9 September 2021

EXPLANATION FOR 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, 137/2020 and 59/2021, hereinafter: Decision on Capital Adequacy), the NBS Executive Board, at its meeting of 9 September 2021,decided to keep the countercyclical capital buffer rate for the Republic of Serbia at 0% having in mind that the estimated real credit-to-GDP ratio is mildly below its long-term trendand that global uncertainty caused by the spread of the coronavirus persists.

The countercyclical capital buffer (hereinafter: CCyB) is an 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.

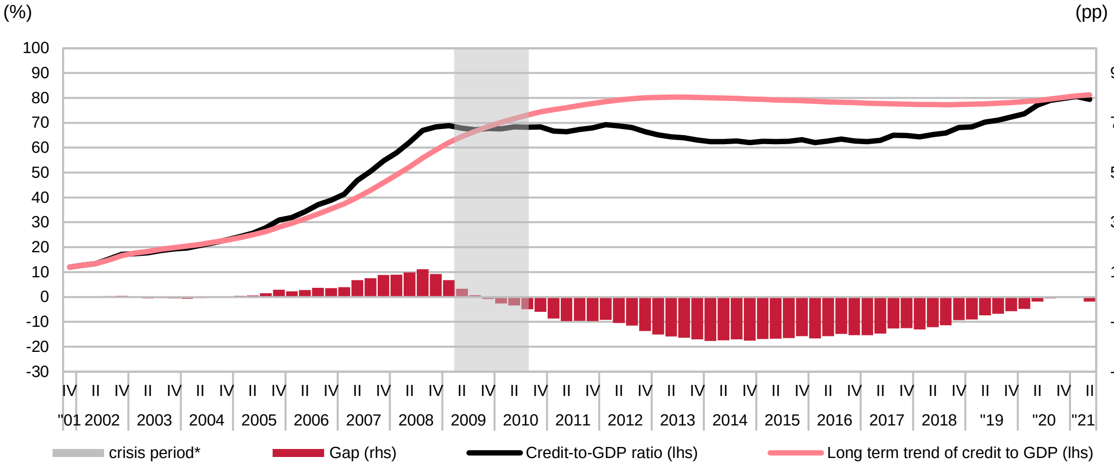
The National Bank of Serbia (NBS) sets the CCyB rate for the Republic of Serbia on a quarterly basis, taking into account the reference guide, applicable guidelines and recommendations of the European Systemic Risk Board and other variables it considers relevant for monitoring the cyclical dimension of systemic risk. In accordance with Section 436, paragraphs 2 and 3 of the Decision on Capital Adequacy, the reference 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[1], 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

[1]The Statistical Office of the Republic of Serbia has revised the GDP data series starting from 2005 and uses 2015 as the benchmark year for the purposes of calculating the real GDP deflator.

the negative territory. Credit activity has been on the rise since 2014 and, as a result, the share of total loans in GDP came closer to its long-term trend. According to June 2021 data, the share of real credit activity in real GDP is below its long-term trend (gap of -1.9pp), while the total credit-to-GDP ratio is 79.4%.The change in the gap relative to end-2014 is 15.6 pp, while compared to the same period last year, it is negligible (down by 0.04 pp). Having in mind that the gap is below its long-term trend, as well as the persisting global uncertainty caused by the spread of the coronavirus, setting the CCyB rate above 0% at this point in time could affect the potential future growth in lending.

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



Source: NBS
*Based on SSI

In the prior period the NBS adopted a number of measures in response to the pandemic-induced crisis. In December 2020, the NBS adopted, inter alia, a decision on additional facilities, obligating banks and financial lessors to approve debt repayment facilities to borrowers who are unable or likely to be unable to settle their obligations due to pandemic-related circumstances, at such borrowers' request.The NBS's well-timed and adequate measures supplied additional dinar and FX liquidity to the domestic financial sector, ensuring continued smooth lending to domestic businesses and citizens.

