Народна банка Србије

Annual Financial Stability Report for 2018

Belgrade, 31 July 2019

External risks and measures

- Slowdown in global economic growth and deterioration of financial conditions;
- Strengthening of trade tensions and withdrawal of major world economies from multilateral trade agreements;
- Changes in monetary policies of the Fed and ECB and the impact on capital flows towards emerging economies;
- Volatile prices in global financial and commodity markets;
- Creation of price bubbles in real estate markets in an environment of low returns on other types of assets;
- A rise in variable interest rates on FX-indexed loans after a period of exceptionally low interest rates of leading central banks.

- Continuation of structural reforms and preservation of solid results of economic policy in order to preserve and strengthen the achieved macroeconomic stability;
- Cautious monetary policy stance to support macroeconomic stability and sustainable economic growth;
- Consistent implementation of macroprudential policy to increase financial system resilience to external risks;
- Cooperation with parent supervisors and international financial institutions to strengthen support to the domestic financial sector;
- Strengthening the domestic investor base;
- Implementation of the new Strategy of Dinarisation of the Serbian Financial System and promoting the use of the domestic currency.

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Internal risks and measures

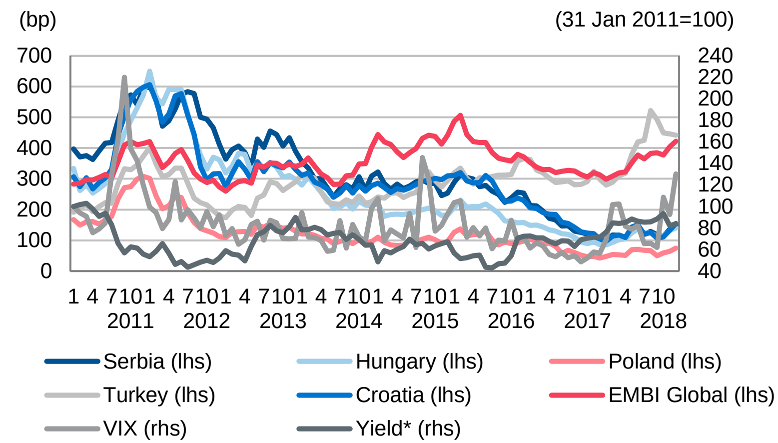
- A high level of euroisation of the financial system increases the exposure of the domestic financial system to developments in international markets;
- Unsecured non-purpose household lending at unreasonably long maturities.
- The build-up of new NPLs as banks take on more risk;
- Increased financial system procyclicality.

- Implementation of measures and activities envisaged by the new Dinarisation Strategy;
- Implementation of regulatory measures aimed at limiting the risk of euroisation and promoting the use of the domestic currency;
- Maintenance of low, predictable and stable inflation and relative stability of the exchange rate;
- Implementation of NBS measures which target this segment of household lending without undesired consequences on overall lending activity;
- Implementation of the NPL Resolution Programme for the 2018–2020 Period and enhanced monitoring of the quality of bank assets;
- Further implementation of macroprudential instruments aimed at mitigation of the cyclical dimension of systemic risk.

International environment

Economic activity of advanced and emerging economies slowed down

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

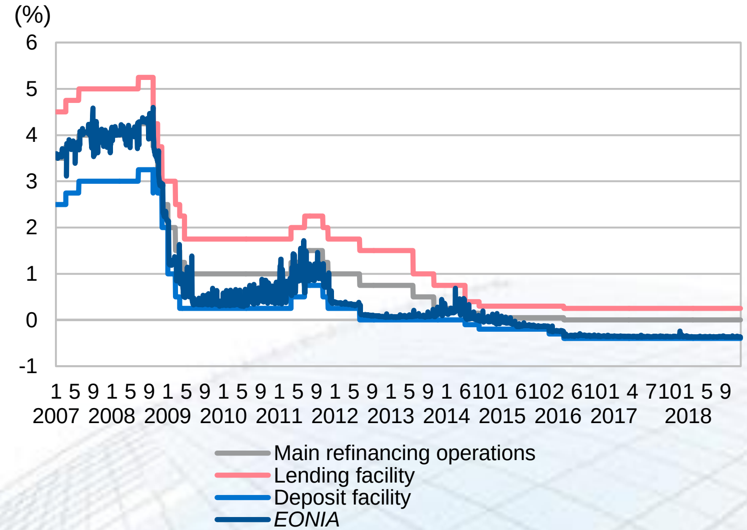


* On derived ten-year US bonds.
Sources: J.P. Morgan and Bloomberg.

