10 December 2020

EXPLANATION OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE FOR THE REPUBLIC OF SERBIA

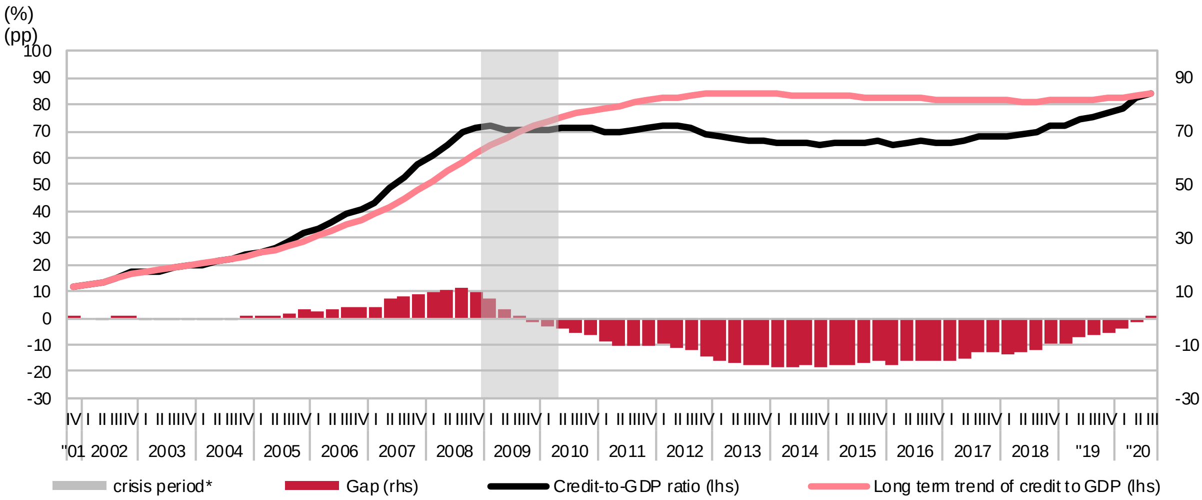
Pursuant to Article 14, paragraph 1, item 11) of the Law on the National Bank of Serbia (RS Official Gazette Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012, 106/2012, 14/2015 and 40/2015 – CC decision and 44/2018) and Section 436 of the Decision on Capital Adequacy of Banks (RS Official Gazette, Nos 103/2016, 103/2018, 88/2019, 67/2020, 98/2020 and 137/2020, hereinafter: Decision on Capital Adequacy), the NBS Executive Board, at its meeting of 10 December 2020, decided to keep the countercyclical capital buffer rate for the Republic of Serbia at 0% bearing in mind the persisting global uncertainty caused by the spread of the coronavirus.

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. After a period of credit expansion from 2000 to 2008, in late 2009 credit-to-GDP gap entered the negative territory. The data from September 2020 show that the share of real credit activity in real GDP slightly stepped into the positive territory (gap value of 0.01 pp), while the total credit-to-GDP ratio equalled 84.1%. The credit activity has been on the rise since 2014 and in Q3 2020 it resulted in a positive gap of the share of total credits in GDP. The change in the gap relative to end-2014 equals 18.2 pp, or 6.5 pp y-o-y. Bearing in mind the persisting global uncertainty caused by the spread of COVID-19, setting the CCyB rate above 0% in this moment could affect the future rise in lending.

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 at unreasonably long maturities, adopted in December 2018, are yielding results, thus reducing the possibility of the build-up of new NPLs. Still, 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 for additional two years regardless of the degree of credit indebtedness.

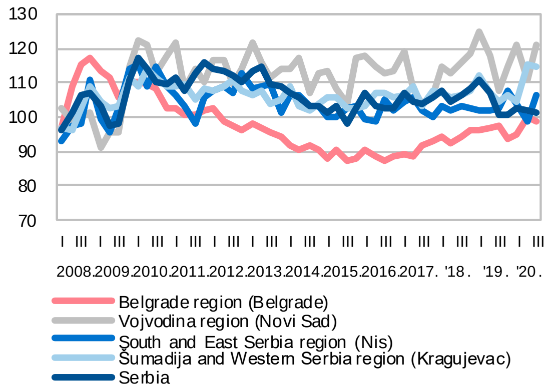
To set the CCyB rate for the Republic of Serbia, in addition to the credit-to-GDP gap, other optional indicators were also taken into account in accordance with Section 436, paragraph 4, of the Decision on Capital Adequacy. Optional indicators for monitoring lending activity were used, which illustrate the characteristics of the domestic financial system, and relate to the real estate market, external imbalance and banking sector developments.

