National Bank of Serbia

Annual Financial Stability Report – 2017

Belgrade, 30 July 2018

National Bank of Serbia

External risks and measures

- Diverging monetary policies of the Fed and the ECB may affect capital flows towards emerging markets;
- Price volatility in the global financial and commodity markets;
- Slower than expected recovery of the euro area and Serbia's other important foreign trade partners;
- Untimely adjustment to the frequent changes of regulatory standards may adversely affect the operations of parent banks and consequently their subsidiaries in the domestic market;
- Increase in variable interest rates on loans indexed to foreign currency after a period of extremely low interest rates of the leading central banks;

- Introduction of adequate macroprudential policy instruments aimed at the cyclical dimension of systemic risk;
- Continuation of consistent, countercyclical, flexible and prudent macroeconomic policy to preserve external and internal balance;
- Cooperation with parent supervisors and international financial institutions in order to provide maximum financial support to the domestic banking sector;
- Boosting the domestic investor base;
- Simulation of annuity plans for new variable-rate loans, in order to alert clients to the interest rate risk;
- Continued implementation of the Strategy of Dinarisation of the Serbian Financial System and promotion of the use of the local currency;

Internal risks and measures

- High degree of euroisation increases exposure of the domestic financial system to international market developments;

- Despite a significant decrease in the previous period, the share of NPLs in total loans may affect banks' risk aversion and consequently credit growth and profitability of the banking sector;

- Uneven recovery of credit activity;

- Increase of financial system procyclicality.

- Continued implementation of the Dinarisation Strategy by all relevant stakeholders: the NBS, Serbian Government, and banks, assisted by the international financial institutions;

- Further application of micro and macro prudential regulatory measures aimed at limiting the risk of euroisation and promotion of dinar financial instruments;

- Further NPL reduction and prevention of new NPLs in order to boost credit activity and lower banks' risk aversion;

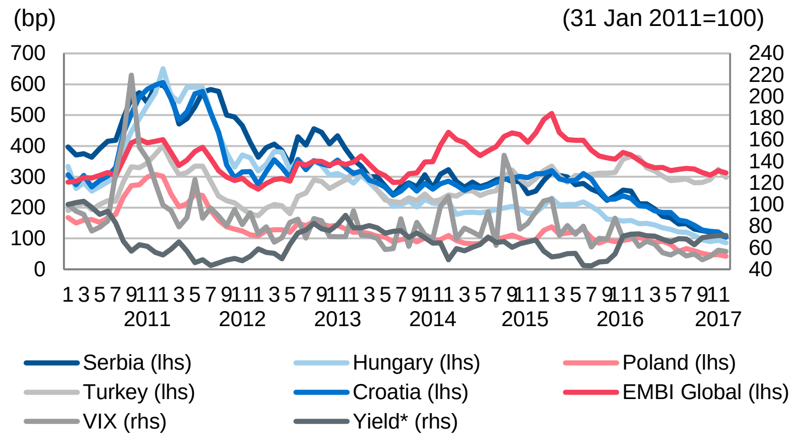
- National Bank of Serbia's measures conducive to banks' credit potential growth, which encourages economic activity;

- Full application of IFRS 9, which prescribes the switch from the incurred loss concept to the expected loss concept;

International environment

Acceleration of global economic activity was the most striking feature of international developments

