The activities of the CBCG in 2018 were directed at resolving problems faced by two minor vulnerable banks in the system. Despite taken activities, liquidity ratio in one vulnerable bank dropped below the statutory minimum starting from the second ten-day period of September, while the solvency ratio in the other bank dropped below the statutory minimum of 10% in H2. The latter vulnerable bank had a negative solvency ratio in Q4.

To maintain the soundness of the financial system, the CBCG introduced interim administration in these two banks in December 2018 and a moratorium in these banks. Based on the reports on financial condition and operating results of these banks, bankruptcy was instigated in both banks in January and April 2019, respectively.

Despite the problems in operations of these banks, the banking system of Montenegro was sound and safe, as confirmed by basic operating indicators. Solvency and liquidity ratios of the banking sector were above the statutory minimum. The aggregate profit amounted to 27.3 million euros. Main monetary indicators, primarily loans and deposits, continued to grow, while interest rates and non-performing loans continued to drop.

In 2018, total banking loans were trending up, recoding the annual growth of 8.5%, while the share of non-performing loans in total loans recorded the annual decline of 0.57 percentage points.

Deposits continued to increase at a high annual rate of 5.9%.

In 2018, the IFRS 9 standard was introduced, according to which losses are recognised in the amount of expected future losses on the basis of data on past and future events, instead of former determination of losses at the time when loss occurred. The banking system of Montenegro implemented the IFRS 9 standard without problems, as confirmed by the annual growth in total banks’ capital of 0.3%. There were three recapitalisations in 2018 totalling to 17.4 million euros.

2.1. Banks

2.1.1. Banks’ liquidity

The banking sector of Montenegro was highly liquid in 2018. Aggregate key liquidity indicators were above the statutory minimum31 (Graphs 2.1 and 2.2)

31 The applicable Decision on Minimum Standards for Liquidity Risk Management in Banks (OGM 60/08) sets out the obligation of banks to maintain the minimum daily (0.9) and ten-day (1.0) liquidity ratios.
During this period, all banks regularly settled their obligations and had daily and ten-day liquidity ratios above the statutory minimum, except one bank whose ten-day liquidity ratio was below the statutory minimum in the last two ten-day periods of September.

At end-2018, the daily liquidity ratio amounted to 1.34 and it was lower compared to the same period of the previous year (1.70). The ten-day liquidity ratio amounted to 1.37, being lower compared to end-2017 (1.68).

The average daily liquidity indicator amounted to 1.46 in 2018, decreasing in relation to the same period of 2017 when it amounted to 1.69.

Liquid assets of banks amounted to 994.5 million euros at end-December 2018. This was 64.5 million euros or 6.1% less than at end-2017, mostly due to intensive lending activity. Liquid assets made up 22.57% of total assets at end-2018, being lower than at end-2017 when they stood at 25.32% (Graph 2.3).

**Graph 2.1**

**Aggregate daily liquidity indicator**

Source: Banks’ daily reports

**Graph 2.2**

**Aggregate ten-day liquidity indicators**

Source: Banks’ ten-day reports

**Graph 2.3**

**Banks’ liquid assets (left) and share of liquid assets in total assets (right)**

Source: CBCG
The loans to deposits ratio amounted to 0.85 at end-December 2018 and it was higher compared to end-2017 when it was 0.83.

2.1.2. Aggregate balance sheet of banks

In 2018, total assets and liabilities of banks were on an uptrend (graph 2.5). Total assets and liabilities of banks amounted to 4,406.8 million euros as at end-2018, which is 5.4% more than at the 2017 year-end.

Banks’ assets structure reveals that loans accounted for the main share of 66.5%, while deposits made up the main portion on the liabilities and capital side, 78.5%.

Growth in banks’ total assets primarily resulted from a significant increase in loans of 228.7 million euros or 8.5%, which resulted in continued increase of loans in the structure of banks’ assets to 66.5%. In addition to loans, securities also recorded a significant annual growth of 53.9 million euros or 11.9%. Share of placements in securities in total assets increased to 11.5%. Cash and deposit accounts with central banks declined by 12 million euros or 1.4%.

On the liabilities and capital side, all items recorded annual growth, with the highest nominal growth in deposits of 192.1 million euros (5.9%), the share of which in total liabilities and capital increased to 78.5% as at end-2018. Banks’ borrowings increased by 18.1 million euros or 6.5%, while banks’ capital grew annually by 1.5 million euros or 0.3%.
At end-2018, total non-performing assets of banks amounted to 261.1 million euros, which was 5.6 million euros or 2.2% more compared y-o-y. However, the share of non-performing assets in total banks’ assets was 5.93%, being 0.19 percentage points lower than at end-2017 (Graph 2.6).

In 2018, banks ran a profit of 27.3 million euros, which is the year-on-year decline of 21.5%. Eleven banks operated with profit, while four operated with loss.

Box 2.1 – Concentration ratios

Compared to 2017, the concentration of the banking system in 2018 decreased when observed by loans and deposits, which is a positive trend. The Herfindahl-Hirschman Index (HHI) showed that the market was non-concentrated in terms of assets (993.1 points) and deposits (991.3 points), while the market concentration in terms of loans was moderate (1,010.9 points).

