

**Republic of Serbia: Financial Sector Assessment Program Update—  
Financial System Stability Assessment**

This Financial System Stability Assessment on the Republic of Serbia was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on March 8, 2010. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Republic of Serbia or the Executive Board of the IMF.

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Republic of Serbia

## Financial System Stability Assessment

Prepared by the Monetary and Capital Markets and European Departments

Approved by José Viñals and Marek Belka

March 8, 2010

This Financial System Stability Assessment (FSSA) is based on the work of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) Update mission that visited Serbia during the period October 7–21, 2009. The findings were discussed with the authorities.

The key findings of the assessment are:

- The financial system has successfully weathered the global financial crisis, but faces the challenge of a possible further deterioration of the economic environment, with attendant effects on asset quality;
- The banking sector is highly capitalized and liquid, and displays considerable resilience in stress tests;
- Several important supervisory challenges remain despite an improvement in the supervisory framework since the 2005 FSAP, including some streamlining of prudential rules, formalizing memoranda of understanding with key home supervisors, and, over the medium term, further upgrading of the supervisory framework and capacity building;
- High capital and reserve requirements have helped limit credit expansion, but in the long run this may contribute to financial disintermediation;
- The planned amendments to the problem bank resolution framework are adequate, although additional measures need to be introduced to mitigate potential conflicts of interest;
- The functions of the Deposit Insurance Agency need a comprehensive review aimed at reducing potential conflicts of interest and strengthening its institutional capacity;
- Debt restructuring mechanisms are insufficient to cope with the increasing level of corporate distress; and
- The insurance sector is adequately capitalized relative to its overall risk exposure, but remains underdeveloped, lagging behind most of the region.

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*FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.*

Contents	Page
Glossary .....	4
Executive Summary .....	5
I. Macroeconomic and Financial Impact of the Crisis .....	9
A. Macroeconomic Developments.....	9
B. Challenges Going Forward.....	10
II. Financial System Structure and Potential Risks.....	11
A. Financial System Structure .....	11
B. Banking System Assets and Liabilities .....	12
C. Performance of the Corporate and Household Sectors .....	14
D. Banking Sector Performance .....	15
E. Overall Assessment and Potential Vulnerabilities of the Banking Sector .....	16
III. Banking Supervision: Regulatory Framework and Challenges .....	21
A. Regulatory Changes and Supervisory Policy.....	21
B. Supervisory Challenges.....	23
IV. Systemic Risk Mitigation Arrangements.....	25
A. Liquidity Framework Arrangements.....	25
B. Crisis Management, Cooperation, and Coordination .....	26
C. Problem Bank Resolution.....	27
D. Deposit Insurance.....	28
V. Other Issues.....	30
A. Government Securities Markets.....	30
B. Corporate and Household Debt Restructuring Issues .....	31
C. Insurance Sector .....	32
D. Anti-Money Laundering and Combating the Financing of Terrorism.....	33
Annex—Observance of Financial Sector Standards and Codes—Summary Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision.....	35
 Tables	
1. Risk Assessment Matrix .....	7
2. Key Recommendations .....	8
3. Selected Economic Indicators, 2004-10 .....	10
5. Asset Structure .....	12
4. Financial Sector Structure, 2005-09 .....	13
6. Corporate Sector’s Financial Indicators, 2006-08 .....	14
7. Household Sector Financial Ratios, 2005-09.....	15
8. Financial Soundness Indicators, 2005-09 .....	19
9. Summary Table for Stress Tests .....	22
10. Regional Comparison of Capital Adequacy Requirements .....	23
11. Regional Comparison of Loan Classification Rules.....	24
12. Key Insurance Sector Performance Indicators, 2006-09 .....	33
13. Summary Compliance with the BCPs—Detailed Assessments.....	41
14. Recommended Action Plan to Improve Compliance with the BCPs .....	44

## Figures

1. Households' FX Bank Deposits.....	9
2. Banking Sector Indicators,.....	11
3. Private Sector Credit Growth.....	12
4. Comparative Financial Soundness Indicators, 2008.....	18

## Appendix

Implementation of 2005 FSAP Recommendations.....	47
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## GLOSSARY

AML	Anti-money laundering
APML	Administration for the prevention of money laundering
BCP	Basel Core Principles
BIS	Bank for International Settlements
BSD	Banking Supervision Department
BSL	Banking Stability Law
CAR	capital adequacy ratio
CESE	Central, Eastern, and Southeastern Europe
CFT	Combating the financing of terrorism
CICR	Currency induced credit risk
CRD	Capital requirements directive
DIA	Deposit Insurance Agency
DIF	Deposit Insurance Fund
DMO	Debt Management Office
EU	European Union
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FSSP	Financial Sector Support Program
FX	Foreign exchange
GDDS	General data dissemination system
GDP	Gross domestic product
GOS	Government of Serbia
GPW	Gross premiums written
IFI	International financial institution
IFRS	International Financial Reporting Standards
ITI	inflation targeting
LOB	Law on Banks
LOLR	Lender of last resort
MOF	Ministry of Finance
MOJ	Ministry of Justice
MOU	Memorandum of understanding
MTPL	Motor third-party liability
NBFI	Nonbank financial institutions
NBS	National Bank of Serbia
NMIC	National Mortgage Insurance Corporation
NPL	Nonperforming loan
NPW	Net premiums written
OECD	Organization for Economic Cooperation and Development
ROE	Return on equity
RR	Reserve requirement
RSD	Serbian dinar
SBA	Stand-By Arrangement
SME	Small and/or medium-size enterprise
SC	Securities Commission
SRR	Statutory reserve requirements
T-Bill	Treasury bill

## EXECUTIVE SUMMARY

**The Serbian financial system has weathered the global financial crisis, although not without costs.** The economy suffered from a 20 percent depreciation of the dinar vis-à-vis the euro, soaring sovereign spreads, weak export demand, and a plummeting stock market. Confidence in the banking sector was affected, reflected in the withdrawal of 18 percent of household deposits from banks. Nonetheless, a conservative regulatory approach had left the banking system with capital and liquidity buffers large enough to withstand these shocks. Since mid-2009, confidence has been largely restored through a coordinated response by the National Bank of Serbia (NBS) and the government, in close cooperation with the banking community, and financing from the Fund and other international financial institutions (IFIs)

**Although banks have been resilient so far, their main challenge will be to withstand a possible further deterioration of the economic environment.** Key risks stem from a recession that persists over the medium-term and indirect effects on credit risk due to corporate and household unhedged foreign exchange (FX) exposures. External financing to banks may be curtailed, and fiscal policy uncertainty within Serbia itself could also impact banking sector stability through a loss of confidence, either domestically or through regional contagion, resulting in higher spreads and strong pressure on the dinar.

**At the same time, the banking sector remains highly capitalized and liquid, and displays considerable resilience in stress tests.** The aggregate capital adequacy ratio (CAR) was 21 percent in June 2009, and the banking system's liquid assets covered 67 percent of short-term liabilities. However, nonperforming loans (NPLs) have increased substantially, reaching 16½ percent in June 2009. Nevertheless, stress tests show that even a substantial increase in NPLs under the most severe scenario would not result in significant undercapitalization.

**Monetary policy management has improved substantially since the 2005 FSAP, but the high reserve requirements (RRs) should be reassessed.** A very high level of Euroization makes monetary policy less effective, and the NBS has been using the RR on FX liabilities to limit credit expansion, increasing banks' funding costs. This has encouraged Serbian corporates to borrow directly from parent banks abroad. To limit financial disintermediation and distortions in the financial system, consideration may need to be given to reducing the level of RRs gradually and simplifying the RR regulations by eliminating numerous exemptions. To improve the functioning of the inflation targeting (IT) framework, NBS operations should aim to deepen the money market and promote de-Euroization.

**Although government securities' issuance arrangements have helped to achieve relatively stable funding conditions, some enhancements should be considered.** In particular, the government should establish a comprehensive debt management strategy. Furthermore, securities issuance and settlement procedures should be enhanced in line with international best practices.

**Despite an upgraded regulatory and supervisory framework since the 2005 FSAP, a number of important challenges remain.** Looking ahead, the challenge will be to (a) further streamline prudential rules by relaxing some regulations on the double penalty on FX loans and the classification of all restructured loans; (b) address the existing impediments

so as to formalize cooperation agreements with significant home supervisors; and (c) strengthen further the capacity of the banking supervision department (BSD).

**The proposed problem bank resolution framework, dividing the responsibilities between the NBS and the Deposit Insurance Agency (DIA), is pragmatic.** A set of legal amendments is under preparation, enabling the authorities to deal with “least cost restructuring” of problem banks. Given the small size of the banking system and the cost of developing additional capacity, this division of responsibilities between the NBS and DIA can work, provided that (a) potential conflicts of interest are mitigated by institutional separation of the NBS’s supervisory and restructuring enforcement responsibilities; and (b) contingent financing mechanisms are in place to allow emergency channeling of government assistance to distressed banks through the DIA as part of a resolution process.

**The mission recommends that the authorities undertake a comprehensive review of the DIA’s functions, including the deposit insurance coverage.** The present level of insured deposits could lead to excessive risk-taking by banks. The DIA currently undertakes several tasks that can adversely affect its clear institutional focus and generate conflicts of interest. A comprehensive medium-term strategy should be prepared.

**Debt restructuring mechanisms are insufficient to cope with the increasing level of corporate distress and NPLs.** A decline in overall corporate performance has led to a doubling of account blocking requests in the past year. The NBS’s decision to temporarily relax some rules to encourage debt rescheduling has provided breathing room. The mission recommends additional incentives to encourage workout procedures, further streamlining of the auction and execution procedures, and further development of a regulated profession of execution officers. Creditors whose claims are not affected should be excluded in order to accelerate and simplify pre-negotiated restructurings.

**The insurance sector is adequately capitalized but remains relatively underdeveloped, lagging behind most of the region.** Despite a small deterioration in the overall asset quality of the industry, underwriting losses and expenses are still below the annual premium intake. Issues that need to be addressed include: (a) promoting the development of life insurance on a level playing field with pension funds; (b) separating life and non-life parts of the business for all companies; and (c) liberalizing the local reinsurance market.

**Table 1. Risk Assessment Matrix**

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat Sometime in the Next 3 Years	Expected Impact on Financial Stability if Threat is Realized
<p>1. Reduced external funding of foreign banks and the corporate sector.</p>	<p><i>Assessment: Medium</i></p> <ul style="list-style-type: none"> <li>• Sudden stop or reversal in capital inflows to Serbia, through a halt in capital funding, or a withdrawal/liquidation of assets in Serbia due to problems at parent banks.</li> <li>• The reversal could be triggered by political turbulence in Serbia or by contagion effects from new crises in countries in the region.</li> </ul>	<p><i>Assessment: High</i></p> <ul style="list-style-type: none"> <li>• Immediate credit crunch in those banks reliant on foreign funding (75 percent of the banking system), particularly if capital inflows reverse.</li> <li>• The sudden stop would impact the exchange rate, which would affect the banks through currency-induced credit risk and the valuation of risk-weighted assets, due to very high Euroization. Under the stress test assumptions used in which the exchange rate depreciates by 25 percent, CICR raised NPLs by almost 6 percentage points.</li> <li>• The credit crunch would also impact on growth, threatening a recovery.</li> </ul>
<p>2. Risk of persistent structural fiscal deficits threatening fiscal sustainability</p>	<p><i>Assessment: Medium</i></p> <ul style="list-style-type: none"> <li>• Unsustainable fiscal policies due to persistently weak aggregate demand and/or difficulties in achieving lasting fiscal consolidation, combined with a tight financing constraint.</li> </ul>	<p><i>Assessment: Medium</i></p> <ul style="list-style-type: none"> <li>• Weakening of investor confidence leading to a higher risk premium and downward pressure on the domestic currency. The impact could be higher if weak fiscal policies result in a sudden reversal of capital inflows.</li> </ul>
<p>3. Substantial deterioration in the economic outlook.</p>	<p><i>Assessment: Medium</i></p> <ul style="list-style-type: none"> <li>• Slow recovery of the real sector would lead to a continued rise in unemployment and further deterioration of the household and corporate sectors' balance sheets.</li> <li>• Continued weakness in export markets and in foreign direct investment.</li> </ul>	<p><i>Assessment: High cumulative impact over a number of years</i></p> <ul style="list-style-type: none"> <li>• Negative impact on the profitability of the banks due to the household and corporate sectors' inability to service their debt.</li> <li>• This, in turn, could trigger a downward spiral of continued deleveraging, a credit crunch, and more NPLs. Under severe stress test assumptions with 6.5 percentage point lower output gap, NPLs increase by 4.5 percentage points.</li> </ul>



**Table 2. Key Recommendations**

Recommendations	Priority
<b>Banking Regulation and Supervision</b>	
Set more precise loan classification criteria and required provisioning rather than broad ranges subject to interpretation	Immediate
Monitor rescheduled and restructured loans	Immediate
Relax provisioning and asset classification requirements related to FX loans and the reclassification of restructured loans	Immediate
Ensure adequate staffing in the BSD through competitive salary structures, training opportunities, and career prospects	Short-term
<b>Liquidity and Securities Market Issues</b>	
Streamline the reserve requirement regulations and reassess its level, although any changes to the level should be gradual.	Immediate
Reduce the number of NBS repo auctions to one per week	Short-term
Prepare alternative liquidity draining channels to allow a scaling down of the NBS repo auctions	Medium-term
Start developing a comprehensive debt management strategy	Short-term
<b>Crisis Management Framework</b>	
Introduce a comprehensive crisis management framework by obtaining approval of the necessary legal amendments	Immediate
Develop crisis memoranda of understanding with relevant home countries	Medium Term
<b>Bank Resolution</b>	
Introduce broader problem bank restructuring options under the NBS for an open bank	Short-term
Issue NBS regulations to separate problem bank resolution functions from supervisory functions, including setting up an independent problem bank restructuring unit when needed, reporting directly to the governor	Short-term
Consider putting in place mechanisms for emergency government financial assistance for bank restructuring costs	Short-term
<b>Deposit Insurance Scheme</b>	
Enhance the operational capacity of the DIA to ensure timely payout of insured deposits	Short-Term
Put in place contingent financing mechanisms between the Ministry of Finance (MOF) and the DIA for emergency drawdown needs	Short-Term
Evaluate the insured deposit coverage when the crisis is over and the system is stable	Medium Term
Prepare a comprehensive strategy for the DIA, including role, responsibilities, and funding	Medium Term
<b>Corporate and Household Debt</b>	
Establish corporate workout guidelines to facilitate restructuring of NPLs and address corporate distress	Immediate
Introduce mandatory registration of bills of exchange in a centralized registry	Short term
Amend pledge law to clarify priority and protection of cash collateral (exempt from blocked accounts process)	Short-term
<b>Insurance Sector</b>	
Separate life and non-life insurance companies in all aspects	Short-term
Adopt measures to promote the insurance sector	Short-term
Liberalize the local reinsurance market	Short-term

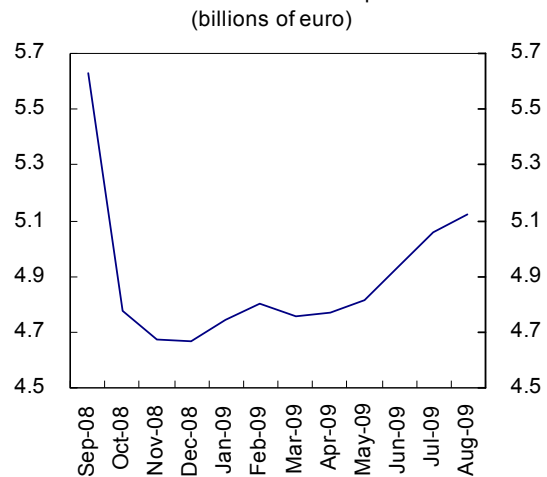
## I. MACROECONOMIC AND FINANCIAL IMPACT OF THE CRISIS

### A. Macroeconomic Developments

1. **Like most countries in the region, Serbia has been hit hard by the global financial crisis (Table 3).** The immediate tensions between October 2008 and February 2009 were reflected in a 20 percent depreciation of the dinar vis-à-vis the euro; soaring sovereign spreads; the withdrawal of 18 percent of household savings deposits from mainly foreign-owned banks (Figure 1); and a stock market decline of about 60 percent. External trade declined by nearly a third, while Gross Domestic Product (GDP) contracted by about 4 percent in the first half of 2009.