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

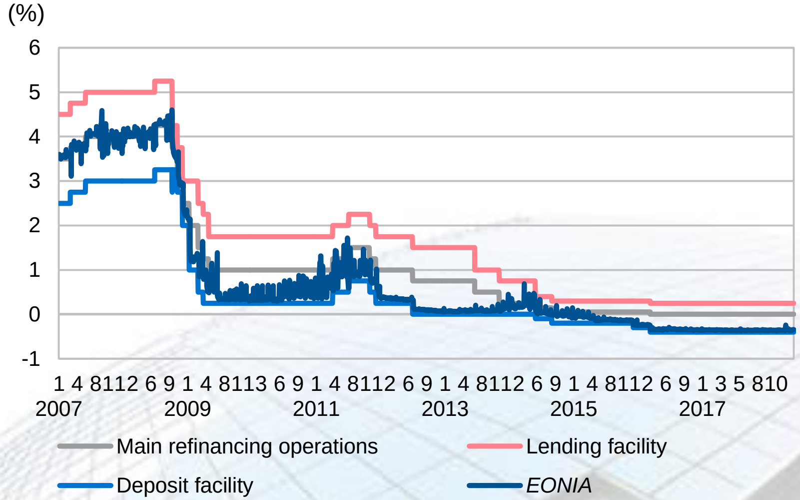


* On derived ten-year US bonds.
Sources: J.P. Morgan and Bloomberg.

- Uncertainty surrounding the movement of global primary commodity prices, the diverging monetary policies of leading central banks and geopolitical tensions are the key risk factors coming from the international environment.
- Euro area growth reflected favourably on the improvement of the growth outlook for CESEE countries and on the fall in their risk premia.

The divergence of monetary policies of the ECB and the Fed increased further

ECB's interest rates and EONIA



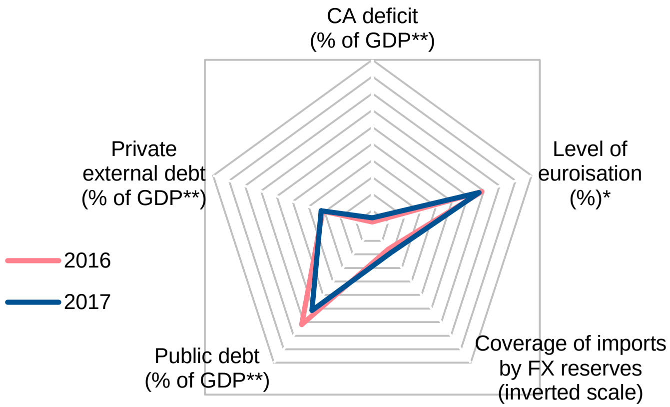
Sources: ECB and Bloomberg.

- In 2017 the ECB maintained the key policy rates unchanged and continued with expansionary monetary policy with lesser monthly purchases of securities than in 2016.
- The Fed proceeded with monetary policy tightening and the key policy rate was raised three times in 2017 (in March, June and December). In October 2017 the decision to commence Fed balance sheet normalisation was made.

Domestic environment

Resilience of the domestic system increased from 2016

Key macroeconomic risks



* Share of FX and FX-indexed loans in total loans of households and corporates.

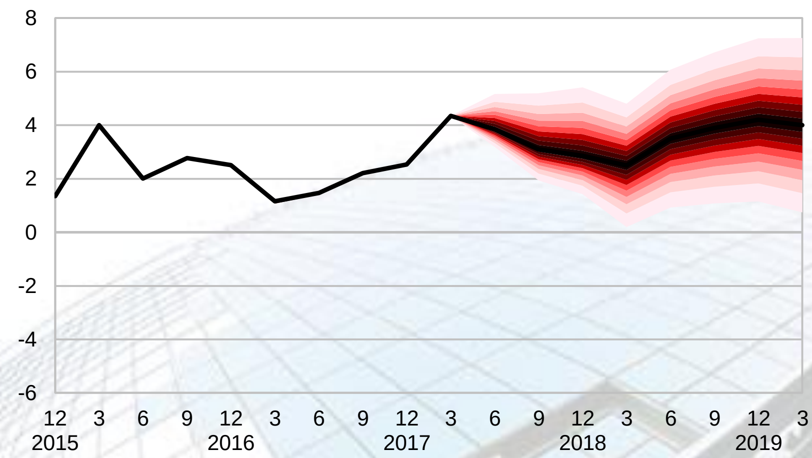
**GDP is compliant with ESA 2010 methodology.

Source: NBS.

