9 December 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 December 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 below its long-term trend and that global uncertainty caused by the spread of the coronavirus and the emergence of new strains persists.

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 (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).

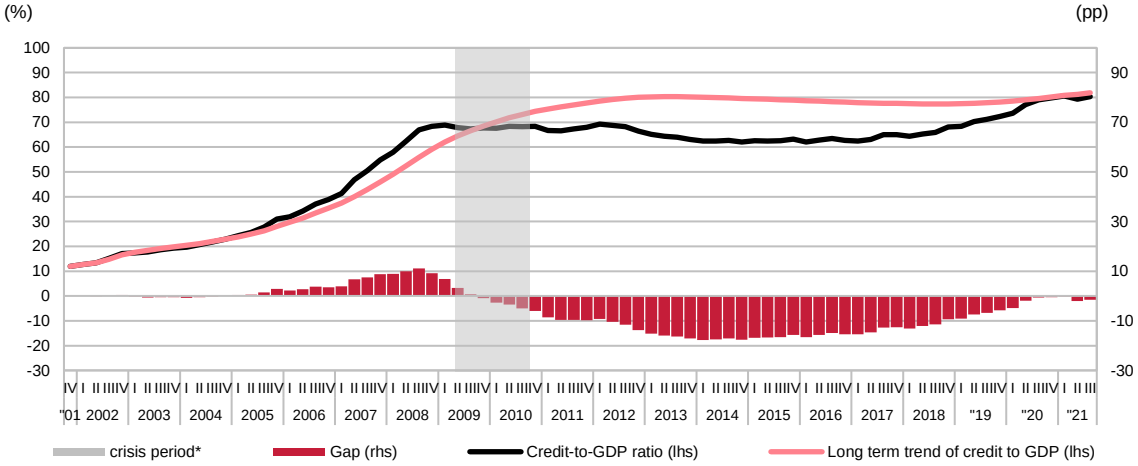
Chart 1 shows the share of credit to the non-government sector in GDP[1], the long-term trend and the estimated credit-to-GDP gap. After a period of credit expansion from 2000 to 2008, in late 2009 credit-to-GDP gap entered

[1]The Statistical Office of the Republic of Serbia uses 2015 as the benchmark year for the purposes of calculating the real GDP deflator.

the negative territory. According to the September 2021 data, the share of real credit activity in real GDP is below its long-term trend (gap of -1.5 pp). 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 (credit-to-GDP gap in Q3 2020 was -0.6 pp). Such trends persisted until Q3 2021. At the end of Q3 2021 the gap widened by 16.0 pp relative to end-2014, while narrowing by 1.0 pp y-o-y and increasing by 0.5 pp q-o-q. Having in mind that the estimated credit-to-GDP ratio is below its long-term trend, as well as the persisting global uncertainty caused by the emergence of new coronavirus strains, setting the CCyB rate above 0% at this point in time could affect the potential future growth in lending.

In the prior period the NBS adopted a number of measures in response to the pandemic-induced crisis. 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.

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



Source: NBS
*Based on SSI

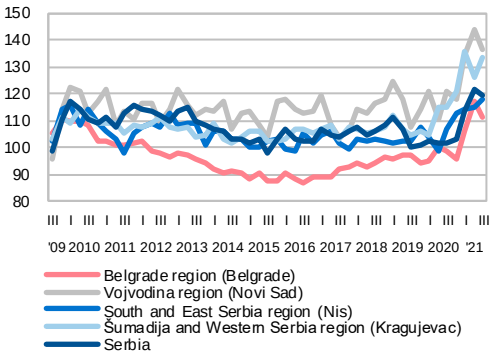
To set the CCyB rate for the Republic of Serbia, in addition to the credit-to-GDP gap, other optional indicators are also taken into account in accordance with Section 436, paragraph 4 of the Decision on Capital Adequacy. The optional indicators for monitoring lending activity illustrate the characteristics 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 1,003 per m^2 in Q3 2021. The total number of issued permits

