12 March 2020

EXPLANATION OF THE COUNTERCYCLICAL BUFFER RATE FOR THE REPUBLIC OF SERBIA

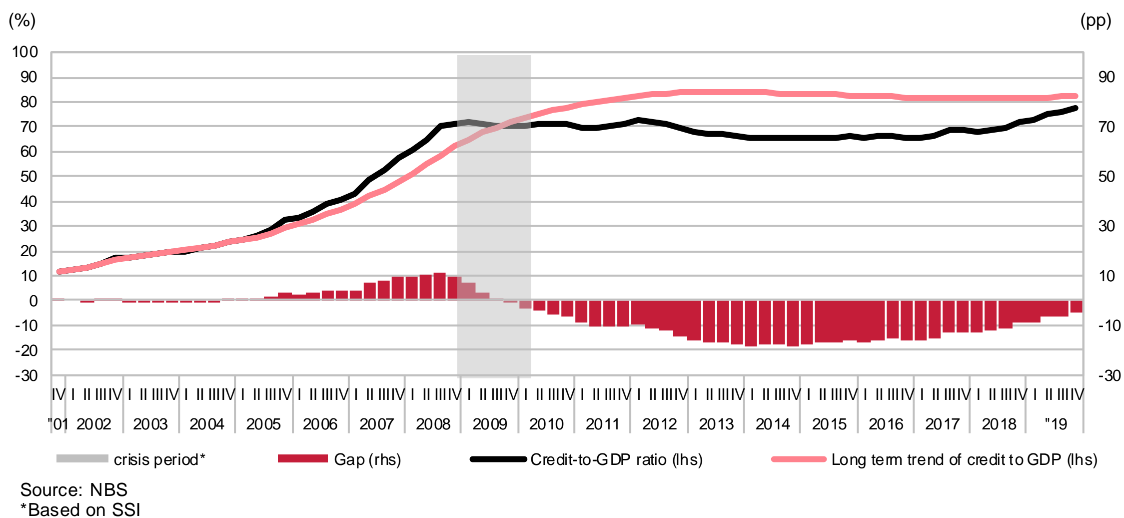
Pursuant to Article 14, paragraph 1, item 11) of the Law on the National Bank of Serbia (RS Official Gazette 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012, 106/2012, 14/2015 and 40/2015 – CC decision and 44/2018) and Section 436 of the Decision on Capital Adequacy of Banks (RS Official Gazette, Nos 103/2016, 103/2018 and 88/2019, hereinafter: Decision on Capital Adequacy), the NBS Executive Board, at its meeting of 12 March 2020, 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 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 a period of credit expansion between 2000 and 2008, credit-to-GDP gap entered the negative territory in late 2009. The data from December 2019 show that the share of total loans in GDP equalled 77.4%,[2] while the estimated credit-to-GDP gap was -5.1 pp. The estimated credit-to-GDP gap records the upward tendency, but is still below the long-term trend. Also, this gap is below the benchmark value of 2 pp,[3] indicating that the value of the

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



Source: NBS
*Based on SSI

reference guide for setting the CCyB rate is 0%.

Bearing in mind that in some segments of household lending, the gap closed faster, the NBS worked proactively, adopting a series of measures aimed at mitigating this risk to financial system stability. Due to the above, and in order to provide a timely response to 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, in December 2018 the NBS adopted a set of regulations

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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 lending.

[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.

introducing novelties in the field of household lending. 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 or more years that were approved or will be approved before the application of the new set of regulations. In 2020, banks will be required to reduce their capital when approving the above types of loans with 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. 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 for the emergence of new NPLs. 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

Relative to the same period of 2018, average real estate prices in the Republic of Serbia increased by 5%, i.e. in Belgrade by 6.7%, in South and East Serbia region by 4.2%, in Vojvodina by 3%, while declining by 1.6% in Šumadija and Western Serbia region.

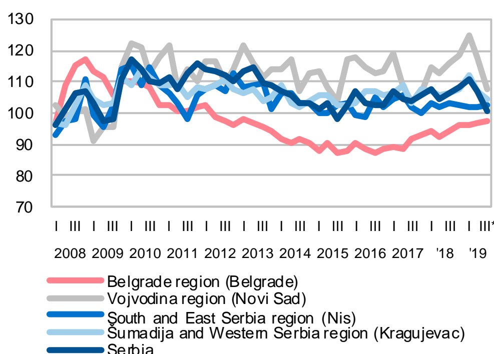
The number of issued permits for new construction is one of the factors indicating expectations regarding the movement of supply in the real estate market. End-Q4 2019 saw a rise of 19.1% in the number of issued construction permits relative to Q4 2018. At the same time, the average LtV

ratio of new housing loans remained significantly below the regulatory maximum of 80%[4], measuring 71.93% in Q4 2019[5].