- In 2017 resilience increased as a result of a significant decrease in the share of public debt in GDP and the falling degree of euroisation of lending.
- Temporary widening of current account deficit worked in the opposite direction.

The achieved results are confirmed by the lower risk premium and upgraded credit rating of the Republic of Serbia

Projection* of real GDP growth
(y-o-y growth rates, %)



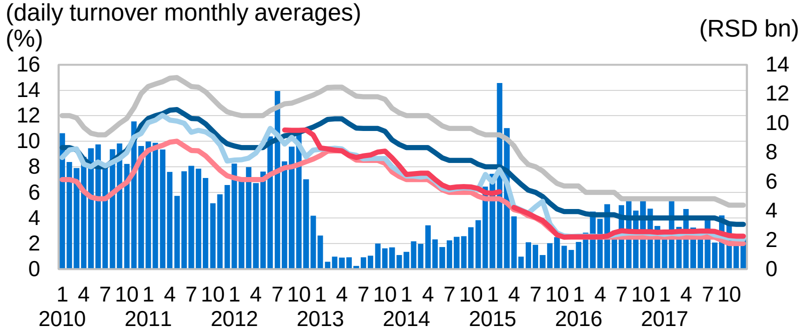
* May 2018
Source: NBS.

- With a sustained favourable structure, economic growth is expected to step up to around 3.5% in 2018 and 2019.
- What marked 2017 were low and stable inflation and a broadly stable exchange rate.

NBS decisions aimed at strengthening stability

Monetary policy easing fed directly into lower dinar interest rates

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

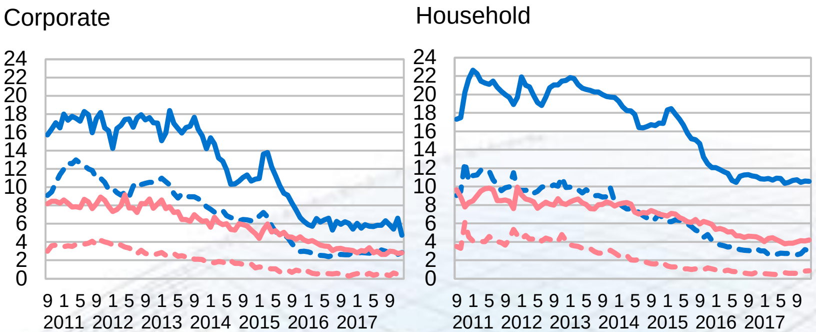


Source: NBS.

- The key policy rate was cut two times in 2017, by 0.25 pp each, to 3.5%. Inflation moved within the new target tolerance band (3%±1.5 pp) throughout the year, touching in December the 3% target, 3% being also its annual average.
- The dinar grew stronger against the euro by 4.2%. The NBS intervened by buying EUR 725 mn net, thereby reinforcing the country's FX reserves.

Reduced interest rates on dinar loans support lending growth and dinarisation

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



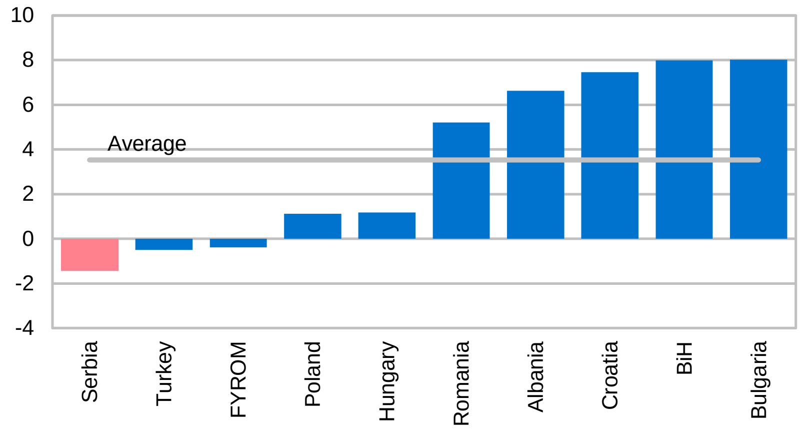
Source: NBS.

