10 September 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 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, 88/201967/2020 and 98/2020, hereinafter: Decision on Capital Adequacy), the NBS Executive Board, at its meeting of 10 September 2020, decided to keep the countercyclical buffer rate for the Republic of Serbia at 0% in order to mitigate the potential negative effects of the pandemic on the conditions of financing of corporates and households.

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.

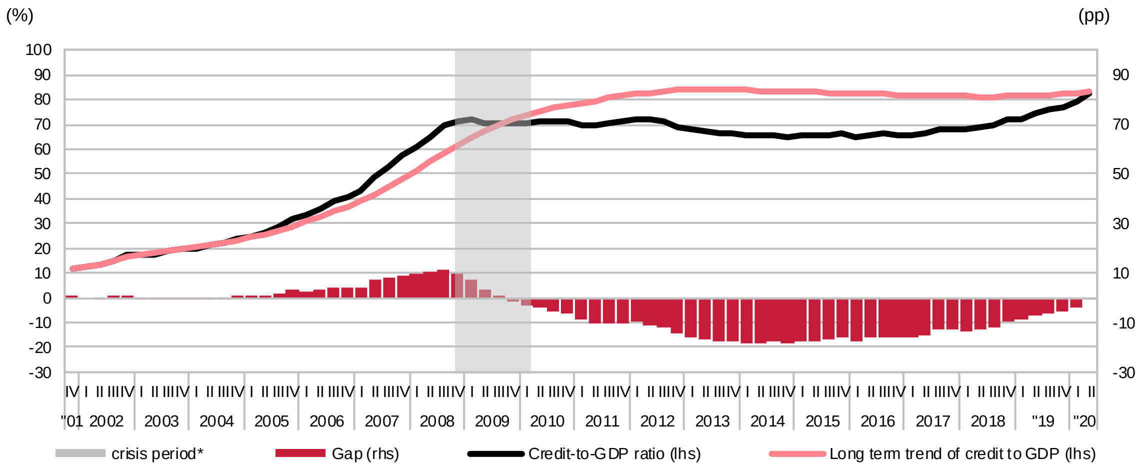
The National Bank of Serbia sets the CCyB rate for the Republic of Serbia on a quarterly basis, taking into account the reference guide, applicable guidelines and recommendations of the European Systemic Risk Board and other variables it considers relevant for monitoring the cyclical dimension of systemic 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 to the non-government sector in GDP, the long-term trend and the estimated credit-to-GDP gap.[1] After the period

[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

of credit expansion from 2000 to 2008, in late 2009 credit-to-GDP gap entered the negative territory. The data from June 2020 show that the share of total loans in GDP equalled 82.8%, while the estimated credit-to-GDP gap was -0.7 pp. The credit-to-GDP gap records the upward tendency, but is still below the long-term trend. Taking into account that the estimated share of real credit activity in real GDP is below its long-term trend, i.e. that the credit-to-GDP gap is below the 2 pp benchmark[2], as well as in view of the heightened global uncertainty caused by the spread of the coronavirus, setting the CCyB rate above 0% could negatively impact credit activity.

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



Source: NBS
*Based on SSI

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 on unreasonably long terms adopted in December 2018 yielded results, reducing the possibility of the build-up of new NPLs. 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 by additional two years regardless of the degree of credit indebtedness.

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

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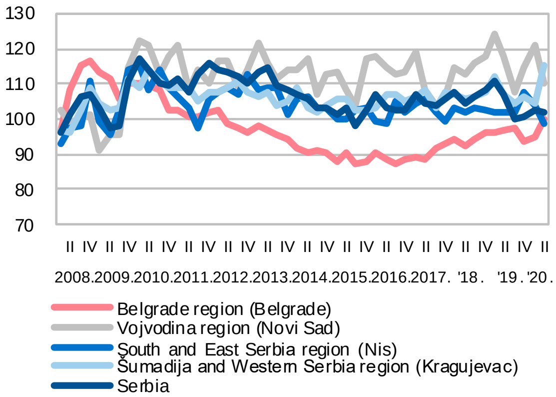
sector in GDP, which, in addition to loans, included given deposits, investment, securities and other financial assets, interest, fee and commission receivables and other lending.

[2] 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.

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.

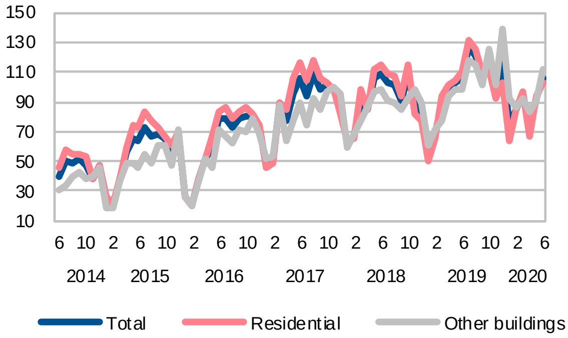
Real estate market

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 July Bank Lending Survey, consistent with the expectations from the April Survey, banks tightened corporate and household credit standards in Q2. Such trends reflect the rising risk aversion amid uncertainty caused by the coronavirus pandemic. On the other hand, competitiveness in the sector and dinar sources of funding are recognised as the factors working towards the easing of standards, which is largely due to the NBS key policy rate cuts. Banks assess that corporate loan demand increased in Q2 – for working capital loans and the restructuring of current liabilities.

