11 June 2020

EXPLANATION OF THE COUNTERCYCLICAL BUFFER RATE FOR THE REPUBLIC OF SERBIA

Pursuant to 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 44/2018) and Section 436 of the Decision on Capital Adequacy of Banks (RS Official Gazette, Nos 103/2016, 103/2018, 88/2019 and 67/2020, hereinafter: Decision on Capital Adequacy), the NBS Executive Board, at its meeting of 11 June 2020, decided to keep the countercyclical buffer rate for the Republic of Serbia at 0% in order to support credit activity of banks and mitigate the negative consequences of the pandemic on the terms of financing of corporates and households.

The Countercyclical Capital Buffer (hereinafter: CCyB) 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, given that 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.

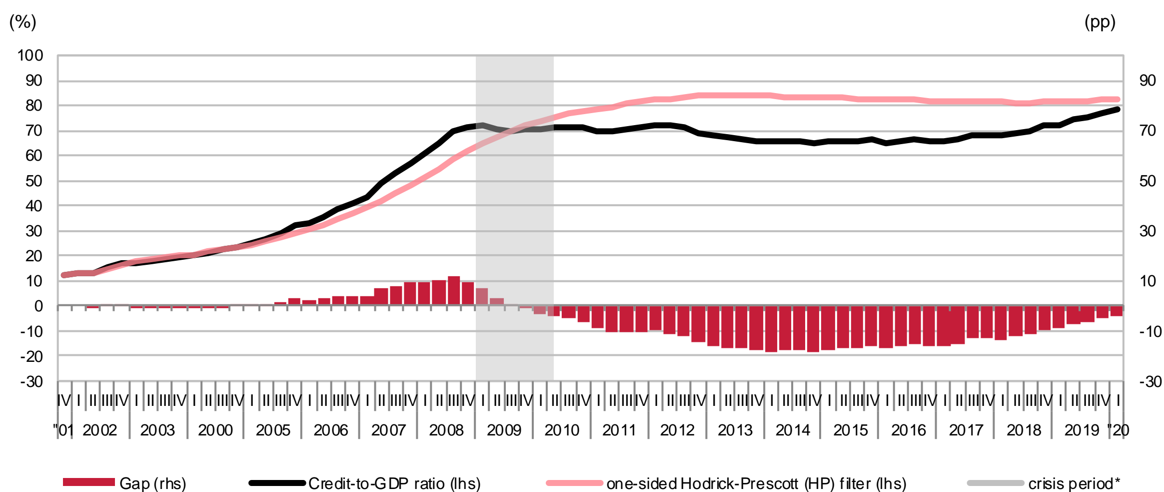
The National Bank of Serbia sets the CCyB rate for the Republic of Serbia on a quarterly basis, taking into account the reference guide, applicable guidelines and recommendations of the European Systemic Risk Board and other variables it considers relevant for monitoring the cyclical dimension of systemic risk. In accordance with Section 436, paragraphs 2 and 3 of the Decision on Capital Adequacy, the guide for setting the CCyB rate is the deviation of the share of loans in GDP from long-term trend (credit-to-GDP gap). The CCyB rate for the Republic of Serbia is set in line with the recommendation for setting the CCyB rate of the European Systemic Risk Board (ESRB/2014/1).

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] After the period of credit expansion from 2000 to 2008, in late 2009 credit-to-GDP gap

[1] Starting from March 2018, the reference guide applied in setting the CCyB rate is the share of loans to the non-government sector in GDP. In the prior period, the reference 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.

entered into the negative territory. The data from March 2020 show that the share of total loans in GDP equalled 78.7%,[2] while the estimated credit-to-GDP gap was -4.2 pp. The estimated credit-to-GDP gap records the upward tendency, but is still below the long-term trend. Taking into account that the estimated share of real credit activity in real GDP is below its long-term trend, and below the reference value of 2 pp[3], as well as in view of the heightened global uncertainty caused by the coronavirus, determining the CCyB rate above 0% could impact future growth of credit activity.

Chart 1 **Credit-to-GDP ratio and estimate of a long-term trend**



Source: National Bank of Serbia.
*Based on SSI.