- NBS monetary policy easing, the fall in risk premium, fiercer bank competition in the credit market and low interest rates in the euro area drove the costs of corporate and household borrowing down.

Significantly reduced NPLs

NPL ratio below the pre-crisis level

Developments of NPL ratio, countries of the region
(2017 relative to 2008, pp)

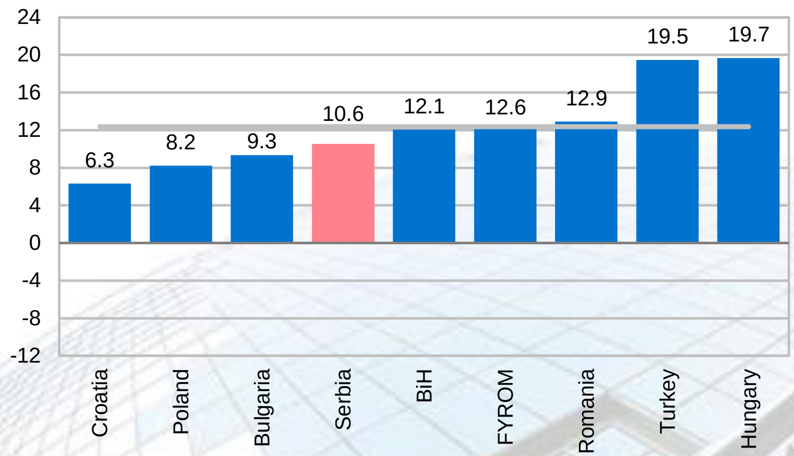


Sources: NBS and IMF: GFSR.

- At end-2017 the share of NPLs in total loans amounted to 9.8% – the lowest level recorded since 2008.
- High coverage of NPLs by the loan loss provisions (133.2%), which is the highest in the region, significantly amortised the NPL channel as a potential cause of instability in the financial system.

A decrease in NPLs helped boost banks' profitability

Return on equity, countries of the region
(2017, latest available data, %)



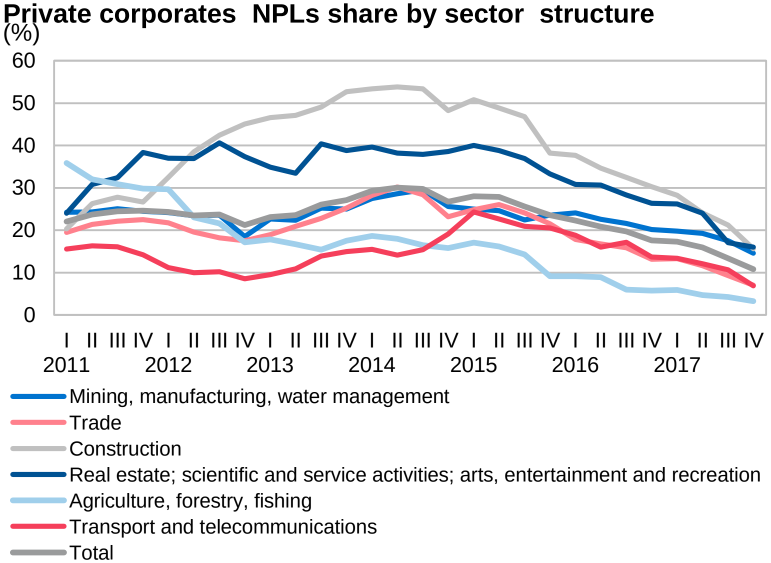
Sources: NBS and IMF: GFSR.

- Improved profitability is attributable chiefly to the one-off effects of banking sector consolidation and the reduction in net loan losses as a result of lower net expenses on account of indirect write-off of balance sheet items.
- A decrease in net interest income worked in the opposite direction.

