8 September 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, 59/2021 and 67/2022, hereinafter: Decision on Capital Adequacy), the NBS Executive Board, at its meeting of 8 September 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 marginally below its long-term trend and that given the global uncertainty amid the build-up of geopolitical tensions and the continued Ukraine conflict, setting the rate above 0% could potentially dampen growth in lending activity.

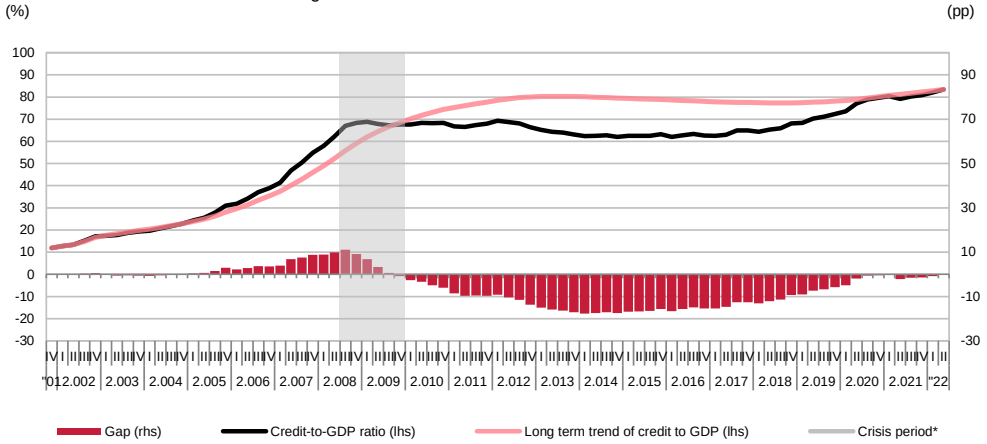
The countercyclical capital buffer (CCyB) is additional Common Equity Tier 1 capital that banks are obliged to maintain above the prescribed regulatory minimum in the amount equal to their risk-weighted assets multiplied by the specific countercyclical buffer rate. This instrument mitigates the cyclical 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, 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. Credit activity has been on the rise since 2014 and, as a result, the share of total loans in GDP came close to its long-term trend in late Q2 2022. According to the June 2022 data, the share of real credit in real GDP is marginally below its long-term trend (gap of -0.002 pp). At end-Q2

2022, the gap widened by 17.5 pp relative to end-2014, and by 2.1 pp y-o-y and 0.8 pp q-o-q. Having in mind that the estimated real credit-to-GDP ratio is marginally below its long-term trend, setting the rate above 0% could potentially dampen growth in lending activity. Also, keeping the rate at 0% helps ease the consequences of increased inflationary pressures and global monetary tightening on local financing conditions for businesses and households, against the backdrop of mounting geopolitical tensions and the continued conflict in Ukraine.

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




Source: NBS
*Based on SSI

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

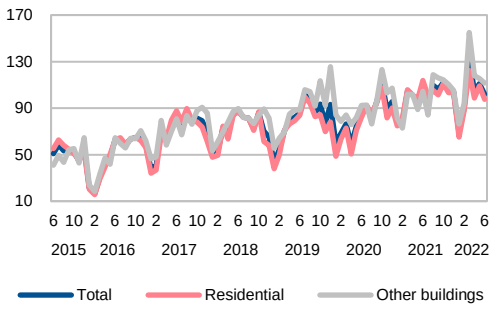
In Q2 2022, the number of issued permits for new construction increased by 3.6% y-o-y. In Q2 2022, the LtV ratio declined q-o-q, to 62.6%[1] (65.4% in Q1 2022), which is significantly below the regulatory maximum of 80%[2].

[1] According to NBS data.

[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.

According to the results of the bank lending survey, in accordance with expectations, in Q2 2022 banks continued to moderately tighten corporate credit standards. After one year of easing, household standards were also slightly tightened in Q2 2022. The increased costs of funding sources and diminished risk propensity are the key factors behind the tightening of standards, which is something banks expect to continue in Q3 2022. According to banks' estimate, both businesses and households increased loan demand in Q2 2022, led by the needs for liquidity and the restructuring of current liabilities, including real estate purchases.[3]

Chart 2. **Indices of the number of newly issued building permits**

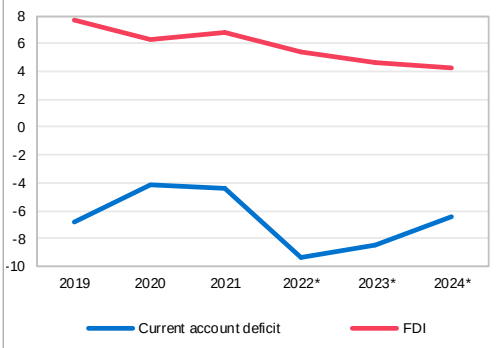



Source: Statistical Office of the Republic of Serbia.

## External imbalance indicators

Net FDI inflow to Serbia amounted to EUR 1,455 mn in H1 2022. Inflows from remittances also increased, and so did the surplus on trade in services, underpinned by the recovery of tourism and continued vibrant growth in the ICT sector exports. Energy imports, driven primarily by the rise in global energy prices, led to the widening of the current account deficit that reached EUR 2.7 bn in H1 2022. The current account deficit is expected to reach around 9.4% of GDP in 2022. In the medium run, the gradual narrowing of the current account deficit and the maintenance of external sustainability will be supported by the increased export capacities and the anticipated weakening of the negative effects of external demand and unfavourable terms of trade. External sustainability will be also reinforced by the continued relatively high inflow of FDI to Serbia.[4]

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




Source: NBS.
* NBS projection, August 2022.