Table 1

<table>
<thead>
<tr>
<th>HH index</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>Q1 2018</th>
<th>Q2 2018</th>
<th>Q3 2018</th>
<th>Q4 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>1,102</td>
<td>1,036</td>
<td>991</td>
<td>982</td>
<td>984</td>
<td>992</td>
<td>993</td>
</tr>
<tr>
<td>Deposits</td>
<td>1,158</td>
<td>1,083</td>
<td>1,009</td>
<td>988</td>
<td>981</td>
<td>997</td>
<td>991</td>
</tr>
<tr>
<td>Loans</td>
<td>1,121</td>
<td>1,023</td>
<td>1,007</td>
<td>1,012</td>
<td>1,016</td>
<td>1,022</td>
<td>1,011</td>
</tr>
</tbody>
</table>

Concentration of three banks (C3) that had the most of deposits in the system was 39.3% of total deposits as at end-2018. Five banks with most deposits (C5) disposed with 60.3% of total deposits as at end-2018. In 2017, the same deposit concentration for three and five banks amounted to respective 38.9% and 60.9%.

Table 2

<table>
<thead>
<tr>
<th>Concentration indices C3 and C5</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Assets</td>
</tr>
<tr>
<td>Loans</td>
</tr>
<tr>
<td>Deposits</td>
</tr>
</tbody>
</table>
2.1.3. Banks’ lending activity

Total banking loans were trending upward in 2018. At end-December 2018, total loans granted amounted to 2,929.2 million euros, which is 228.7 million euros or 8.5% more in relation to end-2017. Compared to 2017 year-end, twelve banks reported growth in loans, while three banks recorded decline.

Of total banking loans at end-2018, the main share of 86.3% was extended to residents, whereby 42.7% referred to the retail sector, followed by nonfinancial institutions (35.2%), General government (7.5%), financial institutions (0.6%), while the share of 0.3% referred to non-governmental and other non-profit organisations. At the end of the observed period, loans granted to non-residents accounted for 13.7% of total loans granted (Graph 2.7).

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### Box 2.2 – Application of ESA 2010 methodology in monetary statistics

The European System of National and Regional Accounts (ESA 2010) methodology is the EU methodology for the production and transmission of statistical data.

As of June 2018, data on monetary statistics have been compiled using this methodology, according to which the statistical data on basic monetary indicators are published following the residence principle. The residents sector is divided into:

- Financial corporations, which includes domestic deposit and other financial institutions;
- Non-financial sector, which includes private non-financial corporations and public non-financial corporations;
- General government, which includes central government, local government, and social security funds;
- Households, which includes natural persons and entrepreneurs, and
- Non-governmental and other non-profit institutions

**Financial corporations** include institutional units whose principal activity is the production of financial services. Such institutional units comprise all corporations principally engaged in financial intermediation and/or auxiliary financial activities. When disclosing statistical data concerning financial corporations, the CBCG publishes data on the level of deposit and other financial corporations.

Pursuant to ESA 2010 definition, deposit-taking corporations include all financial corporations principally engaged in financial intermediation and whose business is to take deposits and/or similar instruments from institutional units, and to grant loans and/or to make investments in securities. Deposit taking institutions in the Montenegrin market include the Central Bank and commercial banks operating in Montenegro’s territory.
Other financial corporations include the following sub-sectors: non-money market investment funds, insurance companies, pension funds, other financial intermediaries, auxiliary financial corporations, and captive financial institutions and money lenders.

**Non-financial corporation sector** includes institutional units which are independent legal entities and market producers, and whose principal activity is the production of goods and non-financial services. This group also includes private and public corporations.

**General government sector** consists of institutional units that are non-market producers whose output is intended for individual and collective consumption. These units are financed by compulsory payments made by units belonging to other sectors, and institutional units principally engaged in the redistribution of national income and wealth. Monetary statistics compilation discloses general government sector in three sub-sectors:

- Central government includes all administrative departments of the state and other central agencies whose competence extends normally over the whole economic territory.
- Local government includes those types of public administration whose competence extends to only a local part of the economic territory.
- Social security funds include institutional units whose principal activity is to provide social benefits.

**Households sector** consists of individuals or groups of individuals as consumers and as entrepreneurs producing market goods and non-financial and financial services.

**Non-profit institutions serving households** are separate legal entities, which serve households and which are private non-market producers. This group includes trade unions, professional or learned societies, consumers' associations, political parties, churches or religious societies, social, cultural, recreational and sports clubs, charities, and the like.

On the other hand, the compilation of data on non-residents uses the definition from the Law on Foreign Current and Capital Transactions.32

Observed by sectors relative to end-2017, all domestic sectors recorded growth, with the highest one recorded in loans to households (133.3 million euros or 11.9%), followed by loans to non-financial sector increasing by 57.6 million euros or 5.9%), and general government (26 million euros or 13.5%).

Compared to 2017, the distribution of loans granted to non-residents by sectors showed growth in loans to the non-financial sector and households, while deposit potential of banks with foreign deposit institutions decreased.33 Loans granted to non-resident nonfinancial sector increased by 44.3 million euros or 77% y-o-y. Loans to non-resident natural persons grew by 16 million euros or 136.8%. Deposits of banks with foreign banks decreased by 65.4 million euros or 19.4%, resulting in a decline of loans to the non-resident sector by 5.1 million euros or 1.3%.

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32 OGRM 45/05, OGM 62/08, 40/11, 62/13, 70/17

33 According to the methodology used in monetary statistics, loans include total loans granted to all sectors, deposits with banks and other deposit taking institutions, factoring, forfeiting, and receivables from unsettled bills of acceptance, guarantees, and bills of exchange.
Monthly trend in total granted loans by sectors show the lowest fluctuation in household and nonfinancial sector, while significant fluctuations were present with the financial sector due to fluctuations in banks’ deposits with other domestic banks (Graph 2.8).