2. **With a significant rebalancing of the economy underway, the external financing worries and inflation have receded for now.** Since domestic demand is contracting faster than output, the current account deficit has been shrinking fast. Helped by stable external financing and migration of FX deposits back to banks, the exchange rate has stabilized, while CPI inflation declined to 6.6 percent in December, well within the NBS's end-2009 target. This allowed the NBS to cut its policy rate by 825 bps in 2009. Owing to weak demand and consumption, tax collections have plunged, and, notwithstanding spending cuts and nominal freezes, the fiscal deficit increased to about 4½ percent of GDP in 2009.

**Figure 1. Households' FX Bank Deposits**



Source: NBS

3. **The authorities' initial response to the crisis focused on maintaining confidence in the banking sector.** The government requested a stand-by arrangement (SBA) with the IMF, and introduced various regulatory and monetary measures, including increased deposit insurance coverage, an injection of €2 billion into the banking system through direct intervention and changes in RRs, and the abolishment of the RR on new foreign borrowing. In addition, access under the IMF program was augmented, while additional loans were secured from other IFIs and the EU.

4. **As the crisis unfolded, the authorities introduced a comprehensive Financial Sector Support Program (FSSP) featuring a combination of commitments by banks and a set of incentives by the NBS.** Under the Vienna Initiative, foreign parent banks have committed to maintaining their exposure to Serbia at the end-2008 level throughout 2009–10, and to keep their subsidiaries sufficiently capitalized and liquid. Incentives by the NBS included access to new liquidity facilities and the softening of some regulatory requirements. The FSSP has helped to restore confidence in the markets.

5. **With the immediate external financing pressures easing, some winding down of these commitments is appropriate.** The current macroeconomic framework assumes that parent banks' exposure limits will be reduced from 100 percent to 80 percent, effective in

April 2010. A gradual and coordinated phase-out would avoid disruptive swings in capital flows at the end of the commitment period.

**Table 3. Selected Economic Indicators, 2006-10**  
(In percent except where indicated)

	2006	2007	2008	2009	2010
				Prel.	Proj.
(Change in percent, unless otherwise indicated)					
Output, prices, and labor market					
Real GDP	5.2	6.9	5.5	-2.9	2.0
Consumer prices (average) 2/	12.7	6.5	12.4	8.1	4.8
Consumer prices (end of period) 2/	6.6	11.0	8.6	6.6	6.0
Unemployment rate (in percent)	21.6	18.8	14.7	17.4	...
Nominal GDP (in billions of dinars)	1,980	2,363	2,751	2,899	3,139
(In percent of GDP)					
General government finances					
Revenue	43.8	42.4	41.4	39.6	38.4
Expenditure	45.4	44.2	44.0	43.7	42.5
Fiscal balance (cash basis)	-1.6	-1.9	-2.6	-4.2	-4.1
Structural fiscal balance 3/	-2.3	-3.6	-4.7	-3.5	-4.4
Gross debt	42.6	33.3	32.1	32.2	33.7
(End of period 12-month change, in percent)					
Monetary sector					
Money (M1)	37.1	25.3	-3.8	-9.7	11.7
Broad money (M2) 4/	38.4	44.5	9.6	7.2	9.8
Domestic credit to non-government	17.1	36.9	35.0	10.0	11.9
NBS repo rate (end of period)	14.0	10.0	17.8	9.5	...
(In percent of GDP, unless otherwise indicated)					
Balance of payments					
Current account balance	-10.1	-15.5	-17.1	-5.7	-8.5
Exports of goods	21.8	21.6	22.0	19.4	19.8
Imports of goods	42.9	44.1	44.6	34.9	34.5
Trade of goods balance	-21.2	-22.5	-22.3	-15.5	-14.7
Capital and financial account balance	31.7	17.9	12.4	11.7	4.2
External debt (end of period; billions of euro)	14.9	17.8	21.8	23.4	25.4
(In percent of GDP)	63.3	60.2	63.6	76.0	79.5
<i>of which:</i> Private external debt	36.0	39.5	45.0	51.7	48.5
Gross official reserves (in billions of euro)	8.7	9.5	8.2	10.6	11.3
(In months of prospective imports of GNFS)	6.6	6.3	7.7	7.3	9.2
(in percent of short-term debt)	294.5	268.4	438.3	207.7	218.0
Exchange rate (dinar/euro, period average)	84.2	80.0	81.5	93.9	...
REER (annual average change, in percent; + indicates appreciation)	6.6	7.2	6.4	-7.1	...

Sources: Serbian authorities; and IMF staff estimates and projections.

1/ Excluding Kosovo (with the exception of external debt).

2/ Retail prices until 2006.

3/ Fiscal balance adjusted for the automatic effects of both the output gap and the external absorption gap on the fiscal position; see IMF Country Report No. 07/390 for details.

4/ Excluding frozen foreign currency deposits.

## B. Challenges Going Forward

### 6. Serbia faces three key risks to its macroeconomic and financial sector stability:

- **Adverse external funding environment.** Though conditions have stabilized, international financial conditions remain fragile. Spillover effects from countries in the region affecting common parent banks, or renewed uncertainty over Serbia's

policy direction, could bring a sudden stop, or reversal, in capital inflows. Concerns over spillover effects reflect shifting market perceptions about the health of emerging European economies and EU members. If such concerns should cause a reversal in capital inflows, a credit crunch would follow, as well as a weaker exchange rate and worsened asset quality due to currency induced credit risk (CICR).

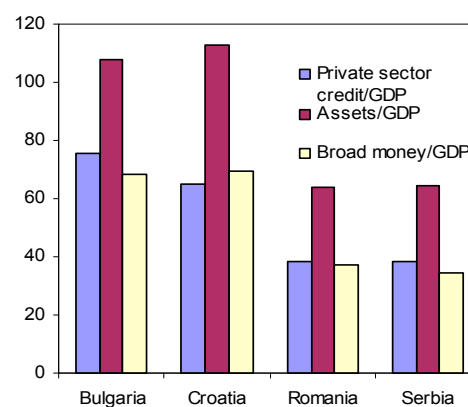
- **Fiscal risk and its impact on investor confidence manifested in a higher risk premium and renewed FX market pressures.** Given the expectation of a modest economic recovery, high spending needs, and low tax receipts, fiscal risks remain.
- **Over the medium-term, prolonged weakness of the real sector and deterioration of banks' balance sheets.** Low growth persisting over a number of years, including through weak external demand, could raise unemployment and reduce corporate and households' ability to service their debts. It would be difficult for bank profitability to recover, and capital cushions could be eroded. This impact would be compounded by a protracted corporate loan restructuring process for loans that are already impaired.

## II. FINANCIAL SYSTEM STRUCTURE AND POTENTIAL RISKS

### A. Financial System Structure

7. **The financial sector is relatively small and bank-dominated.** Financial system assets reached 71 percent of GDP in mid-2009 (Table 4), fairly low compared to others in the region (Figure 2). This is partly due to the authorities' approach to tighten prudential regulations and impose high RRs to help curb credit growth.<sup>1</sup> The nonbank financial institutions (NBFIs), dominated by foreign-owned leasing and insurance companies, have been growing apace in terms of both number and assets, but continue to hold only 11 percent of the financial sector's total assets. Most leasing companies are owned by foreign-owned banks; the NBS also tightened supervision over NBFIs during the credit boom.

**Figure 2. Banking Sector Indicators, 2008**



Sources: NBS; and IMF.

8. **Over the past few years, state ownership of the banking sector has diminished, while foreign-owned banks have increased their dominance.** Through privatization, the share of state-owned banks has declined to 15 percent of total assets in mid-2009. Privatization of banks has brought foreign ownership to almost 75 percent of the banking

<sup>1</sup> RRs are differentiated between dinar and FX liabilities. The RR is 10 percent on dinar liabilities and 5 percent on savings deposits. The RR is 45 percent on the bank's FX borrowing and on corporate deposits, and 40 percent on household FX deposits. Further gradations apply, and exemptions are granted, for example the RR has been lifted temporarily on new FX external borrowing from September 2008.

system, with subsidiaries of Austrian (27 percent of system assets), Greek (16 percent), and Italian banks (15.4 percent) having the largest share.

## B. Banking System Assets and Liabilities

### 9. Banks in Serbia engage in the traditional banking activities of accepting deposits and offering loans, in a highly Euroized environment.

Loans constitute close to 60 percent of assets (Table 5); three-quarters of loans are FX-linked. Banks also hold around a quarter of their assets in the form of cash or as RRs. Holdings of T-Bills and NBS repos have risen since end-2008, as banks prefer to place their funds in safe assets in the current environment. Over half of the loans are granted to enterprises, and about a third of loans go to households, with 16 percent of total loans in mortgages. In terms of economic activity, the industry and trade sectors receive the largest share of loans, at almost 20 percent each.

**Table 5. Asset Structure**  
(In percent of total assets)

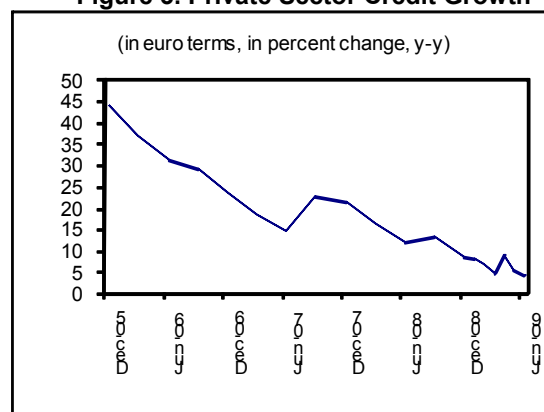
	Dec-07	Dec-08	Jun-09
Cash and RR	24.0	25.9	24.0
T bills and NBS repo	14.1	5.2	7.6
Loans	54.9	60.1	59.4
Other	7.1	8.8	9.0

Source: NBS.

10. **Banks' loan portfolio growth has slowed sharply.** The growth of credit to the private sector has declined (in euro terms) but remained positive through the first half of 2009 (Figure 3).

11. **Guarantees provided by subsidiaries for these cross-border loans form a significant part of off-balance sheet items.** Off-balance sheet items subject to credit risk represent about half of the total balance sheet assets, and are subject to the same risk classification and provisioning rules as on-balance sheet. Off-balance sheet contingent liabilities, totaling about €7.6 billion at end-2008, are concentrated in foreign-owned banks. They consist mainly of (a) guarantees provided by subsidiaries (€4.8 billion, or almost half of cross-border lending); and (b) unutilized credit line commitments. New guarantees have almost stopped since the crisis began.<sup>2</sup>

**Figure 3. Private Sector Credit Growth**



Source: NBS.

<sup>2</sup> The half of off-balance sheet items *not* subject to credit risk records items such as the foreign currency savings bonds, a legacy from past crises for which the banks act as custodians, and collateral pledged by borrowers.

**Table 4. Financial Sector Structure, 2005-09**

	2005			2006			2007			2008			2009-H1		
	Assets			Assets			Assets			Assets			Assets		
	No.	RSD billion	percent of total	No.	RSD billion	percent of total	No.	RSD billion	percent of total	No.	RSD billion	percent of total	No.	RSD billion	percent of total
Financial sector	73	874	100	70	1,293	100	80	1,733	100	85	1,989	100	86	2,083	100
(Percent of GDP at market prices)		52			65			73			73			71	
Banking system:	40	775	89	37	1,169	90	36	1,564	90	34	1,777	89	35	1,860	89
State-owned banks	11	185	21	8	174	13	8	246	14	8	284	14	9	377	18
Local private banks	12	78	9	7	76	6	6	136	8	6	154	8	6	101	5
Foreign-owned banks	17	512	59	22	920	71	22	1,181	68	20	1,339	67	20	1,382	66
Nonbank financial institutions:	33	98	11	33	124	10	44	169	10	51	212	11	51	223	11
Leasing companies	14	52	6	15	68	5	17	95	6	17	123	6	17	120	6
Pension funds	0	0	0	1	0	0	7	3	0	10	5	0	10	6	0
Insurance companies	19	46	5	17	56	4	20	71	4	24	85	4	24	97	5
Memorandum item:															
Domestic government debt/GDP			23			18			14			12			
Stock market capitalization 1/		389	23		658	33		1,292	55		765	27		748	25

Sources: Data provided by the Serbian authorities.

