TOPIC OF THE ISSUE

Banking sector stability

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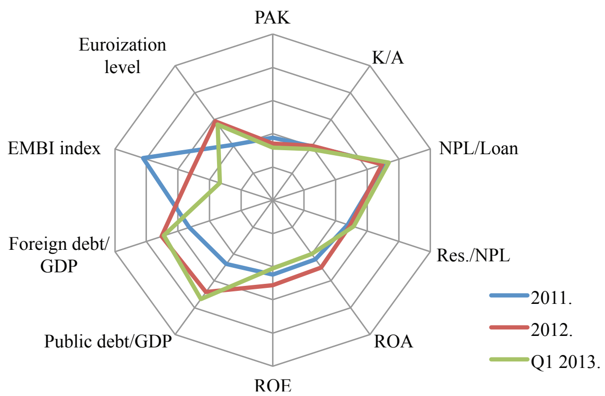
Maintaining the stability of the financial system, especially the banking sector as the key segment, is the most complex and important challenge faced by the holders of macro-prudential policy and economic policy. The importance of this topic is simple. Economic stability and potential growth require that one of the main pillars of the economy - the banking sector - operates at the top level to allow efficient allocation of financial resources. Based on the analysis of the main risks to the banking sector stability in Serbia, some conclusions can be made:

- the level of problem loans is the greatest immediate threat to the sector's stability;
- the levels of external and public debt are also a significant risk that could jeopardize macroeconomic stability and, indirectly, the stability of the sector;
- "capitalization" of the sector is high, but it is necessary to pay attention to individual banks;
- the regulatory framework for responses to perceived risks from the perspective of monetary policy is significantly improved compared to the period before the crisis, but it is still insufficient for practical improvement of the stability indicator values;
- comparison with representative countries confirms the findings according to which the Serbian banking sector is facing an above-average level of risk in terms of non-performing loans and public debt, and that the capitalization of the sector is above-average in the observed countries.

The most effective and clearest intuitive method for assessing financial stability and view of basic trend risks to the stability is webbing diagram. Increase in the distance from the center of the diagram for each variable, warns of an increase in the banking system risk.

The achieved values of stability indicators at the end of the first quarter of 2013 confirm much mentioned ascertainment that the share of problem loans, i.e. the credit risk, is the greatest threat to the banking sector stability. During the first three months of the year, the share of NPLs in total loans increased by 0.5 percentage points and amounted to 20.4%. The decline is due to low economic activity which causes stagnation of lending to both the corporate and the household sectors. Without new loans, the loan portfolio of the banking sector "is getting old", which leads to an increase in the share of loans whose principal debt does not decrease over time. As a result of the strong aversion to lending, banks' liquid assets remain idle and consequently affect the low level of interest income from lending activities. The lack of alternative options for the placement of the banking sector's excess liquidity reduces its profitability. In the medium and long term, termination of lending increase negatively affects the level of activity in the real sector. Stringent regulatory requirements result in high levels of reserves for potential losses, but it is indicative that their movement in the past is not able

Webbing diagram of financial stability



to completely accompany the growth in NPLs. This signal can be significant, and regulatory authorities should pay particular attention to the allocation of reserves in cases of individual banks where the share of NPLs in the portfolio is well above the sector average. Answers to this systemic risk came through amendment of legislation governing the transfer of banks' claims to third parties and the treatment of debt write-off.[1] An additio-

1 The transfer of banks' claims to third parties is governed by the Law on the Financial Services Users Protection (for natural persons) and amendments to the Decision on managing the bank's risk (for legal

nal measure for solving this problem will be required in the future, with particular emphasis on increasing the efficiency of execution of collateral for loans, improving out of court settlement, and generally increasing the efficiency of the courts in this area. However, amendments in the regulatory framework did not introduce significant changes in the actual value of parameters due to the fact that the problem is not regulatory or endogenous by its nature from the standpoint of the banking sector, but it comes from the real sector, i.e. has exogenous character. The solution has to come right from the direction of NPLs. Only the instigation of economic activity and credit growth on that basis will contribute to the reduction of the nominal amount and the share of NPLs, namely (a) through possible collection of problem loans and (b) through rapid increase in the level of total loans. Thus, full coordination with all relevant stakeholders in the market is required to address this problem.