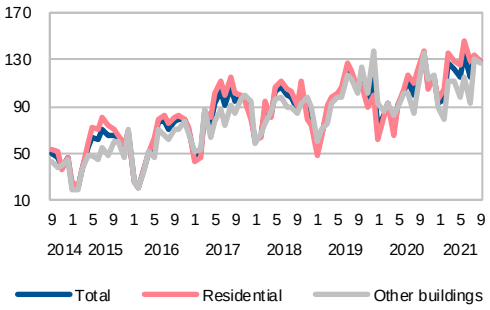
for new construction increased in Q3 2021 by 14.9% y-o-y. At the same time, the average LTV ratio for newly approved housing loans was below the regulatory maximum of 80%[2] and measured 74.64%.[3]

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 construction permits**
(index, 2020 = 100)



Source: Statistical Office of the Republic of Serbia.

According to the NBS's October bank lending survey, corporate loan demand is increasingly driven by the need to finance capital investment (in addition to liquidity needs), while household loan demand is powered predominantly by the purchase of real estate.

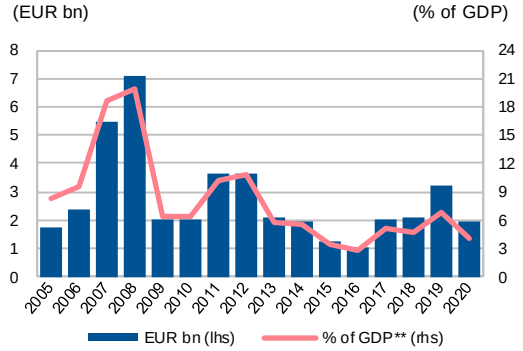
Indicators of external imbalance

According to preliminary data, FDI provided for a net capital inflow of EUR 1.1 bn in Q3 2021 (almost fourfold the amount from the same period last year), while in the first nine months of this year the amount exceeded EUR 2.7 bn. The current account deficit in the first nine months of 2021 amounted to EUR 1.3 bn, which is a decrease of around 23% y-o-y. The current account deficit share in GDP in 2021 will come at around 4%. In the medium run, the current account deficit will move in the range of 4–5% of GDP, with continued full coverage by net FDI inflows.

[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.

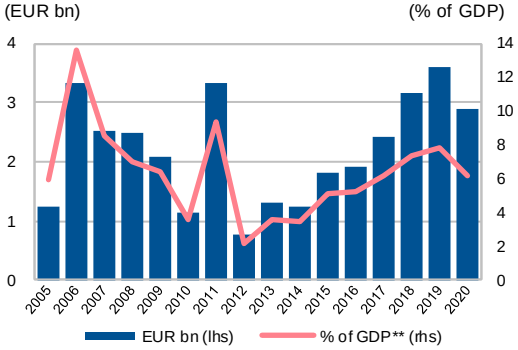
Chart 4 **Current account deficit***



*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***



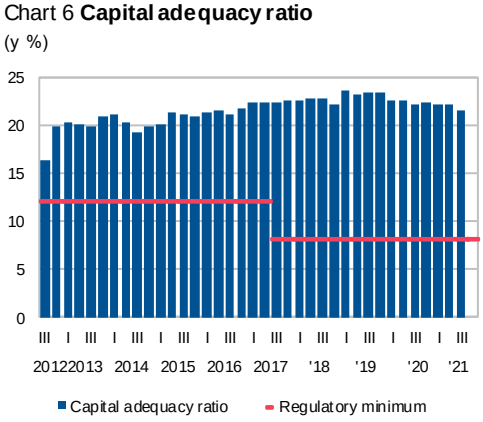
*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM6.

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

Main banking sector indicators

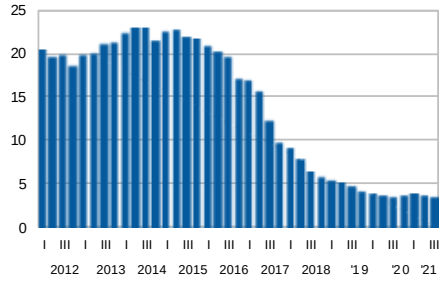
The banking sector has remained adequately capitalised and highly liquid, and is likely to remain so in the coming period. At end-Q3 2021, capital adequacy ratio of the banking sector measured 21.7%, which is well above the regulatory minimum.[4]

Chart 6 **Capital adequacy ratio**



Source: NBS.