- Weaker prospects for global economic growth and rising geopolitical and trade tensions fuelled uncertainties in the international financial and commodity markets.
- Due to the slackening of global economic growth, the normalisation of monetary policies of leading central banks is expected to be slower, which may positively affect capital flows towards emerging market economies.

Monetary policies of the ECB and Fed diverged even further in 2018

ECB's interest rates and EONIA



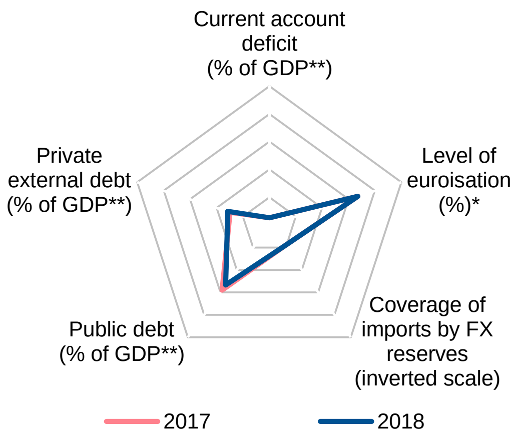
Sources: ECB and Bloomberg.

- In the course of 2018, the ECB kept the key interest rates unchanged and at end-December wound down the asset purchase programme.
- The Fed continued with monetary policy normalisation, with four policy rate hikes in 2018.

Domestic environment

The resilience of the domestic system increased relative to 2017

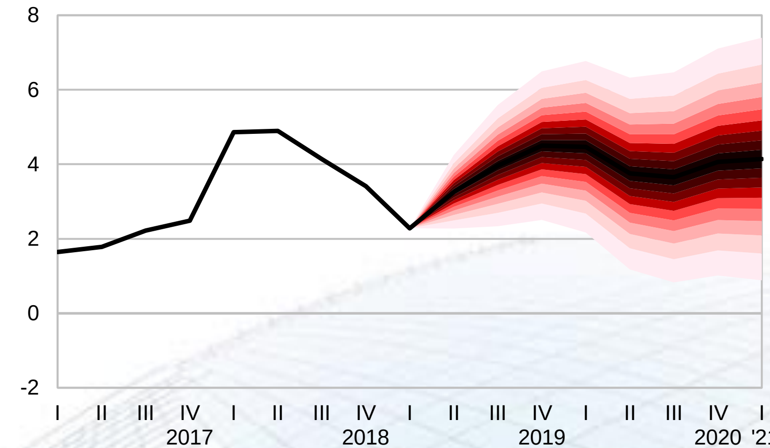
Key macroeconomic risks



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

GDP growth in 2018 accelerated to its highest level in the past ten years

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



* May 2019.
Source: NBS.

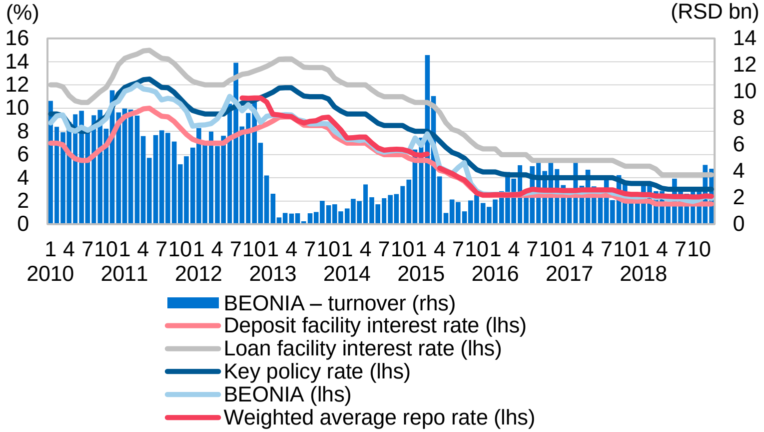
- The resilience of the domestic economy to external uncertainties increased owing to the narrowing of internal and external imbalances.
- Net FX reserves are at the highest level since monitored, which reinforces the country's resilience to external risks.
- The achieved macroeconomic results are also visible in the lower risk premium and a better rating outlook.

