22.1	43.7	14.4	26,674	2
4.	Largest debtor bankrupt	-150.4	9.6	18.4	39.5	11.2	65,800	6
	Market risks test							
1.	Interest rate increase by adding 2 percentage points to cumulative gap of interest rate sensitive positions with 181–365 days maturity	-20.9	12.2	23.9	46.1	15.2	not calculated	2
2.	Adjustment of net open FX position by 40%	-20.8	12.8	24.3	45.6	15.6	not calculated	2

Source: CBCG

As expected, the sensitivity to interest rate risk and the sensitivity to FX risk test showed minor negative impacts on the solvency ratio. In the first case, solvency ratio declined by 0.4 percentage points to 15.7%, while in the latter case, the system level decline was only 0.0007 percentage points, to 15.2%.

[39] Two banks had a solvency ratio below the statutory minimum of 10%, to wit they were lacking capital even before the tests were conducted.

[40] 1) category A – "pass" - calculated in the amount of 90%, and category B increased by 10% of loans from category A, 2) category B – "special mention assets" – calculated in the amount of 95% of the increased category B, 3) category C – "substandard assets" – calculated in the amount of 5% from category B, whereby 95% of category C was kept, 4) category D – "doubtful assets" - calculated in the amount of 5% from category C, while 95% from category D was kept, and 5) category E - "loss" – amount increased by 5% of the amount from category D.

[41] Median value of the debt of banks' 20 top debtors.

Table 4.2

Sensitivity analysis of liquidity risk, 31 December 2018							
No.	Test	Coverage by immediately available liquid assets, thousand euros (617,726 as at 31 December 2018)			Coverage by available liquid assets, thousand euros (743,665 as at 31 December 2018)		
		Lacking amounts (-), sector	Number of banks that failed the test	Lacking amounts (-) for banks that failed the test	Lacking amounts (-), sector	Number of banks that failed the test	Lacking amounts (-) for banks that failed the test
1.	Outflow of 30% of deposits	-420,040	13	-422,229	-294,101	12	-309,087
2.	Outflow of 30% of demand deposits	-69,221	7	-154,516	56,718	6	-85,197
3.	Outflow of demand deposits: 20% for natural persons and 40% for legal persons	-89,192	7	-157,510	36,747	6	-92,416
4.	Outflow of time deposits: 30% for natural persons and 40% for legal persons	230,308	6	-41,666	356,247	5	-20,324
5.	Outflow of deposits of the largest depositor	386,064	2	-4,529	512,003	1	-3,314
6.	Outflow of 50% of deposits of 10 largest depositors	174,324	5	-29,488	300,263	4	-12,965
7.	Outflow of 100% of deposits of public sector	164,016	4	-56,515	289,955	3	-36,570

Source: CBCG

The sensitivity to liquidity risk test, actually tested as a risk of deposit run, was conducted through seven extremely severe and less probable tests. Along with the most liquid - monetary assets of banks, the tests assumed very conservatively the possibility of using only 50% of the reserve requirement[42]. On the other hand, the possibility of using banks' funds in the form of foreign demand deposits was not assumed, which amounted to 189.4 million euros at end-2018, nor the remaining 50% of reserve requirement (125.9 million euros). In addition, neither the possibility of selling non-cash assets (e.g. securities) nor taking loans from parent banks, other participants in domestic or foreign markets, or possibly from the CBCG or the state, have been taken into account.

As expected, even under these assumptions, the testing indicated a good liquidity of the sector as a whole, which only in the case of the first test failed to have liquid assets to respond to the withdrawal of deposits, even after using 50% of the reserve requirement. In all other cases, inadequacy of liquid funds to cover deposit outflow appeared in individual banks. The most pronounced inadequacy, even after the use of 50% of reserve requirement funds, occurred after the application of the second test when six banks failed the test with the liquidity shortfall of 92.4 million euros.

