6 December 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 and 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 6 December 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: 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.

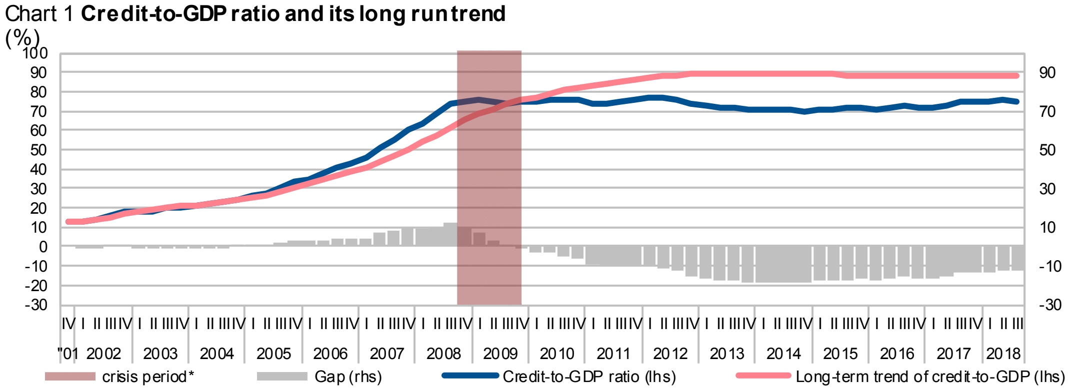
The National Bank of Serbia sets the CCyB rate for the Republic of Serbia on a quarterly basis, taking into account the buffer guide, applicable guidelines and recommendations of the European Systemic Risk Board and other variables it considers relevant for monitoring the cyclical dimension of systemic risk. In accordance with Section 436, paragraphs 2 and 3 of the Decision on Capital Adequacy, the guide for setting the CCyB rate is the deviation of the share of loans in GDP from long-term trends (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] Following a period of expanding credit activity between 2000 and 2008, the credit-to-GDP gap became negative in late 2009. September 2018 data show that the share of total loans in GDP equalled 75.3%, while the estimated credit-to-GDP gap was -12.9 percentage points. The estimated credit-to-GDP gap is recovering

[1] Starting from March 2018, the buffer guide applied in setting the CCyB 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.

but is still below its long-term trend, which indicates that the financial cycle is in a phase in which the introduction of a CCyB rate above 0% could constrain credit activity. The estimated credit-to-GDP gap is below the benchmark value of 2 percentage points,[2] which means that the guide for setting the CCyB rate equals 0%. Nevertheless, closing of the gap in some segments of household lending indicates risk in this credit segment and calls for targeted measures to curb the risk without jeopardising overall lending activity.

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



Source: NBS.
*Based on SSI.

To set the countercyclical buffer 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

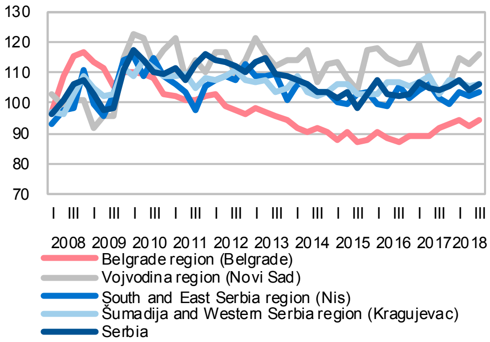
Real estate market indicators for the Republic of Serbia show that this segment of the financial market is recovering.

Serbia's average real estate price, as measured by DOMex, increased by 2.3% y-o-y at end-Q3 2018, and by 2.0% q-o-q.

The number of real estate transactions and the amount of housing loans increased in Q3 2018. The demand for housing loans is expected to rise further in the coming period on the back of an increase in private sector wages and employment as well as favourable terms for housing loans.