1/ Expressed in RSD billion and in percent of GDP, respectively across the columns.

12. **The banks' funding structure has been quite stable.** Deposits account for 60 percent of total liabilities, of which 69 percent are in FX. External liabilities constitute about 20 percent of total liabilities, through borrowing and deposits. Banks rely less heavily on external funding than their regional peers. External borrowing is somewhat longer term in nature (over one year maturity) than deposits. Interbank funding is minimal.

### C. Performance of the Corporate and Household Sectors

13. **The corporate sector's financial condition has deteriorated (Table 6).**<sup>3</sup> Industrial activity has decelerated, and companies registered considerable losses in 2008. Manufacturing showed the worst results and lowest debt service capacity ratios, while the financial sector was the most profitable. These financial difficulties facing the corporate sector are most likely still ongoing and may lead to a further increase in NPLs.

14. **Besides the high FX borrowing from domestic banks, the external debt of corporate clients is high.** Corporate loans contracted directly from international banks and capital markets have reached 36 percent of GDP. This exposes the corporate sector to significant FX risk, particularly given the lack of natural or other hedges and large net open positions. In addition, the weakness of the local currency has increased corporate indebtedness and decreased their capacity to service debt to the local banking sector.

**Table 6. Corporate Sector's Financial Indicators, 2006-08**

(in percent unless indicated otherwise)

	2006		2007		2008		
	Overall	Overall	Overall	Small	Medium	Large	
Sales growth	29.1	20.6	18.7	...	...	...	
Profit margin	2.4	1.0	-0.2	2.4	0.2	-1.5	
ROE (after tax)	3.8	1.5	-1.0	9.6	-0.2	-2.8	
Current ratio (times)	1.0	1.0	1.0	...	...	...	
Acid-test ratio (times)	0.7	0.7	0.7	...	...	...	
Equity to Debt	1.0	0.9	0.7	0.4	0.6	0.9	
Liabilities to assets	51.1	52.8	58.1	...	...	...	
Current liabilities to total liabilities	0.7	0.7	0.7	0.8	0.7	0.6	
Interest Coverage Ratio	2.7	1.7	0.9	4.0	1.2	0.2	

Source: NBS.

Note: Large companies mostly comprise publicly owned companies

15. **Unemployment and dinar depreciation have weakened households' balance sheets.** Most household loans are indexed to FX and are largely to unhedged borrowers and (Table 7). The household exposure to FX risk is partly mitigated by the high level of FX deposits and remittances, although FX depositors are not necessarily the same as FX borrowers. However, Serbian households still have a relatively low debt service burden compared with other countries in Central, Eastern, and Southeastern Europe (CESE).

<sup>3</sup> There are currently around 90,000 companies operating in Serbia, of which 925 are large (defined as >250 employees and > euros 10 million turnover), 3,520 are medium-sized, and 85,389 are small enterprises.

Furthermore, households reportedly hold a positive financial net worth in the form of deposits, investments, and assets held with life insurance and voluntary pension funds. With respect to housing markets, loan-to-value ratios have remained stable and no significant price drops were observed through mid 2009.

**Table 7: Household Sector's Financial Ratios, 2005-09**

	(in percent)					
	2005	2006	2007	2008	2008 H1	2009 H1
FX-linked loans to total loans	...	80.1	81.5	79.6	79.4	79.0
FX-deposits to total deposits	92.0	90.7	91.0	90.6	91.5	91.5
FX-deposits to FX- and FX- indexed loans	...	177.8	172.6	143.1	176.2	158.4
Loan-to-value ratio for mortgage loans	60.6	61.6	64.9	65.4	65.4	65.3
Short-term loans to total household loans	17.7	19.6	15.0	11.6	16.2	12.1

Source: NBS.

#### D. Banking Sector Performance

16. **The banking sector remains highly capitalized (Table 8).** The CAR for the entire banking system is 21 percent, among the highest in the region, and all banks maintain a CAR above the 12 percent prescribed minimum (Figure 4). The additional capital buffers largely reflect the impact of prudential regulations, which aimed to slow credit growth in the pre-crisis period.<sup>4</sup> Similarly, the leverage ratio (total equity/total assets) stands at a comfortable 23 percent, driven mostly by paid-in capital and reserves.

17. **However, increasing NPLs, mainly in the corporate sector, are a source of concern.** The asset quality of the banking sector has worsened markedly in 2009. The NPL ratio reached 16½ percent in June 2009, up from 11.3 percent at end-2008, due to the macroeconomic deterioration and exchange rate depreciation. The NPLs were concentrated mostly in the manufacturing, trade, and real estate sectors. NPLs at the four majority state-owned banks and at private domestic banks (only one of which has market share above 1 percent) are significantly higher.

18. **The banking system is liquid, and has withstood a significant deposit withdrawal.** Liquid assets accounted for a comfortable 42 percent of total assets, and covered 67 percent of short-term liabilities. The system withstood an 18 percent withdrawal of household deposits from mainly foreign-owned banks without the need for NBS support, as parent banks provided liquidity to their subsidiaries. Also, the NBS can release large amounts of liquidity if needed by reducing RRs. The loan-to-deposit ratio declined from 104 percent in 2008 to 100 percent in June 2009, reflecting tighter lending conditions (both higher policy rates and lower supply). There is little interbank activity, and the few transactions that take place would not lead to contagion risk.

19. **Direct exposure to FX and interest rate risks is low, but indirect exposure is high.** The overall net open position accounts for 4.4 percent of Tier I capital as of June 2009, and

<sup>4</sup> For example, a limit on retail lending of 150 percent of Tier I capital was in place, and a 125 percent risk weight on unhedged FX loans.



since the banks mostly held long positions in 2009, they gained from dinar depreciation. The sensitivity of the banking sector to interest rates through net interest margins and duration impacts also appears under control given the duration match between assets and liabilities. However, indirect risk through unhedged FX borrowing by both households and the corporate sector is high, as discussed above (see Section II.C).

20. **Profitability of the Serbian banking system, which is low for the CESE region, exhibited a worrisome drop in 2009.** Historically, low profitability reflects high capital and RRs. Net income halved in 2009 due to large loan losses. As a result, return on equity (ROE) dropped to 4.1 percent (annualized) from 9.3 percent in 2008. Net interest margin remains the main source of banks' profits, and has been relatively stable with respect to total loans despite the stiff competition for deposit market share. Of particular concern is the fact that some 13 banks (with a total of 16 percent market share) are generating significant losses.

#### **E. Overall Assessment and Potential Vulnerabilities of the Banking Sector**

21. **In the run-up to the crisis, the authorities' measures to curb credit growth have had both beneficial and detrimental effects.** They have created capital and liquidity buffers which are helping to keep the financial system resilient. However, the combined effect of these policies has been detrimental to financial system development, including (a) circumvention through direct borrowing abroad (at lower interest cost to corporates); (b) high costs for the banks because of the RRs; and (c) a complex regulatory framework that leaves significant room for discretion (see Section III). These have contributed to the low profitability of Serbian banks relative to other countries in the region.

22. **Although banks have proven resilient, which is confirmed in stress tests, their main challenge will be to withstand a possible further deterioration of the economic environment.** Key risks stem from a prolonged recession, and indirect effects on credit risk due to corporate and household unhedged FX exposures. This diagnosis is validated by stress test results, discussed below—banks can withstand severe shocks within a one-year horizon. However, if sufficient profitability cannot be restored over the medium-term, capital buffers would be eroded. International initiatives to strengthen capital and other requirements could further impair bank profitability if growth opportunities remain subdued. With the global and regional recovery still not assured, further macroeconomic shocks are not implausible. External financing to banks may be curtailed (though this risk is somewhat mitigated by the FSSP), and fiscal policy uncertainty within Serbia itself could also impact financial stability. Such a severe scenario would operate mainly through a loss of confidence, either domestically or through regional contagion, resulting in higher spreads and strong pressure on the dinar.

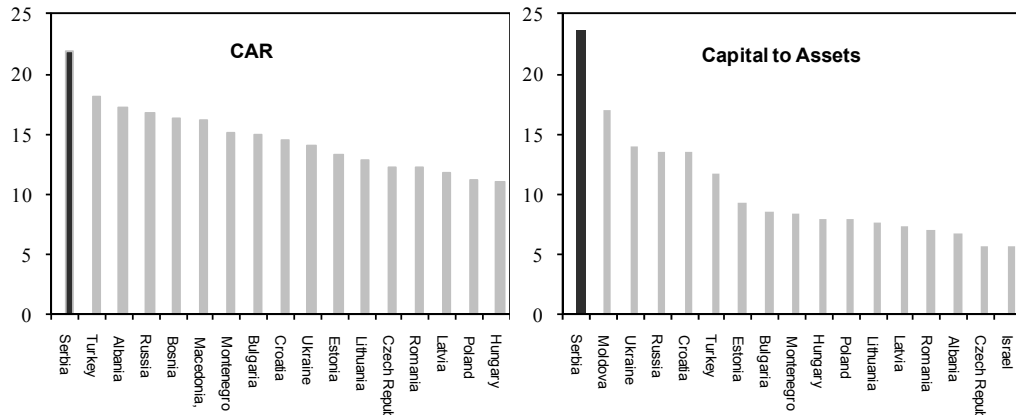
23. **The corporate debt restructuring process needs strengthening, so that NPLs do not become a long-term burden on banks' balance sheets.** Current mechanisms, such as temporary loosening of provisioning for certain restructured loans, are insufficient; further measures to strengthen insolvency and enforcement mechanisms are proposed below (see Section V.B).

24. **De-Euroization over the medium-term would be desirable.** Euroization has been a key source of vulnerability for borrowers and the banking system. Also, with balance sheets so euroized, the NBS' ability to affect incentives through dinar interest rate signals is much reduced, significantly impairing the monetary transmission mechanism. While successful de-Euroization will take many years, it is desirable from the viewpoint of both increasing the efficacy of monetary policy and strengthening the banking system. Even within the context of Serbia's intention to eventually join the Euro area, de-Euroization is an appropriate systemic risk management policy over the medium term. Key elements of a de-Euroization strategy would include sound macroeconomic policies, as well as incentives to encourage the Dinarization of banks' assets. In this context, the considered cut in reserve requirements should be accompanied by measures aimed at making dinar lending operations more appealing. These could include for example, schemes to induce conversion of FX loans to dinar loans, and/or remuneration of RRs in dinars. Even some degree of de-euroization would give the NBS some room for maneuver; the aim is not complete elimination of euroization.

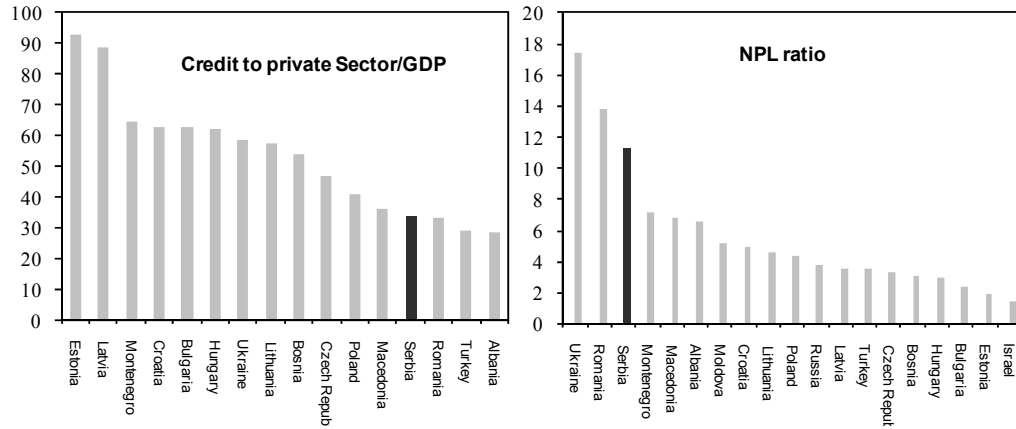
25. **Small banks' financial condition needs to be addressed.** In particular, the authorities should ensure that the capital of majority state-owned banks is sufficiently strengthened before divestment (whether the plans involve mergers or not); and that risk management at private domestic banks is enhanced. The National Mortgage Insurance Corporation should be adequately capitalized and its financial status monitored (see Para. 64).

