7 September 2023

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

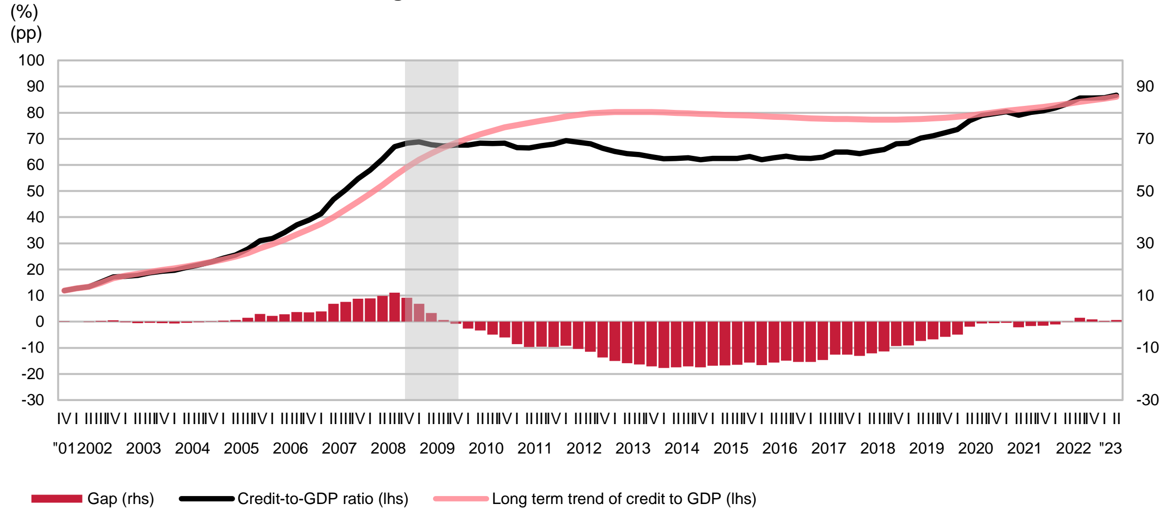
Pursuant to Article 14, paragraph 1, item 11) of the Law on the National Bank of Serbia (RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012, 106/2012, 14/2015 and 40/2015 – CC decision and 44/2018) and Section 436 of the Decision on Capital Adequacy of Banks (RS Official Gazette, Nos 103/2016, 103/2018, 88/2019, 67/2020, 98/2020, 137/2020, 59/2021, 67/2022, 137/2022 and 48/2023, hereinafter: Decision on Capital Adequacy), the NBS Executive Board, at its meeting of 7 September 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 in an environment of tightened global financing conditions.

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 June 2023 data, the credit-to-GDP gap is 0.6 pp. At end-Q2 2023, this gap widened by 18.2 pp relative to end-2014. The gap widened by 0.7 pp y-o-y. The estimated gap value of 0.6 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.

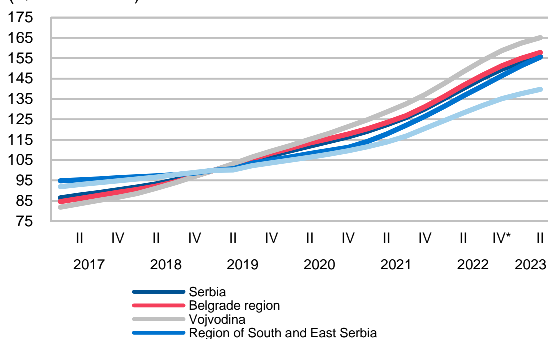
In addition to the credit-to-GDP gap, other optional indicators were also taken into account when setting the CCyB rate for the Republic of Serbia, in accordance with Section 436, paragraph 4 of the Decision on Capital Adequacy. Optional indicators for monitoring lending activity illustrate the characteristics 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 Q2 2023 stood at 11.2%, while relative to the previous quarter the prices of flats rose 1.8%.[1]

Chart 2 **Housing price index**

(Q1 2019 = 100)

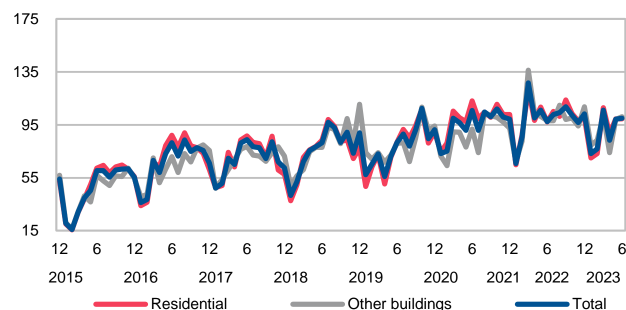


* preliminary data

Source: Republic Geodetic Authority.