Another dimension of systemic risk to the stability of the banking sector has an indirect character. Risks arise as a consequence of the level of external and public debt on macroeconomic stability and external position of the country in the international financial market. At present, credit rating and liquidity of Serbia, combined with the trend of low risk premiums and the existence of available funds for investment in international financial markets, provide a relatively stable borrowing and servicing of previous commitments. However, a high proportion of external and public debt to GDP ratio can affect the perception of international investors about the solvency of the state and can result in an increase in risk premiums and even in the availability of funds. Under these conditions, macroeconomic stability would be significantly affected, while the stability of the banking sector would be under strong pressure. The answer to this risk must be comprehensive and thorough and has to include practical implementation of fiscal consolidation measures and stabilization of the public debt. This method ensures the proper management of public debt in the long run because it is evident that other solutions, like emergency budget revenues from privatization, may have only short-term, one-off, effects.

Level of system Euroization, measured by the share of foreign currency loans and loans with currency clause in total loans, also presents a high risk to the banking sector stability for several reasons. First, in a situation when the entire economy heavily relies on euro as a dominant currency, the possibility to adequately use monetary policy measures is significantly reduced. In addition, maintaining of the system stability is expensive because the risk of spending foreign exchange reserves is also high. Finally, in these conditions, change in the exchange rate directly affects operations of the real economy and standard of living, hinders the functioning of the economic system and threatens the ability to regularly service loans by translating foreign currency risk into credit risk. The answer to this risk came in the form of a Memorandum on dinarisation strategy of the Serbian financial system. Even in this case, the regulatory framework made a significant change in practice and the banking sector and the economic system as a whole have remained under the predominant influence of the dinar-euro trends. According to recommendation of the IMF, it is necessary to comprehensively implement dinarisation strategy, including deepening (increase in sales) of the dinar instruments in national financial markets and rapid development of institutions operating

Achieved values of the financial stability indicators

Indicator	Denomination	2011.	2012.	Q1 2013.
Capital adequacy index	PAK	19,1	19,9	20,4
Balance sheet equity in relation to balance sheet assets	K/A	20,6	20,5	21,2
Share of NPLs in total shares	NPL/Loan	19,0	18,6	19,9
Coverage of NPLs by reserves for estimated losses	Res./NPL	129,2	126,5	122,4
Return on assets	ROA	1,3	1,0	1,5
Return on Equity	ROE	6,3	4,7	7,2
Share of public debt in gross domestic product	Public debt/GDP	48,7	59,2	61,8
Share of foreign debt in gross domestic product	Foreign debt/ GDP	78,7	86,4	85,8
OMB emerging markets - the country risk premium	EMBI index	570,8	457,5	387,7
Share of foreign currency loans and foreign currency clause loans in total loans	Level of Euroiza-tion	78,9	81,1	80,8

Source: NBS

persons), while in the area claim write-off certain improvements have been made by the Law on consensual financial restructuring of companies.

on it (insurance companies and pension funds).

Dimension of webbing diagram, related to the banking sector capitalization, indicates that the capital adequacy is the most powerful argument for preserving the stability of the sector, as a conclusion that the sector can adequately respond to any shocks. However, this signal should be interpreted with caution because recent data indicate that a number of banks (several of which are state-owned) have a level of capital adequacy slightly above the regulatory minimum, and at the same time the list of largest exposures covers economic systems which will certainly not be able to service their loans in the future. This means that some banks will be undercapitalized in the short term and significant investments will be required to ensure their survival. The amount of funds the state will be forced to "invest" in order to preserve financial stability will depend on their definition as "systemically important institutions".