At end-2018, resident legal persons’ debt arising from loans totalled 1,283.4 million euros, which is 8.5% more than at end-2017. The structure of loans by industries indicates that the largest portion of loans from resident legal persons referred to wholesale and retail trade and the repair of motor vehicles and motorcycles (28.5%), followed by public administration and defence; compulsory social security (16.5%), construction (14.1%), accommodation and food service activities (12.9%), while 28% referred to all other sectors (Graph 2.9).

Observed by purpose, the main share of banking loans referred to cash loans (23.1%), liquidity (17.2%), housing loans (12.5%), loans for refinancing of obligations to other banks (6%), loans for the purchase of fixed assets (5.3%), loans for construction and renovation of buildings (3.7%), and overdrafts (3.6%). The remaining 28.6% of funds were used for consumer loans, credit cards, loans for the preparation of tourist season, purchase of cars, purchase of securities, and other purposes (Graph 2.10). The growth of consumer loans was mostly the result of growth in cash loans by 78.2 million euros or 13.1%.
Banking loans are mostly granted in euros and for a period over one year. In 2018, loans granted in euros amounted to 94.3% while, observed by maturity, 78.1% of loans were long-term loans. Loans with agreed maturity over three years amounted to 1,928.2 million euros, and had the highest share both in long-term loans (84.3%) and in total loans (65.8%).

After the application of stricter reporting standards in line with the IFRS 9, non-performing loans (NPLs) fluctuated in 2018, ending the year at slightly lower level than in 2017. At the end of 2018, NPLs amounted to 196.9 million euros, which is 101,000 euros or 0.1% decline in relation to end-2017. Banks’ NPLs made up 6.72% of total banking loans at end-2018 and, due to increase in total loans, their share in total loans declined by 0.57 percentage points y-o-y.

Total value adjustment of banking loans amounted to 149.2 million euros and it made up 75.8% of NPLs as at end-2018, being 30.4 million euros or 25.6% higher compared to end-2017. As a result of the increase in value adjustments, the coverage of NPLs with value adjustments significantly increased compared to end-2017 when it was 60.3% (Graph 2.11).

At the end of the reporting period, past due loans amounted to 182.9 million euros or 6.24% of total approved loans. They declined by 5.5 million euros or 2.9% in relation to end-2017.

Box 2.3 – Banks’ lending activity

In April 2018, the Central Bank of Montenegro launched the Bank Lending Survey, which is harmonised with international practice and methodology. The results of the Survey, in which all banks participate pursuant to the Decision establishing the forms for the submission of information on lending activity, provide the Central Bank with an insight in key determinants of supply of and demand for the loans to enterprises and households. Moreover, the Survey provides the Central Bank with the information on the change in trends of bank’s lending to companies and enterprises, credit standards, factors contributing to such trend, lending conditions, and the expected changes concerning new lending. The Report on the Bank Lending Survey results is compiled and published quarterly.
New loans\textsuperscript{34}

When considering new loans, it is obvious that the lending activity of banks intensified in the observed period. During 2018, banks approved a total of 1,176.4 million euros worth of new loans. Compared to 2017, some 81.7 million euros or 7.5% more loans were approved.

In 2018, the lending growth was supported by more favourable lending conditions and increased demand for loans. The Bank Lending Survey\textsuperscript{35} results suggested that credit standards for loans to enterprises and households eased in 2018. The easing of credit standards for enterprises and households was primarily the result of the strengthened competition in the banking sector, positive expectations of banks concerning the economic activity, greater risk appetite and (this goes for households) a lower risk of collateral requirement. The Survey results show that the demand for enterprise and households loans increased during three quarters of 2018, mostly driven by the requirement to finance working capital and restructure the existing debts of enterprises. The main factors in the households sector contributing to the demand increase were the need to refinance the existing debts and the purchase of immovable property and consumer durable goods.

The maturity structure of new loans shows that the largest part of 891.9 million euros or 75.8% were granted to a period longer than 1 year. The share of long-term loans in the structure of new loans decreased relative to the same period of 2017 when it amounted to 77.9% (Graph 2.12).

The earmarking structure of new loans in 2018 shows that loans for liquidity accounted for the highest share (409.9 million euros or 34.8%) followed by cash loans (341.1 or 29%).

2.1.4. Banks’ investment in securities

The increasing trend in investing of Montenegrin banks into securities started after the global financial turmoil began. Due to less intensified lending activity in previous years, banks have placed a portion of liquid portfolio excess into securities, as an alternative manner of source revenues.

The increasing trend of investing into securities continued in 2018 as well. Thus, banks’ receivables from securities amounted to 508.1 million euros as at end-December 2018, recording a 53.9 million euros or 11.9% growth relative to the 2017 year-end (Graph 2.13).

\textsuperscript{34} Source on new loans: Credit Registry, KRN reports of banks

\textsuperscript{35} The Central Bank of Montenegro has been conducting the Bank Lending Survey since Q2 2018.
The structure of banks’ investments into securities shows that banks mostly invested into safe portfolio. Thus, as at end-December 2018, various domestic state securities accounted for the largest portion (86.4%), while non-residents’ securities accounted for 9%, and the remaining 4.6% were securities of other domestic sectors (Graph 2.14).

