12 December 2019

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 and 103/2018, hereinafter: the Decision on Capital Adequacy), at its meeting of 12 December 2019, the NBS Executive Board decided to keep the countercyclical buffer (CCyB) rate for the Republic of Serbia at 0%.

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 its long-term trend (credit-to-GDP gap).

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 credit expansion between 2000 and 2008, the credit-to-GDP gap became negative in late 2009. September 2019 data show that the share of total loans in GDP equalled 76%[2], while the estimated credit-to-GDP gap was

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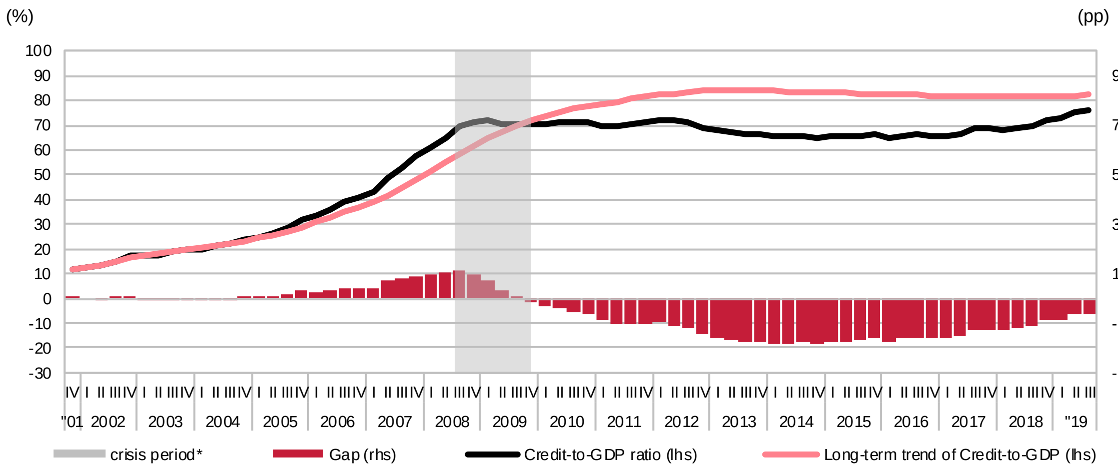
[1] Starting from March 2018, the reference guide applied in setting the CCyB rate is the share of loans to the non-government sector in GDP. In the prior period, the reference guide was the share of lending to the non-government sector in GDP, which, in addition to loans, included given deposits, investment,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

[2] The Serbian Statistical Office revised the data on GDP for 2015 and 2016 and first published estimates (as the sum of four quarters) for 2017. In the next stage, the revision of the series back to 2005 was completed

-6.3 pp. The estimated credit-to-GDP gap records the upward trend, but is still below the long-term trend. Also, the estimated credit-to-GDP gap is below the benchmark value of 2 pp,[3] which indicates that the reference guide for setting the CCyB rate equals 0%.

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



Source: NBS.
*Based on SSI.

Nevertheless, closing of the gap in some segments of household lending called for targeted measures to contain this risk without generating undesired effects on the overall lending activity. In accordance with this, by the end of last year, the NBS Executive Board adopted a set of regulations aimed at preventing the emergence of NPLs in the banking sector and pre-empting potential consequences for financial stability. Among other things, a new indicator of concentration risk was introduced, which at the level of each bank primarily involves the existing portfolio of cash, consumer and other loans (other than housing loans or current account overdrafts) with the agreed maturity of eight years or longer. In addition, the National Bank prescribed a 60% debt-to-income ratio – 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 National Bank of Serbia 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,

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by the end of 2018, and the data before 2005 (starting from 1995) are yet to be revised, i.e. the revision of the whole series will be completed in 2019 – as in the EU Member States.

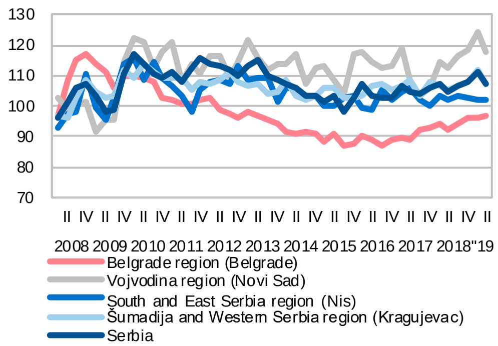
[3] See: Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1), Annex Part II.