However, with the use of deposits that banks have on their foreign accounts and with the total amount of the reserve requirement, even in the first test the system as a whole could respond to the withdrawal of deposits, along with deficits at the level of several banks. Also, the deficits or the number of banks that would not pass other tests under these conditions would be negligible. Again, it should be kept in

[42] According to the Decision on Bank Reserve Requirement to be held with the CBCG ("OGM" No. 88/17), banks may use up to 50% of their reserve requirement without the fee of the CBCG, if those funds are returned by the end of the working day. Technically, and with the CBCG fee of 12% per year, the bank can use more than 50% of the reserve requirement, or use the reserve requirement for a period longer than the end of the day.

mind that these conditions also exclude some of the above-mentioned „layers“ of liquidity, in the form of the sale of securities or possible borrowings from other entities.

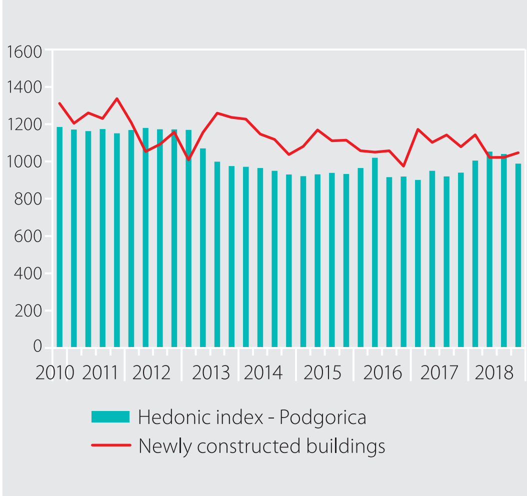
4.7. Real estate market

Parameters that characterize the real estate market in 2018 recorded positive trends, due to better lending conditions, the construction sector's business, as well as favourable macroeconomic conditions in the past year. However, the results of a survey conducted in December suggested that the average price of real estate amounted to 988.1 euros per square meter, which represents a year-on-year increase of 5.2%.[43]

The average price per square meter of new apartments in Montenegro amounted to 1,047 euros in Q4 2018, recording the year-on-year decrease of 3%. However, it should be noted that the differences in the prices of residential units in newly built buildings depend mostly on the share of the Montenegrin Fund for Solidarity Housing Development, thus, the higher the share of these housing units, the lower the prices of newly built housing units and vice versa.

Graph 4.21

Prices of residential buildings obtained using the Hedonic Index and prices of apartments in newly constructed buildings, in euros



Source: CBCG and Monstat

The majority of real estate agencies[44] (50% of them) estimated that the prices on the real estate market remained unchanged over the one-year period, while 33.3% of them pointed to growth between 10% and 15%. Some 16.7% of agencies recorded a decline in real estate prices averaging to 3%. Also, the real state trading with majority of agencies (55.6% of them) remained at the same level as at end-2017. There was an increase in turnover in 44% of agencies.

Housing loans are a significant determinant of demand on the real estate market, and the most important trends are presented in the table 4.3.

In December 2018, housing loans increased by 10.5% compared to the corresponding month of the previous year, which stands as the most intensive annual growth in the post-crisis period. This can be the result of increasingly favourable lending conditions. Namely, the average weighted effective interest rate on new housing loans amounted to 4.6% at the end of 2018 and is lower by almost one percentage point compared to 2017.

[43] As per the Hedonic Index obtained from the CBCG survey where the prices do not reflect actual prices, but essentially represent subjective prices of the real estate owners, i.e. the prices below which they would not be willing to sell their property.

[44] Only ten out of 45 surveyed agencies completed the survey.

