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ABBREVIATIONS

BIS	Bank for International Settlement
bln	billion
GDP	Gross Domestic Product
CBCG	Central Bank of Montenegro
CSDCC	Central Securities Depository and Clearing Company of Montenegro
CHF	Swiss Franc
DAX	Deutscher Aktienindex
DJIA	Dow Jones Industrial Average
DNS	Deferred Net settlement
DSTI	Debt service to income
DTI	Debt to income
ECB	European Central Bank
EBRD	European Bank for Reconstruction and Development
EONIA	Euro Overnight Index Average
EU	European Union
EUR	Euro
EURIBOR	Euro Interbank Offered Rate
Fed	Federal Reserves
FSIs	Financial Stability Indicators
FTSE	Financial Times Stock Exchange
GBP	Pound Sterling
HHI	Hirschman-Herfindal Index
HP	Hodrick-Prescott filter
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRS	International Accounting Standards
JPY	Japanese Yen
lhs	left-hand scale
LIBOR	London Interbank Offered Rate
LSTI	Loan service to income
LTD	Loan to deposit
LTI	Loan to income
LTV	Loan to value
NSF	Net stable funding
mln	million
MSCI	Morgan Stanley Capital International
pp	percentage points
PPP	Purchasing Power Parity
rhs	right-hand scale
ROAA	Return on Average Assets
ROAE	Return On Average Equity
RTGS	Real Time Gross Settlement
USA	United States of America
USD	United States Dollar

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INTRODUCTORY NOTES

Pursuant to the Constitution of Montenegro and the Central Bank of Montenegro Law,[1] the Central Bank of Montenegro is the institution responsible for monetary and financial stability. Since monetary policy instruments available to the Central Bank of Montenegro`s (CBCG) are very limited, primarily because the CBCG is not an issuing central bank, it largely aims 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 Central Bank of Montenegro Law (CBCG Law) also prescribes the obligation of publishing financial stability reports.

The CBCG primarily uses microprudential regulation and supervision in fostering and maintaining financial stability. However, since this approach is primarily focused on stability of individual banks, the CBCG uses, as necessary, macroprudential instruments which effects influence the entire system. This enables the focus on the complex relationship between banks and other economic entities in order to adequately assess 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 the sources of financial stability risk among other economic and financial policy makers in the financial sector and with the general public.

In the financial stability report, the CBCG analyses trends of those risks that are considered to be or may be systemic in nature. Basically, a systemic risk may occur as the consequence of certain internal imbalances and vulnerabilities of the financial system/banking sector, and it can also occur as the consequence of external shocks that may hit the economy in general or specifically the financial system. Certainly, vulnerabilities can intensify and build up instability of the entire economic system via the system of communicating vessels and the spillover of instability among economic entities.

The report comprises of 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 international economic and financial flows. The third section summarises generally accepted local macroeconomic trends and the 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 forth section, which is the main analytical section of the report, discusses trends and risks in the banking sector and other relevant segments of the financial system. A spectrum of financial soundness and macroprudential indicators 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] OGM 44/10, 46/10,6/13 and 70/17.

1. SYSTEMIC RISKS ANALYSIS AND ASSESSMENT

Systemic risks were at very high levels at the end of 2020, showing a significant deterioration compared to the previous year. This was primarily due to the coronavirus pandemic, which was the trigger for certain weaknesses and vulnerabilities in the domestic financial and economic system. However, timely measures adopted by the CBCG contributed to maintaining confidence in the system. The ultimate objective and role of the CBCG is to preserve financial stability, which was achieved in the banking sector. Real economy was not been denied aid, and the preserved banking system is available to support its recovery. However, a lot will depend on the pace of normalisation of the situation in the coming period.

When it comes to the non-financial segment of the economy, it should be noted that the debt of resident non-financial institutions and households to banks increased moderately in nominal terms, but it rose substantially relative to GDP (due to a notable decline in nominal GDP). Real wages saw only a slight growth, but there was a significant increase in unemployment. As for public finances, in order to prevent an even greater decline in economic activity, public debt increased to 105.1% of GDP (84.3%, net),[2] which indicates the need for a decisive implementation of fiscal consolidation measures in the future period.

In 2020, the resident non-financial institutions" debt towards the Montenegrin banks rose by 34.6 mln euros or 3.2%, while the share of this debt in GDP increased from 21.7% to 26.5%. Also, funds of enforced debtors frozen in the process of enforced debt collection increased from 616.2 mln euros to 745.5 mln euros (17.8% of GDP), while the number blocked economic entities rose 3.9%, to 15,167.

Households` debt to Montenegrin banks significantly increased over the past few years although it is still considerably lower compared to the peak leverage if observed in relation to GDP (over 34% at end-January 2009, 27.4% at end-2019, and 33.2% at end-2020). Real earnings saw a minor increase of 2% y-o-y. On the other hand, the unemployment rate (according to the Labour Force Survey) significantly increased, from 15.1% in 2019 to 17.9% in the reporting year, while according to the Employment Agency of Montenegro, the unemployment rate stood at 20.5% in December 2020, which is the year-on-year increase of 4.3 pp. It should be emphasized that this is a high unemployment rate with a pronounced structural component.

The high and rising level of public is the systemic risk in Montenegro. To wit, after a certain reduction of public debt in relation to GDP during 2016 and 2017, the net public debt increased from 64.2% in 2018

[2] Ministry of Finance data

to 76.5% in 2019, which is primarily due to borrowings for the construction of the priority highway section. In order to amortize the impact of the pandemic on an even greater decline in economic activity than that achieved, the debt increased significantly during 2020 to 105.1% of GDP (84.3%, net). Standard & Poor`s assigned B+ credit rating to Montenegro for 2020 (with negative outlook as of May 2020), but in early March 2021, the rating was lowered to „B“, with a stable outlook. In addition to the ongoing pandemic, the challenges for public finances will continue in 2021 when, in addition to repaying the debt on Eurobonds and other credit arrangements, the 14-year loan repayment for financing the priority section of the Bar - Boljare highway will begin. However, a mitigating factor is that the emission of Eurobonds in December 2020 provided the lacking funds earmarked in the budget.

When it comes to the banking sector, it represents the soundest part of the system that has given significant support to the economy during the pandemic. This sector has successfully responded to all challenges, primarily due to the high level of all key indicators in the period before the pandemic outbreak. A very good capitalization of the sector was maintained considering a moderate increase of the solvency ratio during the year that was even higher than the prescribed minimum. In addition, liquidity of banks remained high, with a slight growth during the year. Among the main structural vulnerabilities of banks which are assessed as moderate, those that still stand out are the share of non-performing loans in total loans, growing banks 'exposure to the government, growing banks' exposure to households (especially through cash loans), and increasing maturity mismatch between sources and funds (due to the growth of demand deposits on the one hand and long-term loans on the other). Certainly, a much more realistic picture of the situation regarding non-performing loans and solvency ratios will be known after the completion of the Asset Quality Review (AQR) process, as well as after the termination of the CBCG's temporary measures, which provide significant relief for regulatory credit treatment.

The situation with regard to non-performing loans exacerbated in 2020 as the share of non-performing loans increased from 4.7% to 5.5%. This was expected considering the ongoing pandemic. However, the share remains high which exerts a negative pressure on banks' risk appetite, that is, the level of lending activity and lending conditions. There was still credit growth in 2020 despite the pandemic and it reached 3.2%.[3] The share of (net) loans in assets increased to 63.2% in 2020, which is a positive continuation of the growing trend compared to a few years ago when loans accounted for just over 50% of assets.[4]

Banks' exposure to the government (Central Government) fell during 2020 from 715.7 mln euros to 647.2 mln euros (to 14.1% of banks' assets), which represents a break of the multiyear growing trend of this exposure. A decline in indebtedness is due to a decline in debt arising from securities, while loan debt increased by 45.5 mln euros. In any case, the movement of banks' exposure to the government will remain subject to continuous monitoring by the CBCG.

In 2019, retail cash borrowings (all-purpose loans) intensified (which could be a significant source of risk), so in mid-October of that year the CBCG adopted measures to limit the growth of this segment of loans which were applied as of 1 January 2020. The measures, with a certain impact of the coronavirus

[3] Growth of loans to residents was 4.2%, but the lower growth of total loans was caused by a decline in loans to non-residents of 4.8%. A decline in loans to non-residents was primarily driven by a decline in deposits held by banks with foreign banks, which are included in the scope of loans.

[4] The calculations made here do not account for other loan receivables.

pandemic on credit activity, had a significant impact on stopping the rapid growth of these loans. For example, at the end of 2020, retail cash loans amounted to 615.1 mln euros or 13% less than at the end of 2019 (707.3 mln euros). In addition, their share in total retail loans fell from 51.7% to 43.8% in 2020. However, the maturity structure of retail cash loans did not change significantly: 91.8% were loans with agreed maturity over three years, whereby as much as 50.2% of them are loans with agreed maturity over eight years. The plan is for the measure to continue until the end of 2021 and the CBCG continues to monitor the trends in this segment of the credit market.

A further decline in lending interest rates affected a decline in the interest rate spread during the year, from 5.6 pp to 5.4 pp, while the average effective interest rate on new loans (weighted by monthly loan amounts) fell from 6% in 2019 to 5.5% in 2020. However, interest rates on total income-bearing assets and/or interest-bearing liabilities slightly decreased, from 4.2 pp to 4.1 pp, but this type of spread has not changed significantly over the past ten years. At the same time, the HHI rose to around 1,460 points (indicating a moderate market concentration), but it is still much lower than over 2,400 points in the period preceding the 2008/2009 global financial crisis.

Deterioration in banks' balance sheets, that is, significantly higher impairment and provisioning costs, contributed to the realization of profit of 22.3 mln euros at the system level, which is significantly less than 48.7 mln euros in 2019. Thus, the return on equity dropped to the lowest level since 2017. This is a clear indicator that the banking sector has taken on some of the costs of crisis adjustments.

Banks are the most stable segment of the economic system, which substantially reflects the stability of deposits in the banking system that stood at 3.37 bln euros and they made up the largest portion of banks' liabilities and capital (73.5%) at the end of 2020. Deposits fell by 3% during the year, but given the circumstances, this decline is lower than expected. It was offset by the growth of loans, albeit slightly lower compared to the previous year, and a decline in investments in securities which, quite expectedly, increased the liquid assets of banks. To wit, total liquid assets of banks increased during 2020 by 6.2%, to 1,016.1 mln euros, as did their share in relation to assets and deposits, to 22.2% and 30.1% (from 20.8% and 27.5%), respectively. 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.

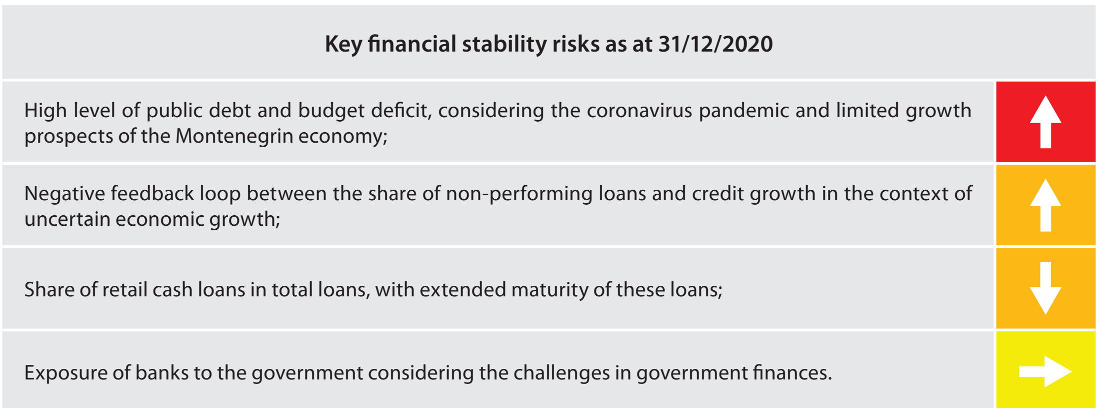
Other financial intermediaries do not represent sources of systemic risk primarily due to their limited size and also the nature of activities they perform (non-depository institutions) as well as a solid financial position of some of the most important ones among them (insurance companies).

With regard to the real estate prices, as the key form of property (and collateral) in the situation of underdeveloped financial markets and instruments, it cannot be said that the prices were substantially above their fundamentals at the year-end. Few years before 2018, there had been a stagnation of prices in this market, but signs of a significant shift appeared in the period 2018-2019, only to be followed by a certain downward correction of prices in 2020.

Turnover on the Montenegro Stock Exchange amounted to 31.4 mln euros (0.7% of GDP) compared to 318.2 mln euros in 2019 (6.4% of GDP) which was primarily generated from trading in government bonds, which was not the case in the reporting year. The Monex index declined by 11.6% relative to end-2019 and it was still multiple times lower relative to its maximum values in April 2007.

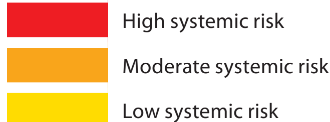
The CBCG`s payment system and the CSDCC`s securities settlement system, as the financial infrastructure pillars in Montenegro, continued working smoothly in 2020.

Scheme 1.1



Key financial stability risks as at 31/12/2020	
High level of public debt and budget deficit, considering the coronavirus pandemic and limited growth prospects of the Montenegrin economy;	↑
Negative feedback loop between the share of non-performing loans and credit growth in the context of uncertain economic growth;	↑
Share of retail cash loans in total loans, with extended maturity of these loans;	↓
Exposure of banks to the government considering the challenges in government finances.	→

Explanation:



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 estimates indicate that due to the coronavirus pandemic, the global economy recorded a decline in activity of 3.3% in 2020, compared to the growth of 2.8% in 2019. This global decline was mostly due to a decline of advanced economies of 4.7%, while activity in developing and emerging economies fell by 2.2%. The leader among advanced economies` decline is the euro area with a 6.6% decline, followed by Japan and the USA with the drops of 4.8% and 3.5%, respectively. On the other hand, China was the main driver of growth with 2.3% both in the group of emerging economies and on the global level. After a 2% growth in 2019, Russia experienced economic activity decline of 3.1% in the reporting year. It is estimated that a large group of European developing and emerging economies[5],

Table 2.1

Overview of selected global indicators, %						
Indicator	2019	2020 estimate	Forecasts		Difference in relation to the October 2020 projections, pp	
			2021	2022	2021	2022
Real GDP growth						
World	2.8	-3.3	6.0	4.4	0.8	0.2
Advanced economies	1.6	-4.7	5.1	3.6	1.2	0.7
USA	2.2	-3.5	6.4	3.5	3.3	0.6
Euro area	1.3	-6.6	4.4	3.8	-0.8	0.7
Japan	0.3	-4.8	3.3	2.5	1.0	0.8
Developing and emerging economies	3.6	-2.2	6.7	5.0	0.7	-0.1
China	5.8	2.3	8.4	5.6	0.2	-0.2
India	4.0	-8.0	12.5	6.9	3.7	-1.1
Russia	2.0	-3.1	3.8	3.8	1.0	1.5
European developing and emerging economies	2.4	-2.0	4.4	3.9	0.5	0.5
Prices of stock exchange goods, average rate						
Oil	-10.2	-32.7	41.7	-6.3	29.7	-9.3
Non-energy producing products	0.8	6.7	16.1	-1.9	11.0	-2.4
Consumer prices, average rate						
Advanced economies	1.4	0.7	1.6	1.7	0.0	0.1
Developing and emerging economies	5.1	5.1	4.9	4.4	0.2	0.1

Source: IMF, April 2021

[5] Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Montenegro, Croatia, Kosovo, Hungary, Moldova, Poland, Romania, Russia, North Macedonia, Serbia, Turkey, and Ukraine.

including Montenegro as well, recorded a decline of 2% (compared to the 2.4% growth in 2019) due to decline in all economies in this group, except Turkey.

After 2020, as the year of the *Great Lockdown*, i.e. the worst recession since the *Great Depression* of the 1930s, the IMF predicts a strong recovery of global economic activity in 2021. To wit, the baseline scenario indicates that the global GDP, driven by growth of all leading economies, will reach 6%, with the euro area lagging behind the U.S. growth. Developing and emerging economies, as a group, will experience a 6.7% GDP growth, as supported by growths of India and China of 12.5% and 8.4%, respectively. For a group of developing and emerging European economies, including Montenegro, economic activity is expected to rise by 4.4% in 2021 and 3.9% in 2022, with growth to be recorded by all economies in that group in both years, albeit to varying degrees.[6] The 2022 forecast points to the global growth of 4.4%.

At the same time, the cumulative losses of GDP per capita in the period 2020-2022, compared to expectations before the pandemic, are expected to equal 20% of the 2019 GDP per capita in developing and emerging economies (excluding China) and 11% in advanced economies. This means that the global GDP in 2024 will be some 3% below the pre-pandemic projection target.