Bearing in mind that in some segments of household lending, the gap closed faster, the NBS acted proactively, adopting a series of measures aimed at mitigating this risk to financial system stability. In December 2018, the NBS adopted a package of regulations in order to contain the unsustainable approval of non-purpose loans to households at maturities which are unsuited for the risk profile of this product type and the creditworthiness of each individual borrower. From the beginning of 2019, the share of cash loans with the maturity of over eight years and the average remaining maturity of real cash loans recorded a downward trend, suggesting that the NBS's measures aimed at limiting non-purpose lending to households at unreasonably long maturities are yielding results, thus reducing the possibility of emergence of new NPLs. In 2020, banks will be required to reduce their capital when approving the above types of loans with

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[2] The Statistical Office of the Republic of Serbia revised the GDP data for 2015 and 2016 and the initially published estimates (as the sum of four quarters) for 2017 . In the next stage, the revision of the series back to 2005 was conducted by end-2018, while the data preceding 2005 (starting from 1995) will be revised, i.e. the whole series will be completed in 2019, same as in EU countries.

[3] 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.*

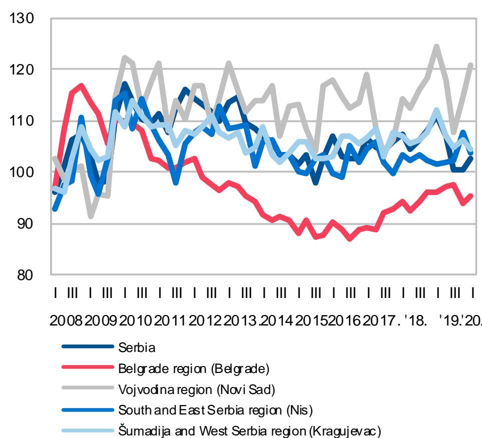
the repayment term of seven years or longer, while starting from 1 January 2021 the same solution shall apply when approving those types of loans with the agreed maturity (repayment term) of six years or longer. In addition, the NBS prescribed a debt-to-income ratio (DTI) – if this ratio is exceeded due to the approval of any loan to a natural person after the entry into force of the new provisions, the bank will be required to separately disclose the receivables from that borrower when reporting to the NBS on the quality of its assets.

To set the CCyB rate for the Republic of Serbia, in addition to the credit-to-GDP gap, 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 lending activity were used, which illustrate the characteristics of the domestic financial system, and relate to the real estate market, external imbalance and banking sector developments.

Real estate market

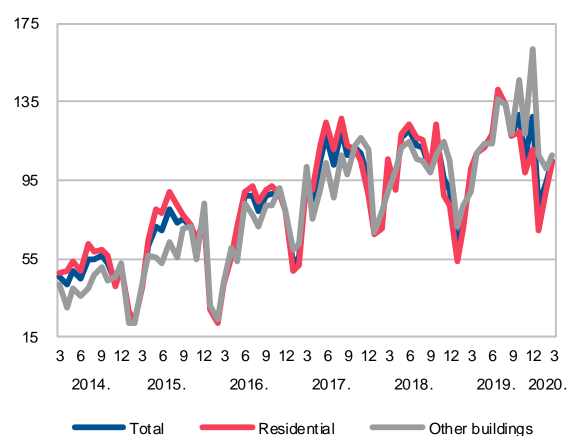
The results of the Bank Lending Survey for April indicate that higher demand for housing loans was fuelled by positive trends in the labour market and a favourable situation in the real estate market. Also, banks expect that in Q2, as a consequence of elevated perceived risk, household credit standards in the segment of housing lending will be tightened and that amid the heightened uncertainty caused by the pandemic, households will reduce consumption and consequently loan demand.

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**
(index, 2018 = 100)



Source: Statistical Office of the Republic of Serbia.

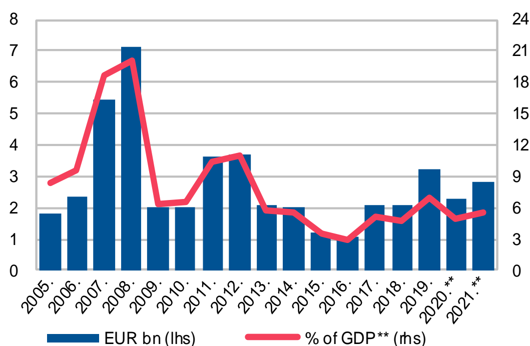
The number of issued permits for new construction is one of the factors indicating expectations regarding the movement of supply in the real estate market. Q1 2020 saw a rise of 21.7% y-o-y. The average LTV[4] ratio of new housing loans is still significantly below the regulatory maximum of 80%[5] amounting to 71.95% in Q1 2020[6].

Indicators of external imbalance

In Q1 2020 the FDI inflow remained robust, despite the coronavirus pandemic, with the net inflow rising by 3.7% y-o-y (7.4% of GDP). The current account deficit is expected to contract to 5.0% of GDP in 2020. Key factors behind the fall in the current account deficit will be lower domestic demand, the fall in oil prices and export resilience due to the diversification and increased production capacities (higher investment in the past period). Current account deficit-to- GDP ratio is expected to remain relatively stable in the medium term, since imports growth fuelled by investment will be compensated by the expansion in export offer.