The results of the NBS bank lending survey carried out in July show that in Q2 banks continued to ease credit standards for household loans and dinar corporate loans, while slightly tightening the standards for FX-indexed corporate loans. Banks have similar expectations for Q3. Favourable outlook regarding economic activity and the real estate market, labour market rebound and higher risk appetite are all recognised as factors working toward an easing of standards.

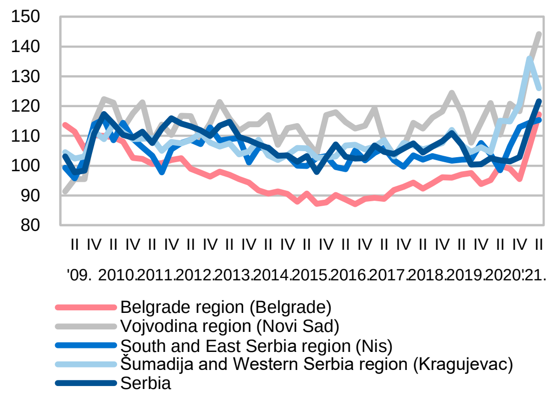
To set the CCyB rate for the Republic of Serbia, in addition to the credit-to-GDP gap, other optional indicators are also taken into account in accordance with Section 436, paragraph 4 of the Decision on Capital Adequacy. The optional indicators for monitoring lending activity illustrate the characteristics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

Real estate market

According to the National Mortgage Insurance Corporation data, the average estimated value of residential real estate in the Republic of Serbia measured EUR 1,024 per m^2 in Q2 2021. Q2 2021 saw an increase in the total number of issued permits for new construction by 40.5% y-o-y. The average LTV ratio of newly approved housing loans is below the regulatory maximum of 80%,[2] amounting to 75.66% in Q2 2021.[3]

Chart 2 **Real estate index DOMex**

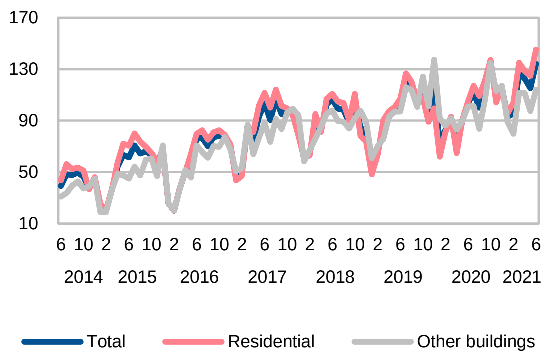
(index, average 2002 - 2010 = 100)



Source: National Mortgage Insurance Corporation.

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

(index, 2020 = 100)



Source: Statistical Office of the Republic of Serbia.

According to the July bank lending survey, corporate loan demand was guided by small and medium-sized enterprises and mainly directed at long-term loans. Another factor behind demand since the start of the year is the need to finance capital investment. Households were mostly interested in dinar cash loans and FX-indexed housing loans.

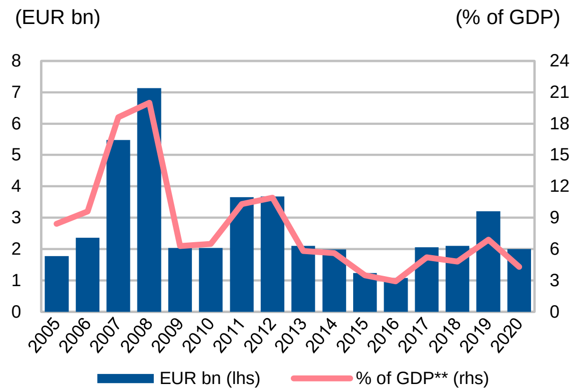
[2] In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, Nos 34/2011, 114/2017 and 84/2020), a mortgage loan may be approved to a natural person if the loan amount does not exceed 80% of the value of the property mortgaged. By way of exception, a bank may approve a mortgage loan to a natural person provided that the amount of such loan does not exceed 90% of the value of the property mortgaged, if the loan is approved as a government-support measure for certain groups of natural persons or if the loan is approved to first-time home buyers.

