National Bank of Serbia

Annual Financial Stability Report for 2016

Belgrade, 27 July 2017

External risks and measures

- divergence between the Fed's and the ECB's monetary policies;
- price volatility in the global commodity and financial markets;
- slower than expected economic recovery of the euro area and Serbia's other important foreign trade partners;
- higher interest rates on loans indexed to foreign currency after a period of extremely low interest rates of leading central banks.

- continued delivery of consistent macroeconomic (monetary, fiscal and macroprudential) policy with the aim of further reducing external and internal imbalance;
- cooperation with European and international financial institutions in order to ensure the greatest possible financial support to the domestic banking sector;
- cooperation with home supervisors to timely assess the effects of measures to be implemented;
- interest rate risk simulation of annuity plans for new variable-rate loans, in order to alert clients to the interest rate risk;
- implementation of the Strategy of Dinarisation of the Serbian Financial System and further strengthening of confidence in the national currency and its use in the financial system.

Internal risks and measures

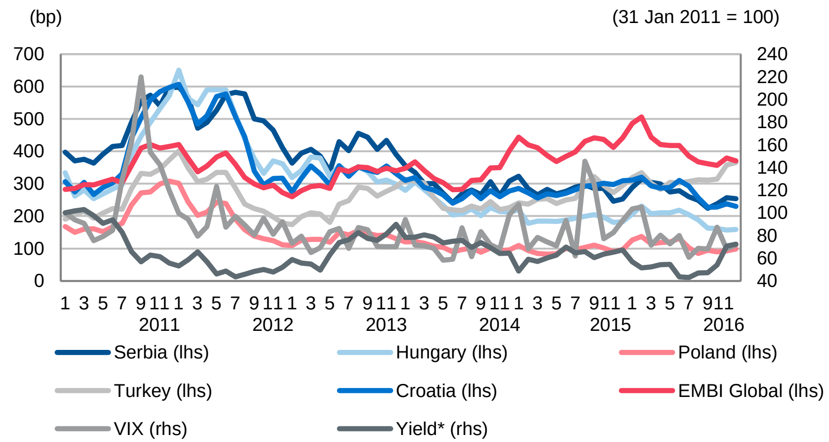
- high degree of financial system euroisation increases exposure of the domestic financial system to credit-foreign exchange risk;
- relatively high share of NPLs can negatively affect banks' risk propensity and credit growth, and jeopardise banking sector profitability;
- relatively muted and unbalanced lending activity;
- increase of financial system procyclicality.

- consistent implementation of the Dinarisation Strategy by all relevant stakeholders: the National Bank of Serbia, Government and banks, with the support of IFIs;
- further promotion of dinar financial instruments, from dinar savings to government securities in the domestic currency;
- continued implementation of the NPL Resolution Strategy and the Government and NBS Action Plans for the implementation of the Strategy;
- National Bank of Serbia's measures that encourage a reduction in interest rates and contribute to banks' credit potential growth, which supports economic activity;
- introduction of macroprudential capital buffers aimed at the mitigation of cyclical systemic risks, in line with Basel III standards.

International environment

Slowdown in global economic activity, an increase in oil prices, and the UK's decision to withdraw from the EU

EMBI for Serbia and other regional peers, VIX and yields on US bonds

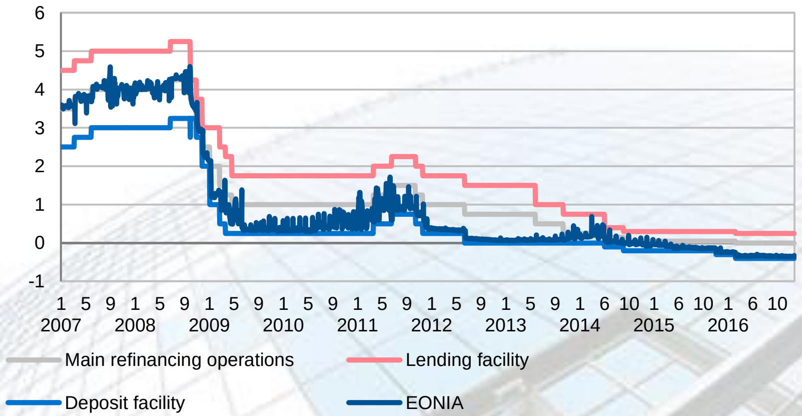


* On derived ten-year US bonds.
Sources: J.P. Morgan and Bloomberg.

