BANKING AGENCY OF REPUBLIKA SRPSKA

RATIONALE FOR INTRODUCING AND SETTING CAPITAL BUFFER FOR SYSTEMIC RISK

Banja Luka, December 2023

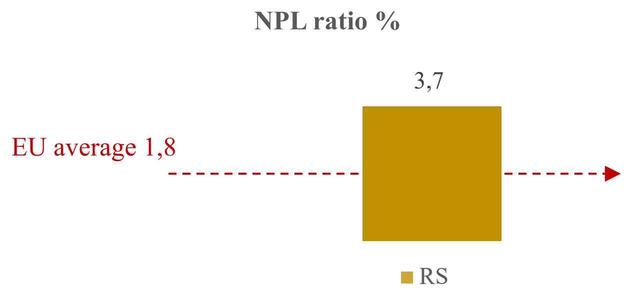
Introduction

The systemic risk is the risk of disruption in the financial sector that can have serious negative consequences for the financial sector and the real economy as a whole. This risk consists of two dimensions. The first dimension includes structural risk, i.e. interconnection risk, which arises from the interconnectedness of financial institutions (the so-called intersectoral risk dimension), and the second dimension is the time component, i.e. risk that varies over time and depends on the phase of the financial cycle (the so-called cyclical risk dimension). It is of great importance to maintain a strong capitalization and resilience of the banking sector, so that in case of materialization of systemic risks, the banks can bear possible losses.

With the adoption of the Decision on calculating capital in banks, in order to introduce the regulatory standard Basel III, the Directive on capital requirements for credit institutions V (CRD V) and the Regulation on capital requirements II (CRR II), which, among other things, regulate capital buffers, were transposed into the domestic regulatory framework. The advantages of introducing capital buffers are reflected in the fact that they increase banks' resistance to losses and influence the limitation of excessive and undervalued exposures. One of the capital buffers is the capital buffer for structural systemic risk. The mentioned buffer is a macroprudential instrument, which represents an additional buffer of CET1 capital, which the bank maintains with the aim of preventing and mitigating long-term, non-cyclical systemic risks.

Decision on capital buffer for systemic risk (hereinafter: the Decision), adopted pursuant to Article 37, Paragraph 9, Item 3) of the Banking Law of Republika Srpska (“Official Gazette of Republika Srpska, No.: 04/17, 19/18 and 54/19), Article 5, Paragraph 1, Item b), Article 20, Paragraph 2, Item b) and Article 37 of the Law on the Banking Agency of Republika Srpska (“Official Gazette of Republika Srpska, No.: 59/13 and 4/17), and Article 6, Paragraph 1, Item b) and Article 19, Item b) of the Statute of the Banking Agency of Republika Srpska (“Official Gazette of Republika Srpska, No.: 63/17), stipulates the requirements for maintaining capital buffer for structural systemic risk in order to preserve and strengthen the stability of the financial system.

Taking into account that macroeconomic disturbances may result in the increase and materialization of credit risk, which is the dominant risk in the banking sector of Republika Srpska, the results of the performed analyzes suggest that the ratio of non-performing loans is still at a significant level compared to the EU average, and that it represents one of the key structural systemic risks to the stability of the banking sector of Republika Srpska.



Graph of NPL ratio as of 30/06/2023

Preventing and mitigating non-cyclical and long-term systemic risks is one of the objectives of applying the capital buffer for structural systemic risk. Considering the level of share and the risk of further growth of non-performing assets, the consequences of which may have an impact on the entire banking system of Republika Srpska, the Agency shall introduce the requirement for the allocation of additional capital requirements by banks in order to mitigate the possible further materialization of risks.

The Agency shall review the obligation to maintain the capital buffer for systemic risk at least every two years, simultaneously adhering to the principle that the buffer for systemic risk may not be used to address risks covered by the countercyclical capital buffer and the capital buffer for a systemically important bank, and that the buffer for systemic risk must not lead to disproportionate adverse effects on the whole or parts of the financial system by creating impediments to the functioning of the internal market.

I Capital buffer rate for systemic risk

1. Ratio for setting the capital buffer rate for systemic risk

The capital buffer rate for systemic risk shall be set based on the annual average of ratios, set on the cut-off date, i.e. shall be set on the last day of the calendar year (31/12), taking into account the average of four quarters, while the same shall be applicable as of 30/06.