Real estate market

According to the October Bank Lending Survey, the rising risk aversion is still present due to the pandemic, therefore banks tightened their corporate and household credit standards in Q3 2020, though much less than in the previous quarter. Generally speaking, credit conditions have tightened, while the measures adopted by the Serbian Government and the NBS helped make dinar financing conditions for SMEs more favourable, and extended the deadlines for the repayment of household loans. Increased loan demand during Q3 2020 was mostly driven by the need for liquid assets and refinancing, as well as household real estate purchase.

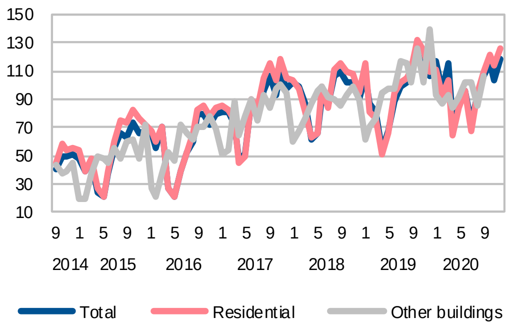
Q3 2020 saw a decline in the total number of issued permits for new construction by 5% y-o-y. The average LTV ratio of new housing loans is still significantly below the regulatory maximum of 80%,[1] amounting to 73.22% in Q3 2020.[2]

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.

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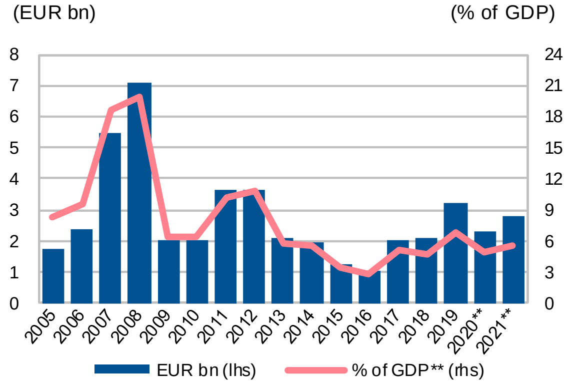
[1] In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, Nos 34/2011 and 114/2017), banks may approve mortgage loans to natural persons provided that the loan amount does not exceed 80% of the value of the mortgaged property. By way of exception, banks may approve mortgage housing loans to natural persons providing that the loan amount does not exceed 90% of the value of the mortgaged property as determined by a certified valuer and reduced by the amount of other receivables secured by first-rank mortgage over the same property, if the loan is approved as a government-support measure for certain groups of natural persons. The Decision amending the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, No 84/2020) allowed for a lower participation required for the approval of housing loans to persons purchasing their first residential property. In accordance with this regulation, for the purchase of the first residential property, banks may approve mortgage housing loans to natural persons providing that the loan amount does not exceed 90% of the value of the mortgaged property.

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

Indicators of external imbalance

Despite the pandemic and the economic slowdown in Serbia's key foreign trade partners, vigorous FDI inflow continued and it still fully covers the current account deficit. According to preliminary data, net FDI inflow in Q3 came at EUR 244.3 mn. Thus, the net FDI inflow in the nine months of 2020 exceeded EUR 1.7 bn, ensuring the full coverage of the current account deficit.

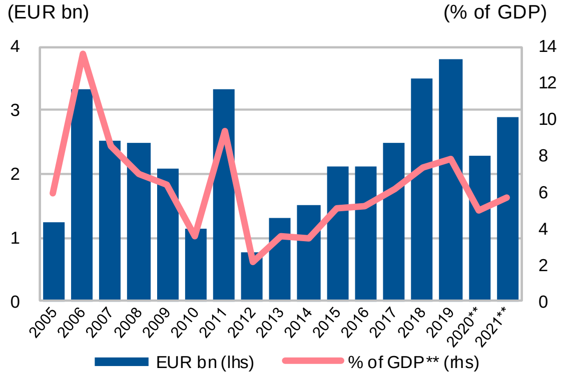
Chart 4. **Current account deficit***



*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, November 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, November 2020

