Народна банка Србије

Annual Financial Stability Report for 2014

Belgrade, 30 July 2015

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- International and domestic environment from the aspect of financial stability
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- Financial markets – money market, bond market, stock market
- Financial infrastructure – focus on the payment system
- Analysis of the real estate market
- **Financial stability function** – regulatory framework as a support to financial stability, macroprudential stress-testing, financial soundness indicators

- **Text boxes** (9) on global and domestic topical issues in the area of financial stability and macroprudential policy

External risks and mitigation measures

- Reduced cross-border exposure of European banks in the medium run and the spillover from parent bank markets, notably Greece;
- Cooperation with home supervisors and banking groups;
- Active participation in international forums, such as the Vienna Initiative and cooperation with working groups within the Vienna Initiative;
- Uncertainties in emerging markets due to expected increase in the Fed's rate;
- Rising rates on FX-indexed loans, following a period of exceptionally low rates of leading central banks;
- Simulation of annuity plans for new loans with variable interest rates to the interest rate risk, in order to alert clients of the interest rate risk;
- Slower than expected recovery of the euro area and our other important foreign trade partners.
- Cooperation with European and international financial institutions to ensure support to the domestic economy.

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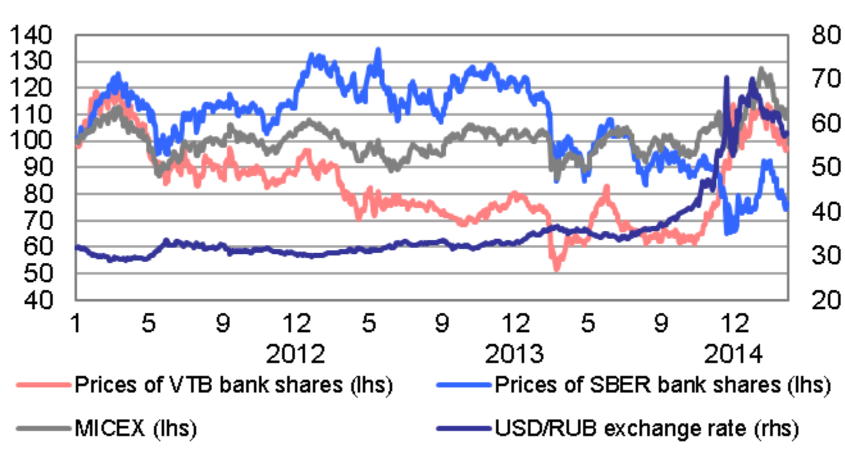
Internal risks and measures

• High level of financial system euroisation;	• Consistent implementation of the dinarisation strategy and further promotion of dinar financial instruments - ranging from dinar savings to local currency government securities; • Simulation of annuity plans for new FX-indexed loans to the FX risk, in order to alert clients of the currency risk;
• High share of NPLs and weak lending activity; • Inadequate collateral valuation.	• Strategy for NPL resolution and implementation of special diagnostic studies of bank asset quality; • Setting up a property valuation database and upgrading the appraiser profession.

International environment

Political crisis in Ukraine and geopolitical tensions…



Source: Bloomberg.

- …heightened by the sanctions imposed on Russia and a strong fall in oil prices.
- Strong ruble depreciation in late 2014, lowering of the credit rating to a speculative level, followed by the central bank's measures.

ECB's monetary easing, Fed's decision to wind down its QE programme and uncertainties surrounding Greece's parliamentary elections

- Modest economic growth, absence of more robust lending to the real sector and deflation in the euro area late in the year further motivated ECB's monetary easing in 2014 (rate cuts and liquidity provision).
- **ECB conducted a comprehensive assessment.**
- The withdrawal of deposits, shrinking of liquidity and financing problems in Greece since late 2014.
- While opinions differ, it is generally believed that the Fed will start increasing its policy rate in the second half of 2015, which may affect the behaviour of foreign investors.

Ownership structure of the banking sector and spillover of risks to Serbia

- European banking groups' subsidiaries account for around 75% of the domestic banking sector's assets. Although all banks are independent legal persons operating in compliance with conservative domestic regulations, developments in the euro area may affect banks in Serbia through the so-called psychological channel.
- There are four **Greek** banks operating in Serbia with a total market share of around 14% at end-2014.
- The presence of **Russian** banks in Serbia is limited to two banks (market share of around 4% at end-2014).
- Owing on the one hand to a strong domestic deposit base which grew in the post-crisis period, and well-calibrated measures of the NBS on the other, the risk of deleveraging, though present, is not a cause for concern and is being monitored and analysed on an on-going basis.
- Bearing in mind that all banks operating in Serbia are legal entities registered in compliance with domestic regulations and guaranteeing payment of liabilities by their own capital, sector-wide exposure to a systemic cross-border deleveraging is highly improbable.

