8 June 2023

EXPLANATION FOR THE COUNTERCYCLICAL CAPITAL BUFFER RATE FOR THE REPUBLIC OF SERBIA

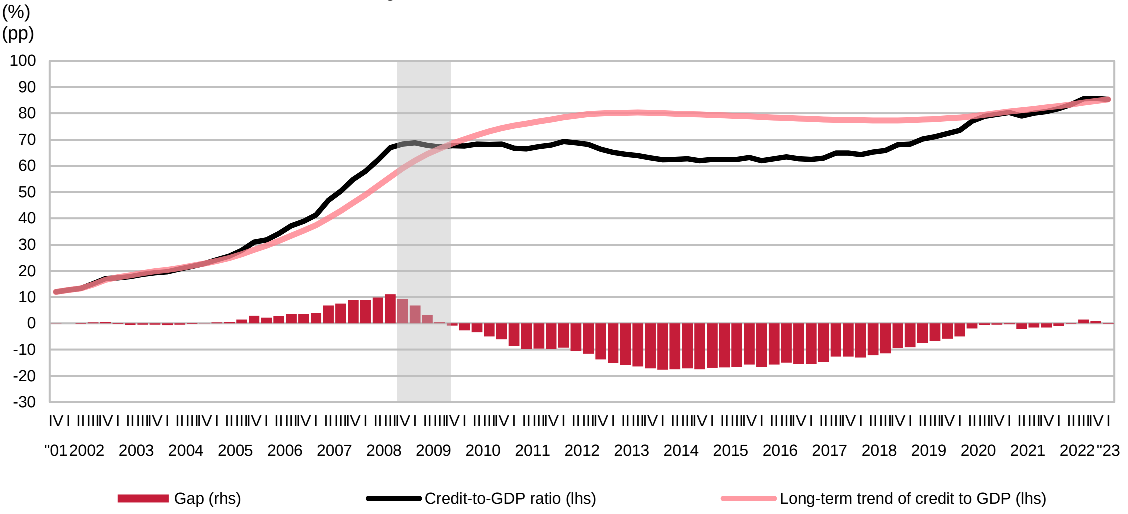
Pursuant to Article 14, paragraph 1, item 11) of the Law on the National Bank of Serbia (RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012, 106/2012, 14/2015 and 40/2015 – CC decision and 44/2018) and Section 436 of the Decision on Capital Adequacy of Banks (RS Official 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 8 June 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 continue supporting 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 between 2000 and 2008, in late 2009 the credit-to-GDP gap entered the negative territory. Lending growth in place since 2014 brought the share of total loans in GDP close to its long-term trend. According to March 2023 data, the credit-to-GDP gap is -0.1 pp. At end-Q1 2023, this gap widened by 17.4 pp relative to end-2014. The gap widened by 0.9 pp y-o-y and narrowed by 1.0 pp q-o-q. The estimated gap value of -0.1 pp is below the lower bound of 2 pp, the benchmark value which, if exceeded, would result in excessive lending growth.

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



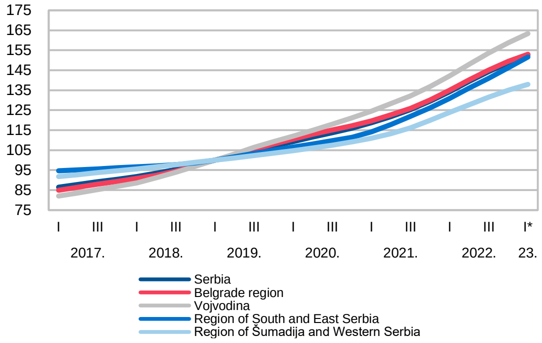
Source: NBS.
*Based on SSI.