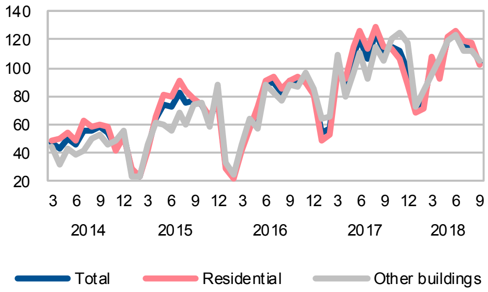
[2] See: Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1), Annex Part II.

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, 2017 = 100)



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 5% at end-Q3 2018 from the end of the year before.

The average LTV ratio of new housing loans is still significantly below the regulatory maximum of 80%,[3] amounting to around 70.4% in Q3 2018.[4]

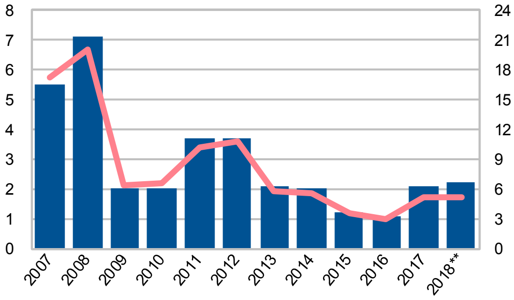
Indicators of external imbalance

Improvement in domestic macroeconomic conditions reduces sensitivity to external risks. Current account deficit came at EUR 1.5 bn in the first nine months of 2018. Net FDI inflow was higher in the first nine months of 2018 compared to the same period of 2017, amounting to over EUR 1.8 bn. FDI is well-diversified and contributes to the country's export potential. FDI inflow in 2018 is expected to be higher than the year before and more than sufficient to cover the current account deficit.

[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), 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 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.

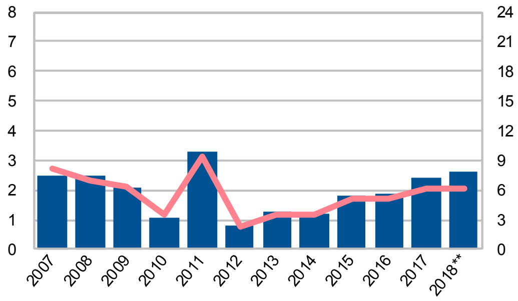
[4] According to data of the National Mortgage Insurance Corporation for new loans insured with the Corporation.

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 BPM5.
** NBS estimate, November 2018.
Source: Statistical Office of the Republic of Serbia and NBS.

Chart 5. **Net foreign direct investments***
(EUR bn) (% of GDP)

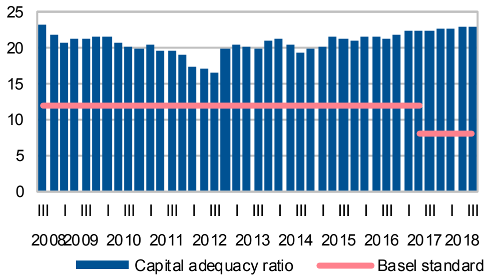


*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5.
** NBS estimate, November 2018.
Source: Statistical Office of the Republic of Serbia and NBS.

Main banking sector indicators

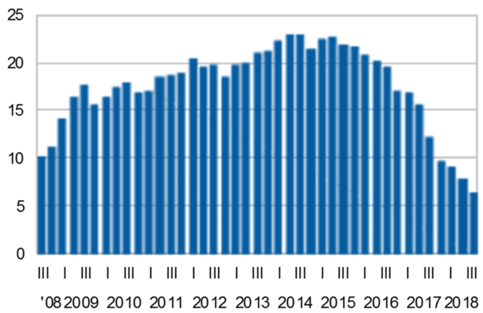
The banking sector is adequately capitalised and highly liquid. A declining level of NPLs, the fact that there is no concentration of some types of assets in the banking sector, and the satisfactory degree of competition testify to the stability of the banking sector.

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-Q3 2018, the capital adequacy ratio equalled 22.8%, well above the regulatory minimum (which as of 30 June 2017 equals 8%).

