# United Bank of Albania Sh.a.

**Independent Auditor's Report**
**and Financial Statements as at and**
**for the year ended December 31, 2018**

# Contents

Building a better working world

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# INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Banka e Bashkuar e Shqiperise sh.a

## Opinion

We have audited the financial statements of Banka e Bashkuar e Shqiperise sh.a (the "Bank"), which comprise the statement of financial position as at December 31, 2018 and the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects the financial position of the Bank as at December 31, 2018 and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards ("IFRS").

## Basis for opinion

We conducted our audit in accordance with International Standards on Auditing ("ISAs"). Our responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the financial statements* section of our report. We are independent of the Bank in accordance with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* ("IESBA Code") together with the ethical requirements that are relevant to our audit of the financial statements in Albania, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

## Other matter

The financial statements of Banka e Bashkuar e Shqiperise sh.a. as at and for the year ending on 31 December 2017, were audited by another auditor, who issued an unqualified opinion on April 17, 2018.

## Other information included in Banka e Bashkuar e Shqiperise 2018 Annual Report

Other information consists of the information that will be included in Bank's 2018 Annual Report other than the financial statements and our auditor's report thereon. Management is responsible for the other information. The Bank's 2018 Annual Report is expected to be made available to us after the date of this auditor's report.

Our opinion on the financial statements does not cover the other information and we will not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above when it becomes available and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

### Responsibilities of management and those charged with governance for the financial statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRS and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Bank or to cease operations or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank's financial reporting process.

### Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance of Banka e Bashkuar e Shqiperise sh.a regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Ernst & Young - Ekspertë Kontabël të Autorizuar
Dega në Shqipëri

Ernst & Young Certified Auditors

May 27, 2019
Tirana, Albania

EKSPERTE KONTABEL TE AUTORIZUAR
ERNST & YOUNG
NIPT: K61911012I
Tirane

Mario Vangjel
Certified Auditor

## Statement of Financial Position

*Amounts in ALL '000*

| | Notes | December 31, 2018 | December 31, 2017 |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | 12 | 2,663,972 | 3,517,936 |
| Restricted balances with Central Bank | 12 | 567,748 | 530,747 |
| Investments with banks and financial institutions | 11 | 3,235 | - |
| Mudaraba - investment funds | 13 | 32,557 | 50,321 |
| Murabaha - financial receivables | 14 | 4,726,570 | 4,010,307 |
| Assets acquired through legal process | 15 | 386,802 | 285,608 |
| Property, equipment and intangible assets | 16 | 163,741 | 172,384 |
| Prepaid income tax | | 13,877 | 11,048 |
| Other assets | 17 | 6,358 | 16,026 |
| **Total assets** | | **8,564,860** | **8,594,377** |
| **Liabilities** | | | |
| Due to banks and financial institutions | 18 | 518,231 | 692,975 |
| Borrowings from financial institutions | 19 | 53,922 | 217,484 |
| Due to customers | 20 | 6,564,597 | 6,270,941 |
| Provision fund | 21 | 12,369 | 13,811 |
| Other liabilities | 21 | 17,210 | 32,644 |
| **Total liabilities** | | **7,166,329** | **7,227,855** |
| **Equity** | | | |
| Share capital | 22 | 1,762,717 | 1,762,717 |
| Reserves | 22 | 109,033 | 109,033 |
| Accumulated losses | | (473,219) | (505,228) |
| **Total equity** | | **1,398,531** | **1,366,522** |
| **Total liabilities and equity** | | **8,564,860** | **8,594,377** |

The financial statements were authorized for release by the Board of Directors and signed on May 24, 2019 its behalf by:

Muhamed Prlja
*General Director*

UNITED BANK OF ALBANIA
UBA
TIRANA
BANKA E BASHKUAR E SHQIPËRISË

Zinaida Musaj
*Finance Manager*

The statement of financial position is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 5 to 67.

**Statement of Profit or Loss and Other Comprehensive Income**
*Amounts in ALL '000*

| | Notes | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|---|
| Income from banking operations | 23 | 277,767 | 253,818 |
| Customers' share in profit | 24 | (59,120) | (55,593) |
| **Net income from banking operations** | | **218,647** | **198,225** |
| Net fee and commission income | | 26,431 | 26,675 |
| Net foreign exchange loss | 25 | (31,615) | (194,118) |
| Other income | | 1,209 | 80,486 |
| **Total non-interest income, net** | | **(3,975)** | **(86,957)** |
| Impairment loss on Murabaha - financial receivables, net | 14 | 125,311 | 10,923 |
| Impairment loss on other financial assets, net | | (1,862) | - |
| FV Change on Mudaraba investment funds, net | 13 | (16,213) | (17,683) |
| Impairment loss from properties taken from collateral execution | 15 | (12,342) | - |
| Gain from disposal of properties | | 297 | - |
| Other provision | | (7,231) | (4,952) |
| Depreciation and amortization | 16 | (22,536) | (21,890) |
| Personnel expenses | 26 | (114,688) | (109,454) |
| Operating lease expenses | | (15,730) | (19,821) |
| Other administrative expenses | 27 | (118,887) | (111,637) |
| **Total operating expenses** | | **(183,881)** | **(274,514)** |
| **Profit/(Loss) before income tax** | | **30,791** | **(163,246)** |
| Current income tax expense | 28 | - | - |
| **Net profit/(loss) for the year** | | **30,791** | **(163,246)** |
| Other comprehensive income | | - | - |
| **Total comprehensive income/(loss) for the year** | | **30,791** | **(163,246)** |
| *Attributable to:* | | | |
| Parent | | 26,696 | (141,534) |
| Non- controlling interest | | 4,095 | (21,712) |
| | | **30,791** | **(163,246)** |

The statement of profit or loss and other comprehensive income is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 5 to 67.

**Statement of Cash Flows**
*Amounts in ALL '000*

| | Note | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| (Loss)/profit before income tax | | 30,791 | (163,246) |
| *Adjustments for non cash items:* | | | |
| Impairment loss on Murabaha - financial receivables, net | 14 | (125,311) | (10,923) |
| Impairment of cash and cash equivalents | 12 | 1,862 | - |
| Change in Mudaraba funds | 12 | 16,213 | 27,083 |
| Impairment on other assets | | 12,342 | - |
| Provisions | | 7,231 | - |
| Depreciation and amortization | 16 | 22,536 | 21,890 |
| Gain on disposal of property, plant and equipment | | (297) | - |
| Income from banking operations | | (277,767) | (253,818) |
| Customers' share in profit | | 59,120 | 55,593 |
| Impact of foreign exchange in cash and cash equivalents | | 31,615 | 205,647 |
| | | **(221,665)** | **(117,774)** |
| *Changes in operating assets and liabilities:* | | | |
| Increase in Murabaha – financial receivables | | (589,135) | (764,627) |
| Decrease in other assets | | (101,965) | 31,367 |
| Decrease in balances with financial institutions | | (40,236) | 189,930 |
| Increase in due to customers | | 292,466 | 1,088,638 |
| Increase in due to banks | | (338,306) | 115,566 |
| Increase/(decrease) in other liabilities | | (24,107) | 15,669 |
| | | **(1,022,948)** | **558,769** |
| Income tax received/ (paid) | | (2,829) | (4,396) |
| Cash received from banking operations | | 238,839 | 262,029 |
| Customers' share in profit paid | | (57,930) | (49,469) |
| **Net cash generated from operating activities** | | **(844,868)** | **766,933** |
| **Cash flows from investing activities** | | | |
| Disposal from sale of equipment | | 297 | - |
| Purchases of equipment and intangible assets | 16 | (13,893) | (9,291) |
| **Net cash generated from investing activitie7s** | | **(13,596)** | **(9,291)** |
| **Cash flows from financing activities** | | | |
| New borrowing | | - | - |
| **Net cash provided by financing activities** | | **-** | **-** |
| Net increase in cash and cash equivalents | | (858,464) | 757,642 |
| Impact of foreign exchange in cash and cash equivalents | | 6,362 | (205,647) |
| **Cash and cash equivalents at beginning of the year** | | **3,517,936** | **2,965,941** |
| **Cash and cash equivalents at the end of the year** | 9 | **2,665,834** | **3,517,936** |

The statement of cash flows is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 5 to 67.

**Statement of Changes in Equity**
*Amounts in ALL '000*

| | Share Capital | Reserves | Accumulated losses | Total |
|---|---|---|---|---|
| **Balance at January 1, 2017** | **1,762,717** | **97,929** | **(330,878)** | **1,529,768** |
| **Total comprehensive income for the year** | | | | |
| Net profit for the year | - | - | (163,246) | (163,246) |
| **Total comprehensive income for the year** | **-** | **-** | **(163,246)** | **(163,246)** |
| **Transactions with owners recorded directly in equity** | | | | |
| Transfer to Reserves | - | 11,104 | (11,104) | - |
| **Balance at December 31, 2017** | **1,762,717** | **109,033** | **(505,228)** | **1,366,522** |
| Impact of adopting IFRS 9 (note 10) | - | - | 1,218 | **1,218** |
| **Restated opening balances under IFRS 9** | **1,762,717** | **109,033** | **(504,010)** | **1,367,740** |
| **Comprehensive income/loss for the year** | | | | |
| Net profit for the year | - | - | 30,791 | 30,791 |
| **Total comprehensive profit for the year** | **-** | **-** | **30,791** | **30,791** |
| **Transactions with owners recorded directly in equity** | | | | |
| Transfer to Reserves | - | - | - | - |
| **Balance at December 31, 2018** | **1,762,717** | **109,033** | **(473,219)** | **1,398,531** |

The statement of changes in equity is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 5 to 67.

## 1. General

### (a) Reporting entity

United Bank of Albania (hereinafter "the Bank" or "UBA") was established in Albania to carry out banking operations in accordance with Albanian laws. Based on its Articles of Association, the Bank follows the Sharia Principles. The Bank's activities include acting as manager, on a trustee basis, of funds invested in accordance with Islamic laws and principles. The Bank is subject to Law no. 9662 "On Banks on the Republic of Albania", dated December 18, 2006 and is under the supervision of the Bank of Albania.

On November 5, 1992, the Bank received approval from the Bank of Albania for carrying out banking operations. The registration procedures were completed on 1 July 1994, the incorporation date. On 11 January 1999, pursuant to the Decision No.165, dated December 11, 1998 of the Bank of Albania, the Bank obtained the license, "For continuing the banking activity in the Republic of Albania", in accordance with Law No.8365, dated July 2, 1998, "On banks in the Republic of Albania".

The registered shareholding structure was as follows:

| | |
|---|---|
| Islamic Development Bank Jeddah | 86.7% |
| Ithmaar Bank B.S.C. | 4.63% |
| Dallah Albaraka Holding Co | 2.32% |
| Other investors | 6.35% |

The Head Office of the Bank is located in Tirana. Currently, the Bank has an Albanian network of 4 branches located in Tirana, Shkodra, Fier and Durres and 2 agencies located in Tirana. As at December 31, 2018, the Bank employs 76 staff (2017: 79 staff).

### (b) Management assessment of the ability to continue as going concern

The Bank has incurred losses in the previous financial year, and profit in the current year. In order to meet minimum capital requirements, to limit the risks from significant exposures and to continue operations, the shareholders assess on a regular basis whether there is a need for capital injections.

Following such, the Management believes that the Bank's ability to continue as going concern will not be impaired. Therefore, the Bank has prepared these financial statements on a going concern basis.

## 2. Basis of preparation

### (a) Statement of compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB).

### (b) Basis of measurement

The financial statements have been prepared on the historical cost basis, except for Mudaraba - Investment fund asset which is measured at fair value through profit or loss.

### (c) Functional and presentation currency

These financial statements are presented in Albanian Lek ('Lek'), which is the Bank's functional currency. Except as otherwise indicated, financial information presented in Lek has been rounded to the nearest thousand.

### (d) Use of estimates and judgements

The preparation of the financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised and in any future periods affected.

Significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amounts recognized in the financial statements and that are described in note 8 are:

- allowances for credit losses,
- determining fair values.

## 3. Changes in accounting policies and disclosures

### *3.1. New and amended standards and interpretations*

In these financial statements, the Bank has applied IFRS 9 and IFRS 7R, effective for annual periods beginning on or after 1 January 2018, for the first time. The Bank has not adopted early any other standard, interpretation or amendment that has been issued but is not yet effective.

### 3.1.1. IFRS 9 Financial Instruments

IFRS 9 replaces IAS 39 for annual periods on or after 1 January 2018. The Bank elected, as a policy choice permitted under IFRS 9, in accordance with IAS 39.

The Bank has not restated comparative information for 2017 for financial instruments in the scope of IFRS 9.
Therefore, the comparative information for 2017 is reported under IAS 39 and is not comparable to the information presented for 2018. Differences arising from the adoption of IFRS 9 have been recognized directly in retained earnings as of 1 January 2018 and are disclosed in Note 4.

#### 3.1.1.1. Changes to classification and measurement

To determine their classification and measurement category, IFRS 9 requires all financial assets, except equity instruments and derivatives, to be assessed based on a combination of the entity's business model for managing the assets and the instruments' contractual cash flow characteristics.

The IAS 39 measurement categories of financial assets (fair value through profit or loss (FVPL), available for sale (AFS), held-to-maturity and amortized cost) have been replaced by:

- Debt instruments at amortized cost
- Debt instruments at fair value through other comprehensive income (FVOCI), with gains or losses recycled to profit or loss on derecognition
- Equity instruments at FVOCI, with no recycling of gains or losses o profit or loss on derecognition
- Financial assets FVPL.

The accounting for financial liabilities remains largely the same as it was under IAS 39, except for the treatment of gains or losses arising from an entity's own credit risk relating to liabilities designated at FVPL, which should be presented in OCI with no subsequent reclassification to the income statement.

The Bank's classification of its financial assets and liabilities is explained in Notes 4.(d)(ii). The quantitative impact of applying IFRS 9 as at 1 January 2018 is disclosed in Note 10.

#### 3.1.1.2. Changes to the impairment calculation

The adoption of IFRS 9 has fundamentally changed the Bank's accounting for loan loss impairments by replacing IAS 39's incurred loss approach with a forward-looking expected credit loss (ECL) approach. IFRS 9 requires the Bank to record an allowance for ECLs for all loans and other debt financial assets not held at FVPL, together with loan commitments and financial guarantee contracts. The allowance is based on the ECLs associated with the probability of default in the next twelve months unless there has been a significant increase in credit risk since origination. If the financial asset meets the definition of purchased or originated credit impaired (POCI), the allowance is based on the change in the ECLs over the life of the asset. Details of the Bank's impairment method are disclosed in Note 4.(d)(iv). The quantitative impact of applying IFRS as at 1 January 2018 is disclosed in Note 10.

### 3.1.2. IFRS 7R

To reflect the differences between IFRS 9 and IAS 39, IFRS 7 *Financial Instruments: Disclosures* was updated and the Bank has adopted it, together with IFRS 9, for the year beginning 1 January 2018. Changes include:

- transition disclosures as shown in Note 10,
- detailed qualitative and quantitative information about the ECL calculations such as the assumptions and inputs used are set out in Note 4 d.

Reconciliations from opening to closing ECL allowances are presented in Notes 10, 12, 14.

## 4. Significant accounting policies

The Bank has consistently applied the following accounting policies to all periods presented in these financial statements, apart from the new standard, IFRS 9 Financial Instruments which has been implemented from 01 January 2018 using the modified restrospective approach through which the opening balances on 1 January 2018 are restated.

### (a) Foreign currency transactions

Transactions in foreign currencies are translated into the respective functional currency of the operation at the spot exchange rate at the date of the transaction.

Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated into the functional currency at the spot exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the period, adjusted for effective interest and payments during the period, and the amortised cost in foreign currency translated at the spot exchange rate at the end of the period.

Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historic cost, are translated at the prevailing foreign exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated into the functional currency at the spot exchange rate at the date that the fair value was determined.

Foreign currency differences arising on retranslation are recognized in profit or loss.

### (b) Income and expenses from banking operations

***Effective interest rate method***

Under both IFRS 9 and IAS 39, interest income is recorded using the effective interest rate (EIR) method for all financial instruments measured at amortized cost, financial instruments designated at FVPL. Interest income on interest bearing financial assets measured at FVOCI under IFRS 9, similarly to interest bearing financial assets classified as available-for-sale or held to maturity under IAS 39 are also recorded by using the EIR method. The EIR is the rate that exactly discounts estimated future cash receipts through the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset.

The EIR (and therefore, the amortized cost of the asset) is calculated by taking into account any discount or premium on acquisition, fees and costs that are an integral part of the EIR. The Bank recognizes interest income using a rate of return that represents the best estimate of a constant rate of return over the expected life of the loan. Hence, it recognizes the effect of potentially different interest rates charged at various stages, and other characteristics of the product life cycle (including prepayments, penalty interest and charges).

If expectations regarding the cash flows on the financial asset are revised for reasons other than credit risk.
The adjustment is booked as a positive or negative adjustment to the carrying amount of the asset in the balance sheet with an increase or reduction in interest income. The adjustment is subsequently amortized through *Income from banking operations* in the income statement.

***Income from banking operations – Murabaha transactions***

Income from banking operations, including income from Murabaha transactions, income from banks and other financial institutions, are recognized in profit or loss by applying the EIR to the gross carrying amount of financial assets other than credit-impaired assets.

When a financial asset becomes credit-impaired and is, therefore, regarded as 'Stage 3', the Bank calculates interest income by applying the EIR to the net amortized cost of the financial asset. If the financial assets cures and is no longer credit-impaired, the Bank reverts to calculating interest income on a gross basis.

For purchased or originated credit-impaired (POCI) financial assets, the Bank calculates interest income by calculating the credit-adjusted EIR and applying that rate to the amortized cost of the asset.

The credit-adjusted EIR is the interest rate that, at original recognition, discounts the estimated future cash flows (including credit losses) to the amortized cost of the POCI assets.

**4. Significant accounting policies (continued)**

**(b) Income and expenses from banking operations (continued)**

***Income from banking operations – Mudaraba investment***

Income from Mudaraba contracts is recognized in profit or loss when the Bank becomes entitled to that profit. Any share of losses for the period is recognized to the extent such losses are deducted from the Mudaraba capital. See accounting policy 3(j).

***Customers' share on profit***

The custmers' share on profit from deposits placed in the bank is allocated to the depositors in accordance with the Sharia principles through sharing profits on reinvested deposits. Payments are made to the depositors and charged to the account of customers as per their share in profits in accordance with the contractual maturities of the deposits. For the maintenance service provided for accounts from Mudarabah a certain fee is gained. The Profit Share allocation from Mudarabah transactions is paid and presented net of Mudarib Charge.

**(c) Fees and commission**

The Bank earns fee and commission income from a diverse range of services it provides to its customers. Fee income can be divided into the following three categories:

***A. Fee income earned from services that are provided over a certain period of time***

Fees and commisiosn earned for the provision of services over a period of time are accrued over that period. These fees include commission income, including account servicing fees, investment management fees, and placement fees.

***B. Fee income from providing financial services and earned on the execution of a significant act***

Fees and commissions arising from negotiating or participating in the negotiation of a transaction with a third party, such as other fees and commission expense relating mainly to transaction and service fees, are recognised on completion of the underlying transaction. Fees or components of fees that are linked to a certain performance are recognised after fulfilling the corresponding criteria.

***C. Fee income forming an integral part of the corresponding financial instrument***

Fees that the Bank considers to be an integral part of the corresponding financial instruments include: loan origination fees, loan commitment fees for loans that are likely to be drawn down and other credit related fees. The recognition of these fees (together with any incremental costs) form an integral part of the corresponding financial instruments and are recognised as interest income through an adjustment to the EIR. The exception is, when it is unlikely that a loan will be drawn down, the loan commitment fees are recognised as revenue on expiry. Loan commitments that are within the scope of IFRS 9 / IAS 39 (i.e., are designated as FVPL, or are at a below market rate of interest, or are settled net) are accounted for as derivatives and measured at fair value through profit or loss.

**(d) Financial instruments – initial recognition and subsequent measurement (IFRS 9)**

***Date of recognition***

Financial assets and liabilities, with the exception of loans and advances to customers and balances due to customers, are initially recognized on the trade date, i.e., the date that the Bank becomes a party to the contractual provisions of the instrument. This includes regular way trades: purchases or sales of financial ~assets that require delivery of assets within the time frame generally established by regulation or convention in the market place. Loans and advances to customers are recognized when funds are transferred to the customers' accounts. The Bank recognizes balances due to customers when funds are transferred to the Bank.