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

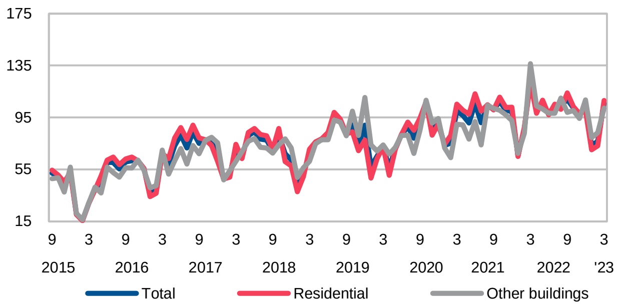
According to the data of the Republic Geodetic Authority, and based on the index of flat prices, the annual growth rate of flat prices in the Republic of Serbia in Q1 2023 stood at 13.6%, while relative to the previous quarter the prices of flats rose 2.6%.[1]

Chart 2 **Housing price index**
(Q1 2019 = 100)



* preliminary data
Source: Republic Geodetic Authority.

Chart 3 **Indices of the number of issued permits for new construction**
(index, 2022 = 100)



Source: Statistical Office of the Republic of Serbia.

In Q1 2023, the total number of issued permits for new construction declined by 8% 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 Q1 2023 and measured 59.4% (61.1% in Q4 2022.)[2]

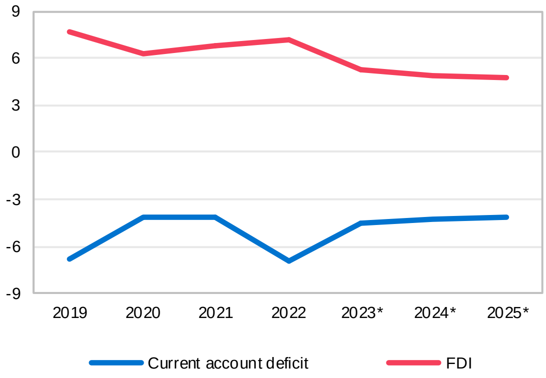
The bank lending survey showed that, expectedly, banks continued to tighten slightly their corporate and household credit standards in Q1 2023. This was mostly due to costlier funding, elevated real estate prices and uncertainty regarding the general economic situation, which translated into a lower risk appetite. Banks expect similar trends to continue in Q2 2023. According to banks, household and corporate loan demand contracted in Q1 2023 due to reduced need for financing capital investment and mergers/acquisitions of other companies in the corporate sector, while the key factor of dented demand in the household sector is the situation in the real estate and labour markets.[3]

[1] Republic Geodetic Authority – Report on the index of flat prices for Q1 2023.
[2] Source: NBS Real Estate Database.
[3] Inflation Report, May 2023.

Indicators of external imbalance

Net FDI inflow to Serbia measured EUR 784 mn in Q1 2023. Gross FDI inflow was EUR 847 mn, up by 41.5% y-o-y. FDI inflow posted new record highs of over 7% of GDP in the past two years and, in three years taken together, measured EUR 11.3 bn, making up around 60% of total inflow to Western Balkan countries and reflecting preserved investment confidence and Serbia's favourable macroeconomic outlook.

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



Source: NBS.
* NBS projection, May 2023

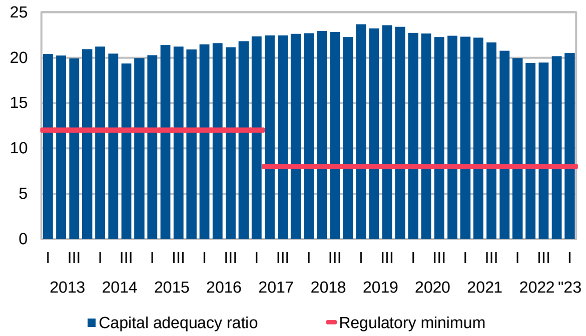
The current account deficit in Q1 2023 was only EUR 112 mn or 0.7% of GDP, down by more than EUR 1.4 bn from the same period of 2022. This was supported by reduced energy imports, largely because of their subdued global prices, but also by the continued growth in the export of goods and services at high nominal and real rates. Taking into account the expected decline in global energy prices this year and the low current account deficit in Q1, the current account deficit is expected to measure around 4.5% of GDP this year, and continue on a downward path to around 4% of GDP in the coming years. As in the past eight years, the current account deficit is expected to stay fully covered by net FDI inflow.

Main banking sector indicators

The banking sector is adequately capitalised and highly liquid, and is expected to remain so going forward. At end-Q1 2023, the capital adequacy ratio at the banking sector level equalled 20.5%, well above the regulatory minimum,[4] while the average monthly liquidity ratio in March 2023 stood at 2.4 (regulatory minimum is 1).

