NATIONAL BANK OF SERBIA

Speech at the presentation of the Annual Financial Stability Report for 2016

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

It is my great pleasure to greet you at the press conference in which we will present our **Annual Financial Stability Report**.

At the beginning, allow me to remind you of the goals of this Report.

First, since the expectations are critical for shaping the behaviour of economic agents, our task was to provide a sufficient amount of reliable information to financial market participants and to the public as a whole about the condition of the system, its resilience within the one-year time horizon, risks and our activities that should strengthen the system in the future. We expect that familiarisation with the risks or warning about the risks will effect a change in the behaviour of economic agents, deterring them from undertaking high risk activities.

Second, assessing the present and the future system resilience, we also presented the methodological framework of the analysis. It is our intention to open a dialogue with the academic community, to draw young (and not only young) researchers' attention to the importance of financial stability analysis. We learn not only from the past, but from others, too! In this area, there is room for cooperation between economic profession and other sciences: physics, biology, geography. So for example, the NBS researchers use network models to estimate "contagion" risks, that is, the spillover of effects inside the banking system as a result of bank interconnectedness or lender-creditor relations or joint exposure to the same clients. Network modelling has a long history in mathematical literature but is a relatively new tool in economics and finance. As we initiate a dialogue with the academic community, we are open to the application of new analytical tools for the assessment of financial stability, but also to criticism!

Allow me also to repeat that one of the key tasks of a central bank is to ensure and preserve the stability of the financial system as a whole.[1] However, nothing is more important for financial stability than the sound banking sector.

The fact that banks are different from other financial market participants makes them so important for financial stability. They have a unique role in the financial market. Loans which they provide can hardly be substituted with other products, especially in the case of small businesses and households. Also, via maturity transformation, that is, by borrowing over a short term by taking deposits and approving loans with longer maturity in conditions when deposits are returned on demand, banks create liquidity, too.

Furthermore, the banking sector is:

- relatively big compared to the size of the economy, and today it is even more important than before, despite the competition coming from institutional investors;

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[1] Despite the fact that there is no consensus about the definition of financial stability, it implies, either individually or cumulatively:

- System capacity to sustain a shock
- System operation without interruptions/halts or interventions
- Confidence of all economic agents in the financial system
- Consistency between the prices of financial and real assets, as well as the price of foreign currency and the equilibrium/long-term values matching the key characteristics of the economy.

- inter-system connected;
- connected with other sectors, by taking deposits and borrowing liquidity, and/or approving loans, including:
    - cross-border connection,
    - connection with the real sector, and
    - connection with the government.

Finally, banks are:

- under the strong influence of macroeconomic developments, acting pro-cyclically: they take the greatest risk during the upturn of the credit cycle, acting conversely once the credit cycle turns.

Today, we know what we need: a resilient, highly liquid and capitalised, well-regulated banking system, sufficiently strong to sustain fierce shocks and to support economic growth by credit activity at all stages of the economic cycle.

What we also know today is that this ambitious task requires the use of at least two approaches to identify risks at an early stage.

The first one is based on the analysis of trends and assessment of interconnectedness of cyclical risks, such as: financial sector indebtedness, non-monetary sectors indebtedness, liquidity and maturity transformation, as well as risk valuation. The second approach examines the resilience of institutions to shocks.

Here we make a distinction between a "shock" ("trigger") – an event that is difficult to predict or prevent and a "risk", which, as a fundamental weakness of a financial system, induces expansion and amplification of the initial shock. Unlike a sudden shock, risk has a tendency to grow over time and the economic policy must be designed in such a way to limit the accumulation and reduce the probability of the occurrence of a systemic event.

The first approach relies on a big set of indicators over a longer time horizon, so that cyclical risks could be identified in relation to our past experience. That means that it is necessary to compare the current level of an indicator and its most probable rising path with historical values to determine whether the present and the future condition indicates a low, average or high risk level.

The second approach focuses on individual institutions and enables us to: identify institutions whose behaviour significantly deviates from the average, with potential system implications; understand how a disturbance in an individual situation spills over to other institutions and expands through the system; predict common behaviour with potential systemic implications.

The financial system can act either as a buffer to unfavourable shocks or as their amplifier. How it will work depends on how prepared it is for the unfavourable scenario. A system with limited liquidity and little capital will amplify the shock. Conversely, a system with adequate capital and liquidity buffers will have the capacity to support the economy in hardships.

Let me remind you of the key regulatory reforms and activities we undertook, believing that the transposition of international standards into our regulations will make our system even more

resilient, and with greater capacity to fight potential operation problems on its own (without resorting to government aid).

The National Bank of Serbia became responsible for macroprudential policy. As a part of that**, the first key novelty was the establishment of different capital standards.** In addition to minimum capital requirement, capital buffers were introduced and their role is to cover cyclical risks (excessive credit growth or excessive increase in the prices of assets), structural risks (for example a high degree of financial euroisation) but also risks with systemic importance. As a result, total capital requirements can amount to 18% of risk-weighted assets, if an institution is systemically important.

