

10 March 2022

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 10 March 2022, 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 new coronavirus strains and the mounting geopolitical tensions 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 its 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).

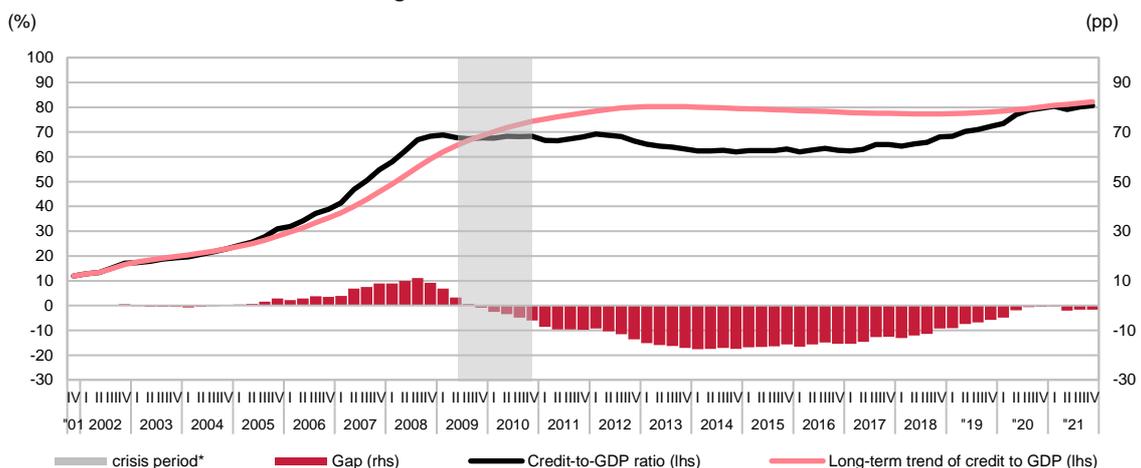
Chart 1 shows the share of credit to the non-government sector in GDP,¹ the long-term trend and the estimated credit-to-GDP gap. After a period of credit expansion from 2000 to 2008, in late 2009 credit-to-GDP gap entered

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. 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 the December 2021 data, the share of real credit activity in real GDP is below its long-term trend (gap of -1.6 pp). At the end of Q4 2021 the gap widened by 15.9 pp relative to end-2014, while narrowing by 1.1 pp y-o-y. 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 and mounting geopolitical tensions caused by the crisis in Ukraine, 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-term trend



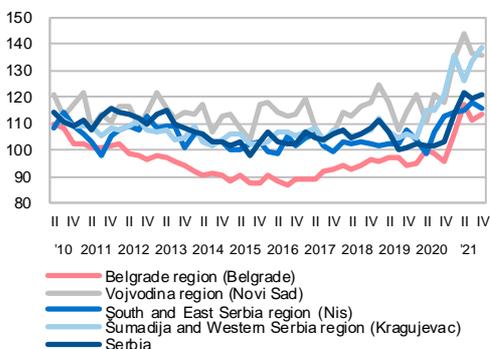
To set the CCyB rate for the Republic of Serbia, in addition to the credit-to-GDP gap, other optional indicators are also taken into account in accordance with Section 436, paragraph 4 of the Decision on Capital Adequacy. The optional indicators for monitoring lending activity illustrate the characteristics 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 1,019 per m² in Q4 2021. The total number of issued permits

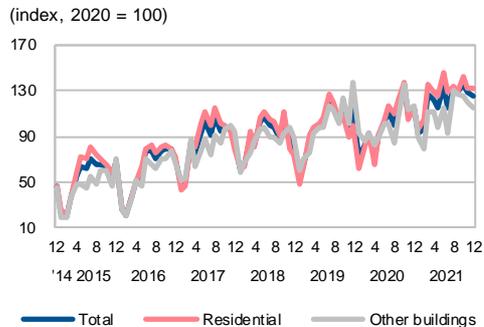
for new construction increased in Q4 2021 by 8.4% y-o-y. At the same time, the average LTV ratio for newly approved housing loans was below the regulatory maximum of 80%² and measured 74.9%.³

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: SORS.

Banks estimate that household dinar credit standards were eased in Q4 2021, for the third quarter in a row. According to the NBS January bank lending survey, in Q4 2021 banks slightly tightened their corporate credit standards – this concerned FX-indexed loans, as standards for dinar loans remained unchanged. Capital investment financing (in addition to liquidity needs) is becoming an increasingly important factor of elevated corporate demand for loans, while household loan demand is powered predominantly by the purchase of real estate.

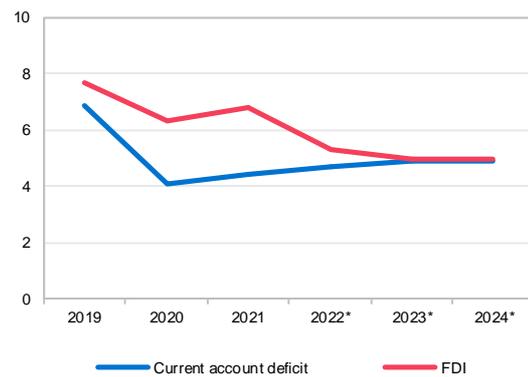
Indicators of external imbalance

According to preliminary data, FDI inflows to Serbia exceeded the record 2019 levels, amounting to EUR 3.6 bn in 2021. Q4 2021 saw net capital inflows worth EUR 862.9 mn (almost fourfold the amount from the same period last year). The current account deficit in 2021 amounted to EUR 2.3 bn. The current account deficit share in GDP in 2021 came at around 4.4%, which is slightly above the last year's figure, reflecting increased energy imports in late year. In the medium run, the current account deficit will remain below 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 and FDI
(in % of GDP)

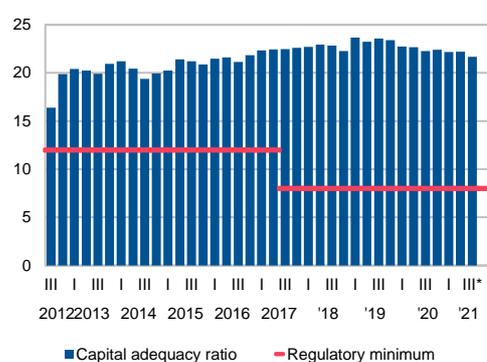


Source: NBS.
* NBS projection, February 2022.