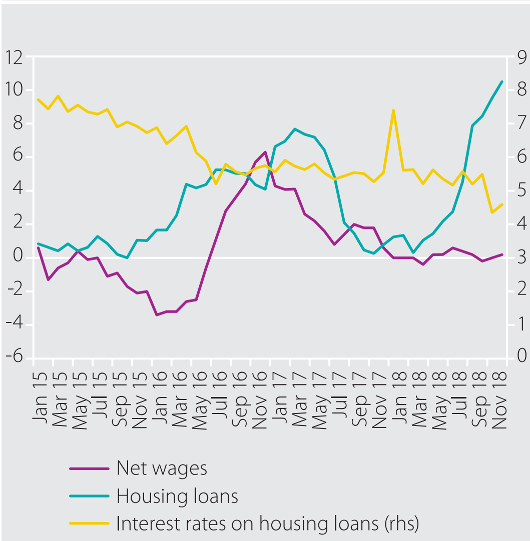
Table 4.3

Housing loans trend, 2007-2018					
Year	stock at year-end	y-o-y growth, %	Per capita (in €)[45]	% of GDP	% of total loans
2007	222,592		362.2	8.3	8.9
2008	264,073	18.6	429.0	8.5	8.9
2009	349,042	32.2	565.6	11.7	13.2
2010	350,880	0.5	566.8	11.2	13.9
2011	325,793	-7.1	525.6	10.0	13.8
2012	309,729	-4.9	499.3	9.7	13.2
2013	317,987	2.7	512.1	9.5	13.2
2014	315,089	-0.9	507.0	9.1	13.3
2015	308,869	-2.0	496.5	8.5	12.9
2016	328,558	6.4	528.0	8.3	13.6
2017	330,983	0.7	531.8	7.7	12.3
2018	365,737	10.5	587.7	7.9	12.5

Source: CBCG and Monstat

Graph 4.22

Annual growth in net wages and salaries and housing loans, and interest rates on housing loans, %



Source: CBCG

However, the share of housing loans in the structure of total loans slightly increased, by 0.2 percentage points. For the same number of percentage points, there was an increase in the share of these loans in GDP, when it amounted to 7.9% of the estimated GDP at end-2018, which could be the result of a significant GDP growth in 2018.[46] The recorded share in GDP is still significantly lower than the average that is typical for the EU countries (about one-third of GDP), which may be the result of lower purchase power of citizens, but also less favourable lending conditions compared to the EU countries. In addition, the amount in the category housing loans per capita during the past year (587.7 euros) is higher than the average net salary in Montenegro (511 euros).

In terms of supply, it can be concluded that there is a potential for further growth. In the past year, long-term loans of legal entities engaged in construction represented 69.8% of their borrowing. It is known that the economy uses long-term loans mainly for investment activities. In 2017, the share of gross value added of the construc-

[45] Data on population include Monstat estimates.

[46] In 2018, according to preliminary Monstat data, GDP growth amounted to 4.9%, which is the highest growth rate in the last ten years.

tion in GDP is 6.7%, which is the year-on-year increase of 1.2 percentage points. Liquid potential in the construction sector is also constantly increasing, and it amounted to 150.3 million euros in 2018. The annual growth rates of deposits in this sector are particularly evident in 2016 (53%) and 2017 (65.8%). Therefore, the rate of non-performing loans fell from 20% in December 2017 to 13.1% in December 2018. Considering that the liquidity potential of the real estate sector increased by 29.8% in 2018 compared to 2017, it can be concluded that there has been a significant pick-up in the real estate market.

The pace of carrying out the important tourist and infrastructure projects in Montenegro in the upcoming period is also expected to fuel the recovery of the construction sector. Next year is expected to bring an increase in banks' lending activity as well as a mild decline in lending interest rates, which might contribute to positive trends in the real estate market. In the upcoming period, positive trends can be expected bearing in mind the macroeconomic situation, i.e. the year-on-year drop in the unemployment rate of 4.3 percentage points in December 2018, as well as the downward trend in interest rates on housing loans. Also, 70% of surveyed real estate agencies believe that real estate prices will continue to grow in the coming period.

