National Bank of Serbia

The Policy Response in Europe: How to Deal with the Financial Cycle

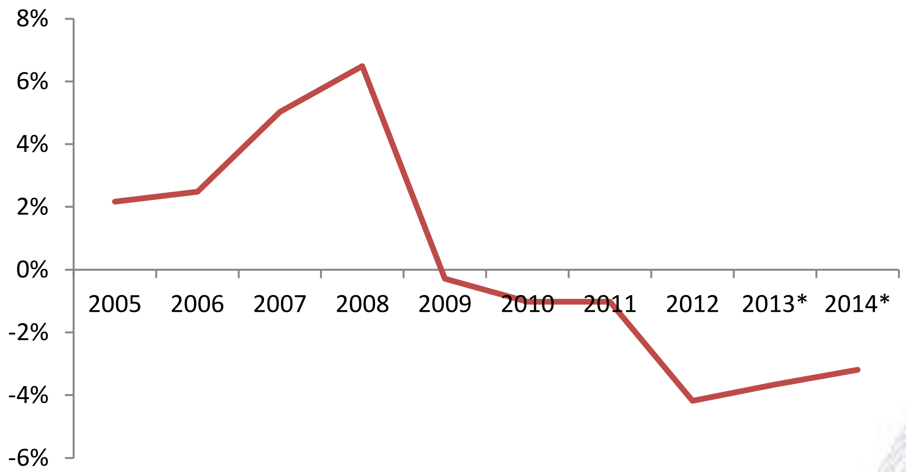
- The Case of Serbia -

Bojana Mijailović, CFA, MScF
Head of Banking Sector Analysis and Regulation Division
Banking Supervision Department

The Latest Business Cycle in Serbia…

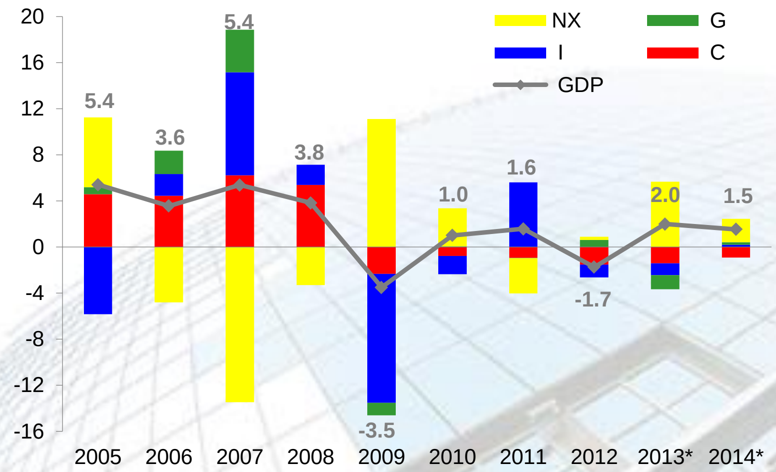
Output gap widened during the crisis

Chart 1 **Output gap**
(in % of potential GDP)



GDP growth rates decreased, but the growth is now more sustainable

Chart 2 **Contributions to Real GDP Growth**
(y-o-y rates, pp)



