

12 September 2019

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 and 103/2018, hereinafter: the Decision on Capital Adequacy), at its meeting of 12 September 2019, the NBS Executive Board decided to keep the countercyclical buffer (CCyB) 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).

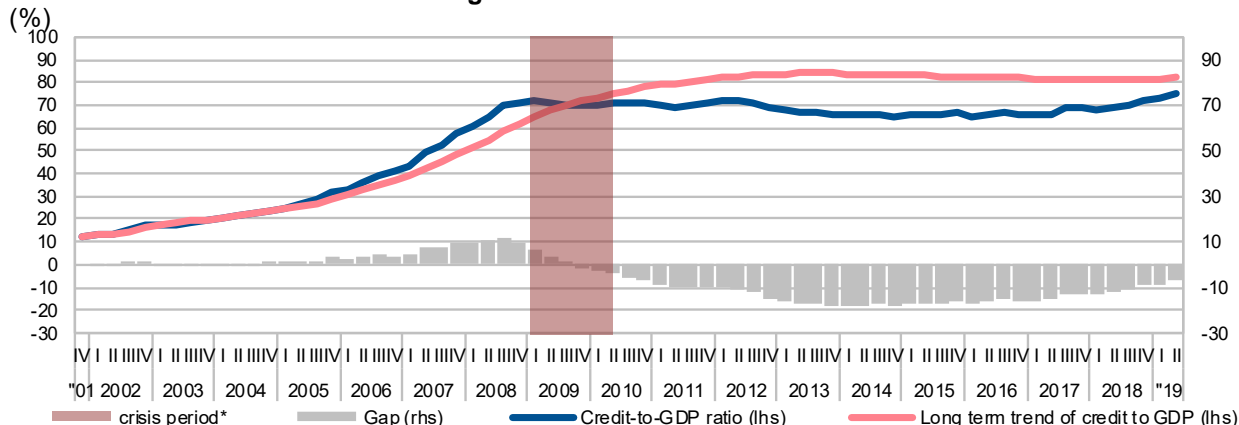
Chart 1 shows the share of credit activity to the non-government sector in GDP, the long-term trend and the estimated credit-to-GDP gap.¹ Following a period of expanding credit activity between 2000 and 2008, the credit-to-GDP gap became negative in late 2009. June 2019 data show that the share of total loans in GDP equalled 75.3%,² while the estimated credit-to-GDP gap

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 Serbian Statistical Office revised the data on GDP for 2015 and 2016 and first published estimates (as the sum of four quarters) for 2017. In the next stage, the revision of the series back to 2005 was completed

was -6.7 percentage points. Though rising, the estimated credit-to-GDP gap 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. Also, the estimated credit-to-GDP gap is below the benchmark value of 2 percentage points,³ which indicates that the guide for setting the CCyB rate equals 0%.

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



Source: NBS
*Based on SSI

Nevertheless, the closing of the gap in some segments of household lending indicates risk in this part of lending and calls for targeted measures to curb the risk without undesirable repercussions on the overall lending activity. Due to the above, and in order to provide a timely response to the increasingly recurrent 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 National Bank adopted a set of regulations⁴ 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 before the application of the new set of regulations. In addition, the National Bank prescribed a 60% debt-to-income ratio – if this ratio is exceeded due to the approval of any loan to a natural person after the

by the end of 2018, and the data before 2005 (starting from 1995) are yet to be revised, i.e. the revision of the whole series will be completed in 2019 – as in the EU Member States.

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.