***Initial measurement of financial instruments***

The classification of financial instruments at initial recognition depends on their contractual terms and the business model for managing the instruments, as described in Notes 4.D.i.A (business model asessment and SPPI test). Financial instruments are initially measured at their fair value (as defined in Note 4.d), except in the case of financial assets and financial liabilities recorded at FVPL, transaction costs are added to, or subtracted from, this amount. When the fair value of financial instruments at initial recognition differs from the transaction price, the Bank accounts for the Day 1 profit or loss, as described below.

**4. Significant accounting policies (continued)**

***(d)* Financial instruments – initial recognition and subsequent measurement (IFRS 9) (continued)**

***Day 1 profit or loss***

When the transaction price of the instrument differs from the fair value at origination and the fair value is based on a valuation technique using only inputs observable in market transactions, the Bank recognizes the difference between the transaction price and fair value in net trading income. In those cases where fair value is based on models for which some of the inputs are not observable, the difference between the transaction price and the fair value is deferred and is only recognized in profit or loss when the inputs become observable, or when the instrument is derecognized.

***Measurement categories of financial assets and liabilities***

From 1 January 2018, the Bank classifies all of its financial assets based on the business model for managing the assets and the asset's contractual terms, measured at either:

- Amortised cost, as explained in Note 4(d)i.A
- FVOCI, as explained in Note 4(d)i.C
- FVPL, as explained in Note 4(d)i.D

The Bank classifies and measures its trading portfolio at FVPL. The Bank may designate financial instruments at FVPL, if so doing eliminates or significantly reduces measurement or recognition inconsistencies, as explained in Note 4(d)i.D.

Before 1 January 2018, the Bank classified its financial assets as loans and receivables (amortized cost) and FVPL, as explained in Note 4(d)i.A. The Bank does not have any financial assets as available-for-sale or held-to-maturity (amortized cost).

Financial liabilities, other than loan commitments and financial guarantees, are measured at amortized cost or at FVPL when they are held for trading and derivative instruments or the fair value designation is applied, as explained in Note 4(d)i.D. However, as at 31 December 2018 and 31 December 2017 there are no such financial liabilities measured at FVPL.

***(i) Financial assets and liabilities***

**A – Investments with banks and financial institutions, Murabaha financial receivables and other financial assets at amortized cost**

Before 1 January 2018, *Investments with Banks and financial institutions*, and *Murabaha financial receivables*, included non–derivative financial assets with fixed or determinable payments that were not quoted in an active market, other than those:

- That the Bank intended to sell immediately or in the near term
- That the Bank, upon initial recognition, designated as at FVPL or as available-for-sale
- For which the Bank may not recover substantially all of its initial investment, other than because of credit deterioration, which were designated as available-for-sale.

From 1 January 2018, the Bank only measures *Due from banks*, *Loans and advances to customers* and other financial investments at amortized cost if both of the following conditions are met:

- The financial asset is held within a business model with the objective to hold financial assets in order to collect contractual cash flows
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.

The details of these conditions are outlined below.

**4. Significant accounting policies (continued)**

***(d)* Financial instruments – initial recognition and subsequent measurement (IFRS 9) (continued)**
***(i)* Financial assets and liabilities (continued)**
**A – Investments with banks and financial institutions, Murabaha financial receivables and other financial assets at amortized cost (continued)**

***Business model assessment***
The Bank determines its business model at the level that best reflects how it manages groups of financial assets to achieve its business objective.

The Bank's business model is not assessed on an instrument-by-instrument basis, but at a higher level of aggregated portfolios and is based on observable factors such as:

- How the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel,
- The risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way those risks are managed,
- How managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected),
- The expected frequency, value and timing of sales are also important aspects of the Bank's assessment.

The business model assessment is based on reasonably expected scenarios without taking 'worst case' or 'stress case' scenarios into account. If cash flows after initial recognition are realised in a way that is different from the Bank's original expectations, the Bank does not change the classification of the remaining financial assets held in that business model, but incorporates such information when assessing newly originated or newly purchased financial assets going forward.

***The SPPI test***

As a second step of its classification process the Bank assesses the contractual terms of financial asets to identify whether they meet the SPPI test.

'Principal' for the purpose of this test is defined as the fair value of the financial asset at initial recognition and may change over the life of the financial asset (for example, if there are repayments of principal or amortization of the premium/discount).

The most significant elements of interest within a lending arrangement are typically the consideration for the time value of money and credit risk. To make the SPPI assessment, the Bank applies judgement and considers relevant factors such as the currency in which the financial asset is denominated, and the period for which the interest rate is set.

In contrast, contractual terms that introduce a more than *de minimis* exposure to risks or volatility in the contractual cash flows that are unrelated to a basic lending arrangement do not give rise to contractual cash flows that are solely payments of principal and interest on the amount outstanding. In such cases, the financial asset is required to be measured at FVPL.

**B - Financial assets or financial liabilities held for trading**

The Bank classifies financial assets or financial liabilities as held for trading when they have been purchased or issued primarily for short-term profit making through trading activities or form part of a portfolio of financial instruments that are managed together, for which there is evidence of a recent pattern of short-term profit taking. Held-for-trading assets and liabilities are recorded and measured in the statement of financial position at fair value. Changes in fair value are recognised in net trading income. Interest and dividend income or expense is recorded in net trading income according to the terms of the contract, or when the right to payment has been established.

The Bank does not hold any instruments for trading purposes.

**4. Significant accounting policies (continued)**

***(d)* Financial instruments – initial recognition and subsequent measurement (IFRS 9) (continued)**
***(i)* Financial assets and liabilities (continued)**

**C - Debt instruments at FVOCI (Policy applicable from 1 January 2018)**

The Bank applies the new category under IFRS 9 of debt instruments measured at FVOCI when both of the following conditions are met:

- The instrument is held within a business model, the objective of which is achieved by both collecting contractual cash flows and selling financial assets,
- The contractual terms of the financial asset meet the SPPI test.

These instruments largely comprise assets that had previously been classified as financial investments available for-sale under IAS 39. FVOCI debt instruments are subsequently measured at fair value with gains and losses arising due to changes in fair value recognised in OCI. Where the Bank holds more than one investment in the same security, they are deemed to be disposed of on a first–in first–out basis. On derecognition, cumulative gains or losses previously recognised in OCI are reclassified from OCI to profit or loss. The Bank does not have such similar financial assets measured at FVOCI.

**D - Financial assets and financial liabilities at fair value through profit or loss**

Financial assets and financial liabilities in this category are those that are not held for trading and have been either designated by management upon initial recognition or are mandatorily required to be measured at fair value under IFRS 9. Management only designates an instrument at FVPL upon initial recognition when one of the following criteria are met. Such designation is determined on an instrument-by-instrument basis:

- The designation eliminates, or significantly reduces, the inconsistent treatment that would otherwise arise from measuring the assets or liabilities or recognising gains or losses on them on a different basis; or
- The liabilities (and assets until 1 January 2018 under IAS 39) are part of a group of financial liabilities (or financial assets, or both under IAS 39), which are managed and their performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy; or
- The liabilities (and assets until 1 January 2018 under IAS 39) containing one or more embedded derivatives, unless they do not significantly modify the cash flows that would otherwise be required by the contract, or it is clear with little or no analysis when a similar instrument is first considered that separation of the embedded derivative(s) is prohibited.

Financial assets and financial liabilities at FVPL are recorded in the statement of financial position at fair value.
Changes in fair value are recorded in profit and loss with the exception of movements in fair value of liabilities designated at FVPL due to changes in the Bank's own credit risk. Such changes in fair value are recorded in the Own credit reserve through OCI and do not get recycled to the profit or loss. Interest earned or incurred on instruments designated at FVPL is accrued in interest income or interest expense, respectively, using the EIR, taking into account any discount/ premium and qualifying transaction costs being an integral part of instrument.

Interest earned on assets mandatorily required to be measured at FVPL is recorded using contractual interest rate. Dividend income from equity instruments measured at FVPL is recorded in profit or loss as other operating income when the right to the payment has been established.

Included in this classification are Investments in Mudaraba (note 4.j).

**4. Significant accounting policies (continued)**

***(d)* Financial instruments – initial recognition and subsequent measurement (IFRS 9) (continued)**
***(i)* Financial assets and liabilities (continued)**

**E - Financial guarantees, letters of credit and undrawn loan commitments**

The Bank issues financial guarantees, letters of credit and loan commitments.

Financial guarantees are initially recognised in the financial statements (within *Provisions*) at fair value, being the premium received. Subsequent to initial recognition, the Bank's liability under each guarantee is measured at the higher of the amount initially recognised less cumulative amortisation recognised in the income statement, and – under IAS 39 – the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee, or – under IFRS 9 – an ECL provision.

The premium received is recognised in the income statement in *Net fees and commission income* on a straight line basis over the life of the guarantee.

Undrawn loan commitments and letters of credits are commitments under which, over the duration of the commitment, the Bank is required to provide a loan with pre-specified terms to the customer. Similar to financial guarantee contracts, under IAS 39, a provision was made if they were an onerous contract but, from 1 January 2018, these contracts are in the scope of the ECL requirements.

The nominal contractual value of financial guarantees, letters of credit and undrawn loan commitments, where the loan agreed to be provided is on market terms, are not recorded on in the statement of financial position. The nominal values of these instruments together with the corresponding ECLs are disclosed in Note 11.

***(ii) Reclassification of financial assets and liabilities***

From 1 January 2018, the Bank does not reclassify its financial assets subsequent to their initial recognition, apart from the exceptional circumstances in which the Bank acquires, disposes of, or terminates a business line.
Financial liabilities are never reclassified. The Bank did not reclassify any of its financial assets or liabilities in 2017.

**A - Derecognition due to substantial modification of terms and conditions**

The Bank derecognises a financial asset, such as a loan to a customer, when the terms and conditions have been renegotiated to the extent that, substantially, it becomes a new loan, with the difference recognised as a derecognition gain or loss, to the extent that an impairment loss has not already been recorded. The newly recognised loans are classified as Stage 1 for ECL measurement purposes, unless the new loan is deemed to be POCI.

When assessing whether or not to derecognise a loan to a customer, amongst others, the Bank considers the following factors:

- Change in currency of the loan,
- Introduction of an equity feature,
- Change in counterparty,
- If the modification is such that the instrument would no longer meet the SPPI criterion.

If the modification does not result in cash flows that are substantially different, the modification does not result in derecognition. Based on the change in cash flows discounted at the original EIR, the Bank records a modification gain or loss, to the extent that an impairment loss has not already been recorded.

**4. Significant accounting policies (continued)**

**(d) Financial instruments – initial recognition and subsequent measurement (IFRS 9) (continued)**
***(iii) Derecognition of financial assets and liabilities***

**B - Derecognition other than for substantial modification**

**Financial assets**

A financial asset (or, where applicable, a part of a financial asset or part of a group of similar financial assets) is derecognised when the rights to receive cash flows from the financial asset have expired. The Bank also derecognises the financial asset if it has both transferred the financial asset and the transfer qualifies for derecognition.

The Bank has transferred the financial asset if, and only if, either:

- The Bank has transferred its contractual rights to receive cash flows from the financial asset; or
- It retains the rights to the cash flows, but has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass–through' arrangement.

Pass-through arrangements are transactions whereby the Bank retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), when all of the following three conditions are met:

- The Bank has no obligation to pay amounts to the eventual recipients unless it has collected equivalent amounts from the original asset, excluding short-term advances with the right to full recovery of the amount lent plus accrued interest at market rates
- The Bank cannot sell or pledge the original asset other than as security to the eventual recipients
- The Bank has to remit any cash flows it collects on behalf of the eventual recipients without material delay.

In addition, the Bank is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents including interest earned, during the period between the collection date and the date of required remittance to the eventual recipients.

A transfer only qualifies for derecognition if either:

- The Bank has transferred substantially all the risks and rewards of the asset; or
- The Bank has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

The Bank considers control to be transferred if and only if, the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer.

When the Bank has neither transferred nor retained substantially all the risks and rewards and has retained control of the asset, the asset continues to be recognised only to the extent of the Bank's continuing involvement, in which case, the Bank also recognises an associated liability. The transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the Bank has retained.

Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration the Bank could be required to pay.

If continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the continuing involvement is measured at the value the Bank would be required to pay upon repurchase. In the case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price.

**4. Significant accounting policies (continued)**

**(d) Financial instruments – initial recognition and subsequent measurement (IFRS 9) (continued)**

**Financial liabilities**

A financial liability is derecognised when the obligation under the liability is discharged, cancelled or expires.
Where an existing financial liability is replaced by another, from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability. The difference between the carrying value of the original financial liability and the consideration paid is recognised in profit or loss.

***(iv) Impairment of financial assets (Policy applicable from 1 January 2018)***

**A - Overview of the ECL principles**

As described in Note 3.1.1, the adoption of IFRS 9 has fundamentally changed the Bank's loan loss impairment method by replacing IAS 39's incurred loss approach with a forward-looking ECL approach. From 1 January 2018, the Bank has been recording the allowance for expected credit losses for all loans and other debt financial assets not held at FVPL, together with loan commitments and financial guarantee contracts, in this section all referred to as 'financial instruments'.

The ECL allowance is based on the credit losses expected to arise over the life of the asset (the lifetime expected credit loss or LTECL), unless there has been no significant increase in credit risk since origination, in which case, the allowance is based on the 12 months' expected credit loss (12mECL) as outlined in Note 4(d)iv.B. The Bank's policies for determining if there has been a significant increase in credit risk are set out in Note 7.b.

The 12mECL is the portion of LTECLs that represent the ECLs that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

Both LTECLs and 12mECLs are calculated on either an individual basis or a collective basis, depending on the nature of the underlying portfolio of financial instruments. The Bank's policy for grouping financial assets measured on a collective basis is explained in Note 7.b.

The Bank has established a policy to perform an assessment, at the end of each reporting period, of whether a financial instrument's credit risk has increased significantly since initial recognition, by considering the change in the risk of default occurring over the remaining life of the financial instrument. This is further explained in Note 7.b.

Based on the above process, the Bank groups its loans into Stage 1, Stage 2, and Stage 3, as described below:

- Stage 1: When loans are first recognised, the Bank recognises an allowance based on 12mECLs. Stage 1 loans also include facilities where the credit risk has improved and the loan has been reclassified from Stage 2.
- Stage 2: When a loan has shown a significant increase in credit risk since origination, the Bank records an allowance for the LTECLs. Stage 2 loans also include facilities, where the credit risk has improved and the loan has been reclassified from Stage 3.
- Stage 3: Loans considered credit-impaired. The bank records an allowance for the LTECLs.

**B - The calculation of ECLs**

The Bank calculates ECLs based on a three probability-weighted scenarios to measure the expected cash shortfalls, discounted at an approximation to the EIR. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive.

The mechanics of the ECL calculations are outlined below and the key elements are, as follows:

- PD - The *Probability of Default* is an estimate of the likelihood of default over a given time horizon. A default may only happen at a certain time over the assessed period, if the facility has not been previously derecognised and is still in the portfolio. The concept of PDs is further explained in Note 7.b.

**4. Significant accounting policies (continued)**

**(d) Financial instruments – initial recognition and subsequent measurement (IFRS 9) (continued)**
***(iv) Impairment of financial assets (Policy applicable from 1 January 2018) (continued)***
**B - The calculation of ECLs (continued)**

- EAD - The *Exposure at Default* is an estimate of the exposure at a future default date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, whether scheduled by contract or otherwise, expected drawdowns on committed facilities, and accrued interest from missed payments. The EAD is further explained in Note 7.b.

- LGD - The *Loss Given Default* is an estimate of the loss arising in the case where a default occurs at a given time. It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from the realisation of any collateral. It is usually expressed as a percentage of the EAD. The LGD is further explained in Note 7.b.

When estimating the ECLs, the Bank considers three scenarios, an optimistic, base and pessimistic. Each of these is associated with different PDs, EADs and LGDs, as set out in Note 4(d)iv.E. When relevant, the assessment of multiple scenarios also incorporates how defaulted loans are expected to be recovered, including the probability that the loans will cure and the value of collateral or the amount that might be received for selling the asset.

With the exception of revolving facilities, for which the treatment is separately set out in Note 4(d)iv.E, the maximum period for which the credit losses are determined is the contractual life of a financial instrument unless the Bank has the legal right to call it earlier.

Impairment losses and releases are accounted for and disclosed separately from modification losses or gains that are accounted for as an adjustment of the financial asset's gross carrying value.

The mechanics of the ECL method are summarized below:

- Stage 1: The 12mECL is calculated as the portion of LTECLs that represent the ECLs that result from default events on a financial instrument that are possible within the 12 months after the reporting date. The Bank calculates the 12mECL allowance based on the expectation of a default occurring in the 12 months following the reporting date. These expected 12-month default probabilities are applied to a forecast EAD and multiplied by the expected LGD and discounted by an approximation to the original EIR. This calculation is made for each of the three scenarios, as explained above.
- Stage 2: When a loan has shown a significant increase in credit risk since origination, the Bank records an allowance for the LTECLs. The mechanics are similar to those explained above, including the use of multiple scenarios, but PDs and LGDs are estimated over the lifetime of the instrument. The expected cash shortfalls are discounted by an approximation to the original EIR.
- Stage 3: For loans considered credit-impaired the Bank recognizes the lifetime expected credit losses for these loans.
- POCI: POCI assets are financial assets that are credit impaired on initial recognition. The Bank only recognises the cumulative changes in lifetime ECLs since initial recognition, based on a probability-weighting of the three scenarios, discounted by the creditadjusted EIR.
- Loan commitments and letters of credit: When estimating LTECLs for undrawn loan commitments, the Bank estimates the expected portion of the loan commitment that will be drawn down over its expected life. The ECL is then based on the present value of the expected shortfalls in cash flows if the loan is drawn down. The expected cash shortfalls are discounted at an approximation to the expected EIR on the loan. For revolving facilities that include both a loan and an undrawn commitment, ECLs are calculated and presented together with the loan. For loan commitments and letters of credit, the ECL is recognised within Provisions.

**C - Debt instruments measured at fair value through OCI**

The ECLs for debt instruments measured at FVOCI do not reduce the carrying amount of these financial assets in the statement of financial position, which remains at fair value. Instead, an amount equal to the allowance that would arise if the assets were measured at amortised cost is recognised in OCI as an accumulated impairment amount, with a corresponding charge to profit or loss. The accumulated loss recognised in OCI is recycled to the profit and loss upon derecognition of the assets.

**4. Significant accounting policies (continued)**

**(d) Financial instruments – initial recognition and subsequent measurement (IFRS 9) (continued)**
***(iv) Impairment of financial assets (Policy applicable from 1 January 2018) (continued)***

**D - Purchased or originated credit impaired financial assets (POCI)**

For POCI financial assets, the Bank only recognises the cumulative changes in LTECL since initial recognition in the loss allowance.

**E - Other revolving facilities**

The Bank's product offering includes retail overdraft facilities, in which the Bank has the right to cancel and/or reduce the facilities with one day's notice. The Bank does not limit its exposure to credit losses to the contractual notice period, but, instead calculates ECL over a period that reflects the Bank's expectations of the customer behaviour, its likelihood of default and the Bank's future risk mitigation procedures, which could include reducing or cancelling the facilities. Based on past experience and the Bank's expectations, the period over which the Bank calculates ECLs for these products, is seven years for retail products.

The ongoing assessment of whether a significant increase in credit risk has occurred for revolving facilities is similar to other lending products. This is based on shifts in the customer's internal credit rating, but greater emphasis is also given to qualitative factors such as changes in usage.

**F - Forward looking information**

In its ECL models, the Bank relies on a broad range of forward looking information as economic inputs, such as:

- GDP growth,

The inputs and models used for calculating ECLs may not always capture all characteristics of the market at the date of the financial statements. To reflect this, qualitative adjustments or overlays are occasionally made as temporary adjustments when such differences are significantly material. Detailed information about these inputs and sensitivity analysis are provided in Note 7.b

***(v) Collateral valuation***

To mitigate its credit risks on financial assets, the Bank seeks to use collateral, where possible. The collateral comes in various forms, such as cash, securities, letters of credit/guarantees, real estate, receivables, inventories, other non-financial assets and credit enhancements such as netting agreements. The Bank's accounting policy for collateral assigned to it through its lending arrangements under IFRS 9 is the same is it was under IAS 39. Collateral, unless repossessed, is not recorded on the Bank's statement of financial position.

However, the fair value of collateral affects the calculation of ECLs. It is generally assessed, at a minimum, at inception and re-assessed on a three year basis. However, some collateral, for example, cash or securities relating to margining requirements, is valued daily. Details of the impact of the Bank's various credit enhancements are disclosed in Note 7.b.

To the extent possible, the Bank uses active market data for valuing financial assets held as collateral. Other financial assets which do not have readily determinable market values are valued using models. Non-financial collateral, such as real estate, is valued based on data provided by third parties such as external independent appraisal.

