

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, 67/2022 and 137/2022, hereinafter: Decision on Capital Adequacy), the NBS Executive Board, at its meeting of 9 March 2023, decided to keep the countercyclical capital buffer rate for the Republic of Serbia at 0% having in mind that the estimated deviation of the real credit-to-GDP ratio from its long-term trend (credit-to-GDP gap) is below the lower bound of 2 pp needed for the introduction of the countercyclical capital buffer (hereinafter: CCyB). The National Bank of Serbia (NBS) has kept the countercyclical capital buffer rate at 0% in order to support financing conditions for corporates and households.

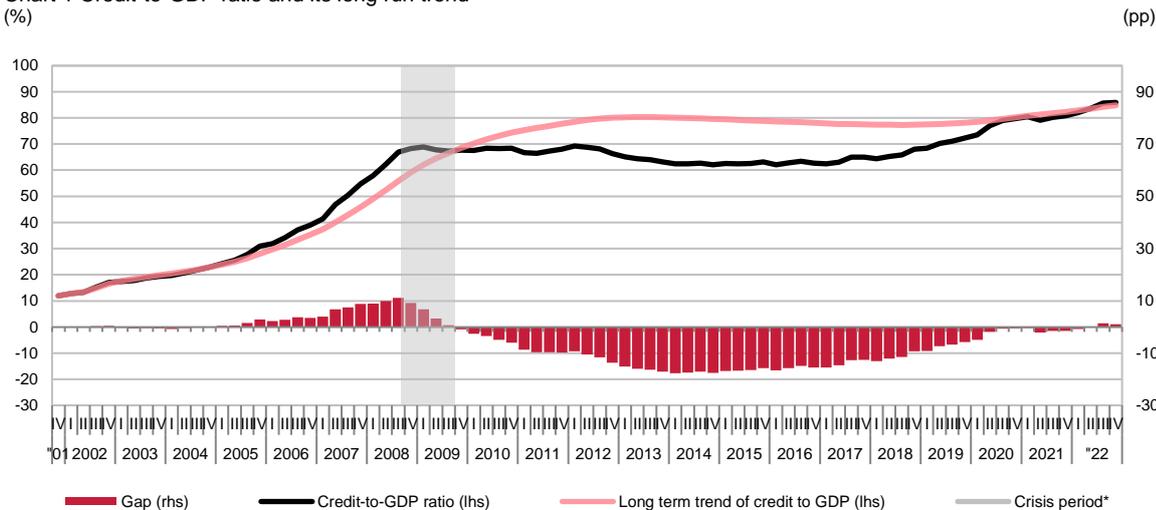
The CCyB is additional Common Equity Tier 1 capital that banks are required to maintain above the prescribed regulatory minimum in the amount equal to their risk-weighted assets multiplied by the specific countercyclical buffer rate. This instrument mitigates the cyclical dimension of systemic risk, creating an additional buffer of Common Equity Tier 1 capital during periods of pronounced credit growth, which can be released when systemic risks materialise.

The 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 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, the long-term trend and the estimated credit-to-GDP gap. After a period of credit expansion from 2000 until 2008, in late 2009 the credit-to-GDP gap entered the negative territory. As a result of global growth slackening in 2022 and lending growth in place since 2014, the share of total loans in GDP slightly exceeded its long-term trend at end-Q4 2022. According to December 2022 data, the credit-to-GDP gap is 1.1 pp. At end-Q4 2022, the gap widened by

18.6 pp relative to end-2014 and by 2.5 pp y-o-y, while in q-o-q terms it narrowed by 0.3 pp. The estimated credit-to-GDP gap of 1.1 pp is below the lower bound of 2 pp needed for the introduction of this capital buffer. Global growth slowdown and monetary policy tightening by leading central banks, as well as the maturing of guarantee scheme loans and the high base effect from 2022, could contribute to a further narrowing of the gap going forward. By keeping the CCyB rate at 0%, support is given to lending activity, thus easing the impact of current global uncertainty on local financing conditions for businesses and households.

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



Source: NBS.
*Based on SSI.

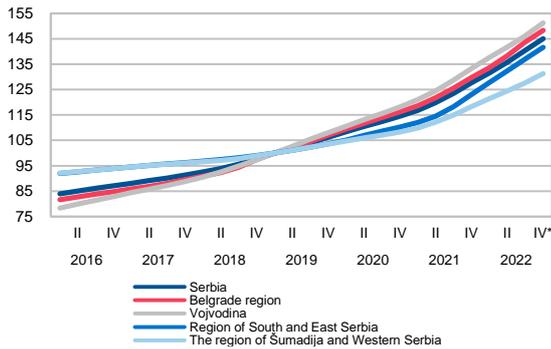
In addition to the credit-to-GDP gap, other optional indicators were also taken into account when setting the CCyB rate for the Republic of Serbia, in accordance with Section 436, paragraph 4 of the Decision on Capital Adequacy. Optional indicators for monitoring lending activity illustrate the characteristics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