Indicators of external imbalance

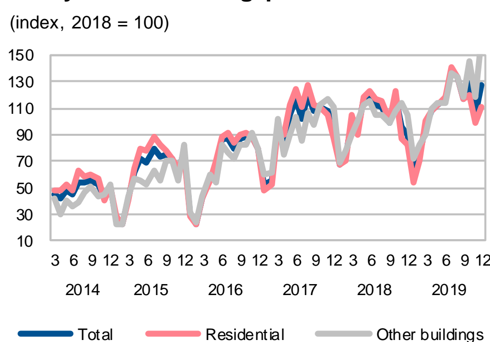
For the fifth year in a row, the current account deficit was fully covered by the net inflow of foreign direct investments. According to preliminary data for the previous year, the net inflow of foreign direct investments of around EUR 3.6 bn was project-diversified and, for a longer period of time, mostly

Chart 2 **Real estate index DOMex**
(index, average 2002 - 2010 = 100)



Source: National Mortgage Insurance Corporation.
*Last available data.

Chart 3. **Indices of the number of newly issued building permits**
(index, 2018 = 100)



Source: Statistical Office of the Republic of Serbia.

channelled to tradable sectors, suppo ting the country's external sustainability and sound economic growth. Heightened interest of foreign investors in government securities in the domestic market generated a net portfolio investment inflow of close to EUR 200 mn.

Main banking sector indicators

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

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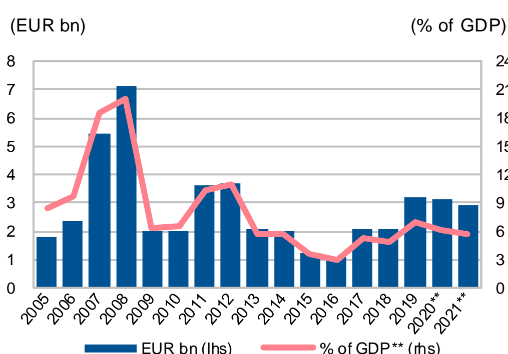
[4] In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, Nos 34/2011 and 114/2017), banks may approve mortgage loans to natural persons provided that the amount of the loan does not exceed 80% of the value of the property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

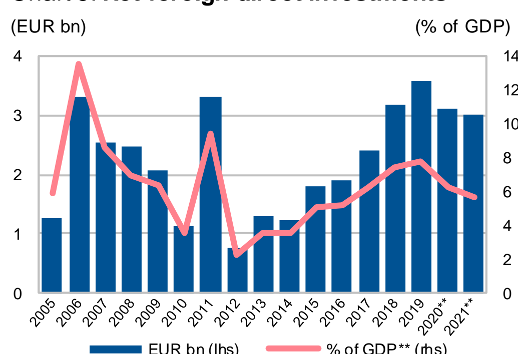
[5] According to data of the National Mortgage Insurance Corporation for new loans insured with the Corporation.

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 2020
Source: 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 2020
Source: Statistical Office of the Republic of Serbia and NBS.

At end-Q3 2019, CAR stood at 23.6%[6], significantly above the regulatory minimum.

At end-Q4 2019, the loan-to-deposit (LtD) ratio measured 0.85. The LtD value below 1 suggests that banks rely more on domestic, stable sources of funding, such as deposits.

Chart 6. **Capital adequacy ratio**

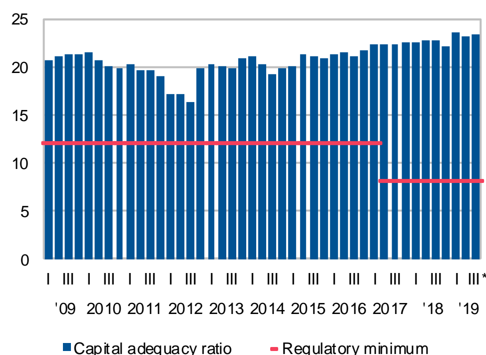
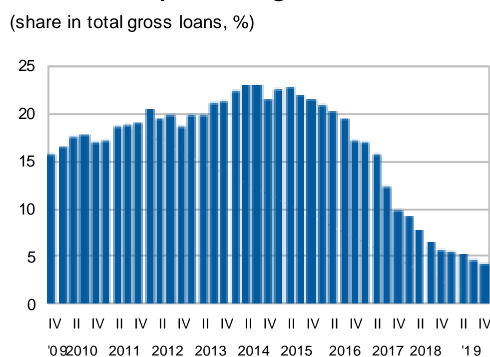


Chart 7. **Non-performing loans**

(share in total gross loans, %)



Source: National Bank of Serbia.

