9 June 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 9 June 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 given the global uncertainty amid the build-up of geopolitical tensions and the outbreak of the Ukraine conflict, setting the rate above 0% could affect potentially lower growth in lending activity.

The countercyclical capital buffer (hereinafter: CCyB) is additional Common Equity Tier 1 capital that banks are obliged 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.

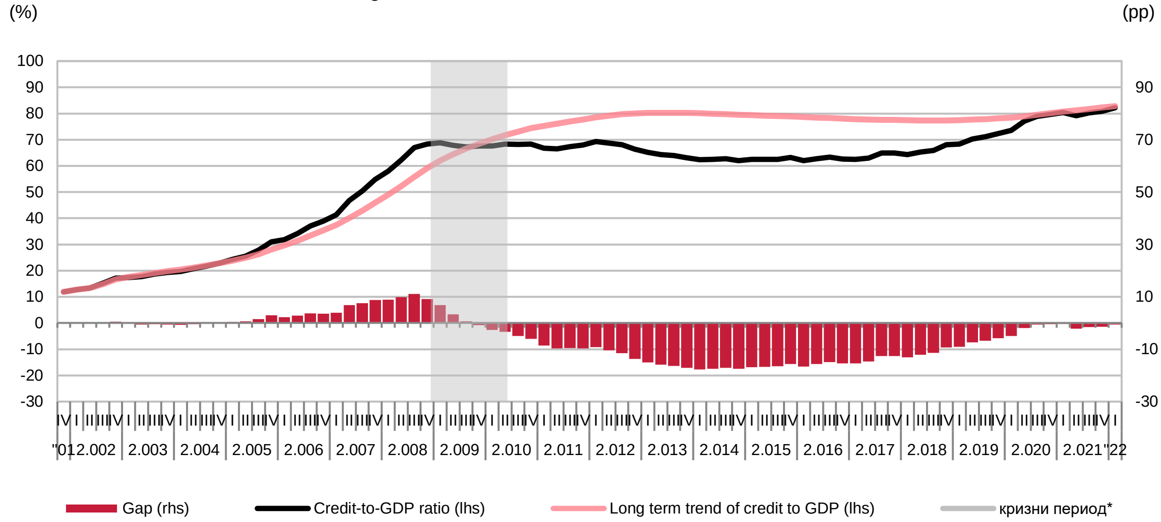
The National Bank of Serbia (NBS) sets the CCyB rate for the Republic of Serbia on a quarterly basis, taking into account the reference guide, applicable guidelines and recommendations of the European Systemic Risk Board and other variables it considers relevant for monitoring the cyclical dimension 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

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

credit expansion from 2000 to 2008, in late 2009 credit-to-GDP gap entered 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 March 2022 data, the share of real credit activity in real GDP is below its long-term trend (gap of -0.6 pp). At end-Q1 2022, the gap widened by 16.9 pp relative to end-2014 and by 0.8 pp q-o-q. Having in mind that the estimated real credit-to-GDP ratio is below its long-term trend and that given the global uncertainty amid the build-up of geopolitical tensions and the outbreak of the Ukraine conflict, setting the rate above 0% could affect potentially lower growth in lending activity.

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



Source: NBS
*Based on SSI

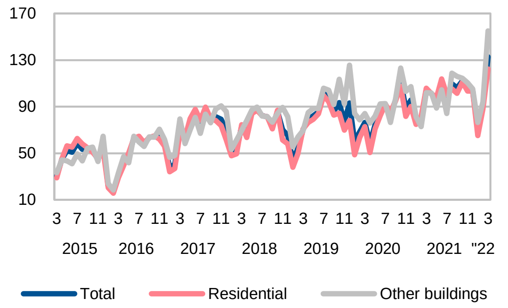
In the prior period the NBS adopted a number of measures in response to the pandemic-induced crisis. The NBS's well-timed and adequate measures supplied additional dinar and FX liquidity to the domestic financial sector, ensuring continued smooth lending to domestic businesses and citizens.