- In 2018, the exchange rate was relatively stable, inflation was low and stable and inflation expectations anchored within the target band.
- In 2019, the economy is expected to grow at a 3.5% rate and to accelerate to around 4% in the medium run, with the maintenance of a favourable growth structure.

NBS decisions in the function of preserving price and financial stability

Low inflationary pressures created room for monetary policy easing

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

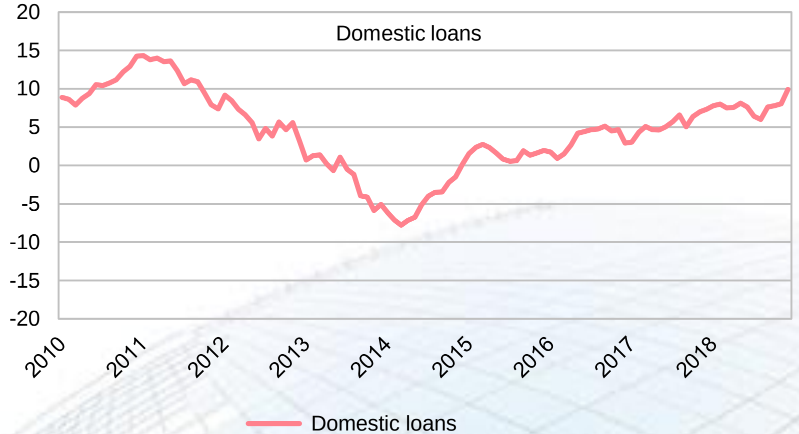


Source: NBS.

- In March and April 2018, the key policy rate was cut by total 50 bp, to 3.0%.
- In 2018, the dinar gained 0.2% against the euro in nominal terms and the NBS intervened by purchasing EUR 1,580 mn net, which increased further the country’s FX reserves.

Falling interest rates on dinar loans contributed to growth in lending

Credit activity*
(y-o-y growth rates, %)



* Excluding the exchange rate effect.
Source: NBS.

- Monetary policy easing contributed to lending activity, which by the year-end recorded a y-o-y growth rate of 9.9%.
- Excluding the effects of NPL write-off and sale, the growth in lending is even more notable.

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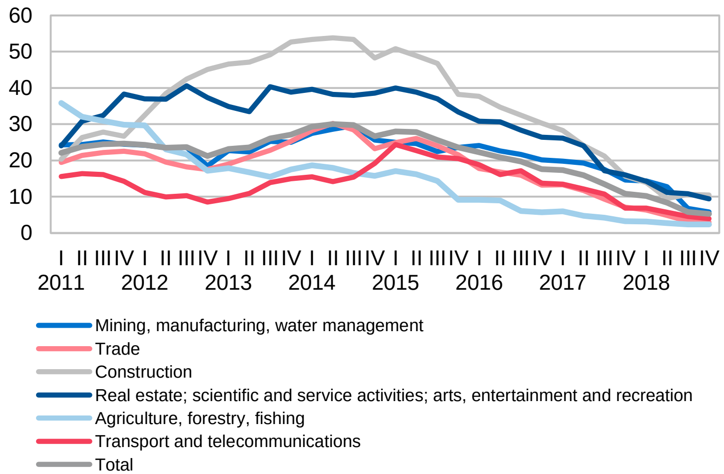
A further rise in profitability and a reduction in NPLs in the corporate sector

The credit portfolio quality improved in all sectors of the economy

NPL share in total loans of corporates, by sector
(%)

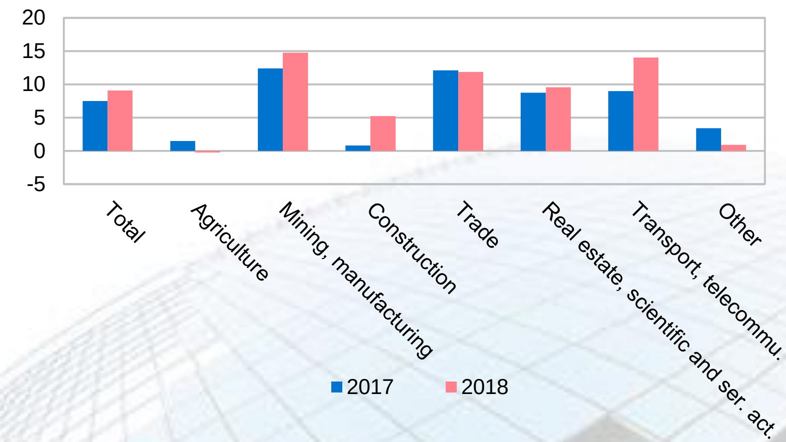


Source: NBS.