Risk assessment of the real estate market has been performed considering the importance of this market for the business cycle and financial stability. Four important series that would approximate the real (fundamental) value of the real estate were used for the given assessment. Every major deviation from the calculated actual real estate value could be a signal of an increased risk in the real estate market, which can affect financial stability, as shown by the financial crisis.

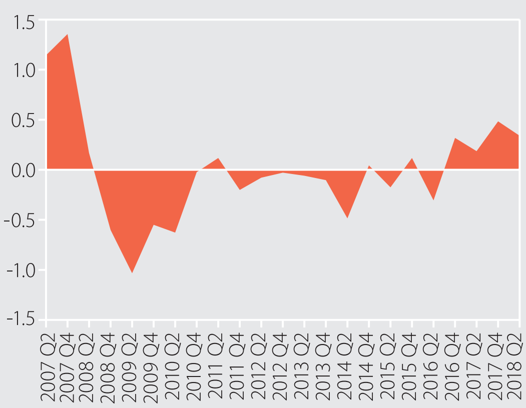
Four series were used for the given analysis: subjective real estate prices to net wages and salaries ratio in the territory of Podgorica, the prices of new buildings to net wages and salaries ratio in the territory of Montenegro, the percentage participation of the effective hours of construction works in GDP and the share of housing loans in GDP. The first two series approximate factors that determine demand (purchasing power of households). The third series approximate the factors that influence the offer at the real estate market. The fourth series approximates the situation in the banking sector, which significantly determines trends in the real estate market. These series are available for the period 2007-2018, and the two series are interpolated due to the inaccessibility of data. *Principal component* analysis was applied on these four series, by which a new variable is created that includes the common variability of the given series over a specified period.

In order to estimate deviations from the actual real estate value, cyclic movements are calculated using the HP filter method (using the recommendations in the estimation of Ravn and Uhlig (2004)). The given cyclical movements are shown in the graph 4.23.

Based on the Graph, it can be said that the period until 2008 is marked by overestimated real estate

Graph 4.23

Deviation from the actual real estate value during 2007-2018



Source: CBCG

values at the market (*boom*), while the period 2008-2011 shows extremely underestimated real estate values (*bust*). The period from 2012 to 2016 exhibited weaker oscillations in the real estate market, with a slight overestimation of real estate values in the last two years. Given the slight deviation, as well as the overall analysis of the real estate market, it is estimated that the real estate market risk to financial stability is low.

The drawbacks of this analysis are the short series that do not include the entire business cycle from the period before 2007, but also the sensitivity of the HP filter method to the length of the series. Also, the analysis would be improved in case of larger number of variables used for the *principal component*. If available, the following series would contribute to a better quality of risk assessment: real estate investments, investments in the construction sector, rent amount, and the like.

4.8. Capital market

The turnover of 147.4 million euros was recorded at the Montenegro Stock Exchange (3.2% of GDP) in 2018 compared to 47.5 million euros of turnover made in 2017[47]. The entire SE turnover was executed through secondary trade, given that there were no primary issues or equity or debt instruments. Share trading made up 97.8% of the secondary turnover, with the companies' share trade accounting for 141.7 million euros and the investment funds' share amounting to 2.4 million euros. The remaining portion of the secondary turnover of 3.2 million euros referred to trading with bonds, whereas trading with T-bills amounted to 2.7 million euros on the secondary market.

At end-2018, the SE indices Monex and MNSE10, stood at 10,840.49 and 837.08 points, recording respective year-on-year growths of 6.5% and 7.8%.

4.9. Payment system

The CBCG`s Payment System - RTGS and DNS systems, as the main payment infrastructures in Montenegro, worked almost without interruptions during 2017. Of 2,159 working hours and without prolongation (totalling 129,540 working minutes) during 254 working days, the CBCG's payment system was in delay of only 128 minutes, achieving the availability of 99.90%.

