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 September 2017, the NBS Executive Board decided to keep the countercyclical buffer rate for the Republic of Serbia at 0%.

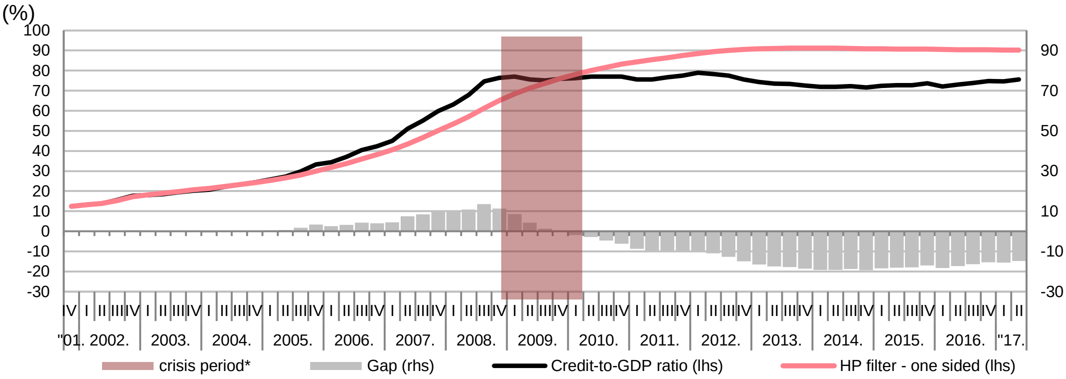
The countercyclical buffer (hereinafter: CCB) is additional Common Equity Tier 1 capital which banks are required to keep above the mandatory regulatory minimum, at the level arrived at by the multiplication of their risk-weighted assets and the specific CCB rate. This instrument helps to mitigate the 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 sets the CCB rate 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, i.e. credit-to-GDP gap. 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 credit-to-GDP gap. Following a period of expansion of credit activity between 2000 and 2008, the total credit to real GDP gap has been negative since late 2009. June 2017 data show that the share of total credit in GDP equalled 75.5%, while the estimated credit-to-GDP gap was -14.7 pp. The estimated credit-to-GDP gap indicates that the current share of credit in GDP is below its long-term trend, i.e. that we are currently in the phase of the financial cycle where introducing a CCB rate above 0% could constrain credit activity. The estimated credit-to-GDP gap is below the reference value of 2 pp[1] and indicates that the reference guide for setting the CCB rate is 0%.

[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.

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



Source: NBS
*Based on SSI

In order to set the countercyclical buffer rate for the Republic of Serbia, in addition to 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 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.

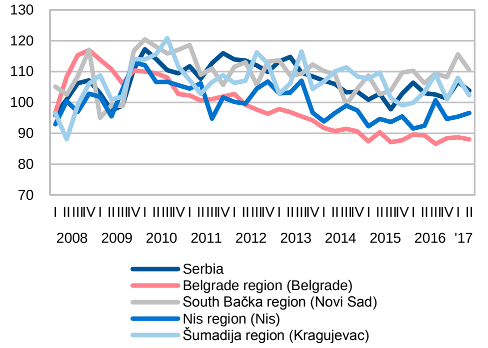
Serbia's average real estate price at end-Q2 2017, as measured by DOMex, increased by 0.8% y-o-y, while falling by 2.65% q-o-q. In view of the decline in interest rates and improved macroeconomic fundamentals, there is potential for a further rise in housing loan demand.

At end-Q2 2017, the number of issued permits for new construction increased by around 34% relative to the same period in 2016.

The average LTV ratio of new housing loans is still significantly below the regulatory maximum of 80%[2], amounting to 71.3%[3] in Q2 2017.