**Figure 4. Comparative Financial Soundness Indicators, 2008**

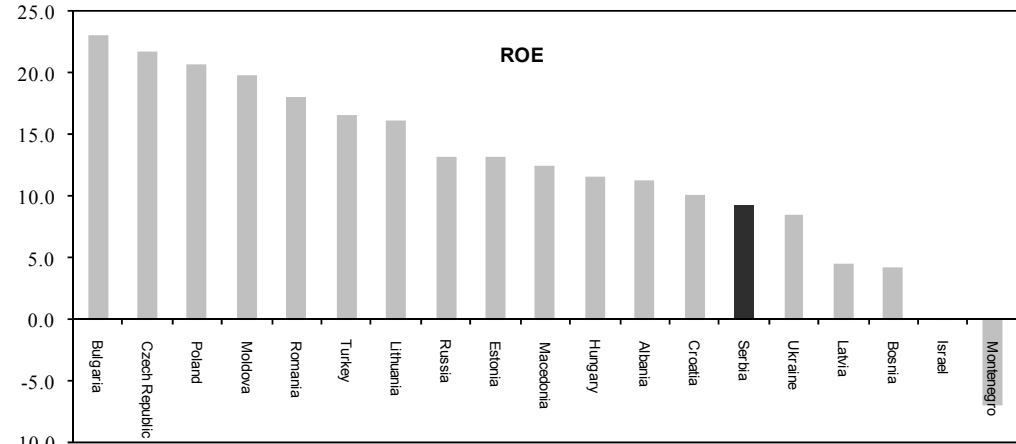
*The banking sector is highly capitalized with above average CARs and leverage ratios...*



*However, bank intermediation is still low by regional comparisons while the NPL ratio is significant and rising ...*



*While significant capital buffers exist, profitability as exhibited by ROE is low by regional standards...*



Source: NBS and GFSR

**Table 8. Financial Soundness Indicators, 2005-09**

(In percent unless otherwise indicated)

	2005	2006	2007	2008	2009-H1
<b>Capital Adequacy</b>					
Regulatory capital to risk-weighted assets	26.0	24.7	27.9	21.9	21.2
Regulatory Tier I capital to risk-weighted assets	22.2	24.2	28.5	22.8	23.7
Capital to assets	16.2	18.5	21.0	23.6	23.3
<b>Asset Composition and Quality</b>					
<i>Sectoral distribution of loans to total loans</i>					
Agriculture	...	...	100.0	100.0	100.0
Industry	...	...	...	3.0	2.9
Trade	...	...	...	17.2	18.0
Construction	...	...	...	17.2	18.5
Other	...	...	...	5.9	5.9
Households	...	...	35.1	32.7	33.4
<i>Of which: Mortgage loans</i>	...	...	10.4	15.0	15.6
Other	...	...	64.9	15.3	10.6
Gross non-performing loans to total loans	...	...	...	11.3	16.5
Specific Provisions to Gross Non Performing Loans	...	...	...	56.9	46.6
Non Performing Loans net of provisions to Tier I capital	...	...	...	14.8	27.1
Loans to shareholders and parent companies to total loans	...	...	2.1	2.2	2.2
Large exposures to Tier I capital	82.5	49.6	46.1	36.6	40.7
Specific Provisions to gross loans	10.3	11.0	8.4	7.1	9.4
<b>Profitability</b>					
Return on Average Assets (ROAA)	1.1	1.7	1.7	2.1	1.0
Return on Average Equity (ROAE)	6.5	9.7	8.5	9.3	4.1
Net interest Margin to gross operating income 1/	...	...	...	...	61.8
Non-interest expenses to gross operating income 1/	...	...	...	...	88.9
Non-interest expenses to average assets	...	...	...	...	7.7
Personnel expenses to non-interest expenses	...	...	...	...	27.7
<b>Liquidity</b>					
Core Liquid assets to total assets 3/	30.5	40.7	37.3	30.3	30.3
Core Liquid assets to short-term liabilities	47.1	69.0	58.9	48.0	47.9
Liquid assets to total assets 4/	19.8	22.9	46.7	43.3	41.8
Liquid assets to short term liabilities	30.6	38.8	73.7	68.6	66.0
FX- denominated loans to total loans	19.0	15.2	15.7	11.8	9.1
FX- indexed loans to total loans	...	...	...	66.2	71.6
FX- deposits to total deposits	70.7	65.9	64.2	69.0	70.1
FX- liabilities to total liabilities	74.7	72.4	67.8	72.1	82.0
Deposits to assets	62.5	57.0	61.4	57.7	59.2
Loans to deposits	94.9	86.7	89.3	104.3	100.3
FX- loans to FX-deposits (including indexed)	...	...	...	113.3	110.7
<b>Sensitivity to Market Risk</b>					
Net open FX position (overall) as percent of Tier I capital	18.6	21.7	14.5	7.4	4.4
Off-balance sheet operations as percent of assets 5/	26.4	41.0	49.2	56.2	49.1

Source: NBS.

1/ Gross operating income in this ratio excludes FX gains due to their volatility and distortionary impact.

2/ Similarly, non-interest expenses in the calculation of this ratio abstracts from FX losses.

3/ Cash, repo and mandatory reserve.

4/ Sum of first- and second-degree liquid receivables of the bank (article 11 of Decision of Liquidity Risk Management).

5/ Includes only risk-classified off-balance sheet items.

## Stress Tests<sup>5</sup>

26. **The stress tests covered the fifteen largest banks and one small state-owned bank, accounting for 84 percent of the banking sector’s assets.** They are grouped into four categories, namely (a) local private banks; (b) foreign banks; (c) state-owned banks; and (d) the consolidated banking sector. The tests covered market, credit (including off-balance sheet), and liquidity risks with single and multi-factor shocks. The shocks were calibrated based on Serbia’s historical experience, as well as cross-country evidence of banking crises.

27. **Two adverse scenarios were simulated, aimed at capturing the key macroeconomic channels of stress identified above**—the exchange rate and output gap (see para. 21). The most severe scenario involved a further widening of the output gap by 6½ percentage points, a 25 percent depreciation of the exchange rate, and an 8 percentage point increase in interest rates, over a one-year horizon.

28. **Results suggest that Serbian banks could largely withstand severe macro shocks thanks to high capital buffers, with credit risk showing the most significant impact (Table 9).** In the most severe scenario, an increase in system NPLs of an additional 13½ percentage points did not result in severe undercapitalization in the large banks. Some banks fell below the minimum required CAR of 12 percent after the shocks, but most stayed above 8 percent.<sup>6</sup> The recapitalization needed to restore the CAR to the minimum 12 percent did not exceed 1.2 percent of GDP in the most severe scenario (excluding net profit buffers). The main contributor to the increase in the NPL ratio was from CICR. The results were similar across peer groups.

29. **With respect to market risks, the direct impact of interest rate shocks appears limited, while that of FX shocks is significant through valuation effects.** The limited direct impact of interest rate shocks is due to banks’ adequate asset-liability management and the marginal share of the trading portfolio in banks’ balance sheets. Most loans carry floating rates and reprice in tandem with short-term deposits. The significant direct impact on CARs operates through FX asset revaluation, reflect the large share of FX loans in banks’ balance sheets and the high risk weights on unhedged FX loans (125 percent); even without higher NPLs, a depreciation increases risk-weighted assets appreciably.

30. **The liquidity test results showed that banks appear resilient thanks to high liquidity buffers, which are partly due to high reserve requirements.** Two separate liquidity shocks were tested, including (i) significant deposit withdrawals and (ii) a pullback in parent bank funding (loans, deposits, and subordinated debt) with maturity of less than one year. In both cases, no bank became illiquid following the shocks.

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<sup>5</sup> The credit risk stress test methodology was broadly consistent with the FSSP component of the Fund program and the regional CESE stress testing exercise. It differs in the treatment of profit buffers (included only in macro scenarios) and the revaluation effect on FX risk-weighted assets.

<sup>6</sup> One state-owned bank, which is already incurring losses and is in the process of restructuring, exhausts its capital in the most severe scenario. Reportedly, a strategic partner has been identified to acquire the bank.

31. **The NBS has made significant strides in its stress-testing and modeling capacities.** The current macro-financial models linking probabilities of default (PDs) of the corporate and household sectors to macroeconomic variables are steps in the right direction, but are hampered by short data series.

### III. BANKING SUPERVISION: REGULATORY FRAMEWORK AND CHALLENGES

#### A. Regulatory Changes and Supervisory Policy

32. **Following the previous FSAP, the Serbian authorities have undertaken a major effort to upgrade the legal framework for banking supervision.** The 2005 Law on Banks (LOB) envisaged harmonization of the legal framework with international standards, EU Directives and Basel Core Principles on Banking Supervision (BCP). For instance, the LOB introduced a two-step licensing procedure, a lowering of the bottom threshold for obtaining prior regulatory approval for acquiring direct or indirect ownership in banks, and the establishment of consolidated supervision. Furthermore, the NBS also enhanced the risk management standards in the banking sector by issuing various regulations.

33. **The NBS intensified cooperation with overseas supervisors, particularly in response to the current crisis.** The NBS initiated discussions with the home country supervisors of parent banks, requesting information on supervisory actions and financial positions. It has also participated in a number of supervisory colleges and undertaken joint inspections with supervisors from foreign agencies.

34. **A relatively strict supervisory policy has helped the banking sector to withstand the financial crisis.** Substantial solvency buffers have served Serbia well in mitigating the impact of the recent financial turmoil. In addition, the NBS has applied risk weights that, for some asset categories, are conservative, compared to other countries in the region (Table 10).

**Table 9. Serbia: Summary Table for Stress Tests**

(Based on June 2009 data)

	Number of banks 1/			State-owned banks		Local Private banks		Foreign banks		Total system		Recapitalization needs 2/	
	CAR <0	CAR 0-8%	CAR 8-12%	CAR	change (%)	CAR	change (%)	CAR	change (%)	CAR	change (%)	in RSD billions	in % of GDP
<b>A. Baseline (before shocks)</b>	0	0	0	21.4		27.9		20.4		21.2		0.0	0.0
<b>B. Single Risk</b>													
<b>Credit Risk</b>													
Increase in NPLs (Step-wise migration of loan portfolio) 3/	0	1	3	17.6	-3.9	26.7	-1.3	17.4	-3.0	18.2	-2.9	5.0	0.2
Increase in NPLs (Step-wise migration of loan portfolio) 4/	1	1	4	14.2	-7.2	24.5	-3.4	15.3	-5.1	15.9	-5.2	20.6	0.7
<b>Market Risk</b>													
<b>Exchange Rate Risk</b>													
Direct Impact of RSD depreciation on Net Open Position and RWA (12%)	0	0	0	20.6	-0.8	27.3	-0.6	18.7	-1.7	19.6	-1.6	0.0	0.0
Direct Impact of RSD depreciation on Net Open Position and RWA (25%)	0	0	1	19.1	-2.3	25.5	-2.4	17.0	-3.4	17.9	-3.2	0.3	0.0
<b>C. Multi-factor scenario 5/</b>													
Scenario 1 6/	1	0	0	18.8	-2.7	33.1	5.2	18.3	-2.1	19.6	-1.5	1.0	0.0
Scenario 2 7/	1	1	5	14.9	-6.5	30.4	2.5	15.3	-5.1	16.5	-4.6	10.7	0.4

1/ Of the sixteen individual banks subject to the stress tests, number of banks that fall below minimum requirements.

2/ Total Recapitalization need to restore the CAR of the banks covered by the stress tests to 12 percent.

3/ Increase in NPLs using the Fund program adverse scenario as of May 2009: increase in output gap (6.5%), RSD depreciation (12%) and increase of interest rates (0.1%). Migration of loan portfolio is from performing asset classes (A, B, and C) to non performing (D and E).

4/ Increase in NPLs using a crisis scenario: increase in output gap (6.5%), RSD depreciation (25%) and increase of interest rates (8%). Migration of loan portfolio as in footnote 2.

5/ Multi-factor scenarios take into account profit buffers. Without such buffers, more banks would become undercapitalized and the recapitalization need would be 1.2 percent of GDP.

6/ Combined impact of credit and market risks based on the program adverse scenario as of May 2009, see footnote 3.

7/ Combined impact of credit and market risks based on a crisis scenario, see footnote 4.

**Table 10. Regional Comparison of Capital Adequacy Requirements**

	Bulgaria	Czech Republic	Romania	Croatia 1/	Serbia
Minimum CAR	12%	8%	10%	10%	12%
Risk weights for selected asset categories	Standardized approach Basel II				
Corporate	20% (AAA to AA-) to 150% (below B-)			100%, unless secured by residential property and/or forex denominated	100%, unless secured by residential property and/or FX denominated
Sovereign	0% (AAA to AA-) to 150% (below B-)			0% (OECD and Serbia) to 100% (other)	0% (OECD and Serbia) to 100% (other)
Bank	20% (AAA to AA-) to 150% (below B-)			20% on domestic banks and foreign banks with "adequate creditworthiness"	20% (BBB and up) to 50% (< BBB)
Retail	75% (CZ, RO) – 100% (BG)			100% unless secured by deposits or pledged property	100%, unless secured by residential property and/or FX denominated
Claims secured by residential property	35% (CZ, RO) – 50% (BG)			50% if fully secured by mortgage or property	50% (dinar or hedged) or 75% (unhedged FX position)
Unsecured foreign currency loans	No specific risk weights for foreign currency loans			Foreign exchange risk captured in denominator of CAR	125% for borrowers with unmatched foreign currency position

Sources: BNB; CNB; CNB; BNR; and NBS.

1/ CAR in Croatia is expressed as capital/ (risk-weighted assets + foreign currency exposure).

35. **The loan classification criteria are stricter than, but not out of line with, those in some other countries in the region.** While Serbian regulation seems to be on the stricter side, some of the other countries surveyed have a more preemptive regime (Table 11). In addition to the criterion of timeliness of repayment, all countries allow classification of loans on the basis of qualitative judgment. For instance, loans can be classified on the basis of the deteriorated financial status of the borrower, even when the borrower is honoring its obligations on time. Similarly, all countries have so-called contamination clauses that affect delinquent borrowers with multiple loans. When one of the loans is classified, the other loans are automatically given a similar classification. Unlike most other countries, Serbia applies a range of possible provisioning levels for each past-due category, with the top of the range among the more conservative within the region.

## B. Supervisory Challenges

36. **Despite an upgraded regulatory framework and improved supervisory practices, a number of important challenges remain.** These include (a) streamlining the framework for loan classification and provisioning; (b) clearing the existing legal impediments so as to facilitate the formalization of cooperation agreements with a number of significant home supervisors; and (c) strengthening further the capacity of the BSD. Over the medium-term, the framework will need continued upgrading to keep up with the challenges of an increasingly complex financial system.



**Table 11. Regional Comparison of Loan Classification Rules**

	Bulgaria	Croatia	Czech Republic	Romania	Serbia
Classification Categories	Standard Watch Nonperforming Loss	A B-1 B-2 B-3 C	Standard Watch Substandard Doubtful Loss	Standard Watch Substandard Doubtful Loss	Standard Watch Substandard Doubtful Loss
Days past-due and provisioning levels					
0 – 15 days	0%	Provisioning in	0%	0%	1 – 2%
16 – 30 days		accordance with	1%	5%	
31 – 60 days	10%	identified	20%	20%	5 – 10%
61 – 90 days		losses	50%	50%	20 – 35%
91 – 180 days	50%		100%	100%	40 – 75%
180 – 360 days	100%				100%
> 361 days					
Loan classification possible on the basis of deteriorated financial status	Possible for all classification categories	Possible for all classification categories	Only possible if repayment capacity is seriously affected (doubtful, loss)	Possible for all classification categories	Possible for all classification categories
Contamination clauses	Yes	Yes	Yes	Yes	Yes 1/

Sources: BNB; CNB; CNB; BNR; and NBS.

1/ Other loans may be given a more favorable classification than the delinquent loan on the basis of the quality of the collateral.