In 2018, the CBCG's payment system processed payments valued 15.1 billion euros (3.3 the amount of GDP), i.e. 12% more than in 2017. Of this amount, 14.3 billion euros (94.4%) referred to the RTGS system and 839.9 million euros (5.6%) referred to the DNS system. In reference to the number of payments, the CBCG's payment system processed 11.2 million of payments or 9.2% more than in 2017. Of this amount, payments in the amount of 4.4 million euros (39.3%) referred to the RTGS system and 6.8 million euros (60.7%) referred to the DNS system. The average value of payments in 2018 amounted to 1,350 euros, with the RTGS accounting for 3,244 euros and the DNS averaging 124 euros.

[47] Block trade of shares of Elektroprivreda Crne Gore, conducted in May (68.9 million euros - shares purchased by the state from A2A) and in September (51.7 million euros - purchase of own shares, purchased by the EPCG from A2A) accounted for 81.8% of the stock market turnover for 2018.

While the DNS participants were only banks, when it comes to RTGS, the situation was different regarding the structure of payments: banks ranked first with 7.9 billion euros (55.2%), followed by the Government Treasury accounts with 5.9 billion euros (41.3%), the CBCG with 363.3 million euros (2.6%) and other clients of the CBCG with 134.9 million euros (0.95%). Based on the number of payments in the RTGS, banks ranked first with 4.1 million payments (93.2%), State Treasury accounts with 290.9 thousand payments (6.6%), CBCG with 5.4 thousand payments (0.12%) and other clients of the CBCG with 2.01 thousand payments (0.05%).

5. CONCLUSION

Pressures in government finances pose a systemic risk in Montenegro. In that respect, the level of public debt (currently exceeding 70% of GDP) is neither the key problem nor cause of the problem but also to a large extent a consequence of the activity of other economic influences, primarily of structural factors. In general, the public debt growth in the case of Montenegro points to a persistently weak international competitiveness, high spending relative to low accumulation, and increased dependence on foreign capital inflows. With determined continuation of the implementation of fiscal consolidation measures, Montenegro will come into a relatively safe zone.

Montenegro's economic growth was mainly fuelled by high foreign investment inflows (substantially in real estates) and a sharp increase in banks' leverage arising from foreign borrowings mainly from their parent banks. However, since maintaining these inflows in the long-run and at the same pace and level was not possible, the economic growth could continue at the same pace only with increased productivity and competitiveness of all market participants. In addition, the global financial crisis induced disrupted commodities and capital flows, increase in the corporate sector's illiquidity, and a growing need for bail-ins (growth in public expenditures).

As of 2009, the weakening of these foreign capital inflow channels has been partially compensated by growth in the government borrowing, primarily through bilateral credit arrangements and subsequently increasingly through Eurobond issues. At end-2018, the government's external debt amounted to 2.76 billion euros, whereby 55.9% referred to loans and the remaining 44.1% to Eurobonds[48]. Thus, the economy avoided deeper recession, while its growth was medium, averaging at 1.9% in the period 2009–2018, mainly due to the recession years 2009 and 2012. However, high growth rates over the last two years indicate positive tendencies.

A substantial portion of public debt was created in the period of relatively available and cheap money on international financial markets, which largely resulted from the policy of historically lowest interest rates of the leading global central banks. Against this background, the state managed and still manages to borrow under low interest rates compared to the historical standards. However, even in such circumstances, the interest expenses were significant and estimated at 88.6 million euros (1.9% of GDP) in 2018, while their 2019 projections point to the amount of 95.8 million euros (2% of GDP). Therefore, a period of normalisation of interest rates at the international financial market, which will occur at a certain point in time (although not in the near future) will pose a special challenge to financing interest expenses and for debt refinancing. Therefore, it is of utmost importance that all adopted fiscal consolidation measures are implemented and that the public debt is reduced to a sustainable level, in line with the Ministry of Finance`s projections.