- Slower growth in economic activity in advanced countries.
- Inflation in the euro area was extremely low in the first half of 2016, even slipping into negative territory in February, April and May.

In 2016, the divergence of monetary policies of leading central banks, the ECB and the Fed, increased further

ECB's interest rates and EONIA
(%)

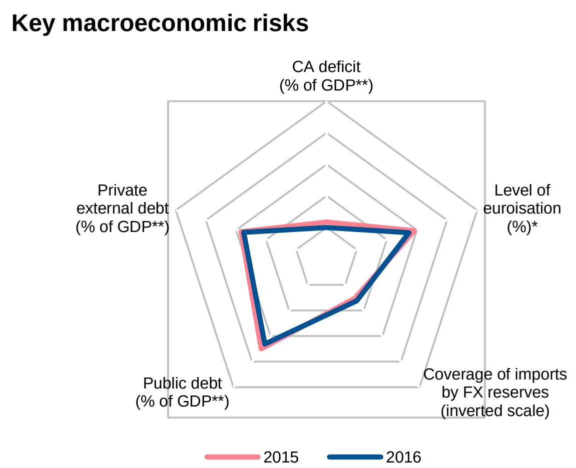


Sources: ECB and Bloomberg.

- The ECB continued to pursue an accommodative monetary policy.
- Low interest rates were the main driver of loan demand of corporates and households in the euro area in 2016.

Domestic environment

Resilience of the domestic system increased in 2016 relative to 2015

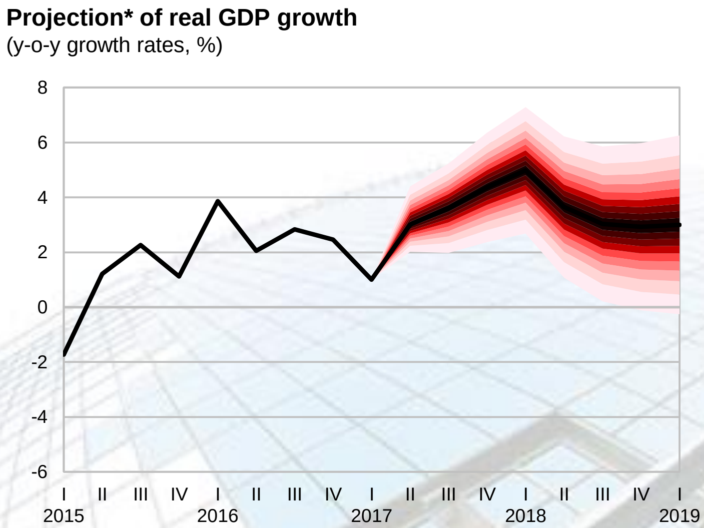


* Share of FX and FX-indexed loans in total loans of households and corporates.
**GDP is compliant with ESA 2010 methodology.
Source: NBS.

- The financial system became more resilient in 2016 relative to 2015 largely on account of the fall in the share of public debt in GDP.

- External imbalances continued to decline (the current account deficit fell from 4.7% to 4.0%).

GDP growth accelerated in 2016, reaching 2.8%



* May 2017
Source: NBS.

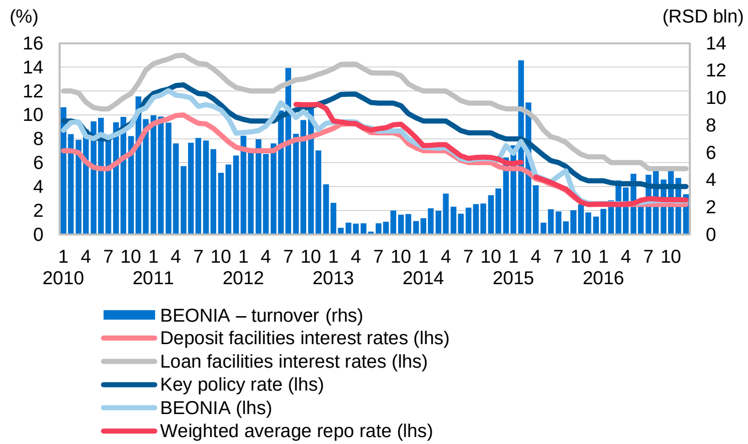
- Economic activity is expected to rally further and economic growth to pick up in 2017, driven by investment and exports.