Chart 3 **Indices of the number of newly issued building permits**

(index, 2022 = 100)



Source: Statistical Office of the Republic of Serbia.

In Q2 2023, the total number of issued permits for new construction declined by 6.9% 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 Q2 2023 and measured 57.7% (59.3% in Q1 2023).[2]

The July bank lending survey showed that, expectedly, banks continued to tighten their corporate and household credit standards slightly in Q2 2023. Higher costs of financing sources, which reflect the monetary policy tightening by the NBS and the ECB, are the key factor behind stricter credit standards. According to banks, household and corporate loan demand edged up slightly in Q2 2023, with households mostly interested in dinar cash loans. Demand for housing loans decreased.[3]

[1] Republic Geodetic Authority – Report on the index of flat prices for Q2 2023.

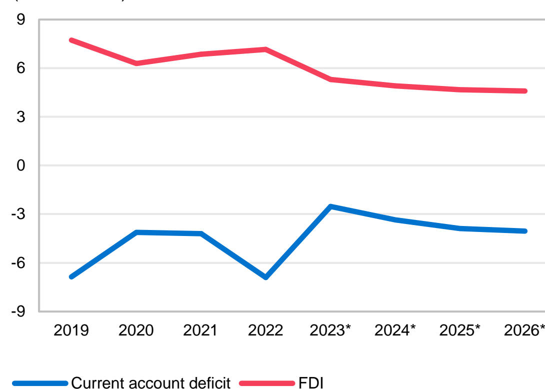
[2] Source: NBS Real Estate Database.

[3] Bank Lending Survey, Q2 2023.

Indicators of external imbalance

The balance of payment movements in H1 2023 were much more favourable than in the corresponding period in 2022, hence the current account deficit declined several times y-o-y, and capital inflow from abroad significantly overshot the current account deficit, thus contributing to the sustainability of Serbia’s external position.

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



Source: NBS.
* NBS projection, August 2023.

Capital inflow under FDI exceeded EUR 2.1 bn in the first six months of 2023, up by 33% y-o-y. In H1 2023, almost 70% of investments were in the form of equity capital and reinvested earnings, which confirms the determination of foreign investors to continue investing in Serbia.

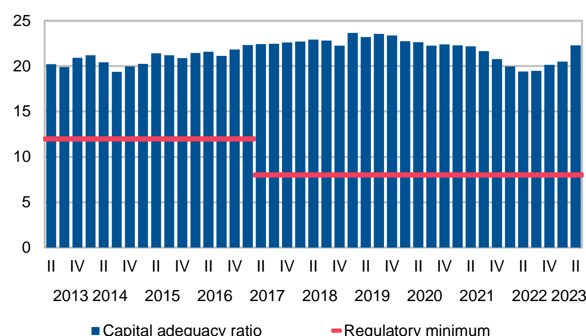
The current account deficit in Q2 2023 remained low, and since the start of the year it equalled only EUR 527 mn, down by EUR 2.4 bn from the same period in 2022. The current account deficit being quite lower in the year to date, it is expected to equal around 2.5% of GDP at the annual level instead of the previously anticipated 4.5%. Also, 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. At end-Q2 2023, the capital adequacy ratio at the banking sector level equalled 22.3%, well above the regulatory minimum.[4]

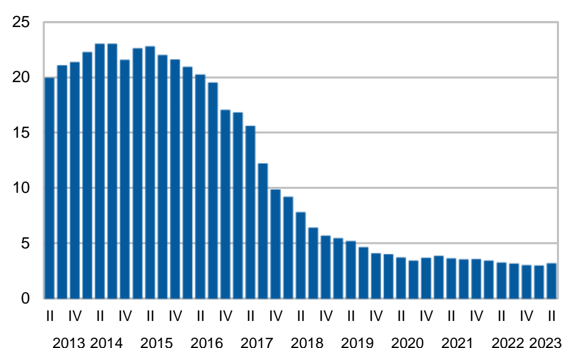
At end-Q2 2023, the loan-to-deposit ratio (LtD) measured 0.86. Keeping this indicator at levels below 1 means that banks largely rely on domestic, stable sources of funding, such as deposits.