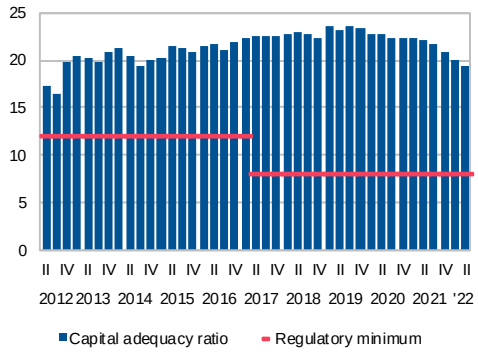
## Key banking sector indicators

The banking sector has remained adequately capitalised and highly liquid, and is likely to remain so in the coming period. At end-Q2 2022, the capital

[3] Report on the Results of the Bank Lending Survey for Q2 2022.
[4] Inflation Report, August 2022.

adequacy ratio of the banking sector measured 19.4%, which is well above the regulatory minimum.[5]

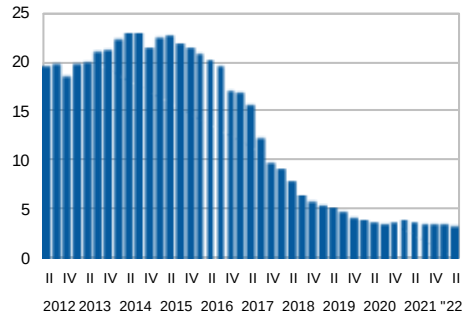
Chart 4. **Capital adequacy ratio**




Source: NBS.

Chart 5. **Non-performing loans**

(share in total gross loans, %)




Source: NBS.

The value of the Loan-to-Deposit (LtD) ratio was 0.81 at end-June 2022, which is 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 contracted significantly, showing an evident declining trend, as a result of the implementation of the NPL Resolution Strategy and other regulatory activities of the NBS. The share of NPLs amounted to 3.26% at end-Q2 2022, which is by around 0.4 pp less than in Q2 2021 and by 19.0 pp less than in August 2015 when the Strategy was adopted.

In the prior period the NBS adopted a number of measures in response to the pandemic-induced crisis. Its well-timed and adequate measures provided additional dinar and FX liquidity to the domestic financial sector so as to ensure smooth lending to businesses and citizens.

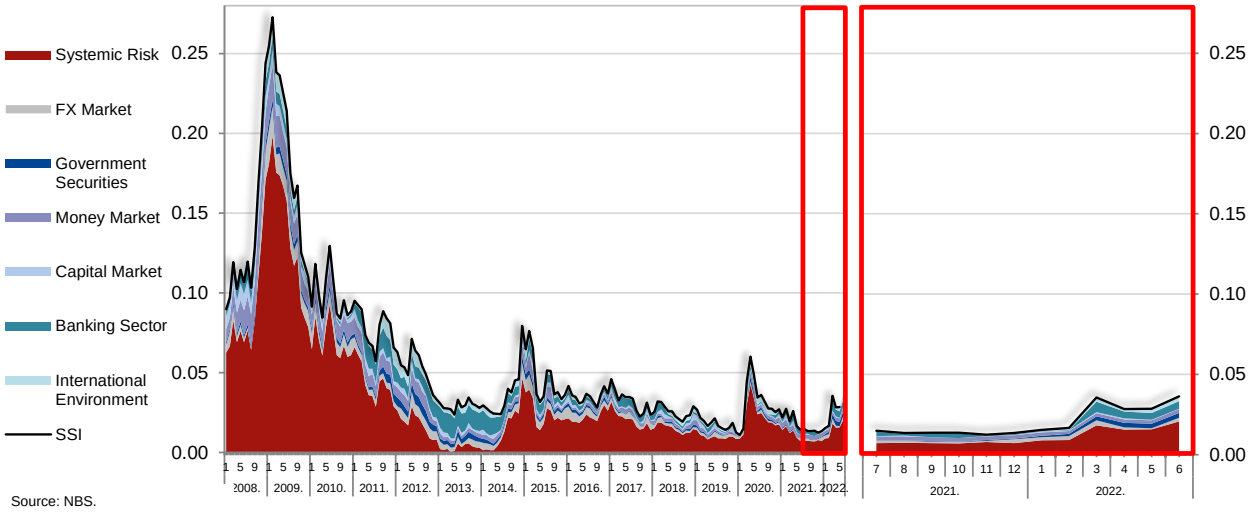
## Assessment of systemic risk in the Serbian financial system

The Systemic Stress Indicator (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.

[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%).

In Q2 as a whole, the SSI rose mildly compared to end-March 2022, even though it was at a slightly lower level in the course of April and May. After recording a stable systemic component during 2021 and until end-February 2022, the SSI increased in March and at end-June 2022, mainly due to risks from the international environment. Mounting geopolitical tensions, the continued conflict in Ukraine and globally high inflation led to monetary policy tightening by leading central banks and to the tightening of financial standards. The materialisation of risks generated in the prior period has dampened global recovery and brought about a downward revision of global growth forecasts for 2022.

Chart 6. **Systemic stress indicator dynamics and contribution of the most importanr risk factors to the Systemic stress indicator**




Source: NBS.

Continuous improvements in the regulatory area by the NBS 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 June 2022, the capital adequacy ratio measured 19.4%, while the average monthly liquidity ratio equalled 1.9. The results of macroprudential stress tests for March 2022 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 early June 2022, Standard & Poor's affirmed Serbia's credit rating at BB+, with a stable outlook, despite a heightened global crisis caused by the outbreak of the Ukraine conflict. In its press release, the agency stressed the credibility and continuity of Serbia's monetary and overall economic policy, resilience of the economy, and the maintained stability of the banking sector.