- A period of low and stable inflation and relative exchange rate stability.

NBS's decisions aimed at preserving monetary and financial stability

BEONIA oscillated at the lower bound of the interest rate corridor

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

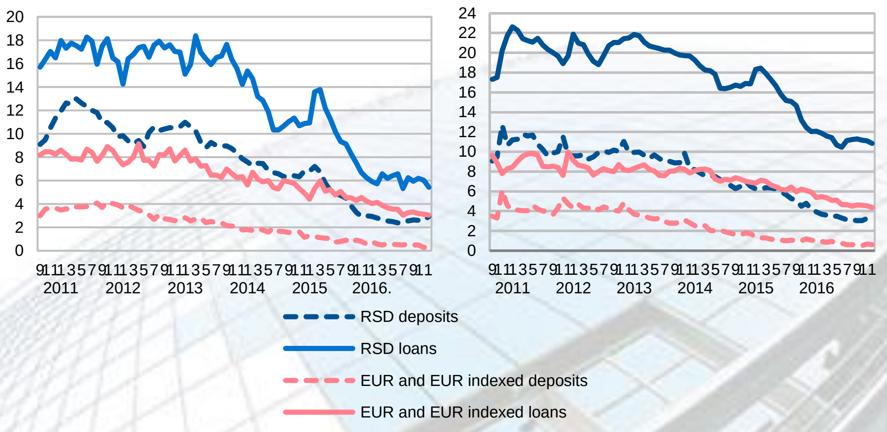


Source: NBS.

- The key policy rate was trimmed twice in 2016, by a total of 0.5 pp (from 4.5% to 4%).
- Narrowing of the interest rate corridor helped stabilise interest rates in the interbank money market.

which led to a fall in interest rates on dinar loans

Interest rates on corporate and household loans and deposits – new business
(weighted average, annual, %)



Source: NBS.

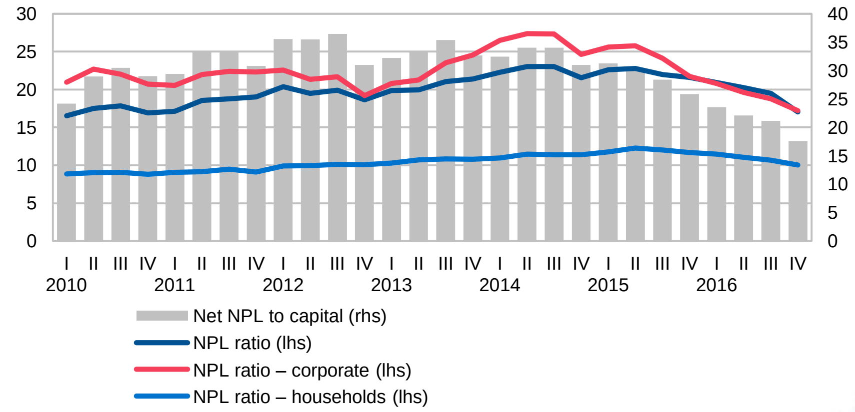
- Key policy rate cuts brought about a decline in the average interest rate on new dinar loans to corporates by 0.82 pp and to households by 1.2 pp.

Considerable decrease in NPLs and rising profitability of the banking sector

Share of NPLs at a five-year low at end-2016

Non-performing loans

(%)



Source: NBS.

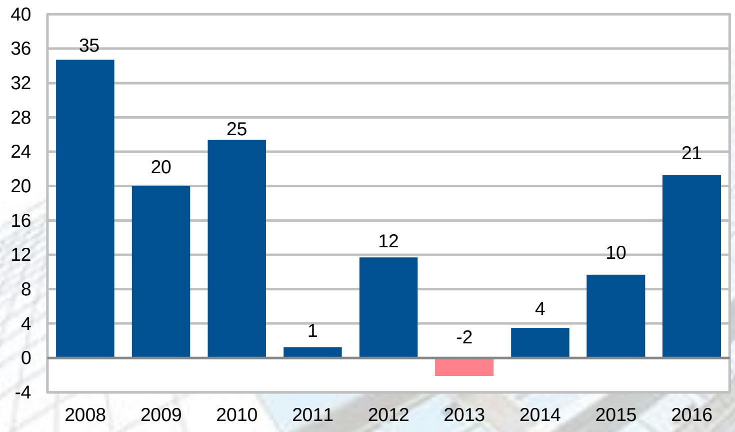
- The implementation of activities envisaged by the NPL Resolution Strategy contributed to a significant reduction of NPLs (down by 4.6 pp y-o-y).