⁴ See: <https://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=13701&konverzija=no>

entry into force of the new provisions, the bank will be required to separately disclose the receivables from that borrower when reporting to the National Bank of Serbia on the quality of its assets. DTI is defined as a ratio of the debtor's total monthly credit liabilities and regular net monthly income. Also, it was established that if a bank, starting from 1 January 2019, approves a consumer, cash or other loan (other than a housing loan or a current account overdraft) due to which the level of credit debt (debt-to-income ratio) exceeds 60%, or the level of credit debt of the borrower in question exceeded 60% prior to loan approval, the bank will be required to reduce its capital by the total outstanding principal amount of exposure to that borrower until the loan is fully repaid. It was prescribed that if a bank, in the course of 2019, approves a consumer loan (except for consumer loans for the purchase of motor vehicles), cash or other loan (other than a housing loan or a current account overdraft), with the repayment term of eight or more years, it will be required to reduce its capital by the total outstanding principal amount of exposure to that borrower until the loan is fully repaid. In 2020 banks will be required to reduce their capital in the same manner 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. It was established that if a bank, starting from 1 January 2019, approves a consumer loan for the purchase of a motor vehicle with the agreed repayment term of eight years or longer, it will be required to reduce its capital by the total outstanding principal amount of exposure to that borrower until the loan is fully repaid.

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

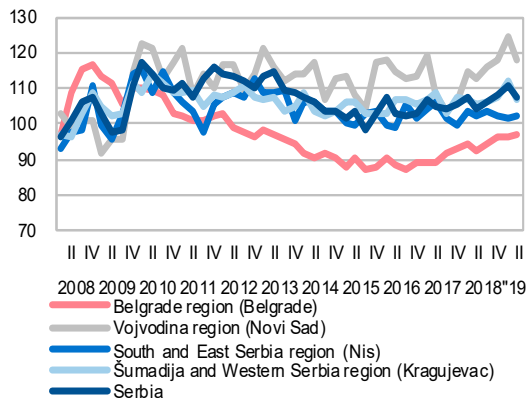
Real estate market indicators for the Republic of Serbia show that this segment of the financial market is recovering.

Serbia's average real estate price, as measured by DOMex, increased at end-Q2 2019 by 2.6% y-o-y, while falling by 3.5% q-o-q.

The number of real estate transactions, financed from housing loans insured with the National Mortgage Insurance Corporation, increased by 4.8% q-o-q. Judging by the results of the bank lending survey for Q1 2019,⁵ household demand for loans increased somewhat - it concerned mainly FX-indexed housing and consumer loans.

Chart 2 Real estate index DOMex

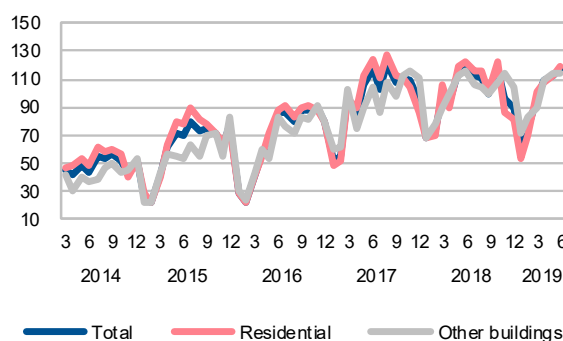
(index, average 2002 - 2010 = 100)



Source: National Mortgage Insurance Corporation.

Chart 3. Indices of the number of newly issued building permits

(index, 2018 = 100)



Source: Statistical Office of the Republic of Serbia.

The number of issued construction permits is another factor of anticipated further growth of supply in the real estate market. Q2 2019 saw a rise of 2.4% relative to Q2 2018. The average LTV ratio of new housing loans is still significantly below the regulatory maximum of 80%,⁶ amounting to 70.98% in Q2 2019.⁷

Indicators of external imbalance

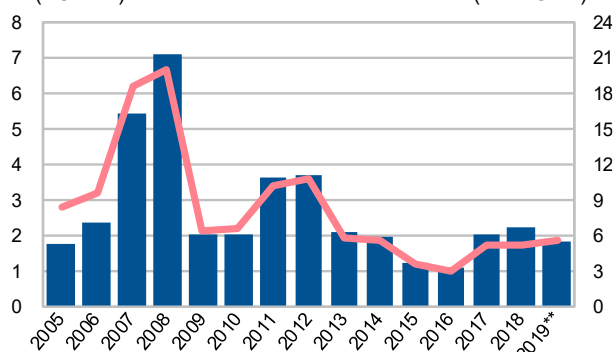
Improvement in domestic macroeconomic conditions reduces vulnerability to external risks. The current account deficit is estimated to stand at around the last year's level, at 5.5% of GDP. The net FDI inflow in H1 equalled EUR 1.8 bn (27.7% higher than in the same period last year), thus fully covering the current account deficit.