The IMF also points to uncertainty of the baseline projection scenario. Some of the most important factors are: the course of the pandemic (including the effectiveness of vaccines against new strains of the coronavirus), the effectiveness of economic policy measures aimed at limiting the long-term damage caused by the pandemic, developments in financial and commodity markets, and economy`s adaptive capacity.

Commodity prices increased by 4.3% during 2020[7], primarily as a result of an increase in the prices of metal of 31.7%, while food prices increased 5.3% yet oil prices dropped by 26.2%.[8] During 2020, the price of aluminium increased from USD 1,771/t to 2,015 USD/t, thus partly recovering after the previous downward trend that began in mid-2018, when the price had reached almost 2,300 USD/t.

The IMF forecasts suggest that oil prices will record the average annual increase of nearly 41.7% in 2021, while non-energy products, as a heterogeneous group of commodities, will rise by 16.1%.

2.2. Global financial trends

Due to the coronavirus pandemic, the leading central banks intensified their already expansionary monetary policies in 2020, maintaining or lowering their reference interest rates to historically lowest levels, while intensifying the program of purchasing government and corporate securities on the secondary market (quantitative easing).[9]

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[6] As for Montenegro, the IMF projects GDP growth of 9% in 2021 and 5.5% in 2022.

[7] December 2020 compared to December 2019.

[8] Oil prices declined by 32.7%, on average (monthly average in 2020 compared to the 2019 monthly average).

[9] For more on the central banks` measures passed in March 2020 see Box 2.1 - Coronavirus pandemic and measures of leading central banks, Financial System Stabilty Report 2019.

In response to the coronavirus pandemic, the Fed lowered the reference interest rate twice in March 2020, to 0% - 0.25%, which is the rate that was in effect in December 2015. The rate remained the same until end-2020. Also, it was decided to intensify the quantitative easing, that is, to start conducting new purchases of government and agency securities in amounts necessary to stabilize the functioning of the market. As a result of these transactions, total Fed`s assets increased by over 75% during 2020.

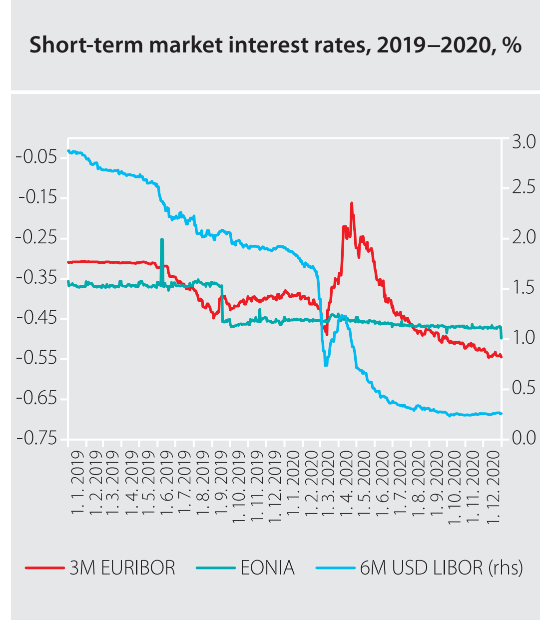
The ECB made no changes to its reference interest rates, thus the interest rate on the main refinancing operations (MRO) stood at 0% during the entire reporting year. Also, the ECB conducted new monthly purchases of securities in the amount of 20 bln euros within the regular portfolio of securities formed through the quantitative easing program, with an additional 120 bln euros since the pandemic outbreak until the end of 2020. This alongside with the amount of 750 bln euros of new securities purchases (by the end of 2020) within a separate emergency program for the purchase of pandemic-related assets,[10] and after increases in June and December, the program was targeted at 1,850 bln euros to last at least until the end of March 2022. Besides this, the ECB recalibrated numerous other instruments with the ultimate aim to relax financing conditions requirements for households and businesses as much as possible.

Throughout the year, the Bank of England, the Bank of Japan, and the Swiss National Bank maintained their interest rates at the levels of 0.1% (after the reduction in March from 0.75%), 0.1%, and -0,75%, respectively.

Short-term market interest rates mostly mirrored the reference interest rates of the central banks. The six-month USD LIBOR thus declined by 1.7 pp during the year to 0.3%, while the three-month EURIBOR and the EONIA dropped by 0.2 pp and 0.1 pp to -0.55% and -0.5%,[11] respectively. However, LIBOR and EURIBOR both increased significantly in the midst of the pandemic in April, and then decreased towards the end of the year, while EONIA showed no notable fluctuations during the year.

The record low Fed interest rates are expected to continue in the following period, which was indirectly announced after the FOMC meeting held on 15 - 16 December 2020. To wit, the Fed Funds Rate, the median value of the range forecast established by the Federal Open Market Committee for the period 2021–2023 amounted to 0.1%.

Graph 2.1



Short-term market interest rates, 2019–2020, %

Source: Bloomberg

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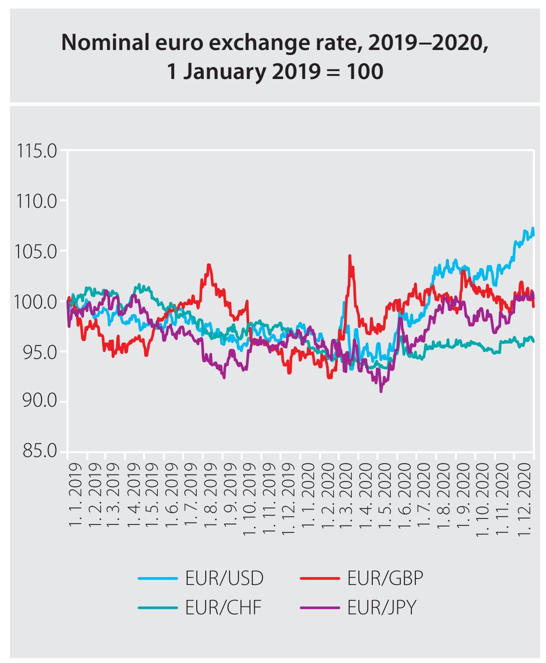
[10] *Pandemic Emergency Purchase Programme, PEPP.*

[11] As at 1 October 2019, the methodology for calculating the *EONIA* rate was changed so that it is calculated as the sum of the euro short-term rate, *€STR*, and 8.5 basis points. At the same time, *€STR* became the official reference market interest rate on 1 October, while the calculation/publication of the *EONIA* rate will be discontinued by the end of 2021.

Regardless of the pandemic, the euro area economy was significantly more fragile than that of the USA, and the problem is largely structural and persistent in nature, so the ECB is expected to continue to maintain its record low interest rates. This was also announced at the Governing Council of the ECB session held in December 2020, where it was stated that the rates will be at the same or lower level until it is clearly and consistently confirmed that inflation is trending below the target, but close to 2%. In addition, increase in the securities portfolio within the quantitative easing will be implemented after the crisis caused by the pandemic has ended and/or immediately before increase in interest rates. After this phase, principal reinvestment (maintaining the same portfolio level) will continue long after the interest rates increase.

During the reporting year, the euro mildly appreciated nominally against the USD (8.9%), the GBP (5.7%), and the JPY (3.6%), yet it slightly depreciated against the CHF (0.4%). The highest exchange rate fluctuation of the EUR, measured by the variance ratio, was in relation to the USD, GBP, and JPY, while the mildest fluctuation was in relation to the then CHF. The euro appreciated against the USD from 1.1213 to 1.2216, averaging at 1.1416 USD for 1 EUR.

Graph 2.2



Source: Bloomberg, CBCG calculations

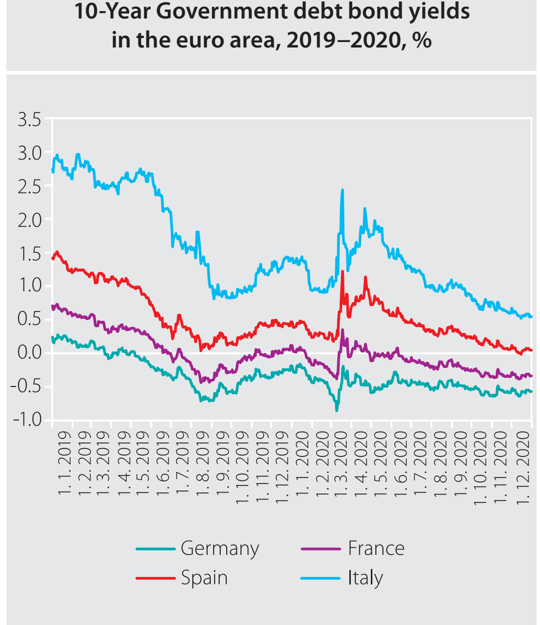
The situation with extremely low yields on government bonds continued in 2020. Generally, yields declined significantly in the euro area countries, both compared to the end of 2019 and observed as the average annual change. For example, the average debt yields in 2020 and the change in yields compared to 2019 for the following countries were: France (-0.1% / -0.3 pp), Greece (1.3% / -1.3 pp), Ireland (-0.1% / -0.4 pp), Italy (1.1% / -0.8 pp), Germany (-0.5% / -0.3 pp), Portugal (0.4% / -0.4 pp), and Spain (0.4% / -0.3 pp). Also, Government Bond Yields of Japan experienced no major changes (0.01% on average compared to -0.09% in 2019), while yields on UK and US government bonds were significantly lower in relation to those recorded in 2019.

The spreads, meaning the differences between a country's bond yields and German government bond yields, were even lower than in 2019, remaining very compressed. With regard to 10-year government bonds, spreads on French, Italian, and Spanish debt averaged at 0.33 pp, 1.62 pp, and 0.86 pp, respectively. This is extremely low bearing in mind the problems in the Italian and Spanish banking sectors and vulnerabilities of external debts of these countries. Also, this led to delays of necessary fiscal and structural reforms 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.

Observing through the TED spread[12], particularly the VIX index,[13] the level of instability in the financial markets was much higher in the reporting year as the TED spread averaged at around 0.29 percentage points, and the VIX index was at some 29 points. In mid-March, the VIX reached 82.7 points and thus exceeded the value as of October 2008, i.e. from the time of the Global financial crisis. At end-March, TED spread was above 1.4 pp, which is by far the highest level in the past 10 years, yet it was not its highest value ever to be recorded.

The price of gold, as a specific indicator of stress and risks in the global economy and financial markets, was at a significantly higher level, showing an increase of 27.1% year-on-year observed by the average price level, and 25.1% growth compared to end-2019. During 2020, the price of gold experienced major oscillations, increasing from 1,520 USD/oz to over 2,050 USD/oz early in early August, yet dropping to 1,900 USD/oz towards the year-end.

Graph 2.3



Source: Bloomberg

The stock markets in developed countries were quite optimistic, albeit with a lot of volatility since after the plunge in March, most of the leading indices recorded notable growths compared to the end of 2019. Thus some indices such as the New York *DJIA* or the Frankfurt *DAX* reached historically highest values in late 2020. Also, the stock exchange index *MSCI* for emerging and developing markets increased by 15.8%, while viewed through the average values in 2020, it recorded the year-on-year decrease of 2.2%.

In addition to the record high values of stock exchange indices, the values of real estate in most developed countries were at their historically highest levels in 2019, such as in the USA where nominal real estate prices were well above the values preceding the Global financial crisis. Moreover, in some advanced countries, real prices of property were at their record levels. The factor that undoubtedly influenced the growth of real estate prices (as well as the growth of financial asset prices) in the period after the Global financial crisis is the policy of historically low interest rates of leading central banks.

It remains to be seen whether downward real estate price adjustments will be made in 2021.

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

[13] A measure of the expected volatility of the U.S. stock prices.

3. DOMESTIC ECONOMIC ENVIRONMENT

3.1. General macroeconomic developments

According to preliminary Monstat data, Montenegro`s real annual GDP dropped by 15.1% in 2020. Data by industries shows that overall decline was spurred by declines reported in tourism, transport, retail trade and construction, while forestry and industrial production proved to be resilient to the pandemic impact, as expected. Looking at the GDP components, as per the expenditure method, the year-on year GDP decline in the reporting year was driven by a drop in the balance of imports and exports of goods and services (a -8.8 pp contribution), and to a lesser extent by a decline in final consumption (-4 pp) and gross fixed capital formation (- 3.4 pp).

Table 3.1

Change rates in key industries, 2020/2019, %	
Industry	Annual rate of change
Tourism, all accommodations, arrivals	-83.2
Tourism, all accommodations, overnights	-82.1
Passenger transport, roads	-52
Passenger transport, railways	-64.9
Passenger transport, air	-80.3
Retail trade, constant prices	-16.6
Construction, value of performed construction work	-5.6
Construction, effective working hours	-3.2
Forestry, produced assortments	4.6
Industrial production	0.9

Source: Monstat

Before the coronavirus crisis, the Ministry of Finance`s baseline scenario forecasted 4.4% and 3.8% growth rates in 2020 and 2021, respectively, while the low-growth scenario forecasted respective growths of 2.4% and 2.5%.

What is encouraging is that recovery is usually much faster after this kind of crisis than after an economic crisis. The CBCG baseline and low-growth scenarios forecast respective GDP growth of 7.5% and 4.3% in 2021. The baseline scenario implies a well-controlled epidemic and high immunisation of the population before the main tourist season, and the low-growth scenario suggests prolongation of

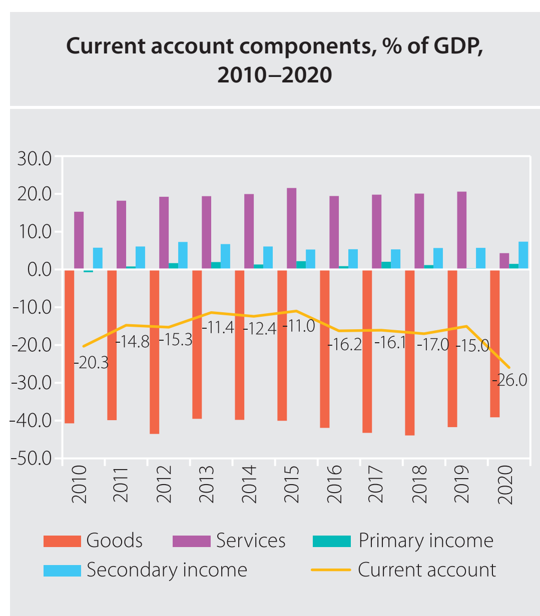
the population immunisation, increased spread of new coronavirus strains, and the reintroduction of restrictive protection measures in Montenegro, EU, Russia, and other countries.

The Ministry of Finance`s growth forecasts laid out in the 2021 - 2023 Economic Reform Programme indicate a 10.5% and 7.3% growths according to the baseline and low-growth scenarios, respectively. International financial institutions also project high growth of Montenegro`s economic activity. Thus, the IMF forecasts an increase in Montenegro's 2021 GDP of 9%, and the World Bank projects a 7.1% growth.

Measured by the CPI, December prices were 0.9% lower than in the same month in 2019, with deflation recorded on the annual basis during most months of 2020. In general, the December average of annual inflation rates for the period 2010 – 2020 amounted to 1.4%, currently showing no substantial inflation or deflation risks in medium-term. Historically, price stability in Montenegro has been constant since the introduction of the euro as the legal tender, with minor oscillations over the years.

Graph 3.1

Current account components, % of GDP, 2010–2020



Source: CBCG calculations

The current account deficit amounted to -1,089.1 mln euros or -26% of GDP in 2020, which is a significant increase compared to -744.2 mln euros or -15% in 2019. As expected, the deficit was generated by the negative balance in the goods account which amounted to -1.64 bln euros. Additionally, the significant decline in the goods account deficit was not sufficiently offset by the balance in the services account which, although positive, recorded a decline of as much as 82.2% due to a decline in tourism revenues as a result of the pandemic. The decline in the goods account deficit was primarily due to a decline in visible imports from 2.53 bln euros to 2.05 bln euros, which was certainly expected given the slowdown in the implementation of significant infrastructure and smaller investment projects due to the pandemic.

As in the previous years, the deficit was primarily funded by foreign direct investments whose net inflow amounted to 467.6 mln euros or 11.2% of GDP. In addition, the deficit was significantly financed by new net government borrowings on international markets through securities (portfolio investments), in the amount of 423.9 mln euros. Historically, the permanent current account deficit has been financed through foreign direct investments but also through portfolio investments and other foreign investments, followed by the accumulation of Montenegro's external debt in all resident sectors, not only public sector, although the public external debt has been the most pronounced.

3.2. Position of non-financial institutions[14]

Debt of non-financial institutions to banks saw a rise in 2020[15] from 1,074.6 mln euros to 1,109.2 mln euros. In relation to GDP, it rose from 21.7% to 26.5%. On the other hand, new borrowings by non-financial institutions from banks resulted in a new debt of 486.8 mln euros, which was 12.1% less than in 2019. In reference to the purpose, new debts mostly referred to loans granted for liquidity for working assets of 62.2% (49.4% in 2019), which has been the most common type of loans granted to non-financial institutions for years[16].

