

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 14 March 2018, 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.

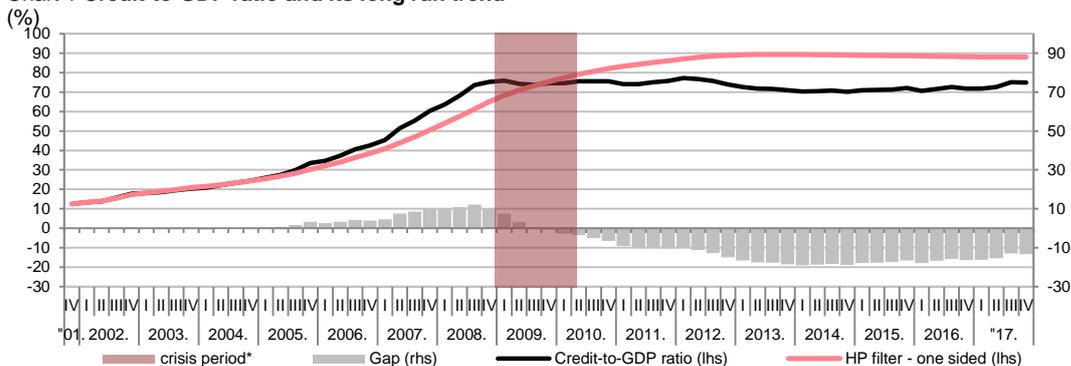
The National Bank of Serbia (NBS) sets the CCB rate for the Republic of Serbia on a quarterly basis, taking into account the buffer guide, the valid guidelines and recommendations of the European Systemic Risk Board and other variables considered relevant for monitoring the cyclical dimension of systemic risk. In accordance with Section 436, paragraphs 2 and 3 of the Decision on Capital Adequacy, the buffer 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 trend¹. 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 deviation of the credit-to-GDP ratio from its long-term trend. Following a period of expansion of credit activity from 2000 to 2008, in late 2009, deviation of the credit-to-GDP ratio from its long-term trend entered the negative territory. December 2017 data show that the share of total credit in GDP equalled 74.9%, while the estimated credit-to-

¹ Starting from March 2018, the buffer guide applied in setting the CCB 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, fees and commission receivables and other lending.

GDP gap was -13.3 pp. The estimated gap and the dynamics of movement of the credit-to-GDP ratio indicate that the current share of credit in GDP is below its long-term trend and is entering the recovery phase, i.e. that we are currently in the phase of the financial cycle where introducing a CCB rate above 0% could constrain credit activity. Also, the estimated credit-to-GDP gap is below the reference value of 2 pp² and indicates that the buffer guide for setting the CCB rate is 0%.

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 deviation of the credit-to-GDP ratio from its long-term trend, 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.

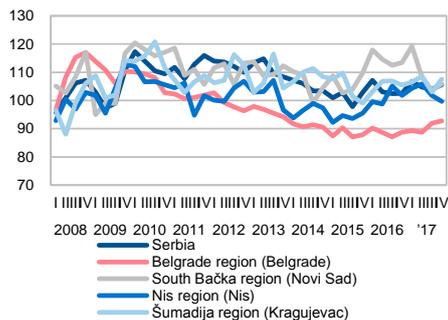
Real estate market

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-Q4 2017, as measured by DOMex, increased by 3.0% y-o-y, or 1.6% q-o-q. In view of the decline in interest rates, improved macroeconomic fundamentals, a rise in employment and wages in the private sector, as well as more favourable movements in the real estate market, housing loan demand continued up into Q4 2017.

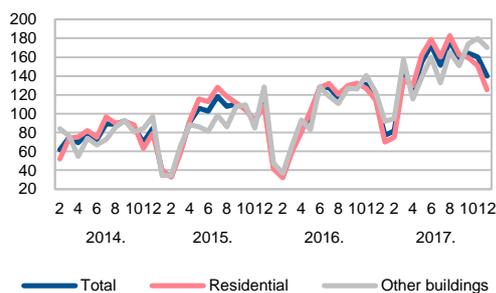
² See: Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1), Annex Part II.

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



Source: Statistical Office of the Republic of Serbia.

The recovery of the construction sector is indicated also by the number of issued permits for new construction, which at end-Q4 2017 increased by around 19.3% relative to the same period a year earlier.

The average LTV ratio of new housing loans is still significantly below the regulatory maximum of 80%³, amounting to 70.2% in Q4 2017⁴.

Indicators of external imbalance

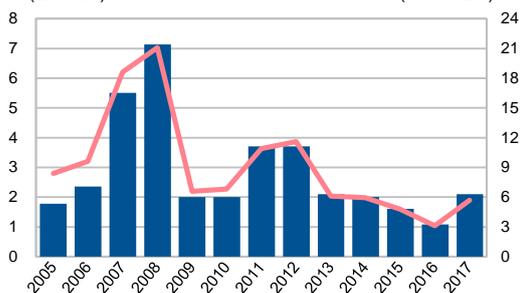
Improvement in domestic macroeconomic conditions reduces vulnerability to external risks.

In 2017, the current account deficit amounted to EUR 2.1 bn and was fully covered by the net FDI inflow. In 2017, the net FDI inflow came at EUR 2.4 bn or 6.6% of GDP and was channelled predominantly to tradable sectors. This inflow will impact a further rise in exports and a reduction in the share of the current account deficit in GDP in 2018.

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), unless a loan is approved in the context of government support measures for some categories of natural persons, banks may approve mortgage loans provided that the amount of the loan does not exceed 80% of the value of the property mortgaged.