Profitability and a considerable cut in the corporate NPL ratio

The credit portfolio quality has improved in all sectors of the economy

Private corporates NPLs share by sector structure

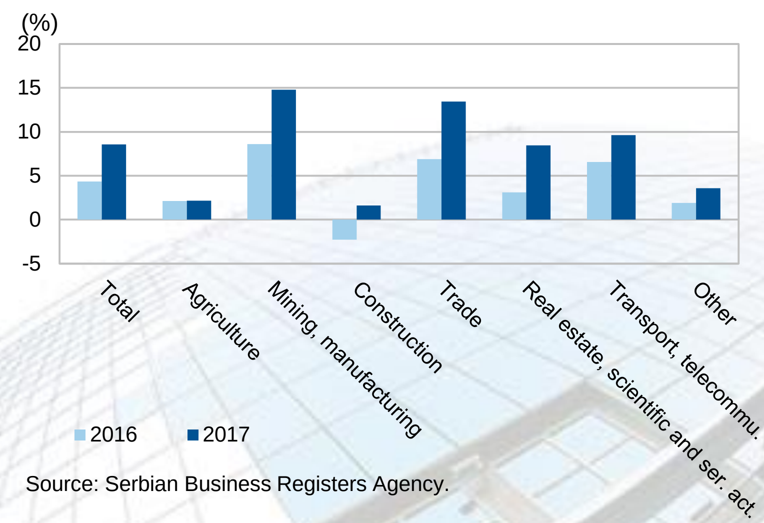


Source: NBS.

- The share of NPLs in total loans to public enterprises and companies amounted to 10.4% at end-2017, down by 6.8 pp relative to the end of the previous year.
- The decrease in NPL ratio was the sharpest in those economic sectors that were hit the most by the global financial crisis.

Sustained profitable operations of economic entities

Corporates return on equity (post-tax) by selected sectors



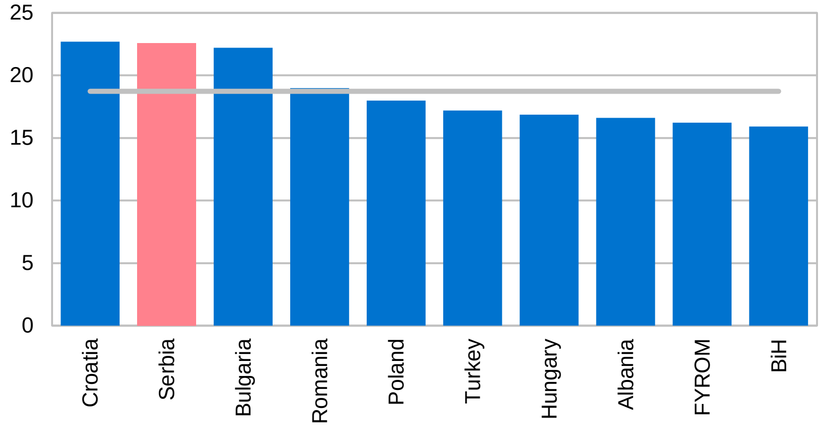
Source: Serbian Business Registers Agency.

- Owing to economic growth acceleration, in 2017 economic entities achieved almost two and a half times higher positive net financial result than in 2016.
- In 2017 all sectors operated with profit.

Banking sector adequately capitalised

Capital adequacy ratios are high, while reliance on the domestic sources of funding reduces the degree of bank exposure to risks from the international environment

Regulatory capital to risk-weighted assets, countries of the region
(2017, latest available data, %)