Q2 2020 saw a decline in the total number of issued permits for new construction by 11.4% y-o-y. The average LTV[3] ratio of new housing loans is still significantly below the regulatory maximum of 80%[4] amounting to 73.05% in Q2 2020[5].

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[3] At the Executive Board meeting of 11 June 2020, the NBS adopted the Decision Amending the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, No 84/2020), creating regulatory preconditions for lower downpayment for first-time home buyers. In accordance with the new regulation, in the case of first-time home buyers, banks may approve a mortgage loan to a natural person provided that the amount of the loan does not exceed 90% of the value of the property mortgaged (the exemption from the general limit of 80%).

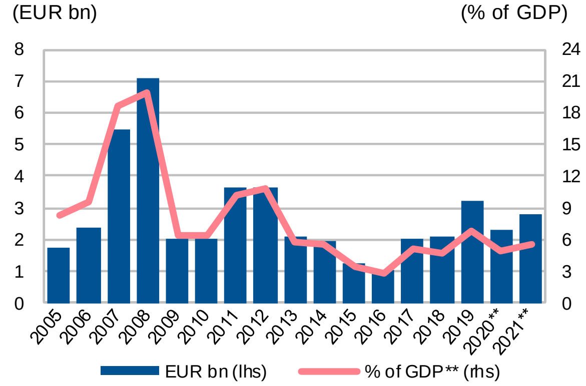
[4] In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, Nos 34/2011 and 114/2017), banks may approve mortgage loans to natural persons provided that the amount of the loan does not exceed 80% of the value of the property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

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

Indicators of external imbalance

Despite heightened uncertainty in the international financial market, vigorous FDI inflows continued. In H1 2020, net FDI inflows came at EUR 1.5 bn (6.7% of GDP) and were sufficient to fully cover the current account deficit.

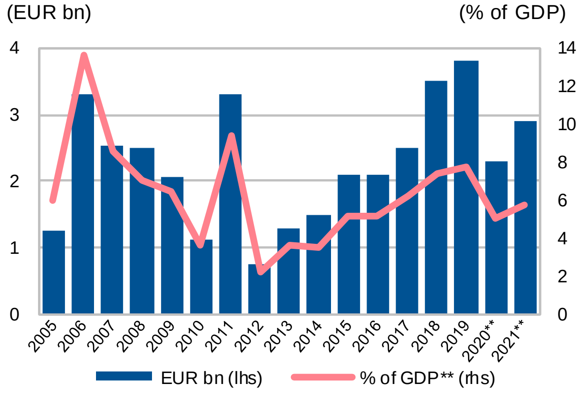
Chart 4. **Current account deficit***



*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, August 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, August 2020

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

Main banking sector indicators

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

At end-Q2 2020 CAR stood at 22.7%, significantly above the regulatory minimum.[6]

[6] 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%).

At end-Q2 2020, the loan-to-deposit (LTD) ratio measured 0.83. This indicator at levels below 1 suggests that banks largely rely on domestic, stable sources of funding, such as deposits.

Chart 6. **Capital adequacy ratio**

(y %)

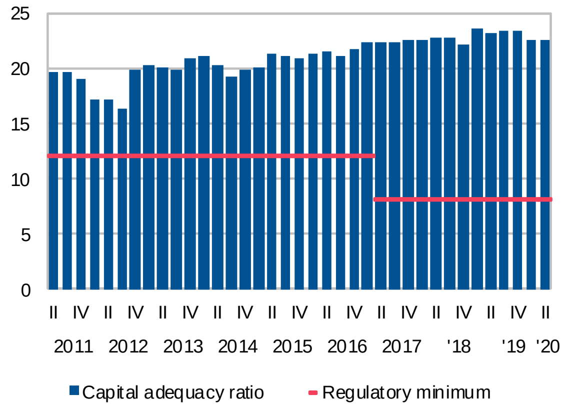
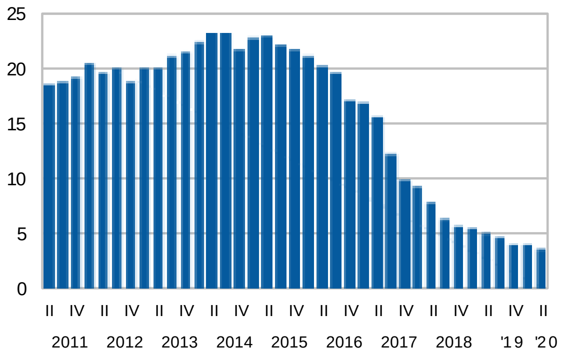