As deposits of non-financial institutions fell to the level of 1,014.8 mln euros during the year, non-financial institutions deepened their position of a net debtor in the banking sector at the end of 2020 to the amount of 90.5 bln euros or 2% of total bank assets. This is much different situation than that in April 2009 when non-financial institutions were a 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 analysed looking only at their debt to banks since the latter sold the major part of their assets to third parties, mostly parent banks, either directly or through factoring companies founded by them or through other entities for the purchase of receivables. Banks sold assets in the amount of 891.2 mln euros between 2006–2019. A significant portion of the sold assets referred to non-performing loans (debt) of nonfinancial institutions, which is still present in debtors' balance sheets.

At end-2020, the number of blocked business entities in the CBCG's enforced collection system was 15,167, which is the annual increase of 3.8%. In relation to the total number of 50,133 active business entities, 30.3% of them were blocked, which as the same number as at the end of 2019. Total debt based on which business entities were blocked amounted to 745.5 mln euros, which is an increase of no less than 21% at the annual level. Due to a high debt concentration, the debt of the top ten borrowers stood accounted to 22.7% and that of the top 50 borrowers made up 43.6% of total debt.

A total of 1,584 business entities were under uninterrupted account blockage up to 365 days with the frozen amount of 89.3 mln euros, whereas a total of 13,583 business entities were blocked over 365 days, with the frozen amount of 656.2 mln euros, accounting for 88% of the total frozen amount, so this debt - as has been confirmed through the longstanding practice - will remain uncollectable for the most part.

When it comes to the maturity of non-financial institutions` debt to banks, debts maturing after three years accounted for the main share of 60.1% at end-2020 (55.5% at end-2019)[17]. Debt with the agreed maturity of over one year made up 79.2% of the debt. As for the debt currency structure, the entire

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[14] 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.

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

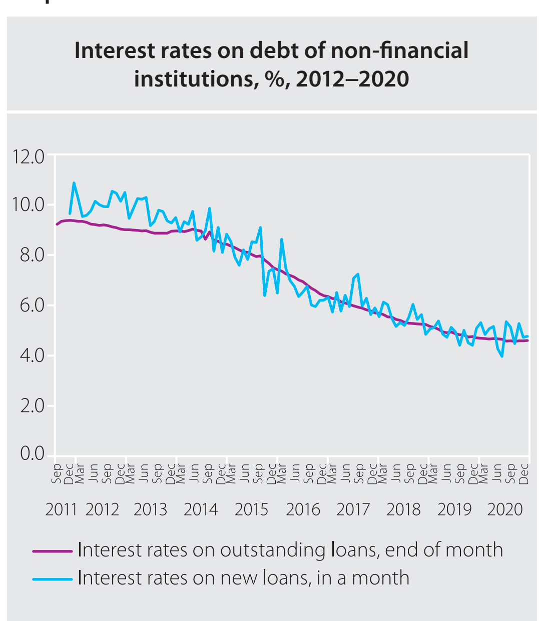
[16] This data refers to all legal entities but they are sufficiently representative as 79% of total loan debt of legal persons referred to non-financial institutions.

[17] Data as per the initially agreed maturity.

debt of non-financial institutions was in euros, which was also the situation that has not changed essentially over the past years.

The quality of debt of non-financial institutions to banks deteriorated during 2020 and remained below the system average. According to the banks' classification, non-performing debt amounted to 91.7 mln euros at end-2020 as compared to 80.4 mln euros at end-2019. Thus, the share of non-performing debt in total non-financial institutions' debt rose from 7.5% to 8.3% (this compared to the record high 35.6% at end-Q1 2013).

Graph 3.2



Source: CBCG

The average interest rate on total non-financial institutions' loan debt further declined during the reporting year, from 4.7% to 4.6%, signalling a continuance of the rate's downtrend. Similarly, the average interest rate on new loans declined from 4.9% to 4.8% (as compared to 10% in 2012)[18]. Regardless of their significant decline over the past six years, the non-financial institutions' borrowing costs remain notably high. Moreover, this decline has not significantly changed the non-financial institutions' position, which serves as a confirmation that lower borrowing costs are just one of the prerequisites for achieving profitability and international competitiveness of these institutions. In other words, structural factors, i.e. the overall business environment, play a more important role here.

3.3. Households' position

In 2020, the households' leverage towards banks additionally increased[19] from 1.36 to 1.39 bln euros, fuelling the debt growth initiated in 2013 after a period of deleveraging between September 2008 and end-2012. The level of indebtedness of the population thus reached its historically peak. Observed in relation to GDP, the debt of households increased by 7.4 pp in the reporting year (reaching 32.2% of GDP).

On the other hand, households` debt based on new loans amounted to 291.9 mln euros, which is a decrease of no less than 42.5% year-on-year. As for loan purpose, 57.7% (69.2% in 2019) were cash (all-purpose) loans, as the most represented type of loans granted to the household sector for years. In addition, new leverage based on loans for apartment purchase and refurbishing declined both in

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

[19] Households include only resident natural persons.

absolute terms, from 84.5 mln euros to 67.2 mln euros, and as a share in total new households' leverage, from 16.7% to 23%.

The net debtor position of households further deepened in the reporting year due to an increase in loans and a simultaneous decline in deposits placed by households that amounted to 1.25 bln euros at the year-end. Thus the net debtor position of households accounted for 3.1% of total assets of banks (compared to 0.9% at end-2019), whereas at end-April 2009, for example, households were the net debtor in the banking sector with 12.9% of total assets of banks.

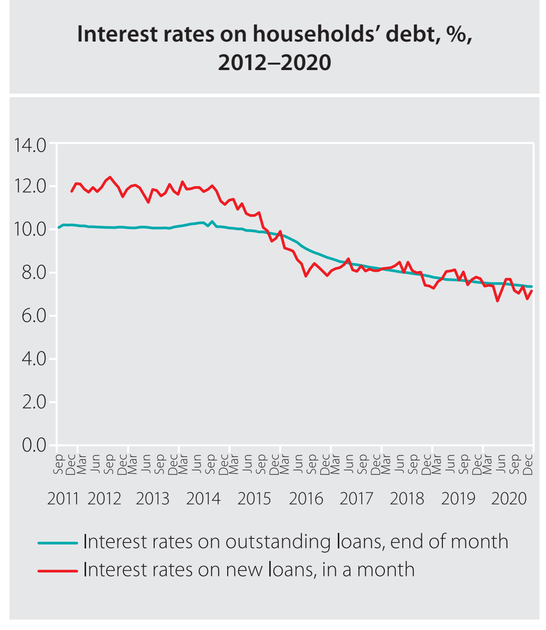
With regard to the maturity of the households' debt to banks, the debt with agreed maturity of over three years accounted for the main share of 94.1% of the debt at end-2020 (93.1% at end-2019), mainly due to the cash loans-based leverage[20]. Debt with agreed maturity over one-year made up 98.4% of the debt. As for the debt currency structure, the debt in euros accounted for 99.7% and a mere 0.3% referred to debt in other currencies.

The quality of households' debt to banks slightly deteriorated during the reporting year. As per banks` classifications, non-performing debt of households amounted to 57 mln euros at end-2020, compared to 53.6 mln euros at end-2019. Thus, the share of non-performing debt in total debt of households rose from 3.9% to 4.1% (compared to 12.6% at end-Q1 2013).

An average interest rate on total households' debt based on loans additionally declined during 2020 from 7.5% to 7.4%, continuing the rate's downtrend initiated after 2014. Similarly, the average interest rate on new loans declined from 7.8% to 7.3% (as compared to 12% in 2012)[21]. Regardless of its significant decline recorded over the past six years, the households' borrowing costs are obviously still high.

According to the Labour Force Survey, the 2020 unemployment rate was 17.9% or 2.8 pp more than in 2019 (15.1%). After a substantial decline in unemployment during the last boom (2006-2008) when it had 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 3.3



Source: CBCG

Observed through the average 12-month data, nominal net earnings rose by 1.7% in 2020, from 514.7 euros to 523.5 euros, which is their highest annual level since the introduction of euro as the legal ten-

[20] Data as per the initially agreed maturity.

[21] The rate is obtained by weighting monthly interest rates on new debt with monthly annuities.

der in Montenegro. At the same time, real net earnings saw an average increase of 2% in the reporting year.[22] Compared to 2006, both nominal and real earnings increased, by 85% and 34.2%, respectively, although they remain below their record levels from 2010.

3.4. Government finances

The coronavirus pandemic hit public finances hard, requiring the 2020 budget revision to be carried out in June that year.

The 2020 government budget recorded a deficit of 425.3 mln euros (10.1% of GDP) or by 89.5 mln euros more planned under the budget revision. Its structure shows that budget revenues were 65.7 mln euros (3.9%) lower than planned under the revision, this primarily due to lower revenues from VAT (by 86 mln euros or 14%) and excise duties (16 mln euros or 7.2%). On the other hand, budget expenditures totalled 23.7 mln euros or 1.2% mroe than envisaged under the budget revision. They increased primarily due to higher capital expenditures in the current budget (by 35.1 mln euros or 18%). The 2020 budget revision also planned the position of *repayment of liabilities from previous years* and this was relatively successful since these expenditures amounted to 18.5 mln euros compared to the planned 16.3 mln euros under the revision.

The budget deficit has been recorded for the twelfth consecutive year, with the average deficit in the period 2009–2020 amounting to 5.3% of GDP and the 2020 deficit being the highest. Deficit in 2021 is planned at 3% of GDP, which will be quite a challenging accomplishment.

Table 3.2

Main categories of Montenegro's budget, 2019–2021

	2019 (draft Law on the annual statement of accounts)		2020 (estimate)		2021 (draft Budget Law)	
	mln euros	% of GDP	mln euros	% of GDP	mln euros	% of GDP
Budget revenues	**1,885.2**	**38.1**	**1,639.3**	**39.1**	**1,880.2**	**40.6**
direct taxes	744.1	15.0	727.8	17.4	796.8	17.2
indirect taxes	974.9	19.7	769.3	18.3	890.1	19.2
non-taxable income	166.2	3.4	142.2	3.4	193.3	4.2
Budget expenditures	**2,028.5**	**41.0**	**2,064.6**	**49.2**	**2,019.3**	**43.6**
Current expenditure	1,756.1	35.5	1,834.7	43.8	1,815.8	39.2
of which: gross earnings	472.9	9.6	499.2	11.9	523.2	11.3
of which: transfers for social welfare	554.3	11.2	558.7	13.3	574.3	12.4
Capital expenditures	272.4	5.5	229.9	5.5	203.5	4.4
Surplus/deficit, cash	**-143.3**	**-2.9**	**-425.3**	**-10.1**	**-139.1**	**-3.0**
Net increase/decrease of liabilities	1.2	0.0	-	-	-	-
Surplus/deficit, adjusted	**-144.5**	**-2.9**	-	-	-	-

Source: Ministry of Finance

[22] The calculations were made by deflating nominal earnings by the consumer price index and/or the cost of living index using 2006 as the base year.

According to the latest Ministry of Finance debt data, public debt amounted to 4.4 bln euros or 105.1% of GDP as at 31 December 2020, of which external debt made up 3.84 bln euros, internal debt was 495.6 mln euros, and debt of local self-governments accounted for 78.1 mln euros. Thus the public debt increased by no less than 28.6 pp of GDP during the reporting year after a growth of 6.4 pp in 2019. However, at the end of 2020, the state had a significant reserve of liquid assets so that the net public debt much lower, 84.3% of GDP, which is an increase of close to 20 pp of GDP at the annual level. The debt relative to GDP has largely increased due to a decline in GDP in 2020 as an unusually difficult year, and the expected calming of the coronavirus pandemic in 2021 and beyond will affect the recovery of GDP and a decline in the share of debt relative to GDP.

Within the external debt, debt arising from Eurobonds accounted for a significant share. Montenegro entered the international bond market for the first time in September 2010 and there have been nine Eurobond issues ever since. The first six issues have been repaid, so the current outstanding issues are those from 2018, 2019, and 2020.[23] The latest Eurobonds were issued in mid-December 2020 in the amount of 750 mln euros, with contracted 7-year maturity and at the interest rate of 2.875%. The interest rate was slightly higher compared to the issue from 2019, but the 2020 issue was realized in an incomparably worse economic period, and it is generally positive that it was implemented in the amount necessary to reasonably cover debts due in 2021 and provide a certain reserve of funds until the pandemic situation has stabilized.

Considering excess liquid funds of banks and their conservatism in lending to non-financial institutions and households, the Government budget still realised a portion of its funding needs through four issues of bonds in the Montenegro Stock Exchange. At the beginning of March 2018, the issue from March 2014 had been fully repaid, and the 2016 issue was paid in mid-November 2020. In addition, in the second half of April 2019, the state issued two series of bonds. Seven-year bonds in the planned amount of 50 mln euros and at the interest rate of 3.5% were sold as one tranche, with the realization of the issue amount slightly above the planned. Five-year bonds with an interest rate of 3% were sold through two tranches, but the planned issue of 140 mln euros was not executed even after the second tranche.[24]

Recent issues of Eurobonds and bonds issued on the Montenegro Stock Exchange have significantly extended average maturity, and the borrowing costs have been declining for years. However, the coming period will be very challenging for public finances, especially in the context of the coronavirus crisis. This considering, inter alia, the repayment of the loan for the highway construction that is scheduled to start in 2021. Namely, the subject of the loan arrangement for highway signed in October 2014 with the Chinese Exim Bank is a loan of 944 mln US dollars with a 6-year grace period and the 14-year repayment period after the expiry of the grace period. As at end-2020, the debt to Exim Bank stood at 640.5 mln euros (translated into euros), and every new withdrawal (of 128.1 mln euros) will increase the public debt arising from the loan.

It is expected that the withdrawal of the loan funds will contribute to further increase in Montenegro's debt in other foreign currencies in the medium term for a couple of percentage points more from the current 15.2%. Also, this will significantly expose the country to a risk of the euro depreciating against the US dollar, so before the start of the loan repayment, it is planned to conclude a hedge agreement, which is still a current issue and the subject of activities of the Ministry of Finance.

[23] The latest repaid issue is that from March 2016 that became due in March 2021.

[24] In the first tranche, 24.6 mln euros were collected, and 67.8 mln euros in the second tranche conducted at the end of May.

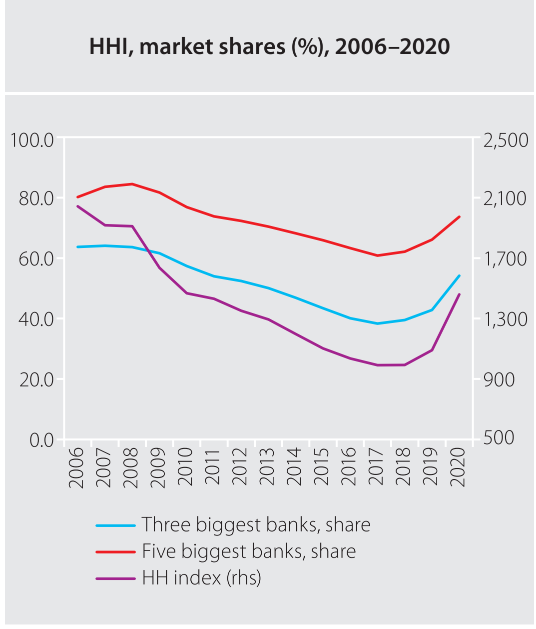
According to its baseline scenario, the Ministry of Finance projected a significant public debt drop to 88.4% of GDP at end-2021, while the lower-growth scenario stands at 90.4% of GDP. The respective scenarios for the end of the forecasted period (end-2023) envisage 69.9% and 75.2% of GDP, respectively.

At end-2020, the balance of debt arising from government guarantees stood at 212.1 mln euros or 5.1% of GDP. Moreover, the balance of debt arising from external guarantees amounted to 171.9 mln euros (4.1% of GDP), while the balance of debt on domestic guarantees was 40.1 mln euros (1% of GDP). At end-2019, the balance of debt arising from government guarantees stood at 244.3 mln euros or 4.9% of GDP. In general, the government has pursued a moderate and prudent policy of issuing guarantees over the past few years, as guarantees are given in relatively limited numbers and exclusively for infrastructure and development projects. Thus only two guarantees were issued in 2020, one for a credit line (stand-by arrangement) to the Deposit Protection Fund and one for a loan to the Innovation and Entrepreneurship Centre „Tehnopolis“.

4. FINANCIAL SYSTEM

The banking sector continues to be the backbone of financial intermediation in Montenegro and has a dominant position in the country's financial system. At end-2020, there were twelve majority foreign owned banks operating in the country.

Graph 4.1



Source: CBCG

During the year, the shares of individual banks in the Montenegrin banking market did not change significantly, except for the capital increase due to the merger of Podgoricka banka with Crnogorska komercijalna banka, which was carried out at the end of the year. Thus, the banking sector concentration, according to the HHI (assets), significantly approached more moderately concentrated market structures (1,460 points). As per the same indicator, market concentration of loans was even higher (1,653 points), while deposits were more evenly distributed as the index stood at 1,378 points.