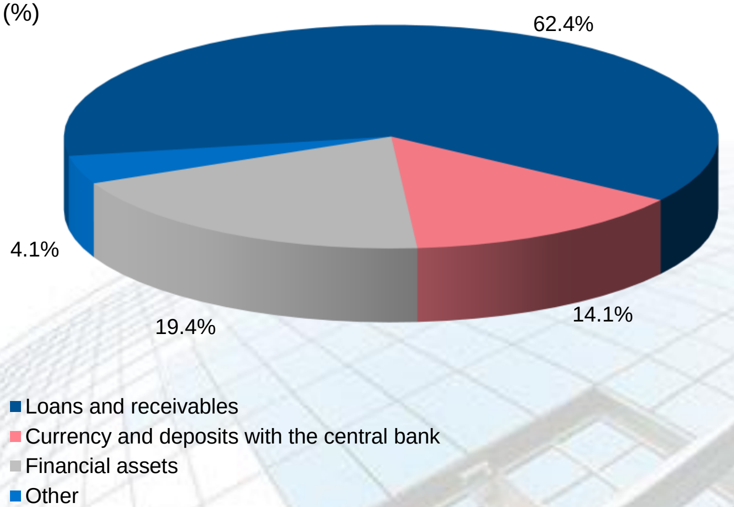


Sources: NBS and IMF: GFSR.

- Domestic banking sector CAR at a high level, above the regional average.
- High share of domestic deposits in liabilities reduces the banking sector’s exposure to external risks and to cross-border deleveraging risk.

Banks oriented towards traditional credit-deposit transactions

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



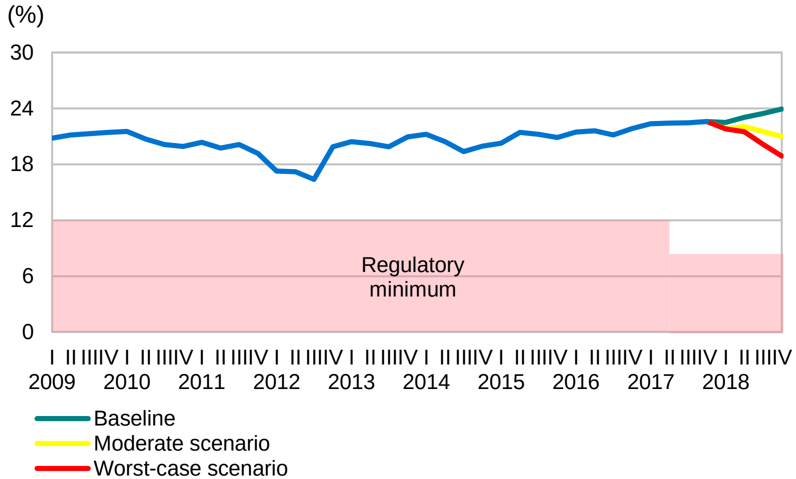
Source: NBS.

- Compared to the year before, lending activity rose by 7.3%, excluding the exchange rate effect.
- The bulk of financial assets is investment in the securities of the Republic of Serbia, evidencing that the banking sector is prone to safer types of investment.

Banking sector is solvent, liquid and resistant to shocks

The banking sector would remain adequately capitalised even in the case of extremely negative developments

Expected capital adequacy ratio by stress scenario*

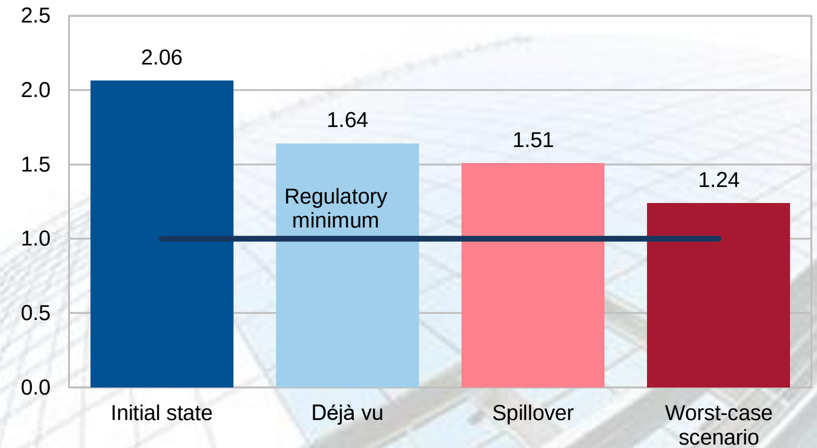


* NBS estimate.
Source: NBS.