The growth in total investments into securities in December 2018 resulted from the increased banks’ investments into government securities. Thus, the total amount of banks’ receivables from state securities thus amounted to 438.9 million euros as at end-December 2018, increasing 50 million euros or 12.9% compared to the previous year-end.

Of the total amount of government securities, some 318.1 million euros or 72.5% were banks’ investments into Montenegro’s Eurobonds, Treasury bills amounted to 77 million euros or 17.5%, while 43.7 million euros or 10% were domestic state bonds.

Compared to the previous year-end, investments into Montenegro’s Eurobonds recorded a significant increase of 46.2 million euros or 17%, while receivables from Treasury bills increased by 14.8 million euros or 23.7%. Domestic state bonds declined by 10.9 million euros or 20%.

2.1.5. Deposits

In 2018, funds deposited in banks continued the uptrend from previous years. Compared to the end-2017, deposits with banks amounted to 3,459.2 million euros at end-2018, and they were 192.1 million euros or 5.9% higher.

The main sources of financing of banks are deposits from the domestic sector, which at the end of the observed period amounted to 2,722.2 million euros or 78.7% of total deposits. Household sector and non-financial sector accounted for 2,427 million euros or 89.2% having the dominant share in deposits of the domestic sector. Deposits of these two sectors increased by 75.2 million euros or 3.2% in relation to end-2017. General government is the third most important depositor in the Montenegrin banking
system with 213.6 million euros or 6.2% of total deposits. Deposits of this sector increased by 29.3 million euros or 15.9% in relation to end-2017. Deposits of the financial sector accounted for only 1% of the total deposits and recorded an increase of 275,527 euros or 1% compared to the end of the previous year (Graph 2.15).

Demand deposits amounted to 2,221.2 million euros or 64.26% of total deposits in banks, while 1,169.4 million euros or 33.8% referred to time deposits. A minor portion of bank deposits (2%) referred to funds in escrow account.

The maturity structure of deposits of banks showed the increasing trend in demand deposits and the decreasing trend in time deposits. Thus, the share of demand deposits and of funds at escrow account increased by 3 and 1.3 percentage points, respectively. The share of long-term deposits and of deposits with maturity of up to one year recorded annual decline of respective 1.1 and 3.2 percentage points (Graph 2.16).

The share of deposits and borrowings in loans by maturity indicates that 32.8% of loans were granted for a period longer than one year and they were covered by sources of financing (in the form of deposits and borrowings) with the same maturity. On the other hand, total demand deposits with banks were 9.3 times higher than total bank receivables arising from demand deposits placed with other banks, while banks’ short-term deposits and borrowings were 1.8 times higher than banking loans granted for a period up to one year (Graph 2.17).
2.1.6. Retail and non-financial sector

2.1.6.1. Retail sector

The household sector is the largest user of banking loans and the largest depositor in the banking system of Montenegro.

During the reporting period, banks’ lending activity increase was mostly the result of growth in retail loans. Total debt of the retail sector arising from banking loans amounted to 1,250.2 million euros at end-2018. This sector’s debt arising from loans increased by 133.3 million euros or 11.9% compared to end-2017. Loans to this sector grew at an average monthly rate of 10.8%, which was lower than the rate recorded in 2017 (11.4%).

Retail sector borrowed mainly from banks, with loan maturity of over one year. At end-December 2018, long-term loans accounted for 97.5% of total loans granted to this sector.

At the end-2018, debt per capita\(^{36}\) amounted to 2,009 euros, which is 214 euros more than at end-2017.

At end-December 2018, total retail sector deposits amounted to 1,327.5 million euros, which is 95.7 million euros or 7.8% more in relation to end-2017. The average y-o-y growth rate of household deposits in the twelve months of 2018 was 9.7%, being higher than in the previous year when they rose at the rate of 9%. This increase in retail deposits is highly important for banking stability, pointing to solid confidence into the banking sector despite negative developments in the two banks at end-2018.

As at end-September 2018, demand deposits accounted for 54.7% of total retail deposits, short-term deposits made up 25.1%, while 20.2% referred to funds deposited for a period over one year. Demand deposits recorded the annual growth of 73.4 million euros or 11.2%, long-term retail deposits in-

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\(^{36}\) Source: MONSTAT, population estimate amounted to 622,359 as at 1 January 2018.
increased by 16.8 million euros or 6.7%, while short-term deposits increased by 5.7 million euros or 1.7% (Graph 2.18).

At the end of 2018, retail sector net savings amounted to 77.3 million euros and, due to faster growth in loans than deposits during the reporting period, it was 37.6 million euros or 32.7% lower than at the end of 2017 (Graph 2.19).

Due to the aforementioned trends in savings and loans in this sector, the loans to deposits ratio recorded slight growth. At the end of the reporting period, it was 0.94, being higher than at the end of the previous year (0.91).

2.1.6.2. Nonfinancial sector

Non-financial sector is the second most important bank borrower and depositor in the banking system.

At end-2018, non-financial sector reported a debt arising from loans in the total amount of 1,031.8 million euros, which accounted for 35.2% of total banking loans granted. During the reporting period, the recovery in lending activity was seen through the growth in non-financial sector loans, which were 57.6 million euros or 5.9% higher than at end-2017 (Graph 2.20).

Total deposits of this sector amounted to 1,099.4 million euros at end-2018 and accounted for 31.8% of total deposits. The non-financial sector deposits decreased 20.5 million euros or 1.8% in relation to end-2017.