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

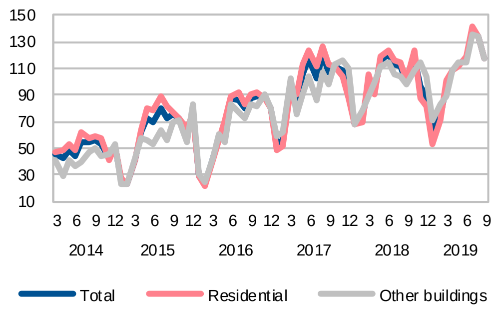
Aggregate real estate market indicators for the Republic of Serbia show that this segment of the financial market is recovering.

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 construction permits**
(index, 2018 = 100)



Source: SORS.

Serbia's average real estate price, as measured by DOMex, increased at end-Q2 2019[4] by 2.6% y-o-y, while falling by 3.5% q-o-q.

Results of the bank lending survey for Q3 2019 indicate an increase in household demand for loans at the aggregate market level, driven mainly by cash and housing loans.

The increase in the number of issued construction permits is another factor of anticipated further growth of supply in the real estate market. End-Q3 2019 saw a rise of 20.6% relative to Q3 2018. The LtV ratio went up from 70.98% in Q2 2019 to 72.76%[5] in Q3 2019, staying significantly below the 80% regulatory ceiling throughout the period observed [6].

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[4] The latest available data.

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

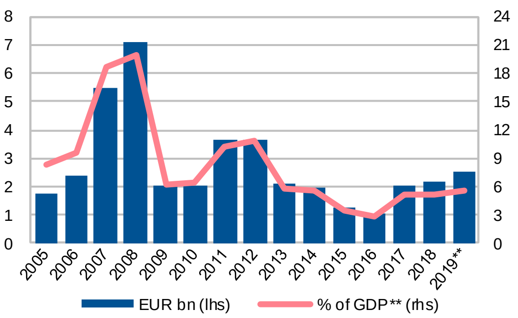
[6] In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, Nos 34/2011 and 114/2017), banks may approve mortgage loans provided that the amount of the loan does not exceed 80% of the value of the property mortgaged, unless a housing loan

Indicators of external imbalance

The current account deficit is fully covered by net FDI inflow. Preliminary data for the first nine months of the year indicate that the FDI inflow of around EUR 2.9 bn is channelled primarily to tradable sectors, which contributes to the country's external sustainability and sound economic growth.

Chart 4 **Current account deficit***

(EUR bn) (% of GDP)

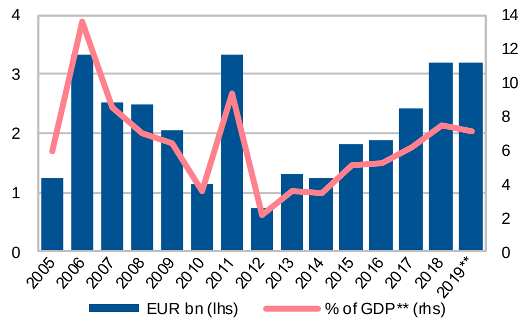


*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM6.
** NBS estimate, November 2019

Source: SORS and NBS.

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

(EUR bn) (% of 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 BPM6.
** NBS estimate, November 2019

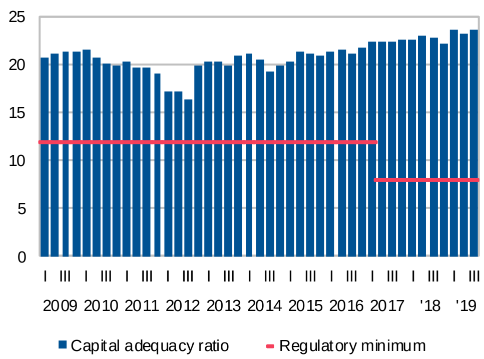
Source: SORS and NBS.

Main banking sector indicators

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

Chart 6. **Capital adequacy ratio**

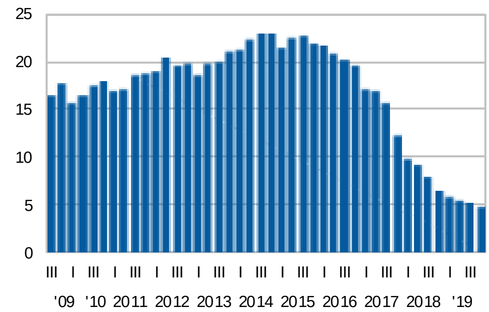
(%)



Source: NBS.

