

EXPLANATION OF THE COUNTERCYCLICAL BUFFER RATE FOR THE REPUBLIC OF SERBIA

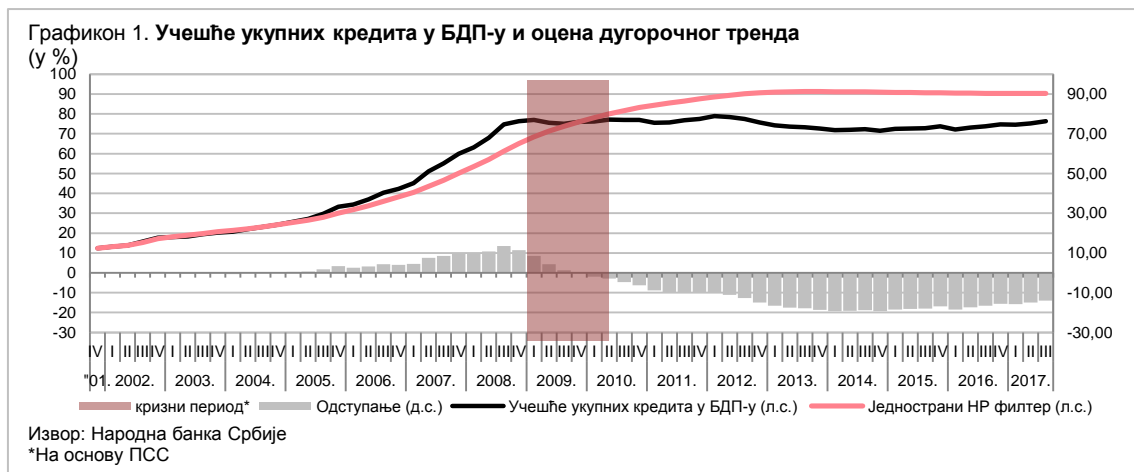
Based on Article 14, paragraph 1, item 11) of the Law on the National Bank of Serbia (RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012, 106/2012, 14/2015 and 40/2015 – CC decision) and Section 436 of the Decision on Capital Adequacy of Banks (RS Official Gazette, No 103/2016, hereinafter: Decision on Capital Adequacy), at its meeting of 7 December 2017, the NBS Executive Board decided to keep the countercyclical buffer rate for the Republic of Serbia at 0%.

The countercyclical buffer (hereinafter: CCB) is additional Common Equity Tier 1 capital which banks are required to keep above the mandatory regulatory minimum, at the level arrived at by the multiplication of their risk-weighted assets and the specific CCB rate. This instrument helps to mitigate the cyclical dimension of systemic risk, as it builds up Common Equity Tier 1 capital during periods of excessive credit growth which can be released when systemic risks materialise.

The National Bank of Serbia (NBS) sets the CCB rate for the Republic of Serbia on a quarterly basis, taking into account the reference guide, the valid guidelines and recommendations of the European Systemic Risk Board and other variables considered relevant for monitoring the cyclical dimension of systemic risk. In accordance with Section 436, paragraphs 2 and 3 of the Decision on Capital Adequacy, the reference guide applied by the NBS in estimating the necessary level of the CCB rate for Serbia is calculated based on deviation of the credit-to-GDP ratio from its long-term trend. The CCB rate setting for the Republic of Serbia is aligned with the Recommendation of the European Systemic Risk Board on guidance for setting CCB rates (ESRB/2014/1).

Chart 1 shows the share of credit to the non-government sector in GDP, the long-term trend and the estimated deviation of the credit-to-GDP ratio from its long-term trend. Following a period of expansion of credit activity from 2000 to 2008, in late 2009, deviation of the credit-to-GDP ratio from its long-term trend entered the negative territory. September 2017 data show that the share of total credit in GDP equalled 76.3%, while the estimated credit-to-GDP gap was -14.0 pp. The estimated gap and the dynamics of movement of the credit-to-GDP ratio indicate that the current share of credit in GDP is below its long-term trend and is entering the recovery phase, i.e. that we are currently in the phase of the financial cycle where introducing a CCB rate

above 0% could constrain credit activity. Also, the estimated credit-to-GDP gap is below the reference value of 2 pp¹ and indicates that the reference guide for setting the CCB rate is 0%.



In order to set the countercyclical buffer rate for the Republic of Serbia, in addition to deviation of the credit-to-GDP ratio from its long-term trend, additional optional indicators were also taken into account, in accordance with Section 436, paragraph 4 of the Decision on Capital Adequacy. Optional indicators for monitoring credit activity were used, which illustrate the characteristics of the domestic financial system and relate to the real estate market, external imbalances and developments in the banking sector.

Real estate market

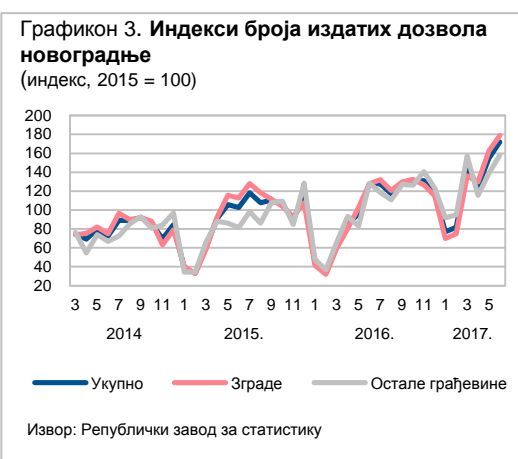
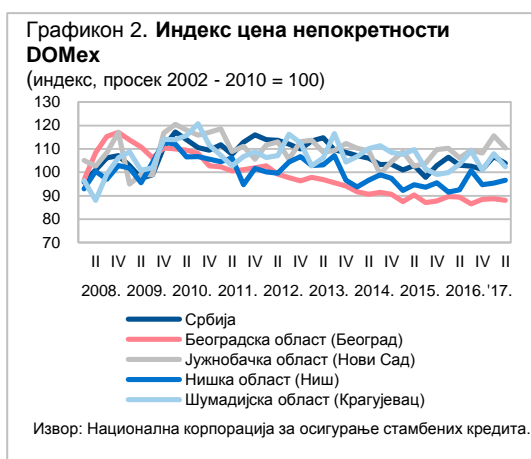
Real estate market indicators for the Republic of Serbia do not reveal any risk accumulation, and show instead that this segment of the financial market is recovering.