- Under the central projection, moderate, and/or worst-case scenario, banking sector CAR would reach 23.9%, 21% and 18.9%, respectively.

… and highly liquid even in the face of extreme deposit outflow

Expected liquidity ratio for the banking sector by stress scenario*



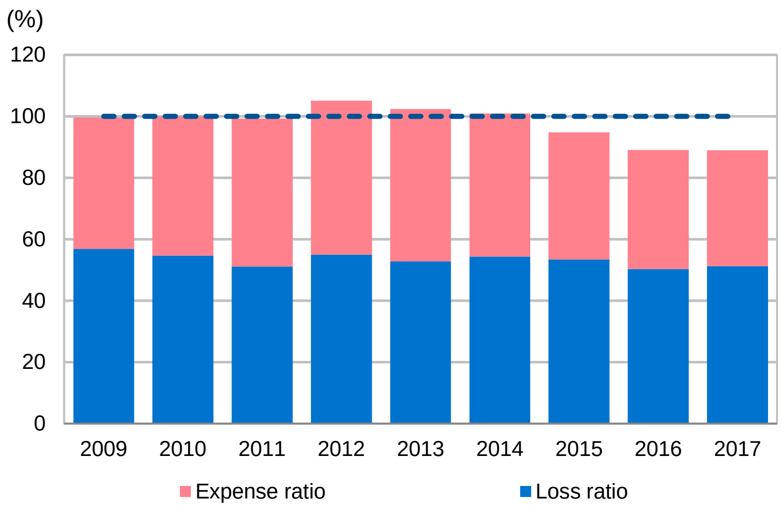
* NBS estimate.
Source: NBS.

- Under the worst-case scenario, banking sector liquidity would range between 2.06 (it measured at end-2017) and 1.24.

Non-banking sector is stable and profitable with a potential for further development

The insurance sector is adequately capitalised and profitable

Combined insurance ratio

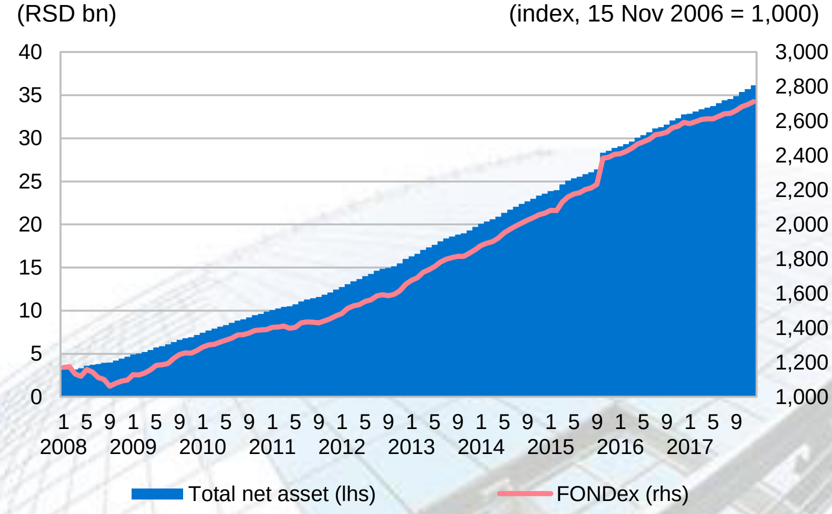


Source: NBS.

- At end-2017 the insurance sector posted a positive net result of RSD 6.4 bn after tax.
- Stress tests conducted for the insurance sector point to its stability and high capitalisation even in the case of extreme and very unlikely shocks.

Other non-banking sectors also recorded positive tendencies

Total VPF net assets and FONDex



Source: NBS.

