14 June 2018

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, 40/2015 – CC decision and 44/2018) 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 held on 14 June 2018, the Executive Board of the National Bank of Serbia decided to keep the countercyclical buffer rate for the Republic of Serbia at 0%.

The Countercyclical Capital Buffer (hereinafter: CCB) is additional Common Equity Tier 1 capital that banks are obligated to maintain above the prescribed regulatory minimum in the amount equal to their risk-weighted assets multiplied by the specific countercyclical buffer rate. This instrument mitigates the cyclical dimension of systemic risk, seeing as it creates an additional buffer of Common Equity Tier 1 capital during periods of excessive credit growth, which can be released when systemic risks materialise.

The National Bank of Serbia sets the CCB rate for the Republic of Serbia on a quarterly basis, taking into account the buffer guide, applicable guidelines and recommendations of the European Systemic Risk Board and other variables it considers 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 guide for setting the CCB rate is the deviation of the share of loans in GDP from long-term trends (credit-to-GDP gap). The CCB rate for the Republic of Serbia is set in line with the recommendation for setting the CCB rate of the European Systemic Risk Board (ESRB/2014/1).

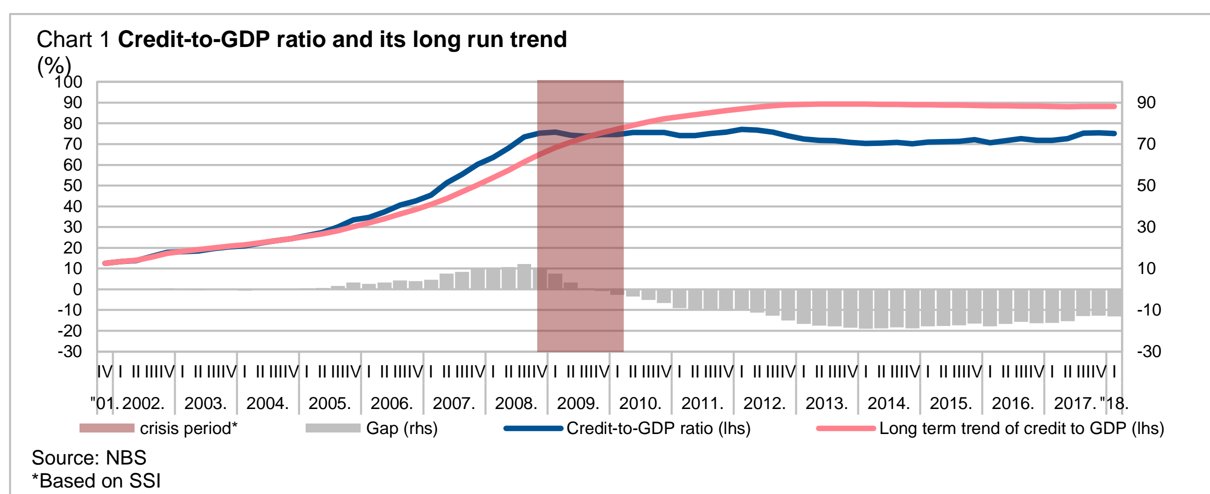


Chart 1 **Credit-to-GDP ratio and its long run trend**

Source: NBS
*Based on SSI

Chart 1 shows the share of credit activity to the non-government sector in GDP, the long-term trend and the estimated credit-to-GDP gap.[1] Following a period of expanding

[1] Starting from March 2018, the buffer guide applied in setting the CCB rate is the share of loans to the non-government sector in GDP. In the prior period, the buffer guide was the share of lending to the non-government sector in GDP, which, in addition to loans, included given deposits, investment, securities and other financial assets, interest, fee and commission receivables and other lending.

credit activity between 2000 and 2008, the credit-to-GDP gap became negative in late 2009. March 2018 data show that the share of total loans in GDP equalled 75.1%, while the estimated credit-to-GDP gap was -13.1 percentage points. The estimated deviation and movements of the share of loans in GDP indicates that the current credit-to-GDP ratio is below its long-term trend and is entering the recovery phase, i.e. that the financial cycle is in a phase in which the introduction of a CCB rate above 0% could constrain credit activity. Also, the estimated credit-to-GDP gap is below the benchmark value of 2 percentage points,[2] which means that the guide for setting the CCB rate equals 0%.