Chart 4 **Current account deficit***

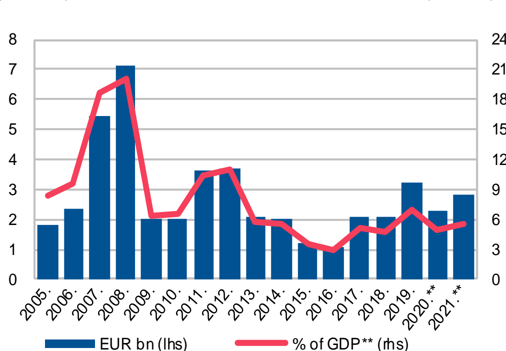
(bn EUR) (% GDP)



* 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 BPM5.
Source: Statistical Office of the Republic of Serbia and NBS.

Chart 4 **Current account deficit***

(bn EUR) (% GDP)



* 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 BPM5.
Source: Statistical Office of the Republic of Serbia and NBS.

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[4] At the Executive Board meeting of 11 June 2020, the NBS adopted the Decision Amending the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System, creating regulatory preconditions for lower downpayment for first-time home buyers. In accordance with the new regulation, in the case of first-time home buyers, banks may approve a mortgage loan to a natural person provided that the amount of the loan does not exceed 90% of the value of the property mortgaged (the exemption from the general limit of 80%).

[5] 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), banks may approve mortgage loans to natural persons provided that the amount of the loan does not exceed 80% of the value of the property mortgaged, unless a housing loan is approved in the context of government support measures for some categories of natural persons, in which case the loan may not exceed 90% of the value of the property.

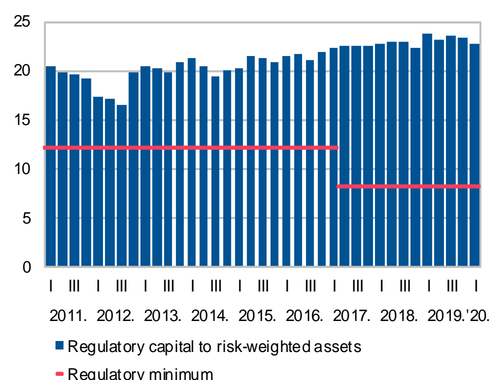
[6] According to data of the National Mortgage Insurance Corporation for new loans insured with the Corporation.

Main banking sector indicators

The banking sector is adequately capitalised and highly liquid, and is likely to remain so in the coming period.

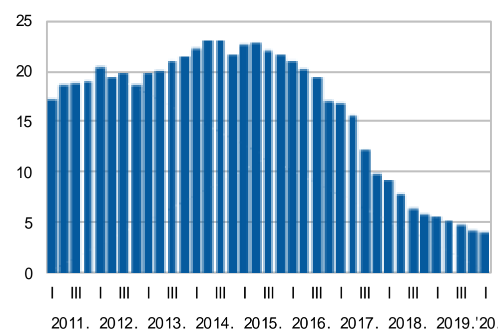
Q1 2020 CAR stood at 22.7%, significantly above the regulatory minimum (8%).

Chart 6 **Capital adequacy ratio**
(%)



Source: National Bank of Serbia.

Chart 7 **Non-performing loans**
(share in total gross loans, %)



Source: National Bank of Serbia.