During 2018, the nonfinancial sector was a net saver in the domestic banking system. In December 2018, the net savings of the non-financial sector amounted to 67.6 million euros, and was lower by 78.1 million euros or 53.6% compared to the end of 2017 (Graph 2.21).
The loans to deposits ratio for this sector amounted to 0.94 at end-2018 and it was higher compared to end-2017 when it was 0.87.

2.1.7. Banks’ foreign assets and liabilities

At end-December 2018, total foreign assets of banks amounted to 649.8 million euros, which is 34.2 million euros or 5.6% more in relation to end-2019.

The growth in foreign assets was largely a result of growth in banking loans approved to non-residents in the total amount of 60.3 million euros or 87.1%, and cash by 27.5 million euros or 16.1%. Debt securities increased 5.8 million euros or 19%, while the category “other” recorded a growth of 6.1 million euros or 80.8%. Deposits of banks with non-residents recorded a decline in foreign assets in the amount of 65.4 million euros or 19.4% (Graph 2.22).

The most important category in the structure of foreign assets was banks’ deposits with foreign banks, which amounted to 272 million euros as at end-2018 and accounted for 41.9% of foreign assets. In addition to deposits, cash and loans had significant shares of 30.6% and 19.9%, respectively, while debt securities accounted for a minor share of 5.5%. The remaining 2.1% referred to other foreign assets items.

Foreign liabilities of banks grew during the reporting period. At the end of 2018, foreign liabilities amounted to 965.9 million euros, increasing by 104.6 million euros or 12.1% in relation to end-2017.

Foreign liabilities structure at end-2018 shows that non-resident deposits accounted for the main share of 76.3%, while 22.8% referred to banks’ borrowings, and the remaining 0.8% to other foreign liabilities items (Graph 2.23).

All categories of foreign liabilities recorded growth against the end of 2017, with the highest growth recorded by deposits of non-residents in the amount of 84.1 million euros or 12.9%. At the same time,
an increase was recorded by non-residents’ borrowings of 14.7 million euros or 7.1%, as well as the category “other liabilities” to non-residents of 5.8 million euros or 215.9%.

In 2018, the most important foreign source of banks’ financing was non-resident deposits, which were on an uptrend in the observed period. Foreign deposit structure shows that the main share of 520.9 million euros or 70.7% referred to retail non-resident deposits, which increased 34.8 million euros or 7.2% y-o-y. The second important foreign depositor was foreign companies with the share of 204.9 million euros or 24.9%, while foreign financial institutions deposited 8.8 million euros or 1.2%. All other external sources accounted for 0.3% (Graph 2.24).

During 2018, foreign assets were consistently lower than foreign liabilities, thus net foreign assets amounted to a negative 316.1 million euros at end December 2018. As the result of stronger growth in banks’ deposits, the difference between foreign assets and liabilities was higher than at the end of the previous year when it amounted to negative 245.7 million euros (Graph 2.25).

The foreign liabilities to total assets and liabilities ratio shows that non-residents financed 21.9% of total bank assets as at end-2018, while 14.7% of bank total assets and liabilities referred to bank claims on non-residents. The gap between foreign assets and foreign liabilities of banks amounted to 7.2% at end-2018 (Graph 2.26).
2.1.8. Banks’ capital

The MSFI 9 has been in effect since 1 January 2018, when it replaced the IAS 39. According to the new standard, losses are recognised in the amount of future losses on the basis of data on past and future events, instead of former determination of losses at the time when loss occurred. Montenegro’s banking system implemented the MSFI without difficulties, as confirmed by the growth in total capital.

Total capital of banks amounted to 515.5 million euros at end-2018, and it was 1.5 million euros (0.3%) higher than at the 2017 year-end (Graph 2.27). In the structure of total capital, positive trend was recorded in share capital due to recapitalisation of three banks in June, July, October, and November in the total amount of 17.4 million euros and in undistributed loss that declined by 21 million euros compared to 2017.

At end-December 2018, nine banks recorded an increase in total capital in relation to end-2017, while other banks recorded a decline.

As regards the ownership structure of banks’ capital at end-2018, foreign capital made up 84.2%, domestic private capital made up 13.5%, while the state accounted for a mere 2.3%.

In 2018, the solvency ratio of the banking system was above the statutory minimum of 10%, and it amounted to 15.63% at the year-end (Graph 2.28). However, the solvency ratio dropped below statutory minimum in two banks since Q3 2018 (in the first) and since Q4 2018 (in the latter).

Box 2.4 – Introduction of interim administration

The activities of the CBCG in 2018 were directed at resolving problems faced by Atlas Bank and IBM Bank. Despite the activities taken, the liquidity ratio of IBM bank declined below the statutory minimum as of the second ten-day period of September. As at Q3-end, its solvency ratio was below the
statutory minimum of 10%, deteriorating during the next quarter. Moreover, Atlas Bank had a negative solvency ratio.

With a view to preserving a sound financial system, the CBCG took the activities in 2018 leading to the introduction of interim administration in these two banks. Pursuant to the Banking Law, interim administration is one of measures that the Central Bank may take to improve the financial situation in vulnerable banks. Pursuant to the Law, interim administration may last up to six months, whereas it may be extended for additional three months if the Central Bank estimates that in the following six months the bank may attain the required level of own funds or solvency ratio and meet the due obligations on a regular basis.

The bankruptcy in the first and the latter bank was introduced in January and April 2019, respectively.

In 2018, banks finished the year with a positive financial result in the total amount of 27.3 million euros (graph 2.29). Eleven banks ended the year with profit, while four banks recorded loss.