Chart 7. **Non-performing loans**

(share in total gross loans, %)



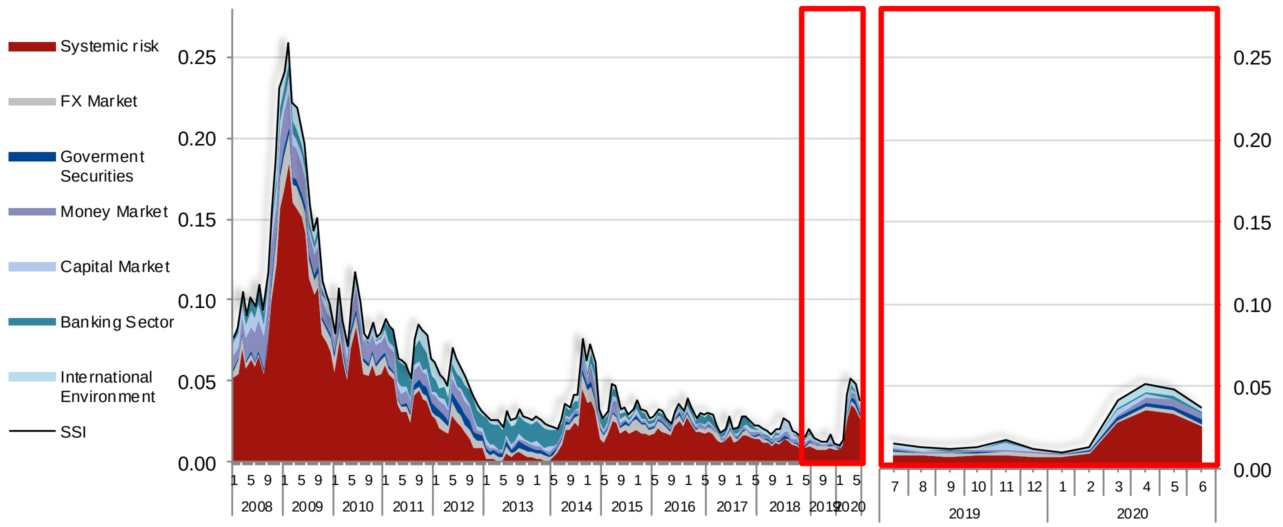
Source: National Bank of Serbia.

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 August 2015, as well as to other regulatory activities of the NBS. The NPL ratio equalled 3.7% at end-Q2 2020, down by 1.5 pp relative to Q2 2019, or by 18.5 pp relative to August 2015. In December, the Serbian Government adopted the NPL Resolution Programme for the period 2018-2020, in order to prevent the build-up of new NPLs and ensure the sustainability of the results achieved in NPL reduction thus far.

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. After higher values recorded in April and May, at end-Q2 2020 the SSI recorded somewhat lower values, which indicates a reduction in the level of systemic stress. The SSI was under the strongest impact of developments in the international market and, to an extent, developments in the local market of government securities.

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



Source: National Bank of Serbia.

In H1 2020, the COVID-19 pandemic triggered rising uncertainty at the global level. To protect the lives of people, containment measures were introduced, followed by shocks in the international financial market, a pronounced rise in uncertainty and flight-to-safety, turmoil in the majority of commodity and financial markets, which resulted in a sharp fall in global economic activity. The uncertainty in the international market pushed up risk premia of emerging economies. This trend did not bypass Serbia either, and its risk premium on dollar debt was on a rise from March to April, only to decline in May and June. In Q2, the risk premium stood at 230 bp on average, up by 139 bp compared to the average premium in Q1 2020. At end-June 2020, Serbia's USD risk premium was 137 bp and was among the lowest in the region (Poland: 51 bp, Croatia: 148 bp, Hungary: 175 bp, Romania: 262 bp) and significantly below EMBI Global (433 bp).

The continuous improvement of NBS regulatory measures reinforces the resilience of the financial system to potential shocks. Given the need to preserve and strengthen financial stability amid potential risks caused by the extraordinary health situation in the country and globally, in March 2020 the NBS adopted measures introducing a three-month moratorium on the repayment of loan and financial lease debt. In July, it introduced an additional moratorium on debtor liabilities falling due from 1 August 2020 to 30 September 2020, and on outstanding liabilities which fell due in July 2020.

Quarterly macroprudential stress tests of the banking sector carried out by the NBS confirm adequate capitalisation and high liquidity of the Serbian banking sector.

Despite the heightened risks caused by the coronavirus pandemic and owing to the significantly buttressed resilience of the Serbian economy compared to the period one decade ago, in May (extraordinary rating assessment) and in June (regular assessment), Standard&Poor’s maintained Serbia’s credit rating at BB+, with a stable outlook.