Looking at assets, the market share of three and five largest banks amounted to 54.2% and 73.7%, respectively.

4.1. Banks' balance sheet structure

The structure of total assets and liabilities of banks did not change significantly during the crisis year. However, the fact that the longstanding uptrend of certain balance sheet items were stopped or reversed indicates the intensity of the external shock caused by the pandemic and the type of banks` response to it.

Deposits have been the primary source of bank funding for many years now and they accounted for 73.5% of total liabilities of the end of 2020. Due to the crisis, deposits were lower in May and their decline as of December 2019 amounted to 5.1% or 176.6 mln euros. The weak tourist season was reflected

in banks' balance sheets in terms of deposit growth, which had usually recorded notable increase in the third quarter. Without any significant inflow during and after the tourist season, deposits` movement was at a level slightly above that in May all the way until the last two months of 2020 when they slightly increased, which may be a sign that economic uncertainty is easing. However, at end-2020, deposits were 3% or 102.9 mln euros lower year-on-year, standing at the level of 3.37 bln euros. Retail deposits amounted to 1.25 bln euros and they were 4.7% lower y-o-y. Deposits by the non-financial sector amounted to 1.01 bln euros or 3.2% less y-o-y.

Non-resident deposits have become an important segment in total deposits over the years. Their share rose slightly during the reporting year to 22.9% although their level reduced by 1.6%.

Bank financing from borrowings increased in 2020 both in terms of the amount and the share in total liabilities. It should be noted that the growth of loans during the year was driven by the banks` liquidity needs. Most of the new borrowings were with agreed maturity of one year and they were foreign borrowings from parent banks or other members in their banking groups. For some of the banks, the share of borrowings in total liabilities is not negligible; however, for now, the growth of leverage does not represent a systemic risk to financial stability in terms of amounts, maturities, and currency structure of borrowings. At the end of the year, borrowings accounted for 9.9% or 451.9 mln euros of total liabilities and capital.

Graph 4.2

Liabilities and capital: structure (lhs) and amount in mln euros (rhs), 2006–2020

Source: CBCG

On the assets side, some of the key positions reached their record highs during the reporting year. Lending activity was notably more modest in the first wave of the pandemic only to recover before the end of the year, reaching its maximum value in November.

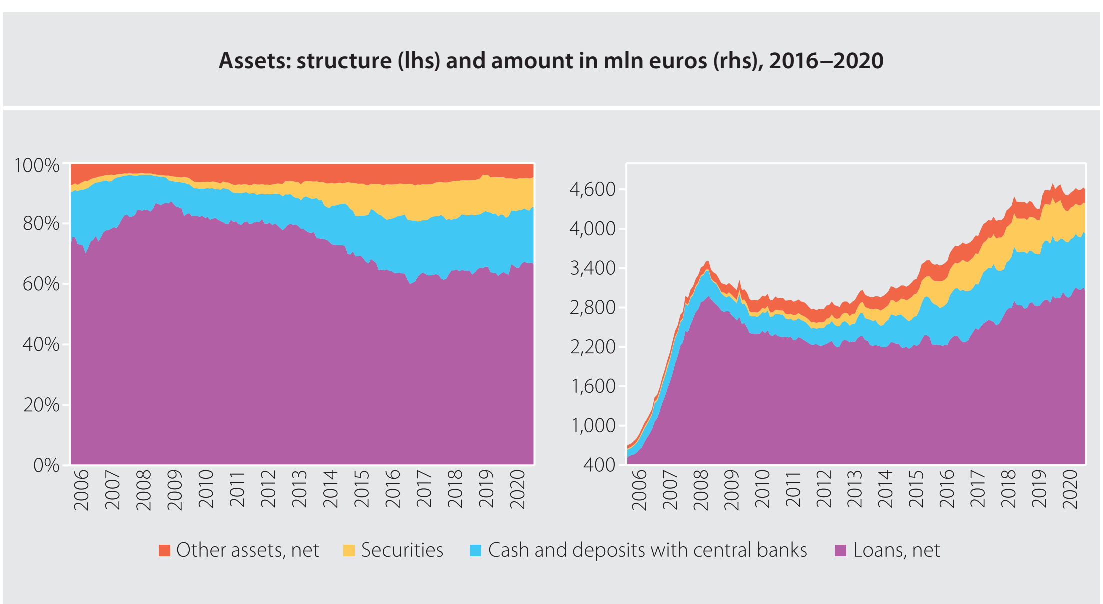
Cash and deposit accounts with central banks trended downward early into the pandemic, but this trend was reversed at the end of the year when their share in total assets and liabilities amounted to

19.3% or 883.6 mln euros. During the year, banks were under liquidity pressure induced by several factors, primarily the lack of cash inflows during the moratorium and loan restructuring, as well as deposit outflows. However, some banks were quite ready to face the impact of the crisis as they had way more than sufficient liquid assets.

Cash was at a satisfactory level throughout the year and banks were able to meet all the needs of households and the economy. However, timely measures adopted by the CBCG contributed to maintaining confidence in the system. The ultimate objective and role of the CBCG is to preserve financial stability, which was achieved in the banking sector. Real economy was not been denied aid, and the preserved banking system is available to support its recovery. However, a lot will depend on the pace of normalisation of the situation in the coming period.

Securities were at the record level in January 2020 (603.2 mln euros or 13% of total assets and liabilities). However, after the pandemic outbreak, securities portfolio of some banks decreased significantly, so compared to the value in January, it fell by 21.9% at the end of the year, while the share in assets fell to 10.3% of total assets and liabilities. Also, the share of securities in bank assets differed significantly across individual banks.

Graph 4.3

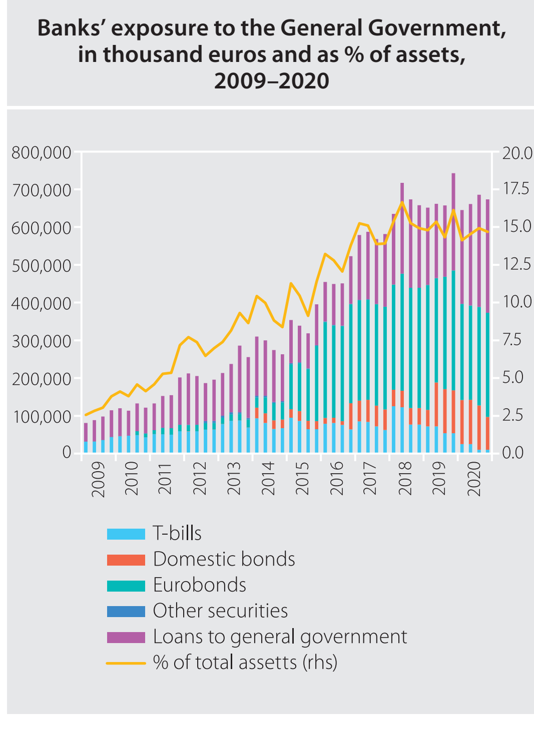


Source: CBCG

As in the previous period, government securities accounted for the majority of the banks` securities portfolios. Banks generally consider these as investments with a favourable interest rate in relation to risks they carry, and this has been especially appealing 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. This year, however, there was a noticeable decline in interest in treasury bills in terms of lower demand and consequent lower sales compared to the planned amounts of issues. Last time such a low interest was seen in 2009.

Graph 4.4

Banks' exposure to the General Government, in thousand euros and as % of assets, 2009–2020



Source: CBCG

At the end of 2020, banks' exposure to the government decreased to 14.7% of total assets (from 16.1% at end-2019). Total exposure of banks to the government stood at 673.3 mln euros.[25] The government used the possibility of taking new credits from banks this year as well (88.5 mln euros), so its bank liabilities increased by 16.7%, to 300.5 mln euros.

Banks' claims on non-residents in the form of deposits were slightly lower at the end of this year than at the end of last year, while their amount decreased in the middle of the year to the 2008 level. Total receivables from non-residents stood at 608.5 mln euros or 13.3% of assets at end-2019. On the other hand, loans payable (borrowings) from abroad increased to 9.4% of total liabilities from 7.1% at end-2019, while foreign deposits amounted to 19.7% of total liabilities of banks. Total liabilities to non-residents amounted to 1,168.5 mln euros or 29.2% of total assets and liabilities. Thus, net foreign assets of banks stood at -12.2% of their total assets and liabilities at end-2020.

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

Despite the pandemic and a significant decline in activity in all key sectors, credit growth was still present and it gave significant support to the economy. Nevertheless, as expected, it was somewhat slower than in the previous years. Total loans rose 3.2% at the annual level and reached 3.16 bln euros at the end-2020. Lending activity in terms of new loans amounted to 908.4 mln euros or 26.4% less than in the previous year, which did not come as a surprise considering the overall environment. A part of the new loans was created in line with the incentives under the CBCG measures aimed at households and the economy. Total loans reached their record level in November 2020.

The negative gap between the loan ratio of the non-financial sector[27] and GDP and the long-term trend of this ratio shrank significantly at the year-end (to -1.8%), which seems as reversal of the trend present since the fourth quarter of 2013. However, the gap shrinkage is not a result of excessive credit growth but primarily of a significant decline of GDP in the reporting year due to the pandemic crisis.

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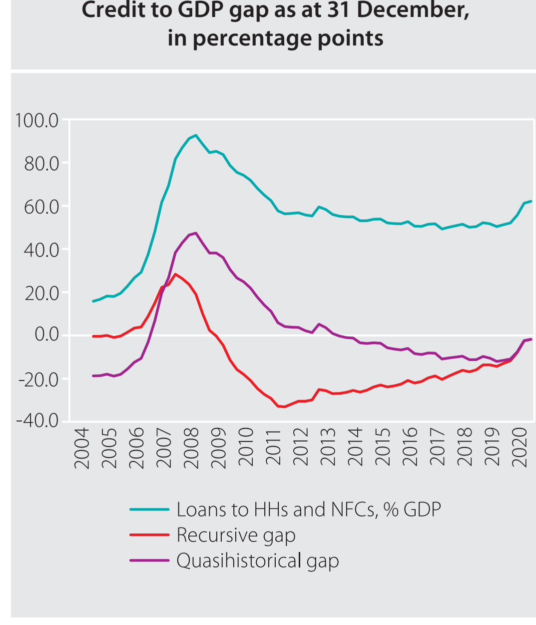
[25] The exposure relates to government securities and loans granted to the general government.

[26] Unless otherwise stated, the data on loans presented in this chapter, as well as in the rest of the report, refer to loans and other receivables of the credit type on a gross principle (with corresponding value adjustments), without accrued interest and prepayments and accruals of interest fees.

[27] Resident natural persons (households and entrepreneurs) and resident non-financial institutions (state companies and private persons).

Such a situation cannot justify the introduction of restrictions on general credit growth as it is expected to be relatively temporary and certainly does not generate risks to stability of the financial system.[28]

Graph 4.5



Source: CBCG

The largest share of banks' loan portfolio referred to retail loans (44.1%) and they have been recording positive growth rates over the last seven years. At end-2020, this rate was 2.7%. Retail loans growth has been outpacing the nominal growth of economic activity since 2016. Given the extraordinary circumstances this year, conclusions about the lending dynamics cannot be drawn so easily.

The volume of new retail loans, which in 2019 exceeded half a billion euros for the first time, was significantly reduced (42.5%), which was expected given the pandemic. Most of these were cash loans (57.7% of total retail loans), albeit half the amount in absolute terms. In early 2020, the implementation of a macroprudential measures aimed at limiting the growth of inadequately secured retail cash loans began, given that these loans were used as a substitute for other types of loans (primarily housing) in the previous period, thus creating a growing imbalance in their maturity and manner of security. The results of the bank lending survey from the first quarter of 2020 already showed that credit standards for households were tightened. However, the exact effect of this measure is not easy to determine due to the simultaneous impact of other CBCG measures and a generally weaker credit activity and demand early into the pandemic. The next in size in the category of retail loans were loans for apartment purchase and refurbishing (67 mln euros) and loans for refinancing obligations to other banks (25 mln euros).[29]

Loans to resident non-financial institutions accounted for 35% of total loans and they increased by 2.9% at the annual level. Observed by new loans, this is still the sector that banks finance the most (486.8 mln euros in 2020). As in the previous years, the main share of new loans to resident non-financial institutions referred to loans for liquidity (working capital). Demand for this type of loan was even higher in 2020 due to the suspension of economic activity (lockdowns) over a certain period, and their share in new loans jumped from 49.4% in 2019 to 62.2% in 2020. For the same reasons, loans for refinancing liabilities to other banks stood out among wholesale loans (12.4%), while loans for the purchase of fixed assets were almost three times smaller, accounting for 5% of new loans to legal entities. Looking at maturity of new wholesale loans, short-term loans made up 43.3%.

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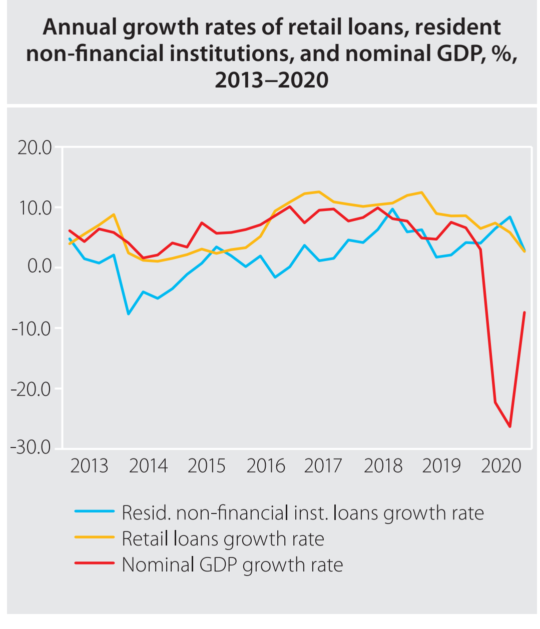
[28] The gap measures the difference between the current loan/GDP ratio and the long-term trend of the loan/GDP ratio. In this case, the recursive gap refers only to the data available at the end of a given quarter and it is calculated only for the given quarter (ignoring the data relating to subsequent quarters), while the quasi-historical gap is calculated for the last and all previous quarters taking into account all historical data available on 31 December 2020.

[29] Decision on Macroprudential Measures related to Retail Banking Loans (OGM 58/19 and 107/20)

Graph 4.6



Source: CBCG

The cyclical nature of credit standards could be seen throughout the year. To wit, in the first two months of the year, banks operated in the pre-pandemic environment so that was reflected in the credit standards. However, highly complex and uncertain economic situation caused by the pandemic significantly influenced the perception of risk in banks.

Thus in the first quarter we already saw a slight tightening of retail credit standards. In the second quarter, during the lockdown, the tightening of the standards was expected. Then we saw some positive movement in the following quarter, and banks expected the same in the last quarter of the year as well.[30] According to banks, the notable decline in household demand for loans in the first half of the year was driven by the deteriorating economic situation in the country and the reduction and postponement of the purchase of real estate and durable consumer goods. Demand for all loans (except housing) gained momentum in the second half of the year and banks perceive this as an increase in financial needs for refinancing and procurement of durable consumer goods.

As for the economy, banks eased credit standards only in the first quarter of the year. Corporate loan demand was in constant growth during the year, this including all loan maturities and companies of almost all sizes. Circumstances caused by the pandemic resulted in the increased demand of the economy for loans, especially short-term ones.

In terms of FX risk, i.e. currency induced credit risk, the loans' currency structure is still very favourable. The marginal part of loans refers to loans in other foreign currencies, which has been the characteristic of banks' loan portfolios for a long time.

In reference to the maturity structure of loans as per initially agreed maturity (excluding credit-type receivables), long-term loans accounted for 90% at end-2020. Observed in terms of remaining loan maturity, the share of long-term loans was significantly lower, 70%.

The materialization of the newly emerging crisis in the form of the overall growth of non-performing loans was relatively limited until the end of 2020 and it did not have the systemic dimension. This does not mean that credit risk to which Montenegrin banks were exposed was not present, but on the contrary, the economy was severely affected and the crisis spillover from the real economy to the financial system was significantly mitigated owing to temporary measures introduced by the CBCG. With a view to preserving financial stability, with its comprehensive approach, the CBCG sought to help both borrowers and banks, thus practically sharing the burden of the crisis.

[30] Data for Q4 2020 were not available at the moment of drafting this report.