- NPLs were fully covered by provisions.

Banking sector profitability increased

Pre-tax profit/loss of the banking sector

(RSD bln)



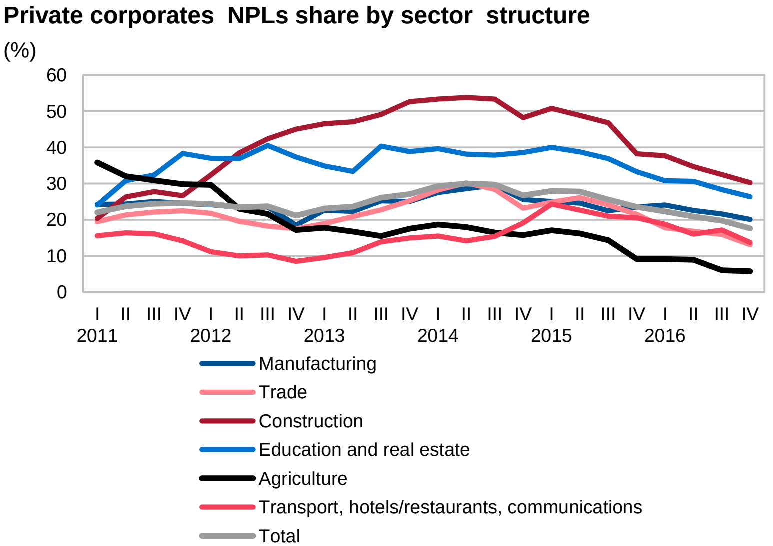
Source: NBS.

- Banking sector profitability was supported primarily by the reduction in net credit losses.

- Though positive, return on equity was lower compared to other countries in the region.

The share of corporate NPLs considerably lower in 2016

Credit portfolio quality improved

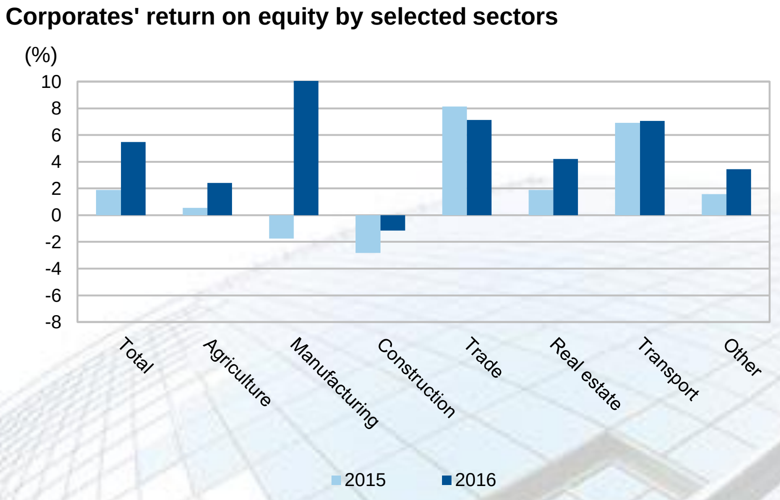


Source: NBS.

- The share of NPLs in total corporate loans in 2016 equalled 17.2%, down by 4.5 pp from end-2015.

- Gross NPLs declined the most in construction and trade.

Corporates continued to operate at a profit



Source: Serbian Business Registers Agency.

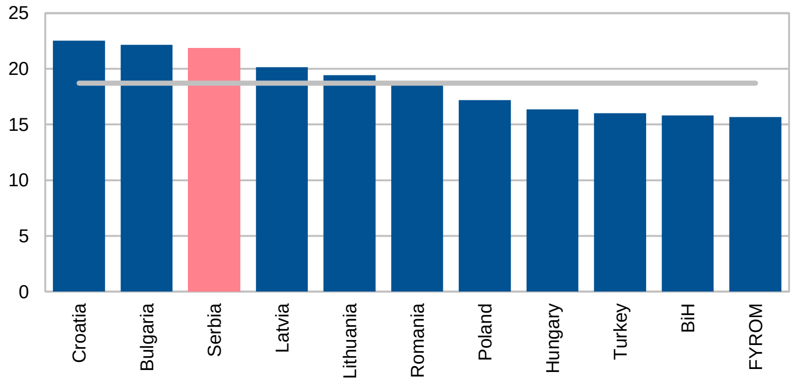
- Owing to accelerated growth in economic activity, corporates achieved almost three and a half times higher positive net financial result in 2016 than in 2015.