***(vi) Collateral repossessed***

The Bank's accounting policy under IFRS 9 remains the same as it was under IAS 39. The Bank's policy is to determine whether a repossessed asset can be best used for its internal operations or should be sold. Assets determined to be useful for the internal operations are transferred to their relevant asset category at the lower of their repossessed value or the carrying value of the original secured asset. Assets for which selling is determined to be a better option are transferred as inventory ("other assets") until recognition criteria to classify these assets as "held for sale" are fulfilled, at which moment they are measured at their fair value (if financial assets) and fair value less cost to sell for non-financial assets at the repossession date in, line with the Bank's policy.

**4. Significant accounting policies (continued)**

**(d) Financial instruments – initial recognition and subsequent measurement (IFRS 9) (continued)**

***(vii) Write-offs***

The Bank's accounting policy under IFRS 9 remains the same as it was under IAS 39. Financial assets are written off either partially or in their entirety only when the Bank has stopped pursuing the recovery. If the amount to be written off is greater than the accumulated loss allowance, the difference is first treated as an addition to the allowance that is then applied against the gross carrying amount. Any subsequent recoveries are credited to credit loss expense.

***(viii) Forborne and modified loans***

The Bank sometimes makes concessions or modifications to the original terms of loans as a response to the borrower's financial difficulties, rather than taking possession or to otherwise enforce collection of collateral.

The Bank considers a loan forborne when such concessions or modifications are provided as a result of the borrower's present or expected financial difficulties and the Bank would not have agreed to them if the borrower had been financially healthy. Indicators of financial difficulties include defaults on covenants, or significant concerns raised by the Risk Department. Forbearance may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated, any impairment is measured using the original EIR as calculated before the modification of terms. It is the Bank's policy to monitor forborne loans to help ensure that future payments continue to be likely to occur.

Derecognition decisions and classification between Stage 2 and Stage 3 are determined on a case-by-case basis. If these procedures identify a loss in relation to a loan, it is disclosed and managed as an impaired Stage 3 forborne asset until it is collected or written off.

From 1 January 2018, when the loan has been renegotiated or modified but not derecognised, the Bank also reassesses whether there has been a significant increase in credit risk, as set out in Note 7.b. The Bank also considers whether the assets should be classified as Stage 3. Once an asset has been classified as forborne, it will remain forborne for a minimum 24-month probation period. In order for the loan to be reclassified out of the forborne category, the customer has to meet all of the following criteria:

- All of its facilities has to be considered performing,
- The probation period of six months has passed from the date the forborne contract was considered performing,
- Regular payments of more than an insignificant amount of principal or interest have been made during at least half of the probation period,
- The customer does not have any contract that is more than 30 days past due.

Details of forborne assets are disclosed in Note 4.f. If modifications are substantial, the loan is derecognised, as explained above.

**(f) Financial assets and financial liabilities recognition and subsequent measurement (IAS 39 - Policy applicable before 1 January 2018)**

***(i) Recognition***

The Bank initially recognizes financial receivables, deposits and investment accounts on the date at which they are originated. Regular way purchases and sales of financial assets are recognized on the trade date at which the Bank commits to purchase or sell the asset. All other financial instruments are initially recognized on the trade date at which the Bank becomes a party to the contractual provisions of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

**4. Significant accounting policies (continued)**

**(f) Financial assets and financial liabilities recognition and subsequent measurement (IAS 39 - Policy applicable before 1 January 2018) (continued)**

***(ii) Classification***

The Bank classifies its financial assets into one of the following categories:

- loans and receivables;
- held to maturity;

See accounting policies 3(i) and (j).

***(iii) Derecognition***

*Financial assets*

The Bank derecognizes a financial asset when the contractual rights to the cash flows from the financial asset expire, or when it transfers the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred or in which the Bank neither transfers nor retains substantially all the risks and rewards of ownership and it does not retain control of the financial asset. Any interest in transferred financial assets that qualify for de-recognition that is created or retained by the Bank is recognized as a separate asset or liability in the statement of financial position.

On de-recognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset transferred), and the sum of the consideration received and any cumulative gain or loss that had been recognized in other comprehensive income is recognized in profit or loss.

The Bank may enter into transactions whereby it transfers assets recognized on its statement of financial position, but retains either all or substantially all of the risks and rewards of the transferred assets or a portion of them. If all or substantially all risks and rewards are retained, then the transferred assets are not derecognized. Transfers of assets with retention of all or substantially all risks and rewards include, for example repurchase transactions.

When assets are sold to a third party with a concurrent total rate of return swap on the transferred assets, the transaction is accounted for as a secured financing transaction similar to repurchase transactions as the Bank retains all or substantially all the risks and rewards of ownership of such assets.

In transactions in which the Bank neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Bank continues to recognize the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset.

In certain transactions the Bank may retain the obligation to service the transferred financial asset for a fee. The transferred asset is derecognized if it meets the de-recognition criteria. An asset or liability is recognized for the servicing contract, depending on whether the servicing fee is more than adequate (asset) or is less than adequate (liability) for performing the servicing.

*Financial liabilities*

The Bank derecognizes a financial liability when its contractual obligations are discharged or cancelled or expire.

***(iv) Offsetting***

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Bank has a legal right to set off the recognized amounts and it intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted under IFRSs, or for gains and losses arising from a group of similar transactions such as in the Bank's trading activity.

**4. Significant accounting policies (continued)**

**(f) Financial assets and financial liabilities recognition and subsequent measurement (IAS 39 - Policy applicable before 1 January 2018) (continued)**

***(v) Amortized cost measurement***

The 'amortized cost' of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortization using the effective interest rate method of any difference between the initial amount recognized and the maturity amount, minus any reduction for impairment.

***(vi) Fair value measurement***

'Fair value' is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or, in its absence, the most advantageous market to which the Bank has access at that date. The fair value of a liability reflects its non-performance risk.

When available, the Bank measures the fair value of an instrument using the quoted price in an active market for that instrument. A market is regarded as active if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

If there is no quoted price in an active market, then the Bank uses valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The chosen valuation technique incorporates all of the factors that market participants would take into account in pricing a transaction.

The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price – i.e. the fair value of the consideration given or received.

If the Bank determines that the fair value at initial recognition differs from the transaction price and the fair value is evidenced neither by a quoted price in an active market for an identical asset or liability nor based on a valuation technique that uses only data from observable markets, then the financial instrument is initially measured at fair value, adjusted to defer the difference between the fair value at initial recognition and the transaction price. Subsequently, that difference is recognised in profit or loss on an appropriate basis over the life of the instrument but no later than when the valuation is wholly supported by observable market data or the transaction is closed out.

If an asset or a liability measured at fair value has a bid price and an ask price, then the Bank measures assets and long positions at a bid price and liabilities and short positions at an ask price.

The fair value of a demand deposit is not less than the amount payable on demand, discounted from the first date on which the amount could be required to be paid.

The Bank recognises transfers between levels of the fair value hierarchy as of the end of the reporting period during which the change has occurred.

***(vii) Identification and measurement of impairment***

At each reporting date the Bank assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired. A financial asset or a group of financial assets is (are) impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the asset(s), and that the loss event has an impact on the future cash flows of the asset(s) that can be estimated reliably.

**4. Significant accounting policies (continued)**

**(f) Financial assets and financial liabilities recognition and subsequent measurement (IAS 39 - Policy applicable before 1 January 2018) (continued)**
***(vii) Identification and measurement of impairment (continued)***

Objective evidence that financial assets (including equity securities) are impaired includes:

- significant financial difficulty of the borrower or issuer,
- default or delinquency by a borrower,
- restructuring of a financial receivables terms by the Bank on terms that the Bank would not otherwise consider,
- indications that a borrower or issuer will enter bankruptcy,
- the disappearance of an active market for a security, or
- other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the Bank, or economic conditions that correlate with defaults in the Bank. In addition, for an investment in an equity security, a significant or prolonged decline in its fair value below its cost is objective evidence of impairment.

The Bank considers evidence of impairment for financial receivables, Mudaraba investments and held-to-maturity investments at both a specific asset and collective level. All individually significant assets are assessed for specific impairment. All individually significant assets found not to be specifically impaired are then collectively assessed for any impairment that has been incurred but not yet identified.

Assets that are not individually significant are collectively assessed for impairment by grouping together financial receivables, Mudaraba investments and held-to-maturity investments with similar risk characteristics.

Those found not to be specifically impaired are then collectively assessed for any impairment that has been incurred but not yet identified. Loans and advances and held-to-maturity investment securities that are not individually significant are collectively assessed for impairment by grouping together loans and advances and held-to-maturity investment securities with similar risk characteristics.

The individual component of the total allowance for impairment applies to financial assets evaluated individually for impairment, and found to be individually impaired, and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, and the workout strategy and estimate of cash flows considered recoverable are independently approved by the Credit Risk function.

A collective component of the total allowance is established for:
- groups of homogeneous loans that are not considered individually significant; and
- groups of assets that are individually significant but that were not found to be individually impaired (loss 'incurred but not reported' or IBNR).

The collective allowance for groups of homogeneous loans is established using statistical methods such as roll rate methodology or, for small portfolios with insufficient information, a formula approach based on historical loss rate experience. The roll rate methodology uses statistical analysis of historical data on delinquency to estimate the amount of loss. Management applies judgement to ensure that the estimate of loss arrived at on the basis of historical information is appropriately adjusted to reflect the economic conditions and product mix at the reporting date. Roll rates and loss rates are regularly benchmarked against actual loss experience.

The IBNR allowance covers credit losses inherent in portfolios of Murabaha - Financial receivables, and held-to-maturity investment securities with similar credit risk characteristics when there is objective evidence to suggest that they contain impaired items but the individual impaired items cannot yet be identified. The IBNR allowance is based on historical loss rates, adjusted to reflect the current economic conditions affecting the portfolio. It reflects assumptions made about the loss emergence period – i.e. the period between a loss event occurring and it being identified. Management estimates a loss emergence period for each identified portfolio and back-tests these estimates against past experience. The factors that may influence the loss emergence period include economic and market conditions, customer behavior, portfolio management information, credit management process and collection experience.

**4. Significant accounting policies (continued)**

**(f) Financial assets and financial liabilities recognition and subsequent measurement (IAS 39 - Policy applicable before 1 January 2018) (continued)**
***(vii) Identification and measurement of impairment (continued)***

In assessing the collective loss allowance, management considers factors such as credit quality, portfolio size, concentrations and economic factors. To estimate the required allowance, assumptions are made to define how inherent losses are modelled and to determine the required input parameters, based on historical experience and current economic conditions. The accuracy of the allowance depends on the model assumptions and parameters used in determining the collective allowance.

**Measurement**

Impairment losses on assets measured at amortised cost are calculated as the difference between the carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate.

If the terms of a financial asset are renegotiated or modified or an existing financial asset is replaced with a new one due to financial difficulties of the borrower, then an assessment is made of whether the financial asset should be derecognised. If the cash flows of the renegotiated asset are substantially different, then the contractual rights to cash flows from the original financial asset are deemed to have expired. In this case, the original financial asset is derecognised and the new financial asset is recognised at fair value.

The impairment loss before an expected restructuring is measured as follows:

- If the expected restructuring will not result in derecognition of the existing asset, then the estimated cash flows arising from the modified financial asset are included in the measurement of the existing asset based on their expected timing and amounts discounted at the original effective interest rate of the existing financial asset.
- If the expected restructuring will result in derecognition of the existing asset, then the expected fair value of the new asset is treated as the final cash flow from the existing financial asset at the time of its derecognition. This amount is discounted from the expected date of derecognition to the reporting date using the original effective interest rate of the existing financial asset.

Impairment losses are recognized in profit or loss and reflected in an allowance account against loans and receivables or held-to-maturity investment securities. Interest on the impaired assets continues to be recognized through the unwinding of the discount. If an event occurring after the impairment was recognized causes the amount of impairment loss to decrease, then the decrease in impairment loss is reversed through profit or loss.

Impairment losses on available-for-sale investment securities are recognized by reclassifying the losses accumulated in the fair value reserve in equity to profit or loss. The cumulative loss that is reclassified from equity to profit or loss is the difference between the acquisition cost, net of any principal repayment and amortization, and the current fair value, less any impairment loss previously recognized in profit or loss. Changes in impairment attributable to application of the effective interest method are reflected as a component of interest income.

**Reversal of impairment and write-offs**

If, in a subsequent period, the fair value of an impaired available-for-sale debt security increases and the increase can be related objectively to an event occurring after the impairment loss was recognized, then the impairment loss is reversed through profit or loss; otherwise, any increase in fair value is recognized through other comprehensive income ("OCI"). Any subsequent recovery in the fair value of an impaired available-for-sale equity security is always recognized in OCI.

The Bank writes off a financial receivable or an investment debt security, either partially or in full, and any related allowance for impairment losses, when Bank Credit determines that there is no realistic prospect of recovery.

**4. Significant accounting policies (continued)**

**(g) Determination of fair value**

In order to show how fair values have been derived, financial instruments are classified based on a hierarchy of valuation techniques, as summarised below:

- *Level 1 financial instruments* − Those where the inputs used in the valuation are unadjusted quoted prices from active markets for identical assets or liabilities that the Bank has access to at the measurement date. The Bank considers markets as active only if there are sufficient trading activities with regards to the volume and liquidity of the identical assets or liabilities and when there are binding and exercisable price quotes available on the balance sheet date.

- *Level 2 financial instruments* − Those where the inputs that are used for valuation and are significant, are derived from directly or indirectly observable market data available over the entire period of the instrument's life. Such inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical instruments in inactive markets and observable inputs other than quoted prices such as interest rates and yield curves, implied volatilities, and credit spreads. In addition, adjustments may be required for the condition or location of the asset or the extent to which it relates to items that are comparable to the valued instrument. However, if such adjustments are based on unobservable inputs which are significant to the entire measurement, the Bank will classify the instruments as Level 3.

- *Level 3 financial instruments* − Those that include one or more unobservable input that is significant to the measurement as whole.

The Bank periodically reviews its valuation techniques including the adopted methodologies and model calibrations. However, the base models may not fully capture all factors relevant to the valuation of the Bank's financial instruments such as credit risk (CVA), own credit (DVA) and/or funding costs (FVA). Therefore, the Bank applies various techniques to estimate the credit risk associated with its financial instruments measured at fair value, which include a portfolio-based approach that estimates the expected net exposure per counterparty over the full lifetime of the individual assets, in order to reflect the credit risk of the individual counterparties for non-collateralised financial instruments.

The Bank evaluates the levelling at each reporting period on an instrument-by-instrument basis and reclassifies instruments when necessary based on the facts at the end of the reporting period.

**(h) Cash and cash equivalents**

'Cash and cash equivalents' include notes and coins on hand, unrestricted balances held with central banks and highly liquid financial assets with original maturities of three months or less from the date of acquisition that are subject to an insignificant risk of changes in their fair value, and are used by the Bank in the management of its short-term commitments.

Cash and cash equivalents are carried at amortized cost in the statement of financial position.

**(i) Murabaha - Financial receivables**

Financial receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term.

Murabaha - Financial receivables to banks are classified as loans and receivables and include:

- those classified as loans and receivables;
- finance lease receivables.

Financial receivables are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortized cost using the effective interest rate method. Loans and advances also include finance lease receivables in which the Group is the lessor (see 3.d(ii)). When the Bank purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date ("reverse repo"), the arrangement is accounted for as a loan or advance, and the underlying asset is not recognized in the Bank's financial statements.

**4. Significant accounting policies (continued)**

**(k) Investment in Mudaraba**

Investments in Mudaraba are partnerships, whereby the Bank in the role of the investor provides capital to the entrepreneur (the 'Mudarib') in order to undertake an investment activity. Investments in Mudaraba are initially recognized at fair value. Fair value of Mudaraba investment is the price that would be received from sale of the asset in an orderly transaction, without deduction of any transaction costs. Fair value of the investment in Mudaraba is determined based on reports of independent appraisers, who hold a recognised and relevant professional qualification and who have recent experience in valuation of property of similar location and category. At each reporting date, the Bank assesses whether there is objective evidence that investments are impaired and makes impairment adjustments to the closing balance.

**(l) Deposits, debt securities issued and subordinated liabilities**

Deposits, debt securities issued and subordinated liabilities are the Bank's sources of debt funding. When the Bank sells a financial asset and simultaneously enters into an agreement to repurchase the asset (or a similar asset) at a fixed price on a future date (sale and repurchase agreement), the arrangement is accounted for as a deposit, and the underlying asset continues to be recognized in the Bank's financial statements. The Bank classifies capital instruments as financial liabilities or equity instruments in accordance with the substance of the contractual terms of the instruments. The Bank's redeemable preference shares bear non-discretionary coupons and are redeemable by the holder, and are therefore included within subordinated liabilities.

Deposits, debt securities issued and subordinated liabilities are initially measured at fair value minus incremental direct transaction costs, and subsequently measured at their amortized cost using the effective interest method, except where the Bank chooses to carry the liabilities at fair value through profit or loss.

Customers' deposist principally include special investment deposits, where the depositors instruct the Bank to invest the funds in specific investments or on predetermined terms. These deposits are invested by the Bank in its own name under the terms of specific Mudarib contracts entered into with depositors. These special investment deposits, which are classified within due to customers, share the direct profit or losses of their respective investments once realised and do not, otherwise, share the Bank's profit or loss.

**(m) Leases**

The determination of whether an arrangement is a lease, or contains a lease, is based on the substance of the arrangement and requires an assessment of whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets or whether the arrangement conveys a right to use the asset.

***i. Lease payments - Lessee***

Leases that do not transfer to the Bank substantially all of the risks and benefits incidental to ownership of the leased items are operating leases. Payments made under operating leases are recognized in profit or loss on a straight-line basis over the term of the lease. Lease incentives received are recognized as an integral part of the total lease expense, over the term of the lease. Contingent rental payable is recognised as an expense in the period in which they it is incurred.

***ii. Lease assets - Lessor***

If the Bank is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, then the arrangement is classified as a finance lease and a receivable equal to the net investment in the lease is recognised and presented within Murabaha - Financial receivables (see (h)).

**4. Significant accounting policies (continued)**

**(n) Income tax**

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that it relates to items recognized directly in equity or in other comprehensive income.

***i. Current tax***

'Current tax' comprises the expected tax payable or receivable on the taxable income or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

The amount of current tax payable or receivable is the best estimate of the tax amount expected to be paid or received that reflects uncertainty related to income taxes, if any. It is measured using tax rates enacted or substantively enacted at the reporting date. Management periodically evaluates positions taken in the tax returns with respect to situations in which applicable tax regulations are subject to interpretation and establishes provisions where appropriate.

***ii. Deferred tax***

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax assets are recognised for unused tax losses, unused tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be used. Future taxable profits are determined based on business plans of the Bank and the reversal of temporary differences. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Unrecognised deferred tax assets are reassessed at each reporting date and recognised to the extent that it has become probable that future taxable profits will be available against which they can be used.

Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

Current and deferred taxes are recognised as income tax benefits or expenses in the income statement except for tax related to the fair value remeasurement of available-for-sale assets, foreign exchange differences and the net movement on cash flow hedges, which are charged or credited to OCI. These exceptions are subsequently reclassified from OCI to the income statement together with the respective deferred loss or gain. The Bank also recognises the tax consequences of payments and issuing costs, related to financial instruments that are classified as equity, directly in equity. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities against current tax assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

**(o) Tax exposures**

In determining the amount of current and deferred tax the Bank takes into account the impact of uncertain tax positions and whether additional taxes and interest may be due. The Bank believes that its accruals for tax liabilities are adequate for all open tax years based on its assessment of many factors, including interpretations of tax law and prior experience. This assessment relies on estimates and assumptions and may involve a series of judgments about future events.

New information may become available that causes the Bank to change its judgment regarding the adequacy of existing tax liabilities; such changes to tax liabilities will impact tax expense in the period that such a determination is made.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which they can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

**4. Significant accounting policies (continued)**

**(p) Assets acquired through legal process**

Assets acquired through legal process represent properties acquired through the enforcement of security over financial receivables. These assets are classified as held for sale if the carrying amount will be recovered principally through a sale transaction rather than through continuing use and the sale is highly probable if their carrying amount will be recovered principally through a sale transaction rather than through continuing use. This condition is regarded as met only when the asset (or disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset (or disposal group) and its sale is highly probable. Management must be committed to the sale, which should be expected to qualify for recognition as a completed sale within one year from the date of classification.

They are initially recognized with the lower of their carrying amount if they were not classified previously as held for sale, and the fair value less cost to sell. Non-current assets held for sale are subsequently measured at the lower of their carrying amount and fair value less costs to sell. Any impairment on these assets is recognized in the statement of profit and loss and other comprehensive income in the period when the impairment is identified.