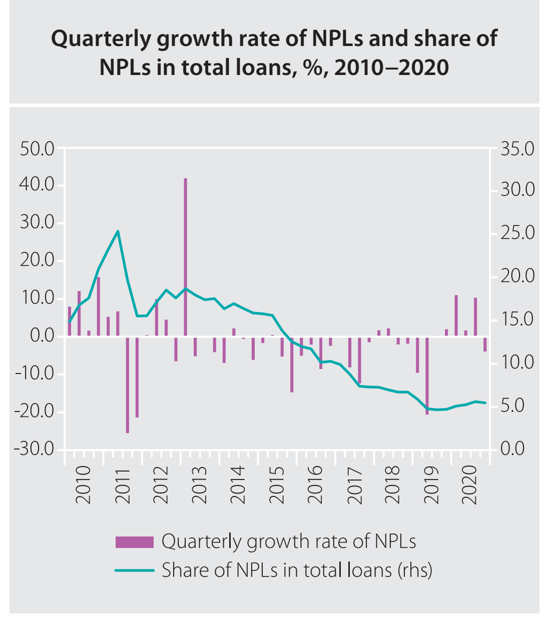
It is clear that credit risk was dampened by these measures; however, taking into account the huge decline in economic activity, banks were allowed to delay the realization of very certain losses. On the other hand, banks were very well capitalized in the pre-crisis period, and credit risk in the form of non-performing loans was reduced to the lowest level since the 2008/2009 crisis. Certain aspects of the measures directly affected the liquidity position of banks, but banks entered this crisis with high liquidity and they successfully managed liquidity risk during the year. Of course, these are short-term measures which can be extended or modified in 2021, and their success will also depend on the duration of the crisis.

At the end of 2020, nine banks had higher shares and three banks had lower shares of NPLs in their total loans than at the end of the previous year. This share was significant in some banks with a higher market share. In the first three quarters of the year, banks recorded increases in NPLs, but they were somewhat lowered in the last quarter. At the aggregate level, the NPL share in total loans rose by 0.8 pp year-on-year, reaching 5.5% at end-2020. The sum of NPLs increased at the annual level by 19.6% and amounted to 172.9 mln euros. The ratio of the sum of NPLs and GDP (although GDP was drastically reduced due to the crisis) amounted to 4.1% at the end of the year (compared to 2.9% at the end of 2019). On the other hand, the sum of loans that were over 30 days past due (168.7 mln euros or 3.8% of total loans) was 45.5% lower than at the end of the previous year.

In addition to the increase in the share of NPLs at the system level, the range between the lowest and highest share of non-performing loans increased at the end of 2020, and the range between the first and third quartile was also larger. NPLs in four largest banks that account for 65.8% of the market were not in the highest quartile range.

Graph 4.7

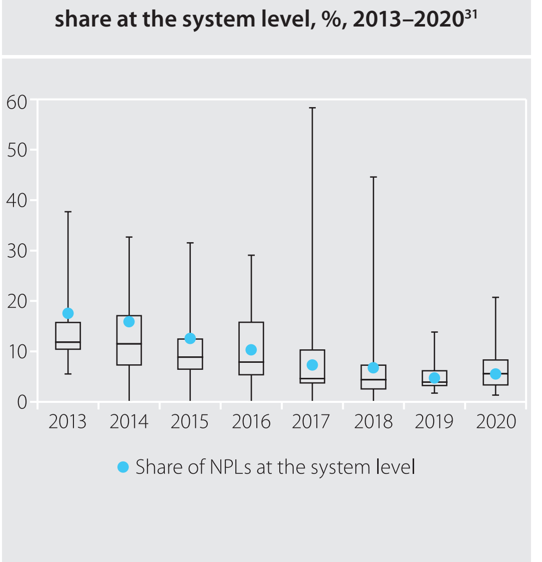
Quarterly growth rate of NPLs and share of NPLs in total loans, %, 2010–2020



Source: CBCG

Graph 4.8

Distribution of the share of NPLs and their share at the system level, %, 2013–2020[31]



Source: CBCG

[31] 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.

At the system level, changes in the structure of credit classification categories were obvious, especially in the first three quarters, albeit not as intense as in some previous crisis periods. The consolidation of credit risk in the portfolios of banks from the previous period was stopped this year and, judging by the share of classification categories, it slightly worsened.

The share of A loans reduced due to the migration of a part of loans from category A to category B and a slower volume of new lending than in the previous year (26.4%). At the system level, B category loans decline in the last quarter so their annual increase amounted to 1.4%. However, in some banks with a higher market share, this category of loans accounted for a significant portion of their loan portfolio.

Graph 4.9

Source: CBCG

At the end of the year, the biggest category change was recorded with C and D loans whose shares rose to 3.3% and 0.3%, respectively. The respective sums of these categories of loans were 54.3% and 39.7% higher year-on-year.

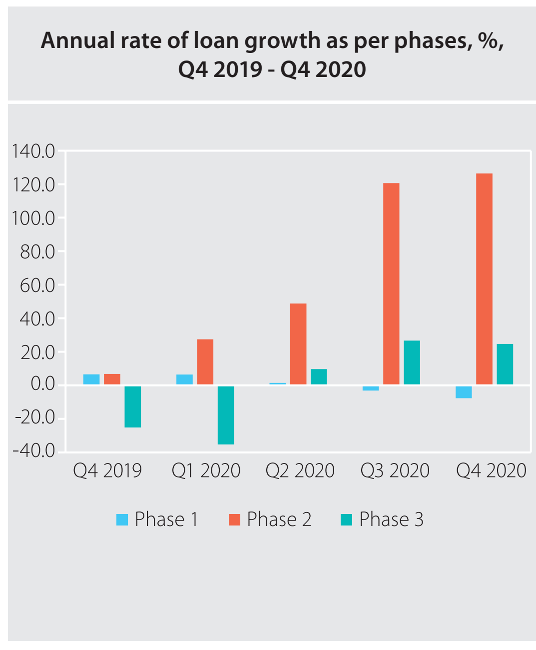
A different, and possibly more realistic picture of the development of credit risk can be seen by observing how banks perceived the movement of risk according to the expected credit losses, i.e. in accordance with the IFRS 9. Many banks reacted promptly by applying a conservative approach in assessing the new situation and its future development. Thus, in the loan portfolio, viewed according to the so-called phases[32], it is very clear that banks have been intensively relocating loans to phase 2 and to a lesser extent to phase 3 throughout the year. The year-on-year increase in phase 2 loans amounted to 126.4% and their share in total loans rose from 6.8% to 14.9% at end-2020. The annual increase in phase 3 loans reached 24.7%. And finally, phase 1 loans declined during the year and their share fell to 78.3%. For the sake of comparison, at end-2019, their share stood at 87.6%. At the same time, banks made value adjustments which, similarly to the mentioned migrations, increased the most in phase 2 loans, by over 100%.

In the pre-crisis period, the gap between credit risk generated by households and non-financial institutions narrowed, but credit risk was always higher in non-financial institutions. Such distribution of credit risk was deepened by the crisis, as corporate credit deteriorated to a much greater extent with credit risk and migration to phases 2 and 3 compared to retail loans.[33] Of course, the speed of

[32] Phase 1 includes financial instruments that did not significantly deteriorated credit risk due to recognition or which had low credit risk at the time of reporting. Phase 2 covers financial instruments where there was a significant increase in credit risk due to recognition, but there was no objective evidence that loan losses had occurred. Phase 3 contains financial assets which had objective evidence of incurred loan losses.

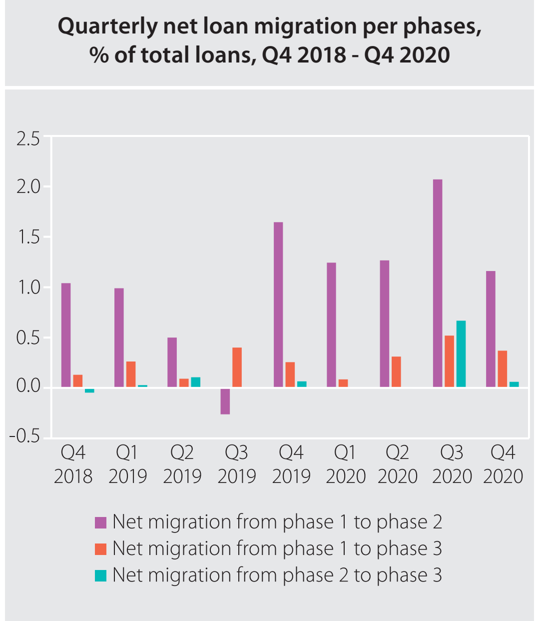
[33] Data on the phases contain only a division into legal and natural persons, but legal entities approximate non-financial institutions quite well.

Graph 4.10



Source: CBCG

Graph 4.11



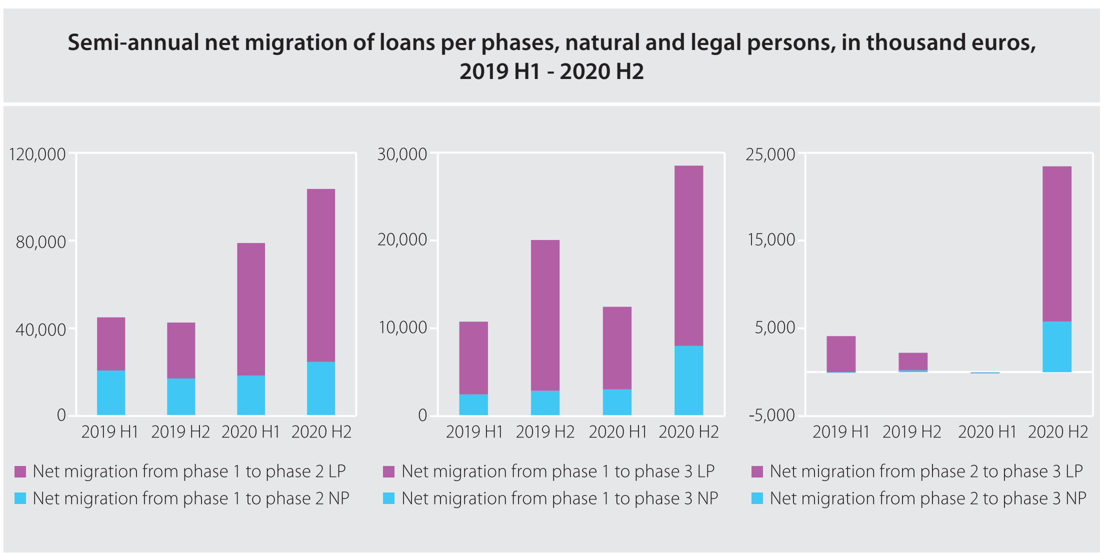
Source: CBCG

migration of corporate loans in phases 2 and 3 during the year was higher than the growth of non-performing loans of non-financial institutions. The share of NPLs in total loans of non-financial institutions was 8.3% at the end of 2020.

The sharp decline in tourist arrivals and overnights inevitably led to a certain spillover of the crisis from the real economy to the financial sector. Thus a sum of NPLs from the *accommodation and food* services activity increased by 174.2% year-on-year, while the share of NPLs in this activity amounted to 14.3%. A large number of loans in the field of tourism was restructured within the temporary measures of the CBCG. Besides tourism, more than half of NPLs of legal persons referred to trade and construction and they rose 23.7% and -4%, respectively.

Credit risk was less pronounced among households this year as well, but it was significantly controlled by a set of CBCG measures. The sum of retail NPLs increased by 6.2% and their share in total retail loans stood at 4.1% at the end of 2020. The share of retail loans that are more than 30 days past due was 4.7%, same as at end-2019.

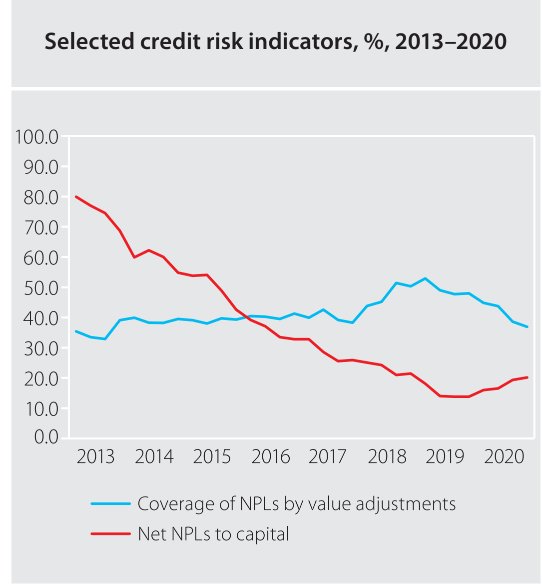
Graph 4.12



Source: CBCG

Of the total amount of active loan debt as at 31 May 2020, the first moratorium covered the amount of 1.3 bln euros or 47.2% of total loans. Of this amount, 41.9% referred to legal persons, 57.8% to natural persons, and 0.3% to entrepreneurs. Observed by activities of legal entities and entrepreneurs, the structure showed the main share of loans were approved for trade[34] with 26%, then tourism[35] with 17.5%, and construction with 13.3%. Among legal persons and entrepreneurs, these three activities were dominant in the next two types/series of moratorium. In those series, moratorium covered much lower sums of loans.

Graph 4.13



Source: CBCG

Of the total amount of loans, 12.3% or 389.2 mln euros worth loans were restructured. Those loans whose restructuring was carried out as a part of the temporary CBCG measures amounted to 217.4 mln euros or 7.5% of gross loans, of which tourism and agriculture, forestry, and fishery sectors accounted for more than 50%. Loans that were restructured independently of the aforesaid measures were 5% lower year-on-year and they amounted to 171.9 mln euros at the end of 2020.

The coverage of NPLs by value adjustments for loan losses (only for NPLs) amounted to 36.9% at

[34] Wholesale and retail trade: repair of motor vehicles and motorcycles.

[35] Accommodation and food service activities.

end-2020, which is much lower than a year ago when they stood at 48%. A higher amount of capital was exposed to credit risk as the ratio of net NPLs („uncovered") and capital increased on the annual basis from 13.8% to 20.2%.[36]

Box 4.1 – CBCG`s temporary measures aimed at mitigating the negative impact of the coronavirus pandemic on the financial system

The Central Bank of Montenegro adopted seven sets of temporary measures to mitigate the negative effects of the coronavirus pandemic on the financial system. The measures were in the form of secondary legislation - CBCG Council decisions (3), as amended. The decisions were technically different in title, but each targeted the crisis caused by the pandemic. Basically, these decisions were aimed at improving the liquidity position of the economy and citizens and encouraging lending activity, and their burden fell on the banking system.

The first decision was adopted on 17 March, with the effect as of 20 March.[37] The main provision of that decision was a 90-day moratorium on credit obligations for all types of debtors. A bank was required to grant a moratorium at a debtor`s request and every debtor was entitled to a moratorium, regardless of whether their finances were affected by the pandemic or not. Also, the decision stimulated loan restructuring through a relaxed regulatory treatment and provisioning.

The first amendments to the decision were passed on 31 March, with effect as of 3 April. The main amendments referred to the prohibition of dividend payment to bank shareholders, except in the form of bank shares, and limits to large exposures specified in the Banking Law that were allowed to be increased, subject to specified circumstance.

The second amendments were introduced on 7 May, with effect as of 16 May. These amendments primarily reduced the rate on used bank reserve requirement not returned on the same day, from 12% to 6%. To wit, a bank may use 50% of its reserve requirement, interest free, if it returns the funds by the end of the same day. Also, if it retains the funds for over a day, it will pay a 6% annual interest (instead of 12% prior to the amendments).

The second decision was adopted on 19 May, with the effect as of 21 May.[38] It repealed the previous decision and any amendments thereof. However, provisions of the previous decision involving dividends, large exposures, and interest rate on reserve requirement were also specified in the second decision, thus practically remain in effect.

The most important novelty in the second decision referred to the issue of moratorium. It allowed moratorium only to those borrowers whose financial condition has been negatively affected by the pandemic, but unlike prescribed in the first decision, here a bank was not obligated to approve the

[36] In order to achieve consistency of the coefficients in this paragraph, non-performing loans include both interest receivables and prepayments and accruals, because for value adjustments there is no separate classification of quality of interest and prepayments and accruals, but only for the total amount/sum: principal, interest and prepayments and accruals.

[37] Decision on interim measures to reduce adverse effects of the new coronavirus outbreak on the financial system (OGM 19/20, 28/20, and 14/20).

[38] Decision on interim measures to reduce adverse effects of the communicable disease COVID-19 epidemic on the financial system after mitigation of measures to protect the population from infectious diseases (OGM 46/20).

moratorium request. This decision also stimulated loan restructuring through a relaxed regulatory treatment and provisioning.

The third decision was passed on 30 July, with effect as of 12 August.[39] It also formally repealed the previous decision. However, the provisions on dividend, large exposures, and reserve requirement interest were repeated, thus they remained in effect.

Here the most notable novelty was the introduction of loan repayment moratorium only to borrowers from the sectors of tourism, agriculture, forestry, and fishery. The moratorium covered the period from 1 September 2020 to 31 August 2021, provided that a loan subject to the moratorium had not been more than 90 days past due as at 31/12/2019 and that it had not been classified as a non-performing loan. If the borrower meets these requirements, then the bank must approve the moratorium. In addition to the moratorium, banks may treat loans that have been approved in the aforementioned period as loans from the classification category „A", which practically means no regulatory provisioning. This decision also stimulated loan restructuring through a relaxed regulatory treatment and provisioning.