During 2018, the return on average equity of the banking system (ROE) was positive, and it stood at 5.36% at the end of the year (Graph 2.30). It deteriorated compared to 2017, when it amounted to 6.92%. This indicator was positive in eleven banks, yet negative in four banks.

**Graph 2.29**

Aggregate financial result, in thousand euros

**Graph 2.30**

Trends of aggregate ROE, %

2.1.9. Banks’ reserve requirements

Reserve requirement amounted to 251.9 million euros at end-2018, which represents an increase of 18.3 million euros or 7.8% in relation to end-2017 (Graph 2.31).
The effective reserve requirement rate, measured by the allocated reserve requirement to total deposits ratio amounted to 7.28% at end-2018, and it increased in relation to end-2017 (7.15%). At the same time, the reserve requirement to deposits plus borrowings ratio amounted to 6.71% and it increased in relation to 2017 when it amounted to 6.59% (Graph 2.32).

Some 55% of the total amount of allocated reserve requirement at end-December 2018 was allocated to reserve requirement accounts in the country, while 45% was allocated to the CBCG account abroad.

Due to the high liquidity of banking sector, none of the banks resorted to their reserve requirement for liquidity purposes in 2018, while all banks allocated the prescribed amount of reserve requirement.

2.2. Banks’ interest rates

2.2.1. Lending interest rates

On total loans granted

The weighted average nominal and effective interest rates on total loans granted had a constant declining trend during 2018. At end-2018, both rates reached their record lows.

The weighted average nominal interest rate (WANIR) on total banking loans amounted to 5.75% in December 2018 and recorded a decline of 0.41 percentage points in relation to end-2017. The weighted average effective interest rate (WAEIR) on total loans granted amounted to 6.36% and was 0.45 percentage points lower in relation to December 2017 (Graph 2.33).
In 2018, banks in Montenegro granted loans to domestic sector at less favourable conditions relative to non-residents (Graph 2.34). The WAEIR on loans granted to residents amounted to 6.42% in end-December 2018, and was by 1.79 percentage points higher than the WAEIR to non-residents. A significant decline in the WAEIR to non-residents occurred in May 2018 due to a decline in the WAEIR on loans granted to foreign nonfinancial companies.

The structure of loans granted to domestic sectors showed that the least favourable lending conditions (WAEIR) were to household sector (7.84%), followed by nonfinancial sector with 5.23%, while the most favourable conditions were to financial sector (2.79%). In 2018, WAEIR of all sectors was declining, whereby the highest decline was recorded by WAEIR on loans to financial sector (2.60 percentage points), nongovernmental and other non-profit institutions (2.43 percentage points), non-financial sector (0.46 percentage points), General government (0.39 percentage points), while the lowest decline of 0.36 percentage points was recorded in rates to retail loans (Graph 2.35).

During the one-year reference period, the WAEIR for all purposes declined, except for loans for foreign payments and repayment of foreign loans recording respective growths of 1.11 and 0.43 percentage points. As at end-2018, the highest WAEIR was recorded for cash loans (8.79%), followed by loans for preparation of tourist season (8.65%) and loans for foreign payments (7.22%), while the lowest rate of 1.50% was recorded for the purchase of consumer goods.
Observed by purpose, all rates for household sector declined except WAEIR for realisation of investments programme. The highest decline of 1.86 percentage points was recorded by the WAEIR on loans for the purchase of fixed assets and for the purchase of consumer goods (1.39 percentage points), while the lowest decline was recorded in WAEIR on loans for refinancing of obligations.

The WAEIR on housing loans has been declining for the last several years, particularly since Q2 2016 (Graph 2.36). The WAEIR on housing loans amounted to 5.84% as at end-2018. Compared to January 2013, it declined by 1.78 percentage points.

Observed by maturity, a downward trend is present in interest rates on short-term and long-term loans, with a more significant decline in short-term interest rates. In December 2018, the WAEIR on short-term loans reached 5.05% and it was 0.48 percentage points below the level at end-2017. In December 2018, the WAEIR on long-term loans amounted to 6.46%, which represents a decline of 0.44 percentage points compared to December 2017 (Graph 2.37).

On new loans

The weighted average nominal and effective interest rates on new loans recorded fluctuations during the reporting period, while both rates recorded a downward trend.

The weighted average nominal interest rate (WANIR) on new banking loans amounted to 4.82% in December 2018 and recorded a decrease of 0.45 percentage points in relation to end-2017. At the same time, the weighted average effective interest rate on new loans amounted to 5.51% and recorded the annual decline of 0.72 percentage points (Graph 2.38).

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37 Source for interest rates on new loans: MFI: Credit Registry, KRN reports of banks
During the reporting period, WAEIR on both short-term and long-term loans recorded significant fluctuations. In December 2018, the WAEIR on short-term loans amounted to 4.43% and recorded the annual decline of 2.98 percentage points. At the same time, interest rate on long-term loans amounted to 6.12% in December, recording a growth of 0.28 percentage points in relation to end-2017 (Graph 2.39).

In terms of purpose of loans granted during 2018, the highest WAEIR was recorded on loans granted for foreign payments (12.53% in March), then loans for investment project (9.70% in June), loans for the preparation of tourist season (9.64 % in August), and cash loans (8.99% in July and 8.80% in May). The lowest rates on new loans were recorded for the purchase of consumer goods (0.03% in June, 0.04% in September, 0.05% in April, and 0.16% both in July and October).

