11 March 2021

EXPLANATION OF THE COUNTERCYCLICAL CAPITAL 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, 67/2020, 98/2020 and 137/2020, hereinafter: Decision on Capital Adequacy), the NBS Executive Board, at its meeting of 11 March 2021, decided to keep the countercyclical capital buffer rate for the Republic of Serbia at 0% bearing in mind the persisting global uncertainty caused by the spread of the coronavirus.

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 (NBS) 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).

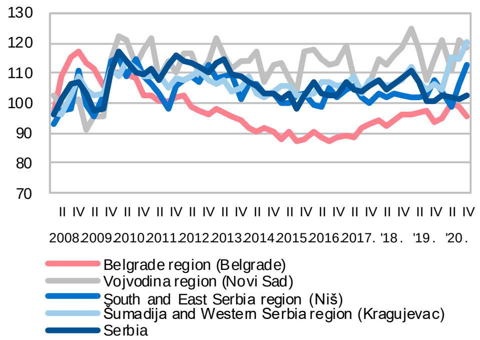
Chart 1 shows the share of credit to the non-government sector in GDP,[1] the long-term trend and the estimated credit-to-GDP gap. After a period of credit expansion from 2000 to 2008, in late 2009 credit-to-GDP gap entered the negative territory. The data for December 2020 show that the share of real credit activity in real GDP was slightly below its long-term trend (gap value of -0.04 pp), while the total credit-to-GDP ratio equalled 80.2%. The credit activity has been on the rise since 2014 and, as a result, in Q4 2020 the share of total loans in GDP came further closer to its long-term trend. The change in the gap relative to end-2014 equals 17.5 pp, or 5.7 pp y-o-y. Bearing in mind the persisting global uncertainty caused by the spread of the coronavirus, setting the CCyB rate above 0% in this moment could affect a potential future rise in lending.

Since early 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 measures aimed to limit non-purpose household lending at unreasonably long maturities, adopted in December 2018, are yielding results, thus reducing the possibility of the build-up of new NPLs. Still, to ease the conditions of loan repayment for citizens who took loans before the outbreak of the pandemic, the NBS encouraged banks to offer to debtors the refinancing of loans approved before 18 March 2020, by extending the maturity date of the last loan instalment for additional two years regardless of the degree of credit indebtedness. Furthermore, the NBS adopted the Decision on Temporary Measures for Banks to Enable Adequate Credit Risk Management amid COVID-19 Pandemic and the Decision on Temporary Measures for Financial Lessors to Enable Adequate Credit Risk Management amid COVID-19 Pandemic. To set the CCyB rate for the Republic of Serbia, in addition to the credit-to-GDP gap, other 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.

[1] The Statistical Office of Serbia revised its GDP dana series from 2005 and it uses 2015 as the reference year for the needs of calculation of real GDP deflator.

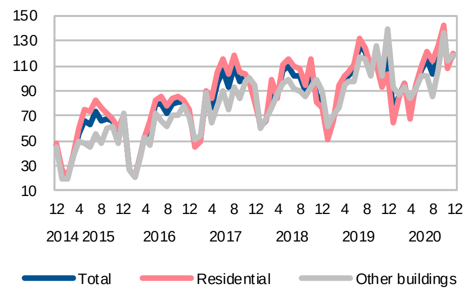
Real estate market

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, 2019 = 100)



Source: Statistical Office of the Republic of Serbia.

According to the January Bank Lending Survey, the rising risk aversion is still present due to the pandemic, therefore banks tightened their corporate credit standards in Q4 2020, though much less than in the previous two quarters. On the other hand, consistent with expectations stated in the October survey, household credit standards were eased in Q4 in response to a positive outlook in the real estate market and banking sector competition. Elevated loan demand in Q4 2020 was led primarily by the need for liquid funds and refinancing, and real estate purchases in the household sector.