Two ratios have been determined on the basis of which the capital buffer rate for systemic risk shall be set, namely: the ratio of credit exposures in default (*Non-Performing Loans*), i.e. the NPL ratio (% of the determined NPL for all credit exposure of the bank on a quarterly basis) and the ratio of NPL coverage by recorded expected credit losses (ECL) on a quarterly basis, for an individual bank.

Non-performing loan ratio (NPL) = non-performing loan value /
total loan value – (gross)

Ratio of NPL coverage by ECL = ECL for non-performing loans /
total non-performing loan value - (gross)

** non-performing loans = credit exposures in default*

** non-performing loan value = non-performing loan value excluding accounting write-off*

**** data according to reporting templates – FISKK (sector structure of loans by credit risk levels)*

Setting the NPL ratios and coverage of NPL by recorded expected credit losses (ECL) shall be disclosed following accounting write-offs, i.e. the amount of accounting write-offs shall not be included in the value of non-performing loans.

2. Setting the capital buffer rate for systemic risk

The capital buffer rate for systemic risk is set through a buffer of 0%, 1% or 2% (natural numbers with multiple of 0.5 percentage points) depending on the combination of indicator ratios for an individual bank. In order for the bank to know which buffer it is obliged to apply, it is necessary to calculate the annual average of the quarterly ratios of non-performing loans (NPL) and the ratios of NPL coverage by ECL for non-performing loans.

Furthermore, after determining the annual averages of the mentioned ratios, the bank shall set the capital buffer rate for systemic risk as follows:

NPL	Coverage of NPL by ECL	Buffer (%)
< 5%	> 65%	0%
< 5%	< 65%	1%
> 5%	> 65%	1%
> 5%	< 65%	2%

II Banks obliged to maintain the capital buffer for systemic risk

All banks headquartered in RS, to which the Agency has issued an operating license, and whose share of non-performing loans in total gross loans is higher than 5%, or whose coverage rate of non-performing loans by recorded expected credit losses is less than 65%, or which fulfill both of these conditions on the cut-off date to be determined by the Agency, shall be obliged to maintain the capital buffer for systemic risk until the next cut-off date.

III Exposures to which the capital buffer rate for systemic risk shall be applied

For the purposes of setting the capital buffer for systemic risk, the bank shall use all domestic exposures and all exposures in the EU Member states and third countries as exposures to which the capital buffer rate shall be applied.

This means that banks (during the currently applicable calculation) will not separately calculate the buffer for systemic risk by sectors as subsets.

IV Calculating buffer for systemic risk

Article 4, Paragraph 5 of the Decision defines the calculation of the capital buffer for systemic risk according to the given formula, which contains two parts.

The first part refers to the case when the capital buffer rate is applied to the total amount of the bank's risk exposure ($B_{SR}=r_T * E_T$), while the second part refers to the case when the capital buffer rate is applied to a subset/subsets of the bank's exposure ($\sum_i r_i * E_i$), which in this application of the calculation and setting of the capital buffer will not be applied, and which is stated in Chapter III of this Rationale. The bank shall calculate the capital buffer for systemic risk as follows:

$$\mathbf{B_{SR}=r_T * E_T} \text{ where}$$

B_{SR} - the capital buffer for systemic risk,

r_T - the capital buffer rate applicable to the total risk exposure amount of the bank,

E_T - the total risk exposure amount of the bank.

V Date by which the banks are obliged to apply the capital buffer for systemic risk

The date by which banks are obliged to apply the capital buffer for systemic risk at the latest is June 30, 2024, and the last day of the previous calendar year will be used as the cut-off date for the purposes of calculating the annual average of the NPL ratio and the ratios of NPL coverage by ECL for non-performing loans (for the first application on December 31, 2023).

The setting of the average NPL ratio and the average ratio of NPL coverage by ECL for non-performing loans is performed annually, and the aforementioned data are used as ratios for determining the obligation to maintain the capital buffer for systemic risk until the next cut-off date (annual cuts).

Redetermination of the obligation to maintain the capital buffer for systemic risk will be determined on the last day of the calendar year and will be applied from June 30 of the following year.

The Agency will review the thresholds for setting the capital buffer for structural systemic risk at least annually and supervise the calculation and monitor the maintenance of the given buffer.