When these assets do not meet the definition of non-current assets held for sale because either the sale is not expected to be completed within one year from the date of their classification as non-current assets held for sale or the properties are not available for immediate sale in its present condition, these assets are classified as inventories in accordance with IAS 2 "Inventories". The assets were initially recognized at fair value when acquired and adjusted for write downs to their recoverable amount.

**(q) Property and equipment**

*(i) Recognition and measurement*

Items of property and equipment are measured at cost less accumulated depreciation and accumulated impairment losses. Changes in the expected useful life are accounted for by changing the amortisation period or methodology, as appropriate, and treated as changes in accounting estimates.

Cost includes expenditures that are directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials and direct labour, any other costs directly attributable to bringing the assets to a working condition for their intended use, the costs of dismantling and removing the items and restoring the site on which they are located, and capitalized borrowing costs.

Purchased software that is integral to the functionality of the related equipment is capitalized as part of that equipment. When parts of an item of property or equipment have different useful lives, they are accounted for as separate items (major components) of property and equipment.

*(ii) Subsequent costs*

The cost of replacing a part of an item of property or equipment is recognized in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Bank and its cost can be measured reliably. The carrying amount of the replaced part is derecognized. The costs of the day-to-day servicing of property and equipment are recognized in profit or loss as incurred.

*(iii) Depreciation*

Depreciation is calculated to write off the cost of items of property and equipment less their estimated residual values using the straight-line method over their estimated useful lives, and is generally recognized in profit or loss. Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Bank will obtain ownership by the end of the lease term. Land is not depreciated.

**4. Significant accounting policies (continued)**

**(q) Property and equipment (continued)**

*(iii) Depreciation (continued)*

The estimated useful lives for the current and comparative periods are as follows:

| | |
|---|---|
| • Buildings | 20 years |
| • Motor vehicles | 5 years |
| • Office equipment | 5 years |
| • Computers and electronic equipment | 4 years |
| • Furniture and fixtures | 5 years |

Depreciation methods, useful lives and residual values are reassessed at each financial year-end and adjusted if appropriate.

*(iv) Derecognition*

Property and equipment is derecognised on disposal or when no future economic benefits are expected from its use. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is recognised in other operating income in the income statement in the year the asset is derecognised.

**(r) Intangible assets**

The Bank's other intangible assets include the value of computer software.

An intangible asset is recognised only when its cost can be measured reliably and it is probable that the expected future economic benefits that are attributable to it will flow to the Bank.

*Software*

Software acquired by the Bank is stated at cost less accumulated amortization and accumulated impairment losses. Expenditure on internally developed software is recognized as an asset when the Bank is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and can reliably measure the costs to complete the development. The capitalized costs of internally developed software include all costs directly attributable to developing the software and capitalized borrowing costs, and are amortized over its useful life. Internally developed software is stated at capitalized cost less accumulated amortization and impairment.

Subsequent expenditure on software assets is capitalized only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

The useful lives of intangible assets are assessed to be either finite or indefinite. Intangible assets with finite lives are amortised over the useful economic life. The amortisation period and the amortisation method for an intangible asset with a finite useful life are reviewed at least at each financial year-end.

Changes in the expected useful life, or the expected pattern of consumption of future economic benefits embodied in the asset, are accounted for by changing the amortisation period or methodology, as appropriate, which are then treated as changes in accounting estimates. The amortisation expense on intangible assets with finite lives is presented as a separate line item in the income statement.

Amortization is recognized in profit or loss on a straight-line basis over the estimated useful life of the software, from the date that it is available for use since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. The estimated useful life of software is four years. Assets in process, if any, are not amortized until software is implemented. Amortization methods, useful lives and residual values are reviewed at each financial year-end and adjusted if appropriate.

**4. Significant accounting policies (continued)**

**(s) Impairment of non-financial assets**

The carrying amounts of the Bank's non-financial assets, other than investment property and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in profit or loss.

An impairment loss is recognised if the carrying amount of an asset or CGU exceeds its recoverable amount.

The Bank's corporate assets do not generate separate cash inflows and are used by more than one CGU. Corporate assets are allocated to CGUs on a reasonable and consistent basis and tested for impairment as part of the testing of the CGUs to which the corporate assets are allocated.

Impairment losses are recognised in profit or loss. They are allocated first to reduce the carrying amount of any goodwill allocated to the CGU, and then to reduce the carrying amounts of the other assets in the CGU on a pro rata basis.

An impairment loss in respect of goodwill is not reversed. For other assets, an impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

**(t) Provisions**

A provision is recognized if, as a result of a past event, the Bank has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The unwinding of the discount is recognized as finance cost.

**(u) Financial guarantees and loan commitments**

In the ordinary course of business, the Bank issues financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognised in the financial statements (within 'other liabilities') at fair value, being the premium received. Subsequent to initial recognition, the Bank's liability under each guarantee is measured at the higher of the amount initially recognised less cumulative amortisation recognised in the income statement, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee.

Any increase in the liability relating to financial guarantees is recorded in the income statement in credit loss expense. The premium received is recognised in the income statement in net fees and commission income on a straight line basis over the life of the guarantee.

**(v) Employee benefits**

*i. Defined contribution plans*

Obligations for contributions to defined contribution plans are expensed as the related service is provided and recognized as personnel expenses in profit or loss. Prepaid contributions are recognized as an asset to the extent that a cash refund or a reduction in future payments is available. Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided.

**4. Significant accounting policies (continued)**

**(v) Employee benefits (continued)**

*(i) Defined contribution plans (continued)*

The Bank makes only compulsory social security contributions that provide pension benefits for employees upon retirement. The Government of Albania is responsible for providing the legally set minimum threshold for pensions in Albania under a defined contribution pension plan. The Bank's contributions to the benefit pension plan are charged to the profit or loss as incurred. The Bank recognizes as a liability the undiscounted amount of the estimated costs related to annual leave expected to be paid in exchange of the employee's service for the period completed.

*(ii) Termination benefits*

Termination benefits are recognized as an expense when the Bank is committed demonstrably, without realistic possibility of withdrawal, to a formal detailed plan to either terminate employment before the normal retirement date, or to provide termination benefits as a result of an offer made to encourage voluntary redundancy. Termination benefits for voluntary redundancies are recognized if the Bank has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably. If benefits are payable more than 12 months after the reporting period, then they are discounted to their present value.

**5. Standards and Interpretations effective in the current period**

The following new amendments to the existing standards issued by the International Accounting Standards Board (IASB) are effective for the current reporting period, but their adoption has not led to any changes in the Company's accounting policies.:

- **Amendments to IFRS 2 "Share-based Payment"** - Classification and Measurement of Share-based Payment Transactions (effective for annual periods beginning on or after 1 January 2018),
- **Amendments to IFRS 4 "Insurance Contracts"** - Applying IFRS 9 "Financial Instruments" with IFRS 4 "Insurance Contracts" (effective for annual periods beginning on or after 1 January 2018 or when IFRS 9 "Financial Instruments" is applied first time),
- **Amendments to IAS 40 "Investment Property"** - Transfers of Investment Property (effective for annual periods beginning on or after 1 January 2018),
- **IFRIC 22 "Foreign Currency Transactions and Advance Consideration"** (effective for annual periods beginning on or after 1 January 2018),
- **Amendments to IFRS 1 and IAS 28 due to "Improvements to IFRSs (cycle 2014-2016)"** resulting from the annual improvement project of IFRS (IFRS 1, IFRS 12 and IAS 28) primarily with a view to removing inconsistencies and clarifying wording (amendments to IFRS 1 and IAS 28 are applied for annual periods beginning on or after 1 January 2018).

**6. Standards issued but not yet effective**

The new and amended standards and interpretations that are issued, but not yet effective, up to the date of issuance of the Bank's financial statements are disclosed below. The Bank intends to adopt these new and amended standards and interpretations, if applicable, when they become effective.

***IFRS 16 Leases***

IFRS 16 was issued in January 2016 and it replaces IAS 17 Leases, IFRIC 4 Determining whether an Arrangement contains a Lease, SIC-15 Operating Leases-Incentives and SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease. IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases and requires lessees to account for all leases under a single on-balance sheet model similar to the accounting for finance leases under IAS 17. The standard includes two recognition exemptions for lessees – leases of 'low-value' assets (e.g., personal computers) and short-term leases (i.e., leases with a lease term of 12 months or less). At the commencement date of a lease, a lessee will recognise a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset). Lessees will be required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset.

**6. Standards issued but not yet effective (continued)**

***IFRS 16 Leases (continued)***

Lessees will be also required to remeasure the lease liability upon the occurrence of certain events (e.g., a change in the lease term, a change in future lease payments resulting from a change in an index or rate used to determine those payments). The lessee will generally recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset.

Lessor accounting under IFRS 16 is substantially unchanged from today's accounting under IAS 17. Lessors will continue to classify all leases using the same classification principle as in IAS 17 and distinguish between two types of leases: operating and finance leases.

IFRS 16, which is effective for annual periods beginning on or after 1 January 2019, requires lessees and lessors to make more extensive disclosures than under IAS 17.

**Transition to IFRS 16**

The Bank will elect to use the exemptions proposed by the standard on lease contracts for which the lease terms ends within 12 months as of the date of initial application, and lease contracts for which the underlying asset is of low value. The Bank has leases of certain office equipment (i.e., personal computers, printing and photocopying machines) that are considered of low value.

The Bank decided that it will apply the standard from its mandatory adoption date of 1 January 2019 using the modified retrospective method, without restatement of comparatives. Right-of-use assets for property leases are measured on transition at the amount of the lease liability at the amount of Lek 36,866 thousand. The actual impacts of adopting the standard on 1 January 2019 may change because the new accounting policies are subject to change until the Bank presents its first financial statements that include the date of initial application.

For the following new standards and interpretations, the Bank anticipates that their adoption will have no material impact on the financial statements of the Bank in the period of initial application and are not expected to have an impact over the financial statements of the Bank:

- **IFRS 17 "Insurance Contracts"** (effective for annual periods beginning on or after 1 January 2021),
- **IFRIC 23 "Uncertainty over Income Tax Treatments"** (effective for annual periods beginning on or after 1 January 2019).
- **Amendments to IFRS 9 "Financial Instruments"** - Prepayment Features with Negative Compensation (effective for annual periods beginning on or after 1 January 2019),
- **Amendments to IFRS 10 "Consolidated Financial Statements" and IAS 28 "Investments in Associates and Joint Ventures"** - Sale or Contribution of Assets between an Investor and its Associate or Joint Venture and further amendments (effective date deferred indefinitely until the research project on the equity method has been concluded),
- **Amendments to IAS 19: Plan Amendment, Curtailment or Settlement** - accounting when a plan amendment, curtailment or settlement occurs during a reporting period (effective for annual periods beginning on or after 1 January 2019)
- **Amendments to IAS 28 "Investments in Associates and Joint Ventures"** - Long-term Interests in Associates and Joint Ventures (effective for annual periods beginning on or after 1 January 2019),
- **Amendments to various standards due to "Improvements to IFRSs (cycle 2015-2017)"** resulting from the annual improvement project of IFRS, which become effective for annual periods beginning on or after 1 January 2019, and including:
    - IFRS 3 Business Combinations
    - IFRS 11 Joint Arrangements
    - IAS 12 Income Taxes
    - IAS 23 Borrowing costs.

## 7. Financial risk management

### (a) Introduction and overview

The Bank has exposure to the following risks from financial instruments:

- credit risk
- liquidity risk
- market risks
- operational risks.

This note presents information about the Bank's exposure to each of the above risks, the Bank's objectives, policies and processes for measuring and managing risk, and the Bank's management of capital.

***Risk management framework***

The Board of Directors has overall responsibility for the establishment and oversight of the Bank's risk management framework. The Board has established internal units and committees, which are responsible for developing and monitoring risk management policies in their specified areas.

The Bank's risk management policies are established to identify and analyse the risks faced by the Bank, to set appropriate risk limits and controls, and to monitor risks and adherence to limits. Risk management policies and systems are reviewed regularly to reflect changes in market conditions, products and services offered. The Bank aims to develop a disciplined and constructive control environment, in which all employees understand their roles and obligations.

The Audit Committee is responsible for monitoring compliance with the Bank's risk management policies and procedures, and for reviewing the adequacy of the risk management framework in relation to the risks faced by the Bank. The Bank's Audit Committee is assisted in these functions by Internal Audit. Internal Audit undertakes both regular and ad-hoc reviews of risk management controls and procedures, the results of which are reported to the Audit Committee.

### (b) Credit risk

Credit risk is the risk of financial loss to the Bank if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Bank's financial receivables and investments. For risk management reporting purposes the Bank considers and consolidates all elements of credit risk exposure (such as individual obligor default risk, location and sector risk).

***Management of credit risk***

The Board of Directors has delegated responsibility for the oversight of credit risk to the Risk Department. This unit is responsible for management of the credit risk, including:

- Formulating credit policies, covering collateral requirements, credit assessment, risk grading and reporting, documentary and legal procedures, and compliance with regulatory and statutory requirements.
- Establishing the authorisation structure for the approval and renewal of credit facilities.
- Reviewing and assessing credit risk prior to facilities being committed to customers. Renewals and reviews of facilities are subject to the same review process.
- Limiting concentrations of exposure to counterparties, geographies and industries.
- Developing and maintaining the risk grading in order to categorise exposures according to the degree of risk of financial loss faced and to focus management on the attendant risks. The risk grading system is used in determining where impairment provisions may be required against specific credit exposures.

The Credit Committee of the Bank approves credit requests of Lek 60,000 thousand or less, while credit requests of more than Lek 60,000 thousand are approved by the Board of Directors of the Bank.

Credit risk is monitored by the Risk Department of the Bank. It is their responsibility to review and manage credit risk, including environmental and social risk for all types of counterparties.

The Bank has established a credit quality review process to provide early identification of possible changes in the creditworthiness of counterparties, including regular collateral revisions. Counterparty limits are established by the use of a credit risk classification system, which assigns each counterparty a risk rating. Risk ratings are subject to regular revision. The credit quality review process aims to allow the Bank to assess the potential loss as a result of the risks to which it is exposed and take corrective actions.

**7. Financial risk management (continued)**

***(b) Credit risk (continued)***

***Exposure to credit risk***

Maximum exposures to credit risk before collateral and other credit enhancements as at December 31, 2018 and 2017 are as follows:

| | Internal Rating Grade | Notes | 31-Dec-18 | 31-Dec-17 |
|---|---|---|---|---|
| **Carrying amount at amortized cost** | | | | |
| Cash and cash equivalents | A | 12 | 2,665,834 | 3,517,936 |
| Restricted balances with Central Bank | A | 12 | 567,748 | 530,747 |
| Investments with banks and financial institutions | | | 3,235 | - |
| Mudaraba - investment funds | E | 13 | 209,749 | 216,130 |
| Murabaha – financial receivables | A - E | 14 | 4,828,598 | 4,241,260 |
| Unused part of the credit commitments | | 29 | - | 41,005 |
| Guarantees issued to customers | A | 29 | 29,595 | 52,106 |
| **Total** | | | **8,304,759** | **8,599,184** |

**Impairment assessment (Policy applicable from 1 January 2018)**

The references below show where the Bank's impairment assessment and measurement approach is set out in this report. It should be read in conjunction with the *Summary of significant accounting policies*.

• The Bank's definition and assessment of default and cure (Note 7.b).
• An explanation of the Bank's internal grading system (Note 7.b).
• How the Bank defines, calculates and monitors the probability of default, exposure at default and loss given default) (Note 7.b).
• When the Bank considers there has been a significant increase in credit risk of an exposure (Note 7.b).
• The Bank's policy of segmenting financial assets where ECL is assessed on a collective basis e (Note 7.b).
• The details of the ECL calculations for Stage 1, Stage 2 and Stage 3 assets (Note 7.b).

**(i) Definition of default and cure**

The Bank considers a financial instrument defaulted and therefore Stage 3 (credit-impaired) for ECL calculations in all cases when the borrower becomes 90 days past due on its contractual payments. The Bank defines a financial instrument as in default, which is fully aligned with the definition of credit-impaired, when it meets either of the following criteria:

1. Unlikeliness to pay ("UTP"): The client is flagged as defaulted due to unlikeliness to pay (indicated in default indicators file) and at the same time has at least 1 active financing, or
   a. significant financial difficulty of the issuer or obligor;
   b. a breach of contract, such as a default or delinquency in interest or principal payments;
   c. the creditor , for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the creditor would not otherwise consider;
   d. it becoming probable that the borrower will enter bankruptcy or other financial reorganization;
   e. the disappearance of an active market for that financial asset because of financial difficulties; or
   f. observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
      i. adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments); or

**7. Financial risk management (continued)**

***(b) Credit risk (continued)***

**Impairment assessment (Policy applicable from 1 January 2018) (continued)**

**(i) Definition of default and cure (continued)**

ii. national or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for financing assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

or

2. 90 DPD: The exposure is more than 90 days past due (DPD90) and at the same time is active and marked as defaulted by UBA bank (this identification is needed because for some financings with misaligned payments/financing, the DPD counter is not correctly reflecting the past due time)

The above criteria have been applied to all financial instruments held by the Bank and are consistent with the definition of default used for internal credit risk management purposes.

It is the Bank's policy to consider a financial instrument as 'cured' and therefore re-classified out of Stage 3 when none of the default criteria have been present for at least six consecutive months. The decision whether to classify an asset as Stage 2 or Stage 1 once cured depends on the updated credit grade, at the time of the cure, and whether this indicates there has been a significant increase in credit risk compared to initial recognition. The Bank's criterion for 'cure' for ECL purposes is less stringent than the 24 months requirement for forbearance which is explained in Note 4.d.

**(ii) The Bank's internal rating and PD estimation process**

The Bank's independent Risk Department operates its internal rating models. The Bank runs separate models for its key portfolios in which its customers are rate from 1 to 5 using internal grades. The models incorporate both qualitative and quantitative information and, in addition to information specific to the borrower, utilise supplemental external information that could affect the borrower's behavior. PDs are then adjusted for IFRS 9 ECL calculations to incorporate forward looking information and the IFRS 9. Stage classification of the exposure. This is repeated for each economic scenarios as appropriate.

In the following tables are presented the presentation of the financial assets of the Bank:

| Internal rating grade | Internal rating description | 12 month PD range | Exposure at Default |
|---|---|---|---|
| **Performing** | | | |
| A | Performing | 0.00%-4.42% | 7,516,278 |
| B | Special Mention | 4.43%-19.91% | 151,324 |
| C | Substandard | 19.92%-48.4442% | 210,904 |
| D | Doubtful | 48.4443%-84% | 261,245 |
| E | Lost | 85%-100% | 135,413 |
| **Total** | | | **8,275,164** |

Murabaha financial receivables into the determined stages and ratings:

| | 31-Dec-18 | | | | 31-Dec-17 |
|---|---|---|---|---|---|
| *Internal Rating grade* | **Stage 1** | **Stage 2** | **Stage 3** | **Total** | **Total** |
| A | 6,337,059 | 1,179,219 | - | 7,516,278 | 7,782,597 |
| B | 2,276 | 149,048 | - | 151,324 | 161,422 |
| C | 3,682 | | 207,222 | 210,904 | 40,029 |
| D | - | 10,513 | 250,732 | 261,245 | 68,570 |
| E | - | 304 | 135,109 | 135,413 | 453,455 |
| **Total** | **6,343,017** | **1,339,084** | **593,063** | **8,275,164** | **8,506,073** |

**7. Financial risk management (continued)**
***(b) Credit risk (continued)***
**Impairment assessment (Policy applicable from 1 January 2018) (continued)**

**(iii) Treasury, trading and interbank relationships**

The Bank's treasury, trading and interbank relationships and counterparties comprise financial services institutions, banks etc. For these relationships, the Bank's risk department analyses publicly available information such as financial information and other external data, e.g., the rating of international rating agencies (S&P) and assigns the internal rating.

**(iv) Corporate and small business lending**

For corporate loans, the borrowers are assessed by specialised risk employees of the Bank. The credit risk assessment is based on a credit scoring model that takes into account various historical, current and forward-looking information such as:

- Historical financial information together with forecasts and budgets prepared by the client. This financial information includes realised and expected results, solvency ratios, liquidity ratios and any other relevant ratios to measure the client's financial performance.
- Any publicly available information on the clients from external parties. This includes external rating grades issued by rating agencies, independent analyst reports, publicly traded bond or CDS prices or press releases and articles.
- Any macro-economic or geopolitical information, e.g., GDP growth relevant for the specific industry and geographical segments where the client operates.
- Any other objectively supportable information on the quality and abilities of the client's management relevant for the company's performance.