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

Indicators of external imbalance

Net capital inflow in respect of FDI measured EUR 730.5 mn in Q2 and around EUR 1.6 bn in H1. FDI inflows alone exceeded EUR 1.7 bn in H1, which is roughly 20% higher than in the same period last year. Almost two-thirds of investment were in the form of equity capital. As goods and services export recovered faster than import since the start of the year, the external position improved further and the current account deficit contracted to around 4% of GDP this year.

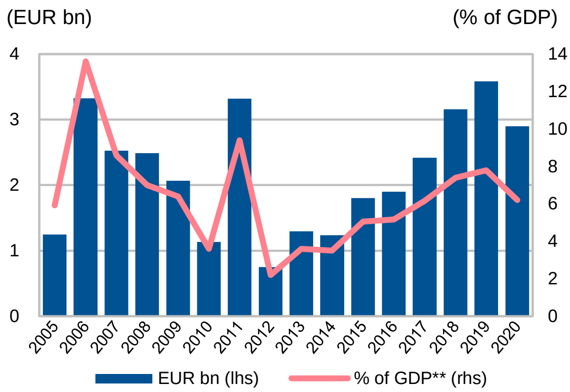
Chart 4. **Current account deficit***



*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.

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

Chart 5. **Net foreign direct investments***



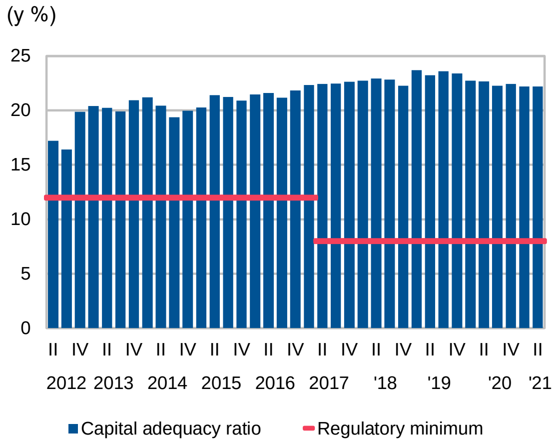
*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM6.

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

Main banking sector indicators

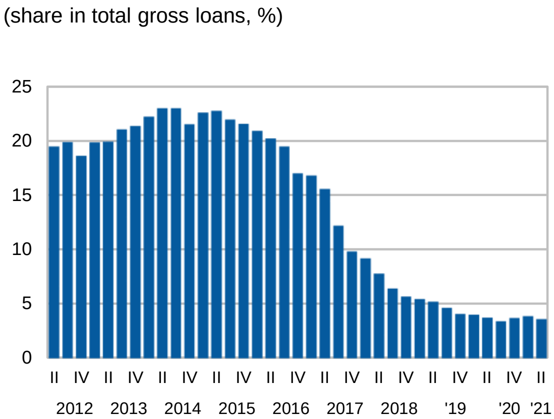
The banking sector remained adequately capitalised and highly liquid, and is likely to remain so in the coming period .

Chart 6. **Capital adequacy ratio**



Source: National Bank of Serbia.

Chart 7. **Non-performing loans**



Source: National Bank of Serbia.

