NATIONAL BANK OF SERBIA

Speech at the presentation of the

Annual Financial Stability Report for 2014

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Ladies and gentlemen, dear colleagues, friends and members of the press,

I am pleased to see you at the presentation of the **Annual Financial Stability Report.** This is the first public presentation of the **Annual Financial Stability Report,** but not the first issue of the Report as you can see for yourselves on the NBS website!

Allow me to briefly touch on the past. **The Annual Financial Stability Report** replaced in 2011 the Financial Stability Report that was published from 2005 to 2010. And this was not only about a change in the name of the Report, but about an essential change in the content and focus of the publication: from looking back on the year behind to providing an assessment of financial stability over a one-year horizon. The change is attributable to the 2010 amendments to the Law on the National Bank of Serbia which entrusted the National Bank with an explicit mandate to contribute to the maintaining and strengthening of financial stability and to take measures to that effect. Let me remind you that financial stability has been our objective since 2003, but at the time this function boiled down solely to microprudential regulation and supervision (i.e. regulation and supervision of individual institutions).

Throughout history, crises have been the turning points that changed the tasks and practice of central banks. The most recent crisis made it obvious that macroprudential perspective is necessary if we are to understand instability and ways to address it. That is why in 2010 the National Bank was entrusted with a macroprudential mandate which encompasses regulation and supervision of the financial system as a whole. Macroprudential policy is the cornerstone of the new financial architecture; it is analytically complex and requires a strong research orientation of the National Bank.

The first message I wish to convey is that the mandate to contribute to the maintaining and strengthening of financial stability cannot be equated with guaranteeing the solvency of individual financial institutions. Banks are private undertakings. Their success depends on their strategy and management. The management is appointed by owners who guarantee with their funds to the bank's business partners. In a market economy, there will always be those who succeed and those who fail. Any entrepreneurial venture carries the risk of insolvency, and a business failure is a part of the normal functioning of a banking system. Hence, a system can be stable despite the fact that some banks are insolvent. On the other hand, the stability or financial health of each individual financial institution does not guarantee the stability of the system.

The stability of the system requires a clear ownership structure, oversight of payment operations, an adequate rate of capitalisation as a result of introducing new capital buffers apart from the regulatory minimum, the protection of depositors' interest, lender of last resort function and an exit strategy for insolvent institutions. Also, the most recent amendments to the central bank law adopted in 2015 broadened the National Bank's mandate even further, making the central bank also responsible for bank resolution.

What are the objectives of the Annual Financial Stability Report?

The Annual Financial Stability Report is forward-looking and oriented towards the following functions:

1. Based on a true account of all relevant facts and analyses, it provides an overview of key risks which could jeopardise the stability of the system and an assessment of the banking sector's ability to absorb potential losses in case risks materialise.

2. It provides information that will help all financial market participants to manage their risks better. Namely, each financial institution manages its ratio of assumed risk and return, but not the consequences (external effects) that its behaviour and business model might cause in other segments of the financial system or the consequences of behaviour of other institutions.

3. It informs the public and participants in the financial market about the measures taken to mitigate risks (not only by the National Bank of Serbia and not only in Serbia).

4. It inspires a wider debate among experts on issues pertaining to financial stability and also encourages the National Bank to be as meticulous and accurate as possible in producing its reports.

All of these functions are aligned to help preserve confidence in financial institutions and financial stability.

What are the sources of systemic risk?

The sources of systemic risk can generally be classified into three broad categories: macroeconomic conditions or sectoral imbalances; risks from within the financial sector; and external or international sources of risk.

Macroeconomic environment represents a source of many risks to the financial system. In that regard, economic recession could lead to an increase in the share of non-performing loans which could affect the solvency of financial institutions and the overall functioning of the financial system. Potential problems in non-financial sectors (corporate and household) may spill over to the financial sector. Thus, for instance, excessive borrowing of households and corporates could significantly diminish their debt (loan) servicing capacity and jeopardise stability of the system.

Risks inherent in the financial system stem from problems generated in particular institutions, shared practices or shared exposure of financial institutions, but also from the financial conditions in the market. Insolvency of a systemically important institution may trigger problems in other financial institutions if they prove to be over-interconnected. Problems in a small institution may have systemic effects if they happen to be common to many such institutions.

External or international factors also have a significant bearing on financial stability. In an increasingly integrated global financial market, problems in one country may quickly spread to other countries. Besides, large financial institutions frequently operate in several countries, so the insolvency of one such institution may affect financial flows in each of the countries involved.

How do we assess system stability?

The Report identifies and assesses risks using different approaches: (1) by analysing financial soundness indicators; (2) by analysing indicators based on market perception and investor expectations; (3) by carrying out macroprudential stress tests relying on mathematical models or computer simulations in the assessment of the effects of a significant rise in interest rates, high depreciation and long-term recession on the capital and profit of the banking system (stress tests are also used to assess the impact of a significant deposit outflow on banking sector liquidity); and (4) by applying network models to assess how insolvency of one financial institution may affect others due to their interconnectedness, as well as how an insolvency of one company (or a group of companies) may affect the banking system due to the shared exposure of banks to the same clients.

Ladies and gentlemen, dear colleagues, friends and members of the press,

Let me leave you with the following points before I give the floor to the General Manager of the Financial Stability Department to present the key risks and the assessment of the stability of the Serbian banking system.

1. The banking system is stable. It could be in a better shape than it is today, and so it will!

2. The new banking regulation and institutional architecture in the EU, which is currently taking shape, is undoubtedly superior to the pre-crisis regime. The new regulation explicitly addresses financial stability, giving the regulatory authorities a number of tools to attain this goal.

3. Our aim is to make use of the new regulatory opportunities for strengthening and developing the system without losing the special edge our system has at this moment. This edge relates primarily to high capitalisation and liquidity!

4. In order to make use of the new regulatory framework, we have already embedded the *Directive on Bank Recovery and Resolution* into our regulations. It clearly defines new instruments and procedures of the regulatory authority in dealing with distressed banks. The most important among the new instruments is the bail-in tool, which will, under certain conditions, provide for capital stabilisation of the bank, by turning loans and deposits into bank's capital. The application of this tool will ensure greater value than the institution of bankruptcy proceedings, without involving the deposit insurance scheme.

5. Following the establishment of a Single Supervisory Mechanism, asset quality reviews and stress testing in the euro area, a significant part of the Serbian banking sector is also covered by asset quality review. These diagnostic studies will help us compare with the region. After that, deadlines will be set for introducing the *Capital Requirements Directive (CRD)* and *Capital Requirements Regulation (CRR) IV* into the domestic legislation. As I said earlier, throughout history crises have been the turning points which changed the tasks and practices of central banks. The latest crisis has shown that the social costs of crisis management were very high. This led to the redefining of the financial stability mandate – from managing the crisis to preventing the occurrence of a new crisis.