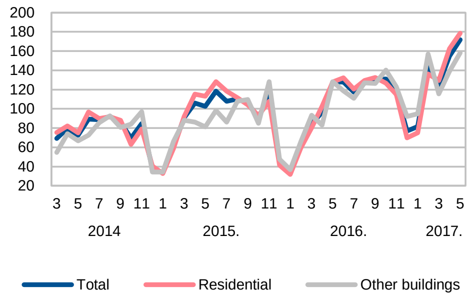
[2] In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, No 34/2011), banks may approve mortgage loans provided that the amount of the loan does not exceed 80% of the value of the property mortgaged.
[3] According to the data of the National Mortgage Insurance Corporation, for new loans insured with the Corporation.

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**

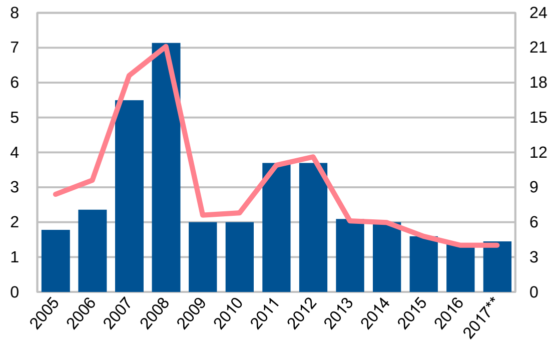


Source: Statistical Office of the Republic of Serbia.

Indicators of external imbalance

Improvement in domestic macroeconomic conditions reduces vulnerability to external risks. As a result of improved trade balance, in 2016 the share of the current account deficit continued down to 4% of GDP at end-2016. In Q1 2017, the current account deficit was somewhat higher due to lower exports and higher energy imports, but it edged down to some extent with warmer weather, lower energy imports and diversification of exports growth. In the first half of 2017, the current account deficit reached EUR 1,020 mn.

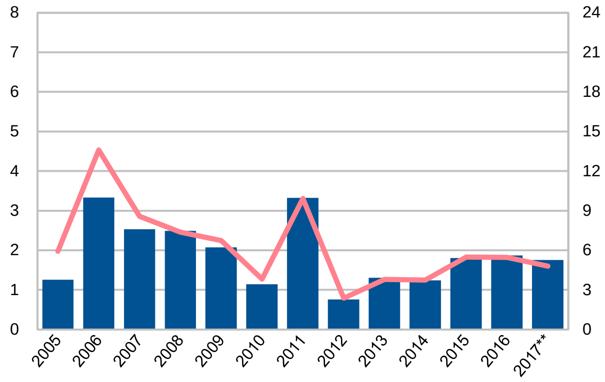
Chart 4. **Current account deficit**
(EUR bn) (% of GDP)



*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.

Source: Statistical Office of the Republic of Serbia 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.

Source: Statistical Office of the Republic of Serbia and NBS

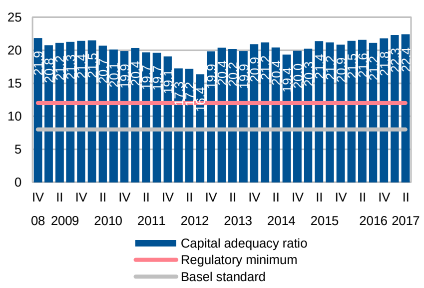
Net inflow of foreign direct investment in H1 2017 equalled EUR 991.8 mn and was channelled predominantly to tradable goods sectors. The net inflow of foreign direct investment in 2017 is expected to be sufficient to cover the current account deficit.

Main indicators of the banking sector

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

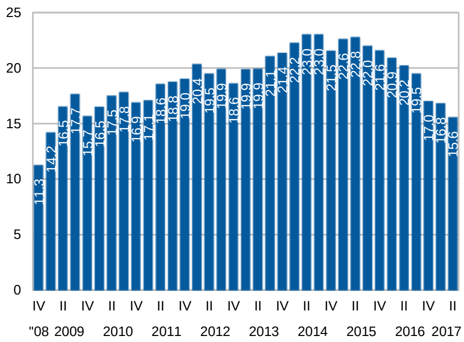
At end-Q2 2017, the capital adequacy ratio equalled 22.4%, well above the regulatory minimum (which as of 30 June 2017 equals 8%).