Chart 7 **Non-performing loans**



Source: National Bank of Serbia.

The value of Loan-to-Deposit (LtD) ratio is below 1 and indicates that banks largely rely on domestic, stable sources of funding, such as deposits.

[4] As of 30 June 2017 the minimum capital adequacy ratio is 8% (minimum Tier 1 capital – 6%, minimum Common Equity Tier 1 – 4.5%).

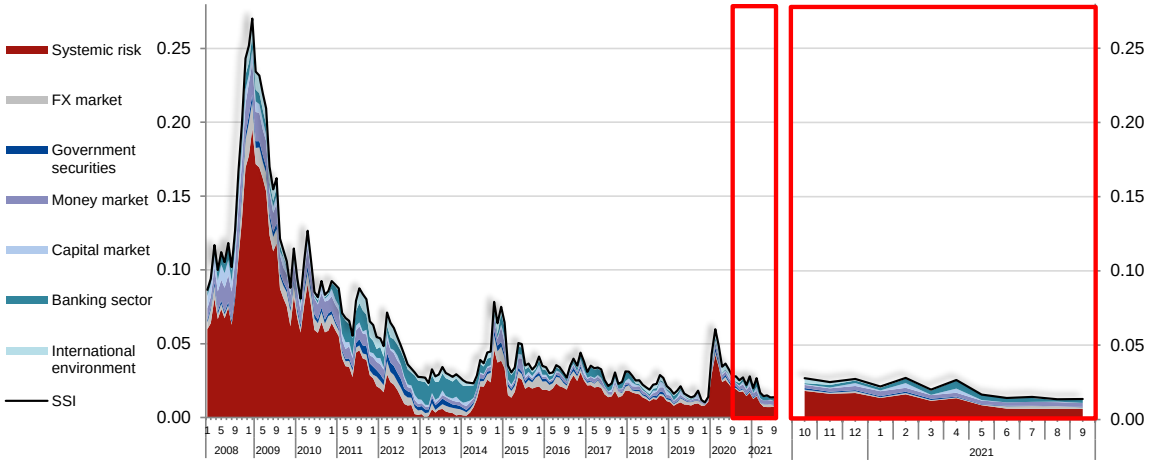
The share of NPLs in total banking sector loans shrunk considerably, showing an evident declining trend, as a result of the implementation of the NPL Resolution Strategy, which was adopted in 2015, and other regulatory activities of the National Bank of Serbia. The share of NPLs amounted to 3.55% at end-Q3 2021, which is by around 0.1 pp less than in Q2 2021, or by 18.7 pp less than in 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 a rise, which was the most pronounced in April and May 2020, due to the spread of the pandemic, SSI continued to decline and record a stable systemic component. In Q3 2021, SSI fell negligibly relative to the quarter before.

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



Source: NBS.

In Q3 2021, the average EMBI risk premium for Serbia's dollar debt equalled 133 bp. At end-Q3 2021, EMBI for Serbia's dollar debt stood at 140 bp (128 bp at end-Q2 2021), below the composite risk measure EMBI Global Composite (324 bp).

Continuous improvements in the regulatory area by the National Bank of Serbia and in the domestic macroeconomic environment in the prior period helped Serbia's banking system to remain stable, adequately capitalised and highly liquid, giving rise to expectations that it will remain so in the period ahead. In September 2021 capital adequacy ratio measured 21.7%, while the average monthly liquidity ratio equalled 2.3. This is also confirmed by the results of macroprudential stress tests for June 2021, which show that in case of the worst case scenario capital adequacy ratio would post values that are significantly above the regulatory minimum.

After Serbia's credit rating was increased to Ba3 from Ba2 by Moody's in March 2021, in June 2021 Standard & Poor's kept Serbia's rating at BB+, with a stable outlook for its further improvement to investment grade. In early September 2021, Fitch Ratings maintained Serbia's rating at BB+, a step away from investment grade, with a stable outlook. In its press release Fitch Ratings assessed, *inter alia*, that Serbia's rating is supported by a credible macroeconomic framework, relatively low inflation and higher FX reserves.