The complexity and granularity of the rating techniques varies based on the exposure of the Bank and the complexity and size of the customer. Some of the less complex small business loans are rated within the Bank's models for retail products.

**(v) Consumer lending and retail mortgages**

Consumer lending comprises personal loans, mortgages and overdrafts. These products along with retail mortgages and some of the less complex small business lending are rated by an automated scorecard tool primarily driven by days past due. Other key inputs into the models are:

- Consumer lending products: use of limits and volatility thereof, GDP growth, unemployment rates, changes in personal income/salary levels based on records of current accounts, personal indebtedness and expected interest repricing
- Retail mortgages: GDP growth, unemployment rates, changes in personal income/salary levels based on records of current accounts, personal indebtedness and expected interest repricing

**(vi) Exposure at Default**

Exposure at default is based on the amounts the Bank expects to be owed at the time of default, over the next 12 months or over the remaining lifetime. The 12-month and lifetime EADs are determined based on the expected payment profile, which varies by product type. For amortising products and bullet repayment financings, this is based on the contractual repayments owed by the borrower over a 12-month or lifetime basis.

To calculate the EAD for a Stage 1 loan, the Bank assesses the possible default events within 12 months for the calculation of the 12mECL. However, if a Stage 1 loan that is expected to default in the 12 months from the balance sheet date and is also expected to cure and subsequently default again, then all linked default events are taken into account. For Stage 2, Stage 3 and POCI financial assets, the exposure at default is considered for events over the lifetime of the instruments.

The Bank determines EADs by modelling the range of possible exposure outcomes at various points in time, corresponding the multiple scenarios. The IFRS 9 PDs are then assigned to each economic scenario based on the outcome of Bank's models.

**7. Financial risk management (continued)**

***(b) Credit risk (continued)***

**Impairment assessment (Policy applicable from 1 January 2018) (continued)**

**(vii) Loss Given Default**

For the loan portfolio, LGD values are assessed at least every three months by the Bank's specialized risk department. The risk assessment is based on a standardised LGD assessment framework that results in a certain LGD rate. These LGD rates take into account the expected EAD in comparison to the amount expected to be recovered or realised from any collateral held. The Bank segments its portfolio into business and retail lending, based on key characteristics that are relevant to the estimation of future cash flows.

The Bank estimates regulatory and IFRS 9 LGDs on a single basis. Under IFRS 9, LGD rates are estimated for the Stage 1, Stage 2, Stage 3 and POCI IFRS 9 segment of each asset class. The inputs for these LGD rates are estimated and, where possible, calibrated through back testing against recent recoveries. These are repeated for each economic scenario as appropriate.

**(viii) Significant increase in credit risk**

The Bank continuously monitors all assets subject to ECLs. In order to determine whether an instrument or a portfolio of instruments is subject to 12mECL or LTECL, the Bank assesses whether there has been a significant increase in credit risk since initial recognition. The Bank considers an exposure to have significantly increased in credit risk when the IFRS 9 lifetime PD has doubled since initial recognition and has increased by more than 10 DPD.

The Bank also applies a secondary qualitative method for triggering a significant increase in credit risk for an asset, such as moving a customer/facility to the watch list, or the account becoming forborne. In certain cases, the Bank may also consider that events explained in Note 7.b are a significant increase in credit risk as opposed to a default. Regardless of the change in credit grades, if contractual payments are more than 10 days past due, the credit risk is deemed to have increased significantly since initial recognition.

When estimating ECLs on a collective basis for a group of similar assets (as set out in Note 7.), the Bank applies the same principles for assessing whether there has been a significant increase in credit risk since initial recognition.

**(ix) Grouping financial assets measured on a collective basis**

As explained in Note 2.6.1 dependant on the factors below, the Bank calculates ECLs either on a collective or an individual basis. Asset classes where the Bank calculates ECL on an individual basis include:

- the specific nature of the financing and its contractual and financial conditions (maturity, reference rate, etc.);
- the exposure profile until maturity in relation to potential market movements;
- the existence of collateral or guarantees; and
- the potential for default based on the internal risk rating.
- The treasury, trading and interbank relationships (such as Due from Banks, Cash collateral on securities borrowed and reverse repurchase agreements and debt instruments at amortised cost/FVOCI
- Exposures that have been classified as POCI when the original loan was derecognised and a new loan was recognised as a result of a credit driven debt restructuring.

Asset classes where the Bank calculates ECL on a collective basis include:

• The smaller and more generic balances of the Bank's Small business lending
• Stage 1 and 2 business and retail
• Purchased POCI exposures managed on a collective basis

**7. Financial risk management (continued)**
***(b) Credit risk (continued)***
**Impairment assessment (Policy applicable from 1 January 2018) (continued)**
**(ix) Grouping financial assets measured on a collective basis (continued)**

The Bank groups these exposure into smaller homogeneous portfolios, based on a combination of internal and external characteristics of the loans, like:

• Product type (buy to let/owner occupied, overdraft, unsecured personal loan, credit card, etc.)
• Property type (prime, standard grade, low grade)
• Geographic location/residence of the borrower
• Loan-to-value ratios
• Internal grade
• Exposure value
• Utilisation
• Exposure value
• Borrower's industry
• Collateral type

**(x) Forward-looking Information**

The assessment of a significant increase in credit risk and the calculation of expected credit losses both incorporate forward-looking information. The Bank has performed historical analysis and identified key economic variables impacting credit risk and expected credit losses for each portfolio.

The impact of economic variables on the probability of default, loss given default and exposure at default is determined using statistical regression to understand the impact changes in these variables have had historically on default rates and on the components of loss given default and exposure at default.

In addition to the base economic scenario, the model also provides a best case and worst case scenario and scenario weightings to ensure non-linearities are captured. The Bank has concluded that three scenarios or less appropriately captures non-linearity. The scenario weightings are determined by a combination of statistical analysis, taking account of the range of possible outcomes each chosen scenario is representative of. The Bank considers these forecasts represent its best estimate of the possible outcomes.

**(xi) Analysis of Contractual Cash Flow Characteristics**

Once the Bank determines that the business model of a specific portfolio is to hold the financial assets to collect the contractual cash flows (or by both collecting contractual cash flows and selling financial assets), it must assess whether the contractual terms of the financial asset give rise on specific dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. For this purpose, interest is defined as a consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin. This assessment will be carried out on an instrument-by-instrument basis on the date of initial recognition of the financial asset.

When assessing whether contractual cash flows are solely payments of principal and interest, the Bank has considered the contractual terms of the instrument. This will include assessing whether the financial asset contains a contractual term that could change the timing or amount of contractual cash flows such that it would not meet this condition. The Bank considers:

- Prepayment, extension terms
- If a claim is limited to specified assets or cash flows
- Contractually-linked instruments

**(xii) Impairment General**

The calculation of expected credit losses requires the use of accounting estimates which, by definition, will rarely equal the actual results. Management exercises judgement in applying the Bank's accounting policies.

**7. Financial risk management (continued)**

***(b) Credit risk (continued)***

**Impairment assessment (Policy applicable from 1 January 2018) (continued)**

**(xii) Impairment General (continued)**

Financial instruments in Stage 1 have their expected credit loss measured at an amount equal to the portion of lifetime expected credit losses that result from default events possible in the next 12 months. Instruments in Stages 2 or 3 have their expected credit losses measured based on expected credit losses on a lifetime basis.

**(xiii) Explanation of Inputs, Assumptions and Estimation Techniques**

The expected credit loss is measured on either a 12-month or lifetime basis depending on whether a significant increase in credit risk has occurred since initial recognition, or whether an asset is considered to be credit-impaired. Forward-looking economic information is also included in determining the 12-month and lifetime PD, EAD. These assumptions vary by clients type divided into Business and Retail. Expected credit losses are the discounted product of the probability of default (PD) and exposure at default (EAD)

**(xiv) Probability of Default**

The probability of default represents the likelihood of a borrower defaulting on its financial obligation over the next 12 months or over the remaining lifetime of the obligation. As a rule, the lifetime probability of default is calculated using the 12 month probability of default, stripped of any margin of conservatism, as a starting point. Thereafter, various statistical methods are used to generate an estimate of how the default profile will develop from the point of initial recognition throughout the lifetime of the financing or portfolio of financings.

In the limited cases where some inputs are not fully available grouping, averaging and benchmarking of inputs are used for the calculation.

**(xv) Sensitivity Analysis**

The most significant assumptions affecting the expected credit loss allowance are as follows:

Business portfolios

- Quarterly GDP by Production Approach, Seasonally adjusted – GDP current prices:
  - Industry
  - Real Estate Services
  - VSHB Gross Value Added
  - PBB gross Domestic Product

- Quarterly GDP by expenditure approach, constant prices
  - Final Consumption Expenditures
  - Gross fixed Capital Formation
  - Domestic Absorption
  - Net Export
  - Import
  - Export

- Retail portfolios Labour Market – Labour Force Survey:
  - Unemployment rate
  - Labour Force Participation

- Prices:
  - Consumer Price Index (CPI)
  - Producer Price Index (PPI)

**7. Financial risk management (continued)**

***(b) Credit risk (continued)***

**Impairment assessment (Policy applicable from 1 January 2018) (continued)**

**(xv) Sensitivity Analysis (continued)**

**Write-off policy**

The Bank writes off an asset balance, and any related allowances for impairment losses, when the Risk Department determines that the asset is uncollectible. This determination is made after considering information such as the occurrence of significant changes in the borrower's / issuer's financial position such that the borrower / issuer can no longer pay the obligation, or that proceeds from collateral will not be sufficient to pay back the entire exposure. For smaller balance standardised financial receivables, write-off decisions generally are based on a product-specific past due status.

During year 2018 the Bank has not written off financial receivables (In 2017: Lek 26,268 thousand).

**Collateral and other credit enhancements**

The Bank holds collateral against financial receivables in the form of mortgage interests over property, other registered securities over assets, and guarantees. Estimates of fair value are based on the value of collateral assessed at the time of borrowing, and are updated on three years frequency and also when the asset is individually assessed as impaired. An estimate of the fair value of collateral held against financial receivables at December 31, 2018 and 2017 is shown below:

**7. Financial risk management (continued)**
***(b) Credit risk (continued)***

**Collateral and other credit enhancements (continued)**

| **31-Dec-18** | **Maximum exposure to credit risk** | **Real Estate** | **Machinery, Equipment and Inventories** | **Cash collateral** | **Other** | **Total collateral** | **Net exposure** | **Associated ECLs** |
|---|---|---|---|---|---|---|---|---|
| **Financial assets** | | | | | | | | |
| Balances with Banks | 2,665,834 | - | - | - | - | - | **2,663,972** | 1,862 |
| Restricted balances with Central Bank | 567,748 | - | - | - | - | - | **567,748** | - |
| Investments with banks and financial institutions | 3,235 | - | - | - | - | - | **3,235** | - |
| Mudaraba - investment funds | 209,749 | - | - | - | - | - | **32,557** | 177,192 |
| Due from financing activities | 4,828,598 | 10,794,662 | 704,054 | 22,825 | 947,954 | 12,469,495 | **4,726,570** | 102,028 |
| *Business* | *3,614,148* | *8,176,010* | *662,308* | *7,763* | *836,642* | *9,682,723* | *3,549,929* | *64,219* |
| *Retail* | *1,214,450* | *2,618,652* | *41,746* | *15,062* | *111,312* | *2,786,772* | *1,176,641* | *37,809* |
| Unused part of the credit commitments | - | - | - | - | - | - | - | - |
| Guarantees issued to customers | 29,595 | - | - | - | - | - | 29,595 | - |
| **Total** | **8,304,759** | **10,794,662** | **704,054** | **22,825** | **947,954** | **12,469,495** | **8,023,677** | **281,082** |

| **31-Dec-17** | **Maximum exposure to credit risk** | **Real Estate** | **Machinery, Equipment and Inventories** | **Cash collateral** | **Other** | **Total collateral** | **Net exposure** | **Associated ECLs** |
|---|---|---|---|---|---|---|---|---|
| **Financial assets** | | | | | | | | |
| Balances with Banks | 3,517,936 | - | - | - | - | - | **3,517,936** | - |
| Restricted balances with Central Bank | 530,747 | - | - | - | - | - | **530,747** | - |
| Investments with banks and financial institutions | - | - | - | - | - | - | - | - |
| Mudaraba - investment funds | 216,130 | - | - | - | - | - | **50,321** | 165,809 |
| Due from financing activities | 4,241,260 | 10,664,470 | 659,242 | 64,529 | 21,100 | 11,409,341 | **4,010,307** | 230,953 |
| *Business* | *3,231,496* | *8,468,777* | *412,486* | *27,269* | - | *8,908,532* | *3,035,502* | *195,994* |
| *Retail* | *1,009,764* | *2,195,693* | *246,756* | *37,260* | *21,100* | *2,500,809* | *974,805* | *34,959* |
| Unused part of the credit commitments | 41,005 | - | - | - | - | - | **41,005** | - |
| Guarantees issued to customers | 52,106 | - | - | - | - | - | **52,106** | - |
| **Total** | **8,599,184** | **10,664,470** | **659,242** | **64,529** | **21,100** | **11,409,341** | **8,202,422** | **396,762** |

**7. Financial risk management (continued)**

***(b) Credit risk (continued)***

**Collateral and other credit enhancements (continued)**

Collateral generally is not required for balances with banks and financial institutions, and no such collateral was held at December 31, 2018 or 2017.

The financial effect of the collateral is being presented by dividing the value of the collateral seperately:

(i) those assets where the value of collateral are equal or overpassed the accounting value of the assets(over-collateralised), and

(ii) those assets where the value of collateral are less than the accounting value of the assets (under collateralised assets).

The tables show the values of the key forward looking economic variables/assumptions used in each of the economic scenarios for the ECL calculations:

| **31-Dec-18** | **Business** | **Retail** | **Total** |
|---|---|---|---|
| Optimistic(25%) | 15,537 | 8,357 | **23,894** |
| Base(50%) | 32,077 | 18,834 | **50,911** |
| Pesimistic(25%) | 16,605 | 10,618 | **27,223** |
| **Total** | **64,219** | **37,809** | **102,028** |

| **01-Jan-18** | **Business** | **Retail** | **Total** |
|---|---|---|---|
| Optimistic(25%) | 46,707 | 9,789 | **56,496** |
| Base(50%) | 94,106 | 20,682 | **114,788** |
| Pesimistic(25%) | 47,473 | 10,978 | **58,451** |
| **Total** | **188,286** | **41,449** | **229,735** |

The value of the collaterals for 31 December 2018 are as below:

| **2018** | **Over collateralised Assets** | | **Under collateralised Assets** | |
|---|---|---|---|---|
| | **Accounting value of the assets** | **Fair Value of the collateral** | **Accounting value of the assets** | **Fair Value of the collateral** |
| Corporate | 686,307 | 1,408,352 | - | - |
| SME | 2,579,051 | 7,489,693 | 55,852 | 9,626 |
| Physical Persons | 276,566 | 771,530 | 7,099 | 3,523 |
| Individuals | 1,138,539 | 2,745,002 | 85,183 | 41,770 |

The value of the collaterals for 31 December 2017 are as below:

| **2017** | **Over collateralised Assets** | | **Under collateralised Assets** | |
|---|---|---|---|---|
| | **Accounting value of the assets** | **Fair Value of the collateral** | **Accounting value of the assets** | **Fair Value of the collateral** |
| Corporate | 669,268 | 1,351,185 | - | - |
| SME | 2,165,646 | 6,856,963 | 92,017 | 59,620 |
| Physical Persons | 261,135 | 614,047 | 35,529 | 26,717 |
| Individuals | 967,764 | 2,471,570 | 49,900 | 29,239 |

**7. Financial risk management (continued)**

***(b) Credit risk (continued)***

**Collateral and other credit enhancements (continued)**

Details of assets obtained by the Bank through taking possession of collateral held as security against financial receivables are shown in Note 12. The Bank's policy is to pursue realisation of the collateral. The Bank generally does not use the non-cash collateral for its own operations.

Details of Mudaraba-investment funds held by the Bank at December 31, 2018 and 2017, are shown in Note 13.

The Bank monitors concentrations of credit risk by sector and by geographic location. An analysis of concentrations of credit risk from cash and cash equivalents, investments with banks and financial institutions, and restricted balances with Central Bank (together as 'Cash and balances with banks'), Due from financing activities at the reporting date is shown below:

| | Cash and balances with banks | | | | Due from financing activities | | | |
|---|---|---|---|---|---|---|---|---|
| | **31-Dec-18** | **As a % of total** | **31-Dec-17** | **As a % of total** | **31-Dec-18** | **As a % of total** | **31-Dec-17** | **As a % of total** |
| Carrying amount | 3,236,817 | | 4,048,683 | | 4,828,598 | | 4,241,260 | |
| **Concentration by sector** | | | | | | | | |
| Corporate | - | | - | | 3,412,790 | 71% | 2,983,855 | 70% |
| Government | 985,073 | 30% | 443,349 | 11% | - | 0% | - | 0% |
| Financial institutions | 2,251,744 | 70% | 3,605,334 | 89% | 201,358 | 4% | 247,641 | 6% |
| Retail | - | 0% | - | 0% | 1,214,450 | 25% | 1,009,764 | 24% |
| **Total** | **3,236,817** | | **4,048,683** | | **4,828,598** | | **4,241,260** | |
| % of concentration for each instrument | 40% | | 49% | | 60% | | 51% | |

**7. Financial risk management (continued)**

***(b) Credit risk (continued)***

**Analyses of risk concentration**

Concentration by location for balances with banks and financial institutions is measured based on the location of the Bank entity holding the asset, which has a high correlation with the location of the borrower. Concentration by location for investment securities is measured based on the location of the issuer of the security. The cash and balances with banks are held with the Central Bank of Albania which is rated B+ (2017: B+) and banks and financial institutions that based on Standard & Poor's ratings were rated as follows:

| | Cash and balances with banks | | Due from financing activities | |
|---|---|---|---|---|
| | **31-Dec-18** | **31-Dec-17** | **31-Dec-18** | **31-Dec-17** |
| Rated A to BBB+ | 868 | 359 | - | - |
| Rated BBB to B- | 2,702,507 | 3,039,201 | - | - |
| Not rated | 206,245 | 612,731 | 4,828,598 | 4,241,260 |
| | **2,909,620** | **3,652,291** | **4,828,598** | **4,241,260** |
| Cash on hand (Note 12) | 327,197 | 396,392 | - | - |
| **Total** | **3,236,817** | **4,048,683** | **4,828,598** | **4,241,260** |

Cash and balances with banks includes restricted balances with Central Bank and investments with banks and financial institutions.

The risk concentration according to the economic sectors within the portfolio of the due from financings are as below:

| *In thousands Leke* | 31-Dec-18 | | 31-Dec-17 | |
|---|---|---|---|---|
| | **Amount** | **%** | **Amount** | **%** |
| Trade, maintenance and repair of motor vehicles and household items | 2,188,336 | 45.32% | 1,502,615 | 35.43% |
| Retail | 1,214,451 | 25.15% | 1,145,430 | 27.01% |
| Production and distribution of electricity, gas and water | 50,440 | 1.04% | 0 | 0.00% |
| Processing Industry | 336,444 | 6.97% | 455,938 | 10.75% |
| Construction | 696,740 | 14.43% | 516,212 | 12.17% |
| Monetary and financial intermediation | 201,358 | 4.17% | 254,309 | 6.00% |
| Transport, storage and telecommunication | 15,133 | 0.31% | 40,997 | 0.97% |
| Agriculture, hunting, forestry | 521.6 | 0.01% | 10,988 | 0.26% |
| Collective activities, social and individual | 23,866 | 0.49% | 41,909 | 0.99% |
| Healthcare and social work activities | 12,705 | 0.26% | 22,598 | 0.53% |
| Education | 41,980 | 0.87% | 32,588 | 0.77% |
| Hotel and restaurants | 41,320 | 0.86% | 109,417 | 2.58% |
| Others | 5,303 | 0.11% | 108,259 | 2.55% |
| **Total of due from financings (before provisions)** | **4,828,598** | **100%** | **4,241,260** | **100%** |

**7. Financial risk management (continued)**

***(b) Credit risk (continued)***

**Analyses of risk concentration (continued)**

Financial receivables detailed as per business segments as per 31 December 2018 and 31 December 2017 are shown in the below tables:

| | 31-Dec-18 | | | | | |
|---|---|---|---|---|---|---|
| | **Individuals** | **Corporates** | **SME** | **Physical Persons** | **Staff** | **Total** |
| **Overdraft** | 1,389 | - | - | - | - | 1,389 |
| **Financings** | | | | | | |
| Short Term | 2,173 | 396,785 | 902,589 | 41,952 | 822 | 1,344,321 |
| Medium Term | 135,178 | 82,996 | 1,021,044 | 56,887 | 8,371 | 1,304,476 |
| Long Term | 1,020,877 | 208,799 | 747,064 | 186,229 | 62,986 | 2,225,955 |
| Minus Disbursement Fee | (17,338) | (4,047) | (22,625) | (3,525) | (8) | (47,543) |
| **Total** | **1,142,229** | **684,533** | **2,648,072** | **281,543** | **72,171** | **4,828,598** |

| | 31-Dec-17 | | | | | |
|---|---|---|---|---|---|---|
| | **Individuals** | **Corporates** | **SME** | **Physical Persons** | **Staff** | **Total** |
| **Overdraft** | **1,195** | **-** | **-** | **-** | **-** | **1,195** |
| **Financings** | | | | | | |
| Short Term | 8,564 | 386,181 | 874,953 | 59,438 | 792 | 1,329,928 |
| Medium Term | 134,593 | 59,161 | 791,310 | 64,686 | 12,248 | 1,061,998 |
| Long Term | 828,562 | 209,326 | 636,111 | 174,470 | 38,588 | 1,887,057 |
| Minus Disbursement Fee | (14,768) | (3,515) | (16,762) | (3,863) | (10) | (38,918) |
| **Total** | **958,146** | **651,153** | **2,285,612** | **294,731** | **51,618** | **4,241,260** |

At December 31, 2018 and 2017, the Bank had the following undrawn credit commitments:

| | 31-Dec-18 | 31-Dec-17 |
|---|---|---|
| Unused part of the credit commitments | - | 41,005 |

**Impairment analyses**

The analysis of the impairment for the financial receivables as of December 31, 2018 and 2017 and the movements in the impairment losses are presented in Note 14.