Real estate market

According to data of the Republic Geodetic Authority, and based on the index of prices of flats, the annual growth rate of flat prices in the Republic of Serbia at end-Q4 2022 stood at 13.7%, while relative to the previous quarter the prices of flats rose 3.3%.¹

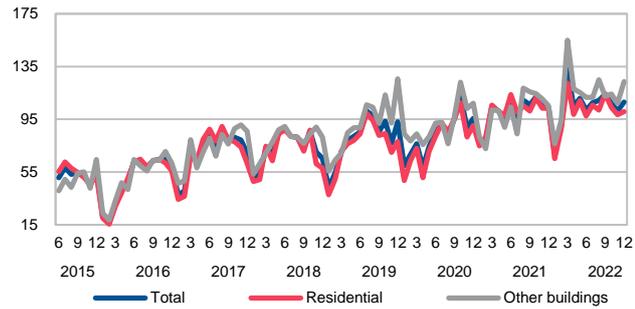
¹ Republic Geodetic Authority – Report on the index of flat prices for Q4 2022.

Chart 2 Housing price index
(Q1 2019 = 100)



* preliminary data
Source: Republic Geodetic Authority.

Chart 3 Indices of the number of newly issued building permits
(index, 2021 = 100)



Source: Statistical Office of the Republic of Serbia.

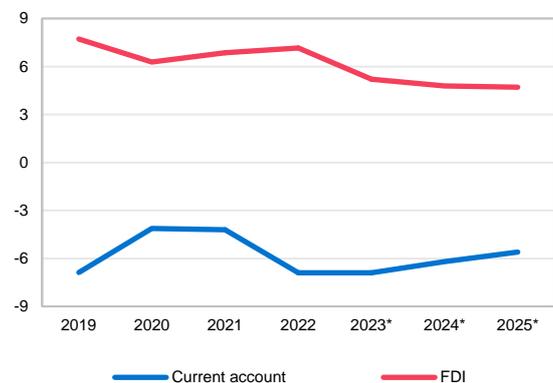
In Q4 2022, the total number of issued permits for new construction declined slightly, by 1.6% y-o-y. The LTV ratio, measured by the ratio of mortgage-backed housing loans for which a flat was mortgaged and the estimated value of the flats, posted a q-o-q decline in Q4 2022 and measured 61.2% (63.4% in Q3 2022).²

According to the results of the bank lending survey, in Q4 2022 banks continued to tighten credit standards for corporates and households. This tightening was mostly due to increased costs of funding sources and uncertainty regarding the overall economic situation, which resulted in diminished risk propensity. Banks expect similar trends in Q1 2023 as well. According to banks' observations, businesses increased their loan demand, while household loan demand drifted down in Q4 2022 and is expected to fall further in Q1 2023 as real estate prices and interest rates on housing loans go up.³

Indicators of external imbalance

FDI inflow to Serbia reached EUR 4.4 bn in 2022 (EUR 4.3 bn net) and is the highest annual FDI inflow on record (since 1997). Even in conditions of elevated global uncertainty, the FDI inflow in 2022 again exceeded expectations and amounted to 7.1% of GDP. For eight years straight, net FDI inflow fully covered the current account deficit, thus contributing to long-term sustainability of Serbia's external position.⁴

Chart 4 Current account deficit and FDI
(in % of GDP)



Source: NBS.

* NBS projection, February 2023

² Source: NBS Real Estate Database.

³ Inflation Report, February 2023.

⁴ Inflation Report, February 2023.

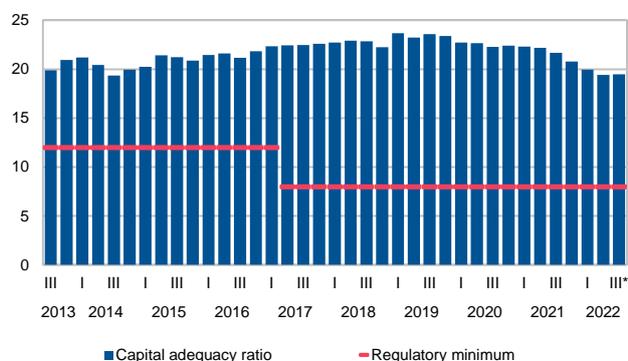
The current account deficit in 2022 rose to EUR 4.1 bn, i.e. 6.9% of GDP, which is less than previously expected (EUR 5.4 bn or around 9% of GDP). The outcome turned out to be more favourable than anticipated primarily thanks to the trade deficit being lower than projected, which is attributable to goods and services import being lower and export higher than expected. The share of the current account deficit in GDP in 2023 is expected to be similar as in 2022, while in the medium term it is likely to gradually decrease to around 5% as a result of an increase in export supply on account of prior investments and recovery in external demand.⁵

Main banking sector indicators

The banking sector stayed adequately capitalised and highly liquid, and is expected to remain so going forward. At end-Q3 2022, the capital adequacy ratio at the banking sector level equalled 19.5%,⁶ well above the regulatory minimum,⁷ while the average monthly liquidity ratio in December 2022 stood at 2.2 (regulatory minimum is 1).