The second key novelty is the introduction of new liquidity standards. The first standard requires from banks to have a sufficient amount of high quality liquid assets (easily converted to cash without or with little discount) which enables them to sustain a strong deposit outflow over 30 calendar days. The second standard is complementary to the first one, and it requires that the banks finance their activities with sufficiently stable sources of funding in the period of one year.

Given that the NBS is responsible for macroprudential policy, stress tests, which are conducted **regularly, on a quarterly basis**, **have the macroprudential dimension**. They are used to determine whether the banking sector has sufficient capital and liquidity to sustain strong adverse macroeconomic or financial shock or a combination of shocks. Therefore, in the first step, banks' reactions to macroeconomic scenarios are predicted, taking into account that the banking sector activity is under the strong influence of macroeconomic movements. What is predicted in the second step, is the macroeconomic variables' feedback on banks' reaction, bearing in mind the interconnectedness of the real and financial sectors.

In case that a bank with critical functions is faced with problems, the resolution network will be activated, which is the third key novelty of the new regulations. Strict standards as to the structure of liabilities need to ensure a controlled exit of a bank from the market, while protecting not only the critical functions, but also the taxpayers' money. The key element, by all means, is the bail-in tool, which for the first time allows that in addition to shareholders (owners), creditors also bear part of the losses.

Finally, same as in other countries, the new international financial reporting standard will be applied as of 2018. The substitution of the concept of "realised" by the concept of "expected" losses will have a bearing on the result in the part of impairment of financial assets and allowances for impairment. The application of new reporting standards should prevent the delayed recognition of losses and insufficiency of allowances for impairment. Although a significant increase of allowances for impairment is expected (a rise by 20–30% compared to the current level), our dual system of provisioning, which apart from the IFRS includes additional regulatory provisions, is more than sufficient to neutralise this effect.

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

Before I give the floor to the General Manager of the Financial Stability Department, allow me to conclude with the following messages:

1. Financial system stability is one of the priorities of the society as a whole, but it is the primary objective of the NBS, together with the stability of prices.

2. Stability of the exchange rate (which does not imply a fixed exchange rate, but limited volatility) is a precondition for preserving and strengthening of financial stability, because of the following characteristics of the Serbian economy:

   a. Small and open economy, highly dependent on imports and vulnerable to shocks on the supply side (fluctuations in oil and primary commodity prices), as well as to changes in the direction and volume of international capital flows which are, as a rule, procyclical

   b. Highly euroised, not only because of a long history of inflation and hyperinflation, but also for other reasons (openness of the economy and the so-called original sin – inability to borrow in the international market exclusively in its own currency)

   c. A significant part of debt of all sectors (household, corporate and government) is in foreign currency

   d. Financial integration (leading local banks are subsidiaries of large cross-border banking groups)

3. High FX reserves represent an important component of our economic defence. Adequate FX reserves provide for swift liquidity support in situations of shaken confidence in the credit and payment systems. They also prevent the occurrence of a financial crisis, as they build confidence in the central bank's capability to intervene when needed.

4. A combination of fiscal policy on the one hand and monetary and regulatory policies of the NBS on the other, has created a more favourable macroeconomic picture which has been conducive to financial system stability – the system is more stable than it used to be!

5. However, even with an appropriate combination of policies in place, risk still may accumulate. That is why early risk detection based on early warning indicators is of key importance.

6. The strongest risks at the moment stem from the international environment. For example, deterioration of investor sentiment could cause significant shifts in international capital flows, at the detriment of countries such as Serbia. However, further improvement of macroeconomic characteristics and accumulation of sufficient capital and liquidity reserves against the risks assumed in the banking sector, will minimise the risks coming from the international

environment. Regulatory uncertainties also persist. Although Basel 3 standards and the Bank Recovery and Resolution Directive are already incorporated in the domestic regulations, the reform is not yet completed. The finalisation of reforms may lead to even higher capital requirements!

7. The crisis has revealed the dangers of approving too many loans. However, refraining from lending is no less dangerous. Some activities must be financed by loans even in bad times, while many other do not deserve to be financed even in good times.

8. Judging by the standard indicators of credit activity, it could be concluded that it has underperformed its long-term trend. However, beneath the stagnant credit activity, dynamic processes unfold – acceleration of new lending and intensified "cleaning" of banks' balance sheets. Since new loans show the actual activity of credit institutions, it may be said that credit activity is not constraining economic growth.

9. Finally, while **non-performing loans** in Serbia have never been a threat to financial system stability, they have been a drag on profitability and credit activity of banks. Cleaning of balance sheets through write-off and sale was incentivised primarily by the NBS's regulatory and supervisory measures. Of course, banks were able to respond to these incentives because of the high coverage of NPLs by allowances for impairment and regulatory provisions and high capital adequacy. In the period from mid-2015 until end-2016 the NPL share decreased by more than 6 percentage points, while the progress achieved in the corporate sector (including entities in bankruptcy) was even more substantial – 9.5 percentage points. NPL reduction continued into 2017, which opens room for further growth of credit activity, especially bearing in mind that final accounts of corporates show a significant growth potential. The NBS's role is to ensure that this growth should be neither excessive nor insufficient, from the standpoint of sustainable economic growth.

Thank you for your attention!