In addition to the credit-to-GDP gap, other optional indicators were also taken into account for setting the CCyB rate for the Republic of Serbia, in accordance with Section 436, paragraph 4 of the Decision on Capital Adequacy. The optional indicators for monitoring the 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

In Q1 2022, the number of issued permits for new construction increased by 12% y-o-y. In Q1 2022, the LTV ratio declined slightly q-o-q, to 65.3%[2] (65.6% in Q4 2021), which is significantly below the regulatory maximum of 80%[3].

Chart 2. **Indices of the number of newly issued building permits**
(index, 2020 = 100)



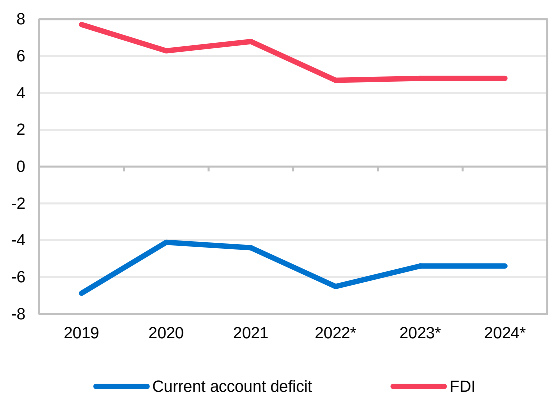
Source: Statistical Office of the Republic of Serbia.

According to the results of the bank lending survey, in Q1 2022 banks continued to moderately tighten corporate credit standards, prompted by higher costs of financing, uncertainty associated with the overall economic situation and the resulting lesser risk propensity. On the other hand, banks assessed that household credit standards were eased in Q1 2022, for the fourth quarter in a row, owing primarily to interbank competition, labour market recovery and factors related to the real estate market. At the same time, the loan demand of both sectors continued up. The financing of working capital and capital investment were the dominant factors behind rising corporate loan demand, while the household sector loan demand was driven mostly by the need for refinancing and real estate purchases.

Indicators of external imbalance

According to preliminary data, in Q1 2022 the net FDI inflow to Serbia amounted to EUR 551.1 mn. It was somewhat lower than in the same period last year, but remained project-diversified and channelled mainly to tradable sectors. Given a significant increase in energy imports, primarily due to soaring global energy prices, the current account deficit measured EUR 1.3 bn in Q1 2022.

Chart 3. **Current account balance and FDI**
(in % of GDP)



Source: NBS.
* NBS projection, May 2022.

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[2] According to NBS data.
[3] 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.

The share of the current account deficit in GDP is expected at around 6.5% in 2022 and will be largely covered by FDI net inflows. In the medium run, the current account deficit is likely to gradually narrow, to 5% of GDP, on the back of more favourable terms of trade among other factors.

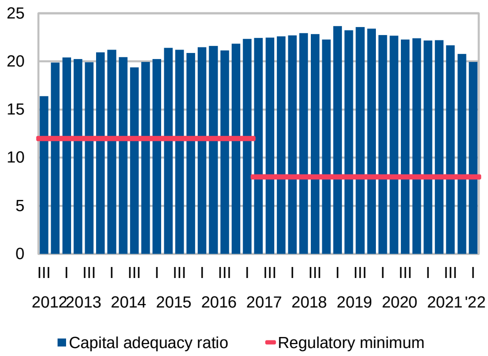
Main banking sector indicators

The banking sector has remained adequately capitalised and highly liquid, and is likely to remain so in the coming period. At end-Q1 2022, the capital adequacy ratio of the banking sector measured 20.0%, which is well above the regulatory minimum.[4]

The value of the Loan-to-Deposit (LtD) ratio was 0.83 at end-March 2022, which is below 1 and indicates that banks largely rely on domestic, stable sources of funding, such as deposits.