Q4 2020 saw a rise in the total number of issued permits for new construction by 12.5% y-o-y. The average LTV ratio of new housing loans is slightly above the regulatory maximum of 80%,[2] amounting to 80.28% in Q4 2020.[3]

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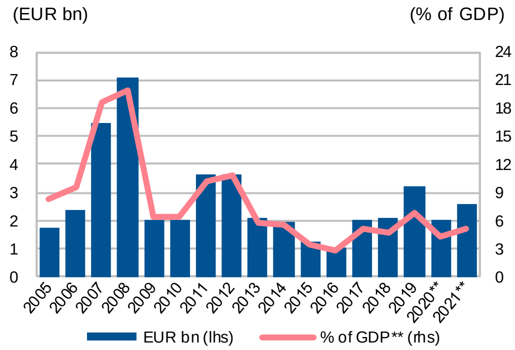
[2] In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, Nos 34/2011 and 114/2017), banks may approve mortgage loans to natural persons provided that the loan amount does not exceed 80% of the value of the mortgaged property. By way of exception, banks may approve mortgage housing loans to natural persons providing that the loan amount does not exceed 90% of the value of the mortgaged property as determined by a certified valuer and reduced by the amount of other receivables secured by first-rank mortgage over the same property, if the loan is approved as a government-support measure for certain groups of natural persons. The Decision amending the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, No 84/2020) allowed for a lower participation required for the approval of housing loans to persons purchasing their first residential property. In accordance with this regulation, for the purchase of the first residential property, banks may approve mortgage housing loans to natural persons providing that the loan amount does not exceed 90% of the value of the mortgaged property.

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

Indicators of external imbalance

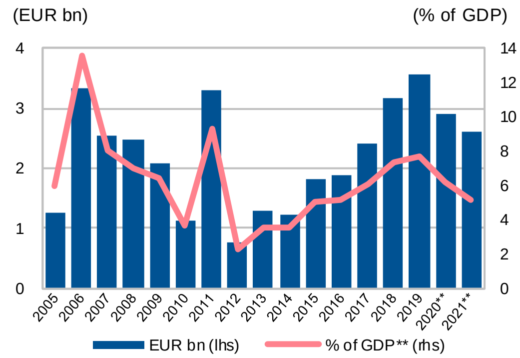
Chart 4 **Current account deficit***



*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, February 2021.

Sources: 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, February 2021.

Sources: Statistical Office of the Republic of Serbia and NBS.

Despite the pandemic-induced crisis, 2020 saw a relatively high FDI inflow of EUR 3.0 bn gross, or EUR 2.9 bn net. In Q4 2020, the net FDI inflow equalled EUR 1.2 bn. The FDI inflow in 2020, higher by 13% than the five-year average and by 41% than the ten-year average, remained broad-based and channelled primarily to export-oriented sectors, ensuring the full coverage of the current account deficit (146.5%).

Main banking sector indicators

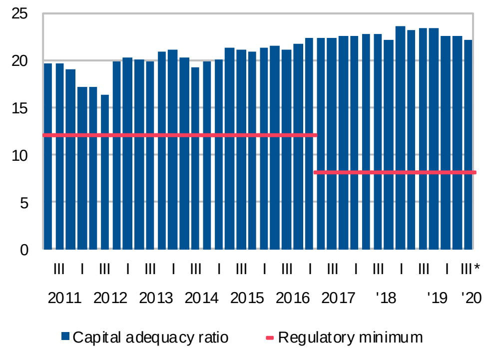
Even with the pandemic spreading, the banking sector remains adequately capitalised and highly liquid, and is likely to remain so in the coming period.

At end-Q3[4] 2020, CAR stood at 22.3%, significantly above the regulatory minimum.[5]

[4] Latest available data.
[5] Since 30 June 2017, the minimum CAR is 8% (minimum Tier 1 capital is 6% and minimum Common Equity Tier 1 capital is 4.5%).

Chart 6 **Capital adequacy ratio**

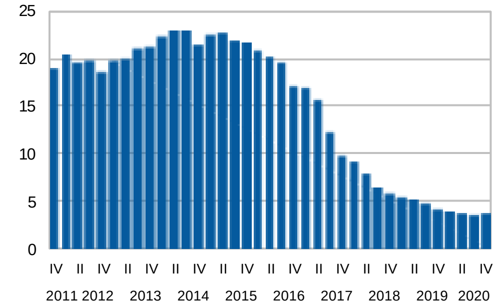
(in %)



*Latest available data
Source: NBS.

Chart 7 **Non-performing loans**

(share in total gross loans, in %)



Source: NBS.