- Sector-wise, all sectors operated at a profit, except construction, which operated at a smaller loss than in 2015.

Banking sector is adequately capitalised

CAR is high, reliance on domestic sources of funding lowers the risk arising from dependence on parent banks

Regulatory capital to risk-weighted assets, countries of the region
(2016, latest available data, %)



Sources: NBS and IMF: GFSR.

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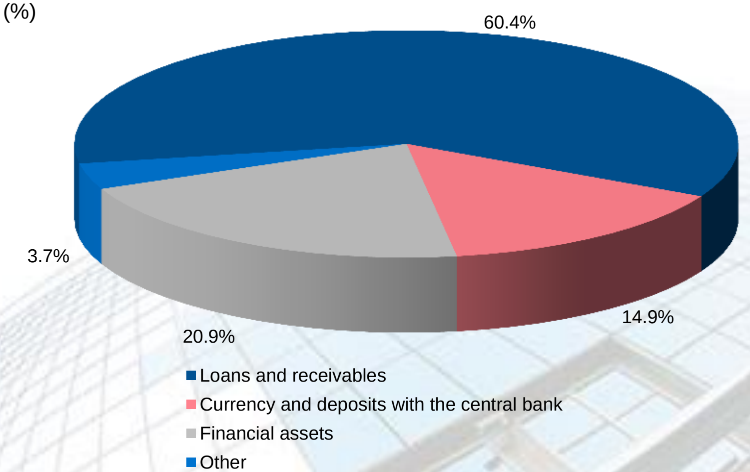
- CAR of the domestic banking sector was high and above the regional average.
- Domestic deposits accounted for a high share of liabilities, lowering the banking sector's exposure to external risks, including the risk of cross-border deleveraging.

Loans dominate the assets side of the banking sector

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



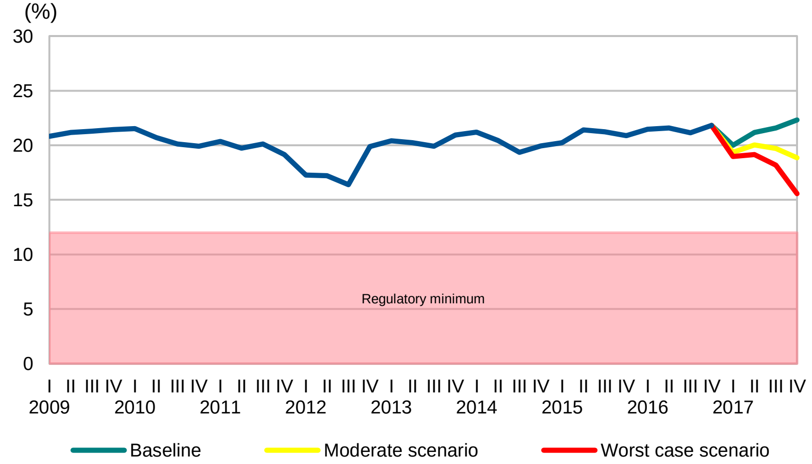
Source: NBS.

- Banks' business models are built around traditional loan and deposit transactions.
- The bulk of financial assets relates to investment in RS securities, reflecting banks' preference for safer investments.

