Dejan Šoškić: Challenges for macro- and microprudential policies in Serbia

Speech by Mr Dejan Šoškić, Governor of the National Bank of Serbia, at the closing event of the Eurosystem Cooperation Programme on “Strengthening macro- and microprudential supervision in EU candidates and potential candidates”, Frankfurt, 16 January 2012.

* * *

Ladies and Gentlemen,

First of all, on behalf of the National Bank of Serbia I would like to express our gratitude to the ECB for organizing, and inviting us to participate in the Eurosystem Cooperation Programme on strengthening macro and micro-prudential supervision in EU candidate countries and potential candidate countries. It has been a valuable capacity building experience for the National Bank of Serbia.

Out of a number of well-known systemic risk factors, lending in foreign exchange[1] to unhedged borrowers has a special role in some of the small open economies of the EU and EU candidate countries. This phenomenon of FX borrowing by unhedged financial clients has its history in many countries across the world. However, it produces specific challenges to the emerging economies without enough hedging instruments available, which still face challenging current account deficits and where FX lending is relatively widespread throughout the economy. Moreover, some of these countries have a relatively recent history of price instability and overall financial instability. A good example in the group of such countries is Serbia.

What are the major challenges of FX lending in Serbia?

In addressing this issue, it is fair to say that in financial systems with widespread lack of confidence due to the recent history of high inflation and widespread banking insolvencies, as was the case with Serbia at the beginning of 2000s, FX lending has played a significant role in creating longer term financial assets, important for the increase in investments and economic growth. However, persistence of relatively high level of FX denominated financial instruments in a financial system (around 70% of bank assets in Serbia) can have several serious consequences:

First: It hampers the effectiveness of the monetary policy and increases the volatility of the reference rate set by the central bank. Since the level of the reference rate directly influences the local currency term structure of interest rates, if a price of the majority of financial instruments is not related to the movement of the local currency reference rate (but rather to the movement of LIBOR, EURIBOR or other international rates), the effectiveness of the local currency reference rate as a major monetary policy tool is lower and its movements need to be more volatile to produce the same results compared to a less dollarized financial system (i.e. euroized, in most of these countries).

Second: If a System relies heavily of FX lending to unhedged borrowers, the link between the market risk (FX rate movement) and the credit risk of unhedged borrowers becomes strong. This component of the credit risk, as we know, has not been addressed satisfactorily in most of traditional risk management practices. Besides, unlike other credit risk factors, it is not related to any specific industry, region or profession, but is nationwide and affects all unhedged borrowers regardless of their employment status, industry sector or town or province of their residence. So, there is a relatively high correlation between the FX rate movement and the movement of credit risk (and the NPLs) in the system.

---

1 Includes FX linked local currencylending

Third: If the bank capital is expressed in local currency and the bank assets are predominantly FX linked (as is the case in Serbia), movement of FX rate (even without any increase in the risk of assets), influences capital adequacy. This produces potentially higher capital adequacy volatility than in the system with less FX lending. With the increase of credit risk driven by FX movements, the risk weighted assets – naturally –increase, too. And this additionally influences capital adequacy volatility. In such a system, obviously, there is an additional need to increase capital buffers because of the systemic inclination towards higher volatility in capital adequacy.

Fourth: There is obviously much less room in such a financial system for using the exchange rate as an automatic stabilizer for external shocks and potentially can impose higher burden on FX reserves of the country.

What has Serbia done so far?

The National Bank of Serbia (NBS) officially initiated the so-called dinarization strategy in early 2010 with a goal to gradually increase the use of local currency – the dinar –throughout the financial system. This strategy relies on the involvement of all key stakeholders – the NBS, government, banking sector, corporates, and households. While inevitably most of the activities are undertaken by the NBS and the banking sector, increasing the awareness of the public and receiving an active support of the government are vital for the success of this strategy.

In September 2011 European Systemic Risk Board (ESRB) issued a set of recommendations on lending in foreign currencies, since foreign currency lending to unhedged borrowers has recently also increased in a number of EU member states. We were pleased to see that our dinarization measures so far, and plans in our strategy for the future, fully coincide with ESRB recommendations. As stated in the document, excessive foreign currency lending may produce significant systemic risks in individual countries and may create conditions inducing negative cross-border spillover effects. The new set of ESRB recommendations deals with consumer protection issues, borrowers' creditworthiness, credit growth fuelled by FX lending, internal risk management of banks, additional capital requirements, liquidity and funding as well as reciprocity and cooperation among supervisors.

Dinarization strategy in Serbia rests on three inter-connected pillars.

The first pillar relies on delivering low and stable inflation and strengthening the stability of the overall macroeconomic environment. This is, perhaps, the most general, but also the most important goal and it focuses on countering the history of macroeconomic instability experienced in Serbia during the 1990's. This prior instability is believed to be one of the main reasons for the high level of euroization of the Serbian economy. In this respect, the NBS will continue to implement and further reinforce its Inflation targeting regime.

