NATIONAL BANK OF SERBIA

Speech at the presentation of the Annual Financial Stability Report for 2017

Dr Diana Dragutinović, Vice Governor

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

Thank you all for being here today with us. It is a great honour and pleasure for me to have been given the opportunity to take part in the presentation of the latest Financial Stability Report. I hope you won't mind if I describe it as a comprehensive, well-documented, clearly written and, most importantly, balanced report, as it gives a true overview of developments (trends) and risks that might occur if some trends continue.

Good news. Let me start off with positive developments that were conducive to the strengthening of financial system stability.

The Serbian economy is growing and is not alone in this, since the world economy is growing too, as well as the European. We still can't say that the growth is dynamic, but it sure is sustainable because it takes place in the phase of deleveraging, that is, a significant reduction in both public and external debt.

The three-year upward trend of the Serbian economy has translated into considerably higher total profitability of the corporate sector. Since 2015, when we started recording positive results, net profit increased from RSD 67.2 bn to RSD 437.2 bn in 2017. A rise in profitability is even more pronounced taking into account the fact that companies operated in 2014 at a net loss of RSD 132.6 bn.

Positive movements were registered in the labour market (growth in employment and average wages), as well as in the domain of public finance.

The number of economic entities under bankruptcy and liquidation procedures went down from 590 in 2013 to 384 in 2017. The number of new NPLs is on the decline, while existing NPLs are being restructured, written off or sold at an accelerated pace. As a result, the share of NPLs in total loans is lower than pre-crisis.

Neither corporates nor households are overindebted. Corporate debt stands at 45% and household at around 20% of GDP. The situation is far better than at global level, where private sector debt makes up around 145% of GDP compared to 65% of GDP in Serbia. And the lesser the debt of the private sector, the smaller the risk that imbalances in the credit market will amplify the fallout from macroeconomic shocks and jeopardise financial stability.

Risks. Despite positive developments, we must not disregard the fact that the indicators signalling risks to financial stability, for instance the number of new bankruptcies or the number of new NPLs, are a result of economic agents' behaviour in the past. On the one hand, this is a significant event and a sure sign that a company is in financial difficulties. On the other hand, there is a considerable period of time between the point when operational problems begin and the point they manifest in the non-performance of obligations or initiation of bankruptcy procedures. That is why expected (future) developments are critical in the assessment of financial stability because expectations are the factor that shapes the present behaviour, that is, future financial difficulties or NPLs.

What can we say about the expected (future) developments? According to the IMF's projections, the Serbian economy will grow by 3.5% in 2018 and 2019. Against the background of accelerated economic growth and historically lowest interest rates, we may expect further acceleration of credit growth.

In this context, the National Bank of Serbia is responsible for regularly assessing the sustainability of public and private debt (credit activity), in order to prevent the build-up of debt and minimise the risk that borrowers will not be able to amortise their loans acting with regulatory measures, even if credit losses do not pose a threat to an individual financial institution.

Comprehensive regulatory reform. We can proudly say that the new international regulatory architecture built as a response to the crisis is fully included in the domestic regulatory framework. An important dimension of the new architecture is a significantly larger number of regulatory rules or limitations for the banking sector. In addition to capital standards, regulatory rules concerning liquidity, financial dependence and loss absorption capacity were introduced. It is a fact that each regulatory limitation encourages banks to arbitration and rule dodging. However, multiple limitations, requiring banks to hold sufficient capital, eligible liabilities and liquidity in order to increase their resilience to potential economic and financial crises – minimise this risk.

The regulator's focus on crises, even though they are not that common as they tend to occur once every 20-25 years, is a consequence of the high costs of the crisis. To assess these costs there are two most frequently used approaches: the cumulative GDP loss relative to the long-term pre-crisis growth rate and the cumulative fiscal costs. Admittedly, pre-crisis economic growth was unsustainable as it was based on excessive credit growth, i.e. debt accumulation by corporates, households and banks.

According to available estaimates of the crisis costs in the largest world economies, the GDP loss is huge and long-lasting as GDP is 30–40% below the level it would have been had the economy been growing at the pre-crisis rate. We get a similar picture by looking at the fiscal costs of the crisis, i.e. by looking at the share of public debt in GDP, which also rose by 30–40% of GDP. High costs of the crisis required a comprehensive regulatory reform.

The international reform of microprudential regulation focused on the four key areas: capital, financial dependence, liquidity and recovery, and resolution.