The profit rate for the financings vary from 2.5% to 13.53% per year for the foreign currency and from 2.26% to 17% per year in Leke (31 December 2017: from 2.5% to 13.53 per year in foreign currency and from 2.26% to 17% per year in Leke). The movements in the provisions for the due from financings detailed as per the business segments for 31 December 2018 and 31 December 2017 are shown in the tables below:

| | 31-Dec-18 | | | | | |
|---|---|---|---|---|---|---|
| | **Individuals** | **Corporates** | **SME** | **Physical Persons** | **Staff** | **TOTAL** |
| **Amounts at the beginning of the year** | **34,959** | **-** | **189,347** | **6,589** | **58** | **230,953** |
| Changes in ECL from adoption of IFRS 9 | 4,817 | 2,259 | (6,624) | (3,285) | 1,615 | (1,218) |
| **Restated amounts at the beginning of the year** | **39,776** | **2,259** | **182,723** | **3,304** | **1,673** | **229,735** |
| Expenses for impairment | 11,704 | 1,047 | 14,028 | 2,402 | 185 | 29,366 |
| Reversal os impairment | (20,635) | (992) | (132,998) | (1,039) | (1,409) | (157,073) |
| **Amounts at the end of the year** | **30,845** | **2,314** | **63,753** | **4,667** | **449** | **102,028** |

**7. Financial risk management (continued)**

**(c) Liquidity risk**

Liquidity risk is the risk that the Bank will encounter difficulty in meeting obligations associated with its financial liabilities that are settled by delivering cash or another financial asset.

***Management of liquidity risk***

The Bank's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Bank's reputation.

Treasury receives information from other units regarding the liquidity profile of their financial assets and liabilities and details of other projected cash flows arising from projected future business. Treasury then maintains a portfolio of short-term liquid assets, largely made up of short-term liquid treasury bills and balances with banks and other financial institutions, to ensure that sufficient liquidity is maintained within the Bank as a whole.

Treasury monitors compliance with local regulatory limits on a daily basis. All liquidity policies and procedures are subject to review and approval by Bank Asset and Liability Committee ('ALCO').

The Bank relies on deposits from customers and banks, and contributions from its shareholders as its primary sources of funding. While contributions from shareholders do not have specified maturities, deposits from customers and banks generally have short maturities and a large proportion of them are repayable on demand. The short-term nature of these deposits increases the Bank's liquidity risk and the Bank actively manages this risk through maintaining competitive pricing and constant monitoring of market trends. As at December 31, 2018 the twenty largest balances due to customers represent 27.78% of the total deposits (in 2017: 30%).

**7. Financial risk management (continued)**

***(c) Liquidity risk (continued)***

The following table shows the Bank's financial assets and liabilities by remaining contractual maturity at December 31, 2018 and 2017:

| 2018 | Unallocated | Up to 1 month | 1-3 months | 3-6 months | Up to 1 year | Over 1 year | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with banks* | 567,748 | 2,669,069 | - | - | - | - | 3,236,817 |
| Due from financing activities | - | 326,419 | 447,403 | 407,172 | 981,377 | 2,666,227 | 4,828,598 |
| Mudaraba - investment funds | - | - | - | - | - | 209,749 | 209,749 |
| **Total** | **567,748** | **2,995,488** | **447,403** | **407,172** | **981,377** | **2,875,976** | **8,275,164** |
| **Liabilities** | | | | | | | |
| Due to banks & financial institutions | - | 394,874 | 123,357 | - | - | - | 518,231 |
| Borrowings from financial institution | - | 53,922 | - | - | - | - | 53,922 |
| Due to customers | - | 2,602,094 | 735,381 | 792,398 | 1,354,159 | 1,080,565 | 6,564,597 |
| **Total** | **-** | **3,050,890** | **858,738** | **792,398** | **1,354,159** | **1,080,565** | **7,136,750** |
| **Liquidity gap** | **567,748** | **(55,402)** | **(411,335)** | **(385,226)** | **(372,782)** | **1,795,411** | **1,138,414** |
| **Cumulative gap** | **567,748** | **512,346** | **101,011** | **(284,215)** | **(656,997)** | **1,138,414** | |

| 2017 | Unallocated | Up to 1 month | 1-3 months | 3-6 months | Up to 1 year | Over 1 year | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with banks* | 530,525 | 3,151,353 | 366,805 | - | - | - | 4,048,683 |
| Due from financing activities | - | 457,985 | 260,042 | 452,987 | 824,544 | 2,245,702 | 4,241,260 |
| Mudaraba - investment funds | - | - | - | - | - | 216,130 | 216,130 |
| **Total** | **530,525** | **3,609,338** | **626,847** | **452,987** | **824,544** | **2,461,832** | **8,506,073** |
| **Liabilities** | | | | | | | |
| Due to banks & financial institutions | - | 560,025 | 132,950 | - | - | - | 692,975 |
| Borrowings from financial institution | - | 217,484 | - | - | - | - | 217,484 |
| Due to customers | - | 2,731,459 | 601,330 | 650,860 | 1,624,263 | 663,029 | 6,270,941 |
| **Total** | **-** | **3,508,968** | **734,280** | **650,860** | **1,624,263** | **663,029** | **7,181,400** |
| **Liquidity gap** | **530,525** | **100,370** | **(107,433)** | **(197,873)** | **(799,719)** | **1,798,803** | **1,324,673** |
| **Cumulative gap** | **530,525** | **630,895** | **523,462** | **325,589** | **(474,130)** | **1,324,673** | |

*Cash and cash equivalents, investments with banks and financial institutions, and restricted balances with Central Bank are presented together as 'Cash and balances with banks'.

**7. Financial risk management (continued)**

***(c) Liquidity risk (continued)***

The previous table shows the discounted cash flows on the Bank's financial instruments, on the basis of their earliest possible contractual maturity. The Bank's expected cash flows on these instruments vary significantly from this analysis. For example, demand deposits from customers are expected to maintain a stable or increasing balance. The table below set out the remaining contractual maturities, undiscounted, for non-derivative financial liabilities including commitments and financial guarantees:

| **31-Dec-18** | **Carrying amount** | **Gross nominal outflow** | | | | |
|---|---|---|---|---|---|---|
| | | **Up to 1 month** | **1-3 months** | **3-6 months** | **Up to 1 year** | **Over 1 year** |
| Due to banks & financial institutions | **518,231** | 394,874 | 123,357 | - | - | - |
| Borrowings from financial institution | **53,922** | 53,922 | - | - | - | - |
| Due to customers | **6,564,597** | 2,720,062 | 736,296 | 793,042 | 1,362,543 | 1,097,698 |
| Commitments/ Financial guarantees | **29,595** | 29,595 | - | - | - | - |
| **Total** | **7,166,345** | **3,198,453** | **859,653** | **793,042** | **1,362,543** | **1,097,698** |

| **31-Dec-17** | **Carrying amount** | **Gross nominal outflow** | | | | |
|---|---|---|---|---|---|---|
| | | **Up to 1 month** | **1-3 months** | **3-6 months** | **Up to 1 year** | **Over 1 year** |
| Due to banks & financial institutions | **692,975** | 560,008 | 132,967 | - | - | - |
| Borrowings from financial institution | **217,484** | 217,484 | - | - | - | - |
| Due to customers | **6,270,941** | 2,773,673 | 604,434 | 654,588 | 1,627,776 | 651,235 |
| Commitments/ Financial guarantees | **52,106** | 52,106 | - | - | - | - |
| **Total** | **7,233,506** | **3,603,271** | **737,401** | **654,588** | **1,627,776** | **651,235** |

To manage the liquidity risk arising from financial liabilities, the Bank holds liquid assets comprising cash and cash equivalents and investments for which there is an active and liquid market. These assets can be readily used to meet liquidity requirements.

**7. Financial risk management (continued)**

**(d) Market risks**

Market risk is the risk that changes in market prices, such as rates and foreign exchange rates will affect the Bank's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return on risk.

***Exposure to market rates risk***

The principal risk to which non-trading portfolios are exposed is the risk of loss from fluctuations in the future cash flows or fair values of financial instruments because of a change in market rates. The Bank attempts to mitigate this risk by monitoring the repricing dates of its assets and liabilities. In addition, the actual effect will depend on a number of other factors, including the extent to which repayments are made earlier or later than the contracted dates and variations in sensitivity within repricing periods and among currencies.

***Interest rate re-pricing analysis***

The following table presents re-pricing dates for the Bank's assets and liabilities. Variable-rate assets and liabilities have been reported according to their next rate change date. Fixed-rate assets and liabilities have been reported according to their scheduled principal repayment dates (the earlier of contractual re–pricing or maturity dates).

| 2018 | Up to 1 month | 1 to 3 months | 3 to 6 months | 6 to 12 months | Over 1 year | Non-interest bearing | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with banks | 1,318,065 | - | - | - | - | 1,918,752 | 3,236,817 |
| Due from finance. Activities | 326,420 | 447,403 | 407,172 | 981,377 | 2,666,226 | - | 4,828,598 |
| Mudaraba - investment funds | - | - | - | - | - | 209,749 | 209,749 |
| **Total** | **1,644,485** | **447,403** | **407,172** | **981,377** | **2,666,226** | **2,128,501** | **8,275,164** |
| **Liabilities** | | | | | | | |
| Due to banks & financial institutions | 136,036 | 123,437 | - | - | - | 258,758 | 518,231 |
| Borrowings from financial institution | 53,922 | - | - | - | - | - | 53,922 |
| Due to customers | 901,314 | 735,381 | 792,398 | 1,354,159 | 1,080,565 | 1,700,780 | 6,564,597 |
| **Total** | **1,091,272** | **858,818** | **792,398** | **1,354,159** | **1,080,565** | **1,959,538** | **7,136,750** |
| **Gap** | **553,213** | **(411,415)** | **(385,226)** | **(372,782)** | **1,585,661** | **168,963** | **1,138,414** |
| **Cumulative gap** | **553,213** | **141,798** | **(243,428)** | **(616,210)** | **969,451** | **1,138,414** | **-** |

**7. Financial risk management (continued)**
**(d) Market risk (continued)**

| 2017 | Up to 1 month | 1 to 3 months | 3 to 6 months | 6 to 12 months | Over 1 year | Non-interest bearing | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with banks | 2,418,023 | 366,805 | - | - | - | 1,263,855 | 4,048,683 |
| Due from finance. Activities | 457,985 | 260,042 | 452,987 | 824,544 | 2,245,702 | - | 4,241,260 |
| Mudaraba - investment funds | - | - | - | - | - | 216,130 | 216,130 |
| **Total** | **2,876,008** | **626,847** | **452,987** | **824,544** | **2,245,702** | **1,479,985** | **8,506,073** |
| **Liabilities** | | | | | | | |
| Due to banks & financial institutions | - | 560,025 | 132,950 | - | - | - | 692,975 |
| Borrowings from financial institution | - | 217,484 | - | - | - | - | 217,484 |
| Due to customers | 887,155 | 600,530 | 650,360 | 1,617,263 | 647,029 | 1,868,604 | 6,270,941 |
| **Total** | **887,155** | **1,378,039** | **783,310** | **1,617,263** | **647,029** | **1,868,604** | **7,181,400** |
| **Gap** | **1,988,853** | **(751,192)** | **(330,323)** | **(792,719)** | **1,598,673** | **(388,619)** | **1,324,673** |
| **Cumulative gap** | **1,988,853** | **1,237,661** | **907,338** | **114,619** | **1,713,292** | **1,324,673** | **-** |

The management of interest rate risk against interest rate gap limits is supplemented by monitoring the sensitivity of the Bank's financial assets and liabilities to various rate scenarios. An analysis of the Bank's sensitivity to an increase or decrease in market interest rates, assuming no asymmetrical movement in yield curves and a constant financial position, is as follows:

| 2018 | up to 1 Year scenarios | | over 1 Year scenarios | |
|---|---|---|---|---|
| | 100 bp Increase | 100 bp Decrease | 100 bp Increase | 100 bp Decrease |
| Estimated Profit (loss) effect | (6,185) | 6,185 | 9,671 | (9,671) |

| 2017 | up to 1 Year scenarios | | over 1 Year scenarios | |
|---|---|---|---|---|
| | 100 bp Increase | 100 bp Decrease | 100 bp Increase | 100 bp Decrease |
| Estimated Profit (loss) effect | (851) | 851 | 14,902 | (14,902) |

**7. Financial risk management (continued)**
**(d) Market risk (continued)**

Interest rate movements affect retained earnings arising from increases or decreases in net income from banking operations and the fair value changes reported in profit or loss.

The equivalent weighted average interest rates for the main financial assets and liabilities are as follows:

| | Equivalent weighted average interest rate | | | | | |
|---|---|---|---|---|---|---|
| | (Lek) | | (USD) | | (EUR) | |
| *December 31* | **2018** | **2017** | **2018** | **2017** | **2018** | **2017** |
| **Assets** | | | | | | |
| Due from banks and financial institutions | 1.05% | 1.28% | 3.19% | 2.14% | 1.22% | 0.92% |
| Financial receivables | 6.07% | 6.52% | 4.81% | 5.08% | 4.83% | 5.36% |
| **Liabilities** | | | | | | |
| Due to banks and financial institutions | 0.00% | 0.00% | 2.05% | 0.80% | 0% | 0.10% |
| Due to customers | 2.14% | 1.72% | 0.59% | 0.65% | 0.65% | 0.59% |

***Foreign currency risk***

Currency risk is the risk that the value of financial instruments will fluctuate due to changes in foreign exchange rates. The Bank attempts to manage this risk by closing daily open foreign currency positions and by establishing and monitoring limits on open positions.

The following table summarizes the Bank's net foreign currency position of financial assets and liabilities at December 31, 2018 and 2017, presented in Lek thousand, and a sensitivity analysis of the profits of banks due to changes in the exchange rate of LEK versus other major currencies to which the Bank has exposures.

| **31-Dec-18** | **LEK** | **USD** | **EUR** | **Other** | **Total** |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and balances with banks | 926,470 | 1,210,938 | 1,075,090 | 24,319 | 3,236,817 |
| Due from fin. Activities | 1,923,695 | 1,097,645 | 1,807,258 | - | 4,828,598 |
| Treasury bills held-to-maturity | - | - | - | - | - |
| Mudaraba - investment funds | - | 209,749 | - | - | 209,749 |
| **Total** | **2,850,165** | **2,518,332** | **2,882,348** | **24,319** | **8,275,164** |
| **Liabilities** | | | | | |
| Due to banks &financial institutions | 23,496 | 317,303 | 177,432 | - | 518,231 |
| Borrowings from financial institution | - | 53,922 | - | - | 53,922 |
| Due to customers | 3,211,322 | 676,964 | 2,652,747 | 23,564 | 6,564,597 |
| **Total** | **3,234,818** | **1,048,189** | **2,830,179** | **23,564** | **7,136,750** |
| **Net position** | **(384,653)** | **1,470,143** | **52,169** | **755** | **1,138,414** |
| **Cumulative Gap** | **(384,653)** | **1,085,490** | **1,137,659** | **1,138,414** | **-** |

| **Sensitivity analysis*** | **Effect of FCR** | **Effect of FCR** | **Effect of FCR** |
|---|---|---|---|
| Lek - +/- 10% | +/- 147,014 | +/- 5,217 | -/+ 75.5 |
| Lek - +/- 5% | +/- 73,507 | +/- 2,608 | -/+ 75.5 |

* Against both currencies, EUR and USD.

**7. Financial risk management (continued)**

**(d) Market risk (continued)**

| 31-Dec-17 | LEK | USD | EUR | Other | Total |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and balances with banks | 757,743 | 1,571,704 | 1,689,829 | 29,407 | 4,048,683 |
| Due from fin. Activities | 1,858,772 | 640,062 | 1,742,426 | - | 4,241,260 |
| Mudaraba - investment funds | - | 216,130 | - | - | 216,130 |
| **Total** | **2,616,515** | **2,427,896** | **3,432,255** | **29,407** | **8,506,073** |
| **Liabilities** | | | | | |
| Due to banks &financial institutions | - | 92,127 | 600,848 | - | 692,975 |
| Borrowings from financial institution | - | 111,122 | 106,362 | - | 217,484 |
| Due to customers | 2,924,625 | 711,414 | 2,599,592 | 35,310 | 6,270,941 |
| **Total** | **2,924,625** | **914,663** | **3,306,802** | **35,310** | **7,181,400** |
| **Net position** | **(308,110)** | **1,513,233** | **125,453** | **(5,903)** | **1,324,673** |
| **Cumulative Gap** | **(308,110)** | **1,205,123** | **1,330,576** | **1,324,673** | **-** |

| Sensitivity analysis | Effect of FCR | Effect of FCR | Effect of FCR |
|---|---|---|---|
| Lek - +/- 10% | +/- 151,323 | +/- 12,545 | -/+ 590 |
| Lek - +/- 5% | +/- 75,662 | +/- 6,273 | -/+ 295 |

**(e) Operational risks**

Operational risk is the risk of direct or indirect loss arising from a wide variety of causes associated with the Bank's processes, personnel, technology and infrastructure, and from external factors other than credit, market and liquidity risks such as those arising from legal and regulatory requirements and generally accepted standards of corporate behavior. Operational risks arise from all of the Bank's operations.

The Bank's objective is to manage operational risk so as to balance the avoidance of financial losses and damage to the Bank's reputation with overall cost effectiveness and to avoid control procedures that restrict initiative and creativity. The implementation of controls to address operational risk is supported by the development of overall standards for the management of operational risk in the following areas:

- requirements for appropriate segregation of duties, including the independent authorisation of transactions
- requirements for the reconciliation and monitoring of transactions
- compliance with regulatory and other legal requirements
- documentation of controls and procedures
- requirements for the periodic assessment of operational risks faced, and the adequacy of controls and procedures to address the risks identified
- requirements for the reporting of operational losses and proposed remedial action
- development of contingency plans
- training and professional development
- ethical and business standards
- risk mitigation, including insurance where this is effective.

Compliance with internal standards is supported by a programme of periodic reviews undertaken by Internal Audit. The results of Internal Audit reviews are discussed with the management of the business unit to which they relate, with summaries submitted to the Audit Committee and senior management of the Bank.

**7. Financial risk management (continued)**

**(d) Capital management**

***Regulatory capital***

The Bank monitors the adequacy of its capital using, among other measures, the rules and ratios established by the Albanian regulator, the Bank of Albania ("BoA"), which ultimately determines the statutory capital required to underpin its business. The regulation "On capital adequacy" is issued pursuant to the Banking Law. The regulatory capital at December 31 2018 and 2017 was as follows:

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Total shareholders' fund* | 1,223,611 | 1,249,557 |
| Deductible intangible assets* | (8,108) | (3,286) |
| Deductible portion of fixed assets* | - | - |
| **Regulatory capital (see note 1 (b))*** | **1,215,503** | **1,246,271** |

*The amounts in the table represent amounts based on Bank of Albania requirements, which differ from those amounts reported in accordance with IFRS. The financial statements prepared in accordance with Bank of Albania requirements are not finalised at the time of completion of these financial statements. However, the Management believes that the Bank's ability to continue as going concern will not be impaired.