37. **The mission recommends that the NBS consider defining a more precise set of loan classification criteria.** The current loan classification system and the criteria appear to be comprehensive and prudent, but also rather complex. One particular weakness is that they leave too much room for judgment in loan classification. Discussions with banks and NBS staff indicated fundamental differences in classification standards and approaches.<sup>7</sup> Moreover, by setting rather broad brackets for provisioning over each class of exposures, the present regime additionally broadens the scope for a divergent interpretation of the global risk provisioning framework. It is recommended that a more clear-cut classification framework be established for days past-due and provisioning levels, taking into account the needs of both supervisors and banks with respect to prudence, clarity, and transparency. In the same vein, the NBS could consider whether it is still justified in both requiring exposures in foreign currency to be automatically downgraded and simultaneously charging them with a higher weight for CAR purposes. Moreover, in the event of loan restructurings, which are duly followed up on, the requirement to automatically downgrade these loans without taking other considerations into account could be revisited.<sup>8</sup>

<sup>7</sup> In one particular example, the NBS and the bank had diverging interpretations on 1/3 of the loan portfolio, with some of the differences being quite extreme. For example, the bank and the supervisors had a fundamentally different view on the financial situation of a borrower, which led the supervisor to downgrade the loan from the “Standard” to the “Loss” category.

<sup>8</sup> This recommendation is with respect to loan restructurings under the normal supervisory regime, not the temporary special measures to combat the crisis.

38. **The NBS is fruitfully cooperating with foreign supervisors in supervising local subsidiaries that are part of international groups, but has had limited success in entering into formal MOUs with some of the critical EU home supervisors due to legal barriers.** In practice, international cooperation in ongoing supervision seems to work quite well, such as through the participation of the NBS in supervisory colleges, the practice of joint inspections, and multilateral MOU agreements. Experience with a parent bank presenting its financial situation and strategy to a college has been shown to be very useful for host supervisors. However, the NBS obligation to share banks' information with the Serbian tax authority, which raises confidentiality concerns on the part of the home supervisors, has suspended the finalization of MOUs with France, Austria, and Germany, which for Serbia are three important home supervisors. It is recommended that the Serbian authorities solve this issue swiftly so as to facilitate the formalization of its cooperation agreements with these three supervisors.

39. **The mission recommends that the NBS give priority to capacity building for the BSD, both in quantitative and in qualitative terms.** The current staffing and budgeting for the BSD appear to be adequate, but some specific competences are still lacking. For instance, there are currently too few portfolio managers (coordinating all supervisory activity over a group of banks), information technology auditors, and sufficiently experienced team leaders over inspection teams. Moreover, the recent crisis has stretched the resources of the onsite examiners. The capacity of the NBS to attract and retain qualified staff not only depends critically on the competitiveness of its remuneration regime but also on the career prospects that it can offer to its staff.

#### IV. SYSTEMIC RISK MITIGATION ARRANGEMENTS

##### A. Liquidity Framework Arrangements

40. **Serbia has staged remarkable progress in monetary management since the 2005 FSAP mission.** The decision to move towards inflation targeting (IT), the related streamlining of its monetary policy implementation framework, and the related reforms in the money and FX markets have strengthened the NBS's monetary policy-making. Still, the high level of Euroization represents a challenge to the NBS.

41. **The NBS RRs on FX liabilities are high and should be re-assessed in the current environment of weak asset growth and low bank profitability.** Although this instrument has served the NBS well in the past, it is a blunt tool and has also brought about some negative side effects. Lowering RRs would reduce banks' FX funding costs and allow them to decrease lending rates or raise returns to savers, and thus could complement the recent monetary easing. However, any reduction in RRs would need to be planned carefully, as the liquidity released could complicate the achievement of monetary policy objectives.

42. **Monetary policy implementation has been successfully streamlined since the introduction of IT, but the NBS liquidity management framework can be further improved.** The creation of an interest rate corridor has strengthened the signaling role of the repo rate, and the dinar RR framework has been adjusted to smooth out further daily BEONIA rate developments. One key remaining concern is the dual role of the 2-week repo,

which is used to both signal the stance of monetary policy and act *de facto* as a standing facility. This duality is posing a challenge, as the rapidly increasing cost of sterilization may over time come into conflict with the monetary policy signaling role of this instrument.

43. **Alternative approaches toward structural liquidity draining operations based on Treasury securities could usefully leverage the ongoing development of the T-Bills market.** Higher T-Bill issuance and the creation of a liquid secondary market would serve the structural liquidity needs of the NBS, and give it more options to manage liquidity actively. The NBS could contemplate a set of liquidity draining options that would help to diversify its instruments and scale down the NBS repo operations.<sup>9</sup> Less frequent NBS repo auctions (once a week instead of two), coupled with a single weekly auction of T-bills, would create greater incentives for interbank operations.

44. **The recently introduced LOLR framework has helpfully broadened the range of collateral that banks can present to the NBS.** The framework could be strengthened further by (a) making sure that the margining policy (haircuts) is in line with the risk profile of the underlying instrument; (b) adjusting the collateral list on an ongoing basis, taking into account the depth of the underlying market; and (c) increasing the legal and institutional options available to the NBS to collect claims.

45. **LOLR operations should generally be carried out under a clear and public commitment of full backing of the central bank by the government.** LOLR operations can be credible only if the general public trusts that the financial soundness of the central bank is not put at risk. The capital of the NBS may not suffice to absorb the losses on the collateral seized in the event of a large-scale bankruptcy, and should be offset by a budgetary transfer to the equity of the NBS (automatic recapitalization), as necessary.

## **B. Crisis Management, Cooperation, and Coordination**

46. **In the aftermath of the crisis in October 2008, the authorities undertook urgent and adequate measures to enhance market confidence.** These included the signing of an MOU between the MOF, the NBS, and the DIA, to lay out a framework for coordinated decision making and a clarification of roles and responsibilities; an extension of the scope and level of insured deposit coverage; the introduction of a loan restructuring framework in the context of loan classification and provisioning rules; the enhancement of liquidity facilities, including LOLR facilities, and for banks participating in the FSSP, an extended dinar liquidity facility and an FX swap facility; a temporary amendment by the NBS to the risk management regulations to facilitate fulfillment of the regulatory compliance commitments; and the introduction of potential bank recapitalization measures based on the results of stress testing under the FSSP above, with the measures including identification of

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<sup>9</sup> Options could include secondary sales of T-bills by the NBS and increase issuance by the Treasury with retention of the related balances on its account with the NBS.

systemic banks that can apply for capital injection from the state (others would have to raise capital from existing owners or be liquidated).<sup>10</sup>

47. **The proposed Banking Stability Law (BSL) provides an adequate crisis management legal framework in case of systemic crisis.** The NBS and MOF are planning to replace some of the above-mentioned measures through the enactment of the BSL, which would allow (a) the NBS and the MOF to announce measures for enhanced deposit or liability coverage in banks, and (b) government financial assistance to be authorized by an extraordinary session of the Parliament. The Government of Serbia's (GOS) equity, acquired as a result of providing financial assistance to troubled banks, would be divested within a year. To enhance LOLR facilities available in normal times, the NBS would be able to request that the GOS issue a guarantee to solvent banks with insufficient collateral or to significantly undercapitalized systemic banks. The GOS guarantee would be given against bank collateral that includes mortgages, receivables, and acceptable securities. The BSL will also provide an exit from the enhanced emergency measures, once stability is restored.

48. **In addition to the proposed BSL, it would be useful to enter into crisis MOUs with other Home Country Supervisors to address any crisis-related burden sharing and supervisory issues.** In light of the size of foreign banks in the Serbian market, the authorities should enter into MOUs on crisis management at least with the home jurisdictions of the largest investors in the country, namely the Austrian, French, German, Greek, and Italian supervisory authorities. However, as noted above, signed MOUs for normal times are also not yet in place with most of these home country supervisory entities (Para. 35).

### C. Problem Bank Resolution

49. **The present problem bank resolution framework is inadequate in terms of the full set of legal tools to undertake bank resolution.** Under Article 117 of the LOB, the NBS can appoint receivers for an open bank, but bank restructuring actions without prior consent of depositors and creditors are not possible. The DIA is mandated by law to only undertake liquidation of a bank once its license has been revoked, and cannot be directly involved in an open bank restructuring.

50. **The separation of the resolution authority and responsibility between the NBS and the DIA is a pragmatic option under the circumstances.** To set up a framework for bank restructuring, several legal amendments are being proposed, aimed at giving the authorities maximum flexibility in dealing with problem banks. The overall responsibility for restructuring open banks will rest with the NBS, while liquidation of closed banks will stay with the DIA. Ideally, this function should be provided by a single agency, preferably by transforming the DIA into a fully fledged resolution entity with resources and powers to select a resolution method based on least cost principle. However, in countries with relatively small

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<sup>10</sup> Systemic banks were defined as banks that have a minimum of more than 2 percent of the total system assets, and 1 percent of retail deposits. Based on this definition, 19 banks out of 34 are deemed systemic. Nonsystemic banks, deemed viable by the NBS, could also benefit from public recapitalization but only up to 50 percent of the capital required.

banking sector, such as Serbia, it could be very costly to build up and maintain competence in dealing with problem banks in a separate agency. Furthermore, the NBS has much more capacity to deal with problem bank than the DIA. For these reasons, the proposed bank resolution method, dividing responsibilities between the NBS and the DIA, seems pragmatic. However, it puts a premium as the close coordination between these two agencies.

51. **For the purpose of restructuring problem banks, it is recommended that the NBS establish a specialized unit (a problem bank resolution unit) within the NBS.** To avoid conflicts of interest between the NBS roles in both bank supervision and bank restructuring, the bank resolution unit should report to the governor and not to the Head of the BSD. It would only be activated when there are problem banks to be resolved. Procedures should be developed in advance that would allow the unit to be quickly up and running. While the functions should be separated within the NBS, appropriate coordination and flow of information need to be in place between the BSD and the resolution unit. For instance, if a purchase and assumption transaction is being envisaged, the supervisory function should be involved to verify the financial soundness of the potential purchaser.

52. **The least-cost solution should be the guiding principle in bank restructuring.** If the restructuring of banks requires public funds, as a least cost option, these should come from the MOF, and contingency provisions should be in place to provide such funds quickly. There may be instances where the MOF, the DIA, and the NBS may agree that the restructuring of an open bank requires public financial assistance as the least-cost option (by law DIA funding cannot be used). In such cases, delays involved in going to the parliament for approval of government assistance may indeed lead to a further deterioration of the bank in the interim. To eliminate a delay in addressing eventual banking problems, the authorities are considering amending the law on public debt, permitting the government to issue bonds or borrow funds to pay for the cost of bank restructuring.

#### **D. Deposit Insurance**

53. **The funding reserves of the Deposit Insurance Fund (DIF), as a percentage of the total insured amount covered as of September 2009, appear adequate, and no premium increase seems warranted at this time.** As of October 2009, the total financial assets of the DIF stood at EUR 98.4 million, showing a healthy growth in reserves. The total amount of insured deposits as of end-2009 was EUR 5.4 billion, implying that the DIA has financial reserves amounting to 1.8 percent of its total exposure. This level of financial coverage is in line with similar figures in other European countries. However, the level of premium coverage going forward should also be assessed using risk weighting of different banks and their likelihood of need for DIF funds.

54. **The funding capacity of the DIF in case of a systemic crisis or failure of a systemic bank is limited, and contingent lines of credit with the government should be put in place.** As of October 2009, the DIF had sufficient financial resources to approximately cover the insured depositors of up to 20 of the smallest banks individually or the sum of the 9 smallest banks in the system. Although DIF Law explicitly recognizes the GOS's backing, no emergency funding arrangements have been set up. Limited funding coupled with no back-up funding reduces the effectiveness of the enhanced coverage and payout expectations.

55. **The present level of insured deposit coverage has the potential for moral hazard and excessive risk-taking by banks.** As a result of the latest coverage increase to EUR 50,000 and broadening the scope beyond household depositors, 99 percent of deposits of the whole banking system are covered by the DIF. Such high coverage may well encourage excessive risk taking by the banking sector, especially by the smaller banks. To enhance the credibility of the DIF coverage and mitigate against moral hazard, the scope of the coverage could be gradually narrowed to more appropriate levels when the financial system stabilizes, with care to maintain depositor confidence.

56. **The mission recommends that the authorities undertake a comprehensive review of the functions performed by the DIA and prepare a medium-term strategy for the DIA.** The DIA's functions include the administration of the DIF and the liquidation of insolvent banks. The DIA undertakes all the functions of the DIF, and is the designated liquidator/bankruptcy administrator for banks. However, DIF resources can only be used for insured deposit payouts and cannot be used to facilitate bank resolutions. In addition to performing DIF functions, the DIA has been tasked by the GOS to manage state-owned and socially-owned bank shares on behalf of the state, and to collect GOS debt in the context of the Paris-London club negotiations. The multiplicity of functions performed by the DIA can affect clear institutional focus and mandate. A medium-term strategy should be prepared for the DIA to ensure clarity and sustainability.

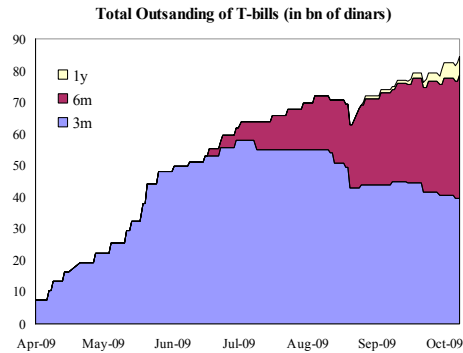
57. **The DIA has organizational limitations in effectively handling large scale payouts.** The DIA has not undertaken any insured depositor payoff since the DIF was created in 2005. Thus, development of detailed payout procedures, investment in adequate software, and information technology platforms for rapid deposit payout are still lagging. The introduction of legal amendments aimed at shortening the payout period has further emphasized the need for advanced institutional technical capability. The DIA should finalize and approve at the earliest its internal procedures.

58. **The DIA needs to develop the capacity to assess risks among the individual banks covered by the DIF.** To do so, it needs to employ actuarial tools to assess the adequacy of the premium charged and of DIF reserves commensurate with the risks. To be able to target the right size of the fund in normal times, the DIA should develop a risk assessment model of the banking sector, and use the information received from the NBS to monitor risk levels in the sector. Besides the size of the DIF, the DIA should also arrange with the GOS for a standby emergency line of credit that could be activated in times of crisis. This would be important in order to reduce the probability that the cost of rescuing a systemically important bank is carried by the central bank, and to allow the DIA to act quickly with the aim of reducing any adverse impact on the rest of the banking sector.