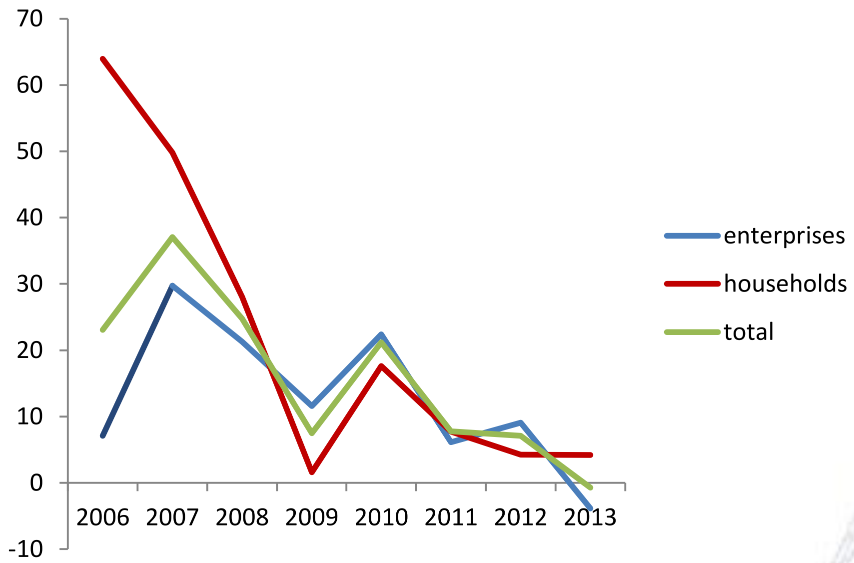
* NBS forecast

- Prior to the crisis, high capital inflows led to unsustainable import driven consumption-based GDP growth.
- With the first wave of the crisis, this trend reversed and growth became slower, but more sustainable - driven by net exports and investments.
- Economic activity in the coming period will be primarily dependent on severity of fiscal consolidation measures and on speed of recovery in euro area.

…Cause or Consequence of Credit Cycle?

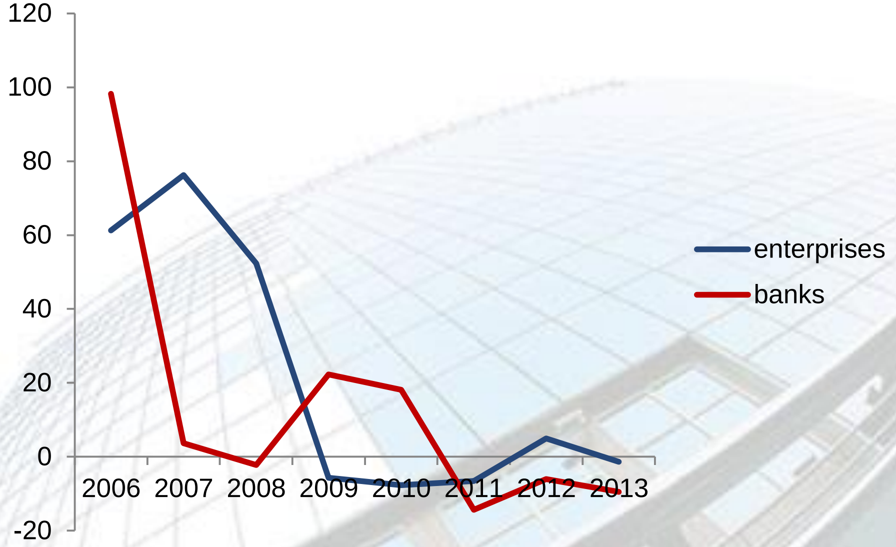
Period of significant credit growth was followed by its slowdown and contraction

Chart 3 **Banking sector loan portfolio**
(y-o-y growth rates, in %)



Credit cycle is also evident in external sources of funding

Chart 4 **Cross border borrowing**
(y-o-y growth rates, in %)

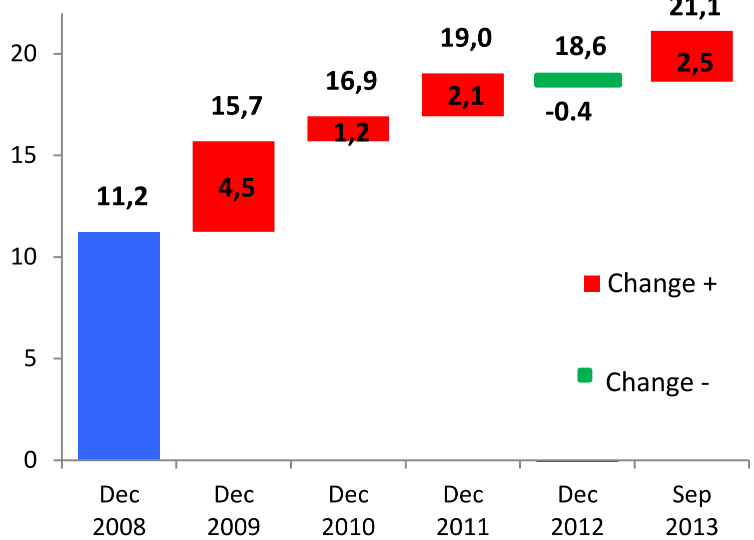


- Have we experienced a “Minsky moment“?
- Following the crisis spill over, immediate pro-cyclical response by the banks was withdrawal from further risk taking, thus decreasing credit growth. Deleveraging process begun.
- Supply side factors: high NPLs, growing risk aversion, and (in some cases) limited sources of funding.
- Demand side factors: sluggish economic recovery, high unemployment and high interest rates.

