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Focus Notes: Serbia

IMF assessment on Serbia's financial sector is encouraging; yet significant challenges still remain

An IMF mission visited Serbia in May to negotiate with the Serbian authorities the fourth review of Serbia's Stand-By Arrangement with the Fund. Part of the discussions focused on the developments and the outlook of the financial sector. Among the issues discussed were the response of the banking system to the crisis, the deteriorating quality of credit, the regulatory framework of NBS, as well as other technical issues.

Overview

The Serbian banking system grew significantly in the years preceding the crisis, although it never attained the stellar growth recorded in other SEE markets such as Bulgaria and Romania. Despite -or probably because of- that, it has shown remarkable resilience to the repercussions of the financial crisis, especially compared to its counterparts in the region. Serbia's banking sector can be characterised as rather small and unconcentrated. Foreign banks hold a 75% market share, with eight out of the top ten banks being subsidiaries of European financial groups. The majority of the largest Serbian-owned banks are controlled by the State.

Banking sector regulatory regime

The prudential framework of the National Bank of Serbia (NBS) had been (and still remains) quite conservative, which has kept banking sector liquid and well capitalised. According to the NBS, Capital Adequacy Ratio stood at 21.5% in Q1:10, being among the highest in Europe. Yet, according to the IMF assessment of Serbia's financial sector, which was published in late March, the stringent and often overly complex regulations have increased the costs of the banks, and even induced private enterprises to borrow directly from the parent institutions of the Serbian banks. The Fund suggests that Serbia should take steps towards simplifying the regulations and relaxing the current, rigid regime.

Large unhedged FX positions

Another source of concern for the Fund is the very high level of euroisation in Serbia. As discussed in our May issue of New Europe: Economics & Strategy, banks have been providing amply loans tied to FX. Since the dinar is a rather volatile and traditionally prone to depreciation currency, banks actually transferred the foreign exchange risk to the borrowers' side, with lower lending rates in return. This strategy seems theoretically to pay off during the last months, as the Serbian currency is constantly depreciating. Yet the risk that banks sought to

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eliminate has rebounded and come back in the form of credit risk, since many firms and (to a smaller extent) households face difficulties in repaying their loans. Gradual de-euroisation of the system should be among the priorities of the banking authorities in the medium term, according to the IMF report. Our view remains that this can be achieved not by addressing just the symptom, but rather its causes, and namely currency instability and persistent inflation.

Rising levels of NPLs

In 2010 the NBS streamlined its method of loan classification and reporting in accordance with the IMF recommendations. This re-classification revealed that the NPLs have reached worrying levels. According to the latest NBS Banking Supervision report, NPLs ratio climbed to 16.5% in March, up from 15.4% at the end of 2009 (using NBS's previous methodology, the latter figure was only 8.5%). Interestingly enough, NPLs share in loans to households does not exceed 8%, while the corresponding figure for private firms is almost 22%. Yet, this hardly comes as a surprise. The timely servicing of loans is traditionally embedded into the Serbian culture. Moreover, over the past years, enterprises borrowed much heavier compared to individuals, who have been more cautious and hesitant. It is quite indicative that loans-to-deposits ratio for non-financial corporations in April stood at 268%, while the tantamount for households was less than 68%.

One of the priorities of the Serbian authorities should be, according to the Fund, the enhancement of the insolvency mechanisms, especially for firms, since currently they are too costly and inefficient to effectively protect the lenders

Other issues

Serbia's Deposit Insurance Fund (DIF) capacity remains limited, even more since deposit guarantee was expanded to include deposits up to €50,000. The report underlines the need to establish an emergency credit line between the government and the DIF, in order for the latter to gain credibility. At present, DIF's assets cover about 1.8% of total insured deposits, and no such link is in place.

As far as compliance to the Basel Core Principles is concerned, Serbia is rated by the IMF as largely -yet not fully- compliant; further steps need to be taken by the NBS towards improving banking supervision and adapting its regulatory framework to the international and EU standards. One of the problematic areas mentioned in the report is banking supervision, since NBS' Supervisory Department operates with limited capacity. Furthermore, the introduction of a more risk-based approach would be desirable. The Serbian regulator is also encouraged to increase its co-operation with the supervisory authorities in the EU countries.

Conclusions

Serbia appears to have made considerable progress in modernising and keeping its financial system stable. However, further efforts are required, since significant vulnerabilities still exist, and major challenges lay ahead. The main potential sources of instability for the financial system listed in the Fund's report are a reduction or reversal in capital inflows, a prolonged anaemic recovery of the real sector, as well as government's failure to achieve fiscal consolidation.

The Serbian banking system has been proven quite resilient to the crisis so far. We believe that it has the potential to withstand further turbulences, as long as Serbian authorities implement the necessary reforms. In any case, we believe that the developments in the real sector are equally, if not more, important this period, and the prospects of the financial sector will be closely tied to the outlook of the Serbian macro-economy for some time yet.

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