***Capital Adequacy Ratio***

The Capital Adequacy Ratio is the proportion of the regulatory capital to risk weighted assets and 'off balance-sheet' items, expressed as a percentage. The minimum Capital Adequacy Ratio required by Bank of Albania is 12%. The Modified Capital Adequacy Ratio is the proportion of the base capital to risk-weighted assets and 'off balance-sheet' items, expressed as a percentage. The minimum modified capital adequacy is 6%.

The Bank has complied with imposed Capital Adequacy Ratios during the period. As at 31 December 2018, the capital adequacy ratio was 19.87% (in 2017: 21.19%).

***Risk-Weighted Assets (RWAs)***

Assets are weighted according to broad categories of notional risk, being assigned a risk weighting according to the amount of capital deemed to be necessary to support them. Four categories of risk weights (0%, 20%, 50%, and 100%) are applied; for example, cash and money market instruments with Bank of Albania have a zero risk weighting, which means that no capital is required to support the holding of these assets. Property and equipment carries a 100% risk weighting, meaning that capital equal to 12% of the carrying amount must support it.

Credit related commitments are taken into account and are weighted for risk using the same percentages as for assets.

## 8. Maturity analysis of assets and liabilities

The table below shows an analysis of assets and liabilities analysed according to when they are expected to be recovered or settled. Trading assets and liabilities including derivatives have been classified to mature and/or be repaid within 12 months, regardless of the actual contractual maturities of the products. With regard to loans and advances to customers, the Bank uses the same basis of expected repayment behaviour as used for estimating the EIR. Issued debt reflect the contractual coupon amortisations.

| **2018** | **Within 12 months** | **After 12 months** | **31-Dec-18** |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | 2,663,972 | - | 2,663,972 |
| Restricted balances with Central Bank | 567,748 | - | 567,748 |
| Investments with banks and financial institutions | 3,235 | - | 3,235 |
| Mudaraba - investment funds | - | 32,557 | 32,557 |
| Murabaha - financial receivables | 2,142,434 | 2,584,136 | 4,726,570 |
| Assets acquired through legal process | - | 386,802 | 386,802 |
| Property, equipment and intangible assets | - | 163,741 | 163,741 |
| Prepaid income tax | 13,877 | - | 13,877 |
| Other assets | 6,358 | - | 6,358 |
| **Total assets** | **5,397,624** | **3,167,236** | **8,564,860** |
| **Liabilities** | | | |
| Due to banks and financial institutions | 518,231 | - | 518,231 |
| Borrowings from financial institutions | 53,922 | - | 53,922 |
| Due to customers | 5,484,032 | 1,080,565 | 6,564,597 |
| Provision fund | - | 12,369 | 12,369 |
| Other liabilities | - | 17,210 | 17,210 |
| **Total liabilities** | **6,056,185** | **1,110,143** | **7,166,328** |
| **Net** | **(658,561)** | **2,057,092** | **1,398,531** |

| **2017** | ***Within 12 months*** | **After 12 months** | **31-Dec-17** |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | 3,517,936 | - | 3,517,936 |
| Restricted balances with Central Bank | 530,747 | - | 530,747 |
| Mudaraba - investment funds | - | 50,321 | 50,321 |
| Murabaha - financial receivables | 1,995,558 | 2,245,702 | 4,241,260 |
| Assets acquired through legal process | - | 285,608 | 285,608 |
| Property, equipment and intangible assets | - | 172,384 | 172,384 |
| Prepaid income tax | 11,048 | - | 11,048 |
| Other assets | 16,026 | - | 16,026 |
| **Total assets** | **5,981,315** | **2,613,062** | **8,594,377** |
| **Liabilities** | | | |
| Due to banks and financial institutions | 692,975 | - | 692,975 |
| Borrowings from financial institutions | 217,484 | - | 217,484 |
| Due to customers | 5,607,912 | 663,029 | 6,270,941 |
| Provision fund | - | 13,811 | 13,811 |
| Other liabilities | - | 32,644 | 32,644 |
| **Total liabilities** | **6,518,371** | **709,484** | **7,227,855** |
| **Net** | **(537,056)** | **1,903,578** | **1,366,522** |

## 9. Use of estimates and judgments

Management discusses with the Audit Committee the development, selection and disclosure of the Bank's critical accounting policies and estimates, and the application of these policies and estimates.

These disclosures supplement the commentary on financial risk management (see note 7).

***Impairment losses on financial assets – IFRS 9 Policy applicable after 1 January 2018***

The measurement of impairment losses both under IFRS 9 and IAS 39 across all categories of financial assets requires judgement, in particular, the estimation of the amount and timing of future cash flows and collateral values when determining impairment losses and the assessment of a significant increase in credit risk. These estimates are driven by a number of factors, changes in which can result in different levels of allowances.

The Bank's ECL calculations are outputs of complex models with a number of underlying assumptions regarding the choice of variable inputs and their interdependencies. Elements of the ECL models that are considered accounting judgements and estimates include:

- The Bank's internal credit grading model, which assigns PDs to the individual grades
- The Bank's criteria for assessing if there has been a significant increase in credit risk and so allowances for financial assets should be measured on a LTECL basis and the qualitative assessment
- The segmentation of financial assets when their ECL is assessed on a collective basis
- Development of ECL models, including the various formulas and the choice of inputs
- Determination of associations between macroeconomic scenarios and, economic inputs, such as unemployment levels and collateral values, and the effect on PDs, EADs and LGDs
- Selection of forward-looking macroeconomic scenarios and their probability weightings, to derive the economic inputs into the ECL models.

***Allowances for credit losses – IAS 39 Policy applicable before 1 January 2018***

Assets accounted for at amortised cost are evaluated for impairment on a basis described in accounting policy 4(f)(vii).

The Bank reviews its loan portfolios to assess impairment on a monthly basis. In determining whether an impairment loss should be recorded in profit or loss, the Bank makes judgments as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

**9. Use of estimates and judgments (continued)**

***Determining fair values***

The determination of fair value for financial assets and liabilities for which there is no observable market price requires the use of valuation techniques as described in accounting policy 3(f)(vi). Fair values analysed by level in the fair value hierarchy and carrying value of assets not measured at fair value are as follows:

| | 2018 | | | |
|---|---|---|---|---|
| | **Fair Value Level 1** | **Fair Value Level 2** | **Fair Value Level 3** | **Total** |
| Cash and cash equivalents | - | - | 2,663,975 | **2,663,975** |
| Mudaraba - investment funds | - | - | 32,557 | **32,557** |
| Financial receivables | - | - | 4,726,570 | **4,726,570** |
| Due to banks and financial institutions | - | - | 518,231 | **518,231** |
| Borrowings from financial institutions | - | - | 53,922 | **53,922** |
| Due to customers | - | - | 6,564,597 | **6,564,597** |

| | 2017 | | | |
|---|---|---|---|---|
| | **Fair Value Level 1** | **Fair Value Level 2** | **Fair Value Level 3** | **Total** |
| Cash and cash equivalents | - | - | 3,517,936 | 3,517,936 |
| Mudaraba - investment funds | - | - | 50,321 | 50,321 |
| Financial receivables | - | - | 4,010,307 | 4,010,307 |
| Due to banks and financial institutions | - | - | 692,975 | 692,975 |
| Borrowings from financial institutions | - | - | 217,484 | 217,484 |
| Due to customers | - | - | 6,270,941 | 6,270,941 |

*Financial Receivables*

Financial Receivables are net of allowances for impairment. The Bank's portfolio has an estimated fair value approximately equal to its book value due to their underlying equivalent interest rates, wich approximate market rates. A significant portion of the portfolio is subject to re-pricing within a year.

*Cash and cash equivalents*

Cash and cash equivalents include current accounts in second tier banks. As these balances are short term and at floating rates their fair value is considered to equate to their carrying amount

*Investment in Mudaraba*

At December 31, 2018, the Bank measured the value of this investment with reference to the market prices as per appraisal reports and recognized an allowance for impairment of Lek 186,190 thousand (2017: Lek 175,080 thousand) (see Note 13).

*Deposits and borrowings*

The time deposits have an estimated fair valye approximately equal to their carrying amount,because of their short-term nature and underlying interest rates, which approximate market rates. The majority of the deposits mature within one year.

**10. Transition Disclosures**

The following pages set out the impact of adopting IFRS 9 on the statement of financial position, and retained earnings including the effect of replacing IAS 39's incurred credit loss calculations with IFRS 9's ECLs.

A reconciliation between the carrying amounts under IAS 39 to the balances reported under IFRS 9 as of 1 January 2018 is, as follows:

| | IAS 39 Measurement | | Re- | Remeasurement | | IFRS 9 | |
|---|---|---|---|---|---|---|---|
| **Financial Assets** | **Category** | **Amount** | **classification** | **ECL** | **Other** | **Amount** | **Category** |
| Cash and cash equivalents | L&R | 3,517,936 | - | - | - | 3,517,936 | AC |
| Restricted balances with Central Bank | L&R | 530,747 | - | - | - | 530,747 | AC |
| Mudaraba - investment funds | FVPL | 50,321 | - | - | - | 50,321 | FVPL |
| Murabaha - financial receivables | L&R | 4,010,307 | - | (1,218) | - | 4,011,525 | AC |
| | | **8,109,311** | **-** | **(1,218)** | **-** | **8,110,529** | |
| **Non-financial assets** | | | | | | | |
| Deferred tax assets | | - | - | - | - | - | |
| **Total Assets** | | | | | | | |
| **Financial liabilities** | | | | | | | |
| Due to banks and financial institutions | AC | 692,975 | - | - | - | 692,975 | AC |
| Borrowings from financial institutions | AC | 217,484 | - | - | - | 217,484 | AC |
| Due to customers | AC | 6,270,941 | - | - | - | 6,270,941 | AC |
| | | **7,181,400** | **-** | **-** | **-** | **7,181,400** | |
| **Non-financial liabilities** | | | | | | | |
| Provisions | | 13,811 | - | - | - | 13,811 | |
| **Total Liabilities** | | **13,811** | **-** | **-** | **-** | **13,811** | |

**10. Transition Disclosures (Continued)**

The impact of transition to IFRS 9 on reserves and retained earnings is, as follows:

| | Reserves and Retained Earnings |
|---|---|
| **Retained Earnings** | |
| Closing balance under IAS 39 (31 December 2017) | (505,228) |
| Reclassification adjustments in relation to adopting IFRS 9 | 1,218 |
| Deferred tax in relation to the above | - |
| *Opening balance under IFRS 9 (1 January 2018)* | *(504,010)* |
| **Total change in equity due to adopting IFRS 9** | **1,218** |

The following table reconciles the aggregate opening loan loss provision allowances under IAS 39 and provisions for loan commitments and financial guarantee contracts in accordance with IAS 37 Provisions Contingent Liabilities and Contingent Assets to the ECL allowances under IFRS 9. Further details are disclosed in Notes 7.1, 8.1, 9.1, 10.1 and 11.1.

| | Loan loss provision under IAS 39/IAS 37 at 31 December 2017 | Remeasurement | ECLs under IFRS 9 at 1 January 2018 |
|---|---|---|---|
| **Impairment allowance for** | | | |
| Loans as per IAS 39/financial assets at amortised cost under IFRS 9 | 230,953 | (1,218) | 229,735 |
| Mudaraba investment as per IAS 39/Debt instruments at FVPL under IFRS 9: | 175,080 | - | 175,080 |
| Available-for-sale debt investment securities per IAS 39/debt financial assets at FVOCI under IFRS 9 | - | - | - |
| | **406,033** | **(1,218)** | **404,815** |
| Financial guarantees | - | - | - |
| | **-** | **-** | **-** |
| | **406,033** | **(1,218)** | **404,815** |

**11. Credit loss expense**

The table below shows the ECL charges on financial instruments for the year recorded in the income statement:

| **2018** | **Stage 1 Individual** | **Stage 1 Collective** | **Stage 2 Individual** | **Stage 2 Collective** | **Stage 3** | **POCI** | **Total** |
|---|---|---|---|---|---|---|---|
| Cash and cash equivalents | - | 1,862 | - | - | - | - | 1,862 |
| Mudaraba - investment funds | - | - | - | - | 16,212 | - | 16,212 |
| Murabaha - financial receivables | - | 2,470 | - | 5,922 | (133,703) | - | (125,311) |
| Financial Guarantees | - | - | - | - | - | - | - |
| **Total Impairment Loss** | **-** | **4,332** | **-** | **5,922** | **(117,491)** | **-** | **(107,237)** |

The table below shows the impairment charges recorded in the income statement under IAS 39 during 2017:

| **2017** | **Specific** | **Collective (individually not significant exposures)** | **Collective (Incurred but not yet identified)** | **Total** |
|---|---|---|---|---|
| **Credit loss expense on Loans and advances to customers** | | | | |
| Corporate | - | - | - | - |
| SME | 84,462 | (70,200) | - | 14,262 |
| Consumer Lending | 9,458 | (12,797) | - | (3,339) |
| Residential mortgages | - | - | - | - |
| | **93,920** | **(82,997)** | **-** | **10,923** |
| **Credit loss expense on financial Investments at FV** | **-** | **-** | **-** | **-** |
| **Total on Balance sheet items** | **93,920** | **(82,997)** | **-** | **10,923** |
| Off Balance sheet items | - | - | - | - |
| **Total** | **93,920** | **(82,997)** | **-** | **10,923** |

## 12. Cash and cash equivalents

| | 31-Dec-18 | 31-Dec-17 |
|---|---|---|
| Cash on hand | 327,197 | 396,392 |
| Current accounts with Central Bank | 417,325 | (87,398) |
| Current accounts with other banks | 603,247 | 889,994 |
| Term investments with maturities of three months or less | 1,318,065 | 2,318,948 |
| Less: Allowance for impairment losses | (1,862) | - |
| | **2,663,972** | **3,517,936** |

### *12.1 Impairment allowance for cash and cash equivalents*

The table below shows the credit quality and the maximum exposure to credit risk based on the Bank's internal credit rating system and year-end stage classification. The amounts presented are gross of impairment allowances, and include all balances with Banks, other than cash on hand. Details of the Bank's internal grading system are explained in Note 12.3.3.2 and policies about whether ECL allowances are calculated on an individual or collective basis are set out in Note 12.3.3.6:

| | 2018 | | | | 2017 |
|---|---|---|---|---|---|
| | Stage 1 Individual | Stage 2 Individual | Stage 3 | Total | Total |
| **Internal Rating Grade** | | | | | |
| **Performing** | **2,665,834** | **-** | **-** | **2,665,834** | **3,517,936** |
| High grade | 2,665,834 | - | - | 2,665,834 | 3,517,936 |
| Standard grade | - | - | - | - | - |
| Sub-standard grade | - | - | - | - | - |
| Past due but not impaired | - | - | - | - | - |
| **Non-Performing** | **-** | **-** | **-** | **-** | **-** |
| Individually Impairment | - | - | - | - | - |
| **Total** | **2,665,834** | **-** | **-** | **2,665,834** | **3,517,936** |

An analysis of changes in the gross carrying amount and the corresponding ECL allowances is, as follows:

| | Stage 1 Individual | Stage 2 Individual | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| **Gross carrying amount as at 1 January 2018** | **3,517,936** | **-** | **-** | **-** | **3,517,936** |
| New assets originated or purchased | 1,522,602 | - | - | - | 1,522,602 |
| Assets derecognised or repaid | (2,374,704) | - | - | - | (2,374,704) |
| Transfers to Stages | - | - | - | - | - |
| Changes to contractual cash flows due to modifications not resulting in derecognition | - | - | - | - | - |
| Amounts written off | - | - | - | - | - |
| Foreign exchange adjustments | - | - | - | - | - |
| **At 31 December 2018** | **2,665,834** | **-** | **-** | **-** | **2,665,834** |

| | Stage 1 Individual | Stage 2 Individual | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| **ECL allowance as at 1 January 2018** | **-** | **-** | **-** | **-** | **-** |
| New assets originated or purchased | - | - | - | - | - |
| Assets derecognised or repaid | - | - | - | - | - |
| Transfers to Stages | - | - | - | - | - |
| Changes to contractual cash flows due to modifications not resulting in derecognition | 1,862 | - | - | - | 1,862 |
| Amounts written off | - | - | - | - | - |
| Foreign exchange adjustments | - | - | - | - | - |
| **At 31 December 2018** | **1,862** | **-** | **-** | **-** | **1,862** |

**12. Cash and cash equivalents (continued)**

**12.1 Impairment allowance for cash and cash equivalents (continued)**

**Restricted balances with Central Bank**

For the deposits in foreing currencies, the rate is 12.5%, for those that it is not applied the rate 0% and the ratio of deposits in respective currencies against the total deposits, is up to 50%. The remaining, that the ratio is more than 50%, it applied min 20%.

Restricted balances with the Central Bank represents mandatory statutory reserve deposits and are not available for use in the Bank's day–to–day operations.

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Statutory reserves with Central Bank | 567,748 | 530,747 |
| | **567,748** | **530,747** |

**13. Mudaraba - investment funds**

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Mudaraba - investment funds | 209,749 | 216,130 |
| Less allowances for impairment | (177,192) | (165,809) |
| | **32,557** | **50,321** |

The Bank invested in an Islamic investment fund that operates on the basis of a joint Mudaraba between investors and the Islamic Investment Company of the Gulf (the 'Mudarib'). The investors share the profits from the operations that have not yet reached the stage of final settlement until the liquidation of this special fund. Under this agreement, the Bank has restricted the use of funds only for the purpose of investing in the European Real Estate Portfolio (EREP). This portfolio comprises four properties located in the center of Brussels, Belgium and in Germany. Based on appraisal reports sent to investors by the Mudarib, the European economic crisis severely impacted the value of the EREP assets and the ability to refinance, rent or sell them.

Based on Mudarib report, two of the properties are sold and one is under finalization of selling process. The Bank estimated its share of the losses, as a proportion of its investment in the total initial investment fund. The latest report, dated 22.02.2018, shows an outstanding amount for UBA Investment at USD 791,092 and the report states that one of the remaining properties, "Eden Blue" Investment, is under sale contract.