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)

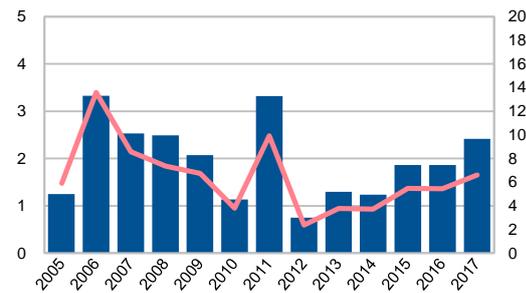


*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM6.

** 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.

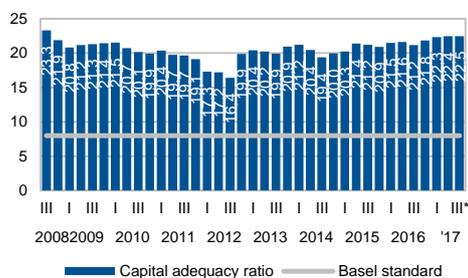
Source: Statistical Office of the Republic of Serbia and NBS

Main indicators of the banking sector

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.

At end-Q3 2017⁵, the capital adequacy ratio equalled 22.5%, well above the regulatory minimum (which as of 30 June 2017 equals 8%).

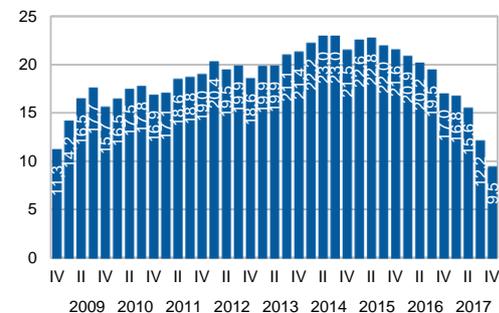
Chart 6. Capital adequacy ratio
(%)



Source: National Bank of Serbia.

*The last data available

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



The LtD ratio (ratio of loans to deposits) stayed below 1 at end-Q4 2017, indicating that banks rely more on domestic, stable sources of funding.

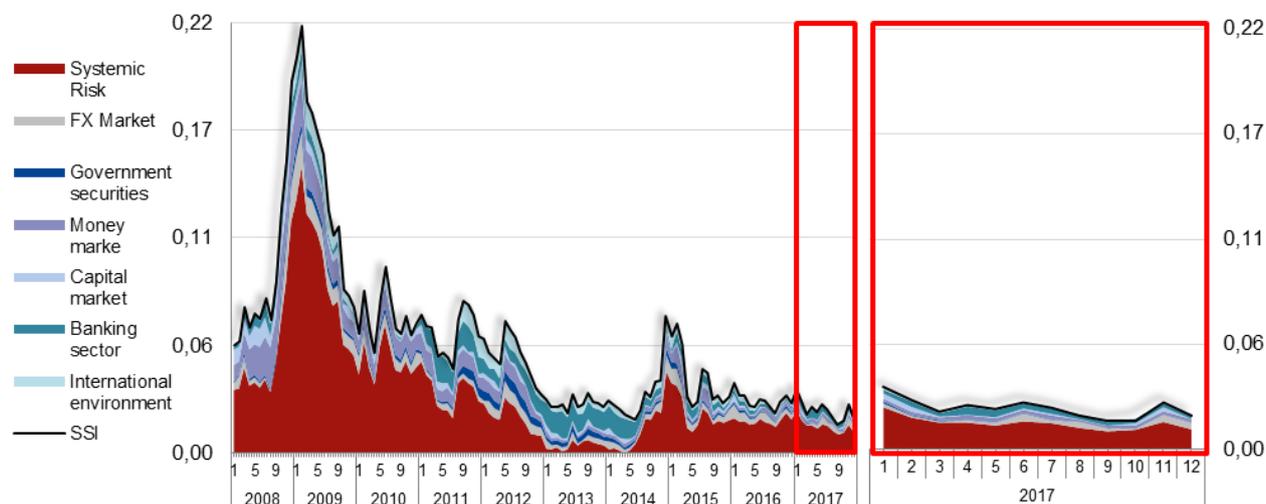
The share of NPLs in total loans of the banking sector continued to trend down in 2017, to 11.08% at end-November 2017, the lowest value of this ratio after the crisis. The reduction in the share of NPLs largely resulted from activities implemented in accordance with the NPL Resolution Strategy and action plans of the Government and the NBS.

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

The systemic stress indicator (SSI) was developed with a view to identifying periods of elevated stress and level of systemic risk in the financial system of the Republic of Serbia. 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.

In the course of 2017, SSI suggested a period of low risk, with a stable and low systemic component.

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



Due to dinar's appreciation against the euro and, thus, increased volatility of the exchange rate, movements in the FX market had the greatest impact on the level of SSI in Q4 2017. Movements in the market of government securities indicated low risk owing to better macroeconomic outlook, improved public finance and a significantly reduced risk premium of the Republic of Serbia. Furthermore, monetary accommodation, along with low interest rates in the euro area financial market, had a positive impact on the

domestic money market. Trends in the capital market in Q4 2017 were somewhat more volatile, which impacted an increase in SSI. Quarterly macroprudential stress tests of the banking sector carried out by the NBS confirm adequate capitalisation and high liquidity of the Serbian banking sector. Improvement of the business and investment environment, and narrowing in internal and external imbalances, contributed to increased resilience to potential negative effects from the international environment.

Low inflationary pressures, continued implementation of fiscal consolidation measures and structural reforms, a higher capital inflow to Serbia, monetary easing and a stable banking system contribute positively to strengthening the resilience of the domestic financial system and, by extension, to the country's macroeconomic stability.