Chart 4. **Capital adequacy ratio**

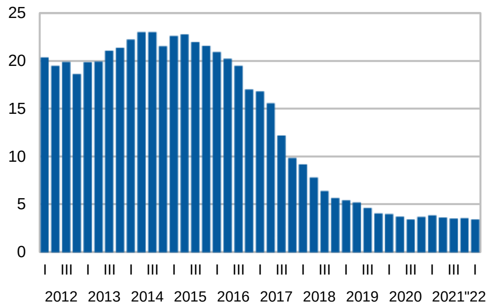
(y %)



Source: NBS.

Chart 5. **Non-performing loans**

(share in total gross loans, %)



Source: NBS.

The share of NPLs in total banking sector loans shrank, showing an evident declining trend, as a result of the implementation of the NPL Resolution Strategy and other regulatory activities of the National Bank of Serbia. The share of NPLs amounted to 3.4% at end-Q1 2022, which is by around 0.4 pp less than in Q1 2021.

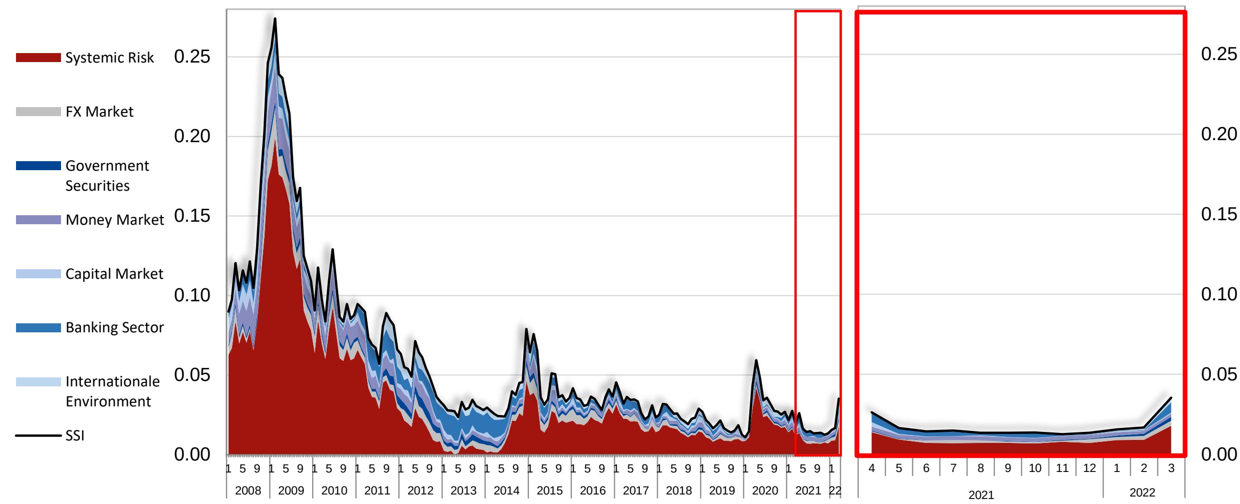
Assessment of systemic risk of the Serbian financial system

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.

[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%).

In Q1 2022, the SSI rose compared to the previous quarter. After the level of systemic stress increased during 2020 due to the spread of the pandemic, the SSI continued to contract and record a stable systemic component until end-February 2022. The SSI increased in March 2022, mainly due to risks from the international environment and trends in the banking sector and the government securities market.

Chart 6 **Systemic Stress Indicator dynamic and contribution of the most important risk factors to the Systemic Stress Indicator**



Source: NBS.

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 March 2022, the capital adequacy ratio measured 20.0%, while the average monthly liquidity ratio equalled 2.0. The results of macroprudential stress tests for December 2021 also confirm that in case of the worst-case scenario, the capital adequacy ratio would post values that are significantly above the regulatory minimum.

In February 2022, Fitch Ratings affirmed Serbia's credit rating at BB+, one step away from investment grade, with a stable outlook. It emphasised Serbia's credible macroeconomic policy framework, responsible fiscal policy, better quality governance and a higher level of Serbia's economic development compared to countries with similar credit ratings.