## V. OTHER ISSUES

### A. Government Securities Markets

59. **The MOF’s recent resumption of T-Bill issuance should continue, and issuance volume should gradually increase to promote the development of the secondary market.** Due to pressing budgetary needs, the volume of T-bills issued has increased steadily, and the average duration of the T-bills stock has also increased with the issuance of 6-month and one-year bills. A



Debt Management Office (DMO) is being set up within the MOF.

60. **Current issuance arrangements have served the treasury well, and achieve relatively stable funding conditions, but further improvements should be considered.**

The auction calendar should be streamlined. The reopening of an already issued line (assimilation through the use of an identical ISIN code for re-issued securities) should be used by the treasury, as it would facilitate the creation of benchmark series, via regular issuance on selected tenor issues to create high-liquidity issues. One weekly auction rather than three auctions would result in more concentrated auctions (less frequent but with larger volumes in each auction) and reduce the potential market power of largest participants, help reduce the risk of a “squeeze”, and allow lifting of the current 15 percent allotment limit for successful bids. A multiple rate allotment process would also facilitate more efficient price-discovery.

61. **The establishment of a comprehensive debt management strategy is important to the further development of the T-bill market.** The strategy would need to lay out how to raise the required amount of funding, achieve its risk and cost objectives (for example maturity profile, currency denomination), and at the same time help foster an efficient market for government securities. Serbia’s public debt is currently 93 percent FX-denominated. This legacy situation, inherited from the freezing of FX deposits, has placed a lasting constraint on debt management. For these reasons, the expansion of the dinar share of the public debt will have to be gradual.<sup>11</sup> The cash management of the MOF will also need to be strengthened to reduce reliance on short-term funds, to help reduce roll over risk and foster development of a yield curve.

62. **Pricing transparency and market-making commitments on the part of key intermediaries could promote the development of the secondary market.** Although the market may not be mature enough to contemplate the establishment of a formal Primary Dealership system, the DMO could contemplate various incentive structures to encourage banks to participate regularly in auctions and to commit to market-making on Treasury securities. This could be achieved by giving to participants that are the most active at auctions and/or in the secondary market, the right to purchase securities post-auction at the auction

<sup>11</sup> The authorities may wish to seek assistance in developing a comprehensive debt management strategy.

cut-off price (i.e., Noncompetitive Offers). The DMO should start studying such measures and consulting with market participants to assess which combination of incentives and obligations could be deemed acceptable and workable.

## **B. Corporate and Household Debt Restructuring Issues**

63. **Loan loss mitigation in Serbia is hampered by a still-evolving but uneven collateral and enforcement framework that complicates restructuring and leads to delays and lower recoveries in execution procedures.** Some collection mechanisms, such as the blocked account process, can even contribute to financial problems. Blockages of a company's current accounts (which have increased by 75 percent over the past year) immobilize corporate activity and lead to distorted corporate behavior. Other parts of the collateral and enforcement framework have been improved since the 2005 FSAP, including laws and systems governing security and mortgage foreclosure, but collective procedures for voluntary dissolution and court-supervised insolvency are costly, ineffective, and unreliable.

64. **Corporate debt restructuring mechanisms are insufficient to cope with increasing levels of corporate distress and NPLs.** The NBS's decision to relax provisioning rules to encourage debt rescheduling is an important step in the right direction. Banks can reschedule a borrower's debt and reclassify it as performing after six months, provided it is a first time rescheduling and the debtor is not delinquent for more than 30 days within a six-month period. Debt rescheduling alone is an impartial solution to the problem. Further incentives might be given to encourage companies to go through a restructuring or workout procedure, such as favorable tax treatment for debt forgiveness, debt equity swaps, access to priority financing, and accelerated approval.

65. **The mission recommends that (a) auction and execution procedures be streamlined further; and (b) an expanded and regulated profession of execution officers be introduced.** Enforcement and insolvency mechanisms are weak and should be strengthened. Currently, judicial enforcement, while improved, still takes too long, up to three years, to obtain and enforce a judgment on collateral. The current non-court auction procedures under the new mortgage law are improved but contain unnecessary restrictions that add little value and delay the process, such as the requirement for multiple auctions with minimum bids pegged to prescribed reduction amounts.

66. **Corporate insolvency mechanisms impose high costs on petitioning creditors, thereby discouraging access to the system, and fail to adequately protect a creditor's collateral rights in the event of bankruptcy.** The World Bank's Doing Business Report suggests that creditor recoveries in the insolvency process in Serbia are among the most costly and yield the lowest returns in the region. The amendments to the bankruptcy law passed in December 2009 should correct some of these problems, including an amendment to the effect that a petitioning creditor should not be obliged to finance the bankruptcy proceeding, which is too costly for a single creditor and discourages use of the system. The amendments to approve a prepackaged plan of reorganization could be further refined to improve its efficiency by excluding from the process creditors whose claims are not being affected or changed.



67. **The framework for household debt restructuring is much improved with respect to real estate and housing, but suffers from some of the same delays related to court execution of other types of assets.** Home loans are reasonably well protected by a modern mortgage law, a new cadastre, and relatively swift non-judicial foreclosure procedures. Transfer of data to the cadastre is mostly complete. Approximately 90 percent of the home loans are insured by the National Mortgage Insurance Corporation (NMIC), a state-owned company established in 2005. It is highly profitable and to date has sustained virtually no losses on payout claims. As yet, the NMIC is not adequately capitalized according to the legal requirements, but it hopes to achieve adequate capitalization within the next year, possibly by means of an initial public offering or partial privatization.

### C. Insurance Sector

68. **The insurance sector remains small and underdeveloped but well capitalized and is fully compliant with the solvency capital regulation (Table 12).** With the insurance consumption of €76 and €10 per capita, for non-life and life insurance, respectively, Serbia lags behind most of its neighbors in CESE. By mid-2009, there were 25 insurance companies, mostly privately owned, and the industry accounted for only 4.6 percent of total assets and 5.6 percent of the total capital of the financial sector. From 2005-09, the Solvency Ratio of the sector was close to 200 percent. The adequacy of the industry's surplus capital can also be gauged from the size of the Premium Leverage Ratio, which is 1.7-1.9 in the Serbian market, versus 2.5-3 internationally, demonstrating a rather healthy capital safety margin.

69. **The overall underwriting performance of the sector, as measured by the loss and combined ratios, has been satisfactory.** During the last few years, the quality of the industry's balance sheet has improved considerably, as can be seen from the growing share of highly liquid assets and declining share of receivables relative to total assets. The industry managed to keep its overall underwriting losses and expenses below the annual premium intake.

70. **The regulatory framework and its vigorous enforcement by the NBS contributed, to a large extent, to a robust insurance sector.** The Insurance Supervision Department currently employs 42 staff. The NBS strategic plan for 2006–09 envisages a progressive evolution from compliance-based to risk-based supervision. The NBS also introduced licensing requirements for insurance agents, improved market transparency, commenced proactive onsite and offsite market supervision, and created a consumer protection unit. It is also developing an “early warning system” to allow the NBS to intervene in companies' affairs before cases of financial or managerial weakness become irreversible.

**Table 12. Key Insurance Sector Performance Indicators, 2006-09**

<b>Ratios ( percent)</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Premium retention ratio (NPW/GPW)	92.0	92.0	92.0	88.0
Claims performance ratio (Outstanding/Total claims)	7.6	7.1	7.2	
Loss ratio	75.0	79.5	77.9	
Combined ratio	97.6	99.7	97.1	
Receivables ratio (Receivables/Total Assets)	14.3	12.7	11.8	
Liquidity Ratio (Cash and short-term investment/total assets)	36.3	39.3	39.1	
Market Solvency Margin Ratio % (Available Surplus Capital/Required Solvency I Capital)	206.0	211.0	173.0	186.0
Largest 5 companies	245.0	252.0	202.0	223.0
Smallest 5 companies	154.0	182.0	116.0	144.0
Non-life technical reserves ratio (Technical reserves/NPW)	66.1	72.8	78.1	

Source: NBS data, 2009.

71. **The mission recommends further strengthening of the insurance regulatory framework and the introduction of incentives to develop the insurance sector.** The NBS should start preparatory work for the early adoption of risk-based supervision envisaged under the Solvency II regime, which would allow the industry to realize a significant reduction in its risk. Three key issues to be addressed are:

- **Liberalization of the local reinsurance market.** It is important to review the current reinsurance requirements with a view to introducing a broader scope for competition among the local and international reinsurers in the Serbian insurance market.
- **Separation of life and non-life insurance.** Life insurance should be separated from non-life insurance, as the existing structure creates opportunities for management of insurance companies to use often sizeable life insurance reserves as a substitute for risk capital (in lieu of reinsurance), which creates the potential for systemic risk in the sector. Moreover, given the lack of real growth in the non-life insurance sector, it would be advisable, at least temporarily, to eliminate the 5 percent tax currently levied on non-life insurance premiums.
- **Development of life insurance.** To ensure a level playing field for all long-term savings products, life insurance should receive tax treatment similar to that allowed under the current pension legislation for individual contributions to a voluntary pension scheme.

#### **D. Anti-Money Laundering and Combating the Financing of Terrorism**

72. **Although the mission did not itself assess measures in relation to anti-money laundering and combating the financing of terrorism (AML/CFT), it is clear that Serbia is taking a number of steps to update its AML/CFT legal and institutional framework.** These include substantial changes to the criminal legislation (amendments to the money laundering offence, the criminalization of the terrorist financing offence, changes to the Criminal Procedure Code covering provisional measures and confiscation), and the adoption of new legislation regarding liability of legal entities, seizure and confiscation of proceeds from crime and mutual legal assistance. The Law on the prevention of money laundering and

the financing of terrorism, which sets out the scope and basic AML/CFT obligations for financial institutions and designated non financial businesses and professions (DNFBPs), entered into force on March 27, 2009. In accordance with the agreement between the IMF and MONEYVAL, and to avoid duplication, the findings of the AML/CFT mutual evaluation of Serbia conducted by MONEYVAL in May 2009, and adopted by MONEYVAL in December 2009, will be used for purposes of the FSAP Update. While welcoming the progress made by Serbia in developing its AML/CFT measures, the report recommends a range of further steps to expand the scope of the measures in place and improve the effectiveness of their implementation.”<sup>12</sup>

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<sup>12</sup> MONEYVAL, the Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, is the Financial Action Task Force (FATF)-style regional body of which Serbia is a member and which conducts AML/CFT mutual evaluations on a regular basis by reference to the FATF Recommendations.

**ANNEX—OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY  
ASSESSMENT OF COMPLIANCE WITH THE BASEL CORE PRINCIPLES FOR EFFECTIVE  
BANKING SUPERVISION**

**Introduction**

1. **This assessment of compliance with the BCP was conducted from October 6 to 21, 2009 as part of the FSAP Update’s evaluation of Serbia’s financial system.** The supervisory framework was assessed against the BCP methodology issued in October 2006. The assessment was conducted by Mr. Miquel Dijkman, World Bank staff, and Mr. Fernand Naert, a consultant with the IMF and former Belgium banking supervision agency staff.

**Information and methodology used for assessment**

2. **The NBS generously provided the assessment team with key documentation, including a self-assessment of compliance with the 25 BCPs completed by the BSD, the legal and regulatory framework for banking supervision as well as numerous documents available at the NBS’s website.** During their stay, the assessors held extensive discussions with the NBS banking supervision department—including staff from the on- and off-site divisions, the legal division, and the Basel II implementation unit—as well as the legal department, accounting and finance, and the international relations department. The assessors also met with representatives from the MOF and banking institutions. The assessors enjoyed excellent cooperation with their counterparts and received all the information requested. The team extends its thanks to the staff of the various institutions and in particular to the staff of the NBS for their participation in the process and their hospitality.

4. **This assessment was made using the revised BCP and methodology issued in October 2006, and is thus not directly comparable to the 2005 FSAP BCP assessment.**

**Institutional and macroeconomic setting and market structure – overview**

5. **The Serbian financial sector is dominated by the banking industry, which accounts for 89 percent of the financial sector assets.** Total financial assets amount to 71 percent of GDP. Currently 34 banks operate in Serbia. They include 9 state-controlled banks (representing 18 percent of total financial sector assets), 6 local private banks (5 percent of total financial sector assets) and 20 foreign-owned banks (66 percent of total financial sector assets). The NBS is responsible for licensing, regulation and supervision of the aforementioned banks, hereinafter called “scheduled banks.” The NBS is also responsible for the supervision of insurance companies, voluntary pension funds, and leasing companies. Although NBFIs have been growing apace, they remain small with assets representing only 11 percent of the financial sector.

6. **Following the complete overhaul of the financial system in the early transition years, the NBS has undertaken major efforts to upgrade the legal and regulatory framework for banking supervision.** The 2005 LOB envisaged harmonization of the legal framework with international standards, EU Directives and the BCPs on banking supervision.

The NBS also has enhanced risk management standards in the banking sector by issuing a new regulation. Banks are now required to set up risk management systems, including risk identification, measurement, assessment, and mitigation taking into account the scope, type, and complexity of their operations. Furthermore, the NBS issued specific rules on a large number of aspects of banking operations, including liquidity risk management, capital adequacy requirements, loan classification and provisioning, external auditing, and know-your-customer procedures. Mirroring increasing foreign ownership in the Serbian banking sector, the NBS also intensified cooperation with foreign supervisors, although cooperation still needs to be formalized in the form of a bilateral MOU with a number of important home supervisors.

7. **The run-up to the 2008 crisis was characterized by a rapid expansion of banks' balance sheets, financed primarily by buoyant growth in foreign-currency deposits and foreign borrowing.** Although new loans were predominantly dinar-denominated, most were indexed to the euro, thereby increasing the banks' credit risk resulting from their borrowers' exposure to exchange rate risk. In response to these developments, the NBS introduced a special 125 percent risk-weight that is applied to unsecured foreign-currency lending to borrowers with an unmatched foreign currency position, and 75 percent risk-weight that is applied to foreign-currency lending to borrowers with an unmatched foreign currency position but secured by a mortgage on residential property. The NBS had also imposed limits on the ratio of gross household loans to core capital. The limit was lowered from 200 percent to 150 percent in November 2007 before it was abolished altogether in June 2009. A number of foreign banks responded by increasing capital. As a result, Serbian banks were (and are) among the best-capitalized in the region, with capital adequacy in the order of 20 percent. Liquidity ratios were similarly reassuring, with liquid assets representing more than 40 percent of total assets. Partly reflecting high solvency buffers, profitability in the Serbian banking system was typically low by regional standards. By 2009H1, the average ROE amounted to 4.1 percent, compared to 9.3 percent in 2008.<sup>13</sup>

8. **The global financial turmoil began to spill over to Serbia in late 2008.** The turmoil manifested itself initially in the form of sharp corrections in the stock market, rising sovereign spreads, slowing capital inflows and—amid high volatility and frequent NBS interventions—a depreciation of the dinar. Credit growth came to a sudden halt and the economy went into a recession.