[48] A portion of Eurobonds is held by Montenegrin banks, but mainly by those that are foreign owned.

In general, the balance of state finances is of high significance even without direct financial links between the government and banks. The reason for this lies in the fact that the government sector is the country's largest "employer and investor" but its financing is based on the private sector. Therefore, every imbalanced and unsustainable financing period that leads to a „piling" of public debt must be followed by a period of fiscal consolidation. A gradual balancing of spending would be more preferable than the sharp one, however, even gradual balancing generates pressures on the financial positions of both retail sector and the sector of nonfinancial institutions that subsequently spills over to banks through difficulties in loan repayment and a decline in deposits as the most important source for banks for credit growth financing.

Increasing direct financial linkage between the government and banks ads to the complexity of Montenegro's position. The exposure of the banking sector to the government, which was only minor in the post-credit boom period, has been on an uptrend ever since, reaching 661.1 million euros or 15% of total assets of banks at end-2018 and is expected to grow further[49], even though the risk arising from this level can still be considered tolerable. The reasons for strengthening this link were ambivalent. Banks realised favourable interest income compared to risks assumed through these investments, in the context of their risk aversion in the post-crisis period and a lack of better alternative solutions. Also, banks were additionally motivated as they did not have to allocate additional capital since these investments were treated as riskless (according to Basel standards that are applicable in Montenegro). On the other hand, liquid assets of banks were a valuable source of financing for the government, which was particularly prominent in the recent period during which the government has faced the challenge of financing debt in the international market. Regardless of its uptrend, at the current level, this leverage does not pose a threat to financial stability since it is still lower than in some EU countries.

Banks are the soundest segment of the economic and financial system, primarily due to the fact that they are largely subsidiaries of major banking groups from advanced European economies - Austria, France, Hungary, and Slovenia. These groups contributed to the stability of their subsidiaries in Montenegro by providing *know-how* as well as various forms of financial support - recapitalisation, borrowing under favourable interest rates and repayment deadlines.

The issue of non-performing loans (6.7% at end-2018) has persisted regardless of a notable decline achieved over the past years, and the situation significantly improved after closing of two vulnerable banks. Bad loans are no longer a systemic issue, but rather a problem of individual institutions. Still, it should be noted that a decline in the share of non-performing loans was to an extent generated through write-offs and sale of bad assets, which leads to a conclusion that the issue was removed from the banking sector rather than actually resolved. All the aspects of this issue have only recently became possible to perceive when the CBCG`s mandate for supervising activities of non-banking financial service providers became fully implemented and operational.

Banks still have the perception of high risk of real sector, which is best indicated by relatively limited lending activity (although considerably intensified in 2018), as well as still high lending interest rates (regardless of the substantial reduction of average lending interest rate) and other lending conditions. Negative feedback loop between a high share in non-performing loans and stagnant credit growth weakened significantly in 2018, however, in view of all the above mentioned, it is early to say that all problems have been resolved.

[49] The data refers to the general government and not just to the central government.

In 2018, credit growth was driven by retail loans, with the largest contribution from cash loans, both in terms of their approved amounts and in terms of maturity. For example, at end-2018, the debt balance (unpaid principal) on cash loans made up 25.9% of total loans, and the share of cash loans with initial maturity over three years in all cash loans with that maturity amounted to 32.3% compare to 18.6% which is the share of housing loans. In general, the maturity structure of cash loans is currently incomparably closer to the maturity structure of housing loans than a few years ago. There can be several reason for this, and one of them is the possible and partial substitution of housing loans with cash loans, taking into account considerably simpler procedures and the absence of some of the accompanying costs when approving cash loans. However, having in mind the history of the quality of this category of loans, it can be concluded that banks adequately control the risk arising from this exposure. The source of systemic risk in this domain may arise in the event of a downward phase of the conjuncture cycle, i.e. in case of an increase in unemployment and/or a decline in real wages and salaries.

