NATIONAL BANK OF SERBIA

FOREIGN EXCHANGE RESERVE MANAGEMENT STRATEGY OF THE NATIONAL BANK OF SERBIA

April 2013

Pursuant to Article 23, paragraph 1, item 3 of the Law on the National Bank of Serbia (RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012 and 106/2012), and at the proposal of the Executive Board of the National Bank of Serbia, the Council of the Governor of the National Bank of Serbia, at its meeting of 28 March 2013, enacts the following

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1 Introduction

The Foreign Exchange Reserve Management Strategy of the National Bank of Serbia (hereinafter: FX reserves) is a fundamental document which sets out long-term FX reserves investment framework, general investment principles and goals, investment instruments, risk and yield estimation and reporting on FX reserves investments.

FX reserves are foreign currency assets that are readily available to and managed by our monetary authorities. As set out in the Law on the National Bank of Serbia, the NBS decides on the creation and use, as well as management and investment of foreign exchange reserves in accordance with monetary and exchange rate policies and guidelines for FX reserve management, with a view to ensuring smooth settlement of the Republic of Serbia's foreign liabilities.

NBS foreign exchange reserves include: NBS's accounts receivable abroad, securities, gold, foreign currency cash, Special Drawing Rights and reserve position with the International Monetary Fund.

2 General Principles and Investment Goals

In accordance with the Law on the National Bank of Serbia, the NBS manages foreign exchange reserves guided by the principles of:

- **Liquidity –** investing FX reserves in readily marketable instruments traded in financial markets in large daily volumes, i.e. instruments that can be promptly cashed in to settle all current and future external obligations in good time.
- **Security –** managing assets and liabilities in accordance with the structure of the Republic of Serbia's foreign debt for the purpose of preserving the value of FX reserves by investing in blue chip securities and placing deposits with financial institutions such as central banks, international financial institutions and prime foreign commercial banks.

By investing FX reserves, the National Bank of Serbia strives to achieve the highest possible investment yield, without endangering liquidity and security.

3 Distribution of Responsibilities for FX Reserve Management

The Executive Board of the National Bank of Serbia (hereinafter: Executive Board) enacts the *Strategic Guidelines for FX Reserve Management*, which give a more detailed information regarding permitted currencies, types of assets, currency structure, benchmarks for measuring the success of FX reserves management and introduce the necessary limitations to ensure protection against market and credit risks. The Strategic Guidelines are drafted by the organisational unit in charge of risk management and control.

Based on the *Strategic Guidelines for FX Reserve Management,* the Executive Board enacts the *Tactical Guidelines for FX Reserve Management* which set out in more detail the allocation of the FX reserves based on short-term expectations in the international financial markets. The Tactical Guidelines are drafted by the Investment Committee.

The organisational unit in charge of FX reserve management implements both guidelines in the process of managing FX reserves, while the organisational unit in charge of risk management and control supervises on a daily basis the application and compliance of FX reserve management with these guidelines and regularly informs members of the Executive Board thereof.

4 Investment Framework

Investment framework specifies the currency structure of FX reserves, financial instruments permitted, levels of required liquidity in foreign currency cash, use of derivatives for risk hedging and the manner of disposing of gold reserves.

a) ***Currency structure***

As in many other central banks, currency structure of FX reserves is determined based on the currency structure of the country's external debt.

b) ***Fixed income instruments and money market instruments***

Fixed income instruments and money market instruments are:

– sovereign bonds issued by the most developed countries, bonds issued by financial institutions, bonds issued by federal units of the most developed countries and financial institutions supported by those countries, as well as the prime covered bonds;

– collateralised deposits (repo transactions) and uncollateralised deposits with central banks, international organisations and prime foreign banks, as well as government T-bills of the most developed countries.

c) ***Gold***

Gold includes gold bars, gold in NBS accounts abroad and coined gold. The National Bank of Serbia can export and take out of the country or import and bring into the country from abroad, gold bars and gold in unprocessed and coined form. The National Bank of Serbia may buy and sell gold bars in the country, and may also use the services of re-melting and casting of gold bars.

d) ***Foreign currency cash***

Foreign currency cash is held in the NBS vaults in the amount necessary for smooth operation of the FX market and safeguarding of financial stability of the Republic of Serbia's banking sector.

e) ***Derivatives***

The National Bank of Serbia may use derivatives for risk hedging and more flexible FX reserve management in order to cut investment costs.