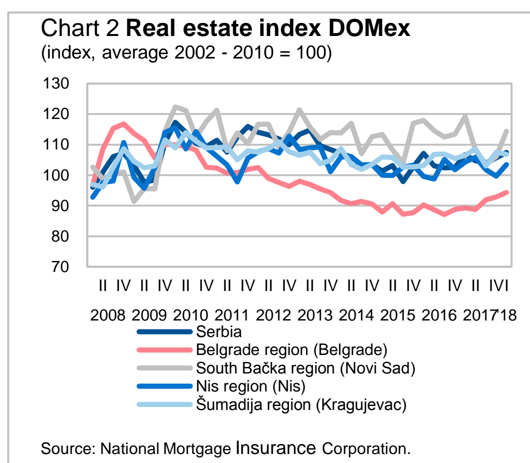
To set the countercyclical buffer rate for the Republic of Serbia, in addition to the credit-to-GDP gap, additional optional indicators were taken into account in accordance with Section 436, paragraph 4 of the Decision on Capital Adequacy. Optional indicators for monitoring credit activity were used, which illustrate the characteristics of the domestic financial system and relate to the real estate market, external imbalances and movements 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.

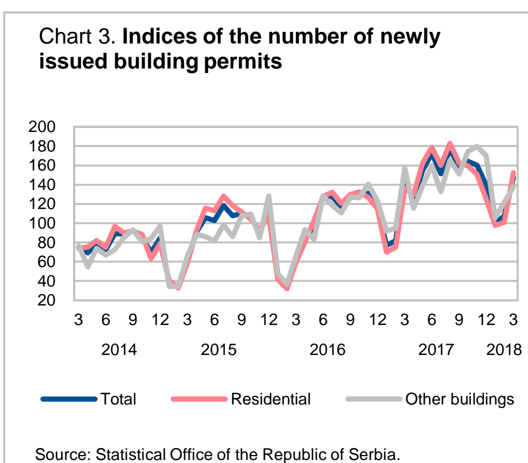
Serbia's average real estate price, as measured by DOMex, increased by 0.7% y-o-y at end-Q1 2018, and by 1.7% q-o-q. In view of the decline in interest rates, improved macroeconomic fundamentals, rise in private sector employment and wages, and more favourable real estate market trends, housing loan demand continued to grow in Q1 2018.

Chart 2 **Real estate index DOMex**
(index, average 2002 - 2010 = 100)



Source: National Mortgage Insurance Corporation.

Chart 3. **Indices of the number of newly issued building permits**



Source: Statistical Office of the Republic of Serbia.

The recovery of the construction sector is indicated by the number of issued construction permits, which gained around 3.3% y-o-y at end-Q1 2018.

The average LTV ratio of new housing loans is still significantly below the regulatory maximum of 80%,[3] amounting to around 70.7% in Q1 2018.[4]

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[2] 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.

[3] In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, Nos 34/2011 and 114/2017), unless a loan is approved in the context of

Indicators of external imbalance

Improvement in domestic macroeconomic conditions reduces sensitivity to external risks. In Q1 2018, the current account deficit measured EUR 650.4 mn, which is around EUR 44 mn less than in the same period last year. Net FDI inflow was somewhat higher in Q1 2018 compared to Q1 2017, equalling EUR 569.1 mn. FDI are well-diversified and contribute to the country's export potential. Net FDI inflow is expected to fully cover the current account deficit in 2018.