The first amendments to the decision were passed on 22 October, with effect as of 6 November. The amendments introduced three important things:

a) a mandatory moratorium for a period of six months to natural persons, at their request. The requirement was that the loan beneficiary whose employment was terminated due to a pandemic on 31 March 2020 or later had not been in default of more than 90 days as at 31 December 2019.
b Loan repayment deadline for retail borrowers is to be extended at the borrower`s request. This is to be granted provided that the borrower`s salary has been reduced by at least 10% as at 31/03/202 or later due to the pandemic.
c) Banks are allowed to calculate the regulatory liquidity ratios as 20% of demand deposits, instead of the previous 30%, when determining the amount of past due liabilities.

The second amendments to the decision were introduced on 1 March, with effect as of 3 March 2021. The amendments introduced four important things:

a) the list of loan beneficiaries entitled to the loan moratorium and/or list of activities entitled to approval of new loans and/or loan restructuring under preferential regulatory treatment was significantly expanded.
b) The extending of the repayment period up to five years to loan beneficiaries whose earnings had been cut by more than 10% as a result of the pandemic.
c) Enabling the extension of loan repayment period for cash retail loans for five years (instead of the initially defined two years with the first interim measures) provided that the loan maturity may not exceed 10 years, this including loans not provided by a high-quality collateral.
d) When assessing creditworthiness of a loan beneficiary and loan classification, banks may disregard the loan beneficiary`s 2020 financial indicators.

The third amendments to the decision were introduced on 30 March, with effect as of 31 March 2021. Here the deadline for the six-month moratorium on retail loan repayments was extended to no later than 31 December 2021 and the list of eligible borrowers was extended to include service activities in land transport.

[39] Decision on interim measures to reduce adverse effects of the communicable disease COVID-19 epidemic on the financial system (OGM 80/20, 105/20,24/21, and 33/21).

A substantial number of loan beneficiaries used the benefits under the interim measures. Moratorium was mostly used in April and May by 62 thousand loan beneficiaries with over 87 thousand credit accounts worth over 1.3 bln euros, which was more than 45% of total loans. The amount of loans under the moratorium generally decreased from then onwards (in line with the change in decisions on temporary measures), and at the end of 2020 it was 67.6 mln euros (2.3% of total loans) and mainly covered loans granted to the sectors of tourism, agriculture, forestry and fishery, of which (in terms of the amount) over one fifth were under the moratorium.

In addition, the amount of restructured loans was almost constantly on an uptrend (also in line with the amendments to the decision on interim measures), reaching 217.4 mln euros at end-2020 (7.5% of total loans). Of this amount, loans granted to tourism, agriculture, forestry and fishery accounted for 107.8 mln euros (35.6% of total loans to these industries), while other sectors accounted for 106.8 mln euros.

In addition to the aforesaid, another CBCG response to the pandemic was amendments to the Decision on Bank Reserve Requirement to be Held With the Central Bank of Montenegro (OGM 88/17). The amendments were passed on 11May, with effect as of 14 May (OGM 43/20), introducing the reduction of the reserve requirement rate from 7.5% to 5.5% (on demand deposits and time deposits with agreed maturity up to one year) and from 6.5% to 4.5% (for time deposits with agreed maturity over one year).

4.3. Liquidity

Banks successfully managed liquidity during the crisis year which they entered with a high level of liquid assets which, measured by the ratio of liquid and total assets, had been amounting to over 20% since 2015. At end-2020, liquid assets of banks accounted for 22.2% of total assets, reaching the level of 1,016.1 mln euros, which is 6.2% more year-on-year.

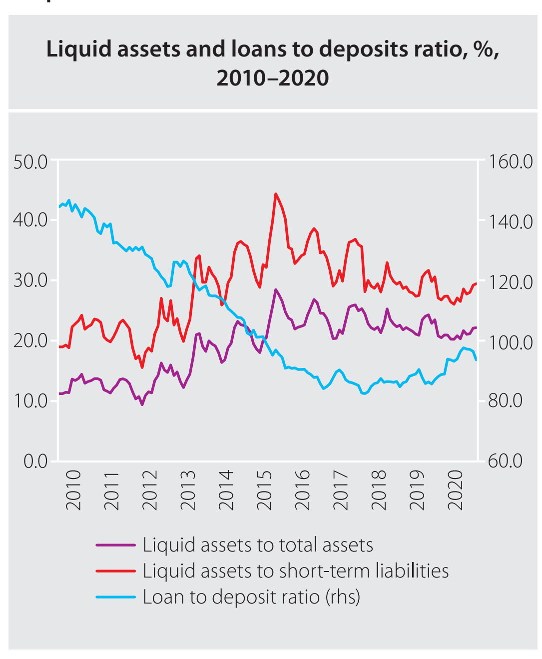
Banks maintained satisfactory daily and ten-day liquidity levels during the entire reporting year. Significant funds were available to banks in a very short period of time for their liquidity needs, primarily deposits that banks hold in settlement accounts with the CBCG (besides required reserves), which amounted to 505.6 mln euros or almost 50% of liquid assets at the end of 2020. Banks hold significant funds with foreign financial institutions and these are primarily demand deposits. They amounted to 217.9 mln euros or 21.4% of liquid funds at the end of the year. Also, banks held cash in vaults in the amount of 198.4 mln euros.

Bank borrowings, as a still available source of funds, were 21.9% higher year-on-year, reaching the amount of 451.9 mln euros. They were at their highest at end-Q3 when they amounted to 501.2 mln euros or 10.9% of banks` total assets and liabilities. Banks` new borrowings, which were mostly up to one year maturity loans, came from parent banks, other members in their respective banking groups, as well as other non-resident deposit institutions.

The loan to deposit ratio increased year-on-year and reached 93.7%. This ratio rose basically due to a decline in deposits of 175 mln euros. However, deposits somewhat picked up pace at the end of the year. Unlike deposits, loans recorded a slight uptrend.

Demand deposits accounted for the main share in the structure of deposits and this was sixth year in a row that we had witnessed such trend. This percentage was 71.4%, same as at end-2019. For the purpose of comparison, this share was 42% at end-2013. This could be explained with a downtrend in deposit interest rates so time deposits became less attractive.

Graph 4.14



Source: CBCG

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 (1% of total sources of funds). Contractual maturity also shows that the ratio of liquid assets and short-term financial liabilities (up to one year) stood at 29.45% and it was higher year-on-year. If we observe the ratio of liquid assets and short-term liabilities up to three months, then this ratio amounted to 35.1%. Both indicators were higher at the end of the year due to an increase in liquid assets and a decline in short-term financial liabilities (both maturities).

With a view to supporting systemic liquidity in case of unforeseen market disturbances caused by the pandemic, the CBCG provided two credit/repo lines during the year worth 350 mln euros from the Bank for International Settlements and the European Central Bank. In addition, the CBCG reduced the reserve requirement rates by 2 pp each, thus contributing to increasing banks` funds in the gyro account held with the CBCG by some 70 mln euros. Also, banks were allowed to calculate the regulatory liquidity ratios using 20% of demand deposits, instead of the previous 30%, thus enabling a more efficient asset management, among other things.

In order to address potential vulnerabilities, the Deposit Protection Fund provided a stand-by arrangement with the European Bank for Reconstruction and Development in the amount of 50 mln euros. It should be added that most banks in the system had a formally agreed liquidity support from their parent banks, which further complements the picture of stability of the system in terms of liquidity.

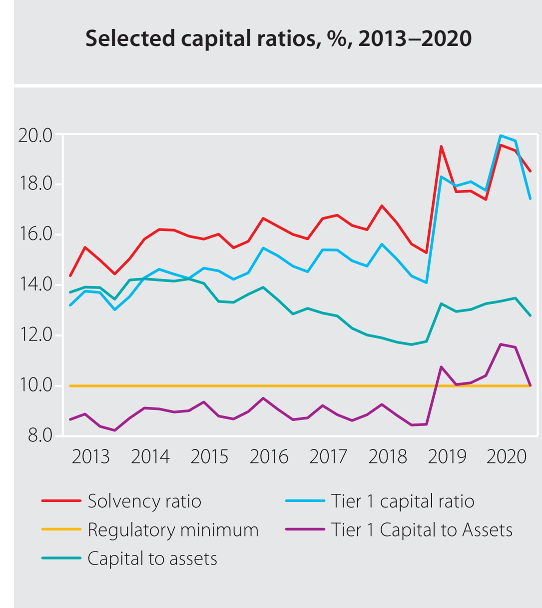
4.4. Solvency

Observed through capital ratios at the aggregate level, the resistance to shocks of Montenegrin banks was satisfactory. The capital adequacy ratio at the system level was 18.5% at the end of the year and it was above the regulatory minimum with all banks. In four largest banks it ranged from 16.2% to 22.9%. The ratio of core capital (Tier 1) and risk-weighted assets amounted to 17.4%.

Three non-systemic banks were recapitalised during the reporting year in the total amount of 9 mln euros.

Total capital of banks throughout the year was higher than at the end of 2019, but by the end of the year it was down by 1.9% and amounted to 586.7 mln euros. This decline was also due to significantly lower bank profits recorded in the reporting year. The share of total capital in total assets and liabilities of banks was 12.8%, while the share of core capital was 10%.

Graph 4.15



Source: CBCG

4.5. Profitability and interest rates

Net profit of banks amounted to 50.6 mln euros in 2020, which was over 50% less than in the previous year.[40] Four largest banks, which individually hold more than 10% of market share in terms of assets, recorded a profit of 13.7 mln euros. Only one bank operated with loss.

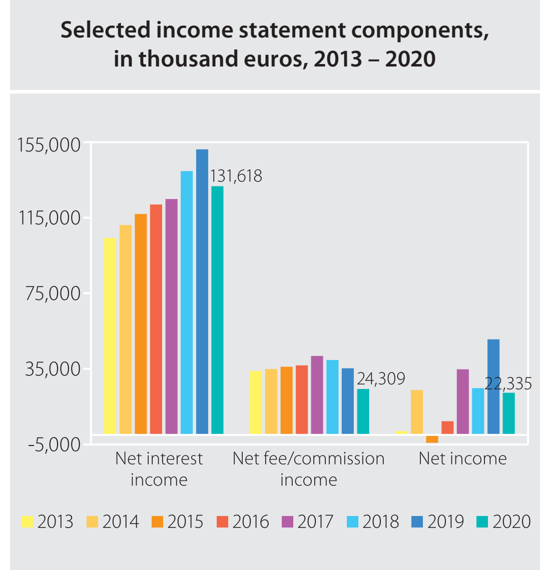
Interest income and similar revenues were 11.8% lower year-on-year at the system level.[41] Banks also earned interest on the portfolio of securities, whose share in total interest income was 9.5%. The situation was somewhat different with the income from fees and commissions, which were 25.7% lower during the entire year because the crisis already affected their decline in the first quarter compared to the same period last year. In recent years, these revenues have gained importance, and they amounted to almost 50% of interest income in 2019, while in 2020 they dropped to 42%.

[40] The decline in profits at the system level was partly related to the profit of Podgoricka banka, whose merger with CKB bank was completed in mid-December 2020. The complete income statement of Podgoricka banka from the beginning of the year was included in the balance sheet (capital) of CKB bank at the time of the merger, thus disappearing from the aggregate income statement of the banking sector.

[41] See the previous footnote. The mentioned treatment of the Podgorička bank income statement particulary reflected on interest income at the system level since most of the other banks in the system had similar interest income levels to those recorded in 2019.

Graph 4.16

Selected income statement components, in thousand euros, 2013 – 2020



Source: CBCG

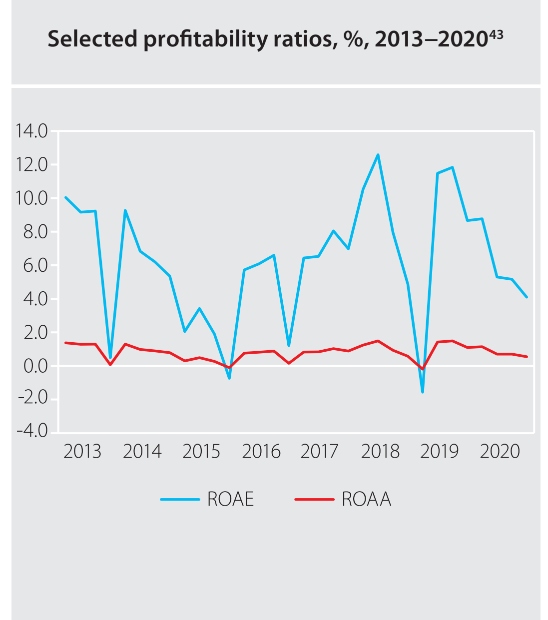
Net interest and similar income were 12.9% lower year-on-year, while net income from fees and commissions dropped by 31.2%.

The decrease in profit for this year was mostly due to an increase in impairment costs[42] as some of the banks applied a conservative approach in assessing the new situation. With such financial result, the ROAA dropped from 1.1% in 2019 to 0.6% in 2020, while the ROAE declined from 8.7% to 4.1%.

Breakdown of the ROAE shows that net interest income had the largest positive contribution. On the other hand, regular expenses accounted for the largest share of expenditure, these being employee expenses and general and administrative expenses. At the system level, banks` employee expenses declined by 23.7% year-on-year.

Graph 4.17

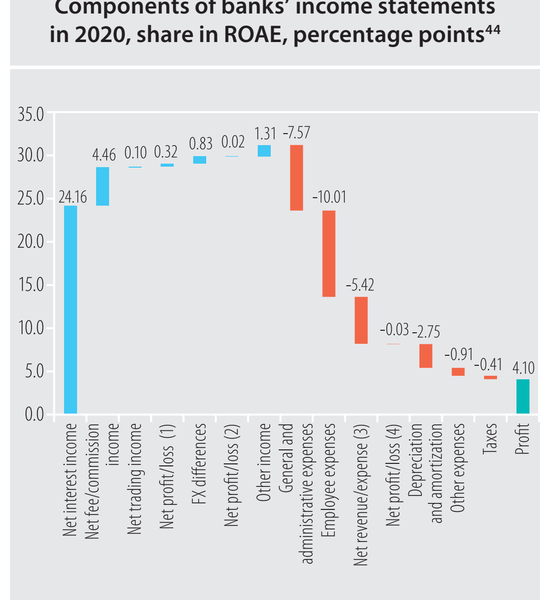
Selected profitability ratios, %, 2013–2020[43]



Source: CBCG

Graph 4.18

Components of banks' income statements in 2020, share in ROAE, percentage points[44]



Source: CBCG

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[42] Impairment of financial instruments that are not measured at fair value through income statement.

[43] 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 the annual level they were transferred by multiplying by 4, 2, and 4/3, respectively.

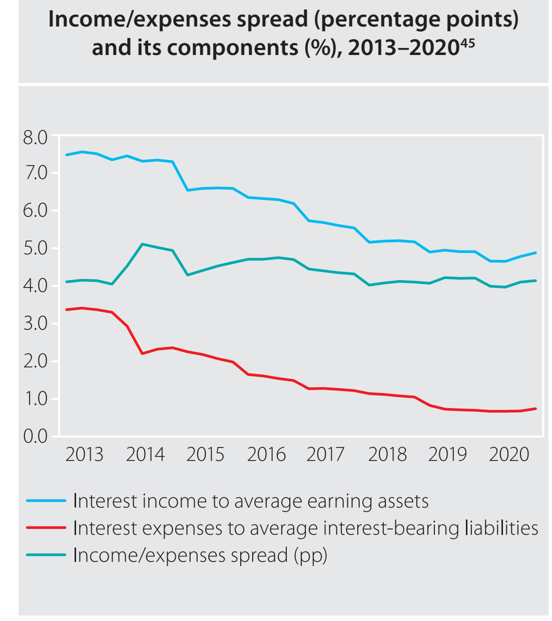
[44] From the graph above, net profit/loss: (1) due to derecognition of financial instruments that are not measured at fair value through income statement, (2) from financial instruments disclosed at fair value in income statement that are not held for trading, 3) from impairment of financial instruments that are not measured at fair value through income statement, (4) due to modification and classification of financial instruments.

The emergency of the situation shows that the costs of impairment were almost three times higher than in the previous year, and the contribution to the ROAE decline was 5.4 pp.

The difference between the interest income to average earning assets ratio and the interest expenses to average interest-bearing liabilities ratio was somewhat lower at the end of 2020, but it remained above 4 pp, varying among individual banks from 0 to 5.3 pp. Average earning assets was 11.4% lower than in 2019, accounting for 77.5% of average assets.