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



Source: National Bank of Serbia.

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



Source: National Bank of Serbia.

The LtD ratio (ratio of loans to deposits) stayed below 1 at end-Q2 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 remains relatively high, albeit with an apparent downward trend. In June 2017 it amounted to 15.6%, down by 4.6 pp compared to June 2016. 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 National Bank of Serbia.

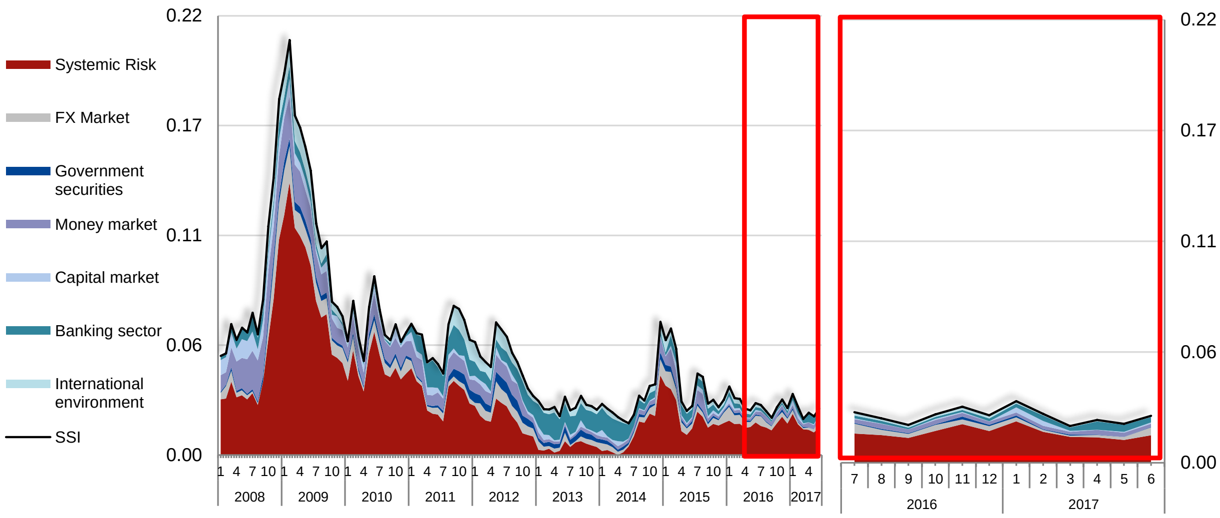
Assessment of systemic risk in the financial system of the Republic of Serbia

In the period June 2016 – June 2017, the indicator of systemic stress (SSI) suggested a period of low risk, with a stable and low systemic component.

Q2 2017 was characterised by the dinar exchange rate appreciation and NBS’s foreign currency purchase interventions. Movements in the market of government securities indicated low risk owing to better macroeconomic outlook, improved public finance and lower risk premium of the Republic of Serbia, which dropped to its ten-year low. Relatively low interest rates and the consistent monetary policy of the National Bank of Serbia contributed to stability in the money market. The growth of BELEX15, initiated in 2016, slowed down in Q2 2017, with the contraction of the total share turnover on the Belgrade Stock Exchange. Banking sector indicators testify to its stability, and credit growth is followed by the growth of deposits expressed in currencies in which they are deposited. 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. In Q2 2017 the Fed continued its monetary policy normalisation, while the ECB continued to pursue its accommodative stance. The Emerging Market Bond Index – EMBI Composite was on a decline in the period observed and risk premia of the majority of countries in the region recorded several-year lows.

Low inflationary pressures, consistent implementation of fiscal consolidation measures and structural reforms, monetary easing and a stable banking system contribute positively to a low level of the systemic risk of the domestic financial system and, by extension, to the country's macroeconomic stability.

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



Source: National Bank of Serbia