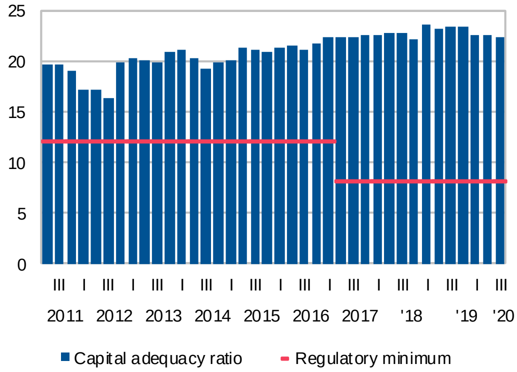
Source: Statistical Office of the Republic of Serbia and NBS.

Main banking sector indicators

Even with the pandemic spreading, the banking sector remains adequately capitalised and highly liquid, and is likely to remain so in the coming period.

Chart 6. **Capital adequacy ratio**

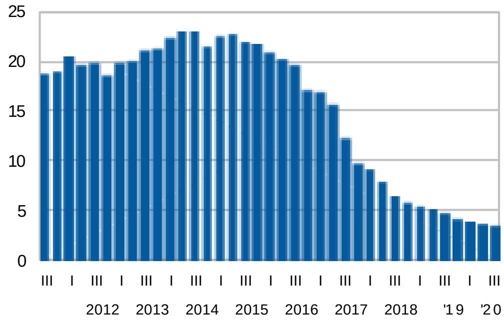
(y %)



Source: NBS.

Chart 7. **Non-performing loans**

(share in total gross loans, %)



Source: National Bank of Serbia.

At end-Q3 2020, CAR stood at 22.4%, significantly above the regulatory minimum.[3]

At end-Q3 2020, the loan-to-deposit (LTD) ratio measured 0.82. This indicator at levels below 1 suggests that banks largely rely on domestic, stable sources of funding, such as deposits.

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 3.4% at end-Q3 2020, down by 1.2 pp relative to Q3 2019, or by 18.8 pp relative to August 2015, when the Strategy was adopted.

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 as a consequence of the first wave of COVID-19, during Q3 2020 we saw a reduction in the level of systemic stress.

[3] 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%).

The SSI was under the strongest impact of developments in the international market and, to a lesser extent, developments in the government securities market. The value of SSI indicates a period of low systemic stress and is significantly below the threshold for the release of the countercyclical capital buffer.

In H1 2020, the COVID-19 pandemic triggered rising uncertainty at the global level. Later, amid expectations about the roll-out of the vaccine and loosening of containment measures, economies embarked on a mild recovery path.

The EMBI Composite for debt in euros equalled 201 bp at end-Q3 2020. Since the start of May, when it reached its peak value in 2020, the EMBI risk premium on Serbia's euro debt returned to downward path. At end-Q3 2020 Serbia's EURO EMBIG equalled 225 bp.

On 25 September 2020, Fitch Ratings affirmed Serbia's long-term foreign- and local-currency issuer default rating at BB+ (a step away from investment grade), with stable outlook. Such decision was made bearing in mind the increased resilience of the Serbian economy as a result of responsible economic policy pursuit in the past years and an adequate response to the COVID-19 crisis by economic policy-makers in Serbia.

The banking sector is adequately capitalised and highly liquid, and expectations are that it will remain so going forward, despite the pandemic. This is also confirmed by the results of macroprudential stress-testing, conducted based on data from June 2020, when even the worst-case scenario had the CAR significantly above the prescribed regulatory minimums. During July, further decisions adopted by the NBS enabled the continuation of the moratorium on liabilities maturing from 1 August 2020 until 30 September 2020, as well as on unsettled liabilities that matured in July 2020. Also, in August 2020, in an extraordinary meeting, the NBS Executive Board adopted the Decision on Temporary Measures for Banks to Facilitate Access to Financing for Natural Persons,[4] which created conditions facilitating access to financial assets for citizens. The continuous improvement and timely adoption of NBS regulatory measures reinforces the resilience of the financial system to potential shocks aiming to maintain financial stability.

[4] RS Official Gazette, No 108/2020.