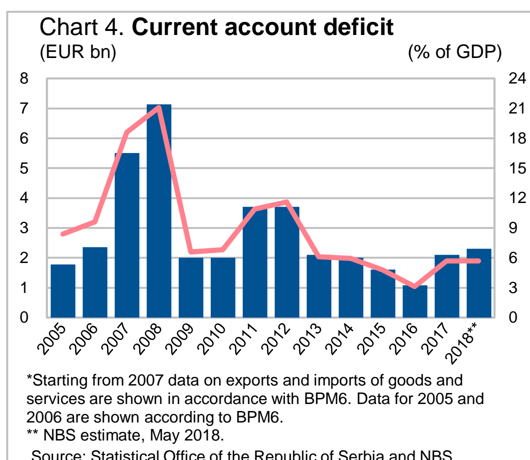

Chart 4. **Current account deficit**

*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM6.
** NBS estimate, May 2018.
Source: Statistical Office of the Republic of Serbia and NBS

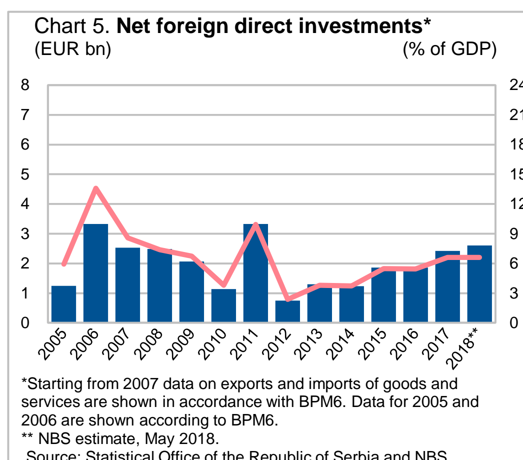

Chart 5. **Net foreign direct investments***

*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM6.
** NBS estimate, May 2018.
Source: Statistical Office of the Republic of Serbia and NBS

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-Q1 2018, the capital adequacy ratio equalled 22.7%, well above the regulatory minimum (which as of 30 June 2017 equals 8%).

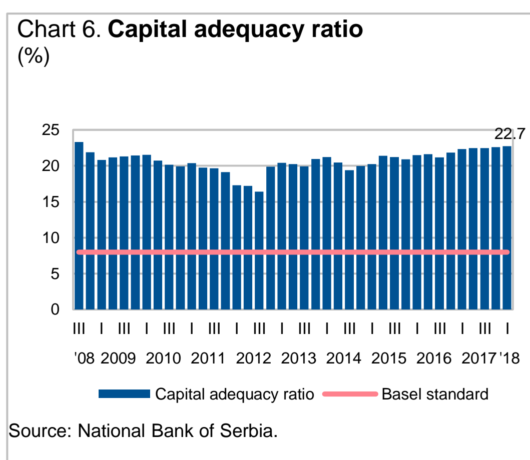

Chart 6. **Capital adequacy ratio**

Source: National Bank of Serbia.

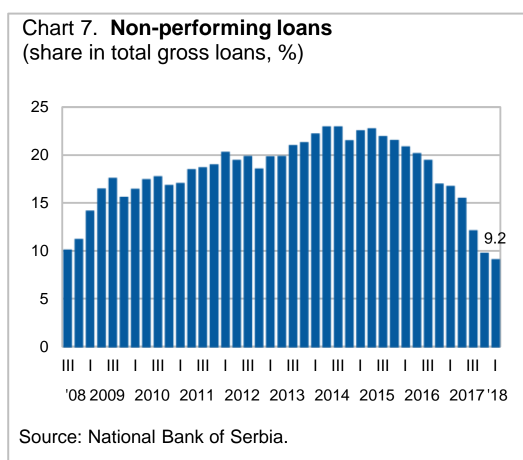

Chart 7. **Non-performing loans**

Source: National Bank of Serbia.

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government support measures for some categories of natural persons, banks may approve mortgage loans provided that the amount of the loan does not exceed 80% of the value of the property mortgaged.

[4] According to data of the National Mortgage Insurance Corporation for new loans insured with the Corporation.

The LtD ratio (ratio of loans to deposits) stayed below 1 at end-Q1 2018, indicating that banks rely more on domestic, stable sources of funding.

