POST - MORATORIUM CREDIT RISKS

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Post-moratorium credit risk

On 14 December 2020, the National Bank of Serbia (NBS) adopted the Decision on Temporary Measures for Banks to Enable Adequate Credit Risk Management Amid Covid-19 Pandemic (*Official Gazette of the Republic of Serbia*, Nos. 150/2020 and 21/2021) and the Decision on Temporary Measures for Lessors Aimed at Preserving Financial System Stability (*Official Gazette of the Republic of Serbia*, Nos. 150/2020 and 21/2021). Both regulations were updates of two initial decisions enacted in March and June 2020, respectively, that introduced a moratorium period on loans and similar financial exposures.

Apart from the Decision on Temporary Measures for Banks to Enable Adequate Credit Risk Management Amid Covid-19 Pandemic, enacted primarily to regulate the moratorium, the NBS also adopted the Decision on Temporary Measures for Banks to Facilitate Access to Financing for Natural Persons (*Official Gazette of the Republic of Serbia*, No. 108/2020) and amended the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (*Official Gazette of the Republic of Serbia*, No. 84/2020), both of which facilitated household borrowing by:

1. permitting banks to extend loans of up to 90,000 dinars (approximately 760 euros) with repayment periods of up to 2 years to natural persons while requiring only a declaration of employment or pension income made under full criminal and civil liability;
2. reducing the minimum deposit for housing loans from 20 to 10 percent;
3. relaxing the minimum completion percentage requirement for homes eligible for housing loans; and
4. extending repayment periods to a maximum of five years for housing loans and eight years for other loans.

The decisions set 30 April 2021 as the cut-off date for applying to use relief under the moratorium. Due to the lengthy window for applications, banks were largely hesitant to accelerate loans before the moratorium period expired, even where this would otherwise have been possible. The NBS's regulations did not affect other aspects of risk management apart from extending repayment periods.

It remains to be seen what the coming months will bring once banks begin to declare loans non-performing, accelerate them, and seek enforced collection. According to the National Bank of Serbia Q2 2021 Trends in Lending Report, the overall level of non-performing loans (NPLs) was lower than before the pandemic, standing at 3.6 percent in June 2021. The ratio was 2.9 percent for business loans and 4 percent for loans extended to households.

After more than a decade of improvements to credit risk management rules and policies, banks were far better prepared for the crisis than they had been in 2008. However, Covid-19 has had an entirely unexpected and long-lasting exogenous impact on the economy and its consequences remain unpredictable. Another open question is how easier household borrowing will affect future NPL rates. In common with many other areas of life, risk management lacks ready-made answers to issues raised by the pandemic.

Acknowledging the likely long-term consequences of the Covid-19 pandemic, in July 2020 the European Central Bank (ECB) sent banks it considers Significant Institutions, entities under its direct supervision, an outline list of supervisory expectations for improving operational capacity to deal with distressed debtors. The ECB has monitored the application of these instructions throughout 2021 to assess compliance with the new regulatory requirements.

The European banking regulator noted it expected banks to improve the following risk management tools:

1. **Strong data infrastructure.** Banks had to develop and regularly update records of their exposures and debtors using systems that ensure data are readily available and easily aggregated. Managing credit risk at a time such as the Covid-19 pandemic required executives to make informed decisions based on clear understanding of the issues involved, which would be impossible if the underlying facts were inaccurate, incomplete, or unavailable. Banking supervision has revealed data aggregation was a major issue for banks, with fragmented information resulting in poor management decisions.

2. **Timely response strategies.** Banks should have strategies in place to manage exposures as soon as borrowers showed signs of distress. These strategies had to permit banks to differentiate between viable, non-viable, and viable but distressed debtors and use such segmentation to introduce and apply credit risk management measures. Experiences with supervision have shown that rapid, reliable, and complete data aggregation has posed the greatest challenge, limiting opportunities for predicting objective risk.

3. **Early solutions for viable borrowers.** Robust data analytics and clear and well-timed response strategies should allow banks to assist viable borrowers at an early stage. This could be achieved through early warning systems that monitor borrower-specific signs of distress and account for the impact of the pandemic. Banks were cautioned that traditional early warning systems were unable to properly recognise distress signals, especially when moratoriums are granted, as their effects may temporarily suggest a borrower has improved their financial position, even in a crisis setting, as various loans and public revenues will have been suspended. Banks should also extend new loans to support viable businesses if risk assessments indicate their performance issues are the temporary consequence of the pandemic crisis. Supervision has highlighted clear differences in credit risk identification and resolution between banks that updated their early warning systems for Covid-19 and those that continued to rely on previous arrangements.

1. **Adjustments to existing procedures.** Banks had to update their forbearance procedures to ensure they took into account risks brought about by the pandemic. Outdated procedures were not fit for purpose as they did not acknowledge the new reality and thus resulted in some emerging risks being overlooked. The ECB found many banks had failed to adjust their procedures as suggested.
2. **Sufficient resources and expertise.** Banks had to have enough resources and the right expertise to manage emerging risks effectively. To ensure adequate resources, banks needed to have realistic projections of how credit risk will affect their operations. Supervisory activities have shown many banks lacked clear processes and infrastructure to identify any increased strain on resources so that they can address evolving issues quickly.

In early 2021, the ECB introduced additional credit risk management guidance for significant institutions under its direct supervision, directing banks to establish policies, processes, and systemic solutions for early identification of risk. The banks were expected to act in a timely and targeted fashion to address and mitigate risk and prevent any sudden build-up of losses, especially in the most vulnerable borrower segments.

What does elevated risk look like in practice?

The commercial real estate sector accounts for as much as 22 percent of exposure of the EU's significant institutions. The pandemic has had a major impact on this industry, with news providing daily reminders of many businesses being reluctant to call many of their staff back into the office even as Covid-19 abates. The decline of traditional brick-and-mortar stores has also contributed to lower occupancy rates in commercial real estate, and the same trend has made retail itself vulnerable and prone to significant risk.

As expected, the food and accommodation sector is a major source of risk and NPLs. Here, the ECB launched a targeted review, focusing on a sample of directly supervised banks with relevant levels of loans to the sector. The review revealed that banks had deviated the significantly from the ECB's supervisory expectations, partly as the sectors had been expected to rebound quickly after the pandemic, and in all likelihood also as the banks relied on targeted government relief providing strong support for these firms. It will be interesting to follow up on how accurate these predictions prove to be, and what banks will do to identify and assist viable businesses in these industries.

In Serbia, the reduced minimum deposit for housing loans and lower minimum completion percentages for homes eligible for loan financing will certainly help the real estate market sustain its current levels or even grow. However, it seems pertinent to look into the long-term effects of these measures on risk management, and especially whether a lower completion percentage is appropriate and justified given the impact of the 2008 financial crisis on most Serbian construction companies.

Notwithstanding the wide-ranging relief measures introduced by the government since the outbreak of the pandemic, a September 2020 assessment by the European Bank for Reconstruction and Development and the International Labour Organisation put the number of jobs jeopardised by Covid-19 in Serbia at 510,000. Loss of stable employment is expected to jeopardise regular repayment of loans and other debts, raising the prospect of today's measures having a long-term impact on NPL rates and generating new risks into the future.

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