Box 2.5 – The reform of benchmark interest rates

Financial benchmark values are defined as indices used to determine the value of a financial instrument. These include interest rates that link payments in financial contracts to standard interest rates in the monetary markets. They are used in a wide range of instruments, including credit products, securities with variable rates, derivatives, corporate contracts, and accounting and taxation methods, as well as in equity valuation and risk assessment methods. The use of these rates to determine the prices of financial contracts reduces their complexity, facilitates standardization, improves liquidity and reduces transaction costs.

Since the outbreak of the global financial crisis (GFC), there has been a need to reform benchmark interest rates as a result of several developments. First, the GFC questioned the appropriateness of the process and the methodologies for formulating benchmark interest rates. Specifically, benchmark rates, formed based on non-binding quotations (such as EURIBOR, LIBOR), based on expert assessments of panels by several banks, rather than actual transactions, leave room for manipulation. After many cases of market manipulation by some panel banks after the GFC outbreak, global banks in several countries faced pecuniary fines imposed by supervisors. Moreover, due to compliance risk, litigation possibility, and consequently...
the reputational risk, panel member banks had become reluctant to remain on the panel, and some with-
drew. Another reason for the interest rates reform include sharp contraction in market activity since 2007
that has questioned the usefulness and strength of benchmark rates based on term unsecured interbank
markets. Specifically, these markets dried up, increasing the dispersion of individual banks’ credit risk,
which reduced the adequacy of reference rates to estimate common banks’ risk. A sharply declining vol-
ume of transactions was partly the result of unconventional central bank monetary policies that provided a
wealthy liquidity offer, reducing interbank lending significantly, especially the unsecured one. In addition,
this decline is partly a result of the significant role of non-banking financial institutions in managing liquid-
ity, since term interbank lending reduced after the GFC, and banks shifted significantly to non-banking
financial institutions as sources of unsecured term financing.

Unreliability of benchmark rates can have adverse impact on monetary policy transmission. Specifically,
since benchmark rates may behave unexpectedly in distress, the conditions for economy’s financing may
change without plan. These risks may overestimate when market participants rely strongly on one bench-
mark rate. Benchmark rates are also very important for financial stability, as loss of confidence due to their
unreliability can disrupt the functioning of the market. Poorly conceived and unreliable reference rates
may convey risks related to bank financing conditions, impede central banks’ ability to respond effectively
to financial fragility, or the like.

Over the recent years, significant activities focused on improving these rates in an effort to solve these
problems. The IOSCO Principles for Financial Benchmarks were adopted in 2013. There is an ongoing global
reform of benchmark interest rates with a view to identifying strong risk-free rates. An EU benchmark regu-
lation (BMR) was adopted in the EU setting out requirements that would ensure timeliness and integrity.
Pursuant to the Regulation, benchmark rates have to be reliable, robust, supported by visible transactions
in an active market with competitive supply and demand. In accordance with this regulation, only author-
ised benchmarks may be used in new contracts as of 1 January 2020. In September 2017, a working group
was formed consisting of the European Central Bank, the European Securities and Markets Regulator, and
the Financial Services and Markets Regulator (the main supervisor of the EONIA and EURIBOR rates) with a
view to adopting risk-free rates as an alternative to the EONIA and EURIBOR benchmark rates used in the
EU.

In September 2018, this group recommended the Euro Short-Term Rate - €STR, as an appropriate risk-free
rate to replace the current EONIA rate. €STR will be produced by the ECB, and it will reflect euro area bank
lending transactions on an unsecured overnight market and will be based on euro lending transactions
conducted and settled with the relevant financial institutions on the previous day (T reporting date) with
a maturity of T + 1, thereby reflecting market steps impartially. The ECB will start publishing the €STR rate
in October 2019. To provide market participants with sufficient time to transition to the €STR, the Work-
ing Group recommended a change in the current EONIA methodology in March 2019. The change implies
calculating the reference rate as €STR increased by the spread as of the date of publishing the €STR rate.

In order to align the EURIBOR rate with EU regulation on benchmarking, the European Money Market In-
stitute (EMMI) is adapting the existing methodology based on non-binding quotations to the so-called
a hybrid, transaction-based methodology in the extent possible. The new hybrid methodology uses real
transactions where possible, and it relies on data from other markets closely related to the unsecured euro
area money market. By the end of Q2 2019, EMMI will ask the Financial Services and Markets Regulators
to authorize the methodology after which the transition of panel banks to a new hybrid methodology is
planned by the end of 2019.

With these reforms, market participants need to prepare for new benchmark interest rates and adjust their
systems, processes and contracts on time.

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38 Institution that publishes EURIBOR
As at end-2018, some 28% of total loans granted in Montenegro were loans granted at variable rates. EURIBOR is the basic rate used in defining the terms of loan agreement conditions at variable rate. Thus, nearly 70% of these loans are granted using EURIBOR as the reference rate, while a smaller proportion of loans were granted at the Libor rate, and other benchmark rates. The most significant portion of loans granted at variable interest rates was granted to households (50%), most of them being housing loans (53%), cash (36%) and loans for refinancing obligations (7%). In addition to households, the non-financial sector was the second user by importance with 32% of loans with variable interest rates, followed by the General Government with 17%. The non-financial sector borrowed at variable rates, primarily for liquidity (20%), the construction of buildings and renovation (12%), procurement of fixed assets (11%), refinancing of liabilities (10%), etc. General government mostly used loans with variable interest rates for liquidity (working assets).