Despite conservative stress scenario assumptions, banking sector is resilient to solvency and liquidity shocks

In 2017 the banking sector will remain adequately capitalised

Expected capital adequacy ratio by stress scenario*

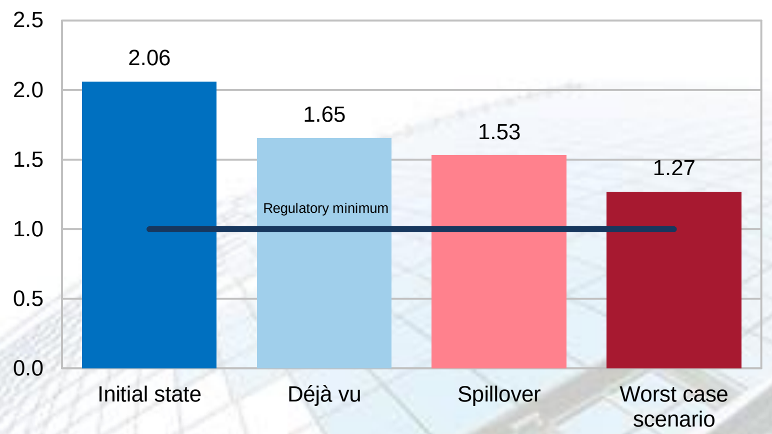


* NBS estimate.
Source: NBS.

- Under baseline, moderate, and worst-case scenarios, CAR of the banking sector was 22.3%, 18.9% and 15.6%, respectively.

...and highly liquid

Expected liquidity ratio for the banking sector by stress scenario*



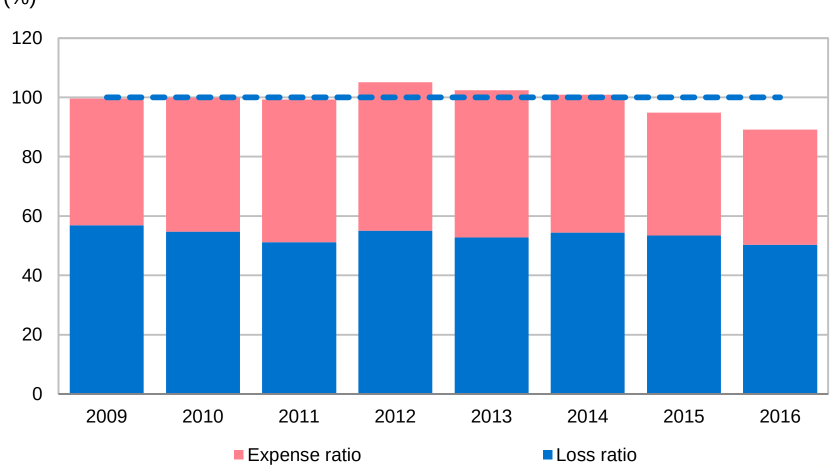
* NBS estimate.
Source: NBS.

- The banking sector liquidity ratio ranged from 2.06 it actually measured at end-2016 to 1.27 in the worst-case scenario.

Non-bank financial sector is stable and profitable, with potential for further development

The insurance sector is adequately capitalised and highly profitable

Combined insurance ratio



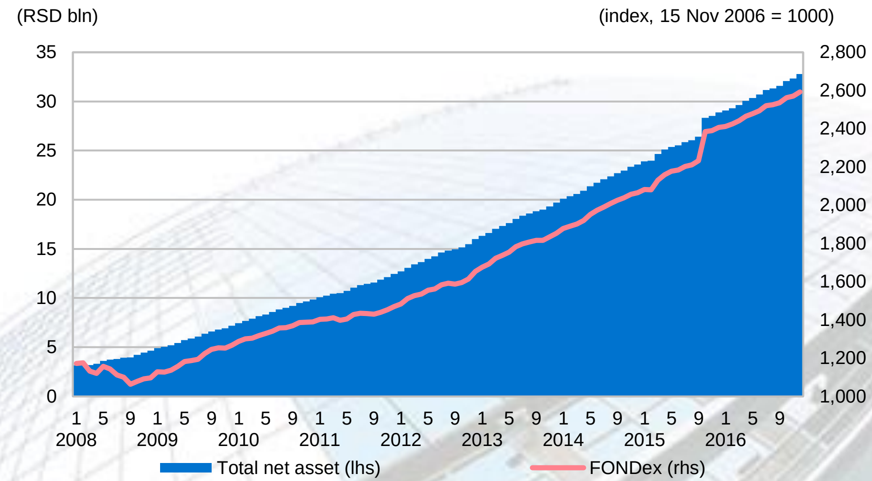
Source: NBS.

- The capital adequacy ratio was twice higher than the regulatory minimum.

- Return on equity equalled 12.9% in 2016.

Other sectors also recorded positive developments

Total VPF net assets and FONDex



Source: NBS.