Economic Downturn and Credit Contraction Led to Increase of NPLs

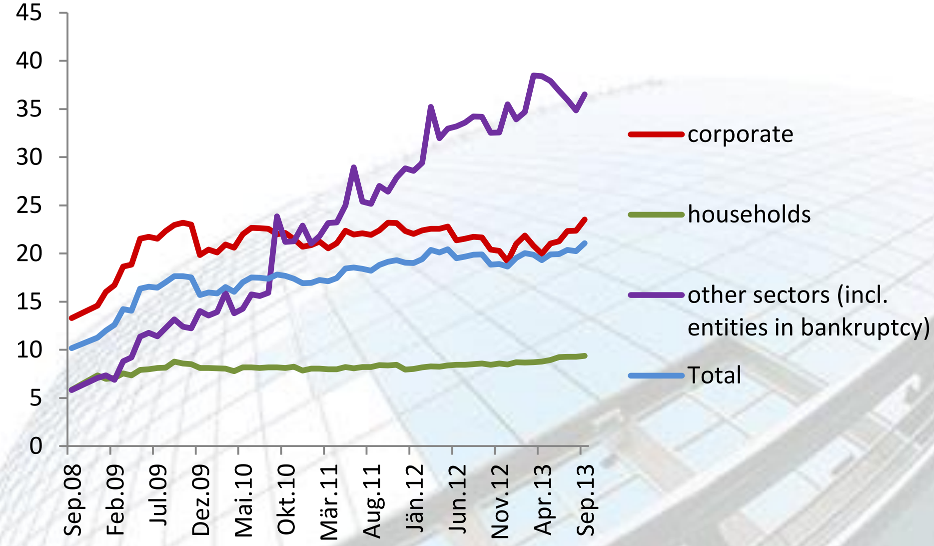
Non-performing loans are high…

Chart 5 **Banking sector gross NPL ratio**
(in %)



... and driven by corporates

Chart 6 **Gross NPL ratio by sectors**
(in %)



- The main drivers of total NPLs are companies in manufacturing, trade and construction sectors and entities in bankruptcy procedure (included in ‘other sectors’).
- While waiting for the implementation of international standards in this field developed by EBA – cautiousness is needed when performing international comparisons!

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What Have We Done in the Boom Phase?

Main challenges and risks:

Excessive growth of loan portfolio (especially for households)

Growing exposure to FX risk and FX-induced credit risk

Measures taken:

- Increase of required reserves and key policy rate
- Tightening regulatory provisions' rules
- Mandatory DTI ratio for households
- Gross households lending / Tier 1 capital (max 200%)

- Increasing required reserves for FX liabilities
- Lower FX ratio (net open position / capital)
- Higher risk weights for FX exposures
- Lower DTI ratio for FX exposures to households

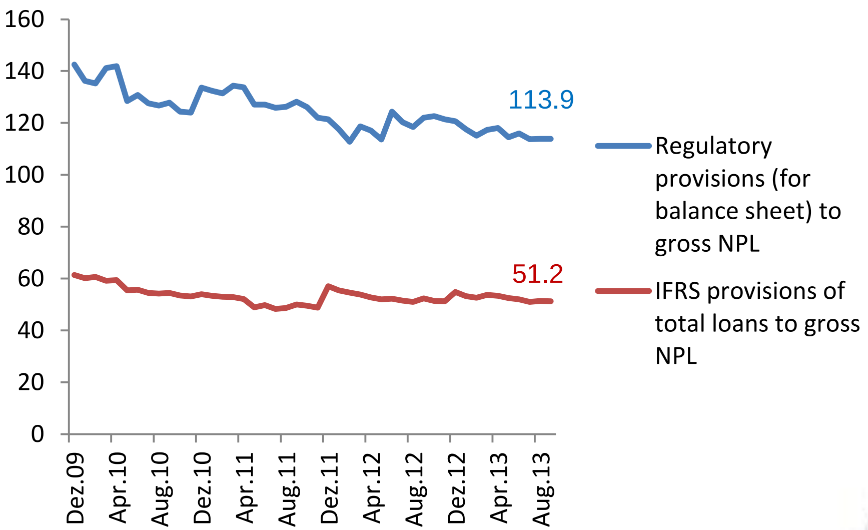
What are We Doing in the Bust Phase?