- At end-2018, the NPL share in total corporate loans was 5.0%, down by 5.4 pp from end-2017.

Corporate profit increased by a third compared to last year

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



Source: Business Registers Agency.

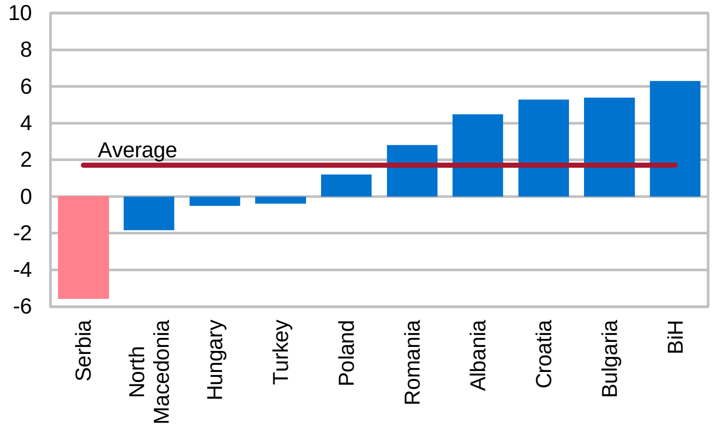
- The trend of profitable operation of the corporate sector, which started in 2015, continued. In an environment of vigorous economic growth, economic entities recorded around RSD 500 bn in net profit.
- SMEs recorded the highest ROE rates.

Positive developments in the banking sector

NPLs significantly lower than pre-crisis

Developments of NPL ratio, countries of the region

(2018 relative to 2008, pp)



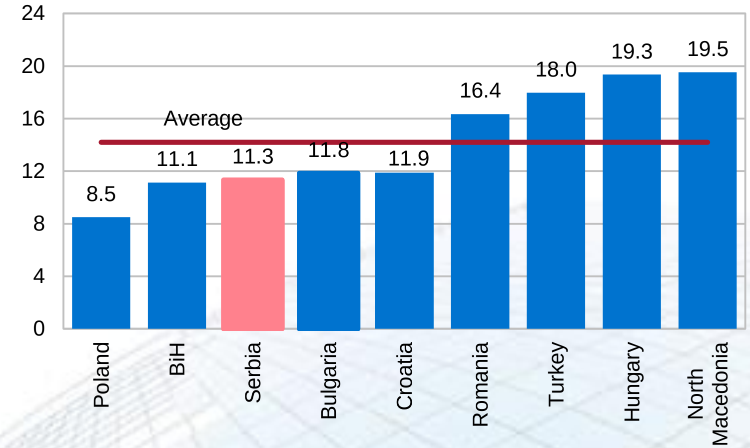
Sources: NBS and IMF - GFSR.

- Owing to NBS measures and successful implementation of the NPL Resolution Strategy, as well as to the growth in economic and credit activity, the share of NPLs continued down in 2018.
- The share of NPLs in total loans at end-2018 was 5.7%, i.e. the lowest since this indicator of asset quality is monitored.

NPL reduction helped increase bank profitability

ROE, countries of the region

(2018, latest available data, %)



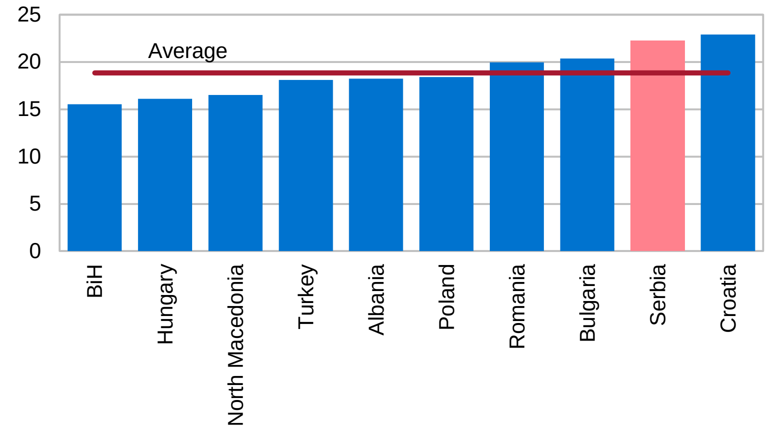
Sources: NBS and IMF - GFSR.