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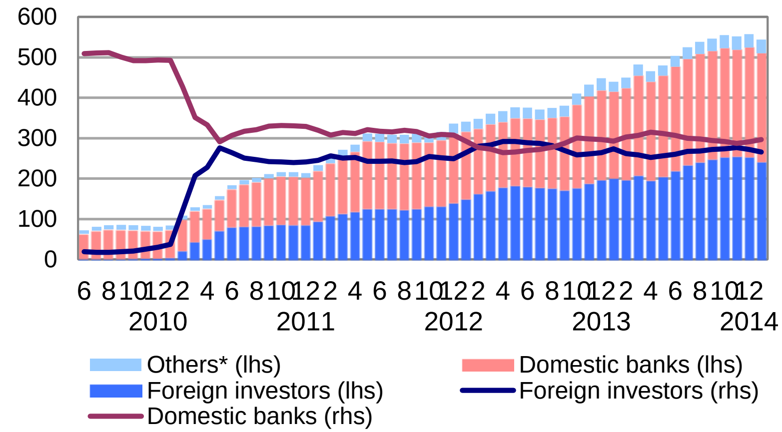
Dinar government bond market continues to grow

Emerging markets remain sensitive to decisions of central banks of developed economies

Structure of portfolio of dinar government bonds from primary auction
(RSD bln) (%)

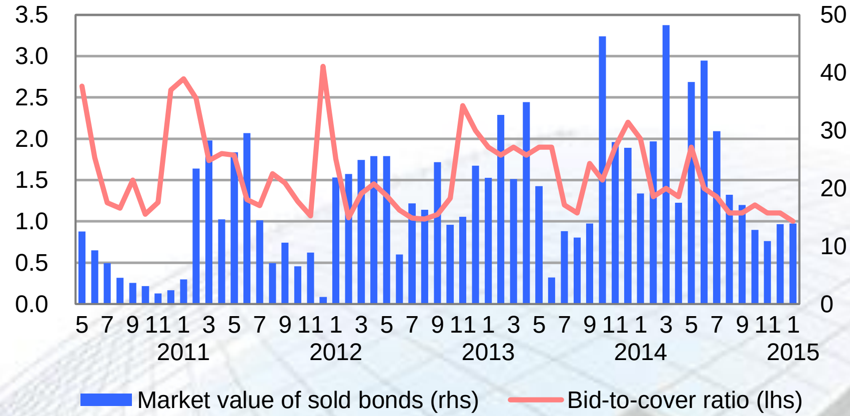


* Custody banks, insurance companies, voluntary pension funds, individuals and other legal entities.
Source: Ministry of Finance.

- The announced increase of Fed's interest rates may pose a challenge to emerging markets in terms of external borrowing. On the other hand, the ECB's programme may alleviate this risk.

Despite the risks stemming from the international environment, the portfolio of dinar government securities has grown

Primary market demand for RSD government bonds
(auctions, in RSD bln)



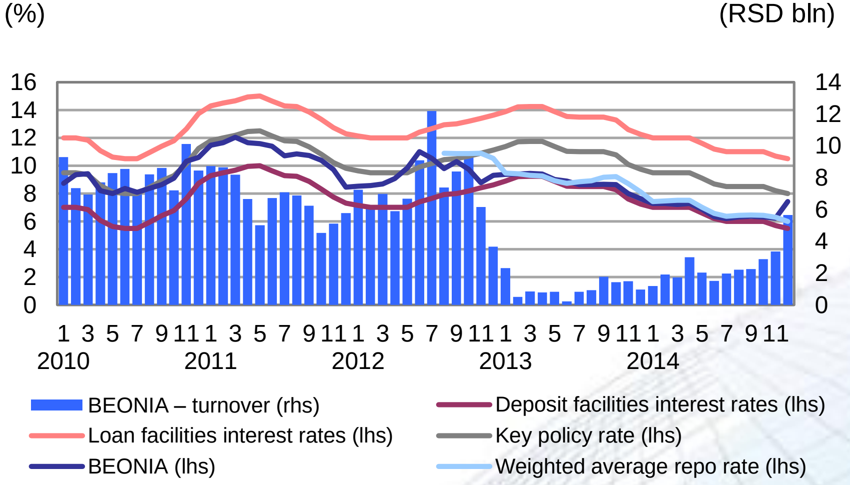
Source: Ministry of Finance.