At the same time, total capital of banks rose significantly, by 115.2 million euros or 29%, resulting in the annual return on equity of only 3% in the period 2013–2018.

In parallel, there are 13 banks operating on the market (as of 5 April 2019), with the HHI per assets (which has generally been on a downtrend in the post-crisis period) currently below 1,000 points. The strengthening competition on the Montenegrin market is encouraging, but it would be very unwelcomed that the possible strengthening results in an excessive loosening of lending standards, and thus in an inadequate risk management assessment, which could potentially restore the issue of non-performing loans in the future. However, there are no serious and firmly grounded findings that would point to credit standards lowering at this point.

ANNEX

Table 1 – Indicators of banking sector stability, 2013–2018

	2013	2014	2015	2016				2017				2018			
	XII	XII	XII	III	VI	IX	XII	III	VI	IX	XII	III	VI	IX	XII
Key indicators of the banking sector stability															
Regulatory capital, % of risk weighted assets	14.4	16.2	15.5	15.7	16.7	16.3	16.0	15.8	16.6	16.8	16.4	16.2	17.1	16.4	15.6
Core capital (Tier 1), % of risk weighted assets	13.0	14.4	14.2	14.4	15.4	15.1	14.7	14.5	15.4	15.3	14.9	14.8	15.6	15.0	14.4
Capital, % of assets	13.4	14.2	13.3	13.6	13.9	13.4	12.9	13.1	12.9	12.8	12.3	12.0	11.9	11.7	11.6
Net non-performing loans, % of capital[1]	44.0	28.8	23.0	21.7	20.3	18.0	18.3	18.6	15.1	14.1	14.8	13.9	13.9	10.6	11.4
Net non-performing loans, % of capital[2]	68.7	54.8	42.6	39.2	37.1	33.5	32.8	32.8	28.6	25.6	25.9	25.1	24.3	21.0	21.5
Non-performing loans, % of total gross loans[3]	17.5	15.9	12.6	12.0	11.7	10.2	10.3	9.9	8.8	7.4	7.3	7.3	7.0	6.7	6.7
Non-performing loans, % of total gross loans[4]	18.4	16.8	13.4	12.9	12.6	11.0	11.1	10.7	9.5	8.1	8.0	8.0	7.7	7.4	7.5
Calculated regulatory reserves, % of non-performing loans	61.0	68.1	67.3	67.0	67.3	67.5	67.3	66.0	69.7	66.5	64.8	69.0	68.7	75.4	73.6
Value adjustments, % of non-performing loans	39.1	39.5	39.3	40.5	40.3	39.5	41.3	39.9	42.6	39.2	38.3	43.8	45.2	51.4	50.3
Distribution of loans per borrower, % of total loans															
Residents	82.6	81.7	82.1	83.1	85.9	80.7	86.1	87.5	86.8	81.9	85.0	85.7	84.9	83.0	86.3
Depository institutions (banks)	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.3	0.3	0.1	0.3	0.3	0.2	0.3
Other financial institutions	0.1	0.2	0.1	0.2	0.2	0.1	0.3	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.3
General Government	6.7	5.2	4.5	4.4	4.6	4.5	5.2	6.9	6.9	6.4	7.1	6.8	8.2	7.8	7.5
Non-financial institutions	39.2	38.5	39.0	39.3	40.8	36.4	38.6	38.6	37.8	34.3	36.1	36.7	35.6	33.9	35.2
Households	36.1	37.4	38.2	39.0	40.2	39.5	41.8	41.5	41.4	40.7	41.4	41.6	40.6	40.6	42.7
Other sectors	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3
Non-residents	17.4	18.3	17.9	16.9	14.1	19.3	13.9	12.5	13.2	18.1	15.0	14.3	15.1	17.0	13.7
Financial	14.5	15.7	14.9	13.6	10.7	16.2	10.3	9.7	10.6	15.4	12.5	11.7	11.8	12.9	9.3
Non-financial	2.9	2.6	3.0	3.2	3.4	3.1	3.6	2.8	2.6	2.7	2.6	2.6	3.3	4.1	4.4
Net profit, % of average assets (ROA)	0.1	0.8	-0.1	0.8	0.8	0.9	0.2	0.8	0.8	1.0	0.9	1.2	1.5	0.9	0.6
Net profit, % of average equity (ROE)	0.5	5.4	-0.9	5.7	6.1	6.6	1.2	6.4	6.5	8.1	7.0	10.5	12.6	8.0	4.9
Net interest and similar income, % of gross income	58.3	60.2	58.1	62.4	59.7	58.8	58.1	57.4	57.7	55.6	54.4	59.1	56.4	56.6	55.0