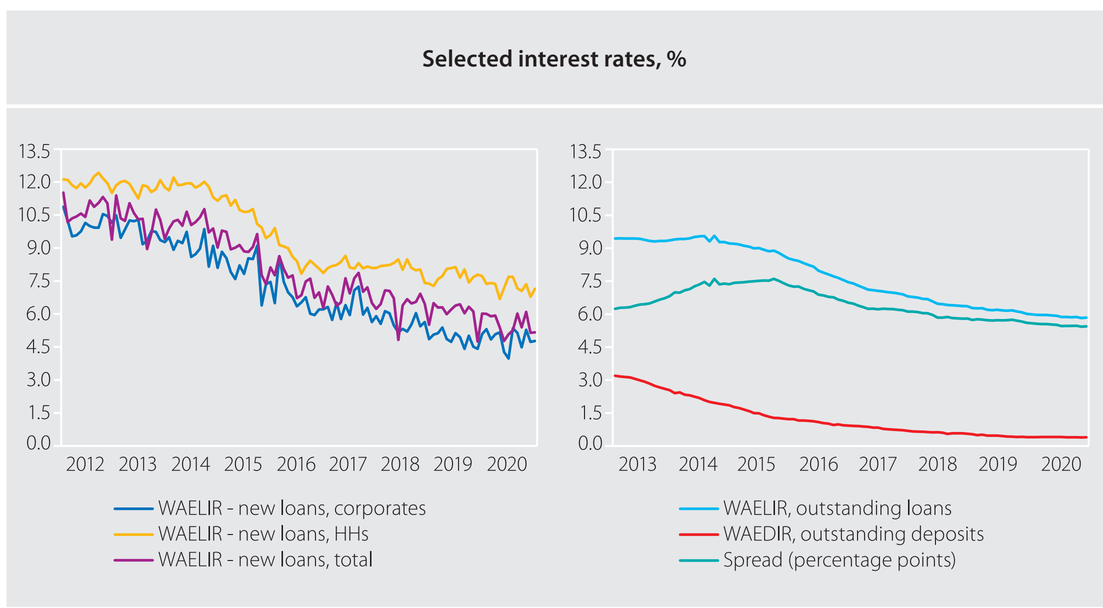
The downtrend in the weighted average lending interest rate (for the entire loan portfolio of banks, i.e. on unpaid principal/debt) continued in 2020 and it dropped by 0.17 pp. As for the weighted average deposit interest rate, its annual decline was rather negligible (0.01 pp). At the end-December, the weighted average lending interest rate was 5.84%, while the weighted average deposit interest rate was 0.4%. Thus the interest spread additionally decreased and at the end of the year it was 5.44 pp.

Graph 4.19



Source: CBCG

Graph 4.20



Source: CBCG

[45] 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 the annual level they were transferred by multiplying by 4, 2, and 4/3, respectively.

In general, borrowing by individuals was more expensive compared to non-financial institutions. The spread between lending interest rates (on total loans, i.e. on outstanding principal/debt) for natural persons and resident non-financial institutions reached 2.75 percentage points at the end of December 2020 as it had been steadily increasing since 2012 (when it stood at its lowest level of 0.82 percentage points) and it stopped in the last quarter of the reporting year due to a decline in wholesale interest rates.

Interest rates on new loans were similar. Lending interest rate on new loans for the whole of 2020 (weighted by monthly amounts of new loans) was 0.53 pp lower compared to 2019 and it amounted to 5.46%. This decline was driven by a decline in loans granted to households. Corporates were granted loans at interest that was higher in the second half of the year (4.9%). The weighted interest rate for the corporate sector was 4.7% in the first six months of the year.

4.6. Sensitivity analysis

Sensitivity testing using four credit risk tests showed significant resilience of banks, with some sensitivity of individual banks in the first and fourth test. To wit, two banks failed the first test with the total amount of capital shortfall of 13.8 mln euros, while three banks did not pass the fourth test as they were lacking capital in the amount of 12 mln euros. However, the solvency ratio at the sector level did not fall below the statutory minimum after any of the tests applied.

Table 4.1

Sensitivity analysis of credit and market risks, 31 December 2020

No.	Test	Solvency ratio after the test, %					Amount lacking capital at the sector level, thousand euros	Number of banks that failed the test
		Minimum	Q1	Q3	Max	System		
		Solvency ratio before the test, %						
		13.4	15.5	21.9	27.0	18.5		
	Credit risk test							
1.	Negative reclassification of classified loans' structure[46]	3.6	11.7	20.7	24.5	16.6	13,824	2
2.	Increase in non-performing loans by 30% and value adjustments by 40%	11.3	14.7	20.4	26.3	17.7	0	0
3.	Large debtor bankrupt[47]	11.6	14.6	19.8	25.2	17.4	0	0
4.	Largest debtor bankrupt	1.6	11.4	17.9	20.4	14.9	12,002	3
	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	12.3	15.5	22.7	27.1	18.3	Not calculated	0
2.	Adjustment of net open FX position by 20%	13.4	15.5	21.9	27.0	18.5	Not calculated	0

Source: CBCG

[46] Reclassification of the structure of classified loans was implemented as follows: 1) category A – "pass" - calculated in the amount of 90%, and category B was 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 assets, while 95% from category D was kept, and 5) category E - "loss" amount wasincreased by 5% of the amount from category D assets.

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

As expected, the sensitivity to interest rate risk and the sensitivity to FX risk test showed minor negative impacts on the solvency ratio which, in the first case, declined by 0.2 percentage points to 18.3% at the sector level, while in the latter case, it dropped by a mere 0.03 percentage points.

Table 4.2

Sensitivity analysis of liquidity risk, 31 December 2020

No.	Test	Coverage by immediately available liquid assets, thousand euros (703,754 as at 31 December 2020)			Coverage by available liquid assets, thousand euros (793,473 as at 31 December 2020)		
		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	-308,101	11	-320,257	-218,382	11	-241,964
2.	Outflow of 30% of demand deposits	-28,009	6	-107,501	61,710	4	-54,396
3.	Outflow of time deposits: 20% for natural persons and 40% for legal persons	-44,354	8	-118,916	45,365	5	-59,293
4.	Outflow of time deposits: 30% for natural persons and 40% for legal persons	391,516	3	-13,756	481,235	3	-5,647
5.	Outflow of deposits of the largest depositor	537,956	2	-10,304	627,675	2	-6,277
6	Outflow of 50% of deposits of 10 largest depositors	343,081	3	-37,572	432,800	3	-23,925
7.	Outflow of 100% of deposits of public sector	326,614	3	-82,116	416,333	3	-63,549

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. In addition to the most liquid banks' funds in the country, the tests very conservatively assumed the possibility of using only 50% more of the reserve requirement.[48] On the other hand, the possibility of using bank funds in the form of demand deposits held abroad, which amounted to 217.8 mln euros at the end of 2020, was not assumed nor did the remaining 50% of the reserve requirement (89.7 mln euros). Also, the options of selling non-cash assets (e.g. securities) or taking loans from parent banks, other participants in domestic or foreign markets or possibly from the CBCG or the state, were not taken into account.

Even under these rigorous assumptions, testing expectedly indicated good liquidity of the sector as a whole, although in the case of the first three tests the sector did not have liquid funds to respond to deposit withdrawals even after using 50% of reserve requirement, where the most problematic was the first test. In all other cases, inadequacy of liquid funds to cover deposit outflow appeared in individual banks. The most pronounced inadequacy, and after the use of 50% of reserve requirement funds, occurred after the conduct of the seventh test when three banks failed the test with the liquidity shortfall of 63.5 mln euros.

However, with the use of deposits that banks have in foreign accounts and with the full amount of reserve requirement, the system as a whole could respond to the withdrawal of deposits in the first test (a shortfall of a mere 0.5 mln euros), with some deficits in several banks. Moreover, with the use of the

[48] Pursuant to the Decision on Bank Reserve Requirement to be Held With the Central Bank of Montenegro (OGM 88/17), a bank may use up to 50% of the reserve requirement without the fee charged by the CBCG, if it returns taken funds by the end of the working day. Technically, even with the CBCG fee of 12% per annum, the bank can use more than 50% of reserve requirement, i.e. use reserve requirement for a period longer than the end of the working day.

mentioned deposits abroad and full reserve requirement, only one bank would not be able to respond to the withdrawal of deposits within the third and sixth test, while all other banks would pass the scenario from all other tests (except the first). Again, it should be kept in mind that these conditions also exclude some of the abovementioned additional layers of liquidity in the form of sale of securities or potential borrowing from other entities.

4.7. Real Estate Market

The 2020 real estate market parameters recorded negative trends due to the global economic crisis induced by the COVID-19 pandemic. Results of the December survey suggest that the average price of a real estate in Podgorica amounted to 1,004 euros per square meter, which represents the year-on-year decline of 3.9%.[49] The average price per square meter of a new apartment was of similar value in December 2020 (1,007 euros) and it recorded the year-on-year decrease of 11.3%. 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

Based on a survey conducted by the Central Bank of Montenegro,[50] most agencies (88%) recorded a decline in trade. Also, most of them (69%) estimated that the average price per square meter remained the same as in 2019, while 31% believe that the prices dropped.

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

In December 2020, housing loans increased by 13.7% y-o-y. However, this growth is not the result of higher demand for loans but a set of CBCG measures aimed at mitigating the negative effects of the health and economic crisis on the economy and the financial system. A temporary suspension (moratorium) of all loan payments (principal, interest, default interest, fees, etc.) was introduced first in March and then in May 2020, both for a period of 90 days. The difference between these two sets of measures is that the first was binding, and the second was optional to include clients whose financial situation had deteriorated and who were not more than 90 days in default on 31 December 31 2019.

[49] 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.

[50] For the purpose of the analysis, 95 real estate agencies were surveyed, most of which have their activities in Podgorica and the coastal region of Montenegro. Of a total of 95 respondents, 18 submitted their answers.

Table 4.3

Housing loans trend, 2007-2020					
Year	Stock at year-end, in 000 €	y-o-y growth, %	Per capita (in €)	% 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
2019	413,423	13.0	664.5	8.4	13.5
2020	470,136	13.7	756.0	11.0	14.9

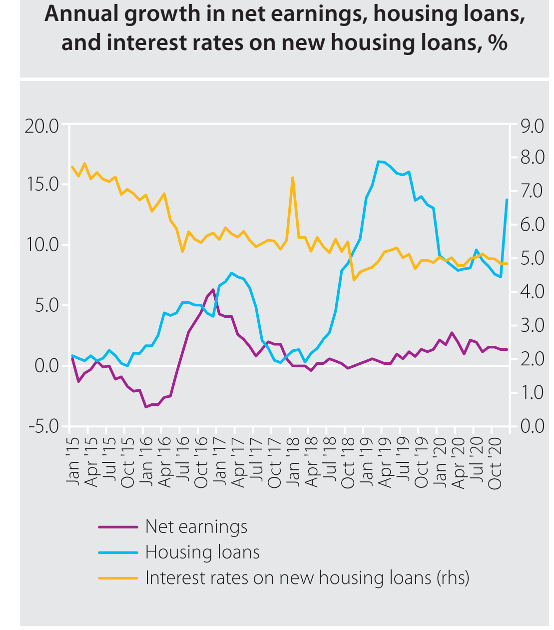
Source: CBCG and Monstat

The first moratorium covered 50% of loans apartment purchase and refurbishing, while the second included 6.9%.[51] Thus, a significant increase in the housing loan rate cannot be attributed to the economic environment in 2020 where we saw a stagnation of net wages and interest rates on new housing loans.

The share of housing loans in the structure of total loans also increased as a result of the first and third set of CBCG measures. It amounted to 14.9% of total loans, which is an increase of 1.4 pp compared to the previous year. The share of loans in GDP increased by 2.6 pp and it amounted to 11% of estimated GDP in 2020. The share in GDP was still significantly lower than the EU average (by some third of the value), which may be the result of lower solvency of citizens, but also less favourable lending conditions compared to the EU countries. In addition, the amount of housing loans per capita in the past year (756 euros) is

Graph 4.22

Annual growth in net earnings, housing loans, and interest rates on new housing loans, %



Source: CBCG

[51] For more details on the effects of the measures of the Central Bank of Montenegro in 2020, see the study by Ivanović, Vujanović, Kilibarda, and Vlahović (2020) "Analysis of the impact of the COVID-19 pandemic on the economy and banking system of Montenegro" available at *https://www.cbcg.me/slike_i_fajlovi/fajlovi/fajlovi_publikacije/radne_studije/analiza_uticaja_covid-19_na_ekon_i_bank_sistem_cg.pdf*

significantly higher than the average net salary in Montenegro (524 euros). Compared to the previous year, indebtedness per capita arising from housing loans increased by 13.8%.

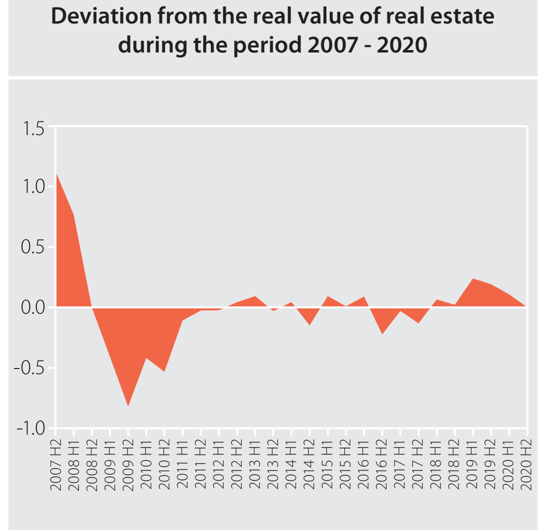
In terms of supply, it can be concluded that there was a decline in parameters in the construction sector. Liquidity potential also declined in the period 2018 - 2020. In 2020, it amounted to 114.8 mln euros, which is a 16.2% decline year-on-year. Total loans to the construction sector also dropped in the reporting year, by 6.2%. Also, 47.1% of total loans of legal persons and entrepreneurs dealing with construction were covered under the moratorium as at 31 May 2020 (under the first set of measures).

Given the above and the stagnation of interest rates on housing loans, but also considering uncertainties regarding the recovery of the economy from the crisis caused by the pandemic COVID-19 in 2021, we can expect a further decline in real estate prices in the coming period. This is also in line with expectation of the surveyed real estate agencies. To wit, 56% of the surveyed agencies expect that prices will fall in the coming period, while 44% believe that they will stay at the same level.

Considering the importance of the real estate market for the business cycle and financial stability, a risk assessment of the market was performed. Four essential series were used that would approximate the real (fundamental) value of a property. Any major deviation from the calculated real estate value could signal an increased risk in the real estate market which, as the financial crisis has shown, may affect financial stability.

The four series used for the given analysis are: the ratio of subjective real estate prices and net earnings in Podgorica, the ratio of new construction prices to net earnings in Montenegro, the percentage share of the value of effective construction hours in GDP, and the share of housing loans in GDP. The first two series approximate the factors that determine demand (purchasing power of the population). The third series approximates the factors that affect the supply in the real estate market. The fourth series approximates the situation in the banking sector, which significantly determines the trends in the real estate market. These series are available for the period 2007-2020. The principal component analysis was applied to these four series, which creates a new variable that includes the common variability of the given series during the specified period.

Graph 4.23



Source: CBCG calculations

In order to estimate the deviations from the real value of real estates, cyclic movements were calculated using the HP filter method (applying the recommendations of Ravn and Uhlig (2004) in the estimation). The given cyclical movements are presented in Graph 4.23.

Based on the given graph, it can be estimated that the period up to 2008 had been characterized by overestimated real estate values on the market (boom), while the period 2008–2011 was characterized by much underestimated real estate values (bust). This cycle (boom and bust) is a consequence of the global financial crisis that hit Montenegro precisely because of the overemphasized

price bubble in the real estate market. The stabilization of prices in relation to its fundamentals came a few years following the financial crisis. The 2011-2017 period was characterized by weaker oscillations in the real estate market and the prices that were rather similar to their fundamentals. In the period before the pandemic (2018–2019), real estate prices were also higher than their fundamental values, but not overemphasized, so the year of the COVID-19 pandemic has led to a practical equalization of real estate prices with their fundamental values. It can be concluded that real estate prices are very much affected by macroeconomic trends, but also by shocks such as the global financial crisis in 2008 and the health and economic crisis in 2020.

The shortcomings of this analysis are short series that do not cover the complete 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 if the number of variables used for principal component analysis were higher. The series that would, in case of availability, improve the quality of risk assessment are investments in real estate, investments in the construction sector, the amount of rent, and the like but, unfortunately, these data are not available.

4.8. Capital market

The turnover of a mere 31.4 mln euros was recorded at the Montenegro Stock Exchange (0.7% of GDP) in 2020, as compared to 318.2 mln euros in the previous year. There were no primary issues.

Trading with shares made up 73.6% of the secondary turnover, of which trading with shares of companies amounted to 23.1 mln euros and trading with shares of investment funds to a mere 12 thousand euros. The rest of the secondary turnover (8.3 mln euros) referred to bond turnover, with government bond trading in the amount of 7.5 mln euros, i.e. trade in corporate bonds in the amount of 0.7 mln euros.