- The portfolio continued to grow (24.5%), while interest rates declined (by 1.1 pp to 9.0% for 2Y). October saw the issuance of a 10Y dinar bond.
- Banks and foreign investors remain major buyers of dinar government securities (94%).

NBS decisions in 2014 were aimed at preserving monetary and financial stability

BEONIA fluctuated closer to the lower edge of the interest rate corridor

Key policy rate, BEONIA, and interest rates on deposit and loan facilities (daily turnover monthly averages)



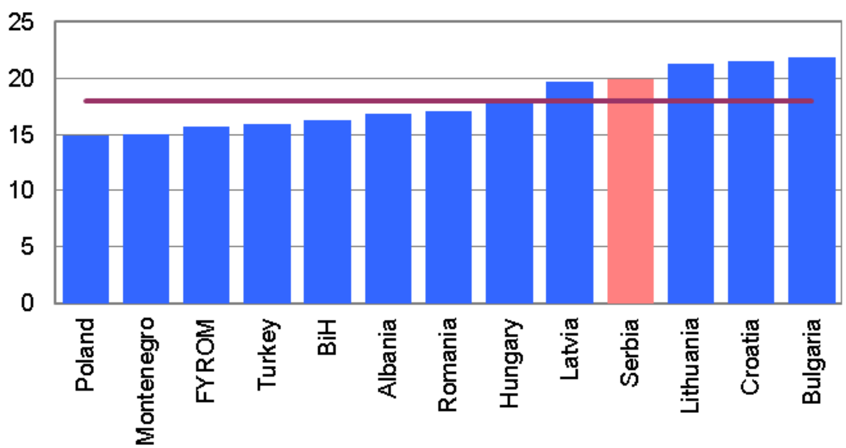
Source: NBS.

- Key policy rate was lowered by 150 bp (from 9.5% to 8.0%).
- Key policy rate cut translated into the decline of the average repo rate by 135 bp (from 7.55% to 6.20%).
- To meet their dinar liquidity needs (for purchase of foreign currency, as well as higher RR allocations in dinars), banks reduced investments into NBS securities (from RSD 110.0 bln to RSD 7.5 bln) and overnight deposits with the NBS (from RSD 19.2 bln to RSD 2.0 bln).

Banking sector is highly capitalised, with a high share of domestic sources of funding, while lending is weak

Banking system's CAR is high, reliance on domestic sources of funding lowers the deleveraging risk

Regulatory capital to risk-weighted assets, countries of the region
(2014, latest available data, %)

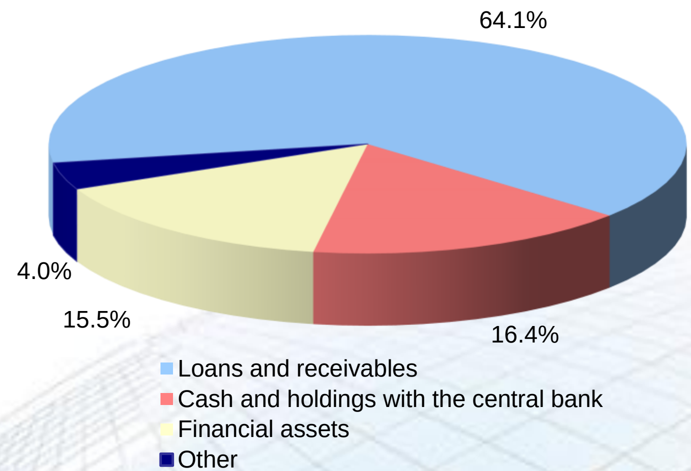


Source: NBS and IMF: GFSR.

- At year-end CAR stood at 20.0%, significantly above the regulatory minimum (12.0%) and two and a half times above the minimum EU requirement.
- At end-2014 total deposits made up 63.7% of total banking sector liabilities, while capital made up 20.7%.

Subsidised lending programme contributed to lending growth

Structure of assets of the Republic of Serbia's banking sector
(%)



Source: NBS.