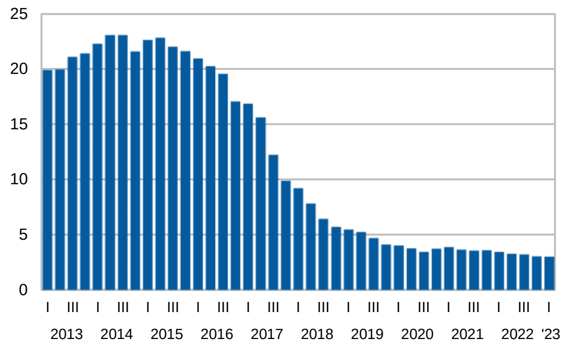
At end-Q1 2023, the loan-to-deposit ratio (LtD) measured 0.85. Keeping this indicator at levels below 1 means that banks largely rely on domestic, stable sources of funding, such as deposits.

Chart 5 **Capital adequacy ratio**
(in %)



Source: NBS.

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



Source: NBS.

Owing to the implementation of the NPL Resolution Strategy and other regulatory activities of the NBS, the share of NPLs in total banking sector loans decreased significantly in the recent period and remained at a record-low level despite the multidimensional crisis we have faced in the past three years. At end-Q1 2023, the NPL ratio equalled 3.0%, down by 0.4 pp relative to Q1 2022 and by 19.2 pp relative to August 2015 when the Strategy was adopted.

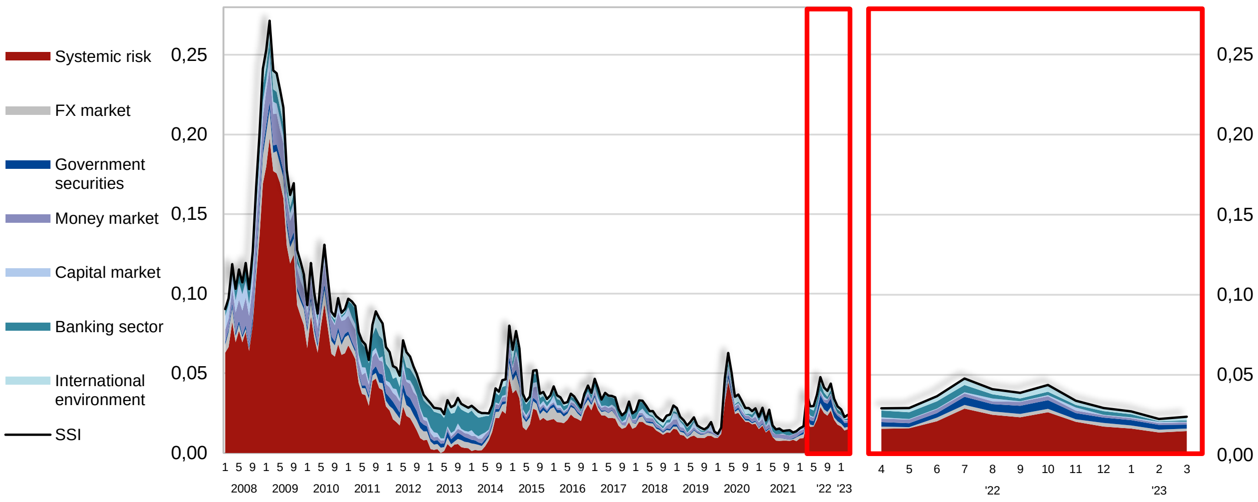
Assessment of systemic risk of the Serbian financial system

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.

[4] 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).

During Q1 2023, the SSI recorded a decline relative to end-2022. Changes in the SSI were mostly affected by movements in the government securities market and by international developments and risks.

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 of high inflation and measures for combating it, as well as in 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 the 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 December 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 mid-February 2023, Fitch Ratings affirmed Serbia's credit rating at BB+, with a stable outlook, despite pronounced uncertainty from the international environment. The rating agency particularly underscored the importance of the preserved stability of the exchange rate in the conditions of heightened geopolitical and other international risks, adequacy of fiscal policy and higher level of economic development measured by GDP per capita compared to rating peers.