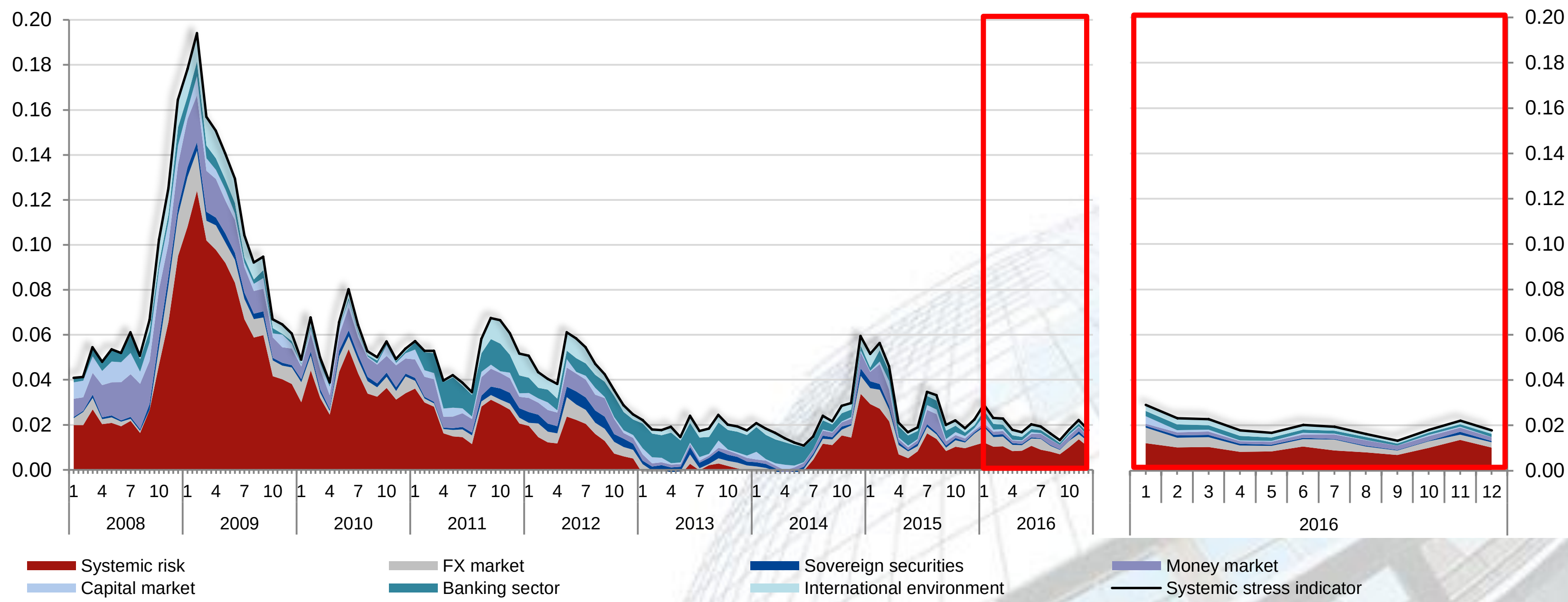
- Net assets of VPFs expanded by around 14% to RSD 32.8 bln, with the annual yield of FONDex of 7.7%.
- The financial leasing sector operated at a profit (RSD 1.3 bln), while its total capital and balance sheet assets grew.

Comprehensive assessment of financial stability in 2016

Early 2016 was marked by developments in the international market

The year 2016 was a period of low systemic stress

Systemic stress indicator dynamics



Source: NBS.

- Q1 2016 saw somewhat higher stress in the money and capital markets due to higher uncertainty in the international market.

- The period of low stress in all segments of the financial system continued throughout 2016.

National Bank of Serbia

Text boxes

1. New International Financial Reporting Standard – IFRS 9
2. Minimum requirements for capital and eligible liabilities (MREL)
3. NPL determinants
4. ECB’s guidance on resolving non-performing loans
5. Conduct of banks with regard to the protection of financial services consumers and the impact on financial stability
6. Capital Markets Union – CMU
7. Enhancing cyber resilience of financial market infrastructures
8. Cryptocurrencies and their impact on financial stability
9. Countercyclical capital buffer
10. Systemically important banks and capital buffer for systemically important banks as a macroprudential policy instrument

THANK YOU FOR YOUR ATTENTION!