2.2.2. Deposit interest rates

The downward trend of the weighted average effective deposit interest rate (WADEIR) continued during 2018. In December, the WADEIR on total deposits amounted to 0.563% and it was 0.13 percentage points lower in relation to end 2017.

At end-2018, the WAEIR on demand deposits amounted to 0.02%, deposits with maturity up to three months 1.76%, deposits with maturity from three months up to one year 1.48%, deposits with maturity from one to three years 1.55%, deposits with maturity from three to five years 1.99%, and on deposits with maturity over five years 2.44%. Observed by maturity, only the interest rate on deposits with maturity up to 3 months increased by 0.53 percentage points compared to December 2017. The highest decline of 0.86 percentage points was recorded by the interest rate on deposits with maturity over five years (Graph 2.40).

Graph 2.40  
Graph 2.41
The difference between lending and deposit interest rates (interest rate spread) showed a downward trend during 2018. At end-2018, the interest rate spread on total loans and deposits of banks amounted to 5.80 percentage points and it recorded a decline in relation to end-2017 when it amounted to 6.12 percentage points (Graph 2.41).

2.3. Microcredit financial institutions (MFIs)

At end-2018, total assets and liabilities of microcredit financial institutions (MFIs) amounted to 64.6 million euros at end-2018, and it showed the year-on-year increase of 3.5 million euros or 5.8%.

At end-December 2018, total MFI loans amounted to 64.8 million euros, which represents an increase of 4.7 million euros or 7.8% y-o-y. Allocation by sectors shows that the main share of MFI loans (96.8%) referred to the retail sector, while 3% referred to non-financial institutions, and the remaining 0.2% referred to financial institutions39 (Graph 2.42). During 2018, MFIs approved a total of 58.2 million euros worth of new loans. Therefore, in the observed period, lending activity of MFI was intensified, recording the year-on-year increase of 4.4 million euros or 8.1% in new loans. The largest part of new placements of MFIs (97.5%) was approved to the retail sector.

With regard to the structure of total liabilities of MFIs, borrowings accounted for the main share (53.2%), while total capital accounted for 42.9% and other liabilities made up 3.9% of total assets and liabilities. Total capital of MFIs amounted to 27.7 million euros as at end-2018, which is 3.3 million euros or 13.5% more than in 2017. Capital from donations accounted for 71.2% of total capital, current year profit made up 16.3%, while retained earnings made up 12.5%.

At end-2018, MFI borrowings amounted to 34.3 million euros and they recorded the year-on-year increase of 97,000 euros or 0.3%. The main share of MFI borrowings (78.2%) was taken from foreign financial institutions, while 20.6% referred to borrowings taken from domestic banks, and 1.2% to other borrowings.

At the aggregate level, in 2018, MFIs reported a net profit of 4.5 million euros, which represents an increase of 23.6% y-o-y.

39 MFI deposits in domestic banks
2.3.1. MFIs’ interest rates

**On total loans granted**

In December 2018, the weighted average nominal interest rate (WANIR) on total loans granted amounted to 20.63% and was 0.21 percentage points higher in relation to end-2017. On the other hand, the weighted average effective interest rate (WAEIR) amounted to 24.42% and it recorded the annual growth of 0.18 percentage points (Graph 2.43).

As at end-2018, WAEIR on total short-term loans was 26.57%, while WAEIR on long-term loans amounted to 24.28%, recording declines growth relative to December 2017 of 0.86 and 0.13 percentage points, respectively.

**On new loans**

In 2018, the WANIR and WAEIR on new MFI loans fluctuated, with an upward trend (Graph 2.44). In December 2018, the WANIR on new MFI loans amounted to 20.96%, recording an increase of 0.78 percentage points y-o-y. At the same time, the WAEIR amounted to 25.07%, recording an increase of 0.72 percentage points.

Observed by maturity, the WAEIR on new short-term loans amounted to 25.95% and it increased by 1.31 percentage points in relation to December 2017. On the other hand, the WAEIR on loans with maturity over one year amounted to 24.94%, recording the annual increase of 0.63 percentage points.

Observed by purpose for which the loans were granted during 2018, the highest WAEIR rates were on loans for land purchase (32.62% in June) and purchase of apartments and adaptation (32.55% in April).

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40 Source on interest rates on new loans: MFI: Credit Registry, KRN reports of banks
Box 2.6 – Comparison of banking and MFI lending interest rates

Interest rates at which banks and MFIs granted loans differed significantly. Specifically, banks’ WANIR on total loans amounted to 5.75% and the WAEIR amounted to 6.36%, while the same rates with MFIs amounted to 20.63% and 24.42%, respectively.

Banks granted short-term loans at the WAEIR of 5.05%, while MFIs WAEIR was 26.57%; as regards long-term loans, banks’ WAEIR was 6.46% and the same rate of MFIs was 24.28% (Graph 1).

Graph 1
Banks’ and MFIs interest rates on total loans, %

There are large discrepancies with regard to interest rates on new loans granted by banks and those granted by MFIs. Namely, the WANIR on banks’ new loans amounted to 4.82% and the WAEIR amounted to 5.51%, while the same rates with MFIs amounted to 20.96% and 25.07%, respectively.

Banks granted short-term loans at the WAEIR of 4.43%, while the same rate of MFIs amounted to 25.95%. The WAEIR on long-term loans with banks amounted to 6.12%, while it was 24.94% with MFIs (Graph 2).

Graph 2
Banks’ and MFIs interest rates on new loans, %