9. **Although the Serbian banking sector entered the crisis with reassuring solvency and liquidity buffers, these developments signaled increasing financial stability risks.** Overall, NPLs increased from 11.3 percent of total loans in 2008 to 16.5 percent in 2009H1. NPLs are more than covered with total provisions.

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<sup>13</sup> As an illustration, the ROE amounted to 20.7 percent for Poland and 19.5 percent for Bulgaria (2008Q4; Financial Soundness Indicators).

10. **In response to the crisis, Serbia launched a FSSP, involving a balanced mix of commitments and incentives to ensure that the banking system's capital and liquidity levels remain adequate.** This involves a commitment of parent banks of participating foreign subsidiaries to maintain their exposure to Serbia at their end-2008 level, provide adequate capital and liquidity support to their subsidiaries, and have their subsidiaries participate in a diagnostic study involving stress tests. Subsidiaries and local banks participating in the FSSP are required to facilitate voluntary conversion of FX and FX-linked loans into local currency loans, work with the NBS toward developing a common loan workout scheme, and facilitate loan restructuring under a pre-agreed framework. This entails an extension of remaining loan maturity by at least 12 months or 20 percent with reduced monthly payments, or any other restructuring that lowers monthly payments by at least 20 percent. In return, banks participating in the FSSP are granted access to an extended dinar liquidity facility and a foreign exchange swap facility.

#### **Preconditions for effective banking supervision**

11. **Prior to the crisis, Serbia posted several years of solid economic growth, which was mainly driven by buoyant domestic demand and accompanied by increasing external imbalances.** The NBS introduced inflation targeting by end-2006 and now conducts a managed float of the dinar. This has contributed to a gradual decline in headline inflation, which stood at 6.6 percent y-o-y at end 2009. In the run-up to the crisis, rising fiscal deficits were offset by a booming economy, causing the public debt ratio to decline. Gross public debt currently stands at around 32 percent of GDP. However, Serbia currently faces a number of risks to its macroeconomic and financial sector stability that are of direct relevance to the banking sector.

13. **Weaknesses in enforcement and insolvency mechanisms are among the principal shortcomings in public infrastructure.** Loan loss mitigation in Serbia is hampered by a still evolving but uneven collateral and enforcement framework that complicates restructuring and leads to delays and lower recoveries in execution procedures. On the other hand, some collection mechanisms, like the blocked account process, can cause rapidly escalating blockages of companies' current accounts and immobilize corporate activity. Parts of the collateral and enforcement framework have been improved over the past years, but collective procedures for voluntary dissolution and court supervised insolvency are still costly and ineffective. Judicial enforcement still takes a long time to obtain and enforcing a judgment on collateral may take up to 2–3 years. Although reforms are underway, creditor recoveries in the insolvency process in Serbia are among the most costly and yield the lowest returns in the region.

14. **Market discipline seems to be well-established in the Serbian financial sector.** Banks in Serbia operate in a rather competitive environment, with 34 banks operating in a small, bank-dominated financial system. This is also illustrated by the stability of net interest margins, despite a large drop in profitability in 2009. Banking regulation and supervisory practices do not discriminate between different categories of banks, ensuring a level playing field.

15. **In the context of the financial crisis, several aspects of the crisis management framework were significantly enhanced.** Besides the additional liquidity facilities for banks participating in the FSSP (see Para 10), the NBS opened LOLR facilities up to one year at 150 percent of the policy rate to solvent banks against selected liquid collateral. In response to the deposit run in late-2008, deposit insurance coverage was raised drastically from EUR 3,000 per private individual depositor per bank to EUR 50,000, while the list of eligible depositors was extended to include sole entrepreneurs and SMEs. Coverage levels are currently very high, as 99 percent of deposits of the banking system by number and 90 percent by volume are covered by the DIF. The DIF's total financial assets currently amount to EUR 98.4 million compared to total insured deposits of EUR 5.4 billion. The funding capacity of DIF in case of a systemic crisis is limited, and no government contingency funding lines of credit are in place. The DIF is prohibited from using its funds for bank resolution actions like mergers or sale of selected liabilities and assets. Lastly, a new Banking Stability Law, outlining the legal framework for contingency measures to be activated in the event of a systemic crisis, is awaiting enactment.

### **Main Findings**

16. **Since the previous FSAP, Serbia has made considerable progress toward enhanced compliance with the BCPs and with international standards.** A major overhaul of the legal framework—the enactment of the new LOB in 2005—and the issuance of new regulations provided the basis for this improvement. The assessors are of the view that overall, Serbia is now largely compliant with the BCPs.

17. **While the NBS is to be lauded for its efforts, a number of challenges remain.** The remaining challenges lie primarily in the areas of international cooperation and the strengthening of supervision on risk management for categories beyond credit risk. The following summarizes the main findings of the detailed assessment of compliance with the BCPs.

### **Objectives, independence, powers, transparency and cooperation (CPI)**

18. **The legal framework of the NBS has benefited from the introduction of the LOB, which envisaged enhanced legal powers and much-improved legal protection for NBS's staff.** The NBS can by now be considered functionally independent, and staffing levels seem adequate given the NBS's current supervisory responsibilities and the state of the financial sector. Basel II implementation, the expected growth of the financial sector, and its increasing complexity do, however, highlight the importance of capacity building, both in quantitative and qualitative terms. In this context, it is important that sufficient priority is given to retaining experienced staff. This requires competitive compensation, training, and promotion packages.

19. **Although the NBS takes a proactive stance with regard to cooperation with foreign supervisors, cooperation with a number of important home supervisors is awaiting formalization in the form of bilateral MOUs.** The main impediment is the

mandatory exchange of information between the NBS and the national tax authority, which raises confidentiality concerns on behalf of the home authorities.

### **Licensing and structure (CP 2 – 5)**

20. **The new LOB has brought major improvements, notably with regard to the licensing process and the legal framework for transfer of significant ownership.** The licensing process is now split into two stages and the NBS has the authority to withdraw a bank's license in case conditions that motivated the NBS to grant the license no longer exist. Following the enactment of the new LOB, threshold levels for supervisory approval for transfer of significant ownership have been lowered and are currently in line with best practices. Effective implementation requires rigorous investigation of indirect ownership structures by identifying ultimate beneficial owners. In this context, the NBS could consider requiring banks to make periodical declarations about ultimate beneficial ownership. The LOB spells out clear limits as to maximum investments that banks are allowed to undertake. A body of criteria, on the basis of which proposed acquisitions of *banks* are assessed, is in place, but the framework does not explicitly address the acquisition of non-bank financial institutions.

### **Prudential regulation and requirements (CPs 6 – 18)**

21. **The capital adequacy framework is conservative by regional standards and is broadly aligned with international sound practice.** It seems adequate given the current structure of the Serbian banking sector and the nature of its operations. There is, however, a need to further upgrade the regulatory framework beyond credit risk. The NBS has started issuing new regulations, which is clearly bearing fruit in some areas (e.g. liquidity risk). However, other areas such as market risk, country risk, operational risk and interest rate risk are still in need of an equivalent upgrading, although a new regulation is being prepared as part of Basel II preparations. Even though these risk categories are presently of limited relevance to the Serbian banking sector, upgrading of regulatory and supervisory practices in those areas is necessary in a financial system that is likely to expand and become increasingly complex in the coming years. Basel II implementation, scheduled for 2011<sup>14</sup>, also makes this an urgent issue.

22. **The regulatory framework for asset classification and provisioning is clear and prudent regarding the number of overdue days.** However, the qualitative elements of the framework and the practice of formulating brackets rather than minimum provisioning levels creates differences in interpretation between banks and the NBS, with potentially far-reaching implications for provisioning levels. With regard to governance requirements, enhancement of the compliance function is suggested.

### **Methods of ongoing banking supervision (CPs 19 – 21)**

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<sup>14</sup> The NBS is currently reviewing the possibility to push back Basel II implementation due to the changes in the international environment and legislation.



23. **Methods and techniques for ongoing supervision appear broadly adequate given the current stage of development of the Serbian banking sector.** Thanks to comprehensive reporting requirements, the NBS has ample information on all relevant aspects of the banking sector at its disposal. Through analysis of individual data and compilation of aggregate figures, it has a good overview of the state of affairs at individual banks as well as the banking sector at large. For this purpose, the NBS uses a CAMEL-based methodology, which is also put to use as a planning and prioritization tool.

24. **An important challenge facing the NBS is to ensure that the emphasis in onsite supervision shifts towards more qualitative assessments.** In a similar vein, the current framework could be made more forward looking, e.g. by developing a full early warning system. It is recommended that the NBS build on the coordinated EU efforts within the framework of Basel II implementation. Furthermore, there is scope to further formalize policies and procedures with regard to analysis at the sector level. Lastly, there is scope for enhancing the quality of prudential reporting by enhancing cooperation between the external auditors and the accounting and finance department of the NBS. Reporting requirements could be further aligned with EU practices.

#### **Accounting and disclosure (CP 22)**

25. **Serbian accounting legislation has been brought into full compliance with IFRS standards.** Accounts of banks are audited and certified by external auditors, who need to be recognized to this effect by the NBS. External auditors are legally obliged to notify the NBS whenever they become aware of breaches of laws or NBS regulations. There is an obligation for banks to publish qualitative and quantitative information on risk exposures and/or risk management strategy according to IFRS 7. Further enhancements can be made in order to bring the framework into full compliance with the international standards stipulated in Pillar III of Basel II.

#### **Corrective and remedial powers of supervisors (CP 23)**

26. **Corrective measures and sanctioning powers appear to be well established.** The NBS has a wide spectrum of corrective actions at its disposal. The framework consists of (a) written warnings; (b) ordering letters; (c) a formal NBS Decision to eliminate irregularities; (d) appointment of a receiver; and (e) removal of the license of the bank. The framework is in the process of being expanded, with enhanced responsibility and authority for receivers in the pipeline—including the capacity to impose a temporary moratorium. The NBS also has the authority to impose fines, and can remove and suspend members of the Board of Directors and of the Executive Board. In order to impose these measures, the NBS observes the principle of proportionality. The main priorities are the strengthening of cooperation with other involved supervisors (both domestically and internationally) and ensuring that internal procedures do not prevent the NBS from acting speedily and decisively in the face of serious irregularities.

### Consolidated and cross-border banking supervision (CPs 24 – 25)

27. **The NBS not only supervises banks, but also leasing companies, insurance companies and pension funds, and is therefore in a favorable position to conduct consolidated supervision over banking groups whose controlling entity is established in Serbia.** The NBS exerts due diligence with regard to banks' shareholder structures, their transparency, and the potential impact on supervision. Serbian law requires publication of consolidated statements on the basis of standards inspired by international practice. The possibility of excluding minor entities from consolidation and the very limited impact of subsidiaries on Serbian banks somewhat limit the impact of this requirement. The NBS does not systematically analyze consolidated risk positions, and supervisory requirements for reporting on a consolidated basis by banks can be improved.

28. **The NBS has taken a proactive stance with regard to international cooperation.** It has signed a number of regional MOUs and bilateral MOUs with countries in the region, it participates in supervisory colleges and a number of joint inspections with foreign supervisors have been conducted. The main shortcoming in the area of international cooperation is that the NBS is prevented from signing MOUs with three important EU home supervisors due to its obligations on domestic information exchange with the tax authorities.

**Table 13. Serbia: Summary Compliance with the BCPs—Detailed Assessments**

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	Supervisory objectives are not stated explicitly.
1.2 Independence, accountability and transparency	There is a need for capacity building, both in terms of headcount but also in terms of upgrading skills. Competitive benefits, training opportunities and attractive career prospects are necessary to retain staff.
1.3 Legal framework	The LOB establishes the NBS's authority to set prudential standards with regard to capital adequacy requirements, risk management and corporate government standards.
1.4 Legal powers	The LOB enables the supervisor to address compliance with regulations and the safety and soundness of the banks under its supervision. It also allows the NBS to impose remedial actions.
1.5 Legal protection	The current Law provides NBS staff with ex post compensation for legal expenses. Legal protection to receivers needs to be enhanced.
1.6 Cooperation	Supervisory cooperation with Austria, France and Germany is awaiting formalization in the form of MOUs. This requires a reconsideration of the mandatory exchange of information with the national tax authority.

Core Principle	Comments
2. Permissible activities	The term 'bank' is reserved for banks while the range of permitted activities is kept concise.
3. Licensing criteria	Introduction of a two-phase licensing process has brought major improvements.
4. Transfer of significant ownership	Thresholds for supervisory approval are in line with best practices. The NBS can refuse on various grounds. Effectiveness of supervision depends among other things on the NBS's capacity to identify ultimate beneficial owners. The NBS could consider requiring banks to make periodical declarations about ultimate beneficial ownership.
5. Major acquisitions	Limits are set on major acquisitions. Reviews are, however, not conducted on major non-banking acquisitions, limiting the awareness of and ability to mitigate the attendant risks.
6. Capital adequacy	Capital adequacy requirements and risk weights are conservative. There is scope for aligning the capital requirements framework with that of most EU countries.
7. Risk management process	For risk categories other than credit and liquidity risk management, specific regulation is under preparation but not yet available. There is scope for strengthening the role of qualitative assessments in onsite supervision.
8. Credit risk	The regulatory framework and supervisory practices seem adequate. Special attention needs to be given to the follow-up on restructured and rescheduled loans for assessing the quality of credit risk management.
9. Problem assets, provisions, and reserves	Classification and provisioning rules are prudent, but the qualitative elements and the practice of formulating brackets rather than minimum provisioning levels create scope for differences in interpretation. Loan classification guidance should be made more precise, consistent and transparent.
10. Large exposure limits	Reporting requirements currently do not allow the NBS to highlight geographical portfolio concentrations.
11. Exposure to related parties	The NBS's flexible definition of related parties is helpful in deciding on a case-by-case basis whether material linkages exist. Additional guidance as to which parties are considered related parties would, however, be useful for reporting purposes.
12. Country and transfer risks	Detailed regulation on country risk is currently not available.
13. Market risks	The NBS faces the challenge of taking market risk supervision a step further, i.e., beyond merely checking compliance of procedures and policies, by assessing the specificities of the limits and their appropriateness given the overall characteristics of the institution involved. Scheduled Basel II implementation as of 2011 makes this an urgent issue.