Value of the financial stability indicators of comparable countries at the end of 2012

State	PAK	NPL/Loan	ROA	ROE	Public debt/ GDP	Foreign debt/ GDP
Serbia	19,9	18,6	1,0	4,7	59,2	86,4
Croatia	20,6	13,8	0,9	4,0	54,0	100,5
Slovakia	15,8	5,2	0,7	8,0	52,2	71,2
Czech Republic	16,4	6,2	1,4	21,4	45,8	50,2
Bulgaria	16,7	16,6	0,7	5,3	18,3	96,4
Hungary	15,7	13,7	-0,4	-3,8	79,2	126,8
Romania	14,6	18,2	-0,6	-5,4	37,8	75,2

Source: Reports of the national banks

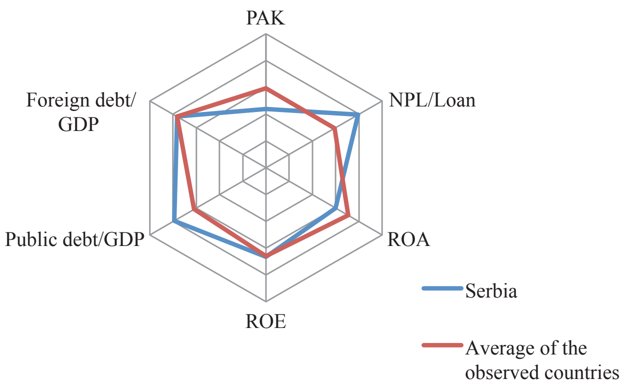
From the standpoint of profitability, it is evident that the following had direct impact on the value of indicators: (a) aversion to lending risk and, on that basis, increase in the share of more certain forms of assets with lower return, as well as (b) "binding" of funds due to capital requirements and high level of reserves for estimated losses. Therefore, it is clear that the banking sector is focused on risk management, rather than on generating profits.

Based on the above facts, we can conclude that the banking sector is now stable and resistant to shocks, but it is necessary to continuously monitor several key systemic risks. Macro-prudential, monetary, fiscal and tax policies have to be compatible and complementary in the process of maintaining the stability. Only in this way preconditions can be provided for the banking sector to be the champion of economic recovery and to have a positive impact on the real economy, the public sector and, indirectly, on the Serbia's external position.

In this context, one should observe the attitude of the IMF[2] according to which the standards of macro-prudential policy should remain at current levels and that their relaxation is not preferred at this point. In addition, the Executive Board of the IMF highlights the need to formulate a clear strategy for the development of state-owned banks, with a focus on improving and strengthening their management as one of the measures to preserve the stability of the sector in the long term.

Comparison of the achieved values of financial stability indicators among comparable countries shows that non-performing loans and the share of foreign debt in gross domestic product are the main threats to the banking sector stability – not only in Serbia but in other countries as well. For markets of Romania, Bulgaria and Serbia level of NPLs is the biggest risk faced by the banking sectors, and results from low economic activity and extremely poor financial position of the economy and population. Foreign debt is at a critically high level in Serbia, Croatia, Bulgaria and Hungary, and is a threat to macroeconomic stability and, directly, to the banking sector stability. Due to the problems expressed in the form of high inflation and full credit contraction,

Comparative review of financial stability risks



profitability indicators in Hungary and Romania are negative and clearly indicate high probability that the stability of the sector is affected or that it, ultimately, heads towards instability. In the case of Hungary, a new tax

2 IMF Executive Board Concludes 2013 Article IV Consultation with Serbia, Public Information Notice No. 13/76, 3 July 2013.

on financial transactions is a further negative impact on the achievement of financial results.

On the other hand, the level of capital adequacy in Croatia and Serbia implies that the banking sectors are most resistant to shocks, but it is evident that regulatory parameters have to be additionally improved (especially in the field of bankruptcy and financial restructuring of companies) in order to maintain stability in the future. Indicator values for Slovakia and the Czech Republic confirm the well known fact that the banking sectors in these two countries are most stable. Macroeconomic stability and a low share of non-performing loans are key contributors to stable results of the banking sector in both countries. Slovakia recorded poorer result from the standpoint of profitability compared to the Czech Republic, due to low net interest margin but also due to increase in fees for banking transactions as laid down by regulatory policy holders.