Main challenges and risks:	Measures taken:
Slowdown in lending activity	- Gradual cut of key policy rate and required reserves - Relaxing regulatory provisions' rules - Government's subsidized loan program (when funds are available)
High exposure to FX risk and FX-induced credit risk	- Higher required reserves for FX liabilities - Risk weights in line with Basel II (focus on Pillar 2) - For households loans: min. 30% down payment or deposit; for mortgage loans LTV ratio 80%; indexation only to euro - Recommendation for CHF mortgage loans
High and increasing NPLs	- Easing conditions for assignment of receivables - Incentives for voluntary debt restructuring - Removal of tax obstacles for write-off
Excessive deleveraging	- Participation in Vienna initiatives - Strengthening alternative sources of funding (local deposits)

Effects of Counter-cyclical Measures

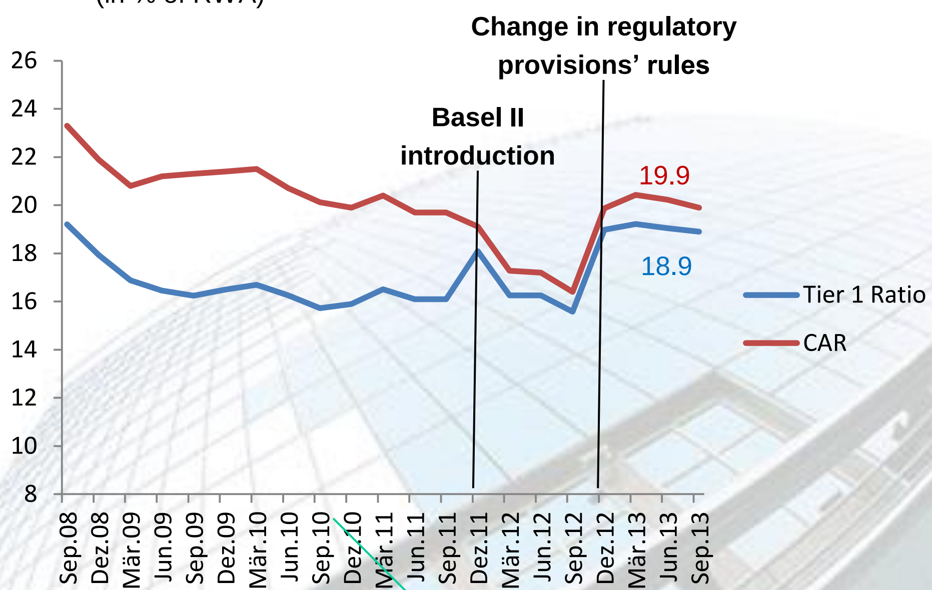
NPLs are continuously fully covered by regulatory provisions

Chart 7 **Gross NPL coverage ratio**
(in %)



Capital adequacy ratio is significantly above regulatory (12%) and Basel minimum (8%)

Chart 8 **Capital adequacy and quality**
(in % of RWA)



- Strong effects for sustaining financial stability - although heavily criticized throughout the credit boom, countercyclical prudential measures created more than adequate buffers for loss absorption.
- Weak effects for NPL resolution and boosting credit growth – NPLs are still rising; besides regulation, economic recovery dynamics and effectiveness of legal framework are also important.

What else is coming?
Besides market challenges, more regulatory…

Opportunities:

Banking Union - opportunity to reduce the probability and severity of future financial crises

Basel III – opportunity to create additional counter-cyclical tools and to introduce the first internationally harmonized liquidity standards

IFRS 9 – opportunity to enhance and harmonize impairments/provisions rules (expected instead of incurred losses) – the most significant change of banks' financial reporting since IFRS' inception

And challenges:

Regulatory changes introduce additional uncertainty, impose burden and reduce profitability - consequences might fall upon not only shareholders but also clients, and thus, in the broader context, upon the entire economy.

For countries like Serbia, additional challenge regarding Banking Union comes from the fact that their financial stability depends on the rules and decisions made outside of the country.

What are Possible Further Steps?