Table 1 – coninued

	2013	2014	2015	2016				2017				2018			
	XII	XII	XII	III	VI	IX	XII	III	VI	IX	XII	III	VI	IX	XII
Interest-free expenses, % of gross income	73.7	75.0	74.3	75.3	73.0	73.2	74.8	72.1	73.2	73.1	74.5	76.7	71.9	81.1	76.9
Liquid assets, % of total assets	20.0	22.2	24.8	21.9	22.6	26.8	24.5	20.3	21.2	25.8	25.3	22.1	21.3	23.5	22.6
Liquid assets, % of short-term liabilities,	32.2	35.7	40.1	32.8	34.4	38.6	34.8	29.0	29.9	36.5	35.6	29.0	28.1	30.8	29.7
Aggregate balance in foreign currencies, % of core capital	0.6	0.7	2.3	4.1	2.9	2.6	1.7	1.9	1.8	1.5	0.9	-1.9	-1.0	0.2	0.0
Additional indicators of the banking sector stability															
Large exposures, % of capital	110.6	98.9	109.8	107.7	110.9	133.4	112.2	105.1	104.2	121.5	108.0	67.3	53.4	121.4	100.2
Derivative financial assets, % of capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Derivative financial liabilities, of % capital	0.0	0.0	0.0	0.0	0.1	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trading income, % of gross income	1.6	2.5	2.5	2.0	2.4	2.6	3.1	3.5	3.0	2.9	3.0	2.2	2.4	2.4	2.3
Provision expenses, % of non-interest bearing expenses	42.9	41.7	40.5	41.7	41.3	40.4	39.6	40.8	39.4	38.1	37.3	37.3	36.5	32.1	32.8
Spread between average interest rate on loans and deposits (percentage points)[5]	6.8	7.4	7.3	7.2	6.9	6.8	6.5	6.3	6.2	6.2	6.1	6.0	5.8	5.8	5.8
Deposits[6], % of total (without inter-bank) loans[7]	98.9	113.9	127.3	125.3	122.3	133.8	131.0	124.7	124.2	135.4	136.6	132.1	128.1	131.5	129.3
Loans in foreign currencies, % of total loans	3.6	3.7	7.9	7.8	6.1	5.5	6.2	6.4	5.8	5.4	6.5	6.3	6.3	5.6	5.7
Liabilities in foreign currencies, % of total liabilities	4.3	4.7	6.9	7.1	6.7	6.2	6.4	6.0	5.9	5.8	6.5	6.9	7.0	6.4	6.4
Loans to private sector, annual growth rate[8]		-0.7	2.5	1.6	3.6	3.9	6.1	8.8	7.5	6.7	7.8	7.5	8.9	10.7	9.4

1/ non-performing loans reduced by calculated regulatory provisions
2/ impaired non-performing loans
3/ without interest and prepayments and accruals
4/ with interests and prepayments and accruals
5/ spread between effective average weighted lending interest rate and effective average weighted deposit interest rates
6/ total deposits excluding deposits of financial institutions less than 1 year
7/ total loans without interbank loans
8/ private sector refers to private companies, entrepreneurs and households

Source: CBCG

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