At end-Q4 2020, the loan-to-deposit (LTD) ratio measured 0.80. This indicator 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 August 2015, as well as to other regulatory activities of the NBS. The NPL ratio equalled 3.7% at end-Q4 2020, down by 0.4 pp relative to Q4 2019, or by 18.5 pp relative to August 2015, when the Strategy was adopted.

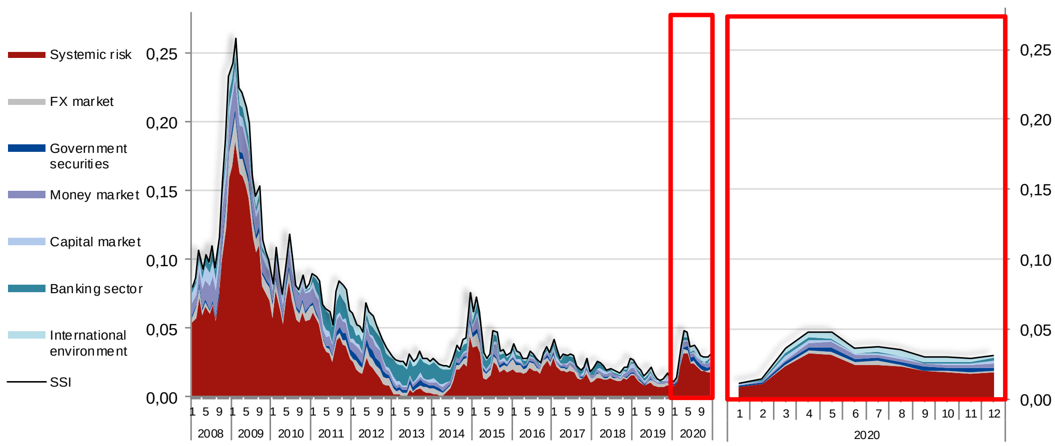
Assessment of systemic risk of the Serbian financial system

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. At end-2020, the SSI slightly increased compared to end-Q3 2020. It was under the strongest impact of developments in the international market and the market of government securities.

Global recovery which began in mid-2020 was slowed by the renewed spread of the coronavirus as of October, which is why different containment measures were reintroduced in many countries. Thus, uncertainty in the international market pushed up the SSI in Q4 2020.

In Q4 2020, elevated uncertainty in the government securities market contributed to a mild rise in the SSI. During that quarter, the Public Debt Administration of the Ministry of Finance reopened two-, five- and 12-year dinar bonds. In November 2020, the Republic of Serbia issued in the international financial market the ten-year eurobond worth USD 1.2 bn at a coupon rate of 2.125% and yield rate of 2.35%.

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



Source: NBS.

On 31 December 2020, J.P. Morgan included the ten-year eurobond in dollars in the calculation of EMBI risk premium on dollar debt for Serbia. On 31 December, EMBI for Serbia on dollar debt equalled 128 bp. The last EMBI for Serbia was published on 28 August 2020, when it equalled 103 bp (SRB 2021 bond was excluded from the calculation as it matured in less than one year). In Q4 2020, average risk premium of Serbia for euro debt (EURO EMBIG) equalled 180 bp (226 bp in Q3). At end-Q4 2020, EURO EMBIG for Serbia equalled 143 bp and was lower than in the majority of countries in the region (Montenegro 341 bp, Romania 202 bp, North Macedonia 171 bp, Hungary 107 bp and Croatia 76 bp)

The results of the latest three-month macroprudential stress-testing of the banking sector, conducted based on data for September 2020, confirm a high level of CAR, which would remain significantly above the regulatory minimum even if the worst-case scenario materialised.

After two rounds of moratoriums enabled to users of bank loans and lessees, in December 2020 the NBS adopted the decision on an additional moratorium – banks and financial lessors are obliged to grant repayment facilities to debtors facing difficulties in the settlement of their obligations due to the pandemic, at debtors' requests.

On 14 December 2020, Standard & Poor's affirmed Serbia's long-term foreign and local currency sovereign credit rating at BB+, with a stable outlook. The agency stated that its decision was supported by the fact that Serbia entered the pandemic-induced crisis with much better overall macroeconomic indicators. The key factor was the preservation of price, financial and fiscal stability, and relative stability of the exchange rate, ensured by the NBS and the Government.