The aim of the capital standards reform was to ensure that banks have sufficient quality capital to absorb unexpected losses and continue to extend loans in stressful conditions. Owing to capital standards, banks must assign granular risk weights to individual assets. As it is sometimes hard to assess risk weights (not only for objective reasons), capital standards were supplemented by the financial indebtedness threshold which, unlike capital standards, does not depend on internal risk assessment models and is, as such, less subject to arbitration.

Solvency standards have been supplemented with liquidity standards. First, they bind a bank to have sufficient high-quality liquid assets to cover thirty-day liquidity needs, leaving enough time to the regulator to potentially launch its resolution. Secondly, a bank's business model must be based on sustainable sources of funding, which is a defence against balance sheet expansion. Each expansion, therefore, must be supported by capital and stable sources of funding.

It transpired during the crisis that the financial regulatory architecture lacked instruments which enable a controlled exit of financial institutions from the market. The Directive establishing a framework for the recovery and resolution of credit institutions and investment firms bridged this gap. The harmonised minimum set of resolution tools includes: the sale of shares, that is entire or a part of assets and liabilities of a bank undergoing resolution to a private entity or a bank; transfer of shares of a bank undergoing resolution or transfer of entire or a part of assets to a state-owned bridge bank; asset separation. However, the key element is the bail-in tool, owing to which creditors, in addition to shareholders (owners), are for the first time exposed to losses, without initiation of a bankruptcy procedure.

Moreover, to ensure that the costs of a controlled market exit be covered exclusively by those who caused problems in operation – i.e. shareholders and creditors of financial institutions, instead of taxpayers – minimum requirements for own funds and eligible liabilities for bail-in (MREL) were introduced.

Microprudential standards were complemented with macroprudential measures, which are a powerful weapon in the struggle against excessive borrowing. The most important reforms concern two areas – macroprudential capital requirements and stress testing.

Historically, capital standards have been static. However, as it was recognised that the risk in the financial system varies during a credit cycle (being the highest in the expansion and lowest in the contraction phase), a component depending on the credit cycle phase was introduced as part of Basel III. The countercyclical capital buffer is an additional capital requirement introduced (raised) in the expansion phase and eliminated (lowered) in the contraction phase.

One of the key lessons learned during the crisis is that some institutions introduce a higher degree of risk to the system due to their size, complexity and connectedness. This is why systemically important institutions must have additional capital buffers to mitigate the additional risk they introduce.

Comprehensive macroprudential stress tests are carried out regularly. Their results are published in the Annual Financial Stability Report. Stress tests were implemented before the crisis as well, but were not comprehensive and macroprudential. They are used as an instrument to assess whether banks have sufficient capital to weather unfavourable trends. For the sake of caution, they are not based on banks' internal models – instead, the regulator determines stress scenario assumptions, models the impact of the stress scenario on solvency and liquidity of banks, and the feedback effect on macroeconomic developments, and defines performance criteria.

Finally, a set of regulatory reforms was supported by more detailed bank reporting, which enables a reliable estimate of individual and systemic risks.

Challenges before the National Bank of Serbia. The key message of this Report is that banks in Serbia are resilient and able to maintain critical services even in turbulent (stressful) times (conditions). They are able to do so because they operate at a profit, have a high level of capital for the risks they assume in their operations and considerable liquidity reserves. On top of this, they are not indebted.

What next? Financial crises of the 1990s taught us that stable public finance is of paramount importance for the stability of the financial system. Today we have sustainable public finance! The latest global financial crisis from 2008 highlighted the need for more stringent capital and liquidity standards and for using resolution as a crisis management method. Today we have these instruments at our disposal. Today we can say with ease that we are better equipped for protection against potential shocks and their negative consequences than we used to be.

Moreover, we have learned from different crises that there is no perfect regulation and that every regulation changes by taking into account current conditions, particularly those that could not be envisaged.

Transparency of transactions and assets recorded in the DLT may build the capacity of regulators to assess risks and oversee compliance with regulatory requirements. Though young and very much underexplored, the DLT has a potential to bring significant economic benefits.

And to conclude – financial system is dynamic and that is why the financial regulatory regime must be adjusted. The challenge before the National Bank of Serbia, and not only the National Bank of Serbia, is to adjust regulatory rules so as to keep up with these developments.

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

Thank you for your attention. I will now give the floor to the General Manager of the Financial Stability Department.