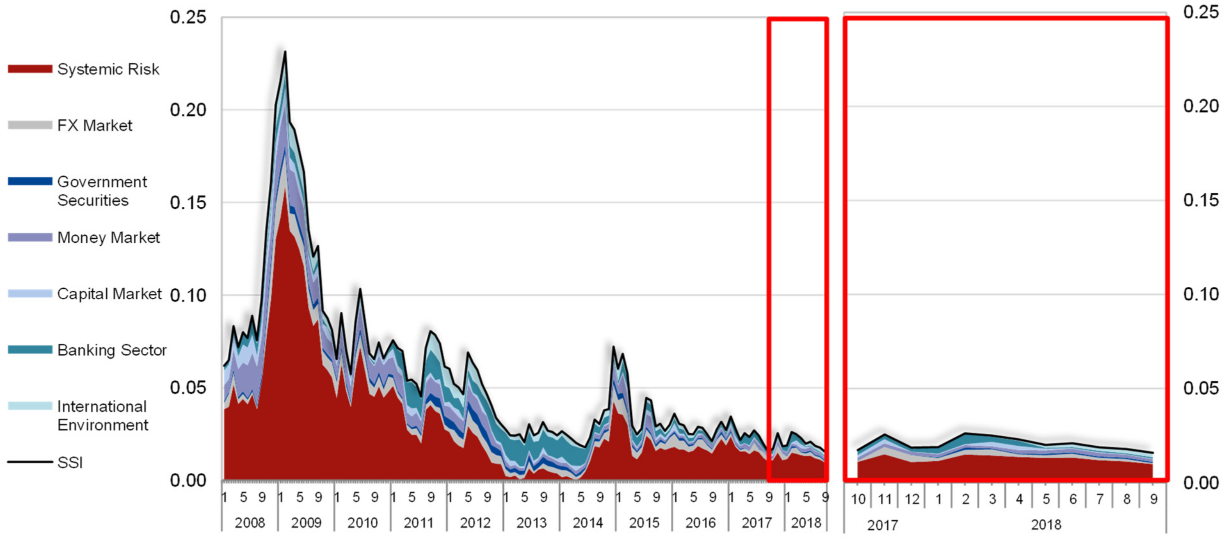
The LtD ratio (ratio of loans to deposits) stayed below 1, at 0.89 at end-Q3 2018, indicating that banks rely more on domestic, stable sources of funding.

The share of NPLs in total loans of the banking sector continued to trend down in 2018, to 6.4% at end-Q3 2018, which is below the pre-crisis level and the lowest level on record for this indicator of bank asset quality. 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 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.

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



Source: The NBS.

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

Developments in the foreign exchange market did not significantly affect the SSI level in Q3 2018. Furthermore, the achieved results and the domestic macroeconomic indicators point to a low level of financial stress originating from the public finance. The average EMBI for Serbia was down by around 12 bp in Q3 2018 relative to the same period of the year before. The NBS monetary policy easing, an adequate level of required reserves and low interest rates on the euro money market marked the first nine months of 2018 and affected favourably the domestic money market which therefore cannot be regarded as a source of the risk of systemic stress in the Serbian financial system. Trends in the capital market in Q3 2018 did not significantly affect the level of systemic stress in the financial system of the Republic of Serbia. The National Bank of Serbia's continuous efforts to improve regulatory measures have led to an improvement in relevant banking sector indicators in 2018 as well, which increased further the resilience of the financial system to potential shocks. 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. Fitch Ratings affirmed Serbia's credit rating for long-term borrowing in the domestic and foreign currency at the level "BB", with stable outlook, citing as the reason the assessment that economic policies would contribute to further strengthening of macroeconomic indicators, improvement of business environment and public debt reduction.

Low inflationary pressures, successful fiscal consolidation and continued structural reforms, higher FDI inflow, cautious monetary policy easing, together with a stable banking system, boost the resilience of the domestic financial system and thus macroeconomic stability of the country.