At end-Q2 2021, banking sector CAR stood at 22.2%, significantly above the regulatory minimum.[4]

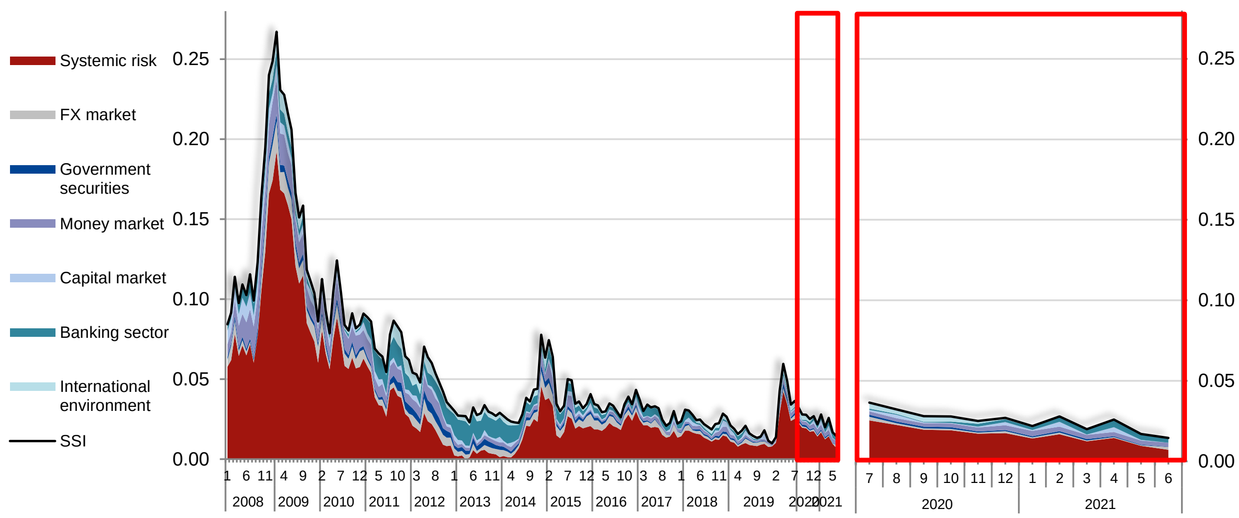
At end-Q2 2021, the loan-to-deposit ratio (LtD) measured 0.80. This indicator at levels below 1 suggests that banks largely rely on domestic, stable sources of funding, such as deposits.

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 other regulatory activities of the NBS. The NPL ratio equalled 3.6% at end-Q2 2021, down by 0.1 pp relative to Q2 2020, or by 18.6 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: FX market, government securities market, money market, capital market, banking sector and the international environment.

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



Source: NBS

[4]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%).

Following its increase, particularly in April and May 2020 due to the pandemic, SSI continued down in Q2 2021 as well and recorded a stable systemic component.

At end-Q2 2021, SSI was lower than at end-Q1 2021, mostly on account of a reduction in the systemic risk component, as well as movements in the securities market, money market, capital market and the international environment.

In Q2 2021, Serbia's average risk premium for euro debt (EURO EMBIG) equalled 154 bp (148 bp in Q1 2021). At end-Q2 2021, EURO EMBIG for Serbia equalled 144 bp and was lower than in most countries in the region (Montenegro 378 bp, Albania 226 bp, Romania 193 bp, North Macedonia 179 bp, Hungary 88 bp, Croatia 86 bp, Bulgaria 74 bp).

The banking sector is adequately capitalised and highly liquid, and is likely to remain so in the coming period. This is also confirmed by the results of macroprudential stress tests for March 2021, when CAR values were significantly above the regulatory minimum in both baseline and worst-case scenarios.

After Moody's upgraded Serbia's credit rating from Ba3 to Ba2 in March 2021, in June 2021 Standard&Poor's affirmed Serbia's credit rating at BB+, with a stable outlook for further improvement to investment-grade level. In its decision, the agency stated that its ratings on Serbia are supported by a credible monetary policy framework of the NBS and moderate public debt. These enabled the adoption of sizeable relief packages for corporates and households which supported the economy and prevented a deeper economic contraction. The agency also highlighted the substantial resilience achieved by the Serbian economy in prior years and the fact that Serbia faced the COVID-19 crisis with much reduced macroeconomic imbalances compared to a decade ago.