EXPLANATION OF THE SYSTEMIC RISK BUFFER

The Decision on the Rate and Manner of Maintaining the Systemic Risk Buffer (RS Official Gazette, No 58/2017) was adopted based on Article 14, paragraph 1, item 11) 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, 106/2012, 14/2015 and 40/2015 – CC decision), which authorises the Executive Board of the National Bank of Serbia to determine measures and activities, within the scope of authority of the National Bank of Serbia, aimed at maintaining and strengthening the stability of the financial system, and Section 446 of the Decision on Capital Adequacy of Banks (RS Official Gazette, No 103/2016, hereinafter: Decision on Capital Adequacy), which prescribes the rate and manner of maintaining the systemic risk buffer for all banks, or for one or several banks, with the aim of preventing and mitigating long-term non-cyclical systemic risks.

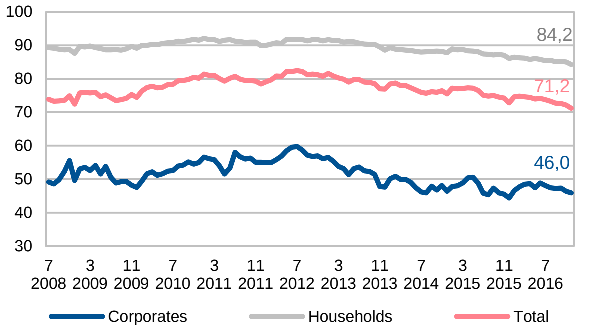
Aiming to implement the Basel III regulatory standards, the Decision on Capital Adequacy transposed into the domestic regulatory framework the Directive on capital requirements for credit institutions No 2013/36/EU (hereinafter: Directive), which regulates capital buffers. Advantages of introducing the buffers are illustrated by the fact that they increase banks' resilience to losses, reduce excessive or underestimated exposures and restrict capital distribution. One of these capital buffers is the systemic risk buffer. This macroprudential instrument serves as an additional buffer of Common Equity Tier 1 capital, maintained by a bank with the aim of preventing and mitigating long-term non-cyclical systemic risks.

Systemic risk is the risk of disruption in the provision of financial services in the financial system with the potential to have negative consequences for the real economy. It includes two dimensions. The first dimension is structural risk, i.e. the risk stemming from linkages among financial institutions (cross-sectoral dimension of risk), while the second dimension is the time component, i.e. the risk that varies through time and depends on the financial cycle phase (cyclical dimension of risk).

Results of the conducted analyses suggest that the high degree of euroisation, expressed as the share of foreign currency and foreign currency-indexed placements in total placements of a bank, is one of the key structural systemic risks to the stability of the banking sector of the Republic of Serbia.

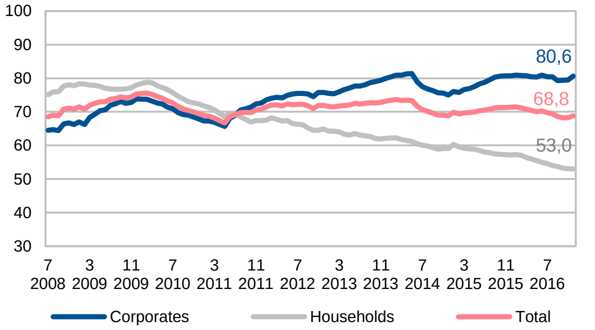
The banking sector of the Republic of Serbia is highly euroised and characterised by a high level of euroisation both of deposits (in December 2016, 71.2% of total deposits of corporates and households were foreign currency and foreign currency-indexed deposits – Chart 1) and placements (in December 2016, 68.8% of total placements to corporates and households were foreign currency and foreign currency-indexed placements – Chart 2).

Chart 1 **Share of FX and FX-indexed deposits in total corporate and household deposits**
outstanding amounts and current exchange rates
(%)



Source: NBS.