- Loans continue to hold a major share in the banking sector's net assets, so the quality of total assets is determined by the quality of lending portfolio.
- Responding to the consequences of weak lending activity, the government launched a programme of subsidised lending to corporates.

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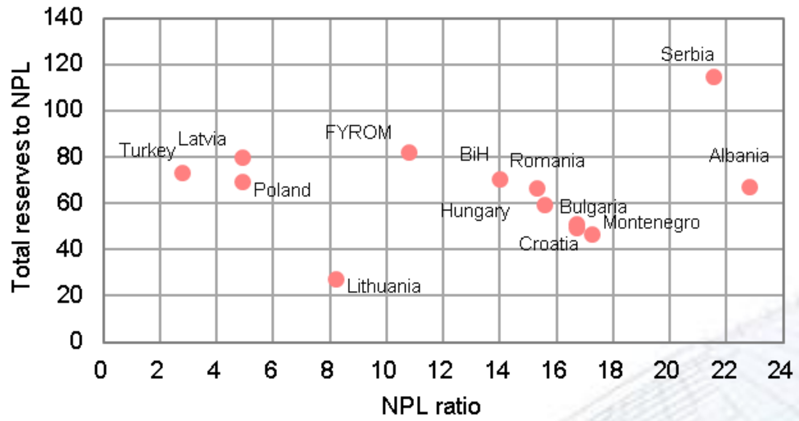
High level of NPLs poses a systemic risk

NPLs are high, but adequately provisioned for

Coverage of non-performing loans by total reserves and NPL ratios, countries of the region
(2014, latest available data, %)



Sources: NBS and IMF: GFSR.

- NPL share is high, up by 0.1 pp to 21.5% in 2014.
- Although loan loss provisions remain a sufficient guarantee that NPLs will not jeopardise financial system stability, high share of NPLs negatively reflects on banks' risk appetite and lending growth, therefore posing a **systemic risk**.
- The fact that problems accumulated over the years and that they can be addressed only with the involvement of a large number of institutions, calls for the development of a **national strategy for NPL resolution**.

Regulatory recommendations –Simulation of annuity plans for interest rate risk and FX risk (1/2015)

In order to reduce the risk of new NPLs, when informing clients of loan terms, banks should create two alternative loan repayment plans.

1) *Interest rate risk*

Refers to loans with an agreed variable interest rate, in which case interest rate growth should be assumed after a certain period (depending on the loan maturity). Clients should then be informed clearly by how much their monthly annuity and their total debt would rise in case of a sudden increase in the interest rate.

2) *FX risk*

Refers to loans indexed to a foreign currency, in which case the dinar's depreciation should be assumed after a certain period (depending on the loan maturity). Clients should then be informed clearly by how much their monthly annuity and their total debt would increase in case of a sudden higher depreciation of the dinar.

Both the moderate and worst case scenario assume an extremely strong shock

Overview of scenarios

	Baseline	Moderate	Worst case
Y-o-y growth in NPL ratios (pp)	2.50	3.81	4.95
Y-o-y depreciation of RSD against EUR (%)	/	17.72	35.92
Y-o-y change in key policy rate (pp)	/	12.50	29.00
Y-o-y growth in real net wages (%)	-5.32	-7.72	-9.32

Source: NBS.

- Of a large number of variables with a potential to impact the dynamics of NPLs, three variables showed a reliable and predictable strength in the case of Serbia: (1) the exchange rate, (2) seasonally-adjusted real net wages and (3) the key policy rate.

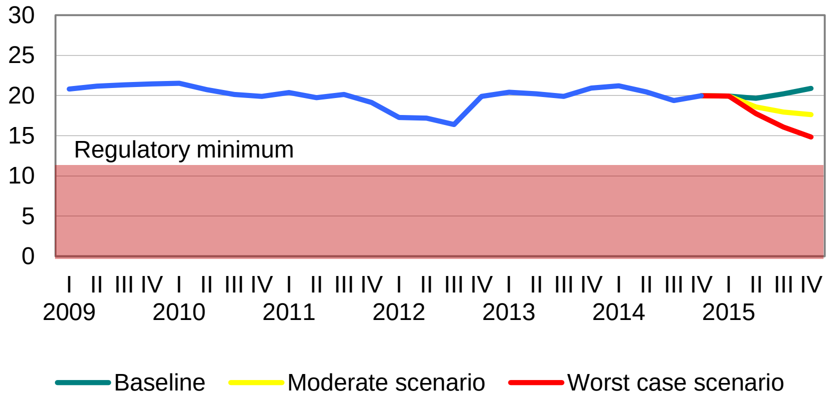
- For stress test purposes, three one-year scenarios are assumed. Moderate and worst case scenarios assume larger shocks to the system, with minimum probability of occurrence.