- The strongest positive effect on banking sector profitability came from increased interest income amid stepped-up lending and from a fall in net credit losses.
- Return on equity was somewhat lower than the regional average due to the high capitalisation of the banking sector.

High capitalisation of the banking sector

Capital adequacy ratios are high owing to the strong capital base

Regulatory capital to risk-weighted assets, countries of the region
(2018, latest available data, %)

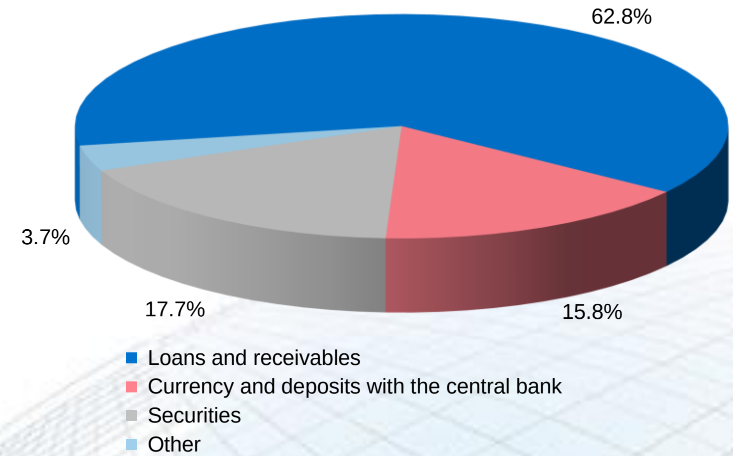


Sources: NBS and IMF.

- Capitalisation of the Serbian banking sector in 2018 was among the highest in the region.
- Banks allocated RSD 130 bn worth of CET 1 in the form of capital buffers, or 5.4% of risk-weighted assets.

Loans account for the dominant share of banking sector assets

Structure of assets of the Serbian banking sector



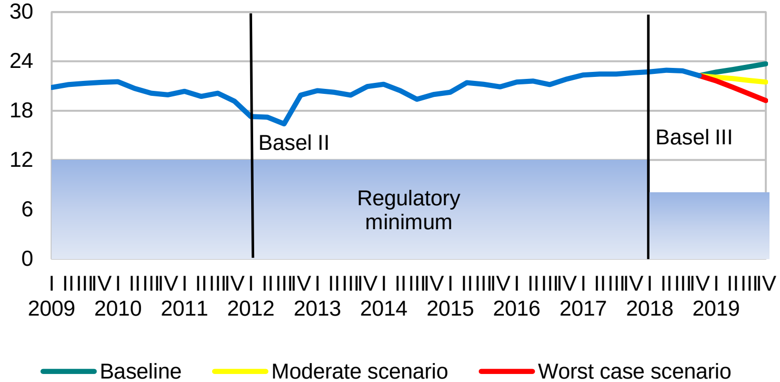
Source: NBS.

- The structure of assets is indicative of high liquidity and risk aversion.
- In terms of the sources of funding, banks rely on domestic corporate and household deposits, which lessens the need for borrowing from their parent banks.