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-Q2 2023, the NPL ratio equalled 3.2%, up by 0.2 pp q-o-q, down by 0.1 pp y-o-y, and down by as much as 19.1 pp relative to August 2015 when the Strategy was adopted.

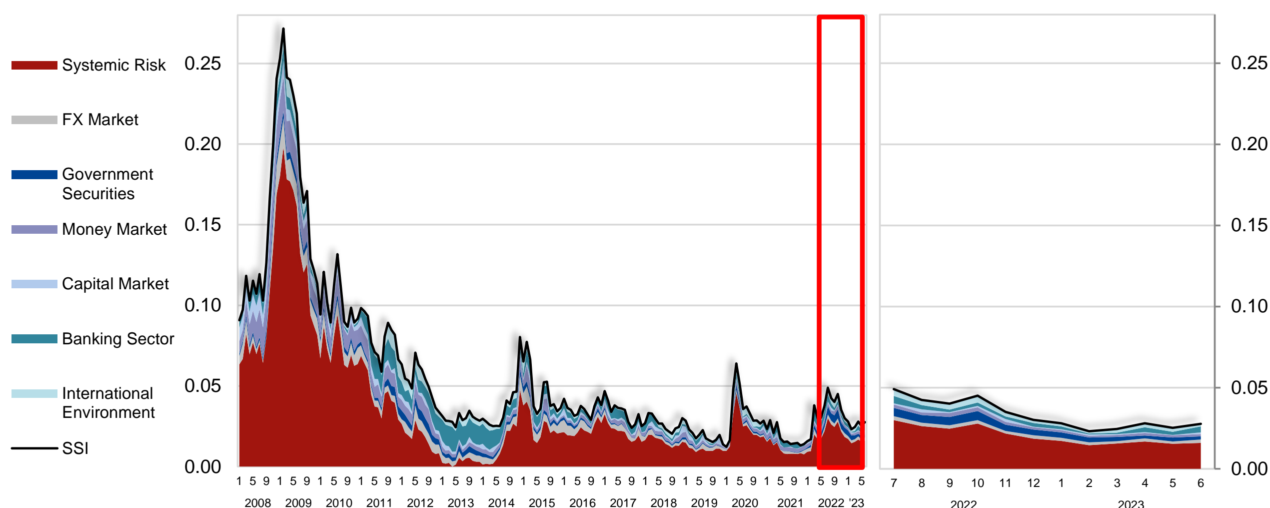
Assessment of systemic risk of the Serbian financial system

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 Q2 2023, the SSI recorded an increase relative to the quarter before, and a decline relative to end-2022. The SSI value was mostly affected by movements in the government securities market and the banking sector.

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



Source: NBS.

Amid the expected global slowdown, pronounced geopolitical tensions, relatively high inflation and tight global financial conditions, 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 March 2023 confirm that even in the case of the most adverse scenario, the banking sector would remain adequately capitalised and liquid.

In April 2023, Standard & Poor's affirmed Serbia's credit rating at BB+, i.e. a notch away from investment grade, with a stable outlook. The agency's statement reads that by lifting the key policy rate gradually, Serbia prevented a further spread of inflationary pressures, and that medium-term inflation expectations remained largely anchored thanks to the monetary policy credibility, monetary tightening and the maintained relative stability of the exchange rate.

In August 2023, Fitch Ratings affirmed Serbia's rating at 'BB+', i.e. a step away from investment grade, with a stable outlook. The agency notes the following key rating drivers underpinning its decision: a credible economic policy framework, higher level of economic activity measured by GDP per

capita, stronger governance and improved human development compared with 'BB' medians, and ordered public finances.