- Scenarios of movements in the key policy rate are **conditional** on the assumed movements in the exchange rate and its impact on inflation. The projection of net wages was made independently.

Despite conservative scenario assumptions, banking sector is resilient to shocks

Banking sector's CAR remains above the regulatory minimum in all three scenarios

Expected capital adequacy ratio by stress scenarios*
(%)

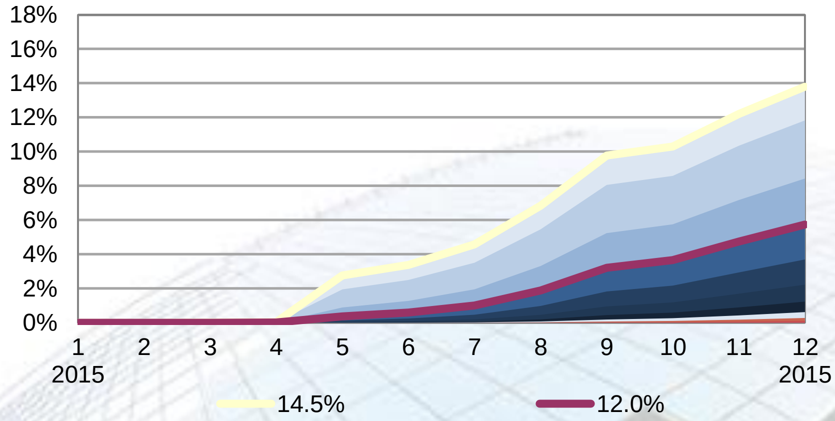


* NBS estimate.
Source: NBS.

- Under the moderate scenario (depreciation of 17.8% and key policy rate increase of 12.5 pp), the banking sector's CAR falls to 17.6%.
- Under the worst case scenario, assuming extremely strong and highly improbable shock, CAR falls to 14.8%.

The probability of CAR falling to 12.0% due to NPL growth is minimal

The probability of NPLs increasing to the level that would result in banking sector capital adequacy ratio of 14.5% and 12%*



* NBS estimate.
Source: NBS.

- NPL growth of 6.2 pp (to 27.7%) pushes the banking sector's CAR down to 12%, but the probability of such event is small.

Banking sector remains liquid even in the case of the largest assumed deposit outflow

Even in case of strong deposit outflow...

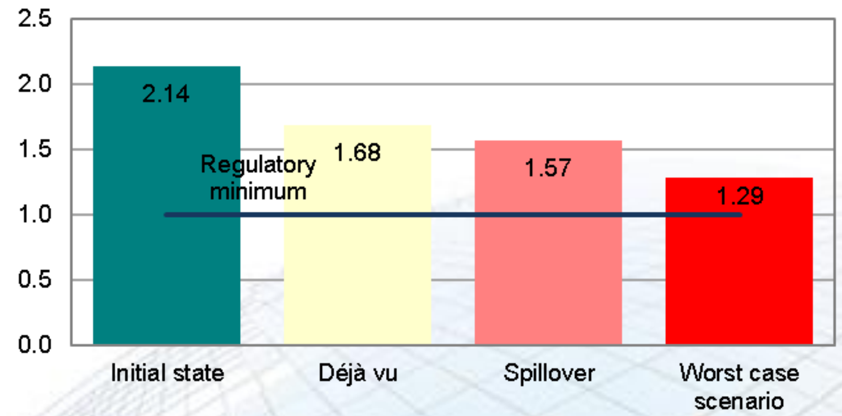
Assumptions of deposit withdrawals by sector

DEPOSIT WITHDRAWAL	Déjà vu 2008	Spillover	Worst case
Banks - demand	0%	60%	60%
Corporate - demand	10%	10%	20%
Households - demand	12%	20%	24%
Government - demand	23%	23%	35%
Other demand deposits	11%	15%	22%
Time deposits	11%	13%	20%
Marketability of 2nd class liquid assets	100%	100%	80%
Stocks and bonds listed on the stock exchange	100%	100%	40%
Total of deposits withdrawn (RSD bln)	**197**	**277**	**392**
Share in total deposits (%)	**10%**	**15%**	**21%**

Source: NBS.