Stress tests confirm the banking sector's resilience to shocks

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

CAR by stress scenario*
(%)

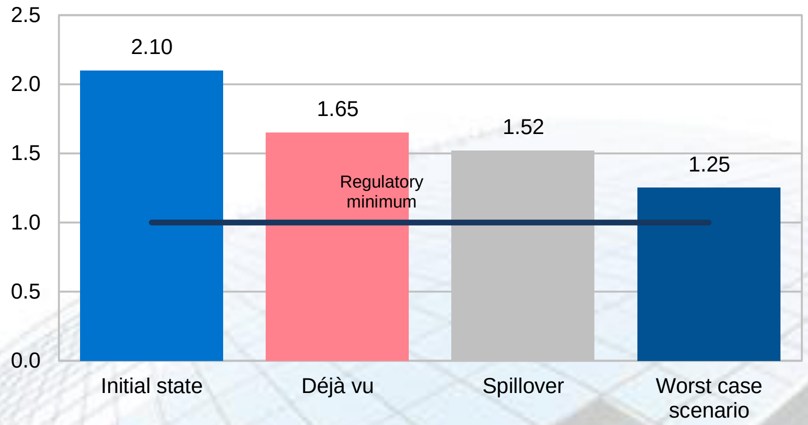


* NBS estimate.
Source: NBS.

- Under the baseline, moderate, and/or worst-case scenario, banking sector CAR would reach 23.7%, 21.5% and 19.2%, respectively.

The liquidity of the banking sector would not be threatened even in the case of extreme deposit outflow

Liquidity ratio for the banking sector by stress scenario*

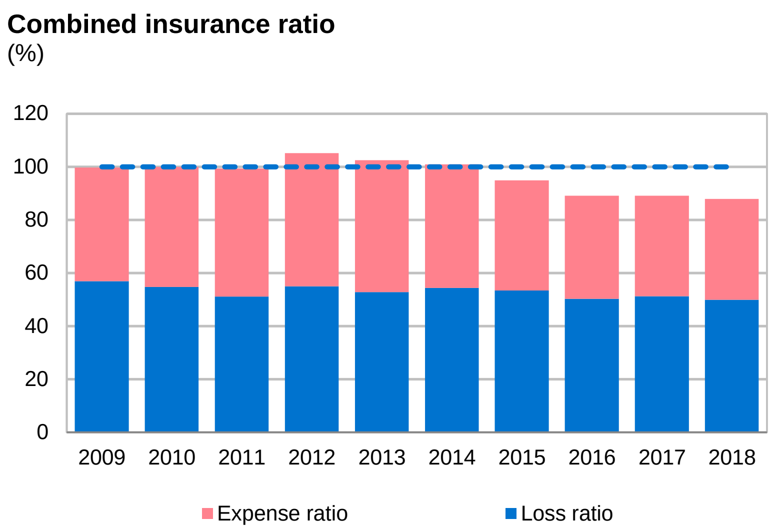


* NBS estimate.
Source: NBS.

- At end-2018, banking sector liquidity ratio was 2.1, whereas in the worst-case scenario it would be 1.25.

Continuing positive trends in the non-banking sector

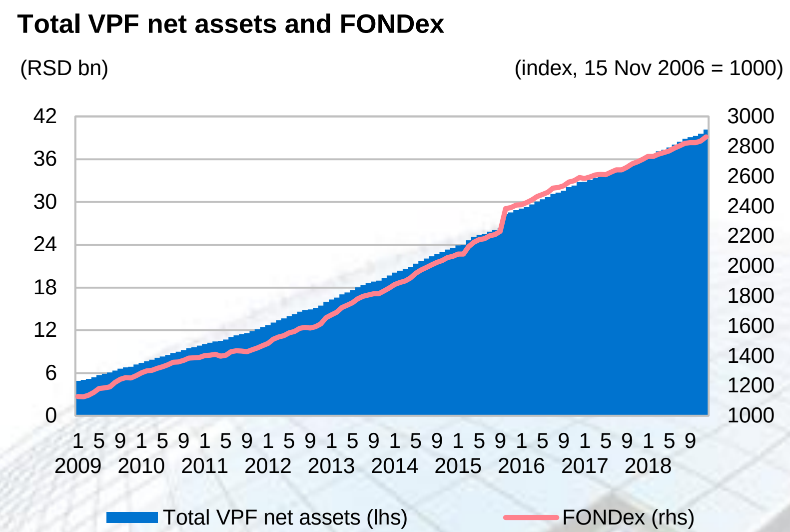
The well-capitalised insurance sector saw a rise in total premium and returns



Source: NBS.

- The capital adequacy ratio of both life and non-life insurance was twice higher than the regulatory minimum.
- The insurance sector's share in the balance sheet total of the financial sector maintained the upward trend.