⁵ The latest available survey.

⁶ 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 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.

⁷ 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)

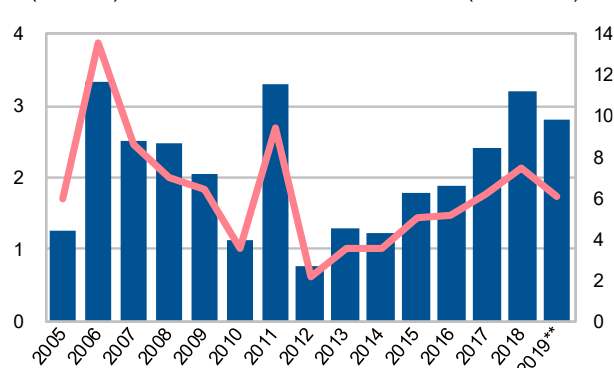


*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM6.

** NBS estimate, August 2019

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, August 2019

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

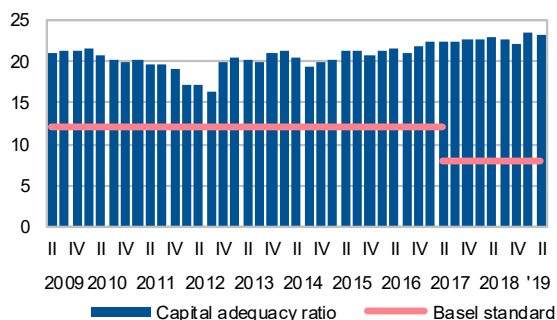
Main banking sector indicators

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

At end-Q2 2019, the capital adequacy ratio equalled 23.2%, well above the regulatory minimum (which as of 30 June 2017 equals 8%).

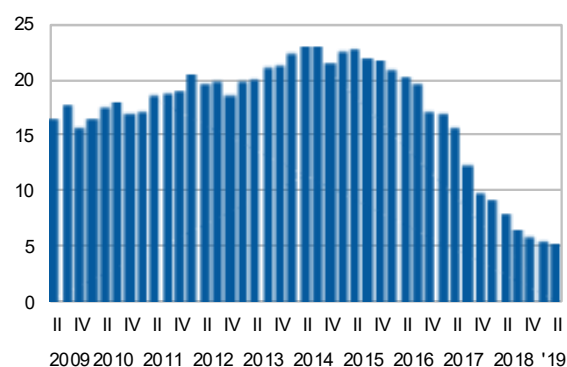
The LtD ratio (ratio of loans to deposits) stayed below 1 at end-Q2 2019, indicating that banks rely more on domestic, stable sources of funding, such as deposits.

Chart 6. Capital adequacy ratio
(%)



Source: National Bank of Serbia.