Core Principle	Comments
14. Liquidity risk	Regulation on liquidity risk is in place and is broadly adequate. The current regulation does not require banks to take into account the impact of other risks on the bank's overall liquidity strategy.
15. Operational risk	Specific skills (IT) are currently lacking with onsite teams, impeding effective supervision in these areas. NBS should upgrade its regulation on outsourcing fully up to EU standards.
16. Interest rate risk in the banking book	Secondary regulation on IRBB management is currently unavailable. Similarly, there is a need to step up supervision in this area.
17. Internal control and audit	The scope of compliance responsibility should be upgraded to cover all potential compliance events entailing reputational risks for the bank; the existing ad hoc committee with banks' boards (as prescribed by the banking law) can be upgraded to Audit Committees according to international best practice.
18. Abuse of financial services	The legal framework for AML/CFT is much-improved and broadly adequate. There is scope for some further tightening with regard to screenings for new staff.
19. Supervisory approach	The analysis on the level of the global banking sector should be enhanced; the NBS is recommended to perform regular and recurrent stress tests.
20. Supervisory techniques	The main challenge facing the NBS is to focus towards more qualitative assessments (onsite), as necessitated by Basel II implementation; NBS needs to step up capacity building for this effort as a priority.
21. Supervisory reporting	NBS is recommended to enquire into the means by which reporting can be enhanced through more systematic certification; it can also consider further alignment of reporting requirements with EU practices.
22. Accounting and disclosure	For disclosure by banks, the law should be fully aligned with EU best practices.
23. Corrective and remedial powers of supervisors	Powers appear adequate. The main priorities are the strengthening of cooperation with other involved supervisors – both domestically and internationally – and ensuring that internal procedures do not prevent the NBS from acting speedily and decisively in the face of serious irregularities.
24. Consolidated supervision	For the future, NBS is recommended to require formal reporting for financial data and risk profiles on a consolidated basis and build proper tools for analysis.

Core Principle	Comments
25. Home-host relationships	The requirement for the NBS to exchange information with domestic tax authorities needs to be revisited and aligned with European practice; this would enable the NBS to sign MOUs with all significant home supervisors over Serbian banks; the NBS is recommended to maintain its proactive attitude with regard to information exchange and in cooperation with home supervisors.

## Recommended action plan and authorities' response

### *Recommended action plan*

**Table 14. Serbia: Recommended Action Plan to Improve Compliance with the BCPs**

Reference Principle	Recommended Action
Independence (BCP 1.2)	Supervisory objectives should be made more explicit
Legal protection (BCP 1.5)	Rather than providing ex post compensation for legal expenses, the legal framework should offer compensation up front. Legal protection for receivers needs enhancement.
Cooperation (BCP 1.6)	The main priority is to clear the way for concluding MOUs with Austria, France, and Germany. This requires a reconsideration of the mandatory exchange of information with the national tax authority.
Major Acquisitions (BCP 5)	The supervisory approval process for evaluating major acquisitions is well established for banks, but a corresponding body of criteria needs to be established for the non-banking sector.
Capital Adequacy (BCP 6)	The main priority is to increase alignment of the capital adequacy framework with the EU.
Risk Management Process (BCP 7)	Risk management regulation needs to be extended to risk categories that are not yet covered. Furthermore, onsite supervision should increasingly focus on the quality and adequacy of risk management policies in banks.
Credit Risk (BCP 8)	The NBS is recommended to monitor banks' strategies and practices with regard to restructuring and/or rescheduling of loans.
Problem assets, provisions and reserves (BCP 9)	Establishing a more precise set of criteria for loan classification because the qualitative elements of the loan classification framework and the practice of formulating brackets currently create scope for differences in interpretation.
Large Exposure Limits (BCP 10)	Reporting requirements could be enhanced to allow for the monitoring of geographical concentrations.
Exposures to related parties (BCP 11)	Additional guidance as to which parties are considered related parties would be useful in order to prevent differences of interpretation between the banks and the NBS.

Reference Principle	Recommended Action
Country and transfer risks (BCP 12)	An upgrading of the supervisory framework for country risk, by issuing secondary legislation specifying the minimum requirements for managing country risk, is recommended.
Market risk (BCP 13)	In addition to issuing a specific regulation on market risk, the NBS faces the challenge of taking market risk supervision a step further by assessing the specificities of limits and their appropriateness given the overall characteristics of the institution involved.
Liquidity risk (BCP 14)	The current regulation could be enhanced in order to ensure that the impact of other risks is taken into account in the bank's overall liquidity strategy.
Operational risk (BCP 15)	The main priority is to upgrade supervisory skills in the area of operational risk, with skill shortages especially acute in the area of IT.
Interest rate risk in the banking book (BCP 16)	The key recommendation is to provide banks with additional guidance by issuing a specific regulation on IRBB.
Internal control and audit (BCP17)	The main recommendation is to broaden the scope of the compliance function to cover all domains where breaches of laws or regulations can expose the bank to reputational risk. The reporting line of internal audit could be enhanced by the requirement to install an audit committee according to international standards.
Abuse of financial services (BCP 18)	Banks should be required to conduct screenings for new staff as standard routine.
Supervisory approach (BCP 19)	The analysis on the level of the banking sector could be enhanced, while the NBS is recommended to conduct regular stress tests.
Supervisory techniques (BCP 20)	The main challenge facing onsite supervision is to shift towards qualitative assessments, which in turn require capacity building as a matter of priority.
Supervisory reporting (BCP 21)	The reliability of reporting could be enhanced through more regular certification, which would require cooperation with external auditors. Reporting requirements could be further aligned with EU practices.
Accounting and disclosure (BCP 22)	Disclosure requirements should be enhanced by fully aligning them with EU best practices.
Corrective and remedial powers of supervisors (BCP 23)	The main priority is to strengthen cooperation with other supervisors (both domestically and internationally) and ensure that internal procedures do not prevent the NBS from acting speedily and decisively in the face of serious irregularities.
Consolidated supervision (BCP 24)	Banks should be required to report on a consolidated basis for key financial indicators (e.g. CAR, provisioning, etc).
Home-host relationships (BCP 25)	The main priority is to clear the way for concluding MOUs with Austria, France, and Germany. This requires a reconsideration of the mandatory exchange of information with the national tax authority.

*Authorities' response*

31. The following response was received from the NBS: "The National Bank of Serbia appreciates the recommendations, considers them as very valuable and, in general, in line with our own assessment and priorities for the forthcoming years.

This is particularly the case with regards to necessity to further upgrade supervisory skills in terms of number of supervisors and their expertise, as well as to provide for adequate framework for retaining experienced staff. Moreover, we fully recognize that risk management regulations, as well as internal supervisory tools and manuals, need to be additionally improved in order to cover all types of risk in more details. We are fully devoted to aligning both regulation and supervisory practices with internationally recognized best practices in line with strategic orientation of the Republic of Serbia to integration in EU.

With that regards, during the year 2007 the National Bank of Serbia adopted the Basel II Implementation Strategy and Action Plan and this project addresses most of the shortcomings identified in the assessment. As it has done so far, the National Bank of Serbia in this process upholds to principles of full transparency and communication with the industry.

Finally, we would like to emphasize following:

- We are closely observing the most recent developments and changes in the international standards and principles, triggered by the recent financial crisis, and we are aligning our plans and actions with them.
- The priorities in developing regulations and supervisory tools for risk management categories are based on the assessment of their materiality for Serbian banking sector.
- Recognizing the significance of adequate home-host cooperation, the National Bank of Serbia is participating in all initiatives from the host supervisors, and continuously initiates communication and information sharing. However, this is a two way process and adequate improvement in this area is subject to effort on both sides."

## Appendix I: Implementation of 2005 FSAP Recommendations

<i>Recommended Measures of Final Aide-Mémoire</i>	<i>Responsible Entity</i>	<i>Status of Implementation</i>
<b>Banks and Banking Supervision</b>		
Adopt a time bound corrective action plan to address deficiencies in compliance with BCP.	NBS	Plan was adopted.
Ensure banks provide the NBS with accurate asset classifications on their loans.	NBS	By-laws on asset classification adopted.
Expand NBS data gathering capabilities to capture all foreign currency and foreign currency indexed loans.	NBS	Done in NBS Decision 51, June 2005.
Require banks to monitor and assess borrower's exposure to exchange rate risk and to reflect their assessment in the loan classification.	NBS	Done in NBS Decision 51, June 2005
Revise the criteria for loan loss provisions to minimize the number of reductions in the required provisions that are allowed.	NBS	Implemented in by-laws pursuant to the LOB.
Undertake full-scope examination of the largest state banks and ensure that recommendations arising from examinations are adopted.	NBS	Two large state-owned banks were recapitalized in 2006 by the EBRD and are now under majority ownership of EBRD and the state. Plans to merge the remaining majority state-owned banks are evolving. Two are planned to be merged into a third bank, and the fourth one will seek a strategic partner.
Bring forward the privatization agenda for the two large state-controlled banks.	MOF/DIA	One of the banks was sold into foreign ownership. The other is still state-controlled, but with EBRD also as a shareholder. Discussions are being held toward recapitalization.
Strengthen all state controlled banks' reporting requirements.	MOF/DIA	Done
Revise NBS chart of accounts to conform to International Financial Reporting Standards (IFRS) accounting principles.	NBS	Done
Require bank boards to have audit committees comprising a majority of independent members.	NBS	The LOB requires that banks have an audit committee of at least three members, at least two of which are members of the bank's board of directors, and with at least one independent member (Articles 79 and 80).
Require banks to disclose to borrowers the effects of foreign exchange fluctuations on their debt service costs.	NBS	Done in NBS Decision, December 2005
Enforce the limits for exposure to large borrowers with respect to state-controlled banks.	NBS	
Require that all state banks' directors are subject to NBS "fit and proper" criteria.	NBS	Done in new LOB for new directors of all banks (Articles 71 and 72).
Amend banking law to authorize the NBS to supervise banks on a consolidated basis.	NBS	The new LOB extends the mandate of the NBS to undertake consolidated supervision (Articles 2, 122, 123, 125, 126, and 127).
Reduce significant ownership level criterion for prior approval by the NBS from 15 percent to 5 percent, or lower if significant influence will be acquired.	NBS	Done in new LOB (Article 95).
Seek explicit statutory protection for the NBS and its officers and staff when performing banking supervision in good faith in accordance with the law.	NBS	Done in new LOB (Article 121)



<i>Recommended Measures of Final Aide-Mémoire</i>	<i>Responsible Entity</i>	<i>Status of Implementation</i>
Establish limits for a bank's aggregate exposures to related parties.	NBS	Done in new LOB (Article 33).
Require bank boards of directors to accept responsibility for establishing and overseeing integrated risk management systems.	NBS	Done in new LOB (Articles 73 and 141)
Include IT specialists within the NBS examinations staff.	NBS	In progress
Define the powers of the courts in the Banking Law to review the substantive or technical decisions of NBS.	MOJ/NBS	The new LOB calls for limits on the powers of the courts to review NBS decisions (Article 9).
Increase further the statutory reserve requirement (SRR) ratio on enterprises' foreign-currency deposits and commercial banks' foreign borrowing.	NBS	The SRR for enterprises has been raised to 38 percent in December 2005 and unified with the SRR for households.
<b>Monetary Policy</b>		
Introduce a single, fully collateralized lender of last resort facility priced at a multiple of the market rate.	NBS	Three lending facilities were unified into one lending facility, which is linked to the repo rate.
Lower the daily minimum requirement of 80 percent of the SRR.	NBS	The NBS has lowered the minimum to 50 percent during 2008.
Link the ceiling and the floor of the interest rate corridor with market conditions.	NBS	In November 2005 the ceiling of the corridor was linked with the repo rate.
Initiate the process of participation of Serbia in the general data dissemination system (GDDS).	NBS/NOS	Done. As of May 2009, Serbia has become a participant in the GDDS.
<b>Financial sector development</b>		
Increase transparency of ownership and control of traded companies.	SC	
Require publication of the full IFRS audit report, supporting schedules and auditor's opinion.	NBS	Done in new LOB.
Strengthen the responsibility and accountability of supervisory boards.	SC/MOF	Done in new LOB.
Increase shareholder protection during capital increase and takeovers.	MOF	Enforcement has been strengthened; no legislative changes.
Ensure IFRS and NBS accounting rules are fully applied to insurance company fixed assets and receivables.	NBS	NBS accounting rules are being fully applied to accounts receivable.
Commence NBS on-site examinations at two large socially owned insurers.	NBS	Done.
Require DDOR and Dunav each to submit their business plans and appoint financial advisors to develop and execute a privatization strategy.	DIA	DDOR has been fully privatized in 2007 while privatization of Dunav is yet to be initiated.
Develop a strategy for funding Third Party Liability Insurance under the guarantee arrangement.	NBS	The new MTPL law was adopted by the Parliament and became effective on October 12, 2009
Phase out restrictive trade practices regarding mandatory reinsurance cessions and long-term property insurance contracts.	NBS	Not done.
Implement the corrective action plan for AML/CFT recommendations put forward in MONEYVAL report.	APML	
Strengthen the Securities Commission (SC) legal authority and institutional capacity.	SC	Institutional capacity enhanced by reorganization and introduction of new remuneration guidelines in July 2005.

<b><i>Recommended Measures of Final Aide-Mémoire</i></b>	<b><i>Responsible Entity</i></b>	<b><i>Status of Implementation</i></b>
Develop regulatory framework for investment funds in line with EU Directives and international practice.	SC	A New Law on Investment Funds was submitted to Parliament in September 2005.
Finalize and implement the law on voluntary pensions.	MOF	A New Law on Voluntary Pensions was passed in September 2005.
Constitute the MOF Commission to adopt certified auditors and accountants.	MOF	Done
Modify accounting and auditing legislation in line with the recommendations of the Accounting and Auditing ROSC.	MOF/NBS	Accounting legislation has been brought in full compliance with IFRS standards.