Positive developments were also recorded in the VPF and financial leasing sectors



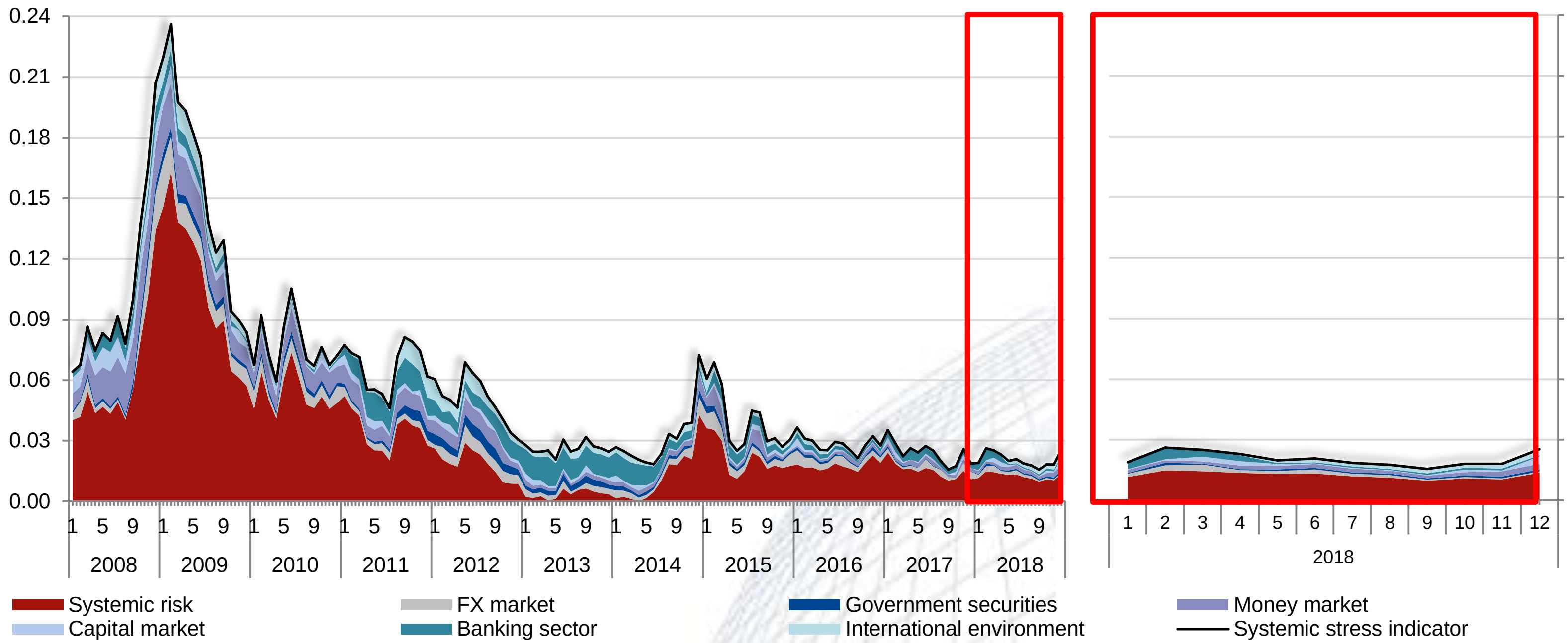
Source: NBS.

- Total net VPF assets expanded by around 11%, driven mainly by the return on investment, with the annual FONDex return reaching 5.5%
- Balance sheet assets of the financial leasing sector continued expanding, while asset quality improved owing to a significant reduction in non-performing receivables.

Overall assessment of financial stability in 2018

For the third year in a row, the systemic stress indicator is stable and in the zone of low stress

Systemic stress indicator dynamics



Source: NBS.

- Marginally elevated stress in the capital and money markets, attributable to temporary seasonal factors, was recorded in early 2018. In the remainder of the year, stress was low in all segments of the financial system.
- The systemic component of risk was low and stable throughout 2018.

Text boxes in the Report

1. Ten years after the global financial crisis
2. Climate change as a challenge to financial stability
3. Results of the 2018 EU-wide stress tests
4. New payment system in the Republic of Serbia – Instant Payments Serbia
5. Real estate valuations in 2018
6. Financial innovations and cyber security
7. Impact assessment of capital-based macroprudential measures on credit and economic growth

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