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 4.1% at end-Q4 2019, which is the lowest level on record, down by 1.6 pp relative to Q4 2018, or by 18.2 pp relative to August 2015. In December, the Serbian Government adopted the

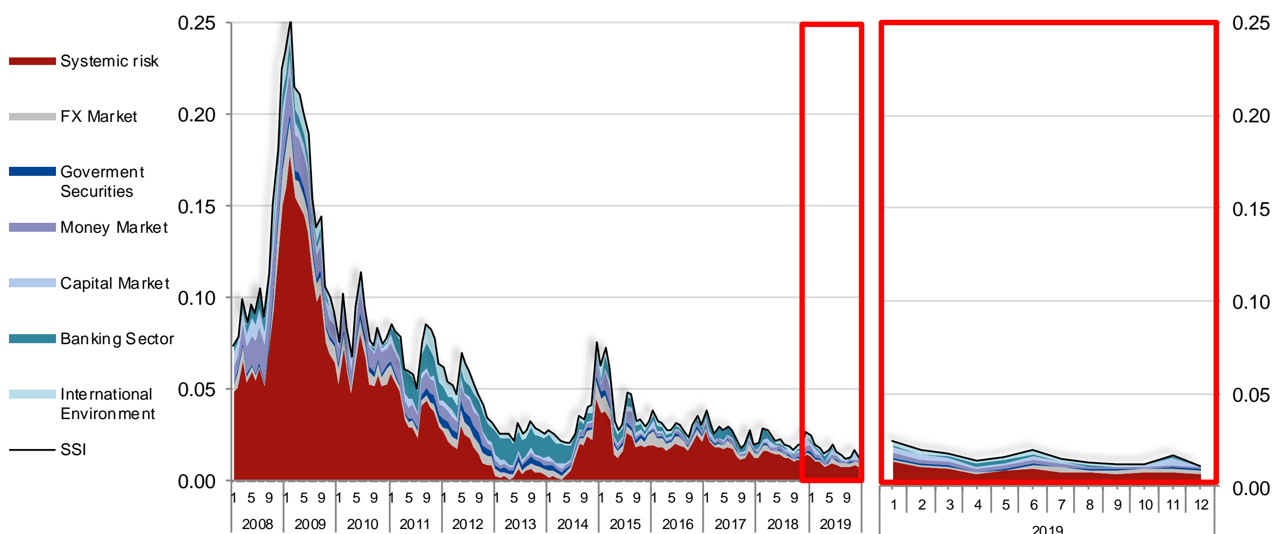
[6] The latest available data.

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 in NPL reduction thus far. 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 aims to further improve the implementation of the bankruptcy framework, while the third 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 June 2018–June 2019 suggests a period of low risk, with a low and stable systemic component.

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



Source: National Bank of Serbia.

Q4 2019 saw a lower level of systemic stress than the quarter before.

Although a high degree of euroisation is one of the key risks to the Serbian financial system, in Q4 2019 movements in the FX market did not

affect significantly the level of the SSI, while movements in the capital market did to a certain extent.

As favourable trends in the money market extended into Q4 2019, the domestic market is not a source of systemic stress in the financial system of the Republic of Serbia. The achieved economic results and stable macroeconomic indicators point to a low level of financial stress originating from public finance in the period observed. The average risk premium for Serbia measured 44 bp in Q4, down by 31 bp compared to the average premium in Q3 2019. In December, Serbia's risk premium touched a new historical low of 5 bp (23 December). At end-December 2019, Serbia's risk premium was 19 bp and, as such, the lowest in the Central and East Europe region (Poland 27 bp, Croatia 42 bp, Hungary 81 bp, Romania 156 bp) and considerably below EMBI Global (277 bp).

The continuous improvement of the 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.

Reduction in the risk premium was supported by the strengthened investor confidence in Serbia's macroeconomic prospects. In mid-December, Standard&Poor's upgraded Serbia's credit rating from BB to BB+, one step away from investment grade. The agency assessed Serbia's rating outlook as positive, which is a strong signal that further upgrades to the country's credit rating are possible in the near term.

Monetary, microprudential and macroprudential policies of the NBS have helped to reduce the level of systemic risk and strengthen the stability of the financial system of the Republic of Serbia.