The second pillar consists of measures geared at promoting dinar-denominated financial instruments and markets, with special emphasis on the development of the dinar bond market. In this respect, government, corporates, banks and the IFIs (both as issuers and guarantors) can play an important role. Development of an actively traded dinar yield curve is an important milestone of this pillar.

The third pillar aims to promote hedging of the existing foreign currency risks. The NBS has been leading the efforts in this field, working together with the banking sector on introducing and developing basic hedging instruments in both the interbank market and in client transactions. The National Bank introduced regular foreign exchange swap auctions for banks. In addition, the NBS has organized a series of seminars and conferences on foreign exchange hedging in the country and launched a foreign exchange hedging webpage.

Throughout 2011, the NBS continued to implement measures geared at a greater use of the dinar and a gradual reduction of the FX risk in the domestic financial system.

1. In early 2011, in the area of monetary policy instruments, the NBS adopted the new *Decision on Banks' Required Reserves with the National Bank of Serbia* with an aim to strengthen the local currency and longer term liability side of the banks' balance sheets. Reserve requirements for local currency sources of bank funding were set to 0% (for maturities over two years) and 5% (for maturities up to two years). However, the reserve requirement ratio for FX sources of funding is set to 25% (for maturities over two years) and 30% (for maturities up to two years). The message intended for banks was the promotion of financial stability, namely: more long term funding and more local currency funding equals cheaper financing.

Also, daily liquidity loans and short-term dinar loans may be extended to banks by the NBS only against the collateral of dinar securities issued by the Republic of Serbia and the NBS. In case of need, the NBS will also conduct dinar liquidity-providing repo operations, again against the collateral of dinar securities. To encourage interbank FX swap trading and the development of the FX hedging market, the NBS continued conducting 3-month FX swap auctions in 2011.

2. In May 2011, the NBS adopted the *Decision on Measures for Safeguarding and Strengthening Stability of the Financial System*. The decision entering into force in June 2011 introduced a set of measures regarding FX-denominated and FX-indexed lending to citizens: a) FX-denominated and FX-indexed loans may be approved only subject to a down payment or placement of deposit of no less than 30% of the loan amount. This rule does not apply to housing loans; b) The LTV of FX-denominated and indexed mortgage loans are limited to a maximum of 80%; c) Loans may be indexed only to the euro, i.e. banks can no longer grant loans indexed to the Swiss franc and other currencies.

3. *The Law on the Protection of Financial Services Consumers*, which entered into force in early June and is implemented as of December 2011, prescribes an obligation for banks to primarily offer to their clients loans in dinars, and to provide an FX linked product only at client request. In such a case, bank is obliged to warn their clients of the FX risk they assume.

4. By the end of 2011, preparations for introduction of Basel II in 2012 were completed. Domestic banking sector was recapitalized to a large extent and new risk management capacities with the banks were developed. In June 2011, the Executive Board of the NBS adopted a set of six decisions introducing Basel II standards and with the new *Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items* of December 2011, the framework for Basel II implementation was fully set. The last NBS by-law was also a first step towards dynamic (countercyclical) provisioning that we want to develop more in the future.

As we saw in September 2011, ESRB recommended to the regulatory authorities to consider applying additional capital requirements (within pillar 2 of Basel II standards) for banks not capitalized enough to cover the specific risks arising from excessive FX lending. In line with that recommendation, we have provided a possibility for the NBS as a supervisor to set capital adequacy ratio (CAR) for a particular bank above the regulatory minimum (which is 12% in Serbia).

In the period from 2007 to 2011, banking sector in Serbia experienced gradual deterioration in the quality of its credit portfolio. Still, the sector remains liquid, solvent, has high loss provisions, and is therefore stable. Household bank deposits have increased during 2011 to their historic peak, more than EUR 3 billion above end 2008. Despite the overall market circumstances and certain regulatory costs, banking sector in Serbia remains reasonably profitable compared to the rest of the region (in terms of both ROA and ROE).

What is important for the future?

The most important thing in the period ahead is to constantly try to fully understand the markets and to closely follow developments on an ongoing basis. Full awareness of the risks taken by banks, other financial institutions, their clients and the system as a whole should be considered a must. This especially needs to be the case with the development of new financial instruments with a large leverage generating potential. It is important to be realistic, to understand where the system stands, and where we want it to be in the future. Communication and cooperation are of the essence, not only among the supervisors themselves, but also with the financial industry. We should always be reminded that preservation of financial stability with competitive and relatively free financial markets is in the long term interest of both the regulators and the industry, and is essential also for the future growth and the overall prosperity of market economies throughout the world.