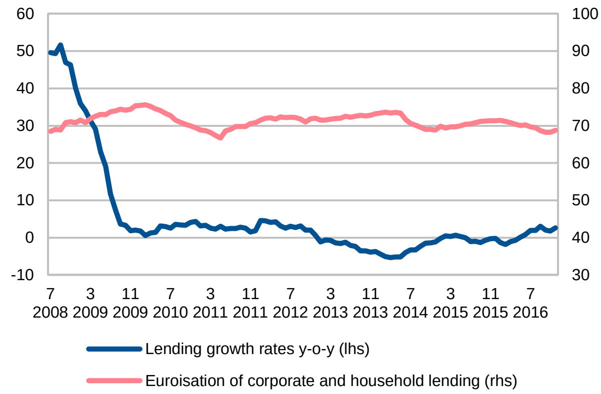
Chart 2 **Share of FX and FX-indexed lending in total corporate and household lending**
outstanding amounts and current exchange rates
(%)



Source: NBS.

A comparison of the degree of euroisation of placements to corporates and households with the year-on-year rate of growth of credit activity (which can be used to approximate the financial cycle) reveals that the risk of euroisation is a long-term structural systemic risk unrelated to financial cycles in the Republic of Serbia. In accordance with Section 446 of the Decision on Capital Adequacy, one of the reasons for using the systemic risk buffer is to prevent and mitigate long-term non-cyclical systemic risks. Though the rate of growth of credit activity dropped considerably as a consequence of the outbreak of the global financial crisis, the degree of euroisation of placements to corporates and households has remained relatively high and stable.

Chart 3 **Noncyclicality of euroization**
(%)



Source: NBS.

The high degree of euroisation at the level of the banking sector increases the sensitivity of the Serbian economy to shocks in the movement of the exchange rate and exposes the banking sector to credit-foreign exchange risk. Foreign exchange risk can spill over to loan beneficiaries, which can lead to problems in loan repayment, causing an increase in the level of NPLs.

The degree of euroisation of placements is high in almost all banks in the Republic of Serbia. Since euroisation is a key structural systemic risk that needs to be resolved at the level of the entire banking sector rather than at the level of individual banks, it was decided that all banks headquartered in the Republic of Serbia with the degree of euroisation exceeding 10%[1] are obliged to maintain a systemic risk buffer at the level of 3% of foreign currency and foreign currency-indexed placements to corporates and households in the Republic of Serbia.

Foreign currency and foreign currency-indexed placements are used as the basis for calculating capital requirements, which is expected to further encourage banks to reduce their exposure to systemic risk caused by euroisation, since the level of capital requirements will decline if they reduce the amount of those placements.

In addition, though all banks are required to maintain the same rate, capital requirements of individual banks will differ depending on the degree of euroisation. By applying a uniform systemic risk buffer rate to foreign currency and foreign currency-indexed placements, banks with a higher share of these loans in total loans are imposed higher capital requirements relative to risk-weighted assets.

The systemic risk buffer applies only to domestic exposures (foreign currency and foreign currency-indexed placements to corporates and households in the Republic of Serbia, while placements to foreign persons are exempted) with the aim of limiting domestic systemic risk on account of euroisation. Due to the above, and taking into account the significance of the risk of euroisation as a key structural systemic risk, based on Section 454, paragraphs 2 and 3 of the Decision on Capital Adequacy, the NBS has established that the banks it deems to be systemically important are obliged to apply the sum of the systemic risk buffer and the capital buffer for a systemically important bank specified for them on an individual, consolidated or sub-consolidated basis.

[1] According to analyses of the ECB (Windischbauer U. Strengthening the role of local currencies in EU candidate and potential candidate countries) and BIS (Alvarez-Plata P. and García-Herrero A. To dollarize or de-dollarize: Consequences for Monetary Policy), the degree of euroisation under 10% is considered low euroisation, which is also in line with EBA guidelines (Guidelines on common procedures and methodologies for the supervisory review and evaluation process).