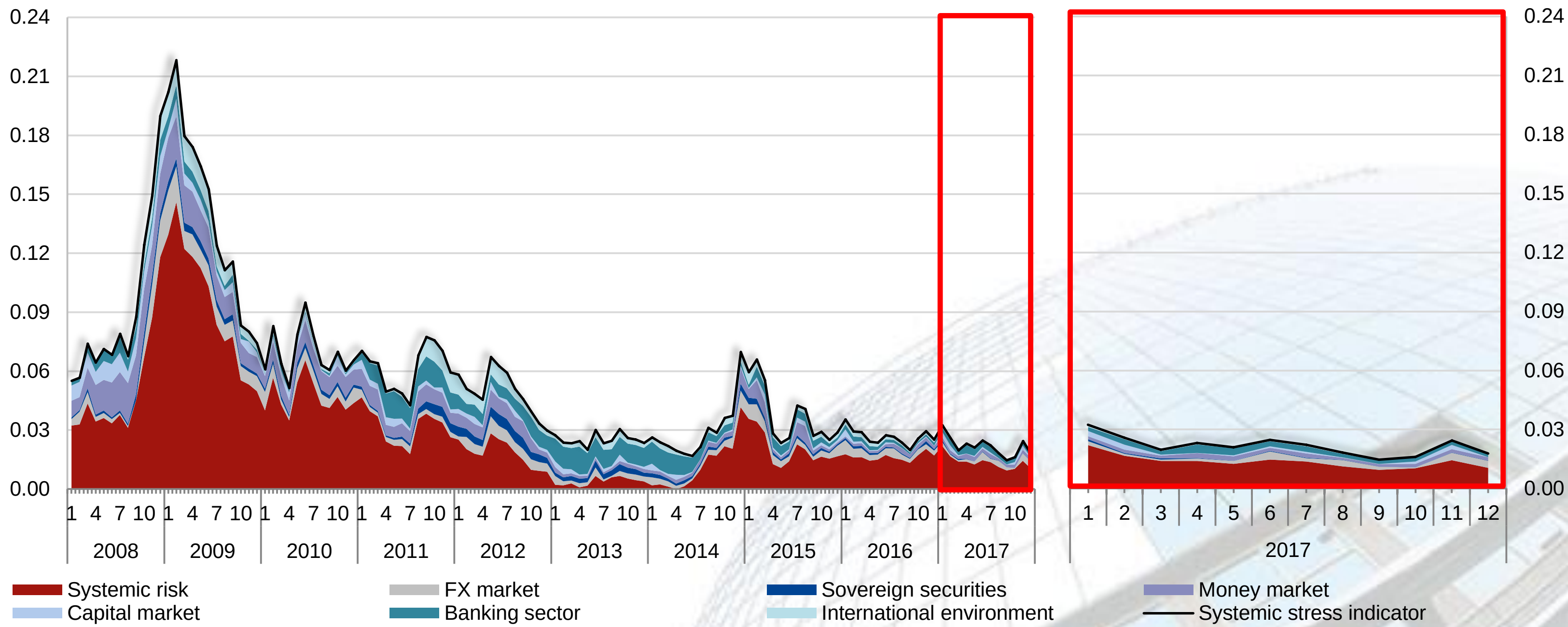
- Total net VPF assets rose by around 10% to RSD 36.2 bn, with the annual FONDex yield of 4.7%.
- Balance sheet assets of the financial leasing kept on growing with enhanced quality on account of significant decrease in non-performing exposures.

Overall assessment of financial stability in 2017

The beginning of 2017 was marked by the developments in the international environment

Overall, 2017 was a year of low systemic stress

Systemic stress indicator dynamics



Source: NBS.

- Early 2017 saw negligibly heightened stress in the money and capital markets mainly on account of rising uncertainty in the international market.

- Low stress levels in all segments of the financial system persisted throughout 2017.

Overview of text boxes

1. Countercyclical capital buffer
2. Systemic risk buffer
3. NPL determinants
4. Effect of the macroprudential stress tests scenario assumptions on capital buffers
5. Development of FinTech and impact on financial stability
6. National DinaCard System
7. Assessment of effects of activities envisaged by the NPL Resolution Strategy

Thank you for your attention!