5 Risk Management

The acceptable levels of risk in FX reserve investment are fully aligned with the conservative investment policy and standards practiced by other central banks. All the relevant financial risks are continually monitored and estimated, especially the market risk (currency risk, interest risk and liquidity risk) and credit risk. Risk management and appraisal are carried out using standard methods such as asset and liability management (ALM), value at risk (VaR), duration etc.

Currency risk is defined as the exposure to potential loss due to change of inter-currency values. The reduction of currency risk is achieved by matching the currency structure of FX reserves with the currency structure of the country's external debt, and possibly introducing currencies of other most developed economies to achieve risk diversification. To manage currency risk it is necessary to define the base value (external debt currency – EDC), a synthetic currency composed of the currency basket that reflects the currency structure of Serbia's external debt.

Interest risk is defined as the exposure to potential loss due to changes in interest rates. This risk is less prominent than the currency risk in FX reserve investment. Management of interest rate risk is performed by determining optimal targeted duration.

Liquidity risk is defined as the exposure to potential loss due to inability to sell securities on short term and with minimal transaction costs, so as to timely settle all obligations due. The liquidity risk management is done by choosing high-quality and high-liquidity securities which are traded in financial markets in large daily volumes, thereby reducing the risk to the lowest possible level.

Credit risk is defined as the exposure to potential loss due to failure to meet financial obligations of the securities issuer – either a financial institution, or a country. Credit risk management is achieved by setting minimum credit ratings for securities to be invested in and for banks with which the National Bank of Serbia may deposit funds, and by setting other limitations regarding credit risk exposure. The minimum credit ratings are set based on the methodology of the National Bank of Serbia which includes information issued by leading rating agencies, financial indicators, market indicators and other available information.

6 Yield

The expected yield deriving from FX reserve investments depends on the acceptable risk level and the required liquidity level. Within the given security and liquidity related boundaries, the expected yield should be the highest possible. The achieved yield is measured in absolute and relative terms – relative to the reference value yield. The National Bank of Serbia sets the reference rate based on this Strategy, taking into account long-term market expectations and risk and yield optimisation.

In order to achieve higher yield rate than the benchmark value, FX reserve portfolio is actively managed. That means making decisions on investing into a portfolio whose structure deviates from the benchmark value structure in conformity with the permitted limitations, so as to provide protection against market and credit risks.

7 Reporting on FX Reserve Management

Based on the analysis of data on FX reserve management, risk exposure and compliance with the set limitations – monthly reports on FX reserve management and portfolio risk exposure are prepared and regularly submitted to the Executive Board.

Monthly report on FX reserve management contains data on the structure of and change in FX reserves, structure of and factors which influenced the portfolio of securities, as well as data on the financial results achieved during the reporting period.

Monthly report on portfolio risk exposure contains data on compliance with the set limitations, registered yields, portfolio structure, portfolio market and credit risk, as well as data on most important movements in financial markets during that period. The report on the level, structure and change in FX reserves, as well as on the results of FX reserve management, is an integral part of the report submitted by the Governor on a quarterly basis to the Council of the Governor of the National Bank of Serbia.

8 Publishing

This Strategy will be published on the website of the National Bank of Serbia.

CG NBS No 4
28 March 2013

B e l g r a d e

President of the Council of the Governor
of the National Bank of Serbia

Prof. Nebojsa Savic