Serbia's average real estate price at end-Q3 2017, as measured by DOMex, increased by 0.15% y-o-y, while falling by 1.04% q-o-q. In view of the decline in interest rates, improved macroeconomic fundamentals, a rise in employment and wages in the private sector, as well as more favourable movements in the real estate market, housing loan demand continued up into Q3 2017.

The recovery of the construction sector is indicated also by the number of issued permits for new construction, which at end-Q3 2017 increased by around 22.5% relative to the same period in 2016.

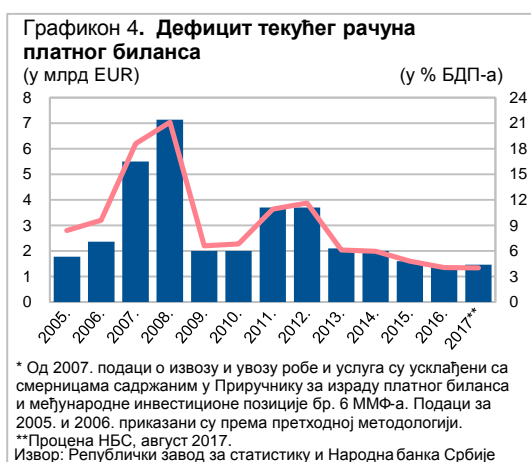
¹ See: Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1), Annex Part II.

The average LTV ratio of new housing loans is still significantly below the regulatory maximum of 80%², amounting to 69.79³ in Q3 2017.



Indicators of external imbalance

Improvement in domestic macroeconomic conditions reduces vulnerability to external risks. In Q1 2017, the current account deficit was somewhat higher due to lower exports and higher energy imports, but Q2 and Q3 saw more favourable current account movements. In the first three quarters of 2017, the current account deficit reached EUR 1.22 bn.



The net inflow of foreign direct investment in the first three quarters of 2017 equalled EUR 1.64 bn and was channelled predominantly to tradable

² In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, No 34/2011), banks may approve mortgage loans provided that the amount of the loan does not exceed 80% of the value of the property mortgaged.

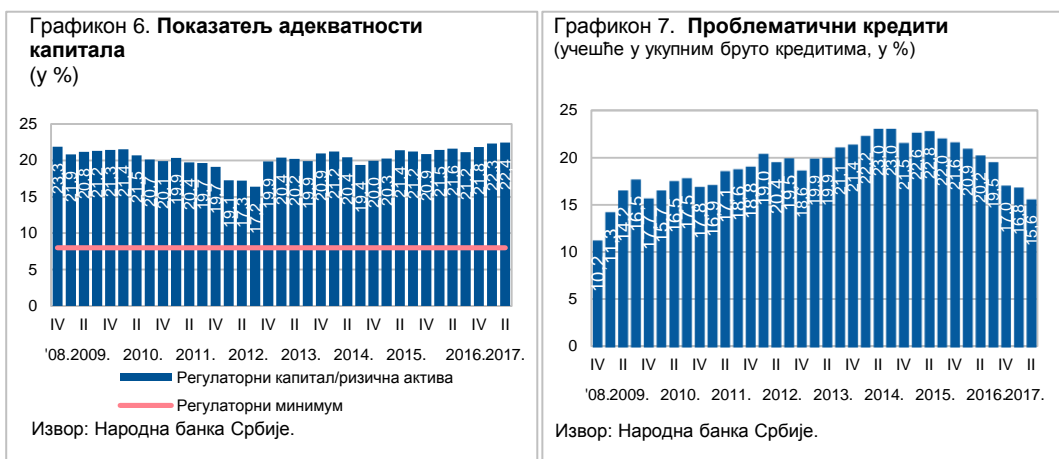
³ According to the data of the National Mortgage Insurance Corporation, for new loans insured with the Corporation.

sectors. The net inflow of foreign direct investment in 2017 is expected to be more than sufficient to cover the current account deficit.

Main indicators of the banking sector

The banking sector is adequately capitalised and highly liquid. A declining level of NPLs, the fact that there is no concentration of some types of assets in the banking sector, and the satisfactory degree of competition testify to the stability of the banking sector.

At end-Q3 2017, the capital adequacy ratio equalled 22.5%, well above the regulatory minimum (which as of 30 June 2017 equals 8%).



The LtD ratio (ratio of loans to deposits) stayed below 1 at end-Q3 2017, indicating that banks rely more on domestic, stable sources of funding, such as deposits.

The share of NPLs in total loans of the banking sector continued to trend down in 2017, to 12.2% at end-Q3, the lowest value of this ratio after the crisis. The reduction in the share of NPLs largely resulted from activities implemented in accordance with the NPL Resolution Strategy and action plans of the Government and the NBS.

Assessment of systemic risk in the financial system of the Republic of Serbia

The systemic stress indicator (SSI) was developed with a view to identifying periods of elevated stress and level of systemic risk in the financial system of the Republic of Serbia. SSI covers a series of indicators which capture the level of financial stress in six key segments of the Serbian financial system: the FX market, government securities market, money market, capital market, banking sector and the international environment.