Based on such estimation, the Bank recognized an allowance for impairment of Lek 177,192 thousand (2017: Lek 165,809 thousand). Movements in the allowances for impairment are as follows:

| | 2018 | 2017 |
|---|---|---|
| **Balance at January 1** | **165,808** | **191,284** |
| Net charge for the year | 16,213 | 17,683 |
| Foreign exchange effect | (4,829) | (43,158) |
| **Balance at December 31** | **177,192** | **165,809** |

**14. Murabaha – financial receivables**

The Murabaha balances as at December 31, 2018 and 2017 are detailed as follows:

| | 31-Dec-18 | 31-Dec-17 |
|---|---|---|
| Financial receivables at amortized cost | 4,849,277 | 4,223,011 |
| Accrued income | 26,863 | 57,166 |
| Less deferred income | (47,542) | (38,917) |
| Less allowances for ECL / impairment losses | (102,028) | (230,953) |
| | **4,726,570** | **4,010,307** |

**14. Murabaha – financial receivables (continued)**

***14.1 Impairment allowances for Murabaha – Financial receivables***

The table below shows the credit quality and the maximum exposure to credit risk based on the Bank's internal credit rating system and year-end stage classification. The amounts presented are gross of impairment allowances. Details of the Bank's internal grading system are explained in Note 7.b and policies on whether ECL allowances are calculated on an individual or collective basis are set out in Note Note 7.b.

| | Year 2018 | | | | Year 2017 |
|---|---|---|---|---|---|
| | **Stage 1** | **Stage 2** | **Stage 3** | **Total** | **Total** |
| Corporate | 404,229 | 78,946 | - | **483,175** | **508,854** |
| Financial Institution | 201,358 | - | - | **201,358** | **297,291** |
| Physical Person | 197,118 | 73,255 | 11,170 | **281,543** | **960,703** |
| Retail | 773,630 | 294,305 | 146,516 | **1,214,451** | **2,420,234** |
| SME | 1,529,864 | 892,578 | 225,629 | **2,648,071** | **54,178** |
| **Total** | **3,106,199** | **1,339,084** | **383,315** | **4,828,598** | **4,241,260** |

An analysis of changes in the gross carrying amount and the corresponding ECL allowances is, as follows:

| | **Stage 1** | **Stage 2** | **Stage 3** | **Total** |
|---|---|---|---|---|
| **Gross carrying amount as at 1 January 2018** | **2,455,803** | **1,210,177** | **575,280** | **4,241,260** |
| New assets originated or purchased | 1,893,064 | 729,928 | 72,651 | 2,695,643 |
| Assets derecognised or repaid | - | - | - | - |
| Repaid Financings | (1,114,180) | (737,799) | (277,664) | (2,129,643) |
| Transfers to Stage 1 | 238,412 | (124,021) | (114,391) | - |
| Transfers to Stage 2 | (364,365) | 391,996 | (27,631) | - |
| Transfers to Stage 3 | (58,385) | (74,286) | 132,671 | - |
| Changes to contractual cash flows due to modifications nor resulting in derecognition | - | - | - | - |
| FX Movement | 55,850 | (56,911) | 22,399 | 21,338 |
| **At 31 December 2018** | **3,106,199** | **1,339,084** | **383,315** | **4,828,598** |

| | **Stage 1** | **Stage 2** | **Stage 3** | **Total** |
|---|---|---|---|---|
| **Gross carrying amount as at 1 January 2018** | **8,465** | **13,245** | **208,025** | **229,735** |
| New assets originated or purchased | 5,793 | 6,784 | 6,505 | 19,082 |
| Assets derecognised or repaid (excluding write offs) | (1,646) | (4,164) | (154,697) | (160,507) |
| Transfers to Stage 1 | (2,209) | 1,851 | 358 | - |
| Transfers to Stage 2 | 912 | (5,075) | 4,163 | - |
| Transfers to Stage 3 | 8,256 | 3,623 | (11,879) | - |
| Changes to contractual cash flows due to modifications not resulting in derecognition | (227) | 256 | 4,012 | 4,041 |
| FX movements | 594 | (152) | 9,235 | 9,677 |
| **At 31 December 2018** | **19,938** | **16,368** | **65,722** | **102,028** |

Movements in the allowances for impairment are as follows:

| | **2018** | **2017** |
|---|---|---|
| Balance at January 1 | 230,953 | 276,181 |
| ECL FTA from IFRS 9 adoption | (1,218) | - |
| Reversal of impairment losses | (125,311) | (10,923) |
| Write off | - | (26,081) |
| Foreign exchange effect | (2,396) | (8,224) |
| **Balance at December 31** | **102,028** | **230,953** |

**14. Murabaha – financial receivables (continued)**

**14.2 Finance lease receivables**

Included in the Murabaha – financial receivables there are items of finance lease receivables in which the Bank is the lessor:

| | Minimum lease payments | | Present value of minimum lease payments | |
|---|---|---|---|---|
| | **December 31, 2018** | **December 31, 2017** | **December 31, 2018** | **December 31, 2017** |
| Less than 1 year | 9,036 | 7,426 | 8,606 | 7,072 |
| Between 1 and 5 years | 42,582 | 40,582 | 40,554 | 38,649 |
| More than 5 years | 132,627 | 171,920 | 126,311 | 163,733 |
| **Present value of minimum finance lease receivable** | **184,245** | **219,928** | **175,471** | **209,454** |
| Less unearned finance income | (30,946) | (37,351) | (29,472) | (35,572) |
| **Net investment in finance leases, receivable** | **153,299** | **182,577** | **145,999** | **173,882** |
| Allowance for uncollectible lease payments | (4,095) | (8,041) | (3,900) | (7,658) |
| **Total** | **149,204** | **174,536** | **142,099** | **166,224** |

Finance lease receivables represent executed collateral from defaulted clients which have been leased back to thirdy party customers against an agreed schedule of repayment. Interest rate varies from 3% to 5% and have a contractual maturity from 10 to 15 years. Fair value of minimum lease payments as at 31 December 2018 is Lek 149,204 thousand (2017: Lek 182,577 thousand).

**15. Assets acquired through legal process**

The Bank's assets acquired through legal process are a consequence of the acquisitions through enforcement of security over financial receivables. These assets were initially classified as non-current assets held for sale and tested for impairment on an annual basis.

In 2018 none of the assets acquired through legal process did meet the definition of non-current assets held for sale and as a result the Bank recognizes these assets as inventories held at the lower of cost and net realizable value. This transfer is prospectively applied.

***Measurement of net realizable value - Fair value hierarchy***

Property appraisers, having professional qualifications and recent experience in the location and category of the property being valued, determine the fair value of these assets. The appraisers provide the fair value of the assets portfolio every year, following the year of acquisition.

Although the ownership has been transferred to the Bank, certain properties are still used by the borrowers, until identification of a potential buyer. The Bank does not aim to make a profit from leasing out these properties, however agreed to rent them out with the purpose of allowing for their maintenance and preservation of the current physical conditions. The total rent income earned in 2018 is Lek 77 thousand (2017: Lek 267 thousand).

The fair values of the Bank's assets acquired through legal processes are categorized into Level 3 of the fair value hierarchy.

**15. Assets acquired through legal process (continued)**

***Level 3 fair value***

The following table shows a reconciliation from the beginning balances to the closing balances for the fair value measurements of the Bank's assets acquired through legal process.

| | 2018 | 2017 |
|---|---|---|
| **Balance at 1 January** | **285,608** | **236,518** |
| Acquired during the year | 127,359 | 82,720 |
| Sold during the year | - | - |
| Transfer to Financial Lease | (14,068) | (34,227) |
| Net changes in fair value from de-evaluation | (12,342) | - |
| Net changes in fair value arising from exchange | 245 | 597 |
| **Balance at 31 December** | **386,802** | **285,608** |

***Valuation techniques and significant unobservable inputs***

When measuring the fair value of an investment property at initial recognition, the Bank generally refers to the final auction for the execution that has resulted in the transfer of ownership of that property to the Bank.

Based on the local legislation, the fair value of such properties is measured by independent appraisers that provide such value to the execution offices upon initiation of the auction procedures. The fair value that is measured with reference to the market prices is used as an initial offer in the first auction, and such offer may be reduced to a limit of 64% of the initial valuation, in cases when the initial auction did not result in a sale to a third party. In cases when no buyer is identified for the final reduced offer, the ownership is transferred to the Bank.

Based on the most recent valuations performed in 2018, the market value of some properties exceeded the auction value, meanwhile some other properties are de-evaluated, given to the recent market conditions and the lack of offers in the auction.

**16. Property, equipment and intangible assets**

| | Buildings | Office equipment | Computers & electronic equipment | Motor Vehicles | Furniture and fixtures | Intangible assets | Fixed Assets in Process | Total |
|---|---|---|---|---|---|---|---|---|
| ***Cost*** | | | | | | | | |
| At January 1, 2017 | **282,846** | **58,784** | **58,563** | **14,630** | **21,754** | **48,967** | **-** | **485,544** |
| Additions | - | 174 | 1,423 | 6,142 | 139 | 1,509 | - | **9,387** |
| Disposals | - | - | (94) | - | - | - | - | **(94)** |
| **At December 31, 2017** | **282,846** | **58,958** | **59,892** | **20,772** | **21,893** | **50,476** | **-** | **494,837** |
| Additions | - | 2,040 | 1,265 | 1,891 | 152 | 6,625 | 1,919 | **13,892** |
| Disposals | - | (633) | (2,720) | (6,348) | (6) | - | - | **(9,707)** |
| **At December 31, 2018** | **282,846** | **60,365** | **58,437** | **16,315** | **22,039** | **57,101** | **1,919** | **499,022** |
| | | | | | | | | |
| ***Accumulated Depreciation*** | | | | | | | | |
| At January 1, 2017 | **(114,722)** | **(57,021)** | **(44,775)** | **(14,630)** | **(21,404)** | **(48,009)** | **-** | **(300,561)** |
| Charge for the year | (14,174) | (856) | (5,415) | (808) | (97) | (542) | - | **(21,892)** |
| Disposals | - - | - | - | - | - | - | - | **-** |
| **At December 31, 2017** | **(128,896)** | **(57,877)** | **(50,190)** | **(15,438)** | **(21,501)** | **(48,551)** | **-** | **(322,453)** |
| Charge for the year | (14,142) | (921) | (5,566) | (1,418) | (125) | (364) | - | **(22,536)** |
| Disposals | - | 633 | 2,720 | 6,348 | 7 | - | - | **9,708** |
| **At December 31, 2018** | **(143,038)** | **(58,165)** | **(53,036)** | **(10,508)** | **(21,619)** | **(48,915)** | **-** | **(335,281)** |
| | | | | | | | | |
| ***Carrying amount*** | | | | | | | | |
| At January 1, 2017 | **168,124** | **1,763** | **13,788** | **-** | **350** | **958** | **-** | **184,983** |
| At December 31, 2017 | **153,950** | **1,081** | **9,702** | **5,334** | **392** | **1,925** | **-** | **172,384** |
| **At December 31, 2018** | **139,808** | **2,200** | **5,401** | **5,807** | **420** | **8,186** | **1,919** | **163,741** |

As at December 31, 2018 the historical cost of the assets which were fully depreciated was Lek 3,525 thousand (2017: Lek 1,517 thousand).

### 17. Other assets

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Prepaid expenses | 2,671 | 4,374 |
| Sundry assets | 3,687 | 11,652 |
| | **6,358** | **16,026** |

### 18. Due to banks and financial institutions

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Current accounts | 225,022 | 94,410 |
| Term deposits | 293,140 | 598,502 |
| Accrued share on profit | 69 | 63 |
| | **518,231** | **692,975** |

At December 31, 2018 and 2017, current and term deposits represent deposits from local Banks and Financial Institution, with a remaining maturity from one to three months.

### 19. Borrowings from financial institutions

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Borrowings from International Commercial Bank (ICB) | 53,910 | 217,460 |
| Accrued share on profit | 12 | 24 |
| | **53,922** | **217,484** |

On 31 December 2018, the bank obtained from ICB a loan of USD 500,000 and with maturity date respectively on 30 January 2019. The interest is payable on maturity date. The interest rate is 2.05% p.a.

### 20. Due to customers

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Current accounts | 1,726,354 | 1,774,182 |
| Investment deposits | 4,790,381 | 4,450,031 |
| Accrued Customers' Share on Profit | 39,711 | 38,521 |
| Other customer accounts | 8,151 | 8,207 |
| **Total** | **6,564,597** | **6,270,941** |

Current accounts at December 31, 2018 include a balance of Lek 579 million (2017: Lek 503 million), which represents amounts blocked by regulatory authorities or by the Bank. Certain balances are not available for use, without prior consent of the authorities. Managed funds relate to investment deposits belonging to customers (refer to note 19), for which the Bank has assumed management responsibility. The customers assume the ultimate investment risk arising from investment of these funds. Current accounts and investment deposits by currencies are as follows:

| **Current accounts** | December 31, 2018 | December 31, 2017 |
|---|---|---|
| In USD | 346,436 | 422,088 |
| In ALL | 541,075 | 394,423 |
| In EUR | 815,279 | 922,361 |
| In GBP | 23,564 | 35,310 |
| **Total** | **1,726,354** | **1,774,182** |

**20. Due to customers (continued)**

| **Investment deposits**: | **December 31, 2018** | **December 31, 2017** |
|---|---|---|
| In USD | 314,695 | 288,352 |
| In EUR | 1,821,357 | 1,669,959 |
| In ALL | 2,654,329 | 2,491,720 |
| **Total** | **4,790,381** | **4,450,031** |

Due to customer detailed as per business segments as per 31 December 2018 and 31 December 2017 are shown in the table below:

| | **December 31, 2018** | **December 31, 2017** |
|---|---|---|
| Corporates | 895,345 | 746,557 |
| SME | 770,629 | 950,109 |
| Individuals | 4,858,912 | 4,535,754 |
| Accrued Customers' Share on Profit | 39,711 | 38,521 |
| **Total** | **6,564,597** | **6,270,941** |

**21. Other liabilities**

Other liabilities are detailed as follows:

| | **December 31, 2018** | **December 31, 2017** |
|---|---|---|
| Accrued expenses | 2,599 | 4,691 |
| Remittances in transit | 7,097 | 21,957 |
| Due to third parties | 261 | 28 |
| Provision fund | 12,369 | 13,811 |
| Other liabilities | 7,253 | 5,968 |
| | **29,579** | **46,455** |

Remittances as at December 31, 2018 represent outgoing transfers in transit for which the Bank acted as intermediary. Litigation provisions arise out of current or potential claims or pursuits alleging non-compliance with contractual or other legal or regulatory responsibilities, which have resulted or may arise in claims from customers, counterparties or other parties in civil litigations. As explained in Note 6.18 and Note 7.9 the Bank is of the opinion that if disclosing these events on a case-by-case basis would prejudice their outcome, then such detailed disclosures have not been included in the Bank financial statements.

| | **December 31, 2018** | **December 31,2017** |
|---|---|---|
| **Balance at January 1** | **13,811** | **8,218** |
| Provision loss net of reversals | (1,442) | 5,593 |
| **Balance at December 31** | **12,369** | **13,811** |

**22. Equity**

***Share capital***

The registered share capital is Lek 1,762,717 thousand (equivalent of USD 13,144 thousand), divided into 547,421 shares with a nominal value of Lek 3,220.04 (USD 24.01). There were no movements in the share capital in 2017 and 2018.

***Reserves***

Reserves of Lek 109,033 thousand (2017: Lek 109,033 thousand) were created pursuant to Article 8 of the Decision No. 51, dated April 22, 1999 of the Bank of Albania, which required the appropriation of 20% of the net profit for the year, Article 213 of the Law No. 7638, dated November 19, 1992 "On commercial companies" which required the appropriation of 5% of the net profit, and the Bank's Statute, which required the appropriation of 10% of net profit for the year.

## 23. Income from banking operations

| | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|
| Income from Murabaha operation | 236,370 | 212,162 |
| Income from banks and other financial institutions | 41,397 | 41,656 |
| | **277,767** | **253,818** |

Included in income from Murabaha operations for the year ended 31 December 2018 is a total of Lek 8,662 thousand (31 December 2017: Lek 19,027 thousand) relating to impaired financial assets.

| | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|
| Cash and cash equivalents | 4,766 | 7,667 |
| Restricted balances with Central Bank | 36,631 | 33,989 |
| Murabaha - financial receivables | 236,370 | 212,162 |
| | **277,767** | **253,818** |

## 24. Customers' share on profits

Customers' share on profit of Lek 59,120 thousand (2017: Lek 55,593 thousand) represents the profit share allocation from Mudarabah Transactions, net of Mudarib Charge.

| | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|
| Due to banks and financial institutions | 1,010 | 912 |
| Borrowings from financial institutions | 1,477 | 177 |
| Due to customers | 56,633 | 54,504 |
| | **59,120** | **55,593** |

## 25. Net foreign exchange (losses)/gains

Foreign exchange gains/loss arise from the re-translation at year-end of the Bank's foreign currency position and gains and losses from transactions in foreign currencies. Bank realized a gain of Lek 8,675 thousand from foreign currency transaction (in 2017: Lek 11,530 thousand) and a loss from revaluation of monetary position of Lek 40,297 thousand (in 2017: loss Lek 205,643 thousand).

| | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|
| Unrealised foreign exchange gains | 9,050 | 22,362 |
| Realised foreign exchange gains | 19,685 | 23,788 |
| ***Subtotal*** | **28,735** | **46,150** |
| Unrealised foreign exchange loss | (49,347) | (228,009) |
| Realised foreign exchange loss | (11,003) | (12,259) |
| ***Subtotal*** | **(60,350)** | **(240,268)** |
| **Total** | **(31,615)** | **(194,118)** |

## 26. Personnel expenses

| | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|
| Wages and salaries - Expatriate staff | 16,337 | 17,208 |
| Local employees | 81,766 | 80,131 |
| Social insurance | 11,626 | 11,232 |
| Bonuses & rewards | 4,959 | 883 |
| | **114,688** | **109,454** |

## 27. Other administrative expenses

Other administrative expenses include the following:

| | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|
| Legal, consultancy and audit fees | 15,936 | 17,203 |
| Office expenses | 29,119 | 22,717 |
| Deposit insurance | 16,797 | 15,502 |
| Security expenses | 13,053 | 12,066 |
| Swift, Reuters and on-line connections | 10,276 | 12,276 |
| Software maintenance | 11,857 | 11,377 |
| Board of Directors and Audit Committee | 5,844 | 5,076 |
| Fees, taxes and duties | 3,090 | 3,312 |
| Telephone and mail | 1,554 | 1,506 |
| Travel and transportation | 998 | 1,829 |
| Advertising and representation expenses | 7,280 | 8,659 |
| Bank of Albania Emergency Fund | 3,046 | - |
| Other expenses | 37 | 114 |
| | **118,887** | **111,637** |

## 28. Income tax

The Bank determines taxation at the end of the year in accordance with the Albanian tax legislation. Income tax in Albania is assessed at the rate of 15% (2017: 15%) of taxable income. The tax on profit before tax differs from the theoretical amount that would arise using the basic tax rate as follows:

| | Tax rate | 2018 | Tax rate | 2017 |
|---|---|---|---|---|
| Profit/(Loss) before income tax | | **30,791** | | **(163,246)** |
| Income Tax expense at 15% **(A)** | 15% | 4,619 | 15% | (24,487) |
| Tax impact of non-deductible expenses **(B)** | 23% | 7,129 | 4% | 5,822 |
| Unrecognised tax losses **(C)** | - | (11,748) | 11% | 18,665 |
| **Current tax expense / Effective tax rate (A+B+C)** | **38%** | **-** | **-** | **-** |

In 2018, the Bank did tax prepayments Lek 2,827 thousand (2017: Lek 4,400 thousand). Prepaid income tax at December 31, 2018 was Lek 13,877 thousand (2017: Lek 11,050 thousand). Based on the local accounting law, starting from January 1, 2008 the Bank must report in accordance with IFRS. In addition, Law No. 10364, dated 16.12.2010 provides for certain amendments (effective as of 24 January 2011). Based on these amendments, the impairment allowances charged by banks in accordance with IFRS shall be considered as tax deductible expenses, provided that they are certified by the external auditors and are not in excess of the limits determined by the Central Bank. Effective from 1 January 2014, the limits determined by the Central Bank are not applicable and the impairment charges recognized in accordance with IFRS are considered as tax deductible expenses. Due to this change in the legislation, there were no temporary differences between the book value and the tax value of financial receivables as of December 31, 2018.

## 29. Commitments and contingencies

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Guarantees | 29,595 | 52,106 |
| Collaterals | 12,469,496 | 11,409,340 |

The Bank issues guarantees for its customers. These instruments bear a credit risk similar to that of credits granted. Based on management's estimate, no material losses related to guarantees outstanding at December 31, 2018 will be incurred and thus no provision have been included in these financial statements.

***Legal***

In the normal course of business the Bank is presented with legal claims; the Bank's management is of the opinion that no material losses will be incurred in relation to legal claims outstanding at December 31, 2018, and no (additional) provisions were created during 2018.

## 29. Commitments and contingencies (continued)

***Lease commitments***

The Bank has entered into non-cancellable lease commitments for all branches. Such commitments for the years ended December 31, 2018 and 2017 are detailed as follows:

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Less than one year | 13,571 | 14,101 |
| Between one and five years | 55,183 | 26,750 |
| | **68,754** | **40,851** |

## 30. Related party transactions

The Bank enters into transactions with its shareholders in the ordinary course of business. The balances with minority shareholders and entities owned by them, are as follows:

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| ***Assets*** | | |
| Accounts and investments with banks and financial institutions | 679,090 | 896,492 |
| Financing activities | 5,376 | 6,354 |
| Provision for financing activities | (54) | (63) |
| Mudaraba - investment funds (note 13) | 218,747 | 225,402 |
| Impairment for Mudaraba - investment funds (note 13) | (186,190) | (175,080) |
| ***Liabilities*** | | |
| Due to customers | 11,264 | 13,176 |

The balances presented above are disclosed as per the objective of IAS 24 is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties..

**Transactions with directors**

Key management personnel, or directors, are those individuals who have the authority and responsibility for planning and exercising power to directly or indirectly control the activities of the Bank and its employees. The Bank considers the members of the Board of Directors (and its sub-committees) and Executive Committee to be key management personnel for the purposes of IAS 24 Related Party Disclosures. The remuneration of directors is included in personnel expenses. It is detailed as follows:

| | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|
| Salaries | 25,165 | 26,383 |
| Bonuses and other benefits | 4,260 | 1,655 |
| Remuneration of the Board of Directors | 5,235 | 4,363 |
| | **34,660** | **32,401** |

The Bank enters into transactions, arrangements and agreements involving directors, senior management and their business associates, or close family members, in the ordinary course of business under the same commercial and market terms, interest and commission rates that apply to non-related parties. The income and expenses arising from transactions with related parties are as follows:

| | Year ended December 31, 2018 | Year ended December 31, 2017 |
|---|---|---|
| **Income:** | | |
| Income from Dallah Holding subsidiaries | 11,096 | 7,178 |
| Income from financing activities | 120 | - |
| **Expenses:** | | |
| Impairment loss on Mudaraba investment funds | 16,213 | 17,683 |
| Customers' share on profit | (55) | (63) |

## 31. Subsequent events

There are no events after the reporting date that would require either adjustments or additional disclosures in the financial statements.