- Banking Union:
  - to develop cooperation with EBA, ECB and SRB (e.g. establish direct line of contacts, enable participation of non-EU member countries in supervisory colleges, and assure participation in reaching decisions which affect their financial stability)
- Basel III:
  - to adopt Strategy for Basel III implementation in Serbia
  - some elements of Basel III already in place (exclusion of Tier 3 capital and a capital conservation buffer, although applied on total regulatory capital)
- IFRS 9:
  - implementation is a step forward in harmonization of regulatory adjustments (deductions from capital) – the need for local regulatory provisions cease to exist
- NPL resolution:
  - so far based on incentives and setting the preconditions, should the process become central bank/supervisor driven?
  - if yes, supervisors could prescribe mandatory write-off and provide clearer guidance and stronger oversight of banks' NPL portfolio management activities; banks to design and implement NPL recovery & resolution strategies to return to pre-crisis NPL level…
  - … but regulatory measures deal with consequences, the cause is in the real sector

Appendix

Serbia's Economic Outlook

Serbia	2008	2009	2010	2011	2012	NBS Forecast 2013	NBS Forecast 2014
Real GDP, y-o-y %	3,8	-3,5	1,0	1,6	-1,7	2,0	1,5
Consumption, y-o-y %	6,8	-2,7	-0,9	-1,1	-1,9	-1,8	-1,2
Investment,[1] y-o-y %	5,9	-37,2	-8,0	31,4	-4,8	-4,6	0,9
Government, y-o-y %	0,0	-4,4	0,3	-0,1	2,6	-5,0	0,9
Exports, y-o-y %	9,8	-8,0	15,3	3,4	4,5	21,7	11,0
Imports, y-o-y %	9,6	-19,1	3,1	7,0	2,3	5,1	4,9
Unemployment Rate, %	13,6	16,1	19,2	23.0	24.0[4]	23.9	22,8
Real Wages, y-o-y, %	5,6	0,7	1,0	0,2	1,1	-	-
Money Supply (M3), y-o-y %	1,1	14,0	2,3	2,9	-	-	-
CPI,[2] y-o-y %	8,6	6,6	10,3	7,0	12,2	3,4	4,0
National Bank of Serbia Repo Rate,[3] %	17,8	9,5	11,5	9,8	11,3	n/a	n/a
Current Account Deficit (% of GDP)	21,6	6,6	6,7	9,1	10,5	4,1	3,2
Budget Deficit (% of GDP)	2,6	4,5	4,7	4,9	6,4	5.5[5]	5.5[5]

¹ Including the effect of change in inventories

² Inflation figures in the table represent Dec on Dec inflation: (Pt/Pt-12)*100-100

³ End of period data

4 Labor Force Survey, average 2012

5 NBS forecast

Banking Sector Overview

Serbia	2008	2009	2010	2011	2012	September 2013
Number of banks	34	34	33	33	32 *	31**
Employees	32.342	31.182	29.887	29.228	28.394	27.545
Branches	2.734	2.635	2.487	2.383	2.243	2.088
HHI Assets	627	636	629	664	678	716
Share of foreign banks, %	75,3	74,3	73,5	74,1	75,2	74,7
Assets (net), EUR m	20.056	22.530	24.015	25.211	25.322	25.346
Capital, EUR m	4.740	4.667	4.720	5.104	5.198	5.278
Loans (gross), EUR m	13.071	13.404	15.324	17.204	17.273	16.636
Of which gross NPL, EUR m	1.474	2.103	2.592	3.275	3.217	3.504
Gross NPL ratio, %	11,3	15,7	16,9	19,0	18,6	21,1
Deposits, EUR m	11.565	13.570	14.263	14.584	14.936	15.018
Pretax Income, EUR m	392	209	241	296***	230****	149
CAR, %	21,9	21,4	19,9	19,1	19,9	19,9
Liquidity Ratio	1,8	1,9	2,0	2,2	2,1	2,5
FX ratio, %	7,4	3,6	3,9	6,2	5,5	4,0
ROA, %	2,08	1,02	1,08	1.23***	0.97****	0,79
ROE, %	9,27	4,62	5,37	6.04***	4.65****	3,81
NIM / total assets, %	5,4	5,1	4,6	4,6	4,3	4,1

* the National Bank of Serbia revoked Nova Agrobanka's operating licence on 27 October 2012

** the National Bank of Serbia revoked operating licence to Razvojna banka Vojvodine on 6 April 2013

*** with Agrobanka: Pretax Income € 12.0m , ROA 0.05, ROE 0.24

**** with Razvojna banka Vojvodina: Pretax Income €102.5m, ROA 0.43, ROE 2.05