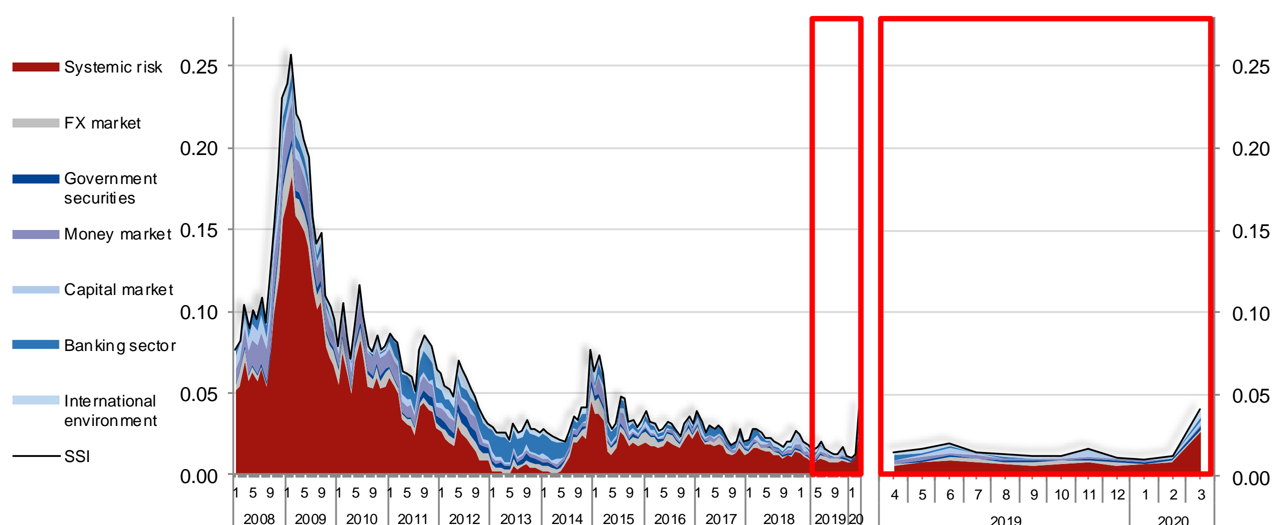
At end-Q1 2020, the loan-to-deposit (LtD) ratio measured 0.85. This indicator hovering at levels below 1 suggests that banks largely rely on domestic, stable sources of funding, such as deposits.

The share of NPLs in total banking sector loans decreased significantly and displays an evident downward trend owing to the implementation of the NPL Resolution Strategy, adopted in 2015, as well as to other regulatory activities of the NBS. The NPL ratio equalled 4.0% at end-Q1 2020, down by 1.4 pp relative to Q1 2019, or by 18.2 pp relative to August 2015. In December, the Serbian Government adopted the NPL Resolution Programme for the period 2018-2020, in order to prevent the occurrence of new NPLs and ensure the sustainability of the results achieved thus far in NPL reduction. The programme covers three areas of activity: The first area is focused on the resolution of non-performing receivables of state financial creditors, the second area aims to further improve the implementation of the bankruptcy framework, while the third area comprises various activities aimed at preventing new NPLs.

Assessment of systemic risk of the Serbian financial system

The Systemic Stress Indicator (hereinafter: SSI) was developed with a view to identifying periods of elevated stress and the 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. The Covid-19 pandemic caused, in Q1 2020, the introduction of emergency measures that were followed by rising uncertainty in international commodity and financial markets, flight to safe assets and a sharp contraction of global economic activity. At end-Q1 2020, after a historic minimum in January 2020, the SSI rose to its 2015-level. The main factors driving the SSI were movements in the international market and the capital market.

Chart 8 **Movement of SSI and contributions of most relevant risk factors to SSI, with identification of financial stress regime**



In Q1 2020, the Covid-19 pandemic reflected on stock exchanges worldwide, including the value and trading in shares on the Belgrade Stock Exchange. Due to such uncertainty in Q1 2020, movements in the capital market also put some upward pressure on the level of systemic stress in the Serbian financial system and on the SSI. In March 2020, BELEX15 went down, in parallel with the contraction in the trading volume, which drove down the market capitalisation of shares.

Favourable trends in the money market extended into Q1 2020, so the domestic market is not a source of systemic stress in the financial system of the Republic of Serbia. The average risk premium for Serbia in USD measured 91 bp in Q1, up by 47 bp compared to the average premium in Q4

2019. At end-March 2020, risk premium for Serbia in USD measured 288 bp (at end-December 2019: 19 bp), being among the lowest in the region (Hungary 253 bp, Croatia 302 bp, Romania 365 bp) and considerably below EMBI Global (577 bp).

The continuous improvement of NBS's regulatory measures reinforces the resilience of the financial system to potential shocks. Quarterly macroprudential stress tests of the banking sector carried out by the NBS confirm adequate capitalisation and high liquidity of the Serbian banking sector.

Despite the newly emerged global crisis induced by the Covid-19 pandemic, at end-March the rating agency Fitch Ratings kept Serbia's credit rating at BB+ with stable outlook going forward. In its press release, Fitch Ratings stated that the Republic of Serbia maintained fiscal discipline and that public finances are good, which results in the government's ability to adequately respond to the newly emerged crisis and to accelerate the recovery after the crisis. In May 2020, Standard and Poor's also kept Serbia's long-term credit ratings in domestic and foreign currency at BB+ with stable outlook going forward. In its press release, Standard and Poor's substantiated the maintenance of credit rating by the preserved long-term macroeconomic stability, the achieved record level of FX reserves and regulated public finance. They particularly underscored that the BB+ credit rating is supported by a credible monetary policy and a moderate level of public debt which enables fiscal policy in crisis conditions to strongly support the economic recovery from the global pandemic.