At end-2020, the SE indices Monex and MNSE10, stood at 10,328.64 and 712.83 points, respectively, recording the year-on-year declines of 9.4% and 8.3%.

4.9. Payment System

The CBCG`s payment systems - RTGS system and DNS system, as the main payment infrastructure in the country, worked smoothly and according to the system schedule during all 255 working days in 2020 despite the crisis situation during most of the year (March-December). There was no downtime or extensions to the system availability was 100%. In addition, as in the previous year, the operation of the system was slightly different on 31 December in relation to other working days.

A total of 10.6 mln payments worth 15.1 bln euros were effected, which is 7.7% and 10.5% more than in 2019, respectively. Of the total number of payments, 35.9% were realized in the RTGS system, with the share in the total value of payments of 94.6%. On the other hand, 64.1% of the total number of payments was effected in the DNS system (5.4% of the total value of payments). Thus, the share of the number of payments executed via the RTGS system in the total payments in the CBCG Payment System decreased by several percentage points compared to 2019 (at the expense of increase in the share

of DNS system), while the share of payments made in both systems was approximately the same as in 2019.

A relatively small number of rejected and pending payments was recorded, which indicates that liquidity of participants in the system was excellent and that the reasons for putting payments on hold and/or refusing payments were primarily of technical and operational nature. For example, due to a lack of funds in the account, only 45 payments (all in the RTGS system) were put on hold and all of them were effected after the inflow of funds later during the same day.

Observing the intraday liquidity of banks, it can be said that the initial balances on the RTGS accounts of banks were largely sufficient to cover their outgoing payments, with some variations by the bank.

5. CONCLUSION

As in most countries, the current crisis caused by the coronavirus pandemic has triggered recession in Montenegro. It is not easy to assess the final scale of recession in the country, but it was certainly very pronounced in 2020 given that restrictive health measures directly affected tourism - the leading industry in the country, as well as the fact that the fiscal space in Montenegro was and still is quite limited. As expected, there was an increase in the budget deficit, a consequent increase in public debt, and the financial position of the population and the economy deteriorated, resulting in deterioration of the quality of loans in banks' portfolios.

Pressures in government finances pose a big systemic risk in Montenegro. In that respect, the level of public debt is neither the key problem nor the only cause of the problem but it is, to a large extent, a consequence of the activity of other economic impacts, primarily 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. In the context of the ongoing coronavirus pandemic and its economic consequences, a decisive continuation of measures of responsible and well-balanced fiscal policy is necessary, with the aim of bringing Montenegro into a relatively "safe zone".

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 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, interest expenses were significant and estimated at 111 mln euros (2.6% of GDP) in 2020, while their 2021 projections point to the amount of 113.1 mln euros (2.4% of GDP). Therefore, a period of normalisation of interest rates on the international financial market, which will occur at a certain point in time (albeit not in the near future), will pose a particular challenge to financing interest expenses and debt refinancing.

In general, the balance of government finances is of extreme importance for financial stability and this not only due to direct financial links between the government and banks. To wit, the government sector is the main employer and investor in the country which financing is based on the private sector. Therefore, every imbalanced and unsustainable financing period that leads to a public debt bubble that must followed by a period of fiscal consolidation. A gradual balancing of spending would be more preferable but even that could generate pressures on the financial positions of both retail and corporate sectors that would subsequently spill over to banks through difficulties in loan repayment and a decline in deposits, the latter being the most important source for banks for credit growth financing.

Direct financial links between the government and banks ad to the complexity of Montenegro's position. Exposure of the banking sectors to the government[52] declined by 71.2 mln euros or 1.5 pp of banks` assets (to 687.2 mln euros or 15%) although it was on almost continuous growth after the 2008/2009 economic and financial crisis. 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. 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. However, although significant, this exposure is still lower than in a number of EU countries and it does not represent a threat to financial stability, but it is also the subject of careful monitoring by the CBCG.

Although significantly affected by the coronavirus pandemic, banks are the healthiest segment of Montenegro's economic and financial system. Despite a notable decline in activity in all key sectors of the Montenegrin economy, banks continued lending and provided a significant support to the economy and households. Seven sets of measures of the CBCG also provided a significant support.

In recent years, and especially after the closure of two vulnerable banks in early 2019, the challenge related to non-performing loans significantly weakened. Still, it should be noted that a decline in the share of non-performing loans was largely achieved through write-offs and sale of bad assets, which leads to a conclusion that the problem was removed from the banking sector rather than actually resolved. Outstanding liabilities arising from these displaced loans continue to burden potential borrowers and affect the level of lending in the country.

Also, the coronavirus pandemic has expectedly re-actualized the problem of non-performing loans, so their share increased to 5.4% in 2020, with the potential for further growth. However, the growth in non-performing loans is still lower than that expected. The feedback loop between a high share in non-performing loans and stagnant credit growth strengthened in 2020. Banks still have the perception of a high credit risk in the real economy, which is best indicated by relatively prudent lending activity as well as still high lending interest rates (regardless of the substantial reduction of average lending interest rate) and other lending conditions. Until now, however, the banking sector has successfully responded to the challenge of non-performing loans owing to significant and high-quality buffers of liquid assets and capital. Certainly, it should be borne in mind that the CBCG's temporary measures to mitigate the consequences of the pandemic - moratoriums and restructuring - have in a way „frozen" or changed the picture of the actual situation regarding this issue, but this will be known after the measures have expired.

The CBCG`s macroprudential measures to limit the growth of unsecured retail cash loans (adopted in mid-October 2019 and effective as of 1 January 2020), with the likely impact of the coronavirus pandemic itself, acted to mitigate the trends related to these loans from the previous period. At the end of 2020, the debt balance (outstanding principal) arising from cash loans accounted for 25.2% of total loans, and the share of cash loans with an initial maturity of more than three years made up 29.9% of all cash loans with the same maturity (compared to 27.9% and 34.1% at the end of 2019, respectively).

[52] The data represents the sum of all types of exposures to the central government and exposures on loans to local government and social security funds.

However, the maturity structure of cash loans remains incomparably closer to the maturity structure of housing loans. There may be several reasons for this, and one of the possible ones is a partial substitution of housing loans with cash loans. Having in mind the credit history of this type of loan, it can be said that banks adequately control that risk. However, the problem may arise in the case of rising unemployment and/or falling real earnings, which is what we have been witnessing with the ongoing pandemic induced crisis. In that sense, it is good that the CBCG measures were in force some two and a half months before the pandemic outbreak.

Deteriorated balance sheets of banks, i.e. higher impairment and provisioning costs, resulted in a significant decrease in profit - to the level of 22.7 mln euros at the system level, bringing the average ROAE to 4.1% in 2020, as compared to a solid 8.7% in 2019.

The solvency ratio at the system level (18.5%) indicates that there is a solid resilience of banks to potential further problems with non-performing loans. The solvency ratios of all banks will be reviewed through the ongoing supervisory process of the CBCG, and in particular through the AQR project which should be completed in autumn 2021, and the results will show which banks need to be recapitalized, if any.

Box 5.1 – Proposal of further CBCG actions

The wide range of macroprudential measures adopted by the CBCG in the period March - October 2020 represents a good basis for combating the negative impact of the pandemic in 2021. However, the subdued growth of credit risk and liquidity needs that banks still service well may in the long run jeopardize banks' capital and their solvency, and thus the stability of the banking and financial system. In order to prevent these trends and mitigate and/or prevent their materialization, the CBCG should:

- continue strengthening the macroprudential framework and supervision of the banking system, especially in terms of monitoring liquidity and credit developments that were the first to have been hit by the crisis (World Bank, 2020);
- continue with proactive macroprudential actions at the cost of further reducing banks' profitability. Thus, the burden of the crisis caused by the COVID-19 pandemic would be borne jointly by both clients and bank shareholders.
- continue monitoring the implementation of the macroprudential measures in force, as well as assess their effectiveness in order to evaluate their usefulness in terms of the need for their termination or extension, depending on the duration of the epidemic and the intensity of its further spillover from the real to the banking sector;
- depending on the development of the pandemic and the state of the economy, consider extending the existing moratoriums and/or introducing new ones;
- continue intensive communication with banks and the Government of Montenegro in order to ensure profiling and calibration of new measures at the right time, based on timely and credible information and exchange of views;
- continue intensive communication with central banks and international financial institutions (ECB, BIS, IMF, WB, EBRD), as a precaution, in case the provided funds to support bank liquidity in unforeseen circumstances and new financing of economic entities are not sufficient;

- given the current circumstances, request banks to review their policies and remuneration practices and variables and align them with the effectiveness of risk management. Remunerations, particularly their variable part, should be formed following a conservative approach, i.e. the payment of variables should be postponed for a longer period due to the risks arising from the pandemic and for a larger proportion in equity instruments (EBA, 2020);
- oversee the classification of bank exposures, on an individual basis, in terms of eliminating flexibility in the implementation of temporary classification measures and debt restructuring, in order to ensure accurate and timely classification of assets;
- recommend banks to review their NPL strategies, defined operational objectives related to reducing NPL levels and implementing financial restructuring;
- encourage banks to consider the possibility of reducing debt principal in cases where this is objectively possible, and especially for clients unable to repay restructured liabilities (Ehrentraud and Zamil, 2020);
- recommend banks to review their existing business and operating models and adapt to the "new normal", with the focus on business digitalisation (Juchem et al., 2020), and
- recommend banks to review their contingency plans and business continuity plans.

ANNEX

Table 1 – Financial Stability Indicators (FSIs), 2016–2020

	2016	2017	2018	2019	2020			
	XII	XII	XII	XII	III	VI	IX	XII
Basic indicators of financial stability for banks								
Regulatory capital / risk weighted assets [1]	16.0	16.4	15.6	17.7	17.4	19.6	19.3	18.5
First class regulatory capital / risk weighted assets [2]	14.7	15.0	14.4	18.1	17.8	19.9	19.7	17.4
Net non-performing loans / capital [3]	27.4	18.7	8.6	3.5	6.2	4.9	7.1	7.1
Non-performing loans / total loans [4]	11.5	8.4	7.4	5.1	5.6	5.6	6.1	5.9
Non-performing loans / total loans [5]	10.3	7.3	6.7	4.7	5.1	5.3	5.6	5.5
Loan structure by institutional sectors, in relation to total loans								
Residents	96.0	97.1	95.2	96.2	96.5	96.6	96.8	96.7
Structure of total loans by institutional sectors: banks	0.0	0.0	0.2	0.3	0.3	0.3	0.3	0.2
Structure of total loans by institutional sectors: central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structure of total loans by institutional sectors: other financial corporations	0.3	0.2	0.3	0.5	0.6	0.6	0.6	0.6
Structure of total loans by institutional sectors: general government	5.7	8.1	8.2	9.1	8.6	9.1	10.0	10.2
Structure of total loans by institutional sectors: non-financial corporations	43.0	41.3	38.9	37.9	38.8	38.6	38.0	37.8
Structure of total loans by institutional sectors: other resident sectors	47.0	47.5	47.6	48.4	48.2	48.0	47.8	48.0
Non-residents	4.0	2.9	4.8	3.8	3.5	3.4	3.2	3.3
ROA[6]	0.2	1.0	1.0	1.3	1.2	0.7	0.7	0.5
ROE[7]	1.5	7.6	8.5	10.0	9.4	5.6	5.1	3.6
Interest margin / gross income [8]	58.6	54.5	56.1	56.6	62.8	64.0	63.3	61.5
Interest-free expenses / gross income	76.6	73.0	76.3	74.9	70.9	72.3	72.3	75.3
Liquid assets / total assets [9]	24.5	25.3	22.6	20.8	20.9	20.8	21.1	22.2
Liquid assets / short-term liabilities [10]	51.4	49.2	35.4	31.1	32.4	32.0	33.4	35.1
Net open position in foreign currencies / capital [11]	1.6	0.8	0.0	0.6	0.4	0.5	0.4	0.7
Additional financial stability indicators								
Banks								
Capital / Assets [12]	8.7	8.6	8.4	10.1	10.4	11.6	11.5	10.0
Large exposures / capital [13]	153.4	140.7	126.8	99.5	111.3	87.5	93.9	91.1
Geographical structure of loans, in relation to total loans [14]								
Montenegro	---	---	95.2	96.2	96.5	96.6	96.8	96.7
Geographical structure of total loans: developed economies, excluding China	---	---	0.7	0.6	0.6	0.6	0.6	0.6
Geographical structure of total loans: other emerging and developing economies, including China	---	---	2.9	2.6	2.4	2.3	2.1	2.1

Table 1 – Financial Stability Indicators (FSIs), 2016–2020 – continued

	2016	2017	2018	2019	2020			
	XII	XII	XII	XII	III	VI	IX	XII
Geographical structure of total loans: Africa	---	---	0.0	0.0	0.0	0.0	0.0	0.0
of which: Sub-Saharan Africa	---	---	0.0	0.0	0.0	0.0	0.0	0.0
Geographical structure of total loans: Central and Eastern Europe	---	---	1.4	1.7	1.5	1.4	1.2	1.1
Geographical structure of total loans: Commonwealth of Independent States and Mongolia	---	---	0.1	0.0	0.0	0.0	0.0	0.0
Geographical structure of total loans: Asian developing countries, including China	---	---	0.0	0.0	0.0	0.0	0.0	0.0
Geographical structure of total loans: Middle East	---	---	1.5	0.9	0.9	0.8	0.8	1.0
Geographical structure of total loans: western hemisphere	---	---	0.0	0.0	0.0	0.0	0.0	0.0
Gross asset position in financial derivatives / capital [11]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross liabilities position in financial derivatives / capital [11]	0.2	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Trading revenue / total revenue [15]	3.1	3.0	1.8	3.8	2.5	2.3	2.4	3.1
Employee expenses / non-interest bearing expenses	39.0	38.2	34.9	37.3	37.0	36.8	36.0	34.9
Difference between reference lending and deposit interest rates (in basis points) [16]	652	612	580	561	555	552	546	544
Customer deposits / total loans, excluding interbank loans [17]	126.4	132.2	123.1	116.1	110.3	104.5	105.2	108.3
Loans denominated in foreign currencies / total loans [18]	1.1	0.7	0.5	0.4	0.3	0.3	0.3	0.2
Liabilities denominated in foreign currencies / total liabilities [19]	6.4	6.5	6.4	6.5	4.5	4.6	4.6	4.9
Real estate market								
Residential real estate prices, annual percentage change [20]	-12.5	10.7	1.8	3.4	-8.2	-17.1	-21.9	-11.3
Housing loans / total loans [21]	15.0	13.9	13.7	14.6	13.9	13.9	13.8	14.3
Commercial real estate loans / total loans [22]	6.8	7.4	6.7	6.1	6.1	5.9	5.7	5.5

The text of all footnotes can be found in the excel file available at *https://www.cbcg.me/me/statistika/statisticki-podaci/indikatori-finansijske-stabilnosti*, and here, as the most important, the footnotes are shown below..

4/ Non-performing loans refer only to the principal of loans classified in categories C, D and E, without interest and prepayments and accruals of interest and fees. On the other hand, total loans (in addition to the principal) include interest and prepayments and accruals of interest and fees for loans classified in categories A and B, while interest and prepayments and accruals of interest and fees for loans classified in categories C, D and E are excluded from the scope. Exceptionally, for the period before 2013, total loans in addition to the principal include only the mentioned interest rates, because data on prepayments and accruals of interest and fees were not available.

Prior to 2013, loans classified in category E (i.e. in the worst classification category - "loss") were kept in off-balance sheet, so that the counter of this indicator (i.e. non-performing loans) contains loans classified as E, while the denominator of this indicator (i.e. total loans) does not contain the same.

5/ Internal definition, according to the methodology used in the CBCG.

By definition, interest and prepayments and accruals of interest and fees are completely excluded from both non-performing loans and total loans. Also, according to the requirements of IFRS 9 (former IAS 39), the definition treats bank deposits with other banks and depository institutions as loans, which is especially relevant for account No. 1009 (from the Decision on the Chart of Accounts for Banks, OGM 82/17, 71/19, former Decision on the Chart of Accounts for Banks, OGM 55/12). Prior to 2013, the definition of loans did not include the aforementioned deposits.

* On 1 January 2018, IFRS 9 replaced IAS 39, with limited impact on the comparability of data series before and starting from 01 January 2018.

IAS 39 was introduced on 1 January 2013. The introduction of IAS 39 resulted in incomparability of a significant number of data series before and starting from 1 January 2013. Most importantly, on 1 January 2013: non-performing loans increased, as well as accounting capital, then total loans to a lesser extent, as did assets to an even lesser extent. The comparability of loan loss provisions, and therefore the comparability of net profit, was also affected by the change. As a consequence, all indicators calculated using these data series are basically incomparable before and starting from 1 January 2013. The consistency of other data series or indicators, such as liquid assets or capital adequacy ratios, has been largely maintained.

Source: Quarterly and monthly reports of banks; MONSTAT

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