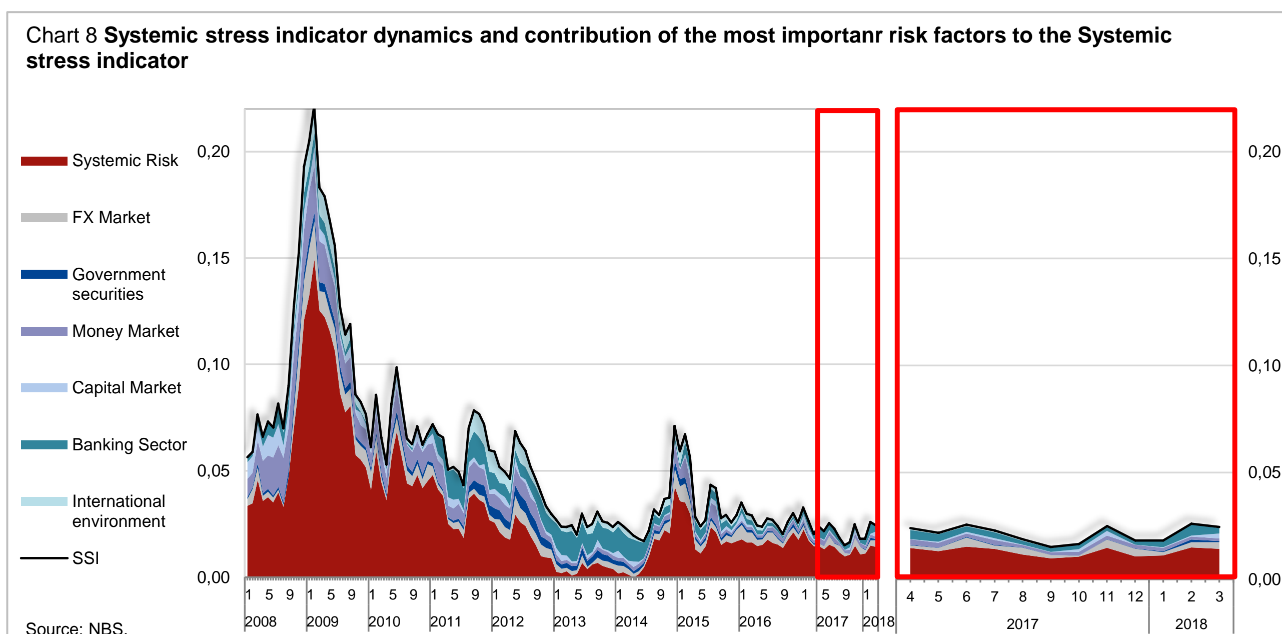
The share of NPLs in total loans of the banking sector continued to trend down in 2018, to 9.2% at end-Q1 2018, which is below the pre-crisis level. The reduction in the share of NPLs largely resulted from activities implemented in accordance with the NPL Resolution Strategy and action plans of the Government and the NBS.

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

The systemic stress indicator (hereinafter: (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. The 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.

From March 2017 to March 2018, the SSI suggested a period of low risk, with a low and stable systemic component.

Chart 8 **Systemic stress indicator dynamics and contribution of the most importanr risk factors to the Systemic stress indicator**



Source: NBS.

Due to continued appreciation of the dinar against the euro and, thus, increased volatility of the exchange rate, movements in the FX market had the greatest impact on the level of the SSI in Q1 2018. Movements in the market of government securities showed that risk was low owing to better macroeconomic fundamentals, improved public finance and considerably lower risk premium of the Republic of Serbia. Also, monetary policy easing, adequate level of required reserves and low interest rates in the financial market of the euro area had a positive impact on the domestic money market. Trends in the capital market in Q1 2018 led to an increase in the SSI, mostly as a result of the volatility of BELEX15 turnover. Quarterly macroprudential stress tests of the banking sector carried out by the National Bank of Serbia confirm adequate capitalisation and high liquidity of the Serbian banking sector. Improvement of the business and investment environment, and

narrowing in internal and external imbalances contributed to increased resilience to potential negative effects from the international environment.

Low inflationary pressures, successful implementation of fiscal consolidation measures and structural reforms, higher capital inflow to Serbia, monetary easing and banking system stability contributed positively to strengthening the resilience of the domestic financial system, and, by extension, to the country’s macroeconomic stability.