Chart 7. **Non-performing loans**

(share in total gross loans, %)



Source: NBS.

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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.

At end-Q3 2019, the capital adequacy ratio was 23.6%, 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 2019, indicating that banks rely more on domestic, stable sources of funding.

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 share equalled 4.7% at end-Q3 2019, down by 1.7 pp relative to Q3 2018 or by 17.6 pp relative to August 2015, when the Strategy was adopted. In December last year, the Government adopted the NPL Resolution Programme for the Period 2018–2020 aiming to prevent new NPLs and ensure the sustainability of the results achieved in this respect. The Programme includes three areas of activities. 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.

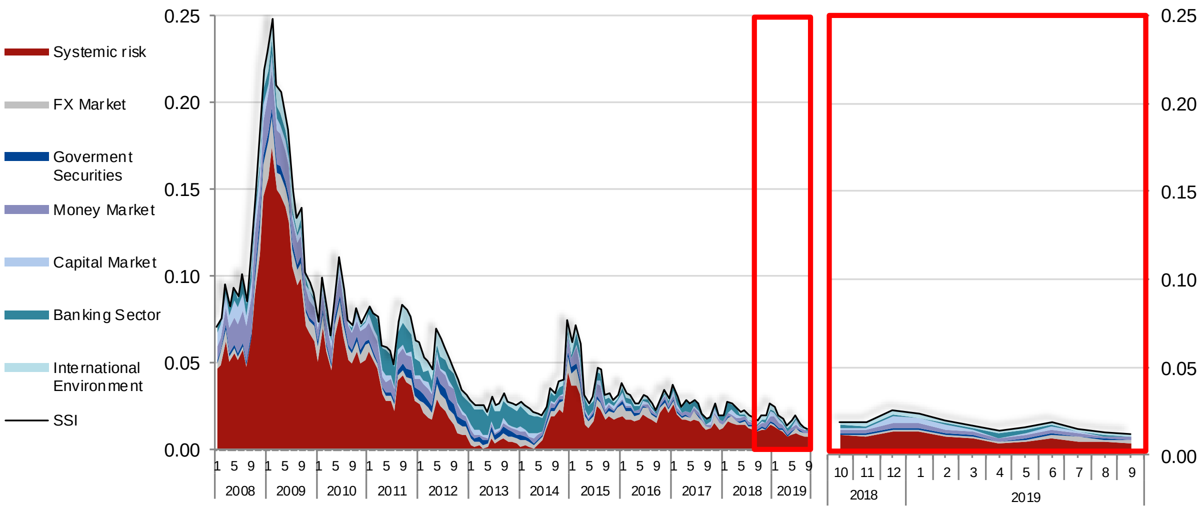
Assessment of systemic risk of the Serbian financial system

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 SSI for September 2018–September 2019 suggests a period of low risk, with a low and stable systemic component and mild volatility in the capital market.

Although a high degree of euroisation is one of the key risks to financial stability, in Q3 2019 trends in the FX market did not affect significantly the level of the SSI. Q3 2019 saw a lower level of systemic stress than the quarter before.

The achieved economic results and stable macroeconomic indicators point to a low level of financial stress originating from public finance in the observed period. Serbia's risk premium averaged 75 bp in Q3, down by 31 bp relative to Q2 2019. On 18 September, Serbia's risk premium touched a new historical low (49 bp). At end-September 2019, it equalled 64 bp and was among the lowest in the region (Poland 34 bp, Croatia 65 bp, Hungary 100 bp, Romania 175 bp) and significantly below EMBI Global (338 bp).

Chart 8 **Systemic Stress Indicator dynamics and contribution of the most important risk factors to the Systemic Stress Indicator**



Source: NBS.

Favourable trends in the money market continued in Q3 2019, which is why the domestic market cannot be regarded as a source of systemic stress risk in the Serbian financial system.

The continuous improvement of NBS 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.

In early September, Moody's upgraded Serbia's outlook from stable to positive and affirmed the country's credit rating at Ba3. In late September, Fitch Ratings increased Serbia's Long-Term Foreign and Local-Currency Issuer Default Ratings from BB to BB+. By maintaining financial stability and transforming its economy, Serbia is now, for the first time, only one step away from investment grade, characteristic of economies offering high security of investment.

Low and stable inflation, consistent implementation of fiscal consolidation and structural reforms, higher capital inflow, monetary policy easing and a stable banking system, all work in favour of boosting the resilience of the domestic financial system and enhancing the overall macroeconomic stability of the country.