Main banking sector indicators

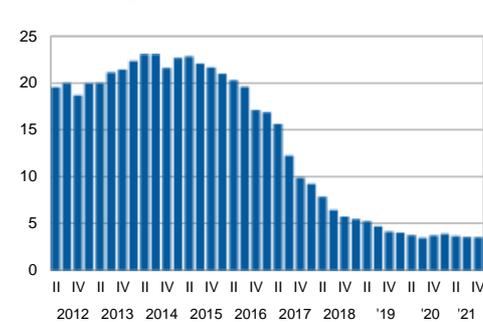
The banking sector has remained adequately capitalised and highly liquid, and is likely to remain so in the coming period. At end-Q3 2021,⁴ capital adequacy ratio of the banking sector measured 21.7%, which is well above the regulatory minimum.⁵

Chart 5 Capital adequacy ratio
(%)



* Latest data available.
Source: NBS.

Chart 6 Non-performing loans
(share in total gross loans, %)



Source: NBS.

The value of the Loan-to-Deposit (LtD) ratio was 0.79 at end-2021, which is much below 1 and indicates that banks largely rely on domestic, stable sources of funding, such as deposits.

The share of NPLs in total banking sector loans shrank considerably, showing an evident declining trend, as a result of the implementation of the

⁴ Latest available data.

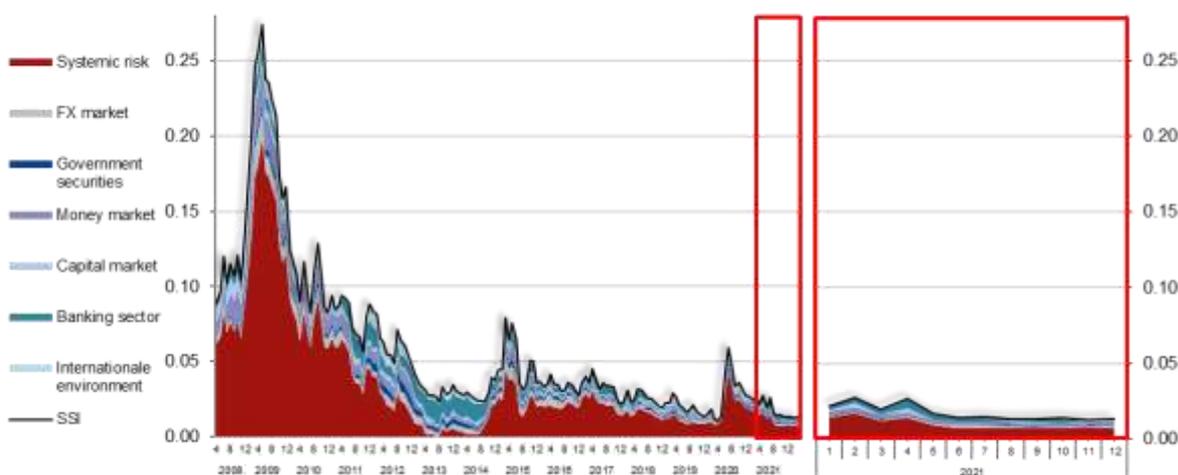
⁵ As of 30 June 2017 the minimum capital adequacy ratio is 8% (minimum Tier 1 capital – 6%, minimum Common Equity Tier 1 – 4.5%).

NPL Resolution Strategy, which was adopted in 2015, and other regulatory activities of the National Bank of Serbia. The share of NPLs amounted to 3.5% at end-Q4 2021, which is by around 0.2 pp less than in Q4 2020, or by 18.8 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.

Chart 7. Systemic stress indicator dynamics and contribution of the most important risk factors to the Systemic stress indicator



Source: National bank of Serbia.

After a rise, which was the most pronounced in April and May 2020, due to the spread of the pandemic, the SSI continued to decline and record a stable systemic component. In Q4 2021, the SSI fell negligibly relative to the quarter before.

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%,⁶ while the average monthly liquidity ratio equalled 2.1 in December 2021. This is also confirmed by the results of macroprudential stress tests for September 2021, which show that in case of the worst-case scenario, capital adequacy ratio would post values that are significantly above the regulatory minimum.

⁶ Latest available data.

After Serbia's credit rating was increased from Ba3 to Ba2 by Moody's in March 2021, in early December 2021 Standard & Poor's also raised Serbia's outlook from stable to positive. The decision was influenced by Serbia's robust economic growth and the demonstrated high level of the domestic economy's resilience to the pandemic-induced shock. In February 2022, Fitch Ratings affirmed Serbia's credit rating at BB+, a notch below investment grade, with a stable outlook. In its decision, Fitch also highlighted the stability of the banking sector and Serbia's increased resilience to external shocks, supported by the continuing full coverage of the current account deficit by FDIs and adequate FX reserves of the country, which went up despite the pandemic.