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



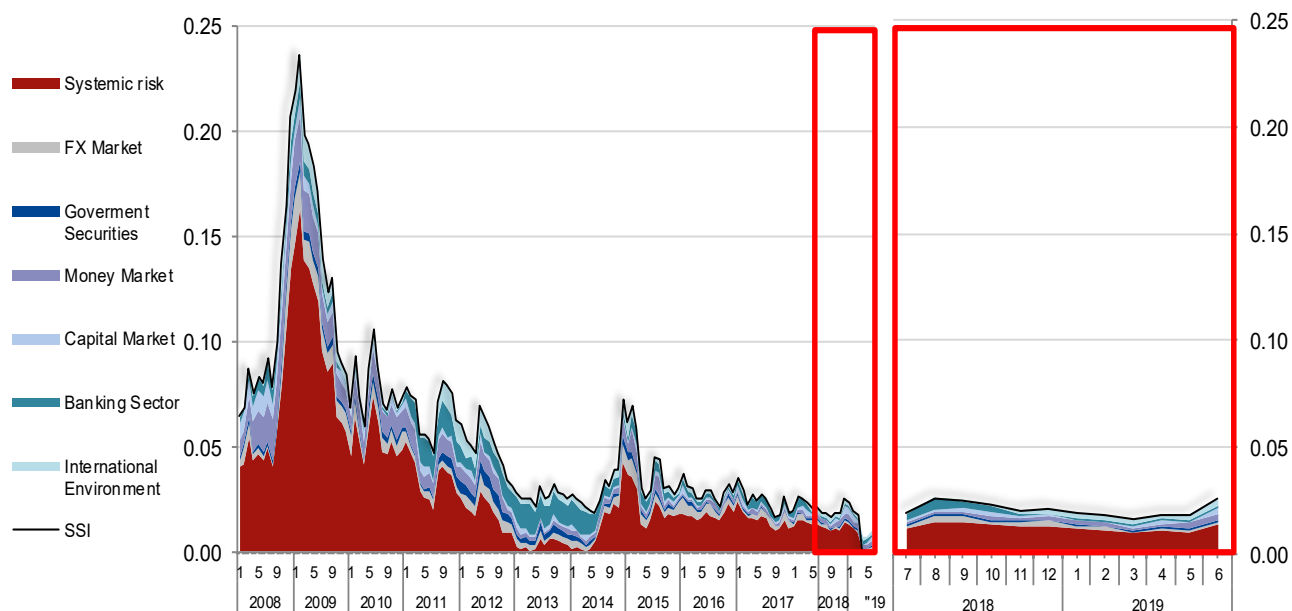
Source: National Bank of Serbia.

The 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 NBS's other regulatory activities. The NPL share equalled 5.21% at end-Q2 2019, down by 2.6 pp relative to Q2 2018, or by 17.0 pp relative to August 2015, when the Strategy was adopted. In December 2018, the Government adopted the NPL Resolution Programme for the Period 2018–2020 aiming to prevent the occurrence of new NPLs and enable the sustainability of the results achieved in this field.

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. From June 2018 to June 2019, the SSI suggested 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.

Although a high degree of euroisation is one of the key risks to financial stability, in Q2 2019 trends in the FX market did not affect significantly the level of the SSI. Q2 2019 saw a low level of systemic stress, with a slight increase compared to March 2019, caused by volatility in the capital market.

Furthermore, domestic macroeconomic indicators point to a low level of financial stress originating from public finance. At end-June 2019, Serbia's risk premium equalled 89 bp and was among the lowest in the region (Croatia 74 bp, Hungary 90 bp, Romania 165 bp) and significantly below EMBI Global (366 bp). The country risk premium continued down in July, when a new historical minimum of 59 bp was recorded (24 July). In the period observed, EMBI Serbia was lower than EMBI Composite, which indicates a lesser risk for Serbia compared to the composite risk of emerging economies, which are included in the calculation of EMBI Composite.

Favourable trends in the money market continued in Q2 2019, which is why the domestic money market cannot be regarded as a source of systemic stress in the Serbian financial system.

The continuous improvement of the NBS regulatory measures increases 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.

In May 2019, Fitch Ratings affirmed a stable credit rating outlook and in June 2019 Standard & Poor's affirmed a positive outlook.

Monetary policy results reflected in low and stable inflation, a highly capitalised and stable banking system along with consistent fiscal consolidation measures and structural reforms positively affect macroeconomic stability and strengthen the resilience of the overall financial system to systemic risks.