At end-Q4 2022, the loan-to-deposit ratio (LtD) measured 0.81. Keeping this indicator at levels below 1 means that banks largely rely on domestic, stable sources of funding, such as deposits.

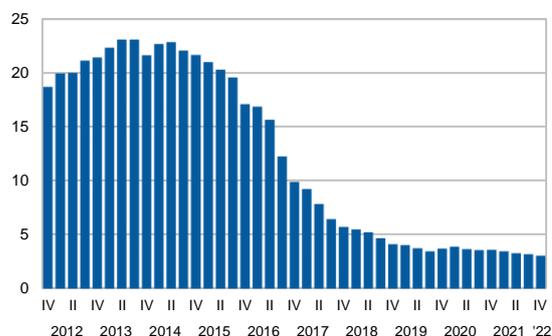
Chart 5 Capital adequacy ratio (%)



*latest available data

Source: NBS.

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



Source: NBS.

The share of NPLs in total banking sector loans decreased significantly owing to the implementation of the NPL Resolution Strategy, as well as other regulatory activities of the NBS. At end-Q4 2022, the NPL ratio equalled 3.0%,

⁵ Inflation Report, February 2023.

⁶ Latest available data.

⁷ 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%). Also, in addition to meeting these conditions, a bank shall maintain its capital at all times at the level necessary for the coverage of all risks to which the bank is or may be exposed in its operation, i.e. at least in the amount necessary for maintaining the increased capital adequacy ratios – if the National Bank of Serbia, in accordance with Section 5 of this Decision, has set capital adequacy ratios for a bank higher than the prescribed ones.

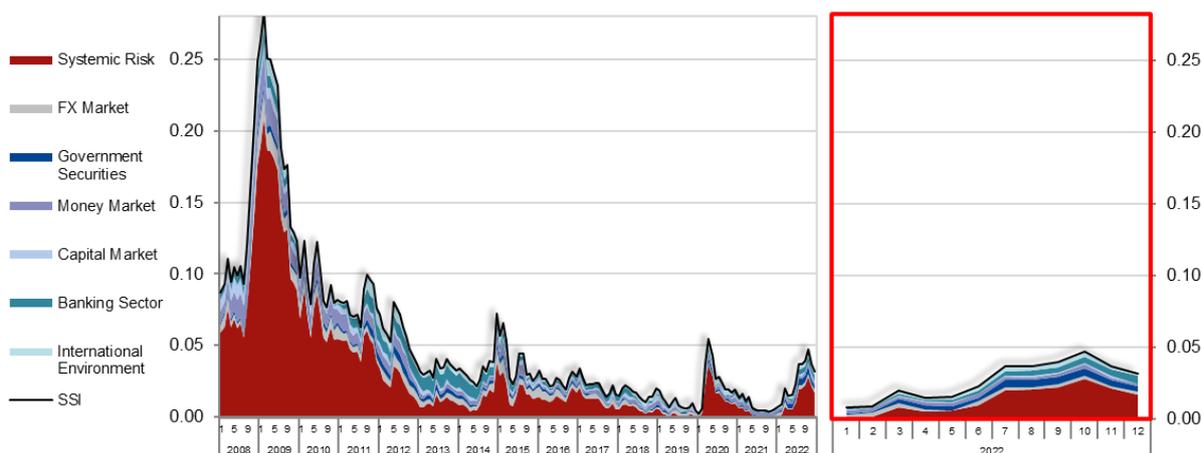
down by 0.6 pp relative to Q4 2021 and by 19.2 pp relative to August 2015 when the Strategy was adopted.

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.

During Q4 2022, the SSI recorded a mild decline relative to end-September 2022. Changes in the SSI were mostly affected by movements in the government securities market and in home markets of banks operating in Serbia.

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



Source: NBS.

Escalating geopolitical tensions resulted in a new economic environment featuring an energy crisis, high inflation and measures for combating it, as well as a global slowdown.

The NBS acted proactively, making timely decisions in view of the need to preserve and strengthen financial stability. A continuous improvement of regulatory measures implemented by the NBS, as well as enhancement of the domestic macroeconomic environment in the previous period helped to maintain a stable, adequately capitalised and highly liquid banking system in Serbia. The results of macroprudential stress tests for September 2022 confirm that even in the case of the most adverse scenario, the capital adequacy ratio would have values well above the regulatory minimum.

In early December 2022, Standard and Poor's kept Serbia's rating at BB+, with a stable outlook, a notch away from investment grade despite pronounced uncertainties arising from the international environment. In its press release, the agency underlined a credible macroeconomic policy framework, supported by the new stand-by arrangement with the IMF, as well as an adequate level of FX reserves which are one of the important pillars in defending our economy from shocks emanating from abroad.