...liquidity ratio remains in the safe zone and is not threatened

Expected liquidity ratio for the banking sector by stress scenarios*



* NBS estimate.
Source: NBS.

- *Déjà vu scenario* – assumes the withdrawal of 10% of total deposits. The scenario applies the deposit withdrawal structure from October 2008.

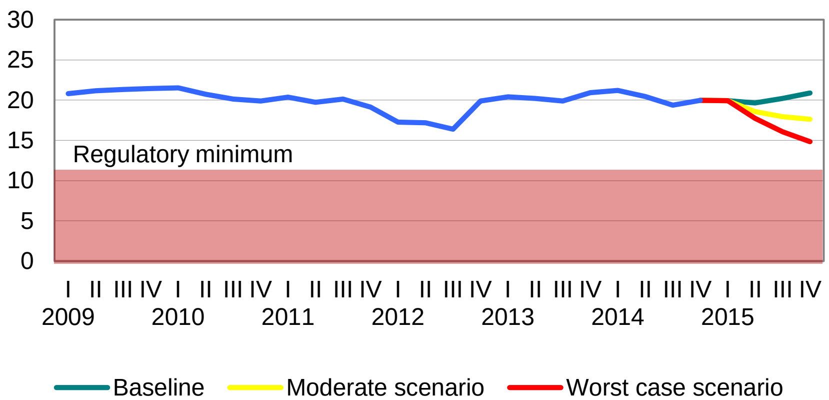
- *Risk spillover scenario* – in addition to the deposit withdrawal of 2008, this scenario envisages deleveraging and withdrawal of 15% of total deposits.

- *Worst-case scenario* – envisages a two times stronger shock than in October 2008, i.e. withdrawal of 21% of total deposits.

CONCLUSION : Macroprudential stress tests indicate high resilience of the system to solvency and liquidity shocks

Both the moderate and worst case scenario assume a strong shock

Expected capital adequacy ratio by stress scenarios*
(%)

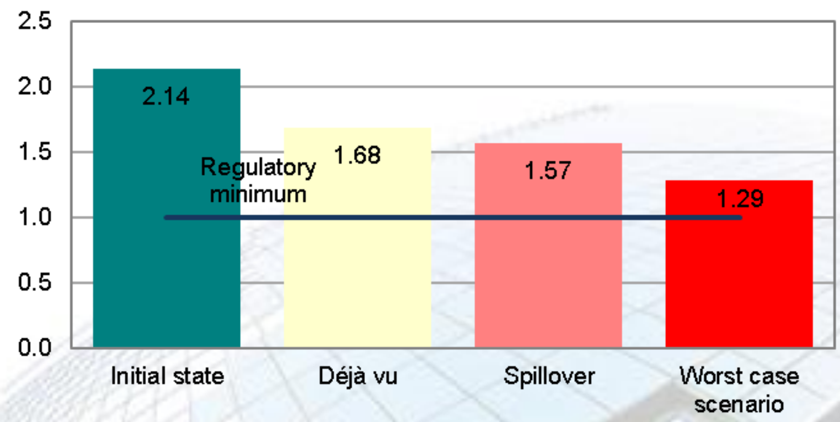


* NBS estimate.
Source: NBS.

- Banking sector's CAR stays above the regulatory minimum even under the worst case scenario, so that solvency of the overall system is not threatened.

Even at high deposit withdrawal, liquidity ratio stays in the safe zone and is not threatened

Expected liquidity ratio for the banking sector by stress scenarios*



* NBS estimate.
Source: NBS.

- Under the worst case scenario, assuming the withdrawal of as much as 21% of total deposits, the system as a whole would remain liquid and liquidity needs of individual banks would remain low.

Overview of text boxes

1. ECB’s comprehensive assessment of banks
2. Banking sector stability index
3. Systemic stress indicator
4. Setting up the database of collateralised property
5. Macroprudential framework
6. EBA Guidelines for Assessment of Other Systemically Important Institutions (O-SIIs)
7. Bank resolution – new statutory function of the NBS
8. Swiss National Bank’s decision to lift the cap on the franc’s value against the euro
9. NPL determinants

Thank you for your attention!